

## IV. MONETARY AND LIQUIDITY CONDITIONS

*In the Q2 of 2011-12, liquidity conditions continued to remain in deficit mode, in line with the policy objective of the Reserve Bank. Base money decelerated as currency growth moderated. Money ( $M_3$ ) growth, however, accelerated moderately as the money multiplier increased. While credit growth is above the indicative trajectory, it will moderate as growth decelerates. Going forward, the global uncertainty and fiscal pressures pose challenges to effective monetary policy management.*

### **Significant monetary tightening in the face of high inflation**

IV.1 The Reserve Bank has been pursuing a tight monetary policy stance since early 2010 in response to sustained inflationary pressures. Inflation, which initially emerged from supply side constraints, increasingly became generalised and the Reserve Bank had to calibrate its policy response to anchor inflation expectations, while at the same time ensuring that the growth impulses of the economy were not hampered. In continuation of this policy stance, the Reserve Bank raised the policy repo rate by 50 bps in July 2011 and again by 25 bps in September 2011 (Table IV. 1). The level of

policy rate and inflation presently are broadly comparable to the levels prevailing in September 2008 (Chart IV.1).

### **Liquidity remained in deficit mode**

IV.2 The average LAF injection, which was around ₹49,000 crore in the first quarter of 2011-12, dropped marginally to around ₹47,000 crore in the second quarter of 2011-12 mirroring the increase in centre's cash deficit. Liquidity deficit largely remained within (+/-) 1 per cent of NDTL of the banks, in line with the stated policy objective of the Reserve Bank. The liquidity deficit, which had witnessed some stress in June 2011 due to quarterly advance tax payouts, eased in early July 2011, reflecting

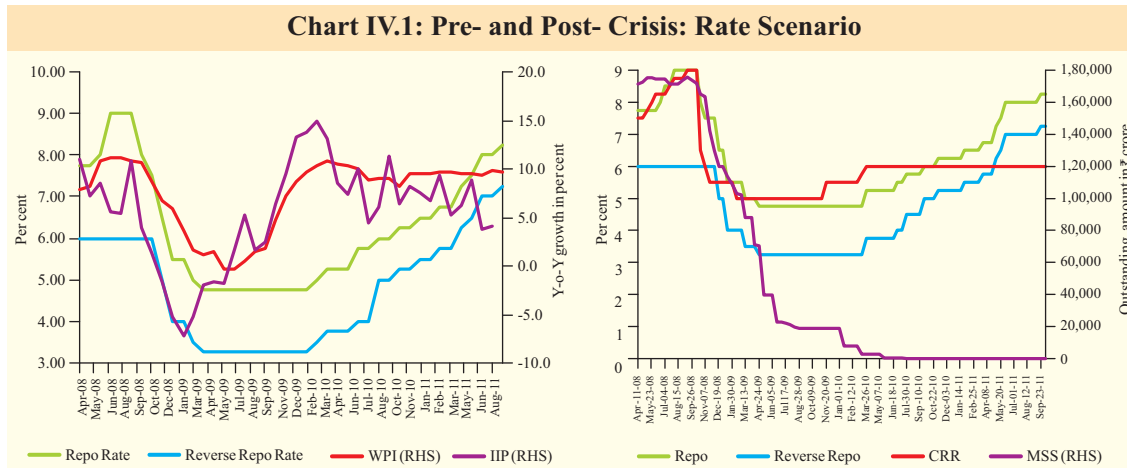
**Table IV.1: Movements in Key Rates in India**

