## First Quarter Review of Monetary Policy: Underlying Macroeconomics[1]

Shri Bhatt and distinguished participants,

I am deeply honoured to be invited to deliver the valedictory address at the High Powered Macroeconomic Workshop organised by the State Bank of India. I am particularly gratified that this Workshop has become a reality, since its genesis is in the extremely useful discussions that we in the Reserve Bank of India had with the Indian Banks' Association as part of pre-Annual Policy consultations held in April this year.

The success of any monetary policy formulation is dependent on successful communication between the central bank and all market participants. The effectiveness of communication would be greatly enhanced if there is deeper understanding among participants of all the reasoning and the process that goes behind policy making. So we greatly value this initiative that you have taken.

On July 31, we set out our first quarter review of the annual policy and you are all aware of the response of financial markets and the banking and financial system to our announcement. Today, I propose to move away from the minutiae of the policy review and share with you my thoughts on the underlying macroeconomics and the unfolding of expectations for the period ahead.

I propose to structure my address by beginning with an overview of domestic and global macroeconomic developments that conditioned our assessment and response on July 31. My approach will be to compare the current situation with that prevailing in April 2007 i.e., at the time of the Annual Policy Statement, in order to highlight the changes that have taken place within the Indian economy but more perceptibly, in the international environment. Against this backdrop, I will try to set out the key elements of our assessment of underlying developments, the complexities and the challenges. Finally, I will draw upon the rationale emerging from this assessment to explain the stance of the first quarter review.

[1] Valedictory Address by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India on August 3, 2007at the Workshop for Top Executives of Banks on Macroeconomic Issues and their Relevance to the Banking System organised by the State Bank of India. Assistance of M.D. Patra and Indranil Bhattacharya in preparing the speech is gratefully acknowledged.

## I. Overview of Macroeconomic Developments – Then and Now

You will all recall that the Annual Policy Statement of April 2007 was formulated at a time when the Indian economy was seen to be facing the intensification of demand pressures which, coupled with supply constraints, were showing up in inflation (as measured by the Wholesale Price Index (WPI)), ruling above 6 per cent through the preceding quarter (January-March, 2007). Consumer price inflation was even higher. There was also expectation internationally at that time that the global economy was moderating after unusually high growth in the last few years. However, some volatility had been observed in international financial markets and there was some expectation of repricing of risks, and its potential effects on financial markets. Overall, while prospects for growth continued to be favourable, monetary authorities around the world were showing an inclination to be watchful about risks to price and financial stability. By late July, while the evolution of macroeconomic and financial developments was broadly on track, with some upward revisions about growth prospects, there are some incipient shifts taking place in sentiment, liquidity and market conditions, particularly in the presence of some volatility in financial markets. Policy responses of central banks across the world have acquired a tone of increased caution.

### *(a) Domestic Developments*

In February 2007 i.e., prior to the Annual Policy Statement, the CSO had placed real GDP growth at 9.2 per cent in 2006-07. By the time of the first quarter review, the CSO had revised this estimate to 9.4 per cent, indicative of the improvement in aggregate supply conditions, but also pointing to the firming up of demand pressures. In the first quarter of 2007-08, some supply conditions seem to have improved. The arrival of the *rabi* harvest, a satisfactory south-west monsoon so far and a slow catch-up in *kharif* sowing provides grounds for optimism regarding agricultural performance this year. Activity in the industrial and services sectors has continued apace, though there seems to have been some moderation in specific sectors. In the disposition of aggregate demand, however, there appear to be signs of some shifts underway. Although the demand for consumer non-durables has picked up, the coincident high growth in capital goods and non-oil imports, secondary effects on intermediate goods and stretched capacity utilisation together suggest that investment demand could be intensifying. There seems to be a general optimism about India's growth prospects in projections made by various agencies; some agencies have taken the lead in initiating upward revisions (Table 1).

