

Monetary trends and developments

Broad money (M_3)

3.5 The annual policy statement for 2004-05 of the RBI (May 18, 2004) placed the growth of broad money (M_3) for 2004-05 at 14.0 per cent, consistent with the expected growth and inflation rate. Although the current year started with a high M_3 growth of 16.6 per cent in the previous year, the growth rate over March 31, 2004 decelerated rapidly, and was 9.7 per cent (net of conversion, 9.5 per cent)² in the current year up to January 21, 2005, considerably below 12.1 per cent in the corresponding previous period. M_3 growth on a year-on-year basis, net of conversion effect, as on January 21, 2005, was 13.9 per cent, almost the same as on the corresponding date last year.

3.6 All the major components of M_3 , viz., currency with the public, demand and time deposits with banks registered a lower growth in the current fiscal up to January 21, 2005 as compared to the previous year. Among the sources, growth of M_3 in the current year was largely driven by bank credit to the commercial sector and net foreign exchange assets (NFA) of the banking sector. Bank credit to the commercial sector registered a significant increase of 20.4 per cent (net of conversion, 17.2 per cent) in the current year (up to January 21, 2005) compared to 7.9 per cent in the corresponding period last year. Bank credit contributed 10.4 percentage points to the growth of M_3 in the current year. Though the

growth of NFA of the banking sector was lower at 13.6 per cent in the current year compared to 28.0 per cent in the corresponding period last year, it still contributed 3.6 percentage points to the growth of M_3 (Table 3.1).

Reserve money (M_0)

3.7 During the current financial year up to January 28, 2005, reserve money grew at a lower rate of 6.4 per cent as compared to 7.8 per cent in the corresponding previous period. This was mainly on account of the lower growth in currency in circulation of 9.0 per cent, down from 11.8 per cent last year. The year-on-year growth of reserve money as on January 28, 2005 was 16.7 per cent compared to 14.1 per cent on the corresponding date last year. In recent years, there has been a significant shift in the sources of reserve money. Net RBI credit to the Government, which drove reserve money growth till 2000-01, has ceased to be an important factor in determining reserve money growth. With large capital flows into the country, NFA of RBI has emerged as the main determinant of reserve money growth. In the current year so far, the RBI's NFA grew by 15.9 per cent on top of a 32.8 per cent growth in the corresponding previous period. Despite its lower growth, NFA contributed 17.7 percentage points to the growth of reserve money in the current year. In contrast, net RBI credit to the Government after declining by 66.9 per cent in the previous year, declined

² Net of conversion of a non-banking entity into a banking entity from October 11, 2004.

Table 3.1 : Sources of change in money stock (M₃)

