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Statement by Dr. Y. Venugopal Reddy, Governor, Reserve Bank of India on the Third Quarter Review of Annual Monetary Policy for the Year 2005-06

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

I. Assessment of Macroeconomic and Monetary Developments

Domestic Developments

Macroeconomic activity has firmed up as evident from estimates of Gross Domestic Product (GDP) for the second quarter (Q2 or July-September) of 2005-06 by the Central Statistical Organisation showing real GDP growth at 8.1 per cent for the first half of the year, one percentage point higher than in the first half of last year. More recent data also suggest that growth is, by and large, well spread across various sectors of the economy.

The progress of the North-East monsoon has been satisfactory, although somewhat concentrated in a few regions. According to the India Meteorological Department, cumulative rainfall up to December 31 was 10 per cent above normal for the country as a whole with excess/normal rain in 17 out of the 36 meteorological sub-divisions. The total water storage in the 76 major reservoirs in the country was 63 per cent of capacity at the full reservoir level up to January 13, 2006, higher than 43 per cent a year ago as well as the ten-year average of 50 per cent. These conditions augur well for *rabi* production. The progress of *rabi* activity and advance estimates of *kharif* production are encouraging. Thus, the foodgrains production target of 215 million tonnes is within striking range and sizeable year-on-year increases are also anticipated in the production of non-food crops. Accordingly, real GDP originating from agriculture and allied activities is poised to show higher growth in the second half of 2005-06 than 2.0 per cent estimated for the first half of the year.

The pick up in growth of real GDP originating in industry to 8.8 per cent in the first half of the year as against 8.3 per cent in April-September, 2004 was led by an expansion of 10.2 per cent in the manufacturing sector. In subsequent months, industrial activity has remained resilient on the back of sustained growth in the manufacturing sector, despite some slowdown in the performance of the infrastructure industries. During April-November, 2005 the index of industrial production (IIP) rose by 8.3 per cent as against 8.6 per cent in the corresponding period of the preceding year. Manufacturing output recorded a growth of 9.4 per cent

as against 9.1 per cent a year ago. Mining and quarrying and electricity generation decelerated. The production of capital goods and consumer goods – both durable and non-durable – recorded double-digit growth rates with the expansion of the capital goods sector at its peak for April-November since 1997-98. While the production of basic goods picked up, intermediate goods recorded a subdued performance.

During April-November, 2005 the overall growth of infrastructure industries at 4.4 per cent was lower than 6.7 per cent a year ago. The slowdown was mainly on account of a decline in the output of crude petroleum and petroleum refinery products as well as deceleration in the production of coal and electricity. Cement production, however, has risen significantly reflecting increased demand from housing and construction as well as exports. The moderate improvement that is underway in the production of finished steel and electricity could, in the normal circumstances, improve the prospects of infrastructure and the overall industrial sector in the ensuing months.

The buoyancy in manufacturing activity has been well supported by export demand across a wide spectrum of industries, expanding bank credit, rising capacity utilisation/expansion, sustained corporate performance and growing business and consumer confidence. The Reserve Bank's Industrial Outlook Survey reports an improvement in overall business expectations in October-December, 2005 over the previous quarter based on a more positive outlook on output growth, access to working capital and finance requirements, exports and capacity utilisation. The Business Expectations Index was at its highest level in October-December, 2005 since the inception of the Survey in 1998. Surveys conducted by other agencies also indicate similar improvements in business confidence for the second half of 2005-06 showing overall invigoration of the growth momentum.

During the first half of 2005-06, growth of the private corporate sector was sustained, *albeit* with some signs of slowing down. Year-on-year growth in sales decelerated from an average of around 23.0 per cent in 2004-05 to 18.5 per cent in the first quarter of 2005-06 and 16.4 per cent in the second quarter. The growth in net profits, which was sustained above 45.0 per cent till the first quarter of 2005-06, decelerated to 27.5 per cent in the second quarter and further to around 20.0 per cent in the third quarter. While the slack in capacity has narrowed, corporates have accumulated significant internal resources to support investment decisions already taken. Unlike in the mid-1990s when investments were undertaken in anticipation of demand, it appears that investments are now driven by global competitiveness and demand generated domestically. Moreover, the impact of new technologies is reflected in shortening of gestation lags in various industries. Accordingly, the overall outlook for the corporate sector continues to be encouraging.

Real GDP originating in the services sector rose by 9.7 per cent in the first half of 2005-06 as against 8.4 per cent a year ago, with all constituent sub-sectors sharing this buoyancy. The growth of construction, up from 4.8 per cent in the first half of 2004-05 to 7.6 per cent in April-September, 2005-06 is expected to pick up further, supported by increasing cement and steel production. The growth of trade, hotels, transport and restaurants, which rose from 11.9 per cent to 12.2 per cent, would benefit in the coming months from the increase in sales of commercial vehicles (11.4 per cent in April-November), railway freight revenue (9.5 per cent in April-October), airline passengers at domestic terminals (22.5 per cent in April-October), cargo handled at major ports (11.7 per cent in April-October), foreign

tourist arrivals (12.7 per cent in April-October) and telephone connections (87.1 per cent in April-October). Financing, insurance, real estate and business services posted a growth of 9.1 per cent in the first half of 2005-06 as against 6.2 per cent a year ago. Community, social and personal services had risen by 6.4 per cent in the first half of 2005-06 as against 5.4 per cent a year ago. Overall, the outlook for the services sector is bright.

Bank credit has expanded significantly reflecting, to a large extent, the strengthening of economic activity. Scheduled commercial banks' credit increased by 23.3 per cent (Rs.2,56,441 crore) during the year up to January 6, 2006 as compared with 19.9 per cent (Rs.1,67,041 crore), net of conversion, in the corresponding period last year. Due to lower procurement for public distribution/stocking, food credit increased moderately by Rs.1,979 crore as against an increase of Rs.9,098 crore a year ago. Non-food credit increased by 24.0 per cent (Rs.2,54,462 crore) on top of the increase of 19.6 per cent (Rs.1,57,943 crore), last year, net of conversion. On a year-on-year basis, non-food credit growth at 32.0 per cent as on January 6, 2006 was higher than 26.6 per cent, net of conversion, a year ago.

Banks' non-food credit operations over the preceding two years point to some shifts in the pattern of deployment. During 2005-06 (up to October), credit to industry increased by 11.5 per cent. Significant increases in credit off-take were recorded by power, iron and steel, automobiles, chemical and chemical products, textiles, gems and jewellery, petroleum, coal products and nuclear fuels, roads and ports and engineering. Bank credit to the services sector increased by as much as 20.7 per cent, accounting for 58.7 per cent of the incremental non-food credit. The growth in credit to the services sector was led by housing, commercial real estate and personal loans which together accounted for over a third of incremental non-food credit in 2005-06. Credit to commercial real estate and personal loans have been rising significantly above trend rates of growth. Credit to agriculture has been growing at over 39.1 per cent on a year-on-year basis since 2004-05, constituting 11.8 per cent of incremental non-food credit.

Scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and the private corporate sector, commercial paper (CP) and other instruments declined by 15.4 per cent (Rs.14,474 crore) up to January 6, 2006 as against a decline of 7.2 per cent (Rs.6,404 crore), net of conversion, in the corresponding period last year. Despite this, the total flow of resources from scheduled commercial banks to the commercial sector showed a significant increase of 20.8 per cent (Rs.2,39,988 crore) as compared with the increase of 16.9 per cent (Rs.1,51,539 crore), net of conversion, in the corresponding period last year. The year-on-year growth in resource flow was also higher at 28.3 per cent as against 23.2 per cent, net of conversion, a year ago.

Aggregate deposits of scheduled commercial banks rose by 14.1 per cent (Rs.2,39,442 crore) during 2005-06 up to January 6, 2006 as compared with an increase of 10.0 per cent (Rs.1,50,094 crore), net of conversion, in the corresponding period of the previous year. On a year-on-year basis, the growth in aggregate deposits was 17.0 per cent as compared with 14.5 per cent, net of conversion. Demand deposits rose faster by 30.3 per cent as against 19.8 per cent a year ago while time deposits increased by 14.8 per cent, higher than 13.7 per cent, net of conversion, last year.

Money supply (M_3) increased by 12.4 per cent (Rs.2,80,483 crore) during 2005-06 up to January 6, 2006 as compared with 8.8 per cent (Rs. 1,76,906 crore), net of conversion, in the corresponding period last year. On a year-on-year basis too, the growth in M_3 was higher at 15.9 per cent than 13.5 per cent, net of conversion, a year ago. The larger expansion of money supply in 2005-06 so far has been driven mainly by the sharp increase in non-food credit.

Reserve money increased by 13.2 per cent (Rs.64,725 crore) during 2005-06 up to January 13, 2006 as against an increase of 5.9 per cent (Rs.25,831 crore) in the corresponding period last year. Currency in circulation increased by 13.3 per cent (Rs.49,028 crore) as compared with 9.6 per cent (Rs.31,556 crore). Bankers' deposits with the Reserve Bank increased by 15.2 per cent (Rs.17,319 crore) as compared with a decline of 4.8 per cent (Rs.5,017 crore). As regards the sources of reserve money, net RBI credit to the Central Government increased by Rs.69,955 crore as against a decline of Rs. 27,012 crore. The Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.10,719 crore, adjusted for revaluation, as compared with the increase of Rs.60,875 crore in the corresponding period last year. The ratio of NFEA to currency declined from 166.2 per cent in March 2005 to 146.9 per cent by January 13, 2006. The year-on-year increase in reserve money was at 19.8 per cent as on January 13, 2006 as compared with 17.3 per cent a year ago.

Total liquidity, as reflected in outstandings under Liquidity Adjustment Facility (LAF), Market Stabilisation Scheme (MSS) and surplus cash balances of the Central Government taken together, had risen to a daily average level of Rs. 1,23,826 crore in September from Rs.1,18,044 crore in April 2005. Sizeable shifts in liquidity conditions characterised the third quarter of 2005-06. Broadly, pressures on market liquidity were partly frictional and arising from seasonal and transient factors including the redemption of India Millennium Deposits (IMD), and partly cyclical, associated with the pick up in growth momentum and the induced demand for bank credit. This warranted appropriate monetary operations to obviate wide fluctuations in market rates and ensure reasonable stability consistent with the monetary policy stance. In October, liquidity conditions firmed up with the onset of festival demand for currency, superimposed upon sustained credit demand. Accordingly, average reverse repo levels under the LAF declined in relation to the preceding month. With resumption of the market borrowing programme of the Central Government under the indicative calendar for the second half of the year, liquidity conditions tightened further in November. There was a release of net liquidity of the order of Rs.5,500 crore in November through MSS redemptions as the Reserve Bank refrained from fresh auctions under the Scheme in the second half of the month. Market conditions improved subsequently and the Reserve Bank returned to absorption mode with a steady build-up of reverse repos under the LAF, including under the second LAF. Thereafter, liquidity tightened again in the run-up to quarterly advance tax outflows in the middle of December, the redemption of IMD at the end of December and on account of accretions to cash balances of the Central Government. Declining reverse repo levels were accompanied by repos from December 16, and generally there were net injections of liquidity. There was a further unwinding of MSS of the order of Rs.19,522 crore during December. On a review of liquidity conditions including the IMD redemption at the end of December 2005, the Reserve Bank announced suspension of the issue of treasury bills and dated securities under the MSS while retaining the flexibility of conducting the auctions under the Scheme from time to time with sufficient notice to the market.

The outstanding balances under MSS, which were at Rs.65,481 crore at end-March 2005, increased to Rs.80,585 crore by September 2, 2005 when MSS securities worth Rs.20,000 crore were redeemed. Subsequently, outstanding balances under MSS reached another high of Rs.71,600 crore in early-November after which it declined in successive weeks to Rs.40,028 crore by January 20, 2006 due to unwinding of securities under MSS. The net absorption of liquidity under LAF was Rs.19,330 crore at end-March 2005 and reached its peak of Rs.51,390 crore by September 5, 2005. Subsequently, due to tightness in the market, the Reserve Bank injected liquidity through repo operations on several occasions. As on January 20, 2006 the net injection of liquidity was of the order of Rs.13,770 crore. During 2005-06 (up to January 18, 2006), the cash balances of the Central Government increased by Rs.11,864 crore. Accordingly, the total liquidity overhang fell to an average level of Rs.94,585 crore in December, 2005 and declined further to Rs.61,317 crore by January 20, 2006. Redemptions of the order of Rs.10,028 crore are due under the MSS during the remaining part of the current financial year and, if there are no fresh issues, the outstanding balances under the MSS would amount to about Rs.30,000 crore at the end of March, 2006.

