Chapter I

Overview

Global Economy

Developments during 2006

1.1 The global economy continued on high growth path with a 5.4 per cent growth during 2006 achieving a four year spell of a sustained growth of over 4 per cent that began in 2003[1]. The broad-based expansion in world output could be explained in terms of a resilient US consumption, despite some slowdown in growth in the second half of the year, a broad-based upswing in Europe and Japan and other advanced industrial countries, and continued rapid growth in emerging market economies (EMEs) particularly, China (11.1 per cent), India (9.4 per cent) and Russia (6.7 per cent). The growth in the world output was led by emerging economies which contributed 3.9 per cent to the world GDP growth in 2006, while the advanced economies contributed 1.5 per cent. Growth in the euro area exceeded that in the United States in the second half of last year, for the first time since 2002. In the EMEs, growth continued to remain firm on account of availability of financial resources, strong commodity prices and abundant global liquidity. Concerns have, however, arisen regarding the sustainability of some of these factors. Economic activity in Japan slowed in the middle of 2006, but recovered by the end of the year.

1.2 As output in many countries seemed close to potential, strong demand, in conjunction with strong gains recorded by global commodity prices, was reflected in some inflationary pressures in major economies. Global headline inflation closely tracked movements in energy prices – rising above 3 per cent in the first half of 2006 on the back of rising oil prices, before dropping sharply as energy prices declined towards the end of the year. The consumer price inflation in advanced economies was 2.3 per cent in the calendar year 2006, the same as a year earlier, but higher than that of 1.9 per cent during the preceding 5-year period (2000-04). Inflation in 'developing Asia' rose from 2.6 per cent during 2000-04 and 3.6 per cent in 2005 to 4.0 per cent in 2006.

1.3 With headline inflation crossing the targets/comfort zones in major countries, many central banks pursued monetary tightening to contain inflationary expectations. Amongst the major advanced economies, the US Federal Reserve Board (US Fed), the European Central Bank (ECB), the Bank of England, the Sveriges Riksbank (Sweden), the Reserve Bank of New Zealand, the Reserve Bank of Australia, and the Bank of Japan tightened their policies during the year.

1.4 Fiscal balances in advanced industrial countries showed signs of improvement in 2006. Measures of structural budget deficits, which attempt to remove cyclical effects from headline deficit figures, declined in the United States (by over 1 percentage point of potential GDP), Germany (by 0.8 percentage points) and Japan (by 0.5 percentage points, largely due to one-off changes in capital transfers), and increased marginally only in Italy. Change in German headline balances was even more pronounced, with the deficit decreasing by 1.8 percentage points in 2006.

1.5 While the credit conditions turned tight in the United States, the expansion has continued in most other areas. As a result, global asset prices either continued to rise or were maintained at unusually high levels. Most Asian EMEs have recorded strong growth with reasonably well-anchored inflation expectations, aided by strong global demand for their exports, favourable terms of trade, easy access to external financing and comfortable foreign currency reserves along with reduced external debt as percentage of GDP. Their banking systems have also been strengthened through improved restructuring and supervisory systems. The resilience to external shocks is reinforced by a combination of lower balance sheet exposure to exchange rate risks, lower refinancing risks in debt structures, strong financial systems and greater policy flexibility. Nevertheless, there are areas of concern and many of these countries

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

have felt the need for containing excess volatility in foreign exchange markets through intervention accompanied by sterilisation. However, such policies have their own limitations and such actions have also been accompanied by differing strategies for liquidity management, including raising cash reserve requirements, issuances of central bank securities, ceilings on lending to specific sectors and the use of prudential tools.

1.6 In international financial markets, prices of risky assets continued to rise throughout most of 2006 and early 2007. A number of equity markets reached historical highs, while various credit spreads touched new lows. Government bond yields in the advanced industrial countries levelled off around mid-2006 and then began to move downwards. Long-term bond yields particularly, in the United States, set on a downward trend during the second half of the year, reflecting investor concerns about US growth prospects and expectations of easing monetary policy. The economic outlook in Japan remained more positive, lending some support to bond yields, while the economic outlook for the euro area brightened progressively and eventually brought about rising euro bond yields. An important factor behind the gains in developed equity and credit markets was continued strong earnings growth. Moreover, ongoing changes in capital structure boosted equity markets, as share buybacks rose further, while merger and acquisition activity grew substantially. Similarly, gains in emerging markets coincided with improved credit ratings and generally strong macroeconomic conditions.

