Statement by Dr.Y.Venugopal Reddy, Governor, Reserve Bank of India on the First Quarter Review of Annual Monetary Policy for the Year 2006-07

This Review consists of three sections: I. Assessment of Macroeconomic and Monetary Developments; II. Stance of Monetary Policy; and III. Monetary Measures. An analytical review of macroeconomic and monetary developments was issued a day in advance as a supplement to this Review, providing the necessary information and technical analysis with the help of charts and tables.

I. Assessment of Macroeconomic and Monetary Developments

Domestic Developments

2. Real GDP growth during January-March 2006 is placed at 9.3 per cent as against 8.6 per cent in the corresponding quarter a year ago. Accordingly, the Central Statistical Organisation (CSO) in its end-May 2006 release, revised the estimates of real GDP growth for 2005-06 to 8.4 per cent - up from the advance estimates of 8.1 per cent released in February 2006. Real GDP originating in agriculture, industry and services sectors rose in the revised estimates by 3.9 per cent, 7.6 per cent and 10.3 per cent, respectively, during 2005-06 as against 0.7 per cent, 7.4 per cent and 10.2 per cent in 2004-05.

3. While the onset of the south-west monsoon occurred nearly a week in advance, its progress stalled in the subsequent fortnight which resulted in delay in sowing in some parts of the country. The revival of monsoon activity from the last week of June and

its spread across various parts of the country should, however, mitigate the impact of these early adversities on the *kharif* output. Of the normal area of 101.1 million hectares under *kharif* crops, 27.2 million hectares were covered by sowing by July 10, up from 24.3 million hectares in the corresponding period of the preceding year. Significant increases in sown area have been recorded under rice (13.7 per cent), pulses (32.4 per cent), cotton (29.6 per cent), coarse cereals (7.7 per cent) and sugarcane (4.1 per cent). There has been a moderate rise so far in the area sown under oilseeds. Soil moisture conditions have improved in regions covered by these crops. During the season so far (June 1 to July 19), rainfall has been excess/ normal in 24 of the 36 meteorological subdivisions and 86 per cent of the long-period average (LPA). The India Meteorological Department (IMD) has updated its initial forecast and has placed the rainfall for the south-west monsoon season at 92 per cent of the LPA for the country as a whole.

4. Led by manufacturing which returned to double-digit growth in April-May, 2006 (10.9 per cent) after a gap of five months and supported by mining (3.2 per cent) and electricity (5.3 per cent), the index of industrial production (IIP) rose by 9.8 per cent, the highest increase since July 2005 and up from 9.5 per cent in April-May, 2005. Within manufacturing, growth was driven by basic metals, machinery and transport equipment, with some slowdown in textiles. In terms of the use-based classification, the key feature in April-May 2006 was the growth of 21.1 per cent in capital goods (13.9 per cent a year ago), reflecting the strength of investment activity. The production of basic goods rose by 9.0 per cent (7.5 per cent) and intermediate goods by 7.6 per cent (3.4 per cent) drawing from the underlying buoyancy in industrial activity. On the other hand, there was some

deceleration in the growth of consumer goods to 9.0 per cent (15.9 per cent), mainly on account of consumer non-durables. The six infrastructure industries, comprising nearly 27 per cent of the IIP, posted a growth of 5.9 per cent during April-May, 2006 as against 7.1 per cent a year ago. Improvement in performance was recorded in petroleum products, whereas the growth of coal production, cement, finished steel and electricity decelerated and crude petroleum production registered a decline.

5. The performance of the private corporate sector has been moderating through 2005-06 from a high growth phase in the preceding three years. A deceleration in sales growth, higher input costs, increase in borrowings, especially from banks, and the consequent increase in interest payments imposed pressures on margins, leading to a distinct slowdown in profit growth from 51.2 per cent in 2004-05 to 24.1 per cent in 2005-06. Early results for the first quarter of 2006-07, however, indicate that both sales growth and profits after tax improved *vis-à-vis* the trends in 2005-06.

6. The Reserve Bank's Industrial Outlook Survey indicates sustained business confidence in April-June, 2006 in relation to the previous quarter and also its level a year ago. Companies reported improvement in the overall financial situation as availability of finance kept pace with the increasing working capital and other requirements. Performance indicators for order books, output, employment, capacity utilisation, exports and imports are expected to be above their levels in the preceding quarter. Over four-fifths of the respondents reported raw material and finished goods inventories to be around the average level and a majority indicated increase in raw material prices. Expectations regarding the overall business situation and other major indicators

for July-September, 2006 are significantly higher than for April-June, 2006. Business expectation surveys conducted by most other agencies also indicate an optimistic outlook in terms of overall economic conditions and investment climate, though there are indications of some tempering of such optimism in one survey. Seasonally adjusted purchasing managers' indices signal an ongoing improvement in operating conditions in June, driven by output and new orders growth, including for exports.

7. Lead indicators of services sector activity suggest that the robust growth recorded in 2005-06 has been sustained in the initial months of 2006-07. Railway revenue earnings from freight traffic increased year-on-year by 11.0 per cent in April 2006, while total cell phone connections and net addition in switching capacity in the telecom sector jumped by 167.0 per cent and 572.1 per cent, respectively. The import and export cargo handled by the civil aviation sector posted growth rates of 19.9 per cent and 10.1 per cent, respectively. Foreign tourist arrivals in April-May 2006 rose by 20.0 per cent over the corresponding period last year. The passengers handled at international and domestic terminals also registered growth of 16.2 per cent and 54.0 per cent, respectively, in April 2006.

