

V. FINANCIAL MARKETS

1.5.1 Global financial markets remained generally benign during 2005-06 notwithstanding a sharp rise in international crude oil prices and growing global financial imbalances. Although short-term interest rates moved up in a number of economies, financing conditions were favourable as real long term rates remained at very low levels and equity prices recorded large gains. Financing conditions in emerging market economies (EMEs) also benefited from record low spreads, reflecting shortage of foreign currency denominated bonds on account of improvements in the fiscal position of many EMEs as well as buybacks of outstanding bonds. Global financial markets, however, exhibited large volatility during May-June 2006 on concerns over rising inflation and expectations that central banks might tighten monetary policy further. Risk spreads widened as investors re-priced risk. Foreign investors pulled out from EMEs, even as fundamentals remained largely strong.

1.5.2 Indian financial markets remained on the whole orderly during 2005-06 even as interest rates edged up across the spectrum in the second half of the financial year. Liquidity conditions were generally comfortable

except for some tightness in the fourth quarter due to the redemption of the India Millennium Deposits (IMDs) amidst sustained credit growth and build-up of cash balances by the Government of India. Call money rates remained generally close to the reverse repo rate for most part of the first half of 2005-06, while remaining close to/exceeding the repo rate in the fourth quarter. Interest rates in the collateralised segment of the money market – which now dominates the turnover in the money market – also edged up, but remained below the repo rate during the fourth quarter. The foreign exchange market remained by and large orderly, exhibiting two-way movements. Yields in the Government securities market hardened during 2005-06 and the yield curve flattened. In the credit market, deposit and lending rates edged up during the year as credit demand accelerated further. Capital markets remained buoyant during 2005-06. The stock indices reached record highs, driven by increased interest by domestic as well as foreign investors on the back of strong macroeconomic fundamentals. Buoyancy in secondary markets enabled a substantial increase in resources raised by the Indian corporates through domestic as well as euro issues (Table 1.51).

Table 1.51: Domestic Financial Markets at a Glance

Month	Call Money		Govt. Securities		Foreign Exchange			Liquidity Management			Equity			
	Average Daily Turnover (Rupees crore)	Average Call Rates* (Per cent)	Average Turnover in Govt. Securities (Rupees crore)+	Average 10-year Yield@ (Per cent)	Average Daily Inter-bank Turnover (US \$ million)	Average Exchange Rate (Rs. per US \$)	RBI's Net Foreign Currency Sales(-)/ Purchases(+) (US \$ million)	Average Forward Premia 3-month (Per cent)	Average MSS Outstanding (Rupees crore) #	Average Daily LAF (Rupees crore)	Average Daily Turnover (Rupees crore)	Average Daily BSE NSE Sensex**	Average S & P CNX Nifty**	
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
2004-05 ^	14,170	4.65	4,826	6.22	8,892	44.93	20,847 £	1.66	46,445	35,592	2,050	4,506	5741	1805
2005-06 ^	17,979	5.60	3,643	7.12	12,738	44.27	8,143 £	1.60	58,792	10,986	3,251	6,253	8280	2513
April	17,213	4.77	3,001	7.02	9,880	43.74	0	1.96	65,638	30,675	1,890	4,136	6379	1987
May	15,269	4.99	3,805	7.11	10,083	43.49	0	1.57	68,539	22,754	1,971	3,946	6483	2002
June	20,134	5.10	6,807	6.88	10,871	43.58	-104	1.40	70,651	13,916	2,543	4,843	6926	2134
July	20,046	5.02	3,698	7.13	11,003	43.54	2,473	1.56	70,758	10,754	3,095	6,150	7337	2237
August	16,158	5.02	4,239	7.04	11,749	43.62	1,552	0.69	71,346	34,832	3,452	6,624	7726	2358
September	16,292	5.05	5,207	7.04	10,040	43.92	0	0.62	67,617	30,815	3,871	6,923	8272	2512
October	17,164	5.12	2,815	7.14	13,087	44.82	0	0.69	68,602	18,608	2,955	6,040	8220	2487
November	22,620	5.79	3,314	7.10	11,228	45.73	0	0.67	67,041	3,268	2,635	5,480	8552	2575
December	21,149	6.00	2,948	7.13	13,808	45.64	-6,541	1.51	52,040	1,452	3,516	6,814	9162	2773
January	17,911	6.83	3,094	7.15	16,713	44.40	0	2.60	40,219	-15,386	3,966	7,472	9540	2893
February	13,497	6.93	2,584	7.32	15,798	44.33	2,614	2.85	33,405	-13,532	3,688	7,125	10090	3019
March	18,290	6.58	2,203	7.40	17,600	44.48	8,149	3.11	29,652	-6,319	5,398	9,518	10857	3236
2006-07														
April	16,909	5.62	3,685	7.45	17,574 P	44.95	4,305	1.31	25,709	46,088	4,860	9,854	11742	3494
May	18,074	5.54	3,550	7.58	17,908 P	45.41	504	0.87	26,457	59,505	4,355	9,155	11599	3437
June	17,425	5.73	2,258	7.89	14,512 P	46.06	0	0.73	31,845	48,611	3,131	6,567	9935	2915
July	18,254	5.86	2,243	8.29	14,047 P	46.46	n.a.	0.83	36,936	48,188	2,605	5,652	10557	3092

* : Average of daily weighted call money borrowing rates. + : Average of daily outright turnover in Central Government dated securities.

@ : Average of daily closing rates. ** : Average of daily closing indices. # : Average of weekly outstanding MSS. n.a. : Not Available.

^ : Data are monthly averages. P : Provisional. £ : Cumulative for the financial year.

LAF : Liquidity Adjustment Facility.

MSS : Market Stabilisation Scheme. BSE : The Stock Exchange, Mumbai.

NSE : National Stock Exchange of India Ltd.

Note : In column 11, (-) indicates injection of liquidity while (+) indicates absorption of liquidity.

INTERNATIONAL FINANCIAL MARKETS

1.5.3 Short-term rates increased in a number of economies during 2005-06 in consonance with continuous monetary tightening as central banks raised their policy rates to ward off inflationary pressures stemming from higher international crude oil prices in an environment of strong domestic demand (Table 1.52). Short-term rates have increased further in a number of economies during 2006-07 so far. In some economies such as Brazil, short-term rates eased in response to weakening of economic activity.

1.5.4 Long-term Government bond yields in major economies remained largely range-bound during 2005-06. This reflected a variety of factors such as: increased demand for fixed income products from pension funds and insurance companies in response to regulatory changes; excess of global savings over global investment; and reduction in inflation risk premium. Intra-year movements in yields were influenced by inflation developments and expectations about the future course of monetary policy. Thus, 10-year Treasury yields in the US declined initially to a 14-month low of 3.8 per cent in early-June 2005 on expectations that monetary authorities could slow down policy tightening due to fragility in the economic recovery. Yields, however, firmed up during July 2005 on expectations that revaluation of the Chinese currency could lead to a reduction in demand for bonds of advanced economies. With the Chinese authorities continuing to manage the renminbi tightly, the yields reversed the increasing trend. Yields, however, again increased in the third quarter of 2005-06 as sharp rise in headline inflation increased expectations regarding future policy rates. In the second half of December 2005, 10-year yields eased again and by the close of December 2005 the yield

Table 1.52: Short-term Interest Rates

(Per cent)

Region/Country	At end of		
	March 2005	March 2006	July 2006
1	2	3	4
Advanced Economies			
Euro Area	2.15	2.80	3.14
Japan	0.02	0.04	0.34
Sweden	1.97	1.99	2.25
UK	4.95	4.58	4.70
US	2.90	4.77	5.45
Emerging Market Economies			
Argentina	4.56	9.63	10.13
Brazil	19.25	16.54	14.66
China	2.25	2.40	2.73
Hong Kong	2.79	4.47	4.39
India	5.37	6.11	6.44
Malaysia	2.82	3.51	3.93
Philippines	7.25	7.38	7.56
Singapore	2.06	3.44	3.56
South Korea	3.54	4.26	4.63
Thailand	2.64	5.10	5.40

Note : Data for India refer to 91-day Treasury Bills rate and for other countries 3-month money market rates.

Source : The Economist.

curve in the US became inverted (Chart I.22). Yields again increased from the second week of January 2006 reaching 4.86 per cent on March 31, 2006 – the highest since June 2004 – on the back of strong data and expectations that the US Fed may push the Federal Funds rate target higher than anticipated. Yields increased further during the first quarter of 2006-07 reflecting concerns over growing inflationary pressures. Long-term yields in Japan increased during 2005-06 reflecting improved economic prospects as also the decision of the Bank of Japan (March 2006) to switch back its operating target to the

Chart I.22: Long-term Yields – Advanced Economies

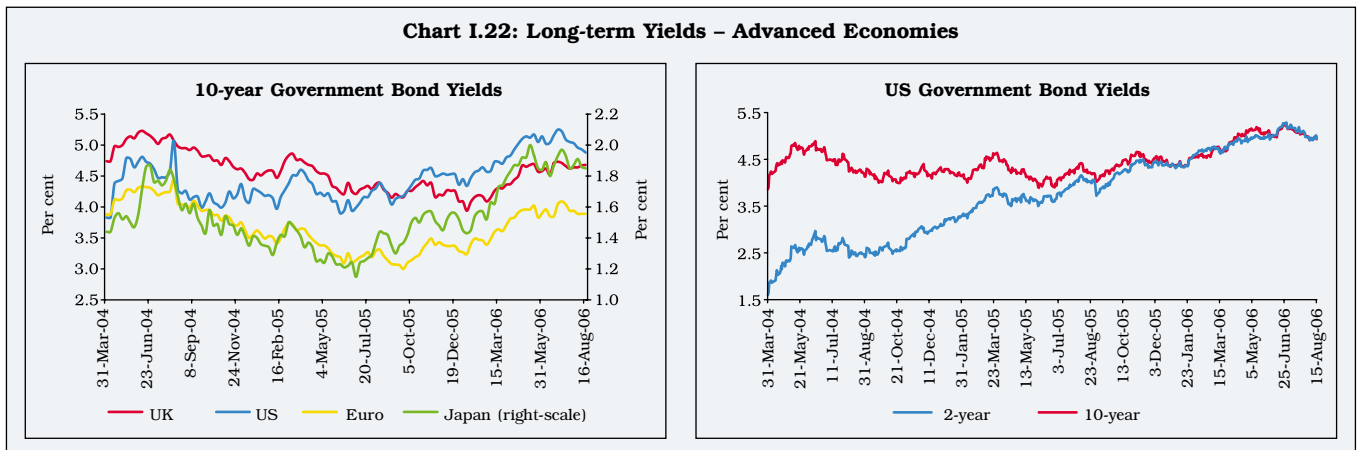


Table 1.53: Equity Markets in 2005-06

Country (Index)	Percentage variation*	P/E Ratio		Volatility**
		31-Mar-2005	31-Mar-2006	
1	2	3	4	5
Emerging Markets				
Russia (RTS)	114.5	15.8	22.5	26.8
India (BSE Sensex)	73.7	15.6	20.9	16.7
Brazil (Bovespa)	42.6	10.5	12.0	15.7
South Korea (KOSPI)	40.8	13.9	10.9	13.3
Indonesia (Jakarta Composite)	22.5	11.8	14.1	6.9
Singapore (Straits Times)	18.3	14.2	15.3	4.6
Taiwan	10.1	11.1	13.8	4.4
Thailand (Bangkok SET)	7.6	9.6	7.4	4.3
Malaysia (KLSE Composite)	6.3	13.8	13.0	2.2
Developed Markets				
US (DJIA)	5.8	19.1	18.6	2.7
US (Nasdaq)	17.0	-	-	5.1
UK (FTSE 100)	21.9	14.5	15.1	6.0
Japan (Nikkei 225)	46.2	27.7	36.0	14.7
Hong Kong (Hang Seng)	16.9	14.4	12.7	4.7
<i>Memo:</i>				
MSCI Emerging Markets	45.9	-	-	12.8
MSCI Asia	20.1	-	-	6.6

* : Variation between end-March 2005 and end-March 2006.
 ** : Measured as coefficient of variation.
Source : Moneyline Telerate, The Stock Exchange, Mumbai (BSE) and Financial Times, London.

uncollateralised overnight call rate. In the UK, the yields eased marginally during 2005-06 in tandem with short-term rates.

1.5.5 Equity markets in many economies exhibited buoyancy during 2005-06 (Table 1.53). Many EMEs in particular, recorded sharp gains reflecting improvements in their fundamentals as well as higher risk appetite in an environment of very low long-term real interest rates. This pushed up valuations sharply and in some cases to new highs. Equity markets in the US under-performed as equities struggled to cope

with the impact of higher US interest rates and increasing activity by US investors in overseas markets. Equity markets, however, registered sharp losses in a number of economies during the quarter ended June 2006 following the turmoil in global financial markets on higher than anticipated US inflation and the concomitant increase in risk aversion.

1.5.6 In the foreign exchange market, the US dollar appreciated during 2005-06. Growing interest rate and growth differential in favour of the US contributed to the US dollar's appreciation, offsetting concerns over its growing macroeconomic imbalances. A year-long tax break designed to encourage US multinationals to repatriate cash held overseas during 2005 also boosted the US dollar (Chart I.23). The US dollar has, however, depreciated during 2006-07 so far over concerns of growing macroeconomic imbalances.

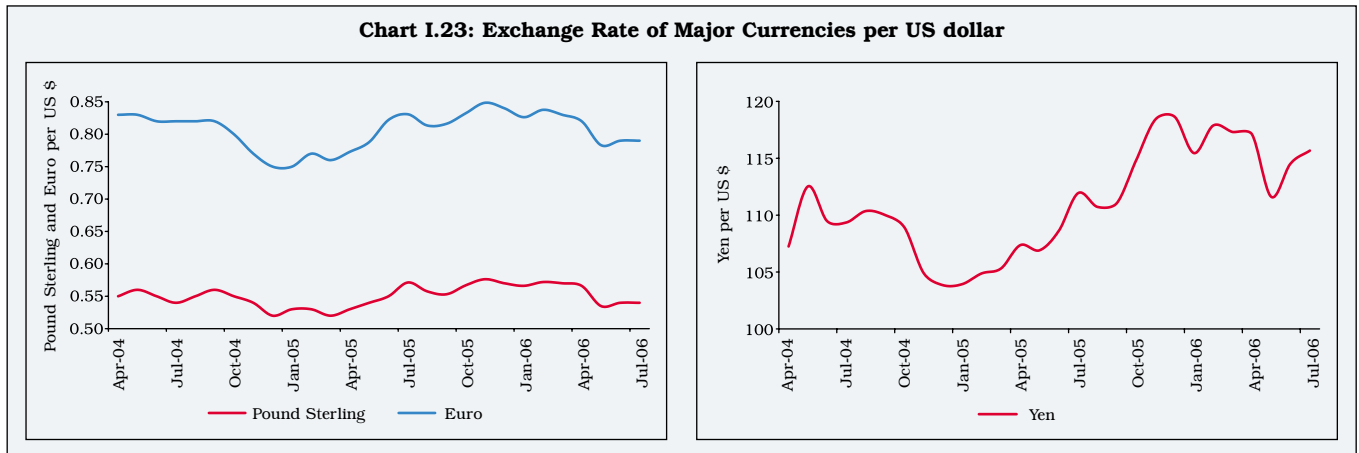
DOMESTIC FINANCIAL MARKETS

Money Market

Call/Notice Money Market

1.5.7 Money market conditions remained largely comfortable during 2005-06, except during the period mid-December 2005 to end-February 2006. During the first half of 2005-06, call money rates were closer to the reverse repo rate, the lower band of the LAF corridor, reflecting comfortable liquidity conditions. With the increase in the fixed reverse repo rate by 25 basis points on April 29, 2005, call rates also edged up by a similar magnitude. Towards the end of June 2005, call rates rose above the reverse repo rate under liquidity pressures on account of advance tax payments and scheduled Treasury Bills auctions. Call rates, however, edged lower towards the reverse repo rate by mid-July 2005 as liquidity conditions improved due to cancellation of some scheduled

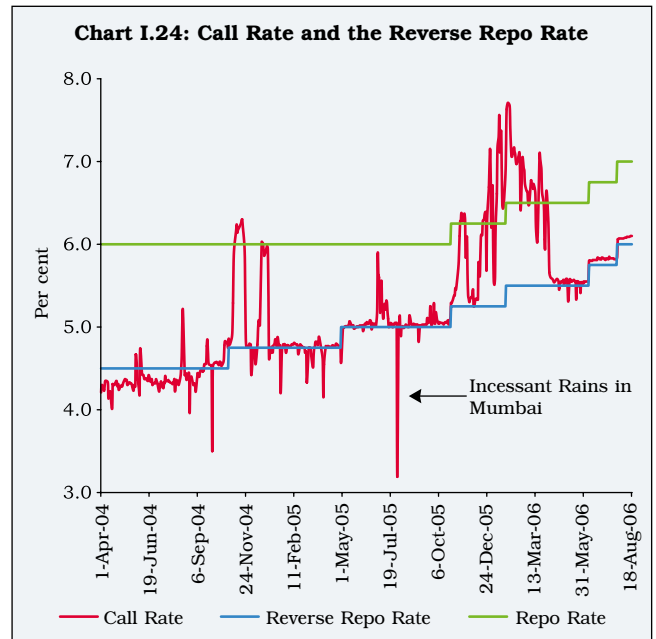
Chart I.23: Exchange Rate of Major Currencies per US dollar



Treasury Bills auctions, return of advance tax payments to the banking system and foreign currency purchases from the authorised dealers during July-August 2005. Call rates remained broadly stable between August 2005 and October 2005 except for transitory mild pressure during the second half of September 2005 reflecting advance tax outflows and scheduled auctions (Chart I.24). During November 2005, the call money rate remained generally above the reverse repo rate and also exceeded the repo rate on a few occasions reflecting liquidity pressures emanating from sustained credit demand, festival demand for currency and scheduled auctions. The Reserve Bank, therefore, injected liquidity into the system through LAF repos on seven occasions during the month (Appendix Table 37). The notified amount of Treasury Bills auctions under the MSS was also cancelled. To fine tune the management of liquidity and in response to suggestions from the market participants, the Reserve Bank introduced a Second Liquidity Adjustment Facility (SLAF), with effect from November 28, 2005.

1.5.8 Beginning with the second half of December 2005, call money rates again edged up and generally remained above the repo rate reflecting liquidity pressures emanating from the IMD redemptions amidst sustained large credit offtake and quarter-end advance tax payments. The Reserve Bank accordingly injected liquidity through LAF operations, unwinding of MSS and purchases of foreign currency. The call rates eased during the second half of March 2006, reflecting improvement in liquidity conditions.

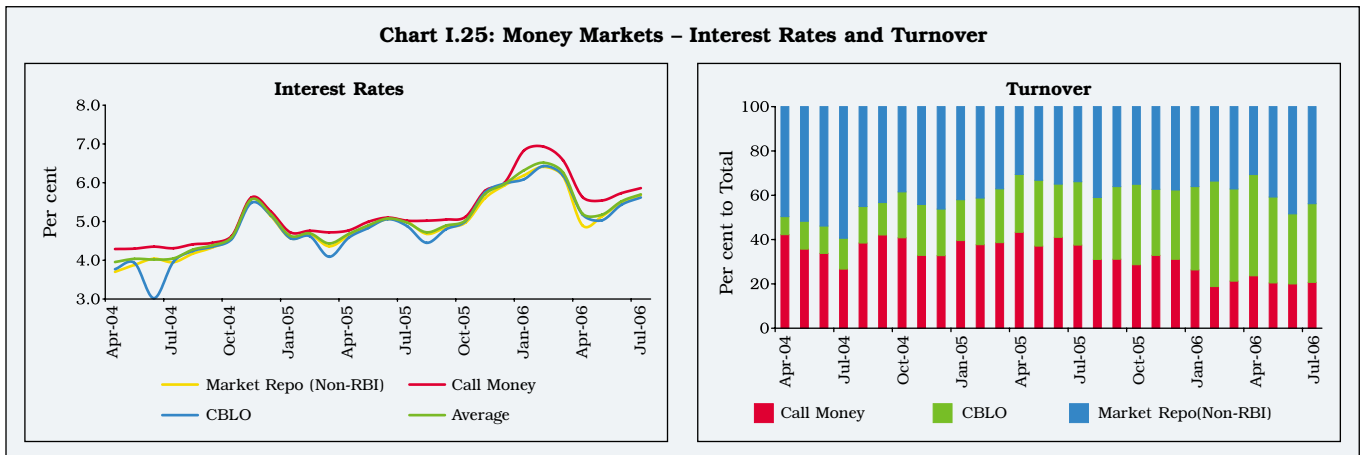
1.5.9 The interest rates in the collateralised segments of the money market also edged higher during the fourth quarter. However, in contrast to call money market, the rates in the collateralised segment



– the market repo (outside the LAF) and the Collateralised Borrowing and Lending Obligation (CBLO) segments – remained below the repo rate. For instance, the rates in the CBLO segment averaged 6.3 per cent during January-February 2006, lower than that of 6.9 per cent in the call money market for the same period. The collateralised market has now emerged as the predominant segment in the money market, with a share of nearly 80 per cent of the total turnover (Chart I.25). The higher call money rates during the last quarter of 2005-06 thus reflected not only liquidity pressures but also the shortage of the eligible collateral with the borrowing banks.

