Chapter I

Overview

Global Economy

1.1 The phase of high economic growth continued during 2005 with global economic growth at 4.9 per cent[1]. This was the third year in succession when the world GDP growth exceeded 4.0 per cent level. The strength of world GDP growth, well above its long-run average of 3.8 per cent, was accompanied by a growing resilience to large systemic shocks, particularly the rise in international oil prices. The growth in the world output was led by emerging Asia, accounting for more than half of the increase in global output in 2005, while the US and Europe grew at a somewhat lower rate during the year. Robust growth in Asia in 2005 was led by China (10.2 per cent), India (8.4 per cent) and Hong Kong (7.3 per cent). The long-awaited revival of Japan is expected not only to add to the dynamism of the Asian region but also strengthen growth in the OECD countries. In Russia and Latin America too, growth has been buoyant. In the United States, high oil prices, rising short-term interest rates, slackness in housing markets and the hurricanes in September contributed to slowing down of real GDP growth to 3.2 per cent in 2005 from 3.9 per cent in 2004. In the euro area, a recovery is underway with real GDP growth rising to 1.3 per cent in 2005.

1.2 Headline inflation firmed up in a number of economies in 2005, reflecting price pressures emanating mainly from spiraling oil prices. Supported by rapid demand growth (especially in emerging Asia), non-energy commodity prices also displayed rising trend through 2005. The oil market faced extreme uncertainty during 2005 on account of two destructive hurricanes in the US Gulf Coast, tensions in the Middle East, political unrest in some other oil exporting countries and limited spare capacity. The international pass-through of oil prices to domestic retail prices has, however, varied across countries with varying implications for future inflation. The inflation expectations during 2005 remained relatively contained, despite strengthening of oil and non-oil prices.

1.3 Global financial imbalances widened further during 2005 with the US current account deficit surpassing US$ 800 billion level in an environment of rising interest rates worldwide and ample liquidity in global financial markets. Financial markets stayed calm despite further deterioration in the US current account balance.

1.4 In an environment of above trend growth in the world economy, unusually low volatility in financial markets and strong profitability, investors purchased risky assets at relatively high prices in 2005. Measures of implied volatility extracted from option prices in major foreign exchange, interest rate and equity markets have been at their lowest levels in several years, suggesting that these favourable developments are expected by the markets to continue. Real short-term and long-term interest rates in the major currency areas stayed well below long-term averages. Ten-year bond yields in Japan, the euro area and the US were at 1.9 per cent, 3.9 per cent and 5.0 per cent, respectively. Associated with this development, low risk premia supported asset values across the board. Housing prices boomed in many countries. Equity prices increased to multi-year highs in the major economies. Unusually tight credit spreads accompanied an acceleration of credit growth to rates comparable to those observed in the late 1990s. The main exception to this general pattern was commodity prices, which showed considerable volatility in recent years.

1.5 However, large fiscal deficits, household savings at unsustainably low levels in some of the developed economies (especially the US), low corporate investment and high global current account imbalances still pose a challenge to the current global upswing.

Developments during 2006

1.6 Global growth accelerated in the first half of 2006 and appears to be getting diffused across the main economic regions. Global growth is expected to pick up from 4.9 per cent in 2005 to

[1] Global developments in this Chapter relate to the calendar year (January to December), while those on the Indian economy relate to the fiscal year (April-March), unless otherwise specified.

5.1 per cent in 2006 (IMF, 2006). In the US, real GDP growth in the third quarter (July-September) was recorded lower at 1.6 per cent as compared with 5.6 per cent and 2.6 per cent in the first and second quarters, respectively. The slowdown in the US economy is expected to be offset by stronger growth in other parts of the world. According to the World Economic Outlook of the IMF released in September 2006, while the growth in the euro area is expected to increase to 2.4 per cent in 2006 – its highest rate in six years – before moderating to 2.0 per cent in 2007, the Japanese economy would grow by 2.7 per cent in 2006, based on strong domestic demand, before easing to 2.1 per cent in 2007. Growth in emerging markets and developing countries is expected to remain very strong at 7.3 per cent in 2006, and moderate only marginally to 7.2 per cent in 2007.

