Statement by Dr. Y. Venugopal Reddy, Governor, Reserve Bank of India on the Mid-Term Review of Annual Policy for the Year 2006-07

This Statement consists of two parts: Part I. Review of Annual Statement on Monetary Policy for the Year 2006-07; and Part II. Review of Annual Statement on Developmental and Regulatory Policies for the Year 2006-07. An analytical review of macroeconomic and monetary developments was issued, a day in advance as a supplement to Part I of this Statement, providing the necessary information and technical analysis with the help of charts and tables.

Part I. Mid-term Review of Annual Statement on Monetary Policy for the Year 2006-07

2. This part is divided into three sections: I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2006-07; II. Stance of Monetary Policy for the Second Half of 2006-07; and III. Monetary Measures.

I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2006-07

Domestic Developments

3. Estimates released at the end of September 2006 by the Central Statistical Organisation (CSO) point to an upswing in domestic economic activity. Real GDP growth during the first quarter of 2006-07 is placed at 8.9 per cent as against 8.5 per cent in the corresponding quarter a year ago. Real GDP growth originating in agriculture, industry and services sectors was 3.4 per cent, 9.7 per cent and 10.5 per cent, respectively, as against 3.4 per cent, 9.5 per cent and 10.1 per cent in the first quarter of 2005-06.

4. Available information indicates that this early acceleration of growth has been sustained in the second quarter (July-September) of 2006-07. Rainfall during the 2006 South-West monsoon season, *i.e.*, June-September was at 99 per cent of its long period average for the country as a whole. Moisture distribution was reasonably even, with deficient rainfall in 10 of the 36 meteorological subdivisions and excess rainfall in 6 subdivisions. First estimates of the Ministry of Agriculture place *kharif* foodgrains production conservatively at 105.22 million tonnes, below the target of 115.25 million tonnes and also lower than 109.70 million tonnes recorded last year. These early estimates are likely to be revised as the outcome for the *kharif* season becomes clearer. As on October 19, 2006 live storage in 76 major reservoirs was 89 per cent of the full reservoir level and 26 per cent higher than the last 10 years' average level. While the improvement in water storage levels strengthens the prospects for *rabi* production, it is necessary to monitor further developments to make a realistic assessment.

5. Industrial output has picked up momentum, supported by favourable demand conditions, resilient business confidence and strong corporate profitability. The index of industrial production (IIP) increased by 10.6 per cent during April-August 2006 as against 8.7 per cent a year ago. Manufacturing has been the engine of industrial growth, rising by 11.8 per cent (9.6 per cent a year ago), the highest since 1996-97. Mining and electricity generation grew by 3.1 per cent (1.6 per cent) and 5.7 per cent (6.0 per cent), respectively. The acceleration in manufacturing activity was led by basic metals and alloys, non-metallic mineral products, machinery and transport equipment, textile products and basic chemicals and products. The use-based classification indicates a firming up of investment demand as reflected in an increase of 18.6 per cent (13.8 per cent) in capital goods production. Demand pressures were also reflected in a growth of 8.3 per cent (6.9 per cent) in production of basic goods and 9.5 per cent (3.5 per cent) in intermediate goods. Production of consumer goods rose by 11.3 per cent (13.7 per cent), mainly driven by consumer durables. Demand-pull impulses seem to be percolating into the consumer non-durables segment, too. The six infrastructure industries, comprising nearly 27 per cent of the IIP, posted a growth of 6.7 per cent during April-

August, 2006 as against 6.1 per cent a year ago. Petroleum refinery products registered double-digit growth and acceleration was recorded in the production of crude petroleum. The growth of cement production, electricity and finished steel decelerated while the growth of coal production was the same as a year ago.

6. Private corporate sector performance seems to have picked up after some moderation that set in during the second half of 2005-06. Sales of sample companies grew by 25.6 per cent in the first quarter of 2006-07 – up from 18.5 per cent a year ago – resulting from robust domestic and export demand conditions, excise duty reduction (*e.g.*, automobiles, information technology (IT) industries), cost saving initiatives (*e.g.*, automobiles, cement, fast moving consumer goods, *i.e.*, FMCG), volume growth (*e.g.*, auto, cement, IT) and higher sales realisations (*e.g.*, non-ferrous metals, FMCG, cement). Net profits of the selected companies increased by 34.7 per cent on top of a growth of 54.2 per cent in the corresponding quarter last year. Early results for the second quarter of 2006-07 indicate that the performance of the private corporate sector continued to be impressive in terms of the growth in sales and post-tax profits.

7. The Reserve Bank's Industrial Outlook Survey indicates cautious optimism on the growth outlook. The business expectations index for July-September, 2006 and October-December, 2006 is lower than in the preceding quarters but higher than in corresponding quarters a year ago. There is an improvement perceived in demand conditions as reflected in order books. Expectations of a rise in capacity utilisation and employment are indicating higher working capital finance requirements. A majority of the respondents reported increase in raw material prices, with raw material and finished goods inventories at around the average level. Business expectation surveys conducted by most other agencies also indicate a cautiously optimistic outlook in terms of overall economic conditions and investment climate. The business confidence index for September-October, 2006 compiled by one agency has risen by 7.6 per cent over the previous round on improved expectations about the overall economic conditions, the investment climate, financial position of firms and some improvement in capacity utilisation which is at its peak level. Seasonally adjusted purchasing managers' indices signal improvement in operating conditions, driven by strong domestic and overseas demand.

8. A contextual analysis of the co-movement between macroeconomic performance and bank credit in the current phase of the business cycle suggests that factors other than demand may also be at work: financial deepening from a low base; structural shifts in supply elasticities; rising efficiency of credit markets; and competitive pressures augmenting the overall supply of credit. Credit extended by scheduled commercial banks (SCBs) increased by Rs.1,36,643 crore (9.1 per cent) during the current financial year up to October 13, 2006 as compared with the increase of Rs.1,19,168 crore (10.3 per cent) in the corresponding period last year. Food credit declined by Rs.7,246 crore – as against a decline of Rs.2,808 crore in the previous year – reflecting lower procurement of foodgrains during the current financial year. Non-food credit registered an increase of Rs.1,43,889 crore (9.8 per cent) as compared with an increase of Rs.1,21,976 crore (11.0 per cent) in the corresponding period of the previous year.

9. On a year-on-year basis, non-food credit of SCBs exhibited a growth of Rs.3,76,105 crore (30.5 per cent) as on October 13, 2006 on top of an increase of Rs.2,97,903 crore (31.8 per cent) a year ago. Provisional information available from select SCBs for June 2006 indicates that within the services sector which currently absorbs about 49 per cent of non-food bank credit, retail lending rose by 47 per cent on a year-on-year basis with growth in housing loans being 54.3 per cent. As a result, the share of retail credit in total bank credit increased marginally from 26.8 per cent in June 2005 to 27.3 per cent in June 2006. Loans to commercial real estate almost doubled during the period, increasing their share in total bank credit from 1.4 per cent to 2.0 per cent. The year-on-year growth in credit to industry was of the order of 26.6 per cent by June 2006; however, its share in total bank credit fell from 43.2 per cent in June 2005 to 37.8 per cent in June 2006. Substantial increases were observed in credit flow to industries like infrastructure (28.3 per cent), metals (38.0 per cent), textiles (32.2 per cent), engineering (23.0 per cent), vehicles (33.0 per cent), gems and jewellery (46.3 per cent), food processing (25.8 per cent) and construction (59.7 per cent). Shares of bank credit to infrastructure, metals and textile industries in total credit to industry increased from 19.8 per cent, 11.1 per cent and 10.8 per cent, respectively, in June 2005 to 20.1 per cent, 12.1 per cent and 11.3 per cent, respectively, in June 2006. The year-on-year growth in bank credit to agriculture was of the

order of 37 per cent by June 2006. The share of agriculture in total bank credit rose marginally from 13.1 per cent in March 2006 to 13.4 per cent in June 2006.

10. Banks' investments in shares, bonds/debentures and commercial paper increased by 1.8 per cent (Rs.1,466 crore) during the current year up to October 13, 2006 against a decline of 10.5 per cent (Rs.9,828 crore) in the corresponding period last year. SCBs' investments in instruments issued by all-India financial institutions and mutual funds, however, increased by Rs.11,602 crore as against a decline of Rs.2,805 crore in the corresponding period of the previous year. The total flow of resources from SCBs to the commercial sector increased by 9.4 per cent (Rs.1,45,355 crore) during the current year so far as compared with the increase of 9.3 per cent (Rs.1,12,148 crore) in the corresponding period of the previous year. The year-on-year growth in resource flow was 28.4 per cent over and above the growth of 28.1 per cent a year ago.

11. Aggregate deposits of SCBs increased by Rs.1,85,244 crore (8.8 per cent) in the current fiscal year up to October 13, 2006 as compared with an increase of Rs.1,15,309 crore (6.5 per cent) in the corresponding period of the previous year. On an annual basis, the growth in aggregate deposits at Rs.3,93,849 crore (20.7 per cent) was higher than that of Rs.2,98,229 crore (18.6 per cent) a year ago. Aggregate deposit growth during 2006-07 has to be viewed in the context of several favourable developments during the period, namely, improvement in corporates' internally generated resources placed with the banking system, the relative attractiveness of bank deposits *vis-à-vis* small savings – owing to higher interest rates on banking deposits and extension of tax incentives for longer term deposits (five years and above) – as well as active deposit mobilisation strategies mounted by banks to fund the expansion in credit. On the other hand, demand deposits, which have exhibited close correlation with stock market activity in the recent period, have moderated since the equity market turbulence in mid-May and June. Overall, it is useful to note that the incremental non-food credit-deposit ratio during the current year so far, has declined to 77.7 per cent from 105.8 per cent a year ago.

12. SCBs' investment in Government and other approved securities at Rs.46,914 crore during the current financial year up to October 13, 2006 was higher than that of Rs.3,400 crore in the corresponding period of the previous year. Adjusted for banks' repo/reverse repo with the Reserve Bank under the Liquidity Adjustment Facility (LAF), their investment in Statutory Liquidity Ratio (SLR) securities increased by Rs.30,806 crore during 2006-07 so far as against an increase of Rs.33,578 crore a year ago. Banks' net investment in Government securities as a proportion to their aggregate deposits has been decelerating to accommodate the demand for non-food advances. There has also been substantial support from non-bank entities for the market borrowing programme of Central and State Governments. Consequently, commercial banks' holdings of Government and other approved securities fell to 29.8 per cent of their net demand and time liabilities (NDTL) as on October 13, 2006 from 34.7 per cent a year ago. While these investments exceeded the required SLR by Rs.1,23,010 crore (Rs. 2,07,903 crore a year ago), the excess SLR investment adjusted for LAF holdings amounted to Rs.1,04,770 crore or 4.1 per cent of NDTL.

13. On a year-on-year basis, the growth in money supply (M3) at 19.0 per cent was higher than 16.8 per cent a year ago. On a financial year basis, M3 increased by Rs.2,13,891 crore (7.8 per cent) in 2006-07 up to October 13, 2006 which was higher than the increase of Rs.1,41,555 crore (6.1 per cent) in the corresponding period of the previous year.

