Macroeconomic and Monetary Developments in 2004-05

Reserve Bank of India
Mumbai

Contents

I. GROWTH, SAVING AND INVESTMENT

Growth Rates

The Central Statistical Organisation (CSO) has estimated real GDP growth at 6.9 per cent in 2004-05, down from 8.5 per cent (revised estimates) in 2003-04. Macroeconomic performance in 2004-05 turned out to be stronger than anticipated. Although beset by an uneven and deficient South-West monsoon, below normal North-East monsoon and the base effect of a seven-year peak growth of 9.6 per cent achieved in 2003-04, real GDP originating from 'agricultural and allied activities' rose by 1.1 per cent in 2004-05. The industrial recovery firmed up and broadened during the year, led by manufacturing and 'electricity, gas and water supply', considerably mitigating the setback to agriculture. Real GDP originating from services continued to sustain the robust growth recorded in 2003-04 (Table 1).

Table 1 : Sectoral Growth Rates of Real GDP

Sector	Average (1992-93 to 2002-03)	2003-04*	2004-05#	2003-04				2004-05		
				Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture and Allied Activities	**2.4**	**9.6**	**1.1**	**0.1**	**7.2**	**18.2**	**10.5**	**3.3**	**-0.8**	**-1.1**
	(27.0)	**(21.7)**	**(20.5)**							
a) Agriculture	2.4									
2. Industry	**6.3**	**6.5**	**8.3**	**5.6**	**6.0**	**6.4**	**7.9**	**7.6**	**8.8**	**9.1**
	(22.0)	**(21.6)**	**(21.9)**							
a) Mining and Quarrying	4.4	6.4	5.3	4.5	4.2	5.8	9.0	6.1	4.9	4.8
b) Manufacturing	6.8	6.9	8.9	6.1	6.9	7.0	7.6	8.0	9.3	10.4
c) Electricity, Gas and Water Supply	5.4	3.7	6.3	3.0	1.1	3.0	9.5	6.3	9.3	4.4
3. Services	**7.6**	**8.9**	**8.6**	**7.8**	**10.5**	**9.5**	**7.6**	**8.9**	**8.0**	**8.7**
	(51.0)	**(56.7)**	**(57.6)**							
a) Trade, Hotels, Restaurants, Transport and Communication	8.5	11.8	11.3	8.0	10.4	13.6	13.8	11.0	11.6	10.5
b) Financing, Insurance, Real Estate and Business services	7.8	7.1	7.1	6.4	7.2	7.3	8.5	7.0	5.9	8.1
c) Community, Social and Personal services	6.7	5.8	6.0	9.0	14.9	5.2	-3.1	9.3	4.5	5.8
d) Construction	5.5	7.0	5.7	7.5	7.8	5.9	7.6	3.6	5.2	8.0
4. GDP at factor cost	**5.9**	**8.5**	**6.9**	**5.6**	**8.8**	**11.0**	**8.2**	**7.4**	**6.6**	**6.2**

* : Quick Estimates. # : Advance Estimates.

Notes : 1. Figures in brackets denote shares in real GDP in per cent.
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.

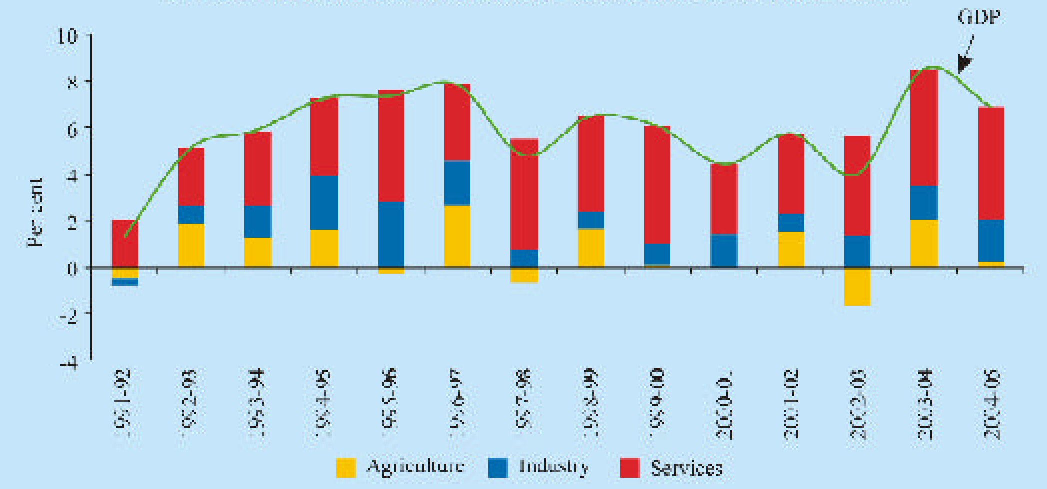
The performance of the Indian economy in 2004-05 has generated considerable optimism about medium-term macroeconomic prospects. It is heartening to note that in spite of the sharp slowdown in agriculture, the overall growth of GDP in 2004-05 was higher than the average growth attained over the preceding 12-year period beginning 1992-93. Consequently, the average growth of 6.5 per cent recorded during the first three years of the Tenth Plan period (2002-07) has already outstripped the average of 5.5 per cent achieved in the Nineth Plan period, *i.e.*, 1997-2002 and is broadly in line with the average of 6.7 per cent achieved in the Eighth Plan period (1992-97). These stylised facts indicate that the structural acceleration of growth that is underway is based on solid foundations, including a weather-proofing of the economy. These factors are equipping India to remain among the fastest growing economies of the world in the medium-term.

The salutary effects of the bumper *rabi* crop of 2003-04, reinforced by a strong pick-up in activity in the industrial and the services sectors, were reflected in an improvement in real GDP growth in the first quarter of 2004-05. In the second and third quarters, the uneven spread of the South-West monsoon from mid-July, despite the early onset, led to an absolute decline in agricultural growth. Deceleration in growth rates of financing, insurance, real estate, business services, community, social and personal services in relation to the corresponding quarter of the previous year dampened the buoyancy of the overall services sector in the second quarter of 2004-05 with the slowing down becoming more pronounced in the third quarter of 2004-05 due to deceleration in 'trade, hotels, restaurants, transport and communication'. Real GDP growth originating in the industrial sector sustained its momentum through the first three quarters of 2004-05.

A significant feature of the macroeconomic developments in 2004-05 was the resurgence of the industrial sector, propelled by buoyant exports and a brightening of the domestic investment climate in an environment of rising business optimism and consumer confidence. Industry contributed 26 per cent to overall growth of the economy, up from 17 per cent in 2003-04, in spite of a secular decline in its share in GDP. 'Agriculture and allied activities', on the other hand, exhibited considerable volatility in terms of contribution to real GDP growth. In 2004-05, 'agriculture and allied activities' contributed 3 per cent of real GDP growth as against 24 per cent in 2003-04 (Chart 1).

The services sector remained the main engine of growth of the economy during 2004-05. Recent gains in growth momentum under 'trade, hotels, transport and communication' were consolidated during the year, benefiting from a sharp rise in net tonne kilometres (8.2 per cent) and passenger kilometres (6.9 per cent) in respect of railways, a surge in the production of commercial vehicles (30.4 per cent), expansion in cargo handled at major ports (11.1 per cent), increase in the gross trading index (8.6 per cent) and rising tele-density

Chart 1: Sectoral Contributions to Real GDP Growth Rate



as a result of a 30.3 per cent increase in the stock of telephone connection, during April-December, 2004-05. The growth of 'community, social and personal services' remained stable at the previous year's level, reflecting the commitment to fiscal consolidation and expenditure containment.

India has been consolidating its position as a world leader in software and Information Technology (IT) services. According to the National Association of Software and Services Companies (NASSCOM), the Indian software industry is expected to raise its export revenues by 35 per cent during 2004-05 to US $ 17.3 billion, reflecting the increasing returns to knowledge advantage. The financial services sector including banks, insurance companies and securities firms account for the largest share of India's software and IT services exports at 37 per cent during 2003-04, followed by the telecommunication and the manufacturing sectors. The Information Technology Enabled Services-Business Process Outsourcing (ITES-BPO) segment generated a revenue of US $ 3.9 billion in 2003-04 and is expected to grow by 44.4 per cent during 2004-05 on top of 45.3 per cent in 2003-04. Alongside the rapid expansion of the IT-ITES sector's contribution to GDP from 1.4 per cent at the end of the 1990s to 3.5 per cent in 2003-04, employment in the sector surged from 5,22,250 in 2001-02 to 8,41,500 in 2003-04. Besides capitalising on labour cost, arbitraging on time zone and language, Indian IT companies are increasingly positioning themselves to seek larger shares in the global IT services market, currently estimated at US $ 396 billion. The increasing consolidation through mergers and acquisitions, expansion of services that are being offered from India, higher value end-services, cost competitiveness and expansion in capacity underscore the strengthening of the Indian ITES-market. Even in the ITES-BPO segment, cross-selling, strong balance sheets, end-to-end service offerings are setting the tone of competitive expansion. Indian IT companies have been moving-up in the value chain into IT consulting and system integration, hardware support and installation and processing services besides emerging areas such as healthcare, telecommunication, retail and government services.

Agricultural Situation

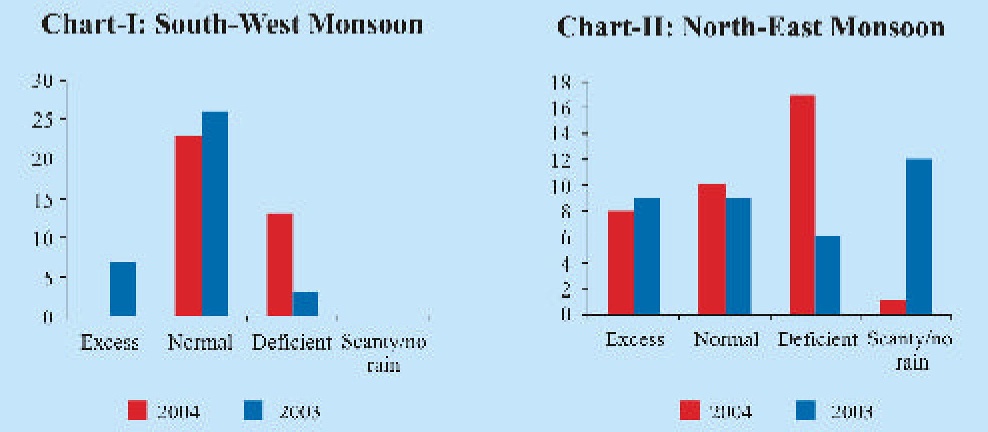
Adverse moisture conditions affected agricultural activity in 2004-05, eroding the gains of the strong rebound in growth that had occurred in 2003-04. The cumulative area weighted rainfall during the South-West monsoon (June 1 to September 30, 2004) was 13 per cent below the Long Period Average (LPA) as compared with two per cent above the LPA during the previous year. The rainfall was also unevenly distributed with 23 out of 36 meteorological sub-divisions registering excess/normal rainfall and 13 with deficient/scanty rainfall (Chart 2). At the sub-divisional level, Himachal Pradesh, West Uttar Pradesh, Punjab, West Rajasthan, Vidharbha and Telangana experienced moderate drought conditions. North-West India was the worst affected with a seasonal rainfall deficiency of 22 per cent, followed by the South Peninsula (15 per cent), Central India (11 per cent) and North-East India (6 per cent). Of the 524 meteorological districts, 25 per cent districts experienced a moderate drought, while seven per cent underwent severe drought conditions (seasonal rainfall deficiency exceeding 50 per cent) at the end of the season. The unsatisfactory spread of the South-West monsoon, particularly in the main sowing month of July, resulted in decline in sown area of major crops and a shift to short-duration low yielding varieties.

The North-East monsoon season (October 1 to December 31, 2004) was satisfactory up to November 24, 2004 but deteriorated thereafter. The cumulative area weighted rainfall during the season was 11 per cent below normal as compared with nine per cent above normal during the previous year.

The total live water storage in the 73 major reservoirs monitored by the Central Water Commission was 23 per cent of the Full Reservoir Level (FRL) on April 8, 2005, *viz.*, 112 per cent of the preceding year's level and 89 per cent of the decennial average.

According to the Third Advance Estimates released by the Ministry of Agriculture, *kharif* foodgrains production in 2004-05 is estimated to be around 104 million tonnes - a shortfall of 11 per cent over the preceding year. The decline was mainly in the production of coarse cereals. *Kharif* oilseeds also recorded a shortfall of over 12 per cent. The satisfactory beginning of the North-East monsoon coupled with a comfortable water reservoir position augured well for *rabi* sowing. *Rabi* foodgrains production - placed at over 106 million tonnes - is expected to exceed the previous year's level (97 million tonnes) and recoup some of the loss of *kharif* output. *Rabi* oilseeds are also expected to register a sizeable increase (23 per cent).

Chart 2: Season-wise Cumulative Rainfall



The Third Advance Estimates placed the total foodgrains production during 2004-05 at over 210 million tonnes, down from over 213 million tonnes in the preceding year. The production of coarse cereals (-10 per cent) and rice (-1 per cent) is expected to have suffered a decline. Wheat and pulses output is, however, expected to have exceeded the previous year's level. Among non-foodgrains, the production of cotton is expected to have recorded a significant growth (16 per cent), while the output of sugarcane and oilseeds is estimated to have declined marginally (Table 2).

The total stocks of foodgrains with the Food Corporation of India and other Government agencies declined from a peak level of 41.3 million tonnes as

Table 2 : Agricultural Production – Crop-wise and Season-wise

Crop	2003-04			2004-05		
	Target (million tonnes)	Achievement (million tonnes)	Area Coverage (% of normal area)	Target (million tonnes)	Achievement $ (million tonnes)	Area Coverage (% of normal area)@
1	2	3	4	5	6	7
Rice	93.0	88.3	91	93.5	87.1	87.0
Wheat	78	72.1	101	79.5	74.1	101
Coarse Cereals	34	38.1	104	36.8	34.3	94
Pulses	15.0	14.9	130	15.3	15.0	122
Foodgrains						
Kharif	111.7	116.9		113.8	104.1	
Rabi	108.3	96.6		111.3	106.4	
Total	**220.0**	**213.5**	**103**	**225.1**	**210.4**	98
Oilseeds						
Kharif	14.7	17.0	99	16.3	14.7	115
Rabi	10.0	8.1	121	9.9	10.5	132
Total	**24.7**	**25.3**	**107**	**26.2**	**25.2**	121
Sugarcane	320.0	237.3	106	270.0	234.7	90
Cotton #	15.0	13.9	83	15.0	16.1	97
Jute and Mesta ##	11.2	11.2	98*	11.8	10.0	85*

$: Third Advance Estimates. ## : Million bales of 180 kgs each. * : Pertains to Jute only.
@ : Area coverage for kharif is as on October 25, 2004, while that for rabi is as on March 28, 2005.

on May 1, 2003 to 21.6 million tonnes (14.2 million tonnes of rice and 7.3 million tonnes of wheat) as on February 1, 2005. The foodgrain stocks, however, remained well above the buffer stock norms (Table 3).

Table 3 : Management of Foodstocks

(Million Tonnes)

Month	Opening Stock of Foodgrains	Foodgrains Procurement	Off-take				Closing Stock	Norms*
			TPDS	OWS	OMS - Domestic	Exports		
1	2	3	4	5	6	7	8	9
2003								
April	32.8	13.1	1.6	0.9	0.2	0.8	41.3	15.8
May	41.3	3.7	2.0	1.6	0.1	0.9	39.8	
June	39.8	0.9	1.5	2.5	0.2	1.3	35.2	
July	35.2	0.2	2.3	1.4	0.1	2.2	30.5	24.3
August	30.5	0.2	1.9	0.8	0.1	0.9	27.9	
September	27.9	0.2	2.2	1.0	0.1	0.9	23.7	
October	23.7	6.4	1.8	0.7	0.1	0.9	22.1	18.1
November	22.1	2.4	2.1	0.7	0.1	0.6	25.4	
December	25.4	2.1	1.9	0.7	0.2	0.5	25.0	
2004								
January	25.0	3.5	2.4	0.9	0.2	0.4	24.0	16.8
February	24.0	2.2	1.9	1.1	0.1	0.5	22.8	
March	22.8	2.1	2.5	1.2	0.1	0.4	20.6	
April	20.6	15.7	2.0	0.5	0.0	0.3	32.4	15.8
May	32.4	3.1	2.3	0.6	0.0	0.1	32.3	
June	32.3	1.3	2.3	1.0	0.0	0.1	30.6	
July	30.6	0.5	2.4	1.0	0.0	0.1	27.2	24.3
August	27.2	0.2	2.4	1.0	0.0	0.1	23.0	
September	23.0	0.2	2.5	1.0	0.0	0.1	20.3	
October	20.3	6.5	2.4	0.8	0.0	0.0	23.7	18.1
November	23.7	2.7	2.4	0.6	0.0	0.0	21.8	
December	21.8	2.6	2.6	0.7	0.0	0.0	21.7	
2005								
January	21.7	3.9	2.3	0.8	0.0	0.0	21.6	16.8
February	21.6	2.3	N.A	N.A	N.A	N.A	N.A	
March	N.A	1.7	N.A	N.A	N.A	N.A	N.A	

TPDS: Targeted Public Distribution System. OWS : Other Welfare Schemes. OMS : Open Market Sales.
N.A. : Not Available.
* : Minimum stocks to be maintained as on April 1, July 1, October 1 and January 1.
Note : 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, GOI.

The procurement of foodgrains (rice and wheat) during 2004-05 was higher by 11 per cent in relation to the previous year. The offtake of foodgrains during 2004-05 (April to January) was higher under the Targeted Public Distribution System (TPDS) by over 20 per cent, reflecting the impact of lower agricultural production in some parts of the country due to deficient rainfall. On the other hand, offtake declined under Open Market Sales (OMS) and Other Welfare Schemes (OWS) due to the comfortable supply position. Exports of foodgrains declined due to reduced level of stocks with the Food Corporation of India and other agencies.

Industrial Performance

The industrial recovery that has set in during the second half of 2003-04 firmed up further in 2004-05, driven mainly by the manufacturing sector. As in 2003-04, surging exports provided a stimulus to manufacturing activity, benefiting from the environment of accelerating industrial activity in other parts of the world. The noteworthy feature of the industrial performance of 2004-05 was the significant improvement in domestic demand that provided a boost to a number of manufacturing industries.

According to the CSO's advance estimates, the upturn in the growth of value-added originating in industry, which occurred in the fourth quarter of 2003-04, was sustained through the third quarter of 2004-05. This was strongly correlated with the index of industrial production (IIP) which rose sharply between May and October 2004 before losing some momentum thereafter (Chart 3). The CSO placed the growth of real GDP originating in manufacturing at 8.9 per cent for 2004-05 as against 6.9 per cent in the preceding year.

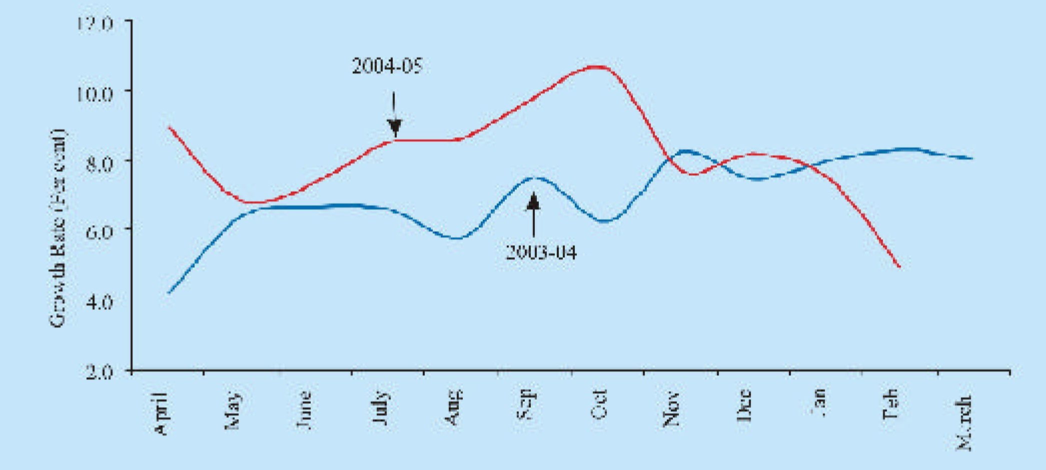
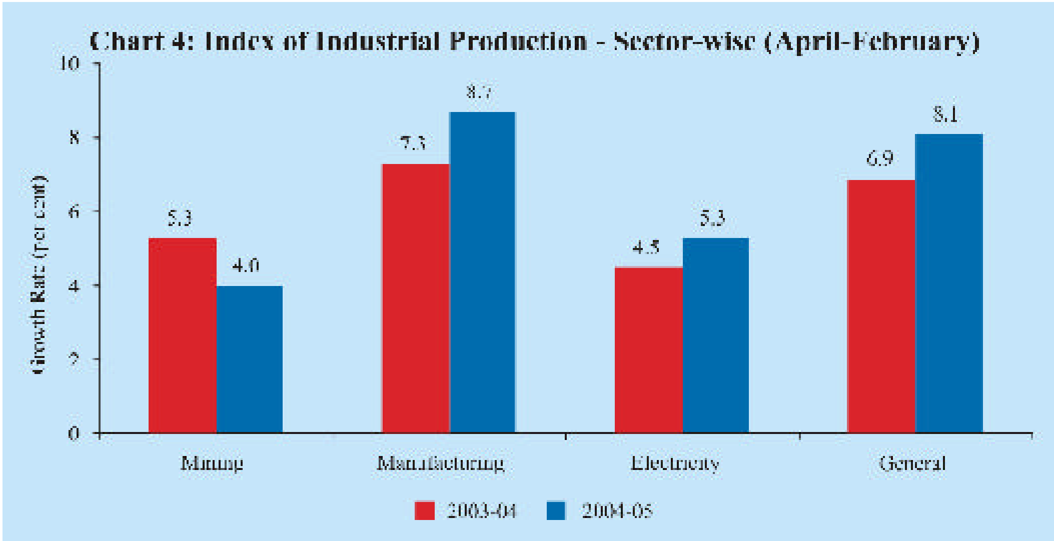
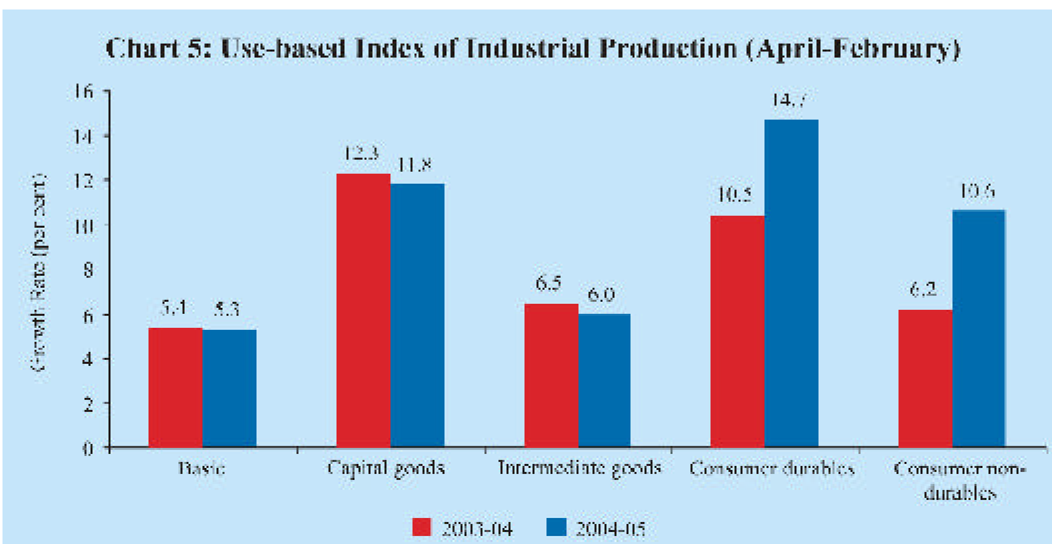


Chart 3: Index of Industrial Production

All the components of industry except mining and quarrying shared in the acceleration of activity during the year (Chart 4). The manufacturing sector recorded the highest growth with a contribution of 89.8 per cent to the overall growth of the industrial sector. Electricity generation recorded a faster expansion due to the higher plant load factor achieved by thermal power plants and improved hydro-generation on the back of comfortable reservoir levels. Output in the mining sector declined marginally despite improved coal mining activities due to higher demand and dispatches.



In terms of the use-based classification, the capital goods sector registered a double-digit growth for the third year in succession, reflecting the all-round buoyancy in industrial activity. Coincident as it was with the sustained expansion in imports of capital goods, it is indicative of the ongoing capacity addition in the industrial sector. The consumer goods sector registered a double-digit growth in 2004-05 on the back of strong growth in both consumer durable and non-durable segments (Chart 5).



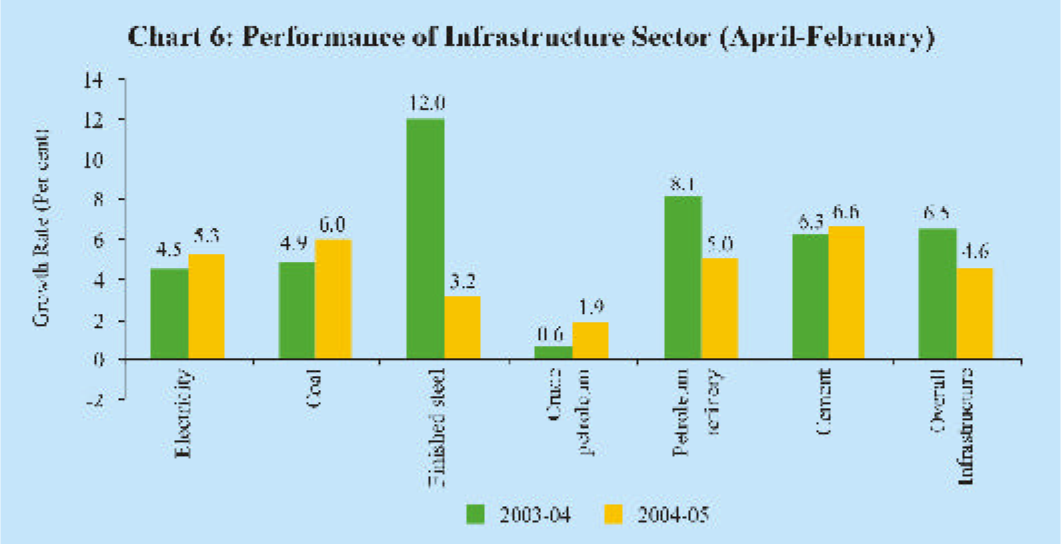
Within the 17 major groups of the manufacturing sector, four groups, *viz.*, 'machinery and equipment other than transport equipment', 'other manufacturing industries', 'textile products (including wearing apparel)' and 'chemical and chemical products except products of petroleum coal' - constituting 28.7 per cent of the IIP - registered growth in the range of 15-20 per cent (up to February). The high growth in 'machinery and equipment other than transport equipment' was reflective of the expansion of capacity and the improved industrial investment. The surge in the growth of 'basic chemicals and chemical products' drew strength from the overall improved demand from other industries. These two industry groups together contributed 64.1 per cent of the growth in the manufacturing sector. Ten industry groups achieved positive growth but less than the growth of the manufacturing sector. On the other hand, two industry groups recorded decline in output, *viz.*, 'food products' and 'wood and wood products, furniture and fixtures' (Table 4).

Table 4 : Manufacturing Industry Groups – Growth Rates in 2004-05 (April-February)

Negative	0-5 per cent	5-10 per cent	Above 10 per cent
1	2	3	4
1. Food products (-0.6)	1. Rubber, plastic, petroleum and coal products (1.5)	1. Cotton textiles (7.3)	1. Machinery and equipment other than transport equipment (19.6)
2. Wood and wood products, furniture & fixtures (-8.5)	2. Jute and other vegetable fibre textiles (3.3)	2. Metal products and parts (6.6)	2. Other Manufacturing industries (17.3)
	3. Transport equipment and parts (3.5)	3. Paper & paper products and printing, publishing & allied industries (8.5)	3. Basic chemicals and chemical products (15.3)
	4. Wool, silk and man-made fibre textiles (2.9)	4. Leather and leather & fur products (5.2)	4. Textile products (16.5)
	5. Basic metal and alloy industries (4.9)		5. Beverages, tobacco and related products (10.03)
	6. Non-metallic Mineral products (1.2)		

Note: Figures in brackets indicate growth rates.

In contrast to the acceleration in manufacturing activity, the output of the infrastructure sector slowed down mainly on account of the subdued performance of finished steel and petroleum refinery products industries (Chart 6).



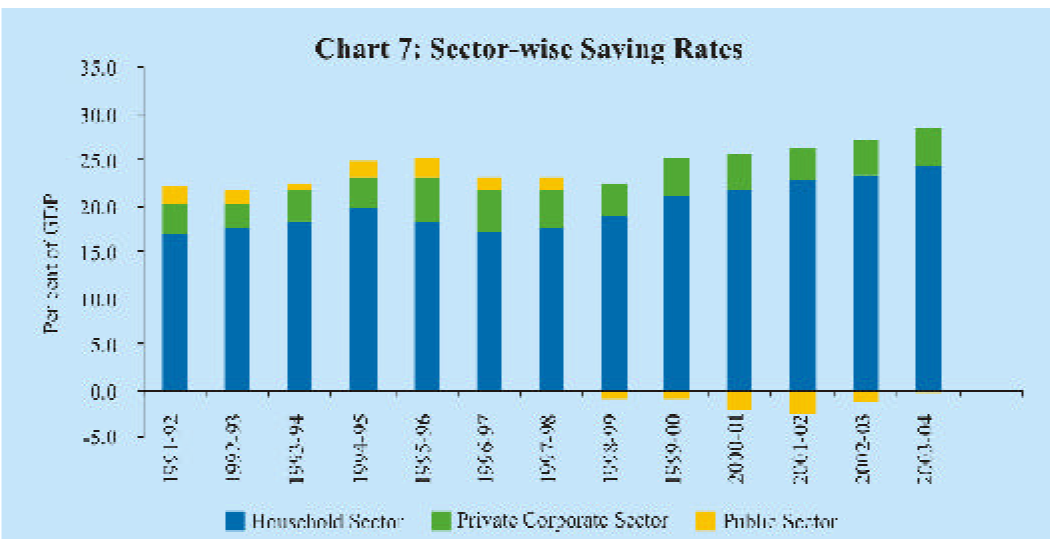
In the coal sector, improved mining activity was driven mainly by higher demand as reflected in the spurt in coal dispatches. The cement sector benefited from increased construction activity in housing and infrastructure segments and increased exports. Crude petroleum output recovered from a decline in the early part of the year to register a growth of 1.9 per cent during 2004-05 (April-February) due to increased capacity utilisation. Petroleum refinery products recorded a lower growth mainly on account of slippage in production at some of the public sector refineries. In the finished steel sector, output slowed down sharply due to rising costs and supply constraints on inputs such as iron ore, scrap iron and coking coal, coupled with a surge in imports in the wake of the lowering of customs duties.

Increased production and imports of capital goods, the surge in banks' non-food credit, the significant increase in sales and profits in the financial performance of the corporate sector together reflect an improvement in the industrial climate. The sharp rise in the incremental flow of funds to industry during 2004-05 reflected the extensive use of bank financing by medium and large industries. External commercial borrowings, including short-term trade credit, increased sharply in 2004-05. Similarly, the resources raised by companies from the primary market were also considerable during the year.

Surveys of business confidence indicate that this upbeat sentiment is shared by corporate India. The Business Confidence Index (BCI) of the National Council of Applied Economic Research (NCAER) showed an improvement for January 2005 to 142.5 from 136.0 reported in the previous round of the survey in October 2004. According to the Reserve Bank's Industrial Outlook Survey, the Business Expectations Index for January-March 2005 stood at 122.5 points, registering a rise of 0.4 per cent over the previous quarter. The Confederation of Indian Industry's Business Outlook Survey for October 2004-March 2005 points to improved capacity utilisation and higher capital investment. The Dun & Bradstreet's Business Optimism Index for the fourth quarter of 2004-05 recorded an increase of 28.4 per cent over the previous quarter. The positive outlook for the industrial sector is an indication of expanding activity and confidence and augurs well for sustaining the recent acceleration of industrial growth.

