

Monetary trends and developments

Broad money supply (M_3)

3.6 During 2005-06, M_3 expanded by 17.0 per cent, up from Rs.2,332,667 crore on April 1, 2005 to Rs. 2,729,536 crore at end-March 2006 (Table 3.1). Even after taking into account the existence of 27 reporting fortnights in 2005-06, this expansion was considerably higher than the expansion of 12.3 per cent during 2004-05 and than the growth rate of 14.5 per cent projected in the April 2005 Annual Policy Statement. With M_3 growing faster than nominal GDP in recent years, the velocity of money (ratio of nominal GDP to the average M_3 stock during the year) has declined from 1.62 during 2001-02 to 1.47 during 2004-05 and further to 1.45 during 2005-06.

3.7 Among the components of M_3 , demand deposits grew the highest (26.1 per cent compared to 10.3 per cent in 2004-05), followed by currency with the public (16.4 per cent compared to 13.0 per cent in 2004-05) and time deposits (15.4 per cent compared to 12.4 per cent in 2004-05). The high growth of demand deposits was mainly due to higher capital mobilisation in the primary market, increased non-food credit by banks, and large mobilisation by domestic mutual funds being temporarily parked in demand deposits pending utilisation. The sharp pick up in time deposits in the second quarter of 2005-06 reflected both the small base in the previous year as well as the rise in deposit rates of interest.

3.8 Net bank credit to commercial sector remained the main source of M_3 growth. Credit continued to grow steadily for the second year in succession, with an expansion of Rs. 359,702 crore in 2005-06 following Rs. 264,099 crore in 2004-05. There was a change, however, in the food and non-food composition of credit between the two years. Non-food credit by SCBs expanded by 31.8 per cent (Rs. 354,192 crore) in 2005-06 compared to 27.5 per cent (Rs. 221,602 crore)

in 2004-05. Food credit increased marginally by Rs. 674 crore in 2005-06 compared to Rs.5,160 crore in 2004-05 thereby registering an increase of 1.7 per cent. With credit outpacing GDP in growth terms, net domestic credit as a proportion of GDP increased from 52.7 per cent at end-March 2000 to 64.1 per cent at end-March 2003 and further to 69.0 per cent at end-March 2006.

3.9 To bridge the widening gap between the growth of credit and deposits, the banks have been funding the credit growth partly by reducing their investment portfolio through sale of Government securities above SLR requirement and liquidating their non-SLR investments. The gilt portfolio of SCBs, after increasing by Rs. 52,031 crore during 2004-05, declined by Rs. 19,514 crore during 2005-06. On March 31, 2006, SLR portfolio of SCBs was 31.0 per cent of their net demand and time liabilities (NDTL), down from 38.0 per cent a year ago. Non-SLR investments, which had increased by Rs.5,992 crore during 2004-05, declined by Rs. 10,256 crore during 2005-06.

3.10 During the current financial year up to January 19, 2007, M_3 expanded by Rs. 342,170 crore (12.5 per cent over end-March 2006) as compared to the expansion of Rs. 203,542 crore (8.7 per cent) during the corresponding period of the previous year. On a year-on-year basis, on January 19, 2007, M_3 expansion was even higher at Rs. 535,497 crore (21.1 per cent) compared to the expansion of Rs.343,007 crore (15.6 per cent) on the corresponding date of the previous year.

3.11 Currency with the public during the current financial year (up to January 19, 2007) increased by 14.2 per cent, marginally higher than 13.7 per cent during the corresponding period of 2005-06. On a year-on-year basis, growth in currency with public was 16.9 per cent as on January 19, 2007 compared to 16.3 per cent on January 20, 2006.

3.12 There was a change in the behaviour of demand and time deposits between 2005-

06 and the current year so far. Up to January 19, 2007, demand deposits with banks declined by Rs. 7,238 crore over the end-March 2006 level to Rs.397,986 crore. Such deposits had increased by Rs. 18,537 crore during the same period of previous year. On a year-on-year basis, growth in demand deposits on January 19, 2007 was lower at 17.1 per cent compared to 28.9 per cent on the corresponding date of last year. On the other hand, with interest rates firming up and availability of tax benefits under section 80C of the Income tax Act for deposits with maturity of five years and above, growth of time deposits accelerated between 2005-06 and the current year so far. On a financial year basis, time deposits increased by 15.3 per cent as of January 19, 2007 compared to 8.4 per cent during the corresponding period of 2005-06. On a year-on-year basis, the acceleration was even sharper with growth at 22.8 per cent on January 19, 2007 compared to 13.4 per cent on January 20, 2006.