14. The year-on-year increase in reserve money was 20.4 per cent as on October 20, 2006 as compared with 14.0 per cent a year ago. On a financial year basis, reserve money increased by Rs.43,884 crore (7.7 per cent) up to October 20, 2006 as compared with the increase of Rs.23,320 crore (4.8 per cent) in the corresponding period of the previous year. While currency in circulation increased by Rs.38,262 crore (8.9 per cent) as compared with Rs.21,877 crore (5.9 per cent), bankers' deposits with the Reserve Bank increased by Rs.7,047 crore (5.2 per cent) as compared with Rs.3,289 crore (2.9 per cent). Among the sources of reserve money, net Reserve Bank's credit to the Central Government increased by Rs.15,029 crore as compared with the increase of Rs.5,073 crore in the corresponding period last year. Adjusted for transactions under the LAF, net Reserve Bank's credit to the Central Government showed an increase of Rs.6,299 crore. The Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.77,310 crore as against an increase of Rs.25,475 crore during the corresponding period of the previous year. NFEA, adjusted for revaluation, increased by Rs.42,544 crore as compared with an increase of Rs.30,077 crore during the

corresponding period of the previous year. The ratio of NFEA to currency increased from 156.3 per cent on March 31 to 160.0 per cent by October 20, 2006.

15. While daily injections under the LAF averaged Rs.11,686 crore during January-March, 2006, the Reserve Bank absorbed Rs.51,490 crore under the LAF on a daily average basis during April-June, 2006 and Rs.36,857 crore in July-September, 2006 with the absorption moderating to Rs.12,956 crore in October (up to October 27, 2006). Additional liquidity amounting to Rs.12,342 crore was absorbed under the market stabilisation scheme (MSS) during 2006-07 up to October 27, 2006. The balances under the MSS increased from Rs.29,000 crore on March 31, 2006 to Rs.41,342 crore by October 27, 2006. On the other hand, the cash balances of the Centre with the Reserve Bank declined from an average of Rs.40,981 crore during January-March, 2006 to Rs.9,569 crore in April-June, 2006 before picking up to Rs.16,029 crore in July-September, 2006 and further to Rs.27,696 crore in October, 2006 (up to October 23, 2006). The average liquidity overhang as reflected in outstandings under the LAF, MSS and surplus cash balances of the Central Government, taken together, increased from Rs.74,334 crore in March, 2006 to Rs.89,786 crore in April-June, 2006 and further to Rs.92,354 crore in July-September, 2006 before declining to Rs.85,196 crore in October, 2006 (up to October 23, 2006).

16. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, eased from its recent peak of 5.5 per cent on June 17, 2006 to 5.3 per cent by October 14, 2006. On an average basis, annual inflation based on the WPI was 4.5 per cent as on October 14, 2006 as compared with 5.3 per cent a year ago.

17. Disaggregating the movements in year-on-year inflation, it is observed that prices of primary articles (weight: 22.0 per cent in the WPI basket) increased by 7.3 per cent as on October 14, 2006 as compared with an increase of 4.1 per cent a year ago. The rise in prices of primary articles was mainly under food articles and minerals. Prices of manufactured products (weight: 63.8 per cent) increased by 4.4 per cent as compared with 2.8 per cent a year ago. In the category of manufactured products, deceleration/decline in the prices of wood and leather products, chemicals, basic metals and alloys, machinery and transport equipment softened the effects of sharp increases in the prices of paper, non-metallic mineral products, food products, rubber and plastic products.

18. The annual increase in prices of the ‘fuel, power, light and lubricants’ group (weight: 14.2 per cent) at 5.2 per cent as on October 14, 2006 was lower than 10.9 per cent a year ago. Excluding the fuel group, inflation was at 5.3 per cent (3.1 per cent a year ago), the same as headline inflation. The average price of the Indian ‘basket’ of international crude was at around US $ 67.9 per barrel during July-September, 2006 comparable to US $ 67.3 in April-June, 2006 but much higher than US $ 58.5 in July-September, 2005. In the recent period, however, there has been some easing of crude oil prices in the international markets and the average Indian basket crude price has come down to US $ 58.9 per barrel as on October 27, 2006.

19. On a year-on-year basis, inflation based on the consumer price index (CPI) for urban non-manual employees, agricultural labourers and rural labourers showed sharp increase to 6.6 per cent, 7.3 per cent and 7.0 per cent in September 2006 from 4.8 per cent, 3.2 per cent and 3.2 per cent, respectively, a year ago. The year-on-year CPI inflation for industrial workers was also placed far higher at 6.3 per cent in August 2006 as against 3.5 per cent a year ago. The relatively higher increase in consumer prices *vis-à-vis* WPI inflation needs to be viewed in the context of the rise in prices of food articles which have a relatively higher weight in the CPI than in the WPI.

20. Revenue receipts of the Union Government as a proportion to the budget estimates (BE) improved from 23.1 per cent in April-August, 2005 to 26.4 per cent in April-August, 2006 reflecting both higher tax and non-tax revenue receipts. Total expenditure at 35.5 per cent of the BE was higher than 33.2 per cent of the BE in April-August, 2005. Non-Plan expenditure at 37.4 per cent was higher mainly on account of food and fertiliser subsidy and increased interest payments. Accordingly, as a proportion to the BE, the gross fiscal deficit (GFD) and revenue deficit increased to 61.0 per cent and 93.7 per cent, respectively, during April-August, 2006 as compared with 57.1 per cent and 78.0 per cent in the corresponding period last year.

21. The gross borrowings of the Central Government at Rs.98,000 crore (Rs.84,000 crore a year ago) through dated securities during 2006-07 so far (up to October 27, 2006) constituted 63.2 per cent of the BE while net market borrowings at Rs.62,986 crore (Rs.51,370 crore a year ago) constituted 54.3 per cent of the BE. The weighted average yield and weighted average maturity of Central

Government securities issued during 2006-07 so far (up to end-October 2006) were 7.92 per cent and 14.09 years, as compared with 7.34 per cent and 16.90 years, respectively, for those issued during 2005-06. All issuances during the current financial year, except three, were reissuances reflecting efforts towards consolidation of public debt and imparting liquidity to the Government securities market. As against the provisional net allocation of Rs.17,277 crore (gross Rs.23,828 crore) for their market borrowing programme, the State Governments have raised a net amount of Rs.3,669 crore (gross Rs.8,595 crore) up to October 27, 2006.

22. Financial markets continued to remain stable and orderly in the second quarter of 2006-07 although interest rates have firmed up in almost all segments. From mid-September 2006, reduction in liquidity with the banking system on account of sizeable tax outflows and build-up of the Centre's cash balances was reflected in a sharp drop in the daily volumes of funds offered at the LAF auctions and transient spikes in overnight rates. Liquidity conditions improved in the subsequent weeks with the return flow of tax collections and drawdown of cash balances. Interest rates in the call, market repo and collateralised borrowing and lending obligations (CBLO) segments of the money market averaged 6.73 per cent, 6.40 per cent and 6.26 per cent, respectively, in October (up to October 27, 2006) as compared with 6.58 per cent, 6.17 per cent and 6.19 per cent in March 2006.

23. The primary yields on 91-day Treasury Bills increased to 6.65 per cent on October 27, 2006 from 5.41 per cent at end-April, 2006. Yields on 364-day Treasury Bills recorded a rise to 6.99 per cent up to October 27, 2006 from 5.90 per cent at end-April, 2006. The outstanding amount of CP was Rs.24,419 crore by end-September, 2006 as compared with Rs.12,718 crore at end-March, 2006. The weighted average discount rate on CP declined to 7.70 per cent from 8.59 per cent over this period. In the market for certificates of deposit (CDs), the weighted average discount rate declined from 8.62 per cent at the end of March, 2006 to 7.74 per cent by mid-September, accompanied by an increase of 46.6 per cent in the outstanding amount (*i.e.,* from Rs.43,568 crore to Rs.63,864 crore).

24. In the foreign exchange market, there was improvement in activity in the spot segment from the last week of July, 2006 with two-way movements in the spot exchange rate. Forward premia increased during the second quarter of 2006-07. The average six-month forward premium increased from 1.04 per cent in July, 2006 to 1.51 per cent in October, 2006 (up to October 26). The turnover in the inter-bank as well as merchant segments of the foreign exchange market during the second quarter of 2006-07 was higher than in the corresponding period of 2005-06. While the inter-bank turnover increased from US $ 234 billion (monthly average) during the second quarter of 2005-06 to US $ 339 billion in the second quarter of 2006-07, the merchant turnover increased from US $ 94 billion to US $ 131 billion. The ratio of inter-bank to merchant turnover was 2.6 during the second quarter of 2006-07, the same as a year ago.

25. The yield on Government securities with one-year residual maturity moved up from 6.20 per cent at end-April, 2006 to 7.02 per cent as on October 27, 2006. The yield on Government securities with 10-year residual maturity also firmed up from 7.39 per cent at end-April, 2006 to 7.62 per cent as on October 27, 2006. The yield on Government securities with 20-year residual maturity rose from 7.80 per cent to 7.93 per cent during the same period. The yield spread between 10-year and one-year Government securities narrowed down from 119 basis points to 60 basis points as on October 27, 2006. The yield spread between 20-year and one-year Government securities narrowed down from 160 basis points to 91 basis points during the same period.

26. During April-October, 2006 public sector banks (PSBs) raised their deposit rates across various maturities by 50-75 basis points. Interest rates offered by PSBs for deposits up to one year maturity increased from a range of 2.25-6.50 per cent to 2.75-7.00 per cent. Similarly, deposit rates for over one to three years maturity increased from 5.75-6.75 per cent to 6.25-7.50 per cent and, for above three years maturity, they increased from 6.00-7.25 per cent to 6.50-8.00 per cent over the same period. The adjustments in rates on term deposits made by private sector banks and foreign banks were somewhat mixed. While their maximum deposit rates increased by 50-175 basis points, their minimum deposit rates declined by 50-150 basis points for some maturities.

27. The benchmark prime lending rates (BPLRs) of PSBs and private sector banks increased to a range of 11.00-12.00 per cent and 11.50-15.00 per cent from 10.25-11.25 per cent and 11.00-14.00 per cent, respectively, during April-October, 2006. The range of BPLR for foreign banks remained, however, unchanged at 10.00-14.50 per cent. During the current year, the weighted average BPLR of

PSBs increased from 10.71 per cent in March to 11.18 per cent in June and further to 11.33 per cent in September. The weighted average BPLRs of private sector banks also increased from 12.37 per cent in March to 12.80 per cent in June and 12.89 per cent in September. The weighted average BPLRs of foreign banks remained stable at around 12.66 per cent during the period.

28. During the second quarter of 2006-07, equity market activity recorded a pick-up in terms of issuances in the domestic primary segment as well as in international stock exchanges. The BSE Sensex rose from 11,280 in end-March, 2006 to reach a peak of 12,612 on May 10, 2006 before receding to 8,929 on June 14, 2006. Thereafter, banking on robust macroeconomic fundamentals and high private corporate profitability, it rallied with intermittent corrections in the successive months to reach 12,907 on October 27, 2006.

