Mid-Term Review of Annual Policy Statement for the Year 2007-08

Reserve Bank of India
Mumbai

Statement by Dr. Y. Venugopal Reddy, Governor, Reserve Bank of India on the Mid-term Review of Annual Policy for the Year 2007-08

This Statement consists of two parts: Part I. Mid-term Review of the Annual Statement on Monetary Policy for the Year 2007-08; and Part II. Mid-term Review of the 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 information and technical analysis with the help of charts and tables.

Part I. Mid-term Review of Annual Statement on Monetary Policy for the Year 2007-08

2. This part is divided into three sections: I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2007-08; II. Stance of Monetary Policy for the Second Half of 2007-08; and III. Monetary Measures.

I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2007-08

Domestic Developments

3. Estimates released by the Central Statistical Organisation (CSO) at the end of August 2007 placed real GDP growth during April-June 2007 at 9.3 per cent as against 9.6 per cent in the corresponding quarter last year. Real GDP growth originating in agriculture, industry and services sectors was 3.8 per cent, 10.6 per cent and 10.6 per cent, respectively, in the first quarter of

2007-08 as against 2.8 per cent, 10.6 per cent and 11.6 per cent a year ago.

4. The pace of the broadening expansion of economic activity appears to have been sustained in the second quarter of 2007-08. Lead indicators point to congenial conditions for a pick-up in agricultural activity on the back of the higher than expected growth recorded in the preceding quarter. Rainfall during the 2007 south-west monsoon season was five per cent above the long-period average (LPA) for the country as a whole according to the India Meteorological Department (IMD). Of the 36 meteorological subdivisions across the country, rainfall was excess/normal in as many as 30 sub-divisions as against 26 in the 2006 season. On the other hand, six sub-divisions which have received deficient rainfall in the 2007 season include Punjab, Haryana, Himachal Pradesh, western Uttar Pradesh and eastern Madhya Pradesh which are major foodgrains producing regions. As on October 18, 2007 live storage in 81 major reservoirs was 81 per cent of designated capacity which is 19.3 per cent higher than the last 10 years' average but 3.1 per cent lower than the level a year ago. The water storage level supports the prospects for *rabi* production.

5. Benefiting from favourable south-west monsoon conditions, the area sown under *kharif* rice, pulses and oilseeds increased to 37.3 million hectares, 12.5 million hectares and 17.8 million hectares, respectively, up to October 19, 2007 as against 37.1 million hectares, 11.4 million hectares and 16.8 million hectares in the 2006 season. Acreage under cash crops such as cotton, jute and sugarcane was also higher than a year ago. First advance estimates released by the Ministry of Agriculture place *kharif* foodgrains production at 112.2 million tonnes, below the

target of 114.2 million tonnes, but higher than 110.5 million tonnes recorded last year. As per these initial estimates, production of nine major oilseeds during the *kharif* season is placed at 16.1 million tonnes which is lower than the target of 18.5 million tonnes, but significantly higher than the output of 13.9 million tonnes in 2006-07. Production of cotton, jute and sugarcane is also expected to register an increase in 2007-08.

6. The index of industrial production (IIP) rose by 9.8 per cent during April-August 2007 as against 11.0 per cent in the corresponding period last year. Manufacturing output increased by 10.3 per cent (12.2 per cent a year ago) while mining activity and electricity generation rose by 5.4 per cent (3.0 per cent) and 8.3 per cent (5.7 per cent), respectively. Manufacturing activity was led by food products, wood products, chemicals, basic metals and alloys and non-transport machinery and equipments which together constituted 53.9 per cent of the manufacturing sector and contributed 71.5 per cent of its growth during April-August 2007. On the other hand, deceleration in the production of textiles and transport equipment, and decline in the production of metal products and parts which have a combined share of 22.3 per cent in the manufacturing sector, had a moderating effect on manufacturing activity as well as on overall industrial growth during this period. The use-based classification indicates sustained investment demand as reflected in an increase of 21.3 per cent (19.5 per cent) in capital goods production. Production of basic goods and intermediate goods increased by 10.0 per cent (8.3 per cent) and 9.3 per cent (10.4 per cent), respectively. Consumer goods growth decelerated to 6.2 per cent (11.4 per cent), mainly due to a decline of 2.3 per cent in the consumer durables. The six infrastructure

industries, which together comprise nearly 27 per cent of the IIP, posted a growth of 6.6 per cent during April-August 2007 as against 8.3 per cent a year ago. Except for electricity generation, all other sectors of core infrastructure recorded decelerated growth.

7. Information on corporate activity indicates that sales of selected companies had risen by 19.2 per cent during April-June 2007, lower than 25.6 per cent in the corresponding quarter a year ago. The rise in other income, lower interest burden, improvements in operational efficiency, higher capacity utilisation and economies of scale appear to have contributed substantially to overall financial performance and high profit margins especially for larger companies, despite an increase of 18.1 per cent in depreciation provision. Net profits rose by 33.9 per cent in the first quarter of 2007-08 as against 34.7 per cent during the corresponding period last year. Buoyant equity markets enabled higher mobilisation of resources by the private corporate sector through public issues and private placements than in the corresponding period of 2006-07. Early results for the second quarter of 2007-08 (July-September) for a truncated sample of companies indicate continuing moderation in sales and profitability growth relative to the corresponding quarter a year ago as well as the preceding quarter, especially for manufacturing companies. On the other hand, some decline in the interest burden on a year-on-year basis, reflecting the relatively higher recourse of corporates to external commercial borrowings (ECBs) and consequently lower interest payments relative to domestic borrowings as well as gains thereon in rupee terms due to exchange rate appreciation boosted other income and helped to shore up net profit margins.

8. The Reserve Bank's Industrial Outlook Survey conducted mainly during August 2007, which covers private manufacturing companies, indicates stable business conditions. Half of the respondent companies reported increase in production and a better overall business situation; over 40 per cent indicated no change in these characteristics. A majority of respondents felt that capacity utilisation would remain unchanged. The overall assessment of working capital requirement, availability of finance and overall financial situation was positive for July-September 2007. The assessment of moderation in export and import growth that started in the beginning of the year continued to prevail. On a net basis, respondents reported a higher increase in input cost than in selling prices. The business expectation index for July-September 2007 improved by 3.1 percentage points from its level in the previous quarter; however, it was lower by 1.8 percentage points from its level a year ago. For October-December 2007, the business expectation index rose by 3.3 percentage points from its level in the previous quarter though lower by 0.9 percentage points on a year-on-year basis. Over a fifth of respondents expect increase in employment level in their companies during July-December 2007. While 60 per cent did not expect any change in profit margins, a fourth of the respondents expected increase in profitability.

9. Other business confidence surveys which also cover services sector companies present a somewhat mixed picture. According to one survey, business confidence shows a fall of 8.9 percentage points in July-December 2007 relative to its level in the previous round, reflecting some increase in the cost of finance and rising prices of raw materials. A lower level of confidence in overall economic conditions and industry/firm level performance is also reflected in some other surveys. On the

other hand, some surveys report optimism on value of production, new orders and utilisation of capacity for the second half of 2007-08. In this view, seasonally adjusted purchasing managers' indices, which cover only manufacturing companies, point to a robust improvement in operating conditions with marked increase in output and new orders, underpinned by favourable domestic market conditions. Price increases for both inputs and outputs were stated to be high by respondents but were not expected to impede the step-up in purchasing activity and hiring of additional staff due to higher production requirements.

10. Lead indicators suggest that the pace of expansion in the services sector activity has been sustained during April-August 2007. The communication sector has recorded robust growth with 34 million telephone connections (fixed plus cellular) in April-August 2007 which is 55.4 per cent higher than 22 million connections provided in the corresponding period last year. Cargo handled at major ports increased by 14.2 per cent, whereas handling of import cargo and export cargo in the civil aviation sector increased by 23.5 per cent and 5.4 per cent, respectively. Railway revenue earnings from freight traffic increased by 7.0 per cent which was lower than the growth of 9.9 per cent in the corresponding period last year, mainly due to lower traffic for carriage of foodgrains and raw materials for steel plants. Passengers handled at domestic and international terminals increased by 27.8 per cent and 12.4 per cent, respectively, as against 40.1 per cent and 12.9 per cent a year ago.

11. According to the CSO's end-August 2007 release, there are indications of underlying shifts in the constituents of aggregate demand. As a proportion to GDP, real private final

consumption expenditure declined to 58.8 per cent during the first quarter of 2007-08 from 60.8 per cent a year ago. On the other hand, real gross fixed capital formation (GFCF) increased to 29.6 per cent of GDP from 27.9 per cent, indicative of the investment led acceleration of growth in the Indian economy. As regards external demand, net exports are placed at (-)1.0 per cent of GDP in April-June 2007 *vis-à-vis* 0.8 per cent a year ago.

12. On a year-on-year basis, total credit extended by scheduled commercial banks (SCBs) increased by Rs.3,81,333 crore (23.3 per cent) up to October 12, 2007 as compared with an increase of Rs.3,66,463 crore (28.8 per cent) a year ago. On a financial year basis, credit extended by SCBs increased by Rs.90,262 crore (4.7 per cent) up to October 12, 2007 as compared with the increase of Rs.1,30,764 crore (8.7 per cent) in the corresponding period last year. Food credit declined by Rs.9,501 crore as against a decline of Rs.7,246 crore in the previous year. Non-food credit registered an increase of Rs.99,763 crore (5.3 per cent) as compared with an increase of Rs.1,38,010 crore (9.4 per cent) in the corresponding period of the previous year.

13. Provisional information available from select SCBs up to August 2007 indicates that credit to industries expanded by 24.6 per cent up to August on a year-on-year basis, slowing from 25.7 per cent in March 2007. Credit to agriculture expanded by 24.4 per cent (32.4 per cent in March 2007). On the other hand, bank credit to services and personal loans at 24.5 per cent (31.0 per cent) and 19.8 per cent (26.5 per cent), respectively, recorded a sizeable slowdown. Within the industrial sector, credit off-take by infrastructure, chemicals and vehicles

and auto parts picked up to 32.1 per cent (26.8 per cent), 16.1 per cent (14.2 per cent) and 28.5 per cent (11.0 per cent), respectively. On the other hand, credit disbursed decelerated in the case of textiles to 28.0 per cent (34.2 per cent), metals to 19.6 per cent (26.7 per cent), engineering to 24.0 per cent (24.5 per cent) and petroleum to 35.7 per cent (41.0 per cent). In the services sector, all constituents barring computer software, tourism and hotels and non-banking financial companies recorded deceleration in credit off-take. In particular, growth in credit to real estate decelerated to 52.9 per cent from 69.8 per cent in March 2007, but still remained high. Under personal loans, sizeable deceleration in credit occurred under housing (to 16.6 per cent in August 2007 from 24.6 per cent in March 2007), consumer durables (to 4.1 per cent from 28.9 per cent) and other personal loans (to 22.5 per cent from 30.3 per cent). Credit to industry recorded the highest share of 41.1 per cent in total incremental non-food bank credit by August 2007, followed by services (23.8 per cent), personal loans (22.4 per cent) and agriculture (12.7 per cent). The shares of infrastructure, engineering and chemical industries in incremental credit to industry increased from 21.4 per cent, 6.0 per cent and 4.9 per cent, respectively, in March 2007 to 26.7 per cent, 6.2 per cent and 5.5 per cent in August 2007. The share of metals, textiles, petroleum and food processing declined from 12.4 per cent, 14.1 per cent, 7.3 per cent and 6.1 per cent, respectively, to 10.0 per cent, 12.4 per cent, 6.2 per cent and 6.0 per cent. The share of the priority sector in incremental non-food gross bank credit declined marginally to 31.0 per cent from 31.2 per cent. Priority sector advances rose by 20.2 per cent up to August 2007, lower than 24.0 per cent in March 2007. While the share of agriculture declined to 12.7 per cent in

August 2007 from 14.4 per cent in March 2007, the share of small scale industries (SSIs) increased to 8.3 per cent from 6.6 per cent. There has been a greater deceleration in credit disbursements in respect of the services and retail sectors as compared with industry.

14. On a year-on-year basis, commercial banks' investments in shares, bonds/debentures and commercial paper (CP) declined by Rs.5,514 crore (6.7 per cent) up to October 12, 2007 as compared with a decline of Rs.895 crore (1.1 per cent) a year ago. On a financial year basis, such investments by banks fell by Rs.6,930 crore (8.5 per cent) during 2007-08 so far (up to October 12), as against an increase of Rs.2,514 crore (3.2 per cent) in the corresponding period of 2006-07. Banks' investments in instruments issued by all-India financial institutions and mutual funds, however, increased by Rs.49,847 crore as against an increase of Rs.11,526 crore in the corresponding period of the previous year. The year-on-year growth in total resource flow from SCBs to the commercial sector was 22.1 per cent, over and above the growth of 28.0 per cent a year ago. In addition, during the first quarter of the current financial year, corporates raised additional resources in the form of external commercial borrowings (ECBs) amounting to Rs.29,498 crore as against Rs.18,882 crore in the first quarter last year.

15. On an annual basis, the growth in aggregate deposits at 24.9 per cent (Rs.5,69,061 crore) was higher than that of 20.4 per cent (Rs.3,88,528 crore) a year ago. On a financial year basis, aggregate deposits of SCBs increased by 9.6 per cent (Rs.2,49,724 crore) up to October 12, 2007 as compared with an increase of 8.5 per cent (Rs.1,79,923 crore) in the corresponding period of the previous year. Reflecting high

profitability and internal generation of resources by the corporate sector, its share in total deposits with the banking system has been increasing, mainly in the form of short-term deposits. On the other hand, the share of savings deposits in total deposits has been declining. The incremental annual non-food credit-deposit ratio declined to 66.4 per cent on October 12, 2007 from 95.3 per cent a year ago.

16. In view of the lower credit growth, banks undertook incremental investment in statutory liquidity ratio (SLR) securities. SCBs' investment in SLR securities at Rs.1,52,488 crore during the current financial year up to October 12, 2007 was higher than that of Rs.49,717 crore in the corresponding period of the previous year. The ratio of such investments to aggregate deposits on an incremental basis was 30.9 per cent as against 6.1 per cent in the corresponding period last year. It needs to be mentioned that a part of this increase was due to bank recapitalisation bonds (amounting to Rs.5,270 crore) being considered as approved securities for SLR, and part due to subscription to SLR bonds issued under the market stabilisation scheme (MSS). Even after adjusting for banks' repo/reverse repo with the Reserve Bank under the Liquidity Adjustment Facility (LAF), SLR investments at Rs.86,758 crore during 2007-08 so far were much higher than the increase of Rs.38,727 crore in the corresponding period last year. Consequently, on an outstanding basis, commercial banks' holdings of Government and other approved securities increased to 30.0 per cent of their net demand and time liabilities (NDTL) as on October 12, 2007 from 28.0 per cent at end-March 2007. While these investments exceeded the required SLR by Rs.1,56,851 crore (Rs.84,223 crore at end-March 2007), the excess SLR investment adjusted for LAF holdings amounted to Rs.1,20,306 crore or 3.8 per cent of NDTL.

17. Year-on-year money supply (M_3) at 21.8 per cent as on October 12, 2007 was higher than 18.9 per cent a year ago and above the range of 17.0-17.5 per cent indicated in the Annual Policy Statement of April 2007. On a financial year basis, M_3 increased by 8.2 per cent (Rs.2,72,010 crore) up to October 12, 2007 as compared with the increase of 7.7 per cent (Rs.2,11,279 crore) in the corresponding period of the previous year.

18. Reserve money increased by 24.4 per cent on a year-on-year as on October 19, 2007 as compared with 20.2 per cent a year ago. On a financial year basis, reserve money increased by 8.0 per cent (Rs.57,060 crore) up to October 19, 2007 as compared with the increase of 7.5 per cent (Rs.42,932 crore) in the corresponding period of the previous year. The large increase in reserve money in the current financial year so far reflects in part the initial impact of recent increases in the cash reserve ratio (CRR). Among the components of reserve money, therefore, bankers' deposits with the Reserve Bank increased by 18.7 per cent (Rs.36,984 crore) during the current year so far as compared with an increase of 5.2 per cent (Rs.7,047 crore) in the corresponding period last year. Currency in circulation, however, registered a lower growth of 4.5 per cent (Rs.22,589 crore) as compared with 8.7 per cent (Rs.37,319 crore). Among the sources of reserve money, Reserve Bank's net credit to the Central Government declined by Rs.1,43,116 crore as compared with an increase of Rs.15,029 crore in the corresponding period last year. Adjusted for transactions under the LAF, Reserve Bank's credit to the Central Government showed a decline of Rs.81,981 crore mainly on account of increased MSS issuance in 2007-08 so far. The Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.1,71,080 crore as against an

increase of Rs.77,310 crore during the corresponding period of the previous year. Adjusted for revaluation, NFEA increased by Rs.2,17,201 crore as compared with an increase of Rs.42,544 crore during the corresponding period of the previous year. The ratio of NFEA to currency increased from 171.8 per cent on March 31, 2007 to 196.9 per cent by October 19, 2007.

