Annual Policy Statement for the Year 2006-07

Reserve Bank of India
Mumbai

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

This Statement consists of two parts: Part I. Annual Statement on Monetary Policy for the Year 2006-07; and Part II. 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.

2. The Annual Policy Statement for 2005-06 introduced a change in format of the presentation, separately focusing upon monetary policy and developmental and regulatory policies in Part I and Part II, respectively. This was intended to ensure clarity of roles and responsibilities within the Reserve Bank and to enable more transparency in policy communication. It has also enabled more frequent reviews of monetary policy at quarterly intervals. In recent years, financial stability has assumed priority in the conduct of monetary policy. The institutional environment has been changing rapidly including, in particular, the implementation of the Fiscal Responsibility and Budget Management Act and the increased financial integration taking place domestically and with global markets. In this context, it has become important to recognise and exploit the strong complementarity between macroeconomic and financial stability. Accordingly, while separate coverage of monetary and developmental and regulatory policies enhances clarity and transparency in communication, it is important to take a holistic approach.

3. The Annual Statement on Monetary Policy will be reviewed on a quarterly basis during 2006-07 as in the previous year, whereas the Annual Statement on Developmental and Regulatory Policies will be reviewed along with the Mid-term Review of monetary policy. Accordingly, the tentative dates for the First Quarter Review, the Mid-term Review and the Third Quarter Review are July 25, 2006, October 17, 2006 and January 23, 2007, respectively.

Part I. Annual Statement on Monetary Policy for the Year 2006-07

4. The Annual Statement on Monetary Policy for the Year 2006-07 consists of three Sections: I. Review of Macroeconomic and Monetary Developments during 2005-06; II. Stance of Monetary Policy for 2006-07; and III. Monetary Measures.

I. Review of Macroeconomic and Monetary Developments during 2005-06

Domestic Developments

5. Real GDP growth projections for 2005-06 for the purpose of monetary policy formulation were revised upwards in two stages from around 7.0 per cent in the Annual Statement for 2005-06 to a range of 7.5 to 8.0 per cent in the Third Quarter Review of January 24, 2006 drawing from indications of a firming up of the recovery in agriculture and sustained momentum of expansion in industry and services. This upward revision turned out to be in alignment with the advance estimate of the Central Statistical Organisation (CSO) released in February 2006 placing real GDP growth during 2005-06 at 8.1 per cent, up from 7.5 per cent in the previous year.

6. Real GDP originating from agriculture and allied activities is estimated to have registered a growth of 2.3 per cent, reviving from a low of 0.7 per cent in the previous year. According to the advance estimates of the Ministry of Agriculture, foodgrain production is placed at 209.3 million tonnes in 2005-06. The outlook for sugarcane is bright while production of oilseeds is expected to be moderately above the level of the preceding year. Production improved in respect of horticulture, livestock, fisheries and plantation crops, imbuing resilience to the real GDP originating from agricultural and allied activities.

7. The growth of real GDP originating in industry is estimated by the CSO to have stepped up to 8.0 per cent in 2005-06 from 7.4 per cent in the previous year. The improvement in industrial activity in 2005-06 was mainly due to acceleration of manufacturing growth from 8.1 per cent in the preceding

year to 9.4 per cent. Sustained expansion in domestic as well as export demand, increased capacity utilisation, augmentation of capacities and positive business and consumer confidence underpinned the strength of the manufacturing sector.

8. The index of industrial production (IIP) recorded an increase of 8.0 per cent during April-February 2005-06 on top of 8.2 per cent a year ago, led by manufacturing which recorded a growth of 9.0 per cent, comparable to 8.9 per cent growth in the corresponding period of the previous year. The production of capital and consumer goods industries increased by 16.5 per cent and 11.7 per cent, respectively. The basic goods segment registered a growth of 6.4 per cent as against 5.3 per cent a year ago. The overall growth in six infrastructure industries was lower at 4.5 per cent during April-February, 2005-06 as compared with 5.8 per cent a year ago due to decline in crude petroleum and deceleration in refinery products and finished steel, somewhat offset by the pick-up in cement and coal. Electricity generation rose by 5.3 per cent as against 5.4 per cent in the preceding year.

9. A review of the financing pattern of the corporate sector over the first half of the current decade indicates that corporates took advantage of the declining interest rate cycle by readjusting their debt portfolio in favour of low cost resources, by increased recycling of internal resources and access to external sources. It is also evident that corporates focused on minimising financing costs and boosting investment income to supplement normal business income. These developments, in conjunction with stronger sales growth, lower tax rates, downsizing and restructuring led to high growth in after-tax profits from mid-2003 until the second quarter of 2005-06, which helped in improving business confidence. During 2005-06, private corporate sales growth moderated from 18.5 per cent and 16.4 per cent during the first and second quarters, respectively, to 13.2 per cent in the third quarter. The growth in net profits slowed from 54.2 per cent and 27.5 per cent in the first and second quarters, respectively, to 27.0 per cent in the third quarter. Corporate investment intentions as also the proposals for capital expenditure indicate prospects of substantial growth and consolidation during 2006-07. The outlook for the corporate sector in terms of financing needs would be important for assessing the credit flow from the banking system to the commercial sector.

10. In response to the Reserve Bank's Industrial Outlook Survey, nearly half of the respondents indicated an improvement in the overall business situation whereas another 40 per cent respondents felt that the situation may be similar to the previous quarter. The survey results indicate seasonal decline in output and order books during April-June 2006 though not as steep as in the preceding years. As regards the overall financial situation, capacity utilisation, employment and working capital finance requirements and availability, most respondents were positive although a majority expects some increase in the cost of raw materials.

11. Real GDP originating in the services sector is estimated to have increased by 10.1 per cent during 2005-06 as against 10.2 per cent a year ago with most sub-sectors sharing this buoyancy. The growth of construction was sustained at 12.5 per cent in 2004-05 and 12.1 per cent in 2005-06, supported by increasing cement and steel production. The growth of trade, hotels and restaurants, transport, storage and communication rose from 10.6 per cent in 2004-05 to 11.1 per cent. Financing, insurance, real estate and business services posted a growth of 9.5 per cent during 2005-06 as against 9.2 per cent a year ago. Community, social and personal services registered a growth of 7.9 per cent in 2005-06 as against 9.2 per cent a year ago.

12. Financing requirements associated with the pick-up in real economic activity were reflected in a robust expansion of bank credit for the second year in succession. Several features distinguish bank credit growth in 2005-06. First, the fact that March 31, 2006 was the balance sheet date for banks coinciding with the last reporting Friday has lent an upward bias to banking data for 2005-06 which had 27 reporting fortnights instead of the usual 26 fortnights. Scheduled commercial banks' (SCB) credit rose by 36.0 per cent (Rs.3,96,045 crore) during 2005-06, over and above 27.0 per cent (Rs.2,26,761 crore), net of conversion of a financial institution into a bank, in the previous year. Food credit increased by Rs.667 crore as against an increase of Rs.5,159 crore in the previous year. Non-food credit remained the key driver of banking activity, growing by 37.3 per cent (Rs.3,95,379 crore) on top of 27.5 per cent (Rs.2,21,602 crore), net of conversion, a year ago. Even after excluding the end-March build-up, the

year-on-year increase in non-food bank credit during 2005-06 (over April 1, 2005) was 30.8 per cent (Rs.3,42,493 crore).

13. Second, distinct shifts in the pattern of deployment of non-food bank credit have become increasingly evident as highlighted by successive monetary policy reviews in 2005-06. During April–January, 2005-06 credit to services sectors emerged as the dominant category, increasing by 36.2 per cent as against 25.1 per cent a year ago and accounting for 63.1 per cent of the incremental non-food credit. Within this category, retail lending has risen rapidly. Retail credit expanded at rates ranging between 22-41 per cent since 2001-02 and accounted for 26.7 per cent of the incremental non-food credit in 2005-06. It is pertinent to note that the share of advances to 'individuals' increased from about 10 per cent of total bank credit in March 2002 to nearly 25 per cent in January 2006. Loans to commercial real estate rose by 84.4 per cent in 2005-06, constituting 4.4 per cent of incremental non-food credit. Housing loans increased by 29.1 per cent and accounted for 14.6 per cent of incremental non-food credit. While the flow of credit to industry as a whole showed a modest increase of 15.6 per cent in 2005-06 from 11.3 per cent a year ago, bank credit to the infrastructure industries, especially power, rose by 28.8 per cent on top of 32.9 per cent a year ago. Substantial increases were observed in credit flow to industries like food processing, iron and steel, cotton textiles, vehicles, chemicals, gems and jewellery and construction. Agricultural credit increased by 22.4 per cent as compared with 18.9 per cent in the corresponding period of the previous year.

14. Third, credit growth outpaced deposit growth by a substantial margin. The aggregate deposits of SCBs increased by 22.8 per cent (Rs.3,87,471 crore) during 2005-06 as against an increase of 12.8 per cent (Rs.1,92,269 crore), net of conversion, in the previous year. Excluding the end-March effect referred to earlier, the year-on-year increase in aggregate deposits during 2005-06 (March 31, 2006 over April 1, 2005) was 16.9 per cent (Rs.3,02,534 crore). The year-on-year incremental non-food credit-deposit ratio continued to remain high at 113.2 per cent during 2005-06 as compared with 117.4 per cent a year ago. Significantly, the incremental non-food credit deposit ratio jumped from 90.4 per cent in the first half of 2005-06 to 132.3 per cent in the second half of the year.

15. Fourth, banks' efforts to raise deposits to fund the credit demand has led to a visible shortening of the maturity profile of deposits in the banking system and an escalation at the margin in the cost of raising deposits. Demand deposits registered a year-on-year growth of 21.4 per cent in 2005-06, up from 16.1 per cent a year ago. While time deposits increased by 16.1 per cent (as against 14.9 per cent a year ago), this was mainly on account of short-term wholesale deposits up to one year maturity at rates which were bid up to a range of 8.0-8.5 per cent. In consonance, discount rates on certificates of deposit (CDs) also rose beyond 8.0 per cent from February, 2006. Banks' deposit mobilisation efforts seem to have turned in favour of non-core bulk deposits of corporates instead of core retail deposits. Bulk deposits raised at relatively higher rates cannot sustain a higher credit demand on an enduring basis and have a potential for adverse consequences for balance sheet management and profitability. It is, therefore, necessary to reiterate the need for banks to review their policies in this regard and make sustained efforts towards mobilising stable retail deposits by providing wider access to better quality of banking services. This would sustain prudent business expansion without facing undue asset-liability mismatches.

16. Fifth, the drive to expand non-food credit induced shifts in banks' portfolios. The decline in statutory liquidity ratio (SLR) investments accommodated the higher credit demand to a large extent. For the first time since the nationalisation of banks in 1969, investment by SCBs in Government and other approved securities declined by Rs.11,576 crore in contrast to an increase of Rs.49,373 crore, net of conversion, in 2004-05. Thus, major support to the market borrowing programme of Central and State Governments came from non-banks.

17. Sixth, banks' investments in bonds/debentures/shares of public sector undertakings and the private corporate sector and commercial paper (CP) declined by 13.0 per cent (Rs.12,238 crore) as compared with an increase of 5.3 per cent (Rs.4,775 crore) in the previous year. The year-on-year increase in total flow of funds from SCBs to the commercial sector, including non-SLR investments, was 27.4 per cent (Rs.3,30,866 crore) as against 30.2 per cent (Rs. 2,79,326 crore) a year ago.

18. As regards money supply (M_3), it is necessary to factor in the end-March effect. M_3 increased by 20.4 per cent (Rs.4,58,456 crore) in 2005-06 as compared with 12.1 per cent (Rs.2,42,260 crore), net of conversion, in the previous year. Even after excluding the end-March effect, the year-on-year M_3 growth was 16.2 per cent (Rs.3,77,238 crore) in 2005-06 (March 31, 2006 over April 1, 2005) reflecting the features discussed above. The year-on-year increase in bank credit to the commercial sector, which excludes the end-March effect, was 26.7 per cent (Rs.3,55,251 crore), which was higher than the increase of 24.3 per cent (Rs.2,54,035 crore), net of conversion, in the previous year. On the other hand, net bank credit to Government increased by 3.8 per cent (Rs.28,819 crore) as against 0.9 per cent (Rs.6,776 crore), net of conversion, a year ago. Banks' credit to Government (excluding the Reserve Bank credit to Government) declined by Rs.11,460 crore. The banking sector's net foreign exchange assets increased by 10.2 per cent (Rs.65,962 crore) year-on-year, primarily reflecting the increase in net foreign exchange assets of the Reserve Bank by 10.1 per cent (Rs.61,545 crore).

19. The total overhang of liquidity as reflected in outstandings under the Liquidity Adjustment Facility (LAF), the Market Stabilisation Scheme (MSS) and surplus cash balances of the Central Government taken together increased marginally from an average of Rs.1,14,192 crore in March 2005 to Rs.1,15,258 crore in October 2005. Thereafter, there was a steady decline in the liquidity overhang to Rs.74,334 crore in March 2006. The IMD redemption at end-December, 2005 accounted for about Rs.32,000 crore of this decline of Rs.40,924 crore. During the year, the financial markets shifted from surplus mode to deficit in terms of LAF. On a net basis, the average daily LAF reverse repo absorption was Rs.22,481 crore and Rs.25,409 crore in the first and the second quarters, respectively, but declined to Rs.7,825 crore in the third quarter, and finally shifted into average daily repo injection of Rs.11,686 crore during the last quarter.

20. Pressures on market liquidity warranted appropriate monetary operations to obviate wide fluctuations in market rates and to ensure reasonable stability in financial markets consistent with the monetary policy stance. In October, liquidity conditions firmed up with the onset of festival

demand for currency, superimposed upon sustained credit demand. Accordingly, average reverse repo levels under the LAF declined in relation to the preceding month. With resumption of the market borrowing programme of the Central Government under the indicative calendar for the second half of the year, liquidity conditions tightened further in November. There was a release of net liquidity of the order of Rs.5,500 crore in November through MSS redemptions as the Reserve Bank refrained from fresh auctions under the scheme in the second half of the month. Market conditions improved subsequently and the Reserve Bank returned to absorption mode with a steady build-up of reverse repos under the LAF, including under the second LAF. Thereafter, liquidity tightened again in the run-up to quarterly advance tax outflows in the middle of December, the redemption of IMD at the end of December and on account of accretions to cash balances of the Central Government. Declining reverse repo levels were accompanied by repos from December 16, and generally there were net injections of liquidity. There was a further unwinding of MSS of the order of Rs.19,522 crore during December. On a review of liquidity conditions including the IMD redemption at the end of December 2005, the Reserve Bank announced suspension of the issue of treasury bills and dated securities under the MSS, while retaining the flexibility of conducting auctions under the scheme from time to time after giving sufficient notice to the market.

21. The outstanding balances under MSS increased from Rs.65,481 crore at end-March 2005 to a peak of Rs.80,585 crore in early September and thereafter declined by Rs.51,585 crore to Rs.29,000 crore by end-March 2006 reflecting the unwinding of MSS balances. During January-March 2006, Rs.17,578 crore was released through unwinding of MSS securities.

