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

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

I. Assessment of Macroeconomic and Monetary Developments

Domestic Developments

2. The growth of real gross domestic product (GDP) in 2007-08 was revised upwards to 9.0 per cent by the Central Statistical Organisation (CSO) in its end-May 2008 estimates from the advance estimates of 8.7 per cent released in February 2008. As per the revised estimates, real GDP originating in agriculture, industry and services rose by 4.5 per cent, 8.1 per cent and 10.7 per cent, respectively, in 2007-08 as compared with 3.8 per cent, 10.6 per cent and 11.2 per cent in the previous year. India's macroeconomic performance in 2007-08 is part of a phase of exceptionally high growth by historical standards, occurring as it did on top of 9.6 per cent in 2006-07 and 9.4 per cent in 2005-06. Accordingly, real GDP growth has averaged 8.8 per cent over the period 2003-08 as compared with 5.4 per cent in the preceding quinquennium.

3. The fourth advance estimates of the Ministry of Agriculture released on July 9, 2008 placed foodgrains production in 2007-08 at a record 230.7 million tonnes, substantially higher than the previous high of 217.3 million tonnes in the previous year. The production of nine major oilseeds and cotton rose by 18.6 per cent and 14.1 per cent, respectively, in 2007-08; however, the output of sugarcane and jute declined by 4.2 per cent and 1.4 per cent, respectively. During the current year's rabi marketing season (April 1-July 18, 2008), wheat procurement has doubled to 22.5 million tonnes from 11.1 million tonnes in the corresponding period of the previous year. The total stock of foodgrains with public agencies increased to 19.8 million tonnes as on April 1, 2008 which was higher than the buffer stock norm of 16.2 million tonnes and the stock of 17.9 million tonnes a year ago.

4. The south-west monsoon covered the entire country by July 10, 2008 – five days ahead of the usual onset. During the current season so far (up to July 23, 2008), the cumulative rainfall over the country as a whole has been 98 per cent of the long period average (LPA). Of the 36 meteorological subdivisions, 21 received excess or normal rainfall whereas 14 received deficient rainfall and rainfall in one meteorological subdivision was scanty. The deficient rainfall regions include Andhra Pradesh, Gujarat, Karnataka, Kerala, Konkan and Goa, Madhya Maharashtra and Vidarbha and some north-eastern States. The Marathwada region recorded scanty rainfall. As on July 17, 2008 the all-India live water storage in 81 major reservoirs was 28 per cent of the designated capacity which is 10 per cent higher than the last 10 years' average. According to the forecast of the India Meteorological Department (IMD) released at end-June 2008, the rainfall in the south-west monsoon season (June-September) this year is likely to be nearly 100 per cent of the LPA.

5. Of the normal area of 72.6 million hectares under kharif foodgrain crops, 29.0 million hectares were sown by July 18 this year, higher than 25.9 million hectares in the corresponding period last year. As regards commercial crops, the area sown under major oilseeds and jute was higher by 2.1 per cent and 22.5 per cent, respectively, whereas acreage under cotton and sugarcane declined by 16.9 per cent and 18.2 per cent, respectively, due to deficient rainfall in the major producing regions.

6. The index of industrial production (IIP) rose by 5.0 per cent during April-May 2008 *vis-à-vis* 10.9 per cent a year ago. Manufacturing output slowed to 5.3 per cent from 11.8 per cent during the same period. Electricity generation also decelerated to 1.7 per cent from 9.0 per cent, while mining activity picked up by 5.6 per cent as compared with 3.2 per cent a year ago. Within manufacturing, beverages, tobacco and related products, basic chemicals and chemical products and transport equipments and parts recorded double-digit growth. The production of basic metals and alloys, leather and fur products, cotton textiles, textile products and non-transport machinery and equipment recorded lower growth than during the corresponding period of 2007-08. The output of industries such as food products, rubber, plastic, petroleum and coal products, jute textiles, wood and wood products and metal products (non-machinery) declined. In terms of the use-based classification of industries, the loss of momentum was diffused across all constituent sub-sectors. The production of basic, capital, intermediate and consumer non-durable goods decelerated to 3.5 per cent, 6.5 per cent, 2.3 per cent and 8.8 per cent, respectively, from 9.4 per cent, 16.9 per cent, 9.7 per cent and 15.4 per cent during April-May 2007. Output of consumer durables, however, recorded a higher growth of 4.8 per cent as compared with 0.8 per cent a year ago.

The six infrastructure industries, comprising nearly 27 per cent of the IIP, posted a lower growth of 3.5 per cent during April-May 2008 as against 6.9 per cent a year ago. Production picked up in respect of coal and crude oil whereas deceleration was recorded in the output of petroleum refinery products, electricity, cement and finished (carbon) steel.

7. Full information that has become available in July 2008 on corporate sector activity reveals that moderation from the high growth phase that began in 2002-03 had set in by the last quarter of 2006-07. Sales growth of selected non-financial private companies decelerated from 26.2 per cent in 2006-07 to 18.5 per cent in 2007-08. The growth of operating profits slowed to 18.6 per cent from 41.3 per cent in the previous year despite considerable cost-cutting initiatives by companies. The interest to gross profits ratio at 13.9 per cent in 2007-08 remained distinctly lower than the ratio of around 50 per cent in the 1990s and 43.7 per cent in the first half of the current decade. While there was a substantial rise in the cost of inputs including raw materials, staff compensation and funding of operations, an increase of 47.0 per cent in the income from non-core activities contributed to net profits that rose by 27.0 per cent. As a result, profitability measured in terms of the ratio of net income to sales improved to 11.8 per cent as against 10.7 per cent in 2006-07, with gains for manufacturing and non-IT services sectors. There was a marginal decline in the profitability ratio for information technology (IT) companies to 21.5 per cent from 22.7 per cent in 2006-07.

8. Early results of selected companies for the first quarter of 2008-09 are mixed, with sustained sales growth, accompanied by higher expenditure growth on account of increase in cost of raw materials, staff costs and interest payments. As a result,

there was further deceleration in net profit growth, extending a phase that had set in during 2007-08. The pick-up in sales growth could be attributed to higher selling prices although volume growth continued to be the major driver. While investment conditions continued to be supported by favourable demand conditions, reliance on external sources of funds increased somewhat in view of lower retained profits of the selected companies.

9. The Reserve Bank's Industrial Outlook Survey conducted during May 2008 indicates some moderation in business confidence in the private corporate manufacturing sector. For April-June 2008, the assessment of growth in production and order books was somewhat lower than in the previous quarter and in the corresponding quarter last year. Close to 56 per cent of respondents reported no change in capacity utilisation. A majority of respondents also indicated no change in the financial situation, working capital finance requirements and availability of finance. Responses relating to export orders, imports and profits were generally mixed. The business expectations index for April-June 2008 declined by 5.4 per cent from its level in January-March, but was marginally higher (by 0.3 per cent) than in the corresponding quarter a year ago. For July-September 2008, nearly half of the respondents expect an improvement in the overall business situation and the outlook for production, order books and capacity utilisation is positive. In continuation of the assessment for the previous quarter, a majority of respondents expect no change in the financial situation, working capital finance requirements, availability of finance and profit margins. Expectations of rise in input costs and selling prices appear to have firmed up. The business expectations index for July-September 2008 is lower by 0.9 per cent than its level in

the previous quarter but higher by 0.8 per cent than its level a year ago.

10. Business sentiment polled by other surveys reflects a similar though more broad-based moderation. One survey reported slower growth expectations for output, foreign trade and pre-tax profits for the next six months. A majority of the respondent firms propose to increase investments during the current year. Another survey reported a significant decline in business optimism due to increase in input costs, global economic instability and hardening of interest rates but nearly half the respondents intend to increase their manpower. In yet another survey, nearly two-third respondents expected increase in order books, exports and investment and nearly half expected to increase employment during April-September 2008. A large majority also expected raw material prices to increase. One survey's business optimism index recorded significant fall over the previous quarter as well as over a year ago, with a tempered outlook diffused across sales volume, inventory levels, new orders, selling prices, employment and net profits. Profit expectations moderated for the sixth consecutive quarter on the view that manufacturers may not be able to pass on the total increase in input costs to customers in the subdued demand conditions prevailing in the economy. Seasonally adjusted purchasing managers' indices for June 2008, however, indicated an improvement in manufacturing business conditions. Robust underlying demand and higher new order volumes combined with expansion plans point to a further increase in employment. Output prices increased at a faster rate than in the previous quarter and some improvement was reported in supplier delivery performance to maintain profitability in view of the rise in input costs.

11. Services sector activity appears to have been sustained in the first quarter of 2008-09 with indications of moderation in some sub-sectors. In the communication sector, 0.89 million lines were added to the switching capacity of telephone exchanges and 16.5 million new telephone connections (fixed plus cellular) were provided during April-May 2008 as compared with 11.2 million new subscribers added during the corresponding period of 2007-08. During the first quarter of 2008-09, railway revenue earning freight traffic increased by 9.4 per cent as compared with 5.4 per cent in the first quarter of 2007-08. Cargo handled at major ports increased by 10.3 per cent during April-May 2008 as against 17.7 per cent a year ago. In civil aviation, handling of import cargo and export cargo increased by 9.3 per cent and 7.6 per cent, respectively, as compared with 21.7 per cent and 1.6 per cent during April-May 2007. During the first quarter of 2008-09, foreign tourist arrivals increased by 10.2 per cent as against 8.2 per cent a year ago. There was deceleration in air traffic growth as passengers handled at domestic and international terminals increased by 5.9 per cent and 9.0 per cent, respectively, during April-May 2008 as against 24.4 per cent and 13.1 per cent, a year ago.

12. During 2007-08, there have been noteworthy shifts in aggregate demand. In real terms, private final consumption expenditure (PFCE) and gross fixed capital formation (GFCF) increased by 8.3 per cent and 13.8 per cent, respectively, as compared with 7.1 per cent and 15.1 per cent in the previous year. In nominal terms, PFCE declined to 55.3 per cent of GDP during 2007-08 from 55.8 per cent in the previous year whereas GFCF increased to 33.9 per cent from 32.5 per cent.

13. Up to July 4, 2008 non-food credit of scheduled commercial banks (SCBs) rose by 25.9 per cent (Rs.4,85,709 crore) on a

year-on-year basis, higher than 24.6 per cent (Rs.3,69,109 crore) a year ago. During the current financial year so far, non-food credit of SCBs increased by Rs.40,344 crore (1.7 per cent) as against a decline of Rs.12,519 crore (–0.7 per cent) in the corresponding period of the previous year. Food credit recorded an increase of Rs.6,322 crore as against a decline of Rs.2,292 crore in the corresponding period last year.