1.7 The strong overall performance of financial firms in advanced industrial countries continued during the year, and banks benefited from another year of a generally benign credit environment and strong retail business. Investment banks registered record profits driven by growth in capital market activity and a boom in private equity. Investor inflows into hedge funds were moderate as compared with the previous years, in response to the declining rates of return registered by the funds. Current profits add to already healthy capital cushions, suggesting that financial firms are well placed to withstand the likely sources of strain over the near term.

Developments during 2007

1.8 World GDP growth, which had accelerated to 5.4 per cent in 2006, maintained pace in the first half of 2007 and appears to have broadened across industrial and emerging market countries. According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in October 2007, global real GDP growth was expected to decline from 5.4 per cent in 2006 to 5.2 per cent in 2007 and further to 4.8 per cent in 2008. Although growth in the United States slowed in the first quarter of 2007, preliminary estimates suggest that it rebounded in the second and third quarters. Activity in most other countries continued to expand strongly. In the euro area and Japan, growth has remained above trend with some welcome signs that domestic demand is taking a more central role in the expansions. Emerging market countries have continued to expand robustly, led by rapid growth in China, India and Russia.

1.9 Headline inflation in major advanced economies generally edged up towards the end of the third quarter of 2007, mainly reflecting hardening of food and fuel prices in the US, and clothing and education in the euro area. On the other hand, headline inflation in the UK eased towards the end of third quarter largely due to lower domestic energy price inflation before picking up again in October 2007. Amongst major economies, headline inflation in October 2007 was 3.5 per cent in the US, 2.1 per cent in the UK and 2.6 per cent in the euro area. Inflation was 2.2 per cent in the OECD countries in September 2007 as compared with 2.0 per cent a year ago. Core inflation remained firm in major economies, reflecting strong demand conditions.

1.10 Global credit markets have experienced large volatility since May 2007 as uncertainties about the size and distribution of losses from the US sub-prime mortgage lending made investors to adjust their positions. Since late 2006, conditions in the sub-prime mortgage market sector in the US have deteriorated significantly resulting in reassessment of risk by investors across products and markets. The losses, though largely concentrated in the US, were dispersed quickly to European and Asian investors holding asset-backed securities and collateralised debt obligations. Within Asia, exposure was reported to be concentrated in Japan, China, Taiwan Province of China, South Korea and Australia.

1.11 Short-term rates hardened further in a number of economies, moving broadly in tandem with policy rates. Several central banks such as the Bank of England, People's Bank of China and

Reserve Bank of New Zealand raised their policy rates further during the quarter ended September 2007 to contain inflation and stabilise inflationary expectations. On the other hand, short-term interest rates in the US declined, reflecting cut in the fed funds target rate by 75 basis points to 4.5 per cent by October 31, 2007. The rate cut in the US on September 18, 2007 was the first after a series of 17 consecutive rate hikes by the Federal Reserve that commenced from June 2004 to June 2006 followed by a pause up to August 2007. Short-term rates eased in a few EMEs such as Brazil and Thailand, as central banks in these countries continued to cut policy rates to support growth.

1.12 In contrast to short-term interest rates, long-term Government bond yields softened in major advanced economies during the second quarter of 2007-08, reversing the increasing trend observed in the first quarter. Decline in the bond yields reflected lower investor appetite for riskier assets in the event of deteriorating housing market and turmoil in the credit market. Between end-March 2007 and November 19, 2007, 10-year yield declined by 35 basis points in the US, and 17 basis points in UK and 15 basis points in Japan, while it increased by 11 basis points in the Euro area.

1.13 Global equity markets recorded further gains during Q3 2007, amidst intermittent corrections. Robust corporate earnings, buoyant merger and acquisition activity and increased risk appetite buoyed the equity markets in major emerging economies such as China (69.8 per cent), South Korea (32.2 per cent), Hong Kong (30.7 per cent), Brazil (28.7 per cent), Indonesia (28.5 per cent), Turkey (25.1 per cent) and Thailand (21.3 per cent). However, factors like slump in the US home sales and rising concerns about the US mortgage and corporate lending markets, increase in international crude oil prices, surge in China's inflation rate and contraction in Japan's economy intermittently dampened the market sentiment.

1.14 In the foreign exchange market, the US dollar depreciated against major currencies up to September 14, 2007, reflecting worries in the mortgage market, falling housing sales and weakening consumer confidence. While the pound sterling strengthened against the US dollar and reached a 25-year high level in July 2007, Japanese yen appreciated against US dollar as a result of unwinding of yen carry trade.