8. Banking sector activity is closely reflecting the impulses from the real economy. In the interpretation of movements in banking aggregates, however, a *caveat* is in order. The Annual Policy Statement of April 2006 had indicated that March 31, 2006 being the last reporting Friday of 2005-06 lent an upward bias to data for that year (since 2005-06 covered 27 fortnights of reported data instead of the usual 26 fortnights). *Per contra,* the same phenomenon has imposed a downward bias on data for 2006-07. Illustratively, variations in banking aggregates up to

July 7, 2006 are measured from March 31, 2006 *i.e.,* seven reporting fortnights. Conventionally, they would have been compared with corresponding variations in 2005-06 which are measured from March 18, 2005 – the last reporting Friday for that year – *i.e.,* covering eight reporting fortnights. On the other hand, if similar comparisons are made, *i.e.,* variations in the corresponding period of 2005-06 are measured from April 1, 2005 so as to cover seven reporting fortnights, the co-movement between banking and real sector activity becomes clearer. All comparison of such aggregates is made on this basis in this Statement.

9. On this basis, non-food credit of scheduled commercial banks (SCBs) increased by Rs.37,749 crore (2.6 per cent) up to July 7, 2006 as compared with an increase of Rs.19,948 crore (1.8 per cent) in the corresponding period a year ago. This increase is contra-seasonal and is the highest first quarter expansion in the past five years. In view of the March 31, 2006 phenomenon, year-on-year changes in monetary, credit and other banking aggregates are more appropriate for analytical purposes than financial year variations. On a year-on-year basis, the increase in non-food bank credit was 32.9 per cent (Rs.3,71,993 crore) on top of an increase of 31.0 per cent (Rs.2,60,164 crore), net of conversion of a non-bank into a bank, a year ago. Provisional information available for April and May, 2006 indicates that within the services sector, which currently absorbs about 50 per cent of non-food bank credit, retail lending rose by 74 per cent on a year-on-year basis with growth in housing loans being 115.5 per cent. Loans to commercial real estate rose by 101.3 per cent. The year-on-year growth in credit to industry was of the order of 26.0 per cent by May 2006. Substantial increases were observed in credit flow to industries like

infrastructure (34.7 per cent), metals (37.6 per cent), vehicles (37.9 per cent), gems and jewellery (43.5 per cent) and construction (52.6 per cent). The growth in bank credit to agriculture was of the order of 35 per cent in May 2006 on a year-on-year basis.

10. Commercial banks' investments in shares, bonds/ debentures and commercial paper (CP) increased by Rs.1,075 crore (1.3 per cent) during 2006-07 so far, as against a decline of Rs.2,683 crore (-2.9 per cent) in the corresponding period of 2005-06. By contrast, on a year-on-year basis, there was a decline in such investments by banks of the order of Rs.9,508 crore (-10.5 per cent) in contrast to an increase of Rs.4,066 crore (4.7 per cent) a year ago. Banks appear to be undertaking portfolio shifts away from investments in order to accommodate the sustained demand for credit. Accordingly, the year-on-year growth in total flow of resources from SCBs to the commercial sector was 29.6 per cent (Rs.3,62,485 crore) over and above 27.7 per cent (Rs.2,57,062 crore), net of conversion, a year ago.

11. Aggregate deposits of SCBs increased by Rs.68,499 crore (3.2 per cent) up to July 7, 2006 as against an increase of Rs.19,435 crore (1.1 per cent) in the corresponding period of the previous year. The accretion to bank deposits during 2006-07 so far is the highest for any comparable period since 1993-94 (excluding the impact of conversion of non-banks into banks). The year-on-year increase in aggregate deposits at 20.7 per cent (Rs.3,72,977 crore) was significantly higher than 14.9 per cent (Rs.2,34,020 crore), net of conversion, a year ago. With the year-on-year growth in credit still outpacing deposit growth, the incremental non-food credit-deposit ratio continued

to remain high at 99.7 per cent as compared with 111.2 per cent, net of conversion, a year ago.

12. Investments in Government and other approved securities by SCBs increased by Rs.49,697 crore during the current year so far (up to July 7, 2006) as against a decline of Rs.1,133 crore in the corresponding period of 2005-06. These investments mainly reflect large magnitudes of reverse repos with the Reserve Bank and the consequent acquisition of Government securities. Exclusive of liquidity adjustment facility (LAF) operations, however, banks' investments in Government and other approved securities declined by Rs.1,328 crore during 2006-07 up to July 7, as compared with an increase of Rs.12,397 crore a year ago. The subdued appetite of banks for investments in general and a preference for funding advances by shedding incremental gilt holdings was reflected in commercial banks' holdings of Government and other approved securities declining from 36.4 per cent of the banking system's net demand and time liabilities (NDTL) on July 8, 2005 to 31.5 per cent as on July 7, 2006. Such investments remain at Rs.1,57,548 crore above the statutory requirement. Excluding LAF holdings, however, investments of banks in approved securities in excess of the prescribed statutory liquidity ratio (SLR) amounted to Rs.99,273 crore or 4.1 per cent of the system's NDTL. This is indicative of the limits to which SLR disinvestment can potentially fund credit demand.

13. On a year-on-year basis, money supply (M_3) growth at 18.8 per cent by July 7, 2006 was higher than 13.8 per cent, net of conversion, a year ago and above the projected trajectory of 15.0 per cent indicated in the Annual Policy Statement for 2006-07. On a financial year basis, M_3 increased by Rs.91,114 crore (3.3 per cent) during 2006-07 up to July 7, 2006 as

compared with the increase of Rs.40,730 crore (1.7 per cent) in the corresponding period of the previous year.

14. On a year-on-year basis, the expansion in reserve money as on July 14 was of the order of 16.0 per cent, lower than 18.0 per cent a year ago. On a financial year basis (July 14 over March 31, 2006), reserve money increased by Rs.15,165 crore (2.6 per cent) up to July 14, 2006 as compared with the increase of Rs.17,806 crore (3.6 per cent) in the corresponding period of the previous year. As regards the components of reserve money, currency in circulation increased by Rs.23,646 crore (5.5 per cent) as compared with Rs.19,536 crore (5.3 per cent). Among the sources of reserve money, foreign currency assets of the Reserve Bank increased by Rs.75,663 crore as against a decline of Rs.20,630 crore in the corresponding period last year. Net Reserve Bank credit to the Central Government declined by Rs.1,736 crore as against an increase of Rs.25,530 crore.

