

III. MONETARY AND LIQUIDITY CONDITIONS

Monetary Trends

Monetary conditions continued to be driven by large capital inflows in 2004-05 as in the previous year. Expansionary effects on base money and money supply were, however, headed off through operations under the Market Stabilisation Scheme (MSS) and the Liquidity Adjustment Facility (LAF). Consequently money supply (M_3) remained well within the projected trajectory of 14.0 per cent. The moderation in monetary expansion *vis-à-vis* the preceding year was also reflected in the residency-based new monetary aggregate (NM_3), which excludes the impact of foreign currency non-resident deposits, as well as the liquidity aggregates (L_1 , L_2 and L_3) (Table 11). A noteworthy feature underlying the evolution of

Table 11 : Monetary Indicators

(Amount in Rs. crore)

Item	Outstanding as on Mar 31, 2005	Variation			
		2004-05		2003-04	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
I. Reserve Money	4,89,128	52,616	12.1	67,451	18.3
II. Broad Money (M_3)	22,65,587	2,57,058	12.8	2,90,569	16.9
a) Currency with the Public	3,57,424	42,016	13.3	43,827	16.1
b) Aggregate Deposits	19,01,680	2,13,678	12.7	2,44,866	17.0
i) Demand Deposits	2,97,088	39,075	15.1	59,256	29.8
ii) Time Deposits	16,04,592	1,74,603	12.2	1,85,610	14.9
of which: Non-Resident Foreign Currency Deposits	76,133	797	1.1	-17,170	-18.6
III. NM_3	22,22,190	2,58,884	13.2	3,21,764	19.6
of which: Call Term Funding from Financial Institutions	34,129	9,459	38.3	12,032	95.2
IV. a) L_1	23,06,998	2,72,304	13.4	3,37,877	19.9
of which: Postal Deposits	84,808	13,420	18.8	16,113	29.2
b) L_2	23,08,649	2,67,710	13.1	3,37,826	19.8
of which: FI Deposits	1,651	-4,594	-73.6	-51	-0.8
c) L_3	23,27,893	2,67,232	13.0	3,37,642	19.6
of which: NBFC Deposits	19,244	-478	-2.4	-184	-0.9
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	7,50,303	6,638	0.9	67,143	9.9
i) Net Reserve Bank Credit to Government	-12,197	-57,105	-127.2	-75,772	-62.8
of which: to the Centre	-13,727	-50,646	-137.2	-76,065	-67.3
ii) Other Banks' Credit to Government	7,62,501	63,742	9.1	1,42,915	25.7
b) Bank Credit to Commercial Sector of which: Scheduled Commercial Banks' Non-food Credit	12,42,345	2,21,870	21.7	1,21,494	13.5
c) Net Foreign Exchange Assets of Banking Sector	10,18,288	2,13,464	26.5	1,25,088	18.4
	6,51,998	1,25,412	23.8	1,32,872	33.7

FIs: Financial Institutions. NBFCs: Non-banking Financial Companies.

Note : 1. Data are provisional.

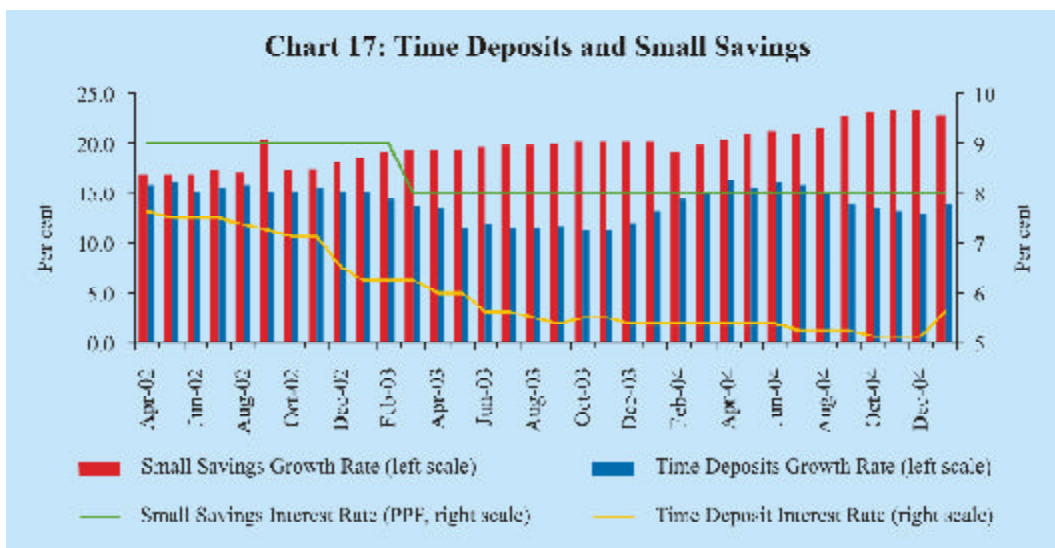
2. Select aggregates are adjusted for the effect of conversion of a non-banking entity into a banking entity since October 11, 2004.

