Macroeconomic and Monetary Developments

First Quarter Review 2006-07

Reserve Bank of India
Mumbai

Contents

I. THE REAL ECONOMY

The Indian economy recorded robust growth for the third successive year during 2005-06, backed by sustained manufacturing activity and impressive performance of the services sector with reasonable support from the recovery in agricultural activity. After recording some slowdown in the third quarter (October-December) of 2005-06, real gross domestic product (GDP) registered a sharp increase in the fourth quarter (January-March) of 2005-06 benefiting from a pick-up in almost all sub-sectors (Table 1 and Chart 1). According to the revised estimates released by the Central Statistical Organisation (CSO) in May 2006, real GDP accelerated from 7.5 per cent in 2004-05 to 8.4 per cent during 2005-06. The Indian economy has, thus, recorded an average growth of over eight per cent in the latest three years (2003-04 to 2005-06).

Table 1: Growth Rates of Real GDP
(Base Year : 1999-2000)

(Per cent)

Sector	2000-01 to 2002-03 (Average)	2003-04	2004-05*	2005-06#	2004-05				2005-06			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11	12	13
1. Agriculture and Allied Activities	**-0.2**	**10.0**	**0.7**	**3.9**	**3.5**	**-0.2**	**-1.2**	**1.5**	**3.4**	**4.0**	**2.9**	**5.5**
	(23.5)	**(22.2)**	**(20.8)**	**(19.9)**								
1.1 Agriculture	-0.5	10.7	0.7	..								
2. Industry	**5.2**	**6.6**	**7.4**	**7.6**	**6.6**	**8.0**	**8.1**	**6.8**	**9.5**	**6.3**	**7.0**	**7.9**
	(19.7)	**(19.5)**	**(19.5)**	**(19.3)**								
2.1 Mining and Quarrying	4.4	5.3	5.8	0.9	8.2	6.0	5.7	3.7	3.1	-2.6	0.0	3.0
2.2 Manufacturing	5.7	7.1	8.1	9.0	6.6	8.3	9.2	8.1	10.7	8.1	8.3	8.9
2.3 Electricity, Gas and Water Supply	2.8	4.8	4.3	5.3	4.9	7.9	3.1	1.4	7.4	2.6	5.0	6.1
3. Services	**6.6**	**8.5**	**10.2**	**10.3**	**10.0**	**8.2**	**10.6**	**11.6**	**10.1**	**10.3**	**9.7**	**11.0**
	(56.8)	**(58.3)**	**(59.7)**	**(60.7)**								
3.1 Trade, Hotels, Restaurants, Transport, Storage and Communication	8.5	12.0	9.7	11.0	10.2	12.9	10.6	11.5	10.6	11.2	11.7	11.0
3.2 Financing, Insurance, Real Estate and Business Services	6.5	4.5	9.2	9.7	8.8	7.5	9.7	10.7	8.8	10.5	8.9	10.5
3.3 Community, Social and Personal Services	4.1	5.4	9.2	7.8	10.7	4.8	8.5	12.7	7.3	8.0	8.4	7.6
3.4 Construction	5.9	10.9	12.5	12.1	8.9	6.8	20.8	13.5	12.4	12.3	11.5	12.0
4. Real GDP at Factor Cost	**4.6**	**8.5**	**7.5**	**8.4**	**7.9**	**6.7**	**7.0**	**8.6**	**8.5**	**8.4**	**7.5**	**9.3**

* : Quick Estimates. #: Revised Estimates. .. : Not available separately.

Note : 1. Figures in parentheses denote percentage shares in real GDP.
2. Q1 : First Quarter (April-June); Q2: Second Quarter (July-September); Q3: Third Quarter (October- December); Q4 : Fourth Quarter (January-March).

Source : Central Statistical Organisation.

Developments during 2006-07

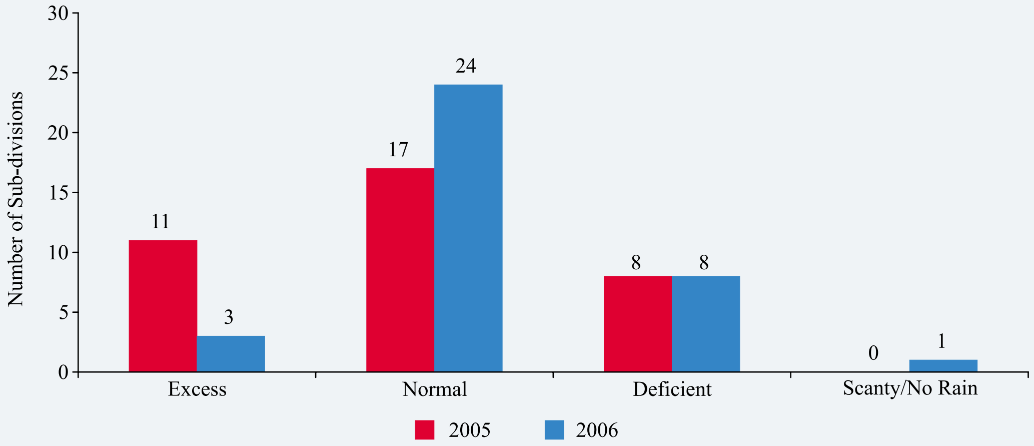
Against this backdrop of robust economic activity during 2005-06, developments in the various sectors of the Indian economy during 2006-07 so far are covered in this Chapter. These include the progress of the South-West monsoon and *kharif* sowing, industrial production, lead information on drivers of service sector activity and indicators of business and investment expectations.

Agricultural Situation

The India Meteorological Department (IMD) in its forecast on April 24, 2006 indicated that the rainfall during the South-West monsoon season (June-September) 2006 for the country as a whole is likely to be 93 per cent of the Long Period Average (LPA) with a model error of +/- 5 per cent. In its update on June 30, 2006, the IMD revised its forecast for the 2006 season marginally to 92 per cent of the LPA with a model error of +/- 4 per cent. It also forecast rainfall for the month of July 2006 at 97 per cent of the LPA with a model error of +/-9 per cent.

The monsoon arrived six days in advance - it reached Kerala on May 26, 2006 and covered rapidly the west coast by May 31, 2006 and up to Gujarat by June 2, 2006. Subsequently, the monsoon entered a weak phase and there was a prolonged hiatus in advancement of monsoon for about 17 days. The monsoon revived in the last week of June 2006, and advanced further into other regions. The cumulative rainfall during the South-West monsoon season 2006 so far (June 1 to July 12, 2006) has been 10 per cent below normal as compared with 1 per cent above normal during the comparable period of 2005. Of the 36 meteorological sub-divisions, cumulative rainfall was deficient/scanty/no rain in 9 sub-divisions (8 sub divisions during last year) (Chart 1). At the district level,

Chart 2: South-West Monsoon: Cumulative Rainfall (up to July 12, 2006)



59 per cent of the total number of districts (533) reported excess/normal rainfall, while the rest received deficient/scanty/no rain. The total live water storage in the 76 major reservoirs[1] as on July 14, 2006 was 37 per cent of the Full Reservoir Level (FRL), higher than that of 29 per cent a year ago.

The area coverage under *kharif* crops up to July 10, 2006 was around 11.9 per cent higher than a year ago. For all crops taken together, around 27 per cent of the normal area has been sown so far (Table 2).

Table 2: Progress of Area under *Kharif* Crops – 2006-07

(Million Hectares)

Crop	Normal Area	Area Coverage (As on July 10)		
		2005	2006	Variation 2006 over 2005
1	2	3	4	5
Rice	39.9	5.4	6.1	0.7
Coarse Cereals	22.9	6.8	7.3	0.5
Of which				
Bajra	9.3	2.4	2.1	-0.3
Jowar	4.6	1.1	1.2	0.1
Maize	6.0	2.7	3.5	0.8
Total Pulses	**10.6**	**2.0**	**2.7**	**0.7**
Total *Kharif* Oilseeds	**15.1**	**3.3**	**3.4**	**0.1**
Of which				
Groundnut	5.5	1.2	1.6	0.4
Soyabean	6.3	1.3	1.1	-0.2
Sesamum	1.6	0.3	0.3	0.0
Sunflower	0.5	0.2	0.4	0.2
Sugarcane	**4.3**	**4.3**	**4.5**	**0.2**
Cotton	**8.3**	**2.5**	**3.3**	**0.8**
All Crops	**101.1**	**24.3**	**27.2**	**2.9**

Source : Ministry of Agriculture, Government of India.

[1] These reservoirs account for 63 per cent of the total reservoir capacity of the country.

Table 3: Agricultural Production

(Million Tonnes)

Crop	2003-04		2004-05		2005-06	
	T	A	T	A	T	A $
1	2	3	4	5	6	7
Rice	87.0	88.5	93.5	83.1	87.8	91.0
Wheat	72.1	72.2	79.5	68.6	75.5	69.5
Coarse Cereals	37.8	37.6	36.8	33.5	36.5	34.7
Pulses	15.2	14.9	15.3	13.1	15.2	13.1
Total Foodgrains	**212.1**	**213.2**	**225.1**	**198.4**	**215.0**	**208.3**
Kharif	112.0	117.0	113.8	103.3	109.9	109.7
Rabi	100.0	96.2	111.3	95.1	105.1	98.6
Total Oilseeds	**25.1**	**25.2**	**26.2**	**24.4**	**26.6**	**27.7**
Kharif	17.0	16.7	16.3	14.2	16.2	16.8
Rabi	8.1	8.5	9.9	10.2	10.4	10.9
Sugarcane	236.2	233.9	270.0	237.1	237.5	278.4
Cotton #	13.8	13.7	15.0	16.4	16.5	19.6
Jute and Mesta ##	11.2	11.2	11.8	10.3	11.3	10.7

T : Target. A : Achievement.
$: Fourth Advance Estimates (July 15, 2006).
: Million bales of 170 kgs each; ## : Million bales of 180 kgs each.
Source: Ministry of Agriculture, Government of India.

Total foodgrains production during 2005-06 was placed at around 208 million tonnes, an increase of 5.0 per cent over the previous year, mainly on the back of higher output of rice. The increase in the production of non-foodgrains crops was led mainly by sugarcane and cotton (Table 3).

Food Management

Total procurement of rice and wheat during 2006-07 (up to July 4, 2006) at 14.0 million tonnes was 22.1 per cent lower than a year ago. The total offtake of foodgrains (up to April 2006) at 2.8 million tonnes was 18.5 per cent lower than a year ago. While the off-take under the Targeted Public Distribution System (TPDS) was marginally higher, that under Other Welfare Schemes (OWS) was lower than the previous year's level. The total stock of foodgrains with the Food Corporation of India (FCI) and the State Government agencies was around 22.8 million tonnes as on May 1, 2006, down by 19.9 per cent from a year ago. The stocks were, however, higher than the buffer stock norms (16.2 million tonnes) (Table 4). Both rice and wheat stocks were above the buffer stock norms of 12.2 million tonnes and 4.0 million tonnes, respectively.

Industrial Performance

Industrial production continued with its momentum during April-May 2006 registering growth of 9.8 per cent. The manufacturing sector with double digit growth (10.9 per cent) continued to be the key driver of industrial activity,

Table 4: Management of Food Stocks

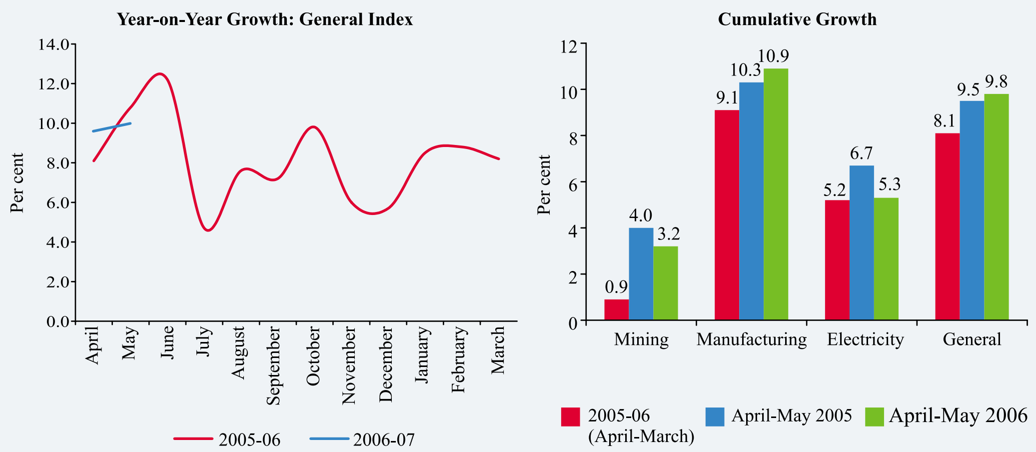
(Million Tonnes)

Month	Opening Stock of Foodgrains			Procurement of Foodgrains			Foodgrains Offtake					Closing Stock	Norms
	Rice	Wheat	Total	Rice	Wheat	Total	PDS	OWS	OMS – Domestic	Exports	Total		
1	2	3	4	5	6	7	8	9	10	11	12	13	14
2005													
January	12.8	8.9	21.7	3.3	0.0	3.3	2.7	0.8	0.0	0.0	3.6	21.5	16.8
February	14.2	7.3	21.5	2.2	0.0	2.2	2.7	0.9	0.0	0.0	3.7	20.0	
March	13.7	5.8	20.0	1.7	0.0	1.7	2.7	1.7	0.0	0.0	4.4	18.0	
April	13.3	4.1	18.0	1.2	12.8	14.1	2.4	1.0	0.0	0.0	3.4	28.5	16.2
May	13.0	15.1	28.5	1.3	1.9	3.1	2.5	0.8	0.0	0.0	3.3	27.9	
June	11.6	15.7	27.9	0.8	0.1	0.8	2.5	1.7	0.0	0.0	4.2	25.1	
July	10.1	14.5	25.1	0.4	0.0	0.4	2.8	0.8	0.1	0.0	3.6	21.4	26.9
August	8.0	13.0	21.4	0.9	0.0	0.9	2.6	0.8	0.1	0.0	3.4	18.4	
September	6.4	11.6	18.4	0.4	0.0	0.4	2.7	0.7	0.1	0.0	3.5	15.5	
October	4.8	10.3	15.5	7.6	0.0	7.6	2.7	0.5	0.0	0.0	3.2	19.8	16.2
November	10.3	9.1	19.8	2.7	0.0	2.7	2.3	0.5	0.1	0.0	2.8	19.0	
December	11.1	7.6	19.0	3.4	0.0	3.4	2.7	0.7	0.2	0.0	3.6	19.3	
2006													
January	12.6	6.2	19.3	3.8	0.0	3.8	2.7	0.8	0.1	0.0	3.6	19.5	20.0
February	14.0	4.9	19.5	2.5	0.0	2.5	2.7	0.6	0.3	0.0	3.6	18.3	
March	14.1	3.4	18.3	1.9	0.0	1.9	2.6	0.9	0.2	0.0	3.6	16.6	
April	13.7	2.0	16.6	1.7	8.7	10.3	2.5	0.3	0.0	0.0	2.8	22.8	16.2
May	12.8	9.0	22.8	1.6	0.6	2.2	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
June	N.A.	N.A.	N.A.	1.5	0.0	1.5	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	
July *	N.A.	N.A.	N.A.	0.1	0.0	0.1	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	

PDS : Public Distribution System. OWS : Other Welfare Schemes. OMS : Open Market Sales.
N.A. : Not Available. * : Procurement up to July 4, 2006.
Notes : Closing stock figures may differ from those arrived at by adding the opening stocks and procurement and deducting offtake, as stocks include coarse grains also.
Source : Ministry of Consumer Affairs, Food and Public Distribution, Government of India.

contributing almost 92.5 per cent of the growth in industry (Chart 3). Electricity and mining sectors, however, continued to exhibit subdued growth.

Chart 3: Growth in the Index of Industrial Production



The robust performance of the manufacturing sector was largely led by 'chemical and chemical products', 'machinery and equipments', 'basic metal and alloy industries', 'transport equipment and parts', and 'non-metallic mineral products' (Table 5). The manufacturing sector growth at 10.9 per cent during April-May 2006 was the highest for this period in the last ten years.

According to the use-based classification, the capital goods sector registered an impressive growth of 21.1 per cent during April-May 2006 even on a high base, reflecting strong investment demand. This is the highest growth for April-May period under the new base (1993-94=100). Higher production of laboratory and scientific instruments, broad gauge passenger carriage, boilers, complete tractors, industrial machinery and textile machinery boosted capital goods production. Basic goods sector was buoyed up by growth in cement sector, carbon steel and other minerals. Intermediate goods sector, after recording subdued growth during most of 2005-06, witnessed moderate improvement, facilitated by higher production of viscose staple fibre, filament yarn, cotton

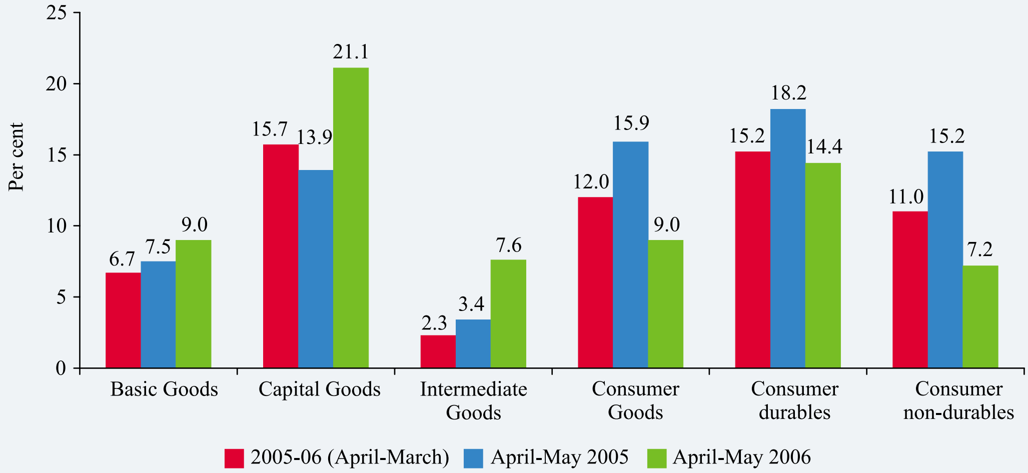
Table 5: Growth Rate of Manufacturing Groups

(Per cent)

Industry Group	Weight in the Index of Industrial Production	Growth Rate April-May		Weighted Contribution April-May	
		2005	2006 (P)	2005	2006
1	2	3	4	5	6
1. Chemicals and chemical products except products of petroleum & coal	14.0	13.3	12.5	25.7	23.4
2. Machinery and equipment other than transport equipment	9.6	11.3	13.4	16.6	18.7
3. Basic metal and alloy industries	7.5	16.2	21.0	13.1	16.9
4. Transport equipment and parts	4.0	13.6	21.4	8.4	12.8
5. Other manufacturing industries	2.6	9.4	31.6	3.0	9.3
6. Non-metallic mineral products	4.4	7.7	12.2	5.1	7.4
7. Beverages, tobacco and related products	2.4	10.4	11.4	5.4	5.6
8. Rubber, plastic, petroleum and coal products	5.7	2.5	8.0	1.7	4.8
9. Paper and paper products and printing, publishing and allied activities	2.7	12.5	12.1	3.9	3.7
10. Wool, silk and man-made fibre textiles	2.3	-8.4	11.9	-3.0	3.3
11. Textile products (including wearing apparel)	2.5	25.3	9.6	7.8	3.2
12. Cotton textiles	5.5	9.2	2.9	3.9	1.2
13. Jute and other vegetable fibre textiles (except cotton)	0.6	-3.6	-2.8	-0.1	-0.1
14. Metal products and parts (except machinery and equipment)	2.8	6.7	-4.1	1.7	-0.9
15. Leather and leather & fur products	1.1	11.4	-12.1	1.2	-1.2
16. Wood and wood products, furniture & fixtures	2.7	-1.3	-21.3	-0.2	-2.4
17. Food products	9.1	7.4	-7.6	5.8	-5.5
Manufacturing – Total	**79.4**	**10.3**	**10.9**	**100.0**	**100.0**

Source : Central Statistical Organisation.

Chart 4: Growth in IIP- Use Based Classification

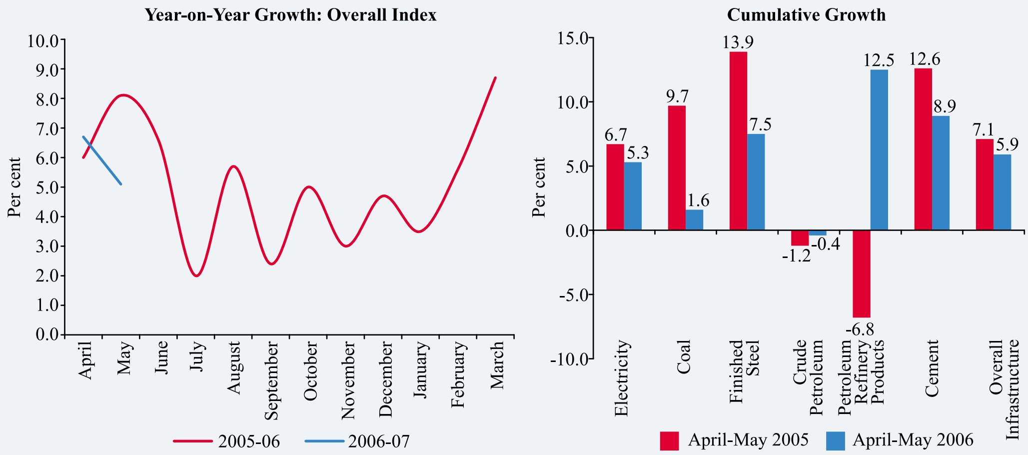


yarn, paints, enamels and varnishes, and PVC pipes and tubes. Consumer goods, both durable and non-durable segments, on the other hand, recorded some deceleration, partly on account of base effect (Chart 4).

Infrastructure

The infrastructure sector recorded growth of 5.9 per cent in April-May 2006 as compared with 7.1 per cent in April-May 2005 on account of deceleration in all industries except petroleum refinery products (Chart 5). Double-digit growth in the petroleum refinery products and moderation in growth of the

Chart 5: Growth in the Infrastructure Industries



cement and steel sectors could be attributed largely to base effect. The decline in crude oil production resulted from fall in production in plants of ONGC at Mumbai High.

Services Sector

Services sector with double-digit growth during the past two years (2004-05 to 2005-06) has further strengthened its place as the leading sector of the Indian economy. Services sector now accounts for more than 60 per cent of overall GDP. Lead indicators of services sector performance for April-May 2006 suggest continued buoyancy. Revenue earning freight of the railways continued to record strong growth. Substantial activity was witnessed in cargo handled by civil aviation and passengers handled at domestic and international airports. There was a sharp rise in new cell phone connections (Table 6). Healthy growth in bank deposits and non-food credit, and, increased business process outsourcing-information technology enabled services exports are expected to buoy up the sub-sector 'financing, insurance, real estate and business services'.

Business Expectations Surveys

Various business confidence surveys suggest that economic activity is likely to remain buoyant in the near term (Table 7). The National Council of Applied Economic Research (NCAER) business confidence index (BCI) increased by

Table 6: Indicators of Service Sector Activity

(Growth rates in per cent)

Sub-sector	2004-05	2005-06	April 2005	April 2006
1	2	3	4	5
Tourist arrivals	23.7	11.7	19.7 $	20.0 $
Commercial vehicles production	28.6	10.6	-5.3	49.7
Railway revenue earning freight traffic	8.1	10.7	14.9	11.0
New cell phone connections	10.4	89.4	7.6	167.0
Cargo handled at major ports	11.3	10.3	15.8	-2.0
Civil aviation				
a) Export cargo handled	12.4	7.3	12.0	10.1
b) Import cargo handled	24.2	15.8	14.6	19.9
c) Passengers handled at international terminals	14.0	12.8	9.9	16.2
d) Passengers handled at domestic terminals	23.6	27.1	19.2	54.0
Roads: Upgradation of Highways	16.1	-23.4	–	–
Cement	8.2	10.7	12.6 $	8.9 $
Steel	7.6	6.0	13.9 $	7.5 $
Aggregate deposits	11.9	22.3	14.9 @	20.7 @
Non-food credit	31.6	38.4	31.0 @	32.9 @
Central Government expenditure	5.6	2.2	-1.0 $	53.9 $

$: April-May.
@ : Year-on-year as on July 7.

Table 7: Business Expectations Surveys

Agency	Business Expectations		Growth over a year ago (per cent)	Growth over previous round (per cent)
	Period	Index		
Dun & Bradstreet	2006 (April-June)	Business Optimism Index	7.5	5.8
NCAER	2006 (April-September)	Business Confidence Index	7.6	1.7
FICCI	2006 (April-September)	Business Confidence Index	5.4	-1.4
CII	2006 (April-September)	Business Confidence Index	..	2.1
RBI	2006 (July-September)	Business Expectation Index	5.8	5.0

1.7 per cent during April-September 2006 to 154 - the highest level since November 1994. According to the NCAER survey, overall economic conditions and investment climate increased by 2.5 percentage points and 2.2 percentage points, respectively. The CII's business confidence index for April-September 2006 increased by 2.1 per cent. The BCI was significantly higher for non-manufacturing firms compared to the manufacturing firms. The survey revealed that 88 per cent of the respondents planned to increase investments while 75 per cent of the respondents expected capacity utilisation will be up to 100 per cent. The FICCI's quarterly Business Confidence Survey conducted during January-March 2006 indicated that the industrial sector was optimistic about sales, selling price, profits, investments, employment and exports. Although the BCI registered a marginal fall from the preceding round partly reflecting the base effect - the BCI had reached an all time high in the previous round - almost 80 per cent of the respondents expected overall economic conditions to be 'moderately to substantially better' in the April-September 2006 period. The corporates appear to be comfortably placed in terms of availability and cost of credit. For 89 per cent of the companies, availability of credit was not a constraining factor, while 78 per cent found cost of credit within their affordable limits. The services sector continued to be the most upbeat among the three industry sectors covered in the survey. At the same time, the survey showed that companies are finding rising cost of raw materials as the key challenge to maintain and improve their growth performance.

According to the Reserve Bank's latest Industrial Outlook Survey, the Business Expectations Index for July-September 2006 quarter increased by 5.0 per cent over the previous quarter's level (Chart 6). The assessment about the overall business situation for April-June 2006 showed an improvement in the level of confidence over the previous quarter. Responses to the survey suggest an improvement in expectations for the overall business situation, production, capacity utilisation, order books, employment, exports, imports, selling prices and profit margins during the quarter July-September 2006 *vis-à-vis* April-June 2006. The financial situation is expected to show an improvement during

Chart 6: Reserve Bank's Industrial Outlook Survey: Business Confidence Index

July-September 2006. While working capital finance requirement is expected to increase, the availability of finance is also expected to improve (Table 8).

Table 8: Net Response on 'A Quarter Ahead' Expectations About the Industrial Performance

(Per cent)

Parameter	Response	July-Sept 2005 (816)	Oct-Dec 2005 (961)	Jan-March 2006 (934)	Apr-June 2006 (1086)	June Sept 2006 (1073)
1	2	3	4	5	6	7
1. Overall business situation	Better	45.5	51.3	49.8	46.3	53.1
2. Financial situation	Better	36.7	42.3	40.7	40.4	43.4
3. Working capital finance requirement	Increase	28.8	32.7	31.9	30.6	32.7
4. Availability of finance	Improve	30.7	34.1	34.1	33.8	35.0
5. Production	Increase	40.7	46.9	46.3	42.5	49.4
6. Order books	Increase	39.6	43.7	41.0	39.1	45.2
7. Cost of raw material	Decrease	-43.6	-30.0	-35.9	-37.3	-45.8
8. Inventory of raw material	Below average	-4.2	-6.9	-6.8	-5.0	-6.3
9. Inventory of finished goods	Below average	-4.2	-3.3	-4.7	-4.5	-2.6
10. Capacity utilization	Increase	25.4	31.1	29.6	24.8	32.1
11. Level of capacity utilization	Above normal	7.6	10.9	11.4	9.4	11.8
12. Assessment of production capacity	More than adequate	5.3	5.0	4.9	4.1	3.6
13. Employment in company	Increase	7.8	12.7	13.3	14.5	16.4
14. Exports, if applicable	Increase	32.5	33.3	31.8	31.0	38.3
15. Imports, if any	Increase	23.7	19.2	20.8	22.7	23.8
16. Selling prices are expected to	Increase	13.3	7.8	10.8	12.4	16.6
17. If increase expected in selling prices	Increase at lower rate	14.0	16.6	16.3	12.0	10.5
18. Profit margin	Increase	7.1	9.6	12.6	9.3	11.1

Note : 1. Figures in parentheses represent number of companies included in the results.
2. 'Net response' is measured as the per cent share differential between the companies reporting 'optimistic' (positive) and 'pessimistic' (negative) responses; responses indicating status quo (no change) are not reckoned. Higher 'net response' indicates higher level of confidence and *vice versa*.

The buoyancy in manufacturing and services sector activities and the positive business confidence and expectations suggest that the recent growth momentum in the Indian economy is likely to be maintained in 2006-07, as has also been projected by different agencies (Table 9).

Table 9: Projections of Real Gross Domestic Product for India By Various Agencies: 2006-07

Agency	Growth Projections for 2006-07 (per cent)				Month of Projections
	Overall Growth	Agriculture	Industry	Services	
1	2	3	4	5	6
ADB	7.6	–	–	–	April, 2006
CDE-DSE	7.7	2.4	9.5	9.2	May, 2006
CII	Around 8.0	–	–	–	June, 2006
CMIE	7.9	2.5	8.5	9.6	June, 2006
ESCAP	7.9	–	–	–	March, 2006
ICRA	7.4-8.2	2.0	8.2-9.7	9.1-9.7	January, 2006
IMF	7.3	–	–	–	April, 2006
Planning Commission*	7.7	3.2	8.9	8.8	December, 2005
Reserve Bank of India	7.5-8.0	–	–	–	April, 2006

– : Not Available.
* : Base year 2001-02, Mid-Year Review of the Tenth Five-Year Plan.
ADB : Asian Development Bank; CDE-DSE : Centre for Development Economics - Delhi School of Economics;
CII : Confederation of Indian Industry; CMIE : Centre for Monitoring Indian Economy;
ESCAP : Economic and Social Commission for Asia and the Pacific;
ICRA : Investment Information and Credit Rating Agency of India;
IMF : International Monetary Fund.

II. FISCAL SITUATION

Combined Government Finances: 2006-07

Key fiscal indicators suggest that the process of fiscal consolidation is expected to continue during 2006-07. The combined gross fiscal deficit (GFD) of the Centre and States is budgeted to decline by one percentage point to 6.5 per cent of GDP in 2006-07. The combined primary deficit and revenue deficit are also budgeted to decline by 0.8 percentage point and 0.9 percentage point of GDP, respectively, in 2006-07 (Table 10). The reduction in the deficits is sought to be achieved primarily through higher tax collections and containment of revenue expenditure. The share of capital outlay in total expenditure is budgeted to improve in 2006-07 though the share of overall developmental expenditure would decline from that in the revised estimates for 2005-06.