Saving and Investment

The CSO's quick estimates for 2003-04 indicate that the rate of Gross Domestic Saving (GDS) increased significantly to 28.1 per cent of GDP at current market prices from 26.1 per cent in 2002-03. The household sector continued to be the major contributor with its rate of saving climbing steadily since 1996-97. Improvement in the financial performance of joint stock companies, co-operative banks and societies enabled the rate of private corporate sector saving to be marginally higher in 2003-04 than in the previous year. The rate of public sector dissaving has declined considerably since 2002-03, benefiting from better performance in government administration, departmental and non-departmental enterprises (Chart 7).



The rate of Gross Domestic Capital Formation (GDCF), which picked up in 2002-03, was placed even higher at 26.3 per cent in 2003-04 due to increase in capital formation in the private corporate sector and the public sector. The rate of capital formation of the household sector remained unchanged. Total final consumption expenditure showed a marginal deceleration in 2003-04 as compared with 2002-03 due to both government and private final consumption expenditures (Table 5).

Table 5 : Gross Domestic Saving and Investment

Item	Per cent of GDP				Amount in Rupees crore			
	2000-01	2001-02	2002-03@	2003-04*	2000-01	2001-02	2002-03@	2003-04*
1	2	3	4	5	6	7	8	9
1. Household Sector Saving	21.6	22.6	23.3	24.3	452268	513110	574681	671692
a) Financial Assets	10.4	11.2	10.3	11.4	216774	253964	254439	314261
b) Physical Assets	11.3	11.4	13.0	13.0	235494	259146	320242	357431
2. Private Corporate Sector Saving	4.1	3.6	3.8	4.1	86142	81076	94269	114157
3. Public Sector Saving	-2.3	-2.7	-1.1	-0.3	-48361	-61912	-26652	-9429
4. Gross Domestic Saving (GDS)	23.5	23.4	26.1	28.1	490049	532274	642298	776420
5. Net Capital Inflow(+)/Outflow(-)	0.4	-0.8	-1.3	-1.8	8130	-18731	-32010	-49552
6. Gross Domestic Capital Formation (GDCF)	23.8	22.6	24.8	26.3	498179	513543	610288	726868
7. Total Consumption Expenditure	77.7	76.0	76.2	75.3	1624255	1772054	1876679	2077958
a) Private Final Consumption Expenditure	65.1	65.5	64.3	64.0	1360018	1488781	1585132	1765849
b) Government Final Consumption Expenditure	12.6	10.5	11.8	11.3	264237	283273	291547	312109
Memo Items								
Saving-Investment Balance (4-6)	-0.4	0.8	1.3	1.8	-8130	18731	32010	49552
Public Sector Balance#	-8.6	-8.9	-6.4	-5.9	-179866	-202007	-158618	-163515
Private Sector Balance#	9.4	10.1	9.9	11.0	197207	230269	242958	304241
a) Private Corporate Sector	-0.9	-1.0	-0.5	-0.4	-19567	-23695	-11481	-10020
b) Household Sector	10.4	11.2	10.3	11.4	216774	253964	254439	314261

@ : Provisional Estimates. * : Quick Estimates. #: Investment figures are not adjusted for errors and omissions.
Source : Central Statistical Organisation.

The rate of GDCF has remained below the rate of GDS since 2001-02, reflecting the current account surpluses in the balance of payments. The overall saving-investment surplus increased to 1.8 per cent in 2003-04 from 1.3 per cent in 2002-03. While the private sector saving-investment surplus increased in 2003-04 in keeping with the uptrend that occurred in 1997-98, the public sector's saving-investment deficit narrowed further, extending the onset of fiscal adjustment since 2001-02.

II. FISCAL SITUATION

Centre's Fiscal Position

With the introduction of the Fiscal Responsibility and Budget Management (FRBM) Rules 2004, the year 2004-05 marked a new beginning in the Centre's fiscal consolidation process. The revenue deficit was budgeted at 2.5 per cent of GDP for 2004-05 as against 3.6 per cent of GDP in the revised estimates (RE) for 2003-04. The RE placed the revenue deficit for 2004-05 at 2.7 per cent of GDP. As against the stipulation of a yearly reduction of 0.5 percentage points in the revenue deficit to GDP ratio in the FRBM Rules, the actual reduction for 2004-05 turned out to be higher at 0.9 percentage points. The required reduction of 0.3 percentage points in the GFD to GDP ratio for 2004-05 under the FRBM Rules was also achieved [The GFD to GDP ratio for 2004-05 was 4.5 per cent in the RE as against 4.8 per cent in 2003-04 (RE)]. Notwithstanding these corrections, the revised estimates for 2004-05 exceeded the budgeted targets in respect of all the key deficit indicators (Table 6). The slippage in the revenue deficit was mainly on account of a shortfall of Rs. 8,102 crore in net tax revenue. The slippage in fiscal deficit, *albeit* of a lower order was on account of reduction in non-defence capital outlay by Rs.4,103 crore and lower net lending (loans and advances net of recovery of loans) to the extent of Rs.2,976 crore.

Table 6 : Deficit Indicators of the Centre

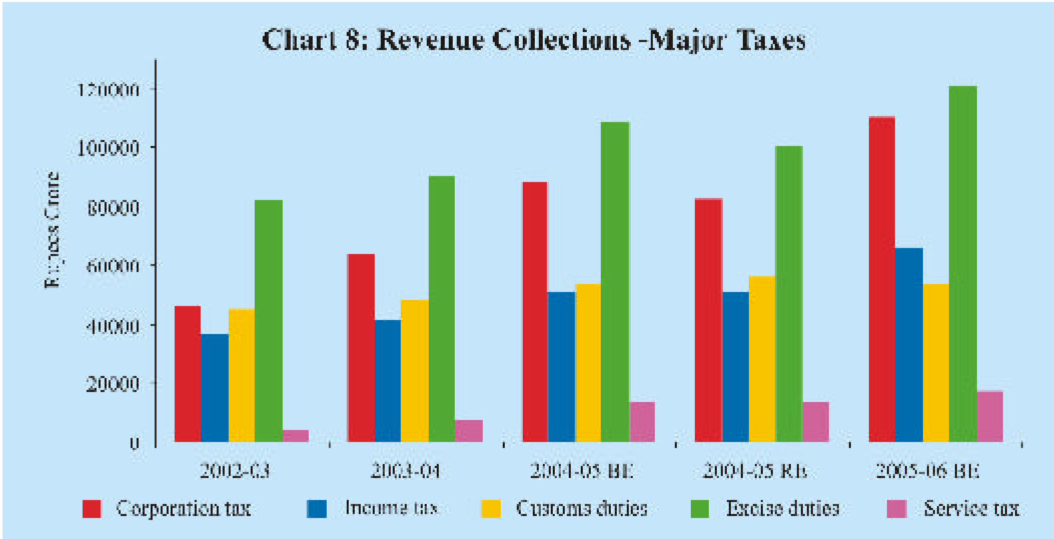
(Amount in Rs. crore)

Item	2003-04	2004-05 (BE)	2004-05 (RE)	Variation (4 over 3)	
				Amount	Per cent
1	2	3	4	5	6
1. Gross Fiscal Deficit	1,23,272 (4.5)	1,37,407 (4.4)	1,39,231 (4.5)	1,824	1.3
2. Revenue Deficit	98,262 (3.6)	76,171 (2.5)	85,165 (2.7)	8,994	11.8
3. Gross Primary Deficit	-816 (0.0)	7,907 (0.3)	13,326 (0.4)	5,419	68.5

BE: Budget Estimates. RE: Revised Estimates.

Note : Figures in parentheses are percentages to GDP.

Revenue receipts of the Centre were lower by 2.7 per cent than their budgeted level for 2004-05 due to decline in both tax and non-tax revenues. The gross tax revenue was 3.7 per cent lower than the budget estimates (BE) mainly on account of lower corporation tax collections and union excise duties (Chart 8). The lower collections from excise duties reflected the post-budget reduction of duties in respect of certain petroleum products and non-alloy steel to contain inflationary pressures.



The shortfall in non-tax revenue was mainly due to lower interest receipts and external grants. Dividends and profits exceeded BE. Non-debt capital receipts (comprising disinvestment and recovery of loans) were significantly higher at 32.0 per cent of the total capital receipts than the budgeted 18.5 per cent (Table 7). This was largely on account of receipts under the Debt Swap Scheme (DSS) which enabled the States to swap their high cost debt owed to the Central Government with additional market borrowings and a part of current small savings transfers. Non-debt capital receipts, after netting the receipts under debt swap, however, constituted 12.0 per cent of the total capital receipts.

Table 7 : Total Receipts of the Centre

(Amount in Rs. crore)

Item	2003-04	2004-05 (BE)	2004-05 (RE)	Variation (4 over 3)	
				Amount	Per cent
1	2	3	4	5	6
1. Total Receipts (2+3)	4,71,368 (17.1)	4,77,829 (15.3)	5,05,791 (16.3)	27,962	5.9
2. Revenue Receipts (i+ii)	2,63,878 (9.6)	3,09,322 (9.9)	3,00,904 (9.7)	-8,418	-2.7
i. Tax Revenue	1,86,982 (6.8)	2,33,906 (7.5)	2,25,804 (7.3)	-8,102	-3.5
ii. Non-tax Revenue	76,896 (2.8)	75,416 (2.4)	75,100 (2.4)	-316	-0.4
3. Capital Receipts	207,490 (7.5)	168,507 (5.4)	204,887 (6.6)	36,380	21.6
of which:					
Market Borrowings	88,869	90,365	45,943	-44,422	-49.2
Recovery of Loans	67,265	27,100	61,565	34,465	127.2
Disinvestment proceeds	16,953	4,000	4,091	91	2.3

BE: Budget Estimates. RE: Revised Estimates.
Note : Figures in parentheses are percentages to GDP.

Aggregate expenditure was higher than the budgeted level by 5.9 per cent for 2004-05, mainly on account of debt swap transactions. Aggregate expenditure net of debt swap transactions, was, however, lower than the budget estimates by one per cent (Table 8). The expenditure was compressed entirely in respect of the Plan component in the form of a reduction of Rs.2,170 crore in the revenue account and Rs.6,033 crore in the capital account.

Table 8 : Aggregate Expenditure of the Centre

(Amount in Rs. crore)

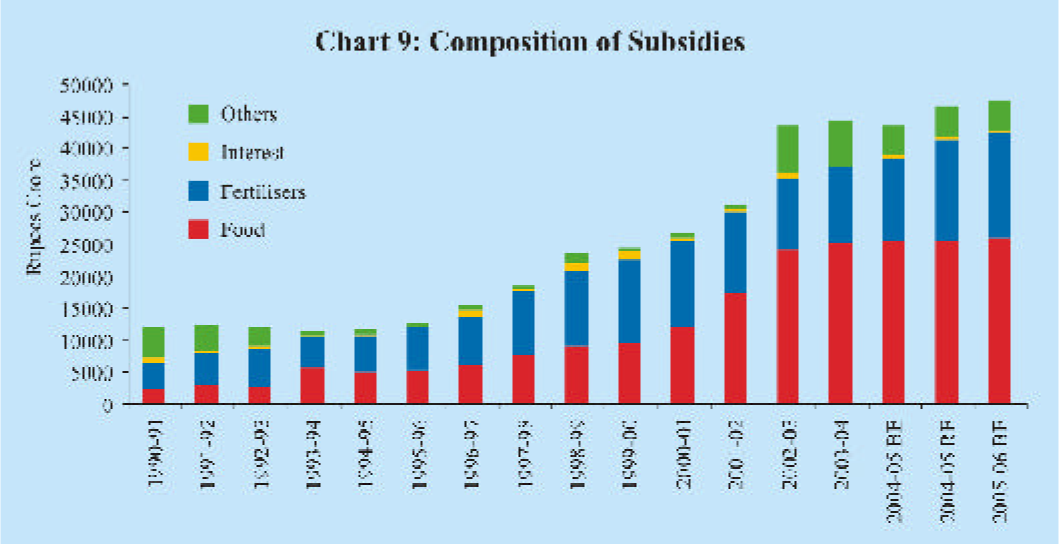
Item	2003-04	2004-05 (BE)	2004-05 (RE)	Variation (4 over 3)	
				Amount	Per cent
1	2	3	4	5	6
1. Total Expenditure (2+3=4+5)	4,25,157* (15.4)	4,77,829 (15.3)	4,73,126* (15.2)	-4,703	-1.0
2. Non-Plan Expenditure	3,02,877* (11.0)	3,32,239 (10.6)	3,35,739* (10.8)	3,500	1.1
of which:					
Interest Payments	1,24,088 (4.5)	1,29,500 (4.1)	1,25,905 (4.1)	-3,595	-2.8
Defence	60,066 (2.2)	77,000 (2.5)	77,000 (2.5)	0	0.0
Subsidies	44,256 (1.6)	43,516 (1.4)	46,514 (1.5)	2,998	6.9
3. Plan Expenditure	1,22,280 (4.4)	1,45,590 (4.7)	1,37,387 (4.4)	-8,203	-5.6
4. Revenue Expenditure	3,62,140 (13.1)	3,85,493 (12.3)	3,86,069 (12.4)	576	0.1
5. Capital Expenditure	63,017* (2.3)	92,336 (3.0)	87,057* (2.8)	-5,279	-5.7

*: Net of the repayments made to the NSSF.

BE: Budget Estimates. RE: Revised Estimates.

Note : Figures in parentheses are percentages to GDP.

Non-Plan revenue expenditure was marginally higher than the BE, mainly on account of higher fertiliser subsidies due to increase in their input cost (Chart 9). Interest payments were, however, lower mainly due to less than anticipated



recourse to market borrowings and substitution of high cost loans with low cost loans.

A notable feature of the Central Government finances during 2004-05 was the persistence of surplus cash balances held by the Government with the Reserve Bank. While this reflected, to a large extent, debt swap proceeds and advance tax payments, particularly in the third quarter of the year, it also represented compression in expenditure. Owing to the availability of surplus cash balances, the Central Government cancelled its auctions for market borrowings of the order of Rs.18,000 crore during October-December 2004. The Central Government had also ended the preceding financial years 2003-04 and 2002-03 with surplus cash positions.

Financing of the Union Budget

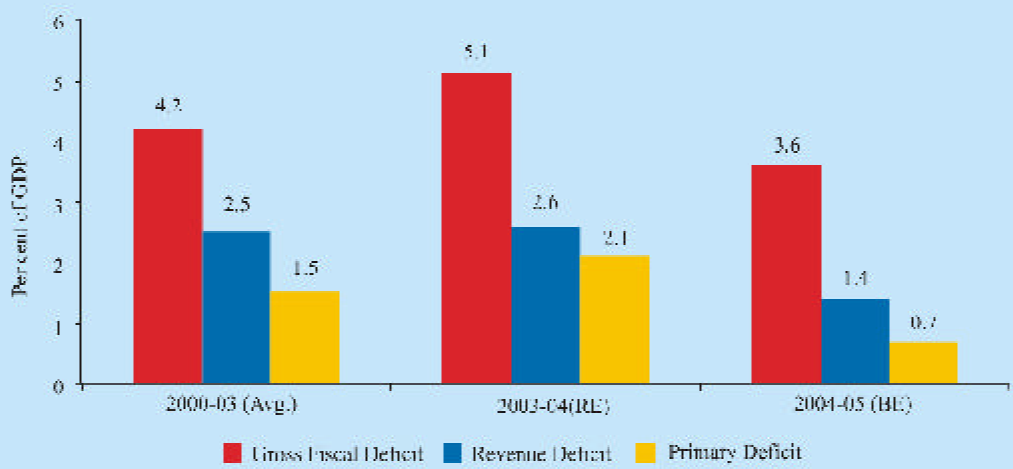
Gross market borrowings of the Centre for 2004-05 were budgeted at Rs.1,50,817 crore and the net market borrowings at Rs.90,365 crore. The RE placed the net market borrowings at Rs.45,943 crore which were 49.2 per cent lower than the budget estimates. Although the DSS transactions are deficit neutral, they resulted in a compositional shift in the financing pattern of GFD. Market borrowings financed 33.0 per cent of GFD as compared with the budgeted level of 65.8 per cent, while the securities issued against small savings - which represent reinvestment by National Small Savings Fund (NSSF) out of the proceeds received on redemption of Special Central Government securities - financed around 24 per cent of the gross fiscal deficit as compared with one per cent in the BE.

The agreed limits on the Centre's Ways and Means Advances (WMA) from the Reserve Bank for the first and second halves of 2004-05 continued to be at Rs.10,000 crore (April-September) and Rs.6,000 crore (October-March), respectively. As alluded to earlier, the Central Government maintained surplus cash balances with the Reserve Bank for the greater part of 2004-05. As a result, the Centre abjured from WMA from September 10, 2004.

State Finances

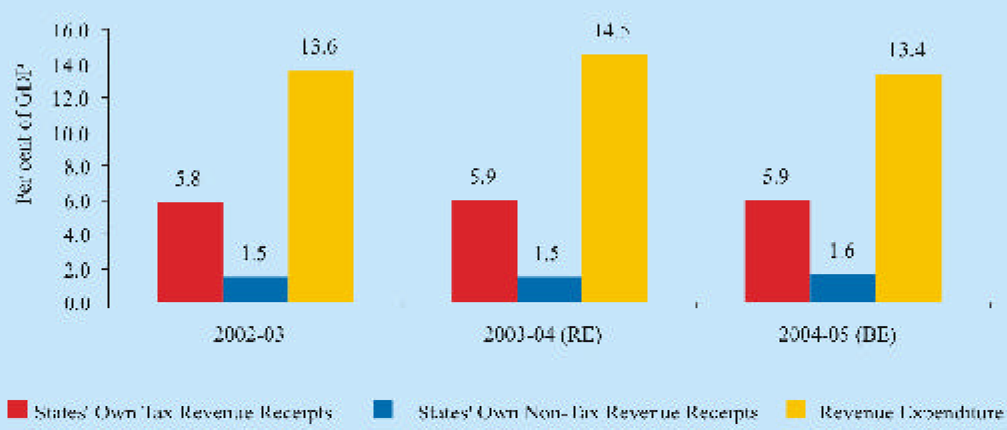
The finances of the State governments are expected to improve during 2004-05 with all the major deficit indicators budgeted to decline in 2004-05 from their respective levels in the revised estimates of the previous year (Chart 10).

Chart 10: Major Deficit Indicators of State Governments



The envisaged fiscal correction in 2004-05 is expected to be brought about mainly through improvement in non-tax revenue and a reduction in revenue expenditure. The States' own tax revenue is, however, estimated to have remained around the previous year's level (Chart 11).

Chart 11: States' Own Revenue Receipts and Expenditure



The decomposition of the States’ GFD indicates that although the share of the revenue deficit would decline substantially in 2004-05, it would still be higher than the average for the first half of the 1990s. Small savings [securities issued to the National Small Savings Fund (NSSF)] would continue to be the main source of financing the GFD, followed by market borrowings (Table 9).

Table 9: Decomposition and Financing of States' Gross Fiscal Deficit

(Per cent)

Item	1990-95 (Avg.)	1995-2000 (Avg.)	2000-02 (Avg.)	2002-03	2003-04 (RE)	2004-05 (BE)
1	2	3	4	5	6	7
Decomposition (1+2+3)	**100**	**100**	**100**	**100**	**100**	**100**
1. Revenue Deficit	24.7	44.7	60.7	54.0	51.1	39.1
2. Capital Outlay	55.3	43.2	34.2	35.8	43.6	54.2
3. Net Lending	20.0	12.1	5.1	10.2	5.3	6.7
Financing (1+2+3+4+5)	**100**	**100**	**100**	**100**	**100**	**100**
1. Small Savings	–	5.8	36.8	51.2	43.4	57.0
2. Market Borrowings	16.0	16.1	16.0	27.9	32.0	24.6
3. State Provident Fund	14.3	13.4	10.2	7.0	6.8	9.3
4. Loans from Centre	49.0	40.6	13.5	-0.9	-15.2	-7.4
5. Others*	20.7	24.0	23.6	14.8	33.0	16.5

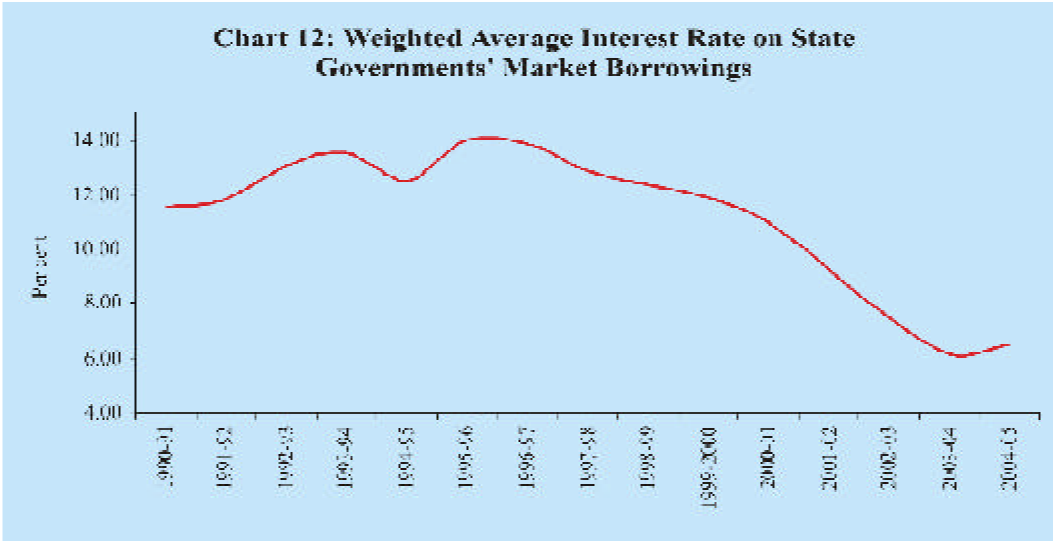
Avg. : Average.

* : Including reserve funds, deposits, loans from banks and other institutions.

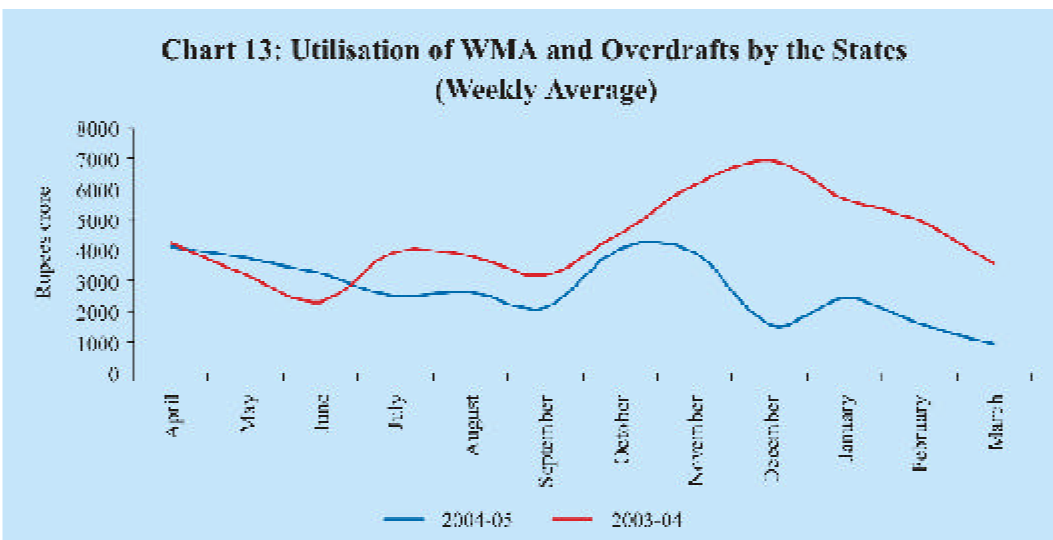
The budget estimates for 2004-05 reveal an endeavour of the State Governments to carry forward fiscal reforms. A number of States have underscored the need to increase the magnitude and efficiency of tax revenue mobilisation. The general approach is to rationalise and simplify the tax structure, broaden the tax base and have moderate rates of taxation. Most of the State Governments have reiterated the need to contain unproductive expenditures and reorient spending towards developmental purposes. Several State Governments have already enacted Fiscal Responsibility legislation (FRL) and formulated medium-term fiscal plans to bring about an orderly correction of their financial positions. Some of the remaining State Governments have also proposed to enact FRL. A number of State Governments have taken initiatives towards empowering the local bodies based on the recommendations of the respective State Finance Commissions. The recent implementation of the Value Added Tax (VAT) by a number of States, with effect from April 1, 2005, is an important milestone in the area of tax reforms.

Financing of the State Budgets

The net market borrowings allocated to the States for 2004-05 amounted to Rs.36,935 crore, including additional allocation of Rs.18,805 crore under the Debt Swap Scheme (DSS). Taking into account repayments of Rs.5,123 crore, the gross allocation amounted to Rs.42,058 crore. The gross market borrowings raised during 2004-05 by the State Governments amounted to Rs.39,101 crore (Rs.38,216 crore through tap sale and Rs.885 crore through auctions) including allocation under the DSS. An amount of Rs.16,943 crore was raised under the DSS. Interest rates on States' market borrowings were in the range of 5.60-7.36 per cent as compared with 5.78-6.40 per cent in 2003-04. The weighted average interest rate on market loans, which declined between the mid-1990s and 2003-04,



firmed up somewhat during 2004-05 (Chart 12). Weaknesses in the finances of some State Governments were manifested in the widening of spreads and under-subscription in respect of their market loans. The spread between the rate of interest on State market loans and Central market loans of ten-year maturity in the secondary market widened from 25 basis points in 2000-01 to 50 basis points in the recent period.



The State Governments' recourse to WMA and overdrafts was lower during 2004-05 than in the previous year (Chart 13).

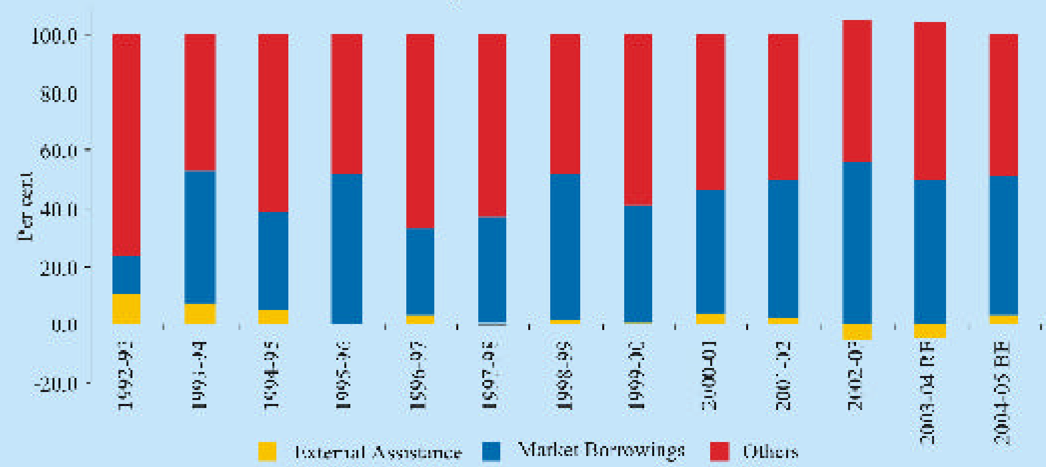
Combined Government Finances

The combined gross fiscal deficit of the Centre and the States for 2004-05 was budgeted at 7.9 per cent of GDP, lower than 9.4 per cent in the RE for 2003-04. Commensurate reductions were also budgeted for the gross primary deficit and the revenue deficit which were placed at 1.8 per cent and 3.8 per cent of GDP, respectively, as compared with RE of 2.9 per cent and 6.2 per cent, respectively, in 2003-04. Reduction in the various deficit indicators was envisaged to be achieved through higher revenue mobilisation and moderation in the growth of expenditure.

Financing Patterns

The combined fiscal deficit of the Centre and the States during 2004-05 is budgeted to be financed primarily from domestic sources. The share of 'other liabilities' (small savings, provident funds and deposits) in financing declined from 54.3 per cent in 2003-04 to 48.8 per cent in 2004-05. The share of financing through market borrowings also declined from 50.1 per cent to 47.9 per cent over the same period. External sources financed 3.3 per cent of the combined fiscal deficit during 2004-05, unlike in the preceding two years when there was a net outflow due to prepayment of external debt (Chart 14).

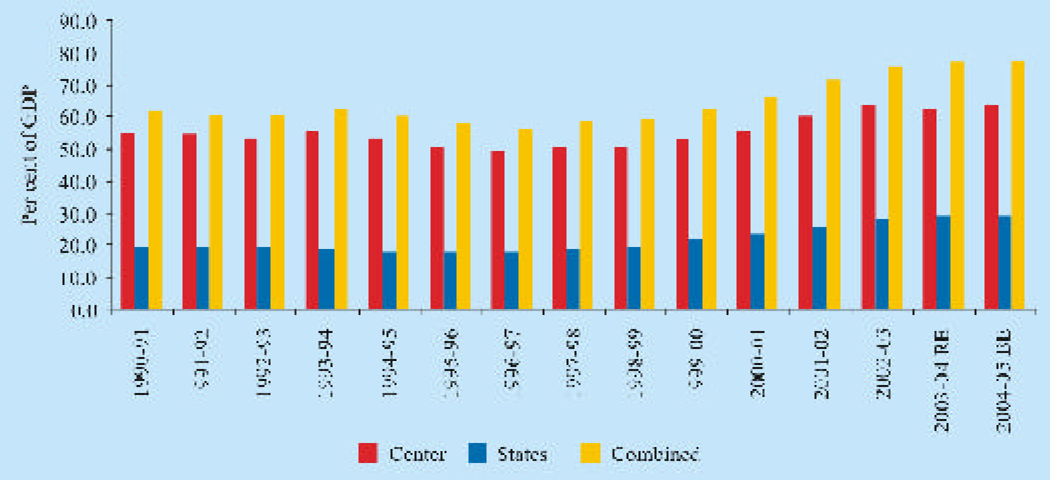
Chart 14: Financing Pattern of the Combined GFD



Public Debt

The combined debt-GDP ratio of the Centre and the States is estimated to have remained broadly stable at 77.6 per cent in 2004-05 as compared with 77.1 per cent in 2003-04 (Chart 15). The weighted average maturity of dated securities of the Central Government issued during the year increased from 7.70 years in 1998-99 to 14.94 years in 2003-04. The maturity profile of dated securities issued during 2004-05 reflected the prevailing liquidity conditions and the sentiment of

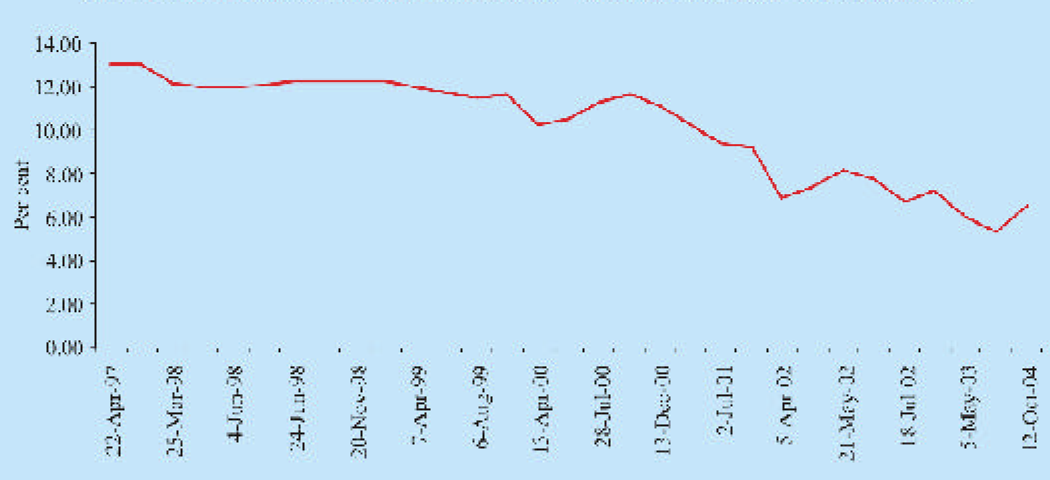
Chart 15: Outstanding Liabilities of the Centre and the States



market participants. Accordingly, the weighted average maturity of the dated securities of the Central Government issued during the current year at 14.13 years was lower than 14.94 years during 2003-04.