**Table 1: Projections of Real GDP for India by various Agencies: 2007-08**

(Per cent)

| Agency | Overall Growth | Agriculture | Industry | Services | Month of Projection |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| ABN Amro | 7.6 | – | – | – | March 2007 |
| Asian Development Bank | 8.0 | – | – | – | March 2007 |
| Confederation of Indian Industry (CII) | 8.5 | 3.0 | 9.3 | 9.9 | April 2007 |
| | 9.2 | 3.0 | 9.4 | 11.2 | July 2007 |
| Centre for Monitoring the Indian Economy (CMIE) | 8.5 | – | – | – | June 2007 |
| Citigroup | 9.3 | 3.0 | 10.3 | 10.9 | April 2007 |
| CRISIL | 7.9-8.4 | 3.0 | 8.4-9.1 | 9.3-9.9 | March/ |
| | | | | | June 2007 |
| Economic Advisory Council to the Prime Minister | 9.0 | 2.5 | 10.6 | 10.4 | July 2007 |
| ICRA | 8.5 | – | – | – | April 2007 |
| Indicus Analytics | 8.4 | 3.0 | 7.9 | 9.7 | April 2007 |
| International Monetary Fund | 8.4*<br>9.0* | – | – | – | April 2007<br>July 2007 |
| JP Morgan | 8.0 | – | – | – | March 2007 |
| Organisation for Economic Cooperation and Development (OECD) | 8.5 | – | – | – | May 2007 |
| National Council for Applied Economic Research (NCAER) | 8.3 | 2.6 | 8.7 | 9.9 | April 2007 |
| Reserve Bank of India | 8.5 | – | – | – | April 2007/<br>July 2007 |
| Median Projection (Q1 Review) | 8.5 | | | | |
| Median Projection (Annual Policy Statement | **8.4** | | | | |

– : Not Available. * : Calendar Year.

Within this overall picture of the real economy, headwinds to growth seem to be reshaping the outlook. While corporate performance continues to be buoyant as assessed in April, there is some deceleration in corporate sales and profitability growth on a year-on-year basis as also increases in input and staff costs. There is some indication of a turn in business sentiment with the optimism reflected in various surveys conducted at the time of the Annual Policy Statement having been moderated by rising cost expectations, strained capacities and the impact of recent exchange rate movements, particularly in IT, commercial vehicles, auto parts and cement.

The key monetary and banking aggregates are exhibiting somewhat diverging profiles. Money supply is running well above the indicative path given in the Annual Policy Statement in April, driven up by the expansion in reserve money and high growth in deposits. With banks having launched aggressive mobilisation strategies, presumably in response to the high credit demand of the last few years, there has been high growth in aggregate deposits in the banking system. Consequent to the lagged and cumulative effects of monetary measures taken since September 2004, there has been some slackening of non-food credit growth. Banks SLR portfolios (at 28.7 per cent of NDTL on July 6) have increased. This will help them to mitigate balance sheet risks and also allow for better liquidity management. The deceleration in credit demand has been localised in the commercial real estate, housing and retail segments. On the other hand, the pick up in bank credit to agriculture and industry is favourable to sustaining the growth momentum (Table 2).

**Table 2: Deployment of Non-food Bank Credit**

(Amount in Rupees crore)

| Sector/Industry | | Outstanding as on May 25, 2007 | Year-on-Year Variation | | | |
|---|---|---|---|---|---|---|
| | | | May 26, 2006 | | May 25, 2007 | |
| | | | Absolute | Per cent | Absolute | Per cent |
| 1 | | 2 | 3 | 4 | 5 | 6 |
| **Non-food Gross Bank Credit (1 to 4)** | | **17,52,349** | **3,10,316** | **32.2** | **3,65,814** | **26.4** |
| **1.** | **Agriculture and Allied Activities** | **2,22,042** | **42,122** | **35.0** | **54,038** | **32.2** |
| **2.** | **Industry (Small, Medium and Large)** | **6,76,440** | **98,947** | **26.4** | **1,41,280** | **26.4** |
| | Small Scale Industries | 1,15,884 | 14,863 | 20.3 | 26,387 | 29.5 |
| **3.** | **Personal Loans** | **4,55,439** | **–** | **–** | **87,944** | **23.9** |
| | Housing | 2,30,751 | – | – | 41,066 | 21.6 |
| | Advances against Fixed Deposits | 39,092 | 6,076 | 22.9 | 6,237 | 19.0 |
| | Credit Cards | 14,221 | – | – | 4,411 | 45.0 |
| | Education | 15,438 | – | – | 4,903 | 46.5 |
| | Consumer Durables | 8,831 | -1,103 | -13.3 | 1,661 | 23.2 |
| **4.** | **Services** | **3,98,428** | **–** | **–** | **82,551** | **26.1** |
| | Transport Operators | 25,321 | – | – | 7,922 | 45.5 |
| | Professional and other Services | 24,834 | – | – | 8,999 | 56.8 |
| | Trade | 1,05,536 | – | – | 23,319 | 28.4 |
| | Real Estate Loans | 46,295 | – | – | 19,010 | 69.7 |
| | Non-Banking Financial Companies | 44,425 | 11,564 | 64.0 | 12,401 | 38.7 |

