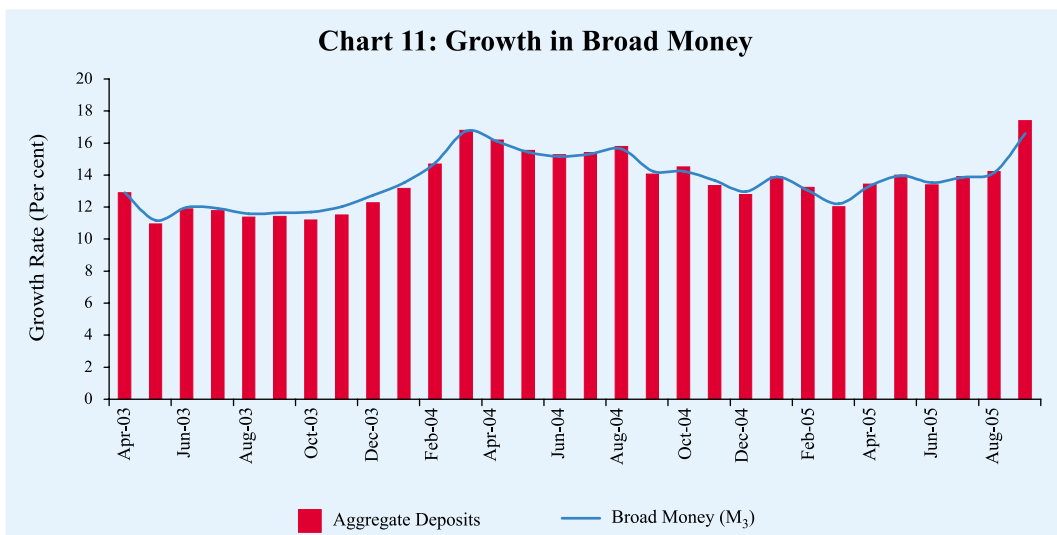


### III. MONETARY AND LIQUIDITY CONDITIONS

#### Monetary Survey

Monetary conditions have remained comfortable during 2005-06 so far despite a sustained pick-up in credit demand from the commercial sector. Banks were able to finance the higher demand for commercial credit by curtailing their incremental investments in Government securities. Strong growth in deposits in the current fiscal year and higher investments by non-bank sources in Government securities also enabled banks to meet credit demand. Concomitantly, reserve money expansion was high, reflecting a lower order of sterilisation operations by the Reserve Bank. Broad money ( $M_3$ ) growth, on a year-on-year basis, was above the indicative trajectory of 14.5 per cent projected in the Annual Policy Statement (April 2005) (Chart 11). Expansion in the residency-based new monetary aggregate ( $NM_3$ ) – which excludes foreign currency non-resident deposits – was higher than  $M_3$  on account of net outflows under foreign currency deposits and continued access of banks to call/term borrowings (Table 15).

Currency demand fell in the second quarter in line with the trend in the previous year. Year-on-year growth in currency, which was lower than a year ago till mid-September 2005, however, edged up during the last fortnight of September (Chart 12).



