III. MONETARY AND LIQUIDITY CONDITIONS

Monetary Survey

Monetary conditions remained easy during Q_1, 2005-06 despite doubling of the trade deficit, a marked increase in the demand for bank credit from the commercial sector and the onset of the Government borrowing programme. As sterilisation operations were significantly lower than a year ago, reserve money increased in the first quarter – as against a decline in the first quarter of the previous year – as banks unwound their LAF positions and withdrew liquidity (lodging Government securities with the Reserve Bank) to finance the higher demand for credit. The year-on-year growth in M_3 was nonetheless within the indicative trajectory of 14.5 per cent projected in the Annual Policy Statement. Expansion in the residency-based new monetary aggregate (NM_3) – which excludes foreign currency non-resident deposits – was marginally higher than M_3 on account of net outflows under non-resident foreign currency deposits and continued access of banks to call/term borrowings (Table 12).

Table 12: Monetary Indicators

(Amount in Rs. crore)

Item	Outstanding as on July 8, 2005	Variation (year-on-year)			
		2004		2005	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
I. Reserve Money*	5,07,068	54,163	14.4	77,615	18.1
II. Broad Money (M_3)	23,71,769	2,77,034	15.3	2,88,579	13.9
a) Currency with the Public	3,76,252	40,706	14.0	44,991	13.6
b) Demand Deposits	2,96,860	37,812	18.8	57,456	24.0
c) Time Deposits	16,93,301	1,97,595	15.1	1,85,417	12.3
of which: Non-Resident Foreign Currency Deposits	75,722	-11,988	-13.4	-1,723	-2.2
III. NM_3	23,29,564	3,08,235	17.8	2,93,789	14.4
of which: Call Term Funding from Financial Institutions	36,250	14,539	95.9	6,549	22.0
IV. a) L_1	24,17,515	3,25,345	18.2	3,06,294	14.5
of which: Postal Deposits	87,951	17,110	29.3	12,505	16.6
b) L_2	24,19,166	3,25,184	18.1	3,01,483	14.2
of which: FI Deposits	1,651	-161	-2.4	-4,811	-74.5
c) L_3	24,39,064	3,24,454	17.9	3,02,157	14.1
of which: NBFC Deposits	19,898	-730	-3.7	674	3.5
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	7,55,108	39,150	5.4	-4,069	-0.5
i) Net Reserve Bank Credit to Government	-5,259	-97,151		-6,529	
of which: to the Centre	-5,610	-96,238		-3,686	
ii) Other Banks' Credit to Government	7,72,560	1,36,301	21.9	14,652	1.9
b) Bank Credit to Commercial Sector	13,23,612	1,58,708	17.7	2,66,256	25.2
of which: Scheduled Commercial Banks' Non-food Credit	10,95,722	1,57,003	23.0	2,56,626	30.6
c) Net Foreign Exchange Assets of Banking Sector	6,26,926	1,59,704	37.9	46,341	8.0

* : Data pertain to July 15, 2005.

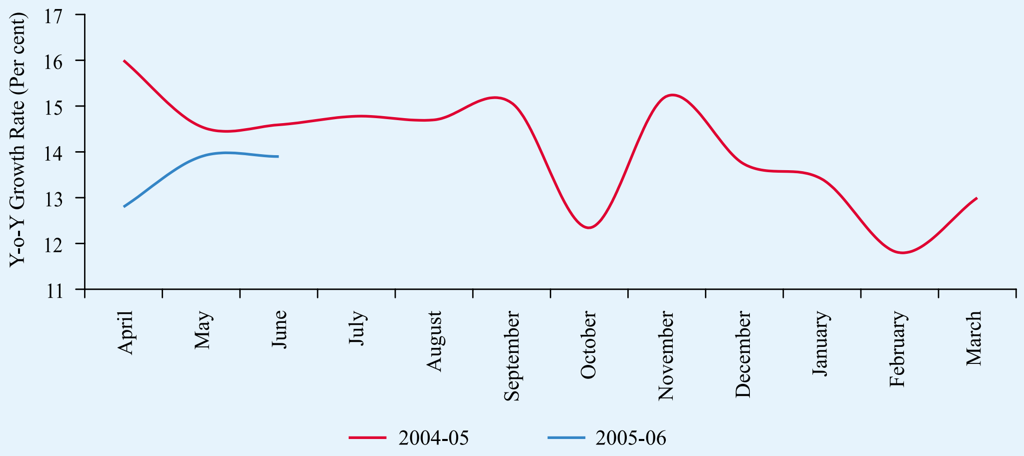
FIs: Financial Institutions. NBFCs: Non-banking Financial Companies.

