Statement by Dr. D. Subbarao, Governor, Reserve Bank of India on the Mid-Term Review of Annual Policy for the Year 2008-09

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

Part A. Mid-Term Review of the Annual Statement on Monetary Policy for the Year 2008-09

2. This part is divided into three sections: I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2008-09; II. Stance of Monetary Policy for the Second Half of 2008-09; and III. Monetary Measures.

I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2008-09

Domestic Developments

3. During the first quarter of 2008-09, real GDP growth was 7.9 per cent as against 9.2 per cent a year ago. The end-August 2008 release of national income aggregates by the Central Statistical Organisation (CSO) placed the growth of real GDP originating in agriculture, industry and services at 3.0 per cent, 5.2 per cent and 10.2 per cent, respectively, during April-June 2008 as against 4.4 per cent, 9.6 per cent and 10.6 per cent a year ago.

4. There are some distinctive features in macroeconomic developments during the second quarter of 2008-09 (July-September) in relation to the preceding quarter. According to the India Meteorological Department (IMD), cumulative south-west monsoon season rainfall for the country as a whole was two per cent below the long period average (LPA). Of the 36 meteorological sub-divisions, rainfall was excess/normal in as many as 32 sub-divisions as against 30 sub-divisions in the 2007 season. The deficient rainfall regions were Vidarbha, Kerala, West Madhya Pradesh, Nagaland, Manipur, Mizoram and Tripura. As on October 15, 2008 live storage in 81 major reservoirs was 73 per cent of the designated capacity which is seven per cent higher than the last 10 years' average but 10 per cent lower than the level a year ago.

5. By October 10, 2008 the area sown under *kharif* rice and major oilseeds increased by 2.9 per cent and 3.6 per cent, respectively, over the previous year's sown area but acreage under coarse cereals, pulses, cotton, sugarcane and jute was lower by 6.4 per cent, 15.5 per cent, 1.3 per cent, 16.6 per cent and 10.8 per cent, respectively, than in the corresponding period a year ago. First advance estimates released by the Ministry of Agriculture place *kharif* foodgrains production at 115.3 million tonnes, below the target of 121.5 million tonnes and also lower than the production of 121.0 million tonnes recorded last year. According to these initial estimates, rice production is estimated at 83.3 million tonnes which is above the preceding year's output of 82.8 million tonnes. Production of nine major oilseeds during the *kharif* season was placed at 17.9 million tonnes which is lower than the target of 20.0 million tonnes for the current year and also below the output of 19.8 million tonnes in 2007-08. Production of sugarcane and cotton is expected to decline in 2008-09 in relation to targets as well as output levels a year ago.

6. The index of industrial production (IIP) rose by 4.9 per cent during April-August 2008 as compared with 10.0 per cent in the corresponding period last year. Manufacturing output growth, electricity generation and mining activity slowed to 5.2 per cent, 2.3 per cent and 4.1 per cent, respectively, from 10.6 per cent, 8.3 per cent and 4.9 per cent in the corresponding period last year. Manufacturing activity was led by chemicals and chemical products, beverages, tobacco and related products, machinery and equipments including transport equipment and parts, which together accounted for 89 per cent of the growth of industrial production during April-August 2008, despite constituting only 30 per cent of the index in terms of weight. On the other hand, production of food products, jute textiles, wood and wood products, rubber, plastic, petroleum and coal products declined and had a moderating effect on overall manufacturing sector growth. The use-based classification indicates some moderation in investment demand with the growth of capital goods production slowing to 9.2 per cent from 20.1 per cent a year ago. Production of consumer non-durables rose by 8.6 per cent on top of 10.0 per cent in the corresponding period last year; consumer durables recorded a turnaround, growing by 5.6 per cent as against a decline of 2.3 per cent a year ago. Production of basic and intermediate goods rose by 3.8 per cent (9.9 per cent a year ago) and 0.7 per cent (9.9 per cent), respectively. The six infrastructure industries, which together comprise 27 per cent of the IIP, posted a growth of 3.4 per cent during April-August 2008 as against 7.1 per cent a year ago. Except for coal, other infrastructure sectors recorded deceleration in growth while the production of crude petroleum declined.

7. For the private non-financial corporate sector, sales increased by 30.0 per cent during April-June 2008, higher than 19.2 per cent in the corresponding quarter a year ago. There was deceleration in income from non-core activities, largely attributable to subdued conditions in the capital market. Growth in expenditure at 34.5 per cent outpaced sales growth. On a year-on-year basis, raw material expenses rose by 35.9 per cent and staff

cost increased by 23.2 per cent. Due to mark-to-market losses on foreign currency borrowings resulting from exchange rate depreciation during the quarter, a sizeable number of companies reported erosion in financial performance. Despite an increase in interest outgo, the interest burden (interest to gross profits ratio) at 16.7 per cent remained distinctly lower when compared with 50.0 per cent in the 1990s and 43.7 per cent in the first half of the current decade. Reflecting the pick-up in expenditures, net profits growth decelerated to 8.2 per cent in the first quarter of 2008-09 as compared with double-digit growth rates recorded in the previous quarters and 33.9 per cent a year ago. At the sectoral level, manufacturing companies recorded higher sales growth when compared with information technology (IT) and non-IT service companies.

8. Early results for the second quarter of 2008-09 for a truncated sample of companies indicate continuing moderation in profitability growth, especially for manufacturing companies. Sales growth was driven by a combination of increased volumes and higher prices but was not able to fully mitigate rising input cost and staff cost pressures. Financing costs have increased due to rising interest payments as well as the impact of losses on foreign liabilities. Income from non-core activities were lower reflecting subdued treasury incomes. Consequently, corporates' earnings growth appears to have weakened further in the second quarter of 2008-09.

9. The 43rd round of the Reserve Bank's quarterly Industrial Outlook Survey conducted during July-August 2008 and covering private manufacturing companies indicates a moderation in business sentiment. The assessment for July-September 2008 reflects a lower level of optimism than in the previous round of the survey, with the business expectations index for July-September 2008 down by 2.4 per cent from the previous quarter. There was moderation in all major parameters such as the overall business situation, the overall financial situation, production, order books, cost of raw materials and profit margins. Demand conditions appear to have weakened as reflected in the assessment of production, order books and export demand. Higher input costs are expected to compress profit margins significantly during the second and third quarters of 2008-09. For October-December 2008, working capital finance requirements are expected to remain high; there are, however, concerns about the availability of finance. Capacity utilisation is expected to remain generally stable and production capacity is expected to be adequate to meet demand. An increasing number of respondent firms expect price pressures to rise on the back of higher raw material costs and expect to pass on higher prices to end-consumers to protect profit margins. The business expectations index for October-December 2008 was 2.6 per cent lower than in the preceding quarter.

10. Other business confidence surveys continue to reflect uncertainty on the outlook, as also noted in the First Quarter Review of July 2008. Business confidence has generally ebbed relative to its level in previous survey rounds on increases in the cost of finance and raw materials and some concerns on moderation in overall economic conditions and export

demand. According to one survey, there was a decline of 19 per cent in the indicator for the overall economic conditions over the next six months in relation to its level polled in the previous quarter. Another survey reported a 28.1 per cent decline in the composite business optimism index for October–December 2008 across sales volumes, new orders and net profits, reflecting subdued demand conditions. Seasonally adjusted purchasing managers' indices indicate that manufacturing sector activity has lost some momentum due to deterioration in both local and export market conditions and increased inflationary pressures. Forward looking indicators point towards some slowdown and margin pressures.

11. Lead indicators of activity in the services sector suggest that the pace of expansion has picked up in the communication sector with an increase of 33.8 per cent in switching capacity in April-July 2008 as against a decline of 53.1 per cent a year ago. There was a robust growth of 32.4 per cent in telephone connections (fixed plus cellular) with the addition of 34.4 million connections as compared with 26.0 million connections provided in the corresponding period last year. Railway revenue earnings from freight traffic increased by 9.4 per cent, higher than the growth of 6.1 per cent in the corresponding period last year due to higher traffic for carriage of petroleum, oil and lubricants (POL), container services and cement. Growth in cargo handled at major ports increased by 8.3 per cent as compared with 14.9 per cent a year ago. In the civil aviation sector, handling of import cargo and export cargo increased by 6.6 per cent and 8.1 per cent, respectively, as against 23.4 per cent and 3.6 per cent in the corresponding period of 2007-08. Growth in passengers handled at domestic and international terminals declined/decelerated to (-) 2.2 per cent and 7.9 per cent, respectively, from 27.3 per cent and 11.8 per cent a year ago.

12. According to the CSO's end-August 2008 release, real private final consumption expenditure (PFCE) increased by 8.0 per cent during April-June 2008, which was marginally higher than the growth of 7.6 per cent recorded in the corresponding period a year ago. Real gross fixed capital formation (GFCF) rose by 9.0 per cent, lower than the growth of 13.3 per cent recorded in April-June 2007. The share of PFCE in GDP at 59.8 per cent during the first quarter of 2008-09 remained stable whereas the share of GFCF increased to 32.3 per cent of GDP from 32.0 per cent a year ago.

13. Credit extended by scheduled commercial banks (SCBs) increased by 29.4 per cent (Rs.5,91,935 crore) on a year-on-year basis up to October 10, 2008 as compared with an increase of 23.1 per cent (Rs.3,77,628 crore) a year ago. On a financial year basis, bank credit increased by 10.4 per cent (Rs.2,45,491 crore) up to October 10, 2008 as compared with the increase of 4.4 per cent (Rs.84,280 crore) in the corresponding period last year. Food credit increased by Rs.4,496 crore as against a decline of Rs.9,501 crore in the previous year. Non-food credit recorded an increase of 10.4 per cent (Rs.2,40,995 crore) as compared with an increase of 5.0 per cent (Rs.93,781 crore) in the corresponding period of the previous year.

14. On a year-on-year basis, non-food credit growth was higher at 29.3 per cent up to October 10, 2008 than 23.3 per cent a year ago. Provisional information on the sectoral deployment of bank credit available up to August 2008 indicates that on a year-on-year basis, credit to the services sector recorded the highest growth (35.3 per cent), followed by industry (30.6 per cent), agriculture (18.5 per cent) and personal loans (17.4 per cent). Growth in housing and real estate loans decelerated to 13.9 per cent (16.6 per cent) and 46.3 per cent (52.9 per cent), respectively. Within the industrial sector, there was a sizeable credit pick-up in respect of infrastructure (35.8 per cent as against 32.0 per cent a year ago), petroleum (91.8 per cent as against 32.9 per cent), basic metals and metal products (32.2 per cent over 20.6 per cent), cement and cement products (62.8 per cent over 18.1 per cent a year ago), chemicals (27.1 per cent as against 15.3 per cent) and construction (48.3 per cent as against 42.9 per cent). There was moderation in credit growth to food processing (25.6 per cent over 29.0 per cent), textiles (23.1 per cent as against 28.7 per cent) and vehicle, vehicle parts and transport equipments (27.5 per cent as against 34.2 per cent). Credit to industry constituted 44.6 per cent of the total expansion in non-food bank credit up to August 2008, followed by services (30.3 per cent), personal loans (16.7 per cent) and agriculture (8.4 per cent). The share of infrastructure, petroleum, construction, cement and mining and quarrying in total credit to industry increased to 22.5 per cent, 6.7 per cent, 3.3 per cent, 1.6 per cent and 1.4 per cent, respectively from 21.6 per cent, 4.6 per cent, 2.9 per cent, 1.3 per cent and 1.0 per cent. On the contrary, the share of credit to textiles, chemicals, engineering, food processing, gems and jewellery and fertiliser declined to 10.4 per cent, 7.5 per cent, 6.1 per cent, 5.4 per cent, 2.9 per cent and 1.2 per cent respectively, from 11.0 per cent, 7.7 per cent, 6.4 per cent, 5.6 per cent, 3.3 per cent and 1.3 per cent. Priority sector advances grew by 20.8 per cent with a moderation in their share in outstanding gross bank credit to 33.1 per cent in August 2008 from 34.7 per cent a year ago. While there has been a sharp increase in credit off-take by petroleum and fertliser companies in 2008-09, the annual growth rate of non-food credit, even excluding credit to petroleum and fertiliser sectors, has been significantly higher at 25.6 per cent in August 2008 as compared with 24.5 per cent a year ago.

15. Commercial banks' investments in shares, bonds/debentures and commercial papers (CPs) increased by 17.5 per cent (Rs.13,600 crore) on a year-on-year basis up to October 10, 2008 as against a decline of 5.4 per cent (Rs.4,458 crore) a year ago. On a financial year basis, such investments by banks fell by 4.6 per cent (Rs.4,386 crore) during 2008-09 so far (up to October 10), as against a decline of 7.2 per cent (Rs.6,025 crore) in the corresponding period of 2007-08.

16. The year-on-year growth in total resource flow from SCBs to the commercial sector was 28.9 per cent up to October 10, 2008 over and above the growth of 21.9 per cent a year ago. During the current financial year, banks' investments in instruments issued by all-India financial institutions and mutual funds declined by Rs.11,411 crore as against an increase of Rs.51,656 crore in the corresponding period of the previous year. Additional resources raised by corporates in the form of external commercial borrowings (ECBs) was lower at Rs.6,494 crore (US $ 1.6 billion) during April-June 2008 as compared with Rs.28,822 crore (US $ 7.0 billion) during the corresponding period last year. An amount of Rs.4,652 crore (US $ 1.1 billion) was mobilised through issuance of American Depository Receipts/Global Depository Receipts (ADRs/GDRs) during April-September 2008 as compared with Rs.11,284 crore (US $ 2.8 billion) raised during the corresponding period last year.

17. Aggregate deposits of SCBs increased by 21.6 per cent (Rs.6,15,263 crore) on a year-on-year basis up to October 10, 2008 as compared with 24.7 per cent (Rs.5,65,124 crore) a year ago. On a financial year basis, aggregate deposits rose by 8.5 per cent (Rs.2,72,420 crore) as compared with an increase of 9.3 per cent (Rs.2,42,163 crore) in the corresponding period of the previous year. The share of savings deposits in total deposits has been declining and there appears to be some migration from small savings instruments to term deposits with banks where the rates of return are relatively more attractive. The incremental annual credit-deposit ratio increased to 96.2 per cent on October 10, 2008 from 66.8 per cent a year ago.

18. SCBs' incremental investment in Government and other approved securities during 2008-09 up to October 10, 2008 was Rs.9,201 crore as against Rs.1,56,236 crore in the corresponding period last year. The ratio of such investments to aggregate deposits on an incremental basis was 3.4 per cent which was much lower than 64.5 per cent in the corresponding period last year. Adjusting for collateral securities under the liquidity adjustment facility (LAF) operations, however, statutory liquidity ratio (SLR) investments increased by Rs.80,176 crore during 2008-09 so far as against the increase of Rs.90,806 crore in the corresponding period last year. Inclusive of LAF collateral securities on an outstanding basis, SCBs' holdings of SLR securities amounted to Rs.10,72,416 crore or 28.2 per cent of net demand and time liabilities (NDTL) on October 10, 2008 implying an excess of Rs.1,20,870 crore or 3.2 per cent of NDTL over the prescribed SLR of 25 per cent of NDTL.

19. Money supply (M_3) increased by 20.3 per cent on a year-on-year basis up to October 10, 2008, lower than 21.9 per cent a year ago but above the indicative projection of 17.0 per cent set out in the Annual Policy Statement of April 2008. On a financial year basis, M_3 increased by 7.7 per cent (Rs.3,07,403 crore) up to October 10, 2008 as compared with the increase of 8.1 per cent (Rs.2,68,694 crore) in the corresponding period of the previous year.

20. Reserve money increased by 17.6 per cent on a year-on-year basis as on October 17, 2008 as compared with 24.4 per cent a year ago. On a financial year basis, reserve money declined by 2.9 per cent (Rs.27,296 crore) up to October 17, 2008 as compared with the increase of 8.1 per cent (Rs.57,189 crore) in the corresponding period of the previous year. Among the components of reserve money, currency in circulation registered a higher growth of 7.3 per cent (Rs.43,095 crore) as compared with 4.5 per cent (Rs.22,702 crore). Bankers' deposits with the Reserve Bank declined by 20.3 per cent (Rs.66,793 crore) against an increase of 18.7 per cent (Rs.36,984 crore) in the corresponding period last year. Among the sources of reserve money, the Reserve Bank's net credit to the Central Government increased by Rs.15,534 crore as against a decline of Rs.1,43,116 crore in the corresponding period last year. Adjusted for transactions under the LAF, however, the Reserve Bank's credit to the Central Government showed an increase of Rs.57,244 crore, mainly on account of securities received under special market operations (SMO) and reduction in cash balances of the Government of India with the Reserve Bank. The Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.93,402 crore as compared with an increase of Rs.1,71,080 crore during the corresponding period of the previous year. Adjusted for revaluation of foreign currency assets, however, NFEA declined by Rs.34,556 crore as compared with an increase of Rs.2,17,201 crore during the corresponding period of the previous year. The ratio of NFEA to currency increased marginally from 209.2 per cent on March 31, 2008 to 209.7 per cent by October 17, 2008.

21. During the second quarter of 2008-09, liquidity conditions were generally tight and, except in the first week of July, there were continuous injections of liquidity under the LAF. In addition, an amount of Rs.26,000 crore (net) was mopped up through the issuances of 91-day, 182-day and 364-day Treasury Bills during July-September, 2008. Net injections under the LAF increased from an average of Rs.8,622 crore in June 2008 to Rs.22,560 crore in August 2008. During September 2008, liquidity injections under the LAF ranged between Rs.1,025-90,075 crore, reaching a level of Rs.90,075 crore on September 29, 2008 with adverse developments in international financial markets coinciding with advance tax outflows and the half-yearly bank closing. To ease liquidity pressures, the Reserve Bank unwound the market stabilisation scheme (MSS) to the tune of Rs.3,105 crore during June 30-August 21, 2008. The Reserve Bank also cut the cash reserve ratio (CRR) by 250 basis points in October 2008 and expanded liquidity support to the market through additional facilities referred to later. During October 2008, liquidity injections under the LAF

rose to Rs.91,500 crore on October 10, 2008, but there was a turnaround in liquidity conditions in the subsequent period and the Reserve Bank absorbed Rs.27,745 crore under the LAF on October 22, 2008. Banks' dependence on export credit refinance (ECR) rose from a daily average of Rs.2,208 crore in June 2008 to Rs.3,110 crore in August 2008 and further to Rs.6,752 crore on September 29, 2008 before declining to Rs.91 crore on October 22, 2008. The Central Government's cash balances declined from Rs.37,194 crore on June 30, 2008 to Rs.2,967 crore on August 2, 2008 and it took recourse to ways and means advances during August 4-6 and September 2-14, 2008 with a peak level of Rs.10,903 crore on September 5, 2008. In the subsequent period, the Central Government's cash balances increased to Rs.29,753 crore on October 20, 2008.