1.7 Consumer price inflation in the advanced economies accelerated in the second quarter of 2006; there was, however, some easing during September 2006 on the back of base effect as well as the sharp decline in international crude oil prices. In the US, consumer prices rose to 4.3 per cent in June 2006 from 3.5 per cent in April, 2006 but eased to 2.1 per cent in September 2006 broadly in tandem with movements in oil prices. In the euro area too, inflation rose to 2.5 per cent in May and June from 2.4 per cent in April; it was 1.8 per cent in September 2006. In major industrial countries, movements in inflation have been driven mainly by movements in oil prices. Crude oil prices started increasing from April 2004 and almost doubled in little over next two years, touching a high of US$ 78.7 per barrel on July 14, 2006. Since then, prices eased sharply to reach around US$ 60 per barrel in the second half of September 2006 and fell below US$ 60 a barrel in early October 2006 on the back of signs of slowdown of global demand, easing of tensions over Iran's nuclear programme and substantial build-up of US inventories. Although prices have eased significantly over the past one month, they still remain quite high. Substantial increases have occurred in a wide range of commodity prices. While prices of oil and metals continue to be the main drivers, food prices have also started edging up. Inflation expectations have also been reflected in the gap between nominal and inflation-indexed bonds which hovered in the range of 2.2-2.7 per cent in the US during May-July, 2006.

1.8 In fact, the recent turmoil in global markets appears to have been triggered by key commodity prices. In addition, risks loom large in the form of lagged second order effects of oil price increases, geo-political tensions, the probability of disruptive adjustment of current account imbalances and the cooling of global housing market.

1.9 Global imbalances, emanating mainly from the twin deficits of the US, continued to widen during 2006 in an environment of rising interest rates worldwide and prospects of contraction of liquidity in the global financial markets. This was matched by increased current account surpluses elsewhere, particularly in Japan, Europe, China and other parts of emerging Asia and oil-exporting countries. The sharp rise in the net foreign liability position of the US raises the risks of an abrupt and disorderly adjustment of major currencies.

1.10 Financial markets are becoming increasingly apprehensive about the risks of a disorderly adjustment of the widening global imbalances. Adverse expectations of markets were recently evident in the large declines in stock exchanges across the globe and a visibly increased preference for debt. Long-term sovereign bond yields, which had moved up briefly, have again fallen well below their long-run averages. Yield curves have either flattened or inverted in major industrial economies. Against the background of these global developments, a large number of central banks recently raised their official interest rates from the unusually low levels that they had reached earlier in the decade.

Indian Economy

Macro Environment

1.11 The Indian economy recorded a strong growth rate of 8.4 per cent during 2005-06 on top of 7.5 per cent growth in the previous year. Real GDP growth between 2003-04 and 2005-06 averaged at 8.1 per cent. The real GDP growth in 2005-06 was contributed by the recovery in agriculture and sustained expansion in industry and services. Real GDP originating from agriculture and allied activities registered a growth of 3.9 per cent, recovering from a low of 0.7 per cent in the previous year. The growth of real GDP originating from industry is estimated by Central Statistical Organisation (CSO) to have moved up to 7.6 per cent in 2005-06 from 7.4

per cent in the previous year. The industrial production, based on index of industrial production (IIP), recorded an impressive growth of 8.2 per cent during 2005-06 on top of 8.4 per cent growth a year ago. Sustained expansion in domestic as well as export demand and increased capacity utilisation underpinned the strength of the manufacturing sector. The services sector maintained a double-digit growth of 10.3 per cent during 2005-06, which was marginally higher than 10.2 per cent growth in the previous year. The services sector, with almost three-fifth of share in the GDP, led the Indian economic growth in 2005-06.

