CHAPTER- IV

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This chapter examines the conduct of monetary policy during the last nineteen years (1991-2010) on the basis of the theoretical background that were explained in the previous chapters, it will help to assess the effectiveness of monetary policy in different economic situations which were prevailing since 1991.


The new Government which assumed office in June 1991 took a series of corrective measures to bring the situation under control. These included short-term measures aimed at crisis management as well as long term measures of structural reform, aimed at improving efficiency and productivity and putting the economy back on the path of sustainable growth with equity and social justice.

4.1. MONETARY POLICY 1991-92

The growth of the economy slowed down substantially in 1991-92, partly because of a slowdown in agriculture and partly because of a deceleration in industrial growth. This sluggish performance, coming after several years of rapid growth, is to be viewed in the context of exceptionally difficult conditions in two respects: a grave external payments crisis and a high rate of inflation. Both reached their peak in the middle of 1991. Foreign currency assets had declined to Rs.2383 crore (US $1.1 billion) at the end of June 1991, which was barely enough to finance two weeks of imports. The annual rate of inflation, which began to accelerate in 1990, reached a
peak of 16.7 per cent in the fourth week of August 1991.

The new Government moved rapidly to implement a programme of macroeconomic stabilization to restore viability to the balance of payments and to bring inflation under control. It also undertook a far reaching programme of structural reform, which included bold initiatives in trade and industrial policy aimed at improving the efficiency of the economy and increasing its international competitiveness. This restructuring was essential to ensure longer-term viability in the balance of payments and to restore the conditions for rapid growth.

The measures have had some success. There has been a marked improvement in foreign exchange reserves, with reserves reaching Rs.11410 crore ($4.4 billion) in the third week of February 1992. The rate of inflation has also declined from the peak level of 16.7 per cent reached in August 1991 to 11.8 per cent in February 1992. However, neither the balance of payments crisis nor the problem of inflation has been overcome. A lasting solution to these problems called for sustained corrective action which continued to receive top priority in 1992-93.

4.2. MONETARY POLICY 1992-93

Although the economic crisis of mid-1991 had been contained, and a programme of structural reforms initiated, inflation was still running high, the balance of payments remained under strain and industrial production was depressed. The economic situation has improved substantially in the year under review. There has been decisive progress in overcoming inflation and the rate of inflation has declined to seven per cent. The balance of payments situation, though still difficult, showed hopeful signs with a pick-up in exports to the hard currency area. Industrial growth was picking up slowly and was better than in the previous year. The policy initiatives introduced after June 1991 have positive impacts. This gave confidence to the policy makers regarding the effectiveness and the direction of reforms, and if the reforms were continued, then Indian economy can overcome the severe constraints and assure a more prosperous future for the people. The programme of stabilization and the economic reform measures put in place in 1991-92 helped to restore economic growth to 4 per cent in 1992-93, brought down the rate of inflation to 7 per cent, restore the level of foreign
currency reserves to $6.4 billion and stimulate a strong recovery in exports towards the end of the financial year.

The year has not been without setbacks. The irregularities in securities trading in some banks damaged liquidity and temporarily raised questions of confidence. The riots in December 1992 and January 1993 disrupted transportation, slowed the growth of exports and industrial production, and reduced revenue. Without these setbacks there would have been faster recovery in both output and employment in 1992-93.

The balance of payments position, which had reached a point of near collapse in June 1991, slowly stabilized during the course of 1991-92. Although new policies to deal with the situation were quickly formulated by the new Government and implemented within a few months the external payments situation took time to stabilize primarily because it had been allowed to deteriorate to a state of near bankruptcy in June 1991. Foreign currency reserves had declined to $1.1 billion despite heavy borrowing from the IMF in 1990-91. However, it was restored to more normal levels increasing from $1.1 billion in June 1991 to $5.6 billion at the end of March 1992. The balance of payments in 1992-93 has performed more or less as expected.

Inflation was the most pressing problem for the common man in 1991-92, especially as the rate of inflation for food articles was much higher than for all commodities. The situation improved considerably in 1992-93 with a gradual decline in the annual rate of inflation in the course of the year. The annual rate of inflation as measured by the wholesale price index declined from 13.6 per cent at the end of 1991-92 to 6.9 per cent on 30 January 1993. The decline in inflationary pressure was especially marked in primary articles including food grains. The deceleration in inflation was a major achievement of economic management in this year.

After growing by 15.3 per cent in 1991-92, money supply (M3) has slowed down in this year with a growth of 12.3 per cent. It is interesting to note that although money supply growth has decelerated in line with the reduction in the fiscal deficit and its monetized component, the budgetary deficit, the growth of M3 remained higher than the targeted level of around 10.5 per cent for the year as a whole.
The role of monetary policy has too long been a passive one, confined to financing the fiscal deficit at administered interest rates in order to minimize the cost to the Government. It was necessary to make a decisive break from this pattern. With the reduction in the fiscal deficit, the Government was working towards a situation where interest rate distortions were reduced and monetary policy could be actively used for short-term macro-economic management. The Government has progressed towards this aim in the past year with a number of initiatives.

It was not enough, however, to change the rules of monetary management; what required was a comprehensive reform of the banking system, the capital market and their regulation. The Narasimham Committee has made comprehensive proposals for reforms in this area.

In recognition of some problems the Government has decided progressively to reduce the pre-emption under the SLR and CRR and steps have been taken in this direction in the course of 1992-93. It was intended by the Government to reduce the SLR to 25 per cent over the next three years and to reduce the CRR to below 10 per cent over a four-year period.

The freeing of financial institutions from compulsory, investment in Government securities has been gone hand-in-hand with the development of a wider market for debt instruments.

With the proposed reduction in SLR and government deficits, it was expected a reduction in the high interest rates being charged in the commercial sector. It was also necessary to rationalize the structure of lending rates. Progress had been made in reducing the number of lending rates from six to four during 1992-93. It is decided to rationalize the structure by reducing the number of rates to three. In the long run, it was considered the possibility of moving to just two rates, with one general rate and one concessionary rate.

4.3. MONETARY POLICY 1993-94

The Year 1993-94 saw further fruits of the initial array of reforms, the deepening of the reform efforts in some areas and the identification of new priorities for
public action. The balance of payments position has improved markedly. Foreign exchange currency reserves had reached $10.91 billion by February 4, 1994. The Standby Arrangement with the IMF negotiated in 1991 was successfully completed in June 1993. Inflation was running below 8.5 per cent in January 1994.

The second kind of borrowing, from the RBI, has, together with the increase in net foreign assets, fuelled the growth of reserve money in the economy. Reserve money increased by 16.9 per cent during 1993-94 (up to January 8, 1994) almost double the growth of 8.5 per cent over the same period in 1992-93. The growth in money supply (M3) during this period of 1993-94 at 14.1 per cent was also higher than the 12.4 per cent growth recorded in the corresponding period of 1992-93. The slower growth of money supply (compared to reserve money) was mainly due to two factors: the unusually large increase in currency held by the public, which moderated expansionary effects of reserve money on money supply; and the inhibitions on bank lending attributable to tighter prudential norms and the post-scam, cautious environment.

Despite the restraints on money supply growth, the expansion of liquidity was sufficient to accommodate an acceleration of inflation from August, 1993. The point-to-point rate of increase in the Wholesale Price Index (WPI) had fallen to 7 per cent by March, and averaged 7 per cent from March to July. It rose to a higher plateau of 8 per cent in August and stood at 8.2 per cent (provisional) on January 29, 1994. With most banks holding excess reserves, the growth of reserve money accelerating in response to heavy recourse to the RBI by the Centre and the strong rise in net foreign assets, 1993-94 saw a substantial build-up of inflationary potential in the economy.

The Advance Estimates of National Income by CSO put growth of GDP (at factor cost) at 3.8 per cent in 1993-94, with agriculture growing at 2.3 per cent, manufacturing at 2.5 per cent and the growth of utilities and other service sectors ranging from 3.8 to 8.1 per cent. While the estimate of overall economic growth was more than three times higher than the growth in 1991-92, it was below the 5.6 per cent rate projected in the Eighth Five Year Plan. At the macro-economic level, the challenge for policy is to stimulate higher growth, while acting firmly to dampen the build-up of inflationary potential in the economy.
The annual rate of growth of money supply (M3) has been less than 14.2 per cent for most fort-nights of 1993-94, but has shown signs of moving up. Reserve money growth showed a similar pattern at 20.1 per cent and was nearly three times the rate of 7.0 per cent a year ago. Increase in net RBI credit to the Central Government and the rapid accumulation of net foreign exchange assets by the RBI were the main sources of this growth. Net bank credit to Government was growing at an annual rate of 17 per cent. Bank credit to the commercial sector has grown by 6 per cent during the financial year 1993-94.

A number of policy changes were introduced to impart greater flexibility to monetary operations. Interest rate on deposits and loans were reduced in line with falling inflation: the minimum lending rate for bank loans above Rs.2 lakh was reduced by three percentage points to 15 per cent during 1993. The Cash Reserve Ratio (CRR) was reduced in two phases and brought down to 14 per cent. The Statutory Liquidity Ratio (SLR) was reduced to 34.75 per cent effective October, 1993, from 37.75 per cent at the beginning of the financial year. The incremental SLR on any increase in net demand and time liabilities was brought down to 25 per cent. At the same time, the Government has increasingly met its borrowing requirements through auctioning of dated Government securities and Treasury Bills.

The year saw a remarkable recovery in the balance of payments position. Foreign currency reserves with the RBI stood at $ 10.9 billion on February 4, 1994. The year could end with reserves close to $12 billion. This represented nearly 6 months of import cover - as compared to 2 weeks of cover in May, 1991.

A noteworthy feature of this year's balance of payments situation was the positive response of foreign investors and portfolio managers to the policy reforms. Thus, one of the worst economic crises in decades was successfully met by a combination of macro-adjustment measures and policy reforms. Far-reaching policy reforms have been introduced with a view to transforming the structure and competitiveness of the economy and setting it on a path of fast labour intensive growth.
4.4. MONETARY POLICY 1994-95

The year 1994-95 saw the fastest growth of the Indian economy in the last four years. After the crisis induced low growth of 0.9 per cent in 1991-92, the economy had already responded smartly to wide-ranging reform measures to record growth of 4.3 per cent in each of the years 1992-93 and 1993-94. This year has seen an acceleration of growth to 5.3 per cent led by strong, broad-based industrial growth of around 8 per cent and supported by a robust agricultural performance. The performance of the external sector continued to be strong with exports growing by more than 17 per cent in dollar terms in the first ten months of the year, the balance on invisibles climbing to over a billion dollars in the first six months of the year and foreign investment (direct plus portfolio) of $3.9 billion in April-December, 1994. Foreign currency reserves have also risen by over $4.5 billion.

Food-grain production was 185 million tonnes in 1994-95. Public stocks of food grains with the Central Pool stood at 30 million tonnes, as of January 1, 1995, compared to 13.9 million tonnes three years earlier. Where as the increase in total economy-wide employment was estimated to have been only about 3 million in 1991-92, an expansion of about 6 million was estimated for each of the years 1992-93 and 1993-94.

Compared to other countries coping with crisis and adjustment, the restoration of macroeconomic stability and revival of growth in output and employment in India has been exceptionally smooth. But these undeniable achievements are not free from threat. In an increasingly open and competitive international environment, perceptions of weakness in macroeconomic policy or economic reforms could easily affect adversely the flow of foreign savings.

