II.47 The promotion of efficient use of resources and technology, private sector participation through contract farming and leasing arrangements, involving new location specific and improved varieties of farm crops, livestock species will help to improve the competitiveness of Indian agriculture. Apart from agronomic measures for raising productivity, interventions are required for educating farmers to enable them to upgrade their skills to improve the quality of products so that they conform to the strictest sanitary standards in the context of WTO.

II.48 In this context, the suspension of the Doha Round of multilateral trade negotiations over the issue of huge subsidies being paid by developed countries to their farmers is a matter of concern. Subsidised exports by developed countries not only pose a threat to food and livelihood security in developing countries, but also expose farmers of developing countries like India to unfair trade competition in their exports. These developments are of particular concern to India in view of the continued dependence of a majority of population on agriculture and a large number of rural poor.

II.49 The Government has introduced the National Rural Employment Guarantee Act in 2005. The basic objective of the Act is to enhance livelihood security in rural areas by providing at least 100 days of guaranteed wage employment in a financial year to every household whose adult members volunteer to do unskilled manual work. This work guarantee can serve other objectives: generating productive assets, protecting the environment, empowering rural women, reducing rural-urban migration and fostering social equity, among others. This is also expected to help in addressing the problems of rural unemployment and poverty as well as provide an impetus to demand in the economy.

Industry

II.50 The rebound in the industrial sector in conjunction with the services sector has powered India’s GDP growth since 2003-04 and has led to build up of optimism of targeting still higher growth for the economy. The resilience shown by the industrial sector against the hardening of global oil prices is reflective of inherent strengths and capabilities that the industrial sector has built up over the years since the initiation of economic reforms in the country. Strong corporate profitability and balance sheets in the past three years have also provided the corporate sector necessary resilience to absorb various shocks. A distinctive feature of India’s industrial sector is the growing competitiveness especially in respect of automobiles and pharmaceuticals, evidenced from their export performance. This has strengthened the manufacturing performance further, which holds potential for India to become more of a manufacturing base for global production in certain sectors. The recent performance of the capital goods sector and the business investment surveys suggest a further scope for capacity additions in the Indian industries. At the same time, corporates are likely to face challenges from factors such as infrastructural bottlenecks, rising input costs from higher oil and other commodity prices, and the possibility of emerging shortages of domestic skilled labour. Furthermore, the manufacturing sector, especially the small and medium enterprises (SMEs), will have to gear up to meet challenges that may emanate from imports from China; it may be recalled that China has already emerged as the largest source of India's non-oil imports. The domestic manufacturing sector will have, thus, to continuously improve its productivity and competitiveness in order to effectively face the likely challenges.

II.51 Improvements in infrastructure facilities will be critical to sustain and accelerate the current industrial growth. It is noteworthy that, in the recent years, improvements have taken place in infrastructure facilities in areas such as telecommunications, roads and, to some extent, ports and railways. These developments are having a positive impact on the productivity and competitiveness of Indian economy. At the same time, infrastructural constraints in most critical areas such as power supply and urban infrastructure continue to impinge on the competitiveness of manufacturing activity. Apart from higher levels of investment, issues of governance and management including policies relating to appropriate pricing and user charges would need to be addressed to achieve satisfactory results.

II.52 Electricity and mining sectors have continued to record subdued growth, remaining a cause of concern and this could hinder the sustainability of manufacturing activity. Electricity generation continues to be hampered by policy shortcomings, continued excessive transmission and distribution losses, and collection of dues along with emerging difficulties in the availability of coal and gas. Furthermore, apart from unreliable supply of power, the tariffs facing the domestic manufacturing sector are higher *vis-à-vis* other countries such as China with implications for domestic competitiveness. The higher tariffs for the manufacturing sector in India reflect cross-subsidisation of tariffs on the one hand and the recourse to captive generation on the other hand.

II.53 India remains dependent upon coal for its energy requirements. The share of coal in total commercial energy consumption in the country is 55 per cent while that of oil is one-third. Supply of coal, however, continues to lag the demand and this, in turn, is having an adverse impact on the power situation in the country. Illustratively, as against the requirement of 338 million tonnes of coal during 2005-06, domestic availability was only 317 million tonnes. Non-availability of the desired level of coal is estimated to have resulted in generation loss of 1512 million units during 2004-05.

II.54 Similarly, demand for natural gas is outstripping supply in India, resulting in a huge loss of power generation. For instance, the country's requirement of gas during 2004-05 at 90 per cent plant load factor (PLF) was 49.7 million cubic metres per day (mcmd). As against this, only 30.7 mcmd (*i.e.*, 62 per cent of the demand) was supplied. The shortage in the gas availability is estimated to have resulted in a generation loss of almost 35 billion units per annum, on average, during 2000-05. Inadequate power generation capacity, lack of optimum utilisation of the existing generation capacity, insufficient inter-regional transmission links, inadequate and ageing sub-transmission and distribution network, slow pace of rural electrification and inefficient use of electricity by the end use consumer have exacerbated the absolute shortages.

II.55 Given the rising international crude oil prices and stagnant domestic crude oil production, an integrated approach to efficient use of energy – both oil and non-oil energy resources – assumes importance. The intensity of oil and overall energy use per unit of GDP in India remains higher than in developed as well as many developing economies. Against this backdrop, measures such as better house keeping in industrial units, better maintenance and upkeep of transport vehicles and improved traffic management would help in energy security. It also becomes necessary to increase the domestic availability of coal and gas through measures such as private participation in non-captive mining through legislative amendments; revival of loss making companies and restructuring of the coal sector; permitting freer trade of coal; and, intensification of exploration and upgradation of coal reserves. Alternative avenues of energy such as coal bed methane, hydel and wind energy sources, ethanol and bio-diesel would also need to be explored. Finally, in view of the large increase in international crude oil prices, a higher degree of pass-through to domestic prices will encourage incentives to economise on the use of oil and thereby moderate the adverse consequences of high oil prices on the real economy.

II.56 Provision of urban infrastructure facilities also needs greater attention. Globally, cities have consistently provided the environment for institutional and technological innovation, and acted as engines of economic growth. Substantial improvement in the quality of urban infrastructure, governance and management is essential to maintain and accelerate the momentum of economic growth and productivity enhancement. The recently launched "National Urban Renewal Mission" with its focus on improving infrastructural facilities in urban areas is a welcome development.

II.57 After carving out its niche in the services sector, India has also the potential of emerging as a favoured manufacturing destination of the world especially in respect of certain manufacturing activities enjoined by entrepreneurial dynamism and cost competitiveness that the country enjoys. Indian manufacturing industries have certain inherent strengths such as relatively inexpensive, adequate and highly skilled labour force, large manufacturing base, vast domestic market and growing external market as well as proximity to some of the fast growing EMEs in the Asian region, which augur well for maintaining high growth in the manufacturing sector in the medium term. The process of dereservation of items reserved for exclusive production by SSIs could be expedited, especially since imports of such reserved items are in any case freely permitted. This would help the sector to reap the economies of scale and add to the manufacturing sector's competitiveness. A substantial manufacturing base is essential to absorb the workforce and ensure sustainable growth of the economy. An economy of India's size and scope cannot ignore the manufacturing sector. A modern manufacturing sector is essential for the development of scientific and technological base, growth of knowledge economy and national security.

II.58 For this potential of manufacturing to be achieved, productivity of Indian labour needs to be improved further. Apart from improvements in physical and social infrastructure, this would, *inter alia*, require imparting requisite skills to the labour through setting up of high quality industrial training institutes (ITIs). Furthermore, the Indian industry needs to step up research and development expenditure to improve its competitiveness in the global economy to move up the value chain and to strengthen its position in skill intensive industries.

Services

II.59 The services sector in the country has benefited from the availability of vast skilled labour and is expected to continue to lead the economy, drawing from its linkage with the well performing industrial sector and expanding international trade. The synergetic relationship between manufacturing and services needs to be sustained and accelerated further. Gains in the services sector activities such as telecommunications and software have not only provided a boost to the value added in the services sector but are also providing cost-efficiency gains and productivity benefits to manufacturing. The spread and the thrust of information and communication technology (ICT) have provided unprecedented scope for productivity gains the world over in a very short span of time. The ICT can have a positive impact on growth through a surge in ICT investment, strong productivity effects from the ICT-producing industries and a more productive use of the ICT in the rest of the economy. The ICT equipments enable new organisational models and other innovations in the production process as well as the production of new goods and services. Thus, even if the ICT investment goods are standard products, they enable firms to innovate and accumulate firm-specific capital with positive spillovers on production. For reaping full benefits of the ICT, complementary investments in human and knowledge capital as well as in organisational innovations become necessary. In this context, it is necessary for the Indian services sector to continuously scan the global markets, identify the evolving preferences of the international clients, diversify the range of services offered and achieve greater efficiency to face the emerging global competition.

II.60 Unlike other countries at this stage of development, India appears to have skipped directly to specialisation in skill intensive industries (within manufacturing) or to services where they appear to have a comparative advantage (at least *vis-à-vis* other poor countries). This advanced skill-intensive part of the Indian economy may be bidding up scarce skills. A renewed emphasis on quality higher education commensurate with the requirements of knowledge intensive industries is needed for the current growth momentum to be maintained and built upon.

II.61 In the coming years, India is expected to benefit further from the demographic dividend emanating from a higher proportion of younger population. For this demographic dividend to be reaped fully, improvements in education, skills, health and governance would be needed so that the Indian labour force is globally competitive. In particular, the provision of educational facilities requires greater attention than before to take advantage of the evolving demographics. There is need to improve the availability of educational facilities at all levels – primary, secondary and tertiary – to equip the labour with the necessary skills to maintain current competitive advantage. With the quality of manufactured goods improving all the time, the demand for high skilled labour is expected to accelerate. Furthermore, the growing knowledge-intensive services activities will require human resources equipped with appropriate skills. Hence, enhancement of skills of human resources at all levels, especially at higher levels of education, requires greater priority. In particular, demand for tertiary education is expected to increase significantly in the coming years. A renewed focus on developing high quality institutions of learning at all levels will be essential for India to benefit from its demographic advantage. Finally, it may be noted that growth of population is not evenly spread through out the country. There is, therefore, a greater need to improve employment skills rapidly in regions with higher population growth and higher unemployment.

FISCAL POLICY

II.62 While the front-loaded revenue augmenting fiscal policy for 2004-05 led to a reduction in revenue and fiscal deficits by more than twice the stipulated minimum thresholds under the FRBM Rules, the ‘pause’ in the FRBM path in 2005-06 has resulted in a slowdown in the progress towards fiscal consolidation. Both revenue deficit and gross fiscal deficit, relative to GDP, slipped in 2005-06 over their levels in 2004-05. With the resumption of progress in approaching FRBM targets in 2006-07, reductions in key deficits have been budgeted to fulfil only the minimum annual stipulations. Consequently, larger deficit reductions in 2007-08 and 2008-09 will be required to meet the FRBM targets. Given that revenue expenditure has remained broadly stable in the last decade and a half, and non-tax receipts continue to be sluggish, the scope for deepening fiscal empowerment lies in improving tax revenue. This would require concerted efforts in substantially improving the tax/GDP ratio through further widening of the tax base and severe curtailment in tax exemptions. In this regard, the Government has identified several exemptions, both in direct as well as indirect taxes, and the continuance of these exemptions is proposed to be reviewed after receiving public feedback and examining the rationale thereof. Broadly, such exemptions are end-use based or have outlived their utility or need certification or give rise to disputes. Removal/reductions of tax exemptions would not only lead to higher tax/GDP ratio but would also enhance economic growth since tax exemptions and deductions distort allocative efficiency, undermine horizontal and vertical equity, increase compliance costs and impose administrative burdens. The Government’s strategy of augmenting tax collection through, *inter alia*, liquidation of tax arrears and improvement in tax administration needs to be continued with greater vigour in the wake of expected sluggishness in non-debt receipts. In addition, the tax regime could be revisited in a comprehensive fashion to minimise transaction costs and remove regressive elements, thus contributing to both growth and fairness in public policy.

II.63 On the expenditure front, with the scope for increasing outlays being constrained by compulsions to meet FRBM targets, reprioritisation needs to be continued so as to ensure adequate investment in the social sector. The shift in emphasis from outlays to outcomes of plan expenditure since 2005-06 with the objective of improving the efficiency of the delivery mechanism needs to be extended to non-plan expenditure as well. A beginning has been made in this regard with the Outcome Budget of Ministry of

Finance for 2006-07 also covering select non-plan schemes apart from plan expenditure. The Government has proposed a thorough review of Plan schemes ahead of the Eleventh Plan so as to merge similar schemes, review schemes of sub-critical size and redesign schemes to improve asset creation role of plan expenditure. These measures along with containment and proper targeting of subsidies would enable effective expenditure management.