22. On a net basis, average daily LAF absorption, which stood at Rs.9,881 crore in the first quarter of 2008-09 changed to a net injection of Rs.30,912 crore during the second quarter and Rs.53,259 crore in October 2008 (up to October 22). The balances under the MSS increased marginally from Rs.1,76,422 crore in June 30, 2008 to Rs.1,77,817 crore on September 25, 2008 before declining to Rs.1,71,317 crore on October 22, 2008. Cash balances of the Central Government with the Reserve Bank fell from an average of Rs.30,587 crore in the first quarter of 2008-09 to Rs.17,821 crore in the second quarter and Rs.36,599 crore in October 2008 (up to October 22). 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 a daily average of Rs.1,93,726 crore in June 2008 to Rs.1,53,863 crore in September 2008 and further to Rs.1,22,182 crore on October 5, 2008. The total overhang of liquidity increased to Rs.2,17,415 crore on October 20, 2008.

23. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, increased to 11.4 per cent as on October 4, 2008 from 7.8 per cent as at end-March 2008 and 3.2 per cent a year ago. At a disaggregated level, prices of primary articles and manufactured products rose by 12.7 per cent and 9.7 per cent, respectively, as compared with the increase of 5.0 per cent and 4.5 per cent a year ago. During 2008-09 so far, inflation for primary articles has been driven mainly by the rising prices of foodgrains, vegetables, fruits, cotton, milk, condiment and spices and tea. Food articles prices, which had eased in June, firmed up in subsequent months. Elevated prices of cotton and oilseeds kept non-food articles inflation high. Manufacturing inflation was largely driven by three groups - basic metal and alloys, food products and chemical and chemical products.

24. Prices of the fuel group increased by 14.6 per cent on a year-on-year basis as against a decline of 1.8 per cent a year ago. The daily average 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 a peak of US $ 141.5 on July 3, 2008 before declining to US $ 96.8 in September, 2008 and to US $ 74.4 in October so far up to October 22, 2008. Excluding the fuel group, year-on-year inflation rose to 10.6 per cent from 4.7 per cent a year ago. Similarly, excluding fuel and food articles, inflation rose to 10.8 per cent from 5.2 per cent a

year ago. On an average basis, annual WPI inflation at 8.0 per cent was higher than 5.4 per cent a year ago.

25. Inflation, based on the consumer price index (CPI) for industrial workers, showed a sharp increase to 9.0 per cent on a year-on-year basis in August 2008 from 7.3 per cent a year ago. Year-on-year inflation based on the CPI for agricultural labourers (AL) and rural labourers (RL) increased to 11.0 per cent each in September 2008 from 7.9 per cent and 7.6 per cent, respectively, a year ago. Inflation based on the CPI for urban non-manual employees (UNME) rose to 8.5 per cent in August 2008 as compared with 6.4 per cent in the corresponding period of the previous year. The divergence between the inflation rates based on the WPI and CPIs is explained largely by the steep rise in prices of fuel items and metals which have a much higher weight in the WPI than in the CPIs.

26. Revenue receipts of the Central Government amounted to 26.8 per cent of the budget estimates (BE) during April-August 2008 as compared with 33.7 per cent in the corresponding period a year ago. As a proportion to the BE, tax and non-tax revenue receipts were 24.7 per cent and 37.7 per cent, respectively, as compared with 24.6 per cent and 78.4 per cent a year ago. Total expenditure at 37.2 per cent of the BE was lower than 39.9 per cent a year ago. The gross fiscal deficit (GFD) and revenue deficit increased to 87.7 per cent and 177.4 per cent of the BE, respectively, during April-August 2008 compared with 68.5 per cent and 74.9 per cent in the corresponding period last year. A notable feature of deficit financing this year so far has been the turnaround in mobilisation from small savings deposits and certificates after a decline in the previous year.

27. Gross market borrowings of the Central Government through dated securities at Rs.1,06,000 crore (Rs.1,07,000 crore a year ago) during 2008-09 so far (up to October 22, 2008) constituted 60.3 per cent of the BE. Net market borrowings at Rs.61,972 crore (Rs.74,875 crore a year ago) constituted 67.6 per cent of the BE. In addition, an amount of Rs.38,500 crore has been mobilised by the Central Government through issuance of additional treasury bills to finance the expenditure on the farm debt waiver scheme during the current year up to October 17, 2008. The weighted average yield and weighted average maturity of Central Government securities issued during 2008-09 so far (up to October 22, 2008) were higher at 8.81 per cent and 15.55 years, respectively, as compared with 8.12 per cent and 14.90 years for those issued during 2007-08 (full year). The borrowings were raised in accordance with the indicative calendar for the first half of 2008-09 except on two occasions. First, in the auction of July 24, 2008 a 10-year benchmark security was issued in place of a higher maturity security in view of uncertain market conditions. Second, after the Government of India completed the issuance of dated securities for the first half of the current fiscal year as per the indicative calendar covering the period April 1, 2008 to September 30, 2008, an unscheduled auction of dated securities amounting to Rs.10,000 crore was held on September 26, 2008 keeping in view the emerging requirements of the Government, market conditions and other relevant factors. On September 26, 2008 the

issuance calendar for dated securities for the second half of 2008-09 (October-March) was released in consultation with the Government with planned issuances of Rs.39,000 crore. The announced auctions of Rs.10,000 crore each scheduled on October 10 and 20, 2008 were, however, cancelled by the Government of India in consultation with the Reserve Bank on a review of liquidity conditions. No special securities were issued to oil companies, fertiliser companies and the Food Corporation of India during the current year so far as against Rs.38,050 crore issued in 2007-08 and Rs.40,321 crore issued in 2006-07. On October 20, 2008 the Union Government sought Parliament approval for an additional cash outgo of Rs.1,05,613 crore to meet expenditure including towards the increased salaries of central Government employees due to the implementation of the Sixth Pay Commission award, the farm debt waiver scheme, enhanced allocation towards rural employment schemes and the fertiliser subsidies among other. As against the estimated gross borrowings of Rs.62,658 crore (net Rs.48,287 crore), the State Governments raised a net amount of Rs.8,738 crore up to October 22, 2008.

28. Financial markets reflected the changes in liquidity conditions during the second quarter of 2008-09. The overnight rates in the call, market repo (outside the LAF) and collateralised borrowing and lending obligation (CBLO) hardened across the spectrum on account of tighter liquidity consequent upon increases in the CRR during April-August 2008 in six stages and in the LAF repo rate on June 12, June 25 and July 30, 2008. The weighted average call rate rose from 7.37 per cent in March 2008 to 9.10 per cent in August 2008 and moved up further to 10.52 per cent in September 2008. The call rate increased to 13.07 per cent on September 16, 2008 on account of advance tax outflows and disruptions in international money and stock markets. The average call rate touched a level of 14.70 per cent on September 29, 2008 following the half-yearly bank closing. During October 2008 (up to October 22), the weighted average call rate was 9.9 per cent, rising to a peak of 19.70 per cent on October 10, 2008, before declining to 6.09 per cent on October 22, 2008. Interest rates in the CBLO and market repo segments moved in tandem with call rates and increased from 6.37 per cent and 6.72 per cent, respectively, in March 2008 to 8.74 per cent and 8.87 per cent in September 2008 and further to 11.44 per cent and 11.77 per cent, respectively, on October 1, 2008 before declining to 5.38 per cent and 6.04 per cent, respectively, on October 22, 2008. The daily average volume (one leg) in the call money market, market repo and the CBLO segments moved from Rs.11,182 crore, Rs.14,800 crore and Rs.37,413 crore, respectively, in March 2008 to Rs.11,690 crore, Rs.10,659 crore and Rs.20,547 crore in September 2008 and increased to Rs.15,730 crore, Rs.13,275 crore and Rs.23,719 crore on October 22, 2008. Thus, the inter-bank money market has been working well throughout the period.

29. The primary yield on 91-day Treasury Bills, which had increased from 7.23 per cent at end-March 2008 to 9.36 per cent at end-July 2008, moderated subsequently to 7.19 per cent on October 22, 2008. Similarly, the primary yield on 364-day Treasury Bills increased from 7.35 per cent at end-March to 9.56 per cent at end-July before declining to 7.40 per

cent on October 22, 2008. The weighted average discount rate on CPs increased to 12.28 per cent at end-September from 10.38 per cent as at end-March 2008 and the outstanding amount increased to Rs.52,038 crore from Rs.32,592 crore over this period. In the market for certificates of deposit (CDs) also, the weighted average discount rate increased from 10.00 per cent at the end of March 2008 to 11.56 per cent by end-September 2008 accompanied by an increase of 18.8 per cent in the outstanding amount from Rs.1,47,792 crore to Rs.1,75,522 crore.

30. The yields on Government securities with one-year, 10-year and 20-year residual maturity increased from 7.49 per cent, 7.93 per cent and 8.11 per cent, respectively, at end-March 2008 to a high of 9.25 per cent, 9.17 per cent and 9.72 per cent on July 14, 2008 and remained at elevated levels up to September 2008. The yields recorded a steady decline from 8.74 per cent, 8.63 per cent and 9.30 per cent, respectively, on September 29, 2008 to 7.40 per cent, 7.58 per cent and 8.31 per cent on October 22, 2008. The yield spread between 10-year and one-year Government security narrowed from 44 basis points in March 2008 to 18 basis points on October 22, 2008. The yield spread between 20-year and one-year Government securities declined from 82 basis points to 71 basis points during this period.

31. Increased activity in the foreign exchange market was reflected in a rise in the average daily turnover to US $ 64.9 billion in September 2008 from a level of US $ 50.5 billion a year ago. While the daily average turnover in the inter-bank segment increased from US $ 36.8 billion to US $ 46.4 billion, the merchant turnover increased from US $ 13.7 billion to US $ 18.5 billion during this period. The six-month forward premia increased from 2.5 per cent as at end-March 2008 to a high of 5.4 per cent by July 1, 2008 but eased subsequently to 2.5 per cent by September 12, 2008 and further to 0.24 per cent by October 22, 2008.

32. During April-October 22, 2008 SCBs increased their deposit rates for various maturities by 50-175 basis points. The range of interest rates offered by the public sector banks (PSBs) on deposits of above one-year maturity increased from 8.00-9.25 per cent in April 2008 to 8.50-10.60 per cent by October 22, 2008. The deposit rates of private sector banks on maturity of one to three years and above three years firmed up from the range of 7.25-9.25 per cent and 7.25-9.75 per cent to the range of 9.00-11.00 per cent and 8.25-11.00 per cent, respectively, during the same period. On the lending side, the benchmark prime lending rates (BPLRs) of PSBs increased by 125-150 basis points in April-October to a range of 13.75-14.75 per cent by October 22, 2008. The private sector banks and foreign banks also increased their BPLR from the range of 13.00-16.50 per cent and 10.00-15.50 per cent to the range of 13.75-17.75 per cent and to 10.00-17.00 per cent, respectively, during the same period.

33. Equity markets experienced a downturn in both the primary and secondary segments during the current financial year so far. In the primary market, resource mobilisation through public issues declined sharply to Rs.12,361 crore during the first half of 2008-09 in comparison with issuances of Rs.31,851 crore in the corresponding period last year. Resource mobilisation through private placement and euro issues also declined considerably when compared with the amounts raised a year ago. In the secondary market, the BSE Sensex (1978-79=100) was volatile with large two-way movements in response largely to movements in global equity markets. The Sensex continued its decline from the peak of 20,873 recorded on January 8, 2008 to reach a level of 10,170 by October 22, 2008.

Developments in the External Sector

34. Balance of payments data for the first quarter of 2008-09 released at end-September 2008 by the Reserve Bank indicate a widening of the merchandise trade deficit, a sustained increase in invisibles, some ebbing of net capital inflows and lower accretion to reserves. In US dollar terms, merchandise export growth was 22.2 per cent during April-June 2008 as compared with 20.7 per cent in the first quarter of the previous year. Commodity-wise data available from the Directorate General of Commercial Intelligence and Statistics (DGCI&S) for April-May 2008 indicate that engineering goods, agricultural and allied products and petroleum products, which together contributed 54.7 per cent of total exports, were the main drivers and contributed 66.5 per cent of overall export growth. Exports of primary products increased by 69.8 per cent, mainly due to the growth of 89.2 per cent in exports of agriculture and allied products. Exports of manufactures recorded a growth of 29.9 per cent as against 17.6 per cent a year ago. While the growth of exports of engineering goods and chemicals and related products was higher at 50.7 per cent and 26.0 per cent, respectively, as compared with 29.8 per cent and 16.7 per cent a year ago, there was a turnaround in the export of textiles and related products which increased by 20.1 per cent as against a decline of 0.5 per cent a year ago. Merchandise import payments recorded a higher growth of 33.3 per cent during the first quarter of the 2008-09 as compared with 21.1 per cent a year ago, due to higher payments for oil imports. Crude oil imports during April-June 2008 recorded a growth of 50.4 per cent as compared with 23.9 per cent a year ago, reflecting the impact of the increase in the price of the Indian basket of international crude which rose to US $ 118.8 per barrel in the first quarter of 2008-09 from US $ 66.4 per barrel in the corresponding quarter of the previous year. On the other hand, non-oil import payments rose by 20.9 per cent as compared with 45.1 per cent a year ago, indicative of some moderation in domestic demand. Capital goods were the main drivers of non-oil import growth during April-May 2008 along with import of fertiliser, chemicals, coal, coke and briquettes. Imports of gold and silver, however, showed a decline of 15.7 per cent as against a growth of 88.4 per cent a year ago. Imports of export-related items like pearls, precious and semi-precious stones also showed a decline in April-May 2008. China

remained the single largest source of imports in April-May 2008, accounting for 11.1 per cent of total imports and 17.7 per cent of non-oil imports. On a payments basis, the merchandise trade deficit widened to US $ 31.6 billion during the first quarter of 2008-09 from US $ 20.7 billion a year ago.

35. During the first quarter of 2008-09, gross invisible receipts at US $ 37.7 billion amounted to nearly 86 per cent of merchandise exports, recording a year-on-year increase of 29.7 per cent. There was an increase in receipts under private transfers along with the steady growth in exports of software services, travel and transportation. On the other hand, invisible payments increased by 14.8 per cent as compared with 22.6 per cent a year ago. While transportation payments rose by 33.1 per cent as compared with 24.8 per cent a year ago, reflecting the rising volume of imports and the hardening of freight rates, payments relating to a number of business and professional services moderated. On a net basis, the invisible account recorded a surplus of US $ 20.9 billion during the first quarter of 2008-09, financing nearly 66 per cent of the trade deficit. Reflecting the movements in merchandise trade and invisible accounts, the current account deficit (CAD) amounted to US $ 10.7 billion as compared with US $ 6.3 billion in the first quarter of 2007-08.

36. Net capital flows amounted to US $ 13.2 billion during the first quarter of 2008-09 as compared with US $ 17.3 billion a year ago. Net ECB inflows at US $ 1.6 billion accounted for only 11.8 per cent of total net capital flows during April-June 2008 as compared with US $ 6.9 billion or 40.3 per cent a year ago. Net inward foreign direct investment (FDI) remained buoyant at US $ 12.1 billion during April-June 2008 as compared with US $ 7.0 billion in the corresponding period last year, reflecting the positive investment climate and continuing liberalisation of the payments regime. Net outward FDI, however, moderated to US $ 2.0 billion from US $ 4.3 billion a year ago with the slowdown in global business activities. There were outflows under net portfolio investment by foreign institutional investors (FIIs) of the order of US $ 5.2 billion during the first quarter of 2008-09 as against a net inflow of US $ 7.1 billion during April-June 2007. Inflows under American Depository Receipts/Global Depository Receipts (ADRs/GDRs) amounted to US $ 1.0 billion in April-June 2008 as against US $ 0.3 billion a year ago. Non-resident Indians (NRI) deposits recorded a net inflow of US $ 0.8 billion in the first quarter of 2008-09, a turnaround from net outflows of US $ 0.5 billion in April-June 2007.

37. These developments in current and capital accounts of the balance of payments resulted in an accretion to foreign exchange reserves (excluding valuation) of US $ 2.2 billion during the first quarter of 2008-09 as compared with US $ 11.2 billion a year ago. Taking into account the valuation gain of US $ 0.2 billion, the level of foreign exchange reserves amounted to US $ 312.1 billion at the end of June 2008.

38. India’s external debt increased marginally by US $ 0.6 billion during April-June 2008 and amounted to US $ 221.3 billion at end-June 2008. While multilateral debt registered a moderate increase of US $ 0.4 billion, there was a decline of US $ 0.9 billion in bilateral debt. ECBs declined by US $ 0.6 billion; however, there was an increase of US $ 2.2 billion under short-term trade credits. Valuation gains on account of the appreciation of the US dollar *vis-à-vis* other major international currencies and the Indian rupee resulted in a decline in external debt by US $ 4.5 billion. The US dollar continued to have a dominant share of 52.3 per cent in India’s external debt whereas rupee-denominated debt accounted for another 14.1 per cent. The ratio of short-term debt to total debt increased to 20.8 per cent at end-June 2008 from 19.9 per cent at end-March 2008. The ratio of foreign exchange reserves to external debt increased marginally to 141.0 per cent at the end of June 2008 from 140.3 per cent at end-March 2008.

39. These developments have extended into the second quarter of 2008-09. Information released by the DGCI&S indicates that exports increased by 35.3 per cent in US dollar terms during April-August 2008 as compared with 19.3 per cent in the corresponding period of the previous year. Imports rose by 38.0 per cent as compared with 34.2 per cent in the corresponding period of the previous year. While non-POL imports decelerated to 28.3 per cent from 42.7 per cent a year ago, the surge in international crude oil prices resulted in POL imports increasing by 60.0 per cent as compared with 17.9 per cent in the corresponding period of the previous year. As a result, the merchandise trade deficit widened to US $ 49.3 billion during April-August 2008 from US $ 34.6 billion in the corresponding period last year with the increase in the oil import bill alone amounting to US $ 17.3 billion.