3. Postal deposits figures pertain to January 2005, FI deposits pertain to February 2005 and NBFC deposits pertain to September 2004.

4. Government balances as on March 31, 2005 are before closure of accounts.

monetary conditions in 2004-05 was the sharp rise in non-food credit which set in from July 2004 onwards in consonance with the buoyancy in industrial activity.

Reflecting the slowdown in agricultural activity, currency demand moderated in relation to the preceding year, barring the usual spurt during the festival season in October-November 2004. The growth in banks' deposits was also a shade lower due to substitution in favour of postal deposits, which continued to grow at a high rate, benefiting from tax incentives and their relatively attractive rate of return in comparison with time deposits (Chart 17). Non-resident foreign currency deposits, which had declined sharply in the previous year on account of redemptions of Resurgent India Bonds (RIBs), registered a moderate increase during 2004-05. Banks increasingly relied on non-deposit sources of funds in 2004-05



Credit Behaviour

The flow of credit to industry from bank and non-bank sources surged during 2004-05 reflecting a broad-based strengthening of the industrial recovery. Food credit also increased during the year due to higher procurement operations, reversing the decline in the previous two years. Among non-bank sources of funds, resources raised by way of external commercial borrowing (ECB) and equity issues increased sharply. Financial assistance extended by financial institutions, however, continued to decline. Retained earnings turned out to be an important source of funds for the industrial sector, reflecting the growing significance of internal generation of funds resulting from improved corporate profitability (Table 12).

Net bank credit to the Government increased by barely 0.9 per cent during 2004-05 due mainly to a lower than budgeted borrowing programme of the Centre.

Table 12 : Key Sources of Funds to Industry

(Rupees crore)		
Item	2004-05	2003-04
1	2	3
A. Bank Credit to Industry (April-December)	29,236	-877
B. Flow from Non-banks to Corporates (1 to 5)	37,332	677
1. Capital Issues * (i+ii)	10,337	1,929
i) Non-Government Public Ltd. Companies (a+b)	7,653	1,829
a) Bonds/Debentures	0	0
b) Shares	7,653	1,829
ii) PSUs and Government Companies	2,684	100
2. ADR/GDR Issues +	2,960	3,098
3. External Commercial Borrowings (ECBs) (April-December) \$	28,354	-4,580
4. Issue of CPs #	3,852	2,304
5. Financial assistance extended by FIs (April-September) (net)	-8,171	-2,074
C. Retained earnings (April-September) @	9,698	6,462
D. Depreciation Provision (April-September)	10,381	9,257
Total Flow of resources to Industry (A+B+C+D)	86,647	15,519

* : Gross issuances excluding issues by banks and financial institutions. Figures are not adjusted for banks' investments in capital issues, which are not expected to be significant.

+ : Including Global Depository Receipts (GDRs)/American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs) excluding issuances by banks and financial institutions.

