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RESERVE BANK OF INDIA

PRESS RELATIONS DIVISION, Central Office, Post Box 406, Mumbai 400001
Phone: 2266 0502 Fax: 2266 0358, 2270 3279

www.rbi.org.in
www.rbi.org.in\hindi
e-mail: helpprd@rbi.org.in

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RBI releases Annual Report for 2006-07

Assessment of 2006-07

Overall Performance

During 2006-07, the Indian economy exhibited acceleration in growth, led by manufacturing and services sector activities. The sustained high growth since 2003-04 has been supported by increase in domestic savings and investment. Robust growth during 2006-07, however, was accompanied by inflationary pressures on account of rising capacity utilisation, strong growth in monetary and credit aggregates, demand-supply gaps in domestic production of foodgrains and oilseeds, and firm global commodity prices. A series of timely and appropriate measures undertaken by the Reserve Bank and other supply side responses to rising prices made by the Government helped to contain headline inflation. More importantly, the measures facilitated the anchoring of inflationary expectations to a certain extent. Strong growth in general and of the industrial sector in particular enabled the corporate sector to maintain high profitability. This, in turn, resulted in buoyant tax collections and played a major role in improving public finances. The growth process was facilitated by financial market conditions, which remained orderly, barring a few episodes of volatility. However, interest rates in various segments of the financial market hardened to some extent. Strong growth led to a widening of the trade deficit. Nonetheless, the current account deficit, as per cent of GDP, remained unchanged from the previous year since the widening of the merchandise trade deficit was offset to a large extent by the continuing buoyancy in net invisibles surplus. Large capital flows led by external commercial borrowings and net foreign direct investment (FDI) inflows resulted in large accretion to foreign exchange reserves.

Real GDP growth accelerated from 9.0 per cent during 2005-06 to 9.4 per cent during 2006-07. The growth, thus, averaged 8.6 per cent per annum during the four-year period ended 2006-07. Real GDP growth during the Tenth Five Year Plan period averaged 7.6 per cent per annum, the highest in any Plan period. Acceleration in the growth rate during 2006-07 was attributable to buoyancy in the industrial and services sectors, which exhibited double-digit growth (11.0 per cent each). Higher growth in the industry and services sectors more than offset the deceleration in the agricultural sector. Growth in the agricultural sector decelerated from 6.0 per cent in 2005-06 to 2.7 per cent in 2006-07, partly on account of uneven rainfall during the South-West monsoon and partly due to the base effect. Although the overall foodgrains production rose by 3.6 per cent in 2006-07, the production of major crops still did not reach the previous peak touched in 2001-02. Amongst the non-foodgrains, the production of sugarcane and cotton scaled new peaks during 2006-07, while that of oilseeds declined.

Monetary Developments

Money supply (M_3) increased by 21.3 per cent (Rs. 5,80,733 crore) during 2006-07 as compared with 17.0 per cent (Rs. 3,96,878 crore) during 2005-06. Amongst the major components, time deposits exhibited a growth of 23.2 per cent (Rs. 4,41,913 crore) during 2006-07 as compared with 15.3 per cent (Rs. 2,53,056 crore) during 2005-06. Higher growth in time deposits could be attributed to factors such as higher interest rates on bank deposits and availability of tax benefits under Section 80C for bank deposits. On the sources side, growth of bank credit remained high, although there was some moderation. Demand for bank credit was largely broad-based with agriculture, industry and personal loans absorbing 14 per cent, 36 per cent and 24 per cent, respectively, of incremental expansion in overall non-food credit during 2006-07. Growth of credit to sectors such as real estate remained high, *albeit* with some moderation. In order to maintain asset quality, the Reserve Bank further tightened the provisioning requirements in respect of sectors witnessing high growth in credit. Banks' SLR investments, as a proportion of their net demand and time liabilities (NDTL), declined further to 28.0 per cent by end-March 2007 (close to the prescribed ratio of 25 per cent) as the expansion in investments did not keep pace with the expansion in the NDTL. Net foreign assets remained the key driver of reserve money and the Reserve Bank continued to modulate market liquidity through operations under the liquidity adjustment facility (LAF), issuance of securities under the market stabilisation scheme (MSS) and use of the cash reserve ratio (CRR).