Interest rates on market borrowings firmed up somewhat during 2004-05, mainly on account of inflationary expectations. The weighted average yield of the dated securities issued during the year worked out to 6.11 per cent as compared with 5.71 per cent in 2003-04, reflecting the firming up of interest rate conditions. The yield on the benchmark security of 10-year maturity in the primary market hardened to 6.99 per cent as on October 12, 2004 from 5.32 per cent as on February 16, 2004 (Chart 16).

Chart 16: Primary Benchmark Yields - Central Government Securities



The debt-GDP ratio of the States is estimated to have risen by over seven percentage points to 29 per cent over the five-year period ending 2004-05. Interest payments on debt were projected to absorb over 24 per cent of revenue receipts of the States in 2004-05 as compared with over 25 per cent in the previous year. While the share of loans from the Centre in the outstanding liabilities of the State Governments declined over the years, that of loans from NSSF, market loans and negotiated loans from banks and other institutions have increased.

Outlook

The Government has committed itself to pursuing fiscal policies designed to promote savings, to devise ways and means to channel these savings into productive investment and to fund necessary social expenditures through the Union Budget, 2005-06. The central theme that runs through the various schemes and programmes is creation of jobs, strengthening of social infrastructure and providing succour to the weaker sections of society. The Union Budget seeks to carry forward the process of fiscal consolidation in coordination with the States through the mechanism of cooperative fiscal federalism.

The Union Budget has set a 'pause' in the path outlined in the Fiscal Responsibility and Budget Management (FRBM) Act 2003 due to constraints emanating from implementation of the Twelfth Finance Commission's (TWFC) recommendations and the need to compensate the States for any revenue loss due to implementation of VAT. It is also significant to note that the disinvestment receipts have been taken out of the budgetary receipts so as to create a separate fund for the same. Revenue receipts of the Centre are expected to grow by 16.7 per cent and aggregate expenditure by 8.7 per cent (over the expenditure net of NSSF repayments in 2004-05). The revenue deficit is budgeted at 2.7 per cent of GDP - the same as in 2004-05 - while the fiscal deficit is budgeted to decline to 4.3 per cent from 4.5 per cent in the preceding year. The gross primary deficit to GDP ratio is placed at 0.5 per cent, marginally higher than 0.4 per cent in the previous year (Table 10).

Under revenue receipts, tax revenue is projected to increase by 21.1 per cent, the major portion of which is estimated to emanate from corporation tax. Collections from customs duties are budgeted to decline reflecting the rationalisation of these duties. Excise duties and income tax are budgeted to register significant increases during 2005-06. Consequently, the gross tax-GDP ratio of the Central Government is expected to rise to 10.5 per cent in 2005-06, the highest level after 1989-90. Non-tax revenue is budgeted to increase by 3.5 per cent mainly on account of higher receipts from 'dividends and profits'. On the expenditure side, revenue expenditure is budgeted to register a significantly higher increase of 15.7 per cent mainly due to higher grants to the States on account of the TWFC's recommendations and compensation to the States for revenue losses that may occur on implementation of VAT. Higher interest payments reflect the

Table 10 : Union Budget 2005-06 at a Glance

(Amount in Rs. Crore)

Item	2004-05 (RE)	2005-06 (BE)	Variation (per cent) (Col. 3 over Col. 2) (Amount)	(Per cent)
1	2	3	4	5
1. Revenue Receipts (i+ii)	3,00,904 (9.7)	3,51,200 (10.0)	50,296	16.7
i) Tax Revenue	2,25,804 (7.3)	2,73,466 (7.8)	47,662	21.1
ii) Non-tax Revenue	75,100 (2.4)	77,734 (2.2)	2,634	3.5
2. Non-Plan Expenditure	3,68,404 (11.9)	3,70,847 (10.6)	2,443	0.7
of which:				
i) Interest Payments	1,25,905 (4.1)	1,33,945 (3.8)	8,040	6.4
ii) Defence	77,000 (2.5)	83,000 (2.4)	6,000	7.8
iii) Subsidies	46,514 (1.5)	47,432 (1.3)	918	2.0
3. Plan Expenditure	1,37,387 (4.4)	1,43,497 (4.1)	6,110	4.4
4. Revenue Expenditure	3,86,069 (12.4)	4,46,512 (12.7)	60,443	15.7
5. Capital Expenditure	1,19,722 (3.9)	67,832 (1.9)	-51,890	-43.3
6. Revenue Deficit	85,165 (2.7)	95,312 (2.7)	10,147	11.9
7. Gross Fiscal Deficit	1,39,231 (4.5)	1,51,144 (4.3)	11,913	8.6
8. Gross Primary Deficit	13,326 (0.4)	17,199 (0.5)	3,873	29.1

BE: Budget Estimates. RE: Revised Estimates.

Note : Figures in parentheses are proportions to GDP in per cent.

continuing dependence on debt resources and the interest outgo on account of the Market Stabilisation Scheme. Capital expenditure is budgeted to decline by 43.3 per cent in 2005-06, reflecting mainly the absence of NSSF repayments and Plan loans to the States in pursuance of the recommendations of the TWFC. Adjusted for these components, capital expenditure is budgeted to show an increase of 9.2 per cent.

During 2005-06, net market borrowings are budgeted to be higher at Rs.1,03,791 crore as against Rs.45,943 crore in the RE for 2004-05. Inclusive of repayments to the tune of Rs.61,676 crore, the gross market borrowings are placed at Rs.1,65,467 crore. Net market borrowings would finance 68.7 per cent of the GFD in 2005-06 as compared with 33.0 per cent in the revised estimates for 2004-05. The securities issued against small savings would finance 2.0 per cent of the GFD as against 24.4 per cent in 2004-05, reflecting the discontinuance of the DSS and associated NSSF repayments. The fiscal measures initiated in the Union Budget would augment revenue, promote efficient utilisation of expenditure and pave the way for sustained economic development.

III. MONETARY AND LIQUIDITY CONDITIONS

Monetary Trends

Monetary conditions continued to be driven by large capital inflows in 2004-05 as in the previous year. Expansionary effects on base money and money supply were, however, headed off through operations under the Market Stabilisation Scheme (MSS) and the Liquidity Adjustment Facility (LAF). Consequently money supply (M_3) remained well within the projected trajectory of 14.0 per cent. The moderation in monetary expansion *vis-à-vis* the preceding year was also reflected in the residency-based new monetary aggregate (NM_3), which excludes the impact of foreign currency non-resident deposits, as well as the liquidity aggregates (L_1, L_2 and L_3) (Table 11). A noteworthy feature underlying the evolution of

Table 11 : Monetary Indicators

(Amount in Rs. crore)

Item	Outstanding as on Mar 31, 2005	Variation			
		2004-05		2003-04	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
I. Reserve Money	4,89,128	52,616	12.1	67,451	18.3
II. Broad Money (M_3)	22,65,587	2,57,058	12.8	2,90,569	16.9
a) Currency with the Public	3,57,424	42,016	13.3	43,827	16.1
b) Aggregate Deposits	19,01,680	2,13,678	12.7	2,44,866	17.0
i) Demand Deposits	2,97,088	39,075	15.1	59,256	29.8
ii) Time Deposits	16,04,592	1,74,603	12.2	1,85,610	14.9
of which: Non-Resident Foreign Currency Deposits	76,133	797	1.1	-17,170	-18.6
III. NM_3	22,22,190	2,58,884	13.2	3,21,764	19.6
of which: Call Term Funding from Financial Institutions	34,129	9,459	38.3	12,032	95.2
IV. a) L_1	23,06,998	2,72,304	13.4	3,37,877	19.9
of which: Postal Deposits	84,808	13,420	18.8	16,113	29.2
b) L_2	23,08,649	2,67,710	13.1	3,37,826	19.8
of which: FI Deposits	1,651	-4,594	-73.6	-51	-0.8
c) L_3	23,27,893	2,67,232	13.0	3,37,642	19.6
of which: NBFC Deposits	19,244	-478	-2.4	-184	-0.9
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	7,50,303	6,638	0.9	67,143	9.9
i) Net Reserve Bank Credit to Government	-12,197	-57,105	-127.2	-75,772	-62.8
of which: to the Centre	-13,727	-50,646	-137.2	-76,065	-67.3
ii) Other Banks' Credit to Government	7,62,501	63,742	9.1	1,42,915	25.7
b) Bank Credit to Commercial Sector	12,42,345	2,21,870	21.7	1,21,494	13.5
of which: Scheduled Commercial Banks' Non-food Credit	10,18,288	2,13,464	26.5	1,25,088	18.4
c) Net Foreign Exchange Assets of Banking Sector	6,51,998	1,25,412	23.8	1,32,872	33.7

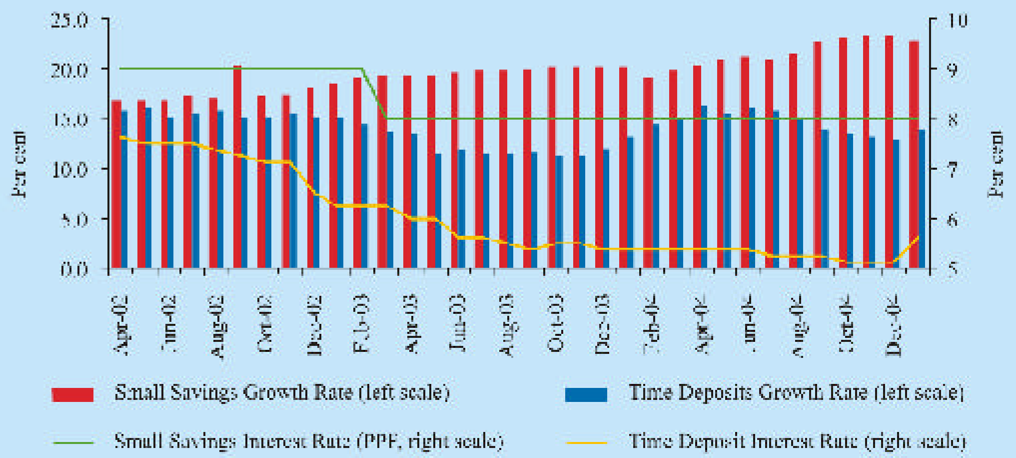
FIs: Financial Institutions. NBFCs: Non-banking Financial Companies.

Note : 1. Data are provisional.
2. Select aggregates are adjusted for the effect of conversion of a non-banking entity into a banking entity since October 11, 2004.
3. Postal deposits figures pertain to January 2005, FI deposits pertain to February 2005 and NBFC deposits pertain to September 2004.
4. Government balances as on March 31, 2005 are before closure of accounts.

monetary conditions in 2004-05 was the sharp rise in non-food credit which set in from July 2004 onwards in consonance with the buoyancy in industrial activity.

Reflecting the slowdown in agricultural activity, currency demand moderated in relation to the preceding year, barring the usual spurt during the festival season in October-November 2004. The growth in banks' deposits was also a shade lower due to substitution in favour of postal deposits, which continued to grow at a high rate, benefiting from tax incentives and their relatively attractive rate of return in comparison with time deposits (Chart 17). Non-resident foreign currency deposits, which had declined sharply in the previous year on account of redemptions of Resurgent India Bonds (RIBs), registered a moderate increase during 2004-05. Banks increasingly relied on non-deposit sources of funds in 2004-05

Chart 17: Time Deposits and Small Savings



Credit Behaviour

The flow of credit to industry from bank and non-bank sources surged during 2004-05 reflecting a broad-based strengthening of the industrial recovery. Food credit also increased during the year due to higher procurement operations, reversing the decline in the previous two years. Among non-bank sources of funds, resources raised by way of external commercial borrowing (ECB) and equity issues increased sharply. Financial assistance extended by financial institutions, however, continued to decline. Retained earnings turned out to be an important source of funds for the industrial sector, reflecting the growing significance of internal generation of funds resulting from improved corporate profitability (Table 12).

Net bank credit to the Government increased by barely 0.9 per cent during 2004-05 due mainly to a lower than budgeted borrowing programme of the Centre.

Table 12 : Key Sources of Funds to Industry

(Rupees crore)

Item	2004-05	2003-04
1	2	3
A. Bank Credit to Industry (April-December)	29,236	-877
B. Flow from Non-banks to Corporates (1 to 5)	37,332	677
1. Capital Issues * (i+ii)	10,337	1,929
i) Non-Government Public Ltd. Companies (a+b)	7,653	1,829
a) Bonds/Debentures	0	0
b) Shares	7,653	1,829
ii) PSUs and Government Companies	2,684	100
2. ADR/GDR Issues +	2,960	3,098
3. External Commercial Borrowings (ECBs) (April-December) $	28,354	-4,580
4. Issue of CPs #	3,852	2,304
5. Financial assistance extended by FIs (April-September) (net)	-8,171	-2,074
C. Retained earnings (April-September) @	9,698	6,462
D. Depreciation Provision (April-September)	10,381	9,257
Total Flow of resources to Industry (A+B+C+D)	**86,647**	**15,519**

* : 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.

\+ : Including Global Depository Receipts (GDRs)/American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs) excluding issuances by banks and financial institutions.

$: Including short-term credit.

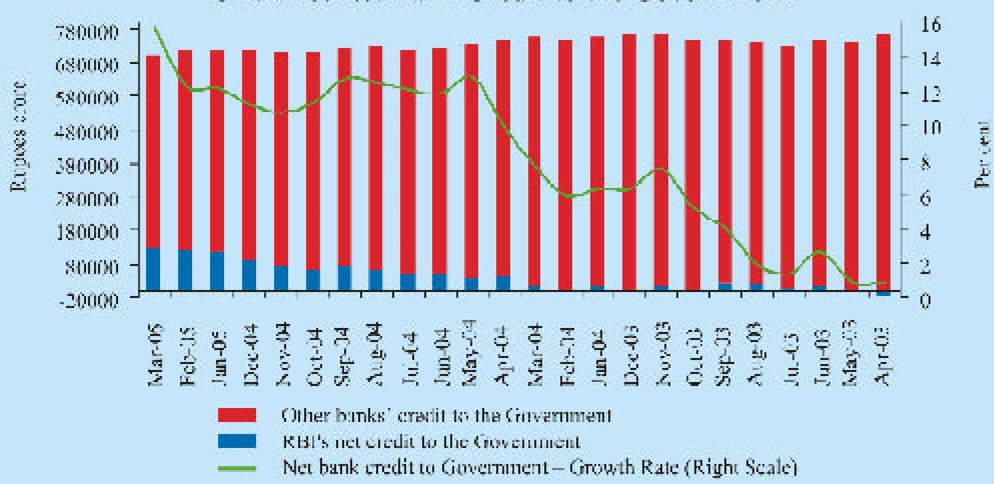
\# : Excluding issuances by financial institutions and banks' investments in CPs.

@ : Owing to non-availability of relevant data, retained earnings have been taken at 47.0 per cent of net profit, based on average share of retained earnings in net profit during last three years.

Note : Data are provisional.

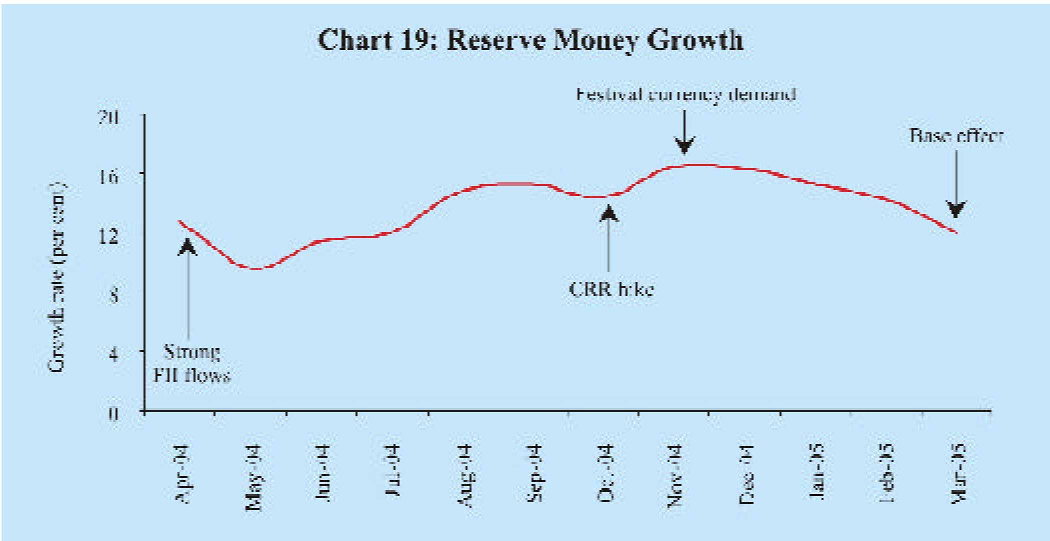
Commercial banks continued to hold government securities of nearly 40 per cent of their net demand and liabilities (NDTL) – far in excess of the prescribed statutory minimum ratio of 25 per cent – despite the fact that incremental investment in government securities during 2004-05 was small (Chart 18).

Chart 18: Net Bank Credit to the Government



Reserve Money Survey

Reserve money grew by 12.1 per cent during 2004-05 as compared with 18.3 per cent during 2003-04, reflecting mainly the dampened currency growth and the base effect of the excess reserves built up on March 31, 2004. Fluctuations in reserve money growth during the year reflect the impact of capital flows, sterilisation operations, the hike in CRR during September-October 2004 and seasonal fluctuations in currency demand (Chart 19).



Reserve money declined in the first quarter of the year mainly due to large-scale sterilisation of capital inflows through the MSS and the LAF and the base effect of the excess reserves built up on March 31, 2004. In the second quarter, reserve money declined mainly due to capital outflows, MSS operations and increase in the Government's surplus cash balances with the Reserve Bank (Table 13).

A strong revival of capital inflows in the third quarter led to a sharp increase in reserve money, which helped in meeting the expansion in currency demand on account of the festival season. Net Reserve Bank credit to the Centre remained almost unchanged as the decline in outstanding LAF balances was counter-balanced by increase in the Government's surplus cash balances with the Reserve Bank. Reserve money continued to grow in the fourth quarter as capital inflows continued to be sizeable (Chart 20).

During 2004-05, owing primarily to large balances under the MSS, net Reserve Bank credit to the Central Government declined sharply by Rs.50,646 crore on top of a decline of Rs.76,065 crore in 2003-04. Another contributing factor was the Centre's increased surplus cash balances with the Reserve Bank.

Table 13 : Variation in Major Components and Sources of Reserve Money

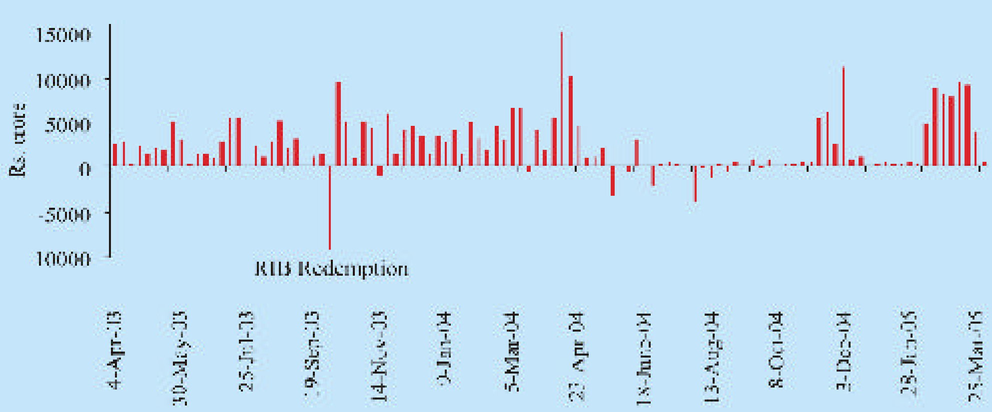
Item	2003-04	2004-05	2003-04 Q1	2003-04 Q2	2003-04 Q3	2003-04 Q4	2004-05 Q1	2004-05 Q2	2004-05 Q3	2004-05 Q4
1	2	3	4	5	6	7	8	9	10	11
Reserve Money	67,451 (18.3)	52,616 (12.1)	16,342	-18,235	23,980	45,363	-6,812	-6,287	31,547	34,166
Components										
1. Currency in circulation	44,555	41,621	17,882	-5,955	17,986	14,641	14,317	-4,166	16,467	15,003
2. Bankers' Deposits with RBI	21,019	9,631	-1,606	-12,633	5,961	29,297	-19,665	-2,874	14,769	17,401
3. Other Deposits with RBI	1877	1,364	65	352	33	1426	-1,463	755	311	1,761
Sources										
1. RBI's net credit to Government	-75,772	-57,105	-4,451	-53,146	-12,506	-5,669	-34,143	-6,179	184	-16,967
of which: to Centre	-76,065	-50,646	434	-53,744	-15,844	-6,911	-30,029	-4,499	203	-16,321
2. RBI's credit to banks and commercial sector	-2,728	-833	-1,564	-2,525	-796	2,156	-2,985	-740	3,726	-835
3. NFEA of RBI	1,26,169	1,28,377	22,710	25,720	51,931	25,808	57,525	-5,260	31,462	44,651
4. Government's Currency Liabilities to the Public	225	141	84	74	43	24	37	9	89	6
5. Net Non-Monetary Liabilities of RBI	-19,557	17,964	437	-11,642	14,692	-23,044	27,245	-5,885	3,915	-7,311
Memo:										
1. Net Domestic Assets	-58,719	-75,761	-6,368	-43,955	-27,951	19,555	-64,336	-1,025	85	-10,485
2. FCA, adjusted for revaluation	1,41,428	1,15,044	23,943	31,832	37,560	48,093	33,160	-3,413	29,858	55,440
3. Net Purchases from Authorised Dealers	1,40,650	91,105	22,237	29,899	40,669	47,845	30,032	-9,789	22,771	48,091
4. NFEA/Reserve Money (per cent) (end-period)	111.0	125.3	98.8	110.8	117.2	111.0	126.1	126.7	124.9	125.3
5. NFEA/Currency (per cent)	148.1	166.2	126.8	138.1	146.8	148.1	158.8	159.2	160.7	166.2

NFEA: Net Foreign Exchange Assets. FCA: Foreign Currency Assets.

Note: 1. Data are based on March 31 for Q4 and last reporting Friday for all other quarters.
2. Figures in brackets are percentage variations over the year.
3. Government balances as on March 31, 2005 are before closure of accounts.

Foreign currency assets of the Reserve Bank increased by Rs.1,15,044 crore (adjusted for revaluation) in 2004-05 on top of an accretion of Rs.1,41,428 crore in 2003-04. The continued strong inflow of foreign exchange assets was reflected in the

Chart 20: Weekly Variation in Reserve Bank's Foreign Currency Assets (net of revaluation)



high level of NFEA/reserve money (125.3 per cent as at end-March 2005) and NFEA/ currency (166.2 per cent as at end-March 2005) ratios (Chart 21).

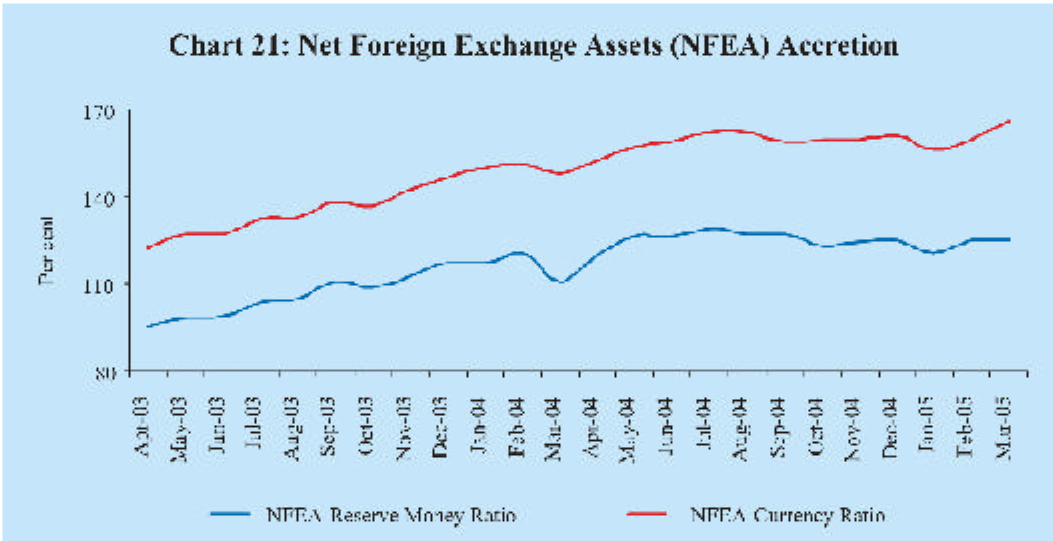


Chart 21: Net Foreign Exchange Assets (NFEA) Accretion

The Reserve Bank was not required to support the Government in the primary market during 2004-05 barring in the second quarter when there was a devolvement of Rs.847 crore after a gap of two years (Table 14).

Table 14 : Net Reserve Bank Credit to the Centre - Variations

Item	2003-04	2004-05	2003-04				2004-05			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
Net Reserve Bank Credit to the Centre(1+2+3+4-5)	-76,065	-50,646	434	-53,744	-15,844	-6,911	-30,029	-4,499	203	-16,321
1. Loans and Advances	0	0	8,145	-8,145	0	0	3,222	-3,222	0	0
2. Treasury Bills held by the Reserve Bank	-3	0	-3	0	0	0	0	0	0	0
3. Reserve Bank's Holdings of Dated Securities	-72,227	12,323	-11,300	-45,530	-15,795	398	-2,901	22,176	14,095	-21,047
4. Reserve Bank's Holdings of Rupee Coins	20	58	163	-68	-51	-23	175	-11	-93	-15
5. Central Government Deposits	3,856	63,027	-3,430	0	-1	7,287	30,525	23,443	13,799	-4,740
*Memo Items **										
1. Market Borrowings of Dated Securities by the Centre #	1,21,500	80,350	44,000	36,000	15,000	26,500	28,000	26,000	14,000	12,350
2. Reserve Bank's Primary Subscription to Dated Securities	21,500	1,197	5,000	0	0	16,500	0	847	0	350
3. Repos (+) / Reverse Repos (-) (LAF), net position £	-32,230	15,315	-19,040	-4,455	-3,580	-5,155	-26,720	34,205	27,600	-19,770
4. Net Open Market Sales #	41,850	2,899	5,620	16,671	14,225	5,332	429	427	871	1,172
5. Mobilisation under MSS	0	64,211	0	0	0	0	37,812	14,444	353	11,602
6. Primary Operations $	-100	-61,305	25,643	-32,608	2,305	4,560	-459	-44,928	-39,338	23,418

* : At face value. # : Excluding Treasury Bills. £ : Including fortnightly repos. $: Adjusted for Centre's surplus investment.

Note : 1. Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.
2. Government balances as on March 31, 2005 are before closure of accounts.

Liquidity Management

The overhang of liquidity in the beginning of the year, combined with large capital inflows, continued to pose challenges for liquidity management and the conduct of monetary policy during 2004-05. The Reserve Bank had to continually absorb liquidity during the year barring some episodic pressures in August, November and December when there were net injections of liquidity through the LAF.

Sterilisation operations were conducted through a new mechanism introduced in April 2004, *viz.*, Market Stabilisation Scheme (MSS). While LAF continues to remain an important instrument for managing day-to-day liquidity, the institution of the MSS has facilitated the management of capital flows.

The liquidity management operations of the Reserve Bank during 2004-05 could be broadly divided into three phases depending upon the movement in capital flows (Table 15). In the first phase (from March 27, 2004 to May 14, 2004), strong capital inflows led to the accretion of foreign currency assets (adjusted for revaluation) to the extent of around Rs.38,000 crore. The decline in the Central Government's surplus cash balances with the Reserve Bank also led to an expansion of liquidity in the system. In this phase, the Reserve Bank managed liquidity primarily through the MSS.

Table 15 : Phases of Reserve Bank's Liquidity Management Operations

(Rupees crore)

Item	2003-04		2004-05		
	April 1, 2003 – December 26, 2003	December 27, 2003 – March 26, 2004	March 27 – May 14, 2004	May 15 – October 29, 2004	October 30, 2004 – March 31, 2005
1	2	3	4	5	6
A. Drivers of Liquidity (1+2+3)	**56,248**	**46,646**	**36,218**	**-24,321**	**42,066**
1. RBI's Foreign Currency Assets (adjusted for revaluation)	93,334	46,171	37,919	-4,614	83,662
2. Currency with the Public	-28,981	-15,126	-20,973	6,789	-27,552
3. Others (residual)	-8,106	15,602	19,272	-26,496	-14,044
3.1 Surplus cash balances of the Centre with the Reserve Bank	-13,135	6,685	15,355	-18,481	-7,721
B. Management of Liquidity (4+5+6+7)	**-60,092**	**-37,242**	**-40,148**	**37,960**	**-31,852**
4. Liquidity impact of LAF Repos (net)	-27,075	-31,910	-12,095	66,040	-11,875
5. Liquidity impact of OMO (net)	-36,517	-5,332	-277	-769	-1,853
6. Liquidity impact of MSS	0	0	-27,776	-27,311	-9,124
7. First round liquidity impact due to CRR change	3,500	0	0	0	-9,000
C. Bank Reserves # (A+B)	**-3,844**	**9,404**	**-3,930**	**13,639**	**10,214**

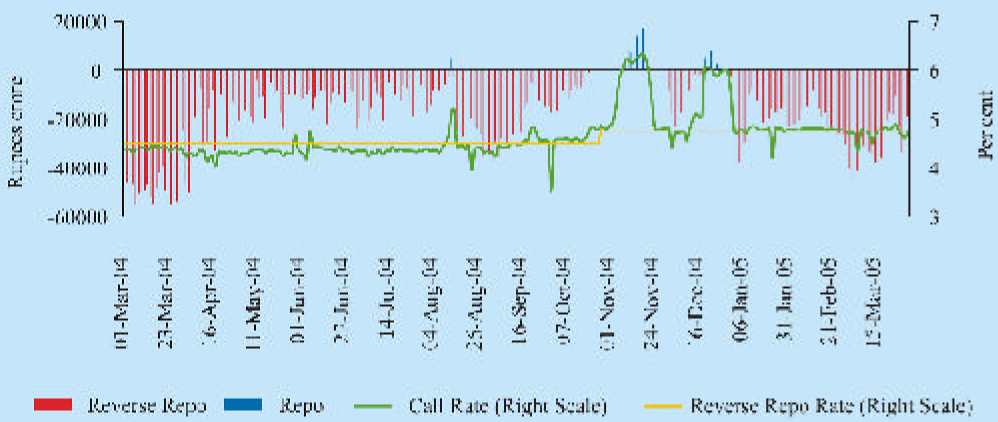
+ : Indicates injection of liquidity into the banking system.
– : Indicates absorption/leakage of liquidity from the banking system.
: Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.

In the second phase (May 15, 2004 to October 29, 2004), net capital outflows, the increase in the Central Government's surplus cash balances with the Reserve Bank and absorption of liquidity through the MSS impacted liquidity in the system. As a result, the outstanding balances locked under the LAF declined by about Rs.66,000 crore. In fact, the Reserve Bank had injected liquidity (Rs.5,000 crore) through the LAF on August 12 to assuage temporary mismatches arising out of pressures from State Development Loans auctions, redemptions from mutual funds and the need to meet reserve requirements. Liquidity conditions remained comfortable until September 2004 when outflow of funds on account of advance tax payments, substantial rise in surplus cash balances of the Government with the Reserve Bank and the hike in the cash reserve ratio (CRR) exerted some pressure, pushing the call rates slightly above the LAF repo rate.

Capital inflows started picking up from end-October 2004, which marked the beginning of the third phase. The robust expansion in non-food credit offtake and a spurt in festival currency demand continued to exert pressure on liquidity, driving the call rates to 6.10 per cent on November 5, 2004 and further to 6.30 per cent as on November 18, 2004. The Reserve Bank injected daily net liquidity of over Rs.10,000 crore, on an average, during the period November 5-22, 2004 through the LAF. The ebbing of currency demand and a pick-up in capital inflows eased liquidity conditions with the call rates sliding to 4.55 per cent by December 10, 2004. The Reserve Bank absorbed excess liquidity resulting from an accretion of nearly Rs.21,000 crore to the net foreign currency assets (net of revaluation) between mid-November 2004 and the second week of December 2004. Liquidity conditions came under pressure briefly during the second half of December 2004 due mainly to moderation of capital inflows, advance tax payments, continued growth in non-food credit and the Central Government maintaining substantial surplus cash with the Reserve Bank. The Reserve Bank again injected daily net liquidity of around Rs.3,500 crore, on an average, from December 20-24, 2004 and did not undertake scheduled issuance of 364-day Treasury Bills under the MSS. Liquidity conditions turned comfortable thereafter facilitated by large capital inflows and decline in Centre's cash balances with the Reserve Bank. Call rates remained anchored to the reverse repo rate through January and the first half of February 2005 (Chart 22).

