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First Quarter Review of the Annual Policy Statement on Monetary Policy for the Year 2007-08

RBI Governor presented the First Quarter Review of Annual Statement on Monetary Policy for the Year 2007-08 today.

Highlights

- Bank Rate kept unchanged.
- Reverse Repo Rate and Repo Rate under LAF kept unchanged.
- Withdrawal of the ceiling of Rs. 3,000 crore on daily reverse repo under the LAF with effect from Monday, August 6, 2007. The Reserve Bank, however, retains the discretion to re-impose a ceiling as appropriate.
- The second LAF, conducted between 3.00 p.m. and 3.45 p.m. on a daily basis, is withdrawn with effect from Monday, August 6, 2007.
- Cash Reserve Ratio to be increased by 50 basis points to 7.0 per cent with effect from the fortnight beginning August 4, 2007.
- GDP growth projection for 2007-08 retained at around 8.5 per cent, barring domestic or external shocks.
- Holding inflation within 5.0 per cent in 2007-08 assumes priority in the policy hierarchy, while reinforcing the medium-term objective to condition policy and perceptions to reduce inflation to 4.0-4.5 per cent on a sustained basis.
- While non-food credit growth has decelerated, the acceleration in money supply and reserve money warrants an appropriate response.
- Recent financial market developments in India and potential uncertainties in global markets warrant a higher priority in the policy hierarchy for managing appropriate liquidity conditions at the current juncture.
- 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 broadly continue to be:
 - To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
 - To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
 - To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.

Dr. Y. Venugopal Reddy, Governor, today presented the First Quarter Review of Annual Statement on Monetary Policy for the Year 2007-08. 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 the quarter January-March 2007 is placed at 9.1 per cent as against 10.0 per cent in the corresponding quarter a year ago and real GDP growth for the year 2006-07 is revised upwards from 9.2 per cent to 9.4 per cent.
- Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, declined from 5.9 per cent at end-March 2007 to 4.4 per cent as on July 14, 2007.
- The average international price of the Indian crude oil basket increased from US \$ 56.2 per barrel in January-March 2007 to US \$ 66.2 per barrel in April-June 2007 and to around US \$ 73.5 per barrel on July 27, 2007.
- Growth in money supply (M3) at 21.6 per cent on a year-on-year basis on July 6, 2007 was above the projected trajectory of 17.0-17.5 per cent indicated in the Annual Policy Statement for 2007-08 and higher than 19.0 per cent a year ago.
- The year-on-year increase in aggregate deposits of scheduled commercial banks (SCBs) at 24.4 per cent (Rs.5,31,881 crore) up to July 6, 2007 was higher than 20.9 per cent (Rs.3,77,392 crore) a year ago.
- The year-on-year non-food credit growth of SCBs at 24.4 per cent (Rs.3,67,258 crore) on July 6, 2007 was lower than 32.8 per cent (Rs.3,70,899 crore) a year ago.
- The total overhang of liquidity under the LAF, the MSS and cash balances of the Central Government taken together declined from an average of Rs.97,449 crore in March 2007 to Rs.72,823 crore on July 27, 2007. An assessment of the total liquidity overhang, however, should also reflect the transfer of Rs.35,351 crore from the Central Government to the Reserve Bank during this period on account of transfer of shares from the Reserve Bank to the Central Government.
- During the first quarter of 2007-08, financial markets experienced sizeable fluctuations in liquidity and attendant episodes of volatility in the money market with overnight rates in the call, market repo and collateralised borrowing and lending obligations (CBLO) segments displaying close co-movement.
- Banks had generally increased their deposit rates by about 25-50 basis points across various maturities between March 2007 and June 2007, but reduced them during July 2007, especially in the shorter maturities. The majority of public sector banks (PSBs) adjusted their deposit rates upwards by 10-25 basis points on maturities above one year, particularly at the longer end.
- By the beginning of the current financial year, several banks had drawn down holdings of statutory liquidity ratio (SLR)-eligible securities close to the statutory floor. Exclusive of liquidity adjustment facility (LAF) operations, however, banks' investments in Government and other approved securities increased by Rs.27,331 crore during the current year so far (up to July 6, 2007) as compared with an increase of Rs.751 crore in the corresponding period of the previous year.
- Gross market borrowings (dated securities and 364-day Treasury Bills) of the Central Government during 2007-08 at Rs.85,628 crore up to July 27, 2007 (Rs.70,813 crore a year ago) constituted 45.4 per cent of the budget estimates while net market borrowings at Rs.46,047 crore (Rs.34,822 crore) constituted 42.0 per cent of the budget estimates.