Effective Since	Reverse Repo Rate	Repo Rate	Marginal Standing Facility Rate	(Per cent)
				Cash Reserve Ratio
1	2	3	4	5
Apr. 21, 2009	3.25 (-0.25)	4.75 (-0.25)		5.00
Feb. 13, 2010	3.25	4.75		5.50 (+0.50)
Feb.27, 2010	3.25	4.75		5.75 (+0.25)
Mar. 19, 2010	3.50 (+0.25)	5.00 (+0.25)		5.75
Apr. 20, 2010	3.75 (+0.25)	5.25 (+0.25)		5.75
Apr. 24, 2010	3.75	5.25		6.00 (+0.25)
Jul. 2, 2010	4.00 (+0.25)	5.50 (+0.25)		6.00
Jul. 27, 2010	4.50 (+0.50)	5.75 (+0.25)		6.00
Sept. 16, 2010	5.00 (+0.50)	6.00 (+0.25)		6.00
Nov. 2, 2010	5.25 (+0.25)	6.25 (+0.25)		6.00
Jan. 25, 2011	5.50 (+0.25)	6.50 (+0.25)		6.00
Mar. 17, 2011	5.75 (+0.25)	6.75 (+0.25)		6.00
May 3, 2011	6.25 (+0.50)	7.25 (+0.50)		6.00
May 9, 2011	6.25	7.25	8.25	6.00
Jun 16, 2011	6.50 (+0.25)	7.50 (+0.25)	8.50 (+0.25)	6.00
July 26, 2011	7.00 (+0.50)	8.00 (+0.50)	9.00 (+0.50)	6.00
Sept. 16, 2011	7.25 (+0.25)	8.25 (+0.25)	9.25 (+0.25)	6.00

**Note :** 1. Reverse repo indicates absorption of liquidity and repo indicates injection of liquidity.

2. As announced in Monetary Policy Statement 2011-12, the Marginal Standing Facility came into effect from May 9, 2011.

3. Figures in parentheses indicate change in policy rates in percentage points.



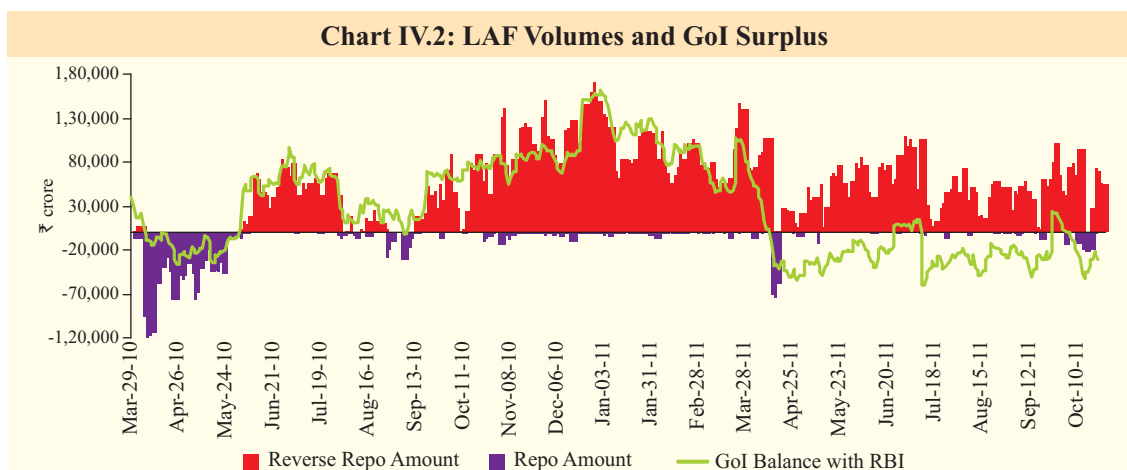
the drawdown of Central Government cash balances and transition to WMA/OD (Chart IV.2 and Table IV.2). Since the introduction of the new operating procedures of monetary policy in May 2011, injection of liquidity under the marginal standing facility (MSF) has been limited to two occasions (₹100 crore on June 10 and ₹4,105 crore on July 15, 2011), which is indicative of the liquidity position not getting over tight.

IV.3 While repo auctions under LAF continued to be conducted between 9.30 am and 10.30 am, the Reserve Bank decided to shift the reverse repo auctions under LAF and MSF operations to the afternoon time slot of 4.30 pm to 5.00 pm on all working days (excluding Saturdays) with effect from August 16, 2011. The prime reason for shifting the reverse repo

window to the afternoon slot is to encourage the market participants to trade amongst themselves and to park any surplus with the Reserve Bank only after exhausting all other avenues to deploy the funds in the money market.