The liquidity overhang, which declined to around Rs.70,000 crore in January 2005 from over Rs.1,00,000 crore as at mid-April 2004, increased again to over Rs.83,000 crore by March 31, 2005. The total stock of Treasury Bills and dated securities issued under the MSS amounted to Rs.64,211 crore as at end-March 2005 inclusive of Rs.25,000 crore raised through dated securities with a residual maturity of up to 2.5 years. With the introduction of the MSS, liquidity absorption through the LAF declined from an outstanding balance of Rs.75,006 crore in April 2004 to Rs.10,805 crore in October 2004 but finally

Chart 22: Repo, Reverse Repo Auctions under LAF and Call Rates



rose to Rs.29,809 crore in March 2005. In addition to the MSS, LAF operations and CRR hike, surplus balances of the Centre with the Reserve Bank also helped in impounding liquidity.

IV. PRICE SITUATION

Inflation conditions firmed up worldwide in 2004, driven up by soaring international crude oil prices and upward pressures from prices of metals and key agricultural commodities. Inflation in India rose sharply up to August 2004 in concert with imported price pressures and was exacerbated by the setback to *Kharif* output from the uneven and inadequate South-West monsoon. From September 2004, however, inflationary pressures began to ease under the impact of a mix of factors including the waning of the impact of the South-West monsoon on agricultural commodity prices, fiscal measures to moderate the pass-through of imported inflation, monetary policy measures to drain excess liquidity from financial markets and stabilise inflation expectations and the strong base effect of the sharp rise in prices in the preceding year. Although international commodity prices are beginning to stabilise, crude oil prices remain at elevated levels which, together with the persistence of nervous sentiment in world oil markets, pose a serious upside risk to inflation.

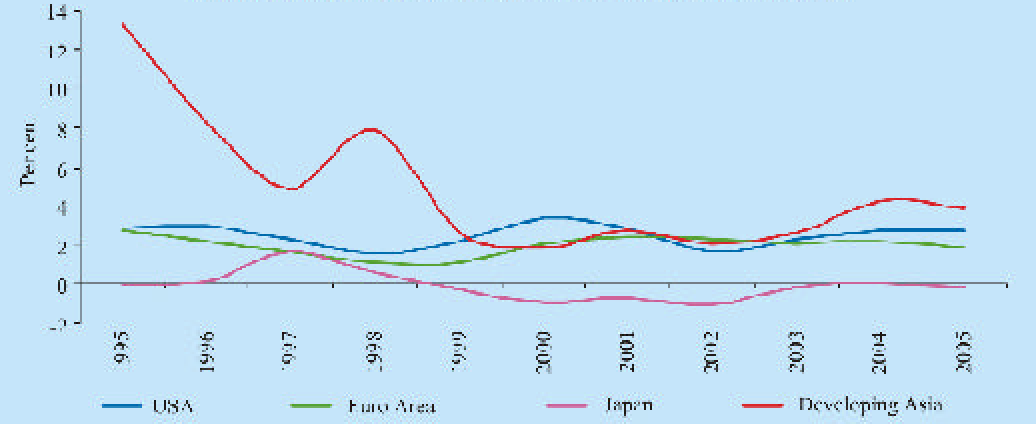
Global Inflation

Globally, inflation began to rise in early 2004, driven up by strong input demand from the global recovery and the continued expansion of the Chinese economy. Demand-side pressures on global inflation remained relatively weak, despite concerns about easy monetary conditions fuelling asset prices. Reflecting the supply-side character of inflation, producer prices tended to lead consumer prices in most economies. As commodity costs represent only a small share of the overall costs, the increase in commodity prices was initially absorbed by firms in their profit margins, creating a wedge between producer and consumer prices.

Consumer prices, however, began to harden by July 2004 as expansion in capacity utilisation forced producers to pass on higher input prices. Consumer price inflation firmed up to 2.0 per cent in advanced economies in 2004, after remaining below two per cent for two years in succession. By contrast, inflation eased somewhat to 5.7 per cent in 2004 after remaning steady at 6.0 per cent in the previous two years across emerging market economies and the developing countries as a group. In developing Asia, inflation was somewhat higher because of strong economic activity and rising oil intensity (Chart 23).

In the US, producer price inflation accelerated to 4.7 per cent in February 2005 from 2.0 per cent a year ago, driven by input demand, oil prices and the weakening of the US dollar. Headline consumer inflation accelerated to 3.0 per cent in February 2005 from 1.7 per cent a year ago. In the Euro area, inflation at 2.4 per cent in December 2004, measured by the Harmonised Index of Consumer

Chart 23: Consumer Price Inflation – Global Trends



Note: Data for 2005 are IMF projections.
Source: World Economic Outlook, IMF, April 2005.

Prices (HICP), crossed the European Central Bank's (ECB) target of about 2.0 per cent, driven by higher oil prices. Inflation at 2.1 per cent in March 2005 continued to be above the target. The Japanese economy experienced some upturn in consumer prices in 2004, especially on account of higher oil prices after a long bout of deflation. Deflationary pressures emerged again in early 2005 with consumer prices falling by 0.3 per cent year-on-year (y-o-y) in February 2005.

In China, the general purchasing price index (PPI) of industrial raw materials, fuels and power increased by 11.4 per cent over the previous year on the back of strong growth, while the factory prices of industrial products rose by 6.1 per cent leaving smaller profit margins. Although real GDP growth continued to be strong at above 9 per cent in the fourth quarter of 2004, consumer price inflation in China dipped to a 9-month low of 2.4 per cent by December 2004 on account of decline in food prices and the higher base of the preceding year. For the full year, inflation rose by 3.9 per cent as compared with 1.2 per cent in 2003, mainly due to a sharp rise in food prices which contributed over 80 per cent of the consumer price inflation of 2004. Consumer price inflation accelerated to 3.9 per cent in February 2005 from 2.1 per cent a year ago.

Monetary Policy Actions

A number of central banks, most notably the US Federal Reserve, began to signal a reversal of their accommodative monetary policy stance in order to stabilise inflation expectations (Table 16). The US Federal Reserve raised its target Federal Funds Rate in seven equal stages by 175 basis points to 2.75 per cent between June 2004 and March 2005. The Federal Open Market Committee

Table 16 : Global Monetary Policy Targets and Inflation

(Per cent)

Country / Region	Key Policy Rate/Target	Changes in Policy Rate/ Target		Inflation Rate	
		From	To	Target	Outcome
1	2	3	4	5	6
US	Target Federal Funds Rate				
June 2003		1.25	1.00	No Target	2.1
June 2004		1.00	1.25		3.3
August 2004		1.25	1.50		2.7
September 2004		1.50	1.75		2.5
November 2004		1.75	2.00		3.5
December 2004		2.00	2.25		3.3
February 2005		2.25	2.50		3.0
March 2005		2.50	2.75		-
UK	Repo Rate				
February 2003		4.00	3.75	2.5	3.2
July 2003		3.75	3.50	2.5	3.1
November 2003		3.50	3.75	2.5	2.5
February 2004		3.75	4.00	2.0*	1.3*
May 2004		4.00	4.25	2.0	1.5
June 2004		4.25	4.50	2.0	1.6
August 2004		4.50	4.75	2.0	1.3
March 2005		**	**	2.0	-
Euro Area	Interest Rate on Main Refinancing Operations				
March 2003		2.75	2.50	2.0	2.5
June 2003		2.50	2.00	2.0	1.9
March 2005		**	**	2.0	2.1
Japan	Target Balance of Current Accounts with the BoJ (Trillion Yen)@				
April 2003		15-20	22-27	No Target	-0.1
May 2003		22-27	27-30		-0.2
October 2003		27-30	27-32		0.0
January 2004		27-32	30-35		-0.3
March 2005		**	**		-

* : Inflation target which was defined in terms of Retail Price Index (RPI) excluding mortgage interest payments was shifted to CPI from December 2003.

** : No Change.

@ : The Bank of Japan (BoJ) switched from short-term interest rate targeting to quantitative easing in March 2001, under which it conducts open market operations aimed at increasing the current account balances held with it by commercial banks.

Source: IMF and official websites of respective central banks.

(FOMC), however, believes that the stance of monetary policy continues to be accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity.

The ECB maintained its monetary policy stance as the overall inflation outlook was perceived to be consistent with price stability in the medium term. Inflation is expected to gradually come down to its target of around 2.0 per cent in the course of 2005.

The Bank of England's Monetary Policy Committee raised its policy repo rate by 125 basis points between November 2003 and August 2004 in order to pre-empt the possibility of any undue increase in asset prices, especially housing prices, from feeding into inflation. CPI inflation at 1.6 per cent in February 2005 is projected to increase to the Bank of England's target of 2.0 per cent over the next two years.

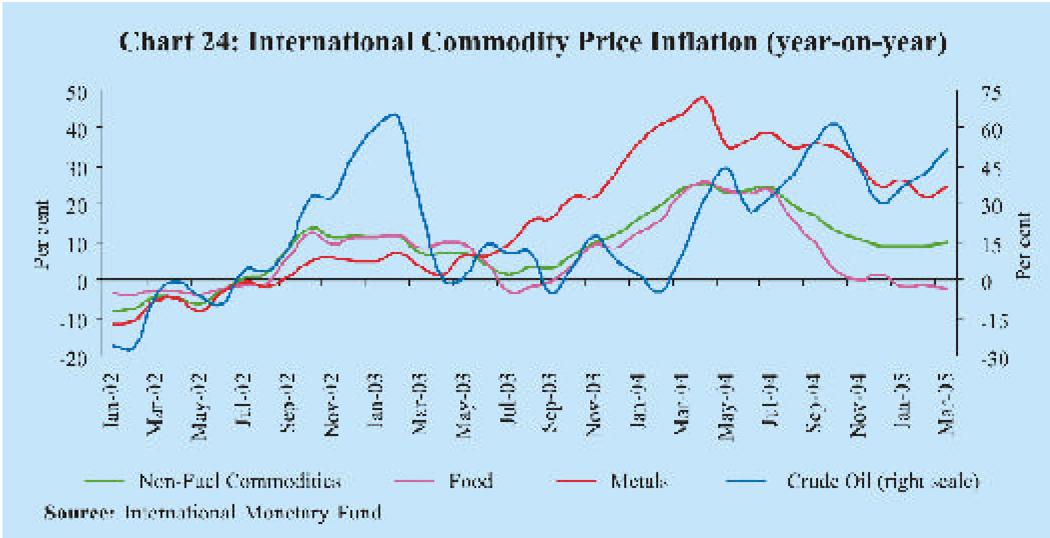
The Bank of Japan (BoJ) switched from the traditional approach of targeting short-term interest rate to quantitative easing in March 2001. This was because the target interest rate being pursued had already approached zero (0.15 per cent), constrainng the BoJ's ability to provide futher stimulus to growth through expansionary monetary policy. Under quantitative easing in the present form, the BoJ conducts open market operations (OMOs) aimed at increasing the current account balances held at the BoJ by commercial banks. In view of the continuing deflation, the Bank of Japan chose to persist with the target range for bank reserves at 30-35 trillion yen in its monetary policy meetings throughout 2004 to ensure sufficient liquidity in the system.

Faced with the challenges of an overheating economy in 2004, the People's Bank of China (PBC) used a mix of monetary policy instruments to appropriately adjust the monetary and credit aggregates on a timely basis and prompted commercial banks to implement the macro financial management policy by differentiating credit support to various industries. The People's Bank of China tightened monetary policy through a mix of higher reserve requirements and a hike in the benchmark deposit and lending interest rates in order to moderate economic expansion and rein in inflation.

Global Commodity Prices

Commodity prices, which had risen sharply in the first half of 2004, stabilised at elevated levels by the end of the year. Fuel prices surged up by 30.9 per cent, on an average, in 2004 on top of an increase of 16.7 per cent in the previous year. Non-fuel commodity prices (covering prices of food, beverages, agricultural raw materials and metals) rose on an average by 18.6 per cent in 2004, led by metals (36.4 per cent) (Chart 24). The increase in commodity prices in the international markets in US dollar terms was much higher than in terms of the Euro or the Japanese Yen. This reflected the depreciation of the US dollar by 9.4 per cent against the Euro and 6.7 per cent against the Yen in 2004.

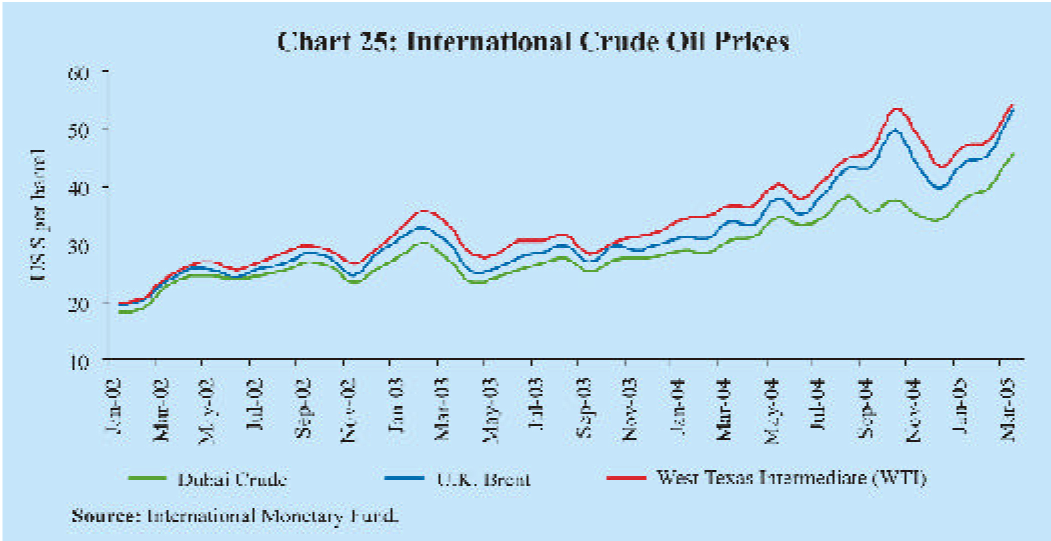
International oil prices hardened during 2004 amidst concerns about strong demand, oil supply bottlenecks, low inventories and very low spare output capacity. In spite of periodic increases in supply by the Organisation of the Petroleum Exporting Countries (OPEC), market sentiment remained nervous on supply concerns and forecasts of a sustained rise in demand. US crude oil prices (West Texas Intermediate or WTI) climbed to a high of US $ 55 per barrel



towards end-October 2004, driven up by a combination of adverse factors such as the effects of Hurricane Ivan on production sites along the Gulf of Mexico, financial difficulties of the major Russian producer Yukos and a drop in US oil inventories on the eve of the winter season. UK crude prices (*i.e.*, UK Brent) rose by 20 per cent during January-March 2005 over and above an increase of 32.8 per cent in 2004.

Oil prices (WTI) receded to sub-US$ 50 levels by November 5, 2004 following an improvement in US inventories, recovery in supply lines along the Gulf of Mexico and a relaxation in the OPEC production ceiling by a further million barrels per day effective November 1, 2004 but crossed US$ 50 per barrel in February 2005 again over supply concerns. Despite the OPEC's decision in its March 16, 2005 meeting to raise its output target immediately by 0.5 million barrels a day (mb/d) to 27.5 mb/d, US crude oil prices (WTI) rose to a record US $ 57.40 on March 17, 2005 on concerns about the OPEC's capacity to meet global demand which is seen as rising faster than supply. Crude oil prices moderated to about US $ 54 a barrel by March 28, 2005 supported by a rebound in the US dollar, but rose again to an all-time peak of US$ 57.8 a barrel on April 4, 2005 triggered by a forecast that prices could spike above US$ 100 a barrel due to robust global demand, tight spare capacity and on concerns about the OPEC's capacity to meet rising global demand.

All categories of international crude oil recorded sharp price increases. The increase in the Dubai crude prices was subdued during June-October 2004 relative to the increase in the prices of US WTI and UK Brent. During January-March 2005, however, Dubai crude prices rose faster than the other categories (Chart 25). This poses significant risks to inflation in India as the



basket of crude oil imported by India is weighted in favour of the Dubai crude variety relative to Brent.

According to the IMF (2004), a permanent increase of US $ 5 per barrel in crude oil prices is estimated to reduce world output by 0.3 per cent a year after the hike. Inflation is estimated to increase by 60-70 basis points in major developing regions - more than three times the increase in industrial economies.

Average coal prices almost doubled in 2004. Begining in the first quarter, coal prices were driven up by strong Chinese demand, higher demand for fuel emerging from the global economic recovery and substitution in favour of coal as a result of increase in prices of natural gas.

Metal prices, on an average, rose sharply by 36.4 per cent in 2004 on the back of strong Chinese demand. The World Bank's composite index of steel products recorded an increase of 54.2 per cent in 2004. Steel prices recorded steep increases of 21 per cent in March 2004 and 10.3 per cent in April 2004. They continued to remain at high levels during the year due to a pick-up in demand from South Asian countries, including India. Rising Chinese demand is also beginning to put pressure on prices of iron ore. Prices of other metals such as aluminium, copper, nickel, tin and zinc also recorded sharp increases.

Prices of agricultural commodities as a group firmed up in the first quarter of the year as bad weather damaged crop prospects in a number of countries. During the course of the year, prices of key commodities such as wheat and oilseeds began to soften because of a bumper crop in the 2004-05 season. The Food and Agricultural Organisation (FAO) estimates that world cereal output increased by 9.2 per cent to a record 2,057 million tonnes in 2004. Cereal production is, in fact, forecast to exceed utilisation in 2004-05 for the first time in five years. Prices in world wheat markets began to soften as production increased by 11.8 per cent on the back of good harvests, in sharp contrast to a decline of 1.5 per cent in 2003-04. Prices of other coarse grains also declined as excess production drove up stocks by 27.9 per cent in 2004-05. Rice prices, however, remained firm amidst supply concerns, especially as the crop in the major producing countries of South Asia was reportedly affected by bad weather. Although rice output is now slated to increase by 3.8 per cent due mainly to a 15 per cent jump in the US output, most of the leading exporter countries, including India, Myanmar and Pakistan are reported to have cut shipments because of supply setbacks. The resultant shrinkage in the international rice trade has kept rice prices firm, notwithstanding a drawdown of world rice stocks by 6.1 per cent.

Global oilseed production is estimated to have increased by 12 per cent during 2004-05, led by bumper soya crops in Argentina, Brazil, China and the US after a poor outturn in the previous year. Although demand remained strong, prices of oilseed-based products such as soyabean, soyabean oil, palm oil and soyabean meal softened substantially in the latter half of 2004-05 from the elevated levels in the first half as a result of a poor 2003-04 crop. Palm oil prices in Malaysia also eased, although fears of a return of *El Nino* resulted in some nervousness in the markets in the middle of the year.

World sugar markets witnessed excess demand conditions in 2004-05. Higher sugar demand, especially from developing countries, was exacerbated by a decline in Chinese production for the second consecutive year. As a result, sugar prices in the international markets were up by about 37 per cent (y-o-y) in March 2005.

In sharp contrast to the experience of the previous year, global cotton prices generally softened through 2004 with production catching up with rising demand. The International Cotton Advisory Committee (ICAC) estimates that cotton production climbed by 25.2 per cent during 2004-05, spurred by the higher prices of the previous year and outpaced consumption which grew by 8.1 per cent. Net imports by China during the 2004-05 season are expected to have remained at the previous year's level of 1.85 million tonnes. As a result, cotton prices reflected by the Cotlook A Index declined to US 53 cents per pound in 2004-05 from US 68 cents per pound in 2003-04.

The hardening of global commodity prices impacted inflation in India. Pressures from international prices of petroleum products and metals, in particular, resulted in these commodities contributing more than half of the wholesale price inflation in India in 2004-05. As against an increase of 49.7

per cent (y-o-y) in Dubai crude prices in March 2005, mineral oil prices in India increased by only 13.7 per cent (y-o-y) at end-March 2005. Domestic prices were last revised in November 2004 when the Dubai crude price was at US $ 34.9 a barrel. Dubai prices increased further by over 30 per cent by March 2005. While international metal prices, on average, increased by 36.4 per cent in 2004, domestic metal prices rose by only 17.0 per cent (y-o-y) during 2004-05. The administered prices of domestic coal and fertilisers limited the automatic pass-through of the sharp rise in international coal and fertiliser prices. While international average coal prices almost doubled in 2004 before moderating somewhat in early 2005, administered prices of coal in India were increased by only 16.7 per cent during 2004-05. The administered prices of urea in India were not changed during 2004-05, despite an increase of over 65 per cent (y-o-y) in world urea prices in March 2005. The appreciation of the rupee against the US dollar during August 2004 - March 2005 (6.1 per cent) also seems to have cushioned the full impact of international commodity prices on domestic inflation.

Inflation Conditions in India

Inflation in India moderated by the end of 2004-05 after spiking in the first half of the year. Supply side pressures dominated the inflation scenario - especially mineral oil - exacerbated by the setback to *Kharif* output from the uneven and inadequate South-West monsoon. The easing of inflation in the latter half reflected the waning of the adverse effect of the South-West monsoon on agricultural commodity prices, fiscal and monetary policy measures to moderate the pass-through of imported inflation and the strong base effect of the sharp rise in prices in the preceding year.

Wholesale Price Inflation

Headline inflation, measured by year-on-year (y-o-y) changes in the wholesale price index (WPI), moved in two distinct phases during 2004-05 (Table 17). The first phase, *i.e.*, April-August 2004 was marked by a hardening of domestic prices of coal, petroleum products, iron and steel and other metals, reflecting lagged adjustments to the increase in international prices. Prices of petroleum products were revised upwards effective June 16 and August 1, 2004. Coal prices were also raised in June 2004. The inadequate and uneven South-West monsoon began to push up prices of food items and non-food agricultural commodities such as cotton and oilseeds by July 2004. As a result, headline inflation rose sharply to a peak of 8.7 per cent by end-August 2004.

Inflationary pressures began to recede in the second phase beginning September 2004, led by a decline in the prices of vegetables as the adverse

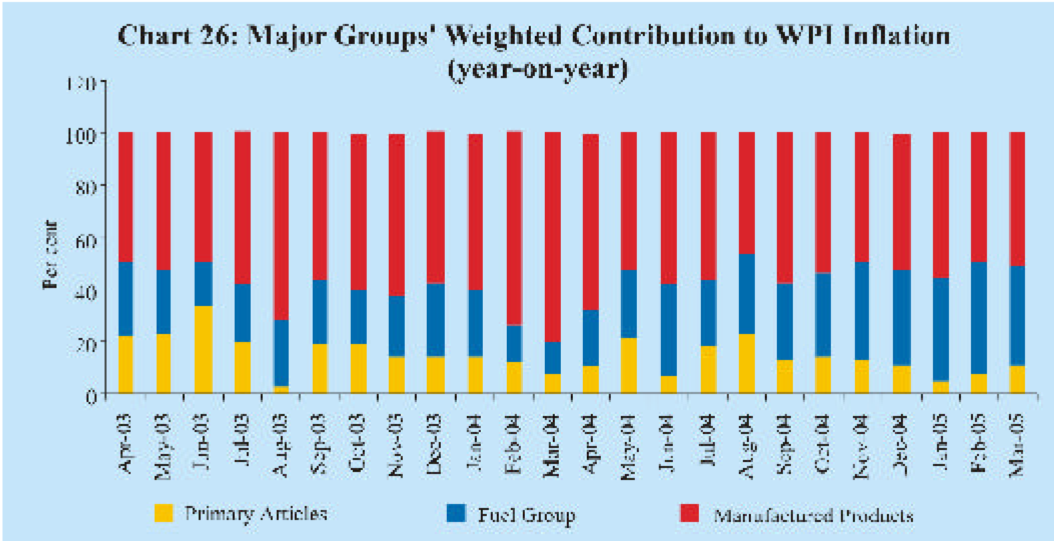
Table 17 : Variation in Wholesale Price Index

(Per cent)

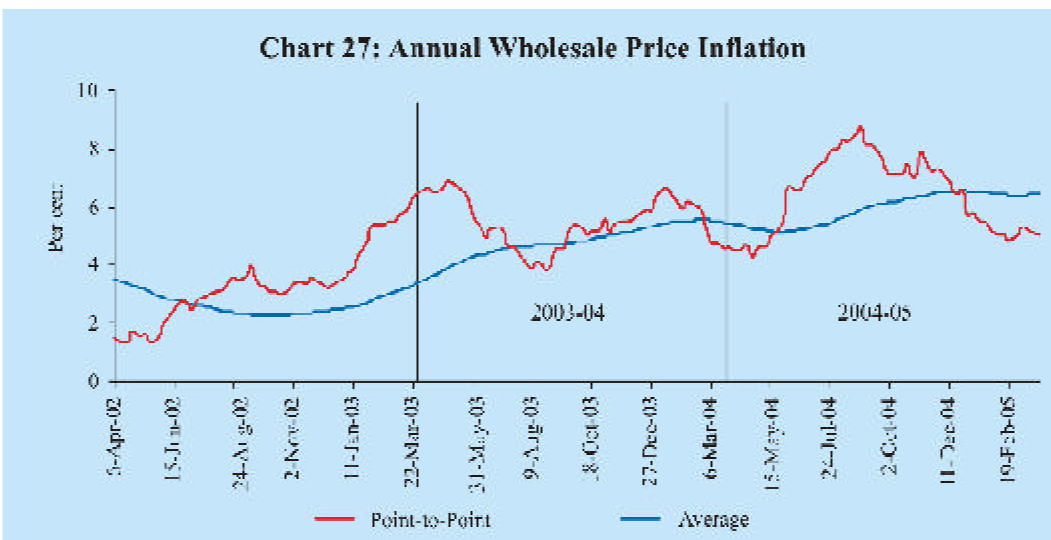
Item	Phase I (End-August 2004 over end-March 2004)	Phase II (End-March 2005 over end-August 2004)
1	2	3
All Commodities	**4.9**	**0.1**
1. Vegetables	77.1	-27.1
2. Eggs, Fish and Meat	10.1	-3.5
3. Raw Cotton	0.8	-24.4
4. Oilseeds	7.7	-11.9
5. Iron Ore	190.0	-18.3
6. Coal Mining	17.1	-0.3
7. Mineral Oil	10.3	3.1
8. Edible Oils	0.1	-8.1
9. Oil Cakes	-8.5	-10.2
10. Tea and Coffee Processing	9.1	-5.6
11. Cotton Textiles	-3.0	-10.4
12. Iron and Steel	17.4	3.3
Memo Item		
i. Total Food Items	4.4	-2.1
ii. Total Non-food Items	5.1	0.3

effect of the inadequate South-West monsoon was found to be restricted largely to sugar. Cotton and oilseeds prices also fell sharply. The impact of fiscal measures in the form of cuts in excise and customs duties in June and August 2004 cushioned the pass-through of the increase in international prices to domestic inflation. Monetary policy measures by the Reserve Bank including higher reserve requirements announced in September 2004 and 25 basis point increase in the reverse repo rate and re-introduction of one-day reverse repo in October 2004 were able to rein in inflation expectations. A hike in fuel prices on November 5, 2004 was partly offset by some moderation, effective November 15, 2004. Sugar prices, however, continued to harden through the year, reflecting reduced domestic supply which also affected international prices. On a year-on-year basis, headline inflation at 5.0 per cent at the close of 2004-05 was well in line with the assumption on inflation in the Reserve Bank's Annual Policy Statement for 2004-05, *albeit* somewhat higher than 4.6 per cent in 2003-04.

The contribution of various commodity groups to overall inflation underwent significant changes during 2004-05. The share of the fuel group climbed to 37.8 per cent during the year from 11.6 per cent during the previous year. The share of the manufactured products group declined to 51.1 per cent from 80.5 per cent in 2003-04 as the increase in sugar prices was more than offset by the decline in the prices of cotton, edible oils and oil cakes. The share of the primary articles group during the year was marginally higher than that in the previous year (Chart 26).



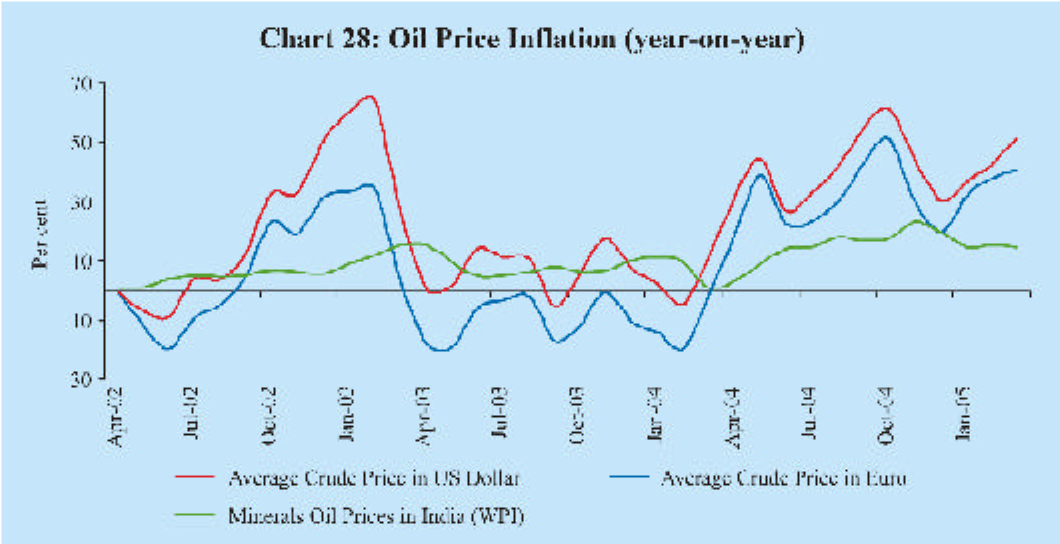
Reflecting the supply-induced character of the inflationary process during the year, annual WPI inflation excluding the administered and partially decontrolled items (electricity, coal mining, mineral oils and urea-N-content) at 4.1 per cent in 2004-05, on a point-to-point basis, was lower than the headline rate of 5.0 per cent. Driven up by the inflationary pressures during the first five months of 2004-05, the average inflation rate accelerated to 6.4 per cent during 2004-05 from 5.4 per cent and 3.4 per cent during 2003-04 and 2002-03, respectively (Chart 27).



Commodity Prices in India

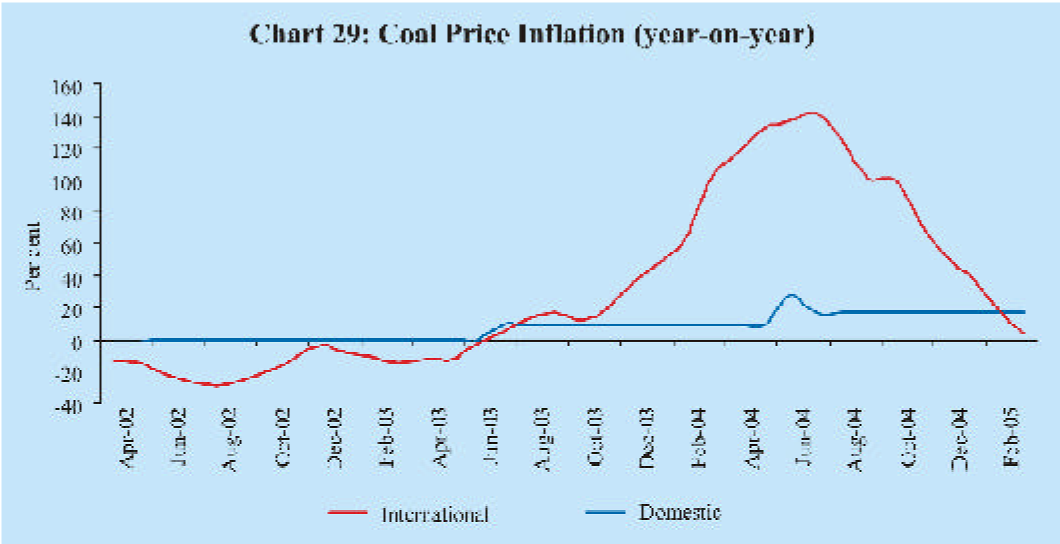
Headline inflation in India was driven mainly by movements in commodity prices in 2004-05 as demand pressures remained muted. Global commodity prices, especially metals and crude oil, had a significant influence on the movements of commodity prices in India. The pass-through of global commodity prices to domestic inflation was, however, cushioned by monetary and fiscal policy measures.