II.64 The persistence of large fiscal deficits in the past has resulted in accumulation of outstanding debt which is substantially high by international standards. The interest burden of the Government, therefore, continues to be high constraining the Government's ability to increase social sector and other productive outlays. Budgetary implications of issuance of oil bonds, outlays on the National Rural Employment Guarantee scheme and revenue implications of special economic zones also need to be factored.

II.65 Adhering to the FRBM targets in respect of fiscal deficit and revenue deficit is, therefore, critical for macroeconomic, financial, external sector and budgetary sustainability. Furthermore, as use of borrowed resources for meeting the current expenditure requirements has resulted in widening of asset-liability mismatches over the years, it is essential to eliminate revenue deficit and generate sufficient revenue surplus which may be utilised for asset creation without creating liabilities. Any slippage in achieving the FRBM targets could erode the gains achieved in the initial year of the FRBM. It could also generate a chain effect at the State levels to relax targets set out in their fiscal responsibility legislations. Any deviation from the FRBM targets will have both national and international repercussions in terms of credibility.

II.66 As regards State finances, notwithstanding the progress in fiscal consolidation since 2004-05, structural rigidities persist as manifested in sluggish non-tax revenue, downwardly rigid non-development expenditure and low allocation in respect of social sectors such as health and education. The State Governments have a major responsibility in regard to provision of social and economic services such as education and health and economic infrastructure such as roads, waterworks and power. In order to make the process of fiscal consolidation durable and sustainable, adequate investment in economic infrastructure and spending on social services would be essential. Accordingly, the States would be required to incur higher outlays on the provision of these services. Against this backdrop, a desirable path to fiscal correction lies through fiscal empowerment, *i.e.*, by expanding the scope and size of revenue flows into budget, rather than fiscal enfeeblement. Augmenting resource mobilisation from non-tax revenue through appropriate user charges and restructuring of State public sector undertakings continues to be of critical importance. Higher user charges will, however, not be feasible unless there is a greater efficiency in the delivery of the services provided by the States. Therefore, improving delivery of public services should be a priority for the State Governments. The issues of power subsidies also need to be addressed.

II.67 Finally, while the fiscal responsibility legislations address the need to constrain deficits of the Central and State Governments, there are no such rules for containing the deficits of the public sector undertakings. As borrowing needs of different segments of the public sector increase and the need to monitor the market behaviour and responses increases, it would be desirable to assess the overall public sector borrowing requirements.

EXTERNAL SECTOR

II.68 Merchandise export growth of 24 per cent per annum, on average, in the past four years points to the growing competitiveness of the Indian manufacturing. In the current fiscal year, export growth has remained strong so far, *albeit* with some deceleration. India's export base (*i.e.*, the commodity and country composition) is far more diversified now than it used to be in the early 1990s. Improvements in infrastructure assume critical importance for maintaining and improving our competitiveness as also encouraging investment in export production and sustaining the pace of export growth in the longer term.

II.69 As the Asian region has developed, intra-Asian trade has gathered momentum leading to even higher economic integration within the region. In the recent years, the Asian economies have, therefore, emerged as major trading partners of India. Emerging Asian economies accounted for a significant share of 22.6 per cent in India's total exports in 2005-06 (15.6 per cent in 2000-01) and 29.0 per cent of India's total non-oil imports (22.1 per cent in 2000-01). China has emerged as the third major export destination for India after the US and the UAE; it has now become the largest source of non-oil imports for India, surpassing the US. India is also at various stages of negotiation for entering into various regional economic cooperation, free/preferential trade agreements and bilateral investment treaties with its Asian neighbours.

II.70 The engagement of Indian firms with the world has acquired new dimensions. Apart from its leading edge in the software services, India has also the potential for becoming a centre for manufacturing in certain sectors. The Indian information technology industry is becoming increasingly global through cross-border acquisitions, on-shore contract wins and organic growth in other low-cost locations. This has been complemented by global majors continuing to significantly improve their off-shore delivery capabilities in India. Indian firms are also acquiring manufacturing firms abroad to leverage comparative advantage of foreign locations, using synergies between the parent company and the company under acquisition and having production facilities near the major markets also. The acquisitions are also driven by the need to have a marketing and distribution base as well as the need to acquire appropriate technologies. The attainment of domain knowledge through such activities, along with best practice business knowledge, and economies of scale in marketing may enhance the productivity growth of Indian business. Reportedly, there is an increasing emphasis on service approach to manufacturing with adaptation of techniques such as lean production to keep quality high and boost efficiency. These tendencies are perhaps reflective of a penchant for innovation among growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive.

II.71 The buoyancy observed in service exports in the recent years is likely to strengthen as exports of business and professional services gather further growth momentum. The remittances from overseas Indian workers are also likely to remain an important and stable source of financial inflows with a continuous transition to higher skill categories of the Indian migrant workers. For the full potential of earnings from exports of services to be realised, issues relating to skill enhancement and quality of education assume greater importance. Demand for education, especially higher education, is expected to grow immensely in the coming years in view of the demand emanating from knowledge intensive nature of the services sector as well as demands from the manufacturing sector. In view of reports of growing shortages of skilled human power, policies that hinder setting up of high quality educational institutions need to be ironed out. Public-private partnership in the field of education holds great promise for equipping the country with institutes of excellence.

II.72 The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements. India's foreign exchange reserves are comfortable in terms of various reserve adequacy indicators. The increase in the reserves in recent years has been mainly on account of higher capital flows rather than a surplus on the current account. The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary. These policies have served the country well so far.

II.73 Persistent rise in international crude oil prices to record highs has led to hardening of consumer price inflation in a number of economies. Core inflation and inflation expectations have also indicated signs of edging higher in recent months. Higher oil prices coupled with ongoing monetary tightening globally are expected to lead to slowdown in aggregate demand and output.

II.74 Apart from higher oil prices, global economic prospects continue to be marked by the risk of a disorderly adjustment to the rising level of global imbalances and their changing distribution across nation states and country groups. International financial markets have witnessed large volatility since May 2006 after having remained benign during 2005 and early part of 2006. Risk premia on a wide variety of risky assets – equities, corporate bonds, emerging markets debt, housing and real estate property assets and government bonds – had declined during 2005, reflecting investors' appetite for risk despite the major macroeconomic risks. However, beginning mid-May 2006, concerns over higher US inflation and possibility of larger than anticipated monetary tightening seemed to have unnerved global financial markets. As a result, investors pulled out of risky assets, especially from those of emerging market economies. Stock markets in many emerging economies recorded large losses while exchange rates came under pressure. The flight to safety led to easing of the yields on gilts in the US and other major economies. Financial markets are currently re-pricing risks in an environment of uncertainty and, in particular, in emerging market economies. There is uncertainty as to whether the process of re-pricing of risks, in general, is complete; and whether corrections are incomplete in the economies which benefited from lower-priced risks in the past. These developments pose downside risks to the growth prospects of the Indian economy.

FINANCIAL SECTOR

II.75 The various reform measures in the financial sector since the early 1990s have had a positive impact on the overall efficiency, productivity and stability of the banking system in India. The measures have also enabled accelerated economic growth in an environment of macroeconomic stability. The financial system is now robust and resilient, contributing to public confidence and overall stability.

II.76 Consistent with the policy approach of conforming the financial sector in India to the best international standards with emphasis on gradual harmonisation with the international best practices, all commercial banks in India are required to start implementing Basel II with effect from March 31, 2007. Banks in India will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some of the banks may be allowed to migrate to the Internal Rating Based (IRB) Approach. On current indications, implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. The cushion available in the system, which at present has a Capital to Risk Assets Ratio (CRAR) of over 12 per cent, provides for some comfort but the banks are exploring various avenues for meeting the capital requirements under Basel II. In addition to the issue of a Guidance Note on Operational Risk Management and the issue of draft guidelines on implementation of the New Capital Adequacy Framework, the Reserve Bank has, for its part, issued policy guidelines enabling issuance of innovative perpetual debt instruments and debt capital instruments by banks so as to enhance their capital raising options. It has also been decided that banks may augment, their capital funds through issuance of perpetual non-cumulative preference shares and redeemable cumulative preference shares; guidelines in these cases will be issued separately in due course.

II.77 Taking into account the size, the complexity of operations, the relevance to the financial sector, the need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to the various entities in the financial sector have been maintained at varying levels of stringency. In the post-March 2007 scenario, thus, Basel II, Basel I and non-Basel entities will be operating simultaneously in the Indian banking system. The three-track approach would not only ensure greater outreach of banking business, but also, in the present scenario of high growth, enable the banks to usefully lend to the disadvantageous sections and successfully pierce the informal credit segment. The three-track approach to Basel II implementation can, in principle, give rise to scope for regulatory arbitrage within the banking system. This would, however, not be of much concern in the Indian context on account of the relatively insignificant size of the non Basel II entities and their relevance from the systemic perspective.

II.78 With gross domestic savings rate of nearly 30 per cent of GDP and the economy recording a growth rate of about 8 per cent annually, a continued increase in household financial savings can be expected. On the production side, there are vast demands for financing the infrastructure investment, the growing services sector, SMEs and rural enterprises. The emphasis on financial inclusion will also lead to enhanced need for financial intermediation. The banking system has to respond adequately to these new challenges, opportunities and risks. Innovative channels for credit delivery for serving these new rural credit needs, encompassing full supply chain financing, covering storage, warehousing, processing, and transportation from farm to market will have to be found.

II.79 While continuing with its efforts to strengthen the domestic financial sector, the Reserve Bank has been laying an increasing stress on financial inclusion with particular attention to issues relating to farmers. A beginning has already been made to ensure greater outreach of banking facilities in rural areas through appointment of reputed non-governmental organisations (NGOs)/post offices *etc.* as banking facilitators and banking correspondents. The Reserve Bank will pursue with its efforts to ensure greater outreach of banking facilities in rural areas and to ensure availability of bank finance at reasonable rates with focus on measures to assist distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme.

II.80 The Reserve Bank is also laying greater stress on customer services to improve basic banking services provided to the common persons. A Banking Ombudsman facility has been established covering all States and Union Territories for redressal of grievances against deficient banking services. The recently constituted Banking Codes and Standards Board of India is an important step in this regard which is expected to ensure that the banks formulate and adhere to their own comprehensive code of conduct for fair treatment of customers. To provide a framework for a minimum standard of banking services, which individual customers can legitimately expect, a “Code of Bank’s Commitment to Customers” has been released. A similar code for lending to SMEs, such as on the lines of the Business Banking Code in the UK, would be useful to nurture the SME sector given their importance in the Indian economy.

MONETARY POLICY

II.81 In the light of high credit growth, the need to ensure asset quality assumes importance. The Reserve Bank has accordingly drawn attention of the banking sector to maintain asset quality. Although the increase in bank credit has been quite broad-based, expansion in bank credit to some sensitive sectors such as commercial real estate was quite large. Appropriate measures such as higher risk weights in case of sectors that have witnessed very high growth and increased provisioning requirements have been put in place in order to ensure financial stability. Furthermore, banks have been advised to put in place stricter credit appraisals on a sectoral basis, monitor loan-to-value ratios and generally ensure the health of credit portfolios on an enduring basis.

II.82 Concomitantly, in view of the observed increased dependence of banks on short-term non-core bulk deposits raised from corporates, banks were advised to focus on mobilisation of retail deposits which have durability. Bulk deposits raised at relatively higher rates can not sustain a higher credit demand on an enduring basis and have a potential for adverse consequences for balance sheet management and profitability. Banks were advised to review their policies and make sustained efforts towards mobilising stable retail deposits by providing wider access to better quality of banking services. This would sustain prudent business expansion without facing undue asset-liability mismatches.