Developments in the External Sector

29. Balance of payments data for the first quarter of 2006-07 released at the end of September, 2006 continue to reflect vibrancy and strength in the external sector of the economy. Merchandise export growth at 17.0 per cent was led by manufactures such as chemicals and related products, engineering goods including machinery and instruments, transport equipment, manufactures of metals and petroleum products. Merchandise imports increased by 23.8 per cent mainly on account of a growth of 44.9 per cent in oil imports on the back of a year-on-year rise of 35.5 per cent in average international crude prices facing India. Non-oil imports excluding gold and silver rose by 17.3 per cent during April-June, 2006 led by imports of industrial inputs and capital goods. Accordingly, on a payments basis, the merchandise trade deficit increased to US $ 18.5 billion during April-June, 2006 from US $ 13.6 billion in the corresponding quarter last year. The buoyancy of software exports, remittances from Indians working overseas and various professional and business services enabled an increase in net invisible earnings to US $ 12.4 billion from US $ 10.0 billion a year ago. Invisible payments rose by 21.9 per cent and, coupled with the wider trade deficit, resulted in a current account deficit (CAD) of US $ 6.1 billion which was higher than the CAD of US $ 3.6 billion in the corresponding quarter a year ago.

30. Net capital inflows during April-June, 2006 at US $ 11.9 billion were supported by both debt and non-debt inflows. Foreign direct investment flows increased to US $ 1.7 billion from US $ 1.2 billion a year ago. Debt flows (net) in the form of external assistance, external commercial borrowings, non-resident deposits and short-term credit increased to US $ 5.2 billion in April-June, 2006 from US $ 1.0 billion a year ago. While net external commercial borrowings amounted to US $ 3.6 billion as compared with US $ 1.1 billion a year ago, non-resident Indian (NRI) deposits increased by US $ 1.2 billion in contrast to an outflow of US $ 0.1 billion a year ago. In the wake of stock market turbulence in May, 2006 there was a marginal outflow of US $ 0.5 billion in portfolio investment during April-June, 2006.

31. Net accretion to foreign exchange reserves, excluding valuation changes, amounted to US $ 6.4 billion during April-June, 2006. Valuation gains, reflecting the appreciation of major currencies against the US dollar, accounted for a rise of US $ 4.9 billion in total reserves as against a valuation loss of US $ 4.3 billion in the corresponding period last year. The foreign exchange reserves, including valuation changes, thus recorded an increase of US $ 11.3 billion during this period as against a decline of US $ 3.1 billion a year ago.

32. These early developments seem to have been extended into the second quarter of 2006-07. According to the Directorate General of Commercial Intelligence and Statistics (DGCI&S), exports increased by 22.9 per cent in US dollar terms during April-September, 2006 as compared with 34.1 per cent in the corresponding period of the previous year. Imports rose by 19.0 per cent as against an increase of 46.6 per cent in the corresponding period last year. While the oil import bill increased by 36.8 per cent, reflecting the hardening of international crude oil prices (prior to the recent softening), non-oil import growth decelerated to 11.0 per cent from 48.5 per cent in the corresponding period last year. The slowing down of non-oil import growth mainly reflects a sharp decline of 30.3 per cent in imports of gold and silver during the first quarter of 2006-07 as against an increase of 52.1 per cent a year ago. Available information for subsequent months of 2006-07 indicate that the decline in bullion imports has continued. The overall trade deficit during April-September, 2006 widened to US $ 24.6 billion from US $ 22.3 billion a year ago. Net FII outflows of US $ 1.8 billion in the first quarter of 2006-07 were recouped and net inflows amounting to US $ 1.7 billion were recorded in the second quarter. Net inflows on account of FIIs continued in October. FDI inflows rose to US $ 4.0 billion during April-August, 2006 – nearly

62 per cent higher than the inflow registered in the corresponding period last year. Net capital flows and resilient invisibles financed the trade deficit resulting in the foreign exchange reserves increasing to US $ 166.2 billion on October 20, 2006 up from US $ 151.6 billion at end-March, 2006 (including valuation effects).

33. The Indian foreign exchange market has generally witnessed orderly conditions during the current financial year so far with the exchange rate exhibiting two-way movements. The exchange rate of the rupee, which was Rs.44.61 per US dollar at end-March, 2006 depreciated to Rs.46.95 per US dollar by July 19, 2006 but strengthened to Rs.45.22 per US dollar by October 27, 2006. Similarly, the rupee depreciated to Rs.59.88 per euro on August 7, 2006 from Rs.54.20 at end-March, 2006 but subsequently appreciated to Rs.57.34 by October 27, 2006. Overall, the rupee depreciated by 1.4 per cent against the US dollar, by 5.5 per cent against the euro, by 9.0 per cent against the pound sterling and by 0.5 per cent against the Japanese yen during the current financial year so far (up to October 27, 2006).

34. The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene, if and when necessary. The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements.

Developments in the Global Economy

35. The global economy, now in its fourth successive year of above-average growth, appears to have maintained the pace of its expansion in the third quarter of 2006 on top of accelerated growth in the first half of the year. The moderation in the US economy seems offset by stronger growth in other parts of the world. According to the World Economic Outlook of the International Monetary Fund (IMF) released in September 2006, global real GDP growth on a purchasing power parity basis is expected to pick up from 4.9 per cent in 2005 to 5.1 per cent in 2006 before easing back to 4.9 per cent in 2007. Based on market exchange rates, world real GDP growth is projected to accelerate from 3.4 per cent in 2005 to 3.8 per cent in 2006 before decelerating to 3.5 per cent in 2007.

36. In the US, real GDP growth was 1.6 per cent in the third quarter (July-September) as compared with 5.6 per cent and 2.6 per cent in the first and second quarters, respectively, mainly indicative of a downturn affecting residential investment and inventories along with an acceleration in imports. The cooling of the housing market was reflected in declines in housing starts as also in new and existing home sales and, more recently, a fall in median house prices for the first time since 1995. The Japanese economy has been experiencing a period of sustained expansion in recent months. There has also been a gradual improvement in conditions for growth in the euro area. Rapid growth appears to have continued in China (10.4 per cent in the third quarter) and India (8.9 per cent in the second quarter). The performance of the other Asian economies has remained firm. Growth has been buoyant in Russia and Latin America, too.

37. The strength of the global economy over recent years has been accompanied by upward pressure on commodity prices till the first half of 2006. Higher demand, shortages in production due to unfavourable weather conditions in the early part of 2006 and declining inventories have tightened the overall cereal and sugar supply-demand situation. World cereal production is projected to decline. Global wheat stocks are at their lowest level in 25 years owing to drought conditions in major producing areas. Higher agricultural product prices are expected to result in an increase of over 2 per cent in the world food import bill in 2006. Metal prices have ruled firm since 2004, rising by 45.5 per cent during the first nine months of 2006 on top of an increase of 36.2 per cent in 2005. In the wake of the slowdown in the US, prices of these commodities have undergone some correction in recent weeks. Industrial metal prices have tended to decline, but dwindling stockpiles and firm demand have provided resistance.

38. Crude oil prices, which increased from around US $ 60 per barrel at the start of the year to reach record highs above US $ 78 in July and August, eased in September and October due to large US fuel inventories, signs of slowing US economic growth, a calmer Atlantic hurricane season and forecasts of a mild winter. Petroleum product prices have also undergone some softening with Nymex gasoline futures down by a third. The International Energy Agency has revised down its forecast for growth in world oil demand for 2006 and increased its forecast for oil production for 2007. The West Texas Intermediate (WTI) crude oil spot price is projected to average around $ 66

per barrel in 2007. Gold prices have also witnessed a correction of about 18 per cent from a 26-year peak reached in the first half of 2006, due to a sharp fall in jewellery fabrication.

39. In the US, consumer prices declined from 4.1 per cent in July to 3.8 per cent in August and further to 2.1 per cent in September, 2006. In the Euro area, inflation declined from 2.5 per cent during May-June to 1.8 per cent in September. Consumer prices increased moderately in Japan, *i.e.,* by 0.6 per cent in September. In the UK, though, inflation breached the Bank of England's target of 2.0 per cent in May and rose from 2.4 per cent in July to 2.5 per cent in August before decelerating to 2.4 per cent in September.

40. Globally, financial markets have been re-pricing risks in the aftermath of the sharp decline in several asset markets in May-June including, in particular, emerging markets. There has been a resilient recovery in global equity markets with the Dow Jones Industrial Average having risen to an all-time high on October 25, 2006. Investor optimism seems to have returned to most equity markets across the world, more significantly, to the emerging markets. The US yield curve remains inverted, reflected in a fall in 10-year bond yields from 5.22 per cent in early July to 4.88 per cent on October 27, 2006. In the Eurozone, 10-year bond yields have fallen from 4.19 per cent in early July to 4.0 per cent, even though the European Central Bank (ECB) is widely expected to raise rates further before the end of the year. Japanese 10-year bond yields have declined from 1.97 per cent in early July to 1.70 per cent. The US dollar depreciated against most major currencies in July and August, but recovered to appreciate marginally by October. In credit markets, spreads on emerging-market and corporate debt, which had widened in May-June, narrowed to all-time lows in September, following several sovereign rating upgrades.

41. The pass-through of international crude prices to domestic retail prices has been varied across countries while inflation expectations have remained firm. These factors have been reflected in monetary policy responses. Most central banks have been increasing policy rates but there is, in some cases, evidence of a pause, notably in the US. The Federal Reserve, which had been increasing its target rate (by 25 basis points each on seventeen occasions from June, 2004 to 5.25 per cent by June, 2006), paused in August-October, 2006. Other central banks that have kept their policy rates steady since July include the Bank of Japan (uncollateralised overnight rate to 0.25 per cent in July, 2006 after maintaining a zero interest rate policy since 2001); the Bank of Canada (by 50 basis points in April-May, 2006 to 4.25 per cent); Bank Negara Malaysia (policy rate at 3.5 per cent since April, 2006); the Bank of Thailand (the 14-day repurchase rate at 5.00 per cent since June, 2006); the Monetary Authority of Singapore; and the Banco Central de Chile (benchmark lending rate raised to 5.25 per cent in July, 2006); the Banco de Mexico (benchmark overnight lending rate at 7.0 per cent since April, 2006). In Turkey, policy rates which were raised by 425–625 basis points in June-July, 2006 were kept unchanged subsequently.

42. The ECB raised its policy rates five times since December, 2005 by 25 basis points each to 3.25 per cent; the Bank of England (which had raised its policy rate in August, 2006 by 25 basis points to 4.75 per cent, for the first time since August, 2005); the Reserve Bank of Australia (by 25 basis points in August, 2006 to 6.0 per cent); the People's Bank of China (lending rate raised by 0.27 percentage points to 6.12 per cent on August 18, 2006; required reserve ratio by 50 basis points on July 5 to 8.0 per cent and a further increase of 50 basis points effective from August 15, 2006); and the Bank of Korea (by 25 basis points to 4.50 per cent on August 10).

43. A few central banks have eased monetary policy in the recent period such as Bank Indonesia (reduced its policy rate from 12.50 per cent to 10.75 per cent on October 5, 2006); and the Banco Central do Brasil (cut Selic rate target gradually from September 2005 to 13.75 per cent by October 2006).

Overall Assessment

44. In the Indian economy, aggregate supply conditions appear to have strengthened in the first half of 2006-07, invigorated by the pick-up in activity in all constituent sectors of the economy. While growth in agriculture in the first quarter seems to have benefited mainly from the *rabi* season of 2005-06 (which came to a close in June 2006), the prospects for agriculture in the rest of 2006-07 seem to have improved. Hence, a resumption of trend growth in agriculture appears realisable for the current year, despite some setbacks on account of floods in various parts of the country and somewhat deficient rainfall in foodgrains growing areas.

45. Industrial production appears to be performing better than consensus expectations, propelled by growth in manufacturing which touched a ten-year high in April-

August, 2006. The industrial climate is characterised by buoyant corporate sales/profitability and record tax collections. This is supported by the strength of domestic and export demand, resilient business confidence and improvement in financing conditions, particularly in sustained growth in bank credit. The momentum of industrial activity, if sustained, is likely to impart an upside bias to expectations of overall macroeconomic performance.