3.13 Credit to the commercial sector during the current year up to January 19, 2007 had expanded by Rs. 272,357 crore compared to the expansion of Rs. 215,797 crore during the same period of the previous year. In percentage terms, however, the growth rate during the current financial year was only marginally lower at 16.1 per cent compared to 16.2 per cent during the same period of the previous year. On a year-on-year basis, growth of credit to the commercial sector on January 19, 2007 was up only to 26.9 per cent from 26.6 per cent on January 20, 2006. Credit to the commercial sector has remained the single most important source of M_3 growth in 2005-06 and in the current year so far. On a financial year (year-on-year) basis, it contributed 10.0 (16.4) percentage points to the overall M_3 growth of 12.5 (21.1) per cent in the current year up to January 19, 2007.

3.14 During the current year up to January 19, 2007, net bank credit to Government expanded by Rs.40,270 crore (5.2 per cent) compared to the expansion of Rs. 33,827 crore (4.5 per cent) during the corresponding period of 2005-06. On a year-on-year basis, on January 19, 2007, net bank credit to

Government expanded by Rs. 26,828 crore (3.4 per cent), compared to the increase of Rs. 20,281 crore (2.7 per cent) on January 20, 2006. During the current year, upto January 19, 2007, net RBI credit to Central Government expanded only by Rs. 6,963 crore compared to Rs.55,578 crore in the corresponding period of last year; on year-on-year basis this declined by Rs.15,241 crore on January 19, 2007 compared to an increase of Rs.16,341 crore on January 20, 2006 (Table 3.1).

Reserve money (M_0)

3.15 M_0 expansion, during 2005-06 at Rs. 83,931 crore (Table 3.2) was substantially higher than the increase of Rs. 52,623 crore in 2004-05. At end-March, M_0 at Rs. 5,73,066 crore in 2006 was up 17.2 per cent from Rs.4,89,135 crore at end-March 2005. During the whole of 2004-05, M_0 had grown only by 12.1 per cent.

3.16 Like in 2004-05, expanding net foreign exchange assets (NFA) of the RBI continued to be the main source of M_0 increase in 2005-06, albeit with reduced intensity. Compared to Rs. 128,377 crore (26.5 per cent) during 2004-05, NFA during 2005-06 expanded by only Rs. 60,193 crore (9.8 per cent), partly due to the redemption of India Millennium Deposits. Net domestic assets (NDA) of the RBI, the other source of M_0 variation, which had declined by Rs. 75,754 crore in 2004-05, increased by Rs.23,738 crore — mainly due to net RBI credit of Rs. 26,111 crore to Government — during 2005-06. In contrast to an increase in Government's deposits with RBI of Rs.72,558 crore on account of large issuances under the market stabilization scheme (MSS) during 2004-05, a temporary suspension of MSS from mid-November 2005 had led to a decline of Rs. 14,541 crore in Centre's deposits with the RBI during 2005-06. NFA contributed only 12.3 percentage points of the 17.2 per cent growth of M_0 during 2005-06 compared to the 29.4 percentage points of 12.1 per cent growth of M_0 during 2004-05. In contrast, contribution of NDA to growth of M_0 was a mere 4.9 percentage points in 2005-06 compared to a negative