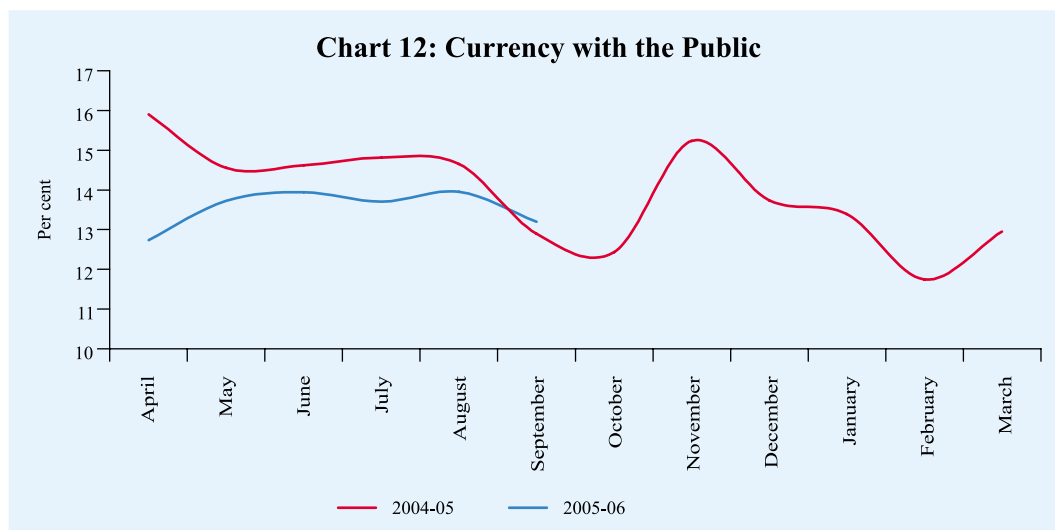
Monetary and Liquidity Conditions

<b>Table 15: Monetary Indicators</b>					
(Amount in Rupees crore)					
Item	Outstanding as on September 30, 2005	Variation (year-on-year)			
		2004		2005	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
I. Reserve Money*	5,17,693	66,894	18.0	78,521	17.9
II. Broad Money (M <sub>3</sub> )	24,65,763	2,69,186	14.6	3,51,296	16.6
a) Currency with the Public	3,63,925	36,746	12.9	42,534	13.2
b) Aggregate Deposits	20,96,624	2,29,581	14.8	3,10,587	17.4
i) Demand Deposits	3,32,074	35,577	15.8	70,821	27.1
ii) Time Deposits	17,64,550	1,94,004	14.6	2,39,767	15.7
of which: Non-Resident Foreign Currency Deposits	76,507	4,373	6.0	-214	-0.3
III. NM <sub>3</sub>	24,28,068	2,80,460	15.7	3,58,217	17.3
of which: Call Term Funding from Financial Institutions	42,168	11,039	57.3	11,851	39.1
IV. a) L <sub>1</sub>	25,23,954	2,97,864	16.1	3,74,434	17.4
of which: Postal Deposits	95,885	17,404	28.0	16,217	20.4
b) L <sub>2</sub>	25,25,605	2,98,629	16.1	3,69,290	17.1
of which: FI Deposits	1,651	765	12.7	-5,144	-75.7
c) L <sub>3</sub>	25,45,445	2,97,505	15.8	3,69,886	17.0
of which: NBFC Deposits	19,840	-1,124	-5.5	596	3.1
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	7,42,354	29,127	4.1	-4,648	-0.6
i) Net Reserve Bank Credit to Government	-33,950	-67,737		-42,644	
of which: to the Centre	-33,909	-64,453		-41,776	
ii) Other Banks' Credit to Government	7,76,304	96,863	15.1	37,996	5.1
b) Bank Credit to Commercial Sector	14,07,816	1,82,459	19.6	2,95,557	26.6
of which: Scheduled Commercial Banks' Non-food Credit	11,83,909	1,79,586	24.9	2,83,553	31.5
c) Net Foreign Exchange Assets of Banking Sector	6,60,700	1,47,770	34.2	81,075	14.0

\* : As on October 14, 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.

Growth in demand deposits remained high in tandem with the sustained pick-up in non-food credit and a buoyant primary capital market, with funds getting temporarily parked in demand deposits (Table 16).



Macroeconomic and Monetary Developments: Mid-Term Review 2005-06

**Table 16: Monetary Aggregates - Variations**

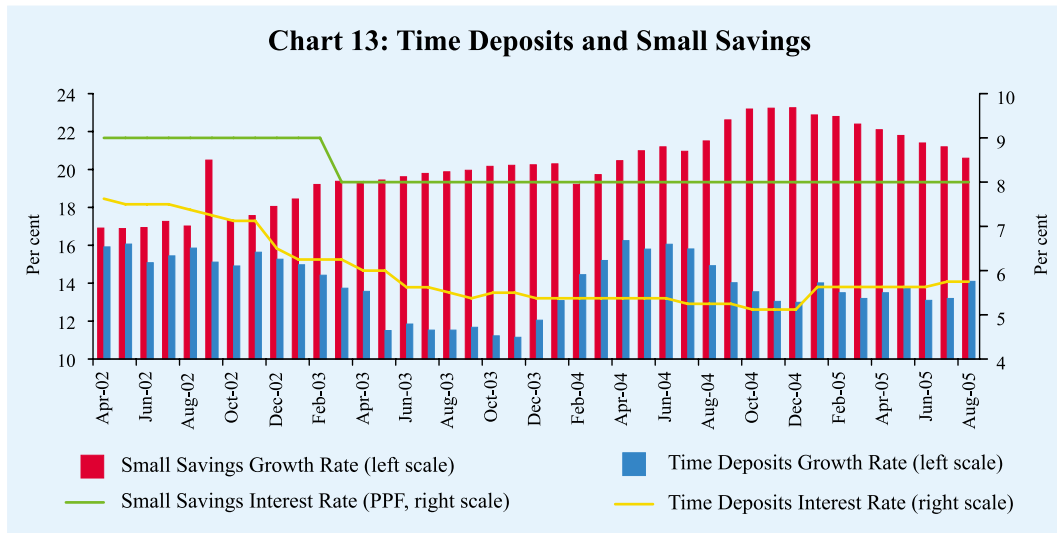
Item	(Rupees crore)						
	2004-05	2004-05				2005-06	
		Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7	8
M <sub>3</sub> (= 1+ 2+3 = 4+ 5+ 6+ 7-8)	2,48,262	69,831	16,999	53,459	1,07,974	1,05,850	1,09,544
<b>Components</b>							
1. Currency with the Public	40,797	14,540	-3,098	15,422	13,933	19,671	-11,514
2. Aggregate Deposits with Banks	2,06,106	56,754	19,342	37,725	92,284	87,737	1,20,764
2.1 Demand Deposits with Banks	25,391	-14,038	2,094	15,721	21,614	11,401	36,657
2.2 Time Deposits with Banks	1,80,716	70,792	17,248	22,004	70,671	76,337	84,107
3. 'Other' Deposits with RBI	1,359	-1,463	755	311	1,756	-1,558	294
<b>Sources</b>							
4. Net Bank Credit to Government Sector	15,002	12,986	-11,798	-4,524	18,338	6,980	-10,339
4.1 RBI's Net Bank Credit to Government Sector	-62,882	-34,143	-6,179	184	-22,744	9,275	-25,251
4.1.1 RBI's Net Credit to Central Government	-60,177	-30,029	-4,499	203	-25,852	14,600	-25,251
4.2 Other Bank Credit to Government Sector	77,884	47,129	-5,619	-4,708	41,082	-2,295	14,912
5. Bank Credit to Commercial Sector	2,64,389	38,057	40,093	1,07,789	78,451	64,221	95,737
6. Net Foreign Exchange Assets of Banking Sector	1,22,669	49,206	-1,335	32,891	41,907	-13,378	24,823
6.1 Net Foreign Exchange Assets of RBI	1,28,377	57,525	-5,260	31,462	44,651	-14,595	24,823
7. Governments' Net Currency Liabilities to the Public	152	37	9	89	17	47	26
8. Net Non-Monetary Liabilities of Banking Sector	1,53,949	30,454	9,969	82,787	30,739	-47,979	703
<b>Memo:</b>							
1. Non-resident Foreign Currency Deposits	802	953	-189	-654	692	-494	596
2. SCBs' Call-term Borrowing from Financial Institutions	44,853	5,409	530	35,464	3,451	643	7,178
3. Overseas Borrowing by Scheduled Commercial Banks	8,529	3,012	-658	6,267	-90	1,788	6,168

