

*Statement by
Dr. Y. Venugopal Reddy,
Governor,
Reserve Bank of India on
the First Quarter Review
of Annual Monetary
Policy for the Year 2007-08*

This Review consists of three sections: I. Assessment of Macroeconomic and Monetary Developments; II. Stance of Monetary Policy; and III. Monetary Measures. An analytical review of macroeconomic and monetary developments was issued a day in advance as a supplement to this Review, providing the necessary information and technical analysis with the help of charts and tables.

**I. Assessment of Macroeconomic
and Monetary Developments**

Domestic Developments

2. At the end of May 2007, the Central Statistical Organisation (CSO) released quarterly real GDP growth estimates for January-March 2007 at 9.1 per cent as against 10.0 per cent a year ago. Along with revisions for the preceding three quarters, real GDP growth in 2006-07 was raised to 9.4 per cent from 9.2 per cent in the CSO's February 2007 advance estimates. In the revised estimates, real GDP originating in agriculture, industry and services sectors increased by 2.7 per cent, 11.0 per cent and 11.0 per cent, respectively, in 2006-07 as against 6.0 per cent, 8.0 per cent and 10.3 per cent in 2005-06. Over the four-year period starting in 2003-04 when the current expansionary phase began, real GDP growth has averaged 8.6 per cent, up from 5.1 per cent in the preceding four years and also above the average of 5.7 per cent achieved in the 1990s.

3. The progress of the 2007 south-west monsoon season has been satisfactory so far, despite initial delays in its onset over the western, north-western and central regions. Of the normal area of 71.9 million

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hectares under *kharif* foodgrain crops, 30.1 million hectares were covered by sowing by July 20 this year, which is comparable with 30.0 million hectares in the corresponding period of the preceding year. Also, 12.2 million hectares were covered under major oilseeds as against 11.7 million hectares last year. While area sown under cotton (7.2 million hectares) was higher, that under sugarcane (4.4 million hectares) and jute (0.8 million hectares) was somewhat lower as compared with the previous year. During June 1 to July 25, 2007 rainfall has been 4 per cent above the long-period average (LPA) and excess/normal in 29 of the 36 meteorological subdivisions, according to the India Meteorological Department (IMD). The IMD has updated its initial forecast released on April 19, 2007 and has placed the rainfall for the south-west monsoon season at 93 per cent of the LPA for the country as a whole in its latest forecast released on June 29, 2007.

4. The general index of industrial production (IIP) rose by 11.7 per cent in April-May 2007 from 10.8 per cent a year ago. The acceleration in industrial activity in the current financial year was led by manufacturing output which rose by 12.7 per cent as against 12.2 per cent in April-May 2006. Electricity generation and mining activity increased by 9.0 per cent and 3.0 per cent, respectively, as against 5.5 per cent and 3.2 per cent a year ago. Within manufacturing, industries such as machinery and equipment, food products, basic metals and alloys and chemicals emerged as growth drivers in 2007-08 (up to May). In terms of the use-based classification, production of capital goods increased by 18.6 per cent (20.6 per cent a

year ago), while the production of basic goods and intermediate goods rose by 9.4 per cent (9.2 per cent) and 10.5 per cent (10.5 per cent), respectively. Consumer goods output increased by 12.7 per cent (9.7 per cent). The six infrastructure industries, comprising nearly 27 per cent of the IIP, posted a growth of 8.1 per cent during April-May 2007 as against 7.2 per cent a year ago. Output growth picked up in respect of petroleum products and electricity, whereas some deceleration was recorded in steel, coal and cement output and crude petroleum production declined marginally.

5. Private corporate activity has gained strength and resilience, extending an unprecedented run of high growth that began in late 2002-03. Full information on corporate sector performance in 2006-07 that is now available for select private non-financial companies indicates that sales growth was of the order of 26.2 per cent, the highest since the 1980s. The pick-up in activity in 2006-07 was aided by improvements in operational efficiency, increased plant automation, cost control through better product mix, capacity utilisation and economies of scale, rising incomes from financial activity and return of pricing power. The growth in net profits of these companies was also high at 45.2 per cent as compared with 24.2 per cent a year ago. Over the period 2003-07, annual sales growth of select private non-financial companies averaged 20.8 per cent, while annual growth in net profits of these companies was 45.1 per cent. Early results for the first quarter of 2007-08 present a complex picture. Demand and investment conditions continue to be favourable. There is some deceleration in sales and profit

growth, relative to the levels recorded in the preceding year. This may be reflecting some increase in input and staff costs.

6. In the Reserve Bank's Industrial Outlook Survey conducted during May 2007, nearly 60 per cent of respondent companies reported no change in capacity utilisation and a majority also indicated no change in the financial situation, working capital finance requirements and availability of finance. Responses relating to export orders, imports and profits were somewhat mixed. The business expectations index for April-June 2007 declined by 7.1 percentage points from its level in the preceding quarter and by 6.0 percentage points from its level a year ago. The outlook for July-September 2007 appears to be optimistic with 54 per cent of the respondents expecting an improvement in the overall business situation on the back of increase in production, order books and capacity utilisation. As in April-June 2007 a majority of respondents expect no change in the financial situation, working capital finance requirements, availability of finance and in profit margins. The overall business expectations index for July-September 2007 declined by 3.8 percentage points from its level in the previous quarter and by 5.4 percentage points from a year ago.

7. Business sentiment polled by other surveys presents a varied response, with optimism relating to sales volume, order books and net profits being tempered by the impact of exchange rate changes on services sector companies as well as export industries with relatively low import content. According to one survey, business confidence for July 2007 continues to be

high but has declined by 8.8 per cent from its level in April-June 2007 and by 2.7 per cent year-on-year. Seasonally adjusted purchasing managers' indices for the first quarter of 2007-08 indicate favourable operating conditions in the manufacturing sector with the growth of output and new orders being maintained, a modest rise in staff hiring and selling prices, some easing of input price inflation and a build-up in pre-production and finished goods inventory levels. These indices also reflect some optimism about the general business scenario among micro, small and medium enterprises with more than 90 per cent planning higher capital investment.

8. Services sector activity has expanded in the first quarter of 2007-08 as reflected in lead indicators. The communication sector has recorded robust growth with 8,18,000 new lines being added to the switching capacity of telephone exchanges and total telephone connections (fixed plus cellular) registering an increase of 77.6 per cent in April-May 2007 on a year-on-year basis. In the transport sector, cargo handled at major ports increased by 17.8 per cent, whereas railway revenue earnings from freight traffic increased by 6.0 per cent. In civil aviation, handling of import cargo and export cargo increased by 21.7 per cent and 1.6 per cent, respectively. Passengers handled at domestic and international terminals increased by 24.4 per cent and 13.1 per cent, respectively, as against 47.2 per cent and 14.1 per cent a year ago.

9. The CSO's end-May 2007 release provides estimates of expenditure components of GDP in 2006-07, which contain information on the evolution of the

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constituents of aggregate demand. As a proportion to GDP, real private final consumption expenditure declined to 57.2 per cent during 2006-07 from 58.9 per cent in the previous year. On the other hand, real gross fixed capital formation (GFCF) increased to 27.9 per cent of GDP from 26.7 per cent, indicating that the acceleration of growth in the Indian economy is mainly investment-driven, despite domestic private consumption remaining the major component of aggregate demand. As regards external demand, net exports at (-) 2.8 per cent of GDP in 2006-07 were comparable to (-) 3.0 per cent in the previous year. Over the four-year period from 2003-04 to 2006-07, private consumption and gross capital formation increased in real terms by 6.3 per cent and 16.3 per cent per annum, respectively.

10. Turning to monetary and financial conditions, the year-on-year non-food credit growth of scheduled commercial banks (SCBs) at 24.4 per cent (Rs.3,67,258 crore) on July 6, 2007 was lower than 32.8 per cent (Rs.3,70,899 crore) a year ago. On a financial year basis, non-food credit declined by Rs.12,094 crore (0.6 per cent) during 2007-08 (up to July 6, 2007), in contrast to an increase of Rs.36,654 crore (2.5 per cent) in the corresponding period of the previous year. Food credit registered a decline of Rs.2,292 crore as against a decline of Rs.2,837 crore in the corresponding period last year.

11. Provisional information on the sectoral pattern of bank credit available up to March 2007 indicates some rebalancing of credit deployment, particularly in January-March 2007. During 2006-07, bank credit to agriculture recorded the highest growth

(32.4 per cent), followed by the services sector (31.0 per cent), personal loans (26.5 per cent) and industry (25.7 per cent). Growth in housing and real estate loans decelerated modestly to 24.6 per cent and 69.8 per cent, respectively, although continuing to remain at elevated levels. Incremental credit off-take, however, was the highest in respect of industry (36.1 per cent), followed by services (25.2 per cent), personal loans (24.3 per cent) and agriculture (14.4 per cent). Within the industrial sector, sizeable credit off-take was recorded in respect of infrastructure (26.8 per cent), textiles (34.2 per cent), basic metals and metal products (26.7 per cent), petroleum (41.0 per cent), food processing (27.9 per cent), engineering (24.5 per cent), chemicals (14.2 per cent) and construction (46.7 per cent). The share of textiles, infrastructure and basic metal and metal products in total credit to industry increased marginally from 10.6 per cent, 20.5 per cent and 12.0 per cent, respectively, to 11.3 per cent, 20.7 per cent and 12.1 per cent, while the share of engineering remained stable at 6.3 per cent. The share of industrial credit to chemicals declined from 8.8 per cent to 8.0 per cent. Priority sector advances grew by 24.0 per cent with a reduction in their share in outstanding non-food gross bank credit to 35.2 per cent in March 2007 from 36.4 per cent a year ago. Provisional information for May 2007 indicates continuing high credit growth to agriculture and the industrial sector and deceleration in credit to housing, real estate and personal loans.