| Items | Outstanding balances | | Variations during | | | | | | | | | |
|---|-----------------------|-----------|-------------------|---------|----------|---------|----------|----------------|---------|---------|---------|---------|
| | | | as on | | | | | Mar. 31 | | | | |
| | March 31, January 21, | | Mar. 31 | Mar. 31 | Mar. 31 | Jan. 24 | Jan. 23 | Mar. 31 | Mar. 31 | Mar. 31 | Jan. 24 | Jan. 23 |
| | 2004 | 2005 | 2003 | 2003 | 2004 | 2003 | 2004 | 2003 | 2003 | 2004 | 2003 | 2004 |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 |
| | | | <i>Rs. crore</i> | | | | | <i>Percent</i> | | | | |
| I. M₁ (Narrow Money) | 576651 | 614759 | 103071 | 54258 | 38108 | 74640 | 86921 | 21.8 | 11.5 | 6.6 | 16.5 | 16.5 |
| II. M₃ (Broad Money) | 2003102 | 2196876 | 285143 | 208064 | 193774 | 232272 | 270853 | 16.6 | 12.1 | 9.7 | 13.7 | 14.1 |
| (1+2+3+4) | | (2193307) | | | (190204) | | (267285) | | | (9.5) | | (13.9) |
| 1. Currency with the public | 315493 | 346930 | 43912 | 34600 | 31437 | 40711 | 40749 | 16.2 | 12.7 | 10.0 | 15.3 | 13.3 |
| 2. Demand deposits with banks | 256039 | 262382 | 57282 | 19436 | 6343 | 33137 | 44189 | 28.8 | 9.8 | 2.5 | 17.9 | 20.3 |
| 3. Time deposits with banks | 1426451 | 1582117 | 182072 | 153806 | 155666 | 157632 | 183932 | 14.6 | 12.4 | 10.9 | 12.7 | 13.2 |
| | | (1578548) | | | (152096) | | (180363) | | | (10.7) | | (12.9) |
| 4. "Other" deposits with RBI | 5119 | 5447 | 1877 | 222 | 328 | 792 | 1983 | 57.9 | 6.8 | 6.4 | 29.6 | 57.2 |
| III. Sources of change in money stock (M₃) | 2003102 | 2196876 | 285143 | 208063 | 193774 | 232273 | 270854 | 16.6 | 12.1 | 9.7 | 13.7 | 14.1 |
| 1. Net bank credit to Governemnt (A+B) | 745499 | 753387 | 68976 | 47785 | 7888 | 76688 | 29079 | 10.2 | 7.1 | 1.1 | 11.8 | 4.0 |
| | | (741194) | | | (-4305) | | (16885) | | | (-0.6) | | (2.3) |
| A. RBIs' net credit to Government | 44908 | 14187 | -75771 | -68270 | -30721 | -55414 | -38222 | -62.8 | -56.6 | -68.4 | -51.4 | -72.9 |
| (i) Central Govt. | 36920 | 11023 | -76064 | -64734 | -25897 | -53863 | -37227 | -67.3 | -57.3 | -70.1 | -52.7 | -77.2 |
| (ii) State Govts. | 7988 | 3164 | 293 | -3536 | -4824 | -1551 | -995 | 3.8 | -46.0 | -60.4 | -27.2 | -23.9 |
| B. Other banks credit to Government | 700591 | 739200 | 144747 | 116055 | 38609 | 132102 | 67301 | 26.0 | 20.9 | 5.5 | 24.5 | 10.0 |
| 2. Bank credit to commercial sector (A+B) | 1017902 | 1225825 | 118922 | 71042 | 207923 | 111346 | 255803 | 13.2 | 7.9 | 20.4 | 13.0 | 26.4 |
| | | (1193142) | | | (175240) | | (223121) | | | (17.2) | | (23.0) |
| A. RBIs' credit to commercial sector | 2061 | 1890 | -987 | -983 | -171 | -861 | -175 | -32.4 | -32.3 | -8.3 | -29.4 | -8.5 |
| B. Other banks' credit to commercial sector | 1015841 | 1223935 | 119909 | 72025 | 208094 | 112207 | 255978 | 13.4 | 8.0 | 20.5 | 13.1 | 26.4 |
| 3. Net foreign exchange assets of the banking sector | 526586 | 598123 | 132871 | 110072 | 71537 | 112358 | 94336 | 33.7 | 28.0 | 13.6 | 28.7 | 18.7 |
| 4. Government's currency liabilities to the public | 7296 | 7374 | 225 | 209 | 78 | 288 | 94 | 3.2 | 3.0 | 1.1 | 4.1 | 1.3 |
| 5. Banking sector's net non-liabilities other than time deposits | 294181 | 387833 | 35851 | 21045 | 93652 | 68407 | 108458 | 13.9 | 8.1 | 31.8 | 32.4 | 38.8 |
| Memorandum Items | | | | | | | | | | | | |
| 1. Money Multiplier (M ₃) | 4.59 | 4.85 | | | | | | | | | | |
| 2. Velocity of Money | 1.48 | | | | | | | | | | | |
| 3. Net domestic assets | 1476516 | 1598753 | 152272 | 97992 | 122237 | 119914 | 176517 | 11.5 | 7.4 | 8.3 | 9.2 | 12.4 |
| 4. Net domestic credit | 1763401 | 1979212 | 187898 | 118827 | 215811 | 188034 | 284882 | 11.9 | 7.5 | 12.2 | 12.5 | 16.8 |

Note: 1. 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 proceeds from RIBs (Resurgent India Bonds), since August 28, 1998 and Rs 25, 662 crore from India Millennium Deposits (IMDs) since November 17, 2000.

