PART TWO: THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

III MONETARY POLICY OPERATIONS

In balancing the twin objectives of price stability and growth, the conduct of monetary policy was conditioned by the shift in policy challenge from "management of recovery" to "management of inflation". During the first half of 2010-11, policy was geared towards non-disruptive normalisation of the monetary policy stance, which supported consolidation of growth. Inflation stayed elevated, but the sources of inflationary pressures warranted cautious calibration of the normalisation process. The anti-inflation accent of monetary policy became stronger during the second half of the year, as the inflation process became generalised and sticky in an environment of strong growth. Furthering transparency about the monetary policy process, minutes of the meetings of the Technical Advisory Committee on Monetary Policy are now being released in the public domain. The operating framework for monetary policy was modified in May 2011, with the switchover to repo rate as the single policy rate for better signalling the stance of monetary policy.

III.1 The monetary policy stance in 2010-11 changed course during the year, from calibrated normalisation to tightening driven by inflation concerns. Liquidity conditions remained consistent with the shift in monetary policy stance, though some of the key determinants of liquidity remained volatile. The cumulative effect of transient factors (such as advance tax collections), frictional factors (large government surplus balances) and structural factors (*i.e.*, high increase in currency in circulation and higher credit growth relative to deposit growth) culminated in large deficit liquidity conditions, which were managed by the Reserve Bank through an appropriate mix of SLR, OMO and LAF.

III.2 A number of steps were taken during 2010-11 to enhance the communication of monetary policy. The Reserve Bank introduced mid-quarter reviews during the year. Another notable development during 2010-11 was the introduction of the Base Rate system which replaced the Benchmark Prime Lending Rate (BPLR) with effect from July 2010. This helped in improving the assessment of the transmission of monetary policy (Box III.1).

Role of communication in monetary policy

III.3 Monetary policy acts on its ultimate objectives of price stability and growth with long and variable lags. Given these lags in monetary transmission, effective communication of monetary policy objectives, rationale for policy actions and expected outcomes is critical. Effective communication along with appropriate monetary actions can help anchor inflation expectations. Like other central banks, the Reserve Bank has also placed a lot of emphasis on effective communication of its policy objectives. The stance of monetary policy and the rationale are communicated to the public in a variety of ways – periodic monetary policy statements, other publications, speeches by the top management and press releases. In order to further enhance the efficacy of the communication process, a number of steps have been taken in the recent period. From September 2010, the Reserve Bank introduced Mid-Quarter Reviews (MQRs) to combine the rigour and comprehensiveness of the quarterly process with the need for flexibility to respond in a fast evolving global and domestic macroeconomic situation.

Box III.1
Monetary Policy Transmission after the Switchover to Base Rate

The Benchmark Prime Lending Rate (BPLR), introduced in 2003, was expected to serve as the benchmark rate for pricing of loan products by reflecting the actual cost of funds for banks. The BPLR system, however, fell short of its original objective of bringing transparency to lending rates. This was mainly because banks could lend below the BPLR under the system. The share of sub-BPLR lending (excluding export credit and small loans) of SCBs was as high as 77 per cent in September 2008, before dropping to 70 per cent, which was still very high, during the quarter ended June 2010. As a result, it was difficult to assess the transmission of policy rates of the Reserve Bank to lending rates of banks.

In order to address these concerns, the Reserve Bank announced the constitution of a Working Group (Chairman: Shri Deepak Mohanty) in the Annual Policy Statement of 2009-10 to review the BPLR system and suggest changes to make credit pricing more transparent. The Working Group submitted its Report in October 2009 and based on the recommendations of the Group and the suggestions from various stakeholders, the Reserve Bank issued guidelines on the Base Rate system in April 2010. The system of Base Rate, that came into effect on July 1, 2010, replaced the BPLR system.

Under the new system, the actual lending rate charged to borrowers is the Base Rate plus borrower-specific charges. The Base Rate is the minimum rate for all loans and banks are not permitted to resort to any lending below the Base Rate except some specified categories such as: (a) Differential Rate of Interest (DRI) advances, (b) loans to banks' own employees, (c) loans to banks' depositors against their own deposits, (d) interest rate subvention given by government to agricultural loans and rupee export credit, and (e) some specific cases of restructured loans. The interest rates on small loans up to ₹2 lakh and rupee export credit have been deregulated to increase the flow of credit to small borrowers and exporters at reasonable rates. With these measures, the Reserve Bank achieved complete deregulation of interest rates relating to rupee lending by commercial banks. The Base Rate system was expected to facilitate better pricing of loans, enhance transparency in lending rates and improve the assessment of the transmission of monetary policy. Though the experience so far is limited, it suggests that these objectives have been largely met.