19. Movements in the key monetary and banking aggregates in the second quarter of 2007-08 were reflected in generally easy conditions of liquidity, except for some short-lived episodes of tightness. The banking system experienced conditions of surplus liquidity on account of substantial deposit mobilisation relative to credit demand as well as capital augmentation through several large IPOs. Consequently, banks made sizeable investments in Government securities/Treasury bills issued under the MSS. With effect from August 6, 2007 the daily ceiling of Rs.3,000 crore on reverse repo under the LAF stipulated since March 5, 2007 was removed. During August 6-31, 2007 average daily net absorption under the LAF was Rs.25,333 crore, despite an additional amount of Rs.13,500 crore absorbed under the MSS. On August 9, 2007 the Reserve Bank transferred its annual profit to the Central Government which included a one-time payment of Rs.34,309 crore on account of profit on sale of the Reserve Bank's stake in the State Bank of India (SBI) which augmented the Central Government's cash balances with the Reserve Bank. Large absorption of liquidity under the LAF and the MSS continued till the third week of September when quarterly advance tax outflows and build-up of the Centre's cash balances led to a sharp drop in the daily volumes of funds offered at the LAF auctions, and the Reserve Bank had to inject liquidity under the LAF on September 21 and 28. In view of large capital inflows, an additional amount of Rs.68,685 crore was sterilised during

September and October under the MSS with the outstanding sterilisation under the MSS increasing to Rs.1,77,155 crore by October 26, 2007. The overhang of liquidity as reflected in the sum of LAF, MSS and the Central Governments' cash balances increased from Rs.85,770 crore at end-March 2007 to Rs.1,24,632 crore on August 6, 2007 and further to Rs.2,22,582 crore by October 24, 2007. The Government of India, in consultation with the Reserve Bank, revised the ceiling under MSS for the year 2007-08 from Rs.1,10,000 crore to Rs.1,50,000 crore on August 8, 2007 and further to Rs.2,00,000 crore on October 4, 2007.

20. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, eased from its peak of 6.4 per cent on April 07, 2007 to 3.1 per cent by October 13, 2007. On an average basis, however, annual WPI inflation at 5.2 per cent was higher than 4.6 per cent a year ago.

21. At a disaggregated level, prices of primary articles (weight: 22.0 per cent in the WPI basket) and manufactured products (weight: 63.8 per cent) increased by 5.2 per cent and 4.1 per cent, respectively, by October 13, 2007 as compared with an increase of 8.1 per cent and 4.6 per cent a year ago. An analysis of constituent price movements indicates that the rise in prices of edible oils, oilseeds and oilcakes, which together have a weight of 6.9 per cent in the WPI, contributed nearly 40 per cent of the headline inflation, while 16 per cent of headline inflation came from increases in prices of primary food items especially rice, milk and vegetables. Excluding food, headline WPI inflation was 3.0 per cent as against 5.0 per cent a year ago. Other items that contributed to headline inflation included cement, drugs and medicines, iron and steel and electrical machinery.

22. Annual inflation of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) declined to 1.6 per cent as on October 13, 2007 as against 5.0 per cent a year ago. Excluding the fuel group, inflation was at 4.4 per cent (5.6 per cent a year ago). The average price of the Indian basket of international crude was at around US $ 72.1 per barrel during July-September 2007 higher than US $ 66.4 in April-June 2007 and US $ 56.6 in January-March 2007. Since the last revision of domestic retail prices of petrol and diesel in February 2007, the price of the Indian basket had increased by about 32 per cent in US dollar terms and about 21 per cent in rupee terms up to September 2007. Subsequently, there has been a further increase in crude oil prices in the international markets and the average price of the Indian crude basket has gone up to US $ 80 per barrel as on October 23, 2007. While the price of the Indian crude basket in rupee terms went up by an average of 22.4 per cent per annum between 2002-03 and 2006-07, the increase in prices of petrol and diesel and the freely priced products (such as aviation turbine fuel, furnace oil and naphtha) were 12.8 per cent and 16.5 per cent per annum, respectively. This suggests an average pass-through of around 57 per cent in the case of petrol and diesel and around 73 per cent in the case of the freely priced products. The subsidy schemes for kerosene and domestic LPG, which were available through public distribution system (PDS) until March 2007, have been extended till March 2010. Domestic retail prices of petrol and diesel have remained unchanged after two downward revisions in 2006-07, thereby increasing the magnitude of incomplete pass-through. The issue of oil bonds and burden sharing by upstream oil public sector units (PSUs) in the form of discounts on crude oil and products is expected to mitigate a part of the under-recoveries. Overall, inflation risks on

account of oil prices remain incipient and it is possible that some increase in domestic prices of petroleum products would translate into some elevation in WPI inflation.

23. Inflation, based on the consumer price index (CPI) for industrial workers, showed a sharp increase to 7.3 per cent on a year-on-year basis in August 2007 from 6.3 per cent a year ago. Year-on-year inflation based on the CPI for urban non-manual employees, agricultural labourers and rural labourers in September 2007 increased to 5.7 per cent, 7.9 per cent and 7.6 per cent, respectively, from 6.6 per cent, 7.3 per cent and 7.0 per cent a year ago. A major portion of the differences between inflation rates based on the WPI and CPIs is explained by prices of food items which have a higher weight in the CPIs than in the WPI. Year-on-year CPI inflation for industrial workers was 9.6 per cent for food items and 5.2 per cent for non-food items in August 2007 whereas for urban non-manual employees and agricultural labourers, it was 7.7 per cent and 8.8 per cent for food items, respectively, and 4.0 per cent and 6.0 per cent for non-food items, in September 2007.

24. In drawing meaningful inferences from the data on fiscal developments during the year, it is necessary to take account of the one-time transaction relating to transfer of the Reserve Bank's shareholding in the State Bank of India (SBI). On June 29, 2007 the Central Government paid Rs.35,531 crore to the Reserve Bank as consideration amount for the transfer. On August 9, 2007 the Reserve Bank transferred an amount of Rs.45,720 crore as its surplus for 2006-07 (July-June) to the Government which included an amount of Rs.34,309 crore on account of sale of SBI shareholding to the Government. Excluding the transactions relating to transfer of the Reserve Bank's stake

in the SBI to the Government, revenue receipts of the Central Government amounted to 26.7 per cent of the budget estimates (BE) in April-August 2007 as compared with 26.4 per cent in April-August 2006. Tax revenue and non-tax revenue were 24.6 per cent and 36.8 per cent of the BE, respectively, during April-August 2007 as compared with 24.9 per cent and 32.9 per cent a year ago. Total expenditure at 36.8 per cent of the BE in April-August 2007 was higher than 35.5 per cent a year ago. As a proportion to the BE, the gross fiscal deficit (GFD) and revenue deficit increased to 67.6 per cent and 122.9 per cent, respectively, during April-August 2007 as compared with 61.0 per cent and 93.7 per cent in the corresponding period last year. A notable feature of deficit financing this year so far has been the decline in net mobilisation from small savings deposits and certificates for the first time.

25. The gross market borrowings of the Central Government through dated securities at Rs.1,27,060 crore (Rs.1,17,548 crore a year ago) during 2007-08 so far (up to October 26, 2007) constituted 67.3 per cent of the BE. Net market borrowings at Rs.75,387 crore (Rs.65,951 crore a year ago) constituted 68.7 per cent of the BE. An additional amount of Rs.27,500 crore (net) was mobilised through issuance of Treasury Bills (TBs) over and above the rollover of TBs maturing during the period. The weighted average yield and weighted average maturity of Central Government securities issued during 2007-08 so far (up to October 26, 2007) were higher at 8.20 per cent and 14.41 years, respectively, as compared with 7.91 per cent and 14.08 years for those issued during the corresponding period last year. As against the provisional net allocation of Rs.28,206 crore (gross Rs.45,385 crore) for their market borrowing programme, the State Governments have

raised a net amount of Rs.8,808 crore up to October 26, 2007. As in the past, an indicative issuance calendar for issue of dated securities for the second half of 2007-08 was issued on September 24, 2007 in consultation with the Central Government with a view to enabling institutional and retail investors to plan their investment in a better manner and also for providing transparency and stability in the Government securities market. In addition to the market borrowing programme, recapitalisation bonds amounting to Rs.12,001 crore were issued in August and September, 2007. Moreover, special securities amounting to Rs.7,500 crore with features similar to securities issued to oil companies and the Food Corporation of India in 2006-07, would be issued during the remaining part of 2007-08. Furthermore, it was announced on October 11, 2007 that the Central Government would bear 42.7 per cent (Rs.23,457 crore) of the total under-recoveries of the oil companies (estimated at Rs.54,935 crore for 2007-08) in the form of oil bonds. Thus, securities amounting to Rs.42,958 crore are planned to be issued by the Central Government (excluding MSS) in addition to the regular market borrowing programme for 2007-08 as against Rs.40,321 crore issued in 2006-07.

26. During the second quarter of 2007-08, financial markets remained generally stable with conditions of abundant liquidity. Reflecting this environment, interest rates moderated in almost all segments of the financial system. Overnight interest rates, which averaged 0.26 per cent in July, returned to the LAF corridor after the ceiling on reverse repo acceptance under the LAF was removed from August 6, 2007 and the CRR was increased from 6.5 per cent to 7.0 per cent with effect from the fortnight beginning August 4, 2007. Despite the overall stability, transient spikes in overnight rates were witnessed in August. Call money rates

averaged 6.31 per cent in August 2007. Some hardening of overnight rates was also witnessed in the second half of September on account of reduction in liquidity with the banking system due to sizeable tax outflows and build-up of the Centre's cash balances which was also reflected in reduced LAF reverse repo. The call money rate has declined from 14.07 per cent in March 2007 to 6.31 per cent in August and to 6.01 per cent on October 26, 2007. Overnight rates in other segments, *viz.,* market repo and collateralised borrowing and lending obligations (CBLO) have moved in tandem with call money rates. Market repo (other than LAF) and CBLO rates declined from 8.13 and 7.73 per cent, respectively, in March 2007 to 5.66 and 6.00 per cent as on October 26, 2007. The daily average volume (one leg) in the call money market rose from Rs.11,608 crore in March 2007 to Rs.12,981 crore as on October 26, 2007. The corresponding volumes in the market repo were Rs.8,687 crore and Rs.27,075 crore, respectively. In the CBLO segment, the volumes were Rs.17,662 crore and Rs.25,090 crore, respectively. As on October 26, 2007 interest rates for CBLO, market repo and call money stood at 5.66 per cent, 6.00 per cent and 6.01 per cent, respectively.

27. The primary yield on 91-day Treasury Bills declined to 7.02 per cent on October 24, 2007 from 7.98 per cent on end-March 2007 whereas the yield on 364-day Treasury Bills declined to 7.36 per cent from 7.98 per cent over the same period. There was higher mobilisation from CPs as the outstanding amount of CP was Rs.33,614 crore by end-September 2007 as compared with Rs.17,688 crore at end-March 2007, with the weighted average discount rate on CP declining to 8.95 per cent from 11.33 per cent over this period. In the market for certificates of deposit (CDs) also, the weighted average discount rate declined from 10.75 per cent at

the end of March 2007 to 8.57 per cent by end-September, accompanied by an increase of 27.0 per cent in the outstanding amount (from Rs.93,272 crore to Rs.1,18,481 crore). It may be noted that overnight and short-term money market rates had firmed up at the end of March 2007 reflecting liquidity tightening resulting from end-year tax outflows.

28. In the foreign exchange market, large surplus conditions in the spot market resulted in a sharp increase in average daily turnover to US $ 52.9 billion in mid-September 2007 from a level of US $ 27.5 billion a year ago. While the inter-bank turnover increased from US $ 20 billion to US $ 37.6 billion, the merchant turnover increased from US $ 7 billion to US $ 15.2 billion. According to the triennial central bank survey conducted by the Bank for International Settlements (BIS), India is among the fastest growing foreign exchange markets in terms of turnover. There has been a general softening in forward premia across all maturities. The six-month forward premia eased from 3.60 per cent in March 2007 to 2.53 per cent by end-June 2007 and further to 1.20 per cent as on October 26, 2007.

29. The yield on Government securities with one-year residual maturity declined from 7.55 per cent at end-March 2007 to 7.40 per cent as on October 26, 2007. The yield on Government securities with 10-year residual maturity also declined from 7.97 per cent to 7.88 per cent. The yield on Government securities with 20-year residual maturity rose from 8.23 per cent to 8.28 per cent. The yield spread between 10-year and one-year Government securities widened from 42 basis points to 48 basis points. The yield spread between 20-year and one-year Government securities also widened from 68 basis points to 88 basis points during the same period.

30. During April–October 2007, public sector banks (PSBs) decreased their deposit rates, particularly at the upper end of the range for various maturities, by 25-60 basis points. Deposit rates of PSBs increased by 25-75 basis points at the lower end for deposits of maturities of one year and above. Interest rates offered by the PSBs on deposits of above one year maturity moved from 7.25-9.75 per cent in April 2007 to 8.0-9.5 per cent in October 2007. Private sector banks' deposit rates for up to one year maturity decreased from a range of 3.00-10.00 per cent to 2.5-9.25 per cent over the same period. Foreign banks' deposit rates for up to one year maturity also declined from a range of 3.00-9.50 per cent to 2.00-9.00 per cent during the same period. The benchmark prime lending rates (BPLRs) of private sector banks moved from a range of 12.50-17.25 per cent to 13.00-16.50 per cent in the same period. The range of BPLRs for PSBs and foreign banks, however, remained unchanged at 12.50-13.50 per cent and 10.00-15.50 per cent, respectively, during this period.

31. During the second quarter of 2007-08, equity market activity recorded a pick-up in terms of issuances in the domestic primary segment as well as in international stock exchanges. The BSE Sensex (1978-79=100) increased from 13,072 at end-March 2007 to cross the 15,000 level on July 9, 2007, the 16,000 level on September 19, 2007, the 17,000 level on September 27, 2007, the 18,000 level on October 9, 2007, the 19,000 level on October 15, 2007 and closed at 19,243 on October 26, 2007. According to the Securities and Exchange Board of India (SEBI), net investments by foreign institutional investors (FIIs) in the equity market were significantly higher at Rs.62,139 crore (US $ 15.1 billion) during April-October 19, 2007 as compared with net investments of Rs.10,231 crore (US $ 2.2

billion) in the corresponding period last year. Mutual funds mobilised funds of the order of Rs.1,05,614 crore during April-September 2007 as against Rs.60,048 crore a year ago.

Developments in the External Sector

32. Balance of payments data for the first quarter of 2007-08 released by the Reserve Bank at the end of September 2007 indicate a widening of the merchandise trade deficit on a year-on-year basis, sustained buoyancy in invisibles and sizeable net capital inflows which comfortably met the external financing requirement for April-June 2007 and also enabled a build-up of international reserves, fortifying the stability and strength of India's external sector. In US dollar terms, merchandise export growth was 17.8 per cent during April-June 2007 as against 23.7 per cent in the first quarter of the previous year. Commodity-wise data available from the Directorate General of Commercial Intelligence and Statistics (DGCI&S) for April-May 2007 indicate that exports of petroleum products, engineering goods and gems and jewellery together contributed 69 per cent of overall export growth as compared with 66 per cent in April-May 2006. The growth of exports of primary products moderated to 7.1 per cent, mainly due to the deceleration in the exports of agriculture and allied products; exports of ores and minerals, however, showed a turnaround during April-May 2007. Exports of manufactures registered a growth of 12.7 per cent in April-May 2007 as against 12.2 per cent a year ago. While growth of exports of chemicals and related products moderated to 7.9 per cent as compared with 12.1 per cent, export of textiles and related products declined by 7.7 per cent as against an increase of 11.6 per cent. Merchandise import payments rose by 21.3 per cent during the first quarter of the 2007-08 as compared

with 22.9 per cent a year ago. While crude oil import growth at 8.0 per cent moderated from 45.2 per cent, non-oil import payments increased by 47.4 per cent, reflecting the underlying strength of domestic demand. The main drivers of non-oil import growth in 2007-08 so far (April-May) were capital goods, iron and steel, gold and silver, pearls, precious and semi-precious stones, chemicals and metalliferrous ores and metal scrap. China remained the major source of imports in April-May 2007 accounting for 10 per cent of total imports and 14.8 per cent of non-oil imports. On a payments basis, the merchandise trade deficit widened to US $ 21.6 billion in the first quarter of 2007-08 from US $ 16.9 billion a year ago.