Note: 1. Data are provisional.

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

3. Postal deposits pertain to March 2005, FI deposits pertain to February 2005 and NBFC deposits pertain to December 2004.

Chart 13: Currency with the Public



Year-on-year growth in demand for currency was somewhat lower in Q_1, 2005-06 than a year ago, reflecting the effect of weak rural activity during 2004-05 (Chart 13).

Demand deposits grew in sharp contrast to the sizeable decline during Q_1 last year (Table 13). This could be attributed to the sharp pick-up in non-food credit, with funds getting temporarily parked in demand deposits.

Table 13: Monetary Aggregates – Variations

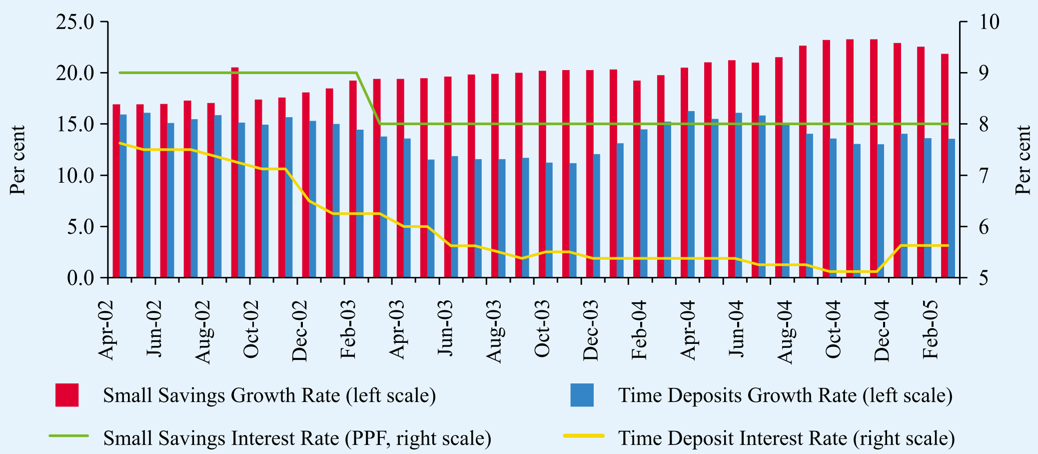
(Rs. Crore)