1.12 Headline inflation, measured by year-on-year variations in the wholesale price index (WPI), was lower at 4.1 per cent at end-March 2006 compared with 5.1 per cent a year ago. In April 2005, inflation ruled high at around 6.0 per cent, reflecting increase in prices of fruits and vegetables, iron and steel and select petroleum products. Subsequently, with the revival of the monsoon, inflation began to ease and reached an intra-year low of 3.3 per cent by August 27, 2005. Inflation again edged up during the third quarter of 2005-06 – but remained below 5.0 per cent - under the impact of the hike in petrol and diesel prices in early September 2005 as also higher vegetable prices. During January-March 2006, seasonal easing of vegetable prices as well as reduction in domestic iron and steel prices offset upward pressures from non-ferrous metals and electricity. Despite dominance of supply-side pressures emanating from oil price increases, headline inflation for 2005-06 turned out to be lower than anticipated. Several factors helped in containing inflation such as pre-emptive monetary policy actions in the form of reverse repo rate hikes, the incomplete pass-through of international oil prices to domestic prices, productivity gains in several sectors and improved corporate profitability.

1.13 The gross fiscal deficit (GFD) to GDP ratio for 2005-06 was at 4.1 per cent as against the budget estimate of 4.3 per cent. The improvement in the GFD was facilitated by a decline in capital outlay and the availability of disinvestment proceeds. The revenue deficit, though lower in absolute terms, remained at budgeted level of 2.7 per cent of GDP in 2005-06.

1.14 Broad money (M3) registered a higher growth of 17.0 per cent during 2005-06 compared with 12.1 per cent during the previous year and 14.5 per cent projected in the Annual Policy Statement for 2005-06. The year-on-year increase in bank credit to the commercial sector, was higher at 27.0 per cent compared with the increase of 22.8 per cent in the previous year. The overall net bank credit to the Government increased by Rs.20,386 crore during 2005-06, as compared with Rs.1,670 crore in 2004-05, reflecting the liquidity injection operations mainly undertaken from November 2005 to March 2006. The banking sector's net foreign exchange assets increased reflecting primarily the increase in net foreign exchange assets of the Reserve Bank. The non-resident foreign currency deposits of scheduled commercial banks declined by Rs.16,876 crore during 2005-06 as against an increase of Rs.802 crore during 2004-05 mainly due to the India Millennium Deposits (IMD) redemption (US $ 7.1 billion or Rs.31,959 crore) in December 2005.

1.15 The Reserve Bank continued to take measures to increase depth and liquidity in the money, the Government securities and the foreign exchange markets during the year. Financial markets generally remained orderly during 2005-06 although interest rates firmed up across the spectrum in the second half of the year. Liquidity conditions were generally comfortable, except for some tightness in the fourth quarter due to redemption of IMDs, amidst sustained credit growth and build up of cash balances by the Government. The total overhang of liquidity as reflected in outstandings under the Liquidity Adjustment Facility (LAF), the Market Stabilisation Scheme (MSS) and surplus cash balances of the Central Government increased marginally from March to October 2005, but declined steadily thereafter till February 2006. The overnight rates in the call money, market repo and collateralised borrowing and lending obligations (CBLO) segments, which were around the lower end of the LAF rate corridor till October 2005, started hardening in November as the shift in liquidity conditions from surplus to deficit rendered a few market participants short of both liquidity and collateral securities. The overnight rates, which were around the LAF reverse repo rate, registered a sharp rise responding to the underlying liquidity conditions. While on many occasions the overnight rates in the call money segment went above the LAF corridor during the third quarter of 2005-06, rates in the collateralised markets moved towards the upper end of the LAF corridor during the same quarter. Interest rate in the call market moved up from an average of 5.12 per cent in October 2005 to 6.93 per cent in February 2006, before moderating to 6.58 per cent in March 2006. A noteworthy development during the year was the substantial migration from the uncollateralised call money segment to the CBLO market.