1.5.10 A noteworthy development during the year, as mentioned above, was the substantial migration of money market activity from the uncollateralised call money segment to the collateralised market repo and

Chart I.25: Money Markets – Interest Rates and Turnover



CBLO (Table 1.54). This migration of activity has been largely the result of the considered policy of phasing out non-bank participants from the call money market, the process for which was completed in August 2005. Volumes in the market repo (outside the LAF) increased from Rs.3,043 crore in April 2005 to Rs.7,991 crore in March 2006 whereas in the CBLO markets, the volumes increased from Rs.5,185 crore to Rs.17,887 crore. Thus, the share of the uncollateralised call market in the total overnight market transactions declined from 51.0 per cent in April 2005 to 26.1 per cent in March 2006. The CBLO market emerged as the preferred overnight segment in 2005-06. By March 2006, 152 members with 79 active members have been admitted in the CBLO segment of the Clearing Corporation of India Limited (CCIL). Initially, only one insurance company and a few cooperative banks had been supplying funds in this segment. However, now mutual funds have emerged as the largest suppliers of funds. For the borrowing banks, CBLO is attractive since it offers anonymity and provides funds at lower costs. The

composition of borrowers is undergoing change with corporates becoming significant borrowers.

I.5.11 During 2006-07 so far, call rates have remained close to the reverse repo rate. Reflecting comfortable liquidity conditions, average call rates eased to 6.10 per cent as on August 18, 2006, 54 basis points lower than that at end-March 2006.

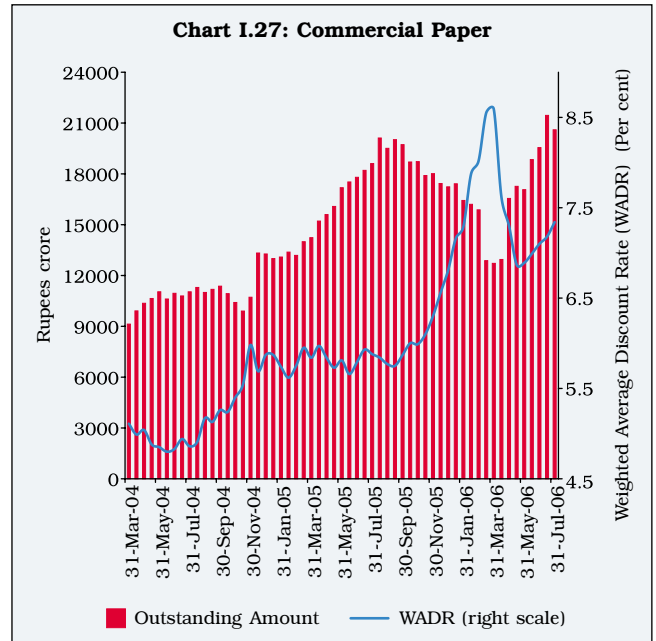
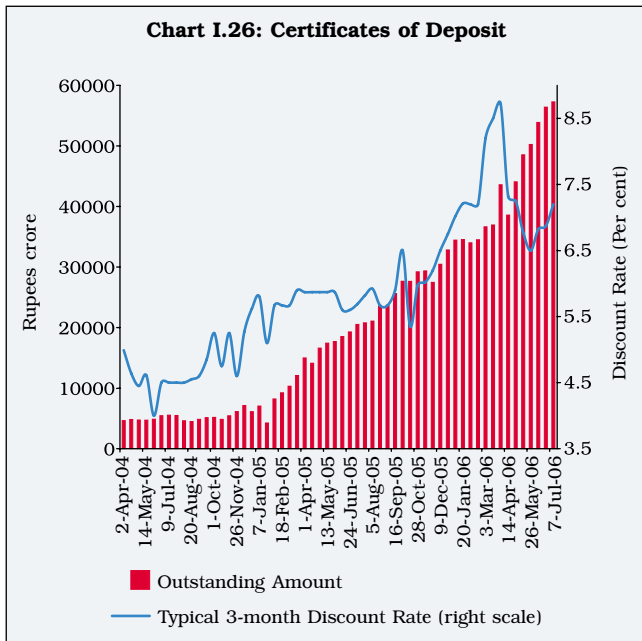
Certificates of Deposit

I.5.12 There was a sharp increase in issuances of certificates of deposit (CDs) during 2005-06 – the amount of CDs outstanding increased from Rs.12,078 crore at end-March 2005 to Rs.43,568 crore by end-March 2006 (Chart I.26 and Appendix Table 38). As on July 7, 2006, the outstanding amount of CDs increased further to Rs.57,256 crore. The large recourse to CDs could be attributed to banks' demand for funds in the wake of acceleration in demand for bank credit. Outstanding CDs constituted 4.8 per cent of aggregate deposits of issuing banks at end-March 2006, marginally higher than that of 4.1 per cent a

Table 1.54: Activity in Money Market Segments

Month	Average Daily Turnover #				Commercial Paper		Certificates of Deposit Outstanding
	Call Money Market	Market Repo (Outside the LAF)	Collateralised Borrowing and Lending Obligation (CBLO)	Term Money Market	Outstanding	Amount Issued	
1	2	3	4	5	6	7	8
2004-05 ^	14,170	17,135	6,697	526	11,723	1,090	6,052
2005-06 ^	17,979	21,183	20,039	833	17,285	3,140	27,298
April	17,213	12,174	10,370	661	15,598	3,549	16,602
May	15,269	13,688	12,233	545	17,182	3,824	17,689
June	20,134	17,163	11,792	534	17,797	2,925	19,270
July	20,046	18,103	15,292	717	18,607	3,360	20,768
August	16,158	21,325	14,544	754	19,508	4,110	23,568
September	16,292	18,872	17,143	1,116	19,725	2,519	27,641
October	17,164	20,980	21,763	734	18,726	2,892	29,193
November	22,620	25,660	20,496	917	18,013	2,483	27,457
December	21,149	25,574	21,265	775	17,234	4,104	32,806
January	17,911	24,596	25,634	1,089	16,431	1,937	34,521
February	13,497	24,096	34,162	813	15,876	3,160	34,487
March	18,290	31,964	35,775	1,338	12,718	2,813	43,568
2006-07							
April	16,909	21,914	32,657	894	16,550	6,065	44,059
May	18,074	36,107	34,293	945	17,067	4,701	50,228
June	17,425	42,250	27,617	1,256	19,550	4,981	56,390
July	18,254	38,684	31,340	864	20,602	5,812	57,256*

: Turnover is twice the single leg volumes in case of call money and CBLO to capture borrowing and lending both, and four times in case of market repo (outside LAF) to capture the borrowing and lending in the two legs for a repo.
^ : Data are monthly averages.
* : As on July 7, 2006.



year ago. Private sector banks were the major issuers of CDs. Reflecting the competitive pressures on banks to offer competing returns to attract wholesale corporate and mutual fund surpluses in an environment of tight liquidity, the issuance costs recorded a sharp rise during 2005-06. The typical discount rate for 3-month maturity on CDs increased from 5.87 per cent in March 2005 to 8.72 per cent in March 2006. The discount rate has since eased to 7.20 per cent as on July 7, 2006.

Commercial Paper

1.5.13 Issuances of commercial paper (CP), which had exhibited sustained increase till mid-September 2005, witnessed a slowdown during the second half of 2005-06. Outstanding CPs after increasing from Rs.14,235 crore at end-March 2005 to Rs.20,019 crore by mid-September 2005 declined to Rs.12,718 crore by end-March 2006 (Chart I.27 and Appendix Table 39). The weighted average discount rate (WADR) on CPs increased from 5.84 per cent on March 31, 2005 to 8.59 per cent on March 31, 2006. Following the easing of liquidity conditions, issuances under CPs have increased during 2006-07 so far and the outstanding amount of CPs was Rs.20,602 crore as on July 31, 2006; concomitantly, the WADR eased to 7.34 per cent.

1.5.14 Leasing and finance companies remained the pre-dominant issuers of CPs, partly reflecting the policy of phasing out the access of these companies to public deposits (Table 1.55). Issuances by

manufacturing companies, on the other hand, recorded a decline. This could be attributed to a variety of factors such as enhanced efficiency in their operations and larger internal accruals. Sub-PLR lending has also enabled some of the corporates to raise funds at comparable rates from banks without incurring additional cost towards stamp duty, demat costs and fees for Issuing and Paying Agents (IPAs) associated with the launching of CP. Currently, a corporate having minimum credit rating of P2 of CRISIL or its equivalent can raise resources through CP. However, the CP issuance is dominated by the prime rated companies. The most preferred maturity of CP had been periods ranging from '61 to 90 days' and '181 days and above'.

Table 1.55: Commercial Paper – Major Issuers

(Rupees crore)

Category of Issuer	End of			
	March 2004	March 2005	March 2006	July 2006
1	2	3	4	5
Leasing and Finance	4,423 (48.4)	8,479 (59.6)	9,400 (73.9)	13,624 (66.1)
Manufacturing	2,039 (22.4)	2,881 (20.2)	1,982 (15.6)	3,993 (19.4)
Financial Institutions	2,670 (29.2)	2,875 (20.2)	1,336 (10.5)	2,985 (14.5)
Total	9,131 (100.0)	14,235 (100.0)	12,718 (100.0)	20,602 (100.0)

Note : Figures in parentheses are percentage share to the total.

Chart I.28: Movement of Rupee vis-à-vis Major Currencies



Forward Rate Agreements (FRAs)/Interest Rates Swaps (IRS)

I.5.15 The outstanding notional principal amount in FRAs/IRS market rose from Rs.13,58,487 crore in April 2005 to Rs.21,94,637 crore in March 2006. Select foreign banks, private sector banks and Primary Dealers (PDs) are the major participants in this market. The interest rate derivatives market in India has remained an Over-the-Counter (OTC) market and the exchange traded products introduced in 2003 have not picked up.

FOREIGN EXCHANGE MARKET

I.5.16 In the foreign exchange market, the Indian rupee exhibited two-way movement vis-à-vis the US dollar during 2005-06, moving in a range of Rs.43.30–46.33 per US dollar (Chart I.28).

I.5.17 The rupee, which was largely range bound during the first quarter of 2005-06, witnessed some appreciation following the revaluation of the Chinese renminbi on July 21, 2005. The rupee reached Rs.43.56 per US dollar on August 18, 2005. The Reserve Bank made net market purchases of US \$

4.0 billion during July-August 2005 (Table 1.56 and Chart I.29). The rupee, however, came under pressure from end-August 2005 under the impact of oil prices, sharp increase in the current account deficit and strong US dollar. The exchange rate moved to Rs.46.33 per US dollar on December 8, 2005. With the revival of FII inflows and weakening of the US dollar in the international markets, the rupee strengthened sharply beginning with the second half of December 2005 notwithstanding the IMD redemptions. Sales of US \$ 6.5 billion during December 2005 on account of redemption of IMDs were recouped by purchases of US \$ 10.8 billion during February-March, 2006. The exchange rate was Rs.44.61 per US dollar as on March 31, 2006. At this level, the Indian rupee depreciated by 1.9 per cent over its level on March 31, 2005. On an annual average basis, the rupee, however, appreciated by 1.5 per cent against the US dollar. Based on daily data, the standard deviation of rupee-dollar exchange rate decreased from 1.03 during 2004-05 to 0.79 during 2005-06. Reflecting cross-currency movements, the rupee appreciated by 4.4 per cent against the Euro, 5.5 per cent against the Pound sterling and 7.3 per cent against the Japanese yen

Table 1.56: Purchases and Sales of US Dollars by the Reserve Bank

(US \$ million)

Month	Purchases(+)	Sales (-)	Net (+/-)	Cumulative (during the financial year)	Outstanding Net Forward Sales (-) / Purchases (+) (end of month)
1	2	3	4	5	6
2004-05	31,398	10,551	(+) 20,847	(+) 20,847	0
2005-06	15,239	7,096	(+) 8,143	(+) 8,143	0
April	0	0	0	0	0
May	0	0	0	0	0
June	0	104	(-) 104	(-) 104	0
July	2,473	0	(+) 2,473	(+) 2,369	0
August	2,003	451	(+) 1,552	(+) 3,921	0
September	0	0	0	(+) 3,921	0
October	0	0	0	(+) 3,921	0
November	0	0	0	(+) 3,921	0
December	0	6,541	(-) 6,541	(-) 2,620	0
January	0	0	0	(-) 2,620	0
February	2,614	0	(+) 2,614	(-) 6	0
March	8,149	0	(+) 8,149	(+) 8,143	0
2006-07					
April	4,305	0	(+) 4,305	(+) 4,305	0
May	504	0	(+) 504	(+) 4,809	0
June	0	0	0	(+) 4,809	0

(+) : Implies purchases including purchase leg under swaps and outright forwards.

(-) : Implies sales including sale leg under swaps and outright forwards.

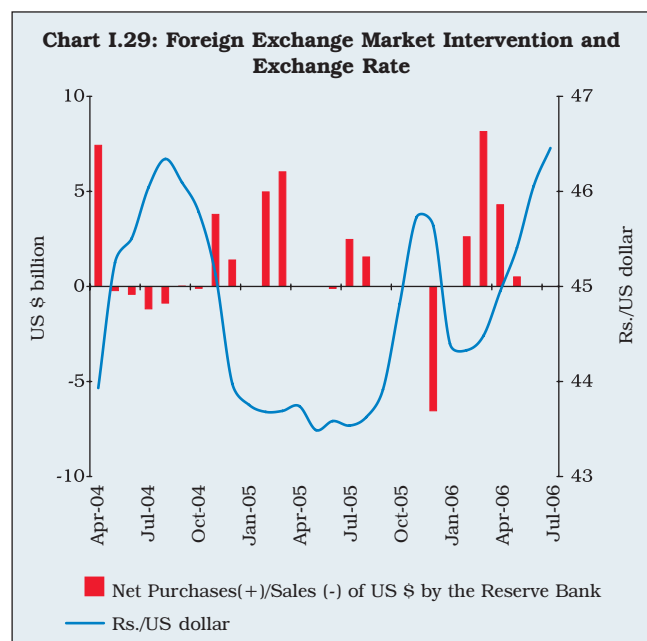
Note : This Table is based on value dates and data are inclusive of transactions under India Millennium Deposits.

between end-March 2005 and end-March 2006. On an annual average basis, the rupee appreciated by 5.0 percent each against the Pound sterling and the euro and by 6.8 per cent against the Japanese yen.

I.5.18 During 2006-07 so far, the rupee has depreciated *vis-à-vis* the US dollar from Rs.44.61 per US dollar at end-March 2006 to Rs.46.48 per US dollar as on August 18, 2006 partly reflecting FII outflows, higher oil prices and further monetary tightening in the US.

I.5.19 In order to take into account the changing composition of India's trade, revised Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices have been constructed with 1993-94 as the base year (Box I.15). The revised 36-currency NEER appreciated by 2.9 per cent during 2005-06, while the REER appreciated by 2.4 per cent (Appendix Table 40).

I.5.20 Forward premia declined during the first half of 2005-06 in tandem with the narrowing of interest rate differential following the higher pace of monetary tightening in the US. The premia, however, edged higher from December 2005 reflecting the rise in domestic money market rates (Chart I.30). Forward premia again declined during the first quarter of 2006-07 in tandem with the narrowing of interest rate differential following easing of domestic money market interest rates coupled with further monetary tightening in the US.



Box I.15**Revision of Nominal and Real Effective Exchange Rate Indices**

The Reserve Bank has been constructing 5-country and 36-country indices of Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) as part of its communication policy and for use as indicators of external competitiveness. Conceptually, the NEER is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign currencies. The REER, on the other hand, is the weighted average of nominal exchange rates adjusted for relative price differential between the domestic and foreign countries, drawing upon the purchasing power parity (PPP) hypothesis.

The significant shift in India's trade relations across countries/regions, mainly towards developing and emerging economies, during the last decade necessitated a change in the currency basket and the weights assigned to India's trading partners included in the existing indices. The revision was also undertaken in order to replace the existing national currencies of the euro zone by the common currency Euro for the members. In view of these developments the Reserve Bank, in December 2005, revised its 5-country and 36-country indices with new 6-currency and 36-currency indices of NEER and REER.

The new 6-currency indices include the US, euro zone, UK, Japan, China and Hong Kong. Two currencies in the old 5-country series, viz., French franc and Deutsche mark have been replaced by Euro in the new indices. The inclusion of China and Hong Kong reflects increasing trade with these economies. The six countries/regions, represented by the six currencies, together accounted for around 40 per cent of India's total foreign trade in 2004-05 as compared with coverage of around 22 per cent in the case of the earlier 5-country index.

The coverage has also changed for the 36-currency REER/NEER indices. The old indices comprised 36 countries including five members of the euro area¹. Countries in the new series have been chosen based on (i) the share in India's exports and trade, (ii) regional representation and (iii) the availability of data on exchange rate and prices on a monthly

basis. The new countries included in the revised series are Hong Kong, Denmark, Iran, Kuwait, Qatar, Russia, South Africa, Sweden and United Arab Emirates². With the inclusion of the euro zone, the new 36-currency indices include all the 12 countries that have Euro as common currency. The revised 36 countries/regions, represented by the 36 currencies, together accounted for, on an average, 76 per cent and 85 per cent of India's total foreign trade and exports, respectively, during 2002-03 to 2004-05 as compared with around 61 per cent and 66 per cent, respectively, in case of the earlier indices. The new 6-currency and 36-currency indices use a 3-year moving average trade weights in order to suitably reflect the dynamically changing pattern of India's foreign trade with its major trading partners in contrast to the fixed weights used hitherto.

In line with the earlier practice, the revised indices (both 6-currency and 36-currency) use the wholesale price index (WPI) as a proxy for Indian prices and the consumer price index (CPI) as a proxy for foreign partner countries. While the 6-currency index updates the WPI data every week, it is updated monthly for the 36-currency index. For a few countries where CPI data are not readily available on a monthly basis, suitable proxies have been used.

The new 6-currency indices have been calculated for two base years: 1993-94 as a fixed base and 2003-04 as a moving base, which would change every year as at present. The choice of 1993-94 as the base year is attributable to generally stable macroeconomic conditions and satisfactory external sector performance during that year, following significant changes in the macroeconomic environment due to structural reforms introduced in the wake of balance of payments crisis in 1990-91. India had moved to a market determined exchange rate regime in April 1993.