Headline inflation firmed up from 4.0 per cent, y-o-y, on April 1, 2006 to 5.9 per cent on March 31, 2007 with an intra-year high of 6.7 per cent on January 27, 2007 and a low of 3.7 per cent on April 15, 2006. Both demand and supply side factors added to inflationary pressures during 2006-07. Demand pressures emanated from both high investment and consumption demand, strong growth in credit and monetary aggregates, and elevated asset prices. Supply side pressures emerged from demand-supply gaps in domestic production of major foodgrains and oilseeds amidst rising global prices. Although there was some improvement in domestic agricultural production during 2006-07, the production of major foodgrains has exhibited stagnation over the past few years. For instance, the production of rice, wheat and pulses during 2006-07 was still lower than the previous peaks touched during 2001-02, 1999-2000 and 1998-99, respectively. Consumer price inflation rose from 4.9-5.3 per cent in March 2006 to 6.7-9.5 per cent in March 2007, mainly reflecting the impact of higher food prices. In order to contain inflation and to stabilise inflationary expectations, the Reserve Bank persevered with the policy of pre-emptive actions and gradual withdrawal of monetary accommodation, using various instruments at its disposal flexibly. Between the second half of 2004 and July 31, 2007, the repo and the reverse repo rates were increased by 175 basis points and 150 basis points, respectively. In addition, the cash reserve ratio was raised by 250 basis points (including the increase of 50 basis points effective August 4, 2007). The Government also took various fiscal and supply-side measures to contain inflation during the latter part of 2006-07.

Balance of Payments

India's balance of payments in 2006-07 reflected a number of positive features. Merchandise trade continued to exhibit robust growth during 2006-07, although there was some loss of pace from the strong growth of 2005-06. The higher growth of imports *vis-à-vis* exports led to a persistent rise in the trade deficit, on a balance of payments basis. Nonetheless, the current account deficit, as per cent of GDP, remained unchanged (1.1 per cent of GDP) from the previous year since the widening of the merchandise trade deficit was offset to a large extent by the continuing buoyancy in net invisibles surplus. Net capital inflows to India remained buoyant (4.9 per cent of GDP), far exceeding the current account deficit. Higher capital flows could be attributed to the strengthening of macroeconomic fundamentals, greater investor confidence and ample global liquidity. Net FDI inflows from abroad of US $ 19.4 billion exceeded FII inflows (net) during 2006-07 aggregating US $ 3.2 billion. The debt flows (net) at US $ 25.0 billion were led by external commercial borrowings reflecting strong investment demand. Net capital flows, after financing the current account deficit, led to accretion of US $ 36.6 billion, excluding valuation changes, to foreign exchange reserves during 2006-07.

Financial Markets

Financial markets remained orderly during 2006-07, barring some episodes of volatility, especially during the second half of March 2007. Capital inflows and movements in Government cash balances continued to be the key drivers of liquidity conditions and overnight interest rates. Interest rates in the various market segments hardened during the year, broadly in tandem with the pre-emptive monetary tightening measures taken by the Reserve Bank. By and large, the exchange rate of the Indian rupee exhibited two-way movement with respect to the main reserve currencies during 2006-07. The stock market remained buoyant with the benchmark indices reaching record highs during 2006-07 amidst intermittent corrections. The primary segment of the capital market exhibited buoyant conditions.

Outlook for 2007-08

Available information so far indicates continuation of the growth momentum during 2007-08 at a strong pace with the impulses of growth getting more broad-based. Steady increases in the rate of gross domestic saving and investment, consumption demand, addition of new capacity as well as more intensive and efficient utilisation/capitalisation of existing capacity are expected to provide support to growth during 2007-08.

For monetary policy purposes, the Reserve Bank, in its Annual Policy Statement (April 2007), placed the real GDP growth for 2007-08 at around 8.5 per cent, assuming no further escalation in international crude prices and barring domestic or external shocks. In view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of shocks emanating in the domestic or global economy, the Reserve Bank in its Annual Policy Statement noted that the policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08. The Reserve Bank in its First Quarter Review of the Annual Statement of Monetary Policy in July 2007 retained its projection of real GDP growth at around 8.5 per cent, barring domestic and external shocks. Assuming that aggregate supply management will continue to receive public policy attention and that a more active management of the capital account will be demonstrated, the outlook for inflation in 2007-08 in the First Quarter Review remained unchanged. Accordingly, it was indicated in the Review that holding headline inflation within 5.0 per cent in 2007-08 assumed 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.

