Annual Policy Statement
for the Year 2007-08

Reserve Bank of India
Mumbai

Annual Policy Statement for the Year 2007-08
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This Statement consists of two parts: Part I. Annual Statement on Monetary Policy for the Year 2007-08; and Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2007-08. 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 Statement on Monetary Policy will be reviewed on a quarterly basis during 2007-08, whereas the Annual Statement on Developmental and Regulatory Policies will be reviewed along with the Mid-Term Review of Monetary Policy, in continuation of the changes in the institutional framework of policy formulation that were initiated in 2005-06. Accordingly, the date for the First Quarter Review is July 31, 2007.

Part I. Annual Statement on Monetary Policy for the Year 2007-08

3. The Annual Statement on Monetary Policy for the Year 2007-08 consists of three Sections: I. Review of Macroeconomic and Monetary Developments during 2006-07; II. Stance of Monetary Policy for 2007-08; and III. Monetary Measures.

I. Review of Macroeconomic and Monetary Developments during 2006-07

Domestic Developments

4. Real gross domestic product (GDP) growth for 2006-07 was placed at 9.2 per cent in the advance estimates of the Central Statistical Organisation (CSO) released in February 2007, over and above 9.0 per cent in 2005-06. These estimates have vindicated the overall optimism building around the performance of the Indian economy which was also reflected in successive upward revisions in growth projections by various agencies during the course of 2006-07, including in the Reserve Bank's quarterly reviews.

5. Real GDP originating from agriculture and allied activities is estimated to have registered a growth of 2.7 per cent in 2006-07, closer to the trend growth but lower than 6.0 per cent in the previous year. According to the estimates of the Ministry of Agriculture released in April 2007, total foodgrains production is expected to have increased marginally to 211.8 million tonnes in 2006-07 from 208.6 million tonnes in 2005-06, with *rabi* production having compensated for the decline of 1.4 per cent in *kharif* foodgrains production. Among the commercial crops, production of sugarcane is estimated to have increased by 14.9 per cent in 2006-07, making India one of the top producers

of sugar in the world, along with Brazil. Cotton production also recorded a sizeable increase of 13.7 per cent. Production of jute and mesta increased by 4.6 per cent whereas oilseeds production declined by 16.9 per cent. The combined value-added by horticulture and plantation crops, livestock and fisheries contributed to growth in real GDP originating from agricultural and allied activities in recent years.

6. Industrial activity expanded strongly, with real GDP originating in industry estimated to have risen by 10.2 per cent in 2006-07 as compared with 8.0 per cent in the previous year. The index of industrial production (IIP) recorded an increase of 11.1 per cent during April-February 2006-07 *vis-à-vis* 8.1 per cent a year ago. All constituent sub-sectors shared in the acceleration. While manufacturing, the prime mover, recorded a growth of 12.1 per cent as compared with 9.1 per cent a year ago, growth in mining and electricity generation were also higher at 4.9 per cent and 7.2 per cent, respectively, as compared with 0.9 per cent and 5.3 per cent a year ago.

7. The production of consumer and capital goods increased by 9.5 per cent and 17.8 per cent, respectively, during April-February 2006-07 over and above the increase of 12.0 per cent and 16.3 per cent a year ago. The basic and intermediate goods segments registered a high growth of 10.1 per cent and 11.6 per cent, respectively, as against 6.5 per cent and 2.4 per cent a year ago. The output of the six key infrastructure industries (with a weight of 26.7 per cent in the IIP) increased by 8.3 per cent as against 6.1 per cent in the corresponding period of the previous year.

8. Corporate sector performance continued to remain buoyant, supported by favourable domestic and export demand conditions during 2006-07. During April-December 2006, sales and net profits of selected non-financial private companies increased by 28.9 per cent and 48.7 per cent, respectively, as against 16.1 per cent and 36.8 per cent in the corresponding period of the preceding year. Profitability ratios were 1.5 to 2.0 percentage points higher than a year ago, reflecting both sales growth and operational efficiency gains. Strong capacity enhancement was also reflected in the increase of 16.7 per cent in depreciation provision. While the momentum of economic activity and the turnaround in the interest rate cycle resulted in an increase of 17.7 per cent in interest payments in contrast to the decline recorded in the preceding two years, higher growth in sales and gross profits in relation to interest payments ensured a lower interest burden (*i.e.,* interest payments relative to gross profits) and interest cost to sales at 12.9 per cent and 2.1 per cent, respectively, as against 16.4 per cent and 2.3 per cent in April-December 2005. Early results for the fourth quarter of 2006-07 indicate that the underlying strength of corporate performance as reflected in sales and earnings growth has been sustained.

9. The Reserve Bank's Industrial Outlook Survey conducted during February 2007 reflects higher confidence and continued optimism surrounding corporate business activities. During January-March 2007, the overall business situation was assessed to be better than in the preceding quarter as well as in the corresponding period a year ago, though there was a moderation in expectations about output growth. While demand conditions as well as export and import growth were perceived to be better than in the corresponding quarter of the previous year, some decline was expected in the availability of finance in relation to the preceding quarter. Capacity utilisation improved over the previous quarter and the inventory of raw material and finished goods was reported to be at average levels. Nearly half the respondents reported increases in the cost of raw materials and a third expected selling prices to go up. Over 55 per cent of respondents expect further improvements in the overall business situation in April-June 2007. The business expectations index for April-June 2007 is higher than in the corresponding quarter a year ago, in spite of the seasonal decline *vis-à-vis* January-March 2007. The quarter-to-quarter seasonal decline in April-June 2007 is, however, expected to be less steep than a year ago in respect of demand, order books, production, working capital requirement and availability of finance. Capacity utilisation and employment growth are expected to go up in relation to the preceding quarter. Over 80 per cent of respondents reported normal levels of pending orders and expected higher capacity utilisation with improvement in expectations of both exports and imports. Above 90 per cent felt that existing capacity would not be a constraint over the next 6-9 months. Nearly one-fourth of the respondents expected some increase in their profitability and nearly 60 per cent more did not perceive any change in their profit margins.

10. Business confidence surveys conducted by other agencies present a somewhat mixed picture. The overall confidence level appears to have been positive on the back of higher macroeconomic activity, enhanced foreign direct investment (FDI) flows, new orders, high capacity utilisation and falling crude prices, although a seasonal decline in activity levels and shortages of some raw materials were expected to put pressure on prices. According to one survey, the confidence level reported in October 2006-March, 2007 increased in respect of ex-factory output prices and employment growth, outweighing a marginal decline in expectations on production/sales, exports, profit margins and selling prices. Seasonally adjusted purchasing managers' indices for the manufacturing sector showed some decline during October 2006-March 2007, despite a marked increase in new orders.

11. Real GDP originating in the services sector increased by 11.0 per cent during 2006-07 as against 10.3 per cent a year ago. The growth of trade, hotels and restaurants, transport, storage and communication accelerated to 13.0 per cent in 2006-07 from 10.4 per cent in 2005-06. The

construction sector registered a lower growth of 9.4 per cent as compared with 14.2 per cent in the previous year. The growth in activity in financing, insurance, real estate and business services, and community, social and personal services at 11.1 per cent and 7.8 per cent, respectively, were comparable to 10.9 per cent and 7.7 per cent in 2005-06.

12. The acceleration in real activity propelled a sizeable expansion in monetary and banking aggregates in 2006-07 for the fourth year in succession. Non-food credit extended by the scheduled commercial banks (SCBs) increased by 28.0 per cent (Rs.4,10,285 crore) on top of 31.8 per cent (Rs.3,54,193 crore) in the previous year, exhibiting some moderation from the sustained growth that characterised the period 2003-06. The system-level incremental non-food credit-deposit ratio edged down to 84.6 per cent during 2006-07 from 109.3 per cent in the previous year, *albeit* with significant variations among banks. Food credit of SCBs increased by Rs.5,830 crore as compared with an increase of Rs.675 crore in the previous year.

13. Provisional information on the sectoral pattern of bank credit available up to December 2006 indicates some evening out of the skew towards the retail and services sector that dominated the deployment of gross bank credit since 2003-04. While on a year-on-year basis, personal loans continued to record the highest growth among major sectors, credit off-take was the highest in respect of the industrial sector in 2006-07. Personal loans recorded a growth of 34.9 per cent by December 2006 followed by services (32.4 per cent), agriculture (31.2 per cent) and industry (27.8 per cent). Housing loans increased by 30.3 per cent while real estate loans rose by 66.7 per cent by December 2006. Within the industrial sector, there was a sizeable credit pick-up in respect of infrastructure (21.7 per cent), basic metals and metal products (35.5 per cent), textiles (35.8 per cent), petroleum (67.0 per cent), chemicals (17.5 per cent), food processing (25.6 per cent) and engineering (19.6 per cent). Credit to industry constituted 35.3 per cent of the total expansion in non-food bank credit in 2006-07, followed by personal loans (28.7 per cent), services (23.7 per cent) and agriculture (12.2 per cent). The share of infrastructure and chemicals in total credit to industry declined marginally from 20.9 per cent and 8.9 per cent, to 19.9 per cent and 8.2 per cent, respectively. On the contrary, the share of credit to basic metals and metal products, textiles and petroleum sectors increased from 11.9 per cent, 10.4 per cent and 3.8 per cent, respectively, to 12.6 per cent, 11.1 per cent and 5.0 per cent. Priority sector advances grew by 25.0 per cent with a moderation in their share in outstanding gross bank credit to 34.8 per cent in December 2006 from 36.5 per cent a year ago.

14. Commercial banks' investments in bonds/debentures/shares of public sector undertakings and the private corporate sector and commercial paper (CP) registered an increase of Rs.4,002 crore during 2006-07 in contrast to a decline of Rs.13,237 crore in the previous year. As a result, total flow of funds from SCBs to the commercial sector, including non-SLR investments, increased by 26.8 per cent (Rs.4,14,287 crore) in 2006-07 as against 28.3 per cent (Rs.3,40,956 crore) in 2005-06.

15. Aggregate deposits of SCBs increased by 23.0 per cent (Rs.4,85,210 crore) during 2006-07 as against 18.1 per cent (Rs.3,23,913 crore) in the previous year. Demand deposit growth slowed to 16.0 per cent from 27.5 per cent in 2005-06 but time deposit growth of 24.5 per cent was notably high *vis-à-vis* 16.4 per cent in the previous year. Several features distinguish deposit growth during 2006-07. First, there was a clear shift from postal savings to time deposits of banks due to favourable interest rate differentials. Second, the tax incentive available on small savings and equity-linked investments was extended to long-term bank deposits. Third, banks aggressively mobilised deposits in order to rebalance their portfolios consistent with emerging needs. Fourth, supported by continued high profitability, cash-rich private and public companies parked their surplus funds with banks. Fifth, non-resident deposits registered a higher growth during 2006-07 than in the previous year.

16. Commercial banks' appetite for Government paper revived during 2006-07 and their investment in Government and other approved securities increased by Rs.74,706 crore in contrast to a decline of Rs.22,809 crore in 2005-06. Commercial banks' holdings of Government and other approved securities declined from 31.4 per cent of the banking system's net demand and time liabilities (NDTL) in March 2006 to 28.0 per cent in March 2007. While SCBs' holdings of Government and other approved securities in excess of the statutory minimum requirement of 25 per cent amounted to Rs.85,728 crore, several banks are operating their statutory liquidity ratio (SLR) portfolios close to the statutory minimum level.

17. Money supply (M_3), on a year-on-year basis, increased by 20.8 per cent (Rs.5,67,372 crore) in 2006-07 as compared with 17.0 per cent (Rs.3,96,881 crore) in 2005-06. Bank credit to the commercial sector increased by 25.4 per cent (Rs.4,30,287 crore) as compared with the increase of 27.2 per cent (Rs.3,61,746 crore) a year ago. Within credit to the Government sector, commercial banks' credit to Government increased by Rs.70,318 crore as against a decline of Rs.19,514 crore in the previous year whereas net RBI credit to Government declined by Rs.3,775 crore as against an increase of Rs.35,799 crore in the preceding year. The banking sector's net foreign exchange assets increased by 28.1 per cent (Rs.2,04,125 crore), primarily reflecting the increase in net foreign exchange assets of the Reserve Bank by 28.7 per cent (Rs.1,93,170 crore).

18. During the year, the financial markets shifted from conditions of easy liquidity to occasional spells of tightness necessitating injection of liquidity through the LAF. The total overhang of liquidity under the LAF, the Market Stabilisation Scheme (MSS) and surplus cash balances of the Central Government taken together increased from an average of Rs.74,334 crore in March 2006 to Rs.92,849 crore in September 2006. During October-December 2006, there was a progressive decline in LAF reverse repo levels. With the LAF slipping into net repos in December 2006 there was a steady moderation in the overhang of liquidity to Rs.78,555 crore by January 2007. In the following weeks, except for a brief episode of tightness during February 15-20 when enhanced cash reserve requirements become effective, liquidity conditions eased up to March 15 warranting moderation of excess liquidity through an augmented programme of MSS, a ceiling on LAF daily absorptions and calibration of CRR changes in addition to increases in the LAF repo rate. With liquidity shortages becoming accentuated in the second half of March 2007 in the wake of advance tax payments, net LAF injections rose to a peak of Rs.43,075 crore on March 21, 2007. The build-up of cash balances of the Government to a peak of Rs.77,726 crore on March 22, 2007 and shortage of collateral as a consequence of steady draw-down of excess SLR holdings exacerbated the tightening of liquidity. As a consequence of the enhanced absorption under the MSS and the build-up of the Centre's cash balances, the overall liquidity overhang increased to an average of Rs.97,449 crore in March 2007.

19. On a net basis, average daily LAF reverse repo absorption declined from Rs.51,490 crore in the first quarter of 2006-07 to Rs.36,857 crore in the second quarter and more sharply to Rs.6,795 crore in the third quarter. Average daily LAF injections during the fourth quarter amounted to Rs.7,582 crore. The outstanding balances under MSS increased from Rs.29,000 crore at end-March 2006 to Rs.64,863 crore by end-March 2007. Cash balances of the Centre with the Reserve Bank increased from an average of Rs.49,995 crore in March 2006 to Rs.55,893 crore in March 2007. During April 2007 (up to April 20), a net amount of Rs.10,658 crore was absorbed by issuing fresh securities/Treasury Bills under MSS.

20. Reserve money increased by 23.7 per cent (Rs.1,35,892 crore) during 2006-07, higher than the increase of 17.2 per cent (Rs.83,922 crore) in the previous year. While currency in circulation rose by 17.1 per cent (Rs.73,491 crore) as compared with the increase of 16.8 per cent (Rs.62,015 crore) in the preceding year, bankers' deposits with the Reserve Bank increased substantially by 45.6 per cent (Rs.61,784 crore) – augmented by the increase of 100 basis points in cash reserve ratio (CRR) during the year – as compared with the increase of 18.9 per cent (Rs.21,515 crore) in 2005-06. Among the sources of reserve money, the Reserve Bank's foreign currency assets (adjusted for revaluation) increased by Rs.1,64,601 crore as compared with the increase of Rs.68,834 crore in the previous year. The Reserve Bank's net credit to the Central Government

(adjusted for the Government's deposit balances including the MSS proceeds) declined by Rs.1,042 crore in 2006-07 as against an increase of Rs.28,417 crore in 2005-06. This decline was mainly due to an increase of Rs.33,912 crore in balances under the MSS, partly offset by increase in net LAF repos (Rs.36,435 crore). The Reserve Bank's credit to banks and the commercial sector increased by Rs.1,990 crore as compared with an increase of Rs.534 crore in the previous year. The ratio of net foreign exchange assets (NFEA) to currency increased from 156.3 per cent in March 2006 to 171.8 per cent in March 2007.

21. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, increased from 4.1 per cent at end-March 2006 to an intra-year peak of 6.7 per cent in end-January 2007 and remained firm in the range of 6.1-6.6 per cent in the succeeding weeks before moderating to 5.7 per cent on March 31, 2007. As on April 7, 2007 inflation stood at 6.1 per cent as against 3.8 per cent a year ago. On an average basis, annual inflation increased from 4.4 per cent in 2005-06 to 5.4 per cent in 2006-07.

22. Prices of primary articles (weight: 22.0 per cent in the WPI) rose by 10.7 per cent as against 4.8 per cent a year ago, largely on account of rising prices of food articles such as wheat, pulses, fruits and milk, and posed upward pressures on headline inflation through 2006-07. Wheat prices remained firm reflecting low stocks, both domestically as well as internationally, and high international prices. The stock of foodgrains with public agencies at 18.1 million tonnes as on February 1, 2007 was 7.4 per cent lower than a year ago. Since July 2006, wheat stocks have been lower than stipulated minimum norms for public agencies under the prevailing buffer stock policy. While prices of pulses went up sizeably reflecting stagnant domestic production as well as higher demand, edible oil prices were driven up by international prices and the decline in oilseeds production. Even excluding food articles, inflation at 5.3 per cent on March 31, 2007 would remain in the upper reaches of the tolerance threshold. Prices of manufactured products (weight: 63.8 per cent in the WPI) increased steadily to 5.8 per cent from 1.9 per cent a year ago. Inflation in terms of prices of manufactured products ruled consistently above 5.0 per cent from early November 2006 and generally above 6.0 per cent since end-January 2007. Within the category of manufactured products, a substantial rise in prices was observed in cement (11.6 per cent) and capital goods, in particular, electrical machinery (12.8 per cent) and metals (11.0 per cent). Within the WPI basket, wheat, milk, pulses, oilseeds, edible oils, oil cakes, grain mill products, basic metals and alloys, cement and electrical machinery with a combined weight of 29 per cent in the WPI contributed to over 63 per cent to headline inflation as compared with a share of 11 per cent a year ago. In the majority of these items, domestic prices are largely mirroring global trends. In addition, export demand is emerging as a significant determinant of inflation.