The Reserve Bank has increased the repo rate by 325 basis points (bps) since mid-March 2010. The effective tightening of the policy rate has, however, been of the order of 475 bps as the system migrated from surplus mode to deficit mode. In response, Base Rates have been raised by 75-375 bps between July 2010 and August 11, 2011 (Table 1). The range of increase was, however, much narrower, *i.e.,* 175-375 bps for 49 major banks.

Table 1: Variation in Policy Rate of the Reserve Bank and Deposit/Lending Rates of SCBs

(bps)

Period	Increase in Repo Rate	Increase in Deposit Rates	Increase in Lending Rate	
			Base Rate	BPLR
Mid-March 2010 to May 2010	50	25-160	Not Applicable	No Change
June 2010 to August 11, 2011	275	25-550	75-375	100-375

It has been observed that there is greater convergence amongst banks in fixing the Base Rate over time *vis-a-vis* under the BPLR system. As a result, the Base Rate system is found to be more transparent and more responsive to hikes in policy rates by the Reserve Bank compared to the BPLR system. This is reflected in the average increase in the Base Rate by public and private sector banks since July 2010. It is seen that the pace of increase in Base Rate in response to increase in policy rate was initially slower but picked up momentum during December 2010-February 2011. Also, the number of days taken by these banks to raise their Base Rates went down during this period (Table 2). However, following gradual moderation in the growth of non-food credit, the pace of increase in Base Rate relative to that of the repo rate slowed down from February 2011 onwards, while the number of days taken to raise the Base Rate also increased.

Table 2: Extent of Increase in Base Rate and Time Taken by Public/Private Sector Banks

Period (Month over Month)	Increase in Repo Rate (bps)	Average increase in Base Rate (bps)	Average no. of days taken to raise Base Rate
Dec.10/July 10	75	58	140
Feb.11/Dec.10	25	65	74
May 11/Feb.11	75	64	88
August 11, 11/May 11	125	69	87

Thus, not only has there been a larger degree of convergence of the Base Rates across banks, they have also become more responsive to increase in policy rates of the Reserve Bank. As a result, the assessment of the transmission of monetary policy has strengthened under the new system, from that under the BPLR system.

III.4 Steps taken to strengthen the existing two-way communication process include webcasting of the Governor's press conference and interaction with researchers/analysts on monetary policy after the quarterly reviews. Audio recordings and transcripts of the press conference and the teleconference with researchers/analysts are also put on the Reserve Bank's website.

III.5 As a part of its communication policy and given the objective of more transparency, the Reserve Bank is endeavouring to put in public domain all data/inputs that go into the formulation of monetary policy. Accordingly, the main points of discussion in the meetings of the Technical Advisory Committee (TAC) on Monetary Policy are being placed on the website, roughly four weeks after the meeting of the Committee. The first such release was in February 2011 of the TAC meeting in January 2011.

Introduction of mid-quarter reviews

III.6 Most major central banks make frequent monetary policy announcements ranging from 8 to 12 announcements a year. Monetary and credit policy was traditionally reviewed by the Reserve Bank twice a year. Over time, a need was felt to increase the frequency of the policy communication and the Annual Policy Statement of 2005-06 announced the introduction of more frequent reviews of monetary policy, at quarterly intervals. The proposed quarterly reviews of monetary policy were intended to provide the opportunity for structured communication with markets on a more frequent basis, while retaining the flexibility to take specific measures warranted by evolving circumstances.

III.7 The gap of a quarter between policy reviews was felt too long in a rapidly evolving macroeconomic situation. There were several occasions (April, June and September-December 2008; January and March 2009; March and July 2010) when the Reserve Bank had to take policy actions in response to macroeconomic developments. While these instances questioned the discipline of the quarterly schedule, they also underscored the need for flexibility.