22. Consistent with the monetary policy stance of ensuring appropriate liquidity, daily net injections of liquidity under the LAF averaged Rs.11,686 crore during January-March, 2006. In addition to the unwinding of funds held under the MSS, the Reserve Bank's open market operations, private placement of Government securities and foreign exchange operations also augmented market liquidity. On the other hand, the cash balances of the Centre with the Reserve Bank increased from an average of Rs.19,693 crore in March 2005

to Rs.40,981 crore during January-March 2006, which added to the tightness in liquidity. Pressures began to ease in the last week of February 2006 with the call rate returning to the level of the repo rate and settling within the LAF corridor from mid-March 2006. Daily average injections fell to Rs.6,319 crore under the LAF in March 2006. On March 31, 2006 there was, in fact, net absorption of liquidity under the LAF of Rs.7,250 crore. The liquidity conditions eased considerably in April 2006 and the Reserve Bank absorbed an average daily amount of Rs.31,532 crore during the first 13 days of April. As on April 13, 2006 the LAF reverse repo amount was Rs.57,050 crore. Thus, there has been a significant shift in the liquidity conditions between the second half of March 2006 and the first half of April 2006.

23. Reserve money increased by 17.2 per cent (Rs.83,900 crore) during 2005-06, higher than the increase of 12.1 per cent (Rs.52,623 crore) in the previous year. As regards the components of reserve money, currency in circulation rose by 16.8 per cent (Rs.61,879 crore) as compared with the increase of 12.7 per cent (Rs.41,633 crore). Among the sources of reserve money, the Reserve Bank's foreign currency assets (adjusted for revaluation) increased by Rs.68,834 crore as compared with an increase of Rs.1,15,044 crore. Net Reserve Bank's credit to the Central Government (adjusted for the Government's deposit balances including the MSS proceeds) increased by Rs.35,830 crore against a decline of Rs.60,177 crore. The increase in net Reserve Bank's credit to the Central Government during 2005-06 mainly comprised acquisition of securities against liquidity injections through LAF of Rs.12,684 crore, MSS unwinding of Rs.35,149 crore and private placement of government securities with the Reserve Bank of Rs.10,000 crore, partly offset by the increase of Rs.13,195 crore in the Central Government cash balances (other than MSS) with the Reserve Bank. The Reserve Bank's credit to banks and the commercial sector increased by Rs.534 crore as compared with a decline of Rs.833 crore in the previous year. The ratio of net foreign exchange assets (NFEA) to currency declined from 166.2 per cent in March 2005 to 156.3 per cent by March 31, 2006. As on April 7, 2006 the year-on-year growth in reserve money was 16.9 per cent.

24. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, was 4.0 per cent at end-March 2006 and

3.5 per cent as on April 1, 2006 after receding from a peak of 6.0 per cent on April 23, 2005. Prices of primary articles (weight: 22.0 per cent) rose by 5.2 per cent as against 1.1 per cent a year ago, largely on account of prices of food articles. Prices of manufactured products (weight: 63.8 per cent), however, remained benign through the year, rising by 1.0 per cent as compared with 5.5 per cent in the previous year. Prices of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) increased by 8.3 per cent as against 11.1 per cent a year ago.

25. The incomplete pass-through to the prices of domestic petroleum products, particularly kerosene, liquefied petroleum gas (LPG), and to a smaller extent in petrol and diesel, appropriate timing of administered price increases into the retreating phase of inflation during the first half of 2005-06 and some burden sharing by oil companies as well as through customs/ excise duty reductions mitigated the immediate cost push impact of international crude prices. The average price of the Indian basket of international crude varieties (comprising Brent and Dubai Fateh) ruled at around US $ 60.1 per barrel in January-March, 2006 higher by 5.7 per cent than in the preceding quarter and by 30.2 per cent than a year ago. By April 13, 2006 the Indian crude basket price increased to US $ 65.5 per barrel. In the event, mineral oils accounted for 13.2 per cent of inflation in 2005-06. Excluding mineral oils, the WPI inflation works out to 2.3 per cent on April 1, 2006. In terms of the year-on-year change in the consumer price index (CPI) for industrial workers, inflation was 5.0 per cent in February 2006 as compared with 4.2 per cent a year ago. On an annual average basis, the CPI inflation was 4.3 per cent during 2005-06 as compared with 3.8 per cent a year ago.

26. Financial markets remained generally stable during 2005-06 although interest rates firmed up in all segments and the uncollateralised overnight call market experienced persistent tightness during the last quarter of the year. A noteworthy and desirable development during the year was the substantial migration of money market activity from the uncollateralised call money segment to the collateralised market repo and collateralised borrowing and lending obligations (CBLO) markets. The daily average volume (one leg) in the call money market increased from Rs.8,607 crore in

April 2005 to Rs.9,145 crore in March 2006. The corresponding volumes in the market repo (outside the LAF) were Rs.3,958 crore and Rs.7,783 crore, respectively, whereas in the CBLO markets, the volumes were Rs.5,185 crore and Rs.17,299 crore, respectively. Thus, the share of the uncollateralised call market in the total overnight market transactions declined from 48.5 per cent in April 2005 to 26.7 per cent in March 2006. Increasingly, the CBLO market has emerged as the preferred overnight segment in 2005-06. The shift of activity from uncollateralised to collateralised segments of the market has largely resulted from measures relating to limiting the call market transactions to banks and primary dealers only. This policy-induced shift is in the interest of financial stability and is yielding results.

27. The overnight rates in the call money, market repo and CBLO segments, which were around the lower end of the LAF rate corridor till October 2005, started hardening in November as the shift in liquidity conditions from surplus to deficit rendered a few market participants short of both liquidity and collateral securities. The overnight rates, which were around the LAF reverse repo rate, registered a steep rise responding to the underlying liquidity conditions. While the overnight rates in the call money segment went above the LAF corridor during the third quarter of 2005-06, rates in the collateralised markets moved towards the upper end of the LAF rate during the same quarter. The interest rate in the call market moved up from an average of 5.12 per cent in October 2005 to 6.93 per cent in February 2006, but moderated thereafter to 6.58 per cent in March 2006. The overnight interest rate in the CBLO and market repo segments also rose from 5.01 per cent and 4.98 per cent, respectively, in October 2005 to 6.43 per cent and 6.41 per cent in February 2006, before moderating to 6.22 per cent and 6.17 per cent in March 2006. Reflecting the easy liquidity conditions, the call, market repo and CBLO rates (average for the first 13 days) declined to 5.69 per cent, 5.20 per cent and 5.24 per cent, respectively, in April 2006.

28. The weighted average discount rate on commercial paper (CP) of 61 to 90-day maturity increased from 5.80 per cent in April 2005 to 8.72 per cent by end-March 2006 and the total outstanding amount declined from Rs.15,214 crore to Rs.12,693 crore. The typical interest rate on 3-month CDs increased from 5.87 per cent in April 2005 to 8.56 per cent by

mid-March 2006 accompanied by a significant increase in outstanding amounts from Rs.14,975 crore to Rs.36,931 crore.

29. In the Government securities market, the primary market yields of 91-day and 364-day Treasury Bills increased from 5.12 per cent and 5.60 per cent at end-April 2005 to 6.11 per cent and 6.42 per cent, respectively, at end-March 2006. The 182-day Treasury Bill yield moved up from 5.29 per cent to 6.61 per cent during this period. The primary market yields of 91-day, 182-day and 364-day Treasury Bills were 5.49 per cent, 6.14 per cent and 6.06 per cent, respectively, in the auctions held in April 2006. The yield on Government securities with 1-year residual maturity in the secondary market increased from 5.77 per cent as at end-April 2005 to 6.52 per cent at end-March 2006 but subsequently declined to 6.29 per cent as on April 13, 2006. The yield on Government securities with 10-year residual maturity increased from 7.35 per cent at end-April 2005 to 7.52 per cent at end-March 2006 and further to 7.55 percent as on April 13, 2006 while the yield on Government securities with 20-year residual maturity marginally declined from 7.77 per cent to 7.72 per cent but increased subsequently to 7.80 per cent during the same period. Consequently, the yield spread between 10-year and 1-year Government securities came down from 158 basis points in April 2005 to 100 basis points in March 2006 but increased to 126 basis points on April 13, 2006. The yield spread between 20-year and 1-year Government securities, however, declined from 200 basis points to 120 basis points as at end-March 2006 but subsequently increased to 151 basis points as on April 13, 2006.

30. The interest rates on deposits of over one year maturity of public sector banks (PSBs) moved up from 5.25-6.50 per cent in April 2005 to 5.75-7.25 per cent in March 2006. During the same period, the benchmark prime lending rates (BPLRs) of public sector banks and foreign banks remained unchanged in the range of 10.25-11.25 per cent and 10.00-14.50 per cent, respectively. The BPLRs of private sector banks moved to a range of 11.00-14.00 per cent from 11.00-13.50 per cent in the same period. The median lending rates for term loans (at which maximum business is contracted) in respect of major PSBs stood at 8.50-12.50 per cent in March 2006 as against 8.00-12.50 per cent in December 2005.

31. The equity market witnessed strong rallies with intermittent corrections and the BSE Sensex (1978-79=100) increased from an average of 6,379 in April 2005 to 10,857 in March 2006. The steep rise in stock prices during the year was largely driven by domestic mutual funds and foreign institutional investors (FIIs) who were responding to optimistic market sentiments as well as ample liquidity. As on April 13, 2006 the BSE Sensex was at 11,237.

32. The revised estimates (RE) of the Central Government's finances for 2005-06 indicate some improvement in the fiscal position. Reduction in non-plan expenditure and in non-defence capital outlay enabled a lowering of the key deficit indicators relative to budget estimates (BE). The revenue deficit, at Rs.91,821 crore or 2.6 per cent of GDP, was lower than 2.7 per cent of GDP in the budget estimates (BE) for 2005-06. This was enabled by some increase in tax revenue and containment of growth in several items of non-plan expenditure like interest payments, grants to States and subsidies. The revised gross fiscal deficit (GFD) for 2005-06 at Rs.1,46,175 crore constituted 4.1 per cent of GDP as against the budgeted 4.3 per cent, contributed by a reduction in the revenue deficit, a decline in capital outlay and the availability of disinvestment proceeds.

33. During 2005-06, the Central Government's net market borrowings at Rs.95,370 crore were 86.5 per cent of the budgeted amount of Rs.1,10,291 crore and gross market borrowings of Rs.1,58,000 crore were 88.5 per cent of the budgeted amount of Rs.1,78,487 crore. Issuances were broadly in accordance with the indicative semi-annual calendar except for rejection/ cancellations of Rs.10,000 crore in October 2005 and Rs.5,000 crore in February 2006. As against this, the Government privately placed dated securities for an amount of Rs.10,000 crore with the Reserve Bank on March 6, 2006 which was outside the issuance calendar. All issuances, except one, were reissuances imparting liquidity to the securities. The State Governments raised Rs.15,455 crore (net) and Rs.21,729 crore (gross). During 2005-06, the combined issuance (net) of Government securities of the Centre (including MSS) and States was, however, only Rs.74,344 crore due to the unwinding of MSS securities to the tune of Rs.36,481 crore as against Rs.1,45,510 crore in 2004-05 and Rs.1,35,192 crore in 2003-04. It is

noteworthy that the aggregate net issuance of Centre and States in 2005-06 was at its lowest level in the last seven years.

34. The weighted average yield on primary issuance of the Central Government's dated securities rose by 123 basis points to 7.34 per cent in 2005-06 from 6.11 per cent in the previous year. The weighted average maturity of the dated securities issued during the year increased to 16.90 years from 14.13 years in the previous year.

35. Commercial banks' holdings of Government and other approved securities remained in excess of the statutory minimum requirement of 25.0 per cent of net demand and time liabilities (NDTL). Such holdings, however, declined from 38.2 per cent of the banking system's NDTL in March 2005 to 31.9 per cent in March 2006. While the excess SLR holdings amounted to Rs.1,56,504 crore in March 2006, several banks seem to be operating their SLR portfolios close to the statutory minimum level.

Developments in the External Sector

36. Balance of payments (BoP) data released at end-March 2006 indicate that merchandise exports recorded a growth of 27.7 per cent in US dollar terms during the first nine months of 2005-06 as compared with 25.4 per cent a year ago. Manufacturing exports provided the leading edge with transport equipment, machinery and parts, iron and steel, gems and jewellery, chemicals and petroleum products emerging as the key drivers of export growth. Merchandise import growth was 36.9 per cent as against 44.5 per cent during the corresponding period a year ago. Oil import payments rose by 47.1 per cent, mainly reflecting the elevated levels of international crude oil prices since volume growth was barely 0.8 per cent. Non-oil imports expanded by 33.0 per cent, led by export-related items and capital goods which mirrored the growth in domestic industrial activity. Consequently, the trade deficit widened to US $ 41.5 billion during April-December 2005 as compared with US $ 26.5 billion a year ago.

37. Information available for subsequent months from the Directorate General of Commercial Intelligence and Statistics (DGCI&S) indicates that, in US dollar terms, merchandise exports increased by 24.7 per cent during

2005-06 as compared with 26.4 per cent in the previous year. Imports showed an increase of 31.5 per cent as compared with 36.4 per cent in the previous year. While the increase in oil imports was higher at 46.8 per cent as compared with 45.2 per cent in the previous year, non-oil imports showed an increase of 25.6 per cent as compared with 33.3 per cent in the previous year. At a further disaggregated level, imports of gold and silver increased by 15.7 per cent during April-December 2005 on top of a high increase of 46.9 per cent in the corresponding period of the previous year. Non-oil imports excluding gold and silver increased by 35.5 per cent as against 32.7 per cent in April-December 2005. During 2005-06, the trade deficit widened to US $ 39.6 billion which was 52.7 per cent higher than the deficit of US $ 26.0 billion in the corresponding period of the previous year. The trade to GDP ratio, which was 14.1 per cent in 1991-92 increased to 30.2 per cent in 2005-06, indicating increasing openness.

38. Regional co-operation in Asia has strengthened over the years and this is reflected in increasing trade volumes within the region. The share of exports to developing Asia in India's total exports increased from 14.4 per cent in 1990-91 to 29.8 per cent in 2005-06 (April-December). The corresponding share in India's imports also increased from 14.0 per cent to 20.8 per cent during this period. In recent years, China has emerged as a major trading partner, accounting for 6.0 per cent of total exports and 7.4 per cent of total imports in 2005-06 (April-December) as compared with 1.9 per cent and 3.0 per cent, respectively, in 2000-01. In recognition of the growing importance of Asian countries in India's foreign trade, the series on nominal and real effective exchange rate indices (1993-94=100) released by the Reserve Bank in December 2005 has added Chinese Renminbi and Hong Kong Dollar in the weighting diagram.

39. Invisible receipts rose by 28.1 per cent in April-December 2005 mainly led by earnings from transportation, software exports and other professional and business services as well as remittances from overseas Indians. Private transfers, comprising primarily remittances from Indians working overseas, remained sizeable at US $ 17.4 billion as compared with US $ 14.3 billion in April-December 2004. Invisibles payments increased by 22.1 per cent mainly on account of IMD interest payments and payments for transportation services

on account of the increase in trade volume and the rise in freight rates. As a result, the current account deficit was placed at US $ 13.5 billion in April-December 2005 as against US $ 5.9 billion in April-December 2004.

