Third Quarter Review of Annual Statement on Monetary Policy for the Year 2006-07

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

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

I. Assessment of Macroeconomic and Monetary Developments

Domestic Developments

2. Real gross domestic product (GDP) increased by 9.2 per cent in the second quarter (July-September) of 2006-07, according to the end-November, 2006 release of the Central Statistical Organisation (CSO), up from 8.9 per cent in the first quarter and 8.4 per cent a year ago. Accordingly, real GDP growth firmed up to 9.1 per cent in the first half of 2006-07 from 8.5 per cent in the first half of 2005-06. Real GDP originating in agriculture, industry and services sectors rose by 2.6 per cent, 10.1 per cent and 10.6 per cent, respectively, during the first half of 2006-07 as against 3.7 per cent, 7.9 per cent and 10.2 per cent a year ago.

3. Information that is available for the third quarter (October-December) of 2006-07 suggests that the momentum of economic activity has been sustained, but with some setbacks in the

agricultural sector. First estimates of the Ministry of Agriculture place *kharif* foodgrains production at 105.2 million tonnes for the current financial year – lower than 109.7 million tonnes in 2005-06 and also well below the target of 115.3 million tonnes. Favourable soil moisture conditions and normal reservoir levels could, however, enable the recouping of *kharif* production losses in the *rabi* output. *Rabi* sowing acreage has increased by 3.4 per cent in the current season so far (*i.e.*, up to January 5, 2007) from its level a year ago. Increases have been recorded in area sown under wheat (6.8 per cent), rice (8.1 per cent), coarse cereals (6.4 per cent) and pulses (4.4 per cent) whereas acreage under oilseeds declined by 8.7 per cent.

4. Industrial activity has picked up in an environment of favourable demand conditions, strong corporate profitability and overall business optimism. The index of industrial production (IIP) rose by 10.6 per cent during April-November 2006 as against 8.3 per cent a year ago. Manufacturing contributed nearly 91.2 per cent of this growth, expanding by 11.5 per cent (9.4 per cent a year ago). Manufacturing activity was led by basic metals and alloys, non-metallic mineral products, machinery and transport equipment, basic chemicals and products and cotton textiles. The strength of investment demand was reflected in an increase of 16.1 per cent (16.2 per cent) in capital goods production, supported by the growth in production of basic goods by 9.3 per cent (6.1 per cent), in intermediate goods by 10.9 per cent (2.5 per cent) and in consumer durable goods by 12.5 per cent (14.2 per cent). In the consumer non-durables segment, production rose by 8.7 per cent (12.9 per cent). Mining and electricity generation grew by 3.8 per cent (0.5 per cent) and 7.3 per cent (5.0 per cent), respectively. The six infrastructure industries, comprising 26.7 per cent of the IIP,

posted a growth of 7.8 per cent during April-November, 2006 as against 5.2 per cent a year ago. Petroleum refinery products and cement production registered double-digit growth, production of crude petroleum recorded a turnaround and the growth of electricity production was higher than a year ago. On the other hand, the growth of coal and finished steel decelerated from the pace of expansion last year.

5. Buoyant domestic and export demand conditions continued to support private corporate sector performance. Sales of sampled non-financial private companies grew by 27.4 per cent in the first half of 2006-07, up from 17.2 per cent a year ago. Net profits increased by 41.6 per cent on top of a growth of 41.3 per cent in the first half of 2005-06. The gross profit margin (gross profits to sales) at 15.6 per cent and the net profit margin (profits after tax to sales) at 10.6 per cent were also at levels higher than those in the corresponding period of the previous year. Early results for the third quarter of 2006-07 indicate sustained growth in sales and in both gross and post-tax profits. At the same time, there was some reduction in the growth of interest burden, *i.e.,* interest payments relative to gross profits in comparison with previous quarters.

6. The Reserve Bank's Industrial Outlook Survey points to optimism on the growth outlook. The business expectations index for October-December, 2006 was higher than in the preceding quarter but marginally lower than in the corresponding quarter a year ago. The expectations index for January-March, 2007 is higher than in the preceding quarter as also in the corresponding quarter a year ago. A positive outlook for demand conditions continues with increased optimism reflected in order books, production, employment and profit margins. The assessment

about growth of exports and imports indicates a marginally lower level of confidence. Expectations of increase in selling prices have moderated somewhat in relation to the preceding quarter.

7. Business confidence polled by other surveys also appears to have picked up in October-December, 2006 on the back of a healthy increase in sales, profits, new orders, selling prices, inventory levels and boosted by strong corporate results, record number of mergers and acquisitions by Indian companies and rising equity prices. Surveys of business expectations for January-March, 2007 indicate sustained optimism with regard to investment climate, financial position of firms, sales volumes, fuller capacity utilisation, new orders and profitability across the goods and services sectors. Selling prices are expected to increase along with some increase in employee levels. Seasonally adjusted purchasing managers' indices for December 2006 signalled the continuing improvements in business conditions in the manufacturing sector, with expansion in production levels boosted by higher volumes of new orders. On the other hand, levels of unfinished business, average costs and output prices appear to have risen in relation to the preceding month while stronger demand and shortages of some raw materials have placed pressure on suppliers.

8. Lead indicators of services sector activity suggest that the robust growth recorded in 2005-06 was sustained in 2006-07 so far. Railway revenue earnings from freight traffic increased by 9.9 per cent in April-October 2006, while total cell phone connections and net addition in switching capacity in the telecommunication sector jumped by 121.9 per cent and 22.9 per cent, respectively. The import cargo handled by the civil aviation sector and cargo handled by major ports increased by

19.3 per cent and 6.6 per cent, respectively, whereas passengers handled at international and domestic terminals registered growth of 11.9 per cent and 38.8 per cent, respectively.

9. Driven by the pick-up in real activity, credit extended by scheduled commercial banks (SCBs) increased by Rs.2,50,402 crore (16.6 per cent) during the current financial year up to January 5, 2007 as compared with the increase of Rs.1,97,551 crore (17.1 per cent) in the corresponding period last year. The increase of Rs.2,392 crore in food credit was low and comparable to the increase of Rs.3,084 crore in the previous year. Non-food credit registered an increase of Rs.2,48,010 crore (16.9 per cent) as compared with an increase of Rs.1,94,468 crore (17.5 per cent) in the corresponding period of 2005-06.

10. On a year-on-year basis, non-food credit of SCBs expanded by Rs.4,07,735 crore (31.2 per cent) as on January 5, 2007 on top of an increase of Rs.3,11,013 crore (31.2 per cent) a year ago. Provisional information available from select SCBs for October 2006 indicates that credit to retail and services sectors increased by 33.4 per cent, constituting 49.2 per cent of total non-food bank credit with the share of retail credit alone at 25.9 per cent. Retail lending rose by 34.3 per cent. Within the retail sector, housing loans recorded a growth of 32.3 per cent. Loans to commercial real estate rose by 83.9 per cent with its share in total non-food bank credit at 2.5 per cent. On a year-on-year basis, credit to industry rose by 24.8 per cent by October 2006; however, industry's share in total non-food bank credit fell from 40.2 per cent in October 2005 to 38.7 per cent in October 2006. Nevertheless, there was a pick-up in credit flow to industries like infrastructure (23.2 per cent), metals (34.6 per cent), textiles (34.2 per cent), chemicals (26.9 per cent), petroleum (42.0 per cent), food processing

(23.6 per cent), construction (49.5 per cent), engineering (15.3 per cent), gems and jewellery (21.7 per cent) and vehicles (20.8 per cent). The share of infrastructure in total credit to industry declined marginally from 20.2 per cent in October 2005 to 20.0 per cent in October 2006. Bank credit to agriculture (which has a share of 12.1 per cent in total bank credit) recorded a growth of 30.8 per cent by October 2006. The share of priority sector advances declined from 36.5 per cent to 35.2 per cent.

11. Banks' investments in shares, bonds/debentures and commercial paper increased by 0.6 per cent (Rs.484 crore) during the current financial year up to January 5, 2007 as against a decline of 14.8 per cent (Rs.13,794 crore) in the corresponding period last year. SCBs' investments in mutual funds also increased by Rs.2,080 crore as against a decline of Rs.6,051 crore in the corresponding period of the previous year. The total flow of resources from SCBs to the commercial sector increased by 16.1 per cent (Rs.2,48,494 crore) during the current financial year so far as compared with the increase of 15.0 per cent (Rs.1,80,674 crore) in the corresponding period of the previous year. The year-on-year growth in total resource flow was 29.5 per cent, over and above the growth of 27.7 per cent a year ago.

12. Aggregate deposits of SCBs increased by Rs.2,72,194 crore (12.9 per cent) in the current financial year up to January 5, 2007 as compared with an increase of Rs.1,58,070 crore (8.9 per cent) in the corresponding period of the previous year. On a year-on-year basis, the growth in aggregate deposits at Rs.4,38,037 crore (22.5 per cent) was higher than that of Rs.2,85,182 crore (17.2 per cent) a year ago and was also the highest since 1993-94 on a comparable basis. There has also

been an expansion in term deposits, indicative of time preference in response to rising interest rates. The incremental non-food credit-deposit ratio has declined to 91.1 per cent from 123.0 per cent a year ago.