III.8 Accordingly, the First Quarter Review of Monetary Policy for July 2010 announced the introduction of MQRs. By instituting MQRs, the Reserve Bank intended to take the surprise element out of the off-cycle actions. The Reserve Bank, however, reserves the flexibility to take swift and pre-emptive policy actions, as and when warranted by the evolving macroeconomic developments. It was decided to announce the MQRs in June, September, December and March by way of a press release, providing a rationale for either action or maintenance of the *status quo*. The first MQR was announced in September 2010.

III.9 Unlike the Quarterly Reviews, the MQRs were intended to be a less intensive process. In the run up to the MQRs, there are no pre-policy consultations with the stakeholders from the financial market and the industry. However, there is a process of consulting the members of the TAC. In order to take the advice of the TAC members in the run up to the MQRs, the Reserve Bank has instituted a mechanism to obtain the views of the members through a structured feedback format.

MONETARY POLICY OPERATIONS: CONTEXT AND RATIONALE

III.10 The monetary policy stance in 2010-11 evolved in line with changing domestic growth-inflation dynamics. In the first half of 2010-11, the thrust of monetary policy was on avoiding policy impediments to the recovery amidst global uncertainties, while also containing inflationary pressures. Headline inflation, which touched double digits in the first quarter of 2010-11, showed moderation in the second quarter of the year, but remained above the comfort zone of the Reserve Bank. Food inflation remained high on account of structural demand-supply imbalances despite normal monsoons. Though non-food manufactured products inflation declined from the elevated levels seen at the start of the year, it remained sticky and above its medium term trend. Considering global uncertainties and associated implications for domestic growth and the fact that inflation was largely driven by supply side factors, the Reserve Bank followed calibrated normalisation of policy (Table III.1).

III.11 In the second half of 2010-11, while growth continued to consolidate, the moderating path of inflation reversed beginning December 2010 due to a series of supply side shocks, both domestic and

Table III.1: Movements in Key Policy Rates and Reserve Requirements in India

(Per cent)

Effective since	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio	Marginal Standing Facility Rate
1	2	3	4	5
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	-
January 25, 2011	5.50 (+0.25)	6.50 (+0.25)	6.00	-
March 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	8.25*
June 16, 2011	6.50 (+0.25)	7.50 (+0.25)	6.00	8.50 (+0.25)
July 26, 2011	7.00 (+0.50)	8.00 (+0.50)	6.00	9.00 (+0.50)

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

* : Marginal Standing Facility is with effect from May 9, 2011.

global. Food prices registered sharp increases in December 2010 and January 2011 following unseasonal increase in vegetable prices. The sharp increase in global prices of raw cotton and rubber, metals and minerals were transmitted quickly to the domestic markets during the second half of the year. Even as mineral oil price inflation showed an uptick, it was less than the extent of the global crude price inflation as the administered mineral oil prices remained unchanged. Robust demand conditions saw input price pressures being increasingly transmitted to final output prices and rising core inflation. It was, therefore, crucial to ensure that the elevated inflationary expectations did not get entrenched. Hence, towards the end of 2010-11, monetary policy stance underwent a shift as the Reserve Bank deviated from the calibrated approach and took stronger monetary policy measures. This was warranted to ensure that the long-term growth prospects were not harmed, even if it meant sacrificing some growth in the short-term (Table III.2).

III.12 Based on the Report of the Working Group to Review the Operating Procedures of Monetary Policy in India (Chairman: Shri Deepak Mohanty) and in the light of the feedback received, changes relating to operating procedures of monetary policy were announced in the Monetary Policy Statement for 2011-12 (Box III.2).

Table III.2: Monetary Policy Reviews

Monetary Policy Statement 2010-11

Backdrop:
- Broad-based recovery taking firm hold with rising domestic and external demand.
- Inflation pressures, initially driven by food prices, becoming more generalized.
- Corporates regaining pricing power in many sectors.
- Inflation expectations of the households at elevated level.

Baseline Projection/Indicative Trajectory:
- 8.0 per cent real GDP growth (with an upside bias) during 2010-11.
- 5.5 per cent WPI inflation for March 2011.
- 17.0 per cent, 18.0 per cent and 20.0 per cent growth in M_3, aggregate deposits and non-food credit, respectively, during 2010-11.

Measures:
- Increase in repo rate, reverse repo rate and CRR by 25 basis points each.