40. Net capital inflows at US $ 14.7 billion during April-December 2005 comprised portfolio investment (US $ 8.2 billion), direct investment (US $ 4.7 billion), NRI deposits (US $ 1.1 billion) and short-term credit (US $ 1.7 billion) while external commercial borrowings registered net outflows (US $ 1.5 billion) due to IMD redemption. There was a one-off principal repayment of IMD (US$ 5.5 billion) in the capital account and interest payments (US$ 1.6 billion) under the current account. Excluding the IMD redemption, external commercial borrowings would show an inflow of US $ 4.0 billion as compared with US $ 2.9 billion a year ago and net capital inflow would work out to US $ 20.2 billion. The net accretion to foreign exchange reserves excluding valuation changes amounted to US $ 1.8 billion during April-December 2005. Taking into account the valuation loss of US $ 6.1 billion due to depreciation of major currencies against the US dollar, foreign exchange reserves recorded a decline of US $ 4.3 billion during April-December 2005. In subsequent months, however, India's foreign exchange reserves increased by US $ 10.1 billion from US $ 141.5 billion at end-March 2005 to US $ 151.6 billion by end-March 2006. As on April 7, 2006 the foreign exchange reserves stood at US $ 154.2 billion.

41. India's external debt declined by US $ 4.0 billion from end-March 2005 to US $ 119.2 billion at end-December 2005. The reduction was essentially brought about by redemption of IMD in December 2005. The ratio of short-term debt to total debt increased marginally from 6.1 per cent at end-March 2005 to 7.5 per cent at end-December 2005.

42. The foreign exchange market remained orderly in 2005-06 with the exchange rate exhibiting two-way movements. The rupee appreciated by 0.6 per cent against the US dollar from Rs.43.75 per US dollar to Rs.43.49 per US dollar during April-July, 2005 but depreciated by 4.2 per cent against the US dollar from Rs.43.99 per US dollar at end-September 2005 to Rs.45.94 per US dollar at end-November 2005. Subsequently, the rupee recorded an appreciation on the back of strong portfolio inflows and

the US dollar's weakness against other major currencies in the international markets. Between end-November 2005 and end-February 2006, the rupee appreciated by 3.4 per cent against the US dollar. During 2005-06, the rupee depreciated by 1.9 per cent against the US dollar but appreciated by 4.4 per cent against the euro, by 5.5 per cent against the pound sterling and by 7.5 per cent against Japanese yen. During 2006-07 so far (up to April 13, 2006), the rupee depreciated by 1.5 per cent against the US dollar, 1.24 per cent against the euro, 2.1 per cent against the pound sterling and 0.68 per cent against the Japanese yen.

43. 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.

44. India's approach to financial integration has so far been gradual and cautious. Although capital inflows have been associated with high growth rates in some developing countries, a number of them have also experienced periodic slumps in economic growth and financial crises with substantial macroeconomic and social costs. The cross-country experience suggests that while trade integration is generally beneficial, there exists a threshold in an economy's resilience in the context of an open capital account. At a more practical policy level, financial integration may be conducive to growth, without its attendant risks and vulnerabilities, when combined with good macroeconomic policies and good quality of domestic governance. Thus, the ability of a developing country to derive benefits from financial globalisation in the presence of volatility in international capital flows can be significantly improved by the quality of its macroeconomic framework and institutions. While a gradual approach to liberalisation of capital account in India has paid dividends so far, continuation of the gradual process may warrant that some hard and basic decisions are taken in regard to macro-economic management, in particular monetary, external and financial sector management.

45. The Reserve Bank of India, in consultation with the Government of India, has appointed on March 20, 2006 a Committee to set out a Roadmap towards Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore). The terms of reference of the Committee will be: to review the experience of various measures of capital account liberalisation in India; to examine implications of fuller capital account convertibility on monetary and exchange rate management, financial markets and financial system; to study the implications of dollarisation in India of domestic assets and liabilities and internationalisation of the Indian rupee; to provide a comprehensive medium-term operational framework with sequencing and timing for fuller capital account convertibility, taking into account the above implications and progress in revenue and fiscal deficit of both Centre and States; to survey the regulatory framework in countries which have advanced towards fuller capital account convertibility; suggest appropriate measures and prudential safeguards to ensure monetary and financial stability; and to make such other recommendations as the Committee may deem relevant to the subject. The Committee will commence its work from May 1, 2006 and is expected to submit its report by July 31, 2006.

Developments in the Global Economy

46. Global growth moderated in the fourth quarter (Q4) of 2005, but is estimated to have risen to 4.8 per cent by the International Monetary Fund (IMF) for the full year in view of the broad-based expansion in economic activity. The strength of world GDP growth, well above its long-run average of 3.8 per cent, has been accompanied by a growing resilience to large systemic shocks. While oil prices doubled between 2003 and 2005, the impact on world growth has been well absorbed. The world economy is expected to continue to grow at about the same pace during 2006 and 2007. The US economy remains the main engine of global growth, but the sustained dynamism in China, India and a few other large developing economies as well as some recent signs of upturn in Japan considerably brightens the outlook for the global economy.

47. According to the World Bank, growth in the OECD countries is expected to have slipped from 3.1 per cent in 2004 to 2.7 per cent in 2005, but is expected to strengthen to 2.9 per cent in 2006 as a result of the recovery in

Japan and Europe. In the United States, high oil prices, rising short-term interest rates, cooling housing markets and the hurricanes in September contributed to slowing of real GDP growth to 3.5 per cent in 2005 from 4.0 per cent in 2004. Nonetheless, low long-term interest rates boosted domestic demand. Consequently, the US current account deficit widened to 6.4 per cent of GDP in 2005 from 5.7 per cent in 2004. The current account deficit continued to be financed by foreign purchases of US financial assets. GDP growth in the US is expected to record a robust pace of 3.4 per cent in 2006.

48. In the euro area, a recovery is underway with real GDP growth rising to 1.4 per cent in 2005 and projected at 1.7-2.5 per cent in 2006 and 1.5-2.5 per cent in 2007. There are signs that the recovery in Japan is becoming more firmly entrenched with real GDP growth rising in Japan by 2.7 per cent in 2005 on top of 2.6 per cent in 2004. Growth remained robust in the developing countries in 2005, led by China (9.9 per cent), Hong Kong (7.3 per cent) and India (7.6 per cent). In Russia and Latin America, too, growth has been buoyant.

49. Consumer price inflation in the advanced economies recorded a decline in the first quarter of 2006. In the US, consumer prices increased to 4.1 per cent in January on account of oil prices but dipped to 3.6 per cent in February. In the euro area too, inflation edged down to 2.2 per cent in March from 2.3 per cent in the previous month. Although deflation continued in Japan with overall consumer prices falling by 0.1 per cent in February, the drop was smaller than in the fourth quarter of 2005. In major industrial countries, inflation appears to be low and the second-round effects of oil price increases in the form of wage increases have been moderate so far. Though price stability has been maintained in these countries in the face of the oil shock, risks loom large in the form of lagged second order effects of oil price increases, geopolitical tensions, the probability of disorderly and rapid adjustment of current account imbalances and the risks emanating from the housing market, particularly when the cycle turns down. Non-energy commodity prices have been increasing through 2005 and the first quarter of 2006 *albeit* at decelerated rates as compared with 2004.

50. As in the past few years, the oil market was characterised by extreme uncertainty during 2005 on account of two destructive hurricanes in the US

Gulf Coast, Middle East tensions, political unrest in some other oil exporting countries and slim upstream and downstream capacity creation. International crude prices firmed up above the US $ 60 level from January 2006 on account of seasonal demand for heating fuel and disturbances in key producing countries. Oil markets are currently characterised by high inventories co-existing with high prices and geopolitical and other uncertainties about future supply. Recent events in Nigeria, Iran and Iraq have been of particular concern and are contributing to nervous market sentiment. Global oil demand growth is expected to accelerate from the levels of 2005 with both China and North America driving the rebound. World spare oil production capacity is projected to increase only modestly during 2006 and 2007. On the whole, the outlook for the oil economy in the near term appears to be tilting in favour of higher prices and greater volatility.

51. The international pass-through of oil prices to domestic retail prices has been varied across countries, with varying implications for future inflation. While domestic retail prices (including tax) of petrol in US dollar terms, increased on a year-on-year basis in March 2006 by 15.3 per cent in the US and 12.6 per cent in Canada, they increased by relatively smaller margins ranging up to 1.5 per cent in the major European economies and Japan and declined by 2.5 per cent in Italy. Similarly, diesel prices increased by 15.5 per cent in the US, by 11.6 per cent in Canada and between 0.2 per cent and 4.3 per cent in the major European economies and Japan. Comparatively, India's domestic retail prices of petrol and diesel (average of four metros) increased by 14.6 per cent and 13.0 per cent, respectively, by March 2006 over March 2005. End-use taxes range between 17 per cent in the US and 68 per cent in the UK. Net of taxes, the retail prices of petrol and diesel have generally increased in the developed world. While the increase in petrol prices, net of taxes, varied in the range of 18.9 per cent in UK, 18.5 per cent in the US and 6.1 per cent in Italy, increases in diesel prices varied in the range of 19.1 per cent in the US and 7.0 per cent in Spain. Net of taxes, the domestic retail prices of petrol and diesel in India (average of four metros) is estimated to have increased by about 25.0 per cent and 15.0 per cent, respectively, by March 2006 over March 2005. The cross-country experience indicates that, by and large, incidence of taxation on petroleum products has not changed significantly from the period prior to the escalation of crude prices since mid-2003.

52. Global imbalances widened further during 2005 in an environment of rising interest rates worldwide and ample liquidity in global financial markets. The current account deficit of the US surpassed US $800 billion, matched by increased surpluses elsewhere, particularly in Europe, East Asia and oil-exporting countries. More than two-thirds of all global capital flows go to finance the US current account deficit. The concomitant 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. The global investment rate has been on a long-term declining trend, reaching a historic low in 2002 and has remained below 22 per cent of world output. Given this lack of investment activity, the imbalances have been financed easily thus far and the large and growing current account imbalances appear to be continuing unabated in 2006. While the deficit is still increasing, the location of the surplus appears to be changing recently. The current account surpluses of the oil-exporting countries of the Middle East are close to those of emerging Asia.

53. With the doubling of oil prices during 2003-05, oil export revenue for the group of oil-exporting countries has risen from US $ 262 billion in 2002 to an estimated US $ 614 billion in 2005 which corresponds to an extra 40 per cent of pre-boom GDP for oil exporters. Additional import spending by these countries has been moderate relative to the two previous oil shocks (1974-76 and 1979-81), when almost 90 per cent was spent on such imports. This suggests that a large part of the increase in oil revenue has been saved. The deployment of oil revenue surpluses by governments of these countries has taken varied forms including repayment of external debt, investment in social and physical infrastructure and deployment in oil stabilisation funds. With relatively lower spending on consumption, oil exporters are now a significant source of foreign savings in the world and are close to becoming more important than Asia in 2006.

54. Less than a third of the combined current account surplus of the oil-exporting countries has been reflected in their foreign exchange reserves which rose by about US $ 90 billion in 2005. There are some indications that the oil surpluses have been deployed in more diversified avenues through new investment agencies and oil stabilisation funds which could be invested in assets other than bank deposits. Oil exporters appear to have taken

advantage of emerging investment opportunity in booming stock markets and real estate. Oil exporters' preference for investing their petro-dollars in the US has been diversified away from treasuries to large stakes in private equity abroad through intermediaries based in large financial or offshore centres. Such inflows could have helped to keep long-term interest rates as also the emerging market bond spreads low, even as the policy rates are rising.

55. In the absence of any unwinding of global imbalances so far, recent global financial developments have been broadly positive, although concerns remain about the pricing of risk in financial markets. In an environment of above trend growth in the world economy, unusually low volatility in financial markets and strong profitability in banking systems in most countries, investors have been prepared to purchase risky assets at relatively high prices in 2005. The perceived risks arise mainly out of global imbalances and the outlook for oil prices, particularly in the light of the emerging geo-political situation. Most market participants seem to sense these risks but this sentiment does not appear to be reflected yet in the pricing of risks. Risks do not disappear but they get transferred to another part of the system. The macro policies in emerging markets, in particular, have to factor in these risks while continuously balancing financial sector reform and stability considerations. More important, monitoring where the risk lies has become very difficult for the regulators, due to emergence of large conglomerates, sophisticated market instruments such as derivatives and presence of players like hedge funds.

56. In this environment, any volatile and unpredictable changes in asset prices could become a source of financial instability. To maintain confidence in the financial system, it is necessary to prevent shocks from spreading through contagion. Surveillance of the institutions in the financial sector and their interactions, both amongst themselves and with lenders and borrowers outside the financial sector, strengthening the financial infrastructure and, as a last resort, crisis management, are crucial in this respect. But, financial crises need not necessarily involve just banks. There is an increasing overlap and interaction between banks and securities markets, and further with the insurance and household sectors. Some of these segments may not have the same rigorous risk management systems or regulatory oversight as

banks. There are also market segments, particularly over the counter, which are not tightly supervised but could be of systemic importance such as hedge fund operations and structured credit derivatives. In this scenario, the financial risks have a tendency to be shifted from well-regulated to weakly or less regulated segments, the household sector being the most vulnerable at one end of the spectrum.

57. For developing countries, access to international finance has improved over the past year. Private capital inflows to emerging market economies increased in 2005; market access continued to be favourable and external financing costs dropped sharply. These conditions have favoured the emerging market economies in particular as low risk premiums prevailed for the external borrowing by these countries in global financial markets. In the first quarter of 2006, asset prices in bonds, equities and currencies of emerging markets have rallied to record highs reflecting steady improvement in many countries' fundamentals as well as investors' heightened appetite for risk. Problem-loan expenses in many banking systems have declined, and the current global default rate on high-risk bonds has reduced siginificantly. Measures of implied volatility extracted from option prices in most major foreign exchange, interest rate and equity markets have been at their lowest levels in several years, suggesting that these favourable developments are expected by the markets to continue. The main exception to this general pattern is commodity prices which have shown considerable volatility in recent years.

58. Long-term bond yields continue to be well below their long-run averages. Ten-year bond yields in Japan, the euro area and the US currently stand at 1.93 per cent, 3.95 per cent and 5.03 per cent, respectively. As long-term yields declined, short-term rates in the US and the euro area edged upwards following policy rate increases by the Federal Reserve and the European Central Bank (ECB). As a consequence, yield curves have flattened, but market participants appeared to be relaxed about the outlook for growth. This general phenomenon is reflected in the low level of credit spreads on bonds issued even by emerging markets and companies with low credit ratings which are around their lowest levels since 1997. Partly in response to these very positive borrowing conditions, an increasing number

of emerging market countries have been able to issue long-term debt in their own currency and thereby reduce foreign currency exposure and rollover risk. There has also been strong growth in structured credit markets.

59. Of the major central banks, the US Federal Reserve has raised its policy rate by 25 basis points each on fifteen occasions from 1.0 per cent in June 2004 to 4.75 per cent by March 2006 while hinting at the need for further rate hikes on account of possible increases in resource utilisation, in combination with the elevated prices of energy and other commodities as having the potential to add upward pressures on inflation. The Bank of England had raised its policy rate to 4.75 per cent in August 2004, which was brought down to 4.50 per cent in August 2005 and has been kept at that level in response to slowing domestic growth. The ECB has raised its policy rate twice since December 2005 by 25 basis points each in response to rising inflationary expectations, after holding it unchanged at 2.0 per cent since June 2003. The Bank of Japan (BoJ) has announced on March 9, 2006 that it will end quantitative easing and introduce a comfort range for core inflation of 0-2 per cent. The policy instrument was switched from outstanding current account balances with the BoJ to the overnight call rate.

60. Monetary policy has been tightened or kept unchanged in several economies in emerging Asia. The Bank of Korea has increased its rate by 25 basis points in February 2006 to 4.0 per cent, but kept it unchanged since then. In Malaysia, the policy rate was hiked to 3.0 per cent in end-November 2005 and kept at that level till a 25 basis point hike in February. Bank Indonesia has kept its rate unchanged after raising its policy rate by 50 basis points to 12.75 per cent on December 6, 2005 which was the tenth successive increase. In Thailand, the 14-day repurchase rate was increased for the ninth time since January 2005 from 2.0 per cent to 4.75 per cent in April 2006. Monetary authorities in Singapore and Hong Kong have tightened their policy rates over December 2005.

