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

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

I. Assessment of Macroeconomic and Monetary Developments

Domestic Developments

2. The growth of real gross domestic product (GDP) moderated to 8.9 per cent in the second quarter (July-September) of 2007-08 from 9.3 per cent in the first quarter and 10.2 per cent a year ago, as per the end-November 2007 release of the Central Statistical Organisation (CSO). Accordingly, real GDP growth was placed at 9.1 per cent in the first half of 2007-08, somewhat lower than 9.9 per cent a year ago. Real GDP originating in agriculture, industry and services sectors rose by 3.7 per cent, 9.5 per cent and 10.5 per cent, respectively, during the first half of 2007-08 as against 2.8 per cent, 11.0 per cent and 11.6 per cent a year ago.

3. Domestic economic activity continued to be steered by investment demand, with gross fixed capital formation (GFCF) increasing by 15.5 per cent in real terms in the first half of

2007-08 (14.5 per cent a year ago); on the other hand, private final consumption expenditure (PFCE) increased by 5.6 per cent (6.4 per cent). In nominal terms, the share of GFCF in GDP increased to 31.8 per cent from 29.6 per cent a year ago whereas the share of PFCE declined to 56.5 per cent from 57.6 per cent.

4. The first advance estimates of the Ministry of Agriculture place *kharif* foodgrains production at 112.2 million tonnes in 2007-08 - higher than 110.5 million tonnes in 2006-07, but below the target of 114.2 million tonnes. Available information suggests that by January 18, 2008 *rabi* sowing acreage was 3.7 per cent lower in the current season than its level a year ago. Declines have been recorded in area sown under wheat (-2.1 per cent), rice (-5.6 per cent), pulses (-5.0 per cent) and major oilseeds (-9.9 per cent) whereas some increase was reported in the area sown under coarse cereals (1.8 per cent). While the cumulative rainfall during the North-East monsoon season (October-December 2007) was 32 per cent below normal, it is relevant to note here that major *rabi* producing regions like Punjab, Haryana, Himachal Pradesh, western Uttar Pradesh and eastern Madhya Pradesh had received deficient rainfall in the 2007 South-West monsoon season. As on January 17, 2008 live storage in 81 major reservoirs was 55 per cent of the designated capacity which is 7.1 per cent lower than the level a year ago though 17.3 per cent higher than the last 10 years' average.

5. Against the backdrop of developments in the first half of 2007-08, industrial activity has experienced further deceleration in the third quarter of the year. The index of industrial production (IIP) rose by 9.2 per cent during April-November 2007 as compared with 10.9 per cent a year ago. The manufacturing sector, which contributed 89.9 per cent of the increase in

industrial production up to November 2007, recorded a growth of 9.8 per cent (11.8 per cent a year ago), led by chemical and chemical products, basic metals and alloys, machinery and equipment other than transport, and products of wood, leather, rubber, plastic, petroleum and coal. On the other hand, deceleration was observed in textiles and transport equipment and parts. The production of metal products and parts declined. The continued buoyancy of investment demand was reflected in the growth in capital goods production at 20.8 per cent (17.4 per cent) supported by the growth in production of basic goods by 8.4 per cent (9.4 per cent), in intermediate goods by 10.1 per cent (11.1 per cent) while consumer non-durable goods output rose by 7.8 per cent (8.9 per cent), the production of consumer durables goods declined by 1.7 per cent (increased by 12.4 per cent). Mining and electricity generation recorded increases of 4.9 per cent (4.2 per cent) and 7.0 per cent (7.3 per cent), respectively. The six infrastructure industries, comprising 26.7 per cent of the IIP, posted a lower growth of 6.0 per cent during April-November 2007 as compared with 8.9 per cent a year ago. All the infrastructure sectors, *viz*., electricity generation, production of crude petroleum and petroleum refinery products, cement, coal and finished steel registered lower growth as compared with the corresponding period of the previous year.

6. Private corporate sector activity exhibited some moderation in the first half of 2007-08. Overall sales of sampled non-financial private companies increased by 17.4 per cent as compared with 27.4 per cent in the first half of 2006-07. Other income from non-core activities registered a high increase of 63.6 per cent as compared with 19.3 per cent a year ago and accounted for 29.5 per cent of post-tax profits. Operational costs increased on account of a substantial rise in staff costs and other expenses *vis-à-vis* sales growth; however, raw material costs grew at a

slower rate in relation to sales, partly on account of cheaper imports. Reflecting the differential between growth in sales *vis-à-vis* expenditure, operating profits increased by 20.0 per cent in April-September 2007. Interest cost continued to be low as the interest to gross profit ratio came down from an average of around 50.0 per cent in 1990s to 39.0 per cent in 2000-05, 13.0 per cent in 2005-07 and to 11.7 per cent during the first half of 2007-08. Depreciation provisions increased by 15.1 per cent in April-September 2007 as compared with 16.1 per cent a year ago. Net profits rose by 31.1 per cent as compared with 41.6 per cent in April-September 2006, attributable to some moderation in consumer demand growth and high base effects. Non-manufacturing companies (IT, communication and other services) performed better than manufacturing companies, with a growth of 26.4 per cent and 48.4 per cent in sales and net profits, respectively, in contrast to 15.1 per cent and 25.1 per cent for manufacturing companies. Buoyant equity markets have enabled higher mobilisation of resources by the private corporate sector through public issues and private placements in 2007-08 so far than in the corresponding period of 2006-07. Early results for the third quarter of 2007-08 (October-December 2007) for a truncated sample of companies indicate that the moderation witnessed in sales growth during the first half has been somewhat arrested and profitability ratios have been shored up by income from both core and non-core activities. The growth in raw material cost and depreciation provisions was lower than in the corresponding quarter a year ago. Operating profits have been reinforced by other income representing non-sales activities of companies.

7. The Reserve Bank's Industrial Outlook Survey conducted during November 2007 indicates some moderation in the underlying business optimism with the share of respondents

expecting a better overall business situation in January-March 2008 being a shade lower than in the previous quarter. The business expectations index for January-March 2008 at 118.6 declined by 4.7 per cent from the preceding quarter and by 6.2 per cent from the corresponding quarter a year ago. The moderation in growth expectations is reflected in anticipation of some deceleration in production and order books growth. Increase in raw material costs, however, has fuelled increased expectations of higher working capital finance requirements for January-March 2008 than in the previous quarter, and some tightening in the overall financial situation and availability of finance is perceived. Significant augmentation in capacities is seen in order to meet the increased production requirements and the overall capacity utilisation may be around the same level as in the last few quarters. Nearly half the firms expect prices of raw materials to go up but less than a fourth perceive any increase in their selling prices, indicating weakening of pricing power. Respondents expect the recent moderation in profit margins to continue in the next quarter.

8. Business confidence surveys conducted by other agencies convey a mixed, though overall positive, picture for the near future. Purchasing managers' indices (seasonally adjusted) reflect positive sentiments for end-2007 driven by rising levels in new business. Local demand is seen as supporting new orders, although the pace of growth of export orders is decelerating. A higher level of growth in the third quarter of 2007-08 is also expected by one agency, propelled by the overall positive economic conditions of the economy. According to another agency, the business sector has responded swiftly to improvements achieved in containing inflation and business confidence recorded a rebound with respect to the previous quarter. It has noted that a stronger rupee has tilted purchases

of raw material by firms in favour of imports and there is a greater pessimism on the export front. A recent survey reflects *status quo* in business conditions and lower optimism in the consumer goods sector. Some other indices reflect improvement in business confidence when compared with the past six months, but lower business confidence when compared with the corresponding period of the previous year. A majority of respondents expect increases in new orders and in exports and more than half expect employment to increase, though successive hikes in interest rates and the rising rupee appear to have depressed sentiment and a weakening of industrial growth in the second half of 2007-08 is indicated.

9. Services sector activity was sustained at a robust pace as reflected in lead indicators. Railway revenue earnings from freight traffic increased by 8.0 per cent during April-November 2007. Total telephone connections in the telecommunications sector increased by 42.4 per cent, and 3.56 million new telephone lines were added to the switching capacity of telephone exchanges. Export and import cargo handled by the civil aviation sector increased by 0.2 per cent and 22.3 per cent, respectively, whereas cargo handled at major ports increased by 13.1 per cent. Passengers handled at international and domestic terminals also registered growth of 13.4 per cent and 25.9 per cent, respectively.

10. Non-food credit extended by scheduled commercial banks (SCBs) increased by Rs.2,22,842 crore (11.8 per cent) during the current financial year up to January 4, 2008 as compared with the increase of Rs.2,56,693 crore (17.5 per cent) in the corresponding period of 2006-07. There was a decline of Rs.5,237 crore in food credit as compared with an increase of Rs.2,392 crore in the previous year.

11. On a year-on-year basis, non-food credit of SCBs expanded by Rs.3,82,155 crore (22.2 per cent) as on January 4, 2008 on top of the increase of Rs.4,16,418 crore (31.9 per cent) a year ago. Provisional information available from select SCBs up to November 2007 indicates that credit to the industrial sector recorded the highest growth of 25.3 per cent followed by credit to the agriculture sector (21.4 per cent), the services sector (20.8 per cent) and personal loans (20.0 per cent). The share of the services sector in outstanding credit declined from 23.7 per cent in November 2006 to 23.4 per cent in November 2007. Within the services sector, real estate loans continued to record a high growth of 33.0 per cent, although their share in total non-food bank credit was only 2.6 per cent. Growth in credit off-take by some other sub-sectors like computer software, professional services and transport operators was also high, although from a relatively lower base. Within the personal loans sector which accounted for 25.4 per cent in total outstanding non-food gross bank credit, housing loans recorded a year-on-year growth of 15.1 per cent. Industry's share in total non-food bank credit increased from 38.3 per cent to 39.2 per cent. This followed from a pick-up in credit flow to industries like infrastructure (34.5 per cent), textiles (24.4 per cent), metals (27.1 per cent), engineering (28.4 per cent), food processing (30.0 per cent), petroleum (17.8 per cent), vehicles (38.5 per cent) and construction (37.0 per cent). The share of infrastructure in total outstanding credit to industry increased from 20.2 per cent in November 2006 to 21.7 per cent in November 2007. The share of priority sector advances declined nominally from 34.9 per cent to 34.3 per cent.

12. Commercial banks' investments in shares, bonds/ debentures and commercial paper (CP) increased by Rs.4,679 crore (5.9 per cent) during the current financial year up to January 4, 2008 as against a marginal decline (Rs.32 crore) in

the corresponding period of the previous year. Their investments in instruments of mutual funds was much higher at Rs.34,155 crore as against Rs.2,130 crore in the corresponding period of the previous year. The total flow of resources from SCBs to the commercial sector increased by Rs.2,27,522 crore (10.4 per cent) during the current financial year so far as compared with the increase of Rs.2,56,661 crore (16.6 per cent) in the corresponding period of the previous year. The year-on-year growth in total resource flow decelerated to 21.7 per cent from 30.1 per cent a year ago.