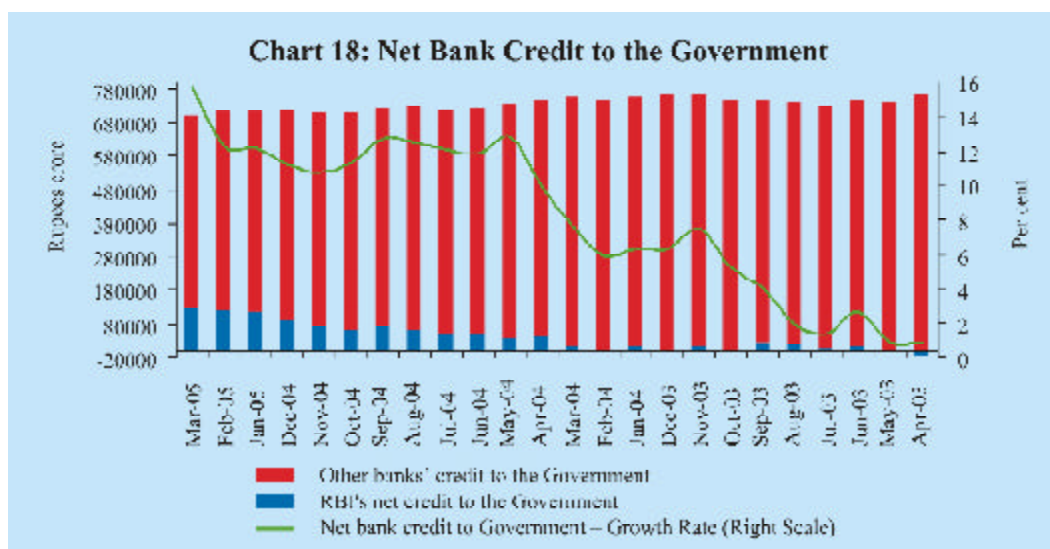
\$: Including short-term credit.

: Excluding issuances by financial institutions and banks' investments in CPs.

@ : Owing to non-availability of relevant data, retained earnings have been taken at 47.0 per cent of net profit, based on average share of retained earnings in net profit during last three years.

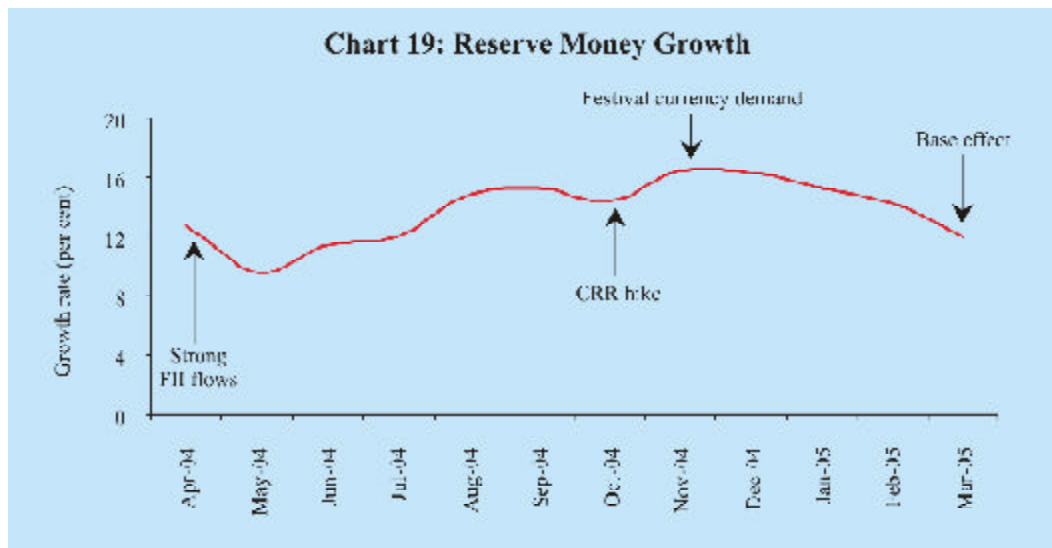
Note : Data are provisional.

Commercial banks continued to hold government securities of nearly 40 per cent of their net demand and liabilities (NDTL) – far in excess of the prescribed statutory minimum ratio of 25 per cent – despite the fact that incremental investment in government securities during 2004-05 was small (Chart 18).



Reserve Money Survey

Reserve money grew by 12.1 per cent during 2004-05 as compared with 18.3 per cent during 2003-04, reflecting mainly the dampened currency growth and the base effect of the excess reserves built up on March 31, 2004. Fluctuations in reserve money growth during the year reflect the impact of capital flows, sterilisation operations, the hike in CRR during September-October 2004 and seasonal fluctuations in currency demand (Chart 19).



Reserve money declined in the first quarter of the year mainly due to large-scale sterilisation of capital inflows through the MSS and the LAF and the base effect of the excess reserves built up on March 31, 2004. In the second quarter, reserve money declined mainly due to capital outflows, MSS operations and increase in the Government's surplus cash balances with the Reserve Bank (Table 13).

