Chapter I

OVERVIEW

Global Economy

Developments during 2007

1.1 The global economy, after a sustained period of expansion, is now entering into a phase of downturn on account of the global financial crisis. Global GDP rose on an average by 5 per cent a year for the four-year period spanning 2004-2007, its highest sustained rate since the early 1970s. Global GDP expanded by 5.0 per cent in 2007. About three-fourths of the global growth (measured on a purchasing power parity basis) was attributable to the broad-based growth in the emerging and developing economies, particularly China (11.9 per cent), India (9.3 per cent) and Russia (8.1 per cent). Advanced economies exhibited a growth rate of 2.6 per cent, with the US growing at 2.0 per cent, Euro Area 2.6 per cent and Japan 2.1 per cent.

1.2 Inflation remained generally contained, *albeit* with some upward drift. Headline inflation in major advanced countries, after showing some moderation up to August 2007, firmed up beginning September 2007. Amongst major economies, headline inflation in December 2007 was 4.1 per cent in the US, 2.1 per cent in the UK, 3.1 per cent in the Euro area, and 0.7 per cent in Japan as compared with 2.5 per cent, 3.0 per cent, 1.9 per cent and 0.3 per cent, respectively, in December 2006. The increased domestic demand combined with rising food, metal and energy prices also led to the build-up of inflationary pressures in a number of countries in emerging Asia.

1.3 International financial markets witnessed a turbulence beginning August 2007, triggered by the US sub-prime mortgage market, which then spread in subsequent months. Losses were recorded worldwide by financial institutions, which consequently undertook huge write-offs, with some of the largest international banks recording considerable decline in profits.

1.4 During the period from June 2007, concerns over losses on US sub-prime mortgage loans escalated into widespread financial stress, raising fears about the stability of banks and other financial institutions. Global credit markets experienced a large scale sell-off during the period, as broad-based deleveraging was combined with uncertainty about the size and valuation of credit exposures. In the process, credit spreads across markets widened markedly from the unusually tight levels observed in early 2007. Rising spreads coincided with a substantial increase in volatilities implied by credit default swap (CDS) index options. After a spike early during the turmoil, volatility has remained elevated relative to the levels observed since the inception of the index in 2002-03, indicating heightened uncertainty about short-run developments. Plummeting investor risk tolerance, in turn, resulted in sharply rising risk premia for credit products. The price of credit risk, as extracted from credit spread implied and empirical default probabilities of lower-quality borrowers, increased markedly in June and July 2008, and further in the

[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.

latter part of 2008. As the activity in asset backed commercial paper (ABCP) dwindled, concerns about banks being forced to take ABCP exposures on to their balance sheets generated apprehensions about an impending credit crunch. Inability of commercial paper issuing vehicles to finance at longer maturities induced them to seek liquidity needs from their sponsor banks, which, in turn, prompted banks to hoard liquidity. The uncertainty about the quality of counterparty assets also aggravated the situation. The disturbances, thus, spilled over into the short-term money markets, causing steep increases in overnight interest rates in major economies in August 2007 as banks sought to conserve their own liquidity in the face of pressures to absorb assets from off-balance sheet vehicles for which they were no longer able to obtain funding and uncertainty about the size and distribution of banks' losses on the holding of sub-prime securities and other structured credits.

1.5 The UK witnessed some of the sharpest increases in inter-bank rates as liquidity requirements at the mortgage lender Northern Rock became more pronounced eventually triggering a bank run. The government bond yields in industrialised countries declined sharply reflecting risk aversion and consequent flight of investors to safety. The US 10-year bond yield declined from 5.19 per cent on June 13, 2007, to 3.42 per cent on January 23, 2008. The 10-year bond yield in the euro area declined from 4.63 per cent on July 9, 2007 to 3.88 per cent on January 23, 2008. The Japanese 10-year bond yield fell from 1.94 per cent on June 13, 2007 to 1.34 per cent on January 23, 2008. Equity prices in the advanced industrial economies began to fall over the summer of 2007, following the widening of CDS spreads during the onset of the credit market turmoil. Worsening of the US macroeconomic outlook triggered worries about future profits and depressed investors' risk tolerance. During the first half of 2007, emerging market asset prices soared, underpinned by yet another year of strong economic performance and strong portfolio capital flows into their equity markets. In the second half of the year, however, emerging market asset values experienced considerable swings in line with the general repricing of risk, although these swings were not as large as those observed in some mature economies at that time.

1.6 Foreign exchange markets experienced a substantial increase in volatility in August 2007 as a consequence of significant dislocations in other financial markets. This marked an important change in the factors driving market developments. After June 2007, the steady depreciation of the US dollar quickened. During 2006 and the first six months of 2007, the US dollar depreciated against the euro at an annualised rate of 9 per cent and appreciated marginally against the yen. Between the beginning of July 2007 and the end of April 2008, the annualised rate of depreciation increased to around 20 per cent against both currencies. Similarly, sterling depreciated by almost 15 per cent in effective terms between July 2007 and April 2008. Other currencies, such as the Russian rouble, depreciated steadily in nominal effective terms over this period. In contrast, a number of other currencies appreciated in effective terms in the second half of 2007 and into 2008.