13. Aggregate deposits of SCBs increased by Rs.3,79,898 crore (14.6 per cent) in the current financial year up to January 4, 2008 as compared with an increase of Rs.2,78,398 crore (13.2 per cent) in the corresponding period of the previous year. On a year-on-year basis, the growth in aggregate deposits at Rs.6,00,761 crore (25.2 per cent) was higher than that of Rs.4,44,241 crore (22.9 per cent) a year ago. There has been a sizeable expansion in term deposits in the current financial year so far, indicative of migration from small savings schemes of the Government. The annual incremental non-food credit-deposit ratio declined to 63.6 per cent from 93.7 per cent a year ago.

14. Commercial banks invested Rs.1,64,458 crore in Government and other approved securities during the current financial year up to January 4, 2008, which was substantially higher than Rs.48,086 crore in the corresponding period of the previous year. Adjusted for banks' collateral securities under the liquidity adjustment facility (LAF), however, their investment in securities increased by Rs.1,02,999 crore during 2007-08 so far as against an increase of Rs.50,151 crore a year ago. Banks' holdings of Government and other approved securities at 29.1 per cent of their net demand and time liabilities (NDTL) as on

January 4, 2008 was marginally higher than 28.6 per cent a year ago. SCBs' stock of such securities in excess of the prescribed statutory liquidity ratio (SLR) amounted to Rs.1,33,017 crore on January 4, 2008 and adjusted for LAF holdings, these holdings stood at Rs.99,128 crore or 3.0 per cent of NDTL. Adjusted for LAF collateral securities and the outstanding issuances under the market stabilisation scheme or MSS, investment in Government and other approved securities by SCBs are placed in the range of 23.0 per cent to 24.0 per cent of NDTL.

15. During the current financial year so far, money supply or M_3 (up to January 4, 2008) increased by Rs.4,40,056 crore (13.3 per cent) which was higher than the increase of Rs.3,33,864 crore (12.2 per cent) in the corresponding period of the previous year and reflected the sizeable deposit mobilisation by banks, including shifts out of small savings schemes of the Government. M3 increased by 22.4 per cent on a year-on-year basis, on January 4, 2008 which was higher than 20.8 per cent a year ago and well above the projected trajectory of 17.0-17.5 per cent indicated in the Annual Policy Statement for 2007-08.

16. On a financial year basis, reserve money increased by Rs.1,29,034 crore (18.2 per cent) up to January 18, 2008 as compared with the increase of Rs.68,764 crore (12.0 per cent) in the corresponding period of the previous year. Currency in circulation increased by Rs.61,964 crore (12.3 per cent) as compared with Rs.57,726 crore (13.4 per cent). With the increase in the cash reserve ratio (CRR), bankers' deposits with the Reserve Bank registered a higher growth of Rs.69,760 crore (35.4 per cent) as compared with an increase of Rs.12,319 crore (9.1 per cent) in the corresponding period of the previous year. Among the sources of reserve money, Reserve Bank's net credit to the Central Government declined by Rs.1,57,815 crore as

against an increase of Rs.6,963 crore in the corresponding period of the previous year. Adjusted for issuances under the MSS, Reserve Bank's net credit to the Central Government showed a decline of Rs.59,731 crore as compared with an increase of Rs.18,392 crore a year ago and mainly reflected the exchange of collateral securities under the LAF and the changes in the Centre's cash balances (non-MSS) with the Reserve Bank. Due to sustained net capital inflows, the Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.2,51,026 crore as against an increase of Rs.1,14,337 crore during the corresponding period of the previous year. The Reserve Bank's foreign currency assets, adjusted for revaluation, increased by Rs.3,11,941 crore as compared with an increase of Rs.80,166 crore during the corresponding period of the previous year. Reserve money increased by 30.6 per cent on a year-on-year basis as on January 18, 2008 as compared with 20.0 per cent a year ago. Adjusted for the first round effect of the increases in the CRR, reserve money growth was 21.5 per cent as compared with 17.5 per cent a year ago. The ratio of NFEA to currency increased from 171.8 per cent on March 31, 2007 to 197.3 per cent by January 18, 2008.

17. Over the third quarter of 2007-08, movements in the key monetary and banking aggregates were reflected in generally easy conditions of liquidity till November 11, 2007. Up to that period, the banking system experienced conditions of surplus liquidity on account of substantial deposit mobilisation relative to credit demand. During November 1-11, 2007 average daily net absorption under the LAF was Rs.10,384 crore, despite an additional amount of Rs.3,000 crore absorbed under the MSS. Thereafter, the system switched to a tighter liquidity mode. With effect from the fortnight beginning November 10, 2007 the CRR was raised to 7.50 per cent which implied a liquidity reduction

of about Rs. 16,000 crore in the banking system. Between November 12-22, 2007 there was net injection of liquidity at the LAF auctions, with repos averaging Rs. 17,911 crore as liquidity remained tight on account of the increased reserve requirements. From November 23, 2007 net issuances under the MSS were halted in view of the prevailing liquidity situation and redemptions of a cumulative amount of Rs.20,000 crore up to January 11, 2008 released funds to the system. The Centre's cash balances moved in a steady range between Rs.28,000 crore - Rs.44,000 crore during this period. However, infusions of liquidity through repo gradually declined in the subsequent period and there were intermittent absorptions under the LAF as well.

18. During the first half of December 2007 liquidity conditions improved, money market rates eased and the LAF returned to absorption mode; however, liquidity tightened in the second half of December amidst substantial outflows towards payment of advance tax. The Centre's cash balances moved up from levels of Rs.30,000 crore - Rs.40,000 crore in the first half of December to around Rs.85,000 crore during December 20-27, 2007 exacerbating the liquidity situation. The LAF shifted to injection mode, with daily repo volumes rising to a peak of Rs.47,665 crore on December 26, 2007. Liquidity conditions began to ease towards end-December 2007 through mid-January 2008 with the LAF returning to absorption mode and the Centre's cash balances stabilising in the range of Rs.35,000 crore-Rs.60,000 crore. The outstanding issuances under the MSS fell to Rs.1,58,155 crore by January 4, 2008 before rising to Rs.1,69,194 crore on January 25, 2008 within the overall ceiling of Rs.2,50,000 crore for 2007-08 as revised on November 7, 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.2,58,187 crore on January 17, 2008 before declining to Rs.2,32,809 crore on January 24, 2008.

19. Inflation, based on variations in the wholesale price index (WPI) on a year-on-year basis, eased to 3.8 per cent as on January 12, 2008 from its peak of 6.4 per cent at the beginning of the financial year and from 6.2 per cent a year ago. On an annual average basis, inflation at 4.7 per cent was lower than 4.9 per cent a year ago.

20. At a disaggregated level, prices of primary articles (weight: 22.0 per cent in the WPI basket) registered a year-on-year increase of 3.9 per cent as on January 12, 2008 as compared with 9.5 per cent a year ago. The relatively lower increase in prices of primary articles during 2007-08 was mainly due to food articles; however, prices of non-food primary articles like cotton and oilseeds went up sharply. Manoeuverability in supply conditions has been reduced considerably due to the existence of a relatively low level of stocks and high price increases in respect of foodgrains in the international markets. The stock of foodgrains with public agencies was lower than buffer stock norms during July-October 2007. The stock of foodgrains with public agencies stood at 19.7 million tonnes in November 2007 as against the norm of 20.0 million tonnes for January 1, 2008 (16.2 million tonnes for November 1, 2007).

21. Inflation in terms of prices of manufactured products (weight: 63.8 per cent) eased to 3.9 per cent from 5.8 per cent a year ago, largely on account of the decline in prices of textiles, sugar and non-ferrous metals and deceleration in prices of non-electrical machinery, wood and paper. On the other hand, prices of edible oils, oil cakes, rubber products, cement, iron and steel and their products and electrical machinery increased on a year-on-year basis.

22. Inflation in terms of the prices of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) was 3.7 per cent as on

January 12, 2008 the same as a year ago. Excluding the fuel group, inflation was at 3.9 per cent (6.9 per cent a year ago). The price of the Indian basket of international crude has registered a sustained increase during 2007 from US $ 56.6 per barrel during January-March to US $ 66.4 in April-June, US $ 72.7 in July-September, US $ 85.7 in October-December 2007 and US $ 88.9 per barrel as on January 25, 2008. While the subsidy schemes for kerosene and domestic LPG have been extended till March 2010, domestic retail prices of petrol and diesel have remained unchanged since February 2007 thereby increasing the magnitude of incomplete pass-through. Since the last revision of domestic retail prices of petrol and diesel in February 2007, the price of the Indian crude basket has increased by about 56 per cent in US dollar terms and about 39 per cent in rupee terms (up to December 2007). Prices of the freely priced petroleum products, on the other hand, have increased substantially, as for instance, for aviation turbine fuel (36.5 per cent), naphtha (35.0 per cent), bitumen (28.4 per cent) and furnace oil (36.9 per cent) by January 12, 2008. While the issuance of oil bonds and burden sharing by upstream oil public sector units would mitigate a part of the under-recoveries, the fiscal costs of such operations have associated monetary implications.

23. In the light of the spurt in international crude oil prices, public authorities in many countries have taken initiatives to protect domestic consumers and to minimise the adverse effects of the pass-through of oil prices to domestic inflation. As against a four-fold rise in average international crude prices over the period 2003-2007, domestic prices of major petroleum products have risen by only 50 per cent in India (LPG and kerosene prices have remained unchanged), by 70 per cent in China and by 150 per cent in Indonesia. Cross-country analysis of end-user

prices of the pass-through, however, needs to adjust for the wedge created by the tax components which ranges from high in European countries to low in the US where the retail prices are determined in a competitive market with an efficient refining industry and can be considered as an approximate benchmark for assessing the pass-through for countries with low taxes. An analysis of the tax component in composite barrel price across countries indicates that the tax component has been brought down substantially by both high-tax and low-tax countries in the recent years in the wake of hardening of crude prices. According to the Organisation of Petroleum Exporting Countries (OPEC), the share of taxes has come down during 1999-2006 from 70 per cent to 53 per cent in France, from 69 per cent to 56 per cent in Italy, from 63 per cent to 57 per cent in Germany, from 68 per cent to 62 per cent in the UK, from 38 per cent to 29 per cent in Canada and from 31 per cent to 25 per cent in the US.

