Annual Policy Statement for the Year 2008-09 by Dr. Y. Venugopal Reddy, Governor, Reserve Bank of India

This Statement consists of two parts: Part I. Annual Statement on Monetary Policy for the Year 2008-09; and Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2008-09. An analytical review of macroeconomic and monetary developments was issued a day in advance as a supplement to Part I of this Statement, providing the necessary information and technical analysis with the help of charts and tables.

2. The Annual Statement on Monetary Policy will be reviewed on a quarterly basis during 2008-09, whereas the Annual Statement on Developmental and Regulatory Policies will be reviewed along with the Mid-Term Review of Monetary Policy, in continuation of the changes in the institutional framework of policy formulation that were initiated in 2005-06. Accordingly, the dates for the First Quarter Review and the Mid-term Review are July 29, 2008 and October 24, 2008, respectively.

Part I. Annual Statement on Monetary Policy for the Year 2008-09

3. The Annual Statement on Monetary Policy for the Year 2008-09 consists of three Sections: I. Review of Macroeconomic and Monetary Developments during 2007-08; II. Stance of Monetary Policy for 2008-09; and III. Monetary Measures.

I. Review of Macroeconomic and Monetary Developments during 2007-08

Domestic Developments

4. The growth of real gross domestic product (GDP) in 2007-08 was placed at 8.7 per cent by the Central Statistical Organisation (CSO) in its advance estimates released in February 2008. Economic activity in 2007-08 has evolved in consonance with policy expectations set out in April 2007, *albeit* with some moderation as compared with 9.6 per cent in 2006-07. In retrospect, the slackening of momentum in 2007-08 appears to have set in as anticipated and moved gradually over the four quarters. Real GDP growth was 9.3 per cent,

8.9 per cent, 8.4 per cent and 8.4 per cent, respectively, in the four quarters of 2007-08 as against 9.6 per cent, 10.1 per cent, 9.1 per cent and 9.7 per cent in the corresponding quarters of 2006-07.

5. Real GDP originating in agriculture and allied activities is estimated to have risen by 2.6 per cent in 2007-08, lower than 3.8 per cent in the previous year. According to the third advance estimates of agricultural production released by the Ministry of Agriculture in April 2008, total foodgrains production is expected to increase to an all-time high of 227.3 million tonnes in 2007-08 from 217.3 million tonnes in 2006-07. *Kharif* foodgrains production is expected to have risen by 8.6 per cent, whereas *rabi* foodgrains production is expected to increase by 0.5 per cent. Output is estimated to have risen in the case of rice (2.5 per cent), wheat (1.3 per cent), coarse cereals (17.0 per cent) and pulses (7.0 per cent). Among the commercial crops, production is estimated to have increased under cotton (2.5 per cent), oilseeds (16.1 per cent) and jute (2.3 per cent) whereas the production of sugarcane declined by 3.2 per cent.

6. Real GDP originating in industry rose by 8.6 per cent in 2007-08 as compared with 10.6 per cent in the previous year. The index of industrial production (IIP) recorded an increase of 8.7 per cent during April-February 2007-08 *vis-à-vis* 11.2 per cent a year ago. In manufacturing, which contributed 89 per cent of the increase in industrial production, the growth of output was lower at 9.1 per cent than 12.2 per cent a year ago. Growth in mining at 5.1 per cent was comparable with 5.0 per cent a year ago, while growth in electricity generation moderated to 6.6 per cent as compared with 7.2 per cent. Production of beverages, tobacco and related products, wood and wood products, leather and leather products, basic chemicals and products and basic metals and alloys recorded double-digit growth in 2007-08 (up to February 2008). The industry groups that registered deceleration of growth include textiles, paper and paper products, non-metallic mineral products and transport equipments and parts. On the other hand, the production of metal products and parts except machinery and equipments recorded a decline.

7. In terms of the use-based classification of industries, the production of capital goods continued to expand at a sustained pace, increasing by 17.5 per cent during April-February 2007-08, over and above the increase of 18.3 per cent a year ago. The basic, intermediate and consumer non-durable goods segments recorded lower growth of 7.4 per cent, 9.2 per cent and 8.9 per cent, respectively, as compared with 10.1 per cent, 11.7 per cent and

9.5 per cent a year ago. Production of consumer durables declined by 1.0 per cent as against an increase of 9.7 per cent a year ago. The output of the six key infrastructure industries (with a weight of 26.7 per cent in the IIP) also registered a lower growth of 5.6 per cent during April-February 2007-08 as against 8.7 per cent in the corresponding period of the previous year.

8. Corporate activity experienced some moderation in growth relative to the recent past but continued to remain healthy during 2007-08. During April-December 2007, growth in sales of surveyed non-financial private companies decelerated to 17.4 per cent from 29.1 per cent in the corresponding period of the preceding year. Net profits growth was also lower at 29.8 per cent from 46.6 per cent a year ago due to a combination of several factors including escalation in input costs and compensation to employees. Corporates' interest burden continues to be low with the interest payment to gross profits ratio estimated at 11.8 per cent, 12.8 per cent and 15.3 per cent in the first three quarters of 2007-08 as against 18.1 per cent and 13.4 per cent in 2005-06 and 2006-07, respectively, and an average of 43.7 per cent in 2000-05. The differential between sales and expenditure growth shrank to 20 basis points from 280 basis points in April-December 2006, reflecting pressure on profits at the operating level, somewhat mitigated by strong support from income from non-core activities which rose by 75.5 per cent in April-December 2007 as compared with 20.9 per cent a year ago. Early results for the fourth quarter of 2007-08 indicate that growth in sales and net profits are lower than in the corresponding quarter a year ago. There was also a larger increase in expenditure on both raw materials and compensation to employees for the selected companies. Consequently, the difference between sales growth and the overall expenditure growth narrowed, resulting in lower profitability both in gross and net terms.

9. The Reserve Bank's Industrial Outlook Survey conducted during February 2008 indicates a mixed picture in the business sentiment. With a pickup in demand conditions (including exports), the assessment for January-March 2007-08 shows an improvement over the expectation for the quarter in the previous round of the survey. The business expectations index for April-June 2008 at 123.2 has moved up from 118.6 recorded in the previous quarter, against the seasonal decline, but is still lower than its level at 127.5 in the corresponding quarter of the previous year. Production, order book positions and capacity utilisation growth are expected to pick up in relation to the previous quarter and increasing number of respondent firms expect employment levels to go up. Price pressures

are seen as rising mainly on the back of higher raw material costs. About 27 per cent of respondent firms expect to pass on the price increase to customers in April-June 2008 as compared with 23 per cent in the corresponding quarter of the previous year. While imports and exports are expected to pick up in April-June 2008 as compared with the previous quarter, the growth in exports would be lower than in the corresponding quarter of 2007-08. With nearly one in every four respondents perceiving higher profit margins and more than 60 per cent expecting *status quo,* the optimism on profit margins for April-June 2008 has improved in relation to January-March 2008, although it is still lower than in April-June 2007.

10. Business confidence surveys conducted by other agencies convey a somewhat tempered though overall positive outlook. One survey's Business Optimism Index indicates a sharp decline in the first quarter of 2008-09 with respect to the previous quarter and a much sharper fall when compared to April-June 2007, attributable to less optimistic sentiment in the services and capital goods sectors. According to another survey, however, the overall economic conditions for the next six months are seen to be positive, with production closely following expectations of growth in domestic sales and a clear upturn in import growth. Seasonally adjusted purchasing managers' indices reflect lower business sentiment for January-March 2008 with some ebbing in relation to the previous quarter but still higher than a year ago. All the surveys indicate sustained though somewhat slower growth of manufacturing with firms trying to protect their profit margins through improvement in productivity and by passing on cost increases into selling prices. Investment sentiment remains positive on expectations of improvement in the financial position, order books and capacity utilisation.

11. Real GDP originating in the services sector rose by 10.6 per cent during 2007-08 as compared with 11.2 per cent a year ago. Activity in construction and financing, insurance, real estate and business services sector expanded by 9.6 per cent and 11.7 per cent, respectively, as compared with 12.0 per cent and 13.9 per cent in 2006-07. The growth of trade, hotels and restaurants, transport, storage and communication was 12.1 per cent in 2007-08, marginally higher than 11.8 per cent in 2006-07. Growth in community, social and personal services at 7.0 per cent was comparable to 6.9 per cent in the previous year.

12. Aggregate demand conditions in 2007-08 continued to be dominated by investment spending as in recent years. The growth of real gross fixed

capital formation (GFCF) accelerated to 15.7 per cent from 15.1 per cent in the previous year. Real private final consumption expenditure (PFCE) increased by 6.8 per cent as compared with 7.1 per cent in 2006-07. In nominal terms, PFCE marginally declined to 55.5 per cent of GDP at current market prices during 2007-08 from 55.8 in 2006-07 and 57.4 per cent in 2005-06. On the other hand, GFCF increased to 34.6 per cent of GDP from 32.5 per cent in 2006-07 and 31.0 per cent in 2005-06.

13. The overall moderation in real sector activity was reflected in the evolution of monetary and banking developments in 2007-08. Non-food credit extended by the scheduled commercial banks (SCBs) increased by 22.3 per cent (Rs.4,19,425 crore) as compared with 28.5 per cent (Rs.4,18,282 crore) in the previous year. The incremental non-food credit-deposit ratio for the banking system declined to 72.3 per cent during 2007-08 from 83.2 per cent in 2006-07, 109.3 per cent in 2005-06 and 130.0 per cent in 2004-05. Food credit of SCBs declined by Rs.2,121 crore in 2007-08 as against an increase of Rs.5,830 crore in the previous year.

14. Provisional information on the sectoral deployment of bank credit available up to February 2008 indicates, as anticipated, a gradual deceleration over the year. On a year-on-year basis, credit to services sector recorded the highest growth (28.4 per cent), followed by industry (25.9 per cent) and agriculture sector (16.4 per cent). On the other hand, growth in personal loans decelerated to 13.2 per cent (30.6 per cent). Growth in housing and real estate loans decelerated to 12.0 per cent (25.8 per cent) and 26.7 per cent (79.0 per cent), respectively. Within the industrial sector, there was a sizeable credit pick-up in respect of infrastructure (42.1 per cent as against 28.2 per cent a year ago), food processing (32.0 per cent as against 27.6 per cent) and engineering (26.2 per cent as against 18.1 per cent). There was moderation in credit growth to basic metals and metal products (19.0 per cent as against 33.3 per cent), textiles (23.0 per cent as against 35.5 per cent), petroleum (23.3 per cent as against 64.4 per cent) and chemicals (13.9 per cent as against 19.2 per cent). Credit to industry constituted 45.2 per cent of the total expansion in non-food bank credit up to February 2008, followed by services (29.8 per cent), personal loans (15.8 per cent) and agriculture (9.2 per cent). The share of infrastructure in total credit to industry increased from 20.5 per cent to 23.1 per cent. On the contrary, the share of credit to metals, textiles, chemicals and petroleum declined from 12.4 per cent, 11.3 per cent, 8.3 per cent and 4.9 per cent, respectively, to 11.7 per cent, 11.1 per cent, 7.5 per cent and 4.8 per cent. Priority sector advances grew by

16.9 per cent with a moderation in their share in outstanding gross bank credit to 33.3 per cent in February 2008 from 34.7 per cent a year ago.

15. SCBs' investments in bonds/debentures/shares of public sector undertakings and the private corporate sector and commercial paper (CP) increased by 14.2 per cent (Rs.11,830 crore) during 2007-08 as compared with an increase of 5.1 per cent (Rs.4,081 crore) in the previous year. As a result, the total flow of funds from SCBs to the commercial sector, including non-SLR investments, increased by 21.9 per cent (Rs.4,31,256 crore) in 2007-08 as against 27.3 per cent (Rs.4,22,363 crore) in 2006-07. Banks' investment in instruments issued by mutual funds increased by Rs.6,818 crore in 2007-08 as compared with Rs.1,315 crore in 2006-07.

16. Commercial banks' investment in Government and other approved securities increased by 22.9 per cent (Rs.1,81,222 crore) during 2007-08 significantly higher than 10.3 per cent (Rs.74,062 crore) in 2006-07. Accordingly, their stock of statutory liquidity ratio (SLR) eligible securities marginally increased to 27.4 per cent of the banking system's net demand and time liabilities (NDTL) in March 2008 from 27.3 per cent in March 2007. Bank's holdings of SLR securities in excess of the prescribed ratio of 25 per cent amounted to Rs.1,02,422 crore although several banks are operating their SLR portfolios close to the prescribed level. Adjusted for collateral securities under the liquidity adjustment facility (LAF) and issuances under the market stabilisation scheme (MSS), banks' investment in SLR-eligible securities would amount to 23.7 per cent of NDTL.

17. Aggregate deposits of SCBs increased by 22.2 per cent (Rs.5,80,208 crore) during 2007-08 as compared with 23.8 per cent (Rs.5,02,885 crore) in the previous year. Demand deposit growth at 20.2 per cent was higher than 17.9 per cent in 2006-07 but time deposit growth moderated to 22.6 per cent from 25.1 per cent in the previous year. In addition to the mobilisation of deposits, the banking sector's lendable resources were augmented substantially by capital raised through public issues and innovative capital instruments during 2007-08.

18. Money supply (M_3) increased by 20.7 per cent (Rs.6,86,096 crore) in 2007-08 as compared with 21.5 per cent (Rs.5,86,548 crore) in 2006-07. Bank credit to the commercial sector increased by 20.3 per cent (Rs.4,32,574 crore) in 2007-08 as compared with the increase of 25.8 per cent (Rs.4,37,074 crore)

a year ago. Net bank credit to Government recorded an increase of Rs.67,363 crore, with increase in banks' investment of Rs.1,83,338 crore in Government securities offset by a decline of Rs.1,15,975 crore (net) in Reserve Bank's credit to Government. The large increase in net foreign exchange assets of the Reserve Bank was reflected in the increase of 38.7 per cent (Rs.3,53,118 crore) in the banking sector's net foreign exchange assets.

19. Reserve money increased by 30.9 per cent (Rs.2,19,326 crore) during 2007-08 as compared with 23.7 per cent (Rs.1,35,935 crore) in the previous year. While currency in circulation rose by 17.2 per cent (Rs.86,606 crore) in 2007-08 as compared with the increase of 17.1 per cent (Rs.73,523 crore) in the preceding year, bankers' deposits with the Reserve Bank increased substantially by 66.5 per cent (Rs.1,31,152 crore) – augmented by the increase of 150 basis points in cash reserve ratio (CRR) during the year – as compared with the increase of 45.6 per cent (Rs.61,784 crore) in 2006-07. Among the sources of reserve money, the Reserve Bank's foreign currency assets (adjusted for revaluation) increased by Rs.3,70,550 crore as compared with the increase of Rs.1,64,601 crore in the previous year. The Reserve Bank's net credit to the Central Government (adjusted for the Government's deposit balances including the MSS proceeds) declined by Rs.7,070 crore in 2007-08 as against an increase of Rs.30,888 crore in 2006-07. Reflecting the liquidity conditions, the Reserve Bank's credit to banks and the commercial sector declined by Rs.2,794 crore as compared with an increase of Rs.1,990 crore in the previous year. The ratio of net foreign exchange assets (NFEA) to currency increased from 171.8 per cent in March 2007 to 209.2 per cent in March 2008.

20. During the year, the financial markets experienced alternating shifts in liquidity conditions. Tightness in liquidity on account of year-end adjustments in March 2007 persisted up to April-May, necessitating net repo injections under the LAF. There was substantial drawdown in the Centre's cash balances during May-July 2007 and a dip in MSS outstanding in June-July 2007 due to redemptions. The total overhang of liquidity as reflected in the balances under the LAF, the MSS and surplus cash balances of the Central Government taken together declined from an average of Rs.97,412 crore in March 2007 to Rs.63,994 crore in July 2007. The resumption of net issuances under the MSS, accretions to Centre's cash balances and the increase in CRR by 100 basis points during August-November 2007 led to a reduction in the liquidity in the banking system and intermittent net liquidity injections of Rs.2,742 crore and

Rs.10,804 crore on a daily average basis in November and December 2007, respectively. Auctions of dated securities under MSS were discontinued between November 2, 2007-January 16, 2008 to ease the stringency in liquidity. The liquidity overhang ruled steady in the range of Rs.2,13,847 crore-Rs.2,18,224 crore during October-December 2007.

21. During the fourth quarter of 2007-08, even though liquidity conditions were comfortable in January 2008 and MSS auctions were resumed in mid-January 2008, some tightness emerged during February 18-28, on account of increase in the Centre's cash balances. In view of the scheduled advance tax payments in mid-March 2008 and the subsequent bank holidays (March 20-22, 2008), the Reserve Bank conducted additional three-day repo/reverse repo auctions on March 14, 2008 (afternoon) and another seven-day repo auction on March 17, 2008 (afternoon) over and above the normal LAF arrangements for smooth liquidity management. Injection of liquidity through LAF repo and redemption of MSS around mid-February 2008 onwards, mitigated the liquidity tightness. During March 17-31, 2008 there were shortages of liquidity in the wake of advance tax payments. Net LAF injections rose to a peak of Rs.53,995 crore on March 31, 2008; however, in the additional LAF operations conducted on that day with a view to meeting the banking sector's year-end liquidity management requirements, there was absorption of liquidity under the LAF to the tune of Rs.3,645 crore. The build-up of cash balances of the Central Government to a peak of Rs.1,04,741 crore on March 27, 2008 also aggravated the liquidity shortage with banks. The overall liquidity overhang increased to the intra-year peak of Rs.2,73,694 crore on March 27, 2008 before declining to Rs.2,43,879 crore on April 25, 2008.

22. On a net basis, average daily LAF repo injections which stood at Rs.4,568 crore in the first quarter of 2007-08 changed to net absorption through LAF reverse repo of Rs.13,472 crore in the second quarter which declined sharply to Rs.7,820 crore in the third quarter and further to Rs.2,116 crore during the fourth quarter of 2007-08. During 2008-09 (up to April 25, 2008), the average daily net absorption under LAF reverse repo increased to Rs.28,271 crore. The average outstanding balances under MSS increased from Rs.64,863 crore at end-March 2007 to Rs.1,70,554 crore by end-March 2008 and further to Rs.1,74,465 crore on April 25, 2008 indicating net issuance of Rs.1,05,691 crore during 2007-08. Cash balances of the Central Government with the Reserve Bank increased from an average of Rs.55,890 crore in March 2007 to Rs.79,409 crore in March 2008 before declining to Rs.36,649 crore as on April 25, 2008.