40. Available information on components of capital flows presents a mixed picture. While inward FDI doubled over the corresponding flows last year and there was a positive turnaround in NRI deposits, net ECBs were much lower this year and there was a large outflow of FII investments. As a result, the deceleration in capital flows witnessed in the first quarter of 2008-09 continued during the second quarter. Portfolio investment by FIIs recorded net outflows amounting to US $ 7.3 billion during the current financial year up to October 10, 2008 as compared with net inflows of US $ 18.9 billion in the corresponding period last year. ADR/GDR issues by Indian companies were lower at US $ 1.1 billion during April-August 2008 as compared with US $ 2.8 billion in the corresponding period last year. On the other hand, gross FDI inflows during April-August 2008 were placed at US $ 16.7 billion as against US $ 8.5 billion a year ago. There were net inflows of US $ 0.3 billion during April-August 2008 under NRI deposits as against net outflows of US $ 0.2 billion a year ago. The foreign exchange reserves declined by US $ 35.8 billion during the current financial year so far and stood at US $ 273.9 billion on October 17, 2008.

41. The exchange rate of the rupee against the US dollar, which was Rs.39.97 at end-March 2008, depreciated sharply thereafter to Rs.49.29 per US dollar by October 22, 2008. During the current financial year so far, the rupee depreciated by 18.9 per cent against the US dollar, by 0.4 per cent against the euro, by 1.1 per cent against the pound sterling and by 19.1 per cent against the Japanese yen. As on October 22, 2008 the exchange rate of the rupee was Rs.49.29 per US dollar, Rs.63.35 per euro, Rs.80.40 per pound sterling and Rs.49.53 per 100 Japanese yen.

42. 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

43. During the first nine months of 2008, the slowdown in global growth spread across developed economies in an environment of heightened uncertainty. Global economic prospects have been dampened by the weakening of the US economy, the wider repercussions of the ongoing financial market crisis and volatility in the energy, food and commodity prices. Concerns about the emergence of protectionist pressures and the possibility of disorderly adjustments to the financial turmoil also carry downside risks to the outlook. According to the World Economic Outlook (WEO) of the IMF released in October 2008, global real GDP growth on a purchasing power parity basis is expected to decelerate from 5.0 per cent in 2007 to 3.9 per cent in 2008 (4.1 per cent in WEO Update, July 2008) and further to 3.0 per cent in 2009 (3.9 per cent in WEO Update, July 2008).

44. In the US, real GDP growth slowed to 2.8 per cent in the second quarter of 2008 from 3.8 per cent a year ago. In the third quarter, labour markets weakened with the unemployment rate rising to 6.1 per cent in September 2008 - the highest in almost five years. Industrial production declined by 6.0 per cent in the third quarter of 2008, mainly on account of hurricanes and production stoppages in September. The rate of capacity utilisation for industry at 76.4 per cent in September 2008 was 4.6 percentage points below the average for 1972-2007. The index of leading indicators increased in September 2008 - the first increase in the index in the last five months. US home prices posted a fall of 16.3 per cent in July 2008 on a year-on-year basis. New home sales in the US decreased by 34.5 per cent in August 2008 from a year ago despite the sharp drop in home prices. Housing starts fell 6.3 per cent in September – a 17-year low – as home-builders sought to reduce the number of unsold homes. Single-family starts fell by 12 per cent to the lowest level since August 1982. In September 2008, US retail sales recorded a year-on-year decline of 1.0 per cent and consumer sentiment dropped sharply in October. The October

2008 WEO of the IMF expects the US economy to slow from 2.0 per cent in 2007 to 1.6 per cent in 2008 and further to 0.1 per cent in 2009.

45. Real GDP in the euro area grew by 1.4 per cent in the second quarter of 2008 on a year-on-year basis as compared with 2.5 per cent a year ago. The economic climate in the euro area has worsened further in the third quarter of 2008. Unemployment in the euro area rose to 7.5 per cent in August 2008 from 7.4 per cent a year ago. Industrial production and business confidence continue to be subdued. While real disposable income is starting to increase as inflation decelerates, weak labour markets are dampening private consumption demand. The October 2008 WEO of the IMF has placed real GDP growth of the euro area at 1.3 per cent in 2008 and 0.2 per cent in 2009 as against 2.6 per cent in 2007.

46. In the Japanese economy, real GDP declined by 3.0 per cent in the second quarter of 2008 as compared with an increase of 2.3 per cent a year ago due to the effects of earlier increases in energy and materials prices and weaker growth in exports. In the third quarter, business fixed investment has declined with corporate profits decreasing on account of deterioration in the terms of trade. Private consumption has been relatively weak, mainly due to slow growth in household income and the increase in prices of petroleum products and food. The recovery in housing investment has been stalled. Public investment, meanwhile, has been sluggish. The October 2008 WEO of the IMF has projected that Japan’s economy will grow by 0.7 per cent in 2008 and 0.5 per cent in 2009 as compared with 2.1 per cent in 2007.

47. The Chinese economy grew by 9.9 per cent in the third quarter of 2008 - the slowest pace in more than five years – as compared with 12.2 per cent a year ago as industrial production and construction slowed because of weak exports and a sluggish real estate market. China’s trade surplus narrowed by 2.6 per cent on a year-on-year basis to US $ 180.9 billion in September on account of regulations to control the surplus and rising energy costs. The total foreign exchange reserves, however, increased to US $ 1.91 trillion in September 2008, recording an increase of US $ 377 billion in the first nine months of 2008 as against US $ 367 billion in the corresponding period of 2007. The CSI 300 Index, which tracks yuan-denominated A shares listed on China’s two exchanges, fell by 66.5 per cent over the year to October 22, 2008. The October 2008 WEO of the IMF has projected that the Chinese economy will grow by 9.7 per cent in 2008 and by 9.3 per cent in 2009 as compared with 11.9 per cent in 2007.

48. 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. In the third quarter, domestic economic activity in Korea has slackened due to sluggish domestic demand although exports continue to post robust growth. A high degree of uncertainty surrounds future economic developments, largely due to the ongoing international financial market turmoil and the global economic

slowdown. In Thailand, economic activity grew by 5.3 per cent in the second quarter of 2008 as against 4.3 per cent a year ago.

49. Globally, inflation has softened in several countries in recent months. In the US, consumer price inflation eased from 5.6 per cent in July 2008 to 4.9 per cent in September 2008. In the euro area, inflation decelerated to 3.6 per cent in September 2008 from the peak of 4.1 per cent in July 2008. In Japan, inflation decelerated to 2.1 per cent in August 2008 from the peak of 2.3 per cent in July 2008 on account of falling oil and food prices. In the UK, however, CPI inflation accelerated to 5.2 per cent in September 2008 from 1.8 per cent a year ago. At the retail level (in terms of retail prices index or RPI) too, inflation rose to 5.0 per cent in September 2008 – the same level as in July 2008 – after dipping to 4.8 per cent in August 2008.

50. Core CPI inflation in the US increased to 2.5 per cent in July-September 2008 from 2.4 per cent in June 2008. In the UK, core CPI inflation increased to 2.2 per cent in September 2008 from 2.0 per cent in August 2008. In the euro area, core CPI inflation increased to 1.9 per cent in August-September 2008 from 1.7 per cent in July 2008. Core inflation in Japan softened to zero in August 2008 as compared with 0.2 per cent in July 2008.

51. The increase in producer price indices (PPI) is beginning to moderate in several industrial economies. In the US, PPI inflation decelerated to 8.7 per cent in September 2008 from the peak of 9.8 per cent in July 2008. In the euro area, it moderated to 8.5 per cent in August 2008 from 9.0 per cent in July 2008. In the UK, it decelerated to 8.5 per cent in September 2008 from 10.0 per cent in July 2008. Wholesale price inflation in Japan fell to 6.8 per cent in September 2008 from 7.2 per cent in August 2008.

52. Inflationary pressures have also begun moderating across emerging market economies (EMEs) in Asia, Latin America and Africa. In China, inflation decelerated from a peak of 8.7 per cent in February 2008 to 4.6 per cent in September 2008. Consumer price inflation in Korea decelerated to 5.1 per cent in September 2008 from 5.9 per cent in July 2008. In Thailand, consumer price inflation softened to 6.0 per cent in September 2008 from 9.2 per cent in July 2008. Inflation showed some signs of deceleration from elevated levels in Brazil, Chile and Mexico. In some EMEs in Asia such as Indonesia and Malaysia, however, inflation has accelerated, induced by high commodity prices. Producer price inflation in EMEs – both in Asia and elsewhere – has been substantial in the first three quarters of 2008 with marginal deceleration in only a few EMEs in the recent months.

53. There has been an overall decrease in prices of food, crude oil and metals since July 2008 which has contributed to the easing in consumer price inflation. The Food and Agriculture Organisation (FAO) Food Price Index, which had risen steadily since early 2006 to a record level of 219 in June 2008, has declined continuously to 188 in September 2008

on encouraging indications of good harvests and rising stocks. In the global foodgrains market, prices of major crops such as corn increased by 5.0 per cent, whereas soyabean and wheat prices have declined by 11.6 per cent and 37.3 per cent, respectively, by October 22, 2008 from their levels a year ago. Food prices, which had risen to a peak in June 2008, eased to a nine-month low in September 2008, reflecting the softening of international prices of all major food and fodder commodities. There has also been a downturn in energy prices in the recent months since the record levels reached in July 2008 with the prospect of a general slowdown in global economic growth. The IMF's metal price index had increased to 201.1 in March 2008 before declining steadily to reach 164.1 by September 2008.

54. The FAO has placed its latest forecast for world cereal production in 2008 at 2,232 million tonnes, 4.9 per cent up from last year and a new record, on account of better than expected harvests throughout Europe, for maize, in particular, in the US and also for coarse grains and rice in east Asia. Cereal production is expected to exceed utilisation in 2008-09 for the first time in four years. With stocks likely to increase, prices of most cereals have started to come down in 2008. Given the outlook for a relatively strong recovery in grain production in 2008 in major exporting countries, the ratio of their aggregate grain supplies to normal market requirements is estimated at 123 per cent in 2008-09 from the relatively low levels in the preceding two years.

55. The cereal production of Low-Income Food-Deficit Countries (LIFDCs) is forecast to increase by 1.7 per cent in 2008. However, as a result of the limited growth in these countries' production this year after the decline in the previous season, they will continue to rely heavily on imports to cover their consumption needs in 2008-09. Global food import expenditure is forecast to reach US $ 1,035 billion in 2008, i.e., 26 per cent higher than the previous peak in 2007.

56. The global wheat output in 2008 is now forecast at 677 million tonnes, a substantial increase of 11 per cent from the previous year and well above the average of the previous five years. In Europe, the latest estimates now point to an increase in production by 25 per cent on above-average yields and a strong recovery in several countries from drought in 2007. International wheat prices have fallen considerably in the past two months after their peak in February 2008. Near-month wheat futures at the Chicago Board of Trade (CBOT) declined from US $ 12.80 per bushel on February 27, 2008 to US $ 5.18 on October 22, 2008. On the same day, futures prices for wheat were quoted higher at US $ 5.38 for March 2009, at US $ 5.64 for July 2009 and at US $ 5.81 for September 2009.

57. Global paddy output is forecast at a record level of 672 million tonnes, which is about 2 per cent above the 2007 level. Favourable weather conditions as well as attractive market prices and fiscal incentives are expected to boost planted areas and yields. International near-month futures price of rice on the CBOT has declined to US $ 14.63 per

hundredweight on October 22, 2008 from a peak of US $ 24.50 on April 23, 2008. On October 22, 2008 futures prices were quoted higher at US $ 14.91 for January 2009, US $ 15.24 for March 2009 and US $ 15.16 for September 2009.

58. The FAO's latest forecast for world production of coarse grains in 2008 has been revised upwards to 1, 106 million tonnes, 2.6 per cent higher than a year ago. The increase is mostly attributed to improved yield prospects for the maize crop in the US as well as better results from the coarse grain harvests throughout Europe. Record high crops have already been gathered in South America. However, market conditions for coarse grains are expected to remain tight with the anticipated total utilisation remaining close to world production on account of the rising use of maize for bio-fuels. The near-month futures prices of corn on CBOT rose to US $ 3.85 on October 22, 2008. On the same day, futures prices for corn were quoted higher at US $ 4.01 for March 2009, at US $ 4.22 for July 2009 and at US $ 4.31 per bushel for September 2009.

59. Metal prices have fallen by 18.4 per cent up to September over the peak of March 2008 following the decline of 8.1 per cent during 2007. Lead and copper prices have increased on supply concerns and dwindling stocks. However, prices of other base metals have softened in the recent period on concerns about global growth which might impact demand. 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 $ 3.54 a year ago. As on October 22, 2008 the near-month futures price for copper stood at US $ 1.85 per pound, US $ 1.87 for December 2008, US $ 1.87 for March 2009 and US $ 1.85 for September 2009. Spot gold declined from US $ 1,032.70 an ounce on March 17, 2008 - the highest since January 1980 - to US $ 757.50 an ounce on October 22, 2008 as the US dollar strengthened and oil prices declined.

60. The spot price of West Texas Intermediate (WTI) crude oil increased to a record level of US $ 145 per barrel on July 3, 2008 on account of perceptions of tenuous supply in several of the major exporting countries before declining to US $ 65.85 on October 22, 2008. Prices of crude oil, which have rebounded since July 2007, declined by 24.8 per cent up to October 22, 2008 from their level a year ago. According to the Energy Information Administration's (EIA) forecasts as on October 7, 2008 the average price of WTI crude oil is expected to be at US $ 111.57 per barrel in 2008 and US $ 112.0 per barrel in 2009. Near-month futures prices reached the level of US $ 66.8 per barrel on October 22, 2008 dipping from US $ 146.5 recorded on July 3, 2008. On October 22, 2008 oil futures ruled marginally higher at US $ 67.2 for January 2009, US $ 68.1 for March 2009 and US $ 71.2 for September 2009. The Organization of the Petroleum Exporting Countries' (OPEC) crude oil production is expected to rise to 32.7 million barrel per day during the third quarter of 2008, increasing by 1.7 million barrel per day from a year ago. The OPEC crude oil production may decline to 32.4 million barrel per day in the fourth quarter of 2008 and fall through 2009 to an average of 31.6 million barrel per day. The non-OPEC crude supply is expected

to decline by about 0.1 million barrel per day during the second half of 2008 from the level a year earlier due to a series of supply disruptions and the impact of hurricanes in the Gulf of Mexico. Consequently, non-OPEC supply in 2008 is now expected to decline for the first time since 2005.

61. Strains in global financial markets have increased significantly in the third quarter of 2008. Equity markets have weakened significantly as valuations reflected disappointing earnings data in the financial and other cyclical sectors. Pressures in inter-bank money markets, which had persisted since May 2008, began to intensify further during the third quarter of 2008. In response to the rapidly unfolding international financial turmoil, there are continuing measures from monetary policy authorities for active liquidity management, some of which are set out below.

62. For the resolution of various issues thrown up by the financial turmoil, the US Treasury and the Federal Reserve have adopted a multi-pronged approach of introducing and enhancing the effectiveness of liquidity facilities, allowing financial support, mergers, conversions and outright bankruptcies, affecting large investment and savings banks, and even a major insurance firm. In early September, the two large US government-sponsored mortgage banks were put into conservatorship by the government. In mid-September, a major investment bank filed for bankruptcy as government support was not forthcoming and a major insurance firm was given central bank assistance. To ameliorate the strains in the money market consequent upon these developments, in addition to the Term Auction Facility (TAF), Primary Dealer Credit Facility (PDCF) and Term Securities Lending Facility (TSLF) instituted earlier and enhanced subsequently, the Federal Reserve announced several initiatives to provide additional support to financial markets. The initiatives introduced in early October included the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility which provides finance to banks in their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds with a view to assisting in meeting redemptions demands and fostering liquidity in the ABCP market, and the Commercial Paper Funding Facility (CPFF) which provides a liquidity backstop to the US issuers of commercial paper to finance the purchase of highly-rated unsecured ABCP from eligible issuers via eligible primary dealers. On October 21, 2008 the Federal Reserve Board announced the creation of the Money Market Investor Funding Facility (MMIFF), which will provide funding to purchase assets including US dollar-denominated CDs and CPs issued by highly-rated financial institutions with 90-day maturities or less from money market mutual funds to provide liquidity to US money market investors.

63. Following the incidents of bailout and default in September, the 3-month US Treasury bill rate fell to 0.0304 per cent on September 17, 2008 - the lowest since 1954 - indicating flight to quality assets such as Treasuries and illiquid repo market conditions. Contagion from the faltering US markets prompted co-ordinated emergency liquidity actions

by major central banks on September 18, 2008 and the Bank of Canada, the Bank of England, the European Central Bank, the Federal Reserve, the Bank of Japan and the Swiss National Bank announced co-ordinated measures designed to address the continued elevated pressures in US dollar short-term funding markets. These included the Federal Open Market Committee (FOMC) authorising an expansion of its existing swap lines with the European Central Bank and the Swiss National Bank and institution of new swap facilities with the Bank of Japan, the Bank of England, and the Bank of Canada who could then provide their respective commercial banks with short-term dollar funding. Similar swap lines were established with the Reserve Bank of Australia, the Danmarks Nationalbank, the Norges Bank and the Sveriges Riksbank on September 24, 2008. Later, the FOMC authorised increases in the size of its temporary swap facilities with the Bank of England, the European Central Bank and the Swiss National Bank till April 30, 2009 so that these central banks can provide US dollar funding in quantities sufficient to meet the demand. Central banks also relaxed eligible collateral for liquidity auctions, changed monetary policy operations procedure and varied the auction maturities to enhance their effectiveness. On September 17, the US Securities and Exchange Commission (SEC) banned naked short-selling in any stock, extending the temporary ban adopted on July 16, 2008, to curtail excessive speculation. In the UK, short selling of financial stocks was banned effective September 19, 2008 till January 16, 2009.

