

IV. MONETARY AND LIQUIDITY CONDITIONS

Liquidity conditions remained tight during the third quarter of 2010-11, warranting liquidity easing measures by the Reserve Bank. The normalisation of monetary policy during the year, as intended, has been non-disruptive. Conditions for enhancing the effectiveness of monetary policy, however, improved in the third quarter of the year, as the tightness in liquidity prompted competition among banks, leading to higher deposit and lending rates. The Reserve Bank injected large primary liquidity through repo and open market operations, which was reflected in the high growth of base money. This was necessary to avoid the risk of liquidity stress adversely impacting the real economy, even though the overall anti-inflationary stance was sustained throughout.

While the goal of non-disruptive normalisation of monetary stance has been achieved with the return of robust growth, persistent high inflation has emerged as the key challenge for monetary policy

IV.1 The Reserve Bank achieved non-disruptive normalisation between March and November 2010 through calibrated tightening of the policy interest rates and liquidity conditions. The predominant objective behind adopting such an approach to normalisation was to gradually raise the anti-inflationary accent of the policy without disrupting growth. While growth has firmly consolidated around the trend now, inflation remains elevated with significant downward inflexibility. The interest rate and liquidity conditions altered significantly during the course of the year on the back of policy normalisation. In the terminal months of 2010, liquidity conditions tightened beyond the comfort level, driven by both frictional and structural factors, and interest rate transmission also strengthened as banks responded to the liquidity deficit by raising deposit and lending rates. The Reserve Bank undertook measures to ease the liquidity pressures to avoid the risk of liquidity stress affecting the flow of credit to productive activities. The anti-inflationary stance of monetary policy, however, continued.

Liquidity conditions started to tighten on the back of policy, but got exacerbated by autonomous factors

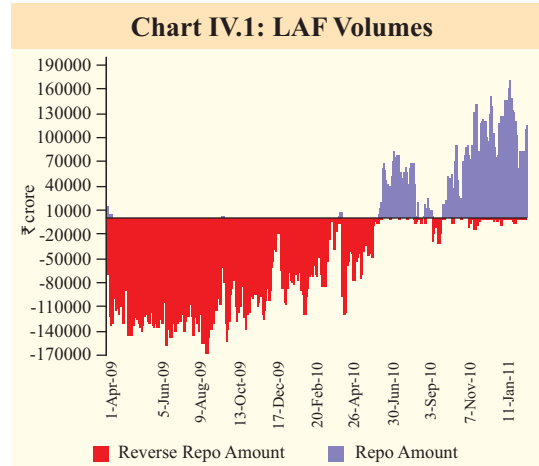
IV.2 In 2010, the repo and the reverse repo rates were raised by 150 basis points and 200 basis points, respectively, as part of the normalisation of policy (Table IV.1). With repo rate emerging as the operative policy rate, there was an effective tightening of policy rate by 300

Table IV.1: Movements in Key Policy Rates in India

Effective Since	(Per cent)		
	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio
1	2	3	4
October 11, 2008	6.00	9.00	6.50 (-2.50)
October 20, 2008	6.00	8.00 (-1.00)	6.50
October 25, 2008	6.00	8.00	6.00 (-0.50)
November 3, 2008	6.00	7.50 (-0.50)	6.00
November 8, 2008	6.00	7.50	5.50 (-0.50)
December 8, 2008	5.00 (-1.00)	6.50 (-1.00)	5.50
January 5, 2009	4.00 (-1.00)	5.50 (-1.00)	5.50
January 17, 2009	4.00	5.50	5.00 (-0.50)
March 4, 2009	3.50 (-0.50)	5.00 (-0.50)	5.00
April 21, 2009	3.25 (-0.25)	4.75 (-0.25)	5.00
February 13, 2010	3.25	4.75	5.50 (+0.50)
February 27, 2010	3.25	4.75	5.75 (+0.25)
March 19, 2010	3.50 (+0.25)	5.00 (+0.25)	5.75
April 20, 2010	3.75 (+0.25)	5.25 (+0.25)	5.75
April 24, 2010	3.75	5.25	6.00 (+0.25)
July 2, 2010	4.00 (+0.25)	5.50 (+0.25)	6.00
July 27, 2010	4.50 (+0.50)	5.75 (+0.25)	6.00
September 16, 2010	5.00 (+0.50)	6.00 (+0.25)	6.00
November 2, 2010	5.25 (+0.25)	6.25 (+0.25)	6.00