Overall Assessment

61. On an overall assessment, the performance of the Indian economy during 2005-06 turned out to be stronger than expected. Real GDP growth

turned out to be higher than projected in the Annual Policy Statement of 2005-06 and, thus, the two upward revisions to this projection that were made during the course of the year were justified. Inflation was contained well within the range projected in the monetary policy stance for 2005-06 and inflation expectations have remained firmly anchored. This has been reflected in the relative stability of long-term interest rates. Financial markets were generally stable during the year, adapting to the shift in liquidity conditions from surplus to deficit with considerable resilience. Appropriate liquidity management by the Reserve Bank played a crucial role in fashioning the market response. There are indications of improvement in the fiscal situation and the return to the path of correction set by the Fiscal Responsibility and Budget Management Rules augurs well for macroeconomic stability. On the other hand, non-food credit growth, deposit growth and money supply growth were higher than the projections made at the beginning of the year. In the external sector, balance of payments developments have evolved in concert with the strength of the macroeconomic fundamentals. While the trade and current account deficits have widened modestly, they have posed no financing constraint, given the strong international investor interest in India and the growing access of Indian entities to international financial markets. The redemption of the IMD has been managed well and the foreign exchange reserves have been quickly rebuilt in the aftermath of the redemption.

62. While these outcomes have imparted considerable optimism for 2006-07, it is important to undertake a careful assessment of the favourable factors and the downside risks, global as well as domestic, that could weigh upon the medium-term outlook. Recent developments indicate that while domestic factors continue to be significant, the global factors are gaining greater importance in determining the near-term outcome and accordingly, in the monetary policy response.

63. There are several positive factors in recent global developments. World economic growth remained reasonably strong and broad-based in 2005 and is expected to continue at the current pace in the near-term. In particular, global growth has exhibited considerable resilience in the face of high and volatile oil prices, geo-political tensions and supply shocks.

World trade has expanded *pari passu* and some rebalancing of the sources of growth is underway with the maturing of the cyclical recovery in a number of economies and the associated unwinding of policy accommodation. Financial flows to emerging market economies have been robust, returning to the pre-Asian crisis levels and several developing countries have successfully launched issuances of debt and equity in international markets, benefiting from the compression in credit spreads and the appetite for emerging market paper.

64. Nevertheless, a number of downside risks loom over the global economy that have implications for the medium-term prospects of countries like India for which the channels of global integration are getting stronger over time. The key global risks for emerging economies are potential escalation and volatility in international crude prices, a disorderly unwinding of the macroeconomic imbalances of the major economies and a hardening of international interest rates along with the direction of movement in setting monetary policy, at least over the ensuing year. Oil prices remain high and upwardly volatile with no signs of easing in conditions of tight supply, growing demand, geo-political concerns, impairment to production and refining capacities caused by natural disasters and other incidents. With global oil demand growth expected to pick up to 2 per cent in 2006, oil prices may impact growth and inflation more strongly than before as the corporate sector's absorptive capacity as also the scope for fiscal maneuverability gets stretched.

65. In several countries across the world, the housing boom has already started to flatten out. This could set off chain reactions in terms of a slowing down of consumption, job creation and real wage growth. In the U.S., for instance, the negative household savings rate is becoming increasingly unsustainable. An abrupt cooling of housing markets would take away a major source of support to world demand, jeopardising growth prospects in other parts of the world. In Japan and Europe, more substantive reforms are generally advocated to spur growth.

66. In the international financial markets, investors' appetite for risk has driven down risk premia on a wide variety of risky assets — equities, corporate bonds, emerging markets debt, housing and real estate property assets and

government bonds. There has also been a significant reduction in price volatility in these asset classes as well as in major currencies and commodity prices with the exception of oil and energy. Despite the major macroeconomic risks presented by the large and widening external current account imbalances and large structural fiscal deficits in key countries, financial markets are not reflecting such risks, suggesting a disconnect between medium-term risks and current perceptions thereof. This poses a key challenge to financial stability worldwide.

67. Over the medium term, the prospects for the global economy are by and large positive, but characterised by significant downside risks. For the Indian economy, the evolving economic and business environment exhibits a number of encouraging signs that suggest reinforcement of the robust economic growth exhibited in recent years. First, increase in the gross domestic saving rate to levels around 30 per cent, coupled with sustained absorption of external savings of 2 to 3 per cent of GDP, would provide the potential for attainment of an accelerated growth trajectory. Each of the saving segments, households, private corporate sector, and the public sector are contributing to the enhancement of the gross domestic saving rate. Particularly noteworthy is the turnaround of public sector saving from negative levels in recent years to positive levels now. This tendency will get reinforced if fiscal rectitude is followed by both the Centre and the States consistent with FRBM objectives.

68. Second, productivity growth in both the real and financial sector bodes well for consistent economic growth with price stability. The micro structural reforms undertaken over the years have enabled continuing productivity gains in the real sector with enhanced access of Indian business to technology, increased competitive pressures, along with evidence of greater attention to R&D and other productivity enhancing activities. The reform process involving widening and deepening of the financial sector, along with improved regulation and supervision, has also yielded encouraging results as seen from the improvement of almost all productivity measures relevant for the sector.

69. Third, there is evidence of increasing business confidence as measured by various business expectation surveys and improvement in

the investment climate. This is also corroborated by some signs of enhanced levels of foreign direct investment. Moreover, the robust performance of Indian merchandise exports in recent years also testifies to the attainment of higher competitiveness of Indian manufacturing, which itself promotes business confidence.

70. Fourth, the most progressive and dynamic Indian companies are manifesting increasing levels of global presence through acquisitions and higher outward foreign direct investment. The attainment of domain knowledge through such activities, along with best practice business knowledge, and other intangibles such as economies of scale in marketing will further enhance the productivity growth of Indian business.

71. Fifth, it is noteworthy that Indian business has managed to exhibit high growth in recent years in terms of most parameters despite the presence of significant constraints posed by infrastructure and labour rigidities. It has also displayed great resilience in terms of the ability to cope with adverse developments such as oil price increases, exchange rate and interest rate changes, as they have emerged at different times. This has been enabled by a high degree of innovative capacity that has been displayed in terms of finding solutions in the face of adversity.

72. Finally, the sustenance of business confidence, enhancement of productivity and maintenance of growth momentum will depend on policy improvements in agriculture, improved quantity and quality of physical infrastructure and progress in fiscal consolidation. No doubt, a credible commitment to price and financial stability will continue to be necessary for desired positive outcomes.

73. The prospects and policy responses for the near-term need to be viewed in this medium-term context. In the near-term also, there have been several positive domestic developments that brighten the outlook for the Indian economy. The recent growth record of the Indian economy has been noteworthy in a global perspective. The recovery in agriculture, alongside the sustained momentum of growth in industry and services, augurs well for the Indian economy. Food processing being recognised as a priority sector will help to boost farm sector growth as also the thrust on rural development

programmes and the increase in budgetary allocation for 2006-07 for rural welfare programmes. The availability of viable credit to agriculture would need to be pursued with equal emphasis on credit quality. There is a gathering confidence that the economy is possibly poised on the threshold of a structural step-up in the growth trajectory. The containment of inflation, and particularly inflation expectations, has boosted growth prospects in an environment of stability and confidence. Timely and even pre-emptive monetary measures reinforcing the policy stance paid dividends in terms of low and stable inflation which, in turn, provided conducive conditions for the undisrupted expansion of economic activity while maintaining macroeconomic and financial stability. The successes gained in external sector management in the context of the large trade deficit have also demonstrated the resilience of the Indian economy. Increasingly, the international community is regarding India as a preferred destination for investment.

74. The progressive diffusion of fiscal responsibility at the sub-national level is yet another positive development that has beneficial effects for the overall fiscal consolidation effort. It needs to be recognised that adhering to the trajectory of reform will require greater commitment and forward looking strategies to ensure credibility. Simultaneously, there has to be a reorienting of the mix of public spending towards infrastructure and agriculture to support the drive to achieving India's growth potential that is increasingly appearing realisable at the current juncture.

75. While the recent performance of the economy has been impressive, it is necessary to recognise the risks embedded in domestic developments which could potentially stall the growth momentum. Sustaining the growth of manufacturing, the key driver of industrial recovery, would depend critically on bridging the large gaps in physical infrastructure. Structural reforms will have to focus on quantum jumps in the provision of physical and social infrastructure. Getting infrastructure right will hold the key to maintaining real GDP growth in 2006-07 and 2007-08 at the level achieved in 2005-06, assuming that the global economic environment remains conducive and that there are no severe unanticipated shocks. Fiscal policy will obviously have to play a key role in improving the delivery of infrastructure services, in fostering public-private partnerships and in crowding in private investment.

A key factor will be the progress in fiscal consolidation. While there has been some improvement in the revenue and fiscal deficits, the larger market borrowing programme envisaged for 2006-07 will have to be managed in the context of the overall liquidity situation and, particularly, the conditions in the debt market.

76. The outlook on inflation as well as the choice of the appropriate manner of dealing with the pass-through of oil prices remains clouded at the current juncture. The Indian economy needs to prepare for higher orders of pass-through into consumer prices, in respect of the overhang as well as the possibility of additional increases in crude prices in the future. While the recommendations of the Rangarajan Committee are being debated, it is increasingly becoming clear that there has to be a fuller pass-through of increases in international crude prices. In the event, inflation could turn out to be higher in 2006-07 than the current benign levels. Regardless of the manner in which the future scenario for crude oil prices unfolds, there is a need for continuous and close monitoring and appropriate policy responses to contain its inflationary impact. This is being increasingly reflected in the stance of central banks the world over. Going forward, therefore, a dominant objective for both monetary and fiscal policy would be to modulate aggregate demand in tune with the evolving circumstances. In an environment fraught with pressures from aggregate demand embodied in rising bank credit, high asset prices and above-trend growth in monetary aggregates as well as global risks from larger macroeconomic imbalances and higher oil prices than before, containing inflation in the medium-term at the current levels is going to test the conduct of stabilisation policies in the ensuing year. In this context, it is useful to reiterate that while there are compelling reasons to maintain the momentum in growth of output, low and stable inflation will enable higher growth on a sustained basis in an environment of overall stability. Further, in the absence of firm and timely responses by all concerned, the present rate of high credit growth and increase in asset prices seem to pose a downside risk to overall financial stability.

77. It appears that globally as well as in India, underlying inflation conditions are perhaps not being appropriately reflected in prices facing

consumers and financing imbalances are growing in the presence of abundant liquidity, rising asset prices and a marked increase in risk appetite. It is in this context, and consistent with the multiple indicator approach adopted by the Reserve Bank, that monetary policy in India has consistently emphasised the need to be watchful about indications of rising aggregate demand embedded in consumer and business confidence, asset prices, corporate performance, the sizeable growth of reserve money and money supply, the rising trade and current account deficits and, in particular, the quality of credit growth. In retrospect, this risk sensitive approach has served us well in reining in aggregate demand pressures and second round effects to an extent. It has also ensured that constant vigil is maintained on threats to financial stability through a period when inflation was on the upturn and asset prices, especially in housing and real estate, are emerging as a challenge to monetary authorities worldwide. Significantly, it has also reinforced the growth momentum in the economy. It is noteworthy that the cyclical expansion in bank credit has extended over an unprecedented 30 months without encountering any destabilising volatility but this situation warrants enhanced vigilance.

II. Stance of Monetary Policy for 2006-07

78. The Third Quarter Review of January 24, 2006 noted that risks to growth and stability are high from rising domestic demand, the incomplete pass-through of crude prices into domestic prices and from global developments. Emphasising the need to shore up the gains of recent high growth, the monetary policy stance was articulated in favour of a greater emphasis on price stability through measured but timely and even pre-emptive policy action to anchor inflation expectations. Accordingly, the fixed reverse repo rate and the repo rate under the LAF were increased by 25 basis points each, thereby maintaining the corridor of 100 basis points. Given the emphasis on price stability, the Reserve Bank resolved to ensure a conducive interest rate environment and to provide appropriate liquidity to meet genuine credit needs and thereby support export and investment demand.

79. Developments in the ensuing months vindicate this pro-active monetary policy stance. With inflation contained and inflationary expectations evolving

consistent with the policy stance, real growth has quickened in an environment of price and financial stability, raising expectations of a structural shift in the medium-term growth path of the economy. Monetary policy has been particularly effective in ensuring that the cost-push impulses from oil prices have not fed through into aggregate demand conditions. In the external sector, the current account deficit has remained within manageable proportions, comfortably financed by buoyant capital flows. The exchange rate has exhibited two-way movements.

80. Monetary management during 2005-06 was conducted broadly in conformity with the stance of the policy set out in the policy statements during the year. First, in terms of macroeconomic outcome, the GDP growth rate turned out to be better than anticipated. Second, the headline inflation was lower than projected earlier. Third, while interest rates firmed up at the shorter end, the long-term interest rates were stable, possibly indicating more stable inflation expectations. Fourth, though non-food credit growth exceeded the earlier projections, a substantial part of it came from a shift in asset portfolio by reduction in banks' investments which was made possible because of unwinding of MSS securities without undue pressure on interest rates. Fifth, deposit growth and money supply growth were higher than the projections made at the beginning of the year. Sixth, the money and government securities markets have, by and large, been stable and there was a large shift of overnight transactions from the uncollateralised market to the collateralised markets. Seventh, the movements in the exchange rate continue to be orderly despite volatility in major currencies. Eighth, the current account remained in deficit due to a larger trade deficit partly capturing the impact of oil prices and, more importantly, reflecting improved buoyancy in economic activity. There was a modest increase in foreign exchange reserves though capital inflows were sustained. Ninth, the domestic business outlook continues to remain buoyant. Notwithstanding these favourable outcomes, monetary management faced some challenges in maintaining stable liquidity conditions particularly in the last quarter of 2005-06.

81. While the concerns on price and financial stability have been reasonably managed, an important aspect of the conduct of monetary policy

in recent months has been the modulation of liquidity in tune with the evolving situation. The Third Quarter Review characterised pressures on liquidity as partly frictional and arising from seasonal and transient factors such as the IMD redemption, and partly cyclical and associated with the upturn in credit demand. Since mid-January 2006, however, the recourse of market participants to primary liquidity support from the Reserve Bank suggests that there has been an overlap between frictional and structural liquidity on account of two factors. First, some market participants had not prepared for the liquidity implications of the movements in the interest rate cycle as also the one-off impact of IMD redemption and, as a consequence, found themselves facing a shortage of liquidity as well as eligible securities with which to access the Reserve Bank's liquidity facilities or even the collateralised money markets. Second, the banking system as a whole was significantly overdrawn in order to sustain the credit disbursements and mismatches between the sources and uses of funds became persistent, forcing them to seek recourse to borrowing and rolling over on an overnight basis, thereby putting pressure on interest rates and liquidity conditions.