A strong revival of capital inflows in the third quarter led to a sharp increase in reserve money, which helped in meeting the expansion in currency demand on account of the festival season. Net Reserve Bank credit to the Centre remained almost unchanged as the decline in outstanding LAF balances was counter-balanced by increase in the Government's surplus cash balances with the Reserve Bank. Reserve money continued to grow in the fourth quarter as capital inflows continued to be sizeable (Chart 20).

During 2004-05, owing primarily to large balances under the MSS, net Reserve Bank credit to the Central Government declined sharply by Rs.50,646 crore on top of a decline of Rs.76,065 crore in 2003-04. Another contributing factor was the Centre's increased surplus cash balances with the Reserve Bank.

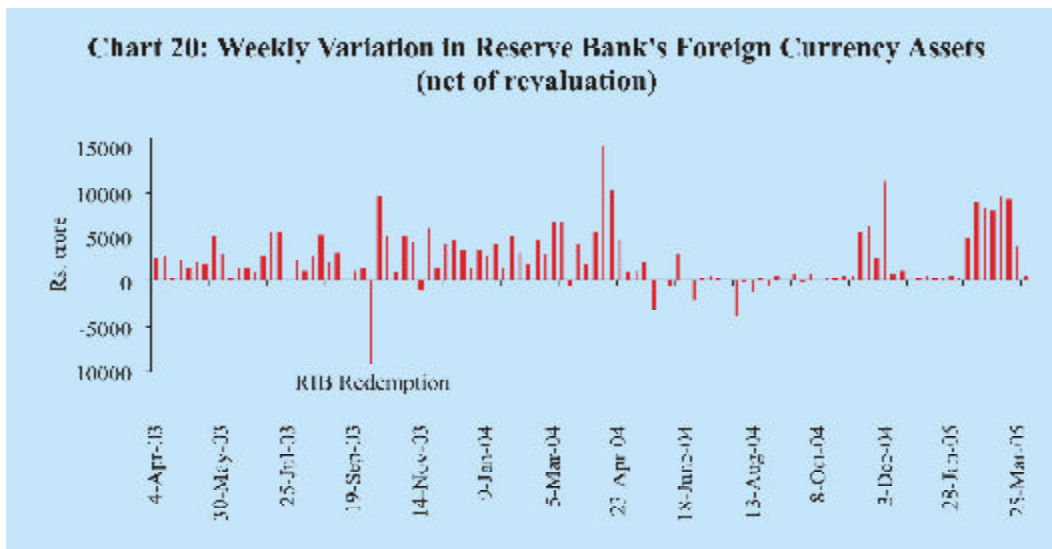
Table 13 : Variation in Major Components and Sources of Reserve Money

Item	2003-04		2004-05		2003-04				2004-05			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
1	2	3	4	5	6	7	8	9	10	11		
Reserve Money	67,451 (18.3)	52,616 (12.1)	16,342	-18,235	23,980	45,363	-6,812	-6,287	31,547	34,166		
Components												
1. Currency in circulation	44,555	41,621	17,882	-5,955	17,986	14,641	14,317	-4,166	16,467	15,003		
2. Bankers' Deposits with RBI	21,019	9,631	-1,606	-12,633	5,961	29,297	-19,665	-2,874	14,769	17,401		
3. Other Deposits with RBI	1877	1,364	65	352	33	1426	-1,463	755	311	1,761		
Sources												
1. RBI's net credit to Government of which: to Centre	-75,772 -76,065	-57,105 -50,646	-4,451 434	-53,146 -53,744	-12,506 -15,844	-5,669 -6,911	-34,143 -30,029	-6,179 -4,499	184 203	-16,967 -16,321		
2. RBI's credit to banks and commercial sector	-2,728	-833	-1,564	-2,525	-796	2,156	-2,985	-740	3,726	-835		
3. NFEA of RBI	1,26,169	1,28,377	22,710	25,720	51,931	25,808	57,525	-5,260	31,462	44,651		
4. Government's Currency Liabilities to the Public	225	141	84	74	43	24	37	9	89	6		
5. Net Non-Monetary Liabilities of RBI	-19,557	17,964	437	-11,642	14,692	-23,044	27,245	-5,885	3,915	-7,311		
Memo:												
1. Net Domestic Assets	-58,719	-75,761	-6,368	-43,955	-27,951	19,555	-64,336	-1,025	85	-10,485		
2. FCA, adjusted for revaluation	1,41,428	1,15,044	23,943	31,832	37,560	48,093	33,160	-3,413	29,858	55,440		
3. Net Purchases from Authorised Dealers	1,40,650	91,105	22,237	29,899	40,669	47,845	30,032	-9,789	22,771	48,091		
4. NFEA/Reserve Money (per cent) (end-period)	111.0	125.3	98.8	110.8	117.2	111.0	126.1	126.7	124.9	125.3		
5. NFEA/Currency (per cent)	148.1	166.2	126.8	138.1	146.8	148.1	158.8	159.2	160.7	166.2		