14. Provisional information on the sectoral deployment of bank credit available up to May 2008 indicates that on a year-on-year basis, credit to the services sector recorded the highest growth (31.3 per cent), followed by industry (26.9 per cent), the agriculture sector (19.3 per cent) and personal loans (15.9 per cent). Growth in housing and real estate loans decelerated to 13.8 per cent (21.6 per cent a year ago) and 31.9 per cent (69.7 per cent), respectively. Within the industrial sector, there was a sizeable credit pick-up in respect of infrastructure (41.7 per cent as against 32.6 per cent a year ago), cement and cement products (54.5 per cent over 18.3 per cent), chemicals (24.8 per cent as against 14.2 per cent) and petroleum (62.8 per cent as against 51.6 per cent). There was moderation in credit growth to basic metals and metal products (24.0 per cent as against 29.3 per cent), textiles (20.9 per cent as against 32.9 per cent), engineering (23.4 per cent as against 25.1 per cent), construction (29.6 per cent as against 49.2 per cent) and vehicles (26.7 per cent as against 28.6 per cent). Credit to industry constituted 43.1 per cent of the total expansion in non-food bank credit up to May 2008, followed by services (29.5 per cent), personal loans (17.2 per cent) and agriculture (10.1 per cent). The share of infrastructure in total credit to industry increased from 21.2 per cent to 23.7 per cent. On the contrary, the share of credit to textiles, chemicals, engineering and metals declined to 10.9 per cent, 7.6 per cent, 6.1 per cent

and 12.1 per cent, respectively, from 11.5 per cent, 7.7 per cent, 6.3 per cent and 12.4 per cent. Priority sector advances grew by 18.3 per cent with a moderation in their share in outstanding gross bank credit to 34.0 per cent in May 2008 from 35.7 per cent a year ago.

15. Commercial banks' investments in shares, bonds/ debentures and commercial papers (CPs) increased by Rs.9,510 crore (12.1 per cent) on a year-on-year basis up to July 4, 2008 as against a decline of Rs.1,188 crore (1.5 per cent) a year ago. During the current financial year so far, such investments by banks fell by Rs.7,126 crore (7.5 per cent) as compared with a decline of Rs.4,676 crore (5.6 per cent) in the corresponding period of 2007-08. Commercial banks invested Rs.13,810 crore in instruments issued by mutual funds during the current financial year so far as against Rs.43,066 crore in the corresponding period of 2007-08. The year-on-year growth in total flow of resources from SCBs to the commercial sector was 25.4 per cent (Rs.4,95,220 crore), higher than 23.2 per cent (Rs.3,67,921 crore) a year ago.

16. The year-on-year increase in aggregate deposits of SCBs at 21.7 per cent (Rs.5,89,646 crore) up to July 4, 2008 was lower than 24.6 per cent (Rs.5,36,617 crore) a year ago. On a financial year basis, aggregate deposits increased by Rs.1,11,286 crore (3.5 per cent) during 2008-09 up to July 4, 2008 as against an increase of Rs.1,06,646 crore (4.1 per cent) in the corresponding period of the previous year. The incremental non-food credit-deposit ratio increased to 82.4 per cent on July 4, 2008 from 68.8 per cent a year ago.

17. Commercial banks' investment in statutory liquidity ratio (SLR) eligible securities increased by Rs.43,667 crore up to

July 4, 2008 as against an increase of Rs.57,653 crore in the corresponding period of 2007-08. Abstracting securities committed for liquidity adjustment facility (LAF) operations, however, banks' investments in Government and other approved securities would have declined by Rs.18,383 crore as compared with an increase of Rs.25,469 crore a year ago. Commercial banks' holdings of Government and other approved securities was 27.7 per cent of the banking system's net demand and time liabilities (NDTL) which was marginally lower than 27.8 per cent at end-March 2008 and 28.7 per cent a year ago. Such investments were Rs.99,238 crore above the prescribed SLR level of 25 per cent of NDTL. Adjusted for banks' holding of market stabilisation scheme (MSS) securities and the collateral securities repoed under the LAF, commercial banks' holding of SLR securities was less than 23.0 per cent of their NDTL.

18. Money supply (M3) increased by 20.5 per cent on a year-on-year basis on July 4, 2008, lower than 21.8 per cent a year ago. On a financial year basis, M_3 increased by 3.5 per cent (Rs.1,39,475 crore) during 2008-09 up to July 4, 2008 as compared with the increase of 3.8 per cent (Rs.1,26,058 crore) in the corresponding period of the previous year.

19. Reserve money increased by 26.5 per cent on a year-on-year basis on July 18, 2008 as compared with 29.0 per cent a year ago. Currency in circulation increased by 21.6 per cent (Rs.1,11,077 crore), higher than 14.3 per cent (Rs.64,432 crore) a year ago. There was also a large increase in bankers' deposits with the Reserve Bank, *i.e.,* of the order of Rs.95,986 crore on top of Rs.97,923 crore a year ago due to successive increases in the cash reserve ratio (CRR). During the current financial year up to July 18, reserve money increased by 2.5 per cent (Rs.23,281 crore) as compared with the increase

of 6.1 per cent (Rs.43,080 crore) in the corresponding period of the previous year. Among the components, currency in circulation recorded a higher increase of 5.9 per cent (Rs.34,915 crore) as compared with 2.1 per cent (Rs.10,539 crore) in the corresponding period last year. Among the sources of reserve money, the Reserve Bank's net foreign exchange assets increased by Rs.75,552 crore, mainly due to revaluation on account of depreciation of the rupee against other currencies during the period, as against an increase of Rs.27,735 crore in the corresponding period last year. Adjusted for revaluation effects, the Reserve Bank's net foreign currency assets declined by Rs.18,139 crore as against an increase of Rs.72,947 crore in the corresponding period of 2007-08. The Reserve Bank's net credit to the Central Government increased by Rs.55,581 crore as against an increase of Rs.18,875 crore in the corresponding period last year. Adjusted for issuances under the MSS, the Reserve Bank's net credit to the Central Government showed an increase of Rs. 58,628 crore as compared with an increase of Rs. 40,928 crore a year ago.

20. Under the Special Market Operation (SMO) scheme announced on May 30, 2008 the Reserve Bank has been conducting open market operations (OMOs) in the secondary market against oil bonds held by public sector oil marketing companies and providing them equivalent foreign exchange through the designated banks. An overall daily ceiling under the SMO was initially set at Rs.1,000 crore and subsequently revised to Rs.1,500 crore on June 11, 2008 on a review of operations. Public sector oil marketing companies have been provided US $ 4.3 billion (Rs.19,325 crore) against oil bonds purchased under the scheme up to July 25, 2008. The SMO is an *ad hoc* measure and is being reviewed on a continuous basis with a view to terminating these operations as soon as feasible.

21. During the first quarter of 2008-09, there were some shifts in liquidity conditions. As end-March balance sheet adjustments unwound and advance tax payments flowed back into the banking system with a large drawdown of Central Government's cash balances, liquidity conditions eased between the first week of April 2008 and the first week of May 2008. Absorption under the LAF averaged Rs.26,556 crore during April 2-May 15, 2008 with the peak absorption of Rs.79,005 crore on April 8, 2008. During April 1-May 21, 2008 there was net absorption of Rs.7,868 crore under the MSS. Under normal 91-day Treasury-bill auctions, an enhanced amount of Rs.3,000 crore was notified during May 14-June 18, 2008 for meeting farm debt waiver commitments. Banks' dependence on export credit refinance (ECR) fell from a daily average of Rs.820 crore during the fortnight ended April 11, 2008 to Rs.208 crore in the fortnight ending May 23, 2008. With increases in the CRR effective from April 26, May 10 and May 24, liquidity conditions tightened. There were net injections through the LAF between May 26-July 1, 2008 but for a brief lull during June 2-9, 2008. During June 2008, however, there was average net injection under the LAF of the order of Rs.8,622 crore. Advance tax outflows and the consequent building up of Central Government's cash balances tightened liquidity conditions further from mid-June 2008. The increase in the CRR announced on June 24, 2008 in two stages of 25 basis points each effective from July 5 and July 19, 2008 sucked out an amount of nearly Rs.20,000 crore from the system. LAF repo operations rose to a peak of Rs.52,315 crore on July 21, 2008. On a review of liquidity conditions, MSS auctions were resumed on July 9, 2008. Banks also availed of ECR in the range of Rs.144 crore - Rs.5,605 crore during June-July 2008.

22. On a net basis, average daily LAF absorption, which stood at Rs.2,116 crore in the last quarter of 2007-08, increased to

Rs.9,881 crore in the first quarter of 2008-09 but changed to net injection of Rs.28,730 crore in July so far (up to July 25). The average daily balances under the MSS increased from Rs.1,71,090 crore in January-March 2008 to Rs.1,75,588 crore during April-June 2008 but fell to Rs.1,73,317 crore by July 25, 2008. Cash balances of the Central Government with the Reserve Bank fell from an average of Rs.66,844 crore in January-March 2008 to Rs.30,587 crore in the first quarter of 2008-09 and declined further to Rs.9,109 crore on July 24, 2008. The total overhang of liquidity as reflected in the balances under the LAF, the MSS and the Central Government's cash balances taken together declined from an average of Rs.2,42,370 crore in April 2008 to Rs.2,12,201 crore in May 2008 and Rs.1,93,726 crore in June 2008 (with an intra-year peak of Rs.2,93,048 crore on April 8, 2008) before declining to Rs.1,45,200 crore on July 25, 2008.

23. Inflation has increased to a 13-year high and inflation expectations have been driven up partly by unrelenting pressures from international commodity prices, particularly crude oil, basic metals and selected food items. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, increased to 11.89 per cent as on July 12, 2008 from 7.75 per cent as at end-March 2008 and 4.76 per cent a year ago. Prices of primary articles and manufactured products rose by 10.15 per cent and 10.72 per cent, respectively, on a year-on-year basis as compared with the increase of 11.13 per cent and 4.80 per cent a year ago. Prices of the fuel group increased by 16.94 per cent as against a decline of 1.44 per cent a year ago. Excluding the fuel group, year-on-year inflation rose to 10.52 per cent from 6.59 per cent a year ago. Similarly, excluding fuel and food, inflation rose to 11.83 per cent from 5.65 per cent a year ago. The main drivers of inflation during 2008-09 so far have been mineral oils (with a weighted contribution of 28.1 per cent), basic

metals and alloys (18.8 per cent), oilseeds, edible oils and oil cakes (13.9 per cent), chemicals and chemical products (9.5 per cent), milk (2.7 per cent), and minerals (4.1 per cent) with a total weight of 36.8 per cent in the WPI basket and a combined contribution of over 77.3 per cent to overall inflation. On an annual average basis, headline WPI inflation was 5.98 per cent up to July 12, 2008 as against 5.62 per cent a year ago.