Monetary Management

Expansion of money supply (y-o-y) as on August 3, 2007 was higher (21.7 per cent) than a year ago (19.3 per cent) and also higher than the indicative projection of 17.0-17.5 per cent set out in the Annual Policy Statement. Growth in aggregate deposits accelerated, led by time deposits. Bank credit witnessed some moderation from the strong pace of the preceding three years. Growth of non-food credit of scheduled commercial banks was 23.6 per cent, y-o-y, as on August 3, 2007 as compared with 32.5 per cent a year ago. Commercial banks' investments in SLR securities, as per cent of their net demand and time liabilities, at 28.6 per cent were marginally higher than those at end-March 2007, but below those of 31.1 per cent a year ago. Growth of reserve money as on August 10, 2007 at 26.9 per cent (19.6 per cent adjusted for the first round impact of the increase in the CRR) was higher than a year ago (17.2 per cent), mainly on account of accretion to the Reserve Bank's net foreign assets.

Headline inflation, based on movements in the wholesale price index (WPI), moderated to 4.1 per cent, y-o-y, on August 11, 2007 from 5.9 per cent at end-March 2007 and 5.1 per cent a year ago. Inflation for all the three sub-groups of the WPI eased from their end-March levels. Fuel group inflation turned negative (-2.1 per cent) reflecting cuts in domestic prices during November 2006 and February 2007. International crude oil (average) prices have, however, increased by around 28 per cent up to July 2007 from February 2007, when domestic prices were cut last. Non-oil global commodity prices also remained firm led by food and metals. Various measures of consumer price inflation were placed lower in June 2007 (5.7-7.8 per cent) than those in March 2007 (6.7-9.5 per cent). However, consumer price inflation continued to exceed wholesale price inflation mainly on account of higher food prices. Although inflation has eased since end-March 2007, inflationary pressures could potentially persist for several reasons. There are concerns regarding further hardening of international commodity prices, in particular, oil prices. Moreover, the possibility of inflationary pressures from domestic factors such as strong growth in monetary aggregates, elevated asset prices and large capital flows with implications for domestic liquidity conditions need to be recognised. Accordingly, a continuous vigil supported by appropriate policy actions by all concerned would be needed to maintain price stability so as to anchor inflationary expectations on a sustained basis.

The stance of monetary policy in 2007-08, as observed in the Annual Policy Statement, would be conditioned by the patterns in which the global and, more particularly, the domestic environment unfold. The likely evolution of macroeconomic and financial conditions indicates an environment supportive of sustaining the current growth momentum in India. Monetary policy, while contributing to growth, has to ensure and maintain conditions of price and financial stability. Accordingly, the policy preference for the period ahead was articulated strongly in favour of reinforcing the emphasis on price stability and anchoring inflation expectations. The Reserve Bank in its First Quarter Review of the Annual Statement of Monetary Policy in July 2007 observed that monetary policy in India would continue to be vigilant and proactive in the context of any accentuation of global uncertainties that pose threat 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 growth momentum, contextually financial stability may assume greater importance in the months to come.

Agriculture

The recent upward trends in global prices of major food items have significant implications for the domestic agricultural sector and overall macroeconomic and financial stability. Increases in global food prices reflected a shortfall in global production and the rising demand for non-food uses such as bio-fuels. Reflecting the sustained uptrend in major food prices, the food price index (compiled by the IMF) reached a 26-year high in June 2007 - the highest since early 1981. Against the backdrop of these hardening trends in global food prices, there is an urgent need to take measures to accelerate the growth in Indian agriculture, especially food crops.

Although the share of agriculture in overall GDP declined over the years from around 40 per cent in 1980-81 to below a fifth in 2006-07, it continues to play an important role in the Indian economy. Since the mid-1990s, however, the growth of the agricultural sector has been low as well as volatile; the growth decelerated from an annual average of 4.7 per cent per annum during the 1980s to 3.1 per cent during the 1990s and further to 2.2 per cent during the Tenth Plan period. Volatility in agricultural production has not only implications for overall growth but also, as the experience of 2006-07 amply demonstrated, for maintaining low and stable inflation. Enhanced growth of the agricultural sector is vital for ensuring food security, poverty alleviation, price stability, overall inclusive growth and sustainability of growth of the overall economy.