As per the assurance given in the Mid-term Review, the Reserve Bank, in close coordination with the State Bank of India (SBI) and other market participants, put in place appropriate arrangements to ensure that the redemption of IMD of Rs.33,000 crore or US $ 7.1 billion occurs without undue stress on the money, foreign exchange and government securities markets. The entire foreign exchange outgo was met by the Reserve Bank out of the foreign exchange reserves in two tranches, *i.e.,* US $ 5.1 billion on December 28 and US $ 2.0 billion on December 29, 2005. The SBI, on its part, undertook adequate steps to mobilise rupee resources to buy foreign exchange from the Reserve Bank. In addition, the Reserve Bank's liquidity support through the LAF (including the second LAF) was also available to overcome short-term residual mismatches in rupee funds. The smooth redemption of IMD reflects the increasing resilience, strength and maturity of financial markets complemented by flexible operations of the Reserve Bank.

Turning to the fiscal situation, the revenue deficit of the Central Government at Rs.87,181 crore during April-November, 2005 accounted for 91.5 per cent of the budget estimates (BE) for 2005-06 as compared with 97.1 per cent (Rs.73,948 crore) in the corresponding period of the previous year. The slower pace of growth in the revenue deficit during the current year was enabled by the increase in tax revenue to 47.6 per cent of BE from 45.6 per cent a year ago and containment of growth in interest payments and subsidies. The gross fiscal deficit (GFD) was higher at Rs.1,12,949 crore or 74.7 per cent of the BE as against 51.5 per cent (Rs.70,717 crore) a year ago; however, adjusted for debt swap transactions, the GFD during April-November 2004 was 74.8 per cent of BE. The growth in the GFD during the current financial year has been mainly due to rise in Plan revenue expenditure and non-plan grants to States and Union Territories.

As on January 20, 2006 the Central Government had completed net market borrowings of Rs.90,051 crore (81.7 per cent of the budgeted amount of Rs 1,10,291 crore) and gross market borrowings of Rs.1,49,682 crore (83.8 per cent of the budgeted amount of Rs.1,78,467 crore) under the borrowing programme for 2005-06. Issuances of treasury bills and dated securities were mostly in accordance with the semi-annual indicative calendars. All issuances, except one, were reissuances reflecting efforts towards consolidation of public debt and imparting liquidity to the government securities market. The weighted average yield on fresh borrowings

through dated securities rose to 7.29 per cent (up to January 20, 2006) from 6.11 per cent in the corresponding period last year. The weighted average maturity of dated securities of the Central Government issued during the current financial year so far increased to 15.61 years from 13.84 years in the corresponding period last year. During 2005-06, as against the net allocation of Rs.18,271 crore (gross Rs.24,546 crore) for their market borrowing programme, the State Governments have raised Rs.9,910 crore (net) and Rs.16,184 crore (gross) up to January 20, 2006.

During the current financial year, inflation measured by the wholesale price index (WPI) on a year-on-year basis, softened from a peak of 6.0 per cent on April 23 to a trough of 3.3 per cent on August 27, 2005. Between September 3 and December 31, 2005, inflation moved in the range of 3.6-4.9 per cent before touching 4.2 per cent on January 7, 2006.

Prices of primary articles (weight: 22.0 per cent) rose by 5.1 per cent as against 1.5 per cent a year ago, mainly on account of the increase of 13.9 per cent in the prices of fruits and vegetables as against an increase of 0.4 per cent a year ago. Prices of non-food articles and minerals increased by 0.8 per cent as compared with the increase of 1.5 per cent last year. Prices of manufactured products (weight: 63.8 per cent) rose by 2.5 per cent, lower than 5.8 per cent a year earlier. In the category of manufactured products, declines in the prices of edible oil, oil cakes and basic heavy organic chemicals softened the effects of sharp increases in the prices of tea and coffee processing, wine industries and wood and wood products.

Prices of the fuel, power, light and lubricants (FPLL) group (weight: 14.2 per cent) rose by 8.1 per cent as against 10.1 per cent a year ago. Within the group, the prices of mineral oils (weight: 6.99 per cent) increased by 12.7 per cent as against 14.8 per cent last year. Although the international crude prices have receded from record highs at end-August, incipient pressures persisted with the average international crude price basket relevant to India ruling at about US $ 62 per barrel on January 20, 2006. Mineral oils contributed to nearly 36 per cent of inflation as on January 7, 2006. Excluding mineral oils, inflation would have been at 2.7 per cent. Excluding the FPLL group, it would have been 2.5 per cent. On an average basis, inflation was 4.7 per cent as on January 7, 2006 which was lower than 6.5 per cent a year ago.

Inflation, measured by the consumer price index (CPI) for industrial workers on a year-on-year basis, was 5.3 per cent in November 2005 as against 4.2 per cent a year ago. On an average basis, CPI inflation was at 4.1 per cent as compared with 3.8 per cent.

Financial markets have remained generally stable although interest rates firmed up in almost all segments. The call money rate increased from an average of 4.77 per cent in April, 2005 to 6.58 per cent in January, 2006 (up to January 20). Through October, call rates remained orderly and closely aligned with the LAF reverse repo rate. Call rates started hardening in November and remained above the repo rate during November 10-18. Liquidity injections from the Reserve Bank calmed the call money market and call rates ebbed to settle at around 5.4 per cent by the end of the month. Call rates began rising again from December 10 and generally remained above the repo rate. The daily average turnover in the call money market increased from Rs.17,213 crore in April to Rs.18,776 crore in January (up to January 20, 2006).

Other market segments at the short end of the spectrum showed similar movements during the current financial year. The market repo (outside the LAF) rate increased from 4.63 per cent to 6.10 per cent with an increase in daily volume from Rs.3,958 crore (one leg) to Rs.6,440 crore (up to January 20, 2006). The average daily volume of collateralised borrowing and lending obligation (CBLO) increased significantly from Rs.5,185 crore to Rs.13,090 crore along with an increase in the CBLO rate from 4.58 per cent to 6.03 per cent. The weighted average discount rate on commercial paper (CP) of 61 to 90-day maturity increased from 5.80 per cent in April 2005 to 7.04 per cent by mid-January 2006 and the outstanding amount rose from Rs.14,809 crore to Rs.17,235 crore. The typical interest rate on 3-month certificates of deposit (CDs) increased from 5.87 per cent in April to 6.75 per cent by end-December 2005, accompanied by a significant rise in outstanding amounts from Rs.14,975 crore to Rs.32,806 crore.

In the government securities market, the 91-day and the 364-day Treasury Bill rates increased from 5.12 per cent and 5.60 per cent in April 2005 to 6.19 per cent and 6.30 per cent, respectively, in January 2006. The 182-day Treasury Bill rate moved up from 5.21 per cent to 6.22 per cent during this period. The yield on government securities with 1-year residual maturity in the secondary market increased from 5.77 per cent in April 2005 to 6.34 per cent in January 2006. The yield on government securities with 10-year and 20-year residual maturities, however, declined from 7.35 per cent and 7.77 per cent to 7.13 per cent and 7.37 per cent, respectively. Consequently, the yield spread between 10-year and 1-year government securities came down from 158 basis points in April 2005 to 79 basis points in January 2006. The yield spread between 20-year and 1-year government securities also declined to 103 basis points from 200 basis points.