– : Not available.

**Note:** 1. Data are provisional and relate to select scheduled commercial banks.

2. Owing to change in classification of sectors/industries and coverage of banks, data for 2006 onwards are not comparable with the earlier periods.

**Source :** Reserve Bank of India.

The combination of rising deposit growth and moderation of non-food credit growth is contributing to the prevalence of excess liquidity conditions in the financial markets. With the imposition of a ceiling of Rs.3,000 crore on daily LAF reverse repos since March 5, 2007, the summary measure of the liquidity overhang, i.e., the sum of LAF, MSS and outstanding cash balances of the government, did not fully capture the counterpart liquidity shifts in the market during this period as the net position in the LAF presents only a partial picture. A large part of the liquidity that would have otherwise been absorbed under the LAF is currently showing up in excess CRR balances and in banks' investments in money market mutual funds. On the other hand, the transfer of funds from the Government to the Reserve Bank on account of the sale of the Reserve Bank's stake in the State Bank of India has had the indirect effect of impounding market liquidity on a temporary basis. Thus, new factors have been impinging the assessment of liquidity in recent weeks, which has been reflected in the behaviour of overnight market rates and in the Reserve Bank's liquidity management operations (Table 3).

**Table 3: Reserve Bank's Liquidity Management Operations**

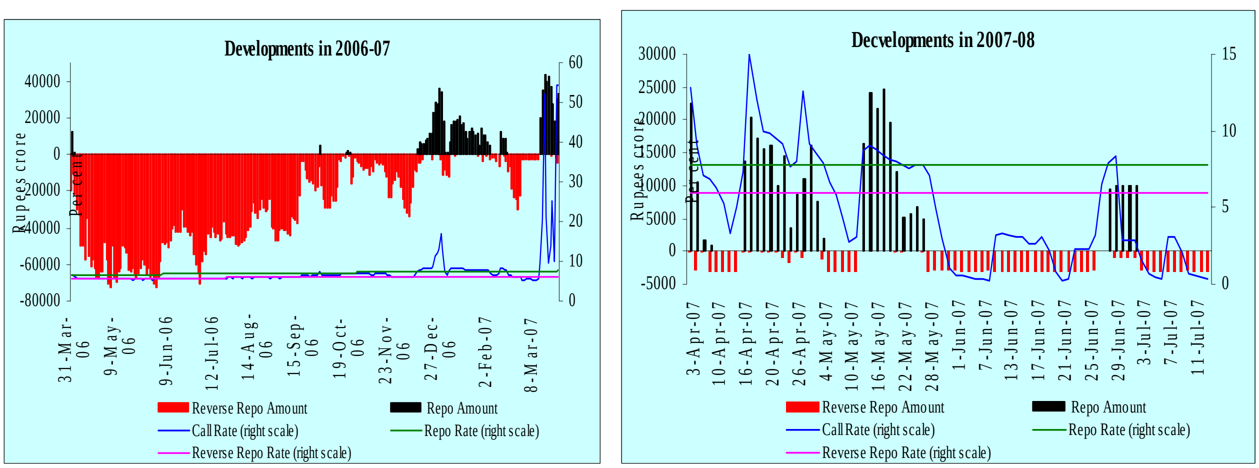
(Rupees crore)