External Developments

- During the first two months of 2007-08, export growth rose to 20.2 per cent from 19.2 per cent in the corresponding period of the previous year. Imports also posted a sharp rise of 33.0 per cent as compared with 16.9 per cent in the corresponding period of the previous year.
- Non-POL imports rose by 47.3 per cent whereas oil imports remained broadly stable at the level recorded a year ago. As a result, the merchandise trade deficit widened to US \$ 13.3 billion during April-May 2007 from US \$ 8.2 billion in April-May 2006.
- As on July 20, 2007 India's foreign exchange reserves increased by US \$ 22.9 billion over their end-March 2007 level to US \$ 222.0 billion.
- During April-June 2007, the rupee appreciated by 6.63 per cent against the US dollar, by 5.19 per cent against the euro, by 4.41 per cent against the pound sterling and by 10.44 per cent against the Japanese yen.

Global Developments

- According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in April 2007, global real GDP growth was expected to decline from 5.4 per cent in 2006 to 4.9 per cent in 2007 and 2008. The update of the WEO released in July 2007 has revised this estimate upwards to 5.5 per cent for 2006 and its forecast for 2007 and 2008 to 5.2 per cent.
- Globally, headline inflation has picked up in the wake of increase in commodity prices and core inflation has also generally remained firm. The inflation outlook remains a matter of concern on account of energy and other commodity prices, increased capacity utilisation rates in developed and major emerging economies and the impact of rising wages on inflation in advanced industrial economies.
- Perceptions of inflation pressures ahead have prompted monetary authorities generally to persevere in withdrawing monetary accommodation. The central banks that have tightened their policy rates include the ECB; the Bank of England; the Bank of Japan; the Bank of Canada; the Reserve Bank of Australia; the Reserve Bank of New Zealand; the People's Bank of China; the Bank of Korea; the Banco de Mexico; and the Banco Central de Chile. Some central banks, such as China and Korea, have used supplementary measures for tightening, besides increasing the key policy rates such as increases in reserve requirements.
- In the first half of 2007, emerging markets outperformed stocks in developed markets. Foreign investor demand for emerging market assets was reflected in a broad-based rise in inflows into dedicated bond and equity markets of the EMEs. Emerging market corporate bond issuance in international bond markets rose to a record level in 2006. The exposure of emerging markets to risky financial assets of the mature markets has increased, and therefore, the overall global financial risks have increased.

Overall Assessment

- Domestic economic activity has continued to expand at a strong pace and there are indications that the impulses of growth are getting broad-based. The recent gains in bringing down inflation and in stabilising inflation expectations should support the current expansionary phase of the growth cycle.
- It is, however, necessary to note that demand pressures and cyclical effects persist, mirrored in investment and consumer demand, monetary and banking aggregates, capacity constraints and a widening trade deficit. Financial markets are reflecting the interplay of these factors, although increases in capital inflows and large changes in liquidity conditions are obscuring an accurate assessment of risks, with attendant uncertainty.
- While there is an abatement of inflation in the recent period, upward pressures persist. In this regard, it is essential to carefully monitor developments relating to aggregate supply conditions and the supply response to the impulses of demand in the short-term, while stepping up efforts to expand production capabilities over the medium-term.
- It is also necessary to continuously assess the risks to the inflation outlook emanating from high and volatile international crude prices, the continuing firmness in key food prices and the uncertainties surrounding the evolution of demand-supply gaps, both globally as well as in India.
- Risks from global developments continue to persist, especially in the form of inflationary pressures, re-pricing of risks by financial markets and danger of downturn in some asset classes, with implications for EMEs in general. International food and energy prices are likely to settle at higher levels than before with indications that the sharp acceleration recorded in 2006 will not reverse. In addition, there are risks emanating from the developments in global financial markets.