The interest rates on deposits of over one year maturity of public sector banks (PSBs) moved up from 5.25-6.50 per cent in April 2005 to 5.50-7.00 per cent in January 2006. During the same period, the benchmark prime lending rates (BPLRs) of public sector banks, private sector banks and foreign banks remained unchanged in the range of 10.25-11.25 per cent, 11.00-13.50 per cent and 10.00-14.50 per cent, respectively. However, the median lending rates for term loans (at which maximum business is contracted) in respect of some major PSBs moved up to 8.00-12.25 per cent in December 2005 as compared with 8.00-11.90 per cent in September 2005.

The equity market remained buoyant with corporates raising resources from the domestic primary segment as well as international capital markets. The secondary market witnessed strong rallies with intermittent corrections. The BSE Sensex (1978-79=100) touched an all-time high of 9648 on January 4, 2006 driven by investments by foreign institutional investors (FIIs) and supported by robust corporate earnings, favourable investment climate and a positive macroeconomic and business outlook, before moving down to 9521 on January 20, 2006.

Developments in the External Sector

Based on the trade data available from the Director General of Commercial Intelligence and Statistics (DGCI&S), merchandise export growth at 18.1 per cent in US dollar terms during April-December, 2005 slowed down from 26.6 per cent in the corresponding period of the previous year. The deceleration in export growth was due to a slowdown in exports of engineering goods, textiles and clothing, and gems and jewellery in an environment of strong domestic demand. The recent moderation of export growth points to the urgency of a supportive policy environment for strengthening export competitiveness such as the development of infrastructure and simplification of procedures.

Imports rose by 27.3 per cent as against 36.3 per cent a year ago. Oil imports recorded a growth of 45.3 per cent, marginally down from 45.7 per cent a year ago, mainly reflecting the softening of international crude prices with the 'Indian basket' edging down to US $ 55.1 per barrel in December. Both imports and consumption of petroleum products declined in volume terms. Non-oil imports increased by 20.2 per cent during April-December, 2005 on top of 32.9 per cent in the corresponding period last year. Non-oil non-gold imports rose by 30.8 per cent in April-October 2005 on top of 29.9 per cent a year ago. Imports of capital goods increased by 32.2 per cent (28.6 per cent a year ago), driven mainly by electrical and non-electrical machinery, transport equipment, project goods, metal manufactures and machine tools. Consequently, the overall trade deficit widened to US $ 29.8 billion, higher by 54.2 per cent than US $ 19.3 billion in the corresponding period of the previous year.

As per balance of payments (BoP) data, the trade deficit during April-September, 2005 widened to US $ 31.6 billion as compared with US $ 14.8 billion in April-September 2004. Invisible receipts rose by 53.0 per cent due to significant growth in receipts from transportation, software exports and other professional and business services. Private transfers, comprising primarily remittances from Indians working overseas, remained sizeable at US $ 12.3 billion as compared with US $ 10.2 billion in April-September 2004. Invisible payments grew sharply (71.0 per cent) on account of outbound tourist traffic, payments for transportation and business services such as business and management consultancy, engineering, technical and distribution services and dividend and profit payouts. As a result, the current account deficit was placed at US $ 13.0 billion in April-September 2005 as against US $ 0.5 billion in April-September 2004.

Capital flows remained buoyant in April-October, 2005. Foreign direct investment (FDI) picked up on sustained growth in industrial and service sector activity and the positive investment climate. FDI inflows amounted to US $ 3.6 billion in April-October, 2005 up from US $ 3.3 billion a year ago. Outward FDI also maintained the rising profile of recent years, reflecting the appetite of Indian companies for global expansion in terms of markets and resources. A turnaround in FII inflows that occurred in June continued through 2005, on the back of strong growth expectations and corporate performance. Portfolio flows rose to US $ 4.8 billion from US $ 1.3 billion, mainly on account of net investment by FIIs which went up to US $ 3.4 billion from US $ 1.1 billion. Portfolio investment by way of ADRs/GDRs also rose to US $ 1.4 billion from US $ 0.2 billion. Net inflows under the non-resident deposit schemes at US $ 231 million turned around during April-October, 2005 from net outflows of US $ 688 million during the corresponding period last year. Higher recourse to external commercial borrowings (ECBs) and short-term credit was enabled by lower spreads on external borrowings and rising import financing requirements.

India's external debt rose by US $ 1.0 billion over end-March, 2005 to US $ 124.3 billion at the end of September, 2005. The increase was mainly in the form of ECBs and short-tem debt, attributable to financing requirements necessitated by the large expansion in both oil and non-oil imports. Accordingly, the ratio of short-term debt to total debt increased marginally from 6.1 per cent at the end of March 2005 to 6.7 per cent at the end of September 2005.

Net accretion to foreign exchange reserves during April-September, 2005 was US $ 6.5 billion (excluding valuation), taking the outstanding foreign exchange

reserves to US $ 143.1 billion. Inclusive of valuation, India's foreign exchange reserves declined by US $ 2.1 billion from US $ 141.5 billion at the end of March 2005 to US $ 139.4 billon as on January 13, 2006. Excluding the one-off impact of IMD redemptions, the foreign exchange reserves would have shown an increase of US $ 5.0 billion.

Orderly conditions prevailed in the Indian foreign exchange market with the rupee exhibiting more flexible two-way movements. Up to January 20, 2006 the rupee appreciated by 5.6 per cent against the euro, by 4.1 per cent against the pound sterling and by 5.4 per cent against the Japanese yen but depreciated by around 1.4 per cent against the US dollar.

Developments in the Global Economy

Global growth appears to have improved in the third quarter (Q3) of 2005. The firming up of global economic activity during the third quarter of 2005 and its broadening ambit suggests that the global growth could reach a level higher than the average for the period 1990-2004. For 2006, the International Monetary Fund (IMF) has projected world growth at 4.3 per cent with advanced economies growing by 2.7 per cent and emerging market and other developing economies growing by 6.1 per cent.