Note: 1. Reverse repo indicates absorption of liquidity and repo indicates injection of liquidity.
2. Figures in parentheses indicate change in policy rates in percentage points.

basis points between March and November 2010. The increase in cash reserve ratio (CRR) in February and April 2010 contributed to the gradual tightening of liquidity and the effective switch of the Liquidity Adjustment Facility (LAF) from absorption through reverse repo to injection through repo (Chart IV.1). From end-May 2010, liquidity tightened on account of the monetary policy actions, which was exacerbated by autonomous factors such as large increase in government surplus with the Reserve Bank as well as the unusually high demand for currency on account of high inflation, increased asset prices and payments under government schemes such as MGNREGS. As deficit liquidity conditions persisted for most part of the year and the severity of the pressure at times



became excessive, the Reserve Bank operationalised several liquidity-easing measures at regular intervals in order to reduce the liquidity deficit (Table IV.2).

Table IV.2: Liquidity Management Measures taken by the Reserve Bank in 2010-11

Time Period/Event	Measures
1	2
End-May 2010: Larger than anticipated collection for 3G/BWA spectrum in addition to advance tax outflow resulted in migration of liquidity to central government's cash balance account with the Reserve Bank	For the period May 28, 2010-July 2, 2010, SCBs were: <ul style="list-style-type: none"> (i) Allowed to avail additional liquidity support under the LAF to the extent of up to 0.5 per cent of their NDTL (for any shortfall in maintenance of SLR arising out of availment of this facility, banks were allowed to seek waiver of penal interest). (ii) Given access to second LAF (SLAF) on a daily basis. With the persistence of deficit liquidity conditions, measure (i) was extended up to July 16, 2010 and measure (ii) up to July 30, 2010.
End-October 2010: Frictional liquidity pressure due to autonomous factors compounded by banks' high CRR requirement (since the fortnight ended October 22, 2010 had seen a large increase in NDTL)	<ul style="list-style-type: none"> (i) The Reserve Bank conducted special SLAF on October 29 and November 1, 2010, a special two-day repo auction under the LAF on October 30, 2010, and allowed waiver of penal interest on shortfall in maintenance of SLR (on October 30-31, 2010) to the extent of 1.0 per cent of NDTL for availing additional liquidity support under the LAF. (ii) The Reserve Bank extended these liquidity easing measures further and conducted SLAF on all days during November 1-4, 2010 and extended the period of waiver of penal interest on shortfall in maintenance of SLR (to the extent of 1.0 per cent of NDTL) for availing additional liquidity support under the LAF till November 7, 2010. (iii) The Reserve Bank re-started purchase of government securities under its open market operations (OMO) from November 4, 2010. (iv) On November 9, 2010, the Reserve Bank reintroduced daily SLAF and extended the period of waiver of penal interest on shortfall in maintenance of SLR to the extent of 1.0 per cent of NDTL for availing additional liquidity support under the LAF till December 16, 2010. (v) On November 29, 2010, the Reserve Bank extended the daily SLAF and allowed additional liquidity support to the SCBs under the LAF to the extent of up to 2.0 per cent of their NDTL till January 28, 2011.
Mid-December 2010: Continued build up in government balances on account of third quarterly advance tax collections	In the mid-Quarter Review of December 2010, the Reserve Bank: <ul style="list-style-type: none"> (i) Reduced the SLR of SCBs from 25 per cent of NDTL to 24 per cent with effect from December 18, 2010. Given the permanent reduction in the SLR, additional liquidity support of 1.0 per cent of NDTL under the LAF would be available from December 18, 2010 till January 28, 2011. (ii) Announced conduct of OMO auctions for purchase of government securities for an aggregate amount of ₹48,000 crore in the next one month (staggered as purchases of ₹12,000 crore per week).