24. Inflation based on the consumer price index (CPI) for industrial workers (IW) declined to 5.5 per cent on a year-on-year basis in November 2007 from 6.3 per cent a year ago. The CPI for urban non-manual employees (UNME), agricultural labourers (AL) and rural labourers (RL) also declined to 5.1 per cent, 5.9 per cent and 5.6 per cent, respectively, in December 2007 as compared with 6.9 per cent, 8.9 per cent and 8.3 per cent a year ago. Prices of food items, which have a higher weightage in the CPI basket relative to the WPI, are the major cause of CPI inflation consistently ruling above WPI inflation during the current year. Average inflation based on CPI for IW was 6.5 per cent in November 2007 as compared with 6.1 per cent a year ago. On an annual average basis, inflation based on CPI for UNME, AL and RL increased to 6.5 per cent, 8.2 per cent and 7.8 per cent, respectively, in December 2007 as compared with 6.0 per cent, 6.7 per cent and 6.4 per cent a year ago.

25. Revenue receipts of the Union Government improved to 56.5 per cent of the budget estimates (BE) in April-November 2007 from 54.8 per cent in April-November 2006. As a proportion to BE, revenue expenditure at 61.8 per cent was comparable with 62.6 per cent a year ago. Within capital expenditure, Plan and non-Plan expenditure were 67.0 per cent and 20.5 per cent (net of transactions relating to transfer of the Reserve Bank's stake in the State Bank of India to the Government) of BE, respectively, as compared with 53.9 per cent and 32.6 per cent in the corresponding period of the previous year. As a proportion to BE, the revenue deficit was 97.9 per cent as compared with 99.7 per cent in the corresponding period of the previous year whereas the gross fiscal deficit decelerated to 63.8 per cent from 72.8 per cent a year ago. In recent months, there has been deceleration in mobilisation under small savings. On December 7, 2007 it was announced that the five-year post office time deposit accounts and the senior citizen savings scheme would enjoy the same tax treatment as bank deposits. The element of bonus on post office monthly income accounts has also been restored.

26. The gross market borrowings of the Central Government through dated securities at Rs.1,47,000 crore (Rs.1,30,000 crore a year ago) during 2007-08 so far (up to January 25, 2008) constituted 94.6 per cent of the BE. Net market borrowings at Rs.1,03,092 crore (Rs.91,432 crore a year ago) constituted 94.1 per cent of the BE. The weighted average yield and weighted average maturity of Central Government securities issued during 2007-08 so far were at 8.15 per cent and 14.57 years, respectively, as compared with 7.89 per cent and 14.72 years for those issued during 2006-07 (full year). In addition, securities amounting to Rs.15,147 crore have been issued by the Central Government (excluding MSS) beyond the regular market

borrowing programme for 2007-08 to fertiliser companies and to oil companies for partial compensation of under-recoveries, over and above issuances of such securities to the tune of Rs.40,321 crore during 2006-07. In addition to provisional net allocation of Rs.28,781 crore for 2007-08, additional allocations of Rs.2,834 crore were made to certain States and Rs.35,518 crore was allocated to meet the shortfall in receipt from the national small savings fund (NSSF). Accordingly, total net allocation for States stood at Rs.67,133 crore (gross Rs.78,687 crore) for 2007-08 against which they raised a net amount of Rs.35,895 crore (gross Rs.47,449 crore) during the current year up to January 25, 2008.

27. During the third quarter of 2007-08, money, debt and foreign exchange markets remained generally stable, despite large movements in liquidity conditions. Overnight interest rates, which averaged around 6.0 per cent in the first eleven days of November, rose to the upper end of the LAF corridor by mid-December and hardened further in the second half of December on account of reduction in liquidity with the banking system due to sizeable tax outflows and build-up of the Centre's cash balances. Thereafter, overnight rates have softened. The call money rate, which had declined from 14.07 per cent in March 2007 to 6.03 per cent in October, rose to 6.98 per cent in November and to a peak of 7.95 on December 26, averaging 7.50 per cent in December 2007. Thereafter, call rates remained within the informal LAF corridor and averaged 6.57 per cent in January 2008 (up to January 25, 2008). Overnight rates in other segments, viz., market repo and collateralised borrowing and lending obligations (CBLO) ruled around the call money rate during the period. Market repo (other than LAF) declined from 8.13 per cent in March 2007 to 5.87 per cent in October 2007 and increased to 7.36 per cent in December 2007, before declining to 6.33 per cent in January 2008 (up to January 25,

2008). CBLO rates moved from 7.73 per cent in March 2007 to 5.61 per cent in October 2007, before increasing to 7.18 per cent in December 2007. However, they declined to 6.17 per cent in January 2008 (up to January 25, 2008). The daily average volume (one leg) in the call money market decreased from Rs.11,608 crore in March 2007 to Rs.8,124 crore in December 2007. The corresponding volumes in the market repo and CBLO segments increased from Rs.8,687 crore and Rs.17,662 crore, respectively, in March 2007 to Rs.13,354 crore and Rs.30,087 crore in December 2007. As on January 25, 2008, call, market repo and CBLO rates were 7.37 per cent, 7.40 per cent and 4.41 per cent, respectively.

28. The primary yields on 91-day Treasury Bills decelerated to 7.10 per cent on January 25, 2008 from 7.98 per cent at end-March 2007 and 7.31 per cent in end-October 2007. Yields on 364-day Treasury Bills moved to 7.39 per cent on January 25, 2008 from 7.98 per cent at end-March 2007 and 7.36 per cent in end-October 2007. The weighted average discount rate (WADR) on CP declined to 9.20 per cent by end-December 2007 from 11.33 per cent at end-March and the outstanding amount of CP increased from Rs.17,688 crore to Rs.40,231 crore over this period. In the market for certificates of deposit (CDs) also, WADR declined from 10.75 per cent at end-March 2007 to 8.81 per cent by December 21, 2007 accompanied by an increase of 32.4 per cent in the outstanding amount (*i.e.*, from Rs.93,272 crore to Rs.1,23,466 crore).

29. Rapid growth in turnover in the foreign exchange market was sustained by large surplus conditions in the spot market as average daily turnover increased to US $ 50.1 billion for the quarter ended December 2007 from US $ 27.6 billion in the corresponding quarter of the previous year. With increasing

volumes of current and capital account transactions, the merchant turnover increased to US $ 15.5 billion from US $ 7.8 billion while the inter-bank turnover increased to US $ 34.6 billion from US $ 19.8 billion. There has been a general softening in forward premia across all maturities over end-March 2007 but some hardening was witnessed after October 2007. 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 1.67 per cent by end-October before it increased to 2.12 per cent on January 25, 2008.

30. The yield on Government securities with one-year residual maturity declined from 7.55 per cent at end-March 2007 to 7.30 per cent as on January 25, 2008. The yield on Government securities with 10-year and 20-year residual maturity also declined from 7.97 per cent and 8.23 per cent, respectively, to 7.46 per cent and 7.66 per cent. The yield spread between 10-year and one-year Government securities narrowed from 42 basis points to 16 basis points and the spread between 20-year and one-year Government securities reduced from 68 basis points to 36 basis points during this period.

31. During March 2007-January 2008, pubic sector banks (PSBs) that were earlier paying higher interest rates on longer term deposits, readjusted their interest rates downwards by 25-50 basis points, while those offering lower deposit rates for similar maturity earlier increased their deposit rates by 50-75 basis points. Similarly, PSBs paying higher interest rates earlier on shorter term deposits of up to one year maturity also revised their deposit rates downwards by 25 basis points. In particular, the interest rates offered by the PSBs on deposits of above one year maturity moved from the range of 7.25-9.50 per cent in March 2007 to 8.00-9.25 per cent in January 2008, while deposit rates for shorter term deposits of up to one year maturity decreased

from the range of 2.75-8.75 per cent to 2.75-8.50 per cent during the same period. On the other hand, private sector banks increased their interest rates for long term deposits of above one year maturity from a range of 6.75-9.75 per cent to 7.25-10.00 per cent during the same period. On the lending side, the benchmark prime lending rates (BPLRs) of PSBs increased by 25-75 basis points from a range of 12.25-12.75 per cent to 12.50-13.50 per cent. The private sector banks increased their BPLR from a range of 12.00-16.50 per cent to a range of 13.00-16.50 per cent, in the same period. The range of BPLRs for foreign banks, however, remained unchanged at 10.00-15.50 per cent during the same period.

32. Buoyancy in the equity market continued in terms of large issuances in the domestic primary segment as well as in international stock exchanges. The secondary market witnessed high volatility despite positive sentiments. 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 20,000 level on December 11, 2007 and closed at 18,362 on January 25, 2008 registering an increase of 40.5 per cent over end-March 2007. According to data released by the Securities and Exchange Board of India (SEBI), net investments by foreign institutional investors (FIIs) in the equity market were significantly higher at Rs.50,201 crore (US $ 12.1 billion) during the current financial year up to January 25, 2008 as compared with Rs.19,161 crore (US $ 4.1 billion) in the corresponding period of the previous year. In October 2007, SEBI made changes in FII registration criteria by modifying the broad-based criteria considering the track record of the applicant, limiting the issuance of offshore derivative instruments/ participatory notes (ODIs/PNs) to only "regulated" entities instead of "registered" entities and giving a road-map for gradual phasing out of existing ODIs/PNs. Also, FII and sub-account registration

has been made perpetual, subject to fee payment. Despite these regulatory measures, there has been considerable volatility in portfolio flows which has been reflected in large movements in stock prices. During April-December 2007, mutual funds mobilised net funds of the order of Rs.1,23,993 crore as against Rs.79,708 crore a year ago.

Developments in the External Sector

33. Balance of payments data released by the Reserve Bank at the end of December 2007 indicate some widening of the merchandise trade deficit in the first half of 2007-08. External financing requirements were comfortably met by the sustained buoyancy in invisibles and sizeable net capital inflows which also enabled a build-up of international reserves. In US dollar terms, merchandise export growth was 19.9 per cent during April-September 2007 as against 25.4 per cent in the first half of the previous year. Commodity-wise data available from the Directorate General of Commercial Intelligence and Statistics (DGCI&S) for April-September 2007 indicate that the growth of exports of primary products moderated to 15.3 per cent from 18.4 per cent. Exports of manufactures registered a lower growth of 14.1 per cent in April-September 2007 as against 18.3 per cent a year ago. While exports of iron ore showed a turnaround, increasing by 22.7 per cent from a decline of 8.2 per cent a year ago, growth of exports of chemicals and related products moderated to 11.4 per cent as compared with 22.0 per cent and growth of exports of textiles and related products moderated to 1.3 per cent as against an increase of 11.6 per cent. Exports of chemicals and related products, petroleum products, engineering goods and gems and jewellery together contributed around three-fourth of overall export growth. Merchandise import payments rose by 21.9 per cent during April-September 2007 as compared with

24.7 per cent a year ago. As per DGCI&S data, oil imports increased by 16.9 per cent in the first half of the current financial year as against 41.2 per cent in April-September 2006, although the average price of the Indian basket of international crude rose from US $ 67.4 per barrel to US $ 69.3 per barrel over this period. Non-oil import growth at 33.2 per cent was substantially higher than 16.1 per cent a year ago and mainly attributable to imports of capital goods, export-related items and gold and silver *vis-à-vis* the previous year. China remained the major source of imports accounting for 11.2 per cent of total imports and 16.3 per cent of non-oil imports in April-September 2007. On a payments basis, the merchandise trade deficit widened to US $ 42.4 billion in the first half of 2007-08 from US $ 33.8 billion a year ago.