1.16 The weighted average discount rate (WADR) on commercial paper of 61-90 day maturity rose to 8.72 per cent in March 2006 from 5.89 per cent in March 2005. As on July 15, 2006, the WADR of CPs of same tenor declined by 176 basis points to 6.96 per cent. In the Government securities market, the primary market yields of 91-day and 364-day Treasury Bills increased from 5.12 per cent and 5.60 per cent at end-April 2005 to 6.11 per cent and 6.42 per cent, respectively, at end-March 2006. The 182-day Treasury Bill yield moved up from 5.29 per cent to 6.61 per cent during the same period. The primary market yields of 91-day, 182-day and 364-day Treasury Bills were 5.49 per cent, 6.14 per cent and 6.06 per cent, respectively, in the auctions held in April 2006. The yield on Government securities with 5-year and 10-year residual maturity hardened by 87 and 84 basis points, respectively, during 2005-06.

1.17 The equity market witnessed strong rallies with intermittent corrections. The BSE Sensex (1978-79=100) increased sharply by 73.7 per cent, on a point-to-point basis, during 2005-06, fuelled largely by large investments by foreign institutional investors (FIIs) and domestic investors on the back of strong macroeconomic fundamentals.

1.18 India's balance of payments (BoP) position remained comfortable during 2005-06, despite pressures from record high international crude oil prices. India's merchandise exports remained robust for the fourth year in succession, averaging 24.0 per cent per annum, reflecting increasing competitiveness of the technology intensive domestic manufacturing. Growth in non-oil imports also remained strong on the back of buoyant investment activity. The surplus on the invisibles account expanded led by exports of software and other business services, and private remittances, thereby financing almost four-fifth of the trade deficit. The current account deficit widened during 2005-06, reflecting the cumulative impact of high level of international crude oil prices and growth in imports underpinned by strong industrial activity. As a proportion of GDP, the current account deficit, however, remained modest. Net inflows under major components of capital flows, foreign direct investment (FDI), portfolio investment and NRI deposits were higher than a year ago, reflecting increased appetite for domestic financial assets and growing interest in the economy's growth. Both FDI and foreign portfolio investment flows increased during 2005-06. FDI registered a robust growth of 28.0 per cent during 2005-06 on the back of positive investment climate, improved growth prospects and initiatives undertaken aimed at rationalising and liberalising the FDI policy and simplifying the procedures. Portfolio equity flows increased further during 2005-06, mainly on account of higher inflows from FIIs.

1.19 India's balance of payments position has continued to remain comfortable during 2006-07 so far. Merchandise exports recorded a strong growth during April-September 2006, *albeit* lower than last year. Growth in non-oil imports registered a sharp deceleration, partly on account of decline in imports of gold and silver. Imports of capital goods increased on the back of investment demand, notwithstanding some deceleration on a high base. Oil imports remained large in view of further hardening of international crude oil prices. The surplus on the invisibles account remained buoyant during the first quarter of 2006-07, led by exports of software and other business services, and the private remittances. It financed two-thirds of the trade deficit. The current account deficit during the first quarter of 2006-07 widened from a year ago, reflecting higher trade deficit.

1.20 India remained one of the largest recipients of portfolio inflows during 2005. With capital inflows substantially higher than the current account deficit, the overall BoP recorded a surplus during 2005-06. Consequently, India's foreign exchange reserves increased by US$ 10.1 billion during 2005-06 to reach US$ 151.6 billion at end-March 2006, which was the fifth largest stock of international reserve assets among emerging market economies.

Scheduled Commercial Banks

1.21 The banking sector reflected a pick-up in the real economic activity during 2005-06. In the backdrop of robust macroeconomic environment, bank credit witnessed a strong expansion for the second year in succession. The demand for credit was also broad-based led by the housing and the retail sectors. The growth in deposits, though higher than the previous year, was insufficient to meet the high credit demand forcing the banks to liquidate their holdings of Government securities. It was the first time since the nationalisation of banks in 1969 that investment by commercial banks in Government securities declined in absolute terms (by Rs.19,514 crore) in any single year. Similarly, investments by the commercial banks in bonds/debentures/shares of the corporate sector also declined during the year.

1.22 Commercial banks' holdings of Government and other approved securities declined from 38.2 per cent of their net demand and time liabilities (NDTL) at end-March 2005 to 31.3 per cent at end-March 2006. While the excess SLR holdings amounted to Rs.1,45,297 crore at end-March 2006, several banks now seem to be operating their SLR portfolios close to the statutory minimum level of 25.0 per cent.