Expected Outcome:
- Contain inflation and anchor inflationary expectations.
- Sustain the recovery process.
- Meet government borrowing requirements and the private credit demand.
- Align policy instruments in a manner consistent with the evolving state of the economy.

Mid-Cycle Policy Measure: July 2, 2010

Backdrop:
- Double-digit headline inflation levels.
- Petrol prices were decontrolled and prices of remaining administered fuel such as diesel, LPG and kerosene were increased in end-June 2010.

Measures:
- Increase in repo rate and reverse repo rate by 25 basis points each (with the LAF window having moved to deficit mode from end-May 2010, effective tightening of 175 basis points).

First Quarter Review of Monetary Policy 2010-11

Backdrop:
- Growth process registered further momentum during Q1 of 2010-11.
- Overall food inflation at elevated level.
- Rise in administered prices of iron ore and electricity.
- Non-food manufactured products inflation much higher than the medium-term trend.

Baseline Projection/Indicative Trajectory:
- 8.5 per cent real GDP growth during 2010-11.
- 6.0 per cent WPI inflation for March 2011.

Measures:
- Increase in repo rate and reverse repo rate by 25 basis points and 50 basis points, respectively.

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Mid Quarter Review: September 2010

- Inflation continued to be the dominant concern for policy.
- Increase in repo rate and reverse repo rate by 25 basis points and 50 basis points, respectively.

Second Quarter Review of Monetary Policy 2010-11

Backdrop:

- Normal monsoons raised the prospects of good *Kharif* cultivation.
- Quarterly industrial outlook survey showed improvement in the overall business conditions.
- Moderation in food inflation not commensurate with a normal monsoon, due to continued elevated prices of protein-rich food items.
- Non-food primary articles, specifically fibres registered significant inflation.

Baseline Projection/Indicative Trajectory:

- 8.5 per cent real GDP growth during 2010-11.
- 5.5 per cent WPI inflation (under the new base) for March 2011, equivalent to 6.0 per cent inflation under the old base.

Measures:

- Increase in repo rate and reverse repo rate by 25 basis points each.

Expected Outcome:

- Sustain the anti-inflationary thrust of the recent monetary actions and outcomes in the face of persistent inflation risk.
- Rein in rising inflationary expectations that could be aggravated by the structural nature of food price increases, while not disrupting growth.

Mid Quarter Review: December 2010

- Management of liquidity came to the forefront of policy concerns, following the excessive tightness in money markets.
- The SLR of SCBs was reduced from 25 per cent of their NDTL to 24 per cent with effect from December 18, 2010.
- Staggered OMO auctions for purchase of government securities for an aggregate amount of ₹48,000 crore announced.
- These measures were expected to release sizeable primary liquidity into the system, bringing down the liquidity deficit in the system close to the comfort zone of the Reserve Bank while stabilising interest rates in the overnight inter-bank market closer to the operative policy rate of the Reserve Bank.

Third Quarter Review of Monetary Policy 2010-11

Backdrop:

- Real GDP increased by 8.9 per cent during the first half of 2010-11, reflecting strong domestic demand, especially private consumption and investment, and improving external demand.
- Series of commodity price shocks – vegetable prices, crude oil prices.

Baseline Projection/Indicative Trajectory:

- 8.5 per cent real GDP growth (with an upside bias) during 2010-11.
- 7.0 per cent WPI inflation for March 2011.

Measures:

- Increase in repo rate and reverse repo rate by 25 basis points each.

Mid Quarter Review: March 2011

- Inflation pressures accentuated further after January 2011.
- Inflation estimated at around 8 per cent for March 2011.
- Increase in repo rate and reverse repo rate by 25 basis points each.

Monetary Policy Statement 2011-12

Backdrop:

- Very sharp rise in inflation and elevated inflationary expectations.
- Rise in inputs costs quickly passed on to domestic manufactured goods.
- Signs of moderation in growth particularly investment spending.
- Rise in administered coal prices in end-February 2011.

Baseline Projection/Indicative Trajectory:

- 8.0 per cent real GDP growth during 2011-12.
- 6.0 per cent WPI inflation (with an upward bias) for March 2012.
- 16.0 per cent, 17.0 per cent and 19.0 per cent growth in M_3, aggregate deposits and non-food credit of SCBs, respectively.