15. The movements in reserve money during 2006-07 so far reflect the significant turnaround in liquidity conditions that has occurred between the last quarter of 2005-06 and the current financial year so far. The overhang of liquidity in the system, as reflected in the LAF, the market stabilisation scheme (MSS) and the Central Government's cash balances with the Reserve Bank which, put together, averaged Rs.65,174 crore during January-March, 2006 increased to Rs.92,664 crore in April 2006 and settled at Rs.85,287 crore and Rs.86,730 crore in May and June 2006, respectively. On a review of the liquidity conditions, the Reserve Bank resumed auctions under the MSS with effect from May 3, 2006 in accordance with the annual ceiling for 2006-07 fixed at Rs.70,000 crore. It may be mentioned that the Reserve Bank had refrained from fresh auctions under the MSS

since the second half of November 2005. The Reserve Bank absorbed an average daily amount of Rs.46,088 crore during April, Rs.59,505 crore in May, Rs.48,611 crore in June and Rs.50,162 crore in July (up to July 20) under the LAF. The liquidity overhang in the system was placed at Rs.91,231 crore as on July 20, 2006.

16. Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, rose from 4.1 per cent at end-March 2006 to 4.7 per cent as on July 8, 2006. Prices of primary articles, manufactured products and 'fuel, power, light and lubricants' registered increases of 4.7 per cent, 3.6 per cent and 7.3 per cent, respectively, as against 2.3 per cent, 3.0 per cent and 10.5 per cent a year ago. Inflationary pressures are mainly reflecting the pass-through of the hike in administered prices of petrol and diesel effected on June 6, 2006 and increases in prices of food items, including the seasonal spike in prices of fruits and vegetables.

17. The increase of 4.2 per cent in prices of food articles accounted for nearly 14 per cent of the year-on-year headline inflation. The main drivers of inflation in the food articles segment were milk, pulses and wheat. A number of measures have been recently undertaken with a view to heading off these supply side pressures on inflation. Import duty on wheat was reduced from 50 per cent to 5 per cent to moderate the landed import costs. In June, private entities were allowed to import wheat, pulses and sugar under easier terms to contain inflation. Furthermore, a general ban has been applied on the export of refined sugar and pulses until the end of March 2007. During 2005-06, total stock of foodgrains with the Food Corporation of India (FCI) and other Government agencies declined by 1.4 million tonnes.

As on May 1, 2006 total foodgrains stock at around 22.8 million tonnes was above the buffer stock norm of 16.2 million tonnes. Procurement of wheat during 2006-07 at 9.2 million tonnes up to July 11, 2006 was lower by 37.6 per cent than in the corresponding period last year.

18. The average international price of the Indian crude basket increased from US $ 60.1 per barrel in January-March, 2006 to US $ 67.3 per barrel in April-June, 2006 and further to US $ 71.4 per barrel in July 2006 (up to July 21). Excluding mineral oils, however, the WPI inflation works out to 3.0 per cent on July 8, 2006. Fuel prices, which account for about 35 per cent of the increase in WPI, constitute a major risk to headline inflation. Domestic prices of petrol and diesel (average of four metros) were increased by nearly 9.0 per cent and 6.5 per cent, respectively, in early June; however, international crude oil prices continue to be volatile and rising.

19. On an annual average basis, WPI inflation was 4.3 per cent as against 6.3 per cent a year ago. During 2006-07 so far, there has been a reversal of the phenomenon of consumer prices lagging wholesale prices, indicative of the sharp increase in food prices which constitute a relatively larger share in the consumer price basket. On a year-on-year basis, inflation based on the consumer price index (CPI) for agricultural labourers and rural labourers increased to 7.2 per cent each in June 2006 from 2.7 per cent each a year ago. The year-on-year CPI inflation for industrial workers and urban non-manual employees was placed at 6.3 per cent and 5.8 per cent in May 2006 as against 3.7 per cent and 4.2 per cent, respectively, a year ago.

20. Revenue receipts of the Union Government improved from 3.4 per cent as a proportion to the budget estimates (BE) in

April-May, 2005 to 4.8 per cent of the BE in April-May, 2006 reflecting both higher tax and non-tax revenue receipts. Total expenditure at 16.3 per cent of the BE was higher than 11.6 per cent of the BE in April-May, 2005. There was a substantial increase in Plan expenditures on account of front-loading of transfers to the public account under the Central Road Fund (CRF) and the National Rural Employment Guarantee Fund (NREGF). There was also a sharp rise in non-Plan revenue expenditure under grants to States, economic services and subsidies and, in particular, interest payments. Accordingly, as a proportion to the BE, the gross fiscal deficit (GFD) and revenue deficit increased to 48.5 per cent and 81.0 per cent, respectively, during April-May, 2006 as compared with 31.5 per cent and 46.3 per cent in the corresponding period last year.

21. Gross market borrowings of the Central Government at Rs.69,533 crore (Rs.60,282 crore a year ago) during 2006-07 so far (up to July 17, 2006) constituted 38.2 per cent of the BE while net market borrowings at Rs.34,572 crore (Rs.39,234 crore a year ago) constituted 30.4 per cent of the BE. The weighted average yield and weighted average maturity of Central Government securities issued during 2006-07 so far were 7.86 per cent and 14.95 years, as compared with 7.34 per cent and 16.90 years, respectively, for those issued during 2005-06.

22. Reflecting the easy conditions at the short end of the market spectrum, interest rates in the call, market repo and collateralised borrowing and lending obligations (CBLO) segments of the money market eased to an average of 5.81 per cent, 5.64 per cent and 5.56 per cent, respectively, in July (up to July 21, 2006) from 6.58 per cent, 6.17 per cent and 6.19 per cent in March 2006.