33. During the first quarter of 2007-08, gross invisible receipts comprising services, current transfers and income at US $ 31.4 billion amounted to nearly 90 per cent of merchandise exports, recording a year-on-year increase of 27.5 per cent. Software exports, travel earnings, other professional and business services and remittances from overseas Indians underpinned the strength of invisible receipts. On the other hand, invisible payments increased by 18.6 per cent, mainly on account of a surge in payments related to travel, business and management consultancy, engineering and technical services and dividend and profit payouts. On a net basis, the invisible account recorded a surplus of US $ 16.9 billion during the first quarter of 2007-08 as against US $ 12.4 billion in the corresponding quarter of the previous year. The current account deficit (CAD) amounted to US $ 4.7 billion, broadly the same as in the first quarter of 2006-07.

34. Net capital flows surged to US $ 15.3 billion during the first quarter of 2007-08 from US $ 10.6 billion a year ago. Net

external commercial borrowings (ECB) inflows at US $ 7.0 billion were sizeable and accounted for 45.8 per cent of total net capital flows as compared with nearly US $ 4.0 billion or 37.5 per cent of net capital flows in the first quarter of the previous year. The growing appetite of Indian companies for global expansion was mirrored in outward foreign direct investment (FDI) from India which showed a significant increase to US $ 5.4 billion in the first quarter of 2007-08 as compared to US $ 1.1 billion a year ago. Net portfolio investment by foreign institutional investors (FIIs) turned around with inflows of US $ 7.1 billion during the first quarter of 2007-08 as against an outflow of US $ 1.8 billion a year ago. The impact of the reduction in ceiling on interest rates during January and April 2007 resulted in non-resident Indians (NRI) deposits recording a net outflow of US $ 0.4 billion in the first quarter of 2007-08, a turnaround from net inflows of US $ 1.2 billion in the first quarter of 2006-07. Inflows under American Depository Receipts/Global Depository Receipts (ADRs/GDRs) amounted to US $ 308 million in April-June 2007.

35. Reflecting the movements in current and capital accounts of the balance of payments, the accretion to foreign exchange reserves (excluding valuation) amounted to US $ 11.2 billion during the first quarter of 2007-08 as against US $ 6.4 billion a year ago. Taking into account the valuation gain of US $ 3.0 billion, the level of foreign exchange reserves amounted to US $ 213.4 billion at the end of June 2007.

36. India's external debt increased by US $ 8.7 billion during April-June 2007 and amounted to US $ 165.4 billion at end-June 2007. While multilateral debt registered a moderate increase of US $ 317 million, there was a marginal decline of US $ 417 million in bilateral debt. ECB increased by US $ 5.5

billion while there was an increase of US $ 1.0 billion in short-term trade credits. Valuation gains on account of the appreciation of the US dollar vis-à-vis other major international currencies added US $ 1.2 billion to the stock of external debt. The US dollar had a dominant share of 50.4 per cent in India's external debt whereas rupee-denominated debt had a share of 18.0 per cent. The ratio of short-term debt to total debt increased marginally to 7.9 per cent at end-June 2007 from 7.6 per cent at end-March 2007. The ratio of foreign exchange reserves to external debt was 129.0 per cent at the end of June 2007 as compared with 127.1 per cent at end-March 2007.

37. These developments appear to have gained ground in the second quarter of 2007-08. According to the DGCI&S, merchandise exports rose by 18.2 per cent in US dollar terms during April-August 2007 as compared with 27.1 per cent in the corresponding period of the previous year. Import growth was higher at 31.0 per cent as compared with 20.6 per cent in the previous year. Non-oil imports rose by as much as 44.3 per cent (10.9 per cent a year ago); oil imports, however, slowed down to 6.0 per cent (44.5 per cent), mainly on account of moderation in the price of the Indian basket of crude oil by 0.5 per cent during April-August 2007 (US $ 68.0 per barrel) as against an increase of 30.2 per cent during April-August 2006 (US $ 68.4 per barrel). On the other hand, oil import in volume terms increased by 18 per cent during April-May 2007 as compared with 13 per cent in April-May 2006. As a result, the merchandise trade deficit widened to US $ 32.5 billion during April-August 2007 from US $ 19.9 billion in April-August 2006. There are also indications of a substantial increase in remittances received from Indians working abroad as well as sustained resilience and growth in exports of software and IT enabled services.

38. Available information points to a scaling up of various elements of net capital flows in relation to their levels a year ago and even in the preceding quarter. Portfolio flows have picked up strongly on account of FIIs, amounting to US $ 21.2 billion during 2007-08 (up to October 19) as compared to an inflow of US $ 0.9 billion in the corresponding period of 2006-07. Gross FDI inflows during April-July 2007 were placed at US $ 6.6 billion as compared with US $ 3.7 billion a year ago. Approvals for ECBs amounted to US $ 8.7 billion during April-June 2007 as compared with US $ 4.4 billion in the corresponding period last year. On the other hand, there were net outflows under NRI deposits of US $ 148 million in April-July 2007 as compared with inflows of US $ 1,585 million during April-July 2006. ADR/ GDR issues by Indian companies amounted to US $ 2.3 billion during April-July 2007 as against an inflow of US $ 1.5 billion in the corresponding period in the previous year. The foreign exchange reserves increased by US $ 62.0 billion and stood at US $ 261.1 billion on October 19, 2007.

39. The exchange rate of the rupee against the US dollar, which was Rs.43.59 at end-March 2007, appreciated thereafter to reach Rs.41.24 at end-August 2007 and strengthened further to Rs.39.51 per US dollar as on October 26, 2007. The rupee appreciated by 10.3 per cent against the US dollar, by 2.4 per cent against the euro, by 5.4 per cent against the pound sterling and 7.1 per cent against the Japanese yen during the current financial year up to October 26, 2007.

40. 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

41. Since late July, global financial markets have experienced bouts of turbulence and high volatility with the unfolding of the US sub-prime mortgage crisis. A freezing of credit markets spread rapidly to equity, currency and bond markets with disorderly re-pricing of risk in all segments. The deterioration in sentiment has affected consumer confidence with apprehensions of potential economy-wide effects in the US. Global economic activity, however, appears so far to have been resilient in the face of the heightening of volatility in international financial markets in the third quarter of 2007. Fundamentals remain strong in other large industrial countries as well as in most emerging market economies, especially in Asia which as a region is running current account surpluses with reduced public debt. Nevertheless, the downside risks to the outlook have increased from a few months ago, accentuated by the recent financial market turmoil. Firm inflationary pressures and high and volatile crude prices are other risks to the outlook. Consensus expectations continue to support a broad-based economic expansion for 2007, although heightening of uncertainties is recognised. According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in October 2007, the forecast for global real GDP growth on a purchasing power parity basis has been retained at 5.2 per cent for 2007 as in the July 2007 update, down from 5.4

per cent in 2006. The IMF has, however, revised the forecast for 2008 down to 4.8 per cent in October from 5.2 per cent in the July 2007 update.

42. In the US, real GDP growth had risen to 3.8 per cent in the second quarter of 2007 as compared with 2.4 per cent a year ago, reflecting growth in net exports, commercial structures and inventories, partly offset by a decrease in residential fixed investment. The IMF's October 2007 WEO now expects the US economy to grow at a slower pace of 1.9 per cent in 2007 and 2008 as against 2.9 per cent in 2006.

43. Real GDP in the euro area grew by 2.5 per cent in the second quarter of 2007 on a year-on-year basis as compared with 2.9 per cent a year ago. Unemployment held steady in August 2007 for the third month running at a record low of 6.9 per cent. Expansionary economic forces are predicted to prevail in the second half of 2007 in Germany – the largest euro area economy – with pick-up in domestic demand, production and exports. The October 2007 update of the IMF's WEO has placed average annual real GDP growth of the euro area at 2.5 per cent in 2007 and 2.1 per cent in 2008.

44. The Japanese economy grew by 2.3 per cent in the second quarter of 2007 as compared with 2.1 per cent a year ago and moderate expansion is likely to continue in the second half of 2007, aided by gains in household spending which offset the decline in corporate outlays. Going ahead, business investment should be an important driver, with high capacity utilisation and profits. In addition, the negative contribution from stock building in recent quarters suggests that inventory accumulation would add to growth. The October 2007 WEO of

the IMF has projected real GDP growth in Japan at 2.0 per cent in 2007 and 1.7 per cent in 2008.

45. In emerging Asia, economic activity has continued to expand at a sustained pace, especially in the largest economies of the region, despite the existence of a volatile global setting with strengthening commodity prices and abundant liquidity. The Chinese economy grew by 11.5 per cent in the third quarter of 2007 as compared with 10.6 per cent a year ago. The deceleration in China's economic growth from 11.9 per cent in the second quarter has been attributed to policy efforts to curb high-polluting, energy-intensive industries as well as monetary tightening policies adopted in the first half, reduction of export rebates and restrictions on processing exports. Inflation accelerated to 6.5 per cent in August 2007 from 1.3 per cent a year ago, and moderated only slightly to 6.2 per cent in September. China is expected to grow by 11.5 per cent in 2007 and by 10 per cent in 2008, but inflation may remain at a level higher than the central bank's target of 3.0 per cent. The impact of losses of China's financial institutions and the transmission of financial turmoil to China's markets seems to be limited.

46. The People's Bank of China (PBC) has raised interest rates seven times since April 2006 to 7.29 per cent and has raised cash reserve requirements eleven times between July 2006 and September 2007. In recent months, the PBC has cut the rebate on VAT taxes and has increased export taxes on some products to discourage the balance of payment surpluses and reduce funds flow to the stock markets which have reached elevated levels. China ran a record US $ 185.7 billion trade surplus in the first nine months of 2007, 69.0 per cent higher

than in the same period last year, which has contributed to the overhang of liquidity in the economy. China's foreign exchange reserves reached US $ 1.4 trillion at the end of September 2007, remaining the key driver of domestic liquidity and contributing to asset price pressures.

47. Among other major Asian economies, the Korean economy grew by 5.8 per cent in the third quarter of 2007, higher than 4.8 per cent a year ago. Exports continue to post robust growth and domestic demand is showing a steady increase, led by consumption. The upward trend of real estate prices has been blunted by the tightening measures taken by the authorities since 2006. The Korean economy is expected to grow by 4.8 per cent in 2007, slower than 5.0 per cent in 2006. Consumer price inflation had accelerated to 2.3 per cent in September 2007 from 1.7 per cent in January 2007. The Bank of Korea has taken tightening steps in 2006 and 2007 by raising its policy rate, increasing reserve requirements, cutting the ceiling on aggregate loans to commercial banks for lending to small and medium enterprises and has attempted to curb the steady rise in property prices by restricting mortgage loan issuance to one contract per person, introduction of price ceilings on new houses and disclosure of construction cost of new homes.

48. In the second quarter, the Thai economy has registered a growth of 4.4 per cent, lower than 5.0 per cent a year ago. The Bank of Thailand introduced a series of measures to stem strong capital inflows into the economy in 2006 and 2007, although monetary policy setting has eased in the context of the moderation in growth. Growth is projected to slowdown to 4.0 per cent in 2007 from 5.0 per cent recorded in 2006, but is expected to recover to 4.5 per cent in 2008.

49. Inflationary pressures remain a key risk to global growth. In the global foodgrains market, prices have been rising in response to the surging demand for major crops such as corn, soybeans and wheat whose prices have increased by 10 per cent, 55 per cent and 51 per cent, respectively, from a year ago. The rally has swept up prices of other commodities such as barley, sorghum, eggs, cheese, oats, rice, peas, sunflower and lentils. The increase in prices has been also driven up by higher energy and fertiliser prices, low levels of inventories, shortfalls in certain crops mainly caused by weather-related factors such as the ongoing drought in Australia and strong increases in the demand for crops. The latter reflects mainly two new emerging sources of demand, which include US Government incentives that are encouraging businesses to turn corn and soybeans into motor fuel and the growing economies of Asia and Latin America which are enabling their large populations to spend more on food. The price of corn, the main feedstock for ethanol production in the United States, rose at the beginning of the year to ten-year highs. As this encouraged US farmers to increase their corn production, they decreased the supply of other agricultural products, with a subsequent upward impact on the prices of these products in world markets.

50. Wheat prices, currently at historically high levels, face a second consecutive small world wheat crop in 2007 and tightening supplies, extremely strong export demand for US wheat and declining world wheat inventories. Production is estimated to be 10.1 million tonnes less than the projected level of world consumption, pointing to a decline in world stocks for the sixth time in seven years. The increasingly tight supply situation has prompted the European Union to scrap limits on grain production imposed 15 years ago which required farmers to set aside 10

per cent of their arable land every year. One month wheat futures at the Chicago Board of Trade (CBOT) rose sharply to US $ 9.53 per bushel on October 1, 2007 from US $ 4.19 on April 3, 2007 before falling to US $ 8.03 on October 26, 2007. The 2007 cereals crop is now estimated to fall below last year's level of 2.0 billion tonnes because of dry and unusually hot weather in April, followed by adverse summer weather in parts of Europe. At the global level, closing wheat stocks in 2007-08 are expected to fall to a historically low level, especially in the major exporting countries.

51. Global coarse grain imports and exports for 2007-08 are increasing mostly as a result of increased demand for feed-grain supplies in Europe, reflected in higher US exports of corn, sorghum and barley. The futures prices of corn on CBOT, which had moderated somewhat up to July, started moving up thereafter and reached US $ 3.73 per bushel on October 26, 2007. Global rice production is projected at a lower level than a year ago due mostly to a decrease in production in China and North Korea, offset partially by small increases in the US, Iraq and Kazakhstan. Global rice stocks have reached a 30-year low leading to an upward pressure on prices. The futures prices of rice on CBOT rose from US $ 9.76 per bushel in end-March 2007 to US $ 11.75 on September 27, 2007 before declining marginally to US $ 11.65 on October 26, 2007. Sugar prices, which reached a 25-year high in early 2006, have declined steadily since then due to a much larger global output than anticipated in most cane-producing countries, particularly Brazil and India. The futures prices of sugar moderated from US cents 11.51 per pound in January 2007 to US cents 8.45 on June 13, 2007 before moving up to US cents 10.13 on October 26, 2007.

52. Russia is introducing price controls on some basic foods in an effort to prevent spiralling prices, mainly in the form of agreement between the country's prominent food retailers and producers. The Government intends to freeze prices at October 15, 2007 levels on select food products, viz., bread, cheese, milk, eggs and vegetable oil until the end of the year, with retail mark-up limited on these goods to 10 per cent. The possibility of increasing the export tariff on wheat from 10 per cent to 30 per cent to enhance domestic supplies is also being explored. These indications have lent upward pressure to wheat prices in major world markets. China has also indicated an inclination to impose food price controls; Egypt, Jordan, Bangladesh and Morocco are increasing subsidies or cutting import tariffs to lower domestic prices. Even advanced economies such as Italy are affected by the food price increases with visible popular discontent.

53. Metal prices have increased by 1.6 per cent during the first nine months of 2007, over and above the increase of 53.6 per cent in 2006 and 36.3 per cent in 2005. According to the futures markets, aluminium, zinc and lead prices are showing an upward trend. Copper prices have been buoyed up by the depreciating US dollar. Future price of copper on New York Metal Exchange increased to a record level of US $ 3.75 per pound on July 20, 2007 but moderated subsequently to US $ 3.53 on October 26, 2007. Spot gold rose to US $ 785 an ounce on October 26, 2007 – the highest since January 1980 - as the dollar fell to a record low against the euro, boosting the demand for the precious metal as an alternative asset.

54. Crude oil prices, which softened from the July-August 2006 peak of US $ 78 per barrel to around US $ 53 per barrel in

January 2007, have rebounded since July 2007 to close at a record level of US $ 91.7 on October 26, 2007 on renewed tension in the Middle East, low US crude stocks, weak US economic data and the easing of the US dollar against other major currencies. Futures prices for crude oil have moved up to US $ 91.86 per barrel. Barring a slowdown in oil demand growth, continued high demand and low surplus capacity leave the crude oil scenario vulnerable to unexpected supply disruptions through 2008. According to the Energy Information Administration (EIA), the price of West Texas Intermediate (WTI) crude oil is expected to remain at US $ 68.84 per barrel in 2007 and US $ 73.50 per barrel in 2008.

55. In the US, consumer prices increased from 2.1 per cent in January 2007 to 2.8 per cent in September 2007, after declining to 2.0 per cent in August 2007. In the euro area, inflation has increased to 2.1 per cent in September 2007 from 1.7 per cent a year ago. Inflation became negative at (-) 0.2 per cent in Japan in September 2007 from 0.6 per cent in September 2006. In the UK, CPI inflation declined to 1.8 per cent in September 2007 from 2.4 per cent a year ago. At the retail level, (Retail Prices Index) inflation rose to 4.8 per cent in the UK in March 2007 - the highest since 1991 - but declined thereafter to 3.8 per cent in July 2007 before increasing to 3.9 per cent in September 2007. Inflation pressures have raised concerns in some of the emerging market economies (EMEs) such as China, Malaysia, Indonesia and Chile.