34. Gross invisible receipts comprising services, current transfers and income are gaining importance in India's external transactions in recent years. At US $ 61.6 billion in April-September 2007, gross invisible receipts were equivalent to 83.6 per cent of merchandise exports as against 81.2 per cent a year ago. Software exports, travel earnings, other professional and business services and remittances from overseas Indians buttressed invisible receipts which increased by 23.4 per cent during April-September 2007 as against 31.0 per cent a year ago. On the other hand, invisible payments increased by 13.0 per cent, mainly on account of a surge in payments related to travel, business and management consultancy, engineering and other technical services and dividend and profit payments. On a net basis, the invisible account recorded a surplus of US $ 31.7 billion during the first half of 2007-08 as against US $ 23.4 billion in the corresponding period of the previous year. The current account deficit (CAD) at US $ 10.7 billion in the first half of 2007-08 was comparable to US $ 10.3 billion during the first half of 2006-07.

35. Net capital flows surged to US $ 50.4 billion during April-September 2007 from US $ 19.2 billion a year ago. Among its components, net external commercial borrowings (ECB) inflows at US $ 10.6 billion were higher than US $ 5.7 billion in the first half of the previous year. Net portfolio investment including FIIs at US $ 18.3 billion during the first half of 2007-08 was also higher than US $ 1.6 billion during April-September 2006. Net foreign direct investment (FDI) into India was higher at US $ 9.9 billion during the first half of the current year against US $ 7.3 billion a year ago. Outward FDI from India showed a significant increase to US $ 6.0 billion in the first half of 2007-08 on account of global expansion of Indian companies as compared with US $ 2.8 billion a year ago. Reflecting the drawdown of assets held abroad by the banking system, net inflow from other banking capital showed a higher increase of US $ 5.3 billion as compared with US $ 3.3 billion a year ago. On the back of growing trade volumes, net short-term trade credit (inclusive of suppliers' credit up to 180 days) increased by US $ 5.7 billion in the first half of 2007-08 as compared with US $ 3.9 billion in April-September 2006. On the other hand, there was a net outflow of US $ 0.1 billion from deposits of non-resident Indians (NRI) in the first half of 2007-08 as against net inflows of US $ 2.2 billion in the first half of 2006-07, mainly on account of the reduction in the ceiling on interest rates during February and April 2007.

36. The foreign exchange reserves (excluding valuation) increased by US $ 40.4 billion during April-September 2007 which was much higher than the accretion of US $ 8.6 billion in the first half of 2006-07 and reflected the overall movements in current and capital accounts of the balance of payments. Taking into account the valuation gain of US $ 8.2 billion, foreign exchange reserves increased by US $ 48.6 billion during April-September 2007 as against US $ 13.7 billion in the first half of 2006-07.

37. India's external debt increased by US $ 20.9 billion during April-September 2007 and amounted to US $ 190.5 billion at end-September 2007. ECB increased by US $ 10.0 billion while there was an increase of US $ 4.6 billion in short-term debt, essentially brought about by a rise in trade credits. There were moderate increases in multilateral and bilateral debt to the tune of US $ 1.7 billion and US $ 0.6 billion. Valuation changes arising on account of the weakening of the US dollar *vis-à-vis* other major international currencies added US $ 7.0 billion to the stock of external debt and explained one-third of the increase in external debt. Commercial borrowings accounted for the highest share (27.2 per cent) in the total debt stock, followed by NRI deposits (22.9 per cent), multilateral debt (19.5 per cent) and bilateral debt (8.7 per cent). The US dollar had a dominant share of 52.8 per cent in India's external debt whereas rupee-denominated debt had a share of 17.6 per cent. The ratio of short-term debt to total debt increased to 16.2 per cent at end-September 2007 from 15.5 per cent at end-March 2007. The ratio of foreign exchange reserves to external debt increased to 130.0 per cent at end-September 2007 as compared with 117.4 per cent at end-March 2007.

38. In the second half of 2007-08, these developments have gained strength. According to the DGCI&S, merchandise exports rose by 21.9 per cent in US dollar terms during April-November 2007 as compared with 26.2 per cent in the corresponding period of the previous year. Import growth was lower at 26.9 per cent as compared with 27.4 per cent in the previous year mainly on account of a lower growth of 9.8 per cent in oil imports as compared with 42.0 per cent a year ago, despite a rise of 12.5 per cent in the price of the Indian basket of crude oil over this period. Non-oil imports, on the other hand, increased by 35.3 per cent as compared with 21.3 per cent a year ago and accounted for nearly 88.0 per cent of the growth of total imports. As a result, the

merchandise trade deficit widened to US $ 52.8 billion during April-November 2007 from US $ 38.5 billion in April-November 2006.

39. Available information also points to a further increase in various elements of capital flows in relation to their levels a year ago and in the first half of 2007-08. Portfolio flows have picked up strongly on account of FIIs, amounting to US $ 26.8 billion during 2007-08 (up to January 11, 2008) as compared with an inflow of US $ 2.5 billion in the corresponding period of 2006-07. Gross FDI inflows during April-November 2007 were placed at US $ 13.8 billion as compared with US $ 10.8 billion a year ago. ECB approvals, including under the automatic route, amounted to US $ 23.3 billion during April-December 2007 as compared with US $ 15.3 billion in the corresponding period of the previous year. On the other hand, there were net outflows under NRI deposits of US $ 0.4 billion in April-November 2007 as compared with inflows of US $ 3.0 billion during April-November 2006. ADR/GDR issues by Indian companies amounted to US $ 5.7 billion during April-November 2007 as against US $ 1.9 billion in the corresponding period in the previous year. The foreign exchange reserves increased by US $ 85.7 billion during the current financial year so far and stood at US $ 284.9 billion on January 18, 2008.

40. The exchange rate of the rupee against the US dollar, which was Rs.43.59 at end-March 2007, appreciated thereafter to reach Rs.40.96 at end-August 2007 and strengthened further to Rs.39.40 per US dollar as on January 25, 2008. During September 29, 2007-January 25, 2008, the movements of the rupee *vis-à-vis* the US dollar generally remained range-bound in the band of Rs.39-40 per US dollar. By January 25, 2008, the rupee appreciated by 9.61 per cent against the US dollar, by 8.85 per cent against the pound sterling and by 0.95 per cent against the Japanese yen over the end-March 2007 level.

Against the euro, the rupee remained at its end-March 2007 level as on January 25, 2008. Over the end-September 2007 level, however, the rupee appreciated by 0.86 per cent against the US dollar and by 2.96 per cent against the pound sterling, whereas it depreciated by 3.27 per cent against the euro and by 6.29 per cent against the Japanese yen.

41. 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

42. During the fourth quarter of 2007, financial markets in developed economies experienced tight conditions following the turbulence witnessed since July 2007 in response to the US subprime mortgage crisis. Reduced financial leverage, lower credit availability and negative wealth effects have emerged as risks to consumption and growth, especially in the US. Firm inflationary pressures from food prices and high and volatile crude prices are other risks to the outlook. Substantial downside risks continue to be associated with respect to housing developments in the US and Europe and the fall-out on financial institutions/markets in an environment of heightened systemic risks and high volatility. 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 is placed at 5.2 per cent for 2007 as compared with 5.4 per cent in 2006, and is expected to decelerate further to 4.8 per cent in 2008.

43. In the US, real GDP growth had risen to 4.9 per cent in the third quarter of 2007 as compared with 1.1 per cent a year ago. In the fourth quarter, labour markets weakened with the unemployment rate rising to 5.0 per cent in December 2007 and job growth the weakest since August 2003. The home builders' housing market index stayed at a 22-year low for the fourth straight month in January 2008 with mortgage delinquencies rising to the highest level since 1986. Real GDP growth is expected to slow down from the fourth quarter of 2007 onwards as the deepening housing market correction and ongoing financial market turmoil are expected to curb growth more severely, although exports could play a mitigating role. Industrial production declined by one per cent in the fourth quarter and capacity utilisation declined further in December 2007 from the peak reached in August 2007. Durable goods orders were weak reflecting sluggish investment spending. The IMF's October 2007 WEO 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.

44. Real GDP in the euro area grew by 2.7 per cent in the third quarter of 2007 on a year-on-year basis as compared with 2.8 per cent a year ago. Unemployment fell in November 2007 to a record low of 7.2 per cent. In the German economy – the largest in the euro area – however, the business climate has worsened in December after a brief improvement in November and the cyclical dynamics are seen as weakening for the next six months. With rising defaults on consumer loans, the credit crisis appears to be adversely impacting financial conditions in Europe. A more restrictive credit policy by banks is likely to affect

companies with weak credit ratings. 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.

45. The Japanese economy grew by 2.6 per cent in the third quarter of 2007 as compared with 1.4 per cent a year ago. Surveys reveal that the business sentiment of large Japanese manufacturers was worse than expected during the quarter ending December 31, and is forecast to deteriorate further in the coming quarter. The Bank of Japan expects the pace of Japan's economic growth to decelerate due to a big drop in housing investment and the slowdown is likely to persist for some time. Consumer sentiment in Japan has been worsening with higher crude oil prices and the rising prices of daily necessities. 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.

46. In emerging Asia, economic activity has continued to expand at a sustained pace, especially in the largest economies of the region, despite the volatile global setting. The Chinese economy grew by 11.4 per cent in 2007 as compared with 11.1 per cent recorded in 2006, despite policy efforts to curb growth by controlling high-polluting, energy-intensive industries as well as monetary tightening policies, reduction of export rebates and restrictions on processing exports. Inflation accelerated to 6.9 per cent in November 2007 as compared with 1.9 per cent in November 2006. In 2008, the Chinese economy is expected to moderate to a growth of 10.0 per cent as tightening policies take effect. The impact of losses of China's financial institutions and the transmission of financial turmoil to China's markets seems to be limited. Deceleration of export growth reflecting weaker demand from the Organisation for Economic Cooperation and Development (OECD) countries and China's

domestic policies restraining low-end exports could reduce GDP growth.