Indian Economy

Macro Environment

1.15 The Indian economy continued to record strong growth during 2006-07. Real gross domestic product (GDP) growth rate accelerated to 9.4 per cent during 2006-07 from 9.0 per cent level in the previous year contributed mainly by the sustained expansion in industry and services. Real GDP growth during the Tenth Plan period (2002-03 and 2006-07) averaged 7.6 per cent – the highest average rate of growth during any plan period so far. Real GDP originating from agriculture and allied activities estimated by the Central Statistical Organisation (CSO) registered a lower growth of 2.7 per cent during 2006-07 than that of 6.0 per cent in the previous year. However, the growth of real GDP originating from industry entered the fifth year of expansion as it recorded a double-digit growth of 11.5 per cent during the year (8.2 per cent in 2005-06), which was the highest growth achieved since 1995-96. While industrial growth was mainly driven by the manufacturing sector, both mining and electricity sectors witnessed accelerated growth. In terms of use-based classification, the performance of the capital goods sector was particularly impressive with 18.2 per cent growth. The basic goods and consumer goods sector also recorded a double-digit growth of 10.3 per cent and 10.1 per cent, respectively, during 2006-07. The well-performing industrial sector was also boosted by improved performance of the infrastructure sector, registering 8.8 per cent growth during 2006-07. The services sector recorded double-digit growth consistently in the last three years. It grew by 11.0 per cent during 2006-07 on top of 10.3 per cent growth in 2005-06, which has been the highest growth since 1999-2000 as per the new series.

1.16 High levels of capacity utilisation in a number of industries, along with supply shocks from primary articles, were reflected in a rise in the inflation rate during 2006-07. Headline inflation, measured by year-on-year variations in the wholesale price index (WPI), rose to 5.9 per cent on March 31, 2007 – remaining generally above the upper end of the Reserve Bank's indicative projections of 5.0-5.5 per cent between mid-November 2006 and end-March 2007. Headline inflation moved in a range of 3.7-6.7 per cent during 2006-07; the average WPI inflation moved up to 5.4 per cent during 2006-07 from 4.4 per cent a year ago. Among the major groups, prices of primary articles exerted upward pressure on inflation during 2006-07, reflecting shortfalls in domestic supply of major agricultural crops. Fuel group inflation, which had dominated the inflation outcome during the preceding two years, eased significantly during the second half of the year to reach its lowest rate in over a decade. Measures of consumer price inflation remained above the wholesale price inflation throughout 2006-07, mainly reflecting the impact of elevated food prices.

1.17 The ongoing improvement in the fiscal position was reflected in lower estimates of key deficit indicators of the Central and State Governments in the revised estimates (RE) *vis-à-vis* the budget estimates for 2006-07. As per provisional accounts, the revenue deficit of the Central Government estimated at Rs. 80,410 crore or 1.9 per cent of GDP was lower than 2.1 per cent of GDP in the budget estimates for 2006-07 and 2.6 per cent in 2005-06. The gross fiscal deficit (GFD) for 2006-07 at Rs.1,42,793 crore constituted 3.5 per cent of GDP as against the budget estimates of 3.8 per cent and 4.1 per cent in the previous year. The improvement in key fiscal indicators was enabled by the sustained buoyancy in tax revenue and containment of growth in Plan expenditure. Reflecting the process of fiscal consolidation, the outstanding domestic liabilities of the Central Government declined to 61.5 per cent of GDP at end-March 2007 (RE) from 63.4 per cent at end-March 2006.

1.18 The year-on-year increase in broad money (M3) accelerated to 21.3 per cent at end-March 2007 from 17.0 per cent a year ago and remained above the growth rate of 15.0 per cent projected in the Annual Policy Statement in April 2006. Demand for commercial credit remained strong during 2006-07 for the third successive year, *albeit* with some moderation. The annual growth in bank credit to the commercial sector at 25.4 per cent as on March 31, 2007 was lower than 27.2 per cent a year ago. Commercial banks' credit to Government increased by Rs.74,238 crore as against a decline of Rs.19,514 crore in the previous year, whereas net RBI credit to Government declined by Rs. 2,384 crore as against an increase of Rs.35,799 crore in the preceding year. The banking sector's net foreign exchange assets increased by 25.7 per cent (Rs.1,86,985 crore), primarily reflecting the increase in net foreign exchange assets of the Reserve Bank by 28.7 per cent (Rs.1,93,170 crore).

1.19 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 most of 2006-07 with some spells of volatility, especially in March 2007 reflecting large capital flows and swings in Government of India's cash balances coupled with high credit demand. Interest rates in the various segments of the financial market hardened in tandem with the policy rate of the Reserve Bank.