56. Core CPI inflation in the US decelerated to 2.1 per cent in August 2007 and remained at the same level in September 2007 as against 2.2 per cent in July 2007. In the UK, core CPI inflation has been declining in tandem with the headline rate

and stood at 1.5 per cent in September, down from 1.8 per cent in August 2007. In the euro area, core CPI inflation declined to 1.8 per cent in September 2007 after remaining at 1.9 per cent over February-August 2007. Core inflation in Japan remained negative (-0.3 per cent) in September 2007 as compared with (-) 0.2 per cent in August 2007. Overall, the expected persistence of high food prices, sustained elevated oil prices along with continued high prices of other commodities, pose significant inflation risks for the global economy, which are likely to set continuing challenges for monetary policy worldwide.

57. There was a sudden fall in credit market confidence in late July brought on by the spread of risks from exposure to the US sub-prime mortgages. Downturn in sentiment affected higher quality asset classes fairly rapidly including equity, currency, corporate bond and emerging market debt segments. These unusual developments indicated heightening uncertainties and emerging challenges for the conduct of monetary policy, especially for EMEs. In the subsequent weeks, these risks became accentuated by solvency threats to hedge funds and even large international banks, especially in Europe, with their usual lenders stopping short-term credit lines. Financial markets remained highly unsettled over the next few days amidst fears of a global credit crunch spreading into corporate bond markets and equity markets.

58. The responses of the central banks to the recent events in financial markets have shown that concerns for financial stability can assume overriding importance. This is evident in the fact that central banks initially reacted by injecting liquidity, including through special facilities and the expansion of eligible securities for collateral, rather than through interest rate cuts.

Central bankers have indicated their willingness to consider other courses of action in favour of protecting growth. In order to prevent a spike in short-term interest rates (which in Europe shot up to 4.7 per cent as against the European Central Bank's benchmark rate of 4 per cent), the European Central Bank and the Fed have intervened since August 9 by providing liquidity to the inter-bank market. They were joined by central banks in Canada, Japan, Australia, Norway and Switzerland. Major central banks have continued to inject liquidity since then and the Bank of England has provided liquidity support to a mortgage lending bank, while giving a blanket guarantee to depositors on the safety of their deposits. The US Federal Reserve has highlighted "unusual funding needs because of dislocations in money and credit markets." While the European Central Bank described its operations as fine-tuning, it noted that there are tensions in the euro money market notwithstanding the normal supply of aggregate euro liquidity. The US Federal Reserve cut its policy rate by 50 basis points on September 18, 2007 both to promote growth and in the interest of financial stability.

59. There are several features characterising the recent turmoil in financial markets which distinguishes it from the historical experience. First, the instability in the financial markets has stemmed from exposures of financial institutions to lower grade credit in the US, in sharp contrast to earlier crises which were associated with turbulence emanating from EMEs as in May-June 2006 and in February 2007. Second, in contrast to earlier episodes, instability is not restricted to a crunch in the credit markets but is spilling into money markets (including for commercial paper) as well as currency, equity and corporate bond markets. Third, these developments have sparked off a flight to safety and investors are increasingly abandoning riskier

assets and less collateralised/ lower rated assets in favour of US treasuries. Fourth, there is widespread concern that the purveyors of the current bout of turbulence are either too lightly regulated or not regulated at all. In this context, the role of external credit rating agencies has come in for considerable criticism for not responding in a timely fashion and for misjudging credit risk embedded in complex derivative instruments. Fifth, although the current turmoil appears to have been triggered by solvency threats to major hedge funds, the impact on financial markets has been cushioned by a combination of large private bail-outs, limits on redemptions and orderly winding ups. Sixth, the insufficiency of private effort is reflected in the coordinated and sizeable liquidity injections conducted by major central banks in order to prevent volatility in money markets and adverse effects on banks. Seventh, intervention of some central banks has included the acceptance of mortgage-backed securities in open market operations. While this has prevented massive sell-offs of good quality assets, there are fears that this has amounted to regulatory forbearance and would eventually cascade into either large official bail-outs and/or force an easing of monetary policy contrary to the commitment to anchoring inflation expectations. In mid-October 2007, in an effort to reassure financial markets by providing easier funding and to complement other solutions, the US Treasury has facilitated a plan led by major US banks to set up a fund of about US $ 100 billion which is expected to act as a buyer for highly rated assets from structured investment vehicles for a set period of time. This plan is still under discussion and is yet to be implemented. These efforts to restore liquidity to credit markets have provoked some scepticism about appropriate valuations, manner of disbursements and realistic assessments of risks embedded in the structured products involved in the refinancing.

60. Despite the volatility in the US equity markets in the third quarter of 2007 (July-September), the Dow Jones Industrial Average ended the quarter by posting a 3.6 per cent rise while the S&P 500 managed a quarterly increase of 1.5 per cent and the technology-laden Nasdaq Composite posted gains of 3.8 per cent for the quarter. Globally, considerable volatility was experienced in the world equity markets especially in EMEs – with indicators reporting record single day falls in mid-August. With the strong recovery in EME stock markets thereafter, diversified emerging markets funds gained substantially in the third quarter. Developed markets turned in mixed results. Tracking US stocks, the international large-cap growth category posted a quarterly advance of 4.3 per cent, while funds with a value-stock orientation struggled to break even. Currency markets have recorded a tentative return to stability and re-establishment of carry trades, but worries about emerging market currencies – that were previously relatively isolated from the turmoil – have surfaced with emerging market bonds coming under selling pressure. In the US, corporate bond spreads have widened across all credit grades and are currently around their highest levels in several years. Spreads on emerging market sovereign bonds have also widened over the past two months, although to a lesser extent than those on lower-rated corporate bonds in the US. A notable aspect of the reduced investor appetite for corporate debt has been the cancellation or postponement of a number of leveraged buyout (LBO) debt issues.

61. Government bond yields in the major economies, which had until recently firmed up, have softened more recently. The US 10-year bond yield increased from 4.70 per cent at end-December 2006 to 5.29 per cent on June 12, 2007 before falling to 4.40 per cent on October 26, 2007. The 10-year bond

yields in the euro area increased from 3.95 per cent at end-December 2006 to 4.68 per cent on July 9, 2007 before falling to 4.17 per cent. The Japanese 10-year bond yield has increased from 1.68 per cent at end-December to 1.97 per cent on June 13, 2007 before falling to 1.62 per cent. These recent developments are indicative of evolving uncertainties in international financial markets with implications for EMEs.

62. On a trade-weighted basis, the US dollar has been depreciating since 2006 with intermittent fluctuations. After the 50 basis points cut in the Fed funds rates announced on September 18, 2007, the US dollar has weakened against other currencies. The pound sterling rose to the level of US $ 2.05 on October 26, 2007 – fractionally lower than the 26-year high of US $ 2.06 reached on July 24, 2007 – amidst concerns relating to the sub-prime mortgage market. The euro, which has also been strengthening against the US dollar since June, rose sharply on July 24 on investor apprehensions about sub-prime mortgage exposures and surged to a fresh high of US $1.44 on October 26, 2007. The Canadian dollar appreciated against the US dollar to a 33-year high to reach US $ 1.04 on October 26, 2007. Turkey experienced a sharp appreciation in its currency *vis-a-vis* the US dollar on October 5, 2007 to reach the level of 84.98 cents, before declining to 84.28 cents on October 26, 2007. The New Zealand dollar had appreciated to 81.10 cents to reach a 22-year peak against the US dollar on July 24, 2007 before declining to 76.53 cents on October 26, 2007.

63. Several central banks have cut policy rates during the third quarter of 2007 after financial markets were significantly affected by turbulence. On September 18, 2007 the US Federal

Reserve cut back its policy rate by 50 basis points to 4.75 per cent after seventeen increases of 25 basis points each between June 2004 and June 2006. The Banco Central do Brasil has cut the Selic rate target eighteen times between September 2005 and September 2007 to 11.25 per cent. Earlier, policy rates have been reduced by Bank Indonesia (BI) (BI rate reduced from 12.50 per cent in May 2006 to 8.25 per cent in July 2007) and the Bank of Thailand (1-day repurchase rate reduced from 4.75 per cent in January 2007 to 3.25 per cent in July 2007 in four stages).

64. The central banks that have tightened their policy rates include the European Central Bank which has raised its policy rates eight times since December 2005 by 25 basis points each to 4.00 per cent (main refinancing rate); the Bank of England (repo rate raised in August and November 2006, January, May and July 2007 by 25 basis points to 5.75 per cent); the Bank of Japan (uncollateralised overnight rate target at 0.25 and 0.50 per cent in July 2006 and February 2007, respectively, after maintaining a zero interest rate policy since September 2001); the Bank of Canada to 4.50 per cent (in July 2007); the Reserve Bank of Australia (Cash Rate raised by 25 basis points each in August and November 2006 to 6.25 per cent and in August 2007 to 6.50 per cent); the Reserve Bank of New Zealand (Official Cash Rate raised to 8.25 per cent by five 25 basis points hikes in December 2005 and March, April, June and July 2007); the People's Bank of China (lending rate raised seven times to 7.29 per cent between April 2006 and September 2007); the Bank of Korea (target overnight call rate raised by 25 basis points each in August 2006, July and August 2007 to 5.00 per cent); the Banco de Mexico (benchmark overnight lending rate raised to 7.50 per cent in October 2007 from 7.25 per cent in April 2007);

and the Banco Central de Chile (benchmark lending rate raised to 5.75 per cent in September 2007 from 5.00 per cent since January 2007).

65. A few central banks in Asia have used supplementary measures for tightening, besides increasing key policy rates. In China, the required reserve ratio was raised by 50 basis points each effective from July 5, August 15 and November 15 in 2006 and on January 15, February 25, April 16, May 15, June 5, August 15, September 25 and October 25 in 2007. The required reserve ratio in China is currently 13.0 per cent. The Bank of Korea raised reserve requirements from 5 per cent to 7 per cent for local currency deposits and short-term foreign currency deposits, after a gap of 17 years, in November and December 2006, respectively, in addition to other measures referred to earlier. Meanwhile, in several EMEs including China and Korea, central bank bonds have continued to absorb liquidity from the banking system. The only central bank that has kept policy rates steady is the Bank Negara Malaysia (Overnight Policy Rate at 3.5 per cent since April 2006).

Overall Assessment

66. Growth in agricultural output in the first quarter was expected to benefit from the strong improvement in the 2006-07 *rabi* output, particularly, wheat, coarse cereals and pulses; however, the overall strength of the supply response from the sector has turned out to be above consensus expectations. In the second quarter, agricultural activity has been well supported by moisture conditions, with rainfall in the current season being above normal and reasonably well-distributed, and reasonably high reservoir levels. *Kharif* sowing has been higher than in last

year's season and first estimates are reflecting expectations of higher production than in the preceding year. These developments have improved the outlook for agriculture which appears set to return to its trend growth in 2007-08. The positive prospects for agriculture augur well for the economy as a whole in terms of both aggregate supply conditions and food prices which, until early 2007, were the main drivers of inflation.

67. Notwithstanding a modest deceleration in the growth of overall industrial activity in the first five months of 2007-08, the manufacturing sector continued to record double-digit growth. There are indications that industrial activity continues to be sustained by strong fundamentals. Growth in basic metals, chemicals, wood and wood products and machinery and equipment has retained buoyancy, together contributing more than half of the growth in industrial production in April-August 2007. Growth in electricity a key infrastructural input has accelerated in the current financial year. The growth of capital goods production has remained strong and higher than headline industrial output growth, suggesting continued capacity expansion. Contraction in output has occurred mainly in the consumer goods segment, transport equipment, metal products, paper and textiles, which could be reflecting transitory factors.

68. While industrial activity continues to display an inherent momentum, there are indications that headline industrial growth is being affected by the large variations recorded in the preceding year. Accordingly, on the basis of available data as well as the uncertainties surrounding global developments, marginal moderation in overall industrial activity over the rest of 2007-08 may not be ruled out within the generally positive prospects for the industrial sector.

69. Despite some moderation reflected in lead indicators, the services sector has continued to grow at a sustained pace, particularly in the financial sub-sector, trade, transport, hospitality and construction, reflecting robust investment activity as well as a pick-up in demand with farm incomes rising on the back of the improvement in agricultural performance in the first quarter of 2007-08. These impulses have been supported by the growth of insurance premiums, telecommunication subscribers and tourist arrivals. While there has been some deceleration in railway freight traffic, lead indicators generally support a positive outlook for service sector activity although, due to the uncertainty surrounding the evolution of the global economy, the possibility of marginal moderation in growth over the rest of 2007-08 cannot be ruled out.

70. Aggregate demand conditions have remained firm and on the uptrend. First, the key driver of the economy appears to be the substantial increase in gross fixed investment in the first quarter of 2007-08, indicative of the strong pace of capacity building underway. In contrast, the growth in private consumption and exports has been relatively modest. Investment-driven growth is supported primarily by saving rates, currently at around 32-33 per cent of GDP and higher by ten percentage points from the beginning of the decade. The step-up in gross domestic saving has been enabled by private corporate saving which has nearly doubled between 2002-03 and 2005-06 on the back of strong growth in profitability. There has also been some improvement in public sector saving which has turned positive after persistent dis-saving up to 2003-04. Interestingly, the momentum in investment has not been affected by changes in the interest rate cycle and spending on capital expenditure and infrastructure has weathered the transient slack in industrial activity in the

second quarter. Second, the key monetary aggregates, *i.e.,* reserve money and money supply have been running well above initial projections, reflecting the impact of higher than expected deposit growth and the exogenous expansionary effects of capital inflows as well as the drawdown of fiscal cash balances. Within the monetary expansion, bank credit growth appears to have been slowing down, but from excessively high rates of the preceding four years. Third, the merchandise trade deficit has widened sizeably, despite reasonably strong export growth, attesting to the spillover of domestic demand into the external sector. Fourth, asset prices remain at elevated levels, although there is some anecdotal evidence of stabilising real estate prices. On the other hand, equity prices are at record highs. Fifth, although inflation in terms of wholesale prices appears to have eased considerably, it still remains high in terms of consumer prices, particularly those facing agricultural workers and rural labourers.

71. Key monetary and banking aggregates have exhibited contrasting variations in the second quarter of 2007-08. On the one hand, reserve money expansion has been sizeable, persisting above 23.8 per cent throughout the quarter, and has been driven up mainly by the Reserve Bank's net foreign currency assets and variations in the Centre's cash balances, partly offset by liquidity absorptions under the MSS and the LAF. Against the backdrop of primary liquidity movements, the rate of money supply, which has averaged 20.9 per cent year-on-year through the quarter in contrast to indicative projections for policy purposes, has warranted intensified monitoring. Propelling money supply is the sustained buoyancy in time deposits, reflecting the migration of current, savings and postal deposits in response to relatively attractive returns and tax benefits for longer term bank

deposits, corporate profits and banks' investments in mutual funds (which reappear as mutual funds' deposits with the banking system), apart from the environment of expansion in the monetary base. On the other hand, non-food credit growth has moderated in alignment with the trajectory set in the Annual Policy Statement of April 2007. Sectoral data suggest that this moderation has been in respect of all the major sectors, while incremental non-food credit offtake in respect of the industrial sector has increased. With deposit growth remaining strong, the deceleration in non-food credit as well as disinvestment of non-SLR assets has resulted in augmenting market liquidity, partly mitigated by a build up of SLR–eligible securities. Critical indicators such as a rising incremental investment/deposit ratio, a decline in non-food credit deposit ratio and sustained profit growth are reflecting these shifts and point to signs of growing resilience in the banking system's balance sheet with favourable implications for financial stability, going forward.

72. The expansionary monetary and financial conditions characterising the second quarter of 2007-08 and the policy response in the form of active liquidity management operations launched in the First Quarter Review were reflected in a generally orderly evolution of market liquidity. Consequent upon the withdrawal of the ceiling on daily reverse repos under the LAF with effect from August 6, absorptions of liquidity by the Reserve Bank resumed after a hiatus spanning March-July. Initial large daily reverse repo bids moderated in subsequent weeks but remained close to an average of Rs 30,000 crore until September interspersed by periods of relatively lower absorptions. Since October 1, 2007 ample liquidity in financial markets has resulted in large daily absorptions through LAF reverse repo auctions, despite sizeable absorptions under the MSS. The Central

Government vacated ways and means advances/overdrafts, but cash balances of the Centre exhibited considerable volatility within an overall downward movement that augmented market liquidity through August and the first half of September. In the following week, these cash balances were built up coincident with the quarterly advance tax payments, but have been drawn down through October augmenting market liquidity. Broadly, however, the primary source of liquidity expansion was the sizeable accretion to the Reserve Bank's net foreign currency assets. In response, sterilisation through the MSS operations picked up in early August and increased steadily over the remaining part of the quarter. Surplus liquidity conditions were also reflected in excess SLR holdings by banks and their investments in mutual funds.