The financing pattern indicates that 52.9 per cent of the combined GFD during 2006-07 would be financed by market borrowings as compared with 45.2 per cent during 2005-06 (Chart 7).

Table 10: Key Fiscal Indicators

(Per cent to GDP)

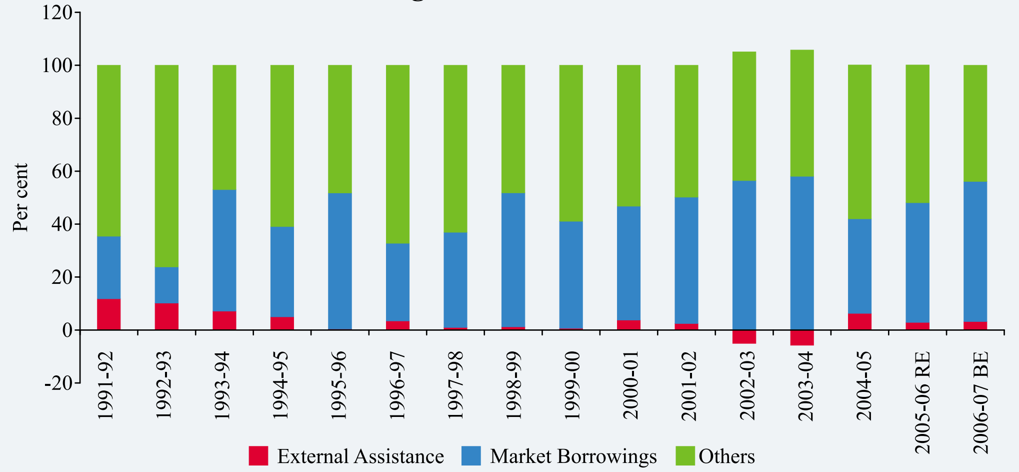
Year	Primary Deficit	Revenue Deficit	Gross Fiscal Deficit
1	2	3	4
		Centre	
2002-03	1.1	4.4	5.9
2003-04	-0.03	3.6	4.5
2004-05	-0.1	2.5	4.0
2005-06 RE	0.5	2.6	4.1
	(0.4)	(2.7)	(4.1)
2006-07 BE	0.2	2.1	3.8
		States	
2002-03	1.3	2.2	4.1
2003-04	1.5	2.2	4.5
2004-05	0.7	1.2	3.5
2005-06 RE	0.7	0.5	3.2
2006-07 BE	0.2	0.05	2.7
		Combined	
2002-03	3.1	6.7	9.6
2003-04	2.1	5.8	8.5
2004-05	1.6	3.7	7.5
2005-06 RE	1.6	3.1	7.5
2006-07 BE	0.8	2.2	6.5

RE: Revised Estimates. BE: Budget Estimates.

Note: 1. Figures in parentheses are provisional accounts.

2. Data in respect of States are provisional for years 2004-05 onwards.

Chart 7: Financing Pattern of the Combined GFD



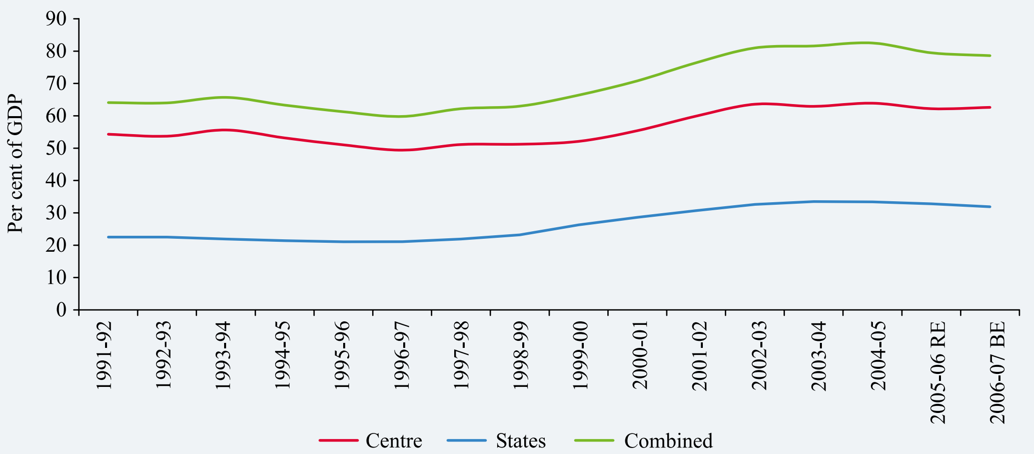
Public Debt

Reflecting the fiscal consolidation, the combined debt-GDP ratio of the Centre and the States is estimated to decline from 79.5 per cent as at end-March 2006 (RE) to 78.6 per cent by end-March 2007 (BE) (Chart 8).

Centre's Fiscal Situation: 2006-07

The Union Budget 2006-07, taking forward the fiscal consolidation stipulated under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004, projected the revenue deficit and gross fiscal deficit at 2.1 per cent and 3.8 per cent

Chart 8: Outstanding Liabilities of the Centre and the States



of GDP, respectively, lower than that of 2.6 per cent (2.7 per cent in the provisional accounts) and 4.1 per cent of GDP in the revised estimates for 2005-06. The Budget envisaged revenue-led correction along with reprioritisation of expenditure to augment allocations for improvement in the social and physical infrastructure particularly in the rural areas.

Available information on Central Government finances during April-May 2006 indicates buoyant tax collections, particularly in respect of corporation tax, personal income tax and customs duties. Union excise duties, however, declined during April-May 2006 over their level a year ago. Non-tax revenue showed improvement mainly on account of returns from economic services. Aggregate expenditure during April-May 2006 registered substantial growth on account of increase in interest payments, food and fertiliser subsidies, grants to States and higher non-defence capital outlay. Accordingly, all the key deficit indicators, as proportion to budget estimates, during April-May 2006 were placed significantly higher than their levels a year ago (Table 11 and Chart 9).

Financing of the Union Budget

Net market borrowings (excluding allocations under Market Stabilisation Scheme), at Rs.1,13,778 crore, are budgeted to finance 76.5 per cent of the GFD

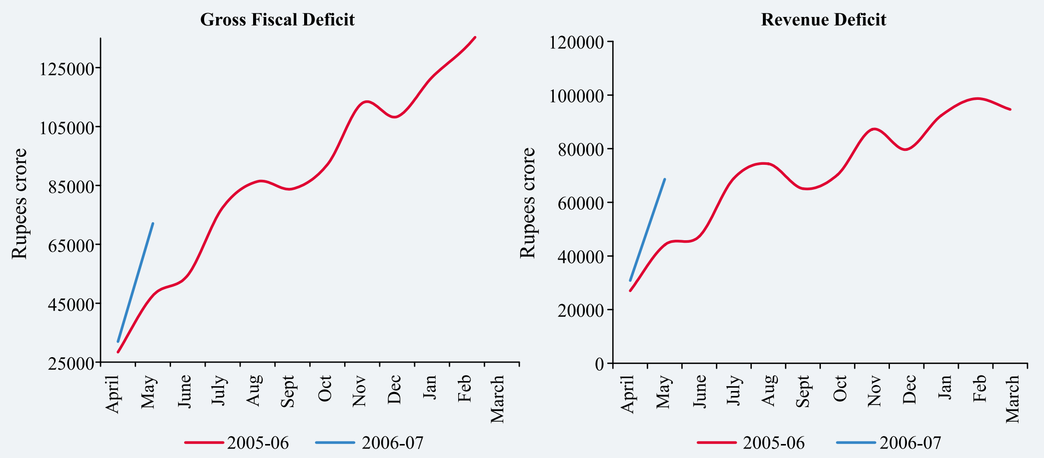
Table 11: Central Government Finances during April-May 2006

(Rupees crore)

	Items	2006-07 (Budget Estimates)	April-May 2005	April-May 2006	Per cent of Budget Estimates April-May 2005	Per cent of Budget Estimates April-May 2006
1		2	3	4	5	6
1.	Revenue Receipts (i + ii)	4,03,465	11,944	19,330	3.4	4.8
	i) Tax Revenue	3,27,205	8,659	15,087	3.2	4.6
	ii) Non-tax Revenue	76,260	3,285	4,243	4.2	5.6
2.	Non-Debt Capital Receipts	11,840	190	500	1.6	4.2
3.	Non-Plan Expenditure	3,91,263	46,788	62,882	12.6	16.1
	of which:					
	i) Interest Payments	1,39,823	21,167	23,919	15.8	17.1
	ii) Defence	89,000	4,751	6,314	5.7	7.1
	iii) Subsidies	44,792	7,196	11,412	15.5	25.5
4.	Plan Expenditure	1,72,728	12,949	29,036	9.0	16.8
5.	Revenue Expenditure	4,88,192	56,098	87,950	12.6	18.0
6.	Capital Expenditure	75,799	3,639	3,968	5.4	5.2
7.	Total Expenditure	5,63,991	59,737	91,918	11.6	16.3
8.	Revenue Deficit	84,727 (2.1)	44,154	68,620	46.3	81.0
9.	Gross Fiscal Deficit	1,48,686 (3.8)	47,603	72,088	31.5	48.5
10.	Gross Primary Deficit	8,863 (0.2)	26,436	48,169	153.7	543.5

Note : Figures in parentheses are percentages to GDP.
Source : Controller General of Accounts, Ministry of Finance.

Chart 9: Key Deficit Indicators of the Centre



in 2006-07 as compared with 69.2 per cent in the preceding year. Including repayment obligations of Rs.65,939 crore, as per the Union Budget, gross market borrowings of the Central Government work out to Rs.1,79,716 crore, Rs.21,857 crore higher than the actual amount raised in 2005-06.

On March 24, 2006, the issuance calendar for dated securities for the first half of 2006-07 fixed at Rs.89,000 crore (Rs.81,000 during the corresponding period of last year) was issued in consultation with the Central Government. During 2006-07 (up to July 18, 2006), the actual issuances of dated securities at Rs.59,000 crore were marginally higher than scheduled in the calendar (Rs.58,000 crore) (Table 12) and the amount raised (Rs.57,000 crore) in the comparable period of the preceding year. The actual issuance was higher than the indicative calendar as the Government, in

Table 12: Central Government Securities Issued during 2006-07

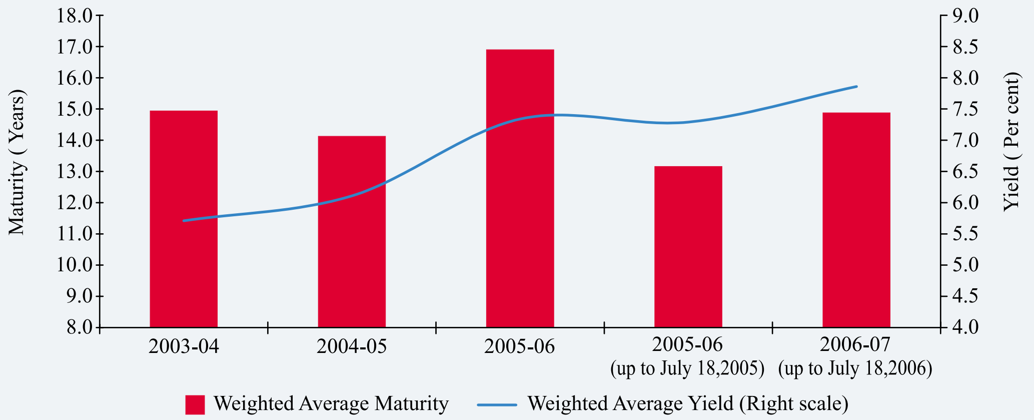
Date of Auction	Notified Amount (Rupees crore)	Residual Maturity (Years)	Cut-off Yield (Per cent)
1	2	3	4
April 10, 2006	5,000	10.00	7.59
	3,000	28.33	7.97
April 25. 2006	6,000	6.02	7.06
	4,000	26.34	8.00
May 4, 2006	6,000	9.94	7.55
	4,000	28.26	8.14
May 23, 2006	5,000	15.00	7.94
June 6, 2006	4,000	30.00	8.33
	6,000	5.07	7.39
June 22, 2006	5,000	8.52	7.92
	4,000	14.95	8.46
July 11, 2006	5,000	9.75	8.29
	2,000	28.08	8.75

consultation with the Reserve Bank of India, frontloaded its market borrowings by an additional Rs.4,000 crore on June 22, 2006. On the other hand, there was a reduction in the notified amount from Rs.6,000 crore and Rs.4,000 crore (as per the issuance auction calendar) to Rs.5,000 crore and Rs.2,000 crore, respectively, in the auctions held on July 11, 2006. An amount of Rs. 5,604 crore devolved on primary dealers during 2006-07 (up to July 18, 2006); there was no devolvement during the corresponding period of the preceding year. During 2006-07 so far, 13 securities have been issued. While 10 securities were reissues, three new securities of 10,15 and 30-year maturity were issued to provide benchmarks in the respective segments. Gross and net market borrowings (including dated securities and 364-day Treasury Bills) raised by the Centre amounted to 38.2 per cent and 30.4 per cent of the budget estimates as compared with 37.2 per cent and 39.1 per cent, respectively, a year ago.

During 2006-07 (up to July 18, 2006), the weighted average maturity of dated securities of the Central Government at 14.88 years was higher than that of 13.16 years in the corresponding period of the preceding year. The weighted average yield of dated securities issued over the same period also increased to 7.86 per cent from 7.29 per cent during the corresponding period of 2005-06 (Chart 10). In this context, it may be noted that the secondary market yield on 10-year Central Government securities increased from 7.01 per cent during April-June 2005 to 7.64 per cent during April-June 2006.

With a view to achieving a smooth transition to the new regime as envisaged in the FRBM Act whereby the participation of the Reserve Bank in the primary issuance of Central Government securities has been prohibited with effect from April 1, 2006, the Ways and Means Advances (WMA) arrangements for

Chart 10: Yield and Maturity of the Dated Securities of the Centre - Primary Auctions



2006-07 were revised in consultation with the Government. As per the revised arrangement, the WMA limits would be fixed on a quarterly basis instead of the existing half-yearly basis. Accordingly, the WMA limits for 2006-07 have been placed at Rs.20,000 crore and Rs.10,000 crore for the first and second quarters, respectively, and Rs.6,000 crore each for the third and fourth quarters of the year. The Reserve Bank would retain the flexibility to revise the limits in consultation with the Government taking into consideration the transitional issues and prevailing circumstances. Furthermore, the interest rates on WMA and overdraft have been linked to the repo rate as against the Bank Rate hitherto, following emergence of the repo rate as the short-term reference rate. Accordingly, the interest rate on WMA will be at the repo rate and that on overdraft will be at repo rate plus two percentage points.

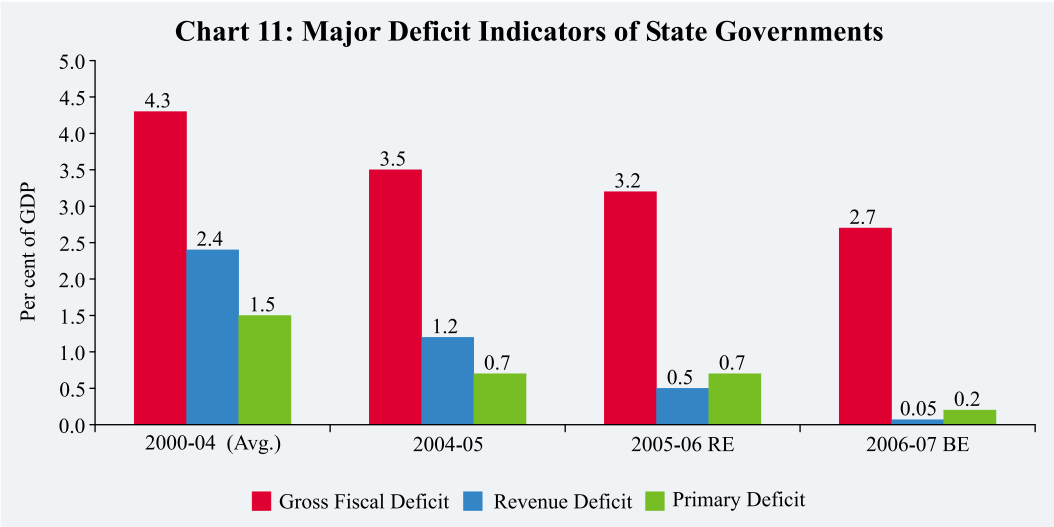
The Central Government took recourse to WMA on 36 days during 2006-07 (up to July 14, 2006) as compared with only two days during the entire fiscal year 2005-06. The average WMA utilisation during 2006-07 (up to July 14) was Rs.1,370 crore as compared with Rs.12 crore in the corresponding period of the preceding year.

State Finances: 2006-07[1]

The State budgets for 2006-07 proposed various policy initiatives to carry forward the process of fiscal correction and consolidation. The States have emphasised fiscal empowerment through broad basing and rationalisation of the tax system. In order to improve the accountability of budget proposals, some States have proposed to introduce ‘Outcome Budget’, following the pattern of the Central Government. Furthermore, many State Governments have proposed to introduce ‘Gender Budgeting’. A number of States announced introduction of new pension schemes based on defined contribution to restrict their rising pension obligations. There has been progressive enactment of fiscal responsibility legislation (FRL) to put in place a rule-based fiscal policy at the State level (22 States as at end-March 2006). All States, barring Tamil Nadu and Uttar Pradesh, have opted for value added tax (VAT) in lieu of sales tax as on April 1, 2006.

All major deficit indicators are budgeted to decline in 2006-07 from their respective levels in the previous year. The revenue deficit as ratio to GDP is budgeted to reach almost zero level in 2006-07 from that of 0.5 per cent in the previous year. Consequently, gross fiscal deficit is budgeted to decline to 2.7 per cent in 2006-07 from that of 3.2 per cent of GDP a year ago (Chart 11). The fiscal correction in State finances during 2006-07 is proposed to be brought about mainly by consolidation of the revenue account with revenue expenditure-GDP

[1] Based on information pertaining to 29 State Budgets, of which four are *Vote-on-Accounts*.



ratio budgeted to decline from 13.4 per cent in 2005-06 to 13.0 per cent in 2006-07 while revenue receipts are budgeted to increase marginally from 12.9 per cent to 13.0 per cent. States' own revenues (taxes and non-taxes) are budgeted to be stagnant at 7.7 per cent of GDP during 2006-07 while current devolution and transfers (grants and shareable Central taxes) from the Centre are budgeted to increase marginally from 5.2 per cent in 2005-06 to 5.3 per cent in 2006-07.

A perusal of the Union Budget 2006-07 in conjunction with State budgets indicates that grants-in-aid have been overestimated while shareable Central taxes have been underestimated by the States. Adjusting for the data as reported in the Union Budget 2006-07, the revenue deficit and gross fiscal deficit of the State Governments, as per cent of GDP, would be placed at 0.3 per cent and 3.0 per cent, respectively. Furthermore, flows (net) from the National Small Savings Fund (NSSF) have been underestimated in the State budgets as compared with Union Budget 2006-07 while the loans from Centre have been overestimated. Adjusting for these, States are not likely to have much difficulty in financing their deficits.

Financing of the States' Budgets

The provisional net allocation under market borrowing programme for State Governments is placed at Rs.17,077 crore during 2006-07. Taking into account the additional allocation of Rs.35 crore and repayments of Rs.6,551 crore, the gross allocation amounts to Rs.23,663 crore. During 2006-07 so far (up to July 18, 2006), the States have raised market loans amounting to Rs.7,343 crore (31.0 per cent of gross allocation) through auctions with a cut-off rate in the range 7.65-8.66 per cent (Table 13). The weighted average interest rate of market loans firmed up from 7.67 per cent during 2005-06 (up to July 18, 2005) to 8.08 per cent during 2006-07 (up to July 18, 2006) (Chart 12).

Table 13: Market Borrowings of State Governments during 2006-07 (up to July 18, 2006)

Items		Date	Cut-off Rate (Per cent)	Tenor (Years)	Amount Raised (Rupees crore)
1		2	3	4	5
A. Tap Issues		–	–	–	–
B. Auctions (i to xviii)					**7,343**
i.	First	April 27, 2006	7.65	10	300
ii.	Second	May 11, 2006	7.89	10	500
iii.	Second	May 11, 2006	8.00	10	1,646
iv.	Second	May 11, 2006	7.95	10	881
v.	Second	May 11, 2006	8.04	10	150
vi.	Second	May 11, 2006	7.96	10	130
vii.	Second	May 11, 2006	7.87	10	400
viii.	Second	May 11, 2006	7.91	10	500
ix.	Second	May 11, 2006	7.98	10	57
x.	Second	May 11, 2006	8.05	10	15
xi.	Second	May 11, 2006	7.93	10	1,307
xii.	Third	July 13, 2006	8.65	10	742
xiii.	Third	July 13, 2006	8.65	10	78
xiv.	Third	July 13, 2006	8.66	10	300
xv.	Third	July 13, 2006	8.65	10	29
xvi.	Third	July 13, 2006	8.65	10	19
xvii.	Third	July 13, 2006	8.62	10	225
xviii.	Third	July 13, 2006	8.65	10	64
Grand Total (A+B)					**7,343**

Source: Reserve Bank of India.

The weekly average utilisation of WMA and overdraft by the States has been substantially lower during 2006-07 so far: Rs.316 crore (up to June 30, 2006) as compared with Rs.1,449 crore in the corresponding period of the previous year (Chart 13). Two States have resorted to overdraft during 2006-07 so far as compared with nine States during the corresponding period of the previous year.

Chart 12: Weighted Average Interest Rate on State Government Market Borrowings

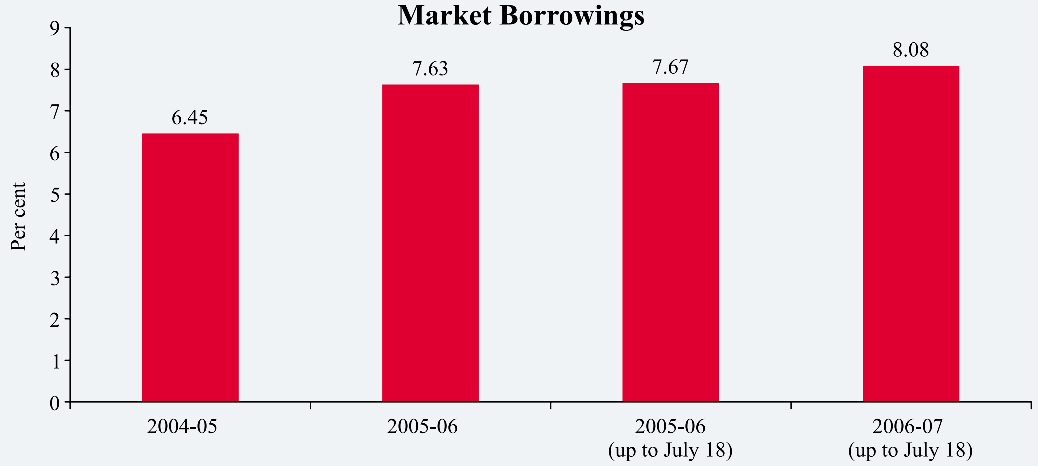
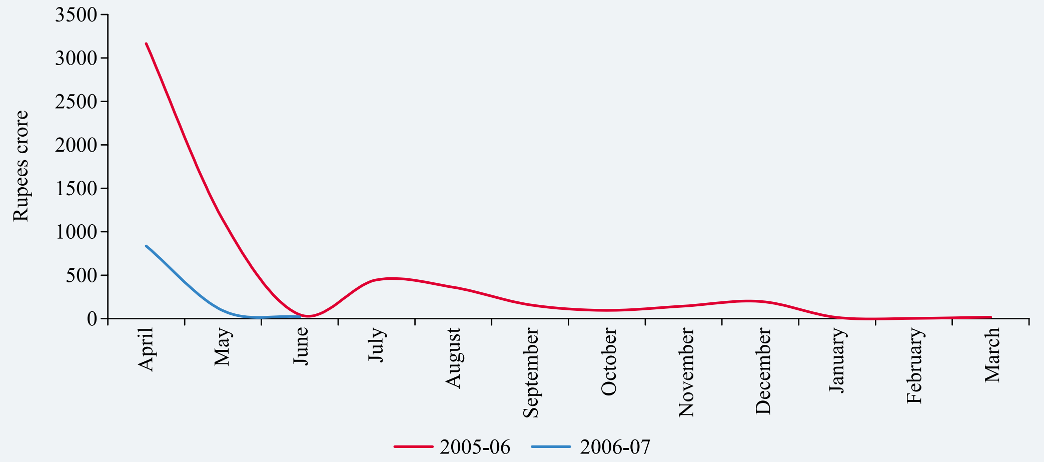
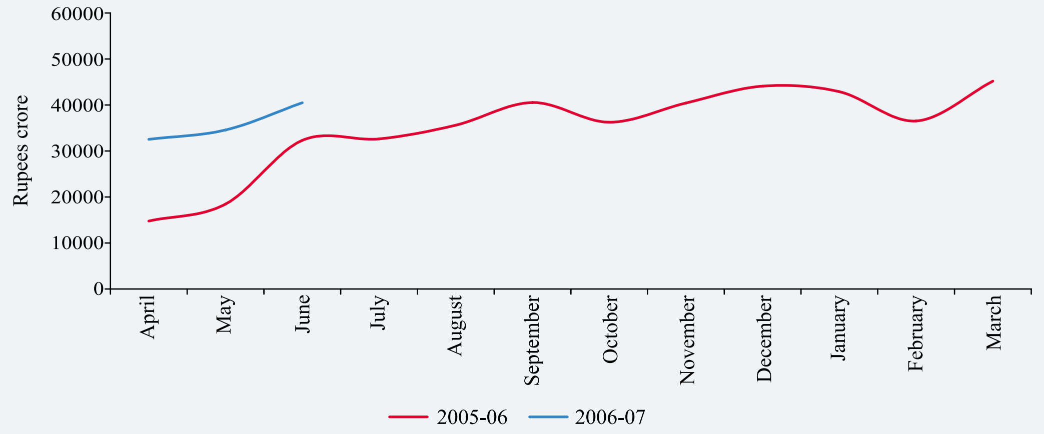


Chart 13: Utilisation of WMA and Overdraft by States (Weekly Average)



The cash surplus position of the States, as reflected in their investments in 14-day Intermediate Treasury Bills, continued to be comfortable. The weekly average investment by the States in the 14-day Treasury Bills during April-June 2006 amounted to Rs.35,859 crore, considerably higher than that of Rs.21,847 crore in the corresponding period of the previous year (Chart 14).

Chart 14: Investments in 14-day Intermediate Treasury Bills by State Governments (Weekly Average)



III. MONETARY AND LIQUIDITY CONDITIONS

Monetary Survey

Monetary and liquidity conditions, after some tightening during the last four months of 2005-06, remained comfortable during the first quarter of 2006-07 despite sustained growth of bank credit. Liquidity conditions eased following reduction in the Centre's surplus balances with the Reserve Bank and injection of liquidity arising from the Reserve Bank's foreign exchange interventions. The Reserve Bank, accordingly, reverted back to absorption of liquidity through operations under the liquidity adjustment facility (LAF) and issuance of securities under the market stabilisation scheme (MSS). Reserve money growth during the fiscal year 2006-07 so far has been driven by accretion to the Reserve Bank's net foreign assets (NFA) as against an accumulation in domestic assets during 2005-06. Bank deposits recorded strong growth during the first quarter of 2006-07 and were able to finance the continued demand for bank credit[1]. Banks' investments in Government securities recorded an increase during April-June 2006 after declining in the previous two quarters. Concomitantly, broad money (M_3) growth – at 18.8 per cent as on July 7, 2006 – was above the indicative trajectory of 15.0 per cent projected in the Annual Policy Statement in the beginning of the year (April 2006). Expansion in the residency-based new monetary aggregate (NM_3) was higher than M_3 on account of continued raising of resources from the call/term market and redemption of India Millennium Deposits (IMDs) – non-resident repatriable foreign currency deposits such as IMDs are included in M_3 but not directly reckoned in NM_3 (Table 14).

Increase in demand for currency during the first quarter of 2006-07 was higher than that during the corresponding period of the previous year (Table 15). On a year-on-year (y-o-y) basis, growth in currency with the public increased from 13.7 per cent as on July 8, 2005 to 16.3 per cent as on July 7, 2006 in consonance with acceleration in economic activity.

While demand deposits declined during the first quarter of 2006-07, increase in time deposits was sharply higher than the position a year ago. The decline in demand deposits during the quarter ended June 2006 could be partly attributed to unwinding of the large accretion during the previous quarter ended March 2006

[1] Data on financial year variation during 2006-07 are not comparable with those of 2005-06 as the financial year variation for scheduled commercial banks' (SCBs) data for 2006-07 is worked out from March 31, 2006 whereas the corresponding variation during 2005-06 is worked out from March 18, 2005 (which are the last reporting Fridays for the respective years). For the purpose of comparability, the analysis of key banking and monetary aggregates for the financial year 2005-06 in this Chapter is based on variations over April 1, 2005.

Table 14: Monetary Indicators

(Amount in Rupees crore)

Item	Outstanding as on July 7, 2006	Variation (Year-on-Year)			
		July 8, 2005		July 7, 2006	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
I. Reserve Money*	5,88,231	77,488	18.0	81,290	16.0
II. Broad Money (M_3)	28,20,649	2,90,207	13.9	4,47,252	18.8
		(2,86,694)	(13.8)		
a) Currency with the Public	4,38,188	45,381	13.7	61,548	16.3
b) Aggregate Deposits	23,75,782	2,44,575	14.0	3,83,919	19.3
i) Demand Deposits	3,73,084	56,148	23.5	77,532	26.2
ii) Time Deposits	20,02,698	1,88,427	12.5	3,06,387	18.1
		(1,84,914)	(12.3)		
of which: Non-Resident Foreign Currency Deposits	62,797	-580	-0.7	-14,068	-18.3
III. NM_3	28,34,282	3,29,007	16.2	4,69,501	19.9
		(2,90,319)	(14.3)		
of which: Call Term Funding from Financial Institutions	83,642	41,280	139.0	12,660	17.8
		(6,105)	(20.6)		
IV. a) L_1	29,09,178	3,00,821	14.3	4,64,514	19.0
of which: Postal Deposits	1,03,789	17,424	23.1	10,919	11.8
b) L_2	29,12,110	2,97,585	14.1	4,64,220	19.0
of which: FI Deposits	2,932	-3,236	-50.1	-294	-9.1
c) L_3	29,33,804	2,99,158	14.0	4,65,117	18.8
of which: NBFC Deposits	21,694	1,573	8.2	897	4.3
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	8,02,655	11,790	1.6	31,687	4.1
		(-403)	(-0.1)		
i) Net Reserve Bank Credit to Government	-2,191	-6,529	–	3,068	–
of which: to the Centre	-2,344	-3,686	–	3,265	–
ii) Other Banks' Credit to Government	8,04,846	18,318	2.4	28,619	3.7
		(6,126)	(0.8)		
b) Bank Credit to Commercial Sector	17,31,749	2,99,955	28.4	3,74,438	27.6
		(2,67,073)	(25.3)		
c) Net Foreign Exchange Assets of Banking Sector	8,02,596	47,558	8.2	1,74,453	27.8
Memo:					
Scheduled Commercial Bank's Aggregate Deposits	21,77,547	2,37,533	15.2	3,72,977	20.7
		(2,34,020)	(14.9)		
Scheduled Commercial Bank's Non-food Credit	15,04,135	2,93,046	34.9	3,71,993	32.9
		(2,60,164)	(31.0)		

FIs: Financial Institutions. NBFCs: Non-Banking Financial Companies. *: Data pertain to July 14, 2006.