2. Figures within bracket are net of conversion of IDBI into bank.

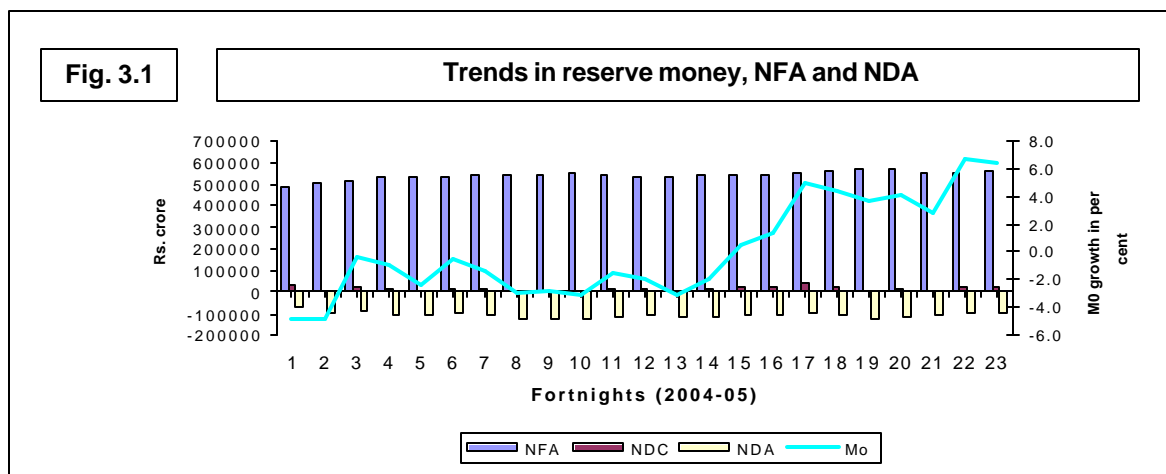
Table 3.2 : Components and sources of reserve money

| Items | Outstanding balances as on | | Variations during | | | | Percentage variations | | | | | |
|--|----------------------------|--------------|-------------------|---------|--------------|--------|-----------------------|-----------------------|---------|--------------|--------|-------|
| | 2003-04 | | Financial far | | Year-on-year | | Full Year | Financial year so far | | Year-on-year | | |
| | March 31, 2004 | Jan 28, 2005 | 2003-04 | 2004-05 | 2003 | 2004 | 2003-04 | 2003-04 | 2004-05 | 2003 | 2004 | |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
| A. Components of reserve money | 436512 | 464350 | 67451 | 28957 | 27838 | 49239 | 66332 | 18.3 | 7.8 | 6.4 | 14.1 | 16.7 |
| a. Currency in circulation | 327028 | 356358 | 44555 | 33452 | 29330 | 42871 | 40434 | 15.8 | 11.8 | 9.0 | 15.7 | 12.8 |
| b. Bankers' deposits with RBI | 104365 | 103590 | 21019 | -5286 | -775 | 5465 | 25531 | 25.2 | -6.3 | -0.7 | 7.5 | 32.7 |
| c. "Other" deposits with RBI | 5119 | 4401 | 1877 | 791 | -718 | 904 | 368 | 57.9 | 24.4 | -14.0 | 28.9 | 9.1 |
| B. Source of reserve money | | | | | | | | | | | | |
| 1. Net RBI credit to Govt. | 44907 | 13530 | -75772 | -80758 | -31377 | -68399 | -26391 | -62.8 | -66.9 | -69.9 | -63.1 | -66.1 |
| 2. RBI credit to banks | 5420 | 6092 | -1741 | -3310 | 673 | -2681 | 2242 | -24.3 | -46.2 | 12.4 | -41.1 | 58.2 |
| 3. RBI credit to comm. sector | 2061 | 1390 | -987 | -982 | -672 | -873 | -677 | -32.4 | -32.2 | -32.6 | -29.7 | -32.8 |
| 4. Net foreign exchange assets of RBI | 484413 | 561595 | 126169 | 117599 | 77182 | 124166 | 85752 | 35.2 | 32.8 | 15.9 | 35.3 | 18.0 |
| 5. Government's currency liabilities to the public | 7296 | 7374 | 225 | 200 | 79 | 288 | 94 | 3.2 | 3.0 | 1.1 | 4.1 | 1.3 |
| 6. Net non-monetary liabilities of RBI | 107585 | 125632 | -19557 | 3802 | 18047 | 3261 | -5312 | -15.4 | 3.0 | 16.8 | 2.6 | -4.1 |
| Memo items: | | | | | | | | | | | | |
| (i) Net domestic assets of RBI | -47901 | -97245 | -58719 | -88642 | -49344 | -74927 | -19420 | -542.8 | -819.4 | 103.0 | 2585.5 | 25.0 |
| (ii) Net domestic credit by RBI | 52388 | 21012 | -78500 | -85049 | -31376 | -71953 | -24826 | -60.0 | -65.0 | -59.9 | -61.1 | -54.2 |

further by 69.9 per cent in the current year (Table 3.2).