**Base money growth slows, reflects moderation in currency expansion**

IV.4 The decelerating trend of base money since December 2010 continued during the second quarter of 2011-12 mainly on account of an absence of significant injection of primary liquidity by the Reserve Bank. While moderate amount of liquidity was injected through LAF operations, no significant primary liquidity was injected either by way of outright purchases of G-Sec or forex operations. In addition, currency growth, which had witnessed significant acceleration and remained above money supply



**Table IV.2: Liquidity Position**

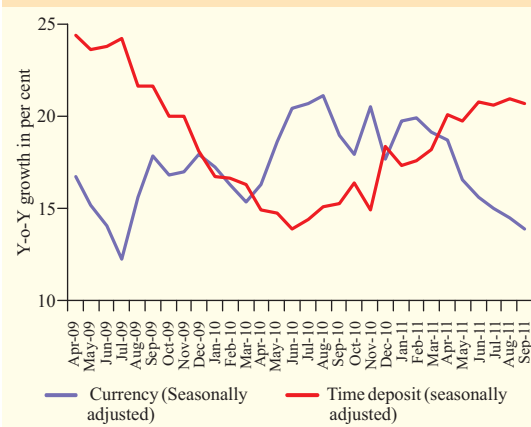
(₹ crore)				
Outstanding as on last Friday	LAF	MSS	Centre's Surplus@	Total
1	2	3	4	5=(2+3+4)
<b>2010</b>				
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-1,17,660	0	86,459	-31,201
November	-1,03,090	0	93,425	-9,665
December	-1,13,415	0	1,44,437	31,022
<b>2011</b>				
January	-76,730	0	1,18,371	41,641
February	-72,005	0	77,397	5,392
March*	-1,06,005	0	16,416	-89,589
April	-39,605	0	-35,399	-75,004
May	-75,795	0	-9,544	-85,339
June	-96,205	0	8,339	-87,866
July	-48,555	0	-25,983	-74,538
August	-49,215	0	-21,192	-70,407
September	-82,645	0	-24,387	-1,07,032
October (on 14 <sup>th</sup> )	-54,270	0	-32,883	-87,153

@ : 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.

growth for most part of 2010-11, has also been decelerating since the first quarter of 2011-12 which moderated the base money expansion. The increase in term deposit interest rates since September 2010 prompted a switch from currency holdings and demand deposits to time deposits (Chart IV.3).

**Chart IV.3: Currency Growth**


### Growing endogeneity of money keeps money supply above trajectory

IV.5 While the base money growth has decelerated sharply, the money supply growth accelerated moderately as the money multiplier rose (Table IV.3 and Chart IV.4). This divergent trend in base money and broad money arises out of increasing endogeneity of money supply as banks respond to strong credit demand, which is met through recourse to additional borrowings, including that from the central bank.

### Robust deposit growth

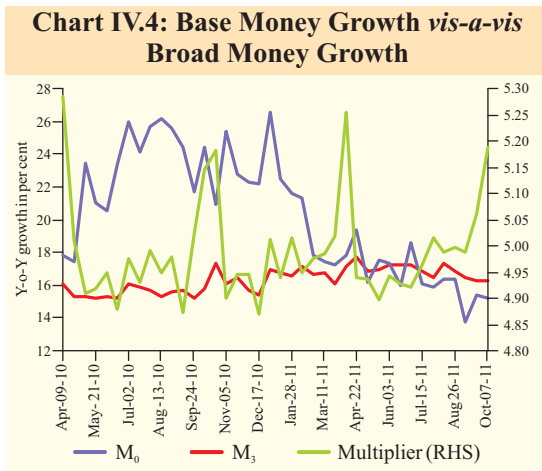
IV.6 Deposits registered robust growth since December 2010 due to successive hikes in