82. Observing the emergence of such trends, the monetary policy statement of April 2005 specifically alluded to the liquidity risks in the following manner: "… banks are taking increasing recourse to non-deposit resources to fund their assets. Against this background, banks are urged to refocus on deposit mobilisation…". Recourse to external borrowings or capital market instruments for raising resources and also for deployment of resources in the conditions prevailing in our country are meant basically to smoothen the diversified business of banks and not become their core activity. The banks are again urged to review their business strategies so that they are in a position to combine longer term viable financing with profitability in operations, recognising the reality of business cycles and counter cyclical monetary policy impulses. Greater efforts aimed at financial inclusion will also contribute to robust deposit mobilisation. A key aspect of the commitment to stability will be a renewed emphasis on credit quality, while simultaneously pursuing greater credit penetration and financial inclusion. Banks would need to focus on stricter credit appraisals on a sectoral basis, monitor loan to value ratios and generally ensure the health of credit portfolios on a durable basis.

83. The growth in money supply in 2005-06 was above the trend. This situation of above normal growth in money supply coupled with a perception of liquidity issues in the banking sector warrants some exploration. While it is difficult to precisely define, assess or measure such factors, it is possible to note some relevant developments in this regard. First, mutual funds have considerable access to funds on a large scale. During 2005-06, mobilisation by mutual funds increased manifold, partly reflecting a low base, as against 16.9 per cent year-on-year growth in bank deposits during the same period. Second, the equity markets have displayed considerable buoyancy. Capital issues have experienced no difficulty in garnering resources and most have been oversubscribed. Third, the real estate sector gives an impression that there are no significant resource constraints for that sector.

84. Turning to the outlook, while global growth has broadened further over the past few months, the risks to sustaining this expansion have remained significant. First, oil prices remain volatile with an upside bias. The risks of higher energy prices are difficult to gauge; although the full impact of recent oil price increases may take time to materialise, a more complete pass-through to both growth and inflation can be expected in the future as capacities for absorbing these increases are progressively declining. Second, current account imbalances seem set to widen over the next two years, with the US current account deficit exceeding 7 per cent of GDP in 2007, while China, Japan, the oil-exporting countries and, to a smaller extent, emerging Asia, move into larger surpluses. There is a growing consensus that the size of the imbalances has exceeded the capacity of markets to bring about an adjustment and that there has to be concerted policy intervention of some form to enable a soft landing. Third, a number of monetary authorities have moved in the direction of tightening their monetary policy stance in response to global uncertainties including potential inflationary pressures. In major advanced economies, interest rates are being raised in tandem and the indications are that further tightening is due in the rest of 2006. While financial markets have generally coped well with the shift in the global interest rate cycle, the potential adverse consequences for consumption demand, household debt, equity and other asset prices and the ability of developing countries to raise and service external debt amplifies the risks and uncertainties emanating from recent global developments. These factors

will have a crucial bearing on the conduct of monetary management as India progressively integrates into the global economy.

85. India's linkages with the global economy are getting stronger and are increasingly reflected in BoP developments. Robust improvements have occurred on several fronts, underpinning the growing openness of the economy. Merchandise exports have surged ahead of the growth of world trade, drawing strength from a distinct firming up of activity in the domestic economy and sustained external demand. Software exports remained resilient and vigorous in the face of the IT slowdown worldwide and remittances from expatriate Indians rose strongly, making India one of the largest recipients of such flows. Accordingly, the degree of openness – merchandise and invisibles transactions taken together instead of the conventional ratio based on merchandise trade alone – is estimated to have reached 45 per cent of GDP in 2004-05 from about 20 per cent in 1990-91. The growing integration is driven not by a greater import dependence but by rising foreign exchange earnings, with the share of current receipts to GDP having improved from 8.2 per cent in 1990-91 to 22.1 per cent in 2004-05. In the capital account too, there are distinct signs of openness, with the ratio of foreign investment to GDP rising from negligible levels in 1990-91 to 1.7 per cent by 2004-05 and expected to rise further in 2005-06. Equity flows constitute more than half of net capital flows to India. In contrast to the 1980s, when more than 80 per cent of net capital flows comprised official flows, it is private capital flows which dominate the capital account currently. By March 2006, India had accumulated the sixth largest stock of international reserves in the world, sufficient to finance 11 months of imports and nearly five years of debt servicing. On the other hand, the debt/GDP ratio declined from 28.7 per cent in 1990-91 to 17.4 per cent in 2004-05.

86. As part of the recent changes in the institutional framework of monetary policy in India, a Technical Advisory Committee (TAC) on Monetary Policy with external experts in the areas of monetary economics, central banking, financial markets and public finance was set up by the Reserve Bank in July 2005 with a view to strengthening the consultative process of policy formulation. The TAC meets on a quarterly basis, reviews macroeconomic and monetary developments and advises on the stance of monetary policy.

The TAC has met four times since its inception and has contributed to enriching the inputs and processes of policy setting.

87. The Government of India is considering amendments to the Reserve Bank of India Act, 1934 and Banking Regulation Act, 1949 for enhancing the Reserve Bank's operational flexibility. The proposed amendments to the RBI Act pending approval from the Parliament, *inter alia*, propose to give more manoeuvrability to the Reserve Bank in its monetary management by giving discretion to decide on cash reserve ratio (CRR) and statutory liquidity ratio (SLR).

88. These developments, including the FRBM Rules, warrant a review of the operating framework of monetary policy in India. Within the multiple indicator approach adopted in India, there has been a distinct preference for indirect instruments over direct instruments. Furthermore, underlying changes in the market conditions, the emergence of the call money market as a pure inter-bank market, migration of activity from the uncollateralised call money market to the collateralised segments such as market repos and CBLO, the withdrawal of the Reserve Bank from primary financing of the fiscal deficit and the emergence of sizeable fiscal cash balances as an offset to market liquidity provide evidence of a paradigm shift in the operating environment. Open market operations (OMO) are set to increase in importance as an operating instrument. The MSS was designed as an instrument of sterilisation to deal with foreign exchange inflows of a durable nature so that the LAF window is essentially utilised for the purpose of day-to-day liquidity management and not a tool for absorption/injection of liquidity by the Reserve Bank on a sustained basis. In fact, with the operationalisation of the MSS in April 2004, the pressure on the LAF for sterilisation declined considerably. In the context of the FRBM, the activation of OMO will further enable the LAF to be even more focused on the role for which it has been designed.

89. Typically, the overnight market rate should lie in the middle of the policy corridor. In India, LAF repo/reverse repo rates provide the corridor within which short-term interest rates are expected to fluctuate. Over the years, the LAF rate corridor has emerged as an important tool of monetary management and any variation in LAF rate(s) is perceived by the market as short-term interest rate signals arising from a change in the monetary policy

stance. In India, however, in surplus conditions, the overnight rate has typically remained near the lower end of the LAF corridor, swiftly rising to the upper end of the corridor in deficit conditions. Thus, the overnight rates are reflective of market conditions and the weighted average overnight rate, which effectively reflects activity in the money market should be providing guidance for fine tuning monetary policy operations. There has also been a progressive narrowing of the corridor from 200 basis points up to March 2004 to 150 basis points in April 2004, to 125 basis points in October 2004 and finally to 100 basis points since April 2005.

90. The India Meteorological Department is yet to release its forecast for the South-West monsoon rainfall for the current year. However, under the assumption of a normal monsoon, an accelerated growth in agriculture is possible. Despite some uncertainties, the overall industrial outlook continues to be positive. Services sector growth is expected to sustain its momentum. Overall, for policy purposes, GDP growth may be placed in the range of 7.5-8.0 per cent during 2006-07 assuming accelerated growth in agriculture under normal monsoon conditions and barring domestic or external shocks.

91. Headline inflation for 2005-06 was lower than anticipated. While increased competition and productivity gains in several sectors have also contributed to some moderation in inflation in the recent period, policy measures have ensured low and stable inflation expectations. The pass-through of international oil price increase has been only partial and the second round effects in India have so far turned out to be lower than anticipated earlier. Taking into account the real, monetary and global factors having a bearing on domestic prices, containing inflationary expectations would continue to pose a challenge to monetary management. The policy endeavour would be to contain the year-on-year inflation rate for 2006-07 in the range of 5.0-5.5 per cent.

92. For the purpose of monetary policy formulation, the expansion in M_3 is projected at around 15.0 per cent for 2006-07. While this indicative projection is consistent with the projected GDP growth and inflation, since there is an overhang of above-trend growth in money supply in the preceding year, in normal circumstances, the policy preference would be for maintaining

a lower order of money supply growth in 2006-07. The growth in aggregate deposits is 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 commercial paper (CP) is expected to increase by around 20 per cent. It needs to be noted that this projected growth of non-food credit implies a calibrated deceleration from a growth of above 30 per cent ruling currently.

93. Higher oil prices and improvement in absorptive capacity of the economy have resulted in a larger trade deficit. This was partly offset by net invisibles, indicative of the rising international competitiveness of India's invisible exports and remittances from Indian nationals working overseas. The current account has remained in deficit for the second consecutive year in 2005-06. Net capital inflows have adequately financed the current account deficit and, as per the current assessment, these trends are likely to continue in 2006-07. The current account deficit appears largely sustainable in the light of continued resilience of the external sector.

94. The Union Budget has placed the fiscal deficit at 3.8 per cent of GDP for the year 2006-07 as against 4.1 per cent in the previous year in the spirit of the FRBM Act, 2003. The net market borrowing programme of the Centre for 2006-07 is budgeted at Rs.1,13,778 crore as against Rs.95,370 crore in the previous year. While the size of the Government borrowing programme is relatively larger than in the previous year, this has to be viewed in the backdrop of the buoyant growth of the economy, growing appetite of non-banks for government securities and the need for many banks to strengthen their SLR portfolio for statutory as also for liquidity management purposes.

95. Against the backdrop of developments during 2005-06 so far, the stance of monetary policy would depend on macroeconomic developments including the global scenario. A key factor is the assessment of the risks in as accurate a manner as is feasible. In this context, it is necessary to be in readiness to act as warranted to meet the challenges posed by the evolving situation, given the unfolding of the risks.

96. Domestic macroeconomic and financial conditions support prospects of sustained growth momentum with stability in India. It is important to recognise, however, that there are risks to both growth and stability from domestic as well as global factors. At the current juncture, the balance of risks is tilted towards the global factors. The adverse consequences of further escalation of international crude prices and/or of disruptive unwinding of global imbalances are likely to be pervasive across economies, including India. Moreover, in a situation of generalised tightening of monetary policy, India cannot afford to stay out of step. It is necessary, therefore, to keep in view the dominance of domestic factors as in the past but to assign more weight to global factors than before while formulating the policy stance.

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

98. 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 at this juncture will be:

- To ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations.

- To focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability.

- To respond swiftly to evolving global developments.

III. Monetary Measures

(a) Bank Rate

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

(b) Reverse Repo Rate

100. In view of the current macroeconomic and overall monetary conditions, it is considered desirable to keep the reverse repo rate unchanged at 5.5 per cent.

101. The repo rate will continue to be linked to the reverse repo rate. The spread between the reverse repo rate and the repo rate has been retained at 100 basis points, as at present. Accordingly, the fixed repo rate under LAF will continue to be 6.5 per cent.

(c) Cash Reserve Ratio

102. The CRR of scheduled banks is currently at 5.0 per cent. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 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.

First Quarter Review

103. The First Quarter Review of this part of the Annual Policy Statement for the year 2006-07 will be undertaken on July 25, 2006.

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

104. The Mid-term Review of October 25, 2005 reaffirmed the stance of the Annual Statement on Developmental and Regulatory Policies for the year 2005-06 of strengthening the financial system with a view to ensuring financial stability. In this context, the Mid-term Review focused on improving credit delivery, developing financial markets and enhancing their integration, financial inclusion and a revitalisation of micro-finance institutions, co-operative credit system and regional rural banks to reorient financial intermediation to cover the widest sections of society. In recognition of the sweeping changes underway in the financial system, the Mid-term Review also emphasised corporate governance practices, risk management and pricing techniques and counter-cyclical prudential norms. The Third Quarter Review of January 24, 2006 reinforced the commitment to financial stability and underscored the need to ensure the quality of credit in the context of the rapid expansion of bank credit in 2005-06. Banks were urged to undertake a comprehensive assessment of segment-wise credit with special reference to those sectors in which credit has been expanding rapidly.

105. In the context of the progressive integration of financial markets, both domestically and cross-border, and the fast-paced changes in technology and institutional architecture, the Reserve Bank has adopted a participative and consultative process in the conduct of financial sector policies. The consultative process has been made broad based, with participation of experts from different areas of the financial sector, academics and market functionaries. Policy initiatives have been calibrated to the country-specific situation even as the ongoing endeavour has been to converge to international best practices.

106. While persevering with the stance set out above, the Annual Statement on Developmental and Regulatory Policies for 2006-07 focuses on certain key areas. First, in the context of the ongoing efforts to refine and augment the channels of delivery of bank credit, the emphasis would be on an integrated approach to financial inclusion and on developing an appropriate environment for extending financial services to all segments of the population. Exploring the need for credit counselling and distress relief for vulnerable

sections, especially farmers, is an integral part of this approach. Second, expanding the development and application of new technology in the financial sector is regarded as an important prerequisite in the drive to achieve global standards in respect of payment and settlement systems. Third, strengthening and rationalising the compliance standards in banks, evolving a mechanism for transparency in banking practices to obviate potential irregularities, consolidating the co-operative structure, streamlining the functioning of non-banking financial companies (NBFCs) and implementing prudential measures in the financial sector assume priority for ensuring financial stability.

107. The Annual Statement on Developmental and Regulatory Policies for the year 2006-07 is divided into five sections. I. Interest Rate Policy; II. Financial Markets; III. Credit Delivery Mechanism and Other Banking Services; IV. Prudential Measures; and V. Institutional Developments.

I. Interest Rate Policy

108. Progressive deregulation of interest rates in those segments that have remained regulated for reasons relevant at different times has been engaging the attention of the Reserve Bank and wide consultations have been held with various stakeholders. In this context, the Reserve Bank requested the Indian Banks' Association (IBA) to undertake a comprehensive review of the interest rate on savings bank deposits and lending rates on small loans up to Rs.2 lakh.

(a) Interest Rate on Savings Bank Deposits

109. The interest rate on savings bank deposits is regulated by the Reserve Bank and is currently prescribed at 3.5 per cent per annum. Based on a review of current monetary and interest rate conditions, including a careful consideration of the suggestions received from the IBA, it is considered appropriate to maintain the *status quo* while recognising that deregulation of this interest rate is essential for product innovation and price discovery in the long run.

(b) Setting of Interest Rates on NRI Deposits

110. The ceilings on interest rates on NRE and FCNR (B) deposits are linked to the LIBOR/SWAP rates and are fixed on the basis of rates prevailing

as on the last working day of the preceding month. In February 2006, banks were advised that the Foreign Exchange Dealers Association of India (FEDAI) would quote/display the LIBOR/SWAP rates to be used for fixing interest rates on NRI deposits, in order to ensure uniformity and transparency. FEDAI publishes the deposit rates for five maturities in six currencies prevailing on the last working day of each month.

(c) Interest Rate on FCNR(B) Deposits

111. Banks were free to accept FCNR (B) deposits and offer fixed and floating rates, subject to the ceiling of LIBOR/SWAP rates for the respective currency/maturities minus 25 basis points. On a review, the ceiling interest rate on FCNR (B) deposits was increased by 25 basis points to LIBOR/SWAP rates for respective currency/maturities with effect from close of business in India on March 28, 2006.

(d) Interest Rate on NRE Rupee Deposits: Increase in Ceiling

112. Interest rates on non-resident (external) rupee deposits for one to three years maturity should not exceed 75 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity. On a review of current monetary and interest rate conditions, it is considered appropriate:

- to increase the ceiling by 25 basis points to 100 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity with immediate effect.