Item	2004-05	2004-05				2005-06
		Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7
M_3 (=1+2+3 = 4+5+6+7-8)	2,48,262	69,831	19,657	52,509	1,06,266	1,05,850
Components						
1. Currency with the Public	40,797	14,540	-3,191	15,523	13,926	19,671
2. Aggregate Deposits with Banks	2,06,106	56,754	22,094	36,675	90,584	87,737
2.1 Demand Deposits with Banks	25,391	-14,038	1,399	15,313	22,717	11,401
2.2 Time Deposits with Banks	1,80,716	70,792	20,694	21,362	67,867	76,337
3. 'Other' Deposits with RBI	1,359	-1,463	755	311	1,756	-1,558
Sources						
4. Net Bank Credit to Government	15,002	12,986	-11,011	-5,340	18,367	6,980
4.1 RBI's net Credit to Government	-62,882	-34,143	-6,179	184	-22,744	9,275
4.1.1 RBI's net Credit to Centre	-60,177	-30,029	-4,499	203	-25,852	14,600
4.2 Other Bank's Credit to Government	77,884	47,129	-4,832	-5,524	41,111	-2,295
5. Bank Credit to Commercial Sector	2,64,389	38,057	44,893	1,05,627	75,813	64,221
5.1 SCBs' Non-food Credit	2,54,484	30,985	46,477	1,01,812	75,210	57,275
6. Net Foreign Exchange Assets of Banking Sector	1,22,669	49,206	-1,335	32,891	41,907	-14,595
6.1 Net Foreign Exchange Assets of RBI	1,28,377	57,525	-5,260	31,462	44,651	-14,595
7. Governments' Currency Liabilities to the Public	152	37	9	89	17	47
8. Net Non-Monetary Liabilities of Banking Sector	1,53,949	30,454	12,898	80,759	29,839	-49,196
Memo items						
1. Non-resident Foreign Currency Deposits with SCBs	802	953	-189	-654	692	-494
2. Scheduled Commercial Banks' Call-term Borrowing from Financial Institutions	44,853	5,409	530	35,464	3,451	643
3. Overseas Borrowing by Scheduled Commercial Banks	8,529	3,012	-658	6,267	-90	1,788

Note : Data include the impact of conversion of a non-banking entity into a banking entity effective October 11, 2004.

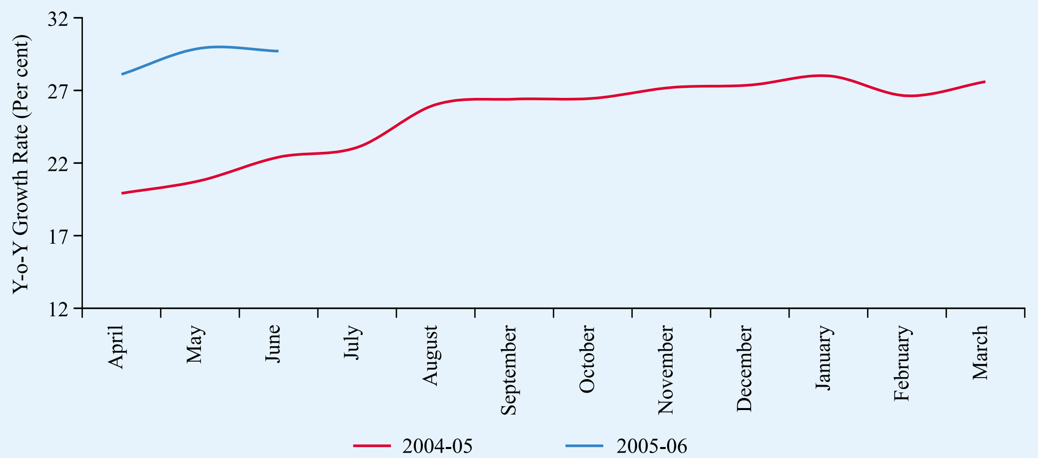
Time deposits decelerated during the quarter, despite marginal increases in deposit rates effective January 2005. The deceleration in time deposits reflected primarily the substitution in favour of postal deposits which provide higher interest rates as well as tax incentives (Chart 14).

Chart 14: Time Deposits and Small Savings



Food credit growth decelerated during the quarter in line with lower procurement of foodgrains. On the other hand, the commercial sector's demand for bank credit, which had accelerated since July 2004 in tandem with a broad-based strengthening of the industrial recovery, gathered further pace in Q_1, 2005-06. Year-on-year non-food credit growth reached 30.6 per cent on July 8, 2005 over and above that of 23.0 per cent a year ago (Chart 15).

Chart 15: Non-food Credit



During April 2005, credit pick-up was led by medium and large industries, housing and real estate. Amongst industries, credit to iron and steel, sugar, cotton textiles, automobiles, construction and petroleum registered high growth. Among non-bank sources of funds, resources raised by way of equity issues were higher than that of Q_1, 2004-05, benefiting from buoyancy in equity markets. Issuances of commercial paper remained strong, reflecting the continued demand from leasing and finance companies (Table 14).