| Item | | | 2006-07 | 2006-07 | | | | 2007-08 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | (April-March) | Q1 | Q2 | Q3 | Q4 | April | May | June |
| 1 | | | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| **A.** | **Drivers of Liquidity (1 to 5)** | | 61,739 | 36,247 | -16,896 | -25,641 | 68,028 | 34,179 | 12,797 | N.A. |
| | 1. | RBI's net Purchases from Authorised Dealers | 1,18,994 | 21,545 | 0 | 22,461 | 74,988 | 8,835 | 5,779 | N.A. |
| | 2. | Currency with the Public | -70,352 | -19,648 | -1,270 | -27,033 | -22,400 | -19,953 | -1,007 | 8,498 |
| | 3. | Surplus Cash Balances of the Centre with the Reserve Bank* | -1,164 | 40,207 | -26,199 | -30,761 | 15,590 | 49,992 | 0 | 0 |
| | 4. | WMA/Overdraft to the Centre | 0 | 0 | 0 | 0 | 0 | 980 | 6,773 | 7,406 |
| | 5. | Others (residual) | 14,260 | -5,856 | 10,574 | 9,693 | -150 | -5,676 | 1,252 | N.A. |
| **B.** | **Management of Liquidity (6 to 9)** | | -24,257 | -39,003 | 32,026 | 31,625 | -48,905 | -39,879 | -24,451 | 10,387 |
| | 6. | Liquidity Impact of LAF Repos | 36,435 | -35,315 | 40,650 | 33,600 | -2,500 | -19,189 | -5,306 | 4,205 |
| | 7. | Liquidity Impact of OMO (Net)@ | 720 | 545 | 145 | 25 | 5 | 10 | 0 | 0 |
| | 8. | Liquidity Impact of MSS | -33,912 | -4,233 | -8,769 | 4,750 | -25,660 | -12,950 | -11,395 | 6,182 |
| | 9. | First Round Liquidity Impact due to CRR change | -27,500 | 0 | 0 | -6,750 | -20,750 | -7,750 | -7,750 | 0 |
| **C.** | **Bank Reserves (A+B) #** | | 37,482 | -2,756 | 15,130 | 5,984 | 19,123 | -5,700 | -11,654 | 15,047 |

N.A. : Not available.
(+) : Indicates injection of liquidity into the banking system.
(-) : Indicates absorption of liquidity from the banking system.
* : Excludes minimum cash balances with the Reserve Bank in case of surplus.
# : Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.
@ : Adjusted for Consolidated Sinking Funds (CSF) and including private placement.
**Note**: For end-March, data pertain to March 31: for all other months, data pertain to last Friday.

In the financial markets, the shifts in liquidity flows between the first quarter of 2007-08 and the preceding quarter have imparted considerable volatility. Overnight rates have been close to zero for a prolonged period of time (Chart 1). These have been caused by the cumulative impact of the unwinding of government cash balances, excess capital flows, and high deposit growth. In the Government securities market, there is reasonable stability but the yield curve seems to be indicating that excess liquidity conditions in the short term segment was beginning to effect longer term yields. The forex market is experiencing continuous upward pressures on the spot exchange rate and forward premia have declined across maturities.

**Chart 1: Liquidity Adjustment Facility and the Call Rate**




The most important change between April and now is in inflation conditions. It may be recalled that in January 2007, the resolve of monetary policy was stated as returning inflation to within the policy tolerance threshold on a priority basis. Against the backdrop of the spike in WPI inflation in January and the persistence in the hardening of consumer prices, this stance was reinforced in April. The combination of monetary, fiscal and supply management measures appears to have had a salutary effect on inflation expectations and from end-May there has been a distinct easing of inflation in terms of the headline. Yet, inflation pressures appear to be ruling firmly. Excluding the decline in energy prices since February, WPI inflation continues to be above 6 per cent. Excluding food and energy prices, inflation would still be above the headline. Inflation in terms of consumer prices is still in the range of 5.7-7.8 per cent. Besides, global prices of key food grains such as wheat and rice, and of oilseeds and livestock products are at historically elevated levels, igniting international concern on the effect of these prices on overall inflation. With food having a higher weight in price indices in developing countries, this development is of particular concern to countries such as ours. International crude prices are high and volatile with expectations that they would remain at these levels through 2007. These factors would have a definite bearing on the manner in which the inflation outlook in India evolves over the months to come. Inflation concerns remain with us and thus our vigil on inflation must continue. There are no grounds for complacency on this account.