The total domestic savings rate has increased only marginally by 0.2 per cent of GDP to 20.2 per cent in 1993-94. The fiscal deficit in 1993-94 was much larger than budgeted, but its monetary impact was contained through sizeable open market sales of Government securities by the Reserve Bank of India. Nevertheless, monetary growth accelerated to 18.2 per cent in 1993-94 from 15.7 per cent in the previous year. This, together with the continuing substantial increase in procurement and issue prices of
food grains, other administered price changes and production shortfalls in key commodities like cotton and sugar, led to a significant increase in the annual rate of inflation in 1993-94. These forces spilled in to the first quarter of 1994-95 and took the annual rate of increase in the Wholesale Price Index to 12 per cent before subsinding to a range of 8 to 10 per cent in the middle two quarters of the year and then rising again to double digits in the final quarter.

The management of monetary and other effects of a sudden rise in foreign capital inflows proved as an important challenge for macroeconomic policy making in 1994-95. To contain the monetary consequences of a rapid rise in foreign exchange reserves in the latter half of 1993-94, a phenomenon which persisted through the first half of 1994-95, a number of counter measures were taken. These included an increase in the general Cash Reserve Ratio (CRR) applicable to commercial banks in May 1994, a reduction in the maximum interest allowable on deposits, the tightening up of guidelines for Euro issues and continuation of open market sales of Government securities by the Reserve Bank of India to mop up excess liquidity. By November 1994, the effects of these measures were apparent in the slowing growth of money supply.

Monetary trends observed in the second half of 1993-94, have continued through most of the next year. The rate of growth of money supply, M3 (currency plus all bank deposits), displayed a gradual but sustained uptrend till November 1994. There was an even stronger acceleration in the annual rate of growth of narrow money, M, (currency plus demand deposits of banks). The annual growth rate of M3, which peaked at 22 per cent in November 1994, has subsequently declined to 18.6 per cent as of January 20, 1995. The reason for the uptrend in monetary growth through most of 1994-95 was a sharp rise in the growth of reserve money, which followed a similar pattern to that of money supply.

Reserve money is the sum of many variables such as RBI credit to government, RBI credit to banks and the commercial sector, and RBI's net foreign exchange assets. The growth rate of two of its important sources has moved in opposite directions. RBI credit to government has shown a decline in growth, while growth of RBI's net foreign exchange assets has accelerated. The net result has been acceleration in the annual rate
of growth of reserve money since the middle of 1993-94. Reserve money growth peaked in February 1994, and, after fluctuating at fairly high levels, it has declined to an annual rate of 21.2 per cent on January 20, 1995. Annual growth of net foreign exchange assets of RBI similarly peaked in March 1994, and was 93 per cent by January 20, 1995. The large accretion of net foreign exchange assets, which has propelled the growth of reserve money, is a reflection of the strong build-up of foreign exchange reserves, arising from improvements in the current and capital accounts of the balance of payments.

What is more remarkable about the growth of reserve money in 1994-95 compared to 1993-94, is the dramatic fall in the contribution of the monetized deficit of the Central Government. Accumulation of net foreign exchange assets by RBI up to January 20, 1995 constituted 88.7 per cent of the total increase in reserve money during the year. Net RBI credit to government made a negative contribution (-20.2 per cent) to the growth of reserve money in 1994-95, because of a decline of Rs.3983 crore. In the corresponding period of 1993-94, the increase in net RBI credit to government constituted 36.4 per cent of the increase in reserve money, while increase in net RBI foreign exchange assets constituted 65.6 per cent of the increase. This very different pattern of reserve money growth has been made possible by the behavior of the Central budget deficit (total expenditures minus total receipts - both revenue and capital) which has been negative for almost six consecutive months of 1994-95 from July 29, 1994 to January 20, 1995. A decline in net RBI credit to Government has been accompanied by a reduction in the growth of "Other banks’ credit to Government" from 27.1 per cent in 1993-94 (till January 21, 1994) to 15 per cent in 1994-95 (till January 20, 1995). The slowing down of the growth of Government borrowing was due to a reduction in the fiscal deficit in 1994-95 from the previous year.

Bank credit to the commercial sector has been much more buoyant in the current financial year. By January 20, 1995, it had grown by 13.6 per cent, which is more than double the growth of 6.3 per cent in the comparable period of 1993-94.

Two major initiatives were taken to improve the working of the monetary system. One was to initiate a process which will break the link between the Central
Government fiscal deficit and reserve money growth. A historic agreement was signed in September 1994 between RBI and the Ministry of Finance to phase out by end 1996-97, Central Government borrowing from RBI through Ad hoc Treasury Bills. The agreement also specified the budget estimate of Rs.6000 crore as ceiling for the year 1994-95. Further, such borrowing will not be allowed to exceed Rs.9000 crore for more than ten consecutive working days during the year. Traditionally, an increase in the fiscal deficit above the availability of conventional sources of borrowing automatically resulted in an increase in the budget deficit and RBI credit to Government. This in turn increased reserve money and led to higher monetary growth. The agreement between the Reserve Bank and the Central Government will sever this direct link between the fiscal deficit and monetary growth, and to that extent make monetary policy independent of the Central budget.

Second, a key psychological barrier to a flexible and market responsive financial system was also crossed in 1994-95, with the abolition of the minimum lending rate on bank loans above Rs.2 lakh. Each bank will now have to set its own prime rate on which the structure of loan rates will rest. This, along with the entry of six new private banks during the financial year, is expected to spur competition and cost consciousness in the banking sector. The cooperative banking sector saw similar changes, with complete decontrol of deposit rates and deregulation of lending rates subject to a minimum lending rate of 12 per cent.

During the year (up to February 4, 1995) the general price level rose by 9.6 per cent compared to 9.1 per cent in the same period last year. The annual growth rate for 1995, was however, closer to 11 per cent. Aggregate inflation has therefore followed a pattern broadly similar to that of monetary variables since the middle of 1993-94. Throughout the second half of 1993-94, inflation was on a rising trend, which continued in 1994-95 to reach a peak of 12 per cent. Primary articles continue to contribute disproportionately to the total inflation, with an increase in their contribution from 35 per cent in 1993-94.

High growth of monetary aggregates was one of the more important factors in the high level of inflation in 1994-95. A number of measures were therefore taken to
control money growth. The cash reserve ratio (CRR) was raised from 14 per cent to 15 per cent to moderate monetary growth. The agreement to limit access of the Central Government to RBI borrowing through Ad hoc Treasury Bills limits monetization of the fiscal deficit. Cash reserve ratios were also imposed on the Foreign Currency Non Resident (Banks) Accounts scheme and on the Non-Resident Non-Repatriable Rupee Deposit (NRNRRD) scheme 15 and 7.5 per cent respectively. The RBI also undertook open market sales of Government securities to mop up excess liquidity.

On the supply side a number of measures were taken since March 1994, to moderate prices of primary articles. The balance of payments position has shown steady improvement since 1991-92 with exports covering a larger proportion of imports than in the earlier years. The export-import ratio has averaged nearly 90 per cent during 1991-92 to 1993-94, compared to an average of about 65 per cent for the preceding three years. The current account deficit has also declined, averaging about 0.7 per cent of GDP for these three years, compared to an average of about 2.6 per cent of GDP in the preceding three years. Even though the export-import ratio for 1994-95 was expected to decline from the high of 94.6 per cent in 1993-94, and the current account deficit rise from the low of 1993-94, the four year average was unlikely to be much different from the three year average.

The improvement in India's balance of payments during 1993-94 which resulted in an unprecedented build up of foreign currency reserves, continued in 1994-95. These assets rose further from $15.1 billion at the end of March 1994 to $19.8 billion by October 1 994, and have since stabilized at around this level.

The reserve build-up, as the net result of all external transactions, reflects the effect of improvements on the current and capital accounts. Sustained growth of exports and direct foreign investment are the keys to sustained viability of the balance of payments.

4.5. MONETARY POLICY 1995-96

The major highlights of the economic developments during 1995-96 were the continued high real GDP growth of 7.1 per cent and the decline in the inflation rate to a
single digit level. Monetary expansion (M3) was substantially lower at 13.2 per cent. There was a deceleration in growth rate of aggregate deposits and bank credit of scheduled commercial banks to 12.1 per cent and 20.1 per cent respectively. The decline in the inflation rate to 5.0 per cent on a point-to-point basis, during the year was sharp, particularly so in the context of the double digit inflation recorded in the previous two years. The external sector developments were marked by robust export performance for the third year in succession with a growth rate of 20.9 per cent while the growth in imports, on BOP basis, was also higher at 30.1 per cent. The foreign currency assets of the Reserve Bank as at end-March 1996 stood at a little over US$17 billion, equivalent to about five months of imports.

4.6. MONETARY POLICY 1996-97

As regards the economic developments during the fiscal year 1996-97, the production of food grains was higher at 191.2 million tones during 1996-97. Industrial production during the first half of this financial year (April- September 1996) registered a lower growth of 9.8 per cent. The budget deficit and monetized deficit have remained high at Rs.13, 755 crore and at Rs.6, 020 crore respectively as on January 24, 1997. The monetary expansion M3 has been higher during the financial year at 10.6 per cent. During the current financial year aggregate deposits of scheduled commercial banks increased substantially by Rs.41, 726 crore or 9.6 per cent while bank credit expanded by Rs.11, 511 crore. The inflation rate was placed at 7.0 per cent, on a point-to-point basis, since the beginning of the financial year. The external sector developments have been characterized by low export growth and exports in dollar terms rose by only 6.4 per cent during the first nine months of this financial year (April-December 1996) while import growth slackened to 4.4 per cent. Balance of payments developments during 1996-97, continued to reflect signs of sustainability in the external sector. India’s foreign exchange reserves stood at US$ 23,973 million as on January 31, 1997. The exchange rate of the rupee remained broadly stable during the year moving within the range of Rs.34.14 per U.S. dollar and Rs.35.94 per U.S. dollar. Fairly good rainfall in most regions of the country has brightened the prospects of a much higher level of agricultural production this year.
With regard to industrial production, while manufacturing sector and capital goods segment in particular have recorded an impressive performance, there is a slow down in terms of overall growth. These factors pointed to the feasibility of the real GDP growth during 1996-97 to be around 6.8 per cent as forecasted by the CSO. The external payments situation remained under control. The foreign currency assets of the RBI remained comfortable at around US$ 19.8 billion this year. Economic developments during 1996-97 have, however, raised certain concerns. These relate to industrial growth, interest rates and export growth. For economic growth to be sustained at a rate of 7.0 per cent there is an imperative need to raise further the saving rate even though the national income data showed a pick up in the saving rate. A better alignment between desired investment rate and domestic saving rate as well as maintenance of inflation rate at a reasonably low level helps to bring down the interest rate in a sustained way.

4.7. MONETARY POLICY 1997-98

In 1997-98, the Indian economy performed remarkably well in terms of output growth, price stability, banking sector performance, and the balance of payments position. The real GDP growth, at the estimated 5.1 per cent in 1997-98, though lower than 7.5 per cent registered in 1996-97 was still impressive by the standards of performance of most other Asian economies.

The broad money (M3) expansion was placed higher at 17.6 per cent during 1997-98 as compared with 15.9 per cent in 1996-97. Bank deposit has increased by 19.4 per cent as compared to 17.4 per cent in the previous year. Growth in time deposits, facilitated by interest rate deregulation in respect of short-term time deposits was an important feature of 1997-98. The high rate of increase in M3 during 1997-98 was a result of increases in both domestic credit and net foreign exchange assets of the banking sector. Bank credit to commercial sector increased by 14.9 per cent as compared with 9.2 per cent in the previous year. The increase in net bank credit to Government was also higher at 14.6 per cent as against 12.0 per cent in the previous year. Net foreign exchange assets of the banking sector have expanded by 20.0 per cent on top of an increase of 28.4 per cent in the previous year. Reserve money growth at
Rs.26, 248 crore (13.1 per cent) was substantially higher than that of Rs.5, 528 crore (2.8 per cent) in 1996-97.