II.83 Consistent with the multiple indicator approach adopted by the Reserve Bank, monetary policy in India has emphasised the need to be watchful about indications of rising aggregate demand embedded in consumer and business confidence, asset prices, corporate performance, the sizeable growth of reserve money and money supply, the rising trade and current account deficits and, in particular, the quality of credit growth. In retrospect, this risk sensitive approach has served the country well in containing aggregate demand pressures and second round effects to an extent. It has also ensured that constant vigil is maintained on threats to financial stability through a period when inflation was on the upturn and asset prices, especially in housing and real estate, are emerging as a challenge to monetary authorities worldwide. Significantly, it has also reinforced the growth momentum in the economy. It is noteworthy that the cyclical expansion in bank credit has extended without encountering any destabilising volatility but this situation warrants enhanced vigilance. In this context, despite sustained pressures from record high international crude oil prices as well as pressures from prices of primary food articles, inflation has been contained while keeping inflation expectations low and stable. This has been facilitated by timely and appropriate monetary policy measures. In this context, it is also important to recognise the importance of inflation perceptions. If the prices of commodities, which are purchased frequently, rise, the perception of inflation would be different from say, a rise in the price of television set. While recognising the overlap, the distinction between inflationary expectations and inflation perceptions in the context of inflation policy is worth bearing in mind. Inflation perceptions tend to harden if prices of frequently purchased goods increase.

II.84 In the context of the recent firming up of headline inflation across the globe, primarily on account of higher oil and other commodity prices, issues of proper measurement of inflation and inflationary pressures have attracted renewed debate. In particular, the debate involves the relevance of core inflation as a guide for the conduct of monetary policy *vis-à-vis* the use of headline inflation. Use of core measures is debatable in the current context of record high crude oil prices. A core measure is useful if a shock is temporary. In the current scenario, a large part of increase in the oil price is widely believed to have a large permanent component. Therefore, the use of core inflation excluding oil prices could be somewhat misleading. Furthermore, the current high oil prices reflect in large part the increase in global demand for oil from countries such as China. At the same time, these emerging economies have added to global supply of manufactures and this has kept prices of tradables low. Thus, exclusion of high oil prices while including the benefits from low prices of tradables – both of which are a result of the phenomenon of increased globalisation – is conceptually debatable. In India, core inflation is not considered relevant for several reasons, especially because the two major sources of supply shock, food and fuel, account for a large share of the index. Moreover, pass through of higher oil prices has been halting and not full and the headline inflation in a way understates the problem. Thus, the Reserve Bank in its recent monetary policy communications has emphasised the fact that there is clear evidence of a permanent component in the oil price increase, and hence the headline inflation may be understated till that component is fully passed through. While the permanent component is judgmental, broad magnitudes could be perceived and articulated. Such an explanatory approach to headline and underlying inflation pressure in monetary policy has added credibility to the policy and influenced and guided the inflation expectations in India.

II.85 In this context, distinction between monitoring and influencing inflation expectations on the one hand and giving forward indication on the other has attracted growing interest in recent months. There are dangers of a central bank trying to give forward guidance in a highly uncertain world. The Reserve Bank of India provides detailed information and shares relevant analysis fully to influence expectations while being hesitant to give firm inferences from analysis or forward guidance. Guidance on future course becomes far more difficult when the policy rates of monetary authorities get closer to what appears to be the relevant range of neutral interest rates. This is because the trade offs get more acute, judgmental and contextual relative to a state when interest rates are clearly farther from the range of possible neutral rates and the direction of movement is fairly obvious to all. The challenge of communication gets more daunting, if simultaneously, the inflation expectations are also under stress.

II.86 To conclude, the Indian economy is exhibiting strong fundamentals and displaying considerable resilience. At the same time, there are continuing signs of demand pressures, especially high credit growth, that could exert upward pressure on prices when associated with supply shocks such as from oil. These pressures have the potential for impacting stability and inflation expectations. Against this background, judgments are necessary on a continuing basis as to the relative weights to be accorded to growth and price stability, recognising lags in monetary policy. While domestic developments continue to dominate the economy, global factors tend to gain more attention now than before. The global outlook for growth is positive but downside risks in regard to inflation and re-pricing of risks in financial markets need to be recognised. Hence, it is necessary to strike a balance between reinforcing the resilience of the Indian economy against global risks and giving a boost to growth prospects over the medium-term, taking advantage of global expansion.

PART TWO : THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

III MONETARY AND CREDIT POLICY OPERATIONS

III.1 The key issues that had to be addressed by monetary management during 2005-06 were the risks arising from rising domestic demand, high and volatile international crude oil prices and upturn in the global interest rate cycle. Monetary management also faced some challenges in maintaining stable liquidity conditions, which particularly arose in the last quarter of 2005-06, partly due to transient factors such as the redemption of India Millennium Deposits (IMDs) and partly cyclical factors associated with the upturn in credit demand. Nonetheless, calibrated and pre-emptive monetary measures during the year helped to keep inflation and inflationary expectations well-contained while supporting investment demand in the economy. The Reserve Bank continued with its policy of active demand management of liquidity through the flexible use of policy instruments at its disposal designed to ensure stability in financial markets. With inflation contained and inflationary expectations seen to be consistent with the policy stance, real growth picked up in an environment of price and financial stability, raising expectations of a structural shift in the medium-term growth path of the economy. Monetary policy was particularly effective in ensuring that the cost-push impulses from oil prices did not feed through into aggregate demand conditions. Monetary management during 2005-06 was, thus, conducted broadly in conformity with the stance of the policy set out in the policy statements during the year.

III.2 During 2005-06, the Reserve Bank initiated the system of reviewing the Annual Policy Statement on a quarterly basis as against the prevailing system of a half-yearly review. With a view to further strengthening the consultative process in monetary policy formulation, the Reserve Bank, in July 2005, set up a Technical Advisory Committee on Monetary Policy (TACMP) with external experts in the areas of monetary economics, central banking, financial markets and public finance. The Committee meets at least once in a quarter and reviews macroeconomic and monetary developments, and advises the Reserve Bank on the stance of monetary policy. The Committee has met five times since its inception and has contributed to enriching the inputs and processes of policy setting.

III.3 The fixed reverse repo rate, the price at which the Reserve Bank absorbs liquidity under the LAF was increased by 75 basis points during 2005-06 – 25 basis points each on three occasions (April 2005, July 2005 and January 2006) – to 5.50 per cent by end-March 2006. The repo rate, the price at which the Reserve Bank injects liquidity under the LAF, was hiked twice – 25 basis points each during October 2005 and January 2006 – to 6.5

per cent by end-March 2006. The spread between the repo rate and the reverse repo rate has, thus, been progressively reduced to 100 basis points by end-April 2005 from 200 basis points at end-March 2003.

Bank Rate

III.4 The Bank Rate signals the medium-term stance of monetary policy. Keeping in view the assessment of the economy including the outlook for inflation, the Bank Rate was retained at the existing level of 6.0 per cent, unchanged since April 2003.

Cash Reserve Ratio

III.5 The cash reserve ratio (CRR), which was increased by 50 basis points during September-October 2004, was left unchanged at 5.0 per cent of the net demand and time liabilities (NDTL) during 2005-06. All scheduled commercial banks (excluding RRBs) complied with CRR requirements during 2005-06. In line with the stipulation, banks generally maintained minimum daily level of 70 per cent of fortnightly CRR requirement on all the days.

III.6 Consequent upon amendment to sub-Section 42(1) of the Reserve Bank of India Act, 1934 in June 2006, the Reserve Bank, having regard to the needs of securing the monetary stability in the country, can prescribe CRR for scheduled banks without any floor rate or ceiling rate. Before the enactment of this amendment, in terms of Section 42(1) of the Act, the Reserve Bank could prescribe CRR for scheduled banks between 3 per cent and 20 per cent of their NDTL. The amendments will provide the Reserve Bank with greater flexibility in the conduct of monetary policy. In the light of the enactment of the Reserve Bank of India (Amendment) Bill, 2006 the Reserve Bank has decided to continue with the *status quo* on the existing provisions of CRR maintenance, including the CRR rate and extant exemptions. Accordingly, scheduled banks shall continue to maintain CRR of 5.0 per cent of their NDTL.

III.7 The Reserve Bank, prior to the amendment of the Act, had been paying interest on scheduled banks' CRR balances above the statutory minimum of 3.0 per cent and up to the prescribed level of 5.0 per cent – known as eligible cash balances – at an interest rate determined by the Reserve Bank, which has been set at 3.5 per cent with effect from September 18, 2004. No interest was payable on any amount upto the statutory minimum CRR balances of 3.0 per cent or any amount actually maintained in excess of the balance required to be maintained. Consequent upon the amendment of sub-Section 42 (1A) of the Act, the statutory minimum CRR of 3.0 per cent no longer exists. Furthermore, with the removal of the sub-Section 42 (1B) of the Act, the Reserve Bank can not pay interest on any portion of CRR balances of banks. Accordingly, no interest is payable on CRR balances with effect from the fortnight beginning June 24, 2006.

III.8 The CRR for non-scheduled banks and non-scheduled cooperative banks continues to be governed by the provisions of Section 18 and Section 56, respectively, of the Banking Regulation Act, 1949 which remain unchanged. Accordingly, non-scheduled banks, including non-scheduled cooperative banks, shall continue to maintain CRR equivalent to 3.0 per cent of their NDTL as on the last Friday of the second preceding fortnight.

Liquidity Management

III.9 Monetary management faced some challenges in maintaining stable liquidity conditions particularly in the last quarter of 2005-06. The recourse of market participants to primary liquidity support from the Reserve Bank during the last quarter of 2005-06 suggested an overlap between frictional and structural liquidity. First, some market participants had not prepared for the liquidity implications of the movements in the interest rate cycle as also the one-off impact of IMDs redemption and, as a consequence, found themselves facing a shortage of liquidity as well as securities eligible for accessing the Reserve Bank's liquidity facilities or even the collateralised money markets. Second, the banking system as a whole was significantly overdrawn in order to sustain the credit disbursements and the persistent mismatches between the sources and uses of funds forced them to seek recourse to borrowing and rolling over on an overnight basis, thereby putting pressure on interest rates and liquidity conditions.

MONETARY POLICY STANCE FOR 2006-07

III.10 Against the backdrop of developments during 2005-06, the stance of monetary policy during 2006-07, as the Annual Policy Statement for 2006-07 noted, would depend on macroeconomic developments including the global scenario. Domestic macroeconomic and financial conditions support prospects of sustained growth momentum with stability in India. It is important to recognise, however, that there are risks to both growth and stability from domestic as well as global factors and, the balance of risks is currently tilted towards the global factors. The adverse consequences of further escalation of international crude prices and/or of disruptive unwinding of global imbalances are likely to be pervasive across economies, including India. Moreover, in a situation of generalised tightening of monetary policy, India cannot afford to stay out of step. Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the prevailing assessment of the economy including the outlook for inflation, the Annual Policy Statement for 2006-07 indicated that the overall stance of monetary policy would be:

- To ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations.
- To focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability.
- To respond swiftly to evolving global developments.

III.11 While leaving the repo rate and the reverse repo rate unchanged, the Reserve Bank took certain prudential measures in April 2006. In the context of continued strong credit growth and in order to maintain asset quality, the Reserve Bank raised risk weight on exposures to commercial real estate and banks' total exposure to venture capital funds further to 150 per cent. The general provisioning requirement on standard advances in specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans was also raised from the existing level of 0.40 per cent to 1.0 per cent.

III.12 On review of macroeconomic and overall monetary conditions, the Reserve Bank increased the reverse repo rate and the repo rate by 25 basis points each to 5.75 per cent and 6.75 per cent, respectively, with effect from June 9, 2006.

Quarterly Review of Monetary Policy

III.13 In its First Quarter Review of Annual Statement on Monetary Policy in July 2006, the Reserve Bank observed that the domestic economy is exhibiting strong fundamentals and displaying considerable resilience. At the same time, the Review pointed out that disturbing signs of demand pressures, especially continuing high credit growth, could exert upward pressure on prices when associated with supply shocks such as from oil. These pressures have the potential for impacting stability and inflationary expectations. Although domestic developments continue to dominate the Indian economy, global factors tend to gain more attention now than before. While reaffirming its forecast for GDP growth of 7.5-8.0 per cent as set out in the April 2006 Statement, the Reserve Bank observed that 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. On balance, the Reserve Bank indicated that a modest pre-emptive action in monetary policy was appropriate. Accordingly, the Reserve Bank increased the reverse repo rate and the repo rate further by 25 basis points each to 6.00 per cent and 7.00 per cent, respectively, with effect from July 25, 2006.

CREDIT DELIVERY

III.14 Public sector banks, private sector banks and foreign banks, as groups, achieved the overall target for priority sector lending as on the last reporting Friday of March 2006. However, two public sector banks and 11 private sector banks could not achieve the overall priority sector lending target of 40 per cent.

Credit to Agricultural Sector

III.15 The Reserve Bank had advised public sector banks in 1994-95 to prepare Special Agricultural Credit Plans (SACPs) on an annual basis. During the fiscal year 2005-06, the disbursements to agriculture under this Plan, at Rs.94,278 crore, exceeded the target of Rs.85,024 crore. The SACP mechanism has been made applicable to private sector banks from the year 2005-06. Disbursements to agriculture by private sector banks were Rs.30,386 crore (provisional) as against the target of Rs.24,222 crore for the year.