**Note:** Data include effect of conversion of a non-banking entity into a banking entity on October 11, 2005.

Year-on-year (y-o-y) growth in time deposits as on September 30, 2005 at 15.7 per cent was higher than a year ago, benefiting from modest increases in deposit rates and reflecting base effects of a low growth during the previous year. There was some deceleration in growth of small savings to 20.6 per cent by end-August 2005 from 23.3 per cent in December 2004. Nonetheless, the growth of small savings still remains substantially higher than that of time deposits reflecting both higher interest rates and tax incentives (Chart 13).

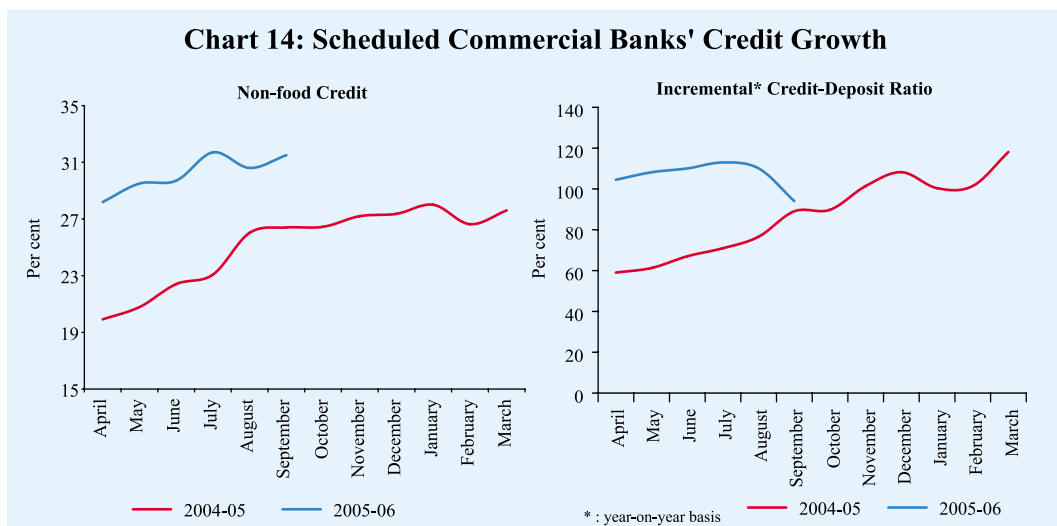
Food credit recorded a decline from its end-March 2005 level in line with a lower order of procurement of foodgrains. On the other hand, commercial sector's demand for bank credit continued to remain strong reflecting a strengthening of the industrial recovery and demand for housing credit. Accordingly, scheduled commercial banks' non-food credit, on a year-on-year basis, registered a growth of 31.5 per cent as on September 30, 2005 on top of a base as high as 24.9 per cent a year ago. Incremental credit-deposit ratio of SCBs remained above 100 per cent between November 2004 and August 2005 (Chart 14). Latest available data indicate that credit pick-up during April-August 2005 was quite broad-based. The high growth of credit to the priority sector reflected largely the sharp growth in agricultural credit as well as small housing loans (up to Rs.15 lakh). Amongst industries, credit to iron and steel, other metal and metal products, engineering, automobiles, cement, construction, paper, rubber, tobacco, textiles and gems and jewellery recorded an upsurge (see Table 35).