64. On September 21, with their share values plummeting, two major US investment banks were allowed by regulators to become Federal Reserve-regulated bank holding companies (BHCs). On September 25, money markets ground to a virtual halt and interbank and repo rates rose to almost record highs. This prompted the US Treasury to announce a plan for a federal fund of US $ 700 billion to clear the bad debt overhang by (i) buying unviable paper to restore liquidity in markets; (ii) allowing orderly restructuring over time without distress sales; (iii) lessening foreclosures; and (iv) helping the Federal Deposit Insurance Corporation (FDIC) in assisting troubled institutions, which was authorised by Congress in early October under the Emergency Economic Stabilization Act. On October 14, 2008 the Board of Governors of the Federal Reserve System, the US Department of the Treasury and the FDIC made a joint statement to protect the US economy, to strengthen public confidence in the financial institutions and to foster the robust functioning of the credit markets through a voluntary capital purchase programme and a temporary FDIC guarantee programme for a broad array of financial institutions. A wave of banking contagion in Benelux, Germany, UK, Spain, Ireland and Iceland required government intervention from late September onwards and some banks were taken into temporary state ownership. The Government in the UK has taken steps for recapitalisation of the UK banking system for stabilising the financial system. The Reserve Bank of Australia and the Reserve Bank of New Zealand have relaxed collateral norms for repo operations. The governments in Australia and New Zealand have announced their decision to guarantee bank deposits.

65. Central banks have engaged in continuous close consultation and have cooperated in unprecedented joint actions. In addition to the US dollar swap lines, the Bank of Canada, the Bank of England, the European Central Bank, the Federal Reserve, the Sveriges Riksbank and the Swiss National Bank reduced their policy rates by 50 basis points on October 8, 2008. Also, the Bank of Japan expressed its strong support of these policy actions. In order to provide broad access to liquidity and funding to financial institutions, on October 13, 2008 the Bank of England, the European Central Bank, Federal Reserve, the Bank of Japan and the Swiss National Bank jointly announced measures to improve liquidity in short-term US dollar funding markets. As a part of the G-7 action plan, on October 14, 2008 the Bank of Canada announced its intentions to provide exceptional liquidity to the Canadian financial system as long as the situation warrants. The Bank of Japan has increased the frequency and the size of CP repo operations and also broadened the range of eligible collateral.

66. Since December 2007, the Federal Reserve has conducted 21 Term Auction Facility (TAF) auctions amounting to US $ 1,203.3 billion for 28 days maturity each, an auction of US $ 20 billion with 35 days maturity and two auctions of US $ 25 billion each with 84 days maturity and one more auction for 85 days of US $ 138.1 billion up to October 20, 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 $ 94 billion during April–September 2008. Also, on August 28, 2008 the Federal Reserve Board announced the launch of an online resource to help consumers make informed choices when refinancing a home loan.

67. Since December 2007, the European Central Bank has conducted 16 overnight US dollar TAF auctions amounting to US $ 880 billion, three auctions of US $ 120 billion of 3 days maturity and one auction of US $ 100 billion of 4 days maturity, two auctions of US $ 206 billion of 7 days maturity, 20 auctions amounting to US $ 460 billion for 28 days maturity each, two auctions of US $ 10 billion each of 84 days maturity and one auction of US $ 20 billion of 85 days maturity up to October 21, 2008. The Bank of Canada has conducted 13 auctions amounting to US $ 35 billion for 28 days and two auctions of US $ 8 billion of 91 days maturity till October 21, 2008. The Swiss National Bank has conducted 24 overnight auctions amounting to US $ 182 billion, three auctions of US $ 15 billion of 7 day maturity, 15 auctions amounting to US $ 87 billion for 28 days each, two 84 days auctions amounting to US 4 billion and an auction of US $ 4 billion for 88 days maturity up to October 22, 2008. Between September 18 and October 22, 2008 the Bank of England has conducted 24 overnight US dollar repo auctions amounting to US $ 312 billion, one 3 days auction for US $ 30 billion, one 6 days auction for US $ 12.5 billion, seven one week auctions of US $ 242 billion and one 28 days auction of US $ 26 billion.

68. Emerging market central banks have also responded in various ways to the events unfolding in the advanced economies. They stepped into money markets in the second half of September 2008 to contain liquidity shocks from the US credit turmoil. Japan, Korea, Taiwan and Australia injected liquidity into the banking systems to help Asian banks which suffered credit losses due to exposure to the troubled US investment banks *via* hedges and collaterals, and used open market operations to contain declining bond yields and stock prices and stabilise financial market volatility. Monetary policy actions such as reducing required reserves and interest rates to boost liquidity have also been undertaken by some EMEs to stem the financial crisis. The Bank of Korea has introduced a competitive auction swap facility from October 20, 2008 to enhance the effectiveness of foreign currency supply and to promote stability in the foreign currency funding market.

69. On September 30, 2008 the Hong Kong Monetary Authority expanded collateral accepted for accessing the discount window to include US dollar assets of suitable credit quality and waive limitations on using Hong Kong exchange fund paper as collateral. It will extend the duration of funds available on a case-by-case basis and may conduct US/HK dollar swaps with affected banks. All measures have been effective from October 2 and will remain in place until March 2009. On October 14, 2008 the Hong Kong Monetary Authority has taken measures to provide assurance to depositors to use the Exchange Fund to guarantee the repayment of all customer deposits held in authorised institutions in Hong Kong. Secondly, Hong Kong Monetary Authority has established a Contingent Bank Capital Facility for the purpose of making available additional capital to local banks. Both the measures will remain in force until the end of 2010.

70. The Singapore Government has decided to guarantee all Singapore dollar and foreign currency deposits of individual and non-bank customers in banks, finance companies and merchant banks licensed by the Monetary Authority of Singapore until December 2010. Consistent with these regional initiatives, the government of Malaysia and the Bank Negara Malaysia have also guaranteed ringgit and foreign currency deposits with banks and regulated development financial institutions until December 2010. The Bank Negara Malaysia would also extend liquidity facility to non-banks such as insurance companies. For maintaining liquidity in domestic and foreign currency markets on October 14, 2008 Bank Indonesia announced several measures including *inter alia* extension of foreign exchange swap of tenors ranging from seven days to one month and selling foreign currency reserves through banks for domestic companies. Several central banks in Asia have cut their policy rates in tandem with the advanced economies and have provided assurances of liquidity support to financial markets.

71. The Dow Jones Industrial Average, Standard and Poor's (S&P) 500 and Nasdaq Composite exhibited considerable volatility and posted declines of 37.2 per cent, 40.5 per cent and 41.3 per cent, respectively, by October 22, 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, softened thereafter as demand for government debt increased with investors seeking safe haven. The US 10-year bond yield increased from 4.70 per cent at end-December 2006 to 5.29 per cent on June 12, 2007 before falling to 3.60 per cent on October 22, 2008. The 10-year bond yield in the euro area increased from 3.95 per cent at end-December 2006 to 4.67 per cent on July 6, 2007 before falling to 3.80 per cent on October 22, 2008. The Japanese 10-year bond yield has increased from 1.68 per cent at end-December 2006 to 1.97 per cent on July 10, 2007 before falling to 1.53 per cent on October 22, 2008. With the dimming of growth prospects, the EMEs witnessed declines in equity prices and increase in spreads, in various degrees, across countries. The equities sell-off in emerging markets triggered by the US financial meltdown led to a sharp drop in the MSCI Emerging Markets (EM) Index which declined by 52 per cent over the year, up to October 22, 2008 with almost all emerging equity markets falling as higher borrowing costs and credit losses led investors to shun risky assets and, on average, emerging market equities have returned to 2006 levels.

72. On a trade-weighted basis, the US dollar had been depreciating since 2006 with intermittent fluctuations. After the cuts in the Fed funds rates since September 2007, the US dollar had weakened against other currencies. It has, however, strengthened significantly in the recent weeks. The pound sterling moved to the level of US $ 1.63 on October 22, 2008 from the 26-year high of US $ 2.11 reached on November 8, 2007. The euro, which had 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 1.28 on October 22, 2008.

73. 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. Between September 18, 2007 and October 8, 2008 the US Federal Reserve reduced its policy rate by 375 basis points to 1.50 per cent after seventeen increases to 5.25 per cent between June 2004 and June 2006. The Bank of England reduced its Bank Rate to 4.50 per cent by 25 basis points each in February and April 2008 and 50 basis points on October 8, 2008. The European Central Bank reduced its main refinancing operations rate by 50 basis points to 3.75 per cent on October 8, 2008. The Bank of Canada reduced its policy rate to 2.25 per cent by 25 basis points reductions each in December 2007 and January 2008 and 50 basis points each in March and April and by 75 basis points in two stages in October 2008. The Reserve Bank of Australia raised its Cash Rate by 25 basis points each in February-March 2008 to 7.25 per cent

before reducing it by 25 basis points to 7.00 per cent on September 3, 2008 and by 100 basis points to 6.00 per cent effective October 8, 2008. The Reserve Bank of New Zealand reduced the Official Cash Rate from 8.00 per cent to 7.50 per cent on September 11, 2008 and further to 6.50 per cent on October 23, 2008. The People’s Bank of China reduced its policy lending rate twice by 27 basis points each time to 6.93 per cent on September 16 and October 9, 2008. It has also reduced the cash reserve ratio by 100 basis points to 16.5 per cent effective September 25, 2008 and further by 50 basis points effective October 10, 2008 after increasing it in phases to 17.5 per cent by June 25, 2008. The Bank of Korea reduced its Base Rate by 25 basis points to 5.00 per cent on October 9, 2008. The Hong Kong Monetary authority changed the formula for determination of its Base Rate, from October 9, 2008 which reduced the spread of 150 basis points above the prevailing Federal Funds Target Rate by 50 basis points.

74. Central banks of some countries such as Japan and Malaysia have not changed their policy rates in 2008.

75. Some central banks that have tightened their policy rates in recent months include Bank Indonesia (BI rate by 150 basis points in April-October 2008); Bank of Thailand (1-day repurchase rate by 25 basis points to 3.75 per cent on August 27, 2008); the Banco Central de Chile (benchmark lending rate to 8.25 per cent by 25 basis points in January and 50 basis points each in June-September 2008 from 6.00 per cent in December 2007), Banco Central do Brasil (overnight Selic rate by 75 basis points to 13.75 per cent on September 10, 2008) and Banco de Mexico (overnight funding rate by 25 basis points each in June-August 2008 to 8.25 per cent).

Overall Assessment

76. Aggregate supply conditions in the Indian economy have shown resilience in the second quarter of 2008-09 in the face of a deteriorating global macroeconomic and financial environment. There are, however, growing indications that the underlying economic cycle is turning in tune with global economic developments and that domestic economic activity is straddling a point of inflexion. While the 2008 south-west monsoon season has been near normal as anticipated, large temporal variations have resulted in some production losses on account of floods in June in some north-eastern, eastern and northern States and deficient rainfall in July over the north-east, central India and Kerala. At the all-India level, the area sown under various crops is close to the normal cropping coverage but lower by about 2.6 per cent in relation to the high level a year ago. Acreage under key crops such as rice and oilseeds has increased on a year-on-year basis but there are downside risks for the prospects of crops such as sugarcane, coarse cereals, pulses and jute. First advance estimates of the production of foodgrains in 2008-09 from the Ministry of Agriculture suggest that some improvement in these key crops could occur as

these early indications firm up into a clearer picture on the final level of output for the year and the overall outlook on agriculture.

77. Industrial activity in the second quarter of 2008-09 has shown mixed developments with indications of a moderation in pace diffusing across the sector. While the pick-up in industrial production in July 2008 surprised consensus expectations, occurring as it did after an uneven trough during November 2007-June 2008, base effects weighed heavily on the growth rates observed in August and could continue to cast a shadow in some of the months ahead, especially in October-December 2008. Slackening of momentum is essentially located in the basic and intermediate goods sectors, weighed down by the decline in production of fertilisers, steel, aluminum products, yarns and fibre, organic pigments and the like. The rebound in capital goods production in July after a sag in the preceding two months was not sustained in August, indicative of considerable uncertainty in the evolving investment climate. On the other hand, the sustained turnaround in consumer goods output, particularly durables, indicates that the strength of consumption demand is inducing supply responses, aided by the return of pricing power in an environment of high inflation. Manufacturing activity is being driven by industries such as chemicals, machinery and transport equipment and beverages and tobacco products. In fact, excluding items such as wood and products, leather and paper products, textiles, rubber, plastic, petroleum and coal products which have recorded a decline/negligible growth in production and together have a weight of only 26 per cent in the IIP, the growth of industrial output would be 6.5 per cent, somewhat above the observed headline growth of 4.9 per cent in April-August, 2008. Surveys of corporate finances are indicating a worsening outlook with erosion of profitability due to rising expenditures relative to sales, particularly in respect of raw materials and other inputs, staff costs and exchange losses. Various surveys suggest that overall business confidence is flagging. Service sector activity appears to be moderating in several sub-sectors except in communication and freight movement in terms of lead indicators. Construction activity may pick up in the coming months on the back of some improvement in cement and steel production.

78. Widening gaps in the physical infrastructure, markedly in power but elsewhere too except in coal production, could impose a binding constraint on growth. Capacity addition in the power sector has remained far short of tenth Plan targets, worsening the persisting large shortage in the country. Electricity output appears to have been sharply affected by the downslide in hydro power generation, with the energy content of reservoirs posting a shortfall of 27 per cent of the full reservoir level (FRL) at the all-India level up to mid-October 2008. While thermal power generation has provided support, delays in commissioning/commercial operations, high moisture content in coal due to the monsoon as well as the loss of 3.8 billion units of generation during April-August due to shortages of coal reported by utilities across the country are debilitating factors. Shortages of fuel have

also resulted in a loss of 1.2 billion units in the first five months of 2008-09 under nuclear power generation.

79. Aggregate demand conditions continue to be mainly investment-driven, although some slackening which set in during the first quarter of 2008-09 appears to have become broad based. So far, however, investment intentions remain strong as indicated by the memoranda/letters of intent/direct industrial licences posted with the Department of Industrial Policy and Promotion. Private consumption, the mainstay of aggregate domestic demand in India, appears to be firming up steadily since the third quarter of 2007-08 and is expected to benefit from fiscal stimuli on account of enhanced expenditures of subsidies, the farm loan waiver and salaries consequent upon the Sixth Pay Commission award that could come into play during the second half of the year.

80. Reflecting the aggregate demand pressures, key monetary and banking aggregates – money supply, deposit and non-food credit growth – have been expanding during the year so far at rates that are significantly elevated relative to indicative trajectories given in the Annual Policy Statement of April 2008. Money supply has continued to rise at the expansionary rates of 2003-08, propelled by the sustained pace of credit growth. In the July 2008 Review, concerns relating to the significantly overdrawn state of the banking system due to elevated credit growth were expressed in this context. Supervisory review processes have been initiated with selected banks with a view to putting in place appropriate adjustments in their operations. The unabated bank credit growth relative to the sources of funds and the whittling down of excess SLR investments warrants serious policy surveillance in the context of overall financial stability and the efficiency of financial intermediation.

81. The developments in monetary conditions resulted in a tightening of liquidity conditions in domestic financial markets through the second quarter of 2008-09. The strains on market liquidity were aggravated by sizeable fluctuations in the Central Government's cash balances, advance tax payments in mid-September, higher than anticipated credit growth as well as the heightening of volatility in domestic equity and foreign exchange markets in the wake of the sudden deterioration in international financial markets. In the money market, overnight interest rates generally ruled above the upper bound of the corridor *albeit* in a narrow range with a peak in the second week of October 2008 as the international financial turbulence intensified. While the measures announced by the Reserve Bank in September-October 2008 alleviated these pressures, considerable uncertainty surrounds the evolution of liquidity conditions in the months ahead, given the fragile international environment. In response to the measures announced by the Reserve Bank, interest rates have moderated across the overnight market segments.

82. In the Government securities market, high demand for SLR securities depressed yields across the spectrum from mid-July with intermittent spurts on liquidity concerns. Yield curve inversion became persistent through the quarter, with the yield on the benchmark 10-year security ruling consistently below those on lower maturity securities in reflection of the uncertain macroeconomic outlook and to some extent, the softening of international crude prices.

83. In the foreign exchange market, activity picked up mainly on rising import demand induced by volatile international crude prices, portfolio outflows and uncertainties surrounding the global outlook. There was considerable volatility in the spot segment with the exchange rate slipping to multi-year lows as the extraordinary developments in international financial markets unfolded. Forward premia rose sharply at end-June and remained at elevated levels up to July 2008 after which the premia have tended to ease *albeit* unevenly across all maturities. The forward premia went into discount due to dollar shortages towards end-September 2008 but recovered modestly in October 2008. The equity markets have weakened sporadically on cues from global markets, and particularly those in Asia. These developments in domestic financial markets render the macroeconomic outlook unsettled and uncertain.

84. Signs of deterioration in the fiscal situation appear to be adding to aggregate demand pressures in the economy. The revenue deficit of the Central Government has exceeded 177 per cent of the budget estimates during April-August 2008 and overshooting is also observed in the other deficit indicators. While tax revenues were buoyant and direct taxes raised their contribution to gross tax collections to 45 per cent, current expenditures on subsidies, social and other economic services eroded these gains and widened the deficits at all levels. Impending expenditures on subsidies and salary revisions could bring additional pressures to bear on the fisc and consequently, on aggregate demand. The Government will need to address the issue of providing subsidies to the public sector oil marketing and fertiliser companies directly in cash instead of the current practice of issuance of oil and fertiliser bonds.

85. Excess demand conditions are also reflected in the merchandise trade deficit which has expanded by close to 43 per cent in April-August 2008 on a year-on-year basis, though mainly in response to the increase of 77 per cent in the average price of the Indian basket of crude. Although the outlook remains uncertain at the current juncture, the softening of international crude prices in subsequent months should have a salutary effect in terms of containing the merchandise trade deficit over the rest of the year. Non-oil import growth has remained elevated, *albeit* considerably moderated from the increase recorded a year ago. While exports are regaining momentum and international commodity prices, including crude, seem to be retreating, the widening of the trade deficit needs to be viewed in the context of the turmoil in international financial institutions and markets and the evolving

environment for capital flows. The initial conduits of contagion have been equity and currency markets with portfolio investors seeking to wind down positions to meet capital requirements. There are growing concerns about the risks of a more broad-based tightening of external credit conditions setting in with implications for the access of Indian entities to ECBs and short-term trade credits, although ECB norms have been liberalised recently. For the Indian economy, the sizeable increase in foreign direct investment inflows in the first half of 2008-09 provides a measure of comfort. Furthermore, the turnaround in non-resident deposits and in Indian issuances in international stock markets, coupled with the enduring strength of inward remittances are operating as built-in stabilisers in the balance of payments. The level of foreign exchange reserves is adequate in the context of prospective external payment obligations for over a year.