Note: The central government, in consultation with the Reserve Bank, undertook a number of measures for cash management which also helped in management of liquidity. These included repurchase of dated securities in tranches, reduction in the amount of borrowing in the indicative calendar for the second half of 2010-11 by ₹10,000 crore and rescheduling of auction amount of g-secs from that mentioned in the indicative calendar on a few occasions.

Table IV.3: Reserve Bank's Liquidity Management Operations

Item	(₹ crore)						
	2009-10				2010-11		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8
A. Drivers of Liquidity (1+2+3+4)	-45,110	-44,514	-66,785	55,055	-1,04,914	27,034	-1,09,215
1. RBI's net Purchase from Authorised Dealers	-15,874	2,523	436	910	816	751	5,991
2. Currency with the Public	-18,690	-9,020	-43,224	-31,650	-58,210	54	-42,730
3.a. Centre's surplus balances with RBI	3,382	-67,938	-22,663	85,257	-58,249	10,953	-78,960
3.b. WMA and OD	0	0	0	0	0	0	0
4. Others (residual)	-13,928	29,921	-1,334	538	10,729	15,275	6,484
B. Management of Liquidity (5+6+7+8)	-21,674	62,376	89,870	1,618	67,255	-41,456	1,34,075
5. Liquidity impact of LAF	-1,30,020	25,390	86,330	18,795	75,785	-44,545	83,165
6. Liquidity impact of OMO* (net)	43,159	32,869	3,540	2,787	1,550	2,772	50,910
7. Liquidity impact of MSS	65,187	4,117	0	16,036	2,420	317	0
8. First round impact of CRR change	0	0	0	-36,000	-12,500	0	0
C. Bank Reserves # (A+B)	-66,784	17,863	23,085	56,673	-37,659	-14,422	24,860

(+) : Injection of liquidity into the banking system.
 (-) : Absorption of liquidity from the banking system.
 * : Includes oil bonds but excludes purchases of government securities on behalf of State Governments.
 # : Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.
Note: Data pertain to March 31 for Q4 and last Friday for all other quarters. Data are provisional.

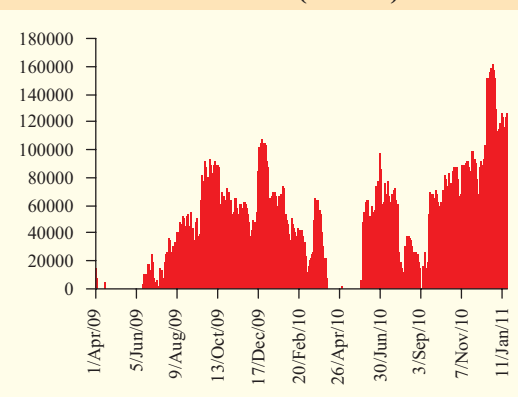
IV.3 The tight liquidity conditions during the third quarter of the year were mainly the result of autonomous factors, *i.e.*, increase in the government's surplus balance with the Reserve Bank and currency with the public. The Reserve Bank managed the liquidity conditions primarily through operations under the LAF and OMO, by means of which large amount of primary liquidity was injected into the system (Table IV.3).

Frictional tightness in liquidity reflected unusually large government surplus balances with the Reserve Bank

IV.4 The tight liquidity conditions since end-October 2010 were primarily on account of unusually large unspent cash balances of the government. During the third quarter of 2010-11, the government surplus with the Reserve Bank hovered in the range of 1.0 to 3.0 per cent of net demand and time liabilities (NDTL) of banks (Chart IV.2). The effective impact on liquidity, therefore, was equivalent to an increase in CRR by 100-300 basis points.

