RESERVE BANK OF INDIA

ANNUAL REPORT 2006-07
SUMMARY

Summary of the Report of the Central Board of Directors on the Working of the Reserve Bank of India for the Year ended June 2007

The complete Annual Report can also be accessed on Internet

URL : www.rbi.org.in

*For the Year July 1, 2006 to June 30, 2007**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I ECONOMIC REVIEW

I. MACROECONOMIC POLICY ENVIRONMENT

I.1.1 Global economic activity remained buoyant for the fourth successive year during 2006 and available information suggests that the growth momentum is likely to continue during 2007, *albeit* with some moderation. Global economic growth accelerated from 4.9 per cent during 2005 to 5.5 per cent during 2006, and has averaged 4.9 per cent per annum during the four-year period 2003-2006. A positive feature of the global economic activity during 2006 was the broadening of growth across major regions/countries. The moderation of economic activity in the US since the second half of 2006 has been largely offset by the acceleration of activity in the euro area and in Japan; emerging and developing countries, led by China and India, have provided stable support to the global economy with sustained high growth. The rising global activity is, however, leading to closing of output gaps in many countries; strong demand, in conjunction with strong gains recorded by global commodity prices, was reflected in inflationary pressures in major economies. With headline inflation crossing the targets/comfort zones in major countries, many central banks pursued monetary tightening to contain inflationary expectations.

I.1.2 In an environment of strong global growth, the Indian economy continued to exhibit robust growth during 2006-07. Real GDP growth accelerated to 9.4 per cent in 2006-07 from 9.0 per cent in 2005-06, boosted by the double-digit growth in the services and industrial sectors. Real GDP growth, thus, averaged 7.6 per cent per annum during the Tenth Five Year Plan period (2002-03 to 2006-07) – the fastest pace of expansion in any Plan period so far – significantly higher than that of 5.7 per cent per annum during the 1980s and the 1990s. Growth in per capita income (*i.e.*, per capita net national product at factor cost) accelerated from 7.4 per cent in 2005-06 to 8.4 per cent during 2006-07. Per capita income growth averaged 6.1 per cent per annum during the Tenth Plan period and 7.1 per cent per annum during the last four years (2003-04 to 2006-07), more than double of 3.4 per cent per annum recorded during the 1980s and the 1990s. The acceleration of economic activity is being

* : While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2007. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

supported by a significant rise in domestic savings and investment, and productivity gains. A notable feature of the economic growth during 2006-07 was the further strengthening of the manufacturing activity. Consequently, in view of the sustained high growth since 2003-04, capacity utilisation has risen in a number of industries which, along with supply shocks from primary articles, were reflected in a rise in the various measures of inflation during 2006-07. The Reserve Bank, accordingly, took a series of pre-emptive monetary measures to contain inflationary expectations. The monetary measures were also accompanied by fiscal and supply side measures.

I.1.3 The sustained strengthening of domestic economic activity over the past few years has been underpinned by proactive policy measures to improve the productivity and competitiveness of the Indian economy. A number of steps covering the various sectors of the economy – real, fiscal, external, monetary and financial sectors – were taken during the year to sustain the current growth momentum, and make it more inclusive in an environment of macroeconomic and financial stability.

REAL SECTOR POLICIES

Agriculture and Allied Activities

I.1.4 In view of the renewed focus on faster, more broad-based and inclusive growth, reversal of the deceleration and containment in volatility in agricultural growth remained the highest priority of the Government. A number of steps were taken to improve the availability of irrigation facilities, crop yields, flow of institutional credit and rural infrastructure while also providing some relief to debt stressed farmers.

I.1.5 A National Rainfed Area Authority was created in November 2006 to support upgradation and management of dryland and rainfed agriculture. The Authority would coordinate all schemes relating to watershed development and other aspects of land use. The Union Budget 2007-08 allocated Rs.100 crore for the new Rainfed Area Development Programme. It also proposed to revamp the Accelerated Irrigation Benefit Programme (AIBP) in order to complete more irrigation projects in the quickest possible time. The outlay under AIBP was budgeted to increase from Rs.7,121 crore in 2006-07 to Rs.11,000 crore in 2007-08 (inclusive of the grant component of Rs.3,580 crore to the State Governments). In line with the pilot project launched in March 2005, to repair, renovate and restore water bodies in 13 States, similar projects are planned for other States with assistance from the World Bank. The Union Budget 2007-08 urged the State Governments to come forward with proposals so that the whole country can be covered in the next two years. Depletion of ground water has assumed grave proportions, with the Central Ground Water Board identifying 1,065 assessment blocks in the country as 'over-exploited' or 'critical'. The Union Budget 2007-08 provided for 100 per cent subsidy to small and marginal farmers and 50 per cent subsidy to other farmers to erect structures which would divert rain water into dug wells. Of the proposed seven million structures, about two million structures would be on land belonging to small and marginal farmers. In this regard, a sum of Rs.1,800 crore would be transferred to the National Bank for Agriculture and Rural Development (NABARD). The amount would be held in escrow account and would be disbursed through the lead bank of the district concerned to the beneficiaries.

I.1.6 The National Development Council (NDC) in its 53rd meeting held on May 29, 2007 adopted a resolution that agricultural development strategies must be reoriented to rejuvenate agriculture to meet the needs of farmers. The NDC resolved that the Central and State Governments needed to take a number of steps to achieve 4 per cent annual growth in the agricultural sector during the Eleventh Plan. Furthermore, the Central Government committed Rs.25,000 crore for public investment in agriculture in the next four years.

I.1.7 The credit flow to the agricultural sector exceeded the target for the third consecutive year during 2006-07. As against the target of Rs.1,75,000 crore, the actual disbursements of farm credit by the banking system in 2006-07 were Rs.2,03,296 crore. For 2007-08, the Union Budget has fixed a target of Rs.2,25,000 crore as farm credit with an addition of five million new farmers to the banking system. The Union Budget, 2006-07 provided for the continuance of the two per cent interest subvention scheme for short-term crop loans up to Rs.1 lakh granted by banks in *kharif* and *rabi* of 2005-06. Furthermore, in accordance with the Union Budget announcement, crop loans up to a principal amount of Rs.3 lakh were provided at seven per cent rate of interest beginning *kharif* 2006-07 for which the Government provided interest rate subvention of two per cent. The Union Budget, 2007-08 announced the continuance of this scheme for 2007-08 also. A National Agricultural Innovation Project, launched in July 2006, was aimed at enhancing livelihood security by involving farmer groups, Panchayati Raj Institutions and private sector. In order to improve the flow of credit from the cooperatives, a package for revival of the short-term rural cooperative credit structure was announced in January 2006. The Union Budget 2007-08 asked the regional rural banks (RRBs) to undertake an aggressive branch expansion programme and open at least one branch in the 80 uncovered districts of the country in 2007-08.

I.1.8 The National Rural Employment Guarantee Scheme (NREGS), a demand-driven scheme carrying a legal guarantee for employment, was launched on February 2, 2006. The Union Budget 2007-08 made an initial allocation of Rs.12,000 crore (including the North Eastern Region component) for the NREGS. The Government intends to expand the coverage of the NREGS from the current level of 200 districts to 330 districts. In addition, Rs.2,800 crore has been provided for *Sampoorna Gramin Rozgar Yojana* (SGRY) for rural employment in the districts not covered by the NREGS. The Union Budget also increased allocation for *Swaranjayanti Gram Swarozgar Yojana* (SGSY), intended to promote self employment among the rural poor, from Rs.1,200 crore in 2006-07 to Rs.1,800 crore in 2007-08.

Manufacturing and Infrastructure

I.1.9 The acceleration of activity in the manufacturing sector since 2003-04 has been, *inter alia*, facilitated by improvement in investor friendly and sector specific policies. The policy framework was further rationalised and simplified during 2006-07 and 2007-08 so far to entrench the growth momentum, with a focus on upgrading the infrastructural facilities in the country. Initiatives to upgrade human skills to cope with the growing demand for the skilled labour were intensified during the year. Steps were also taken to strengthen the small and medium enterprises (SMEs) segment.

I.1.10 Work on the golden quadrilateral (GQ) is nearly complete while considerable progress has been made in the North-South, East-West corridor project, which is expected to be completed by 2009. The phases of the National Highway Development Programme (NHDP), *viz.,* NHDP-III, NHDP-V and NHDP-VI are in advanced stages of planning or implementation. Under the NHDP-III, the Government has approved upgradation and four-laning of 12,109 km of National Highways on build, operate and transfer (BOT) basis. Approval has also been granted for the six laning of 6,500 km of the National Highways (including 5,700 km of the GQ) under NHDP-V and for construction of 1,000 km of expressways under the NHDP-VI. So far, the National Highways Authority of India (NHAI) has given Rs.2,072 crore as viability gap funding but has also received Rs.1,900 crore. The private sector investment leveraged under the NHDP was Rs.25,366 crore from the year 2001 to January 2007 with a corresponding public component of Rs.3,423 crore.The Union Budget 2007-08 proposed to increase the provision for the NHDP from Rs.9,945 crore in 2006-07 to Rs.10,667 crore in 2007-08.

I.1.11 The Information Technology (IT) Amendment Bill was introduced in the Parliament on December 15, 2006 to put in place technology applications, security practices and procedures relating to such applications. The Bill has also addressed the issue of technological neutrality in IT laws as recommended by UNCITRAL Model Law on Electronic Signature. In order to ensure penetration of the IT and IT-enabled services (ITES) in the rural areas, the Government has formulated a proposal to establish 100,000 Common Service Centres (CSCs) in rural areas, which will serve not only as the front-end for most government services but also as a means to connect the citizens of rural India to the world wide web. The scheme will be implemented through PPP. An outlay of Rs.5,742 crore has been approved; of this, the share of the Central Government and the State Governments would be Rs.856 crore and Rs.793 crore, respectively. The balance would be invested by the private sector.

FISCAL POLICY

I.1.12 Fiscal policy resumed the process of fiscal correction in 2006-07 as stipulated under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004, while at the same time pursuing the objectives of economic growth, equity and macroeconomic stability. The revised estimates of the finances of the Central Government indicate reductions in all key deficit indicators, *viz*., revenue deficit, fiscal deficit and primary deficit by 0.1 percentage point of GDP from the corresponding budget estimates. The provisional accounts, released subsequently in May 2007, indicated a reduction of further 0.1-0.2 percentage point of GDP in the revenue and fiscal deficits over the revised estimates. Robust growth, increased tax revenues and prudent expenditure management policies contributed to the improvement in all key deficit indicators by more than the minimum stipulated reductions under the FRBM Rules, 2004, whereby the fiscal deficit is envisaged to decline by at least 0.3 percentage point of GDP and the revenue deficit by 0.5 percentage point every year till 2008-09.

The gross tax/GDP ratio improved to 11.5 per cent in 2006-07 as per provisional accounts from 10.3 per cent in 2005-06. The expenditure management policy measures were aimed at stabilising expenditure pattern and curtailing of non-Plan revenue expenditure.

Union Budget 2007-08

I.1.13 The Union Budget 2007-08 noted that the Indian economy appeared to have entered a phase of high growth. The fiscal consolidation strategy for 2007-08 was based on the need to sustain the momentum of progress made under the FRBM roadmap with the aim of achieving the FRBM goals by 2008-09. In view of the growing necessity for expenditure on social sectors and physical infrastructure, the approach to fiscal consolidation continued to be essentially revenue-led, with a focus on outcomes and improvement of the allocative efficiencies of public expenditure.

State Governments

I.1.14 The States continued to pursue fiscal correction and consolidation programme during 2006-07 and made further progress in terms of the path of fiscal restructuring prescribed by the Twelfth Finance Commission (TFC). The improvement in the fiscal position of the States was facilitated by the larger grants and shareable Central taxes, as recommended by the TFC. Fiscal Responsibility Legislations (FRLs) have been enacted by 26 State Governments (as at end-July 2007). All States, excepting Uttar Pradesh, have implemented the Value Added Tax (VAT) in *lieu* of sales tax. The Medium Term Fiscal Plans (MTFP) of various States focus on removing tax distortions and prioritising expenditure.

EXTERNAL SECTOR POLICIES

I.1.15 With the aim of providing further momentum to export growth and for creating employment, the Government of India announced (April 2007) the Annual Supplement 2007 to the Foreign Trade Policy (2004-09). While deepening the incentives provided under the focus products and the focus markets schemes, the Annual Supplement also sought to reduce the transaction costs in foreign trade. In order to support agriculture exports, the *Vishesh Krishi* and *Gram Udyog Yojana* schemes are being expanded to include more commodities such as coconut oil, soyabean oil, potato flakes, meals and flours, and cardamom. For handloom and handicraft industries, arrangements are being made to provide for tools, machinery and equipment within the present duty-free entitlement ceiling so as to enable these rural-based activities to modernise and scale up operations to meet the market challenges. Similarly, in order to promote exports of gems and jewellery, tools, machinery and equipment needed by this sector would be covered within the present duty-free entitlement limit. With a view to facilitating the export of services from India, all the services rendered abroad and charged on exports from India would be exempted from the payment of service tax. As regards steps for reducing transaction costs and delays, the Annual Supplement announced on-line verification of documents under the various export promotion schemes, discontinuation of the restrictive requirement of block-wise fulfilment of export obligations and reduction of the length of the existing *Aayat Niryat Form.*

Foreign Exchange Transactions

I.1.16 During the year, a number of measures were initiated to further simplify and liberalise the external payments regime and deepen the foreign exchange market, drawing from the recommendations of the Committee on Fuller Capital Account Convertibility (FCAC) (Chairman: Shri S.S. Tarapore) (2006). The Internal Task Force, which was constituted on the basis of the recommendations of the FCAC, reviewed and made recommendations on 169 issues encompassing all areas under the foreign exchange management.

MONETARY POLICY FRAMEWORK

I.1.17 The conduct of monetary policy during 2006-07 was guided by the policy challenge to manage the transition to a higher growth path while containing inflationary pressures. The Reserve Bank emphasised the need to be watchful in view of the increased demand pressures in the form of an upturn in investment in infrastructure, shortening capital expenditure cycle, increasing consumption demand, high monetary growth, invigorated by the pick-up in activity in all constituent sectors of the economy. Although there was no conclusive evidence of overheating in the Indian economy, the Reserve Bank indicated the need to reckon with the dangers of possible overheating. It was emphasised that persistence of high inflation not only operates as a tax on the poor but also undermines economic growth and macroeconomic stability. In the prevailing conditions of growth, price and financial stability, unequivocal relative emphasis on stability was warranted and a determined and co-ordinated effort by all to contain inflation without unduly impacting the growth momentum was an economic necessity.

I.1.18 In recognition of the cumulative and lagged effects of monetary policy, the pre-emptive monetary tightening measures, which were initiated in September 2004, continued during 2006-07 and 2007-08. Since September 2004, the repo rate and the reverse repo rate have been increased by 175 and 150 basis points, respectively, while the cash reserve ratio (CRR) has been raised by 250 basis points. In view of the need to maintain asset quality against the backdrop of strong and sustained growth in credit, monetary measures were reinforced by tightening of provisioning norms and risk weights. In the context of large capital inflows and implications for liquidity and monetary management, the interest rate ceilings on non-resident deposits have been reduced by 75-100 basis points since January 2007.

I.1.19 While persevering with the policy measures to contain inflation and inflation expectations, the Reserve Bank continued with its initiatives of greater credit penetration and financial inclusion. In order to channel greater flow of credit to the priority sector – which includes agriculture, small scale units, micro credit, education loans and housing loans up to specified limits – guidelines for the priority sector lending were revised.

FINANCIAL SECTOR POLICIES

I.1.20 The financial sector plays an important role in the efficient allocation of resources and this aspect assumes all the more significance in the context of an economy such as India which is on a rising growth trajectory. In view of the critical role played by the financial sector in supporting the acceleration in growth, the Reserve Bank continued to take measures during 2006-07 to strengthen the financial sector. Provisioning norms and risk weights were tightened to ensure asset quality in the face of sustained high credit growth to certain sectors. The Reserve Bank also took measures to strengthen the accounting and disclosure norms in order to enforce greater market discipline. Final guidelines for the implementation of the New Capital Adequacy Framework (Basel II) were issued. In consonance with the stated policy of benchmarking the Indian financial sector to international best practices in a phased manner, commercial banks will start implementing Basel II norms from end-March 2008. The objective of strengthening the urban cooperative banks was persevered with during 2006-07 by encouraging Memorandum of Understanding with the State Governments, setting up of State level Task Forces, and merger of weak banks with stronger banks. With regard to non-banking financial companies (NBFCs), the regulatory framework was strengthened by placing prudential limits on banks' exposure to NBFCs while also specifying capital adequacy norms and exposure norms for Non-Deposit taking Systemically Important NBFCs (NBFC-ND-SI). Alongside its initiatives to strengthen the financial sector, the Reserve Bank continued to take measures for protecting customers' rights, and enhancing the quality of customer service. A separate Customer Service Department was set up in the Reserve Bank in July 2006 to promote the interests of the customers.

Policies for Financial Markets

I.1.21 During 2006-07, initiatives to further widen and deepen the various segments of the domestic financial markets were intensified. The implementation of the provision of Fiscal Responsibility and Budget Management (FRBM) Act, 2003, which prohibits the Reserve Bank from participating in the primary market from April 2006 onwards, necessitated several structural and developmental measures for the Government securities market. These included revamping the primary dealer (PD) system to ensure a more dynamic and active participation of PDs in the auctions; allowing banks to undertake PD business; allowing stand-alone PDs to diversify their activities; standardising settlement cycle; permitting short-selling of Government dated securities; and introduction of 'when issued' market.

Legal Framework

I.1.22 During 2006-07, significant amendments to the major banking legislations, *viz*., the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 were carried out, which would provide greater flexibility to the Reserve Bank in its conduct of monetary policy while also strengthening its regulatory powers

I.1.23 The Reserve Bank of India (Amendment) Act, 2006 was passed in June 2006. The amendment to the Act, *inter alia*, removed the ceiling as well as the floor of the CRR prescribed for scheduled banks. The Reserve Bank has, thus, been provided with the discretion to decide the percentage of scheduled banks' demand and time liabilities to be maintained as CRR without any ceiling or floor. Furthermore, consequent to the amendment, no interest will be paid on the CRR balances so as to enhance the efficacy of the CRR, as payment of interest attenuates its effectiveness as an instrument of monetary policy. The definition of "repo" and "reverse repo" provided under the amended Act would facilitate transactions of market participants/banks in these instruments. The amendment Act also provides the Reserve Bank with the statutory backing for regulating the money market and trading of over-the-counter derivatives.

I.1.24 The Banking Regulation (Amendment) Act, 2007 (replacing the Banking Regulation (Amendment) Ordinance, 2007 which came into effect on January 23, 2007) was notified in the gazette on March 28, 2007. Consequent upon the amendment to Section 24 of the Banking Regulation Act, 1949, the floor rate of 25 per cent for the statutory liquidity ratio (SLR) has been removed and the Reserve Bank has also been empowered to determine the SLR-eligible assets.

I.1.25 The State Bank of India Amendment Ordinance 2007 was promulgated on June 21, 2007 to amend the State Bank of India Act, 1955 to enable the transfer of the Reserve Bank's shareholding in the SBI to the Central Government. The transfer was aimed at allowing the Reserve Bank to focus on its regulatory and supervisory functions and removing the conflict of interest in due discharge of its duties as the banking regulator and also the owner.

I.1.26 The Payments and Settlements Bill, 2006 was introduced in the Lok Sabha on July 25, 2006. The Bill seeks to designate the Reserve Bank as the authority to regulate payment and settlement systems. The Bill contains provisions for (i) compulsory requirement of an authorisation by the Reserve Bank to operate payment systems; (ii) empowering the Reserve Bank to regulate and supervise the payment systems by determining standards, calling for information, returns, documents, *etc.*; (iii) empowering the Reserve Bank to audit and inspect by entering the premises where payment systems are being operated; (iv) empowering the Reserve Bank to issue directions; and, (v) overriding other laws and providing for settlement and netting to be final and irrevocable at the determination of the amount of money, securities or foreign exchange payable by participants. The Bill was referred to the Standing Committee on Finance for its consideration and the Report of the Committee was presented to the Lok Sabha in May 2007.

II. THE REAL ECONOMY

I.2.1 Continuing the high growth phase that started in 2003-04, the Indian economy exhibited robust growth during 2006-07. Real GDP growth accelerated to 9.4 per cent in 2006-07 from 9.0 per cent achieved in the previous year on the back of a further firming up of activity in the industrial and the services sectors. Both these sectors recorded double-digit growth, which more than offset the deceleration in the agricultural sector. The services sector continued to be the mainstay of the economy, contributing 71.5 per cent to overall growth. The sustained resurgence in industrial activity in the recent period has reinforced the growth process, and has imparted stability to the growth process.

I.2.2 Real GDP growth averaged 8.6 per cent during the four-year period 2003-04 to 2006-07 and 7.6 per cent during the 10th Plan period (2002-03 to 2006-07), significantly higher than that of 5.7 per cent during the 1980s and 1990s. The actual growth during the 10th Plan period was quite close to the target of 8.0 per cent. Amongst major sectors, growth of the industrial sector averaged 8.0 per cent during 2002-03 to 2006-07, higher than that of 5.7 per cent during the 1990s and 6.4 per cent during the 1980s. Growth of the services sector has exhibited a consistent uptrend from 6.3 per cent during the 1980s and 7.1 per cent during the 1990s to 9.5 per cent during the 10th Plan period. Growth in agriculture and allied activities averaged 2.3 per cent during the 10th Plan period, lower than that of 3.2 per cent during the 1990s and 4.4 per cent during the 1980s. The step up in the growth rate of the economy since 2003-04 onwards has been driven by a higher investment rate, supported by a sizeable increase in the rate of gross domestic saving.

AGGREGATE SUPPLY

Agriculture

I.2.3 According to the CSO's revised estimates, real GDP growth originating from agricultural and allied activities decelerated from 6.0 per cent in 2005-06 to 2.7 per cent in 2006-07, partly attributable to the base effect of the preceding year and some setbacks to the production from an uneven monsoon. Overall agricultural production, in terms of the Index of Agricultural Production, is likely to post an increase of around 5.2 per cent during 2006-07 (8.5 per cent a year ago) on account of lower growth in the total foodgrains production (3.6 per cent during 2006-07 as compared with 5.2 per cent during 2005-06).

I.2.4 As per the Fourth Advance Estimates, the foodgrains production during 2006-07 was 216.1 million tonnes, an increase of 3.6 per cent over the previous year, led by higher production of wheat. The *rabi* foodgrains production was estimated at 105.6 million tonnes, the highest since 1999-2000. Among non-foodgrains, the production of sugarcane and cotton scaled new peaks during 2006-07; the production of oilseeds was, however, lower on account of decline in acreage

1.2.5 Notwithstanding some improvement in foodgrains production during 2006-07, the production of major crops has witnessed stagnation in recent years. For instance, the production of rice, wheat and pulses during 2006-07 was still below the previous peaks touched in 2001-02, 1999-2000 and 1998-99, respectively. This stagnation in production was on account of plateauing of yields, which could be attributed to a variety of factors such as limited varietal breakthrough, almost non-existent extension services, low resilience to moisture stress and pest infestation, low water use efficiency, inequity in water use and irrigation development, and decline in agricultural investment.

Industrial Performance

I.2.6 According to the CSO's revised estimates, real GDP growth originating from the industrial sector increased from 8.0 per cent in 2005-06 to 11.0 per cent in 2006-07, driven by strong manufacturing activity. The upsurge in the industrial growth entered the fifth year of expansion on the back of strong investment and consumption demand. The industrial growth, thus, averaged 9.1 per cent during the three-year period ended 2006-07 and 8.0 per cent during the five-year period 2002-03 to 2006-07.

I.2.7 Based on the movements in the Index of Industrial Production (IIP), industrial growth accelerated from 8.2 per cent during 2005-06 to 11.5 per cent during 2006-07, the highest growth achieved since 1995-96 (13.1 per cent). Growth during the year was driven mainly by the manufacturing sector, which contributed 91.1 per cent to the industrial growth. The growth of the manufacturing sector at 12.5 per cent in 2006-07 was the highest since 1995-96 (14.1 per cent). The 'Machinery and equipments', 'basic metal and alloy industries' and 'chemicals and chemical products' groups remained the main drivers of growth, contributing almost 50 per cent to the manufacturing growth.

I.2.8 In terms of use-based classification, marked acceleration in growth was observed in respect of basic, capital and intermediate goods sectors. These three sectors more than offset the deceleration in the consumer goods sector. The growth of the basic goods sector – the highest since 1995-96 – benefited from increased production of cement, high speed diesel, and various iron and steel products such as carbon steel, bars and rods, pipes and tubes. The intermediate goods sector, which had recorded subdued growth in 2005-06, bounced back and recorded a growth of 11.9 per cent in 2006-07, also the highest since 1995-96 (19.3 per cent). The growth in the capital goods sector accelerated from 15.8 per cent in 2005-06 to 18.2 per cent in 2006-07, reflecting sustained investment demand in the country. The consumer goods sector, on the other hand, witnessed moderation in growth on account of decline in production of some non-durable goods such as food items, drugs, edible oils and durables.

Services Sector

I.2.9 According to the CSO's revised estimates, real GDP growth originating from the services sector accelerated from 10.3 per cent in 2005-06 to 11.0 per cent in 2006-07. The growth in the services sector was led by acceleration in the sub-sectors 'trade, hotels and restaurants, transport, storage and communication' and 'financing, insurance, real estate and business services'. Buoyancy in foreign tourist arrivals, domestic travel, hotel occupancy, retail credit, commercial vehicles production, telecom use, revenue earning freight traffic of the railways, and passengers handled by civil aviation propped up the sub-sector 'trade, hotels and restaurants, transport, storage and communication'. This sub-sector has emerged as the key driver of economic activity in the country, constituting almost one-half of the growth of the services sector and almost one-third of overall real GDP growth during 2006-07.

I.2.10 The construction sub-sector continued to exhibit high growth during 2006-07 (10.7 per cent), though there was some deceleration from the strong pace of over 14 per cent in the preceding two years. The sub-sector 'financing, insurance, real estate and business services' recorded double-digit growth for the second successive year, reflecting acceleration of growth in bank deposits, sustained growth in non-food credit, rapid growth of activity in the insurance sector and continued buoyancy in the information technology (IT) sector. The IT sector was marked by sustained revenue growth, steady expansion of newer service-lines and increased geographic penetration. The sector attracted a substantial rise in investments from multinational corporations (MNCs).

Saving and Capital Formation

I.2.11 Domestic savings and investment rates reached record highs during 2005-06. Gross domestic savings rose to 32.4 per cent of GDP in 2005-06 from 31.1 per cent in 2004-05 and 23.5 per cent in 2001-02. The increase during the year was driven by higher private corporate and household savings. Reflecting the improvement in corporate profitability, as alluded to earlier, the private corporate saving rate doubled between 2002-03 and 2005-06. Savings of the household sector recovered in

2005-06 but remained below the level attained in 2003-04. Public sector saving witnessed some moderation in 2005-06, reversing the trend of improvement that started in 2003-04. Reflecting the rise of 1.3 percentage points in the domestic savings rate as well as the higher recourse to foreign savings, the domestic investment rate increased by 2.3 percentage points of GDP to 33.8 per cent of GDP in 2005-06, a substantial jump from 22.9 per cent recorded during 2001-02. The increase from the trough of 2001-02 has been led by the more than doubling in the private corporate sector investment to 12.9 per cent of GDP, offsetting some decline in household investment. The ratio of gross fixed capital formation to GDP at current market prices rose by a further 1.4 percentage points during 2006-07 to 29.5 per cent from 28.1 per cent in 2005-06.

III. MONEY, CREDIT AND PRICES

I.3.1 Growth in monetary and liquidity aggregates accelerated during 2006-07, with broad money growth remaining above the indicative trajectory projected by the Reserve Bank at the beginning of the financial year. Expansion in reserve money was led by a large accretion to the Reserve Bank's net foreign assets (NFA). Growth in bank deposits accelerated during the year, led by time deposits. Demand for bank credit remained robust for the third successive year, *albeit* with some moderation in growth.The Reserve Bank continued to modulate market liquidity with the help of repo and reverse repo operations under the liquidity adjustment facility (LAF), issuance of securities, including dated securities, under the market stabilisation scheme (MSS) and the cash reserve ratio (CRR).