1.20 During 2006-07, the financial markets shifted from conditions of easy liquidity to occasional spells of tightness necessitating injection of liquidity through the LAF. The total overhang of liquidity under the LAF, the market stabilisation scheme (MSS) and surplus cash balances of the Central Government taken together increased from an average of Rs.74,334 crore in March 2006 to Rs.92,849 crore in September 2006. With liquidity shortages getting accentuated in the second half of March 2007 in the wake of advance tax payments, net LAF injections rose to a peak of Rs.43,075 crore on March 21, 2007. The overnight rates remained within the corridor set by the Reserve Bank's reverse repo and repo rates during the year, barring some occasions during December 2006-March 2007 (especially, the second half of March 2007), when overnight rates increased sharply as the market experienced temporary tightness. Interest rates in the collateralised segment of the overnight money market also hardened, but remained below the call rate during the year. For the financial year 2006-07, as a whole, interest rates averaged 6.24 per cent (5.34 per cent in 2005-06) in the CBLO segment and 6.34 per cent (5.36 per cent) in the market repo segment, respectively, as compared with 7.22 per cent (5.60 per cent) in the call money market. The weighted average interest rate in the call money, the CBLO and the repo segments rose from 5.43 per cent in 2005-06 to 6.57 per cent in 2006-07.

1.21 The weighted average discount rate (WADR) on commercial paper (CP) increased from 8.59 per cent during the fortnight ended March 31, 2006 to 11.33 per cent during the fortnight ended March 31, 2007, and the WADR of certificate of deposits (CDs) increased from 8.62 per cent at end-March 2006 to 10.75 per cent at end-March 2007 in tandem with the upward movement of other money market interest rates. Deposit and lending rates of scheduled commercial banks (SCBs) increased during 2006-07.

1.22 Yields in the Government securities market hardened during 2006-07. In the current financial year, yields hardened up to mid-June 2007 but declined thereafter. The 10-year yield was 7.97 per cent as on March 31, 2007, 45 basis points higher than the level as on March 31, 2006 (7.52 per cent). However, the yield curve flattened. During 2007-08, yields remained range-bound between 7.97 and 8.19 per cent till end-May 2007 and peaked at 8.30 per cent in mid-June 2007 due to hardening of interest rates globally. Yields softened thereafter and moved between 7.85 and 8.01 per cent till first week of November 2007, reflecting the continued prevalence of easy liquidity conditions. The 10-year yield closed at 7.96 per cent on November 8, 2007, which was 37 basis points higher than the level as on November 8, 2006.

1.23 The stock markets reached record highs during the year 2006-07 interspersed with periodic corrections. The primary market segment of the capital market continued to exhibit buoyant conditions. The BSE Sensex at end-March 2007 increased by 15.9 per cent (year-on-year) on top of the increase of 73.7 per cent a year ago. Strong corporate profitability and continued liquidity support from foreign institutional investors (FIIs) and domestic mutual funds buoyed up the stock markets even as they witnessed sharp corrections on a few occasions (May-June 2006, December 2006 and February-March 2007) in consonance with the trends in global equity markets.

1.24 In the foreign exchange market, the Indian rupee exhibited two-way movements in the range of Rs.43.14 – 46.97 per US dollar during 2006-07 with a strengthening bias from mid-July 2006. The rupee initially depreciated against the US dollar during the year, reaching Rs.46.97 on July 19, 2006, reflecting higher crude oil prices and FII outflows. The rupee, however, strengthened thereafter on the back of moderation in crude oil prices, large capital inflows and weakness of the US dollar in international markets to reach Rs.43.14 per US dollar on March 28, 2007. The exchange rate was Rs.43.60 per US dollar at end-March 2007.

1.25 India's balance of payments position indicated sustained strength and vibrancy in the external sector during 2006-07, reflecting the robust macroeconomic fundamentals. The growth in merchandise export and non-oil import moderated from the strong growth in the previous year. Earnings from exports of software and other business services as well as remittances from Indians working abroad continued to exhibit buoyancy. The net surplus under invisibles expanded further during 2006-07 and continued to finance a large part of the growing merchandise trade deficit. Consequently, the current account deficit remained modest during the year, and, as a proportion of GDP, was at the same level (1.1 per cent) as a year ago. Led by foreign direct investment and external commercial borrowings (ECBs), capital flows (net) to India witnessed a large increase during 2006-07 on the back of strengthening of growth prospects, and buoyancy in domestic investment and import demand. Outward direct investment also witnessed a jump reflecting growing overseas acquisitions by Indian corporates. With net capital flows remaining in excess of the current account deficit, the overall balance of payments recorded a significant surplus, which was mirrored in an accretion of US $ 47.6 billion to foreign exchange reserves during 2006-07. While the stock of external debt rose due to higher ECBs and non-resident deposits, net international liabilities fell, reflecting the continuous build-up of foreign exchange reserves, which rose to reach a level of US $ 199.2 billion by end-March 2007.