Developments during 2008

1.7 The global financial turmoil has accentuated significantly during 2008 so far and its adverse impact on the real sector is clearly in evidence. Many advanced economies are experiencing recessionary conditions. Growth in emerging market economies is also weakening. The financial crisis seems to have entered a new turbulent phase since September 2008 which has severely impaired confidence in global financial institutions and markets. According to the World Economic Outlook Update by the International Monetary Fund (IMF) in November 2008, prospects for global growth have deteriorated as financial sector deleveraging has continued and producer and consumer confidence have fallen. Accordingly, world output is projected to decelerate to 3.7 per cent in 2008 and further to 2.2 per cent in 2009.

1.8 Slowdown has been witnessed in both advanced and emerging market economies in the second quarter of 2008. All major advanced economies such as Euro Area, Japan, Korea, the UK, the US and OECD countries registered decelerated growth in the second quarter of 2008, as compared with that in the first quarter of 2008. The deceleration in growth was also exhibited by emerging and developing economies such as Argentina, China, India, Malaysia and Thailand in the second quarter of 2008.

1.9 Headline inflation firmed up in major economies up to August 2008, reflecting the combined impact of elevated food and fuel prices, as well as strong demand conditions, especially in emerging markets. Subsequently, inflation eased on account of marked decline in food and fuel prices as well as augmentation of downward risks to growth from the intensification of global financial market crisis. Amongst major economies, headline inflation increased in the US to 5.6 per cent in July 2008 (from 2.4 per cent a year earlier) before declining to 3.7 per cent in October 2008. In the UK, CPI inflation rose to 5.2 per cent in September 2008 (from 1.8 per cent), but moderated to 4.5 per cent by October 2008 and in the euro area to 4.0 per cent in July 2008 (from 1.8 per cent) before falling sharply to 2.1 per cent by November 2008. Inflation firmed up in most emerging market economies (EMEs) on the back of strong growth, elevated commodity prices and ample liquidity up to August 2008, but moderated thereafter. Globally, inflation has, however, softened in several countries in recent months. According to the IMF, the combination of stabilising commodity prices and slowdown of the economy would help contain inflationary pressures.

1.10 Strains in financial markets increased significantly as negative cyclical expectations were fuelled by further weakness in housing markets. There was further increase in mortgage delinquencies and foreclosures in the US, with house price depreciation projected to extend well into the future. Sentiment deteriorated further as concerns mounted about the losses and longer-term prospects of two US Government sponsored mortgage securitisation companies, *viz*., Fannie Mae and Freddie Mac.

1.11 While markets continued to be fragile, worries about the economic outlook and related uncertainties gained prominence, weighing on valuations across asset classes. Credit markets witnessed renewed pressure from end-May 2008 as spreads widened to reflect the implications of the ongoing cyclical adjustment for loss expectations and financial sector balance sheets. Corporate earnings and credit quality eroded as input cost increased and demand subsided in an environment of higher inflation and lower growth. Bond yields in major advanced economies declined, reflecting a flight to safety, worsening growth outlook, but possibly improving near-term inflation outlook. Equity markets declined further on concerns about growth, news of further financial losses by leading investment banks and deteriorating earnings. In the inter-bank money markets, funding pressures continued and spreads between the London inter-bank offer rate (LIBOR) and corresponding overnight indexed swap (OIS) rates widened on the back of renewed concerns about financial sector write-downs, weak equity markets, counterparty credit risk and liquidity factors. CDS spreads rose with the US fiveyear CDX high-yield index spread widening by almost 136 basis points to over 700 by late August 2008. European and Japanese CDS indices broadly mirrored the performance of their US counterparts.

1.12 During the third quarter of 2008, short-term interest rates in advanced economies witnessed a mixed trend, moving broadly in tandem with the policy rates. In the US, short-term interest rates declined. The US Fed kept its fed funds rate target unchanged at 2.0 per cent in its meetings in June, August and September 2008. The pause occurred after a series of consecutive reductions in the fed funds rate target undertaken between September 18, 2007 and April 30, 2008. In the UK, short-term interest rates increased, notwithstanding cut in the policy rate in the second half of 2007-08 and also in April 2008. The Bank of England, which had increased its policy rate in May 2007 and July 2007, reduced the rate in December 2007, February 2008 and April 2008 to 5.0 per cent in the wake of concerns over slow growth. Short-term interest rates increased in the Euro Area during the quarter ended September 2008. The European Central Bank raised its refinance rate by 25 basis points on July 3, 2008. In the EMEs, short-term interest rates generally softened in Argentina, China and the Philippines, but firmed up in Brazil, Hong Kong, Malaysia, Singapore, South Korea and Thailand. In September 2008, the People's Bank of China reduced its benchmark lending rate by 0.27 percentage points and also reduced its reserve requirement ratio by one percentage point. The half-point coordinated rate cut by six major central banks, *viz*., the Federal Reserve, the European Central Bank (ECB), the Bank of England, the Riksbank, the Swiss National Bank and the Bank of Canada, on October 7, 2008 has been an unprecedented move to abate the panic in global equity and inter-bank markets. The Federal Reserve further reduced the policy rate by 50 basis points to 1.0 per cent on October 29, 2008, the Bank of England by 150 basis points to 3.0 per cent on November 6, 2008 and the Riksbank by 50 basis points to 3.75 per cent on October 29, 2008.

1.13 Long-term government bond yields in major advanced economies, which had softened at end-March 2008, hardened during the second quarter of 2008 and again softened during the third quarter of 2008, reflecting worsening growth expectations and improved near-term inflation outlook.