In the US, real GDP rose by 3.7 per cent in Q3 on a year-on-year basis on the strength of business spending, with consumer confidence regaining much of the ground lost after the August hurricanes. The merchandise trade deficit has improved to US $ 64.2 billion in November. The US current account deficit narrowed in the third quarter to 6.2 per cent of GDP. The easy financing of the current account deficit reflected sustained foreign appetite for US assets. In the euro area, a recovery seems to be setting in with real GDP up by 1.2 to 1.6 per cent in 2005. Conditions for emerging out of deflation steadily improved in Japan with real GDP growth rising to 2.9 per cent in Q3, driven mainly by domestic demand and supported by a rise in bank lending. Industrial production also rose by 1.4 per cent in November, increasing for the fourth month in a row, combined with signs of higher employment. Growth in Q3 remained robust in the developing countries led by China (9.4 per cent), Hong Kong (8.2 per cent) and India (8.0 per cent). In Russia and Latin America, too, growth has been buoyant, except for Brazil where real GDP fell in Q3 by 2.8 per cent. High oil prices, domestic capacity constraints and some building up of inflationary pressures continue to be seen as factors restraining growth for most developing countries.

With the moderation in international crude prices since September, consumer price inflation in the advanced economies has fallen in the fourth quarter of 2005. In the US, consumer prices dipped by 0.1 per cent in December, leaving inflation for 2005 at 3.4 per cent. In the euro area too, inflation edged down to 2.4 per cent in November from 2.5 per cent in the previous month. Deflation continued in Japan with overall consumer prices falling by 0.8 per cent in November, the biggest drop in three years. In major industrial countries, inflation appears to have been contained and spillovers of oil prices into wage increases have been moderate. By and large, price stability has been maintained in these countries in the face of the oil shock although asset prices, especially house prices, remain a cause for concern in terms of potential inflationary pressures and the repercussions on consumer spending and financial sector balance sheets. On the other hand, inflation has risen in major emerging market economies. Besides elevated levels of oil prices, tight non-oil commodity markets have imposed price pressures.

Future spikes in crude oil prices continue to carry the major risk to prospects of global growth and stability. While demand generally drove oil prices up in 2004, the price increases in 2005 were also the result of supply disruptions, inadequate investment as well as the reduction in world oil spare capacity which fell to its lowest level in over three decades. World oil prices have climbed throughout 2005 despite somewhat slower demand growth in both China and the United States. Declines in petroleum product prices (especially petrol and diesel) during October-November due to mild weather in the northern hemisphere and ongoing hurricane recovery efforts in the US have been followed by some firming up of prices since December due to geopolitical factors. The average price of the Indian basket of international crude varieties (comprising Brent and Dubai Fateh) ruled at around US $ 60.0 per barrel in October-January 20, 3.8 per cent lower than in the preceding quarter but 41.5 per cent higher than a year ago.

The international pass-through of oil prices to domestic retail prices has been varied across countries. While domestic retail prices (including tax) of petrol in December 2005 increased on a year-on-year basis by 22.5 per cent (in US dollar terms) in Canada and 16.9 per cent in the US, they declined by 4.9 per cent in Japan and Italy. Similarly, diesel prices increased by 23.5 per cent in Canada and 20.5 per cent in the US while they declined by 4.5 per cent in France. Comparatively, India's domestic retail prices of petrol and diesel (average of four metros) increased by 14.6 per cent and 13.0 per cent, respectively, by January, 2006. While international crude prices have risen by 69.0 per cent between March 2004 and December 2005, domestic prices of petrol and diesel have increased by 34.0 per cent during this period; price of LPG increased by 16.4 per cent but there has been no increase in the price of kerosene. Since the tax component in retail prices varies from country to country, it is more appropriate to compare the position net of the tax component. The retail prices, net of taxes, of petrol and diesel have increased across the board in the developed world. While the increase in petrol prices ranged between 32.0 per cent in Canada, 21.1 per cent in the US and 1.1 per cent in Japan, that of diesel prices was between 29.0 per cent in Canada, 25.9 per cent in the US and 3.3 per cent in France. Prices for crude oil, petroleum products and natural gas are projected to remain high through 2006 because of continuing tightness in international supplies and increasing demand. According to the World Bank, a supply shock that reduces oil deliveries by 2 million barrels per day could push prices up to above US $ 90 per barrel, reducing global growth by 1.0 per cent and the growth of large low-income economies by 1.7 per cent.

The financing of the large current account deficit of the US is increasingly becoming a cause for concern. Government saving has fallen in the US and Japan and household financial saving has virtually disappeared in countries with housing booms. On the counterpart side, many emerging markets, particularly in Asia, have run current account surpluses resulting in build-up of international reserves. The US current account deficit is projected by the OECD to exceed 7.0 per cent of GDP in 2007 with substantial surpluses elsewhere. Such a configuration could increase the probability of a disorderly unwinding of macro imbalances and disruptive movements in major currencies.

Within the mounting global imbalances, oil exporting countries are currently running large current account surpluses, repaying debt, as in the case of Russia, and building up assets. Oil exporting countries have been actively using their export

revenue to buy financial assets in various countries. Thus, the rise in oil prices has represented a sizeable redistribution of income from oil consumers to oil producers which could have an impact on global demand and the future course of unwinding of global imbalances.

The prospect of a faster pace of monetary tightening contributed to a sharp drop in equity prices around the world in early October. Equity markets rebounded strongly since November, boosted by signs of still robust growth in the US as well as announcements of mergers, share buybacks and dividend increases. Japan outperformed most other equity markets throughout this period. Upward revisions in policy rates had a surprisingly muted impact on the prices of emerging market assets. Emerging markets benefited from record inflows of foreign portfolio investment in 2005. As concerns about slowing US growth eased, emerging markets bounced back strongly from their late October lows. By late November, equity and bond prices had returned to their end-September highs and had generally reached record levels by early January 2006. Equity markets have, however, weakened overseas thereafter mainly on account of renewed firmness in global crude oil prices. Corporate credit default swap rates and bond spreads remained more or less unchanged in October although they have widened significantly since November. While long-term interest rates rose in many markets in September and October, they retreated slightly in November, and at the end of December it was still unclear whether the recent rise in yields would prove as ephemeral as previous increases. The increase in longer-term yields mainly reflected upward revisions to interest rate expectations over the near term. Further, the potential for rising energy costs to add to inflationary pressures was a key focus of investors' attention. The rise in implied volatility also reflected growing uncertainty about the economic outlook. During December 27-30, 2005 yields on 10-year US Treasuries fell briefly below those on two-year notes for the first time since December 2000, inverting in intra-day trading and signalling expectations that interest rates could fall in future that is generally associated with weak growth. This inversion came as analysts were finally anticipating an end to the current tightening cycle and a lower long-term risk premium than in the past. In January 2006, however, the spread has turned positive again. The US dollar appreciated by 3.5 per cent in trade-weighted terms during 2005 and a similar trend continued in January 2006.