Banking developments during 1997-98 were characterized by a sharp accretion to deposits, especially of time deposits for the second year in succession, and a pick-up in credit expansion. The growth in scheduled commercial banks credit was substantially higher at 16.4 per cent as compared with 9.6 per cent in 1996-97. Food credit as well as non-food credit increased substantially than that in the previous year. The total flow of resources to the commercial sector from the commercial banks, both in terms of bank credit and investments in commercial papers, debentures, bonds and shares of companies, was higher at Rs.54,442 crore during 1997-98 as compared with Rs.30,951 crore in the previous year.

The price situation achieved a distinct moderation during 1997-98, notwithstanding a relatively high order of monetary expansion and an increase in the administered prices of certain petroleum products. The annual inflation rate, measured in terms of variation in the Wholesale Price Index (WPI), on a point-to-point basis, declined to 5.3 per cent from 6.9 per cent in 1996-97. On an average basis, the inflation rate was lower at 4.8 per cent than that of 6.4 per cent in the preceding year and a double-digit rate during 1990-91 to 1995-96. The variation in consumer price index for industrial worker (CPI-IW) was also lower than in 1996-97 on both point-to-point and average basis. However, the rate of increase in CPI-IW in 1997-98 was higher than that in WPI during the year under review.

Notwithstanding the deterioration on trade account, the external sector position of the economy remained strong. It was also able to withstand the external uncertainties and foreign exchange market pressures attributable to South-East Asian financial crisis. The balance of payments recorded an overall surplus of US $ 4,511 million (1.2 per cent of GDP) in 1997-98 and foreign exchange reserves during 1997-98 increased by US $ 2, 9445 million to US $29,367 million at end-March 1998, equivalent to seven months of imports from US $ 26,423 million at the end of March 1997. The foreign exchange reserve level of seven months of imports and current account deficit to GDP
ratio of 1.7 per cent in 1997-98 provided the needed international confidence in the Indian economy, and strengthened the macroeconomic environment.

4.8. MONETARY POLICY 1998-99

There was a sharp upturn in GDP growth in 1998-99, which reversed the deceleration in growth seen in 1997-98. GDP (at factor cost) growth accelerated to 6.8 per cent in 1998-99 from 5 per cent in 1997-98. The primary supply side factor for the recovery was agriculture. GDP from the agriculture and allied sectors, which had fallen by 1.9 per cent in 1997-98 recovered dramatically to grow by 7.2 per cent in 1998-99. As in the previous year GDP from "public administration & defense" contributed 0.7 per cent point to the overall GDP growth rate in 1998-99. This was primarily because of the wage increase for government employees’ consequent to the Fifth Central Pay Commission’s recommendations. The wage increase was largely implemented by the Central Government in 1997-98 and by the State Governments in 1998-99.

On the demand side, private consumption recovered in 1998-99 from its slump in 1997-98, with real consumption growth doubling from 2.6 per cent in 1997-98 to 5.1 per cent in 1998-99. Recovery in agricultural income clearly contributed to this growth as indicated by the lower saving rate in terms of household saving in physical assets. Perhaps the windfall income of government servants, which was initially saved also, started getting spent.

Total investment (at 1993-94 prices) declined by about half a per cent in 1998-99 after increasing by over 13 per cent the year before. This deceleration in investment was linked to the deceleration in manufacturing and the slump in agriculture in 1997-98.

Gross domestic saving declined sharply in 1998-99 to 22.3 per cent of GDP. The 2.4 per cent points of GDP decline in the saving rate resulted from a 1.4 per cent point decline in public saving and a 1 per cent point decline in household saving in physical form (i.e. direct investment).

An analysis of the yield curve movement in the Government securities market during 1998-99 showed that while the short-term rates respond quickly and
pronouncedly to the changes in monetary policy rates, long-term rates exhibit somewhat sticky behaviour.

The restoration of stability in the Indian currency market was primarily the result of a credible stance to arrest volatility caused by speculation and keep rupee stable and the gradual moderation of pressures in the East Asian currency markets in end-January 1998. As the rupee adjusted downwards smoothly, the Reserve Bank eased some of the monetary measures clamped earlier in the face of volatility. The Bank Rate was reduced by 50 basis points each time effective March 19 and April 3, 1998, respectively, and further by 100 basis points to 9.0 per cent effective April 29, 1998. The fixed rate for repo auctions was reduced to 8.0 per cent effective March 18, 1998 and thereafter gradually to 5.0 per cent effective June 15, 1998. The CRR was scaled down by 25 basis points each in two phases effective March 28 and April 11, 1998, respectively. Export credit refinance limits were restored in April 1998. Reflecting the return of easy liquidity conditions, the interest rate structure also softened, with average call rates easing to 6.85 per cent and five-year bond yields softening to 11.06 per cent in April 1998. A majority of banks reduced their lending and deposit rates in response to the Bank Rate cut as also in line with seasonal trends.

The foreign exchange market saw the return of excess demand conditions in mid-May 1998, in reaction to the impending sanctions, resulting in the exchange rate weakening from Rs.39.73 per US dollar at the beginning of May to Rs.42.38 by June 11, 1998. The Reserve Bank sold foreign currency in response to excess demand in the foreign exchange market, depleting its NFA by Rs.6,597 crore (adjusted for revaluation). Net merchant forward sales jumped to US $ 5,498 million, resulting in a sharp increase in the one-month forward premium to 9.59 per cent in June 1998 from 3.67 per cent in April 1998.

The Reserve Bank announced a package of policy measures on June 11, 1998 to contain volatility in the foreign exchange market. Stability returned briefly but pressures renewed by the end of the month. The rupee touched Rs.42.92 per US dollar on June 23, 1998 but firmed up at end- June 1998 to Rs.42.47 per US dollar as stability
was restored with the sentiment improving in response to the Reserve Bank’s policy response and favorable political developments.

The foreign exchange market again came under pressure in August 1998, reflecting the adverse sentiment on account of the deepening of financial crisis in Russia, resulting in a depreciation of the rupee to Rs.43.42 on August 19, 1998. The Reserve Bank announced a second package of measures in order to prevent speculative pressures on the foreign exchange market, which, included: (i) a hike in the CRR from 10.0 per cent to 11.0 per cent, (ii) increase in repo rate from 5.0 per cent to 8.0 per cent, and (iii) withdrawal of the facility of rebooking of the cancelled contracts for imports. A significant contribution towards maintaining orderly exchange market conditions in this phase was made by the mobilization of US $ 4.2 billion through Resurgent India Bonds (RIBs) that helped in an accretion of US $ 3.7 billion to the foreign exchange reserves. As a result, the rupee was strengthened.

Liquidity conditions tightened with the return of excess demand conditions in the foreign exchange market during May-June 1998, but eased after the Reserve Bank announced its intention to limit the impact of the large Government borrowing programme by accepting private placements of Government securities. The Reserve Bank continued to strategically subscribe to fresh Government securities (Rs.20, 000 crore at face value) and later offloaded them through open market sales (Rs.11, 437 crore, of which Rs.6, 726 crore to commercial banks) in the last quarter of the year to modulate liquidity conditions. The measures announced on August 21, 1998, however, pushed up the call rates to above 8.0 per cent (the repo rate) during the year.

The external debt to GDP ratio has been declining continuously from a high of 41 per cent in 1991-92 to 23.5 per cent in 1998-99.

Domestic market integration is an important aspect of overall financial integration. To a large extent, domestic financial integration can be gauged by the integration of the term structure of interest rates. The application of term structure in the conduct of monetary policy in India is, however, constrained by the absence of a well defined yield curve. An assessment of the transmission link from the policy interest rates to other interest rates in the financial system is critical for the effective
conduct of monetary policy in a market economy. While studying the dynamics of monetary policy shocks and their impact on the financial markets in India, Joshi and Bhattacharya found evidence supporting integration of the financial markets. Their results showed that the Bank Rate has emerged as a more effective instrument of policy in terms of its impact on the financial markets in relation to other instruments, such as, the CRR or the balance sheet operations of the Reserve Bank involving changes in reserve money.

4.9. MONETARY POLICY 1999-2000

Financial year 1999-2000 was characterized by low inflation and a comfortable supply position of most items of daily consumption. The downtrend in the annual rate of inflation, which began in the middle of 1998-99 continued in 1999-2000. Inflation touched a record eighteen-year low of 2.0 per cent at the end of July 1999. The annual inflation (point to point) for the week ending January 29, 2000 is 2.9 per cent, while the 52 week average rate for this period was 3.3 per cent.

The Wholesale Price Index (WPI) of all commodities increased by 3.3 per cent during the first 44 weeks of the financial year. The WPI of the fuel group however has increased sharply by 12.2 per cent. This was largely due to the 40 per cent hike in diesel prices announced by the Government on October 6, 1999 necessitated by near doubling of international prices of crude oil during 1998.

Retail prices as reflected in the most commonly used CPI (IW) registered the lowest ever inflation rate recorded so far under the current CPI (IW) series with base 1982. In fact, the index did not register any movement for the month of November 1999 over the corresponding month last year, probably one of the rare times in history of CPI (IW) series. In December, it was still at a low of 0.5 per cent.

The inflation rate dropped to international levels of 2 to 3 per cent for the first time in decades. The balance of payments survived the twin shocks of the East-Asian crisis and the post-Pokhran sanctions with a low current account deficit and sufficient capital inflows. This was demonstrated by the continuing rise in foreign exchange
reserves by over US $ 2.4 billion during the year until the end of January 2000 coupled with a relatively stable exchange rate.

Inflation dropped dramatically in 1999, surprising many observers by remaining at low levels. As of January 29, 2000, the annual inflation as measured by the WPI was 2.9 per cent (point to point), down from a peak 8.8 per cent on September 25, 1998. The inflation rate has been less than 4 per cent since April 1999, with the result that the average (52 week) inflation was 3.3 per cent (provisional) as on January 29, 2000. The decline in inflation as measured by the CPI for industrial workers has been even more dramatic, falling to zero in November 1999 from a peak of 19.7 per cent in November 1998. The strong agricultural growth in 1998-99, the increasing openness of the economy to manufactured imports along with the fall in international prices has contributed greatly to this decline.

Broad money (M3) growth was 16.6 per cent (annual point to point) on January 14, 2000. Growth of M3 during the financial year till January 14, 2000 at 12 per cent was lower than the 13.7 per cent in the corresponding period of last year. Reserve money growth during this period was negative as against an increase of 10.7 per cent in the corresponding period of the previous financial year. The negative growth of reserve money was due to the much lower growth in net RBI credit to Government, which grew by only 1.3 per cent till January 14, 2000 compared to 13.4 per cent in the corresponding period of 1998-99. The decline in RBI credit to the commercial sector and slower growth in net foreign exchange assets also contributed to negative growth in reserve money. The higher money multiplier reflected the impact of cash reserve ratio (CRR) reduction to 10 per cent in May 1999 and to 9 per cent in November 1999.

The growth in non-food credit has picked up in the second quarter in response to increase in demand for credit arising from acceleration in industrial growth. During the financial year up to January 14, 2000, non-food credit had grown by 10.6 per cent, as against 7.2 per cent in the corresponding period of the previous year. Inclusive of investment, the flow of funds from banks during this period has increased by 11.6 per cent as against 10.0 per cent in the corresponding period of last year. Net bank credit to
Government increased by only 14.1 per cent till January 14, 2000 in contrast to 15.9 per cent in the corresponding period of the previous year.