(e) Interest Rate on Export Credit in Foreign Currency: Increase in Ceiling

113. At present, exporters can avail of pre-shipment and post-shipment credit in foreign currency at interest rate within a ceiling of LIBOR plus 75 basis points. On the basis of the recommendations of the Working Group to Review Export Credit, it is proposed:

- to increase the ceiling interest rate on export credit in foreign currency by 25 basis points to LIBOR plus 100 basis points from LIBOR plus 75 basis points with immediate effect.

II. Financial Markets

114. Significant changes in the institutional framework for financial markets have come about in consonance with the Reserve Bank's efforts to develop various segments of the financial market spectrum in terms of instruments, processes and micro-structure. Simultaneously, the orderly functioning and soundness of financial market segments has been pursued through regulatory initiatives. Within the Reserve Bank, a clearer assignment of functional responsibilities has been sought to improve operational effectiveness by minimising overlaps and conflict of interest. A Financial Markets Department (FMD) has been set up in July 2005 to fully integrate market operations and improve efficiency in the Reserve Bank's operations in money, government securities and foreign exchange markets.

115. The implementation of FRBM Act has necessitated a review of the Reserve Bank's market operations, including introduction of new instruments and refining existing instruments in the context of the evolving scenario. It is in this context that an Informal Group to examine Financial Market Operations by the Reserve Bank has been constituted to evaluate current practices in regard to liquidity operations and refinements in the operating procedure in accordance with evolving circumstances. The report of the Group is under consideration of the Reserve Bank.

Money Market

116. A number of measures were undertaken in recent years with a view to preserving the integrity of money market. Further measures in this direction are given below:

(a) NDS-CALL

117. In pursuance of an announcement made in the Annual Policy Statement of April 2005, a screen-based negotiated quote-driven system for dealings in call/notice and term money market (NDS-CALL) has been developed by the Clearing Corporation of India Ltd. (CCIL) and would be launched shortly with participation by market constituents on a voluntary basis.

(b) Money Market Overnight Rates

118. At present, the Reserve Bank provides information pertaining to money market operations covering volumes, weighted average rates and range of rates for call/notice money market transactions on a daily basis on its website. In order to enable market participants to assess the liquidity conditions in an efficient and transparent manner, it is proposed:

- to provide information on overnight rates and volumes for CBLO and market repo in addition to call money market on the Reserve Bank's website.

Government Securities Market

119. The Reserve Bank has taken several structural and developmental measures for deepening and widening the Government securities market. In this direction, some of the recent initiatives are highlighted below:

(a) Central Government Securities Market

120. In the context of the significant changes underway in the setting and operating framework of monetary, debt management and regulatory policies of the Reserve Bank, a medium-term framework for the evolution of the Central Government securities market was proposed by the Reserve Bank's internal technical group in July 2005. As a first step in pursuance of these recommendations, intra-day short-selling in Central Government securities was introduced with effect from February 28, 2006. Some additional measures proposed in this regard are:

(i) Introduction of 'When Issued' Market

121. In order to further strengthen the debt management framework, it is proposed:

- to introduce a 'when issued' (WI) market in Government securities. Guidelines covering permissible categories of securities and participants, surveillance system, limits on positions, internal control and reporting requirements have been prepared in consultation with market participants and are being issued separately.

(ii) Diversification of Primary Dealer Business

122. Primary dealers (PDs) have approached the Reserve Bank to permit them to diversify their activities for better risk management through generation of alternate streams of income. Based on a review, it is proposed:

- to permit PDs to diversify their activities as considered appropriate, in addition to their core business of Government securities, subject to limits.

The guidelines covering regulatory and prudential norms would be issued separately.

(iii) Expansion in Primary Dealer Business

123. It was announced in the Annual Policy Statement of April 2005 that the permitted structure of PD business would be expanded to include banks which fulfill certain minimum eligibility criteria. Accordingly, draft guidelines were put on the Reserve Bank's website and taking into account the feedback received, guidelines have been issued in February 2006.

(iv) Revised Scheme for Underwriting Commitment and Liquidity Support to PDs

124. A revised scheme for underwriting commitment and liquidity support to PDs has been introduced with effect from April 1, 2006. Under the scheme, PDs are required to meet an underwriting commitment, replacing the earlier requirement of bidding commitment and voluntary underwriting. The underwriting commitment is divided into two parts - minimum underwriting commitment (MUC) and additional competitive underwriting (ACU). The MUC of each PD is computed to ensure that at least 50 per cent of each issue is covered by the aggregate of all MUCs. The remaining portion of the notified amount is open to competitive underwriting under ACU. In addition, liquidity support would be extended to stand-alone PDs. Of the total liquidity support, half of the amount would be divided equally among all the stand-alone PDs and the remaining half would be extended on the basis of their performance in the primary auctions and turnover in the secondary market.

(v) New WMA Arrangements for the Central Government

125. A revised arrangement for Ways and Means Advances (WMA) to the Government of India for the fiscal year 2006-07 is being put in place in consultation with the Government. As per the arrangement, the WMA limits would be fixed on a quarterly basis as against half-yearly as hitherto. The limits are placed at Rs.20,000 crore for the first quarter, Rs.10,000 crore for the second quarter and Rs.6,000 crore each for the third and fourth quarters. The Reserve Bank would retain the flexibility to revise the limits in consultation with the Government, taking into consideration the transitional issues and prevailing circumstances.

(vi) Consolidation of Central Government Securities

126. As indicated in the Annual Policy Statement of April 2005, 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. Accordingly, it was proposed to consolidate and build up large volumes of liquid securities while continuing with the programme of reissuances. Identified illiquid securities will be bought from the secondary market by the Reserve Bank and once a critical amount of securities is acquired, they would be bought back by the Government to extinguish the stock. The modalities of consolidation are being worked out in consultation with the Government.

(b) Extension of NDS-OM Module to New Participants

127. In the Mid-term Review of October 2005, a screen-based order-driven anonymous NDS Order Matching (NDS-OM) Module was extended to all insurance entities for trading in Government securities. The Union Budget, 2006-07 announced the extension of the NDS-OM module to qualified mutual funds (MFs), provident funds and pension funds. Accordingly, it is proposed:

- to permit MFs, which are NDS members, to access the NDS-OM module with immediate effect. Other MFs would be permitted access by opening temporary current/SGL accounts with the Reserve Bank.

- to permit large pension/provident funds like CBOT/Seamens'/Coal Miners' funds to access the NDS-OM module by opening temporary

current/SGL accounts with the Reserve Bank. The smaller funds would be allowed access through the CSGL route.

These arrangements are being made on a temporary basis to enable immediate access to new participants to the NDS-OM module. Meanwhile, software is being developed to shift all entities, other than banks and PDs, which access NDS-OM from current accounts with the Reserve Bank to such accounts with commercial banks.

(c) Debt Management for State Governments

128. The following measures have been initiated by the Reserve Bank to strengthen debt management operations of State Governments:

(i) Auctions for Market Borrowings of State Governments

129. At present, State Governments have the discretion to issue securities by way of auctions, tap sales or a combination of both under the open market borrowing programme. During 2005-06, an amount of Rs.10,543 crore was raised through the auction route constituting 48.5 per cent of the total market borrowings of Rs.21,729 crore of State Governments. As the auction route promotes price discovery, maintains market discipline and contributes to improved secondary market liquidity, it is proposed that:

- State Governments may be encouraged to progressively increase the share of market borrowings under the auction route with a view to covering the entire market borrowings through auctions as early as possible.

(ii) Introduction of Indicative Calendar for Market Borrowings of States

130. The system of issuance of half-yearly indicative calendars for dated Government of India securities was introduced in 2002-03 to provide transparency and stability in the Government securities market and enable institutional and retail investors to plan their investments. The issuances of State Government securities, however, do not follow any such indicative calendar. It is now proposed that:

- States, at their discretion and initiative, would be encouraged to develop an advance indicative open market borrowing calendar.

(iii) Scheme for Investment Management of State Governments

131. At present, Consolidated Sinking Funds (CSFs) and the Guarantee Redemption Funds (GRFs) of State Governments are invested in Government securities held in the books of the Reserve Bank. The Twelfth Finance Commission (TFC) recommended that all States should set up sinking funds for amortisation of all loans (and not just market borrowings) and continue to maintain the Calamity Relief Fund (CRF) in its present form. In the context of these developments and for management of investments of State Governments, it is proposed:

- to revisit the scheme of CSF to cover the entire liabilities of State Governments and not just open market borrowings as at present.
- to prepare a scheme of CRF in consultation with the Government.

(iv) WMA/Overdraft Scheme for State Governments

132. As indicated in the Mid-term Review of October 2005, the Advisory Committee on Ways and Means Advances to State Governments (Chairman: Shri M.P. Bezbaruah) submitted its report to the Reserve Bank in October 2005. The recommendations of the Committee were discussed in the 17th Conference of State Finance Secretaries held on January 13, 2006 and a revised scheme of WMA/Overdraft for State Governments has been operationalised from April 1, 2006. As per the scheme, the aggregate normal WMA limits for 2006-07 have been enhanced to Rs.9,875 crore as against Rs.8,935 crore in the previous year. Incentives in the form of Special WMA have also been provided to the States to invest in CSF/GRF.

(v) Liquidity of State Government Securities

133. A Working Group on Liquidity of State Government Securities (Chairman: Shri V.K.Sharma) was constituted to review the issue of low liquidity of State Government securities and suggest appropriate measures. Drawing from the recommendations of the Group and with a view to widening the investor base in State Development Loans (SDLs), it is proposed:

- to extend the facility of non-competitive bidding (currently limited to Central Government dated securities) to the primary auction of SDLs.

- to introduce purchase and resale of SDLs by the Reserve Bank under the overnight LAF repo operations.

(d) Constitution of Standing Technical Committee on State Governments' Borrowings

134. It was indicated in the Annual Policy Statement of April 2005 that the implementation of the recommendations of the TFC would have major implications for the market borrowing programmes of States. The Reserve Bank would facilitate smooth transition in consultation with the Central and the State Governments. As a first step, consultations were held with State Finance Secretaries in April 2005. Subsequently, the Government of India constituted a Technical Group (Chairperson: Smt. Shyamala Gopinath) in July 2005 to work out the modalities for a smooth transition to the proposed arrangement. On the basis of the recommendations of the Group, it is proposed:

- to constitute a Standing Technical Committee (STC) under the aegis of the State Finance Secretaries Conference with representation from the Central and State Governments and the Reserve Bank to advise on the wide-ranging issues relating to the borrowing programmes of Central and State Governments through a consensual and co-operative approach.

(e) High Level Expert Committee on Corporate Bonds and Securitisation

135. Pursuant to the announcement made in the Union Budget, 2005-06 a High Level Expert Committee on Corporate Bonds and Securitisation (Chairman: Dr. R.H. Patil) was appointed to examine legal, regulatory, tax and market design issues in the development of the corporate bond market. The recommendations of the Committee included enhancing the issuer as well as investor base, simplification of listing and disclosure norms, rationalisation of stamp duty and withholding tax, consolidation of debt, improving trading systems through introduction of an electronic order matching system, efficient clearing and settlement systems, a comprehensive reporting mechanism, developing market conventions and self-regulation and development of the securitised debt market. In this context, in so far as actions by the Reserve Bank are concerned, it is proposed:

- to constitute a Working Group to examine the relevant recommendations and suggest a roadmap for implementation. Consultation will be held with SEBI and IRDA as appropriate.

Foreign Exchange Market

136. The Reserve Bank has taken several initiatives to liberalise and simplify procedures for conduct of foreign exchange business with a view to facilitating prompt and efficient services. Further measures proposed in this direction are detailed below:

(a) Extension of Time Limit to Realise Export Proceeds

137. At present, Authorised Dealers (ADs) are allowed to extend the time limit for realisation of export proceeds beyond the prescribed period of six months up to an invoice value of US$ 100,000. As a measure of liberalisation, it is proposed that:

- ADs could, henceforth, grant extension of time to realise export proceeds up to US $ 1 million beyond the prescribed period of six months.

(b) Remittance of Initial and Recurring Expenses for Branch Offices Opened Abroad

138. ADs are permitted to remit initial and recurring expenses of the branch office of an Indian entity abroad up to 2 per cent and 1 per cent of the average annual sales/income or turnover during the last two accounting years, respectively. As a measure of further liberalisation and simplification, it is proposed that:

- ADs would, henceforth, allow remittances towards initial and recurring expenses of branch offices of Indian entities up to 10 per cent and 5 per cent of the average annual sales/income or turnover during the last two accounting years, respectively.

(c) Working Group on Cost of NRI Remittances

139. Remittances from non-resident Indians (NRIs) constitute a significant segment of the country's foreign exchange inflows. Concerns have been expressed on the relatively high cost that can be faced, particularly by migrants

wishing to send small amounts back to families. In these cases, the exchange rate charged on money transfers can be a significant additional cost that is often not obvious to those sending money transfers.

140. The Reserve Bank has recently constituted a Group (Chairman: Shri P.K. Pain), including representatives from banks, to examine the various cost aspects including cost structure for each element of the value chain and associated transfer costs and suggest measures to reduce the cost and make remittance business more efficient. The Group is expected to submit its report by end-May 2006. The report will be put in the public domain for feedback from the public.

(d) Advisory Group on FEMA Regulations Relating to Services

141. Services are one of the fastest growing sectors in the Indian economy and contribute substantially to output, employment and exports. The current Foreign Exchange Management Act (FEMA) regulations are generally oriented to trade in both goods and services and the unique features of the services sector may need to be specifically and clearly addressed. It is, therefore, proposed to:

- constitute an Advisory Group (Chairman: Shri Mohandas Pai) to review all foreign exchange regulations relating to services and make appropriate suggestions for further clarification or simplification and prepare a compendium of all foreign exchange regulations that apply to the services sector.

(e) Access to Foreign Exchange for Individuals

142. With the progressive liberalisation in foreign exchange related transactions, a large segment of the population can undertake a variety of current account transactions without approaching the Reserve Bank. More entities are being allowed to handle non-trade current account transactions in order to enable individuals to have easy access to foreign exchange as well as to enhance competition among the service providers. Select full fledged money changers (FFMCs), urban co-operative banks (UCBs) and regional rural banks (RRBs) are permitted to release/remit foreign exchange for a range of current account transactions such as private visits, business travel, fee for participation in global conferences/training/international

events, film shooting, medical treatment, emigration and emigration consultancy fees. Consequently, scheduled commercial banks holding full fledged AD licence are designated as AD Category I and those undertaking non-trade current account transactions as AD Category II.

(f) Anti-Money Laundering Guidelines for Authorised Money Changers

143. The Reserve Bank issued guidelines for authorised money changers (AMCs) in February 2006 in order to protect them from being used for money laundering activities. The guidelines require AMCs to put in place a policy framework on 'know your customer' and 'anti-money laundering' measures for prevention of money laundering while undertaking money changing transactions.

III. Credit Delivery Mechanisms and Other Banking Services

144. It has been the endeavour of the Reserve Bank to improve credit delivery mechanisms and banking services by creating a conducive environment for banks to provide adequate and timely finance at reasonable rates without procedural hassles to different sectors of the economy. Developments and further measures initiated in this regard are detailed below:

(a) Delivery of Credit to Agriculture and Other Priority Sectors

145. Recent initiatives taken by commercial banks to improve technology and processing practices are expected to increase their lending to the agricultural sector and, in particular, induce appropriate pricing of credit to micro level borrowers. The implementation of the recommendations of the Vaidyanathan Committee (I & II) is expected to revive the rural co-operative credit structure and reduce the cost of multi-layering. Initiatives have been taken by the Reserve Bank to enable banks to significantly step up their exposure to self-help groups (SHGs) and also to take increased recourse to micro-finance institutions and post offices as agents to widen and deepen their outreach. The setting up of a Committee on Financial Inclusion has been announced by the Finance Minister. These

measures are aimed at facilitating the delivery of financial services in rural areas at a reasonable cost.