Reference

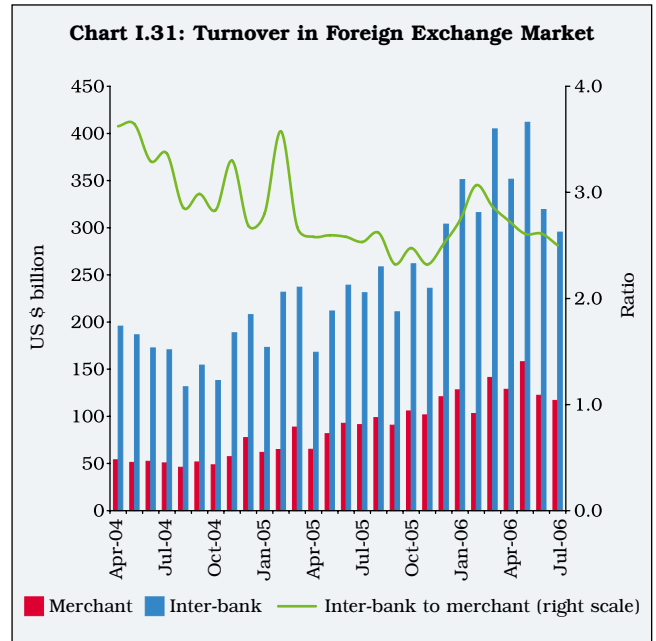
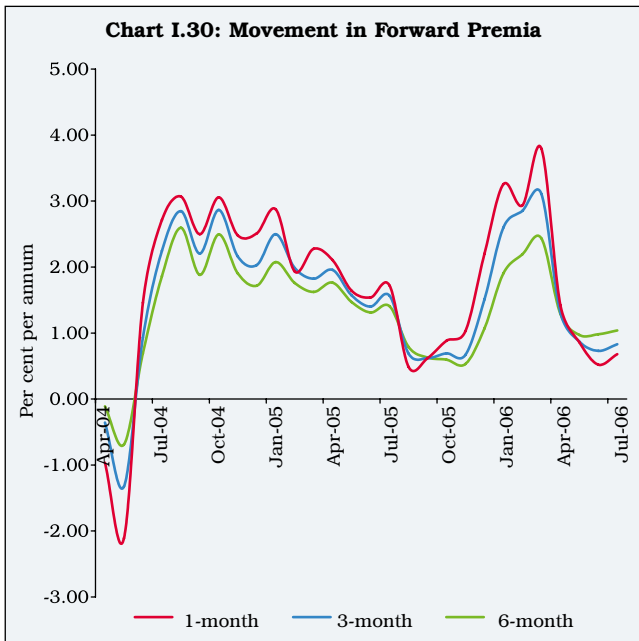
"Revision of Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) Indices", Reserve Bank of India Bulletin, December 2005.

I.5.21 The turnover in the inter-bank as well as merchant segments of the foreign exchange market increased sharply during 2005-06, reflecting strong growth in underlying transactions relating to current as well as capital account of balance of payments. While inter-bank turnover increased from US \$ 237

billion during March 2005 to US \$ 405 billion in March 2006, the merchant turnover increased from US \$ 89 billion to US \$ 141 billion (Chart I.31 and Appendix Table 41). The ratio of inter-bank to merchant turnover ranged between 2.3-3.1 during 2005-06.

¹ These were Belgium, France, Germany, Italy and Netherlands.

² The 36 currencies included in the revised REER series are those of Argentina, Australia, Bangladesh, Brazil, Canada, China, Denmark, Egypt, Euro, Hong Kong, Indonesia, Iran, Israel, Japan, Kenya, Korea, Kuwait, Malaysia, Myanmar, Mexico, Nigeria, Pakistan, Philippines, Qatar, Russia, Saudi Arabia, Singapore, South Africa, Sri Lanka, Sweden, Switzerland, Thailand, Turkey, UAE, UK and USA.

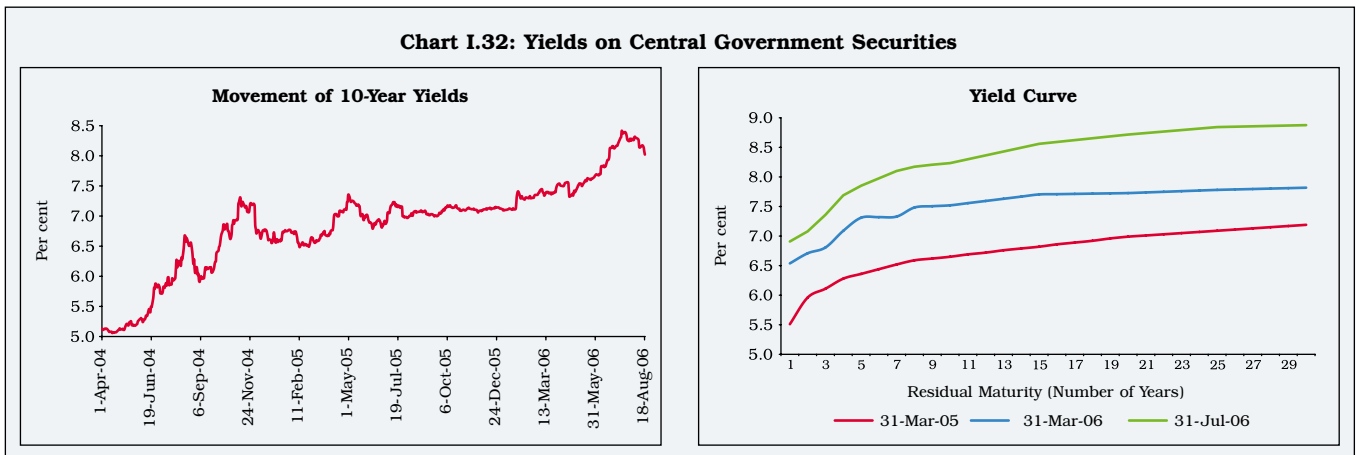


GOVERNMENT SECURITIES MARKET

1.5.22 Yields in the Government securities market hardened during 2005-06. The increase in yields for longer-term maturities was, however, less than for shorter-term maturities, reflecting relatively stable inflation expectations. Intra-year movements in yields were influenced by domestic liquidity conditions, inflationary expectations, volatility in crude oil prices and movements in the US yields. On April 30, 2005 the yields on 10-year paper firmed up sharply by 70 basis points to 7.35 per cent over end-March 2005 on fears of higher inflation in the backdrop of rising global crude oil prices and announcement of hike in the reverse repo rate by 25 basis points in the Annual Policy Statement on April 28, 2005. The yields, however, eased during May and June 2005 to reach 6.89 per cent on June 30, 2005 amidst comfortable

liquidity position, benign inflation and fall in the US treasury yields. The markets rallied briefly in July 2005 and yields softened as the reverse repo rate was left unchanged in the First Quarter Review of the Annual Statement on Monetary Policy on July 26, 2005. Yields remained broadly stable between August and December 2005 (Chart I.32).

1.5.23 Yields, however, edged up in the last week of January 2006 following the increase of 25 basis points in both the reverse repo and the repo rates in the Third Quarter Review of the Annual Statement on Monetary Policy on January 24, 2006. The 10-year yield reached 7.41 per cent on January 27, 2006 before declining somewhat to 7.28 per cent on January 31, 2006. For most part of February-March 2006, yields were range-bound. However, in end-March, rise in US yields led to a rise in the yields in



the Indian market with the 10-year yield reaching 7.52 per cent on March 31, 2006. The spread between 1-year and 10-year yields narrowed to 98 basis points at end-March 2006 (from 114 basis points at end-March 2005), mirroring liquidity tightness in money markets. The spread between 10-year and 30-year yields narrowed to 30 basis points (from 54 basis points at end-March 2005), reflecting increased appetite for long-term securities from non-bank participants such as insurance companies and pension funds (Table 1.57).

1.5.24 Yields increased further during April-July 2006 reflecting further monetary policy tightening in the US and in other economies, high and volatile crude oil prices, hike in domestic policy rates, expected issuances of oil bonds and higher Government expenditure in the first quarter of 2006-07. Yield on 10-year paper increased from 7.52 per cent at end-March 2006 to 8.02 per cent as on August 18, 2006.

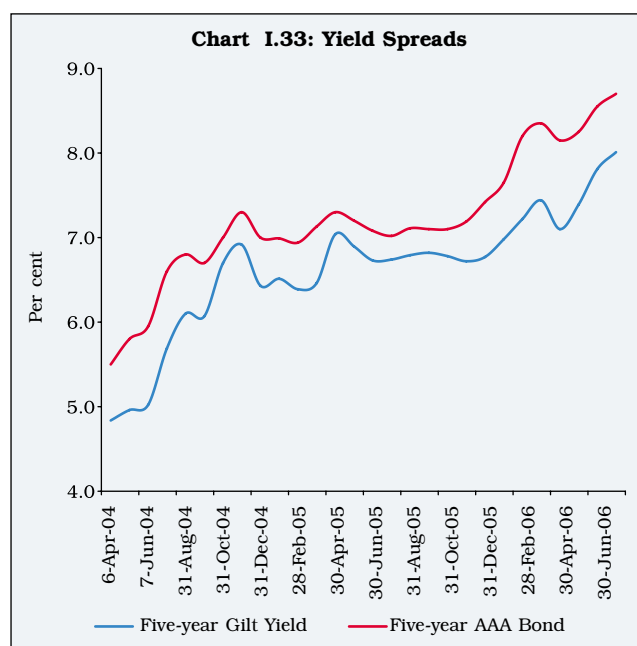
1.5.25 The yields on 5-year AAA-rated corporate bonds increased during 2005-06 in tandem with higher yields in Government securities. The yield spread over 5-year Government securities – after remaining broadly stable at 30 basis points during April-October 2005 – increased to 91 basis points at end-March 2006 from 67 basis points at end-March 2005 (Chart 1.33).

Table 1.57: Yield Spread

(Basis points)

Month-end	10 Year-reverse repo rate	10 Year 1 Year	20 Year 10 Year	30 Year 10 Year
1	2	3	4	5
2004-05 *	164	101	55	77
2005-06 *	196	106	36	45
April	231	141	46	60
May	197	120	42	75
June	189	111	26	56
July	201	120	48	45
August	209	129	42	44
September	211	124	35	38
October	185	121	40	42
November	183	111	37	48
December	186	91	37	34
January	178	51	30	35
February	186	53	25	30
March	202	98	21	30
2006-07				
April	190	118	40	56
May	218	120	36	52
June	237	113	38	41
July	223	133	48	64

* : Data are monthly averages.

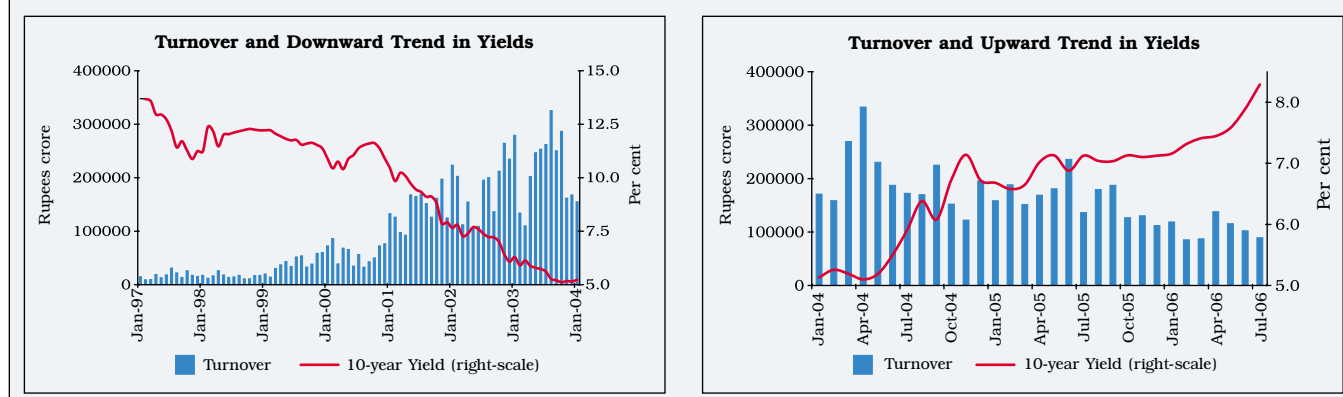


1.5.26 The turnover in Government securities declined during 2005-06 as banks preferred to hold securities, rather than trade, in an environment of hardening of yields. Average daily turnover fell from Rs.4,826 crore during 2004-05 to Rs.3,643 crore during 2005-06. The ratio of turnover to outstanding stock of Government securities also fell from 2.0 to 1.5. In the absence of instruments that allow players to take a view on the interest rates, it is observed that the markets are active and liquid when the rates are falling but turn lacklustre and illiquid when the rates rise (Chart 1.34 and Appendix Table 42). A number of measures have been taken to enable participants to manage their interest rate risk more efficiently and also to impart liquidity to the markets, even in a rising interest rate scenario (see Chapter IV).

CREDIT MARKET

1.5.27 As discussed earlier in this Chapter, demand for bank credit accelerated during 2005-06. In order to meet the higher credit demand, banks, *inter alia*, intensified efforts to mobilise deposits. This was reflected in upward movement in deposits as well as lending rates. During the second half of 2005-06, banks increased their deposit rates by about 25-150 basis points across various maturities (Table 1.58). As regards lending rates, many banks revised upwards their sub-Benchmark Prime Lending Rates (BPLRs), while keeping their BPLRs unchanged. Some private sector banks increased their BPLRs as well. The band of BPLRs for private sector banks and foreign banks remained wider than that of public

Chart I.34: Government Securities Market – Turnover and Yields



sector banks, although for a majority of banks, the BPLRs lie in a relatively narrow range. For instance, in regard to private sector banks, more than half of banks (16 out of 29 for which comparative data are available) had BPLRs in a range of 11-12 per cent at end-March 2006, while five banks had BPLRs in a range of 10-11 per cent. As regards foreign banks, nine of them had BPLRs in a range of 12-13 per cent, while five each had BPLRs in a range of 10-11 per cent and 11-12 per cent. Deposit as well as lending rates of banks increased further during the

first quarter of 2006-07. Deposit rates increased by about 25-100 basis points across various maturities between March 2006 and June 2006. On the lending side, banks revised upwards their BPLRs by 25-50 basis points.

EQUITY AND DEBT MARKETS

I.5.28 The capital market exhibited buoyancy during 2005-06. Resources raised by the Indian corporates through public offerings, private placements and euro

Table 1.58: Movements in Deposit and Lending Rates

Interest Rate	(Per cent)					
	March 2005	June 2005	September 2005	December 2005	March 2006	June 2006
1	2	3	4	5	6	7
1. Domestic Deposit Rate						
Public Sector Banks						
Up to 1 year	2.75-6.00	2.75-6.00	2.00-6.00	2.00-6.00	2.25-6.50	2.75-6.50
More than 1 year and up to 3 years	4.75-6.50	5.25-6.25	5.25-6.25	5.25-6.25	5.75-6.75	5.75-7.00
More than 3 years	5.25-7.00	5.50-6.50	5.50-6.00	5.50-6.50	6.00-7.25	6.00-7.25
Private Sector Banks						
Up to 1 year	3.00-6.25	3.00-6.25	3.00-6.25	3.00-6.25	3.50-7.25	3.50-6.75
More than 1 year and up to 3 years	5.25-7.25	5.00-7.00	5.00-7.00	5.00-7.00	5.50-7.75	6.50-7.75
More than 3 years	5.75-7.00	5.50-7.25	5.75-7.25	5.75-7.25	6.00-7.75	6.50-8.25
Foreign Banks						
Up to 1 year	3.00-6.25	3.00-5.50	3.00-5.75	3.00-5.75	3.00-6.15	3.25-6.50
More than 1 year and up to 3 years	3.50-6.50	3.50-6.50	3.50-6.50	3.50-6.50	4.00-6.50	5.00-6.50
More than 3 years	3.50-7.00	4.00-7.00	4.00-7.00	4.00-7.00	5.50-6.50	5.50-6.75
2. Benchmark Prime Lending Rate						
Public Sector Banks	10.25-11.25	10.25-11.25	10.25-11.25	10.25-11.25	10.25-11.25	10.75-11.50
Private Sector Banks	11.00-13.50	11.00-13.50	11.00-13.50	11.00-13.50	11.00-14.00	11.00-14.50
Foreign Banks	10.00-14.50	10.00-14.50	10.00-14.50	10.00-14.50	10.00-14.50	10.00-14.50
3. Actual Lending Rate*						
Public Sector Banks	2.75-16.00	3.35-16.50	4.00-16.50	4.00-16.50	4.00-16.50	4.00-16.50 P
Private Sector Banks	3.15-22.00	3.15-24.94	3.15-20.22	3.15-20.50	3.15-20.50	3.15-26.00 P
Foreign Banks	3.55-23.50	4.00-25.00	2.86-25.00	2.86-24.00	4.75-26.00	4.75-25.00 P

* : Interest rate on non-export demand and term loans above Rs.2 lakh excluding lending rates at the extreme five per cent on both sides.
P : Provisional.

issues increased significantly. Resource mobilisation by mutual funds through various schemes also increased sharply. The secondary market registered sharp gains during 2005-06 and continued to surge during early part of 2006-07 with the benchmark indices recording all time high levels. Large investments by foreign institutional investors (FIIs) and domestic mutual funds on the back of robust macroeconomic fundamentals, congenial investment climate and strong corporate profitability buoyed the stock markets.

Primary Market

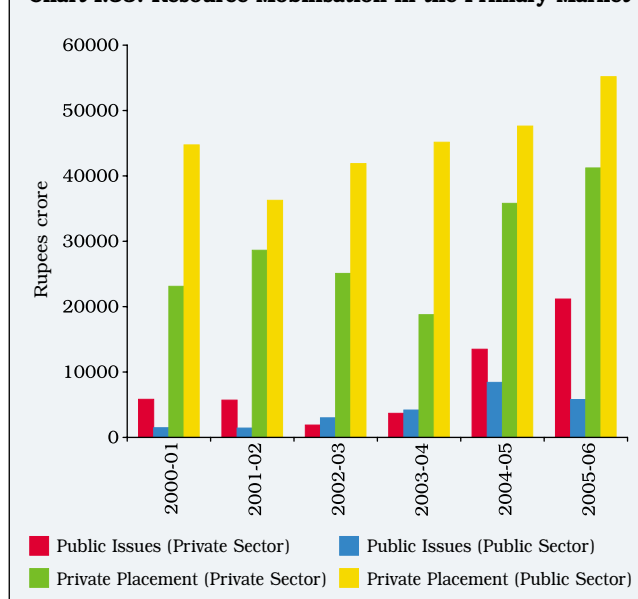
I.5.29 Resource mobilisation from the primary market through public issues (excluding offers for sale) increased by 23.1 per cent to Rs.26,940 crore during 2005-06 (Table 1.59 and Chart I.35). The increase in

Table 1.59: Mobilisation of Resources from the Primary Market*

(Amount in Rupees crore)

Item	2004-05		2005-06P	
	No. of Issues	Amount	No. of Issues	Amount
1	2	3	4	5
A. Prospectus and Rights Issues**				
1. Private Sector (a+b)	54	13,482	131	21,154
		(266.9)		(56.9)
a) Financial	12	5,710	11	7,746
b) Non-financial	42	7,772	120	13,408
2. Public Sector (a+b+c)	5	8,410	7	5,786
		(101.4)		(31.2)
a) Public Sector Undertakings	-	-	-	-
b) Government Companies	1	2,684	1	373
c) Banks/Financial Institutions	4	5,726	6	5,413
3. Total (1+2)	59	21,892	138	26,940
		(178.8)		(23.1)
<i>Of which:</i>				
(i) Equity	54	18,024	136	26,695
(ii) Debt	5	3,868	2	245
B. Private Placement				
1. Private Sector	717	35,794	944	41,205
		(92.1)		(15.1)
a) Financial	255	20,974	374	26,553
b) Non-financial	462	14,820	570	14,652
2. Public Sector	193	47,611	168	55,164
		(5.2)		(15.9)
a) Financial	124	25,531	138	39,395
b) Non-financial	69	22,080	30	15,769
3. Total (1+2)	910	83,405	1,112	96,368
		(30.5)		(15.5)
<i>Memo:</i>				
Euro Issues	15	3,353	49	11,358
		(8.2)		(238.7)
* : Including both debt and equity.		P : Provisional.		
** : Excluding offers for sale.		- : Nil/Negligible.		
Note : Figures in parentheses represent percentage variations over the previous year.				