86. At the time of the First Quarter Review in July 2008, headline WPI inflation was close to 12 per cent and June CPI inflation in the range of 7-9 per cent. It was noted that the escalation in inflation has become a global phenomenon, that the rise in inflation in India was not proportionately different from elsewhere and that a noticeable decline in inflation could occur towards the last quarter of 2008-09. While CPI inflation has climbed further in July-September, there is some ebb since mid-August in the underlying momentum of WPI inflation, mainly on account of free-priced petroleum products, edible oils and textiles. More incoming information will be needed to identify a trend if it is forming. Of the increase of 369 basis points in WPI inflation during 2008-09 up to early October, about 55 per cent was due to the rise in prices of POL, food articles, metals and oilseeds/edible oil/oil cakes all of which reflect the global demand-supply balances. Global prices of these commodities had risen sizeably over the same period, leading to sharp increases in inflation across the world, and more so in producer (input and output) prices. Domestically, these imported inflation pressures have been keeping headline inflation at elevated levels with considerable uncertainty as to where it will peak and when. In the absence of further shocks, however, these factors cannot sustain a generalised inflation, especially with money supply contained at the average rate of 2003-08, a period when inflation was low and stable. It needs to be noted, however, that just as the elevation of international commodity prices were not fully passed on to domestic prices, the effect of softening international commodity prices on inflation in India could be similarly muted. The challenge for the setting of monetary policy is to balance the costs of lowering inflation in terms of output volatility, particularly in the context of the moderation in industrial and service sector activity, against the risk of current levels of inflation persisting and getting embedded in inflation expectations. While there are considerable uncertainties associated with this judgment, it is important to remain focused on bringing inflation down to levels that are compatible with a high but stable momentum of growth in the economy and financial stability.

87. Since the First Quarter Review of July 2008, global economic prospects have weakened further. The global economy is facing the deflationary effects of the financial crisis. After the contraction of output in major advanced economies, except the US, in the second quarter of 2008, global growth prospects have worsened in consonance with financial conditions in the third quarter. Retail sales have continued to fall in the third quarter along with consumer confidence in the major economies and unemployment has gone up. The sharp tightening of lending conditions since August could precipitate a dropping away of demand by aggravating the pains of the adjustment underway in the residential sector in several advanced economies. The corporate sector is also adjusting to the pressures from weakening demand and high input costs, which in turn enhances the downside risks to employment. In the US, the erosion of disposable incomes and household wealth is reflecting the decline in real personal consumption. Housing starts and permits plunged in August, weighed down by excess supply of housing units, rise in fixed-rate mortgage rates and expectations of further declines in house prices.

88. There is increasing evidence that the US slowdown is spreading *via* the trade and financial channels. In the euro area, retail sales are also pointing to weaker activity. The residential downturn appears to have deepened in several economies although household financial conditions remain strong. More recent manufacturing orders growth suggests that business investment in the euro area is also turning down. For the Japanese economy, the outlook has deteriorated sharply in recent months with the weakening of industrial production and retail sales on top of large terms-of-trade losses. Business confidence has declined in the third quarter of 2008, especially among small firms with employment and nominal wage growth slowing in recent months. In the UK, economic activity has slowed sharply and the near-term outlook has weakened sharply with the intensification of financial distress. The deterioration of real incomes associated with higher inflation in conjunction with the squeeze in money and credit conditions is restraining spending. The depreciation of sterling also poses new inflation risks. In other major advanced economies, economic activity has been weakening as well and for the relatively open economies such as Canada, terms-of-trade shifts could dampen otherwise resilient domestic demand. Consensus forecasts place growth in industrial economies in 2008 at 1.5 per cent, still a moderate expansion but with significant downside risks.

89. The outlook for the emerging economies remains positive, but uncertainties about their resilience to the global shocks have increased. Industrial production and export volumes have slowed, while equity markets have fallen sharply in tandem with those in advanced economies and bond spreads have widened. In Latin America, equity price declines have shadowed the softening of commodity prices; in Asia, they have been driven down by portfolio investors switching to safe havens. In some EMEs, banking sectors have witnessed some weakening. Domestic demand, however, continues to be strong, supported by rising household incomes and reflected in still rapidly expanding bank credit.

The outlook for exports from emerging economies is less robust, and terms-of-trade effects could dampen domestic demand. Concerns about growth prospects and, more importantly, inflation is impacting sentiment relating to these countries as regards the macroeconomic outlook, capital flows and asset prices. While estimates of capital flows do not indicate sharp reversals, there are indications of a sizeable drop from the second quarter of 2008 onwards in relation to the preceding quarters. With the turmoil in major financial centres, issuances of international equity and debt securities have been constricted and spreads have widened to levels that impede access to external financing. Banking flows have also been affected by the financial turbulence with a drying up of commercial and trade credits and restrictions on rollovers. Many emerging market currencies have depreciated against the US dollar. Investor sentiment relating to emerging economies appears to have been dampened by inflation concerns and expectations of contagion from the slowdown in advanced economies. Among the vulnerable emerging economies are those with large current account deficits and relatively greater reliance on short-term external debt, high fiscal deficits and public sector indebtedness, volatile currencies, inverted yield curves and high inflation. In the period ahead, the soundness and resilience of the financial sector in these economies will have a crucial bearing on growth prospects.

90. Headline inflation still remains high worldwide. Consensus forecasts for industrial economies consumer price inflation have risen from 2.2 per cent in 2007 to 3.6 per cent in 2008 with an even larger increase for emerging economies, driven by food and energy prices. For the latter, there are upward revisions to inflation forecasts for 2008 and 2009 across all regions. Efforts to cushion the impact on retail prices by preventing a full pass-through has weakened fiscal positions in several of these economies. For emerging economy inflation targeters, 13 out of 15 are encountering inflation above the target for some time now and informal targets in other regimes have also been breached persistently. Central banks in these economies have generally responded by tightening monetary policy; for several, however, the risks to growth have emerged as concerns. While some emerging economies have engaged in exchange market interventions to curb inflationary exchange rate depreciation, these efforts are more recently being scaled back. In many emerging economies, strong real domestic bank credit growth has accompanied the inflationary pressures. Upward price pressures are also feeding into core inflation in the advanced economies. The sharp increase in commodity prices in the first half of 2008 that showed up in surging producer price inflation is getting transmitted through to retail levels. The pass-through of input prices to output prices, however, has so far been limited. On the other hand, the recent easing of crude and other commodity prices and indications from futures markets imply that these prices could stabilise over the near term. Considerable uncertainty surrounds both scenarios. If growth slows as the consensus forecasts suggest, the decline in inflation could be more than currently predicted. So far, there is little evidence of generalised increase in wages which would have a determining influence on inflation persistence. Nominal wages are reported to be rising rapidly in some emerging economies.

While market-based inflation expectations have fallen in some of the advanced economies, consumers' inflation expectations have remained elevated with implications for the formations of inflation expectations in the period ahead.

91. The international financial system is gripped by extreme risk aversion in the wake of spectacular failures among the world's largest financial institutions, including several credited with history and tradition. Fears of further disclosure on write-downs/losses/foreclosures/buy-outs and rising concerns about 'toxic assets' spilling over into a more broad-based deterioration in credit quality have exacerbated investor pessimism. Announcements of sizeable public policy bail-outs, guaranteeing of deposits with banking systems and restructuring of weak institutions have not sufficiently assuaged the sense of panic or returned markets to normalcy as yet. Financial markets have experienced an intensification of pressures since May 2008, with the events of September-October 2008 triggering a crisis of confidence that could fundamentally alter the financial landscape in the advanced economies, and in particular, the US. Funding pressures in money markets have been amplified by the unwinding of long US dollar exposures of European banks to non-banks. Central banks and financial regulators have responded with massive liquidity injections, coordinated operations (including swaps and rate cuts) and the banning of certain financial transactions such as short sales. Equity markets have been going through synchronised downturns across the world alongside the weakening of the US dollar against major currencies.

92. As mortgage-related losses widen in their ambit, credit losses and write-downs are spilling out of securitisation and capital market related segments to the more traditional banking book. Across the financial system there is an acute shortage of capital, provoking large rights issues by European banks which, by diluting holdings of existing shareholders, could have actually dampened equity market sentiment. The decline in banks' share prices has reduced the market capitalisation of global banks by close to US $ one trillion, with market value of net assets below book value in a growing number of cases. Banks' capacity to raise capital has been severely circumscribed by these large share price declines. In response, policy authorities in some industrial economies have stepped in to recapitalise troubled financial entities. Sovereign wealth funds and official institutions that provided most of the capital in 2007 have turned cautious. At the same time, asset sales are encountering large losses and questions about the incentive structure in regulatory systems to enable such distressed sales. Weaker real sector activity and in particular, the housing sector and the residential mortgage market, has generally added to the pressures on the financial system, notwithstanding fiscal efforts to support US government-sponsored enterprises (GSEs) whose share prices continue to be weak and credit default swap spreads on subordinated debt have widened significantly in relation to the last quarter.

93. In summary, conditions in global financial markets have worsened with the freezing of inter-bank markets in US and Europe necessitating massive liquidity injection facilities from central banks in these economies including dollar swap arrangements, coordinated monetary policy actions in terms of both liquidity injections and reduction of policy rates, recapitalisation of troubled private banks by governments, coordinated action by European governments to bail out weak banks and guaranteeing of all deposits in the banking system in many countries. These problems have been compounded by falling prices in already weak housing markets and the unwinding of complex derivatives with attendant mark-to-market losses impacting the health of balance sheets, and falling equity prices. With the spread of contagion through indirect effects due to financial integration to countries outside the epicenter of the crisis, authorities in these economies, particularly in east Asia, have taken steps to guarantee deposits and injected liquidity into banking systems, besides undertaking monetary policy actions in the form of reducing required reserves and interest rates.

94. In the overall assessment, global economic conditions have worsened and the future path of their evolution has turned highly uncertain. The broadening slowdown of economic activity in the advanced economies is beginning to impact the macroeconomic prospects of emerging economies, with those reliant on exports and on international financial markets for external financing needs likely to be the most vulnerable. Inflation remains elevated and a key risk to global economic prospects. While commodity prices have been coming off their recent heights and are expected to soften further by the futures markets, the pass-through of the recent prolonged escalation is still seeping into headline inflation and may keep it firm at current levels in the near-term. At the current juncture, the deepening of the financial crisis could impact the weakening macroeconomic outlook in advanced economies with second round effects across the rest of the world. Consequently, monetary policy action against inflation in advanced and emerging economies alike appears to be getting increasingly circumscribed by the more overarching concerns relating to the economy and the financial system. Domestically, lowering inflation as soon as feasible to tolerable levels and anchoring inflation expectations remains a key concern. The momentum in industrial and service sector activity is somewhat moderated in relation to the recent high growth phase of 2005-08. The expected improvement in agricultural output should augment aggregate supply and assuage the inflationary pressures. While the financial system in India has so far been reasonably insulated from the carnage in international financial markets, cataclysmic events including the sheer spread of the turmoil and the type of financial institutions that have plunged under, regardless of reputation or size, warrants an intensified watchfulness with a readiness to act swiftly to cushion the economy and the domestic financial system from external shocks.

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

95. This Mid-Term Review is set in the context of several complex and compelling policy challenges. The global financial system is in a crisis of unprecedented dimensions. The problem that originated in delinquencies in the US sub-prime mortgage market and the associated ballooning of the market for complex derivatives in August 2007, snowballed into a financial sector turmoil spanning the entire financial sector. What started off as a liquidity problem quickly turned into a solvency problem triggering a crisis of confidence in the financial markets. The crisis spread rapidly from the US to Europe and then partially to the rest of the world with some spillover of the contagion from the financial sector to the real sector. There have been severe disruptions in international money markets, sharp declines in stock markets across the world and evidence of extreme risk aversion among financial sector participants. Governments, central banks and financial regulators around the world are responding to the crisis with aggressive, radical and unconventional measures to restore calm and confidence to the markets and bring them back to normalcy and stability.

96. India's financial sector is stable and healthy. All indicators of financial strength such as capital adequacy, ratios of non-performing assets (NPA) and return on assets (RoA) for our commercial banks, which account for 88 per cent of banking assets, are robust. While many banks and quasi-banking financial institutions in advanced countries suffered large losses and needed substantial capital infusion and bail out packages, Indian banks have been affected only peripherally as they do not have direct financial exposure to the US sub-prime assets. Mark-to-market losses on the financial instruments held in the overseas portfolio of foreign branches and foreign subsidiaries of Indian banks are due to the general widening of credit spreads. The overall capital adequacy ratio of commercial banks in India is 12.7 per cent, well above the regulatory minimum of 9 per cent and the Basel Accord requirement of 8 per cent. In fact, all commercial banks in India have a capital adequacy ratio above 10 per cent. Furthermore, the regulatory mandate of keeping 25 per cent of net demand and time liabilities as SLR and 6.5 per cent as CRR provides an inherent strength to the Indian banks. The most prominent symptom of the problem in the financial sectors of advanced countries has been the freezing up of inter-bank markets. On the contrary, the inter-bank market in India has been functioning in an orderly manner and transaction volumes in recent weeks have been comparable to, or oftentimes above, those in the previous six months.

97. Nevertheless, the global developments have had some indirect, knock-on effects on domestic financial markets. Money markets have experienced unusual tightening of liquidity in recent weeks as a result of global developments which were amplified by transient local factors such as advance tax payments. The foreign exchange market experienced some pressure on account of portfolio investment outflows by FIIs and the enhanced foreign

exchange requirements of oil and fertiliser companies resulting from higher international prices and import volumes. Constraints in access to external financing as also repricing of risks and higher spreads resulted in additional demand for domestic bank credit with attendant hardening of interest rates across the spectrum. The combined impact of these factors was a perception of credit pressures despite a sizeable increase in the growth of bank credit during the current financial year so far. Domestic equity markets were significantly affected by the global de-leveraging of assets and the adverse sentiment from overseas markets.

98. Liquidity conditions in the domestic markets tightened abruptly in mid-September. The overnight call money rate jumped from around 9 per cent on September 8 to over 13 per cent on September 16. While this spurt was partly triggered by the scheduled mid-September advance tax outflows, it was soon clear that the tightness in liquidity was not solely due to local and seasonal factors as the call rate climbed to close to 15 per cent on September 29. Volumes in the LAF repo auctions, which had averaged around Rs.12,500 crore in the first half of September, rose to above Rs.68,000 crore in the second half of the month.

99. During the last financial year, as against a current account deficit of 1.5 per cent of GDP, India received net capital flows of the order of nearly 10 per cent of GDP. While these inflows were partially sterilised by the issuance of MSS securities and successive increases in the CRR, they had an expansionary effect on domestic liquidity conditions. As the global liquidity crisis deepened over the last two months, capital inflows dried up and increased the demand for credit from the domestic banking system, thereby aggravating liquidity pressures.

100. In the wake of the stress on our financial markets as a result of the global financial crisis, the immediate challenge for the Reserve Bank was to infuse confidence by augmenting both domestic and foreign exchange liquidity. Accordingly, the Reserve Bank announced the following measures on September 16, 2008:

> Reserve Bank assured financial market participants that it would continue to sell foreign exchange to augment supply in the domestic foreign exchange market or even intervene directly to meet any demand-supply gaps at the prevailing market rates and as per market practice.
>
> A second LAF was also re-introduced on a daily basis as an assurance to market participants of liquidity in the event of market stress.
>
> The interest rate ceilings on FCNR (B) deposits of all maturities and on deposits under the NR(E)RA for one to three years maturity were increased by 50 basis points.

As an *ad hoc* and temporary measure, banks were allowed to avail of additional liquidity support under the LAF to the extent of up to one per cent of their net demand and time liabilities and seek waiver of penal interest.

101. Liquidity conditions tightened even further after October 7 as contagion from the US financial crisis spread to Europe and Asia. Globally, money markets froze up and the stock markets turned highly volatile as even coordinated policy actions by monetary authorities in America, Europe, Asia and Australia failed to inspire the confidence of financial markets. In the fortnight ending October 10, 2008 there was a sizeable expansion in bank credit of the order of Rs.65,000 crore which was the highest for any fortnight during 2008-09 so far. Consequently, in the domestic money market, call money rates touched a peak of 19.8 per cent on October 10 with LAF repo volumes crossing Rs.90,000 crore through the early part of October. In view of the persisting uncertainty in the global financial situation and its impact on India, and continuing demand for domestic market liquidity, the following measures were taken in October 2008:

In view of the continuing uncertain global situation, these measures were augmented by a cumulative reduction of 250 basis points in the CRR effective from the fortnight beginning October 11.

A special 14-day repo facility for a notified amount of Rs.20,000 crore was instituted to alleviate liquidity stress faced by mutual funds and banks were allowed temporary access to SLR-eligible securities by an additional 0.5 per cent of NDTL exclusively for this purpose.

Commercial banks and All India term lending and refinancing institutions were allowed to lend against and buy back CDs held by mutual funds for a period of 15 days.

At the request of the Government, the Reserve Bank agreed to provide the sum of Rs.25,000 crore as the first instalment under the Agricultural Debt Waiver and Debt Relief Scheme to commercial banks, RRBs and co-operative credit institutions immediately.

The interest rate ceilings on FCNR (B) deposits of all maturities and on deposits under the NR(E)RA for one to three years maturity were further increased by 50 basis points each.

Banks were permitted to borrow funds from their overseas branches and correspondent banks to the extent of 50 per cent of their unimpaired Tier I capital or US $ 10 million, whichever is higher.

The Reserve Bank also announced that it would institute special market operations to meet the foreign exchange requirements of public sector oil market companies against oil bonds when they become available.

102. On October 20, 2008 in order to alleviate the pressures on domestic credit markets brought on by the indirect impact of the global liquidity constraint and, in particular, to maintain financial stability, it was decided to reduce the repo rate under the Liquidity Adjustment Facility (LAF) by 100 basis points to 8.0 per cent with immediate effect.

103. Taken together, the measures taken since mid-September 2008 have substantially assuaged liquidity stress in domestic financial markets arising from the contagion of adverse external developments. The total liquidity support through reductions in the CRR, the temporary accommodation under the SLR and the first instalment of the agricultural debt waiver and debt relief scheme was of the order of Rs.1,85,000 crore. In the inter-bank call money market, rates have eased from well above 10 per cent to a range near the LAF reverse repo rate. There has been a steady improvement in call money turnover which constituted a third of total volumes transacted in the overnight markets. The LAF window saw a mode reversal from a net injection of Rs.91,720 crore on October 1, 2008 to a net absorption through reverse repos of the order of Rs.27,745 crore on October 22, 2008. Yields in the Government securities market have reflected the improvement in liquidity conditions with the benchmark 10 year yield easing from 8.30 per cent on October 3, 2008 to 7.58 per cent on October 22, 2008. Furthermore, it is expected that the cut in the repo rate effected on October 20, 2008 will ease the constraints in money and credit markets, restore their orderly functioning and sustain financial stability.