Stance of Monetary Policy for the Remaining Period of 2007-08

- The projection of real GDP growth in 2007-08 at around 8.5 per cent, as set out in the Annual Policy Statement of April 2007, is retained, barring domestic or external shocks.
- The outlook for inflation in 2007-08 remains unchanged. Accordingly, holding headline inflation within 5.0 per cent in 2007-08 assumes priority in the policy hierarchy; while reinforcing the medium-term objective to condition policy and perceptions to reduce inflation to 4.0-4.5 per cent on a sustained basis.
- For the purpose of monetary policy formulation, the Annual Policy Statement of April 2007 projected growth of money supply (M_3) at around 17.0-17.5 per cent for 2007-08 in consonance with the outlook on growth and inflation. Consistent with the projections of money supply, the growth in aggregate deposits in 2007-08 was placed at around Rs.4,90,000 crore while non-food credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper (CP) was projected to decelerate to 24.0-25.0 per cent in 2007-08 from the average of 29.8 per cent over 2004-07. While non-food credit growth has

decelerated, the acceleration in money supply and reserve money warrants an appropriate response.

- The global outlook is positive with continuing prospects for strong and stable growth but there are concerns about inflationary pressures worldwide. Monetary authorities are inclined to regard the current levels of real interest rates as warranting further withdrawal of monetary accommodation and are indicating a preparedness to respond to the manner in which the inflation scenario evolves. Financial markets have been aggressively re-pricing risks; however, the wide diffusion of risks and the abundance of liquidity have imparted considerable uncertainty. These developments are necessitating intensified policy monitoring with a policy preference for insulating domestic real activity from these shocks.
- Monetary policy in India would continue to be vigilant and pro-active in the context of any accentuation of global uncertainties that pose threats to growth and stability in the domestic economy. The domestic outlook continues to be favourable and would dominate the dynamic setting of monetary policy in the period ahead.
- It is important to design monetary policy such that it protects growth by contributing to the maintenance of stability. Accordingly, while the stance of monetary policy would continue to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustain the growth momentum, contextually, financial stability may assume greater importance in the months to come.
- Recent developments in financial markets in India and potential uncertainties in global markets warrant a higher priority for managing appropriate liquidity conditions in the policy hierarchy at the current juncture.
- The Reserve Bank will continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and open market operations (OMO) including the MSS and LAF, 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 broadly continue to be:
 - To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
 - To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
 - To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.

Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent.
- Reverse Repo Rate and Repo Rate under LAF kept unchanged at 6.00 per cent and 7.75 per cent, respectively.
- In view of the current macroeconomic and overall monetary and liquidity conditions, it has been decided to withdraw the ceiling of Rs. 3,000 crore on daily reverse repo under the LAF with effect from Monday, August 6, 2007. The Reserve Bank, however, retains the discretion to re-impose a ceiling as appropriate and has the flexibility to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warrant.
- The Reserve Bank retains the option to conduct overnight or longer term repo/reverse repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.
- The second LAF, which was introduced from November 28, 2005 and is conducted between 3.00 p.m. and 3.45 p.m. on a daily basis, is withdrawn with effect from Monday, August 6, 2007.
- On a review of the current liquidity situation, it is considered desirable to increase the CRR by 50 basis points to 7.0 per cent with effect from the fortnight beginning August 4, 2007.

The Mid-Term Review of the Annual Policy Statement for the year 2007-08 will be undertaken on October 30, 2007.

Alpana Killawala
Chief General Manager

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