13. Commercial banks' investment in Government and other approved securities at Rs.48,331 crore during the current financial year up to January 5, 2007 was substantially higher than the decline of Rs.17,559 crore in the corresponding period of the previous year. Banks' holdings of Government and other approved securities fell to 28.6 per cent of their net demand and time liabilities (NDTL) as on January 5, 2007 from 32.6 per cent a year ago. The stock of securities with banks in excess of the minimum statutory liquidity ratio (SLR) requirement amounted to Rs.96,407 crore on January 5, 2007. Adjusted for banks' repo/reverse repo with the Reserve Bank under the liquidity adjustment facility (LAF), their investment in securities increased by Rs.50,396 crore during 2006-07 so far as against a decline of Rs.1,519 crore a year ago. Excess SLR investment, adjusted for LAF holdings, was higher at Rs.91,222 crore or 3.4 per cent of NDTL.

14. On a year-on-year basis, the growth in money supply (M_3) at 20.4 per cent on January 5, 2007 was higher than 16.0 per cent a year ago and above the projected trajectory of 15.0 per cent indicated in the Annual Policy Statement for 2006-07. During the current financial year so far, M_3 increased by Rs.3,24,624 crore (11.9 per cent) which was higher than the increase of Rs.2,04,175 crore (8.8 per cent) in the corresponding period of the previous year.

15. The year-on-year increase in reserve money was 20.0 per cent as on January 19, 2007 as compared with

14.9 per cent a year ago. On a financial year basis, reserve money increased by Rs.68,724 crore (12.0 per cent) up to January 19, 2007 as compared with the increase of Rs.45,809 crore (9.4 per cent) in the corresponding period of the previous year. While currency in circulation increased by Rs.57,575 crore (13.4 per cent) as compared with Rs.48,574 crore (13.2 per cent), bankers' deposits with the Reserve Bank registered a growth of Rs.12,319 crore (9.1 per cent) due to the increase in the cash reserve ratio (CRR) as compared with a decline of Rs.870 crore (0.8 per cent). Among the sources of reserve money, net Reserve Bank's credit to the Central Government increased by Rs.6,963 crore as compared with the increase of Rs.50,622 crore in the corresponding period last year. Adjusted for transactions under the LAF, net Reserve Bank's credit to the Central Government showed a decline of Rs.12,097 crore, mainly reflecting the changes in balances under the Market Stabilisation Scheme (MSS) and the Centre's cash balances. The Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.1,14,337 crore as against an increase of Rs.2,043 crore during the corresponding period of the previous year. The Reserve Bank's foreign currency assets, adjusted for revaluation, increased by Rs.80,166 crore as compared with an increase of Rs.11,185 crore (inclusive of sales towards IMD redemption) during the corresponding period of the previous year. The ratio of NFEA to currency increased from 156.3 per cent on March 31, 2006 to 161.3 per cent by January 19, 2007.

16. Average daily net absorption under the LAF which was Rs.36,857 crore in July-September, 2006 moderated to Rs.12,262 crore in October, 2006. The Reserve Bank injected liquidity through LAF repos during October 20-25, 2006; however, some reverse repo bids were also received during this period, indicating

that the distribution of liquidity in the system was skewed. Liquidity conditions balanced in subsequent weeks with the LAF returning to absorption mode. Reverse repo under the LAF came down to Rs.9,937 crore in November and net absorptions continued until December 12, 2006. Injections under the LAF resumed from December 13, 2006 as liquidity tightened with outflows from the banking system on account of advance tax payments as well as the 25 basis points increase in the CRR which became effective from December 23, 2006. Average daily liquidity injection under the LAF amounted to Rs.16,768 crore during December 13-31, 2006 as against average daily liquidity absorption of Rs.22,125 crore during December 1-12, 2006. In January so far (up to January 25, 2007), with the second round of 25 basis points increase in the CRR coming into effect from January 6, 2007 there was net average daily injection of liquidity of Rs.11,034 crore. Additional liquidity amounting to Rs.13,040 crore was absorbed under the MSS during 2006-07 up to January 25, 2007. The balances under the MSS increased from Rs.29,000 crore on March 31, 2006 to Rs.42,040 crore by January 25, 2007. In several auctions of Treasury Bills and dated securities under the MSS, there was partial acceptance of the notified amounts. The Central Government's cash balances with the Reserve Bank increased from an average daily level of Rs.9,569 crore in April-June 2006 to Rs.16,029 crore in July-September, 2006, Rs.36,769 crore in October-December and Rs.49,156 crore in January 2007 (up to January 25). The average liquidity overhang as reflected in outstandings under the LAF, MSS and surplus cash balances of the Central Government taken together, which was Rs.89,786 crore in April-June, 2006 and Rs.92,354 crore in July-September, 2006 declined to Rs.84,312 crore in October-December, 2006 and further declined to Rs.78,800 crore in January (up to January 25, 2007).

17. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, increased from its end-March 2006 level of 4.1 per cent to 5.4 per cent at end-October, 2006 and increased to the intra-year peak of 6.1 per cent on January 6, 2007 before marginally declining to 6.0 per cent by January 13, 2007. On an average basis, annual inflation based on the WPI, which was at 4.6 per cent at end-October 2006, increased to 4.9 per cent by January 13, 2007 as compared with 4.7 per cent a year ago.

18. At a disaggregated level, prices of primary articles (weight: 22.0 per cent in the WPI basket) registered a year-on-year increase of 9.3 per cent as on January 13, 2007 as compared with an increase of 5.6 per cent a year ago. The rise in prices of primary articles was under food as well as non-food items. Prices of manufactured products (weight: 63.8 per cent) was steadily driven up by rising domestic demand and the return of pricing power to corporates. Manufacturing inflation increased to 5.6 per cent by January 13, 2007 from 1.9 per cent at the beginning of the current financial year and 2.2 per cent a year ago, led by prices of paper, non-metallic mineral products, food products, rubber and plastic products. There was deceleration/ decline in the prices of wood and leather products, chemicals, basic metals and alloys, machinery and transport equipment. Within the category of manufactured products, prices of cement have risen by 17.9 per cent (12.9 per cent a year ago), contributing 4.5 per cent of the headline WPI inflation. Prices of capital goods have been rising, coincident with high growth in production and imports, and are indicative of rising investment demand. Among capital goods, prices of electrical machinery rose by 11.3 per cent (1.9 per cent a year ago) with a contribution of 5.8 per cent to overall inflation.

19. The average price of the 'Indian basket' of international crude which was US $ 67.3 per barrel in April-June, 2006 and US $ 67.9 per barrel during July-September, 2006 declined to a low of US $ 57.6 per barrel in October 2006 before firming up to US $ 58.4 per barrel and US $ 60.0 per barrel in November and December 2006, respectively. Thereafter, it reduced to US $ 51.0 per barrel by January 25, 2007. The annual increase in prices of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) at 3.7 per cent as on January 13, 2007 was lower than 7.9 per cent a year ago and reflected the impact of reduction in prices of petrol and diesel at end-November 2006. Excluding the fuel group, inflation was at 6.6 per cent (2.5 per cent a year ago), which was higher than the headline.

20. Inflation based on the consumer price index (CPI) for urban non-manual employees, agricultural labourers and rural labourers showed a sharp year-on-year increase to 6.9 per cent, 8.9 per cent and 8.3 per cent in December 2006, respectively, from 5.7 per cent, 4.7 per cent and 4.9 per cent, a year ago. The year-on-year CPI inflation for industrial workers was also placed higher at 6.3 per cent in November 2006 than 5.3 per cent a year ago. On an annual average basis, CPI for industrial workers registered a year-on-year increase of 6.0 per cent in November 2006 as against 4.1 per cent a year ago. Elevated prices of food articles, which have a higher weightage in the CPI basket relative to the WPI, is a significant factor in the divergence between consumer prices and wholesale prices.

21. Revenue receipts of the Union Government as a proportion to the budget estimates (BE) improved to 54.8 per cent in April-November, 2006 from 49.5 per cent in April-November 2005. Revenue expenditure at 62.6 per cent of the BE was, however,

higher than 58.4 per cent a year ago mainly on account of a substantial increase in non-Plan revenue expenditure. Accordingly, the revenue deficit increased to 99.7 per cent of BE during April-November, 2006 as compared with 91.5 per cent in the corresponding period last year. The gross fiscal deficit as a proportion to the BE, however, decreased to 72.8 per cent from 74.7 per cent a year ago due to cutbacks in non-defence capital outlay.