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

Items	Outstanding balances as on		Variations during									
			Apr. 1	Apr. 1	Mar. 31	Jan. 21	Jan. 20	Apr. 1	Apr. 1	Mar. 31	Jan. 21	Jan. 20
	Mar. 31,	Jan. 19,	2005	2005	2006	2005	2006	2005	2005	2006	2005	2006
	2006	2007	to	to	to	to	to	to	to	to	to	to
1	2	3	4	5	6	7	8	9	10	11	12	13
			<i>Rs. crore</i>					<i>Percent</i>				
I. M ₁ (Narrow Money)	825246	865538	142693	65463	40292	131783	128769	20.9	9.6	4.9	21.4	17.2
II. M ₃ (Broad Money) (1+2+3+4)	2729536	3071706	396869	203542	342170	343007	535497	17.0	8.7	12.5	15.6	21.1
1. Currency with the public	413143	471845	58272	48663	58702	56532	68311	16.4	13.7	14.2	16.3	16.9
2. Demand deposits with banks	405224	397986	83861	18537	-7238	76179	58086	26.1	5.8	-1.8	28.9	17.1
3. Time deposits with banks	1904290	2196166	254176	138079	291876	211224	407973	15.4	8.4	15.3	13.4	22.8
4. "Other" deposits with RBI	6879	5709	560	-1737	-1170	-928	1127	8.9	-27.5	-17.0	-16.8	24.6
III. Sources of change in money stock (M ₃)												
1. Net bank credit to Government (A+B)	769092	809362	20385	33827	40270	20281	26828	2.7	4.5	5.2	2.7	3.4
A. RBIs' net credit to Government	8136	12242	35798	54985	4106	13136	-15081					
(i) Central Government	5160	12123	33374	55578	6963	16341	-15241					
(ii) State Governments	2976	119	2424	-593	-2857	-3205	160					
B. Other banks credit to Government	760956	797120	-15413	-21158	36164	7145	41909	-2.0	-2.7	4.8	1.0	5.5
2. Bank credit to commercial sector (A+B)	1690961	1963318	359702	215797	272357	324977	416262	27.0	16.2	16.1	26.6	26.9
A. RBIs' credit to commercial sector	1387	1907	-3	950	520	450	-433	-0.2	68.3	37.5	23.8	-18.5
B. Other banks' credit to commercial sector	1689574	1961411	359705	214847	271837	324527	416695	27.0	16.2	16.1	26.6	27.0
3. Net foreign exchange assets of the banking sector	726194	835577	78291	7812	109383	56163	179862	12.1	1.2	15.1	9.4	27.4
4. Government's currency liabilities to the public	8754	8054	1306	1216	-700	1228	-610	17.5	16.3	-8.0	16.5	-7.0
5. Banking sector's net non-monetary liabilities other than time deposits	465466	544604	62817	55110	79138	59642	86845	15.6	13.7	17.0	15.0	19.0
Memorandum Items												
1. Money multiplier (M ₃)	4.76	4.79						-	-	-	-	-
2. Velocity of money	1.45											
3. Net domestic assets	2003341	2236130	318576	195730	232789	286844	355635	18.9	11.6	11.6	18.0	18.9
4. Net domestic credit	2460053	2772680	380087	249624	312627	345258	443090	18.3	12.0	12.7	17.4	19.0
<p>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 RIB (Resurgent India Bonds), since August 28,1998 and Rs 25, 662 crore from India Millennium Deposits (IMDs) since November 17, 2000.</p> <p>2. Financial year variations during 2006-07 so far is worked out from March 31, 2006, whereas the corresponding financial year variation during 2005-06 is worked out from April 1, 2005.</p>												

Table 3.2 : Sources of change in reserve money(M₀)

