Money supply

1.35 The Reserve Bank of India's monetary policy stance is to serve the twin objectives of managing the transition to a higher growth path and containing inflationary pressures. For policy purposes for 2007-08, the RBI assumed a real GDP growth of 8.5 per cent with inflation close to 5 per cent, and targeted the monetary expansion in the range of 17-17.5 per cent and credit expansion in the range of 20 to 24 per cent as consistent with envisaged growth and inflation. In its mid-term review, the RBI reiterated continuation of the policy stance announced in April 2007 with an additional resolve "to be in readiness to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusual heightened global uncertainties, and the unconventional policy responses to the developments in financial markets".

1.36 Annual average growth of Money (M_3) reached a trough of 13 per cent in 2003-04 and has been on an accelerating trend since then, reaching 19.5 per cent in 2006-07. The cumulative (FY to date) increase in the stock of M_3 in 2007-08 has also remained above the cumulative growth in 2006-07 and was 13.3 per cent on January 4, 2008, compared to 12.2 per cent on January 5, 2006. Thus it is difficult to relate either the annual or trend rate of growth of M_3 to inflation which has been on a down trend during this period, with two cycles peaking in August 2004 and March 2007. This is perhaps because of the parallel process of monetary deepening of the informal economy that is under way. The ratio of average M_3 to GDP has increased from 44 per cent in 1990-91 to 71 per cent in 2006-07. This could be attributed to the spread of banking services and the saving habit, resulting in a rise of time deposits. The monetization of the economy as measured by the ratio of average M_1 to GDP has increased from 15 per cent in 1990-91 to 21 per cent in 2006-07.

1.37 The average growth of bank credit to commercial sector (BCCS) also reached a low of 11.8 per cent in 2003-04 and rose in the next two years to 28 per cent in 2005-06. However, in contrast to money supply, average credit growth slowed marginally to 26.8 per cent in 2006-07 and has decelerated further in 2007-08. The cumulative (FY to date) increase in the credit extended by the banking sector to commercial sector during 2007-08 is less than in 2006-07. The cumulative increase in non-food credit by January 4, 2008, was 11.8 per cent, much slower than the 17.5 per cent increase till the corresponding date of 2007. This deceleration could be related to the deceleration in growth of manufacturing and construction sectors and the consequent slowdown in demand for credit.

1.38 Nominal interest rates, as measured by the cut-off yield at auction on 91-day and 364-day Treasury Bills have followed a pattern similar to that of money growth. The average cut-off yield on 364-day (91-day) Treasury Bills reached a trough of 4.7 (4.6) per cent in 2003-04 and has been rising since then. Yields averaged 7 (6.6) per cent during 2006-07. Yields have risen further to an average of 7.5 (7) per cent in April-December 2007 from 6.8 (6.3) per cent in April-December 2006. Real cut-off yields, as measured using the trailing 12 month increase in the WPI, have lagged this increase, by reaching a trough of -1.2 (-1.5) per cent in 2004-05 and rising thereafter to 1.6 (1.2) per cent in 2006-07. The latter were marginal higher than the average yield in 2005-06. Real cut-off yields on 364 (91) day treasury bills have (more than) doubled to an average of 3.2 (2.7) per cent in April-December 2007 from 1.7 (1.2) per cent in April-December 2006. The doubling of the real interest rate may have had a moderating effect on credit demand and consequently on both inflation and growth. It has also led to a widening of the interest differential between domestic and global rates.

1.39 During 2006-07, the yield on 10-year G-sec hardened by 45 basis points over the level observed on March 31, 2006, to reach 7.97 per cent on March 31, 2007. Yields moved to 8.32 per cent at end-June 2007 but softened subsequently to reach 7.77 per cent as on January 4, 2008, which was 20 basis points over the end-March 2007 level.

1.40 The acceleration in reserve money growth continued in 2007-08. The expansion in M_0 (up to January 4, 2008) was 13.6 per cent compared to 9.1 per cent during the corresponding period of the previous year. The main driver of growth of M_0 on financial year as well as on annual basis continued to be net foreign assets (NFA) of the RBI. NFA of the RBI expanded by 25.2 per cent in the current year (39.1 per cent on annual basis) compared to an expansion of 15.9 per cent (26.1 per cent on annual basis) during the same period of the previous year. The share of NFA in the aggregate reserve money increased to 122.2 per cent as on March 31, 2007, as against 117.4 per cent on March 31, 2006. This ratio further increased to 134.7 per cent on January 4, 2008. With the continuing surge in capital flows during 2007-08 and the need to regulate domestic liquidity, the MSS limits were revised upward four times to a level of Rs. 2,50,000 crore during the year. During April-December 28, 2007, liquidity absorbed under MSS was Rs. 96,742 crore with outstanding balances at Rs. 1,59,717 crore. The higher growth of the monetary variables (M_0 and M_3), despite the MSS operations, generated higher liquidity in the system. Short-term liquidity variations were addressed by RBI through the Liquidity Adjustment Facility.