73. A notable development in the second quarter of 2007-08 has been the steady retreat of headline WPI inflation from mid-July. The receding of WPI inflation over July-October 2007 has been discernible across commodities and also in exclusion-based measures (WPI excluding energy; WPI excluding food and energy), but pronounced in the category of primary food articles and, particularly, under vegetables, milk, rice and oilseeds. On the other hand, inflation in the category of manufactured products and non-food primary articles has been relatively less relenting.

74. While the recent headline inflation outcomes, juxtaposed with expectations survey results and information from financial markets, are indicative of reasonably well-anchored inflation expectations, some of the recent developments have shown that there are major risks to this assessment that are still evolving. First, CPI inflation rose in July with the price rise for rural and

agricultural labourers exceeding 8.5 per cent in August, *i.e.*, the softening of wholesale food prices has not set in at the retail level. Second, the global environment is fraught with uncertainties. International crude prices are volatile at new highs, having breached the level of US $ 90 per barrel while elevated food and metal prices would, in current circumstances, pass through to domestic inflation. The incomplete pass-through of international prices of crude, metals, food and commodities in general to consumer prices is indicative of suppressed inflation which carries destabilising potential into the future. Third, the state of monetary and liquidity conditions evoke traditional concerns that they could carry the seeds of future inflation. Fourth and most importantly, the expansion of global liquidity conditions in the wake of the recent financial market turmoil has occurred in a period when concerns about firm inflation expectations were being reflected in a withdrawal of accommodation in the monetary policy stance of countries across the world, both mature and emerging. The massive injection of liquidity by mature central banks reflects a deviation from their stance on inflation in order to ensure financial stability which could potentially weaken their ability to fight inflationary pressures.

75. Domestic money markets have exhibited orderly behaviour and surplus liquidity conditions generally, except when equity markets turned volatile primarily in response to global developments. A notable feature is the muted impact of mid-September advance tax outflows on money markets in the current financial year, indicative of active monetary and liquidity management. In the foreign exchange market, large inflows have imposed persistent upward pressures on the exchange rate of

the rupee which have become accentuated in the wake of the 50 basis points cut in the US Federal Funds target rate on September 18. In the Government securities market, orderly conditions have prevailed through the quarter with yields firming mildly during mid-July to mid-August in response to the sub-prime crisis in the US. Thereafter, yields have edged down, reflecting underlying liquidity conditions and benign inflation expectations.

76. Finances of the Central Government appeared to be under some strain during April-August 2007. Buoyant tax collections seem to have been neutralised by higher expenditure on interest payments and subsidies. Consequently, the revenue deficit exceeded the BE for 2007-08 by July 2007. Transfer of surplus from the Reserve Bank and the accounting of the SBI stake sale under non-tax revenue (as against under non-debt capital receipts indicated earlier) enabled some pull-back of the revenue deficit *vis-à-vis* the BE in August 2007. The gross fiscal deficit, even adjusted for the SBI stake sale was also above BE in April-August reflecting, in addition to the revenue deficit, a sharp rise in non-defence capital expenditure. As regards financing, market borrowings for the first half of 2007-08 have been completed broadly in accordance with the announced calendar. There has, however, been a higher recourse to short-term borrowings and WMA/overdraft from the Reserve Bank in comparison to the position last year, mainly on account of the SBI stake sale.

77. While there has been some progress in fiscal rectitude, it is important to take note of some adverse features in the finances of the Central Government during 2007-08 so far. Excluding the transfer of the Reserve Bank's stake in the SBI, the revenue deficit for April-August 2007 is placed at 122.9 per cent of the

BE for the full year (2007-08) as compared with 93.7 per cent a year ago. Furthermore, there has been a sharp increase in expenditure under all categories with total expenditure rising by 40 per cent over the level in the corresponding period of the previous year. In view of the priority attached to ensuring stability in the context of the recent heightening of global uncertainties, it is necessary to persevere with fiscal consolidation consistent with the FRBM Rules through prudent expenditure management while also ensuring the quality of expenditure by both the Centre and the States.

78. Several aspects of recent developments in the external sector of the economy merit attention. First, domestic demand pressures are strongly in evidence, driving up non-oil imports and the merchandise trade deficit in the first half of 2007-08, notwithstanding some saving on account of subdued POL import growth. Second, while merchandise exports have continued to exhibit innate dynamism and resilience in the face of adverse price/cost and global developments, moderation in pace seems to be setting in when viewed in perspective against the recent high growth phase, *i.e.*, 2003-07. Third, lead indicators suggest that the buoyancy characterising net invisible receipts has been sustained. In view of these developments, the current account deficit in the first half of 2007-08 is expected to have been contained at the level of a year ago. Fourth, net capital flows to India have increased substantially in the wake of the recent turmoil in international financial markets and the response of major central banks in terms of injecting liquidity into money markets in their economies. In particular, the sizeable turnaround in portfolio flows in the current financial year has been noteworthy. Fifth, while FDI to India has been running higher in the current financial year, it is necessary to note that a significant proportion

of these flows are attributable to private equity and venture capital which are essentially in the nature of portfolio flows. Sixth, an important feature of external sector developments is the rising volume of FDI from India, representing the silent transformation in India's interface with the world being driven by Indian corporates leveraging their domestic balance sheets to gain scale, scope and global scan. Seventh, the increasing size of debt flows – mainly ECB and trade credits, since NRI deposits are responding to policy initiatives – and consequently, increasing external indebtedness needs to be noted. Eighth, India recorded the third highest accretion to foreign exchange reserves in April-September, 2007 among all EMEs. At US $ 261 billion at mid-October 2007, India holds the world's fifth largest stock of international reserves, sufficient to cover 15 months of imports/ 17 months of debt service/ 127 per cent of external debt/ 69 per cent of international liabilities.

79. The First Quarter Review of July, 2007 warned of the dark shadow cast by the under-priced and widely diffused risks emanating from the unfolding of the US sub-prime mortgage crisis. Since late July, global financial markets have experienced unusual volatility, strained liquidity and heightened risk aversion. There have been sharp movements in major financial markets, in particular in money and credit markets since early August. While the trigger was the rising default rates on sub-prime mortgages in the US, the source of the problem was arguably not macro-global imbalances but certainly significant mis-pricing of risks in the financial system. Easy monetary policy in major financial centres, globalisation of liquidity flows, wide-spread use of highly complex structured debt instruments and inadequacy of banking supervision in coping with financial innovations also contributed to the severity of the crisis. The persistent under-

pricing of risks was suspected by several central banks for quite some time, but it was felt by many that since risks were now widely dispersed through financial innovation they would not pose any serious problems to the system. When the sub-prime crisis did occur, however, it triggered a wide contagion affecting many of the largest of the world's financial institutions. Banks, in particular, appear to have ceased to trust each other's creditworthiness leading to freezing of money markets in the US, Europe and the UK and hence lack of liquidity. This has resulted in each financial institution shoring its own liquidity to meet its obligations. The problems of maturity mis-matches in the conduits or structured investment vehicles (SIVs) created by the banks for purposes of securitisation manifested themselves in a sudden great demand for liquid assets. This is deemed necessary in order to cope with adjustments which could potentially arise, including the possible need to take back the conduits or SIVs into the balance sheets of sponsoring banks or the winding up of such vehicles. During the process of adjustment, which is apparently still underway, there are problems of marking-to-market of securitised debt instruments in highly illiquid markets and transparency in regard to counter-party risks. Contrary to initial expectations, even with the release of end-September accounts of major international banks, the picture remains somewhat unclear.

80. The central banks in major countries have had to take recourse, in appropriate mix, to three instruments to avoid serious spill-over of these issues in money or credit markets into the wider economy : (i) adjustment of interest rates for borrowing and lending; (ii) money market operations designed to inject special liquidity in order to avoid a break-down in payment systems among banks, and (iii) to put in mechanisms for financial

transactions among the largest of the financial intermediaries which automatically impact the second and third rung intermediaries. Central banks in major industralised economies, by and large, responded with injection of liquidity for a longer period than is usually done; they also resorted to dilution in the quality of collateral required for liquidity support, and in some cases, reduction in rates. Most of these operations have not been conducted at the penal rates expected in such situations. This is an unprecedented package which, some observers believe, is indicative of the seriousness of the underlying problems. In addition, there were two specific-institution oriented operations, namely, in Germany to bail out a public sector bank and in the United Kingdom to bail out a private sector bank, coupled with open-ended Government guarantee for all public deposits in financial institutions. The US Federal Reserve has been the most aggressive in terms of monetary policy actions, with a higher than expected rate cut, reflecting the concerns over impact of housing issues on consumption and, hence, growth. These measures have restored some order to the financial system, though concerns remain on how the situation will unfold.

81. There are several immediate issues which need to be visited constantly to track the evolution of the resolution of the problem and consequent impact on India. First, there is debate as to how smoothly the new injection of liquidity will impact global liquidity and potential inflation. Second, there are concerns about the size, location and impact of credit infirmities. There is a view that credit infirmities are small and, in any case dispersed; there is another view that mutual funds, pension funds and insurance companies, which are perceived to be less rigorously regulated than banks, may be adversely affected. In the latter

case, households could be severely impacted. Third, while some believe that the adjustment will be smooth since it is only a mismatch of maturities in asset-liabilities, others argue that equity and currency markets cannot but be affected at some stage. In other words, there is a view that the current situation could have the potential for serious financial contagion globally. Fourth, an issue of special interest is whether the problem will remain confined to the financial sector and get resolved over time sooner or later, or whether there would be a real sector impact. It is believed that some large corporates have been active in the financial sector through treasury operations and commodity markets. While the impact on consumption in the US is anticipated, a fiscal impact is not ruled out. Fifth, there is a view that US housing prices have to undergo a significant correction. There is, however, debate over what period this will happen, whether it will have significant consumption and saving effects and the manner in which it will spill over into the global economy. Another issue of interest is whether there will be similar housing price corrections in other countries since housing prices are seen by many to be inflated in many economies. Finally, as far as emerging markets are concerned, there could be a negative impact if the credit markets are affected through the real economy. In select cases, some EMEs may turn out to be second order safe-havens with consequent implications for capital flows, exchange rates and their alignment with economic fundamentals.

82. It is also useful to recognise some positive elements in the global economy. First, the global economy has proved to be strong and resilient in recent years. The real economy is robust, except in a few countries, notably the US, which, in turn, has impressive flexibilities. Second, EMEs, by and large, have a better macro-environment than before and can hence contribute

possibly to global output and stability. Third, globally, corporate balance sheets are strong and less leveraged than in the past, thus adding to comfort. Fourth, the large financial intermediaries are perhaps adequately capitalised to absorb the shocks of credit infirmities. Fifth, the inflation environment has been, on the whole, benign though incipient pressures, especially due to oil prices, food grains, ample liquidity and possible transmission of upward pressure on prices in China, in the recent past, should not be ignored.

83. There are five determining factors in the manner in which the current issues would unfold as the exit from the current turbulence occurs. First, how quickly and durably the counterparty transparency would be established among the large financial intermediaries, despite the common interest in resolving the issue. The major hurdle would be the fact that the financial markets are integrated globally while the regulatory and transparency regimes are national. The issues of burden-sharing among the institutions/jurisdictions could impact the search for early and meaningful transparency. For example, an issue is the method of marking to market, in a credible manner, instruments that are virtually illiquid and opaque. Second, it is now recognised that there has been excessive leverage and hence the next steps should be de-leveraging on a massive scale, with implications for cost of capital for such an exercise. Third, it is also recognised that excessive disintermediation by the banks has been an important factor. Hence, the next steps should be re-intermediation, namely, bringing the off-balance sheet items of banks back on to their balance sheets with attendant calls on capital of banks at a time when confidence in financial system is under stress. In brief, there are reasons to believe that risks are so widespread and financial innovations have enabled such

multi-layering at the expense of transparency that significant segments of the financial sector are closer to a black box than ever before.

84. The most important issue for India is the possible impact of these developments in financial markets and policy responses by central banks in major economies. For convenience, the analysis could be made in terms of financial sector, balance sheet, trade and inflation channels. In regard to the financial sector channel, the primary channel in India is through the equity markets. The currency markets are affected through equity market players or in the guise of equity market players. It is possible to take positions in equity even if the sole motive is currency speculation or 'carry trade'. However, the movements in currency cannot but affect the real sector as a whole, not merely exporters, as is often believed. Domestic industry could be impacted through the pressure of higher imports since trade is open but this will only become evident with a time lag. In terms of balance sheets, Government, households, corporates and financial intermediaries have, relative to many other EMEs, lower exposure but are not immune to the impact. Large corporates with overseas borrowings or plans for mergers and acquisitions may face constraints due to possible re-pricing of risks and risk aversion in credit markets. The trade channel will also be an important channel, especially if there were to be a slowdown in the US. India's export basket is diversified but software exports are critical. Past experience shows that there are occasions when a slowdown in the US did not dampen the off-shoring to India. However, the impact on the competitiveness of software due to large movements in currency could be a new factor yet to be fully assessed. Finally, the inflation channel could be critical both from demand and supply side. Liquidity that is injected in the US and the euro area to

manage the financial turmoil cannot be fully confined to those economies, thus potentially adding to excess liquidity in India also through renewed capital flows. The supply side pressures in regard to oil and food do not appear to be abating. The evolution of inflation pressures requires enhanced vigilance. In brief, as far as first order effects are concerned, the major issues relate to financial contagion, and potential inflation, and the possibility of real sector impact as the second order effect. The policy challenge is to ensure financial stability and persevere with managing inflation – the tasks identified in the First Quarter Review of the monetary policy and the emerging challenges appear to be daunting. As of now, only a marginal slowdown in global output growth is anticipated and by all indications output growth in India in the short-run may be marginally impacted. The immediate task for public policy in India, therefore, is to manage the possible financial contagion which is in an incipient stage with highly uncertain prospects of being resolved soon.

85. At the current juncture and looking ahead, there are several complexities facing the conduct of monetary policy in India. On the domestic front, the biggest challenge is the management of capital flows and the attendant implications for liquidity and overall stability. A visible reflection of the sheer magnitude of the inflows is the accretion to the foreign exchange reserves which has been of the order of US $ 62 billion during the current financial year up to October 19, of which US $ 48 billion has been built up since end-June 2007. In response, the Reserve Bank has engaged in an active management of liquidity through a combination of instruments at its disposal. The total amount of issuances under the MSS has gone up by 159 per cent over the end-March 2007 level and by 102 per cent over the end-June 2007 level, enabling sterilisation of capital

flows of the order of Rs.1,12,292 crore during the current financial year so far up to October 26, 2007. In addition, liquidity absorbed in the form of net reverse repos under the LAF has been Rs.47,320 crore since end-March 2007 – five times the amount in the corresponding period of 2006-07. The CRR was raised by 100 basis points in July 2007 over and above the cumulative increase of 100 basis points during December 2006-March 2007. During 2007-08 up to October 26 on a fortnightly average basis, a total amount of Rs.54,198 crore has been additionally impounded through the CRR from SCBs, an increase of 235 per cent over that absorbed in the corresponding period of the preceding year.

86. While monetary policy has operated reasonably well on the domestic demand-supply and credit-deposit balances even as liquidity emanating from capital flows has been absorbed in the short run, the key future challenge is liquidity management, taking into account the current levels of capital flows. The persistence of these flows has implications for domestic financial stability and future inflation with potential lagged effects on aggregate demand. Consequently, monetary policy will have to address not only the liquidity overhang but also incremental flows in the future if they continue at present levels. In this regard, there are some signs of efforts towards active management of capital flows in public policy which needs to be taken into account in setting the monetary policy stance. It is necessary, however, to continuously and carefully monitor how persistent and effective these measures will be in terms of their impact on managing expectations in financial markets.

87. Yet another challenge for the conduct of monetary policy in the context of recent domestic developments is the rapid

escalation in asset prices, particularly equity and real estate, which are significantly driven by capital flows. These pools of capital, which are private, often opaque, highly leveraged and largely unregulated, have the potential for heightening risks to the domestic financial system and posing threats to overall financial stability as well as the prospects for growth. In view of the size of business accruing to these flows in mergers and acquisition activity, stock markets and in real estate, monetary policy will have to contend with the risks to overall macroeconomic stability and threats to inflation expectations emanating from fluctuations in asset prices, the re-pricing of risks and their diffusion across the financial system.

88. Threats to inflation in the future emanate not only from domestic liquidity conditions but also from the underlying global pressures. The possible impact of injection of liquidity by central banks to meet the recent turbulence in global financial markets on global inflation is not yet clear. In any case, globally, pressures on future inflation are embedded in the high and volatile levels of international crude prices as well as prices of food and metals. Furthermore, the sharp increase in inflation in China can get transmitted to major trading partners, given the dominant position of China in the global economy today. Hence, over the next twelve to eighteen months, risks to inflation and inflation expectations would continue to demand priority in policy monitoring.