Scheduled Commercial Banks

1.26 The banking sector witnessed accelerated growth during 2006-07. The faster growth of the banking sector in relation to the real economy pushed up the ratio of assets of scheduled commercial banks to GDP to 92.5 per cent at end-March 2007. Broad based credit growth with some rebalancing in sectoral credit allocation away from housing and commercial real estate sectors was observed during the year. The accelerated growth of deposits mainly contributed by sharp increase in term deposits, however, obviated the need of unwinding of investment portfolio to finance credit growth by banks as was witnessed in the previous year (Table I.1). However, as a percentage of both total assets and net demand and time liabilities (NDTL), investment by banks in Government securities continued to decline. The consolidation of the banking sector continued with the merger of three old private sector banks, bringing down the total number of SCBs to 82 from 85 at end-March 2006.

Table I.1: Select Financial Sector Indicators: 2006-07

Category	Indicator	2005-06	2006-07
1	2	3	4
1. Scheduled Commercial Banks	a) Growth in Major Aggregates (per cent)		
	Aggregate Deposits	17.8	24.6
	Loans and Advances	31.8	30.6
	Investment in Government Securities	-1.2	9.3
	b) Financial Indicators (as percentage of total assets)		
	Operating Profits	2.0	1.9
	Net Profits	0.9	0.9
	Spread	2.8	2.7
	c) Non-Performing Assets (as percentage of advances)		
	Gross NPAs	3.1	2.4
	Net NPAs	1.2	1.0
2. Urban Co-operative Banks	a) Growth in Major Aggregates (per cent)		
	Deposits	6.3	6.1
	Credit	4.0	9.8
	b) Financial Indicators (as percentage of total assets)@		
	Operating Profits	1.3	1.2
	Net Profits	0.8	0.6
	Spread	2.2	2.3
	c) Non-Performing Assets (as percentage of advances)		
	Gross NPAs	18.9	17.0
	Net NPAs	8.8	7.7
3. Rural Co-operative Banks	a) Number	1,07,497	–
	b) Growth in Major Aggregates (per cent)		
	Deposits	4.9	–
	Credit	6.2	–
	c) Financial Indicators		
	Societies in Profit (Number)	44,968	–
	Societies in Loss (Number)	53,344	–
	Overall Profit/Loss (Rs. crore)	-271	–
	d) Non-Performing Assets (as percentage of advances)*	23.8	–
4. All-India Financial Institutions	a) Growth in Major Aggregates (per cent)[1]		
	Sanctions	41.0	12.9
	Disbursements	47.1	82.8
	b) Financial Indicators (as percentage of total assets)[2]		
	Operating Profits	1.4	2.1
	Net Profits	1.0	1.5
	Spread	1.8	1.6
5. Non-banking Financial Companies	a) Growth in Major Aggregates (per cent)		
	Public Deposits	-32.1	-16.5
	b) Financial Indicators (as percentage of total assets)		
	Net Profits	1.5	1.2
	c) Non-Performing Assets (as percentage of advances)[3]		
	Net NPAs	0.5	0.4
6. Residuary Non-banking Companies	a) Growth in Major Aggregates (per cent)		
	Deposits	21.5	12.1
	b) Financial Indicators (as percentage of total assets)		
	Net Profits	0.7	0.9

– : Not available.
@ : Relating to scheduled urban co-operative banks.
* : Includes overdues amount for PACS.
1 Relating to IFCI, IIBI, SIDBI, IVCF, ICICI Venture, TFCI, LIC, and GIC.
2 Relating to eight FIs, viz., IFCI, IIBI, Exim Bank, TFCI, SIDBI, NABARD and NHB.
3 For reporting companies with variations in coverage.

1.27 Financial performance of SCBs during 2006-07 was underpinned by hardening of interest rates, both on the liability and the asset sides. Both net interest income and non-interest income of banks increased sharply in absolute terms, but declined in relation to total assets. Banks, however, were able to maintain their profitability by containing operating expenses. Unlike last year, provisions and contingencies made by banks increased during the year, although they were a shade lower in relative terms (*i.e.*, as percentage of assets). While return on assets (RoA) of SCBs remained stagnant, their return on equity (RoE) improved during the year. Net profits of SCBs increased sharply, underpinned by the sharp increase in net interest income due to strong growth in credit volumes and containment of operating expenses.

1.28 The asset quality of SCBs improved further during 2006-07, which was reflected in the decline in gross and net non-performing assets as percentage of loans and advances. The trend in absolute gross NPA, however, remained divergent across bank groups. While the absolute gross NPAs of PSBs (particularly, nationalised banks) and old private sector banks declined during the year, those of new private sector banks and foreign banks showed an increase.