23. Prices of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) increased by 1.0 per cent in 2006-07 as against 8.3 per cent a year ago. The average price of the Indian basket of international crude varieties (comprising Brent and Dubai Fateh) increased from US $ 55.4 per barrel in 2005-06 to US $ 62.4 per barrel in 2006-07. In terms of monthly averages, the price of the Indian basket increased from US $ 66.8 per barrel in April 2006 to US $ 71.1 per barrel in July 2006, but declined to US $ 57.3 per barrel in October 2006 and further to US $ 53.0 per barrel in January 2007 before increasing to US $ 60.4 per barrel in March 2007. As on April 20, 2007 it stood at US $ 64.0 per barrel. In view of the intra-year decline in the average price of the 'Indian basket' of international crude, domestic retail prices of petrol and diesel were reduced in two stages - at end-November 2006 and again in mid-February 2007 - by around 6.0 per cent. Excluding mineral oils, WPI inflation works out to 6.6 per cent on March 31, 2007 as against 2.9 per cent a year ago.

24. In terms of the year-on-year change in the consumer price index for industrial workers (CPI-IW), inflation was 7.6 per cent in February 2007 as compared with 5.0 per cent a year ago. On an annual average basis, CPI-IW inflation was 6.6 per cent as compared with 4.3 per cent a year ago. Inflation, based on the CPI for urban non-manual employees (CPI-UNME), for agricultural labourers (CPI-AL) and for rural labourers (CPI-RL) showed a sharp year-on-year increase to 7.8 per cent, 9.8 per cent and 9.5 per cent in February 2007, respectively, from 4.8 per cent, 5.0 per cent and 4.7 per cent a year ago. Elevated prices of primary food articles, which have a higher weightage in the CPI basket relative to the WPI, have been the main drivers of consumer prices and the major cause of the divergence between inflation rates based on the CPI and the WPI.

25. The revised estimates (RE) of the Central Government's finances for 2006-07 indicate ongoing improvement in the fiscal position and lowering of the key deficit indicators as ratios of GDP, relative to budget estimates (BE). The revenue deficit estimated at Rs.83,436 crore or 2.0 per cent of GDP was lower than 2.1 per cent of GDP in the budget estimates for 2006-07 and 2.6 per cent in 2005-06. The gross fiscal deficit (GFD) for 2006-07 at Rs.1,52,328 crore constituted 3.7 per cent of GDP as against the budget estimates of 3.8 per cent and 4.1 per cent in the previous year. The improvement in key fiscal indicators was enabled by the sustained buoyancy in tax revenue and containment of growth in Plan expenditure.

26. During 2006-07, the Central Government's net market borrowing at Rs.1,11,275 crore was 97.7 per cent of the budgeted amount of Rs.1,13,778 crore and gross market borrowing of Rs.1,79,373 crore was 98.6 per cent of the budgeted amount of Rs.1,81,875 crore. While the actual issuance of dated securities, in aggregate terms, matched the total quantum of issuances provided in the calendar for the first half (*viz.,* Rs. 89,000 crore), there were four occasions when the actual

issuance differed from the issuance calendar. For the second half, deviations were noted on two occasions, reflecting investor demand in favour of longer maturity instruments and buoyant revenue collections. Out of 33 issuances, 30 issues were reissuances, intended to impart liquidity while the remaining three securities were issued to provide benchmarks in the key segments of 10-15 year and 30-year maturity. The State Governments raised Rs.20,825 crore (gross) and Rs.14,274 crore (net) and under their market borrowing programme during 2006-07. The combined issuance (net) of Government securities of the Centre (excluding MSS) and States was Rs.1,25,549 crore as against Rs.1,13,691 crore in 2005-06, Rs.80,028 crore in 2004-05 and Rs.1,35,192 crore in 2003-04.

27. The weighted average yield on primary issuance of the Central Government's dated securities rose by 55 basis points to 7.89 per cent in 2006-07 from 7.34 per cent in the previous year whereas the weighted average maturity of the dated securities issued during the year decreased to 14.72 years from 16.90 years in the previous year. Weighted average yields on securities issued by State Governments firmed up to 8.10 per cent in 2006-07 from 7.63 per cent in 2005-06 even though maturity of the issues has remained the same at 10.0 years.

28. Financial markets experienced generally stable conditions during the greater part of 2006-07, *albeit* with some volatility in the second half amidst heightened activity as volumes increased steadily and interest rates firmed up in all segments. The uncollateralised call/notice money market experienced occasional tightness during the last quarter of the year. While call money rates exceeded 10.0 per cent through the last week of December 2006, they declined subsequently but stayed above the LAF corridor on all the days from the second week of January to the first week of February 2007, with a peak at 8.35 per cent on January 8, 2007. Although average call rates eased to 6.72 per cent in the second week of February, they firmed up thereafter and reached 7.91 per cent in the third week. While easy liquidity returned in the subsequent period up to the third week of March, call rates rose markedly from March 16, 2007 following advance tax outflows. Call rates peaked at 54.32 per cent on March 30, 2007. With the easing of liquidity conditions in the banking system in April, call rates moved back within the corridor and even below in the second week of April. The call rate firmed up again from April 17, 2007 on account of enhanced reserve requirements and expectations surrounding the forthcoming Annual Policy Statement for 2007-08. The overnight rates in the call money segment went above the LAF corridor intermittently during December-March 2006-07 and ranged between 6.64–12.96 per cent in January 2007, between 6.08–8.08 per cent in February 2007 and between 5.31–54.32 per cent in March 2007.

29. The overnight rates in the market repo and collateralised borrowing and lending obligations (CBLO) segments, which were around the lower end of the LAF rate corridor till May 2006, started hardening in June in responce to underlying liquidity conditions. Over the rest of the year, quarterly advance tax outflows, the build-up of the Centre's cash balances and changes in liquidity with the banking system on account of sustained credit demand resulted in sizeable shifts in liquidity conditions. Rates in the collateralised markets also moved towards the upper end of the LAF rate corridor. The interest rate in the call market moved up from an average of 5.69 per cent in April 2006 to 8.63 per cent in December 2006 and further to 14.07 per cent in March 2007. Interest rates in the CBLO and market repo segments rose from 5.23 per cent and 5.10 per cent, respectively, in April 2006 to 7.05 per cent and 7.47 per cent in December 2006 and further to 7.73 per cent and 8.13 per cent in March 2007. The daily average volume (one leg) in the call money market increased from Rs.7,890 crore in April 2006 to Rs.11,608 crore in March 2007. The corresponding volumes in the market repo (outside the LAF) were Rs.5,479 crore and Rs.8,687 crore, respectively, whereas in the CBLO segment, the volumes were Rs.16,327 crore and Rs.17,662 crore, respectively. As on April 20, 2007 the weighted average interest rate for CBLO, market repo and call rate stood at 9.80 per cent, 7.78 per cent and 7.85 per cent, respectively.

30. The weighted average discount rate on commercial paper (CP) increased from 8.6 per cent at end-March 2006 to 11.33 per cent at end-March 2007. The total outstanding amount of CPs increased from Rs.12,718 crore to Rs.17,333 crore during this period. The weighted average discount rate for certificates of deposit (CDs) increased from 8.62 per cent at end-March 2006 to 10.8 per cent in early-March 2007 accompanied by a significant increase in outstanding amounts from Rs.43,568 crore to Rs.92,468 crore.

31. In the Government securities market, the primary market yields of 91-day and 364-day Treasury Bills increased from 5.41 per cent and 5.90 per cent at end-April 2006 to 7.98 per cent each by March 2007. The 182-day Treasury Bill yield moved up from 5.61 per cent to 8.20 per cent during this period. The yield on Government securities with 1-year residual maturity in the secondary market increased from 6.22 per cent at end-April 2006 to 7.92 per cent by April 20, 2007. The yield on Government securities with 10-year residual maturity increased from 7.40 per cent in April 2006 to 8.09 per cent by April 20, 2007 while the yield on Government securities with 20-year residual maturity increased from 7.80 per cent to 8.34 per cent during the same period. Consequently, the yield spread between 10-year and 1-year Government securities came down from 118 basis points in April 2006 to 17 basis points on April 20, 2007. The yield spread between 20-year and 1-year Government securities also declined from 158 basis points to 42 basis points during this period. By mid-April 2007, the primary market yields of 91-day, 182-day and 364-day Treasury Bills stood at 7.48 per cent, 7.75 per cent and 7.70 per cent, respectively.

32. Interest rates on deposits of over one year maturity of public sector banks (PSBs) moved up from 5.75-7.25 per cent in April 2006 to 7.25-9.50 per cent in March 2007. Term deposits rates of up to one year for private sector banks moved from 3.50-7.25 per cent in April 2006 to 3.00-9.00 per cent in March 2007, while rates on deposits of one year and above moved from 6.00-7.75 per cent in April 2006 to 6.75-9.75 per cent in March 2007. The deposit rates of up to one year maturity for foreign banks increased from 3.00-5.75 per cent in April 2006 to 3.00-9.50 per cent in March 2007 and the deposit rates of more than one year maturity moved from 4.00-6.50 per cent to 3.50-9.50 per cent during the same period. In April 2007, PSBs and private sector banks increased their deposit rates at the longer end by 25-100 basis points for various maturities.

33. The benchmark prime lending rates (BPLRs) of PSBs and private sector banks increased from 10.25-11.25 per cent and 11.00-14.00 per cent to a range of 12.25-12.75 per cent and 12.00-16.50 per cent, respectively, during the same period. The BPLRs of foreign banks increased from 10.00-14.50 per cent in April 2006 to a range of 10.00-15.50 per cent in March 2007. The median lending rates for term loans (at which maximum business is contracted) in respect of PSBs moved from 8.00-11.63 per cent in March 2006 to 8.50-12.00 per cent in December 2006. In April 2007, PSBs and private sector banks increased their BPLRs by 25-75 basis points to the range of 12.50-13.50 per cent and 12.00-17.25 per cent, respectively.

34. Equity markets witnessed major swings during 2006-07. The BSE Sensex (1978-79=100) increased from 11,280 at end-March 2006 to the peak of 12,612 on May 10, 2006 after which it declined to a intra-year trough of 8,929 on June 14, 2006. It rebounded in subsequent months on institutional buying support, robust macroeconomic fundamentals and high private corporate profitability. The Sensex rallied with intermittent corrections to reach a high of 14,652 on February 8, 2007 but subsequently moderated to 13,072 by end-March 2007. As on April 20, 2007 the BSE Sensex stood at 13,897.

35. The Annual Policy Statement for the year 2006-07 had indicated that amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 were under consideration in order to provide greater flexibility in the conduct of monetary policy and to strengthen the regulatory powers of the Reserve Bank. The Reserve Bank of India Act, 1934 was amended in June 2006 with a view to enhancing the Reserve Bank's operational flexibility and providing it with greater manoeuvrability in monetary management. The Reserve Bank of India (Amendment) Act, 2006 gives discretion to the Reserve Bank to decide the percentage of scheduled banks' demand and time liabilities to be maintained as CRR without any ceiling or floor. Consequent to the amendment, no interest will be paid on CRR balances so as to enhance the efficacy of the CRR, as payment of interest attenuates its effectiveness as an instrument of monetary policy. The revised definition of

"repo" and "reverse repo" provided under the amendment would facilitate transactions of market participants/banks in these instruments. The amendment also provides the Reserve Bank with the statutory backing for regulating the money market and also for regulating trading of over-the-counter derivatives.

36. Consequent to the amendment, the Reserve Bank announced the removal of the floor of 3 per cent and ceiling of 20 per cent in respect of the CRR. Furthermore, it was announced that no interest shall be payable on CRR balances with effect from the fortnight beginning June 24, 2006. The Extraordinary Gazette notification, however, notified January 9, 2007 as the date on which all the provisions, except Section 3, of the Reserve Bank of India (Amendment) Act, 2006 shall come into force. Section 3 of the Reserve Bank of India (Amendment) Act, 2006 provided for the removal of the ceiling and floor on the CRR to be prescribed by the Reserve Bank as also the provisions for interest payment on eligible CRR balances. Pending the notifications of the relevant provisions, the floor and ceiling on CRR were restored and the Reserve Bank decided to pay interest on eligible CRR balances but consistent with the monetary policy stance and measures at relevant periods of time. The Reserve Bank also exempted those banks from payment of penal interest which had breached the statutory minimum CRR level of 3.0 per cent during June 22, 2006 to March 2, 2007.

37. The Government of India notified Section 3 of the Reserve Bank of India (Amendment) Act, 2006 and appointed the first day of April 2007 as the date on which the related provisions shall come into force. Pursuant to the notification of the relevant section, the floor and ceiling on CRR to be prescribed by the Reserve Bank no longer exist and the Reserve Bank decided, in view of the prevailing monetary conditions, to maintain *status quo* on the existing provisions of CRR maintenance, including the CRR rate and extant exemptions which will be operative till further change. The Reserve Bank has also indicated that no interest will be payable on CRR balances of banks with effect from the fortnight beginning March 31, 2007 consistent with the amendment.

38. Consequent upon the promulgation of the Banking Regulation (Amendment) Ordinance, 2007 dated January 23, 2007 Section 24 of the Banking Regulation Act, 1949 has been amended, which *inter alia* removed the floor rate of 25 per cent for statutory liquidity ratio (SLR) to be prescribed by the Reserve Bank and empowered it to determine the SLR-eligible assets, giving it more flexibility in its monetary management operations. The Ordinance has subsequently been repealed and replaced by the Banking Regulation (Amendment) Act, 2007 which received the assent of the President on March 26, 2007 and is deemed to have come into force on January 23, 2007.

39. As a part of the recent changes in the institutional framework of monetary policy in India and with a view to strengthening the consultative process, the Reserve Bank of India had constituted the Technical Advisory Committee (TAC) on Monetary Policy with external experts in the areas of monetary economics, central banking, financial markets and public finance in July 2005. In its quarterly meetings, the TAC reviewed macroeconomic and monetary developments and contributed to enriching the inputs and processes of policy setting and advised on the stance of monetary policy. After its tenure ended in January 2007, the Reserve Bank of India reconstituted the TAC with a view to obtaining continued benefit of expert opinion from the external experts with a tenure up to January 31, 2009. The reconstituted TAC has five external members and two members of the Central Board of the Reserve Bank. The Committee is chaired by the Governor, with the Deputy Governor in charge of monetary policy as vice-chairman and other Deputy Governors as members. The Committee would meet at least once in a quarter to review macroeconomic and monetary developments and advise on the stance of monetary policy. It may be noted that the TAC is advisory and provides guidance to the making of policy from time to time. As such, the responsibility, accountability and time paths for decision making are not formally constrained by the meetings of the TAC.

Developments in the External Sector

40. Balance of payments data released at the end of March 2007 indicate sustained strength and vibrancy in the external sector over the first nine months of 2006-07, reflecting the robust macroeconomic fundamentals. While merchandise export growth remained strong as in the past few years, it decelerated in US dollar terms to 22.5 per cent in April-December 2006 from 29.5 per cent in the corresponding period of 2005-06. The loss of momentum was mainly due to lower growth in exports of 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 36.2 per cent a year ago, mainly due to moderation of non-oil import growth to 18.6 per cent from 34.3 per cent in April-December 2005. Oil imports increased by 39.2 per cent as against 46.9 per cent during April-December 2005 with the persistent high growth in these imports due to elevated international crude oil prices and strong volume growth. Provisional information on commodity-wise imports available from the Directorate General of Commercial Intelligence and Statistics (DGCI&S) shows that imports of gold and silver increased by 21.3 per cent during April-November 2006 as against 27.4 per cent a year ago. The merchandise trade deficit increased to US $ 52.3 billion during April-December 2006 from US $ 40.1 billion in the corresponding period of 2005-06.

41. Net invisible earnings amounted to US $ 40.5 billion in April-December 2006 as against US $ 28.1 billion a year ago. 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 underpinned the strength of net invisible receipts. Within the category of invisible transactions, private transfers, comprising primarily remittances from Indians working overseas, remained sizeable at US $ 19.6 billion as compared with US $ 17.2 billion a year ago. Software export proceeds amounted to US $ 21.8 billion as against US $ 16.6 billion in April-December 2005. Non-software miscellaneous services also increased substantially to US $ 21.6 billion from US $ 14.7 billion a year ago. Invisible payments increased by 18.9 per cent mainly on account of payments for business services such as management consultancy, engineering, technical know-how and dividend and profit payouts. Reflecting these developments in the merchandise and invisible accounts, the current account deficit (CAD) at US $ 11.8 billion was broadly at the level in the corresponding period of the previous year.

42. Net capital inflows during April-December 2006 at US $ 27.3 billion comprised both debt and non-debt inflows. While net foreign direct investment (FDI) rose to US $ 5.8 billion from US $ 3.3 billion in April-December 2005, portfolio investment slowed down markedly from US $ 8.2 billion to US $ 5.2 billion over the same period, partly reflecting the impact of the stock market turbulence of May-June 2006. There was a major turnaround in external commercial borrowings (ECBs) which increased by US $ 9.1 billion as against a decline of US $ 1.2 billion in the previous year (which had included a one-off principal repayment of US $ 5.5 billion for India Millennium Deposits). Non-Resident Indian (NRI) deposits also registered a higher increase of US $ 3.2 billion than that of US $ 1.1 billion in April-December 2005. On the whole, debt flows (net) in the form of external assistance, external commercial borrowings (ECBs), NRI deposits and short-term credit put together increased substantially to US $ 14.5 billion in April-December 2006 from US $ 2.7 billion a year ago.

43. Net accretion to foreign exchange reserves, excluding valuation changes, amounted to US $ 16.2 billion during April-December 2006 as against US $ 1.8 billion in April-December 2005. Valuation gains, reflecting the appreciation of major currencies against the US dollar, accounted for US $ 9.4 billion of the total accretion to the reserves during April-December 2006 as against a valuation loss of US $ 6.1 billion in the corresponding period of 2005-06. The foreign exchange reserves, including valuation changes, recorded an increase of US $ 25.6 billion during April-December 2006 and rose to reach a level of US $ 199.2 billion by end-March 2007. As on April 13, 2007 the foreign exchange reserves stood at US $ 203.1 billion.