Items	Outstanding balances as on		Variations during				Percentage variations					
			2005-06	Year-on-year		Financial year so far		2005-06	Year-on-year		Financial year so far	
	Mar 31, 2006	Jan. 19, 2007		20 Jan 06	19 Jan 07	20 Jan 06	19 Jan 07		20 Jan 06	19 Jan 07	20 Jan 06	19 Jan 07
			over	over	over	over	over	over	over	over	over	
		21 Jan 05	20 Jan 06	31 Mar 05	31 Mar 06	21 Jan 05	20 Jan 06	31 Mar 05	31 Mar 06			
1	2	3	4	5	6	7	8	9	10	11	12	13
	Rs. Crore						Per cent					
Reserve Money(M ₀)	573066	641790	83931	69213	106846	45809	68724	17.2	14.9	20.0	9.4	12.0
A: Components of Reserve Money												
a. Currency in circulation	430676	488251	62015	59241	71015	48575	57575	16.8	16.5	17.0	13.2	13.4
b. Bankers' deposits with RBI	135511	147830	21515	10900	34704	-870	12319	18.9	10.7	30.7	-0.8	9.1
c. "Other" deposits with RBI	6879	5709	401	-928	1127	-1896	-1170	6.2	-16.8	24.6	-29.3	-17.0
B: Sources of Reserve Money												
1. Net RBI credit to Government	8136	12242	26111	13136	-15081	45298	4106					
2. RBI credit to banks	5795	7804	537	-150	1720	826	2009	10.2	-2.4	28.3	15.7	34.7
3. RBI credit to commercial sector	1387	1907	-3	450	-433	950	520	-0.2	23.8	-18.5	68.3	37.5
4. Net foreign exchange assets of RBI	672983	787321	60193	54490	172487	2044	114338	9.8	9.7	28.1	0.3	17.0
5. Government's currency liabilities to the public	8754	8054	1306	1228	-610	1216	-700	17.5	16.5	-7.0	16.3	-8.0
6. Net non-monetary liabilities of RBI	123990	175537	4214	-60	51237	4524	51547	3.5	0.0	41.2	3.8	41.6
Memo items:												
1. Net domestic assets of RBI	-99917	-145531	23738	14723	-65641	43765	-45614	-542.8	-15.6	82.2	-838.6	203.8
2. Net domestic credit by RBI	15318	21953	26645	13436	-13794	47074	6635	-60.0	60.2	-38.6	-72.7	-58.1

contribution of (-) 14.6 percentage points in the previous year.

3.17 NFA of RBI has continued to be the main driver of M₀ expansion even during the current year, with such NFA expanding by Rs. 114,338 crore as on January 19, 2007 over the end-March 2006 level of Rs. 672,983 crore thereby contributing 20.0 percentage points to the overall 12.0 per cent growth in M₀. During the same period of the previous year, that is between end-March 2005 and January 20, 2006, NFA had expanded only by Rs. 2,044 crore.

3.18 On a year-on-year basis, M₀ expanded by 20.0 per cent on January 19, 2007, considerably higher than 14.9 per cent observed on January 20, 2006, to reach Rs. 641,790 crore. Such year-on-year growth in M₀ was mainly due to robust growth in the NFA of the RBI at 28.1 per cent on January 19, 2007 which was nearly thrice the growth of 9.7 per cent observed a year ago, matched by a sharp year-on-year decline in the NDA of the RBI of Rs. 65,641 crore compared to an increase in RBI's NDA of Rs. 14,723 crore on the corresponding date of the previous year (Table 3.2). The contributions of NFA and NDA of the RBI to the 20.0 per cent growth of M₀

on a year-on-year basis on January 19, 2007 were 32.2 percentage points and (-) 12.3 percentage points, respectively.

3.19 Reflecting these developments, the share of NFA in M₀ and in currency in circulation declined from 125.3 per cent and 166.2 per cent, respectively, to 117.4 per cent and 156.3 per cent, respectively, between end-March 2005 and end-March 2006. In a reversal of this trend in the current financial year, these ratios rose to 122.7 per cent and 161.3 per cent, respectively, on January 19, 2007 from 114.9 and 147.4 per cent, respectively, on January 20, 2006.

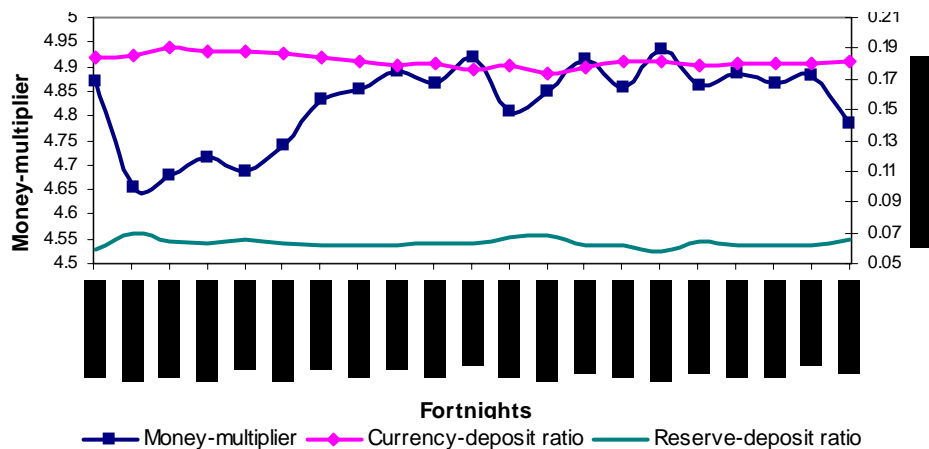
3.20 Sustained faster growth of M₃ relative to that of M₀ in recent years has resulted in