III.16 With a view to doubling credit flow to agriculture within a period of three years and to provide some debt relief to farmers within the limits of financial prudence, the Union Finance Minister had announced several measures on June 18, 2004. While the Reserve Bank and the IBA issued necessary operational guidelines to commercial banks, NABARD issued similar guidelines to regional rural banks (RRBs), state cooperative banks (StCBs) and district central cooperative banks (DCCBs). As against a target of

Rs.1,05,000 crore to agriculture sector for the year 2004-05, banks (including cooperative banks and RRBs) disbursed Rs.1,15,243 crore, a growth of 32 per cent over the actual disbursement of Rs.86,981 crore during 2003-04. For the year 2005-06, banks were advised to increase the flow of credit to agriculture to Rs.1,42,000 crore. As against this target, the disbursement by all banks during the year 2005-06 was Rs.1,57,480 crore, a growth of 37 per cent over the disbursement during the previous year.

III.17 The Union Finance Minister, in his budget speech for the year 2006-07, asked the banks to increase the level of agricultural credit to Rs.1,75,000 crore during the year 2006-07 and also add another five million farmers to their portfolio. In view of tenant farmers not being adequately served, banks have been asked to open a separate window for Self-Help Groups (SHGs) or joint liability groups of tenant farmers and ensure that a certain proportion of the total credit is extended to them.

III.18 Outstanding agricultural advances of public as well as private sector banks increased by 40.9 per cent and 67.2 per cent, respectively, during 2005-06. While the share of agricultural advances in bank credit for public sector banks decreased marginally during the year, that of private sector banks increased.

III.19 The recovery of direct agricultural advances of public sector banks continued to show improvement during the year ended June 2005.

IV DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

IV.1 During 2005-06, a number of steps were taken to strengthen the institutional framework for financial markets in terms of instruments and processes so as to improve price discovery. Simultaneously, the orderly functioning and soundness of financial market segments has been pursued through regulatory initiatives. The policy initiatives during 2005-06 were particularly guided by provisions of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. The FRBM Act, *inter alia*, prohibits the Reserve Bank from participating in the primary market for Central Government securities with effect from April 2006. This development has completed the transition to a fully market based issuance of Government securities, a process that was initiated in the early 1990s with the introduction of auctions. The implementation of the FRBM Act also necessitated a review of the Reserve Bank's market operations. A Financial Markets Department (FMD) was set up in July 2005 to fully integrate market operations and improve efficiency in the Reserve Bank's operations in the money, Government securities and foreign exchange markets. An Informal Group to examine financial market operations by the Reserve Bank was also constituted to evaluate current practices in regard to market operations and refinements in the operating procedure in accordance with evolving circumstances.

MONEY MARKET

IV.2 The money market provides a focal point for the central bank's operations in influencing liquidity and transmitting the monetary policy impulses. The broad policy objectives that are being pursued for the development of money market include ensuring stability in short-term interest rates, minimising default risk and achieving a balanced development of various segments of the money market. Following recommendations of the Technical Group on Money Market (May 2005), the focus and policy thrust of the Reserve Bank in the money market has been towards encouraging the growth of collateralised segment, developing the rupee yield curve, ensuring transparency and better price discovery, providing avenues for better risk management and strengthening monetary operations.

GOVERNMENT SECURITIES MARKET

IV.3 In light of the FRBM Act under which the Reserve Bank can no longer participate in primary issues of Central Government securities from April 1, 2006, a number of initiatives were taken during 2005-06 to deepen and widen the Government securities market. Various initiatives during the year included permitting intra-day short sale; introduction of 'When Issued' markets; proposals for active consolidation of Government securities; greater responsibilities for PDs to support primary issuances, such as, 100 per cent underwriting commitments for PDs; allowing PDs to diversify and expand their business; and the operationalisation of NDS-Order Matching (NDS-OM) system.

FOREIGN EXCHANGE MARKET

IV.4 During 2005-06, the Reserve Bank took a number of steps to create a more conducive environment for external transactions while according high priority to customer service. The measures taken on the capital account front are part of gradual and sequenced approach to liberalisation of capital account and for the current account transactions, the objectives were aimed towards the removal of restrictions and simplification of procedures. The procedure for compounding of contraventions was put in place with a view to reducing the transaction costs and providing comfort to the citizens and corporates. Anti-Money Laundering (AML) guidelines have been put in place for prevention of money laundering.

IV.5 Services are one of the fastest growing sectors in the Indian economy and contribute substantially to output, employment and exports. The Foreign Exchange Management Act (FEMA) regulations are, however, generally oriented to trade in both goods and services. The unique features of the services sector may need to be specifically and clearly addressed. It is, therefore, proposed to constitute an Advisory Group to review all foreign exchange regulations relating to services and make appropriate suggestions for further clarification or simplification and prepare a compendium of all foreign exchange regulations that apply to the services sector.

Outlook

IV.6 The Reserve Bank will continue with its efforts to deepen and widen the various segments of the financial markets in order to enable efficient price discovery in interest rate and exchange rate markets. In regard to foreign exchange market, the calibrated liberalisation of capital account transactions will be continued. Given the fact that the Reserve Bank is not participating in primary issuance of Central Government securities with effect from April 1, 2006 and States will have to be more market dependent, this situation calls for a paradigm shift in the Government securities market. The Reserve Bank will, therefore, continue to take initiatives to widen and deepen the market so as to ensure that the borrowing programme of the Government is successfully carried out and the cost of borrowing is also kept at a reasonable level.

V FINANCIAL REGULATION AND SUPERVISION

V.1 The Reserve Bank undertook various measures during 2005-06 to strengthen the financial sector with a view to maintaining financial stability. Various policy initiatives during 2005-06 were guided by the need to prepare the commercial banks for implementation of Basel II. In view of the enlarged capital requirements under Basel II, banks were permitted to raise capital through new instruments. In order to provide a benchmark for banks to establish a scientific operational risk management framework, a guidance note was issued to banks. In the context of sharp growth in bank credit to a few sectors, prudential measures were tightened for the specific sectors to safeguard the health of the banking system. Concomitantly, the Reserve Bank laid an increasing emphasis on financial inclusion to provide the financial services to vast segments of the population. Apart from scheduled commercial banks, which are the dominant players in the financial sector, initiatives to strengthen other segments of the banking system were intensified. In the case of regional rural banks, the focus was on amalgamations for improving the efficiency of their operations. In regard to urban cooperatives banks, memoranda of understanding have been signed between the Reserve Bank and a few State Governments to overcome, to an extent, the problem of dual control. In the case of non-banking financial companies, the reporting system for large non-deposit taking companies was strengthened to facilitate macro-level assessment.

REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

V.2 The Reserve Bank continued to exercise its supervisory role over the financial system encompassing commercial and urban cooperative banks (UCBs), financial institutions, non-banking financial companies (NBFCs) and primary dealers (PDs) through the Board for Financial Supervision (BFS). As on March 31, 2006, there were 89 scheduled commercial banks [excluding regional rural banks (RRBs)], 133 RRBs, 1,864 UCBs, 8 development finance institutions (DFIs), 13,049 NBFCs (of which 434 NBFCs are permitted to accept/hold public deposits) and 17 PDs. The BFS, constituted as a Committee of the Central Board of the Reserve Bank since November 1994, is headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members. The BFS provides direction on a continuing basis on regulatory polices and supervisory practices. In respect of State and district central co-operative banks, and regional rural banks, while the Reserve Bank is the regulator, the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD). Insurance companies and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI), respectively. A coordinated approach to supervision is ensured through a High-Level Coordination Committee on Financial Markets with the Governor of the Reserve Bank, as Chairman, and the chiefs of SEBI, IRDA and Pension Fund Regulatory and Development Authority (PFRDA), and the Secretary, Economic Affairs, Ministry of Finance, Government of India as the members.

Strengthening Prudential Norms

V.3 The Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) had recommended that, as a prudential measure, a general provision of one per cent of standard assets would be appropriate and this should be implemented in a phased manner. To maintain asset quality in the light of high credit growth during 2005-06, provisioning requirements were tightened in two stages. In November 2005, the provisioning requirement on standard assets, with the exception of direct advances to agricultural and small and medium enterprise (SME) sectors, was raised from 0.25 per cent to 0.40 per cent of the funded outstanding on global loan portfolio basis. In May 2006, the provisioning requirement on standard advances in specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans was raised from 0.40 per cent to 1.0 per cent. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent.

V.4 In order to provide banks additional options for raising capital funds for smooth transition to Basel II, banks were allowed to augment their capital funds by issue of additional instruments.

V.5 Risk weights were tightened during the year for some sensitive sectors. In view of the sharp growth in bank credit to commercial real estate, the risk weight on banks' exposure to the commercial real estate was increased from 100 per cent to 125 per cent in July 2005 and further to 150 per cent in April 2006.

V.6 With effect from July 26, 2005, the risk weight for credit risk on certain capital market exposures was increased from 100 percent to 125 percent. Capital market exposures subject to higher risk weights included: (i) direct investment by a bank in equity shares, convertible bonds and debentures and units of equity oriented mutual funds; (ii) advances against shares to individuals for investment in equity shares [including Initial Public Offerings (IPOs)/Employee Stock Option Plans (ESOPs)], bonds and debentures and units of equity oriented mutual funds; and (iii) secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers and market makers.

V.7 Venture capital funds (VCFs) play an important role in encouraging entrepreneurship. While significance of venture capital activities and need for banks' involvement in financing venture capital funds is well recognised, there is also a need to address the relatively higher risks inherent in such exposures. In the absence of adequate public disclosures with regard to performance/ asset quality of VCFs, prudence demands treatment of exposures to VCFs as ‘high risk’. Accordingly, in May 2006, it was decided that a bank’s total exposure to venture capital funds will form a part of its capital market exposure and banks are, therefore, required to assign a higher risk weight of 150 per cent to these exposures.

Financial Inclusion

V.8 In view of the extant banking practices that tend to exclude, rather than attract, vast sections of population, the Reserve Bank urged banks to review their existing banking practices to align them with the objective of financial inclusion. With a view to achieving the objective of greater financial inclusion, all banks were advised in November 2005 to make available a basic banking ‘no-frills’ account either with ‘nil’ or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population.

Opening Up of Financial Sector

V.9 Indian banks continued to expand their presence overseas during 2005-06. There were 18 Indian banks with overseas operations by end-July 2006, with a network of 168 offices (110 branches, 34 representative offices, 6 joint ventures and 18 subsidiaries) in 47 countries.

V.10 During the calendar year 2005, permission was granted to eight foreign banks to open 13 branches, one more than the existing World Trade Organisation (WTO) commitment of 12 branches in a year. During the calendar year 2006 so far (up to July), four foreign banks have been given permission to open 13 branches. Approval was also given for opening of representative office to one foreign bank during the calendar year 2005. Seven more foreign banks have been given approval to open representative offices during 2006 so far (up to July 2006). At present, 31 representative offices of foreign banks are operating in India.

V.11 The Reserve Bank receives complaints against banks at its offices/ departments. The Government of India also forwards to the Reserve Bank complaints against banks received by it. Such complaints are handled at the regional offices of the Reserve Bank by the regulatory departments concerned, which liaise with the banks named in the complaints. At the central office of the Reserve Bank, receipts of such complaints and liaison with banks concerned were centralised at the Public Grievances and Redressal Cell in the Department of Banking Supervision till June 30, 2006. A separate complaints redressal system, with the Complaints Redressal Cell in the Department of Government and Bank Accounts as the nodal point, was also in place till then to attend to customer service and grievance redressal in respect of services rendered by the Reserve Bank. In order to bring together all activities relating to customer service in banks and the Reserve Bank in a single department, the Reserve Bank constituted on July 1, 2006 a new department called ‘Customer Service Department (CSD)’. The functions of this new department include administering the Banking Ombudsman scheme, taking steps for ensuring transparency in banker-customer relationship, monitoring the working of internal grievance machinery of banks, and liaison with banks, Indian Banks’ Association, Banking Codes and Standards Board of India (BCSBI), Banking Ombudsmen and various customer fora on matters relating to customer service.