23. On a year-on-year basis, inflation based on the wholesale price index (WPI) stood at 7.4 per cent at end-March 2008 as compared with 5.9 per cent a year ago. During 2007-08, headline inflation declined from 6.4 per cent at the beginning of the financial year to a low of 3.1 per cent in mid-October before firming up from mid-February 2008 onwards. On an annual average basis, inflation at 4.7 per cent during 2007-08 was lower than 5.4 per cent in the previous year. As on April 12, 2008 the headline inflation stood at 7.3 per cent as against 6.3 per cent a year ago.

24. At a disaggregated level, prices of primary articles (weight: 22.0 per cent in the WPI basket) registered a year-on-year increase of 8.9 per cent at end-March 2008 as compared with 10.7 per cent a year ago. The increase in prices of primary articles during 2007-08 was led by the rise in prices of food articles and non-food articles such as cotton and oilseeds. As on February 1, 2008 the stock of foodgrains with public agencies stood at 21.4 million tonnes as against the buffer stock norm of 20.0 million tonnes applicable for January-March, 2008. The build-up in food stocks on the back of the jump in foodgrains production during 2007-08 provides some comfort for supply management. Wheat procurement during the current *rabi* marketing season has also risen by 20.6 per cent on a year-on-year basis, strengthening food security strategies and conditions for stabilisation of domestic food prices going forward.

25. Inflation in terms of prices of manufactured products (weight: 63.8 per cent) was 7.1 per cent as compared with 6.1 per cent a year ago. Prices of edible oils, oil cakes, basic metals, alloys and metal products and basic heavy inorganic chemicals contributed to the rise in manufacturing prices in 2007-08. On the other hand, prices of textiles, leather and leather products and non-ferrous metals declined during the year.

26. The year-on-year increase in prices of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) was 6.7 per cent at end-March 2008 as compared)with 1.0 per cent a year ago. Excluding the fuel group, headline inflation was 7.6 per cent (7.4 per cent a year ago). The average price of the Indian basket of international crude increased by 27.6 per cent from US $ 62.4 per barrel during 2006-07 to US $ 79.7 per barrel in 2007-08. While there has been no revision in prices of kerosene and domestic LPG during 2007-08, domestic retail prices of petrol and diesel have been revised upwards only once during 2007-08 with effect from February 15, 2008 by 4.5 per cent for petrol and by 3.25 per cent for diesel (average of four metros). Among the

freely priced petroleum products, however, prices of naptha, bitumen, furnace oil and aviation turbine fuel, recorded increases of 33.7 per cent, 36.4 per cent, 37.6 per cent and 38.7 per cent, respectively, over their levels a year ago.

27. Inflation, on a year-on-year basis, based on the consumer price index (CPI) for industrial workers (IW) stood at 5.5 per cent in February 2008 as compared with 7.6 per cent a year ago. The CPI for urban non-manual employees (UNME), agricultural labourers (AL) and rural labourers (RL) also declined to 6.0 per cent, 7.9 per cent and 7.6 per cent, respectively, in March 2008 as compared with 7.6 per cent, 9.5 per cent and 9.2 per cent a year ago. On an annual average basis, inflation based on CPI for IW was 6.1 per cent in February 2008 compared with 6.6 per cent a year ago and that for UNME, AL and RL were 5.9 per cent, 7.5 per cent and 7.2 per cent, respectively, in March 2008 as compared with 6.6 per cent, 7.8 per cent and 7.5 per cent a year ago.

28. The revised estimates (RE) of the Central Government's finances for 2007-08 indicate ongoing improvement in the fiscal position and lowering of the key deficit indicators relative to budget estimates (BE). The revenue deficit estimated at 1.4 per cent of GDP (Rs.63,488 crore) was lower than 1.5 per cent of GDP in the BE for 2007-08 and 1.9 per cent of GDP in 2006-07. The gross fiscal deficit (GFD) for 2007-08 constituted 3.1 per cent of GDP (Rs.1,43,653 crore) as against the budget estimates of 3.3 per cent and 3.5 per cent in 2006-07. The improvement in key fiscal indicators was largely enabled by the sustained buoyancy in tax revenue which, at Rs.4,31,773 crore (RE) was 6.9 per cent higher than the budget estimates and recorded a growth of 22.9 per cent over the previous year.

29. During 2007-08, the Central Government's net market borrowing through dated securities at Rs.1,10,671 crore was 101.0 per cent of the budgeted amount of Rs.1,09,579 crore and gross market borrowing of Rs.1,56,000 crore through dated securities was 100.35 per cent of the budgeted amount of Rs.1,55,455 crore. The Central Government also issued additional securities amounting to Rs.38,050 crore, outside the market borrowing programme and the MSS, to public sector oil companies for partial compensation of under-recoveries, to the State Bank of India and to various fertiliser companies. During 2006-07, the Central Government had issued such securities amounting to Rs.40,321 crore. The State Governments and the Union Territory of Pondicherry raised Rs.67,779 crore (gross) and

Rs.56,224 crore (net) during 2007-08 under their market borrowing programme. The combined issuance (net) of Government securities under the market borrowing programme of the Centre and States was Rs.1,66,895 crore in 2007-08 as against Rs.1,21,190 crore in 2006-07, Rs.1,10,825 crore in 2005-06, Rs.80,012 crore in 2004-05 and Rs.1,35,192 crore in 2003-04.

30. Out of 35 issuances under the market borrowing programme of the Central Government, one new 10-year paper was issued and the remaining 34 issues were reissuances intended to impart liquidity. The actual issuance of dated securities under the Centre's market borrowing programme was generally as per the advance calendar except for one occasion when, in consultation with the Central Government, securities for Rs.5,000 crore were issued on June 12, 2007 over and above the scheduled issuances in the indicative calendar for the first half of 2007-08. The weighted average yield on primary issuance of the Central Government's dated securities increased by 23 basis points to 8.12 per cent in 2007-08 from 7.89 per cent in the previous year whereas the weighted average maturity of the dated securities issued during the year increased to 14.90 years from 14.72 years in the previous year. In the case of market borrowing by State Governments, the weighted average yields firmed up by 15 basis points to 8.25 per cent in 2007-08 from 8.10 per cent in 2006-07, whereas the average maturity of these issues has remained the same at 10.0 years.

31. Movements in interest rates in the domestic financial markets reflected the factors driving changes in liquidity with the banking system during 2007-08. The weighted average call market rates declined from 8.33 per cent in April 2007 to 0.73 per cent in July 2007 coincident with a ceiling of Rs.3,000 crore placed on daily reverse repo from March 5, 2007. The rates moved up in August following the removal of the ceiling but generally stayed within the informal LAF rate corridor up to December 2007. As liquidity conditions tightened, call money rates strayed, *albeit* marginally, above the repo rate during the last fortnight of February and in March 2008. The daily weighted average call rate during March 2008 was much lower at 7.37 per cent as compared with 14.10 per cent in March 2007. In April 2008, call rates declined further and the weighted average call rate stood at 5.93 per cent as on April 25, 2008. Interest rates in the CBLO and market repo segments moved in sympathy with call rates and declined from December 2007 peaks to 6.37 per cent and 6.72 per cent, respectively, in March 2008 and further to 4.93 per cent

and 5.45 per cent in April 2008 (up to April 25, 2008). The daily average volume (one leg) in the call money market declined from Rs.14,845 crore in April 2007 to Rs.11,182 crore in March 2008 and further to Rs.9,374 crore in April 2008 (up to April 25, 2008). The corresponding volumes in the market repo (outside the LAF) were Rs.7,173 crore, Rs.14,800 crore and Rs.11,911 crore respectively, whereas in the CBLO segment, the volumes were Rs.18,086 crore, Rs.37,413 crore and Rs.31,297 crore, respectively.

32. Mobilisation of resources through issuance of commercial papers (CPs) was stepped up during 2007-08 as the weighted average discount rate on CP declined by 95 basis points from 11.33 per cent at end-March 2007 to 10.38 per cent in end-March 2008 and the outstanding amount of CPs increased from Rs.17,688 crore to Rs.32,592 crore during this period. The weighted average discount rate for certificates of deposit (CDs) also declined from 10.75 per cent at end-March 2007 to 10.00 per cent in end-March 2008, accompanied by a significant increase in outstanding amounts from Rs.93,272 crore to Rs.1,47,792 crore.

33. In the Government securities market, primary market yields of 91-day, 182-day and 364-day Treasury Bills softened over the course of 2007-08, declining by 63-84 basis points to reach 7.23 per cent, 7.36 per cent and 7.35 per cent, respectively, by end-March 2008. By April 25, 2008 the primary market yields of 91-day, 182-day and 364-day Treasury Bills stood at 7.44 per cent, 7.60 per cent and 7.69 per cent, respectively. In the secondary market, the yield on Government securities with 1-year residual maturity declined from 7.55 per cent at end-March 2007 to 7.49 per cent in March 2008 before increasing to 7.84 per cent as on April 25, 2008. The yield on Government securities with 10-year residual maturity declined marginally from 7.97 per cent in March 2007 to 7.93 per cent before rising to 8.23 per cent by April 25, 2008 while the yield on Government securities with 20-year residual maturity increased from 8.23 per cent at end-March 2007 to 8.31 per cent at end-March 2008 and further to 8.63 per cent as on April 25, 2008. Consequently, the yield spread between 10-year and 1-year Government securities increased marginally from 42 basis points at end-March 2007 to 44 basis points at end-March 2008 before declining to 39 basis points as on April 25, 2008. Similarly, the yield spread between 20-year and 1-year Government securities increased from 68 basis points at end-March 2007 to 82 basis points at end-March 2008 and subsequently declined marginally to 79 basis points as on April 25, 2008.

34. Rapid growth in turnover in the foreign exchange market was sustained by large surplus conditions in the spot market. The average daily turnover increased to US $ 57.30 billion at end-March 2008 from US $ 33.18 billion at end-March 2007. With increasing volumes of current and capital account transactions, the merchant turnover for the period increased to US $ 16.37 billion from US $ 8.66 billion, while the inter-bank turnover increased to US $ 40.88 billion from US $ 24.52 billion. There was a general softening in forward premia across all maturities over end-March 2007 but some hardening was witnessed after September 2007. The six-month forward premia eased from 4.40 per cent in March 2007 to 2.55 per cent by end-June 2007 and further to 0.78 per cent by end-September before it increased to 2.50 per cent at end-March 2008 and further to 2.67 per cent by April 25, 2008.

35. During March 2007-March 2008, pubic sector banks (PSBs) readjusted their deposit rates downwards by 25-50 basis points, while those offering lower deposit rates for similar maturity earlier increased their deposit rates by 50-100 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 March 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 7.25-9.75 per cent during the same period. Foreign banks set deposit rates lower for maturities of less than one year while they have marginally raised their rates for deposits of longer maturities.

36. On the lending side, the benchmark prime lending rates (BPLRs) of PSBs increased by 75 basis points from a range of 12.25-12.75 per cent to 12.25-13.50 per cent during 2007-08. 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. The median lending rates for term loans (at which maximum business is contracted) in respect of PSBs moved from a range of 9.13-12.50 per cent in March 2007 to 10.00-13.00 per cent by March 2008.

37. The Indian equity market witnessed large swings during 2007-08. The BSE Sensex (1978-79=100) increased by 19.7 per cent during the year from 13072 at end-March 2007 to 15644 at end-March 2008. The intra-year peak of 20873 was recorded on January 8, 2008 whereas the intra-year trough of 12445 was recorded on April 2, 2007. Corporates mobilised large resources through public issues during the year. Sound macroeconomic fundamentals, private corporate profitability, institutional buying support and global macroeconomic conditions were the major factors determining the movements in equity prices. As on April 25, 2008 the BSE Sensex stood at 17126.

Developments in the External Sector

38. The Reserve Bank's end-March 2008 release sets out the balance of payments data for April-December 2007. In US dollar terms, merchandise exports increased by 24.6 per cent during April-December 2007 from 23.9 per cent in April-December 2006. Provisional information on commodity-wise trade available from the Directorate General of Commercial Intelligence and Statistics (DGCI&S) shows that export growth in 2007-08 was driven by petroleum products, engineering goods and gems and jewellery. During the first nine months of 2007-08, merchandise import growth accelerated to 27.9 per cent from 27.7 per cent a year ago, mainly due to an increase of 29.9 per cent in non-oil imports from 22.7 per cent in April-December 2006. The growth in non-oil imports was mainly due to capital goods, pearls and precious stones, chemicals, and gold and silver. Oil imports increased by 24.0 per cent as against 39.4 per cent during April-December 2006 as the average price of the Indian basket of international crude recorded an annual increase of 15.9 per cent to US $ 74.7 per barrel in April-December 2007. On payments basis, the merchandise trade deficit increased to US $ 66.5 billion during April-December 2007 from US $ 50.3 billion in the corresponding period of 2006-07.

39. Net invisible earnings amounted to US $ 50.5 billion in April-December 2007 as against US $ 36.3 billion a year ago. The key contributors to invisibles were remittances from Indians working overseas, export of software services and travel earnings. Private transfers, comprising primarily remittances from overseas Indians, remained sizeable at US $ 28.8 billion as compared with US $ 20.2 billion a year ago. While the inward remittances for family maintenance increased by 39.0 per cent, local withdrawals from non-resident Indian (NRI) deposit accounts were higher by 49.0 per cent which may be attributed to higher returns domestically *vis-à-vis* NRI deposits. Software export

proceeds amounted to US $ 27.5 billion as against US $ 21.8 billion in April-December 2006. Miscellaneous receipts, net of software exports, stood at US $ 18.1 billion in April-December 2007 as compared with US $ 17.6 billion a year ago, mainly on account of business services such as trade-related services, business and management consultancy, engineering and technical know-how. Invisible payments increased to US $ 49.7 billion during the first nine months of 2007-08 as compared with US $ 43.1 billion a year ago. The key components of invisible payments were travel payments, transportation, business and management consultancy, technical services, dividends, profit and interest payments. With invisible receipts rising faster than payments, the net invisible surplus increased from US $ 36.3 billion in April-December 2006 to US $ 50.5 billion in April-December 2007. Reflecting these developments in the merchandise and invisible accounts, the current account deficit (CAD) at US $ 16.0 billion was higher than US $ 14.0 billion in the corresponding period of the previous year.

40. Net capital inflows surged by 172 per cent to US $ 81.9 billion during April-December 2007 as compared with US $ 30.1 billion a year ago. While net foreign direct investment (FDI) increased by US $ 8.4 billion from US $ 7.6 billion in April-December 2006, portfolio investment recorded a substantial increase of US $ 33.0 billion from US $ 5.2 billion. Enabled by finer spreads and in response to rising financing requirements for domestic capacity expansion, net external commercial borrowings (ECBs) increased to US $ 16.3 billion as against an increase of US $ 9.8 billion in the previous year. During the first nine months of 2007-08, NRI deposits registered a net outflow of US $ 0.9 billion as against an increase of US $ 3.7 billion in April-December 2006, responding to the reduction in the ceiling on interest rate on NRI deposits in April 2007. Net short-term trade credit rose to US $ 10.8 billion as compared with US $ 5.7 billion a year ago. On the whole, debt flows (net) in the form of external assistance, ECBs, NRI deposits and short-term credit put together increased to US $ 27.5 billion in April-December 2007 from US $ 20.2 billion a year ago.

41. There was a large accretion of US $ 67.2 billion to foreign exchange reserves, excluding valuation changes, during April-December 2007 as against US $ 16.2 billion in April-December 2006. Valuation gains, reflecting the appreciation of major currencies against the US dollar, accounted for US $ 8.9 billion of the total accretion to the reserves during April-December 2007. Including these valuation effects, the foreign exchange reserves recorded

an increase of US $ 76.1 billion and rose to reach a level of US $ 275.3 billion by end-December 2007. India's external debt increased by US $ 31.8 billion from end-March 2007 to US $ 201.4 billion at end-December 2007. The increase was mainly under ECBs (US $ 15.3 billion) and short-term credit (US $ 8.8 billion). Valuation changes due to the depreciation of the US dollar *vis-à-vis* major international currencies and the Indian rupee, accounted for US $ 6.0 billion of the increase in external debt during the period. In the total external debt stock, ECBs accounted for the highest share (28.3 per cent), followed by NRI deposits (21.4 per cent), multilateral debt (18.8 per cent) and bilateral debt (8.6 per cent). At end-2007, the ratio of short-term debt to total debt was 17.5 per cent. The share of US dollar–denominated debt in total debt was highest at 54.5 per cent, followed by 17.1 per cent in rupee–denominated debt and 11.2 per cent in Japanese yen–denominated debt.

42. Information available for subsequent months from the DGCI&S indicates that merchandise exports increased by 22.8 per cent in US dollar terms during April-February 2007-08 as compared with 23.2 per cent in the corresponding period of the previous year. On the other hand, imports showed an increase of 30.1 per cent as compared with 25.2 per cent. While the increase in oil imports was lower at 26.4 per cent as compared with 31.2 per cent, non-oil import recorded a higher growth of 31.8 per cent as compared with 22.6 per cent. During April-February 2007-08, the trade deficit widened to US $ 72.5 billion which was 46.8 per cent higher than the deficit of US $ 49.4 billion in the corresponding period of the previous year.

43. The sustained strength of capital flows during the year is noteworthy. Net portfolio flows on account of investments by FIIs surged to US $ 20.3 billion in 2007-08 from US $ 3.2 billion in the previous year. Net inflows in the form of FDI rose to US $ 25.5 billion in April-February 2007-08 from US $ 19.6 billion a year ago. Net inflows under ADRs/GDRs increased to US $ 8.7 billion from US $ 3.8 billion. On the other hand, net accretions to NRI deposits amounted to US $ 0.1 billion as against US $ 3.9 billion. During 2007-08, the foreign exchange reserves increased by US $ 110.5 billion to US $ 309.7 billion by end-March 2008 and stood at US $ 313.5 billion as on April 18, 2008.

