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Macroeconomic and Monetary Developments: Mid-Term Review 2006-07

The Reserve Bank of India today released the document “Macroeconomic and Monetary Developments: Mid-Term Review 2006-07” to serve as a backdrop to the Mid-Term Review of the Annual Policy Statement for 2006-07 being announced on October 31, 2006.

The highlights of macroeconomic and monetary developments during 2006-07 so far are:

The Real Economy

- The Indian economy continued to exhibit strong growth during the first quarter of 2006-07. According to the Central Statistical Organisation (CSO), real gross domestic product (GDP) registered an increase of 8.9 per cent in the first quarter (April-June) of 2006-07 as compared with 8.5 per cent in the corresponding period of 2005-06, benefiting from strong manufacturing as well as service sector activities.
- Industrial production, in its fifth year of expansion, remained buoyant during the first five months of 2006-07. During April-August 2006, industrial production accelerated to 10.6 per cent - the highest growth recorded in April-August period since 1995-96 - from 8.7 per cent in the same period of 2005. The manufacturing sector with a growth of 11.8 per cent, also the highest since 1996-97, continued to be the main driver of the industrial activity.
- The infrastructure sector witnessed some improvement during April-August 2006 (growth of 6.7 per cent as compared with 6.1 per cent in the comparable period of the preceding year) on account of better performance of crude petroleum and petroleum refinery products.
- Services sector with double-digit growth (10.5 per cent in April-June 2006 on top of 10.1 per cent in April-June 2005) remained the leading sector of the Indian economy.

- Although some of the surveys show some dip in business confidence and expectations, the buoyancy in manufacturing and services sector activities coupled with the recovery in domestic stock markets and positive investment climate suggest that the recent growth momentum in the Indian economy is likely to be maintained in 2006-07, as has also been projected by different agencies.

Fiscal Situation

- The information on Central Government finances for the first five months of 2006-07 (April-August) indicates that all key deficit indicators (as proportion to budget estimates) were placed higher than during the corresponding period of the previous year. While tax revenues continued to be buoyant, aggregate expenditure was substantially higher. Tax revenues increased mainly on account of higher collections under personal income tax, corporation tax and customs duties. As regards aggregate expenditure, the increase was entirely on account of sharp rise in revenue expenditure; capital expenditure showed a decline.
- Gross and net market borrowings (including dated securities and 364-day Treasury Bills) raised by the Centre during 2006-07 (up to October 23, 2006) amounted to 64.1 per cent and 58.0 per cent of the budget estimates as compared with 61.4 per cent and 51.7 per cent, respectively, a year ago.
- During 2006-07 so far (up to October 23, 2006), the States have raised market loans amounting to Rs.8,595 crore (or 36.1 per cent of gross allocation) through auctions.

Monetary and Liquidity Conditions

- Monetary and liquidity conditions have remained comfortable during 2006-07 so far.
- Strong acceleration in deposit growth was able to accommodate sustained growth of bank credit. Growth in non-food credit has remained above 30 per cent, year-on-year (y-o-y).
- Broad money growth was 19.0 per cent (y-o-y) as on October 13, 2006 as compared with 16.8 per cent a year ago.
- Banks increased their investments in Government securities in the first half of 2006-07 in contrast to the second half of 2005-06 when they liquidated their gilt investments.
- The Reserve Bank continued to absorb liquidity through reverse repo operations under the liquidity adjustment facility (LAF) and issuance of securities under the Market Stabilisation Scheme (MSS).
- Reserve money growth was 20.4 per cent (y-o-y) as on October 20, 2006 as compared with 14.0 per cent a year ago.

Price Situation

- Headline inflation remained at elevated levels till August 2006 in major advanced economies against the backdrop of high international crude oil prices. There was some easing during September 2006 on the back of softening of oil prices; core inflation, however remains, firm. Many central banks continued with pre-emptive monetary tightening to abate the second round effects of soaring oil prices, especially in the face of strong demand. In August 2006, the European Central Bank (ECB), the Bank of England, the Reserve Bank of Australia, the Bank of Korea and the South African Reserve Bank raised their policy rates. The ECB and the South African Reserve Bank raised their policy rates again in October 2006. The US Fed, however, has left its rates unchanged since end-June 2006.
- In India, headline inflation has largely remained contained during 2006-07 so far. Primary food articles prices have emerged as the key driver of inflation during 2006-07 so far. Pre-emptive monetary and fiscal measures have helped in containing inflationary expectations although underlying inflationary pressures remain.
- Wholesale price inflation was 5.3 per cent on October 14, 2006 as compared with 4.1 per cent at end-March 2006.
- Consumer price inflation has remained higher than the WPI inflation since November 2005, reflecting the higher order of increase in food prices as well as the higher weight of food items in the CPI. Various measures of consumer price inflation were placed in the range of 6.6-7.3 per cent in September 2006.

Financial Markets

- Call money rates remained generally close to the reverse repo rate during the second quarter except in the last fortnight of September 2006. Call rates increased from the second half of September 2006 on account of liquidity pressures emanating from advance tax outflows and festival season currency demand amidst high credit demand.
- In the foreign exchange market, the Indian rupee exhibited two-way movement.
- Yields in the Government securities market softened from mid-July 2006 mirroring trends in the US yields and the sharp fall in crude oil prices.
- Deposit and lending rates edged up during the quarter as credit demand remained strong.

The External Economy

- India's balance of payments position has continued to remain comfortable during 2006-07 so far.

- Merchandise exports recorded strong growth, *albeit* lower than last year.
- Growth in non-oil imports registered a sharp deceleration partly on account of decline in imports of gold and silver. Imports of capital goods increased on the back of investment demand although they also witnessed some deceleration on a high base. Oil imports remained large in view of further hardening of international crude oil prices.
- The surplus on the invisibles account remained buoyant during the first quarter of 2006-07, led by exports of software and other business services and private remittances, and financed two-thirds of the trade deficit.
- The current account deficit during the first quarter of 2006-07 widened from a year ago, reflecting higher trade deficit.
- The higher current account deficit was easily financed by capital flows which have remained large during 2006-07 so far.
- India's foreign exchange reserves were US \$ 166.2 billion as on October 20, 2006, showing an increase of US \$ 14.5 billion over end-March 2006 level.

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