12. On a year-on-year basis, commercial banks' investments in shares, bonds/debentures and commercial paper (CP)

declined by Rs.809 crore (1.0 per cent) as compared with a decline of Rs.9,961 crore (11.1 per cent) a year ago. On a financial year basis, such investments by banks fell by Rs.4,145 crore (5.2 per cent) during 2007-08 so far (up to July 6), as against an increase of Rs.593 crore (0.7 per cent) in the corresponding period of 2006-07. Banks, however, invested Rs.45,048 crore in instruments issued by mutual funds as against only Rs.15,902 crore in the corresponding period of 2006-07. The year-on-year growth in total flow of resources from SCBs to the commercial sector was 23.1 per cent (Rs.3,66,450 crore), lower than 29.5 per cent (Rs.3,60,938 crore) a year ago.

13. The year-on-year increase in aggregate deposits of SCBs at 24.4 per cent (Rs.5,31,881 crore) up to July 6, 2007 was higher than 20.9 per cent (Rs.3,77,392 crore) a year ago. The outflow of long-term deposits during the preceding two years has been arrested and there were fresh accretions to long-term deposits in April-June 2007 which augurs well for banks' asset-liability management. On a financial year basis, aggregate deposits increased by Rs.1,05,534 crore (4.0 per cent) during 2007-08 up to July 6, 2007 as against an increase of Rs.72,913 crore (3.5 per cent) in the corresponding period of the previous year. The accretion to bank deposits during the current financial year so far (April-July 6, 2007) is at a 14-year high. The incremental annual non-food credit-deposit ratio as on July 6, 2007 declined to 69.0 per cent from 98.3 per cent a year ago.

14. By the beginning of the current financial year, several banks had drawn down holdings of statutory liquidity ratio (SLR)-eligible securities close to the

statutory floor to accommodate the sustained non-food credit demand over the last three years. Reflecting the ongoing shifts in banks' portfolios to comply with the statutory requirements in view of this depletion, investment in Government and other approved securities by SCBs increased by Rs.59,515 crore during the current year so far (up to July 6, 2007) as against an increase of Rs.51,776 crore in the corresponding period of 2006-07. Exclusive of liquidity adjustment facility (LAF) operations, however, banks' investments in Government and other approved securities increased by Rs.27,331 crore as compared with an increase of Rs.751 crore a year ago. On July 6, 2007 commercial banks' holdings of Government and other approved securities was 28.7 per cent of the banking system's net demand and time liabilities (NDTL) as against 28.0 per cent at end-March 2007 and 31.5 per cent a year ago. Such investments were Rs.1,10,207 crore above the statutory minimum of 25 per cent of NDTL. It may be recalled that the Union Budget, 2006-07 announced the unwinding of the entire outstanding amount of recapitalisation bonds/special securities of Rs.20,809 crore issued to nationalised banks. Accordingly, bonds/securities issued to 19 nationalised banks worth Rs.8,709 crore were converted into marketable securities on February 15, 2007 and made eligible for SLR purposes. This conversion augmented the stock of SLR-eligible securities in the system which would increase even further with the conversion of the remaining recapitalisation bonds/special securities during the course of 2007-08.

15. Money supply (M_3) increased by 21.6 per cent on a year-on-year basis on July 6,

2007 which was above the projected trajectory of 17.0-17.5 per cent indicated in the Annual Policy Statement for 2007-08 and higher than 19.0 per cent a year ago. On a financial year basis, M_3 increased by 3.8 per cent (Rs.1,24,365 crore) during 2007-08 up to July 6, 2007 as compared with the increase of 3.5 per cent (Rs.95,488 crore) in the corresponding period of the previous year.

16. Reserve money increased by 29.1 per cent on a year-on-year basis on July 20, 2007 which was higher than 17.2 per cent a year ago. During the current financial year up to July 20, 2007 reserve money increased by 6.2 per cent (Rs.43,659 crore) as compared with the increase of 1.8 per cent (Rs.10,069 crore) in the corresponding period of the previous year. Among the components, currency in circulation increased by 2.1 per cent (Rs.10,380 crore) as compared with 4.6 per cent (Rs.19,630 crore). Among the sources of reserve money, the Reserve Bank's net foreign currency assets increased by Rs.29,653 crore as against an increase of Rs.85,084 crore in the corresponding period last year. Adjusted for revaluation effects, the Reserve Bank's net foreign currency assets increased by Rs.72,947 crore as against an increase of Rs.30,663 crore in the corresponding period of 2006-07. Net Reserve Bank credit to the Central Government increased by Rs.18,875 crore as against a decline of Rs.6,356 crore.

17. Over the first quarter of 2007-08, generally easy conditions of liquidity were interspersed with sporadic and transient periods of tightness. Build-up of the Central Government's cash balances by the third week of March 2007 and balance sheet adjustments by banks at the end of March

necessitated daily injections of liquidity through the LAF between March 16 and April 8. With the two-stage 50 basis point increase in the CRR announced on March 30 becoming effective on April 14 and April 28, repo operations were conducted again through April 16 - May 6. Throughout this period, contrastingly, market participants took recourse to reverse repos on a daily basis within the ceiling of Rs.3,000 crore set since March 5, 2007. During the quarter, an amount of Rs.18,377 crore was sterilised through the Market Stabilisation Scheme (MSS), warranted by strong capital inflows. By April 27, 2007 the Central Government slipped into drawal of ways and means advances (WMA) which deteriorated into overdraft during May 30-June 8. Call rates remained high during most part of April and May and ruled above the LAF repo rate.

18. From May 28, 2007 the system shifted into a phase of large surplus liquidity with continuous reverse repos on a daily basis, capped at Rs.3,000 crore, except on June 28-29, 2007 when the Reserve Bank injected money through repos to assuage liquidity tightness due to advance tax outflows. While the Central Government vacated overdrafts from June 9, it continued to avail of WMA until June 17, 2007. There was a brief return to surplus cash balances during June 18-28 but recourse to WMA resumed thereafter, turning into overdrafts during July 3-8 and July 18, 2007 onwards. Additional market borrowings beyond the calendar were resorted to in order to finance, in part, the purchase of the Reserve Bank's stake in the State Bank of India. The amount of Rs.35,351 crore has been received by the Reserve Bank on June 29, 2007. The customary surplus transferable to the

Central Government from the Reserve Bank for the year ending June 2007 is likely to be credited to the account of the Central Government in mid-August 2007.

19. The suffusion of liquidity flows in the financial markets mainly on account of the sharp depletion of the Central Government's cash balances was reflected in call rates plunging to close to one per cent levels, going even below on several occasions. The total overhang of liquidity under the LAF, the MSS and cash balances of the Central Government taken together declined from an average of Rs.97,449 crore in March 2007 to Rs.72,823 crore on July 27, 2007. An assessment of the total liquidity overhang, however, should also account for the transfer of Rs.35,351 crore from the Central Government to the Reserve Bank during this period. It also needs to be noted that in view of the ceiling on daily LAF reverse repos, the overhang as defined here provides the magnitude of liquidity impounded only through these instruments and it captures the overhang only when the Reserve Bank injects liquidity under the LAF. On a net basis, average daily LAF repos declined from Rs.11,858 crore in March 2007 to average daily reverse repo of Rs.2,117 crore in July 2007 (up to July 27, 2007). The outstanding balances under MSS increased from Rs.64,863 crore at end-March 2007 to Rs.90,030 crore on July 27. Cash balances of the Centre with the Reserve Bank declined from an average of Rs.55,893 crore in March 2007 to a debit of Rs.20,199 crore on July 27, 2007.

20. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, declined from 5.9 per cent at end-March 2007 to 4.4 per cent as on July 14,

2007. Prices of primary articles and manufactured products rose by 10.0 per cent and 4.6 per cent, respectively, as against the increase of 3.8 per cent and 3.9 per cent a year ago. Prices of the fuel group declined by 1.4 per cent as against an increase of 7.2 per cent a year ago. On an annual average basis, WPI inflation was 5.5 per cent up to July 14, 2007 as against 4.3 per cent a year ago.