104. The task of monetary management has always centred around managing a judicious balance between price stability, sustaining the growth momentum and maintaining financial stability. The relative emphasis between these objectives has varied from time to time depending on the underlying macroeconomic conditions. Prudent regulatory surveillance and effective supervision have ensured that our financial sector has been and continues to be robust. The global financial turmoil, has, however, reinforced the importance of putting special emphasis on preserving financial stability. At the same time, inflation, which is still in double digits, and the moderation in growth continue to be critical policy concerns. Consequently, the central task for the conduct of monetary policy has become more complex than before, with increasing priority being given to financial stability. The current challenge, accordingly, is to strike an optimal balance between preserving financial stability, maintaining price stability, anchoring inflation expectations, and sustaining the growth momentum. To manage this challenge, the Reserve Bank has deployed and will continue to deploy both conventional and unconventional tools.

105. The First Quarter Review of July 2008 placed the projection of real GDP growth in 2008-09 at around 8.0 per cent for policy purposes. Since then, there have been significant global and domestic developments which have rendered the outlook uncertain, and have increased the downside risks associated with this projection. In particular, the global downturn may be deeper and more protracted than expected earlier. Consequently, the adverse implications through trade and financial channels for emerging economies, including India, have amplified. If the recession is deeper and the recovery is long drawn as is the current expectation, emerging economies have also to contend with second round effects in the form of potential terms of trade losses, erosion of export competitiveness and restricted external financing. These adverse developments are overlaid on the moderation of growth in the industrial and services sectors in the first half of 2008-09. The south-west monsoon conditions and water storage levels support the prospects of maintaining the medium-term trend growth rate in agriculture in 2008-09. Taking these developments and prospects into account, the Reserve Bank has revised the projection of overall real GDP growth for 2008-09 to a range of 7.5-8.0 per cent.

106. Globally, pressures from commodity prices, including crude, appear to be abating, though they continue to rule at elevated levels. Domestically, prices of food articles are moderating and the beneficial effects of the south-west monsoon should enable a further easing in the coming months. There are also incipient signs of some softening in prices of some manufactured goods. Consequently, WPI inflation, excluding food articles and the fuel category, is showing some plateauing *albeit* at high levels. Moreover, the decline in the price of the Indian basket of crude to around US $ 70 in recent weeks has reduced the probability of upward revisions in administered prices in the period ahead. The moderation in key global commodity prices, if sustained, would contribute to reduction in inflationary pressures from the current levels. On the other hand, consumer price inflation for agricultural and rural labourers has risen to double digits in August and September for the first time in nearly a decade. Within the wholesale price segment too, inflationary pressures from non-food articles - mainly cotton, edible oils and metals – are as yet unyielding; indeed there has been some firming up in recent weeks. It is possible that these prices would also soften if the global slowdown is more severe than expected. All in all, it is the Reserve Bank’s assessment that inflation continues to be a concern and that we cannot afford to let the guard slip on our inflation vigil.

107. The First Quarter Review of July 2008 noted that this round of inflation emanated, in part, from global supply pressures, and that inflation over the past year has not been proportionately different from elsewhere. However, inflation in double digits is well beyond our tolerance levels and is clearly unacceptable. As indicated in past policy reviews, it will be the Reserve Bank’s endeavour to bring down inflation to a tolerable level of below 5 per cent at the earliest, while aiming for convergence with the global average inflation of

around 3.0 per cent over the medium-term. Keeping in view the supply management measures taken by the Government and the lagged demand response to the monetary policy measures taken by the Reserve Bank over the last one year, the earlier projection of inflation of 7.0 per cent by end-March 2009 appears to be valid. It has, therefore, been decided to maintain this estimate for policy purposes.

108. Going forward, the Reserve Bank’s policy endeavour would be to modulate the monetary overhang generated by the sustained expansion of money supply since 2005-06. This is necessary in order to ensure that inflationary pressures are not fuelled and that the current stance of monetary policy is not attenuated by expansionary monetary conditions. Accordingly, as stated in the First Quarter Review, it is necessary to moderate the rate of money supply to 17 per cent in 2008-09. This translates to a requirement of growth in aggregate deposits in 2008-09 to 17.5 per cent and the growth of non-food credit, including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and CP, to around 20 per cent. The enhanced borrowing requirement of the Central Government in the second half of 2008-09, however, is an upside risk to the realisation of these projections and will have implications for the conduct of monetary policy.

109. Non-food credit has posted a growth of 29 per cent on a year-on-year basis as of October 10, 2008. This is well beyond the projection of 20 per cent for 2008-09. This higher rate of credit growth could possibly be due to the additional demand on domestic credit because of constraints in excess to external credit as noted earlier. Even so, such a rapid rate of credit growth is a cause for concern and will warrant intensified monitoring and continued correction. While maintaining credit quality has always been our central concern, the global financial crisis has reinforced risks of allowing rapid and unbridled credit expansion and the resultant systemic threat to financial stability. Banks should continue to lend for productive purposes and, in particular, permit drawals of sanctioned limits guided by their usual commercial judgment. Banks should also consider restructuring the dues of small and medium enterprises on merits. At the same time, they should pay attention to maintaining credit quality. In pursuit of this objective, banks should focus on stricter credit appraisals on a sectoral basis, monitor loan to value ratios and calibrate their credit portfolio in tune with their asset-liability projections. The Reserve Bank will monitor the rate of credit growth and credit quality closely and will, as necessary, engage with select banks which are outliers on the norms.

110. India’s balance of payments continues to reflect strength and resilience in a highly unsettled international environment. A resumption in the vigour of export growth in the second quarter of 2008-09 is a comforting factor. Moreover, the significant softening of international crude oil prices in recent weeks can be expected to moderate the trade deficit in the second half of the current fiscal year. However, the volatility in international crude oil

prices warrants continues monitoring. In the capital account, the sustained inflows in the form of FDI and the turnaround in NRI flows have mitigated the impact of the outflows under portfolio investment. Overall, the current account deficit may be somewhat higher in 2008-09 than in the preceding year but it is expected that net capital flows would meet the external financing requirement in 2008-09.

111. Given the uncertainty in the global financial situation, monitoring and maintenance of domestic financial stability warrants continuous attention. There are some positive aspects of our financial system. Corporate balance sheets are healthy and leverage levels are within normal ranges. The interest burden of corporates too is low by historical standards. On the negative side, pressures on liquidity could emerge from anywhere in the deep chain of the financial system. These could potentially be a source of vulnerability. The Reserve Bank will maintain a close vigil on the entire financial system to prevent pressures building up in the financial markets. This will include enhancing liquidity if pressures persist. This could also mean curtailing liquidity if the recent liquidity easing measures are seen to have injected excess liquidity, thereby stoking inflationary pressures.

112. The management of the global financial crisis has highlighted two important aspects. First, that resolution of a crisis of this magnitude and complexity demands going beyond the rule book to unconventional, unorthodox and swift policy actions. Second, there is need for close coordination between the Government and the regulatory agencies without at the same time eroding institutional integrity and independence. These aspects are important and relevant for India too. India has well functioning institutional arrangements, both formal and informal for inter-regulatory agency coordination. These have stood the test of time. All the same, there is need to constantly endeavour to build on these arrangements to further refine and strengthen them.

113. The global financial situation, described as the worst since the Great Depression, continues to be uncertain and unsettled. There are continuing concerns about the nature and depth of the crisis, the manner of and the time frame for its resolution and the response to the policy measures announced so far. Furthermore, the deflationary impact of the financial turmoil is intertwined with a distinct weakening of global growth. In what is clear evidence of the depth and degree of financial integration, this uncertainty is transmitting also to countries outside the epicenter of the crisis. India cannot be immune to these global developments. These external pressures coming on top of already existing domestic pressures pose complex challenges for monetary management. This is uncharted territory with no standard or conventional solutions. The Reserve Bank has endeavoured to be proactive, and has taken measures to manage the rapid developments and ease pressures stemming from the global crisis. In conclusion, the Reserve Bank reiterates that it is confident of managing the situation and minimising the adverse impact of the global crisis on the Indian economy. Our financial system is strong and healthy, and our economic

fundamentals are strong. Once the global situation is managed and calm and confidence are restored, we will return to our higher growth trajectory.

114. Based on the above overall assessment of the macroeconomic situation, the stance of monetary policy for the rest of 2008-09 will be as follows :

> Ensure a monetary and interest rate environment that optimally balances the objectives of financial stability, price stability and well-anchored inflation expectations, and growth;
>
> Continue with the policy of active demand management of liquidity through appropriate use of all instruments including the CRR, open market operations (OMO), the MSS and the LAF to maintain orderly conditions in financial markets;
>
> In the context of the uncertain and unsettled global situation and its indirect impact on the domestic economy in general and the financial markets in particular, closely and continuously monitor the situation and respond swiftly and effectively to developments, employing both conventional and unconventional measures;
>
> Emphasise credit quality and credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

III. Monetary Measures

(a) Bank Rate

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

(b) Repo Rate/Reverse Repo Rate

116. The repo rate under the LAF has been kept unchanged at 8.0 per cent.

117. The reverse repo rate under the LAF has been kept unchanged at 6.0 per cent.

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

119. 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 flexibly 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

120. The cash reserve ratio (CRR) of scheduled banks is currently at 6.5 per cent of net demand and time liabilities (NDTL). On a review of the current liquidity situation, it has been decided to keep the CRR unchanged at 6.5 per cent of NDTL.

Third Quarter Review

121. The Third Quarter Review of the Annual Policy Statement on Monetary Policy will be undertaken on Tuesday, January 27, 2009.

Part B. Mid-Term Review of the Annual Statement on Developmental and Regulatory Policies for the Year 2008-09

122. The Annual Policy Statement of April 2008 set developmental and regulatory policies for the year 2008-09 with a focus on developing a sound, efficient and vibrant financial system that ensures the efficient provision of financial services to the widest sections of society. Against the backdrop of the international financial turmoil, the securing and maintenance of financial stability was accorded priority from a policy perspective with a readiness for swift responses, both conventional and unconventional, to any threats to financial stability from adverse international developments. Credit quality, credit delivery and financial inclusion alongside credible communication, adequate and timely availability of information and a broad-based, participative and consultative approach with involvement of all stakeholders were emphasised in the stance of developmental and regulatory policies for the year.

123. As stated in the Annual Policy Statement and reiterated in the First Quarter Review of July 2008, the recent global financial developments may carry profound implications for the health of the financial sector, business strategies, capital requirements, risk pricing and management tools, transparency, and starkly in the recent period, the blurring of the boundaries between liquidity and solvency stress in situations of generalised uncertainty and loss of confidence among financial entities. In this environment, banks in India were enjoined to monitor their credit portfolios closely in the context of the persisting high growth in bank credit at the systems level and to take corrective action as appropriate in order to prevent undue asset-liability mismatches or deterioration in the quality of credit, recognising the reality of business cycles and counter-cyclical monetary policy responses. The Reserve Bank's response to global developments has also been swift, pre-emptive and even unconventional, especially in the context of assuaging the liquidity pressures

impacting domestic financial markets, as demonstrated in the policy measures taken in September and October 2008 and referred to in Part A of this Review.

124. During 2008-09 so far, the Reserve Bank has put in place several measures for the development of financial markets and instruments, credit delivery mechanisms, in particular, for weaker sections, the priority sector and potentially viable sick, small and medium enterprises (SME) units and financial inclusion. Alongside, initiatives have been taken for strengthening of prudential norms and entrenching the three-track approach for Basel II with due emphasis on country-specific requirements in the convergence with international best practices.

125. In the period ahead, the developmental and regulatory policies of the Reserve Bank would continue to adopt a holistic approach to the responsibility for price and financial stability. The Reserve Bank is committed to deepening and expanding reforms in the financial sector so that efficient and competitive financial intermediation evolves in tune with real sector objectives so as to secure sustained growth with stability. The process of participation of and consultation with all stakeholders would be further intensified for the promotion of inclusive growth through provision of prompt and accessible financial services and the spread of financial education so as to develop a system that is attentive to the needs of the common person.

126. The Mid-Term Review of Annual Statement on Developmental and Regulatory Policies focuses on certain key areas: carrying forward development of various segments of financial markets and strengthening the financial market infrastructure; further liberalisation of foreign exchange transactions; relaxation in the interest rate ceilings on non-resident Indian (NRI) deposits; strengthening the supervisory framework in terms of cross-border supervision, risk-based supervision and bank-led conglomerates; enhancement in the off-site monitoring system and surveillance over banks' credit portfolios; development of instruments and infrastructure relating to payment and settlement systems in response to financial innovations; strengthening urban cooperative banks (UCBs) and regional rural banks (RRBs) for improved credit delivery mechanisms and financial inclusion.

127. This part is divided into five sections: I. Interest Rate Policy; II. Financial Markets; III. Credit Delivery Mechanisms and Other Banking Services; IV. Prudential Measures; and V. Institutional Developments.

I. Interest Rate Policy

Interest Rates on FCNR(B) and NR(E)RA Deposits

128. Recent global developments brought some pressure to bear on the domestic money and foreign exchange markets in conjunction with temporary local factors. In response, the Reserve Bank increased the interest rate ceiling on FCNR(B) deposits by 50 basis points, *i.e.*, to Libor/Swap rates minus 25 basis points and the interest rate ceiling on NR(E)RA deposits by 50 basis points, *i.e.*, to Libor/Swap rates plus 50 basis points effective from the close of business on September 16, 2008. These ceilings were increased further by 50 basis point each, *i.e.,* Libor/Swap rates plus 25 basis points and Libor/Swap rates plus 100 basis points, respectively, with effect from the close of business on October 15, 2008.

II. Financial Markets

Money Market

(a) Special Market Operations

129. The Reserve Bank announced Special Market Operations (SMO) on May 30, 2008 on an *ad hoc* and temporary basis to minimise potential adverse consequences for financial markets and for overall financial stability in view of liquidity and other related issues arising from the unprecedented escalation in international crude prices. Under the SMO, the Reserve Bank conducted open market operations in the secondary market through designated banks in oil bonds held by public sector oil marketing companies in their own accounts subject to an overall ceiling of Rs.1,500 crore on any single day and provided equivalent foreign exchange through designated banks at market exchange rates to the oil companies. The SMO was terminated effective from August 8, 2008. Taking into account the continuing uncertain global situation and the potentially adverse implications for domestic financial markets, the Reserve Bank announced on October 15, 2008 that it has decided to reinstitute a similar facility when oil bonds become available.

(b) Second Liquidity Adjustment Facility

130. The Reserve Bank operates a liquidity adjustment facility (LAF) to inject/absorb liquidity through daily repo/reverse repo auctions. These operations are conducted in the forenoon between 9.30 A.M. and 10.30 A.M. In response to suggestions from market participants for fine-tuning the management of bank reserves on the last day of the maintenance period, a second LAF (SLAF) on reporting Fridays was introduced with effect from August 1, 2008 which is conducted between 4.00 P.M. and 4.30 P.M. In view of the recent extraordinary global developments, the SLAF is conducted on a daily basis beginning September 17, 2008.

131. Taking in to account the continuing uncertainty and its indirect impact on our financial markets, the Reserve Bank decided to conduct a special 14-day repo for a notified amount of Rs.20,000 crore on October 14, 2008 with a view to enabling banks to meet the liquidity requirements of mutual funds. As only Rs.3,500 crore was utilised on October 14, 2008, this 14-day repo facility was further extended to be conducted every day up to the cumulative amount of Rs.20,000 crore. It was further decided that purely as a temporary measure, banks may avail of additional liquidity support exclusively for the purpose of meeting the liquidity requirements of mutual funds to the extent of up to 0.5 per cent of their NDTL. This accommodation was extended in addition to the temporary measures announced on September 16, 2008 permitting banks to avail of additional liquidity support to the extent of up to 1 per cent of their NDTL. Furthermore, the Reserve Bank relaxed the restrictions on lending and buy-back only in respect of the certificates of deposit (CDs) held by mutual funds effective from October 14, 2008.

Government Securities Market

(a) Central Government Securities

(i) Floating Rate Bonds: Development of NDS Auction Format

132. The Annual Policy Statement of April 2008 had indicated that the Clearing Corporation of India Limited (CCIL) is developing a primary auction module for dated Government securities which would cover all types of instruments, including floating rate bonds (FRBs). Necessary software modifications are being incorporated for issuance of FRBs. The new structure of issuance incorporated in the Negotiated Dealing System (NDS) auction module (Version 2) is being developed by the CCIL. The FRBs will be issued at an appropriate time taking into account the prevailing market conditions.

(ii) Auction Process of Government of India Securities

133. As announced in the Annual Policy Statement for the year 2008-09, the recommendations of the Internal Working Group on the Auction Process (Chairman: Shri H. R. Khan) are in the process of implementation. The major recommendations of the Working Group include reduction in the time gap between bid submission and declaration of auction results, withdrawal of the facility of bidding in physical form and submission of competitive bids only through the NDS. In the first phase, the recommendations relating to the reduction in the time gap and withdrawal of physical bids are being implemented. Some of the recommendations like facilitating direct participation of non-NDS members in auctions through a secured web-based system are under examination.

(iii) Collateral Facility Extended for Savings Bonds

134. On August 19, 2008 the Government of India amended the notifications relating to the 7 per cent Savings Bonds, 2002, the 6.5 per cent Savings Bonds, 2003 (non-taxable), and the 8 per cent Savings Bonds, 2003 (taxable) schemes and allowed for pledge or hypothecation or *lien* of these bonds as collateral for obtaining loans from scheduled banks in accordance with the provisions of Section 28 of the Government Securities Act, 2006 and Regulations 21 and 22 of the Government Securities Regulations, 2007. These amendments would enable pledge of these instruments for raising of loans by the holders, thereby imparting liquidity to these instruments.

(b) Debt Management for State Governments

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

135. With a view to widening the investor base and enhancing the liquidity of State Development Loans (SDLs), a scheme for Non-Competitive Bidding Facility has been approved by the State Governments. Accordingly, the General Notifications on issue of SDLs have been amended by the State Governments. The NDS Auction Module (Version 2), which would facilitate introduction of the scheme, is under development by the CCIL. The parallel run of the new Version 2 will commence shortly and the scheme will be operationalised by end-December 2008.