RESERVE MONEY

I.3.2 Reserve money expanded by 23.7 per cent (18.9 per cent adjusted for the first round impact of the hike in the CRR) during 2006-07 as compared with 17.2 per cent during 2005-06. The expansion in reserve money during 2006-07 was driven primarily by the accretion to the Reserve Bank's NFA. The Reserve Bank's foreign currency assets (net of revaluation) increased by Rs.1,64,601 crore during 2006-07 (Rs.68,834 crore during the previous year).

I.3.3 During 2006-07, as in recent years, the movement in the net Reserve Bank credit to the Government was mainly on account of liquidity management by the Reserve Bank rather than passive financing of the fiscal gap of the Government. Reflecting the liquidity management operations, the Reserve Bank's net credit to the Centre declined by Rs.3,024 crore in 2006-07 as against an increase of Rs.28,417 crore in the previous year.

MONETARY SURVEY

I.3.4 Broad money (M_3) growth, y-o-y, accelerated to 21.3 per cent at end-March 2007 from 17.0 per cent a year ago and remained above the growth rate of 15.0 per cent projected in the Annual Policy Statement in April 2006

I.3.5 Amongst the major components of broad money, currency with the public accelerated during 2006-07 to 17.0 per cent from 16.4 per cent during the previous year, in consonance with higher economic activity.

I.3.6 Growth in scheduled commercial banks' (SCBs') time deposits accelerated to 24.9 per cent, y-o-y, at end-March 2007 from 16.4 per cent a year earlier which could be attributed to, *inter alia*, stronger economic activity, higher interest rates on bank deposits and extension of tax benefits under Section 80C for deposits with maturity of five years and above. In contrast to the sharp acceleration in time deposits, postal deposits witnessed a deceleration to 11.2 per cent in March 2007 from a growth of 17.2 per cent a year ago, partly attributable to rising interest rate differential in favour of bank deposits against the backdrop of unchanged interest rates on postal deposits.

I.3.7 SCBs' non-food credit rose by 28.4 per cent, y-o-y, on March 31, 2007 as compared with 31.8 per cent a year ago. Reflecting the slowdown in credit growth and the acceleration in deposits, the incremental credit-deposit ratio moderated towards the second half of 2006-07 after remaining above/around 100 per cent for the most part since October 2004. As at end-March 2007, the incremental credit-deposit ratio was around 84 per cent (y-o-y) as compared with 110 per cent a year ago.

I.3.8 The credit-GDP ratio increased from 30 per cent at end-March 2000 to 47 per cent at end-March 2006 to 51 per cent at end-March 2007. The credit-GDP ratio in India, however, still remains lower than major advanced economies as well as most East Asian economies.

I.3.9 Disaggregated data show that credit growth during 2006-07 was broad-based. While 36 per cent of the incremental non-food credit was absorbed by industry and another 14 per cent by agriculture, personal loans absorbed 24 per cent of the incremental non-food credit during the year. The share of housing loans in personal loans on an incremental basis (y-o-y) declined to 47.7 per cent at end-March 2007 from 49.4 per cent a year earlier. Loans to commercial real estate continued to record high growth, though with some moderation. The Reserve Bank further tightened the provisioning requirement and risk weights in respect of those categories, which witnessed relatively higher credit growth.

I.3.10 Based on the trends emerging from the Basic Statistical Returns data, the share of personal loans in total bank credit extended by SCBs increased from 6.4 per cent at end-March 1990 to 23.3 per cent at end-March 2006, driven by housing as well as non-housing loans. While the share of housing credit in overall credit rose from 2.4 per cent to 12.0 per cent, that of non-housing retail credit rose from 4.0 per cent to 11.3 per cent.

I.3.11 In recent years, the corporate sector has increasingly relied on non-bank sources to fund their financing requirements. This trend continued during 2006-07 with the corporate sector raising large resources from the capital markets and by way of external commercial borrowings (ECBs), besides relying increasingly on internal funds. Resources raised through domestic equity issuances more than doubled during 2006-07. Internal sources of funds continued to provide large financing support to the domestic corporate sector during 2006-07.

I.3.12 Commercial banks' holdings of SLR securities, as a proportion to their NDTL, declined to 28.0 per cent at end-March 2007 from 31.3 per cent at end-March 2006 and 42.7 per cent in April 2004. Excess SLR investments of SCBs fell to Rs.84,223 crore at end-March 2007 from Rs.1,45,297 crore at end-March 2006.

PRICE SITUATION

Global Inflation

I.3.13 Global headline inflation remained firm during 2006-07 reflecting the combined impact of higher international crude oil prices in an environment of strong demand and closing of output gaps. Although inflation moderated somewhat with the easing of crude oil prices from August 2006, inflationary pressures continued from other commodity prices and increased capacity utilisation rates. As a result, headline inflation remained above the inflation targets/comfort zones in major economies. In OECD countries, headline inflation rose from 2.5 per cent in March 2006 to an intra-year peak of 3.1 per cent in June 2006 before moderating to 2.4 per cent in March 2007; core inflation (*i.e.*, excluding food and energy) rose from 1.6 per cent in March 2006 to 2.1 per cent in March 2007. The consumer price inflation in advanced economies was 2.3 per cent in the calendar year 2006, the same as a year ago, but higher than that of 1.9 per cent during the preceding 5-year period (2000-04). Inflation in Developing Asia rose from 2.6 per cent during 2000-04 and 3.6 per cent in 2005 to 4.0 per cent in 2006. Although inflation has firmed up in many economies in the past couple of years, it still remains relatively contained despite sustained increase in commodity prices and buoyant demand .

I.3.14 Against the backdrop of inflationary pressures, many central banks, therefore, tightened monetary policies during 2006-07 in order to contain inflation and inflationary expectations. Amongst the major advanced economies, the US Federal Reserve Board (US Fed), the ECB, the Bank of England, the Sveriges Riksbank (Sweden), the Reserve Bank of New Zealand, the Reserve Bank of Australia, and the Bank of Japan tightened their policies during the year.

Global Commodity Prices

I.3.15 International non-fuel commodity prices firmed up during 2006-07 led by metals and food prices. Metal prices recorded gains on the back of robust demand in emerging economies, especially China and increased investors' interest. Amongst food items, prices of wheat and edible oils rose reflecting a shortfall in global production. Crude oil prices exhibited large volatility, initially rising sharply to reach a record high in July 2006 followed by a sharp correction in the subsequent months. Overall, non-fuel commodity prices (as measured by the World Bank's index of non-energy commodities) were 19 per cent higher in March 2007 (year-on-year). Some central banks in emerging market economies also took recourse to the use of cash reserve requirements in order to manage excess liquidity arising from large external capital flows. Some central banks changed direction during the course of the year – raising rates initially and then cutting them to support growth.

INFLATION CONDITIONS IN INDIA

Wholesale Price Inflation

I.3.16 Headline inflation in India, based on movement in the wholesale price index (WPI), rose to 5.9 per cent as on March 31, 2007, year-on-year, from 4.0 per cent a year ago. The increase in inflation reflected supply pressures emanating from higher primary articles prices as well as demand pressures amidst strong growth. Headline inflation moved in a range of 3.7-6.7 per cent during 2006-07. Inflation generally remained within the Reserve Bank's indicative projection of 5.0-5.5 per cent up to November 11, 2006 but exceeded the upper band during the remaining part of the year. Inflation remained above 6.0 per cent during the period January 6, 2007 and March 24, 2007. Reflecting the intra-year movement of inflation, the average WPI inflation rate (average of the 52 weeks) increased to 5.4 per cent from 4.4 per cent a year ago. The y-o-y inflation, excluding the fuel group, at 7.4 per cent was above the headline inflation rate of 5.9 per cent as on March 31, 2007. In order to anchor inflation expectations to sustain the growth momentum, the Reserve Bank continued with pre-emptive monetary measures during 2006-07 including increase in the repo and the reverse repo rates as well as the cash reserve ratio.

I.3.17 Among the major groups, prices of primary articles exerted upward pressure on inflation during 2006-07, reflecting shortfalls in domestic supply of major agricultural crops amidst elevated international prices. Wheat, pulses, milk, oilseeds and raw cotton were the major drivers of primary articles inflation. While prices of wheat rose, year-on-year, by 7.3 per cent as on March 31, 2007, those of pulses edged higher by 12.5 per cent (on top of 33.3 per cent increase a year ago). Prices of oilseeds witnessed a sharp turnaround - an increase of 31.6 per cent, y-o-y, as against a decline of 9.2 per cent a year ago. Raw cotton prices increased by 21.9 per cent, y-o-y, as on March 31, 2007 in contrast to a marginal decline in global prices. Overall, prices of primary articles, on a y-o-y basis, increased by 10.7 per cent (4.8 per cent a year ago), the highest rate of increase in the past decade.

I.3.18 In order to contain the price rise in primary commodities, the Government undertook a number of fiscal and supply side measures such as (i) allowing the State Trading Corporation (STC) to tender overseas for 5.5 million tonnes of wheat to supplement domestic availability; (ii) permitting private traders to import wheat initially at 5 per cent duty from June 27, 2006 and subsequently at zero duty from September 9, 2006; (iii) allowing import of pulses at zero duty from June 8, 2006 and a ban on their exports from June 27, 2006; (iv) exempting sugar from customs duty from June 22, 2006 and a ban on its exports; (v) allowing imports of maize at zero duty in February 2007; (vi) reducing the customs duty on palm oils by 10 percentage points each in August 2006 and April 2007, and by another 5 percentage points in July 2007, and on crude palm oil, sunflower oil and refined sunflower oil by 10 percentage points each in January 2007.

I.3.19 Fuel group inflation, which had dominated the inflation outcome during the preceding two years, eased significantly during the second half of the year to reach its lowest rate in over a decade. Fuel group inflation initially rose from 8.3 per cent as on April 1, 2006 to an intra-year peak of 9.9 per cent on June 17, 2006 but moderated to 1.0 per cent by March 31, 2007 reflecting the base effect as well as cuts in prices of petrol, diesel and other fuel products. Domestic prices of petrol and diesel were initially raised by Rs.4 and Rs.2 per litre, respectively, in June 2006; subsequently, these were reduced by Rs.2 per litre (around 4 per cent) and Re. 1 per litre (around 3 per cent), respectively, on November 29, 2006 and, by a similar order again, effective February 15, 2007. However, the pass-through remains incomplete, especially in the case of kerosene oil and LPG whose prices have remained unchanged since April 2002 and November 2004, respectively. Apart from reduction in customs duty on petrol and diesel to 7.5 per cent from 10.0 per cent in June 2006, the Government also issued oil bonds aggregating Rs.24,121 crore during 2006-07 (Rs.11,500 crore in the previous year).

I.3.20 Manufactured products, on the other hand, emerged as a key driver of inflation during 2006-07 amidst strong growth and demand conditions, and high capacity utilisation. Manufactured products group inflation increased to 6.1 per cent as on March 31, 2007 (from 1.9 per cent a year ago) contributing more than a half of overall y-o-y inflation during 2006-07. Amongst the manufactured products, prices of metals increased by 11.3 per cent, y-o-y, as on March 31, 2007 contributing 17.4 per cent to headline inflation. Within the metals group, non-ferrous metal prices rose by 29.3 per cent, y-o-y, on top of an increase of 17.5 per cent a year ago, broadly in line with international trends. Iron and steel prices increased by 8.1 per cent, y-o-y, in contrast to a decline of 4.2 per cent a year ago. Cement prices increased by 11.6 per cent, y-o-y, as on March 31, 2007 on top of an increase of 14.9 per cent a year earlier, in consonance with strong domestic demand emanating from construction activity related to both housing and other infrastructure activities. Prices of electrical machinery increased by 12.9 per cent reflecting the buoyant investment demand. Rise in prices of edible oils (increase of 14.1 per cent in contrast to a decline of 3.3 per cent a year ago), oil cakes (increase of 32.9 per cent as against a decline of 8.2 per cent), and grain mill products (increase of 16.6 per cent on top of an increase of 13.5 per cent a year ago) also contributed to manufactured products inflation. Domestic sugar prices declined in line with global trends.

I.3.21 In order to reduce the cost of manufacturing and infrastructure development, the Government took fiscal measures on January 22, 2007 in the form of reduction in customs duties on select items such as inorganic chemicals, non-ferrous metals, cement, capital goods and project imports. The Government further reduced the peak customs duty from 12.5 per cent to 10.0 per cent in the Union Budget, 2007-08 and, in the case of some items, below 10.0 per cent. On April 3, 2007, the Government decided to exempt import of portland cement from countervailing duty and special additional customs duty; it was earlier exempted from basic customs duty in January 2007.

Consumer Price Inflation

I.3.22 Consumer price inflation firmed up during 2006-07 and all the four measures were higher than WPI inflation throughout the year, mainly reflecting the higher order of increase in food prices as well as the higher weight of food items in the CPI. Food items have weights in the range of 67-69 per cent in the CPI for rural labourers and agricultural labourers, and in the range of 46-47 per cent in the CPI for industrial workers and urban non-manual employees as compared with 27 per cent (composite) in the WPI. Disaggregated data show that food group inflation in various CPI measures rose from 4.9-5.8 per cent in March 2006 to 10.9-12.2 per cent by March 2007. As a result of higher order of increase in food prices coupled with their large weight in the indices, various measures of CPI inflation increased from 4.9-5.3 per cent in March 2006 to an intra-year peak of 7.6-9.8 per cent in February 2007 before easing to 6.7-9.5 per cent in March 2007. Higher fuel group prices also contributed to consumer price inflation. Prices of services proxied by "miscellaneous group" exhibited a mixed trend during the year. Housing rent, however, decelerated in the case of CPI for Industrial Workers but marginally increased in the case of CPI for Urban Non-Manual Employees.

Asset Prices and Inflation

I.3.23 Domestic equity and bullion markets recorded gains during 2006-07, with intermittent corrections during the course of the year. Overall, the BSE Sensex gained 15.9 per cent during 2006-07. Domestic gold prices increased by about 10 per cent during 2006-07, broadly mirroring movements in international prices. International gold prices initially rose to US $ 715 per ounce on May 12, 2006 but fell to US $ 559 as on June 14, 2006 in consonance with the trends in various commodities in the international market. Gold prices recovered in July 2006 but again eased in September 2006 as headline inflation in major economies eased in tandem with the softening of international crude oil prices. Gold prices rebounded from the fourth quarter of 2006 before easing somewhat to around US $ 660 per ounce by end-March 2007.

IV. GOVERNMENT FINANCES

I.4.1 The combined finances of the Central and State Governments showed an improvement in 2006-07. The key deficit indicators, *viz.,* gross fiscal deficit (GFD), revenue deficit and primary deficit, in 2006-07 were placed 0.2 -0.6 percentage points of GDP lower than the preceding year, largely facilitated by the noticeable increase in tax revenues. The buoyancy in tax revenue reflected the impact of strong economic growth as well as continued efforts at improving the taxation system through moderation of tax rates and broadening of tax base. A noteworthy feature of the combined finances was enhanced allocation for development expenditure.

Central Government Finances – 2006-07

I.4.2 The revised estimates (RE) of the Central Government finances for 2006-07 exhibited an improvement *vis-à-vis* the budget estimates (BE). The key deficit indicators, *viz.*, revenue deficit, GFD and primary deficit were placed 0.1 percentage point of GDP lower than their budgeted levels. In absolute terms, the revenue deficit and the primary deficit turned out to be lower than budgeted, while the GFD was higher in the revised estimates than in the budget estimates. The improvement in revenue account in the revised estimates was mainly due to higher tax revenues. Collections under all taxes, except excise duties, were higher than budgeted. The buoyancy in revenues more than offset the increase in the revenue expenditure (mainly due to higher interest payment and subsidies), and this enabled a reduction of the revenue deficit in the revised estimates. The GFD was, however, placed higher in the revised estimates than the budget estimates mainly due to higher net lending. Capital outlay, on the other hand, was lower on account of decline in defence outlay.

1.4.3 The provisional accounts for 2006-07 released by the Controller General of Accounts reveal that both the revenue deficit and GFD, relative to GDP, narrowed down further by 0.1 percentage point and 0.2 percentage point, respectively, *vis-à-vis* the revised estimates, on account of increase in both tax and non-tax revenues (Primary balance turned surplus.

Debt position of the Central Government

I.4.4 Reflecting the process of fiscal consolidation, the outstanding domestic liabilities of the Central Government - comprising internal debt and other liabilities such as national small savings fund (NSSF), state provident funds, other accounts, reserve funds and deposits - declined to 59.0 per cent of GDP at end-March 2007 (RE) from 60.7 per cent at end-March 2006 and 61.8 per cent at end-March 2005. Internal debt was the largest component of the outstanding liabilities of the Central Government (61.3 per cent of the total debt at end-March 2007) followed by liabilities on account of NSSF, State provident funds and other accounts.

State Government Finances – 2006-07

I.4.5 Consolidated fiscal position of States for 2006-07 indicates further progress in the direction of fiscal consolidation, enabled by the enactment and implementation of Fiscal Responsibility Legislations. The consolidated revenue deficit in the revised estimates (RE) for 2006-07 was placed at Rs.1,303 crore (0.03 per cent of GDP) as against a deficit of Rs.4,511 crore (0.11 per cent of GDP) in 2006-07 (BE). Several States have achieved revenue surplus two years ahead of the target for achieving revenue balance by 2008-09 as prescribed by the Twelfth Finance Commission (TFC). This improvement resulted from higher revenue receipts (4.5 per cent above the budgeted level), offsetting the slippage in revenue expenditure (3.9 per cent above budgeted level). The higher revenue receipts in 2006-07 (RE) were due to increase in grants from the Centre (3.6 per cent), shareable taxes (5.8 per cent), States' own tax receipts (3.9 per cent) and States' own non-tax receipts (6.9 per cent). There was, however, a marginal slippage in the GFD/GDP ratio to 2.8 per cent from the budgeted level of 2.6 per cent on account of enhanced capital outlay (10.8 per cent), mainly in respect of education, rural development, irrigation, energy and transport sectors. Capital outlay, as a ratio to GDP, rose by 0.3 percentage points to 2.6 per cent. All the major deficit indicators, as per cent of GDP, were placed much lower in the revised estimates of 2006-07 than their average levels during the period 2000-05.

Combined Budgetary Position of the Centre and States – 2006-07

I.4.6 During 2006-07, the revenue deficit of the combined Government finances in the revised estimates was placed lower than the budget estimates. Buoyant tax collections, both direct and indirect, and higher non-tax receipts enabled a reduction of 0.1 percentage point of GDP in the revenue deficit *vis-a-vis* budgeted level. Aggregate expenditure was higher than budgeted on account of increase in both development and non-development expenditures. While development expenditure exceeded the budget estimates on account of higher expenditure on education, health, family welfare and water supply and sanitation, the increase in non-development expenditure was due to higher allocation for administrative services.

FISCAL OUTLOOK FOR 2007-08

Central Government

I.4.7 The Union Budget 2007-08 sought to strengthen the fiscal correction process as prescribed under the FRBM Rules, 2004. Accordingly, the GFD is budgeted to decline by 0.4 percentage point to 3.3 per cent of GDP during 2007-08 while the revenue deficit is budgeted to decline by 0.5 percentage points to 1.5 per cent of GDP. These budgeted reductions are in consonance with the annual reductions stipulated under the FRBM Rules, 2004. The Budget envisages a primary surplus of 0.2 per cent of GDP during 2007-08 as against a primary deficit of 0.1 per cent of GDP during 2006-07. The underlying strategy for reducing deficits is essentially revenue-led, accompanied by improvements in allocative efficiencies of public expenditure. During 2007-08, as the GFD is budgeted to be lower than the Plan expenditure, the financing of the Plan will not be entirely from borrowed resources. Furthermore, the envisaged reduction in the revenue deficit to GFD ratio will facilitate higher capital outlays.

State Budgets 2007-08

I.4.8 State Governments through their budgets for 2007-08 have committed to bring further improvement in their fiscal position in line with their Fiscal Responsibility Legislations while making higher allocations for the social and rural sectors in line with the priorities set out in the Eleventh Five Year Plan. Notwithstanding the variation across the States, the consolidated revenue balance is budgeted to show a noticeable improvement in 2007-08, with a surplus of 0.4 per cent of GDP as compared with the deficit of 0.03 per cent of GDP in 2006-07 (RE). As a result, the GFD is estimated to decline to 2.4 per cent of GDP in 2007-08 (BE) from 2.8 per cent of GDP during 2006-07 (RE). The consolidated primary deficit is budgeted at 0.1 per cent of GDP in 2007-08.

Combined Finances for 2007-08

I.4.9 An overview of the combined budgetary position of the Central and State Governments for 2007-08 indicates continuance of the fiscal consolidation process. The key deficit indicators are budgeted to decline *vis-à-vis* the revised estimates for 2006-07, both in absolute terms and in terms of GDP. The improvement in combined finances during 2007-08 would primarily be due to the marked improvement in State finances, reflecting the build-up of sizeable surplus in their revenue accounts.

I.4.10 Market borrowings are budgeted to finance a higher proportion of the combined GFD during 2007-08 than in the preceding year. While the share of the State Provident Funds is budgeted to increase marginally, the contribution of small savings to the financing of GFD is budgeted to decline during 2007-08.

V. FINANCIAL MARKETS

I.5.1 Indian financial markets remained generally orderly during the most part of 2006-07. There were, however, some spells of volatility, especially in March 2007, reflecting shifts in liquidity conditions arising from large changes in capital flows and cash balances of the Government. Interest rates in various segments of the financial markets hardened in tandem with the policy rates of the Reserve Bank. The overnight rates remained within the corridor set by the Reserve Bank's reverse repo and repo rates during the year, barring some occasions during December 2006-March 2007 (especially, the second half of March 2007), when the overnight rates increased sharply as the market experienced temporary tightness. Interest rates in the collateralised segment of the overnight money market also hardened, but remained below the call rate during the year. In the foreign exchange market, the Indian rupee exhibited two-way movements with a strengthening bias from mid-July 2006. Yields in the Government securities market hardened during the year. However, the yield curve flattened. Banks' deposit and lending rates edged up, especially in the second half of the year. The stock markets reached record highs during the year interspersed with periodic corrections. The primary market segment of the capital market continued to exhibit buoyancy.

MONEY MARKET

I.5.2 Money market rates edged up during 2006-07, broadly moving in line with the policy rates. The call rate averaged 7.22 per cent during 2006-07, 162 basis points higher than that in 2005-06. Movements of interest rates during the year depended upon the evolving liquidity conditions on account of factors such as advance tax outflows, Government cash balances, festive season currency demand, trends in capital flows and credit demand. The call money rate, which was generally anchored to the reverse repo rate up to mid-September 2006, remained mostly within the repo-reverse repo corridor from mid-September 2006 to December 12, 2006. Effective December 13, 2006, the call rate edged up and crossed the repo rate under the impact of advance tax outflows and the announcement (on December 8, 2006) of a hike of 25 basis points each in the cash reserve ratio (CRR) effective the fortnights beginning December 23, 2006 and January 6, 2007. The weighted average call rate touched 16.88 per cent on December 29, 2006 but eased in the first week of January 2007 on some improvement in liquidity conditions. The call rate, however, continued to remain above the repo rate till the first week of February 2007. The call rate eased further to around 6.5 per cent – below the repo rate – by the second week of February 2007 as a consequence of the Reserve Bank's foreign exchange operation.

I.5.3 Interest rates in the collateralised segments of the money market – the market repo (outside the LAF) and the collateralised borrowing and lending obligation (CBLO) – increased in line with call rates. The collateralised market is now the predominant segment in the money market, and it accounted for about 70 per cent of the total volume during 2006-07. Rates in these segments continued to remain below those in the call market during 2006-07 and exhibited relative stability *vis-à-vis* the call rate. For the financial year 2006-07, as a whole, the interest rates averaged 6.24 per cent (5.34 per cent in 2005-06) in the CBLO segment and 6.34 per cent (5.36 per cent) in the market repo segment, respectively, as compared with 7.22 per cent (5.60 per cent) in the call money market. The weighted average interest rate of the call money, the CBLO and the repo segments rose from 5.43 per cent in 2005-06 to 6.57 per cent in 2006-07.

Certificates of Deposit

I.5.4 Banks continued to take recourse to certificates of deposit (CDs) to supplement their deposit resources to fund the credit demand. The flexibility of return that can be offered to attract bulk deposits has made CDs the preferred route for mobilising resources for the cash-strapped banks. The outstanding amount of CDs increased from Rs.43,568 crore at end-March 2006 (4.80 per cent of aggregate deposits of issuing banks) to Rs.93,272 crore (4.83 per cent) by end-March 2007. As on June 22, 2007, the outstanding amount of CDs increased further to Rs.98,337 crore. A substantial part of the CDs issuance (around 20 per cent of total outstanding amount) took place during the first fortnight of March 2007, mainly by private sector banks. Smaller banks having lower deposit base had a higher ratio of CDs to aggregate deposit in comparison with large public sector banks. The weighted average discount rate (WADR) of CDs increased from 8.62 per cent at end-March 2006 to 10.75 per cent at end-March 2007 in tandem with the upward movement of other money market interest rates. The WADR softened to 9.37 per cent at end-June 2007. Mutual funds are the major investors in the CDs.

Commercial Paper

I.5.5 The outstanding amount of commercial paper (CP) issued by corporates increased from Rs.12,718 crore at end-March 2006 to Rs.17,838 crore at end-March 2007. The outstanding amount of CP increased sharply in the first half of 2006-07, but was largely range-bound during October 2006-January 2007 and declined during ebruary-March 2007. At present, a corporate having minimum credit rating of P2 of CRISIL or its equivalent can raise resource through CP. As a result, CP issuance is dominated by the prime rated companies. For instance, during the fortnight ended March 31, 2007, the prime rated companies raised funds aggregating Rs.1,190 crore (93.0 per cent of total) through CP at a weighted average discount rate (WADR) of 11.3 per cent, whereas medium rated companies raised funds worth Rs.90 crore (seven per cent) at a WADR of 11.78 per cent. Overall, the WADR on CP increased from 8.59 per cent during the fortnight ended March 31, 2006 to 11.33 per cent during the fortnight ended March 31, 2007 in tandem with the increase in other money market rates. The outstanding amount of CP increased to Rs.26,256 crore as on June 30, 2007. The WADR softened to 8.93 per cent in June 2007. The most preferred maturity of CP was for periods ranging from ‘61 to 90 days’ and ‘181 days and above’.

GOVERNMENT SECURITIES MARKET

I.5.6 Yields in the secondary segment of the Government securities market hardened during 2006-07 accompanied by some flattening of the yield curve. Yields initially rose during 2006-07 to reach an intra-year peak of 8.40 per cent on July 11, 2006 on the back of sustained domestic credit demand, higher international crude oil prices, apprehensions over domestic fuel price hike and continuous pre-emptive monetary tightening globally as well as in India. Subsequently, however, yields softened in consonance with the easing of Government bond yields in the US, the Fed’s decision to keep the fed funds rate target unchanged, easing of international crude oil prices, increased demand for gilts from banks to meet their SLR requirements and the announcement of the borrowing calendar of the Central Government for the second half of 2006-07 which was in accordance with market expectations. The 10-year yield reached a low of 7.38 per cent as on November 28, 2006. There was again some hardening of yields from the second half of December 2006 in tandem with tightness in domestic liquidity conditions on the back of advance tax outflows, higher inflation and hikes in the CRR. The 10-year yield was 7.97 per cent as on March 31, 2007, 45 basis points higher than the level as on March 31, 2006 (7.52 per cent).

I.5.7 The yield curve flattened during 2006-07, with the spread between 1-10 year yields narrowing down to 42 basis points at end-March 2007 from 98 basis points at end-March 2006. During 2007-08, the increase in the yield spreads as at end-July 2007 indicated that the softening in the 10-year yield did not permeate the longer end of the yield curve. The yield spread of 5-year AAA-rated bonds over 5-year Government securities, however, widened to 142 basis points at end-March 2007 from 91 basis points at end-March 2006 after narrowing down to 69 basis points in July 2006.