21. Inflationary pressures emerging from supply constraints in the agricultural sector eased somewhat in the first quarter of 2007-08. The total stock of foodgrains with public agencies increased to 25.1 million tonnes on May 1, 2007 as against the buffer stock norm of 16.2 million tonnes and was also higher than 22.8 million tonnes a year ago. Year-on-year inflation in terms of foodgrains prices decelerated from 13.5 per cent in mid-December 2006 to 7.4 per cent by mid-July 2007. There has, however, been hardening in the prices of oilseeds since November 2006 with second-round effects on prices of edible oils and oil cakes. These three items, which together have a weight of 6.8 per cent in the WPI, contributed 28.7 per cent of headline inflation as on July 14, 2007. The easing of inflation in terms of prices of manufactures since end-March 2007 from 6.1 per cent to 4.6 per cent by the second week of July has been mainly on account of decline in the prices of sugar and some deceleration in prices of basic metals and alloys and textiles.

22. The recent surge in global prices of several agricultural commodities is attributed partly to transitory factors such as drought-related supply shortfalls and low stocks. Weather-related setbacks to production occurred in a number of

countries such as the US, the EU, Canada, Russia, Ukraine and most notably in Australia, where production fell by more than 50 per cent in 2006-07. According to the projections made by the Organisation for Economic Co-operation and Development (OECD)–Food and Agricultural Organisation (FAO), global prices of agricultural commodities are likely to rule higher than their historic equilibrium levels over the next ten years on account of various factors including the rapidly expanding bio-fuel industry which is pushing up the prices of agricultural commodities through spill-over effects. Growing cereal use for ethanol has caused reduction in acreage of oilseeds, particularly in the US, in favour of maize with adverse price effects. Indirectly, the prices of livestock products have also gone up due to rising feed costs. These developments have major implications for India to the extent of dependence on imports of edible oils and wheat for meeting domestic shortfalls.

23. The global dairy market has been facing an increasing demand for premium products which is likely to continue over the near-term. In Asia, particularly in China, and in Latin America, demand for milk products has gone up rapidly. US milk prices increased by 20 per cent during March-June 2007 fuelled by export demand and drought-related supply disruptions in Australia and New Zealand. Milk futures in the Chicago Mercantile Exchange have risen by 60 per cent. The US Department of Agriculture expects milk prices to remain firm over the rest of 2007 and in 2008 as well. In India, milk prices reflected in the WPI increased by 7.7 per cent as on July 14,

2007, on a year-on-year basis, contributing 7.2 per cent to the headline WPI inflation.

24. Notwithstanding the higher production of foodgrains expected during 2006-07, there is a need for regular stock-taking, assessment and planning for ensuring the adequate availability of essential food articles in view of the global outlook. A comprehensive approach in this regard may take cognisance of changes in population, consumption patterns and the evolving trends in international trade.

25. During 2007-08 so far, West Texas Intermediate (WTI) prices have moved in a range of US \$ 61-77 per barrel with UK Brent prices above the WTI by US \$ 4.1 per barrel, while the premium of the WTI over the Dubai variety was US \$ 1.40 per barrel. In tandem with the hardening of international crude prices, the average price of the Indian crude basket increased from US \$ 56.2 per barrel in January-March 2007 to US \$ 66.2 per barrel in April-June and to around US \$ 73.5 per barrel on July 27, 2007, *i.e.*, an increase of 32.9 per cent over the level in February 2007. Domestic prices of petrol and diesel have, however, remained unchanged since mid-February; prices of aviation turbine fuel, which are market-determined, have increased by 11.3 per cent in the same period. Excluding the fuel group, year-on-year inflation was 6.1 per cent on July 14, 2007 and was higher than headline inflation. According to the US Energy Information Administration (EIA), global demand is expected to increase by 1.3 million barrels a day during 2007, while the supply is likely to increase only by 0.6 million barrels a day. WTI prices are expected to average US \$ 65.7 per barrel in 2007.

26. On a year-on-year basis, inflation based on the consumer price index (CPI) for agricultural labourers and rural labourers increased to 7.8 per cent and 7.5 per cent, respectively, in June 2007 from 7.2 per cent each a year ago. Year-on-year inflation based on CPI for industrial workers and urban non-manual employees was placed at 6.6 per cent and 6.1 per cent, respectively, in May and June 2007 as against 6.3 per cent and 6.5 per cent, a year ago. The softening of food prices is being reflected in a reduced difference between inflation rates based on the CPI and the WPI.

27. In terms of proportions to budget estimates (BE), revenue receipts of the Central Government increased to 5.3 per cent during April-May 2007 from 4.8 per cent in April-May 2006. Total expenditure at 13.3 per cent was lower than 16.3 per cent a year ago. Both Plan and non-Plan expenditures were lower as proportions to BE than a year ago. Accordingly, the gross fiscal deficit (GFD) declined to 41.2 per cent from 48.5 per cent a year ago. The revenue deficit at 83.0 per cent of the BE in April-May 2007 was marginally higher than 81.0 per cent in the corresponding period last year.

28. Gross market borrowings (dated securities and 364-day Treasury Bills) of the Central Government during 2007-08 at Rs.85,628 crore up to July 27, 2007 (Rs.70,813 crore a year ago) constituted 45.4 per cent of the BE while net market borrowings at Rs.46,047 crore (Rs.34,822 crore) constituted 42.0 per cent of the BE. Additional borrowings of Rs.6,000 crore through 182-day Treasury Bills and Rs.18,500 crore through 91-day Treasury Bills were undertaken in June 2007 in order

to, *inter alia*, support the special operation of funding the transfer of the Reserve Bank's stake in the State Bank of India to the Government of India. Against the allocated net borrowing programme of Rs.23,359 crore for 2007-08, State Governments have raised a net amount of (-) Rs.645 crore (gross Rs. 8,541 crore; repayment: Rs.9,186 crore) during the current year (up to July 27, 2007).

29. During the first quarter of 2007-08, financial markets experienced sizeable fluctuations in liquidity and attendant episodes of volatility. Call money rates stayed firm during most part of April and May 2007, due to the usual tightening of liquidity at the end of March 2007 which were accentuated by CRR increases referred to earlier. Call rates stayed above the LAF corridor for prolonged periods with intermittent fluctuations. In June, market conditions shifted into surplus liquidity, engendered by large drawdown of the Central Government's cash balances during end-May and early June and capital inflows. Call rates hovered around one per cent for most part of June and July (up to July 27) except on June 28-29, 2007 when advance tax outflows briefly pushed up call rates above the LAF repo rate. Overnight rates in the call, market repo and collateralised borrowing and lending obligations (CBLO) segments have displayed close co-movement. The interest rate in the call market declined from an average of 14.07 per cent in March 2007 to 8.33 per cent, 6.96 per cent and 2.42 per cent in April, May and June 2007 and further to 0.90 per cent in July 2007. Interest rates in the market repo (outside the LAF) and CBLO segments declined from 8.13 per cent and 7.73 per

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cent, respectively, in March 2007 to 6.76 per cent and 6.12 per cent in April 2007 and further to 0.26 per cent and 0.07 per cent in July 2007. The daily average volume (one leg) in the call money market declined from Rs.11,608 crore in March 2007 to Rs.8,687 crore in July 2007. The corresponding volumes in the market repo were Rs.8,646 crore and Rs.12,070 crore, respectively, whereas in the CBLO segment, the volumes were Rs.17,662 crore and Rs.18,509 crore, respectively. As on July 27, 2007 the weighted average interest rate for CBLO, market repo and call rate stood at 0.02 per cent, 0.18 per cent and 0.22 per cent, respectively.

30. In the primary market, the yield on 91-day Treasury Bills declined from 7.97 per cent at end-March 2007 to 4.46 per cent by July 25, 2007. The yield on 364-day Treasury Bills also recorded a decline from 7.98 per cent to 6.58 per cent by July 18, 2007. There was a marked increase in commercial paper (CP) issuances and the outstanding amount increased to Rs.26,256 crore by end-June 2007 from Rs.17,688 crore at end-March 2007. The weighted average discount rate on CP declined from 11.33 per cent to 8.93 per cent over this period. In the market for certificates of deposit (CDs), the weighted average discount rate declined from 10.75 per cent at the end of March 2007 to 9.37 per cent by end-June and the outstanding amount increased from Rs.93,272 crore to Rs.98,337 crore over this period.

31. In the secondary market, the yield on government securities with one-year residual maturity moved down from 7.55 per cent at end-March 2007 to 6.84 per cent by July 27, 2007. The yields on Government

securities with 10-year and 20-year residual maturity also eased during this period from 7.97 per cent to 7.89 per cent and from 8.23 per cent to 8.21 per cent, respectively. Consequently, the yield spread between 10-year and one-year Government securities widened from 42 basis points to 105 basis points whereas the spread between 20-year and one-year Government securities widened from 68 basis points to 137 basis points over this period.