V.12 Introduction of the Banking Ombudsman scheme in 1995 to provide expeditious and inexpensive forum to bank customers for resolution of their complaints relating to deficiency in banking services was an important initiative of the Reserve Bank in the area of customer service. The Scheme was revised first in 2002 and again in 2006. The present Banking Ombudsman Scheme, 2006 is applicable to all commercial banks, regional rural banks and scheduled primary cooperative banks having business in India. Banking Ombudsmen currently have their offices in 15 centres spread across the country. The Ombudsman offices are staffed and funded by the Reserve Bank.

V.13 Recognising an institutional gap in measuring the performance of the banks against codes and standards based on established best practices, the Reserve Bank set up the Banking Codes and Standards Board of India (BCSBI) in February 2006. The BCSBI is an autonomous and independent body, adopting the stance of a self-regulatory organisation in the larger interest of improving the quality of customer services by the Indian banking system. Banks register themselves with the Board as its members and provide services as per the agreed standards and codes. The Board, in turn, monitors and assesses the compliance with codes and standards, which the banks have agreed to. The registration of banks with the BCSBI enables the Reserve Bank to derive greater supervisory comfort.

V.14 In view of the importance of the regional rural banks (RRBs) as purveyors of rural credit, and in order to strengthen them, sponsor banks were encouraged to merge, State-wise, the RRBs sponsored by them. In this context, the Government of India, after consultation with NABARD, the concerned State Governments and the concerned sponsor banks initiated the process of amalgamation of the RRBs in September 2005. As a result of these initiatives, 132 RRBs have been amalgamated till August 2, 2006 to form 41 new RRBs (sponsored by 19 banks in 15 States). This has brought down the total number of RRBs from 196 at end-March 2005 and 133 at end-March 2006 to 105 as on August 2, 2006. Some more amalgamation proposals are under consideration of the Government of India.

V.15 Urban cooperative banks (UCBs) complement the efforts of the Reserve Bank towards greater financial inclusion by providing credit facilities to middle class/lower middle class population in the urban and semi-urban areas. In recent years, the Reserve Bank's policy initiatives in regard to UCBs have, therefore, focused on ensuring that they emerge as a sound and healthy network of jointly owned, democratically controlled and ethically managed banking institutions, providing need-based quality banking services, essentially to the middle and lower middle classes and marginalised sections of the society. During 2005-06, the Reserve Bank continued to undertake several initiatives to strengthen the cooperative banking sector.

V.16 The Reserve Bank continued its efforts to strengthen the non-banking financial companies. The submission of quarterly return on important financial parameters of NBFCs not accepting/ holding public deposits and having asset size of Rs.500 crore has been changed to monthly periodicity to facilitate a macro level assessment of large non-deposit taking companies at more frequent intervals. The asset size was also changed from Rs.500 crore and above to Rs.100 crore and above to widen the coverage. Besides, the reporting format has been amended to incorporate additional information relating to capital market exposure covering financing of IPOs, gross sales and purchases in various segments and guarantees issued on behalf of share brokers.

MACRO-PRUDENTIAL INDICATORS REVIEW

V.17 In order to monitor the health and the stability of financial system in India, the Reserve Bank has been compiling macro-prudential indicators (MPIs) from March 2000 onwards. The MPIs comprise both aggregated micro-prudential indicators of the health of individual financial institutions and macroeconomic indicators associated with financial system soundness. India is one of the countries which volunteered to participate in the coordinated compilation exercise of the financial soundness indicators for December 2005 under the aegis of the International Monetary Fund (IMF); the requisite data was forwarded to the IMF on July 31, 2006.

V.18 An overview of MPIs for 2005-06 indicates a further improvement in asset quality of all the constituents of the financial sector. Although there was some decline in the capital adequacy ratios, they remained above the minimum requirements. Return on assets of scheduled commercial banks during 2005-06 was almost the same as in the previous year while that of primary dealers (PDs) witnessed a substantial turnaround.

Outlook

V.19 The Reserve Bank would continue to undertake regulatory and supervisory initiatives to strengthen the financial sector in order to enhance efficiency of resource allocation while ensuring financial stability in the economy. These initiatives will be guided by the objective of benchmarking the financial sector in India to the best international standards, but with emphasis on gradual harmonisation with the international best practices. All commercial banks in India are required to start implementing Basel II with effect from March 31, 2007. While banks will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk, some of them may be allowed to migrate to the Internal Rating Based (IRB) Approach after adequate skills are developed, both by the banks and the supervisors. Banks which are internationally active should look to significantly improve their risk management systems and migrate to the advanced approaches under Basel II since they will be required to compete with the international banks which are adopting the advanced approaches. This strategy would also be relevant to other banks which are looking at adoption of the advanced approaches. Finally, while pursuing with its initiatives to strengthen the financial sector, the Reserve Bank would intensify its efforts to ensure financial inclusion so that banking services are available to all segments of the population.

VI PUBLIC DEBT MANAGEMENT

VI.1 During 2005-06, the Reserve Bank, as the Government's debt manager, continued to be guided by the twin objectives of minimisation of cost over time and elongation of the maturity profile of Government securities in a scenario of an upward shifting yield curve. A number of developments had an impact on the management of the internal marketable debt as well as the liquidity position of the Central and State Governments during 2005-06. First, the sustained pick-up in non-food credit coupled with the rise in international crude oil prices and global interest rates put some upward pressure on domestic interest rates, which affected the volume of transactions and yields on Government securities. Second, reflecting the ongoing fiscal consolidation process, gross fiscal deficit (GFD) of State Governments showed further moderation during 2005-06, which helped to contain the pressure on the demand for funds. Third, following the recommendations of the Twelfth Finance Commission (TFC), Central loans for State Plan schemes were eliminated during 2005-06, exposing the States to greater market discipline. Finally, the financing pattern of the GFD of the State Governments continued to reflect the predominance and buoyancy of small savings, an 'autonomous' source of funds, which helped to reduce the need for accessing alternative market resources, *albeit* at a relatively higher cost.

VI.2 The Reserve Bank continued with its efforts towards imparting liquidity to the Government securities market by favouring reissuances of existing securities. The borrowing programme of the Central Government which was considerably larger than that in the previous year was completed successfully in 2005-06 without any devolvement on the Reserve Bank. Market borrowings by States during 2005-06 also elicited good response reflecting improved market perception of States' fiscal position. Both the Central and the State Governments recorded an improvement in their liquidity positions. The issuances of floating rate bonds were discontinued in 2005-06 due to lukewarm market response in the previous year on concerns about issues relating to their pricing and liquidity.

VI.3 The weighted average cost of market borrowings of the Centre and the States increased for the second consecutive year amidst the general hardening of interest rates across the financial markets. The weighted average maturity of the primary issuances of loans of the Centre during 2005-06 increased by nearly three years as the lukewarm response from banks was neutralised by increased participation by non-bank players, such as insurance companies and pension/provident funds, with higher appetite for longer maturity papers. Furthermore, there was a decline in the spread between primary market cut-off yields in the auctions of dated securities and the prevailing secondary market yields of securities of similar maturity reflecting efficient price discovery on account of the concerted efforts by the Reserve Bank in deepening and widening the market.

CENTRAL GOVERNMENT

VI.4 Reflecting the improvement in its cash position, the Central Government did not resort to overdrafts during 2005-06. Furthermore, the Centre availed WMA on two days only during the year (May 3 and June 4, 2005). In the previous year, although the Centre had not resorted to overdraft, it had availed of WMA on a number of occasions till September 9, 2004. Since then, the Central Government continuously maintained surplus cash balances in its current account with the Reserve Bank up to end-March 2006. While the build-up of the Centre's surplus during 2004-05 had mainly reflected substantial inflows on account of prepayment of high cost debt by the States under the debt swap scheme (DSS), the build-up during 2005-06 mainly reflected the investment of the State Governments in 14-day Intermediate Treasury Bills and auction Treasury Bills. With the ceiling on investment balance retained at Rs. 20,000 crore since October 2004, the Central Government's cash balances in the form of investment balance (Rs.20,000 crore) and cash balance (Rs.28,928 crore) parked as non-interest bearing deposits with the Reserve Bank amounted to Rs.48,928 crore as at end-March 2006 as compared with Rs.26,202 crore in the previous year.

VI.5 With a view to achieving a smooth transition to the new regime as envisaged in the Fiscal Responsibility and Budget Management (FRBM) Act whereby the participation of the Reserve Bank in the primary issuance of Central Government securities has been prohibited with effect from April 1, 2006, and to facilitate market preparedness, the WMA arrangements for 2006-07 were revised in consultation with the Government. As per the revised arrangement, the WMA limits would be fixed on a quarterly basis instead of the existing half-yearly basis. Accordingly, the WMA limits for 2006-07 have been placed at Rs.20,000 crore and Rs.10,000 crore for the first and second quarters, respectively, and Rs.6,000 crore each for the third and fourth quarters of the year. The Reserve Bank would retain the flexibility to revise the limits in consultation with the Government of India taking into consideration the transitional issues and prevailing circumstances. Furthermore, the interest rates on WMA and overdraft have been linked to the repo rate as against the Bank Rate hitherto, following its emergence as the short-term reference rate. Accordingly, the interest rate on WMA will be at the repo rate and that on overdraft will be at repo rate plus two percentage points. During 2006-07 so far (up to August 18, 2006), the Centre did not resort to overdraft but availed of WMA on five occasions (39 days in all).

VI.6 The weighted average yield of the dated securities issued during 2005-06 increased further by 123 basis points to 7.34 per cent. The weighted average maturity of the dated securities issued during 2005-06 increased by 2.77 years to 16.90 years, reflecting appetite for longer maturity papers by non-bank investors such as insurance companies. Despite an increase in the yield during the year, the weighted average coupon on the outstanding stock of Government securities declined further, *albeit* marginally, during the year.

STATE GOVERNMENTS

VI.7 During 2005-06, the average utilisation of normal WMA, special WMA and overdrafts by the States remained substantially lower reflecting an improvement in their overall cash position. There was a reduction in the number of States that availed normal WMA during 2005-06 (12 States as compared with 21 States in 2004-05) as well as the number of days (ranging between 14-63 days, except for Kerala which had availed normal WMA for 240 days as compared with 348 days in 2004-05). Similarly, there was a reduction in the number of the State Governments availing overdraft (eight States as compared with 13 States in the previous year). Only two States resorted to overdraft on more than one occasion during the year. During 2006-07 so far (up to August 18, 2006), six States availed of WMA for a period of 2-61 days while two States resorted to overdraft for a period ranging between 3-15 days. The lower utilisation of WMA reflects persistent cash surplus with State Governments.

VI.8 Based on the recommendations of the Bezbaruah Committee, a revised WMA Scheme for State Governments was put in place for 2006-07. Accordingly, the aggregate Normal WMA limit was increased by 10.5 per cent to Rs.9,875 crore for the year 2006-07. The interest rate on WMA has been linked to the LAF repo rate as against the Bank Rate earlier.

VI.9 During 2005-06, State Governments preferred to borrow through the auction route, raising as much as 48.5 per cent of their total borrowings through auctions (only 2.3 per cent in 2004-05). Twenty-four States opted for the auction route under the market borrowing programme during 2005-06 as compared with only three States in the previous year. In fact, for the first time ever, a State (Punjab) raised the entire amount through the auction mode. The increased recourse to auctions indicated improved market perception of States' fiscal situation as reflected in the lower spread of cut-off yields *vis-à-vis* tap issues (20-50 basis points in auctions as against 50 basis points in tap issues) over Central Government securities of corresponding maturity. The coupon of the tap issuance ranged between 7.53-7.77 per cent while the cut-off yield in the auction of State Government securities ranged between 7.32-7.85 per cent. The wider range of yields at auctions mainly reflected the timing of the issuances which were spread throughout the year (except May, July and October 2005). There were only three tap issuances during 2005-06 (in the months of May 2005, September 2005 and January 2006).

VI.10 The weighted average yield of State Government securities issued during 2005-06 increased to 7.63 per cent from 6.45 per cent during 2004-05. The rise in yields was in line with that of Central Government securities and reflected general upward movement in interest rates. All the securities issued during 2005-06 were of 10-year maturity while in the previous year one issue was of 9-year maturity and two issuances were of 12-year maturity.

Major Initiatives

VI.11 At present, Consolidated Sinking Funds (CSFs) and the Guarantee Redemption Funds (GRFs) of State Governments are invested in Government securities held in the books of the Reserve Bank. The TFC recommended that all States should set up sinking funds for amortisation of all loans (and not just market borrowings) and continue to maintain the Calamity Relief Fund (CRF) in its present form. In the context of these developments and for management of investments of State Governments, the Annual Policy Statement for 2006-07 proposed to revisit the scheme of CSF to cover the entire liabilities of State Governments. It was also proposed to prepare a scheme of CRF in consultation with the Government.