1.29 Banks' capital raising efforts kept pace with the asset growth and risk profile of new assets. Hence, the capital to risk-weighted asset ratio of SCBs, a measure of the capacity of the banking system to absorb losses, was at 12.3 per cent at end-March 2007 - same as at end-March 2006.

Co-operative Banks

1.30 Operations of urban co-operative banks (UCBs) witnessed a moderate growth during 2006-07. The growth in loans and advances was higher than the deposits growth. Though the UCBs missed the priority sector lending target, they were able to meet the stipulated sub-target for the weaker sections. Investments by UCBs witnessed a decline during the year due mainly to the decline in SLR investments; non-SLR investments, however, increased during the year. The financial performance of scheduled UCBs improved significantly with higher operating and net profits as well as increase in spread. This indicates the success of the medium-term framework suggested by the vision document. Asset quality of UCBs improved markedly with both gross and net NPA declining in absolute as well as relative terms.

1.31 Balance sheets of all segments of the rural co-operative banking sector, except PACS, expanded during 2005-06. However, their financial performance worsened during the year. Wide variations were also observed in the financial performance of different segments of the rural co-operative banking sector. While the upper tier of both short-term and long-term rural co-operative credit institutions made profits during 2005-06, the lower tier *viz.*, primary agricultural credit society (PACS) and primary co-operative agriculture and rural development banks (PCARDBs), made overall losses. Asset quality of all types of rural co-operative banks deteriorated, except PACS whose recovery performance improved. The recovery performance of district central co-operative banks (DCCBs) and PCARDBs worsened during the year.

Financial Institutions

1.32 Financial assistance disbursed by All-India Financial Institutions (AIFIs) witnessed a sharp rise during 2006-07 despite slowdown in financial assistance sanctioned by them. Financial assistance sanctioned and disbursed by FIs increased by 12.9 per cent and 82.8 per cent, respectively, during 2006-07 as compared with a rise of 41.0 per cent and 38.0 per cent, respectively, witnessed during the previous year. The sharp rise in disbursements was accounted for mainly by a rise in disbursements by investment institutions and specialised financial institutions, while the slowdown in sanctions was mainly due to lower sanctions by all-India term-lending institutions.

1.33 Net interest income of AIFIs registered a marginal growth of 1.7 per cent during 2006-07 as compared with a growth of 20.2 per cent during 2005-06. Non-interest income of FIs increased significantly during the year. However, in contrast with the sharp increase in the previous year, the operating expenses of FIs registered a decline of 55.9 per cent during the year. As a result, the operating profit increased sharply by 73.6 per cent during the year. This was also reflected in the significant increase in net profit of FIs, despite higher provisions earmarked for taxation. The capital adequacy ratio of FIs continued to be significantly higher than the prescribed norm of 9 per cent.

Non-Banking Financial Companies

1.34 The assets/liabilities of deposit taking NBFCs (NBFCs-D) expanded at a much higher rate of 26.9 per cent during 2006-07 as compared with the moderate rise of 5.1 per cent during 2005-06. Borrowing which is the major source of funds for NBFCs-D, increased by 30.6 per cent during the year, while public deposits declined by 16.5 per cent. Financial performance of NBFCs-D turned around during 2006-07 entirely on account of sharp rise in fund based income, which offset the sharp rise in operating expenditure and financial expenditure. As a result both operating profits as well as net profit witnessed a rise. The asset quality also improved significantly. While the proportion of NBFCs-D with CRAR above 30 per cent declined, the proportion of NBFCs-D with CRAR of less than 12 per cent also declined over the year. Among NBFC groups, AFCs held the largest share in total assets/liabilities (51.5 per cent), followed by hire purchase finance companies (35.7 per cent), loan companies (8.7 per cent) and investment companies (3.4 per cent).

1.35 Information based on the returns received from 173 non-deposit taking systemically important NBFCs with asset size of Rs.100 crore and above (NBFCs-ND-SI) for the year ended March 2007 showed an increase of 14.7 per cent in their liabilities/assets over the year ended March 2006. Total borrowings (secured and unsecured) by NBFCs-ND-SI increased by 26.8 per cent to Rs.2,11,986 crore during the year ended March 2007, constituting 66.7 per cent of their total liabilities. NBFCs-ND-SI earned a profit of Rs.7,460 crore during the year ended March 2007, which was higher by 73.4 per cent as compared with the profit earned during the year ended March 2006 (Rs. 4,301 crore), partly reflecting the increase in number of companies in this category.

Developments during 2007-08

1.36 According to the estimates released by the CSO in August 2007, the Indian economy continued to grow at a high rate with the real GDP growth of 9.3 per cent during the first quarter of 2007-08 compared with 9.6 per cent during Q1 2006-07. The growth in real GDP was backed by double-digit growth in the manufacturing and services sectors, while the agricultural sector showed signs of recovery.