The reduction in agricultural growth since the mid-1990s could be attributed to stagnant/declining yields, which, in turn, reflect a variety of factors such as declining investment, lack of proper irrigation facilities, inadequate other infrastructural facilities, inadequate attention to R&D for developing high yielding varieties of seeds, absence of major technological breakthroughs, improper use of fertilisers/nutrients and institutional weaknesses. In view of stagnation in the production of major foodgrains, there may be a need to refocus production efforts in alternative potential areas with suitable agro-climatic conditions, rather than the traditional areas, particularly in the case of rice and wheat. As Indian agriculture continues to be heavily dependent on the monsoon, the need for enhancing the irrigation potential to meet the growing water requirements of farmers and to impart stability to agricultural production and yield assumes greater emphasis. More focus needs to be placed on agricultural research in the coming years as the success so far has been restricted to select crops. A growing disparity between the actual and the potential yields points to a crucial gap between research and extension. There is an urgent need to revive the extension system so that it is able to respond to the emerging demands of renewed agricultural growth. In order to bring marketing reforms, there is a need to take forward the process of implementing Agricultural Produce Marketing Committee (APMC) Act in all the States. There is also a need to have an appropriate legislative framework that is conducive to participatory organisations. In view of significant weather and price risks, appropriate risk mitigation policies would need to be put in place to provide relief to distressed farmers as well as enhance efficiency of production. While agricultural growth is envisaged at four per cent per annum during the Eleventh Plan, the Planning Commission’s projections suggest that the production of foodgrains needs to increase by 2-2.5 per cent per annum. The production of non-foodgrains will, thus, have to expand at a much higher rate to achieve the overall target of four per cent which will necessitate substantial development of activities such as horticulture, dairy, poultry, and fishery. This would require a revolution on the lines of the green revolution of the 1970s.

Inclusive growth calls for greater financial inclusion with, *inter alia,* enhanced and easy access to institutional credit. The programme for financial inclusion initiated by the Reserve Bank in collaboration with banks and several State Governments by adopting modern technology needs to be intensified and expanded urgently. In view of small and fragmented farm holdings, the population dependent upon agricultural activity and incomes will have to increasingly rely on non-farm sources of income in future. Thus, diversification towards activities such as poultry, food processing and other rural industries will be critical for the betterment of living standards in rural areas. While there has been rapid integration of the

Indian economy with the global economy since the early 1990s, the pace of progress on intra-regional integration within the country needs to be quickened to enable the rural areas to reap the benefits of higher growth.

Industry and Infrastructure

The rebound in industrial production that started during 2002-03 continued during 2006-07 resulting from increased domestic and external demand. The sustained growth has led to high capacity utilisation and is contributing to increased investment activity. Modernisation of the capital stock, reduction/rationalisation of import tariffs and other taxes, increased openness of the economy, higher foreign direct investment inflows, greater competitive pressures, increased investment in information and communication technology and greater financial deepening are contributing to productivity gains in industry. The sustained growth in industry is vital to generate employment opportunities and to absorb the disguised labour force dependent upon the agricultural sector.

The manufacturing sector has recorded robust growth, despite several infrastructure deficiencies. It is imperative to augment the existing infrastructure facilities, particularly roads, ports and power, to provide the enabling environment for industry to prosper. There has been mixed progress in the infrastructure sector so far. The telecom sector has witnessed high growth as reflected in the accelerated spread of mobile telephony in the country. Railways and ports have also witnessed some improvement. However, progress remains less than adequate in other sectors such as power, coal, water, roads, urban infrastructure and rural infrastructure. Urban infrastructure is a vital element in the growth process. Studies show that increase in the size of urban agglomerations is associated with large productivity gains. These gains emanate from the proximity to the product as well as labour markets, which provide savings in trade and transport costs on the one hand and the availability of skilled labour on the other. Efficient functioning of cities of all sizes is essential for improving the overall efficiency. Improvements in the provision of water, transport, sanitation, health and education facilities in urban areas are also essential for the welfare of the poor. The High Level Committee on Infrastructure headed by the Prime Minister has estimated that an investment of Rs.14,50,000 crore during the Eleventh Plan would be required to develop world class infrastructure. This would require a substantial increase in spending on infrastructure by both the public and privates sectors from the current levels of 4.6 per cent of GDP to almost 8 per cent of GDP every year.