CREDIT MARKET

I.5.8 Deposit and lending rates of scheduled commercial banks (SCBs) increased during 2006-07. For instance, interest rates offered by public sector banks (PSBs) on deposits of maturity of one year to three years rose from a range of 5.75-6.75 per cent in March 2006 to a range of 7.25-9.50 per cent in March 2007, while those on deposits of maturity of above three years increased from 6.00-7.25 per cent to 7.50-9.50 per cent over the same period. Interest rates offered by private sector banks and foreign banks, generally, were also higher than a year ago

1.5.9 The Benchmark Prime Lending Rates (BPLRs) of PSBs increased from a range of 10.25-11.25 per cent in March 2006 to a range of 12.25-12.75 per cent in March 2007. The BPLRs of private sector as well as foreign banks also rose during the year. During 2007-08, BPLRs of PSBs and private sector banks moved to a range of 12.50-13.50 per cent and 13.00-17.25, respectively, by July 2007. The BPLRs of foreign banks remained unchanged during the period. The weighted average BPLR of PSBs increased from 10.7 per cent in March 2006 to 12.4 per cent in March 2007 and 13.1 per cent in July 2007, while that of private sector banks increased from 12.4 per cent to 14.1 per cent and 14.9 per cent over the same period. The weighted average BPLR of foreign banks rose from 12.7 per cent in March 2007 as well as March 2006 to 13.9 per cent in July 2007. A significant proportion of bank lending continued to be below the BPLR. Almost 79 per cent of the lending by the SCBs was at sub-BPLR at end-March 2007 (69 per cent a year ago). Bank group-wise, the PSBs, private sector banks and foreign banks lent funds at sub-BPLR to the extent of 74 per cent, 92 per cent and 72 per cent, respectively, of their total loans at end-March 2007.

EQUITY AND DEBT MARKETS

I.5.10 The resource mobilisation from the primary market through the public issues (excluding offer for sale) increased by 20.2 per cent to Rs.32,382 crore during 2006-07. The bulk of the resource mobilisation continued to be through equity issuances (97 per cent of the total during 2006-07 as compared with 99 per cent during the previous year).

I.5.11 The Indian corporate sector continued to rely heavily on the domestic private placement market. Mobilisation of resources through the private placement route during 2006-07 increased by 50.9 per cent to Rs.1,45,571 crore. Bulk of resources from the private placement market during 2006-07 were mobilised by private sector entities – both financial and non-financial – 58.0 per cent as compared with 42.7 per cent in the preceding year.

I.5.12 Net resources mobilised by mutual funds increased by 78.1 per cent to Rs.93,985 crore during 2006-07 due primarily to higher resource mobilisation by private sector mutual funds. Net assets managed by mutual funds also increased significantly by 40.7 per cent to Rs.3,26,292 crore at end-March 2007 on account of increased resource mobilisation and increase in the market value of their portfolio.

I.5.13 The domestic stock markets recorded further gains during 2006-07. The BSE Sensex at end-March 2007 increased by 15.9 per cent (year-on-year) on top of the increase of 73.7 per cent a year ago. Strong corporate profitability and continued liquidity support from FIIs and domestic mutual funds buoyed up the stock markets even as they witnessed sharp corrections on a few occasions (May-June 2006, December 2006 and February-March 2007) in consonance with the trends in global equity markets. During 2006-07, the BSE Sensex moved in a range of 8929 (June 14, 2006) and an all-time high of 14652 (February 8, 2007), before closing at 13072 on March 30, 2007.

VI. EXTERNAL SECTOR

I.6.1 Developments in India's balance of payments during 2006-07 continued to reflect sustained strength and vibrancy of the external sector. Merchandise export and non-oil import growth remained robust, although there was some deceleration from the strong pace of the previous year. Earnings from exports of software and other business services as well as remittances from Indians working abroad continued to exhibit buoyancy. The net surplus under invisibles expanded further during 2006-07 and continued to finance a large part of the growing merchandise trade deficit. Consequently, the current account deficit remained modest during the year, and, as a proportion to GDP, was at the same level as a year ago. Led by foreign direct investment and external commercial borrowings (ECBs), capital flows (net) to India witnessed a large increase during 2006-07 on the back of strengthening of growth prospects, and buoyancy in domestic investment and import demand. Outward direct investment also witnessed a jump reflecting growing overseas acquisitions by Indian corporates. With net capital flows remaining in excess of the current account deficit, the overall balance of payments recorded a significant surplus, which was mirrored in an accretion of US $ 47.6 billion to foreign exchange reserves during 2006-07. While the stock of external debt rose due to higher ECBs and non-resident deposits, net international liabilities fell, reflecting the continuous build-up of foreign exchange reserves.

Merchandise Trade

I.6.2 India's merchandise exports recorded a growth of 22.5 per cent during 2006-07 as compared with 23.4 per cent during 2005-06. Commodity-wise data reveal that engineering goods and petroleum products recorded a strong growth during 2006-07, while exports of other principal items like chemicals and related products, gems and jewellery, textiles and related products and ores and minerals showed a moderation in growth. Exports of primary products posted a growth of 19.4 per cent (20.8 per cent in 2005-06), even though ores and minerals showed a deceleration in growth. Within agricultural exports, tea, tobacco, spices and sugar and molasses maintained high growth during 2006-07. Deceleration in exports of chemicals and related products was mainly due to slowdown of growth in exports of drugs, pharmaceuticals and fine chemicals. India's textile exports after registering a sharp acceleration in 2005-06, slowed down in 2006-07.

I.6.3 In 2006-07, the US remained the major destination of India's exports accounting for 14.9 per cent of India's total exports, followed by the UAE (9.5 per cent), China (6.6 per cent) and Singapore (4.8 per cent). During 2006-07, growth of exports to most of the major markets, with the exception of the UAE, decelerated. Acceleration of growth in the exports to UAE can be attributed to the increased petroleum exports to the country. Over the years, developing countries, particularly, the Asian countries have emerged as the major destinations of India's exports, while the share of developed countries has tended to decline.

I.6.4 Growth of India's merchandise imports moderated to 27.8 per cent during 2006-07 from 33.8 per cent a year ago . Growth in oil imports moderated to 29.8 per cent during 2006-07 (47.3 per cent a year ago), mirroring some slowdown of growth in the price of the Indian basket of crude oil (12.7 per cent during 2006-07 as compared with 42.2 per cent during 2005-06). On the other hand, growth in the volume of oil imports at 19.3 per cent during 2006-07 was significantly higher than that of 4.2 per cent a year ago.

I.6.5 Growth in non-oil imports moderated to 26.9 per cent during 2006-07 from 28.8 per cent a year ago, mainly on account of decline in imports of pearls, precious and semi-precious stones. On the other hand, imports of gold and silver expanded by 29.4 per cent during 2006-07 as compared with growth of 1.5 per cent a year ago, partly mirroring the movement in gold prices. Non-oil imports, excluding gold and silver, increased by 26.6 per cent during 2006-07 as compared with 33.1 per cent growth a year ago. Imports of capital goods continued to exhibit a buoyant growth (40.6 per cent during 2006-07 on top of 49.9 per cent during 2005-06), in consonance with strong domestic investment demand. Capital goods remained the mainstay of imports, accounting for almost 61 per cent of the increase in non-oil non-bullion imports during 2006-07.

I.6.6 During 2006-07, China remained the major source of total imports (oil *plus* non-oil imports) with a share of 9.1 per cent in India's total imports followed by Saudi Arabia (7.0 per cent),Germany (6.6 per cent), the US (6.6 per cent), Switzerland (4.8 per cent) and the UAE (4.5 per cent).

Invisibles

I.6.7 Invisibles surplus (services, transfers and income taken together) remained buoyant during 2006-07, led by robust growth in exports of software and other services, and supported by private remittances. Gross invisible receipts comprising services, income from financial assets, labour and property and workers' remittances are rapidly catching up with the merchandise exports. Gross invisible receipts were 48 per cent of current receipts during 2006-07 as compared with 29 per cent during 1990-91. The net surplus under invisibles expanded from 2.1 per cent of GDP in 2000-01 to 6.0 per cent of GDP in 2006-07 on the back of sharp expansion in gross invisible receipts from 7.0 per cent to 13.0 per cent. During 2006-07, the net surplus under invisibles financed more than three-fourths of the trade deficit.

Current Account

I.6.8 The sustained rise in invisibles surplus during 2006-07 continued to moderate the impact of the growing merchandise trade deficit. As a result, the current account deficit could be contained at US $ 9.6 billion during 2006-07, marginally higher than that in the corresponding period of the previous year. As a proportion to GDP, the current account deficit at 1.1 per cent in 2006-07 was the same as a year ago. Merchandise trade deficit, after fluctuating around 3-4 per cent of GDP between the mid-1990s and 2003-04, widened sharply to 7.1 per cent of GDP in 2006-07 on the back of higher oil as well as non-oil imports. The import-led trade deficit and predominance of capital goods imports and export-related items signify the underlying strong investment demand backed by encouraging growth prospects. Nonetheless, the current account deficit has remained relatively low - averaging around one per cent of GDP since 1990-91 - attributable to sustained trend growth in net invisibles surplus from 2.1 per cent of GDP in 2000-01 to 6.0 per cent in 2006-07. Unlike India, a number of EMEs recorded surpluses on trade and current accounts during 2006.

Capital Account

I.6.9 Net capital flows rose further during 2006-07, reflecting growing investor interest in India's growth prospects as well as global liquidity conditions. Capital flows (net) jumped from an average of around US $ 9 billion (1.9 per cent of GDP) during 2000-03 to around US $ 30-31 billion (3.5 per cent of GDP) (adjusted for the IMD effect) during 2004-06, remaining well above the current account deficit. During 2006-07, capital flows (net) were US $ 44.9 billion led by external commercial borrowings and foreign direct investment flows.

Foreign Investment

I.6.10 Foreign direct investment (FDI) to India increased sharply from US $ 7.7 billion during 2005-06 to US $ 19.5 billion during 2006-07 on the strength of expansion in domestic activity, positive investment climate, progressive liberalisation of the FDI policy regime, and simplification of procedures. The rising pace of mergers and acquisitions in sectors such as financial services, manufacturing, banking services, information technology and construction also boosted FDI inflows. FDI flows into India during 2006-07 were significantly higher than portfolio flows. Overseas direct investment from India also exhibited a significant rise during the year - from US $ 4.5 billion during 2005-06 to US $ 11.0 billion during 2006-07 - reflecting large overseas acquisition deals by Indian corporates to gain market shares and reap economies of scale, amidst the progressive liberalisation of the external payments regime.

EXTERNAL DEBT

I.6.11 Reflecting rise in net inflows under external commercial borrowings and NRI deposits, as alluded to earlier, India's total external debt increased by US $ 28.6 billion during 2006-07. The external debt was placed at US $ 155.0 billion at end-March 2007. The stock of external commercial borrowings rose by US $ 15.9 billion accounting for nearly 55.6 per cent of the increase in the total external debt during 2006-07. Among different components of ECBs, commercial bank loans increased from US $ 16.4 billion at end March 2006 to US $ 25.8 billion at end-March 2007, while securitised borrowings (including FCCBs) increased from US $ 9.7 billion to US $ 15.7 billion.

I.6.12 Almost 49 per cent of the external debt stock was denominated in US dollars, followed by the Indian Rupee (17.4 per cent), SDR (13.3 per cent) and Japanese Yen (12.9 per cent). The ratio of external debt to GDP has witnessed a steady decline since the 1990s, reaching 16.4 per cent at end-March 2007 from 30.8 per cent at end-March 1995. Although India was the seventh largest debtor country in 2005, its debt-GDP ratio was the second lowest among the top 20 debtor countries, next only to China. As at end-March 2007, foreign exchange reserves were 28.5 per cent in excess of the stock of external debt. Current receipts exceeded the external debt stock by 58.4 per cent, reflecting the sustained robust growth in exports of goods, services and remittances. The ratio of short-term to total debt and short-term debt to foreign exchange reserves remained relatively modest. The debt-service ratio fell to 4.8 per cent in 2006-07. The increase in debt service ratio during 2005-06 reflected the one-off impact of the bullet redemption of the IMDs.

FOREIGN EXCHANGE RESERVES

I.6.13 With capital flows (net) remaining significantly higher than the current account deficit, the overall balance of payments continued to record large surplus during 2006-07. As a result, foreign exchange reserves comprising foreign currency assets, gold, SDRs and the reserve tranche position with the IMF increased by US $ 47.6 billion during 2006-07 to US $ 199.2 billion at end-March 2007. As at end-March 2007, the total quantum of India's contribution under the Financial Transactions Plan (FTP) of the IMF was SDR 493 million.

I.6.14 India held the fifth largest stock of international reserve assets among EMEs at end-March 2007. India's foreign exchange reserves are at comfortable level as reflected by different reserve adequacy indicators. Total reserves were equivalent of over 12.4 months of imports at end-March 2007, and 16.6 times the short-term debt.

II ASSESSMENT AND PROSPECTS

ASSESSMENT OF 2006-07

II.1 During 2006-07, the Indian economy exhibited acceleration in growth, led by manufacturing and services sector activities. The sustained high growth since 2003-04 has been supported by increase in domestic savings and investment. Robust growth during 2006-07, however, was accompanied by inflationary pressures on account of capacity constraints in certain sectors, strong growth in monetary and credit aggregates, demand-supply gaps in domestic production of foodgrains and oilseeds, and firm global commodity prices. A series of timely and appropriate measures undertaken by the Reserve Bank, and other supply side responses to rising prices made by the Government helped to contain headline inflation. More importantly, the measures facilitated the anchoring of inflationary expectations to a certain extent. Strong growth in general and of the industrial sector in particular enabled the corporate sector to maintain high profitability. This, in turn, resulted in buoyant tax collections and played a major role in improving public finances. The growth process was facilitated by financial market conditions, which remained orderly, barring a few episodes of volatility. However, interest rates in various segments of the financial market hardened to some extent. Strong growth led to a widening of the trade deficit. Nonetheless, the current account deficit, as per cent of GDP, remained unchanged from the previous year since the widening of the merchandise trade deficit was offset to a large extent by the continuing buoyancy in net invisibles surplus. Large capital flows led by external commercial borrowings and net foreign direct investment (FDI) inflows resulted in large accretion to foreign exchange reserves.

II.2 The Indian economy recorded robust growth for the fourth successive year during 2006-07. Real GDP growth accelerated from 9.0 per cent during 2005-06 to 9.4 per cent during 2006-07. The growth, thus, averaged 8.6 per cent per annum during the four-year period ended 2006-07. Real GDP growth during the Tenth Five Year Plan period averaged 7.6 per cent per annum, the highest in any Plan period. Acceleration in the growth rate during 2006-07 was attributable to buoyancy in the industrial and services sectors, which exhibited double-digit growth (11.0 per cent each), since higher growth in the industrial and services sectors more than offset the deceleration in the agricultural sector.

II.3 Growth in the agricultural sector decelerated from 6.0 per cent in 2005-06 to 2.7 per cent in 2006-07, partly on account of uneven rainfall during the South-West monsoon and also the base effect reflecting high growth in 2005-06. Although the overall foodgrains production rose by 3.6 per cent in 2006-07, the production of major crops still did not reach the previous peak touched in 2001-02. Amongst the major crops, the production of rice, wheat and pulses during 2006-07 was below the peaks reached in 2001-02, 1999-2000 and 1998-99, respectively. The stagnation in the production of major foodgrains and decline in stocks amidst firming up of global prices led to a significant hardening of domestic food prices during 2006-07. Amongst the non-foodgrains, the production of sugarcane and cotton scaled new peaks during 2006-07, while that of oilseeds declined.

II.4 The industrial upturn that started in April 2002 maintained its momentum during 2006-07. Based on the index of industrial production, industrial growth accelerated from 8.2 per cent in 2005-06 to 11.5 per cent in 2006-07, the highest growth achieved over the past decade. The growth led by the manufacturing sector (12.5 per cent) was broad-based. In terms of use-based classification, all sectors, except consumer goods, exhibited acceleration in growth. The production of capital goods remained buoyant with growth of 18.2 per cent indicative of robust investment demand. The basic goods and intermediate goods sectors also recorded higher growth during 2006-07. The growth of core infrastructure industries at 8.6 per cent during 2006-07 has been the highest since 1999-2000 (9.1 per cent).

II.5 The services sector with double-digit growth for the third successive year consolidated its position as the key driver of economic activity in the country. The services sector accounted for 61.8 per cent of GDP in 2006-07 and contributed nearly three-fourths to the overall real GDP growth during the year. The services sector benefited from the robust growth in domestic tourism, foreign tourist arrivals, telecom sector, railways traffic, civil aviation, cargo handled, construction, business process outsourcing (BPO), information technology enabled services (ITES), and banking and insurance activity.

II.6 The strengthening of economic activity in recent years has been supported by a steady upward trend in domestic savings and investment rates coupled with an efficient use of capital. The savings rate continued its upward trend from 23.5 per cent of GDP in 2001-02 to 32.4 per cent in 2005-06, while the investment rate rose from 22.9 per cent to 33.8 per cent over the same period. Data for 2006-07 suggest continuation of these trends, with the rate of gross fixed capital formation increasing by 1.4 percentage points to 29.5 per cent of GDP from 28.1 per cent in 2005-06.

II.7 The sustained economic growth since the early 1990s has also been associated with a significant reduction in poverty. The proportion of people living below the poverty line (based on uniform recall period) declined from 36.0 per cent in 1993-94 to 27.8 per cent in 2004-05. There is also evidence of pick-up in employment growth (based on usual principal status) from 1.57 per cent per annum (1993-94 to 1999-2000) to 2.48 per cent (1999-2000 to 2004-05). The annual growth in employment (2.48 per cent) was, however, marginally lower than that of the labour force (2.54 per cent) during 1999-2000 to 2004-05. As a result, the unemployment rate rose from 2.78 per cent in 1999-2000 to 3.06 per cent in 2004-05.

II.8 Growth in money supply (M_3) accelerated from 17.0 per cent during 2005-06 to 21.3 per cent during 2006-07. Amongst the major components, time deposits exhibited a higher growth during 2006-07 which could be attributed to factors such as higher interest rates on bank deposits and availability of tax benefits under Section 80C for bank deposits of appropriate maturity. On the sources side, growth of bank credit remained high, although there was some moderation from the previous two years. Demand for bank credit was largely broad-based with agriculture, industry and personal loans sectors absorbing 14 per cent, 36 per cent and 24 per cent, respectively, of the incremental expansion in overall non-food credit during 2006-07. Growth of credit to sectors such as real estate remained high, *albeit* with some moderation. In order to maintain asset quality, the Reserve Bank further tightened the provisioning requirements and risk weight prescriptions in respect of sectors witnessing high growth in credit. Commercial banks' SLR investments, as a proportion of their net demand and time liabilities (NDTL), declined further to 28.0 per cent by end-March 2007 (close to the prescribed ratio of 25 per cent) as the expansion in investments did not keep pace with the expansion in the NDTL. Net foreign assets (NFA) remained the key driver of reserve money and the Reserve Bank continued to modulate market liquidity through operations under the liquidity adjustment facility (LAF), issuance of securities under the market stabilisation scheme (MSS) and use of the cash reserve ratio (CRR).

II.9 Headline inflation firmed up from 4.0 per cent, y-o-y, on April 1, 2006 to 5.9 per cent on March 31, 2007 with an intra-year high of 6.7 per cent on January 27, 2007 and a low of 3.7 per cent on April 15, 2006. Both demand and supply side factors added to inflationary pressures during 2006-07. Supply side pressures emerged from higher food prices due to demand-supply gaps in domestic foodgrains and oilseeds production amidst rising global prices. Consumer price inflation rose from 4.9-5.3 per cent in March 2006 to 6.7-9.5 per cent in March 2007, mainly reflecting the impact of higher food prices. In order to contain inflation and to stabilise inflationary expectations, the Reserve Bank persevered with the policy of pre-emptive actions and gradual withdrawal of monetary accommodation, using various instruments at its disposal flexibly. Since the second half of 2004, the repo and the reverse repo rates have been increased by 175 basis points and 150 basis points, respectively. In addition, the cash reserve ratio has been raised by 250 basis points. The Government also took various fiscal and supply-side measures to contain inflation during the latter part of 2006-07.

II.10 The Central Government's provisional accounts for 2006-07 reflected the Government's commitment of staying on course with the path of fiscal correction under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004. Gross fiscal deficit (GFD) and revenue deficit (RD), as ratios to GDP, at 3.5 per cent and 1.9 per cent, respectively, in 2006-07 (provisional accounts) were lower by 0.6 percentage point and 0.7 percentage point in comparison with 2005-06. The fiscal corrections, thus, turned out to be higher than the respective minimum reductions of 0.3 percentage point and 0.5 percentage point stipulated per year under the FRBM Rules, 2004, thereby partly compensating for the pause taken in 2005-06. Furthermore, the provisional accounts showed a primary surplus during 2006-07, reflecting containment of non-interest expenditure below the non-debt receipts. For the first time since 1970-71 (the period for which such data are readily available), primary surpluses were recorded in 2004-05 and again in 2006-07. If this trend continues in the coming years, it will help in stabilising and then reducing the debt/GDP ratio. The reduction in deficit indicators was enabled by buoyant revenue growth, reflecting both cyclical and structural factors that have resulted in higher economic growth, and improved expenditure management. The gross tax/ GDP ratio maintained its upward trend and reached 11.5 per cent in 2006-07 (provisional accounts). Expenditure management efforts focused on moderating non-plan expenditure, while increasing plan expenditure. However, capital outlay continued to be low at around 1.4 per cent of GDP.

II.11 The consolidated fiscal position of the State Governments during 2006-07 (revised estimates) reflected the progress made by the States towards fiscal correction and consolidation. The consolidated revenue deficit was placed at 0.03 per cent of GDP in 2006-07 (revised estimates). In all, 17 States (including NCT Delhi) reported revenue surplus during the year. The correction in the revenue account was facilitated by buoyant own tax revenues of the States, aided by implementation of Value Added Tax (VAT) and higher devolution and transfers from the Centre consequent to the implementation of the recommendations of the Twelfth Finance Commission (TFC). The increase in revenue receipts more than compensated for the increase in revenue expenditure. The sustainability of this positive trend will depend upon the continued growth in States' own tax efforts over a period of time. The State Governments stepped up capital outlays, especially for education, rural and infrastructure development, which translated into GFD exceeding the budget estimates. A number of State Governments managed to bring down the ratio of GFD to Gross State Domestic Product (GSDP) to less than 3 per cent, two years ahead of the targets of the TFC. The State Governments continued to draw comfort from the accruals under the National Small Savings Fund (NSSF), notwithstanding some moderation in the accruals during 2006-07. Most of the State Governments continued to maintain high level of surplus cash balances. Consequently, the recourse to Ways and Means Advances (WMA) was low.

II.12 Financial markets remained orderly during 2006-07, barring some episodes of volatility, especially during the second half of March 2007. Capital inflows and movements in Government cash balances continued to be the key drivers of liquidity conditions and overnight interest rates. Interest rates in the various market segments hardened during the year, broadly in tandem with the pre-emptive monetary tightening measures taken by the Reserve Bank. By and large, the exchange rate of the Indian rupee exhibited two-way movement with respect to the main reserve currencies during 2006-07. The stock markets remained buoyant, with the benchmark indices reaching record highs during 2006-07, amidst intermittent corrections. The primary segment of the capital market also exhibited buoyant conditions.

II.13 India's balance of payments in 2006-07 reflected a number of positive features. Merchandise trade continued to exhibit robust growth during 2006-07, although there was some loss of pace from the strong growth of 2005-06. Based on the DGCI&S data, merchandise exports and imports expanded by 22.5 per cent and 27.8 per cent, respectively, during 2006-07, building upon the high growth phase that began in 2002-03. Export and import growth averaged 23.6 per cent and 30.2 per cent, respectively, during the five-year period ended 2006-07. On the import side, oil imports remained the largest component of imports in 2006-07 (29.9 per cent of total imports). Growth in oil imports during 2006-07 was on account of both volume and price changes. Non-oil imports continued to record strong growth in tandem with economic activity. Reflecting the growing integration with the global economy, import intensity (imports-GDP ratio) increased to 20.9 per cent in 2006-07 from 18.5 per cent in 2005-06. The higher growth of imports *vis-a-vis* exports led to a persistent rise in the trade deficit, on a balance of payments basis, from US $ 10.7 billion in 2002-03 to US $ 64.9 billion in 2006-07. The trade deficit, as a percentage of GDP, widened from 2.1 per cent in 2002-03 to 7.1 per cent in 2006-07. However, the spill over of the widening trade deficit to the current account was contained by robust growth in exports of services, led by software and other business services, and remittances from overseas Indians. Gross invisible receipts are fast catching up with the level of merchandise exports. Net surplus under invisibles at 6.0 per cent of GDP during 2006-07 offset a substantial part of the trade deficit. The current account deficit at 1.1 per cent of GDP during 2006-07 was the same as in 2005-06.

II.14 Net capital flows to India remained buoyant at US $ 45 billion or 4.9 per cent of GDP, far exceeding the current account deficit. Higher capital flows could be attributed to the strengthening of macroeconomic fundamentals, greater investor confidence and ample global liquidity. Both debt and non-debt flows witnessed a large increase during 2006-07. Direct investment flows showed a strong bi-directional movement. Net FDI inflows to India increased sharply from US $ 7.7 billion during 2005-06 to US $ 19.4 billion during 2006-07, while net FDI outflows increased from US $ 2.9 billion to US $ 11.0 billion. Hence, FDI flows (net) at US $ 8.4 billion exceeded FII inflows (net) of US $ 3.2 billion during 2006-07. The debt flows (net) at US $ 25.0 billion were led by external commercial borrowings reflecting strong demand for capacity expansion, greater risk appetite of global investors for emerging market bonds and further liberalisation of the policy framework. Net capital flows, after financing the current account deficit, led to accretion of US $ 36.6 billion, excluding valuation changes, to foreign exchange reserves during 2006-07. While the stock of external debt rose during 2006-07, net international liabilities of the country declined reflecting a large increase in foreign exchange reserves.

II.15 Although the current account deficit has remained modest, averaging one per cent of GDP since the early 1990s, the integration of the Indian economy with the global economy has increased significantly over the same period. This can be seen in the steady rise in the current receipts-GDP ratio from around 8 per cent in 1990-91 to 27 per cent in 2006-07. Over the same period, current receipts and current payments combined together increased from 19 per cent to 55 per cent. Gross capital inflows and outflows constituted 45 per cent of GDP in 2006-07 as compared with only 12 per cent in 1990-91.

II.16 To sum up, the Indian economy witnessed acceleration in growth during 2006-07 led by manufacturing and services sector activities, extending the current phase of high growth that began in 2003-04. Growth in agricultural production, however, decelerated with the agriculture sector characterised by stagnation in output of major foodgrains. Both structural and cyclical factors contributed to the acceleration in growth of the Indian economy during 2006-07. The step-up in investment and domestic savings rates, growing linkages with the global economy, both on the trade and capital accounts, and signs of some improvement in productivity growth are the key structural changes that have provided support to economic activity in recent years. Several cyclical factors have also boosted domestic growth. These include: (i) robust global GDP growth for the fourth successive year; (ii) the persistent high growth in bank credit and money supply; (iii) the pick-up in non-oil import growth and the widening of the trade deficit in recent years. Cyclical forces were also evident in the steady increase in prices of manufactures, resurgence of pricing power among corporates, indications of wage pressures in some sectors, high level of capacity utilisation and elevated asset prices.

OUTLOOK FOR 2007-08

II.17 According to the latest forecast by the India Meteorological Department, the rainfall during the South-West monsoon season (June-September) is likely to be 93 per cent of the normal rainfall, with a model error of +/- 4 per cent. The cumulative rainfall during the season so far (up to August 8, 2007) has been 7 per cent above normal, *albeit* uneven in terms of temporal and spatial distribution. As on August 2, 2007, the total live water storage in 78 major reservoirs was 59 per cent of the full reservoir level (FRL); this was higher than that of 47 per cent last year and the average of 36 per cent for the past ten years. Sowing under *kharif* crops is picking up and as of August 3, 2007, 78.6 per cent of normal area had been sown (about 4.2 per cent higher than a year ago).