44. The Indian foreign exchange market witnessed generally orderly conditions during 2007-08 with the exchange rate exhibiting two-way movements. The exchange rate of the rupee against the US dollar, which was Rs.43.59 at end-March 2007 appreciated by 5.6 per cent to Rs.41.29 at

end-April 2007 and further to Rs.39.27 by January 8, 2008. In the subsequent period the exchange rate depreciated, easing to Rs.39.97 per US dollar by end-March 2008. The rupee-euro exchange rate depreciated from Rs.58.14 at end-March 2007 to Rs.63.09 by end-March 2008. Overall, during 2007-08, the rupee appreciated by 9.1 per cent against the US dollar and by 7.5 per cent against pound sterling but depreciated by 7.7 per cent against the Japanese yen, and by 7.8 per cent against the euro. As on April 25, 2008 the exchange rate of the rupee was Rs.40.18 per US dollar, Rs.62.90 per euro, Rs.79.25 per pound sterling and Rs.38.47 per 100 Japanese yen.

45. 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

46. Global economic activity decelerated somewhat in relation to earlier expectations, mainly on account of the slowdown in the US economy. During the first quarter of 2008, the unfolding of the subprime mortgage crisis coupled with growing concerns about a contraction of economic activity in the US in 2008 appears to be feeding into a deterioration in the outlook for global growth which has remained relatively resilient so far. There are some signs that the slowdown in the US may spill over to the euro area, China and Japan with potential implications for the emerging market economies (EMEs) through trade, financial markets and other linkages. According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in April 2008, the forecast for global real GDP growth, on a purchasing power parity basis, is expected to slow from 4.9 per cent in 2007 to 3.7 per cent in 2008 – as compared with the projection of 4.1 per cent published in January 2008 – and 3.8 per cent in 2009. World real GDP growth, on the basis of market exchange rates, is estimated to decelerate from 3.7 per cent in 2007 to 2.6 per cent in 2008 and 2009.

47. In the US, real GDP grew by 0.6 per cent in the fourth quarter of 2007 as compared with 2.1 per cent a year ago and 4.9 per cent in the previous

quarter. In the first quarter of 2008, labour markets weakened with the unemployment rate rising to 5.1 per cent in March 2008. Household and consumption demand is likely to be affected with home prices having fallen by 10.7 per cent in the year ending January 2008, bank seizures having more than doubled in March 2008 over the level a year ago and the year-on-year monthly foreclosure continuing to increase in March 2008 for the 27th consecutive month. US real GDP growth is expected to slow further during 2008 as the housing market downturn deepens and the financial market turmoil spreads across the financial system with macroeconomic implications as apprehended by the IMF in its April 2008 Global Financial Stability Report. The index of leading indicators increased marginally in March after a continuous decline up to February 2008. However, consumer sentiment was at its lowest level in 26 years in April 2008. The US economy is expected to show some improvement in the second half of 2008, when tax rebates in the fiscal stimulus package could lift growth. The IMF's April 2008 update of its WEO expects the US economy to grow at a slower pace of 0.5 per cent in 2008 as against 2.2 per cent in 2007, but projects some recovery to 0.6 per cent in 2009.

48. Real GDP in the euro area grew by 2.3 per cent in the fourth quarter of 2007 on a year-on-year basis as compared with 3.3 per cent a year ago. Real activity appears to have strengthened in the first quarter of 2008. Unemployment fell in January-February 2008 to a record low of 7.1 per cent notwithstanding currency appreciation, surging oil prices and the US slowdown. Growth in European service industries has accelerated above projections with optimism on export prospects. However, European retail sales fell in March after rising for the first time in five months in February. Retailers continue to lack pricing power with consumer spending held down by inflation at its highest level in 14 years. The April 2008 update of the IMF's WEO has placed real GDP growth of the euro area at 1.4 per cent in 2008 and 1.2 per cent in 2009 as against 2.6 per cent in 2007.

49. The Japanese economy grew by 3.7 per cent in the fourth quarter of 2007 as compared with 2.2 per cent a year ago. In the first quarter of 2008, lead indicators point to some slackening of momentum while consumer and business sentiment has weakened. Japan's factory production fell in January-February 2008 as a deepening US slowdown weakened demand for cars and electronics. Exports and production are slowing and wages remain subdued. Consumer sentiment in Japan has been worsening with higher crude

oil prices and the rising prices of daily necessities. The April 2008 WEO of the IMF has projected that Japan's economy, the world's second largest, will grow by 1.4 per cent in 2008 and by 1.5 per cent in 2009 as compared with the estimated growth of 2.1 per cent in 2007.

50. These unusual developments in global economy indicate heightened uncertainties and emerging challenges for the conduct of monetary policy, especially for EMEs. The IMF has forecast that the emerging and developing economies' growth will slow to 6.7 per cent in 2008 from 7.9 per cent in 2007 and further to 6.6 per cent in 2009. Developing Asia will slow by 1.5 percentage points to a still-rapid 8.2 per cent. However, downside risks are emerging to the extent EMEs' growth has depended heavily on external demand and also due to the possibility of capital inflows drying up in the present risk-averse scenario. Rise in risk aversion has already dampened private bond issuance in several EMEs. Most importantly, inflation has raised its head in several EMEs and this might complicate monetary policy decision-making even further, particularly in view of the greater weight for food in consumer prices as well as inflation perceptions in EMEs.

51. The Chinese economy grew by 11.9 per cent in 2007 as compared with 11.1 per cent in 2006 in spite of measures to cool down the pace of growth, including reduction of export rebates and restrictions on processing exports. In the first quarter of 2008, however, growth has moderated to 10.6 per cent as compared with 11.7 per cent a year ago. Reflecting the slowdown in export growth, China's trade surplus fell year-on-year by 10.8 per cent in March 2008 to US $13.4 billion. The total foreign exchange reserves, however, increased to US $ 1.7 trillion in March 2008 as compared with US $ 1.2 trillion in March 2007. In 2008, the Chinese economy is expected to moderate to a growth of 9.3 per cent as tightening policies take effect. The CSI 300 Index, which tracks yuan-denominated A shares listed on China's two exchanges, has fallen by 28.8 per cent to 3803.1 on April 25, 2008 after increasing six-fold in the two years through 2007. The Chinese authorities are making efforts to resolve problems such as overheated growth in fixed asset investment, excessive supplies of money and credit and a huge trade surplus.

52. Among other major Asian economies, the Korean economy grew by 5.0 per cent in 2007, decelerating marginally from 5.1 per cent in 2006 despite higher exports to emerging markets such as China. Economic activity is expected to slow down further to 4.2 per cent in 2008 before accelerating to

4.4 per cent in 2009. In Thailand, economic activity is expected to grow by 5.3 per cent in 2008 and further to 5.6 per cent in 2009 as against 4.8 per cent in 2007, as stronger domestic demand growth and expansionary public expenditures offset slowing export growth.

53. Continuing strong demand and dwindling stocks are reflected in a tight supply-demand food situation globally, leading to the emergence of food price inflation as a key risk to global stability. The FAO's global food price index, which rose by 40 per cent in 2007 to the highest level on record, has continued to increase in the first quarter of 2008 as well, as world food stocks have fallen to their lowest levels in 25 years. Food import bills in the low-income food-deficit countries are likely to rise by 35 per cent for the second consecutive year in 2008. Shortages and high prices for all kinds of food have caused social tensions around the world in recent months in Haiti, Indonesia, Pakistan and several African countries. China has imposed price controls on cooking oil, grain, meat, milk and eggs. In Egypt, the Government has significantly raised food subsidies and signed a bilateral agreement with Kazakhstan for 1 million tonnes of wheat at a preferential price to be delivered during 2008. Indonesia has removed the 5 per cent duty on wheat import and suspended a 10 per cent duty on imported soybeans. In April 2008, the global food crisis appears to have intensified with Kazakhstan – one of the world's biggest wheat exporters – curbing exports, alongside restrictions in Russia, Ukraine and Argentina. These curbs are likely to trigger similar moves in other foodgrain exporting countries in the face of rising domestic prices worldwide.

54. In the global foodgrains market, prices of major crops such as corn, soyabeans and wheat have increased by 58.2 per cent, 86.3 per cent and 56.5 per cent, respectively, by April 25, 2008 from a year ago in response to surging demand. The increase in overall foodgrain 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. Higher rice prices are also contributing to inflation in many developing countries as the price of rice, a staple in the diets of nearly half the world's population, has almost doubled on international markets in the last three months. Drawing down of costly stockpiles of rice in recent years has removed an effective price dampener in the face of adverse demand-supply imbalances. Rising prices and a growing fear of scarcity have prompted some of the world's largest rice producers – India, Vietnam, Egypt and Cambodia – at end-March 2008 to

announce drastic limits on the amount of rice they export which have driven prices on the world market even higher. Philippines has started to track down rice hoarders. Rice prices in Thailand have trebled over their level in the beginning of 2008. With Indonesia joining other major rice exporters in banning exports, international near-month futures price of rice on Chicago Board of Trade (CBOT) has risen to a high of US $ 23.8 per hundredweight on April 25, 2008 – up by 71 per cent since January 2008. On the same day, futures prices were quoted higher at US $ 24.18 for July 2008, but the quotes moderated for September 2008 to US $ 22.09 and for May 2009 to US $ 22.38.

55. Wheat prices remained generally firm and volatile since October 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 1.6 per cent in 2007. Trade is expected to contract because of high and volatile prices, coupled with soaring freight rates. One month wheat futures at the CBOT rose from US $ 9.15 per bushel on January 2, 2008 to US $ 12.8 on February 27, 2008 before falling to US $ 8.01 on April 25, 2008. On the same day, futures prices for wheat were quoted higher for July 2008 at US $ 8.16, for December 2008 at US $ 8.49 and for May 2009 at US $ 8.68.

56. 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. The futures prices of corn on CBOT, which had moderated somewhat up to July 2007, started moving up thereafter and reached US $ 5.77 on April 25, 2008. On the same day, futures prices for corn were quoted higher for July 2008 at US $ 5.90, for September 2008 at US $ 6.00 and for May 2009 at US $ 6.25.

57. Metal prices have increased by 23.7 per cent during first three months of 2008 after declining by 8.1 per cent during 2007 following increases of 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 $ 4.03 per pound on April 9, 2008. As on April 25, 2008 the May 2008 futures prices for copper which stood at US $ 3.96 per pound were quoted lower for July 2008 at US $ 3.91, at US $ 3.89 for September 2008 and at US $ 3.78 for May 2009. Spot gold rose to US $ 1000.10

an ounce on March 13, 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, before declining to US $ 885.15 an ounce on April 25, 2008.

58. Prices of crude oil, which have rebounded since July 2007, increased by 83.2 per cent up to April 25, 2008 from their level a year ago and near-month futures prices have ruled at the record level of US $ 119.64 per barrel on April 25, 2008 – the highest since trading began on the Nymex in 1983. On the same day, oil futures ruled at a lower level of US $ 115.77 for September 2008 and US $ 114.06 for December 2008 and US $ 111.6 for May 2009. According to the Energy Information Administration (EIA), tight fundamentals, reflected by low available crude oil surplus production capacity, combined with supply concerns in several oil exporting countries, have continued to put upward pressure on world crude oil prices. The outlook over the next two years points to some easing of the oil market balance due to increased production outside of the Organization of the Petroleum Exporting Countries (OPEC) and planned additions to OPEC capacity. However, delays to capacity additions in both OPEC and non-OPEC nations could alter the outlook, as could OPEC production decisions. According to the EIA, the price of West Texas Intermediate (WTI) crude oil is expected to be at US $ 100.61 per barrel in 2008 and US $ 92.50 per barrel in 2009. Surplus production capacity is projected to decelerate from its current level of a little over 2 million barrels per day (bbl/d) to more than 1 million bbl/d by the end of 2009.

59. In the US, consumer prices increased from 2.8 per cent in March 2007 to 4.0 per cent in March 2008. In the euro area, inflation increased to 3.6 per cent in March 2008 – the highest level since the introduction of the euro – from 1.9 per cent a year ago. In Japan, inflation increased to a decade-high rate of 1.2 per cent in March 2008 from (-) 0.1 per cent a year ago on account of rising oil and food costs. In the UK, CPI inflation decelerated to 2.5 per cent in February-March 2008 from 2.8 per cent a year ago. 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 March 2008 with some fluctuations in between. Inflation pressures have also raised concerns in some of the EMEs such as China, Malaysia, Indonesia and Chile.

60. Core CPI inflation in the US increased to 2.4 per cent in March 2008 from 2.3 per cent in February 2008. In the UK, core CPI inflation has been

declining in tandem with the headline rate and stood at 1.2 per cent in February-March, down from 1.3 per cent in January 2008. In the euro area, core CPI inflation increased to 2.0 per cent in March 2008 from 1.8 per cent in February 2008. Core inflation in Japan turned positive (0.1 per cent) in March 2008 as compared with – 0.1 per cent in February 2008. The increase in producer prices has been sharper than in consumer prices, reflecting increased input costs. In the US, producer prices increased from 3.1 per cent in March 2007 to 6.9 per cent in March 2008. In the euro area, producer prices increased from 2.8 per cent in March 2007 to 5.3 per cent in March 2008. In the UK, producer prices increased to 6.2 per cent in March 2008 from 2.7 per cent in March 2007. Wholesale price inflation in Japan increased from 1.2 per cent in February 2007 to 3.4 per cent in February 2008. Overall, the persistence of high food and 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.

61. In the EMEs, the recent jump in headline inflation caused by higher energy and food prices are of concern since this requires a balanced response in controlling inflation while being alert to decelerating impulses from the slowdown in the developed countries and the possibilities of a prolonged global financial market turmoil. Even though higher headline inflation may be driven initially by rising food and energy prices, it could quickly lead to broader price and wage pressures in the EMEs which are witnessing rapid growth. In China, inflation accelerated to 8.7 per cent in February 2008 before easing to 8.3 per cent in March as compared with 3.3 per cent in March 2007 despite the central bank's repeated efforts to rein in inflation through monetary tightening policies. At end-March 2008, the Chinese State Council decided to increase budgetary subsidies for grain production and the government's minimum grain procurement prices to address the potential shortfall in grain production. Farmers' interest in grain production has been declining as raw material costs were rising faster than grain prices. Consumer price inflation in Korea accelerated to 3.9 per cent in March 2008 from 2.2 per cent in March 2007 which is causing concern. Inflation increased to 5.3 per cent in March 2008 in Thailand from 2.0 per cent in March 2007.

62. Concerns about a US slowdown and the uncertainty surrounding the financial health of some of the biggest US financial entities have imparted considerable volatility in the US equity markets since January 2008. On January 21, 2008 equity markets across the world experienced sharp declines with fall

in Asian stocks as well. The volatility and bearishness in equity markets have continued in February-April 2008 on account of weak US economic data and substantial write-offs by financial institutions. The Dow Jones Industrial Average, Standard and Poor's (S&P) 500 and Nasdaq Composite exhibited considerable volatility and posted declines of 1.5 per cent, 6.5 per cent and 4.9 per cent, respectively, by April 25, 2008 over their levels a year ago. In the fixed income segment, Government bond yields in the major economies, which had firmed up in the first half of 2007, have softened thereafter since demand for government debt has increased as investors shifted their funds to the treasuries acknowledging the likelihood that the economy is already in a recession and seeking safety. 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 3.87 per cent on April 25, 2008. The 10-year bond yield in the euro area increased from 3.95 per cent at end-December 2006 to 4.68 per cent on July 9, 2007 before falling to 4.18 per cent on April 25, 2008. 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 1.61 per cent on April 25, 2008. These recent developments are indicative of evolving uncertainties in international financial markets with implications for EMEs.

63. 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 $ 1.99 on April 25, 2008 – close to 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 a peak of US $ 1.60 on April 22, 2008 before declining to US $ 1.56 on April 25, 2008. 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 $ 1.01 on April 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 77.95 cents on April 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 78.07 cents on April 25, 2008.

64. Since the beginning of the turbulence in August 2007, central banks of advanced economies have responded with both conventional and unconventional measures to ease liquidity stress in financial markets and

solvency issues among large financial institutions. There has, however, been several aspects that differentiate the approaches of the central banks. Some central banks, notably the ECB, the Reserve Bank of Australia and the Swiss National Bank have responded by providing liquidity to inter-bank markets, implicitly viewing the financial turmoil as essentially a problem of liquidity tightness. These central banks have provided liquidity through fine-tuning operations aimed at assuring orderly conditions in their respective money markets. On the other hand, some central banks like the US Fed, the Bank of England and the Bank of Canada have responded in a more diverse fashion, regarding the market stress as reflecting both liquidity seizure as well as broader threats to financial stability, coupled with dangers of the slowdown in economic activity becoming protracted. Accordingly, they have moved to inject liquidity into money markets through normal and special facilities. They have also relaxed the class of eligible securities for liquidity availment from the central bank. Furthermore, they have also cut policy rates substantially amid fears that the subprime crisis could turn into a major credit crunch with adverse implications for the real sector. The US Fed has also been involved in resolution of problems arising in non-bank entities like investment banks and insurance companies. The Bank of England has provided generalised and institution-specific emergency liquidity and facilities for swapping securities.

65. In the second phase of central bank intervention in December 2007 (the first phase being spread over August-September), major central banks such as the Federal Reserve, the Bank of Canada, the Bank of England, the European Central Bank and the Swiss National Bank (SNB) injected liquidity in a coordinated manner. Actions taken by the Federal Reserve included 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; 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 $ 6 billion to the ECB and the SNB, respectively, for use in their jurisdictions; a Term Securities Lending Facility announced on March 11, 2008; and a Primary Dealer Credit Facility (PDCF) on April 22, 2008. The Fed has also conducted nine auctions amounting to US $ 340 billion having 28-day maturity and an auction of US $ 20 billion having 35-day maturity.

66. Since December 2007, the ECB has conducted seven US dollar TAF auctions amounting to US $ 85 billion up to April 24, 2008 for 28 days maturity each. The Bank of Canada has conducted five 28-day auctions amounting

to US $ 10 billion till April 17, 2008. The SNB has conducted four auctions amounting to US $ 20 billion for 28 days each up to April 22, 2008. The Bank of England increased liquidity injections from £2.85 billion to £11.35 billion for its operations in December 2007-January 2008 of which £10 billion was offered for 3-month maturity. It also announced that long term repo operations would be held against a wider range of high quality collateral. In April 2008, the Bank of England launched a scheme to allow banks to swap temporarily their high quality mortgage-backed and other securities for UK Treasury Bills. It has so far allotted amounts of £44.9 billion (three months), £2.95 billion (six months), £1.6 billion (nine months) and £ 0.8 billion (12 months) in four long-term repo auctions since December 2007.