Table 14: Select Sources of Funds to Industry

(Rupees crore)

Item	2004-05	2004-05				2005-06
		Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7
1. Bank Credit to Industry	53,235	-267	18,089	13,733	21,680	12,065 #
2. Capital Issues * (i+ii)	10,466	228	4,529	3,214	2,495	1,254
i) Non-Government Public Ltd. Companies (a+b)	7,782	228	4,529	530	2,495	1,254
a) Bonds/Debentures	0	0	0	0	0	118
b) Shares	7,782	228	4,529	530	2,495	1,136
ii) PSUs and Government Companies	2,684	0	0	2,684	0	0
3. ADR/GDR Issues +	2,960	770	597	872	721	789
4. External Commercial Borrowings (ECBs) $	38,887	12,199	3,860	11,084	11,744	–
5. Issue of CPs	5,104	1,819	421	1,901	963	3,547

: Data pertain to April 2005. – : Not Available.

* : 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.

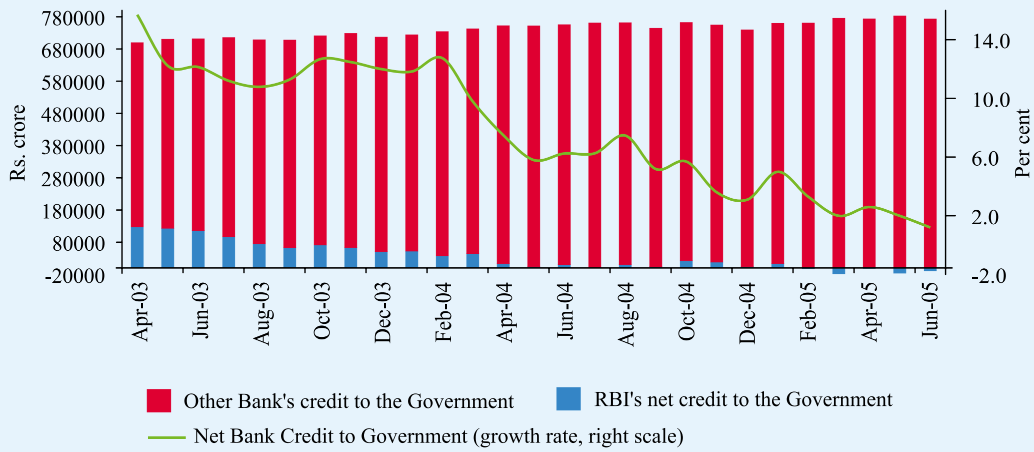
+ : Including Global Depository Receipts (GDRs)/American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs) excluding issuances by banks and financial institutions.

$: Including short-term credit.

Note : Data are provisional.

Banks financed the strong demand for credit by the commercial sector by reducing credit to Government by Rs. 2,295 crore during Q_1, 2005-06 (Chart 16). As this switch primarily took the form of reversal of reverse repos under the LAF, the consequent lodging of securities with the Reserve Bank was reflected in an increase in net Reserve Bank credit to Government. Although the growth of net bank credit to the Government had been relatively subdued during Q_1, 2005-06, commercial banks' holding of securities eligible for the statutory liquidity ratio (SLR), at nearly 36 per cent of their net demand and time liabilities (NDTL), substantially exceed the statutory minimum requirement of 25 per cent.