The East Asian crisis, which loomed as a large black cloud over the world at the beginning of 1999, seemed to disappear as quickly and unexpectedly as it had arrived. This recovery contributed to the recovery of world output and trade volumes in 1999. Output growth accelerated from 1.9 per cent in 1998 to 2.6 per cent in 1999, while world trade volume growth accelerated from 4.2 per cent in 1998 to 5 per cent in 1999. All these are however projected to show a BOP growth of 2.5 to 2.8 per cent in 2000.

The Foreign currency assets of the RBI increased by US $3.5 billion in 1998-99 and further by about US $2.4 billion in 1999-2000 (till end January 2000) to US $31.94 billion. The value of RBI gold holding had declined to $2945 million by end January 2000 because of redemption under the Gold Bond Scheme and valuation changes. Total foreign exchange reserves (including gold and SDRs) at the end of January 2000 amounted to US$ 34.90 billion, which provides cover for about 8 months of estimated imports in 1999-2000.

The external debt to GDP ratio, at the end September 1999, was lower at 22.3 per cent. The absolute value of external debt rose marginally to $ 98.87 billion in September 1999.

4.10. MONETARY POLICY 2000-01

According to the estimates of National income for 2000-01 provided by the Central Statistical Organization on January 31, 2002, the overall GDP growth rate decelerated significantly from 6.1 per cent in 1999-2000 to 4 per cent in 2000-01. The gross value added in agriculture and allied sectors declined by 0.2 per cent in 2000-01 compared with an increase of 1.3 per cent in 1999-2000.

The saving and investment rates in India were high as judged by the country’s level of economic development. Gross domestic savings improved marginally from 23.2 per cent of GDP in 1999-2000 to 23.4 per cent of GDP in 2000-2001 as a result of better performance by household savings and private corporate savings. However, there was a steep fall in public sector savings due to an increase in the spending of
government administrative departments. In fact, public sector savings were negative in 1998-99, 1999-2000 and 2000-01. As a percentage of GDP, public sector savings declined from (-) 0.9 per cent in 1999-2000 to (-) 1.7 per cent in 2000-01.

Gross domestic investment at current prices declined marginally from 24.3 per cent of GDP in 1999-2000 to 24 per cent of GDP in 2000-01 mainly due to a fall in private sector investment. The rate of gross capital formation in real terms also declined from 26.7 per cent of GDP in 1999-2000 to 26.3 per cent of GDP in 2000-01 due to deceleration in the growth rates of real gross domestic capital formation in both public and private sectors. While the real gross fixed capital formation by the public sector increased by 10.9 per cent in 2000-01, that by the private sector increased by only 2.4 per cent in the same year.

As in earlier years, the rates of domestic investment were higher than the rates of domestic savings in both 1999-2000 and 2000-01. The investment-savings gap was financed by the positive net capital inflow from abroad, which amounted to 1.1 per cent and 0.6 per cent of GDP respectively in 1999-2000 and 2000-01.

Real GDP growth rate in 2000-01 is estimated at 6 per cent compared with a growth rate of 6.4 per cent achieved in 1999-2000 and 6.6 per cent in 1998-99. Despite deceleration of growth rate for the second consecutive year, India has the distinction of being one of the fastest growing economies in the world. The Indian economy has shown remarkable resilience in the face of substantial increase in the international price of crude oil over the last two years.

The reduction of overall growth rate of GDP to 6 per cent in 2000-01 is mainly due to a decline in the growth rate of service sector from 9.6 per cent in 1999-2000 to 8.3 per cent in the current year.

During 2000-01, the annual rate of inflation in terms of WPI has shown an increasing trend due to pressure from energy prices. The inflation rate, as on January 27, 2001, was around 8.2 per cent on point to point basis (compared with 3.6 per cent on the corresponding date of the previous year) and 6.6 per cent on the basis of 52 weeks average (compared with 3.4 per cent on the corresponding date of the previous
year). This increase in inflation was caused mainly by the fuel, power, light and lubricants group, whose point to point annual inflation as on January 27, 2001 was 29.6 per cent compared to 16.2 per cent in the corresponding period of the previous year. During the financial year the cumulative inflation rate was 4.8 per cent as on January 27, 2001 compared with 3 per cent during the corresponding period of 1999-2000. Given the trend, the year-end average rate of inflation in terms of WPI expectation was around 6.5-7.0 per cent.

Inflation rate in terms of the Consumer Price Index for Industrial Workers (CPI) decelerated continuously during the year to reach a low of 2.7 per cent in November 2000 as against zero per cent in November 1999. The index rose moderately by 3.5 per cent in December 2000. According to the twelve months average basis the inflation works out to 4 per cent for the year 2000 compared with 4.7 per cent for the year 1999.

According to the official BOP statistics, compiled by the RBI for 2000-01, trade deficit increased from US$ 7.6 billion in April-September 1999 to US$ 9.2 billion in April-September 2000. Consequently, foreign exchange reserve has declined by US $ 1.5 billion during April-September 2000.

During the first half of 2000-2001, foreign currency reserves showed declining trend due to excess demand for foreign currency caused by the huge import bill on oil. As per quarterly BOP estimates, foreign exchange reserves declined by US $1460 million in April-September 2000 compared with an increase of US $ 821 million in April-September 1999. Subsequently, the issues of India Millennium Deposits by SBI helped to raise foreign currency assets amounting to US $ 5.51 billion, which were added to RBI’s foreign currency reserves in November 2000. Total foreign exchange reserves (including gold and SDRs) at the end of January 2001 amounted to over US $ 41 billion, providing cover for 8 months of projected imports in 2000-01.

The sharp reduction in current account deficit and the funds raised under the IMD Scheme resulted in large accumulation of official foreign exchange reserves for the fifth year in succession during 2000-01. On BOP basis, the reserves increased by a substantial US $5.83 billion. This was on top of an increase of US $6.14 billion in
1999-2000 and an increase of US $4.51 billion per year, on an average, during the previous three years, i.e. 1996-97 to 1998-99.

The year-on-year growth of broad money supply (M3) was 15.8 per cent as on January 12, 2001 as against 16.7 per cent as on January 14, 2000. This reflected expansion in monetary base through the India Millennium Deposits in November 2000. Driven by the increase in the net foreign exchange assets of the RBI, reserve money increased by 5.1 per cent till January 12 in current financial year compared with negligible growth in the corresponding period of the previous year. The year-on-year growth in deposits of scheduled commercial banks (SCBs) as on January 12, 2001 at 17.9 per cent was above the RBI’s projected growth rate of 15.5 per cent. However, this reflected the inclusion of Rs. 25,662 crore from the India Millennium Deposits (IMD) Scheme in time deposits of banks, which grew at 15.7 per cent till January 12 in the current financial year compared to 13 per cent in the corresponding period of the previous year. Currency with the public expanded at a lower pace of 10.0 per cent till January 12, 2001 as against 14.9 per cent in the corresponding period of 1999-2000.

An important measure designed to further enhance the efficiency of the money market taken in June this year was related to the transition to a full-fledged Liquidity Adjustment Facility (LAF) involving injection and absorption of liquidity via variable rate reverse repo auctions and variable rate repo auctions respectively. Regulatory powers have been given to RBI under amendment to the Securities Contracts (Regulation) Act, 1956 to regulate dealings in Government and money market securities. The measures for further deepening and widening the Government securities market included permission to entities, who have been allotted securities in primary auctions, to sell them on the allotment date itself, and permission to all entities having SGL and current account with RBI Mumbai office to undertake repos in Treasury Bills and Central/State Government dated securities.

The previous decade can be described as the decade of reforms for the Indian economy. While the early years of the decade witnessed the first phase of structural reforms in industrial, financial and external sectors, the final years saw the beginning of the second phase of economic restructuring. The decade of reform was successful in
eliciting supply responses as evidenced in the higher growth of GDP, comfortable foreign exchange reserves, improving short term debt profile, moderate inflation and buoyant exports.

4.11. MONETARY POLICY 2001-02

The Indian economy was passing through a difficult phase caused by several unfavorable domestic and external developments. Domestic output and demand conditions were adversely affected by poor performance in agriculture in the previous two years. The global economy experienced an overall deceleration and estimated to record an output growth of 2.4 per cent during the past year. These tendencies were exacerbated in the aftermath of the terrorist attacks in United States in September 2001. Consequently, export growth has suffered and industrial profitability has also been affected by the prevailing low commodity and product prices globally. Despite these constraints, growth in real GDP in 2001-02 was expected to be 5.4 per cent as estimated by the Central Statistical Organization. This growth rate marks some recovery over the low growth of 4 per cent in 2000-01.

The average annual growth rate during the Ninth Five Year Plan (1997-2002) was estimated at 5.4 per cent which is lower than the plan target of 6.5 per cent. Although this raised new challenges for reinvigorating growth in the Tenth Five Year Plan, the Indian growth record is one of the highest among the major economies in the world during the years. The Indian economy has been resilient in the face of several external shocks during this period such as the East Asian crisis of 1997-98, the oil price increase of 2000-01, and the most recent world economic slowdown. Domestic shocks in the shape of an adverse security environment, natural disasters like the Orissa cyclone and Gujarat earthquake, and two consecutive years of poor agricultural performance, have also been faced successfully by the economy.

The overall growth of 5.4 per cent in 2001-02 is supported by a growth rate of 5.7 per cent in agriculture and allied sectors, 3.3 per cent in industry and 6.5 per cent in services. The acceleration of the overall GDP growth rate is basically due to a significant improvement in value added in the agriculture and allied sectors from a negative growth rate of (-) 0.2 per cent in 2000-01 to 5.7 per cent in 2001-2002. There
has been significant deceleration in the growth rate of industry. However, the performance of the services sector has improved moderately.

The point to point inflation rate according to the Wholesale Price Index (WPI) for the week ending January 19, 2002 was 1.3 per cent, which was the lowest in the last two decades. The 52-week average inflation rate declined from 7.0 per cent at the beginning of the year to 4.7 per cent for the week ending January 19, 2002.

The price situation remained under control during 2001-02. The impact of the fuel price increases announced first during 1999-2000, and subsequently twice during 2000-01, bottomed out during the year, reducing inflation to below 5 per cent by September 2001. The deceleration in prices continued through the months of October and November 2001. Inflation was recorded at 2.21 per cent at the beginning of December 2001 (the lowest since December 1999) and reduced further to 1.3 at the end of January 2002.

The average annual rate of inflation in terms of the Wholesale Price Index (WPI) increased significantly from 3.3 per cent in 1999-2000 to 7.1 per cent in 2000-01 due to a substantial rise in administered prices of petroleum products. During 2001-02, the inflation rate declined in terms of the WPI. The 52 week average inflation rate declined from 7 per cent at the beginning of 2001-02 to 4.7 per cent for the week ended January 19, 2002. The point-to-point inflation rate reached a low of 1.3 per cent by the end of January, 2002 which was the lowest in over two decades.

The inflation rate in terms of the Consumer Price Index for Industrial Workers (CPI-IW) remained below 4 per cent until July 2001 and increased to 5.2 per cent in August 2001. The Index displayed a downward trend during September-October, 2001. However, it increased again to 4.9 per cent in November and further to 5.2 per cent in December 2001.