67. Some central banks have cut policy rates since the third quarter of 2007 when the financial market turmoil surfaced. During September 18, 2007 to March 18, 2008 the US Federal Reserve cut its policy rate by 300 basis points to 2.25 per cent after seventeen increases to 5.25 per cent between June 2004 and June 2006. The Bank of England reduced its repo rate to 5.0 per cent by 25 basis points each in February and April 2008. The Bank of Canada reduced its rate to 3.0 per cent by 25 basis points reductions each in December 2007 and January 2008 and 50 basis points each in March and April 2008. Central banks of several countries, including the euro area, New Zealand, Japan, Korea, Malaysia, Thailand and Mexico have not changed their rates since the last quarter of 2007. Some 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 February-March 2008 to 7.25 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 Central do Brasil (overnight Selic rate raised by 50 basis points to 11.75 per cent in April 2008).

68. Large capital flows to EMEs have elicited various responses from central banks for managing and stabilising these flows including monetary tightening involving either hikes in policy rates or in reserve requirements or both. In China, the required reserve ratio was raised from 8 per cent in July 2006 to 16.0 per cent on April 25, 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.

69. 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. However, with effect from March 3, 2008 the Bank of Thailand has lifted the URR on short-term capital inflows and said it would introduce three supporting measures to temper the impact of the change. These measures involve (a) an increase in the foreign investment limit to US $30 billion to allocate to securities companies, mutual funds and individual investors, (b) an improvement in measures to prevent baht speculation and (c) a revision to the structure of non-residential baht accounts so as to help monitor fund flows of non-residents. 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. Chile and Brazil's central bank have bought up substantial amount of inflows from the spot market to add to reserves and also conducted sizeable operations in the forward markets.

70. Over the year gone by, global developments have brought forward several new realities that pose severe challenges to monetary policy globally. First, concerns relating to the US slowdown and its intensity have mounted in view of the potential spillover on to the global economy. Second, threats to the global economy are emanating from advanced economies in sharp contrast to earlier crises which stemmed from the emerging world. Third, there are indications that protectionist tendencies have increased around the world in anticipation of the growing possibilities of slower growth in advanced economies. In several key commodity-producing economies, policy measures are in place and are being intensified to restrict the availability of supplies to the international markets. Fourth, linkages between financial sector developments and the real sector have become more worrisome than before, with apprehensions that financial turmoil may spillover to the real sector with adverse implications for employment and growth. With financial institutions reporting tightening in lending standards, deterioration in asset quality and

deceleration in consumer loan demand, there are signals that events in the financial markets are beginning to have a persisting impact on other dimensions of the real economy as well. Fifth, higher and more volatile prices of food, energy and other commodities have imparted a significant upside bias to inflation and inflation expectations across the world, complicating the conduct of monetary policy at a time of severe financial stress. In several countries, there are threats to food availability with consequent social tensions. Sixth, terms-of-trade losses due to soaring commodity prices and exchange rate appreciation are reducing the capacity of the euro area and Japan to contribute to a re-balancing of the world economy. Seventh, EMEs are exhibiting resilience so far in the face of the global financial turmoil reflecting relatively stronger macroeconomic framework and sustainable macroeconomic balances. Thus, there is so far some divergence in terms of growth performance between mature economies and EMEs but whether, how long and to what extent it will persist is uncertain. On the other hand, inflationary pressures appear to be common to mature economies and EMEs but the latter are under heavier pressure.

71. There are several issues emerging out of recent financial developments that are interacting with global macroeconomic changes and carry implications for the conduct of monetary policy globally. First, financial markets are currently at the heart of the turmoil and are regarded as sources of higher potential instability going forward. Despite sizeable central bank action over a wide spectrum, market interest rates and policy rates continue to be widely divergent. Second, there are renewed concerns about the gaps in the financial architecture and its limited capability for withstanding shocks or for preventing spillovers. Third, the effectiveness of financial regulations and supervision has come under scrutiny, especially in the context of appropriately assessing capital adequacy in large financial institutions, complex financial products and vehicles and risk management practices. In this context, it is important to note that even the Basel II and related processes are being reviewed in their granularities. Fourth, the role of credit rating agencies is being subjected to critical reassessment, particularly in view of their envisaged role under Basel II. There is active discussion on the need for credit rating agencies to clearly differentiate the ratings for structured products, improve their disclosure of rating methodologies, and assess the quality of information provided by originators, arrangers, and issuers of structured products. Fifth, current practices relating to transparency and disclosure are being subject to careful appraisal in view of their inadequacy in the context of structured financial products and special

purpose vehicles. Sixth, the role of investment banks and their adequacy of capital needs to be reviewed, along with stipulation of separate yet complementary sets of best practices for hedge fund investors and asset managers to increase accountability for participants in this industry.

Overall Assessment

72. While aggregate supply capacities expanded and alleviated domestic macro-imbalances in 2007-08 to some extent, available indicators suggest that economic activity in India currently continues to be mainly demand-driven. The rate of gross fixed capital formation at current prices rose by 2.1 percentage points of GDP at current market prices in 2007-08, more than compensating for the decline of 0.3 percentage points in the rate of private final consumption expenditure and that of 0.2 percentage points in the rate of government final consumption expenditure. Looking ahead, the Union Budget for 2008-09 is likely to provide a stimulus to both private and government consumption in view of the proposals for effective reduction of the tax burden under personal income and excise as well as the revenue expenditure implications emanating from the recommendations of the Sixth Pay Commission. The dominance of investment demand in the economy is likely to persist in 2008-09 and beyond, supported as it were by the buoyancy in corporate saving in view of the sustained resilience of sales and profitability, and the ongoing improvement in public sector saving. Furthermore, patterns of domestic industrial output and imports remain skewed in favour of capital goods, indicative of ongoing expansion in capacity, both new and existing. Moreover, resources raised through public issues as well as investment intentions more than doubled in 2007-08, pointing to the corporate sector's positive assessment of evolving demand conditions and underlying plans for expanding production capacities. Finally, the sharp widening of the merchandise trade deficit reflects the spillover of domestic demand into the external sector with implications for the year ahead.

73. The pick-up in inflation during the fourth quarter of 2007-08 has, however, mainly emanated from supply-side pressures such as the one-off increase in domestic petrol and diesel prices to partially offset the global crude oil price increase over the year; continuous hardening of prices of petroleum products that are not administered, rising prices of wheat and oilseeds and the adjustment in steel prices in March 2008 due to the surge in international prices. In recognition of the unanticipated supply-sided origin of pressures in the recent months, partly due to global developments, the first response of

public policy to the hardening of inflation has been in terms of reducing import duty on rice and edible oils, followed by a ban on exports of non-basmati rice and pulses, an increase in the minimum export price relating to basmati rice, reduction of customs duty on butter, ghee and maize, and administrative measures to enable imposition of stock limits on selected agricultural products. There are growing concerns that this upsurge in inflation in India has occurred at a time when global commodity prices have been volatile at historically elevated levels and central banks in mature and emerging economies alike have been articulating heightened inflation concerns. Consequently, there are concerns that demand pressures, which have been reasonably contained so far, are being coupled with supply-side factors which, if not temporary in view of global demand-supply imbalances, could impact domestic inflation significantly.

74. Monetary and financial conditions appear to have gone through underlying shifts in the fourth quarter of 2007-08. While the rate of money supply has dipped from mid-February 2008 in tandem with a moderation in the growth of time deposits, it remains high in relation to indicative projections. On the other hand, the moderation in non-food credit growth that was evident in the first half of 2007-08 appears to have extended into the fourth quarter of the year. The deceleration has been marked in respect of interest-sensitive sectors such as housing, personal loans and real estate as well as in some categories of services such as trade, professional and other services, shipping, transport operators, tourism, hotels and restaurants which had been recording significantly elevated growth rates in preceding years. These movements in banking aggregates have enabled a better balance between banks' sources and uses of funds than before, as reflected in the decline in the incremental non-food credit deposit ratio to below 75 per cent for the first time since August 2004.

75. During the fourth quarter of 2007-08, financial markets were impacted by unusual swings and high volatility in foreign exchange flows as well as in cash balances of the Government with the Reserve Bank with consequent shifts in liquidity conditions. These variations were smoothened by active liquidity management through a combination of instruments such as the MSS, the LAF and the CRR so that volatility in overnight interest rates was broadly contained within the informal LAF corridor. As a result, advance tax payments did not produce the usual spikes in money market rates. Generally orderly conditions were also observed in the Government securities market with some

widening of yield spreads across maturities on concerns about rising inflation domestically, recent escalations in food, energy and metal prices internationally, and the atmosphere of heightened uncertainty. In the credit market, while deposit rates have been adjusted downwards, lending rates have edged up. In the foreign exchange market, two-way movements in spot rates have been in evidence in the fourth quarter of 2007-08 and in April 2008. On the other hand, asset prices, particularly equity prices, rose to record highs in January 2008 before declining dramatically in February-March 2008.

76. Finances of the Central Government have undergone further consolidation in 2007-08 in consonance with the path charted under the FRBM. Sustained buoyancy in corporation and personal income taxes lifted gross tax revenues above the budgeted level by 0.8 percentage points of GDP. Reflecting the fruits of a better balancing of the tax structure, marked improvement in compliance and efficiency gains in tax administration, the tax-GDP ratio has moved up from 9.2 per cent in 2003-04 to 12.5 per cent in 2007-08 and is likely to reach 13.0 per cent in 2008-09. While aggregate expenditure was 0.7 percentage points of GDP higher than budgeted, this was essentially on account of revenue (non-Plan) expenditure in the form of interest payments and subsidies. Capital expenditure, however, declined in relation to budget estimates. There was also a sizeable recourse to mobilisation of resources through extra-budgetary transactions in the form of issuances of securities to public sector entities. These developments are indicative of potential pressures in the period ahead, notwithstanding the marginal reduction achieved in the revenue deficit and in the gross fiscal deficit in relation to GDP.

77. Within India's growing integration with the global economy, some aspects of India's external sector developments in 2007-08 merit attention. First, there has been a sizeable widening of the trade deficit on sustained demand for non-oil imports – particularly for capital goods, export-related inputs and bullion – and as a result of escalating international crude oil prices. Second, net capital flows in April-December 2007 were 2.7 times those in April-December 2006 and 1.8 times of the net flows in the full year 2006-07. Gross capital inflows to India constituted 18 per cent of gross private capital flows to emerging and developing economies in 2007 reported by the IMF's WEO. Third, outward FDI has more than doubled, reflecting the growing global reach of the Indian corporate sector. Fourth, the level of reserves is currently the third largest stock of reserves among the EMEs but still lower than India's international liabilities at US $ 371 billion at book value at end-September 2007.

78. The global economic outlook has worsened since the Third Quarter Review of January 2008. Until October 2007, there appeared to have been reasonable confidence in the resilience of the world economy to cope with the freeze in US financial markets – world GDP growth was expected by the IMF to be 0.3 percentage points above its initial April 2007 forecast for 2007 but lower by 0.1 percentage points for 2008. Since January 2008, this confidence appears to have eroded rapidly. In April 2008, the IMF's forecast for 2008 has been lowered by 1.2 percentage points and by 1.1 percentage points for 2009 from the April 2007 projections. Risks of contagion from the financial turmoil are regarded as high with a 25 per cent probability of it spreading into a global recession – world real GDP growth of 3 per cent or less. According to the IMF, a one per cent reduction in US GDP growth leads to a 0.5 percentage points decline in growth in advanced European economies with a six month lag, and about a 0.75 percentage points decline in the growth of EMEs, taking into account the joint effect of a slowdown in the US and Europe. World trade is also expected to decelerate – by 1.2 percentage points by the IMF and by 1.0 percentage points by the World Trade Organisation – in 2008 reflecting the expectations of slower global growth.

79. Globally, inflation has risen considerably from its level a year ago in mature economies and EMEs alike. While the upsurge in inflation is reflected in varying degrees in consumer prices, both headline and core, the increase in producer prices on the back of commodity price pressures has been relatively higher reflecting the sharp increase in input costs. The resurgence of inflation risks worldwide from food and energy prices has also exacerbated the concerns about slowdown in activity in the context of compressed real disposable incomes and consumer purchasing power. Other factors imparting upside pressures to inflation are persistent strength in underlying demand, especially from EMEs, and low levels of inventories. Supply side pressures are expected to persist in the coming months with considerable uncertainties surrounding the evolution of key commodity prices and second order effects.

80. Growth forecasts for EMEs have been moderated in the face of the financial turbulence and the anticipated slowdown in the US economy. The underlying macroeconomic fundamentals of the EMEs remain resilient and the robust momentum of domestic demand in large emerging economies of Asia and Latin America could withstand a protracted weakening of growth in advanced economies. They, however, remain vulnerable to negative effects in terms of slower export growth and volatility in financial flows. Furthermore,

asset prices have declined and equity markets in EMEs seem coupled and volatile in tandem with US markets, indicating that some rebalancing is still underway. A key risk to the outlook for EMEs is rising food, energy and commodity prices that are already imparting inflationary pressures and raising concerns about impacting the momentum of growth in these economies. Several EMEs are increasingly having to deal with rising public intolerance to high food inflation which appears to be setting into a structural phenomenon due to more frequent crop failures than before and diversion of acreage for bio-fuels, supported in the US by fiscal subsidies. Moreover, the rising international commodity prices have impacted EMEs differently with commodity exporters benefiting from sizeable terms of trade gains while commodity importers have experienced wider trade deficits and higher domestic inflation. Finally, the recent monetary policy responses in the US have also heightened the uncertainties facing EMEs by widening interest rate differentials and increasing the costs of sterilisation, especially in a period when inflationary pressures warrant tightening. It is in the context of these concerns that EMEs have generally been reluctant to lower key policy rates in consonance with the US. Some EMEs have recently raised policy rates on domestic economy considerations while the majority have kept interest rates on hold.

81. The outlook for the global financial system is overcast by the rising incidence of losses and write-offs in banking systems in the US and Europe amidst dislocations in the securitised credit market. Banks are facing capital constraints, as credit/market risks associated with off-balance sheet investments have to be re-intermediated. Credit to housing is the worst affected. Banks in the US and Europe have reported a widespread tightening in credit standards. There are also growing uncertainties surrounding the viability of financial guarantors and doubts about their business models as well as the approach of rating agencies with potential systemic implications. Global financial markets have exhibited heightened uncertainty and bearish sentiment in the early months of 2008, exacerbated by weakening macroeconomic prospects. Credit markets continue to be seized up with spreads even on investment grade credits continuing to remain widened and those on sub-investment grade credits at prohibitive levels. Global equity markets dropped sharply in January 2008 and weakened again in March-April with volatility well above long-term averages. In the continuing turmoil, bond markets have re-emerged as safe havens. In the currency markets, the US dollar has been weakening against the backdrop of monetary policy actions, already undertaken and prospective.

82. In the overall assessment, there have been significant shifts in both global and domestic developments in relation to initial assessments. While global growth was expected to moderate in the Annual Policy Statement of April 2007, the outlook for the global economy deteriorated from the time of the Mid-Term Review of October, and sharply after the Third Quarter Review of January 2008. The dangers of global recession have increased at the current juncture although consensus expectations do not rule out a soft landing. Globally, inflationary pressures were evident in April 2007 in the elevated levels of commodity and asset prices. From January 2008, the upside pressures from international food and energy prices appear set to impart a degree of persistent upward pressure to inflation globally. At the end of July 2007, risks from financial markets had enhanced the vulne*rabi*lity of the global financial system, with amplified exchange rate fluctuations and large changes in the magnitude and direction of capital flows. There was growing uncertainty as to when, how and to what extent would the withdrawal of liquidity take place and impact economies like India. By January 2008, it was clear that the subprime mortgage crisis carries by far the gravest risks for the world economy. On the domestic front, the outlook remained positive up to January 2008, with indications of moderation in industrial production, service sector activity, business confidence and non-food credit, as anticipated. In the ensuing months, consensus assessment of the prospects for growth in the year ahead have been trimmed. Since January 2008, risks to inflation and inflation expectations from the upside pressures due to international food, crude and metal prices have become more potent and real than before. Volatile capital flows, large movements in the cash balances of the Government and consequent changes in liquidity conditions continue to complicate monetary management.

II. Stance of Monetary Policy for 2008-09

83. The Third Quarter Review of January 29, 2008 had noted with concern the unfolding of global developments and the responses of monetary authorities which seemed to provide an indication of the threat to growth and financial stability worldwide. Consequently, developments in global financial markets in the context of the subprime crisis warranted more intensified monitoring and swift responses with all available instruments to preserve and maintain domestic macroeconomic and financial stability. In addition, risks to inflation from high and volatile international prices of fuel, food and metal prices had intensified, complicating the task of monetary authorities in assuaging liquidity and solvency stress in financial markets and institutions. It was also indicated

that liquidity management will continue to assume priority in the conduct of monetary policy. In this context, financial markets continued to be under careful and continuous surveillance 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. Against this backdrop, it was emphasised that 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. Accordingly, the Third Quarter Review reaffirmed the stance of monetary policy set out in the Annual Policy Statement of April 2007 and subsequent Reviews of reinforcing 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. While credit quality continued to receive priority, credit delivery, in particular, for employment-intensive sectors was emphasised while pursuing financial inclusion. Reckoning global factors as becoming increasingly relevant even though domestic factors dominated the policy stance, the Third Quarter Review committed to monitor the evolving heightened global uncertainties and the domestic situation impinging on inflation expectations, financial stability and the growth momentum in order to respond swiftly with both conventional and unconventional measures, as appropriate.