NM_3 is the residency-based broad money aggregate and L_1,L_2 and L_3 are liquidity aggregates compiled on the recommendations of the Working Group on Money Supply (Chairman: Dr. Y.V. Reddy, 1998). Liquidity aggregates are defined as follows:

L_1 = NM_3 + Select deposits with the post office saving banks.

L_2 = L_1 +Term deposits with term lending institutions and refinancing institutions (FIs) + Term borrowing by FIs + Certificates of deposits issued by FIs.

L_3 = L_2 + Public deposits of non-banking financial companies.

Note : 1. Data are provisional.
2. Figures in parentheses are adjusted for the effect of conversion of a non-banking entity into a banking entity on October 11, 2004.
3. Liquidity aggregates pertain to end-June and are adjusted for conversion effect.
4. Data on non-resident foreign currency deposits reflect redemption of India Millennium Deposits (IMDs) on December 29, 2005.

Table 15: Monetary Aggregates – Variations

(Rupees crore)

	Variation during							
	2005-06 (April-March)*	2005-06 (upto July 8)	2006-07 (up to July 7)	2005-06				2006-07
				Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8	9
M_3 (=1+2+3=4+5+6+7-8)	4,78,086	40,730 [1,21,948]	91,114	27,448 [1,08,666]	1,22,457	45,106	2,01,857	58,060
Components								
1. Currency with the Public	57,280	21,770 [20,778]	25,046	20,492 [19,500]	-10,835	30,124	18,491	25,795
2. Aggregates Deposits with Banks	4,20,406	20,386 [1,02,754]	66,268	8,819 [91,188]	1,32,531	15,729	1,80,958	33,115
2.1 Demand Deposits with Banks	1,20,069	-25,812 [10,397]	-32,140	-21,953 [14,256]	41,566	-2,357	66,604	-41,704
2.2 Time Deposits with Banks	3,00,336	46,197 [92,357]	98,408	30,772 [76,932]	90,965	18,086	1,14,354	74,818
3. 'Other' Deposits with Banks	401	-1,426	-200	-1,862	761	-747	2,408	-849
Sources								
4. Net Bank Credit to Government	12,326	22,261 [14,201]	33,562	17,398 [9,339]	-5,017	-5,722	13,726	20,090
4.1 RBI's net credit to Government	26,111	22,403 [12,716]	-10,328	18,963 [9,275]	-25,251	19,879	22,208	53
4.2 Other Bank's Credit to Government	-13,785	-142 [1,485]	43,890	-1,565 [63]	20,234	-25,601	-8,481	20,037
5. Bank Credit to Commercial Sector	4,10,712	26,053 [77,062]	40,789	10,235 [61,245]	1,18,712	61,731	1,69,025	21,879
6. Net Foreign Exchange Assets of Banking Sector	76,939	-19,760 [-21,112]	76,402	-12,026 [-13,378]	24,062	27,701	38,554	71,845
6.1 Net Foreign Exchange Assets of RBI	60,193	-20,977	76,402	-13,243	24,823	23,741	26,224	71,845
7. Government's Currency Liabilities to Public	1,306	384	64	384	910	-100	112	64
8. Net Non-Monetary liabilities of Banking Sector	23,197	-11,792 [-51,412]	59,702	-11,456 [-51,077]	16,210	38,504	19,560	55,818
Memo:								
1. Non-resident Foreign Currency Deposits with SCBs	-17,130	713 [460]	3,521	804 [550]	187	1,856	-19,723	2,992
2. SCBs' Call-term Borrowing from Financial Institutions	13,621	-939 [1,459]	498	-1,002 [1,395]	7,359	1,836	3,031	2,990
3. Overseas Borrowing by SCBs	4,169	-630 [2,244]	732	-925 [1,948]	3,618	-622	-775	3,425
4. SCBs' Non-food Credit	4,07,078	19,948 [72,834]	37,749	4,205 [57,091]	1,20,290	61,394	1,68,303	15,484

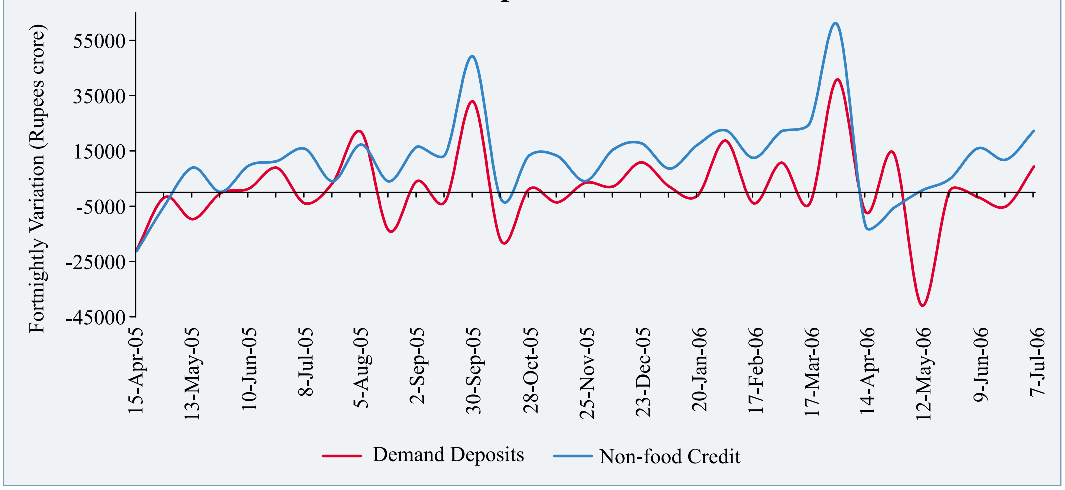
* Variation during March 31, 2005 and March 31, 2006.

Note: 1. Data on fiscal year variation for 2005-06 are not comparable with those of the previous years as the data for 2005-06 include 27 fortnights while usually the data for a year include 26 fortnights. Moreover, the last reporting Friday of 2005-06 coincided with March 31, the closing day for banks' accounts.

2. Variation during 2006-07 is worked out from March 31, 2006 whereas the corresponding variation during 2005-06 is worked out from April 1, 2005. Figures in [ ] are variations for 2005-06 worked out over March 31, 2005 (which incorporate scheduled commercial banks' data as on March 18, 2005).

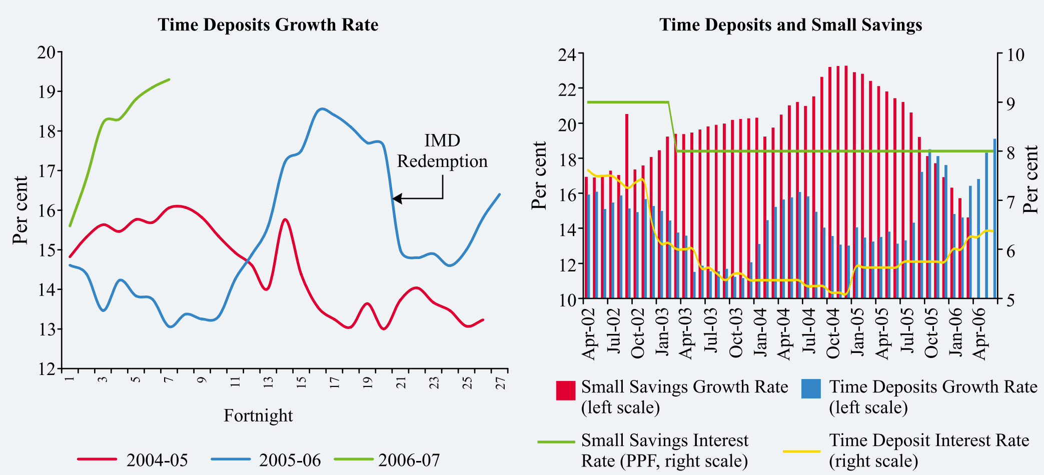
(Rs.66,604 crore), redemption pressures on mutual funds and decline in the number of public issues during June 2006. On a y-o-y basis, growth in demand deposits at 26.2 per cent as on July 7, 2006 was, however, higher than that a year ago (23.5 per cent). The strong growth in y-o-y demand deposits could be attributed to a variety of factors such as sharp rise in non-food credit, higher resource mobilisation through the primary capital market, and large mobilisation by domestic mutual funds, with funds getting temporarily parked in demand deposits pending utilisation (Chart 15).

Chart 15: Demand Deposits and Non-food Credit



Scheduled commercial banks' time deposits growth at 19.3 per cent (y-o-y) as on July 7, 2006 was higher than that recorded a year ago (13.4 per cent; net of the conversion effect) reflecting the higher interest rates as well as the base effect. Interest rates on time deposits of 1-3 year maturity offered by public sector banks have increased from 5.75-6.75 per cent in March 2006 to 5.75-7.00 per cent by June 2006. Rates offered by private sector banks on similar maturity deposits moved from a range of 5.50-7.75 per cent to 6.50-7.75 per cent over the same period. Concomitantly, growth in postal deposits, which was on a upward trajectory between April 2003 and December 2004, moderated to 14.6 per cent (y-o-y) as at end-March 2006 from its recent peak of 23.3 per cent in December 2004 (Chart 16).

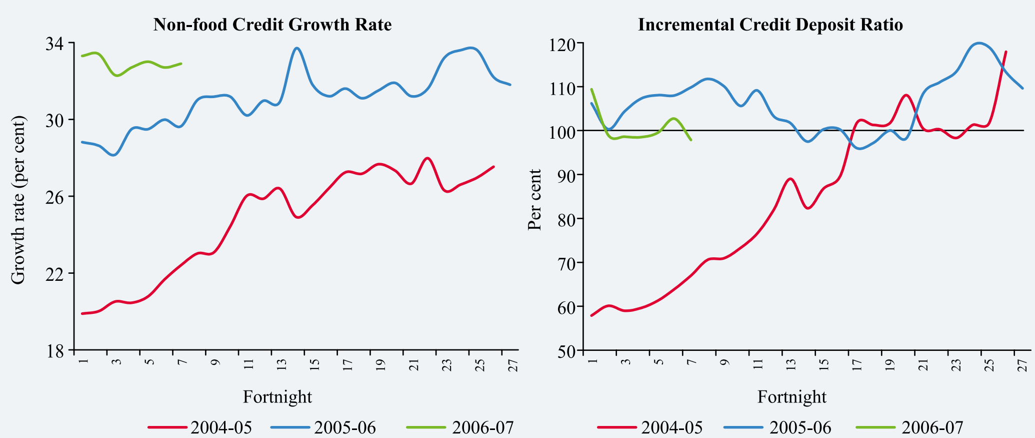
Chart 16: Time Deposits Growth



Demand for bank credit from the commercial sector remained strong during the first quarter of 2006-07. Bank credit to commercial sector expanded by Rs.40,789 crore during the financial year 2006-07 (up to July 7, 2006), higher than that of Rs.26,053 crore during the corresponding period of the previous year (see Table 15). Scheduled commercial banks' (SCBs) non-food credit, on a year-on-year basis, registered a growth of 32.9 per cent as on July 7, 2006 on top of a base as high as 31.0 per cent a year ago. Reflecting the acceleration in deposits growth, incremental credit-deposit ratio of SCBs has shown some moderation in recent months but still remains high, hovering around 100 per cent (Chart 17). Scheduled commercial banks' food credit, however, witnessed a decline of Rs.2,837 crore during the financial year 2006-07 (up to July 7, 2006) – reflecting lower order of procurement of foodgrains – as compared with an increase of Rs.4,801 crore during the corresponding period of the previous year.

Disaggregated available data for 2005-06 show that almost 30 per cent of incremental non-food credit went to the industrial sector, while over 14 per cent of incremental non-food credit was on account of housing loans and another 12 per cent of incremental non-food credit was absorbed by the agricultural sector and allied activities (Table 16). The increase in industrial credit in consonance with sustained growth in domestic industrial production was mainly on account of infrastructure (*viz.*, power, roads, ports and telecommunications), construction, textiles, iron and steel, chemicals, petroleum, vehicles and food processing industries. Infrastructure sector alone accounted for about one fourth of incremental credit to the industry, while textiles and iron and steel industries absorbed another one-fourth of the incremental credit to the industry. Credit to agriculture recorded a robust growth, reflecting the impact of various policy initiatives to improve the flow

Chart 17: Scheduled Commercial Banks' Credit Growth*



*Year-on-year basis, excluding conversion of a non-banking entity into a banking entity as on October 11, 2004.

Table 16: Sectoral Deployment of Non-food Bank Credit

(Amount in Rupees crore)

Sector / Industry	Outstanding as on March 31, 2006	Variation			
		2004-05		2005-06	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
Non-food Gross Bank Credit (1 to 6)	**14,05,146**	**1,88,069**	**25.8**	**4,05,358**	**40.5**
1. Agriculture and Allied Activities	**1,72,292**	**31,774**	**35.1**	**47,042**	**37.6**
2. Industry (Small, Medium and Large)	**5,49,057**	**62,014**	**19.8**	**1,22,165**	**28.6**
Of which, Small Scale Industries	90,239	8,051	12.2	15,651	21.0
3. Services	**48,137**	n.a.	n.a.	**17,553**	**57.4**
Transport Operators	16,101	n.a.	n.a.	6,502	67.7
Professional and Other Services	16,070	n.a.	n.a.	2,809	21.2
4. Personal Loans	**3,53,777**	n.a.	n.a.	**1,08,697**	**44.4**
Consumer Durables	8,783	108	1.3	-300	-3.3
Housing	1,86,429	n.a. (23,192)	n.a. (44.6)	57,701	44.8
Advances against Fixed Deposits	34,897	3,259	12.4	5,047	16.9
Advances to Individuals against Shares, Bonds	5,089	366	18.1	972	23.6
Credit Card Outstandings	9,177	n.a.	n.a.	3,417	59.3
Education	10,057	n.a.	n.a.	4,938	96.5
5. Trade	**81,402**	**31,262**	**125.7**	**23,454**	**40.5**
6. Others	**2,00,481**	**n.a.**	n.a.	**86,447**	**75.8**
Real Estate Loans	26,682	7,622	136.7	13,380	100.6
Non-Banking Financial Companies	30,942	2,501	14.9	8,458	37.6
Memo:					
Priority Sector	**5,09,910**	**1,06,235**	**40.3**	**1,28,434**	**33.7**
Industry (Small, Medium and Large)	**5,49,057**	**62,014**	**19.8**	**1,22,165**	**28.6**
Food Processing	30,843	1,109	5.4	6,410	26.2
Textiles	57,716	4,648	13.6	13,739	31.2
Paper and Paper Products	9,216	-228	-3.8	2,336	33.9
Petroleum, Coal Products and Nuclear Fuels	24,103	1,426	10.6	8,534	54.8
Chemicals and Chemical Products	48,935	1,661	5.4	9,443	23.9
Rubber, Plastic and their Products	6,989	717	27.7	3,323	90.6
Iron and Steel	50,385	3,120	11.9	14,384	40.0
Other Metal and Metal Products	14,436	1,938	23.7	2,800	24.1
All Engineering	34,666	273	1.0	5,270	17.9
Vehicles, Vehicle Parts and Transport Equipments	18,667	2,900	54.7	6,805	57.4
Gems and Jewellery	19,866	3,013	32.8	5,560	38.9
Construction	13,867	1,708	28.6	5,745	70.7
Infrastructure	1,08,787	21,829	42.5	29,778	37.7

n.a. : Not available.

Note : 1. Data are provisional and relate to select scheduled commercial banks which account for over 90 per cent of bank credit of all scheduled commercial banks.

2. Owing to change in classification of sectors/industries and coverage of banks, data for 2005-06 are not comparable with earlier data. Figures in parentheses for 2004-05 pertain only to housing loans of above Rs.15 lakh. Data on housing loans for 2005-06, on the other hand, are also inclusive of loans less than Rs.15 lakh.

of credit to the sector. Credit to the housing sector continued to be strong, benefiting from low interest rates and tax incentives. Apart from housing, strong credit demand emanated from education and other personal loans as well as from credit card holders. Credit to the commercial real estate continued to increase sharply, constituting around three per cent of incremental non-food credit.

Table 17: Select Sources of Funds to Industry

(Rupees crore)

Item	2005-06 (April-March)	2005-06 Q1	2005-06 Q2	2005-06 Q3	2005-06 Q4	2006-07 Q1
1	2	3	4	5	6	7
A. Bank Credit to Industry	1,22,165	11,148	28,061	24,484	58,472	–
B. Flow from Non-banks to Corporates						
1 Capital Issues (i+ii)	12,661	1,264	2,758	5,549	3,090	10,275 *
i) Non-Government Public Ltd. Companies (a+b)	12,288	1,264	2,758	5,549	2,717	10,275 *
a) Bonds/Debentures	118	118	0	0	0	0 *
b) Shares	12,170	1,146	2,758	5,549	2,717	0 *
ii) PSUs and Government Companies	373	0	0	0	373	0 *
2 ADR/GDR Issues	6,445	789	739	3,643	1,274	3,793 *
3 External Commercial Borrowings (ECBs)	40,496	4,326	12,989	9,132	14,049	–
4 Issue of CPs	-1,517	3,562	1,928	-2,491	-4,516	4,203
C. Depreciation Provision ++	25,014	7,137	7,617	7,748	7,265	–
D. Profit after Tax ++	60,747	16,726	18,169	18,790	19,686	–

* : Pertain to April-May, 2006.

++ : Data are based on audited/ unaudited abridged results of select sample of non-financial non-Government companies. Quarterly variations may not add up to annual variation due to difference in coverage of companies.

Note : 1. Data are provisional.

2. Data on capital issues pertain to gross issuances excluding issues by banks and financial institutions. Figures are not adjusted for banks' investments in capital issues, which are not expected to be significant. Data on ADR/GDR issues exclude issuances by banks and financial institutions.

3. Data on external commercial borrowings include short-term credit. Data for 2005-06 are exclusive of the IMD redemption.

The corporate sector continued to augment its recourse to bank credit with a variety of other sources. Equity issuances in the domestic market during April-May 2006 were substantially higher as corporates took advantage of buoyancy in the secondary market. Mobilisation through external commercial borrowings (ECBs) remained strong during 2005-06. Mobilisation through issuances of commercial papers, after remaining subdued during the second half of 2005-06, staged a turnaround during the first quarter of 2006-07. Internal sources – backed by strong corporate sector profitability – continued to constitute a significant source of funds for the corporate sector (Table 17).

In view of strong credit demand, apart from increasing their deposit mobilisation efforts, banks continued with recourse to funding from financial institutions as well as borrowings from abroad. Raising funds through equity issuances in the primary market as well as large internal reserves also helped banks to fund credit demand. Furthermore, banks continued to restrict their incremental investments in Government papers to fund demand for credit (Table 18). On a year-on-year basis, commercial banks' holding of Government and other approved securities increased by 3.8 per cent as on July 7, 2006 as against a decline of 0.4 per cent a year ago. In the current fiscal year so far (up to July 7, 2006), commercial banks' investment in such securities registered an increase of Rs.49,697 crore, reflecting acceleration in deposit growth. Commercial banks' holding of Government securities fell from over 36 per cent

Table 18: Scheduled Commercial Bank's Survey

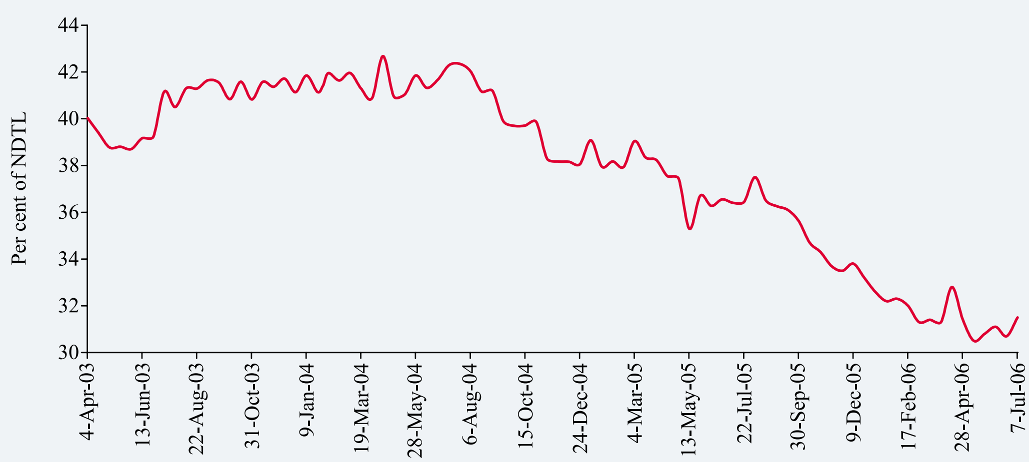
(Amount in Rupees crore)

Item	Variation (year-on-year)			
	As on July 08, 2005		As on July 07, 2006	
	Amount	Per cent	Amount	Per cent
1	2	3	4	5
Sources of Funds				
Aggregate Deposits	2,34,020	14.9	3,72,977	20.7
Call/Term Funding from Financial Institutions	6,105	20.6	12,660	17.8
Overseas Foreign Currency Borrowings	7,326	35.6	2,657	9.5
Capital and Reserves	37,255	30.8	30,248	19.1
Uses of Funds				
Bank Credit	2,61,524	29.6	3,65,031	31.0
Investments in Government Securities	-69	–	25,079	3.5
Investments in Other Approved Securities	-2,806	-12.5	2,942	15.0
Investments in Non-SLR Securities	2,527	1.8	10,668	7.6
Foreign Currency Assets	-2,731	-8.8	3,458	12.2
Balances with the RBI	26,060	37.2	19,542	20.3

Note: 1. Data are provisional.
2. Variations of select aggregates are adjusted for the effect of conversion of a non-banking entity into a banking entity on October 11, 2004.

of their net demand and time liabilities (NDTL) as on July 8, 2005 to 31.5 per cent as on July 7, 2006 (Chart 18).

Chart 18: SLR Investments by Scheduled Commercial Banks

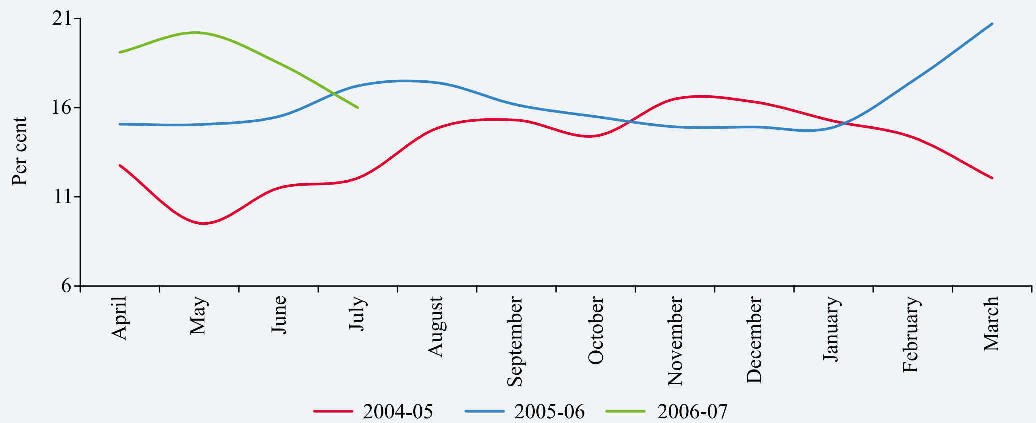


Reserve Money Survey

Reserve money growth at 16.0 per cent, y-o-y, as on July 14, 2006 was lower than that a year ago (18.0 per cent) (Chart 19)

Growth of reserve money during the financial year 2006-07 (up to July 14, 2006) was driven largely by expansion in the Reserve Bank's net foreign assets

Chart 19: Reserve Money Growth



Note: Data for July 2006 pertain to July 14, 2006.

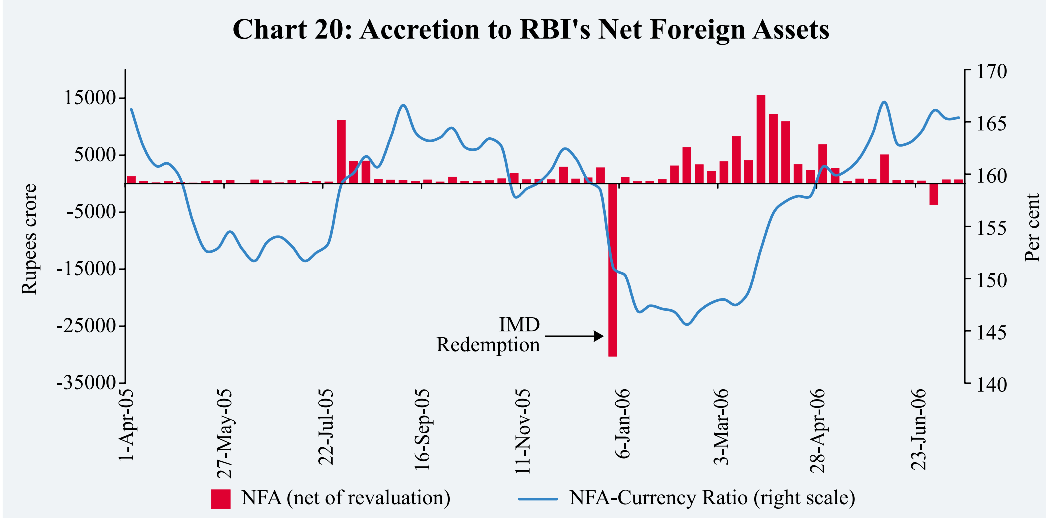
(NFA) in contrast to being driven by accretion to its domestic assets during the corresponding period of 2005-06. The Reserve Bank's foreign currency assets (net of revaluation) have increased by Rs.29,894 crore during the fiscal year 2006-07 so far as compared with an increase of Rs.6,094 crore during the corresponding period of the previous year (Table 19 and Chart 20).

Table 19: Major Components and Sources of Reserve Money

(Rupees crore)

	Variation during							
	2005-06 (April-March)	2005-06 (up to July 15)	2006-07 (up to July 14)	2005-06 Q1	2005-06 Q2	2005-06 Q3	2005-06 Q4	2006-07 Q1
1	2	3	4	5	6	7	8	9
Reserve Money	83,930	17,806	15,165	7,177	1,062	25,440	50,251	15,215
Components								
Currency in Circulation	62,015	19,536	23,646	19,877	-9,479	29,154	22,462	23,268
Bankers' Deposits with RBI	21,515	-171	-8,214	-10,680	9,780	-2,967	25,382	-7,204
Other Deposits with RBI	401	-1,559	-266	-2,021	761	-747	2,408	-849
Sources								
RBI's net credit to Government Sector	26,111	20,407	-4,754	9,275	-25,251	19,879	22,208	53
of which: to Centre	28,417	25,530	-1,736	14,600	-25,251	19,812	19,256	3,071
RBI's Credit to Banks and Commercial Sector	535	-1,663	-3,082	1,155	-1,869	101	1,148	-3,135
NFEA of RBI	60,193	-20,941	78,467	-14,595	24,823	23,741	26,224	71,845
Govt's Currency Liabilities to the Public	1,306	384	64	384	910	-100	112	64
Net Non-Monetary liabilities of RBI	4,215	-19,619	55,530	-10,957	-2,450	18,180	-559	53,612
Memo:								
Net Domestic Assets	23,737	38,747	-63,302	21,771	-23,760	1,700	24,027	-56,631
FCA, adjusted for revaluation	68,834	6,094	29,894	5,034	23,665	11,998	28,137	28,107
Net Purchases from Authorised Dealers	32,884	-467	21,545*	0	17,027	0	15,857	21,545*
NFEA/RM (per cent) (end-period)	117.4	116.7	127.7	120.5	125.3	123.7	117.4	126.6
NFEA/Currency (per cent) (end-period)	156.3	152.5	165.4	154.0	164.4	158.4	156.3	164.1

NFEA : Net Foreign Exchange Assets. FCA : Foreign Currency Assets. RM : Reserve Money.
* : Up to May 26, 2006.
Note: Data are based on March 31 for Q4 and last reporting Friday for all other quarters.



Mirroring the liquidity absorption operations through LAF, the Reserve Bank's holdings of Government securities declined by Rs.30,766 crore during the financial year 2006-07 (up to July 14) as against an increase of Rs.15,993 crore in the corresponding period of 2005-06. Over the same period, there was a decline

Table 20: Net Reserve Bank Credit to the Centre

(Rupees crore)

Item	Variation during							
	2005-06 (April-March)	2005-06 (up to July 15)	2006-07 (up to July 14)	2005-06 Q1	Q2	Q3	Q4	2006-07 Q1
1	2	3	4	5	6	7	8	9
Net Reserve Bank Credit to the Centre (1+2+3+4-5)	28,417	25,530	-1,736	14,600	-25,251	19,812	19,256	3,071
1. Loans and Advances	0	0	0	0	0	0	0	0
2. Treasury Bills held by the Reserve Bank	0	0	0	0	0	0	0	0
3. Reserve Bank's Holdings of Dated Securities	13,869	15,993	-30,766	8,221	-17,243	19,378	3,513	-27,610
4. Reserve Bank's Holdings of Rupee Coins	7	-48	-13	-40	-33	157	-77	9
5. Central Government Deposits	-14,541	-9,586	-29,043	-6,419	7,974	-277	-15,820	-30,672
*Memo**								
1. Market Borrowings of Dated Securities by the Centre #	1,31,000	52,000	59,000	42,000	39,000	24,000	26,000	52,000
2. Reserve Bank's Primary Subscription to Dated Securities	10,000	0	0	0	0	0	10,000	0
3. Repos (+) / Reverse Repos (-) (LAF), net position	12,080	11,965	-32,435	9,660	-14,835	18,635	-1,380	-23,060
4. Net Open Market Sales @	3,913	2,069	2,503	1,543	941	261	1,168	1,536
5. Mobilisation under MSS	-35,149	6,047	7,198	7,469	-4,353	-19,713	-18,552	4,062
6. Primary Operations $	-33,328	27,313	75,386	18,205	-24,689	-38,715	11,871	62,063

* : At face value. #: Excluding Treasury Bills.
@: Excluding Treasury Bills but including Consolidated Sinking Funds (CSF) and other investments.
$: Adjusted for MSS and Centre's surplus investment.
Note: Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.

of Rs.29,043 crore in Central Government deposits with the Reserve Bank. The Reserve Bank's net credit to the Centre, therefore, declined by Rs.1,736 crore during the fiscal year 2006-07 (up to July 14) as against an increase of Rs.25,530 crore during the corresponding period of 2005-06 (Table 20).