24. Within primary articles, both food and non-food articles contributed to the price rise with milk, oilseeds, raw cotton and iron ore being the major components. Year-on-year inflation in terms of foodgrains prices increased to 5.6 per cent as on July 12, 2008 from 7.4 per cent in the corresponding period of the previous year. Prices of some key food items have decelerated in recent months as record agricultural production has augmented supply conditions including higher stock of foodgrains with public agencies. There has, however, been continuous hardening of the prices of oilseeds since November 2006 due to both domestic and global factors with a consequential increase in the prices of edible oils and oil cakes. Iron ore prices also rose on account of high domestic and export demand.

25. The large contribution of petroleum products, both administered and freely-priced, in the recent spurt in inflation needs to be seen in the context of the fact that the pass-through of oil prices has not been happening on a continuous basis. The price of the Indian basket of crude oil increased from US $ 99.4 per barrel in March 2008 to US $ 129.8 in June 2008 and further to US $ 141.5 on July 3, 2008 before declining to US $ 121.9 on July 25, 2008. While international crude (Indian basket) prices increased by 129 per cent in US dollar terms

and 122 per cent in rupee terms during February 2007-June 2008, the domestic prices of freely priced products increased by about 76 per cent and the prices of administered products increased by only around 14 per cent over the same period.

26. On a year-on-year basis, inflation based on the consumer price index (CPI) for agricultural labourers and rural labourers increased to 8.8 per cent and 8.7 per cent, respectively, in June 2008 from 7.8 per cent and 7.5 per cent a year ago. Year-on-year inflation based on CPI for industrial workers and urban non-manual employees stood at 7.8 per cent and 6.8 per cent, respectively, in May 2008 as compared with 6.6 per cent and 6.8 per cent a year ago. The CPI-based inflation measures have increased in the range of 2.0-3.2 percentage points over their levels in January 2008.

27. In terms of proportions to budget estimates (BE), revenue receipts of the Central Government increased to 6.0 per cent in April-May 2008 from 5.3 per cent during April-May 2007. Plan expenditure was higher whereas non-Plan expenditure was marginally lower resulting in the total expenditure rising to 14.6 per cent of BE in April-May 2008 from 13.3 per cent of BE a year ago. Accordingly, the gross fiscal deficit (GFD) increased to 54.9 per cent of BE from 41.2 per cent of BE a year ago. The revenue deficit at 122.7 per cent of the BE during April-May 2008 was higher than 83.0 per cent in the corresponding period last year.

28. The gross market borrowings of the Central Government through dated securities at Rs.72,000 crore (Rs.73,000 crore a year ago) during 2008-09 so far (up to July 25, 2008) constituted 41.0 per cent of the BE whereas net market borrowings at Rs.47,982 crore (Rs.45,232 crore a year ago)

constituted 48.5 per cent of the BE. The weighted average yield and weighted average maturity of Central Government securities issued during 2008-09 so far were higher at 8.62 per cent and 15.18 years, respectively, as compared with 8.12 per cent and 14.90 years for those issued during 2007-08 (full year). As against the estimated gross market borrowing of Rs.59,000 crore (net: Rs.44,629 crore), State Governments mobilised Rs.8,712 crore (net: Rs.3,583 crore) by July 25, 2008.

29. The Central Government had issued special securities amounting to Rs.38,050 crore and Rs.40,321 crore, respectively, during 2007-08 and 2006-07 outside the market borrowing programme and the MSS. There have been no such issuances during 2008-09 so far. As mentioned in the Annual Policy Statement of April 2008 issuances of Government bonds to public sector oil marketing companies for partial compensation of their under-recoveries and to fertiliser companies to cover their under-recoveries/subsidy need to be continuously monitored in view of the implication for the evolving fiscal outlook.

30. Financial markets reflected the changes in liquidity conditions during the first quarter of 2008-09. The weighted average call money rates rose from 6.11 per cent in April 2008 to 7.75 per cent in June 2008 due to tighter liquidity consequent upon increases in the CRR in April and May 2008 and in the LAF repo rate on June 12, 2008 and June 25, 2008. The call rates started moving upwards from June 12 and reached a level of 9.12 per cent on July 25, 2008. Interest rates in the collateralised borrowing and lending obligation (CBLO) and market repo segments moved in tandem with call rates and increased from 5.05 per cent and 5.48 per cent, respectively, in April 2008 to 7.21 per cent and 7.42 per cent in June 2008 and further to 8.51 per cent and 8.64 per cent on July 25, 2008.

The daily average volume (one leg) in the call money market increased from Rs.9,758 crore in April 2008 to Rs.10,854 crore in June 2008. The corresponding volumes in the market repo (outside the LAF) were Rs.14,966 crore and Rs.11,262 crore, whereas in the CBLO segment, the volumes were Rs.38,828 crore and Rs.35,774 crore, respectively. During July 2008 (up to July 25), the average daily volume in the call, market repo and CBLO segments were Rs.13,367 crore, Rs.7,255 crore and Rs.20,501 crore, respectively.

31. There was a marked increase in CP issuances and the outstanding amount increased to Rs.48,342 crore by mid-July 2008 from Rs.32,592 crore at end-March 2008. The weighted average discount rate (WADR) on CP, which had declined from 10.38 per cent at end-March 2008 to 8.57 per cent as on May 15, 2008 increased to 10.75 per cent by mid-July 2008. In the market for certificates of deposit (CDs), the WADR declined from 10.0 per cent at end-March 2008 to 8.49 per cent as on April 25, 2008 but subsequently increased to 9.68 per cent as on July 4, 2008. The outstanding amount of CDs increased from Rs.1,47,792 crore at end-March, 2008 to Rs.1,64,557 crore as on July 4, 2008.

32. Yields in the Government securities market hardened substantially during the current financial year in both primary and secondary segments. Primary yields on 91-day, 182-day and 364-day Treasury Bills increased by 184 basis points, 196 basis points and 210 basis points, respectively, over the end-March 2008 level to 9.06 per cent, 9.32 per cent and 9.45 per cent by July 25, 2008. In the secondary market, yields on Government securities with one year residual maturity moved up by 176 basis points over their end-March 2008 level to 9.25 per cent by July 25, 2008. The yields on Government

securities with 10-year and 20-year residual maturity also increased during this period by 117 basis points and 133 basis points, respectively, to 9.10 per cent and 9.64 per cent. Consequently, the yield spread between 10-year and one-year Government securities narrowed from 44 basis points in March 2008 to (-)15 basis points as on July 25, 2008 whereas the spread between 20-year and one-year Government securities narrowed from 82 basis points to 39 basis points over the same period.

33. Deposit rates of SCBs increased, particularly at the longer end of the maturity spectrum, during the first four months of 2008-09 (up to July 25). The interest rates of public sector banks (PSBs) on deposits of maturity from 91 days and up to one year increased to the range of 5.75-9.25 per cent in July 2008 as compared with 5.25-8.50 per cent in March 2008. The deposit rates of private sector banks on deposits of both maturity of one to three years and above three years firmed up to the range of 8.00-10.00 per cent in July 2008 as compared with the range of 7.25-9.25 per cent and 7.25-9.75 per cent, respectively, in March 2008. On the lending side, the benchmark prime lending rate (BPLR) of PSBs and private sector banks were placed in the range of 12.75-14.00 per cent and 13.50-17.25 per cent, respectively, in July 2008 as compared with 12.25-13.50 per cent and 13.00-16.50 per cent in March 2008.

34. Increased activity in the foreign exchange market was reflected in a rise in the average daily turnover to US $ 49.4 billion in July 2008 (up to July 18, 2008) from US $ 44.9 billion a year ago. While the inter-bank turnover increased from US $ 32.6 billion to US $ 37.2 billion, the merchant turnover at US $ 12.3 billion was close to US $ 12.2 billion a year ago. There has been a hardening of forward premia across all maturities. The six-month

forward premia increased from 2.47 per cent at end-March 2008 to 4.70 per cent as on July 25, 2008.

35. The equity markets witnessed a major downturn in both the primary and secondary segments during the current financial year so far, continuing the moderation that had set in by early January 2008. In the primary market, resource mobilisation through public issues declined sharply as compared with the corresponding period last year. Resource mobilisation through private placement and euro issues, however, increased significantly during the current year so far when compared with the corresponding period last year. In the secondary market, the BSE Sensex (1978-79=100) recorded a low of 12576 on July 16, 2008 before increasing to 14275 by July 25, 2008 which was 8.8 per cent lower than the end-March 2008 level and 31.6 per cent lower than the peak level of 20873 recorded on January 8, 2008.

Developments in the External Sector

36. Balance of payments data for January-March 2008 as well as for the full year 2007-08 were released by the Reserve Bank at end-June 2008. In US dollar terms, merchandise exports recorded an increase of 23.7 per cent during 2007-08 on a payments basis, as against 21.8 per cent in the previous year. Commodity-wise data released by the Directorate General of Commercial Intelligence and Statistics (DGCI&S) for 2007-08 indicate a pick-up in the growth of exports of primary products as well as manufactured goods. Agriculture and allied products, engineering goods, gems and jewellery and petroleum products contributed about 69 per cent of export growth during 2007-08. Merchandise imports on a payments basis rose by 29.9 per cent

in 2007-08 as compared with 21.8 per cent in 2006-07. Imports of petroleum, oil and lubricants (POL) increased by 39.4 per cent on top of the growth of 30.0 per cent in 2006-07 mainly on account of an increase of 27.4 per cent in the average price of the Indian basket of crude oil during the year. POL imports in terms of quantity, however, showed a relatively moderate growth of 10.1 per cent. Non-oil import payments increased by 24.4 per cent, mainly on account of strong growth in imports of capital goods and gold and silver. As a result, the merchandise trade deficit widened to US $ 90.1 billion (7.7 per cent of GDP) on a payments basis in 2007-08 from US $ 63.2 billion (6.9 per cent of GDP) in the previous year.