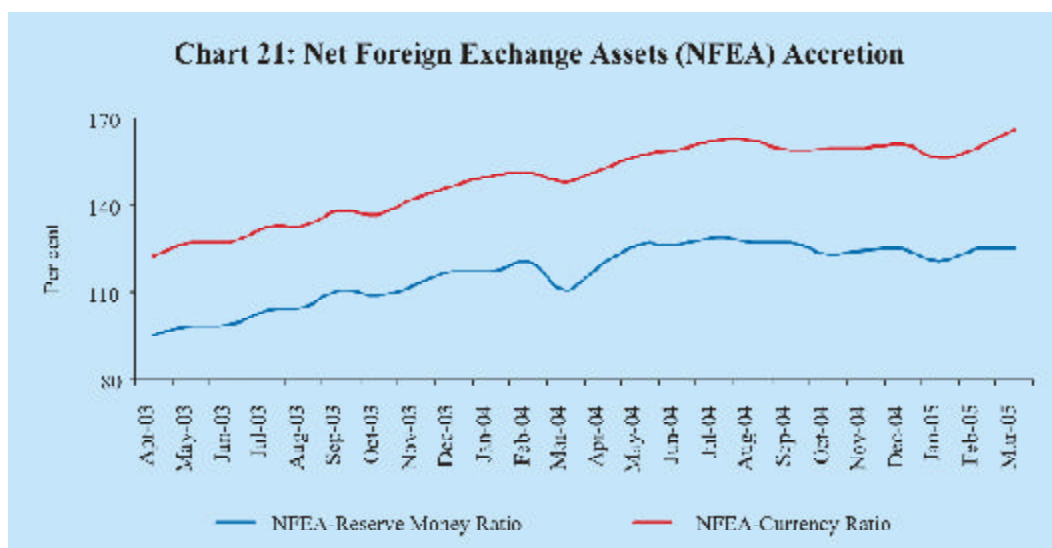
NFEA: Net Foreign Exchange Assets. FCA: Foreign Currency Assets.

Note: 1. Data are based on March 31 for Q4 and last reporting Friday for all other quarters.
2. Figures in brackets are percentage variations over the year.
3. Government balances as on March 31, 2005 are before closure of accounts.

Foreign currency assets of the Reserve Bank increased by Rs.1,15,044 crore (adjusted for revaluation) in 2004-05 on top of an accretion of Rs.1,41,428 crore in 2003-04. The continued strong inflow of foreign exchange assets was reflected in the



high level of NFEA/reserve money (125.3 per cent as at end-March 2005) and NFEA/currency (166.2 per cent as at end-March 2005) ratios (Chart 21).



The Reserve Bank was not required to support the Government in the primary market during 2004-05 barring in the second quarter when there was a devolvement of Rs.847 crore after a gap of two years (Table 14).