46. Lead indicators point to continued bright prospects for growth in services. There has been a sustained improvement in railway revenue earnings in freight traffic and in import/export cargo handled by civil aviation. Foreign tourist arrivals as well as passengers handled at domestic air terminals have recorded increases during the first half of 2006-07. Furthermore, there has been a noticeable addition to switching capacity under both telephone and cell phone connections. Accordingly, all sub-sectors under services, which account for about 70 per cent of overall GDP growth, display dynamism.

47. Turning to aggregate demand conditions, there seems to be some evidence of pressures firming up in the form of high growth in capital goods output, an upturn in investment in infrastructure and a quickening of the capital expenditure cycle. There are indications that strengthening investment demand is beginning to drive the economy. More importantly, consumption demand, which accounts for over two-thirds of aggregate domestic demand, also seems to be gathering strength. This is evident from high retail credit and double-digit growth in the production of consumer durables in the first five months of 2006-07. Consumer non-durables have shed their earlier sluggishness and picked up in July and August. Demand pressures are also visible in the expansion of money supply and reserve money which has been sizeably higher than anticipated.

48. The demand for bank credit has been growing at above 30 per cent for the third year in succession. Available information points to high growth in credit extended by banks to fast growing sectors such as housing, commercial real estate and retail loans. Asset prices remain at elevated levels and current levels of commodity prices make an overall assessment a complex task.

49. Against this background, it is critical to be watchful for early signs of overheating. An overheating economy is one which is growing rapidly and its productive capacity cannot keep up with resulting demand pressures. Emergence of inflationary pressures is usually seen as the first indication of overheating. In this context, policy makers keenly analyse the behaviour of the output gap, *i.e.*, the excess of current output over potential or full capacity output. In the context of setting monetary policy, judging how close an economy is to operating at full capacity is crucial. If the monetary authority senses that there is unutilised capacity, the increase in demand generated by growth can be accommodated without inflationary pressures and, therefore, the need to act against overheating may not arise. On the other hand, if demand is running ahead of full capacity, there is a case for tightening of monetary policy with a view to slowing down the economy and heading off overheating.

50. Globally, there seems to be increasing difficulty in identifying the symptoms of overheating. There is some evidence of a blurring of the relationship between output gaps and inflation. Moreover, the size and direction of an economy's potential output is becoming increasingly difficult to diagnose. In particular, globalisation has expanded the supply potential of various economies, especially emerging economies. In the recent period, it appears that the current positive supply shock has made the concept of potential output fuzzier than in the past. For a developing economy like India, the concept of overheating is less of a guide for monetary policy than in advanced economies on account of the existence of large unemployment/underemployment of resources and the absence of a clear assessment of potential output. Furthermore, it is difficult to obtain a clear judgement of potential output in an economy that is undergoing structural transformation. Nevertheless, recent developments, in particular, the combination of high growth and consumer inflation coupled with escalating asset prices and tightening infrastructural bottlenecks underscore the need to reckon with dangers of overheating and the implications for the timing and direction of monetary policy setting. While there is no conclusive evidence of overheating in the Indian economy at the current juncture, the criticality of monitoring all available indications that point to excess aggregate demand is perhaps more relevant now than ever before.

51. Monetary policy operates with lags that can be long and variable, depending on the specifics of the country situation. It is in this context that the setting of monetary policy is required to be forward looking with the full impact of current policy actions coming into play 12 to 18 months later. In India, the key policy signalling rates

embodied in the LAF repo/reverse repo rates have been raised since October, 2004 by a cumulative 100/150 basis points, supported by a 50 basis points increase in the CRR. This calibrated withdrawal of accommodation is in the process of working itself through the various sectors of the economy. Hence, in addition to current signs of demand pressures, the evolution of demand conditions in the next few months is critical for considering the possible emergence of overheating, if any, with concurrent implications for both price and financial stability.

52. In the domestic financial markets, there seems to be some evidence of moderation in volatility in the second quarter of 2006-07 within an overall re-pricing of risks. Money markets continue to be characterised by conditions of excess liquidity, interrupted by brief spells of temporary tightness in the second half of September on account of advance direct tax outflows and balance sheet requirements. Short-term rates have generally evolved in alignment with policy rates and have responded favourably to the policy stance in June and July. In the foreign exchange market, the exchange rate of the rupee has exhibited two-way movements. Since end-July, however, the market sentiment has turned upbeat, mirrored in a modest nominal appreciation. In the Government securities market, yields have come off mid-July highs and have corrected substantially.

53. Inflationary pressures, as exhibited in wholesale and consumer prices warrant continued special focus. Despite recent easing, it will be prudent to presume that oil prices at current levels may still contain some elements of a 'permanent' component which is yet to be matched by full pass-through. Hence, the possible risks for inflation in the months ahead need to be viewed against this background. It is desirable to watch for incipient pressures building up on prices of manufactures with the quickening of domestic industrial activity and the elevated levels of international commodity prices. It is also necessary to monitor the seasonal movements in prices of food articles in the remaining part of the year, given their criticality for inflation perceptions and consequently, inflation expectations. In the months ahead, it is difficult to assess whether productivity gains and competitive conditions will be able to head off the squeeze on margins that seems to be setting in. Furthermore, it is possible to hold that positive base effects that have couched the impact of upside pressures on price changes so far would wear off and this could amplify measured inflation towards the close of 2006-07.

54. Fiscal spending has picked up in the first five months of 2006-07 and the Centre's gross fiscal deficit has been running higher on an annual basis in relation to budget estimates. The buoyancy in tax revenues may, however, mitigate the expansionary impact if it gets entrenched in the remaining months of the year. Consumer prices for all categories have been rising through the first half of 2006-07, reflecting the impact of heightened primary product prices, including those of essential commodities. The wedge between consumer prices and wholesale prices remains larger than before. While a combination of fiscal and monetary measures seems to have reinforced each other and helped to mitigate the inflationary risks, there are reasons to be vigilant on this front. In particular, looking ahead, it may be appropriate to hold that the outlook for inflation in India is more likely to be driven by demand conditions rather than by the strong positive supply-side effects noticed in the recent past.

55. In an economy-wide sense, the faster growth of aggregate demand relative to aggregate supply during 2006-07 has begun to be manifested, to some extent, in the external sector. The merchandise trade deficit and the current account deficit have expanded despite buoyant export growth and some moderation in the growth of non-oil imports. So far, the high prices of international crude seem to have been driving the widening of the trade deficit. Softening of these prices in the months ahead could offset such pressures. Merchandise export growth has remained reasonably strong. Gross invisible earnings have expanded rapidly in recent years and are poised to equal merchandise exports. Fast growth in earnings from travel, software and other business service exports has complemented the stable support from inward remittances which is being increasingly regarded as a 'permanent' component of India's external balance sheet. Capital flows seem to have recovered from the turbulence of May-June and have resumed strongly with debt flows in April-June, 2006 increasing to US $ 5.2 billion from US 1.0 billion a year ago. On the whole, it is reasonable to expect that, as in the recent past, capital flows will enable financing of the current account deficit and some continuing accretion to the level of foreign exchange reserves.

56. In recent months, there are some indications of a shift in the patterns of global growth. First, the US economy, which has powered the recent phase of global expansion, seems to be beginning to slow, driven down primarily by the contracting housing market. Second, activity appears to have gathered momentum in the Euro

area and Japan but it is unclear as to whether or not this recovery is self-sustained. Third, the onus for sustaining global growth seems to be shifting to the emerging economies, particularly low per capita income countries. Financial upheavals right up to May-June this year are a reminder that market conditions in emerging economies have been relatively volatile in response to exogenous developments. Fourth, shifts in the pattern of international trade are also discernible. China's rising importance has been paralleled by a reduced reliance of major emerging economies on the US as an important export destination.

57. Globally, inflation risks remain, though incipient at the current juncture. While headline inflation rates are moderating, core inflation, especially in the US, has remained firm, indicating that upside pressures from oil and commodity prices persist across advanced and emerging economies, especially at the producer level. Potential risks from the possible full indirect effects of elevated and uncertain oil/commodity prices, some possible tightening of global production capacities and the remaining overhang of global liquidity continue to weigh upon the setting of monetary policy worldwide. There are also signs of wage pressures setting in. While some deceleration in economic activity in recent months seems to have induced a pause in the policy tightening cycle of several important central banks, the persistent threats of inflation constrain monetary authorities from possible moves towards a more neutral stance in an aggressive fashion.

58. Global imbalances have continued to widen during 2006. With some central banks actively reassessing their stance now, the potential drainage of global liquidity would test the resilience of world financial markets and weigh upon the outlook on the global economy. Globally, the concerns are not about the existence of current account deficits or surpluses *per se*, but the persistence of large deficits and surpluses, particularly in large and systemically important economies. It is in this context that the IMF's projection of the U.S. current account deficit at about 7 per cent of GDP in 2007 with large surpluses continuing in Japan, emerging Asia and oil-exporting countries is disturbing. The sharp rise in the net foreign liability position of the US raises the risks of abrupt and disorderly adjustment of major currencies as the global imbalances unwind. However, there is an interesting lull in the serious concerns expressed both by policy makers and financial markets in regard to the global imbalances, possibly on the assumption that universal recognition of the problem would *per se* lead to harmonised actions that would avoid hard landing.

59. Global financial markets have revised expectations in response to the changes in the magnitude and pace of monetary tightening between June and September, 2006. In the money markets, there appear to be widening expectations that, at best, interest rates are expected to rise only gradually from now on. On the other hand, these revisions in expectations have coincided with falling long-term interest rates in the US, the Euro area and Japan leading to inversion/flattening of yield curves. Global equity markets have recovered some of the losses suffered in May and June with those markets that recorded the largest losses gaining the most. Spreads in corporate credit markets have remained tight, broadly unchanged from late June. A boom in global mergers and acquisitions has been underway and has been financed, to some extent, by increased leverage. Changes in expected short-term interest rate differentials have emerged as important drivers of foreign exchange markets, enabling a moderate strengthening of the euro. The yen's role as a funding currency for carry trades remains significant. The pound sterling has strengthened in the wake of the increase in the policy rate by the Bank of England. Currencies of emerging economies have benefited from a reversal of May-June portfolio outflows. Renewed strength in commodity prices has also played a role in foreign exchange markets. Nevertheless, geopolitical risks remain a key factor in determining the evolution of major currency movements. It is also important to recognise the potential risks emanating from the possible moderation of liquidity and oil surpluses on account of the impact of monetary policy action as well as the likelihood of the ebbing of oil prices.

60. Credit markets, particularly in developing countries, have been experiencing heightened activity since 2004. During 2006, there seems to be growing evidence that a synchronised upswing in bank credit is taking hold across emerging economies in Asia and Latin America in an environment of strong growth and excess liquidity in banking systems. This recent surge is accompanied by compositional shifts on the assets side of banks' portfolios. Households, not corporates – historically the most important borrowers from banks – have absorbed a significant portion of the credit growth. There seem to be some risks to sustainability of the recent rapid pace of bank credit growth to households. First, households could become overextended as reflected in credit card busts in several

emerging economies. Second, large accumulation of debt could leave households prone to future interest rate/exchange rate shocks since banks have, in effect, transferred a large part of their market risks to households. Third, excessive reliance on debt-financed consumption could turn out to be a serious problem if refinancing options dry up. Fourth, moral hazard and adverse selection is a constant challenge facing banks. Fifth, housing markets continue to remain overheated and, therefore, a source of risk.