VI.12 The Reserve Bank's Annual Policy Statement for 2005-06 had drawn attention to the likely impact of the implementation of the recommendations of the TFC on the borrowing arrangements for State Governments. In the 16th Conference of State Finance Secretaries convened on April 8, 2005 to specifically discuss the recommendations of the TFC, the necessity to strengthen the joint approach among the Centre, States and the Reserve Bank to ensure a smooth transition to the proposed arrangement was noted. Subsequently in July 2005, the Government of India constituted a Technical Group (Chairperson: Smt. Shyamala Gopinath) comprising members from the Centre, select State Governments and the Reserve Bank to work out the modalities for a smooth transition to the proposed arrangement for States' borrowings. The Group submitted its Report to the Government of India on December 22, 2005. On the basis of the recommendations of the Group, the Annual Policy Statement for 2006-07 proposed to constitute a Standing Technical Committee (STC) under the aegis of the State Finance Secretaries Conference with representation from the Central and State Governments and the Reserve Bank to advise on the wide-ranging issues relating to the borrowing programmes of Central and State Governments through a consensual and co-operative approach.

VI.13 During 2005-06, the 16th and 17th conferences of State Finance Secretaries were held on April 8, 2005 and January 13, 2006, respectively. In the 16th Conference, the recommendations of the TFC and operational issues emanating therefrom were deliberated exclusively. In the 17th Conference, issues relating to market borrowings of State Governments, setting up of Consolidated Sinking Fund, and operational and technical issues regarding Government transactions were discussed. In the Conference, the recommendations of the Report of the Technical Group on Borrowings by State Governments, Report of the Advisory Committee on WMA to State Governments, Report of the Working Group on Liquidity of State Government Securities and Report of the Working Group on Compilation of State Government Liabilities were also discussed. While the recommendations of the WMA Committee have been implemented from the year 2006-07, the Annual Policy Statement for 2006-07 has proposed action points in respect of recommendations made by the Groups on 'Borrowings by State Governments' and 'Liquidity of State Government Securities'.

Outlook

VI.14 The market borrowing programme of the Central Government during 2006-07 is budgeted to be higher than that in the previous year. Furthermore, yields have hardened domestically reflecting oil price induced inflationary pressures and upturn in the international interest rate cycle. The Reserve Bank would endeavour to conduct debt management consistent with the objectives of minimising cost and rollover risk. The Reserve Bank's exit from the primary auctions of Central Government securities and the cessation of Central loans for State Plans necessitating States to mobilise resources from the market call not only for improved liquidity but also newer instruments for managing market risks for a smooth transition to the new environment. Against this backdrop, the steps taken by the Reserve Bank towards deepening and widening the Government securities market through measures such as emphasis on passive consolidation, introduction of intra-day short-selling and 'when issued' market in Government securities as well as allowing new participants and diversification of activities by the existing participants are expected to enhance liquidity and facilitate efficient price discovery for the smooth conduct of debt management operations. As a result of the various market development measures, the combined market borrowing programme for 2006-07, though larger than that in 2005-06, is expected to be completed successfully.

VII CURRENCY MANAGEMENT

VII.1 The Reserve Bank continued to take measures to ensure adequate availability of banknotes and coins while improving the quality of banknotes in circulation. Banknotes with new/ additional security features were introduced during the year. Mechanisation of note processing activities at currency chests and disposal of soiled banknotes remained the major thrust areas towards improving the quality of banknotes. Banks were advised to install note sorting machines at all currency chests. The trend of reverse flow of coins continued although there was some abatement towards the end of the year as demand for coins picked up in a few centres.

BANKNOTES IN CIRCULATION

VII.2 During 2005-06, banknotes in circulation registered growth of 16.8 per cent (13.0 per cent a year ago) in value terms in consonance with acceleration in economic activity. The ratio of currency with the public to broad money fell to 15.1 per cent at end-March 2006 from 15.8 per cent at end-March 2005, continuing with its declining trajectory over the past few years.

VII.3 The growth in volume of banknotes (2.3 per cent) continued to be substantially lower than that in the value, reflecting the ongoing compositional shift towards higher denomination banknotes, particularly Rs.1000 and Rs.500 denominations. The volume of banknotes in circulation of Rs.2, Rs.5, Rs.10 and Rs.50 denominations declined further during the year. On the other hand, the volume of banknotes in circulation of Rs.100 denomination recorded an increase of 9.2 per cent while those of Rs.500 and Rs.1000 denominations recorded sharp increases of 19.4 per cent and 52.7 per cent, respectively. In terms of volume, Rs.100 denomination notes continue to lead the circulation while in terms of value, Rs.500 denomination notes take the largest share.

VII.4 Total supplies by the Presses were 47 per cent of indent in terms of volume and 41 per cent of indent in terms of value. The shortfall in supply was due to the delay in arrival of Cylinder Mould Vat Watermarked Bank Note (CWBN) paper with revised specifications for printing of banknotes with new/additional security features and the decision to commence printing of new design banknotes only on exhausting old design paper to avoid mixing of old and new notes and to salvage maximum number of old design notes from semi-processed sheets. Although supply was less than 50 per cent of the indent, the available supplies were distributed judiciously by arranging supplies from surplus circles to needy circles, especially during festival season. Furthermore, the return of soiled notes recorded a decline from 11,285 million pieces in 2004-05 to 9,304 million pieces in 2005-06. No case of any short supply of banknotes was reported.

CLEAN NOTE POLICY

VII.5 The Reserve Bank persevered with its efforts to improve the quality of banknotes in circulation. In addition to regular supply of fresh notes, speedier disposal of soiled banknotes, mechanisation of cash processing activity, and discontinuance of the practice of stapling banknotes have contributed to improvement in quality of banknotes. Banks have also been issued directives instructing, *inter alia*, to sort banknotes into issuable and non-issuable, issue only clean notes to public and to remit the soiled notes in unstapled condition to the Reserve Bank through currency chests.

New/Additional Security Features of Banknotes

VII.6 Security features of banknotes are reviewed continuously and updated periodically with the objective of staying ahead of the counterfeiters and to maintain the confidence of the public in the banknotes as also to take advantage of the latest innovations. In continuation of this process, the Reserve Bank introduced banknotes with the following new/additional security features in a phased manner in 2005-06: (a) demetallised, magnetic and machine readable windowed security thread with a colour shift from green to blue in Rs.100, Rs.500 and Rs.1000 denominations, (b) improved intaglio printing, (c) improved see-through feature having the denominational numeral instead of the floral design and (d) electrolyte watermark having denominational numeral alongside Mahatma Gandhi portrait in the watermark window. These enhanced features approved for banknotes of Rs.10, Rs.20, Rs.50, Rs.100, Rs.500 and Rs.1000 denominations have already been introduced. Press briefings and posters containing the pictorial details on security features of banknotes with additional/new security features for educating the public were made available to all the banks. Posters in Hindi and English have been put on the website of the Reserve Bank. Regional offices have also been advised to create public awareness at the local level through public organisations like the railways and police authorities. The publicity is being carried out continuously. All banks have been advised to set up a Forged Note Vigilance Cell at their Head Offices to closely monitor detection of counterfeit banknotes at currency chests and initiate control/measures on the dispensation of counterfeit banknotes through ATMs or over the counters. Banks have also been advised to install note sorting machines at their currency chest branches to, *inter alia*, detect counterfeit banknotes so that they are not issued through ATMs/cash counters or any other delivery channel at the bank branches.

VII.7 It has been decided to introduce star series numbering system for replacement of defectively printed banknotes at the printing presses.

Computerisation of Currency Management

VII.8 The Reserve Bank has taken up the task of putting in place an Integrated Computerised Currency Operations and Management System (ICCOMS) in the Issue Departments in regional offices and in the central office. The project also includes computerisation and networking of the currency chests with the Reserve Bank's offices to facilitate prompt, efficient and error-free reporting and accounting of the currency chest transactions in a secure manner. It is expected that the IT initiatives taken by the banks for computerisation of branch operations coupled with the advances in the communication facilities in the country will provide the necessary environment for successful implementation of the system across all banks and all over the country.

Outlook

VII.9 The Reserve Bank will continue with its key objectives of providing adequate supply of good quality banknotes and coins in the country. The ongoing computerisation of currency chests along with enhanced mechanisation of note processing would help to improve the quality of banknotes. The Reserve Bank will pursue with its efforts to further strengthen security features in banknotes to offset challenges posed by counterfeiting. Efforts will, therefore, continue to ensure availability of coins and banknotes to the consumers in their day-to-day cash transactions, to combat the counterfeiting of banknotes, to examine various options for increasing the circulation life of banknotes of lower denominations, to ensure printing of banknotes to very strict quality rules/ standards, to review the banknotes and coins handling practices including recycling of banknotes and coins, to upgrade banknote security features on a continuous basis, and to put in place an integrated computerised system for management of currency.

VIII PAYMENT AND SETTLEMENT SYSTEMS AND INFORMATION TECHNOLOGY IN THE RESERVE BANK

VIII.1 Payment and settlement systems play a vital role in the efficient functioning of the financial system. The Reserve Bank, therefore, continued to strengthen the institutional framework for payment and settlement systems during 2005-06. The 'Payment and Settlement Systems Vision Document (2005-08)' was released in May 2005 laying down a road-map for the medium-term. The Reserve Bank focused on promoting electronic funds transfer (EFT) during the year with a view to bringing about efficiency in the retail and large value payment systems. The National Electronic Funds Transfer (NEFT) system for catering to retail payment requirements was operationalised in November 2005, a month ahead of the target. A noteworthy event in the payment and settlement systems is the growing popularity of the Real Time Gross Settlement (RTGS) system which enabled the discontinuation of the paper based inter-bank clearing during 2005-06.

VIII.2 The role played by information technology (IT) in the financial sector is considerable. The banking sector, in particular, has been an extensive user of IT for improving efficiency and customer service with the introduction of new technology oriented delivery channels. The Reserve Bank, therefore, published the 'Financial Sector Technology Vision Document' in July 2005 for facilitating smooth and orderly technological upgradation of the financial sector.

Board for Regulation and Supervision of Payment and Settlement Systems

VIII.3 The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has been constituted as a Committee of the Central Board of the Reserve Bank since March 2005. The Board lays down policies relating to the regulation and supervision of all types of payment and settlement systems, sets standards for existing and future systems, authorises the payment and settlement systems, determines criteria for membership to these systems, including continuation, termination and rejection of membership. The Department of Payment and Settlement Systems provides secretarial assistance to the BPSS. The BPSS, since its constitution on March 7, 2005, has met on five occasions till June 2006.

PAYMENT SYSTEMS

VIII.4 The overall turnover in the various payment and settlement systems rose by 35 per cent during 2005-06 on top of 67 per cent during 2004-05. The turnover in respect of RTGS transactions increased sharply. In terms of value, turnover in RTGS now constitutes the largest component, followed by foreign exchange clearing and high value clearing among the Systemically Important Payment Systems (SIPS).

SETTLEMENT SYSTEMS

VIII.5 Paper-based clearing remains the most important segment of the retail payment and settlement system. New MICR cheque processing centres (CPCs) started operations at 10 centres during 2005-06, increasing the total number of centres to 53. These centres account for about 83 per cent and 85 per cent of the total cheque volumes and value, respectively. MICR CPCs will be set up at six more centres by March 2007.

Real Time Gross Settlement System

VIII.6 The implementation of Real Time Gross Settlement (RTGS) system has revolutionised the large value payment system in the country by facilitating faster movement of funds across accounts. With the stabilisation of the RTGS, the paper based inter-bank clearing at all the Reserve Bank managed centres was discontinued from June 2005. The RTGS facility was being provided by 96 banks as at end-June 2006, including the Reserve Bank, at over 21,916 branches in 2,793 centres in 469 districts. The value of transactions through RTGS system nearly trebled during 2005-06.

INFORMATION TECHNOLOGY IN THE RESERVE BANK

VIII.7 Information technology (IT) has brought substantial changes in the functioning of organisations the world over in the last decade. In the Reserve Bank too, the use of IT has become vital and an integral part of the day to day operations and functions. With IT becoming an important facilitator, efforts have been made to ensure the smooth implementation of IT while meeting all user requirements with relative ease.