The balance of payments outlook remains strong and resilient between April and now. A sharper than expected increase in non-oil imports has resulted in a widening of the merchandise trade deficit in the early months of 2007-08. The key difference between expectations and outlook relating to the external sector is the magnitude of capital inflows received so far. In reflection, the foreign exchange reserves have gone up by nearly US $ 23 billion during April-July 20, which is already nearly half of the entire reserve accretion during the year 2006-07. By current indications, managing capital flows and consequently, liquidity will be the main challenge facing monetary policy in 2007-08.

### *(b) Global Developments*

The key change in the global outlook between April and July is the upward revision by the IMF in global growth forecasts for 2007 and 2008 from 4.9 per cent to 5.2 per cent. This upward revision is expected to be shared by all major mature economies, barring the US, as well as the emerging market economies (EMEs), particularly China and India. In the EMEs which are progressively increasing their contribution to global growth, the prospects are strong but embedded with risks of overheating, volatile crude prices, leveraged international financial markets and persisting global imbalances. In China, in particular, there have been rising concerns, as stated by their highest authorities, that the growth process could have the potential of becoming unstable and unsustainable. Inflation concerns have become renewed on the back of the flare up of crude prices alongside elevated levels of food and metal prices (Table 4).

**Table 4: International Commodity Prices**

| Commodity | Unit | 2004 | Index | | | | | | Variation (per cent) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | 2004 | 2005 | 2006 | 2007 | | | June 2007/ March 2007 | June 2007/ June 2006 |
| | | | | | | January-June | March | June | | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 |
| Coal | $/mt | 53.0 | 100 | 90 | 93 | 105 | 105 | 114 | 9.0 | 15.3 |
| Crude oil (Average) | $/bbl | 37.7 | 100 | 142 | 170 | 163 | 161 | 181 | 12.5 | -0.1 |
| Palm oil | $/mt | 471.3 | 100 | 90 | 102 | 146 | 132 | 171 | 29.7 | 84.7 |
| Soybean oil | $/mt | 616.0 | 100 | 88 | 97 | 122 | 117 | 135 | 15.7 | 38.3 |
| Soybeans | $/mt | 306.5 | 100 | 90 | 88 | 107 | 105 | 118 | 12.1 | 35.2 |
| Rice | $/mt | 237.7 | 100 | 120 | 128 | 133 | 134 | 136 | 1.4 | 3.5 |
| Wheat | $/mt | 156.9 | 100 | 97 | 122 | 129 | 127 | 142 | 12.0 | 14.2 |
| Sugar | c/kg | 15.8 | 100 | 138 | 206 | 140 | 146 | 130 | -11.0 | -39.7 |
| Cotton A Index | c/kg | 136.6 | 100 | 89 | 93 | 93 | 94 | 94 | 0.0 | 5.9 |
| Aluminium | $/mt | 1716.0 | 100 | 111 | 150 | 162 | 161 | 156 | -3.1 | 8.1 |
| Copper | $/mt | 2866.0 | 100 | 128 | 235 | 237 | 225 | 261 | 15.8 | 3.8 |
| Gold | $/toz | 409.2 | 100 | 109 | 148 | 161 | 160 | 160 | 0.1 | 10.0 |
| Silver | c/toz | 669.0 | 100 | 110 | 173 | 199 | 197 | 196 | -0.2 | 22.0 |
| Steel cold-rolled coil/sheet | $/mt | 607.1 | 100 | 121 | 114 | 107 | 107 | 107 | 0.0 | 0.0 |
| Steel hot-rolled coil/sheet | $/mt | 502.5 | 100 | 126 | 119 | 109 | 109 | 109 | 0.0 | -4.3 |
| Tin | c/kg | 851.3 | 100 | 87 | 103 | 158 | 163 | 166 | 1.5 | 78.6 |
| Zinc | c/kg | 104.8 | 100 | 132 | 313 | 340 | 312 | 344 | 10.1 | 11.7 |

$ : US dollar. c: US cent. bbl: barrel. mt: metric tonne. kg: Kilogram. toz: troy oz.

Source: Based on World Bank's actual commodity price data. The year 2004 has been taken as the base to better exhibit price trends over the relevant period.