22. The gross borrowings of the Central Government at Rs.1,25,000 crore (Rs.1,15,000 crore a year ago) through dated securities during 2006-07 so far (up to January 22, 2007) constituted 83.1 per cent of the BE, while net market borrowings at Rs.91,432 crore (Rs.83,079 crore a year ago) constituted 80.4 per cent of the BE. The weighted average yield and weighted average maturity of the Central Government securities issued during 2006-07 so far were 7.86 per cent and 14.56 years, as compared with 7.34 per cent and 16.90 years, respectively, for those issued during 2005-06. All issuances during the current financial year, except three, were reissuances reflecting efforts towards consolidation of public debt and imparting liquidity to the Government securities market. As against the provisional net allocation of Rs.17,242 crore (gross: Rs.25,860 crore) for their market borrowing programme, the State Governments have raised a net amount of Rs.7,668 crore (gross: Rs.14,204 crore) up to January 25, 2007.

23. Stable and orderly conditions in financial markets were interrupted by short episodes of volatility in the first half of November and the second half of December with interest rates firming up in almost all segments. Tightness in liquidity due to advance tax outflows, which had pushed up call rates above the

LAF repo rate in the second half of September, resurfaced during October in the run up to the announcement of the Mid-Term Review. In the second half of November, stability returned and call rates fell back to within the LAF corridor. Reduction in liquidity with the banking system on account of sustained credit demand, sizeable tax outflows and build-up of the Centre's cash balances led to a sharp drop in the daily volumes of funds offered at the LAF auctions and a rise in overnight rates after December 13, 2006. Call rates touched a level of 16.9 per cent on December 29 – the highest since June, 2000. In subsequent weeks, while call rates have come off these levels, they remain above the LAF corridor. Interest rates in the call, market repo and collateralised borrowing and lending obligations (CBLO) segments of the money market averaged 8.28 per cent, 7.34 per cent and 7.10 per cent in January 2007 (up to January 25, 2007) respectively, up from 6.75 per cent, 6.44 per cent and 6.29 per cent in October 2006.

24. The primary yields on 91-day Treasury Bills increased to 7.39 per cent on January 24, 2007 from 5.41 per cent at end-April, 2006 and 6.65 per cent in end-October 2006. Yields on 364-day Treasury Bills increased to 7.27 per cent on January 17, 2007 from 5.90 per cent at end-April, 2006 and 6.99 per cent in end-October 2006. The outstanding amount of CP was Rs.23,663 crore by mid-January 2007 as compared with Rs.12,718 crore at end-March, 2006. The weighted average discount rate (WADR) on CP increased to 8.70 per cent from 8.59 per cent over this period. In the market for certificates of deposit (CDs), WADR declined from 8.62 per cent at the end of March, 2006 to 8.28 per cent by December 22, 2006 accompanied by 57.5 per cent increase in the outstanding amount (*i.e.,* from Rs.43,568 crore to Rs.68,619 crore).

25. In the foreign exchange market, there was an increase in activity in both the spot and the forward segments during the third quarter of 2006-07. The average daily turnover in the inter-bank segment increased from US $ 16.08 billion during the quarter ended September, 2006 to US $ 19.75 billion during the quarter ended December, 2006. The average daily turnover in the merchant segment also increased from US $ 6.20 billion to US $ 7.78 billion during the period. The ratio of inter-bank to merchant turnover was 2.54 during the quarter ended December, 2006 as against 2.59 in the previous quarter. Six-month forward premia increased from 2.11 per cent in end-October, 2006 to 3.98 per cent by January 25, 2007.

26. The yield on Government securities with one-year residual maturity moved up from 6.22 per cent at end-April, 2006 to 7.30 per cent as on January 25, 2007. The yield on Government securities with 10-year residual maturity also firmed up from 7.40 per cent at end-April, 2006 to 7.89 per cent as on January 25, 2007. The yield on Government securities with 20-year residual maturity increased from 7.80 per cent to 8.16 per cent during the same period. The yield spread between 10-year and one-year Government securities narrowed down from 118 basis points to 59 basis points as on January 25, 2007. The yield spread between 20-year and one-year Government securities narrowed down from 158 basis points to 86 basis points.

27. Deposit rates offered by SCBs on various maturities have generally been revised upwards during the current financial year. Deposit rates, which had increased by 25-175 basis points in October over April 2006, particularly for the longer end, rose further by 25-50 basis points in December over October 2006,

and by 25-125 basis points in January 2007 across various maturities. In addition, higher interest rates have been offered on special deposit schemes of specified maturities in terms of number of days, with attractive features such as put options for depositors and in schemes specifically meant for senior citizens. In January 2007, some private sector banks raised deposit rates on specific maturity brackets by over 200 basis points, reflecting aggressive pricing strategies in the wake of continuing high credit growth, but also indicative of growing mismatches in their asset-liability positions.

28. On the lending side, most SCBs increased their lending rates (BPLRs) by 75-150 basis points between April, 2006 - January, 2007. The BPLRs of public sector banks (PSBs) and private sector banks increased to a range of 11.50-12.25 per cent and 11.75-15.50 per cent from 10.25-11.25 per cent and 11.00-14.00 per cent, respectively, during the same period. The weighted average BPLR of PSBs increased from 10.71 per cent in March, 2006 to 11.18 per cent in June, 2006 and further to 11.58 per cent in December, 2006. The weighted average BPLRs of private sector banks also increased from 12.37 per cent in March, 2006 to 12.80 per cent in June, 2006 and 13.22 per cent in December, 2006. The weighted average BPLRs of foreign banks increased from 12.67 per cent to 12.72 per cent during the same period.

29. During the current year so far, equity market activity recorded a significant increase in terms of issuances in the domestic primary segment as well as in international stock exchanges. The BSE Sensex (1978-79 = 100) which had risen from 11,280 in end-March, 2006 to 12,612 on May 10, 2006 before receding to 8,929 on June 14, 2006 was supported in

subsequent months by robust macroeconomic fundamentals and high private corporate profitability. The Sensex rallied with intermittent corrections to reach a high of 14,283 on January 25, 2007.

Developments in the External Sector

30. Balance of payments data for the second quarter of 2006-07 released at the end of December 2006 indicate underlying shifts in the external sector of the economy. Merchandise export growth in US dollar terms decelerated to 22.9 per cent in April-September 2006 from 34.2 per cent in the first half of 2005-06, mainly in some segments such as chemicals and related products, textile and related products, leather and manufactures and a decline in exports of handicrafts and gems and jewellery. Merchandise import growth also decelerated to 25.3 per cent from 48.2 per cent a year ago, mainly due to lower growth of non-oil imports at 11.5 per cent as against 47.9 per cent a year ago. The merchandise trade deficit increased to US $ 35.1 billion during April-September, 2006 from US $ 27.1 billion in the first half of 2005-06. Buoyant exports of software, transportation services, the continuing strength of remittances from Indians working overseas and the growing net exports of various professional and business services resulted in an increase of US $ 23.5 billion in net invisible earnings from US $ 19.9 billion a year ago. The increase in invisible payments by 39.8 per cent, in conjunction with the wider trade deficit, resulted in a current account deficit (CAD) of US $ 11.7 billion which was higher than the CAD of US $ 7.2 billion a year ago.

31. Net capital inflows during April-September, 2006 at US $ 19.3 billion were composed of both debt and non-debt

inflows. While portfolio investment slowed down markedly from US $ 5.4 billion in April-September, 2005 to US $ 1.6 billion mainly due to stock market turbulence in May-June, 2006 foreign direct investment (FDI) doubled to US $ 4.2 billion from US $ 2.1 billion. Debt flows (net) in the form of external assistance, external commercial borrowings (ECBs), non-resident Indian (NRI) deposits and short-term credit put together increased substantially to US $ 9.4 billion in April-September, 2006 from US $ 4.5 billion a year ago.

32. Net accretion to foreign exchange reserves, excluding valuation changes, amounted to US $ 8.6 billion during April-September, 2006. Valuation gains, reflecting the appreciation of major currencies against the US dollar, accounted for a rise of US $ 5.1 billion in total reserves as against a valuation loss of US $ 5.0 billion in the corresponding period last year. The foreign exchange reserves, including valuation changes, thus recorded an increase of US $ 13.7 billion during this period as against a modest increase of US $ 1.5 billion a year ago.

33. According to the provisional data released by the Directorate General of Commercial Intelligence and Statistics (DGCI&S), exports recorded a growth of 22.0 per cent during April-December 2006 as compared with 29.9 per cent in the corresponding period of 2005. Exports of petroleum, oil and lubricants (POL) increased by 64.6 per cent to US $ 8.2 billion. Imports rose by 24.8 per cent during April-December 2006 as compared with 37.8 per cent a year ago. While POL imports rose by 39.2 per cent during April-December, 2006 (46.9 per cent a year ago), non-oil import growth decelerated to 18.7 per cent during April-December 2006 from 34.3 per cent

a year ago. Imports of gold and silver, which declined by 3.6 per cent during April-September, 2006 against an increase of 58.5 per cent a year ago, picked up substantially in October and November, according to information received from authorised banks. Among other non-oil imports, pearls, precious and semi-precious stones declined by 32.8 per cent as against an increase of 37.5 per cent a year ago. On the other hand, non-oil non-bullion imports decelerated to 19.2 per cent from 47.0 per cent in April-September, 2006. Imports of capital goods maintained strong growth (38.8 per cent during April-September 2006 as compared with 47.8 per cent a year ago) in consonance with the sustained investment demand in the economy. Reflecting the higher order of expansion in imports, the trade deficit, based on DGCI&S data, increased from US $ 31.7 billion during April-December 2005 to US $ 41.6 billion during April-December, 2006.