47. In recent months, the Chinese authorities have cut the rebate on value added taxes (VAT) and have increased export taxes on some products to discourage balance of payment surpluses and reduce funds flow to the stock markets which have reached elevated levels. China ran a record US $ 262.2 billion trade surplus in 2007, despite slowdown in export growth and the negative impact of the US subprime crisis, which is 48.0 per cent higher than in the preceding year, contributing to the overhang of liquidity in the economy. China's foreign exchange reserves reached US $ 1.53 trillion at the end of 2007.

48. Among other major Asian economies, the Korean economy grew by 5.5 per cent in 2007, higher than 5.0 per cent in 2006, led by exports, due to higher sales in emerging markets such as China. Consumer price inflation had accelerated to 3.6 per cent in December 2007 from 3.0 per cent in October 2007. In Thailand, the economy is expected to grow at 4.8 per cent in 2007, driven by robust export growth and expansionary public expenditures that support the economy at the time when private expenditures have been slowing down. In 2008, the Thai economy is forecast to grow in the range of 4.5-6.0 per cent. Inflation decelerated to 3.2 per cent in 2007 from 3.50 per cent in 2006.

49. In the US, consumer prices increased from 2.5 per cent in 2006 to 4.1 per cent in 2007. In the euro area, inflation increased to 3.1 per cent in 2007 from 1.9 per cent a year ago. In Japan, inflation increased to 0.7 per cent in 2007 from 0.3 per cent a year ago. In the UK, CPI inflation declined to 2.1 per cent in 2007 from 3.0 per cent in 2006. At the retail level (in terms of retail prices index or RPI), 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 4.0 per cent in December 2007. Inflation pressures have also raised concerns in some of the emerging market economies (EMEs) such as China, Malaysia, Indonesia and Chile.

50. Core CPI inflation in the US increased to 2.4 per cent in December 2007 from 2.3 per cent in November 2007. In the UK, core CPI inflation has been declining in tandem with the headline rate and stood at 1.4 per cent in December, down from 1.5 per cent in October 2007. In the euro area, core CPI inflation increased to 1.9 per cent in October-December 2007 from 1.8 per cent in September 2007. Core inflation in Japan remained negative (-0.1 per cent) in November-December 2007 as compared with (-0.3 per cent) in October 2007. Overall, the persistence of high food prices, oil prices sustained at elevated levels and continued high prices of other commodities pose significant inflation risks for the global economy and challenges for monetary policy worldwide.

51. Globally, inflationary pressures have re-emerged as a key risk to global growth. In the global foodgrains market, prices of major crops such as corn, soyabeans and wheat have increased by 22.4 per cent, 75.2 per cent and 87.7 per cent, respectively, from a year ago in response to surging demand. The rally has swept up prices of other food items as well. The increase in prices has gained momentum from 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. According to the Food and Agriculture Organisation (FAO), 37 countries are facing food crises due to conflict and disasters. The FAO's global food price index rose 40 per cent in 2007 to the highest level on

record. Food costs in the world's poorest countries – including Iraq, Afghanistan, Nepal, Pakistan, and 20 African countries – rose 25 per cent to US $ 107 billion in 2007.

52. Wheat prices remained generally firm and volatile in October 2007-January 2008 and reached a record high in December 2007 on account of repeated downward revisions of production forecasts in a number of major exporting countries, most notably Australia. World wheat output is now estimated to have risen by only 1.3 per cent in 2007. One month wheat futures at the Chicago Board of Trade (CBOT) rose from US $ 9.53 per bushel on October 1, 2007 to US $ 9.74 on December 19, 2007 before falling to US $ 9.36 on January 25, 2008. Trade is expected to contract because of high and volatile prices, coupled with soaring freight rates.

53. Strong demand for animal feed as well as for ethanol is the main driver in global coarse grain markets but supply tightness in several exporting countries is also providing support to prices. International prices have declined in recent months but they still remain well above the previous season's levels. Trade is expected to increase despite high prices caused by import demand and shortages of feed wheat that have encouraged importers to switch to major coarse grains, especially maize and sorghum. The futures prices of corn on CBOT, which had moderated somewhat up to July 2007, started moving up thereafter and reached US $ 5.12 per bushel on January 14, 2008 before declining to US $ 4.99 on January 25, 2008.

54. According to FAO's All Rice Price Index, international rice prices continued to increase for most of 2007. Rice inventories in the five major exporting countries indicate that world market conditions may remain tight in 2008. The futures prices of rice

on CBOT rose from US $ 11.71 per hundredweight on October 1, 2007 to US $ 14.53 on January 25, 2008. Sugar prices have firmed up in recent months due to a shortfall in supply and expanding investor interest. The futures prices of sugar increased from US cents 9.93 per pound on October 1, 2007 to US cents 12.45 on January 17, 2008 before declining to US cents 11.94 on January 25, 2008.

55. Metal prices have declined by 8.1 per cent during 2007 after increasing by 53.6 per cent in 2006 and 36.3 per cent in 2005. In the futures markets, aluminium, zinc and lead prices are showing a downward trend since October 2007. Copper prices have been buoyed up by the depreciating US dollar and high demand. Futures price of copper on the New York Mercantile Exchange (Nymex) increased to a record level of US $ 3.75 per pound on July 20, 2007 but moderated subsequently to US $ 3.18 on January 25, 2008. Spot gold rose to US $ 923.73 an ounce on January 25, 2008 – the highest since January 1980 – as the dollar fell to a record low against the euro and on concerns about declining supply on mine shutdowns in South Africa.

56. Prices of crude oil have increased by 69 per cent up to January 25, 2008 from a year ago and futures prices have risen to US $ 90.33 per barrel, somewhat lower than the peak of US $ 99.29 on November 21, 2007 – the highest since trading began on the Nymex in 1983. Crude oil prices, which softened to around US $ 53 per barrel in January 2007, have rebounded since July 2007 to close at a record level of US $ 99.6 on January 2, 2008 on account of disturbances in Nigeria before declining to US $ 90.39 on January 25, 2008 over concerns about global growth prospects. According to the Energy Information Administration (EIA), the main drivers of recent oil price movements are fundamentals such as strong world economic

growth, moderate production increase by the OPEC, low spare production capacity, inventory tightness in developed countries, worldwide refining bottlenecks, ongoing geopolitical risks and concerns about supply availability. Continued high demand and low surplus capacity leave the crude oil scenario vulnerable to unexpected supply disruptions through 2008. According to the EIA, the price of West Texas Intermediate (WTI) crude oil is expected to be at US $ 87.21 per barrel in 2008 and US $ 81.67 per barrel in 2009.

57. The turbulence in the international financial markets since July 2007, triggered by massive payment defaults in the US subprime mortgage market, appears to have deepened in subsequent months. Payment defaults were felt worldwide by financial institutions which consequently undertook high write-offs, with some of the largest international banks recording considerable declines in profits. These unusual developments indicated heightened uncertainties and emerging challenges for the conduct of monetary policy, especially for EMEs.

58. Concerns about write-offs and uncertainty surrounding the health of large financial institutions have imparted considerable volatility in the US equity markets. The Dow Jones Industrial Average, Standard and Poor's (S&P) 500 and Nasdaq Composite exhibited considerable volatility and posted declines of 2.4 per cent, 6.4 per cent and 4.4 per cent, respectively, by January 25, 2008 over their levels a year ago. On January 21, 2008 equity markets across the world experienced sharp declines over concerns about the US slowdown. While the Dow Jones Industrial Average declined by about 1.0 per cent on the following day, Asian stocks fell more sharply. Crude oil prices declined to a five-week low on the Nymex. Confronted by the deep panic in global financial markets, the US Federal Reserve lowered its policy rates in the

inter-meeting period by 75 basis points to 3.50 per cent on January 22, 2008. The Fed indicated that it has taken the decision in view of a weakening of the economic outlook and increasing downside risks to growth. While strains in short-term funding markets have eased somewhat, broader financial market conditions have continued to deteriorate and credit has tightened further for some businesses and households. Moreover, incoming information indicates a deepening of the housing contraction as well as some softening in labour markets. On the same day, the Bank of Canada reduced its policy rate. Other major central banks have, however, maintained their rates.

59. 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 3.56 per cent on January 25, 2008. 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 3.97 per cent. The Japanese 10-year bond yield has increased from 1.68 per cent at end-December 2006 to 1.97 per cent on June 13, 2007 before falling to 1.48 per cent. These recent developments are indicative of evolving uncertainties in international financial markets with implications for EMEs.

60. On a trade-weighted basis, the US dollar has been depreciating since 2006 with intermittent fluctuations. After the cuts in the Fed funds rates since September 2007, the US dollar has weakened against other currencies. The pound sterling moved to the level of US $ 1.98 on January 25, 2008 - lower than the 26-year high of US $ 2.11 reached on November 8, 2007 - amidst concerns relating to the US subprime mortgage market. The euro, which has also been strengthening against the US dollar since June 2007, rose to US $ 1.47 on January 25, 2008, *albeit* lower

than the peak of US $ 1.49 reached on November 26, 2007. The Canadian dollar appreciated against the US dollar to a 33-year high to reach US $ 1.09 on November 6, 2007 before declining to US $ 0.99 on January 25, 2008. Turkey experienced a sharp appreciation in its currency *vis-a-vis* the US dollar to reach the level of 86.95 cents on January 10, 2008 before moving to 84.27 cents on January 25, 2008. 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 76.96 cents on January 25, 2008.

61. With the beginning of the turbulence, central banks of advanced economies undertook an increasingly expansive monetary policy course by cutting policy rates (US Federal Reserve) and also supplying financial markets with additional liquidity. On December 12, 2007 the Federal Reserve, the Bank of Canada, the Bank of England, the European Central Bank and the Swiss National Bank (SNB) announced measures to alleviate elevated pressures in short-term funding markets. Actions taken by the Federal Reserve include the establishment of a temporary Term Auction Facility (TAF) against a wide variety of collateral that can be used to secure loans at the discount window, and the establishment of foreign exchange swap lines with the ECB and the SNB which will provide dollars in amounts of up to US $ 20 billion and US $ 4 billion to the ECB and the SNB, respectively, for use in their jurisdictions. Four auctions have been conducted by the US Federal Reserve so far and it may conduct additional auctions in subsequent months, depending in part on evolving market conditions. The other four central banks have also conducted several auctions.

62. During December 2007 and January 2008, the US Federal Reserve injected about US $ 70 billion (up to January 14, 2008)

through three auctions. The ECB provided 648.6 billion euros through four auctions for 5-16 days; the Bank of England injected 11.35 billion pounds through two auctions; the Bank of Canada released 4 billion Canadian dollars through two auctions and the SNB injected US $ 4 billion in one auction. The US Federal Reserve has announced an auction of US $ 30 billion on January 28, 2008. Since the announcement and subsequent auctions, pressures in short-term money markets have eased considerably from their earlier peaks, although spreads have not yet returned to historical levels.