61. In the overall assessment, while global growth has been strong and broad-based, there seem to be some indications of moderation in recent months. There are also perceptions of risks to growth from the cooling of the housing market in the US and the potential drainage of liquidity from financial markets. While global inflation conditions have not worsened, concerns relating to potential price pressures persist, particularly in the context of the firming up of food and metal prices, the uncertainty surrounding international crude prices and the monetary overhang. While geopolitical risks continue to cast a shadow, it is necessary to recognise that global risks have not changed significantly from the time of the First Quarter Review of July, 2006. Domestic developments exhibit strength and resilience with some downside risks. There is a pick-up in the momentum of growth which also appears to be spreading across all constituent sectors of the economy. Domestic financial markets have exhibited stable and orderly conditions. In the external sector, there are signs of abiding strength and the current account deficit has been well-managed so far. On the other hand, there are indications of growing demand pressures and potential risks from rapid credit growth and strains on credit quality. High levels of monetary expansion and the evolution of the liquidity situation will need to be continuously monitored for any signs of risks to inflation. The elevated levels of asset prices also represent a risk to the outlook for macroeconomic and financial stability. In brief, at the current juncture, for policy purposes, the two major issues that exert conflicting pulls are exploration of signs of overheating firming up to warrant a policy response, and, the impact of lagged effects of earlier policy action on the evolution of macroeconomic developments.

II. Stance of Monetary Policy for the Second Half of 2006-07

62. The First Quarter Review of July, 2006 noted that the global growth outlook has brightened and the prospects of sustaining high growth in India appear favourable with inflationary pressures contained. Nevertheless, the First Quarter Review pointed to demand pressures continuing to be in evidence within the domestic economy and that it is critical that inflationary expectations are anchored for supporting economic growth and financial stability. Accordingly, while reiterating the stance of the Annual Policy Statement for 2006-07 of being in readiness to meet the challenges posed by the unfolding of various risks, the First Quarter Review sought to ensure a monetary and interest rate environment that enables continuation of the growth momentum while emphasising price stability with a view to anchoring inflation expectations. The focus on credit quality and financial market conditions for maintaining macroeconomic and, in particular, financial stability was reinforced while supporting export and investment demand in the economy. In response to the evolution of macroeconomic and overall monetary conditions, a modest pre-emptive action was considered appropriate. The fixed reverse repo/repo rates under the LAF were raised by 25 basis points each with immediate effect on July 25, 2006 while retaining the spread between the reverse repo rate and the repo rate at 100 basis points. The First Quarter Review also committed the Reserve Bank to consider measures as appropriate to the evolving global and domestic circumstances impinging on inflation expectations and the growth momentum.

63. The course of macroeconomic and financial developments in the ensuing months has shown that the monetary policy stance was appropriate. First, recent macroeconomic performance has been impressive in terms of the first half-year growth record, justifying the relatively higher weight assigned to sustaining the growth momentum in the stance set out in the First Quarter Review of July, 2006. This positive development seems to be reviving expectations of a structural upward shift in the medium-term growth path of the economy, as alluded to in the Annual Policy Statement of April, 2006. Second, the acceleration of growth and its widening ambit has been enabled by an environment of moderate inflation and reasonable financial stability. Third, inflation expectations have remained well-anchored around the policy threshold, drawing confidence from the combination of fiscal and monetary measures recently undertaken. Fourth, financial markets have responded to monetary policy signals. Long-term rates, in particular, have moderated sizeably, flattening the yield curve and a

general revival of positive sentiment seems to be pervading all segments of the market continuum. Fifth, trade and current account deficits have been accommodated by continued net capital inflows.

64. The Annual Policy Statement for 2006-07 and subsequently, the First Quarter Review emphasised the need to ensure the quality of bank credit in the context of financial stability. It is important to reiterate these concerns, particularly in the context of preserving the recent gains in macroeconomic performance and productivity. Diligent monitoring of the health of credit portfolios would lead to reduction in non-performing assets, economy in the requirements of regulatory capital and, therefore, a greater freeing up of resources resulting in augmenting the ability of banks to expand lending further. Banks need to recognise this cycle in the monitoring of their loan portfolios.

65. As per current indications, real GDP originating in agriculture is poised to maintain trend growth of 3.0 per cent. The overall industrial outlook has improved in relation to the assessment made in July and services sector growth is expected to sustain its momentum. Overall, for policy purposes, the forecast for GDP growth may be placed at around 8.0 per cent during 2006-07 as compared with the range of 7.5-8.0 per cent projected in the Annual Policy Statement and the First Quarter Review.

66. Inflation conditions so far have been as per expectations. Globally, however, there are incipient pressures on prices of cereals, sugar and pulses in addition to metals. Crude prices have moderated but remain at elevated levels with an uncertain outlook. Observers note the possible elevation of capacity utilisation levels in industries globally. In the domestic economy, the major source of pressure has been from prices of primary products. While some seasonal correction in prices of food articles is possible during the remaining part of the year, policy intervention may be expected in terms of active supply management such as enhanced procurement and effective distribution through the public distribution system. On the demand side also, there are some indications of pressures and possible spillover into inflation expectations. Accordingly, containing the year-on-year inflation rate for 2006-07 in the range of 5.0-5.5 per cent assumes policy priority in terms of watchful monitoring and appropriate policy responses.

67. Monetary and credit aggregates seem to be mirroring the accelerated pace of overall economic activity during the current year. Recognition of this pick-up in momentum is reflected in the upward revision of the forecast for real GDP growth in 2006-07 relative to the projections made in the Annual Policy Statement of April 2006 and the First Quarter Review. The expansion in money supply above indicative projections in the recent period is, to some extent, being driven by the high growth in bank credit. There seems to be anecdotal evidence of ongoing expansion in productive capacity which is perhaps muting inflationary pressures that are traditionally associated with high monetary expansion. Moreover, credit penetration in India remains low, even by emerging economy standards, and the growing financial intermediation is possibly being reflected in monetary and credit aggregates in a manner that standard approaches fail to capture. There is also empirical evidence of a structural break in the evolution of the elasticity of bank credit with respect to output, with an upward shift since the end of the 1990s. Faster growth in credit demand is being supported by a wider dispersal across sectors, and particularly towards households. These factors complicate the assessment of the extent of excess demand pressures.

68. The expansion in M_3 was projected at around 15.0 per cent for 2006-07 in the Annual Policy Statement. The growth in aggregate deposits was projected at around Rs.3,30,000 crore in 2006-07. Non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and CP was expected to increase by around 20 per cent. By current indications, the growth in monetary and credit aggregates is now expected to be somewhat higher than the initial indicative projections. It is, however, important to reiterate the concerns expressed in the First Quarter Review and take careful note of the higher expansion in money supply, deposits and credit while assessing liquidity conditions.

69. In brief, recent global developments and the outlook do not provide any definitive indication for further monetary policy action. Hence, the increasing importance of global factors, by itself, would not warrant any change in the policy stance at this stage, though the evolving monetary policy actions of major economies need to be watched. In the domestic economy, there are signs of demand pressures in addition to possible transient supply constraints in respect of primary commodities. It is also possible to argue that lagged effects of monetary policy actions would influence the future path of output and prices in the desired direction. While there is no conclusive evidence of overheating, and though traditional indicators

may overestimate demand pressures, it will be risky to ignore the prevalence and relevance of these factors. Furthermore, containing inflation expectations in the current environment and consolidating gains achieved so far in regard to stability would warrant appropriate, immediate measures and willingness to take recourse to all possible measures in response to evolving circumstances promptly. The objective is to continue to maintain conditions of stability that contribute to sustaining the momentum of growth on an enduring basis. Towards this objective, the monetary policy stance and measures will need to be in a process of careful rebalancing and timely adjustment.

70. The Reserve Bank will ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank will continue with its policy of active demand management of liquidity through open market operations (OMO) including the MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

71. In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be:

- To ensure a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations.
- To maintain the emphasis on macroeconomic and, in particular, financial stability.
- To consider promptly all possible measures as appropriate to the evolving global and domestic situation.

III. Monetary Measures

(a) Bank Rate

72. The Bank Rate has been kept unchanged at 6.0 per cent.

(b) Reverse Repo Rate/Repo Rate

73. It is considered desirable to keep the reverse repo rate under the LAF unchanged at 6.0 per cent.

74. In view of the current macroeconomic and overall monetary conditions, it has been decided to increase the fixed repo rate under the LAF by 25 basis points from 7.0 per cent to 7.25 per cent with immediate effect.

75. The Reserve Bank retains the option to conduct overnight repo or longer term repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.

(c) Cash Reserve Ratio

76. The cash reserve ratio (CRR) of scheduled banks is currently at 5.0 per cent. On a review of the current liquidity situation, it is felt desirable to keep the present level of CRR at 5.0 per cent unchanged.

Third Quarter Review

77. The Third Quarter Review of the Annual Statement on Monetary Policy will be undertaken on Tuesday, January 30, 2007.

Part II. Mid-term Review of Annual Statement on Developmental and Regulatory Policies for the Year 2006-07

78. Financial stability has assumed priority in the hierarchy of objectives of the Reserve Bank in the context of elevated asset prices, rapid growth in bank credit and heightened appetite for risk in an environment of ample liquidity despite sizeable re-pricing of risks in more recent months. Accordingly, the quality of financial assets and the state of financial market conditions have also become important concerns in the formulation and setting of monetary policy. The Annual Policy Statement of April 2006 emphasised financial stability in its stance and sought to draw upon the strong complementarity between macroeconomic and financial stability. It noted that separate coverage of monetary, and developmental and regulatory policies enhances clarity and transparency in communication; yet, it observed, it is important to adopt a holistic approach that exploits the synergies between the responsibility for price and financial stability and regulatory policies in order to secure high growth with stability. Keeping in view the overall macroeconomic conditions and the possibilities of global risk factors materialising, the Annual Policy Statement strengthened prudential norms in the sectors recording high credit

growth. Banks were provided with additional avenues for raising capital through innovative instruments to augment their capital base. Banks were also encouraged to undertake sound stress testing practices for assessment of capital adequacy. The First Quarter Review of July, 2006 urged banks to focus on mobilisation of retail deposits, stricter credit appraisals on sectoral basis, and to ensure the health of credit portfolios on an enduring basis. It retained and reinforced the emphasis on financial stability set out in the Annual Policy Statement.

79. It has been the endeavour of the Reserve Bank to develop sound and efficient intermediaries and markets so as to provide foundations for a robust, efficient and diversified financial system, a key requisite for effective transmission of monetary policy. Efforts are being made to evolve a system that will detect sources of vulnerability early and trigger corrective strategies. In this context, the importance of communication has increased and the Reserve Bank has adopted a participative and consultative process in the conduct of its developmental and regulatory policies. The process is becoming broad-based with wider involvement of all stakeholders and emphasis on financial inclusion as well as financial education. It is not just confined to transparency but also encompasses financial education that should foster a more informed evaluation of policies.