34. Capital flows to India remained sizeable during 2006-07 so far, taking the form of foreign direct investment (FDI), capital issues under Amercian Depository Receipts (ADRs)/Global Depository Receipts (GDRs) and net accretions to NRI deposits. FDI inflows at US $ 8.6 billion during April-November 2006 were higher by 91.7 per cent than in the corresponding period of the previous year. Source-wise, Mauritius, the US and Singapore remain the dominant sources of FDI to India. Foreign institutional investors (FIIs) were net sellers during May-July 2006 against the backdrop of weakness in domestic equity markets in consonance with the trends in international markets. During August-November, 2006 FIIs made large purchases in the Indian stock markets. Since December 2006, however, FIIs registered outflows against the backdrop of volatility in Asian equity markets subsequent to the tightening of capital controls by Thailand. The

net cumulative FII inflows during 2006-07 so far (up to January 19, 2007) amounted to US $ 2.4 billion as against US $ 5.7 billion during the corresponding period last year. Amounts mobilised by corporates through ADRs/GDRs were also higher during April-November 2006. NRI deposits recorded inflows of the order of US $ 2.7 billion during April-November 2006 as compared with inflows of US $ 0.5 billion registered during the corresponding period of 2005, partly reflecting higher interest rates offered by banks on such deposits. The foreign exchange reserves rose to US $ 178.1 billion by January 19, 2007 from US $ 151.6 billion at the end of March, 2006.

35. The Indian foreign exchange market has generally witnessed orderly conditions during the current financial year so far with the exchange rate exhibiting two-way movements. The exchange rate of the rupee against the US dollar, which was Rs.44.61 at end-March, 2006 depreciated to Rs.46.95 by July 19, 2006 but appreciated thereafter to Rs.44.24 by January 25, 2007. Similarly, the rupee-euro exchange rate depreciated from Rs.54.20 at end-March, 2006 to Rs.59.90 by August 22, 2006 before appreciating to Rs.57.33 by January 25, 2007. Overall, the rupee appreciated by 0.8 per cent against the US dollar, and by 3.4 per cent against the Japanese yen but depreciated against the euro by 5.5 per cent and against the pound sterling by 10.5 per cent during the current financial year so far (up to January 25, 2007).

36. The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene, if and when necessary. The overall approach to the

management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements.

Developments in the Global Economy

37. The International Monetary Fund (IMF) has projected in its World Economic Outlook of September 2006 that global real GDP growth on a purchasing power parity basis is expected to accelerate to 5.1 per cent in 2006 from 4.9 per cent in 2005 but will slow down to 4.9 per cent again in 2007. World real GDP growth, on the basis of market exchange rates, is estimated to accelerate to 3.8 per cent in 2006 from 3.4 per cent in 2005 before easing back to 3.5 per cent in 2007.

38. In the US, real GDP growth was 2.0 per cent in the third quarter (July-September) as compared with 5.6 per cent and 2.6 per cent in the first and second quarters, respectively. The slowdown was mainly on account of lower residential fixed investment and higher imports. In the third quarter of 2006, the US current account deficit stood at 6.8 per cent of GDP. Recent indicators such as stronger employment in December and higher producer price indices reflect some support for growth in the fourth quarter. The year 2006 recorded the largest rate of decline in new home sales since 1990 and the inventory of completed-but-unsold homes rose to a record level. Euro area GDP growth decelerated to 0.5 per cent in the third quarter of 2006 from the second quarter growth of 1 per cent, though the year-on-year growth rate remained on the projected trajectory of 2.7 per cent. The European Central Bank (ECB) has estimated Euro area GDP growth to be between 2.5 per cent and 2.9 per cent in

2006 and between 1.7 per cent and 2.7 per cent in 2007. Activity has been strong in 2006, consumer and business confidence have risen, business investment has picked up and unemployment has fallen below 8 per cent for the first time since 2001. Buoyant household consumption has imparted further strength to the recovery. In Germany, marked buoyancy in economic activity has emanated from business confidence and exports. The weaker pace of expansion (0.8 per cent) in the recovering Japanese economy in the third quarter was due to downward revisions in consumer spending and capital investment. The outlook for the fourth quarter is, however, more positive on anticipated business plans to boost spending. Japan's corporate sector activity has firmed in recent months as indicated by industrial production and machinery orders, and the household sector is recovering from the softness witnessed in mid-2006.

39. In the developing world, growth has picked up in Asia and other emerging markets, including Latin America and Russia, on account of favourable international financial conditions, strong commodity prices and abundant global liquidity. Growth held up well in most of Asia in the third quarter of 2006 despite a slowdown in US demand and, notwithstanding some uncertainties, growth forecasts for 2007 have been revised upward. Inflation risks remain moderate in the region, helped by the recent fall in global crude prices.

40. Rapid growth was experienced in China which expanded by 10.7 per cent in 2006, marking the fastest growth since 1995 and the fourth consecutive year of growth of at least 10 per cent. Inflation for 2006 was at 2.8 per cent. There are concerns that such high levels of growth might be unsustainable and that some parts of the economy are becoming overheated. Hence,

the Government and the People's Bank of China have taken a series of measures in a bid to slow down growth to more sustainable levels and reduce potential inflationary pressures in sensitive sectors. These measures are expected to help in containing the growth in money supply and credit in the Chinese economy and lessen the possibilities of overheating in 2007.

41. China's foreign exchange reserves have crossed US $ one trillion in 2006 and China plans to ease the rules for capital outflows in 2007 while restricting inflows, together with actively exploring alternative channels to invest the reserves. A substantial amount of the liquidity emanating from China's trade surplus has flowed into its stock markets and the total assets held in domestic equity funds accounted for about 10 per cent of China's total equity market capitalisation. To rein in potential stock market overheating, measures have been taken to slow the large inflow of investments into the domestic share markets. China continues to maintain controls on portfolio equity flows in both directions. In January, 2007 the securities regulators have delayed approval for launch of new money market funds.

42. The Korean economy is expected to grow by 4.4 per cent in 2007, slower than 5.0 per cent in 2006. In Korea, consumer price inflation has decelerated over 2006. There are, however, concerns about a relatively rapid growth in house prices along with a rise in household indebtedness. In response, the Bank of Korea (BoK) has raised its policy rate, increased reserve requirements and has cut the ceiling on aggregate loans to commercial banks by 20 per cent for lending to small and medium enterprises in December. The BoK announced an increase in its foreign currency lending to banks so that they could increase their investment in overseas securities.

43. In Thailand, headline inflation had been gradually easing during 2006 in response to policy rate increases in January, March, April and June. Following an increase in headline inflation in November (3.5 per cent), however, the Bank of Thailand introduced controls on short-term capital inflows on December 18, 2006. This was preceded by a series of steps to stem strong capital inflows into the economy over the past few months, including a minimum three-month holding period for foreign investors for their investment in government or central bank paper; banning onshore banks from conducting sell-buy swap operations with non-residents who were using this method to increase their long baht positions; and seeking co-operation from the Thai business entities not to issue or sell short-term securities to non-residents.

44. Malaysia recorded a growth rate of 5.8 per cent in the third quarter of 2006 and is expected to grow by 5.3 per cent in 2007. Malaysia's growth is largely export-oriented. Exports recorded a decline in October, 2006 in tandem with the slowdown in export growth in other Asian economies. Inflation has not been a serious concern in Malaysia during the last two years and has come down by 0.4 percentage point over 2006.

45. In 2006, there has been a surge in the international prices of cereals, in particular, wheat and maize. Poor harvests in key producing countries due to reasons such as drought conditions in Australia, the expectation of a decline in carry-over stocks in exporting countries, and fast growing demand for bio-fuel production have been the main constraints on grain markets. The decline in production of wheat in 2006 has turned out to be the largest since 1996 with concomitant sharp increases in prices. World trade in wheat in 2006-07 is, however, likely to remain at

the high levels recorded in the previous year, mainly due to larger imports by Brazil and India. The steep rise in ocean freight rates has also contributed to the increase in the food import bills of developing countries. Supply constraints have also dominated the rice economy. After three years of deficit, global sugar production is expected to outpace demand in 2006, although the sugar market remains particularly susceptible to large demand swings and price volatility. Futures prices of foodgrains have climbed to record levels due to substantial reductions in crop production estimates. Wheat futures had risen to a 10-year high on October 17, 2006. Corn prices have surged to a 10-year high on January 16, 2007 in the US after the government predicted the smallest global supply in 29 years. These record prices are spilling over into wheat, soyabean and other agricultural commodities being traded on the futures market, except for sugar. Wheat futures are driven by concerns that US growers will switch from wheat to corn because of the improved outlook coupled with demand from the US ethanol industry, even as wheat stocks remain around 10-year lows.