Liquidity Management

After a spell of some tightness in market liquidity during December 2005-March 2006, liquidity conditions have eased significantly during 2006-07 so far. The turnaround in the liquidity conditions could be attributed to unwinding of the Centre's surplus balances with the Reserve Bank and the Reserve Bank's purchase of foreign exchange from authorised dealers (Table 21). Accordingly, the Reserve Bank reverted back to liquidity absorption mode during 2006-07. On an average, the Reserve Bank absorbed liquidity through reverse repos to the extent of Rs.51,490 crore during April-June 2006 as against a net injection of liquidity through repos to the extent of Rs.11,686 crore during the previous quarter (January - March 2006). Average daily liquidity absorption during April-June 2006 was more than double of that during the corresponding quarter of the previous year (Rs.22,481 crore during April-June 2005).

On a review of liquidity conditions, issuances under the MSS were re-introduced effective May 3, 2006. The balances under the MSS, which had

Table 21: Phases of Reserve Bank's Liquidity Management Operations

(Rupees crore)

Item	Variation during					
	April 1-July 22, 2005	July 23-August 12, 2005	August 13-October 28, 2005	October 29-Dec 30, 2005	Dec 30, 2005-Mar 31, 2006	April 1-July 14, 2006
1	2	3	4	5	6	7
A. Drivers of Liquidity (1+2+3+4)	**-6,587**	**27,406**	**-14,621**	**-60,555**	**22,638**	**28,928**
1. RBI's Foreign Currency Assets (adjusted for revaluation)	6,412	19,348	5,193	-21,696	59,577	29,894
2. Currency with the Public	-15,125	-1,914	-7,434	-12,734	-20,073	-25,990
3. Surplus Cash Balances of the Centre with the Reserve Bank	6,053	5,972	-7,421	-24,357	-2,973	39,158
4. Others (residual)	-3,927	4,000	-4,959	-1,768	-13,893	-14,134
B. Management of Liquidity (5+6+7+8)	**1,329**	**-24,567**	**16,187**	**72,235**	**-7,215**	**-39,486**
5. Liquidity Impact of LAF Repos	8,845	-26,565	16,210	48,595	-35,005	-32,435
6. Liquidity Impact of OMO (net)	0	0	0	0	10,740	147
7. Liquidity Impact of MSS	-7,516	1,998	-23	23,640	17,050	-7,198
8. First Round Liquidity Impact due to CRR change	0	0	0	0	0	0
C. Bank Reserves # (A+B)	**-5,258**	**2,839**	**1,566**	**11,680**	**15,423**	**-10,558**

+: Indicates injection of liquidity into the banking system.
–: Indicates absorption of liquidity from the banking system.
#: Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.
*: Adjusted for Consolidated Sinking Funds (CSF).

Table 22: Liquidity Management

(Rupees crore)

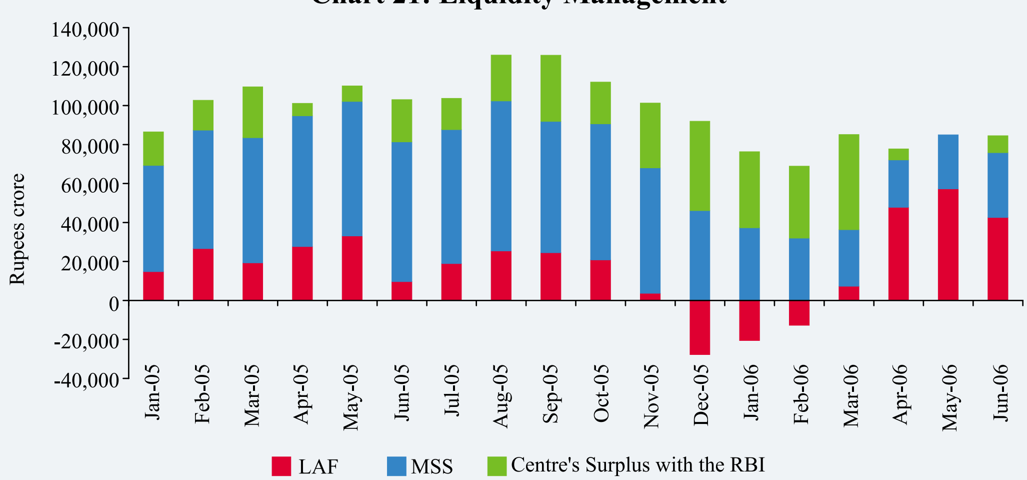
Outstanding as on last Friday of	LAF	MSS	Centre's Surplus with the RBI @	Total (2 to 4)
1	2	3	4	5
2005				
January	14,760	54,499	17,274	86,533
February	26,575	60,835	15,357	102,767
March *	19,330	64,211	26,102	109,643
April	27,650	67,087	6,449	101,186
May	33,120	69,016	7,974	110,110
June	9,670	71,681	21,745	103,096
July	18,895	68,765	16,093	103,753
August	25,435	76,936	23,562	125,933
September	24,505	67,328	34,073	125,906
October	20,840	69,752	21,498	112,090
November	3,685	64,332	33,302	101,319
December	-27,755	46,112	45,855	64,212
2006				
January	-20,555	37,280	39,080	55,805
February	-12,715	31,958	37,013	56,256
March	-7,250	29,062	48,828	85,140
April	47,805	24,276	5,611	77,692
May	57,245	27,817	0	85,062
June	42,565	33,295	8,621	84,481
July (as on July 14)	39,685	36,260	9,670	85,615

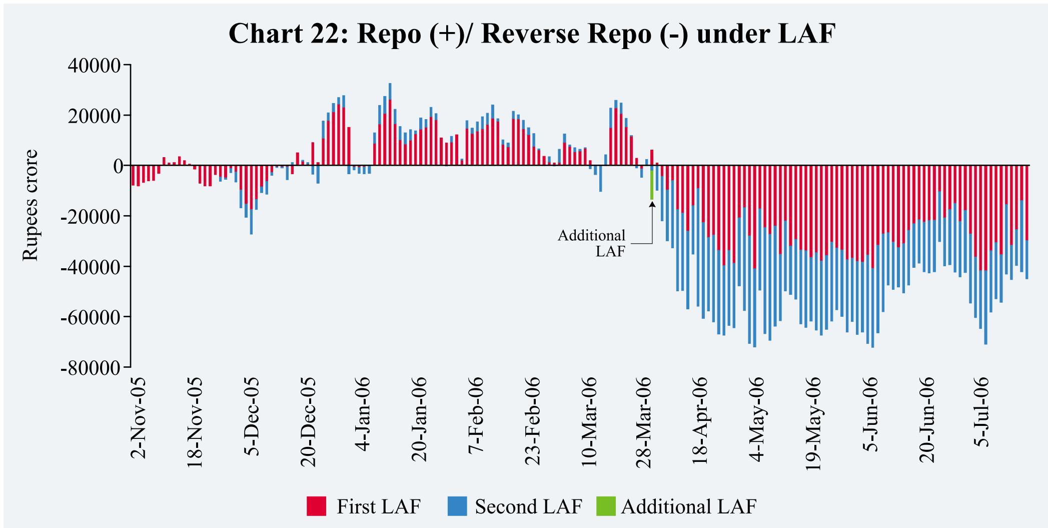
@ : Excludes minimum cash balances with the Reserve Bank.
Note : Negative sign in column 2 indicates injection of liquidity through LAF repo.
* : Data pertain to March 31, 2005.

been falling since November 2005, thus, increased during May-June 2006 (Table 22 and Chart 21).

In order to fine-tune the management of liquidity and in response to suggestions from the market participants, the Reserve Bank had introduced a

Chart 21: Liquidity Management





Second Liquidity Adjustment Facility with effect from November 28, 2005. The recourse by market participants to the second LAF *vis-a-vis* the first LAF was relatively small during the phase of liquidity injection between November 2005 and March 2006. However, with the easing of liquidity conditions, there has been a significant increase in the recourse to the second LAF since April 2006 onwards (Chart 22). The daily average absorption under the second LAF during April-May 2006 at Rs.28,776 crore exceeded that of Rs.24,131 crore in the first LAF. The daily average absorption under the second LAF declined during June 2006 and was also somewhat lower than that in the first LAF (Table 23).

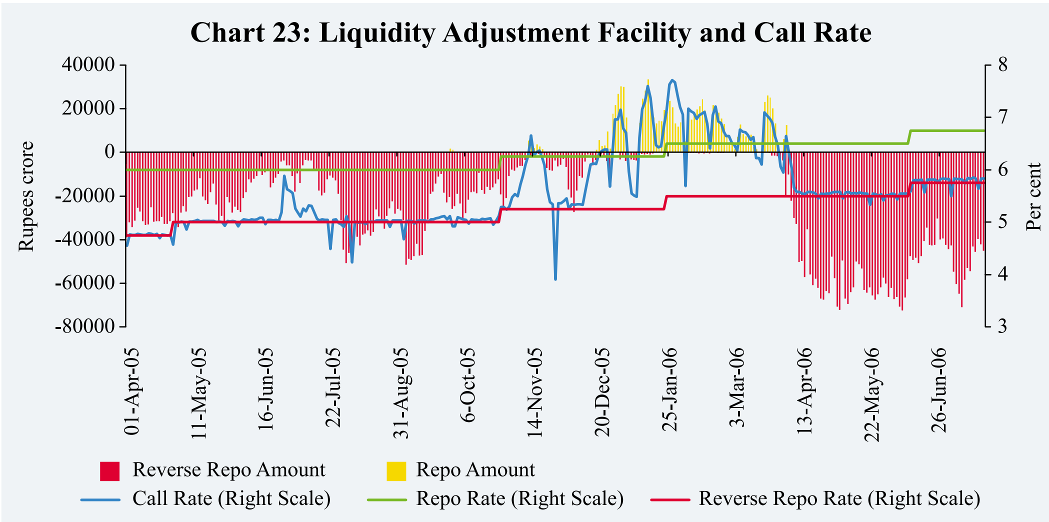
Liquidity absorption through LAF fell during June 2006 reflecting increase in the Centre's surplus balances with the Reserve Bank and fresh issuances under the MSS. Liquidity absorption, however, increased again during the first week of

Table 23: Dynamics of First and Second LAF

(Amount in Rupees crore)

	Average daily LAF Operations (net)	Average daily First LAF Operations (net)	Average daily Second LAF Operations (net)	Share of First LAF in Total LAF (per cent)	Share of Second LAF in Total LAF (per cent)
1	2	3	4	5	6
December 2005	-1,452	654	-2,106	64.6	35.4
January 2006	15,386	12,938	2,447	72.9	27.1
February 2006	13,532	10,850	2,682	75.0	25.0
March 2006 @	6,319	5,520	799	54.1	45.9
April 2006	-46,088	-18,480	-27,608	41.1	58.9
May 2006	-59,505	-29,600	-29,905	49.7	50.3
June 2006	-48,611	-25,647	-22,964	52.8	47.2

Note : (+) indicates injection of liquidity through LAF repo while (-) indicates absorption of liquidity through LAF reverse repos.
@ : LAF amounts for Additional LAF conducted on March 31, 2006 have been shown under second LAF.



July 2006 mirroring the decline in the Centre's surplus balances. Reflecting the easing of liquidity conditions, call rates have remained close to the reverse repo rate during 2006-07 so far. The call rates edged higher from June 9, 2006 onwards in consonance with the increase of 25 basis points each in the reverse repo rate and the repo rate (Chart 23).

IV. PRICE SITUATION

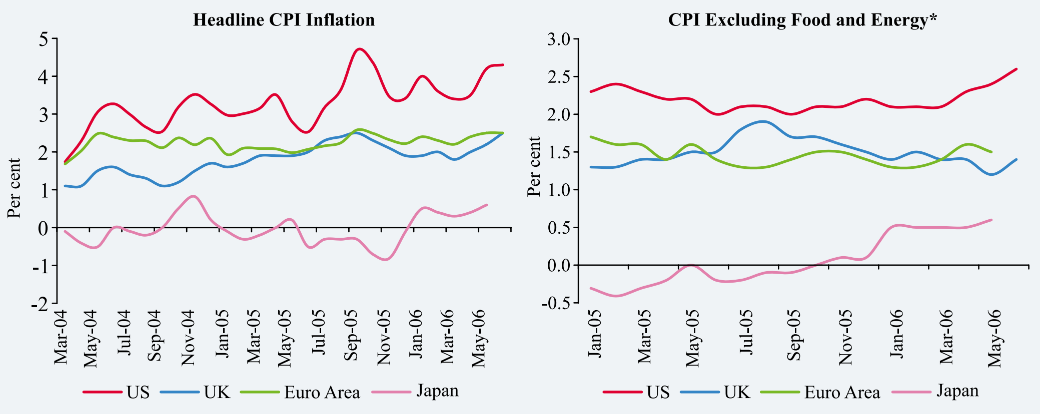
Headline inflation firmed up further in several countries during the first quarter of 2006-07 in response to sustained pressures from record high international crude oil prices. Core inflation and inflation expectations which had so far remained relatively benign have also edged higher in recent months. With a significant part of the increase in international crude oil prices being considered as permanent, many central banks tightened monetary policies further to contain inflation and inflationary expectations. With inflation turning higher than anticipated, this raised fears of US monetary tightening going further than expected hitherto. This, in turn, seems to have unnerved global financial and commodity markets during May-June 2006.

In India, supply-side factors continued to be the major factors driving inflation during the first quarter of 2006-07. Apart from higher oil prices, primary food articles prices also posed upward pressure on inflation in the first quarter. Nonetheless, headline inflation remained within the indicative trajectory during the first quarter of 2006-07 although underlying inflation pressures continued. Pre-emptive monetary and fiscal measures have helped in containing inflationary expectations.

Global Inflation

Headline inflation firmed up further in the first quarter of 2006-07 in a number of economies in tandem with the movements in international crude oil prices (Chart 24). With oil prices reaching a new high of over US $ 75 a barrel in

Chart 24: Consumer Price Inflation - Developed Economies

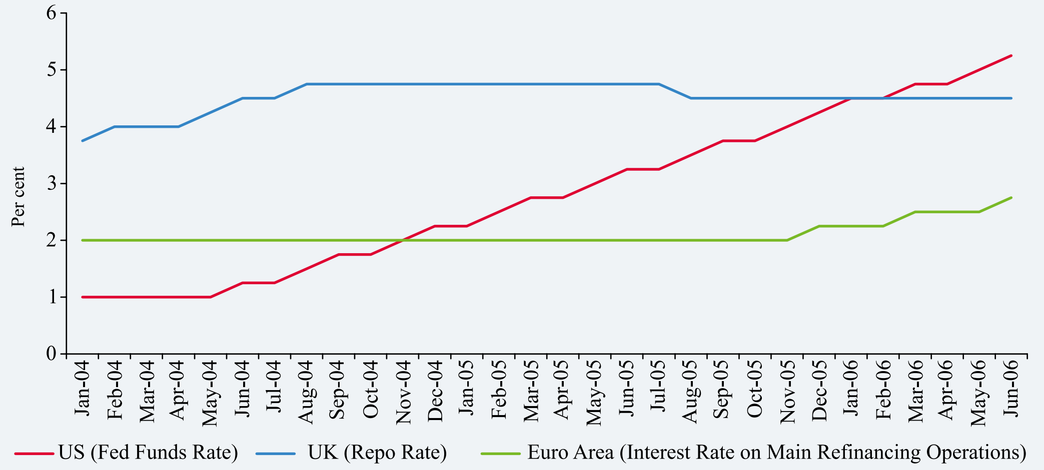


* : Data for Japan is excluding fresh food only.
Source: International Financial Statistics and the Economist.

April 2006, headline inflation edged up sharply in major advanced economies in June 2006 exceeding the accepted levels/targets – inflation, year-on-year (y-o-y), reached 4.3 per cent in the US and 2.5 per cent each in the Euro area and in the UK. Core inflation, which had till recently remained relatively stable, has also shown signs of some increase in recent months. Many central banks have, therefore, continued to tighten monetary policy during 2006 in order to contain inflation and inflationary expectations, especially in view of continued strength of demand and possible stronger pass-through of previous increases in oil prices.

In the US, with rising resource utilisation and elevated energy and other commodity prices viewed as having the potential to add to inflationary pressures, the US Federal Reserve raised its target federal funds rate further by 50 basis points during April-June 2006 – 25 basis points each in May and June 2006 to 5.25 per cent. The fed funds rate has thus increased by 425 basis points since the tightening began in June 2004 (*i.e.*, 25 basis points hike at each of its 17 meetings) (Chart 25). The US Federal Open Market Committee (FOMC) has noted that the extent and timing of any additional firming that may be needed will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information. In the Euro area, inflation is expected to remain above the target of 'below but close to 2.0 per cent' in the coming months due to upside risks from further increases in oil prices, the possibility of stronger pass-through of past oil price rises, and additional increases in administered prices and indirect taxes. The European Central Bank (ECB), therefore, raised the key policy rate by 25 basis points again in June 2006 – a total increase of 75 basis points since December 2005 – to keep inflation expectations in the Euro-area anchored to levels consistent with price stability. The Reserve Bank of Australia also raised its policy rate in May 2006 – after a gap of more than one

Chart 25: Central Bank Policy Rates



year – by 25 basis points to 5.75 per cent in response to strong economic activity and underlying inflation pressures. Amongst other advanced economies, Sweden, Norway and Switzerland raised their policy rates by 25 basis points each while Canada raised rates by 50 basis points during the quarter ended June 2006 in view of inflationary pressures.

In the UK, on the other hand, the Bank of England after cutting its policy rate by 25 basis points on August 4, 2005 has kept it unchanged since then. In Japan, year-on-year consumer price inflation has turned positive since January 2006. The Bank of Japan (BoJ) expects the economy to expand for a sustained period and the year-on-year change in the consumer prices is also projected to continue to follow a positive trend. Accordingly, after maintaining zero interest rates for an extended period, the BoJ on July 14, 2006 decided to increase the uncollateralised overnight call rate (adopted as the operating target for monetary policy since March 2006) by 25 basis points (Table 24).

Table 24: Global Inflation Indicators

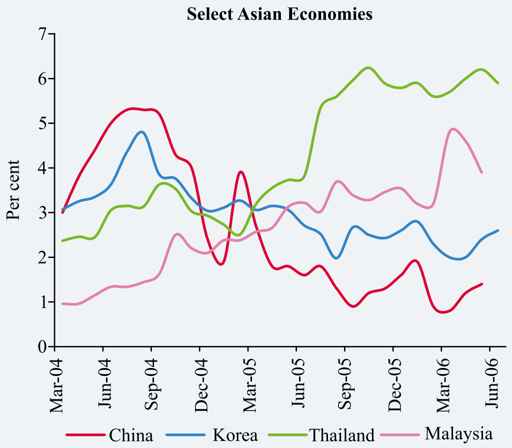
(Per cent)

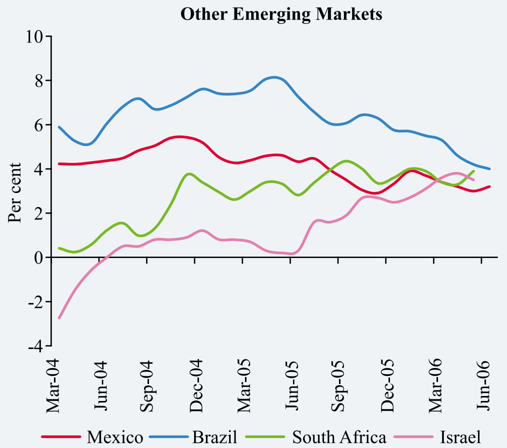
Country/ Region	Key Policy Rate	Policy Rates (As on July 19, 2006)	Changes in Policy Rates (basis points)		CPI Inflation (y-o-y)		Growth (y-o-y)	
			Since end-March 2005	Since end-March 2006	2005 (May)	2006 (May)	2005 (Q1)	2006 (Q1)
1	2	3	4	5	6	7	8	9
Developed Economies								
Australia	Cash Rate	5.75	25	25	2.4	3.0 #	1.9	3.1
Canada	Overnight Rate	4.25	175	50	1.6	2.8	3.3	3.2
Euro area	Interest Rate on Main Refinancing Operations	2.75	75	25	2.1	2.5 @	1.5	1.9
Japan	Uncollateralised Overnight Call Rate	0.25	**	25	0.2	0.6	1.1	3.8
UK	Repo Rate	4.50	(-)25	0	2.0	2.5 @	1.9	2.3
US	Federal Funds Rate	5.25	250	50	2.5	4.3 @	3.6	3.7
Developing Economies								
Brazil	Selic Rate	15.25	(-)400	(-)125	7.3	4.0 @	2.6	3.4
India	Reverse Repo Rate	5.75	100	25	3.7	6.3	8.6	9.3
Indonesia	BI Rate	12.25	375 *	(-)50	7.4	15.5 @	6.4	4.6
Israel	Key Rate	5.25	175	50	0.2	3.5	4.1	5.2
Korea	Overnight Call Rate	4.25	100	25	2.7	2.6 @	2.7	6.1
Philippines	Reverse Repo Rate	7.50	75	0	7.6	6.7	4.6	5.5
South Africa	Repo Rate	7.50	0	50	3.3	3.9	4.2	4.0
Thailand	14-day Repo Rate	5.00	275	50	3.8	5.9 @	3.3	6.0

y-o-y : year-on-year. # : First quarter of 2006. @ : June. * : Change since July 2005.
** : The Bank of Japan decided on March 9, 2006 to change the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralised overnight call rate.
Note : Indian data on inflation pertain to CPI for Industrial Workers.
Source : International Monetary Fund, websites of respective central banks, the Economist and the OECD.

In emerging Asia, with inflation remaining firm, many central banks further tightened their monetary policies to stabilise inflationary expectations. In Thailand, although core inflation has remained within the target range in 2006 so far, the Bank of Thailand raised policy rates by 25 basis points each in April and June 2006 to 5.0 per cent – a total hike of 275 basis points since end-March 2005. In Korea, even though inflation remains modest, inflationary pressures seen from strong economic recovery and high oil prices prompted the Bank of Korea to raise the policy rate by 25 basis points to 4.25 per cent in June 2006 – a total of 100 basis points since the tightening began in October 2005. The Bank Indonesia, which had raised policy rates by 425 basis points during July-December 2005, cut the policy rate by 25 basis points each in May and July 2006 to 12.25 per cent to support growth. Inflation still remains high, although there has been some moderation from its recent peak of 18.4 per cent in November 2005 to 15.5 per cent in June 2006. The Bank of Philippines has maintained the policy reverse repo rates at 7.5 per cent since October 2005 (when it had raised the rate by 25 basis points) on expectations of deceleration in inflation by the second-half of 2006. On the other hand, despite strong growth, consumer price inflation in China decelerated to 1.4 per cent in May 2006 from 1.8 per cent a year ago, mainly due to lower prices of meat and poultry products as well as downward pressures on prices in some sectors reflecting excess capacity (Chart 26). Nonetheless, China increased the benchmark 1-year lending rate by 27 basis points effective April 28, 2006 and raised the cash reserve ratio by 50 basis points to 8.0 per cent effective July 5, 2006 in view of stronger growth in money supply and credit. Amongst other emerging economies, South Africa – after having kept policy rates unchanged since April 2005 – raised the policy rates by 50 basis points to 7.50 per cent in June 2006. Turkey increased its policy rate by 175 basis points on

Chart 26: Consumer Price Inflation - Emerging Market Economies





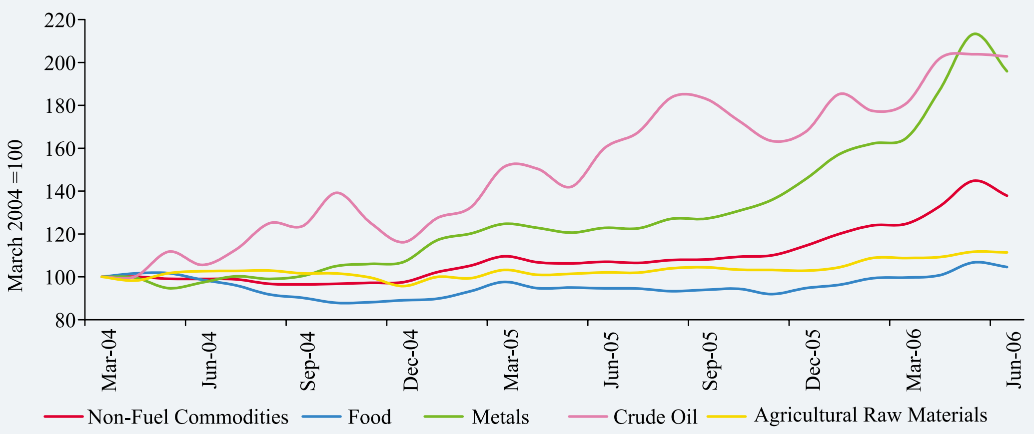
June 8, 2006 and another 225 basis points on June 25, 2006 as inflation rate significantly exceeded the target path and on concerns over the possible pass-through effect of the exchange rate movements arising from the recent volatility in international financial markets. On the other hand, in view of weak economic activity, Brazil has reduced policy rates on eight occasions since September 2005 to 15.25 per cent on May 31, 2006.

Global Commodity Prices

International commodity prices rose further during the first quarter of 2006-07, led by crude oil and metals prices, reflecting robust economic activity and supply constraints (Chart 27). Crude oil prices reached new record highs reflecting tight supply conditions and geo-political factors. Non-fuel commodity prices also increased led by metals reflecting strong demand, higher energy prices, lags in supply and interest by investors in commodity markets – *albeit* with some corrections during May-June 2006 following concerns that further monetary tightening might slow global growth and demand.

International crude oil prices which rose to record highs during 2005-06 firmed up further during the first quarter of 2006-07. Despite some deceleration in growth in global oil demand during 2005, oil prices continued to firm up reflecting limited surplus capacity and geo-political uncertainties (Table 25). WTI prices reached a new high of US $ 75.3 a barrel on April 21, 2006 reflecting renewed concerns over Iran's nuclear programme and unrest in Nigeria. Prices eased marginally in subsequent weeks to around US $ 70 a barrel, partly on concerns of likely slowdown in demand in view of further monetary tightening. However, they again edged higher on concerns of geo-political uncertainties in the Middle East and reached a new record high of

Chart 27: International Commodity Prices



Source: International Monetary Fund.

Table 25: International Crude Oil Prices

(US dollars per barrel)

Year/Month	Dubai Crude	UK Brent	US WTI	Average Crude Price	Indian Basket Price
1	2	3	4	5	6
2001-02	21.8	23.2	24.1	23.0	22.4
2002-03	25.9	27.6	29.2	27.6	26.6
2003-04	26.9	29.0	31.4	29.1	27.8
2004-05	36.4	42.2	45.0	41.3	38.9
2005-06	53.4	58.0	59.9	57.1	55.4
March 2004	30.5	33.8	36.7	33.7	31.9
March 2005	45.6	53.1	54.2	50.9	48.8
March 2006	57.7	62.3	62.9	60.9	59.6
April 2006	64.1	70.4	69.4	68.0	66.8
May 2006	64.9	70.2	70.9	68.7	67.2
June 2006	65.1	68.9	70.9	68.3	66.7

Source : International Monetary Fund and the World Bank.

US $ 78.4 a barrel on July 14, 2006. Average international crude oil prices, which had increased by 38.3 per cent to US $ 57.1 a barrel in 2005-06, rose further by about 12 per cent between March 2006 and June 2006.

With limited surplus global crude oil production capacity and the U.S. oil production and refining industries still to recover fully, oil prices are expected to remain firm in the near future (Table 26). The Energy Information Administration (EIA) of the US, therefore, expects WTI prices to average US $ 69.1 per barrel in calendar year 2006, an increase of about 22 per cent over the price prevailing in 2005 (US $ 56.5 per barrel).

Metal prices firmed up sharply during April and early May 2006 with prices reaching record highs/multi-year highs on the back of robust construction and

Table 26: World Supply-Demand Balance of Oil

(Million barrels per day)

Item	2003	2004	2005	2006 (P)	2006 P			
					Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9
Demand								
1. OECD	48.7	49.5	49.6	49.9	50.2	48.8	49.9	50.8
2. Non-OECD	31.2	33.0	34.4	35.6	35.1	35.2	35.4	36.8
of which: China	5.6	6.5	6.9	7.4	7.2	7.3	7.4	7.6
3. Total (1+2)	79.9	82.5	84.0	85.6	85.3	84.0	85.4	87.6
Supply								
4. Non-OPEC	48.9	50.1	50.1	50.9	50.7	50.4	51.0	51.6
5. OPEC	30.7	32.9	33.9	34.1	33.7	33.5	34.5	34.7
6. Total (4+5)	79.6	83.1	84.0	85.0	84.4	83.9	85.5	86.3
Stock Changes	0.3	-0.6	-0.1	0.5	0.9	0.1	-0.1	1.3

P: Projections.
Source: US Energy Information Administration, July 2006.

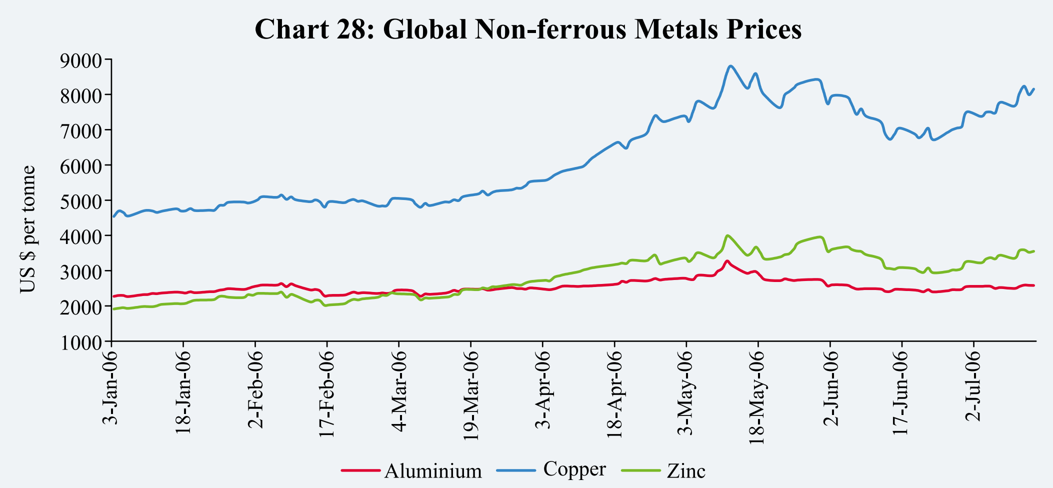
manufacturing demand from China and the US, and supply constraints amidst growing investors' interest. The rally in metal prices was led by copper, zinc and aluminium, reflecting decline in inventories to historical lows as well as a series of supply disturbances, including the labour strikes in the US and Chile in the copper industry (Table 27). As a result, the IMF's metals price index rose by 77 per cent y-o-y in May 2006. However, following the release of higher than anticipated US inflation data for April 2006, global metal prices witnessed correction from mid-May 2006 onwards on fears that further monetary tightening by the US might slow down demand for metals. Consequently, prices of copper, aluminium and zinc on the London Metal Exchange (LME) fell by 18 per cent, 17 per cent and 16 per cent, respectively, between May 17, 2006 and June 29, 2006 (Chart 28). Notwithstanding this correction, prices are still substantially higher than their levels a year ago – prices of copper and zinc during June 2006 were higher by about 104 per cent and 153 per cent, respectively, over June 2005 levels. International steel prices which had stabilised in the second half of 2005 edged higher in June 2006.