1.23 Interest rates on deposits of over one year maturity of public sector banks (PSBs) moved up from 5.25-7.25 per cent in April 2005 to 5.50-7.75 per cent in March 2006. During the same period, the benchmark prime lending rates (BPLRs) of public sector banks and foreign banks remained unchanged in the range of 10.25-11.25 per cent and 10.00-14.50 per cent, respectively. The BPLRs of private sector banks moved up to a range of 11.00-14.00 per cent from 11.00-13.50 per cent in the same period. The median lending rates for term loans (at which maximum business is contracted) in respect of major PSBs, which remained unchanged at 8.00-11.63 per cent during December 2005 to March 2006, increased to 8.00-12.00 per cent in June 2006 and further to 8.50-12.00 per cent in September 2006 (provisional).

1.24 The net profits of the scheduled commercial banks (SCBs) as a group increased during 2005-06 (Table I.1). The sharp rise in credit growth was a accompanied by a significant improvement in asset quality as reflected in the decline in the gross and net non-performing assets (NPAs) of SCBs, both in absolute terms and in relation to loans and advances. This trend was witnessed across all the bank groups. Robust macroeconomic environment and various institutional measures put in place by the Reserve Bank/Government have improved the recovery climate significantly.

1.25 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, increase in risk weights on lending to certain sectors and application of capital charge for market risk. Tier I capital adequacy ratio increased significantly to 9.3 per cent in March 2006 from 8.4 per cent in March 2005, partly due to transfer of IFR from Tier II capital and partly due to increase in reserves and surplus, and fresh resources raised from the capital market, both domestic and international. The higher Tier I ratio implies the availability of more headroom for raising capital funds through the Tier II route.

Co-operative Banks

1.26 Operations of the urban co-operative banks (UCBs) witnessed a moderate growth during 2005-06 financed mainly by deposits growth. While loans and advances as well as investments witnessed a moderate growth, non-SLR investments grew substantially. Sharp growth was also noticed in short-term deployment of funds. The financial performance of scheduled UCBs improved significantly. Asset quality of UCBs improved markedly, both in absolute terms and relative to the loan portfolio.

1.27 Business operations of all segments of rural co-operative banks expanded during 2004-05. Sharp growth in credit was observed in sync with other segments of the financial sector, while deposits grew moderately. There were wide variations, however, across institutions. Within the short-term rural structure, while the state co-operative banks earned lower profit, district central co-operative banks earned higher profit. Primary agricultural credit societies (PACS), on the whole, continued to record overall losses, although many of them earned profit. In the case of long-term co-operative structure, while the state co-operative agriculture and rural development banks made losses, primary co-operative agriculture and rural development banks (PCARDBs) made a turnaround. Asset quality of