23. The primary yields on 91-day Treasury Bills increased to 6.44 per cent on July 21, 2006 from 6.11 per cent at end-March, 2006. Yields on 364-day Treasury Bills recorded a sharper rise from 6.42 per cent at end-March, 2006 to 7.02 per cent in July 2006. Activity in the CP market picked up with an increase in the outstanding amount by 53.2 per cent to Rs.19,490 crore by end-June, 2006 from Rs.12,718 crore at end-March, 2006. The weighted average discount rate on CP declined from 8.59 per cent to 7.10 per cent over this period. In the market for certificates of deposit (CDs), the weighted average discount rate declined from 8.62 per cent at the end of March 2006 to 7.19 per cent by end-June, accompanied by an increase of 29.4 per cent in the outstanding amount (*i.e.,* from Rs.43,568 crore to Rs.56,390 crore).

24. Gilt prices declined in the secondary market for government securities. The yield on government securities with one-year residual maturity moved up from 6.52 per cent at end-March, 2006 to 6.95 per cent as on July 21, 2006. The yield on Government securities with 10-year residual maturity also firmed up from 7.52 per cent at end-March 2006 to 8.27 per cent as on July 21, 2006. The yield on Government securities with 20-year residual maturity rose from 7.72 per cent to 8.69 per cent during the same period. Consequently, the yield spread between 10-year and one-year Government securities widened from 100 basis points to 132 basis points as on July 21, 2006. The yield spread between 20-year and one-year Government securities widened from 120 basis points to 174 basis points during the same period. Secondary market yields have generally hardened since June 2006 with the 10-year yield increasing sharply from 7.67 per cent on June 8 to 8.24 per cent on July 21, 2006. The underlying factors in this regard could be unsettled

inflation expectations in the wake of soaring international crude prices feeding into interest rate uncertainty; sustained credit growth and competing demand for funds between public and private sectors; some spillover from global markets; and apprehensions of additional pressures on market resources from perceptions of possible higher borrowings by the Centre in the second half of the year coupled with announcement of issuances of bonds to oil companies.

25. Banks increased their deposit rates by about 25-100 basis points across various maturities between March 2006 and July 2006. A majority of PSBs adjusted their deposit rates up to three year maturity upwards by 25 to 50 basis points, while keeping the range of 6.00-7.25 per cent unchanged for deposits of over three years over the same period. The adjustments in deposit rates made by some private sector and foreign banks were somewhat higher, up to 100 basis points, particularly for deposit rates of over one year maturity. The benchmark prime lending rates (BPLRs) of PSBs and private sector banks moved to a range of 10.75-11.50 per cent and 11.00-14.50 per cent from 10.25-11.25 per cent and 11.00-14.00 per cent, respectively, in the same period. The range of BPLRs for foreign banks remained unchanged at 10.00-14.50 per cent during the period.

26. In the foreign exchange market, some indications of pressure from mid-May, 2006 due to the sharp decline in stock indices and currencies worldwide were observed. Market sentiment corrected by June and orderly conditions have prevailed thereafter. In contrast to the movements in the spot segment, the forward rates appreciated after April 2006. The average six-month forward premia eased from around 1.3 per cent to about 1.0 per cent during May-July, 2006. Market activity as measured by the overall daily turnover in various foreign exchange market segments increased from about US $ 27 billion in April 3, 2006 to around US $ 36 billion by May 15, 2006 before moderating to about US $ 26 billion by June 30, 2006.

27. The equity markets witnessed significant swings during the first quarter of 2006-07. The BSE Sensex (1978-79=100) increased from 11,280 at end-March 2006 to reach the all-time high of 12,612 on May 10, 2006 and a decline set in during the second half of May. The Sensex reached a trough of 8,929 on June 14, 2006 but firmed up thereafter to reach 10,086 on July 21, 2006.

Developments in the External Sector

28. Balance of payments data for 2005-06 released at end-June 2006 continue to indicate strength and resilience in the external sector. Merchandise exports maintained a high growth trajectory, rising by 27.5 per cent during the year. Exports of manufactures and, in particular, transport equipments, machinery and instruments, woollen yarn, fabrics and readymade garments, basic chemicals and pharmaceuticals and petroleum products underpinned the momentum of overall export growth. Merchandise import payments also rose sharply by 31.6 per cent, largely reflecting a growth of 47.3 per cent in petroleum, oil and lubricants (POL) imports on the back of a rise in the average price of the Indian basket of international crude by 42.4 per cent from US $ 38.9 per barrel in 2004-05 to US $ 55.4 per barrel in 2005-06. Non-oil import payments increased by 20.5 per cent with capital goods as key components, signifying the underlying strength of domestic industrial activity. Accordingly, on a payments basis, the merchandise trade deficit widened to US $ 51.6 billion (6.5 per cent of GDP) from US $ 36.6 billion (5.3 per cent) in the previous year.

29. During 2005-06, gross invisible receipts increased by 27.3 per cent, apace with merchandise exports. At US $ 91.5 billion, invisible receipts amounted to about 87 per cent of merchandise

exports. The major components driving this expansion were software exports, remittances from Indians working overseas and a host of professional and business services. During 2005-06, invisible payments increased by 24.4 per cent, mainly on account of higher interest payments and imports of transportation, business and technology-related services. Nevertheless, the net invisible surplus rose to US $ 40.9 billion in 2005-06 from US $ 31.2 billion in the previous year. Accordingly, the current account deficit (CAD) amounted to US $ 10.6 billion during 2005-06 or 1.3 per cent of GDP, up from US $ 5.4 billion or 0.8 per cent of GDP in 2004-05.

30. In the capital account, net inflows under foreign direct investment (FDI), portfolio investment and non-resident Indian (NRI) deposits recorded increases in 2005-06 while other capital flows including external assistance and external commercial borrowings moderated in relation to their levels in the preceding year. Net FDI inflows to India picked up to US $ 5.7 billion in 2005-06 from US $ 3.2 billion in 2004-05 on sustained interest in India as an attractive investment destination, strong macroeconomic performance and corporate profitability. FDI inflows were mainly channelled into manufacturing, business and computer services. Net inflows under portfolio investment remained buoyant at US $ 12.5 billion in 2005-06, up from US $ 8.9 billion in 2004-05, extending an expansionary phase that began two years ago. American Depository Receipts/Global Depository Receipts (ADRs/GDRs) issuances also remained buoyant as corporates took advantage of external market conditions to issue equities abroad. NRI deposits showed a significant turnaround from net outflows of US $ 1.0 billion in the previous year to net inflows of US $ 2.8 billion in 2005-06. There was a one-off principal repayment of India Millennium Deposits

(IMD) (US $ 5.5 billion) in the capital account and interest payments (US $ 1.6 billion) under the current account.