Of the major central banks, the US Federal Reserve has raised its policy rate by 25 basis points each on thirteen occasions from 1.0 per cent in June 2004 to 4.25 per cent by December 2005 while recently providing indications of nearing the end of the cycle of measured rise in the policy rate. The Bank of England has kept its repo rate unchanged at 4.50 per cent since August 2005 in response to slowing domestic growth. The European Central Bank (ECB) has raised its policy rate by 25 basis points in response to rising inflationary expectations, after holding it unchanged at 2.0 per cent since June 2003. Monetary policy has been tightened in several economies in emerging Asia, primarily in response to higher fuel prices and to the measured pace of policy tightening in the US. Bank Indonesia raised its policy rate by 50 basis points to 12.75 per cent on December 6, 2005 which was the tenth successive increase during the year. In Thailand, the 14-day repurchase rate was increased for the seventh time since January 2005 from 2.00 per cent to 4.25 per cent on January 18, 2006. Monetary authorities in Singapore and Hong Kong raised their policy rates by 187 basis points and 200 basis points, respectively, during the year up to December. In Malaysia, the policy rate was hiked to 3.0 per cent in end-November, 2005. In emerging market economies in general, the direction of policy

change has been towards either tightening or withdrawal of the accommodative stance.

Overall Assessment

On an overall assessment, the outlook for the Indian economy has brightened considerably in the first three quarters of 2005-06. Inflation, although drifting from an end-August trough, remains well within acceptable limits. Proactive policy responses have contributed to this congenial configuration of macroeconomic performance. The Reserve Bank, on its part, has moved promptly to head off potential excess demand pressures that typically manifest themselves in an expansionary phase of the growth cycle. LAF rates have been raised three times by 25 basis points each since October 2004 with a view to reining in excess liquidity from feeding into demand pressures. In addition, concerns about the quality of credit growth have been underscored for focused public attention. Surveillance over exposure limits in the banking system in respect of sensitive sectors such as equity markets has been stepped up. Risk weights for calculation of capital adequacy have been increased in respect of housing and real estate. In addition, the Reserve Bank has instituted a pro-cyclical provisioning policy. It has also set up a selective supervisory review for banks with relatively risky profiles. It is hoped that these measures will extend the current expansionary phase of the growth and credit cycles in India.

Since the Mid-term Review of October 25, 2005 aggregate demand appears to be on the upswing. Both employment and salaries in the organised services sector are rising. Investment is picking up and consumer spending remains buoyant. The demand for banks' non-food credit is very strong. Corporate performance continues to be robust and based on sound fundamentals. Asset prices – housing, equity, bullion – have continued to accelerate. However, there is some moderation in the growth of exports and industrial output. The deterioration in the performance of the infrastructure industries could potentially impose a supply constraint. Hence, improvements in the availability and the quality of the physical infrastructure would considerably ease the supply constraints on growth.

The global economy has turned out to be stronger and more resilient than initially expected. When a fuller picture emerges, world GDP growth in 2005 could well be higher than 4.3 per cent projected by the IMF. This has been accompanied by an acceleration in the growth of world trade. On the other hand, recent global developments as described below have amplified the existing downside risks, particularly for emerging economies like India.

First, international crude prices continue to remain the major risk to both growth and inflation. Geopolitical tensions threatening supply have not abated even as the range of forecasts converges to an expansion in global demand for petroleum products in 2006. International crude prices have been edging up in recent weeks and are projected to remain at elevated levels through 2006. In this context, the imminent possibility of higher orders of pass-through to consumer prices and second order effects can assume the form of generalised price increases that could adversely impact inflationary expectations.

Second, rising asset prices in conditions of abundant liquidity pose a risk for households' balance sheets and indebtedness. Consequently, policy authorities are on guard against adverse effects on consumption spending while instituting monetary policy actions, given the potential repercussions on asset prices. Sudden

reversals in other asset prices such as gold and equity could also have contractionary effects.

Third, although inflation expectations have stabilised in the US, they appear to be at elevated levels in some parts of the world, particularly among developing countries.

Fourth, the risks from currency movements have increased significantly with the widely expected correction in the US dollar not materialising. Notwithstanding a current account deficit of US $ 195.8 billion in the third quarter of 2005, the US dollar rose by 3.5 per cent in trade-weighted terms during the year. This is attributed to strong appetite for US dollar denominated assets on the back of widening interest rate differentials between the US and the rest of the world. While it is difficult to base monetary policy action on the possibility of currency adjustments, authorities need to be well prepared for such an eventuality. In the final analysis, these developments have increased the uncertainty surrounding currency movements.

While policy responses to these developments have been varied in the context of the country-specific situations, the general direction of policy actions has been towards withdrawal of accommodation. There is also some consensus that the extent of perseverance with this policy stance would be limited by reaching the 'neutral' rate of interest, *i.e.,* the rate at which economic activity is neither spurred nor retarded. There is also some agreement that the level of the neutral rate is currently lower than indicated by historical experience. In view of evolving conditions and assuming that the potential risks do not materialise, it is likely that the withdrawal of accommodation in monetary policy will reach the somewhat ill-defined levels of the neutral rate of interest sometime in 2006.

Real GDP growth in India has averaged 8.0 per cent over the past nine quarters. So far, growth has been led by manufacturing activity despite large gaps in the infrastructure. Accordingly, adequate investment in infrastructure holds the key for pushing up the potential growth of the economy. Along with reinforcing the signs of consolidation in public finances that is underway, it is important, therefore, to step up budgetary expenditures on the infrastructure sectors and improve the regulatory environment for adequate resource flow to the private sector. Improvement in gross domestic saving, essential for maintaining the growth momentum with stability, is contingent upon reduction in the revenue deficits of the Centre and the States. Assuming that the global environment does not turn adverse, that there are no unanticipated shocks, and that appropriate and timely policy initiatives are taken in the agriculture, infrastructure and, above all, fiscal areas, real GDP growth could be maintained in 2006-07 at a level close to those in 2004-05 and 2005-06.

Inflation in India has been contained so far in spite of global developments, particularly the elevated and volatile levels of international crude prices. At the current juncture, the pass-through of international oil price increases to domestic prices has been managed through burden-sharing/cross-subsidisation between oil companies, the government and consumers. In the aggregate analysis, the pass-through remains incomplete in respect of LPG, kerosene and, to some extent, in respect of petrol and diesel. Assuming that current prices represent a permanent component, the need to align with international prices and the probability being assigned to higher crude prices in the year ahead imparts an upside risk to inflation in 2006-07. The step up in credit growth, movement in asset prices and growth in monetary aggregates pose further risks of potential inflationary pressures. Aggregate

demand management will, thus, pose a challenge for which careful and continuous vigil over domestic and global developments is warranted. Globally, the uncertainties surrounding currency movements, interest rate movements and oil prices are the key risks to monetary policy objectives. The outlook for inflation in 2006-07 will depend on the evolution of these risks and timely response of monetary policy, recognising that the policy measures have a lagged effect. Against this background, a policy setting aimed at containing inflation in 2006-07 at the level not exceeding that in 2005-06 is appropriate. The overriding importance of maintaining well-anchored inflation expectations is critical for sustaining the growth momentum and assuring macroeconomic and financial stability.