II.18 Industrial production remained buoyant during April-June 2007, led by manufacturing activity. Industrial production expanded by 11.0 per cent during April-June 2007 (10.5 per cent a year ago) on the back of 11.9 per cent growth in the manufacturing sector. In terms of use-based classification, basic, capital and consumer goods sectors exhibited accelerated growth. Growth of intermediate goods sector, however, decelerated. The growth of infrastructure industries was 6.9 per cent during April-June 2007 as compared with 7.4 per cent during April-June 2006.

II.19 Available information on lead indicators of service sector performance presents a mixed picture. Growth in tourist arrivals, revenue earning freight traffic of the railways, new cell phone connections, export cargo handled by civil aviation, passengers handled by civil aviation, cement, steel and banking aggregates moderated during April-June 2007. On the other hand, cargo handled at major ports and import cargo handled by civil aviation accelerated *vis-à-vis* the previous year.

II.20 Global economic activity in 2007 so far has remained buoyant, notwithstanding continuing weakness in the US economy. Robust growth in advanced economies other than the US and major emerging economies provided support to global growth. According to the estimates by the International Monetary Fund (IMF) (released in July 2007), global growth is likely to moderate from 5.5 per cent in 2006 to 5.2 per cent each in 2007 and 2008. Growth in the world trade volume is also expected to decelerate from 9.4 per cent in 2006 to 7.1 per cent in 2007 and 7.4 per cent in 2008.

II.21 Strong global growth since 2003 onwards and the growing integration of the Indian economy with the global economy have provided a boost to export demand and domestic economic activity. The emergence of protectionist pressures, further rise in oil prices, persisting global imbalances, adjustment in the US on account of housing slowdown and potential shifts in financial market sentiment pose downward risks to global growth prospects. These risks, if materialise, could have some adverse impact on the domestic economy. In particular, global financial market could turn volatile with attendant implications for EMEs like India. Conditions in the sub-prime mortgage sector in the US have deteriorated significantly as reflected in the rise in delinquencies on adjustable-rate loans. Further deterioration in sub-prime delinquencies could lead to reassessment of risk by investors across products and markets and retrenchment of capital from the emerging market economies (EMEs), given the contagion and herd mentality. The volatility in capital flows could be exacerbated by the growing dominance of players such as hedge funds in the volume of cross-border flows. Furthermore, private equity funds have emerged as a key source of capital flows to the EMEs. Such flows are sensitive to interest rate changes. Therefore, any further monetary tightening in major economies and reassessment of risks by investors has the potential to accentuate volatility in global financial markets, and adversely impact growth and stability in the EMEs.

II.22 Expansion of money supply (y-o-y) as on August 3, 2007 (21.7 per cent) was higher than a year ago (19.3 per cent) and also higher than the indicative projection of 17.0-17.5 per cent set out in the Annual Policy Statement. Growth in aggregate deposits accelerated, led by time deposits. Bank credit witnessed some deceleration from the strong pace of the preceding three years. Growth of non-food credit of scheduled commercial banks was 23.6 per cent, y-o-y, as on August 3, 2007 as compared with 32.5 per cent a year ago. Commercial banks' investments in SLR securities, as per cent of their NDTL at 28.6 per cent were marginally higher than those at end-March 2007, but below those of 31.1 per cent a year ago. Growth of reserve money as on August 10, 2007 at 26.9 per cent (19.6 per cent adjusted for the first round impact of the increase in the CRR) was higher than a year ago (17.2 per cent) and much beyond the trend growth mainly on account of high increase in bankers' deposits with the Reserve Bank due to CRR increases during last one year which were backed by accretion to the Reserve Bank's NFA.

II.23 Headline inflation, based on movements in the wholesale price index (WPI), moderated to 4.1 per cent on August 4, 2007 from 5.9 per cent at end-March 2007 and 5.1 per cent a year ago. Inflation for all the three sub-groups of the WPI eased from their end-March levels. Fuel group inflation y-o-y turned negative (-2.1 per cent) reflecting cuts in domestic prices during November 2006 and February 2007. International crude oil (average) prices have, however, increased by around 28 per cent up to July 2007 from February 2007, when domestic prices were cut last. Non-oil global commodity prices also remain firm led by food items and metals. Various measures of consumer price inflation were placed lower in June 2007 (5.7-7.8 per cent) than those in March 2007 (6.7-9.5 per cent). However, consumer price inflation continued to exceed wholesale price inflation, mainly on account of higher food prices. Although inflation has eased since end-March 2007, inflationary pressures could potentially persist for several reasons. There are concerns regarding further hardening of international commodity prices, in particular, oil prices. Moreover, the possibility of inflationary pressures from domestic factors such as strong growth in monetary aggregates, elevated asset prices and large capital flows with implications for domestic liquidity conditions need to be recognised. Accordingly, a continuous vigil supported by appropriate policy actions by all concerned would be needed to maintain price stability so as to anchor inflationary expectations on a sustained basis.

II.24 For monetary policy purposes, the Reserve Bank, in its Annual Policy Statement (April 2007), placed real GDP growth for 2007-08 at around 8.5 per cent, assuming no further escalation in international crude oil prices and barring domestic or external shocks. In view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of shocks emanating in the domestic or global economy, the Statement noted that the policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08. The Reserve Bank in its First Quarter Review of the Annual Statement of Monetary Policy in July 2007 retained its projection of real GDP growth at around 8.5 per cent, barring domestic and external shocks. Assuming that aggregate supply management will continue to receive public policy attention and that a more active management of the capital account will be demonstrated, the outlook for inflation in 2007-08 in the First Quarter Review remained unchanged. Accordingly, it was indicated in the Review that holding headline inflation within 5.0 per cent in 2007-08 assumes priority in the policy hierarchy; while reinforcing the medium-term objective to condition policy and perceptions to reduce inflation to 4.0-4.5 per cent on a sustained basis.

II.25 The stance of monetary policy in 2007-08, as the Annual Policy Statement observed, would be conditioned by the patterns in which the global and, more particularly, the domestic environment unfold. The likely evolution of macroeconomic and financial conditions indicates an environment supportive of sustaining the current growth momentum in India. Monetary policy, while contributing to growth, has to ensure and maintain conditions of price and financial stability. Accordingly, the policy preference for the period ahead was articulated strongly in favour of reinforcing the emphasis on price stability and anchoring inflation expectations. The Reserve Bank in its First Quarter Review of the Annual Statement on Monetary Policy in July 2007 observed that monetary policy in India would continue to be vigilant and proactive in the context of any accentuation of global uncertainties that posed a threat to growth and stability in the domestic economy. The domestic outlook continues to be favourable and would dominate the dynamic setting of monetary policy in the period ahead. It is important to design monetary policy such that it protects growth by contributing to the maintenance of stability. Accordingly, while the stance of monetary policy would continue to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustain growth momentum, contextually financial stability may assume greater importance in the months to come.

II.26 Both the Central and State Governments have proposed to further strengthen the fiscal consolidation process during 2007-08. The revenue deficit and the gross fiscal deficit of the Central Government are budgeted at 1.5 per cent of GDP and 3.3 per cent of GDP during 2007-08, 0.5 percentage point and 0.4 percentage point lower than 2006-07 (revised estimates). Available information for 2007-08 (April-June) indicates that revenue deficit declined by 2.9 per cent. The fiscal deficit [adjusted for the expenditure incurred on acquisition of the Reserve Bank's stake in State Bank of India (Rs.35,531 crore)] also declined by 1.1 per cent over the corresponding period of 2006. The reduction in deficit indicators was primarily on account of higher tax revenue and non-debt capital receipts. However, as per cent of full-year budget estimates (BE), the revenue deficit during April-June 2007 increased to 96.0 per cent from 83.4 per cent a year ago, while the adjusted fiscal deficit declined to 50.9 per cent from 52.3 per cent during the corresponding period of the previous year. During 2007-08 (up to August 10, 2007), gross and net market borrowings (including 364-day Treasury Bills) amounted to Rs.96,628 crore and Rs.56,047 crore, respectively. Gross and net borrowings amounted to 51.5 per cent and 50.6 per cent, respectively, of the full year estimates as compared with 47.2 per cent and 39.3 per cent a year ago. The weighted average maturity of dated securities issued during 2007-08 (up to August 10, 2007) at 14.32 years was higher than that of 13.21 years during the corresponding period of the previous year, while the weighted average yield increased to 8.23 per cent from 7.87 per cent.

II.27 The State Governments have budgeted a revenue surplus during 2007-08, which would facilitate a reduction in the GFD to 2.4 per cent of GDP from 2.8 per cent in 2006-07. The surplus in the revenue account would also enable enhancement in capital disbursements for the social and rural sectors in line with the priorities set out in the Eleventh Five Year Plan. Adoption of fiscal reform measures aimed at augmentation of revenue and containment of non-plan revenue expenditure has helped several State Governments to achieve the targets set by the TFC ahead of the recommended schedule. All States, except eight, have budgeted revenue surpluses during 2007-08, a year ahead of the TFC target. Furthermore, 12 States (five special category and seven non-special category) have budgeted for gross fiscal deficit at less than three per cent of their respective GSDP, two years ahead of the target. The State Governments have budgeted for a deceleration in both revenue receipts and expenditure during 2007-08, after a sharp increase in the previous year. The accruals to the NSSF would remain the major source of financing the GFD; their share would, however, come down on account of reduction in the obligatory share of the State Governments in the NSSF to 80 per cent as announced in the Union Budget 2007-08. The State Governments have continued to maintain high levels of cash surplus during 2007-08 so far, as reflected in their investments in Treasury Bills.

II.28 Financial markets have remained generally orderly during 2007-08 so far. Short-term interest rates have eased from end-March 2007 levels. The amount of liquidity absorbed through the reverse repo operations under the liquidity adjustment facility was limited to a maximum of Rs.3,000 crore each day in terms of the modified arrangements from March 5, 2007. Overnight interest rates continued to exhibit volatility reflecting the impact of movements in Government cash balances and capital flows on liquidity conditions. Subsequently, in view of the prevailing macroeconomic and overall monetary and liquidity conditions, the First Quarter Review of the Annual Statement on Monetary Policy for 2007-08 announced the withdrawal of the ceiling of Rs. 3,000 crore on daily reverse repo under the LAF and the withdrawal of the Second LAF with effect from August 6, 2007. Call rates reverted to within the reverse repo-repo corridor from the second week of August 2007. Long-term Government bond yields and banks' deposit and lending rates have hardened. The Indian rupee has appreciated *vis-à-vis* the US dollar and other major currencies from its end-March 2007 levels till May but depreciated thereafter. The stock markets have recorded gains during 2007-08 so far, even as they turned volatile in the second and third weeks of August 2007 mainly on account of problems in the US sub-prime mortgage market.

II.29 Growth in merchandise exports was lower during April-June 2007, while imports posted a higher growth during this period as compared with the corresponding period of the previous year. According to DGCI&S, merchandise exports increased by 17.9 per cent during April-June 2007 (23.5 per cent a year ago). Imports expanded by 34.2 per cent (18.9 per cent), led by non-oil imports (growth of 47.4 per cent as compared with 8.9 per cent). Growth in oil imports moderated, mainly reflecting the impact of international crude oil prices. The trade deficit widened to US $ 20.6 billion in April-June 2007 from US $ 11.8 billion in April-June 2006. The growth momentum in India's exports of software services and ITES-BPO, and other business services continues to be strong. The remittances from overseas Indian workers also remain an important stable source of financial inflows with a continuous transition to higher skill categories of Indian migrant workers.

II.30 Capital inflows during 2007-08 so far have been higher than those in the corresponding period of 2006-07, led by a significant turnaround in FII inflows (net) (an increase of US $ 10.1 billion) during 2007-08 (up to August 10, 2007) in contrast to outflows (of US $ 1.5 billion) a year ago. FDI flows were US $ 3.7 billion during April-May 2007 (US $ 1.2 billion during April-May 2006). There were, however, net outflows of US $ 0.6 billion during April-May 2007 under non-resident deposits as against net inflows of US $ 0.7 billion a year ago. Foreign exchange reserves rose by US $ 27.3 billion between end-March 2007 and August 17, 2007. The overall trade and current account deficits in 2007-08 are expected to be of the same order as in 2006-07. Net capital flows are also likely to adequately finance the expected current account deficit in 2007-08.

II.31 To sum up, available information so far indicates continuation of the growth momentum during 2007-08 so far at a strong pace with the impulses of growth getting more broad-based. Steady increases in the gross domestic saving and investment rates, consumption demand, addition of new capacity as well as more intensive and efficient utilisation/ capitalisation of existing capacity are expected to provide support to growth during 2007-08. Despite some efforts to remove the supply constraints in infrastructure, the higher growth in demand is placing greater pressure for accelerated expansion of supply of infrastructure, resulting in the stretching of capacity utilisation in sectors such as electricity generation, roads, ports and major airports. Supply constraints emanating from shortfalls in agricultural performance, and physical and social infrastructure could constrain future growth while also exerting inflationary pressures. In this environment of demand-supply mismatches, inflation can emerge as the key downside risk to the evolving macroeconomic outlook. The recent gains in bringing down inflation and in stabilising inflation expectations should support the current expansionary phase of the growth cycle. It is, however, necessary to continuously assess the risks to the inflation outlook emanating from high and volatile international crude oil prices, the continuing firmness in key food prices and uncertainties surrounding the evolution of demand-supply gaps globally as well as in India.

II.32 Appropriate macroeconomic policies have to be in place to avoid risks of financial imbalances and recurrence of inflationary pressures while facilitating the growth momentum in an inclusive fashion. In this regard, policy priority needs to be accorded to: (a) removal of infrastructure constraints; (b) improving investment climate especially for domestic investors, in particular small and medium enterprises; (c) stepping up growth of agriculture, in particular, production of foodgrains to ensure food security; (d) strengthening of institutional and micro structural environment that enhances flexibilities, especially supply elasticities in the economy; and (e) fiscal empowerment, emphasising provision of education, health, water and sanitation along with an equitable tax structure. These are some of the critical elements that need attention to enable non-disruptive and optimal path of further liberalisation in the financial and external sectors. Indeed, the progress in these critical elements will help resolve the dilemmas that were faced in 2006-07 in terms of large rupee liquidity and excess capital flows in foreign currency.

REAL SECTOR

Agriculture

II.33 The recent upward trends in global prices of major food items have significant implications for the domestic agricultural sector and overall macroeconomic and financial stability. Global wheat prices in July 2007 were 52 per cent above the average prices prevailing during the calendar year 2004, while rice prices were 38 per cent higher. Prices of major edible oils increased by 44 to 71 per cent over the same period. In view of large dependency on edible oil imports (about 45 per cent of domestic consumption), the higher international prices coupled with diversion of acreage from oilseeds towards coarse cereals, especially maize as bio-fuel feed stock as alluded to earlier, could further exacerbate pressure on prices of edible oils. Sugar prices, notwithstanding substantial correction since the second half of 2006, were also higher by 42 per cent. Increases in global food prices reflected a shortfall in global production and the rising demand for non-food uses such as bio-fuels. According to the latest assessment by the US Department of Agriculture (USDA), world vegetable oils stocks were expected to fall by about 12 per cent during 2006-07 and by an additional 9 per cent during 2007-08. Although global wheat production is expected to increase by 2.9 per cent in 2007-08 (June-May), global wheat stocks are likely to decline further in 2007-08 to 114.8 million tonnes - the lowest levels since 1981-82. Furthermore, wheat, apart from oilseeds, is reportedly also being diverted for bio-fuels. Rice stocks are also expected to decline by about 5 per cent during 2007-08. Reflecting the sustained uptrend in major food prices, the food price index (compiled by the IMF) reached a 26-year high in June 2007 - the highest since the early 1981. Against the backdrop of these hardening trends in global food prices, there is an urgent need to take measures to accelerate the growth in Indian agriculture, especially food crops.

II.34 Although the share of agriculture in overall GDP has declined over the years from around 40 per cent in 1980-81 to less than a fifth in 2006-07, it continues to play an important role in the Indian economy. The proportion of the population dependent upon agriculture remains large (almost 60 per cent). Since the mid-1990s, however, the growth of the agricultural sector has been low as well as volatile; the growth decelerated from an annual average of 4.7 per cent per annum during the 1980s to 3.1 per cent during the 1990s and further to 2.2 per cent during the Tenth Plan period. Per capita annual production of cereals declined from 192 kilogram (kg) during 1991-95 to 174 kg during 2004-07 and that of pulses from 15 kg to 12 kg over the same period. Per capita availability of foodgrains has, thus, fallen close to the levels prevailing during the 1970s.

II.35 Volatility in agricultural production has not only implications for overall growth but also, as the experience of 2006-07 amply demonstrated, for maintaining low and stable inflation. Although domestic foodgrains production rose by 3.6 per cent in 2006-07, the production of major crops was still below the previous peaks. Demand-supply gaps were reflected in higher domestic food prices in 2006-07. The recent rise in international agriculture prices could potentially represent the beginning of a structural increase in prices, reflecting both demand and supply side factors. Demand pressures for food items could strengthen further in view of strong growth in emerging economies, particularly India and China, and the growing demand for animal proteins. The supply side pressures could emanate from diversion of corn and oilseeds to produce bio-fuel as energy substitute, exacerbated by tendencies towards global warming. The consequent impact of demand-supply mismatches on inflation perceptions and hence, on inflation expectations could be disproportionately large, perhaps even in the industrialised economies. Developments such as the increasing global financialisation of commodity markets pose additional challenges to public policy in managing food prices. According to a recent joint assessment by the OECD and the FAO, global prices of agricultural commodities are likely to rule higher than their historic equilibrium levels over the next ten years.

II.36 Thus, enhanced growth of the agricultural sector is vital for ensuring food security, poverty alleviation, price stability, overall inclusive growth and sustainability of growth of the overall economy. The Eleventh Plan envisages agricultural growth of 4 per cent per annum. In view of the Eleventh Plan's vision of faster, more broad-based and inclusive growth, reversing the deceleration in agricultural growth was placed on top of the agenda in the Union Budget 2007-08.

II.37 The reduction in agricultural growth since the mid-1990s could be attributed to stagnant/declining yields, which, in turn, reflect a variety of factors such as declining investment, lack of proper irrigation facilities, inadequate other infrastructural facilities, inadequate attention to R&D for developing high yielding varieties of seeds, absence of major technological breakthroughs, improper use of fertilisers/nutrients and institutional weaknesses. Public investment in agriculture declined from 3.4 per cent of agricultural GDP during 1976-80 to 2.6 per cent during 2005-06, while budgetary subsidies to agriculture increased from three per cent (1976-80) to seven per cent of GDP (2001-03). Given the budget constraint, higher subsidies come at the cost of higher investments. While subsidies may provide short-term benefits, they tend to hinder long-term investments which may yield more durable benefits to the agricultural and rural sectors. Subsidies also encourage inefficiency in the use of resources. For instance, the existing scheme of subsidy with regard to fertilisers encourages excessive use of nitrogen at the cost of other nutrients. Indian agriculture is becoming increasingly unsustainable both from the point view of overall economic progress and environmental balance. Intensive and concentrated input usage for some of the crops is causing salinity, water logging and ground water depletion with adverse implications of desertification of soil in the long-run. As noted by the Prime Minister[1], the weak performance of the agricultural sector can be attributed to four deficits, *viz*., public investment and credit deficit, infrastructure deficit, market economy deficit and knowledge deficit. In this context, it is noteworthy that the National Development Council (NDC) in its 53rd meeting held on May 29, 2007 adopted a resolution to reorient agricultural development strategies to meet the needs of the farmers. The NDC called upon the Central and the State Governments to evolve a strategy to rejuvenate agriculture to achieve 4 per cent annual growth in the agricultural sector during the Eleventh Plan. Furthermore, the Central Government committed Rs. 25,000 crore for public investment in agriculture in the next four years.

II.38 In view of stagnation in the production of major foodgrains, there may be a need to refocus production efforts in alternative potential areas with suitable agro-climatic conditions, rather than the traditional areas, particularly in the case of rice and wheat. The closing of the substantial yield gaps that exist in the case of major crops amongst various States can increase the production of cereals and pulses. This would need intensive efforts to improve inputs such as timely availability of seeds and fertilisers, provision of irrigation facilities, and adequate availability of credit.

II.39 As Indian agriculture continues to be heavily dependent on the monsoon, the need for enhancing the irrigation potential to meet the growing water requirements of farmers and to impart stability to agricultural production and yield assumes greater emphasis. While there was an addition of 8.8 million hectares to the potential irrigated area during the Tenth Plan, it was only one half of the target. Nonetheless, there was no

[1] Address by the Prime Minister at the 2nd Agricultural Summit (October 2006).

increase in irrigated area over the Plan period, partly because water use was more intense than planned and partly due to some existing irrigated area going out of the system due to poor maintenance/ decay. In view of the diminishing scope for new large scale irrigation projects, greater focus may be needed on completing ongoing projects and on modernisation of the existing projects. The Government has revamped the Accelerated Irrigation Benefit Programme (AIBP) to complete more irrigation projects in the quickest possible time. A National Rainfed Area Authority has been established to coordinate all schemes relating to watershed development and other aspects of land use. As past efforts in terms of increased outlays have not yielded the expected/ targeted results in terms of actual addition to the existing potential, greater emphasis needs to be placed on monitoring the ongoing projects and their timely completion to avoid time and cost overruns.

II.40 Greater focus needs to be placed on agricultural research in the coming years as the success so far has been restricted to select crops. Efforts to modernise and strengthen the agricultural research system, including the agricultural universities, need to be intensified. A growing disparity between the actual and the potential yields points to a crucial gap between research and extension. There is an urgent need to revive the extension system so that it is able to respond to the emerging demands of renewed agricultural growth. The public extension system needs to become more demand driven, with stronger synergies between public and private extension efforts. There is a need for a more regionally differentiated research strategy and greater co-ordination between the public and the private sectors. According to the estimates of the Planning Commission, public expenditure on research would need to increase from the present 0.7 per cent of agricultural GDP to 1.0 per cent by the end of the Eleventh Plan.

II.41 In order to bring marketing reforms, there is a need to take forward the process of implementing Agricultural Produce Marketing Committee (APMC) Act in all the States. So far, 15 States and five Union Territories have amended their APMC Acts; rules in many States are yet to be notified. There is also a need to have an appropriate legislative framework that is conducive to participatory organisations. In view of significant weather and price risks, appropriate risk mitigation policies would need to be put in place to provide relief to the distressed farmers as well as enhance efficiency of production.

II.42 While agricultural growth is envisaged at four per cent per annum during the Eleventh Plan, the Planning Commission's projections suggest that the production of foodgrains needs to increase by 2.0-2.5 per cent per annum. The production of non-foodgrains will, thus, have to expand at a much higher rate to achieve the overall target of four per cent which will necessitate substantial development of activities such as horticulture, dairy, poultry and fishery. This would require a revolution on the lines of the green revolution of the 1970s. In view of relatively homogeneous nature of cereal production and of milk, it was possible to design national programmes that were broadly applicable country wide with relatively easy regional variations. However, in the case of new agricultural activities, products are very heterogeneous and they also exhibit great regional differences. Accordingly, there may be a need for decentralised and regionally disaggregated packages for many different activities. Finally, the financing requirements of the supply chain from farm to market – warehouses, cold storages, rural transportation, refrigerated trucks and other service intermediaries – will need to be in place while minimising the transaction costs.

II.43 Inclusive growth calls for greater financial inclusion with *inter alia* enhanced and easy access to institutional credit. The programme for financial inclusion initiated by the Reserve Bank in collaboration with banks and several State Governments by adopting modern technology needs to be intensified and expanded urgently. Farm credit continues to grow at a satisfactory pace. The goal of doubling farm credit in three years, initiated in June 2004, was achieved in two years. Reform of the cooperative sector on the lines of the recommendations of the Vaidyanathan Committee would further increase the flow of credit to the agricultural sector on a sustainable basis.

II.44 In view of small and fragmented farm holdings, the population dependent upon agricultural activity and incomes will have to increasingly rely on non-farm sources of income in future. Thus, diversification towards activities such as poultry, food processing and other rural industries will be critical for the betterment of living standards in rural areas. While there has been rapid integration of the Indian economy with the global economy since the early 1990s, the pace of progress on intra-regional integration within the country needs to be quickened to enable the rural areas to reap the benefits of higher growth. Inadequate intra-national integration prevents the rural population from accessing new economic opportunities arising from rapid economic growth elsewhere. Greater intra-regional integration is hampered by a variety of factors such as segmented markets for agricultural produce, virtual absence of markets in land (arising from lack of clear titles and land records) to facilitate consolidation of fragmented and unviable holdings, lack of reliable and stable power supply, absence of connectivity to outside markets through wired and wireless communication systems, lack of all-weather village roads, non-availability of rural infrastructure to support fruit and vegetable processing, preservation and transport to marketing centres, and poor service delivery in primary education and basic health services.

Industry and Infrastructure

II.45 The rebound in industrial production that started in 2002-03 continued during 2006-07 benefiting from increased domestic and external demand. The sustained growth has led to high capacity utilisation and is contributing to higher investment activity. Industry grew, on an average, at 8.1 per cent in the five-year period ended 2006-07, mainly on account of 8.8 per cent growth in manufacturing. Industrial growth during the Tenth Plan period (2002-2007), however, fell short of the targeted 10 per cent. The continued double-digit growth of the capital goods sector since 2002-03, along with robust growth in imports of capital goods, indicates that the industrial sector is responding to the buoyant demand conditions of the economy through new capacity additions. Modernisation of the capital stock, reduction/rationalisation of import tariffs and other taxes, increased openness of the economy, higher foreign direct investment inflows, greater competitive pressures, increased investment in information and communication technology, and greater financial deepening are contributing to productivity gains in the industry. As a result, the industry is increasingly becoming an important growth driver in conjunction with the services sector. Many of the services such as trade, transport, communication and construction are directly linked to the industry.

II.46 The buoyancy in industrial performance in recent years highlights the beneficial impact of economic reforms over the past 15 years, which have enhanced the competitiveness and productivity of industry in an increasingly open economy amidst significant reduction in tariffs. The manufacturing companies in India are fast emerging as internationally efficient and low-cost producers in some areas. Many companies have started acquiring foreign firms to increase their presence in the international market.

II.47 It is encouraging to note that employment generation in the economy accelerated during the period 1999-2000 to 2004-05 from the preceding period (1993-94 to 1999-2000). Growth in employment during the period 1999-2000 to 2004-05, however, still trailed the growth in labour force over the same period. Moreover, it is the unorganised manufacturing sector that has generated more employment in recent years. The sustained growth in industry is, therefore, vital to generate employment opportunities and to absorb the disguised labour force dependent upon the agricultural sector. The formation of appropriate skills through a wide variety of vocational training as well as greater flexibility in labour laws could lead to greater employment generation, especially in the organised sector.

II.48 The manufacturing sector has recorded robust growth, despite several infrastructure deficiencies. As the Approach Paper to the Eleventh Plan (2007-12) has noted, the absence of world class infrastructure and shortage of skilled manpower are the most critical short-term barriers to the growth of the manufacturing sector. It is imperative to augment the existing infrastructure facilities, particularly roads, ports and power, to provide the enabling environment for industry to prosper.

II.49 There has been mixed progress in the infrastructure sector so far. The telecom sector has witnessed high growth as reflected in the accelerated spread of mobile telephony in the country. Railways and ports have also witnessed some improvement. However, progress remains less than adequate in other sectors such as power, coal, water, urban infrastructure and rural infrastructure.