(c) Development of Market Infrastructure

(i) Introduction of Interest Rate Futures

136. A Working Group on Interest Rate Futures (Chairman: Shri V. K. Sharma) was constituted to review the experience gained with interest rate futures since its introduction in India in June 2003, with particular reference to product design issues. The recommendations of the Group were placed before the Technical Advisory Committee (TAC) for Money, Foreign Exchange and Government Securities Markets. Taking into consideration the feedback and comments received from the public, experts, banks, market participants and the Government of India, the report was finalised and has been placed on the Reserve Bank's website on August 8, 2008. The RBI-Securities and Exchange Board of India (SEBI) Standing Technical Committee has been entrusted with the work relating to the operationalisation of these recommendations. Accordingly, the Committee has initiated work on various issues which broadly fall into three categories: product design and specification issues; exchange related issues and specifications like margins; and regulatory issues for banks. On October 13, 2008 banks were permitted to take trading positions in interest rate futures (IRFs), as recommended by the Working Group. This will

add depth and liquidity to the market. It is expected that IRF contracts as recommended by the Working Group would be launched in early 2009 along with the supporting changes in the regulatory regime.

(ii) Multi-modal Settlement

137. The Annual Policy Statement of April 2008 proposed a new settlement mechanism in Government securities through settlement banks in order to facilitate direct access to NDS and NDS Order Matching (NDS-OM) by participants who do not maintain current accounts but maintain Subsidiary General Ledger (SGL) accounts with the Reserve Bank. Accordingly, guidelines were issued on June 2, 2008 to operationalise the mechanism. Secondary market transactions in Government securities are being settled only through the designated settlement banks (DSBs) with effect from June 30, 2008. Arrangements for settlement of primary auction bidding under the new mechanism are being worked out.

(iii) Access to NDS-OM Through CSGL Route

138. Access to the NDS-OM segment, which was launched in August 2005, was initially allowed to commercial banks and primary dealers (PDs) and later to other NDS members such as insurance companies, mutual funds and large provident funds for their proprietary deals. To widen its reach, access to NDS-OM was extended to certain entities maintaining gilt accounts with the NDS members (*i.e.*, banks and PDs) through the Constituent SGL (CSGL) route in a phased manner and is now available to deposit-taking non-bank financial companies (NBFCs), provident funds, pension funds, mutual funds, insurance companies, cooperative banks, RRBs, trusts and systemically important non-deposit taking NBFCs (NBFCs-ND-SI). As proposed in the Annual Policy Statement of April 2008, access to NDS-OM through the CSGL route was further extended to investors such as other non-deposit taking NBFCs, corporates and FIIs. These entities can place orders on NDS-OM directly through NDS-OM members using the CSGL route. Such trades will settle through the CSGL accounts and current accounts of the NDS-OM members.

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

139. The CCIL has operationalised a trade reporting platform for over-the-counter (OTC) rupee interest rate derivatives which has been functioning satisfactorily. The average daily turnover is currently about Rs.14,000 crore. It was announced in the Annual Policy of April 2008 that a clearing and settlement arrangement for OTC rupee interest rate derivatives would be put in place. Accordingly, permission has been given to the CCIL to operationalise a clearing and settlement arrangement for OTC rupee interest rate derivatives on a non-guaranteed basis and this is expected to commence within a month. Once the software systems are in place and the issues relating to counter-party exposure

and risk weights as applicable to the CCIL are advised, the CCIL would operationalise settlement of these products on a guaranteed basis within three months.

Foreign Exchange Market

(a) Liberalisation of Foreign Exchange Transactions

140. Measures taken during 2008-09 towards further liberalisation of foreign exchange transactions and improvement of foreign exchange facilities are set out below:

(i) Overseas Investment

Registered trusts and societies engaged in manufacturing/ education/hospitals were allowed to make investment in the same sector(s) in a joint venture (JV) or wholly owned subsidiary (WOS) outside India with the prior approval of the Reserve Bank, subject to compliance with the prescribed eligibility criteria.

Indian entities were allowed to invest in overseas unincorporated entities in the oil sector up to 400 per cent of their net worth as on the date of the last audited balance sheet.

(ii) Overseas Borrowing

Based on a review, the external commercial borrowings (ECBs) policy was modified and accordingly, effective October 22, 2008 ECBs up to US $ 500 million per borrower per financial year are permitted for rupee expenditure and/or foreign currency expenditure for permissible end-uses under the automatic route.

Payment for obtaining licence/permit for 3G Spectrum is considered an eligible end-use for the purpose of ECBs.

The ECBs borrowers have been extended the flexibility to either keep the proceeds off-shore or to remit to India for credit to their rupee accounts with AD Category I banks in India, pending utilisation for permissible end-uses.

In view of the tight liquidity conditions in the international financial markets, all-in-cost ceilings were rationalised and enhanced and accordingly, the ceiling for ECBs of average maturity period of three years and up to five years was enhanced to 300 basis points and the ceiling for ECBs over five years was enhanced to 500 basis points.

Keeping in view the risks associated with unhedged foreign exchange exposures of SMEs, a system of monitoring such unhedged exposures by the banks on a regular basis is being put in place.

The definition of infrastructure for the purpose of availing of ECBs has been expanded to include mining, exploration and refining.

Entities in the services sector, *viz*., hotels, hospitals and software companies were permitted to avail ECBs up to US $ 100 million in a financial year under the approval route for the purpose of import of capital goods.

The Foreign Currency Exchangeable Bonds (FCEB) Scheme, 2008 notified by the Government of India on February 15, 2008 was operationalised by the Reserve Bank.

AD Category – I banks were allowed to convey 'no objection' under the Foreign Exchange Management Act (FEMA), 1999 for the creation of charge over immoveable assets and financial securities and issue of corporate or personal guarantees on behalf of the borrower in favour of the overseas lender to secure ECBs under automatic/approval route, subject to certain conditions.

Banks were allowed to borrow funds from their overseas branches and correspondent banks up to a limit of 50 per cent of their unimpaired Tier I capital as at the close of the previous quarter or US $ 10 million, whichever is higher, as against the existing limit of 25 per cent.

(iii) Trade-related Measures

The limit of US $ 100,000 was enhanced to US $ 300,000 for making remittances for imports where the import bills/documents were received directly by the importer from the overseas supplier.

The limit for advance remittance for import of goods without bank guarantee/stand-by letter of credit was increased from US $ 1 million or its equivalent to US $ 5 million or its equivalent.

The limit for advance remittance for import of services without bank guarantee was enhanced from US $ 100,000 to US $ 500,000 or its equivalent.

The usance period of letters of credit opened for import of platinum, palladium, rhodium and silver has been limited to 90 days from the date of shipment.

(b) Introduction of Currency Futures

141. The final report of the Internal Working Group on Introduction of Currency Futures in India (Chairman: Shri Salim Gangadharan) was placed on the Reserve Bank's website on April 28, 2008. The report of the RBI-SEBI Standing Technical Committee on Exchange Traded Currency Futures, constituted to suggest a suitable framework to operationalise currency futures, was also placed on the Reserve Bank's website on June 13, 2008. The recommendations of the Working Group were examined and accepted by the Reserve Bank. Directions were issued under provisions of the Reserve Bank of India Act, 1934 and the necessary Notification was issued under FEMA on August 5, 2008 for the introduction of exchange traded currency futures. The directions permit scheduled commercial banks (AD Category–I) to become trading/clearing members of the currency derivatives segment set up by recognised stock exchanges, subject to their fulfilling certain prudential requirements. Banks which do not meet the minimum prudential requirements are permitted to participate in the currency futures market only as clients, after obtaining approval from the Reserve Bank.

142. The exchange traded currency futures started trading first on the National Stock Exchange on August 29, 2008, followed by the Bombay Stock Exchange and the Multi Commodity Exchange – Stock Exchange (MCX-SX) on October 1, 2008 and October 7, 2008, respectively.

(c) Branch/Liaison Offices in India by Foreign Entities

143. Under the current provisions of the FEMA, a person resident outside India requires prior approval of the Reserve Bank for establishing branch/liaison offices in India. The Reserve Bank has placed on its website for public comments the draft circulars regarding delegation of powers for extension of the validity period or closure of liaison offices of foreign entities in India and the eligibility criteria and procedural guidelines for branch/liaison offices of foreign entities in India with a view to further liberalising the procedure and achieving greater transparency. Final guidelines will be issued by end-December 2008.

(d) Clearing and Settlement of Forex Forwards

144. The CCIL provides a platform for guaranteed settlement of inter-bank foreign exchange trades to banks in India. Settlement is on a multilateral net basis, with the CCIL becoming the central counter-party to the trades through the process of novation. The guaranteed settlement of foreign exchange trades mitigates risks and also allows banks to use their capital in an optimal manner. Currently, 72 banks as members for foreign exchange settlement operations settle, on an average, 8,500 deals daily with a gross volume of US $ 17 billion. Forward trades are accepted for guaranteed settlement only when they enter the spot window.

145. The Reserve Bank has accorded its approval to the CCIL for commencement of guaranteed settlement of inter-bank foreign exchange forward trades from the trade date. The CCIL has notified to banks its readiness to start operations of the foreign exchange forward segment and the software has been fully tested. The CCIL would operationalise the settlement system within a month, once the issues relating to counter-party exposure and risk weights are advised.

(e) Liberalisation of Hedging Facilities

Expansion of Hedging Facilities to Domestic Crude Oil Refining Companies

146. Major domestic crude oil refining companies are permitted to hedge their commodity price risks on overseas exchanges/markets. Major oil refining and shipping companies have been representing to the Reserve Bank for extending the hedging facilities further in view of the volatility of freight rates. With a view to facilitating better management of freight risk, it is proposed:

- to permit domestic oil and shipping companies to hedge their freight risk with overseas exchanges/ OTC markets.

In respect of other customers who are exposed to freight risk, AD banks may approach the Reserve Bank for permission on behalf of customers.

(f) Trade Credit: Enhancement of All-in-cost Ceilings

147. In view of the tight liquidity conditions in the global credit markets, domestic importers are experiencing difficulties in raising trade credits within the existing all-in-cost ceilings. Considering the international developments, it is proposed:

- to enhance the all-in-cost ceiling for trade credits less than 3 years to 6 months LIBOR *plus* 200 basis points.

III. Credit Delivery Mechanisms and Other Banking Services

(a) Priority Sector Lending

(i) Weaker Sections' Lending Targets: Status

148. As indicated in the Annual Policy Statement of April 2008, domestic SCBs were advised that the shortfall in achievement of the sub-target of lending to weaker sections will also be taken into account for the purpose of allocating amounts for contribution to the Rural Infrastructure Development Fund (RIDF) maintained with the National Bank for

Agriculture and Rural Development (NABARD) or funds with other financial institutions as specified by the Reserve Bank, with effect from April 2009.

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

149. Consequent upon the announcement made in the Annual Policy Statement of April 2008, banks were allowed to classify 100 per cent of the credit outstanding under General Credit Cards (GCC) and overdrafts up to Rs.25,000 (per account) granted against 'no-frills' accounts in rural and semi-urban areas as indirect finance to agriculture under the priority sector.

(iii) Increasing Opportunities for RRBs for Lending to Priority Sector: Status

150. With a view to augmenting RRBs' funds/resource base, commercial banks/sponsor banks were allowed to classify in their books loans granted to RRBs for on-lending to agriculture and allied activities as indirect finance to agriculture. Furthermore, RRBs were permitted to sell loan assets held by them under priority sector categories in excess of the prescribed priority sector lending target of 60 per cent.

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

151. Under the Special Agricultural Credit Plan (SACP), disbursements by public and private sector banks to agriculture aggregated Rs.1,25,758 crore (provisional) and Rs.47,862 crore, respectively, during 2007-08 as against the target of Rs.1,52,133 crore and Rs.41,427 crore. Under the kisan credit card (KCC) scheme, public sector banks have issued 4.6 million KCCs covering limits aggregating Rs.59,582 crore during 2007-08. Since the inception of the scheme, public sector banks have issued 31.22 million KCCs covering an amount of Rs.1,54,294 crore.

152. The Union Budget for 2008-09 had announced establishment of the Rural Infrastructure Development Fund (RIDF XIV) with the NABARD with a corpus of Rs.14,000 crore, and a separate window under RIDF (XIV) for rural roads programme under the Bharat Nirman Programme with a corpus of Rs.4,000 crore. The Union Finance Minister had also announced setting up of specific funds with the NABARD/Small Industries Development Bank of India (SIDBI)/National Housing Bank (NHB) with contributions by SCBs which failed to achieve their obligations to lend to the priority sector.

153. Since the inception of the RIDF (I to XIV), including separate windows under RIDF for rural roads under the Bharat Nirman Programme, the total allocation was of the order of Rs.86,000 crore. While cumulative sanctions to State Governments and the National Rural Roads Development Agency (NRRDA) under various tranches of RIDF (I to XIV) stood at Rs.79,920 crore and Rs.12,000 crore, respectively, as on August 31, 2008 the cumulative disbursements stood at Rs.48,615 crore and Rs.4,889 crore, respectively. During 2008-09 (up to August 31), various State Governments were sanctioned loans aggregating Rs.5,864 crore, which included Rs.522 crore sanctioned to the distressed districts of four States, *viz*., Andhra Pradesh, Kerala, Karnataka and Maharashtra. The disbursements under various tranches of RIDF during the year 2008-09 (up to August 31) amounted to Rs.3,021 crore.

(c) Interest Subvention Relief to Farmers

154. Pursuant to the announcement made in the Union Budget for 2006-07, commercial banks were advised to grant interest relief of two percentage points in the interest rate on the principal amount on each crop loan up to Rupees one lakh granted by banks during *Kharif* and *Rabi* seasons of 2005-06. Furthermore, consequent upon announcements made in the Union Budgets for the years 2007-08 and 2008-09, public sector banks, RRBs and rural co-operative banks were advised to grant interest rate subvention of 2 per cent per annum to farmers in respect of short-term production credit up to Rupees three lakh provided to them.

(d) Simplification of Lending Procedures for Crop Loans

155. As announced in the Annual Policy Statement of April 2008, banks were advised to accept *affidavits* submitted by landless labourers, share croppers and oral lessees giving occupational status (*i.e.,* details of land tilled/crops grown) for loans up to Rs.50,000, where there are difficulties in getting certification from local administration/*panchayati raj* institutions regarding the cultivation of crops. Furthermore, banks were advised to select one rain-fed district for introduction of a cyclical credit product for financing crop production on pilot basis, where 20 per cent of the limit would be continuously available to farmers as a core component.

(e) Agricultural Debt Waiver and Debt Relief Scheme, 2008

156. A scheme of agricultural debt waiver and debt relief for farmers was announced in the Union Budget for 2008-09 for implementation by all SCBs, RRBs and cooperative credit institutions. The modalities of the scheme were finalised and notified by the Government of India on May 23, 2008. The scheme covers direct agricultural loans extended to marginal and small farmers and other farmers by SCBs, RRBs, cooperative credit institutions

(including urban cooperative banks) and local area banks (LABs). Accordingly, the Reserve Bank advised all SCBs, including LABs, to take necessary action towards expeditious implementation of the scheme. The NABARD issued similar guidelines to RRBs and cooperatives. The Reserve Bank also advised all SCBs, including LABs, to utilise at their discretion the floating provisions held for advances portfolio to the extent of meeting the interest/charges (*i.e.,* interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges, miscellaneous charges and the like). The floating provisions should not, however, be utilised for meeting any other provisioning requirements without the Reserve Bank's prior approval, as hitherto.

157. Under the scheme, the Government had agreed to provide to commercial banks, RRBs and co-operative credit institutions a sum of Rs.25,000 crore as the first instalment. At the request of the Government, the Reserve Bank has agreed to provide the sum to the lending institutions immediately. This temporary liquidity support provided by the Reserve Bank of India under Section 17(3-B) and Section 17(4-E) of the RBI Act to scheduled banks and the NABARD, respectively, is available till November 3, 2008.

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

158. As indicated in the Annual Policy Statement of April 2008, the report of the Internal Working Group constituted within the Reserve Bank to study the recommendations of the National Commission for Enterprises in the Unorganised Sector (Chairman: Dr. Arjun K. Sengupta) in its report on 'Conditions of Work and Promotion of Livelihood in the Unorganised Sector' was placed on the Reserve Bank's website for wider dissemination.

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

159. As indicated in the Annual Policy Statement of April 2007, the report of the Working Group (Chairman: Dr. K. C. Chakraborty), constituted to look into the issues and suggest remedial measures so that potentially viable sick units can be rehabilitated at the earliest, was placed on the Reserve Bank's website in April 2008. Based on the comments received, it is proposed:

to issue detailed guidelines to banks on rehabilitation of potentially viable sick SME units by end-November 2008.

(h) SHG-Bank Linkage Programme

160. The self help group (SHG)-Bank Linkage programme has emerged as the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and cooperative banks. As on March 31, 2008, 3.48 million SHGs had outstanding

bank loans of Rs.22,227 crore. During 2007-08, banks financed 0.74 million SHGs, including repeat loans to existing SHGs to the tune of Rs. 4,228 crore.

(i) Financial Inclusion Fund and Financial Inclusion Technology Fund

161. In the Union Budget for 2007-08, constitution of the Financial Inclusion Fund (FIF) and the Financial Inclusion Technology Fund (FITF) were announced with an overall corpus of Rs.500 crore each with the NABARD. The Government of India also advised that for the year 2007-08, the initial contribution of Rs.25 crore each in these two Funds would be shared by the Central Government, the Reserve Bank and the NABARD in the ratio of 40:40:20. The Reserve Bank's contribution to these funds would accordingly be Rs.10 crore each.

(j) Regional Rural Banks (RRBs)

(i) Branch Licensing: Further Liberalisation

162. In order to give further impetus to branch expansion programmes of RRBs, existing branch licensing criteria have been further liberalised. Accordingly, it is proposed:

to allow RRBs greater flexibility in opening new branches as long as they are making operational profits and their financials are improving.

(ii) Technology Upgradation of RRBs

163. As indicated in the Annual Policy Statement of April 2008, the report of the Working Group (Chairman: Shri G. Srinivasan), constituted for preparing a road map for RRBs to adopt appropriate technology and migrate to core banking solutions (CBS), was placed on the Reserve Bank's website. The Report has set September 2011 as the target for all RRBs to move towards CBS and all RRB branches opened after September 2009 are to be CBS-compliant. The report has been forwarded to all sponsor banks for necessary action.