**Table IV.3: Monetary Indicators**

Item	Outstanding Amount (₹ crore)	FY variations (per cent)		Y-o-Y Variations (per cent)	
		2010-11	2011-12	Oct. 08, 2010	Oct. 07, 2011
1	2	3	4	5	6
<b>Reserve Money (<math>M_0</math>)*</b>	<b>13,84,833</b>	<b>6.2</b>	<b>0.6</b>	<b>21.4</b>	<b>12.8</b>
<b>Broad Money (<math>M_3</math>)</b>	<b>69,62,822</b>	<b>6.9</b>	<b>7.1</b>	<b>15.8</b>	<b>16.2</b>
<b>Main Components of <math>M_3</math></b>					
Currency with the Public	9,49,232	8.6	3.8	18.9	13.8
Aggregate Deposits	60,11,223	6.6	7.7	15.3	16.7
of which: Demand Deposits	6,51,919	-5.9	-9.2	14.3	-3.5
Time Deposits	53,59,304	8.8	10.2	15.5	19.7
<b>Main Sources of <math>M_3</math></b>					
Net Bank Credit to Govt.	21,57,973	5.2	8.8	22.5	22.9
Bank Credit to Commercial Sector	44,44,825	7.3	4.9	19.8	18.7
Net Foreign Assets of the Banking Sector	15,42,066	5.1	10.7	1.1	14.5

**Note:** 1. Data are provisional.

2. \* : Data pertain to October 14, 2011.



interest rates. The opportunity cost of saving in lower interest bearing instruments like small savings increased, resulting in a shift from small savings to term deposits (Chart IV.5).

IV.7 During 2011-12 so far, banks' investment in government securities has accelerated (Chart IV.6 a). However, no sharp rise in SLR maintenance is observed as NDTL has increased at a higher rate (Chart IV.6 b).

***Credit expansion still above indicative trajectory but may correct ahead***

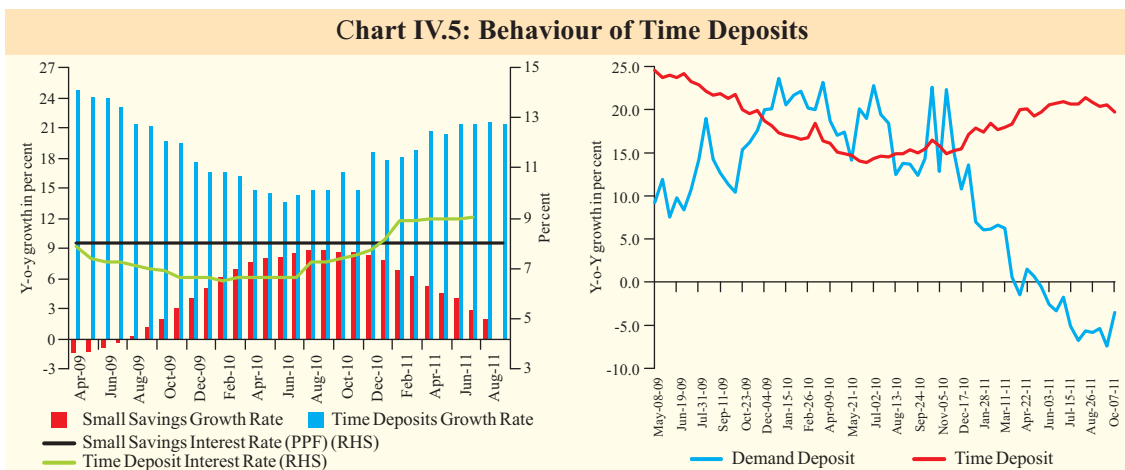
IV.8 Credit growth, which had witnessed a sharp deceleration in the first quarter of 2011-12, continued the trend in the initial period of the second quarter, partly reflecting high base of last year (Chart IV.7). Notwithstanding this deceleration, credit growth remained above the indicative trajectory of 18 per cent set out by