37. During 2007-08, gross invisible receipts comprising services, current transfers and income at US $ 145.2 billion recorded an increase of 26.2 per cent and amounted to nearly 92 per cent of merchandise exports. There was sustained growth in software exports, travel and transportation along with steady inflows of remittance from overseas Indians. Private transfer receipts, mainly comprising remittances from Indians working overseas, amounted to US $ 42.6 billion as compared with US $ 29.0 billion in 2006-07. Invisible payments increased by 17.7 per cent during 2007-08, mainly on account of a surge in travel payments related to outbound tourist traffic as also the impact of liberalisation of outward foreign exchange remittance for individuals, business and management consultancy services, engineering and technical services as well as dividend, profit and interest payouts. During 2007-08, the net invisibles surplus was US $ 72.7 billion as compared with US $ 53.4 billion in the previous year. Accordingly, the current account deficit (CAD) amounted to US $ 17.4 billion (1.5 per cent of GDP), up from US $ 9.8 billion (1.1 per cent of GDP) in 2006-07.

38. Gross capital inflows to India amounted to US $ 428.7 billion, while gross capital outflows were of the order of US $ 320.7 billion during 2007-08. Net capital flows at US $ 108.0 billion were 2.4 times and 4.2 times higher than net capital inflows during 2006-07 and 2005-06, respectively. Sizeable increases in net inflows were received under portfolio investment, external commercial borrowings (ECB), foreign direct investment (FDI), short-term credit and banking capital excluding non-resident Indian (NRI) deposits. Net FDI inflows amounted to US $ 15.5 billion in 2007-08, sizeably higher than US $ 8.5 billion in 2006-07. Inward FDI were channelised into sectors such as manufacturing, construction, business and computer services. Net ECBs of US $ 22.2 billion were higher than US $ 16.2 billion in the previous year and were enabled by finer spreads and rising financing requirements. Net portfolio inflows were significantly higher at US $ 29.3 billion than US $ 7.1 billion in 2006-07, mainly due to net foreign institutional investment (FII) inflows at US $ 20.3 billion as against US $ 3.2 billion, reflecting net purchases in the Indian stock market as well as resource mobilisation by the Indian companies through their global offerings of American Depository Receipts/Global Depository Receipts (ADRs/GDRs) in view of the favourable external market conditions. Driven by increased financing requirements of crude oil imports, net short-term trade credit increased by US $ 17.7 billion against US $ 6.6 billion in the previous year. Net accretion to NRI deposits increased marginally by US $ 0.2 billion as compared with US $ 4.3 billion in the previous year.

39. Reflecting the movements in current and capital accounts of the balance of payments, the accretion to foreign exchange reserves (excluding valuation) amounted to US $ 92.2 billion during 2007-08 which was much higher than US $ 36.6 billion in 2006-07. Foreign exchange reserves amounted to US $ 309.7 billion at end-March 2008.

40. India's external debt increased by 30.4 per cent during 2007-08 and amounted to US $ 221.2 billion at end-March 2008. The increase was mainly due to ECBs and short-term borrowings that contributed around 39.5 per cent and 34.8 per cent, respectively, of the total increase of US $ 51.5 billion in external debt. Multilateral and bilateral debt registered a moderate increase. Valuation effects, reflecting the depreciation of the US dollar against other major international currencies and the Indian rupee, accounted for US $ 9.9 billion. The US dollar had a dominant share of 57.1 per cent in India's external debt whereas rupee-denominated debt had a share of 14.5 per cent. The share of short-term debt in total debt increased to 20.0 per cent at end-March 2008 from 15.5 per cent a year ago.

41. Information released by the DGCI&S indicates that exports increased by 21.7 per cent in US dollar terms during the first two months of the current financial year, as compared with 24.2 per cent in the corresponding period of the previous year. Imports rose by 31.8 per cent as compared with 37.9 per cent in the corresponding period of the previous year. While non-POL imports moderated to 24.6 per cent from 43.8 per cent a year ago, POL imports increased by 48.6 per cent on account of the surge in crude oil prices as compared with 25.7 per cent in the corresponding period of the previous year. As a result, the merchandise trade deficit widened to US $ 20.7 billion during April-May 2008 from US $ 13.9 billion in the corresponding period last year.

42. Available information points to deceleration in capital flows during the current financial year so far. Portfolio investment in India recorded net outflows by FIIs amounting to US $ 6.5 billion

during 2008-09 (up to July 18, 2008); on the other hand, ADR/GDR issues by Indian companies amounted to US $ 999 million during April-May 2008 as compared with US $ 16 million in the corresponding period last year. Gross FDI inflows during April-May 2008 were placed at US $ 7.7 billion as against US $ 3.8 billion a year ago. There were net inflows of US $ 292 million during April-May 2008 under NRI deposits as against net outflows of US $ 559 million a year ago. The foreign exchange reserves declined marginally by US $ 2.6 billion during the current financial year so far and stood at US $ 307.1 billion on July 18, 2008.

43. The exchange rate of the rupee against the US dollar, which was Rs.39.97 at end-March 2008, depreciated thereafter to Rs.43.37 per US dollar on July 8, 2008 before appreciating somewhat to Rs.42.23 on July 25, 2008. During the current financial year up to July 25, 2008 the rupee depreciated by 5.4 per cent against the US dollar, by 5.0 per cent against the euro, by 5.2 per cent against the pound sterling and by 1.3 per cent against the Japanese yen. As on July 25, 2008 the exchange rate of the rupee was Rs.42.23 per US dollar, Rs.66.41 per euro, Rs.83.39 per pound sterling and Rs.39.58 per 100 Japanese yen.

44. 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

45. During the first half of 2008, global economic activity decelerated in an environment of surging inflation and heightened uncertainty. There are indications that the slowdown is deepening in the advanced economies and could affect emerging market economies (EMEs), notwithstanding the strength of domestic demand. Despite some abatement in the global financial turbulence and the continuing process of balance sheet repair for key institutions, financial risks remain high and concerns about rising losses have exacerbated the pessimism on the macroeconomic outlook. According to the update of World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in July 2008, global real GDP growth on a purchasing power parity basis is expected to decelerate from 5.0 per cent in 2007 to 4.1 per cent in 2008 (3.7 per cent in WEO, April 2008) and further to 3.9 per cent in 2009 (3.8 per cent in WEO, April 2008).

46. In the US, real GDP grew by 1.0 per cent in the first quarter of 2008 as compared with 0.6 per cent a year ago. The pick-up in growth in the early months of 2008 reflected positive contributions from personal consumption expenditures (PCE) for services, exports of goods and services, federal government spending and private inventory investment. On the other hand, there was a decline in residential fixed investment, imports and PCE on durable and non-durable goods. Labour markets weakened with the unemployment rate rising to 5.5 per cent in May-June 2008. Industrial production dropped by 3.1 per cent in the second quarter of 2008 *vis-à-vis* the first quarter of 2008. The rate of capacity utilisation for industry moved up to 79.9 per cent, a level 1.1 percentage points below the average for 1972-2007. US home prices, which had recorded a steep decline in the

first quarter of 2008, posted a fall of 15.3 per cent in April 2008 as compared with a year earlier. Single-family housing starts declined to their lowest level in 17 years in June. The July home-builder confidence fell to a record low for the third consecutive month. In June, US retail sales recorded an increase of 3.0 per cent on account of fiscal stimulus payments. Consumer sentiment also improved in July from the 28-year low recorded in June. The index of leading indicators declined marginally in May-June, continuing the downward trend that began in the middle of 2007. The IMF's July 2008 update of its WEO expects the US economy to slow from 2.2 per cent in 2007 to 1.3 per cent in 2008, with the gains in the first quarter being moderated during the second half of the year as consumption is dampened by rising commodity prices and tight credit conditions. The US economy is projected to grow at 0.8 per cent in 2009.

47. Real GDP in the euro area grew by 2.2 per cent in the first quarter of 2008 on a year-on-year basis as compared with 3.0 per cent a year ago. Growth is forecast to slow down considerably in the coming quarters. Industrial production is losing momentum and expectations polled in business surveys are declining. While unemployment in the euro area fell to 7.2 per cent in May 2008 from 7.5 per cent a year ago, real disposable income growth is likely to remain weak with increases in nominal wages eroded by high inflation rates. Private consumption is expected to grow only modestly in 2008. The expansion of investment is also likely to moderate. The July 2008 update of the IMF's WEO has placed real GDP growth of the euro area at 1.7 per cent in 2008 and 1.2 per cent in 2009 as against 2.6 per cent in 2007.

48. The Japanese economy grew by 3.3 per cent in the first quarter of 2008 as compared with 2.6 per cent a year ago. The

pace of growth of business fixed investment and exports has slowed, corporate profit has deteriorated and business sentiments have become more cautious. Growth in private consumption has recently turned sluggish due to continued increase in food and fuel prices. The July 2008 WEO of the IMF has projected that Japan's economy will grow by 1.5 per cent each in 2008 and 2009 as compared with 2.1 per cent in 2007.

49. The Chinese economy grew by 10.1 per cent in the second quarter of 2008 as compared with 11.9 per cent a year ago. Currency appreciation, higher wages and rising raw material costs are being reflected in an erosion of China's export competitiveness. China's trade surplus for June 2008 was US $ 21.4 billion as against US $ 26.9 billion in June 2007 on account of deceleration in exports, particularly to the US. The total foreign exchange reserves, however, increased to US $ 1.81 trillion in June 2008, recording an increase of 35.7 per cent over June 2007. The CSI 300 Index, which tracks yuan-denominated A shares listed on China's two exchanges, has fallen by 30.9 per cent over the year to close at 2939 on July 25, 2008. The July 2008 WEO of the IMF has projected that the Chinese economy will grow by 9.7 per cent in 2008 and by 9.8 per cent in 2009 as compared with 11.9 per cent in 2007.

50. Elsewhere in Asia, the Korean economy grew by 4.8 per cent in the second quarter of 2008 as against 4.9 per cent a year ago. Economic activity is expected to decelerate in 2008 due to slowdown in domestic demand, rising fuel costs and moderation in export growth. In Thailand, economic activity grew by 6.0 per cent in the first quarter of 2008 as against 4.2 per cent a year ago.

51. Inflation has become a global phenomenon in recent months with no noticeable signs of abatement in the near future.

In the US, consumer prices increased from 2.7 per cent in June 2007 to 5.0 per cent in June 2008. In the euro area, inflation increased to 4.0 per cent in June 2008 from 1.9 per cent in June 2007. In Japan, inflation increased to 2.0 per cent in June 2008 from (-)0.2 per cent a year ago on account of rising oil and food costs. In the UK, CPI inflation accelerated to 3.8 per cent in June 2008 from 2.4 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 July 1991. RPI inflation has remained elevated since then and was 4.6 per cent in June 2008.