80. The main focus of the Mid-term Review is on select areas. First, it is proposed to further develop and integrate financial markets with a view to enhancing allocative efficiency. Second, ongoing efforts to improve and expand credit delivery would be oriented towards financial inclusion and extension of financial services to the under-privileged segments of the population. Third, strengthening the capital base of banks with a view to preparing them to migrate to Basel II norms, putting in place the appropriate financial architecture for risk management and implementing prudential measures in consonance with international best practices in the financial sector continues to assume high priority. Fourth, consistent with the sweeping changes in India and the global economy in the recent period, the pace of gradual liberalisation of the external sector needs to be kept up within the framework for fuller capital account convertibility recommended by the Committee appointed by the Reserve Bank with the objectives of promoting economic growth, improving financial sector efficiency and providing opportunities for diversification of investments by residents.

81. The Mid-term Review of Developmental and Regulatory Policies for the year 2006-07 is divided into four sections: I. Financial Markets; II. Credit Delivery Mechanism and Other Banking Services; III. Prudential Measures; and IV. Institutional Developments.

I. Financial Markets

82. The Reserve Bank continues its efforts to develop various segments of financial markets in terms of operational flexibility, transparency and institutional structure. Concomitantly, orderly functioning and preservation of soundness of the market segments are ensured through effective monitoring and regulation.

83. The Technical Advisory Committee (TAC) on Money, Foreign Exchange and Government Securities Markets has provided valuable guidance to the Reserve Bank in the context of its developmental role *vis-à-vis* financial markets. The Reserve Bank reconstituted the TAC on Money, Foreign Exchange and Government Securities Markets in June, 2006. The TAC would meet as often as it is required but at least once in a quarter, to review and recommend measures for deepening and widening the money, foreign exchange and Government securities markets including those relating to participants, products, institutional and infrastructural arrangements.

Money Market

84. A number of measures have been undertaken in 2006-07 with a view to improving the functioning of various segments of the money market and enhancing smooth flow of funds across instruments and participants. These measures are intended to fortify the institutional architecture for the smooth play of money markets.

NDS-CALL

85. In pursuance of the announcement made in the Annual Policy Statement of April, 2006 a screen-based negotiatedquote-driven system for all dealings in call/notice and term money market (NDS-CALL) was operationalised with effect from September 18, 2006. The system has been developed by the Clearing Corporation of India Ltd. (CCIL) and is expected to improve ease of transactions and bring about greater transparency and efficient price discovery.

Government Securities Market

86. The implementation of the Fiscal Responsibility and Budget Management (FRBM) Act has necessitated

several structural and developmental measures for the Government securities market to prepare it for the withdrawal of the Reserve Bank from the primary segment.

(a) 'When Issued' Market for Fresh Issuance of Securities: Extension

87. As indicated in the Annual Policy Statement of April, 2006 a 'when issued' (WI) market in Government securities was introduced and trading in this market has commenced from August, 2006. To begin with, WI trading has been permitted in reissuable securities. It is now proposed:

- to extend 'when issued' trading in the case offresh issues of Central Government securities on aselective basis.

(b) Allowing Short Sale beyond Intra-daySettlement Cycle

88. On the basis of the recommendations of the Technical Group on the Central Government Securities Market, intra-day short-selling in Central Government securities was permitted in February, 2006. On an assessment of the market feedback, it is now proposed:

- to allow eligible participants, *viz.*, scheduled commercial banks (SCBs) and primary dealers (PDs) to cover their short positions within an extended period of five trading days.

89. As this arrangement may result in carrying short positions across settlement cycles, the participants would be allowed to deliver a shorted security by borrowing it through the repo market.

(c) Consolidation of Central Government Securities

90. The Annual Policy Statement of April, 2006 stated that there is a need to enlarge the number of actively traded Central Government securities in order to enhance liquidity and improve pricing in the market. The modalities of consolidation are being worked out in consultation with the Government of India.

Foreign Exchange Market

91. The Reserve Bank has taken several initiatives to liberalise the conduct of foreign exchange business. A key consideration has been the rationalisation and simplification of procedures with a view to facilitating prompt and efficient customer service in external transactions.

(a) Follow-up of Recommendations of the Committee on Fuller Capital Account Convertibility

92. The Reserve Bank, in consultation with the Government of India, had appointed a Committee on Fuller Capital Account Convertibility (FCAC) (Chairman: Shri S.S. Tarapore) on March 20, 2006. The Committee submitted its report to the Reserve Bank in July, 2006 which has been placed on the Reserve Bank's website. Keeping in view the recommendations of the Committee, the following measures are proposed:

(i) Setting up of Internal Task Force for Procedural Rationalisation and Simplification

93. The Reserve Bank has constituted an Internal Task Force to review the exchange and payments regime. The Task Force has suggested some rationalisation and procedural simplifications in areas related to trade and miscellaneous remittances and, accordingly, a circular is being issued separately.

(ii) Liberalised Remittance Scheme:Enhancement of Limit

94. Resident individuals would henceforth be free to remit up to US $ 50,000 per financial year for any current or capital account transaction or a combination of both, as against the earlier limit of US $ 25,000. The existing facilities for gifts, donations and investment by resident individuals in overseas companies would be subsumed under this revised limit. The existing facility for private travel up to US $ 10,000 per financial year will continue to be available on a self-declaration basis.

(iii) Exchange Earners' Foreign Currency Accounts: Liberalisation

95. All categories of foreign exchange earners may henceforth retain up to 100 per cent of their foreign exchange earnings in their Exchange Earners' Foreign Currency (EEFC) accounts with a view to providing the facility uniformly to all eligible residents.

(iv) Project and Service Exports: Liberalised Procedures

96. With a view to facilitating project exporters and exporters of services and providing greater flexibility in conducting their overseas transactions, it is proposed that:

- large turnkey/project exporters/service exporters with satisfactory track record may operate one foreign currency account with inter-project transferability of funds/machinery in any country, subject to specified reporting requirements;

- large turnkey/project exporters/service exporters with good track record may deploy their temporary cash surpluses either in investments in short-term bank deposits or AAA-rated short-term paper abroad, subject to monitoring by the authorised dealer bank(s); and
- the stipulation regarding recovery of market value of machinery from the transferee project is withdrawn; however, such transfer of machinery should be reported to and monitored by the authorized dealer bank(s)/approving authority.

(v) Banks' Borrowings from Overseas: Enhancement

97. With a view to providing further flexibility to authorised dealer banks in seeking access to funds overseas, the following liberalisation is proposed:

- authorised dealer banks may henceforth borrow funds from their overseas branches and correspondent banks (including borrowings for financing export credit, ECBs and overdrafts from their Head Office/Nostro account) up to a limit of 50 per cent of their unimpaired Tier I capital or US $ 10 million, whichever is higher, as against the earlier overall limit of 25 per cent (excluding borrowings for financing export credit). Short-term borrowings up to a period of one year or less, however, should not exceed 20 per cent of unimpaired Tier I capital within the overall limit of 50 per cent;
- all borrowings in the form of subordinated debt placed by head offices of foreign banks with their branches in India as Tier II capital, capital funds raised/augmented by issue of innovative perpetual debt instruments (IPDI) and other overseas borrowing with the specific approval of the Reserve Bank would, however, continue to be outside the limit of 50 per cent; and
- in order to phase in these limits in a non-disruptive manner, banks whose overseas borrowings exceed the revised prudential limit may approach the Reserve Bank with a proposed road-map for complying with these limits.

(vi) External Commercial Borrowings: Increased Access

98. Borrowers currently eligible for accessing external commercial borrowings (ECBs) can avail of an additional amount of US $ 250 million with average maturity of more than 10 years under the approval route, over and above the existing limit of US $ 500 million under the automatic route, during a financial year. Other ECB criteria such as end-use, all-in-cost ceiling, recognised lender and the like would continue to apply. Prepayment and call/put options, however, would not be permissible for such ECBs up to a period of 10 years.

99. With a view to providing greater flexibility to the corporates in managing their liquidity and interest costs, prepayment of ECB up to US $ 300 million, as against the earlier limit of US $ 200 million, will now be allowed by authorised dealer banks without prior approval of the Reserve Bank subject to compliance with the stipulated minimum average maturity period as applicable to the loan.

(vii) Establishment of Offices Abroad

100. In order to provide greater flexibility to Indian corporates in establishing overseas offices, authorised dealer banks may now allow remittances on behalf of their customers up to 15 per cent of the average annual sales/ income or turnover during the last two financial years or up to 25 per cent of their net worth, whichever is higher, for initial expenses. For recurring expenses, authorised dealer banks may allow remittances up to 10 per cent of the average annual sales/income or turnover during the last two financial years. Authorised dealer banks may also permit remittances for acquisition of immovable property for the overseas office, within these limits.

(viii) FIIs' Investment in Government Securities

101. It is proposed to permit FIIs to invest in securities issued by the Central and State Governments by an incremental amount of 5 per cent of total net issuance in the previous financial year. This would be over and above the current stipulation of investment up to US $ 2 billion. Accordingly, the existing limit of US $ 2 billion will be enhanced in phases to US $ 2.6 billion by December 31, 2006 and further to US $ 3.2 billion by March 31, 2007. The extant limit of US $ 1.5 billion for investment in corporate debt would, however, continue.

(ix) Overseas Investment by Mutual Funds: Enhancement of Ceiling

102. The extant ceiling of overseas investment by mutual funds of US $ 2 billion is enhanced to US $ 3 billion with a view to providing greater opportunity to mutual funds to invest overseas.

(x) Liberalisation of Forward Contract Regulations

103. Customs authorities use a fixed exchange rate for a month for the purpose of levying import duty. In order

to provide the facility of hedging economic exposure, importers will henceforth be permitted to book forward contracts for their customs duty component of imports.

104. As per the extant guidelines, FIIs are allowed to hedge the market value of their entire investment in equity and/ or debt in India as on a particular date. Furthermore, these forward contracts, once cancelled, cannot be rebooked but may be rolled over on or before maturity. It is proposed to allow FIIs to rebook a part, say, 25 per cent of the cancelled forward contracts, provided such contracts are supported by underlying exposure. The modalities would be finalised in consultation with market participants.

105. Authorised dealer banks are currently permitted to allow importers and exporters to book forward contracts on the basis of a declaration of an exposure and based on past performance up to the average of the previous three financial years' actual import/export turnover or the previous year's actual import/export turnover, whichever is higher. Furthermore, contracts booked in excess of 25 per cent of the eligible limit have to be on deliverable basis and cannot be cancelled. In order to provide greater flexibility to exporters and importers, it is proposed to enhance this limit to 50 per cent.

(xi) Data Collection and Monitoring

106. The Internal Task Force set up by the Reserve Bank would review the data collection/compilation system in pursuance of a recommendation of the Committee on FCAC. A 'Working Group on Data Related Issues' is also proposed to be set up.

(b) Other Measures

(i) Bank Guarantees and/or Letters of Credit to cover Temporary Trade Related Credits – Delegation of Powers to Authorised Dealer Banks

107. Authorised dealer banks are permitted to allow advance remittances for import of services up to US $ 100,000 without the counter-guarantee of a bank of international repute situated outside India. As a measure towards further liberalisation, it is proposed to permit authorised dealer banks to issue guarantees/letters of credit for import of services up to US $ 100,000 where the guarantee is intended to secure a direct contractual liability arising out of a contract between a resident and a non-resident.

(ii) Remittances out of NRO Accounts

108. The existing regulations permit NRIs and persons of Indian origin (PIOs) to remit up to US $ one million per calendar year for any *bonafide* purpose out of the balances in their Non-resident Ordinary (NRO) accounts. The amounts credited to the NRO accounts would also represent the sale proceeds of immoveable property acquired by the non-resident concerned out of her/his resources in India, or proceeds of property received by way of inheritance or gift. The sale proceeds of the immoveable property are at present subject to a lock-in period. On a review, it is proposed to eliminate the lock-in period, provided the amount being remitted in any financial year does not exceed US $ one million.

