PRESS RELEASE

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July 25, 2006

RBI Governor presented the **First Quarter Review of Annual Statement on Monetary Policy for the Year 2006-07 today.**

Highlights

- Reverse Repo Rate increased to 6.0 per cent and Repo Rate to 7.0 per cent.
- Bank Rate and Cash Reserve Ratio kept unchanged.
- GDP growth projection for 2006-07 retained at 7.5-8.0 per cent.
- Containing inflation within 5.0-5.5 per cent for 2006-07 warrants appropriate priority in policy responses.
- Money supply, deposit and credit growth above the indicative projections, warranting caution.
- Appropriate liquidity to be maintained to meet legitimate credit requirements, consistent with price and financial stability.
- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be:
    - To ensure a monetary and interest rate environment that enables continuation of the growth momentum while emphasising price stability with a view to anchoring inflation expectations.
    - To reinforce the focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic and, in particular, financial stability.
    - To consider measures as appropriate to the evolving global and domestic circumstances impinging on inflation expectations and the growth momentum.

Dr. Y. Venugopal Reddy, Governor, today presented the First Quarter Review of Annual Statement on Monetary Policy for the Year 2006-07. The Review consists of three sections: I. Assessment of Macroeconomic and Monetary Developments; II. Stance of Monetary Policy; and III. Monetary Measures.

Domestic Developments

- Real GDP growth during January-March 2006 is placed at 9.3 per cent as against 8.6 per cent in the corresponding quarter a year ago and real GDP growth for the year 2005-06 is revised to 8.4 per cent from 8.1 per cent.

- Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, rose from 4.1 per cent at end-March 2006 to 4.7 per cent as on July 8, 2006.

- The average international price of the Indian crude basket increased from US $ 60.1 per barrel in January-March, 2006 to US $ 67.3 per barrel in April-June, 2006 and further to US $ 71.4 per barrel in July 2006 (up to July 21).

- During 2006-07 so far, there has been a reversal of the phenomenon of consumer prices lagging wholesale prices, indicative of the increase in food prices which constitute a relatively larger share in the consumer price basket.

- On a year-on-year basis, money supply (M_3) growth at 18.8 per cent by July 7, 2006 was higher than 13.8 per cent, net of conversion, a year ago and above the projected trajectory of 15.0 per cent indicated in the Annual Policy Statement for 2006-07.

- The year-on-year increase in aggregate deposits at 20.7 per cent (Rs.3,72,977 crore) was significantly higher than 14.9 per cent (Rs.2,34,020 crore), net of conversion, a year ago.

- On a year-on-year basis, the increase in non-food bank credit was 32.9 per cent (Rs.3,71,993 crore) on top of an increase of 31.0 per cent (Rs.2,60,164 crore), net of conversion of a non-bank into a bank, a year ago.

- The overhang of liquidity in the system, as reflected in the liquidity adjustment facility (LAF), the market stabilisation scheme (MSS) and the Central Government's cash balances with the Reserve Bank which, put together, averaged Rs.65,174 crore during January-March, 2006 stood at Rs.91,231 crore as on July 20, 2006.

- Reflecting the easy conditions at the short end of the market spectrum, interest rates in the call, market repo and collateralised borrowing and lending obligations (CBLO) segments of the money market eased while gilt prices declined in the secondary market for government securities.

- Banks increased their deposit rates by about 25-100 basis points across various maturities between March 2006 and July 2006. A majority of public sector banks adjusted their deposit rates up to three year maturity upwards by 25 to 50 basis points, while keeping the range of 6.00-7.25 per cent unchanged for deposits of over three years over the same period. The adjustments in deposit rates made by some private sector and foreign banks were somewhat higher, up to 100 basis points, particularly for deposit rates of over one year maturity.

- Exclusive of LAF operations, banks' investments in Government and other approved securities declined by Rs.1,328 crore during 2006-07 up to July 7, as compared with an increase of Rs.12,397 crore a year ago.

- Gross market borrowings of the Central Government at Rs.69,533 crore (Rs.60,282 crore a year ago) during 2006-07 so far (up to July 17, 2006) constituted 38.2 per cent of the budget estimates while net market borrowings at Rs.34,572 crore (Rs.39,234 crore a year ago) constituted 30.4 per cent of the budget estimates.

External Developments

- Export growth in US dollar terms moderated to 16.9 per cent during April-June, 2006 from 35.4 per cent a year ago. Merchandise import also decelerated to 17.7 per cent from 45.4 per cent.

- While petroleum, oil and lubricants (POL) import growth rose sharply to 39.0 per cent from 31.0 per cent reflecting the steep rise in international crude oil prices, non-oil imports posted a relatively modest growth of 9.6 per cent as compared with 51.7 per cent a year ago.