The year-on-year growth in broad money (M3) as on January 11, 2002 was 14.4 per cent compared with 16.6 per cent a year ago. The sharp decline in money supply since November 16, 2001 reflects the sudden expansion in volume of broad money resulting from India Millennium Deposits with effect from the corresponding date in
the previous year. Among the various components of money supply, only currency with
the public registered a higher rate of growth in the year (till January 11, 2002)
compared to the corresponding period of the previous year. As far as sources of broad
money are concerned, growth in bank’s investment in Government securities and the
expansion in net foreign exchange assets of RBI contributed significantly to the broad
money growth in this year. This financial year witnessed a deceleration in the growth of
net domestic assets of RBI as compared to the corresponding previous period. This was
partly offset by the announced acceleration in the growth of net foreign exchange assets
of RBI. Reserve money registered a growth of 2.6 per cent during the financial year (till
January 11, 2002) as compared with 5 per cent during the corresponding previous
period.

Bank credit, comprising food credit and non-food credit, increased at a lower
rate of 10.6 per cent in 2001-02 compared to 14.3 per cent in the previous year. Recent
years have witnessed strong growth of food credit in response to the increase in the
quantum as well as price of food grains procured in support of the twin objectives of
food security and price support. The deceleration in the growth of non-food credit to
8.7 per cent from 12.1 per cent during the previous year mirrored the weak demand for
commercial credit owing to economic slowdown, which has been aggravated by the
global downturn in economic activity.

India’s balance of payments remained reasonably comfortable in both 2000-01
and 2001-02. The current account deficit as a percentage of GDP declined from 1.1 per
cent in 1999-2000 to about 0.5 per cent in 2000-01 due to a dynamic export
performance and sustained buoyancy in invisible receipts. However, in the year 2001-
02, exports have been almost stagnant and have recorded a growth of only 0.6 per cent.
An assessment of the Balance of Payments (BOP) outlook conducted jointly by the
Reserve Bank of India (RBI) and the Ministry of Finance for the year indicated it as
quite manageable.

The exchange rate of the rupee in terms of the major currencies of the world
remained reasonably stable during the year, despite occasional fluctuations caused by
normal market forces of supply and demand. Foreign exchange reserves (including gold
and SDR) reached a record level of nearly US$50 billion at the end of January 2002, which is equivalent to almost 10 months of estimated imports for the current year.

4.12. MONETARY POLICY 2002-03

This is the first year of the Tenth Five Year Plan (2002-07), which envisaged an average annual growth rate of 8 per cent. In this year, notwithstanding the deficient monsoon, there were no shortages in availability of essential commodities, or flare-ups in their prices. The 52-week average inflation rate based on the Wholesale Price Index (WPI) was only 2.6 per cent in mid January 2003. Prices of primary products remained below 4 per cent for the larger part of the year, while inflation in manufactured products was around 3 per cent.

Inflation, as measured by the Consumer Price Index for industrial workers (CPI-IW) declined from 4.7 per cent at the beginning of 2002-03 to 3.2 per cent in December 2002.

Foreign currency assets at end-March 2002 amounted to US $51.05 billion, up by US $11.5 billion over US $39.5 billion at end-March 2001. Foreign exchange reserves reached a record high of US $73.58 billion at the end of January 2003, with an increase of US $19.47 billion over the level of end-March 2002. A Reserve Bank of India (RBI) study showed that this was due to a surplus in the current account, non-debt creating capital flows and valuation gains.

The strengthening of the balance of payments has impacted on the monetary sector, with net foreign exchange assets (NFA) of RBI emerging as an important source of reserve money. NFA had reached 78.1 per cent by the end of 2001-02, became 100.7 per cent on January 24, 2003, which is close to a currency board situation. Similarly, the NFA to currency ratio increased from 105.2 per cent as on March 31, 2002, to 127.7 per cent on January 24, 2003. For liquidity management, the substantial increase in foreign exchange assets was partly neutralized by the decline in RBI’s net domestic credit. In this financial year, RBI credit to the government remained negative, and reserve money grew by 2.9 per cent up to January 24, 2003, as compared with 4.7 per cent in the corresponding period of last year. The money multiplier; the ratio of broad
money (M3) to reserve money had increased from 4.3 in the previous year, to 4.8 as on January 10, 2003. In the current financial year up to January 10, 2003, broad money grew at 9.8 per cent as compared with 11.2 per cent in the corresponding period of last year. The year-on-year growth in M3, as on January 10, 2003, amounted to 12.8 per cent compared with 14.5 per cent in last year. In spite of the slower growth of money supply, this year has been characterized by easy liquidity conditions. There were signs of a pick-up in non-food credit and a fall in interest rates, including in the yields on government securities.

Facilitated by relatively lower inflation, interest rates continued to soften during the year. The RBI reduced the bank rate by 25 basis points to 6.25 per cent in October 2002. At this level, the bank rate is the lowest since 1973. The cash reserve ratio (CRR) was reduced by 50 basis points to 5.0 per cent from June 1, 2002, and further to 4.75 per cent from the fortnight beginning November 16, 2002. The PLR of five major commercial banks declined from 11.00-12.00 per cent to 10.75-11.50 per cent in this year. Another noticeable development is the sub-PLR lending by commercial banks. Yields on government securities continued to maintain their downward trend. The yield on 7.4 per cent 12-year government paper reached a low of 6.13 per cent on December 31, 2002. A significant reform in this year was the dismantling of the administered price mechanism for petroleum products from April 1, 2002, exactly as per the schedule announced in 1997.

With a faltering global recovery, private final consumption expenditure has been the major factor sustaining growth in the Indian economy. Private final consumption expenditure, at constant 1993-94 prices, has increased by Rs. 48,275 crore or 5.9 percent in 2001-02. Compared to a rise of only 5.6 per cent in GDP at factor cost at constant prices in 2001-02, gross and net domestic savings at current prices, grew by 11.8 per cent and 13.3 per cent respectively, to increase their share in GDP at market prices. The household sector was once again the best performer, with the increase in its gross savings exceeding the total increase in gross domestic savings. Gross domestic capital formation at constant prices grew at 3.0 per cent in 2001-02, which was considerably lower than the growth of GDP. Domestic demand, and particularly, private final consumption expenditure, has been fuelling growth in last few years. The
contribution of investment to growth has been following an uneven pattern, with a year of reasonably high contribution followed by a year of low contribution. The same erratic behavior was observed again in 2001-02, when investment accounted for around 21 per cent of the increase in GDP.

As a result of the softening of nominal interest rates, the real PLR of five major commercial banks, based on a 52-week average of the WPI general index, has come down marginally from 9.6 per cent in 1997 to 9.0 per cent by January 2003.

4.13. MONETARY POLICY 2003-04

The economy appeared in a resilient mode in terms of growth, inflation, and balance of payments, a combination that offers large scope for consolidation of the growth momentum with continued macroeconomic stability. Real Gross Domestic Product (GDP) was estimated to have grown by 8.2 % and it reached at 8.5% in 2003-04. A growth rate higher than 8 per cent has been achieved in the past in only three years: 1967-68 (8.1 per cent), 1975-76 (9.0 per cent) and 1988-89 (10.5 per cent).

The GDP growth rate of 10.4 per cent in the 3rd quarter of 2003-04 was the highest in any quarter since at least 1997-98, when CSO started compiling quarterly estimate. The robust performance of India and the emerging market economies contributed to the good performance of the world economy, this year.

The growth recovery in 2003-04 was accompanied by continued maintenance of relative stability of prices. Inflation, as measured by the wholesale price index (WPI), was 4.6 per cent at end-March 2004 over end-March 2003, and 5.5 per cent on average.

Retail price inflation, as measured by the Consumer Price Index for Industrial Workers (CPI-IW), touched a peak of 5.1 per cent in April 2003 followed by a declining trend and reached 3.5 per cent in March 2004. CPI inflation declined further to 2.2 per cent in April 2004, compared to 5.1 per cent in April 2003, and abundant food grain stocks helped in maintaining stability in food prices.

A strong balance of payments (BOP) position during the area has resulted in a steady accumulation of foreign exchange reserves. After a robust growth of US$21.3
billion in 2002-03, foreign exchange reserve (including gold, SDRs and Reserve position in IMF), has increased by an unprecedented US$36.9 billion in 2003-04. The focus of the monetary policy in 2003-04 was, thus, on dealing with this surge in reserves. The RBI had to moderate the impact of these inflows (Rs. 124,169 crore in domestic currency terms) through open market sale of Government securities and repo operations through the Liquidity Adjustment Facility. Moreover, outward foreign investment policies were liberalized and interest spreads over LIBOR on various non-resident deposit schemes were reduced.

Reserve money growth nearly doubled from 9.2 per cent in 2002-03 to 18.3 per cent in 2003-04, driven entirely by the increase in the net foreign exchange assets of the RBI. Reserve money growth in 2003-04 was the highest during the years. Net RBI credit to the government continued to remain negative, owing to the open market sale of government securities to sterilize the foreign inflows. The declining stock of government securities held by the RBI somewhat constrained the scope of these operations. Broad money (M3) grew by 16.4 per cent in 2003-04, higher than the targeted growth of 14.0 per cent mentioned in the annual monetary and credit policy, reflecting, primarily, the higher-than-anticipated GDP growth achieved during the year.

The money multiplier - the ratio of M3 to reserve money - after increasing from 4.43 in 2001-02 to 4.66 in 2002-03, declined to 4.58 in 2003-04, suggesting some headroom for further expansion in M3. The virtuous decline in income velocity of money, continued in 2003-04. Income velocity declined from 1.62 in 2001-02 to 1.50 in 2002-03 and further to 1.48 in 2003-04.

Adequate liquidity in the banking system continued, and with a resurgence of growth, supported a credit pick up in 2003-04. Total bank credit (food and non-food) increased by 14.6 per cent in 2003-04 after an increase of 16.1 per cent in the previous year. In 2003-04, the total flow of agricultural credit from all lending institutions is estimated at around Rs.80000 crore.

The downward trend in interest rates continued in 2003-04. RBI reduced the Bank Rate from 6.25 per cent to 6.00 per cent from the close of business on April 29, 2003. Also, the cash reserve ratio (CRR) was reduced by 25 basis points to 4.50 per
cent in June, 2003. Lending rates have remained sticky and have not fallen by as much as the deposit rates. As a result, interest spread of commercial banks witnessed an increase during the years. The RBI has advised scheduled commercial banks (SCBs) to announce benchmark prime lending rates based on their actual costs, and this has fortified the soft interest rate regime. A significant development in 2003-04 was the lower than budgeted market borrowings by the Central government, which was facilitated by an improvement in the cash position. During the year 2003-04, SCBs improved their profitability on account of higher income from treasury operations and higher spread.

It is well known that there was a significant decline in the poverty ratio from 36 per cent in 1993-94 to 26.1 per cent in 1999-2000. The Tenth Five Year Plan (2002-07) has set a target of reduction in poverty ratio by five percentage points by 2007 and by 15 percentage points by 2012.

4.14. MONETARY POLICY 2004-05

The performance of the Indian economy in 2004-05 has exceeded expectations formed at the beginning of the year. Following the ‘bumper’ growth in 2003-04, initial growth projections for 2004-05 were placed in the range of 6.2 per cent to 7.4 per cent. According to the advance estimate of the Central Statistical Organization (CSO) released on February 7, 2005, the economy was likely to grow by 6.9 per cent in 2004-05. But the actual growth was 7.5% in this year.