32. Banks had generally increased their deposit rates by about 25-50 basis points across various maturities between March 2007 and June 2007, but reduced them during July 2007, especially in the shorter maturities. The majority of public sector banks (PSBs) adjusted their deposit rates upwards by 10-25 basis points on maturities above one year, particularly at the longer end. Interest rates offered by the PSBs on deposits of above one-year maturity moved up from 7.25-9.50 per cent in March 2007 to 7.25-9.60 per cent in July 2007. Private sector banks' deposit rates for one year and up to three years maturity moved from 6.75-9.75 per cent in March 2007 to 6.75-10.25 per cent in July 2007, while interest rates on deposits greater than three years maturity increased from 7.75-9.60 per cent to 7.50-10.00 per cent over the same period. The range of interest rates offered by foreign banks on deposits of maturities above one year remained largely unchanged at 2.50-9.50 per cent in July 2007 compared to 3.50-9.50 per cent in March 2007. The benchmark prime lending rates (BPLRs) of PSBs and private sector banks moved from a range of 12.25-12.75 per cent and 12.00-16.50 per cent to 12.50-13.50 per cent and 13.00-17.25 per cent, respectively, in the same period.

The range of BPLRs for foreign banks was 10.00-15.50 per cent during the period.

33. In the foreign exchange market, large surplus conditions in the spot market were accompanied by a sharp increase in average daily turnover in the foreign exchange market to US \$ 38.2 billion from a level of US \$ 23.6 billion a year ago. While the inter-bank turnover increased from US \$ 17.1 billion to US \$ 27.7 billion, the merchant turnover increased from US \$ 6.5 billion to US \$ 10.5 billion. Forward premia spiked in April 2007 but in subsequent months, there has been a softening across all maturities. The six-month forward premia eased from 3.60 per cent in March 2007 to 2.53 per cent by end-June 2007 and further to 1.28 per cent as on July 27, 2007.

34. The equity markets were buoyant on the back of strong corporate profitability, a positive investment climate and sound fundamentals. The BSE Sensex (1978-79= 100) increased from 13,072 at end-March 2007 to cross the 15,000 level on July 9, 2007 and reached 15,795 on July 24, 2007. On July 27, 2007 the BSE Sensex declined to 15,235.

Developments in the External Sector

35. The Reserve Bank's end-June 2007 release sets out balance of payments data for January-March 2007 and preliminary data for the full year 2006-07. In US dollar terms, merchandise export growth was maintained at 22.5 per cent in 2006-07 as against 23.4 per cent in the previous year. Commodity-wise data released by the Directorate General of Commercial Intelligence and Statistics (DGCI&S) indicate that petroleum, oil and lubricants (POL)

exports recorded a growth of 59.4 per cent and accounted for 29.7 per cent of the total export growth in 2006-07. Non-POL exports rose by 17.9 per cent, with exports of both primary and manufactured products exhibiting some moderation in growth in relation to the preceding year. The growth in merchandise import payments also moderated from 33.8 per cent in 2005-06 to 27.8 per cent in 2006-07. Crude oil import growth moderated from 47.3 per cent in 2005-06 to 29.8 per cent in 2006-07, reflecting a growth of 19.3 per cent in volume terms and an increase of 12.7 per cent in the average price of the Indian basket of international crude which moved up to US \$ 62.4 per barrel from US \$ 55.3 per barrel in the previous year. Net POL imports, *i.e.*, POL imports minus POL exports, were US \$ 38.5 billion in 2006-07 as against US \$ 32.3 billion in 2005-06. Non-oil import payments increased by 26.9 per cent mainly on account of rising imports of capital goods, metalliferrous ores, metal scrap and gold and silver. As a result, on a payments basis, the merchandise trade deficit widened to US \$ 64.9 billion (7.1 per cent of GDP) from US \$ 51.8 billion (6.4 per cent of GDP) in the previous year.

36. During 2006-07, gross invisible receipts at US \$ 119.2 billion amounted to as much as 94 per cent of merchandise exports, recording an increase of 29.1 per cent. The sustained growth of software exports as well as earnings from other professional and business services and travel have provided innate strength to the invisibles account in conjunction with steadily rising inflows of remittance from overseas Indians. During 2006-07, invisible payments increased by 28.7 per cent, mainly on

account of a surge in outbound tourist traffic, imports of business and management consultancy services, engineering and technical services as well as dividend and profit payouts. The net invisibles surplus rose to US \$ 55.3 billion in 2006-07 from US \$ 42.7 billion in the previous year. Accordingly, the current account deficit (CAD) amounted to US \$ 9.6 billion (1.1 per cent of GDP), up from US \$ 9.2 billion (1.1 per cent of GDP) in 2005-06.

37. Net capital flows were buoyant in 2006-07, nearly doubling to US \$ 44.9 billion from US \$ 23.4 billion in 2005-06. Sizeable increases in net inflows were received under foreign direct investment (FDI), non-resident Indian (NRI) deposits, external commercial borrowings (ECB), external assistance and short-term credit while net portfolio inflows moderated in relation to their levels in the preceding year. There was bi-directional movement in direct investment flows with Indian corporates exhibiting a strong appetite for global expansion. As regards inward FDI, sectors such as manufacturing and construction, financial and banking services and information technology services were the main recipients in the net inflows of US \$ 8.4 billion in 2006-07, sizeably higher than US \$ 4.7 billion in 2005-06. Net ECB disbursements accounted for a third of total net capital inflows in 2006-07, reflecting extremely favourable conditions for Indian borrowers in the global financial markets. Net portfolio inflows were lower at US \$ 7.1 billion than US \$ 12.5 billion in 2005-06, partly due to volatility in Asian and global equity markets in February-March 2007. On the other hand, American Depository Receipts/Global Depository Receipts (ADRs/

GDRs) issuances remained buoyant as corporates took advantage of favourable external market conditions to issue equities abroad. NRI deposits increased by US \$ 3.9 billion as compared with US \$ 2.8 billion in the previous year.

38. Reflecting the movements in current and capital accounts of the balance of payments, the accretion to foreign exchange reserves (excluding valuation) amounted to US \$ 36.6 billion during 2006-07, higher than US \$ 15.1 billion in 2005-06. The level of foreign exchange reserves amounted to US \$ 199.2 billion at the end of March 2007.

39. India's external debt increased by US \$ 28.6 billion during 2006-07 and amounted to US \$ 155 billion at end-March 2007. While multilateral and bilateral debt registered moderate increase, ECBs increased by 59.2 per cent, followed by trade credit and NRI deposits. Valuation gains on account of the depreciation of the US dollar *vis-à-vis* other major international currencies also added to the stock of external debt. The US dollar had a dominant share of 49.1 per cent in India's external debt whereas rupee-denominated debt had a share of 17.4 per cent. The ratio of short-term debt to total debt increased marginally to 7.7 per cent at end-March 2007 from 6.9 per cent a year ago.

40. During the first two months of 2007-08, developments in the external sector indicate sustained strength and resilience. Export growth rose to 20.2 per cent from 19.2 per cent in the corresponding period of the previous year. Imports also posted a sharp rise of 33.0 per cent as compared with 16.9 per cent in the corresponding period of the previous year. Non-POL imports rose by 47.3 per cent whereas oil imports

remained broadly stable at the level recorded a year ago. As a result, the merchandise trade deficit widened to US \$ 13.3 billion during April-May 2007 from US \$ 8.2 billion in April-May 2006.

41. Available information points to a sizeable increase in net capital flows during the current financial year in the main components. Portfolio flows have picked up strongly on account of foreign institutional investors (FIIs) which amounted to US \$ 8.4 billion during 2007-08 (up to July 13) as compared to an outflow of US \$ 2.0 billion in the corresponding period of 2006-07. Gross FDI inflows during April 2007 were placed at US \$ 1.6 billion as compared with US \$ 0.7 billion a year ago. Approvals for ECBs amounted to US \$ 8.7 billion during April-June 2007 as compared with US \$ 4.4 billion in the corresponding period last year. On the other hand, there were net outflows under NRI deposits of US \$ 274 million in April 2007 as compared with inflows of US \$ 253 million during April 2006. ADR/GDR issues by Indian companies amounted to US \$ 11.0 million during April 2007 as against an inflow of US \$ 435 million in the corresponding period in the previous year. The foreign exchange reserves increased by US \$ 22.9 billion and stood at US \$ 222.0 billion on July 20, 2007.

42. The exchange rate of the rupee against the US dollar, which was Rs.43.59 at end-March 2007, appreciated sharply thereafter to touch an intra-day high of Rs.40.28 per US dollar on May 28, 2007 before reaching Rs.40.70 at end-June 2007. The rupee appreciated against the euro from Rs.58.14 at end-March 2007 to Rs.55.12 at end-June 2007, against the pound sterling from Rs.85.53 at end-March 2007 to Rs.81.76 at

end-June 2007 and against the Japanese yen from Rs.36.89 per 100 yen to Rs.33.04 per 100 yen at end-June 2007. Overall, during April-June 2007 the rupee appreciated by 6.63 per cent against the US dollar, by 5.19 per cent against the euro, by 4.41 per cent against the pound sterling and by 10.44 per cent against the Japanese yen. As on July 27, 2007 the exchange rate of the rupee closed at Rs.40.52 per US dollar, Rs.55.35 per euro, Rs.82.28 per pound sterling and Rs.34.12 per 100 Japanese yen.