89. It is important to recognise that large fluctuations in financial markets have deep-seated and lasting effects on the real sectors of the economy, output and employment. At this stage of development of the Indian economy, the formulation of monetary policy has to be acutely sensitive to the impact of

excessive market volatility on the real sector with feedback effects on the financial sector. Furthermore, the burden on monetary policy is larger in view of the limited room for manoeuvre for fiscal policy. It is in the context of these developments that monetary policy has to be vigilant and proactive in cushioning the real economy from excess volatility in financial markets.

90. In the overall assessment, the strategy of active liquidity management with a combination of measures used flexibly and often pre-emptively in view of the recognition of their lagged and cumulative effects appears to be yielding positive outcomes. First, domestic developments reflect the dominance of investment demand which has favourable implications in terms of expanding future aggregate supply. Second, there have been strong and sustained imports of capital goods which would augment productive capacity and enhance the elasticity of the supply response in the period ahead. Third, notwithstanding some moderation in headline industrial production, the production of capital goods has maintained its growth momentum, reinforcing aggregate supply conditions and attesting to the underlying strength of investment demand and the ongoing expansion of capacity in conjunction with imports of capital goods. Fourth, business confidence has generally remained buoyant in recognition of the strength of the fundamentals and the resilience of macroeconomic management. Fifth, while there has been a decline in the production of consumer durables, it is important to recognise elements of correction, normalising the excesses of the past that are being reflected in rising defaults on bank lending to the sector. Sixth, there has been a moderation of the mismatch in banks' balance sheets and rebalancing between credit and deposit growth has occurred.

91. Despite these positive developments, monetary aggregates such as reserve money, money supply and liquidity are expanding at unacceptably high levels, essentially driven by capital inflows, warranting priority in policy attention and posing extraordinary challenges for the conduct of monetary policy going forward. Furthermore, the escalated level of prices of real estate, the role of private foreign equity and non-bank financial companies, and the still strong pace of growth in bank lending to the sector is a cause for concern. In addition, the sizeable off-balance sheet exposures of select banks could pose some risks in a few cases. On balance, domestic conditions, by and large, have evolved so far in line with policy objectives and expectations as set out in the Annual Policy Statement in April 2007. In the period ahead, continuous watchfulness in regard to food and crude prices, asset prices, monetary and liquidity conditions and, above all, developments in global financial as well as commodity markets would be critical. The policy challenge for the Reserve Bank is to manage the current transition to a higher growth path while containing inflationary pressures and focusing on financial stability. Contextually, maintaining enhanced vigilance to be able to respond appropriately to the prevailing heightened uncertainties in global financial and monetary conditions assumes vital importance.

II. Stance of Monetary Policy for the Second Half of 2007-08

92. At the end of July 2007, risks to the outlook for global growth and financial markets had become accentuated by adverse developments in the US sub-prime mortgage market. Regulators and monetary authorities were expressing concern about the global financial system in the context of rising levels of widely diffused risks. Accordingly, banks, financial institutions and corporates in India were advised to be vigilant and well-prepared with appropriate risk mitigation strategies to deal with significantly higher volatility than before and to monitor various types of exposures with appropriate hedging of risks to balance sheets. In view of the continuing uncertainty regarding the full dimensions and characteristics of the crisis in developed financial markets, banks, financial institutions and corporates are urged to enhance their vigilance with respect to the possibility of unfolding risks arising from global developments. In this context, they should ensure hedging of risks embedded in various types of exposure and put in place appropriate risk-management strategies to protect their balance sheets and preserve asset quality. Furthermore, banks need to step up their monitoring of similar risks that could affect corporates that have international market exposure.

93. With domestic economic activity seen as expanding strongly and inflation expectations well anchored, the First Quarter Review noted that monetary policy in India would continue to be vigilant and pro-active in the context of any accentuation of global uncertainties that pose threats to growth and stability in the domestic economy. It was also indicated that while the stance

of monetary policy would continue to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustain the growth momentum, contextually, financial stability may assume greater importance in the months to come. The First Quarter Review reiterated the stance of the Annual Policy Statement for 2007-08 of reinforcing 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. Credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability were re-emphasised while simultaneously pursuing greater credit penetration and financial inclusion. A readiness to respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum was also reiterated.

94. Developments in global financial markets in the immediate aftermath showed that several risks associated with global developments that were indicated in the First Quarter Review have materialised, vindicating the emphasis on vigilance and preparedness in the context of global uncertainties. First, the sudden fall in credit market confidence brought on by the spread of the sub-prime loan risks into higher quality debt unsettled financial markets across the world. The response of monetary authorities provides an indication of the threat to growth and financial stability. Second, a sympathetic and sustained surge in international crude prices has added to the building uncertainty; despite alternating movements, the volatility of crude prices around elevated levels may crystallise into potential second round effects impacting inflation expectations. Third, food prices have

continued to rule at historically high levels with no immediate relief from improvement in global supply conditions. Consequently, consumer price inflation has hardened in a number of countries, with food importers being most adversely affected. The persistence of inflationary pressures presents a dilemma for monetary authorities in the context of the immediate need for assuaging liquidity and solvency stress in the context of financial stability.

95. Domestic macroeconomic developments have exhibited enduring strength and resilience. First, growth has been sustained and has broadened. In particular, the improvement in agricultural supply conditions in conjunction with the sustained pace of industrial and service sector activity is indicative of an acceleration in the underlying momentum of the economy above the projected trajectory. Second, considerable success has been achieved in lowering inflation and in anchoring inflation expectations. The environment of price stability has entrenched the foundations of a higher growth path for the economy. Third, financial markets have, by and large, exhibited orderliness in the face of the turmoil in global markets. Fourth, while the merchandise trade deficit has widened, the strength of invisible earnings has kept the current account deficit at a level that is modest in comparison with the net capital flows. As a consequence, there has been a sizeable accretion to the foreign exchange reserves as in the preceding year.

96. The First Quarter Review of July 2007 had indicated that potential uncertainties in global markets and recent developments in domestic financial markets warrant a higher priority for managing appropriate liquidity conditions in the policy hierarchy. By and large, the combination of measures that were put in place has worked satisfactorily in terms of returning overnight

interest rates to the LAF corridor and ensuring that they generally evolve in an orderly manner. Nevertheless, financial markets continue to experience conditions of surplus liquidity, warranting an appropriate response in order to ensure orderly market conditions on an enduring basis.

97. Real GDP growth originating in agriculture and allied activities has risen above trend in the first quarter of 2007-08 and is poised to maintain this performance over the rest of the year on the back of a favourable south-west monsoon and improvement in sown acreage. Recent developments indicate some slackening of momentum in the industrial and services sectors. Moreover, global uncertainties may have some moderating influence on the performance of manufacturing as well as services. Overall, these sectors are expected to sustain the momentum of growth. Accordingly, real GDP growth in 2007-08 is placed at 8.5 per cent for policy purposes, as set out in the Annual Policy Statement of April 2007 and reiterated in the First Quarter Review, assuming no further escalation in international crude prices and barring domestic or external shocks.

98. The gains achieved in reining in inflation in the first quarter of 2007-08 have been extended into the second quarter and currently headline inflation appears to be emerging out of a prolonged trough. At this juncture, however, rising and volatile international crude prices and the heightened levels of food prices pose risks to the inflation outlook. In view of the persisting high levels of the price of the Indian crude basket, some pass-through to domestic petroleum product prices appears reasonable. A key issue going forward in this regard is the timing of the pass-through in the context of the expected path of headline inflation. The policy resolve going

forward should be to consolidate the success in lowering inflation on an enduring basis so that an environment of stability prevails to nurture and protect the transition to higher growth. There are indications that the public's perceptions on inflation are increasingly converging with the policy preference for price stability. Accordingly, 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. 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 expectations in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent becomes a medium-term objective consistent with India's broader integration into the global economy.

99. Money supply has so far been expanding well above the indicative trajectory of 17.0 -17.5 per cent set in the Annual Policy Statement of April 2007. Fiscal spending and exchange market interventions have mainly driven this acceleration as reflected in sizeable reserve money growth. Deposit growth has been running ahead of the projection of Rs.4,90,000 crore for 2007-08 as a whole. Non-food credit (inclusive of non-SLR investments) has decelerated and is currently close to the projection of 24.0-25.0 per cent given in the Annual Policy Statement. However, moderating the expansionary effects of net capital flows is warranted so that money supply is not persistently out of alignment with the indicative projections set out in the Annual Policy Statement.

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

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

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

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

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

- To be in readiness to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusual heightened global uncertainties, and the unconventional policy responses to the developments in financial markets.

III. Monetary Measures

(a) Bank Rate

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

(b) Repo Rate/Reverse Repo Rate

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

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

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

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

(c) Cash Reserve Ratio

107. The cash reserve ratio (CRR) of scheduled banks is currently at 7.0 per cent. On a review of the current liquidity situation, it is considered desirable to increase the CRR by 50 basis points to 7.5 per cent with effect from the fortnight beginning November 10, 2007.

Third Quarter Review

108. The Third Quarter Review of the Annual Policy Statement on Monetary Policy will be undertaken on Tuesday, January 29, 2008.

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

109. The Annual Policy Statement of April 2007 emphasised the need for credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while pursuing greater credit penetration and financial inclusion. In consonance, the Annual Policy Statement on Regulatory and Developmental Policies set out measures in terms of issuance of guidelines on derivatives; implementation of Basel II; restructuring of advances including advances to SMEs; differentiated bank licenses; bank finance to factoring companies; enhancement of disclosures; know your customer (KYC) norms/ anti-money laundering (AML) standards; credit information companies; and convergence with international best practices. In this context, drawing up of a road-map for introduction of currency and interest rate futures was proposed along with ongoing liberalisation of foreign exchange transactions.

110. The First Quarter Review of July 2007 intensified policy monitoring in the context of high volatility in equity and currency markets. Banks, financial institutions and corporates were advised to be vigilant and well prepared with appropriate risk mitigation strategies to deal with significantly higher volatilities than before. It was indicated that contextually, financial stability would assume greater importance in the months to come.

111. Going forward, the Reserve Bank would continue to balance the development of a sound, efficient and diversified financial system that facilitates smooth transmission of monetary policy with financial inclusion in which satisfactory customer

services are rendered by financial institutions/intermediaries. Credible communication, adequate availability of information and a broad-based, participative and consultative approach will shape the conduct of developmental and regulatory policies in respect of the financial system.

112. The Mid-term Review of the Annual Statement on Developmental and Regulatory Policies focuses on certain key areas: new financial instruments and prudential requirements; liberalisation of foreign exchange transactions; strengthening risk management in banks; migration to Basel II; fine-tuning of supervisory processes in response to financial innovations and consolidation in the banking sector and business processes; ongoing development and integration of various segments of financial markets; and improved credit delivery mechanisms with specific focus on the developmental needs of agriculture and small and medium enterprises and inclusive growth.

113. This Review is divided into four sections: I. Financial Markets; II. Credit Delivery Mechanism and Other Banking Services; III. Prudential Measures; and IV. Institutional Developments.

I. Financial Markets

114. The Reserve Bank has consistently emphasised the importance of developing financial markets as well as operational flexibility for market participants in various segments in an environment secured by effective regulation and oversight.

115. The Technical Advisory Committee (TAC) on Money, Foreign Exchange and Government Securities Markets has

provided valuable guidance to the Reserve Bank in the context of its developmental and regulatory role *vis-à-vis* financial markets. The Committee has met three times since the announcement of the Annual Policy Statement in April 2007.

Government Securities Market

116. The Reserve Bank has endeavoured to broaden and deepen the Government securities market in terms of participants, instruments and processes. Consequent upon the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 and withdrawal of the Reserve Bank from the primary segment, development of the Government securities market has assumed vital importance.

(a) State Government Borrowings

(i) Market Borrowings of States: Information Dissemination

117. In consultation with State Governments, the information on gross allocation inclusive of net allocation, additional allocation and repayments during 2007-08 and the amount that could be raised during the remaining period of 2007-08 as market borrowings by State Governments was disseminated through a press release in September 2007.

(ii) Non-Competitive Bidding Scheme in the Auctions of State Development Loans: To be Operationalised

118. The Annual Policy Statement of April 2007 proposed to introduce a 'Non-Competitive Bidding Scheme' in the auctions of State Development Loans (SDLs) in the financial year

2007-08 following discussions with State Governments. Accordingly, a scheme for Non-Competitive Bidding Facility was incorporated in the Revised General Notification issued by all State Governments on July 20, 2007. The scheme would be operationalised by March 31, 2008.

(iii) Reissuance of State Government Securities

119. Reissuance of SDLs has been favoured with a view to building up a critical mass of stock in the gilt market thereby improving the secondary liquidity of such securities. The Reserve Bank, in consultation with State Governments, has proposed to introduce a system of reissuances. Responses received from State Governments in this regard are being examined and it is proposed to re-issue SDLs in the second half of 2007-08.

(iv) Power Bonds

120. 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. State Governments could exercise the call option for full or part prepayment of their outstanding power bonds on April 1, 2008 as per the terms and conditions of the respective Notifications.

(b) Central Government Securities

Floating Rate Bonds

121. With a view to simplifying the methodology for pricing of floating rate bonds (FRBs) in the secondary market, the Annual Policy Statement of April 2007 had proposed to examine the

change in valuation methodology in consultation with Fixed Income Money Market and Derivatives Association (FIMMDA)/ Primary Dealers' Association of India (PDAI). Accordingly, a new issuance structure for FRBs has been approved by the TAC on Money, Foreign Exchange and Government Securities Markets and the facility to handle the new issuance structure is being built into the new Negotiated Dealing System (NDS) auction system being developed by the Clearing Corporation of India Limited (CCIL). This is expected to be completed by March 31, 2008.

(c) Development of Market Infrastructure

(i) Repos in the Corporate Bond Market

122. 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 Securities and Exchange Board of India (SEBI) has since operationalised the reporting platforms managed by the two exchanges, namely, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), as well as the industry body, the FIMMDA. As the corporate debt markets develop and the Reserve Bank is assured of availability of fair prices, and an efficient and safe settlement system based on delivery *versus* payment (DvP) III and Straight Through Processing (STP) is in place, the Reserve Bank is committed to permitting market repos in corporate bonds.

(ii) Reporting Platform for Interest Rate Swaps

123. In the Annual Policy Statement of April 2007, it was announced that the CCIL would develop a trade reporting platform for Rupee Interest Rate Swaps (IRS). The platform has since

been operationalised on August 30, 2007 and banks and Primary Dealers (PDs) have started reporting the IRS and Forward Rate Agreements (FRAs) trades on the platform on a daily basis.

(iii) Interest Rate Derivatives

124. Interest rate futures were introduced in India in June 2003. In the context of continued financial market developments, the Annual Policy Statement of April 2007 had proposed to set up a Working Group under the aegis of the TAC on Money, Foreign Exchange and Government Securities Markets to study and suggest measures to facilitate the development of the interest rate futures market. Accordingly, the Reserve Bank has constituted a Working Group on Interest Rate Futures (Chairman: Shri V.K. Sharma) which would review the experience gained so far with interest rate futures with particular reference to product design issues and make recommendations for activating the instrument. The Group would also revisit the recommendations of the earlier Committees in this area and examine regulatory requirements as well as the scope and extent of participation of non-residents while making its own recommendations. The report would be placed on the Reserve Bank's website within three months (by December 31, 2007) after further discussions with the TAC on Money, Foreign Exchange and Government Securities Markets.

(iv) Market Stabilisation Scheme: Revision of Ceiling

125. A Memorandum of Understanding (MoU) was signed between the Government of India and the Reserve Bank on March 25, 2004 detailing the rationale and operational modalities of the MSS. The Government of India, in consultation with the

Reserve Bank, has periodically raised the ceiling on the outstanding obligations of the Government of India by way of issuance of bills/securities under the MSS for the year 2007-08 to the level of Rs.2,00,000 crore as on October 4, 2007. The Reserve Bank announces the auctions under the MSS, if any, for the succeeding week every Friday.

(v) Guidelines on 'Short Sales' and 'When Issued' Transactions

126. Currently, 'Short sale' and 'When Issued' transactions are undertaken on the Negotiated Dealing System - Order Matching (NDS-OM) system only. In order to provide further flexibility to participants, it is proposed:

- to permit covering of 'Short-sale' and 'When Issued' transactions outside the NDS-OM system.