II. Stance of Monetary Policy

The Mid-term Review of October 25, 2005 reaffirmed the stance of monetary policy set out in the Annual Policy Statement of April 29 while rebalancing the priorities assigned to policy objectives in the context of the assessment of the economy and, particularly, the outlook on inflation. In response to the risks that had emerged – credit quality concerns, rising asset prices especially housing, high and volatile international crude prices with a substantial part of the increase in crude prices being regarded as permanent, the widening trade deficit and the upturn in the international interest rate cycle – greater emphasis was placed on price stability. Consistent with this stance, the Reserve Bank committed to ensuring a conducive interest rate environment and the provision of appropriate liquidity to meet genuine credit needs of the economy for maintaining the growth momentum. The Reserve Bank also stated that it would consider measures in a calibrated and prompt manner to stabilise inflation expectations in response to evolving circumstances. Stating that without a policy response, it would be difficult to contain inflation within the projected range of 5.0-5.5 per cent, the fixed reverse repo rate under the LAF was increased by 25 basis points to 5.25 per cent while retaining the spread between reverse repo and repo rates at 100 basis points.

Macroeconomic and financial developments since then are in support of the monetary policy stance. First, inflation expectations have stabilised in a manner consistent with policy projections. Appropriate timing of the pass-through of international crude prices has significantly muted the second round effects of oil price hikes anticipated earlier. Demand pull factors have remained reasonable though there has been a significant pick up in overall activity. Excluding mineral oils, inflation was 2.7 per cent, while the headline inflation was 4.2 per cent on January 7, 2006. The modest ebbing of crude prices from their highs in August-September and the softening of global prices of agricultural products has also mitigated the pressures from imported inflation. Second, the widening of the trade deficit under the impact of high international crude prices and buoyant industrial demand for imported inputs has been financed by capital flows. The exchange rate of the rupee *vis-à-vis* the US dollar has appreciated by about 2.0 per cent by mid-January 2006 since the beginning of November 2005. Third, appropriate and flexible liquidity management by the Reserve Bank through the LAF, MSS and standing facilities under both surplus and deficit conditions has calmed financial markets, enabling market expectations about inflation and policy responses to evolve synchronously with the policy stance. In the event, the overhang of liquidity has declined by Rs.60,472 crore between September 2005 and January 2006 from Rs.1,23,826 crore to Rs.63,354 crore.

In response to the needs of market participants, the Reserve Bank introduced a second LAF with effect from November 28, 2005 as an additional instrument to fine-tune liquidity management. It has proved to be reasonably effective in maintaining appropriate liquidity in the system, especially in the wake of the IMD redemption.

The baseline outlook on growth has further brightened in recent months. First, apprehensions of monsoon stress have definitely subsided and the prospects for the *rabi* crop are favourable at the current juncture. This has made the foodgrains target set for the year as well as a return to trend growth of GDP originating in agriculture realisable. Second, overall industrial growth has been sustained by the strength of manufacturing activity, notwithstanding the drag imposed by the infrastructure sector. Industrial performance has been amply supported by buoyant and broad-based bank credit, high corporate profitability which has boosted internal funding for investment, sustained export demand and business optimism. Third, the all-round expansion of the services sector has imbued confidence into aspirations of higher growth of the economy, backed by rising international competitiveness. Fourth, the Reserve Bank's liquidity management operations have contributed to stability in financial markets and have also enabled a smooth switch in banks' portfolios in favour of commercial credit. Fifth, international investor appetite for the Indian economy has strengthened, endorsing the improvement of the macroeconomic fundamentals. This has found reflection in large portfolio flows as well as a sizeable increase in direct investment flows and international bank lending to India. All these factors tend to place an upside bias to growth prospects.

There are indications of a pick up in aggregate demand during the third quarter of 2005-06. A number of surveys point to improvement in consumer and business confidence. The strength of domestic demand is also evident in terms of rising asset prices, sustained sales growth, growth in final output demand, surge in indirect tax collections and stronger than anticipated expansion in monetary and credit aggregates. The coincident growth of capital and consumer goods industries has supported the absorption of final demand. The robust year-on-year non-food credit growth, and particularly to industry, infrastructure and retail sectors, shows that the expansion in demand is getting broad-based. Overall aggregate demand has been managed reasonably well in 2005-06 so far, facilitated by appropriate liquidity management by the Reserve Bank and muted pressures from the fisc, given the modest improvement evident in the Centre's finances. Recent developments, however, point to according high priority to aggregate demand conditions, especially fiscal developments, warranting careful and continuous monitoring for the effective conduct of monetary management.

While strong credit growth, which is well diversified, is a reflection of greater credit penetration and investment activity, there are concerns about credit quality in the expansion phase. The Reserve Bank has already announced some measures and sensitised the banks in this regard. Recent trends in credit growth warrant a reiteration of these concerns. Banks are urged to undertake a comprehensive review of credit quality, including a segment-wise analysis of activities with special reference to those sectors where credit is expanding rapidly.

In reviewing the monetary policy stance at this juncture, it may also be appropriate to consider potential downside risks to the outlook. First, international crude prices remain a potent threat to overall price stability. While the pass-through of international crude prices has been managed well so far, further escalations could

immediately endanger the fragile balance that currently prevails between the fisc, oil companies and consumers. Second, portfolio switches and liquidity mismatches that have emerged have produced sizeable volatility in reserve money with an upward pressure on money supply, combined with a shortening of maturity of deposits in the banking system. Demand deposits have grown faster than time deposits and CDs have become an important source of funding for certain banks. These developments warrant continuous and careful monitoring so as to be on guard against the incipient build-up of potential demand pressures. Third, the possible strain on credit quality continues to be an area of concern especially in the context of ensuring financial stability and thereby deriving synergies with macroeconomic and price stability. Fourth, the surge in imports has produced a sizeable expansion in the current account deficit in the first half of 2005-06. In this context, it is important to keep a continuous vigil on the external front and to ensure stable financing of the current account deficit. Fifth, in view of the upward pressures on aggregate demand including pick up in investment activity, a reduction in the revenue deficit and further improvement in the fiscal deficit will add comfort to macroeconomic management.