Monetary and Liquidity Conditions



In addition to bank credit, industry has also increasingly relied upon non-bank sources of funds in recent years. Equity issuances continued to be steady during April-September 2005, benefiting from buoyancy in capital markets. Mobilisation through issuances of commercial papers also remained strong. Funds raised through external commercial borrowings (ECBs), which were large during 2004-05, moderated. This was mainly on account of turnaround in short-term trade credits as oil companies increased their recourse to domestic financing (Table 17).

Sustained high growth in commercial credit was funded by the banks mainly by restricting their incremental investments in Government securities. Incremental investments by commercial and co-operative banks in the Government papers at Rs.12,617 crore in the current fiscal (up to September 30) were less than one-third of



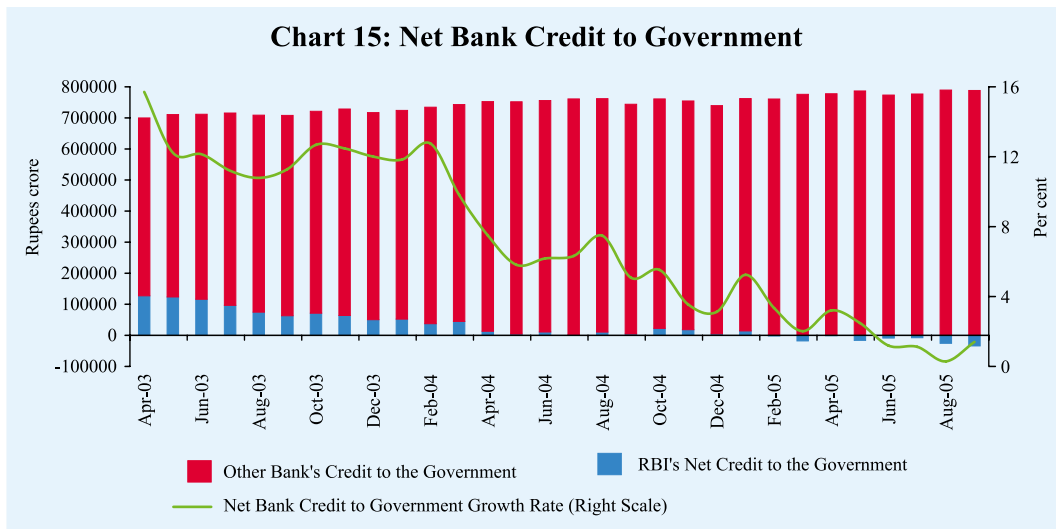
Macroeconomic and Monetary Developments: Mid-Term Review 2005-06

**Table 17: Select Sources of Funds to Industry**

Item	(Rupees crore)					
	2004-05				2005-06	
	Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7
A. Bank Credit to Industry	6,636	11,186	13,733	21,680	11,148	14,698 @
B. Flow from Non-banks to Corporates						
1. Capital Issues* (i+ii)	228	4,529	3,214	2,495	1,254	4,977
i) Non-Government Public Ltd. Companies (a+b)	228	4,529	530	2,495	1,254	4,977
a) Bonds / Debentures	0	0	0	0	118	0
b) Shares	228	4,529	530	2,495	1,136	4,977
ii) PSUs and Government Companies	0	0	2,684	0	0	0
2. ADR / GDR / FCCBs +	770	597	872	721	789	739
3. External Commercial Borrowings (ECBs) \$	12,199	3,860	11,084	11,744	3,026	-
4. Issue of CPs	1,819	421	1,901	963	3,562	1,928
C. Depreciation Provision	5,504	5,836	5,731	6,106	7,137	-
D. Profit after Tax	10,396	13,004	13,196	16,798	16,726	-

\* : 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.  
+ : 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. @ : Data pertain to July-August 2005.  
**Note:** Data are provisional.

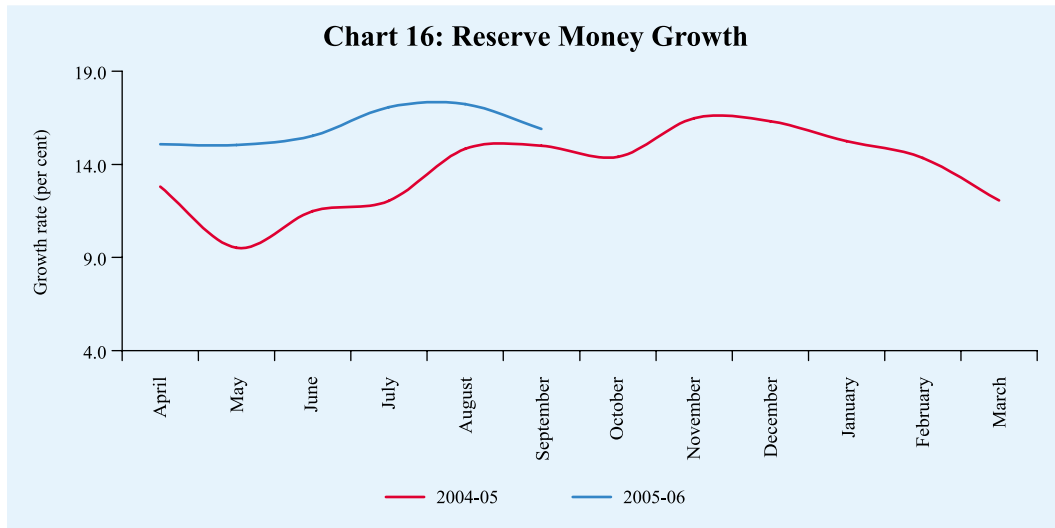
their incremental investments in the corresponding period of the previous year. Consequently, commercial banks' holding of Government securities fell below 36 per cent of their net demand and time liabilities (NDTL) as on September 30, 2005 from nearly 40 per cent a year ago, but still substantially in excess of the statutory requirement of 25 per cent (Chart 15).