84. It is observed that domestic financial markets have not been seriously impacted by the turbulence overseas, except for equity markets which have reflected the widespread risk aversion and the increase in uncertainty in the international financial environment. On the other hand, localised factors such as banks' balance sheet adjustments in the run-up to the year-end closure of accounts, advance tax flows and sizeable movements in Government cash balances produced large swings in market liquidity. Consequently, the LAF switched from an absorption mode up to mid-February into persistent daily injections during the rest of the month. In the first half of March, the LAF returned to moderate daily absorption, but switched into sizeable liquidity injections during March 17-31, as expected. In accordance with the priority assigned to liquidity management in the Third Quarter Review, MSS auctions were held in abeyance from mid-February 2008 in view of the tightening of liquidity conditions. Furthermore, in pursuance of the policy of active demand management of liquidity using all the policy instruments flexibly, including the option to conduct overnight or longer term repo/reverse repo under LAF, additional arrangements were instituted at the request of a number of banks

in view of the schedule of advance tax payments in mid-March 2008 and the subsequent bank holidays (March 20-22, 2008). As stated earlier, additional LAF operations on March 14, 17 and 31, 2008 were held to enable banks to manage year-end liquidity conditions. MSS auctions were resumed from April 9, 2008 in conjunction with LAF reverse repos to manage large surpluses in financial markets. These liquidity management operations have, by and large, smoothed market interest rates and enabled their orderly evolution. It is important to recognise, however, that the unwinding of the specific factors currently in evidence will have implications for the evolution of market liquidity in the period ahead in an environment of heightened uncertainty and volatility in global markets and the danger of potential spillovers to domestic equity and currency markets. Against this backdrop, liquidity management will continue to receive priority in the hierarchy of policy objectives, going forward. In particular, the volatility in capital flows and in cash balances of the Government will continue to necessitate active liquidity management with a combination of instruments as warranted.

85. Notwithstanding the moderation in industrial activity which was anticipated in the Mid-Term Review and the Third Quarter Review, the outlook for sustaining the underlying growth momentum appears to be reasonably well embedded into the medium-term. In the Third Quarter Review, it was indicated that while the moderation in private consumption expenditure merits consideration, a disaggregate analysis of supply and demand factors across select sectors would enable appropriate public policy responses. The recent measures announced in the Union Budget 2008-09 to *inter alia* raise personal disposable incomes and to reduce and rationalise excise duties reflects this approach. Institutional and procedural changes to improve credit delivery to productive sectors, especially those with relatively higher employment intensity, have been undertaken by the Reserve Bank. Going forward, the combination of these measures should provide a conducive environment for the revival of consumption demand. Investment demand is robust and likely to remain the driving force of overall economic activity, powered by rising domestic saving, ongoing improvement in productivity and the actualisation of the sizeable expansion of supply capabilities that has been underway since 2003-04. At the same time, it is important to recognise that the threats to growth and stability from global developments have increased considerably with highly uncertain likelihood of early resolution. Besides the dangers surrounding the unfolding of events in international financial markets referred to earlier, potential inflationary pressures from international food and energy prices appear to have

amplified and, by current indications, are likely to remain so for some time. Furthermore, there is now much higher probability of a global economic and credit slowdown than was anticipated till recently.

86. Initial forecasts predict a near-normal rainfall at 99 per cent of the long period average for the country as a whole in the 2008 south-west monsoon season, auguring well for the sustenance of trend growth in agriculture. The expected decline in world GDP growth in 2008 in relation to the preceding year could temper the prospects of growth in the industrial and service sectors at the margin although the underlying momentum of expansion in these sectors is likely to be maintained. In view of these factors, overall, for policy purposes, real GDP growth in 2008-09 may be placed in the range of 8.0 to 8.5 per cent, assuming that (a) global financial and commodity markets and real economy will be broadly aligned with the central scenario as currently assessed and (b) domestically, normal monsoon conditions prevail.

87. In view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of new adversities emanating in the domestic or global economy, the policy endeavour would be to bring down inflation from the current high level of above 7.0 per cent to around 5.5 per cent in 2008-09 with a preference for bringing it as close to 5.0 per cent as soon as possible, recognising the evolving complexities in globally transmitted inflation. The resolve, going forward, would continue to be to condition policy and perceptions for inflation 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 and with the goal of maintaining self-accelerating growth over the medium-term.

88. Money supply has risen above indicative projections persistently through 2005-07 on the back of sizeable accretions to the Reserve Bank's foreign exchange assets and a cyclical acceleration in credit and deposit growth, particularly the latter, in 2007-08. In view of the resulting monetary overhang, it is necessary to moderate monetary expansion and plan for a rate of money supply in the range of 16.5-17.0 per cent in 2008-09 in consonance with the outlook on growth and inflation so as to ensure macroeconomic and financial stability in the period ahead. Consistent with the projections of money supply, the growth in aggregate deposits in 2008-09 is placed at around 17.0 per cent

or around Rs.5,50,000 crore. Based on an overall assessment of the sources of funding and the overall credit requirements of the various productive sectors of the economy, the growth of non-food credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper (CP) is placed at around 20.0 per cent in 2008-09 consistent with the monetary projections.

89. The escalated levels of international food and crude prices carry some pressures for the external sector. On the whole, it is prudent to assume for policy purposes a continued strong and sustainable external sector though with a marginally higher order of overall trade and current account deficits in 2008-09 than in the preceding year. It is likely that net capital flows would comfortably meet the external financing requirements in 2008-09.

90. The Union Budget for 2008-09 has placed the GFD at 2.5 per cent of GDP for 2008-09, down from 3.1 per cent in the revised estimates for 2007-08 and within the FRBM target. The revenue deficit has been placed at 1.0 per cent of GDP in 2008-09, rescheduled from the target on account of enhanced allocations for the social sector. The net market borrowing programme of the Centre for 2008-09 is budgeted at Rs.99,000 crore as against Rs.1,10,727 crore in the previous year. The moderate reduction in the size of the Government borrowing programme is consistent with the path of the GFD envisaged in the FRBM.

91. Fiscal developments, especially on account of evolving expenditure commitments related to the implementation of the farm debt waiver scheme, the recommendations of the Sixth Pay Commission, issuance of Government bonds to oil and fertiliser companies to cover their under-recoveries/subsidy need to be continuously monitored in view of the prevailing conditions characterised by high and volatile global food prices and the incomplete pass-through of the escalation of international crude prices to prices of domestic petroleum products.

92. The heightened uncertainty surrounding global financial markets and the unusual policy responses of major central banks provides some indications of the threats to global growth and stability that loom over the near-term horizon. High volatility, still frozen credit markets and massive losses suffered by large financial institutions could impact India's external financing conditions – trade, capital flows and asset prices – and, therefore, the evolving monetary policy stance in 2008-09. While India's foreign trade is well-diversified and the reliance

on external finance has averaged around one per cent of GDP, domestic activity and sentiment cannot remain immune to these developments. The major source of the direct impact is through the financial flows, in particular, in the equity markets and, consequently, on the foreign exchange market in India.

93. Recent global developments have considerably heightened the uncertainty surrounding the outlook on capital flows to India, complicating the conduct of monetary and liquidity management. In view of the strong fundamentals of the economy and massive injections of liquidity by central banks in advanced economies, there could be sustained inflows, as in the recent past. If the pressures intensify, it may necessitate stepped up operations in terms of capital account management and more active liquidity management with all instruments at the command of the Reserve Bank. At the same time, it is necessary in the context of recent global events not to exclude the possibility of reversals of capital flows due to any abrupt changes in sentiments or global liquidity conditions. In this scenario, it is important to be ready to deal with potentially large and volatile outflows along with spillovers. In this context, there is headroom with the Reserve Bank to deal with both scenarios in terms of the flexibility in the deployment of instruments such as the MSS, the CRR, the SLR and the LAF for active liquidity management in both directions, complemented by prudential regulations and instruments for capital account management.

94. In assessing the prospects for the global economy in 2008-09, it is useful to recognise the anticipated global slowdown and heightened uncertainties in addition to mounting inflationary pressures. Whether the slowdown would have a moderating effect on inflationary pressures or whether the global economy would slip into stagflation is not yet clear. Inflationary pressures seem common to the global and our domestic economy with some elements of contagion. Overall, uncertainties in regard to the Indian economy, however, appear less relative to those in the global economy and moderation in growth rather than a significant slowdown appears likely in the case of India. In regard to the interaction between global and national economies, some early signs of revival of protectionism are seen globally, especially in regard to food and fuel policies. This makes the assessment of impact of the global economy on India, particularly in regard to inflation and capital flows, extremely difficult. However, domestic factors will continue to dominate the policy setting, with a contextual emphasis on inflation expectations while recognising the significance of maintaining hard-earned gains in terms of both outcomes of and positive sentiments on India's growth momentum.

95. In brief, given the unprecedented complexities involved and the heightened uncertainties at this juncture, there are some key factors that govern the setting of the stance of monetary policy for 2008-09. First, there is the immediate challenge of escalated and volatile food and energy prices which possibly contain some structural components. It is necessary, however, to recognise that there are also cyclical components in their evolution. Second, while demand pressures persist, there has been some improvement in the domestic supply response alongside a build-up of additional capacities, enabled by a conducive policy environment. Accordingly, even as investment demand remains strong, supply elasticities can be expected to improve further and new capacities should come on stream in the months ahead. Third, monetary policy has lagged and cumulative effects as demonstrated in the positive outcomes relating to growth and stability at the current juncture, barring recent episodes of external shocks. Calibrated monetary policy actions undertaken since September 2004 thus continue to have some stabilising influence on the economy. Further, the very recent initiatives in regard to supply-management by the Government of India and measures relating to the cash reserve ratio by the Reserve Bank are in the process of impacting the economy, while a more reliable assessment of crop prospects is underway. Fourth, critical to the setting of monetary policy is the importance of anchoring expectations relating to both global and domestic developments. Accordingly, policy responses for managing expectations should consider the evolving global and domestic uncertainties surrounding the slowing down of global output growth and also the potential for exaggerated bearishness in the Indian context. Fifth, while monetary policy has to respond proactively to immediate concerns, it cannot afford to ignore considerations over a relatively longer term perspective of, say, one to two years, with respect to overall macroeconomic prospects. At the same time, it is critical at this juncture to demonstrate on a continuing basis a determination to act decisively, effectively and swiftly to curb any signs of adverse developments in regard to inflation expectations. In view of the above unprecedented uncertainties and dilemmas, it is important to take informed judgements with regard to the timing and magnitude of policy actions; and such judgements need to have the benefit of evaluation of incoming information on a continuous basis.

96. 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.

97. In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy, assuming that capital flows are effectively managed, and keeping in view the current assessment of the economy including the outlook for growth and inflation, the overall stance of monetary policy in 2008-09 will broadly be:

- To ensure a monetary and interest rate environment that accords high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to continuation of the growth momentum.

- To respond swiftly on a continuing basis to the evolving constellation of adverse international developments and to the domestic situation impinging on inflation expectations, financial stability and growth momentum, with both conventional and unconventional measures, as appropriate.

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

III. Monetary Measures

(a) Bank Rate

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

(b) Repo Rate/Reverse Repo Rate

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

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

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

102. 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

103. Scheduled banks are required to maintain cash reserve ratio (CRR) of 7.75 per cent with effect from the fortnight beginning April 26, 2008 and 8.0 per cent with effect from the fortnight beginning May 10, 2008 as announced on April 17, 2008. On a review of the evolving liquidity situation, it is considered desirable to increase the CRR by 25 basis points to 8.25 per cent with effect from the fortnight beginning May 24, 2008.

First Quarter Review

104. The First Quarter Review of this part of the Annual Policy Statement for the year 2008-09 will be announced on July 29, 2008.

Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2008-09

105. The Annual Statement of April 2007 and subsequently the Mid-Term Review of October 2007 set the stance of developmental and regulatory policies for the year 2007-08 in terms of emphasis on credit quality, orderly conditions in financial markets, greater credit penetration and financial inclusion. In the Third Quarter Review of January 2008, heightened vigilance in the context of potential spillovers from the global financial turbulence was accorded priority, along with preparedness for swift responses to ensure financial stability. During 2007-08, development of the financial market infrastructure, liberalisation of foreign exchange transactions, strengthening risk management in banks and supervisory processes in response to financial innovations engaged the Reserve Bank, alongside the refinement of credit delivery mechanisms with specific focus on agriculture, micro, small and medium enterprises and financial inclusion.

106. The setting of developmental and regulatory policies for 2008-09 will continue to focus on developing a sound, efficient and vibrant financial system that ensures the efficient provision of financial services to the widest sections of society. In the context of recent financial developments internationally, the securing and maintenance of financial stability will continue to receive priority from a policy perspective. Credible communication, adequate and timely availability of information and a broad-based, participative and consultative approach in the conduct of its developmental and regulatory policies with involvement of all stakeholders would shape the Reserve Bank's responses to the emerging challenges.

107. Recent financial developments have brought to the fore several issues that carry implications for the health of the financial sector. First, there is close scrutiny of the business strategies of banks and financial institutions which are based on the model of 'originate and distribute'. Second, issues relating to securitisation are being debated in the context of incentive structures that provide for economising on capital requirements and enhancement of off-balance sheet exposures relative to considerations of financial soundness. Third, recent events have also underscored the need for enhanced market transparency relating to disclosures of off-balance sheet exposures, particularly with regard to liquidity commitments to conduits, valuations regarding structured credit products and the like. Fourth, the apparent inadequacy of financial institutions'

capital cushions has been exposed. In this context, the role of sovereign wealth funds as providers of capital is being carefully assessed by supervisory authorities across the world. Fifth, the sharp repricing of risk that began in the middle of 2007 has raised issues relating to the marking to market of portfolios of financial institutions and attendant issues relating to capital provision. Sixth, there are concerns that existing risk pricing and management tools and techniques employed in banks and financial institutions are inadequate in relation to the evolving risks. Seventh, there is a progressive blurring of the boundaries between liquidity and solvency stress in situations of generalised uncertainty and loss of confidence among financial entities. Eighth, the role of structured investment vehicles (SIVs), the potential liquidity demands that could crystallise on balance sheets and the degree of leverage embedded in the global financial system has been largely underestimated with implications for the soundness and efficiency of the financial sector. Ninth, the functioning of the credit rating agencies and excessive reliance of institutional investors on the ratings are under scrutiny.

108. Against this backdrop, several measures have been suggested for mitigating the impact and improving the global financial system. According to the Institute of International Finance (IIF), banks should commit themselves to follow best practices in a number of areas where the financial crisis has revealed weaknesses. 'Best practice' should not imply legal obligations but high standards for entities to develop their own tailor-made solutions. The proposals made by the Financial Stability Forum (FSF) [a forum of select senior representatives of national financial authorities – including central banks, supervisory authorities and treasury departments – international financial institutions, international regulatory and supervisory groupings and committees of central bank experts] and ratified in early April 2008 by the G-7 to be implemented over the next 100 days are comprehensive and cover full and prompt disclosure of risk exposures, write downs and fair value estimates for complex and illiquid instruments; urgent action by setters of accounting standards and other relevant standard setters to improve accounting and disclosure standards for off-balance sheet or entities and to enhance guidance on fair value accounting, particularly on valuing financial instruments in periods of stress; strengthening of risk management practices, supported by supervisors' oversight, including rigorous stress testing; and strengthening of capital positions as needed. In addition, proposals made by the FSF for implementation by end-2008 include: strengthening prudential oversight of capital, liquidity, and risk management under Basel II, especially for

complex structured credit instruments and off-balance sheet vehicles; enhancing transparency and valuation for off-balance sheet entities, securitisation exposures, and liquidity commitments under the Basel Committee's guidance; enhancing due diligence in the use of ratings; adherence by credit rating agencies to the revised code of conduct of the International Organisation of Securities Commissions (IOSCO); strengthening the authorities' responsiveness to risk through cooperation and exchange of information so as to act swiftly to investigate and penalise fraud, market abuse, and manipulation; implementing robust arrangements for dealing with stress in the financial system such as liquidity support from the central banks; and, strengthening arrangements for dealing with weak and failing banks, domestically and cross border. It may be noted that the International Monetary and Financial Committee (IMFC) has welcomed the above policy recommendation of FSF [The IMFC is a Committee of select Board of Governors of the IMF of which the Finance Minister, Shri P. Chidambaram is a member].

109. In the light of the current macroeconomic environment and global developments as discussed in Part I of the Statement, the Annual Statement on Developmental and Regulatory Policies focuses on certain key areas: new financial instruments, carrying forward development of various segments of financial markets and strengthening financial market infrastructure; developing a safe, secure and integrated real time payment and settlement system; further liberalisation of foreign exchange transactions; cross-border supervision, risk-based supervision and bank-led financial conglomerates; strengthening the supervisory framework as appropriate to evolving requirements; enhancing public confidence and consolidation in urban cooperative banks (UCBs) and regional rural banks (RRBs); improved credit delivery mechanisms and conducive credit culture, customer service and financial inclusion.

110. The Annual Statement on Developmental and Regulatory Policies for the year 2008-09 is divided into four sections. I. Financial Markets; II. Credit Delivery Mechanism and Other Banking Services; III. Prudential Measures; and IV. Institutional Developments.

I. Financial Markets

Government Securities Market

111. The Reserve Bank has taken significant steps to further broaden and deepen the Government securities market in consultation with market participants. In this direction, the following initiatives are proposed:

(a) Central Government Securities

(i) Floating Rate Bonds: Status

112. The Mid-Term Review of October 2007 had indicated that a new issuance structure for floating rate bonds (FRBs) is being built into the Negotiated Dealing System (NDS) auction format being developed by the Clearing Corporation of India Limited (CCIL) to simplify the methodology for pricing of FRBs in the secondary market. The CCIL is currently developing the primary auction module for the dated Government securities which would cover all types of instruments, including FRBs. The issuance of FRBs would be considered at an appropriate time, taking into account the market conditions.

(ii) Ways and Means Advances to the Government of India: Status

113. The Reserve Bank, in consultation with the Government of India, has retained the extant arrangements for the Ways and Means Advances (WMA) for the fiscal year 2008-09. As per the arrangements, the WMA limits would continue to be fixed on a half-yearly basis and are placed at Rs.20,000 crore for the first half and Rs.6,000 crore for the second half of 2008-09. The applicable interest rate on WMAs and overdrafts would continue to be linked to the repo rate, as hitherto. The Reserve Bank, however, retains the flexibility to revise the limits in consultation with the Government of India, taking into consideration the prevailing circumstances.

(iii) Auction Process of Government of India Securities

114. An Internal Working Group (Chairman: Shri H.R. Khan) was constituted to review the auction procedure for the Government securities and make suggestions to reduce the time taken for completion of the auction process with a view to improving efficiency on par with the best international practices. Some of the important recommendations made by the Working Group include: reduction in the time gap between bid submission and declaration of auction results; withdrawal of the facility of bidding in physical form; submission time for the non-competitive bids to be de-linked from that of competitive bids; competitive bids to be submitted only through the Negotiated Dealing System (NDS); and designing of a secured web system facilitating direct participation of non-NDS members in the auctions of Government securities. The modalities for implementing the recommendations of the Working Group are being worked out.