the money multiplier ($\frac{M_3}{M_0}$) steadily increasing

from 4.43 at end-March 2002 to 4.60 at end-March 2005, 4.76 at end-March 2006 and further to 4.79 on January 19, 2007 (Figure 3.1). Between January 20, 2006 and January 19, 2007, while the currency-deposit ratio declined to 0.181 from 0.189, the reserve-deposit ratio increased to 0.065 from 0.062, reflecting partly the effect of the recent hike in the cash reserve ratio (CRR) by the RBI.

Fig. 3.1

Trends in Money Multiplier, Currency-Deposit Ratio and Reserve-Deposit Ratio



Liquidity management

3.21 Unwinding of the Central Government surplus balances with the RBI during the current financial year and continued intervention by the RBI in the foreign exchange market to maintain orderly conditions led to an increase in the liquidity in the system. This was also reflected in higher bids offered and accepted by RBI through reverse-repo transactions under LAF. During 2006-07, up to September 8, 2006, RBI had not received any bid for repo and the continuous flow of funds under reverse-repo indicated a comfortable liquidity position. Thereafter, with the onset of the festival season, demand for currency increased, and high credit expansion together with outflows on account of advance tax started to affect the overall liquidity condition in the system. In response, RBI, under repo transactions, accommodated Rs.275 crore on September 15, 2006 and Rs. 5,010 crore on September 29, 2006. Such accommodations intensified during October 2006, and on six occasions, RBI injected liquidity under repo transactions: Rs. 35 crore on October 13, Rs. 1000 crore on October 19, Rs. 1,585 crore on October 20, Rs. 1,465 crore on October 23, Rs. 10 crore on October 26, and Rs. 330 crore on October 27. However, with liquidity absorption under reserve-repo simultaneously on, in net terms, there was injection of liquidity under LAF only on October 20, October 23 and October 26, 2006.

3.22 With year-on-year inflation stubbornly above 5 per cent since early-August 2006, on October 31, 2006, the RBI in its Mid-Term Review announced measures to stem inflationary expectations and also to contain

the credit off-take at the desired growth rate of 20.0 per cent stipulated in the Annual Policy Statement of April, 2006. The repo rate was raised by 25 basis points to 7.25 per cent. On December 8, 2006, it was further announced that the CRR rate would be hiked by one-half of one percentage point on net demand and time liabilities (NDTL) in two stages effective from December 23, 2006 (5.25 per cent) and January 6, 2007 (5.50 per cent). The CRR increase, which was expected to absorb about Rs. 13,500 crore from the banking sector, together with the continued high credit growth, introduced some strain on the liquidity in the system from mid-December 2006. In fact, liquidity injection into the system under LAF during December, 2006, amounted to Rs. 44,090 crore (injection under repo of Rs.3,58,955 crore exceeding absorption under reverse-repo of Rs. 3,14,865 crore). Though the LAF had been in an injection mode between January 8, 2007 to February 7, 2007, subsequently the liquidity in the system increased as reflected in absorptions under reverse-repo. In the light of the emerging liquidity situation and inflationary expectations, RBI announced on February 13, 2007 further hike in CRR by 25 basis points each effective from the fortnights beginning February 17 and March 3, 2007. This is expected to absorb Rs. 14,000 crore from the banking system.

3.23 The liquidity in the system was also addressed during 2006-07 by MSS operations. Outstanding balance under MSS, after increasing from Rs. 29,062 crore (1.0 per cent of M_3) on March 31, 2006 to a high of Rs. 42,364 crore (1.5 per cent of M_3) on August 25, 2006, started declining thereafter to reach Rs. 40,491 (1.3 per cent of M_3) on January 19, 2007.