Table I.1: Select Financial Sector Indicators: 2005-06

Category		Indicator	2004-05	2005-06
1		2	3	4
1. Scheduled Commercial Banks	a)	Growth in Major Aggregates (per cent)		
		Aggregate Deposits	16.6	17.8
		Loans and Advances	33.2	31.8
		Investment in Government Securities	9.4	-1.0
	b)	Financial Indicators (as percentage of total assets)		
		Operating Profits	2.2	2.0
		Net Profits	0.9	0.9
		Spread	2.8	2.8
	c)	Non-Performing Assets (as percentage of advances)		
		Gross NPAs	5.2	3.3
		Net NPAs	2.0	1.2
2. Urban Co-operative Banks	a)	Growth in Major Aggregates (per cent)		
		Deposits	-4.7	6.9
		Credit	-1.6	5.2
	b)	Financial Indicators (as percentage of total assets)@		
		Operating Profits	0.8	1.1
		Net Profits	0.2	0.5
		Spread	1.8	1.9
	c)	Non-Performing Assets (as percentage of advances)		
		Gross NPAs	23.4	19.7
		Net NPAs	12.5	9.6
3. Rural Co-operative Banks	a)	Number	1,09,924	–
	b)	Growth in Major Aggregates (per cent)		
		Deposits	3.3	–
		Credit	9.0	–
	c)	Financial Indicators (as percentage of total assets)@		
		Societies in Profit (Number)	47,610	–
		Societies in Loss (Number)	61,872	–
		Overall Profit/Loss (Rs. crore)	232	–
	d)	Non-Performing Assets (as percentage of advances)*	24.4	–
4. All-India Financial Institutions	a)	Growth in Major Aggregates (per cent)#		
		Sanctions	-45.1	38.9
		Disbursements	-37.0	33.9
	b)	Financial Indicators (as percentage of total assets)**		
		Operating Profits	1.2	1.4
		Net Profits	0.8	1.0
		Spread	1.6	1.8
	c)	Non-Performing Assets (as percentage of advances)**		
		Net NPAs	4.0	1.1
5. Non-banking Financial Companies (excluding RNBCs)	a)	Growth in Major Aggregates (per cent)		
		Public Deposits	-9.1	-32.1
	b)	Financial Indicators (as percentage of total assets)		
		Net Profits	1.6	0.4
	c)	Non-Performing Assets (as percentage of advances)##		
		Net NPAs	2.5	0.4
6. Residuary Non-banking Companies (RNBCs)	a)	Growth in Major Aggregates (per cent)		
		Deposits	8.3	21.5
	b)	Financial Indicators (as percentage of total assets)		
		Net Profits	0.5	0.7

@ : Relating to scheduled urban co-operative banks.
* : Includes overdues amount for PACS. .
# : Relating to IFCI, IIBI, SIDBI, IVCF, ICICI Venture, TFCI, LIC, and GIC.
** : Relating to seven FIs, *viz.*, IFCI, IIBI, Exim Bank, TFCI, SIDBI, NABARD and NHB.
: For reporting companies with variations in coverage.

short-term rural co-operative institutions improved, while that of long-term institutions deteriorated during the year. Improvement in the recovery performance of the PACS brought down their overdues ratio.

Financial Institutions

1.28 Financial assistance sanctioned and disbursed by all-India financial institutions (AIFIs) registered a sharp turnaround during 2005-06. Financial assistance sanctioned and disbursed by FIs increased by 38.9 per cent and 33.9 per cent, respectively, during 2005-06 as compared with a sharp decline of 45.1 per cent and 37.0 per cent, respectively, during the previous year. Almost all categories of financial institutions witnessed a high growth during 2005-06 as against the varying performance witnessed during 2004-05.

1.29 Capital adequacy ratio of FIs, barring the two loss-making institutions, continued to be significantly higher than the prescribed norms. However, CRAR of IIBI and IFCI eroded further during the year on account of continued financial losses.

1.30 The higher lending rates accompanied with reduced costs resulted in higher spread for FIs as the net interest income as percentage of total assets increased to 1.8 per cent in 2005-06 from 1.6 per cent in 2004-05. Non-interest income of FIs also registered a significant increase during the year. However, near doubling of operating expenses resulted in erosion of profitability of FIs.

Non-banking Financial Companies

1.31 Total assets/liabilities of NBFCs (excluding RNBCs), which had increased by 9.9 per cent during 2004-05, declined by 1.2 per cent during 2005-06. Borrowings, which represent a major source of funds for NBFCs, increased at a lower rate of 2.6 per cent during 2005-06 compared with a growth of 10.5 per cent in the previous year. While owned funds (capital and reserves) registered a marginal increase, public deposits declined by 32.1 per cent during 2005-06. On the asset side, loans and advances and hire purchase assets together accounted for more than three-fourth of total assets. While loans and advances declined by 27.8 per cent, hire purchase assets increased by 38.1 per cent during 2005-06.

1.32 Among NBFC groups, while assets/ liabilities of hire purchase finance companies increased, those of equipment leasing companies, investment and loan companies declined during the year ended March 2006. This broadly reflected the impact of resources raised through deposits and borrowings. Hire purchase finance companies was the largest NBFC group, constituting 80.7 per cent of total assets/liabilities of all NBFCs at end-March 2006, followed distantly by equipment leasing companies (9.8 per cent), investment companies (4.5 per cent) and loan companies (3.9 per cent).