31. Reflecting the movements in current and capital accounts of the balance of payments, the accretion to foreign exchange reserves (excluding valuation) amounted to US $ 15.1 billion during 2005-06 on top of US $ 26.2 billion in 2004-05. At the end of March 2006, the foreign exchange reserves stood at US $ 151.6 billion.

32. India's external debt increased marginally by US $ 2.0 billion during 2005-06 to US $ 125.2 billion at end-March, 2006. Among the various components of debt, NRI deposits, trade credit and multilateral debt registered increases which were moderated by the redemption of IMD in December 2005. The US dollar had a dominant share of 45.1 per cent in India's external debt by currency whereas rupee-denominated debt had a share of 19.9 per cent in the external debt at end-March, 2006. The ratio of short-term debt to total debt increased marginally to 7.0 per cent at end-March, 2006 from 6.1 per cent a year ago.

33. According to the Directorate General of Commercial Intelligence and Statistics (DGCI&S), export growth in US dollar terms moderated to 16.9 per cent during April-June, 2006 from 35.4 per cent a year ago. Merchandise import also decelerated to 17.7 per cent from 45.4 per cent. While POL import growth rose sharply to 39.0 per cent from 31.0 per cent reflecting the steep rise in international crude oil prices, non-oil imports posted a relatively modest growth of 9.6 per cent as compared with 51.7 per cent a year ago. Accordingly, the trade deficit at US $ 12.6 billion during April-June, 2006 was higher than that of US $ 10.5 billion in the corresponding period last year. Net invisible earnings and capital flows have remained reasonably

strong despite outflows by foreign institutional investors (FIIs) in May-June. Accordingly, India's foreign exchange reserves increased by US $ 11.0 billion over their end-March, 2006 level to US $ 162.7 billion as on July 14, 2006.

34. The exchange rate of the rupee depreciated by 4.7 per cent against the US dollar, by 8.4 per cent against euro, by 10.2 per cent against pound sterling and by 5.1 per cent against Japanese yen during 2006-07 so far (up to July 21, 2006). Orderly conditions have prevailed in the domestic foreign exchange market during the period.

35. The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary. The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements.

Developments in the Global Economy

36. Global expansion appears to be proceeding at a strong pace in 2006 and is getting diffused across the main economic regions. According to the World Economic Outlook of the International Monetary Fund (IMF) released in April 2006, global growth is expected to pick up from 4.8 per cent in 2005 to 4.9 per cent in 2006 before easing to 4.7 per cent in 2007.

37. Global growth accelerated in the first half of 2006. In the US, real GDP increased by 5.6 per cent in the first quarter, led

by personal consumption expenditure, exports and federal government spending. The US economy is expected to grow at 3.4 per cent in 2006 and remains the main engine of global growth. In the euro area, a recovery is underway with first quarter real GDP growth at 1.9 per cent and projected to rise to 2.0 per cent in 2006. In Japan, the recovery is gathering momentum, and there are encouraging signs that the economy has emerged from the debt-deflation spiral of the past decade. In China (11.3 per cent in the second quarter), Hong Kong (8.2 per cent in the first half) and India (9.3 per cent in the first quarter), the rapid pace of growth appears to have picked up further. In Russia and Latin America, too, growth has been buoyant.

38. Substantial increases have occurred in a wide range of commodity prices. While prices of oil and metals continue to be the main drivers, food prices have started edging up. Crude oil prices surged since April and almost doubled over the levels recorded in the last two years, touching a high of US $ 76.7 per barrel on July 13, 2006. The international pass-through of oil prices to domestic retail prices has been varied across countries, with implications for future inflation. World cereal production, in particular, wheat and coarse grains, is expected to decrease in 2006, leading to a drawdown of stocks for the second consecutive year. Prices of rice and wheat, in particular, are expected to harden on strong demand growth, high input prices and low global stocks. Non-energy prices have been increasing through 2005 and the first half of 2006. In fact, the recent turmoil in global markets appears to have been triggered by key commodity prices. Global metal prices rose by 48.4 per cent on an annual basis during the first six months of 2006 on top of an increase of 26.4 per cent in 2005. Metal price movements in recent

months have been characterised by a heightened degree of volatility.

39. Consumer price inflation in the advanced economies accelerated in the second quarter of 2006. In the US, consumer prices rose to 4.3 per cent in June from 3.5 per cent in April, primarily on account of energy prices. In the euro area too, inflation rose to 2.5 per cent in May and June from 2.4 per cent in April. Consumer prices continue to increase moderately in Japan, *i.e.,* by 0.6 per cent in May on account of higher oil prices. In the UK, inflation breached the Bank of England's target of 2.0 per cent in April and rose to 2.5 per cent in June. In major industrial countries, inflation appears to be on the upswing mainly on account of oil price increases. In addition, risks loom large in the form of lagged second order effects of oil price increases, geopolitical tensions, the probability of disruptive adjustment of current account imbalances and the cooling global housing market. Inflation expectations have also been reflected in the gap between nominal and inflation-indexed bonds which hovered in the range of 2.2-2.7 per cent in the US in May-July.