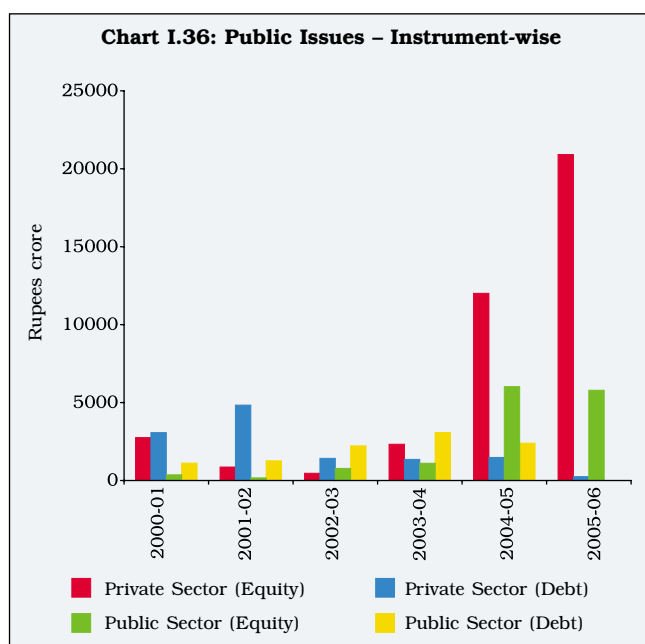
Chart I.35: Resource Mobilisation in the Primary Market



resource mobilisation during 2005-06 was entirely on account of private sector companies as resources raised by public sector companies were lower than a year ago. Private sector companies continued to dominate the public issues market, mobilising 78.5 per cent of the total resource mobilisation during 2005-06 as compared with 61.6 per cent during 2004-05 (Appendix Table 43). Banks were the major issuers during the year in view of their requirements for capital adequacy purposes. Banks and financial institutions in both public and private sectors mobilised 48.8 per cent of resources by public issues in 2005-06. Six public sector banks raised equity worth Rs.5,413 crore through public issues, accounting for about 20.1 per cent of the resources raised during 2005-06. Almost one-half (46.7 per cent) of the amounts raised during the year were through the initial public offerings (IPOs). Equity issues constituted 99.1 per cent of the total resource mobilisation through public issues during 2005-06 as compared with 82.3 per cent during the previous year (Chart I.36).

I.5.30 During 2006-07 (April-June), resource mobilisation through public issues (excluding offers for sale) amounted to Rs.10,642 crore through 25 issues as compared with Rs.3,894 crore through 25 issues during the corresponding period of 2005-06.

I.5.31 The Indian corporate sector also continued to rely heavily on domestic private placement market. Mobilisation of resources through private placements increased by 15.5 per cent during 2005-06 as compared with an increase of 30.5 per cent during 2004-05 (Table 1.59). The increase during the year



was led by issuances by the public sector entities (both financial and non-financial) who mobilised bulk of the resources (57.2 per cent). The resource mobilisation by financial intermediaries (both public and private sectors) increased by 41.8 per cent to Rs.65,948 crore, accounting for 68.5 per cent of the total resource mobilisation. Amongst the financial intermediaries, banks (both public and private sectors) mobilised Rs.30,151 crore through private placements, which was 98.1 per cent higher than that in the previous year.

1.5.32 Buoyant stock markets also provided an opportunity to corporates to raise funds from international capital markets for their investment requirements. Resources raised by Indian corporates from international capital markets during 2005-06 increased substantially by 238.7 per cent to Rs.11,358 crore (see Table 1.59). Out of these, Rs.9,779 crore were mobilised in the form of Global Depository Receipts (GDRs), followed by American Depository Receipts (ADRs) (Rs.1,573 crore) and Foreign Currency Convertible Bonds (FCCBs) (Rs.6 crore). Most of the euro issues were made by private non-financial companies. During 2006-07 (April-June), resources raised through euro issues by Indian corporates at Rs.5,786 crore were substantially higher than those of Rs.1,834 crore during the corresponding period of 2005-06.

Mutual Funds

1.5.33 Net resources mobilised by mutual funds increased sharply during 2005-06 led by higher inflows under equity oriented schemes reflecting

Table 1.60: Resource Mobilisation by Mutual Funds

(Rupees crore)

Mutual Funds	2004-05		2005-06	
	Net Mobilisation	Net Assets*	Net Mobilisation	Net Assets*
1	2	3	4	5
Private Sector	7,600	1,17,487	42,977	1,81,515
Public Sector	-2,677	11,374	6,379	20,829
UTI	-2,722	20,740	3,424	29,519
Total	2,201	1,49,601	52,780	2,31,862

* : As at end-March.
Note : Data exclude funds mobilised under Fund of Funds schemes.
Source: Securities and Exchange Board of India (SEBI).

investor interest due to attractive returns in a buoyant secondary market. Net assets of mutual funds also increased considerably by 55.0 per cent during 2005-06 as compared with 7.2 per cent during 2004-05 on account of increase in the market value of their equity portfolio (Tables 1.60 and 1.61). Net assets of mutual funds, thus, increased from 4.8 per cent of GDP at end-March 2005 to 6.6 per cent of GDP at end-March 2006. During April-June 2006, net resources mobilised by mutual funds increased further by 264.7 per cent to Rs.52,053 crore. Net mobilisation during the first quarter of 2006-07 was almost at the same level as during the full year 2005-06.

All India Financial Institutions

1.5.34 Currently, a Financial Institution (FI) can raise resources, short term as well as long term, such that the total outstanding at any time does not exceed 10 times of its Net Owned Funds (NOF). Within this overall ceiling, eight institutions, viz., IFCI, EXIM Bank, SIDBI, IIBI, TFICI, NABARD, IDFC and NHB have been given umbrella limits to raise resources equivalent to 100 per cent of their NOF through such instruments as term money, term deposit, inter-corporate deposits (ICDs), CDs and CP. The aggregate umbrella limit for raising resources by these FIs increased from Rs.16,160 crore as on April 1, 2005 to Rs.17,046 crore as on March 31, 2006 and further to Rs.18,041 crore as on May 26, 2006. The outstanding amount of resources raised by the financial institutions by way of these instruments declined from Rs.2,862 crore (17.7 per cent of limits) as on April 1, 2005 to Rs.1,449 crore (8.5 per cent of limits) as on March 31, 2006. CP was the most preferred instrument throughout the year. Only five institutions, viz., NABARD, EXIM Bank, NHB, IDFC and SIDBI were active in mobilising resources through these instruments during 2005-06.

Table 1.61: Funds Mobilised by Mutual Funds – Type of Schemes

(Amount in Rupees crore)

Scheme	2004-05			2005-06		
	No. of Schemes	Net Mobilisation	Net Assets*	No. of Schemes	Net Mobilisation	Net Assets*
1	2	3	4	5	6	7
A. Income/Debt Oriented Schemes	227	-5,244	1,06,250	325	16,622	1,24,913
(i) Liquid/ Money Market	39	10,348	54,068	45	4,205	61,500
(ii) Gilt	30	-1,345	4,576	29	-1,560	3,135
(iii) Debt (other than assured return)	158	-14,247	47,605	251	13,977	60,278
B. Growth/Equity Oriented Schemes	188	7,100	38,484	231	35,231	99,456
(i) Equity Linked Savings Scheme	37	-194	1,727	37	3,592	6,589
(ii) Others	151	7,294	36,757	194	31,639	92,867
C. Balanced Schemes	35	345	4,867	36	927	7,493
D. Fund of Funds Scheme	12	59	980	13	-241	1,012
TOTAL	462	2,260	1,50,581	605	52,539	2,32,874

*: As at end-March.

Source: Securities and Exchange Board of India.

I.5.35 Total resources mobilised by the All-India Financial Institutions (AIFIs), excluding erstwhile IDBI, in the form of bonds and debentures rose by 19.0 per cent to Rs.17,828 crore during 2005-06 (Table 1.62). Some FIs such as IFCI Ltd. and IIBI Ltd. continued to be barred from mobilising fresh resources on account of their poor financial performance. Financial assistance sanctioned and disbursed by AIFIs increased by 77.4 per cent and 56.3 per cent, respectively, during 2005-06 (Appendix Table 44).

Secondary Market

I.5.36 The stock markets witnessed bullish conditions during 2005-06 with the benchmark indices touching all time high levels. The BSE Sensex rose by 73.7 per cent between end-March 2005 and end-March 2006, while the S&P CNX Nifty increased by 67.1 per cent (Chart I.37 and Appendix Table 45).

I.5.37 The stock market gains were driven mainly by continued investments by both FIIs and domestic

Table 1.62: Resources Raised by way of Bonds/Debentures by Select All-India FIs

(Amount in Rupees crore)

Institution	Resources Raised		Outstanding Borrowings		Weighted Average Cost of Funds (Per cent)		Weighted Average Maturity (years)	
	2004-05	2005-06	March 2005	March 2006	2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6	7	8	9
IIBI	..	..	1,855	1,425	..	..	..	..
IFCI	..	..	11,628	10,805	..	..	..	..
TFCI	..	..	339	277	..	..	..	..
Exim Bank	955	2,860	9,384	6,949	6.9	7.0	5.1	4.7
IDFC	1,153	1,532	3,183	4,212	6.8	7.0	5.9	7.3
SIDBI	1,607	2,610	6,239	8,025	6.3	4.5	7.0	7.0
NABARD	8,843	8,195	17,204	20,817	6.6	5.8	2.1	2.0
NHB	2,419	2,631	11,215	13,693	6.5	5.9	2.8	2.2
Total	14,977	17,828	61,047	66,203				

.. : Not applicable.

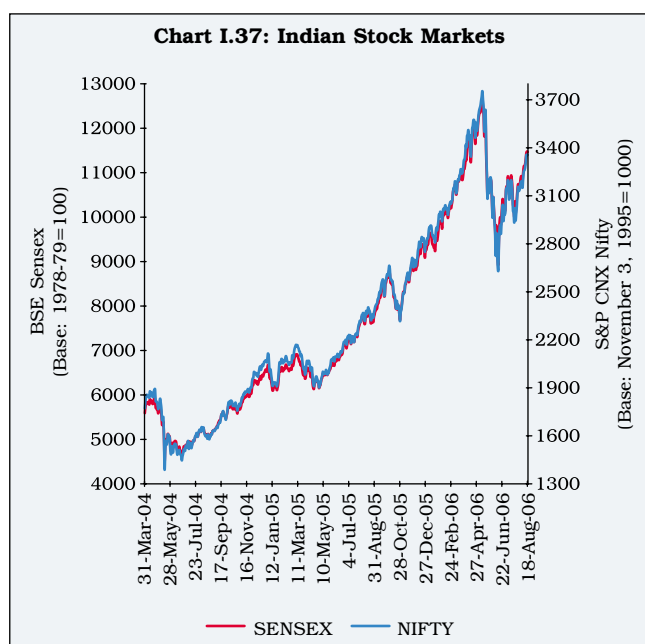
Note : 1. Data relate to rupee resources only.

2. Data on resources raised include: long-term resources mobilised through bonds/debentures; short-term resources mobilised through commercial papers, certificates of deposit, ICDs, term deposits and term money.

3. Data are provisional.

Source : Respective Financial Institutions (FIs).

ECONOMIC REVIEW



institutional investors on the back of strong macroeconomic fundamentals, sound business

outlook and robust corporate earnings. Profits after tax of select non-financial non-Government companies recorded a growth of more than 40 per cent for 11 successive quarters from October-December 2002 to April-June 2005. Subsequently, growth in profits decelerated, but still remains high given the strong base of the previous quarters (Table 1.63).

I.5.38 FIs continued to make large investments in stock markets for the third successive year. Equity investments by FIs in domestic markets have averaged Rs.44,294 crore (US\$ 9.8 billion) per annum between 2003-04 and 2005-06. Investments by domestic mutual funds surged from Rs.448 crore in 2004-05 to Rs.14,302 crore in 2005-06. Consequently, equity investments by mutual funds which were only one per cent of investments by FIs during 2004-05 increased sharply during 2005-06 and were about 30 per cent of investment by FIs (Table 1.64). Positive measures announced in the Union Budget, 2006-07 such as raising FI investment limit in Government securities and corporate debt, treating open-ended equity-oriented schemes and close-ended equity-oriented schemes on par for dividend distribution tax,

Table 1.63 Corporate Financial Performance

(Growth rates in per cent)

Item	2003-04			2004-05				2005-06			
	2	3	4	5	6	7	8	9	10	11	12
Sales	16.0	24.1	16.9	24.8	23.7	24.1	21.0	18.5	16.4	13.2	19.5
Expenditure	13.2	21.9	16.4	23.4	22.4	24.3	19.8	18.0	16.3	12.7	18.9
Gross Profit	25.0	32.5	20.3	36.0	35.8	30.5	35.3	32.0	19.1	21.2	16.6
Interest	-11.9	-5.8	1.9	-3.2	2.1	-13.0	-5.4	-13.5	-8.0	4.6	3.8
Profit After Tax	59.8	51.2	24.2	51.2	45.3	45.5	51.4	54.2	27.5	27.0	15.1
Select Ratios (Per cent)											
Gross Profit to Sales	11.1	11.9	13.0	12.8	13.4	12.3	13.2	13.1	13.0	12.8	12.7
Profit After Tax to Sales	5.9	7.2	8.7	7.7	8.5	8.1	9.4	8.6	8.5	8.6	8.7
Interest Coverage Ratio (number)	3.3	4.6	6.4	4.8	5.7	6.1	7.5	6.0	6.2	6.2	7.3
Interest to Sales	3.4	2.6	2.0	2.7	2.3	2.0	1.8	2.2	2.1	2.1	1.7
Interest to Gross Profits	30.7	21.8	15.7	20.9	17.5	16.4	13.4	16.6	16.2	16.2	13.7
Memo : (Amount in Rupees crore)											
No. of Companies	2,214	2,214	2,210	1,255	1,353	1,464	1,301	2,355	2,361	2,366	2,415
Sales	4,42,743	5,49,449	7,74,578	1,35,156	1,53,040	1,62,193	1,79,632	1,94,608	2,12,693	2,19,098	2,49,971
Expenditure	4,22,110	5,14,574	6,66,690	1,15,656	1,31,227	1,40,574	1,56,647	1,66,972	1,83,717	1,88,934	2,18,511
Depreciation Provision	20,406	22,697	28,883	5,504	5,836	5,731	6,106	7,137	7,617	7,748	8,340
Gross Profit	49,278	65,301	1,00,666	17,234	20,448	20,017	23,736	25,577	27,620	28,135	31,652
Interest	15,143	14,268	15,789	3,597	3,584	3,273	3,177	4,241	4,467	4,555	4,348
Profit After Tax	26,182	39,599	67,506	10,396	13,004	13,196	16,798	16,726	18,169	18,790	21,634

Note : 1. Growth rates are percentage change in the level for the period under reference over the corresponding period of the previous year.
2. Data are based on the audited/unaudited abridged results of the non-financial non-Government companies except column (2) and column (3) which are based on audited balance sheets for 2003-04 and 2004-05, respectively.

Table 1.64: Trends in Institutional Investments

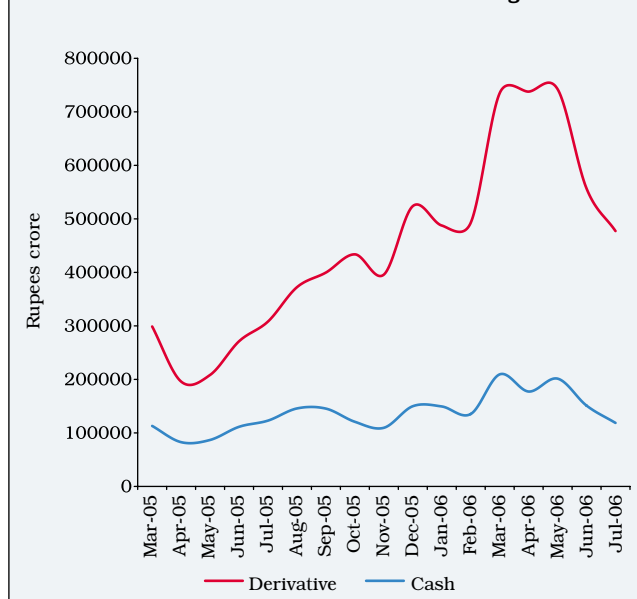
(Rupees crore)

Year	FIIs		Mutual Funds	
	Net Investment in Equity	Net Investment in Debt	Net Investment in Equity	Net Investment in Debt
1	2	3	4	5
2001-02	8,067	685	-3,796	10,959
2002-03	2,528	60	-2,067	12,604
2003-04	39,959	5,805	1,308	22,701
2004-05	44,123	1,759	448	16,987
2005-06	48,801	-7,334	14,302	36,801

Source: Securities and Exchange Board of India.

rationalisation of excise duties and relaxation in fringe benefit tax (FBT) also helped to boost the market sentiment.

1.5.39 Reflecting strong gains in stock prices, the price-earning (P/E) ratios increased during the year; for instance, the P/E ratio for the 30 scrips included in the BSE Sensex increased from 15.6 at end-March 2005 to 20.9 at end-March 2006 (Table 1.65 and Appendix Table 46). The market capitalisation of the BSE increased by 77.9 per cent during 2005-06, reflecting increase in stock prices as well as listing of new securities. Market capitalisation of the BSE jumped from 54.4 per cent of GDP at end-March 2005 to 85.5 per cent at end-March 2006. Although volatility in the stock market increased, domestic stock markets functioned smoothly without causing any disruption in the financial markets. The total turnover in cash segment increased sharply during 2005-06. The average daily turnover of BSE and NSE increased by

Chart I.38: Turnover in Cash and Derivative Segment - NSE

44.9 per cent to Rs.9,504 crore during 2005-06. The increase in turnover in equity derivatives segment was stronger than that of the cash segment (Chart I.38 and Appendix Table 47). Trading in stock futures accounted for a significant portion of turnover in equity derivatives.

1.5.40 The spurt in stock prices during 2005-06 was broad based, encompassing all indices (BSE 500, BSE Mid-cap, BSE Small-cap and BSE Sensex) and across all sectors (metal, auto, banks, capital goods, consumer durables, IT, oil and gas). The broad-based BSE 500 index increased by 65.2 per cent on a point-to-point basis during 2005-06 as

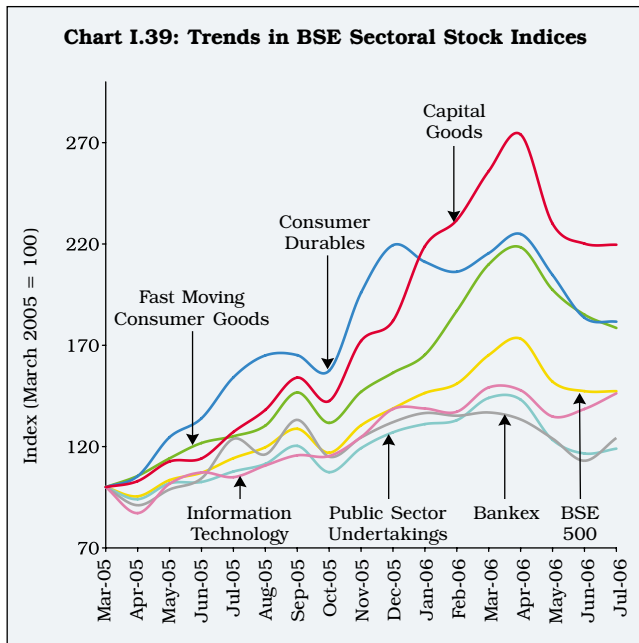
Table 1.65: Indian Equity Markets – Key Indicators

Indicator	BSE		NSE	
	2004-05	2005-06	2004-05	2005-06
1	2	3	4	5
1. BSE Sensex/S&P CNX Nifty				
(i) Average	5741	8280	1805	2513
(ii) End of the year	6493	11280	2036	3403
2. Coefficient of Variation (per cent)	11.16	16.72	11.28	15.60
3. Price-Earning Ratio (end-period) @	15.61	20.92	14.60	20.26
4. Price-Book Value Ratio@	3.70	5.10	3.82	5.15
5. Yield @ (per cent per annum)	1.70	1.20	1.97	1.33
6. Listed Companies	4,731	4,781	970	1,069
7. Cash Segment Turnover (Rupees crore)	5,18,715	8,16,074	11,40,071	15,69,556
8. Market Capitalisation (Rupees crore) #	16,98,428	30,22,191	15,85,585	28,13,201

@ : Based on 30 scrips included in the BSE Sensex and 50 scrips included in the S&P CNX Nifty.

: As at end-March.