44. India's external debt increased by US $ 16.2 billion from end-March 2006 to US $ 142.7 billion at end-December 2006. The increase was mainly under ECBs (US $ 9.1 billion) and NRI deposits (US $ 3.2 billion). The ratio of short-term debt to total debt increased from 6.9 per cent in March 2006 to 7.0 per cent at end-December 2006.

45. Information available for subsequent months from the DGCI&S indicates that merchandise exports in US dollar terms increased by 19.3 per cent during 2006-07 (April-February) as compared with 26.3 per cent in the previous year. Imports showed an increase of 27.8 per cent as compared with 32.7 per cent in the previous year. While the increase in oil imports was lower at 32.6 per cent as compared with 49.7 per cent in the previous year, non-oil import growth at 25.7 per cent was comparable to 26.4 per cent in the previous year. During April-February 2006-07, the trade deficit widened to US $ 55.8 billion which was 48.5 per cent higher than the deficit of US $ 37.6 billion in the corresponding period of the previous year.

46. Updated information on capital flows shows that net FDI flows, accretions to NRI deposits, and capital issues under American Depository Receipts (ADRs)/ Global Depository Receipts (GDRs) continued to support capital inflows. Gross FDI inflows increased to US $ 16.4 billion during April-January 2006-07 from US $ 5.8 billion in the corresponding period in the previous year. It may be noted that the classification of flows under FDI includes sizeable investments from private equity funds and venture capital funds. Furthermore, one transaction amounting to US $ 3.1 billion involving swap of shares was reflected in both FDI inflows and outflows and, as such, did not have any net impact. Inflows on account of Foreign Institutional Investors (FIIs) moderated to US $ 3.2 billion during 2006-07 from US $ 9.9 billion during 2005-06. Net inflows under NRI deposits were US $ 3.7 billion during April-January 2006-07 as compared with inflows of US $ 1.7 billion during the corresponding period of 2005-06. ADR/GDR issues by Indian companies amounted to US $ 3.5 billion during April-January 2006-07 as compared with US $ 2.1 billion a year ago.

47. The Indian foreign exchange market has witnessed generally orderly conditions during 2006-07 and 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.43.59 by end-March 2007. The rupee-euro exchange rates depreciated from Rs.54.20 at end-March 2006 to Rs.58.14 by end-March 2007. Overall, during 2006-07, the rupee appreciated by 2.3 per cent against the US dollar and 2.7 per cent against the Japanese yen, but depreciated by 6.8 per cent against the euro and by 9.0 per cent against the pound sterling. As on April 20, 2007 the exchange rate of rupee was Rs.41.99 per US dollar, Rs.57.22 per euro, Rs.84.22 per pound sterling and Rs.35.36 per 100 Japanese yen.

48. 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

49. The world economy expanded strongly in 2006, shrugging off initial expectations of a deceleration in relation to 2005, and achieved a four-year run of sustained growth that began in 2003. Moreover, the expansion was broad-based; while the US economy slowed somewhat in the second half of the year, the momentum of growth in Europe and Japan continued to be firm. Robust growth in China and India led the strong macroeconomic performance of emerging and developing countries. Strong growth has also been recorded in low-income countries, especially in sub-Saharan Africa. The International Monetary Fund (IMF) has projected in its World Economic Outlook of April 2007 that global real GDP growth on a purchasing power parity basis is expected to decelerate from 5.4 per cent in 2006 to 4.9 per cent in 2007 and 2008. World real GDP growth, on the basis of market exchange rates, is estimated to decelerate from 3.9 per cent in 2006 to 3.4 per cent in 2007 before accelerating fractionally to 3.5 per cent in 2008.

50. In the US, real GDP rose by 3.3 per cent in 2006 as compared with 3.2 per cent in 2005. Acceleration in consumer and government spending, exports and a downturn in imports underpinned the growth momentum, offset partially by lower investment in inventories, equipment and software. Despite heightened risks from the contraction in housing, the US economy is expected to achieve moderate growth in 2007 as indicated by high employment and industrial output data in the first quarter, with continuing upside risks to inflation. Continuing weakness in the housing market and volatility in the major stock indices remain a cause for concern. Real GDP growth in the euro area picked up to 2.6 per cent in 2006 from 1.4 per cent in 2005 and is expected to grow by 2.3 per cent in 2007. Growth in the euro area is expected to be fuelled by consumer spending on the back of increased hiring and spending in major European countries, indicating improved consumer confidence. The unemployment rate in the eurozone fell in February to 7.3 per cent - the lowest level since 1993. While fiscal deficits in the EU states have been narrowing and there is a likelihood of continuing appreciation of the euro, risks to the medium-term outlook for price stability remain and could tighten monetary conditions in the euro area, going forward. The Japanese economy grew by 2.2 per cent in 2006 and is expected to grow by 2.3 per cent in 2007.

According to the Bank of Japan, the economy is expanding moderately, aided by increasing public investment, buoyant exports and business fixed investment fed by high corporate profits, firm trends in private consumption and a moderate increase in housing investment. With the rise in demand, both at home and abroad, production has also been on an increasing trend and this is expected to continue.

51. In the emerging market economies (EMEs), growth has continued to be firm on account of availability of financial resources, strong commodity prices and abundant global liquidity. Concerns have, however, arisen regarding the sustainability of some of these factors. Growth forecasts for 2007 continue to be optimistic, but some uncertainties persist, especially with the Chinese economy which accelerated by 10.7 per cent in 2006 and contributed about a tenth of global growth, marking the fourth consecutive year of growth of at least 10 per cent. Inflation in China for 2006 was at 2.8 per cent. While China is expected to grow by 10.0 per cent in 2007 with inflation at 2.2 per cent, this growth is perceived to be unstable and environmentally unsustainable by Chinese authorities. High investment growth, excessive lending, overhang of liquidity, strengthening retail demand and imbalances in trade and international payments were some of the factors causing concern. China ran a record US $ 177.5 billion trade surplus in 2006 which has contributed to the overhang of liquidity in the economy. Consumer price inflation has risen steadily from less than 1 per cent in February 2006 to 3.3 per cent in March 2007. In the first quarter of 2007, the Chinese economy accelerated by 11.1 per cent, following which the Chinese authorities aim to take further steps to keep the economy from overheating. The People's Bank of China has raised interest rates three times since April 2006 to reach 6.39 per cent and has raised cash reserve requirements six times in the past one year to reach 10.5 per cent. Any slowdown in the Chinese economy would ultimately affect the countries which supply inputs for manufacturing activity in China.

52. Among the other major Asian economies, 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 accelerated in 2007 to 2.20 per cent in March from 1.70 per cent in January. The Bank of Korea (BoK) has already taken tightening steps in 2006 by raising its policy rate to 4.5 per cent, increasing reserve requirements and cutting the ceiling on aggregate loans to commercial banks by 20 per cent for lending to small and medium enterprises. Korean authorities are concerned about the steady rise in property prices in recent months. A series of measures were announced in January 2007 to stabilise property prices: restricting mortgage loan issuance to one contract per person, introduction of price ceilings on new houses, and disclosure of construction cost of new homes.

53. In Thailand, slowing demand has led the Bank of Thailand (BoT) to cut its growth forecasts for 2007 to 4.5 per cent from 5.0 per cent recorded in 2006. Headline inflation had been gradually easing during 2006 and 2007 (up to March 2007) in response to policy rate increases in January 2006, March 2006, April 2006 and June 2006. The BoT introduced a series of measures to stem strong capital inflows into the economy in 2006. To enhance the efficiency and transparency of the BoT's monetary policy implementation as well as to facilitate continued development of the Thai financial markets, the MPC changed the policy rate to the 1-day repurchase rate, instead of the 14-day repurchase rate, effective from January 17, 2007. In order to stimulate the economy, BoT has cut this policy rate by 100 basis points since January 2007.

54. Most Asian EMEs (AEMEs) have recorded strong growth with reasonably well-anchored inflation expectations, aided by strong global demand for their exports, favourable terms of trade, easy access to external financing and comfortable foreign currency reserves along with reduced external debt as percentage of GDP. Their banking systems have also been strengthened through improved restructuring and supervisory systems. The resilience to external shocks is reinforced by a combination of lower balance sheet exposure to exchange rate risks, lower refinancing risks in debt structures, strong financial systems and with greater policy flexibility. However, there are several challenges facing these fast-growing AEMEs. Concerns about inflationary pressures are being reinforced by ample liquidity and rapidly rising credit, largely driven by excess capital flows. The existence of significant current account surpluses in many AEMEs and large capital flows in recent months and years have posed new challenges for macroeconomic and external sector management in these countries. Just as capital flows are robust at the present time, partly reflecting accommodative monetary policies in the mature economies in recent years, such flows do have the potential of reversing rapidly in response to the withdrawal of monetary accommodation now taking place. In response to these dilemmas, each AEME has evolved its own mix of policies so as to manage rather than resolve them. The currency appreciation or depreciation of countries enjoying current account surplus could, at times, be steep and sudden, resulting in possible disruption in the real sector. Therefore, they have felt the need for containing excess volatility in foreign exchange markets through foreign exchange market intervention accompanied by sterilisation. However, such policies have their own limitations and such actions have also been accompanied by differing strategies for liquidity management, including raising cash reserve requirements, issuances of central bank securities, ceilings on lending to specific sectors, the use of prudential tools and the like. Furthermore, aligning the operations of large financial conglomerates and foreign institutions with local public policy priorities remains a challenge for domestic financial regulators in many AEMEs.

55. International foodgrains prices, in particular, wheat and maize, scaled record levels in 2006 as global cereal output fell by 2.7 per cent from the previous year, largely due to reduced plantings and adverse weather conditions in some of the world's major producing and exporting countries, including the United States, several European countries and Australia. With the overall strength of demand *vis-à-vis* supply and low stock positions the world over, global wheat prices are expected to rise further. Apart from weather conditions, fast growing demand for bio-fuel production has also led to excessive demand and high prices for grains. The strong demand for grains from bio-fuels has contributed to the fall in global corn and wheat stockpiles to about 25-year lows in terms of days of consumption. International prices of wheat (and products thereof such as flour) have been steadily rising in recent months. There are, however, favourable prospects for world cereal crops in 2007, mainly following expansion of plantings in Europe and North America, coupled with generally satisfactory weather conditions. Although the bulk of the decline in world cereal output in 2006 was among the major producing and exporting countries, cereal production in low-income food-deficit countries increased significantly. As a result, cereal import requirements, including food aid, declined in 2006-07 in many of these countries, mostly in Africa. World trade in wheat in 2006-07 has remained at the high levels recorded in the previous year, mainly due to larger imports by Brazil and India. Corn prices doubled since the start of 2006 and reached a 10-year high in March whereas wheat futures prices reached a 10-year high in February. Current high prices are expected to spur large crops and more abundant world stocks.

56. Metal prices have increased by 4.0 per cent during the first three months of 2007, over and above the increase of 53.6 per cent in 2006 and 36.2 per cent in 2005. Low stock levels, increasing demand and the recent firmness in crude oil prices have kept most metal prices high and these high levels are likely to persist in the near term. Gold prices, which had sharply risen to their highest level in 26 years in May 2006, are expected to remain firm in 2007 because of contracting mine supply, an expected decline in the dollar and lower sales by Europe's central banks.

57. Spot crude oil prices softened from the July-August 2006 peak of US $ 78 per barrel to around US $ 53 per barrel in January 2007 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 2006. Thereafter, crude prices have gone up to US $ 63.5 per barrel on April 20, 2007 due to geopolitical tensions in the Middle East. In April 2007, the Energy International Administration has projected that the West Texas Intermediate (WTI) crude oil price would be at US $ 63.9 per barrel in 2007 and US $ 63.83 per barrel in 2008.

58. In the US, consumer prices increased from 2.0 per cent in November 2006 to 2.8 per cent in March 2007. In the Euro area, inflation declined from 2.3 per cent during August 2006 to 1.9 per cent in March 2007. Inflation turned negative in Japan to -0.2 per cent in February 2007 from 0.9 per cent in August 2006. In the UK, inflation has been exceeding the target of 2.0 per cent since May 2006 and stood at 3.1 per cent in March 2007 following which the Governor of the Bank of England has written an open letter to the Chancellor on April 16, 2007, as required by the monetary policy remit. The letter explains that the rise in inflation to 3.1 per cent from 1.8 per cent a year ago was due to a sharp increase in domestic energy prices in the second half of 2006, rise in food prices, recovery in pricing power of corporates and spending, and capacity pressures. The letter also states that, at its May meeting, the Monetary Policy Committee will have an opportunity to assess the inflation and other data before reaching its next decision on interest rate. In the April meeting of the MPC held on April 5, 2007 the BoE had kept its repo rate unchanged at 5.25 per cent. At the retail level, RPI inflation rose to 4.8 per cent in the UK in March 2007 - the highest since 1991.

59. The acceleration in headline inflation in the US was reflected in core inflation, indicating that underlying inflationary pressures persist. Core inflation in March 2007 was 2.5 per cent as against 2.7 per cent in February 2007. In the UK, core inflation has been increasing in tandem with the headline rate and stood at 1.9 per cent in March, up from 1.7 per cent in February 2007. In the Euro area, core inflation has remained at the level of 1.9 per cent in March – the same as in February 2007. Core inflation in Japan was negative (-0.30 per cent) in February 2007 as compared with no change in January 2007. Globally, headline inflation has picked up in the wake of increase in commodity prices, and core inflation has also generally remained firm. This is likely to pose risks to inflation expectations as international crude prices have started rising again.

60. Despite the good growth prospects for the global economy for 2007, it must be recognised that the growth projected for 2007 involves a deceleration of about 0.5 per cent from 5.4 per cent in 2006 to 4.9 per cent in 2007. In addition, there are a number of risks emanating from the behaviour of oil prices, adverse developments in the US housing market, persistence of global imbalances, large leveraged positions in financial markets, and possible emergence of inflationary pressures. It is important to recognise the risk of an abrupt and disorderly adjustment of global payments imbalances, particularly between the US and Asia. With financial globalisation, the exposure of emerging markets to risky financial assets in mature markets has increased. Similarly, the risk appetite of institutional investors has also increased in search of higher yields. This is reflected in the compression of spreads for emerging market financing which cannot be fully justified by improved fundamentals. Overall, the financial risks have increased. In the event of a loss of risk

appetite and consequent unwinding of leveraged positions, there could be serious adverse effects in emerging markets.

61. Volatility in international financial markets has increased in recent months with notably, a sharp pick-up in loan arrears in sub-prime residential mortgages in the US, the deterioration in asset values of hedge funds and global stock market turbulence. In addition, complex derivative products, widely used by hedge funds to manage risks, have diffused these risks and complicated the challenge facing regulators. The announcement of measures to control stock market activities in China at end-February 2007 led to a sharp fall in the Chinese stock market and widespread turmoil in the global capital markets, including capital markets in the developed economies. The Chicago Board Options Exchange Volatility Index rose sharply during the turmoil as investors displayed shared anxiety about the stock market, underlining the extent of global integration in recent years. If the recent sell-off is compared to the event in May-June 2006, it emerges that the initial conditions in both the cases were similar where the stock markets had reached very high levels of valuation and were looking for a trigger to correct. However, the reasons starting the sell-off were somewhat different. In May-June 2006, concerns about tightening of monetary policy globally, especially in the US and sharp declines in record-level global commodity prices led to the fall in stock prices. In the February 27, 2007 episode, the announcements by Chinese authorities and subsequent correction in the Chinese market acted as the trigger for decline in all the markets. The initial fall was exacerbated by the strengthening of the yen, following the Japanese policy rate increase on February 21, 2007 which led to some unwinding of carry trade on anticipation of decline in profitability.

62. Looking ahead, it is important to recognise market concerns that the reversal of carry trades may intensify further, portending a liquidity crisis. These developments cast a shadow on the short-term prospects for EMEs if there is a flight to safety by global funds, as in the May-June 2006 sell-off. World stock markets have regained buoyancy and growth by April 2007. The Dow Jones Industrial Average rose to a record level by April 19, 2007 on the back of strong corporate results, and favourable news about the housing sector and inflation in the US. Financial markets have reacted relatively calmly to events that, in the past, might have been the catalyst for disruptive adjustments.

63. Recent developments have also seen a small rise in credit spreads on emerging market debt and lower-rated corporate debt, but these spreads remain at levels that are historically low. For lower-rated corporate bonds in the United States, spreads have fallen by about two-thirds since late 2002, with the default rate on high-yield bonds reaching a 25-year low of 1.57 per cent in 2006. Since 2002, spreads on emerging market sovereign bonds have also fallen noticeably.

64. The levels of government bond yields in the major economies also remain low. The US 10-year bond yield increased from 4.70 per cent at end-December 2006 to 4.78 per cent in April 20, 2007, reducing the extent of inversion of the yield curve. The 10-year bond yield in the Euro area increased from 3.95 per cent at end-December to 4.20 per cent. The Japanese 10-year bond yield has increased from 1.68 per cent at end-December to 1.69 per cent. On a trade-weighted basis, the US dollar which had depreciated during October-December, rose to a seven-week high against major currencies on January 9, 2007 following concerns expressed by Fed officials about inflation, but has eased in the subsequent weeks recording a 15-year low against the British pound on April 17, 2007.

65. 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, giving rise to continuing global imbalances. 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 and abundant liquidity, investors have been prepared to purchase risky assets at relatively high prices. The perceived risks arising mainly out of the prospects of withdrawal of liquidity and global imbalances does not appear to be reflected in the pricing of risks. Also, monitoring risks has become very difficult for the regulators, due to emergence of large conglomerates, sophisticated market instruments such as derivatives, presence of players like hedge funds and shifting of financial risks from well-regulated to weakly or less regulated segments.