Developments during 2006-07

1.33 Real GDP growth during Q1 2006 (April-June) was placed at 8.9 per cent over the corresponding quarter of the previous year. Accordingly, the CSO, in September 2006, revised the estimates of real GDP growth for 2005-06 to 8.4 per cent - up from the advance estimates of 8.1 per cent released in February 2006. Led by manufacturing, which returned to double-digit growth in April-August, 2006 (11.8 per cent), mining and electricity, the index of industrial production (IIP) rose by 10.6 per cent during April-August 2006, higher than 8.7 per cent in April-August 2005. The services sector recorded an impressive double-digit growth at 10.5 per cent in April-June 2006 (10.1 per cent in April-June 2005) on the back of impressive growth in 'trade, hotel, restaurants, transport, storage and communication' (13.2 per cent in April-June 2006). Lead indicators of services sector activity suggest that the robust growth recorded in 2005-06 would be sustained in 2006-07.

1.34 Inflation, measured by variations in the wholesale price index (WPI), on a year-on-year basis, rose to 5.4 per cent as on October 21, 2006 from 4.1 per cent at end-March 2006. During the current financial year 2006-07 (up to October 14, 2006), prices of primary articles, manufactured products and 'fuel, power, light and lubricants' registered increases of 7.8 per cent, 4.5 per cent and 5.5 per cent, respectively, as against 2.8 per cent, 2.8 per cent and 10.6 per cent, respectively, in the corresponding period of last year. Prices of primary food articles lead by wheat, pulses, fruits and milk have posed upward pressures on headline inflation during 2006-07 so far. Manufactured products inflation has been mainly on account of higher prices of metals.

1.35 During the fiscal year 2006-07 (up to October 13, 2006), M3 increased by 7.8 per cent as compared with an increase of 6.1 per cent in the corresponding period of the previous year. On a year-on-year basis, money supply (M3) increased by 19.0 per cent as compared with 16.8 per cent last year. Net bank credit to the Government increased by 4.7 per cent during the financial year (up to October 13, 2006) as compared with an increase of 3.0 per cent in the corresponding period of the previous year. Bank credit to the commercial sector, on a year-on-year basis, increased by 26.4 per cent on top of the increase of 26.9 per cent a year ago. The movements in reserve money during 2006-07 (up to October 20, 2006) largely reflected in liquidity management operations of the Reserve Bank. The overhang of liquidity in the system, as reflected in the outstanding balances under LAF, the Market Stabilisation Scheme (MSS) and the Central Government's cash balances with the Reserve Bank was Rs.69,153 crore as on October 20, 2006 as compared with Rs.85,140 crore at end-March 2006.

1.36 Bank deposits as well as credit recorded a strong growth during the fiscal year 2006-07. Bank deposits and bank credit increased by Rs.1,85,244 crore (8.8 per cent) and Rs.1,36,643 crore (9.1 per cent), respectively, during the fiscal year 2006-07 (up to October 13, 2006) so far as compared with Rs.1,15,309 crore (6.5 per cent) and Rs.1,19,168 crore (10.3 per cent), respectively, during the corresponding period of 2005-06. Demand for bank credit continued to remain high in view of strong macroeconomic activity. Scheduled commercial banks' non-food credit, on a year-on-year basis, expanded by 30.5 per cent as on October 13, 2006 on top of the increase of 31.8 per cent a year ago. Provisional information on sectoral deployment of bank credit indicates that retail lending rose by 47.0 per cent at end-June 2006, year-on-year, with growth in housing loans being 54.0 per cent. Loans to commercial real estate grew by 102.0 per cent. The year-on-year growth in credit to industry and agriculture was 27.0 per cent and 37.0 per cent, respectively, at end-June 2006.