II.50 During 2006-07, the electricity sector performed well benefiting largely from improved plant load factor in thermal power plants and higher hydro power generation due to improved reservoir levels. However, the overall performance of the power sector was not very promising. The power shortage of around 10 per cent and a peak hour shortage of over 13 per cent is a deterrent to the sustained current high growth phase. In the Tenth Plan, capacity addition was around 50 per cent of the target. Expansion of private investment in the power sector has been constrained due to perceived lack of assurance of timely payment for power supplied or as contracted. Security in collection of tariffs along with appropriate tariffs and measures to reduce theft of power would also facilitate greater investment in the power sector. The gas-based power plants, which account for about 11 per cent of the installed generating capacity, are operating below their capacity in view of inadequate supply of gas and constraints in using alternate, high-cost fuels such as naphtha and high speed diesel. Transmission and distribution losses remain unacceptably high, ranging from 30-45 per cent in many States. Upgradation of the transmission and distribution system in a time-bound manner along with steps to reduce thefts could increase availability of power supply in the country, reduce the cost of power for the users and improve the financial position of the State Electricity Boards.

II.51 In this context, it is important to note that significant investment activity is taking place in the industry as indicated by trends in investment intentions. According to the National Accounts Statistics, real gross capital formation in industry (at 1999-2000 prices) increased by around 29 per cent, on an average, during 2003-04 to 2005-06. Such significant investment activity is expected to further increase the demand for electricity in the country. At the same time, it needs to be recognised that the higher electricity generation has emanated, in part, from the rise in the thermal plant load factor (PLF), which increased from 64.6 per cent during 1998-99 to 74.0 per cent during 2005-06 and further to 76.8 per cent during 2006-07. In view of the substantial rise in the PLF, the scope of a further increase in the PLF is limited. Thus, higher electricity generation in future will have to increasingly come from new capacity addition. Therefore, there is need for fresh investment in the power sector. Higher capacity addition in electricity will improve the competitiveness of the Indian industry and help sustain the current growth momentum.

II.52 Growth of the mining sector during the last five years (an average of 4.4 per cent per annum during 2002-03 to 2006-07) lagged significantly behind manufacturing growth over the same period (8.8 per cent). Despite having significant reserves of coal – the third largest in the world, after the United States and China – the country continues to suffer from inadequate domestic supplies and problems of coal shortages. Further reforms in the mining sector may be necessary to increase the mining growth and ease constraints on industrial growth. Higher electricity generation will need assured fuel supplies. The demand for coal, thus, is expected to be significantly higher than that in the recent past.

II.53 The progress in the road sector at national level has been satisfactory. While the Golden Quadrilateral project is nearing completion, the North-South and East-West corridor projects are expected to be completed by 2009. The various phases of the National Highway Development Programme (NHDP) for upgradation of the existing roads/ construction of expressways are at advanced stages of planning or implementation. As noted earlier, the Government is also undertaking steps to improve rural roads under the *Bharat Nirman*. Progress on the roads and highways front will depend, *inter alia*, on the success in dealing with constraints such as delays in land acquisitions, removal of structures and shifting of utilities, law and order problem in some States, and poor performance of some contractors.

II.54 Urban infrastructure is a vital element in the growth process. Studies show that increase in the size of urban agglomerations is associated with large productivity gains. These gains emanate from the proximity to product as well as labour markets, which provide savings in trade and transport costs on the one hand, and the availability of skilled labour on the other. Strengthening the management of cities will enable improvement in urban infrastructure facilities across the country. Efficient functioning of cities of all sizes is essential for improving overall efficiency. Improvements in the provision of water, transport, sanitation, health and education facilities in urban areas are also essential for the welfare of the poor. The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) is a significant move to address the weaknesses in urban infrastructure, but comprehensive planning and effective monitoring are essential to take this scheme successfully to its logical conclusion.

II.55 Given the large infrastructure requirements of the country, the public sector will always have to play a large role in providing infrastructure funding. This will require greater focus on improvement in the delivery of public services. The High Level Committee on Infrastructure headed by the Prime Minister has estimated that an investment of Rs.14,50,000 crore during the Eleventh Plan would be required to develop world class infrastructure. This would require a substantial increase in spending on infrastructure by both the public and private sectors from the current levels of 4.6 per cent of GDP to almost 8 per cent of GDP every year. These investments are to be achieved through a combination of public investment, public private partnerships (PPPs) and exclusive private investments, wherever feasible. The Government is actively pursuing PPPs to bridge the infrastructure deficit in the country and several initiatives have been taken in the last couple of years to promote PPPs in the infrastructure development. The appraisal mechanism for the PPP projects has been streamlined to ensure speedy clearance of the projects, removal of red tape, adoption of international best practices and bringing uniformity in guidelines. The awareness of concerns and issues relating to PPPs, however, is still lacking and not evenly spread across different States.

II.56 Domestic savings rose sharply to 32.4 per cent of GDP in 2005-06 from 23.5 per cent in 2001-02. In view of the increasing domestic savings, higher investment in infrastructure, both in the public and private sectors, is clearly possible. However, commensurate progress on project design, project implementation, appropriate user charges and appropriate policies would be necessary for such investments to be profitable and self-financing.

Services

II.57 The services sector has grown at double-digit rates in the last three years and emerged as the key driver of economic activity in the country. The sustained strength of manufacturing activity, strong growth in tourism, improvements in the telecommunications, buoyancy in IT and BPO sectors, robust growth of the construction sector, acceleration in deposit and credit growth and opening up of the insurance sector have buoyed the services sector in recent years. The impressive performance of the services sector was attributable largely to the availability of skilled and cheap labour. However, the sustained acceleration in services and the manufacturing activities is leading to incipient pressures on the supply of good quality skilled labour. While its demographic profile places the country favourably in terms of manpower availability, there are reports of emerging talent supply shortages. Only 10 per cent of the relevant age group is getting enrolled into institutions of higher learning in the country as compared with 40-50 per cent in most developed countries. Less than a half of secondary school students only join college education. Moreover, the quality of education imparted in several colleges and universities in the country remains less than adequate to meet the emerging demands for skilled professionals.

II.58 In order to reap the benefits of the demographic dividend, substantial expansion and reforms in the education sector would be needed on an urgent basis. The Government is focusing on vocational education in order to equip the labour force with the requisite skills. With the implementation of the *Sarva Shiksha Abhiyan,* which aims to provide universal elementary education and bridge all social, gender and regional gaps with the active participation of the community in the management of schools, enrolment of students in the secondary schools is expected to increase. In view of this, there would be a need for major expansion of infrastructure at secondary school level as well in the near future. Given the focus on skills in the increasingly knowledge intensive economic activities, special emphasis would need to be placed on imparting tertiary education and developing institutes of higher learning also. Education facilities would, thus, need to be extended at all levels, *viz*., primary, secondary and at a tertiary level. In this context, the Central Government has decided to establish 30 new Central Universities in the country with the objective of expanding the access to high quality education. The setting up of the proposed universities would need to be supplemented with upgradation of facilities in nationally well spread out existing colleges/universities to bridge the emerging demand-supply mismatches in the availability of skilled manpower and to reap the demographic dividend. Concerted efforts in the direction of improving the physical, urban and social infrastructure in the country would further entrench the growth of the services sector.

FISCAL POLICY

II.59 The process of fiscal consolidation in Central Government finances under the rule-based framework of the FRBM has been characterised by front-loaded reduction in deficit indicators in 2004-05, pause in 2005-06 and resumption of the process in 2006-07. The fiscal correction process is budgeted to continue during 2007-08. With gross fiscal deficit budgeted at 3.3 per cent of GDP in 2007-08, the FRBM target of 3.0 per cent by 2008-09 appears feasible. The revenue deficit is budgeted at 1.5 per cent of GDP for 2007-08; the FRBM path envisages elimination of revenue deficit in 2008-09. It is, thus, useful to note that the adherence to the FRBM target would require a reduction of 1.5 per cent in the revenue deficit/GDP ratio during 2008-09.

II.60 The revenue augmentation of the Government has been supported by a steady increase in the tax-GDP ratio, led by direct tax revenues. The share of direct taxes in total tax revenues increased to about 49 per cent in 2006-07 (RE) from 36 per cent in 2000-01. Within direct tax, the share of corporate income tax moved up significantly to about 64 per cent in 2006-07 from 52 per cent in 2000-01, with the corresponding decline in the share of individual income tax. As a proportion to GDP, both corporate and individual income taxes have exhibited an increase since 2000-01. While the ratio of corporate income tax increased from 1.7 per cent during 2000-01 to 3.6 per cent during 2006-07 (RE), that of individual income tax increased from 1.5 per cent to 1.8 per cent. Maintaining the current buoyancy in tax revenues over a higher base needs to be continued with sustained effort in the light of high income growth. The scope for deepening fiscal empowerment further through improved tax revenues lies in maintaining a moderate structure of tax rates and broadening the base without affecting the growth momentum of the economy. In order to broaden the tax base, it is imperative to rationalise/eliminate major tax concessions and bring the key segments of the services sector within the ambit of tax net in tandem with the growing share of this sector in GDP. The service tax constituted eight per cent of gross tax revenues and about 16 per cent of indirect taxes of the Central Government in 2006-07. With the successful implementation of value added tax (VAT) system by the State Governments and the move towards phasing out of central sales tax (CST), appropriate conditions are in place for the introduction of goods and services tax (GST) with effect from April 1, 2010. This is expected to have a positive impact on the efficiency of the indirect tax system. Furthermore, improvement in the efficiency and effectiveness of tax administration would enable reduction of tax arrears. The stock of tax revenues raised but not realised declined by about 19 per cent during 2005-06 to Rs.90,256 crore at end-March 2006.

II.61 Expenditure management of the Central Government in recent years has focused increasingly on improving the quality of implementation and on enhancing the efficiency and accountability of the delivery mechanism for translating budgetary outlays into the intended outcomes. The Government's policy of reprioritising expenditure has led to higher outlays for the social sector. The shares of public expenditure on education and health in India are, however, still low by international standards. In 2004, the share of public expenditure on health in India at 0.9 per cent of GDP was lower than Brazil (4.8 per cent), China (1.8 per cent) and least developed countries (1.8 per cent). Reprioritisation of expenditures towards social sectors along with higher capital outlays would promote fiscal discipline without restricting operational efficiency of the Government. Higher public spending on social services would improve the social infrastructure and provide productivity gains.

II.62 The finances of the State Governments have also exhibited significant improvement since 2003-04 guided by the Fiscal Responsibility Legislations (FRLs). As the State Governments come closer to meeting the objective of reduction in deficit indicators, they would have the challenge of containing non-developmental expenditures, while undertaking higher developmental expenditures in line with the priorities laid down in the Eleventh Five Year Plan. The improved macroeconomic performance is expected to have positive impact on tax mobilisation of the State Governments (both own tax revenue and shareable Central taxes). At the same time, it needs to be noted that it is the States who are primarily responsible for the provision of health and education. Apart from higher allocations towards social and economic services, the States would also need to focus on improving the quality of delivery of services, which would, in turn, enable them to adequately price these services. The States would also need to undertake enabling reforms to reap the full benefits of centrally sponsored schemes such as Jawaharlal Nehru National Urban Renewal Mission.

II.63 A salient feature of the fiscal consolidation process in recent years has been significant reduction in the key deficit indicators. However, deficit indicators as well as public debt in India still remain higher than many emerging and developed countries. Furthermore, there are certain risks to the fiscal consolidation process such as expected increase in expenditure from the revision of pay scales on implementation of the Sixth Pay Commission's recommendations, subsidies and the rising average cost of borrowings.

II.64 Adhering to the FRBM/FRL targets by the Centre as well as States would enable a further rise in public savings and overall domestic savings, apart from moderating the public debt burden. The reduction in the debt burden would contribute to overall macroeconomic stability and also ensure the sustenance of the growth momentum. For the current growth momentum to be entrenched on a durable basis, there is a need for a significant enhancement in capacity building and in the availability of public services that cannot be adequately provided by the private sector. Fiscal empowerment would allow higher capital outlays and boost infrastructure and social sector spending with beneficial impact on domestic productivity, growth and employment. It is, thus, necessary to emphasise the criticality of quality of fiscal adjustment.

EXTERNAL SECTOR

II.65 The external sector has imparted significant resilience to the Indian economy in the post-reform period. India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy and the two-way movement in financial flows. The ratio of merchandise exports to GDP has been rising since the early 1990s, reflecting growing international competitiveness. During 2002-2006, export growth of India was much higher than its key competitors in the Asian region, except China. At the same time, import intensity has been rising steadily as domestic entities have expanded access to internationally available raw materials and intermediate goods as well as quality inputs for providing the cutting edge to domestic production and export capabilities. Structural shifts in services exports, led by software and other business services, and remittances have imparted stability and strength to India's balance of payments. The net invisibles surplus has offset a significant part of the expanding trade deficit and helped in containing the current account deficit to an average of one per cent of GDP since the early 1990s. Gross current receipts (merchandise exports and invisible receipts) and gross current payments (merchandise imports and invisible payments) taken together, at present, constitute more than one half of GDP, highlighting the significant degree of integration of the Indian economy with the global economy.

II.66 The liberalised external payments regime is facilitating the process of acquisition of foreign companies by Indian corporates, both in the manufacturing and services sectors, with the objectives of reaping economies of scale and capturing of offshore markets to better face the global competition. Notwithstanding higher outflows, there has been a significant increase in capital flows (net) to almost five per cent of GDP in 2006-07 from an average of two per cent during 2000-01 to 2002-03. Capital flows (net) have remained substantially above the current account deficit and have implications for the conduct of monetary policy and macroeconomic and financial stability.

II.67 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. In India, foreign exchange reserves have been accumulated on account of capital inflows unlike other Asian economies which have built up a significant part of the reserves through current account surpluses. Nevertheless, these countries continue to intervene in the foreign exchange market as reflected in the high level of foreign exchange reserves in countries across Asia. Furthermore, ample global liquidity, relatively low interest rates in major advanced economies and the search for yield have led to large capital inflows into emerging market economies.

II.68 In India, interventions have been by and large successful in reducing volatility in the foreign exchange market, and have contributed to the overall financial stability. This, among other factors, makes India a preferred investment destination by overseas investors. While large corporates may be in a position to manage increased volatility, a large section of the population in countries like India does not have the wherewithal to withstand volatility in the financial markets. Interests of such sections of the population against volatility also need to be considered. Excessive volatility can also threaten financial stability and impinge on the real sector. The extent of volatility, thus, has to be consistent with the objectives of growth, and price and financial stability. As the Asian crisis demonstrated, even large corporates may not be in a position to withstand sudden volatility in exchange rates and interest rates as weaknesses in corporate balance sheets can spread to other participants in the economy, including the banking sector.

II.69 Like India, several other countries are facing a similar situation of excess foreign exchange inflows, which is affecting monetary management in these countries as well. However, monetary management at the current juncture in India is more complex than in other EMEs for several reasons. First, domestic interest rates are higher than the return on foreign exchange reserves, which leads to quasi-fiscal costs. Second, although the fiscal deficit and public debt have declined in recent years in India, by international standards, they still remain high. This restricts the flexibility available to fiscal policy to keep inflation relatively low. Third, in India, the real sector has been liberalised over the years which constrains the ability to take administrative measures with regard to supply management. At the same time, several policy rigidities persist, inhibiting the rapid and flexible adjustments that are needed by the demands of a well-functioning market economy. Further, in India, the banking system has been gradually deregulated and the conduct of monetary policy is largely through the use of market-based instruments. This restricts the ability to use administrative instruments such as prescribing deposit and lending rates, which some other countries may be able to use. Moreover, some countries are managing capital account more actively than before. Finally, it is also necessary to recognise that India is one of the few emerging market economies (EMEs) to record current account deficits, along with a significantly high trade deficit.

II.70 Though there has been a significant liberalisation of the policy framework with regard to capital outflows over the past few years, further possible liberalisation measures in this regard will continue to receive attention. However, each country has to design its policy regime for capital outflows keeping in view specific country context especially the characteristics of the real sector, and not merely the contextual level of inflows and extant absorptive capacity of the economy. First, the current regime of outflows in India is characterised by liberal but not incentivised framework for corporates to invest in the real economy outside India, including through the acquisition route. The regime has served the country well since Indian corporates are increasingly able to establish synergies with overseas units, to make up for lack of scale that has been a legacy problem in India, and to quickly acquire domain knowledge through acquisition. Second, significant liberalisation of outflows by individual households has been implemented following recommendations of the Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore, 2006). Further liberalisation here would be done in the light of some international experience which shows that resident individuals often precede overseas investors in initiating outflows when the perceptions in regard to domestic economy's performance or stability appear to turn adverse. Third, as regards the regime for outflows through financial intermediaries, the approach is characterised by caution and quantitative stipulations whereby both prudential considerations and compulsions of management of capital account are relevant.

II.71 Trade integration is undeniably beneficial but financial integration has both, benefits and risks, at the current stage of India's development. It is useful to narrate some noteworthy features of capital inflows to India. Foreign Direct Investment (FDI) is generally perceived to be an investment that creates physical assets and is associated with a degree of stability, in particular due to managerial skills. However, new types of FDI flows through private equity funds and venture capital funds may not necessarily have a direct link with investment in physical assets and could contain a volatile component at the margin. Similarly, inflows to acquire existing stakes or expanding foreign stakes in Indian companies are classified as FDI, but they do not contribute to the further creation of physical assets. However, these inflows do add to the foreign resources available for investment in the economy, which would be most productive when there is corresponding absorptive capacity at the macro level. Similarly, FIIs in their own account are generally long term investors with little or no interest in managerial control. However, investments under the category of FIIs in India have a significant part of portfolio flows through participatory notes and sub-accounts. Capital flows, particularly the portfolio flows, being volatile can easily reverse their direction and it is difficult to invoke the "rules of origin" with regard to such capital flows. Against this backdrop, the gradual process of fuller capital account liberalisation will be pursued over the medium-term, while recognising the growing ineffectiveness of micro controls in a world of growing trade and financial integration. Thus, in India, the trade, financial and capital account liberalisation do go together, but in a harmonious and well-sequenced manner, while closely aligning with the progress in the real sector, fiscal sector and institutional developments, including governance.

II.72 Given the flux associated with both financial markets and monetary policy settings, India cannot be immune to these developments. Accordingly, banks, financial institutions and corporates need to be vigilant and well-prepared with appropriate risk mitigation strategies to deal with significantly higher volatility than before. It is in this context that they are urged to monitor various types of exposures and hedge them to protect their balance sheets. The Reserve Bank has expanded the range of hedging tools available to market participants over the years and facilitated dynamic hedging.

FINANCIAL SECTOR

II.73 A strong and robust financial sector plays a critical role in the efficient allocation of resources among savers and investors, thereby contributing to the growth process. It also facilitates the transmission of monetary policy impulses to the rest of the economy. Accordingly, the various policy initiatives by the Reserve Bank since the early 1990s have aimed at developing a robust, efficient and diversified financial system[2]. During 2006-07, the Reserve Bank continued to fine tune the regulatory and supervisory initiatives. In order to ensure asset quality, prudential measures were further tightened through increases in the provisioning requirements and risk weights in respect of specific sectors. The focus of the various prudential and supervisory measures was on anchoring financial stability while providing flexibility to the financial system. In order to further strengthen the domestic banking sector and to conform the banking sector with international best practices, commercial banks will migrate to Basel II norms in a phased manner beginning March 2008. Although implementation of Basel II poses significant challenge to both banks

[2] On the role of financial markets in economic development, see the *Report on Currency and Finance, 2005-06* of the Reserve Bank of India. The Report with the theme “Development of Financial Markets and Role of the Central Bank” considered approaches for making financial markets in India more developed, efficient and integrated in the light of India’s own experience gained so far and keeping in view the international best practices, while recognising that India is an emerging market economy. The pace of financial market development will necessarily have to be guided by the predominant imperative of maintaining macroeconomic and financial stability, while enabling growth inclusive.

and the regulators, it also offers two major opportunities to banks, *viz*., refinement of risk management systems and improvement in capital efficiency.

II.74 The Reserve Bank will persevere with its efforts towards deepening the financial system and widening its reach, given the present stage of development of the country. The burst of entrepreneurship across the country has to be nurtured and financed. Interest rates charged by banks in India on various types of loans and advances vary significantly. Banks need to tone up their risk assessment and risk management capacities to appropriately price their loans. In this context, the setting up of credit information bureaus should help in reducing the transaction and information costs for banks by making available the credit histories of both individuals and small businesses. Although banks' investments in SLR securities registered an increase during 2006-07 in contrast to a decline in the preceding year, such investments, as a proportion of NDTL, declined further during 2006-07. As a result, banks' portfolio of Government securities is now very close to the prescribed norm. To meet the growing credit demand, therefore, banks need to widen their deposit base. In particular, banks need to bring more and more financially excluded people within their fold. Apart from helping the low income households, this would help strengthen the financial deepening and provide necessary resources to the banks to expand credit and sustain high economic growth.

MONETARY POLICY

II.75 The conduct of monetary policy in India has been guided by the objectives of maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy for sustaining overall economic growth. The relative emphasis between price stability and growth, however, depends on the underlying macroeconomic conditions. In view of incipient inflationary pressures, the stance of monetary policy progressively shifted from an equal emphasis on price stability along with growth (October 2004/ April 2005) to one of reinforcing price stability with immediate monetary measures and to take recourse to all possible measures promptly in response to evolving circumstances (January 2007). Concomitantly, the Reserve Bank has taken pre-emptive monetary measures beginning mid-2004 to contain inflation and inflationary expectations. The major policy challenge for monetary policy during the recent period has been to manage the transition to a higher growth path while containing inflationary pressures so that potential output and productivity are firmly entrenched to sustain growth. Monetary measures, supported by supply side and fiscal measures, have helped in containing inflation and anchoring inflation expectations while supporting the growth momentum.

II.76 The Reserve Bank's self-imposed medium-term ceiling on inflation at 5.0 per cent has had a salutary effect on inflation expectations and the socially tolerable rate of inflation has come down. In recognition of India's evolving integration with the global economy and societal preferences in this regard, the resolve, going forward, would be to condition policy and expectations for inflation in the range of 4.0-4.5 per cent. This would help in maintaining self-accelerating growth over the medium-term, keeping in view the desirability of inflation at around 3 per cent to ensure India's smooth global integration.

II.77 The conduct of monetary policy has become more challenging in recent years for a variety of reasons. Globalisation has brought in its train considerable fuzziness in reading underlying macroeconomic and financial developments, obscuring signals from financial prices and clouding the monetary authority's gauge of the performance of the real economy. Consequently, dealing with the impossible trinity of fixed exchange rates, open capital accounts and discretion in monetary policy has become more complex than before. Moreover, there is considerable difficulty faced by monetary authorities across the world in detecting and measuring inflation, especially inflation expectations. The operation of monetary policy in India is also constrained by some uncertainties in the transmission of policy signals to the economy. First, some categories of interest rates continue to be administered, thereby muting the impact of monetary policy on the structure of interest rates. Second, external sector management is complicated by the incentives for some elements of capital flows provided by the public policy setting. Thus, the magnitudes and direction of capital flows to select sectors in the domestic economy are beset with uncertainties with regard to the global and domestic environment not necessarily related to economic fundamentals or the monetary policy setting. Third, the operation of monetary policy has to be oriented around the predominantly public sector ownership of the banking system which plays a critical role not only in the transmission of monetary policy signals but also in other public policy considerations.

II.78 Monetary policy in India has also to contend with the burden of challenges emanating from other sectors. First, fiscal imbalances remain large by international standards and have to be managed in a non-disruptive manner. However, the recent salutary improvement in the fiscal position of States and significant consolidation in the finances of the Centre have alleviated the extent of the burden that monetary policy has to bear on this account. Second, the enduring strength of foreign exchange inflows complicates the conduct of monetary policy. In the event of demand pressures building up, increases in interest rates may be advocated to preserve and sustain growth in a non-inflationary manner. Higher interest rates, however, increase the possibility of further capital inflows and potentially reduce the efficacy of monetary policy tightening. Third, in India, levels of livelihood of a large section of the population are inadequate to withstand sharp financial fluctuations which impact real activity. Accordingly, monetary policy has also to take into account the effect on these segments of the economy from volatility in financial markets, often related to sudden shifts in capital flows.

II.79 Fourth, limitations on the elasticity of aggregate supply domestically impose an additional burden on monetary policy, particularly in the short term. While open trade has expanded the supply potential of several economies, it does not seem to have had any significant short-term salutary effect on supply elasticities. Persisting supply shocks to prices of commodities and services to which headline inflation is sensitive can exert a lasting impact on inflation expectations. Faced with longer term structural bottlenecks also in supply, with less than adequate assurance of timely, convincing and demonstrated resolution, monetary policy has to respond appropriately. The burden and the dilemmas, in fact, are greater in the event of a structural supply problem on account of its persistent effects on inflation. Managing structural change while keeping inflation low and stable without dampening the growth momentum is the quintessential challenge to monetary policy in the period ahead.

II.80 To sum up, there is evidence of some cyclical elements in the current growth process, although significant structural changes have also taken place in the Indian economy. There is a growing evidence that the economy is possibly poised on the threshold of a step-up in the growth trajectory, provided the vigil on price stability, including financial stability is intensified in a convincing manner.

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

III MONETARY AND CREDIT POLICY OPERATIONS

III.1 The conduct of monetary policy during 2006-07 faced various challenges due to persistent inflationary pressures and continuing large capital inflows. The major policy challenge was to manage the transition to a higher growth path while containing inflationary pressures so that potential output and productivity were firmly entrenched to sustain growth. During the year, inflationary pressures emanating from rising capacity utilisation, sustained growth in monetary and credit aggregates and elevated asset prices were exacerbated by supply shocks emerging from primary articles. The Reserve Bank stressed the need to be watchful for early signs of overheating, even though there was no conclusive evidence of potential overheating in the Indian economy. Against this backdrop, the Reserve Bank continued to take pre-emptive measures during the year to contain inflation and inflationary expectations. Monetary measures were supported by prudential measures to contend with sustained high growth in bank credit, particularly in certain sectors. Legislative amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, which took place during the year, would provide greater flexibility to the Reserve Bank in the conduct of monetary policy in future.

III.2 The Reserve Bank persevered with its policy objective of ensuring adequate flow of credit to the various productive sectors of the economy, particularly agriculture and small scale industries (SSI). These initiatives were aimed at facilitating a conducive environment for banks to provide adequate and timely finance to small borrowers at reasonable rates without procedural hassles so as to bring about maximum financial inclusion of the poorer sections of the society.

III.3 Inflationary pressures, large capital inflows and government cash balances posed a major challenge in the conduct of monetary policy and liquidity management. Both wholesale and consumer price inflation rose during 2006-07; the increase in consumer price inflation was, however, much higher than the wholesale price inflation, reflecting mainly the impact of higher food prices and the higher weight of such items in consumer price inflation measures. The enduring nature of capital flows complicated the conduct of monetary policy and liquidity management as higher interest rates to contain inflation could potentially attract greater capital flows, thus, reducing the efficacy of monetary tightening. Policy rates and the cash reserve ratio were raised while interest rates on non-resident deposits were reduced. Prudential measures in the form of tightening of provisioning requirements in respect of sectors witnessing relatively higher order of credit growth were also undertaken to maintain asset quality and financial stability.

III.4 Alongside monetary and prudential measures, efforts were also made to improve credit delivery and promote financial inclusion. The Reserve Bank continued to take steps to improve the credit delivery mechanism for small borrowers in order to bring the poorer sections of the society within the fold of formal channels of credit delivery. Guidelines relating to the priority sector lending were revised in order to enlarge its base. Banks were advised to scale up information technology (IT) initiatives for speedy promotion of financial inclusion. As a part of a pilot project on greater financial inclusion, 100 per cent financial inclusion was achieved in the Union Territory of Puducherry and in 24 districts in Haryana, Himachal Pradesh, Karnataka, Kerala and Punjab. Reflecting the impact of various policy initiatives, banks achieved the targets fixed under the special agricultural credit plans and under the scheme of doubling the agricultural credit in three years.

MONETARY POLICY OPERATIONS

III.5 The Annual Policy Statement for 2006-07 noted that the stance of monetary policy during 2006-07 would depend on macroeconomic developments including the global scenario. In an environment fraught with pressures from aggregate demand embodied in rising bank credit, high asset prices and above-trend growth in monetary aggregates as well as global risks from larger macroeconomic imbalances and higher oil prices than before, containing inflation in the medium-term was going to test the conduct of stabilisation policies. In this context, the Statement stressed that while there were compelling reasons to maintain the momentum in growth of output, low and stable inflation would enable higher growth on a sustained basis in an environment of overall stability. Furthermore, in the absence of firm and timely responses by all concerned, the rate of high credit growth and increase in asset prices seemed to pose a downside risk to overall financial stability.