Sugar prices, which had increased sharply in the second half of 2005-06, eased during May-June 2006. Notwithstanding this easing, global sugar prices during April-June 2006 were almost double of their levels a year ago reflecting a decline in global inventories and higher global sugar consumption, especially from the developing countries of the Far East and Latin America. Wheat and rice prices

Table 27: International Commodity Prices

Commodity	Unit	2004	2005	2005	2006		2006			
				Apr-Jun	Jan-Mar	Apr-Jun	Mar	Apr	May	Jun
1	2	3	4	5	6	7	8	9	10	11
Energy										
Coal	$/mt	53.0	47.6	51.2	46.9	52.6	49.8	52.9	52.6	52.4
Crude oil (Average)	$/bbl	37.7	53.4	50.8	61.0	68.3	60.9	68.0	68.7	68.3
Non-Energy Commodities										
Palm oil	$/mt	471.3	422.1	421.7	436.4	438.7	440.0	439.0	440.0	437.0
Soybean oil	$/mt	616.0	544.9	548.0	535.3	576.3	539.0	541.0	588.0	601.0
Soybeans	$/mt	306.5	274.7	290.7	256.7	263.7	256.0	258.0	266.0	267.0
Rice	$/mt	237.7	286.3	292.0	298.8	307.6	303.5	302.3	308.0	312.5
Wheat	$/mt	156.9	152.4	142.0	173.8	189.6	174.4	180.3	193.2	195.2
Sugar	c/kg	15.8	21.8	19.3	37.5	36.5	38.0	38.6	37.1	34.0
Cotton A Index	c/kg	136.6	121.7	122.6	131.1	121.8	129.3	123.7	120.2	121.5
DAP	$/mt	221.2	247.0	235.6	259.6	266.9	256.6	260.8	270.8	269.2
Urea	$/mt	175.3	219.0	241.6	219.2	228.1	244.1	248.4	227.8	208.2
Aluminium	$/mt	1715.5	1898.3	1790.0	2420.8	2653.0	2429.0	2621.0	2861.0	2477.0
Copper	$/mt	2865.9	3678.9	3389.0	4940.0	7210.0	5103.0	6388.0	8046.0	7198.0
Gold	$/toz	409.2	444.8	427.3	554.0	627.4	557.1	610.7	675.4	596.1
Silver	c/toz	669.0	733.8	718.2	969.4	1226.1	1037.5	1263.2	1337.8	1077.4
Steel products index	1990=100	121.5	137.9	141.6	138.6	131.6	138.6	138.6	125.2	131.2
Steel cold-rolled coil/sheet	$/mt	607.1	733.3	750.0	750.0	666.7	750.0	750.0	600.0	650.0
Steel hot-rolled coil/sheet	$/mt	502.5	633.3	650.0	650.0	591.7	650.0	650.0	550.0	575.0
Tin	c/kg	851.3	738.0	796.3	760.6	852.9	794.0	885.3	883.7	789.6
Zinc	c/kg	104.8	138.1	127.3	224.2	329.2	241.7	308.5	356.6	322.6

$: US dollar. c: US cent. bbl: barrel. mt: metric tonne. kg: Kilogram. toz: troy oz.
Source: World Bank.



Source: London Metal Exchange.

have firmed up since the second half of 2005 due to lower production, higher demand from many countries in Asia, and a tightening of export availabilities in major exporting countries. Prices of oilseeds and edible oils have also edged up in recent months due to strong consumption demand from China and India and demand for non-food uses such as biodiesel from the EU and the US. Global cotton prices have eased in recent months (see Table 27).

Inflation Conditions in India

Taking into account the real economy, monetary and global factors having a bearing on domestic prices, the Reserve Bank in its Annual Policy Statement for 2006-07 (released in April 2006) noted that containing inflationary expectations would continue to pose a challenge to monetary management. The policy endeavour would be to contain the year-on-year inflation rate for 2006-07 in the range of 5.0-5.5 per cent.

Inflation movements continued to be driven by supply shocks in the first quarter of 2006-07. Apart from sustained pressures from oil prices, primary food articles prices also posed upward pressures. Nonetheless, headline inflation remained within the indicative trajectory although underlying inflation pressures continued. Inflation expectations remained largely stable, reflecting pre-emptive monetary policy actions which have helped in anchoring inflation expectations. In order to stabilise inflation expectations as also taking into account the global interest rate cycle, the Reserve Bank increased the LAF reverse repo rate and the repo rate by a further 25 basis points each effective June 9, 2006 (Table 28). The pass-through of international oil prices to domestic prices in a phased manner amidst the burden sharing strategy by oil companies as well as duty reductions

Table 28: Movement in Key Policy Rates

(Per cent)

Effective since	Reverse Repo Rate	Repo Rate	Effective since	CRR
1	2	3	4	5
March 5, 2002	6.00	8.50	December 29, 2001	5.50
March 28, 2002	6.00	8.00	June 1, 2002	5.00
June 27, 2002	5.75	8.00	November 16, 2002	4.75
October 30, 2002	5.50	8.00	June 14, 2003	4.50
November 12, 2002	5.50	7.50	September 18, 2004	4.75
March 3, 2003	5.00	7.50	October 2, 2004	5.00
March 7, 2003	5.00	7.10		
March 19, 2003	5.00	7.00		
August 25, 2003	4.50	7.00		
March 31, 2004	4.50	6.00		
October 27, 2004	4.75	6.00		
April 29, 2005	5.00	6.00		
October 26, 2005	5.25	6.25		
January 24, 2006	5.50	6.50		
June 9, 2006	5.75	6.75		

Note : With effect from October 29, 2004, nomenclature of repo and reverse repo has been interchanged as per international usage. Prior to that date, repo indicated absorption of liquidity while reverse repo meant injection of liquidity. The nomenclature in this Report is based on the new usage of terms even for the period prior to October 29, 2004.

also mitigated the immediate cost push impact of international crude oil prices. Furthermore, competitive pressures, corporate profitability and productivity gains in several sectors have enabled corporates to absorb a part of the higher input costs into their profit margins. This has partially helped in abating the second order effects of higher oil prices and contained manufactured products inflation.

Headline inflation, based on movement in the wholesale price index (WPI), eased initially to 3.7 per cent as on April 15, 2006 from 4.1 per cent at end-March 2006, reflecting partly the base effect of higher prices last year. Inflation rate edged up somewhat in May-June 2006 to reach 5.4 per cent on June 17, 2006 reflecting higher prices of petrol and diesel, vegetables, milk and metals. Subsequently, inflation moderated to 5.0 per cent during the week ended July 1, 2006 on account of decline in the prices of fruits and milk as well as base effects (Table 29). The average WPI inflation rate eased to 4.3 per cent as on July 1, 2006 from 6.3 per cent a year ago.

Fuel prices continue to dominate the inflation outcome, notwithstanding the incomplete pass-through (Chart 29). In view of sustained rise in international crude oil prices, domestic petrol and diesel prices which were last raised in September 2005 were again increased by about Rs.4 (around nine per cent) and Rs.2 (around six per cent), respectively, effective June 6, 2006. Apart from raising oil prices, the Government also announced the following measures: i) reduction in customs duty on petrol and diesel to 7.5 per cent from the existing 10.0 per cent, ii) movement to trade parity pricing mechanism for petrol and diesel from the existing system of import parity pricing, and iii) issuance of oil bonds worth Rs.28,000 crore (over and

Table 29: Wholesale Price Inflation in India (year-on-year)

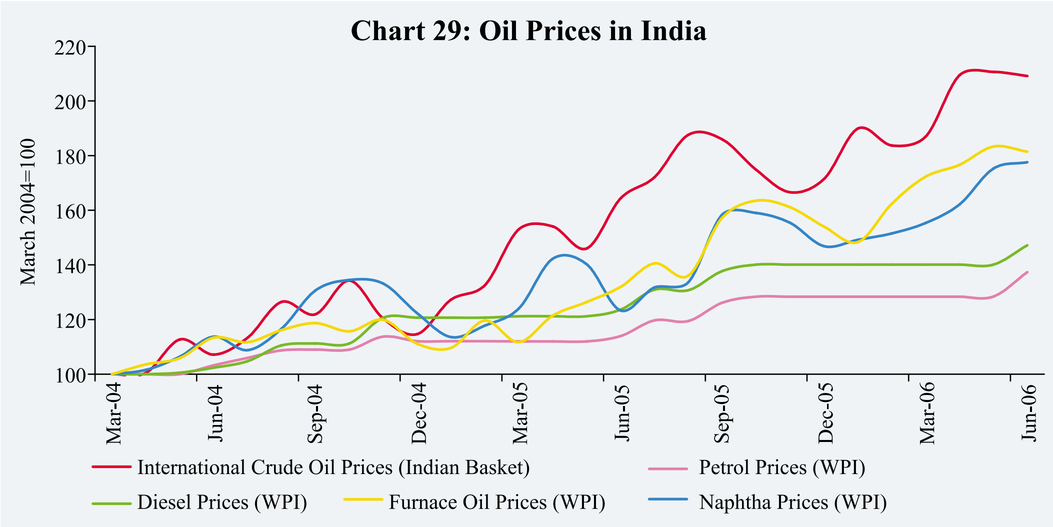
(Per cent)

Commodity		2005-06 (March 25)		2005-06 (July 2)		2006-07 P (July 1)	
	Weight	Inflation	WC	Inflation	WC	Inflation	WC
1	2	3	4	5	6	7	8
All Commodities	**100.0**	**4.1**	**100.0**	**4.1**	**100.0**	**5.0**	**100.0**
1. Primary Articles	**22.0**	**5.4**	**28.3**	**0.2**	**0.9**	**7.4**	**31.9**
Food Articles	15.4	6.6	24.2	3.4	12.4	7.7	23.4
i. Rice	2.4	2.7	1.4	4.4	2.3	1.3	0.6
ii. Wheat	1.4	12.9	4.3	3.0	1.0	8.8	2.3
iii. Pulses	0.6	33.2	4.4	7.2	1.0	31.9	3.7
iv. Vegetables	1.5	8.1	2.1	4.9	1.8	9.3	2.8
v. Fruits	1.5	-1.0	-0.5	10.3	3.7	-2.5	-0.8
vi. Milk	4.4	1.9	1.9	0.3	0.3	6.7	5.6
vii. Eggs, Fish and Meat	2.2	14.3	7.9	4.7	2.7	8.9	4.3
Non-Food Articles	6.1	-1.9	-2.7	-6.9	-10.6	1.8	2.1
i. Raw Cotton	1.4	-1.4	-0.4	-21.8	-7.1	2.6	0.5
ii. Oil Seeds	2.7	-7.8	-4.5	-7.0	-4.5	-5.2	-2.5
iii. Sugarcane	1.3	0.7	0.3	-0.7	-0.3	0.7	0.2
Minerals	0.5	43.6	6.8	-5.4	-1.0	47.2	6.4
2. Fuel, Power, Light and Lubricants	**14.2**	**8.9**	**47.9**	**10.5**	**53.4**	**7.3**	**33.0**
i. Mineral Oils	7.0	13.2	39.8	15.3	42.2	13.3	33.9
ii. Electricity	5.5	4.5	8.2	6.2	11.1	-0.6	-0.9
iii. Coal Mining	1.8	0.0	0.0	0.4	0.2	0.0	0.0
3. Manufactured Products	**63.8**	**1.7**	**23.2**	**3.3**	**44.7**	**3.2**	**35.9**
i. Food Products	11.5	0.9	2.2	1.0	2.5	2.0	4.2
of which: Sugar	3.6	6.6	4.9	12.4	8.3	8.4	5.1
Edible Oils	2.8	-2.4	-1.3	-5.9	-3.3	-0.7	-0.3
Oil Cakes	1.4	-10.0	-3.6	-12.2	-5.2	-4.7	-1.4
ii. Cotton Textiles	4.2	1.1	1.0	-11.9	-11.3	0.5	0.3
iii. Man Made Fibre	4.4	-4.6	-2.5	-3.9	-2.1	5.0	2.1
iv. Chemicals and Chemical Products	11.9	3.6	10.2	4.5	12.6	3.9	8.9
of which : Fertilisers	3.7	0.3	0.2	3.0	2.4	0.8	0.5
v. Basic Metals, Alloys and Metal Products	8.3	-2.9	-6.7	7.8	17.3	2.4	4.6
of which: Iron and Steel	3.6	-7.5	-8.7	6.3	7.1	-2.3	-2.2
vi. Non-Metallic Mineral Products	2.5	8.6	4.7	7.0	3.6	13.4	5.9
of which: Cement	1.7	13.0	4.8	7.1	2.4	19.8	5.8
vii. Machinery and Machine Tools	8.4	3.9	6.1	7.6	11.2	3.3	4.3
viii. Transport Equipment and Parts	4.3	1.2	1.1	5.0	4.2	1.1	0.8
Memo:							
Food Items (Composite)	**26.9**	**4.2**	**26.5**	**2.4**	**14.9**	**5.3**	**27.6**
WPI Excluding Food	**73.1**	**4.0**	**73.5**	**4.8**	**85.1**	**4.8**	**72.4**
WPI Excluding Fuel	**85.8**	**2.7**	**52.1**	**2.4**	**46.6**	**4.3**	**67.0**

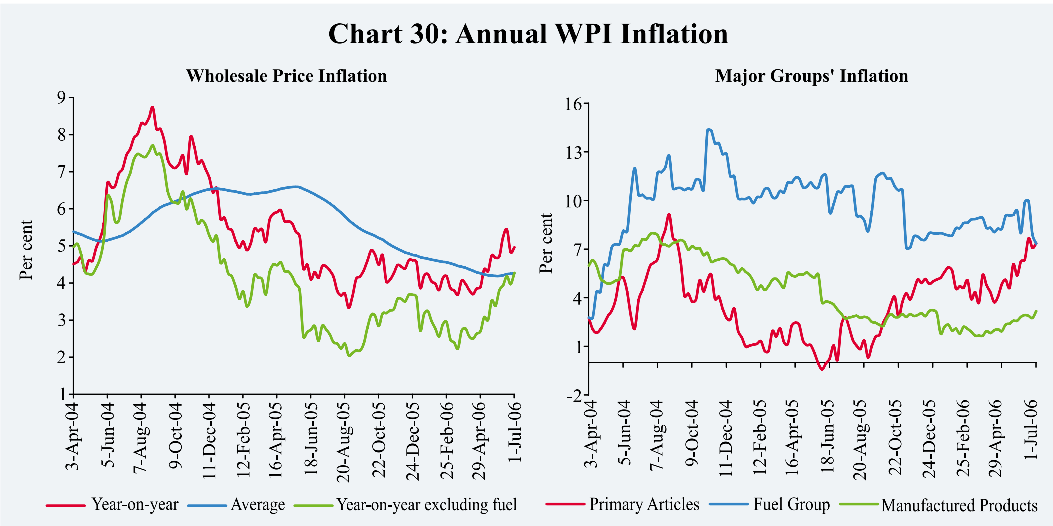
P: Provisional. WC : Weighted Contribution.

above Rs.11,500 crore issued during 2005-06) to oil marketing companies to compensate for their under-recoveries in domestic operations.

Although fuel prices have been the key driver of domestic inflation, domestic petroleum products prices still lag the increase in international crude oil prices. As compared with more than doubling of international crude oil prices (the Indian basket) between March 2004 and June 2006 (from US $ 31.9 a barrel to



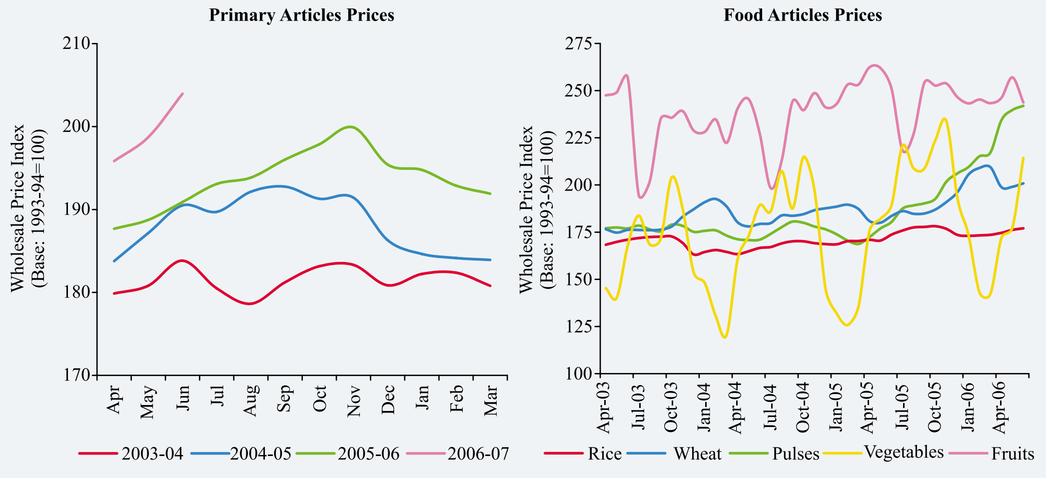
US $ 66.7 a barrel), domestic mineral oils prices in the WPI basket have increased by about 38.4 per cent over the same period (up to July 1, 2006) – petrol by 40.3 per cent and high-speed diesel by 49.5 per cent. The pass-through of higher international oil prices has been restricted to petrol and diesel. Domestic prices of liquefied petroleum gas (LPG) have remained unchanged since November 2004 while kerosene prices have been unchanged since April 2002 on grounds of social concerns. Notwithstanding this phased and incomplete pass-through, mineral oils inflation alone contributed almost one-third to the headline inflation. Accordingly, the y-o-y WPI inflation excluding the fuel group at 4.3 per cent as on July 1, 2006 remained below the headline rate (Chart 30).

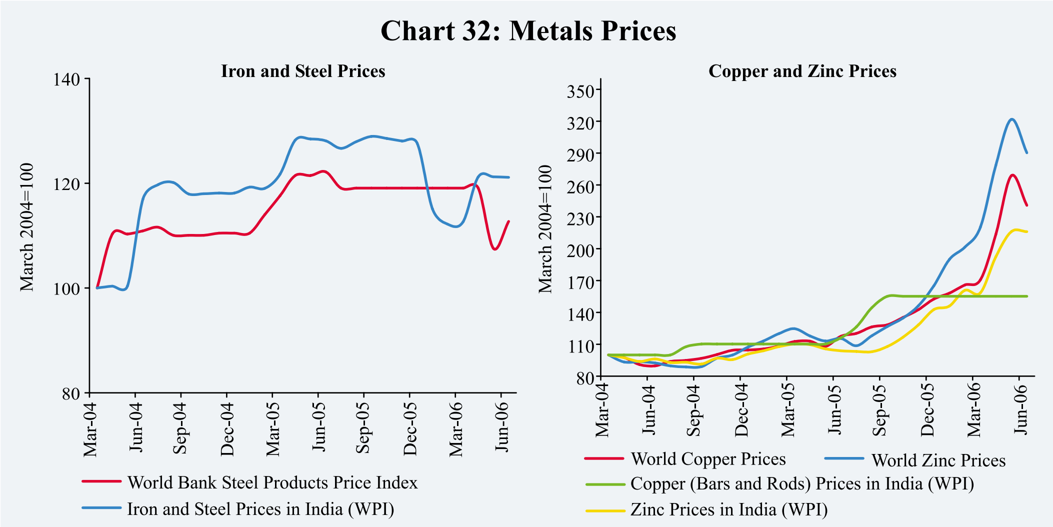


Prices of primary food articles also posed upward pressures on headline inflation during the first quarter of 2006-07 (Chart 31). Wheat prices, which had firmed up till March 2006 on reports of fall in stocks, moderated somewhat during April-June 2006. Nonetheless, wheat prices, on a year-on-year basis, have increased by about 8.8 per cent as on July 1, 2006. Vegetables prices have increased by about 51 per cent over end-March 2006 (almost the same order of increase as a year ago) reflecting the seasonal hardening patterns. Prices of pulses also edged higher from last year's level reflecting stagnant domestic production as well as higher demand. In order to improve domestic supplies so as to stabilise inflation expectations, the Government, during June 2006, took fiscal measures such as exempting imports of pulses and sugar from customs duty (till March 31, 2007 and September 30, 2006, respectively), allowing import of wheat at a concessional rate of 5 per cent customs duty (till end-December 2006) and restriction on exports of pulses. Oilseeds prices have increased since end-March 2006 on concerns about progress of monsoon. Overall, prices of primary articles have increased by 5.0 per cent since end-March 2006 (as compared with an increase of 3.1 per cent in the corresponding period of the previous year). On a y-o-y basis, prices of primary articles have increased by 7.4 per cent as compared with a marginal increase (0.2 per cent) a year ago. As a result, the primary articles contribution to headline inflation increased to 32 per cent as on July 1, 2006 from a negligible level a year ago.

Manufactured products inflation remained relatively modest – 3.2 per cent, y-o-y, as on July 1, 2006 as compared with 3.3 per cent a year ago. Competitive pressures, productivity gains as well as strong corporate profitability have provided firms the flexibility to absorb higher input costs into their profit margins. Furthermore, pre-emptive monetary actions by anchoring inflation expectations

Chart 31: Primary Commodity Prices in India



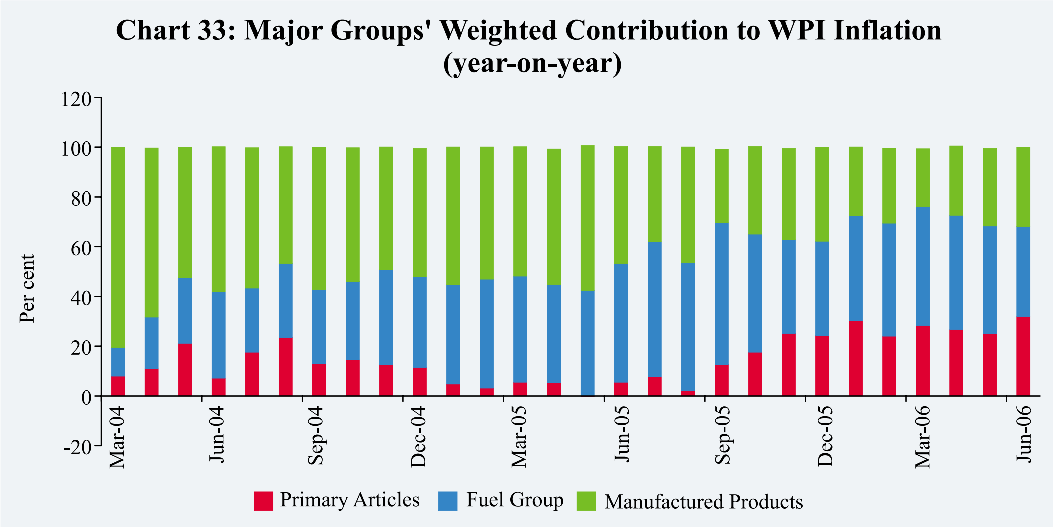


have restrained the second order effects of past increases in oil prices to manufactured products prices. Manufactured products inflation was led by a few commodities such as sugar, chemicals, cement and non-ferrous metals. Notwithstanding higher domestic sugarcane output, sugar prices have remained firm in line with international trends. In order to contain rising sugar prices, the Government, on June 22, 2006, as noted earlier, allowed duty-free imports of sugar till September 2006. Metal prices have moved in line with international trends (Chart 32). Non-ferrous metal prices rose sharply – prices of copper and zinc increased, y-o-y, by about 23 per cent and 96 per cent, respectively, on July 1, 2006. In contrast, the turnaround in iron and steel prices – a decline of 2.3 per cent, y-o-y, as on July 1, 2006 as against an increase of 6.3 per cent a year ago – contributed to some moderation in headline inflation. Although domestic iron and steel prices have declined on a y-o-y basis, they have edged up since March 2006 (an increase of 9.8 per cent) in tandem with international price movements.

In brief, domestic WPI inflation during 2006-07 so far (as on July 1, 2006) continues to be dominated by mineral oils prices, which alone contributed about 34 per cent to the y-o-y headline inflation. Primary articles' contribution to the overall y-o-y inflation was 32 per cent mainly due to higher prices of wheat, pulses, vegetables, milk, and eggs, meat and fish (Chart 33). Manufactured products' contribution fell to 36 per cent (45 per cent a year ago), largely on account of a decline in iron and steel prices.

Consumer Price Inflation

Consumer price inflation edged up, especially during May 2006, largely reflecting higher prices of food items (Table 30). As food prices have a higher



weight in the CPI *vis-à-vis* the WPI, the CPI inflation has remained higher than the WPI inflation since November 2005. WPI inflation was, on the other hand, higher than CPI inflation during the first half of 2005-06 reflecting higher fuel and metals prices which have higher weights in the WPI *vis-à-vis* CPI (Chart 34).

Asset Prices

Equity and gold prices, after having recorded sharp gains during 2005-06, witnessed some correction in the first quarter of 2006-07. Following higher than anticipated inflation in the US, global commodity prices and equity markets recorded losses in May 2006 on concerns that monetary tightening might slow prospects for global growth. In consonance with these international trends, domestic equity prices fell during May and early June 2006. Equity prices recovered somewhat in the second half of June 2006 and by end-June 2006, equity prices were down by around 6 per cent over end-March 2006 (Chart 35). International gold prices which rose to US $ 715 per ounce on May 12, 2006

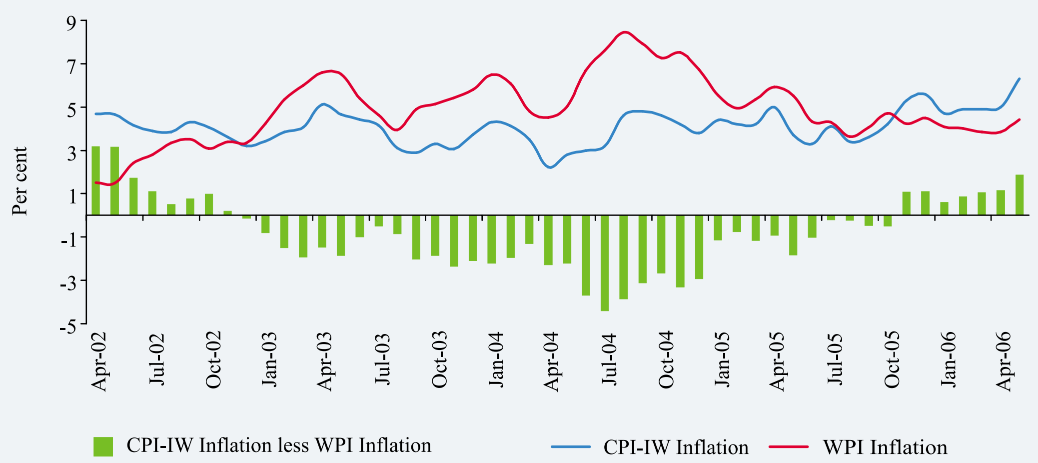
Table 30: Consumer Price Inflation (CPI) in India (year-on-year)

(Per cent)

Inflation Measure	March 2003	March 2004	March 2005	March 2006	April 2006	May 2006
1	2	3	4	5	6	7
CPI-IW	4.1	3.5	4.2	4.9	5.0	6.3
CPI- UNME	3.8	3.4	4.0	5.0	5.0	5.8
CPI-AL	4.9	2.5	2.4	5.3	5.6	6.4
CPI-RL	4.8	2.5	2.4	5.3	5.2	6.4
Memo:						
WPI Inflation (end-month)	6.5	4.6	5.1	4.1	3.9	4.7

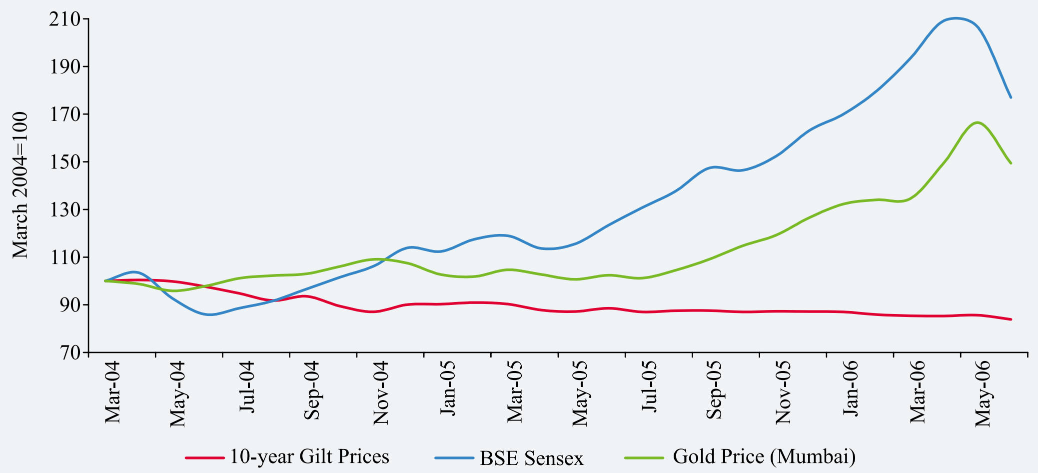
IW : Industrial Workers UNME : Urban Non-Manual Employees
AL : Agricultural Labourers RL : Rural Labourers

Chart 34: CPI and WPI Inflation



witnessed sharp correction and fell to US $ 559 as on June 14, 2006 in consonance with the trends in various commodities in the international market. Prices have since then recovered and were US $ 624 per ounce as on July 19, 2006. Domestic gold prices, after crossing Rs.10,000 per 10 grams in mid-May 2006, witnessed correction in line with international trends and fell to about Rs.8,470 per 10 grams on June 14, 2006. Prices recovered to about Rs.9,500 per 10 grams as on July 19, 2006. Gilt prices fell and yields rose further during the first quarter of 2006-07 on the back of increase in yields in major economies, concerns over domestic inflation in view of higher oil prices and the hike in the reverse repo rate.