1.14 Equity markets, which had recovered somewhat during April-May 2008, turned extremely volatile thereafter. During the third quarter of 2008, equity markets in most of the developed economies and in EMEs declined on the back of negative news about the health of financial institutions, rising oil prices, concerns over economic slowdown in the US, Europe and Asia, extension of credit losses, high inflation and fears over decline in corporate earnings.

1.15 In the foreign exchange market, the US dollar which had depreciated during April-July 2008, appreciated from early-August 2008, notwithstanding an increase in the unemployment rate and persistent low housing sales. The US dollar's strength from early-August 2008, however, reflected narrowing of these growth differential between the US and Europe, liquidation of positions in the overseas equity and bond markets by US investors and repatriation of the money back to the US due to slowing growth in the Euro area. Between March 2008 and November 2008, the US dollar appreciated by 24.2 per cent against the Euro, 29.7 per cent against the Pound sterling but depreciated 4.8 per cent against the yen. Amongst Asian currencies, the US dollar depreciated by 2.7 per cent against Chinese yuan, but appreciated by 52.2 per cent against Korean won, 24.7 per cent against the Indian rupee, 16.4 per cent against the Russian rouble, 13.6 per cent against the Malaysian ringgit and 11.9 per cent against Thai baht.

Indian Economy

Macro Environment

1.16 The Indian economy continued to record strong growth during 2007-08, *albeit* with some moderation. Real gross domestic product (GDP) growth rate at 9.0 per cent during 2007-08 moderated from 9.6 per cent during 2006-07, reflecting some slow down in industry and services. A positive feature during the year was a recovery in the growth of real GDP originating in the agricultural sector, after the slowdown experienced in the previous year. Despite this moderation, the overall growth rate of the Indian economy during 2007-08 was noteworthy in the global context.

1.17 During 2007-08, the growth of real GDP originating from the industrial sector decelerated to 8.2 per cent as against 10.6 per cent in 2006-07. In terms of Index of Industrial Production (IIP), industrial growth was at 8.5 per cent as against 11.5 per cent in 2006-07. Manufacturing sector growth at 9.0 per cent during 2007-08 (12.5 per cent during 2006-07) was the lowest in the last four years. The mining and electricity sectors also grew at a slower pace during 2007-08. In terms of use-based classification, the performance of the capital goods sector was particularly impressive with 18.0 per cent growth. However, the basic goods, intermediate goods and consumer goods sectors recorded decelerated growth of 7.0 per cent, 8.9 per cent and 6.1 per cent, respectively, during 2007-08. The performance of the industrial sector was also affected by the subdued performance of the infrastructure sector, registering 5.6 per cent growth during 2007-08. The services sector recorded double digit growth consistently in the last three years. It grew by 10.7 per cent during 2007-08, on top of 11.2 per cent growth in 2006-07.

1.18 Headline inflation in India, based on movement in the wholesale price index (WPI), increased to 7.7 per cent at end-March 2008 from 5.9 per cent a year earlier. Inflation softened initially up to mid-October 2007, partly reflecting moderation in the prices of some primary food articles and some manufactured products as also due to the base effect. Inflation, however, hardened subsequently to reach an intra-year high of 8.0 per cent on March 15, 2008, reflecting tightening of supply-side pressures on key commodities and surge in international fuel prices. Headline WPI inflation in 2007-08 was mainly driven by 12 items/groups, *viz.*, rice, wheat, milk, raw cotton, oilseeds, iron ore, coal mining, mineral oils, edible oils, oil cakes, basic heavy inorganic chemicals and metals, with a combined weight of about 35 per cent in the WPI basket accounting for almost 82 per cent of WPI inflation, on a year-on-year basis, as on March 29, 2008 (as compared with 56 per cent a year ago). Among the major groups, primary articles, fuel group and manufactured products exhibited inflation of 9.7 per cent, 6.8 per cent and 7.3 per cent, respectively.

1.19 The key deficit indicators for the Central and State Governments were placed lower in the revised estimates (RE) *vis-à-vis* the budget estimates for 2007-08. The revenue deficit of the Central Government estimated at Rs.63,488 crore or 1.4 per cent of GDP was lower than 1.5 per cent of GDP in the budget estimates for 2007-08 and in 2006-07. The combined gross fiscal deficit (GFD) for 2007-08 at Rs.2,47,831 crore constituted 5.3 per cent of GDP as against 5.6 per cent in the previous year. The primary balance continued to remain in surplus. The improvement in key fiscal indicators was facilitated by buoyancy in tax revenue, especially direct tax revenues. The combined outstanding liabilities as a proportion to GDP at 77.0 per cent at end-March 2008 (RE) were the same as at end-March 2007. The increase in the outstanding liabilities of the Central Government was offset by the decline in the liabilities of the State Governments.

1.20 Broad money (M3) growth at 20.8 per cent as on March 31, 2008 was above the indicative trajectory of 17.0-17.5 per cent for 2007-08 set out in the Annual Policy Statement in April 2007. However, the rate of growth of M3 dipped from mid-February 2008, reflecting some moderation in the growth of time deposits. Non-food credit growth moderated in 2007-08 and remained marginally lower than the Reserve Bank's policy projection of 24.0-25.0 per cent (April 2007). Banks' investments in SLR securities increased in tandem with growth in deposits. As a result, their SLR investments as a proportion of their NDTL remained almost at the same level as at end-March 2007. Demand for commercial credit at 20.6 per cent in 2007-08 showed some moderation from 25.8 per cent during 2006-07. Commercial banks' credit to Government increased during the year, while net RBI credit to Government declined, as a result of MSS issuance. The banking sector's net foreign exchange assets increased by 41.8 per cent. Accretion to net foreign exchange assets continued to be a major source of monetary expansion, while growth of bank credit to the commercial sector moderated.