(iii) Assistance to RRBs for Adoption of ICT solutions for Financial Inclusion: Status

164. The report of the Working Group (Chairman: Shri G. Padmanabhan), constituted to examine provision of financial assistance to RRBs for defraying a part of their initial cost in implementing information and communication technology (ICT)-based solutions for financial inclusion, was placed on the Reserve Bank's website in August 2008. The Group has *inter alia* recommended that the funding of ICT solutions for financial inclusion may be done through interest-free loans to be routed through the Institute for Development and Research in Banking Technology (IDRBT). The recommendations are under examination.

(k) Financial Inclusion

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

165. So far, 342 districts were identified by SLBCs for 100 per cent financial inclusion. Of these, 155 districts have reported having achieved the target of 100 per cent financial inclusion. The Reserve Bank had undertaken evaluation studies of the progress made in achieving this target in 26 districts through external agencies to draw lessons for further action in this regard. Based on the findings of the studies, it is proposed to:

provide feedback to banks to make the process of financial inclusion more effective.

(ii) Special Task Force in North-Eastern Region

166. Consequent to the meeting that the former Governor of the Reserve Bank had with the Chief Ministers of a few States in the North-Eastern Region in May 2008, a Special Task Force (Chairperson: Smt. Usha Thorat) was constituted in order to give a fresh impetus for setting up of banking facilities at additional centres in the region perceived as essential for public policy. A scheme of providing financial support to banks by the Reserve Bank for setting up banking facilities (currency chests, extension of foreign exchange and Government business facilities) at such centres, provided that the State Governments make available necessary premises and other infrastructural support, has been formulated. The Government of Meghalaya has agreed to the proposal of providing premises and necessary security arrangements for the new branches. Similar mechanisms for other States in the North-Eastern region where requests have been received are under consideration.

(iii) Setting up of Credit Counseling Centres on Pilot Basis

167. A concept paper on Financial Literacy and Counselling Centres was prepared and placed on the Reserve Bank's website on April 3, 2008 for public feedback in order to take this initiative forward. Based on the feedback, it is proposed:

to notify a Model Scheme for Financial Literacy and Credit Counselling Centres.

(l) High Level Committee on Lead Bank Scheme

168. As announced in the Mid-Term Review of October 2007, a High Level Committee (Chairperson: Smt. Usha Thorat) was constituted to review the Lead Bank Scheme and improve its effectiveness in the light of the recent developments in the banking sector. The Committee had several rounds of discussions with different State Governments, banks and

other stakeholders, including academicians, micro-finance institutions and NGOs, and is in the process of consolidating its findings and crystallising its recommendations. The broad view that is emerging is that while greater banking and credit penetration by the formal financial institutions for facilitating inclusive growth should be the primary objective of the scheme, it would also be necessary to strengthen the institution and processes through which the scheme is implemented. The Committee is expected to submit its report by December 2008.

(m) Relief Measures by Banks in Flood affected areas in Assam, Bihar and Orissa

169. The Reserve Bank has issued comprehensive standing instructions to banks for ensuring continuity of banking operations and providing relief and rehabilitation to persons affected by natural calamities. Consequent to the unprecedented rains and floods resulting in heavy losses of life and property in the States of Assam, Bihar and Orissa, special committees/meetings of banks and State Governments at district/State level, as appropriate, were held to trigger the implementation of these standing instructions which include re-scheduling of existing loans, grant of fresh credit and consumption loans, making available currency in adequate measures and ensuring continuance of normal banking services.

(n) Study on Courier/Postage Charges of Banks

170. The Annual Policy Statement of April 2008 indicated that the Reserve Bank is in the process of collecting details of various charges levied by banks for public dissemination with a view to bringing about greater transparency in banks' services to the common person. Accordingly, information in respect of courier/postage charges levied for collection of outstation cheques and for sending statements/cheque books to the customer was collected, compiled and placed on the Reserve Bank's website. The Reserve Bank would conduct such studies from time to time in respect of other charges and will place the results on its website.

IV. Prudential Measures

(a) Cross-border Supervision

171. An Internal Working Group (Chairman: Shri S. Karuppasamy) was constituted to lay down the roadmap for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged by the Basel Committee on Banking Supervision (BCBS). The Working Group consulted both Indian banks with overseas branches and foreign banks with Indian operations to elicit the practices followed relating to cross-border activities, inspection methodology and

frequency adopted by overseas supervisors, systems followed for securing of supervisory rating and progress made in implementation of Basel II. The Group sought information from various overseas regulators/supervisors on the practices adopted by them on information sharing/policies on cross-border supervisory cooperation and the existing legal framework in those jurisdictions. The Group examined the legal position on cross-border supervision arrangements and also explored the feasibility of executing memoranda of understanding (MoUs) with overseas supervisors. The Group is expected to submit its report by mid-November 2008.

(b) Consolidated Supervision and Financial Conglomerates

172. The Annual Policy Statement of April 2008 had proposed realignment of various internal supervisory processes for implementing an improved consolidated supervision process in order to enhance the effectiveness of the banking supervisory system for bank-led conglomerates. Accordingly, an ‘approach paper’ on the supervision of financial conglomerates is expected to be finalised by end-November 2008.

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

173. Special purpose vehicles (SPVs) and trusts set up by banks are generally unregulated and are subject to inadequate independent board oversight. As the activities of these entities could be a potential risk to the parent bank and could also pose systemic risk, the Annual Policy Statement of April 2008 proposed to study and recommend a suitable supervisory framework for activities of SPVs/trusts set up by banks. Accordingly, a Working Group (Chairman: Shri S. Sen) has been constituted in October 2008 with representatives from the Reserve Bank, banks and credit rating agencies which is expected to submit its report within three months. The Group would study various types of trusts/SPVs set up by banks, management control by parent banks, related regulatory/supervisory issues and recommend a suitable supervisory framework.

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

174. With a view to evolving an appropriate model of risk-based supervision (RBS), a departmental Group was set up to study international practices on such systems. The Group studied the RBS mechanism adopted by various supervisory authorities across certain jurisdictions (the US, the UK, Australia, France, Hong Kong, Singapore, Thailand and Malaysia) with a view to evolving a suitable RBS framework without diluting the intensity of the existing supervisory framework. An approach paper in this regard is under preparation and is expected to be finalised by mid-December 2008.

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

175. The Inter-departmental Group constituted to review the existing regulatory and supervisory framework for overseas operations of Indian banks held consultations with Indian banks having large overseas presence. An appropriate supervisory framework, including a revised off-site surveillance system for overseas operations of Indian banks, is expected to be finalised by end-November 2008.

(f) Supervisory Review Process Related to Banks' Credit Portfolio

176. The First Quarter Review of July 2008 had indicated that the Reserve Bank would consider undertaking a supervisory review of select banks which are over-extended in terms of their credit portfolios relative to their sources of funds. Accordingly, banks were identified based on their off-site returns and detailed information from these banks was sought regarding the sources and deployment of their funds. Detailed discussions with the top management of banks were held and concerns were conveyed to them for taking appropriate action.

(g) Review of Banks' Exposures to Agricultural Commodities

177. In view of the current public policy concerns in regard to trading in food items, the Annual Policy Statement of April 2008 had urged banks to review their advances to traders of agricultural commodities including rice, wheat, oilseeds and pulses as also advances against warehouse receipts. Banks were advised to forward the first such review to the Reserve Bank for carrying out supervisory review of banks' exposures to the commodity sector. A supervisory review of banks' exposures to agricultural commodities as on March 31, 2008 was carried out on the basis of data submitted by banks. The review revealed that banks' advances to traders in agricultural commodities and advances against warehouse receipts constituted less than one per cent of their gross advances. Banks also confirmed that they are exercising due caution while extending advances to agricultural commodities so as to ensure that bank finance is not used for hoarding. A further review of the position as on June 30, 2008 was also made and no significant change was observed in such exposure of banks.

(h) Implementation of Basel II Framework in India: Status

178. Indian banks with overseas presence and branches of foreign banks functioning in India have migrated to Basel II Framework with effect from March 31, 2008. Considering the level of sophistication of risk management techniques and availability of data, these banks have been advised to follow the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. All banks in India follow the Standardised

Measurement method for computation of capital charge for market risk since June 2004. With the issuance of guidelines on Pillar II in March 2008, banks are also required to have an Internal Capital Adequacy Assessment Process (ICAAP) to ensure that they have adequate capital to support all risks in their business and are encouraged to develop and use better risk management techniques in monitoring and managing risks. The evaluation of the ICAAP of individual banks is being taken up by the Reserve Bank in conjunction with the annual financial inspection of banks. As planned, the remaining banks are required to migrate to the Basel II framework with effect from March 31, 2009.

(i) Introduction of Credit Derivatives in India: Review of Status

179. The Reserve Bank had issued draft guidelines on credit default swaps (CDS) in May 2007, followed by a revised version in October 2007 for another round of consultation. However, in view of certain adverse developments in international financial markets, particularly credit markets, resulting in considerable volatility, it was not considered opportune to introduce the credit derivatives. Accordingly, the issuance of final guidelines on the introduction of credit derivatives was kept in abeyance. This decision was taken so as to be able to draw upon the experience of the financial sector of some of the developed countries, particularly in the current circumstances in which the entire dimensions of the credit market crisis have not yet been gauged. The Reserve Bank would draw from lessons from the recent turmoil and review the proposal to introduce the CDS at an appropriate time.

(j) Strengthening of Risk Management in Banks: Liquidity Risk

180. The on-going turmoil in international financial markets has brought the management of liquidity risk in banks to the fore front. It is clear that even the most sophisticated banks had not considered the amount of liquidity they might need to satisfy contingent obligations, either contractual or non-contractual, as they viewed funding of these obligations to be highly unlikely or regarded the availability of resources to meet such funding requirements as stable over future periods. Many international banks had envisaged severe and prolonged liquidity disruptions as highly unlikely and did not conduct stress tests that factored in the possibility of market-wide strain or the severity and duration of disruption. The Reserve Bank had issued guidelines on asset-liability management in February 1999 which created a sound framework for liquidity risk and interest rate risk management in banks. These guidelines were modified in October 2007 to bring about granularity of time buckets and recognised the impact of cumulative outflows on liquidity across time buckets. The Reserve Bank is in the process of significantly revising these guidelines, especially in the light of a paper entitled '*Principles for Sound Liquidity Risk Management and Supervision*' published by the Basel Committee on Banking Supervision in September 2008, to ensure that banks' liquidity risk measurement and management capabilities are in tune with the level of complexity of their operations.

(k) Stress Testing

181. Stress testing has evolved as a practical risk management tool and its applications are expanding. As observed in the Committee on Global Financial System (CGFS) Report, 2005 stress testing works as a complement rather than as a supplement to major risk management tools such as value-at-risk. It is, therefore, becoming an integral part of the risk management frameworks of banks and securities firms. In an increasingly complex financial environment where banks are facing new risks and markets are becoming more global, stress testing benefits from its flexibility, comprehensibility and the responsibility that it puts on managements to evaluate the risks that a bank is currently running. The stress tests are increasingly being integrated into risk management frameworks of financial institutions.

182. The Reserve Bank had issued guidelines to banks on stress testing in June 2007 which require banks to have a sound stress testing policy which will determine the liquidity risk, interest rate risk, credit risk and foreign exchange risk under stressed scenarios. It is proposed to upgrade these guidelines appropriately to provide further guidance to banks in the matter. Banks are also encouraged to improve their management information systems (MIS) and risk management skills for conducting stress tests and make full use of the insights gained from such tests.

(l) Financial Stability Forum Report: Status

183. The Annual Policy Statement of April 2008, while presenting the status on the implementation of the proposals of Financial Stability Forum (FSF), indicated that the Reserve Bank has put in place regulatory guidelines covering many of these proposals and in other cases, actions are being initiated. In the ensuing period, the Reserve Bank has issued guidelines on prudential norms for off-balance sheet exposures of banks which are set out below:

(i) Exposure Norms: Method of Computation

184. Banks shall compute their credit exposures arising on account of their interest rate and foreign exchange derivative transactions and gold using the ‘Current Exposure Method’. Banks may exclude ‘sold options’ provided that the entire premium/fee or any other form of income is received/realised while computing the credit exposure.

(ii) Capital Adequacy: Computation of the Credit Equivalent Amount

185. For the purpose of capital adequacy, all banks, both under Basel I and under Basel II frameworks, shall use the ‘Current Exposure Method’ to compute the credit equivalent amount of the interest rate and foreign exchange derivative transactions and gold.

(iii) Provisioning Requirements for Derivative Exposures

186. Credit exposures computed as per the current marked-to-market value of the contract arising on account of the interest rate and foreign exchange derivative transactions and gold shall also attract provisioning requirements as applicable to the loan assets in the ‘standard’ category of the counterparties concerned. All conditions applicable for treatment of provisions for standard assets would also apply to the provisions for derivatives and gold exposures.

(iv) Asset Classification of the Receivables Under the Derivatives Transactions

187. In respect of derivative transactions, any amount due to the bank which remains unpaid in cash for a period of 90 days from the specified due date for payment will be classified as non-performing assets as per the prudential norms on income recognition, asset classification and provisioning pertaining to the advances portfolio.

188. These modifications would come into effect from the financial year 2008-09. Banks would, however, have the option of complying with the additional capital and provisioning requirements arising from these modifications in a phased manner over a period of four quarters ending March 31, 2009.

V. Institutional Developments

Payment and Settlement Systems

(a) Payment and Settlement Systems Act, 2007

189. The Payment and Settlement Systems Act, 2007 (51 of 2007) and the Payment and Settlement Systems Regulations, 2008 were notified and have come into effect from August 12, 2008. The Payment and Settlement Systems Act stipulates that no person other than the Reserve Bank shall commence or operate a payment system except under and in accordance with an authorisation issued by the Reserve Bank under the provisions of the Act. Accordingly, all persons currently operating a payment system or desirous of setting up a payment system as defined in the Act need to apply for authorisation to the Reserve Bank unless specifically exempted in terms of the Act. All existing payment systems will cease to have the right to carry on their operations unless they obtain an authorisation within six months from the commencement of the Act (i.e., August 12, 2008). The Payment and Settlement Systems Regulations, 2008 detail the form and manner in which the application is to be made to the Reserve Bank for grant of authorisation.

(b) Regulatory Guidelines: Mobile Payments

190. As indicated in the Annual Policy Statement of April 2008, the Reserve Bank had placed on its website 'Draft Operating Guidelines for Mobile Payments in India' in consultation with banks and a few industry bodies for public comments. Following a wide-ranging consultative process, operative guidelines were issued for adoption by banks under Section 18 of the Payment and Settlement Systems Act, 2007 (Act 51 of 2007) with effect from October 8, 2008.

Urban Cooperative Banks

(a) Creation of Umbrella Organisation and Revival Fund for Urban Cooperative Banks

191. As indicated in the Annual Policy of April 2008, the Reserve Bank constituted a Working Group (Chairman: Shri V.S Das) to suggest measures, including the appropriate regulatory and supervisory framework, to facilitate emergence of umbrella organisation(s) for the UCB sector. The Group would also look into the issues concerning creation of a Revival Fund for the sector. The Group's report is expected to be submitted by end-December 2008.

(b) Information Technology Support to UCBs

192. As indicated in the Annual Policy of April 2008, the report of the Working Group (Chairman: Shri R. Gandhi), constituted to examine various areas where IT support could be provided to UCBs by the Reserve Bank, was submitted on April 17, 2008. The report has been placed on the Reserve Bank's website on August 13, 2008 for comments. Appropriate action would be initiated on the recommendations of the Group based on the comments received.

(c) Investment in Government Securities for SLR Purposes by Non-scheduled UCBs

193. Non-scheduled UCBs in Tier I were exempted from maintaining SLR in Government and other approved securities up to 15 per cent of their NDTL provided the amount is held in interest-bearing deposits with the State Bank of India and its subsidiary banks and the public sector banks, including Industrial Development Bank of India Ltd. It has been decided:

> to continue the exemption provided that with effect from October 1, 2009 such exemption shall not exceed 7.5 per cent of NDTL. The exemption will stand withdrawn effective from April 1, 2010.

In view of the exemption, it has also been decided that:

> Non-scheduled UCBs in Tier I shall maintain SLR in the form of Government and other approved securities not less than 7.5 per cent of their NDTL by September 30, 2009 and 15 per cent of their NDTL by March 31, 2010.
>
> The current prescription of holding SLR in Government and other approved securities not less than 15 per cent of their NDTL in respect of non-scheduled UCBs in Tier-II shall continue up to March 31, 2010.
>
> From March 31, 2011 onwards all UCBs (non-scheduled and scheduled) shall be required to maintain SLR in Government and other approved securities up to 25 per cent of their NDTL.

Non-Banking Financial Companies

Financial Regulation of Systemically Important NBFCs: Review of Prudential Regulations

194. In 2006, regulatory guidelines covering the prudential norms for systemically important NBFCs and banks' relationship with them were put in place. The Reserve Bank has been monitoring the functioning of systemically important NBFCs and banks' exposure to them. In the light of international developments and increasing bank exposure to these systemically important NBFCs, the Annual Policy Statement of April 2008 proposed to review the regulations in respect of capital adequacy, liquidity and disclosure norms of these entities. Accordingly, draft guidelines on systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) regarding prudential norms have been placed on the Reserve Bank's website for public comments. Taking into consideration the comments received from the public, the final guidelines dated August 1, 2008 were issued.

Committee on Financial Sector Assessment: Developments

195. The Annual Policy Statement of April 2008 had outlined the progress made by the Committee on Financial Sector Assessment (CFSA), constituted by the Government of India, in consultation with the Reserve Bank, to undertake a comprehensive assessment of the financial sector. Since then, the reports of four Advisory Panels constituted by the Committee covering assessment of Financial Stability Assessment and Stress Testing, assessment of relevant international standards and codes as applicable to Financial Regulation and Supervision, Institutions and Market Structure and Transparency Standards were peer-reviewed by external experts in each relevant area identified for the purpose. The CFSA also held a two-day seminar in June and a one-day conference in July 2008 with

the peer reviewers and Advisory Panel members to discuss the major issues/recommendations of the various Panel reports. The Panels have finalised their reports by appropriately incorporating the comments of the peer reviewers. Simultaneously, the overview report of the CFSA is also under preparation. It is expected that the four Advisory Panel Reports and the overview report of the CFSA will be released by December 2008.

Mumbai
October 24, 2008