Services

The sustained strength of manufacturing activity, strong growth in tourism, improvements in the telecommunications, buoyancy in IT and BPO sectors, robust growth of the construction sector, acceleration in deposit and credit growth and opening up of the insurance sector have buoyed the services sector in recent years. The impressive performance of the services sector was attributable largely to the availability of skilled and cheap labour. However, the sustained acceleration in the services and the manufacturing activities is leading to incipient pressures on the supply of good quality skilled labour. While its demographic profile places the country favourably in terms of manpower availability, there are reports of emerging talent supply shortages. In order to reap the benefits of the demographic dividend, substantial expansion and reforms in the education sector would be needed on an urgent basis.

Fiscal Policy

The process of fiscal consolidation in Central Government finances under the rule-based framework of the FRBM has been characterised by front-loaded reduction in deficit indicators in 2004-05, pause in 2005-06 and resumption of the process in 2006-07. The fiscal correction process is budgeted to continue during 2007-08. With the gross fiscal deficit budgeted at 3.3 per cent of GDP in 2007-08, the FRBM target of 3.0 per cent by 2008-09 appears feasible. The revenue deficit is budgeted at 1.5 per cent of GDP for 2007-08; the FRBM path envisages elimination of revenue deficit in 2008-09. Adherence to the FRBM target would require a reduction of 1.5 per cent in the revenue deficit/GDP ratio during 2008-09.

The fiscal consolidation strategy has been underpinned by revenue-led correction and reprioritisation of expenditures with a focus on outcomes, reflecting improved quality of adjustment. Maintaining the current buoyancy in tax revenues over a higher base needs to be continued with sustained effort in the light of high income growth. The scope for deepening fiscal empowerment further through improved tax revenues lies in maintaining a moderate structure of tax rates and broadening the base without affecting the growth momentum of the economy. The Government's policy of reprioritising expenditure has led to higher outlays for the social sector. The shares of public expenditure on education and health in India are, however, still low by international standards. Reprioritisation of expenditures towards social sectors along with higher capital outlays would promote fiscal discipline without restricting operational efficiency of the Government. Higher public spending on social services would improve the social infrastructure and provide productivity gains.

External Sector

India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy and the two way movement in financial flows. The ratio of merchandise exports to GDP has been rising since the early 1990s reflecting growing international competitiveness. At the same time, import intensity has been rising steadily as domestic entities have expanded access to internationally available raw material and intermediate goods as well as quality inputs for providing the cutting edge to domestic production and export capabilities. Structural shifts in services exports, led by software and other business services, and remittances have imparted stability and strength to India's balance of payments. The net invisible surplus has offset a significant part of the expanding trade deficit and helped to contain the current account deficit to an average of one per cent of GDP since the early 1990s. Capital flows (net) have remained substantially above the current account deficit and have implications for the conduct of monetary policy and macroeconomic and financial stability.

Like India, several other countries are facing a similar situation of excess foreign exchange inflows which is affecting monetary management in these countries as well. However, monetary management at the current juncture in India is more complex than in other EMEs for several reasons. First, domestic interest rates are higher than the return on foreign exchange reserves, which leads to quasi-fiscal costs. Second, although the fiscal deficit and public debt have declined in recent years in India, by international standards, they still remain high. This restricts the flexibility available to fiscal policy to keep inflation relatively low. Third, in India, the real sector has been liberalised over the years which constrains the ability to take administrative measures with regard to supply management. At the same time, several policy rigidities persist, inhibiting the rapid and flexible adjustments that are needed by the demands of a well-functioning market economy. Further, in India, the banking system has been gradually deregulated and the conduct of monetary policy is largely through the use of market-based instruments. This restricts the ability to use administrative instruments such as prescribing deposit and lending rates, which some other countries may be able to use. Moreover, some countries are managing capital account more actively than before. Finally, it is also necessary to recognise that India is one of the few emerging market economies (EMEs) to record current account deficits, along with a significantly high trade deficit.