1.21 Domestic financial markets conditions remained orderly during 2007-08, barring a brief spell of volatility in the call money market and occasional bouts of volatility in the equity market during the second-half of August 2007, second-half of December 2007 and beginning of the second week of January 2008 broadly in tandem with trends in international equity markets. The primary market segment of the capital market, which had witnessed increased activity till early January 2008, turned subdued thereafter, due to volatility in the secondary market. Yields in the Government securities market softened during the large part of the year.

1.22 Brief spells of volatility were observed in the money market on account of changes in capital flows and cash balances of the Central Government with the Reserve Bank. The money market was also affected by the imposition of the ceiling of Rs.3,000 crore on reverse repo acceptances under the liquidity adjustment facility (LAF) from March 5, 2007 to August 5, 2007. Call/ notice rates softened to below the reverse repo rate during June-July 2007. Interest rates in overnight money markets subsequently moved broadly in the reverse repo and repo corridor for the most part of the year after the withdrawal of the ceiling of Rs.3,000 crore on reverse repo acceptances under the LAF in August 2007. During 2007-08, interest rates averaged 5.20 per cent, 5.50 per cent and 6.07 per cent, respectively, in collateralised borrowing and lending obligation (CBLO), market repo and call/notice money market (6.24 per cent, 6.34 per cent and 7.22 per cent, respectively, a year earlier).The weighted average rate for all the three money market segments combined together was 5.48 per cent during 2007-08, as compared with 6.57 per cent a year ago, partly due to low overnight interest rates during March to August period when there was a ceiling of Rs.3,000 crore on LAF absorption.

1.23 Indian financial markets have generally remained orderly during 2008-09 so far. Money market rates moderated at the beginning of the first quarter of 2008-09, but mostly hovered above/around the repo rate during the second quarter of 2008-09, reflecting the impact of, *inter alia*, the hikes in the cash reserve ratio (CRR) and the repo rate as well as foreign exchange market operations of the Reserve Bank. In view of the tight liquidity conditions in the domestic money markets in September 2008, the Reserve Bank announced a series of measures beginning September 16, 2008 (detailed in Chapter II). As a result, the average call rate, which was at 10.52 per cent, declined to 7.57 per cent in November 2008.

1.24 The Reserve Bank during 2007-08 had to contend with large variations in liquidity not only due to swings in cash balances of the Central Government, but also on account of large and volatile capital flows. The Reserve Bank judiciously used the CRR, LAF and MSS to manage such swings in liquidity conditions, consistent with the objectives of price and financial stability. As a whole, there was a net absorption of liquidity on 171 days and net injection of liquidity on 75 days during 2007-08. The average daily net outstanding balances under LAF varied between injection of Rs.10,804 crore during December 2007 to absorption of Rs.36,665 crore in October 2007. Net issuances under the Market Stabilisation Scheme (MSS) during 2007-08 amounted to Rs.1,05,691 crore.

1.25 The weighted average discount rate (WADR) on commercial paper (CP) declined from 11.33 per cent on March 31, 2007 to 7.65 per cent at end-October 2007, but increased thereafter, to reach 10.38 per cent as on March 31, 2008. The WADR on certificates of deposit (CDs), which declined from 10.75 per cent at end-March 2007 to 7.40 per cent at the beginning of August 2007, increased thereafter to 10.00 per cent at end-March 2008. Deposit and lending rates of scheduled commercial banks (SCBs) increased during 2007-08.

1.26 Yields in the Government securities market hardened somewhat during the first quarter of 2007-08 up to mid-June 2007, but declined thereafter. The 10-year yield moved in a range of 7.42-8.32 per cent during 2007-08. As on March 31, 2008, the 10-year yield was 7.93 per cent, four basis points lower than that at end-March 2007.

1.27 During 2007-08, the domestic stock markets continued to surge till January 8, 2008. The upward trend up to January 8, 2008 was interspersed by mild corrections during mid-August 2007, mid-October 2007 and mid-December 2007. However, beginning January 9, 2008, the domestic stock markets turned volatile. The BSE Sensex at 15,644 at end-March 2008, had declined by 25.1 per cent from its all time high level of 20,873 on January 8, 2008. However, it still was higher by 19.7 per cent over its end-March 2007 level (13,072).

1.28 In the foreign exchange market, the Indian rupee exhibited two-way movements in the range of Rs.39.26-43.15 per US dollar during 2007-08. The Indian rupee depreciated to Rs.41.58 per US dollar on August 17, 2007 from Rs.40.43 per US dollar on July 31, 2007. The exchange rate of the rupee appreciated thereafter up to January 2008. The rupee moved in a range of Rs.39.26-39.84 per US dollar during October 2007-January 2008. However, the rupee started depreciating against the US dollar from the beginning of February 2008 on account of FII outflows, rising crude oil prices and heavy dollar demand by oil companies. The exchange rate of the rupee was Rs.39.99 per US dollar at end-March 2008.