IV.5 It may be noted that in 2009-10, the surplus balance of the government helped in

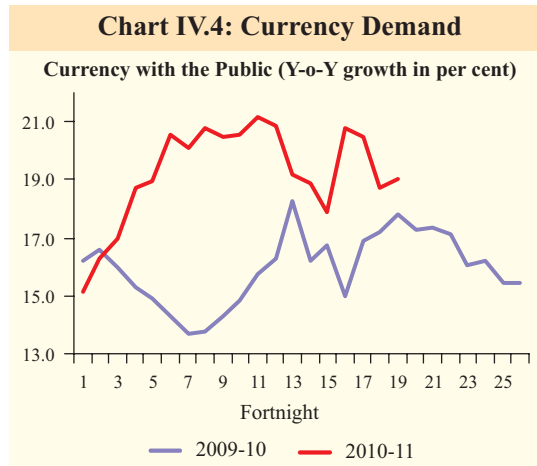
modulating the liquidity overhang in the system. With the change in the liquidity conditions from the previous year, however, the same factor widened the deficit in liquidity to the extent of becoming a source of stress for the financial system. Since government's surplus balances only reflect the temporary mismatch in their cash flows on receipts and expenditure side, this factor is generally seen as a frictional determinant of autonomous liquidity. The unusually tight liquidity in the system in recent months has been a result of this frictional factor persisting longer than usual.

Chart IV.2: GoI Balance with the Reserve Bank (₹ crore)


Structural imbalance between deposit and credit growth and above trend growth in currency added to the liquidity pressure

IV.6 The divergence between the growth rates of credit and aggregate deposits of SCBs widened during the third quarter of 2010-11 (the gap peaked at 9 percentage points in mid-December), emerging thereby as a structural source of pressure on liquidity (Chart IV.3). During the quarter, up to mid-December, banks mobilised ₹88,514 crore of deposits and lent out ₹2,14,638 crore of credit. This mismatch partly reflected the delayed response of banks in raising deposit rates, even though the monetary policy stance had provided the signals for timely response by the banks. With active deposit mobilisation in the last reporting fortnight of December 2010, the mismatch narrowed considerably.

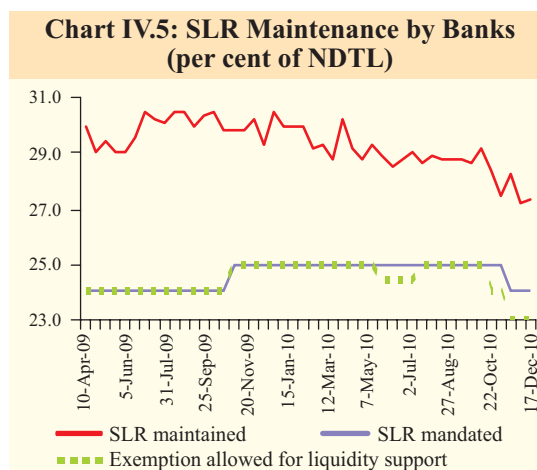
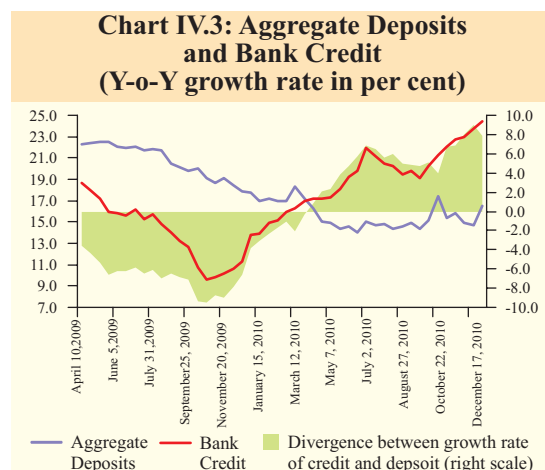
IV.7 The subdued deposit growth partly reflected the higher growth in currency demand in 2010-11 (Chart IV.4). Increase in currency with the public is another autonomous factor which drains liquidity from the system. The growth rate of currency with the public during the year so far has been, on average, 3.4 percentage points higher than during the corresponding period of last year. Moreover, the third quarter of the financial year typically registers an increase in currency demand due to the festive season. The observed pattern in currency demand and deposit, reflected partly



the normal response to high inflation and persistent low or even negative real return on deposits.