52. Core CPI inflation in the US increased to 2.4 per cent in June 2008 from 2.3 per cent in May 2008. In the UK, core CPI inflation increased to 1.6 per cent in June from 1.5 per cent in May 2008. In the euro area, core CPI inflation increased to 1.8 per cent in June 2008 from 1.7 per cent in May 2008. Core inflation in Japan was at 0.1 per cent in June 2008 as compared with (-) 0.1 per cent in May 2008. The increase in producer prices has been sharper than in consumer prices, reflecting increased input costs. In the US, producer prices increased to 9.2 per cent in June 2008 from 3.3 per cent in June 2007. In the euro area, producer prices increased to 7.1 per cent in May 2008 from 2.5 per cent in May 2007. In the UK, producer prices increased to 10.0 per cent in June 2008 from 2.5 per cent in June 2007. Wholesale price inflation in Japan increased to 4.7 per cent in May 2008 from 1.7 per cent in May 2007. Overall, the persistence of high food and oil prices at elevated levels and continued high prices of other commodities pose significant inflation risks for the global economy and challenges for monetary policy worldwide.

53. Inflation pressures have raised serious concerns in EMEs across Asia, Latin America and Africa, mainly on account of

supply-demand imbalances in food, fuel and commodity markets. In China, inflation decelerated from a peak of 8.7 per cent in February to 7.1 per cent in June 2008 to 8.7 per cent as compared with 4.4 per cent in June 2007. The Peoples' Bank of China has raised the required reserve ratio in phases to 17.5 per cent on June 25, 2008. Consumer price inflation in Korea accelerated to 5.5 per cent in June 2008 from 2.5 per cent in June 2007. In Thailand, inflation increased to 8.9 per cent in June 2008 from 1.9 per cent in June 2007. Other EMEs such as Brazil, Chile and Mexico in Latin America have witnessed acceleration in their inflation rates in the wake of high inflation in commodity prices. Producer price inflation in EMEs – both in Asia and elsewhere – has been substantial in the first half of 2008, driven by escalating commodity prices, particularly energy and food.

54. In recent months, high food prices have led to serious difficulties in the form of erosion of purchasing power and inadequate supplies, especially for vulnerable population groups that spend a substantial part of their incomes on food. For many developing countries, the steady rise in world prices of all cereals has pushed up the food import bill, generating widespread increases in domestic food prices on imported pressures. The food price index of the Food and Agricultural Organisation (FAO) increased by 44 per cent on a year-on-year basis up to June 2008, resulting in a doubling of global food prices over the past two years. In the global foodgrains market, prices of major crops such as corn, soyabean and wheat have increased by 82.7 per cent, 84.2 per cent and 28.1 per cent, respectively, by July 25, 2008 from their levels a year ago in response to surging demand, sparking food riots in several countries.

55. Global food imports are forecast by the FAO to be US $ 1,035 billion, *i.e.,* an additional US $ 215 billion over

the level recorded in 2007. The food import bill of the Low-Income Food-Deficit Countries (LIFDCs) is likely to climb to US $ 169 billion in 2008, 40 per cent more than in 2007. While the expected good harvest in the current year may exert a dampening effect on inflation, food prices are unlikely to ease significantly in view of the escalated cost of inputs and sustained demand including the need to replenish stocks. A major factor pushing up international prices of basic foods has been the low level of exportable surpluses resulting from domestic utilisation outstripping production for several crops in a number of major exporting countries. Restrictions on exports announced by major foodgrain-exporting nations such as Argentina, Kazakhstan and Russia for wheat and Cambodia, Egypt, India, Pakistan and Vietnam for rice continue, imposing pressures on the global food price inflation. Concerns about weather-related production losses, surging oil prices and the weaker dollar have also fuelled speculative demand for agricultural products.

56. The FAO has placed its latest forecast for world cereal production in 2008 at a record 2,180 million tonnes, 2.8 per cent up from last year's record level. The bulk of the increase is expected in wheat which is forecast at 658 million tonnes, representing an increase of 8.3 per cent over the level in 2007. Bigger harvests are expected in all regions with the exception of Asia. Strong demand in domestic and world markets has, however, depleted stocks in major exporting countries where production in 2007 suffered from exceptionally poor yields. World wheat stocks at the close of the season in 2007-08 are forecast at 151.2 million tonnes, down 6.0 per cent from their already reduced opening level. World wheat stocks are, however, expected to increase by 11.5 per cent and reach 169 million tonnes by the close of the crop season in 2008-09. Wheat prices have remained generally firm and volatile since October 2007.

One-month wheat futures at the Chicago Board of Trade (CBOT) declined from US $ 9.15 per bushel on January 2, 2008 to US $ 8.11 on July 25, 2008. On the same day, futures prices for wheat were quoted higher for December 2008 at US $ 8.35, for March 2009 at US $ 8.55 and for July 2009 at US $ 8.82 per bushel.

57. Global paddy production in 2008 may rise by 1.4 per cent to 666 million tonnes as producers in all regions have responded to high market prices in the first half of the year by increasing rice cultivation. International near-month futures price of rice on the CBOT has fallen to US $ 16.72 per hundredweight on July 25, 2008 after a rise of 80.5 per cent since January 2008 to a high of US $ 24.50 on April 23, 2008. On July 25, 2008 futures prices were quoted higher at US $ 17.00 for November 2008, US $ 17.61 for March 2009 and at US $ 18.21 for July 2009.

58. The FAO's forecast for global coarse grains output in 2008 at 1,078 million tonnes is virtually unchanged from last year's record high. The growth in world coarse grain utilisation is forecast to slow down in 2008-09 to 1.6 per cent from over 5 per cent in 2007-08 on account of tighter supplies which would boost usage of wheat and non-grain alternatives for animal feed. Strong demand for ethanol is the main driver of high prices in the global coarse grain markets. The futures prices of corn on CBOT, which had moderated somewhat up to August 2007, started moving up thereafter and reached US $ 5.77 per bushel on July 25, 2008. On the same day, futures prices for corn were quoted higher for December 2008 at US $ 5.97, for March 2009 at US $ 6.16 and for July 2009 at US $ 6.38 per bushel.

59. Metal prices have increased by 14.6 per cent during the first six months of 2008 after declining by 8.1 per cent during

2007. Prices of metals such as aluminium have softened in the recent period on concerns about global growth which might impact demand. However, lead and copper prices have increased on supply concerns and dwindling stocks. Futures price of copper on the New York Mercantile Exchange (Nymex) increased to a record level of US $ 4.08 per pound on July 2, 2008 from US $ 3.50 a year ago. As on July 25, 2008, the near-month futures price for copper stood at US $ 3.70 per pound, US $ 3.61 for September 2008, US $ 3.59 for December 2008 and US $ 3.50 for July 2009. Spot gold rose to US $ 1002.30 an ounce on March 17, 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 $ 922.71 an ounce on July 25, 2008 from US $ 661.62 a year ago.

60. Prices of crude oil, which have rebounded since July 2007, increased by 60.0 per cent up to July 25, 2008 from their level a year ago. Near-month futures prices reached the level of US $ 122.51 per barrel on July 25, 2008 dipping from US $ 145.31 recorded on July 3, the highest since trading began on the Nymex in 1983. On July 25, oil futures ruled higher at US $ 123.26 for September 2008, US $ 124.62 for December 2008 and US $ 124.83 for July 2009. According to the Energy Information Administration (EIA), the oil supply system continues to operate at near capacity and remains vulnerable to both actual and perceived supply disruptions. World oil markets have been particularly tight during the first half of 2008, with year-on-year growth in world oil consumption outstripping growth in non-Organisation of the Petroleum Exporting Countries (OPEC) production by over 1 million barrel per day. The combination of rising global demand, fairly normal seasonal inventory patterns, slow gains

in non-OPEC supply and low levels of available surplus production capacity is providing firm support for prices.

61. Net non-OPEC production, especially from Russia, the North Sea and Brazil, could be lower than expected, leading to both higher demand for OPEC oil and higher prices than currently projected. Even with increased Saudi Arabian output at 9.7 million barrels per day from July, available surplus production capacity during the third quarter would be only 1.2 million barrels per day. World oil consumption is projected to rise by 1.2 million barrels per day during the second half of 2008 and by 1.4 million barrels per day in 2009. According to the EIA, the average price of West Texas Intermediate (WTI) crude oil is expected to be at US $ 127.39 per barrel in 2008 and US $ 132.75 per barrel in 2009.

62. In the global financial markets, sentiment has been adversely affected by concerns relating to a deep and prolonged recession in the US, somewhat alleviated by recent data on consumer sentiment, durable goods orders, consumer spending and oil prices. In addition, losses to the financial sector continue to mount in addition to rising debt defaults. Inter-bank stress remains high despite unprecedented and sustained central bank interventions. Banks' wholesale funding remains weak, especially in the asset backed commercial paper (ABCP) market. There has also been continued weakness in equities and bond markets in recent months. The easing of the turmoil does not appear to be in sight with news about fresh write-downs and job losses emanating every day, indicating renewed dislocations.

63. The Dow Jones Industrial Average, Standard and Poor's (S&P) 500 and Nasdaq Composite exhibited considerable volatility and posted declines of 17.5 per cent, 17.2 per cent

and 10.6 per cent, respectively, by July 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 as demand for government debt increased with investors seeking safe haven on the likelihood that the economy is already in a recession. The US 10-year bond yield increased from 4.70 per cent at end-December 2006 to 5.29 per cent on June 12, 2007 before falling to 4.11 per cent on July 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 4.62 per cent on July 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 1.58 per cent on July 25, 2008. In emerging markets, however, especially in Asia, there has been sustained growth in public issues during 2008 so far, despite a credit crunch in the US and its attendant fall-out on the rest of the global economy.

64. 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 July 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 an intra-day peak of US $ 1.60 on July 15, 2008 before declining to US $ 1.57 on July 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 74.11 cents on July 25, 2008.

65. Central banks have continued to work together and to consult regularly on liquidity conditions in financial markets. In view of the persistent liquidity pressures in some term funding markets, the European Central Bank (ECB), the Federal Reserve and the Swiss National Bank (SNB) announced an expansion of their liquidity measures on May 2, 2008. Since December 2007, the Fed has conducted fifteen auctions amounting to US $ 790 billion for 28 days maturity each and an auction of US $ 20 billion with 35 days maturity up to July 14, 2008. It has also announced an offer of US $ 75 billion in 28 days credit through its term auction facility (TAF) on July 28, 2008. In a bid to ensure continuation of economic growth, the US Treasury has issued fiscal stimulus payments to American households for an amount of about US $ 91 billion during April 28-July 11, 2008.