43. On July 12, 2007 the Government announced a package of measures to provide relief to exporters for a temporary period in response to representations received in regard to exchange rate movements. The package, involving an estimated outlay of Rs.1,400 crore, included tax/duty concessions and other measures such as concessional pre-shipment and post-shipment credit by banks for small and medium exporters and enterprises that export textiles, readymade garments, leather products, handicrafts, engineering products, processed agricultural products, marine products, sports goods and toys. Under the scheme, interest subvention of 2 percentage points per annum would be provided to all scheduled commercial banks in respect of rupee export credit extended by them to the specified categories of exporters.

44. 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

45. World GDP growth, which had accelerated to 5.5 per cent in 2006, has maintained pace in the first half of 2007 and appears to have broadened across industrial and emerging market countries. While consensus expectations support a broad-based economic expansion for 2007, firm inflationary pressures and high and volatile crude prices carry risks to this outlook. According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in April 2007, global real GDP growth was expected to decline from 5.4 per cent in 2006 to 4.9 per cent in 2007 and 2008. The update of the WEO released in July 2007 has now revised this forecast upwards to 5.5 per cent for 2006 and 5.2 per cent for 2007 and 2008.

46. In the US, real GDP growth which had decelerated to 0.6 per cent in the first quarter of 2007, accelerated to 3.4 per cent in the second quarter of 2007 as compared to 2.6 per cent a year ago, reflecting positive contributions from narrowing trade deficit, commercial structures investment, personal consumption expenditure and government spending, partly offset by a decrease in residential fixed investment. Several headwinds to growth are, however, evident in the weak growth in incomes and consumer spending and the continued weakness in the sub-prime housing sector

which is spilling over to higher quality credit market as also into debt and equity markets.

47. Real GDP in the euro area grew by 3.0 per cent in the first quarter of 2007 on a year-on-year basis. Various surveys of business and consumer confidence suggest firm growth continuing in the second quarter. The WEO update places average annual real GDP growth at 2.3 per cent in 2007 and 2.5 per cent in 2008. The unemployment rate in the euro-zone fell in May to 7.0 per cent - the lowest level since 1993. Business confidence remained buoyant in Europe in June 2007 with a step-up in investment and hiring. According to the European Central Bank (ECB), interest rates still support economic expansion, implying that further tightening is possible going ahead.

48. The Japanese economy grew by 2.6 per cent in the first quarter of 2007 as compared with 3.0 per cent a year ago and moderate expansion is likely to continue. Exports and business fixed investment have risen steadily against the background of high corporate profits. Household income has been rising moderately, accompanied by firmness in private consumption. Housing investment and production has been flat in the recent period. Public investment has been declining as a trend.

49. Emerging market economies (EMEs) have posted strong growth in a relatively benign inflation environment. The strength of macroeconomic performance has attracted significant capital flows with net inflows of foreign private capital to the EMEs reaching a level of US \$ 256 billion in 2006. In some of the EMEs, high investment growth, excessive lending, overhang of

liquidity, strengthening retail demand and imbalances in trade and international payments pose risks to growth. In addition, there are a number of downside risks emanating from the behaviour of oil prices, adverse developments in the US housing market, persistence of global imbalances, large leveraged positions in financial markets and possible emergence of inflationary pressures, especially from the foodgrains sector.

50. In Asia, the EMEs have extended the run of robust economic growth in a favourable global setting, strong commodity prices and abundant global liquidity. The Chinese economy accelerated by 11.9 per cent in the second quarter of 2007 as compared with 11.5 per cent a year ago – the fastest in 11 years. Inflation in China was at 2.8 per cent in 2006 but has risen steadily to 4.4 per cent in June 2007. China is expected to grow by 11.2 per cent in 2007 but inflation may cross the central bank's target of 3.0 per cent to reach 3.2 per cent. With the current phase of growth perceived as unstable and environmentally unsustainable, macroeconomic management policies have been tightened, including taxation measures aimed at dampening speculative excesses in the stock market. The People's Bank of China (PBC) has raised interest rates five times since April 2006 and has raised cash reserve requirements nine times between July 2006 and July 2007. On July 20, 2007 the PBC has cut the interest income tax to enhance the attractiveness of bank deposits and reduce funds flow to the stock markets which reached a record level in July. China ran a record US \$ 112.5 billion trade surplus in the first six months of 2007, 83 per cent more than in the same period

last year, which has contributed to the overhang of liquidity in the economy. China's foreign exchange reserves reached US \$ 1.33 trillion at the end of June 2007. The rising risks of overheating, inflationary pressures, liquidity overhang, expanding credit and surging stock markets point to further monetary tightening.

51. Among the other major Asian economies, the Korean economy grew by 4.0 per cent in the first quarter of 2007, lower than 6.3 per cent a year ago. Exports continued to show steady growth, while investment and construction are picking up and private consumption has recovered. The Korean economy is expected to grow by 4.4 per cent in 2007, slower than 5.0 per cent in 2006. Consumer price inflation has accelerated to 2.5 per cent in June 2007 from 1.7 per cent in January 2007. The Bank of Korea has taken tightening steps in 2006 and 2007 by raising its policy rate, increasing reserve requirements, cutting the ceiling on aggregate loans to commercial banks for lending to small and medium enterprises and has attempted to curb the steady rise in property prices by restricting mortgage loan issuance to one contract per person, introduction of price ceilings on new houses and disclosure of construction cost of new homes.

52. In Thailand, growth is projected to slow down to 4.5 per cent for 2007 from 5.0 per cent recorded in 2006. In the first quarter, the Thai economy has registered a growth of 4.3 per cent, from 6.1 per cent a year ago. The Bank of Thailand introduced a series of measures to stem strong capital inflows into the economy in 2006 and 2007, although monetary policy setting has eased

in the context of the slowdown in growth so far.

53. Improved global wheat crop prospects, coupled with a more positive supply outlook in major exporting countries could result in a modest decline in international wheat prices in 2007. Improvement in crop prospects is likely due to increase in winter wheat plantings and favorable growing conditions. At the onset of the new season, however, stocks in major exporting countries are still small which is contributing to price volatility in world markets. World trade in wheat in 2007-08 is placed at 109 million tonnes with smaller imports by India and higher export supplies from Australia. A series of setbacks have severely impacted paddy production in 2006-07 and may result in tightening of the demand-supply situation in world rice markets in 2007. International rice prices followed a steady upward trend between December 2006 and March 2007, but have stabilised since then, largely influenced by falling export demand due to the imposition of tight quality certification requirements in key import markets. With large imports projected for the rest of the year and limited current supplies in exporting countries, upward pressure on international rice prices may continue over the next few months. Despite the expected record world coarse grains harvest in 2007 following increased plantings, international coarse grains prices are likely to stay high in 2007-08 in response to strong demand for ethanol production. Sugar prices, which reached a 25-year high in early 2006, have declined since then due to much larger global output than anticipated in most cane-producing countries, particularly Brazil and India.

54. Metal prices have increased by 15.6 per cent during the first six months of 2007, over and above the increase of 53.6 per cent in 2006 and 36.3 per cent in 2005. According to the futures markets, aluminum may gain in the rest of 2007, while copper, nickel, zinc and tin are expected to decline. Gold prices, which had sharply risen to their highest level in 26 years in May 2006, are on a decline in the face of increased central bank sales. On July 27, gold prices fell to US \$ 659.50 per ounce on renewed strength in the U.S. dollar and sharp declines in the broader stock market indices.

55. Spot crude oil prices softened from the July-August 2006 peak of US \$ 78 per barrel to around US \$ 53 per barrel in January 2007 but have rebounded in July on expectations of good demand, low US crude stocks, failure by the Organisation of Petroleum Exporting Countries (OPEC) to lift output and a potentially harsh hurricane season to close at US \$ 77 on July 27, 2007. September 2007 future crude prices climbed to US \$ 77.02 per barrel on July 27, 2007.

56. The inflation outlook remains a matter of concern on account of energy and other commodity prices, increased capacity utilisation rates in developed and major emerging economies and the impact of rising wages on inflation in advanced industrial economies. In the US, consumer prices increased from 2.1 per cent in January 2007 to 2.7 per cent in June 2007. In the euro area, inflation has remained at 1.9 per cent in March-June 2007. Inflation became zero in Japan in April-May 2007 from 0.9 per cent in August 2006 and turned negative at (-) 0.2 per cent in June 2007. In the UK, CPI inflation declined to 2.4 per cent in June

2007. At the retail level, Retail Prices Index (RPI) inflation rose to 4.8 per cent in the UK in March 2007 - the highest since 1991 - but declined thereafter to 4.4 per cent in June 2007. Inflation pressures have raised concerns in some of the EMEs.

57. Core CPI inflation in the US decelerated to 2.2 per cent in May-June 2007 as against 2.3 per cent in April 2007. In the UK, core CPI inflation has been increasing in tandem with the headline rate and stood at 2.0 per cent in June, up from 1.9 per cent in May 2007. In the euro area, core CPI inflation has remained at the level of 1.9 per cent over March-June 2007. Core inflation in Japan was negative (-0.4 per cent) in June 2007 as compared with (-) 0.3 per cent in May 2007. Globally, headline inflation has picked up in the wake of increase in commodity prices and core inflation has also generally remained firm.