Source: The Stock Exchange, Mumbai and the National Stock Exchange of India Limited.



compared with an increase of 73.7 per cent in the BSE Sensex (Chart I.39).

1.5.41 The capital goods stocks rose due to pick-up in investment activity, strong industrial performance and Government's emphasis on infrastructural developments. The consumer durables and fast moving consumer goods (FMCG) stocks were buoyant due to good financial results of some of the companies. FMCG stocks also gained from abolition of excise duty on branded foods and reduction in excise duty from 16 per cent to eight per cent on select fast food items in the Union Budget, 2006-07. Banking sector scrips registered gains due to sustained pick up in non-food credit of the banks, and permission to banks to raise capital through a variety of new instruments.

1.5.42 After recording sharp gains during 2005-06, stock markets witnessed correction during May-June 2006. Stock markets began 2006-07 on a buoyant note, continuing to record new highs on back of sustained investments by FIIs and domestic mutual funds. Both the BSE Sensex and S&P CNX Nifty closed at all time high levels of 12612 and 3754, respectively, on May 10, 2006, registering an increase of 11.8 per cent and 10.3 per cent, respectively, over their end-March levels. In the second half of May 2006, the stock markets declined substantially, following sharp correction in international commodity prices on concerns that US monetary policy tightening may be more than expected. Weakness in international stock markets, sales by FIIs, lower than expected results

of some major corporates, triggering of margin calls and fears of higher tax on investors led to further weakness in domestic stock markets. The BSE Sensex fell to 8929 on June 14, 2006. Stock markets, however, recovered some of the losses thereafter, reflecting fresh buying by FIIs, onset of the monsoon, robust corporate earnings and recovery in major international stock markets. The BSE Sensex closed at 11466 as on August 18, 2006, 1.6 per cent higher than that its end-March 2006 level.

Developments in Wholesale Debt Market Segment of NSE

1.5.43 In the Wholesale Debt Market (WDM) segment of the NSE, 3,174 securities were available for trading as on March 31, 2006 as compared with 3,097 securities as on March 31, 2005. Total market capitalisation of the securities available for trading on the WDM segment increased from Rs. 14,61,374 crore at March-2005 to Rs. 15,67,574 crore at end-March 2006. The turnover in WDM, however, declined by 46.4 per cent to Rs. 4,75,523 crore in 2005-06.

1.5.44 To conclude, domestic financial markets largely remained orderly during 2005-06 even as interest rates edged up in various market segments during the year. There was a substantial migration of money market activity from uncollateralised segment to the collateralised segment. The foreign exchange market remained by and large orderly. Yields in Government securities market edged up. Capital markets remained buoyant and the stock indices reached record highs during 2005-06 reflecting increased interest by domestic as well as foreign investors on the back of growth prospects.

VI. EXTERNAL SECTOR

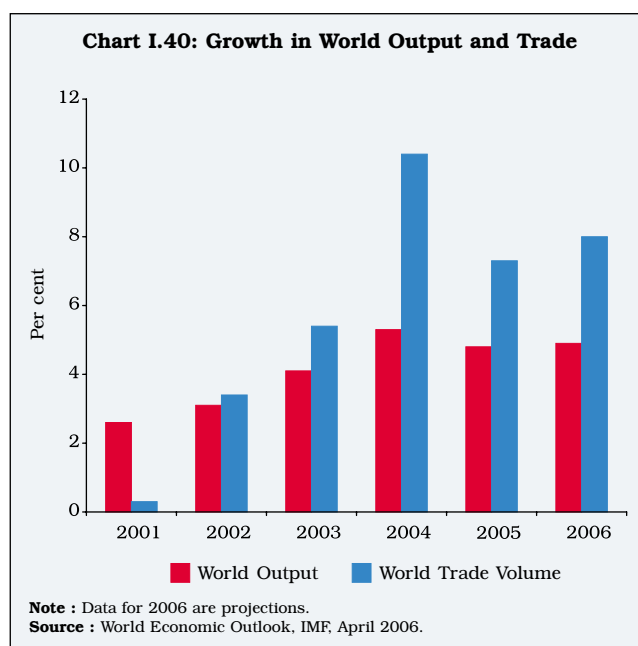
1.6.1 India's balance of payments position remained comfortable during 2005-06, notwithstanding pressures posed by record high oil prices. Balance of payments developments during 2005-06 showed a number of positive features. First, merchandise exports remained robust for the fourth year in succession, reflecting increasing competitiveness of technology intensive domestic manufacturing. Second, non-oil import demand recorded strong growth led by imports of capital goods, on account of large investment activity in the economy. Imports of gold and silver, on the other hand, were almost unchanged from the previous year. Third, invisible earnings from services and transfers continued to grow at a stable pace and thereby

financed a large part of the trade deficit. Fourth, the current account deficit widened during 2005-06. As a proportion to GDP, the current account deficit, however, remained modest. Fifth, sustained appetite for domestic financial assets was maintained in view of growth prospects of the Indian economy. This led to capital inflows remaining well in excess of the current account deficit. Sixth, the redemption of India Millennium Deposits (IMDs) amounting to US \$ 7.1 billion was completed smoothly. Seventh, notwithstanding the large outgo on IMD redemption and higher current account deficit, the overall balance of payments recorded a substantial surplus, leading to a further increase in foreign exchange reserves. Finally, external debt (as a proportion to GDP) continued to decline. Annual current receipts and the stock of foreign exchange reserves exceed the country's stock of external debt.

INTERNATIONAL DEVELOPMENTS

1.6.2 Global output growth remained robust at 4.8 per cent in 2005, *albeit* it decelerated from the three-decade high of 5.3 per cent during 2004 (Appendix Table 48). Thus, global economic activity exhibited considerable strength despite continued headwinds from record high international crude oil prices. Notwithstanding continuous pre-emptive monetary tightening by major central banks, macroeconomic policies were still largely accommodative. Financial market conditions were largely benign with real long-term rates remaining at low levels which supported the growth process. In advanced economies, growth decelerated from 3.3 per cent in 2004 to 2.7 per cent in 2005, reflecting some slowdown in the US and the euro area partly offset by the Japanese expansion. Growth in emerging market and developing economies remained strong at 7.2 per cent in 2005 on top of 7.6 per cent in 2004, led by China (9.9 per cent), India (8.4 per cent) and Russia (6.4 per cent). Volume of world trade in goods and services witnessed a growth of 7.3 per cent during 2005 as compared with 10.4 per cent in 2004 (Chart I.40). Developing countries maintained higher export growth during 2005 at 11.5 per cent than that of industrial countries (5.3 per cent).

1.6.3 Private capital flows to emerging market and developing countries strengthened further during 2005, reflecting enhanced growth prospects in these economies. Foreign direct investment flows continued to be the major driver of private capital flows, contributing more than four-fifths to total flows. Net portfolio investments, which had increased sharply



during 2004, were sustained at elevated levels during 2005 (Table 1.66). Asia continued to be a major recipient of private foreign capital, led by China. Capital flows to Western Hemisphere, particularly, Mexico and Brazil were boosted by increased cross-border merger and acquisition activity in the banking and manufacturing sectors.

1.6.4 Global GDP is projected by the IMF to grow by 4.9 per cent in 2006 (Appendix Table 48). Continued headwinds from high oil prices are expected to be offset by a gradual pick-up in investment, as increasing capacity constraints are expected to encourage corporates to reduce their net savings. Growth forecasts for the emerging market and developing countries remain robust, led by India and China. World trade in volume terms is projected to grow by 8.0 per cent during 2006, slightly higher than a year ago.

Table 1.66: Net Capital Flows to Emerging Market and Developing Economies

(US \$ billion)

Item	2003	2004	2005	2006P	2007P
1	2	3	4	5	6
Private Capital Flows	160.4	230.6	254.0	178.8	153.8
Direct Investment	157.5	184.3	212.3	220.6	217.5
Portfolio Investment	-3.7	34.5	38.5	-4.7	-3.2
Others	6.6	11.8	3.2	-37.1	-60.5
Official Capital Flows	-61.5	-81.5	-138.6	-161.3	-163.6

P : IMF Projections.

Source : World Economic Outlook, IMF, April 2006.

1.6.5 Global growth prospects, however, are subject to a number of downside risks. First, a major risk arises from the huge and growing financial imbalances between the US and the rest of the world (Box I.16). The huge current account deficit of the US is currently being financed by other advanced countries, oil exporting countries of the Middle East and middle income countries of South East Asia. The possibility

of an abrupt and disorderly adjustment of the imbalances poses significant risks to the world economy in the form of disorderly exchange rate adjustments and large increase in interest rates. Second, high and volatile oil prices continue to pose a threat to global economy. Rising oil prices by increasing the current account surplus of the major oil exporting countries are also exacerbating global

Box I.16

Global Macroeconomic Imbalances

The current global macroeconomic imbalance is reflected in large mismatches in the current account positions in some countries (large and growing deficit in the US and surpluses in oil exporting countries and some Asian countries such as China) and its mirror image in the form of mismatches in domestic savings and investment. The massive absorption of global capital by the US is of questionable sustainability and, if sustainable, of dubious desirability (Summers, 2006). The possibility of an abrupt and disorderly adjustment of the imbalances poses significant risks to the world economy. An unwinding of global imbalances, if it is not to be recessionary for the global economy, requires compensatory actions in other parts of the world.

Against this backdrop, as the Communiqué issued by the International Monetary and Financial Committee (IMFC) released on April 22, 2006 observed, adequate and timely policy action for orderly medium-term resolution of global imbalances is a shared responsibility, and will bring greater benefit to members and the international community than actions taken individually by countries. Key elements of the strategy towards orderly resolution of the global imbalances suggested in the Communiqué are:

- Raising national saving in the United States — with measures to reduce the budget deficit and spur private saving;
- Implementing structural reforms to sustain growth potential and boost domestic demand in the euro area and other countries;
- Further structural reforms, including fiscal consolidation, in Japan;
- Allowing greater exchange rate flexibility in a number of countries in emerging Asia; and
- Promoting efficient absorption of higher oil revenues in oil-exporting countries with strong macroeconomic policies.

In view of the complex nature of global imbalances, various possibilities may be explored to minimise the risks of disorderly adjustments. Looking at the national balance sheets would be useful to acquire a sense about the potential for adjustment, and they will give a sense of the possible impact of relative price changes on the value of assets and liabilities (Reddy, 2006). The possibility of bringing about global rebalancing through exchange rate adjustment by itself may not be very encouraging. Although exchange rate would have an important role to play in

global rebalancing, its relationship with other components of the whole package like saving-investment, fiscal deficit, structural reforms and domestic output as well as employment is important.

As regards India, its policies have not only served the economy well but have also contributed to global stability. Between 2001-02 and 2003-04, India registered modest current account surpluses, but this was more of a reflection of phase of business cycle, and with the turnaround in the business cycle, India has registered a current account deficit in the last two years. Second, in contrast to most of the Asian EMEs and Japan, capital flows, as opposed to current account surpluses, played an increasingly important role in the accumulation of reserves in India. Third, India's policy of market determined exchange rate with no predetermined target along with market interventions essentially to manage volatility has served the country well. Finally, the main driver of growth in India has been domestic demand, facilitated by improvement in the rate of aggregate domestic saving.

As regards the likely impact of disorderly adjustment of the global imbalances on India, it may be noted that India does not depend on the international capital market for financing the fiscal deficit and consequently, to some extent, adverse consequences of the global developments would be muted. However, there could be a spill over effect of global developments on domestic interest rates and thus on the fisc too. Similarly, any abrupt adjustment in global imbalances may affect corporates, banks and households in India, though the impact may be less than in some other emerging economies. In other words, while India by itself hardly contributes to the current global financial imbalances, any large and rapid adjustments in major currencies and related interest rates or current accounts of trading partners could indirectly, but significantly, impact the Indian economy (Reddy, 2006).

Reference

1. Reddy, Y. V. (2006), "Global Imbalances - An Indian Perspective", Reserve Bank of India Bulletin, June.
2. Summers, Lawrence (2006), "Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation", Reserve Bank of India Bulletin, April.

current account imbalances. Third, the recent volatility and re-pricing of risk in the international financial markets also pose downside risks. Finally, while both the probability and potential risk from the avian flu pandemic are impossible to assess with any certainty, a worse case scenario could have extremely high human and economic costs, particularly for developing countries.

BALANCE OF PAYMENTS

1.6.6 India's balance of payments remained comfortable during 2005-06 despite record high oil prices and the redemption of the India Millennium Deposits (IMDs). Although export growth remained robust for the fourth successive year and invisible earnings were buoyant, the current account deficit widened during 2005-06 reflecting the cumulative impact of high level of international crude oil prices

and growth in imports emanating from strong industrial activity (Table 1.67 and Appendix Table 49). Structural shifts in the services exports since the mid-1990s have provided much needed resilience to India's invisibles. During 2005-06, besides software, there was a surge in exports of a number of professional and business services. India continued to remain the leading remittance receiving country in the world with relative stability in such inflows. Capital flows continued to remain large, led by foreign investment flows reflecting increased appetite for domestic financial assets. The surge in imports was also manifested in recourse to debt flows – trade credit and external commercial borrowings. Consequently, the balance of payments position remained comfortable with foreign exchange reserves increasing by US \$ 10.1 billion during 2005-06, despite an outflow of US \$ 7.1 billion during December 2005 from the reserves on account of the redemption of IMDs.

Table 1.67: Balance of Payments – Key Indicators

(US \$ million)

Item/Indicator	1990-91	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 P
1	2	3	4	5	6	7	8
i) Trade Balance	-9,438	-12,460	-11,574	-10,690	-13,718	-36,629	-51,554
ii) Invisibles, net	-242	9,794	14,974	17,035	27,801	31,229	40,942
iii) Current Account Balance	-9,680	-2,666	3,400	6,345	14,083	-5,400	-10,612
iv) Capital Account	7,056	8,840	8,551	10,840	16,736	31,027	24,693
v) Overall Balance #	-2,492	5,868	11,757	16,985	31,421	26,159	15,052
vi) Foreign Exchange Reserves* [Increase(-), Decrease (+)]	1,278	-5,842	-11,757	-16,985	-31,421	-26,159	-15,052
Indicators (in per cent)							
1. Trade							
i) Exports/GDP	5.8	9.9	9.4	10.6	11.0	11.8	13.1
ii) Imports/GDP	8.8	12.6	11.8	12.7	13.3	17.1	19.6
iii) Export Volume Growth	11.0	23.9	3.9	21.7	6.0	13.2	n.a.
2. Invisibles							
i) Invisibles Receipts/GDP	2.4	7.0	7.7	8.3	8.9	10.3	11.5
ii) Invisibles Payments/GDP	2.4	4.9	4.5	4.9	4.3	5.8	6.4
iii) Invisibles (net)/GDP	-0.1	2.1	3.1	3.4	4.6	4.5	5.1
3. Current Account							
i) Current Receipts@/GDP	8.0	16.8	16.9	18.8	19.8	22.0	24.5
ii) Current Receipts Growth@	6.6	14.8	4.5	17.6	25.2	28.6	27.5
iii) Current Receipts@/Current Payments	71.5	96.4	103.8	106.6	112.8	96.2	94.5
iv) Current Account Balance/GDP	-3.1	-0.6	0.7	1.3	2.3	-0.8	-1.3
4. Capital Account							
i) Foreign Investment/GDP	0.0	1.5	1.7	1.2	2.6	2.1	2.5
ii) Foreign Investment/Exports	0.6	14.9	18.2	11.2	23.7	17.6	19.3
5. Others							
i) Debt - GDP Ratio	28.7	22.4	21.1	20.4	17.8	17.3	15.8
ii) Debt - Service Ratio	35.3	16.6	13.4	16.4	16.3	6.1	10.2
iii) Liability - Service Ratio	35.6	18.4	14.9	16.1	19.1	7.1	11.5
iv) Import Cover of Reserves (in months)	2.5	8.8	11.7	14.2	16.9	14.3	11.6
P : Preliminary. # : Includes errors and omissions.							
* : Excluding valuation changes. @ : Excluding official transfers. n.a. : Not Available.							

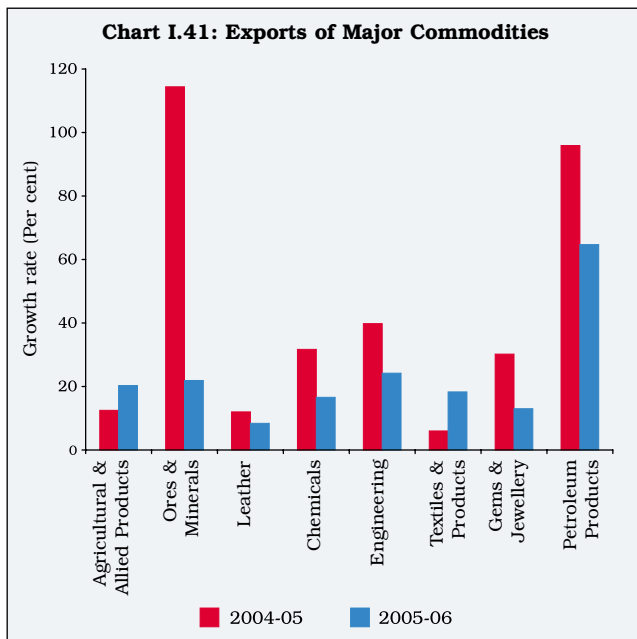
Merchandise Trade

I.6.7 India's merchandise trade maintained the momentum of strong growth in the environment of buoyant global economy and supportive domestic policy measures. India's merchandise exports sustained the high growth trajectory for the fourth year in succession, averaging 24 per cent per annum, reflecting increasing competitiveness of the technology intensive domestic manufacturing. Despite some moderation in growth in global trade in 2005, India was one of the fastest growing exporters among emerging economies in the world. As a result, India's share in world exports increased to 0.86 per cent in 2005. According to the World Trade Organisation (WTO), India became the 29th largest exporter in 2005 from being the 30th largest in 2004. India's merchandise imports also remained buoyant in 2005 reflecting strong growth in domestic industrial activity – India emerged as the 17th largest importer in the world in 2005 (24th in 2004).

I.6.8 India's merchandise exports increased by 23.0 per cent during 2005-06 on top of 30.8 per cent during 2004-05. As a result, exports crossed US \$ 100 billion during 2005-06, surpassing the annual target of US \$ 92 billion set by Government of India for 2005-06 (Appendix Table 50). Export growth was broad-based (Chart I.41). Exports of primary products benefited, *inter alia*, from the strengthening of commodity prices. Agricultural and allied commodities exports witnessed a sharp acceleration, driven by coffee, rice, cotton, oil meal and spices. Ores and minerals, especially iron ore, continued to post high

export growth, although there was some deceleration partly due to strong domestic demand for metals.

I.6.9 Exports of manufactured products during 2005-06 were led by technology intensive engineering goods, chemicals, textiles, and gems and jewellery. In the recent years, the commodity composition of manufactured exports has witnessed a notable shift with engineering goods emerging as the key driver of growth (Box I.17). In 2005-06, engineering goods (comprising goods such as machinery and instruments, transport equipments, manufactures of metals, iron and steel, and electronic goods) remained the mainstay, accounting for the highest share of 21.0 per cent in the total exports, followed by textiles (15.6 per cent), gems and jewellery (15.1 per cent) and chemicals (14.1 per cent). Engineering goods exports registered growth of 24.2 per cent during 2005-06, fuelled by strong demand from major markets such as the US, euro area, Eastern Europe, East Asia and Latin America. Within chemicals, basic chemicals, drugs and pharmaceuticals, rubber, glass and paints registered higher growth than a year ago. Growth in India's exports of textiles and textile products accelerated from 6.0 per cent in 2004-05 to 18.3 per cent in 2005-06 benefiting from access to the markets of erstwhile quota countries. Exports to erstwhile quota countries (the US, EU and Canada) increased sharply by 31.6 per cent. Exports to non-quota countries, on the other hand, were almost unchanged during 2005-06 (in fact, a marginal decline of 0.1 per cent). The EU and the US remained the major export markets, together accounting for 62 per cent of India's total textile exports in 2005-06. Within textile and textile products, exports of manmade fabrics, yarn and made-ups declined by 2.2 per cent mainly due to the sharp decline in exports to non-quota countries. Readymade garments, the major component of India's textiles exports, benefited from strong demand in the major markets such as the US and Europe. According to the US Department of Commerce, Office of Textiles and Apparel, India's textiles and apparel exports to the US increased by 27.1 per cent during 2005 (13.1 per cent during 2004) and India was one of the fastest growing exporters to the US. During 2005-06, petroleum exports continued to record strong growth, reflecting higher international prices of petroleum products. Petroleum exports have now emerged as a major export item of India, accounting for 11.2 per cent of total exports, as compared with 8.4 per cent in 2004-05. Growth in gems and jewellery exports, however, moderated which could be attributed, *inter alia*, to sharp increase in prices of gold and cut and polished diamonds (Appendix Table 51).