1.29 According to the data released by the Directorate General of Commercial Intelligence and Statistics (DGCI&S), India's merchandise exports recorded a growth of 28.9 per cent during 2007-08 as compared with 22.6 per cent in 2006-07. Growth in India's imports accelerated to 35.4 per cent during 2007-08, from 24.5 per cent in 2006-07. India's merchandise trade deficit, on a balance of payments basis, widened from US $ 63.2 billion in 2006-07 to US $ 90.1 billion in 2007-08. The sustained increase in invisibles surplus during 2007-08 continued to cushion the impact of widening of merchandise trade deficit. As a result, the current account deficit amounted to US $ 17.4 billion during 2007-08 (US $ 9.8 billion in 2006-07). As a proportion to GDP, the current account deficit at 1.5 per cent in 2007-08 was higher than that of the previous year (1.1 per cent), led by the higher trade deficit. 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 increase in forex reserves to US $ 309.7 billion at end-March 2008 as compared with US $ 199.2 billion at end-March 2007. Reflecting higher external commercial borrowings (ECBs) and short term debt, the external debt rose to US $ 221.2 billion by end-March 2008.

Scheduled Commercial Banks

1.30 The assets of the banking sector continued to grow at a faster rate than the real economy, resulting in an increase in the assets to GDP ratio to 91.8 per cent at end-March 2008 as compared with 83.5 per cent a year ago. Credit growth during the year showed some deceleration mainly on account of lower growth in agriculture and allied activities and personal loans, whereas credit to the services sector showed a higher growth. Notwithstanding some deceleration, the growth of credit to real estate remained higher than most other sectors. Deposits of banks continued to show a robust growth, despite some moderation in term deposits. There was a significant increase in investments in Government securities (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, *albeit* marginally. The consolidation of the banking sector continued with the merger of two old private sector banks and takeover of one foreign bank, bringing down the total number of SCBs at end-March 2008 to 79 from 82 at end-March 2007.

1.31 Financial performance of SCBs during 2007-08 was underpinned by hardening of lending rates and deposit rates. The net interest income of banks in relation to total assets declined somewhat. However, non-interest income of banks increased reflecting their efforts to diversify their sources of income. As operating expenses (in relation to assets) declined, banks were able to maintain their operating profits in relation to total assets. Provisions and contingencies made by banks as percentage of assets were marginally lower than those in the previous year. As a result, return on assets (RoA) of SCBs showed a moderate improvement during the year. However, return on equity (RoE) declined, reflecting mainly the impact of increase in capital base as banks raised resources from capital market during the year and strengthened reserves and surplus.

1.32 The asset quality of SCBs improved further during 2007-08, which was reflected in the decline in gross non-performing assets (NPAs) as percentage of loans and advances. The net NPAs as percentage of net advances remained unchanged at the previous year's level. However, gross and net NPAs were higher in absolute terms during 2007-08, as fresh accruals of NPAs exceeded the NPAs recovered and written-off during the year. This trend was observed across all bank groups, barring old private sector banks.

1.33 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, improved to 13.0 per cent at end-March 2008 from 12.3 per cent a year ago.

Co-operative Banks

1.34 Operations of the urban co-operative banks (UCBs) witnessed impressive growth during 2007-08. The growth in deposits was higher than the growth in loans and advances. However, UCBs missed both the priority sector lending target as also the stipulated sub-target for the weaker sections. Investments by UCBs increased during the year due to both the increase in SLR investments and non-SLR investments. The financial performance of all UCBs improved in terms of operating profits.

Table I.1: Select Financial Sector Indicators: 2007-08

	Category		Indicator	2006-07	2007-08
	1		2	3	4
1.	Scheduled Commercial Banks	a)	Growth in Major Aggregates (per cent)		
			Aggregate Deposits	24.6	23.1
			Loans and Advances	30.6	25.0
			Investment in Government Securities	9.3	22.7
		b)	Financial Indicators (as percentage of total assets)		
			Operating Profits	1.9	1.9
			Net Profits	0.9	1.0
			Spread	2.6	2.4
		c)	Non-Performing Assets (as percentage of advances)		
			Gross NPAs	2.5	2.3
			Net NPAs	1.0	1.0
2.	Urban Co-operative Banks	a)	Growth in Major Aggregates (per cent)		
			Deposits	6.4	14.1
			Credit	11.3	11.6
		b)	Financial Indicators (as percentage of total assets)@		
			Operating Profits	1.5	1.4
			Net Profits	0.7	0.6
			Spread	2.8	2.6
		c)	Non-Performing Assets (as percentage of gross advances)		
			Gross NPAs	18.3	16.4
			Net NPAs	7.8	7.5
3.	Rural Co-operative Banks	a)	Number	98,343	-
		b)	Growth in Major Aggregates (per cent)		
			Deposits	9.1	-
			Credit	11.7	-
		c)	Financial Indicators (as percentage of total assets)@		
			Societies in Profit (Number)	34,641	-
			Societies in Loss (Number)	48,529	-
			Overall Profit/Loss (Rs. crore)	-1,405	-
		d)	Non-Performing Assets (as percentage of advances outstanding)*	19.8	-
4.	Financial Institutions (FIs)	a)	Growth in Major Aggregates (per cent)[1]		
			Sanctions	12.9	86.2
			Disbursements	82.8	14.6
		b)	Financial Indicators (as percentage of total assets)[2]		
			Operating Profits	1.5	1.6
			Net Profits	1.0	1.0
			Spread	1.5	1.5
5.	Deposit taking Non-banking Financial Companies (NBFCs-D)	a)	Growth in Major Aggregates (per cent)		
			Public Deposits	-15.1	-1.9
		b)	Financial Indicators (as percentage of total assets)		
			Net Profits	1.0	2.9
		c)	Non-Performing Assets (as percentage of net advances)[3]		
			Net NPAs	0.2	-8.7
6.	Residuary Non-Banking Companies (RNBCs)	a)	Growth in Major Aggregates (per cent)		
			Deposits	12.1	-1.2
		b)	Financial Indicators (as percentage of total assets)		
			Net Profits	0.9	1.5