58. Global financial markets recovered from the turbulence witnessed in February-March 2007. The buoyancy of the US stock markets in the first quarter of 2007 continued in the second quarter, aided by strength in manufacturing and strong merger activity. Global mergers-and-acquisitions volume, fuelled by private equity buyers mostly in the US market, surged in the first half of 2007. In the second quarter of 2007, emerging market spreads tightened to new historical lows as credit default spreads fell and stock markets surged. Accordingly, in the first half of 2007, emerging markets outperformed stocks in developed markets, led by Brazil, Turkey, China and Korea. Foreign investor demand for emerging market assets was reflected in a broad-based rise in inflows into dedicated bond and equity markets of the EMEs.

Emerging market corporate bond issuance in international bond markets rose to a record level in 2006. The exposure of emerging markets to risky financial assets of the mature markets has increased, and therefore, the overall global financial risks have increased.

59. In late July 2007, the fall in credit market confidence brought on by the spread of the subprime loan risks into higher quality debt, affected stock markets around the world. Share prices fell by significant amounts on July 26 and 27, led by the Dow Jones Industrial Average. This resulted in a decline in sentiment in the international corporate bonds along with emerging market debt. It has been reported that in response to expectations that the Reserve Bank of New Zealand may not increase interest rates any further, there are indications of some abatement of the yen carry trade. There are evolving uncertainties in the direction of carry trade with implications for EMEs.

60. Government bond yields in the major economies had, until recently, firmed up. The US 10-year bond yield increased from 4.70 per cent at end-December 2006 to 5.29 per cent on June 12, 2007 before falling to 4.77 per cent on July 27, 2007. The 10-year bond yield in the euro area increased from 3.95 per cent at end-December to 4.68 per cent on July 9, 2007 before falling to 4.33 per cent. The Japanese 10-year bond yield has increased from 1.68 per cent at end-December to 1.97 per cent on June 13, 2007 before falling to 1.78 per cent. These recent developments are indicative of evolving uncertainties in international financial markets with implications for EMEs.

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61. On a trade-weighted basis, the US dollar has been depreciating since 2006 with intermittent fluctuations against most major currencies, especially due to narrowing interest rate advantage over other currencies. On July 24, 2007 the pound sterling rose to a 26-year high of US \$ 2.06 on concerns that the emerging developments in the subprime mortgage market will hurt the broader economy. The euro has also been strengthening against the US dollar since June, after the ECB lifted its benchmark rate, and rose to a record high on July 24, on investor apprehension about the subprime mortgage market. The Canadian dollar reached a 30-year high against the US dollar on July 6, 2007 ahead of an expected rate hike by the Bank of Canada, and appreciated further to a new peak on July 24, 2007. Turkey experienced a sharp appreciation in its currency *vis-à-vis* the euro and the US dollar on July 2, 2007 boosted by strong economic performance and large capital inflows. The New Zealand dollar had appreciated to 81.10 cents to reach a 22-year peak against the US dollar on July 24, 2007. The Reserve Bank of New Zealand had to intervene in the foreign exchange market on June 11, 2007 for the first time since 1985. These unusual developments in the currency markets in recent months are indicative of heightened uncertainties, giving rise to significant challenges for monetary management in EMEs.

62. Perceptions of inflation pressures ahead have prompted monetary authorities generally to persevere in withdrawing monetary accommodation. The central banks that have tightened their policy rates include the ECB which has raised its policy rates eight times since December 2005 by

25 basis points each to 4.00 per cent (main refinancing rate); the Bank of England (repo rate raised in August and November 2006, January, May and July 2007 by 25 basis points to 5.75 per cent); the Bank of Japan (uncollateralised overnight rate target at 0.25 and 0.50 per cent in July 2006 and February 2007, respectively, after maintaining a zero interest rate policy since September 2001); the Bank of Canada to 4.50 per cent (in July 2007); the Reserve Bank of Australia (Cash Rate raised by 25 basis points each in August and November 2006 to 6.25 per cent); the Reserve Bank of New Zealand (Official Cash Rate raised to 8.25 per cent by five 25 basis points hikes in December 2005 and March, April, June and July 2007); the People's Bank of China (lending rate raised five times to 6.84 per cent between April 2006 and July 2007); the Bank of Korea (target overnight call rate raised by 25 basis points to 4.50 per cent in August 2006 and 4.75 per cent in July 2007); the Banco de Mexico (benchmark overnight lending rate raised to 7.25 per cent in April 2007 from 7.0 per cent since April 2006); and the Banco Central de Chile (benchmark lending rate raised to 5.25 per cent in July 2007 from 5.00 per cent since January 2007).

63. A few central banks have used supplementary measures for tightening, besides increasing the key policy rates such as increases in reserve requirements. In China, the required reserve ratio was raised by 50 basis points each effective from July 5, August 15 and November 15 in 2006 and on January 15, February 25, April 16, May 15, June 5 and August 15 in 2007. The required reserve ratio in China is now 12.0 per cent. The Bank of Korea raised reserve

requirements from 5 per cent to 7 per cent for local currency deposits and short-term foreign currency deposits, after a gap of 17 years, in November and December 2006, respectively. Meanwhile, in several EMEs including China and Korea, central bank bonds have continued to absorb liquidity from the banking system.

64. Some central banks have paused in their policy cycles, particularly the US. The pause of the Federal Reserve since August 2006 came after seventeen increases by 25 basis points each between June 2004 and June 2006. Other central banks that have kept their policy rates steady include the Bank Negara Malaysia (Overnight Policy Rate at 3.5 per cent since April 2006).

65. Some other central banks have cut back their policy rates in recent months, usually on the back of earlier strong actions to contain inflation. These include Bank Indonesia (BI) (BI rate reduced from 12.50 per cent in May 2006 to 8.25 per cent in July 2007); the Bank of Thailand (1-day repurchase rate reduced from 4.75 per cent in January 2007 to 3.25 per cent in July 2007 in four stages); and the Banco Central do Brasil (Selic rate target cut between September 2005 and July 2007 to 11.50 per cent).

Overall Assessment

66. There are indications that a strong momentum of activity has been sustained in the Indian economy in the early months of 2007-08. Aggregate supply conditions appear to have firmed up mainly on the back of high growth in industry and services.

67. Industrial output has risen faster than consensus market expectations in April and

May 2007, extending a run of consecutive months of double-digit growth that began in November 2006. The acceleration in industrial activity continues to reflect the performance of manufacturing which has recorded double-digit growth through April 2006 to May 2007, with October 2006 being the sole outlier. Infrastructure output growth has also picked up in April-May 2007, led by electricity generation, steel and crude petroleum production with some deceleration in cement production due to capacity constraints. Several infrastructure industries, notably petroleum refineries, steel and cement are operating at above 90 per cent capacity utilisation.

68. Lead indicators, particularly cargo handled in major ports, cell phone connections, passengers handled at domestic and international terminals, road upgradation and banking and financial sector activity seem to point to the recent pace of growth of services sector activity being maintained in the first quarter of 2007-08.

69. On the agricultural front, the outlook is somewhat unclear and would depend on the spread and intensity of the south-west monsoon. Up to June 2007, rainfall has been significantly above the LPA for the country as a whole although somewhat deficient over central India. While the live water storage in important reservoirs appears to have dipped below the level a year ago, it still remains higher than the average of the last ten years. The area sown under various *kharif* crops was lower than a year ago in respect of all major crops, except cotton and oilseeds. The progress of the monsoon and a fuller assessment of crop sowing situation

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will enable a more informed appraisal of the likely performance of agriculture over the rest of the year.

70. While growth in industry and services has accelerated in recent years, stagnation in the productivity levels of major crops and overall volatility of agricultural output have emerged as issues of serious policy concern. It is in this context that the Planning Commission has targeted a growth rate of 4 per cent per annum in the agricultural sector, which is necessary not only to ensure food security but also to enable inclusive growth.

71. Aggregate demand pressures remain in evidence, although there are signs of some moderation beginning to set in. The current pace of growth continues to be driven by private investment and consumption demand which has so far been supported by resilient corporate profitability and business confidence, stretched capacity utilisation, rising incomes and ongoing capacity expansion, including in infrastructure. The growth of the production of capital goods in April-May 2007 has been somewhat slower than a year ago; nevertheless, the sustained vigour of the expansion, together with the surge in non-oil imports in April and May 2007, is indicative of the strength of investment demand which continues to maintain the upturn in capital spending by the corporate sector. Second-round demand pressures are also visible in the pick-up in the growth of intermediate goods production in April-May 2007 on top of the smart turnaround recorded in 2006-07. Consumer demand has also firmed up further in the early months of 2007-08 from rising levels in 2006-07 as evident in the sizeable increase in the

production of consumer goods, particularly consumer non-durables, which appear to be on a high growth trajectory since March 2007. Monetary and banking aggregates continue to rise at persistently high rates. While there is a moderate slackening of non-food bank credit growth, banks' investments in mutual funds have increased sizeably. There are also reports of stretched capacity in the cement sector and some slowdown in the commercial vehicles and auto parts industries. Export demand continues to remain strong, except in some industries facing capacity constraints and rising cost conditions as in textiles, but a sharp pick-up in non-oil imports has resulted in a widening of the merchandise trade deficit, indicating the spillover of domestic demand.