There has been a significant liberalisation of the policy framework with regard to capital outflows over the past few years. The policy regime for capital outflows is designed keeping the specific country context in view, especially characteristics of the real sector, and not merely the contextual level of inflows and extant absorptive capacity of the economy. First, the current regime of outflows in India is characterised by liberal but not incentivised framework for corporates to invest in the real economy outside India, including through the acquisition route. The regime has served the country well since Indian corporates are increasingly able to establish synergies with overseas units; to make up for lack of scale that has been a legacy problem in India, and to quickly acquire domain knowledge through acquisition. Second, significant liberalisation of outflows by individual households has been implemented following recommendation of the Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore, 2006). However, the international experience shows that resident individuals often precede overseas investors in initiating outflows when the perceptions in regard to domestic economy's performance or stability appear to turn adverse. Further, more favourable tax treatment, if any, on investments from foreign destinations relative to domestic investments provides a compelling incentive for round tripping. Third, as regards the regime for outflows through financial intermediaries, the approach is characterised by caution and quantitative stipulations whereby both prudential considerations and compulsions of management of capital account are relevant.

Financial Sector

During 2006-07, the Reserve Bank continued to fine tune the regulatory and supervisory initiatives. In order to ensure asset quality, prudential measures were further tightened through increases in the provisioning requirements and risk weights in respect of specific sectors. The focus of the various prudential and supervisory measures was on anchoring financial stability while providing flexibility to the financial system. In order to further strengthen the domestic banking sector and to conform the banking sector with international best practices, commercial banks will migrate to Basel II norms in a phased manner from the year ending March 2008. Although implementation of Basel II poses a significant challenge to both banks and the regulators, it also offers two major opportunities to banks, *viz*., refinement of risk management systems and improvement in capital efficiency.

Monetary Policy

In view of the incipient inflationary pressures, the stance of monetary policy progressively shifted from an equal emphasis on price stability along with growth (October 2004/April 2005) to one of reinforcing price stability with immediate monetary measures and to take recourse to all possible measures promptly in response to evolving circumstances (January 2007). Concomitantly, the Reserve Bank has taken pre-emptive monetary measures beginning mid-2004 to contain inflation and inflationary expectations. The major policy challenge for monetary policy during the recent period has been to manage the transition to a higher growth path while containing inflationary pressures so that potential output and productivity are firmly entrenched to sustain growth. Monetary measures, supported by supply side and fiscal measures, have helped in containing inflation and anchoring inflation expectations while supporting the growth momentum.

The Reserve Bank's self-imposed medium-term ceiling on inflation at 5.0 per cent has had a salutary effect on inflation expectations and the socially tolerable rate of inflation has come down. In recognition of India's evolving integration with the global economy and societal preferences in this regard, the resolve, going forward, would be to condition policy and expectations for inflation in the range of 4.0–4.5 per cent. This would help in maintaining self-accelerating growth over the medium-term, keeping in view the desirability of inflation at around 3 per cent to ensure India's smooth global integration.

The conduct of monetary policy has turned out to be more complex in recent years for a variety of reasons. Globalisation has brought in its train considerable fuzziness in reading underlying macroeconomic and financial developments, obscuring signals from financial prices and clouding the monetary authority's gauge of the performance of the real economy. There is considerable difficulty faced by monetary authorities across the world in detecting and measuring inflation, especially inflation expectations. The operation of monetary policy in India is also constrained by some uncertainties in the transmission of policy signals to the economy.

Monetary policy in India has also to contend with the burden of challenges emanating from other sectors. First, fiscal imbalances remain large by international standards and have to be managed in a non-disruptive manner. Second, the enduring strength of foreign exchange inflows complicates the conduct of monetary policy. Third, in India, levels of livelihood of a large section of the population are inadequate to withstand sharp financial fluctuations which impact real activity. Accordingly, monetary policy has also to take into account the effect on these segments of the economy of volatility in financial markets, often related to sudden shifts in capital flows. Fourth, limitations on the elasticity of aggregate supply domestically impose an additional burden on monetary policy, particularly in the short term. While open trade has expanded the supply potential of several economies, it does not seem to have had any significant short-term salutary effect on supply elasticities. Persisting supply shocks to prices of commodities and services to which headline inflation is sensitive can exert a lasting impact on inflation expectations. Faced with longer term structural bottlenecks also in supply, with less than adequate assurance of timely, convincing and demonstrated resolution, monetary policy has to respond appropriately. The burden and the dilemmas, in fact, are greater in the event of a structural supply problem on account of its persistent effects on inflation. Managing structural change, while keeping inflation low and stable, without dampening the growth momentum is the quintessential challenge to monetary policy in the period ahead.

Alpana Killawala
Chief General Manager

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