Technology Implementation in the Reserve Bank

VIII.8 The Reserve Bank has made concerted efforts in exploiting the potential of IT based on a set of guiding principles: (i) providing for latest, state-of-the-art systems; (ii) migration towards centralisation to the maximum extent possible; (iii) conforming to the generic architecture for the Reserve Bank and ensuring standardisation of systems; and (iv) providing holistic solutions rather than attempting to provide for individual, stand alone requirements. These guidelines have been followed with due importance to safety and security. Furthermore, the implementation of systems has been pursued using a project based approach with close coordination with the business owners, and by involving external expertise, wherever required.

VIII.9 Various efforts were made in 2005-06 towards consolidation of IT within the Reserve Bank. The year saw the completion of many projects which followed the generic architecture of 'Centralised Data Processing with Decentralised Access'. One of the major activities which got a fillip during the year was the integration of related processing functions. The year witnessed commencement of parallel runs using the new IAS for the DAD at Mumbai. This system is tightly coupled with the RTGS system, thus enabling Straight-Through-Processing (STP) operations between these components. The system is also being provided with interfaces to operate with the Centralised PDO system. A new Centralised PAD system is currently being tested along with the existing system, and will be made fully operational soon; and the consolidation of this with the IAS would make the systems used for operations of the Banking Department of the Reserve Bank function in an integrated way.

Outlook

VIII.10 The Reserve Bank would continue to focus on oversight of the various payment and settlement systems for ensuring safety and improving efficiency. As a step in this direction, the Reserve Bank has framed minimum operational standards for MICR cheque processing centres. These centres will be assessed through quarterly returns against the standards. The Reserve Bank is in the process of bringing out the first Report on Payment Systems Oversight. The Report would help in highlighting the areas which require further improvements. The Reserve Bank would also endeavour to put in place a more formal structure for conducting oversight over existing payment systems. In order to provide a statutory basis for its oversight function over the payment and settlement systems within the country, the Reserve Bank is pursuing with the Government of India for enactment of a separate legislation *viz*., the Payment and Settlement Systems Act. The Bill was introduced in the Parliament on July 25, 2006. The Reserve Bank has also framed the Electronic Funds Transfer Regulations which are awaiting the approval of the Government of India.

VIII.11 The Reserve Bank would continue to harness the full potential of IT to improve operational efficiency. The amalgamation of IT with business requirements would pave the way for capabilities to process increased volume of transactions and provide good and efficient management information system inputs. It would also provide for better risk management and more effective ways of monitoring performance of banks.

IX HUMAN RESOURCE DEVELOPMENT AND ORGANISATIONAL MATTERS

IX.1 During 2005-06, the Reserve Bank continued to take initiatives to manage its human resources to enhance the efficiency of its operations while nurturing the personal growth and well-being of its staff to foster a feeling of pride and belonging. Efforts to upgrade the skills of its human resources as well as of those in the financial sector remained an area of thrust. A key development in this regard was the launching of the *Centre for Advanced Financial Learning* by the Honourable Prime Minister. The other significant initiative was the setting up of the Joint India-IMF Training Programme as a cooperative effort between the International Monetary Fund (IMF) and the Reserve Bank of India. Improving the internal communications mechanism in the Reserve Bank, striving towards a better work life balance, putting in place human resource management systems and working out a substantially improved compensation package were amongst the important initiatives in the area of human resource development. Measures were initiated to ensure transparency in operations and to improve customer service. Initiatives to improve inputs for the conduct and formulation of policies were intensified during the year. The Reserve Bank continued to disseminate information to the public on its policies, their rationale as well as its assessments through speeches by top management and key publications. A noteworthy development was the release of the third volume of the Reserve Bank's History covering the period 1967-81 by the Honourable Prime Minister.

HUMAN RESOURCE INITIATIVES

IX.2 The ongoing opening and liberalisation of the financial sector in India over the last decade and a half has triggered the need for developing a distinctly different set of competencies in banks and financial institutions in India. An urgent need was, therefore, felt for a policy-oriented institute that would promote the study and dissemination of knowledge on the entire range of issues relating to banking and finance and would conduct high-quality research and training for senior executives of banks and financial institutions from a broad, multi-disciplinary perspective. To meet these objectives, a major initiative by the Reserve Bank during the year 2005-06 was the setting up of the *Centre for Advanced Financial Learning*. The Centre was launched by the Honourable Prime Minister of India during the course of his visit to the Reserve Bank's central office on March 18, 2006.

Training and Skills Enhancement

IX.3 As competencies required to perform in the changed environment and context would be vastly different, the Reserve Bank has been trying to shift the focus of its capacity building initiatives from training to learning. In view of this, the three major training colleges of the

Reserve Bank, *viz*., the *Bankers' Training College* (BTC), Mumbai, the *Reserve Bank Staff College* (RBSC), Chennai and the *College of Agricultural Banking* (CAB), Pune have been in process of reorienting their focus for catering to the training needs of the officers of the Reserve Bank and the banking industry. In addition to this, the four *Zonal Training Centres* (ZTCs) located in the four metros across the country continued to focus exclusively on training of Class III and IV staff of the Reserve Bank.

Dissemination Policy

IX.4 The Reserve Bank continued to disseminate information through press releases, publications, notifications, master circulars, speeches, frequently asked questions and advertisements. During the year ended June 30, 2006, the Reserve Bank issued 1,716 press releases, 90 master circulars and 431 notifications. It organised meetings, workshops and seminars to interact with special audiences. The helpdesks in departments and offices continued to furnish replies to the queries raised by the general public mainly through emails.

The Right to Information Act, 2005

IX.5 The Government of India enacted the Right to Information Act, 2005 on June 15, 2005. The Act which came into effect from October 12, 2005 aims at providing the right to information for citizens in order to promote transparency and accountability in the working of every public authority. The Reserve Bank, as a public authority, as defined in the Right to Information Act, 2005 is obliged to provide information to the members of public. During the period up to June 30, 2006, 702 requests (88 per cent of total requests) received under the Act have been resolved. As on June 30, 2006, 74 appeal cases have been filed. Of these, 7 cases have been referred to the Central Information Commissioner (CIC).

Research Activities

Department of Economic Analysis and Policy

IX.6 Department of Economic Analysis and Policy (DEAP) continued to provide analytical research on various aspects of the Indian economy in the conduct and formulation of policies by the Reserve Bank. The Department also contributed to the Reserve Bank's efforts to disseminate information to the public about its policies and assessments through major publications. The statutory reports prepared in the Department and released during the year were the Reserve Bank's Annual Report, 2004-05, and the Report on Trend and Progress of Banking in India, 2004-05.

Department of Statistical Analysis and Computer Services

IX.7 Department of Statistical Analysis and Computer Services (DESACS) conducted various surveys during 2005-06 to provide support to the Reserve Bank's conduct and formulation of policies. Given the growing importance of inflation expectations in the conduct of monetary policy, the Department introduced surveys on inflation expectations and conducted four rounds of the survey during 2005-06.

CENTRAL BOARD AND ITS COMMITTEES

IX.8 Eight meetings, including one Special meeting, of the Central Board were held during the year ended June 30, 2006. Of these, five meetings were held at traditional centres, *viz*., New Delhi, Kolkata, Chennai and Mumbai and three were held at non-traditional centres, *viz*., Bhopal, Port Blair and Mussoorie. The Special Central Board meeting, held at Mumbai was addressed by Dr. Manmohan Singh, Honourable Prime Minister of India and was attended by Shri S.M. Krishna, Honourable Governor of Maharashtra, Shri Vilasrao Deshmukh, Honourable Chief Minister of Maharashtra and Shri P. Chidambaram, Honourable Union Finance Minister, as Guests of Honour. Former Governors, Shri M. Narasimham, Shri S. Venkitaramanan, Dr. C. Rangarajan and Dr. Bimal Jalan were the special invitees for the meeting. The discussions at the meetings of the Central Board broadly covered matters pertaining to general superintendence and direction of the Reserve Bank's affairs, in which the Directors, with their vast experience in diverse fields, actively contributed to important decisions in areas such as currency management, information technology, human resource development, banking supervision, monetary and credit policy, the Reserve Bank's accounting policy, internal debt management policy and central bank governance. The deliberations of the Board also focused on the critical assessment of the percolation of benefits of growth to the poorer sections of the society and the efficacy of the Reserve Bank's policies relating to agriculture and rural areas. The Central Board and its Committee also reviewed the functioning of Local Boards in their areas of operations. 46 weekly meetings of the Committee of the Central Board were held during the year at Mumbai. The Committee of the Central Board, as usual, attended to the current business of the Reserve Bank, including approval of the Reserve Bank's weekly accounts pertaining to the Issue and the Banking Departments.

Reconstitution of Central Board

IX.9 The Central Board was reconstituted with effect from June 27, 2006. Shri Y.H. Malegam was re-appointed as Member of the Western Area Local Board of the Reserve Bank with effect from June 27, 2006 and was re-nominated as Director of the Central Board under Section 8(1)(b) of the Reserve Bank of India Act, 1934 with effect from the same date. Shri Suresh D. Tendulkar, Dr. U.R. Rao and Shri Lakshmi Chand were appointed as Members of the Eastern, Northern and Southern Area Local Boards of the Reserve Bank, respectively, with effect from June 27, 2006 and were nominated as Directors of the Central Board under Section 8(1)(b) of the Reserve Bank of India Act from the respective Local Boards, with effect from the same date. With effect from June 27, 2006, Shri H.P. Ranina and Dr. A.S. Ganguly were re-nominated as Directors of the Central Board under Section 8(1)(c) of the Reserve Bank of India Act, 1934. Shri Azim Premji, Shri Kumar Mangalam Birla, Smt. Shashi Rekha Rajagopalan, Shri Suresh Kumar Neotia, Dr. A.Vaidyanathan, Prof. Man Mohan Sharma, and Dr. D. Jayavarthanavelu were nominated as Directors under Section 8(1)(c) of the Act with effect from June 27, 2006.

X THE RESERVE BANK'S ACCOUNTS FOR 2005-06

Surplus Transferable to Government of India

X.1 The surplus transferable to the Central Government for the year 2005-06 amounted to Rs.8,404.00 crore, inclusive of Rs.2,106.00 crore towards interest differential on special securities converted into marketable securities. The transfer on account of interest differential is intended to compensate the Government for the difference in interest expenditure which the Government had to bear consequent on the conversion.

INCOME

X.2 The gross income of the Reserve Bank for the year 2005-06 was Rs.26,320.31 crore, which was higher by Rs.7,292.03 crore (38.3 per cent) than the previous year's total income of Rs.19,028.28 crore. There was an increase in income from foreign sources while income from domestic sources declined during the year.

Earnings from Foreign Sources

X.3 The Reserve Bank's earnings from the deployment of foreign currency assets and gold increased by Rs.7,558.56 crore (44.5 per cent) from Rs.16,979.47 crore in 2004-05 to Rs.24,538.03 crore in 2005-06. This was mainly on account of increase in the level of foreign currency assets and hardening of global short term interest rates. Before accounting for mark-to-market depreciation on securities, the rate of earnings on foreign currency assets and gold was 4.1 per cent in 2005-06 as against 3.2 per cent in 2004-05. The rate of earnings on foreign currency assets and gold, after accounting for depreciation, increased from 3.1 per cent in 2004-05 to 3.9 per cent in 2005-06.

Income from Domestic Sources

X.4 Domestic income decreased by Rs.266.53 crore (13 per cent) from Rs.2,048.81 crore in 2004-05 to Rs.1,782.28 crore in 2005-06. The decline in income was mainly on account of reduced profit on sale of securities (from Rs.4,220.52 crore in 2004-05 to Rs.3,776.20 crore in 2005-06) and a decline in interest income on loans due to lower recourse to WMA by Central and State Governments in the face of substantial cash balances.

EXPENDITURE

X.5 Total expenditure of the Reserve Bank declined by Rs.962.17 crore (14.1 per cent) from Rs.6,811.27 crore in 2004-05 to Rs.5,849.10 crore in 2005-06.

Interest Payment

X.6 Interest payment increased by Rs.138.13 crore (10 per cent) from Rs.1,386.28 crore in 2004-05 to Rs.1,524.41 crore in 2005-06. The increase was mainly on account of higher payment of interest on cash reserve ratio (CRR) which was due to higher growth in aggregate deposits during the year. The Bank had earmarked certain Government securities from its Investment Account in order to cover the liabilities in Provident Fund, Superannuation Fund and Encashment of Ordinary Leave Fund. Consequently, interest payments on these funds during 2005-06 (Rs.449.21 crore) have been made from the interest earned on these earmarked securities and hence do not form part of interest payments.