Measures:

- Repo rate increased by 50 basis points to 7.25 per cent.
- Reverse repo rate, determined with a spread of 100 basis points below the repo rate, automatically adjusted to 6.25 per cent.
- Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, fixed at 8.25 per cent.
- Interest rate on savings bank deposit rate increased from 3.5 per cent to 4.0 per cent.

Expected Outcome:

- Contain inflation by reining in demand-side pressures.
- Anchor inflationary expectations and sustain the growth in the medium-term by containing inflation.

Mid Quarter Review: June 2011

- The monetary policy stance remains anti-inflationary.
- Repo rate increased by 25 basis points.

First Quarter Review of Monetary Policy 2011-12

Backdrop:

- Some moderation underway in industrial production.
- Prospects of agriculture not clear.
- Continued high level of inflation.
- Rise in administered fuel prices in June 2011.

Baseline Projection/Indicative Trajectory:

- 8.0 per cent real GDP growth during 2011-12.
- 7.0 per cent WPI inflation for March 2012.
- 15.5 per cent and 18.0 per cent growth in M_3 and non-food credit of SCBs, respectively.

Measures:

- Repo rate increased by 50 basis points to 8.0 per cent.
- Reverse repo rate, determined with a spread of 100 basis points below the repo rate, automatically adjusted to 7.0 per cent.
- MSF rate, determined with a spread of 100 basis points above the repo rate, fixed at 9.0 per cent.

Box III.2
Changes in Operating Procedure of Monetary Policy

Background

The operating procedure of monetary policy in India has witnessed significant changes since the beginning of the 1990s with developments in money market and changes in liquidity conditions brought about by financial sector reforms. In this process, the LAF, introduced in June 2000, emerged as the principal operating procedure of monetary policy, with the repo and the reverse repo rates as the key instruments for signalling the monetary policy stance. LAF, supported by instruments such as the CRR, OMO and MSS, had served the Indian monetary and financial system well. Large volatility in capital flows and sharp fluctuations in government cash balances, however, posed several challenges to liquidity management by the Reserve Bank.

Thus, the first Quarter Review of Monetary Policy for 2010-11 proposed the need for revisiting the operating procedures of monetary policy in India. Accordingly, on October 1, 2010, a Working Group (Chairman: Shri Deepak Mohanty) was constituted with members drawn from the Reserve Bank, financial market participants and the academia.

Changes in the Extant Operating Procedures of Monetary Policy

Based on the Group's recommendations and the feedback received, the following changes in the extant operating procedures of monetary policy were effected as announced in the Monetary Policy Statement for 2011-12:

- The weighted average overnight call money rate is now the operating target of monetary policy.
- The repo rate has acquired the status of being the only one independently varying policy rate.
- A new MSF has been instituted from which SCBs can borrow overnight up to 1.0 per cent of their respective NDTL at 100 basis points above the repo rate.

The revised corridor has a fixed width of 200 basis points. The repo rate has been placed in the middle of the corridor, with the reverse repo rate 100 basis points below it and the MSF rate 100 basis points above it. However, the Reserve Bank will have the flexibility to change the width of the corridor, should monetary conditions so warrant.

Asset price implications for monetary policy

III.13 In general, wealth impact is not observed to be very significant in India. Only a small portion of savings, *i.e.,* about 12 per cent of total savings of the household sector in financial assets, is invested in the equity market. In many advanced economies, the share of such investment in total financial savings is much bigger. Therefore, cooling down of the equity market should not have any significant impact on the aggregate demand. As regards, the real estate market, home owners in India, unlike advanced economies, do not borrow against the houses already purchased when their valuations go up. As such, cooling of real estate prices should also not have any significant impact on consumption and hence aggregate demand. Thus, asset prices do not seem to influence the inflation path and conduct of monetary policy may refrain from responding directly to asset price cycles. The Reserve Bank has used both micro and macro prudential measures to limit the risks to financial stability from asset price cycles. Monetary policy, as a macroeconomic policy tool, enables an environment in which prudential regulation works more effectively.