46. Metal prices have risen by 53.6 per cent in 2006, over and above the increase of 36.2 per cent in 2005. Low stock levels and continuing demand has kept most metal prices high and elevated levels are likely to persist in the near term. Gold prices, which had sharply risen to its highest level in 26 years in May 2006, have eased recently due to the strengthening of the US dollar.

47. Spot crude oil prices softened from the July-August peak of US $ 78 per barrel to around US $ 53 per barrel in January due to unusually warm weather and change in funds flow to the oil sector, despite production cuts by the Organization of

Petroleum Exporting Countries (OPEC) since December. In January 2007, the International Energy Agency has projected that demand growth in 2007 might slow down owing to uncertainty about the course of the US economy, fuel switching and lower demand in the former Soviet Union countries. In the futures market, the West Texas Intermediate (WTI) crude oil is currently being priced at US$ 57.59 per barrel six months hence.

48. In the US, consumer prices declined from 3.8 per cent in August to 2.0 per cent in November, 2006 but accelerated to 2.5 per cent in December. In the Euro area, inflation declined from 2.3 per cent during August to 1.9 per cent in December. Inflation decelerated in Japan, *i.e.,* to 0.3 per cent in December from 0.9 per cent in August. In the UK, inflation has been exceeding the target of 2.0 per cent since May and stood at 3.0 per cent in December, the highest in a decade. The retail RPI inflation rose to 4.4 per cent in the UK in December, 2006 - the highest since 1991.

49. The slowdown in headline inflation in September-October in the US was not matched by similar declines in core inflation, indicating that underlying inflationary pressures persist. Core inflation in December was 2.6 per cent as against 2.7 per cent in October. In the UK, core inflation has been increasing in tandem with the headline rate and stood at 1.8 per cent in December, up from 1.6 per cent in November. In the Euro area, both headline and core inflation have stabilised with the latter at 1.5 per cent over the third quarter. Core inflation in Japan has declined by 0.3 per cent in December as compared with the decline of 0.2 per cent in November. Globally, headline inflation has been moderating mainly on account of the decline in international crude prices, while core inflation has generally

remained firm and is likely to shape inflation expectations which can get exacerbated if international crude prices start rising again and current pressures are allowed to continue.

50. The Dow Jones Industrial Average rose to an all-time intraday high on January 24, 2007. Markets have also been boosted by a number of company-specific events, including merger and acquisition announcements which reached record levels in 2006. Balance sheets of corporations and financial institutions have strengthened significantly, with many accumulating substantial liquid assets, and bankruptcy rates remained near record low levels worldwide. The US yield curve inverted with 10-year bond yields at 4.88 per cent between end-October and January 26, 2007 *albeit* with intermittent variations. The 10-year bond yields in the Euro area have increased from 4.0 per cent at end-October to 4.09 per cent. The Japanese 10-year bond yield has declined from 1.71 per cent at end-October to 1.68 per cent. On a trade-weighted basis, the US dollar which had depreciated during October-December, has appreciated marginally in January 2007. The US dollar rose to a seven-week high against major currencies on January 9, 2007 following concerns expressed by Fed officials about inflation. In credit markets, spreads on credit default swaps (CDSs), which had widened in May-June, has tightened.

51. The US current account deficit is projected by the OECD to reach 6.5 per cent of GDP in 2007 with substantial surpluses elsewhere, particularly in Asia. There has been a sharp expansion in long-term CDSs, reflecting increasing liquidity at the longer end of the maturity spectrum. Growth in lending to emerging Asian economies expanded, mainly to China and Korea. The US dollar remains the largest single currency of debt issuance

for emerging market economies. The proportion of US dollars held in banks outside the US is 30–50 percentage points higher than the corresponding ratios for the euro or the Japanese yen, reflecting the continuing importance of the US dollar as an international currency. By and large, monetary policy authorities are inclined to continue to regard inflation as a major global risk and are vigilant about threats to inflation expectations. They are also watchful about the emergence of excessive volatility and disorderly conditions in currency markets. They have generally displayed a preparedness to act pre-emptively against the possibility of these risks materialising.

52. Some central banks have paused in their policy cycles, particularly the US. The pause of the Federal Reserve during August-December came after seventeen increases by 25 basis points each between June 2004 and June 2006. Other central banks that have kept their policy rates steady include the Bank of Canada at 4.25 per cent since May, 2006); the Bank of Japan (uncollateralised overnight rate target at 0.25 per cent since July, 2006 after maintaining a zero interest rate policy since September 2001); Bank Negara Malaysia (Overnight Policy Rate at 3.5 per cent since April 2006); and the Banco de Mexico (benchmark overnight lending rate at 7.0 per cent since April, 2006).

53. Some other central banks have cut back their policy rates in recent months. These include Bank Indonesia (BI) (BI rate reduced from 12.50 per cent in May, 2006 to 9.50 per cent in January, 2007); the Banco Central do Brasil (Selic rate target cut between September 2005 and January 2007 to 13.0 per cent); the Banco Central de Chile (benchmark lending rate reduced to 5.00 per cent in January 2007 from 5.25 per cent in July 2006)

and the Bank of Thailand (1-day repurchase rate reduced from 4.94 per cent to 4.75 per cent in January, 2007).

54. The central banks that have tightened their policy rates include the ECB which has raised its policy rates six times since December, 2005 by 25 basis points each to 3.50 per cent (main refinancing rate); the Bank of England (repo rate raised in August and November, 2006 and January, 2007 by 25 basis points to 5.25 per cent), the Reserve Bank of Australia (Cash Rate raised by 25 basis points each in August and November 2006 to 6.25 per cent); the People's Bank of China (lending rate raised twice to 6.12 per cent by August 18, 2006); and the Bank of Korea (target overnight call rate raised by 25 basis points to 4.50 per cent on August 10). In order to contain financial market volatility arising from large liquidity flows, several central banks have tended to tighten monetary policy, even at relatively low current inflation rates, as in Thailand, Turkey, Saudi Arabia and Iceland. The Saudi Arabian Monetary Agency (SAMA) increased its policy repo and reverse repo rates by 45 basis points during 2006 to contain the inflationary impact of petro-dollars, though inflation in Saudi Arabia remains one of the lowest in the region given extensive price controls and subsidies. In Iceland, despite a deceleration in inflation since November, the central bank increased its policy rate to 14.25 per cent in December 2006, which is the twelfth increase in last two years to contain the price inflation in the housing market, investment boom and a depreciation in the currency.

55. A few central banks have sought to reinforce the increases in key policy rates with increases in the reserve requirements. In China, the required reserve ratio was raised by 50 basis points each effective from July 5, August 15, November 15, 2006 and

January 15, 2007. The Bank of Korea raised reserve requirements from 5 per cent to 7 per cent for local currency deposits and short-term foreign currency deposits after 17 years in November and December 2006, respectively. Meanwhile, in China and Korea, central bank bonds have continued to absorb liquidity from the banking system.

Overall Assessment

56. The improvement in aggregate supply conditions, noted in the Mid-Term Review of October 2006, seems to have been sustained in the ensuing period, driven by double-digit growth in manufacturing and services. Industrial activity has gathered momentum on the back of manufacturing activity, supported by mining and electricity generation. Lead indicators point to the sustained strength of growth in the services sector. Agricultural performance, on the other hand, has not been as sanguine with output growth decelerating in the first half of 2006-07 in relation to a year ago. Supply-side pressures due to declines in the production of rice, coarse cereals, oilseeds, pulses and cotton have emerged as a source of concern for the near-term outlook, especially in view of the relatively low levels of food stocks. A fuller assessment of the *rabi* prospects would enable a more informed forward-looking evaluation.

57. There are continuing signs of aggregate demand firming up. First, the pick-up in investment intentions and synchronous high growth of capital goods production and capital goods imports suggest that investment demand is strengthening further. Corporates are also reporting sustained business optimism and rising capital expenditure. Second, double-digit growth in the production of consumer durables is reflecting the buoyancy of

consumer demand. Third, the demand for bank credit remains high, extending the high growth phase that began in 2004. Accordingly, concerns remain relating to credit quality and that some banks may be overextended in terms of the balance between sources and uses of funds, as reflected in high credit-deposit ratios. The growth in banks' investments in Government and other approved securities appears to be low relative to credit growth. Excluding LAF holdings, banks' SLR investments are close to the statutory minimum which has implications for liquidity management. Credit growth is also being reflected in the sizeable and higher than anticipated expansion in money supply. Fourth, on the external front, the trade deficit, which is a relevant indicator of domestic demand conditions had expanded to 6.5 per cent of GDP in 2005-06 and is set to rise even higher in the current financial year. Export growth has regained vigour, but there are shifts in the pattern of imports. There are reports that expansion of capacity may be constrained in terms of pending import orders. Fifth, there is increasing evidence that the infrastructural bottlenecks are becoming tighter and more binding. Sixth, some indications of wage cost pressures seem to be in evidence. Surveys of corporate activity show that the staff costs of the sampled firms increased sizeably in the first half of 2006-07, particularly for information technology (IT) and services companies. While staff costs in manufacturing firms have increased at a more moderate pace, they are likely to face incipient pressures on margins from rising input costs. Seventh, elevated asset prices are generating wealth effects which are fuelling aggregate demand.