66. By and large, globally 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 in asset prices, underpricing of risks and disorderly conditions in currency markets. They have generally displayed a preparedness to act pre-emptively against the possibility of these risks materialising.

67. Some central banks have recently paused in their policy cycles, particularly the US. The pause of the Federal Reserve during August 2006-March 2007 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); 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).

68. Some other central banks have cut back their policy rates in recent months, usually on the back of earlier strong actions to contain inflation. These include Bank Indonesia (BI) (BI rate reduced from 12.50 per cent in May 2006 to 9.00 per cent in March 2007); the Banco Central do Brasil (Selic rate target cut between September 2005 and April 2007 to 12.50 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 4.75 per cent to 4.50 per cent in February 2007 and further to 4.00 per cent in April 2007).

69. The central banks that have tightened their policy rates include the ECB which has raised its policy rates seven times since December 2005 by 25 basis points each to 3.75 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 Bank of Japan (uncollateralised overnight rate target at 0.25 and 0.50 per cent since July 2006 and February 2007, respectively, after maintaining a zero interest rate policy since September 2001); the Reserve Bank of Australia (Cash Rate raised by 25 basis points each in August and November 2006 to 6.25 per cent); the Reserve Bank of New Zealand (Official Cash Rate raised to 7.50 per cent by two 25 basis points hikes in December 2005 and March 2007); the People's Bank of China (lending rate raised thrice to 6.39 per cent by March 19, 2007); and the Bank of Korea (target overnight call rate raised by 25 basis points to 4.50 per cent on August 10, 2006).

70. A few central banks have reinforced the increases in key policy rates with increases in reserve requirements. In China, the required reserve ratio was raised by 50 basis points each effective from July 5, August 15, November 15, 2006, January 15, 2007, February 25, 2007 and April 16, 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

71. The distinguishing feature of India's macroeconomic performance in 2006-07 has been the strong acceleration of growth. Industry and services, comprising 82 per cent of the economy, registered double-digit growth. The step-up in the overall growth momentum, setbacks to agriculture notwithstanding, occurred *inter alia* in an environment of building international interest, and rising business and consumer confidence domestically, in the strength and dynamism of the economy. Real GDP growth, which averaged under three per cent in the 1970s picked up to 5.8 per cent in the 1980s and 1990s but lost pace in the subsequent period and slowed to 4.6 per cent in 2000-03. Since then, however, there seems to have occurred an upward shift in trajectory, with real GDP growth averaging 8.5 per cent in the period 2003-04 to 2006-07.

72. While there seems to be evidence of structural changes taking place in the economy, there are indications that the upsurge of demand pressures in 2006-07 may contain a cyclical component. First, as regards structural changes, the recent growth momentum is driven by a step-up in the investment rate, which, in turn, is supported by a sizeable increase in the rate of gross domestic saving. This noteworthy improvement is attributable mainly to a distinct increase in corporate saving, reflecting the sustained 18-quarter buoyancy in corporate profitability which has provided internally generated resources for investment funding. Another positive development is the turnaround in public sector dissaving from 2003-04 onwards. Household saving continues to remain the mainstay of gross domestic saving. Second, India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy. The ratio of merchandise exports to GDP has been rising since the 1990s reflecting growing international competitiveness. This has been supported by buoyancy in export of software and business services, indicative of the knowledge advantage and the sophistication setting into the domestic services sector. At the same time, the ratio of imports (including services) to GDP has been steadily rising as domestic entities have expanded access to internationally available raw material and intermediate goods as well as quality inputs for providing the cutting edge to domestic production and export capabilities. Sustained inflows of capital, reflecting the international confidence in macro fundamentals of the economy, have considerably eased the external financing constraint, enabling steady accretions to foreign exchange reserves that have taken their level to 12.5 months of imports or 124.3 per cent of external debt. Third, there are indications of some improvement in capital use, a turnaround in total factor productivity in manufacturing since 2002-03, restructuring during the period 1996-2003, and a steady improvement in productivity growth in the services sector.

73. At the same time, it is important to take note of various cyclical factors underlying the recent growth experience. First, robust global GDP growth, which exhibited four years of strong expansion has been supportive of high growth in India. Second, the persistent high growth in bank credit and money supply, the pick-up in non-oil import growth and the widening of the trade deficit in recent years together indicate upside pressures on aggregate demand. Third, cyclical forces are also evident in the steady increase in prices of manufactures, resurgence of pricing power among corporates, indications of wage pressures in some sectors, strained capacity utilisation and elevated asset prices.

74. Against this backdrop, it is important to assess the optimism generated by India's recent macroeconomic performance against the evolving configuration of risks which are likely to shape the outlook. First, the buoyant growth in industry and services has been somewhat marred by the setback to agriculture which has suffered substantial deceleration and instability. It is now widely recognised that the performance of agriculture is critical not only for output and employment but also, particularly for price stability. There has been a virtual stagnation in the output of major food crops such as rice, wheat, pulses and oilseeds over the past decade. In the more recent period, shortfalls in wheat (accompanied by depleting stocks), oilseeds and pulses have emerged and the supply situation in respect of these crops is further complicated on account of weather related adverse international conditions. The decline in the global production of wheat in 2006 has turned out to be the largest in ten years with depletion in carry over stocks and loss of cereal acreage in favour of bio-fuel production.

75. Second, in the domestic economy, there are indications that supply constraints are impacting the growth momentum. Alongside shortfalls in agricultural performance, large gaps have emerged in the physical infrastructure. In fact, infrastructural bottlenecks are emerging as the single most important constraint on the Indian economy. Rapid growth in demand for infrastructure with a less than proportionate supply response in the prevailing investment climate has resulted in stretching capacity utilisation in electricity generation, roads, ports and major airports to overheating. Against the targeted capacity addition of 41,110 megawatts of electricity over the period 2002-07, the actual capacity addition has been less than 57 per cent, taking the peak electricity deficit to an eight year high in 2006-07. Capacity addition in roads and highways has been delayed over the last two years. Seaports are reported to be operating at close to full capacity utilisation. Capacity constraints at the major airports in Mumbai and Delhi are causing restrictions to be imposed on the number of flights that can be operated during peak hours by domestic airlines. Managing the supply situation is emerging as a formidable challenge, especially as constraints on the supply response to the momentum of growth have become more binding than before.

76. Third, a significant worrisome feature of domestic developments in 2006-07 is the firming up of inflation through the year. Currently ruling above indicative projections in terms of wholesale prices and at unconscionable levels in terms of consumer prices, inflation represents the key downside risk to the evolving macroeconomic outlook. It is important to undertake a careful assessment of the manner in which inflation is evolving. Primary food articles, unlike in recent years, have contributed significantly to inflation during 2006-07. Accounting for a fourth of headline WPI inflation, they can be interpreted to originate from supply side pressures, including the cost push imposed by the international prices of cereals. At the same time, prices of manufactured products account for well above 50 per cent of headline inflation. Strains on domestic production capacities in respect of basic and intermediate goods imposed by the industrial growth momentum are showing up as inflationary pressures, contributing roughly a quarter of the headline WPI increase. Domestic prices are firming up in sympathy with international prices. In conjunction with emerging strains on capacity, elevated asset prices and the surging demand for bank credit, the rising prices of manufactures constitute the demand pressures on inflation. The recent hardening of international crude prices has heightened the uncertainty surrounding the inflation outlook and has brought forward the need to prepare for the potential consequences for domestic prices of petroleum products and second round effects. Globally too, policy authorities are bracing up to the increasing probability of a renewal of escalation in international crude prices even while core inflation has generally remained firm.

77. Monetary and financial conditions are reflecting these demand-supply gaps as well as the onset of a durable pick-up in aggregate spending. Banks' non-food credit is beginning to dip after expanding above 30 per cent for three years in succession, driving up money supply and squeezing overall liquidity. The growth of bank credit has favoured retail lending, particularly housing, real estate, trade, transport and professional services and non-banking financial companies – sectors which hitherto were not significant in the credit market. While banks' exposures to some of these new sectors is still relatively small, given the low base, the high rates of growth have raised worries about the quality of these assets and potential non-performance. Default rates in regard to credit card receivables and personal loans have been rising. While buoyant deposit growth has, to an extent, alleviated the financial constraints on banks, incremental non-food credit deposit ratios remain high and investments in gilts have been drawn down to close to the statutory minimum of the SLR. These developments are likely to pose challenges to banks in managing liquidity.

78. Financial markets have experienced some volatility in the fourth quarter of 2006-07 alongside sizeable swings in liquidity and a hardening of interest rates across the spectrum. Money markets experienced spells of tightening of liquidity in November, from mid-December to early February and again in the second half of March 2007, interspersed with periods of easing. During episodes of tightness, contrasting conditions were often observed when short-term interest rates had firmed up despite the availability of funds through the LAF, but long-term rates had declined in the Government securities market. From December onwards, there was an inversion of the yield curve and a narrowing of yield spreads. Forward premia firmed up 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.

79. Global real GDP growth, both at market exchange rates and on a purchasing power parity basis, is expected to decelerate by about 50 basis points relative to the preceding year. In the mature economies, continuing weaknesses in housing markets and volatility in equity markets remain concerns in the context of the growth outlook. In the emerging economies, there are heightened concerns about the sustainability of capital flows, commodity prices and global liquidity, with potential adverse consequences for otherwise firm growth prospects. International foodgrains prices have risen to record levels and global cereal output has declined. Low stocks and rising demand have kept most metal prices at elevated levels which could persist in the near term. International crude prices have firmed up recently and remain highly volatile, reflecting geopolitical tensions, with implications for inflation expectations. Headline inflation has picked up globally and core inflation has remained firm.

80. Volatility in international financial markets has increased in recent months with deterioration in the sub-prime segment of the US mortgage market in early 2007, concerns on systemic implications of hedge fund failures and the wide diffusion of risks through derivative markets. There are also worries that a sharp reversal of carry trades could precipitate liquidity stress and affect near-term prospects of emerging market economies, should there occur a generalised search for safe haven. Risk spreads are at historically low levels and the dispersion of credit risks obscures an understanding of where the risks ultimately lie. Consequently, monitoring of risks has become much more complex than before. There are, therefore, serious concerns that financial markets/investors may be assigning insufficient weight to downside risks.

81. While capital flows to emerging market economies and, in particular, to Asia in 2006 have reflected the improvement in macroeconomic performance, they were also driven by a search for yields and a stronger appetite for risk. Consequently, reversals of capital flows can pose challenges to emerging economies, particularly in the context of withdrawal of monetary accommodation in developed economies. It is useful to evaluate the challenges and risks from capital flows in the context of underlying global developments. Since the technology stocks meltdown in 2000, there has been a massive monetary accommodation by the major economies – the US, Euro area and Japan – and it is estimated that between one-half and two-thirds of US currency supply is held outside the US. There is clear evidence of abundant excess liquidity reflected in the macro imbalances between the US and Asia. It is important to recognise that while India has a current account deficit, most of the rest of Asia runs surpluses. Consequently, while the overall imbalances *vis-à-vis* the rest of the world in India and the rest of Asia are not different, given the current account situation, real sector implications for India as a result of the excess liquidity flowing out of mature economies, need to be carefully assessed.

82. Monetary policy in India has to also contend with the burden of challenges emanating from other sectors. First, it is recognised that monetary policy has to bear the burden of fiscal dominance. Fiscal imbalances remain large by international standards and have to be managed in a non-disruptive manner, keeping in view the interaction of the financial markets and the real economy as well as the given legal, institutional and public policy environment. However, the recent salutary improvement in the fiscal position of States and significant consolidation in the finances of the Centre have alleviated the extent of the burden that monetary policy has to bear on this account.

83. Second, as pointed out in the Third Quarter Review of January 2007 the enduring strength of foreign exchange inflows has complicated the conduct of monetary policy. In the event of demand pressures building up, increases in interest rates may be advocated to preserve and sustain growth in a non-inflationary manner. Such monetary policy responses, however, increase the possibility of further capital inflows, apart from the associated costs for growth and potential risks to financial stability. Thus, foreign exchange inflows can potentially reduce the efficacy of monetary policy tightening by expanding liquidity.

84. Third, in India, levels of livelihood of large sections of the population are inadequate to withstand sharp financial fluctuations which impact real activity. Accordingly, monetary policy has to also bear the burden of protecting these segments of the economy from volatility in financial markets often related to sudden shifts in capital flows.

85. Fourth, a situation in which aggregate supply is not elastic domestically imposes an additional burden on monetary policy. While open trade has expanded the supply potential of several economies, it does not seem to have had any significant short-term salutary effect on supply elasticities. There is a view that monetary policy cannot impact supply conditions and, therefore, should not react to supply pressures. In this context, it is important to take note of caveats to this view. If supply is inadequate in relation to demand, even a normal level of demand shows up as excess demand, warranting a policy response. Moreover, there are some commodities and services to which headline inflation is sensitive. Accordingly, persisting supply shocks to prices of these commodities can impart a lasting impact on inflation expectations. It is for this reason that monetary policy has to focus on the permanent component of supply shocks to the inflation process. If there is a supply side problem and the assessment is that it is merely a temporary disruption of supply, it is in order for monetary policy to treat it as a supply shock. Faced with longer term, structural bottlenecks in supply with less than adequate assurance of timely, convincing and demonstrated resolution, monetary policy has to respond appropriately. The burden and the dilemmas, in fact, are greater in the event of a structural supply problem on account of its persistent effects on inflation.

86. It is useful to recall the several complexities affecting the conduct of monetary policy at the current juncture. First, globalisation has brought in its train considerable fuzziness in reading underlying macroeconomic and financial developments, obscuring signals from financial prices and clouding the monetary authority's gauge of the performance of the real economy. Consequently, dealing with the impossible trinity of fixed exchange rates, open capital accounts and discretion in monetary policy has become more complex than before. Second, there is considerable difficulty faced by monetary authorities across the world in detecting and measuring inflation, especially inflation expectations. Third, global macro imbalances have increased even as financial markets have remained benign and continue to under-price the risks that these imbalances contain. Fourth, global growth has remained strong in spite of elevated crude and asset prices, amplifying the uncertainty surrounding the prospects of resolution. Fifth, despite sizeable movements in major international currencies, the pass-through to domestic inflation has been muted.

87. The operation of monetary policy in India is also constrained by some uncertainties in transmission of policy signals to the economy. First, despite the progressive deregulation since the early 1990s, some categories of interest rates continue to be administered, thereby muting the impact of monetary policy on the structure of interest rates. Second, external sector management is complicated by the incentives for some elements of capital flows provided by public policy setting. Thus, the magnitudes and direction of capital flows to select sectors in the domestic economy are beset with uncertainties in regard to the global and domestic environment not necessarily related to economic fundamentals or the monetary policy setting. Third, the operation of monetary policy has to be oriented around the predominantly public sector ownership of the banking system which plays a critical role not only in the transmission of monetary policy signals but also in other public policy considerations.

88. To sum up the assessment, global growth is strong but expected to moderate in 2007 relative to 2006. Inflationary pressures are evident along with elevated levels of commoditty and asset prices and the withdrawal of monetary accommodation is likely to persist. In the global financial markets, current indications suggest that the risks, including geopolitical risks, remain under-priced and diffused. On the domestic front, there is evidence of some cyclical elements though a significant structural change is taking place in the Indian economy. There is a gathering confidence that the economy is possibly poised on the threshold of a step-up in the growth trajectory. However, demand pressures appear to have intensified alongside robust growth and there are increased supply side pressures in evidence.

II. Stance of Monetary Policy for 2007-08

89. Against the backdrop of sustained momentum of growth in the industrial and service sectors, somewhat clouded by supply pressures from deceleration in agriculture, the Third Quarter Review of January 31, 2007 noted that the outlook for inflation assumes criticality in terms of policy monitoring and action. A judicious balancing of weights assigned to monetary policy objectives warranted priority to stability to support growth on a sustained basis. At the time of the Third Quarter Review, the conduct of monetary policy was confronted with a variety of challenges; demand pressures appeared to have intensified; and increased supply side pressures in terms of primary articles as well as some manufactured items seemed to be in evidence. Recognising the lagged response of productive capacity and infrastructure to the ongoing expansion in investment, the Third Quarter Review warned of the possibility of accentuation of inflationary pressures in the period ahead. Drawing from the analysis of inflation dynamics, it was emphasised that effective

containment of inflation is best served by a combination of fiscal, external and supply management policies supplemented and complemented by ongoing monetary measures.

90. It was indicated that inflation, to the extent it is a monetary phenomenon, demands appropriate timely and credible monetary policy actions. Timing of measures is key, conditioned by the recognition that monetary policy operates cumulatively and with variable, often long, lags. Accordingly, a three-pronged approach was adopted in the Third Quarter Review – a measured 25 basis points increase in the LAF repo rate to address demand pressures; enhanced provisioning requirements and risk weights in specific sectors to shore up the quality of credit in the context of persisting high growth in bank credit; and, tightening of ceilings on interest rates on non-resident deposits coupled with prohibition on fresh loans in excess of a specified threshold to depositors or third parties so as to modulate these interest-sensitive inflows from abroad to ensure effective liquidity management. The overall stance of monetary policy for the period ahead reinforced the emphasis on price stability and well-anchored inflation expectations so as to enable continuation of the growth momentum. The priority assigned to credit quality and orderly financial markets was reinforced alongside the pursuit of greater credit penetration and financial inclusion. The policy stance was underpinned by a commitment to respond swiftly with all possible measures to developments impinging on inflation expectations and the growth momentum.