Overall Assessment

III.14 During the major part of 2010-11, the stance of the monetary policy was for calibrated normalisation. The moderation in inflation in Q2 and Q3 of 2010-11 justified such a calibrated approach. As the LAF window of the Reserve Bank transited from a surplus to a deficit mode, consistent with the Reserve Bank's anti-inflationary stance and its calibrated approach to absorb surplus liquidity, liquidity management also became a central focus in 2010-11. It had to be ensured that the primary liquidity needs of an expanding economy were met in a manner consistent with the anti-inflationary monetary policy stance. Inflation pressures, however, intensified in Q4 of 2010-11 even as the growth process showed some signs of moderation. The proximate cause of the intensification of inflationary pressure was a series of supply side shocks, both domestic and global, which rapidly fed into a broad spectrum of manufactured products. The inflation pressures and elevated inflation expectations emerged as a source of risk to future growth. Accordingly, the stance of monetary policy for 2011-12 gave foremost priority to containing inflation and anchoring inflation expectations even at the cost of some growth in the short-run.

Management of liquidity – evolving factors driving Reserve Bank's operations

III.15 During 2010-11, the centre's cash balance with the Reserve Bank and currency in circulation were key drivers of autonomous liquidity. With the consolidation of economic growth, credit growth accelerated faster than deposit mobilisation, leading to structural squeeze on liquidity for an extended period. The deficit liquidity conditions were reflected in large recourse to the LAF repo window (Chart III.1). The Reserve Bank actively managed liquidity so that neither a surplus diluted monetary transmission, nor a deficit choked fund flows. While the overall liquidity in the system remained in deficit, consistent with the policy stance, the extent of deficit went beyond the Reserve Bank's comfort zone of (+)/(-) one per cent of NDTL of banks, requiring appropriate policy measures (Table III.3).

III.16 The liquidity conditions changed significantly during Q1 of 2010-11. With the recovery of the economy firmly in place, the Reserve Bank moved in a calibrated manner in the direction of normalising its policy instruments. Accordingly, there was gradual moderation in the volume of surplus liquidity in the system from February 2010. The liquidity conditions switched to deficit mode from end-May 2010, due to large increase in government balances with the Reserve Bank generated from 3G/BWA spectrum auctions and the first instalment of quarterly advance tax payments in June 2010.

III.17 During Q2 2010-11, the liquidity conditions continued to remain in deficit mode till end-July 2010 and eased thereafter mainly on account of large scale public debt redemptions. After a brief period of surplus liquidity (from end-August to early-September 2010), it again switched to deficit mode as liquidity migrated to government balances with the Reserve Bank on account of the second quarterly advance tax payments.

III.18 The liquidity conditions tightened significantly during Q3 2010-11 mainly due to autonomous factors, *i.e.*, increase in the government's surplus balance with the Reserve Bank and currency in circulation compounded by the structural liquidity mismatch faced by banks. The government's surplus balance peaked in December 2010 reflecting advance tax collections. The net injection under the LAF peaked at ₹1,70,485 crore during the third week of December 2010 (Chart III.2).

Chart III.1: Repo (+)/ Reverse Repo (-) under LAF

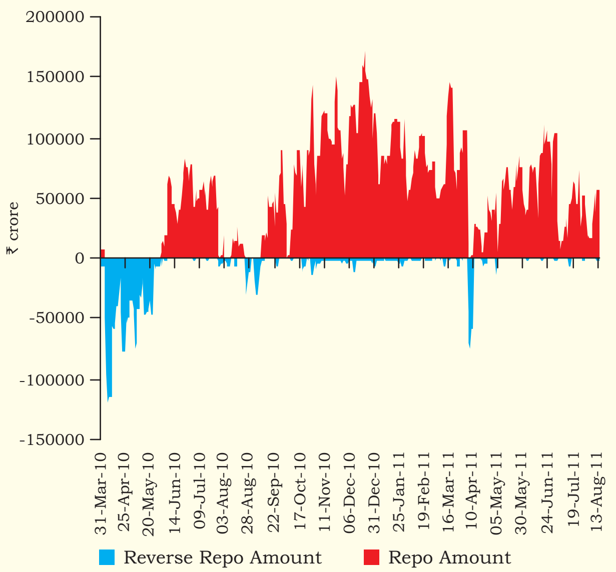
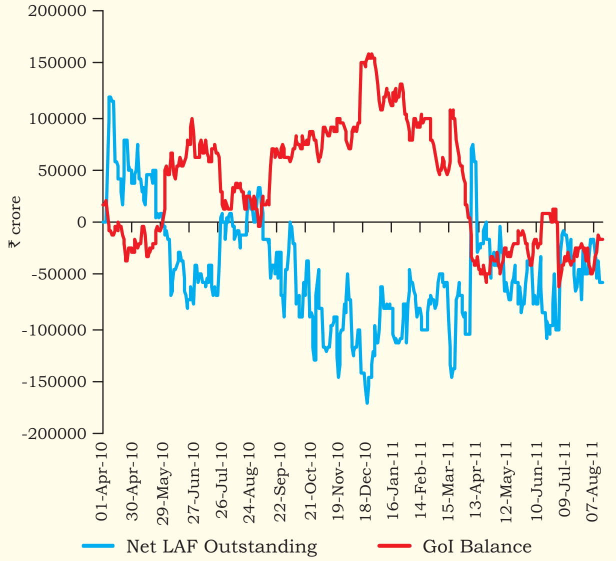