66. Since December 2007, the ECB has conducted thirteen US dollar TAF auctions amounting to US $ 235 billion up to July 17, 2008 for 28 days maturity each. The Bank of Canada (BoC) has conducted nine 28-day auctions amounting to US $ 16 billion till June 12, 2008. On June 23 and July 8, 2008, the BoC has stated that it will not renew the term purchase and resale agreements (PRA) transactions maturing on June 26 and July 10, 2008. The SNB has conducted ten auctions amounting to US $ 56 billion for 28 days each up to July 15, 2008. The Bank of England (BoE) 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 BoE launched a scheme to allow banks to swap their high quality mortgage-backed and other securities temporarily for UK Treasury Bills. The BoE has, up to July 15, 2008 allotted an amount of £ 54.9 billion for three months' maturity in six

long-term repo auctions since December 2007 against an extended range of collaterals.

67. The confluence of slowdown in growth and mounting inflation alongside financial vulnerabilities has complicated the task of monetary authorities across the world and rendered the future direction of policy setting highly uncertain. Monetary easing in the leading developed countries has increased global liquidity with attendant implications for monetary management in the emerging economies. Some central banks have cut policy rates since the third quarter of 2007 when the financial market turmoil surfaced. During September 18, 2007 to April 30, 2008 the US Federal Reserve reduced its policy rate by 325 basis points to 2.00 per cent after seventeen increases to 5.25 per cent between June 2004 and June 2006. The BoE reduced its Bank Rate to 5.0 per cent by 25 basis points each in February and April 2008 but has left it unchanged since then. The BoC reduced its policy 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. The Reserve Bank of New Zealand reduced the Official Cash Rate from 8.25 per cent to 8.0 per cent on July 24, 2008.

68. Central banks of some countries such as Japan, Korea, Malaysia and China have not changed their policy rates in 2008.

69. Some central banks that have tightened their policy rates in recent months include the ECB (main refinancing operations rate raised by 25 basis points to 4.25 per cent on July 3, 2008); the Reserve Bank of Australia (Cash Rate raised by 25 basis points in February-March 2008 to 7.25 per cent); Bank Indonesia (BI rate raised by 75 basis points in April-June 2008); Bank of Thailand (1-day repurchase rate raised by 25 basis points to

3.50 per cent on July 16, 2008); the Banco Central de Chile (benchmark lending rate raised to 7.25 per cent by 25 basis points in January and 50 basis points each in June and July 2008 from 6.00 per cent in December 2007), Banco Central do Brasil (overnight Selic rate raised by 125 basis points to 13.00 per cent in June-July 2008) and Banco de Mexico (inter-bank 1-month rate by 25 basis points each in June-July 2008 to 8.00 per cent).

Overall Assessment

70. Leading indicators of aggregate supply conditions are emitting mixed signals in an environment of heightened uncertainty. The outlook for agriculture is generally positive on the back of the satisfactory progress of the South-West monsoon across the country so far which has also improved water storage conditions and enabled a substantial increase in sowing area in respect of key crops. There are, however, concerns in some quarters that deficient rainfall received in the monsoon season so far in Andhra Pradesh, Gujarat, Karnataka and Maharashtra may adversely affect the prospects of crops such as oilseeds, pulses, cotton and sugarcane. A sizeable step-up in procurement operations enabled by the record foodgrains production in the preceding year has been supported by expansion in food credit extended by banks under a consortium arrangement. Going forward, the rising level of buffer stocks and prospects for overall improvement in foodgrains production would assuage supply shortages, dampen inflation expectations, economise on imports and fortify food security in the context of the intensifying food crisis worldwide. In this context, it is worthwhile, however, to explore the implications of this rapid build-up in buffer stocks, in particular, the possible unintended consequences of limiting

market supplies at a time when demand-supply gaps are strained and reflected in elevated food prices.

71. Headline industrial growth has moderated and turned somewhat volatile during September 2007-May 2008 following a sustained expansion that began in 2003-04 and peaked in November 2006. In May 2008, however, the growth of industrial production slowed below consensus expectations across all constituent sectors, after appearing to have regained some momentum in April. While production has picked up in some industries such as beverages and tobacco, chemicals and transport equipment, and consumer goods production has been buoyed up by a turnaround in the production of consumer durables out of a trough in January-March 2008, there appears to be a slackening of pace in the basic and intermediate goods segments. The slowing sectors include labour-intensive and small and medium-scale manufacturing industries such as textiles, non-metallic mineral products, rubber, plastic and coal products which together account for about a fourth of manufacturing activity. Output has declined in respect of food products and metal products and parts. Capital goods production, which had held up resiliently so far, weakened in May 2008 and joined other use-based categories in dragging down overall industrial growth. The continuing slowdown in infrastructure is impacting the outlook for the industrial sector.

72. Construction activity may be affected in view of the sluggishness in steel and cement production. More critically, the sharp deceleration in electricity generation is a cause for concern. There are indications of moderation in growth in some of the services sectors, particularly under trade, hotels and restaurants, transport, construction as well as in some categories of financing, real estate and business services. Business confidence surveys

and purchasing managers' indices are indicating some moderation in expectations relating to manufacturing and service sector performance over the months ahead. The recent slackening of growth in the manufacturing sector, in particular, warrants a careful and disaggregated analysis to study the impact of escalated input costs, delays in project implementation due to lags in public policy clearances and competitive pressures from imports with a view to designing medium-term strategies to improve the supply response of India's manufacturing sector as well as its external competitiveness.

73. Aggregate demand pressures appear to be strongly in evidence, exacerbated by the slack in the supply response. First, inflation has surged to a 13-year high and inflation expectations have been driven up by unrelenting pressures partly emanating from international commodity prices, particularly crude oil, oilseeds/edible oils and metals. Second, the sharp escalation of inflationary pressures has occurred in an environment of high growth in monetary and banking aggregates which continue to rule above indicative policy projections for the fourth year in succession, warranting concern in the context of the monetary overhang created by large capital inflows in 2006-07 and particularly in 2007-08. Third, investment demand continues to be strong, growing in the range of 14-19 per cent since 2002-03 and currently constituting 36 per cent of GDP. Furthermore, consumption demand appears to be reviving the production of consumer goods, especially durables. Fourth, with merchandise imports running ahead of exports, the trade deficit has widened sizeably in April-May 2008, reflecting the pressure of domestic demand. There has also been some tightening of external financing conditions in the ongoing global financial turmoil. Fifth, there are indications of growing fiscal stress in the volume of off-budget borrowings by the Centre, impending expenditures

on account of food, fertilizer and POL subsidies, the debt waiver scheme and the award of the Sixth Pay Commission with consequent pressures on aggregate demand.

74. The upsurge in inflation during the current financial year reflects a combination of forces at work. First, on a year-on-year basis, about 30 per cent of headline WPI inflation is contributed by mineral oils, partly reflecting the pass-through of international crude prices to domestic administered prices effected on June 5, 2008. In addition, prices of petroleum products which are not administered have gone up pari passu with international crude prices, exerting considerable pressure on headline inflation. Unlike in some developed economies, the pass-through is not occurring on a continuous basis in developing economies including India which are tailoring their policy responses to suit domestic conditions. Second, there are inflationary pressures in addition to crude oil prices. Even after excluding fuel and food, WPI inflation has remained close to or higher than the headline during the year so far. There are also indications that consumer price inflation is catching up with producer prices so that inflationary pressures at the retail level appear to be broadening in their ambit. Prices of manufactured products have contributed nearly 50 per cent of headline inflation mainly on account of food products, metal products and chemicals which have been impacted by the steep rise in input costs, including import prices. Primary articles have contributed about a fifth of headline inflation, mainly driven by prices of oilseeds, raw cotton and milk. Movements in international prices of key commodities indicate elevated upside pressures for domestic prices of a number of commodities such as coal, edible oil, rice and steel in view of the linkages between global and domestic demand-supply balances, with implications for the evolving scenario.

75. There are some signs of moderation in key monetary and banking aggregates in response to monetary measures which have withdrawn liquidity from the system and tightened interest rates across the term structure. The rate of money supply and deposit growth have started to dip in consonance since June, edging towards the trajectory set for 2008-09. The balancing of monetary and liquidity conditions has not, however, impacted the demand for bank credit which has accelerated on a year-on-year basis. In particular, food credit has recorded a turnaround to support the large-scale operations in food procurement by public agencies. While credit to the petroleum sector has risen sizeably due to the funding requirements of oil companies in the context of the escalation in international crude prices, bank credit to other sectors has also picked up, particularly to infrastructure, cement, chemicals, transport operators and professional and other services, reflecting resilient activity in these sectors. On the other hand, bank credit flowing to agriculture, housing, real estate, construction, metal products, textiles, gems and jewellery and engineering has moderated on account of sector-specific factors which have impacted input costs and impeded the flow of credit. It is noteworthy that the growth in credit during 2008-09 so far has taken the incremental non-food credit-deposit ratio to 82.4 per cent which appears high given the prescribed CRR/SLR and banks' preference for holding excess reserves on a day-to-day basis.

76. Financial markets have generally experienced some tightening of liquidity conditions and hardening of interest rates, particularly since the second half of May as monetary measures took effect. In the money markets, interest rates moved towards the ceiling of the LAF corridor, rising even beyond in June with advance tax payments and in the following weeks, albeit within a narrow range above the repo rate. In the Government

securities market, yields have risen across the spectrum on inflation concerns; with short-term yields responding to monetary measures, there has been a flattening of the yield curve with intermittent inversions. In the foreign exchange market, the spot exchange rate has been under sustained downward pressure from international crude prices, portfolio outflows and uncertainty surrounding the outlook. Forward premia have, however, risen sharply in the recent period as market participants have engaged in adjustments in their positions in response to the shift in the underlying trend of the spot market. The credit market has experienced some tightening in view of banks raising both deposit and lending rates in response to monetary policy action.

77. Fiscal developments in the early months of 2008-09 indicate some stress on the financial position of the Union Government. The headline deficit indicators have generally worsened in April-May 2008 from their levels a year ago. Gross tax revenues have remained buoyant with direct taxes constituting 43 per cent, up from their share of 36 per cent in the first two months of 2007-08. Aggregate plan revenue expenditure on social and other economic services as well as grants to States has risen significantly. Capital outlay has also risen, mainly on account of non-defence spending. In contrast, the growth of non-plan expenditure has been somewhat muted. In view of the enhanced outgo on subsidies, interest payments, farm loan waiver and salaries that is likely to occur over the coming months, public finances have emerged as a source of concern from the point of view of macroeconomic management.