63. Some central banks have cut policy rates during the third and fourth quarters of 2007 after financial markets were significantly affected by turbulence. During September 18, 2007 to January 22, 2008 the US Federal Reserve cut its policy rate by 175 basis points to 3.50 per cent after seventeen increases to 5.25 per cent between June 2004 and June 2006. The Bank of England reduced its repo rate by 25 basis points to 5.50 per cent on December 6, 2007. The Bank of Canada reduced its rate to 4.0 per cent by two 25 basis points reductions on December 4, 2007 and January 22, 2008.

64. Central banks of several countries, including the euro area, New Zealand, Japan, Korea, Malaysia, Thailand and Brazil have not changed their rates in the last quarter of 2007.

65. The central banks that have tightened their policy rates in recent months include the Reserve Bank of Australia (Cash Rate raised by 25 basis points in November 2007 to 6.75 per cent); the People's Bank of China (lending rate raised to 7.47 per cent in December 2007 from 7.29 per cent in September 2007); the Banco Central de Chile (benchmark lending rate raised to 6.25 per cent in January 2008 from 5.75 per cent in October 2007) and Banco de Mexico (policy rate raised by 25 basis points to 7.50 per cent in October 2007).

66. Several central banks that have been confronted with volatile and large capital flows have employed a variety of measures to manage and stabilise these flows with a view to reducing overheating, currency appreciation and the economy's vulnerability to sharp reversals of flows. A common feature among the policies adopted by most of them is monetary tightening involving either hikes in policy rates or hikes in reserve requirements or both. In China, the required reserve ratio was raised from 8 per cent in July 2006 to 15 per cent in January 2008. After a gap of 17 years, 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 in November and December 2006, respectively. Meanwhile, in several EMEs including China and Korea, central bank bonds have continued to absorb liquidity from the banking system.

67. Measures directly aimed at managing capital flows are also in evidence in many EMEs. On December 18, 2006 Thailand imposed unremunerated reserve requirements (URR) of 30 per cent on most capital inflows, requiring them to be deposited with the central bank for one year. These controls have been substantially relaxed since their inception by (a) providing a fully hedged option as an alternative to the reserve requirement, particularly for loans and for investment in fixed income securities and mutual fund units, and (b) waiving the reserve requirement on investments in equity-like securities, namely, warrants and exchange-traded fund units. In addition, regulations on foreign currency deposit and transfer have been relaxed. In May 2007, Colombia introduced a package of measures, including a 40 per cent URR on external borrowing to be held for six months in the central bank. Additionally, a new ceiling on the foreign exchange position of banks, including gross positions in derivative markets, was stipulated to limit circumvention of the URR and banks'

exposure to counterparty risk. The PBC raised the amount of foreign currencies that lenders must keep as reserves to 5 per cent from 4 per cent of their foreign-currency deposits from May 15, 2007. The Bank of Korea is investigating large volume trading of currency forward contracts by exporters and financial companies to limit gains in the won, which appreciated to a 10-year high in 2007. Brazil's central bank has bought up substantial amount of inflows from the spot market to add to reserves and also conducted sizeable operations in the forward markets.

Overall Assessment

68. Real GDP originating in agriculture and allied activities has accelerated in the first half of 2007-08 in comparison with April-September 2006. Advance estimates of kharif output have been placed somewhat higher than a year ago, which augurs well for the prospects of growth in agriculture in the third and also the fourth quarters of 2007-08. The outlook on rabi output is somewhat mixed and unclear at this juncture. While there has been some initial slack in rabi sowing, a catch-up appears to be underway. In the face of shortfalls in the spread and intensity of North-East monsoon rainfall, reasonable levels of water storage in major reservoirs across the country provide some cushion against inclement weather conditions. These developments seem to confirm the positive outlook for agriculture envisioned in the Annual Policy Statement of April 2007 and in subsequent Reviews. By current indications, growth in agriculture in 2007-08 is poised to return to trend.

69. Industrial activity appears to have moderated in the third quarter of 2007-08 with manufacturing and electricity generation impacted by 'high base' effects. A positive aspect of industrial performance is the continuing capacity expansion that is driving

growth in manufacturing, supported by electricity generation and mining activity. Industries such as chemicals and chemical products, wood and wood products, jute textiles, leather and leather products and food products recorded acceleration in April-November, 2007, contributing about 30 per cent of the growth of overall industrial production. Industries such as basic metals and alloys, machinery and equipment, transport equipment and parts which together contributed over 30 per cent of industrial production are set to catch up although, on a cumulative basis, their growth rates appear somewhat moderated in relation to a year ago. There are downside risks emanating from high international crude prices, rising input costs and the uncertain global environment wherein the possibility of some slowdown in economic activity and, consequently, in export demand seems to be gaining ground. Under the circumstances and recognising that the high base effects may be reflected in the relevant indices, moderation in the rate of industrial growth over the remaining part of 2007-08 needs to be reckoned. On balance, assuming that there are no exogenous shocks, either global or domestic, the prospects for the industrial sector over the rest of 2007-08 remain reasonably positive at this juncture.

70. In the services sector, all constituent sub-sectors except community, social and personal services have recorded double-digit growth in the first half of 2007-08. The outlook for the services sector has improved with lead indicators such as the growth in railway revenue earning freight traffic, sales of passenger and commercial vehicles, cargo handled at major ports, telephone connections, tourist arrivals and civil aviation traffic indicating a pick-up in the pace of growth of transport and communication services in coming months. Headline indicators also suggest continuing high growth in financial and business services while construction activity is expected to continue to expand strongly

on the back of investment demand. On the other hand, activity relating to trade, hotels and restaurants and community, social and personal services has recorded some slackening in the second quarter of 2007-08. On balance, therefore, the prospects for services continue to be favourable at this juncture; however, uncertainties surrounding the evolution of global developments cloud the outlook as noted in the Mid-Term Review of October 2007.

71. Key indicators point to the persistence of aggregate demand pressures, including into the near-term. First, the disposition of GDP by expenditure in the first half of 2007-08 indicates that there has been a distinct step-up in fixed capital formation as a proportion to GDP at constant market prices. On the other hand, private final consumption expenditure has moderated. The strength of investment demand is also reflected in the growth of capital goods production - at its highest for April-November since 1993-94 - the continuing high growth in imports of capital goods and the increase in intermediate goods production - highest for April-November since 1995-96. The sustained pace of construction activity is also reflective of the driving force of investment demand. Furthermore, resources raised through public issues have increased sizeably. Second, since the time of the Mid-Term Review, both reserve money and money supply have accelerated, reflecting the significant expansionary effects of large capital inflows embodied in the Reserve Bank's foreign currency assets (adjusted for revaluation) being 289 per cent higher than the increase in the corresponding period of the previous year. Non-food credit, which had been slowing down in the first half of 2007-08, appears to have picked up, which may restrain any slowdown in aggregate deposit growth that has been running well above indicative projections throughout 2007-08 so far. Third, with non-oil imports recording a sharp acceleration in growth in October and November, the merchandise trade deficit

has expanded in spite of the pace of export growth, pointing to the pressure from domestic demand. Fourth, inflation in terms of wholesale prices, has started to rise since December after a prolonged trough beginning in mid-July 2007. With the wholesale prices of key food articles firming up in recent weeks along with prices of some manufactures, further softening of inflation in terms of consumer prices may not accrue, going forward. Fifth, the incomplete pass-through of the indeterminate permanent component of the increase in international oil prices is indicative of potential upward pressure on inflation. Finally, escalated and volatile levels of equity, gold and real estate prices are visibly reflecting the strain imposed by aggregate demand conditions.

72. Headline WPI inflation has been edging up moderately since early December 2007, coming out of the mid-October-end-November trough that started to form in mid-July. The upturn is largely attributable to the onset of base effects that could prevail up to mid-February 2008. The main contributors to the recent rise in headline inflation are milk, rice, raw cotton and oilseeds in the primary articles category, non-administered petroleum products in the fuel group and edible oil, oilcakes, iron and steel, cement, drugs and medicines and electrical machinery in the category of manufactured products which together accounted for nearly 100 per cent of WPI inflation. Consumer prices continue to rule at elevated levels, despite some softening in the third quarter of 2007-08.

73. It is important to note that indications are getting stronger of upside inflationary risks in the period ahead. First, exclusion-based measures, *i.e.*, WPI excluding food and energy, place inflation higher than the headline, indicative of the underlying aggregate demand pressures. Second, disaggregated analysis suggests that the favourable effects of the cuts in petrol/diesel prices in 2006-07,

which facilitated benign inflation conditions over the greater part of 2007-08, have ceased since December 2007. Prices of non-administered petroleum products (naphtha, furnace oil, aviation fuel and the like) have increased in the range of 28-37 per cent. Accordingly, fuel prices, even if unchanged, are set to drive up headline inflation going forward, in contrast to their dampening role hitherto. In view of the new highs to which international crude prices have recently been lifted, the threats to domestic price stability have risen and turned extremely volatile, representing a serious risk to inflation expectations. It is difficult to differentiate, *ex ante*, the permanent and temporary components of the elevated international crude prices but, in any case, at current levels, it is necessary to recognise the need for some more pass-through from international crude prices and implications for domestic inflation conditions.

74. The softening of inflation in terms of manufactures through the year and primary food articles since mid-July 2007 is increasingly becoming vulnerable to the adverse global developments in the period ahead. International foodgrain prices, which have escalated to historic peaks, are poised to enter a prolonged period of hardening, with demand projected to run well ahead of supply and historically low stocks, exacerbated by bio-fuel diversion. The weighted average price paid on wheat import tenders during June-November 2007 were significantly higher than a year ago. In the primary non-food category, the upside inflation risks emanating from the oilseeds/edible oil group have increased substantially, both domestically and globally. The outlook on international metal prices remains uncertain with demand pressures from Asia continuing to be sustained by robust growth in the region.

75. While CPI inflation has moderated by about 200 basis points between August and November due to the easing of food

price inflation, this could be a short-lived phenomenon in view of the uncertainty surrounding rabi output and the deteriorating international environment. Furthermore, domestic monetary and liquidity conditions continue to be more expansionary than before and are likely to be amplified by global factors, particularly, the recent massive injections of liquidity by major central banks to activate frozen money markets. It is also necessary to recognise that despite the turmoil in international financial markets, asset prices continue to rule at escalated levels, fuelled by the abundance of liquidity.