(iv) Restructuring of Primary Dealers' Activities: Status

115. Primary Dealers (PDs) were permitted in July 2006 to manage risks inherent in their business by diversifying into other business lines, *i.e.,* corporate debt, money market, equity and securitisation instruments, subject to certain prudential limits, while retaining the requirement of predominance of Government securities business. They were also allowed to offer certain fee-based services. PDs, however, are not permitted to set up step-down subsidiaries in order to ensure that the balance sheets of the PDs do not get affected by the spillover of risks from other businesses/subsidiaries and that the regulation of PDs is focused on their primary dealership activities. In compliance with the guidelines, all the nine standalone PDs have restructured their operations for undertaking permissible activities.

(v) The Government Securities Act, 2006: Status

116. The Government Securities (GS) Act, 2006 was passed and was published in the Gazette of India on August 31, 2006 for general information. The Government Securities Regulations, 2007 were framed by the Reserve Bank in terms of Section 32(1) of the GS Act, which came into force from December 1, 2007. The main features of the Regulations include investor friendly automatic redemption facility, *i.e.,* no physical discharge is required if the investors submit bank account details for receiving redemption proceeds of Government security held in the form of bond ledger account (BLA), subsidiary general ledger (SGL) or stock certificate; facility of pledge, hypothecation or lien of Government security; simplified procedure for recognition of title to a Government security of a deceased holder; nomination facility for stock certificate and BLAs; simplified procedure for issue of duplicate Government promissory note; and simplified procedure for making vesting order. For better customer service, it is proposed to widely disseminate these investor friendly features of the regulations through media publicity and the website of the Reserve Bank by way of easy to understand material and frequently asked questions (FAQs).

(b) Debt Management for State Governments

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

117. The Mid-Term Review of October 2007 indicated that a scheme for non-competitive bidding facility in the auctions of State Development Loans

(SDLs) was incorporated in the Revised General Notification issued by all State Governments on July 20, 2007 with a view to widening the investor base and enhancing the liquidity of SDLs. The business requirement specification relating to this scheme has been incorporated in the dated securities auction module of the NDS auction which is being developed by the CCIL. The module is expected to become functional by September 2008.

(ii) Ways and Means Advances Limits of the States: Status

118. On a review of the State-wise limits of normal WMA for the year 2007-08, the Reserve Bank has kept these limits unchanged for the year 2008-09. Accordingly, the aggregate normal WMA limit for State Governments is placed at Rs.9,925 crore, including the WMA limit of Rs.50 crore for the Government of the Union Territory of Puducherry. Other terms and conditions of the Scheme remain unchanged.

(c) Development of Market Infrastructure

(i) Introduction of Interest Rate Futures

119. A Working Group on Interest Rate Futures (Chairman: Shri V.K. Sharma) was constituted to review the experience gained with interest rate futures since its introduction in India in June 2003 with particular reference to product design issues. The recommendations of the Group were presented to the Technical Advisory Committee (TAC) for Money, Foreign Exchange and Government Securities Markets and their suggestions/views were taken into consideration in the Group's report which has been placed on the Reserve Bank's website on March 3, 2008 for comments/suggestions. Action on the recommendations of the report would be initiated on the basis of the feedback received.

(ii) Separate Trading for Registered Interest and Principal of Securities

120. A Working Group (Chairman: Shri M.R. Ramesh) comprising banks and market participants was constituted to suggest guidelines in order to operationalise Separate Trading for Registered Interest and Principal of Securities (STRIPS) in Government securities. The Working Group submitted its report which was placed on the Reserve Bank's website for wider dissemination. An implementation group also examined the issue of operationalisation of STRIPS. With the enactment of the Government Securities Act, 2006 effective from December 1, 2007, it is proposed to introduce STRIPS

in Government securities by the end of 2008-09. The activity of stripping/ reconstitution of securities would be carried out on the Public Debt Office (PDO)-NDS platform.

(iii) Multi-modal Settlement

121. A new settlement mechanism in Government securities through settlement banks is being formulated in order to facilitate direct access of NDS and NDS-OM participants who do not maintain current accounts but maintain SGL accounts with the Reserve Bank. This new system would facilitate phasing out of current accounts of non-banks and non-PD entities with the Reserve Bank. The CCIL has developed the required software changes and has also entered into arrangements with three banks to function as settlement banks for the present. The new arrangement is expected to be operationalised in May 2008.

(iv) NDS-OM: Extension of Access through the CSGL Route

122. Access to the order matching segment on NDS (NDS-OM), which was launched in August 2005, was initially allowed to commercial banks and primary dealers and later to other NDS members such as insurance companies, mutual funds and large provident funds for their proprietary deals. Access to NDS-OM was extended to other entities maintaining gilt accounts with NDS members, *i.e.,* banks and PDs through the Constituents' Subsidiary General Ledger (CSGL) route from May 2007. Initially, permission was accorded to deposit-taking NBFCs, provident funds, pension funds, mutual funds, insurance companies, cooperative banks, RRBs and trusts. With effect from November 2007, the facility has also been extended to the systemically important non-deposit taking NBFCs (NBFCs-ND-SI). These entities can place orders on NDS-OM through direct NDS-OM members, *i.e.,* banks and PDs, using the CSGL route. Such trades are settled through the CSGL account and current account of the NDS-OM members.

123. Certain segments of investors such as other non-deposit taking NBFCs, corporates and FIIs do not have access to NDS-OM through the CSGL route. In the light of requests received, it is proposed:

- to allow these participants also to access the NDS-OM through the CSGL route.

(v) Clearing and Settlement of OTC Rupee Interest Rate Derivatives

124. It was announced in the Annual Policy Statement of May 2004 that a clearing and settlement arrangement through the CCIL was being considered to strengthen the over-the-counter (OTC) derivatives market and mitigate the risks involved. With some of the underlying issues having been addressed with the enactment of the Payment and Settlement Systems Act, 2007 a clearing and settlement arrangement for OTC rupee derivatives is proposed to be put in place. The modalities for operationalising the clearing and settlement system for the OTC rupee interest rate derivatives would be worked out in consultation with the CCIL.

(d) Repo in Corporate Bonds

125. Most of the recommendations of the High Level Committee on Corporate Bonds and Securitisation (Chairman: Dr. R.H. Patil) have been taken up for implementation. The Union Budget, 2008-09 has abolished tax deduction at source (TDS) on corporate bonds. The trading platforms started by the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) have now been in operation since July 2007. The Fixed Income Money Market and Derivatives Association of India (FIMMDA) trade reporting platform for capturing the OTC trade data has also been operational since September 2007.

126. These initiatives will ensure development of a healthy secondary market once there is adequate incentive for more public issuances and listing. The Securities and Exchange Board of India (SEBI) is in the process of simplification of the issuance procedures and rationalisation of the listing norms for corporate bonds.

127. As indicated in the Mid-Term Review of October 2007, introduction of repo in corporate bonds would be considered once the prerequisites *viz.,* efficient price discovery through greater public issuances and secondary market trading, and an efficient and safe settlement system based on Delivery versus Payment (DvP) III and Straight Through Processing (STP) are met.

Foreign Exchange Market

128. Measures towards further liberalisation and improvement of foreign exchange facilities are set out below.

(a) Expansion of Hedging Facilities

129. With a view to facilitating domestic crude oil refining companies to hedge their commodity price risk exposures, it is proposed to:

- permit domestic crude oil refining companies to hedge their commodity price risk on domestic purchase of crude oil and sale of petroleum products on the basis of underlying contracts which are linked to international prices on overseas exchanges/markets.

- permit domestic crude oil refining companies to hedge their commodity price risk on crude oil imports in overseas exchanges/ markets on the basis of their past performance up to 50 per cent of the volume of actual imports during the previous year or 50 per cent of the average volume of imports during the previous three financial yeas, whichever is higher. The companies will have to ensure regularisation of the contracts booked under this facility by production of supporting import orders during the currency of the hedge.

(b) Introduction of Currency Futures

130. The draft report of the Internal Working Group on Introduction of Currency Futures in India (Chairman: Shri Salim Gangadharan) was placed on the Reserve Bank's website on November 16, 2007. The comments received from the public, banks, market participants, academicians and the Government of India were discussed in the meetings of the TAC on Money, Foreign Exchange and Government Securities Markets. Taking into account the feedback and expert views of the TAC, the report has been finalised and has been placed on the Reserve Bank's website on April 28, 2008. An RBI-SEBI Standing Technical Committee has been set up to advise on operational aspects in regard to trading of currency futures on exchanges. In consultation with the SEBI, it has been decided that currency futures will be introduced in the eligible exchanges and the broad framework is expected to be finalised by the end of May 2008.

(c) Overseas Direct Investment

131. With a view to further liberalising the policy on overseas investment, it is proposed:

- to allow Indian companies to invest overseas in energy and natural resources sectors such as oil, gas, coal and mineral ores in excess of the current limits with the prior approval of the Reserve Bank.

(d) Capitalisation of Export Proceeds

132. In order to rationalise the policy on capitalisation of outstanding exports and to align it with the export-import policy, it is proposed that:

- Indian parties may now approach the Reserve Bank for capitalisation of export proceeds for exports outstanding beyond the prescribed period of realisation.

(e) Liberalisation of Settlement of Claims Relating to Export Bills

133. In order to liberalise further the procedures relating to settlement of claims in respect of export bills, it is proposed to permit authorised dealer (AD) banks to write off, in addition to claims settled by the Export Credit Guarantee Corporation of India (ECGC), the outstanding export bills settled by other insurance companies which are regulated by the Insurance Regulatory Development Authority (IRDA). Accordingly, AD banks shall henceforth, on an application received from the exporter, supported by documentary evidence from the ECGC/insurance companies confirming that the claim in respect of the outstanding bills has been settled and that the export incentives, if any, have been surrendered, write off the relative export bills.

(f) Liberalisation of the Period for Realisation and Repatriation of Export Proceeds

134. At present, exporters are required to realise and repatriate to India the full export value of goods or software exported within six months from the date of export. Exporters who have been certified as `Status Holder' in terms of Foreign Trade Policy, 100 per cent Export-Oriented Units (EOUs) and units set up under Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Biotechnology Parks (BTPs) Schemes are permitted to realise and repatriate the full value of export proceeds within a period of 12 months from the date of export. Where the goods or software are exported by the units in the Special Economic Zones (SEZs), the stipulation of the period of realisation and repatriation to India of the full export value of goods or software is not applicable. Requests have been received to extend

the period of realisation of exports proceeds in view of the external environment. It is, therefore, proposed in consultation with the Government of India:

- to enhance the present period for realisation and repatriation to India of the full export value of goods or software exported from six months to twelve months from the date of export, subject to review after one year.

II. Credit Delivery Mechanisms and Other Banking Services

(a) Augmenting RRBs' Funds for Lending to Agriculture and Allied Activities

135. With a view to augmenting RRBs' funds/resource base, commercial banks/sponsor banks have been allowed to classify loans granted to RRBs for on-lending to agriculture and allied activities as indirect finance to agriculture in their books.

(b) Weaker Sections' Lending Target: Ensuring Adherence

136. In terms of the revised guidelines on lending to priority sector effective from April 30, 2007 domestic SCBs are required to lend 40 per cent of adjusted net bank credit (net bank credit plus investments made by banks in non-SLR bonds held in the held to maturity category) or credit equivalent of off-balance sheet exposures, whichever is higher, to the priority sector. These SCBs are also required to lend at least 18 per cent to the agriculture sector and 10 per cent to weaker sections covering small and marginal farmers with land holding of five acres and less; landless labourers, tenant farmers and share croppers; artisans, village and cottage industries where individual credit limits do not exceed Rs. 50,000; beneficiaries of Swarnjayanti Gram Swarozgar Yojana (SGSY), Swarna Jayanti Shahari Rozgar Yojana (SJSRY), the Scheme for Liberation and Rehabilitation of Scavengers (SLRS) and the Differential Rate of Interest (DRI) scheme; scheduled castes and scheduled tribes; self-help groups (SHGs); and distressed poor who have to prepay their debt to the informal sector against appropriate collateral or group security. It has been observed that banks have not been achieving the sub-target of 10 per cent for lending to weaker sections. At present, domestic SCBs having shortfall in the

priority sector lending target and/or the agriculture sub-target are allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) maintained with the National Bank for Agriculture and Rural Development (NABARD). It is, therefore, proposed:

- to take into account shortfall in lending to weaker sections also for the purpose of allocating amounts to the domestic SCBs for contribution to RIDF or funds with other financial institutions as specified by the Reserve Bank, with effect from April 2009.

(c) Increasing Opportunities for Flow of Credit to Priority Sectors

137. In terms of the revised guidelines on lending to the priority sector, SCBs can undertake outright purchase of any loan asset eligible to be categorised under the priority sector from other banks and financial institutions and classify the same under the respective categories of priority sector lending (direct or indirect), provided the loans purchased are held at least for a period of six months. To enable greater flow of credit to the priority sectors, it is proposed:

- to allow RRBs to sell loan assets held by them under priority sector categories in excess of the prescribed priority sector lending target of 60 per cent.

(d) Simplification of Lending Procedures for Crop Loans

138. The Working Group (Chairman: Shri C.P.Swarnkar) appointed by the Reserve Bank and the Committee on Agricultural Indebtedness (Chairman: Dr.R.Radhakrishna) appointed by the Government of India made several recommendations to address credit constraints faced by farmers, including the issue of availability of cash throughout the year for agricultural operations. The report of the Internal Working Group (Chairman: Shri V.S.Das), set up by the Reserve Bank to examine the recommendations of the Radhakrishna Committee, has been placed on the Reserve Bank's website for wider consultation.

139. While action on the recommendation of the Radhakrishna Committee will be finalised based on comments/responses received, it is proposed:

- to ask each domestic commercial bank, including RRBs, to select one district for introduction, on a pilot basis, of a simplified cyclical credit product for farmers to enable them to continuously utilise a core component of 20 per cent of the credit limit. This arrangement should ensure minimum year-round liquidity as long as the interest is serviced.

- to introduce a simplified procedure for crop loans to landless labourers, share croppers, tenant farmers and oral lessees whereby banks can accept an affidavit giving details of land tilled/crops grown by such persons for loans up to Rs.50,000 without any need for independent certification. Banks could also encourage the Joint Liability Group (JLG)/SHG mode of lending for such persons.

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

140. The National Commission for Enterprises in the Unorganised Sector (Chairman: Dr. Arjun K. Sengupta) had submitted to the Central Government a report on 'Conditions of Work and Promotion of Livelihood in the Unorganised Sector' which had suggested a package of measures for addressing some critical issues relating to farm and non-farm sectors. The report of the Internal Working Group constituted within the Reserve Bank to study the recommendations of the National Commission that are relevant to the financial system and to suggest an appropriate action plan would be placed on the Reserve Bank's website by May 15, 2008.

(f) Banking Code for Micro and Small Enterprises

141. In collaboration with the Indian Banks' Association (IBA), the Banking Codes and Standards Board of India (BSCBI) is evolving a banking code for small and micro enterprises which will go a long way in empowering the sector.

(g) Working Group on Rehabilitation/Nursing of Potentially Viable Sick SME Units

142. As indicated in the Mid-Term Review of October 2007, a Working Group (Chairman: Dr.K.C.Chakraborty) was constituted with representatives from banks and the Small Industries Development Bank of India (SIDBI) to examine the feasibility of SMEs bringing in additional capital through alternative routes such as equity participation and venture financing and to suggest remedial measures for those potentially viable sick units that can be rehabilitated at the earliest. The report of the Group has been placed on the Reserve Bank's website for wider dissemination/response.

(h) Strengthening Regional Rural Banks and Enhancement of their Operational Efficiency: Status

143. As indicated in the Mid-Term Review of October 2007, a Working Group (Chairman: Shri G.Srinivasan) has been constituted with representatives from the NABARD, sponsor banks and RRBs in order to prepare RRBs to adopt appropriate technology and migrate to core banking solutions for better performance and improved customer services. The Group is expected to submit its report by June 30, 2008.

144. The Task Force for Improving the Operational Efficiency of RRBs (Chairman: Dr.K.G.Karmakar), set up in 2006, had submitted its report to the Reserve Bank in February 2007. While some action points have been referred to the Government of India, action has already been taken on accepted recommendations and the remaining are under examination.

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

145. Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof.A.Vaidyanathan) and in consultation with State Governments, the Government of India had approved a package for revival of the short-term rural cooperative credit structure. So far, 20 States (Andhra Pradesh, Arunachal Pradesh, Bihar, Chhattisgarh, Gujarat, Haryana, Jammu and Kashmir, Karnataka, Madhya Pradesh, Maharashtra, Meghalaya, Nagaland, Orissa, Punjab, Rajasthan, Tamilnadu, Tripura, Uttarkhand, Uttar Pradesh and West Bengal) have executed Memoranda of Understanding (MoUs) with the Government of India and the NABARD, as envisaged under the package. Seven States have made necessary amendments in their Cooperative Societies Acts. An aggregate amount of Rs.3,325.12 crore has been released by the NABARD as the Government of India's share and State Governments have released their shares to the tune of Rs.333.93 crore to seven States for recapitalisation assistance of Primary Agricultural Credit Societies (PACS).

146. Implementation and monitoring of the revival package are being overseen by the National Implementing and Monitoring Committee (NIMC) set up by the Government of India. Furthermore, a study of the long-term cooperative credit structure was entrusted to the Task Force by the Government of India, which had submitted its report in August 2006. It was announced in

the Union Budget 2008-09 that the Central Government and the State Governments have reached an agreement on the content of the package for revival of the long-term cooperative credit structure. The cost of the package is estimated at Rs.3,074 crore, of which the Central Government's share will be Rs.2,642 crore.

(j) Micro-finance: Status

147. The SHG-bank linkage programme has emerged as the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and cooperative banks. As on March 31, 2007, 28.94 lakh SHGs had outstanding bank loans of Rs.12,366.49 crore. While commercial banks accounted for 70.8 per cent of the outstanding loans, RRBs and cooperative banks accounted for 22.7 per cent and 6.5 per cent, respectively.

148. Out of 290 banks reporting data on recovery to the NABARD as on March 31, 2007, 73 per cent of banks had more than 80 per cent recovery on loans given to SHGs.