Box I.17

India's Exports of Engineering Goods

India's exports of engineering goods have shown a phenomenal growth in recent years. In an environment of increasing openness of the economy and supportive policy framework since the early 1990s, exports of engineering goods have increased from US \$ 1.2 billion in 1987-88 to US \$ 21.5 billion in 2005-06. In the recent three years (2003-04 to 2005-06), exports of engineering goods recorded an annual average growth of 33.8 per cent. As a result, their share in India's total exports has increased sharply and they now contribute more than one-fifth of India's total exports. Since 2004-05, engineering goods have emerged as the largest item of manufacturing exports, surpassing the exports of textiles and gems and jewellery. According to the Engineering Export Promotion Council (EEPC), almost 40 per cent of engineering goods exports are contributed by small and medium enterprises.

The destination of India's engineering goods exports has undergone substantial diversification in recent years. During the 1980s, the major destinations of India's engineering goods exports were Asia and Africa. Since the 1990s, the trend has changed with the share of the US, Europe and Australia increasing substantially. During 2005-06, the US was the major export destination accounting for 15.5 per cent of total engineering products exports.

Within engineering goods, automotive products segment has turned out to be the major driver. Since the mid-1990s,

India's automotive industry has witnessed rapid transformation from a low volume and fragmented sector into a highly competitive sector characterised by world-class technology, large and assured volumes and strict delivery schedules in response to the demand from global vehicle manufacturers. Several Indian companies have entered into technological collaborations and equity partnerships with world leaders in automotive components. India's competitive advantages in this sector are low labour costs and availability of skilled workforce. Furthermore, India's automotive components industry is highly diversified with a capacity to produce as many as 150 different products. Despite the increasing share of engineering products exports in India's total trade, India's share in world engineering goods exports remains negligible. Moreover, India's exports consist mainly of low value and some amount of medium value products.

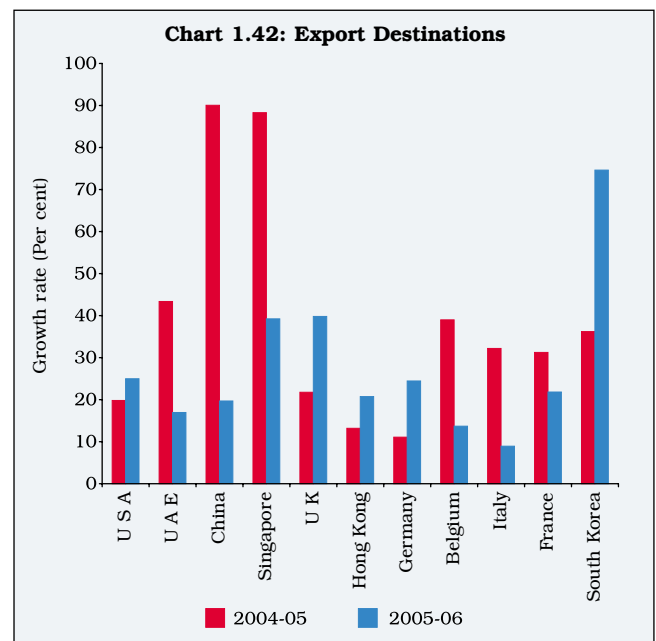
References

1. Government of India (2002), Auto Policy 2002.
2. Engineering Export Promotion Council (2005), Strategy Paper for Growth of Engineering Exports, 2005-06 to 2009-10.
3. Illiyan, A. (2006), "Progress and Prospects of Indian Engineering Goods Exports (1956-2005)", Foreign Trade Review, Vol. XL, No.4, January-March.

I.6.10 Destination-wise, the US continued to be the major trade partner of India accounting for 16.7 per cent of India's total exports, followed by the UAE (8.4 per cent), China (6.5 per cent), Singapore (5.4 per cent), UK (5.0 per cent), Hong Kong (4.3 per cent) and Germany (3.4 per cent). Region-wise, Latin America was the fastest growing market for India's exports during 2005-06 followed by Africa, Europe, East Asia and South Asia. A key feature of India's exports in the recent years is the emergence of Asian countries as an important destination in an environment of growing role of south-south trade in world trade (Chart I.42, Box I.18).

I.6.11 Imports maintained high growth at 27.7 per cent during 2005-06 (42.7 per cent growth a year ago), reflecting higher oil prices as well as strong overall domestic demand. Oil imports at US \$ 44.0 billion increased by 47.3 per cent during 2005-06. This was mainly on account of elevated international oil prices as in volume terms, the growth of oil imports decelerated from 5.5 per cent during 2004-05 to 4.2 per cent in 2005-06. India's oil import bill has increased from 2.9 per cent of GDP in 2001-02 to 5.5

per cent of GDP in 2005-06, mirroring the surge in international crude oil prices.



Box I.18

India's Merchandise Trade with Asia

World trade has witnessed many noteworthy changes over the past 25 years with trade between developing economies growing twice as fast as world trade. Intra-regional trade accounted for 43 per cent of developing countries' exports in 2004 as compared with only 26 per cent in 1980. The surge in developing economies trade, led by East Asia, China and India, has occurred due to the significant improvement in market access resulting from outward-oriented development strategies, trade and economic reforms, regional trade agreements and above all, faster output growth in developing Asian countries. The fragmentation of vertically integrated supply chains based on locational advantages has played a major role in promoting intra-regional trade in the Asian region.

India's merchandise trade has moved increasingly towards developing countries, especially with other Asian countries in tune with the shifts in destination of world trade. Developing economies account for a major share of India's total trade: 56.7 per cent of India's total exports and 52.9 per cent of India's total non-oil imports in 2005-06 (Table). In particular, the Asian economies are emerging as major trading partners of India. India's trade has grown faster with these countries than its overall trade growth. Emerging Asian economies accounted for 22.6 per cent of India's

total exports in 2005-06 (15.6 per cent in 2000-01) and 29.0 per cent of total non-oil imports (22.1 per cent in 2000-01). In 2005-06, China emerged as the third major export destination for India and it has now become the largest source of imports for India. Exports to China surged by 19.7 per cent in 2005-06, while imports from China increased by 51.3 per cent reflecting growing trade relations between the two countries.

Commodity-wise, engineering goods (including metals, metal products, transport equipment, and iron and steel), gems and jewellery, petroleum products, chemicals and iron ores are India's major exports to Asia. The major items of India's imports from Asia are electronic goods, pearls, precious and semi-precious stones, chemicals, gold and silver, vegetable oils and non-electrical machinery.

India's increasing trade with developing countries is attributable to trade liberalisation, reduction in tariffs, reduction of non-tariff barriers, various trade policy measures and regional cooperation efforts. Emerging Asia has the advantage of geographical proximity and a large market of 45 per cent of the world population and 11 per cent of world GDP.

In recognition of the growing importance of Asian countries in India's foreign trade, the series of nominal and real effective exchange rate indices released by the Reserve Bank have been revised to include Chinese renminbi and Hong Kong dollar in the weighting scheme. Japan being already included, the representation of Asian economies has increased to three out of the total of six countries (Reddy, 2006).

Table: India's Trade with Asia in 2005-06

Region/Group	Exports	Non-oil Imports	(US \$ million)	
			Share in total exports (Per cent)	Share in non-oil imports (Per cent)
Developing Countries	58,265	52,039	56.7	52.9
Asia	44,812	40,755	43.6	41.4
Emerging Asia	23,258	28,577	22.6	29.0
China	6,721	10,740	6.5	10.9
SAARC	5,359	1,339	5.2	1.4
ASEAN	10,513	10,611	10.2	10.8
Gulf Cooperation Council	11,753	7,728	11.4	7.8

Source : DGCI&S.

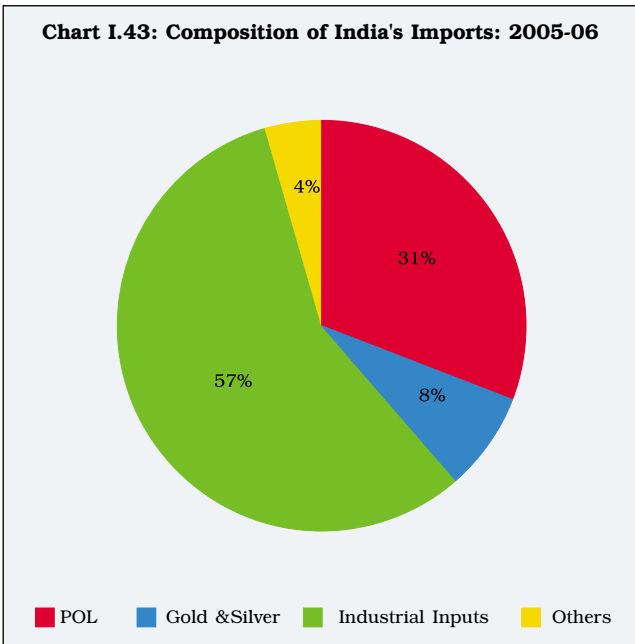
I.6.12 Non-oil non-gold imports maintained the momentum of growth, increasing by 23.7 per cent during 2005-06 as compared with 39.0 per cent a year ago. Imports of industrial inputs (non-oil imports net of gold and silver, bulk consumption goods, manufactured fertilisers and professional instruments) recorded strong growth of 24.7 per cent (41.4 per cent increase a year ago). Imports of capital goods were the mainstay, accounting for 39.1 per cent of the imports of industrial inputs. Imports of capital goods increased by 26.0 per cent during 2005-06 (37.5 per cent a year ago) in consonance with

References

1. Reddy, Y.V. (2006), "India in Emerging Asia", Reserve Bank of India Bulletin, June.
2. UNCTAD (2005), Handbook of Statistics.
3. _____ (2005), Trade and Development Report.

acceleration in domestic production of capital goods, reflecting large investment demand and continued expansion in capacity. Growth in imports of gold and silver, however, decelerated to 0.4 per cent in 2005-06 from 62.6 per cent a year ago, which could be attributed to the surge in gold prices (Appendix Table 52 and Chart I.43). Among bulk commodities, imports of manufactured fertilisers, metalliferous ores and scraps, non-ferrous metals, and iron and steel rose steeply while imports of bulk consumption goods such as edible oils witnessed a decline during 2005-06.

Chart I.43: Composition of India's Imports: 2005-06



I.6.13 Country-wise, China was the major source of imports with a share of 10.9 per cent in India's total non-oil imports, followed by the US (7.9 per cent), Switzerland (6.6 per cent), Australia (4.9 per cent), Belgium (4.8 per cent) and UAE (4.4 per cent). Region-wise, developing economies were the major source, accounting for 52.9 per cent of India's total non-oil imports.

I.6.14 Led by the expansion of oil imports (which increased by US \$ 14.1 billion) and non-oil imports (an increase of US \$ 16.8 billion), trade deficit, on DGCI&S basis, expanded by 41.8 per cent to US \$ 39.7 billion during 2005-06 (Appendix Table 50). Non-oil trade deficit, however, recorded a relatively modest increase from US \$ 5.1 billion during 2004-05 to US \$ 7.2 billion during 2005-06.

I.6.15 During 2006-07 (April-July), growth in merchandise exports decelerated to 20.8 per cent (in US dollar terms) from 34.6 per cent a year ago. Oil imports during April-July 2006 increased by 43.2 per cent on top of 36.5 per cent growth a year ago, reflecting further hardening of international crude oil prices. Non-oil imports during April-July 2006 grew by 9.9 per cent, a sharp deceleration from growth of 52.0 per cent a year ago. Commodity-wise data available for April-May 2006 indicate that this deceleration could be partly attributed to imports of gold and silver which declined by 33.7 per cent as against an increase of 55.6 per cent during April-May 2005. Imports of capital goods continued to record strong growth (37.2 per cent

during April-May 2006, *albeit* lower than that of 55.9 per cent during April-May 2005). The trade deficit increased to US \$ 16.7 billion during April-July 2006 from US \$ 14.4 billion during the corresponding period of 2005.

Invisibles

I.6.16 The sustained rise in invisibles surplus during 2005-06 – net balance under services, transfers and income – continued to moderate the impact of growing merchandise trade deficit. Net surplus under invisibles expanded from US \$ 31.2 billion during 2004-05 to US \$ 40.9 billion during 2005-06 (Appendix Table 53). As in recent years, growth in invisible receipts during 2005-06 was led mainly by significant expansion in software exports, other professional and business services and remittances from overseas Indians. This has led to a rise in the share of invisibles in the current receipts from 29 per cent in 1990-91 to 47 per cent in 2005-06 (Chart I.44). Reflecting the sustained growth since the early 1990s, gross invisible receipts have expanded sharply from 2.4 per cent of GDP in 1990-91 to 11.5 per cent in 2005-06. Gross invisible payments have expanded at a relatively modest pace over the same period from 2.4 per cent of GDP to 6.4 per cent. Consequently, the net surplus under invisibles – which recorded a modest deficit of 0.1 per cent in 1990-91 – has turned out to be quite substantial in recent years to reach 5.1 per cent of GDP in 2005-06.

Chart I.44: India's Invisible Receipts

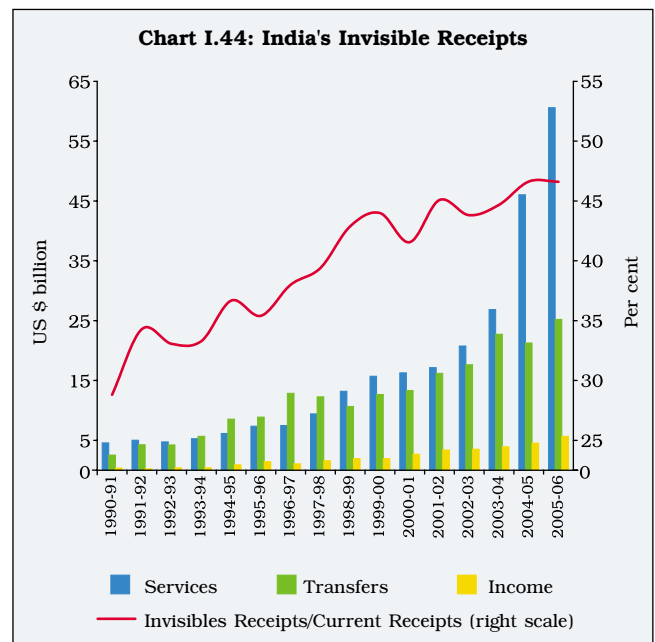


Table 1.68: Structure of India's Services Exports

Year	Amount (US \$ million)	Share in Total Services Exports (Per cent)					
		Travel	Transportation	Insurance	G.N.I.E.	Software	Miscellaneous*
1	2	3	4	5	6	7	8
1970-71	292	16.8	49.7	5.5	13.7	–	14.4
1980-81	2,804	43.5	16.3	2.3	4.0	–	33.9
1990-91	4,551	32.0	21.6	2.4	0.3	–	43.6
2000-01	16,268	21.5	12.6	1.7	4.0	39.0	21.3
2003-04	26,868	18.7	11.9	1.6	0.9	47.6	19.2
2004-05	46,031	14.1	10.4	2.0	0.7	37.4	35.4
2005-06	60,610	12.9	10.4	1.7	0.5	38.9	35.6

* : Excluding software services.

G.N.I.E. : Government not included elsewhere.

Services

I.6.17 Services exports during 2005-06 continued to be led by rapid growth in software services exports, other business and professional services (Table 1.68). Within the services exports, rising prominence of business services reflects high skill intensity of the Indian work force. There has also been a strong revival in international tourist interest in India since 2003-04.

I.6.18 Reflecting these positive developments and continued buoyancy of India's services exports, the share of India's services exports in world exports has recorded a significant increase from 0.6 per cent in 1995 to 1.8 per cent in 2004. India was the 18th largest

service exporter in the world in 2004 (Table 1.69). The gains recorded by the exports of services have far exceeded those recorded by exports of goods (Chart I.45).

I.6.19 Tourism earnings continued with their buoyancy witnessed since 2003-04, reflecting both business and leisure travel (Table 1.70). Foreign tourist arrivals in India followed the usual seasonal pattern, peaking in October-December with the tourist season extending up to March. Concomitantly, travel payments also increased from US \$ 5.5 billion in 2004-05 to US \$ 6.4 billion in 2005-06, reflecting rising business and leisure travel in consonance with (i) growing merchandise and services trade and (ii) growing disposable incomes of residents in an environment of liberalised payments regime.

Table 1.69: Exports of Services, 2004

Country	Exports (US \$ billion)	Share in World Exports (%)
1	2	3
USA	340	15.2
UK	181	8.1
Germany	142	6.3
France	110	4.9
Japan	98	4.4
Spain	85	3.8
Italy	84	3.7
Netherlands	73	3.3
China	62	2.8
Hong Kong	54	2.4
Belgium	52	2.3
Ireland	52	2.3
Austria	49	2.2
Canada	48	2.1
Switzerland	43	1.9
Korea	41	1.9
Singapore	41	1.8
India	40	1.8
Sweden	39	1.7

Source : Balance of Payments Statistics Yearbook 2005, IMF and Reserve Bank of India.

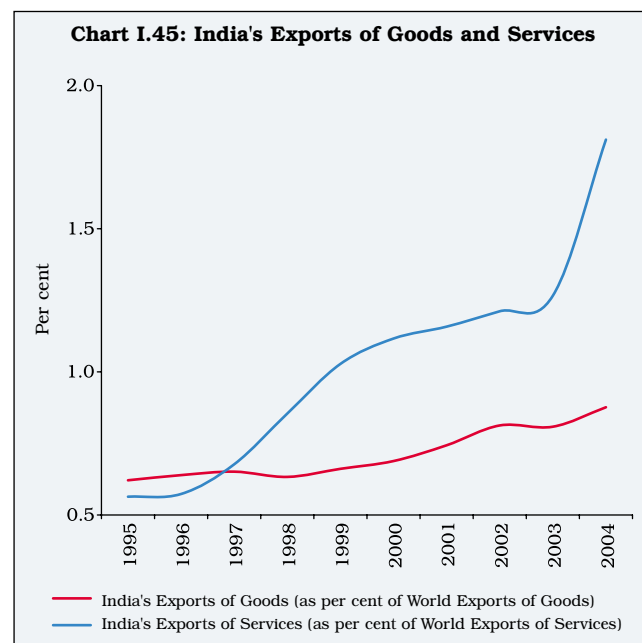


Table 1.70: Foreign Tourist Arrivals in India and Outbound Tourist Traffic

Year	Arrivals (millions)	Growth Rate (%)	Departure (millions)	Growth Rate (%)
1	2	3	4	5
1992	1.9	11.3	2.2	15.8
2000	2.7	6.9	4.4	7.3
2001	2.5	-7.4	4.6	4.5
2002	2.4	-4.0	4.9	6.5
2003	2.7	12.5	5.4	10.2
2004	3.5	29.6	6.2	14.8
2005	3.9	11.4	7.2	16.1

Source : Ministry of Tourism and Culture, Government of India.

I.6.20 Impressive growth in receipts from business services continued during 2005-06, indicating India's rising comparative advantage in commercial services. Earnings from exports of software and IT-enabled services remained the key driver of services earnings during 2005-06, recording a growth of 33 per cent (Table 1.71). Globally, India ranks second to Ireland in exports of computer and information services (Table 1.72). Notwithstanding increasing competitive pressures, India remains an attractive source because of its low cost of operations, high quality of products and services and availability of skilled manpower. Favourable time zone difference also helps organisations run round the clock internal operations and render better customer service. In order to withstand growing global competition, the Indian IT companies have started moving up the value chain by exploring untapped potential in IT consulting and system integration, hardware support and installation and processing services. Security concerns have also been duly recognised to maintain customer confidence. Sharp acceleration in non-software services exports continued during the year, emanating from dynamism in export of services such

Table 1.71: Services and Software Exports of India

(US \$ million)

Year	IT Services	ITES-BPO	Total Software
1	2	3	4 (2+3)
1995-96	754	-	754
2000-01	5,287	930	6,217
2004-05	13,100	4,600	17,700
2005-06	17,300	6,300	23,600

ITES : IT Enabled Services.