The upward revision in prices of petroleum products in three stages effective June 16, August 1 and November 5, 2004 (with some moderation effective November 15, 2004) resulted in domestic mineral oil prices emerging as the principal mover of inflation during the year (Chart 28). The contribution of mineral oils to year-on-year headline inflation worked out to as high as 30 per cent in 2004-05. The pass-through of the increase in international prices in 2004-05 was, however, cushioned by the absorption of a part of the burden of the oil price increase by the Government and oil companies. On June 15, 2004 excise duties on petrol, high-speed diesel and liquefied petroleum gas (LPG) were reduced by 4 percentage points, 3 percentage points and 8 percentage points, respectively. On August 18, 2004, excise duties were further cut for petrol and diesel (3 percentage points each) and kerosene (4 percentage points). This was buttressed by a reduction of customs duties on petrol, diesel, LPG and kerosene by 5 percentage points each. The revenue-neutral restructuring of customs and excise duties on petroleum products proposed in the Union Budget, 2005-06 is not expected to have any significant impact on retail prices.



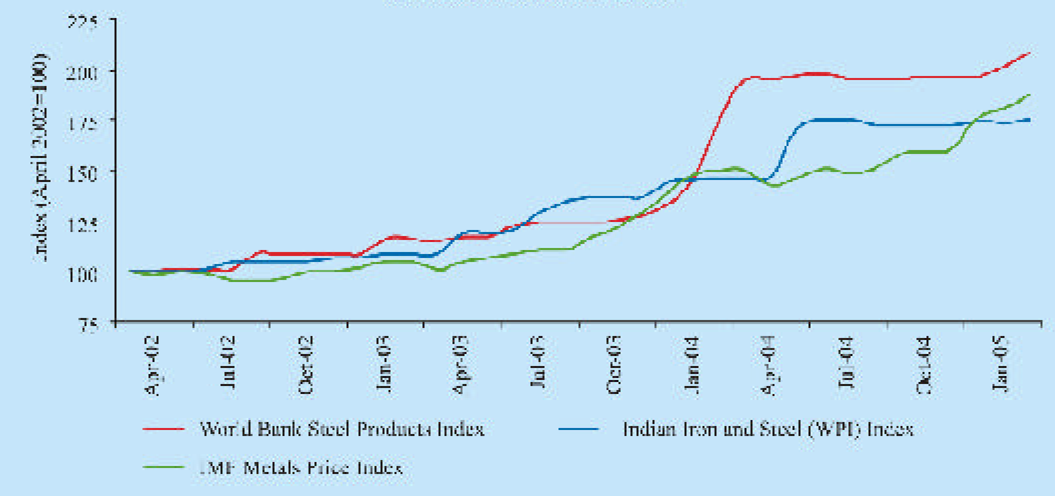
The impact of a hike in world oil prices varies from country to country depending on the energy intensity of production, import intensity of consumption and impact on terms of trade. A change in the prices of petroleum products impacts inflation directly to the extent of its weighted contribution in the overall price index. As petroleum products are used as inputs in several other commodities, prices of all those commodities also change which, in turn, impacts inflation indirectly. In the Indian case, in the absence of countervailing policy intervention, it is estimated that every US dollar increase in crude oil prices could potentially add 15 basis points to WPI inflation as a direct effect and another 15 basis points as an indirect effect.

The upward revision in coal prices in June 2004 reflected the twin pressures of higher domestic demand and the sharp increases in international coal prices driven by strong Chinese growth (Chart 29). The Union Budget, 2005-06 has proposed to bring down the customs duty on coking coal with high ash content to 5 per cent from 15 per cent. Furthermore, coal production is estimated to have risen by 6.0 per cent in 2004-05 (up to February) from 4.9 per cent during the corresponding period of the previous year.



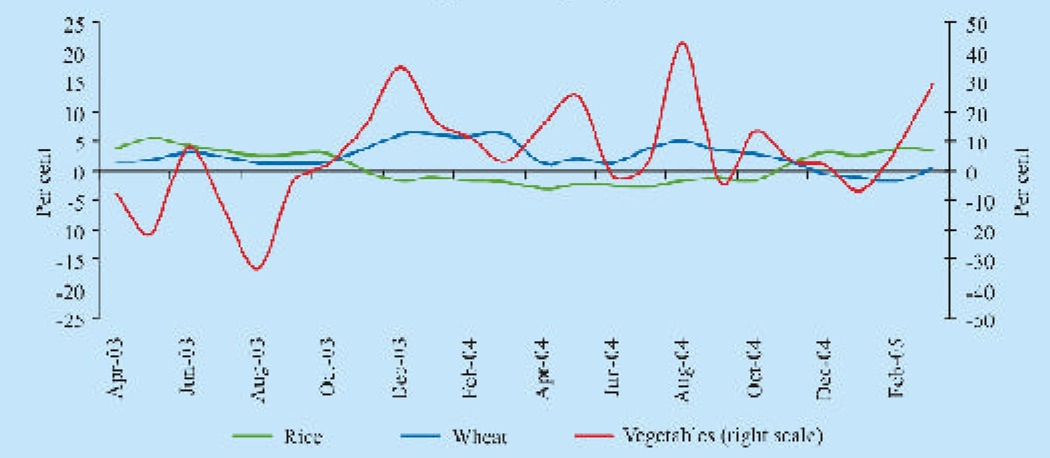
Domestic iron and steel prices increased by 21.3 per cent during 2004-05 on top of an increase of 34.6 per cent in 2003-04 (Chart 30). This accounted for as much as 17.2 per cent of the increase in headline inflation during 2004-05. A sharp increase in international steel prices together with higher domestic demand drove up steel prices during April-August 2004. During April 2004-February 2005, the growth of production of finished steel at 3.2 per cent was lower than the increase of 6.3 per cent in consumption which was driven by substantial construction activity. The impact of the increase in international steel prices on domestic prices was partly contained by cuts in the customs and excise duties on inputs as well as on finished products. Domestic steel prices have stabilised since August 2004 in line with international price movements. Although the Union Budget, 2005-06 has proposed to restore the excise duty on iron and steel to the normal level of 16 per cent from 12 per cent, this is not expected to have any major impact on prices as the entire duty is modvatable by most categories of consumers.

Chart 30: Metal Prices



Prices of agricultural and agriculture-related commodities rose during July-August 2004, reflecting mainly the concerns about the impact of the South-West monsoon on the *Kharif* crop (Chart 31). Rice prices hardened *albeit* marginally.

Chart 31: Agricultural Commodity Price Inflation (year-on-year)

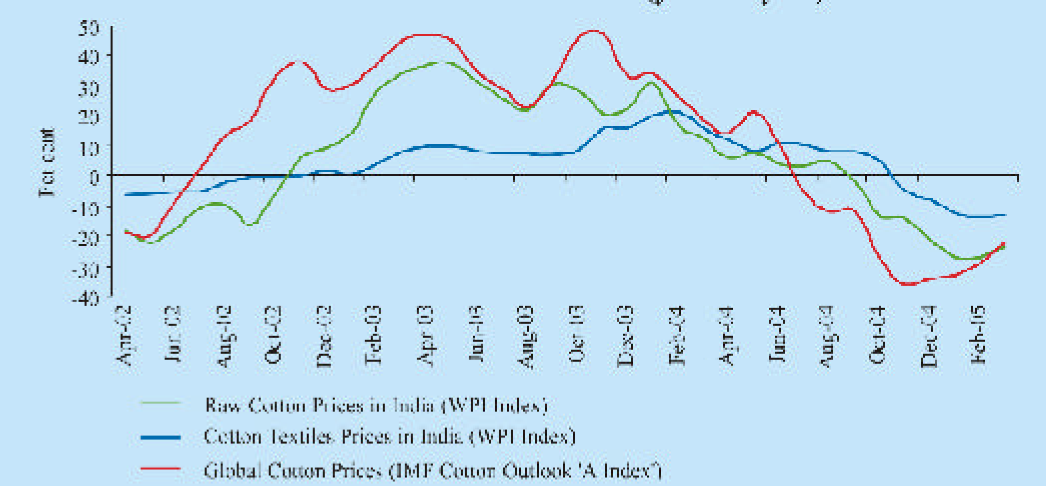


Jowar price inflation increased to double digits by August as output of coarse grains declined during the year. Potato prices also rose sharply in June-October as the unseasonal rainfall affected the crop on top of a lean season in 2003-04.

Prices of agriculture and related products began to move downwards in the latter half of the year as a result of the easing of drought fears and the expectation of a bumper *rabi* crop.

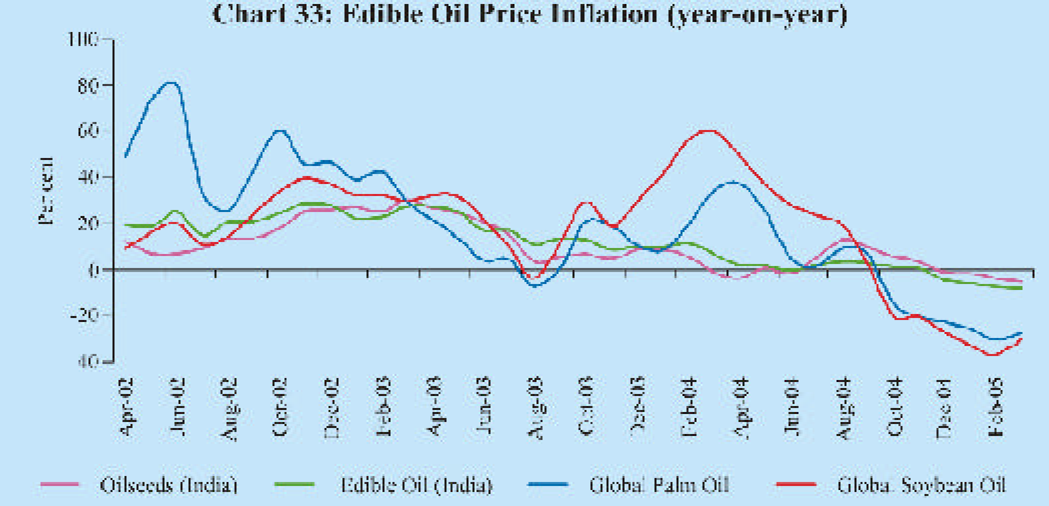
The intra-year movements in raw cotton and cotton textile prices reflected the diverse impact of international prices and domestic supply. Raw cotton prices began to harden in July 2004, reflecting worries about the South-West monsoon. The cotton crop is estimated to be 16.1 million tonnes during 2004-05, up from 13.8 million tonnes last year, spurred by the highly remunerative prices of the previous year. As supply concerns receded, cotton prices began to decline from September 2004 in line with the international price movements (Chart 32). Higher production of cotton also drove down prices of cotton textiles during the year.

Chart 32: Cotton Price Inflation (year-on-year)



Domestic oilseeds prices hardened in the first phase despite the bumper crop of the previous year (Chart 33). Reports of a domestic crop failure resulting from inadequate rainfall were compounded by uncertainties over the possibilities of *El Nino* damaging Malaysian palm oil production. Besides, imports of edible oils during April 2004-January 2005 at 3.6 million tonnes were lower than 4.5 million tonnes during the corresponding period of 2003-04 in the wake of sufficient domestic production. Oilseeds prices began to soften in the second phase beginning September 2004 as the *Kharif* crop estimated at 16.8 million tonnes turned out to be actually higher than the preceding year's output of 15.0 million tonnes. Furthermore, the acreage for the *rabi* season was also higher than the area sown in 2003-04. In order to contain rising prices, the Government reduced tariffs on vegetable oils in September 2004. A mix of reduction in tariff values alongside an increase in import duties was deployed in February 2005 to take care of the interests of both the farmers and the consumers.

Chart 33: Edible Oil Price Inflation (year-on-year)



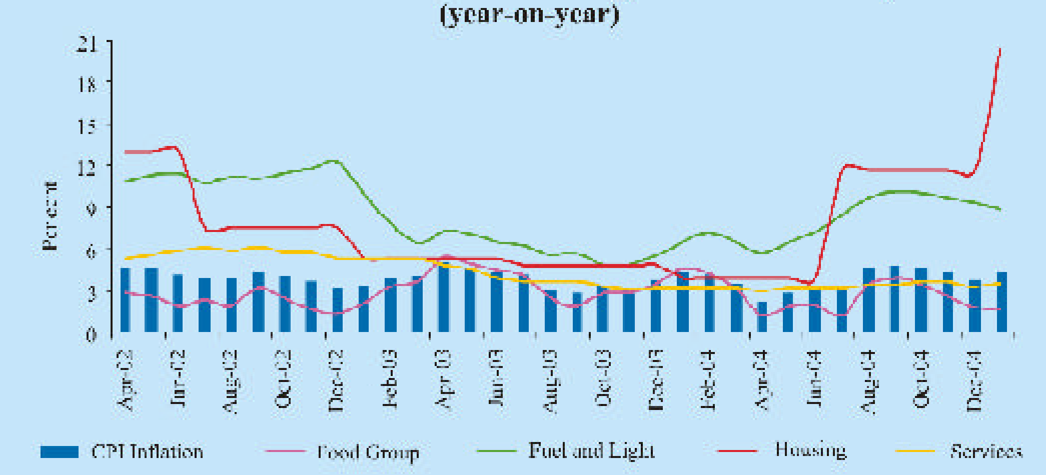
Sugar prices hardened in the latter half of 2004-05, reflecting domestic demand and supply imbalances as well as higher international prices (Chart 34). International sugar prices, in turn, have been affected by the domestic situation as India is the world's largest consumer of sugar. The decline in output in the face of growing consumption put pressure on sugar prices in 2004-05. Although the Government released higher free sale quota of sugar during the latter half of the year, prices of sugar continued to increase unabated till March 2005.

Chart 34: Sugar Price Inflation (year-on-year)

Consumer Price Inflation

Retail price inflation, measured by y-o-y variation in the consumer price index for industrial workers (CPI-IW), accelerated to 4.8 per cent in September 2004 from 2.2 per cent in the beginning of the financial year and 2.9 per cent a year ago (Chart 35). This was driven by the increase in food prices emanating from the deficient and uneven progress of the South-West monsoon during July-August 2004. The food group (weight of 57 per cent) accounted for as much as 45 per cent of the overall retail inflation (y-o-y) in September 2004. Consumer price inflation decelerated thereafter to 3.8 per cent by December 2004 reflecting the easing of the impact of the monsoon on food prices. Consumer price inflation firmed up to 4.4 per cent in January 2005 mainly due to increase in the prices of fish, meat, sugar, kerosene oil and housing, before decelerating to 4.2 per cent in February 2005. On an annual average basis, CPI inflation at 3.8 per cent in February 2005, remained broadly at the level of the previous year.

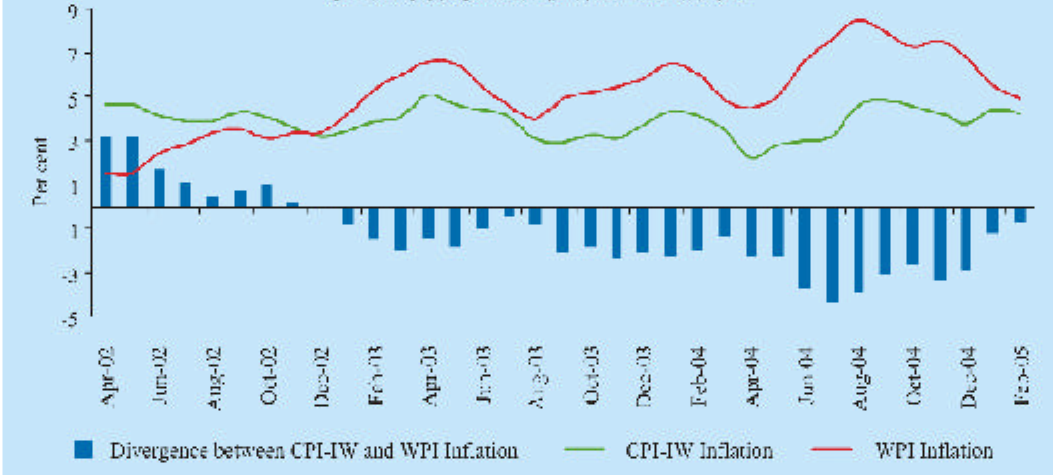
Chart 35: Consumer Price Inflation (Industrial Workers) (year-on-year)



All other measures of consumer price inflation also showed upward movements in the first half of 2004-05. The annual CPI inflation for Urban Non-Manual Employees increased from 2.9 per cent in April 2004 to 4.0 per cent by August and remained steady at that level till November 2004. It fell to 3.6 per cent in December 2004 before edging up to 3.8 per cent in February 2005. CPI inflation for Agricultural Labourers increased from 1.5 per cent in the beginning of the financial year to 3.6 per cent by October 2004. It, however, gradually declined thereafter to 2.4 per cent in February 2005, lower than the previous year's level of 3.1 per cent. CPI inflation for Rural Labourers also increased from 1.8 per cent in the beginning of the year to 3.6 per cent by October 2004 and thereafter declined gradually to 2.4 per cent in February 2005.

A distinctive feature of the recent inflation experience was a wedge between consumer price inflation and wholesale price inflation for the larger part of 2004-05 (Chart 36). This essentially reflected the differences in the composition of the two commodity baskets. Key drivers of wholesale price inflation such as fuels and metals have a negligible weight in the consumer price indices.

Chart 36: CPI and WPI Inflation



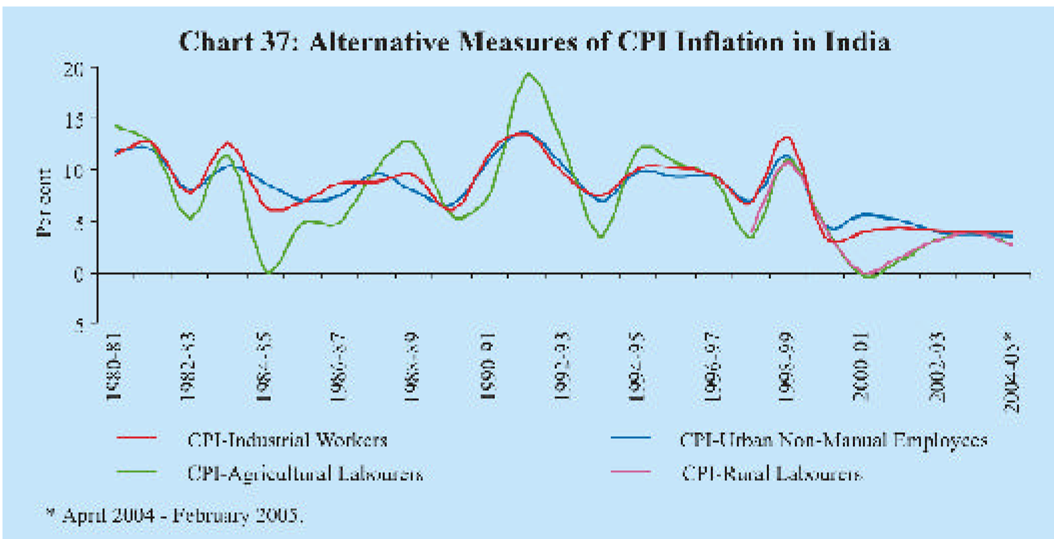
Harmonised Index of Consumer Prices (HICP)

Various price indices are currently available to measure prices paid by a consumer or a producer. Most countries, therefore, compute indices of consumer prices to capture the cost of living and producer prices to capture the cost of production. In India, there are two sets of indices, *viz.*, wholesale price index (WPI) and consumer price indices (CPIs), based on social classification and category of residence (rural or urban). The four broad measures of CPIs available at the national level to capture prices of a defined basket of goods and services consumed by a particular segment of the population are: CPI for Agricultural Labourers (CPI-AL) (defined as households which derive half their income through agricultural labour); CPI for Rural Labourers (CPI-RL) (households which derive half their income through rural labour); CPI for Industrial Workers (CPI-IW) (working class families, essentially in urban areas) and CPI for Urban Non-Manual Employees (CPI-UNME) (urban middle class families).

There are two key sources of difference in the four CPIs. The weight of cereals is about 10 per cent in the CPI basket for urban non-manual employees and about 20 per cent for industrial workers, while it is around 40 per cent for the agricultural/rural labourers. Housing is not considered in the CPI for agricultural/rural labourers, while it has a weight of as high as 16.4 per cent in the CPI for urban non-manual employees and 8.7 per cent in the CPI for industrial workers.

Although various measures of CPI do move together in the long run, significant variations have been observed in the short-run (Chart 37). This renders the interpretation of inflationary pressures difficult which, in turn, complicates the process of monetary policy formulation.

While different consumer price indices serve the purpose of assessing inflation for different sections of society, the analytical value of information provided by different CPIs can be enhanced by combining them into a Harmonised Index of Consumer Prices (HICP) which assesses consumer price inflation on a economy-wide scale.



V. FINANCIAL MARKETS

International financial markets weathered the bouts of uncertainty pervading various segments during the year and experienced heightened activity as risk aversion ebbed and appetite of investors for both advanced and emerging markets was rekindled after a brief lull in the second quarter of 2004-05. Money market rates firmed up in most economies as some of the leading central banks began to reverse their accommodative monetary policy stances in response to inflationary pressures (Table 18).

Table 18 : Short-term Interest Rates

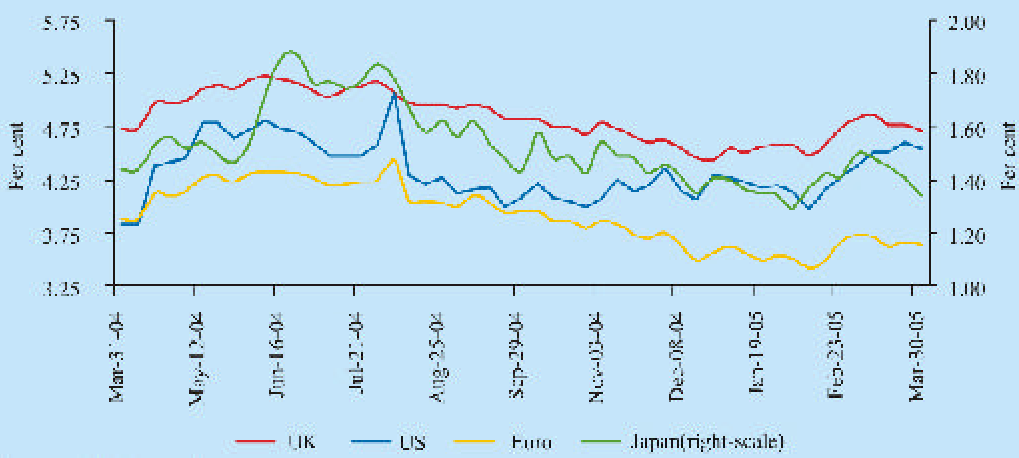
(Per cent)

Country	March 2005	January 2005	March 2004	March 2003
1	2	3	4	5
Advanced Economies				
US	2.90	2.56	1.04	1.18
UK	4.91	4.81	4.31	3.63
Euro Area	2.14	2.14	1.96	2.53
Japan	0.02	0.02	0.03	0.02
Emerging Market Economies				
China	2.25	2.50	–	–
Hong Kong	2.45	0.85	0.17	1.37
South Korea	3.55	3.53	3.90	4.76
Argentina	4.44	4.38	2.88	8.40
Brazil	19.24	18.24	16.02	23.65
Malaysia	2.82	2.82	3.00	3.10
Philippines	6.38	7.00	9.19	8.44
Singapore	2.00	1.75	0.69	0.69
Thailand	2.62	2.45	1.31	1.75

Source : The Economist.

Government bond yields in advanced economies firmed up during April-August, 2004 as inflation began to harden on account of a spurt in fuel and other key commodity prices. They started declining from September 2004 as inflation expectations eased with the leveling off of commodity prices (Chart 38).

Chart 38: 10-year Govt. Bond Yields - Advanced Economies

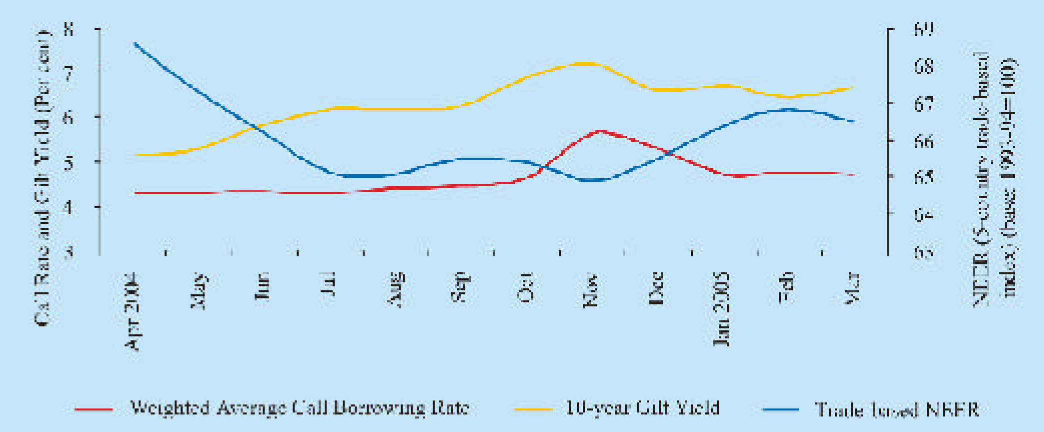


Source : The Economist

Equity markets displayed divergent trends across the world as country-specific factors dominated the generally positive expectations generated by the strengthening of the global recovery *albeit* dampened by higher oil prices.

Domestic financial markets remained broadly stable during 2004-05 in an environment suffused with uncertainty and nervous sentiment created by the upturn in the international interest rate cycle, switches in capital flows and a soaring of international fuel prices. Money market segments exhibited easy liquidity conditions during the greater part of the year barring episodic pressures. The foreign exchange market remained generally orderly with moderate upward pressure on the exchange rate, notwithstanding the ebbing of capital flows during May-July 2004 and the rise in demand for foreign exchange due to higher oil prices. Discounts in the forward markets, however, turned into premia by June 2004. Yields in the Government securities market firmed up due to resurgence of inflationary pressures in the first two quarters of the year and the hardening of international interest rates (Chart 39).

Chart 39: Call Rate, Gilt Yield and Nominal Effective Exchange Rate



The credit market continued to experience a step-up in activity which began in the second half of 2003-04. Commercial credit offtake remained strong and broad-based on the back of strengthening of industrial activity. Medium and large industry joined the housing and retail segments to drive up the demand for banks' non-food credit. Shrugging off a sluggish phase, the equity market staged a strong rally beginning in the second half of 2004, which pushed the BSE Sensex to a historic high in March 2005 (Table 19).

Table 19 : Domestic Financial Markets at a Glance – 2004-05

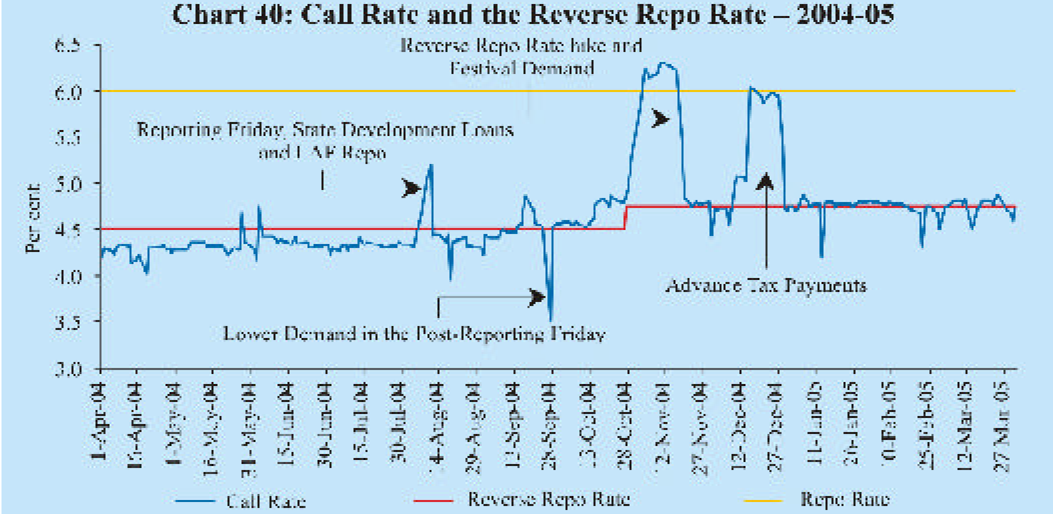
Month	Average Daily Turnover (Rs. crore)	Average Call Rates (Per cent)	10-year Yield (Per cent)	Turnover in Govt. Securities (Rs. crore)+	Average Daily Inter-bank Turnover (US $ Million)	Average Exchange Rate (Rs. per US $)	RBI's net Foreign Currency Sales (-)/ Purchases (+) (US $ Million)	Forward premia 3-month (Per cent)	Net OMO Sales (-) / Purchases (+)(Rs. crore)	Average Daily Reverse Repo (LAF) Outstanding (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
April	12,916	4.29	5.14	3,00,864	10,118	43.93	7,427	(-) 0.35	-253	75,006	2,243	5,048	5809	1848
May	10,987	4.30	5.29	1,92,264	8,521	45.25	-220	(-)1.33	-116	74,502	2,188	4,710	5205	1640
June	10,973	4.35	5.81	1,75,802	7,741	45.51	-413	0.93	-60	61,981	1,681	3,859	4824	1506
July	8,632	4.31	6.18	1,30,400	7,684	46.04	-1,180	2.25	-218	59,594	1,793	4,265	4973	1568
August	11,562	4.41	6.16	1,29,373	5,753	46.34	-876	2.85	-78	42,692	1,736	3,948	5144	1615
September	17,088	4.45	6.23	1,75,635	7,266	46.09	19	2.20	-131	31,589	1,800	4,023	5423	1692
October	16,667	4.63	6.89	1,12,709	7,039	45.78	-99	2.87	-189	10,805	1,730	3,785	5702	1795
November	13,820	5.62	7.18	78,225	9,808	45.13	3,792	2.16	-342	-5,066	1,787	4,102	5961	1874
December	19,527	5.28	6.57	1,33,447	9,309	43.98	1,393	2.03	-339	7,570	2,184	5,026	6394	2022
January	16,534	4.72	6.69	1,10,535	7,875	43.75	0	2.50	-703	18,721	2,310	5,249	6307	1978
February	16,041	4.76	6.45	1,29,917	11,404	43.68	–	1.99	-37	18,930	2,484	4,999	6595	2067
March	15,293	4.72	6.65	87,892	–	43.69	–	1.82	-389	29,809	2,706	5,139	6679	2096

OMO : Open Market Operations. + : Outright turnover in Central Government dated securities. – : Not available.
BSE : The Stock Exchange, Mumbai. NSE : National Stock Exchange of India Ltd. LAF : Liquidity Adjustment Facility.

Money Market

Money markets began the year in conditions of abundant liquidity stemming from the overhang in the system, a bunching of capital flows in April and the announcement of a truncated Government borrowing programme. The Reserve Bank, in fact, had to supplement large-scale reverse repo operations with sale of Government paper under the Market Stabilisation Scheme (MSS), operationalised in April 2004. Reflecting these easy liquidity conditions, average daily call money borrowing rates ruled at sub-reverse repo rate levels, except on a few occasions in May, June, August and September when call rates crossed the policy floor rate (Chart 40). Temporary mismatches on account of outflow

Chart 40: Call Rate and the Reverse Repo Rate – 2004-05



of funds, short cover by some banks and primary dealers (PDs) and payment by market participants for primary auction of Government bonds pushed up call rates in the late hours on May 28 and June 4, 2004. Call rates also firmed up in the first half of August due to State Development Loan (SDL) auctions, redemption pressure on mutual funds and the need to meet reserve requirements by the reporting Friday of August 13, 2004. The Reserve Bank had to inject liquidity through repos (Rs.5,000 crore on August 12). During the second half of September 2004, call rates firmed up again due to outflow of funds on account of advanced tax payments, substantial rise in surplus cash balances of the Government with the Reserve Bank and the hike in the cash reserve ratio (CRR).