(c) Advisory Group on FEMA Regulations Relating to Services

109. An Advisory Group (Chairman: Shri Mohandas Pai) was constituted, as indicated in the Annual Policy Statement of April, 2006 to review all foreign exchange regulations relating to services and prepare a compendium of all foreign exchange regulations that apply to the services sector. The Group is expected to submit its report shortly.

(d) Working Group on Cost of NRI Remittances

110. The Working Group (Chairman: Shri P.K. Pain) constituted by the Reserve Bank to examine various cost aspects of NRI remittances submitted its report in August, 2006. This report has been placed on the Reserve Bank's website for wider dissemination and comments. On the basis of the recommendations of the Group, it is proposed:

- to dispense with the existing restrictions on the number of tie-ups by banks with exchange houses and the number of drawee branches for rupee drawing arrangements in respect of those banks having sound risk management systems. Guidelines in this regard would be issued separately; and
- to put in place an 'Awareness Programme' to sensitise NRIs on options to minimise cost of remittances; PSBs to identify remittances as an independent business segment and resort to latest technology for handling large volume at lower cost and explore tie-ups with more correspondent banks; to review the existing scale of charges, both at the foreign and domestic end; large PSBs in India to examine the feasibility of setting up Centralised Remittance Receiving Centres for efficiency and better service; improvements in infrastructure and extending the scope of real time gross settlement (RTGS) for inter-city settlement between the banks in India.

II. Credit Delivery Mechanisms and Other Banking Services

111. It has been the endeavour of the Reserve Bank to improve credit delivery mechanisms and make available basic banking services to the widest sections of the society without procedural hassles. Initiatives taken in this regard encompass a wide ambit covering augmenting credit flow to agriculture and other priority sectors as well as to distressed farmers and areas stricken by natural calamities; institutional reform including revival of the co-operative structure and regional rural banks (RRBs); development of new avenues of credit dispensation such as micro-finance institutions and legislation for regulating money lending; financial inclusion and improvement in customer services.

(a) Priority Sector Lending

112. As indicated in the Annual Policy Statement of April, 2006 the revised draft Technical Paper of the Internal Working Group (Chairman: Shri C.S. Murthy) set up by the Reserve Bank to review the existing policy on priority sector lending was placed on the Reserve Bank's website for wider dissemination and comments. Based on the feedback, the draft circular will be put in the public domain shortly.

(b) Micro and Small Enterprises

113. Consistent with the notification of the Micro, Small and Medium Enterprises Development Act, 2006, it is proposed to modify the definition of small-scale industry and micro and small enterprises engaged in providing or rendering of services for the purpose of priority sector lending. Guidelines to banks would be issued separately.

(c) Revival of Rural Co-operative Credit Structure

114. The recommendations of the Task Force (Chairman: Prof. A.Vaidyanathan) appointed by the Government of India to propose an action plan for reviving the short-term rural co-operative credit structure have been accepted in principle. The Government of India, in consultation with the State Governments, has approved a revival package for the short-term co-operative credit structure. The revival package has been accepted by the States of Maharashtra, Rajasthan, Gujarat, Orissa, Madhya Pradesh, Andhra Pradesh, Sikkim, and the Union Territory of Dadra and Nagar Haveli.

(d) Regional Rural Banks

115. In view of the importance of RRBs as an effective instrument of credit delivery in the Indian financial system, sponsor banks have been encouraged to merge RRBs State-wise. The amalgamation of 134 RRBs into 42 new RRBs sponsored by 18 banks in 16 States has been implemented. Consequently, the total number of RRBs has come down from 196 to 104 by end-August, 2006.

116. A Task Force on Empowering Boards of Regional Rural Banks for Improving their Operational Efficiency (Chairman: Dr. K.G. Karmakar) has been set up in September, 2006 in order to empower the boards of RRBs in various functional areas.

(e) Relief Measures by Banks in Areas Affected by Natural Calamities

117. The Reserve Bank has issued guidelines to banks on relief measures to be provided in areas affected by natural calamities. These guidelines focus on various reliefs and concessions that may be extended to existing borrowers, mainly agriculturists. As announced in the Annual Policy Statement of April, 2006 the Internal Working Group (Chairman: Shri G. Srinivasan) constituted to examine various issues in respect of areas affected by natural calamities, submitted its report in June, 2006. Based on the recommendations of the Group, additional guidelines covering issuance of fresh loans and restructuring of existing loans to non-farm borrowers, access to bank accounts, currency management, know your customer (KYC) norms, clearing and settlement system and business continuity planning in the affected areas were issued to banks.

118. An Empowered Task Force was constituted in the Union Territory of Andaman and Nicobar Islands to expedite relief measures by banks for tsunami-affected borrowers. The recommendations of the Task Force are being implemented.

(f) Relief Measures for Distressed Farmers

119. The Working Group (Chairman: Prof. S.S. Johl), constituted by the Reserve Bank to suggest measures for assisting distressed farmers including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme under the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act for such farmers, submitted its interim report in October, 2006. In the light of the recommendations of the Group and with a view to ensuring transparency in implementation of the one time settlement (OTS) scheme, it is proposed that:

- banks, with approval of their boards, may formulate a transparent policy for providing OTS facility to those farmers whose accounts have been rescheduled/ restructured due to natural calamities as also those who have defaulted on account of circumstances beyond their control.

(g) Technical Group for Review of Legislations on Money Lending

120. The Reserve Bank constituted a Technical Group (Chairman: Shri S.C. Gupta) to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States in the interest of rural households. Various State Governments have shown interest in the deliberations of the Group. It has, therefore, been proposed to co-opt them as special invitees from the State Governments on this Group for wider representation.

(h) Financial Inclusion

121. The Annual Policy Statement of April, 2006 urged all banks to give effect to the measures announced by the Reserve Bank from time to time on financial inclusion at all their branches.

(i) Pilot Project of SLBCs for 100 per cent Financial Inclusion

122. State Level/Union Territory Bankers' Committee (SLBC/UTLBC) convenor banks in all States/Union Territories were advised to identify at least one suitable district in each State/Union Territory for achieving 100 per cent financial inclusion by providing "no frills" accounts as also general purpose credit cards (GCC) on the lines of the initiative taken in the Union Territory of Pondicherry. All SLBCs/UTLBCs have since identified one or more districts for 100 per cent financial inclusion. Furthermore, the SLBCs/UTLBCs were advised to allocate villages to banks operating in the respective State/ Union Territory for ensuring 100 per cent financial inclusion and for monitoring the progress in the SLBC/ UTLBC meetings.

(ii) Improvement of Banking Services in Uttaranchal

123. In consultation with the Government of Uttaranchal, a Working Group (Chairman: Shri V.S. Das) was constituted to examine the problems/issues relating to banking services in Uttaranchal and to prepare an action plan for their improvement. The report of the Working Group has been placed on the Reserve Bank's website for wider dissemination. The Group's recommendations are being implemented.

(iii) Improvement of Banking Services in Chhattisgarh

124. In consultation with the Government of Chhattisgarh, a Working Group (Chairman: Regional Director for Chhattisgarh and Madhya Pradesh) has been constituted to draw up an action plan for improvement of banking services in the State of Chhattisgarh. The Group is expected to submit its report by end-January, 2007.

(iv) Report on Problems Faced by Banks and Borrowers in Bihar

125. As a sequel to the Finance Minister's review of the working of banks in the State of Bihar, a Working Group was constituted (Chairman: Shri V.S. Das) to look into the problems faced by banks and borrowers in the State of Bihar. The Group's report is under implementation.

(v) Report of the Committee on Financial Sector Plan for North-Eastern Region

126. A Committee (Chairperson: Smt. Usha Thorat) was constituted by the Reserve Bank to improve provisions of financial services in the north-eastern region and prepare an appropriate State-specific monitorable action plan for the region for achieving greater financial inclusion. The report of the Committee has been placed on the Reserve Bank's website for wider dissemination. The action points that emerged from the recommendations of the report have been forwarded to the agencies concerned for implementation.

(vi) Financial Inclusion, Small Customers and KYC Requirements

127. In the context of financial inclusion, it is proposed to further simplify the KYC procedure:

a. *Small accounts:* For opening small accounts, banks need to seek only a photograph of the account holder and self-certification of address. Outstanding balances in these accounts at any time will be limited to Rs.50,000 and the total transactions limited to Rs.200,000 in one year. As and when the balances or total transactions exceed these limits, banks may convert them into normal accounts and follow the normal procedure of KYC.

b. *Normal accounts:* Banks would continue with the KYC procedure of obtaining documents of proof of identity and address as hitherto. The Reserve Bank will issue certain clarifications in respect of conduct of the KYC procedure for normal accounts also so as to make it more customer-friendly.

*(i) **Customer Service***

128. The Reserve Bank of India has been taking measures on an ongoing basis for protection of customers' rights, enhancing the quality of customer services and strengthening grievance redressal mechanisms in the Reserve Bank as well as in banks.

(i) Banking Codes and Standards Board of India

129. The Banking Codes and Standards Board of India (BCSBI), which was set up as a society in February 2006, released the Code of Banks' Commitment to Customers (Code) in July, 2006 which sets out minimum standards for fair practices on various banking transactions for individual customer. Out of 84 SCBs, 55 covering approximately 93 per cent of domestic assets of SCBs are committed to follow the Code as members of the BCSBI.

(ii) Fair Practices Code: Reasonableness of Bank Charges

130. Pursuant to the Annual Policy Statement of April, 2006 the Reserve Bank constituted a Working Group comprising a nominee of the Indian Banks' Association (IBA) and representatives of customers to formulate a scheme for ensuring reasonableness of bank charges and to incorporate the same in the Fair Practices Code which would be monitored by the BCSBI. The report of the Working Group has been placed on the Reserve Bank's website for wider dissemination and comments. The report has enumerated 27 services of banks as basic services to individuals and has indicated broad principles of reasonableness for bank charges. Furthermore, in regard to monitoring of compliance with the Code by banks, the Group has recommended that the BCSBI may collect from member banks details of complaints relating to service charges and track the changes in the levels of service charges to identify any abnormal increases. The recommendations of the Working Group have since been examined and operational guidelines to banks, in this regard, would be issued shortly.

(iii) Housing Loans: Fairness and Transparency

131. It has been reported that some banks, while lending for housing, are not fully transparent in indicating the circumstances and factors governing the benchmark in respect of floating rates as well as in regard to reset clauses. Banks are urged to review all practices which are less than fair or transparent. They are also urged to afford an opportunity to borrowers to obtain fair and transparent terms consistent with legal requirements and fair practices.

(iv) Pension Payment Services

132. The Reserve Bank continues to take initiatives to improve services provided by agency banks to pensioners under various schemes announced by the Government of India. Under the 'Scheme for Payment of Pension for Central Government Civil Pensioners through Authorised Banks', a pensioner receives pension through her/his savings/current account operated individually by her/him. Since June, 2006 the Central Pension Accounting Office of Government of India has allowed crediting of the pension amount to a joint account operated by pensioner with her/his spouse where family pension has been authorised. The Reserve Bank has issued suitable instructions to agency banks in this regard.