Year-on-year WPI-based inflation was 5 per cent on February 5, 2005. The economy has managed to maintain the growth momentum in spite of a deficient South-west monsoon and hardening international environment. The year 2004-05, after starting with a point-to-point, annual inflation rate of 4.5 per cent on April 3, 2004 witnessed a peak level of inflation at 8.7 per cent on August 28, 2004, the highest in the last four years. However, as a result of the quick monetary and fiscal measures taken by the Reserve Bank of India (RBI) and Government, coupled with a slight easing of global petroleum prices, inflation has been on a declining trend and stood at 5 per cent on February 5, 2005 compared to 6.1 per cent a year ago. The 52-week average inflation rate at 6.4 per cent on February 5, 2005 was, however, higher than the 5.5 per
percent registered in the previous year. A study compared to the international prices showed that a major part of inflation was due to external factors. Year-on-year inflation as measured by the Consumer Price Index (CPI) for industrial workers declined significantly from 5.1 per cent in April 2003 to 2.2 per cent in April 2004. Thereafter, the CPI inflation rate started registering an increasing trend, as WPI inflation pushed up the consumer prices also. Partly in response to policy measures, and the subsequent easing of external pressure of oil imports, CPI declined to 3.8 per cent in December 2004. The CPI inflation, which is considered a more appropriate indicator of general inflation, is also substantially lower than the average WPI inflation at 6.7 per cent in December 2004.

In the second quarter of 2004-05, Government stepped in to keep inflation under check by reducing excise and customs duties on petroleum products and selected items. The RBI hiked the Cash Reserve Ratio (CRR) in two stages, effective from September 18, 2004, and October 2, 2004, respectively, and the reverse-repo rate was hiked effective from October 27, 2004, to check liquidity overhang in the system. These measures coupled with the subsequent fall in international crude prices, helped to rein in inflation.

The current account balance, after being in surplus for the three previous years in succession, has turned into a deficit in the first half of the year 2004-05, i.e. US$3.2 billion. Improvement in India’s external debt position continued in 2003-04. Compared to its stock at the beginning of the year, the growth in reserve money, which had accelerated from 9.2 per cent during 2002-03 to a high of 18.3 per cent during 2003-04, declined to 6.4 per cent in this year up to January 28, 2005. The corresponding growth in reserve money a year ago was 7.8 per cent. The lower growth of reserve money in the current year was on account of lower growth of 15.9 per cent in net foreign exchange assets (NFA) of the RBI compared with 32.8 per cent in the corresponding period last year.

The sharp decline in net RBI credit to Government observed in 2003-04 (62.8 per cent in the full year) continued in this year also with a further fall of 69.9 per cent up to January 28, 2005, and resulted in NFA constituting 120.9 per cent of reserve
money as of that date. Despite a lower growth of reserve money in this year, liquidity management remained a major concern. This was because, after a sharp increase in reserve money in the previous year, there was a liquidity overhang of over Rs.81,000 crore in the form of outstanding reverse repos under the Liquidity Adjustment Facility (LAF), Government surplus balances and excess reserves of banks from the previous year. This overhang posed a nascent problem in liquidity management. The Government raised the limit under MSS from Rs.60,000 crore to Rs. 80,000 crore on August 26, 2004, after the threshold limit of Rs.50,000 crore was crossed. Measures taken by the RBI include discontinuation of the auction of 7-day and 14-day reverse repo and its substitution by an overnight fixed rate reverse repo, and raising the cash reserve ratio by 50 basis points to 5 per cent.

Compared to its stock at the beginning of the year, broad money (M3) grew by 9.5 per cent in the current year up to January 21, 2005, compared with the high of 16.6 per cent in the whole of the previous year, and 12.1 per cent in the same period last year. The money multiplier — the ratio of M3 to reserve money — which increased from 4.43 at end-March 2002 to 4.65 at end-March 2003 declined to 4.59 at end-March 2004. As on January 21, 2005, this ratio stood at 4.72.

Despite lower growth of money supply in the current year, there was an impressive growth in gross bank credit by scheduled commercial banks (SCBs). Gross bank credit, increased by 19.9 per cent up to January 21, 2005 compared to 9.3 per cent in the corresponding previous period. Growth was observed in both food and nonfood credit, more so in the case of the latter. The Government announced a comprehensive policy envisaging a 30 per cent increase in agriculture credit in the current year and doubling the credit flow to the sector in three years.

In this year, there was a marginal northward movement in deposit rates of five major banks by 25 basis points. Call money rates moved up in the second half of the year, reflecting higher growth of bank credit. Nevertheless, interest rates continue to be moderate. The benchmark prime lending rates of five major banks were lower by 25 to 50 basis points in December, 2004 compared to the rates prevailing a year ago.
The significant improvement in the rates of savings and investment witnessed in 2002-03 continued through 2003-04. Savings rate, which is gross domestic savings as a proportion of GDP at current market prices, increased from 23.4 per cent in 2001-02 to 26.1 per cent in 2002-03. The corresponding increase in investment rate (gross domestic capital formation as a proportion of GDP) was from 22.6 per cent to 24.8 per cent. There were further improvements in savings and investment rates in 2003-04 to 28.1 per cent and 26.3 per cent, respectively. The savings rate in 2003-04 is the highest recorded so far and the investment rate in 2003-04 is the highest since 1996-97.

4.15. MONETARY POLICY 2005-06

Growth expectation was at 8.1 per cent in the year, 2005-06. Growth of Gross Domestic Product (GDP) at constant prices in excess of 8.0 per cent has been achieved by the economy in only five years of recorded history, and two out of these five were in the last three years. Some significant dimensions of the dynamic growth during the years are new industrial resurgence, a pick up in investment, modest inflation in spite of spiraling global crude prices, rapid growth in exports and imports with a widening of the current account deficit, laying of some institutional foundations for faster development of physical infrastructure, progress in fiscal consolidation and the launching of the National Rural Employment Guarantee (NREG) Scheme for inclusive growth and social security.

Against the annual average growth rate of 8.0 per cent envisaged in the Tenth Five Year Plan (2002-2007), the average rate was estimated to have been 7.0 per cent in the first four years ending in 2005-06. Maintenance of growth at or above 8 per cent in 2006-07 will yield a plan period annual average growth rate of at least 7.2 per cent. The growth trend for the last three years appears to indicate the beginning of a new phase of cyclical upswing in the economy from 2003-04. The initial momentum to this new phase of expansion, in 2003-04, was provided by agriculture. After a somewhat subdued impetus from the farm sector in 2004-05, there is a moderate recovery in agricultural growth in 2005-06.

Inflation, in most parts of the world, showed a rising tendency on account of rising global crude oil prices. The sharp and spiraling increase in international oil prices
from late 2003, posed considerable challenge in the maintenance of macroeconomic stability. In India, inflation, measured by a point-to-point increase in the Wholesale Price Index (WPI) declined from 5.7 per cent on April 2, 2005, to a low of 3.3 per cent on August 27, 2005 and to 4.1 per cent on February 4, 2006. Like in the previous year, the fuel, power, light, and lubricants group, having a weight of 14.2 per cent in the WPI basket, contributed the most to price rises in the economy.

In April 2005, inflation, year on year, in terms of consumer price index for agricultural laborers (CPI-AL) and of consumer price index for industrial workers (CPI-IW) was 3 per cent and 5 per cent, respectively. Data for CPI-AL for the first nine months of 2005-06, indicated that inflation in CPI-AL remained below that in CPI-IW for each of the months of the financial year including December 2005. Inflation in both CPI-AL and CPI-IW, after declining to 3.2 per cent and 3.4 per cent respectively – with some minor fluctuations – between April and August, 2005, revealed an upward trend. In December, 2005, inflation in CPI-IW was 5.6 per cent. The upward trend in consumer prices was primarily on account of hardening of retail prices of vegetables and pulses.

Maintaining price stability continued to be one of the main objectives of monetary policy. For achieving this, along with the other objective of providing an enabling environment for higher investment and growth, the policy variables were recalibrated appropriately. While the Bank Rate and the cash reserve ratio (CRR) were kept unchanged during the current year at 6.0 per cent and 5.0 per cent, respectively, the fixed reverse repo rate under the Liquidity Adjustment Facility (LAF) of the Reserve Bank of India (RBI) was raised three times by 25 basis points each, to reach 5.50 per cent on January 24, 2006. With the given spread of 100 basis points, the repo rate is pegged at 6.50 per cent since January 24, 2006. RBI’s policy response was in line with the cautious approach in many other countries of moving policy interest rates in a measured way in the face of the threat of inflationary expectations firming up with high crude oil prices.

Growth in broad money (M3) of 12.2 per cent at end-March 2005 was lower than both the 14.0 per cent projected by the RBI in its Annual Policy Statement for
2004-05 and 16.7 per cent observed at end-March 2004. Furthermore, during 2004-05, relative to the previous year, growth in sources of M3 displayed some diversity with net domestic credit growing faster (13.3 per cent compared to 11.7 per cent during 2003-04) and net foreign exchange assets (NFA) of the banking sector growing slower (23.3 per cent compared to 33.7 per cent during 2003-04). Much of the net domestic credit expansion in 2004-05 was from growth in bank credit to the commercial sector (22.8 per cent) while net bank credit to government increased by only 0.4 per cent. Relative to end-March 2005, on January 20, 2006, M3 was up by 13.2 per cent compared to 9.2 per cent observed in the corresponding period of the previous year.

The year-on-year growth of M3 at 16.4 per cent on January 20, 2006 was not only higher than the projected 14.5 per cent in RBI’s Annual Policy Statement for 2005-06, but also higher than the rate observed a year ago. Price stability despite a rapid increase in money supply during the current year testified to the Investment-driven nature of the credit growth and stability of inflation expectations based on confidence in the appropriate stance of monetary and fiscal policies.

The money-multiplier (the ratio of M3 to reserve money, M0) rose steadily from 4.59 at end-March 2004 to 4.61 at end-March 2005 and further to 4.77 on January 20, 2006. This reflected a decline in the reserve-deposit ratio for example, from 0.064 to 0.061 between January 21, 2005 and January 20, 2006.

Consequently, growth in reserve money (M0) was slightly slower than that of M3. Furthermore, M0 growth had also decelerated from 18.3 per cent at end-March 2004 to 12.1 per cent at end-March 2005. Continuing the deceleration observed in the previous year, in the current financial year, on January 20, 2006, M0 growth was 14.9 per cent compared to 15.3 per cent observed on the corresponding date of the previous year. The growth of NFA of the RBI dominated the evolution of M0 in 2004-05.

In 2004-05, a part of this growth in NFA had to be sterilized by recourse to the Market Stabilization Scheme (MSS) and Liquidity Adjustment Facility (LAF) and a resultant decline in net domestic assets (NDA) of the RBI. The call money rates followed an upward trend to reach 4.94 per cent on April 30, 2005, when the fixed reverse-repo rate was raised by 25 basis points to 5.0 per cent. Call rates remained
under pressure to reach 7.71 per cent on January 27, 2006, but moderated to 6.88 per cent on February 16, 2006.

In 2004-05, rising interest rates had an adverse effect on bond prices and reduced treasury profits of banks. SCBs’ total income during 2004-05 grew at a slower rate of 1.5 per cent than 6.7 per cent observed in 2003-04. Furthermore, with credit growing faster than deposits, recourse to funding sources like borrowing increased.

The sharp rise in current account deficit reflected the burgeoning trade deficit during the year. Net invisibles increased, but were not enough to neutralize the expanding trade deficit. In April-September 2005, while the capital account surplus at US$19.5 billion remained higher than the current account deficit of US$13.0 billion, there was a slowdown in reserve accretion on BOP basis.