76. A sizeable swing in liquidity was experienced towards the middle of the third quarter of 2007-08. With the 50 basis point increase in the CRR announced in the Mid-Term Review becoming effective from November 10, 2007 and aided by festival demand for cash, a build-up of the Government's cash balances and advance tax outflows, the large daily LAF reverse repo absorptions that characterised August-October 2007, ceased. Daily injections through the LAF repos commenced through November 2007-December 2007 with brief interruptions and reversion to the absorption mode in the last week of December 2007 and early January 2008. Liquidity injections reached a peak on December 26, 2007. The Central Government's cash balances exhibited a generally unidirectional upward movement, rising to a peak on December 22, 2007 coincident with advance tax payments, and further constricted liquidity although in the following weeks these balances have been drawn down, augmenting market liquidity. In view of the liquidity conditions, maturing securities under the MSS were allowed to be redeemed during November 23, 2007 to January 11, 2008. Notwithstanding these contrasting movements in components, there was a large increase in the total overhang of liquidity (LAF, MSS and Government cash balances taken

together) over the third quarter of 2007-08, reflecting the sizeable expansion in primary liquidity generated by the large accretions to the Reserve Bank's net foreign assets. The banking system generally remained in surplus mode with large investments in mutual funds and a moderate increase in excess SLR holdings in comparison to a year ago.

77. Overnight money market rates, which were hovering around the LAF reverse repo rate till November 11, 2007 rose thereafter to rule around the repo rate up to end-December, before easing again to reverse repo rate levels in January 2008 with the resumption of surplus liquidity conditions, barring some spikes in the second half of the month. A notable feature is the muted impact of mid-December advance tax outflows on money markets indicative of the success 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 cuts in the US Federal Funds target rate over September 2007-January 22, 2008. In the Government securities market, orderly conditions have prevailed through the quarter with yields declining across all maturities.

78. There has been some improvement in the finances of the Central Government during April-November 2007. On the revenue account, there has been a strong growth in non-tax revenues in the form of interest receipts which has supported the underlying buoyancy of tax revenues. Some moderation in the growth of revenue expenditures has been enabled by a slower growth of non-Plan spending. Accordingly, there has been a decline in the revenue deficit in absolute terms on a year-on-year basis. Higher interest receipts have also enabled a gross primary surplus in contrast to a deficit in the corresponding period of the previous

year. Higher allocations to States and Union Territories, transport and highways, rural development and health were the principal forces driving up Plan expenditure. While capital expenditure (net of transactions related to the transfer of the Reserve Bank's stake in the SBI) was moderately higher than a year ago, it has remained lower as a proportion to budget estimates, and the expansion in capital outlay remains modest. The gross fiscal deficit has declined in absolute terms as well as in terms of its proportion to the budget estimates, indicating that adherence to the Fiscal Responsibility and Budget Management (FRBM) rules in the current financial year is on track.

79. There are indications of some changes underway in India's external sector developments which carry implications for the period ahead. First, there has been a widening of the trade deficit in the first half of 2007-08 on account of the sustained demand for non-oil imports - particularly for capital goods, export-related inputs and bullion - notwithstanding the moderation in the quantity of PoL imports. Second, the sources of growth driving invisible receipts appear to be changing. While there was some deceleration in exports of software and business services in the first half of 2007-08, remittances from Indians working overseas and investment income receipts associated with the deployment of foreign exchange reserves have increased sharply, more than compensating for the slack in software export growth and enabling a higher invisible surplus than a year ago. Accordingly, the current account deficit during April-September 2007 remained broadly at the same level as a year ago as a proportion to GDP. Third, net capital flows have risen nearly three-fold and all categories, barring non-resident deposits, have recorded sizeable increases. Net FDI inflows have accelerated, preferring manufacturing, business and computer services. Outward FDI has more than doubled, reflecting the growing global reach of the

Indian corporate sector. Net inflows on account of external commercial borrowings and short–term trade credits have also gone up sizeably. Fourth, while the accretion to reserves during the current financial year has been unprecedented by historical standards, from the national balance sheet perspective, India's international liabilities at US $ 322 billion at book value at end-June 2007 were substantially in excess of the foreign exchange reserves and this gap has widened at end-December 2007 with net capital flows set to exceed the level of 5 per cent of GDP recorded in 2006-07.

80. Developments in global financial markets since the Mid-Term Review of October 2007 present several issues that need to be monitored carefully in the context of the implications for EMEs. First, alongside inter-bank term interest rates, corporate credit spreads and those on mortgage-backed securities have widened since early October as concerns relating to the possibility of prolonged disruption to credit intermediation have deepened. In the credit markets, investors are increasingly demanding risk premia for product complexity and exposure to asset-backed commercial papers (ABCPs) and structured investment vehicles (SIVs). Second, the impact of the recent financial market turmoil has been sizeable on banks, particularly internationally active banks from both sides of the Atlantic. Several large banks have already recognised substantial losses on holdings of collaterailised debt obligations (CDOs), mortgage-backed leveraged products and the picture continues to unfold. Market perceptions of increasing systemic risk in the banking system are being reflected in declines in bank share prices, a sharp increase in spreads on credit default swap (CDS) and growing concerns relating to off-balance sheet positions. Third, as pointed out in the Mid-Term Review, the responses of

central banks to recent events have demonstrated that ensuring financial stability can, under certain circumstances, assume overriding importance relative to other more explicitly pursued goals.

81. Global macroeconomic prospects in the near-to-medium term are expected to be influenced by the rebalancing that has been underway over the last few years towards Europe, Japan and the EMEs. In this context, the role of EMEs in supporting the global economy and in cushioning global downturns is conditioned by the environment for decoupling from the US. It is important to recognise that the extent of decoupling will depend on the impact of developments in the financial sector in general and real sector developments in the US economy in particular. First, in the near-term, EMEs face risks from tightening of credit standards in advanced economies. Second, dependence on imports and higher energy intensity of output may make EMEs more exposed to inflation shocks. Third, international financial markets respond differently to the same macroeconomic or political development depending on whether it is an EME or an advanced economy. Hence, EMEs have to follow a more pragmatic and contextual policy. Fourth, the self-correcting mechanisms in financial markets happen to operate more efficiently in advanced economies and far less efficiently in the EMEs, particularly during highly uncertain global economic conditions. Hence, the extent of or lack of self-correcting mechanisms in an economy should be treated as given, in the short–term, and a suitable policy of intervention has to be pursued accordingly. Fifth, real sector flexibilities may be far less in EMEs. Hence, the real sector responses to exchange rate movements are not likely to be as flexible as in the advanced economies. Sixth, the distinction between flexibility and volatility in the context

of financial markets in EMEs has to be based on the preparedness of the markets and the market participants. It is in this context that the decoupling of EMEs from the US remains to be tested.

82. There are indications of significant changes in the global macroeconomic and financial environment in the fourth quarter of 2007 that could have a bearing on the outlook for growth and inflation. Financing conditions in a number of major economies have tightened. There are also growing concerns relating to the vulnerability of the banking system to potential losses, the true magnitude of which is still unknown, and the associated systemic risks. Conditions in the US housing sector have worsened. A sharp depreciation in the US dollar and soaring crude prices are other factors that have produced shifts in the balance of risks to the global economy. In recent months, forward-looking indicators, including global purchasing managers' indices and consumer and business confidence, have deteriorated in major industrial economies. Consensus forecasts so far indicate a slowing of the global economy in 2007 and 2008 with risks currently seen as weighed to the downside. So far, spillovers from the credit markets to the real economy have been small, except for some retrenchment in consumer spending. There are, however, risks of exogenous shocks such as a disruptive decline in the US dollar. Forecasts for other advanced economies have been pared and the US subprime crisis, food and crude prices pose the gravest risks.

83. Headline inflation has trended up in the US, the euro area, Japan and China in November 2007. The recent sharp rise in commodity prices has added uncertainty to global inflation prospects. Food prices are pushing up inflation in many EMEs

and are expected to remain high over the medium-term. Higher oil prices pose the risk of aggravating inflation risks directly as well as through the demand for oil substitutes which, in turn, contributes to the rise in food prices. Wage pressures in the context of strong labour market conditions are posing inflation risks in advanced and emerging economies across the world, in conjunction with higher input costs. Overall, inflationary pressures have firmed up with implications for the outlook for 2008.

84. In the overall assessment, the domestic outlook remains positive with continued favourable prospects of sustaining the growth momentum in an environment of price and financial stability. There are some indications of moderation in industrial production, corporate sales and profitability, business confidence and non-food credit. Domestic activity continues to be investment driven, supported by external demand. Building up of supply capacities, both new and existing, is strongly underway as reflected in the sustained demand for domestic and imported capital goods. Monetary and financial conditions as well as asset prices are reflecting these expansionary impulses. The external sector developments are dominated by the extraordinarily large capital flows, to a considerable extent reflecting sustained international investor confidence in India. In contrast to domestic prospects, the outlook for the global economy has worsened somewhat from the time of the Mid-Term Review with risks to both growth and inflation having accentuated. While the dangers of global recession are relatively subdued at the current juncture and consensus expectations seem to support a soft landing, the upside pressures on inflation have become more potent and real than before. Food and energy prices are set to impart a permanent upward shock to inflation globally and, in particular, in EMEs. The future evolution of the subprime mortgage crisis carries by far the gravest risks for the world economy. For EMEs

in particular, the probability attached to tail risks has, in fact, increased over recent months as information is getting revealed on the extent of contaminated financial assets and the extent of contagion. Several EMEs are likely to face the dilemma of responding to slackening of growth induced by global developments even as inflationary pressures remain firm. Furthermore, the overarching objective of ensuring financial stability would pose a testing challenge for the conduct of monetary policy in the period ahead.

II. Stance of Monetary Policy

85. The Mid-Term Review noted that 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, particularly in view of the limited room for manoeuvre for fiscal policy. On the domestic front, it was indicated that risks to inflation and inflation expectations would continue to demand priority in policy monitoring, with the biggest challenge being the management of capital flows and the attendant implications for liquidity and overall stability, especially in the context of the rapid escalation in asset prices driven by capital flows. Threats to inflation were also seen as emanating from global factors – injection of liquidity by central banks; the high and volatile levels of international commodity prices; and the sharp increase in inflation in China.

86. Against this backdrop, the Mid-Term Review persisted with the stance set out in the Annual Policy Statement for 2007-08 and the First Quarter Review 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. While reiterating 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, the Mid-Term Review resolved to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusually heightened global uncertainties, and the unconventional policy responses to the developments in financial markets.