91. In the aftermath of the issue of the Third Quarter Review, some notable developments prompted a swift reinforcement of the monetary policy stance. With the pace of growth accelerating further as reflected in the buoyancy in industrial output and non-food bank credit, concerns about the accentuation of excess demand pressures seemed to be considerably heightened, particularly with the tightening of the supply constraints. Headline inflation surged to a two-year peak by end-January, with potential upside risks to inflation expectations and, therefore, warranting an immediate policy response. In sharp contrast, aggregate deposit growth rose to a 11-year high as banks aggressively mobilised funds to support over-extended credit portfolios. Consequently, the liquidity adjustment facility (LAF), which had been in an injection mode persistently during January 7–February 7, 2007 flipped into absorption mode in the following week (February 8-13) with additional liquidity absorbed under the MSS. Reflecting the large reversal of liquidity, the call money rate which was ruling 25-85 basis points above the repo rate, eased below the middle of the LAF corridor, indicating easing of liquidity conditions. It was considered necessary on February 13, 2007 to increase the CRR in two stages of 25 basis points each effective from the fortnights beginning February 17 and March 3, 2007. The increase in the CRR was intended to drain excess liquidity, pre-empt the stoking of demand pressures and contain inflation expectations. It was also consistent

with the stance set out in the Third Quarter Review of responding swiftly to developments impinging on inflation expectations and the growth momentum.

92. Liquidity conditions emerged in the ensuing period as the dominant feature of the evolving situation. Consequently, liquidity management assumed priority in the policy hierarchy as prognosticated in the Third Quarter Review. Despite the cumulative increase in the CRR of 100 basis points between December 23, 2006 – March 3, 2007 which absorbed close to Rs.30,000 crore, the LAF continued to remain in sizeable absorption mode, indicating the continued prevalence of surplus liquidity in financial markets. A two-tiered approach was adopted on March 2, 2007 to deal with the large swings in liquidity and the analytical assessment of some durability in external inflows. First, it was decided to modulate the mix of Treasury bills and dated securities issued under the MSS with a view to draining away, for relatively longer periods, liquidity associated with those flows that were deemed to be of a more durable character. Accordingly, dated MSS securities amounting to Rs.16,000 crore with average residual maturity of 2.4 years were issued in March 2007 in addition to calendar-based Treasury bill auctions within the annual ceiling resulting in a total absorption of Rs.64,863 crore. Additional dated securities amounting to Rs.9,000 crore were issued in April 2007 (up to April 20, 2007). In view of the augmented and more active MSS operations envisaged, daily liquidity absorption under the LAF was restricted to a ceiling of Rs.3,000 crore. In consonance with this measure, strict adherence to LAF business rules was underscored. It was also indicated that the recourse to the LAF by market participants should not be persistent in order to fund balance sheets for credit needs of customers. Banks can utilise the LAF for inter-bank lending as part of normal money market functioning for management of temporary mismatches.

93. While indications of the sustained momentum of growth continued to firm up, inflation in terms of the WPI ruled stubbornly around 6.5 per cent up to March 23, 2007 with this persistence threatening to impact inflation expectations. In terms of consumer prices, inflation was even higher in the range of 7.6-9.8 per cent. Other indicators of demand pressures were also emitting warning signals - money supply at 22.0 per cent; non-food credit growth at 29.5 per cent; capacity constraints; pending import orders; pricing power of corporates as exemplified in the cement and steel sectors; wage pressures in some sectors; and rising input costs. Alongside these developments, there were large swings in liquidity and associated heightened volatility in the financial markets inconsistent with the prevailing monetary policy stance of tightening aggregate demand conditions to contain inflationary pressures and stabilise expectations. In spite of sizeable injections through the LAF, call money rates spiked to 50-60 per cent. There was also a large build-up of the cash balances of the Government with the Reserve Bank to Rs.77,726 crore on March 22,

2007 and the unwinding of these balances thereafter portended a large reversal of liquidity in April and a return to sizeable surplus conditions. In April 2006, *i.e.*, a year ago, the reversal of these cash balances and consequent injection of liquidity into the system was of the order of Rs.70,000 crore. Furthermore, the mobilisation of deposits and expansion of non-food credit that typically occurs in the last fortnight of March, unwinds in April resulting in a return flow of liquidity. In April last year, this unwinding was of the order of Rs.48,000 crore. An additional source of autonomous liquidity injection into the system was from the increase in net foreign assets of the Reserve Bank and corresponding release of rupee liquidity into the system. During January 27–March 23, 2007 the Reserve Bank's net foreign assets adjusted for revaluation increased by Rs.72,734 crore.

94. It is in the context of this scenario that it was considered necessary to reinforce the measures already taken for maintaining price stability and anchoring inflation expectations in order to sustain the growth momentum. Accordingly, the Reserve Bank announced monetary measures on March 30, 2007 with the objective of draining out liquidity and improving the efficacy of interest rate signals in the period ahead. The fixed repo rate under the LAF was increased by 25 basis points to 7.75 per cent with immediate effect. The CRR was increased by 50 basis points in two stages of 25 basis points each, effective from the fortnights beginning April 14 and April 28, 2007. The interest rate on eligible CRR balances was reduced from 1.0 per cent per annum to 0.5 per cent per annum beginning April 14, 2007. It was also indicated that the policy of withdrawal of semi-durable and durable elements of liquidity through the MSS would continue along with other arrangements relating to the operation of the LAF. The objective was to continue to demonstrate that inflation beyond the tolerance threshold of the Reserve Bank is unacceptable and that the resolve to ensure price stability is always backed by timely and appropriate policy responses.

95. Turning to the outlook for the Indian economy, growth prospects have brightened considerably in the wake of the 2006-07 record and appear well entrenched to build on the current momentum. There are indications that the pace of growth will continue to be supported by steady increases in the rate of gross domestic saving and some improvement in the efficiency of capital use. Accordingly, it is reasonable to expect that the underlying strength of investment demand is likely to be sustained in the medium-term, supported by consumption demand as per capita incomes grow. Currently, the expansion in demand is spurring sizeable additions to supply capabilities in terms of both addition of new capacity as well as more intensive and efficient utilisation/capitalisation of existing capacity. It is important to recognise, however, as pointed out in the Third Quarter Review of January 2007 that the addition to aggregate supply will occur with a lag. Lumpiness and 'gestation', that are inevitable in building production capacities, tend to delay the supply response to the impetus from aggregate demand and realisation of the capacity

expansion could be constrained over the next two years. It should be recognised that international trade cannot, by its nature, fully mitigate all supply side issues among all sectors. Looking ahead, therefore, it is prudent to recognise that the first effects of the expansion in demand would be reflected in inflationary pressures and risks to macroeconomic and financial stability. These factors have been in evidence in the form of sustained demand for capital goods and consumer durables, high rates of money and credit, indications of wage pressures in some sectors, rising input costs and the emergence of pricing power. The overarching policy challenge is to manage the transition to a higher growth path while containing inflationary pressures.

96. On the basis of initial forecasts of rainfall at 95 per cent of the long period average for the country as a whole in the 2007 south-west monsoon season and a resumption of trend growth in agriculture, it is expected that the impulses for expansion will emanate from the industrial and service sectors in which growth seems to indicate an innate buoyancy going forward. At the same time, it is necessary to recognise that global GDP growth is expected to decline by 50 basis points in 2007 in relation to the preceding year. In view of these factors, overall, for policy purposes, real GDP growth in 2007-08 may be placed at around 8.5 per cent, assuming no further escalation in international crude prices and barring domestic or external shocks.

97. In view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of shocks emanating in the domestic or global economy, the policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08.

98. It may be recalled that the Reserve Bank had articulated a self-imposed medium-term ceiling on inflation at 5.0 per cent. There are indications supporting the belief that this approach has had a salutary effect on inflation expectations and the socially tolerable rate of inflation has come down. In recognition of India's evolving integration with the global economy and societal preferences in this regard, the resolve, going forward, would be to condition policy and perceptions for inflation in the range of 4.0–4.5 per cent. This objective would be conducive for maintaining self-accelerating growth over the medium-term.

99. Money supply has remained well above indicative projections in 2005-06 and 2006-07. While high expansion in money supply has become a worldwide phenomenon, resulting in its progressive de-emphasis in monetary analysis, in a medium-term perspective and given the monetary overhang of 2005-07, it is important to contain monetary expansion in 2007-08 at around 17.0-17.5 per cent in consonance with the outlook on growth and inflation. Consistent with the

projections of money supply, the growth in aggregate deposits in 2007-08 is placed at around Rs.4,90,000 crore. Based on an overall assessment of the sources of funding, a graduated deceleration of non-food credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper (CP) to 24.0-25.0 per cent in 2007-08 from the average of 29.8 per cent over 2004-07 is consistent with the monetary projections.

100. Recent trends in the evolution of the external sector of the economy are expected to continue to shape the outlook for the balance of payments. On the whole, the overall trade and current account deficits in 2007-08 are expected to be of the same order as in 2006-07. Net capital flows are also likely to adequately finance the expected current account deficit in 2007-08.

101. The Union Budget for 2007-08 has placed the fiscal deficit at 3.3 per cent of GDP for the year 2007-08 as against 3.7 per cent in the previous year in the spirit of the FRBM Act, 2003. The net market borrowing programme of the Centre for 2007-08 is budgeted at Rs.1,09,579 crore as against Rs.1,07,453 crore in the previous year. While the size of the Government borrowing programme is moderately higher than in the previous year, this has to be viewed against the backdrop of the buoyant growth of the economy, growing appetite of the non-bank segment for government securities and the need for many banks to strengthen their SLR portfolio for statutory as also for liquidity management purposes.

102. The stance of monetary policy in 2007-08 would be conditioned by the patterns in which the global and, more particularly, the domestic environment unfolds. The likely evolution of macroeconomic and financial conditions indicates an environment supportive of sustaining the current growth momentum in India. It is important to reiterate that monetary policy, while contributing to growth, has to ensure and maintain conditions of price and financial stability. Accordingly, the policy preference for the period ahead is strongly in favour of reinforcing the emphasis on price stability and anchoring inflation expectations.

103. 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.

104. 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 continue to be :

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

III. Monetary Measures

(a) Bank Rate

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

(b) Reverse Repo Rate/Repo Rate

106. In view of the current macroeconomic and overall monetary conditions, it has been decided to keep the fixed reverse repo rate and repo rate under the LAF unchanged at 6.00 per cent and 7.75 per cent, respectively.

107. 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

108. Scheduled banks are required to maintain cash reserve ratio (CRR) of 6.5 per cent with effect from the fortnight beginning April 28, 2007 as announced on March 30, 2007.

First Quarter Review

109. The First Quarter Review of this part of the Annual Policy Statement for the year 2007-08 will be undertaken on July 31, 2007.

Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2007-08

110. The stance of the Annual Statement on Developmental and Regulatory Policies for the year 2006-07 for strengthening the financial system, with an emphasis on the quality of financial assets and state of financial market conditions, was reinforced in the Mid-Term Review of October 2006. The main endeavour has been to put in place appropriate risk management and counter-cyclical prudential measures while promoting the integration of various segments of the financial markets and enhancing the flexibility of market constituents in their operations. Along with the ongoing liberalisation of foreign exchange transactions, several measures were taken towards developing an appropriate environment for extending financial services to all segments of the population. The Third Quarter Review of January 2007 observed that in the global financial markets there are indications of risks becoming more diversified and, therefore, there is an increasing discomfort of the possibility of tail risk materialising. Accordingly, it reinforced the emphasis on macroeconomic and financial stability with a view to managing the challenges of sustaining a higher growth path and the attendant pressures on the financial system in terms of expanding financial intermediation, improving allocational efficiency and augmenting the mobilisation of resources to finance the gathering pace of growth. Expressing renewed concerns about the rapid expansion of bank credit for three years in succession and the surge in capital inflows, the Third Quarter Review called for concerted actions in fiscal, external, monetary and prudential policies. Provisioning requirements on standard assets were enhanced and risk weights were increased with regard to exposure to sectors such as real estate, capital markets, consumer loans and systemically important non-banking financial companies with a renewed emphasis on credit quality. Furthermore, the ceiling on administered interest rates relating to Non-Resident Indian (NRI) deposits was reduced with a view to fortifying liquidity management and ensuring orderly conditions in the financial markets.

111. It has been the endeavour of the Reserve Bank to develop a robust, efficient and diversified financial system so as to anchor financial stability and to facilitate effective transmission of monetary policy. Simultaneously, the emphasis has been to evolve an effective and comprehensive regulatory regime that is alert to any possible build-up of financial imbalances and which demonstrates a preparedness to respond proactively with policy responses. The focus has been on providing flexibility to the financial system contextually with a view to deriving optimum benefits.

There has been a concerted and calibrated move to rebalance the regulatory and supervisory role and customer awareness so as to ensure an inclusive and equitable financial system. In this context, the Reserve Bank has adopted a broad-based, participative and consultative approach in the conduct of its developmental and regulatory policies with the involvement of all stakeholders in the processes leading up to policy formulation. The importance of communication has received significant emphasis in the recent period and the Reserve Bank has been reaching out in order to encompass the widest sections of society in the financial system through the spread of financial education so as to encourage a more informed evaluation of its policies.

112. Against this backdrop and in the light of the current macroeconomic environment and external developments as discussed in Part I of the Statement, the Annual Statement on Developmental and Regulatory Policies focuses on certain key areas. First, the maturing of the financial sector will continue to warrant the use of prudential tools in support of monetary policy. Second, the process of liberalising foreign exchange transactions would be carried forward with some acceleration in the pace of capital account liberalisation. Third, it is proposed to further consolidate the development of various segments of the financial markets with proper checks and balances in order to enhance allocative efficiency. Fourth, in the context of the volatility and risks in financial markets arising from cross-border flows, it is proposed to draw up a road map for introduction of currency and interest rate futures. Fifth, preparing the banks to migrate to Basel II norms with specific and limited dispensation to those sectors which do not pose systemic risks, consolidating the banking sector including co-operatives and regional rural banks (RRBs) and implementing prudential measures in line with international best practices in the financial sector, assume priority for improving operational efficiency and public confidence. Sixth, in order to address the developmental needs of agriculture and small and medium enterprises (SMEs), there is a need to prioritise and incentivise credit delivery.

113. The Annual Statement on Developmental and Regulatory Policies for the year 2007-08 is divided into five sections**:** I. Interest Rate Prescriptions; II. Financial Markets; III. Credit Delivery Mechanisms and Other Banking Services; IV. Prudential Measures; and V. Institutional Developments.

I. Interest Rate Prescriptions

114. In the context of large capital inflows and implications for liquidity and monetary management, there is a need to review the interest rate prescriptions related to NRI deposits, *viz.,* foreign currency non-resident (banks) (FCNR(B)) deposits and Non-Resident (External) Rupee Account (NR(E)RA) deposits, especially in the light of inflation and interest rate differentials between India and the rest of the world. In this context, the following measures are proposed:

(a) Interest Rates on FCNR (B) Deposits

115. Currently, the interest rate ceiling on FCNR (B) deposits of all maturities has been fixed at LIBOR/SWAP rates for the corresponding maturities minus 25 basis points for the respective foreign currencies. In view of the prevailing monetary conditions, it is proposed:

- to reduce, with immediate effect, the interest rate ceiling on FCNR (B) deposits by 50 basis points, *i.e.*, to LIBOR minus 75 basis points.

(b) Interest Rate on NR(E)RA Deposits

116. Currently, the interest rate ceiling on NR(E)RA for one to three years maturity should not exceed 50 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity. In view of the prevailing monetary conditions, it is proposed:

- to reduce, with immediate effect, the interest rate ceiling on NR(E)RA deposits by 50 basis points, *i.e.*, to LIBOR/SWAP rates.

II. Financial Markets

117. The institutional framework for financial markets is undergoing significant changes in terms of participants, instruments and processes. This ongoing transformation has led to a sharpening of focus in the Reserve Bank's operations in money, Government securities and foreign exchange markets with a view to improving functional assignment and operational effectiveness. Simultaneously, the orderly functioning and soundness of financial markets are being pursued through regulatory initiatives.

118. In the context of financial deepening and development, the Reserve Bank has pursued a policy of gradual development of financial markets, in particular, the money markets, the Government securities market and the foreign exchange market. With the increasing openness of the economy and the growing integration of domestic market segments with international financial markets, this process needs to be taken forward.

Government Securities Market

119. The implementation of the Fiscal Responsibility and Budget Management Act, 2003 has necessitated introduction of several structural and developmental measures for deepening and widening the Government securities market in terms of participants, instruments and market practices.

(a) State Government Borrowings

(i) Buy-back of State Development Loans

120. Faced with the accumulation of surplus cash balances and a negative spread earned on the investment of such balances, some State Governments had approached the Reserve Bank to arrange for the buy-back of their outstanding State Development Loans (SDLs). Accordingly, the Reserve Bank formulated a general scheme for the buy-back of SDLs with the concurrence of the Government of India. So far, buy-back auctions have been conducted for two State Governments (*viz.*, Orissa and Rajasthan) and a total amount of Rs.479.07 crore of SDLs has been bought back.

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

121. The Annual Policy Statement of April 2006 had indicated that States, at their discretion and initiative, would be encouraged to develop an advance indicative open market borrowing calendar, with a view to helping investors to plan their investments in advance and, in turn, to avoid undue liquidity pressure in the system. Following discussions with the State Governments, the operational modalities for introduction of an indicative calendar are being finalised.

(iii) Non-Competitive Bidding Scheme in the Auctions of State Development Loans

122. The Annual Policy Statement of April 2006 had proposed to extend the facility of non-competitive bidding (currently limited to Central Government dated securities) to the primary auction of SDLs, with a view to widening the investor base and enhancing the liquidity of SDLs. Following discussions with State Governments, a 'Non-Competitive Bidding Scheme' in the auctions of SDLs would be introduced in the financial year 2007-08. The modalities for operationalisation of the scheme are being finalised.

(iv) Re-issuance of State Government Securities

123. Reissuance of SDLs has been favoured with a view to building up a critical mass and thereby improving the secondary liquidity of such securities. The Reserve Bank is in consultation with the State Governments to introduce a system of reissuances.