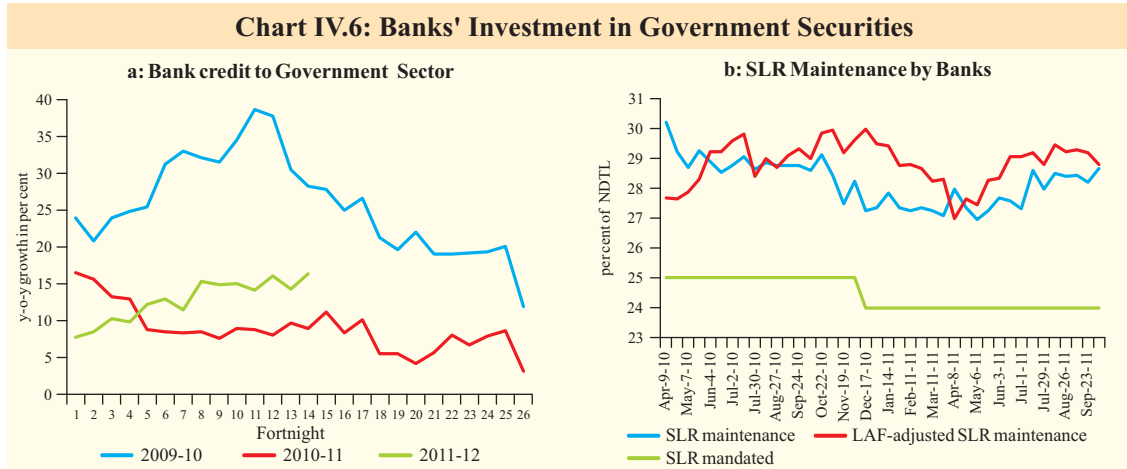
the Reserve Bank in the July 2011 review, mainly due to high nominal GDP growth.

IV.9 During the first three quarters of 2010-11, the divergence between credit growth and deposit growth was high and growing. As the cost of funds under LAF increased progressively with the rise in the repo rate, banks raised their deposit and lending rates. This stronger transmission of monetary policy helped in narrowing the divergence between deposit and credit growth. The gap between the two declined from 9 percentage points in mid-December 2010 to 5.6 percentage points in March 2011 and further to 2.1 percentage points in October 2011(Chart IV.8).

***Non-banking sources dominate credit expansion***

IV.10 The non-bank sources have occupied the space that was vacated by banks in meeting the credit requirements of the economy during 2011-12 so far (up to September 2011) (Table IV.4). This is reflected in the increase in the share of non-bank sources in total flow of financial resources from about 46 per cent in April-September 2010 to 54 per cent in April-September 2011, with both domestic and foreign funding sources showing significant increase. Within domestic sources, net issuance under CPs, NBFCs-ND-SI and housing finance companies (HFCs) increased. The resource flow from external sources rose on account of higher mobilisation through FDI and ECBs.



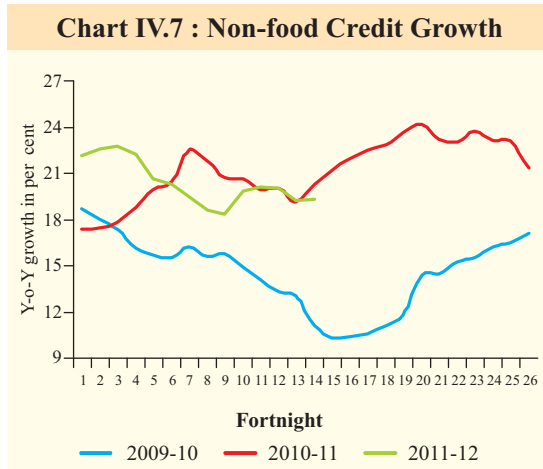


**Credit expansion not broad-based**

IV.11 The credit growth of foreign banks registered a sharp rise, while that of public sector banks continued to witness a deceleration in continuation of the trend observed in first