- : Not available.
@ : Relating to scheduled urban co-operative banks.
* : Includes overdues amount for PACS. .
1. Figures for 2006-07 relating to IFCI, SIDBI, IIBI, IVCF, TFCI, LIC, GIC and its subsidiaries. Figures for 2007-08 relate to SIDBI, IIBI, IVCF, LIC, GIC and its subsidiaries.
2. Relating to four FIs, *viz*., EXIM Bank, SIDBI, NABARD and NHB.
3. For reporting companies with variations in coverage.

However, higher ‘provisions, contingencies and taxes’ led to a decrease in net profits. Asset quality of UCBs declined markedly as both gross and net NPAs increased in absolute terms. However, both gross and net NPAs as percentage of gross advances declined.

1.35 Balance sheets of all segments of the rural co-operative banking sector, except state co-operative agricultural and rural development banks (SCARDBs), expanded during 2006-07. Wide variations were 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 2006-07, the lower tier (*viz.*, primary agricultural credit society (PACS) and primary co-operative agricultural and rural development banks (PCARDBs) incurred overall losses. Asset quality in terms of NPA as a percentage of loans outstanding improved for all categories of rural co-operative banks, except PCARDBs, for which it remained at the previous year's level. While the recovery performance of district central co-operative banks (DCCBs), PACS and PCARDBs improved, that of state co-operative banks (StCBs) and SCARDBs worsened during the year.

Financial Institutions

1.36 Financial assistance sanctioned by Financial Institutions (FIs) witnessed a sharp rise during 2007-08, as against a decline during the previous year. However, the disbursements slowed down during the year. Financial assistance sanctioned and disbursed by FIs increased by 86.2 per cent and 14.6 per cent, respectively, during 2007-08 as compared with a rise of 12.9 per cent and 82.8 per cent, respectively, witnessed during the previous year. The sharp rise in sanctions and slow down in disbursements were accounted for mainly by investment institutions (especially LIC).

1.37 Net interest income of FIs registered a sharp growth of 19.7 per cent during 2007-08. Non-interest income of FIs also increased significantly during the year. However, in contrast with the decline in the previous year, the operating expenses of FIs registered a rise of 46.6 per cent during the year, even though the wage bill declined substantially by 32.7 per cent. As a result, the operating profit recorded an increase of 30.1 per cent during the year. Net profit of FIs also increased, despite the increase in provision 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

1.38 Total assets/liabilities of deposit taking non-banking financial companies (NBFCs-D) increased at a much higher rate of 44.8 per cent during 2007-08, compared with 28.4 per cent during 2006-07. Borrowings, which represent the major source of funds for NBFCs-D, increased by 55.3 per cent during 2007-08, as compared with an increase of 30.1 per cent in the previous year. While net owned funds (capital and reserves) registered a substantial increase, public deposits declined marginally by 1.9 per cent during 2007-08.

1.39 Total assets/liabilities of NBFCs-ND-SI increased by 28.6 per cent during 2007-08 as compared with an increase of 26.8 per cent during 2006-07. The profits earned by NBFCs-ND-SI registered an increase of 16.7 per cent on top of the rise of 73.4 per cent during the previous year. The gross NPAs to total assets ratio of NBFCs-ND-SI remained unchanged at 2.3 per cent for the year ended March 2008. A new classification of NBFCs, *viz.*, asset finance company (AFC) became effective in 2006. Companies financing real/physical assets for productive/economic activities have been re-classified as AFCs. At end-March 2008, asset finance companies held the largest share (64.1 per cent) in assets/liabilities of NBFCs-D, partly reflecting the reclassification of NBFCs.

Micro Finance

1.40 The micro finance movement has been gaining momentum in India in recent years. At present, there are two predominant models for micro finance delivery in India. These are the SHG-bank linkage programme (SBLP) model and the micro finance institution (MFI) model. The SBLP model, which was first initiated as a pilot project by NABARD in 1992, has now emerged as a dominant model in terms of number of borrowers and loans outstanding. In terms of coverage, this model is considered to be the largest micro finance programme in the world. Recognising the potential of micro finance to positively influence the income and socio-economic conditions of the poor, the Reserve Bank, NABARD and SIDBI have taken several initiatives over the years to give a further fillip to the micro finance movement in India. With a view to providing an account of the progress achieved by this movement against the backdrop of these policy developments, a new chapter titled 'Micro Finance' has been introduced in this Report.

1.41 The SBLP has made considerable progress since its inception in the early 1990s, both in terms of the member of SHGs credit linked with banks as also the banks loans disbursed by SHGs. As on March 31, 2007 (latest data available so far), 2.9 million SHGs were having outstanding bank loans of Rs.12,366 crore under the SBLP programme. As on March 31, 2007, the number of SHGs maintaining savings bank accounts with the banking sector was 4.2 million with outstanding savings of Rs. 3,513 crore, thereby covering more than 58 million poor households under the programme.