(v) Power Bonds

124. Under the scheme for one-time settlement of outstanding dues of the State Electricity Boards (SEBs) to Central Public Sector Undertakings (CPSUs), power bonds for an aggregate amount of Rs.31,581 crore were issued by 27 State Governments. The repayment of these power bonds started from the year 2006-07. A few State Governments have exercised the call option to prepay their entire or part of their outstanding power bonds. Accordingly, as on April 1, 2007 the outstanding amount of power bonds in respect of 25 State Governments amounted to Rs.26,051 crore.

(b) Central Government Securities

(i) Floating Rate Bonds

125. With a view to simplifying the methodology for pricing of floating rate bonds (FRBs) in the secondary market, it is proposed to use the average cut-off yield on 182-day Treasury Bills, instead of the yield on 364-day Treasury Bills as a benchmark rate for the FRBs to be issued in future. The base rate for the new FRBs would be the average implicit cut-off yield emerging in the last three auctions of 182-day Treasury Bills held before the coupon reset date. The change in valuation methodology is also being examined in consultation with Fixed Income Money Market and Derivatives Association (FIMMDA)/Primary Dealers' Association of India (PDAI).

(ii) Active Consolidation in Central Government Securities

126. The Annual Policy Statement of April 2006 stated that there is a need to enlarge the number of actively traded Central Government securities in order to enhance liquidity and improve pricing in the market. Accordingly, it was proposed to consolidate and build up large volumes of liquid securities while continuing with the programme of reissuances. The modalities for undertaking active consolidation of Central Government securities have already been finalised in consultation with the Government of India. In the Union Budget 2007-08, a budgetary provision of Rs.2,500 crore has been made towards premium payments for consolidation. The exercise would commence shortly.

(c) Measures for Development of Market Infrastructure

(i) Repos in the Corporate Bond Market

127. The High Level Expert Committee on Corporate Bonds and Securitisation (Chairman: Dr.R.H.Patil) had recommended, *inter alia*, the establishment of a trade reporting platform for better price discovery. The reporting platforms for corporate bonds have already been established by stock exchanges as per the Securities and Exchange Board of India (SEBI) guidelines. The FIMMDA is also in the process of setting up a reporting platform for over-the-counter (OTC) trades in corporate bonds and providing a consolidated ticker service for reporting all trades in corporate bonds. Widening of the repo market to include corporate bonds will be considered after the proposed trading platforms stabilise and robust clearing and settlement systems (Delivery *versus* Payment system) are established.

(ii) Reporting Platform for Interest Rate Swaps

128. The Reserve Bank has recently issued comprehensive guidelines in respect of interest rate derivatives, incorporating the broad regulatory framework for undertaking derivative transactions. In respect of OTC derivative transactions, it has become necessary to have a mechanism for transparent capture and dissemination of trade information as well as an efficient post-trade processing infrastructure to address some of the attendant risks. To begin with, the CCIL is being advised to start a trade reporting platform for Rupee Interest Rate Swaps (IRS). This reporting module would be functional by August 31, 2007 and will thereafter be available to all market participants.

(iii) Interest Rate Derivatives

129. An anonymous order driven system for trading in Interest Rate Derivatives (IRDs) had been introduced on exchanges in 2003. Banks were allowed to hedge the risk in their underlying investment portfolio while Primary Dealers (PDs) were also permitted as market-makers. Since then, the Government securities market has undergone numerous developmental measures, including the introduction of short selling and when-issued markets. Recognising the need for a robust interest rate futures market as an effective instrument for management of interest rate risk, on the recommendation of the Reserve Bank's Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets, a Working Group is being set up to go into all the relevant issues and to suggest measures to facilitate the development of interest rate futures market.

Foreign Exchange Market

130. The Reserve Bank has taken several initiatives to provide a more conducive environment for the conduct of foreign exchange business. The prime concern has been to provide prompt and efficient customer service by progressively liberalising foreign exchange related transactions, removing restrictions and simplifying procedures. Concomitantly, powers have been delegated to authorised dealers with a view to improving ease of transactions for the common person.

131. Keeping in view the recommendations of the Committee on Fuller Capital Account Convertibility (CFCAC), the following measures are proposed towards liberalisation of foreign exchange facilities with operational instructions being issued separately:

(a) Rationalisation of Overseas Investment

(i) Investment in Joint Ventures (JVs)/Wholly Owned Subsidiaries (WOS) Abroad

132. In order to provide greater flexibility to Indian companies for investments abroad and to rationalise the existing facilities, it is proposed:

- to enhance the overseas investment limit (total financial commitments) for Indian companies from the existing limit of 200 per cent of their net worth to 300 per cent of their net worth, as per the last audited balance sheet.

- to reckon the amount of guarantee at 100 per cent of the amount instead of the current conversion factor of 50 per cent for determining the total financial commitments.

133. Along with liberalisation, it is also imperative to put in place a robust information system for monitoring capital flows. The current reporting system does not capture data comprehensively on costs and means of funding overseas acquisitions and performance indicators. It has, therefore, been decided to:

- introduce a revised reporting framework on overseas investments.

(ii) Portfolio Investment Overseas

134. At present, listed Indian companies have a separate limit of 25 per cent of net worth for portfolio investment abroad in listed overseas companies. It has been decided:

- to enhance this limit to 35 per cent of net worth.

(iii) Overseas Investment by Mutual Funds

135. At present, the aggregate ceiling on overseas investment by mutual funds is US $ 3 billion. With a view to providing greater opportunity to mutual funds for investment overseas, it is proposed:

- to increase the ceiling to US $ 4 billion.

(b) External Commercial Borrowing

136. With a view to providing greater flexibility to corporates in managing their liquidity and interest costs, it is proposed:

- to allow prepayment of external commercial borrowings (ECBs) up to US $ 400 million as against the existing limit of US $ 300 million by authorised dealer banks without prior approval of the Reserve Bank, subject to compliance with stipulated minimum average maturity period as applicable to loans.

(c) Facilities for Individuals: Liberalised Remittance Scheme

137. In order to further liberalise the Scheme, it is proposed:

- to enhance the present limit of US $ 50,000 to US $ 100,000 per financial year for any permitted current or capital account transaction or a combination of both.

(d) Expansion of Hedging Facilities

138. The basic principle for accessing domestic foreign exchange markets is hedging of underlying foreign exchange exposures. In keeping with the evolution of the foreign exchange market and the increase in depth and volumes, a range of hedging instruments have been permitted to market participants including foreign exchange forwards, swaps and options, but mainly against crystallised foreign currency exposures. It is now proposed to expand the range of hedging tools available to the market participants as also facilitate dynamic hedging by the residents.

(i) Economic Exposure

139. The Reserve Bank has received representations from domestic producers and users of certain metals for permission to hedge the price risk on domestic purchase and sale in international exchanges, like London Metal Exchange (LME) in order to take advantage of greater depth and liquidity in such exchanges. It has, therefore, been proposed that authorised dealer Category-I banks, which have specifically been authorised by the Reserve Bank in this regard, may henceforth permit:

- domestic producers/users to hedge their price risk on aluminium, copper, lead, nickel and zinc in international commodity exchanges, based on their underlying economic exposures.

- actual users of aviation turbine fuel (ATF) to hedge their economic exposures in the international commodity exchanges based on their domestic purchases.

- authorised dealer banks to approach the Reserve Bank for permission on behalf of customers who are exposed to systemic international price risk, not covered above.

(ii) Forward Contracts

Exporters and Importers

140. At present, importers and exporters of goods and services are permitted to book forward contracts on the basis of declaration of an exposure and based on past performance. Furthermore, contracts booked in excess of 50 per cent of the eligible limits have to be on deliverable basis and cannot be cancelled. In order to facilitate dynamic hedging of foreign exchange exposures of exporters and importers of goods and services, it is proposed:

- to enhance this limit to 75 per cent.

Corporates

141. Currently, residents with overseas direct investments in equity and debt are permitted to hedge their exchange risk arising out of such investments, provided the forward contracts are completed by delivery or rolled over on the due date and not cancelled. With a view to giving greater flexibility to residents with overseas direct investments, it is proposed that:

- the forward contracts entered into for hedging overseas direct investments may, henceforth, be allowed to be cancelled and rebooked.

Small and Medium Enterprises

142. In order to enable small and medium enterprises (SMEs) to hedge their foreign exchange exposures, it is proposed:

- to permit them to book forward contracts without underlying exposures or past records of exports and imports. Such contracts may be booked through authorised dealers with whom the SMEs have credit facilities. The SMEs are also permitted to freely cancel and rebook the contracts.

Individuals

143. In order to enable resident individuals to manage/hedge their foreign exchange exposures, including anticipated exposures, it is proposed:

- to permit resident individuals to book forward contracts without production of underlying documents up to an annual limit of US $ 100,000, which can be freely cancelled and rebooked.

(iii) Study on Currency Futures Market

144. As per the extant guidelines, residents in India are permitted to use forward foreign exchange contracts and options (cross-currency and foreign currency/rupee) contracts as hedging instruments. Market participants and the users have gained experience in using such instruments for proactively hedging their risks. The liquidity for such products has also increased and accounting systems are being put in place in line with international best practices. It is now proposed:

- to set up a Working Group on Currency Futures to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework.

(e) Rationalisation and Simplification of Foreign Exchange Regulations: Recommendations of the Task Force

145. Consequent upon and pursuant to the recommendations of the CFCAC and as announced in the Mid-Term Review of October 2006, the Reserve Bank had constituted an Internal Task Force to identify anomalies in the present regulatory framework for current and capital account transactions and propose rectifications.

146. The Task Force reviewed the regulations and the suggestions/requests from the user groups (including EXIM Bank, Federation of Indian Export Organisations, Foreign Exchange Dealers Association of India and Chambers of Commerce). It also examined the issues marked for review by the CFCAC. Some of the issues recommended by the Task Force have been implemented and circulars have been issued by the Reserve Bank. It is now proposed to accept certain other recommendations made by the Task Force for further liberalisation and simplification of the procedures as set out below:

(i) Residents

Corporates

i) Authorised dealers may permit remittances on account of donations by corporates for specified purposes, subject to a limit of 1 per cent of their foreign exchange earnings during the previous three financial years or US $ 5 million, whichever is lower.

ii) Authorised dealers may permit Indian companies to remit up to US $ 10 million as against the current limit is US $ 1 million for consultancy services for executing infrastructure projects.

iii) Authorised dealers may allow remittance of foreign exchange towards reimbursement of pre-incorporation expenses incurred in India where the remittance does not exceed 5 per cent of the investment brought into India or US $ 100,000, whichever is higher, on the basis of certification from statutory auditors.

iv) Authorised dealers may permit remittances on account of cash calls for the purpose of oil exploration, provided the operator/consortium member in India submits documents to the satisfaction of the authorised dealer.

v) Authorised dealers may allow remittances on account of requests from Business Process Outsourcing (BPO) companies towards payment of the cost of equipment to be installed at overseas sites in connection with setting up of International Call Centres, subject to specified terms and conditions.

vi) Authorised dealers may henceforth open foreign currency accounts in India for ship manning/crew managing agencies that are rendering services to shipping companies incorporated outside India.

vii) Authorised dealers may remit winding up proceeds of companies under liquidation, subject to orders issued by the official liquidator or a court in India or under any scheme framed by the Government of India and also subject to tax compliance.

Individuals

viii) A uniform period of 6 months is proposed for surrender of received/ unspent/unused foreign exchange from the date of receipt/purchase/acquisition/date of return of the traveller, as the case may be.

(ii) *Non-residents*

Corporates

i) Authorised dealers may open escrow/special accounts on behalf of non-residents, subject to specific conditions where such accounts are required to be opened in terms of the SEBI regulations for open offers/delisting offers/exit offers and the like.

Individuals

ii) The facility of operation of accounts by power of attorney holder is extended to NRO account holders.

iii) At the request of the depositor, authorised dealers can permit remittance of the maturity proceeds of FCNR (B) deposits to third parties outside India, provided the authorised dealer is satisfied about the *bonafides* of the transaction.

III. Credit Delivery Mechanisms and Other Banking Services

147. It has been the endeavour of the Reserve Bank to improve the credit delivery mechanism and make available basic banking services to the wider sections of society and to ensure development of the rural-agrarian economy. Initiatives taken in this regard have been wide-ranging; improving credit flow to agriculture and other segments of priority sector, strengthening of the rural financial infrastructure and promoting financial inclusion, financial literacy and credit counselling.

(a) Delivery of Credit to Agriculture and Other Segments of Priority Sector

148. Domestic scheduled commercial banks, both in the public and private sectors, are required to formulate special agricultural credit plans (SACP) in order to achieve a distinct improvement in the flow of credit to agriculture. During 2006-07 (by end-September 2006), disbursement to agriculture by public sector banks (PSBs) and private sector banks under SACP aggregated

Rs.58,887 crore and Rs.13,973 crore (provisional), respectively. Since the inception of the kisan credit card (KCC) scheme in 1998, the PSBs have issued 25.6 million KCCs (up to December 2006) covering limits aggregating Rs.88,279 crore. During 2006-07 (up to December 2006), 3.8 million KCCs were issued by PSBs covering limits aggregating Rs.19,781 crore. The Union Budget, 2007-08 has announced establishment of the rural infrastructure development fund (RIDF) XIII with the National Bank for Agriculture and Rural Development (NABARD) with a corpus of Rs.12,000 crore and a separate window under RIDF XIII for rural roads under Bharat Nirman Programme with a corpus of Rs.4,000 crore. Cumulative sanctions and disbursements till February 2007 under various tranches of RIDF (I to XII) amounted to Rs.59,429 crore and Rs.35,121 crore, respectively.

(b) Priority Sector Lending: Refocus on Employment-Intensive Sectors

149. Guidelines on lending to the priority sector have been revised based on the Technical Paper of the Internal Working Group (Chairman: Shri C.S. Murthy). The focus of the revised guidelines is on sectors that impact large and weaker segments of population and are employment-intensive. The revision also seeks to rationalise the definitions related to priority sector lending. Based on a series of consultations with banks and other stakeholders:

- revised guidelines on lending to the priority sector are being issued shortly for implementation by all scheduled commercial banks.

(c) Simplification of the Procedures and Processes for Obtaining Agricultural Loans

150. The Working Group constituted in December 2006 to examine procedures and processes for agricultural loans (Chairman: Shri C. P. Swarnkar) for simplification of the procedures and processes for obtaining agricultural loans, especially by small and marginal farmers, has submitted its report. While the report has been taken up for detailed examination, it is proposed to:

- dispense with the requirement of “no due” certificate for small loans up to Rs.50,000 to small and marginal farmers, share-croppers and the like and instead, obtain self-declaration from the borrower.

- accept certificates provided by local administration/*panchayati raj* institutions regarding the cultivation of crops in case of loans to landless labourers, share-croppers and oral lessees.

(d) Loans Extended against Gold and Silver Ornaments: Reduction of Risk Weight

151. Loans against gold and silver ornaments are commonly availed by the poorer sections of the society in both rural and urban areas. These loans entail relatively low risk as they are extended with adequate margins and the collateral (gold or silver) is easily marketable, particularly where the size of the loan is small. Such loans being in the nature of retail (personal) loans currently attract a risk weight of 125 per cent. It is now proposed:

- to reduce the risk weight on loans up to Rs.1 lakh against gold and silver ornaments to 50 per cent from the existing level of 125 per cent for all categories of banks.

(e) Revival of Rural Co-operative Credit Structure: Status

152. Based on the recommendations of the Task Force (Chairman: Prof.A.Vaidyanathan), Government of India has prepared a package for revival of the rural co-operative credit structure and has set up a National Implementing and Monitoring Committee (NIMC) to oversee implementation and progress of the revival package. Seventeen States and one Union Territory have accepted the Government of India package in principle. Of these, ten States have executed Memoranda of Understanding with the Government of India and the NABARD. Special Audits of all Primary Agricultural Credit Societies (PACS) have been completed and recommended by the respective District/State Level Implementation Committees in all districts of Rajasthan, five districts of Andhra Pradesh and four districts of Haryana. In Orissa, although the Special Audits have been completed in all the districts, they are yet to be recommended by the District Level Implementation Committee. Andhra Pradesh has passed the amendment to the State Co-operative Societies Act as required under the revival package, which is awaiting the consent of the Governor, State of Andhra Pradesh.

(f) Regional Rural Banks: Status and Further Action

153. Regional Rural Banks (RRBs) have a dominant presence in rural areas especially in backward and tribal districts. Being owned by the Central Government (50 per cent), the State Government (15 per cent) and sponsor banks (35 per cent), RRBs are expected to play a significant role in financing rural employment opportunities and meeting the need for financial services in their areas of operation. In order to strengthen and empower the RRBs, several steps taken in the recent period include expansion of the scope and flexibility of their operations, liberalisation and

simplification of branch expansion and setting up of automatic teller machines (ATMs), and amalgamation of all RRBs in the State of the sponsor bank. As a result of mergers, the number of RRBs has fallen from 196 to 96. The deposits and advances of RRBs increased by 18.0 per cent and 22.8 per cent, respectively, in 2006 as compared to 12.1 per cent and 20.8 per cent in 2005. The credit-deposit ratio increased from 46.9 per cent in December 2003 to 60.2 per cent in December 2006. The number of loss-making RRBs has fallen from 40 in 2003 to 22 in 2006. The Union Budget, 2007-08 proposals, including phased recapitalisation of RRBs, will further strengthen the RRBs. Sponsor banks have been advised to take full responsibility for their RRBs and provide requisite support in areas of information technology (IT) and human resources (HR). State Governments, being major stakeholders, are expected to provide full support to the RRBs in meeting the objectives for which they were set up. As a measure of providing further business opportunities, it is proposed:

- to allow RRBs to take up corporate agency business, without risk participation, for distribution of all insurance products, including health insurance and animal insurance.