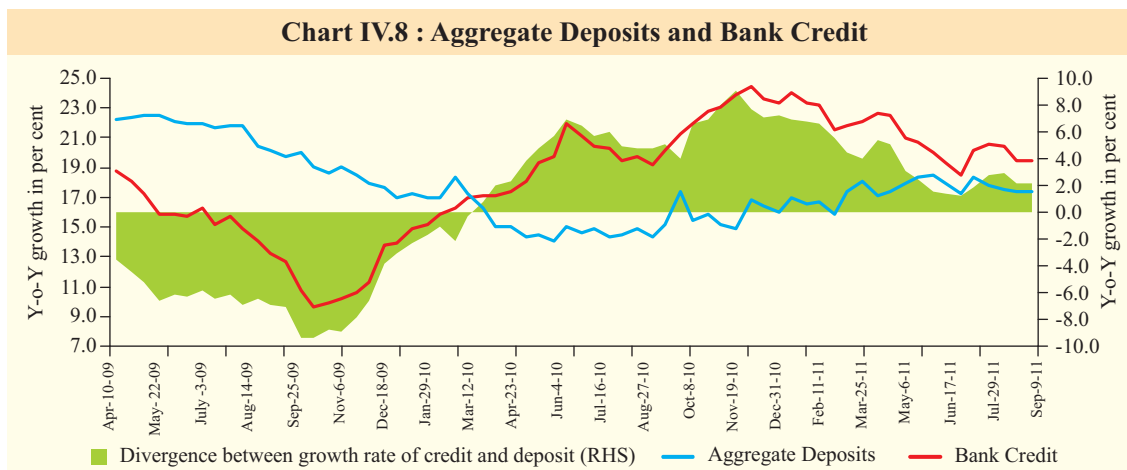
quarter of 2010-11. As public sector banks continued to be the largest lenders, the overall credit growth decelerated (Table IV.5).

IV.12 The credit deceleration has been diffused over a wide range of sectors that include chemical and chemical products, engineering, power, telecommunications and consumer durables (Table IV.6). The slowdown in credit growth may have been prompted by deceleration in investment demand that could have impacted term loans. Further, the top rated corporates resorted to relatively cheaper sources of borrowings including ECBs and CPs.



**Real interest rates low and non-disruptive to growth**

IV.13 Real lending interest rates have remained positive, but low and supportive of growth in the recent period (Chart IV.9). Despite monetary



**Table IV.4: Flow of Financial Resources to the Commercial Sector**

Item	(₹ crore)			
	April-March		April-September	
	2009-10	2010-11	2010-11	2011-12
1	2	3	4	5
<b>A. Adjusted Non-Food Bank Credit (NFC)</b>	<b>4,78,614</b>	<b>7,11,031</b>	<b>2,59,692</b>	<b>2,29,157 +</b>
i) Non-Food Credit	4,66,960	6,81,501	2,27,006	2,07,483 +
<i>of which: petroleum and fertilizer credit</i>	10,014	-24,236	-24,130	1,573&
ii) Non-SLR Investment by SCBs	11,654	29,530	32,686	21,674 +
<b>B. Flow from Non-banks (B1+B2)</b>	<b>5,88,784</b>	<b>5,14,495</b>	<b>2,20,690</b>	<b>2,70,441</b>
<b>B1. Domestic Sources</b>	<b>3,65,214</b>	<b>2,95,573</b>	<b>1,23,652</b>	<b>1,37,838</b>
1 Public issues by non-financial entities	31,956	28,520	10,054	6,205
2 Gross private placements by non-financial entities	1,41,964	67,436	-	-
3 Net issuance of CPs subscribed to by non-banks	26,148	17,207	41,875	59,693 *
4 Net Credit by housing finance companies	28,485	38,386	8,775	11,110&
5 Total gross accommodation by 4 RBI regulated AIFs - NABARD, NHB, SIDBI & EXIM Bank	33,783	40,007	15,282	8,558
6 Systematically important non-deposit taking NBFCs (net of bank credit)	60,663	67,937	35,209	39,784 \$
7 LIC's net investment in corporate debt, infrastructure and Social Sector	42,215	36,080	12,457	12,488&
<b>B2. Foreign Sources</b>	<b>2,23,570</b>	<b>2,18,922</b>	<b>97,038</b>	<b>1,32,603</b>
1 External Commercial Borrowings / FCCB	15,674	52,899	27,635	41,809
2 ADR/GDR Issues excluding banks and financial institutions	15,124	9,248	7,250	1,783
3 Short-term Credit from abroad	34,878	50,177	19,707	13,721 #
4 Foreign Direct Investment to India	1,57,894	1,06,598	42,446	75,290&
<b>C. Total Flow of Resources (A+B)</b>	<b>10,67,398</b>	<b>12,25,526</b>	<b>4,80,382</b>	<b>4,99,598</b>
<b>Memo:</b>				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	96,578	-36,707	3,266	3,426
+: up to October 7, 2011    *: up to August 15, 2011    \$: up to July 2011    #: up to June 2011    &: up to August 2011    -: Not available				
<b>Note:</b> FDI Data include equity capital of incorporated entities for the period April-August and does not include reinvested earnings, other capital and equity capital of unincorporated entities.				

tightening, real interest rates have fallen due to high inflation.

