Monetary trends and developments

Broad money (M_3)

3.3 M_3 grew by 16.4 per cent in 2003-04, higher than the expansion of 14.0 per cent envisaged in the annual monetary and credit policy statement but in consonance with the high growth in output during the year (Table 3.1). GDP growth in 2003-04, which had been put at 6.0 per cent in the annual policy statement and subsequently revised upwards in the mid-term review of monetary policy to the range of 6.5-7.0 per cent with an upward bias, was 8.1 per cent accoding to the advance estimates released by the Central Statistical Organisation (CSO) in February, 2004. The higher growth of M_3 in 2003-04 needs to be seen in the context of higher than-expected GDP growth in 2003-04.

3.4 Among the components of M_3, both currency with the public and deposits registered a higher growth in 2003-04 as compared with the previous year, adjusted for merger effects. Net foreign exchange assets of the banking sector registered a higher growth in spite of the redemption of the Resurgent India Bonds (RIBs) during the year. Investments in Government securities became very attractive to banks with interest

Table 3.1 : Sources of change in money stock (M_3)

Items	Outstanding balances as on Mar 31, 2003	Outstanding balances as on Mar 31, 2004	Variations during Mar 31, '02 to Mar 31, '03	Variations during Mar 31,'03 to Mar 31,'04	Variations during Mar 31, '02 to Mar 31, '03	Variations during Mar 31,'03 to Mar 31,'04
1	2	3	4	5	6	7
	Rs. crore				Per cent	
I. M_1 (Narrow Money)	**472414**	**573170**	**49570**	**100756**	**11.7**	**21.3**
II. M_3 (Broad Money) (1+2+3+4)	**1719202**	**2000349**	**220846**	**281147**	**14.7**	**16.4**
1. Currency with the public	271382	316758	30587	45376	12.7	16.7
2. Demand deposits with banks	197790	251371	18591	53581	10.4	27.1
3. Time deposits with banks	1246788	1427179	171276	180391	15.9	14.5
4. "Other" deposits with RBI	3242	5041	392	1799	13.8	55.5
III. Sources of change in money stock (M_3)						
1. Net bank credit to Govt. (A+B)	**674429**	**741969**	**84865**	**67540**	**14.4**	**10.0**
A. RBIs' net credit to Governent	120679	44908	-31498	-75771	-20.7	-62.8
(i) Central Government	112985	36920	-28398	-76065	-20.1	-67.3
(ii) State Governments	7694	7988	-3100	294	-28.7	3.8
B. Other banks credit to Government	553750	697061	116363	143311	26.6	25.9
2. Bank credit to commercial sector (A+B)	**892088**	**1011074**	**132441**	**118986**	**17.4**	**13.3**
A. RBIs' credit to commercial sector	3048	2061	-2881	-987	-48.6	-32.4
B. Other banks' credit to commercial sector	889040	1009013	135322	119973	18.0	13.5
3. Net foreign exchange assets of the banking sector	**393714**	**515304**	**82679**	**121590**	**26.6**	**30.9**
4. Government's currency liabilities to the public	**7071**	**7291**	**705**	**220**	**11.1**	**3.1**
5. Banking sector's net non-monetary liabilities other than time deposits	**248101**	**275288**	**79843**	**27187**	**47.5**	**11.0**
Memorandum Items						
1. Money multiplier (M_3)	4.66	4.58				
2. Velocity of money	1.50	1.48				
3. Net domestic assets	1325488	1485045	138167	159557	11.6	12.0
4. Net domestic credit	1566517	1753042	217306	186525	16.1	11.9

Note : All figures are provisional. RBI data relate to end March after closure of Government accounts. Variations in respect of scheduled commercial banks (SCBs) are based on data for last reporting Friday of March. SCBs time deposits include Rs17, 945 crore on account of procedes from RIBs (Resurgent India Bonds), since August 28,1998 and Rs 25, 662 crore from India Millennium Deposits (IMDs) since November 17, 2000.

on these instruments becoming market determined following the reforms initiated in the financial sector in the early nineties. Despite high growth of other banks' credit to Government, total net bank credit to the Government grew by a lower rate of 10.0 per cent in 2003-04 as compared with 14.4 per cent in the previous year on account of a significant reduction in net RBI credit to the Central Government by 67.3 per cent. The substantial reduction in net RBI credit to the Central Government was due to open market sales of securities exceeding the private placement and the Centre's surplus balances with the RBI. In 2003-04, as against private placement of Government securities with RBI amounting to Rs.21,500 crore, sale of Government securities by RBI amounted to Rs.41,849 crore. With overdraft regulations for States becoming more stringent (from April, 2003, States cannot remain in overdraft for more than 36 days in a quarter), outstanding overdrafts of States witnessed a substantial reduction.