154. A Task Force (Chairman: Dr. K.G. Karmakar) on empowering the Boards of RRBs for operational efficiency was set up in September 2006. The Task Force has submitted its report which is under examination. The recommendations cover areas relating to HR, resource base of RRBs, investment avenues and the like.

(g) Relief Measures for Distressed Farmers: Status

155. The Working Group (Chairman: Prof.S.S.Johl) constituted by the Reserve Bank to suggest measures for assisting distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme under the DICGC Act for such farmers, submitted its final report in November 2006. Based on the recommendations of the Working Group, it is proposed:

- to introduce a credit guarantee scheme for distressed farmers. The details of the scheme will be placed in the public domain for comments/feedback by May 31, 2007.

(h) Technical Group for Review of Legislations on Money Lending: Status

156. In the context of the finding of the All India Debt and Investment Survey (Fifty-Ninth Round) that the share of moneylenders in total dues of rural households increased from 17.5 per cent in 1991 to 29.6 per cent in 2002, the Reserve Bank constituted a Technical Group (Chairman: Shri S.C.Gupta) to review the efficacy of the existing legislative framework governing money lending, to examine the linkages, if any, between money lending activities and formal credit channels and make recommendations to the State Governments to improve the legal and enforcement machinery for money lending and similar activity, in the interest of rural households. The Group will submit its report by June 30, 2007.

(i) Credit to SME sector

157. The definition of small-scale industry and small business enterprises for purposes of inclusion in priority sector has been changed in alignment with the definition adopted in the Micro, Small and Medium Enterprises Development Act, 2006. Further, in order to improve credit delivery to SMEs:

- banks are urged to review their institutional arrangements for delivering credit to the SME sector, especially in identified clusters in various parts of the country, and to take measures to strengthen the expertise in and systems at branches located in or near such identified clusters with a view to providing adequate and timely credit.

(j) Financial Inclusion

158. Concerted initiatives have been taken by the Reserve Bank to provide smooth and efficient banking services to the general public at large. Efforts towards 'financial inclusion' include sensitising the banks to the banking and financial needs of the common person and ensuring access to basic banking facilities.

(i) Pilot Project for SLBCs for 100 per cent Financial Inclusion: Status and Further Action

159. State Level/Union Territory Level Bankers' Committees (SLBC/UTLBC) convener banks in all States/Union Territories were advised to allocate villages to banks operating in their respective States/Union Territories for ensuring 100 per cent financial inclusion, with progress thereon monitored in the SLBC/UTLBC meetings. So far, SLBCs/UTLBCs have reported having achieved 100 per cent financial inclusion in the Union Territory of Puducherry and in some districts in Haryana, Himachal Pradesh, Karnataka, Kerala and Punjab. In this context, it is proposed:

- to undertake an evaluation of the progress made in these districts by an independent external agency to draw lessons for further action in this regard.

(ii) Working Group on Improvement of Banking Services in Less Developed Regions/States: Status and Action

160. A number of Working Groups were set up in the recent period by the Reserve Bank to draw up action plans for improvement in banking services in some of the less developed States and regions. These States included Uttarakhand, Chhattisgarh, Bihar, Sikkim and those in the North-eastern region. The implementation of the recommendations of these Working Groups is being monitored by the SLBCs and the Regional Offices of the Reserve Bank. For the North-eastern region, there is a high-powered committee which is overseeing the implementation. In the light of the positive experience, it is proposed:

- to constitute a Working Group for the Union Territory (UT) of Lakshadweep to recommend measures for enhancing the outreach of banking services in the UT.

(iii) Services to Depositors and Small Borrowers in Rural and Semi-Urban Areas: Status

161. The Annual Policy Statement of April 2005 proposed a survey with a view to making an assessment of customer satisfaction on credit delivery in rural areas by banks. Accordingly, the National Council of Applied Economic Research (NCAER) was entrusted to carry out a study on 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 NCAER initiated the study in January 2006 and submitted a draft report in January 2007. The NCAER is expected to submit the final report by May 31, 2007.

(iv) Credit Counselling: Setting up of Centres on Pilot Basis

162. The Working Group (Chairman: Prof.S.S.Johl) constituted by the Reserve Bank to suggest measures for assisting distressed farmers had recommended that financial and livelihood counselling are important for increasing the viability of credit. Further, the Working Group constituted to examine procedures and processes for agricultural loans (Chairman: Shri C.P.Swarnkar) has also recommended that banks should actively consider opening of counselling centres, either individually or with pooled resources, for credit and technical counselling with a view to giving special thrust in the relatively under-developed regions. In the light of the recommendations of these two Groups, it is proposed:

- to advise State Level Bankers' Committee convenor banks to set up, on a pilot basis, a financial literacy-cum-counselling centre in any one district, and based on the experience gained, to ask the concerned lead banks to set up such centres in other districts.

(v) IT-enabled Financial Inclusion

163. Introduction of 'zero balance' or 'no frills' accounts has enabled the common person to open bank accounts. However, providing banking facilities closer to the customer, especially in remote and unbanked areas, while keeping transaction costs low, remains a challenge. Recognising that IT-enabled services have the potential for effectively meeting this challenge, banks have initiated pilot projects utilising smart cards/mobile technology to increase their outreach. Biometric methods for uniquely identifying customers are also being increasingly adopted. Accordingly:

- banks are urged to scale up IT initiatives for financial inclusion speedily while ensuring that solutions are highly secure, amenable to audit, and follow widely-accepted open standards to ensure eventual inter-operability among the different systems.

(k) Micro-Finance: Evaluation Studies

(i) Bank-SHG Linkage Programme: Evaluation

164. The cumulative number of self-help groups (SHGs) linked to banks was 2.58 million with total bank credit extended to these SHGs at over Rs.14,479 crore (by end-February 2007). During the year 2006-07 (end-February 2007), as many as 346,000 new SHGs were linked to banks and the total bank credit to these SHGs was Rs.3,082 crore. It is proposed:

- to conduct an evaluation of the bank-SHG linkage programme through the regional offices of the Reserve Bank with a view to ascertaining the degree of transparency in maintaining the accounts by the SHGs and their adherence to well-accepted best practices.

(ii) Micro-finance Institutions: Findings of Study and Advisory

165. The Reserve Bank conducted a joint fact-finding study with a few major banks and, based on the findings, banks were advised to encourage micro-finance institutions (MFIs) assisted by them to focus on unbanked and underbanked areas, desist from multiple lending, engage in capacity building and empowerment of the groups and follow practices that maintain the cohesiveness of the groups.

(I) Customer Service

166. The Reserve Bank has been sensitising banks to the objective of extending good quality banking services. Within the domain of necessary freedom to banks to choose the types of services to be offered to the customers and related cost, banks are encouraged to set for themselves a quantifiable benchmark for the quality of services.

(i) Banking Codes and Standards Board of India: Status

167. The Banking Codes and Standards Board of India (BCSBI), set up as a society in February 2006, released the Code of Bank's Commitment to Customers (Code) in July 2006 setting out minimum standards for fair practices on various banking transactions for individual customer. Pursuant to the adoption of the Code, member banks have evolved policies on collection of dues and repossession of securities, cheque collection, compensation, and grievances redressal. A few banks have placed these documents in the public domain for improving customer awareness. The BCSBI has commenced its field visits to identify systemic gaps/deficiencies in banks in implementation of the Code and would facilitate rectification with a view to providing seamless services to individual customers.

(ii) Complaints about Excessive Interest Charged by Banks

168. The Reserve Bank and the Banking Ombudsmans' offices have been receiving several complaints regarding levying of excessive interest rates and charges on certain loans and advances. Although interest rates have been deregulated, rates of interest beyond a certain level may be seen to be usurious and can neither be sustainable nor in conformity with the normal banking prudence.

- The boards of banks are, therefore, advised to lay down internal principles and procedures so that such usurious interest, including processing and other charges, are not charged.

(iii) Banking Ombudsman Scheme, 2006

169. Based on customer feedback, the Banking Ombudsman Scheme, 2006 is being amended to make it more customer-centric and sensitive to the present needs of the bank customer. Among other changes, it is proposed:

- to extend the appeal option under the Scheme, which is currently allowed only in respect of awards made by the Banking Ombudsman (BO), to decisions of the BO rejecting complaints relating to matters falling within the grounds of complaint specified under the Scheme.

(m) Currency Management

170. In the area of currency management, the Reserve Bank endeavours to benchmark its systems and procedures against the best international practices to bring about better customer service with greater efficiency. In order to make it easier for members of the public to obtain the refund value in respect of mutilated notes, it is proposed:

- to modify the Reserve Bank of India Note (Refund) Rules (as amended up to 1980). The revised rules will come into effect after approval by the Government of India and after they are placed before the Parliament.

IV. Prudential Measures

171. The Reserve Bank continues to sharpen its regulatory and supervisory roles for ensuring the smooth and effective functioning of the financial system thereby contributing to public confidence and accelerated economic growth. The approach also seeks convergence between Indian standards and international best practices with regard to prudential norms, accounting standards, transparency and disclosure, asset-liability management and risk management systems. Keeping in view the pace and pattern of developments in the financial sector, the Reserve Bank has intensified its consultative process and provided stakeholders with the flexibility to absorb changes in a non-disruptive manner.

(a) Extension of Credit Facilities to Overseas Step-down Subsidiaries of Indian Corporate

172. The Mid-Term Review of October 2006 enhanced the prudential limit on credit and non-credit facilities extended by banks to Indian Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) abroad from the existing limit of 10 per cent to 20 per cent of their unimpaired capital funds (Tier I and Tier II capital) with a view to facilitating the expansion of Indian corporates' business abroad.

173. Over the years, Indian industry has been successfully building up its presence abroad with increasing overseas acquisitions and as a consequence, the exposure of banks to such financing is rising. As overseas markets are expected to offer better opportunities for growth and bring in higher revenue and volumes, it is proposed:

- to permit Indian banks to extend credit and non-credit facilities to step-down subsidiaries which are wholly owned by the overseas subsidiaries of the Indian corporates, within the existing prudential limits and some additional safeguards.

(b) Comprehensive Guidelines on Derivatives: Status

174. The Reserve Bank had constituted an Internal Group to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives for banks in view of the growing complexity, diversity and volume of derivatives used by banks. Based on the Group's report, draft comprehensive guidelines on derivatives were placed on the Reserve Bank's website and final guidelines have been issued on April 20, 2007 in the light of the feedback received. These guidelines relate to rupee derivatives and cover operational issues relating to interest rate derivatives and broad generic principles for undertaking derivatives transactions, management of risk and sound corporate governance requirements as also adoption of suitability and appropriateness policy, while undertaking derivatives transactions.

(c) Introduction of Credit Default Swaps

175. As part of the gradual process of financial sector liberalisation in India, it is considered appropriate to introduce credit derivatives in a calibrated manner at this juncture. The risk management architecture of banks has strengthened and banks are on the way to becoming Basel II compliant, providing adequate comfort level for the introduction of such products. Furthermore, the recent amendment to the Reserve Bank of India Act, 1934 has provided legality of OTC derivative instruments, including credit derivatives. Accordingly, to begin with, it is proposed:

- to permit banks and primary dealers to begin transacting in single-entity credit default swaps (CDS). Detailed guidelines in this regard will be issued by May 15, 2007.

(d) New Capital Adequacy Framework (Basel II): Status and Plans

176. Taking into account the size, complexity of operations, relevance in the financial sector, the need for greater financial inclusion and the necessity of an efficient delivery mechanism for directed credit, capital adequacy norms applicable to banking entities in India have been maintained at varying levels of stringency. On the first track, commercial banks are required to maintain capital for both credit and market risks as per the Basel I framework; on the second track, co-operative banks are required to maintain capital for credit risk as per the Basel I framework and surrogates for market risk; on the third track, the RRBs have a minimum capital requirement which is, however, not on par with the Basel I framework. Consequently, the Indian banking system has a major segment of systemically important banks on a full Basel I framework, a portion of the minor segment partly on Basel I framework and an insignificant segment on a non-Basel I framework. Against this backdrop, at least initially, a similar diversity would be visible in the Indian banking segment even after the commercial banks begin implementing New Capital Adequacy Framework (Basel II) in March 2008.

177. The Reserve Bank had issued draft guidelines for implementation of the Basel II framework in February 2005 inviting feedback from banks. On the basis of the feedback received from a wide spectrum of banks and other stakeholders, the draft guidelines were revised and issued to banks on March 20, 2007 for a second round of consultation. On the basis of the feedback received, the final guidelines are being issued separately.

(e) Establishment of Credit Information Companies: Status

178. With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information pertaining to borrowers of banks/financial institutions (FIs), the Credit Information Companies (Regulation) Act, 2005 was passed in the Parliament in May 2005 and notified in the Gazette of India on June 23, 2005. Collection and dissemination of credit information will help the banks and FIs in strengthening their credit risk management systems.

179. The Rules and Regulations for implementation of the Credit Information Companies (Regulation) Act, 2005 were notified by the Government of India on December 14, 2006 and the Act has become operational. A press release has since been issued inviting applications for establishment of Credit Information Companies. A High Level Advisory Committee has been set up to screen the applications and recommend the names of credit information companies to whom certificate of registration for commencement/continuing business of credit information could be granted.

(f) Introduction of KYC Norms/AML Standards: Procedure for Wire Transfer

180. The Financial Action Task Force (FATF) has made forty recommendations and nine special recommendations to address the concerns relating to money laundering and terrorism financing. The Reserve Bank had earlier issued detailed guidelines to banks based on the FATF recommendations to ensure that a proper policy framework on 'Know Your Customer' and Anti-Money Laundering measures is put in place. Special Recommendation VII (SR VII) aims at preventing terrorists and other criminals from having unfettered access to wire transfers for moving their funds. Accordingly, banks were advised in April 2007 that all cross-border wire transfers and related messages that are sent by them should be accompanied by accurate and meaningful originator information (name, address and account number) and the information should remain with the transfer or related message throughout the payment chain. Furthermore, the record of originator information accompanying a wire transfer should be kept for ten years. In case any overseas ordering bank/financial institution fails to furnish information on the remitter, the receiving bank should restrict or even terminate its business relationship with the ordering bank.

(g) Bank Finance to Factoring Companies: Review of Existing Guidelines

181. The extant guidelines of the Reserve Bank enable banks to freely extend financial assistance to non-banking financial companies (NBFCs) except for certain activities. A Working Group has been constituted with representatives from banks, factoring companies and the Reserve Bank to review the existing guidelines regarding financing of factoring companies in view of difficulties expressed by some banks.

(h) Segment Reporting under Accounting Standard 17: Enhancement of Disclosure

182. In March 2003, banks were advised to adopt three business segments, *viz.,* 'Treasury', 'Other Banking Business' and 'Residual' as the uniform business segments and 'Domestic' and 'International' as the uniform geographic segments for the purpose of segment reporting under Accounting Standard - 17 (AS-17). The reporting segment under the 'Other Banking Business' category is fairly broad covering large part of the 'banking book'. This segment is further divided into three categories, *viz.,* 'Corporate/Wholesale Banking', 'Retail Banking' and 'Other Banking Business' in order to impart greater transparency in disclosures. 'Retail Banking' would include exposures which fulfil the four criteria of orientation, product, granularity and low value of individual

exposures for retail exposures as laid down in the Basel Committee on Banking Supervision (BCBS) document entitled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework". In addition, individual housing loans will also be included in the retail banking segment. Wholesale banking would include all advances to trusts, partnership firms, companies and statutory bodies, which are not included under 'Retail Banking'. 'Others Banking Business' would include all other banking operations not covered under 'Treasury', 'Wholesale Banking' and 'Retail Banking' segments. It will also include all other residual operations such as para-banking transactions/activities. Banks will also be required to report any additional segments, which fulfill the criteria laid down under AS-17. The disclosure requirement will come into force from the reporting period ending March 31, 2008.

(i) Guidelines on Restructuring of Advances

183. As indicated in the Annual Policy Statement of April 2006, a Working Group comprising members from commercial banks, the Indian Banks' Association (IBA), and the Reserve Bank was constituted to review and align the existing guidelines on restructuring of advances (other than under the corporate debt resctructuring (CDR) mechanism) on the lines of provisions under the revised CDR mechanism. The recommendations of the Group envisage rationalisation of the guidelines that are applicable to restructured/rescheduled accounts under the CDR mechanism as also outside its purview. The Group's recommendations are under examination. The copy of the report of the Working Group has been placed on the Reserve Bank's website and based on the comments/feedback received, the Reserve Bank would issue operational guidelines by May 31, 2007.

(j) Residential Housing Loans: Reduction of Risk Weight

184. Under the standardised approach for credit risk under Basel II which is being implemented as per the schedule already indicated, the risk weight on residential property fully secured by mortgages is prescribed at 35 per cent, subject to fulfillment of strict prudential criteria. Keeping this in view and the fact that banks have been advised to tighten their credit administration in this area in particular, from time to time, it is proposed:

- to reduce the risk weight on the residential housing loans to individuals from the existing 75 per cent to 50 per cent as a temporary measure. This dispensation will be applicable for loans up to Rs.20 lakh and will be reviewed after one year, keeping in view the default experience and other relevant factors.

(k) Differentiated Bank Licenses

185. A differentiated licensing procedure for banks is an accepted practice internationally. While in some countries there is no discrimination between domestic and foreign banks in regard to licensing policy, in other countries separate norms exist. In India, there is no differentiated licensing policy between domestic and foreign banks as the regulatory regime for domestic and foreign banks is non-discriminatory. With a view to directing the resources of banks to their niche areas and to sustain efficiency in the banking system, a graded approach of licensing may be appropriate which can be equally applicable to both domestic and foreign banks. A technical paper on this subject will be placed on the website by May 31, 2007 inviting comments/suggestions from the public.