40. Global imbalances, emanating mainly from the twin deficits of the US and reflected in misalignment of major currencies, have continued to widen during 2006 in an environment of rising interest rates worldwide and prospects of contraction of liquidity in the global financial markets. The current account deficit of the US surpassed US $ 800 billion in 2005, matched by increased surpluses elsewhere, particularly in Japan, Europe, China and other parts of emerging Asia and oil-exporting countries. The IMF projects that the U.S. current account deficit will remain at about 6 per cent of GDP into the medium term, with some improvement in the U.S. fiscal position offset by low private

savings and rising interest payments. The sharp rise in the net foreign liability position of the US raises the risks of abrupt and disorderly adjustment of major currencies as the global imbalances unwind.

41. Financial markets are becoming increasingly apprehensive about the risks of a disorderly adjustment of the widening global imbalances. Adverse expectations of markets were recently evident in the large declines in stock exchanges across the globe and a visibly increased preference for debt. Long-term sovereign bond yields, which had moved up briefly, have again fallen well below their long-run averages and yield curves have either flattened or inverted in major industrial economies. Ten-year bond yields in Japan, the euro area and the US currently stand at 1.79 per cent, 3.95 per cent and 5.05 per cent, respectively.

42. Against the background of these global developments, a large number of central banks have raised their official interest rates from the unusually low levels that they had reached earlier in the decade. They include the US Federal Reserve (by 25 basis points each on seventeen occasions from June 2004 to 5.25 per cent by June 2006); the European Central Bank (ECB) (three times since December 2005 by 25 basis points each to 2.75 per cent); the Bank of Japan (uncollateralised overnight rate to 0.25 per cent in July after maintaining a zero interest rate policy since 2001); the Bank of Canada (by 50 basis points in April-May, 2006 to 4.25 per cent); the Reserve Bank of Australia (by 25 basis points in May 2006 to 5.75 per cent); the People's Bank of China (lending rate raised by 0.27 percentage points to 5.85 per cent on April 28, 2006; required reserve ratio by 50 basis points on July 5 to 8.0 per cent

and a further increase of 50 basis points to become effective from August 15, 2006); the Bank of Korea (by 25 basis points to 4.25 per cent in June); and the Banco Central de Chile (benchmark lending rate raised to 5.25 per cent on July 13, 2006).

43. Some central banks have kept their policy rates steady as for instance, the Bank of England (repo rate at 4.50 per cent since August 2005); Bank Negara Malaysia (policy rate at 3.5 per cent since April 2006); the Bank of Thailand (the 14-day repurchase rate at 5.00 per cent since June 2006); and the Monetary Authority of Singapore.

44. A few central banks have eased monetary policy in the recent period such as the Banco de Mexico (cut the benchmark overnight lending rate from 7.50 per cent to 7.25 per cent in March 2006 and further to 7.0 per cent in April 2006); Bank Indonesia (reduced its policy rate from 12.50 per cent to 12.25 per cent on July 6, 2006); and the Banco Central do Brasil (cut Selic rate target gradually from September 2005 to 14.75 per cent by July 2006).

Overall Assessment

45. There are several positive factors in domestic developments during 2006-07 so far which support an optimistic near-term outlook for the Indian economy. First, corporate performance remains reasonably robust, despite some deceleration. Second, investment activity is picking up in an environment of rising capital expenditures of corporates, a surge in capital goods production in April and May, continuing expansion of investment intentions and strong demand for bank credit. Third, most business confidence surveys report growth in new

order books, increase in capacity utilisation and improvement in financing conditions notwithstanding some hardening of interest rates. Fourth, even as non-food bank credit has continued to expand at the high rates recorded over the last couple of years, deposit growth has picked up and overall liquidity in the system has been ample. Banks continue to hold over Rs.1,50,000 crore of excess SLR investments which could, to some extent, accommodate the demand for bank credit. Fifth, financial markets have responded to these shifts in financing conditions, on the whole, in an orderly fashion. Sixth, inflation has stabilised since mid-June, despite increases in administered prices of petroleum products and the spike in food prices. Price stability has created conducive conditions for growth to continue undisrupted.

46. On the external front, export growth remains strong. Although early indications suggest that non-oil import growth appears to have slackened somewhat, the continuing sharp growth of POL imports, driven by soaring international crude prices, has resulted in a higher trade deficit. Invisible earnings and capital flows have, however, enabled the financing of the rising trade deficit while adding to the reserves during the year so far.

47. Some developments in the first quarter of 2006-07 do suggest the need to remain on guard against the emerging risks. The changes in administered prices of petrol and diesel in June 2006 imparted a direct effect of 45 basis points on headline inflation. Given that catch-up of domestic POL product prices with the possible permanent component of international prices remains incomplete, the upside risks to inflation are evident. In the recent period, these risks have become amplified by the renewed hardening of international crude prices to new highs,

due to escalating geopolitical tensions. The recent increases in domestic food prices occurring in an environment in which international food prices are also hardening is a relevant factor in this regard, though some seasonal elements in movements in domestic prices of food items are possible. These risks to inflation are being carefully monitored with appropriate supply-side policy responses of the Government.

48. Non-food bank credit growth on a year-on-year basis remains high and comparable to the elevated rates recorded since 2004-05. The growth of monetary aggregates is also higher on a year-on-year basis. Interest rates in various segments of the financial markets have hardened with the exception of the money markets which reflect contrasting conditions of excess liquidity. Accordingly, call, market repo and CBLO rates have eased with absorption of liquidity of about Rs 60,000 crore, and even beyond, on a daily basis in the LAF during mid-May to early June and again in the first week of July. By contrast, the tightening of yields in the Government securities market needs to be noted. These developments would warrant closer policy attention in response to evolving circumstances. On the whole, financial markets in India, despite the noticeable volatility in equity markets, have exhibited resilience relative to most other emerging market economies.