58. In the Mid-Term Review of October 2006, the Reserve Bank had indicated the need to reckon with the dangers of

possible overheating even though there was no conclusive evidence thereof. In the subsequent period, the relevant signs, especially in terms of aggregate demand, have firmed up as explained above. Investment demand is strong and is augmenting productive capacity. But it is also important to recognise that the addition to productive capacity occurs with a lag and the first sign of a step up in investment is reflected in an expansion of aggregate demand. Meanwhile, sizeable capital inflows appear to have flowed into sectors such as real estate which add to demand pressures, contributing to sharp increases in asset prices as well as greater volatility in financial markets.

59. It is important to recognise that signs of overheating could be transitional in nature. There is evidence of substantial investment taking place, accompanied by overall productivity increases which should add to potential output. Furthermore, the data indicate an upward shift in gross domestic saving and investment rates which could provide the underpinnings for a higher level of the structural component of growth. Hence, the policy challenge is to manage the transition to a higher growth path while containing inflationary pressures so that potential output and productivity are firmly entrenched in order to sustain growth at the current level with the potential for further acceleration. The objective of recent monetary policy initiatives is to continue to maintain conditions of stability that contribute to sustaining the momentum of growth on an enduring basis. In this regard, it is relevant to note that when the CRR was increased in December, 2006 it was indicated *inter alia* that expansion of capacity is underway but the realisation could be constrained over the next two years.

60. Financial markets have, by and large, remained stable. Money markets experienced generally orderly conditions along with spells of tightening of liquidity in November and again from mid-December. During these episodes, contrasting conditions have often been observed when short-term interest rates have firmed up despite LAF absorptions but long-term rates have declined in the Government securities market. In December, there was an inversion of the yield curve and a narrowing of yield spreads. Forward premia have firmed up in November and December across the board in concert with the hardening of short-term interest rates in the domestic money market segments. On the other hand, asset prices, particularly equity prices, have risen to record highs.

61. Up to November, 2006 total expenditure of the Union Government had been higher than a year ago in relation to the budget estimates in spite of cutbacks in capital expenditure. The substantial increase in non-plan expenditure had been partly accommodated by buoyant tax and non-tax revenue receipts. Accordingly, the gross fiscal deficit seems to have moderated from its level a year ago as a proportion to the budget estimates. The market borrowing programme is on course with a large part having been successfully completed with some shortening of the weighted average maturity and firming up of yields. There are also indications of some improvement in State finances as reflected in the steady increase in their cash balances and lower recourse to Ways and Means Advances/overdrafts.

62. Merchandise export growth has resumed strongly from a dip in October, 2006. At the same time, imports of POL have increased sizeably as in the previous year, but reflecting a sharp increase in import volume in the current year. Non-oil import

growth, which remained subdued in the early months of 2006-07, has picked up during the third quarter in consonance with industrial activity. There are also reports of a substantial pick up in bullion imports in October-November. While the merchandise trade deficit has consequently widened, the sustained surplus on account of invisibles is expected to contain the current account deficit at well under two per cent of the GDP. The capital flows to India have recovered from the moderation during May-June 2006. Accordingly, the current account deficit is expected to be comfortably financed in the remaining part of the year.

63. It is important to undertake a careful assessment of factors affecting inflation expectations. First, prices of primary food articles continue to remain firm and the usual seasonal decline since November has been muted during the current financial year. Second, prices of manufactured products have also exhibited upward movement. Third, surveys of business suggest that capacity utilisation in the manufacturing sector has risen. Fourth, indications of demand pressures have been incipiently building up as reflected in increasing consumption and investment demand. Fifth, the sizeable expansion in the demand for bank credit continues to pose concerns. Sixth, asset prices appear to have risen even beyond the elevated levels at the time of the Mid-Term Review. Seventh, international crude prices have moderated considerably and are expected to remain around the current levels in the near future. Accordingly, the pass-through to domestic prices of petrol and diesel can be assumed to be complete. However, it is necessary to recognise that headline inflation has hardened and has moved beyond the projection of the Reserve Bank only on four occasions during the fiscal year, *viz.*, in the weeks ending October 21 and December 30, 2006

and January 6 and January 13, 2007. These spikes in inflation have been contributed to by base effects, supply-side constraints and demand pressures. Overall, the impact of these developments on inflation perceptions due to rise in prices of food articles and on inflation expectations, in general, warrant a determined policy response by all concerned to quell such adverse developments for several critical reasons.

64. In recognition of the cumulative and lagged effects of monetary policy, the Reserve Bank began a graduated withdrawal of accommodation in mid-2003 in spite of inflation being within its tolerance band. Since September, 2004 repo/reverse repo rates have been increased by 125/150 basis points, the CRR has been raised by 100 basis points, risk weights have been raised in the case of housing loans (from 50 per cent to 75 per cent), commercial real estate (from 100 per cent to 150 per cent) and consumer credit (from 100 per cent to 125 per cent) and general provisioning requirement for standard advances in specific sectors has been raised to 1.0 per cent of standard advances. The stance of monetary policy has progressively shifted from an equal emphasis on price stability along with growth to one of reinforcing price stability with immediate monetary measures and to take recourse to all possible measures promptly in response to evolving circumstances.

65. In the global economy, the balance of growth seems to be shifting away from the US towards the euro area, Japan and the emerging economies. There is some evidence that the slowing in housing in the US has significant elements of an inventory correction. Non-residential investment remains strong. Pressure from energy prices has ebbed, while unemployment

appears to have fallen. In Japan, domestic demand is seen as holding the key to sustaining the recovery. In the Euro area, domestic demand and employment are picking up and the outlook for growth is optimistic. In emerging Asia and in Latin America, the outlook for growth remains positive, supported by external demand, although there are concerns relating to the possible US slowdown. In the overall assessment, the global outlook continues to be favourable for the prospects of countries like India, although persisting geopolitical risks remain a potential threat to growth and stability worldwide.

66. In industrial countries, headline inflation has eased somewhat, but core inflation has remained firm. While global oil prices may have stabilised, non-oil inflation has been rising steadily and it is feared that sooner or later, wage pressures would build up. Monetary policy authorities in inflation-targeting countries are facing the difficult situation of inflation prevailing above the target over a prolonged period. Even as long-term inflation expectations have trended down, interpreting short-run fluctuations is becoming complicated by uncertainty about how strongly these expectations could get revised and which factors might trigger the revision. Therefore, while there are several factors holding down inflation expectations, central banks consider it important to strengthen the pursuit of price stability.

67. Global financial markets have been reasonably stable while re-pricing risks. Short-term interest rates have firmed up since October, but long-term bond yields have fallen, translating into a steeper inversion of the yield curve. Foreign exchange markets have been recording lower levels of volatility in recent weeks than before. Most emerging market currencies have made modest gains against the US dollar. Global equity markets have

posted steady gains, except in Japan, boosted by the ebbing of crude prices and the pause in US policy rates. A pick-up in merger and acquisition activity has also supported equity prices. It is important to recognise that in the current environment of relatively low interest rates which, in turn, affect risk-pricing by financial markets, even small changes in interest rates can produce large changes in asset prices and associated volatility, as noticed in the global sell-offs in equity markets during May-June, 2006. Accordingly, policy authorities as well as market constituents need to be watchful and prepared for sudden fluctuations in asset prices which can have significant real sector effects.

68. In line with developments in the major markets, emerging equity markets in Asia and Latin America have continued to recover from the May-June sell-off. The markets which suffered the largest losses have more than recouped earlier losses. Perceptions of sound fundamentals in many emerging economies, reflected in stable ratings and the resurgence of investor interest in dedicated emerging market funds, have enabled international issuances of debt and equity from these economies, with some countries replacing foreign currency debt by local currency debt. Private issuances have far exceeded sovereign issues as firms took advantage of favourable market conditions.

69. In India, recent developments, in particular, the combination of high growth and firming inflation, coupled with escalating asset prices and tightening infrastructural bottlenecks, have complicated the conduct of monetary policy. The enduring strength of capital inflows poses a challenge to monetary and liquidity management. In the event of demand pressures building

up, increases in interest rates may be advocated to sustain growth in a non-inflationary manner but such action, apart from associated costs for growth and potential risks to financial stability, increases the possibility of further capital inflows so long as a significant part of these flows is interest sensitive and explicit policies to moderate flows are not undertaken. These flows can potentially reduce the efficacy of monetary policy tightening by enhancing liquidity.