(v) Conduct of Government Business: Extending ECS Facility

133. Payment of income tax refund up to Rs.25,000 to salaried assessees are made through electronic clearing services (ECS) in cities where banks offer this facility. The Government of India has allowed extending ECS for income tax refunds to all categories of tax payers without monetary limits and, accordingly, the Reserve Bank has extended ECS to additional thirteen cities with effect from September 1, 2006. Eleven more cities will be covered shortly through the State Bank of India.

III. PRUDENTIAL MEASURES

134. The Reserve Bank has been continuously sharpening its regulatory and supervisory roles in order to establish a stable financial system which contributes to public confidence and accelerated economic growth. Furthermore, the Reserve Bank is committed to continuing the process of adopting international best practices with regard to prudential norms and standards of transparency and disclosure.

(a) New Capital Adequacy Framework: Status

135. Commercial banks (excluding RRBs) had been advised that they will be required to adopt the standardised approach for credit risk and basic indicator approach for operational risk with effect from March 31, 2007. Under the standardised approach, banks are required to use risk weights which are dependent on credit ratings. These credit ratings are to be assigned by External Credit Assessment Institutions (ECAIs) which have been found eligible by the Reserve Bank. An internal Working Group constituted by the Reserve Bank for identifying eligible domestic ECAIs has submitted its report and its

recommendations are being incorporated into the final guidelines.

(b) Basel II: Schedule for Compliance

136. The Reserve Bank is committed to the adoption of Basel II by the banks and had indicated March 31, 2007 as the intended date for adoption by all. Taking into account the state of preparedness of the banking system, however, it has been decided to provide banks some more time to put in place appropriate systems so as to ensure full compliance with Basel II. Foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009. The Steering Committee of banks will continue to interact with banks and the Reserve Bank, and guide the smooth implementation of Basel II.

(c) Comprehensive Guidelines on Derivatives

137. Derivatives play a critical role in shaping the overall risk profile of banks. Over the years, banks have been increasingly using derivatives for managing risks and have also been offering these products to corporates. The Reserve Bank has issued several guidelines to banks from time to time on various derivative instruments. In view of the growing complexity, diversity and volume of derivatives used by banks, an Internal Group has been constituted by the Reserve Bank to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives for banks. These guidelines are intended to cover broad generic principles for undertaking derivative transactions, management of risk and sound corporate governance requirements. The draft guidelines would be placed on the Reserve Bank's website by end-November, 2006.

138. On the basis of the recommendations of an earlier Internal Group, a 'Discussion Paper on Derivative and Hedge Accounting by Banks' was prepared and placed on the Reserve Bank's website for wider dissemination. The feedback received from market participants on the Discussion Paper is under examination.

(d) Credit Information Companies (Regulation) Act, 2005: Status

139. Consequent upon the enactment of the Credit Information Companies (Regulation) Act, 2005 the Reserve Bank constituted a Working Group (Chairman: Shri Prashant Saran) to frame draft rules and regulations for implementation of the Act. The draft rules and regulations were prepared and placed on the Reserve Bank's website for wider dissemination and comments. On the basis of the responses received, the draft rules and regulations have been prepared and would be notified shortly in consultation with the Government of India.

(e) Funded and Non-funded Limits by Indian Banks to Joint Ventures/Wholly Owned Subsidiaries of Indian Corporates: Enhancement

140. In April, 2003 Indian banks were permitted to extend credit/non-credit facilities to Indian Joint Ventures (JVs)/ Wholly Owned Subsidiaries (WOS) abroad up to the extent of 10 per cent of their unimpaired capital funds (Tier I and Tier II), subject to certain conditions. In order to facilitate the expansion of Indian corporates' business abroad, it is proposed:

- to enhance the prudential limit on credit and non-credit facilities extended by banks from the existing 10 per cent to 20 per cent of unimpaired capital funds (Tier I and Tier II capital) of the bank.

***(f)* Banks' Exposures to Systemically Important NBFCs**

141. An Internal Group was constituted by the Reserve Bank to study the issues of regulatory convergence, regulatory arbitrage and to recommend a policy framework for level-playing field in the financial sector. The report of the Group was placed on the Reserve Bank's website for wider dissemination and comments. In the light of the recommendations of the Group and the feedback received, and in view of the importance of this segment of the financial sector, a draft circular will be put in the public domain to invite further feedback by November 3, 2006. After providing two weeks for comments, the final circular will be issued before November 30, 2006.

IV. Institutional Developments

Payment and Settlement Systems

142. The Reserve Bank continues to strengthen the framework for payment and settlement systems and harness the full potential of information technology (IT) to improve operational efficiency. During 2006-07 so far, the focus has been on security of IT systems, financial

inclusion and development of electronic payment products.

(a) Information Systems Security and Audit: Security of IT-based Delivery Channels

143. The Annual Policy Statement of April 2006 encouraged banks to ensure compliance with the findings of information systems audit on a time-bound basis in order to maintain robustness of IT systems. There have been, however, a few instances of fraudulent attempts to extract customer information by tampering with IT-based delivery channels of banks. Banks are urged to ensure that adequate and appropriate systems such as enhanced security measures and customer education are put in place in order to prevent such malpractices.

(b) IT-Facilitated Financial Inclusion

144. The Reserve Bank has been advocating the need for financial inclusion which involves the provision of banking services to all segments of the society. Some of the challenges which need to be addressed for increasing the scope and coverage of financial inclusion include lack of adequate infrastructure in rural areas, higher transaction costs and low volumes of transactions. Recognising that IT-enabled services have the potential for effectively addressing these issues, the Reserve Bank has initiated action in this direction in the north-east region, to begin with. The Institute for Development and Research in Banking Technology (IDRBT) is providing technological solutions to increase the extent of banking facilities in this region. Banks are urged to harmonise their IT-based initiatives to ensure that the objective of greater financial inclusion is achieved.

(c) Electronic Payment Products: Status and Proposed Action

145. The coverage of the RTGS system has increased significantly. By October 23, 2006 RTGS connectivity was available in 24,425 branches as against a target of 20,000 branches set for end-June, 2006. The number of monthly transactions of the system has exceeded 300,000. The Reserve Bank is committed to improving the quality of service and further increasing the number of customer transactions through the RTGS on a priority basis.

146. The national electronic funds transfer (NEFT) system for electronic transfer of funds, which was operationalised on November 1, 2005 is now available at 9,096 branches. The Reserve Bank is currently engaged in informing the public about the benefits of the system in order to ensure increased rural coverage.

147. The pilot project for cheque truncation system, which aims at enhancing efficiency in the retail cheque clearing sector, is expected to be implemented in New Delhi by end-December, 2006.

148. It was indicated in the Annual Policy Statement of April, 2006 that the National Settlement System (NSS) which aims at settling clearing positions of various clearing houses centrally would be introduced by end-December, 2006. Accordingly, to begin with, integration of the Integrated Accounting System (IAS) with the RTGS was initiated to facilitate settlement of various CCIL-operated clearings (inter-bank Government securities, inter-bank forex, CBLO and National Financial Switch) through Multilateral Net Settlement Batch (MNSB) mode in the RTGS in Mumbai. On stabilisation of MNSB in Mumbai, settlements at other centres under the NSS would be taken up in a phased manner.

URBAN CO-OPERATIVE BANKS

(a) Vision Document for UCBs

149. Pursuant to the draft vision document for Urban Co-operative Banks (UCBs), the Reserve Bank has been entering into Memoranda of Understanding (MoU) with State Governments with a view to putting in place a structured arrangement for co-ordination between the State Government and the Reserve Bank to address the problem of dual control. The Reserve Bank has signed MoU with four State Governments, namely, Uttaranchal, Rajasthan, Chhattisgarh and Goa in addition to the earlier MoU signed with four State Governments, *viz.,* Andhra Pradesh, Gujarat, Karnataka and Madhya Pradesh. Task Forces for Urban Co-operative Banks (TAFCUBs) in these States have been constituted by the Reserve Bank and consultative processes are in operation.

(b) Conversion of Extension Counters into Full-Fledged Branches

150. In view of the regulatory co-ordination brought about through signing MoU with State Governments and based on the positive experience of the TAFCUBs, it is proposed:

- to allow financially sound UCBs registered in States that have signed MoU with the Reserve Bank and those registered under the Multi-State Co-operative Societies Act, 2002 to convert existing extension counters into full-fledged branches subject to certain conditions. Guidelines in this regard would be issued separately.

(c) Innovative Options for Augmenting Capital of UCBs

151. As indicated in the Annual Policy Statement of April, 2006 a Working Group (Chairman: Shri N.S. Vishwanathan) comprising representatives of the Reserve Bank, State Governments and the UCB sector was constituted to explore various options for raising regulatory capital funds of UCBs and identify alternate instruments/avenues for augmenting the capital funds. The Group has since submitted its report which would be placed in the public domain for feedback.

(d) Fair Practices Codes for Lenders

152. UCBs play an important role in meeting the credit needs of small and medium enterprises and retail traders. They also cater to housing loan requirements predominantly under the priority sector. The UCBs are also eligible institutions for applicability of SARFAESI Act. In this context, it is important for UCBs to draw up and implement a Fair Practices Code for Lenders with a view to putting in place a fair and transparent mechanism for sanction, disbursal and recovery of loans. Accordingly, it is proposed that:

- the Reserve Bank, taking into consideration the State specific environment and needs, would place a model draft Fair Practices Code for consideration of TAFCUBs set up in the States that have signed MoUs for deliberation and adoption.

Non-banking Financial Companies

153. Non-banking financial companies (NBFCs) play a critical role as an instrument of credit delivery, particularly in the small scale and retail sectors. The Reserve Bank has been continuously emphasising on developing NBFCs into financially strong entities with skill levels necessary to cater to the needs of the common people. In order to strengthen the NBFC sector by diversifying their area of business, it is proposed to allow NBFCs:

- to issue co-branded credit cards with banks without risk sharing; and
- to market and distribute mutual fund products as agents of mutual funds.

Non-banking Financial Companies: Classification

154. A request had been received from the representatives of the NBFC sector to provide a separate classification for NBFCs engaged in financing tangible assets. Companies engaged in financing real/physical assets supporting economic activity such as automobiles, general purpose industrial machinery and the like would generally correspond to the classification as asset financing companies. Accordingly, it is proposed to re-group them as asset financing companies. Detailed operational instructions in this regard would be issued separately.

Committee on Financial Sector Assessment

155. The World Bank and the IMF have jointly brought out a Handbook on Financial Sector Assessment in September, 2005 on the basis of their experience in the conduct of the Financial Sector Assessment Programme (FSAP) in member countries. The Handbook is designed for use in financial sector assessments and intended to serve as a reference book on the techniques of such assessments. India has been a forerunner in comprehensive self-assessment of various international financial standards and codes, besides being one of the earliest member countries participating voluntarily in the FSAP.

156. In this context, the Reserve Bank had released a Synthesis Report on Financial Sector Assessment in May, 2002 and a progress report on the assessment in December, 2004. Consistent with this approach, the Government of India, in consultation with the Reserve Bank, has constituted a Committee on Financial Sector Assessment to undertake a self-assessment of financial sector stability and development using the Handbook as the base. The Committee is chaired by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India, with Shri Ashok Jha, Secretary, Economic Affairs, Ministry of Finance, Government of India as Co-Chairman. The Committee would report the progress to the Government of India/ Reserve Bank within a period of six months. The Reserve Bank would provide the secretariat to the Committee.

Mumbai
October 31, 2006