Chart 35: Asset Price Movements



V. FINANCIAL MARKETS[3]

Global financial markets, after remaining relatively benign during 2005-06, exhibited large volatility during May-June 2006. With inflation rising sharply during May 2006, expectations that central banks might tighten further than earlier anticipated unnerved financial markets, especially commodity and equity markets. Risk spreads, which had declined to record lows in 2005-06 on the back of search for yield, widened as investors re-priced risk. Foreign investors pulled out from emerging market economies (EMEs), reflecting increase in risk aversion even as fundamentals remain largely strong.

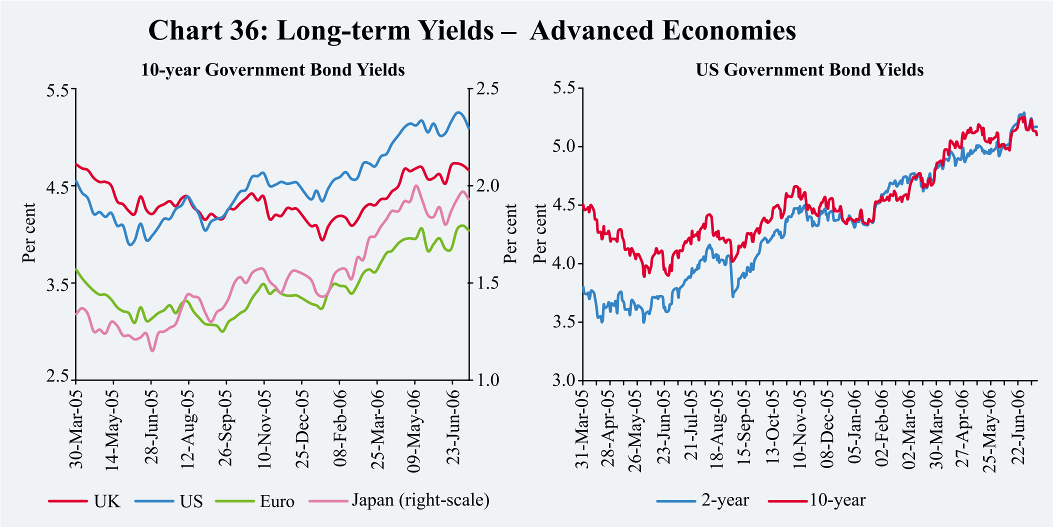
Short-term interest rates increased further in a number of economies during the first quarter of 2006-07 in consonance with continuous monetary tightening as central banks raised their policy rates further to ward off inflationary pressures stemming from higher international crude oil and other commodity prices in an environment of strong domestic demand (Table 31). The US increased its fed funds rate target by 50 basis points (bps) during the quarter while the European Central Bank raised its policy rate by 25 basis points during the quarter. Other advanced economies such as Australia, Canada, Norway and Sweden and EMEs such as Korea, Israel, South Africa, Thailand and Turkey also increased their policy rates during the quarter. After maintaining zero interest rates for an extended period, the Bank of Japan on July 14, 2006 decided to increase the

Table 31: Short-term Interest Rates

(Per cent)

Region/Country	At end of			
	March 2004	March 2005	March 2006	June 2006
1	2	3	4	5
Advanced Economies				
Euro Area	1.96	2.15	2.80	3.06
Japan	0.03	0.02	0.04	0.24
Sweden	2.12	1.97	1.99	2.23
UK	4.31	4.95	4.58	4.70
US	1.04	2.90	4.77	5.48
Emerging Market Economies				
Argentina	2.88	4.56	9.63	10.00
Brazil	16.02	19.25	16.54	15.18
China	N.A.	2.25	2.40	3.00
Hong Kong	0.17	2.79	4.47	4.67
India	**4.24**	**5.37**	**6.11**	**6.36**
Malaysia	3.00	2.82	3.51	3.93
Philippines	9.19	7.25	7.38	8.00
Singapore	0.69	2.06	3.44	3.50
South Korea	3.90	3.54	4.26	4.57
Thailand	1.31	2.64	5.10	5.40

N.A. : Not Available.
Note : Data for India refer to 91-day Treasury Bills rate and for other countries 3-month money market rates.
Source : The Economist.

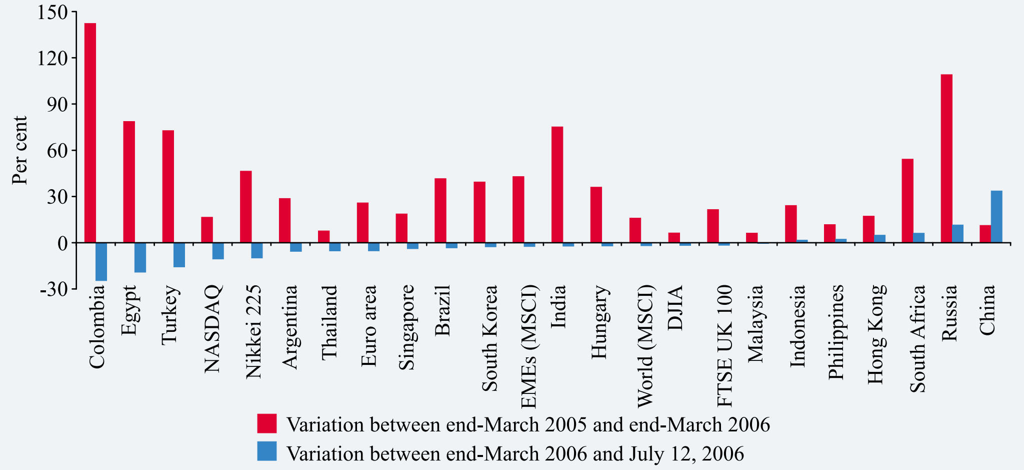


uncollateralised overnight call rate (adopted as the operating target for monetary policy since March 2006) by 25 basis points.

Long-term Government bond yields which had started rising in January 2006 rose further during April 2006 reflecting concerns about growing inflationary pressures (Chart 36). In the US, yields increased on the expectations that the US Federal Reserve may push the federal funds rate target higher than anticipated. Following the turmoil in global financial markets in mid-May 2006 over concerns of higher than anticipated inflation, there was a flight to safety and investors preferred to invest in risk-free Government bonds. Accordingly, long-term yields fell in the second half of May 2006. Yields, however, again edged up in the second half of June 2006 on renewed concerns over rise in the US core inflation. Between end-March 2006 and end-June 2006, 10-year yields increased by 29 basis points in the US, 34 basis points in the euro area and 14 basis points in Japan. In the euro area and Japan, the increase in yields also reflected strengthening outlook for economic activity.

Equity markets registered losses in a number of economies during the quarter ended June 2006, reversing a part of the large gains recorded during 2005. Equity markets in EMEs initially rallied during April 2006 continuing the trend of the previous year reflecting continuing search for yield amidst strong macroeconomic fundamentals and announcement of better than expected corporate profits for the first quarter of 2006. As on May 10, 2006, the world Morgan Stanley Capital International (MSCI) index was 11.5 per cent higher than end-2005, while the EMEs MSCI index increased by 24.5 per cent. The turmoil in global financial markets following higher than anticipated US inflation and the concomitant increase in risk aversion also impacted global equity markets. As a result, equity markets around the world fell. Equity markets in many EMEs were

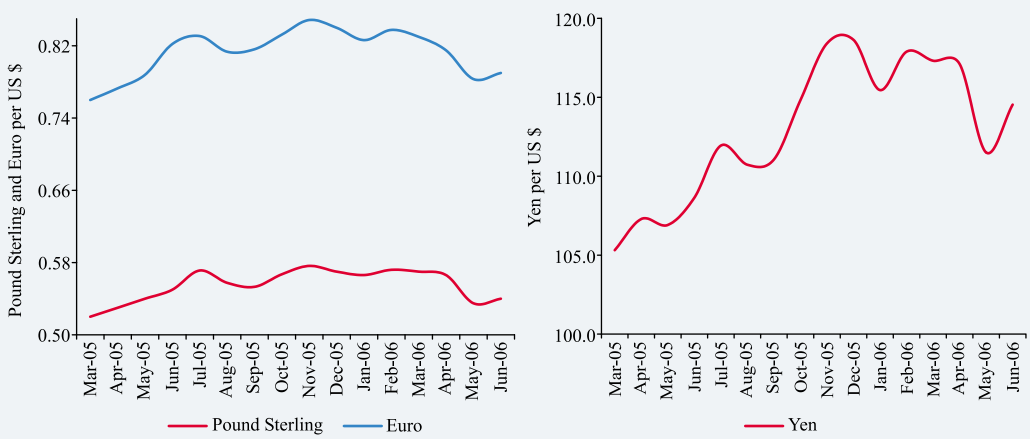
Chart 37: International Stock Markets



the hardest hit (Chart 37). Equity markets, however, staged some recovery during June 2006.

In the foreign exchange market, the US dollar depreciated during April-May 2006 (Chart 38). Growing macroeconomic imbalances and inflation concerns in the US contributed to the dollar's decline. The US dollar, however, appreciated during June 2006 reflecting demand for US assets as investors pulled out of EMEs on the back of increase in risk aversion following higher than anticipated inflation in the US. During the quarter, the US dollar depreciated by 5.3 per cent against the Pound sterling, 2.4 per cent against the Yen and 4.8 per cent against the Euro.

Chart 38: Exchange Rates of Major Currencies per US Dollar



Indian financial markets remained largely orderly during the first quarter of 2006-07. Call money rates eased during the quarter and remained generally close to the reverse repo rate. Interest rates in the collateralised segment of the overnight money market – which now dominates the turnover in the money market – remained below the reverse repo rate and the call rate during the quarter. The foreign exchange market remained orderly even as the Indian rupee depreciated during May-June 2006. Yields in the Government securities market hardened during the quarter. The yield curve steepened as the increase at the longer end was higher than at the short-end. In the credit market, deposit and lending rates edged up during the quarter as credit demand remained strong. The stock markets, after reaching an all time high level on May 10, 2006, witnessed correction in line with the trends in major international markets. The stock markets recovered some of these losses during June 2006. The primary market segment of the equity market witnessed a sharp increase in resources raised during April-May 2006 on the back of a buoyant secondary market and strong macroeconomic fundamentals (Table 32).

Table 32: Domestic Financial Markets at a Glance

Month	Call Money		Government Securities		Foreign Exchange				Liquidity Management		Equity			
	Average Daily Turnover (Rs. crore)	Average Call Rates* (Per cent)	Average 10-Year Yield@ (Per cent)	Average Turnover in Govt. Securities (Rs. crore)+	Average Daily Inter-bank Turnover (US $ million)	Average Exchange Rate (Rs. per US $)	RBI's net Foreign Currency Sales(-)/ Purchases (+) (US $ million)	Average Forward Premia 3-month (Per cent)	Average MSS Out-standing# (Rs. crore)	Average Daily LAF Out-standing (Rs. crore)	Average Daily BSE Turnover (Rs. crore)	Average Daily NSE Turnover (Rs. crore)	Average BSE Sensex**	Average S&P CNX Nifty**
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
2004-05	**14,170**	**4.65**	**6.22**	**4,826**	**8,894**	**44.93**	**20,847**	**1.66**	**46.445**	**35,592**	**2,054**	**4,513**	**5,751**	**1,808**
2005-06	**16,622**	**5.60**	**7.12**	**3,643**	**12,655**	**44.27**	**8,143**	**1.60**	**58,792**	**11,075**	**3,248**	**6,256**	**8295**	**2520**
April	17,213	4.77	7.02	3,001	9,880	43.74	0	1.96	65,638	30,675	1,890	4,136	6379	1987
May	15,269	4.99	7.11	3,805	10,083	43.49	0	1.57	68,539	22,754	1,971	3,946	6483	2002
June	20,134	5.10	6.88	6,807	10,871	43.58	-104	1.40	70,651	13,916	2,543	4,843	6926	2134
July	20,046	5.02	7.13	3,698	11,003	43.54	2,473	1.56	70,758	10,754	3,095	6,150	7337	2237
August	16,158	5.02	7.04	4,239	11,749	43.62	1,552	0.69	71,346	34,832	3,452	6,624	7726	2358
September	16.292	5.05	7.04	5,207	11,040	43.92	0	0.62	67,617	30,815	3,871	6,923	8272	2512
October	17,164	5.12	7.14	2,815	13,087	44.82	0	0.69	68,602	18,608	2,955	6,040	8220	2487
November	22,620	5.79	7.10	3,314	11,228	45.73	0	0.67	67,041	3,268	2,635	5,480	8552	2575
December	21,149	6.00	7.13	2,948	13,808	45.64	-6,541	1.51	52,040	1,452	3,516	6,814	9162	2773
January	17,911	6.83	7.15	3,094	16,713	44.40	0	2.60	40,219	-15,386	3,966	7,472	9540	2893
February	13,497	6.93	7.32	2,584	15,798	44.33	2,614	2.85	33,405	-13,532	3,688	7,125	10090	3019
March	18,290	6.58	7.40	2,203	17,600	44.48	8,149	3.11	29,652	-6,319	5,398	9,518	10857	3236
2006-07														
April	16,909	5.62	7.45	3,685	17,574 P	44.95	4,305	1.31	25,709	46,088	4,860	9,854	11742	3494
May	18,074	5.54	7.58	3,550	17,908 P	45.41	504	0.87	26,457	59,505	4,355	9,155	11599	3437
June	17,425	5.73	7.89	2,258	14,512 P	46.06	n.a.	0.73	31,845	48,611	3,251	6,828	9935	2915

* : Average of daily weighted call money borrowing rates.
\+ : Average of daily outright turnover in Central Government dated securities.
@ : Average of daily closing rates.
** : Average of daily closing indices.
LAF : Liquidity Adjustment Facility.
MSS : Market Stabilisation Scheme.
BSE : The Stock Exchange, Mumbai.
NSE : National Stock Exchange of India Ltd.
\# : Average of weekly outstanding MSS.
P : Provisional
n.a. : Not available.
Note : In column 11, (+) indicates absorption and (-) indicates injection of liquidity.

Money Market

Money market conditions remained largely comfortable during the first quarter of 2006-07. Call money rates which had edged up during the second half of 2005-06 eased during April-May 2006 and remained close to the reverse repo rate, the lower band of the liquidity adjustment facility (LAF) corridor, reflecting easing of liquidity conditions. With the increase in the fixed reverse repo rate by 25 basis points effective June 9, 2006, call rates also edged up by a similar magnitude (Chart 39). Call rate was 5.83 per cent as on July 19, 2006, 81 basis points lower than that at end-March 2006.

The interest rates in the collateralised segments of the money market – the market repo (outside the LAF) and the Collateralised Borrowing and Lending Obligation (CBLO) segments – also eased during April-June 2006 and continued to remain below the call rate. For instance, the rates in the CBLO segment averaged 5.21 per cent during April-June 2006, 42 basis points lower than that in the call money market over the same period. The collateralised market has now emerged as the predominant segment in the money market, with a share of more than 75 per cent in the total turnover (Chart 40 and Table 33). The supply of funds in the CBLO as well as the market repo segments has been augmented by participation of mutual funds (MFs) and insurance companies reflecting large surpluses with them in view of higher resource mobilisation. Commercial banks are the major borrowers of funds in the CBLO market. By June 2006, 155 members with 81 active members have been admitted in the CBLO segment of the Clearing Corporation of India Limited.

Chart 39: Call Rate and the Reverse Repo Rate

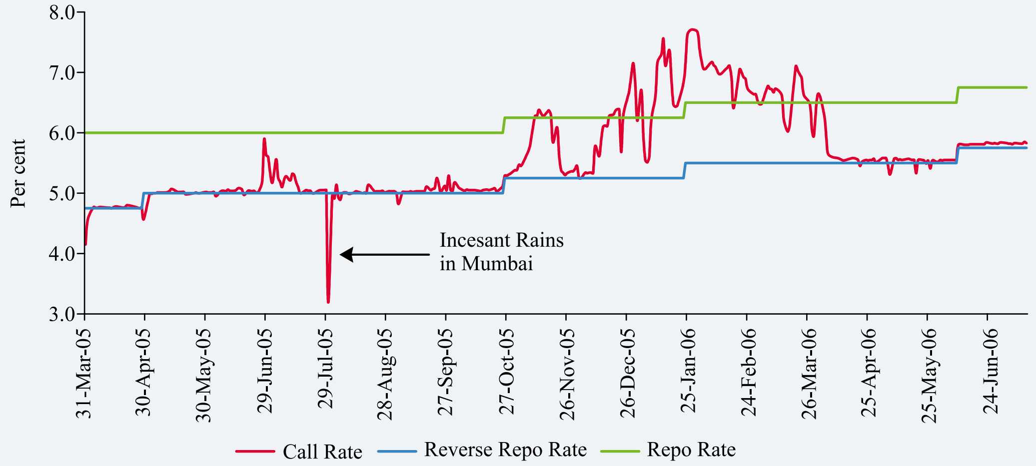
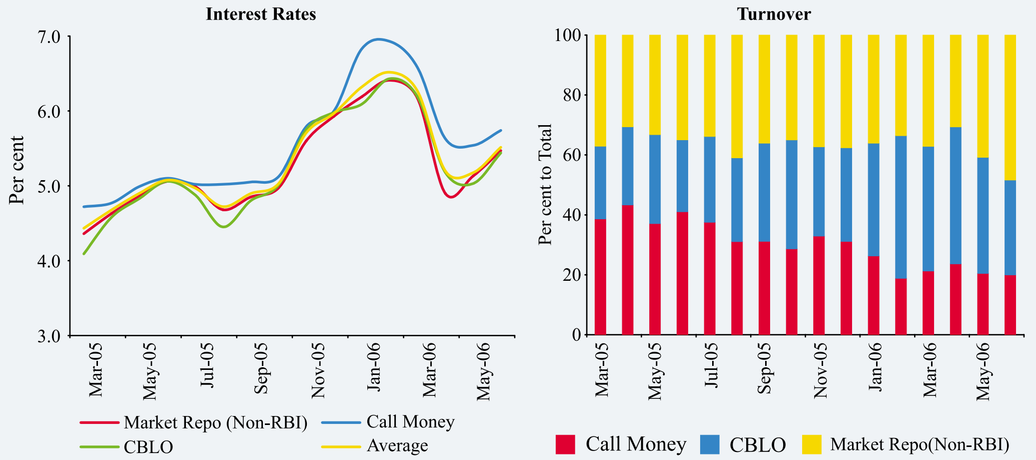


Chart 40 : Money Markets – Interest Rates and Turnover



Certificates of Deposit

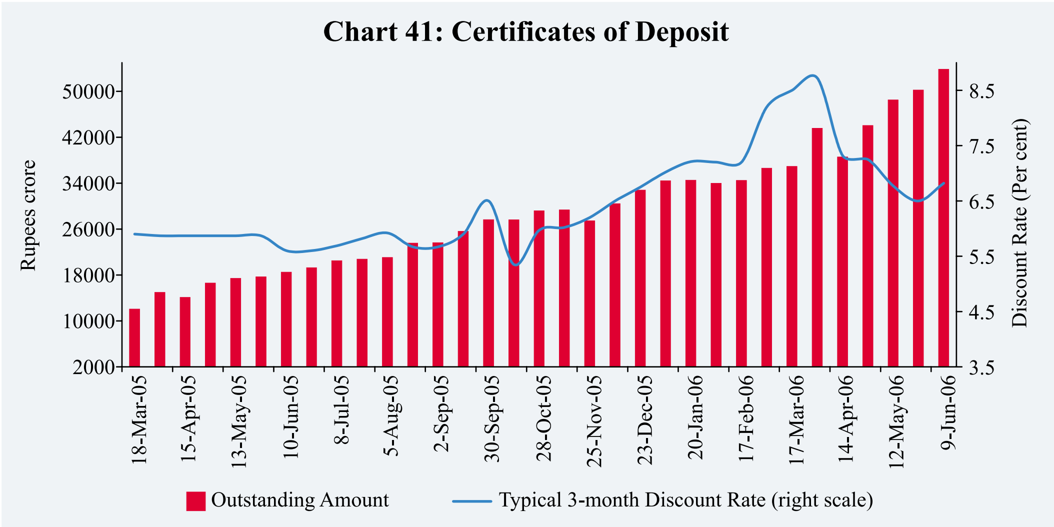
Demand for certificates of deposit (CDs) remained strong during the first quarter of 2006-07 as banks continued to supplement their sources of funds to

Table 33: Activity in Money Market Segments

(Rupees crore)

Month	Average Daily Turnover #				Commercial Paper		Certificates of Deposit
	Call Money Market	Repo Market (Outside the LAF)	Collateralised Borrowing and Lending Obligation (CBLO)	Term Money Market	Outstanding	Amount Issued	Outstanding
1	2	3	4	5	6	7	8
2004-05 ^	**14,170**	**17,135**	**6,697**	**526**	**11,723**	**1,090**	**6,052**
2005-06 ^	**17,979**	**21,183**	**20,039**	**833**	**17,285**	**3,073**	**27,298**
April	17,213	12,174	10,370	661	15,598	3,549	16,602
May	15,269	13,688	12,233	545	17,182	3,824	17,689
June	20,134	17,163	11,792	534	17,797	2,925	19,270
July	20,046	18,103	15,292	717	18,607	3,360	20,768
August	16,158	21,325	14,544	754	19,508	4,110	23,568
September	16,292	18,872	17,143	1,116	19,725	2,519	27,641
October	17,164	20,980	21,763	734	18,726	2,892	29,193
November	22,620	25,660	20,496	917	18,013	2,483	27,457
December	21,149	25,574	21,265	775	17,234	3,304	32,806
January	17,911	24,596	25,634	1,089	16,431	1,937	34,521
February	13,497	24,096	34,162	813	15,876	3,160	34,487
March	18,290	31,964	35,775	1,338	12,718	2,813	43,568
2006-07							
April	16,909	21,914	32,657	894	16,525	6,065	44,059
May	18,072	36,107	34,293	945	16,922	4,701	50,228
June	17,425	42,250	27,617	1,256	19,490	4,981	53,863*

: Turnover is twice the single leg volumes in case of call money and CBLO to capture borrowing and lending both, and four times in case of market repo (outside LAF) to capture borrowing and lending in the two legs for a repo.
* : As on June 9, 2006. ^ : Data are monthly averages.



support credit demand. The amount of CDs outstanding increased from Rs.43,568 crore at end-March 2006 to Rs.53,863 crore by June 9, 2006 (Chart 41). Outstanding CDs constituted 4.2 per cent of aggregate deposits of issuing banks as on June 9, 2006 (4.8 per cent at end-March 2006). The typical discount rate for 3-month maturity on CDs, which had edged higher during February-March 2006 in view of tight liquidity conditions, eased during the quarter from 8.72 per cent at end-March 2006 to 6.82 per cent by June 9, 2006.

Commercial Paper

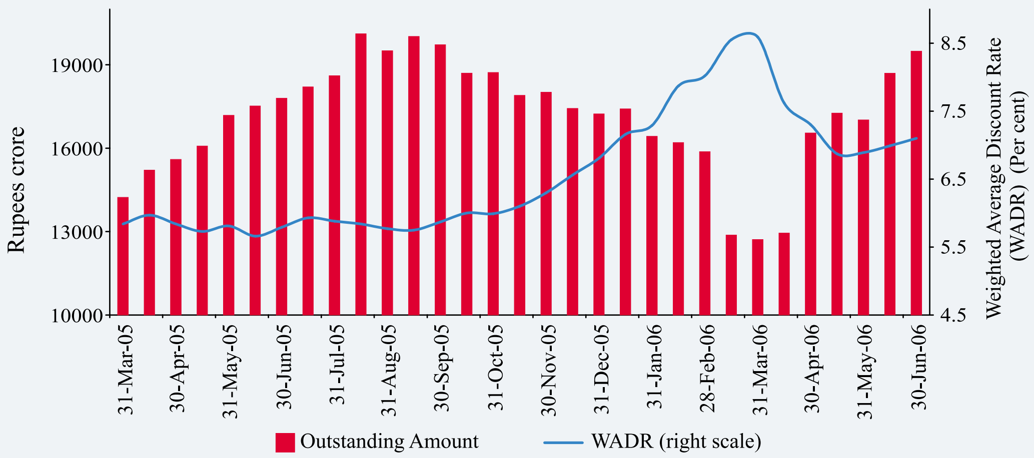
Issuances of commercial paper (CP), which had exhibited some moderation in the second half of 2005-06, picked up again during April-June 2006 following easing of liquidity conditions. Outstanding CPs increased from Rs.12,718 crore at end-March 2006 to Rs.19,490 crore at end-June 2006 (Chart 42). The sharp increase in the weighted average discount rate (WADR) on CPs in the second half of 2005-06 was reversed during April-June 2006: the WADR fell from 8.59 per cent on March 31, 2006 to 7.10 per cent on June 30, 2006.

Leasing and finance companies remained the predominant issuers of CPs, partly reflecting the policy of phasing out the access of these companies to public deposits (Table 34). Issuances by manufacturing companies also recorded an increase during the quarter, benefiting from fall in the discount rate.

Treasury Bills

The primary market yields on Treasury Bills witnessed mixed trends. The yields which had increased substantially between November 2005 and

Chart 42: Commercial Paper



February 2006, declined sharply till the third week of April 2006 with easing of liquidity conditions. The yields, however, firmed up from the first auction of May 2006 on concerns of higher inflation, hike in the fed funds rate target and larger issuances on account of reintroduction of auctions under the Market Stabilisation Scheme (MSS). The cut-off yields increased further during the second half of June 2006 reflecting hike in the reverse repo and repo rates by 25 basis points each effective June 9, 2006 (Table 35 and Chart 43). The yield spread between 91-day and 364-day Treasury Bills at end-June 2006 was 62 basis points as compared with 32 basis points at end-March 2006.

Table 34: Commercial Paper – Major Issuers

(Rupees crore)

Category of Issuer	End of		
	March 2005	March 2006	June 2006
1	2	3	4
Leasing and Finance	8,479 (59.6)	9,400 (73.9)	13,400 (68.8)
Manufacturing	2,881 (20.2)	1,982 (15.6)	4,054 (20.8)
Financial Institutions	2,875 (20.2)	1,336 (10.5)	2,035 (10.4)
Total	**14,235** **(100.0)**	**12,718** **(100.0)**	**19,490** **(100.0)**

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

Table 35: Treasury Bills in the Primary Market

Month	Notified Amount (Rupees crore)	Average Implicit Yield at Minimum Cut-off Price (Per cent)			Average Bid-Cover Ratio		
		91-day	182-day	364-day	91-day	182-day	364-day
1	2	3	4	5	6	7	8
2004-05	**1,38,500**	**4.91**	**–**	**5.16**	**2.43**	**–**	**2.52**
2005-06	**1,55,500**	**5.68**	**5.82**	**5.96**	**2.64**	**2.65**	**2.45**
April	19,000	5.17	5.36	5.62	4.03	4.48	2.54
May	15,000	5.19	5.35	5.58	3.30	3.37	2.29
June	18,500	5.29	5.37	5.61	1.54	2.42	1.81
July	11,500	5.46	5.67	5.81	1.21	1.79	1.68
August	21,000	5.23	5.42	5.63	3.07	2.68	2.54
September	23,000	5.24	5.37	5.70	1.52	1.45	1.61
October	15,000	5.50	5.71	5.84	1.69	1.53	3.44
November	11,000	5.76	5.85	5.96	2.12	1.92	2.30
December	5,000	5.89	6.00	6.09	3.07	2.97	2.36
January	5,000	6.25	6.22	6.21	2.86	2.83	2.72
February	5,000	6.63	6.74	6.78	3.04	2.07	2.71
March	6,500	6.51	6.66	6.66	4.17	3.43	3.36
2006-07							
April	5,000	5.52	5.87	5.98	5.57	4.96	2.02
May	18,500	5.70	6.02	6.34	1.88	1.36	1.69
June	15,000	6.15	6.49	6.77	1.63	1.83	2.11

Note : 182-day TBs were reintroduced with effect from April 2005.

Foreign Exchange Market

In the foreign exchange market, the Indian rupee depreciated *vis-à-vis* the US dollar during the first quarter of 2006-07. The rupee's weakness could be attributed partly to selling by the foreign institutional investors (FIIs) in equity

Chart 43: Yields on Treasury Bills

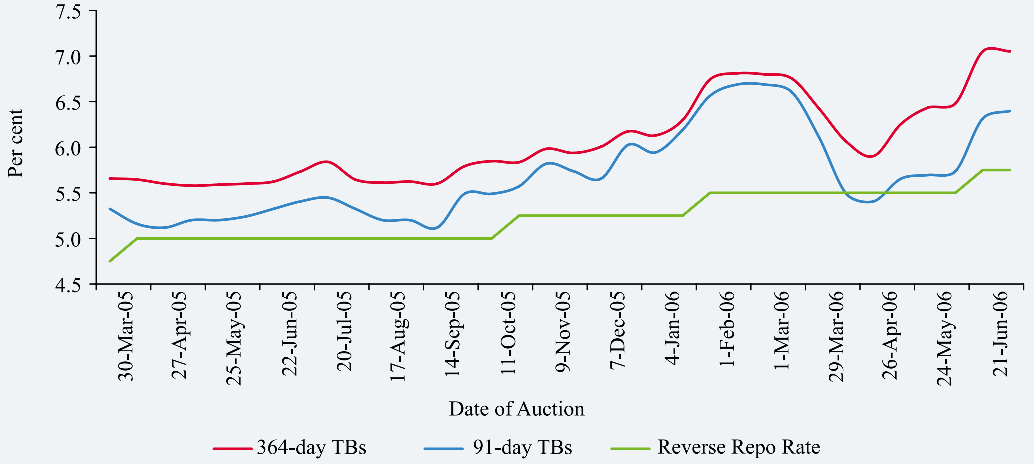


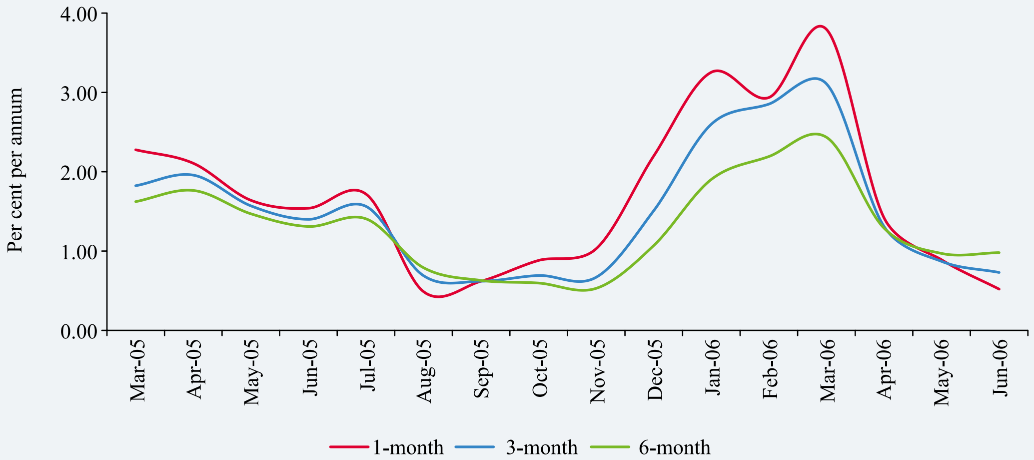
Chart 44: Movement of Rupee *vis-à-vis* Major Currencies

market, continued monetary policy tightening by the US and higher crude oil prices. FIIs have registered outflows of about US $ 1.8 billion during April-June 2006. The rupee has moved in a range of Rs.44.61– 46.97 per US dollar during 2006-07 so far (up to July 19, 2006) (Chart 44). The exchange rate was Rs.46.97 per US dollar as on July 19, 2006 – a depreciation of 5.0 per cent over its level on March 31, 2006. Over the same period, the rupee also depreciated by 9.3 per cent against the Pound sterling, 7.7 per cent against the Euro and 4.9 per cent against the Japanese yen.