146. The Budget announced a scheme providing short-term credit to farmers at 7 per cent per annum with a view to providing some relief to farmers through fiscal measures rather than cross-subsidisation within the banking sector. The Reserve Bank has commenced implementation of the budget measures, while ensuring the commercial viability of banks and the overall soundness of the credit system.

(b) Revival of Rural Co-operative Banking Institutions and Long-term Co-operative Credit Structure

147. 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 banking institutions were accepted in principle by the Government and consultative meetings were held with the State Governments.

148. The Government also entrusted the work of studying the long-term co-operative credit structure for agriculture and rural development to the Task Force which has since submitted its draft report to the Government. The report of the Task Force has been placed on the websites of the Government and the NABARD for wider dissemination and comments. The Reserve Bank's comments on the report have been sent to the Government.

(c) Shifting and Opening of Branches of Regional Rural Banks

149. In view of the importance of the RRBs as purveyors of rural credit, sponsor banks were encouraged to merge the RRBs sponsored by them State-wise in order to strengthen them. In this context, the Government has so far issued notifications providing for amalgamation of 93 RRBs into 27 new RRBs, sponsored by 15 banks in 12 States. Further proposals for amalgamation of 36 RRBs into 13 new RRBs are under consideration.

150. As indicated in the Annual Policy Statement of April 2005, the Reserve Bank took further steps in December 2005 to reposition RRBs as an effective instrument of delivery of financial services in the rural areas. Necessary instructions have been issued to RRBs and sponsor banks in this regard.

151. At present, authorisations for opening branches by RRBs are issued by the Reserve Bank, based on requests received from them through the NABARD and duly recommended by sponsor banks. In order to liberalise and simplify the branch licensing policy, it is proposed:

- to permit RRBs to open/shift offices after obtaining clearance from the Empowered Committees (ECs). Similarly, requests for conduct of foreign exchange business as limited authorised dealers (for current account transactions) will be approved on clearance by the ECs.

(d) Relief Measures for Distressed Farmers

152. Despite the spread of banking facilities in rural areas and availability of bank finance at reasonable rates, farmers in several areas are still in distress. It is proposed:

- to constitute a Working Group to suggest measures for assisting distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme under the DICGC Act for such farmers.

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

153. The All India Debt and Investment Survey (NSS Fifty-Ninth Round) has revealed that the share of money lenders in total dues of rural households has increased from 17.5 per cent in 1991 to 29.6 per cent in 2002. Considering that high indebtedness to money lenders can be an important reason for distress of farmers, it is proposed:

- to set up a Technical Group to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and make recommendations to State Governments for improving the legal and enforcement framework in the interest of rural households.

(f) Micro-finance

154. The programme of linking self-help groups (SHGs) with the banking system continues to be the major micro-finance programme in the country.

By end-March 2006, as many as 1,996,488 (provisional) SHGs were linked to banks and the total flow of credit to SHGs was Rs.9,495 crore. The Union Budget, 2006-07 has proposed to enhance the annual target of credit linkage to 385,000 SHGs during the year.

155. The Internal Group (Chairman: Shri H.R. Khan), constituted by the Reserve Bank to examine issues relating to rural credit and micro-finance submitted its report in July 2005, which was placed on the Reserve Bank's website for wider dissemination. On the basis of the recommendations of the Group, banks have been permitted on January 25, 2006 to use the services of non-governmental organisations/self-help groups (NGOs/SHGs), micro-finance institutions (MFIs) and other civil society organisations (CSOs) and post offices as intermediaries in providing financial and banking services through the use of Business Facilitator and Correspondent models.

(g) Financial Inclusion

156. The Mid-term Review of October 2005 urged all banks to make basic banking facilities accessible to vast sections of population with a view to achieving greater financial inclusion. Accordingly, banks were advised to make available a basic 'no-frills' account either with 'nil' or very low minimum balances as well as charges. Banks were also advised to provide a simplified general purpose credit card (GCC) facility without insistence on collateral or purpose, with a revolving credit limit up to Rs.25,000 based on cash flow of the household to enable hassle-free access to credit to rural households. Such finance could be included by banks under indirect finance to agriculture. A simplified mechanism for one-time settlement (OTS) of loans with principal amount up to Rs.25,000 which have become doubtful and loss assets as on September 30, 2005 was suggested for adoption. In case of loans granted under Government-sponsored schemes, banks were advised to frame separate guidelines following a State-specific approach to be evolved by the State Level Bankers' Committee (SLBC). Banks have been specifically advised that borrowers with loans settled under the OTS scheme will be eligible to re-access the formal financial system for fresh credit. Banks are urged to give effect to these measures at all branches for achieving greater financial inclusion.

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

157. The SLBC in the Union Territory of Pondicherry has taken steps to achieve 100 per cent financial inclusion by ensuring that every household in the Union Territory is given access to a 'no-frills' account as also a general purpose credit card (GCC) by December 2006. In order to ensure maximum financial inclusion, it is proposed:

- to advise SLBC convenors in all States/UTs to identify at least one district in their area for achieving 100 per cent financial inclusion by providing a 'no-frills' account and a GCC on the lines of the initiative taken in Pondicherry. On the basis of the experience gained, the scope for providing 100 per cent financial inclusion would be considered by each SLBC to cover other areas/districts.

(ii) Committee on Financial Sector Plan for the North-Eastern Region

158. A Committee (Chairperson: Smt. Usha Thorat) with members from banks, State Governments from the North-Eastern States and academics has been constituted by the Reserve Bank in order to improve provision of financial services in the North-Eastern region and prepare an appropriate State-specific monitorable action plan. The Committee is expected to submit its report by end-June 2006.

(h) Customer Service

159. The progress made in specific areas and further initiatives in this regard are detailed below:

(i) The Banking Ombudsman Scheme 2006

160. As indicated in the Annual Policy Statement of April 2005, the Banking Ombudsman Scheme, 2002 was revised and the Banking Ombudsman Scheme, 2006 came into force with effect from January 1, 2006. The scope of the Scheme has been enlarged to cover customer complaints in areas such as credit card complaints, deficiencies in providing the services assured by banks and banks' sales agents, levying service charges without prior

notice to the customer and non-adherence to the fair practices code as adopted by individual banks. The Scheme also provides for on-line submission of complaints. Furthermore, the Banking Ombudsman page on the Reserve Bank's website has been incorporated to provide details of awards given by Consumer Courts on deficiencies in services over the last few years.

(ii) Banking Codes and Standards Board of India

161. As indicated in the Mid-term Review of October 2005, the Banking Codes and Standards Board of India (BCSBI) has been set up in February 2006 as a society promoted by banks. The management of the Board has been entrusted to a Governing Council under the chairmanship of Smt. K.J. Udeshi, former Deputy Governor.

(iii) Fair Practices Code: Reasonableness of Bank Charges

162. The Reserve Bank continues to receive representations from the public about unreasonable and non-transparent service charges being levied by banks indicating that the existing institutional mechanism in this regard is not adequate. In order to ensure fair practices in banking services, it is proposed:

- to make it obligatory for banks to display and update, in their offices/branches as also on their websites, the details of various service charges in a format to be approved by the Reserve Bank. The Reserve Bank would also place such details on its website.

- to constitute a Working Group comprising a nominee of the 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, the compliance of which would be monitored by the BCSBI.

(iv) Pension Payment Services by Banks

163. The Reserve Bank has taken certain initiatives to improve services provided by agency banks to pensioners under various pension schemes announced by the Government from time to time. In order to reduce the time lag between the announcement of Government orders relating to dearness

relief arrears and payments released by banks to pensioners, banks have been advised to put in place a mechanism to collect copies of government orders and send them to pension paying branches for release of pension amounts to pensioners. Controlling offices/head offices of agency banks have also been advised to closely monitor and supervise timely and correct disbursement of pension to eligible pensioners. In order to facilitate payment of the pension amount to the nominees of pensioners, banks have been advised to record the names of nominees as declared on the nomination forms on the front page of the passbooks.

(v) Services to Depositors and Small Borrowers in Rural and Semi-Urban Areas

164. The Annual Policy Statement of April 2005 proposed a survey in order to make an assessment of customer satisfaction on credit delivery in rural areas by banks. Accordingly, the National Council of Applied Economic Research (NCAER) has been entrusted to carry out a study to find out the quality of services rendered by branches of commercial banks to their customers, both depositors and small borrowers, in rural and semi-urban areas. The study would also attempt to bring out regional and inter-bank comparisons of various services provided by banks to their customers, besides covering the expectations and requirements of the customers from the banks.

(i) Priority Sector Lending

165. As indicated in the Mid-term Review of October 2005, the 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, it is proposed:

- to place revised draft proposals on the website for further feedback.

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

166. As recommended by the Advisory Committee on Flow of Credit to Agriculture and Related Activities from Banking System (Chairman: Prof. V.S. Vyas), banks were advised by the Reserve Bank in October 2005

that if a District Consultative Committee (DCC) is satisfied that there has been extensive crop loss on account of natural calamities, the relief including conversion/restructuring facilities of agricultural loans as per the extant guidelines could be extended to the farmers without declaring Annewari.

167. As indicated in the Mid-term Review of October 2005, an Internal Working Group (Chairman: Shri G. Srinivasan) was constituted to examine various issues in respect of areas affected by natural calamities and suggest suitable revisions to the existing guidelines with a view to making them comprehensive. The Group's recommendations include restoration of banking operations and activities for providing continuous banking access to customers, restructuring of existing loans and easier guidelines for issuance of fresh loans and rationalisation of regulatory reportings. The draft report of the Group has been placed on the Reserve Bank's website for wider dissemination and comments.

168. An Empowered Task Force was constituted for adopting a bank-specific approach in the Union Territory of Andaman and Nicobar Islands to expedite measures for tsunami-affected borrowers. The Task Force has submitted its recommendations and the banks concerned are being suitably advised.

IV. Prudential Measures

169. The Reserve Bank has focused continuously on regulatory and supervisory aspects of the financial sector in order to improve efficiency, stability and soundness of regulated entities and markets. As has been stated in earlier policy Statements, the Reserve Bank is committed to continuing the process of adopting international best practices with appropriate flexibility in view of the differences in the existing institutional framework and capacity. In this direction, the following further measures are proposed:

(a) Capital Adequacy Requirements: New Option for Raising Capital

170. The Reserve Bank issued guidelines to banks in January 2006 for raising capital funds through the issue of innovative perpetual debt instruments (IPDI) (Tier I capital) and debt capital instruments (upper Tier II capital) to meet business as well as the Basel II requirements. In terms of these guidelines, IPDI should not exceed 15 per cent of total Tier I capital of the issuing bank

and investment in these instruments by FIIs and NRIs should be within an overall limit of 49 per cent and 24 per cent of the issue, respectively, subject to the investment by each FII not exceeding 10 per cent of the issue and investment by each NRI not exceeding 5 per cent of the issue. A few banks had expressed some difficulties in complying with some of these limits on individual issuance basis and requested that these limits could be operated on an overall basis. Accordingly, necessary clarifications have been issued.

(b) Preference Shares

171. The Basel I framework recognises issue of preference shares as an eligible instrument of capital. Although nationalised banks are able to raise capital through public issue of preference shares, there are restrictions on other banks. The Reserve Bank has, therefore, proposed necessary legal amendments in this regard to enable all banks in India to avail of this option for raising capital.

(c) Protected Disclosure Scheme for Private Sector and Foreign Banks

172. Disclosure of information in the public interest by the employees of an organisation is increasingly gaining acceptance by public bodies for ensuring better governance standards and probity/transparency in the conduct of affairs of public institutions. In this regard, on April 21, 2004 the Government had authorised the Central Vigilance Commission (CVC) as the 'Designated Agency' to receive written complaints or disclosure of any allegation of corruption or of misuse of office and recommend appropriate action. The jurisdiction of the CVC is restricted to employees of the Government or of any corporation established by it or under any Central Act, Government companies, societies or local authorities owned or controlled by the Government.

173. As private sector and foreign banks are outside the purview of the CVC, the Reserve Bank has formulated a scheme called "Protected Disclosures Scheme for Private Sector and Foreign Banks". The draft of the proposed scheme has been placed on the Reserve Bank's website on January 25, 2006 soliciting comments/suggestions from the public. The scheme is being finalised on the basis of the feedback received.

(d) Prudential Norms for Restructuring of Advances (Other than under CDR Mechanism)

174. The Reserve Bank had issued guidelines in March 2001 allowing banks/financial institutions to restructure/reschedule credit facilities extended to industrial units which are fully secured by tangible assets. In August 2001, an institutional mechanism was put in place for restructuring of corporate debt in the form of the Corporate Debt Restructuring (CDR) system. The CDR mechanism, which was reviewed twice in 2003 and 2005, covers multiple banking accounts/syndication/consortium accounts with outstanding exposure of Rs.10 crore and above by banks and institutions. In addition, in September 2005, the Reserve Bank issued guidelines for restructuring of debt of all eligible small and medium enterprises (SME) which cover SME accounts with outstandings up to Rs.10 crore. As banks would need to restructure credit facilities pertaining to borrowers who are not covered by any of the above guidelines issued so far, it is proposed:

- to constitute a Working Group to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR mechanism.

(e) Draft Guidelines Relating to Classification and Valuation of Investments in Alignment with International Standards

175. The Reserve Bank has been continuously working towards aligning the accounting standards for banks with the best international standards. The Institute of Chartered Accountants of India (ICAI) proposes to issue an accounting standard on 'Financial Instruments: Recognition and Measurement' which would be the Indian parallel of IAS 39. The proposed accounting standard will be of considerable significance for financial entities and, therefore, has implications for the financial sector. In this context, an Internal Group was constituted to review the existing guidelines on classification and valuation of investments by banks and to align them with the accounting standard proposed by ICAI, consistent with international standards. The Group, taking into account the unique country-specific circumstances, has focused on dovetailing the provisions of IAS 39 with the existing prudential guidelines relating to classification and valuation of investments. The report of the Group

has been referred to experts for their comments. On the basis of the feedback received, draft guidelines would be prepared and placed on the Reserve Bank's website for wider dissemination and comments.

(f) Working Group to Review Asset-Liability Management Guidelines

176. Asset-Liability Management (ALM) guidelines were issued to banks in February 1999, based on maturity gap analysis for management of risks. As the ALM systems in banks have stabilised, it is appropriate to move towards the modified duration gap approach to interest rate risk management, as envisaged in the guidelines. Accordingly, a Working Group was constituted to suggest a framework to enable banks to implement the modified duration gap approach for management of interest rate risk. The Group has submitted its report. Draft guidelines, based on the recommendations of the Group, have been placed on the Reserve Bank's website for comments.

(g) New Capital Adequacy Framework: Status

177. Banks in India were advised to adopt the Standardised Approach for credit risk and Basic Indicator Approach for operational risk under the New Capital Adequacy Framework with effect from March 31, 2007. Under the Standardised Approach, banks are required to compute capital requirements for credit risk exposures on the basis of ratings assigned to these exposures by external credit assessment institutions (ECAI). National supervisors are responsible for determining whether the ECAIs meet the eligibility criteria stipulated by Basel Committee on Banking Supervision (BCBS) before allowing banks to use the ratings awarded by these agencies. Accordingly, an in-house Group has been constituted by the Reserve Bank for identifying the ECAIs whose ratings may be relied upon by banks. The Group's recommendations are being finalised.