78. In the external sector, the growth of both exports and non-oil imports has moderated in April-May 2008. POL imports, however, have expanded sizeably on account of elevated international crude oil prices. A noteworthy development in recent

years has been the buoyancy in POL exports, particularly since 2003-04 with growth averaging close to 60 per cent per annum up to 2007-08. As a result, the POL deficit (POL exports minus POL imports), which was 118.8 per cent of the overall merchandise trade deficit in 2003-04, declined to 67.9 per cent by 2007-08. Net invisibles continue to provide a stable source of support to the balance of payments. Capital flows are exhibiting mixed developments. While FDI has more than doubled, there have been episodes of reversals of portfolio flows from institutional investors reflecting continuing risk aversion and concerns about the global slowdown. On the other hand, issuances of equity and debt instruments by Indian entities in stock exchanges abroad have picked up. While there has been some drawdown of the foreign exchange reserves during the current financial year, external financing conditions continue to remain viable. The level of reserves is equivalent of more than a year's imports and exceeds the level of external debt.

79. Downside risks to global economic prospects appear to have intensified since the Annual Policy Statement of April 2008. The slowdown of growth seems to be spreading from the US to several other advanced economies with housing and labour markets weakening sharply. The deepening financial turbulence in major financial centres has worsened the macroeconomic outlook further by erosion of consumer and business sentiment and tightening of financing conditions with indications that a generalised credit squeeze may take hold. In the US, the downturn in the housing sector is contracting residential and non-residential investment and consumption demand even as household indebtedness has risen. A positive feature is the strength of export growth which augurs well for investment in the tradeable sector. In the UK, economic activity has continued to slow in 2008 with consumption spending being dragged down

by tightening of credit conditions and falling consumer confidence. The slowing housing sector is also impacting construction activity. While growth in the euro area has been somewhat more resilient, business confidence has declined and private consumption has decelerated along with exports. The Japanese economy has expanded in the first half of 2008 on the back of strong exports and relatively robust consumption and employment growth, although falling residential investment and deteriorating business sentiment appears to be tempering domestic demand. Consensus forecasts suggest that the global economy will slow significantly in 2008 but whether or not it will avoid a sharp and synchronised downturn is yet unclear.

80. The impact of the slowdown in developed economies on EMEs cannot but be adverse, but it has so far been limited by the strength of domestic demand, particularly investment, and consumption spending has remained stable. The slowing of import demand from developed economies could, however, pose a risk to the growth outlook for these economies. Equity markets in many emerging economies have weakened in 2008 partly on lower growth expectations. Tightening of financing conditions in international markets is a growing risk for emerging economies with current account deficits and relatively large reliance on cross-border bank borrowing. In particular, terms of trade losses have impacted the external positions of some emerging economies that are net commodity importers. The impact of the global financial turmoil has so far been restricted to portfolio flows and bank lending to EMEs while foreign direct investment has remained strong. On the other hand, outward direct investment from emerging economies, particularly Asia, has increased significantly. Consensus growth forecasts for EMEs have declined in recent months but continue to remain reasonably optimistic about the near term.

81. Inflation has emerged as the biggest risk to the global outlook, having risen to very high levels across the world, levels that have not been generally seen for a couple of decades. Developed and emerging economies alike are reporting multi-year highs in inflation, driven mainly by escalating commodity prices, particularly of energy, food and metals. In terms of consumer prices, developed economies are reporting increases up to 170 basis points since January 2008. For emerging economies, the increase in inflation has been even higher *i.e.,* in the range of 120-570 basis points. In terms of producer prices, inflation is rapidly heading to or is already at double-digit levels in most developed and emerging economies. Core measures of inflation and survey-based inflation expectations have also risen markedly. There are growing concerns across economies that rising food and energy prices are triggering a more generalised inflation spiral through second-round effects. Crude futures do not indicate any let-up in the current level of prices up to December 2008. Steel prices have increased in the range of 69-88 per cent in June 2008 on a year-on-year basis and are set to harden even further. At the current juncture, globally food prices are likely to remain high at least up to end-2008, constrained by record low inventories and restrictions on exports by major foodgrain producers. In several emerging economies, higher inflation has become associated with increasing volatility in currency and equity markets as well as financial sector fragility. By and large, while inflation was expected to rise, the size of the change in 2008 so far on a global scale has been clearly unanticipated. Policy responses have also been constrained in some countries by concerns about the speed and depth of the slowdown in growth.

82. Developments in the global financial system have heightened the uncertainty characterising the outlook. While a

possible crisis in global finance seems to have been averted, several vulnerabilities persist in the leading financial centres. The ultimate size of losses among the largest financial institutions and the requirement of capital continues to be opaque at this stage, even as defaults on residential loans appear to be rising, balance sheets have become extremely sensitive to repricing and valuation changes and market liquidity remains frozen despite massive central bank interventions. For the developed economies affected by the turmoil, balance sheet positions of corporates as well as those of households - already weakened by rapid increase in debt and the fall in house prices - have become increasingly vulnerable to widening spreads and tighter credit conditions. Banks have been the most severely affected entities with large write-downs related to mortgage exposures and a decline in profitability. Investment banking has suffered from a large decline in profits and near-failure episodes with the urgent need to infuse substantial amounts of new capital. Central bank interventions in this context have also been extraordinary and on a scale not seen since the Great Depression, demonstrating a resolve to act decisively against threats to financial stability. With the exception of monoline insurers, the effect of the financial turmoil on insurance companies has been less severe than on banks and exposures are not as wide-spread. In the early months of 2008, hedge funds, private equity and leveraged buy-outs have experienced significant pressure and poor performance in a challenging market environment.

83. Since the end of May 2008, there are incipient signs of financial markets tending towards some normalcy with financial institutions being more proactive in disclosing losses, deleveraging and raising new capital. Spreads have retreated from their peaks; however, market activity remains somewhat

strained. The full truth about the extent of losses and exposures is not yet known and perceptions of a pronounced increase in default risk continues to prevail as evident in high credit default swap (CDS) spreads. Money markets remain dislocated and, despite central bank liquidity injections alleviating pressures, uncertainty about future liquidity supply and counterparty risk persists. Equity markets have dropped sharply in 2008 with the worsening of the macroeconomic outlook and renewed credit related concerns. Between April 2008 and July 2008, global share prices have fallen considerably with an increase in volatility and a decline in investors' risk tolerance. Bond yields, which stabilised since mid-March, have started to recover in developed economies and a flight to safety is leading up to a shortage of paper. Longer term real yields have declined sharply on recession fears. In the foreign exchange market, the US dollar and the pound sterling depreciated in effective terms whereas the euro, the yen and the Swiss franc appreciated along with several Asian currencies. Some currencies that had proved to be resilient in 2007 such as the Canadian dollar, the Korean won and the South African rand have depreciated, in some cases substantially, in 2008 so far. Concerns about a more widespread slowdown, rising inflation and perceptions of overvaluation have been weighing on emerging market asset classes in 2008 with spreads on sovereign debt widening.

84. In the overall assessment, several risks looming over the global economy at the time of the Annual Policy Statement of April 2008 have either materialised or intensified with implications for every national economy, including India. The outlook is highly unclear and the prospects of resolution of the multiple disequilibria embedded in global developments are fraught with uncertainty. Although the IMF has revised its forecast of global growth for 2008 up by 0.4 percentage points in July over its

April projection, the consensus now appears to be that the slowdown of growth is deepening and broader in its span than initially expected with more significant slowing likely in the period ahead. In view of the international linkages that are stronger now than before, macroeconomic prospects for the EMEs, that have so far remained relatively unscathed, are overcast with downside risks from knock-on and lagged effects of the downturn. Globally, inflation pressures brought on by the elevated levels of crude, metal and some food prices show no signs of abating and instead, appear to be getting entrenched into inflation expectations. While high inflation is now a worldwide phenomenon, country responses have differed widely depending on perceptions of the nature of the shock, how long it will last and the stage of the inflation cycle in terms of the onset of the second-order impact. In some developed countries, the policy response to inflation has been proscribed by relatively overarching concerns for financial stability in the context of the ongoing financial turmoil. While vestiges of calm appear to have been restored in financial markets by end-June, the dangers of further deepening of the crisis and potential contagion have, in fact, increased. In emerging economies like India, these effects are already in evidence in the currency and equity markets and phases of capital outflows have occurred from some of these countries. Accordingly, heightened vigilance and stress testing of the preparedness to deal with these developments assumes critical importance as recent weeks have shown.

85. Domestically, some moderation appears to be underway with slower momentum in industrial and service sector activity, while the outlook for agriculture provides a silver lining in terms of food availability and the mitigating effect on inflation expectations. Nevertheless, inflation risks have increased sharply and appear to be persistent at this juncture. The conduct of

monetary policy in the context of bringing down inflationary pressures and anchoring inflation expectations is, however, complicated by global developments and domestic demand pressures.

II. Stance of Monetary Policy for the Remaining Period of 2008-09

86. The Annual Policy Statement of April 2008 had indicated concerns that threats to growth and stability from global developments had increased considerably with a highly uncertain likelihood of early resolution. However, it was stated that domestic factors would continue to dominate the policy setting, with a contextual emphasis on inflation expectations. Accordingly, the overall stance of monetary policy in 2008-09 was set in terms of ensuring 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 with due emphasis on credit quality and credit delivery. It was resolved 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. Liquidity management was accorded priority in the context of underlying monetary and financial developments.

87. In the subsequent period, active liquidity management assumed critical importance in view of persistent surplus conditions in financial markets coinciding with an upsurge in inflation. Accordingly, the CRR was raised on April 17, 2008 by

25 basis points each from the fortnights beginning April 26 and May 10, 2008. Subsequently, another increase of 25 basis points in the CRR effective from May 24, 2008 was announced in the Annual Policy Statement. On May 30, 2008 special market operations were announced to alleviate the binding financing constraints faced by public oil companies in importing POL as also to minimise the potential adverse consequences for financial markets in which these oil companies are important participants. Subsequent to the announcement of the hike in administered POL prices, the repo rate was increased by 25 basis points on June 11, 2008. Furthermore, on June 24, the repo rate was increased by 50 basis points and the CRR was increased by 25 basis points each from the fortnights beginning July 5 and July 19. These measures, along with the calibrated and graduated withdrawal of monetary accommodation undertaken since September 2004, impart a stabilising influence on the economy in the period ahead. In view of the criticality of anchoring inflation expectations, a continuous heightened vigil over ensuing monetary and macroeconomic developments is maintained to enable swift responses with appropriate measures as necessary, consistent with the monetary policy stance.