### Reserve Money Survey

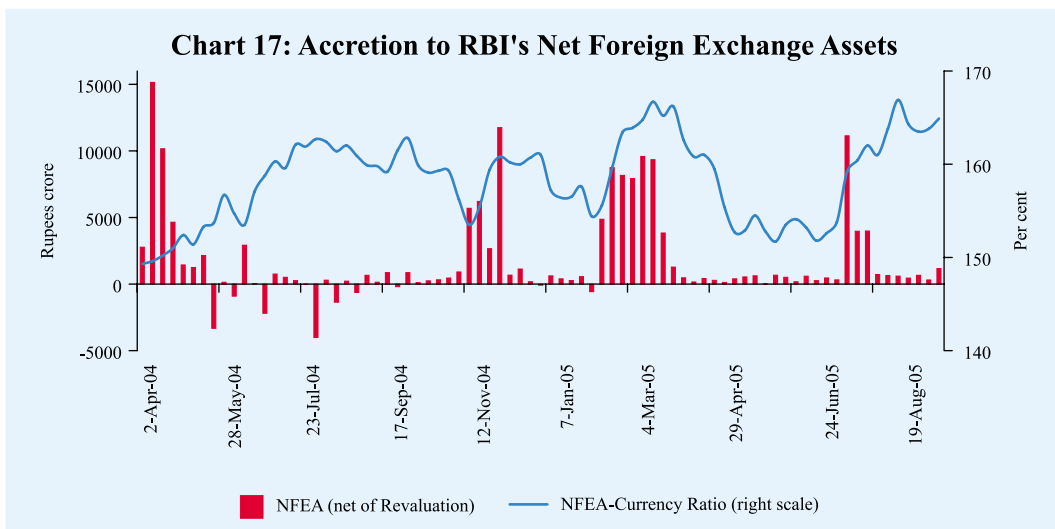
Reserve money growth as on October 14, 2005 at 17.9 per cent was almost the same as that a year ago (18.0 per cent), although the growth rate during 2005-06 till October 7, 2005 had remained consistently above that of 2004-05 (Chart 16). The higher growth in reserve money, despite broadly a similar order of accretion to the

Monetary and Liquidity Conditions



Reserve Bank's net foreign exchange assets (NFEA) (net of revaluation) during the current fiscal, primarily reflected the relatively lower order of sterilisation operations. This, in turn, reflected a lower appetite for Government securities by the banking system in view of strong credit demand from the commercial sector. The higher order of expansion in the reserve money was also due to the impact of the increase in the cash reserve ratio (CRR) by 50 basis points during September-October 2004.

The Reserve Bank's foreign currency assets (net of revaluation) increased by Rs.29,544 crore during fiscal 2005-06 (up to October 14), comparable to that of Rs.30,604 crore during the corresponding period of 2004-05. Most of the increase in the NFEA was concentrated in the second quarter of the fiscal and consequently the quarter also witnessed liquidity absorption operations (Chart 17 and Table 18).



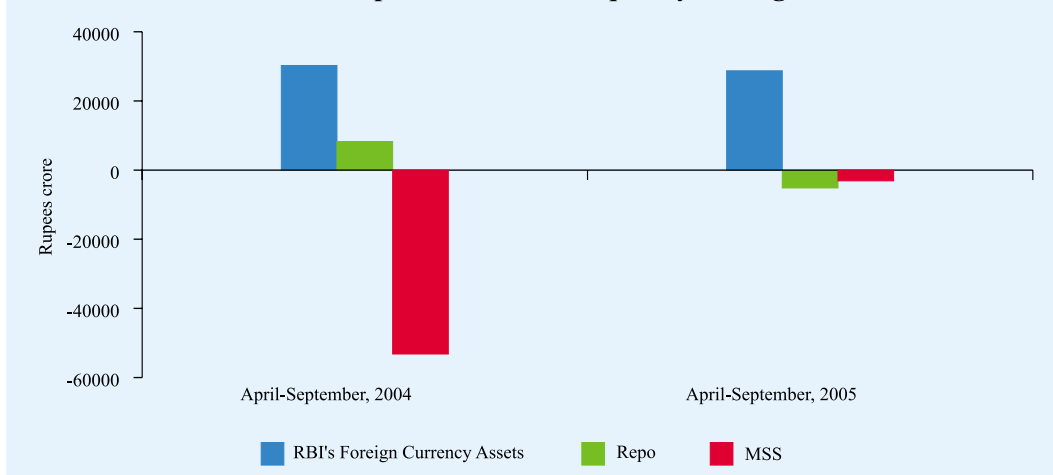
Macroeconomic and Monetary Developments: Mid-Term Review 2005-06