(k) Financial Inclusion

(i) Pilot Project of State Level Bankers' Committees (SLBCs) for 100 per cent Financial Inclusion

149. So far, 277 districts have been identified for 100 per cent financial inclusion and the target has been achieved in 134 districts in 18 States and five Union Territories. Notably, all districts of Haryana, Himachal Pradesh, Karnataka, Kerala, Uttarakhand, Puducherry, Daman and Diu, Dadra & Nagar Haveli and Lakshadweep have achieved 100 per cent financial inclusion. An evaluation of the progress made in achieving 100 per cent financial inclusion in these districts is being undertaken to draw lessons for further action in this regard.

(ii) General Purpose Credit Cards and Overdrafts Against 'No-frills' Account as Indirect Finance to Agriculture Under Priority Sector

150. With a view to providing credit card like facilities in rural areas with limited point-of-sale (POS) and limited automated teller machine (ATM) facilities, all SCBs, including RRBs, were advised in December 2005 to introduce a General Credit Card (GCC) Scheme for their constituents in rural

and semi-urban areas, based on the assessment of income and cash flow of the household similar to that prevailing under normal credit cards. Banks also provide a small overdraft facility against basic banking 'no-frills' accounts. At present, 50 per cent of the credit outstanding under GCC is allowed to be classified as indirect finance to agriculture under the priority sector. It is proposed:

- to permit banks to classify 100 per cent of the credit outstanding under GCC and overdrafts up to Rs.25,000 against 'no-frills' accounts in rural and semi-urban areas as indirect finance to agriculture under the priority sector.

(iii) Working Groups on Improvement of Banking Services in Lakshadweep, Himachal Pradesh and Jharkhand

151. As indicated in the Mid-Term Review of October 2007, Working Groups were constituted to undertake studies of banking services in the Union Territory of Lakshadweep and States of Himachal Pradesh and Jharkhand. The Working Groups have submitted their reports and their recommendations have been forwarded to the respective agencies through regional offices of the Reserve Bank for implementation.

(iv) Differential Rate of Interest (DRI) Scheme: Eligibility Limits Raised

152. The limit of loans under the DRI Scheme was raised from Rs.6,500 to Rs.15,000 and that of housing loans under the Scheme from Rs.5,000 to Rs.20,000 per beneficiary, on the basis of the announcements made in the Union Budget for 2007-08. Consequent upon the announcement made in the Union Budget for 2008-09 the borrower's eligibility criterion in terms of annual family income has been raised to Rs.18,000 in rural areas and Rs.24,000 in urban areas.

(v) Concept Paper on Financial Literacy and Counselling Centres

153. The Mid-Term Review of October 2007 had indicated that a concept paper on Financial Literacy and Counselling Centres would be prepared and placed on the Reserve Bank's website. Accordingly, a concept paper on Financial Literacy and Counselling Centres has been prepared and placed

on the Reserve Bank's website on April 3, 2008 for public feedback in order to take this initiative forward.

(vi) Financial Literacy

154. Lack of knowledge among common persons with respect to financial services and financial planning is a major reason for financial exclusion. The Reserve Bank launched Project Financial Literacy with a view to creating awareness, especially among common persons, on matters relating to banking, finance and the central bank for promoting financial inclusion. The literacy campaign is targeted at groups such as rural folk, urban poor, school/college children, women, senior citizens and defence personnel. A multilingual website for common persons was launched in July 2007. This was followed by a number of initiatives such as having a section on financial education on the Reserve Bank's website, educational books for children and rural folk in the form of comics, participation in fairs/exhibitions through educational displays/ exhibits/ interactive games. Notably, the Reserve Bank put up an exhibition on the evolution of banking in India since Independence aboard the Azadi Express, a train run by the Government of India all over the country to celebrate 60 years of India's Independence. The Reserve Bank also organised essay competitions across the country to generate interest among the children in the area of banking and finance. A Young Scholar's Internship Award Scheme, designed at giving opportunity to young college students to work as interns with the Reserve Bank during their vacations, is under implementation.

(vii) Assistance to RRBs for Adoption of ICT Solutions

155. As indicated in the Mid-Term Review of October 2007, a Working Group (Chairman: Shri G. Padmanabhan) was constituted to examine providing financial assistance to RRBs for defraying a part of their initial cost in implementing Information and Communication Technology (ICT)-based solutions, including installation of solar power generating devices for powering ICT equipment in remote and under-served areas. The Group has since submitted its report, which is under examination.

(viii) Ex-Servicemen, Retired Government/Bank Employees to act as Business Correspondents

156. In the Union Budget for 2008-09, the Finance Minister indicated that individuals such as retired bank officers, ex-servicemen and others would be allowed to be appointed as credit counsellors. Accordingly, guidelines for

allowing retired bank/government employees and ex-servicemen as business correspondents were issued on April 24, 2008.

(l) Review of Lead Bank Scheme

157. The Lead Bank Scheme, introduced in 1969, aimed at coordinating the activities/efforts of banks, State Governments and other developmental agencies for promoting overall development of the rural sector. Although the Scheme was reviewed in 1989 when the service area approach was adopted, there have been significant changes in the financial system in the post-reform period. More recently, there is increased focus on financial inclusion. At the same time, planning has become more decentralised with greater devolution of expenditure to the grassroots levels. In the revised context and in order to improve the effectiveness of the Scheme as announced in the Mid-Term Review of October 2007, a High Level Committee (Chairperson: Smt. Usha Thorat) with members drawn from various financial institutions, banks and State Governments was constituted to review the Lead Bank Scheme. The Committee has so far held seven meetings and has interacted with most of the State Governments and banks. Interactions are also proposed with academics and Non-Governmental Organisations (NGOs). The Committee is expected to submit its report by July 2008.

(m) Credit Delivery, Credit Pricing and Credit Culture

158. In the Mid-Term Review of Monetary and Credit Policy of November 2003, the importance of adequate, timely and hassle free credit delivery, appropriate credit pricing related to risk and a conducive credit culture was emphasised. Since then, there have been several developments including doubling of credit to agriculture, significant rise in credit to the small and medium enterprises (SMEs) sector, administered interest rates for crop loans, one time settlement (OTS) and rescheduling/restructuring schemes for distressed farmers, simplification of procedures and other measures such as adoption of business correspondent (BC) model and use of smart cards. The regulations under the Credit Information Companies Act have been notified and soon new credit information companies will be authorised to commence business. This is expected to reduce information asymmetry and facilitate efficient credit allocation and pricing while fostering a better credit culture. While concessional credit and debt relief schemes are intended to alleviate farmers' distress and reopen

the credit lines that have been choked, sustaining an appropriate credit culture going forward would require incentive systems for greater flow and efficient allocation of credit. Accordingly, it is proposed:

- to set up an Internal Working Group to look at issues relating to credit delivery, credit pricing and credit culture in a holistic manner.

(n) Banks' Services to the Common Person and Transparency in Charges Levied

159. In the last few years, the Reserve Bank has been focusing on safeguarding the interest of common persons in their interface with banks while improving the ease and efficiency of conducting banking transactions. The measures taken by the Reserve Bank include setting up of the Banking Codes and Standards Board of India, revamping the Banking Ombudsman scheme, constitution of board-level customer service committees in banks, dissemination of customer-centric information in local languages and promoting fair and transparent policies and practices, especially in the matter of bank charges, interest rates, customer acquisition and debt collection. Banks have also responded positively, including adoption of the Code of Commitment to their customers. Nevertheless, analyses of the types, frequency and trends of complaints reaching the Reserve Bank and the offices of the Banking Ombudsmen suggest that the essence of the Code still needs to percolate down to the level of the customer service delivery interface in banks. Banks, therefore, need to pay closer attention to these aspects, particularly, sensitivity of the staff to meeting the legitimate expectations of customers. They also need to ensure that they have in place effective internal arrangements for customer grievance redressal.

160. In 2007, on account of concerns about high bank charges and excessive interest rates in personal segment, the Reserve Bank laid down principles for ensuring reasonableness of bank charges and communicating them in respect of identified basic banking services. Banks were also cautioned against excessive interest rates, which are not sustainable and may be seen as usurious and broad guidelines in this regard were laid down. For greater transparency in setting interest rates banks were advised that they must use external or market-based rupee benchmark interest rates for pricing their floating rate loan products. The Reserve Bank has, thus, attempted to involve banks' boards in implementation of various guidelines to ensure fairness, reasonableness and transparency in bank charges for various services and

setting interest rates and use of external transparent benchmark for this purpose while giving them flexibility on consideration of commercial judgement. It is expected that banks' boards will take necessary care that these objectives are met and need for more prescriptive regulation is avoided.

161. With a view to bringing about greater transparency, the Reserve Bank is in the process of collecting details of various charges levied by banks for public dissemination.

(o) Currency Management

162. Currency management continues to be guided by benchmarks set in terms of operational efficiency and improved customer service. All currency chest branches of banks have been equipped with note sorting machines to ensure quality and genuineness of bank notes in circulation. These machines segregate notes into fit and unfit categories and facilitate timely detection of counterfeit notes. During 2007-08, soiled notes to the tune of 27 per cent of notes in circulation were withdrawn from circulation while fresh notes to the extent of 37 per cent were introduced with a view to ensuring adequate supply of notes of all denominations and to improve the quality of bank notes in circulation. In order to ensure that all bank branches provide better customer services to members of public at bank counters for exchange of notes, it is proposed:

- to introduce a scheme of incentives and penalties for bank branches (including currency chests), based on their performance in rendering such services.

III. Prudential Measures

(a) Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances: Infrastructure Projects Involving Time Overrun

163. In terms of the current guidelines, banks had been advised that as regards industrial projects to be financed by them, the date of completion of the project should be clearly spelt out at the time of financial closure of the project and if the date of commencement of commercial production extends

beyond a period of six months after the date of completion of the project as originally envisaged, the account should be treated as a sub-standard asset. For infrastructure projects, however, the period for recognising asset impairment was extended to one year with effect from March 31, 2007.

164. On a representation made in regard to delays in completion of infrastructure projects for legal and other extraneous reasons, the Reserve Bank undertook a review of select projects and concluded that there is merit in this representation. Accordingly, it has been decided that:

- in case of infrastructure projects to be financed by banks, the date of completion of the project should be clearly spelt out at the time of financial closure of the project and if the date of commencement of commercial production extends beyond a period of two years (as against the current norm of one year) after the date of completion of the project as originally envisaged, the account should be treated as sub-standard. The revised instructions will be effective from March 31, 2008.

(b) Off-Balance Sheet Exposures of Banks

165. The Reserve Bank has, in the light of domestic developments, taken steps to strengthen the prudential framework in respect of on-balance sheet exposures of banks. Such measures included additional risk weights and provisioning requirements for exposures to specific sectors. In view of the recent developments in the global financial markets and drawing from suggestions for ensuring financial stability, it is proposed:

- to review current stipulations regarding conversion factors, risk weights and provisioning requirements for specific off-balance sheet exposures of banks and prescribe prudential requirements as appropriate. The guidelines in this regard would be placed on the Reserve Bank's website by May 15, 2008.

166. In view of the risks associated with international financial developments impacting the balance sheets of corporates and banks, the Third Quarter Review of January 2008 had urged banks to review large foreign currency exposures and put in place a system for monitoring such unhedged exposures on a regular basis so as to minimise risks of instability in highly uncertain conditions. Banks were 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.

167. The Reserve Bank has also issued comprehensive guidelines on derivatives laying down broad generic principles for undertaking all derivative transactions, management of risks and sound corporate governance requirements as also adoption of suitability and appropriateness policy. Banks and their clients who have scrupulously followed the extant guidelines, including the Regulations framed under the FEMA, both in letter and spirit, would be well equipped to meet any potential consequences.

(c) Review of Loans to Commodities Sector by Banks

168. In view of the current public policy concerns in regard to trading in food items, banks are required to review their advances to traders in agricultural commodities including rice, wheat, oilseeds and pulses as also advances against warehouse receipts. They are further advised to exercise caution while extending such advances to ensure that bank finance is not used for hoarding. The first such review should be completed by May 15, 2008 and forwarded to the Reserve Bank for carrying out supervisory review of banks' exposure to the commodity sector.

(d) Prudential Norms for Housing

169. On a review of recent developments, it has been decided to enhance the limit of Rs.20 lakh to Rs.30 lakh in respect of bank loans for housing in terms of applicability of risk weights for capital adequacy purposes. Accordingly, such loans will carry a risk weight of 50 per cent.

(e) Credit Information Companies

170. The Reserve Bank had issued a press release on April 18, 2007 inviting applications from companies interested in continuing/commencing the business of credit information. The last date for submission of such applications was July 31, 2007. In response, 13 applications have been received. An external High Level Advisory Committee (HLAC) (Chairman: Dr.R.H.Patil) has been set up by the Reserve Bank for screening the applications and recommending the names of the companies to which certificates of registration can be granted by the Reserve Bank. After the announcement of the FDI policy for Credit

Information Companies, the processing of applications has been taken up and the Reserve Bank would complete the process by June 30, 2008.

(f) Three-Track Approach for Basel II

171. The Reserve Bank has adopted a three-track approach to capital adequacy regulation in India with the norms stipulated at varying degrees of stringency for different categories of banks given the variations in size, nature and complexity of operations and relevance of different types of banks to the Indian financial sector, the need to achieve greater financial inclusion and to provide an efficient credit delivery mechanism. Accordingly, commercial banks, which account for a major share in the total assets of the banking system and are Basel II standards compliant, would be on Track I, banks which are Basel I compliant would be on Track II and banks which are in the nature of local community banks would be on Track III.

172. An Internal Technical Group (Chairman: Shri Prashant Saran) has been constituted to propose criteria for the applicability of Basel norms to State Cooperative Banks/District Central Cooperative Banks/RRBs. The Group is expected to submit its report by June 30, 2008.

(g) Cross-border Supervision

173. The Mid-Term Review of October 2007 proposed to constitute a Working Group to lay down the road-map for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS). Accordingly, an Internal Working Group (Chairman: Shri S.Karuppasamy) has been constituted which is currently studying the cross-country practices, including the legal issues in this regard.

(h) Consolidated Supervision and Financial Conglomerates

174. The Mid-Term Review of October 2007 proposed to integrate the process of consolidated supervision with the financial conglomerate monitoring mechanism in order to enhance the effectiveness of the banking supervisory system for bank-led conglomerates. Accordingly, realignment of various internal supervisory processes for implementing an enhanced consolidated supervision process would be completed by August 31, 2008.

(i) Supervisory Review Process on Activities of the Trusts/SPVs Set up by Banks

175. Special purpose vehicles (SPVs) and Trusts are set up by banks to carry out a number of activities such as facilitating securitisation, asset management and investing in other entities. These entities are generally unregulated and are subject to inadequate independent board oversight. Besides, the downstream activities of these entities are normally not captured in the financial statements of the bank. As the activities of these entities could be a potential risk to the parent bank and could also pose systemic risk, there is a need for placing them under suitable supervisory oversight. Accordingly, it is proposed:

- to constitute a Working Group to study and recommend a suitable supervisory framework for activities of SPVs/Trusts set up by banks.

(j) New Model of Risk-Based Supervision: Evolution

176. Risk-based supervision (RBS) was introduced on a pilot basis in eight selected banks in 2003-04, which was extended to 15 banks in 2004-05, four more banks in 2005-06 and eight more banks in 2006-07. On the basis of the experience gained from these pilot runs and with a view to evolving an appropriate model of RBS, a departmental Group has been set up to study international practices on such systems. The study would focus on impact assessment, periodic reviews of horizontal risks across the system, inclusion of supervisory review process prescribed under Pillar 2 of Basel II framework in the RBS assessment, simplification of the existing system of risk profiling and would recommend an appropriate RBS framework with a view to integrating the RBS system with the existing supervisory process based on capital adequacy, asset quality, management, earnings, liquidity, and systems (CAMELS) evaluation.

(k) Overseas Operations of Indian Banks: Review of Existing Off-Site Monitoring Framework

177. In view of the rapid expansion of overseas operations, introduction of new products and processes, increasing off-balance sheet exposures including derivative products, a need has arisen for a review of the reporting system. Accordingly, an inter-departmental Group has been constituted to review the existing regulatory and supervisory framework for overseas

operations of Indian banks and recommend appropriate changes, including off-site reporting systems.

(I) Financial Stability Forum (FSF) Report: Status

178. As already mentioned, in the wake of the turmoil in global financial markets, the FSF brought out a report in April 2008 identifying the underlying causes and weaknesses in the international financial markets. The Report contains, *inter alia*, proposals of the FSF for implementation by end-2008 regarding strengthening prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, changing the role and uses of credit ratings, strengthening the authorities' responsiveness to risk and implementing robust arrangements for dealing with stress in the financial system. The Reserve Bank had put in place regulatory guidelines covering many of these aspects, while in regard to others, actions are being initiated. In many cases, actions have to be considered as work in progress. In any case, the guidelines are aligned with global best practices while tailoring them to meet country-specific requirements at the current stage of institutional developments. The proposals made by the FSF and status in regard to each in India are narrated below:

1. Strengthened Prudential Oversight of Capital, Liquidity and Risk Management

(i) Capital requirements:
Specific proposals will be issued in 2008 to:

- *Raise Basel II capital requirements for certain complex structured credit products;*
- *Introduce additional capital charges for default and event risk in the trading books of banks and securities firms;*
- *Strengthen the capital treatment of liquidity facilities to off-balance sheet conduits.*

Changes will be implemented over time to avoid exacerbating short-term stress.

(ii) Liquidity:

Supervisory guidance will be issued by July 2008 for the supervision and management of liquidity risks.

(iii) Oversight of risk management:

Guidance for supervisory reviews under Basel II will be developed that will:

- *Strengthen oversight of banks' identification and management of firm-wide risks;*
- *Strengthen oversight of banks' stress testing practices for risk management and capital planning purposes;*
- *Require banks to soundly manage and report off-balance sheet exposures;*

Supervisors will use Basel II to ensure banks' risk management, capital buffers and estimates of potential credit losses are appropriately forward looking.

(iv) Over-the-counter derivatives:

Authorities will encourage market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound.

179. The road-map for the implementation of Basel II in India has been designed to suit the country-specific conditions. The phased implementation process got underway with the Basel II Accord being made applicable to foreign banks operating in India and Indian banks having operational presence outside India with effect from March 31, 2008. All other commercial banks (except Local Area Banks and RRBs) are encouraged to migrate to Basel II in alignment with them but in any case not later than March 31, 2009. The process of implementation is being monitored on an on-going basis for calibration and fine-tuning.