III.6 While domestic macroeconomic and financial conditions supported prospects of sustained growth momentum with stability in India, there were risks to both growth and stability from domestic as well as global factors, with the balance of risks tilted towards the global factors. The adverse consequences of further escalation of international crude prices and/or of disruptive unwinding of global imbalances were likely to be pervasive across economies, including India. In a situation of generalised tightening of monetary policy, India could not afford to stay out of step. It was necessary to keep in view the dominance of domestic factors as in the past but to assign more weight to global factors than before while formulating the policy stance.

III.7 Under the assumption of a normal monsoon, positive industrial outlook and sustained momentum in services sector growth, the real GDP growth, for policy purposes, was placed in a range of 7.5-8.0 per cent during 2006-07 barring domestic or external shocks. Taking into account the real, monetary and global factors having a bearing on domestic prices, it was noted that containing inflationary expectations would continue to pose a challenge to monetary management. The policy endeavour was to contain the year-on-year (y-o-y) inflation rate for 2006-07 in the range of 5.0-5.5 per cent. For the purpose of monetary policy formulation, the expansion in M_3 was projected at around 15.0 per cent for 2006-07, consistent with the projected GDP growth and inflation. Non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper (CP) was expected to increase by around 20 per cent, implying a calibrated deceleration from a growth of above 30 per cent ruling at end-March 2006. The Reserve Bank took certain prudential measures in the context of continued strong credit growth and in order to maintain asset quality.

Bank Rate

III.8 The Bank Rate signals the medium-term stance of monetary policy. Keeping in view the assessment of the economy including the outlook for inflation, the Bank Rate was retained at the existing level of 6.0 per cent; the rate was last revised in April 2003.

Cash Reserve Ratio

III.9 The CRR was hiked by a cumulative of 100 basis points during 2006-07 in four equal phases of 25 basis points each during December 2006-February 2007. During 2007-08, the CRR has been raised further by another 100 basis so far to 7.0 per cent of the banks' net demand and time liabilities (NDTL).

III.10 The Reserve Bank of India Act, 1934 was amended in June 2006. The Reserve Bank of India (Amendment) Act, 2006 gives discretion to the Reserve Bank to decide the percentage of scheduled banks' demand and time liabilities to be maintained as CRR without any ceiling or floor. Consequent to the amendment, the Reserve Bank was also not required to make interest payment on CRR balances.

Statutory Liquidity Ratio

III.11 The statutory liquidity ratio (SLR) was kept unchanged at 25 per cent of banks' NDTL during 2006-07; the ratio was last revised in November 1997. Commercial banks' holdings of Government securities, as a proportion to their NDTL, continued to decline during the year, reaching 28.0 per cent of their NDTL at end-March 2007 from 31.3 per cent at end-March 2006.

III.12 Consequent upon the promulgation of the Banking Regulation (Amendment) Ordinance, 2007 dated January 23, 2007, Section 24 of the Banking Regulation Act, 1949 was amended, which, *inter alia*, removed the floor rate of 25 per cent for SLR to be prescribed by the Reserve Bank and empowered it to determine the SLR-eligible assets, thereby giving it more flexibility in its monetary management operations.

Liquidity Management

III.13 During 2006-07 the Reserve Bank continued with its policy of active management of liquidity through LAF, MSS and CRR, using all the policy instruments at its disposal flexibly. The aim was maintenance of appropriate liquidity in the system so that all legitimate requirements of credit, particularly for productive purposes, are met consistent with the objective of price and financial stability. Liquidity conditions during 2006-07 continued to be influenced by sustained credit offtake, seasonal variations in currency demand, capital inflows and quarterly tax collections. During 2006-07 the reverse repo rate was hiked from 5.50 per cent to 6.00 per cent while the repo rate was hiked from 6.50 per cent to 7.75 per cent. The daily reverse repo absorptions were restricted to a maximum of Rs.3,000 crore effective

March 5, 2007. In view of the prevailing macroeconomic and overall monetary and liquidity conditions, the First Quarter Review of the Annual Statement on Monetary Policy for 2007-08 announced the withdrawal of the ceiling of Rs.3,000 crore on daily reverse repo under the LAF and the withdrawal of Second LAF with effect from August 6, 2007.

Interest Rate Policy

III.14 During 2006-07, the interest rate ceiling on NRE deposits was increased by 25 basis points in April 2006 but was reduced by 50 basis points in January 2007. Interest rate ceiling on FCNR(B) deposits was reduced by 25 basis points in January 2007. The ceiling interest rates on NRE deposits and FCNR(B) deposits were reduced by 50 basis points in April 2007.

III.15 The ceiling interest rate on export credit in foreign currency was increased by 25 basis points to LIBOR *plus* 100 basis points with effect from April 18, 2006.

Annual Policy Statement for 2007-08

III.16 The Annual Policy Statement observed that the stance of monetary policy in 2007-08 would be conditioned by the patterns in which the global and, more particularly, the domestic environment unfold. The likely evolution of macroeconomic and financial conditions indicated an environment supportive of sustaining the current growth momentum in India. The Statement reiterated that monetary policy, while contributing to growth, had to ensure and maintain conditions of price and financial stability. Accordingly, the policy preference for the period ahead was articulated strongly in favour of reinforcing the emphasis on price stability and anchoring inflation expectations.

CREDIT DELIVERY

III.17 For ensuring effective credit delivery, the thrust of the Reserve Bank's efforts in recent years has been on strengthening and empowering regional rural banks (RRBs), reforming cooperatives, expanding the purview of the priority sector, modifying the prudential norms and simplifying the procedures in the case of agricultural loans. During 2006-07, the Reserve Bank continued to take steps to improve credit delivery mechanism for small borrowers in order to bring about maximum financial inclusion of the poorer sections of the society. The guidelines on lending to the priority sector were revised based on the draft Technical Paper submitted by the Internal Working Group on Priority Sector Lending (Chairman: Shri C.S. Murthy) and the feedback received thereon. Employment-intensive sectors such as agriculture, and micro and small enterprises – which impact large and weaker sections of the population – have been retained as priority sector in the revised guidelines which became effective from April 30, 2007. The broad categories of advances included in the priority sector are agriculture, small enterprises, micro credit, retail trade, education loans and housing loans up to Rs 20 lakh.

III.18 The Reserve Bank has taken several initiatives to provide smooth and efficient banking services to the general public at large. Efforts towards 'financial inclusion' include sensitising the banks to the banking and financial needs of the common person and ensuring access to basic banking facilities. With a view to educating the general public as also the existing customers of banks about the various financial products and services that are available in the market/offered by the banks, the Reserve Bank has initiated the process of financial education. In the light of the recommendations made by two Working Groups set up by the Reserve Bank, convenor banks of the State/Union Territory Level Bankers' Committees (SLBCs/UTLBCs) were advised in May 2007 to set up, on a pilot basis, a financial literacy-cum-counselling centre in any one district in the State/ Union Territory coming under their jurisdiction.

III.19 With a view to according priority to the most needy, a special drive has been initiated by the Regional Offices of the Reserve Bank for 100 per cent financial inclusion in the districts with maximum concentration of Scheduled Castes (SCs)/ Scheduled Tribes (STs) and minorities. For this purpose, the Regional Offices have been advised to use a list of 121 minority concentrated districts forwarded by the Ministry of Finance, Government of India together with Census/other data on SCs/STs and minorities.

Relief Measures for Distressed Farmers

III.20 In the light of the recommendations of the Working Group constituted under the Chairmanship of Prof. S.S. Johl and in order to assist distressed farmers, banks were advised to frame transparent one time settlement (OTS) policies for such farmers, with the approval of their boards. The remaining recommendations of the Group are under examination.

III.21 Pursuant to the announcement made by the Union Finance Minister in the budget speech for the year 2006-07, commercial banks were advised to grant interest relief of two percentage points in the interest rate on the principal amount up to Rs 1 lakh on each crop loan granted by them during *kharif* and *rabi* of 2005-06, and credit the relief to the borrower's account before March 31, 2006. The Union Finance Minister in his budget speech for the year 2007-08 announced that the two per cent subvention scheme for short-term crop loans would continue for the year 2007-08 also.

Priority Sector Lending

III.22 Domestic banks and foreign banks are required to provide 40 per cent and 32 per cent, respectively, of their net bank credit to the priority sector. As on the last reporting Friday of March 2007, public sector banks fell short of the target of 40 per cent by 0.4 percentage point, while private sector banks and foreign banks, as groups, achieved the overall lending target. Six out of 28 public sector banks, four out of 26 private sector banks and five out of 29 foreign banks could not achieve their priority sector lending target as on the same date.

Credit to Agricultural Sector

III.23 In order to improve the flow of credit to the agricultural sector, the Reserve Bank had advised public sector banks to prepare Special Agricultural Credit Plans (SACP) in 1994-95. The SACP mechanism was also made applicable to private sector banks in 2005-06. The disbursements by public sector banks to agriculture under the SACP rose by 44.6 per cent during 2005-06, exceeding the target by almost 11 per cent. The disbursements by private sector banks also exceeded the target by almost 29 per cent during 2005-06. During 2006-07, the disbursements to agriculture under the plan by public sector banks aggregated Rs.1,22,215 crore (provisional) against a target of Rs.1,18,160 crore.

III.24 During 2006-2007, the public sector banks issued 4.8 million KCCs covering limits aggregating Rs.26,215 crore. Since the inception of the scheme, 26.6 million KCCs have been issued by the public sector banks, with limits amounting to Rs.94,712 crore.

III.25 In terms of revised priority sector guidelines, the foreign banks not meeting the priority sector target/sub-targets will be required to contribute the shortfall to the Small Enterprises Development Fund (SEDF) to be set up with the SIDBI, or for such other purpose as may be stipulated by the Reserve Bank from time to time.

Micro-finance

III.26 Of the different models for delivery of micro-finance, the SHG-Bank Linkage Programme has emerged as the major micro-finance programme in the country. As at end-March 2007, 2.9 million SHGs were linked to banks covering a total flow of credit of Rs.18,040 crore.

Credit to Women

III.27 Public sector banks (PSBs) are required to lend at least 5 per cent of their net bank credit to women. The credit extended to women by all PSBs was 4.95 per cent of the overall net bank credit at end-March 2007, with 21 PSBs reaching the target. Eight PSBs have opened 15 specialised women branches.

Credit to Small and Medium Enterprises

III.28 The total credit provided by the PSBs to the SSI sector as on the last reporting Friday of March 2007 was Rs.1,04,703 crore, constituting 8.0 per cent of their net bank credit and 20.1 per cent of their total priority sector advances. Advances to cottage industries, artisans and tiny industries amounted to Rs.44,311 crore, constituting 42.3 per cent of the advances to the SSI sector. PSBs are required to operationalise at least one specialised SSI branch in every district and centre having cluster of SSI units. At end-March 2007, the PSBs had operationalised 636 specialised SSI bank branches.

III.29 The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 came into effect from October 2, 2006. The Act classifies enterprises broadly into (i) manufacture/production of goods and (ii) providing/rendering of services.

IV DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

IV.1 During 2006-07, the institutional framework for financial markets was further strengthened in terms of instruments and processes to improve price discovery, while allowing greater flexibility to market participants to carry out their transactions. The broad policy objectives in the money market continued to be ensuring stability, minimising default risk and achieving a balanced development of its various segments. Policy initiatives in the Government securities market segment were guided by the need to ensure a smooth transition to a regime in which the Reserve Bank is prohibited from participating in the primary market for Central Government securities, (effective April 1, 2006). The Government Securities Act, 2006 was also passed by the Parliament during the year. The focus in the foreign exchange market was on further liberalising and simplifying the external payments regime for resident entities in pursuance of the recommendations of the Committee on Fuller Capital Account Convertibility (FCAC).

IV.2 In the money market, a screen-based negotiated quote-driven system for dealings in the call/notice and term money markets was operationalised. Recognising the need for a robust interest rate futures market as an effective instrument for management of interest rate risk, a Working Group has been set up to go into all the relevant issues and to suggest measures to facilitate the development of the interest rate futures market. In the Government securities market, the membership of the NDS-Order Matching (NDS-OM) platform was expanded to include insurance companies, mutual funds and provident funds. The 'when issued' market, which was initially introduced for 'reissued' Central Government dated securities, was later extended to newly issued securities. Short-selling in Central Government securities, which was initially allowed on an intra-day basis, was later extended to five days. In the foreign exchange market, the limit for remittances for individuals was increased from US $ 25,000 to US $ 1,00,000. For corporates, limits on remittances for overseas investments were further raised to facilitate overseas acquisitions. The guidelines for external commercial borrowings were liberalised by raising the prepayment limits. In view of the experience gained by market participants in using various hedging instruments such as forward foreign exchange contracts and options, and improvements in liquidity and accounting systems relating to these instruments, a Working Group on Currency Futures has been set up to study the international experience and suggest a suitable framework to operationalise the proposal.

IV.3 The Technical Advisory Committee (TAC) on Money, Foreign Exchange and Government Securities Markets, which was reconstituted in June 2006, continued to provide valuable guidance to the Reserve Bank on issues relating to the development and regulation of financial markets. Three meetings of the TAC have been held since its reconstitution.

MONEY MARKET

IV.4 The money market is the key link in the transmission of monetary policy impulses. Accordingly, a number of measures have been undertaken in recent years with a view to improving the functioning of various segments of the money market and enhancing the smooth flow of funds across instruments and participants. The broad policy objectives being pursued for the development of the money market are to ensure stability, minimise default risk and achieve a balanced development of various segments through introduction of new instruments, broadening of participants' base and strengthening of institutional infrastructure. The policy thrust given to the growth of the collateralised segment has improved options for liquidity management while reducing risks. Developments in institutional and technological infrastructure have also helped in improving transparency, facilitating price discovery process and providing avenues for better liquidity and risk management.

IV.5 In pursuance of the announcement made in the Annual Policy Statement (April 2006), a screen-based negotiated quote-driven system for dealings in the call/notice and term money markets (NDS-CALL) was operationalised with effect from September 18, 2006. Developed by the Clearing Corporation of India Ltd. (CCIL), the system has helped in improving the ease of transactions, while also bringing about greater transparency and efficient price discovery. Though banks are free to contract deals outside the NDS-CALL system, there is a growing preference for the NDS-CALL screen, which currently accounts for around 75 per cent of the total call money volumes.

GOVERNMENT SECURITIES MARKET

IV.6 The provision of the Fiscal Responsibility and Budget Management Act, 2003 prohibiting the Reserve Bank from participating in the primary issuances of Government securities came into effect on April 1, 2006. Building upon the measures already put in place in 2005-06 to meet the requirements of the new environment, a number of initiatives were taken during 2006-07 with the objective of further deepening and widening the Government securities market. These measures included extending short selling in the Central Government securities to five-day basis, introduction of 'when issued' market, permitting diversification of primary dealer (PD) business and extension of the NDS-OM module to new participants such as qualified mutual funds, provident funds and pension funds.

FOREIGN EXCHANGE MARKET

IV.7 During 2006-07, the Reserve Bank continued to pursue the objective of creating a more conducive environment for external transactions while according high priority to customer service. India's cautious approach towards opening of the capital account and viewing capital account liberalisation as a process contingent upon certain preconditions has held it in good stead. Given the changes that have taken place over the last two decades, the need was felt to revisit the subject and suggest a roadmap towards fuller capital account convertibility (FCAC) based on current realities. In consultation with the Government of India, the Reserve Bank appointed a Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore). The Committee made several recommendations for the development of financial markets in addition to addressing issues related to interaction of monetary policy and exchange rate management, regulation/ supervision of banks and the timing and sequencing of capital account liberalisation measures. The Committee, *inter alia*, noted that countries intending to move towards FCAC need to ensure that different financial market segments, besides being well-developed, in terms of physical infrastructure, skill and competency levels, are also well integrated. If different markets remain segmented, any policy shock to influence market behaviour would not get transmitted to the various segments, thus, leading to inefficiency of policy outcome. Moreover, segmentation impedes the development of a term structure of interest rates, which in turn, impedes the transmission of monetary policy.

IV.8 The Committee on FCAC also recommended that an Internal Task Force should be constituted to re-examine the extant regulations under the Foreign Exchange Management Act (FEMA) and make recommendations to remove the operational impediments in the path of liberalisation already in place. Accordingly, an Internal Task Force was constituted and it completed the assigned task in January 2007. The Task Force made recommendations on 169 issues encompassing all areas under foreign exchange management. Certain recommendations of the Task Force were implemented in the Annual Policy Statement for the year 2007-08 announced on April 24, 2007

Outlook

IV.9 The Reserve Bank will continue with its efforts to deepen and widen the money market, the Government securities market and the foreign exchange market in order to enable efficient price discovery in interest rates and exchange rate. Deep and liquid financial markets would enable mobilisation of savings on a greater scale and help to channel these savings to meet the growing investment demands of the Indian economy so as to sustain the current growth momentum. Further development of the term money market, greater flexibility in the use of derivatives in the foreign exchange market, development of the corporate bond market and enhancing liquidity in secondary markets would help in imparting more depth to the domestic financial markets. Efforts will also be aimed at further integration of the various segments of the domestic market so as to strengthen the monetary transmission mechanism and ensure efficient dispersal of risks amongst various market participants, especially in the context of the envisaged move towards fuller capital account convertibility. The Reserve Bank would continue to take steps to maintain integrity and stability of the various segments of the financial market with a view to strengthening macroeconomic and financial stability.

V FINANCIAL REGULATION AND SUPERVISION

V.1 During 2006-07, the Reserve Bank continued to focus its regulatory and supervisory initiatives on promoting a stable and competitive financial sector in an environment characterised by rising globalisation, ongoing financial deregulation and rapid technological innovations. Prudential, accounting and disclosure norms were strengthened so as to promote financial stability. Consistent with the policy approach of conforming the domestic financial sector to the international best standards with emphasis on gradual harmonisation, final guidelines for implementation of the New Capital Adequacy Framework (Basel II) by banks were issued. Initiatives to strengthen the urban cooperative banks were pursued during the year, following the path set out in the draft Vision Document. In view of the important role played by the non-banking financial companies in broadening access to financial services, enhancing competition and diversification of the financial sector, the Reserve Bank continued with its efforts to strengthen these entities. The Reserve Bank also focused on the initiatives for protecting customers' rights, enhancing the quality of customer service and strengthening the grievance redressal mechanism in banks during 2006-07.

V.2 The supervisory review process (SRP) undertaken with respect to select banks having significant exposure to the sensitive sectors revealed that real estate exposure increased across banks, mainly on account of individual housing loans. The prudential norms were strengthened, especially in view of rapid credit growth in various sectors. The smooth migration to the Basel II framework continued to engage the attention of the Reserve Bank as commercial banks in India would start implementing Basel II norms from March 31, 2008. A 'Code of Banks' Commitment to Customers' was released to provide a framework for a minimum standard for banking services which individual customers can legitimately expect. As a part of the gradual process of financial liberalisation, it is considered appropriate to introduce credit derivatives in a calibrated manner. In the context of the recent amendment to the Reserve Bank of India Act, 1934 providing legality to OTC derivative instruments, including credit derivatives, it was proposed in the Annual Policy Statement for the Year 2007-08 to permit banks and PDs to begin transacting in single-entity credit default swaps. Given the significant role played by urban cooperative banks in providing banking services to the middle/ lower middle income people, initiatives were also undertaken to strengthen these banks. Following the path set out in the draft Vision Document, Memoranda of Understanding (MoU) have been signed with the 12 States and the Task Force for Co-operative Urban Banks (TAFCUBs) have also been constituted in these States. UCBs in States, which have signed MoUs, have been enabled to expand their business by allowing them to set up currency chests, sell mutual fund products, provide foreign exchange services, open new ATMs and convert extension counters into branches. The MoUs have also been signed between the Reserve Bank and the Central Government in respect of Multi-State UCBs. Almost 83 per cent of the UCBs accounting for about 90 per cent of the total deposits are covered under the MoU arrangements. The regulatory framework with regard to systemically important non-banking financial companies was strengthened to reduce regulatory gaps. Systemically important non-deposit taking NBFCs were also defined and prudential norms were specified for these entities.

REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

V.3 The Reserve Bank performs regulatory and supervisory role over commercial and urban co-operative banks (UCBs), financial institutions, non-banking financial companies (NBFCs) and primary dealers (PDs) through the Board for Financial Supervision (BFS). As at end-March 2007, there were 82 commercial banks [excluding regional rural banks (RRBs)] (of which nine were permitted to undertake PD business), 96 RRBs, 1,815 UCBs, 7 development finance institutions (DFIs), 13,020 NBFCs (of which 403 NBFCs are permitted to accept/hold public deposits) and 11 PDs. The BFS continued to exercise its supervisory role over the segments of the financial system that are under the purview of the Reserve Bank. The BFS is headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members. In respect of the State and district central co-operative banks, and RRBs, while the Reserve Bank is the regulator, the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD). Insurance companies and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI), respectively. A coordinated approach to supervision is ensured through a High-Level Coordination Committee on Financial and Capital Markets (HLCCFM) with the Governor of the Reserve Bank, as Chairman, and the chiefs of the SEBI, the IRDA and the Pension Fund Regulatory and Development Authority (PFRDA), and the Secretary, Economic Affairs, Ministry of Finance, Government of India as the members.

Strengthening Prudential Norms

V.4 Bank credit has recorded sustained high growth since 2003-04, with non-food credit by scheduled commercial banks recording an annual average growth of about 30 per cent per annum during 2004-05 to 2006-07. Banks' loans and advances portfolios are pro-cyclical and concomitantly, there is a tendency to underestimate the level of inherent risk during times of accelerated credit growth. In order to ensure that asset quality is maintained in the light of high credit growth and taking into account the rise in default rates with regard to personal loans and credit card receivables, the general provisioning requirement for standard advances by banks in specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh, commercial real estate loans and loans to non-deposit taking systemically important NBFCs were raised in May 2006/January 2007. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes to the permitted extent. The revised provisioning requirements are also applicable to the urban cooperative banks (UCBs).

V.5 An Internal Group was constituted by the Reserve Bank to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives. Based on the Group's report, comprehensive guidelines on derivatives were issued on April 20, 2007. These guidelines relate to rupee interest rate derivatives and cover broad generic principles for undertaking derivative transactions, management of risk and sound corporate governance requirements and detailed guidance on suitability and appropriateness policy to be adopted by market makers. Guidelines in respect of foreign exchange derivatives will be issued separately. As a part of the gradual process of financial liberalisation, it is considered appropriate to introduce credit derivatives in a calibrated manner. In the context of the recent amendment to the Reserve Bank of India Act, 1934 providing legality of OTC derivative instruments, including credit derivatives, it was proposed in the Annual Policy Statement of the Reserve Bank in April 2007 to permit banks and PDs to begin transacting in single-entity credit default swaps. In this context, draft guidelines on credit default swaps were issued in May 2007.

V.6 The prudential framework governing banks' exposure to VCFs was revised in August 2006. Under the revised framework, banks' exposures to VCFs (both registered and unregistered) are deemed to be on par with equity and hence reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure).

V.7 Guidelines on banks' exposure to capital markets were rationalised in terms of base and coverage in April 2007. In terms of the revised guidelines, aggregate exposure of a bank on solo as well as on consolidated basis to the capital markets in all forms (both fund and non-fund based) should not exceed 40 per cent of its net worth (consolidated net worth in the case of consolidated bank) as on March 31 of the previous year. Within this overall ceiling, direct investment in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and all exposures to VCFs (both registered and unregistered) should not exceed 20 per cent of the bank's net worth/consolidated net worth.

V.8 From the perspective of financial stability, the concentration risk on the liability side of banks is as important as that on the asset side. While the counterparty risk concentration on the assets side has attracted adequate attention and received regulatory policy response, the concentrated risk on the liability side of the banks has not received similar attention. Uncontrolled liabilities, in particular inter-bank liabilities, may have systemic implications, even if the individual counterparty banks are within the allocated exposure. In order to reduce the extent of concentration on the liability side of banks, the Reserve Bank put in place a comprehensive framework of liability management in March 2007. Accordingly, banks were advised to fix, with the approval of their boards of directors, a limit for their inter-bank liabilities within the prudential limit of 200 per cent of their net worth, based on their audited balance sheet as on March 31 of the previous year. Banks with CRAR of more than 11.25 per cent are allowed to have an additional limit of 100 percentage points, *i.e.*, up to 300 per cent of the net worth. The limit so fixed will include only fund based inter-bank liabilities. Since the limits are for inter-bank borrowings within India, inter-bank borrowings/liabilities outside would be excluded. Collateralised borrowings under the CBLO and refinance from NABARD and SIDBI would also be excluded. The existing limit on the call money borrowings prescribed by the Reserve Bank would operate as a sub-limit within the above limits.

Opening up of the Financial Sector

V.9 During 2006-07, Indian banks continued to expand their presence overseas. As at end-June 2007, 16 banks (11 public sector banks and 5 private sector banks) had a network of 188 offices (123 branches, 38 representative offices, 7 joint ventures and 20 subsidiaries) overseas.

V.10 During the calendar year 2006, the Reserve Bank issued approvals for opening 13 branches of foreign banks in India. During 2006-07 (July 2006-June 2007), permission was granted to three existing foreign banks to open 10 branches in India, to six foreign banks to open one representative office each in Mumbai and to one foreign bank to open a representative office in New Delhi. During the same period, six foreign banks have opened their branches across India and four foreign banks have opened their representative offices in Mumbai. As at end-June 2007, 29 foreign banks were operating in India with 268 branches. In addition, 34 foreign banks were also operating in India through their representative offices.

Supervisory Initiatives

V.11 The Basel Committee on Banking Supervision (BCBS) had released the document 'International Convergence of Capital Measurement and Capital Standard: A Revised Framework' (popularly known as Basel II framework) on June 26, 2004. With a view to ensuring migration to Basel II in a non-disruptive manner, the Reserve Bank adopted a consultative approach and constituted a Steering Committee comprising senior officers from banks, the Indian Banks' Association (IBA) and the Reserve Bank. On the basis of the recommendations of the Steering Committee and the sub-groups formed by it, the Reserve Bank had issued draft guidelines for implementation of the new capital adequacy framework for comments in February 2005. The draft guidelines were revised on the basis of the feedback received and reissued for a second round of consultation in March 2007. On the basis of feedback received on the second draft, the guidelines for implementation of the New Capital Adequacy Framework (Revised Framework) were finalised and issued on April 27, 2007.

Customer Service

V.12 The broad approach of the Reserve Bank to customer service is to empower the common person in availing banking services and strengthen customer-service delivery in banks by adopting a consultative process with banks through the Indian Banks' Association (IBA). Specifically, the focus is on (a) sensitising banks to customer service and encouraging the involvement of boards of banks, especially in matters relating to banks' own grievance redressal machinery; (b) insisting on transparency in all dealings with the customers and ensuring reasonableness in pricing; (c) promoting adherence to self-imposed codes by banks on commitments to bank customers and monitoring compliance by an independent agency, *viz.,* Banking Codes and Standards Board of India (BCSBI); (d) strengthening and empowering institutional mechanism for dispute resolution; (e) using regulation/prescription only when essential, while encouraging IBA to take initiatives; and (f) rationalising the Reserve Bank's own systems and procedures.

V.13 With the setting up of the Customer Service Department on July 1, 2006 in the Reserve Bank, various customer service activities relating to the banks and the Reserve Bank, which were handled by different departments of the Reserve Bank, have been brought under a single roof.

Regional Rural Banks

V.14 The process of amalgamation of regional rural banks (RRBs) initiated in September 2005 in order to strengthen them continued during 2006-07. With the amalgamation of 145 RRBs into 45 new RRBs, the total number of RRBs declined from 196 at end-March 2005 to 133 at end-March 2006 and further to 96 at end-March 2007.

V.15 Urban cooperative banks (UCBs) play a significant role in achieving the objective of financial inclusion by providing credit and deposit facilities to middle/lower middle income people in urban/semi-urban areas. The Reserve Bank, therefore, continued with its policy initiatives during 2006-07 to ensure that these banks emerge as a sound and healthy network of jointly owned, democratically controlled, and ethically managed banking institutions, for providing need based quality banking services, essentially to the middle and lower middle classes and marginalised sections of the society.