Table 14 : Net Reserve Bank Credit to the Centre - Variations

Item	2003-04	2004-05	2003-04				2004-05			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
Net Reserve Bank Credit to the Centre(1+2+3+4-5)	-76,065	-50,646	434	-53,744	-15,844	-6,911	-30,029	-4,499	203	-16,321
1. Loans and Advances	0	0	8,145	-8,145	0	0	3,222	-3,222	0	0
2. Treasury Bills held by the Reserve Bank	-3	0	-3	0	0	0	0	0	0	0
3. Reserve Bank's Holdings of Dated Securities	-72,227	12,323	-11,300	-45,530	-15,795	398	-2,901	22,176	14,095	-21,047
4. Reserve Bank's Holdings of Rupee Coins	20	58	163	-68	-51	-23	175	-11	-93	-15
5. Central Government Deposits	3,856	63,027	-3,430	0	-1	7,287	30,525	23,443	13,799	-4,740
<i>Memo Items *</i>										
1. Market Borrowings of Dated Securities by the Centre #	1,21,500	80,350	44,000	36,000	15,000	26,500	28,000	26,000	14,000	12,350
2. Reserve Bank's Primary Subscription to Dated Securities	21,500	1,197	5,000	0	0	16,500	0	847	0	350
3. Repos (+) / Reverse Repos (-) (LAF), net position £	-32,230	15,315	-19,040	-4,455	-3,580	-5,155	-26,720	34,205	27,600	-19,770
4. Net Open Market Sales #	41,850	2,899	5,620	16,671	14,225	5,332	429	427	871	1,172
5. Mobilisation under MSS	0	64,211	0	0	0	0	37,812	14,444	353	11,602
6. Primary Operations \$	-100	-61,305	25,643	-32,608	2,305	4,560	-459	-44,928	-39,338	23,418
* : At face value. # : Excluding Treasury Bills. £ : Including fortnightly repos. \$: Adjusted for Centre's surplus investment.										
Note : 1. Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters. 2. Government balances as on March 31, 2005 are before closure of accounts.										

Liquidity Management

The overhang of liquidity in the beginning of the year, combined with large capital inflows, continued to pose challenges for liquidity management and the conduct of monetary policy during 2004-05. The Reserve Bank had to continually absorb liquidity during the year barring some episodic pressures in August, November and December when there were net injections of liquidity through the LAF.

Sterilisation operations were conducted through a new mechanism introduced in April 2004, *viz.*, Market Stabilisation Scheme (MSS). While LAF continues to remain an important instrument for managing day-to-day liquidity, the institution of the MSS has facilitated the management of capital flows.

The liquidity management operations of the Reserve Bank during 2004-05 could be broadly divided into three phases depending upon the movement in capital flows (Table 15). In the first phase (from March 27, 2004 to May 14, 2004), strong capital inflows led to the accretion of foreign currency assets (adjusted for revaluation) to the extent of around Rs.38,000 crore. The decline in the Central Government's surplus cash balances with the Reserve Bank also led to an expansion of liquidity in the system. In this phase, the Reserve Bank managed liquidity primarily through the MSS.

Table 15 : Phases of Reserve Bank's Liquidity Management Operations

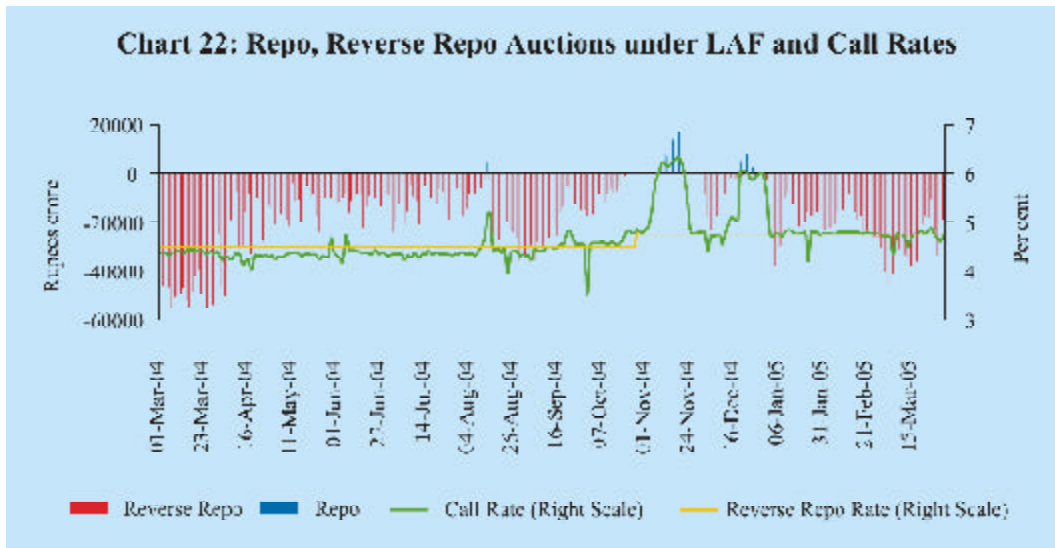
(Rupees crore)					
Item	2003-04		2004-05		
	April 1, 2003 – December 26, 2003	December 27, 2003 – March 26, 2004	March 27 – May 14, 2004	May 15 – October 29, 2004	October 30, 2004 – March 31, 2005
1	2	3	4	5	6
A. Drivers of Liquidity (1+2+3)	56,248	46,646	36,218	-24,321	42,066
1. RBI's Foreign Currency Assets (adjusted for revaluation)	93,334	46,171	37,919	-4,614	83,662
2. Currency with the Public	-28,981	-15,126	-20,973	6,789	-27,552
3. Others (residual)	-8,106	15,602	19,272	-26,496	-14,044
3.1 Surplus cash balances of the Centre with the Reserve Bank	-13,135	6,685	15,355	-18,481	-7,721
B. Management of Liquidity (4+5+6+7)	-60,092	-37,242	-40,148	37,960	-31,852
4. Liquidity impact of LAF Repos (net)	-27,075	-31,910	-12,095	66,040	-11,875
5. Liquidity impact of OMO (net)	-36,517	-5,332	-277	-769	-1,853
6. Liquidity impact of MSS	0	0	-27,776	-27,311	-9,124
7. First round liquidity impact due to CRR change	3,500	0	0	0	-9,000
C. Bank Reserves # (A+B)	-3,844	9,404	-3,930	13,639	10,214