Global financial markets, which faced major episodes of turbulence in May-June, 2006 and again in February 2007, seem to be experiencing heightened volatility again in July due to the fall in confidence related to the adverse developments in the US subprime mortgage market transmitted to other segments through the highly leveraged activities of hedge funds and private equity funds. Even as financial markets are repricing risks, there continues to be a compression of risk spreads and an ever widening search for returns, interrupted by sporadic flights to safety. While there seem to be signs of some abatement in the carry trade, there are persisting uncertainties and EMEs, in particular, need to be on guard against the manner in which carry trades unfold. Perhaps, the most volatile segments have been currency and equity markets with increasing linkages and potential vulnerability to contagion effects.

In response to these developments, several monetary authorities have continued to display a readiness to tighten monetary policy further in reinforcement of their stance in April. Central banks in EMEs have supported the withdrawal of monetary accommodation with successive increases in cash reserve requirements and in the application of non-monetary measures. In India and China, in particular, the use of cash reserve requirements has been more frequent than in other EMEs (Table 5).

**Table 5 : Cash Reserve Ratio**

*(per cent)*

| China | | India | |
|---|---|---|---|
| **Effective** | **CRR** | **Effective** | **CRR** |
| Sept-21,2003 | 7.00 | Jun-14,2003 | 4.50 |
| April-25,2004 | 7.50 | Sep-18,2004 | 4.75 |
| July-5,2006 | 8.00 | Oct-2,2004 | 5.00 |
| Aug-15,2006 | 8.50 | Dec-23,2006 | 5.25 |
| Nov-15,2006 | 9.00 | Jan-6,2007 | 5.50 |
| Jan-15,2007 | 9.50 | Feb-17,2007 | 5.75 |
| Feb-25,2007 | 10.00 | March-3,2007 | 6.00 |
| April-15,2007 | 10.50 | April-14,20007 | 6.25 |
| May-15,2007 | 11.00 | April-28,2007 | 6.50 |
| June-5,2007 | 11.50 | Aug-4, 2007 | 7.00 |
| Aug-15,2007 | 12.00 | | |

Thus, central banks across the world remain hawkish with respect to inflation and prepared to act against any signs of instability developing. Where they have paused, as in the US, they have done so on the back of sustained prior action. The outlook on inflation continues to drive the response of central banks (Table 6).

| Table 6: Key Macroeconomic Indicators: Emerging Markets | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | (Per cent) |
| **Country** | **Consumer Price Inflation** | | **Current Account Balance (per cent to GDP)** | | **Real Effective Exchange Rate (REER)** | | **Central Govt. Fiscal Balance (per cent of GDP)** | | **Real Policy Rate** | | **Real GDP Growth** | |
| | **June 2006** | **June 2007** | **2005** | **2006** | **June 2006** | **June 2007** | **2005** | **2006** | **July 2006** | **July 2007** | **2005** | **2006** |
| **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** | **11** | **12** | **13** |
| Brazil | 4.0 | 3.7 | 1.6 | 1.3 | 6.8 | 13.7 | -3.4 | -3.2 | 10.8 | 7.8 | 2.9 | 3.7 |
| China | 1.5 | 4.4 | 7.2 | 9.1 | 1.6 | 4.7 | -1.3 | -0.7 | 4.9 | 2.4 | 10.4 | 11.1 |
| | | | | | | | (17.9) | (17.3) | | | | |
| **India** | **6.3** | **5.7** | **-1.1** | **-1.1** | **-4.8** | **12.0** | **-4.1** | **-3.5** | **0.3** | **2.1** | **9.0** | **9.4** |
| | **(5.2)** | **(4.3)** | **(-6.4)** | **(-7.1)** | | | **(63.9)** | **(63.4)** | **(2.3)** | **(3.3)** | | |
| Indonesia | 15.5 | 5.8 | 0.1 | 2.7 | 14.6 | 6.1 | -0.5 | -1.0 | -3.0 | 2.5 | 5.7 | 5.5 |
| | | | | | | | (46.5) | (40.9) | | | | |
| Israel | 3.5 | -0.7 | 2.9 | 5.2 | -0.8 | -0.8 | -2.9 | -2.7 | 2.9 | 4.2 | 5.2 | 5.1 |
| Korea | 2.4 | 2.5 | 1.9 | 0.7 | 5.2 | 0.9 | 1.9 | 1.8 | 2.0 | 2.3 | 4.2 | 5.0 |
| | | | | | | | (29.5) | (32.2) | | | | |
| Philippines | 6.7 | 2.3 | 2.0 | 2.9 | 7.5 | 14.3 | -2.7 | -1.0 | 1.1 | 3.7 | 5.0 | 5.4 |
| Russia | 9.1 | 8.5 | 10.9 | 9.8 | 10.0 | 4.6 | 7.5 | 7.5 | 2.2 | 1.5 | 6.4 | 6.7 |
| South Africa | 3.9 | 6.9 * | -3.8 | -6.4 | -3.0 | -2.1 | -- | -- | 2.5 | 2.6 | 5.1 | 5.0 |
| Thailand | 5.9 | 1.9 | -4.5 | 1.6 | 9.6 | 8.9 | 0.2 | 0.1 | 0.6 | 1.4 | 4.5 | 5.0 |
| | | | | | | | (26.1) | (27.3) | | | | |