The scenario began to change by October 2004 when conditions in the money market tightened. Pressures emanating from a number of factors such as the robust expansion of non-food credit, drying up of capital inflows and an increase in reserve requirements drove the call rates above the reverse repo rate in the second half of October. A hike in the reverse repo rate by 25 basis points to 4.75 per cent effective October 27, 2004 correspondingly raised the floor in the money markets. Festival cash demand and scheduled Government securities auctions drove call rates beyond the repo rate to a peak of 6.30 per cent on November 18, 2004. The Reserve Bank injected liquidity through LAF repo operations in mid-November 2004 to calm the market sentiment. With the ebbing of festival cash demand and revival of FII inflows, call rates came down to 4.8 per cent on November 25, 2004. Call rates firmed up again in the second half of December 2004 due to tightening of liquidity conditions resulting from advance tax payments, continued strong growth in non-food credit and the Government maintaining substantial surplus cash balances with the Reserve Bank.

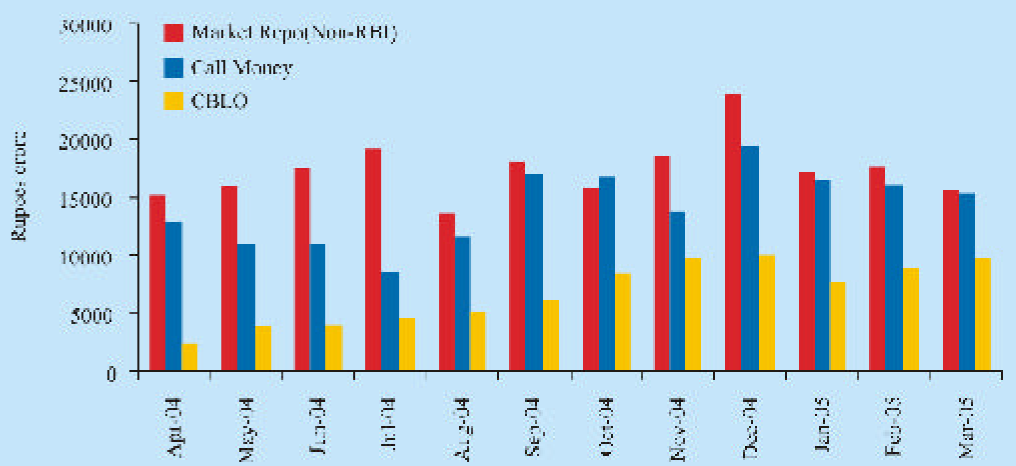
The turnover in the call/notice money market continued to contract, reflecting the underlying surplus situation combined with the emergence of alternative segments such as the repo (other than with the Reserve Bank) market and the Collateralised Borrowing and Lending Obligations (CBLOs). A part of the demand for funds has shifted from the call money market to the repo and CBLO as these segments offer lower cost funding. This, in turn, helped in achieving greater integration among the three segments. The call/notice money markets remained stable throughout the year except for some volatility in November-December 2004 (Table 20).

Table 20 : Call/Notice Money Market – 2004-05

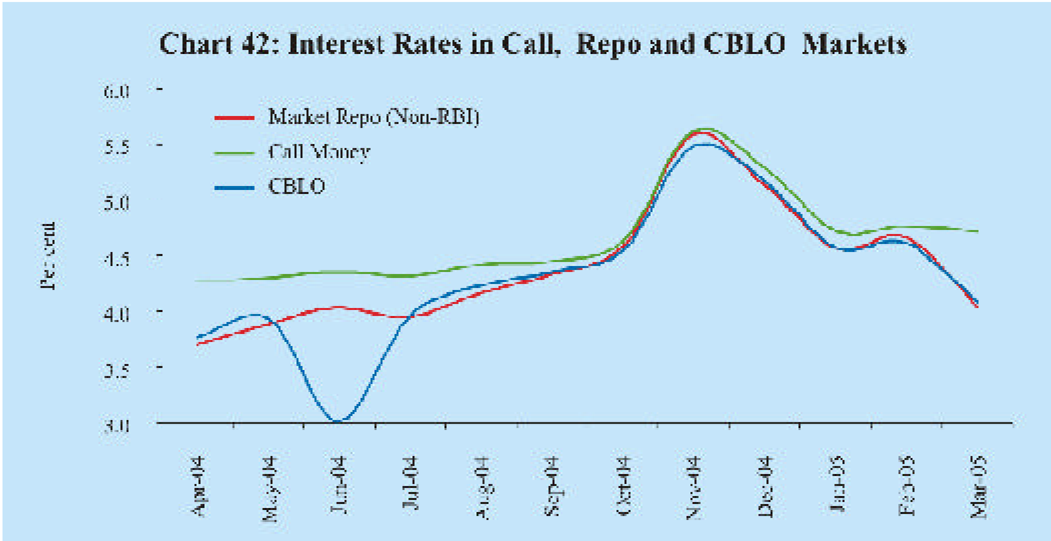
Month	Average Call /Notice Money Borrowing Rate (Per cent)	Coefficient of Variation of Call Rate	Average Daily Call/ Notice Turnover (Rs. Crore)
1	2	3	4
April	4.29	0.01	12,916
May	4.30	0.02	10,987
June	4.35	0.02	10,973
July	4.31	0.01	8,632
August	4.41	0.05	11,562
September	4.45	0.05	17,088
October	4.63	0.03	16,667
November	5.62	0.11	13,820
December	5.28	0.11	19,527
January	4.72	0.01	16,534
February	4.76	0.03	16,041
March	4.72	0.02	15,293

The gradual exit of non-bank participants from the call money market led to the increased activity in the repo (other than with the Reserve Bank) and CBLO segments of the market (Chart 41).

Chart 41: Turnover in Call, Repo and CBLO Markets



Interest rates in CBLO and market repo (other than with the the Reserve Bank) segments moved in alignment with call rates (Chart 42). All these rates are now better aligned with the Reserve Bank's reverse repo rate.



Treasury Bills

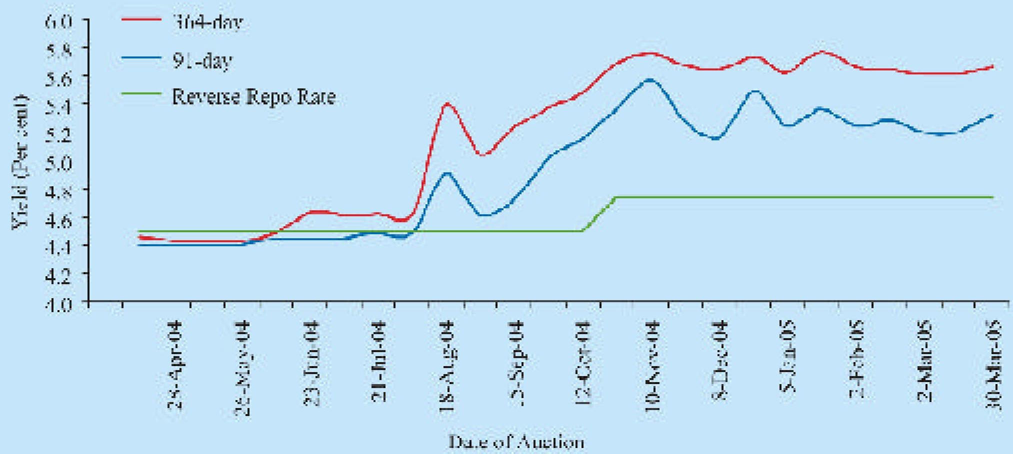
Excess liquidity conditions at the beginning of 2004-05 evinced a vigorous market response to Treasury Bill auctions (Table 21). This was reflected in an increase in bid-cover ratios (ratio of competitive bid amount received to notified amount). Primary yields of 91-day and 364-day Treasury Bills fell below the reverse repo rate during April-May 2004.

Table 21 : Treasury Bills in the Primary Market – 2004-05

	Average Implicit Yield at minimum cut-off Price (Per cent)		Bid-Cover Ratio	
	91-day	364-day	91-day	364-day
1	2	3	4	5
April 2004	4.38	4.44	2.15	2.47
May	4.39	4.33	2.93	2.46
June	4.44	4.55	2.61	1.28
July	4.46	4.60	2.39	2.06
August	4.76	5.00	1.81	3.36
September	4.72	5.14	2.51	2.83
October	5.15	5.46	1.82	2.75
November	5.47	5.71	2.80	2.64
December	5.30	5.69	2.69	2.81
January 2005	5.31	5.69	2.19	2.06
February	5.25	5.65	2.99	2.81
March	5.24	5.63	2.31	2.74

Domestic inflationary pressures pushed up 91-day Treasury Bill yields in the primary market beyond the reverse repo rate in August 2004. Yields started declining from December 2004 with the easing of headline inflation. The yield spread between the 91-day and 364-day Treasury Bills widened from six basis points in April 2004 to 39 basis points in March 2005 (Chart 43).

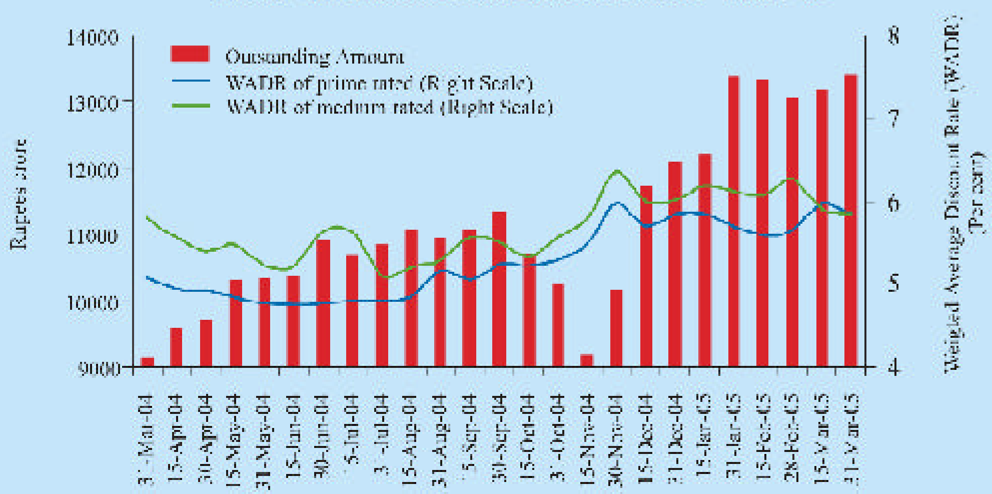
Chart 43: Yields of Treasury Bills – 2004-05



Other Money Market Instruments

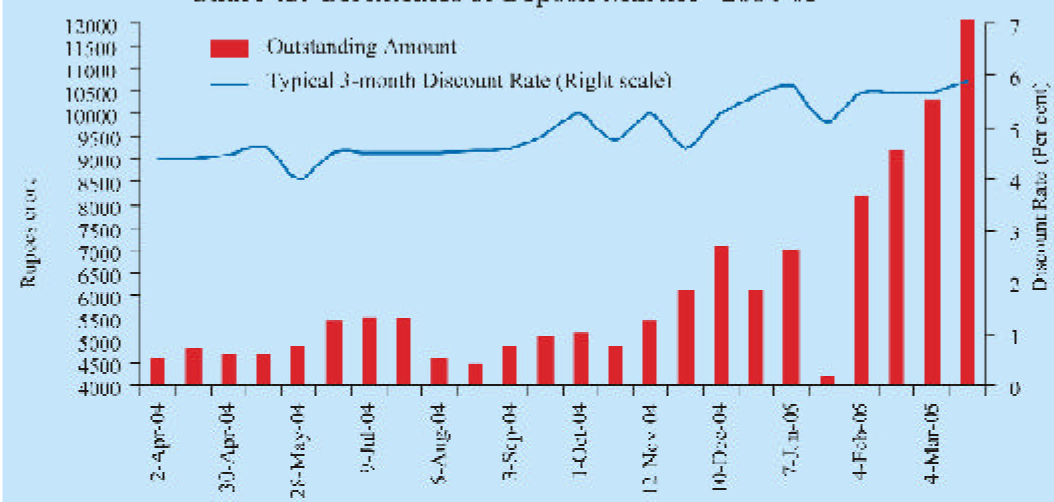
The commercial paper (CP) market remained buoyant despite the strong credit offtake. Outstanding CPs increased from Rs.9,131 crore at the beginning of the year to Rs.13,419 crore at the end of March 2005. The share of CPs issued by leasing and finance companies in the total CPs outstanding increased from 48.4 per cent in March 2004 to 64.2 per cent in March 2005, partly reflecting the policy-induced phasing out of public deposits. The weighted average discount rate (WADR) on commercial paper began to edge up during the year with higher credit demand. The spread between the WADR of prime-rated and medium-rated companies moved in a relatively narrow band of 11-87 basis points during the year as compared with 21-162 basis points in the preceding year (Chart 44).

Chart 44: Commercial Paper Market - 2004-05



The market for certificates of deposit (CDs) remained subdued during the first half of the year because of easy liquidity conditions. The amount of CDs outstanding increased from Rs.4,626 crore in early April 2004 to Rs.12,078 crore by mid-March 2005 mainly on account of higher issuances by some private sector banks in line with seasonal trends. The typical three-month discount rate on CDs increased by 145 basis points during the year with sustained commercial credit offtake (Chart 45).

Chart 45: Certificates of Deposit Market - 2004-05



Other money market segments recorded heightened activity. The market for forward rate agreements and interest rate swaps (FRAs/IRS) continued to expand during the year. The number of contracts for both FRAs/IRS increased by 88.9 per cent during April 2004-March 2005. The notional amount increased to Rs.11,08,036 crore in early March 2005 from Rs.5,18,260 crore in March 2004. In most of these contracts, the NSE-Mumbai Inter-Bank Offered Rate (MIBOR) and Mumbai Inter-Bank Forward Offered Rate (MIFOR) were used as the benchmark rates. The other benchmark rates used included secondary market yields of the Government of India securities with a residual maturity of one year and the primary cut-off rate on 364-day Treasury Bills. The market for FRAs and IRS is getting enlarged with the participation of select public sector banks, PDs and foreign and private sector banks.

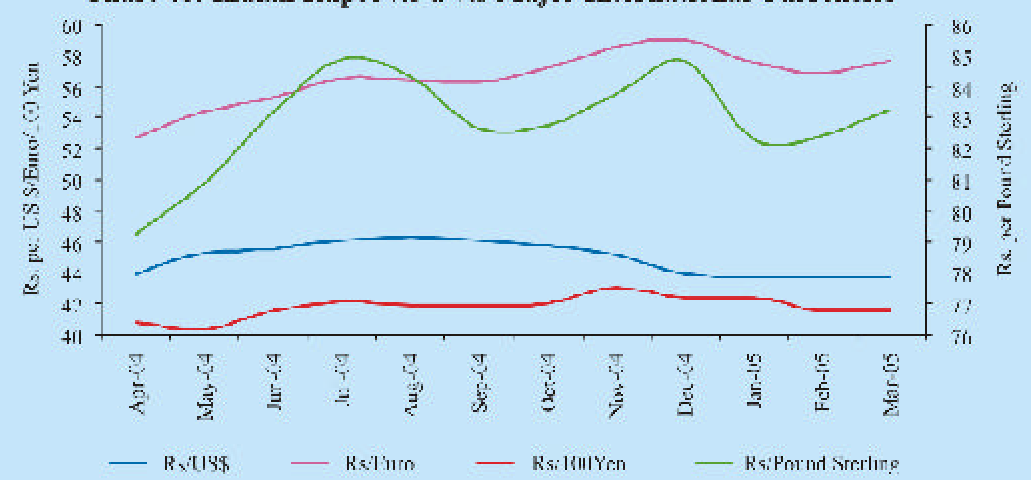
Turnover in collateralised borrowing and lending obligations (CBLO), introduced in January 2003, expanded rapidly. The daily average turnover in the CBLO segment increased from Rs. 2,506 crore in March 2004 to Rs.9,625 crore in March 2005. About 110 members were operating in the CBLO segment of the Clearing Corporation of India Limited (CCIL) in March 2005 out of which 56 were active. While the supply of funds has been augmented by mutual funds, the demand side has been strengthened by regular participation of public sector banks, followed by primary dealers and private sector banks on account of favourable borrowing costs in the CBLO segment *vis-à-vis* the call market.

Foreign Exchange Market

The excess supply conditions that prevailed in the foreign exchange market during the major part of 2003-04 persisted at the beginning of 2004-05. Pressures began to emerge by mid-May 2004 due to a shift in market sentiment driven by turbulence in the equity market and rising global oil prices. The ebbing of capital flows, the rising demand for imports and the surge in international oil prices drained away the excess supplies, leading the Indian rupee to depreciate against the US dollar by 4.5 per cent during May-July 2004. With the resumption in portfolio flows in August, the rupee started gaining strength against the US dollar. The US dollar's weakness against the major international currencies and a decline in international crude oil prices helped the rupee to recover lost ground and appreciate against the US dollar by 6.6 per cent during August-December 2004.

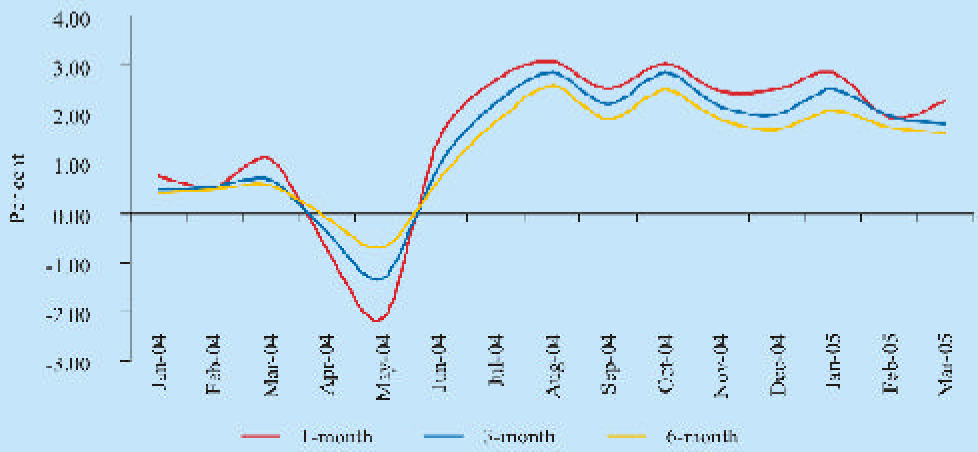
During 2004-05, the rupee moved in the range of Rs. 43.36-46.46 per US dollar, depreciating by only 0.7 per cent over its end-March 2004 level. On the other hand, the rupee depreciated against the Pound Sterling and the Euro by 3.0 per cent and 6.0 per cent, respectively, and appreciated by 2.1 per cent against the Japanese Yen (Chart 46). Although the five-country (trade-weighted) nominal effective exchange rate (NEER) of rupee depreciated by 3.3 per cent during April-January 2004-05, the real effective exchange rate (REER) fell marginally by 0.4 per cent, indicating fair valuation.

Chart 46: Indian Rupee *vis-a-vis* Major International Currencies



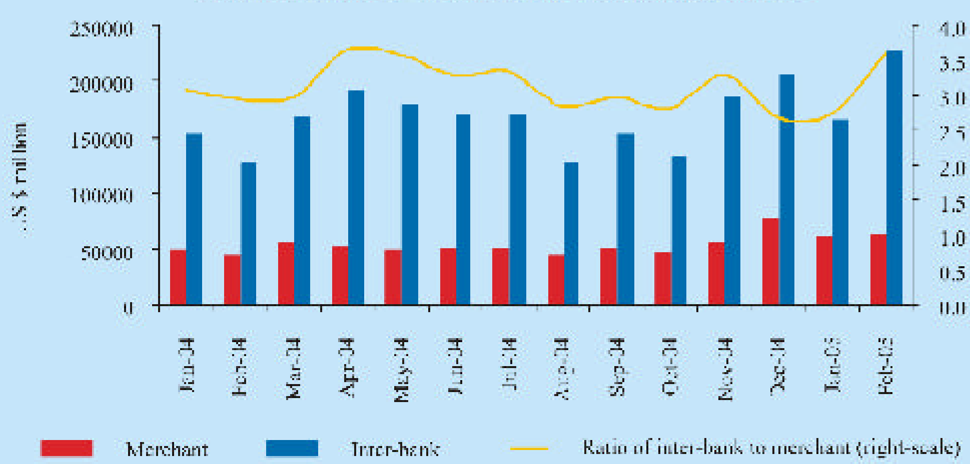
Forward rates began the year at a discount, reflecting the excess supply conditions in the spot segment. They, however, turned into premia from June 2004 with the depreciation of the rupee against the US dollar due to the strong pick-up in import demand and rising oil prices (Chart 47). The variation in forward premia is indicative of greater two-way movement of the rupee in recent months.

Chart 47: Movements in Forward Premia



Both the merchant and inter-bank segments of the foreign exchange market recorded increased activity. While the total monthly merchant turnover increased to US $ 63.3 billion in February 2005 from US $ 52.4 billion in April 2004 after achieving a peak of US 76.5 billion in December 2004, total monthly inter-bank turnover increased to US $ 228.1 billion in February 2005 from US $ 192.2 billion during April 2004 (Chart 48). The ratio of inter-bank to merchant turnover hovered in the range of 2.7-3.7 during the year (up to February 2005), indicating orderly market activity.

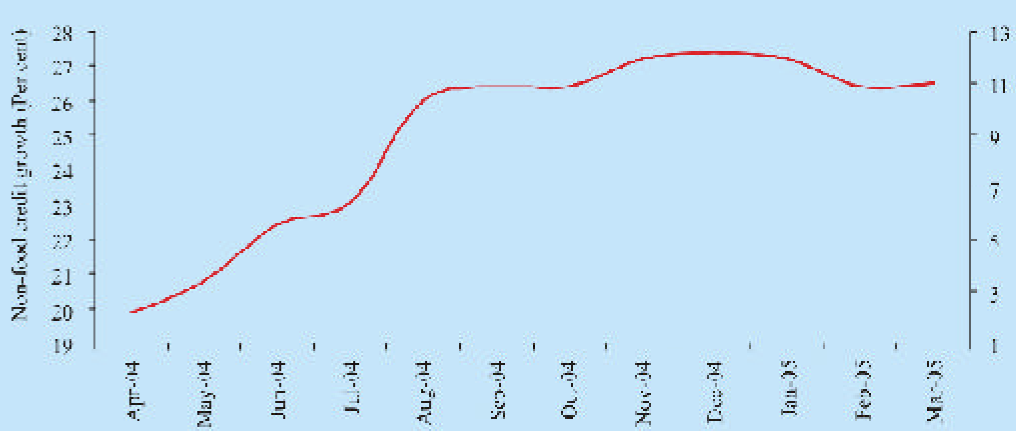
Chart 48: Turnover in Foreign Exchange Market



Credit Market

A distinctive feature of the domestic financial markets during the year was the sharp increase in credit offtake. During 2004-05, non-food credit grew by 26.5 per cent (net of conversion[1]) as compared with 18.4 per cent in the corresponding period of the previous year (Chart 49). The decline in food credit extended by the banking system in 2003-04 reversed in 2004-05 on account of higher procurement and lower offtake under open market sales.

Chart 49: Year-on-year Non-food Credit Growth



In consonance with the upsurge in industrial activity, credit to medium and large industries expanded by Rs. 32,274 crore during April-January 2004-05 as compared to a meagre increase of Rs. 1,736 crore during the corresponding period of the previous year (Table 22). There was also a sustained expansion in retail sector, particularly to the housing and consumer credit. Priority sector advances continued to expand at a steady pace. Credit to agriculture accelerated to 18.9 per cent during 2004-05 (up to January) from 12.3 per cent during the comparable period of the previous year, while the demand for housing loans remained strong. In order to improve flow of credit to the housing sector, the Reserve Bank allowed banks to extend direct finance to the housing sector up to Rs.15 lakh, irrespective of location, as part of their priority sector lending. At the same time, as a temporary counter-cyclical measure, risk weights were hiked from 50 per cent to 75 per cent in the case of housing loans and from 100 per cent to 125 per cent in the case of consumer credit, including personal loans and credit cards.

[1] The conversion of a non-banking entity into banking entity from October 11, 2004.

Table 22 : Sectoral and Industry-wise Deployment of Gross Bank Credit of Scheduled Commercial Banks (Fiscal Year Variations) – Select Categories

(Rupees crore)

Sector/Industry	2003-04 (Up to January)		2004-05 (Up to January)	
	Absolute	Per cent	Absolute	Per cent
1	2	3	4	5
1. Priority sector#	33,720	15.9	48,303	18.3
Agriculture	9,075	12.3	17,155	18.9
Small Scale	2,627	4.3	3,211	4.9
Others	22,018	28.3	27,937	26.0
2. Industry (Medium & Large)	1,736	0.7	32,274	13.1
Petroleum	-3,923	-26.6	1,609	13.1
Infrastructure	6,693	25.5	15,053	40.4
Other Metal & Metal Products	-657	-7.7	1,349	16.5
Construction	493	10.1	1,838	30.7
Electricity	1,482	13.3	1,831	13.0
Drugs & Pharmaceuticals	793	10.0	1,292	14.9
Gems & Jewellery	1,372	18.2	1,678	18.3
3. Housing	11,901	32.5	20,581	39.6
4. Non-Banking Financial Companies	-472	-3.3	-24	-0.1
5. Wholesale Trade	965	4.3	6, 601	26.5
6. Export Credit	4,821	9.8	4,422	7.7

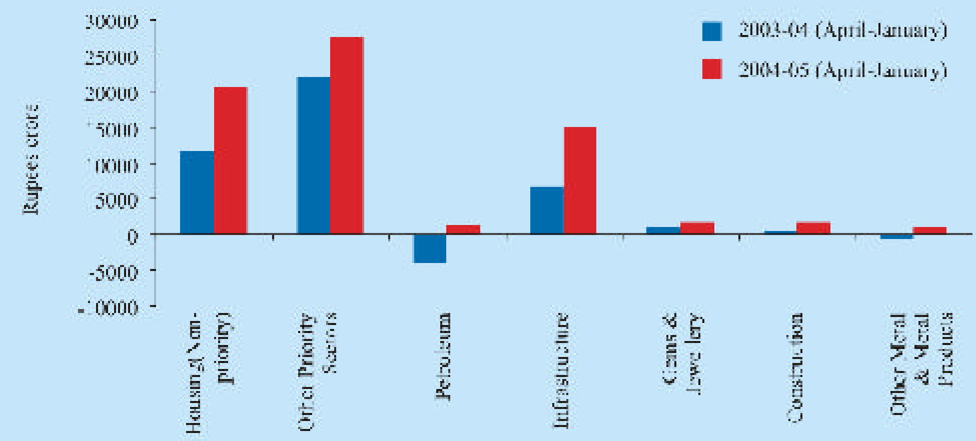
: Excluding investment in eligible securities.

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

The increase in industrial credit in 2004-05 was broad-based. Infrastructure continued to lead the credit absorption, accounting for 42 per cent of the industrial credit expansion during the first 10 months. Petroleum, construction, gems and jewellery, cotton textiles, electricity, iron and steel, other metals and metal products also recorded growth in credit offtake and together accounted for a third of the incremental offtake during April-January 2004-05. The higher demand for credit by infrastructure industries and construction reflected strong investment demand. Credit to the telecommunication sector, in particular, recorded a sharp increase of 65.3 per cent during 2004-05 (up to January) from 21.8 per cent. Credit for roads and ports increased by 43.8 per cent. Petroleum credit increased by 13.1 per cent during the same period in contrast to the decline of 26.6 per cent, partly reflecting the incomplete pass-through of the increase in international crude oil prices to domestic finished petroleum products. The higher credit to the gems and jewellery sector was driven by export demand (Chart 50). Credit offtake was, however, lower for industries such as coal, jute textiles, paper and paper products, engineering, sugar, tobacco and tobacco products, petro-chemicals, fertiliser and computer software.

Public sector banks (PSBs) marginally reduced their deposit rates in the tenor of one-year and above from a range of 5.00-6.00 per cent in March 2004 to

Chart 50: Credit Offtake by Major Industries



4.75-5.75 per cent by December 2004 in view of easy liquidity conditions. Deposit rates, however, hardened in March 2005 (Table 23).

Table 23 : Movements in Deposit and Lending Rates

(Per cent)

Interest Rate	March 2004	June 2004	September 2004	December 2004	March 2005@
1	2	3	4	5	6
1. Domestic Deposit Rate					
Public Sector Banks					
Up to 1 year	3.75-5.25	3.50-5.25	3.50-5.00	3.50-5.00	2.75-6.00
More than 1 year and up to 3 years	5.00-5.75	5.00-5.75	4.75-5.75	4.75-5.50	4.75-6.50
More than 3 years	5.25-6.00	5.25-5.75	5.25-5.75	5.00-5.75	5.25-7.00
Private Sector Banks					
Up to 1 year	3.00-6.00	3.00-6.00	3.00-6.00	3.00-6.00	3.00-7.00
More than 1 year and up to 3 years	5.00-6.50	5.00-6.50	5.00-6.50	5.00-6.75	5.00-7.25
More than 3 years	5.25-7.00	5.25-7.00	5.25-7.00	5.25-6.50	5.50-7.00
Foreign Banks					
Up to 1 year	2.75-7.75	2.75-7.50	2.75-7.50	3.00-5.75	3.00-6.25
More than 1 year and up to 3 years	3.25-8.00	3.25-8.00	3.25-8.00	3.50-7.00	3.50-7.00
More than 3 years	3.25.800	3.25-8.00	3.25-8.00	3.50-7.00	3.50-7.00
2. Benchmark Prime Lending Rate					
Public Sector Banks	10.25-11.50	10.25-11.50	10.25-11.50	10.25-11.25	10.25-11.25
Private Sector Banks	10.50-13.00	9.75-13.00	9.75-13.00	10.50-13.50	10.00-14.50
Foreign Banks	11.00-14.85	11.00-14.85	11.00-14.85	10.00-15.00	11.00-13.50
3. Actual Lending Rate*					
Public Sector Banks	4.00-16.00	4.25-16.00	2.75-16.00	3.50-19.50	–
Private Sector Banks	4.50-22.00	4.00-22.19	3.15-21.48	2.62-22.00	–
Foreign Banks	3.75-23.00	3.75-23.00	2.55-23.00	3.00-23.00	–

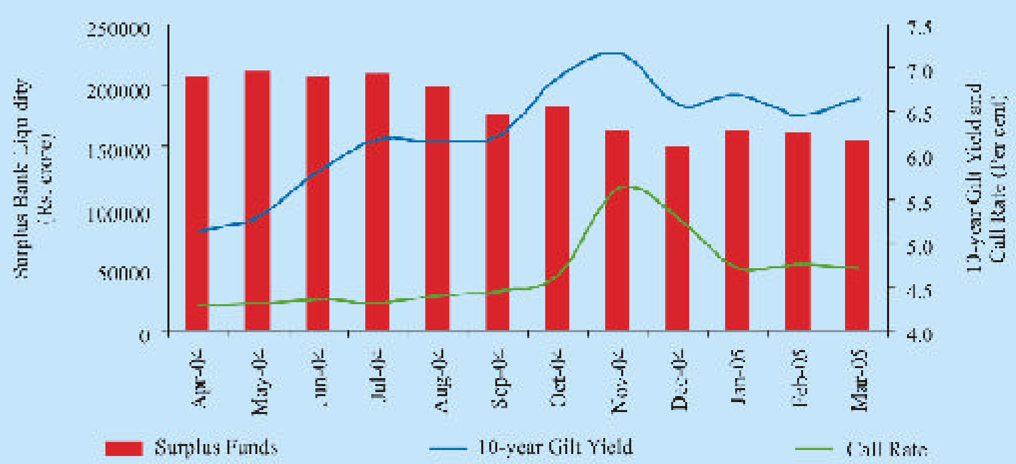
* : Interest rate on non-export demand and term loans above Rs.2 lakh excluding lending rates at the extreme 5 per cent on both sides. @ : As on March 4, 2005.