BPO : Business Process Outsourcing.

Source : NASSCOM.

Table 1.72: Computer and Information Services Exports, 2004

(US \$ billion)

Rank	Country	Amount
1	2	3
1	Ireland	18.6
2	India	17.7
3	U.K.	10.6
4	Germany	7.9
5	U.S.A.	6.6
6	Israel	4.3
7	Netherlands	3.6
8	Spain	2.9
9	Canada	2.8
10	Belgium	2.4

Source : Balance of Payments Statistics Year Book 2005, IMF and Reserve Bank of India.

as communications, construction, and management services. Business services payments also expanded reflecting the ongoing technological transformation of the economy and modernisation of Indian industry with the focus on foreign technological collaborations.

Private Transfers

I.6.21 Workers' remittances remained buoyant during 2005-06 benefiting from robust global output growth and constant improvement in remittance infrastructure domestically (Box I.19). Strong growth in oil exporting countries on the back of the surge in international crude oil prices also provided support to private remittances. India continues to be the highest remittance receiving country in the world (Table 1.73).

Investment Income

I.6.22 Investment income receipts continued to rise during 2005-06, reflecting mainly the income earned on deployment of foreign exchange reserves. Higher investment income receipts also reflect the impact of rising Indian overseas investment as also the expansion of commercial activities by the Indian companies. Investment income payments expanded, primarily on account of debt servicing costs as well as reinvested earnings of FDI enterprises. As income payments remained in excess of receipts, investment income recorded a deficit of US \$ 5 billion during 2005-06.

Box I.19

Inward Remittances

Remittance inflows have become an important source of financing of current account deficit not only in India but in several countries. Inward remittances to developing countries have surged from US \$ 58 billion in 1995 to US \$ 160 billion in 2004 (World Bank, 2005). Remittances have emerged as the second important source of funds to developing countries after foreign direct investment. Remittances are equivalent to about 6.7 percent of developing countries' imports and 7.5 percent of their domestic investment, indicating the significance of these inflows for the host economies, especially smaller economies. Remittances were even larger than total capital inflows in many developing countries in 2004 and exceeded merchandise exports in a number of countries. In part, the surge in officially recorded remittances to developing countries in recent years reflects better data collection owing to greater awareness of the development potential of remittances as well as concerns about money laundering. In a number of countries, Government policies to improve banking access and the technology of money transfers have also helped increase the flow of remittances and promote their transfer through formal channels. Workers remittances are found to be counter-cyclical and as such they have provided some element of stability to the recipient countries.

Remittance Inflows to India

The surge in workers' remittances to India, responding to the oil boom in the Middle East during the 1970s and 1980s, and the information technology revolution in the 1990s, has put India as the highest remittance receiving country in the world. Remittances include repatriation of funds for family maintenance and local withdrawals from the non-resident Indian (NRI) deposits.

Inward remittances from Indians working abroad have surged from US \$ 2.1 billion in 1990-91 to reach US \$ 24.6 billion in 2005-06, thereby proving to be a source of stable support to India's balance of payments (Table).

Table: Private Transfers to India

Year	Total Remittances (US \$ billion)	Share in Current Receipts (Per cent)	Total Remittances (Per cent of GDP)
1990-91	2.1	8.0	0.7
1995-96	8.5	17.1	2.4
1999-00	12.3	18.1	2.7
2000-01	13.1	16.8	2.8
2001-02	15.8	19.4	3.3
2002-03	17.2	18.0	3.4
2003-04	22.2	18.5	3.7
2004-05	20.7	13.4	3.0
2005-06	24.6	12.5	3.1

Inward remittances have offset India's merchandise trade deficit to a large extent, thus keeping current account deficits modest through the 1990s.

The sustained expansion in remittances since the 1990s has been underpinned by structural reforms, including market-based exchange rate, current account convertibility as well as a shift in the labour outflow pattern from semi-skilled to increasingly high-skilled categories. Policy initiatives to facilitate remittance flows through speedier and cost effective money transfer arrangements like banking channels, money transfer agencies and post offices have also contributed to stability in remittances. While banking channels account for bulk of the inward remittances to India, Money Transfer Service Scheme (MTSS) and Rupee Drawing Arrangements (RDA) are also assuming significance. These schemes provide benefits of easier and speedier operations and play an important role in expanding the outreach of remittance services to remote locations in the country.

Reference

World Bank (2005), *Global Economic Prospects 2006*.

Table 1.73: Workers' Remittances

Country	(US \$ million)		
	1996	2003	2004
1	2	3	4
Brazil	1,866	2,018	2,459
China	1,672	3,343	4,627
Colombia	..	3,060	3,170
Egypt	3,107	2,961	3,341
India	8,453	21,885	19,612
Mexico	4,224	13,396	16,613
Morocco	2,165	3,614	4,221
Pakistan	..	3,963	3,943
Portugal	3,575	2,752	3,032
Spain	2,749	4,718	5,189

Source : Balance of Payments Statistics Yearbook, 2005, IMF and Reserve Bank of India.

Current Account

I.6.23 Merchandise trade deficit, on balance of payments basis, increased from US \$ 36.6 billion during 2004-05 to US \$ 51.6 billion during 2005-06, led by higher imports. Net invisibles surplus also expanded during the year, financing a substantial part – about 79 per cent – of trade deficit during 2005-06. With the expansion in merchandise trade deficit, however, in excess of the expansion in the invisibles surplus, the deficit on the current account increased from US \$ 5.4 billion during 2004-05 to US \$ 10.6 billion during 2005-06. As a proportion to GDP, the current account deficit increased from 0.8 per cent during 2004-05 to 1.3 per cent in 2005-06. Thus, unlike many other emerging markets, which continue

Table 1.74: Current Account Balances in Select Countries

(Per cent to GDP)

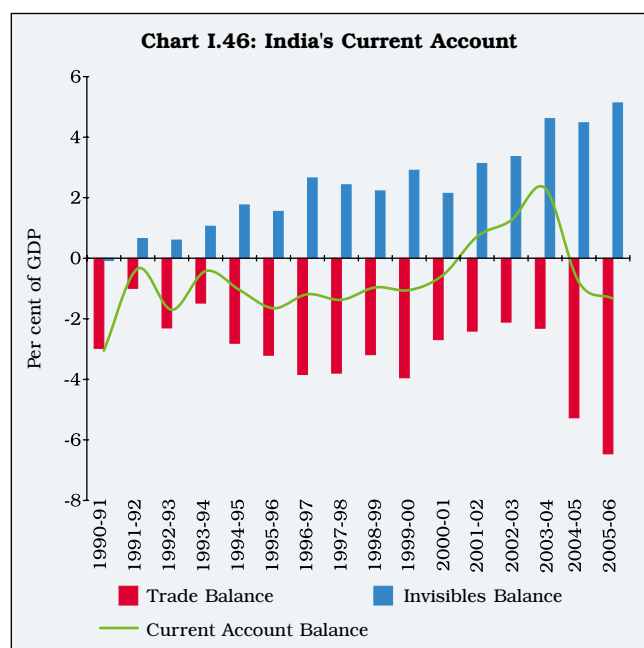
Country	1996	2000	2003	2004	2005
1	2	3	4	5	6
Argentina	-2.5	-3.2	6.3	2.2	1.8
Brazil	-3.0	-4.0	0.8	1.9	1.8
China	0.9	1.7	2.8	3.6	7.1
Germany	-0.6	-1.7	1.9	3.7	4.1
India@	-1.2	-0.6	2.3	-0.8	-1.3
Indonesia	-3.2	4.8	3.4	1.2	1.1
Japan	1.4	2.6	3.2	3.8	3.6
Korea	-4.1	2.4	2.0	4.1	2.1
Malaysia	-4.4	9.4	12.7	12.6	15.6
Mexico	-0.8	-3.2	-1.3	-1.1	-0.7
Philippines	-4.6	8.2	1.8	2.7	3.0
Thailand	-7.9	7.6	5.6	4.2	-2.3
US	-1.5	-4.2	-4.7	-5.7	-6.4

@ : Data pertain to fiscal year.

Note : (-) indicates deficit.

Source : World Economic Outlook, IMF, April 2006.

to record surpluses, India's current account balance shows a deficit (Table 1.74 and Chart I.46). Current account developments during 2005-06 point towards growing openness and integration of the Indian economy with the global economy. The ratio of current receipts to GDP increased from 22.0 per cent in 2004-05 to 24.5 per cent in 2005-06. Similarly, trade openness – the ratio of merchandise exports and imports to GDP – has increased from 28.9 per cent during 2004-05 to 32.7 per cent during 2005-06.



Capital Account

I.6.24 During 2005-06, capital flows remained buoyant, mainly led by foreign investment flows reflecting, to a large extent, growing interest in the economy's growth prospects (Appendix Table 54).

Foreign Investment

I.6.25 Both direct and portfolio foreign investment flows increased during 2005-06 (Table 1.75 and Box I.20). Foreign direct investment (FDI) flows into India were 37 per cent higher during 2005-06 on the back of positive investment climate, improved growth prospects and initiatives aimed at rationalising and liberalising the FDI policy and simplifying the procedures.

I.6.26 Country-wise, Mauritius and the US remained the major FDI investors in India (Table 1.76). FDI flows from the UK and Singapore increased sharply during 2005-06. Sector-wise, FDI flows continued to be

Table 1.75: Foreign Investment Flows to India

(US \$ million)

Item	2003-04	2004-05	2005-06 P
1	2	3	4
A. Direct Investment (I+II+III)	4,322	5,652	7,751
I. Equity (a+b+c+d+e)	2,229	3,777	5,820
a) Government (SIA/FIPB)	928	1,062	1,126
b) RBI	534	1,258	2,233
c) NRI	-	-	-
d) Acquisition of shares*	735	930	2,181
e) Equity capital of unincorporated bodies	32	527	280
II. Re-invested Earnings	1,460	1,508	1,676
III. Other Capital #	633	367	255
B. Portfolio Investment (a+b+c)	11,377	9,315	12,492
a) GDRs/ADRs	459	613	2,552
b) FIIs @	10,918	8,686	9,926
c) Off-shore funds and others	-	16	14
C. Total (A+B)	15,699	14,967	20,243

P : Provisional

- : Nil/Negligible.

* : Relates to acquisition of shares of Indian companies by non-residents under section 6 of the FEMA, 1999.

: Data pertain to inter-company debt transactions of FDI entities.

@ : Data represent net inflow of funds by FIIs.

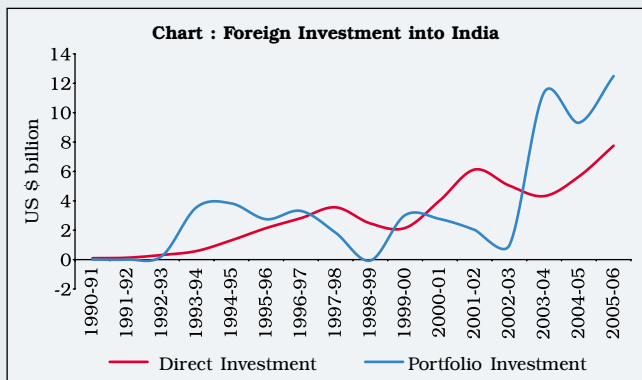
Note : 1. Data on reinvested earnings for 2004-05 and 2005-06 are estimates.

2. Data on foreign investment presented in this table represent inflows into the country and may not tally with the data presented in other tables. They may also differ from data relating to net investment in stock exchanges by FIIs.

Box I.20

Foreign Investment Flows to India

Foreign investment flows in to India, comprising foreign direct investment (FDI) and foreign portfolio investment (FPI), have risen sharply during the 1990s reflecting the policies to attract non-debt creating flows. Foreign investment flows have increased from negligible levels during 1980s to reach US \$ 20 billion by 2005-06 (Chart). Cumulative foreign investment flows have amounted to US \$ 106 billion since 1990-91 and almost evenly balanced between direct investment flows (US \$ 49 billion) and portfolio flows (US \$ 57 billion). Since 1993-94, FDI flows have exceeded portfolio flows in five years while portfolio flows have exceeded FDI flows in the remaining eight years. As a proportion to FDI flows to emerging market and developing countries, FDI flows to India have shown a consistent rise from 1.6 per cent in 1998 to 3.7 per cent in 2005. The share of net FPI flows to India as a proportion to total flows to emerging market and developing countries is higher and remained in the range of 12-15 per cent during 2004 and 2005.



The sharp rise in portfolio investment into India since 2003-04 reflects both global and domestic factors. Search for yield in view of very low real long-term rates in advanced economies have been an important factor driving portfolio flows to emerging market economies as a group and India has also attracted such flows. Domestic factors such as strong macroeconomic fundamentals, resilient financial sector, deep and liquid capital market, improved financial performance of the corporate sector and attractive valuations also attracted large portfolio flows between 2003-04 and 2005-06.

Recognising the macro economic implications of volatility associated with capital flows, India has adopted a policy of managing the capital account with a preference for non-debt flows (Mohan, 2005). Consistent with the principle of hierarchy of capital flows, India has been making efforts towards encouraging more inflows through

FDI and enhancing the quality of portfolio flows by strict adherence to 'Know Your Investor' principle (Reddy, 2005). The Government has also taken steps to enhance the FDI sectoral caps in infrastructure in recent years (e.g. telecom, civil aviation). FDI up to 100 per cent through the Reserve Bank's automatic route was permitted for a number of new sectors in 2005-06 such as greenfield airport projects, laying of pipelines, export trading. FDI caps under the automatic route were enhanced to 100 per cent for coal and lignite mining for captive consumption and setting up infrastructure relating to marketing in petroleum and natural gas sector. All these measures have been contributing towards increasing direct investment. With the FDI inflows to developing world still in a stage of recovery to the pre-East Asian crisis level, India's FDI growth of above 30 per cent during past two years is encouraging. Although the FDI inflows into India are small as compared to other emerging markets, their size is growing on the back of growing interest by many of the world's leading multinationals. India has improved its rank from fifteenth (in 2002) to become the second most likely FDI destination after China in 2005 (AT Kearney).

In the context of encouraging FII flows, sufficient attention needs to be given to address the macroeconomic implications of volatility of capital flows. There is a need to examine the likely implications of excessive inflows and outflows on macroeconomic management. Furthermore, in order to maintain the financial integrity of the Indian markets, there is a need to take suitable measures to address the growing international concerns regarding origin and source of investment funds flowing into the country. Such measures would enhance the confidence of the foreign investors and regulators alike in the Indian financial system, given the fact that adherence to best practices and standards are important determinants for assessment of the quality of regulation.

References

1. Mohan, Rakesh (2005), "Indian Economy in the Global Setting", Reserve Bank of India Bulletin, October.
2. Planning Commission (2002), Foreign Investment: India, Government of India, August.
3. Reddy, Y.V.(2005), "Overcoming Challenges in a Globalising Economy: Managing India's External Sector", Reserve Bank of India Bulletin, July.
4. AT Kearney (2005), FDI Confidence Index Survey.

Table 1.76: Foreign Direct Investment to India: Country-wise and Industry-wise*

(US \$ million)

Source/Industry	2003-04	2004-05	2005-06 P
1	2	3	4
Total FDI Flows	1,462	2,320	3,358
Country-wise Inflows			
Mauritius	381	820	1,363
USA	297	469	346
UK	157	84	261
Germany	69	143	45
Netherlands	197	196	50
Japan	67	122	86
France	34	44	12
Singapore	15	64	166
Switzerland	5	64	68
South Korea	22	14	61
Others	218	300	901
Industry-wise Inflows			
Fisheries	2	10	28
Mining	18	11	6
Manufacturing	426	924	1,257
Food and Dairy Products	64	183	148
Electricity	90	14	83
Construction	172	209	191
Trade, Hotels & Restaurants	67	22	95
Transport	20	70	66
Financing, Insurance, Real Estate & Business Services	206	363	452
Computer Services	166	372	770
Educational Services	0	2	4
Research & Scientific Services	1	5	5
Health & Medical Services	15	25	61
Other Services	2	10	49
Others	213	100	143

* : Data in this Table exclude FDI inflows under the NRI direct investment route through the Reserve Bank and inflows due to acquisition of shares under section 6 of FEMA, 1999.

P: Provisional.

attracted by the increasing competitiveness of select manufacturing industries and services, particularly business and computer services. At the global level, services have been the key attraction for foreign direct investors, a structural shift indicative of offshoring. In India, the services sector attracted the largest FDI flows – US \$ 1.8 billion in 2005-06 (US \$ 1.1 billion in 2004-05). FDI flows into the manufacturing sector also increased substantially during 2005-06.

I.6.27 India has steadily improved its rank of both Inward and Outward FDI Performance Index (World Investment Report, 2005) indicating improved investment climate and better growth prospects (Chart I.47).

I.6.28 Portfolio equity flows increased further during 2005-06, led mainly by higher inflows from foreign institutional investors (FIIs). Net inflows by FIIs in the Indian stock markets increased by 14 per cent to US \$ 9.9 billion, driven by strong corporate profitability and better growth prospects (see Table 1.75). The number of FIIs registered with the SEBI increased from 685 at end-March 2005 to 882 by end-March 2006. Capital inflows through the issuances of American depository receipts (ADRs)/global depository receipts (GDRs) were also substantially higher as booming stock markets offered corporates the opportunity to issue equities abroad. India remained one of the largest recipients of portfolio inflows during 2005 (Table 1.77 and Chart I.48).

I.6.29 An expert group under the Chairmanship of the Chief Economic Adviser, Ministry of Finance was constituted by the Government of India to examine the issues regarding FII flows and provide an action plan for time-bound implementation. The Group came out with its recommendations in November 2005. The Reserve Bank expressed its dissent on certain issues which were also made part of the Report.

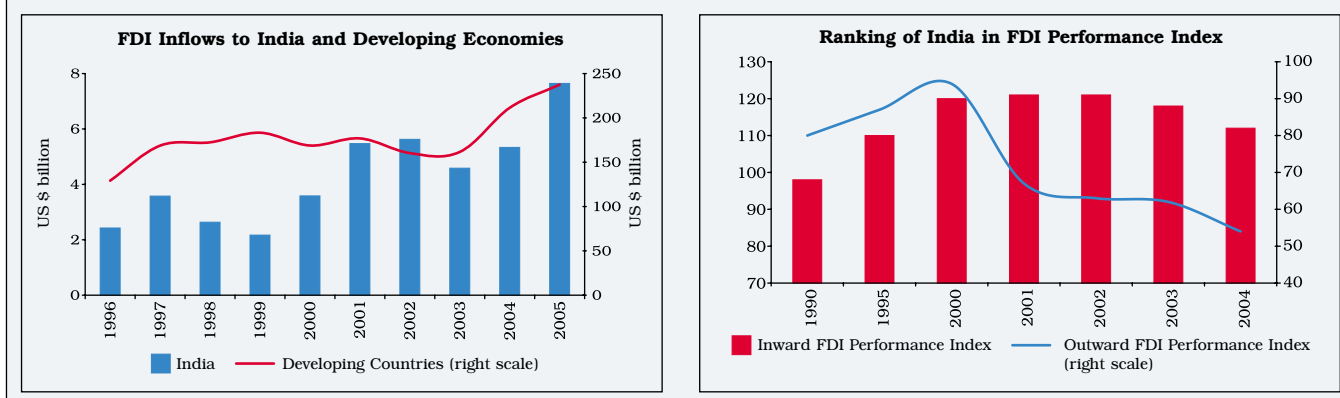
Chart I.47: FDI Flows to India

Table 1.77: Foreign Portfolio Investment Flows

(US \$ billion)

Country	2003	2004	2005
1	2	3	4
Brazil	5.1	-4.0	6.7
Chile	2.1	1.1	1.6
Hong Kong	1.4	3.9	9.1
India	8.2	8.8	11.9
Philippines	0.2	0.3	n.a.
Russia	-2.3	4.4	-0.9
South Korea	22.7	19.0	8.4 *
Thailand	0.9	0.9	6.9

n.a. : Not Available. * : Up to September.