*: May.

Note : 1. For India, data pertain to fiscal years 2005-06 and 2006-07.
2. Consumer price inflation data are on a year-on-year basis. Data for India are for CPI-Industrial Workers.
3. Real policy rate is the policy rate less year-on-year consumer price inflation. For India, repo rate is used.
4. Figures in parentheses in columns (2) and (3) refer to wholesale price inflation.
5. Figures in parentheses in columns (4) and (5) refer to trade balance/GDP ratio.
6. Data on fiscal balance for Korea and Israel pertain to general government balance.
7. Figures in parentheses in columns (8) and (9) refer to central government debt/GDP ratio. For China, data refer to public sector debt.
8. Figures in parentheses in columns (10) and (11) for India are based on wholesale price inflation.
9. Data on REER refer to year-on-year variation in broad indices (CPI-based) compiled by the Bank for International Settlements. A positive figure indicates appreciation while a negative figure indicates depreciation. For India, data are based on movements in 6-currency indices.

Source: International Monetary Fund, Asian Development Bank. Bank for International Settlements, World Bank and official websites of respective central banks.

One key issue that many of the key Emerging Market Economies (EMEs) are facing is the issue of excess forex flows, both because of a current account surplus in most cases, and additional capital flows. In this regard, the key difference between India and most of these economies is the existence of a current account deficit, though modest, along with a significant merchandise trade deficit which is now in excess of 7 per cent of GDP. Most of these countries, along with us, have experienced significant real exchange rate appreciation over the last year or two. So the practice of monetary management has encountered significant complexity in a number of EMEs. We are not alone. We may note that we have so far been managing this complexity relatively successfully within the context of high economic growth, high credit growth, a reasonable degree of price stability and most importantly maintenance of financial stability. The quality of bank balance sheets has been improving on a continuous basis, and we are hopeful that they will reach international best practice soon. It is interesting to observe that, just like us, many of these countries have been using the whole range of monetary instruments, including direct sterilisation through issuance of government or central bank bonds, increases in reserve requirements, and different means of capital account management to manage the monetary impact of excess forex flows. The overall problem of the capital flows, both from the point of view of the monetary management of EMEs and reverse capital flows to industrialised countries, is now receiving worldwide attention. The Committee of Global Financial System (CGFS) under the aegis of BIS has also appointed a Working Group to look into these complex issues.

## II. Macroeconomics of Policy Assessment

Domestic macroeconomic prospects are currently seen to be broadly favourable, with the pace of growth being maintained and the inflation outlook softer. As already stated, however, the attendant risks from global developments relating to food, commodity, and energy prices remain and will have to be monitored carefully, and acted upon as necessary. In an overall perspective, the main objective of policy as set out in April, is to manage the transition to higher growth with price and financial stability. The key issues for the conduct of monetary policy in the context of this objective are a continuing emphasis on price stability and well anchored inflation expectations. This will involve managing liquidity in the presence of the pressures from high deposit growth, shifts in government cash balances and continuing capital flows. The flux in global financial markets is a clear and present danger to stability for which policy makers and all stake holders have to be well prepared. Exchange rate movements have become amplified by these developments. Going forward, it will be necessary to reinforce the commitment to financial stability alongside the containment of inflation so as to support growth. The Reserve Bank's Annual Policy statement had announced the initiation of further development of financial markets, such as the work related to currency futures, interest rate futures and credit default swaps. Our annual publication, Report on Currency and Finance has, this year, paid particular attention to the overall development of financial markets in some detail. The key element of our approach is the maintenance of financial stability, along with the continuous development of markets.