V.16 The approach followed for strengthening the UCBs sector focuses on the following elements: (a) withholding, in each State, new licenses/new branch authorisations till the Reserve Bank has regulatory comfort; (b) consultative and collaborative handling of the problems at a decentralised level (State) with representation from all stakeholders to avoid problem of dual control; (c) professionalisation of audit and management through consent; (d) emphasis on minimising systemic impact on account of exit of weak banks; (e) encouraging mergers to facilitate non-disruptive exit; (f) incentivising the State governments to enter into MoUs by linking liberalisation/flexibility in operations of UCBs in the State with the signing of MoU; and (g) calibrating expansion incumbent on financial strength and regulatory comfort.

Non-Banking Financial Companies

V.17 NBFCs are increasingly being recognised as complementary to the banking system; they are capable of absorbing shocks as also spreading risks at times of financial distress. The application of different levels of regulations to the activities of banks and NBFCs, and even among different categories of NBFCs, had given rise to some issues arising out of the uneven coverage of regulations. Based on the recommendations of an Internal Group to examine the issues relating to the level playing field, regulatory convergence and regulatory arbitrage in the financial sector and taking into consideration the feedback received thereon, it was decided to put in place a revised framework to address the issues pertaining to the overall regulation of systemically important NBFCs and the relationship between banks and NBFCs. Furthermore, under the revised framework, non-deposit taking NBFCs with asset size of Rs 100 crore and above have been defined as 'systemically important NBFCs' (NBFC-ND-SI).

MACRO-PRUDENTIAL INDICATORS REVIEW

V.18 The Reserve Bank has been compiling macro-prudential indicators (MPIs) since March 2000. These comprise both aggregated micro-prudential indicators (AMPIs) of the health of individual financial institutions and macroeconomic indicators (MEIs) associated with the financial system soundness. India is one of the countries which volunteered to participate in the coordinated compilation exercise of financial soundness indicators in December 2005 under the aegis of the International Monetary Fund.

V.19 An overview of MPIs for 2006-07 indicates a further improvement in asset quality of the major constituents of the financial sector. Capital adequacy ratios continued to remain above the minimum requirements. Return on assets of scheduled commercial banks during 2006-07 remained almost unchanged at the previous year's level, while that of primary dealers (PDs) witnessed a sharp decline due to the merger of nine stand-alone PDs into bank-PDs.

Outlook

V.20 The Reserve Bank would continue with various regulatory and supervisory initiatives to strengthen the domestic financial sector in order to maintain financial stability. In consonance with the aim of benchmarking the Indian financial sector to the international best practices, commercial banks in India will start implementing Basel II from the year ended March 2008 onwards. In order to strengthen the risk management in banks, credit derivatives are proposed to be introduced in a calibrated manner, taking into account the risk management systems in banks and their state of preparedness for Basel II. The principles for accounting of derivatives are also being finalised. In view of the fast pace of deregulation, liberalisation and the emergence of financial conglomerates, the supervisory process is being constantly fine-tuned to ensure that adequate attention is given to the complexities of organisational structures, business processes and risk-positions of the banks. The focus is on risk based supervisory framework and smooth migration to Basel II that will require appropriate capacity building in the Reserve Bank as well as in the banks. While strengthening the regulatory and the supervisory framework, the Reserve Bank will continue to persevere with its efforts towards greater financial inclusion and improvement in customer service provided by the banking sector.

VI PUBLIC DEBT MANAGEMENT

VI.1 During 2006-07, the debt management strategy of the Reserve Bank continued to be guided by the twin objectives of minimisation of cost over time and pursuit of maturity profiles consistent with rollover risk. The debt management operations were undertaken in an environment characterised by pre-emptive monetary tightening measures and upward shifting of yield curve. A major source of the demand for Government securities emanated from the banking and insurance sectors for complying with the statutory requirements. The Reserve Bank was prohibited from participating in the primary issuances of Government securities from April 1, 2006 in accordance with the provisions of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. Carrying forward the process of development of the Government securities market and with a view to facilitate debt management in the post-FRBM environment, specific measures were undertaken during the year such as permitting short sales, introduction of "when issued" market and introduction of a revised scheme of underwriting commitment for primary dealers. The Reserve Bank continued with the policy of passive consolidation of dated securities and elongation of maturity profile.

VI.2 The borrowing programme of the Central Government, higher than that in the previous year, was conducted smoothly during 2006-07 - the first year of the Reserve Bank's absence from the primary market as per the FRBM stipulations. This was enabled by concerted efforts to improve the market microstructure. The pre-emption of revenue receipts by the interest cost of open market loans continued to decline during 2006-07. At the same time, the risk profile of outstanding open market debt improved as reflected in the near stability in the weighted average maturity (around 10 years) as well as in modified duration (5.6 years) in recent years. The weighted average cost of market borrowings increased during the year, reflecting the hardening of interest rate structure.

VI.3 A notable aspect of the market borrowings of the States during 2006-07 was that the actual borrowings were lower than those allocated. The reduction in borrowings was mainly on account of a build-up of cash balances. The upsurge in cash balances during 2006-07, notwithstanding deceleration in small savings collections, was facilitated by fiscal consolidation initiatives and higher Central devolution and transfers. For the first time, the States raised the entire amount through the auction route. In general, the spreads of the cut-off yields in the auctions over the secondary market yields of comparable Central Government securities were lower than those in the previous year, reflecting improved market perception of States' fiscal position.

CENTRAL GOVERNMENT

VI.4 With the Reserve Bank withdrawing from participation in the primary issuance of Central Government securities with effect from April 1, 2006 in accordance with the FRBM Act, 2003, the Ways and Means Advances (WMA) arrangements were revised from 2006-07 in consultation with the Government. Under the previous arrangements, the limits of WMA were fixed on a half-yearly basis; for 2005-06, the limits were Rs.10,000 crore for the first half of the fiscal year (April-September) and Rs.6,000 crore for the second half of the fiscal year (October-March). In order to facilitate the transition necessitated by the new FRBM provisions, under the revised arrangements, the limits for 2006-07 were fixed on a quarterly basis instead of a half-yearly basis. Accordingly, the WMA limits for 2006-07 were placed at Rs.20,000 crore and Rs.10,000 crore for the first and second quarters, respectively, and Rs.6,000 crore each for the third and fourth quarters of the year. The Reserve Bank retained the flexibility to revise the limits in consultation with the Government of India taking into consideration the transitional issues and prevailing circumstances. Interest rates on WMA and overdraft have been linked to the repo rate as against the Bank Rate hitherto, following the emergence of the repo rate as the short-term reference rate. Accordingly, the interest rate on WMA is at the repo rate and that on overdraft is at repo rate *plus* two percentage points.

VI.5 The liquidity position of the Government remained by and large comfortable during 2006-07. The surplus cash balances of the Centre which amounted to Rs.48,928 crore (inclusive of investment balance of Rs.20,000 crore) at end-March 2006 dwindled during April 2006 and the Centre had to take recourse to WMA during May-August 2006. The peak WMA availed during the year was Rs.11,754 crore (59 per cent of the limit) on June 6, 2006. The Centre, however, did not resort to overdraft during the year. During 2006-07, the Centre availed WMA for a total of 39 days as compared with only two days during 2005-06. The Centre availed WMA up to August 7, 2006, and, thereafter, maintained surplus cash balances with the Reserve Bank. The surplus exceeded the investment ceiling of Rs.20,000 crore from September 16, 2006. The surplus balance reached a historic peak of Rs.77,726 crore on March 22, 2007, reflecting State Governments' investment in Government of India Treasury Bills and buoyancy in advance tax collections. The surplus balance, however, declined to Rs.50,092 crore as on March 31, 2007, but remained higher than the previous year's level of Rs.48,928 crore. The surplus averaged Rs.27,976 crore during 2006-07 as compared with Rs.25,772 crore a year ago.

VI.6 The WMA limits for 2007-08 have been fixed at Rs.20,000 crore for the first half of the year (April-September) and Rs.6,000 crore for the second half of the year (October-March). The applicable interest rate on WMA and overdraft would continue to be linked to the repo rate as hitherto. The Centre began the fiscal year with a large surplus balance of Rs.50,092 crore, which eroded rapidly and turned into a deficit by April 27, 2007 reflecting sharp reduction in the investments in the Government of India Treasury Bills by States, higher than anticipated spending and lower collections under the National Small Saving Fund (NSSF). The cash balance of the Government persisted in a deficit mode till June 17, 2007 except for a brief period of 2 days on May 17-18, 2007. The cash deficit crossed the WMA limit of Rs.20,000 crore on May 30, 2007 and remained in an overdraft position till June 8, 2007. Additional issuance of 91-day and 182-day Treasury Bills amounting to Rs.27,500 crore on six occasions, during June 6-27, 2007, coupled with an auction of dated securities amounting to Rs.5,000 crore on June 12, 2007 outside the calendar, advance tax inflows for the April-June quarter together with the resumption of investment by States in the Government of India Treasury Bills facilitated building up of a surplus position in Government balances from June 18, 2007. With the transfer of the State Bank of India (SBI) stake from the Reserve Bank of India to the Government involving cash outgo of Rs.35,531 crore on June 29, 2007, the cash balance of the Government again turned into a deficit and remained so till August 8, 2007. Following the transfer of surplus from the Reserve Bank on August 9, 2007, the cash balance of the Government of India returned to a surplus mode. The Government resorted to overdraft on three occasions during 2007-08 (up to August 10, 2007) in contrast with the previous year when it did not resort to any overdraft. During 2007-08 so far, the Government availed of WMA/OD on 90 days as against 39 days during the previous year.

VI.7 Net market borrowings through dated securities during 2006-07 amounted to Rs.1,06,916 crore, showing an increase of 12.1 per cent over that of Rs.95,370 crore during 2005-06. Gross market borrowings aggregated Rs.1,46,000 crore in 2006-07 (11.5 per cent higher than that of Rs.1,31,000 crore during 2005-06). The total devolvement on the PDs during 2006-07 was Rs.5,604 crore; there was no devolvement on the PDs or the Reserve Bank during 2005-06.

VI.8 The Reserve Bank continued with the policy of passive consolidation and elongation of maturity profile of Government dated securities during 2006-07. The share of reissued securities in total issuances in 2006-07 was 90.4 per cent (97.7 per cent in the previous year). The market response to the primary auctions of dated securities during 2006-07, as measured by bid-to-cover ratio (BCR), was more favourable than that in the previous year.

VI.9 The weighted average yield of dated securities increased to 7.89 per cent during 2006-07 from 7.34 per cent during 2005-06 and 6.11 per cent during 2004-05 reflecting the hardening of interest rate structure. Despite an increase in the yield during the year, the weighted average coupon on the outstanding stock of Government dated securities continued its downward trend, declining to 8.55 per cent as on March 31, 2007 from 8.75 per cent at end-March 2006 and 10.84 per cent at end-March 2002. The weighted average maturity of dated securities issued during 2006-07 was 14.72 years; it was lower than that of 16.90 years during 2005-06 but close to that prevailing during 2001-02 to 2004-05. The weighted average maturity of outstanding stock, however, inched up further to 9.97 years as on March 31, 2007 from 9.92 years at end-March 2006 and 8.20 years at end-March 2002.

VI.10 During 2006-07, the spread between the primary cut-off yields in the auctions of dated securities and the prevailing secondary market yields of dated securities of similar maturity ranged between (-) 3 and 14 basis points. However, for a majority of issues (22 out of the 30 auctions of dated securities), the spread was quite narrow (ranged between (-) 3 and 6 basis points), indicating efficient price discovery in the primary auctions.

VI.11 The declining trend in the share of high cost debt continued during 2006-07. The share of outstanding debt with coupon of more than 8 per cent declined to 46.6 per cent at end-March 2007 from 49.8 per cent a year ago. About 45 per cent of the outstanding stock of debt at end-March 2007 was contracted at interest rates of 6.00-7.99 per cent (36.4 per cent a year ago).

VI.12 During 2006-07, insurance companies continued to absorb the largest share of fresh issues of dated securities, followed by commercial banks, largely reflecting their increased investment requirements. Notwithstanding the steady erosion in their share over the past three years, commercial banks continued to account for the predominant share in the outstanding stock of dated securities at end-March 2007.

STATE GOVERNMENTS

VI.13 Following the recommendations of the Advisory Committee on Ways and Means Advances (WMA) and Overdrafts (OD) to State Governments (Chairman: Shri M.P. Bezbaruah), a revised WMA/OD Scheme was put in place from 2006-07. The aggregate Normal WMA limit for the State Governments was increased by 10.5 per cent to Rs.9,875 crore for 2006-07. The rates of interest on Normal and Special WMA and OD were linked to the repo rate. In addition, with the objective of providing an incentive to the State Governments to build-up the Consolidated Sinking Fund (CSF) and the Guarantee Redemption Fund (GRF), net incremental annual investments in these Funds were made eligible for the purpose of availing Special WMA up to a ceiling equivalent to the Normal WMA limit.

VI.14 The daily average utilisation of Normal WMA, Special WMA and overdrafts by the State Governments declined during 2006-07. During 2006-07, eight States resorted to WMA as against 12 States in the previous year. Only two States resorted to overdraft during 2006-07 as against eight States in the previous year. The lower utilisation of WMA reflected improved liquidity position on the back of persistent cash surplus with the State Governments.

VI.15 Notwithstanding some slowdown in the automatic inflow of funds under the high-cost NSSF, most State Governments continued to accumulate sizable cash surpluses during 2006-07 emanating mainly from substantially higher Central transfers by way of taxes and grants, and fiscal consolidation measures. The surplus cash balances of the State Governments are automatically invested in 14-day Intermediate TBs, the discount rate in respect of which is 5 per cent at present. While 14-day Intermediate TBs can be rediscounted with the Reserve Bank (with a load of 50 basis points), auction TBs cannot be rediscounted with the Reserve Bank. The outstanding investments of States in 14-day Intermediate TBs at Rs.45,769 crore (by 22 States) at end-March 2007 was 17 per cent higher than that of Rs.38,983 crore (by 24 States) at end-March 2006. On the other hand, the outstanding investment of the State Governments in auction TBs recorded a substantially higher order of increase of 165 per cent to Rs.34,186 crore at end-March 2007 from Rs.12,883 crore at end-March 2006. This could be attributed to the perceived durability of surplus balances with the State Governments and relatively higher yield (around 7-8 per cent) in auction TBs. In terms of monthly averages, the total investments (14-day Intermediate TBs and auction TBs taken together) increased from Rs.41,066 crore during 2005-06 to Rs.63,995 crore during 2006-07.

VI.16 Following the recommendations of the Advisory Committee on Ways and Means Advances and Overdrafts to the State Governments (Chairman: Shri M.P. Bezbaruah), the State-wise limits of Normal WMA limits for 2006-07 were reviewed towards the end of the year. It was perceived that the extant Normal

WMA limits were adequate, *inter alia,* on account of (i) low utilisation of WMA by the State Governments during 2006-07; (ii) acclimatisation of the State Governments to the changes in the fiscal environment as envisaged by the Twelfth Finance Commission, thereby signaling the end of the period of transition; and (iii) expected persistence of the comfortable liquidity position of the State Governments during 2007-08. Accordingly, it was decided to retain the extant State-wise Normal WMA limits for 2007-08. Other terms and conditions of the Scheme would also continue to remain unchanged for 2007-08.

VI.17 The liquidity position of most of the States has remained fairly comfortable during 2007-08 so far. The weekly average investment by the States in the 14-day TBs during 2007-08 (up to July 31, 2007) at Rs.35,683 crore was broadly at the same level as that in the corresponding period of the previous year. On the other hand, the weekly average investment by the States in ATBs during 2007-08 (up to July 31, 2007) at Rs.34,791 crore was higher than that of Rs.16,919 crore in the corresponding period of the previous year. A few States, which could not build up a sufficient financial buffer during 2006-07 by way of investment in TBs, however, had to resort to WMA/OD facility from the Reserve Bank for meeting their temporary cash mismatches. During 2007-08 (up to July 31, 2007), seven States availed of Normal WMA, of which three States availed it for a period exceeding two weeks and also resorted to overdrafts. The daily average utilisation of WMA and overdraft by the States was Rs.763 crore in 2007-08 (up to July 31, 2007) as compared with Rs.255 crore in the corresponding period of the previous year.

VI.18 The provisional net allocation under the market borrowing programme for the State Governments for 2006-07 was placed at Rs.17,242 crore. Taking into account the repayments of Rs.6,551 crore and additional allocation of Rs.2,804 crore, the gross allocation amounted to Rs.26,597 crore during 2006-07. The State Governments raised a gross amount of Rs.20,825 crore in 2006-07 as compared with Rs.21,729 crore in the previous year. The entire amount was raised through the auction route during 2006-07 as compared with 48.5 per cent in the previous year and 2.3 per cent in 2004-05. Six States (Bihar, Chhattisgarh, Gujarat, Haryana, Karnataka and Orissa) did not participate in the market borrowing programme during 2006-07, while two States, *viz*., Goa and Tripura did not raise their full allocations.

VI.19 The weighted average yield of State Government securities issued firmed up by 47 basis points to 8.10 per cent during 2006-07 in line with that of Central Government securities, reflecting the general upward movement in interest rates. The cut-off yield in the auction of State Government securities during 2006-07 ranged between 7.65-8.66 per cent.The cut-off yields were 12 to 52 basis points higher than secondary market yields of Government of India dated securities of comparable maturity.

VI.20 As at end-March 2007, 70.3 per cent of outstanding stock of debt was at interest rate of less than 9 per cent (65.6 per cent a year ago). Almost two-thirds of the outstanding stock of State Government securities were in the maturity bucket of 6-10 years at end-March 2007.

Outlook

VI.21 The size of the open market borrowing programme of the Central Government during 2007-08 through dated securities is placed slightly higher than the actual borrowing raised in the previous year. Carrying forward the market development process of the previous year, active consolidation, introduction of STRIPS, and re-introduction of floating rate bonds and inflation-indexed bonds are some of the measures that could be pursued during 2007-08. These are expected to enhance the efficiency of debt management operations. As far as the State Governments are concerned, efforts to enhance the liquidity of State Government securities and streamline their market borrowing operations would facilitate the mobilisation of funds in a cost effective manner. Reflecting the impact of various policy initiatives, it is expected that the combined Government market borrowing programme for 2007-08 would be completed successfully in accordance with the objectives of debt management.

VII CURRENCY MANAGEMENT

VII.1 Ensuring adequate availability of good quality banknotes and coins is one of the core functions of the Reserve Bank. Towards this objective, the Reserve Bank continued to take measures during 2006-07 to meet the public's demand for banknotes and coins while simultaneously improving the quality of banknotes. The demand for banknotes was met almost in full. There was a marked improvement in the quality of Rs.10 denomination banknotes due to sustained efforts. The mechanisation of note processing activities at currency chests was carried forward by equipping the currency chests with the sorting machines. The disposal capacity of soiled notes has been augmented by putting in place six Currency Verification and Processing Systems (CVPS) at a new sub-office in Lucknow. With this, the Reserve Bank now has a total of 54 CVPS and 28 Shredding and Briquetting Systems (SBS) at its 19 offices.

BANKNOTES IN CIRCULATION

VII.2 During 2006-07, the value of banknotes in circulation rose by 17.5 per cent (16.8 per cent during 2005-06). The ratio of currency with the public to GDP has risen steadily over the years from 9.5 per cent of GDP at end-March 1990 to 11.6 per cent at end-March 2006 and further to 11.7 per cent at end-March 2007. The ratio of currency with the public to broad money (M_3) declined from 15.1 per cent at end-March 2006 to 14.6 per cent at end-March 2007 continuing with its declining trajectory over the past few years.

VII.3 The volume of banknotes rose by 5.2 per cent during 2006-07 (2.3 per cent a year ago). The growth in the volume of banknotes, thus, continued to be substantially lower than that in value terms, mainly on account of the gradual compositional shift towards higher denomination banknotes, particularly Rs.1000 and Rs.500 denominations. While the volume of Rs.500 denomination notes increased by 23.6 per cent during 2006-07 (19.4 per cent a year ago), that of Rs.1000 denomination notes rose by 45.7 per cent (52.7 per cent a year ago). The volume of Rs.10 banknotes increased by 14 per cent due to sustained efforts to pump in more fresh banknotes into circulation to bring about an improvement in the quality of these banknotes. On the other hand, the volume of banknotes of denominations Rs.2 and Rs.5 declined during the year, while that of Rs.20, Rs.50 and Rs.100 remained at almost the same level as in 2005-06.

Currency operations

VII.4 The Reserve Bank continued with its initiatives to provide the public with good quality banknotes. Towards this objective, a multi-pronged approach is pursued involving regular supply of fresh notes, speedier disposal of soiled banknotes, improvement in inventory management and mechanisation of cash processing activity. In the recent period, the discontinuance of the practice of stapling banknotes has also contributed to improvement in quality of banknotes. Banks have been advised to issue only clean notes to the public and to remit the soiled notes in unstapled condition to the Reserve Bank through currency chests. Efforts are being made to increase the life of the banknotes and the Reserve Bank is examining various options in this regard.

Printing of Fresh Banknotes

VII.5 The supply of banknotes, both in volume and value terms, from the printing presses recovered during 2006-07 from the sharp decline in the preceding year. Total supplies in volume terms rose by 64 per cent during 2006-07 while those in value terms increased by almost 115 per cent during the year. Total supplies during 2006-07 were 99.8 per cent in terms of volume and 99.0 per cent in terms of value of the indent. The relatively lower supply of Rs.20 denomination banknotes *vis-à-vis* the indent was due to the reason that printing of these denominations with new/additional security features commenced late during 2006-07.

New/Additional Security Features of Banknotes

VII.6 In order to maintain the confidence of the public in the banknotes, the Reserve Bank, in consultation with the Government of India, reviews the security features of banknotes periodically. As a part of this process, the Reserve Bank had started from 2005-06, the introduction of banknotes with several new/additional security features in denominations of Rs.10, Rs.50, Rs.100, Rs.500 and Rs.1000. These include (a) demetallised, magnetic and machine readable windowed security thread with a colour shift from green to blue in Rs.100, Rs.500 and Rs.1000 denominations; (b) improved intaglio printing; (c) improved see-through feature incorporating the denominational numeral instead of the floral design; and (d) electrotype watermark featuring the denominational numeral alongside Mahatma Gandhi portrait in the watermark window. The process of issuance of all the denominations of the banknotes in the Mahatma Gandhi Series 2005 with additional/new security features was completed during 2006-07 with the issuance of Rs.20 denomination banknotes with additional/new security features in August 2006. Posters containing the pictorial details of additional/new security features on banknotes have been provided to all the banks for public dissemination. The Regional Offices of the Reserve Bank have been advised to facilitate public awareness of these security features at the local levels through organisations such as the railways and police authorities as well as through posters printed in vernacular. The details regarding the security features of the new banknotes have been posted on the Reserve Bank's website.

Introduction of Star Series Banknotes

VII.7 The Reserve Bank commenced the issuance of Star series banknotes in the denomination of Rs.10, Rs.20 and Rs.50 during 2006-07. The Star series banknotes look exactly like the earlier banknotes in the Mahatma Gandhi series but have an additional character, *viz.*,* (Star) in the number panel between the prefix and the serial number. The packets with Star series notes contain, as usual, 100 pieces, though not in serial order. The Star series system helps in streamlining the procedures at the printing presses and reducing manpower deployed in replacement activity. The bands of the fresh note packets containing the Star series numbered note/s clearly indicate the presence of such banknotes in the packets.

Computerisation of Currency Management

VII.8 The Reserve Bank has taken up the task of putting in place an Integrated Computerised Currency Operations and

Management System (ICCOMS) in the Issue Departments in Regional Offices and in the Central Office. The project also includes computerisation and networking of the currency chests with the Reserve Bank's offices to facilitate prompt, efficient and error-free reporting and accounting of the currency chest transactions and seamless flow of information between Issue Departments and the Central Office in a secure manner with proactive monitoring. All offices of the Reserve Bank commenced 'live-run' on the Currency Chest Reporting System (CCRS) and the Chest Accounting Module (CAM) of ICCOMS-ID component. Once these two components are completed, the Currency Management Information System (CMIS) Module at the Department of Currency Management (DCM) at the Central Office of the Reserve Bank will be taken up for implementation, the testing for which has already begun.

Outlook

VII.9 The Reserve Bank would continue to conduct its currency management operations with a view to ensuring efficient customer service through an adequate supply of good quality banknotes and coins in the country. The Reserve Bank will continue with its efforts to explore various options for increasing the circulation life of banknotes. Rationalisation of systems and procedures with a view to increasing the efficiency of operations and to strive towards setting international benchmarks in currency management would also be pursued.

VIII PAYMENT AND SETTLEMENT SYSTEMS AND INFORMATION TECHNOLOGY

VIII.1 Rapid and ongoing innovations in technology and communication infrastructure and its integration with the various modes of payments have led to significant changes in the payment and settlement systems. While leading to greater efficiency in the payment and settlement systems, these innovations have also necessitated increased emphasis on integrity of the various systems to maintain financial stability. The Reserve Bank, therefore, continued to take measures to provide efficient and integrated payment and settlement systems in the country during 2006-07 while simultaneously taking steps to mitigate risks. Furthermore, the use of information technology (IT) in various banking activities has witnessed a rapid expansion in recent years, both in the Reserve Bank and the commercial banking sector. Developments in IT are facilitating the processing of large volumes of transactions in an efficient and reliable manner.

VIII.2 The main thrust of the various initiatives relating to payment and settlement systems was on electronification of the payment systems and building of appropriate legal and technological infrastructure. The turnover of the RTGS system has expanded rapidly on account of movement of large value time critical payments to this system and the widening of the RTGS network to cover more bank branches. In order to enhance the efficiency of the paper based clearing system, the Reserve Bank has also undertaken a cheque truncation system (CTS). The Payment and Settlement Systems Bill has been placed in the Parliament. Once enacted, it would vest the Reserve Bank with the formal power to conduct oversight of the payment and settlement systems. As regards IT related initiatives in the Reserve Bank during 2006-07, an enterprise-wide approach continued to be adopted. In order to use the IT systems efficiently and to provide for business continuity, state-of-the-art data centres are being set up. The Institute for Development and Research in Banking Technology (IDRBT) continued to discharge its Certification Authority related functions for the banking sector, apart from managing the Indian Financial Network (INFINET) and the National Financial Switch (NFS) during the year.

Board for Regulation and Supervision of Payment and Settlement Systems

VIII.3 The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), constituted in March 2005, as a Committee of the Central Board of the Reserve Bank, is entrusted with the responsibility for the smooth development and functioning of the payment and settlement systems in the country. Specific directions of the Board included (i) preparing a roadmap for migration from paper-based funds transfer to electronic payment systems; (ii) bringing all real time gross settlement (RTGS) enabled branches under the national electronic funds transfer (NEFT); (iii) exploring the feasibility of setting up a low cost cross-border remittance system with neighbouring countries, especially Nepal; (iv) studying the feasibility of a couple of large banks providing associate membership to the smaller banks to participate in the cheque truncation system; (v) proposal to conduct an assessment of the RTGS system; (vi) studying payment systems in select countries to draw relevant lessons for India; and (vii) promoting credit/debit/pre-paid cards as one of the strategies for the increased use of electronic payments.

DEVELOPMENTS IN PAYMENT AND SETTLEMENT SYSTEMS

VIII.4 In value terms, the annual turnover in the various payment and settlement systems rose by 37.5 per cent during 2006-07 (44.2 per cent during 2005-06). As a ratio to GDP, the annual turnover in terms of value increased from 6.0 in 2003-04 to 10.3 by 2006-07. The rise in the turnover could be attributed mainly to increased activity in financial markets which, in turn, reflects various measures to widen and deepen the various segments of the financial markets. The expansion in the turnover during 2006-07 was led by the systemically important payments systems (SIPS); the turnover in the SIPS segment now constitutes more than four-fifths of the total turnover. Amongst the various constituents of the SIPS, the RTGS constituted the largest segment in terms of value (over 50 per cent), followed by foreign exchange clearing and high value clearing. The turnover of the RTGS system continued to expand rapidly, both in terms of volume and value (60 per cent growth in the latter during 2006-07 on top of an increase of 183 per cent during 2005-06). The growth in RTGS can be attributed largely to the movement of large value time critical payments to this system and the widening of the RTGS network to cover more bank branches.