1.37 Inflation, measured by variations in the WPI, on a year-on-year basis, eased from 5.9 per cent at end-March 2007 to 3.0 per cent by October 27, 2007. The annual inflation rate for all major groups, primary articles, fuel group and manufactured products was lower at 5.1 per cent, (-)1.5 per cent and 3.9 per cent, respectively, as on October 27, 2007 as compared with 10.7 per cent, 1.0 per cent and 6.1 per cent, respectively, at end-March 2007. Pre-emptive monetary measures since mid-2004 accompanied by fiscal and supply-side measures helped in containing inflation. Consumer price inflation remained firm during the second quarter of 2007-08 and continued to be above the WPI inflation, mainly reflecting the impact of higher food prices.

1.38 The key deficit indicators of combined finances of the Central and State Governments for 2007-08 are budgeted to decline over the revised estimates for 2006-07, both in absolute terms and proportion to GDP. The surplus in the revenue account of the State Government was the most significant development on the fiscal front. The envisaged improvement in revenue account is expected to bring down the combined GFD by 0.8 per cent of GDP in 2007-08. Available information on Central Government finances for the first six months of 2007-08 (April-September 2007) indicates that as a percentage of budget estimates, GFD and gross primary deficit (net of cost of acquisition of RBI stake in SBI and transfer of profit from RBI to the Union Government) were placed lower that those in April-September, 2006[2]. Revenue deficit during April-September, 2007 was lower as percentage of GDP over the comparable period a year ago. However, as per cent of budget estimates it was somewhat higher than last year despite the higher revenue receipts growth of 22.6 per cent mainly due to lower budgeted amount envisaged for revenue deficit.

1.39 During the fiscal year 2007-08 (up to October 26, 2007), M3 increased by 9.0 per cent as compared with an increase of 7.9 per cent in the corresponding period of the previous year. On a year-on-year basis, money supply (M3) increased by 22.5 per cent as compared with 18.4 per cent

[2] The surplus transfer on account of transfer of Reserve Bank's stake in SBI (Rs. 34,308 crore) was included under non-tax revenue for April-August 2007. However, this transaction has been recorded under non-debt capital receipts for April-September 2007 by the Controller General of Accounts (CGA) as indicated in the Union Budget for 2007-08.

a year ago. Thus, M3 growth continued above the indicative trajectory of 17.0-17.5 per cent for 2007-08 set out in the Annual Policy Statement (April 2007). Net bank credit to the Government increased by 1.7 per cent during the financial year (up to October 26, 2007) as compared with an increase of 5.6 per cent in the corresponding period of the previous year. Bank credit to the commercial sector increased by 5.1 per cent compared with 9.0 per cent during the corresponding period of the previous year. Commercial banks' investments in Government and other approved securities as percentage of their NDTL increased to 29.4 per cent as on September 14, 2007 from 28.0 per cent at end-March 2007. Reserve money expanded by 26.7 per cent, year-on-year, as on November 2, 2007 (17.1 per cent adjusted for the first round effects of the hikes in the CRR) as compared with 15.6 per cent a year ago. The liquidity pressures built up from mid-April 2007 onwards on account of hikes in CRR, but gradually began to ease from May 28, 2007, reflecting increase in Government expenditure and net purchase of foreign exchange from authorised dealers by the Reserve Bank. During the second quarter of 2007-08 (up to mid-September), the Reserve Bank continued to absorb liquidity using the reverse repo window under the liquidity adjustment facility (LAF).

1.40 Scheduled commercial banks' non-food credit expanded by 23.0 per cent, year-on-year, as on October 26, 2007 as compared with 28.4 per cent at end-March 2007 and 29.7 per cent, a year ago. The deceleration in credit growth coupled with the acceleration in deposits growth led to a reduction in the incremental credit-deposit ratio (y-o-y) of SCBs to 62.9 per cent as on October 26, 2007 from 98.3 per cent in the corresponding period of the previous year. The sectoral deployment data available up to August 17, 2007 show that about 41 per cent of incremental non-food credit (y-o-y) was absorbed by industry, around 13 per cent by agriculture and nearly 22 per cent by personal loans. Within the industrial sector, the demand for credit was led by infrastructure (power, port, telecommunication, *etc*.), textiles, iron and steel, engineering, petroleum, food processing, chemicals, vehicles and construction. The infrastructure sector alone accounted for over 27 per cent of the incremental credit to the industry. Growth in loans to commercial real estate remained high.