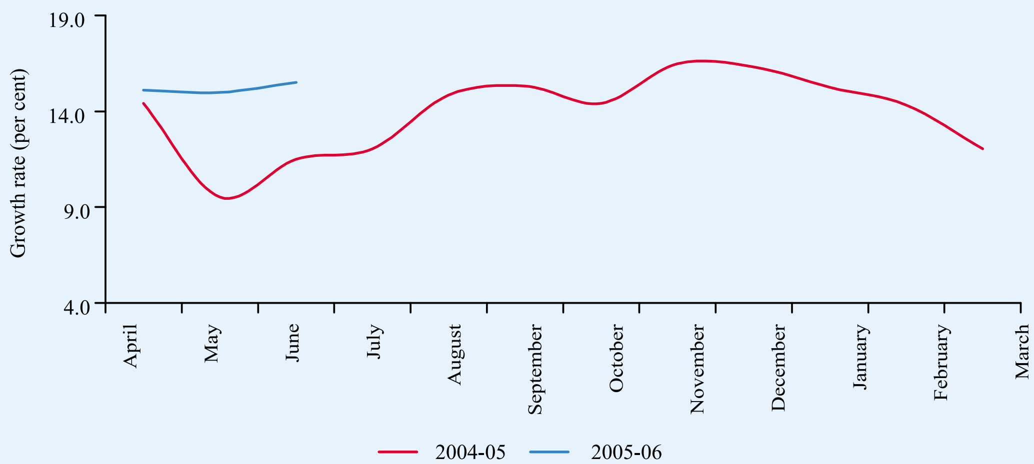
Chart 16: Net Bank Credit to Government



Reserve Money Survey

Reserve money expansion was on a more moderate scale in Q_1, 2005-06 than in the immediately preceding two quarters. Year-on-year growth, however, remained higher than a year ago (Chart 17).

Chart 17: Reserve Money



The expansion in reserve money during Q_1, 2005-06 was primarily due to an increase in net Reserve Bank credit to the Government (Table 15).

Table 15: Variation in Major Components and Sources of Reserve Money

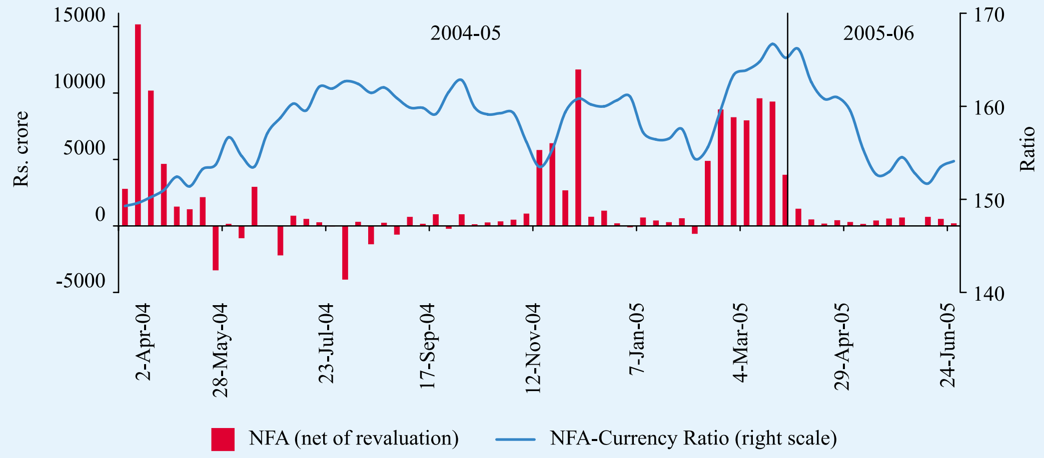
(Rs. Crore)