As mentioned in the last review, recent developments in the BoP seem to indicate that the Indian economy has entered an expansionary phase of the business cycle. The current account deficit of the order of US $ 13 billion in the first half of 2005-06 needs to be regarded as consistent with the scaling up of the growth path that has occurred in the current financial year. Underlying the widening of the merchandise trade deficit is the sizeable growth in non-oil imports, emanating from capital goods, export-related inputs and a range of intermediate goods including fertiliser, non-ferrous metals and iron and steel. It needs to be noted that non-oil imports have an intrinsic growth-linked character and the recent high growth in these imports attests to the onset of a durable pick up in the economy. Besides, the large expansion in imports is also spurring a vigorous export growth. In this sense, the merchandise trade deficit has acquired a growth-leading dimension and could be seen as a positive development.

The appropriate level of the current account deficit (CAD) is a dynamic concept and has to be assessed over a medium-term perspective. The size of the CAD is a function of the underlying growth momentum in the economy – a faster growing economy is likely to run a higher CAD than one with relatively slower growth. In recent years, there has been some acceleration in the growth of current receipts within which growth rates of software earnings and a wide variety of business services lend comfort. Besides, private transfer receipts, comprising mainly remittances from Indians working abroad, seemed to have acquired a more enduring character and have risen steadily to constitute around 3 per cent of GDP in recent years. These factors strengthen the capability of the Indian economy to manage higher CADs than what was considered sustainable in the past. Net capital flows have so far exceeded the CAD requirements reflected in large accretions to the reserves. During the first half of 2005-06, the CAD has been financed by net capital flows with US $ 6.5 billion added to the foreign exchange reserves. The current widening of the CAD essentially represents the simultaneous expression of the impact of the crude oil prices and the pick up in domestic investment. It is expected that the sizeable expansion in imports of capital goods and embodied technology will further boost the competitiveness of India's merchandise exports which hold the key to the strength of the external sector. It is, however, necessary to closely monitor export competitiveness and exercise continued vigil on external developments while being ready to respond to any uncertainties and shocks.

Taking into account the foregoing assessment of macroeconomic and monetary conditions and near term prospects, for the purpose of monetary management, (i) GDP growth in 2005-06 is placed in the range of 7.5-8.0 per cent based on the current assessment of a pick up in agricultural output and in the momentum in industrial and services sectors, and (ii) inflation is placed in the range of 5.0-5.5 per cent as projected earlier. Expansion in M_3 is expected to be significantly higher than 14.5 per cent projected in the Annual Policy Statement of April 29, 2005 and growth in aggregate deposits would also be sizeably higher than Rs.2,60,000 crore projected earlier. Non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector, CP and others, is expected to be significantly higher than 19.0 per cent projected earlier. It is necessary to take careful note of the potential upward bias in monetary and credit aggregates for 2005-06, even while ensuring appropriate liquidity to sustain the growth momentum.

The commitment to price and financial stability will require continuous and careful monitoring of global developments, in particular, movements in international interest rates and the ongoing adjustments of global imbalances, the international oil price scenario, the booming levels of credit and asset market activity in India and the rising trade and current account deficits. While prospects for growth have improved in recent months, it is critical to ensure that these gains are neither dissipated by inflationary pressures nor by any threat to financial stability. The Reserve Bank has consistently emphasised the quality of credit while nurturing a buoyant growth in non-food credit to support export and investment demand in the economy. While domestic factors continue to dominate over external factors in the growth and inflation outlook for the economy, at the current juncture there is a need to recognise the growing impact of external conditions on the Indian economy. While recognising that the current configuration of macroeconomic and financial factors favour growth with stability in India, it is important to extend these gains by continuing the greater emphasis on price stability. The risks to inflation from both domestic and global developments remain high, persisting well into 2006-07. In particular, the remaining pass-through of international crude prices into domestic prices of LPG and kerosene portends an upward bias to inflation in 2006-07.

Indications of pick up in aggregate demand are getting stronger with some manageable spill-over into the external sector in the form of widening trade and current account deficits. It is important to respond in a timely and even pre-emptive manner to these developments to ensure that generalised inflation spirals do not develop in an environment of higher than anticipated expansion in money supply and bank credit with large shifts in liquidity. A measured policy response at this juncture would stabilise inflation expectations and prevent corrosive effects on growth. It would also avert the compulsion of undertaking larger and more drastic adjustments in the future, should the prevailing situation evolve in a manner that threatens macroeconomic and price stability. The Reserve Bank would strive for maintaining stable inflationary expectations and orderly financial markets while ensuring the continuation of the positive investment climate. Against this background, the stance of monetary policy from time to time would depend on emerging demand and supply factors, both domestically and globally, while taking into account the lagged effects of monetary policy.

The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all genuine requirements of credit are met, consistent with the objective of price and financial stability. Towards this end, the

Reserve Bank will continue with its policy of active demand management of liquidity through OMO including MSS, LAF and CRR, and use all the policy instruments at its disposal flexibly, as and when the situation warrants.

In sum, based on an informed assessment of macroeconomic developments including the outlook on growth and inflation in a forward looking manner, and barring the emergence of any adverse and unexpected developments in various sectors of the economy, the overall stance of monetary policy at the current juncture will be:

- To maintain the emphasis on price stability with a view to anchoring inflationary expectations.
- To continue to support export and investment demand in the economy for maintaining the growth momentum by ensuring a conducive interest rate environment for macroeconomic, price and financial stability.
- To provide appropriate liquidity to meet genuine credit needs of the economy with due emphasis on quality.
- To consider responses as appropriate to evolving circumstances.

III. Monetary Measures

(a) Bank Rate

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

(b) Reverse Repo Rate

In view of the current macroeconomic and overall monetary conditions, it has been decided:

- To increase the fixed reverse repo rate under the liquidity adjustment facility (LAF) of the Reserve Bank by 25 basis points from 5.25 per cent to 5.50 per cent, with immediate effect.

The repo rate will continue to be linked to the reverse repo rate. The spread between the reverse repo rate and the repo rate has been retained at 100 basis points, as at present. Accordingly, the fixed repo rate under LAF will be 6.50 per cent, with immediate effect.

(c) Cash Reserve Ratio

The cash reserve ratio (CRR) of scheduled banks is currently at 5.0 per cent. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, on a review of the current liquidity situation, it is felt desirable to keep the present level of CRR at 5.0 per cent unchanged.

Annual Policy Statement for 2006-07

The Annual Policy Statement for the year 2006-07 will be announced on April 18, 2006.

Alpana Killawala
Chief General Manager

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