Note : Data include both debt and equity investments.

Source : International Financial Statistics, IMF.

First, the Group had recommended that investments by FIIs may be considered over and above the sectoral caps prescribed for FDI. According to the Reserve Bank, the Group's recommendation could lead to a situation where total foreign investments would exceed the sectoral cap and, therefore, the Government should retain the option of keeping separate FII limits without allowing any interchange. Second, the Group was of the view that the existing arrangement for participatory notes (PNs) may continue. According to the Reserve Bank, PNs should not be permitted to be issued since the nature of the beneficial ownership or the identity of the investor will not be known. If PNs are allowed to be issued by the FIIs, it would bypass the processes

to ensure compliance with 'Know Your Investor' as, in case of PNs, the ultimate beneficiary of the funds is not known. Both conceptually and in practice, restrictions on suspicious flows enhance the reputation of markets and lead to healthy flows. Third, regulatory developments with regard to hedge funds in the US and elsewhere, including Europe, may be closely watched to formulate policy on the basis of experiences of these countries. In case there are any funds which are believed to be hedge funds and are registered with SEBI, such cases would need to be looked at closely. Fourth, in regard to cases where sub-accounts are not eligible to register as FIIs, the Reserve Bank noted that it may not be advisable to permit registration under the sub-account category. Finally, regarding the recommendations to ease the quantitative restrictions on FII investments in debt instruments and allow investment based on a cap on the annual flows instead of a ceiling on aggregate portfolio flows, the Reserve Bank indicated that it may not be feasible to allow FIIs unhindered access to the domestic debt markets as long as there is a wedge between the Indian inflation and debt yield with the rest of the world. Accordingly, the ceiling should be on the total stock of FII investment in debt and not on an incremental basis.

India's Direct Investment Abroad

I.6.30 Following the phased liberalisation in the regime for Indian investments overseas, investments in joint ventures (JV) and wholly owned subsidiaries (WOS) abroad have emerged as important avenues for promoting global business by Indian entrepreneurs. They are also a source of increased exports of plants and machinery and goods from India. Joint ventures have also been perceived as a medium of economic cooperation between India and other countries. Transfer of technology and skill, sharing of results of R&D, access to wider global markets, promotion of brand image, generation of employment and utilisation of raw materials available in India and in the host country are other significant benefits arising out of such overseas investments. Overseas investments which started off initially with the acquisition of foreign companies in the IT and related services sector have now spread to other areas, particularly pharmaceuticals and petroleum (Table 1.78). Overseas investment is being funded through a variety of sources such as drawal of foreign exchange in India, capitalisation of exports, balances held in EEFC accounts and swap of shares. A part of overseas investment is also financed through funds raised abroad such as external commercial borrowings,

Chart I.48: Portfolio Equity Flows to India and Developing Countries

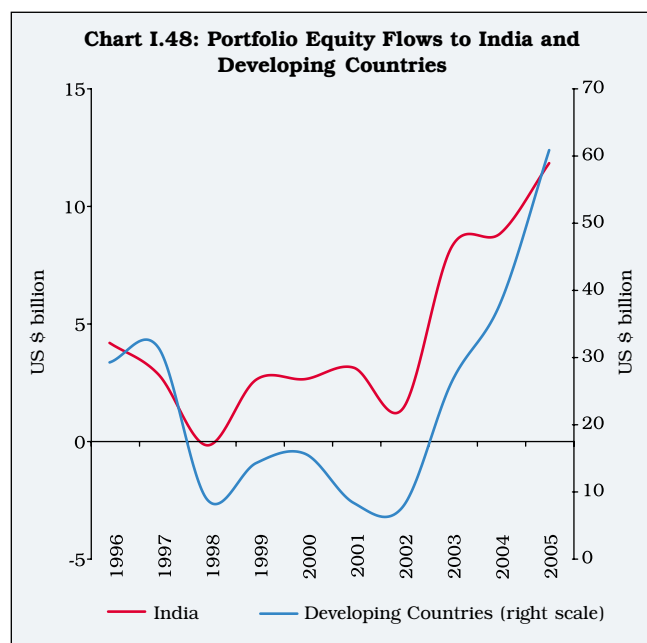


Table 1.78: India's Direct Investment Abroad

(US \$ million)

Industry	2000-01	2003-04	2004-05	2005-06
1	2	3	4	5
Manufacturing	169	893	1,068	1,538
Financial Services	6	1	7	156
Non-Financial Services	470	456	283	531
Trading	52	113	181	215
Others	12	31	108	239
Total	709	1,494	1,647	2,679

Note : Data are provisional.

foreign currency convertible bonds and ADRs/GDRs. Overseas investment also takes place through leveraged buyout by way of setting up of special purpose vehicles (SPVs) abroad. These SPVs typically raise funds from international markets to finance the buyout and such transactions are not captured in the overseas investment statistics.

Debt Flows

I.6.31 Reflecting the increased domestic investment activity, demand for external commercial borrowings (ECBs), including foreign currency convertible bonds (FCCBs), remained high during 2005-06. Corporates resorted to ECBs mainly for import of capital goods, project financing, capital investment, modernisation of plants and expansion of activity. Gross disbursements under ECBs increased from US \$ 8.5 billion during 2004-05 to US \$ 13.5 billion during 2005-06. Net disbursements under ECBs were lower during 2005-06 essentially on account of the one-off effect of principal repayment of IMDs (US \$ 5.5 billion). Recourse to short-term trade credits also increased during the year, reflecting rising import financing requirements.

I.6.32 NRI deposits recorded larger inflows during 2005-06. This could be partly attributed to relaxation of ceiling on interest rates on NRE deposits from "US dollar LIBOR/swap rates of corresponding maturity plus 50 basis points" in November 2004 to "LIBOR/swap rates of US dollar plus 75 basis points" on November 17, 2005 (Table 1.79). Inflows under NRI deposits also appear to have benefited from the IMD redemptions.

External Assistance

I.6.33 India received external assistance (net) of US \$ 1.5 billion during 2005-06 as compared with US \$ 2.0 billion a year ago. India continued to extend

Table 1.79: Balances under NRI Deposit Schemes

(US \$ million)

Scheme	Outstanding (end-March)		Net Inflows@ (April-March)	
	2005	2006	2004-05	2005-06
1	2	3	4	5
1. FCNR(B)	11,452	13,064	492	1,612
2. NR(E)RA	21,291	22,070	84	1,177
Total	32,743	35,134	576	2,789

@ : All figures are inclusive of accrued interest and valuation changes arising on account of fluctuation in non-dollar currencies against the US dollar.

Note : Net inflows in respect of NR(E)RA deposits in columns 4 and 5 may not match with the differences between the outstanding stocks on account of exchange rate fluctuations during the year.

assistance to other countries, mainly in the form of grants and loans. External assistance provided in the form of grants and loans by India to other countries rose to US \$ 489 million in 2005-06 from US \$ 247 million in 2000-01 (Table 1.80). India provides aid mainly in the form of technical cooperation and training, with the grants component dominating external aid with a share of 79 per cent. The major beneficiaries of the assistance during 2005-06 were Bhutan, Nepal, Bangladesh and the African countries.

I.6.34 During 2006-07 so far, capital flows, except FII flows, have remained large. FDI inflows increased from US \$ 922 million during April-May 2005 to US \$ 1,199 million during April-May 2006 while amounts raised under ADRs/GDRs increased from US \$ 360 million to US \$ 1,007 million. NRI deposits recorded net inflows of US \$ 816 million during April-May 2006 as against net outflows of US \$ 118 million over the same period of 2005. In contrast, FII flows recorded net outflows of US \$ 1,787 million during April-June 2006 as against net inflows of US \$ 544 million a year ago.

EXTERNAL DEBT

I.6.35 India's total external debt increased by about US \$ 2 billion during 2005-06 and was placed at US \$ 125.2 billion at end-March 2006. The increase in the external debt during 2005-06 was mainly on account of a rise in NRI deposits and trade credit (up to 1 year maturity) [Table 1.81 and Appendix Table 56]. The rise in NRI deposits, as noted earlier, could be attributed partly to the upward revision in interest rates on NRE term deposits, while higher short-term trade credit reflected rising import financing requirements. The decline in the stock of external

Table 1.80: India's Grants and Loans to Foreign Governments

(US \$ million)

Item	2000-01			2005-06		
	Grant	Loan	Total	Grant	Loan	Total
1	2	3	4	5	6	7
A. Plan						
(External Affairs)	76	44	120	100	63	163
B. Non-Plan (i+ii+iii)	88	38	127	287	39	326
<i>i. External Affairs</i>	81	16	97	261	0	261
Bangladesh	2	16	18	12	0	12
Bhutan	44	0	44	93	0	93
Nepal	14	0	14	15	0	15
Africa	1	0	1	14	0	14
Myanmar	4	0	4	5	0	5
Sri Lanka	2	0	2	6	0	6
Other Developing Countries	14	0	14	117	0	117
<i>ii. Finance</i>	7	22	29	25	39	65
Contribution to U.N.D.P.	5	0	5	5	0	5
Mauritius	0	2	2	0	7	7
Myanmar	0	4	4	0	6	6
Sri Lanka	0	3	3	0	16	16
Surinam	0	0	0	0	2	2
Other Countries	2	13	15	5	0	5
Development Assistance	0	0	0	16	0	16
<i>iii. Shipping</i>	1	0	1	0	0	0
Bangladesh	1	0	1	0	0	0
C. Grand Total (A+B)	165	82	247	387	102	489

Source : Union Budgets, Government of India.

commercial borrowings was mainly due to the one-off effect of the repayment of IMDs. The valuation effect, on account of appreciation of the US dollar against other major international currencies, had a moderating impact on the stock of external debt. The US dollar continues to dominate the currency composition of external debt.

1.6.36 Indicators of sustainability suggest continued improvement in India's external debt position. The ratio of external debt to GDP has recorded a steady decline to 15.8 per cent at end-March 2006 from 30.8 per cent at end-March 1995 (Table 1.82). Amongst the top 15 debtor countries, India had the lowest debt-GDP ratio, next only to China. India's foreign exchange reserves continued to exceed the external debt stock. Current receipts also exceed the external debt stock. This reflects the sustained robust growth in exports of goods, services and remittances. The ratio of the short-term debt to total external debt, notwithstanding some increase during the year, remains modest. The

Table 1.81: India's External Debt

(US \$ million)

Item	End-March 2005	End-March 2006	Variation during 2005-06	
			Amount	Per cent
1	2	3	4	5
1. Multilateral	31,702	32,558	856	2.7
2. Bilateral	16,930	15,784	-1,146	-6.8
3. Trade Credit	4,980	5,326	346	6.9
4. External Commercial Borrowings	27,024	25,560	-1,464	-5.4
5. NRI Deposit	32,743	35,134	2,391	7.3
6. Rupee Debt	2,301	2,031	-270	-11.7
7. Long-term (1 to 6)	1,15,680	1,16,393	713	0.6
8. Short-term	7,524	8,788	1,264	16.8
Total	1,23,204	1,25,181	1,977	1.6

increase in debt service ratio during 2005-06 was on account of redemption of the IMDs during the year.

Table 1.82: External Debt Service Payments

(US \$ million)

Item	2004-05	2005-06
1	2	3
1. External Assistance@	2,468	2,690
2. External Commercial Borrowings*	5,101	15,217
3. IMF	0	0
4. NRI Deposits (Interest Payments)	1,353	1,497
5. Rupee Debt Service	417	572
6. Total Debt Servicing	9,339	19,976
7. Total Current Receipts **	1,53,381	1,95,594
8. External Debt to GDP Ratio	17.3	15.8
9. Short Term Debt to Total Debt Ratio (%)	6.1	7.0
10. Short Term Debt to Foreign Exchange Reserves Ratio (%)	5.3	5.8
11. Foreign Exchange Reserves to External Debt Ratio (%)	114.9	121.1
12. Debt Service Ratio (6/7) (%)	6.1	10.2
13. Interest Payments to Current Receipts Ratio (%)	9.7	3.1
14. Debt to Current Receipts Ratio (%)	80.3	64.0
15. Liability Service Ratio (%)	7.1	11.5

@ : Inclusive of non-Government loans.

* : Inclusive of interest components of trade credits.

** : Excluding official transfers.

Note : 1. Debt Service payments in this table follow accrual method of accounting consistent with balance of payments compilation and may, therefore, vary from those recorded on cash basis.

2. Liability service ratio represents debt service payments and remittances of profits and dividends taken together as a ratio of total current receipts.

Table 1.83: Foreign Exchange Reserves

(US \$ million)

As at end of March	Gold	SDRs	Foreign Currency Assets	Reserve Position in the IMF	Total (2+3+4+5)	Use of IMF Credit
1	2	3	4	5	6	7
1993	3,380	18	6,434	296	10,128	4,799
1994	4,078	108	15,068	299	19,553	5,040
1995	4,370	7	20,809	331	25,517	4,300
1996	4,561	82	17,044	310	21,997	2,374
1997	4,054	2	22,367	291	26,714	1,313
1998	3,391	1	25,975	283	29,650	664
1999	2,960	8	29,522	663	33,153	287
2000	2,974	4	35,058	658	38,694	26
2001	2,725	2	39,554	616	42,897	0
2002	3,047	10	51,049	610	54,716	0
2003	3,534	4	71,890	672	76,100	0
2004	4,198	2	1,07,448	1,311	1,12,959	0
2005	4,500	5	1,35,571	1,438	1,41,514	0
2006	5,755	3	1,45,108	756	1,51,622	0

FOREIGN EXCHANGE RESERVES

I.6.37 With capital flows remaining in excess of the current account deficit, the balance of payments continued to record an overall surplus during 2005-06. As a result, India's foreign exchange reserves – comprising foreign currency assets, gold, SDRs and the reserve tranche position with the IMF – increased by US \$ 10.1 billion during 2005-06 to reach US \$ 151.6 billion at end-March 2006 (Table 1.83 and Appendix Table 57). The increase in the value of gold holdings mirrored the increase in global prices of gold. India which had turned a creditor to the IMF under the Financial Transactions Plan (FTP) in 2003 provided SDR 34 million during 2005-06 to countries like Turkey and Uruguay. The total quantum of India's contribution under FTP has been SDR 493 million as at end-March 2006. At end-March 2006, India held the fifth largest stock of international reserve assets among EMEs. India's foreign exchange reserves were US \$ 165.4 billion as on August 18, 2006, an increase of US \$ 13.7 billion over end-March 2006.

I.6.38 In terms of various adequacy indicators, India's reserves remain comfortable. As noted above, reserves exceed external debt stock while short-term debt/reserves ratio remains modest. As regards trade-related indicators, reserves are well-above the conventional criterion although the import cover came down from 14 months at end-March 2005 to about 12 months at the end of March 2006.

I.6.39 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. The objectives of reserve management in India are preservation of the long-term value of the reserves in terms of purchasing power and the need to minimise risk and volatility in returns. Foreign assets are held in major convertible currencies. Investments comprise deposits with other central banks, the Bank for International Settlements (BIS), top-rated foreign commercial banks, securities representing debt of sovereigns and supranational institutions with residual maturity not exceeding 10 years and any other instruments or institutions as approved by the Central Board of the Reserve Bank. Accordingly, the foreign currency assets are invested in multi-currency and multi-market portfolios (Table 1.84).

INTERNATIONAL INVESTMENT POSITION

I.6.40 India's net international investment position, *i.e.*, the stock of external assets net of the stock of external liabilities, has witnessed continuous

Table 1.84: Deployment Pattern of Foreign Currency Assets

(US \$ million)

Item	March 31, 2005	March 31, 2006
1	2	3
Foreign Currency Assets	1,35,571	1,45,108
(a) Securities	36,819	35,172
(b) Deposits with other central banks and BIS	65,127	65,399
(c) Deposits with foreign commercial banks	33,625	44,537

improvement in the recent years. Latest available data on international investment position, which pertain to end-March 2005, show that India's external assets continued to be dominated by reserve assets. As regards external liabilities, the share of non-debt liabilities such as direct and portfolio investment in total liabilities has increased. Net external liabilities declined by US \$ 6 billion during 2004-05 to US \$ 41 billion at end-March 2005 as the increase in reserve assets exceeded the expansion in international liabilities. Reflecting these trends, the ratio of net external liabilities to GDP ratio has almost halved since end-March 2003 to 6.3 per cent at end-March 2005 (Table 1.85).

I.6.41 International liabilities of the Indian banking sector rose by 17.9 per cent during the year ended March 2006. The international assets increased by

Table 1.85: International Investment Position of India

(US \$ billion)

Item	End-March		
	2003 PR	2004 PR	2005P
1	2	3	4
A. Assets	95.6	137.1	169.3
1. Direct Investment	5.8	7.1	9.6
2. Portfolio Investment	0.8	0.8	0.8
2.1 Equity Securities	0.4	0.4	0.4
2.2 Debt Securities	0.4	0.4	0.4
3. Other Investment	12.9	16.3	17.4
3.1 Trade Credits	1.1	1.9	3.9
3.2 Loans	1.4	1.7	1.8
3.3 Currency and Deposits	7.5	9.6	8.3
3.4 Other Assets	2.9	3.1	3.3
4. Reserve Assets	76.1	113.0	141.5
B. Liabilities	156.0	184.1	210.1
1. Direct Investment	31.2	39.1	44.5
2. Portfolio Investment	32.4	43.7	55.5
2.1 Equity Securities	20.1	34.0	42.8
2.2 Debt Securities	12.3	9.8	12.7
3. Other Investment	92.4	101.3	110.2
3.1 Trade Credits	4.8	6.3	9.6
3.2 Loans	61.1	61.9	65.9
3.3 Currency and Deposits	25.6	32.2	33.5
3.4 Other Liabilities	0.9	0.9	1.2
C. Net Position (A-B)	-60.4	-47.0	-40.9
D. Net Foreign Liabilities to GDP (%)	12.7	8.1	6.3
<i>Memo:</i>			
Debt Liabilities/Total Liabilities	67.1	60.3	58.5
Non-debt Liabilities/Total Liabilities	32.9	39.7	41.5
PR: Partially revised. P: Provisional.			

Table 1.86: International Liabilities and Assets of Banks in India

(US \$ million)

Category/Item	Amount outstanding at end of		
	March 2004	March 2005	March 2006 P
1	2	3	4
Total International Liabilities	50,871	58,292	68,723
<i>of which:</i>			
FCNR(B) Deposits	10,460	11,612	13,025
NRE Rupee Deposits	17,501	19,616	22,483
Foreign Currency Borrowings	7,743	10,410	14,283
Bonds (including IMDs)	6,389	6,681	988
NR(NR) Rupee Deposits	1,690	188	0
ADRs and GDRs	1,474	2,265	3,325
EEFC Accounts	1,045	1,296	1,348
Total International Assets	26,680	30,458	35,459
<i>of which:</i>			
Foreign Currency Loans to Residents	10,159	13,280	14,173
Outstanding Export Bills	4,750	5,983	7,073
NOSTRO Balances	9,053	8,155	9,978

P : Provisional

IMDs : India Millennium Deposits.

ADRs : American Depository Receipts

GDRs : Global Depository Receipts.

EEFC : Exchange Earners' Foreign Currency.

Note : All figures are inclusive of accrued interest.

16.4 per cent during the same period (Table 1.86). The international liabilities of banks continued to be almost double their international assets. Country-wise, the US accounted for nearly one fourth of total international liabilities and assets of Indian banks. While the assets denominated in foreign currency formed 95.5 per cent of total international assets, the proportion of foreign currency denominated liabilities in total international liabilities was lower at 50.4 per cent at end-March 2006.

I.6.42 To sum up, export earnings from goods and services as well as remittances remained robust during 2005-06. The current account deficit, however, widened mirroring the sharp expansion in imports in consonance with higher oil prices and the pick-up in investment activity in the economy. Despite some expansion of the current account deficit as well as large outgo on account of the redemption of the IMDs, India's balance of payments remained comfortable during 2005-06 as normal capital flows continued to remain large and were more than sufficient to finance the current account deficit. India's foreign exchange reserves increased by US \$ 10.1 billion during 2005-06.