(l) Restructuring of Advances to SMEs

186. There is a set of guidelines covering restructuring of exposures to SMEs by banks. These guidelines will also be reviewed and modified, if necessary, in the light of the recommendations of the Working Group constituted to review and align the existing guidelines on restructuring of advances by May 31, 2007.

(m) Strengthening of the Financial Sector Regulated by the Reserve Bank

187. In line with the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II), the Reserve Bank has been undertaking a series of steps aimed at progressively strengthening the institutions regulated by it. The Committee had *inter alia* recommended strengthening of the capital adequacy of banks and conversion of Development Financial Institutions (DFIs) into banks or NBFCs in view of the convergence of activities between banks and DFIs. The progress made in this regard is set out as under:

(i) Banks in the Private Sector

188. As on March 31, 2005, three banks that had CRAR below 9 per cent have since been amalgamated with other banks and currently there is no bank whose capital adequacy ratio does not meet the minimum requirement of 9 per cent.

189. As on March 31, 2005, there were 15 banks not having the minimum requirement of net worth of Rs.300 crore. With the amalgamation of seven banks with other banks and three banks having raised capital to meet the net worth criteria, only five banks remain whose net worth is below the minimum of Rs.300 crore. The matter has been taken up with the remaining individual banks for compliance with the requirements relating to net worth in a time-bound manner.

(ii) Public Financial Institutions

190. At present, there are 49 Public Financial Institutions (PFIs) which are notified under section 4(A) of Companies Act, 1956 by the Ministry of Company Affairs, Government of India. Earlier, one institution each had been converted into a bank (IDBI) and an NBFC (IDFC). Of the 49 PFIs, 12 are regulated by the Reserve Bank, four are Refinancing Institutions (RFIs) and the remaining eight are NBFCs. One of the Reserve Bank regulated RFIs, *viz.*, Small Industries Development Bank of India (SIDBI), in turn, supervises 28 PFIs, namely, 18 State Financial Corporations (SFCs) and 10 State Industrial Development Corporations (SIDCs). SIDCs are registered as NBFCs. The Reserve Bank is in the process of strengthening the prudential, regulatory and supervisory norms in respect of the SIDBI with a view to bringing about convergence in the regulatory framework *vis-a-vis* banks. Of the remaining nine entities, the IRDA regulates five while four are unregulated.

V. Institutional Developments

Payment and Settlement Systems

191. The Reserve Bank continues to take initiatives to strengthen the framework for a secured and integrated real time payment and settlement systems in line with technological developments. The emphasis has been on utilising the full potential of information technology (IT) to improve operational efficiency and maintain public confidence. In 2007-08, there will be continued focus on prompt and timely customer service, financial inclusion and further improvements of electronic payment products.

(a) Technology and Convergence of Financial Business

192. In the recent period, there is an increasing trend towards convergence of various financial business segments with significant parts of the convergence chain resting with the banking sector. With the rapid developments in technology and changing customer preferences, delivery channels in the banking sector have concomitantly undergone a metamorphosis in order to remain competitive. Internet-based delivery services and mobile telephony have emerged as potential

channels for prompt customer services necessitating convergence between banking and mobile communication services. In this context, while technology would facilitate the process of convergence, there is an imperative need to ensure that separate identities of each of the business processes are retained for rendering better customer service. Accordingly, banks are urged to evaluate various options available in this regard and implement them as appropriate, keeping in view their business requirements.

(b) Use of Public Networks for Financial Transactions

193. The use of public networks for transmission of financial information is increasingly gaining acceptance in the recent period. Processing of financial messages is, however, associated with risks necessitating putting in place all requisite safeguards, *viz.*, confidentiality, authenticity and integrity of messages flowing through such networks. In this context, it is proposed that the Indian Financial Network (INFINET) system should be operationalised as a Multi-Protocol Label Switching (MPLS) network by the Institute for Development and Research in Banking Technology (IDRBT).

(c) Process of Outsourcing

194. With increased dependence on outsourcing, especially in areas relating to information technology, managing the outsourced entities by banks assumes greater importance. Banks are urged to ensure adequate safeguards of the processes of outsourcing and appropriately address confidentiality of the information and customer privacy with a view to rendering seamless customer service.

(d) Disaster Recovery and Business Continuity Plans

195. With increasing migration to centralised systems and usage of information technology (IT), there is a need for conducting regular and periodic tests of disaster recovery (DR) and business continuity plans (BCP) of banks to ensure continuous service. The Reserve Bank has been supporting banks in their individual testing of DR. The Reserve Bank has initiated DR testing, which has migrated to a single comprehensive performance testing for the whole system with all members participating on a synchronous basis with a view to ensuring a holistic approach towards DR testing and effective BCP. The first such test cycle was performed in December 2006 and similar tests would be conducted at regular intervals in future.

(e) Centralised Public Accounts Department System

196. As indicated in the Annual Policy Statement of April 2006, the Centralised Public Accounts Department (CPAD) System was developed, tested and implemented at the Chennai Office of the Reserve Bank. The system, which would improve management of accounting transactions processed by the Reserve Bank on behalf of the Central and State Governments, would be extended to cover all its offices during the year 2007-08.

(f) Payment Systems: Developments

197. An Internal Group constituted by the Reserve Bank examined various aspects of payment systems, particularly relating to switching over to electronic modes. Based on the recommendations of the group, the minimum value for customer based Real Time Gross Settlement (RTGS) transactions was enhanced to Rs. 1 lakh from January 1, 2007. Other measures which are proposed to be implemented during 2007-08 include: mandating all inter-bank transactions for settlement only through the RTGS mode; review of the norms relating to membership of the INFINET to facilitate larger participation in electronic payment based message transfers; effecting the settlements arrived at by the Clearing Corporation of India Ltd. (CCIL) and the major stock exchanges National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) as RTGS batch settlements; implementation of the National Settlement System (NSS) for processing the clearing settlements of the major clearing houses as RTGS batch settlement; implementation of the National Electronic Funds Transfer (NEFT) for greater coverage and reach for the common man; gradual upward revision of the per-transaction limit for customer based transactions to a level of Rs.10 crore; migration of Government-based payment and receipt transactions to electronic means.

(g) Message Based Information Transmission

198. The need for a secure and safe message transmission process is critical in view of extensive use of electronic means for communication amongst banks and between banks and their customers. The use of the Structured Financial Messaging System (SFMS) of the IDRBT holds promise for ensuring Straight-Through Processing (STP) of financial messages in a secure manner. Banks are urged to take steps to ensure the safety of message-based information transmission.

(h) Electronic Payment Products: Status and Proposed Action

199. Coverage of the RTGS system has increased significantly. By April 13, 2007 RTGS connectivity was available in more than 28,776 bank branches and the Reserve Bank is committed to improving the quality of services through the RTGS.

200. The launch of the pilot project for Cheque Truncation System, which aims at enhancing efficiency in the retail cheque clearing sector, is expected to be implemented in December 2007.

201. As indicated in the Mid-Term Review of October 2006, the Multilateral Net Settlement Batch (MNSB) mode to facilitate settlement of various CCIL-operated clearings (inter-bank government securities, inter-bank forex, CBLO and National Financial Switch) was operationalised through the RTGS in Mumbai. A Committee (Chairman: Dr.R. B. Barman) has been constituted to examine the proposal of introducing the NSS which aims at settling clearing positions of various clearing houses centrally.

202. The Reserve Bank had waived processing fees on banks for electronic clearing service (ECS) and electronic fund transfer (EFT) transactions as well as for the RTGS and the NEFT transactions up to March 31, 2007 with a view to promoting electronic transactions. The Reserve Bank would continue with the waiver of processing fees to banks in order to further promote electronic transactions system, till the retail operations are taken over by the National Payments Corporation of India (NPCI). Accordingly, the Reserve Bank has waived processing fees for transactions relating to RTGS, ECS, EFT and NEFT up to March 31, 2008.

(i) Introduction of Eligibility Criteria for Access to Payment Systems

203. At present, all the banks are direct members of the clearing houses for cheque clearing system. In view of the rapidly evolving payment systems and emerging systemic risks due to probable failure of financially weak members of the clearing houses, it is imperative to put in place appropriate eligibility criteria. It is, therefore, proposed:

- to prepare comprehensive draft guidelines on minimum eligibility criteria to become direct members of the clearing houses and to place these guidelines on the Reserve Bank's website for comments/feedback by May 31, 2007.

204. The eligibility criteria will also cover membership in RTGS, NEFT, ECS and INFINET connectivity.

(j) Annual Review of Payment and Settlement Systems

205. The objective of an efficient payment and settlement system is to ensure timely, cheap and dependable service to customers. In the context of progressive integration of financial markets, both domestically and cross-border, and the fast-paced changes in technology and institutional infrastructure, there is a need for annual review of payment and settlement systems. The parameters of the reviews would be based on timeliness of customer service, cost of operation, service charges and overall impact on the financial system. To begin with, it is proposed that the first such review would be made for the year ended March 31, 2007. The outcome of the review would be placed in the public domain by August 2007.

(k) Migration from Paper-Based Payment Systems to Electronic Payment Systems: Time-Bound Action Plans

206. The Reserve Bank has been continuously taking initiatives to migrate from paper-based payment to electronic payment systems by creating appropriate technological infrastructure, while the ongoing endeavour has been to adopt international best practices. In this context, an Internal Group was constituted to examine various issues connected with the use of electronic payment systems. The Group's report has been placed on the Reserve Bank's website inviting comments/suggestions. On the basis of the feedback, a time-bound action plan would be drawn up by June 1, 2007.

Urban Co-operative Banks

207. Urban co-operative banks (UCBs) play a crucial role in the Indian financial system in channelising funds and bridging the financing gap in respect of small and medium borrowers. A 'Vision Document for Urban Co-operative Banks' was prepared keeping in view the heterogeneity of the sector in terms of size, area of operation, performance and strength. The Vision Document was placed on the Reserve Bank's website in March 2005. Pursuant to the Vision Document, the Reserve Bank has so far entered into Memoranda of Understanding (MoUs) with nine State Governments, with a view to putting in place a structured arrangement for co-ordination between State Governments and the Reserve Bank to address the problem of dual control. Task Forces for Urban Co-operative Banks (TAFCUBs) have been constituted in States that have signed MoUs and consultative processes are in operation. A TAFCUB has also been set up for the multi-state co-operative banks coming under the Central Registrar of Co-operative Societies. Consequently, 79

per cent of the UCBs, constituting 90 per cent of the deposits of this sector, are covered by MoUs/TAFCUBs.

(a) Licensing of Branches of UCBs

208. It was indicated in the Annual Policy Statement of May 2004 that fresh issuance of licenses to UCBs would be considered only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, is put in place and a policy for improving the financial health of the UCB sector is formulated. As a sequel thereto, grant of licences for opening of new branches was also put on hold. Keeping in view the positive developments in the UCB sector, it is proposed:

- to consider granting of branch licenses to well-managed and financially sound UCBs in States that have signed MoUs, subject to fulfillment of certain parameters.

(b) Guidelines on Augmenting Capital of UCBs

209. A Working Group comprising representatives of the Reserve Bank, State Governments and the UCB sector was constituted to explore various options for raising of regulatory capital funds of UCBs and identify alternate instruments/avenues for augmenting the capital funds. The report of the Group was placed on the Reserve Bank's website in November 2006 for wider dissemination and feedback. Based on the recommendations of the Working Group and comments received thereon, it is proposed:

- to issue guidelines to UCBs on the various options for raising capital by May 31, 2007.

(c) Prudential Norms for UCBs: Extension of Time

210. As a part of the two-track regulatory approach to deal with the UCBs sector, UCBs are classified under two categories, *viz.,* Tier I and Tier II banks. Tier I UCBs were allowed to classify loan accounts as NPAs based on 180 days delinquency norm instead of 90 days norm up to March 31, 2007. Furthermore, effective from the financial year 2006-07, UCBs in Tier II were required to move towards a more stringent provisioning norms for doubtful assets. Taking into consideration the progress made by UCBs, so far, it is proposed:

- to extend by one year the existing relaxed prudential norms applicable to Tier I and Tier II banks.

(d) Undertaking Insurance Business

211. At present, Scheduled UCBs in Grade I with a net worth of not less than Rs.50 crore are permitted to undertake insurance business as corporate agents, without risk participation. Further, all UCBs are allowed to undertake insurance business on referral basis. With a view to providing avenues for fee-based income for a larger number of banks, it is proposed:

- To allow all UCBs in Grade I and II with a net worth of Rs.10 crore and registered in a State that has signed the MoU with the Reserve Bank or under the Multi-State Co-operative Societies Act, to undertake insurance business as corporate agents, without risk participation.

Deposit Insurance and Credit Guarantee Corporation (DICGC)

(a) Recent Initiatives

212. The Corporation has taken a number of initiatives recently to eliminate delay in settlement of claims to the depositors. These include:

(i) Follow-up with liquidators, providing guidance and training to them for speedy preparation and submission of claim lists.

(ii) Where claim lists are not forthcoming from the liquidators within the prescribed time, the Corporation issues an advertisement in local newspapers. The advertisement mentions the non-receipt of claims at its end and also requests depositors to make claims with the liquidator under intimation to the Corporation. Before issue of such advertisements the concerned Registrar of Co-operative Societies is given one month’s time for arranging submission of claim lists. The DICGC processes such cases after obtaining necessary details from the liquidator.

(iii) Where there is a Court case challenging cancellation of license/liquidation of banks, the depositors claims in such cases as per claim list will be settled after obtaining an irrevocable undertaking from the liquidator. If the court has directly restrained it from settling claims, the Corporation will make an application to have the injunction lifted.

(b) Liberalised Interpretation in case of Joint Holding

213. Currently, the maximum claim payable by DICGC to any depositor in the same right and same capacity is Rs.1 lakh. In case of joint deposit accounts, two accounts held in the names of, say, 'A & B' and 'B & A' are currently clubbed and considered as being held in the same right and capacity with claim payment limited to Rs.1 lakh.

214. In view of the large number of representations received and in order to redress the grievance of depositors, it is proposed:

- to treat only those joint accounts held exactly in the same nomenclature and having names in the same order with different branches of the same bank, as being held in the same capacity and same right. Accordingly, joint deposits held in the names of 'A & B' and 'B & A' will be treated as two separate accounts eligible for maximum claim of Rs.1 lakh each.

Non-Banking Financial Companies

(a) Setting up of Mortgage Guarantee Companies: Status

215. A mortgage guarantee company issues guarantees for the repayment of the amount of housing loan and interest accrued thereon to a creditor institution on the occurrence of a pre-determined trigger event. These guarantees help the primary lenders to the housing loan sector to transfer their credit risk to the mortgage guarantee company.

216. The draft guidelines for setting up mortgage guarantee companies have been put on the Reserve Bank's website on April 2, 2007 for comments from the public. On the basis of the feedback received, the final guidelines will be issued on June 15, 2007.

(b) Interest Rate Ceiling on Deposits Accepted by NBFCs

217. The interest payable on deposits by NBFCs (other than residuary non-banking financial companies (RNBCs)) accepting public deposits is subject to a ceiling of 11.0 per cent per annum. There have been requests from deposit-taking NBFCs for enhancement of the ceiling on the interest payable on deposits. Taking into account the market developments, it is now proposed:

- to increase the ceiling on the rate of interest payable by NBFCs (other than RNBCs) on deposits by 150 basis points to 12.5 per cent per annum and such interest would be paid or compounded at rests which should not be shorter than monthly rests.

Committee on Financial Sector Assessment: Developments

218. The Government and the Reserve Bank of India has constituted a Committee on Financial Sector Assessment to undertake a comprehensive self-assessment of the Indian financial sector using the Handbook brought out by the World Bank and the IMF as the base. The central plank of the assessment is based on three mutually reinforcing pillars, namely, financial stability assessment and stress testing; legal, infrastructural and market development issues, and, assessment of the status and progress in implementation of international financial standards and codes. The Committee has since constituted Technical Groups comprising officials directly handling different subject areas drawn from regulatory and market agencies, besides the Government of India to undertake the assessment. The Committee envisages constituting Advisory Panels drawing non-official experts whose reports will be peer reviewed for enhancing credibility. The Committee would publish Advisory Panel reports and also its own report. Based on an objective analysis of the present strengths and weaknesses of the financial sector and the status with regard to standards, the Committee is expected to lay out a road-map for further reforms in a medium-term perspective. The Committee is expected to complete the assessment by December 2007.

High-Powered Expert Committee on Making Mumbai an International Financial Centre

219. The High-Powered Expert Committee (HPEC) on Making Mumbai an International Financial Centre (Chairman: Shri Percy S. Mistry) has offered an exhaustive list of recommendations towards facilitating the ensuing process of making Mumbai an international financial hub. The HPEC has suggested *inter alia* introduction of some specific measures in the areas of monetary policy and capital account liberalisation. It has underscored the complicated challenges of monetary management with large fiscal deficits and an open capital account in a rapidly growing developing economy like India. It emphasises the need to focus on the single task of managing a key short-term 'base rate' to maintain price stability (*e.g.*, inflation being kept within a range of 3 to 4 per cent), consistent with supporting a high growth rate of around 8 to 10 per cent. It has suggested that various issues pertaining to monetary operations, which have also been examined by the CFCAC, need to be looked into further by a specialised expert technical committee. On capital account liberalisation, the HPEC expressed the view that the ongoing process should be rapidly accelerated towards faster achievement of goals than is presently envisaged. It sets the target of achieving capital account convertibility within the next 18-24 months, *i.e.,* by the end of calendar 2008 at the earliest as compared to a five-year timeframe suggested by CFCAC along with the concomitants. In

this context, it is proposed to constitute an Internal Working Group to examine the report of the HPEC and implement the recommendations as appropriate.

Mid-Term Review

220. A review of the Annual Policy Statement on Developmental and Regulatory Policies will be undertaken on October 30, 2007.

Mumbai
April 24, 2007