88. Monsoon conditions have, by and large, been favourable so far in large parts of the country barring deficient/scanty rainfall in some regions that could affect the prospects of some crops. Nevertheless, in the absence of unanticipated weather adversities, moisture conditions should support a continuation of the above medium-term trend growth in agriculture. On the other hand, there is more than originally anticipated moderation in activity in the industrial and in some services sectors. Such a moderation could persist in the short-term, notwithstanding the still robust underlying momentum in these sectors. Furthermore, world GDP growth is projected by the IMF to undergo a

pronounced slowdown in the second half of the year and is expected to decelerate by close to one percentage point in relation to 2007 with second round effects on world trade growth. Overall, taking into account aggregate demand management and supply prospects described above, the projection of real GDP growth of the Indian economy in 2008-09 in the range of 8.0 to 8.5 per cent as set out in the Annual Policy Statement of April 2008 may prove to be optimistic and hence for policy purposes, a projection of around 8.0 per cent appears a more realistic central scenario at this juncture, barring domestic or external shocks.

89. Bringing down inflation from the current high levels and stabilising inflation expectations assumes the highest priority in the stance of monetary policy. Currently, pressures from global inflation developments emanate from prices of some food articles, crude oil and other commodities such as metals. As regards food prices, there are indications of improvement in crop conditions in some of the major foodgrains producing countries. For the Indian economy, monsoon conditions augur well for an expansion of the domestic supply response, particularly in respect of key foodgrains. In this context, domestic food prices may soften in the months ahead as these positive developments take hold. International crude prices remain at elevated levels with no clear indication of any tendency towards assured moderation, despite some incipient softening in recent weeks. There is, however, a view that slowdown in global activity may moderate demand and speculative elements. Accordingly, there is a possibility, albeit remote, of a drastic reduction in the level of crude prices in the period ahead. In the event, however unlikely, of international crude prices falling below the level up to which pass-through to domestic POL prices in India has occurred, there could be some easing of domestic inflation. There is also a view that international prices of other commodities

including metals could also moderate with the slowing down of aggregate demand globally. While such moderation in some global commodity prices in future cannot be ruled out, it is prudent to assume that in all likelihood, the current elevated levels will continue in the near future with added uncertainties.

90. The Annual Policy Statement of April 2008 stated that, 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 to around 5.0 to 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 Annual Policy Statement added that 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. Recent developments, global as well as domestic, on both supply and demand sides described in this Policy Review, however, point to accentuation of inflationary pressures, especially in terms of inflation expectations and perceptions during the first quarter of 2008-09.

91. Over the last 12 months, the escalation in inflation has become a global phenomenon and the increase in inflation in India over the previous year is not proportionately different from elsewhere. Looking forward, the global and more importantly, the domestic factors pose severe challenges to monetary

management and warrant reinforced policy actions on several fronts. Against this background, it is expected that inflation would moderate from the current high levels in the months to come and a noticeable decline in inflation can be expected towards the last quarter of 2008-09. Accordingly, while the policy actions would aim to bring down the current intolerable level of inflation to a tolerable level of below 5.0 per cent as soon as possible and around 3.0 per cent over the medium-term, at this juncture a realistic policy endeavour would be to bring down inflation from the current level of about 11.0-12.0 per cent to a level close to 7.0 per cent by March 31, 2009.

92. As indicated in the Annual Policy Statement of April 2008, the sustained expansion of money supply above indicative projections since 2005-06 has resulted in a sizeable monetary overhang which warrants continuous policy monitoring in view of the implications for fighting inflation at the current juncture and over the medium term as the lagged and cumulative effects of monetary policy actions work their way through the economy. Accordingly, it is necessary to moderate monetary expansion and plan for a rate of money supply growth in the range of around 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 projection of money supply, the growth in aggregate deposits in 2008-09 is now placed at around 17.5 per cent or around Rs.6,00,000 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 CP is placed at around 20.0 per cent in 2008-09, as indicated in the Annual Policy Statement, consistent with the

monetary projections. While there are early signs of some moderation in money supply and deposit growth, they continue to expand above the indicative projections warranting continuous vigilance and appropriate and timely policy responses.

93. Active management of liquidity conditions through the flexible use of policy instruments has, to a significant extent, insulated domestic financial markets from the turmoil in major financial centres in developed economies. These liquidity management operations have generally absorbed excessive market pressures and enabled orderly conditions. In view of the evolving environment of heightened uncertainty, volatility in global markets and the dangers of potential spillovers to domestic equity and currency markets, liquidity management will continue to receive priority in the hierarchy of policy objectives over the period ahead. In particular, volatility in capital flows and cash balances of the Government will continue to necessitate active liquidity management with a combination of instruments as warranted. In this context, it is necessary to note that there is headroom with the Reserve Bank in terms of the flexibility in the deployment of instruments, complemented by prudential regulations and instruments for capital account management.

94. Since April 2005, the Reserve Bank has been expressing concerns about strong credit growth, the significantly overdrawn state of the banking system to sustain the credit disbursement, mismatches between sources and uses of funds and implications for interest rates, liquidity conditions and credit quality. Several monetary and prudential measures have been undertaken in this period and banks have been sensitised in this regard. While there has been some rebalancing and overall correction during 2007-08 in response to policy initiatives, in 2008-09 so far, however, some banks have expanded credit rapidly in relation

to the system level growth, with attendant worsening of their credit-deposit ratios. These developments warrant heightened policy concerns in the interest of overall systemic stability and the quality of financial intermediation. In this context, banks are urged to review their business strategies so that they are in a position to combine longer term viable financing with profitability in operations, recognising the reality of business cycles and countercyclical monetary policy responses. A key aspect of this review should be a renewed emphasis on credit quality while simultaneously pursuing greater credit penetration and financial inclusion. Banks should focus on stricter credit appraisals on a sectoral basis, monitor loan to value ratios and generally ensure the health of credit portfolios on a durable basis without encountering undue asset-liability mismatches. If necessary, the Reserve Bank would consider undertaking supervisory review of those select banks which are over extended in terms of their credit portfolios relative to their sources of funds.

95. The impact of the escalation in international food, crude and other commodity prices is already being reflected in a sizeable expansion in the merchandise trade deficit and persisting downward pressures in the foreign exchange market. Furthermore, capital flows have exhibited some volatility with episodes of portfolio outflows and tightening of international bank lending. Overall, the merchandise trade deficit is expected to be somewhat higher and the current account deficit marginally higher in 2008-09 than in the preceding year. It is, however, expected that net capital flows would meet the external financing requirement in 2008-09.

96. Early fiscal indicators point to some strains on the Centre's fiscal position which has worsened somewhat in relation to

budget estimates. In view of growing off-budget liabilities and enhanced expenditures on subsidies, loan waivers and salaries in the rest of the year, fiscal developments warrant close and careful monitoring in view of the configuration of risks both domestically and globally, and, in particular, the implications for inflation and external sector management. The evolving fiscal conditions in an atmosphere of persistent inflationary pressures pose severe challenges to monetary management, especially if supply inelasticities continue to prevail in the short-term.

97. As stated in the press release announcing monetary measures on June 24, 2008 and increasingly relevant at this juncture, the overriding priority for monetary policy is to eschew any further intensification of inflationary pressures and to firmly anchor inflation expectations. In this regard, monetary policy has to urgently address aggregate demand pressures which appear to be strongly in evidence. The Reserve Bank's approach in this regard is in a calm and calculated fashion avoiding exaggerated bearishness and on an ongoing basis, in a timely manner and conscious of strengths and challenges in this context. This measured monetary policy response has moderated early signs of overheating that emerged in 2006-07 and would continue to work in conjunction with supply-side measures to bring down inflation to more acceptable levels on an urgent basis by building on actions already taken. Therefore, it is important to recognise that in an environment of limited supply elasticities in the short run, an adjustment of overall aggregate demand on an economy-wide basis is warranted to ensure that generalised instability does not develop and erode the hard-earned gains in terms of both outcomes of and positive sentiments on India's growth momentum. In this specific context, the Reserve Bank's

effort is to smoothen and enable this adjustment so that inflation expectations are contained.

98. Global growth has decelerated in the first quarter of 2008 and is expected to slow down further over the rest of the year as indicated in the waning business and consumer confidence and weak industrial activity. There are also indications that the slowdown is becoming more broad-based in advanced economies and incipiently in emerging economies as well. Threats to financial stability also continue to rule at elevated levels with possible feedback into the prospects for macroeconomic performance. Inflation pressures are likely to intensify further in both advanced and emerging economies, driven by the relentless rise in food and fuel prices and tightening supply constraints. Slower growth in demand may temper commodity prices and ultimately inflationary pressures; however, the manner and period over which this adjustment would take place is highly uncertain. Increasingly, it is felt that a multilateral effort is needed to ameliorate the social and economic deprivation associated with this shock, improve the supply-demand balance in commodity markets and fortify the national macroeconomic policy responses.

99. These global developments have implications for India's macroeconomic outlook with sharp challenges and dilemmas confronting the setting of monetary policy. First, it is necessary to recognise the global dimensions of the crisis which is threatening the credibility of monetary policy worldwide. Second, monetary policy has to deal with the structural components embedded in the drivers of inflation which, unlike cyclical elements, are somewhat impervious in the short run to instruments of aggregate demand management. Third, while

modulation of aggregate demand assumes crucial importance, it is also necessary to nurture and consolidate the recent gains in augmenting supply capacities and improvements in productivity and efficiency which accrue over a longer term horizon. Fourth, even though concerns about the financial crisis deepening have retreated in recent weeks, financial markets are still fragile and impairment to balance sheets of financial institutions and credit conditions has increased the vulnerability to financial instability, further complicating the conduct of monetary policy. Against this backdrop, it is essential to stabilise and anchor inflation expectations as soon as feasible.

100. Accordingly, as stated in the Annual Policy Statement of April 2008, 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.

101. 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.

102. 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 continue to 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

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

(b) Repo Rate/Reverse Repo Rate

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

105. In view of the current macroeconomic and overall monetary conditions, it has been decided to increase the fixed repo rate under the LAF by 50 basis points from 8.5 per cent to 9.0 per cent with immediate effect.

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

107. 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

108. The cash reserve ratio (CRR) of scheduled banks is currently at 8.75 per cent. On a review of the current liquidity situation, it is considered desirable to increase the CRR by 25 basis points to 9.0 per cent with effect from the fortnight beginning August 30, 2008.

Mid-Term Review

109. The Mid-Term Review of the Annual Policy Statement for the year 2008-09 will be announced on October 24, 2008.

Mumbai
July 29, 2008