3.5 The money multiplier—the ratio of M_3 to reserve money—after increasing from 4.43 at end-March 2002 to 4.66 at end-March 2003, declined to 4.58 at end-March 2004. The income velocity of money—the ratio of gross domestic product at current market prices to the average money stock during the year—has been witnessing a continuous decline. It declined from 1.61 in 2001-02 to 1.50 in 2002-03 and further to 1.48 in 2003-04. This trend indicates more and more M_3 being used for transactions resulting in an increase in income of one rupee. (Table 3.1)

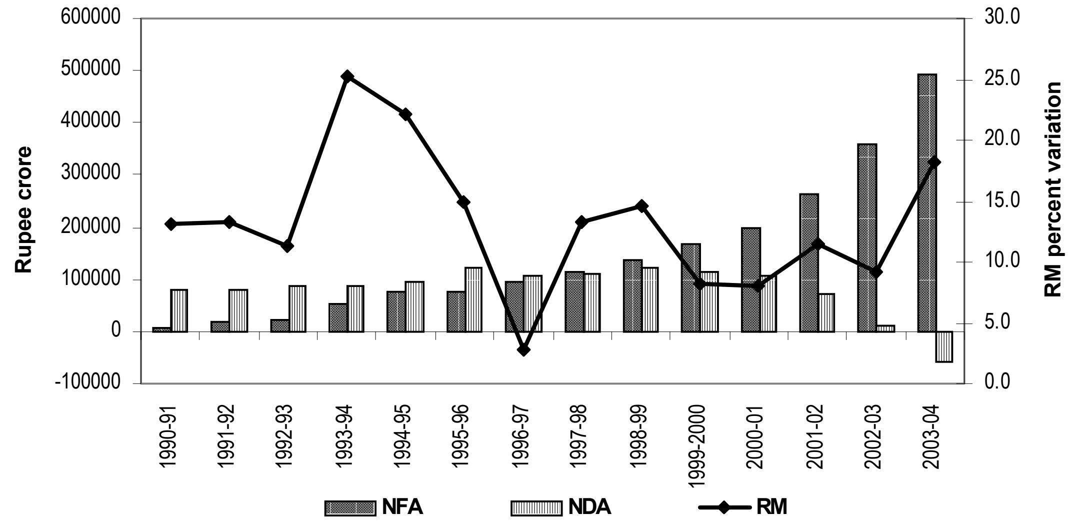
Reserve money

3.6 Reserve money grew by 18.3 per cent in 2003-04 as compared with 9.2 per cent in the previous year. The only source which had contributed to the higher growth in reserve money was the net foreign exchange assets of the RBI. Over the last few years, net foreign exchange assets of the RBI have been surging with large capital flows into the country. In 2003-04, these assets increased by 35.2 per cent as compared with 35.7 per cent in 2002-03 (Table 3.2). During the period 1994-95 to 1998-99, average annual accretion to foreign exchange reserves amounted to Rs.17,306 crore. This increased to Rs.69,292 crore in the period 1999-2000 to 2003-04. In 2003-04 alone, net accretion to RBI's foreign exchange reserves was