178. Draft guidelines for implementation of the New Capital Adequacy Framework were formulated and placed on the Reserve Bank's website on February 15, 2005 for wider dissemination and comments. The feedback received in this regard is being examined by the Reserve Bank. Final guidelines on implementation of the New Capital Adequacy Framework would

be issued after taking into account the recommendations of the in-house Group.

179. The BCBS has undertaken the Fifth Quantitative Impact Study (QIS-5) to assess the impact of adoption of the New Capital Adequacy Framework. Eleven Indian banks, accounting for about 50 per cent of market share (by assets), participated in the QIS-5 exercise. Preliminary analysis indicates that the combined capital adequacy ratio of these banks is expected to come down by about 1 percentage point when these banks apply Basel II norms for Standardised Approach for credit risk and Basic Indicator Approach for operational risk. Although none of these banks would be breaching the minimum capital adequacy ratio under the new framework, the net impact reflects a wide range and as such, the results are being further examined.

(h) Credit Information Companies (Regulation) Act, 2005

180. In pursuance of powers conferred under the Credit Information Companies (Regulation) Act, 2005 (CIC Act) the Government requested the Reserve Bank to frame rules and regulations for implementation of the Act. Accordingly, a Working Group (Chairman: Shri P. Saran) was constituted by the Reserve Bank to frame draft rules and regulations for implementation of the Act. The draft rules and regulations were placed on the Reserve Bank's website for wider dissemination and were open for comments up to April 15, 2006. The draft rules and regulations will be reviewed in the light of the feedback received and forwarded to the Government for consideration.

181. The Credit Information Bureau (India) Ltd. (CIBIL), established in 2001, has been collecting data on suit-filed accounts and the accounts in respect of which the borrowers have given consent for sharing information with CIBIL. After the CIC Act is operationalised, banks/FIs would be able to submit data to credit information companies without obtaining consent of the borrowers. Pending the operationalisation of the CIC Act and in order to build up the credit database, banks were advised by the Reserve Bank to obtain consent from all existing borrowers at the time of renewal of loans for sharing the credit information with the CIBIL. The Reserve Bank proposes to call for credit information on customers from CIBIL in order to ensure that the process of obtaining consent has been completed.

(i) Working Group on Conflict of Interest in the Indian Financial Services Sector

182. As indicated in the Annual Policy Statement of April 2005, the Reserve Bank constituted a Working Group on Conflict of Interest in the Indian Financial Services Sector (Chairman: Shri D. M. Satwalekar) which submitted its report in December 2005. The Group examined various conflict of interest situations, both nationally and internationally, and provided an integrated framework of forward-looking measures to mitigate/prevent such situations. The report of the Group has been placed on the Reserve Bank's website for wider dissemination.

(j) Know Your Customer Guidelines

183. In November 2004, guidelines on Know Your Customer (KYC) and Anti Money Laundering (AML) standards were issued by the Reserve Bank and banks were advised to put in place a policy framework to ensure that they are fully compliant with the provisions.

184. The Government of India, notified on July 1, 2005 the Rules under the Prevention of Money Laundering Act (PMLA), 2002. Accordingly, the provisions of PMLA, 2002 came into effect from July 1, 2005. In terms of the Rules, the Financial Intelligence Unit – India (FIU-IND) was set up to collect, compile, collate and analyse the cash and suspicious transactions reported by banks and financial institutions. Reporting formats for suspicious transactions and currency transactions were finalised in consultation with the FIU-IND and, accordingly, banks were advised to report cash and suspicious transactions as prescribed under PMLA, 2002 to FIU-IND.

(k) Prudential Provisioning Requirements

185. The Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) had recommended that, as a prudential measure, a general provision of about one per cent of standard assets of banks would be appropriate and should be implemented in a phased manner. The Mid-term Review of October 2005 increased the provisioning requirement on standard assets, with the exception of direct advances to agricultural and SME sectors, from 0.25 per cent to 0.40 per cent of the funded outstanding

on portfolio basis. To ensure that asset quality is maintained in the light of high credit growth, it is proposed:

- to increase the general provisioning requirement on standard advances in specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans from the present level of 0.40 per cent to 1.0 per cent. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent.

Operational guidelines in this regard would be issued separately.

(l) Risk Weight on Exposures to Commercial Real Estate

186. In July 2005, the Reserve Bank had increased the risk weight on exposures to commercial real estate from 100 per cent to 125 per cent. Given the continued rapid expansion in credit to this sensitive sector, it is proposed:

- to increase the risk weight to 150 per cent.

(m) Exposure to Venture Capital Funds Included for Capital Market

187. Venture capital funds (VCFs) play an important role in encouraging entrepreneurship. In the absence of adequate public disclosures with regard to performance/asset quality of VCFs, prudence would demand treatment of exposures to VCFs as 'high risk'. Therefore, in terms of risk, all exposures to VCFs would have to be deemed to be on par with 'equity'. While significance of venture capital activities and need for banks' involvement in financing venture capital funds is well recognised, there is also a need to address the relatively higher risks inherent in such exposures. Accordingly, it is proposed that:

- a bank's total exposure to venture capital funds will form a part of its capital market exposure and banks should, henceforth, assign a higher risk weight of 150 per cent to these exposures.

Operational guidelines in this regard would be issued separately.

(n) Stress Testing of Asset Portfolio by Banks

188. In the present liberalised environment, banks need to have a robust and sound stress testing process for assessment of capital adequacy. The stress testing involves identifying possible events, future economic conditions that could unfavourably impact bank's credit exposures and making an assessment of the ability of banks to withstand the loss arising out of such events. There is also a need for carrying out stress tests on the asset portfolio incorporating various scenarios, like economic downturns, industrial downturns, market risk events and sudden shifts in liquidity conditions. Furthermore, exposures to sensitive sectors and high risk category of assets would have to be subjected to more frequent stress tests based on realistic assumptions for asset price movements. Stress tests would enable banks to assess the risk more accurately and, thereby, facilitate planning for appropriate capital requirements. This stress testing would also form a part of preparedness for Pillar 2 of the Basel II framework. Against this backdrop, it is proposed:

- to advise banks to undertake sound stress testing practices.

(o) Internal Group on Regulatory Convergence and Regulatory Arbitrage in the Financial Sector

189. The Reserve Bank constituted a Group to study the issues of regulatory convergence, regulatory arbitrage and to recommend a policy framework for a level playing field in the financial sector. The report of the Group has been placed on the Reserve Bank's website for wider dissemination and comments.

(p) Rationalisation of Calendar of Reviews

190. In an effort to reduce the burden on boards of banks and with a view to ensuring that boards deal with important issues in a focused manner, the calendar items were reviewed in June 2005. Accordingly, the total number of reviews were reduced by leveraging the work of several committees of the boards. The Reserve Bank requested the IBA to offer its views on the structure of calendar of reviews with a view to further rationalising the structure. The IBA has since forwarded its views which are under consideration for implementation.

V. Institutional Developments

Payment and Settlement Systems

191. The Reserve Bank has taken a number of initiatives in order to put in place a safe, secure, efficient and integrated real time payment and settlement system. The progress made in specific areas and further initiatives in this regard are detailed below:

(a) Information Systems Security and Audit

192. Periodical information systems (IS) audit assumes importance in view of large scale dependence of banks on information technology (IT) based systems for day-to-day processing of transactions. The scope of such audit not only covers concluded transactions, but also failed and potentially risky transactions, apart from studying the systems and procedures. Banks are encouraged to ensure compliance with the findings of such IS audit on a time bound basis in order to maintain robustness of the IT system.

(b) Centralised Public Accounts System

193. A new Centralised Public Accounts Department System (CPADS) software is being put in place by the Reserve Bank to facilitate processing requirements of the Government accounts maintained with it. The system will be operational by the end of 2006 and is expected to process transactions for the Central and State Governments efficiently.

(c) National Payments Corporation of India

194. As indicated in the Mid-term Review of October 2005, the proposed new organisation for retail payment systems named 'National Payments Corporation of India' (NPCI) is being constituted under Section 25 of the Companies Act, 1956. The NPCI would take over the MICR cheque processing centres (CPCs) as well as the operation of retail electronic payment systems. The NPCI would focus on creating a nation-wide payments system with secured connectivity. The NPCI is expected to commence operations in the second half of 2006-07.

(d) *Electronic Payment Products: Status and Proposed Action*

195. The coverage of Real Time Gross Settlement (RTGS) system has increased significantly. By April 13, 2006 RTGS connectivity was available in 19,301 bank branches as against a target of 15,000 branches by end-March 2006. By end-June 2006, 20,000 branches are proposed to be covered.

196. The National Electronic Funds Transfer (NEFT) system for electronic transfer of funds was operationalised on November 21, 2005. The NEFT (Extended) system would be implemented in a phased manner in order to facilitate non-networked branches of banks to transfer funds electronically. Under this system, non-networked branches could access NEFT-enabled branches of banks for transfer of funds. NEFT (Extended) would work on a T+1 basis and banks should ensure wide rural coverage of the system to enable their customers to avail the benefits of electronic funds transfers.

197. 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.

198. As indicated in the Mid-term Review of October 2005, the proposed National Settlement System (NSS) which aims at settling clearing positions of various clearing houses centrally would be introduced by end-December 2006.

199. The Reserve Bank has waived processing fees on banks for both electronic clearing service (ECS) and electronic fund transfer (EFT) transactions up to March 31, 2006 with a view to promoting electronic transactions. Furthermore, no processing fees are levied by the Reserve Bank for RTGS and NEFT transactions and this waiver was valid up to March 31, 2006. Although there has been a substantial increase in volume of electronic transactions, the Reserve Bank would continue with the waiver of processing fees on banks in order to further promote electronic transactions system, till the retail operations are taken over by the NPCI. Waiver of processing fees for RTGS transactions would continue up to March 31, 2007.

Urban Co-operative Banks

(a) Vision Document for UCBs

200. As envisaged in the draft Vision Document for UCBs, the Reserve Bank has signed Memoranda of Understanding (MoUs) with four State Governments, *viz*., Andhra Pradesh, Gujarat, Karnataka and Madhya Pradesh with a view to facilitating the development of the UCB sector. The Reserve Bank has also constituted Task Forces for Urban Co-operative Banks (TAFCUBs) in these States in order to provide for a structured arrangement for co-ordination and consultation as well as professionalisation of management of UCBs. The TAFCUBs have so far considered the financial position of the UCBs and made various recommendations on the future course of action. Based on the recommendations, the Reserve Bank has granted licence to four unlicenced banks in Gujarat and Andhra Pradesh. Based on the positive experience of the TAFCUBs, it is proposed:

- to widen the scope of TAFCUBs to cover the scheduled UCBs registered in the State concerned and set up a similar forum for regulatory co-ordination in respect of scheduled UCBs registered under the Multi-State Cooperative Societies Act.

(b) Regulatory Framework

201. The Reserve Bank has given effect to the two-tiered regulatory structure by permitting the UCBs with deposit base of less than Rs.100 crore and having branches within a single district to adopt 180 days delinquency norm for NPA classification till March 2007. These banks are also eligible for partial exemption (not exceeding 15 per cent) from the prescribed SLR of 25 per cent to the extent of funds invested in interest-bearing deposits of public sector banks. Consequently, these banks can obviate market risks associated with investment in government securities. Based on the representations received, UCBs have been given modified guidelines for valuation of securities transferred from AFS category to HTM category.

(c) Augmenting Capital of UCBs

202. Share capital and retained earnings constitute the owned funds of co-operative banks. Share capital can be withdrawn by members after the

minimum lock-in period and does not have the permanence of equity. Co-operative banks are also not allowed to issue shares at a premium. In order to explore various options for raising regulatory capital, it is proposed:

- to constitute a Working Group comprising representatives of the Reserve Bank, State Governments and the UCB sector to examine the issues involved and identify alternate instruments/avenues for augmenting the capital funds of urban co-operative banks.

(d) Consolidation in the UCB Sector

203. The Reserve Bank had issued guidelines on merger/amalgamation in UCB sector in February 2005 with a view to facilitating emergence of strong entities and providing an avenue for non-disruptive exit of unviable entities. Further, relaxations in this regard were announced in the Mid-term Review of October 2005. The Reserve Bank has given 'no objection certificate' for 13 merger proposals since then, of which four have already taken effect. The remaining proposals are under various stages of consideration/ operationalisation by the Registrars of Co-operative Societies of the respective States. The Reserve Bank has received seven more proposals that are under examination.

(e) Delivery of Services to UCB Customers

204. The Reserve Bank has issued instructions permitting UCBs in States where MoUs have been signed and those registered under the Multi-State Co-operative Societies Act to offer mutual fund products, as agents, to their customers subject to certain conditions. It is further proposed:

- to allow well managed scheduled and non-scheduled UCBs to open select off-site/on-site ATMs, based on the recommendation of the TAFCUBs.

(f) Settlement of Depositors' Claims

205. In respect of UCBs whose licences are cancelled, the preparation, submission and settlement of claims and recoveries from assets for distribution are delayed due to the involvement of several agencies and stages in the

process of liquidation. In order to ensure appropriate co-ordination between agencies and to expedite the process of settlement of claims and recovery of dues in those UCBs whose licences are cancelled, it is proposed:

- to set up a sub-committee of the TAFCUB to review the progress made by the liquidator in settlement of claims, recovery of dues and repayment to DICGC and other creditors including depositors.

Non-banking Financial Companies

Support to NBFCs Catering to SMEs and Agri-based Services

206. As indicated in the Annual Policy Statement of April 2005, the Reserve Bank is examining the issue of smooth flow of bank finance to NBFCs in order to develop NBFCs into a financially strong sector with improved skill and technology. In view of the increased need to support financing of the SME sector and agri-related activities and taking into account the critical role NBFCs play as an instrument of credit delivery, the SIDBI and the NABARD have agreed to evolve a viable credit dispensation arrangement to provide resource support to NBFCs catering to the needs of these sectors. These institutions would also evolve appropriate mechanisms, in consultation with NBFCs, to address their needs in this regard and provide support in terms of their capacity building to develop expertise for financing these sectors.

Currency Management - Star Series for Currency Notes

207. Currently, all fresh banknote packets issued by the Reserve Bank contain one hundred serially numbered banknotes. In a serially numbered packet, banknotes with any defect detected at the printing stage are replaced at the presses by banknotes carrying the same number in order to maintain the sequence. As part of the Reserve Bank's ongoing efforts to benchmark its procedures against international best practices, as also for greater efficiency and cost effectiveness, it is proposed to adopt the STAR series numbering system for replacement of defectively printed banknotes. A 'star series' banknote will have an additional character, *viz.*, a star symbol * in the number panel and will be similar in every other respect to a normal bank note and would be legal tender. Any new note packet carrying a star series note will

have a band on which it will be indicated that the packet contains a star note(s). The packet will contain one hundred notes, though not in serial order. To begin with, star series notes would be issued in lower denominations, *i.e.,* Rs.10, Rs.20 and Rs.50 in the Mahatma Gandhi series. Wide publicity through issue of press advertisements is being undertaken and banks are urged to keep their branches well informed so as to guide their customers.

Mid-term Review

208. A review of the Annual Policy Statement will be undertaken on October 17, 2006.

Mumbai
April 18, 2006