Item	2004-05	2004-05 Q1	Q2	Q3	Q4	2005-06 Q1
1	2	3	4	5	6	7
Reserve Money	52,623	-6,812	-6,285	31,547	34,173	7,303
Components						
1. Currency in circulation	41,633	14,317	-4,166	16,467	15,015	19,541
2. Bankers' Deposits with RBI	9,631	-19,665	-2,874	14,769	17,401	-10,680
3. 'Other' Deposits with the RBI	1,359	-1,463	755	311	1,756	-1,558
Sources						
1. RBI's net credit to Government	-62,882	-34,143	-6,179	184	-22,744	9,275
of which: to Central Government	-60,177	-30,029	-4,499	203	-25,852	14,600
2. RBI's credit to banks and commercial sector	-833	-2,985	-740	3,726	-835	1,155
3. NFEA of RBI	1,28,377	57,525	-5,260	31,462	44,651	-14,595
4. Government's Currency Liabilities to the Public	152	37	9	89	17	47
5. Net Non-Monetary Liabilities of RBI	12,191	27,245	-5,885	3,915	-13,084	-11,420
Memo items						
1. Net Domestic Assets	-75,754	-64,336	-1,025	85	-10,478	21,898
2. FCA, adjusted for revaluation	1,15,044	33,160	-3,413	29,858	55,440	5,034
3. Net Purchases from Authorised Dealers	91,105	30,032	-9,789	22,771	48,091	0
4. NFEA/Reserve Money (per cent) (end-period)	125.3	126.1	126.7	124.9	125.3	120.5
5. NFEA/Currency (per cent)	166.2	158.8	159.2	160.7	166.2	154.1

FEA : Net Foreign Exchange Assets.
FCA : Foreign Currency Assets.
Note : Data are based on March 31 for Q4 and last reporting Friday for all other quarters.

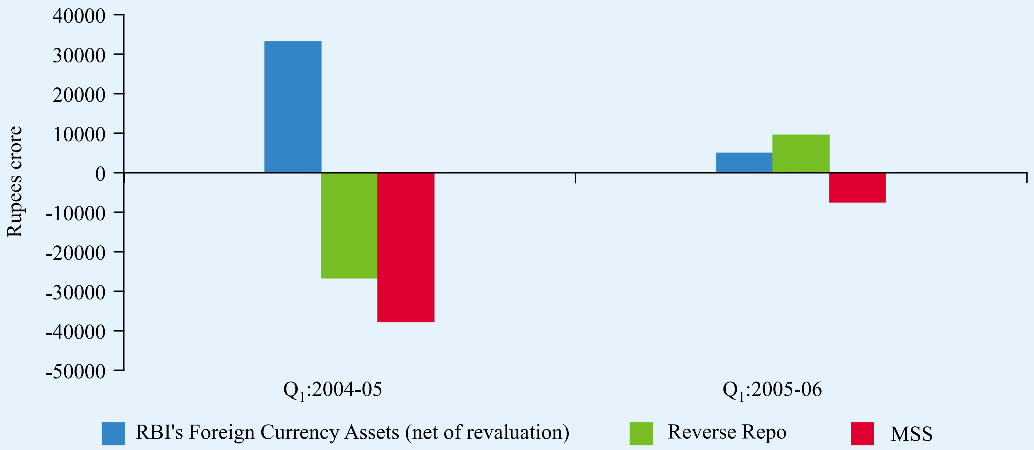
The Reserve Bank's foreign currency assets (net of revaluation) increased by Rs.5,034 crore during Q_1, 2005-06 substantially lower than that of Rs. 33,160 crore during the first quarter of the preceding year. There were no net purchases from the authorised dealers during the quarter resulting in a decline of the NFA-currency ratio (Chart 18).

Chart 18: Accretion to RBI's Net Foreign Assets



The absence of purchases of foreign currency from authorised dealers was mirrored in incremental absorption through the market stabilisation scheme (MSS) going down to Rs.7,469 crore *i.e.*, one-fifth of the level in the comparable period of 2004 and an unwinding of liquidity under LAF reverse repos of the order of Rs.9,660 crore (Chart 19).

Chart 19: Capital Flows and Liquidity Management



Net purchases of Government dated securities from the market and a reduction in the Centre's surplus investment resulted in an increase in the Reserve Bank's net credit to the Government (Table 16).