Against this backdrop and a careful assessment of the balance of risks, the projection of real GDP growth for 2007-08 has been retained around at 8.5 per cent as in the Annual Policy Statement. A key assumption is that agriculture will post a return to trend growth and the momentum will be maintained in industry and services. While the outlook for inflation remains unchanged, the policy priority in the first quarter review is to hold headline inflation within 5 per cent in 2007-08 and within 4.0 - 4.5 per cent over the medium term. While money supply and aggregate deposits are currently high, moderating the growth of these key aggregates has assumed policy priority. Early indications suggest that the balance of payments position is strong, that the current account deficit will be managed within sustainable limits but the uncertainties and volatility associated with capital flows will test the evolving policy stance.

While the domestic outlook is positive and should remain so with appropriate corrections in liquidity and financial market conditions to align them with the policy stance, it is the global outlook which presents the greatest threats to growth with stability in India. The conduct of monetary policy must ensure that the gains of strong macroeconomic performance are not lost in the cross currents of global financial markets and the periodic episodes of volatility of turbulence which have world wide ramifications. It is in this context that the Reserve Bank has reinforced the emphasis on price stability and financial stability in the first quarter review with a view to supporting growth by contributing stability. To sum up, therefore, inflation risks and potential dangers of financial market turbulence dominate the macroeconomics of current policy assessment.

## III. The Policy Response

The operating framework of monetary management is rendered complex, particularly in a developing economy such as ours which is undergoing significant financial deepening and structural change. The relationship between real economy variables such as GDP growth and monetary aggregates is subject to constant change. Similarly, the relationships between different monetary aggregates themselves such as broad money ($M_3$), narrow money ($M_1$) and reserve money ($M_0$) is also subject to continuous change. It is for this reason that we have to operate policy flexibly, leading to some impressions of lack of transparency. Our overall job is to maintain price stability in the presence of the existing scenario of welcome accelerated growth, along with the maintenance of financial stability of the system. It is our firm judgement that low and stable inflation is essential to maintenance of the growth process and we are determined to achieve this continuing goal. Similarly, in a low income country such as ours, we also believe that the ability of market participants, ranging from far flung subsistence farmers to the ultra sophisticated financial market players, such as you, is much more varied than in a developed country. The costs of risks unfolding are asymmetric, so we have to place a higher weight on the maintenance of financial stability than in a developed country, as we pursue overall growth and associated financial market development.

The stance of monetary policy in the first quarter review assigns a higher priority for managing appropriate liquidity in the financial markets while maintaining the intensive vigil on price and financial stability. The Reserve Bank has articulated its approach to liquidity management in the form of "appropriate use of CRR stipulations, open market operations including MSS and LAF and all policy instruments at its disposal flexibly, as and when the situation warrants".

In view of the surplus conditions in the financial markets, the ceiling on daily reverse repos under the LAF has been removed. The objective is to absorb excess liquidity and align overnight rates with the prevailing monetary policy stance so that policy signals are efficiently and transparently passed through into the structure of interest rates, aggregate demand and thereby, growth and stability. The restoration of the informal LAF corridor should help in stabilising overnight rates and smoothing volatility. The key policy rates have been kept unchanged. The cash reserve ratio has been raised by 50 basis points to 7 per cent in the first quarter review with a view to impounding liquidity generated by excessive deposit growth in the banking system. The CRR is expected to work in conjunction with the restoration of the LAF corridor to ensure appropriate liquidity conditions in the economy. The policy stance will be under careful and continuous review and the mix of instruments will be modulated by the evolving situation. To reflect the Reserve Bank's point of view at the present time, the stance of policy for the period ahead has been enunciated as:

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.

- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.

- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.

Once again, I congratulate Shri Bhatt and the State Bank of India for organising this extremely useful and illuminating workshop.

Thank you.