70. In the overall assessment, there are shifts underway in the patterns of global growth even while inflation expectations remain stable at present. While risks to the outlook from the contraction in the US housing market, rising food and metal prices remain, global financial markets remain vulnerable to sudden shifts in expectations and volatility, as experienced in the recent period. There are concerns relating to the uncertainty surrounding international crude prices. While crude prices have moderated recently, geo-political risks remain. Central banks are, by and large, persisting with withdrawal of monetary accommodation. Global factors, by themselves, do not seem to warrant a policy response; however, corporates and financial intermediaries need to be aware of sudden reversals in sentiment in global financial markets unrelated to economic fundamentals, especially if triggered by geo-political factors. Banks are, therefore, advised to ensure the hedging of their exposures and to undertake pre-emptive strategies to insulate their balance sheets from currency and interest rate risks.

71. In the light of the above, a three-pronged approach is warranted at this juncture. First, early warning signals emanating from rising inflation in an environment of high money and credit growth indicate that monetary policy is still accommodative,

warranting a policy response. Accordingly, a measured increase in interest rates should be appropriate in assuaging demand pressures. Second, there are also abiding concerns relating to the persistently high credit growth and the potential for erosion in the quality of credit. It is in this context that balance sheets of banks need to be fortified against the build-up of loan delinquencies by precautionary provisioning and a greater sensitivity to underlying risks by enhancement of risk weights applied to advances to specific sectors in which banks' exposures have been rising at a fast pace. Third, there are also indications that capital inflows are likely to be sustained with expansionary effects carrying potential inflationary pressures and attenuating monetary and liquidity management. In particular, inflows into non-resident deposit schemes have recorded sizeable increases during the year in response to interest rate differentials. Therefore, it is important to modulate these flows appropriately so as to ensure effective liquidity management. In all the three areas, a continuous process of rebalancing the relative emphasis between growth and stability is critical while devising specific measures from time to time.

II. Stance of Monetary Policy

72. At the end of October 2006, *i.e.,* at the time of the Mid-Term Review, the outlook for global growth and inflation was positive but uncertain with no definitive indications for the course of monetary policy. On the other hand, early signs of overheating in the domestic economy were recognised as too risky to ignore. Accordingly, the repo rate under the LAF was raised by 25 basis points with immediate effect on October 31, 2006 while keeping the reverse repo rate unchanged. In continuation of the stance of the Annual Policy Statement of April 2006 and the First Quarter Review of July, the Mid-Term Review of October set the stance of monetary policy for the period ahead in terms of ensuring a monetary and interest rate environment that sustains the growth momentum while securing price stability and anchoring inflation expectations. The emphasis on macroeconomic and financial stability was reinforced with a readiness to consider appropriate, immediate measures and all possible measures promptly in response to the evolving global and domestic outlook.

73. In the subsequent months, macroeconomic performance has turned out to be somewhat better than anticipated on the back of strong growth in manufacturing and services. Against this background, with a view to draining excess liquidity and pre-empting upward pressures on inflation expectations, it was decided to increase the CRR of the SCBs, regional rural banks (RRBs), scheduled state co-operative banks and scheduled primary (urban) co-operative banking system by one-half of one percentage point of their NDTL in two stages, to 5.25 per cent and 5.50 per cent, effective from the fortnights beginning December 23, 2006 and January 06, 2007, respectively. With

this increase in the CRR, an amount of about Rs.13,500 crore of resources of banks was sought to be absorbed. The increase in the CRR announced on December 8, 2006 was consistent with the stance of the Mid-Term Review of October 2006 of containing inflation expectations in the current environment and consolidating gains achieved so far in regard to stability in order to sustain the momentum of growth on an enduring basis.

74. Financial markets have responded to these developments with some tightening of liquidity conditions, re-pricing and corrections in valuations. Except for the first half of December, short-term interest rates have generally risen. Contrastingly, long-term yields have declined, resulting in a narrowing of yield spreads and an inversion of the yield curve. In the credit market, buoyant deposit growth has considerably alleviated the financing constraint on the banking system. Nevertheless, both deposit and lending rates have edged up in recent months. In the foreign exchange market, sustained inflows, aided by a combination of global and domestic developments, have comfortably accommodated a modest current account deficit and have been reflected in an appreciating exchange rate. Equity markets have been driven up by strong rallies, with some intermittent corrections. The policy incentive structure for external investment is favourable to real estate and the capital market, leading to sizeable inflows and rising asset prices.

75. Real GDP growth originating from agricultural and allied activities has been somewhat lower than expected in the first half of 2006-07, based on the likely production in the *kharif* season. Pending a clearer assessment of the *kharif* crop performance and taking into account the favourable water storage conditions that should augur well for the *rabi* season, it is

reasonable to expect that agriculture will maintain its trend growth of 3.0 per cent as anticipated in the Annual Policy Statement and the Mid-Term Review. On the other hand, the momentum of growth has been sustained in the industrial and service sectors and the outlook remains bright. Accordingly, real GDP growth for 2006-07 is currently expected to be in the range of 8.5-9.0 per cent as compared with around 8.0 per cent projected in the Mid-Term Review and 7.5-8.0 per cent in the Annual Policy Statement and the First Quarter Review.

76. Against this backdrop, the outlook for inflation assumes criticality in terms of policy monitoring and action. Prices of food articles will have considerable impact on headline inflation over the rest of the year. The seasonal decline in prices of food articles in the second half of the year has been less than normal. Prices of manufactures are firming up and were close to the headline level by the end of December, 2006. The recent initiatives by the Government of India should give comfort to the inflation outlook on account of both primary articles and manufactured products. The benefit of the reduction in prices of petrol and diesel, which came into effect in end-November, should help moderate the pressures. As regards the outlook on international crude prices, the probability of current levels being maintained is high, though some geo-political risks remain. The recent monetary policy measures, in particular, the increase in the CRR in December 2006 should work towards containing inflation expectations. On the way forward, it should be possible to build on the timely and pre-emptive actions taken so far to address issues of price stability and related expectations.

77. It is generally recognised that persistence of high inflation not only operates as a tax on the poor but also undermines

economic growth and macroeconomic stability in several ways. While the objectives of monetary policy in India are growth and price stability, the relative emphasis depends on the context. In the prevailing conditions of growth, price and financial stability, unequivocal relative emphasis on stability is warranted in the current context for several reasons. High growth benefits all but the benefits to the poor accrue in a lagged fashion. While the benefits of high growth often percolate to the poor with a time lag, the impact of high prices has no such time lag and is, in fact, immediate. Furthermore, the impact of inflation is asymmetrical in our society since only about ten per cent of the work-force, which is in the organised sector, has an inflation hedge, while the rest do not have any inflation hedging mechanism. Moreover, the adverse impact of inflation on the poor would be particularly severe if the prices of basic necessities of life increase. Hence, a determined and co-ordinated effort by all to contain inflation without unduly impacting the growth momentum is not only an economic necessity but also a moral compulsion. To the extent the current inflationary pressures are attributable to monetary conditions, it is essential to undertake appropriate measures, in continuation of those already taken and in the light of anticipated developments.

78. In our economy, large segments of economic agents may not have adequate resilience to withstand volatility in currency and money markets. A large segment of population is at a level of living which would warrant minimising the risk of large disruption in their monetary and financial conditions, however temporary it may be. These factors lend additional weight in favour of monetary stability and avoidance of imbalances in the financial system. The Reserve Bank's policies are, therefore, vigilant to any indications of volatility in currency and money markets.

79. On the basis of available evidence, global growth continues to be strong but is exhibiting mixed patterns. Global imbalances continue to grow, but no immediate correction or hard landing is anticipated. In the global financial markets, current indications suggest that the risks remain under-priced and it is debatable as to whether this is on account of *ex ante* excess saving or under-investment. There are indications that the risks have become more diversified. It is important to recognise, however, that these risks do not disappear. Consequently, there is an increasing discomfort of the possibility of tail risk materialising. The incentive mechanism of large financial intermediaries, especially hedge funds, tends to under-price risks in such situations. International futures markets are predicting that current levels of crude prices may hold, at least over the next six months. Consequently, the concern surrounding the imbalances has shifted to the evolution of global liquidity and unknown risks. There are some forecasts which suggest that external flows to emerging markets would moderate in the coming months and, along with monetary policy tightening and reduction in oil surpluses, would reduce global liquidity. In brief, the outlook is more unclear than before and geo-political risks remain significant, requiring a close and careful monitoring of their evolution.

80. The experience of several emerging economies in recent months has shown that sharp movements in exchange rates can take place in a very short period even when no changes in fundamentals are noticed. It is true that recent episodes in the EMEs did not involve contagion and that these economies have shown resilience in bouncing back, aided by prompt and appropriate policy responses. The fact remains that in these affected EMEs, there has been extreme volatility in financial markets, unrelated to fundamentals, which cause disruptions to

normal activity and leave some permanent impact on the real sector balance sheets. There is, therefore, increasing recognition among policymakers of the need to contain extreme volatility in capital flows and, in some cases, consequent liquidity conditions also.