With room for collateralised borrowing by banks from the Reserve Bank getting smaller, lowering of SLR requirement helped ease the pressure

IV.8 On account of the tight liquidity conditions and the consequent measures taken by the Reserve Bank, *i.e.*, reduction and temporary reprieve in SLR maintenance, the excess SLR investments of SCBs moderated to ₹1,77,694 crore as on December 31, 2010 from ₹2,56,566 crore a year ago. After the reduction in SLR, banks could use the additional space for accessing liquidity through OMOs and the repo window. Excess SLR holdings for the system as a whole are much lower than last year, with large divergence across banks (Chart IV.5).



Liquidity tightness could ease further with increase in government spending

IV.9 Alongside the build up of government surplus with the Reserve Bank that drained liquidity from the system, the injection of liquidity under the LAF scaled up significantly (Table IV.4). The surplus peaked in December 2010 reflecting advance tax collections. The salutary effect of higher government spending since end-December 2010 is mirrored in the lower surplus balances and the corresponding decline in LAF volumes. The gradual easing of liquidity conditions is also reflective of the staggered OMOs carried out by the Reserve Bank since the mid-quarter Review of December 2010. It is expected that the

government would spend in order to meet its committed expenditure for the year during the ongoing quarter, which is the last quarter of the financial year. With government cash surplus beginning to flow back into the system, the liquidity position would improve.

Money supply growth deceleration continued reflecting the deposit pattern, but reached closer to the indicative trajectory of the Reserve Bank

IV.10 At the end of the third quarter of 2010-11, money growth remained below the Reserve Bank's indicative trajectory as set out in the Second Quarter Review of Monetary Policy (Table IV.5). Broad money (M_3) growth trend is largely influenced by the pattern of growth in aggregate deposits of the banking system, which account for over 85 per cent of the stock of M_3 (Chart IV.6). There has been a sharp moderation in both time (which are nearly 87 per cent of total deposits) and demand deposits, partly reflecting the response to lower deposit rates in an environment of high inflation. There was, however, a sharp turnaround in the last fortnight of the quarter when banks mobilised almost 66 per cent of the total incremental deposits for the entire quarter. This reflected active mobilisation as well as quarter-end/month-end accruals of interest payments and salaries/pensions credited to accounts¹. Besides, there were two fortnights during the third quarter of 2010-11, during which deposit growth, and hence, money growth, registered notable increase. This was on account of inflows for subscription to Coal India and Power Grid capital issues in the second fortnights of October and November 2010, respectively.

IV.11 The moderation in the growth rate of money is also on account of the change in the key determinants of the money multiplier. During the current year, currency growth has

Table IV.4: Liquidity Position

(₹ crore)				
Outstanding as on Last Friday	LAF	MSS	Centre's Surplus@	Total
1	2	3	4	5=(2+3+4)
2009				
April	1,08,430	70,216	-40,412	1,38,234
May	1,10,685	39,890	-6,114	1,44,461
June	1,31,505	22,890	12,837	1,67,232
July	1,39,690	21,063	26,440	1,87,193
August	1,53,795	18,773	45,127	2,17,695
September	1,06,115	18,773	80,775	2,05,663
October	84,450	18,773	69,391	1,72,614
November	94,070	18,773	58,460	1,71,303
December	19,785	18,773	1,03,438	1,41,996
2010				
January	88,290	7,737	54,111	1,50,138
February	47,430	7,737	33,834	89,001
March*	990	2,737	18,182	21,909
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-1,17,660	0	86,459	-31,201
November	-1,03,090	0	93,425	-9,665
December	-1,13,415	0	1,44,437	31,022
2011				
January 14	-82,570	0	1,14,290	31,720

@ : Excludes minimum cash balances with the Reserve Bank in case of surplus.

* : Data pertain to March 31.