Forward premia declined during the first quarter of 2006-07 in tandem with the narrowing of interest rate differential following easing of domestic money market interest rates coupled with further monetary tightening in the US (Chart 45).

The turnover in the inter-bank as well as merchant segments of the foreign exchange market fell during the first quarter of 2006-07. While inter-bank turnover declined from US $ 405 billion during March 2006 to US $ 319 billion in June

Chart 45: Movement in Forward Premia



2006, the merchant turnover fell from US $ 141 billion to US $ 122 billion over the same period (Chart 46). The ratio of inter-bank to merchant turnover was 2.6 during June 2006 (2.9 during March 2006).

Credit Market

Deposit as well as lending rates of banks increased during the first quarter of 2006-07 as banks intensified efforts to mobilise deposits to meet the higher credit demand. Banks increased their deposit rates by about 25-100 basis points across various maturities between March 2006 and June 2006 (Table 36 and

Chart 46: Turnover in Foreign Exchange Market

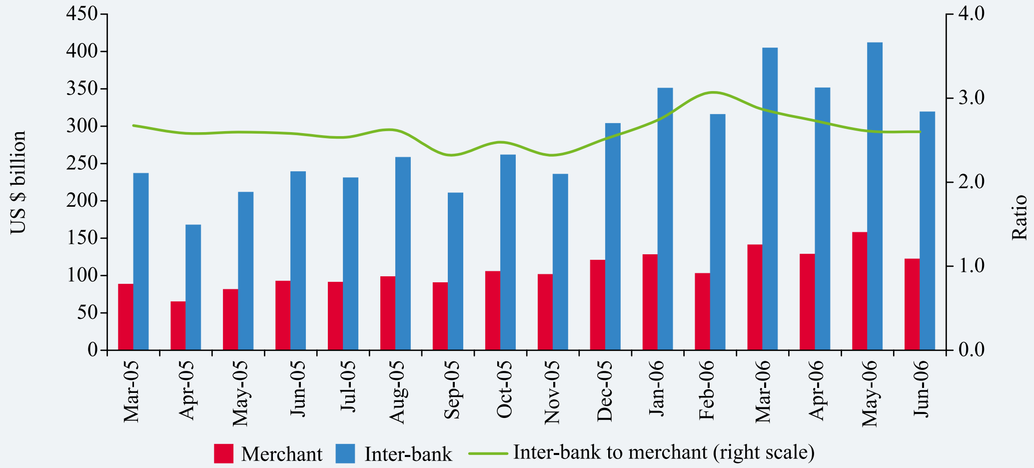


Table 36: Movements in Deposit and Lending Rates

(Per cent)

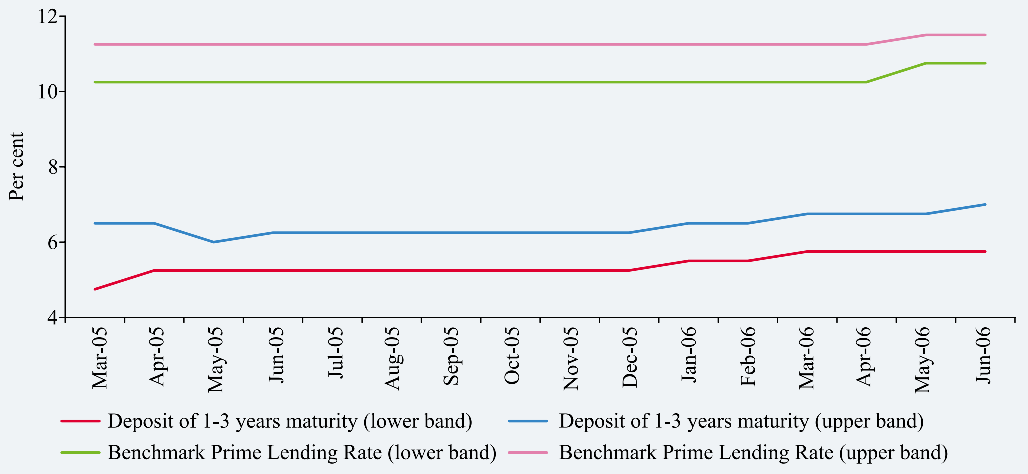
Interest Rate	March 2005	March 2006	April 2006	May 2006	June 2006
1	2	3	4	5	6
1. Domestic Deposit Rate					
Public Sector Banks					
Up to 1 year	2.75-6.00	2.25-6.50	2.25-6.50	2.75-6.50	2.75-6.50
More than 1 year and up to 3 years	4.75-6.50	5.75-6.75	5.75-6.75	5.75-7.00	5.75-7.00
More than 3 years	5.25-7.00	6.00-7.25	6.00-7.25	6.00-7.25	6.00-7.25
Private Sector Banks					
Up to 1 year	3.00-6.25	3.50-7.25	3.50-7.25	3.50-6.75	3.50-6.75
More than 1 year and up to 3 years	5.25-7.25	5.50-7.75	6.50-7.75	6.50-7.75	6.50-7.75
More than 3 years	5.75-7.00	6.00-7.75	6.00-7.75	6.50-8.25	6.50-8.25
Foreign Banks					
Up to 1 year	3.00-6.25	3.00-5.75	3.00-5.75	3.25-6.50	3.25-6.50
More than 1 year and up to 3 years	3.50-6.50	4.00-6.50	4.00-6.50	5.00-6.50	5.00-6.50
More than 3 years	3.50-7.00	5.50-6.50	5.50-6.50	5.50-6.75	5.50-6.75
2. Benchmark Prime Lending Rate					
Public Sector Banks	10.25-11.25	10.25-11.25	10.25-11.25	10.75-11.50	10.75-11.50
Private Sector Banks	11.00-13.50	11.00-14.00	11.00-14.00	11.00-14.50	11.00-14.50
Foreign Banks	10.00-14.50	10.00-14.50	10.00-14.50	10.00-14.50	10.00-14.50
3. Actual Lending Rate*					
Public Sector Banks	2.75-16.00	4.00-16.50	–	–	–
Private Sector Banks	3.15-22.00	3.15-20.50	–	–	–
Foreign Banks	3.55-23.50	4.75-26.00	–	–	–

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

– : Not available.

Chart 47). On the lending side, banks revised upwards their Benchmark Prime Lending Rates (BPLRs) by 25-50 basis points. Public sector banks raised their BPLRs by 25-50 basis points between March 2006 and June 2006; these banks had kept their BPLRs unchanged during 2005-06 while revising upwards their sub-BPLRs. The band of BPLRs for private sector banks and foreign banks

Chart 47: Deposit and Lending Rates - Public Sector Banks



remained wider than that of public sector banks, although for a majority of banks, the BPLRs lie in a relatively narrow range. For instance, more than half of private sector banks (16 out of 30 for which comparative data are available) had BPLRs in a range of 11-12 per cent at end-June 2006, while seven banks had BPLRs in a range of 12-13 per cent and six banks had BPLRs in a range of 10-11 per cent. As regards foreign banks, nine of them had BPLRs in a range of 12-13 per cent, while eight had BPLRs in a range of 13-15 per cent and five each in a range of 10-11 per cent and 11-12 per cent.

Government Securities Market

The yields in the Government securities market hardened further during the first quarter of 2006-07 (Chart 48). After recording some decline around mid-April 2006, yields moved upwards thereafter reflecting a variety of factors such as sustained credit demand, further monetary policy tightening in the US and in other economies, high and volatile crude oil prices, apprehensions over domestic fuel price hike, hike in the reverse repo and repo rates effective June 9, 2006, expectations of further rate hike and volatility in stock markets. Expected issuances of oil bonds, conversion of recapitalisation bonds into tradable, SLR-Government dated securities and higher Government expenditure in the first two months of 2006-07 also led to hardening of yields. The 10-year yield has increased by 84 basis points during 2006-07 so far: from 7.52 per cent as on March 31, 2006 to 8.36 per cent as on July 19, 2006.

The spread between 1-year and 10-year yields which had narrowed during January-March 2006 (reflecting largely higher rise in yields at short end on account of tightening of liquidity conditions) increased during April-June 2006. The spread

Chart 48: Yields on Central Government Securities

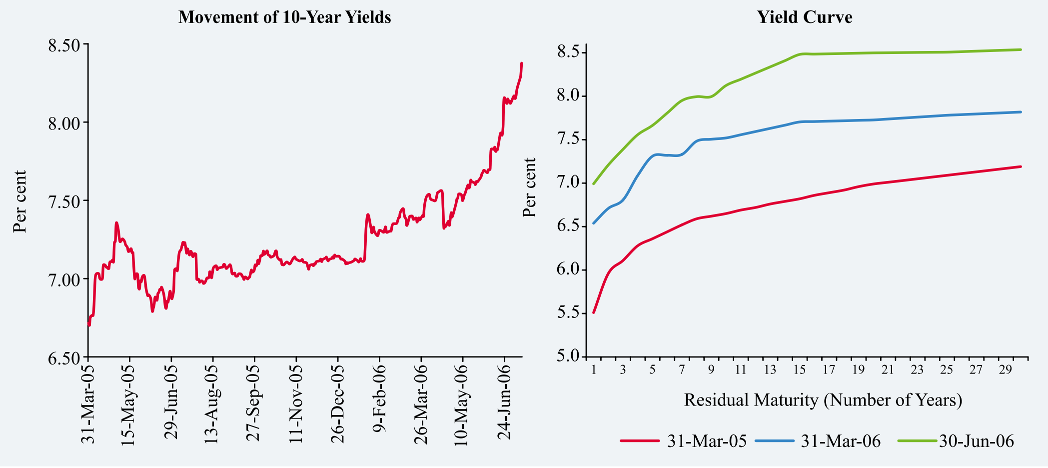


Table 37: Yield Spread

(Basis points)

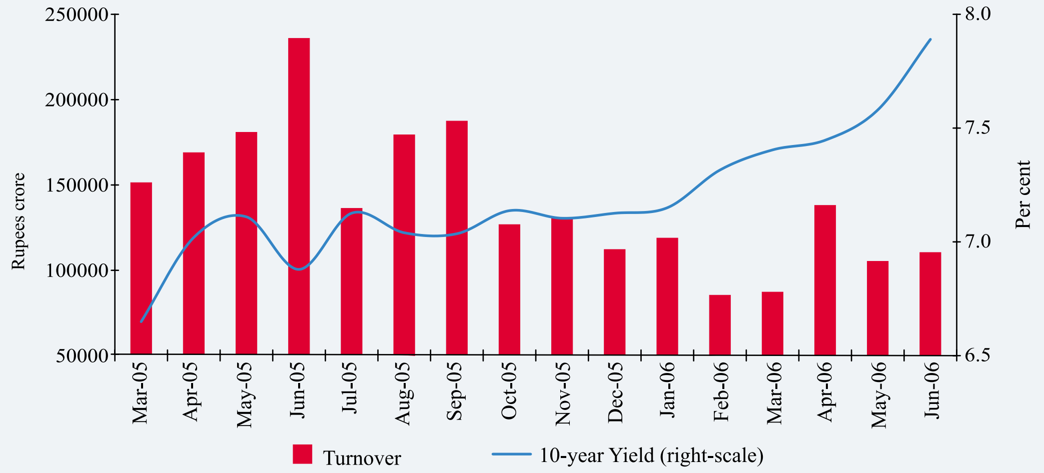
Month-end	10 Year-Reverse Repo Rate	10 Year-1 Year	20 Year-10 Year	30 Year-10 Year
1	2	3	4	5
2004-05 ^	**164**	**101**	**55**	**77**
2005-06 ^	**196**	**106**	**36**	**45**
April	231	141	46	60
May	197	120	42	75
June	189	111	26	56
July	201	120	48	45
August	209	129	42	44
September	211	124	35	38
October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

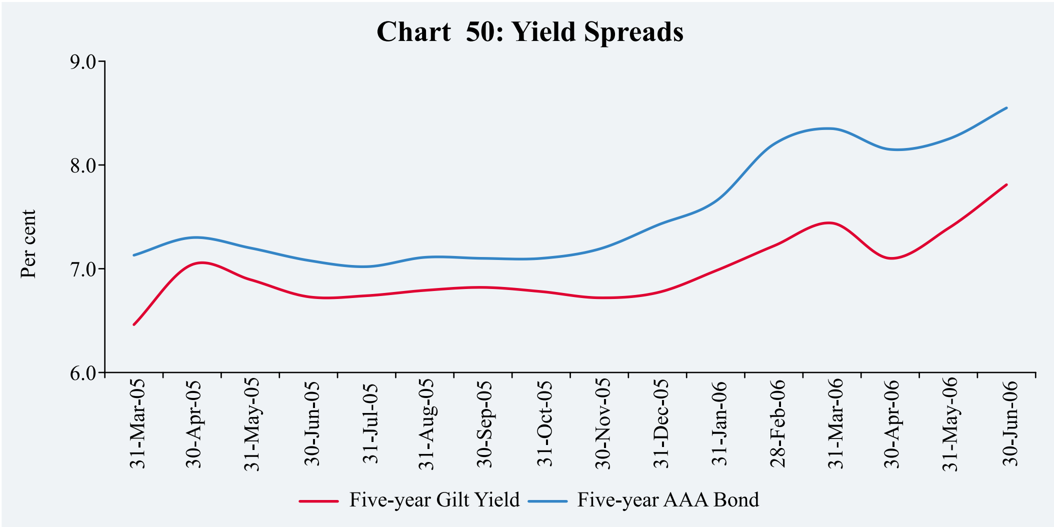
^ : Data are monthly averages.

between 1-10 year yields increased to 113 basis points at end-June 2006 (from 98 basis points at end-March 2006) but was comparable to that during the first half of 2005-06. The spread between 10-year and 30-year yields also increased to 41 basis points (from 30 basis points at end-March 2006) (Table 37).

The turnover in Government securities has largely remained subdued since the second half of 2005-06 as banks preferred to hold securities, rather than trade, in an environment of hardening of yields (Chart 49).

Chart 49: Government Securities Turnover and Yields





The yields on 5-year AAA-rated corporate bonds increased during April-June 2006 in tandem with higher yields on Government securities. The yield spread over 5-year Government securities was 74 basis points at end-June 2006, lower than that of 91 basis points at end-March 2006 (Chart 50).

Equity Market

Primary Market

Resources raised through the public issues segment jumped by 247 per cent during April-May 2006 over the corresponding period of 2005 (Table 38). The average size of public issues increased from Rs.185 crore during April-May 2005 to Rs.686 crore during April-May 2006. All public issues during April-May 2006 were by non-Government public limited companies (private sector) in the form of equity. Out of 15 issues during April-May 2006, nine issues were initial public offerings (IPOs), constituting 93.0 per cent of resource mobilisation, while during the corresponding period of 2005, eight out of 16 issues were IPOs (constituting 13.4 per cent of resource mobilisation).

Mobilisation of resources through private placement increased by 15.5 per cent during 2005-06 as compared with an increase of 30.5 per cent during 2004-05 (Table 38). Resources mobilised by public sector entities (both financial and non-financial) increased by 15.9 per cent during 2005-06 as compared with an increase of 5.2 per cent during 2004-05. Public sector entities accounted for 57.2 per cent of total mobilisation through private placement during 2005-06 (almost the same ratio as a year ago). Resources raised by financial intermediaries (both from public sector and private sector) accounted for 68.4 per cent of the total mobilisation through private placement during 2005-06 (55.8 per cent during 2004-05).

Table 38: Mobilisation of Resources from the Primary Market

(Amount in Rupees crore)

Item	No. of Issues	Amount	No. of Issues	Amount
1	2	3	4	5
	2005-06 (April-May)		2006-07 (April-May) P	
A. Prospectus and Rights Issues*				
1. Private Sector (a+b)	**14**	**692**	**15**	**10,290**
a) Financial	1	45	1	15
b) Non-financial	13	647	14	**10,275**
2. Public Sector (a+b+c)	**2**	**2,270**	**–**	**–**
a) Public Sector Undertakings	–	–	–	–
b) Government Companies	–	–	–	–
c) Banks/Financial Institutions	2	2,270	–	–
3. Total (1+2)	**16**	**2,962**	**15**	**10,290**
Of which:				
(i) Equity	15	2,844	15	10,290
(ii) Debt	1	118	–	–
	2004-05		2005-06 P	
B. Private Placement				
1. Private Sector	**717**	**35,794**	**944**	**41,205**
a) Financial	255	20,974	374	26,533
b) Non-financial	462	14,820	570	14,652
2. Public Sector	**193**	**47,611**	**168**	**55,164**
a) Financial	124	25,531	138	39,395
b) Non-financial	69	22,080	30	15,769
3. Total (1+2)	**910**	**83,405**	**1,112**	**96,368**
Of which:				
(i) Equity	908	82,822	1,111	96,218
(ii) Debt	2	583	1	150
Memo:				
Euro Issues	**5**	**1,573**	**15**	**4,614**

P : Provisional. * : Excluding offers for sale. – : Nil/Negligible.

During April-May 2006, the resources raised through Euro issues – American Depository Receipts (ADRs), Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs) – by Indian corporates almost trebled to Rs.4,614 crore as corporates took advantage of buoyant secondary markets to raise funds for their investment activities (Table 38).

During the first quarter of 2006-07, net mobilisation of funds by mutual funds increased substantially by 264.7 per cent to Rs.52,053 crore reflecting investor interest due to attractive returns in the secondary market (Table 39). Net mobilisation of funds during the first quarter of 2006-07 was almost at the same level as during the full year 2005-06. Net inflows were witnessed in case of both income/debt-oriented schemes and growth/equity-oriented schemes.

Secondary Market

The domestic stock markets witnessed a mixed trend during the first quarter of 2006-07. Stock markets remained buoyant till May 10, 2006, but

Table 39: Resource Mobilisation by Mutual Funds

(Rupees crore)

Mutual Fund	April-March		April-June			
	2005-06		2005-06		2006-07	
	Net Mobilisation @	Net Assets #	Net Mobilisation @	Net Assets *	Net Mobilisation @	Net Assets *
1	2	3	4	5	6	7
Private Sector	42,977	1,81,515	13,288	1,30,585	43,039	2,11,225
Public Sector	6,379	20,829	481	11,986	4,825	24,194
UTI	3,424	29,519	504	21,976	4,189	30,115
Total	**52,780**	**2,31,862**	**14,273**	**1,64,547**	**52,053**	**2,65,534**

@ : Net of redemptions. # : As at end of March. * : As at end of June.
Source : Securities and Exchange Board of India.

witnessed large correction in the rest of May 2006 (Chart 51). Both the BSE Sensex and the S&P CNX Nifty closed at all time high levels of 12612 and 3754, respectively, on May 10, 2006, reflecting continuing support from FIIs on the back of strong fundamentals, corporate results, upgradation of India's sovereign credit rating from stable to positive by Standard & Poor and upward trend in major international equity markets. Profits after tax of sample non-financial non-Government companies recorded a growth of more than 40 per cent for 11 successive quarters from October-December 2002 to April-June 2005. Subsequently, growth in profitability has, however, decelerated (Table 40). The stock market witnessed correction beginning from May 11, 2006 mainly due to net sales by FIIs, fears of rising global interest rates, sharp fall in metal prices and fears of higher domestic inflation amidst weak trends in major international equity markets. The BSE Sensex reached 8929 as on June 14, 2006, a decline of 20.8 per cent over end-March 2006. Stock markets, however, recovered some of

Chart 51: Indian Stock Markets

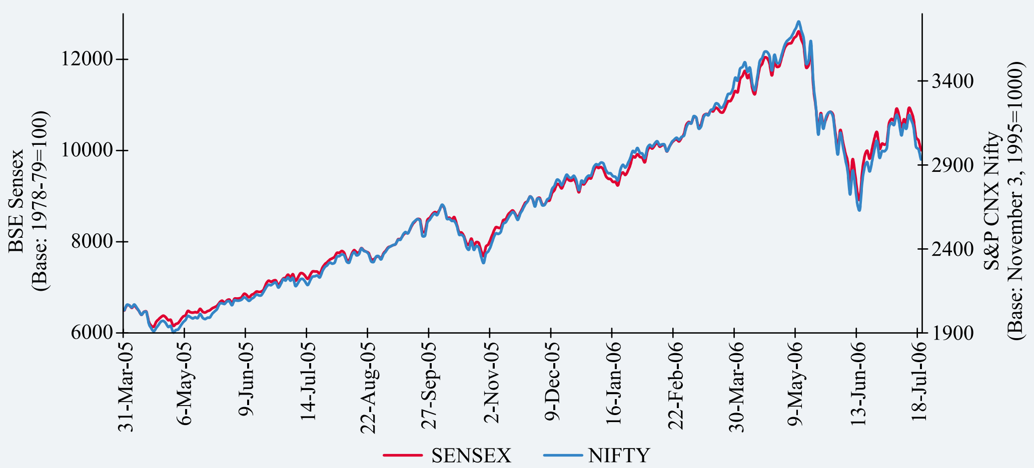


Table 40: Corporate Financial Performance

(Growth rate in per cent)

Item	2003-04	2004-05	2005-06*	2004-05				2005-06			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4*
1	2	3	4	5	6	7	8	9	10	11	12
Sales	16.0	24.1	17.5	24.8	23.7	24.1	21.0	18.5	16.4	13.2	20.6
Expenditure	13.2	21.9	17.1	23.4	22.4	24.3	19.8	18.0	16.3	12.7	20.3
Gross Profit	25.0	32.5	20.6	36.0	35.8	30.5	35.3	32.0	19.1	21.2	18.1
Interest	-11.9	-5.8	2.9	-3.2	2.1	-13.0	-5.4	-13.5	-8.0	4.6	5.3
Profit After Tax	59.8	51.2	24.1	51.2	45.3	45.5	51.4	54.2	27.5	27.0	15.6
Select Ratios (Per cent)											
Gross Profit to Sales	11.1	11.9	13.4	12.8	13.4	12.3	13.2	13.1	13.0	12.8	13.1
Profit After Tax to Sales	5.9	7.2	9.2	7.7	8.5	8.1	9.4	8.6	8.5	8.6	9.0
Interest Coverage Ratio (number)	3.3	4.6	6.9	4.8	5.7	6.1	7.5	6.0	6.2	6.2	7.8
Interest to Sales	3.4	2.6	1.9	2.7	2.3	2.0	1.8	2.2	2.1	2.1	1.7
Interest to Gross Profits	30.7	21.8	14.5	20.9	17.5	16.4	13.4	16.6	16.2	16.2	12.9
Memo items											(Amount in Rupees crore)
No. of Companies	2214	2214	1410	1255	1353	1464	1301	2355	2361	2366	1624
Sales	4,42,743	5,49,449	6,63,656	1,35,156	1,53,040	1,62,193	1,79,632	1,94,608	2,12,693	2,19,098	2,17,731
Expenditure	4,22,110	5,14,574	5,67,263	1,15,656	1,31,227	1,40,574	1,56,647	1,66,972	1,83,717	1,88,934	1,88,961
Depreciation Provision	20,406	22,697	25,014	5,504	5,836	5,731	6,106	7,137	7,617	7,748	7,265
Gross Profit	49,278	65,301	89,142	17,234	20,448	20,017	23,736	25,577	27,620	28,135	28,545
Interest	15,143	14,268	12,894	3,597	3,584	3,273	3,177	4,241	4,467	4,555	3,669
Profit After Tax	26,182	39,599	60,747	10,396	13,004	13,196	16,798	16,726	18,169	18,790	19,686

* : Data in column (4) and column (12) are provisional.

Note : 1. Growth rates are percentage change in the level for the period under reference over the corresponding period of the previous year.

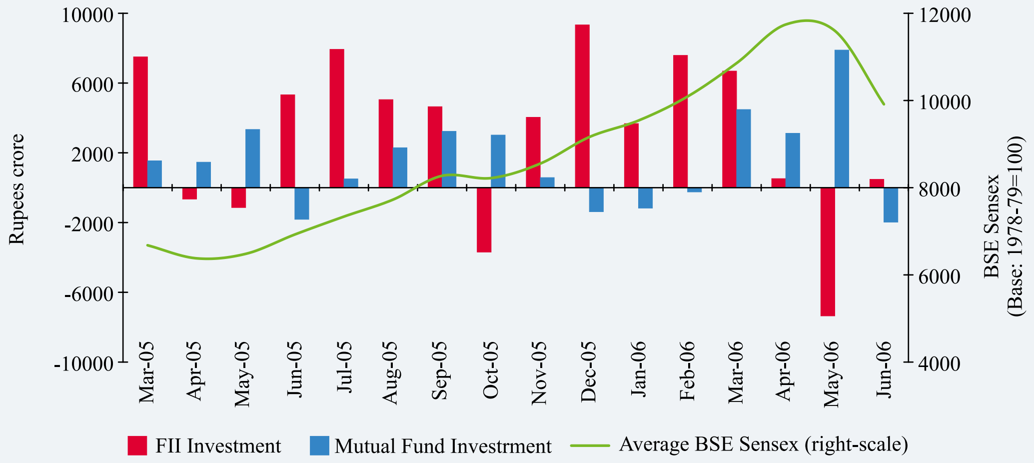
2. Data are based on the audited / unaudited abridged results of the non-financial non-Government companies except column (2) and column (3) which are based on audited balance sheets for 2003-04 and 2004-05, respectively.

the losses during June 2006 reflecting fresh buying by FIIs, onset of the monsoon and recovery in major international stock markets. The BSE Sensex was 10007 as on July 19, 2006, around 11 per cent below its end-March 2006 level.

According to the Securities and Exchange Board of India (SEBI) data, FIIs invested Rs.522 crore in the Indian stock markets during April 2006 but turned net sellers in May to the extent of Rs.7,354 crore. Reflecting the buying interest, FIIs again invested Rs.480 crore during June 2006. During 2006-07 so far (up to July 14, 2006), FIIs have made net sales of Rs.6,127 crore (US $ 1.4 billion) as against net purchases of Rs.7,366 crore (US $ 1.7 billion) during the corresponding period of previous year (Chart 52). On the other hand, mutual funds have made net investments of Rs.8,311 crore in the current financial year so far (up to July 14, 2006), substantially higher than that of Rs.2,231 crore during the corresponding period of last year.

The correction in the stock markets during the first quarter of 2006-07 was across major indices and sectors (Chart 53). On a point-to-point basis (up to July 14, 2006), BSE 500 declined by 10.8 per cent, while BSE Small-cap and BSE Mid-cap registered losses of 19.7 per cent and 18.6 per cent, respectively. Amongst major sectors, public sector undertakings (PSUs) registered loss of 19.6 per cent over end-March 2006 followed by banking (19.0 per cent), capital goods

Chart 52: Institutional Investment and Stock Market



(15.0 per cent), consumer durables (14.2 per cent), fast moving consumer goods (11.1 per cent) and IT sector (2.3 per cent).

Reflecting the correction in stock prices, the price-earnings (P/E) ratios declined during the quarter; for instance, the P/E ratio for the 30 scrips included in the BSE Sensex fell from 20.9 at end-March 2006 to 19.4 as on June 30, 2006 (Table 41). The market capitalisation of the BSE declined by 9.9 per cent between end-March 2006 and end-June 2006. Although volatility in the stock market increased, domestic stock markets functioned smoothly without causing any disruption in the financial markets.

Chart 53: Trends in BSE Sectoral Stock Indices

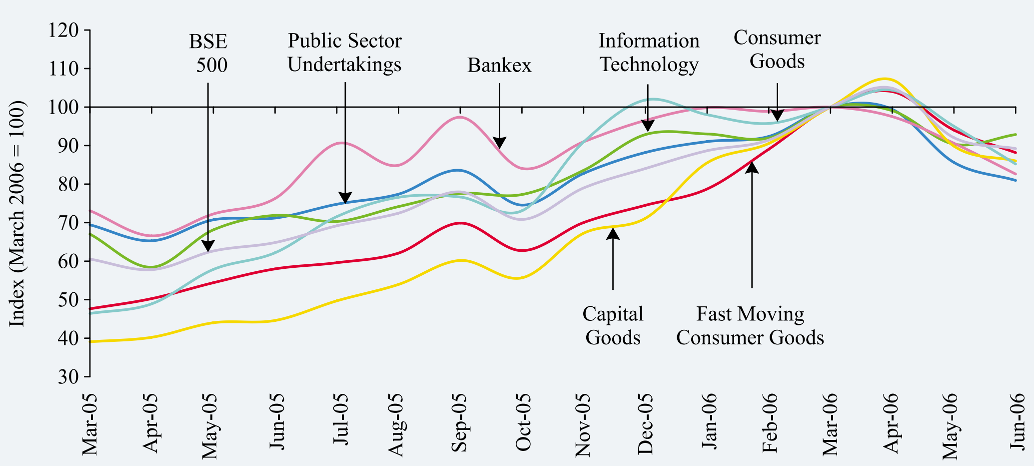


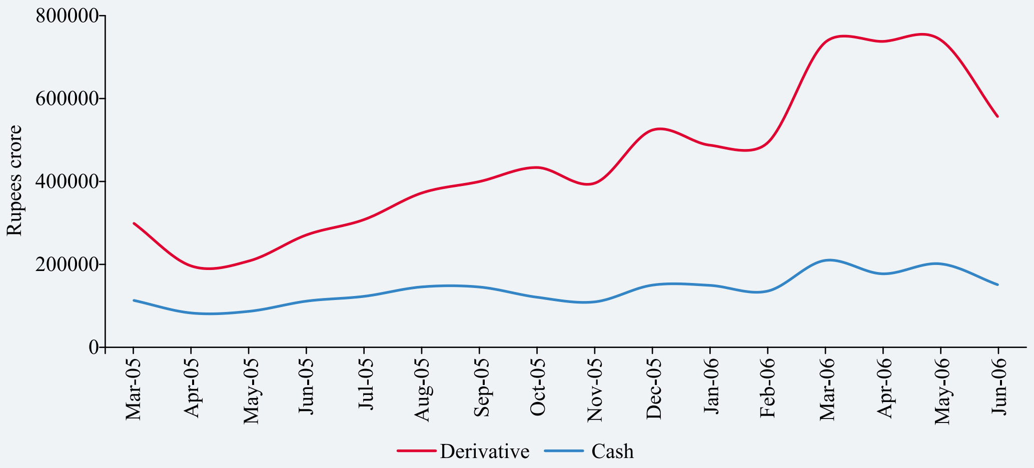
Table 41: Stock Market Indicators

Indicators	BSE				NSE			
	April-March		April-June		April-March		April-June	
	2004-05	2005-06	2005-06	2006-07	2004-05	2005-06	2005-06	2006-07
1	2	3	4	5	6	7	8	9
BSE Sensex / S&P CNX Nifty								
End-period	6493	11280	7194	10609	2036	3403	2221	3128
Average	5741	8279	6608	11032	1805	2513	2044	3263
Volatility	11.16	16.72	4.28	9.12	11.28	15.60	4.04	9.62
P/E Ratio (end-period)*	15.61	20.92	16.03	19.40	14.60	20.26	14.31	18.44
Turnover (Rupees crore)	5,18,716	8,16,074	1,39,648	2,55,320	11,40,071	15,69,556	2,80,917	5,29,831
Market Capitalisation (Rupees crore) (end-period)	16,98,429	30,22,191	18,50,377	27,21,677	15,85,585	28,13,210	17,27,502	25,24,659

* : For 30 scrips included in the BSE Sensex and 50 scrips included in the S&P CNX Nifty.
Source: The Stock Exchange, Mumbai (BSE) and National Stock Exchange of India Ltd. (NSE).