The increasing trend in gross domestic savings as a proportion of GDP observed since 2001-02 continued, according to the new series of national accounts, with the savings ratio rising from 26.5 per cent in 2002-03 to 28.9 per cent in 2003-04 and further to 29.1 per cent in 2004-05. In 2004-05, the rise in the savings rate was contributed by two of its three components: namely public and corporate savings. The third component, namely household savings, grew at 5.9 per cent – slower than the GDP growth rate – and made a negative contribution by coming down as a proportion of GDP. While consumption expenditure, when measured as a proportion of GDP, exhibited a declining trend both in public and private consumption categories, such expenditure continued to dominate the demand side of national income. As a proportion of GDP at current prices, Government final consumption expenditure (GFCE) declined from 12.9 per cent in 1999-2000 to 11.2 per cent in 2003-04. The proportion is estimated to have grown marginally to 11.3 per cent in 2004-05.

In line with the rise in the rate of gross domestic savings in 2002-03 and 2003-04, there was an increase in the rate of GDCF or investment. However, the increase in GDCF was less than the increase in savings, leading to a current account surplus in BOP, as a proportion of GDP, of 1.2 per cent and 1.6 per cent, respectively. In 2004-05, reflecting the pick up in investment in the economy, GDCF increased by 2.9 percentage points of GDP, surpassing the 0.2 percentage point increase in the ratio of gross
domestic savings to GDP. A current account deficit in BOP of 0.8 per cent of GDP largely bridged the savings-investment gap. Gross domestic investment grew from 27.2 per cent in 2003-04 to 30.1 per cent in 2004-05, mainly on account of private investment growing at 19.7 per cent.

4.16. MONETARY POLICY 2006-07

Vigorous growth with strong macroeconomic fundamentals has characterized developments in the Indian economy in 2006-07. However, there are some genuine concerns on the inflation front. Growth of 9.0 per cent and 9.2 per cent in 2005-06 and 2006-07, respectively, by most accounts, surpassed expectations. While the up-and-down pattern in agriculture continued with growth estimated at 6.0 per cent and 2.7 per cent in the two recent years, and services maintained its vigorous growth performance, there were distinct signs of sustained improvements on the industrial front. The overall macroeconomic fundamentals are robust, particularly with tangible progress towards fiscal consolidation and a strong balance of payments position.

The advance estimates (AE) of gross domestic product (GDP) for 2006-07, released by the Central Statistical Organization (CSO) on February 7, 2007, placed the growth of GDP at factor cost at constant (1999-2000) prices in the current year at 9.2 per cent. But it reached at 9.7% during the year. In 2006-07, while the share of agriculture in GDP declined to 18.5 per cent, the share of industry and services improved to 26.4 per cent and 55.1 per cent, respectively.

A notable feature of the current growth phase is the sharp rise in the rate of investment in the economy. Investment, in general being a forward looking variable, reflects a high degree of business optimism.

As much as 39.4 per cent of the overall inflation in WPI on February 3, 2007 came from the primary group of commodities. Within the primary group, the mineral subgroup recorded the highest year-on-year inflation at 18.2 per cent, followed by food articles at 12.2 per cent and non-food articles at 12.0 per cent. Food articles have a high weight of 15.4 per cent in the WPI basket. However, average inflation in the 52 weeks ending on February 3, 2007 remained at 5 per cent.
Inflation, with its roots in supply-side factors, was accompanied by buoyant growth of money and credit in 2005-06 and 2006-07. While GDP growth accelerated from 7.5 per cent to 9.0 per cent between 2004-05 and 2005-06, the corresponding acceleration in growth of broad money (M3) was from 12.3 per cent to 17.0 per cent. Year-on-year, M3 grew by 21.1 per cent on January 19, 2007. The industrial resurgence and upswing in investment was reflected in, and sustained by, growth of gross bank credit (as per data covering 90 per cent of credit by scheduled commercial banks), for example, to industry (Medium and large) at 31.6 per cent and for housing loans at 38.0 per cent in 2005-06. It was also observed in year-on-year growth of gross bank credit at 32.0 per cent in September 2006.

Reconciling the twin needs of facilitating credit for growth on the one hand and containing liquidity to tame inflation on the other remained a challenge. Liquidity conditions remained fairly comfortable up to early September 2006 with the unwinding of the Central Government surplus balances with the RBI and continued intervention in the foreign exchange market to maintain orderly conditions. During 2006-07, up to September 8, 2006, RBI had not received any bid for repo under Liquidity Adjustment Facility (LAF) and the continuous flow of funds under reverse-repo indicated a comfortable liquidity position.

From mid-September through October, 2006, while RBI had to provide accommodation to some banks through repo facility, with reverse repo operations simultaneously, in net terms, RBI absorbed liquidity from the system. With year-on-year inflation stubbornly above 5 per cent from early-August 2006, on October 31, 2006, the RBI announced more measures to stem inflationary expectations and also to contain the credit off-take at the desired growth rate of 20.0 per cent. Unlike the previous four times, when both the repo and the reverse repo rates were raised by the same 25 basis points, thereby keeping their spread constant at 100 basis points, on October 31, 2006, only the repo rate was raised by 25 basis points. With a repeat of this policy move on January 31, 2007, the repo rate reached 7.50 per cent with a spread of 150 basis points over the reverse repo rate. Since deposits are growing at a lower rate than credit, the higher repo rate signaled to the banks the higher price of accommodation they would have to pay in case of credit overextension.
The cash reserve ratio (CRR) was hiked by 25 basis points each time on December 23, 2006 (5.25 per cent) and January 6, 2007 (5.50 per cent). While a further increase of CRR of 25 basis points was effective on February 17, another similar increase of 25 basis points followed on March 3, 2007. Sustained faster growth of M3 relative to that of reserve money (M0) observed in recent years continued in 2005-06 and 2006-07 with the money multiplier steadily increasing from 4.76 at end-March 2006 and to 4.79 on January 19, 2007. The increase in money multiplier coincided with fast growth of M0 at 17.2 per cent during 2005-06 and year-on-year at 20.0 per cent on January 19, 2007 and resulted in the rapid growth of M3.

The growth of NFA between end-March 2006 and January 19, 2007 was Rs. 114,338 crore. Liquidity in the system continued to be addressed by Market Stabilization Scheme (MSS) operations. The change in the liquidity and inflation environment is reflected in the continuous hardening of interest rates in 2005-06 and in 2006-07. With the high demand for credit not adequately matched by deposit growth, there was steady increase in the credit-deposit ratio and hardening of interest rates. Movements in the call money rates also reveal a similar picture. The hardening of rates was more pronounced at the shorter end of the yield curve, suggesting concerns about inflation only in the short run.

The rapid growth in NFA of the RBI was a reflection of the buoyant flows of foreign exchange reserves through the balance of payments. Reserve accretion through the balance of payments was US$15.1 billion in 2005-06 and US$8.6 billion in the first six months of 2006-07. Foreign exchange reserves grew to US$185.1 billion on February 9, 2007.

The current account deficit reflected the large and growing trade deficit in the last two years. Exports grew fast, but imports grew even faster, reflecting in part the ongoing investment boom and the high international petroleum price. In 2006-07, imports (in US dollar terms and customs basis) had grown by 36.3 per cent. Overall, the external environment remained supportive with the invisible account remaining strong and stable capital flows seamlessly financing the moderate levels of current account deficit caused primarily by the rise in international oil prices.
The increasing trend in gross domestic savings as a proportion of GDP was observed as 32.4 per cent in 2005-06. The rise in the savings rate in 2005-06 was contributed by two of its three components: private corporate and the household sector, which as proportion of GDP, increased by 1.0 percentage point and 0.7 percentage points, respectively. The third component, namely public savings, declined by 0.4 percentage points, and made a negative contribution to the overall savings rate.

In tandem with the rise in the rate of gross domestic savings, there was a step up in the rate of gross domestic capital formation (GDCF) or investment from 28 per cent of GDP to 31.5 per cent of GDP leading to a savingsinvestment gap or a current account deficit of 0.4 per cent of GDP in 2004-05.

GDCF rose further to 33.8 per cent of GDP in 2005-06, widening the saving–investment gap to 1.4 per cent of GDP, with its implications for the current account of the balance of payments.

4.17. MONETARY POLICY 2007-08

The economy has moved decisively to a higher growth phase. The projected economic growth was 8.7 per cent for 2007-08. This represents a deceleration from the unexpectedly high growth of 9.4 per cent and 9.6 per cent, respectively, in the previous two years. With the economy modernizing, globalizing and growing rapidly, some degree of cyclical fluctuation is to be expected. This was taken into account while setting the Eleventh Five Year Plan (2007-08 to 2011-12) growth target of 9 per cent. GDP at current market prices was projected at Rs. 46, 93, 602 crore in 2007-08 by the Central Statistical Organization in its advance Estimates. Per capita income at nominal exchange rate is estimated at US$ 1,021.

Growth in 2006-07 initially estimated at 9.2 per cent in February 2007 was revised upwards to 9.4 per cent and further to 9.6 per cent in the Quick Estimates released by the CSO on January 31, 2008. This suggested that upward adjustments in the 2007-08 projections are possible.

A notable feature of the recent GDP growth has been a sharply rising trend in gross domestic investment and saving, with the former rising by 13.1 per cent of GDP
and the latter by 11.3 per cent of GDP over five years till 2006-07. The average investment ratio for the Tenth Five Year Plan at 31.4 per cent was higher than that for the Ninth Five Year Plan, while the average saving rate was also 31.4 per cent of GDP higher than the average ratio of 23.6 per cent during the Ninth Five Year Plan.

Gross domestic savings as a proportion of GDP continued to improve, rising from 26.4 per cent in 2002-03 to 34.8 per cent in 2006-07 with an average of 31.4 per cent during the Tenth Five Year Plan. The savings-investment gap which remained positive during 2001-04 became negative thereafter. In a modern economy, the excess of domestic saving over domestic investment suggests a deflationary situation in which demand has not kept pace with increased capacity. Thus the reversal of the saving-investment balance should be viewed as a correction of the domestic supply-demand balance, occurring through above normal increase in demand during 2005-06 and 2006-07.

Inflation as measured by the Wholesale Price Index (WPI) rose from 4.4 per cent in 2005-06 to 5.4 per cent in 2006-07 and was expected to return to around 4% in 2007-08. Annual headline inflation was 4.1 per cent on February 2, 2008. The close monitoring of prices and appropriate policy interventions initiated in the previous year helped in maintaining price stability and reducing the impact of increase in global prices on domestic consumers.

The Reserve Bank of India’s monetary policy stance is to serve the twin objectives of managing the transition to a higher growth path and containing inflationary pressures. For policy purposes for 2007-08, the RBI assumed a real GDP growth of 8.5 per cent with inflation close to 5 per cent, and targeted the monetary expansion in the range of 17-17.5 per cent and credit expansion in the range of 20 to 24 per cent as consistent with envisaged growth and inflation.

The cumulative increase in the stock of M3 in 2007-08 has also remained above the cumulative growth in 2006-07 and was 13.3 per cent on January 4, 2008, compared to 12.2 per cent on January 5, 2006. Thus it is difficult to relate either the annual or trend rate of growth of M3 to inflation which has been on a down trend during this period.
The average growth of bank credit to commercial sector (BCCS) also reached a low of 11.8 per cent in 2003-04 and rose in the next two years to 28 per cent in 2005-06. However, in contrast to money supply, average credit growth slowed marginally to 26.8 per cent in 2006-07 and has decelerated further in 2007-08.