1.42 The emerging role of MFIs as institutions other than banks engaged in providing financial services to the poor is being recognised and the banking sector has been extending loans to MFIs for on-lending to SHGs. During the year 2006-07 (latest data available so far), bank loans amounting Rs. 1,152 crore were disbursed to 334 MFIs, taking the total loans outstanding to. Rs.1,584 crore to 550 MFIs as on March 31, 2007.

Developments during 2008-09

1.43 According to the second quarter estimates of 2008-09 released by the Central Statistical Organisation (CSO) on November 28, 2008, real GDP growth during July-September 2008 was placed at 7.6 per cent compared with 9.3 per cent during the corresponding quarter of previous year. The deceleration was spread across all the three sectors, *viz*., agriculture and allied activities, industry and services. As per the latest data, the IIP in September 2008 plummeted to 4.8 per cent over the same month in 2007. Cumulative growth during April-September 2008 decelerated to 4.9 per cent, as compared with 9.5 per cent during April-September 2007.

1.44 Inflation, measured by variations in the WPI, on a year-on-year basis, firmed up to an intra-year peak of 12.9 per cent on August 2, 2008 from 7.7 per cent at end-March 2008. Subsequently, WPI annual inflation eased to 8.4 per cent as on November 22, 2008, driven by the decline in prices of freely priced petroleum products, oilseeds/edible oils/oil cakes, raw cotton, cotton textiles and iron and steel. While annual inflation rates for primary articles and manufactured products were higher (12.0 per cent and 8.1 per cent respectively as on November 22, 2008) than the end-March 2008 levels (9.7 per cent and 7.3 per cent respectively), that of fuel group was lower (5.3 per cent) than that at end-March 2008 (6.8 per cent). Various measures of consumer price inflation were placed in the range of 9.5-11.1 per cent during September/ October 2008 as compared with 7.3-8.8 per cent in June 2008 and 5.5-7.0 per cent in October 2007.

1.45 The key deficit indicators of combined finances of the Central and State Governments for 2008-09 are budgeted to decline over the revised estimates for 2007-08, both in absolute terms and as a proportion to GDP. The surplus in the primary balance is budgeted to increase to 0.8 per cent of GDP in 2008-09 (BE). The buoyant tax receipts are expected to increase the revenue receipts (by 0.4 per cent of GDP in 2008-09), while revenue expenditure as a proportion of GDP remained at the 2007-08 (RE) level. The envisaged improvement in revenue account is expected to bring down the combined revenue deficit by 0.4 per cent of GDP. The anticipated improvement in the revenue account is also expected to contribute significantly in bringing down the combined gross fiscal deficit (GFD) by 0.7 per cent of GDP in 2008-09.

1.46 Monetary and liquidity aggregates witnessed some moderation during the second quarter of 2008-09, partly reflecting decline in capital flows. During the fiscal year 2008-09 (up to November 21, 2008), broad money (M_3) increased, year-on-year (y-o-y), above the indicative trajectory of 17.0 per cent set out in the First Quarter Review (July 2008) of the Annual Policy Statement for 2008-09. M_3 growth, on a y-o-y basis, was placed at 19.0 per cent on November 21, 2008 as compared with 23.0 per cent a year ago. On a financial year basis, money supply (M_3) increased by 9.3 per cent up to November 21, 2008 as compared with 11.0 per cent during the corresponding period of the previous year.

1.47 Scheduled commercial banks' credit to the commercial sector expanded by 27.0 per cent (y-o-y) as on November 21, 2008, as compared with 23.1 per cent a year ago. Non-food credit of scheduled commercial banks expanded by 26.9 per cent, y-o-y, as on November 21, 2008, higher than 23.7 per cent a year ago. The higher expansion in credit growth relative to the expansion in deposit growth resulted in a higher incremental credit-deposit ratio (y-o-y) of SCBs of 93.7 per cent as on November 21, 2008 compared with 65.9 per cent a year ago. Disaggregated sectoral data available up to September 28, 2008 showed that about 48 per cent of incremental non-food credit (y-o-y) was absorbed by industry, around 9 per cent by agriculture, and nearly 14 per cent by personal loans, of which about 38 per cent was constituted by housing loans. The growth in non-food credit to industry during this period was led by infrastructure (power, port and telecommunication), petroleum, iron and steel, textiles, chemicals, engineering, food processing, construction and vehicles industries. Growth in loans to commercial real estate remained high, notwithstanding some moderation.

1.48 Liquidity conditions and the movement in money market rates during 2008-09 so far can be broadly categorised into two phases partitioned by the knock-on effects of disruptions in international financial markets on domestic financial markets beginning mid-September 2008. During the first phase (April to mid-September 2008), the drying up of capital inflows and the consequent turnaround in the foreign exchange market operations of the Reserve Bank from net spot purchases up to May 2008 to net spot sales thereafter (barring August 2008) restrained the generation of domestic liquidity. During the second phase, beginning mid-September 2008, extraordinary global developments triggered by the bankruptcy/sell-out/restructuring of some of the world's largest financial institutions resulted in severe disruptions of international money markets, sharp declines in stock markets across the globe and extreme investor risk aversion. These developments also brought pressures on the domestic money and foreign exchange markets, in conjunction with temporary local factors such as advance tax outflows during the mid-September 2008. The average injection through LAF window reached Rs.43,000 crore in September 2008 and rose further to Rs.46,000 crore in October 2008. This sizeable easing has ensured a comfortable liquidity position starting mid-November 2008 as evidenced in a number of indicators. Since November 18, 2008, the LAF window has largely been in the absorption mode. The average daily net outstanding liquidity injection declined to around Rs.8,017 crore during November 2008.