Chart III.2: Outstanding LAF and GoI Balance



Note: (-)ve LAF indicates injection of liquidity into the system.

Table III.3:Liquidity Management Measures taken by the Reserve Bank in 2010-11

Time Period/Event	Measures
1	2
End-May 2010 : Larger than anticipated collection from 3G/BWA spectrum auctions in addition to advance tax outflows 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 : (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	(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 purchased government securities under 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 MQR, the Reserve Bank: (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 was made available from December 18, 2010 to January 28, 2011. (ii) Announced conduct of OMO auctions for purchase of government securities for an aggregate amount of ₹48,000 crore over the next one month (staggered as purchases of ₹12,000 crore per week).
End-January 2011: Frictional and structural liquidity pressure	In the Third Quarter Review of January 2011, the Reserve Bank extended the daily SLAF and additional liquidity support to SCBs of 1.0 per cent of NDTL under the LAF till April 8, 2011. Subsequently, both the measures were extended till May 6, 2011.

III.19 At the start of Q4 2010-11, injections under the LAF declined marginally due to the cumulative impact of decline in surplus balances of the Centre and staggered OMO carried out by the Reserve Bank in December 2010-January 2011. During 2010-11, the Reserve Bank purchased government securities for an aggregate amount of about ₹67,000 crore under OMO auctions. The liquidity conditions improved further in February 2011 with the decline in the surplus balances of the Centre. Notwithstanding the quarterly advance tax outflows during mid-March 2011, the liquidity deficit remained controlled on account of higher government expenditure during the month. Thus, the quantum of liquidity deficit declined in Q4

as compared with Q3, mainly on account of the Reserve Bank's OMO purchases and the decline in government cash balances with the Reserve Bank.

III.20 The current financial year began with liquidity remaining in absorption mode in the first week of April 2011 on account of high government expenditure and the absence of normal government securities auctions. The liquidity conditions again shifted to injection mode from the second week of April 2011. The average daily net liquidity injection declined significantly to about ₹19,000 crore during April 2011 from about ₹81,000 crore in March 2011. While the negative government balance with the Reserve Bank added liquidity into the system, the increasing currency with the public acted in the opposite direction during the month. The liquidity conditions tightened further in May 2011 as the gap between pace of credit growth and deposit mobilisation by banks, which had been narrowing from end-December 2010, reversed trend and increased in May 2011. There was also a decline in WMA/OD availed by the government.

III.21 The liquidity conditions remained in deficit mode in June 2011 due to quarterly advance tax outflows. The average daily net liquidity injection increased further to around ₹74,000 crore. The liquidity conditions improved at the beginning of July 2011 partly on account of redemption of a security with outstanding stock of ₹37,000 crore. The liquidity deficit, however, increased subsequently and the average daily net liquidity injection was around ₹44,000 crore during July 2011. The average daily net liquidity injection under the LAF was around ₹37,000 crore during August 1-16, 2011. Up to mid-August 2011, availment of funds under the MSF, which came into operation in May 2011, has happened only twice.

III.22 As the main drivers of liquidity conditions varied from quarter to quarter as discussed above, the Reserve Bank had to manage liquidity actively while avoiding any possible conflict with the monetary policy stance. Persistence of inflation at elevated level was a key challenge for monetary policy, despite evidence of strengthening monetary policy transmission.