87. The unfolding of global developments in recent weeks and the responses of monetary authorities provide an indication of the threat to growth and financial stability worldwide, bearing out the Reserve Bank's stance of enhanced vigilance to be able to respond appropriately to global financial and monetary conditions. In addition, risks to inflation from high and volatile international prices of fuel, food and metal prices appear to have intensified. Consumer price inflation has hardened in a number of countries, complicating the task of monetary authorities in assuaging liquidity and solvency stress in financial markets and institutions. Domestically, managing the expansionary effects of large capital inflows on liquidity, monetary aggregates and asset prices has posed a testing challenge for the conduct of monetary policy. With the 50 basis point increase in the CRR announced in the Mid-Term Review coming into effect from November 10, 2007 the strategy of active liquidity management with a combination of measures has been successful in managing overall liquidity conditions consistent with the policy stance. Overnight interest

rates rose to the upper reaches of the LAF corridor in an orderly manner up to December 2007, followed by some intermittent softening in January 2008 as surplus liquidity conditions resumed. Nevertheless, financial markets continue to warrant careful and continuous monitoring with a readiness to respond flexibly and pre-emptively to ensure orderly liquidity conditions, particularly in the context of the management of volatile and large movements in capital flows.

88. On balance, the prospects for the domestic economy over the remaining part of 2007-08 are consistent with policy expectations. First, there has been a modest deceleration in output growth in the second and third quarters. Second, aggregate supply conditions have continued to expand in all constituent sectors and the ongoing investment boom should entrench the improvement in supply elasticities, going forward. Third, corporate profitability and business confidence continue to be sustained by the underlying macroeconomic fundamentals, positive sentiment in financial markets and resilient export demand, especially in view of the global economic and financial environment. Fourth, inflation has so far been within tolerance thresholds at the wholesale level. Fifth, prudential and profitability indicators suggest that banks' balance sheets have become stronger and sounder than before. Sixth, domestic financial markets have been orderly and insulated so far from the turmoil in global markets on account of the subprime crisis though there has been unusual volatility in equity markets that is to some extent influenced by global developments. Seventh, in the external sector, the current account deficit remains well within sustainable limits, with net invisible surpluses offsetting the merchandise trade deficit to a considerable degree. Accordingly, the build-up in the foreign exchange reserves during the current financial year has been historically unprecedented. On the other

hand, the expansion of monetary and liquidity conditions as well as asset prices contain risks of upward inflationary pressures for the Indian economy, alongside international price pressures particularly on account of oil and food prices. Most importantly, in the period ahead, developments in global financial markets in the context of the subprime crisis would warrant more intensified monitoring and swift responses with all available instruments to preserve and maintain macroeconomic and financial stability.

89. Real GDP originating in agriculture and allied activities has recorded above-trend growth in the first half of 2007-08 with *kharif* foodgrains production placed higher than in the preceding year. More information will be necessary to make a full and realistic assessment of *rabi* production, including the extent to which reservoir storage will have a mitigating effect on shortfalls in the winter North-East monsoon. On the other hand, industrial activity appears to be experiencing some transient and cyclical effects affecting manufacturing performance. With the momentum of growth in the services sector expected to be sustained, drawing from leading indicators, the projection of overall real GDP growth in 2007-08 is maintained at around 8.5 per cent for policy purposes, assuming no further escalation in international crude prices and barring domestic or external shocks.

90. Headline inflation has picked up since the beginning of December 2007 with attendant implications at the retail/consumer level. While this is largely attributable to base effects that may extend up to February 2008, escalated and volatile international crude prices and the heightened levels of food prices pose clear and present risks to the inflation outlook at the current juncture, especially if and when some pass-through to domestic petroleum product prices becomes inevitable. In the overall assessment, in view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming ongoing improvement in supply

management, 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.

91. The rate of money supply has picked up since the Mid-Term Review of October 2007, coincident with a jump in the growth of reserve money over this period, driven by the accretion to the Reserve Bank's foreign exchange assets. This has been reflected in the acceleration in the growth of banks' aggregate deposits driven by cyclical factors in the upturn. Over the greater part of 2007-08, deposit growth has been running ahead of the projection of Rs.4,90,000 crore for 2007-08 as a whole, mainly driven by aggressive rate setting behaviour of banks. Non-food credit (inclusive of non-SLR investments), although below the projected growth of 24.0-25.0 per cent given in the Annual Policy Statement, has been picking up since mid-August 2007. Moderating money supply in alignment with the indicative projections of 17.0-17.5 per cent set out in the Annual Policy Statement of April 2007 may warrant appropriate responses, given the considerations for ensuring macroeconomic and financial stability going forward.

92. At the current juncture, global uncertainties have increased considerably in the context of the downside risks to growth and financial stability. Global financial markets continue to experience unusual volatility, strained liquidity and credit conditions as well as heightened risk aversion. While these pressures have been sought to be addressed through coordinated actions by several

leading central banks, the impact and outcomes of these recent actions of monetary authorities still appear unclear for the near-term outlook for financial markets and for the longer term on the real economy in terms of growth and stability. Some major central banks have engaged in lowering policy rates – sizeably in January 2008 even by historical standards – in view of the weakening economic outlook and the continuing deterioration in broader financial market conditions, in spite of the judgement that it will be necessary to monitor inflation developments carefully.

93. Recent global events were not entirely unanticipated, as already articulated in previous monetary policy statements, but the intensity appears to be severe and the duration uncertain. It appears that a process of reordering of global economic balances is underway and hence, the process is likely to continue to be complex with significant implications for trade flows, financial flows, asset prices and balance sheets. In terms of the impact of such a process on India, our external trade is, relative to many other EMEs, well diversified. Similarly, on a systemic basis, most parts of the balance sheets of both the public sector and the private sector are relatively less exposed to foreign currencies. However, more recently, several large corporates have expanded their foreign currency exposures which have to be managed carefully. The major source of impact is through the financial flows, in particular, in the equity markets and, consequently, on the foreign exchange market in India. The second order effects on account of financial contagion or real sector developments are somewhat indeterminate at this stage.

94. In view of the risks associated with international financial developments impacting balance sheets of corporates with sizeable external liabilities, banks are urged to review large foreign currency exposures and to put in place a system for monitoring such unhedged exposures on a regular basis so as

to minimise risks of instability in the financial system under the current highly uncertain conditions. Internal limits as deemed appropriate may be made applicable for foreign currency loans on the basis of a well laid out policy approved by banks' boards. Banks are also urged to carefully monitor corporate activity in terms of treasury/trading activity and sources of other income to the extent that embedded credit/market risks pose potential impairment to the quality of banks' assets.

95. In the context of a more open capital account and the size of inflows currently, public policy preference for a hierarchy of capital flows with a priority for more stable components could necessitate a more holistic approach, combining sectoral regulations with broader measures to enhance the quality of flows and make the source of flows transparent. In this context, it is critical for public policy to effectively, demonstrably and convincingly indicate commitment to managing capital flows consistent with macro fundamentals through appropriate and decisive policy actions.

96. While the focus has generally been on managing the excess capital inflows and volatility in regard to the excess, it is essential not to exclude the possibility of some change in course, due to any abrupt changes in sentiments or global liquidity conditions, despite strong underlying fundamentals of the Indian economy. Events in the second and third week of January 2008 indicate a potential for reversal in capital flows, though it is not yet clear how transient such events will turn out to be. Strategic management of the capital account would warrant preparedness for all situations, and the challenges for managing the capital account in such an unexpected turn of events may be quite different.

97. The setting of monetary policy in India has been rendered complex in the light of these developments. On the one hand,

the underlying fundamentals of the economy remain strong and resilient and the outlook continues to be positive. At the same time, while there is no visible or immediate threat to financial stability in India from global developments, the need for continued but heightened vigilance has increased with an emphasis on readiness to take timely, prompt and appropriate measures to mitigate the risks to the extent possible. As noted in the Mid-Term Review, the immediate task for public policy in India is to manage the possible financial contagion that seems to have highly uncertain prospects of being resolved soon. Accordingly, monetary policy has to be vigilant and proactive in cushioning the real economy from excess volatility in financial markets while recognising that India cannot be totally immune to global developments.

98. The developments in the domestic economy are broadly in line with the policy expectations and in the normal course would not warrant any significant monetary policy initiatives at this juncture. However, moderation in the growth of the industrial sector may need further exploring to assess whether some of the segments are reflecting correction of the excesses in the previous years or whether there are sector-specific factors which require attention. While growth in investment demand is likely to ease the supply constraints in future by adding to capacities, the moderation in private consumption expenditure warrants consideration. Such a disaggregated analysis of supply and demand factors across select sectors would enable appropriate public policy responses keeping in view the employment intensity of some of these sectors. Monetary policy, *per se*, can essentially address issues relating to aggregate demand but the associated policies in the financial sector could, to the extent possible, take account of the evolving circumstances as reflected in the disaggregated analysis. In view of the prevailing liquidity conditions and the sustained profitability of banks as reflected in

net interest margins, there is a need for banks to undertake institutional and procedural changes for enhancing credit delivery to sectors that are employment-intensive.

99. Over the period ahead, liquidity management will continue to assume priority in the conduct of monetary policy. Liquidity conditions are being shaped by several underlying factors which appear to exert conflicting pulls and pose challenges for designing the appropriate policy response. First, money supply has been expanding well above indicative projections in 2007-08 driven up by high deposit growth despite successive increases in the CRR with no remuneration. Expansionary liquidity conditions engendered by capital flows, have not, however, prompted banks to reduce deposit/lending rates which have been broadly maintained at the elevated levels of the preceding year. Consequently, effective interest rates on time deposits at the margin are currently ruling above the LAF repo rate. Apparently, there have been little or no adverse effects on banks' net interest margins and profitability has remained high, boosted by operating income. Notwithstanding the surplus liquidity conditions, bank credit growth has moderated. Despite comfortable liquidity conditions, banks have not expanded credit proportionately; instead, banks have preferred to make excess investments in SLR securities including MSS issuances, money market mutual funds and the LAF reverse repo, despite earning apparently lower interest rates thereon. Furthermore, reflecting the continuing uncertainty in global financial markets, significant volatility has also been observed in the Indian capital markets with the associated impact on liquidity. These developments have implications for liquidity management going forward and warrant appropriate and timely action.

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. For the purpose of formulating the stance of monetary policy, domestic factors, which are better balanced, stable and remain positive, dominate while global factors are reckoned to be increasingly relevant. 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 growth and 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 conducive to continuation of the growth momentum and orderly conditions in financial markets.

- To emphasise credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

- To monitor the evolving heightened global uncertainties and domestic situation impinging on inflation expectations, financial stability and growth momentum in order to respond swiftly with both conventional and unconventional measures, as appropriate.

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 7.5 per cent. On a review of the current liquidity situation, it is considered desirable to keep the present level of the CRR at 7.5 per cent unchanged.

108. The Annual Policy Statement for the year 2008-09 will be announced on April 29, 2008.

Mumbai
January 29, 2008