- India's foreign exchange reserves increased by US $ 11.0 billion over their end-March, 2006 level to US $ 162.7 billion as on July 14, 2006.

- The exchange rate of the rupee depreciated by 4.7 per cent against the US dollar, by 8.4 per cent against euro, by 10.2 per cent against pound sterling and by 5.1 per cent against Japanese yen during 2006-07 so far (up to July 21, 2006). Orderly conditions have prevailed in the domestic foreign exchange market during the period.

Global Developments

- According to the World Economic Outlook of the International Monetary Fund (IMF) released in April 2006, global growth is expected to pick up from 4.8 per cent in 2005 to 4.9 per cent in 2006 before easing to 4.7 per cent in 2007.

- In major industrial countries, inflation appears to be on the upswing mainly on account of oil price increases. In addition, risks loom large in the form of lagged second order effects of oil price increases, geopolitical tensions, the probability of disruptive adjustment of current account imbalances and the cooling global housing market.

- A large number of central banks have raised their official interest rates, *inter alia*: the US Federal Reserve, the European Central Bank, the Bank of Japan, the Bank of Canada, the Reserve Bank of Australia, the People's Bank of China, the Bank of Korea and the Banco Central de Chile. Some central banks have kept their policy rates steady as for instance, the Bank of England, the Bank Negara Malaysia, the Bank of Thailand and the Monetary Authority of Singapore. A few central banks have also eased monetary policy such as the Banco de Mexico, the Bank Indonesia and the Banco Central do Brasil.

- Global imbalances, emanating mainly from the twin deficits of the US and reflected in misalignment of major currencies, have continued to widen during 2006 in an environment of rising interest rates worldwide and prospects of contraction of liquidity in the global financial markets.

Overall Assessment

- There are several positive factors in domestic developments during 2006-07 so far, *inter alia*: reasonably robust corporate performance, pick-up in investment activity, strong demand for bank credit, growth in new order books, increase in capacity utilization, ample liquidity, stabilisation of inflation since mid-June and strong export growth.

- Some developments in the first quarter of 2006-07 do suggest the need to remain on guard against the emerging risks: incomplete catch-up of domestic POL product prices with the possible permanent component of international prices; growth in non-food bank credit and monetary aggregates higher than the projections; and contrasting liquidity conditions in the Government securities market *vis-à-vis* money markets.

- While the prospects for growth in the world economy in 2006 are considered bright in the near-term as reflected in indicators of business confidence and unemployment in major economies, downside risks to the economic outlook internationally continue in the form of large fiscal deficits, low household savings and low investment in some large economies; unprecedented and growing current account imbalances; narrowing or closing in of output gaps in many economies; record highs in oil prices accompanied by uncertainties about their future evolution; the outlook for inflation firming up; the hardening of international interest rates along with the direction of movement in setting monetary policy; and re-pricing of risks by financial markets, in particular, in emerging market economies.

Stance of Monetary Policy

- The forecast for GDP growth is retained in the range of 7.5-8.0 per cent during 2006-07 as projected in the Annual Policy Statement, barring domestic or external shocks.

- Taking into account the real, monetary and global factors, containing the year-on-year inflation rate for 2006-07 in the range of 5.0-5.5 per cent warrants appropriate priority in policy responses.

- For the purpose of monetary policy formulation, the expansion in M_3 was projected at around 15.0 per cent for 2006-07 in the Annual Policy Statement. The growth in aggregate deposits was projected at around Rs.3,30,000 crore in 2006-07. Non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and CP was expected to increase by around 20 per cent. Developments during the first quarter of 2006-07 indicate that money supply, deposit and credit growth are running well above the indicative projections, warranting caution by all concerned in this regard.

- While domestic developments continue to dominate our economy, global factors tend to gain more attention now than before.

- The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, 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 open market operations (OMO) including MSS, LAF and cash reserve ratio (CRR), and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be:

  - To ensure a monetary and interest rate environment that enables continuation of the growth momentum while emphasising price stability with a view to anchoring inflation expectations.

- To reinforce the focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic and, in particular, financial stability.
- To consider measures as appropriate to the evolving global and domestic circumstances impinging on inflation expectations and the growth momentum.

Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent.
- Reverse Repo Rate and Repo Rate, each raised by 25 basis points to 6.00 per cent and 7.00 per cent, respectively.
- CRR kept unchanged at 5.0 per cent.

The Mid-term Review of the Annual Policy Statement will be undertaken on October 31, 2006 instead of October 17, 2006 and the Third Quarter Review on January 30, 2007 instead of January 23, 2007 as indicated in the Annual Policy Statement of April 2006.

Alpana Killawala
Press Release : 2006-2007/114 Chief General Manager