72. A heartening feature of recent macroeconomic developments has been the decline in headline inflation from the late January 2007 peak to within the policy tolerance threshold by end-May. This is attributable to the pass-through of monetary, fiscal and supply-side measures in conjunction with seasonal factors especially the moderation of food prices with the arrival of the *rabi* harvest. Accordingly, inflation in terms of primary articles has fallen significantly from double-digits recorded in January-May 2007. With foodgrains production expected to increase during the 2006-07 agriculture year, coupled with early indications of a favourable south-west monsoon, pressures on prices of key foodgrains such as wheat and rice in India may ease somewhat, although global wheat prices were at a 11-year high in June 2007 and prices of oilseeds remain subject to upward pressures over the near term. The

decline in the prices of the 'fuel' category has also enabled some easing of headline WPI inflation so far.

73. International crude prices have risen beyond the US \$ 70 level and are extremely volatile, representing a serious risk to inflation expectations. Even with the EIA projection of US \$ 65.7 per barrel in 2007, international crude prices would remain considerably higher than the level of US \$ 53 per barrel at the beginning of the year. Domestic prices of petrol and diesel, on the other hand, have undergone two downward revisions during 2006-07 and at their current levels, it is necessary to recognise the need for some more pass-through from recent movements in international crude prices. It is difficult to differentiate, *ex ante*, the permanent and temporary components of the elevated international crude prices but, in any case, they would have implications for domestic inflation conditions.

74. A positive feature of recent developments has been the encouraging response of banks to the sustained policy emphasis and actions for ensuring credit quality and overall financial stability. Rebalancing of banks' balance sheets seems to be underway, captured by movements in key banking aggregates. Beginning in the last quarter of 2006-07, a dip in non-food credit growth from the persistent high rates that prevailed during 2004-07 has turned into a steady deceleration in broad alignment with the indicative trajectory given in the Annual Policy Statement of April 2007. While the slowdown reflects, in part, the usual seasonal decline in bank credit that occurs at this time of the year, there has also been some deceleration in bank lending to

sectors such as real estate, housing, computer software, trade and transport operators in response to rising lending rates, shifts in banks' portfolios in favour of investments in gilts and prudential considerations. On the other hand, there are indications of a pick-up in credit demand from agriculture and industry, in particular, infrastructure. Banks have aggressively mobilised time deposits (including certificates of deposit) with aggregate deposit growth in the first quarter of 2007-08 outstripping the 11-year high recorded in 2006-07. Accordingly, the incremental non-food credit deposit ratio (year-on-year) has come off appreciably from the average level of 115 per cent prevailing in the preceding two years. These readjustments augur well for the health of the banking system by reducing asset-liability mismatches and attendant balance sheet risks.

75. Finances of the Union Government in April-May 2007 exhibited some improvement with the gross fiscal deficit and the revenue deficit declining from their levels a year ago. Gross tax collections have increased significantly and already account for close to a fifth of the budget estimates. Total expenditure has declined in the first two months of 2007-08, with a contraction of 20 per cent in Plan expenditure being partly offset by a moderate increase in the non-Plan component. A noteworthy aspect of recent developments in the Centre's finances is the pick-up in capital expenditure, which is conducive for the overall investment outlook. While the borrowing programme of the Centre in terms of dated securities has progressed broadly in alignment with the calendar set

in the beginning of the year, there has been higher recourse to short-term borrowings through Treasury Bills to manage the exceptional circumstances discussed earlier.

76. Financial markets have experienced large swings in liquidity conditions and heightened volatility within a general softening of interest rates across the spectrum, except in the credit market. Money markets, and in particular, the overnight segments, have experienced excess liquidity released into the system through a drawdown of the Central Government's cash balances to overdrafts on two occasions in the current financial year so far. Capital flows and the Central Government's cash balances have been the principal sources of volatility in systemic liquidity, with the former being tempered by sterilisation measures. The Central Government's cash balances maintained with the Reserve Bank came down from Rs.65,582 crore in December 2006 to Rs.49,992 crore at the end of March 2007 and further to a debit of Rs.7,753 crore in May 2007, a turnaround of Rs.73,335 crore in a span of five months.

77. In the domestic financial markets, money markets have experienced some volatility amidst surplus liquidity conditions. Generally stable and orderly conditions have been observed in the government securities market. Yield spreads have widened, especially for corporate bonds. In the credit markets, both deposit and lending rates have edged up, the former more conspicuously. In the forex market, there have been strong and persistent upward pressures on the exchange rate.

78. Developments in the external sector in the first quarter of 2007-08 reflect the

underlying strength of economic activity. Merchandise export growth has picked up in April-May 2007 in relation to a year ago. Information available up to February 2007 indicates that engineering goods and petroleum products are the drivers of exports. With POL imports holding at broadly the level in the corresponding period of 2006-07, a jump in non-oil import growth has widened the merchandise trade deficit. Lagged data on the composition of imports suggest that capital goods, industrial raw materials, gold and electronic goods are the main components, indicative of the strength of domestic investment and consumption demand. Despite the expansion of the trade deficit by close to US \$ 5 billion in relation to its level a year ago, there has been a sizeable accretion to the foreign exchange reserves over the first quarter of 2007-08.

79. India's macroeconomic performance in the first quarter of 2007-08 needs to be assessed in the context of global developments and the evolving international environment. While global growth had shown some signs of moderation in the first quarter of 2007, there has been a gain in momentum in more recent months, leading to upward revisions in consensus forecasts. Demand pressures appear to be holding up economic activity in the mature economies, stronger than expected. While headline inflation has remained generally steady, inflationary pressures remain and seem to be more persistent than before, along with elevated levels of commodity and asset prices. Risks to inflation expectations have also heightened with international crude prices rising again and with crude futures firming up. In particular, uncertainty relating

to supplies have increased, building a risk premium into the evolution of crude prices. In the EMEs, the outlook continues to be optimistic with early indications of strengthening growth. Business and consumer sentiment appears to be positive and some EMEs have experienced a moderate decline in unemployment, particularly in Asia and Latin America. At the same time, concerns have arisen regarding the sustainability of high growth. For most Asian EMEs (AEMEs), inflationary pressures are being reinforced by rising food and fuel prices along with ample liquidity and rapidly rising credit, largely driven by excess capital flows.

80. In the global financial markets, the volatility experienced in the first quarter of 2007, triggered by concerns about the US subprime mortgage market and potential economy-wide effects, seems to have been repeated recently in late July. After the February 2007 events, there had been a rapid recovery of prices for all asset classes, including for EMEs. Long-term interest rates have risen in the mature markets since May, driving up gilt yields. Global equity prices have risen rapidly along with long-term interest rates until mid-July, reflecting upward revisions in growth prospects and profit expectations. Equity markets have also revealed an increasing synchronicity across mature and emerging economies. The current phase of market activity, along with a revision in expectations on the direction of future monetary policy changes, appears to have triggered a reassessment of risks by financial markets. Nonetheless, current indications suggest that the risks, including geopolitical risks, remain under-priced and widely spread.

81. Risks to the outlook for global growth and financial markets from the prolonged slump in the US housing market have become accentuated with the adverse developments in the subprime mortgage market that surfaced in late 2006 and has continued into 2007. In the recent period, solvency threats to hedge funds with large subprime exposure have increased the danger of 'event risk' in leveraged loan and junk bond markets from the collapse in prices of illiquid or 'hard-to-trade' securities linked to subprime loans. Limits on redemptions by several hedge funds and the ensuing flight to quality has raised concerns that contagion could spread across credit markets and corporate bond markets in a spiral of repricing, tighter mortgage and borrowing conditions, falling house prices and slower consumption growth which could ultimately drag down US and global economic growth. Regulators and monetary authorities have expressed concern about the vulnerability of the global financial system due to excessive leveraging and gaps in creditor supervision in the context of rising levels of widely diffused risks.

82. Hedge funds are private, largely unregulated pools of capital. Their role has risen significantly with systemic implications and they have added depth and breadth to financial markets. Managers of hedge funds follow complex investment strategies to leverage portfolio size through sophisticated derivative contracts. While their potential for imparting risks to the financial system has always been engaging the attention of regulators, in the recent period there is a heightened awareness of possible threats to overall financial stability. With greater risk aversion going forward,

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with credit quality deteriorating and with the widening of credit spreads, the potential fragility of hedge funds could pose significant risks to financial market stability and to the prospects for financing and growth in the EMEs.

83. It is estimated that the private equity industry accounted for more than a quarter of global mergers and acquisitions in the first half of 2007. In consonance with the boom in private equity, particularly since 2006, there has been the incidence of higher leverage to enhance investment returns. In view of the opaque nature of private equity activity, the high levels of leveraging has raised concerns about longer-term sustainability. Recent events have shown that counterparties could have grossly underestimated the riskiness of individual funds, and the vulnerability of the markets in which they are active, to sudden turns in sentiment or even tightening of credit conditions. Given the size of business accruing to private equity, they carry risks to overall macroeconomic stability and, in particular, to EMEs.