VIII.5 The integration of the RTGS with the Integrated Accounting System (IAS) has enabled the provision of online funds transfer facility from current account with the Reserve Bank to the RTGS settlement account and *vicè versa*. The integration also facilitates settlement of various CCIL-operated clearings (inter-bank Government securities, inter-bank foreign exchange, CBLO and National Financial Switch) through multilateral net settlement batch (MNSB) mode in the RTGS in Mumbai. With the integration of the RTGS-IAS with the securities settlement system (SSS), automatic intra-day liquidity (IDL) is available as per the eligibility of the participants.

INFORMATION TECHNOLOGY

VIII.6 The use of information technology in the day-to-day operations of the Reserve Bank has increased rapidly in the past few years with the objective of reaping efficiency gains. The intensive use of IT in the Reserve Bank is reflected in the setting up of the state-of-the-art data centres. The Reserve Bank is in the process of setting up three data centres which, besides enabling the consolidation of systems and centralised data processing, would also take care of business continuity and disaster recovery in the event of any contingency. With the establishment of the data centres, the process of migration of systems from the existing distributed setup to the centralised backbone at the data centre would commence. The Central Accounts Section (CAS) system and the Document Management Information System (DMIS) are being migrated to the new setup, while work is currently in progress in respect of migration of the Centralised Public Accounts Department System (CPADS); other systems are at various stages of migration.

Technology Implementation within the Reserve Bank

VIII.7 The focus of the IT facilitatory services for the internal users of the

Reserve Bank followed a three-pronged approach. This includes (a) adhering to the 'centralisation with decentralised access' approach so as to ensure smooth migration to the data centres; (b) aiming at the goal of 'providing capabilities for on-line transaction processing, analytical and decision support facilities at the desktop of each official of the Bank'; and (c) activating high levels of safety and security in the IT based processing environment.

VIII.8 The current status of the IT based systems for the key operational areas of the Reserve Bank is as follows:

- The Deposit Accounts Department (DAD) at Mumbai migrated to the use of the new integrated accounting system (IAS), replacing the erstwhile BASIS system.
- The new Centralised Public Accounts Department System (CPADS) has been made operational at Chennai, Thiruvananthapuram, New Delhi and Hyderabad.
- The Centralised Public Debt Office (CPDO) system, in use for more than three years, has been upgraded to meet the changing requirements of debt management policies.
- The integrated computerised currency operations and management system (ICCOMS) was made operational during 2006-07, with more than 90 per cent of the currency chests in the country and more than 92 per cent of the link offices reporting movement of currency notes through this system.

VIII.9 The setting up of the data centres follows the need for consolidation of IT systems to facilitate better management of such systems. The data centres also take care of the needs for business continuity, with recovery time objectives (RTO) surpassing normal standards and recovery process objectives requiring 'zero data loss' levels. To this end, high availability of the systems is being provided for at the data centres which, apart from providing for the state-of-the-art latest technological platforms, would also match the Tier IV Standard of the Uptime Institute.

Outlook

VIII.10 The Reserve Bank will persevere with its objectives of ensuring greater efficiency in the payment and settlement systems in a secure manner. The focus in the coming years would be on consolidation of the existing payment systems while promoting electronic means of payment and settlements. Efforts to create infrastructure for remittance facility between some of the neighbouring countries would be pursued. In order to achieve the objective of timely, cheap and dependable service to customers, an annual review of the payment and settlement systems is proposed, beginning with a review for the year ended March 31, 2007. The review would be based on parameters such as timeliness of customer service, cost of operation, service charges and overall impact on the financial system.

VIII.11 The Reserve Bank would intensify steps to achieve greater operational efficiency within the organisation through large scale and holistic IT usage. In this context, the setting up of data centres would enable the functional units to focus more on their business related functions with the IT related aspects being managed centrally out of the data centres. The Financial Sector Technology Vision Document will be reviewed in the light of developments in the financial system.

IX HUMAN RESOURCE DEVELOPMENT AND ORGANISATIONAL MATTERS

IX.1 In view of the fast changing external environment brought about by the growing deregulation, liberalisation and opening up of the Indian economy, human resources management has assumed high significance. The Reserve Bank, therefore, continued with its endeavour of upgrading the skills of its human resources. The focus was on facilitating the transition to a learning environment that lays stress on developing functional, inter-personal and leadership skills, creativity and communication capabilities as well as the ability to work in a cross-cultural work environment and with cross-functional teams. Efforts to benchmark the work processes in the Reserve Bank to the international best practices were carried forward during 2006-07. With a view to reaching out to the common person in the country, the Reserve Bank has also been suitably designing and developing communication strategies for disseminating information on its policies. Speeches by Top Management, reports of the various Working Groups, and regular publications, an important part of the communication policy, are all placed on the Reserve Bank's website.

HUMAN RESOURCE INITIATIVES

Training and Skills Enhancement

IX.2 Three training colleges of the Reserve Bank, *viz*., the Bankers' Training College (BTC), Mumbai, the Reserve Bank Staff College (RBSC), Chennai and the College of Agricultural Banking (CAB), Pune continued to cater to the training needs of the officers of the Reserve Bank and the banking industry. The four Zonal Training Centres (ZTCs) focused on training of Class III and IV staff of the Reserve Bank.

Dissemination Policy

IX.3 In order to explain the rationale and the analytics of its policies to the public, the Reserve Bank disseminates a wide range of information through press releases, notifications, master circulars, publications, speeches, frequently asked questions and advertisements. During the year ended June 30, 2007, the Reserve Bank issued 1,826 press releases, 79 master circulars and 447 notifications. It organised meetings, workshops and seminars to interact with special audiences. The e-mail helpdesks continued to furnish replies to the queries raised by the general public. Members of the public continued to send their queries relating to various services provided by the Reserve Bank through e-mail/ telephone/fax to the helpdesks set up in various departments and Regional Offices. These queries are over and above the queries received under the Right to Information Act.

The Right to Information Act, 2005

IX.4 The Government of India enacted the Right to Information Act, 2005 on June 15, 2005. The Act, which came into effect from October 12, 2005, aims at providing the right to information to citizens in order to promote transparency and accountability in the working of every public authority. The Reserve Bank, as a public authority, as defined in the Right to Information Act, 2005 is obliged to provide information to the members of public. Central Assistant Public Information Officers (CAPIOs) have been designated to receive the applications for information or appeals under the Act at all Regional Offices and Central Office departments. Increased awareness of the Act resulted in a rise in the number of requests for information received from 796 (October 2005 to June 2006) to 2,163 (July 2006 to June 2007). Almost 95 per cent of the requests received during the period were resolved. Furthermore, 393 appeals against non-disclosure of information were received by the Bank's Appellate Authority. In 53 such cases, the appellants approached the Central Information Commission (CIC).

Risk Management

IX.5 The Reserve Bank performs several functions of a diverse nature. These functions expose the Reserve Bank to various risks such as market risk, credit risk, liquidity risk and operational risk. Market risk is one of the critical sources of risk faced by the Reserve Bank which arises from revaluation of its financial assets due to exchange rate and interest rate changes both in India and abroad. The balance sheet of the Reserve Bank has become very sensitive to exchange rate changes due to increase in the share of foreign currency assets in its balance sheet in recent years. Since foreign currency assets are invested in fixed income instruments, they are also subject to interest rate changes. Deployment of foreign currency assets and gold in deposits and debt instruments, lending or refinancing operations of the Reserve Bank expose it to credit risk. Liquidity risk arises when foreign currency assets are to be converted into cash for intervening in the markets or meeting any other cash obligations. The Reserve Bank is also exposed to operational risk which may result in direct or indirect loss on account of inadequate or failed internal process, people and systems or from external events.

IX.6 These risks are managed in line with the laid down policy. Market risk is periodically monitored. Credit risk is managed by placing limits for counterparties and entering into transactions through delivery *versus* payment systems. Liquidity risk is effectively managed by deploying a considerable proportion of foreign currency assets in highly liquid assets.

IX.7 Adequate measures have also been taken to mitigate operational risk by ensuring sound internal control systems/inspection/audit arrangements and well laid down procedures and policies, business continuity plan for systems, insurance and physical safety of assets, process control and validation checks for data integrity. For managing the operational risk, increased emphasis is being placed on promoting human integrity and alertness. Since operational risk is unquantifiable, the Reserve Bank has also initiated measures for developing a database of past losses/ operational risks to analyse and control the same.

Research Activities

Department of Economic Analysis and Policy

IX.8 The Department of Economic Analysis and Policy (DEAP) provided policy research relating to various aspects of the economy. The Department also contributed to the Reserve Bank's efforts to disseminate information to the public about its policies and assessments through major publications. The statutory reports prepared in the Department and released during the year were the Reserve Bank's Annual Report, 2005-06, and the Report on Trend and Progress of Banking in India, 2005-06. The Report on Currency and Finance, 2005-06 covering the theme "Development of Financial Markets and Role of the Central Bank" was released during the year. The Report assessed the various aspects of the development of the different segments of the financial market and also provided a way forward for each market segment for further development of financial markets in India. The publication "State Finances: A Study of Budgets of 2006-07", providing a comprehensive assessment of the evolving developments and trends in consolidated finances of the State Governments, was released during the year.

Department of Statistical Analysis and Computer Services

IX.9 The Department of Statistical Analysis and Computer Services (DESACS) provides high quality statistical service which encompasses collection, compilation, analysis and dissemination of information relating to various sectors of the economy. The Department is also entrusted with managing electronic data dissemination platforms, *viz.*, Central Database Management System (CDBMS) and Database on Indian Economy (DBIE). Providing technical support to other departments in statistical analysis and large-scale data management in specific areas also form the core activities of the Department.

CENTRAL BOARD AND ITS COMMITTEES

IX.10 Seven meetings of the Central Board were held during the year ended June 30, 2007. Of these, four meetings were held at traditional centres (New Delhi, Kolkata, Chennai and Mumbai) and three were held at non-traditional centres (Raipur, Hyderabad and Shimla). Forty-six weekly meetings of the Committee of the Central Board were held during the year at Mumbai. Three Committees (Committee of the Central Board, Board for Financial Supervision and Board for Payment and Settlement Systems) and three sub-Committees (Inspection and Audit Sub-Committee, Staff Sub-Committee and Building Sub-Committee) have been constituted to assist the Central Board in direction of the affairs of the Reserve Bank. The Committee of the Central Board, as usual, attended to the current business of the Reserve Bank, including approval of the Reserve Bank's weekly accounts pertaining to the Issue and the Banking Departments. The discussions at the meetings of the Central Board broadly covered matters pertaining to general superintendence and direction of the Reserve Bank's affairs, in which the Directors, with their vast experience in diverse fields, actively contributed to important decisions pertaining to currency management, information technology, human resource development, banking regulation and supervision, monetary and credit policy, the Reserve Bank's accounting policy, internal debt management policy, among others. The deliberations of the Board also focused on the critical assessment of the percolation of benefits of growth to the poorer sections of society and on agriculture and rural areas in general.

Directors/Members of the Central Board/ Local Boards

IX.11 Shri Sanjay Labroo was nominated as Director of the Central Board of the Reserve Bank with effect from January 2, 2007 under Section 8(1) (c) of the Reserve Bank of India Act, 1934 in place of Shri D.S. Brar who ceased to be a Director of the Central Board with effect from January 2, 2007. Shri Labroo was nominated on the Inspection and Audit Sub-Committee (IASC) of the Central Board. Dr. D. Subbarao, Secretary, Department of Economic Affairs, Ministry of Finance, Government of India was nominated as Director on the Central Board under Section 8(1)(d) of the Reserve Bank of India Act, 1934, with effect from May 10, 2007 *vice* Shri Ashok K. Jha. Dr. Subbarao has been designated as Finance Secretary and Secretary, Department of Economic Affairs with effect from July 2, 2007. Prof. Mahendra Singh Sodha, resigned from the Local Board (Western Area) with effect from May 10, 2007 for personal reasons.

X THE RESERVE BANK'S ACCOUNTS FOR 2006-07

X.1 During the year, Bank's entire equity holding in State Bank of India of 31,43,39,200 shares (Book value Rs.1,222.73 crore) was transferred to the Government of India at market rate, resulting in a profit of Rs.34,308.60 crore. This extraordinary profit item has been accounted under interest and other income which has made the figures non-comparable with earlier years.

Surplus Transferable to Government of India

X.2 The surplus transferable to the Government of India for the year 2006-07 amounted to Rs.45,719.60 crore, inclusive of (i) Rs.1,914.00 crore towards interest differential on special securities converted into marketable securities, intended to compensate the Government for the difference in interest expenditure which the Government had to bear consequent on the conversion of special securities and (ii) Rs.34,308.60 crore pertaining to profit on sale of SBI shares held by the Reserve Bank to the Government of India.

Income

X.3 The gross income of the Reserve Bank for the year 2006-07 was Rs.75,348.33 crore, which includes Rs.34,308.60 crore on account of profit on sale of SBI shares. The gross income (excluding profit on sale of SBI shares) was Rs.41,039.73 crore, registering an increase of 55.9 per cent over the previous year. This was mainly on account of increase in income from foreign sources. Income from domestic sources (excluding profit on sale of SBI shares) also increased during the year.

Earnings from Foreign Sources

X.4 The Reserve Bank's earnings from the deployment of foreign currency assets and gold increased by Rs.10,614.96 crore (43.3 per cent) from Rs.24,538.03 crore in 2005-06 to Rs.35,152.99 crore in 2006-07. This was mainly on account of increase in the level of foreign currency assets and hardening of global short-term interest rates. Before accounting for mark-to-market depreciation on securities, the rate of earnings on foreign currency assets and gold was 4.7 per cent in 2006-07 as against 4.1 per cent in 2005-06. The rate of earnings on foreign currency assets and gold, after accounting for depreciation, increased from 3.9 per cent in 2005-06 to 4.6 per cent in 2006-07.

Income from Domestic Sources

X.5 Domestic income (excluding the profit on sale of SBI shares to the Government of India) for the year 2006-07 increased to Rs.5,886.74 crore as against Rs.1,782.28 crore in the previous year.The increase in domestic income was mainly on account of lower provisioning for depreciation on securities held in the Bank's portfolio. Higher net interest earned under the liquidity adjustment facility (LAF) during 2006-07 also contributed to higher income Domestic income including profit on sale of SBI shares increased from Rs.1,782.28 crore during 2005-06 to Rs.40,195.34 crore during 2006-07.

EXPENDITURE

X.6 Total expenditure of the Reserve Bank increased by Rs.1,315.15 crore (22.5 per cent) from Rs 5,849.10 crore in 2005-06 to Rs.7,164.25 crore in 2006-07.

Interest Payment

X.7 Interest payment decreased by Rs.389.03 crore (25.5 per cent) from Rs.1,524.41 crore in 2005-06 to Rs.1,135.38 crore in 2006-07. This was mainly on account of lower interest payments on eligible cash reserve ratio (CRR) balances. Further, no interest is payable on eligible CRR balances with effect from March 31, 2007. Hence, interest was paid only for 9 months during the year 2006-07.

Establishment Expenditure

X.8 Establishment expenditure increased from Rs.919.88 crore in 2005-06 to Rs.1,425.81 crore in 2006-07 mainly on account of increase in provision towards Gratuity and Superannuation Fund from Rs.19.26 crore in 2005-06 to Rs.453.01 crore in 2006-07, as advised by actuaries. Net of this provision, the increase was Rs.72.18 crore. The establishment expenditure during 2006-07 comprised salary (30.2 per cent), allowances (18.2 per cent), funds (35.1 per cent) and miscellaneous expenditure (16.5 per cent).

Non-Establishment Expenditure

X.9 The expenditure incurred on security printing (cheque, note forms, *etc.*) charges in 2006-07(July-June) increased by Rs.986.03 crore (95.3 per cent) to Rs.2,020.89 crore from Rs.1,034.86 crore in 2005-06. The increase in expenditure was on account of increase in supply of bank notes (63.9 per cent) to 11,473.3 million pieces in 2006-07 from 7,001 million pieces in 2005-06 and introduction of bank notes with additional/new security features.

BALANCE SHEET

LIABILITIES

X.10 There were no operations in the National Industrial Credit (Long Term Operations) Fund (established under Section 46 C of the Reserve Bank of India Act, 1934) during 2006-07 except the credit of Rs.1.00 crore to the Fund out of the Reserve Bank's income. The National Housing Credit (Long Term Operations) Fund was established by the Reserve Bank in terms of Section 46 D(1) of the Reserve Bank of India Act, 1934 in January 1989. A token contribution of Rs.1.00 crore was made to the Fund out of the Reserve Bank's income during 2006-07. 'Deposits - Banks' represent balances maintained by banks in current account with the Reserve Bank mainly for maintaining CRR and as working funds for clearing adjustments. 'Deposits - Others' include deposits from financial institutions, employees' provident fund deposits, surplus earmarked pending transfer to the Government and sundry deposits.

X.11 'Other Liabilities' include the internal reserves and provisions of the Reserve Bank and net credit balance in the RBI General Account. These liabilities declined by Rs.43,173.78 crore (25.1 per cent) from Rs.1,72,373.80 crore as on June 30, 2006 to Rs.1,29,200.02 crore as on June 30, 2007 mainly on account of decrease in the level of Currency and Gold Revaluation Account (CGRA).

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

X.12 Gains/losses on valuation of foreign currency assets and gold due to movements in the exchange rates and/ or prices of gold are not taken to Profit and Loss Account but instead booked under a balance sheet head named as CGRA. The balance represents accumulated net gain on valuation of foreign currency assets and gold. During 2006-07, there was a depletion of Rs.65,065.66 crore in CGRA, thus decreasing its balance from Rs.86,789.18 crore as on June 30, 2006 to Rs.21,723.52 crore as on June 30, 2007. The balance in CGRA at the end of June 2007 was equivalent to 2.5 per cent of foreign currency assets and gold holdings of the Reserve Bank, as compared with 11.6 per cent at the end of June 2006. The decrease was on account of depreciation of US dollar against Indian Rupee calculated on an increased level of foreign currency assets during 2006-07. The balance in EEA represents provision made for exchange losses arising out of forward commitments. The balance in the EEA as on June 30, 2007 stood at Rs.9.68 crore. The balances in CGRA and EEA are grouped under 'Other Liabilities' in the balance sheet.

Contingency Reserve and Asset Development Reserve

X.13 The Reserve Bank maintains a Contingency Reserve (CR) to enable it to absorb unexpected and unforeseen contingencies.The balance in CR increased from Rs.73,281.10 crore as on June 30, 2006 to Rs.93,770.07 crore as on June 30, 2007 with the transfer of Rs.20,488.97 crore made to CR during 2006-07 from the Reserve Bank's income. The balance in CR is sufficient to meet contingent liabilities.

X.14 In order to meet the internal capital expenditure and make investments in its subsidiaries and associate institutions, the Reserve Bank had created a separate Asset Development Reserve (ADR) in 1997-98, with the aim of reaching one per cent of the Reserve Bank's total assets within the overall indicative target of 12 per cent set for CR. In the year 2006-07, an amount of Rs.1,971.51 crore was transferred from income to ADR raising its level from Rs.7,592.82 crore as on June 30, 2006 to Rs.9,564.33 crore as on June 30, 2007. CR and ADR together constituted 10.3 per cent of total assets of the Bank as on June 30, 2007.

ASSETS

Foreign Currency Assets

X.15 The foreign currency assets comprise foreign securities held in Issue Department, balances held abroad and investments in foreign securities held in Banking Department. Such assets rose from Rs.7,18,701.18 crore as on June 30, 2006 to Rs.8,39,878.79 crore as on June 30, 2007. The increase in the level of foreign currency assets was mainly on account of net purchases of US dollars from the market and interest and discount received.

Investment in Government of India Rupee Securities

X.16 Investment in Government of India Rupee Securities, which was Rs.38,934.50 crore as on June 30, 2006, increased by Rs.50,145.16 crore (128.8 per cent) to Rs.89,079.66 crore as on June 30, 2007.The increase is largely attributable to the purchases under RBI LAF operations, as system liquidity changed to deficit mode on June 29, 2007 from a liquidity surplus situation on June 30, 2006.

Investments in Shares of Subsidiaries and Associate Institutions

X.17 During the year, the Bank's holdings in State Bank of India (Rs.1,222.73 crore) were sold to the Government of India. There was no other change in the Reserve Bank's investments in the shares of its subsidiaries and associate institutions.

Other Assets

X.18 'Other Assets' comprise mainly fixed assets, gold holdings in the Banking Department, amounts spent on projects pending completion and staff advances. The level of 'Other Assets' increased by Rs.6,620.71 crore (32.1 per cent) from Rs.20,623.80 crore as on June 30, 2006 to Rs.27,244.51 crore as on June 30, 2007.

RESERVE BANK OF INDIA
BALANCE SHEET AS AT 30TH JUNE 2007

ISSUE DEPARTMENT

(Rupees Thousands)

2005-06	LIABILITIES	2006-07	2005-06	ASSETS	2006-07
	Notes held in the			**Gold Coin and Bullion:**	
11,60,96	**Banking Department** **16,99,84**		23265,67,29	(a) Held in India **22592,97,15**	
440977,00,18	**Notes in circulation** **506545,30,17**		–	(b) Held outside India –	
			416525,46,17	**Foreign Securities** **482800,79,66**	
440988,61,14	**Total Notes issued**	**506562,30,01**	439791,13,46	**Total**	**505393,76,81**
			151,04,68	**Rupee Coin**	**122,10,20**
			1046,43,00	**Government of India Rupee Securities**	**1046,43,00**
			–	**Internal Bills of Exchange and other Commercial Paper**	–
440988,61,14	**Total Liabilities**	**506562,30,01**	440988,61,14	**Total Assets**	**506562,30,01**

BANKING DEPARTMENT

2005-06	LIABILITIES	2006-07	2005-06	ASSETS	2006-07
5,00,00	**Capital paid-up**	**5,00,00**	11,60,96	**Notes**	**16,99,84**
6500,00,00	**Reserve Fund**	**6500,00,00**	10,32	**Rupee Coin**	**3,84**
	National Industrial Credit		4,16,82	**Small Coin**	**3,82**
15,00,00	**(Long Term Operations) Fund**	**16,00,00**			
	National Housing Credit			**Bills Purchased and Discounted :**	
189,00,00	**(Long Term Operations) Fund**	**190,00,00**	–	(a) Internal	–
			–	(b) External	–
			–	(c) Government Treasury Bills	–
	Deposits		278498,41,58	**Balances Held Abroad**	**329695,08,67**
	(a) Government				
33395,23,29	(i) Central Government	**81236,85,31**			
41,17,69	(ii) State Governments	**41,18,09**			
	(b) Banks		65538,16,23	**Investments**	**118166,19,46**
126129,85,51	(i) Scheduled Commercial Banks	**206613,01,42**			
1827,03,54	(ii) Scheduled State Co-operative Banks	**2620,36,50**			
2207,55,33	(iii) Other Scheduled Co-operative Banks	**3475,30,34**			
50,68,59	(iv) Non-Scheduled State Co-operative Banks	**50,70,07**			
4053,46,63	(v) Other Banks	**5774,86,24**			
20613,91,74	**(c) Others**	**59249,57,87**		**Loans and Advances to :**	
			–	(i) Central Government	**19421,00,00**
			105,74,00	(ii) State Governments	**174,40,00**
429,44,80	**Bills Payable**	**419,19,77**		**Loans and Advances to:**	
			2,06,00	(i) Scheduled Commercial Banks	**580,53,00**
			–	(ii) Scheduled State Co-operative Banks	**10,00,00**
			–	(iii) Other Scheduled Co-operative Banks	–
			–	(iv) Non-Scheduled State Co-operative Banks	–
			2962,87,96	(v) NABARD	–
			34,23,00	(vi) Others	**33,28,48**
172373,79,72	**Other Liabilities**	**129200,02,09**		**Loans, Advances and Investments from National Industrial Credit (Long Term Operations) Fund:**	
				(a) Loans and Advances to:	
			–	(i) Industrial Development Bank of India	–
			–	(ii) Export Import Bank of India	–
			–	(iii) Industrial Investment Bank of India Ltd.	–
			–	(iv) Others	–
				(b) Investments in bonds/debentures issued by:	
			–	(i) Industrial Development Bank of India	–
			–	(ii) Export Import Bank of India	–
			–	(iii) Industrial Investment Bank of India Ltd.	–
			–	(iv) Others	–
				Loans, Advances and Investments from National Housing Credit (Long Term Operations) Fund:	
			50,00,00	(a) Loans and Advances to National Housing Bank	**50,00,00**
			–	(b) Investments in bonds/ debentures issued by National Housing Bank	–
			20623,79,97	**Other Assets**	**27244,50,59**
367831,16,84	**Total Liabilities**	**495392,07,70**	367831,16,84	**Total Assets**	**495392,07,70**

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

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH JUNE 2007

(Rupees Thousands)

2005-06	INCOME		2006-07
14257,09,61	**Interest, Discount, Exchange, Commission *etc.*** [1]		**52887,85,08**
14257,09,61	**Total**		**52887,85,08**
	EXPENDITURE		
1524,41,09	**Interest**		**1135,38,41**
919,88,29	**Establishment**		**1425,81,16**
1,19,11	**Directors' and Local Board Members' Fees and Expenses**		**1,50,46**
17,01,03	**Remittance of Treasure**		**21,22,84**
1833,55,04	**Agency Charges**		**2042,49,63**
1034,86,21	**Security Printing (Cheque, Note forms *etc.*)**		**2020,89,24**
17,50,64	**Printing and Stationery**		**17,49,52**
46,70,75	**Postage and Telecommunication Charges**		**34,87,24**
59,10,63	**Rent, Taxes, Insurance, Lighting *etc.***		**60,05,12**
1,88,91	**Auditors' Fees and Expenses**		**1,81,82**
2,95,27	**Law Charges**		**1,76,95**
179,25,59	**Depreciation and Repairs to Bank's Property**		**181,40,07**
210,77,05	**Miscellaneous Expenses**		**219,52,25**
5849,09,61	**Total**		**7164,24,71**
8408,00,00	**Available Balance**		**45723,60,37**
	Less: Contribution To:		
	National Industrial Credit (Long Term Operations) Fund	1,00,00	
	National Rural Credit (Long Term Operations) Fund [2]	1,00,00	
	National Rural Credit (Stabilisation) Fund [2]	1,00,00	
	National Housing Credit (Long Term Operations) Fund	1,00,00	
4,00,00			**4,00,00**
8404,00,00	**Surplus Payable to Central Government**		**45719,60,37**

1. After making the usual or necessary provisions in terms of Section 47 of the Reserve Bank of India Act, 1934 amounting to Rs.22460,47,52 thousands (2005-06 – Rs.12063,21,12 thousands).
2. These funds are maintained by National Bank for Agriculture and Rural Development (NABARD).

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

REPORT OF THE AUDITORS

TO THE PRESIDENT OF INDIA

We, the undersigned auditors of Reserve Bank of India (hereinafter referred to as the Bank), do hereby report to the Central Government upon the Balance Sheet of the Bank as at June 30, 2007 and the Profit and Loss Account for the year ended on that date.

We have examined the Balance Sheet of the Bank as at June 30, 2007 and the Profit and Loss Account of the Bank for the year ended on that date and report that where we have called for information and explanations from the Bank, such information and explanations have been given to our satisfaction.

These financial statements include the accounts of nineteen Accounting Units of the Bank which have been audited by the Statutory Branch Auditors. The branch audit reports have been furnished to us which we have considered in preparing our report.

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

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

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

A. D. Shenoy
(M. No. 11549)
For Ford, Rhodes, Parks & Co.,
Chartered Accountants

Daraius Z. Fraser
(M. No. 42454)
For Kalyaniwalla & Mistry
Chartered Accountants

Dated August 9, 2007