Note: 1. Negative sign in column 2 indicates injection of liquidity through LAF.

2. Negative sign in column 4 indicates WMA /OD availed by the central government.

¹Reporting fortnight for data compilation coincided with the last day of the month and the quarter, i.e., December 31, 2010. Hence, interest payments and accruals to salary/pension accounts contributed partly to the higher incremental deposits.

Table IV.5: Monetary Indicators

Item	(Growth in per cent)			
	Year-on-Year		Financial year to date	
	2010-11	2009-10	2010-11	2009-10
1	2	3	4	5
Broad Money (M ₃)	16.5	17.9	10.8	11.0
Narrow Money (M ₁)	15.6	19.8	5.7	8.5
Main Components of M ₃				
Currency with the Public	19.1	17.2	13.1	9.6
Aggregate Deposits	16.1	18.1	10.4	11.3
of which: Demand Deposits	11.7	23.6	-2.1	7.6
Time Deposits	16.8	17.3	12.6	11.9
Main Sources of M ₃				
Net Bank Credit to the Government	17.0	34.3	7.5	19.9
Bank Credit to the Commercial Sector	23.2	13.5	15.3	8.4
Net Foreign Assets of the Banking Sector	2.2	3.9	6.5	-1.2
Reserve Money	22.5	14.8	8.7	3.8
Reserve Money adjusted for CRR changes	17.3	16.9	7.7	3.7
Scheduled Commercial Banks				
Non-food Credit	24.1	14.4	15.7	9.1
Aggregate Deposits	16.5	17.7	10.7	11.3

Note: 1. Data are provisional.
2. Data pertain to December 31, 2010 except reserve money, which is for January 14, 2011.

been much higher than deposit growth, which led to a higher currency to deposit ratio. The reserve to deposit ratio has also gone up on account of the increase in the CRR that was effected in February and April 2010. The increase in both these ratios has had some moderating influence on the money multiplier, thereby lowering M₃ growth (Chart IV.7). Higher incremental deposits in the last fortnight of 2010, however, led to a significant moderation in the currency to deposit ratio.

IV.12 Among the major sources of M₃ growth, the banking system’s credit to the commercial sector has steadily gone up since November 2009, reflecting the growth momentum and the

associated demand for credit, while the growth in banking system’s credit to the government has decelerated.

Base money expansion remains strong reflecting injection of primary liquidity by the Reserve Bank

IV.13 Reserve money continued to grow at an accelerated pace during the third quarter of 2010-11, reflecting the injection of primary liquidity in the face of tight liquidity conditions. The third quarter registered the highest quarterly increment in base money during the current financial year. The injection of primary liquidity during the third quarter in the form of repo operations under the LAF and open market

Chart IV.6: Money and Aggregate Deposit (Y-o-Y growth in per cent)