84. It is in the context of these developments that monetary policy authorities remain hawkish and vigilant about threats to inflation expectations and volatility in money and currency markets. In the face of fluctuations in asset prices, underpricing of risks and disorderly adjustments, several central banks have acted pre-emptively in the early months of 2007 to tighten monetary policy. A few central banks, in particular those in the Asian EMEs, have reinforced the increases in key policy rates with increases in reserve requirements and in some cases, with non-monetary measures.

85. In the overall assessment, therefore, domestic economic activity has continued to expand at a strong pace and there are indications that the impulses of growth are getting broad-based. The recent gains in bringing down inflation and in stabilising inflation expectations should support the current expansionary phase of the growth cycle. While noting the inflation environment in recent weeks, it is necessary to continuously assess the risks to the inflation outlook emanating from high and volatile international crude prices, the continuing firmness in key food prices and the uncertainties surrounding the evolution of demand-supply gaps globally as well as in India. It is also necessary to note that demand pressures and cyclical effects persist, mirrored in investment and consumer demand, monetary and banking aggregates, capacity constraints and a widening trade deficit. Financial markets are reflecting the interplay of these factors, although surges in capital inflows and large changes in liquidity conditions are obscuring an accurate assessment of risks, with attendant uncertainty. It is necessary to note that while there is an abatement of inflation in the recent period, upward pressures persist. In this regard, it is essential to carefully monitor developments relating to aggregate supply conditions and the supply response to the impulses of demand in the short-term, while stepping up efforts to expand production capabilities over the medium-term.

86. Risks from global developments continue to persist, especially in the form of inflationary pressures, re-pricing of risks by financial markets and danger of downturn in some asset classes, with

implications for EMEs in general. International food and energy prices are likely to settle at higher levels than before with indications that the sharp acceleration recorded in 2006 will not reverse. In addition, there are risks emanating from the developments in global financial markets. While excessive leveraging by hedge funds and private equity has enhanced the vulnerability of the global financial system, exchange rate fluctuations in respect of the major currencies have become amplified with large changes in the magnitude and direction of capital flows.

87. Given the flux associated with both financial markets and monetary policy settings, India cannot be immune to these developments. Accordingly, banks, financial institutions and corporates are advised to be vigilant and well-prepared with appropriate risk mitigation strategies to deal with significantly higher volatility than before. It is in this context that they are urged to monitor various types of exposures, including economic exposure, and to ensure hedging of currency and interest rate risks to balance sheets that might impact the quality of assets. It may be noted that the Reserve Bank has expanded the range of hedging tools available to market participants and facilitated dynamic hedging.

II. Stance of Monetary Policy for the Remaining Period of 2007-08

88. In April 2007, at the time of the Annual Policy Statement for 2007-08, global growth was expected to moderate and inflationary pressures were seen as persisting worldwide. With demand pressures having

intensified in the domestic economy along with supply-side constraints, the Annual Policy Statement reiterated the stance set out in January 2007 of reinforcing the emphasis on price stability and well-anchored inflation expectations so as to enable continuation of the growth momentum. Credit quality and orderly financial markets were re-emphasised in conjunction with greater credit penetration and financial inclusion. The Annual Policy Statement also reaffirmed the resolve to respond swiftly with all possible measures to developments impinging on inflation expectations and the growth momentum. It was recognised that the likely evolution of macroeconomic and financial conditions indicates an environment supportive of sustaining the current growth momentum and that the Indian economy is possibly poised on the threshold of a step-up in the growth trajectory, but that there is evidence of some cyclical elements embedded in the structural change. Noting that the overarching policy challenge is to manage the transition to a higher growth path while containing inflationary pressures, the policy preference for the period ahead was indicated as strongly in favour of price stability and well-anchored inflation expectations with the endeavour being to contain inflation close to 5.0 per cent in 2007-08 and to the range of 4.0–4.5 per cent over the medium-term.

89. On a review, the prospects for growth in 2007-08 appear positive at the current juncture. The IMD has maintained its initial forecasts of rainfall at 93 per cent of the LPA for the country as a whole in the 2007 south-west monsoon season. Accordingly, by current indications, a return to trend growth

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in agriculture should be realisable. Growth in industrial and service sector activity, which constitute more than 80 per cent of the economy and contribute over 94 per cent of headline growth, is expected to be sustained, given the current momentum of expansion despite evolving uncertainties observed in recent weeks. Overall, for policy purposes, the projection of real GDP growth in 2007-08 at around 8.5 per cent, as set out in the Annual Policy Statement of April 2007, is retained, barring domestic or external shocks.

90. There are indications that the combination of lagged and cumulative effects of monetary policy actions and fiscal and administrative measures for supply management has had a salutary effect on inflation expectations, and headline inflation has turned benign in sharp contrast to the last quarter of 2006-07. Going forward, monetary management would need to be watchful of movements in commodity prices, particularly oil prices, the elevated levels of asset prices and the re-emergence of pricing power among producers as potential threats to inflation expectations. Assuming that aggregate supply management will continue to receive public policy attention and that a more active management of the capital account will be demonstrated, the outlook for inflation in 2007-08 remains unchanged. Accordingly, holding headline inflation within 5.0 per cent in 2007-08 assumes priority in the policy hierarchy; while reinforcing the medium-term objective to condition policy and perceptions to reduce inflation to 4.0-4.5 per cent on a sustained basis.

91. For the purpose of monetary policy formulation, the Annual Policy Statement of April 2007 projected the rate of money

supply (M_3) at around 17.0-17.5 per cent for 2007-08 in consonance with the outlook on growth and inflation. Consistent with the projections of money supply, the growth in aggregate deposits in 2007-08 was placed at around Rs.4,90,000 crore while non-food credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper (CP) was projected to decelerate to 24.0-25.0 per cent in 2007-08 from the average of 29.8 per cent over 2004-07. While non-food credit growth has decelerated, the acceleration in money supply and reserve money warrants an appropriate response.

92. Recent developments in the external sector indicate that the overall trade and current account deficits in 2007-08 are evolving as per expectations. However, net capital flows have been very strong so far in the current financial year. Early fiscal indicators suggest that the Centre's fiscal deficit is evolving as budgeted and is on course to meet the targets set in the Fiscal Responsibility and Budget Management (FRBM) Act, 2003.

93. By current reckoning, the global outlook is positive with continuing prospects for strong and stable growth but there are concerns about inflationary pressures worldwide. Monetary authorities are inclined to regard the current levels of real interest rates as warranting further withdrawal of monetary accommodation and are indicating a preparedness to respond to the manner in which the inflation scenario evolves. Financial markets have been aggressively re-pricing risks; however, the wide diffusion of risks and the abundance of liquidity has imparted considerable

uncertainty. Visitations of volatility in equity and currency markets with worldwide ramifications have imparted an additional dimension of uncertainty to the evolution of the international economic environment. These developments are necessitating intensified policy monitoring with a policy preference for insulating domestic real activity from these shocks. Looking ahead, monetary policy in India would continue to be vigilant and pro-active in the context of any accentuation of global uncertainties that pose threats to growth and stability in the domestic economy. The domestic outlook continues to be favourable and would dominate the dynamic setting of monetary policy in the period ahead. It is important to design monetary policy such that it protects growth by contributing to the maintenance of stability. Accordingly, while the stance of monetary policy would continue to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustain the growth momentum, contextually, financial stability may assume greater importance in the months to come.

94. Keeping the above in view, recent developments in financial markets in India and potential uncertainties in global markets warrant a higher priority for managing appropriate liquidity conditions in the policy hierarchy at the current juncture.

95. The Reserve Bank will continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and open market operations (OMO) including the MSS and LAF, using all the policy instruments at its disposal flexibly, as and when the situation warrants.

96. 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 broadly continue to be:

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.

III. Monetary Measures

(a) *Bank Rate*

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

(b) *Repo Rate/Reverse Repo Rate*

98. The repo rate under the LAF is kept unchanged at 7.75 per cent.

99. The reverse repo rate under the LAF is kept unchanged at 6.0 per cent.

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100. In view of the current macroeconomic and overall monetary and liquidity conditions, it has been decided to withdraw the ceiling of Rs. 3,000 crore on daily reverse repo under the LAF with effect from Monday, August 6, 2007. The Reserve Bank, however, retains the discretion to re-impose a ceiling as appropriate.

101. The Reserve Bank has the flexibility to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warrant.

102. The Reserve Bank retains the option to conduct overnight or longer term repo/reverse 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.

103. The second LAF, which was introduced from November 28, 2005 and is conducted between 3.00 p.m. and 3.45 p.m. on a daily basis, is withdrawn with effect from Monday, August 6, 2007.

(c) Cash Reserve Ratio

104. The cash reserve ratio (CRR) of scheduled banks is currently at 6.5 per cent. On a review of the current liquidity situation, it is considered desirable to increase the CRR by 50 basis points to 7.0 per cent with effect from the fortnight beginning August 4, 2007.

Mid-Term Review

105. The Mid-Term Review of the Annual Policy Statement for the year 2007-08 will be undertaken on October 30, 2007.

Mumbai
July 31, 2007