49. The Annual Policy Statement of April 2006 warned of three key risks from global developments for emerging economies including India: potential escalation and volatility in international crude prices; a disorderly unwinding of the global imbalances; and a hardening of international interest rates along with the direction of movement in setting monetary policy. Since then, the evolution of the global economy seems to indicate that each

of these risks is materialising; in fact, these risks appear to have heightened in recent months. First, international crude prices have risen from an average level of US $ 57 per barrel at end-2005 to above US $ 73 per barrel currently. By all indications, crude oil prices are expected to remain at elevated levels until the end of 2007 with no respite in sight. Second, global imbalances are likely to persist in 2006. Large misalignment among major currencies is now in evidence with sharp cross-currency movements characterising recent months. Third, while core inflation appears contained, headline inflation has hardened across countries in the second quarter of 2006, driven up mainly by crude prices and some pressure from non-energy prices. Fourth, since the announcement of the Annual Policy Statement, monetary policy has been tightened further with increases in key policy rates in some advanced economies such as the US, the Euro area, Canada, Japan and Australia as well as in some emerging economies like China, Korea and Chile, with some of them even acting simultaneously in early June. Market expectations seem to reflect apprehensions of further tightening in the coming months. Fifth, along with the recent shifts in portfolios away from the emerging markets and commodity exchanges, financial markets are currently re-pricing risks in an environment of uncertainty and, in particular, in emerging market economies.

50. The prospects for growth in the world economy in 2006 are considered bright and indicators of business confidence and unemployment in major economies lend credence to this optimism for the near-term. However, it is widely recognised that several features of the current global upswing are causes for concern: large fiscal deficits, low household savings and low investment in some large economies; unprecedented and growing current

account imbalances; narrowing or closing in of output gaps in many economies; record highs in oil prices accompanied by uncertainties about their future evolution; and the outlook for inflation firming up.

51. In the global financial markets, the period since the Annual Policy Statement has been characterised by significant re-pricing of risks. The first four months of 2006 saw a continuation of the shift by investors towards higher-risk asset classes, with marked increase in equity, commodity and high-yield debt prices. There were, however, some initial signs of discomfort in financial markets in February 2006 attributed to unwinding of carry trades and the steep fall in select equity markets. There was also some evidence of increased uncertainty in foreign exchange markets, globally. A clear reversal of direction in many markets came to the fore in mid-May. The prices of highly rated government bonds rose, while those of riskier assets fell. The mid-May correction was felt acutely by emerging market economies – especially in equity markets - including India. Currencies of some emerging market economies depreciated significantly against the US dollar. It is clear that fundamentals could not have changed in such a dramatic fashion in a short time and, hence, it is reasonable to suggest that those economies that had gained most from lower pricing of risks in recent years felt the impact of reversal in direction since mid-May the most. The two important questions in assessing the outlook are: whether the process of re-pricing of risks, in general, is complete; and whether corrections are incomplete in the economies which benefited from lower-priced risks in the past. The overall macroeconomic and geopolitical global environment is admittedly indicative of marked downside risks.

II. Stance of Monetary Policy for the Remaining Period of 2006-07

52. The Annual Policy Statement for 2006-07 had stated that in the context of macroeconomic developments and the global scenario, it is necessary to be in readiness to act as warranted to meet the challenges posed by the evolving situation, given the unfolding of the risks. It had also indicated that the balance of risks was tilted towards the global factors and that in a situation of generalised tightening of monetary policy, India cannot afford to stay out of step. While keeping in view the dominance of domestic factors as in the past, the Annual Policy Statement assigned more weight to global factors than before while formulating the policy stance. The overall stance of monetary policy for the year as a whole was expressed in terms of ensuring a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations. A key element of the stance was the focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, and in particular, financial stability. Emphasis was laid on responding swiftly to evolving global developments.

53. Since the announcement of the Annual Policy Statement in April 2006, there was definitive evidence of widespread and simultaneous monetary policy tightening among several countries in early June. This had to be viewed against the backdrop of marked and heightened volatility in the financial markets. Though not entirely unanticipated, the virtual global coverage, nature and timing of these developments posed a serious threat to

the domestic economy which, thus far, had been spared of turbulence in the debt and foreign exchange markets. These developments, viewed in the light of the prevailing monetary and credit environment underscored compulsions of swift action, as indicated in the Annual Policy Statement. Accordingly, on June 8, 2006 the LAF reverse repo/repo rates were increased by 25 basis points. The spread between repo and reverse repo rate under the LAF was retained at 100 basis points.

54. In India, the prospects of sustaining the high growth momentum of recent years appear favourable at the current juncture with the outlook on agriculture somewhat positive and industrial and services sector activity remaining robust in the early months of 2006-07. Inflationary pressures have, by and large, been contained so far by appropriate monetary policy action and supply-side policy measures that have been put in place to head off the cost-push effects of the recent hardening of food prices. Business confidence continues to be healthy on the acceleration of growth in industrial production, particularly capital goods and exports. The economy can also be expected to benefit from the brightened growth prospects of the global economy. As regards the balance of payments, despite the growing oil import bill, the anticipated current account deficit in 2006-07 is manageable, as in the past, due to the continuing underlying strength of merchandise exports, invisibles and capital flows.

55. There is also a need to note that within the domestic economy, demand pressures continue to be in evidence. First, the year-on-year money supply and credit growth indicates that aggregate demand conditions continue to be strong. Second, there has been a significant turnaround in the liquidity conditions from considerable tightness in the last quarter of 2005-06 to

a large overhang of surplus liquidity. Third, factors like increased prices of primary food articles and industrial raw materials are new forces impinging on domestic inflation expectations. This is in addition to the incomplete pass-through of global oil price increases which is largely being regarded now as containing a significant permanent component. Against this background, it is critical that underlying inflationary pressures are contained and that inflationary expectations are anchored for supporting economic growth and financial stability.

56. The Annual Policy Statement had alluded to the liquidity risks embedded in a system which was significantly overdrawn in terms of credit portfolios. Banks need to recognise the reality of business and credit cycles and the worldwide concern that is currently surrounding their evolution. Analytical assessment of these realities could justify counter-cyclical switches in portfolios between loans and investments. Ensuring credit quality remains a priority in the context of financial stability. Banks would need to focus on mobilisation of retail deposits which have durability, stricter credit appraisals on a sectoral basis, monitor loan-to-value ratios and generally ensure the health of credit portfolios on an enduring basis.

