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Monetary and Banking Developments

The stance of monetary policy as announced by the Reserve Bank of India (RBI) in its annual policy statement for 2004-05 was (i) to ensure the provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level and (ii) consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and macroeconomic and price stability. The RBI faced two main challenges in the conduct of monetary policy during the current year. The first was a liquidity overhang of over Rs. 81,000 crore from the previous year. The sharp increase in reserve money in the previous year on account of large capital flows further complicated the problem of liquidity. The second related to an acceleration in the inflation rate beyond about 5.0 per cent anticipated at the time of annual policy formulation on the assumption of no significant supply shocks and appropriate management of liquidity. Headline inflation, as measured by the wholesale price index (WPI), touched a high of 8.7 per cent by end-August 2004.

3.2 Taking the two challenges into account, the RBI, in its mid-term review in October, 2004, announced that its overall monetary policy in the second half of 2004-05 would be (i) to ensure provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability, (ii) consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth, and (iii) to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations. During the year, the RBI took monetary measures from time to time in response to the evolving situation. The RBI addressed the problem of liquidity overhang through the use of Market Stabilisation Scheme (MSS) and Liquidity Adjustment Facility (LAF). For enabling the RBI to effectively deal with the problem of liquidity overhang, the limit under MSS was raised from Rs. 60,000 crore to Rs. 80,000 crore on August 26, 2004, after the threshold limit of Rs. 50,000 crore was crossed. Liquidity absorption through MSS amounted to Rs. 54,499 crore as on January 28, 2005.

3.3 The RBI discontinued the auction of 7-day and 14-day reverse repo with an overnight fixed rate repo and reverse repo from November 1, 2004,[1] taking into account the bunching of liquidity due to 7-day minimum tenure of LAF repo. This facilitated management of liquidity in a more flexible manner. In September 2004, on review of liquidity conditions, the Reserve Bank announced raising of the cash reserve ratio (CRR), in two stages, by 50 basis points to 5.0 per cent. This reduced the liquidity in the banking system by over Rs.9,000 crore. The

[1] The RBI has switched over to the international usage of the terms ‘repo’ and ‘reverse repo’ effective from October 29, 2004. As per the international usage, absorption of liquidity by the RBI is termed as ‘reverse repo’ and injection as ‘repo’. (Prior to October 29, 2004 absorption of liquidity was termed as ‘repo’ and injection as ‘reverse repo’).

decision to increase the CRR was partly for absorbing excess liquidity in the system, but more importantly for moderating the inflationary expectations by reiterating the importance of stability in financial market conditions. In addition, the slow-down in capital inflows during the current year and a higher credit demand helped in bringing down the excess liquidity.

3.4 A noticeable development in the current year relates to a significant increase in the flow of bank credit to the commercial sector. The pick up in non-food credit witnessed since the second half of 2003-04 not only continued but accelerated through the current year. During the current year, market borrowings by the Central Government remained at a lower level. Up to January 21, 2005, the Government's net market borrowings, through issuances of dated securities, were lower at Rs. 65,684 crore, including an amount of Rs. 25,000 crore raised under MSS, as compared to Rs. 91,816 crore raised in the corresponding previous period, reflecting pre-payment of high cost loans by States under the debt-swap scheme.