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Monetary and Banking Developments

After a growth of 7.5 per cent and inflation of 5 per cent in the previous year, 2005-06 started with signs of a growth rebound accompanied by some inflationary pressures stemming from hardening petroleum and primary product prices in the international markets. Recognising the emerging trend, the Reserve Bank of India (RBI), in April 2005, in its Annual Policy Statement for the year 2005-06, identified the need for assuring appropriate liquidity in the system and at the same time for pursuing polices for macroeconomic stability to facilitate growth. Furthermore, in the liberalised financial sector, banks and other financial institutions are now designing new products at competitive prices, which have transformed the operating framework. Recognising the greater systemic risks, RBI has initiated a series of regulatory and supervisory measures in tune with the best international practices to strengthen and safeguard the monetary framework.

3.2 In 2004-05, the higher demand for bank credit induced by a robust performance of the industrial and the services sectors resulted in a 13.3 per cent increase in net domestic credit from the banking system from Rs. 17,59,053 crore at end-March 2004 to Rs.19, 93,371 crore at end-March 2005. The Annual Policy Statement of the RBI in April 2005 projected GDP growth at 7.0 per cent and the rate of inflation in the range of 5.0-5.5 per cent for 2005-06. Consistent with this, broad money (M_3) was projected to grow at 14.5 per cent during 2005-06. Monetary developments during 2005-06 so far have been characterised by (i) rapid increase in credit, (ii) reduction in SLR investments by banks to meet rising non-food credit demand, (iii) slow down in accretion of foreign exchange reserves and hence net foreign assets of the banking system, and (iv) higher international commodity and crude oil prices influencing expectations about the impact on domestic inflation. Accordingly, the monetary policy stance calibrated the extent of operations of Market Stabilisation Scheme (MSS), as well as the Liquidity Adjustment Facility (LAF) through reverse repo/repo operations and introduction of second LAF to modulate liquidity in the system. With prudent monetary management, the redemption of India Millennium Deposits (IMDs) by the State Bank of India in end-December 2005 could go through smoothly. Owing to the timely and apposite initiatives, the liquidity and interest rates in the system have continued to catalyse growth.

3.3 The upbeat growth trend of 8.1 per cent in the first half of 2005-06 has been reflected in a steady increase of 17.5 per cent in net domestic credit from the banking system from Rs.19,84,330 crore on January 21, 2005 to Rs. 23,32,326 crore on January 20, 2006. The growth in net domestic credit during the current financial year up to January 20, 2006 was 14.4 per cent. The steady expansion in net domestic credit contributed as much as 15.9 percentage points to the overall increase in M_3 (year–on-year) on January 20, 2006. The year-on-year growth of M_3 at 16.4 per cent was higher than the growth not only of 13.9 per cent last year but also of the RBI-projected 14.5 per cent for the full year in April, 2005. Nevertheless, headline (point to point) inflation declined sharply to 3.3 per cent in the week ended August 27, 2005 from 5.7 per cent for the week ended April 2, 2005. The inflation rate in the week ended January 28, 2006 was 4.3 per cent. Price stability despite a rapid increase in money supply during the current year testified the investment-driven nature of the credit growth and stability of inflation expectations based on confidence in the appropriate stance of monetary and fiscal policies.