Table 16: Net Reserve Bank Credit to the Centre – Variations

(Rs. Crore)

Items	2004-05	2004-05 Q1	Q2	Q3	Q4	2005-06 Q1
1	2	3	4	5	6	7
Net Reserve Bank Credit to the Centre (1+2+3+4-5)	-60,177	-30,029	-4,499	203	-25,852	14,600
1. Loans and Advances	0	3,222	-3,222	0	0	0
2. Treasury Bills held by the Reserve Bank	0	0	0	0	0	0
3. Reserve Bank's Holdings of Dated Securities	12,323	-2,900	22,176	14,095	-21,048	8,221
4. Reserve Bank's Holdings of Rupee Coins	58	175	-11	-93	-15	-40
5. Central Government Deposits	72,558	30,525	23,443	13,799	4,791	-6,419
*Memo Items**						
1. Market Borrowings of Dated Securities by the Centre #	80,350	28,000	26,000	14,000	12,350	42,000
2. Reserve Bank's Primary Subscription to Dated Securities	1,197	0	847	0	350	0
3. Repos (+) / Reverse Repos (-) (LAF), net position £	15,315	-26,720	34,205	27,600	-19,770	9,660
4. Net Open Market Sales #	2,899	429	427	871	1,172	1,543
5. Mobilisation under MSS	64,211	37,812	14,444	353	11,602	7,469
6. Primary Operations $	-6,625	37,353	-30,484	-36,984	23,490	18,205

* At face value. # Excluding Treasury Bills. £ Including fortnightly repos.
$ Adjusted for Centre's surplus investment and MSS.
Note: Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.

Liquidity Management

During Q_1, 2005-06 the Reserve Bank injected primary liquidity into the system in view of the sustained demand for credit and widening of the merchandise trade deficit partly offset by some drawdown of the Centre's surplus balances maintained with the Reserve Bank. The absorption of liquidity through increase in balances under the MSS was more than offset by liquidity released through the LAF (Table 17).

Table 17: Phases of Reserve Bank's Liquidity Management Operations

(Rupees crore)

Item	2003-04		2004-05			2005-06
	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	April 1- June 24, 2005
1	2	3	4	5	6	7
A. Drivers of Liquidity (1+2-+3)	**56,248**	**45,844**	**37,170**	**-24,471**	**43,734**	**-11,458**
1. RBI's Foreign Currency Assets (adjusted for revaluation)	93,334	46,171	37,919	-4,614	83,662	5,034
2. Currency with the Public	-28,981	-15,928	-20,021	6,639	-25,896	-19,671
3. Others (residual)	-8,106	15,602	19,272	-26,496	-14,032	3,179
3.1 Surplus cash balances of the Centre with the Reserve Bank	-13,135	6,685	15,355	-18,481	-7,721	4,357
B. Management of Liquidity (4+5+6+7)	**-60,092**	**-37,242**	**-40,148**	**37,960**	**-31,852**	**648**
4. LAF Repos	-27,075	-31,910	-12,095	66,040	-11,875	9,660
5. OMO (net)	-36,517	-5,332	-277	-769	-1,853	-1,543
6. MSS	0	0	-27,776	-27,311	-9,124	-7,469
7. First round impact of CRR change	3,500	0	0	0	-9,000	0
C. Bank Reserves # (A+B)	**-3,844**	**8,602**	**-2,978**	**13,489**	**11,882**	**-10,810**

+ : 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.

Easy liquidity conditions kept the call money rates close to the level of the reverse repo rate. With the increase in the fixed reverse repo rate from 4.75 per cent to 5.00 per cent, effective April, 2005 call rates also edged up in the subsequent period (Chart 20). In view of comfortable liquidity conditions during the quarter, the Reserve Bank conducted LAF repos only on two days (June 28, 2005 and June 30, 2005) of Rs.210 crore and Rs.575 crores, respectively. On a net basis, however, the Reserve Bank absorbed liquidity on both these days. The outstanding amount under reverse repo increased from Rs.6,470 crore at end-June 2005 to Rs.18,470 crore as on July 20, 2005.

Chart 20: Liquidity Adjustment Facility and Call Rates