**Table 18: Variation in Major Components and Sources of Reserve Money**

Item	(Rupees crore)							
	2004-05		2005-06 (up to Oct. 14)		2004-05		2005-06	
			Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7	8	9
<b>Reserve Money</b>	<b>52,623</b>	<b>28,557</b>	<b>-6,812</b>	<b>-6,285</b>	<b>31,546</b>	<b>34,174</b>	<b>6,856</b>	<b>159</b>
<b>Components</b>								
1. Currency in Circulation	41,633	22,516	14,317	-4,166	16,467	15,015	19,556	-10,378
2. Bankers' Deposits with RBI	9,631	7,431	-19,665	-2,874	14,769	17,401	-10,680	9,780
3. Other Deposits with RBI	1,359	-1,389	-1,463	755	310	1,757	-2,021	757
<b>Sources</b>								
1. RBI's net credit to Government <i>of which: to Central Government</i>	-62,882	6,641	-34,143	-6,179	184	-22,744	9,275	-25,251
2. RBI's credit to banks and commercial sector	-833	-1,377	-2,985	-740	3,726	-835	1,155	-1,869
3. NFEA of RBI	1,28,377	24,272	57,525	-5,260	31,462	44,651	-14,595	24,823
4. Government's Currency Liabilities to the Public	152	73	37	9	89	17	63	10
5. Net Non-Monetary Liabilities of RBI	12,191	1,052	27,245	-5,885	3,916	-13,085	-10,957	-2,446
<i>Memo:</i>								
1. Net Domestic Assets	-75,754	4,285	-64,336	-1,025	84	-10,477	21,450	-24,664
2. FCA adjusted for revaluation	1,15,044	29,544	33,160	-3,413	29,858	55,440	5,034	23,665
3. Net Purchases from Authorised Dealers	91,105	17,878 *	30,032	-9,789	22,771	48,091	0	17,878 *
4. NFEA/Reserve Money (per cent) (end-period)	125.3	123.1	126.1	126.7	124.9	125.3	120.6	125.6
5. NFEA/Currency (per cent) (end-period)	166.2	162.9	158.8	159.2	160.7	166.2	154.1	164.9
* : Up to August 26, 2005.								
NFEA : Net Foreign Exchange Assets.								
FCA : Foreign Currency Assets.								
<b>Note</b> : Data are based on March 31 for Q4 and last reporting Friday for all other quarters.								

Liquidity absorption operations during 2005-06 so far have mainly been in the form of reverse repo operations under the liquidity adjustment facility (LAF) in contrast to a heavy reliance on issuances under the market stabilisation scheme (MSS) during the comparable period of the preceding year (Chart 18).

**Chart 18: Capital Flows and Liquidity Management**



Monetary and Liquidity Conditions

In the absence of any subscription to the Government's market borrowing programme, the Reserve Bank's net credit to the Centre reflected liquidity management operations of the Bank (Table 19). The Reserve Bank's net credit to the Centre increased by Rs.11,897 crore during 2005-06 (up to October 14) as against a substantial decline of Rs.21,395 crore during the comparable period of 2004-05.

**Table 19: Net Reserve Bank Credit to the Centre - Variations**

Item	(Rupees crore)							
	2004-05	2005-06 (up to Oct. 14)	2004-05				2005-06	
			Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7	8	9
<b>Net Reserve Bank Credit to the Centre (1+2+3+4-5)</b>	<b>-60,177</b>	<b>11,897</b>	<b>-30,029</b>	<b>-4,499</b>	<b>203</b>	<b>-25,852</b>	<b>14,600</b>	<b>-25,251</b>
1. Loans and Advances	0	0	3,222	-3,222	0	0	0	0
2. Treasury Bills held by the Reserve Bank	0	0	0	0	0	0	0	0
3. Reserve Bank's Holdings of Dated Securities	12,323	6,952	-2,900	22,176	14,095	-21,048	8,221	-17,243
4. Reserve Bank's Holdings of Rupee Coins	58	119	175	-11	-93	-15	-40	-33
5. Central Government Deposits	72,558	-4,826	30,525	23,443	13,799	4,791	-6,419	7,974
<i>Memo *</i>								
1. Market Borrowings of Dated Securities by the Centre #	80,350	84,000	28,000	26,000	14,000	12,350	42,000	39,000
2. Reserve Bank's Primary Subscription to Dated Securities	1,197	0	0	847	0	350	0	0
3. Repos (+) / Reverse Repos (-) (LAF), net position	15,315	10,075	-26,720	34,205	27,600	-19,770	9,660	-14,835
4. Net Open Market Sales £	2,899	2,521	429	427	871	1,171	1,543	941
5. Mobilisation under MSS	64,211	4,065	37,812	14,444	353	11,602	7,469	-4,353
6. Primary Operations §	-6,625	37,485	37,353	-30,484	-36,984	23,490	18,205	15,167
* : At face value. #: Excluding Treasury Bills. £ : Excluding Treasury Bills and including operations under Consolidated Sinking Funds (CSF) and Other Investments. § : Adjusted for MSS and Centre's surplus investment. <b>Note:</b> Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.								