Table 3.2 : Components and sources of reserve money

	Outstanding balances (Rs. crore)		Variations during (Rs. crore)		Per cent variation	
	March 31, 2003	March 31, 2004	2002-03	2003-04	2002-03	2003-04
Reserve money	**369061**	**436429**	**31090**	**67368**	**9.2**	**18.3**
A : Components						
a. Currency in circulation	282473	327023	31499	44550	12.6	15.8
b. Banker's deposits with RBI	83346	104365	-801	21019	-1.0	25.2
c. "Other" deposits with RBI	3242	5041	392	1799	13.8	55.5
B : Sources						
1. Net RBI credit to Government	120679	44907	-31499	-75772	-20.7	-62.8
2. RBI credit to banks	7160	5419	-3588	-1741	-33.4	-24.3
3. RBI credit to commercial sector	3048	2062	-2881	-986	-48.6	-32.3
4. Net foreign exchange assets of RBI	358244	484413	94275	126169	35.7	35.2
5. Government's currency liabilities to the public	7071	7291	705	220	11.1	3.1
6. Net non-monetary liabilities of RBI	127141	107663	25921	-19478	25.6	-15.3
Memorandum items						
a. Net domestic assets of RBI	10817	-47984	-63185	-58801	-85.4	-543.6
b. Net domestic credit by RBI	130887	52388	-37968	-78499	-22.5	-60.0

Fig. 3.1 Trends in reserve money, NFA and NDA



Rs.1,26,169 crore. The increase in the foreign exchange assets of the RBI was partly neutralised by a corresponding reduction in the domestic assets. Trends in reserve money, net foreign exchange assets (NFA) and net domestic assets (NDA) of RBI are depicted in Figure 3.1.

3.7 Dealing with the surge in capital flows became an important part of monetary management. The RBI has been moderating the impact of increase in capital flows through open market sale of Government securities held by it and through daily repo operations under the LAF. Both these operations, however, require an adequate stock of Government securities. The use of entire stock of securities for outright open market sales was constrained by allocation of a part of securities for day-to-day LAF operations as well as for investments of surplus balances of the Government. The stock of marketable Government securities held by the RBI declined to Rs. 44,217 crore as on March 31, 2004 from a level of Rs. 1,16,444 crore as on March 31, 2003. The RBI has taken a number of measures to supplement its stock of Government securities. These include the following :

- Raising the limit of 91- day treasury bills from Rs.500 crore to Rs.1,500 crore for eight auctions between August 6, 2003 and September 24, 2003.
- Conversion of the entire stock of Government of India treasury bills amounting to Rs. 61,818 crore into marketable securities, on a private placement basis.
- Acquisition of Government security by funding pre-payment of Government's external debt.

3.8 These measures were considered inadequate as capital flows continued to remain buoyant. The RBI constituted an Internal Working Group on Instruments of Sterilisation. Based on the recommendations of the Group, a scheme for launching market stabilisation bonds was formulated. The Government of India and the RBI signed a Memorandum of Understanding on March 25, 2004 detailing the rationale and operational modalities of the Market Stabilisation Scheme (MSS). The scheme became effective from April 2004. Main features of the scheme are listed in Box 3.1.

3.9 RBI also constituted an Internal Working Group on Liquidity Adjustment Facility. Based on its recommendations, a revised scheme of LAF was put in place effective March 29, 2004. The revised LAF scheme consists of i) 7-day repo conducted daily, ii) overnight fixed

Box 3.1 : Market stabilisation scheme

- Government of India issues treasury bills or dated securities under the MSS in addition to normal borrowing requirements to absorb excess liquidity. These instruments indistinguishable from the present treasury bills and dated securities issued by the Government are eligible for the purposes of SLR and repo.
- Government of India in consultation with the RBI fixes an annual aggregate ceiling for treasury bills and/or securities under the MSS. The initial ceiling for 2004-05 is fixed at Rs. 60,000 crore, which is subject to revision.
- The amounts raised under the MSS is held in a separate identifiable cash account maintained and operated by the RBI.
- Payment of interest and discount not made from the MSS account but shown in the budget documents of the Government of India.
- Securities under the MSS are matched by an equivalent cash balance held by the Government with the RBI offsetting the monetary impact of accretion to the RBI's net foreign assets.

rate repo conducted daily, and iii) reverse repo auction on overnight basis at a fixed rate. The present 14 day repo will be phased out in due course. The overnight variable repo auction facility was continued till April 2, 2004 to facilitate a smooth transition to the new scheme. Under the revised scheme, the repo rate is fixed by the RBI from time to time. The present repo rate of 4.50 per cent is retained for this purpose. The reverse repo rate will be 150 basis points higher than the repo rate. Increase in the minimum tenor of the LAF operations from overnight to seven days is expected to enable balanced development of various segments of the money market. Fixed rate repo auctions under the revised scheme, with the flexibility to conduct overnight repo, if the situation warrants, is intended to enhance the ability of the RBI to transmit policy signals to the market.