1.41 Indian financial markets have generally remained orderly during 2007-08 so far. As a result of easing of liquidity conditions, call money rates during April-July 2007, remained below the reverse repo rate between June-July 2007. However, consequent upon the withdrawal of the ceiling of Rs.3,000 crore on daily reverse repo with effect from August 6, 2007, call money rates firmed up. During September-October 2007, call money rates remained by and large within the corridor set by reverse repo and repo rate. Issuances of commercial paper (CP) increased to Rs.38,495 crore as on October 15, 2007 from Rs.17,688 crore at end-March 2007. The WADR on CP declined from 8.93 per cent at end-June 2007 to 7.99 per cent on October 15, 2007 and the most preferred maturity of CP was for periods ranging from '61 to 90 days' and '181 days and above'. Leasing and finance companies continued to be the major issuers of CPs. The outstanding amount of certificates of deposit (CDs) increased to Rs. 1,18,481 crore (5.55 per cent of aggregate deposits of issuing banks) by September 28, 2007 from Rs.93,272 crore at end-March 2007 (4.8 per cent). The WADR on CDs declined to 8.57 per cent as on September 28, 2007 compared with 10.75 per cent at end-March 2007.

1.42 In view of easing inflation and in sync with the trends in the money market segment, the primary yields on 91-day Treasury Bills declined to 7.11 in October 2007 from 7.73 per cent in March 2007. The yield spread between 364-day and 91-day Treasury Bills widened slightly to 26 basis points in October 2007 from 23 basis points in March 2007. The 10-year yield remained almost unchanged at 7.96 per cent as on November 8, 2007 from the level at end-March 2007 (7.97 per cent). The spread between 1-10 year yields narrowed to 21 basis points at end-October 2007 from 42 basis points at end-March 2007.

1.43 Deposit rates of SCBs declined from July 2007 to August 2007, particularly at the upper end of the range for various maturities. Interest rates of PSBs on deposits of maturity of one year to three years were placed in the range of 7.25-9.00 per cent in August 2007 as compared with 7.25-9.75 per cent in June 2007 (7.25-9.50 per cent in March 2007), while those on deposits of maturity of above three years were placed in the range of 7.75-9.50 per cent in August 2007 as compared with 7.75-9.75 per cent in June 2007 (7.50-9.50 per cent in March 2007). While BPLRs of PSBs and foreign banks remained unchanged during the second quarter of 2007-08, those of private sector banks softened to the range of 13.00-16.50 per cent in August 2007 as compared with 13.00-17.25 per cent in June 2007.

1.44 During 2007-08, the Indian rupee, which had appreciated *vis-à-vis* the US dollar till end-May 2007, exhibited a two-way movement during the second quarter. During the financial year 2007-08 (up to November 8, 2007), the rupee moved in the range of Rs.39.26-43.15 per US dollar. During 2007-08 (up to November 8, 2007), the Indian rupee appreciated by 10.8 per cent against the US dollar, 3.6 per cent against the Pound sterling, 1.0 per cent against the Euro and 6.2 per cent against the Japanese yen.

1.45 Continuing the upward trend during 2007-08, the BSE Sensex closed at an all-time high level of 19976 on November 2, 2007, an increase of 52.82 per cent over end-March 2007. The S&P CNX Nifty also reached a record high of 5932 on November 2, 2007. Liquidity support from foreign institutional investors (FIIs), strong GDP growth, robust corporate profitability, decline in annual domestic inflation rate, upward trend in major international equity markets and rise in metal prices enthused the market sentiment. However, after November 2, 2007, the domestic stock markets witnessed some corrections mainly due to downward trend in major international equity markets on account of renewed concerns over sub-prime losses and credit crunch in the US and Europe and depreciation of US dollar against major currencies. Increase in global crude oil prices to record high levels, net sales by FIIs in the Indian equity market, appreciation of rupee against the US dollar, decline in global metal prices and other sector and stock specific news also dampened the market sentiment.

1.46 India's balance of payments position has remained comfortable during 2007-08 so far. While merchandise exports witnessed some moderation during April-September 2007, overall growth in imports during the same period remained high. Oil imports, however, witnessed a sharp deceleration from the strong growth recorded during the corresponding period of the previous year. The surplus in the invisibles account during the first quarter of 2007-08, led by higher growth in private transfers moderated the current account deficit at US $ 4.7 billion in Q1 of 2007-08, broadly the same level as in the first quarter of 2006-07. Reflecting large flows under portfolio investment and external commercial borrowings, net capital inflows were substantially higher at US $ 15.3 billion in Q1 of 2007-08 compared with US $ 10.6 billion in the corresponding period 2006-07. Foreign exchange reserves increased further to US $ 236 billion as on September 21, 2007 from US $ 199.2 billion at end-March 2007.