### Liquidity Management

During 2005-06 so far (up to October 14, 2005), the Reserve Bank's operations to absorb liquidity from the system have been relatively moderate in view of the marked increase in merchandise trade deficit and the pick-up in domestic credit demand. Liquidity management operations during 2005-06 so far can be analysed in terms of three phases (Table 20). The first period – beginning end-March 2005 up to July 22, 2005 – did not witness purchases from the foreign exchange market by the Reserve Bank reflecting a sharp widening of the trade deficit. Moreover, the period also witnessed FII outflows during April-May 2005. Although FII inflows bounced back during June 2005, foreign



Macroeconomic and Monetary Developments: Mid-Term Review 2005-06

<b>Table 20: Phases of Reserve Bank's Liquidity Management Operations</b>						
(Rupees crore)						
Item	2004-05			2005-06		
	March 27 - May 14, 2004	May 15 - October 29, 2004	October 30, 2004 - March 31, 2005	April 1 - July 22, 2005	July 23 - August 12, 2005	August 13 - October 14, 2005
1	2	3	4	5	6	7
<b>A. Drivers of Liquidity (1+2+3)</b>	<b>37,170</b>	<b>-24,746</b>	<b>44,009</b>	<b>-6,959</b>	<b>28,014</b>	<b>-24,455</b>
1. RBI's Foreign Currency Assets (adjusted for revaluation)	37,919	-4,614	83,662	6,412	19,348	3,785
2. Currency with the Public	-20,021	6,365	-25,622	-14,828	-1,307	-5,360
3. Others (residual)	19,272	-26,497	-14,031	1,457	9,973	-22,880
3.1 Surplus cash balances of the Centre with the Reserve Bank	15,355	-18,481	-7,721	6,053	5,972	-12,666
<b>B. Management of Liquidity (4+5+6+7)</b>	<b>-40,148</b>	<b>37,960</b>	<b>-31,852</b>	<b>1,329</b>	<b>-24,567</b>	<b>35,090</b>
4. Liquidity impact of LAF Repos	-12,095	66,040	-11,875	8,845	-26,565	27,795
5. Liquidity impact of OMO (net)*	-277	-769	-1,853	0	0	0
6. Liquidity impact of MSS	-27,776	-27,311	-9,124	-7,516	1,998	7,295
7. First round liquidity impact due to CRR change	0	0	-9,000	0	0	0
<b>C. Bank Reserves # (A+B)</b>	<b>-2,978</b>	<b>13,214</b>	<b>12,157</b>	<b>-5,630</b>	<b>3,447</b>	<b>10,635</b>
+ : Indicates injection of liquidity into the banking system.						
- : Indicates absorption of liquidity from the banking system.						
# : Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.						
* : Adjusted for operations under Consolidated Sinking Funds (CSF) and Other Investments.						

exchange markets were more or less balanced reflecting pressures from the trade deficit. During this phase, in the face of sustained credit demand, banks curtailed their incremental investments in the Government securities and reduced their operations under the Reserve Bank's reverse repo window. Consequently, the Reserve Bank injected primary liquidity through reversal of reverse repo operations.

During July 23 - August 12, following the revaluation of the Chinese currency, there were large foreign exchange inflows. Moreover, there was a reduction in the Centre's surplus investment balances. As a result, the balances under LAF reverse repo increased sharply from Rs.10,485 crore as on July 22 to Rs.37,050 crore as on August 12, peaking at Rs.50,610 crore on August 3, 2005. In the subsequent period (August 13 - October 14), again, accretion to the Reserve Bank's foreign exchange assets (net of revaluation) slowed down. Government surplus balances with the Reserve Bank started bouncing back leading to locking up of liquidity. Accordingly, the period witnessed injection of liquidity through reversal of reverse repos as balances under LAF were unwound (Table 21 and Chart 19).