Establishment Expenditure

X.7 Establishment expenditure declined by Rs.733.29 crore (44.4 per cent) from Rs.1,653.17 crore in 2004-05 to Rs.919.88 crore in 2005-06. The decline in establishment expenditure was due to reduction in provision towards Gratuity and Superannuation Fund from Rs.743.06 crore in 2004-05 to Rs.19.26 crore in 2005-06, which was on account of utilisation of additional provision of Rs.515 crore made in earlier year. The establishment expenditure during 2005-06 comprised of salary (45.8 per cent), allowances (23.3 per cent), funds (7.2 per cent) and miscellaneous expenditure (23.7 per cent).

Non-Establishment Expenditure

X.8 Expenditure on security printing comprising, *inter alia*, cost of printing currency notes and cheque forms decreased by Rs.408.71 crore (28.3 per cent) from Rs.1,443.57 crore in 2004-05 to Rs.1,034.86 crore in 2005-06 mainly due to lower supply of notes by 478.30 crore pieces. The expenditure incurred for security printing includes a sum of Rs.106.67 crore paid for banknotes supplied during the previous years.

Currency and Gold Revaluation Account (CGRA) and Exchange Equalisation Account (EEA)

X.9 Gains/losses on valuation of foreign currency assets and gold due to movements in the exchange rates and/ or prices of gold are not taken to Profit and Loss Account but instead booked under a balance sheet head named as CGRA. The balance represents accumulated net gain on valuation of foreign currency assets and gold. During 2005-06, there was an accretion of Rs.59,882.97 crore in CGRA, thus increasing its balance from Rs.26,906.21 crore as on June 30, 2005 to Rs.86,789.18 crore as on June 30, 2006. The balance in CGRA at the end of June 2006 was equivalent to 11.6 per cent of foreign currency assets and gold holdings of the Reserve Bank, as compared with 4.5 per cent at the end of June 2005. The increase was on account of increase in the level of foreign currency assets during 2005-06, hardening of international gold prices, depreciation of rupee against the US dollar and depreciation of US dollar against other currencies. The balance in EEA represents provision made for exchange losses arising out of forward commitments. The balance in the EEA as on June 30, 2006 stood at Rs.3.28 crore. The balances in CGRA and EEA are grouped under 'Other Liabilities' in the balance sheet.

Contingency Reserve and Asset Development Reserve

X.10 The Reserve Bank maintains a Contingency Reserve (CR) to enable it to absorb unexpected and unforeseen contingencies. The balance in CR has increased from Rs.62,344.68 crore as on June 30, 2005 to Rs.73,281.10 crore as on June 30, 2006. A transfer of Rs.10,936.42 crore was made to CR during 2005-06 from the Reserve Bank's income. The balance in CR is sufficient to meet contingent liabilities.

X.11 In order to meet the internal capital expenditure and make investments in its subsidiaries and associate institutions, the Reserve Bank had created a separate Asset Development Reserve (ADR) in 1997-98, with the aim of reaching one per cent of the Reserve Bank's total assets within the overall indicative target of 12 per cent set for CR. In the year 2005-06, an amount of Rs.1,126.79 crore was transferred from income to ADR raising its level from Rs.6,466.03 crore as on June 30, 2005 to Rs.7,592.82 crore as on June 30, 2006. CR and ADR together constituted 10 per cent of total assets of the Bank as on June 30, 2006.

ASSETS

Foreign Currency Assets

X.12 The foreign currency assets comprise foreign securities held in Issue Department, balances held abroad and investments in foreign securities held in Banking Department. Such assets rose from Rs.5,75,863.66 crore as on June 30, 2005 to Rs.7,18,701.18 crore as on June 30, 2006. The increase in the level of foreign currency assets was mainly on account of net purchases of US dollars from the market, interest and discount received and revaluation gains.

Investment in Government of India Rupee Securities

X.13 Investment in Government of India Rupee Securities, which was Rs.68,476.48 crore as on June 30, 2005 declined by Rs.29,541.98 crore (43.1 per cent) to Rs.38,934.50 crore as on June 30, 2006.

Investments in Shares of Subsidiaries and Associate Institutions

X.14 There was no change in the Reserve Bank's investments in the shares of its subsidiaries and associate institutions during 2005-06.

Other Assets

X.15 'Other Assets' comprise mainly fixed assets, gold holdings in the Banking Department, amounts spent on projects pending completion and staff advances. The level of 'Other Assets' has increased by Rs.6,220.23 crore (43.2 per cent) from Rs.14,403.57 crore as on June 30, 2005 to Rs.20,623.80 crore as on June 30, 2006.

RESERVE BANK OF INDIA
BALANCE SHEET AS AT 30TH JUNE 2006

ISSUE DEPARTMENT

(Rupees Thousands)

2004-05	LIABILITIES	2005-06	2004-05	ASSETS	2005-06
	Notes held in the			**Gold Coin and Bullion:**	
12,97,72	**Banking Department** **11,60,96**		15828,39,88	(a) Held in India **23265,67,29**	
378467,68,09	**Notes in circulation** **440977,00,18**		–	(b) Held outside India **–**	
			361033,08,40	**Foreign Securities** **416525,46,17**	
378480,65,81	**Total Notes issued**	**440988,61,14**	376861,48,28	**Total**	**439791,13,46**
			101,94,35	**Rupee Coin**	**151,04,68**
				Government of India	
			1517,23,18	**Rupee Securities**	**1046,43,00**
				Internal Bills of Exchange	
			–	**and other Commercial Paper**	**–**
378480,65,81	**Total Liabilities**	**440988,61,14**	378480,65,81	**Total Assets**	**440988,61,14**

BANKING DEPARTMENT

2004-05	LIABILITIES	2005-06	2004-05	ASSETS	2005-06
5,00,00	**Capital paid-up**	**5,00,00**	12,97,72	**Notes**	**11,60,96**
6500,00,00	**Reserve Fund**	**6500,00,00**	4,33	**Rupee Coin**	**10,32**
	National Industrial Credit		2,97,93	**Small Coin**	**4,16,82**
14,00,00	**(Long Term Operations) Fund**	**15,00,00**			
	National Housing Credit			**Bills Purchased and Discounted :**	
188,00,00	**(Long Term Operations) Fund**	**189,00,00**	–	(a) Internal	–
			–	(b) External	–
			–	(c) Government Treasury Bills	–
	Deposits		195675,14,64	**Balances Held Abroad**	**278498,41,58**
	(a) Government				
72080,93,54	(i) Central Government	**33395,23,29**			
41,16,97	(ii) State Governments	**41,17,69**			
	(b) Banks		90087,46,43	**Investments**	**65538,16,23**
101361,60,23	(i) Scheduled Commercial Banks	**126129,85,51**			
1938,60,16	(ii) Scheduled State Co-operative Banks	**1827,03,54**			
1953,58,90	(iii) Other Scheduled Co-operative Banks	**2207,55,33**			
61,36,38	(iv) Non-Scheduled State Co-operative Banks	**50,68,59**			
3548,97,15	(v) Other Banks	**4053,46,63**			
15920,99,91	**(c) Others**	**20613,91,74**		**Loans and Advances to :**	
			–	(i) Central Government	–
			345,02,00	(ii) State Governments	**105,74,00**
378,41,96	**Bills Payable**	**429,44,80**		**Loans and Advances to:**	
			100,00,00	(i) Scheduled Commercial Banks	**2,06,00**
			1,90,00	(ii) Scheduled State Co-operative Banks	–
			–	(iii) Other Scheduled Co-operative Banks	–
			–	(iv) Non-Scheduled State Co-operative Banks	–
			3632,95,77	(v) NABARD	**2962,87,96**
			36,86,50	(vi) Others	**34,23,00**
100356,27,02	**Other Liabilities**	**172373,79,72**		**Loans, Advances and Investments from National Industrial Credit (Long Term Operations) Fund:**	
				(a) Loans and Advances to:	
			–	(i) Industrial Development Bank of India	–
			–	(ii) Export Import Bank of India	–
			–	(iii) Industrial Investment Bank of India Ltd.	–
			–	(iv) Others	–
				(b) Investments in bonds/debentures issued by:	
			–	(i) Industrial Development Bank of India	–
			–	(ii) Export Import Bank of India	–
			–	(iii) Industrial Investment Bank of India Ltd.	–
			–	(iv) Others	–
				Loans, Advances and Investments from National Housing Credit (Long Term Operations) Fund:	
				(a) Loans and Advances to	
			50,00,00	National Housing Bank	**50,00,00**
				(b) Investments in bonds/ debentures issued by	
			–	National Housing Bank	–
			14403,56,90	**Other Assets**	**20623,79,97**
304348,92,22	**Total Liabilities**	**367831,16,84**	304348,92,22	**Total Assets**	**367831,16,84**

Significant Accounting Policies and Notes to the Accounts as per Annex.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH JUNE 2006

(Rupees Thousands)

2004-05	INCOME		2005-06
12215,26,71	**Interest, Discount, Exchange, Commission *etc.*** [1]		**14257,09,61**
12215,26,71	**Total**		**14257,09,61**
	EXPENDITURE		
1386,27,61	**Interest**		**1524,41,09**
1653,16,59	**Establishment**		**919,88,29**
1,29,73	**Directors' and Local Board Members' Fees and Expenses**		**1,19,11**
17,16,62	**Remittance of Treasure**		**17,01,03**
1824,16,88	**Agency Charges**		**1833,55,04**
1443,56,51	**Security Printing (Cheque, Note forms *etc.*)**		**1034,86,21**
15,68,62	**Printing and Stationery**		**17,50,64**
28,48,40	**Postage and Telecommunication Charges**		**46,70,75**
55,27,60	**Rent, Taxes, Insurance, Lighting *etc.***		**59,10,63**
1,73,14	**Auditors' Fees and Expenses**		**1,88,91**
1,49,05	**Law Charges**		**2,95,27**
166,87,97	**Depreciation and Repairs to Bank's Property**		**179,25,59**
216,07,99	**Miscellaneous Expenses**		**210,77,05**
6811,26,71	**Total**		**5849,09,61**
5404,00,00	**Available Balance**		**8408,00,00**
	Less: Contribution To:		
	National Industrial Credit (Long Term Operations) Fund	1,00,00	
	National Rural Credit (Long Term Operations) Fund [2]	1,00,00	
	National Rural Credit (Stabilisation) Fund [2]	1,00,00	
	National Housing Credit (Long Term Operations) Fund	1,00,00	
4,00,00			**4,00,00**
5400,00,00	**Surplus Payable to Central Government**		**8404,00,00**

1. After making the usual or necessary provisions in terms of Section 47 of the Reserve Bank of India Act, 1934 amounting to Rs.12063,21,12 thousands (2004-05 - Rs.6813,00,61 thousands).
2. These funds are maintained by National Bank for Agriculture and Rural Development (NABARD).

Prabal Sen	**Usha Thorat**	**Shyamala Gopinath**	**V. Leeladhar**	**Rakesh Mohan**	**Y. V. Reddy**
Chief General Manager	Deputy Governor	Deputy Governor	Deputy Governor	Deputy Governor	Governor

REPORT OF THE AUDITORS

TO THE PRESIDENT OF INDIA

We, the undersigned auditors of Reserve Bank of India (hereinafter referred to as the Bank), do hereby report to the Central Government upon the Balance Sheet of the Bank as at June 30, 2006 and the Profit and Loss Account for the year ended on that date.

We have examined the Balance Sheet of the Bank as at June 30, 2006 and the Profit and Loss Account of the Bank for the year ended on that date and report that where we have called for information and explanations from the Bank, such information and explanations have been given to our satisfaction.

These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and according to the best of our information and explanations given to us and as shown by the books of account of the Bank, the Balance Sheet read with Significant Accounting Policies and Notes to the Accounts is a full and fair Balance Sheet containing all necessary particulars and is properly drawn up in accordance with the Reserve Bank of India Act, 1934 and Regulations framed thereunder so as to exhibit a true and correct view of the state of the Bank's affairs, in conformity with the accounting principles generally accepted in India.

Shivji K. Vikamsey	S. N. Nanda	S.R.Ananthakrishnan	V.K.Issar	A. D. Shenoy	S.Neelakantan
(M. No. 2242)	(M. No. 5909)	(M. No. 18073)	(M. No. 9519)	(M. No. 11549)	(M. No.18961)
Khimji Kunverji & Co.,	**S. N. Nanda & Co.,**	**J. L. Sengupta & Co.,**	**Rajendra K.Goel & Co.,**	**Ford, Rhodes, Parks & Co.,**	**M. K. Dandeker & Co.,**
Chartered Accountants	Chartered Accountants	Chartered Accountants	Chartered Accountants	Chartered Accountants	Chartered Accountants

Dated August 10, 2006