1.37 Indian financial markets remained largely orderly during 2006-07, although some pressures were observed in the Government securities market. Call money rates eased by 52 basis points from 6.6 per cent at end-March 2006 to 6.1 per cent during August 2006. In September 2006, the monthly average call money rate increased to 6.3 per cent mainly due to the transient liquidity pressure on account of advanced tax outflow amidst high credit growth and festival season currency demand during the second half of the month. The monthly average call rate increased further to 6.8 per cent in October 2006. Call money rates remained generally close to the reverse repo rate. Activity in the CP market picked up with an increase in the outstanding amount by 90.0 per cent to Rs.24,419 crore by end-September 2006 from Rs.12,718 crore at end-March, 2006. The weighted average discount rate on CP declined from 8.6 per cent to 7.7 per cent during the period. The weighted average discount rate on certificates of deposit (CDs) declined marginally to 8.5 per cent as on September 15, 2006 from 8.6 per cent at end-March 2006. The outstanding amount of CDs increased by 46.6 per cent to Rs.63,864 crore during the financial year so far (up to September 15, 2006).

1.38 The primary yields on 91-day Treasury Bills increased to 6.6 per cent as on October 26, 2006 from 6.1 per cent at end-March, 2006. Yields on 10-year Government securities, on the other hand, increased to 7.6 per cent as on October 30, 2006 from 7.5 per cent at end-March 2006. The hardening was due to a variety of factors such as: (i) unsettled inflation expectations in the wake of soaring international crude oil prices feeding into interest rate uncertainty; (ii) sustained credit growth and competing demand for funds between public and private sectors; and (iii) apprehensions of additional pressures on market resources from perceptions of possible higher borrowings by the Centre in the second half of the year.

1.39 In the credit market, deposit and lending rates edged up as credit demand remained strong. Banks generally increased their deposit rates by about 50-175 basis points across various maturities between March 2006 and October 2006. Many public and private sector banks increased their benchmark prime lending rates by 50-100 basis points over the same period. Foreign banks kept their BPLR unchanged at 10.00-14.50 per cent over the period.

1.40 The Indian foreign exchange market generally witnessed orderly conditions during the current financial year so far (up to October 27, 2006). The exchange rate of the rupee which was at 44.61 per US dollar at end-March 2006, depreciated by 1.4 per cent to 45.22 by October 27, 2006. The rupee depreciated against major international currencies such as euro, pound sterling and Japanese yen. During the current financial year (as on October 27, 2006), the rupee depreciated by 5.5 per cent against euro, 9.0 per cent against pound sterling and 0.5 per cent against Japanese yen. The behaviour of Indian rupee against other major currencies was largely a reflection of the movements of US dollar against these currencies. Forward premia declined during the first quarter of 2006-07 in tandem with the narrowing of interest rate differential following easing of domestic money market interest rates coupled with further monetary tightening in the US. However, forward premia moderately firmed up during the second quarter of 2006-07.

1.41 The equity markets witnessed significant swings during 2006-07 (up to October 31, 2006). The stock markets witnessed a sharp correction during May-June 2006 in line with the trends in major international markets. However, the markets recouped losses thereafter as the BSE Sensex firmed up to reach an all-time high of 13131 on November 3, 2006, on account of net investments by FIIs, strong corporate financial results, firm trend in major Asian equity markets, US Federal Reserve's decision to keep interest rates unchanged in the last three FOMC meetings and decline in global crude oil prices.

1.42 India's merchandise exports recorded a strong growth of 22.9 per cent during April-September 2006 as compared with 34.2 per cent in the corresponding period of the previous year. The overall growth in imports moderated during April-September 2006 mainly due to deceleration in non-oil imports growth (11.5 per cent compared with 47.9 per cent a year ago). The trade deficit widened to US $ 24.6 billion during April-September 2006 from US $ 22.3 billion during April-September 2005. The buoyancy witnessed in the capital inflows to India during the year 2005-06, continued in the current financial year as well. Inflows under FDI, NRI deposits and issuances under ADRs/GDRs during April-August 2006 were higher than those in the corresponding period of 2005. On the other hand, FIIs recorded net outflows of US$ 29 million during 2006-07 so far (up to October 13, 2006). India's foreign exchange reserves increased to US $ 167.1 billion as on October 27, 2006.