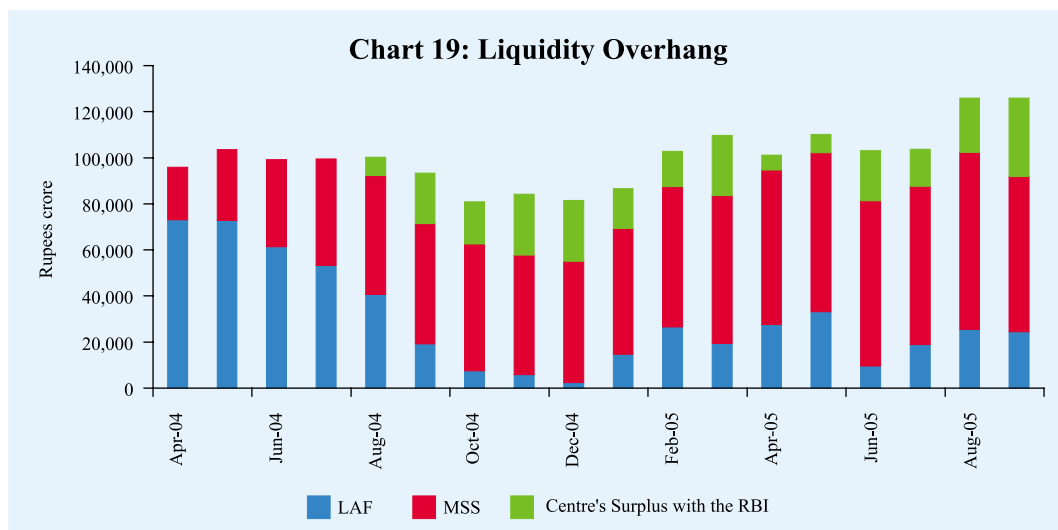
Monetary and Liquidity Conditions

**Table 21: Liquidity Overhang**

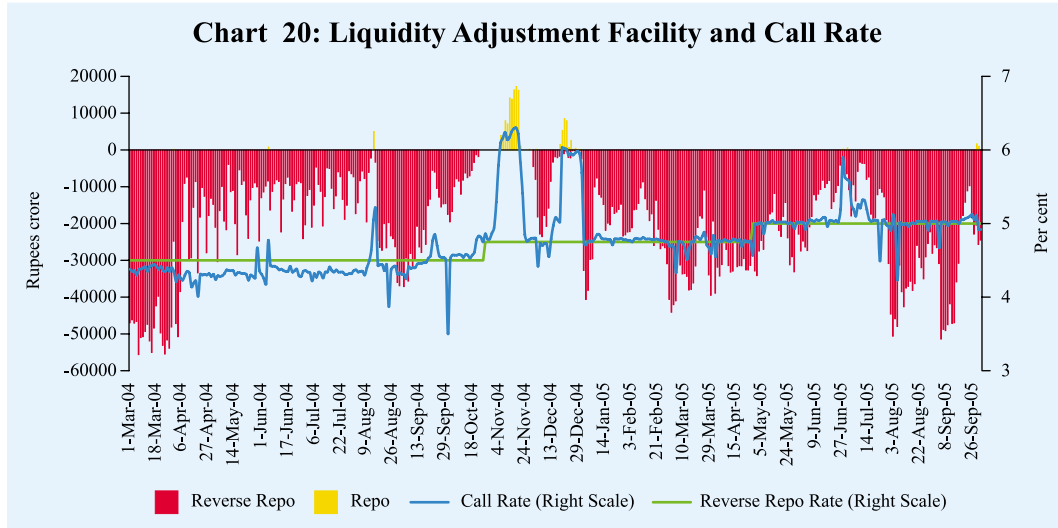
(Rupees crore)				
Outstanding as on last Friday/March 31	LAF	MSS	Centre's Surplus with the RBI @	Total (2 to 4)
1	2	3	4	5
<b>2004</b>				
April	73,075	22,851	0	95,926
May	72,845	30,701	0	1,03,546
June	61,365	37,812	0	99,177
July	53,280	46,206	0	99,486
August	40,640	51,635	7,943	1,00,218
September	19,245	52,255	21,896	93,396
October	7,455	55,087	18,381	80,923
November	5,825	51,872	26,518	84,215
December	2,420	52,608	26,517	81,545
<b>2005</b>				
January	14,760	54,499	17,274	86,533
February	26,575	60,835	15,357	1,02,767
March	19,330	64,211	26,102	1,09,643
April	27,650	67,087	6,449	1,01,186
May	33,120	69,016	7,974	1,10,110
June	9,670	71,681	21,745	1,03,096
July	18,895	68,765	16,093	1,03,753
August	25,435	76,936	23,562	1,25,933
September	24,505	67,328	34,073	1,25,906
October*	9,255	68,276	26,743	1,04,274

\* As on October 14, 2005. @ : Excludes minimum cash balance with the RBI.

Stable and comfortable liquidity conditions kept the call money rates close to the level of the reverse repo rate (Chart 20). 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. In view of comfortable liquidity



Macroeconomic and Monetary Developments: Mid-Term Review 2005-06



conditions, the Reserve Bank conducted LAF repos only on four occasions during 2005-06 (June 28, June 30, September 28 and September 29, 2005) of Rs.210 crore, Rs.575 crore, Rs.1,640 crore and Rs.1,000 crore, respectively. On a net basis, the Reserve Bank, however, absorbed liquidity even on those four days.