3.8 The progressive shift in the relative importance of the sources of reserve money in favour of NFA became more distinct in 2003-04 with NFA actually exceeding reserve money. The share of NFA in reserve money, which had increased from 9.1 per cent at end-March 1991, to 78.1 per cent at end-March, 2002, increased further to 111.0 per cent at end-March 2004. There was a corresponding decline in the share of net RBI credit to the Government, from over 101 per cent at end-

March, 1991 to 45.0 per cent at end-March, 2002 and further to 10.3 per cent at end-March, 2004. Currently, it is 2.9 per cent. The substantial reduction in the share of net RBI credit to Government in recent years can be mainly attributed to sustained open market operations (OMOs) including repo operations under the LAF, sterilisation of foreign currency flows and large build up of cash balances by the Central Government in 2003-04 on account of disinvestment proceeds, large repayment of loans by States under the Debt Swap Scheme and higher mobilisation under savings bonds (Figure 3.1).



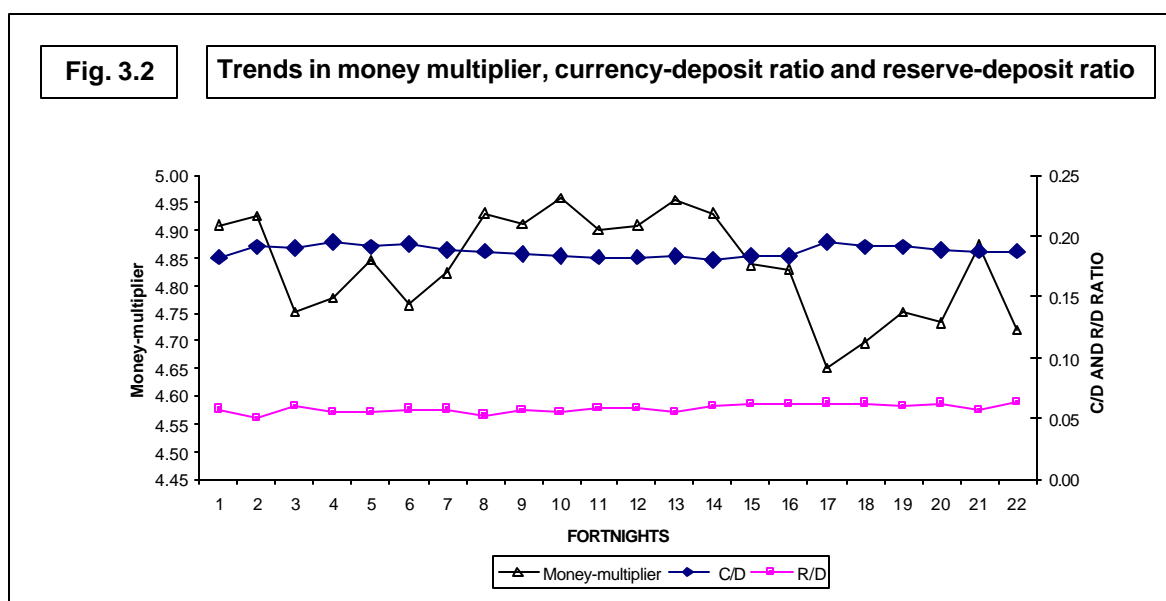
3.9 Changes in the relative importance of sources of reserve money have important implications as pointed out in the Annual Report of the RBI for 2003-04. Firstly, a higher share of foreign exchange assets relative to that of domestic assets in the balance sheet of a central bank strengthens its credibility in conducting monetary policy and exchange market operations. Secondly, monetisation of capital flows, by adding directly to bank liquidity, amplifies the process of credit creation. The rise in NFA, while imparting credibility to monetary management, has raised a few concerns relating to market risk in the event of a sharp appreciation in the rupee, quasi fiscal costs associated with sterilisation of foreign capital flows, and sustaining these operations over time.