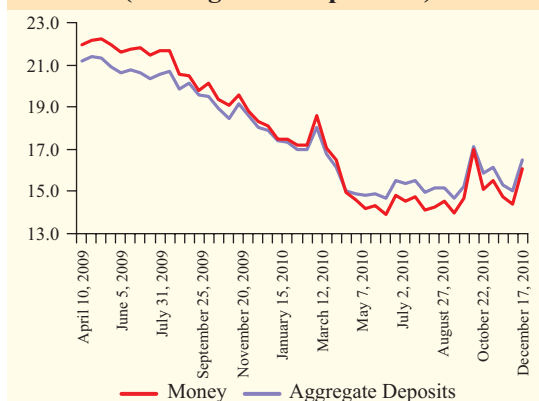


Chart IV.7: Money Multiplier and Behavioural Ratios

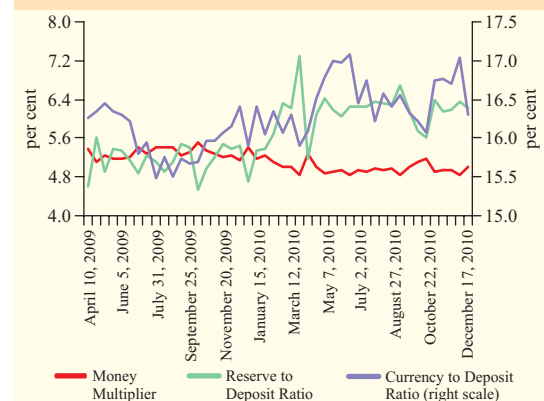
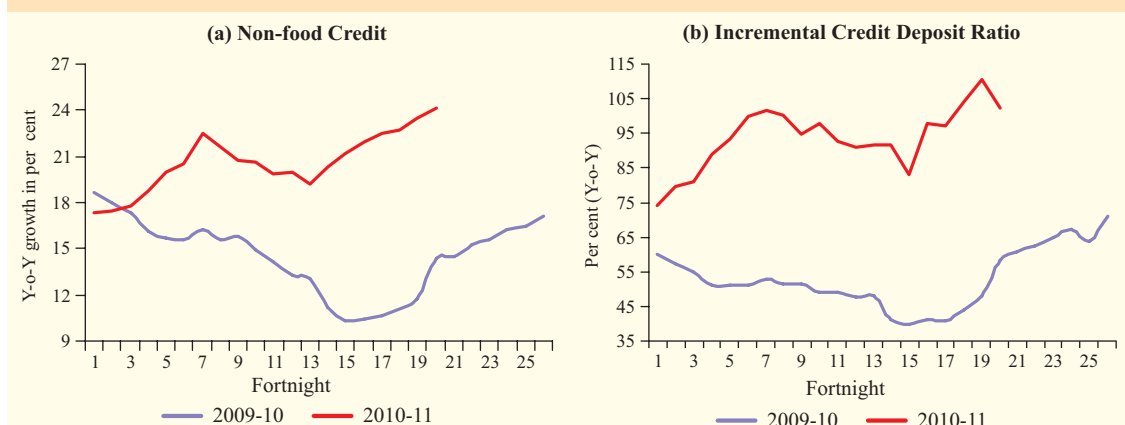


Chart IV. 8: Credit Indicators


purchases was ₹1,32,902 crore, roughly 60 per cent of which was offset by the incremental build-up in government surplus with the Reserve Bank.

Credit growth, though still dominated by infrastructure, is gradually getting broad-based

IV.14 With economic growth consolidating around the pre-crisis trend, non-food credit continued to grow at an accelerated pace during the third quarter of the year. Also, with deposit mobilisation lagging behind the fast pace of increase in credit, the incremental non-food credit to deposit ratio peaked at 110.5 per cent in mid-December 2010, an indication of the role of the structural squeeze on liquidity during the quarter. The ratio, however, dipped by over 8 percentage points by end-December 2010 (Chart IV.8).

IV.15 The increased credit off-take was seen across all bank groups (Table IV.6). Even as

private sector banks and foreign banks registered high growth in credit flow as compared to the previous year, public sector banks remained the dominant lenders in the banking system, accounting for nearly three-fourths of the incremental year-on-year credit off-take at the end of the third quarter of 2010-11.

IV.16 Data on sectoral deployment of gross non-food credit show the increasing broad-based pattern (Chart IV.9). Disaggregated data suggest that credit flow to industry has been robust. Infrastructure, basic metal and metal products and engineering industries accounted for two-third of the annual incremental credit off-take as on December 17, 2010.

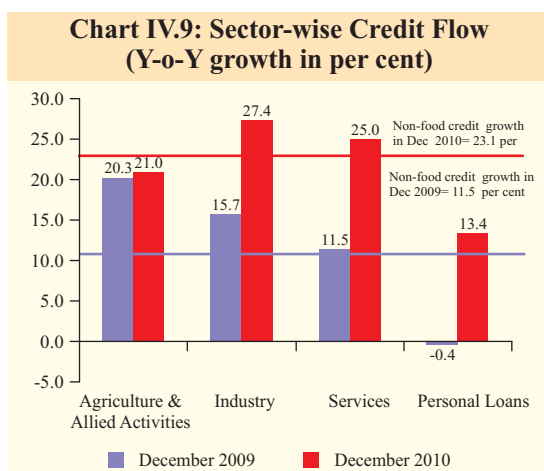
IV.17 Due to the buoyancy in credit flow from the banking system, banks accounted for nearly three-fifth of total incremental financing to the commercial sector during April-December 2010 (Table IV.7). For the period