At the NSE, the total turnover in the cash segment during April-June 2006 at Rs.5,29,831 crore was more than double over the corresponding period of 2005 (Chart 54). The total turnover in the derivative segment during April-June 2006 increased sharply by 202 per cent over the corresponding period of the previous year to Rs.20,37,019 crore.

Chart 54: Turnover in Cash and Derivative Segment - NSE



VI. THE EXTERNAL ECONOMY

India's balance of payments position remained comfortable during 2005-06, despite pressures from record high international crude oil prices. Merchandise exports continued to post a healthy growth rate. Growth in non-oil imports also remained strong on the back of buoyant investment activity. The surplus on the invisibles account expanded, led by exports of software and other business services, and private remittances, thereby financing almost four-fifth of the trade deficit. Nonetheless, the current account deficit during 2005-06 was almost double of that in the previous year, in line with the growth in investment demand in the economy. As a proportion of GDP, the current account deficit, however, remained modest. Net inflows under major components of capital flows – foreign direct investment, portfolio investment, NRI deposits and commercial borrowings – were higher than a year ago. With capital inflows substantially higher than the current account deficit, the overall balance of payments (BoP) recorded a surplus during 2005-06.

Developments during 2006-07 so far indicate some deceleration in growth of merchandise exports and non-oil imports. Oil imports remained large in view of further hardening of international crude oil prices. Capital flows, except FII flows, remained buoyant. During the year 2006-07 (up to July 14, 2006), foreign exchange reserves have increased by US $ 11.0 billion.

International Developments

The momentum and resilience of the global economy witnessed in 2005 continued in the first quarter of 2006. Emerging Asia forged ahead, with China registering double-digit expansion (10.9 per cent growth in the first half of 2006) and India growing rapidly as well in the first quarter of 2006. In the US, after transient impact of hurricanes on economic activity, growth bounced back in early 2006. There are, however, incipient signs of deceleration in spending in the US attributable to higher interest rates, gasoline prices and a cooling housing market. This may lead to a moderation of economic growth in the US in the remainder of 2006. In the euro area, economic growth is broadening and becoming more sustained with domestic demand making a significant contribution. Japanese economy continued to recover steadily on the back of rise in private consumption, business investment and exports (Table 42).

The outlook for the world economy remains fairly benign, buttressed by favourable financing conditions, healthy corporate profits, still accommodative macroeconomic policies in many countries and strong consumer confidence. The IMF projects the world economy to grow by 4.9 per cent in 2006, marginally

Table 42: Growth Rates – Global Scenario

(Per cent)

Country	2004	2005	2005-Q1	2005-Q2	2005-Q3	2005-Q4	2006-Q1
1	2	3	4	5	6	7	8
Advanced Economies							
Euro Area	2.1	1.3	1.5	1.5	1.6	1.7	1.9
Japan	2.3	2.7	1.1	2.7	2.7	4.0	3.8
Korea	4.6	4.0	2.7	3.3	4.5	5.3	6.1
UK	3.1	1.8	1.9	1.7	1.9	1.8	2.3
US	4.2	3.5	3.6	3.6	3.6	3.2	3.7
OECD Countries	3.3	2.7	2.6	2.7	2.9	2.9	3.1
Emerging Economies							
Argentina	9.0	9.2	8.0	10.1	9.2	9.1	8.6
Brazil	4.9	2.3	2.6	3.9	1.0	1.4	3.4
China	10.1	9.9	9.4	9.5	9.4	9.9	10.3
India	7.5 *	8.4 #	8.6	8.5	8.4	7.5	9.3
Indonesia	5.1	5.6	6.4	5.5	5.3	4.9	4.6
Malaysia	7.1	5.3	5.7	4.1	5.3	5.2	5.3
Thailand	6.2	4.4	3.3	4.4	5.3	4.7	6.0

* : FY 2004-05 # : FY 2005-06.

Source: International Monetary Fund; The Economist; and the OECD.

higher than that of 4.8 per cent in 2005. Renewed pressure on energy prices and the possibility of a disorderly unravelling of persisting global imbalances, however, continue to pose downside risks to global growth prospects.

Cross-border net private capital flows witnessed an increase from US $ 231 billion in 2004 to US $ 254 billion in 2005 mainly on account of higher direct investment flows attributable to privatisations and cross border mergers and acquisitions. The upward trend in private capital flows appears to have continued in early months of 2006. However, short to medium-term prospects critically hinge upon the course and dynamics of the necessary adjustments for unwinding of global imbalances.

World exports in US dollar terms grew by 11.9 per cent during January-February 2006 as compared with 13.8 per cent in the corresponding period of the previous year (Table 43). During the first quarter of 2006, exports of developing economies accelerated, while those of industrial countries recorded a deceleration. Amongst major countries, the US exports grew 14.2 per cent in the first quarter of 2006 (8.7 per cent growth a year ago) while China's exports growth remained firm at 26.6 per cent (34.8 per cent a year ago).

Balance of Payments: 2005-06

During 2005-06, India's exports remained buoyant recording an increase of 27.5 per cent, on balance of payments basis, led by manufactured goods and supported by exports of petroleum products. Imports also maintained a strong growth of 31.6 per cent on balance of payments basis, led by oil and non-oil imports.

Table 43: Growth in Exports – Global Scenario

(Per cent)

Region/Country	2005	2005-Q1	2006-Q1
1	2	3	4
World	**12.5**	**13.8 ***	**11.9 ***
Industrial Countries	**8.5**	**10.4 ***	**7.0 ***
USA	10.8	8.7	14.2
France	4.5	8.6	2.2
Germany	7.3	11.4 *	5.5 *
Japan	5.2	6.3	5.3
Developing Countries	**18.2**	**20.1**	**25.3**
Non-Oil Developing Countries	18.5	20.9	26.0
China	28.4	34.8	26.6
India	31.7	35.5 #	13.5 #
Indonesia	-33.1	32.2	14.9
Korea	12.0	12.7	10.7
Malaysia	12.0	16.5	14.0
Singapore	15.6	27.5	23.0
Thailand	14.4	12.7	18.6

***** : January-February. # : January-June.
Source : International Financial Statistics, International Monetary Fund, June 2006; DGCI&S for India.

According to the DGCI&S, imports of petroleum products, crude oil and lubricants (POL) in US dollar terms grew by 47.3 per cent during 2005-06 as compared with 45.1 per cent a year ago, reflecting the steep rise in international crude oil prices. In volume terms, oil imports recorded a modest growth of 4.2 per cent during 2005-06 (5.5 per cent in 2004-05). Non-oil imports (DGCI&S data) in US dollar terms also posted a strong growth of 20.5 per cent in 2005-06, *albeit* substantially lower than 41.8 per cent growth a year ago. While imports of capital goods remained buoyant, those of gold and silver showed a sharp deceleration while that of 'pearls, precious and semi-precious stones' recorded a decline.

Net surplus under the invisibles account expanded further during 2005-06 led by higher exports of services and private transfers (Table 44). Gross invisible receipts recorded a rise of 27.3 per cent during 2005-06 reflecting higher earnings from travel, business and professional services, software services and remittances from Indian workers abroad. Exports of services contributed almost two-third of gross invisible receipts while private transfers contributed another 27 per cent. Gross invisible payments during 2005-06 registered a rise of 24.4 per cent, mainly due to increase in payments relating to investment income, transportation services, and other business and technology related services. On the whole, the net invisible surplus during 2005-06 at US $ 40.9 billion was 31 per cent higher than that in 2004-05.

While the net invisible surplus expanded by US $ 9.7 billion to US $ 40.9 billion during 2005-06, the merchandise trade deficit, on balance of payments basis, expanded by US $ 14.9 billion to US $ 51.6 billion during the year. The current account deficit, therefore, almost doubled from US $ 5.4 billion during

Table 44: Invisibles Account (Net)

(US $ million)

Item	2004-05 PR	2005-06 P	2005-06			
	April-March		April-June PR	July-Sept. PR	Oct.-Dec. PR	Jan-March P
1	2	3	4	5	6	7
Services	14,199	22,265	5,372	6,139	4,432	6,322
Travel	985	1,368	178	250	432	508
Transportation	259	-1,117	-169	-96	-409	-443
Insurance	187	57	6	253	-127	-75
Government, not included elsewhere	67	-175	-17	-50	-18	-90
Software	16,526	22,262	4,853	4,989	5,755	6,665
Other Services	-3,825	-130	521	793	-1,201	-243
Transfers	20,844	24,276	5,503	4,990	6,436	7,347
Investment Income	-2,669	-5,027	-695	-1,409	-2,693	-230
Compensation of Employees	-1,145	-572	-132	-133	-164	-143
Total	**31,229**	**40,942**	**10,048**	**9,587**	**8,011**	**13,296**

PR : Partially Revised. P : Preliminary.

2004-05 to US $ 10.6 billion during 2005-06 (Table 45). After posting a deficit of US $ 4 billion per quarter, on an average, during the first three quarters of 2005-06,

Table 45: India's Balance of Payments

(US $ million)

Item	2004-05 PR	2005-06 P	2005-06			
	April-March		April-June PR	July-Sept. PR	Oct.-Dec. PR	Jan-March P
1	2	3	4	5	6	7
Exports	82,150	104,780	24,150	24,060	26,400	30,170
Imports	118,779	156,334	37,754	38,692	38,237	41,651
Trade Balance	-36,629	-51,554	-13,604	-14,632	-11,837	-11,481
	(-5.3)	(-6.5)				
Invisible Receipts	71,854	91,481	19,686	19,832	24,024	27,939
Invisible Payments	40,625	50,539	9,638	10,245	16,013	14,643
Invisibles, net	31,229	40,942	10,048	9,587	8,011	13,296
	(4.5)	(5.1)				
Current Account	-5,400	-10,612	-3,556	-5,045	-3,826	1,815
	(-0.8)	(-1.3)				
Capital Account (net)*	31,559	25,664	4,803	10,301	-846	11,406
		[31,164] @			[4,654] @	
of which:						
Foreign Direct Investment	3,240	5,733	1,198	1,086	1,412	2,037
Portfolio Investment	8,907	12,489	972	4,436	2,748	4,333
External Commercial Borrowings $	5,040	1,591	1,091	1,758	-4,281	3,023
		[7,091] @			[1,219] @	
Short-term Trade Credit	3,792	1,708	-151	1,123	759	-23
External Assistance	1,923	1,438	212	183	477	566
NRI Deposits	-964	2,789	-108	341	881	1,675
Change in Reserves #	-26,159	-15,052	-1,247	-5,256	4,672	-13,221

PR : Partially Revised. P : Preliminary.
* : Includes errors and omissions.
$: Medium and long term borrowings.
\# : On balance of payments basis (excluding valuation); (-) indicates increase.
@ : Excluding the IMD redemption.
Note : Figures in parentheses are per cent to GDP.

the current account recorded a surplus of US $ 1.8 billion during the fourth quarter (January-March 2006) reflecting a sharp rise in the net invisible surplus. As a proportion of GDP, the current account deficit remained modest, widening from 0.8 per cent in 2004-05 to 1.3 per cent in 2005-06.

Capital flows during 2005-06 [adjusted for the redemption of the India Millennium Deposits (IMDs)] were broadly of the same order as a year ago. Foreign investment flows, both direct and portfolio, picked up further reflecting sustained interest in India as an attractive investment destination due to strong economic activity and continued strength of the corporate sector. Demand for external commercial borrowings (adjusted for IMDs) remained large, in consonance with the step-up in investment activity in the country. Higher accretions to non-resident deposits could be attributed partly to increase in interest rates on these deposits during the year. The ceiling on NRE(R)A term deposits was revised upwards by 25 basis points to LIBOR/SWAP rates of US dollar *plus* 75 basis points on November 17, 2005.

With the surplus in the capital account more than offsetting the current account deficit, there was an accretion to the foreign exchange reserves of the order of US $ 15.1 billion on a balance of payments basis (*i.e.*, excluding valuation effects) during 2005-06.

External Debt

India's total external debt was placed at US $ 125.2 billion at end-March 2006, about US $ 2 billion above the end-March 2005 level. This increase was mainly on account of NRI deposits and trade credit (up to 1 year maturity) (Chart 55). The rise in NRI deposits, as noted earlier, could be attributed partly to the upward

Chart 55: Components of External Debt

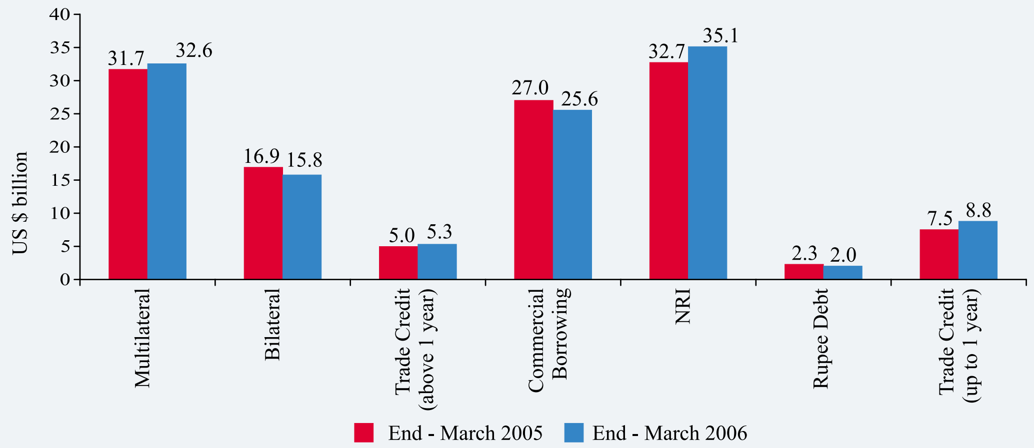


Table 46: Indicators of External Debt Sustainability

(Per cent)

Indicator	End-March 1995	End-March 2005	End-March 2006
1	2	3	4
Total debt /GDP	30.8	17.3	15.8
Short-term/Total debt	4.3	6.1	7.0
Short-term debt/Reserves	16.9	5.3	5.8
Concessional debt/Total debt	45.3	33.3	31.5
Reserves/ Total debt	25.4	114.9	121.1
Debt Service Ratio*	25.9	6.1	10.2

* : Relates to the fiscal year.

revision in interest rates on NRE(R)A term deposits. Recourse to higher short-term trade credit reflected rising import financing requirements. Though the corporate sector's demand for external commercial borrowings (including FCCBs) remained strong in consonance with the domestic industrial activity, the stock declined due to the one-off effect of the IMDs repayment of US $ 5.5 billion. The valuation effect, on account of appreciation of the US dollar against other major international currencies, had a moderating impact on the stock of external debt.

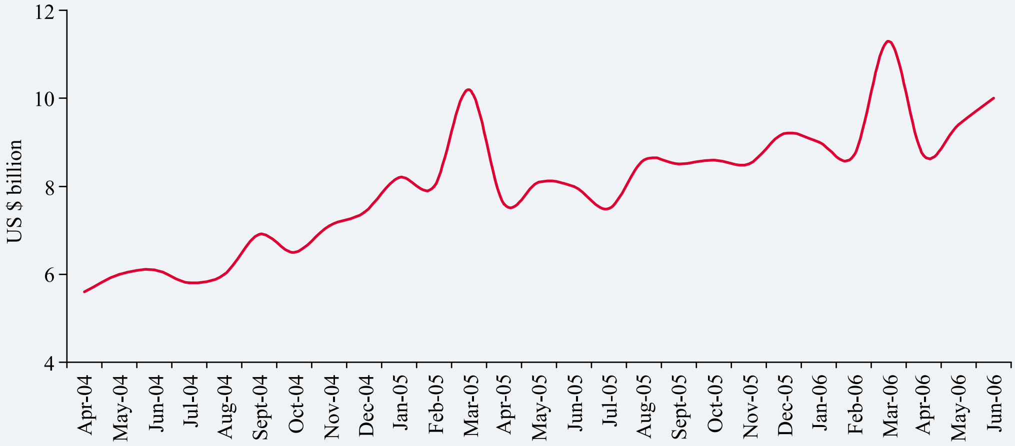
There has been a perceptible improvement in external debt indicators over the years indicating the growing sustainability of external debt of India. The ratio of external debt to GDP has almost halved over the past decade to 15.8 per cent at end-March 2006 from 30.8 per cent at end-March 1995. The debt service ratio remains low, although it increased from 6.1 per cent during 2004-05 to 10.2 per cent during 2005-06 due to the one-off effect of the IMDs repayment. Reflecting the rise in short-term debt during 2005-06, the ratios of short-term to total debt and short-term debt to reserves rose to 7.0 per cent and 5.8 per cent, respectively, but still remain fairly modest. India's foreign exchange reserves exceeded the external debt by US $ 26.4 billion providing a cover of 121.1 per cent to the external debt stock at end-March 2006 (Table 46).

Developments during 2006-07

During April-June 2006, growth in India's merchandise exports (in US dollar terms) decelerated to 16.9 per cent from 35.4 per cent a year ago (Chart 56).

Commodity-wise data (available up to April 2006) indicate that exports of both primary products and manufactured goods exhibited deceleration in growth. Exports of manufactured goods, led by engineering goods, remained the key driver of merchandise exports. Exports of petroleum products maintained high growth, reflecting the impact of elevated prices of petroleum products (Table 47). During April 2006, exports of the traditional items such as leather, iron ore, tea, rice, cashew and marine products declined, while ready-made garments and some agricultural products such as raw cotton, tobacco, spices, oil meal, sugar and molasses recorded an increase.

Chart 56: India's Merchandise Exports



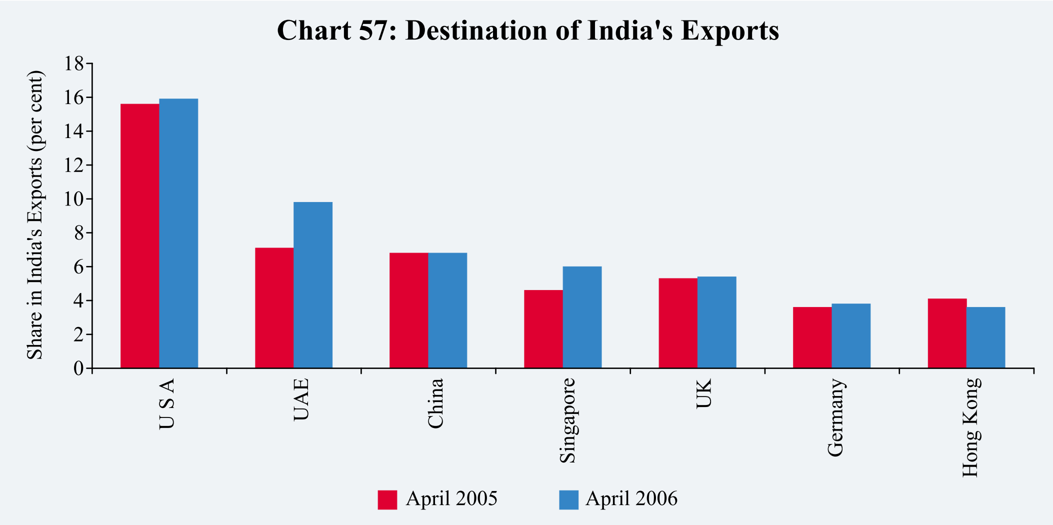
Destination-wise, the US continued to be the major trade partner of India accounting for 15.9 per cent of India's total exports during April 2006, followed by the UAE (9.8 per cent), China (6.8 per cent), Singapore (6.0 per cent), UK (5.4 per cent), Germany (3.8 per cent) and Hong Kong (3.6 per cent) (Chart 57). Region-wise, North America was the fastest growing market for India's exports during April 2006 followed by Latin America, South Asia, East Asia and the European Union.

During April-June 2006, growth in imports moderated to 17.7 per cent from 45.4 per cent a year ago, attributable to deceleration in non-oil imports. POL imports continued to post large growth of 39.0 per cent during April-June

Table 47: Exports of Principal Commodities

Commodity Group	US $ billion			Variation (per cent)	
	2005-06	2005-06	2006-07	2005-06	2006-07
		April		April	
1	2	3	4	5	6
1. Primary Products	**16.4**	**1.3**	**1.4**	**32.3**	**9.0**
of which:					
a) Agriculture and Allied Products	10.2	0.8	0.9	19.0	15.7
b) Ores and Minerals	6.2	0.5	0.5	61.2	-1.8
2. Manufactured Goods	**71.8**	**5.4**	**6.2**	**37.4**	**16.6**
of which:					
a) Chemicals and Related Products	14.5	1.2	1.2	40.4	3.6
b) Engineering Goods	21.5	1.6	2.2	52.8	34.0
c) Textiles and Textile Products	16.0	1.3	1.4	44.2	11.5
d) Gems and Jewellery	15.5	1.0	1.2	12.8	16.4
3. Petroleum Products	**11.5**	**0.7**	**0.9**	**21.0**	**32.6**
4. Total Exports	**102.7**	**7.6**	**8.7**	**36.1**	**14.6**

Source : DGCI&S.



2006 (31.0 per cent a year ago). This increase was almost entirely on account of higher crude oil prices as, in volume terms, POL imports in April 2006 posted growth of only 3.9 per cent (11.2 per cent a year ago).

During April-June 2006, growth of non-oil imports decelerated to 9.6 per cent from a high of 51.7 per cent a year ago (Chart 58). Commodity-wise import data available for April 2006 show that the deceleration in growth of non-oil imports was partly on account of the decline in imports of 'pearls, precious and semi-precious stones' and gold and silver (Table 48). The decline in imports of gold and silver could be attributed to higher gold prices. Reflecting strong domestic investment activity, and in consonance with acceleration in domestic production

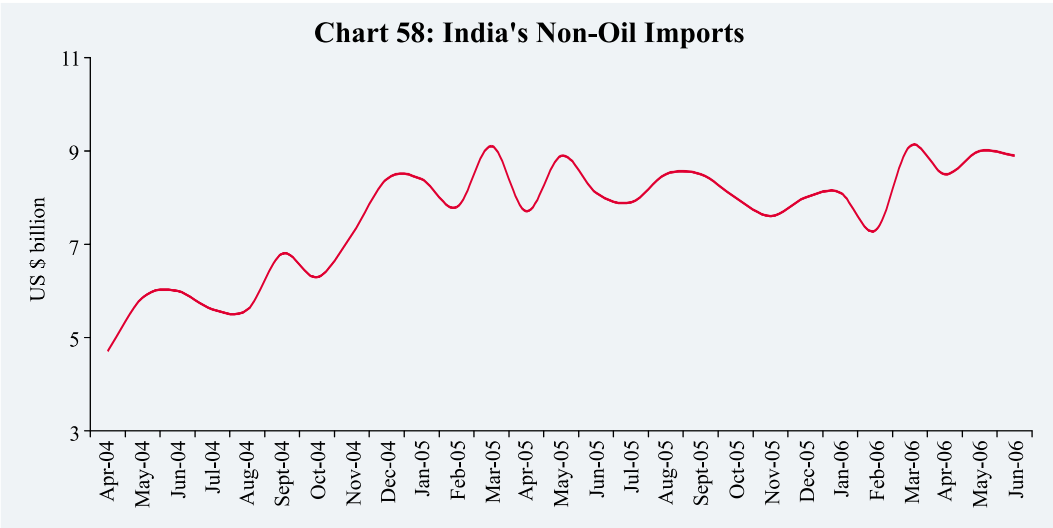


Table 48: Imports of Principal Commodities

Commodity Group	US $ billion			Variation (per cent)	
	2005-06	2005-06	2006-07	2005-06	2006-07
		April		April	
1	2	3	4	5	6
POL	44.0	3.1	4.2	32.3	35.6
Edible Oils	2.0	0.1	0.2	-23.9	60.0
Fertilisers	2.1	0.1	0.1	241.8	-44.1
Iron and Steel	4.4	0.3	0.3	126.6	-5.4
Capital Goods	31.7	2.2	2.9	79.1	29.4
Pearls, Precious and Semi-Precious Stones	9.1	0.8	0.6	116.4	-21.8
Chemicals Organic and Inorganic	6.9	0.5	0.5	74.0	-2.2
Gold and Silver	11.2	1.4	1.2	48.2	-14.9
Total Imports	**142.4**	**10.8**	**12.7**	**56.0**	**18.3**
Memo:					
Non-oil Imports	98.5	7.7	8.5	68.1	11.3
Non-oil Imports Excluding Gold and Silver	87.3	6.2	7.3	73.5	17.3
Mainly Industrial Imports*	81.0	5.8	6.9	75.2	18.0

* : Non oil imports net of gold and silver, bulk consumption goods, manufactured fertilisers and professional instruments.
Source : DGCI&S.

of capital goods, imports of capital goods continued to record strong growth, *albeit* lower than a year ago. Among bulk commodities, imports of metalliferrous ores and scraps, non-ferrous metals, and paper and paperboard including newsprint rose while imports of bulk consumption goods such as manufactured fertilisers and iron and steel witnessed a decline during April 2006.

China continued to be the largest source for India's imports during April 2006 with a share of 8.0 per cent in India's total imports, followed by Switzerland (6.6 per cent), the US (4.9 per cent), Australia (2.9 per cent), Belgium (2.5 per cent) and UAE (2.4 per cent). Developing economies (excluding OPEC) were the major source, accounting for 25.7 per cent of India's total imports. Within developing economies, East Asia was the main source, accounting for 19.5 per cent of India's total imports.

Notwithstanding some moderation in growth of imports, trade deficit expanded from US $ 10.5 billion during April-June 2005 to US $ 12.6 billion during April-June 2006 (Table 49).

Capital flows have remained large during 2006-07 so far. Foreign direct investment (FDI) inflows during April-May 2006 were higher than that during April-May 2005, reflecting strong fundamentals and growing investor interest. On the other hand, FIIs registered outflows during April-June 2006 mirroring the weakness in domestic equity markets in consonance with the trends in

Table 49: India's Merchandise Trade

Item	2004-05	2005-06	2005-06	2006-07
			April-June	
	US $ billion			
1	2	3	4	5
Exports	83.5	102.7	23.7	27.7
Imports	111.5	142.4	34.2	40.3
Oil	29.8	44.0	9.4	13.1
Non-oil	81.7	98.5	24.8	27.2
Trade Balance	-27.9	-39.6	-10.5	-12.6
Non-oil Trade Balance	-5.1	-7.2	-0.7 *	-0.7 *
	Variation (Per cent)			
Exports	30.8	23.0	35.4	16.9
Imports	42.7	27.7	45.4	17.7
Oil	45.1	47.3	31.0	39.0
Non-oil	41.8	20.5	51.7	9.6

* : April.
Source: DGCI&S.

international markets. The number of FIIs registered with the SEBI increased from 882 at end-March 2006 to 928 by end-June 2006. Amounts raised through the issuances of American depository receipts (ADRs)/global depository receipts (GDRs) during April-May 2006 were substantially higher as stock markets offered corporates the opportunity to issue equities abroad (Table 50). Net inflows under various non-resident deposit schemes during April-May 2006 amounted to US $ 816 million as against outflows during April-May 2005, partly reflecting higher interest rates. The ceiling interest rate on FCNR(B) deposits was raised by 25 basis points to "LIBOR/SWAP rates for the respective currency/maturity" in March 2006 from "LIBOR/SWAP rates *minus* 25 basis points". The ceiling interest rate on NRE(R)A deposits, which was raised by 25 basis points in November 2005, was further increased by 25 basis points in April 2006 to LIBOR/SWAP rates of US dollar *plus* 100 basis points.

Table 50: Capital Flows

(US $ million)

Components	2004-05	2005-06	2005-06	2006-07
	April-March		April-May	
1	2	3	4	5
Foreign Direct Investment into India	5,652	7,751	922	1,199
FIIs (net)	8,686	9,926	544 *	-1,787 *
ADRs/GDRs	613	2,552	360	1,007
External Assistance (net)	1,923	1,438	N.A.	N.A.
External Commercial Borrowings (net)	5,040	1,591	N.A.	N.A.
(Medium and long-term)		[7,091] @		
Short-term Trade Credits (net)	3,792	1,708	N.A.	N.A.
NRI Deposits (net)	-964	2,789	-118	816

@ : Excluding the IMD redemption.
* : April-June.
N.A.: Not Available.

Table 51: Foreign Exchange Reserves

(US $ million)

End-Month	Gold	SDR	Foreign Currency Assets	Reserve Position in the IMF	Total (2+3+4+5)
1	2	3	4	5	6
March 1995	4,370	7	20,809	331	25,517
March 2000	2,974	4	35,058	658	38,694
March 2005	4,500	5	1,35,571	1,438	1,41,514
March 2006	5,755	3	1,45,108	756	1,51,622
April 2006	6,301	6	1,53,598	772	1,60,677
May 2006	7,010	–	1,56,073	785	1,63,868
June 2006	6,180	–	1,55,968	764	1,62,912
July 2006 *	6,180	–	1,55,716	763	1,62,659

– : Negligible.
* : As on July 14, 2006.

India's foreign exchange reserves were US $ 162.7 billion as on July 14, 2006; at this level, they were US $ 11.0 billion higher over end-March 2006 level (Table 51). India holds the fifth largest stock of reserves among the emerging market economies and the sixth largest in the world. The overall approach to the management of India's foreign exchange reserves in recent years reflects the changing composition of the balance of payments and the 'liquidity risks' associated with different types of flows and other requirements. Taking these factors into account, India's foreign exchange reserves continued to be at a comfortable level and consistent with the rate of growth, the share of external sector in the economy and the size of risk-adjusted capital flows.