1.49 The WADR on CP declined from 13.16 per cent on March 31, 2008 to 8.57 per cent by mid-May 2008, but increased thereafter to 12.28 per cent at mid-November 2008 in tandem with other money market rates. The most preferred maturity of CP was for periods ranging from '181 days and above'. The WADR on CDs declined from 10.0 per cent at end-March 2008 to 9.16 per cent at end-June 2008, but increased thereafter to 12.57 per cent by October 2008. As at end-October, the WADR on CDs declined to 10.0 per cent in tandem with other money market rates.

1.50 In view of higher inflation and in sync with higher money market interest rates, primary market yields on Treasury Bills (TBs) hardened during the second quarter of 2008-09. The yield spread between 364-day and 91-day TBs was 4 basis points in November 2008 (7 basis points in March 2008).

1.51 During 2008-09 (up to November 18, 2008), scheduled commercial banks increased their deposit rates for various maturities by 50-175 basis points. The range of interest rates offered by public sector banks (PSBs) on deposits of maturity of one year to three years increased to 9.00-10.50 per cent in November 2008 from 8.25-9.25 per cent in March 2008. On the lending side, the benchmark prime lending rates (BPLRs) of PSBs increased to 13.00-14.75 per cent by November 2008 from 12.25-13.50 per cent in March 2008. Private sector banks and foreign banks also increased their BPLR to 13.00-17.75 per cent and 10.00-17.00 per cent from 13.00-16.50 per cent and 10.00-15.50 per cent, respectively, during the same period. Accordingly, the weighted average BPLR of public sector banks, private sector banks and foreign banks increased to 13.99 per cent, 16.42 per cent and 14.73 per cent, respectively, in September 2008 from 12.8 per cent, 15.1 per cent and 13.9 per cent, respectively, in March 2008.

1.52 During 2008-09 (up to December 2, 2008), the Indian rupee generally depreciated, and moved in the range of Rs.39.89-50.53 per US dollar. The rupee depreciated beginning April 2008, reflecting FII outflows, bearish stock market condition, high inflation and higher crude oil prices reflecting higher demand for dollars. The exchange rate of the rupee was Rs.50.53 per dollar as on December 2, 2008 as compared with Rs.39.99 per dollar at end-March 2008. At this level, the Indian rupee depreciated by 20.9 per cent over its level on March 31, 2008. Over the same period, the rupee appreciated by 5.9 per cent against the Pound sterling, but depreciated by 1.0 per cent against the Euro, 26.2 per cent against the Japanese yen and 22.1 per cent against the Chinese yuan.

1.53 The BSE Sensex closed at 9163 on December 8, 2008, registering a fall of 41.4 per cent over the end-March 2008 level. The performance of the domestic stock markets during 2008-09 so far has witnessed four distinct phases. In the first phase between April 1 and May 21, 2008, the markets staged a recovery. In the second phase between May 22 and July 16, 2008, the market sentiment turned cautious on account of increase in international crude oil prices, hike in domestic retail fuel prices, rise in domestic inflation rate, net sales by FIIs in the Indian equity market, concerns over rising trade deficit and depreciation of the rupee, downward trend in major international equity markets, domestic political uncertainties and other sector and stock-specific news. In the third phase from July 17, 2008 to first week of September 2008, domestic stock markets recovered, notwithstanding some intermittent corrections on account of decline in international crude oil prices. In the fourth phase beginning from the second week of

September 2008, domestic stock markets turned volatile, and weak due to bankruptcy/ sell-out/restructuring of some of the world's largest financial institutions resulting in severe disruptions in international financial markets, heavy net sales by FIIs, decline in global metal prices, slowdown in industrial and export growth, decline in indirect tax collections and deceleration in corporate earnings growth.

1.54 India's merchandise exports which remained resilient till August 2008 (35.3 per cent during April-August 2008), decelerated in September 2008 (10.4 per cent); exports recorded negative growth during October 2008 (-12.1 per cent). According to the provisional data released by the DGCI&S, during April-October 2008, India's merchandise exports and imports recorded a growth of 23.3 per cent and 36.0 per cent, respectively, which was higher than that of 22.7 per cent and 27.4 per cent, respectively, recorded a year ago. Merchandise trade deficit increased during April-October 2008 on account of sustained increase in oil imports. India's balance of payments position during the first quarter of 2008-09 (April-June) reflected a widening of the current account deficit to US $ 10.7 billion and decline in capital flows. Net surplus under invisibles remained buoyant, led by increase in software exports and private transfers. The large increase in merchandise trade deficit led to an increase in the current account deficit over its level during April-June 2007. Net capital inflows have remained volatile during 2008-09 so far. While foreign direct investment into India increased during April-September 2008, portfolio investments showed an outflow during April-October 2008. During 2008-09 (up to November 28, 2008), foreign exchange reserves declined by US $ 62.0 billion over the end-March 2008 level to US $ 247.7 billion as on November 28, 2008.