180. The minimum capital to risk-weighted asset ratio (CRAR) in India is placed at 9 per cent, one percentage point above the Basel II requirement. Further, regular monitoring of banks' exposure to sensitive sectors and their liquidity position is also undertaken. In India, off-balance sheet vehicles in the form of SPVs for the purpose of securitisation are in existence for which

extensive guidelines, in line with the international best practices, have already been issued. Liquidity facilities to such SPVs are subject to capital charge. Banks have been required to put in place appropriate stress test policies and relevant stress test frameworks for various risk factors by March 31, 2008.

181. In order to further strengthen capital requirements, it has been decided to review the credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items including derivatives. Further, in India, complex structures like synthetic securitisation have not been permitted so far. Introduction of such products, when found appropriate, would be guided by the risk management capabilities of the system.

182. The Reserve Bank had issued broad guidelines for asset-liability management and banks have flexibility in devising their own risk management strategies as per board-approved policies. However, in regard to liquidity risks at the very short end, the Reserve Bank has taken steps to mitigate risks at the systemic level and at the institution level as well. The Reserve Bank has introduced greater granularity to measurement of liquidity risk by splitting the first time bucket (1-14 days, at present) into three time buckets, *viz.,* next day, 2-7 days and 8-14 days. The net cumulative negative mismatches in the three time buckets have been capped at 5 per cent, 10 per cent, 15 per cent of the cumulative cash outflows.

183. The Reserve Bank had recognised the risks of allowing access to unsecured overnight market funds to all entities and, therefore, restricted the overnight unsecured market for funds only to banks and primary dealers (PD). Since August 2005, the overnight call market is a pure inter-bank market. Accordingly, trading volumes have shifted from the overnight unsecured market to the collateralised market.

184. Greater inter-linkages and excessive reliance on call money borrowings by banks could cause systemic problems. The Reserve Bank has, therefore, introduced prudential measures to address the extent to which banks can borrow and lend in the call money market. On a fortnightly average basis, call market borrowings outstanding should not exceed 100 per cent of capital funds (*i.e.,* sum of Tier I and Tier II capital) in the latest audited balance sheet.

185. Recognising the potential of 'purchased inter-bank liabilities' (IBL) to create systemic problems, the Reserve Bank had issued guidelines in

March 2007 prescribing that IBL of a bank should not exceed 200 per cent of its net worth (300 per cent for banks with a CRAR more than 11.25 per cent).

2. Enhancing Transparency and Valuation

(i) Robust risk disclosures:

- *The FSF strongly encourages financial institutions to make robust risk disclosures using leading disclosure practices at the time of their mid-year 2008 reports.*

- *Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II will be issued by 2009.*

(ii) Standards for off-balance sheet vehicles and valuations: Standard setters will take urgent action to:

- *Improve and converge financial reporting standards for off-balance sheet vehicles;*

- *Develop guidance on valuations when markets are no longer active, establishing an expert advisory panel in 2008.*

(iii) Transparency in structured products:

Market participants and securities regulators will expand the information provided about securitised products and their underlying assets.

186. The Reserve Bank has, over the years, issued guidelines on valuation of various instruments/assets in conformity with the international best practices while keeping India-specific conditions in view. In order to encourage market discipline, the Reserve Bank has developed a set of disclosure requirements which allow the market participants to assess key pieces of information on capital adequacy, risk exposure, risk assessment processes and key business parameters which provide a consistent and understandable disclosure framework that enhances comparability. Banks are also required to comply with the Accounting Standard (AS) on Disclosure of Accounting Policies issued by the Institute of Chartered Accountants of India (ICAI).

187. In recognition of the fact that market discipline can contribute to a safe and sound banking environment and as part of the ongoing efforts to implement

the Basel II Accord, the Reserve Bank issued guidelines on minimum capital ratio (Pillar 1) and market discipline (Pillar 3) in April 2007 and guidelines for Pillar 2 (supervisory review process) were issued in March 2008. Under these guidelines, non-compliance with the prescribed disclosure requirements would attract a penalty, including financial penalty.

3. Changes in the Role and Uses of Credit Ratings

Credit rating agencies should:

- *Implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process;*

- *Differentiate ratings on structured credit products from those on bonds and expand the information they provide.*

Regulators will review the roles given to ratings in regulations and prudential frameworks.

188. The Reserve Bank has undertaken a detailed process of identifying the eligible credit rating agencies whose ratings may be used by banks for assigning risk weights for credit risk. Banks should use the chosen credit rating agencies and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Banks are not allowed to 'cherry pick' the assessments provided by different credit rating agencies. If a bank has decided to use the ratings of some of the chosen credit rating agencies for a given type of claim, it can use only the ratings of those credit rating agencies, despite the fact that some of these claims may be rated by other chosen credit rating agencies whose ratings the bank has decided not to use. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

189. Banks must disclose the names of the credit rating agencies that they use for the risk weighting of their assets, the risk weights associated with the particular rating grades as determined by the Reserve Bank through the mapping process for each eligible credit rating agency as well as the aggregated risk weighted assets as required.

190. In India, complex structures like synthetic securitisations have not been permitted so far. As and when such products are to be introduced, the Reserve Bank would put in place the necessary enabling regulatory framework, including calibrating the role and capacity building of the rating agencies.

4. Strengthening the Authorities' Responsiveness to Risks

- *A college of supervisors will be put in place by end-2008 for each of the largest global financial institutions.*

191. In the Indian context, there have been exchange of supervisory information on specific issues between the Reserve Bank and few other overseas banking supervisors/regulators. Supervisory cooperation has been working smoothly and efficiently.

192. The Mid-Term Review of October 2007 had announced the constitution of a Working Group to lay down a road-map for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS). A Working Group has been constituted in March 2008 and would complete the work by August 2008. A number of overseas regulators of countries such as the USA, the UK, Canada, Hong Kong, Australia and Singapore have been formally approached to share systems and practices, including legal positions, in the matter of supervisory cooperation and sharing of information with overseas regulators. The response from a few countries has been received and is being examined. The 'Supervisory College' arrangement for this purpose is also being examined by the Group.

5. Robust Arrangements for Dealing with Stress in the Financial System

- *Central banks will enhance their operational frameworks and authorities will strengthen their cooperation for dealing with stress.*

193. In the Reserve Bank, there is an institutional arrangement in place to oversee the functioning of the financial markets on a daily basis. There is a Financial Market Committee monitoring and assessing the functioning of different financial markets. Based on such an oversight, appropriate and prompt action is taken, whenever necessary.

194. The Reserve Bank has the necessary framework for provision of liquidity to the banking system, in terms of Sections 17 and 18 of the Reserve Bank of India Act, 1934. The regular liquidity management facilities of the Reserve Bank include the LAF, OMO and MSS besides standing facilities such as export credit refinance (ECR) and the liquidity facility for standalone PDs. The Reserve Bank can undertake purchase/sale of securities of the Central or State Governments and can purchase, sell and rediscount bills of exchange and promissory notes drawn on and payable in India and arising out of *bona fide* commercial or trade transactions for provision/absorption of liquidity for normal day-to-day liquidity management operations as also for provision of emergency liquidity assistance to the banks under the lender of last resort function.

195. The Reserve Bank is empowered under the existing legal framework to deal with the resolution of weak and failing banks. The Banking Regulation Act provides the legal framework for voluntary amalgamation and compulsory merger of banks under Sections 44 (A) and 45, respectively. The Deposit Insurance and Credit Guarantee Corporation (DICGC) offers deposit insurance cover in India. The mergers of many weak private sector banks with healthy banks has improved overall stability of the system. Not a single scheduled commercial bank in the country has capital adequacy ratio which is less than the minimum regulatory requirement of nine per cent.

IV. Institutional Developments

Payment and Settlement Systems

(a) Payment and Settlement Systems Act, 2007

196. The Payment and Settlement Systems Bill was passed by the Parliament and became an Act known as 'Payment and Settlement Systems Act, 2007' after receiving the assent of the President on the December 20, 2007. The Act empowers the Reserve Bank to regulate and supervise the payment and settlement systems in the country; gives it authority to permit the setting up/ continuance of such systems and to call for information/data and issue directions from/to payment system providers. The Act defines a payment system and gives legal recognition to multilateral netting and settlement finality. Accordingly, the Reserve Bank has placed the draft regulations under the Payment and Settlement Systems Act, 2007 on its website inviting public

comments to be received latest by May 15, 2008. The regulations will be finalised in consultation with the Government of India.

(b) IT-based Financial Inclusion Products and Services

197. Information Technology (IT) has enhanced the scope of financial inclusion with low cost technology by reaching out to hitherto unexplored sectors of the economy. The usage of card-based products for multiple applications is cost-effective and holds potential for large-scale deployment. With a wide range of IT-based products such as smart cards, hand held devices and secured message transfers, there is an imperative need to ensure that these instruments blend seamlessly with the existing operative systems at the bank level. Accordingly, banks are urged to ensure that security of banking transactions is adequately addressed while using such products.

(c) Real Time Gross Settlement (RTGS): Compliance with the Core Principles

198. The RTGS system implemented by the Reserve Bank has been in operation for nearly four years. The system has also stabilised over the years and has been witnessing increased coverage in terms of bank branches and transaction volume. The Bank for International Settlements (BIS) has published a set of Core Principles in 2001 which are in the nature of standards to measure the efficiency of the systemically important payment systems and the Reserve Bank has been assessing the compliance of the Indian RTGS system with these principles on annual basis. As per the latest review, the system is fully compliant with six core principles, broadly compliant with three, and one principle is not applicable for the Indian RTGS system. Out of the four responsibilities of the central bank under the core principles, full compliance has been achieved in respect of two core principles, broad compliance with one and one responsibility is not applicable in the Indian context.

(d) Electronic Payment Products: Status

199. The coverage of the RTGS system has increased significantly. By March 31, 2008 RTGS connectivity was available in more than 43,500 bank branches. The Reserve Bank continues to improve the quality of services through the RTGS.

200. The launch of the pilot project for Cheque Truncation System, which aims at enhancing efficiency in the retail cheque clearing section, has become operational from February 1, 2008 in 10 banks.

201. The Committee (Chairman: Dr.R.B.Barman), constituted for introduction of the National Settlement System (NSS), examined various models and recommended the Centralised Funds Transfer System (CFTS) model for implementation. Under the CFTS model, banks would be able to transfer funds across all Deposit Accounts Departments (DADs) on real time basis. So far, CFTS has been implemented at 16 centres.

202. The Electronic Clearing Service (ECS), which facilitates bulk payments, is currently available at 68 centres. The Mid-Term Review of October 2007 had proposed to operationalise the National Electronic Clearing Service (NECS) using the existing infrastructure of National Electronic Funds Transfer (NEFT) system with a view to widening the geographical coverage of the ECS in consultation with banks. Software development and testing has been completed for the first phase covering the existing ECS centres and the testing report has been approved for implementation.

203. Considering that the potential for a shift from paper-based system to electronic system is large, the processing charges for ECS / EFT / NEFT were waived up to March 31, 2008. The Reserve Bank, in its role as promoter and facilitator of electronic funds transfer would like to continue this approach for one more year. Accordingly, the processing charges for all electronic payment products, *viz.,* ECS, EFT, NEFT and RTGS are waived for another year *i.e.,* up to March 31, 2009.

(e) Regulatory Guidelines: Mobile Payments

204. The reach of mobile phones has been increasing at a rapid pace in India. There were about 231 million mobile phone connections in the country at the end of December 2007. The rapid expansion of this mode of communication has thrown up a new payment delivery channel for banks. Many countries in the world have adopted this mode of delivery to successfully spread the reach of the banking facility to the remote parts of their respective countries. This channel facilitates small value payments to merchants, utility service providers and the like and money transfers at a low cost.

205. The Reserve Bank is in the process of formulating the regulatory guidelines for mobile payments systems in India and is in discussion with banks, service providers and industry bodies for this purpose. The draft guidelines will be placed on the Reserve Bank's website by June 15, 2008.

(f) Electronic Based Social Security Payments

206. The report of the Committee (Chairman: Dr.R.B.Barman), set up by the Reserve Bank to examine matters relating to electronic based payments by the Central and State Governments under various social welfare schemes like social security pension payment, National Rural Employment Guarantee Scheme (NREGS) and insurance scheme for persons living below the poverty line, has been placed on the Reserve Bank's website.

(g) Migration from Paper Based Payment Systems to Electronic Payment Systems: Mandating

207. The Reserve Bank has been continuously taking initiatives to migrate from paper-based payment to electronic payment systems by creating the appropriate technological infrastructure. In this context, an Internal Group was constituted to examine various issues connected with the use of electronic payment systems. Based on the Group's report, an approach paper was placed on the Reserve Bank's website inviting comments/suggestions from the public. On the basis of the feedback, effective from April 1, 2008 all payment transactions of Rs. one crore and above in the money, Government securities and foreign exchange markets and the regulated entities (banks, PDs and NBFCs) have been made mandatory to be routed through the electronic payment mechanism.

(h) Eligibility Criteria for Access to Payment Systems

208. An Internal Working Group, constituted to prepare comprehensive draft guidelines on minimum eligibility criteria for direct members of the clearing houses, submitted its report in September 2007 which was placed on the Reserve Bank's website for public comments. Final guidelines in this connection have been made effective from January 1, 2008 and banks have been advised to implement these guidelines.

Urban Cooperative Banks

(a) Creation of Umbrella Organisation and Revival Fund for Urban Cooperative Banks: Setting up of a Working Group

209. The Working Group (Chairman: Shri N.S.Vishwanathan), constituted to explore various options and alternate instruments/avenues for raising of regulatory capital funds of urban cooperative banks (UCBs), observed that creating a legal framework for facilitating the emergence of umbrella organisation(s) like those prevalent in other parts of the world appears to be the only long-term solution for raising of capital in the UCB sector. There have also been requests from the sector for creation of a revival/liquidity support fund. Accordingly, it is proposed:

- to constitute a Working Group comprising representatives of the Reserve Bank, Central/State Governments and the UCB sector to suggest measures, including the appropriate regulatory and supervisory framework, to facilitate emergence of umbrella organisation(s) for the UCB sector in the respective States.

(b) Opening of On-site ATMs by UCBs: Liberalisation

210. At present, UCBs are allowed to open on-site ATMs subject to certain eligibility norms, including minimum deposit criterion of Rs.100 crore. With a view to liberalising this facility, it is proposed:

- to dispense with the extant eligibility norms for opening on-site ATMs for well-managed and financially sound UCBs in the States that have signed MoUs with the Reserve Bank and those registered under the Multi-State Cooperative Societies Act, 2002.

(c) Branch Licensing Norms: Liberalisation

211. As proposed in the Annual Policy Statement of April 2007, well-managed and financially sound UCBs in States that have signed MoUs with the Reserve Bank and those registered under the Multi-State Cooperative Societies Act, 2002 were permitted to open branches and extension counters subject to fulfilling certain eligibility criteria. With a view to liberalising and rationalising the branch licensing norms for such UCBs, it is proposed:

- to consider approvals for branch expansion, including off-site ATMs, based on annual business plans, subject to maintenance of minimum CRAR of 10 per cent on a continuing basis and other regulatory comfort.

(d) Insurance Business by UCBs: Liberalisation of Norms

212. At present, UCBs registered in States that have signed MoUs with the Reserve Bank or registered under the Multi-State Cooperative Societies Act, 2002 with a minimum net worth of Rs.10 crore are permitted to undertake insurance business as corporate agents without risk participation, subject to certain conditions. Taking into consideration the representations from UCBs, it is proposed:

- to dispense with the minimum net worth criterion for undertaking such insurance business provided other criteria as prescribed from time to time are met.

(e) Individual Housing Loan: Enhancement of Limit

213. As per extant norms, UCBs can grant housing loans to individuals up to a maximum of Rs.25 lakh. Based on the representations made by UCBs, it is proposed:

- to increase the extant limit on individual housing loans from Rs.25 lakh to a maximum of Rs.50 lakh in respect of Tier-II UCBs, subject to certain conditions.

(f) Information Technology Support to UCBs

214. As proposed in the Mid-Term Review of October 2007 and in pursuance of commitments made under the Memoranda of Understanding (MoUs) signed with various State Governments and the Central Government, a Working Group (Chairman: Shri R.Gandhi) was constituted comprising representatives of the Reserve Bank, State Governments and the UCBs to examine various areas where IT support could be provided by the Reserve Bank. The Group submitted its report on April 17, 2008 which is under consideration.

Non-Banking Financial Companies

Financial Regulation of Systemically Important NBFCs: Review of Prudential Regulations

215. In 2006, regulatory guidelines covering the prudential norms for systemically important NBFCs and banks' relationship with them were put in

place. The Reserve Bank has been monitoring the functioning of systemically important NBFCs and banks' exposure to them.

216. It is observed that many systemically important non-deposit taking NBFCs are highly leveraged and use short-term sources to fund their activities. In the light of international developments and increasing bank exposure to these systemically important NBFCs, it has now been decided to review the regulations in respect of capital adequacy, liquidity and disclosure norms. Revised instructions will be issued by May 31, 2008.

Committee on Financial Sector Assessment: Developments

217. The Mid-Term Review of October 2007 had outlined the progress made by the Committee on Financial Sector Assessment (CFSA) (Chairman: Dr.Rakesh Mohan; Co-Chairman: Dr.D.Subbarao). Since then, the four Advisory Panels constituted by the Committee covering Financial Stability Assessment and Stress Testing, assessment of relevant international standards and codes as applicable to Financial Regulation and Supervision, Institutions and Market Structure and Transparency Standards have prepared their draft reports and these reports have been sent to external peer reviewers in relevant subject areas. The comments from the peer reviewers on five out of eleven reports have already been received. Two external experts have also been undertaking an overarching review of all draft reports. The peer reviews are expected to be completed by May 2008 and the CFSA has proposed a two-day seminar in Mumbai for closer interaction with peer reviewers. The reports of the CFSA as also those of Advisory Panels are expected to be finalised by end-June 2008 and will be placed thereafter on the Reserve Bank's website.

Mid-term Review

218. A review of the Annual Statement on Developmental and Regulatory Policies will be undertaken on October 24, 2008.

Mumbai
April 29, 2008