127. Guidelines in this regard would be issued in consultation with the FIMMDA and the PDAI.

(vi) CSGL Option on NDS-OM

128. The screen-based order driven anonymous NDS-OM module was operationalised in August 2005 for trading in Government securities. Access to the module was initially extended to banks and PDs and later to other NDS members including insurance companies, mutual funds and bigger provident funds for their proprietary deals. Constituent trading on the NDS-OM was enabled from May 2007 and access to the system was extended to certain 'qualified entities', including deposit taking non-banking financial companies (NBFCs) maintaining gilt accounts with NDS members. It is

now proposed:

- to include systemically important non-deposit taking NBFCs (NBFC-ND-SI) as ‘qualified entities’ for accessing the NDS-OM using the CSGL route.

Foreign Exchange Market

129. The Reserve Bank has taken several initiatives to rationalise and simplify the procedures in the conduct of foreign exchange transactions with a view to facilitating prompt and efficient customer service. Keeping in view the recommendations of the Committee on Fuller Capital Account Convertibility (CFCAC), a number of measures were taken towards liberalisation of foreign exchange transactions.

130. The pace of implementation of the recommendations of CFCAC was accelerated with regard to foreign exchange outflows. These measures include: (i) permitting Indian companies as well as registered partnership firms to invest in overseas joint ventures (JV)/wholly owned subsidiaries (WOS) up to 400 per cent of the their net worth under the automatic route; (ii) increasing the existing limit of 35 per cent of the net worth for portfolio investments by listed companies to 50 per cent of the net worth and dispensing with the requirement of 10 per cent reciprocal share holding in the listed Indian companies by overseas companies; (iii) increasing the existing limit for prepayment of external commercial borrowings (ECBs) without the Reserve Bank’s approval from US $ 400 million to US $ 500 million, subject to compliance with the minimum average maturity period; (iv) increasing the aggregate ceiling for overseas investments by mutual funds registered with the SEBI from US $ 4 billion to US $ 5 billion while continuing with the existing

facility of investing up to US $ 1 billion in overseas Exchange Traded Funds that may be permitted by the SEBI; and (v) enhancing the existing limit under the Liberalised Remittance Scheme (LRS) for resident individuals from US $ 100,000 to US $ 200,000 per financial year.

131. In the context of recent global and domestic developments and with a view to giving an opportunity to small and medium enterprises to manage the challenges in global markets, the Reserve Bank, in consultation with the Government of India, permitted all exporters as a temporary measure, to earn interest on their Exchange Earners' Foreign Currency (EEFC) accounts to the extent of outstanding balances of US $ 1 million per exporter. This facility would be valid up to October 31, 2008 and banks are free to determine the rate of interest.

132. In addition, the coverage of the interest subvention scheme in respect of rupee export credit to specified categories of exporters was widened and the validity of the scheme was extended by three months from December 31, 2007 to March 31, 2008.

(a) Expansion of Hedging Facilities

133. The range of hedging tools available to the market participants has been further expanded keeping in view the evolution of foreign exchange market.

Forward Contracts

Hedging Facility for Exporters and Importers

134. Under extant guidelines, exporters and importers are permitted to hedge on the basis of declaration of an exposure and based on past performance criteria as specified. Market

participants have represented to the Reserve Bank that the facility of hedging under the past performance route may be available on a continuous basis. In order to facilitate exporters and importers to hedge their exposures on a dynamic basis, it is now proposed:

- to permit reinstatement of the eligible limits under the past performance route to the extent that supporting underlying documents are produced during the term of the hedge undertaken; and
- the reinstatement facility would not, however, be available for contracts already cancelled under the scheme.

Oil Refining and Marketing Companies

135. With a view to facilitating hedging of foreign exchange exposure in respect of oil companies, it is proposed:

- to permit oil companies to hedge their foreign exchange exposures to the extent of 50 per cent of their inventory volume as at the end of the previous quarter by using overseas over-the-counter (OTC)/ exchange traded derivatives up to a maximum of one year forward.

(b) Currency Futures

136. The Annual Policy Statement of April 2007 proposed to set up a Working Group on Currency Futures to study the international experience and suggest a suitable framework to operationalise the proposal within the existing legal and regulatory framework. Accordingly, an Internal Working Group on Currency

Futures (Chairman: Shri Salim Gangadharan) was set up which studied, *inter alia,* the experiences of some emerging market economies where currency futures exchanges have been functioning within an environment of capital controls. The Group considered the views of a wide cross section of stakeholders, including banks, industry associations, domestic and international exchanges, and has had extensive and detailed consultations with market participants in the TAC on Money, Foreign Exchange and Government Securities Markets. The Group has explored various options for the proposed currency futures exchange, particularly on aspects like participation, clearing and settlement, market intermediaries, margins, contract design and surveillance mechanism. The draft report of the Group would be placed on the Reserve Bank's website for comments by November 15, 2007.

(c) Derivatives

137. The Reserve Bank had constituted an Internal Group for preparing consolidated guidelines on derivatives. Based on the recommendations of the Group in respect of foreign exchange derivatives, the following measures are proposed with a view to providing greater flexibility to the residents:

(i) Writing of Options

138. Currently, corporates are allowed only to purchase options on a stand-alone basis. In certain cases, corporates are permitted to write options as part of a zero cost structure. It is now proposed:

- to allow importers and exporters having foreign currency exposures to write covered call and put options in both foreign currency/rupee and cross currency and receive premia.

(ii) Running Options Book

139. In terms of extant guidelines, authorised dealers (ADs) desirous of running options books in foreign currency rupee options are permitted to do so, subject to approval by the Reserve Bank. In order to enable the ADs to manage their risks efficiently, it is proposed:

- to permit ADs to run cross currency options books, subject to the Reserve Bank's approval.

(iii) Types of Options

140. Under extant guidelines on foreign currency rupee options, ADs are permitted to offer only *plain vanilla* European options. In keeping with the gradual evolution of the foreign exchange market and based on market demand, it is now proposed:

- to permit ADs to offer American options as well.

II. Credit Delivery Mechanisms and Other Banking Services

141. It has been the endeavour of the Reserve Bank to address the developmental needs of sectors of the economy that are disadvantaged in the credit market, especially agriculture and SMEs, by improving credit delivery mechanisms and making available basic banking services to the widest sections of the society without procedural hassles. Initiatives taken in this regard include refocus on employment-intensive sectors under priority sector lending; simplification of the procedures for obtaining agricultural loans; reduction of risk weight on loans extended against gold and silver; augmenting credit flow to distressed

farmers; revival of the cooperative structure and regional rural banks (RRBs); development of new avenues of credit dispensation such as micro-finance institutions; and legislation for regulating money lending, deepening financial inclusion and improving customer services.

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

142. Domestic scheduled commercial banks, both public and private, are required to formulate special agricultural credit plans (SACP) in order to achieve a distinct improvement in flow of credit to agriculture. During 2006-07, disbursements to agriculture by public sector banks (PSBs) and private sector banks under SACP aggregated Rs.1,22,443 crore and Rs.25,360 crore (provisional), respectively, as against the target of Rs.1,80,160 crore and Rs.40,656 crore. Since the inception of the kisan credit card (KCC) scheme in 1998, PSBs have issued 27.27 million KCCs covering an amount of Rs.1,00,226 crore. During 2007-08 (up to June 30), PSBs have issued 0.66 million KCCs covering limits aggregating Rs.5,514 crore (provisional). 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 the RIDF XIII for rural roads under the Bharat Nirman Programme with a corpus of Rs.4,000 crore. Since the inception of the RIDF, the total allocation under the RIDF (I to XII) was of the order of Rs.64,000 crore. While cumulative sanctions to State Governments and the National Rural Roads Development Agency (NRRDA) under various tranches of the RIDF (I to XII) stood at Rs.61,312 crore and Rs.4,000 crore, respectively, the cumulative

disbursements stood at Rs.38,934 crore (as on July 31, 2007). The disbursements under various tranches of RIDF during 2007-08 (up to July 31) amounted to Rs.1,374 crore. During 2006-07, various State Governments were sanctioned loans aggregating Rs.10,555 crore, including Rs.1,023 crore sanctioned to the distressed districts of four States *viz.*, Andhra Pradesh, Kerala, Karnataka and Maharashtra.

(b) Priority Sector Lending: Revised Guidelines

143. Guidelines on lending to the priority sector were revised with effect from April 30, 2007 based on the Technical Paper of the Internal Working Group (Chairman: Shri C. S. Murthy) and the feedback received thereon from the Government of India, banks, financial institutions, NBFCs, associations of industries, media, public and the Indian Banks' Association (IBA). The revised guidelines focus on ensuring adequate flow of bank credit to weaker segments of the population and to employment-intensive sectors of the economy. The broad categories that are covered under the priority sector include agriculture, small enterprises, retail trade, micro credit, education and housing, subject to certain limits. The revised guidelines also take into account the revised definition of small and micro enterprises envisaged in the Micro, Small and Medium Enterprises Development Act, 2006.

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

144. The Working Group (Chairman: Shri C.P. Swarnkar) constituted by the Reserve Bank to examine the

documentation, procedures and other requirements prescribed by banks in providing agricultural loans, submitted its report in April 2007 which was placed on the Reserve Bank's website. On the basis of its recommendations, all SCBs (including RRBs) were advised to dispense with the requirement of submitting 'Nil Dues' Certificate (NDC) 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. Furthermore, in order to overcome the problem of producing identification/status documents, banks were advised to 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) Agricultural Indebtedness: Constitution of Internal Working Group

145. The Committee on Agricultural Indebtedness (Chairman: Dr. R. Radhakrishna) constituted by the Government of India has submitted its report, which, *inter alia*, addresses issues relating to creation of credit absorption capacities, need for risk mitigation practices, introduction of cyclical credit system, dispute resolution mechanisms and setting up of a debt redemption fund. It is proposed to constitute an Internal Working Group to examine the Committee's recommendations that are relevant to the banking system in general and the Reserve Bank, in particular. The Group is expected to have consultations with stakeholders and submit its report before December 31, 2007. The Working Group's report will be placed in the public domain for feedback and further processing.

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

146. Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with State Governments, the Government of India had approved a package for revival of the short-term rural cooperative credit structure. Thirteen States have executed Memoranda of Understanding (MoUs) with the Government of India and the NABARD as envisaged under the package. Implementation and monitoring of the revival package are being overseen by the National Implementing and Monitoring Committee (NIMC) set up by the Government of India. Furthermore, a study on the long-term cooperative credit structure was entrusted to the Task Force by the Government of India which submitted its report in August 2006. The Government is in the process of formulating a package of measures in consultation with State Governments.

(f) Regional Rural Banks: Status and Further Action

147. The Government of India initiated the process of State-level sponsor bank-wise amalgamation of RRBs in September 2005 in order to strengthen them. Consequent upon amalgamation of 147 RRBs into 46 new RRBs sponsored by 18 banks in 17 States, the total number of RRBs was reduced from 196 to 95.

148. In order to prepare RRBs to adopt appropriate technology and migrate to core banking solutions for better customer services, it is proposed:

- to constitute a Working Group with representatives from the Reserve Bank, the NABARD, sponsor banks and RRBs for preparing a road-map for migration to core banking solutions by RRBs.

149. The Internal Working Group on RRBs (Chairman: Shri A. V. Sardesai) had recommended that RRBs may be advised to maintain a minimum level of capital to risk-weighted assets ratio (CRAR) which would be progressively raised to the current level of CRAR as per the Basel I norms. At present, capital adequacy norms are not prescribed for RRBs and state/central cooperative banks. In order to further strengthen the capital structure of RRBs and state/central cooperative banks as also in the context of financial stability of the whole system, it is proposed that:

- RRBs and state/central cooperative banks should disclose the level of CRAR as on March 31, 2008 in their balance sheets.

- a road-map may be evolved for achieving the desired level of CRAR by these banks.

(g) Relief Measures for Distressed Farmers

150. The Working Group (Chairman: Prof.S.S.Johl) constituted by the Reserve Bank to suggest measures for assisting distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme under the Deposit Insurance and Credit Guaranee Corporation (DICGC) Act for such farmers, submitted its final report in November 2006. Based on the recommendations of the Working Group, an Agricultural Loans (Distressed Farmers) Guarantee Scheme, 2007 has been drafted and forwarded to the Government of

India. The Scheme is being revised based on the Government's comments.

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

151. The Technical Group (Chairman: Shri S.C. Gupta) set up to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and make recommendations to State Governments for improving the legal and enforcement framework in the interest of rural households, submitted its report in July 2007. The report has been forwarded to State Governments for consideration.

(i) Credit Flow to Micro, Small and Medium Enterprises Sector

152. Consequent upon announcement made in the Annual Policy Statement of April 2007, all State Level Bankers' Committee (SLBC) convenor banks were advised on May 8, 2007 to review their institutional arrangements for delivering credit to the small and medium enterprises (SME) sector, especially in 388 clusters identified by the United Nations Industrial Development Organisation (UNIDO) spread over 21 states in various parts of the country.

(j) Promotion of Livelihood in the Unorganised Sector: Role of Financial System

153. The National Commission for Enterprises in the Unorganised Sector, under the Chairmanship of Dr. Arjun K.Sengupta has submitted to the Central Government a

comprehensive report on ‘Conditions of Work and Promotion of Livelihood in the Unorganised Sector’. The report has suggested a package of measures for addressing some critical issues relating to farm and non-farm sectors. Some of the recommendations contained in the report relate to the Indian financial system. In order to study these recommendations and suggest the way forward, it is proposed:

- to constitute a Working Group to study the various recommendations of the report of the Sengupta Committee which are relevant to the financial system and to suggest an appropriate action plan for implementation of acceptable recommendations. The Group would submit its report within a month.

(k) Rehabilitation/Nursing of Potentially Viable Sick SME Units

154. The Standing Advisory Committee on Flow of Institutional Credit to the SME Sector observed in its eighth meeting held on January 16, 2007 that there has been considerable delay in rehabilitation/nursing of the potentially viable sick SME units due to the inability of promoters to bring in additional contribution for rehabilitation/nursing of the units. As suggested in the meeting, a Working Group has been constituted (Chairman: Dr.K.C. Chakrabarty) with representatives from banks and the Small Industries Development Bank of India (SIDBI) to examine the feasibility of bringing in additional capital through alternative routes such as equity participation and venture financing and suggest remedial measures for those potentially viable sick units which can be rehabilitated at the earliest. The Group is expected to submit its report by December 2007.

(I) Financial Inclusion

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

155. So far, 160 districts have been identified for financial inclusion and 100 per cent financial inclusion has been achieved in the Union Territory of Puducherry and in 28 districts in eight States (Andhra Pradesh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Punjab and West Bengal). Notably, all districts of Himachal Pradesh have achieved financial inclusion. An evaluation of the progress made in achieving financial inclusion in these districts is being undertaken to draw lessons for further action in this regard.

(ii) Working Group on Improvement of Banking Services in Lakshadweep: Status

156. A Working Group (Chairman: Regional Director for Kerala and the Union Territory of Lakshadweep) with members from the Government of the Union Territory, the zonal heads of the NABARD, the SIDBI and the SLBC convenor bank has been constituted to undertake a study of banking services provided in the Union Territory of Lakshadweep. The Group is currently examining the various issues relating to improvement in banking services in the Union Territory.

(iii) Working Group on Improvement of Banking Services in Himachal Pradesh

157. A Working Group (Chairman: Regional Director for Punjab and Himachal Pradesh and the Union Territory of Chandigarh) has been constituted to review the role of banks and financial institutions in supporting initiatives taken by the State Government

of Himachal Pradesh for promoting economic development and recommending measures for enhancing greater outreach/ penetration of the banking system in the State. The Group has representatives from the State Government of Himachal Pradesh, the NABARD, the SIDBI and the SLBC convenor bank. The Group submitted its report in September 2007 which is under examination.

(iv) Working Group on Improvement of Banking Services in Jharkhand

158. With a view to improving banking facilities in certain less developed States/regions, the Reserve Bank had earlier constituted State-specific working groups to suggest necessary developmental initiatives. In pursuance of this policy, a working group for the State of Jharkhand has since been constituted to recommend measures to enhance the outreach of banking services in the State.

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

159. As indicated in the Annual Policy Statement of April 2005, 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 the rural and semi-urban areas. The NCAER has since submitted its report which is being placed in the public domain.

(vi) Lead Bank Scheme

160. The Lead Bank Scheme, introduced in 1969, aimed at coordinating the activities of banks and other development

agencies for achieving the overall objectives of enhancing the flow of bank finance to the priority sector and promoting banks' role in overall development of the rural sector. With a focus on financial inclusion and recent developments in the banking sector, and in order to improve the Scheme's effectiveness, it is proposed:

- to constitute a High Level Committee to review the Lead Bank Scheme.