### *Monetary overshooting a risk in the face of fiscal pressures*

IV.14 Credit growth has remained strong notwithstanding the successive interest rate hikes. As a result, even though there has been only moderate injection of primary liquidity

through LAF transactions, broad money growth has stayed above the indicative trajectory, operating on the impetus provided by the endogenous factors like strong credit growth and high deposit growth, bolstered by substitution from currency to deposits. Going forward however, credit growth could moderate as growth decelerates and inflation moderates. However,

**Table IV.5: Credit Flow from Scheduled Commercial Banks**

Item	Outstanding as on October 7, 2011	(Amount in Rupees crore)			
		Variation (y-o-y)			
		As on Oct 8, 2010		As on Oct 7, 2011	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks	30,38,986	4,24,615	19.8	4,70,704	18.3
2. Foreign Banks	2,21,422	17,923	11.4	45,898	26.1
3. Private Banks	7,86,334	1,25,973	24.5	1,45,213	22.6
4. All Scheduled Commercial Banks*	41,48,598	5,84,064	20.2	6,75,538	19.5
<b>Note:</b> 1. Data as on October 7, 2011 are provisional.					
2. *Including Regional Rural Banks.					

Monetary and Liquidity Conditions

**Table IV.6: Sectoral Deployment of Credit**

Sector	Outstanding Credit as on Sept. 23, 2011 (₹ crore)	Y-o-Y Variation		Financial Year Variation	
		Sept. 24, 2010 over Sept. 25, 2009	Sept. 23, 2011 over Sept. 24, 2010	Sept. 24, 2010 over Mar. 26, 2010	Sept. 23, 2011 over Mar. 25, 2011
1	2	3	4	5	6
<b>Non-food credit</b>	<b>37,96,893</b>	<b>18.7</b>	<b>18.7</b>	<b>5.2</b>	<b>3.5</b>
<b>Agriculture and allied activities</b>	<b>4,33,791</b>	<b>19.3</b>	<b>7.9</b>	<b>-3.4</b>	<b>-5.8</b>
<b>Industry</b>	<b>17,42,163</b>	<b>24.4</b>	<b>22.9</b>	<b>8.1</b>	<b>7.5</b>
<i>of which,</i> Chemical & chemical products	96,670	15.3	9.4	3.1	2.3
All engineering	1,01,632	27.8	22.5	12.4	8.9
Infrastructure	5,64,958	47.4	20.3	23.6	7.3
<i>of which,</i> Power	3,00,752	46.9	32.2	21.1	11.7
Telecommunications	89,964	94.7	-10.2	68.8	-10.4
Roads	1,03,545	28.3	31.9	6.7	11.9
<b>Services</b>	<b>9,12,413</b>	<b>17.4</b>	<b>19.3</b>	<b>5.2</b>	<b>1.3</b>
<i>of which,</i> Commercial Real Estate	1,14,459	7.9	12.6	10.3	2.3
NBFCs	1,83,761	18.5	46.2	10.8	4.7
<b>Personal Loans</b>	<b>7,08,526</b>	<b>8.6</b>	<b>15.2</b>	<b>5.0</b>	<b>3.4</b>
<i>of which,</i> Consumer durables	8,492	12.5	-6.5	9.5	-16.4
Housing (incl. Priority sector)	3,66,889	10.4	15.7	5.4	6.0
Education	48,339	23.6	18.1	11.1	10.6
Vehicle loans	83,981	16.1	19.3	10.3	5.9

**Note:** 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.

even with some deceleration expected in credit growth, containing monetary growth remains a challenge in face of large market borrowing.

**Chart IV.9 : Real Rate of Interest on Demand Loans and Term Loans**