+ : Indicates injection of liquidity into the banking system.
 - : Indicates absorption/leakage of liquidity from the banking system.
 # : Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.

In the second phase (May 15, 2004 to October 29, 2004), net capital outflows, the increase in the Central Government's surplus cash balances with the Reserve Bank and absorption of liquidity through the MSS impacted liquidity in the system. As a result, the outstanding balances locked under the LAF declined by about Rs.66,000 crore. In fact, the Reserve Bank had injected liquidity (Rs.5,000 crore) through the LAF on August 12 to assuage temporary mismatches arising out of pressures from State Development Loans auctions, redemptions from mutual funds and the need to meet reserve requirements. Liquidity conditions remained comfortable until September 2004 when outflow of funds on account of advance tax payments, substantial rise in surplus cash balances of the Government with the Reserve Bank and the hike in the cash reserve ratio (CRR) exerted some pressure, pushing the call rates slightly above the LAF repo rate.

Capital inflows started picking up from end-October 2004, which marked the beginning of the third phase. The robust expansion in non-food credit offtake and a spurt in festival currency demand continued to exert pressure on liquidity, driving the call rates to 6.10 per cent on November 5, 2004 and further to 6.30 per cent as on November 18, 2004. The Reserve Bank injected daily net liquidity of over Rs.10,000 crore, on an average, during the period November 5-22, 2004 through the LAF. The ebbing of currency demand and a pick-up in capital inflows eased liquidity conditions with the call rates sliding to 4.55 per cent by December 10, 2004. The Reserve Bank absorbed excess liquidity resulting from an accretion of nearly Rs.21,000 crore to the net foreign currency assets (net of revaluation) between mid-November 2004 and the second week of December 2004. Liquidity conditions came under pressure briefly during the second half of December 2004 due mainly to moderation of capital inflows, advance tax payments, continued growth in non-food credit and the Central Government maintaining substantial surplus cash with the Reserve Bank. The Reserve Bank again injected daily net liquidity of around Rs.3,500 crore, on an average, from December 20-24, 2004 and did not undertake scheduled issuance of 364-day Treasury Bills under the MSS. Liquidity conditions turned comfortable thereafter facilitated by large capital inflows and decline in Centre's cash balances with the Reserve Bank. Call rates remained anchored to the reverse repo rate through January and the first half of February 2005 (Chart 22).

The liquidity overhang, which declined to around Rs.70,000 crore in January 2005 from over Rs.1,00,000 crore as at mid-April 2004, increased again to over Rs.83,000 crore by March 31, 2005. The total stock of Treasury Bills and dated securities issued under the MSS amounted to Rs.64,211 crore as at end-March 2005 inclusive of Rs.25,000 crore raised through dated securities with a residual maturity of up to 2.5 years. With the introduction of the MSS, liquidity absorption through the LAF declined from an outstanding balance of Rs.75,006 crore in April 2004 to Rs.10,805 crore in October 2004 but finally



rose to Rs.29,809 crore in March 2005. In addition to the MSS, LAF operations and CRR hike, surplus balances of the Centre with the Reserve Bank also helped in impounding liquidity.