Table IV.6: Credit Flow from Scheduled Commercial Banks

Item	Outstanding as on Dec 31, 2010	Variation (Y-on-Y)			
		As on Jan 1, 2010		As on Dec 31, 2010	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks	27,93,705	3,25,608	16.9	5,41,737	24.1
2. Foreign Banks	1,90,766	-14,028	-8.1	31,474	19.8
3. Private Banks	6,89,232	41,424	8.4	1,51,618	28.2
4. All Scheduled Commercial Banks*	37,63,213	3,66,914	13.8	7,38,641	24.4

* : Including Regional Rural Banks.

Note: Data for December 31, 2010 are provisional.



Note: Chart IV.9 and the details in paragraph IV.16 are based on data collected from select SCBs that account for 95 per cent of the total non-food credit extended by all SCBs. These data are being disseminated every month from November 2010.

under consideration, funding from non-bank sources registered a decline compared to the previous year, on account of a decline in both

domestic and foreign non-bank sources. The funding from foreign sources decreased on account of lower amount of net FDI inflow into India as well as lower subscription to ADRs/GDRs.

Stronger monetary policy transmission is expected to enhance the effectiveness of policy

IV.18 The anti-inflationary monetary policy measures taken during the course of the year could become more effective with the stronger transmission in the financial system that has become visible since the third quarter of the financial year. The tight liquidity conditions would improve as the government steps up its expenditure, but the magnitude of the deficit may have to continue at around 1.0 per cent of NDTL for monetary transmission to remain effective.

Table IV.7: Flow of Financial Resources to the Commercial Sector

Item	April-March		April-December	
	2008-09	2009-10	2009-10	2010-11
1	2	3	4	5
A. Adjusted Non-food Bank Credit (NFC)	4,21,091	4,80,258	2,51,774	5,34,276
i) Non-Food Credit	4,11,824	4,66,960	2,48,874	5,00,966
of which petroleum and fertiliser credit	31,159	8,491	-181	-23,136 *
ii) Non-SLR Investment by SCBs	9,267	13,298	2,900	33,310
B. Flow from Non-banks (B1+B2)	4,51,399	5,88,559	3,84,661	3,66,238
B1. Domestic Sources	2,58,132	3,64,989	2,37,733	2,27,255
1. Public issues by non-financial entities	14,205	31,956	19,791	23,224
2. Gross private placements by non-financial entities	77,856	1,41,964	70,991	43,280 ^
3. Net issuance of CPs subscribed to by non-banks	4,936	25,835	69,603	34,390 #
4. Net credit by housing finance companies	25,876	28,485	9,852	22,911 *
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI and EXIM Bank	31,408	33,871	-1,443	32,361
6. Systemically important non-deposit taking NBFCs (net of bank credit)	42,277	60,663	40,611	51,534 *
7. LIC's gross investment in corporate debt, infrastructure and social sector	61,574	42,215	28,328	19,556
B2. Foreign Sources	1,93,267	2,23,570	1,46,928	1,38,983
1. External commercial borrowings/FCCBs	30,948	15,674	13,552	27,947
2. ADR/GDR issues excluding banks and financial institutions	4,788	15,124	15,164	8,490
3. Short-term credit from abroad	-13,288	34,878	-283	31,016 ^
4. FDI to India	1,70,819	1,57,894	1,18,495	71,530 *
C. Total Flow of Resources (A+B)	8,72,017	10,68,817	6,36,435	9,00,514
Memo Item:				
<i>Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes</i>				
	-32,168	96,578	1,50,085	-29,961

* : April-November ^ : April-September # : April-Dec 15, 2010.