(vii) Credit Counselling: Setting up of Financial Literacy-cum-Counselling Centres

161. In the light of the recommendations of the Working Group (Chairman: Prof. S. S. Johl) constituted for suggesting measures for assisting distressed farmers as also the Working Group (Chairman: Shri C. P. Swarnkar) constituted to examine procedures and processes for agricultural loans, SLBC convenor banks were advised to set up a financial literacy-cum-counselling centre in any one district on a pilot basis and extend it to all other districts in due course, based on the experience gained. Several banks have since taken initiatives in opening credit counselling centres in the country. In order to take this initiative forward it is proposed:

- to prepare a concept paper on the subject detailing the future course of action and place it on the Reserve Bank's website for feedback.

(viii) Information and Communication Technology to Enhance Financial Inclusion

162. Widespread use of Information and Communication Technology (ICT) is expected to make 100 per cent financial

inclusion a feasible goal in terms of convenience, delivery, cost effectiveness, reliability and security for costumers as well as providers of financial services. The initial cost in rolling out such technology-based services could hinder the path of financial inclusion. Furthermore, in certain remote areas, the unavailability of electricity supply may also require investment in solar power generating devices for use of ICT. It is, therefore, proposed:

- to provide financial assistance to RRBs for defraying a part of their initial cost in implementing ICT-based solutions, including installation of solar power generating devices for powering ICT equipment in remote and under-served areas.

(m) Micro-finance

163. The self help group (SHG)-Bank Linkage Programme has emerged as the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and co-operative banks. By 2006-07, 29,24,973 SHGs were credit-linked to banks, with cumulative bank loans of Rs.18,047 crore.

(n) Customer Service in the Reserve Bank

164. It has been the endeavour of the Reserve Bank to improve the quality of its public services to the common person and reduce transaction costs as well as time, both for the Reserve Bank and the citizens/organisations. A Committee on Procedures and Performance Audit on Public Services (CPPAPS) (Chairman: Shri S.S. Tarapore) was set up in 2003 to undertake procedures and performance audit on public services and regulatory clearances in the Reserve Bank and to coordinate with the

Committees on Customer Services set up by banks. It has now been proposed to constitute a Committee (Chairman: Shri Prabhakar Rao) to evaluate customer services rendered by the Reserve Bank. The Committee would evaluate the efforts for improving public services to common persons undertaken by the Reserve Bank since the adoption of the recommendations of the CPPAPS, review the existing policies and procedures and suggest improvement in the quality of services.

III. Prudential Measures

165. The Reserve Bank has been adapting regulatory and supervisory tools to facilitate appropriate evolution of the financial system. The endeavour has been to anchor public confidence, to engage in financial development to support accelerated economic growth and to adopt international best practices with regard to prudential regulations, disclosure standards and supervisory processes.

(a) Discussion Paper on Holding Companies in Banking Groups

166. In many countries, deregulation and financial consolidation has led to the development of financial holding companies (commercial banking, insurance, investment banking and other financial activities are conducted under the same corporate umbrella). Different financial services within the same organisation are purveyed using different conglomerate models, *viz.,* the universal bank, the bank subsidiary and the bank holding company. These conglomerate models can have one or more layers of intermediate holding companies. Accordingly, a discussion paper on holding companies in banking groups has

been placed on the Reserve Bank's website for feedback. Guidelines in this regard would be issued by end-November 2007.

(b) Guidelines on Asset-Liability Management System: Amendments

167. The Reserve Bank had issued guidelines on the Asset-Liability Management (ALM) system in February 1999, which covered, *inter alia*, interest rate risk and liquidity risk measurement/reporting framework and prudential limits. Having regard to the international practices, the level of sophistication of banks in India and the need for a sharper assessment of the efficacy of liquidity management, these guidelines have been reviewed and amended with reference to the approach to the measurement of liquidity risk, mismatches and the structural liquidity as also the frequency of supervisory reporting. Operational guidelines in this regard have since been issued.

(c) Introduction of Credit Default Swaps

168. The recent amendments to the Reserve Bank of India Act, 1934 has provided legality of OTC derivative instruments, including credit derivatives, and accordingly the Annual Policy Statement of April 2007 proposed to permit banks and PDs to begin transacting in single-entity credit default swaps (CDS). The draft guidelines on CDS were placed on the Reserve Bank's website for wider dissemination and comments. On the basis of the feedback, revised draft guidelines have been placed on the Reserve Bank's website for a second round of consultation and final guidelines would be issued by end-November 2007.

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

169. In view of difficulties expressed by some banks, 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. The Group would submit its report by November 15, 2007.

(e) Differentiated Bank Licences

170. The Annual Policy Statement of April 2007 proposed to prepare a technical paper on differentiated bank licences with a view to directing the resources of banks to their niche areas and to sustain efficiency in the banking system which can be equally applicable to both domestic and foreign banks. The technical paper has been placed on the Reserve Bank's website on October 19, 2007.

171. The paper examined the statutory background of licensing of banks, the existing policies of licensing of private sector banks and foreign banks, international experiences and practices, and pros and cons of the introduction of a differentiated bank licensing regime. The paper recommended that in order to enable the banking system to operate at optimum efficiency and in the interest of financial inclusion, it would be necessary for all banks to offer certain minimum services to all customers, while allowing sufficient freedom to function according to their own business models. The paper also recommended continuation of the existing system for the time being.

(f) Recovery Agents Engaged by Banks

172. In view of the rise in the number of litigations against banks for engaging recovery agents in the recent past, it is felt that the adverse publicity could result in serious reputational risk for the banking sector as a whole. An urgent need has, therefore, arisen to review the policy, practice, procedure involved in the engagement of recovery agents by banks in India. Accordingly, banks are urged to follow prescribed specific considerations while engaging recovery agents.

173. Complaints received by the Reserve Bank regarding abusive practices followed by a bank's recovery agents would invite serious supervisory disapproval. The Reserve Bank would consider imposing a temporary ban (or even a permanent ban in case of persistent abusive practices) for engaging recovery agents on those banks where strictures have been passed/ penalties have been imposed by a High Court/Supreme Court or against its Directors/Officers with regard to the abusive practices followed by their recovery agents. An operational circular in this regard would be issued by November 15, 2007.

(g) Cross-border Supervision

174. Cross-border supervision has assumed importance in view of rapid integration of financial markets as also the heightened pace of merger and acquisition activities worldwide. In this context, the present system of informal exchange of information and supervisory cooperation amongst regulators need to be enhanced and well structured, particularly for internationally active banks. Accordingly, it is proposed:

- to constitute a working group to lay down the road-map for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS).

(h) Consolidated Supervision and Financial Conglomerate Monitoring Mechanism: Integration

175. Guidelines for consolidated accounting and other quantitative methods to facilitate consolidated supervision were issued to banks in February 2003, based on recommendations of the report of a multi-disciplinary working group (Chairman: Shri Vipin Malik). Consolidated supervision is undertaken through consolidated financial statements (CFSs) which are intended for public disclosure, consolidated prudential reports (CPRs) for supervisory assessment of risks that could be transmitted to banks by other group members, and compliance with prudential norms on group basis.

176. The financial conglomerates (FC) monitoring framework was put in place on the basis of the recommendations of the report of the Inter-regulatory Working Group (Chairperson: Smt. Shyamala Gopinath) on monitoring of Systemically Important Financial Intermediaries (Financial Conglomerates). The focus of the FC return is mainly on intra-group transactions and exposures (both fund-based and non-fund based transactions). The dominant/major entity in the group, called a 'designated entity' (DE), collects and collates FC data/information and forwards them to the principal regulator for analysis.

177. The evaluation of overall risks and possible transfer thereof within the group structure, however, needs to be evolved under

the consolidated supervision process for bank-led conglomerates. Accordingly, in order to enhance the effectiveness of the banking supervisory system for bank-led conglomerates, it is proposed to integrate the process of consolidated supervision with the financial conglomerate monitoring mechanism. Draft guidelines in this regard would be placed on the Reserve Bank's website by end-January 2008.

(i) Monitoring Banks' Exposure to Derivatives

178. At present, supervision of derivatives transactions by banks is carried out through on-site inspection during the annual financial inspection of banks and off-site monitoring of exposures through specified returns. In view of the potential of derivatives instruments to amplify systemic risks, there is a need to put in place a comprehensive oversight structure targeting the credit risk and operational risk in addition to the market risk, as at present. Furthermore, supervisory oversight needs to include stress testing of derivatives portfolios of banks for credit risk, particularly in view of banks resorting to multi-lateral netting for their counter party exposures. In view of majority of derivatives being over the counter (OTC) products, it is proposed:

- to cover, besides general market risk, specific risk, especially the credit risk arising out of deficient documentation or settlement risk, under the supervisory process.

(j) Implementation of Basel II - Pillar 2

179. The Reserve Bank issued final guidelines on implementation of Basel II framework in regard to Pillar 1 and Pillar 3 in April 2007. As regards Pillar 2, banks were advised to

put in place internal capital adequacy assessment process (ICAAP) to capture all material risks, including those that are partly covered or not covered under the other two Pillars, with the approval of their boards. The ICAAP of banks are required to be subject to a supervisory review evaluation process (SREP) for which the structure and methodologies for identification and quantification of various risks (not covered under Pillar 1) and provision of additional capital or controls/management actions are being worked out.

(k) Supervisory Review Process

180. The Mid-term Review of October 2005 had indicated the initiation of a supervisory review process (SRP) for select banks having significant exposure to some sectors, namely, real estate, highly leveraged NBFCs, venture capital funds and capital markets, in order to ensure that effective risk mitigants and sound internal control systems are in place. In the first round of SRP, a framework was developed for monitoring the systemically important individual banks. The second round of SRP analysed the exposure to sensitive sectors, in particular, to the real estate and capital market sectors of select banks. Ten banks were identified as outliers based on the real estate and capital market exposures in excess of 200 per cent and 25 per cent, respectively, of their net worth. The initial analysis revealed that *prima facie,* all banks under review had put in place risk management policies and systems and controls to manage risks arising from exposures to sensitive sectors. In case of exposures to real estate, certain irregularities were observed with regard to the implementation of banks' own approved policies. Accordingly, banks were advised to improve risk management processes at operating levels. Furthermore, banks were provided with an indicative list of

deficiencies and irregularities and were advised to explicitly spell out the required norms for lending to the real estate sector in their policies.

IV. Institutional Developments

Payment and Settlement Systems

181. The Reserve Bank continued to strengthen the framework for payment and settlement systems by utilising the full potential of information technology (IT) to improve operational efficiency. The main focus has been on ensuring business continuity, prompt customer service and development of electronic payment products.

(a) Adequacy of Business Continuity Plans

182. The Annual Policy Statement of April 2007 emphasised adequate business continuity plans by banks as part of disaster recovery management, with a view to ensuring continuous and prompt customer services. With increasing reliance on the use of IT-based processing of day-to-day operations for extending banking and financial services, ensuring appropriate business continuity plans assumes critical importance. The Reserve Bank conducts regular and periodic drills in respect of critical inter-bank systems in order to facilitate banking services and ensure continuity. The level of preparedness by the participating banks in these exercises conducted by the Reserve Bank is, however, inadequate. Banks are urged to ensure that adequate disaster recovery systems are put in place so as to fully comply with the requirements of the next drill of the Reserve Bank.

(b) Implementation of Core Banking Systems

183. Implementation of core banking systems (CBS) for banking operations has increased and banks have been encouraged to install the CBS in a phased manner. In view of the advantages of these systems in promoting better costumer services, banks are urged to draw up time-bound action plans for implementation of CBS across all their branches.

(c) Electronic Payment Products: Status and Proposed Action

184. The coverage of the Real Time Gross Settlement (RTGS) system has increased significantly. By October 23, 2007 RTGS connectivity was available in more than 34,023 branches and the Reserve Bank continues to improve the quality of services through the RTGS.

185. The Committee (Chairman: Dr.R.B. Barman) constituted for introduction of the National Settlement System (NSS) examined various models and recommended the Centralised Funds Transfer System (CFTS) model for implementation. Under the CFTS model, banks would be able to transfer funds across all Deposit Accounts Departments (DADs) on real time basis. The CFTS interface would enable the member banks to transfer funds from surplus centre for meeting the clearing obligations smoothly. So far, 11 DADs - Mumbai, Chennai, New Delhi, Kolkata, Hyderabad, Bangalore, Nagpur, Ahmedabad, Chandigarh, Kanpur and Jaipur - have been connected to the CFTS. The remaining five centres would be connected after the system stabilises in these 11 centres.

186. The Electronic Clearing Service (ECS), which facilitates

bulk payments, is currently available at 67 centres. The Reserve Bank proposes to operationalise the National Electronic Clearing Service (NECS) using the existing infrastructure of National Electronic Funds Transfer (NEFT) system with a view to widening the geographical coverage of the ECS. Under the NECS, the clearing and settlement would be centralised at Mumbai. Banks would receive their ECS centrally and transfer the transactions either on their core banking solution or arrange to distribute to their branches. Banks having their branches under the core banking solution can derive maximum benefits out of this system. It is proposed to draw up an action plan for its implementation in consultation with banks.

(d) Eligibility Criteria for Access to Payment Systems

187. An Internal Working Group, constituted to prepare comprehensive draft guidelines on minimum eligibility criteria for direct members of the clearing houses, submitted its report in September 2007 which has been placed on the Reserve Bank's website for public comments. The Group has recommended a set of financial parameters as criteria for clearing house membership and has also suggested for periodical review of compliance by members with a view to ensuring continued safety and soundness of the system.

(e) Annual Review of Payment and Settlement Systems

188. The Annual Policy Statement of April 2007 proposed an annual review of payment and settlement systems and accordingly, its first review was undertaken for the year ended

March 31, 2007. The comments/views of banks, chambers of commerce and industry/trade bodies were obtained on the review and a policy paper would be placed on the Reserve Bank's website by November 15, 2007.

Urban Co-operative Banks

Information Technology Support to UCBs

189. Considerable progress has been made in the area of human resources development for facilitating the growth of the UCB sector, pursuant to the Reserve Bank entering into MoUs with State Governments and the Government of India. During 2006-08, 69 programmes have been held in which 675 Directors, 515 Executives, 163 Auditors have participated with a view to professionalising the management of UCBs. In furtherance of commitments under the MoUs and with a view to identifying the areas requiring IT support for UCBs, it is proposed:

- to constitute a working group comprising representatives of the Reserve Bank, State Governments and the UCB sector to examine the various areas where IT support could be provided by the Reserve Bank.

Committee on Financial Sector Assessment

190. The Annual Policy Statement of April 2007 outlined the approach and progress made by the Committee on Financial Sector Assessment (CFSA) (Chairman: Dr.Rakesh Mohan; Co-Chairman: Dr.D.Subbarao) to undertake a self-assessment of the Indian financial sector. As envisaged, the CFSA has constituted four Advisory Panels for the assessment of Financial

Stability and Stress Testing, Financial Regulation and Supervision, Institutions and Market Structure and Transparency Standards. The Advisory Panels would prepare separate reports covering each of the above aspects. These Advisory Panels comprise of non-official experts with domain knowledge in respective areas and officials with similar expertise represented as Special Invitees.

191. The Advisory Panel on Financial Stability and Stress Testing (Chairman: Shri M.B.N. Rao) would conduct macro-prudential surveillance (including system-level stress testing) to assess the soundness and stability of financial system and suggest measures for strengthening the financial structure and system and its development in a medium-term perspective. The other three Advisory Panels would identify and consider the relevant standards and codes as currently prescribed and applicable to different areas, evaluate their implementation in the Indian context, identify gaps in adherence to respective standards and suggest possible roadmaps towards compliance in a medium-term perspective. The Advisory Panel on Financial Regulation and Supervision (Chairman: Shri M.S. Verma) would consider the relevant standards and codes applicable for financial regulation and supervision pertaining to the banking sector, financial markets and insurance; the Advisory Panel on Institutions and Market Structure (Chairman: Shri C.M. Vasudev) would consider the relevant standards and codes applicable to bankruptcy laws, accounting and auditing, payment and settlement systems and corporate governance policies; and the Advisory Panel on Transparency Standards (Chairman: Shri Nitin Desai) would consider the relevant standards and codes applicable for transparency in monetary, financial, fiscal and data dissemination policies.

192. The CFSA, before setting up of the Advisory Panels, had set up Technical Groups comprising of officials representing mainly regulatory agencies and the Government in all the above-mentioned subject areas which have progressed with technical work in their respective areas. These Groups also provide the Advisory Panels with technical notes and background material as necessary.

193. The CFSA submitted an interim report delineating its approach and reviewing the progress of work to the Finance Minister and Governor, Reserve Bank of India in July 2007. As mentioned in the Annual Policy Statement, the CFSA would publish Advisory Panel reports and also its own Synthesis Report. Based on an objective analysis of the present strengths and weaknesses of the financial sector and the status with regard to standards, the CFSA is also expected to lay out a road-map for further reforms in a medium-term perspective. The CFSA is expected to complete the assessment by March 2008.

Mumbai
October 30, 2007