3.10 The money multiplier, the ratio of broad money to reserve money, in recent years, has shown fluctuating trends. The money supply multiplier varies inversely with the policy-determined reserve-deposit ratio and the currency-deposit ratio endogenously determined by the public. The money multiplier increased from 4.43 at end-March 2002 to 4.65 at end-March 2003 and then declined to 4.59 at end-March 2004. During the current financial year (up to January 21, 2005), money multiplier varied between 4.96 (August 6, 2004) and 4.65 (November 12, 2004). As on January 21, 2005, this ratio stood at 4.72 compared to

4.77 on the corresponding date a year ago. The decline in the money-multiplier, despite a decline in currency-deposit ratio to 0.1881 (January 21, 2005) from 0.1894 (January 23, 2004), with the people increasingly going for more deposits than currency, was due to an increase in the reserve-deposit ratio from 0.0521 last year to 0.0554 in the current year. The increase in the reserve-deposit ratio was partly on account of an increase in CRR by RBI and as a deliberate policy decision by banks to hold excess reserves with the RBI (Figure 3.2).

Liquidity management

3.11 Liquidity management operations in 2004-05 had to cope with the sharp increase in reserve money in the previous year emanating largely from build-up of excess cash balances by commercial banks towards the end of the year, particularly in the last week of March, 2004. Another problem in liquidity management in the current year was the carry forward of excess liquidity amounting to Rs.81,000 crore from the previous year. The Government and the RBI have been taking appropriate steps to address the concerns emanating from large capital flows. The RBI has been moderating the impact of capital flows through open market sale of Government securities held by it and through repo operations under the LAF. The depletion of the



stock of Government securities held by the RBI from Rs.1,16,444 crore at end-March, 2003 to Rs.44,217 crore at end-March, 2004 constrained the OMOs of the RBI. As reported in the Economic Survey 2003-04, MSS was introduced effective April 1, 2004 to augment the stock of Government securities held by the RBI. The ceiling of Rs.60,000 crore fixed for raising treasury bills and dated securities under MSS for the year 2004-05 was raised to Rs.80,000 crore on August 26, 2004, when the amount raised under MSS crossed the threshold limit of Rs.50,000 crore. Liquidity absorption through MSS was Rs. 54,499 crore as on January 28, 2005.

3.12 The RBI had put in place a revised LAF scheme effective March 29, 2004 consisting of i) 7-day fixed rate reverse repo conducted daily, and ii) overnight fixed rate reverse repo conducted daily on weekdays, and iii) repo auction on overnight basis at a fixed rate and gradual phasing out of the extant 14-day repo. In its mid-term review of the annual policy statement for 2004-05 (October 26, 2004), the RBI introduced further changes in the LAF scheme to enhance its effectiveness and to facilitate liquidity management in a flexible manner. These changes relate to operating LAF scheme with overnight fixed rate repo and reverse repo and discontinuation of 7-day and

14-day reverse repo from November 1, 2004. The RBI increased the fixed reverse repo rate by 25 basis points to 4.75 per cent from October 27, 2004.

3.13 The spread between reverse repo and repo rates was reduced from 150 basis points to 125 basis points from October 27, 2004 to maintain the fixed repo rate unchanged at 6.0 per cent. The interest rate on eligible CRR balances was de-linked from the Bank Rate and was reduced to 3.5 per cent. With the operationalisation of MSS, the daily volumes under LAF have come down drastically. Though RBI has been absorbing liquidity under MSS and LAF to address the problem of overhang of liquidity, there have been occasions in recent months when RBI injected liquidity through the LAF window, indicating situations of occasional strains in liquidity in the banking system on account of a significant increase in domestic credit. The outstanding occasional injection of liquidity touched a peak of Rs.17,235 crore on November 18, 2004. Excess liquidity sterilised as on January 28, 2005 was about Rs. 69,259 crore, with Rs. 54,499 crore sterilised under MSS and Rs. 14,760 crore absorbed under LAF. In addition, surplus balances in the Central Government account with the RBI also helped in sterilising excess liquidity from time to time.