Prime lending rates (PLR) remained sticky, especially with higher credit demand. Sub-PLR lending of the banking system (excluding exports, the bulk of which is at sub-PLR) constituted over 65 per cent of total outstanding advances above Rs.2 lakh. The spreads around PLRs of PSBs (excluding 5 per cent of the credit sanctioned at extreme rates on either side of lending) for term loans narrowed during June-December 2004.

Government Securities Market

Activity in the Government securities markets during 2004-05 was essentially governed by domestic liquidity conditions, movements in international interest rates and inflationary expectations. Yields began to firm up from May 2004 onwards, driven by expectations about reversal of the accommodative monetary policy stance by the US Federal Reserve and the upturn in domestic inflation. A mix of higher credit offtake and drying up of capital inflows also led to contraction in surplus bank liquidity (net demand and time liabilities in excess of statutory pre-emptions and credit off take) and reduced the market appetite for Government paper (Chart 51). The 10-year benchmark yield moved up to 6.73 per cent on August 11, 2004 before retreating to 6.16 per cent by end-August 2004 with the reintroduction of one-day reverse repos in place of 7-day and 14-day reverse repos, announcement of fiscal measures to rein in inflation, lower than anticipated hike in the MSS ceiling (Rs.80,000 crore) and moderation in global oil prices. Besides, banks were also allowed in September 2004 to exceed the present limit of 25 per cent of total investment under held-to-maturity (HTM) category, provided the excess comprises only Statutory Liquidity Ratio (SLR) securities and the total SLR securities held in HTM category is not more than 25 per cent of the demand and time liabilities (DTL) as on the last Friday of the second preceding fortnight. To enable this, as a one-time measure, they could shift SLR securities to the HTM category as a one-time transfer during the accounting year 2004-05.

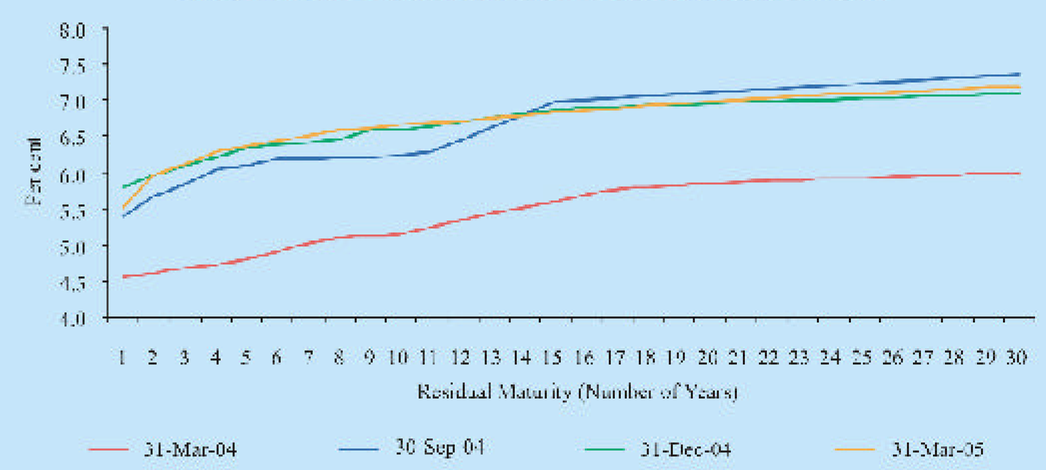
Chart 51: Surplus Bank Liquidity and Interest Rates



Gilt yields began to harden in the third quarter of the year. Although domestic inflation softened from the peak of 8.7 per cent in end-August 2004, higher inflation expectations fuelled by the spurt in international oil prices drove the 10-year yield up to a peak of 7.31 per cent on November 8, 2004. The turnover in the Government securities market contracted to about Rs.78,225 crore in November 2004 which was about 25 per cent of the April 2004 turnover. Strong festival demand in the wake of a hike in the CRR by 50 basis points in two stages on September 18, 2004 and October 2, 2004 added to market pressures.

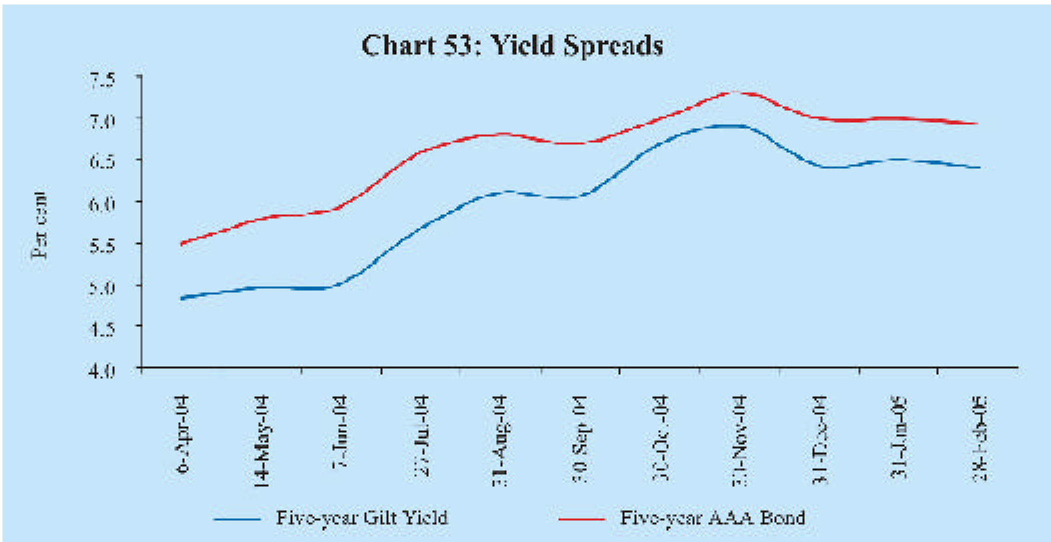
Yields softened during December 2004 and January 2005 with the easing of liquidity conditions resulting from the cancellation of scheduled auctions, a revival of capital inflows and a moderation of inflation expectations (Chart 52). The turnover in the gilt market also improved between December 2004 and January 2005. Beginning February 2005, Government securities market experienced two-way trading interest. The upgradation of the sovereign rating by Standard and Poor's (S&P) led to the softening of yields, while the hike in Employees' Provident Fund (EPF) rate was largely ignored by the market. The 10-year yield closed at 6.45 per cent on February 28, 2005. The yields hardened again in the beginning of March on concerns about the higher than expected Government borrowing as announced in the Union Budget 2005-06 and remained range-bound amidst lacklustre trading. The yields hardened further during the month on concerns arising from persistent rise in the international crude oil prices. The 10-year yield stood at 6.65 per cent on March 31, 2005.

Chart 52: Yield Curve of Central Government Securities



The yield curve shifted upwards almost continuously throughout the year with the hardening of yields across the maturity spectrum. The spread between 1-year and 10-year yields more than doubled to 140 basis points by end-November 2004 from 61 basis points at end-March 2004. By end-March 2005, the spread moderated to 114 basis points with the easing of inflationary pressures and revival of capital inflows.

The yield spreads between 5-year Government securities and AAA-rated corporate bonds widened during first half of the year 2004-05 but narrowed somewhat subsequently because of hardening of yields on Government securities (Chart 53).



Equity Market

The stock markets mirrored the growing confidence in the strong fundamentals of the Indian economy as ebullient investor sentiment strained against intermittent technical corrections. Primary market activity gathered momentum during the year, particularly in the equity segment. Foreign institutional investors (FIIs) remained net buyers in each month of the year barring May 2004. Although market sentiment was dampened by political uncertainties in the early part of the year, the surge in international crude oil prices and the edging up of inflation domestically, a strong rally in the secondary market pushed the domestic stock indices to new highs.

The BSE Sensex performed better as compared with the major international indices since November 2004 (Chart 54).

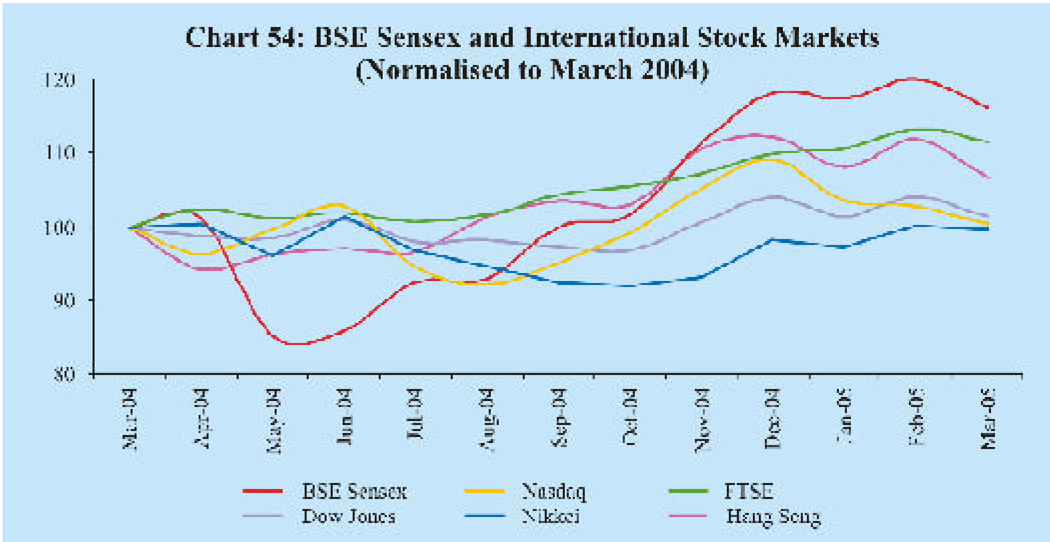


Chart 54: BSE Sensex and International Stock Markets (Normalised to March 2004)

Primary Market

Investor interest in the public issues segment strengthened during 2004-05, encouraged by the upbeat sentiment in the secondary market. Resource mobilisation through public issues (excluding offers for sale) increased sharply to Rs.19,666 crore from 56 issues as compared with Rs.7,190 crore from 35 issues during 2003-04 (Chart 55). Non-Government public limited companies (private sector) accounted for 65.3 per cent of total resource mobilisation by way of public issues. Of the 56 issues in the current financial year, 23 issues were initial public offerings (IPOs), of which 22 were by non-financial companies in

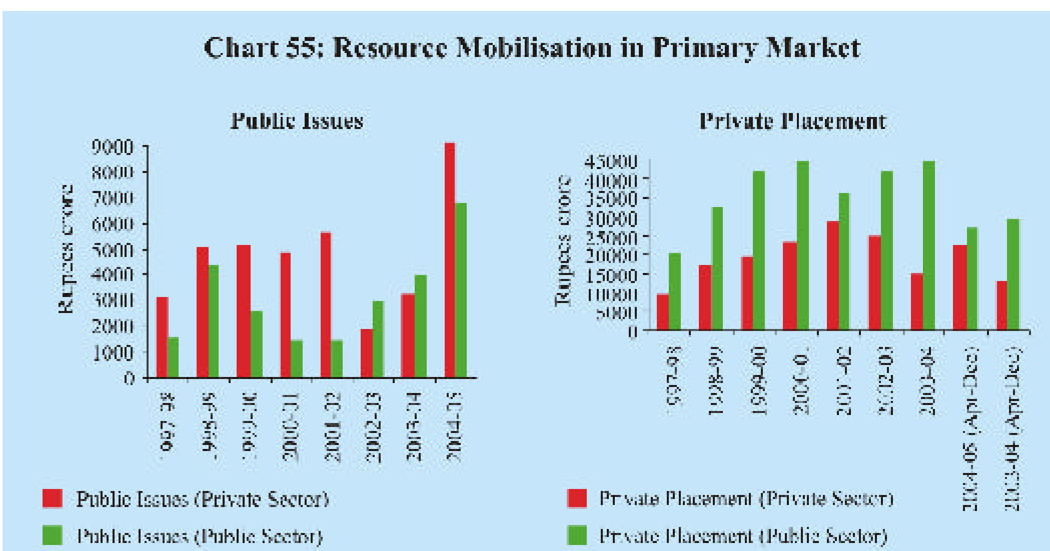
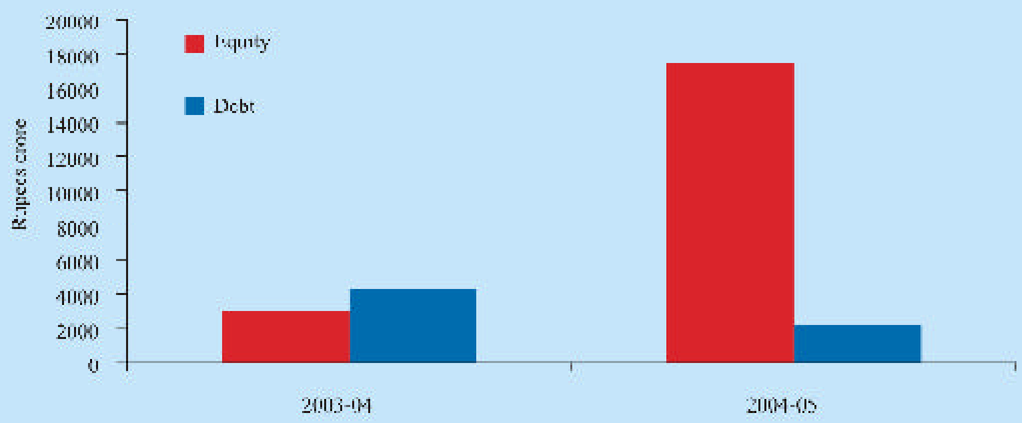


Chart 55: Resource Mobilisation in Primary Market

the private sector. Public issues by six companies, *viz*., ICICI Bank Ltd., TCS Ltd., Sterlite Industries (India) Ltd., National Thermal Power Corporation Ltd., Jet Airways (India) Ltd. and Punjab National Bank, together accounted for 72.9 per cent of total resource mobilisation.

During 2004-05, equity issues dominated the market constituting 88.7 per cent of the total resource mobilisation (Chart 56).

Chart 56: Public Issues - Instrument-wise



Resource mobilisation through private placements aggregated Rs.49,255 crore during April-December 2004 as compared with Rs.42,372 crore a year ago. In all, 141 entities entered the market in April-December 2004 with 651 floatations as compared with 133 entities with 678 floatations during the first three quarters of the previous year. All issues in the private placement market barring one were debt issues. Financial Institutions continued to dominate the private placement market with a share of 58.2 per cent (as compared with 63.3 per cent in the preceding year) in total resource mobilisation.

Indian companies raised Rs.3,353 crore through 15 Euro issues during 2004-05 as compared with Rs.3,098 crore through 18 issues during the previous year. There was no American Depository Receipt (ADR) issue during 2004-05, while resources mobilised by way of Global Depository Receipts (GDRs) registered a sharp increase.

Resource mobilisation by mutual funds declined by 95.3 per cent to Rs.2,200 crore during 2004-05 mainly on account of redemption pressures on income, gilt and equity-linked saving schemes due to shift of resources in favour of small saving schemes which offered attractive tax adjusted rates of return. The

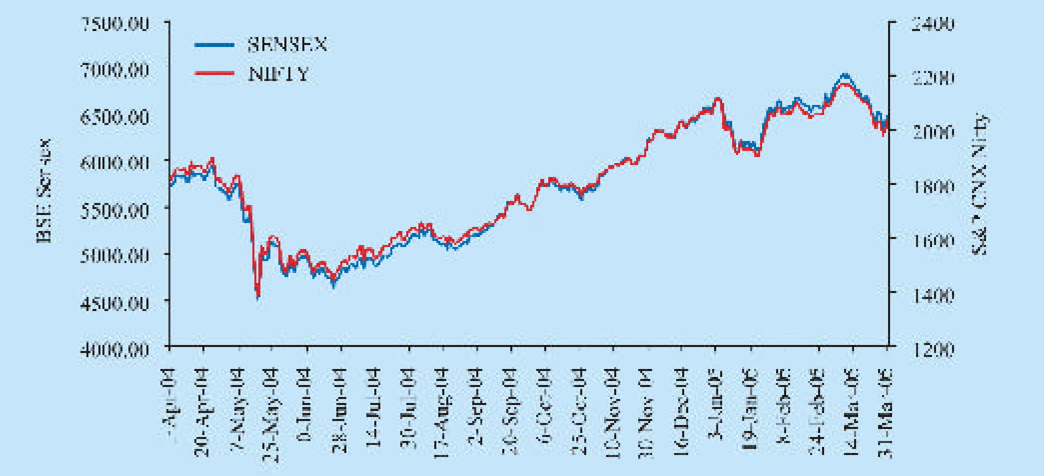
UTI Mutual Fund recorded net outflows of Rs.2,722 crore during 2004-05 as compared with net inflows of Rs.1,667 crore during 2003-04. The public sector mutual funds also recorded net outflows of Rs. 2,677 crore during 2004-05 as compared with net inflows of Rs.2,597 crore in the previous year. Resource mobilisation by private sector mutual funds was substantially lower at Rs.7,600 crore as compared with Rs.42,545 crore in the previous year. The bulk of the resources mobilised by mutual funds were under liquid/money market schmes and growth/equity oriented schemes, while resource mobilisation under debt schemes declined sharply due to change in the interest rate scenario.

Secondary Market

The stock market turned somewhat volatile during April-June 2004 within an overall buoyancy carried forward from the preceding year. On May 17, 2004, the stock markets experienced turbulent conditions due to the political uncertainty arising out of formation of the new Government at the Centre after the General Elections. Rising oil prices and apprehensions of upward movements in international interest rates were the other factors contributing to the sudden reversal of market sentiment. The sharp decline in the Indian stock market on May 17, 2004 was, however, a transitory phenomenon and in keeping with the movements in other emerging markets in Asia such as South Korea (-5.1 per cent), Taiwan (-5.1 per cent) and Thailand (-4.6 per cent), which also fell sharply that day.

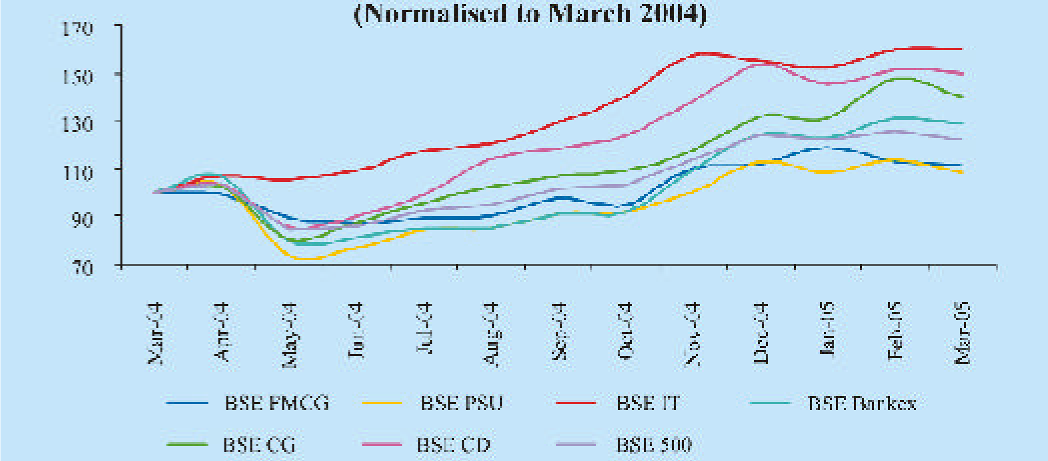
Although orderly conditions in the stock market were quickly restored, the market sentiment remained risk-averse till the first half of August 2004. The announcement of the imposition of Securities Transaction Tax (STT) in the Union Budget, 2004-05 affected the market sentiment adversely. Several other favourable proposals in the Union Budget such as reduction in short-term capital gains tax and abolition of long-term capital gains tax, increase in FDI for certain sectors and encouraging corporate results failed to cheer the markets. During the first half of August 2004, sentiment was also weighed down by the increase in international crude oil prices and a sharp rise in domestic inflation. Buoyant conditions returned to the market from the second half of August 2004. Between the last week of October 2004 and end-March 2005, a strong rally pushed the BSE Sensex to a historic high of 6915.05 on March 8, 2005 (Chart 57). Strong macroeconomic fundamentals, renewed buying interest by FIIs, encouraging financial performance of Indian companies, policy initiatives relating to foreign direct investment in telecom and construction sectors, tax incentives and structural measures proposed in the Union Budget 2005-06, moderation in domestic inflation and easing of international crude oil prices were some of the major factors that contributed to the upsurge.

Chart 57: Indian Stock Markets - 2004-05



The rally in the stock markets during 2004-05 was broad-based with several sectors registering significant gains. On a monthly average basis, the IT sector registered a gain of 59.5 per cent over March 2004, followed by consumer durables (50.5 per cent), capital goods (39.9 per cent), Bankex (28.6 per cent), Fast Moving Consumer Goods (FMCG) (11.6 per cent) and Public Sector Undertakings (PSUs) (8.3 per cent). The BSE 500 registered an increase of 21.9 per cent over end-March 2004 (Chart 58). Strong corporate results and positive international developments, including the sustained rally in the US stock market and favourable expectations relating to business process outsourcing (BPO)

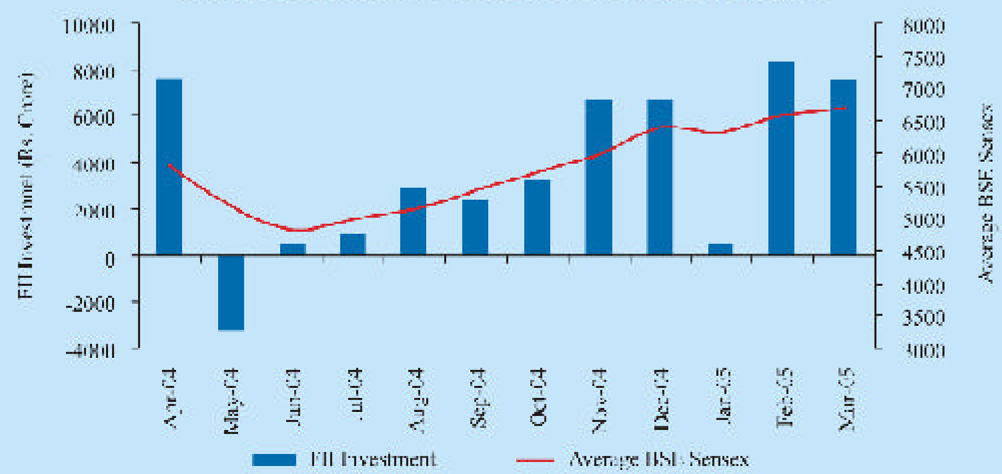
Chart 58: Trends in Sectoral Stock Indices
(Normalised to March 2004)



contributed to the performance of the IT sector scrips. The index of the capital goods sector was buoyant due to acceleration in industrial activity, signs of revival in the investment climate including a pick-up in infrastructure investment and the Government's decision in February 2005 to allow 100 per cent FDI in the construction sector. Banking sector scrips registered gains due to the unprecedented pick-up in bank credit and expectations of better financial performance due to consolidation in the sector. The Government's commitment to allow higher FDI in private sector banks and more recently, the road map for banking sector reforms released by the Reserve Bank, had a favourable impact on the movement of banking sector scrips. The sharp increase in the scrips in the consumer durables sector was on account of robust corporate results led by the increase in sales in electronics and auto segments.

During 2004-05, foreign institutional investors (FIIs) remained net buyers in the equity market during each month barring May 2004 (Chart 59). According to the Securities and Exchange Board of India (SEBI), net purchases by FIIs stood at Rs.44,123 crore during 2004-05 as compared with Rs. 39,959 crore during the previous year. FII investments were particularly large during November-December 2004 and February-March 2005. Mutual funds made net investment of Rs. 445 crore in equities during 2004-05.

Chart 59: Trends in FII Investment and BSE Sensex



The BSE Sensex registered an increase of 16.1 per cent as on March 31, 2005 over the end-March 2004 level. On a daily average basis, the BSE Sensex rose by 27.8 per cent, while the S&P CNX Nifty witnessed an increase of 26.5 per cent during the same period (Table 24).

Table 24 : Stock Market Indicators

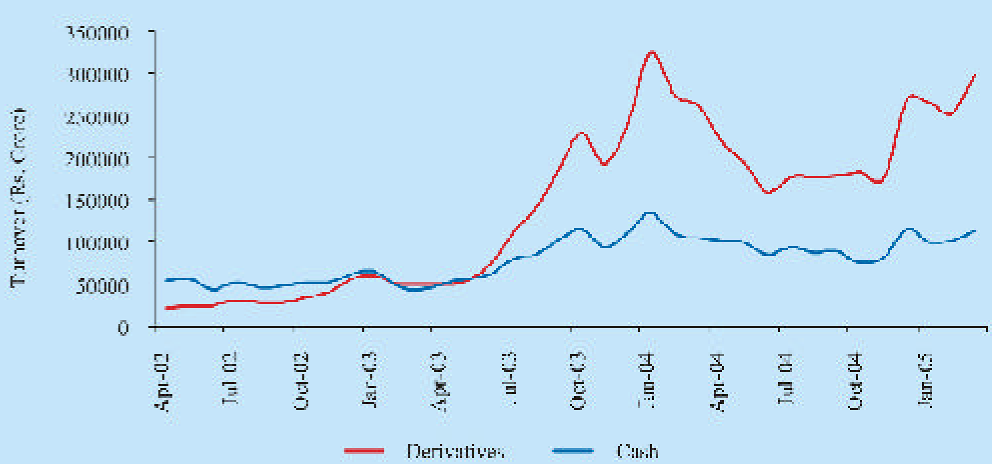
Indicator	BSE		NSE	
	2004-05	2003-04	2004-05	2003-04
1	2	3	4	5
Average BSE Sensex / S&P CNX Nifty	5740.99	4492.19	1805.26	1427.50
Volatility	11.15	22.95	11.28	23.30
Turnover (Rs. crore) (April-March)	5,18,716	5,02,618	11,40,071	10,99,535
Market Capitalisation (Rs. crore) (End-period)	16,98,429	12,01,207	15,85,585	11,20,976

Source: The Stock Exchange, Mumbai (BSE) and National Stock Exchange of India Ltd. (NSE).

The market capitalisation of BSE reached an all-time high of Rs. 17,95,267 crore on March 8, 2005, which was higher by 43.8 per cent over the end-March 2004 level. The price-earnings (P/E) ratio at 15.61 as on March 31, 2005 was lower than that of 18.57 at end-March 2004.

At NSE, the total turnover in the cash segment registered a modest increase of 4.2 per cent to Rs. 11,40,071 crore during 2004-05 from Rs. 10,99,535 crore during 2003-04. The turnover in the derivative segment continued to remain much above that in the cash segment (Chart 60). Total turnover in the NSE derivatives segment increased by 19.5 per cent to Rs.25,46,986 crore during 2004-05 from Rs. 21,30,612 crore during 2003-04.

Chart 60: Turnover in Derivative and Cash Segments – NSE



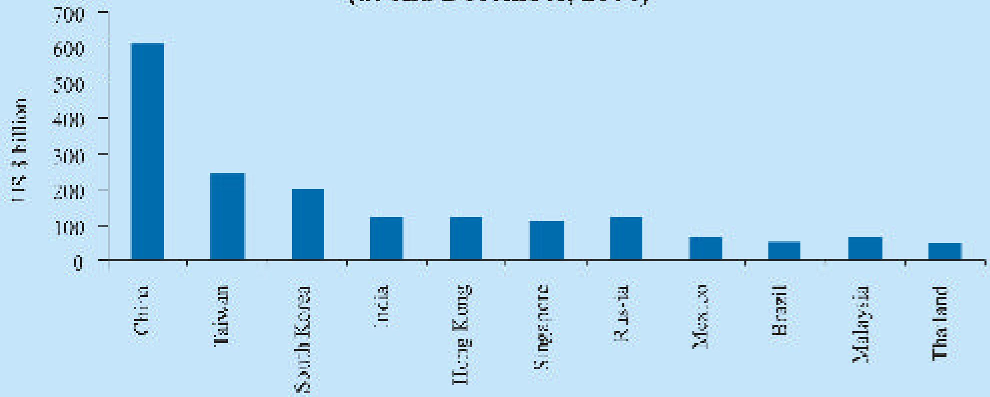
VI. THE EXTERNAL ECONOMY

External sector developments were dominated by the dramatic escalation of international crude oil prices from the beginning of 2004-05 and their persistence at elevated levels with high volatility through the year. For India, as in many other parts of the world, the soaring crude oil prices translated into a massive increase of imports and an upsurge of inflationary pressures. Nervous sentiment pervading world oil markets fuelled considerable uncertainty about the prospects for global growth itself. Fortuitously, the global recovery, which has been underway since 2003, remained resilient and gathered momentum during 2004 undeterred by the oil price shock.

In this tumultuous environment, the innate strengths of India's external sector came to the fore, reflecting increasingly the robust macroeconomic fundamentals. India turned out to be one of the fastest growing merchandise exporters of the world with considerable support from buoyant invisible earnings. These current receipts enabled a comfortable absorption of the expansion in import payments on account of the oil price shock as well as the augmented input requirements of the domestic industrial recovery. India's strong macroeconomic performance in a period of generalised uncertainty invigorated international investor confidence and enhanced the attractiveness of the Indian economy as a preferred habitat for private capital flows.

These developments produced significant shifts in India's balance of payments. The current account balance swung from a continuous run of surpluses between 2001-02 and 2003-04 into a modest deficit during 2004-05. In the capital account, surges of portfolio flows occurred for the second successive year, taking India's share in global portfolio flows to emerging market economies (EMEs) to about 25 per cent in 2004, the second largest among EMEs. Direct investment flows also picked up to provide support to the balance of payments, with foreign exchange reserves rising to US $ 141.5 billion on March 31, 2005. At the end of December 2004, India's foreign exchange reserves (excluding gold) were the fifth largest in the world and the fourth largest among EMEs (Chart 61).

Chart 61: Foreign Exchange Reserves - Emerging Market Economies (at end December, 2004)

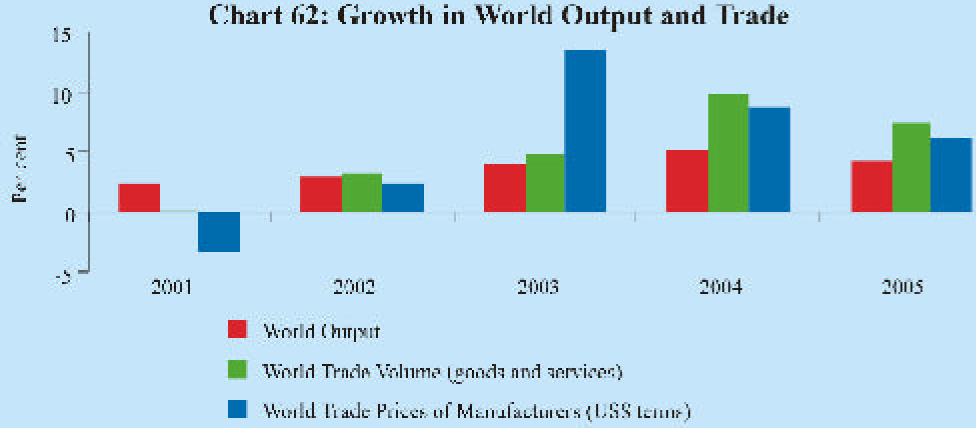


Source: International Financial Statistics, IMF.

International Developments

The global economy continued to expand at a robust pace during 2004, although the rate of growth moderated from the exceptionally high levels observed at the beginning of the year. Aided by strong growth in industrial countries and rapid expansion in emerging economies such as China and India, world output is projected to have risen by 5.1 per cent in 2004, the highest after 1976 (Chart 62).

Chart 62: Growth in World Output and Trade



Source: World Economic Outlook, IMF, April 2005.
Note: Data for 2005 are IMF projections.

Among the advanced economies, while economic activity in the United States turned robust, growth moderated in Japan and the UK. In the US, GDP growth was placed at 4.4 per cent in 2004, led by private investment and household consumption.

The US trade deficit widened to over US $ 617 billion in 2004 from around US $ 496 billion a year ago, mainly due to an increase in the volume of imports of oil products and a decline in external demand for US capital goods. The US fiscal deficit also climbed to 4.5 per cent of GDP in 2004; this exerted downward pressure on the US dollar which depreciated by 9.4 per cent against the Euro and 6.7 per cent against the Japanese Yen. Despite these constraints and the upward movement of long-term yields, the US has been successful so far in withdrawing its accommodative monetary policy stance through successive hikes in the target Federal Funds Rate at a measured pace.