57. The outlook for the global economy presents, in some sense, a complex combination of strong growth and heightened uncertainties, especially the volatility in equity, and to some extent, in currency and bond markets, particularly in emerging economies, in addition to the concerns relating to oil prices. The responses of monetary authorities to developments in financial markets in the second quarter of the calendar year 2006 indicate greater resilience among most economies, developed as well as emerging, as financial markets re-price their risks aggressively,

although some nervous sentiments on the way forward are evident. In the circumstances, the response of our monetary policy to global developments should be pre-emptive at signs of heightened uncertainties but should also be willing to discern possible trends towards normalcy. Thus, monetary policy may not be unidirectional for a prolonged period, recognising that the pace of changes in the global economic and financial environment is far more rapid now than ever before.

58. Some uncertainty continues to surround the progress of the monsoon. As of now, it is reasonable to assume that real GDP originating in agriculture would maintain its trend growth of 3.0 per cent. The overall industrial outlook continues to be positive and services sector growth is expected to sustain its momentum. Overall, for policy purposes, the forecast for GDP growth is retained in the range of 7.5-8.0 per cent during 2006-07 as projected in the Annual Policy Statement, barring domestic or external shocks.

59. There is some evidence that while increased competition and productivity gains in several sectors have contributed to some moderation in inflation, commodity prices and input costs are currently rising with producers increasingly prone to passing on the squeeze on margins to consumers. The pass-through of international oil price increases is expected to be higher in the future than before and policy authorities have to be on guard against second round effects. Taking into account the real, monetary and global factors, containing the year-on-year inflation rate for 2006-07 in the range of 5.0-5.5 per cent warrants appropriate priority in policy responses.

60. For the purpose of monetary policy formulation, the expansion in M_3 was projected at around 15.0 per cent for

2006-07 in the Annual Policy Statement. The growth in aggregate deposits was projected at around Rs.3,30,000 crore in 2006-07. Non-food bank credit including investments in bonds/debentures/ shares of public sector undertakings and private corporate sector and CP was expected to increase by around 20 per cent. Developments during the first quarter of 2006-07 indicate that money supply, deposit and credit growth are running well above the indicative projections, warranting caution by all concerned in this regard.

61. Central bankers all over the world revel over the dream run of low inflation coupled with high growth in recent years. They are confronted with the confusing realities presented by financial markets, oil markets and inflation uncertainties. They face the uncertainties of the future more acutely than ever before, since an increasingly globalised world is making assessments as well as policy options in the domestic arena very constrained. India is no exception to this, but a greater complexity is imparted since structural transformation of the economy and its gradual integration with the global economy add to the uncertainties. Yet, the trade-offs and judgments have to be made, keeping in view the criticality of timeliness in actions and flexibility to respond appropriately. For our economy, the domestic considerations continue to dominate and maintaining growth momentum is of the highest importance, but if, contextually, priority has to be accorded to demand management, price stability, inflation expectations and financial stability, there should be no hesitation to do so. The current situation calls for some stabilising influences while keeping all the options open for the future to maintain a successful and dynamic balance between growth and stability that has been the hallmark of our macroeconomic policies during the reform period.

62. Our current assessment points to the domestic economy exhibiting strong fundamentals and displaying considerable resilience. At the same time, there are disturbing signs of demand pressures, especially continuing high credit growth, that could exert upward pressure on prices when associated with supply shocks such as from oil. These pressures have the potential for impacting stability and inflation expectations. Against this background, as usual, judgments are necessary as to the relative weights to be accorded to growth and price stability, recognising lags in monetary policy. While domestic developments continue to dominate our economy, global factors tend to gain more attention now than before. The global outlook for growth is positive but downside risks in regard to inflation and re-pricing of risks in financial markets need to be recognised. Hence, it is necessary to strike a balance between reinforcing the resilience of our economy against global risks and taking advantage of global expansion. Both domestic and global factors are delicately balanced in terms of growth *vis-à-vis* price stability with a tilt towards the possibility of identified downside risks materialising in the near-term being more likely than before. The unfolding path of the identified risks, however, is naturally unclear at this stage. On balance, a modest pre-emptive action in monetary policy is appropriate at this juncture while being ready to respond flexibly and promptly by closely monitoring the related developments.

63. The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank will continue with its policy of active demand management of liquidity through

open market operations (OMO) including MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

64. In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be:

- To ensure a monetary and interest rate environment that enables continuation of the growth momentum while emphasising price stability with a view to anchoring inflation expectations.

- To reinforce the focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic and, in particular, financial stability.

- To consider measures as appropriate to the evolving global and domestic circumstances impinging on inflation expectations and the growth momentum.

III. Monetary Measures

(a) Bank Rate

65. The Bank Rate has been kept unchanged at 6.0 per cent.

(b) Reverse Repo Rate

66. In view of the current macroeconomic and overall monetary conditions, it has been decided:

- To increase the fixed reverse repo rate under the liquidity adjustment facility (LAF) of the Reserve Bank by 25 basis points from 5.75 per cent to 6.00 per cent, with immediate effect.

67. The repo rate will continue to be linked to the reverse repo rate. The spread between the reverse repo rate and the repo rate has been retained at 100 basis points, as at present. Accordingly, the fixed repo rate under the LAF will be 7.00 per cent, with immediate effect.

(c) Cash Reserve Ratio

68. The cash reserve ratio (CRR) of scheduled banks is currently at 5.0 per cent. On a review of the current liquidity situation, it is felt desirable to keep the present level of CRR at 5.0 per cent unchanged.

Mid-term Review

69. The Mid-term Review of the Annual Policy Statement will be undertaken on October 31, 2006 instead of October 17, 2006 and the Third Quarter Review on January 30, 2007 instead of January 23, 2007 as indicated in the Annual Policy Statement of April 2006.

Mumbai
July 25, 2006

First Quarter Review of Annual Statement on Monetary Policy for the Year 2006-07

Reserve Bank of India
Mumbai