81. At this point in time, the conduct of monetary policy is confronted with three important issues. First, demand pressures appear to have intensified, reflected in rising inflation, high money and credit growth, elevated asset prices, strains on capacity utilisation, some indications of wage pressures and widening of the trade deficit. Second, there are increased supply side pressures in evidence from prices of primary articles. Third, monetary policy will have to contend with the lagged response of productive capacity and infrastructure to the ongoing expansion in investment. By current indications, monetary policy may have to reckon with the accentuation of some of the identified pressures warranting reinforcement of the stance and actions articulated in the Annual Policy Statement of April 2006 and subsequent reviews. As in the past, the conduct of monetary policy depends on multiple indicators and recourse to multiple instruments which encompasses, besides the standard monetary measures, prudential measures as well, due to segmentation in the financial markets and evolving market orientation of large financial intermediaries.

82. Evolving conditions underscore the importance of persevering with further withdrawal of policy accommodation in a timely manner to ensure both price and financial stability. A judicious balancing of weights assigned to monetary policy objectives would accord priority to stability in order to support growth on a sustained basis. Accordingly, an appropriate

response in terms of policy stance and monetary measures is warranted at this juncture. In essence, the conduct of monetary policy in India at the current juncture involves operating on three mutually influencing and interacting tracks: ensuring price stability while recognising the objective reality of lags in monetary policy efficacy; anchoring inflation expectations which, in turn, depend on public perceptions as well as the sources of inflationary pressures; and contending with rising asset prices.

83. It is essential to recognise the links between accelerating inflation and escalating asset prices, even when no view is taken on the appropriateness of such levels of asset prices. Large movements in asset prices impact consumer demand through wealth effects and often, accelerating inflation tends to encourage investments in assets as a hedge. Thus, concerted actions in fiscal, external, monetary and prudential policies would be appropriate to meet such mutually reinforcing situations. In this background, provisioning requirements in the banking sector are being enhanced to sectors such as real estate, capital markets and consumer loans.

84. The continued high credit growth in the real estate sector, outstanding credit card receivables, loans and advances qualifying as capital market exposure and personal loans is a matter of concern. Furthermore, the data reveal higher default rates in regard to credit card receivables and personal loans. It has, therefore, become imperative to increase the provisioning requirement in respect of the standard assets in the aforesaid four categories of loans and advances (excluding residential housing loans) to two per cent from the existing level of one per cent. The provisioning requirement in respect of residential housing loans will remain unchanged at 0.4 per cent for loans

up to Rs.20 lakh and at one per cent for loans in excess of Rs.20 lakh. It has also been decided to increase the provisioning requirement for banks' exposures in the standard assets category to the non-deposit taking systemically important non-banking financial companies (NBFCs) to two per cent from the existing level of 0.4 per cent and to increase the risk weight for banks' exposure to such NBFCs to 125 per cent from the existing level of 100 per cent. Provisioning requirements and risk weights for banks' exposures to asset finance companies will remain unchanged. In order to ensure continued and adequate availability of credit to highly productive sectors of the economy, the risk weights for all other categories of exposures also remain unchanged. Similarly, the provisioning requirements in regard to agricultural loans, loans to SMEs and loans to industry, in general, remain unchanged.

85. Asset prices in capital markets as well as in real estate are influenced by relative fiscal incentives and external sector policies, in addition to overall liquidity conditions. There is merit in moderating additions to liquidity from large capital inflows and, hence, some changes in administered rates relating to non-resident deposits are considered appropriate. These have to be viewed as part of several measures undertaken to moderate liquidity with a view to enabling continuous re-balancing in the relative emphasis between growth and price stability, including financial stability.

86. A sizeable increase in Non-Resident (External) Rupee Account [NR(E)RA] and Foreign Currency Non-Resident (Banks) [FCNR(B)] deposits has been observed in 2006-07 so far. At the same time, there are reports of large growth in advances being granted against such deposits. It may be recalled that, based on

the prevailing monetary conditions, the interest rate ceilings on NR(E)RA and FCNR(B) deposits have been reviewed on an ongoing basis and have been adjusted on several occasions. In the current context, it has been decided to reduce the interest rate ceilings on NR(E)RA and FCNR(B) deposits by 50 basis points and 25 basis points, respectively. Furthermore, keeping in view the objective of making these facilities available to individual NRIs and considering the prevailing monetary conditions, there is merit in avoiding upward pressure on asset prices in sensitive sectors through utilisation of this facility. Pending a review of the extent of large advances to high net worth individuals, banks are being prohibited from granting fresh loans in excess of Rs. 20 lakh against the NR(E)RA and FCNR(B) deposits, either to depositors or to third parties. Banks are also being advised not to undertake artificial slicing of the loan amount to circumvent the ceiling.

87. In recognition of the rising inflationary pressures, the Government of India has moved in a determined fashion in recent weeks to contain inflation expectations. With a view to reducing manufacturing costs, customs duty on specified capital goods and parts thereof, project goods and extensions has been reduced from 12.5/10 per cent to 7.5 per cent. The duty on inorganic chemicals, base metals of primary and semi-finished form, ferro-alloys, stainless steel and other alloy steel has been reduced to 5.0 per cent. Portland cement has been exempted from customs duty. In order to contain pressures from prices of essential commodities, the customs duty on edible oils has been reduced, in addition to exempting maize, wheat and pulses. Furthermore, a ban has been imposed on forward trading of *tur* and *urad* to minimise price volatility. While the recent actions taken by the Government are welcome and support the

continuum of monetary measures undertaken since October 2004, it is important to reiterate that effective containment of inflationary pressures is best served by a combination of fiscal, external and supply management policies, supplemented and complemented by ongoing implementation of monetary measures.

88. Inflation, to the extent it is a monetary phenomenon, demands timely and credible monetary policy actions, recognising the lagged effects of such policies. Thus, the current package of measures should be viewed not only as complementing the lagged effects of the actions already taken but also as meeting the emerging pressures on price stability, and more importantly, inflationary expectations. The monetary measures are meant to complement the fiscal and supply-side measures already undertaken in the recent period. This is in consonance with the Annual Policy Statement for 2006-07 as well as the Mid-Term Review which state that the policy endeavour is to contain year-on-year inflation for 2006-07 in the range of 5.0 to 5.5 per cent. The objective of the policy measures being undertaken at the current juncture would be to bring the inflation as close as possible to the stated range of 5.0 to 5.5 per cent at the earliest, while continuing to pursue the medium-term goal of a ceiling on inflation at 5.0 per cent.

89. Over the remaining part of the year, management of liquidity would receive priority in the policy hierarchy. Consequent to the tightening of market liquidity, the impact of monetary policy is expected to be stronger than before. The Reserve Bank would use all policy instruments, including the CRR, to ensure the appropriate modulation of liquidity in responding to the evolving situation. It is important to note that bank credit continues to

grow at a rapid pace for the third year in succession and the rates of growth are clearly excessive, warranting measures to moderate growth even after accounting for the relatively low level of credit penetration in our country and the structural transformation of the economy that is underway. Banks have been drawing down their investments in gilts sizeably to accommodate credit demand, including to levels close to the minimum SLR in some cases. Mismatches between the sources and uses of funds persist. The system level incremental non-food credit-deposit ratio remains high at 91 per cent, but at even higher levels for some banks. The depletion of SLR investments by banks has resulted in anomalous situations in which call rates have firmed up to the ceiling of the LAF corridor and beyond even when reverse repo bids have been received under the LAF and funds have been absorbed from the system. This indicates that some banks are clearly overdrawn in terms of both collateral and cash, necessitating recourse to rollovers at the short end of the market spectrum and consequent pressures on liquidity and interest rates. Banks need to recognise that shortage of SLR securities could constrain their recourse to LAF liquidity, which can turn adverse in critical times, forcing them to resort to uncollateralised exposures and attendant risks. Banks should be aware that accessing the Reserve Bank's window for funds should be for very temporary periods and for equilibrating very short-term mismatches. The use of such resources for on-lending by banks needs to be eschewed.

90. The Reserve Bank will ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank will continue with its policy of active

demand management of liquidity through open market operations (OMO) including the MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

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

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

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

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

III. Monetary Measures

(a) Bank Rate

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

(b) Reverse Repo Rate/Repo Rate

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

94. In view of the current macroeconomic and overall monetary conditions, it has been decided to increase the fixed repo rate under the LAF by 25 basis points from 7.25 per cent to 7.50 per cent with immediate effect.

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

(c) Cash Reserve Ratio

96. The cash reserve ratio (CRR) of scheduled banks is currently at 5.5 per cent. On a review of the current liquidity situation, it is felt desirable to keep the present level of CRR at 5.5 per cent unchanged.

Annual Policy Statement for 2007-08

97. The Annual Policy Statement for the year 2007-08 will be announced on April 24, 2007.

Mumbai
January 31, 2007