By contrast, growth moderated in the Euro area and the UK dampened by subdued investor sentiment and limited household spending, with external demand embodied in rising export demand from developing countries providing the main sustenance to growth. The European Central Bank, in fact, downgraded its projection of economic growth during 2005 to 1.2-2.0 per cent in February 2005 from 1.4-2.4 per cent in December 2004 and 1.8-2.8 per cent in September 2004. In Japan, economic recovery lost momentum by the final quarter of 2004. Exports to developing countries provided the main stimulus to growth. The turnaround out of deflation was, however, fragile and real GDP growth was placed at 2.6 per cent for the full year 2004. Amongst the EMEs, the developing Asia group is projected to have grown by 8.2 per cent in 2004, over and above 8.1 per cent in the preceding year. Despite monetary tightening measures, Chinese economic growth continued to expand at 9.5 per cent in 2004, which was comparable to 9.3 per cent in the preceding year. Latin America saw broad-based economic growth driven by exports and domestic demand.

According to the World Bank, world trade volume recorded a growth of 10.2 per cent during 2004. The robust expansion in demand for raw materials in a number of developing countries led by China, the sustained demand expansion in the US and modest economic recovery in other major industrialised countries led to the expansion in trade volume. In US dollar terms, world merchandise exports recorded a growth of 20.3 per cent during the first ten months of 2004 as compared with 15.5 per cent in the same period of 2003. Exports from the Asian region, led by Korea, India and China grew faster than world trade (Table 25). Apart from volume growth, this also

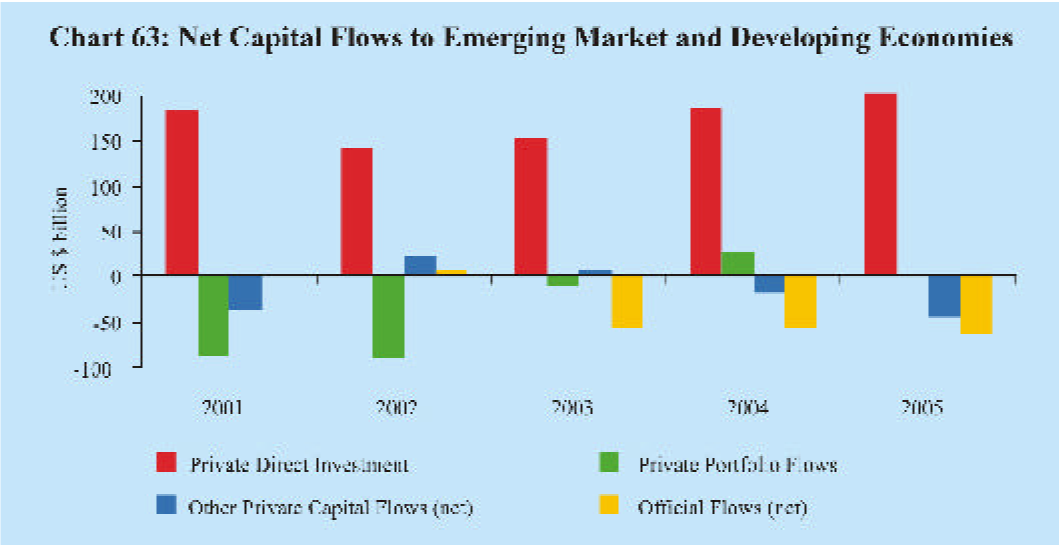
Table 25 : Growth in Merchandise Exports – Global Scenario

Region/ Country	2003	2003 (January-October)	2004 (January-October)
1	2	3	4
World	16.2	15.5	20.3
Industrial Countries	14.6	14.0	17.1
US	4.6	3.3	13.4
Germany	22.7	22.5	21.1
Japan	13.2	12.5	20.9
Developing Countries	18.8	17.9	25.3
China	34.6	32.7	19.5
India	16.3	11.7	28.1
Korea	19.3	17.9	33.1
Singapore	15.2	14.4	24.9
Indonesia	8.3	8.3	10.3
Malaysia	11.5	10.6	21.8
Thailand	18.0	17.0	21.1

Source : International Financial Statistics, IMF.

reflected the continued increase in commodity prices. Global commodity prices in US dollar terms increased by 17 per cent in 2004 (10.2 per cent in 2003).

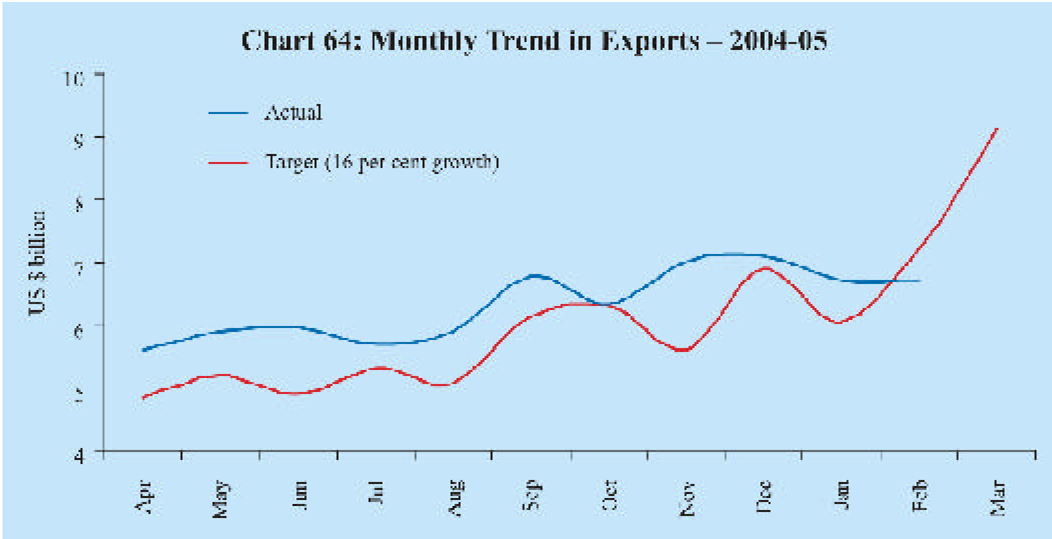
Private direct investment flows to emerging and developing economies are estimated to have increased from US $ 149.5 billion in 2003 to US $ 196.6 billion in 2004. On the other hand, while private portfolio flows have increased, other (net) flows, private as well as official, to emerging market and developing economies are expected to have declined in 2004 (Chart 63).



The International Monetary Fund (IMF) has projected world output growth at 4.3 per cent for 2005, down from 5.1 per cent in 2004. Potential risks to the prospects for growth are global imbalances and consequent disorderly exchange rate movements, reversal of global capital flows from emerging and developing economies in the case of a realignment of interest rates, slow investment growth on account of higher interest rates with tightening of monetary policy stance by leading central banks, slowdown of growth in China and moderation of demand on account of a rise in oil prices. According to the World Bank, the hike in oil prices already observed can be expected to dampen output in 2005 by about 0.5 per cent of world GDP. The rising and volatile oil prices continue to be a major risk for global growth.

Merchandise Trade

According to the Directorate General of Commercial Intelligence and Statistics (DGCI&S), India's export growth at 27.1 per cent during the first eleven months of the current fiscal year (April-February 2004-05) was substantially higher than the annual target of 16 per cent for 2004-05 set by the Government of India (Chart 64).



The improvement in export performance was broad-based (Table 26). Exports of primary products recorded a sharp increase of 24.7 per cent during April-January 2004-05 with significant contributions from agricultural commodities (*viz.*, tea, tobacco, cashew, spices and oil meal) and ores and minerals. Exports of manufactured products accelerated to record a growth of 22.2 per cent during the period. Gems and jewellery, engineering goods, and chemicals and related products were key drivers. Exports of petroleum products surged by 92.4 per cent. Exports of handicrafts, however, declined.

Within the overall expansion, India's exports were well diversified in terms of destination. Exports to the European Union, the OPEC and developing countries of Asia, Africa and Latin America posted a significant increase. Among the major

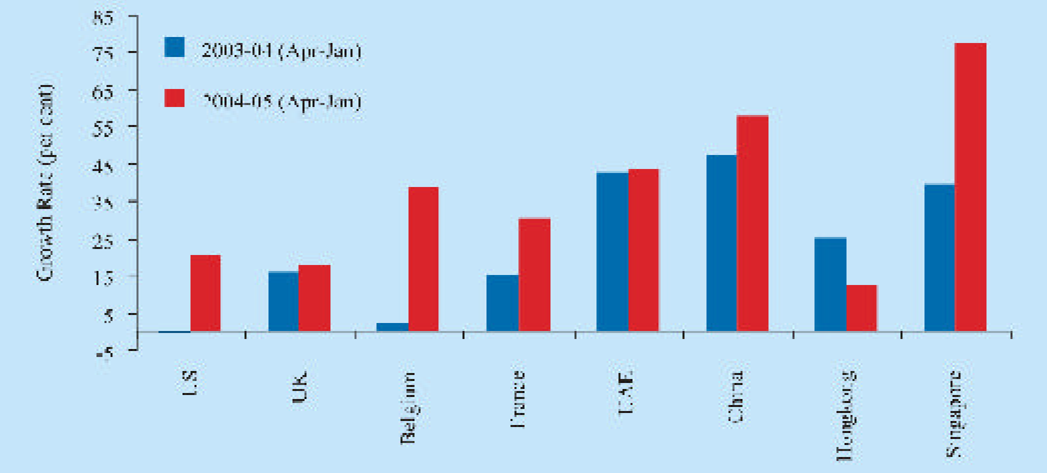
Table 26 : Merchandise Exports – April-January

Commodity Group	US $ billion		Variation (per cent)	
	2003-04	2004-05	2003-04	2004-05
1	2	3	4	5
1. Primary Products	**7.6**	**9.5**	**5.0**	**24.7**
2. Manufactured Goods	**37.8**	**46.3**	**15.3**	**22.2**
of which:				
a. Chemicals and Related Products	**7.3**	**9.5**	**19.1**	**29.3**
b. Engineering Goods	**9.7**	**12.9**	**33.8**	**33.0**
of which:				
Metals	1.9	2.6	26.4	34.3
Machinery and Instruments	2.2	2.7	34.2	21.2
Transport Equipments	1.5	2.3	51.1	49.9
Iron and Steel	1.9	2.8	32.6	50.2
Electronic Goods	1.4	1.4	34.9	1.3
c. Textiles	**9.5**	**9.8**	**5.7**	**3.0**
d. Gems and Jewellery	**8.2**	**10.7**	**11.9**	**30.2**
3. Petroleum Products	**2.9**	**5.5**	**49.6**	**92.4**
4. Total Exports	**49.7**	**63.2**	**16.4**	**27.0**

Source: DGCI&S.

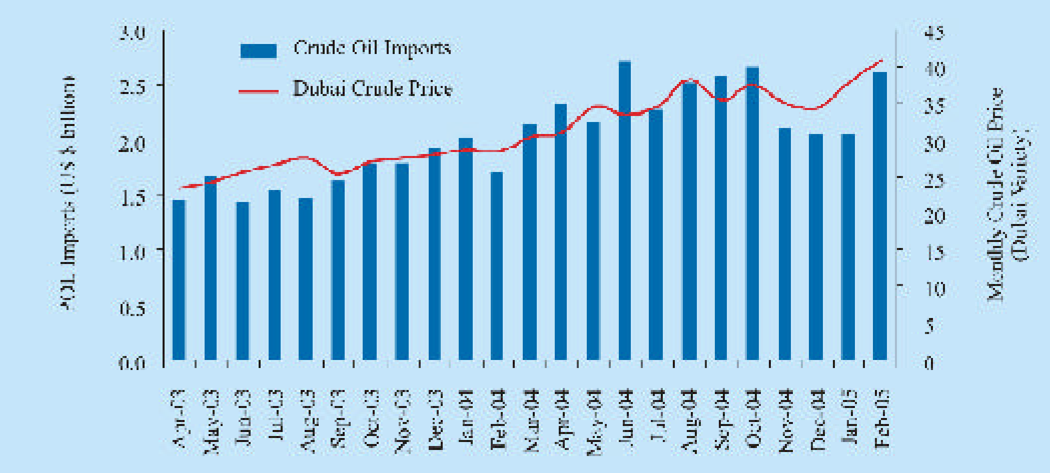
partner countries, exports to the US, the UK, Belgium, France, UAE, China, Hong Kong and Singapore recorded significant increases (Chart 65). The destination pattern of exports is gradually shifting in favour of developing Asian countries with China accounting for the major share.

Chart 65: India's Exports to Major Countries



Imports grew strongly by 36.4 per cent during 2004-05 (April-February) mainly due to a surge in oil imports by 44.6 per cent following a rise in international crude oil prices (Chart 66). The average 'Indian basket' comprises about 57 per cent 'sour' variety (benchmarked by Dubai crude) and 43 per cent 'sweet' variety. The average crude prices for the Dubai variety rose sharply during April-February 2004-05 to US $ 35.7 per barrel from an average of US $ 26.6 per barrel during

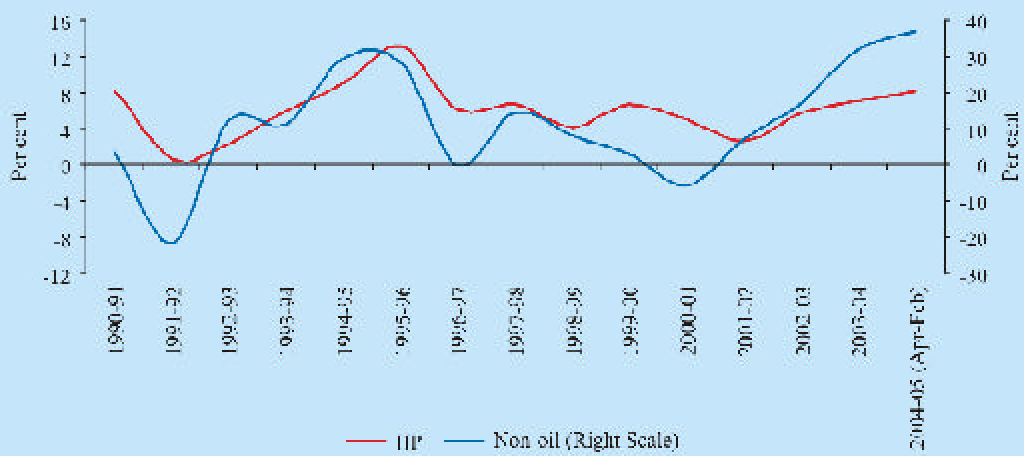
Chart 66: International Crude Price and India's POL Imports



the corresponding period of the previous year. In volume terms, oil import growth slowed down to 5.3 per cent during April-January 2004-05 as compared with 9.9 per cent in the same period of the previous year.

The value of non-oil imports increased by 33.3 per cent during April-February 2004-05 on top of a rise of 28.8 per cent during the corresponding period of the previous year, providing lead indication of the strengthening of industrial activity (Chart 67). In fact, non-oil non-gold and silver imports increased by 33.8 per cent during April-January 2004-05.

Chart 67: Growth in Non-oil Imports and Industrial Production



Imports of 'mainly industrial inputs' led the surge, growing by 36.8 per cent during April-January 2004-05 on top of the increase of 24.8 per cent in the previous year (Table 27). Among other major items, gold and silver

Table 27 : Merchandise Imports: April-January

Commodity Group	US $ billion		Variation (per cent)	
	2003-04	2004-05	2003-04	2004-05
1	2	3	4	5
1. POL	**16.7**	**24.0**	**16.5**	**43.8**
2. Edible Oils	2.1	1.9	44.4	-8.3
3. Iron and Steel	1.2	2.0	51.8	69.8
4. Capital Goods	**13.7**	**18.1**	**30.1**	**32.1**
5. Pearls, Precious and Semi-Precious Stones	5.8	7.2	15.5	24.3
6. Chemicals	3.3	4.4	30.3	34.7
7. Gold and Silver	5.4	8.7	50.9	60.8
8. Total Imports	**62.3**	**86.5**	**24.3**	**38.8**
Memo Items:				
Non-Oil imports excluding gold and silver	40.2	53.7	24.8	33.8
Mainly Industrial Imports*	36.1	49.4	24.8	36.8

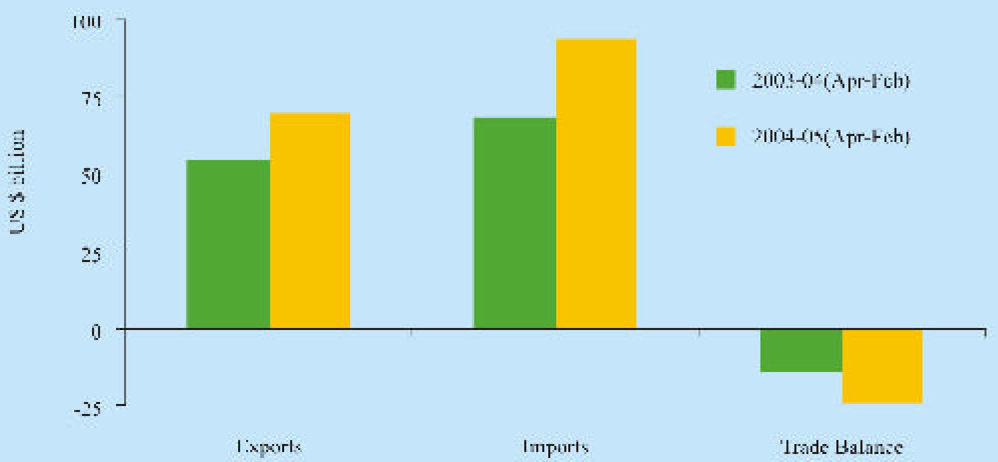
* : Non oil imports net of gold and silver, bulk consumption goods, manufactured fertilisers and professional instruments.

Source: DGCI&S.

increased sharply, while bulk consumption goods, especially edible oil and pulses, declined. Source-wise, imports from the OPEC, Eastern Europe and Asian countries grew sharply.

The trade deficit during April-February 2004-05 widened to US $ 23.8 billion from US $ 13.7 billion during the corresponding period of 2003-04 (Chart 68).

Chart 68: India's Merchandise Trade



Invisibles and Current Account

Surpluses on account of invisible transactions have financed a significant portion of the merchandise trade deficit that has traditionally characterised India's balance of payments. Through 2001-04, sizeable invisible surpluses comfortably financed the merchandise trade gap and spilled over into current account surpluses. Invisible receipts increased by 37.5 per cent during April-December 2004 over the corresponding period of the previous year. The key drivers of invisibles receipts were travel earnings, software exports and workers' remittances. Travel receipts reflected the jump in tourist arrivals by 24 per cent. India is fast emerging among the top ten tourism exporting countries of the world. Software exports, in which India is a world leader, continued to be buoyant on the back of sustained growth in industrial countries. According to the NASSCOM, Indian software and services exports are likely to have recorded 35 per cent growth to reach revenues of US $ 17.3 billion in 2004-05. Private transfers, representing overseas workers' remittances, were placed at US $ 15.8 billion in April-December 2004. In 2003-04, India was the world's leading recipient of remittances, accounting for 20 per cent of global flows. This position is expected to be maintained in 2004-05. Invisible payments, however, recorded a sharp rise of 62.3 per cent during April-December 2004 mainly on account of increased payments for travel, transportation, insurance and other business services. While the higher outgo on travel payments emanated from the rapid expansion in outbound tourists from India, transportation and insurance payments reflected mainly the expansion in merchandise trade. The sharp expansion in payments for other business services, particularly communication services, construction services, financial services, royalties, copyrights and license fees, and management services is in consonance with the ongoing technological transformation of the economy and the modernisation of Indian industry.

Despite the support from invisible earnings, the expansion in invisible payments coupled with a record level of the trade deficit led to a current account deficit to the tune of US $ 7.4 billion during the first three quarters of 2004-05 after a phase of current account surpluses ruling from 2001-02 to 2003-04 (Chart 69). The resurgence of a current account deficit in India's balance of payments augurs well for the growth of the economy. It marks the cessation of a period of net capital exports and signals an investment scenario in which net foreign saving can supplement domestic saving to achieve desired rates of investment and growth.

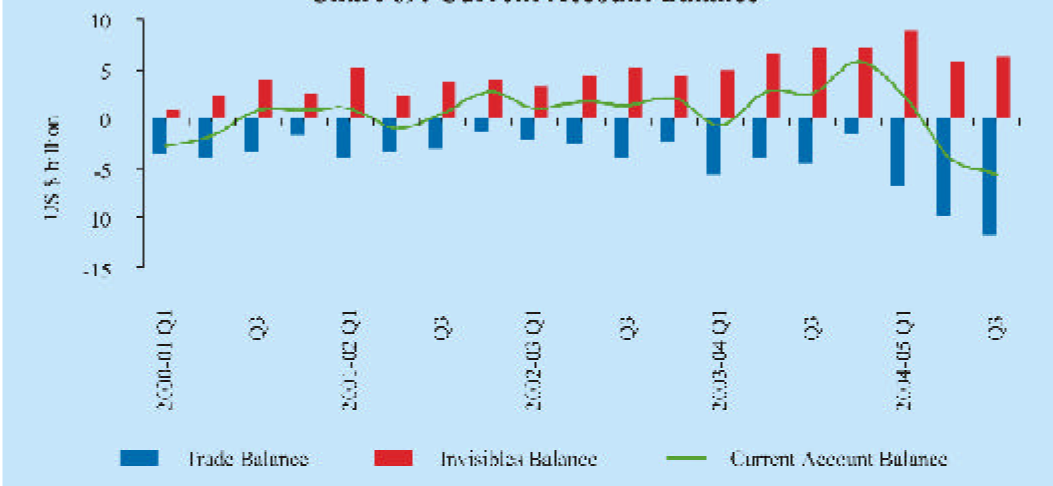


Chart 69: Current Account Balance

Capital Account

Net capital flows during 2004-05 were dominated by foreign investment. Portfolio flows brought in by foreign institutional investors (FIIs) went through significant shifts in the early part of the year before cumulating into a surge that was interrupted only briefly in the early part of January 2005. The appetite for investing in India was also shared by foreign direct investors who responded positively to the ongoing liberalisation. Drawing strength from the strong investor enthusiasm and credit rating upgrades, Indian entities expanded their access to international capital markets through foreign currency convertible bonds, trade credits and external commercial borrowings. Even as net outflows continued under non-resident Indian (NRI) deposits, banks compensated for the shrinkage in foreign currency funds by borrowing overseas and drawing down nostro balances.

Net capital inflows at US $ 20.7 billion during April-December 2004 were higher by 25 per cent as compared with US $ 16.6 billion recorded in the corresponding period of the previous year. The major contributors to the capital account surplus were foreign investment, short-term trade credit, external commercial borrowings and other capital, while NRI deposits recorded net outflow (Table 28).

Inflows in the form of foreign direct investment (FDI) into India (which also includes equity capital of unincorporated entities, reinvested earnings and inter-corporate debt transactions between the related entities) picked up to US $ 4.1 billion during April-December 2004 from US $ 3.4 billion during April-December 2003. The services sector was the largest recipient of FDI inflows. Mauritius remained the largest source of FDI flows to India, followed by the US, the Netherlands and Germany. The improvement in FDI reflects the recent initiatives taken to create an enabling environment for FDI and infusion of new technologies and management practices. The Union Budget for 2004-05 raised the sectoral caps on FDI in telecom (from 49 per cent to 74 per cent), and in air transport services (domastic airlines) up to 49 per cent from 40 per cent.

India's outward FDI flows increased rapidly from US $ 757 million in 2000-01 to US $ 1.3 billion in 2003-04 and US $ 1.9 billion in the first three quarters of 2004-05. Indian FDI is mostly in manufacturing, although FDI in IT services has begun to grow rapidly, particularly through mergers and acquisitions. The increasing competitiveness of Indian firms and their expanding global scan in a wide range of manufacturing, IT-related services and pharmaceuticals is driving the outward FDI surge. In recent years, Indian public sector entities have aggressively sought to acquire equity in the petroleum and gas sectors of key

Table 28 : Net Capital Flows into India

(US $ billion)

Item	2004-05	2003-04
	April-December	
1	2	3
Total Capital Flows	**20.7**	**16.6**
Of which:		
Foreign Direct Investment	2.2	2.5
Portfolio Investment	5.1	7.6
Non-Resident Indian Deposits	-1.3	3.7
Banking Capital, Excluding NRI Deposits	3.0	2.1
External Commercial Borrowings	4.1	-3.4
Short Term Trade Credits	2.7	2.4
External Assistance	0.7	-1.8

producer countries as a strategic initiative to manage the growing energy intensity of the economy. This has emerged as a new engine of growth for Indian FDI overseas. Access to markets, natural resources, distribution networks, foreign technologies and strategic assets such as technology and brand names are the main motivations. Ongoing liberalisation of the policy framework has provided a conducive environment for FDI from India.

Inflows on account of foreign portfolio investment came off the peak level recorded in 2003-04 and turned into a net outflow of US $ 1.4 billion during the three-month period of May-July 2004. This phenomenon was observed across the Asian markets as FII activities remained subdued on account of global uncertainties caused by hardening of crude oil prices and edging up of international interest rates as several central banks began to exit from accommodative monetary policy stances. FII flows turned positive beginning August 2004 and in the subsequent period, there was a dramatic surge in net portfolio inflows into India, spurred by a positive growth outlook, improved corporate performance, upgradation of credit ratings and attractive returns on Indian stocks. The continued FII interest in India was also visible in the number of FIIs registered with the SEBI which increased to 685 by end-March 2005 with the total number of sub-accounts at 1,709. Investments by FIIs are well diversified. Moreover, FIIs also invested in mid-cap and small-cap stocks. Notwithstanding this surge for the second year in succession, valuation of Indian stocks remain attractive *vis-a-vis* other EMEs (Table 29).

In order to facilitate FII inflows, the registration procedure was simplified. The cumulative debt investment limit for FIIs was hiked to US $ 1.75 billion from US $ 1 billion. A cumulative sub-ceiling of US $ 500 million was fixed for FII investment in corporate debt over and above the sub-ceiling of US $ 1.75 billion for Government debt under the overall ECB ceiling.

Table 29 : Foreign Portfolio Investment Flows

(US $ billion)

Country	Portfolio Inflows			Price-Earnings Ratio (Per cent)
	2002	2003	2004	2004
1	2	3	4	5
Chile	1.0	1.7	0.1	16.8
Hong Kong	-1.1	1.4	-0.2	16.1
India	1.1	8.2	8.8	14.1
Philippines	1.6	0.9	1.9	18.9
South Korea	5.4	22.7	18.3	14.2
Thailand	-0.7	0.9	0.5	8.5

Note : Data for Chile, Hong Kong, the Philippines, South Korea and Thailand for calendar year 2004 are up to September and for India up to December.

Source : International Financial Statistics, IMF.

Indian corporates' recourse to ECBs was substantially higher in April-December 2004, which reaffirms the strong resumption of investment demand riding on the back of growth in industrial production. The higher recourse to ECBs was also facilitated by the narrowing down of spreads on emerging market bonds and upgrades of sovereign rating by international credit rating agencies. In contrast to the preceding two years which were characterised by large prepayments, external assistance recorded net positive flows in 2004-05 due to lower repayment obligations. Short-term trade credits rose strongly in tandem with the surge in import demand. Net outflows from NRI deposits reached US $ 1.3 billion during April-December 2004 attributable to alignment of interest rates on such deposits with global interest rates. The revision in interest rates on NRE deposits to LIBOR/ SWAP rates of US dollar plus 50 basis points on October 26, 2004 brought in an inflow of NRE deposits of US $ 207 million in November 2004, followed, however, by a small net outflow in December 2004. The NR(NR)R deposits recorded an outflow of US $ 927 million during April-December 2004. The Union Budget for 2005-06 proposes to continue the exemption from tax on interest earned on accounts maintained by non-resident Indians.

The overall balance showed a surplus of US $ 13.5 billion during April-December 2004 as compared with US $ 21.4 billion in April-December 2003.

Foreign Exchange Reserves

The strength of the external sector was reflected in a sizeable accumulation of India's foreign exchange reserves comprising foreign currency assets, gold, SDRs and the reserve position with the IMF which touched US $ 141.5 billion as on March 31, 2005. The accretion to the reserves of US $ 28.6 billion during 2004-05 was significant, occurring as it did on top of an unprecedented accretion of US $ 36.9 billion in 2003-04.

In terms of trade-related reserve adequacy indicators, India's foreign exchange reserves at about 15 months of imports are higher than those of several other EMEs in Asia (Table 30). India's ratio of short-term debt comfortably satisfies the adequacy criterion *vis-à-vis* other comparable countries. The level of reserves is higher than India's overall external debt. In terms of total external liabilities, which include portfolio liabilities, India's reserves are broadly adequate.

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. The policy for reserve management is, thus, judiciously built upon a host of identifiable factors and other contingencies. 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 the external sector in the economy and the size of risk-adjusted capital flows.

Table 30 : Reserve Adequacy Indicators

(Per cent)

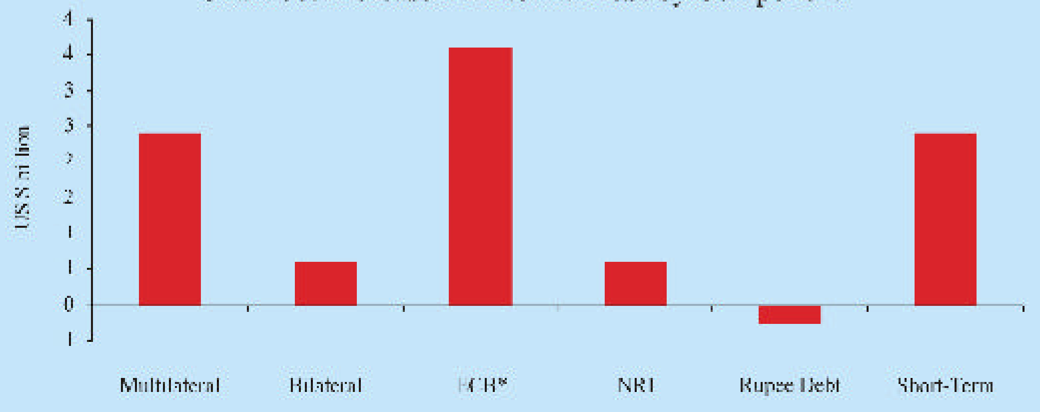
Criterion	India	Korea	Singapore	Hong Kong
1	2	3	4	5
Trade-related Indicators				
Import cover (months)	14.8	11.4	10.5	5.6
Current payment cover	10.8	8.7	7.7	4.4
Debt-related Indicators				
Reserves to external debt	108.5	112.0	50.1	29.2
Reserves to short-term external debt	1911.1	331.8	67.5	40.5
Reserves to total external liabilities	61.2	45.2	25.6	15.0
Money-based Indicators				
Reserves to broad money	26.2	21.8	154.3	42.3
Reserves to reserve money	120.2	521.23	830.3	326.3
Macro Indicators				
Reserves to GDP	17.6	25.7	91.5	75.3

Source : 1. International Financial Statistics, IMF.
2. Websites of respective central banks.

External Debt

India's external debt at US $ 120.9 billion at end-December 2004 increased by US $ 9.2 billion over its end-March level of US $ 111.7 billion. Long-term debt increased by US $ 6.7 billion during the same period. Within long-term debt, multilateral debt recorded an increase of US $ 2.4 billion mainly due to the higher utilisation of World Bank loans, while bilateral debt increased by US $ 554 million. NRI debt increased by US $ 0.6 billion, while Rupee debt declined by US $ 0.3 billion (Chart 70). External commercial borrowings recorded the highest growth of US $ 3.3 billion following the increased access to international capital markets by Indian corporates.

Chart 70: Increase in External Debt by Component



*: Including export credit.

Note: Data relate to April-December 2004.

Short-term debt increased by US $ 2.4 billion on account of a surge in both oil and non-oil imports during April-December 2004. The short-term debt component of NRI deposits became nil, reflecting the impact of the policy decision to restrict NRE deposits to maturities of more than one year with effect from April 29, 2003.

The key external debt indicators have shown considerable improvement in the recent past. The ratios of short-term debt to India's total external debt and short-term debt to foreign exchange reserves registered modest increases at end-December 2004 on account of the rise in short-term debt (Chart 71).