Nominal interest rates, as measured by the cut-off yield at auction on 91-day and 364-day Treasury Bills have followed a pattern similar to that of money growth. The average cut-off yield on 364-day (91-day) Treasury Bills reached a trough of 4.7 (4.6) per cent in 2003-04 and has been rising since then. Yields averaged 7 (6.6) per cent. The acceleration in reserve money growth has continued in 2007-08. The expansion in M0 (up to January 4, 2008) was 13.6 per cent compared to 9.1 per cent during the corresponding period of the previous year. The main driver of growth of M0 on financial year as well as on annual basis has continued to be net foreign assets (NFA) of the RBI. NFA of the RBI expanded by 25.2 per cent in this year (39.1 per cent on annual basis) compared to an expansion of 15.9 per cent (26.1 per cent on annual basis) during the same period of the previous year. The share of NFA in the aggregate reserve money increased to 122.2 per cent as on March 31, 2007, as against 117.4 per cent on March 31, 2006. This ratio further increased to 134.7 per cent on January 4, 2008. With the continuing surge in capital flows during 2007-08 and the need to regulate domestic liquidity, the MSS limits were revised upward four times to a level of Rs. 2,50,000 crore during the year.

The higher growth of the monetary variables (M0 and M3), despite the MSS operations, generated higher liquidity in the system. Short-term liquidity variations were addressed by RBI through the Liquidity Adjustment Facility during 2006-07. The doubling of the real interest rate may have had a moderating effect on credit demand and consequently on both inflation and growth. It has also led to a widening of the interest differential between domestic and global rates.

The current account deficit (CAD) mirrors the saving-investment gap in the national income accounts and thus constitutes net utilized foreign savings. The challenge is to leverage foreign inflows (i.e. foreign savings and investment) to promote growth without having the long-term consequences of external payment
imbalances. Thus the challenge for policy is to maximize the benefits while minimizing the costs of exchange rate management.

With the demand for foreign exchange (debit side of BOP) not keeping pace with the supply of foreign exchange (credit side of BOP), the rupee appreciated by 8.9 per cent against the US dollar during the current financial year between April 3, 2007, and February 6, 2008. It even depreciated marginally against the Euro during this financial year.

4.18. MONETARY POLICY 2008-09

Despite the slowdown in growth, investment has remained relatively buoyant, growing at a rate higher than that of GDP. The ratio of fixed investment to GDP consequently increased to 32.2 per cent of GDP in 2008-09 from 31.6 per cent in 2007-08. This reflects the resilience of Indian enterprise, in the face of a massive increase in global uncertainty and risk aversion and freezing of highly developed financial markets.

A noteworthy development during the year was a sharp rise in Wholesale Price Index (WPI) inflation followed by an equally sharp fall, with the WPI inflation falling to unprecedented level of close to zero per cent by March 2009. This was driven largely by the rapid rise and equally rapid fall in global commodity prices during January 2008 to March 2009. Domestic food price inflation, as measured by the WPI food sub-index, though declining, remains much higher than overall inflation.

The global financial meltdown and consequent economic recession in developed economies have clearly been major factor in India’s economic slowdown.

Economic growth decelerated in 2008-09 to 6.7 per cent. This represented a decline of 2.1 per cent from the average growth rate of 8.8 per cent in the previous five years (2003-04 to 2007-08). Per capita GDP growth, a proxy for per capita income, which broadly reflects the improvement in the income of the average person, grew by an estimated 4.6 per cent in 2008-09.

The growth of GDP at factor cost (at constant 1999-2000 prices) at 6.7 per cent in 2008-09 nevertheless represented a deceleration from high growth of 9.0 per cent
and 9.7 per cent in 2007-08 and 2006-07 respectively. The deceleration of growth in 2008-09 was spread across all sectors except mining and quarrying and community, social and personal services. The growth in agriculture and allied activities decelerated from 4.9 per cent in 2007-08 to 1.6 per cent in 2008-09. A notable feature of the growth of the Indian economy from 2002-03 has been the rising trend in the gross domestic capital formation (GDCF). Gross capital formation (GCF), which was 25.2 per cent of the GDP in 2002-03, increased to 39.1 per cent in 2007-08. Much of this increase is attributable to a rise in the rate of investment by the corporate sector.

The growth in capital formation in recent years has been amply supported by a rise in the savings rate. The gross domestic savings as a percentage of GDP at current market prices stood at 37.7 per cent in 2007-08 as compared to 29.8 per cent in 2003-04. Private sector savings dominated the total savings in 2007-08 and were at 33.2 per cent of GDP.

The saving investment gap in the public sector stood at (-) 5.3 per cent in 2003-04 that moderated to (-) 4.6 per cent in 2007-08. This reflected the narrowing gap between public sector capital formation and public sector gross domestic savings. For the household sector the gap has remained more or less constant reflecting no major change in the saving investment balance. In the case of the private corporate sector however, the saving investment gap widened to (-) 7.0 per cent in 2007-08 reflecting the high rate of capital formation over and above their internal savings.

India could not insulate itself from the adverse developments in the international financial markets. The effect on the Indian economy was not significant in the beginning, but, the current account was affected mainly after September 2008 through slowdown in exports. Despite setbacks, however, the BOP situation of the country continues to remain resilient. The global crisis also meant that the economy experienced extreme volatility in terms of fluctuations in stock market prices, exchange rates and inflation levels during a short duration necessitating reversal of policy to deal with emergent situations.

Before the onset of the financial crisis, the main concern of the policymakers was excessive capital inflows, which increased from 3.1 per cent of GDP in 2005-06 to
9.3 per cent in 2007-08. While this led to increase in foreign exchange reserves, it also contributed to monetary expansion, which fuelled liquidity growth. WPI inflation reached a trough of 3.1 per cent in October 2007, a month before global commodity price inflation zoomed to double digits from low single digits. The rising oil and commodity prices, contributed to a significant rise in prices, with annual WPI peaking at 12.8 per cent in August 2008. The monetary policy stance during the first half of 2008-09 was therefore directed at containing the price rise.

The policy stance of the Reserve Bank of India (RBI) in the first half of the year was oriented towards controlling monetary expansion, in view of the apparent link between monetary expansion and inflationary expectations partly due to the perceived liquidity overhang. In the first six months of 2008-09, year-on-year growth of broad money was lower than the growth of reserve money. The Government also took various fiscal and administrative measures during the first half of 2008-09 to rein in inflation. The key policy rates of RBI thus moved to signal a contractionary monetary stance. The repo rate (RR) was increased by 125 basis points in three tranches from 7.75 per cent at the beginning of April 2008 to 9.0 per cent with effect from August 30, 2008. The reverse-repo rate (R-RR) was however left unchanged at 6.0 per cent. The cash reserve ratio (CRR) was increased by 150 basis points in six tranches from 7.50 per cent at the beginning of April 2008 to 9.0 per cent with effect from August 30, 2008.

The surge in the supply of foreign currency in the domestic market led inevitably to a rise in the price of the rupee. The rupee gradually appreciated from Rs. 46.54 per US dollar in August 2006 to Rs. 39.37 in January 2008, a movement that had begun to affect profitability and competitiveness of the export sector. The global financial crisis however reversed the rupee appreciation and after the end of positive shock around January 2008, rupee began a slow decline. The annual average exchange rate during 2008-09 worked out to Rs. 45.99 per US dollar compared to Rs. 40.26 per US dollar in 2007-08. The outflow of foreign exchange, as fallout of crisis, also meant tightening of liquidity situation in the economy. To deal with the liquidity crunch and the virtual freezing of international credit, the monetary stance underwent an abrupt change in the second half of 2008-09. The RBI responded to the emergent situation by
facilitating monetary expansion through decreases in the CRR, repo and reverse repo rates, and the statutory liquidity ratio (SLR).

The repo rate was reduced by 400 basis points in five tranches from 9.0 in August 2008 to 5.0 per cent beginning March 5, 2009. The reverse-repo rate was lowered by 250 basis points in three tranches from 6.0 (as was prevalent in November 2008) to 3.5 per cent from March 5, 2009. The reverse-repo and repo rates were again reduced by 25 basis points each with effect from April 21, 2009. SLR was lowered by 100 basis points from 25 per cent of net demand and time liabilities (NDTL) to 24 per cent with effect from the fortnight beginning November 8, 2008. The CRR was lowered by 400 basis points in four tranches from 9.0 to 5.0 per cent with effect from January 17, 2009. The credit policy measures by the RBI broadly aimed at providing adequate liquidity to compensate for the squeeze emanating from foreign financial markets and improving foreign exchange liquidity. These measures were supplemented by sector-specific credit measures for exports, housing, micro and small enterprises and infrastructure. The monetary measures had a salutatory effect on the liquidity situation. The weighted average call money market rate, which had crossed the LAF corridor at several instances during the first half of 2008-09, remained within the LAF corridor after October 2008. Since mid-2008-09, the growth in reserve money decelerated after September 2008. The deceleration in M0 was largely on account of the decline in net foreign exchange assets (NFA) of RBI (a major determinant of reserve money growth) due to reduced capital inflows. On the other hand, the net domestic credit (NDC) of the RBI expanded due to an increase in net RBI credit to the Central Government in the second half of the year. Taking the year as whole, broad money (M3) recorded an increase of 18.4 per cent during 2008-09, as against 21.2 per cent in 2007-08.

The money multiplier, which is the ratio of M3 to M0, was 4.3 in end-March 2008. The demand for bank credit increased sharply during April-October 2008 as companies found that external sources of credit were drying up in the wake of the global financial crisis. There was also a sharp increase in credit to oil marketing companies. However, towards the latter part of 2008-09, credit growth declined abruptly reflecting the slowdown of the economy in general and the industrial sector in particular. On a full year basis, bank credit growth fell from 22.3 per cent in 2007-08
to 17.3 per cent in 2008-09. Having regard to the structural rigidities associated with the money market, it was observed that the average PLR did not show much variation. From 12.5 per cent in April 2008, it increased to 13.9 per cent in September 2008 and thereafter declined to 12.0 per cent in March 2009.

The overall balance of payments situation remained resilient in 2008-09 despite signs of strain in the capital and current accounts, due to the global crisis. The average WPI inflation for 2008-09 was 8.4 per cent as against 4.7 per cent in 2007-08. There has also been significant variation in inflation rate in terms of WPI and the Consumer Price Indices (CPIs). Inflation rate as per Consumer Price Index for Rural Laborers (CPI-RL) was 9.7 per cent and on CPI for Industrial Workers (CPI-IW) was 8 per cent as of end-March 2009. The average inflation on CPI-RL and CPI-IW for the year 2008-09 was 10.2 and 9.1 per cent, respectively. The implicit deflator for GDPMP defined as the ratio of GDP at current prices to GDP at constant prices is the most comprehensive measure of inflation on an annual basis. Overall inflation, as measured by the aggregate deflator for GDPMP, declined from 5.0 per cent in 2006-07 to 4.9 per cent in 2007-08 and is estimated at 6.2 per cent in 2008-09 as a result of the higher inflation experienced during most of the year.

4.19. MONETARY POLICY 2009-10

The fiscal year 2009-10 began as a difficult one. There was a significant slowdown in the growth rate in the second half of 2008-09, following the financial crisis that began in the industrialized nations in 2007 and spread to the real economy across the world. The growth rate of the gross domestic product (GDP) in 2008-09 was 6.7 per cent, with growth in the last two quarters hovering around 6 per cent. There was apprehension that this trend would persist for some time, as the full impact of the economic slowdown in the developed world worked through the system. It was also a year of reckoning for the policymakers, who had taken a calculated risk in providing substantial fiscal expansion to counter the negative fallout of the global slowdown. Inevitably, India’s fiscal deficit increased from the end of 2007-08, reaching 6.8 per cent (budget estimate, BE) of GDP in 2009-10. A delayed and severely subnormal monsoon added to the overall uncertainty. The continued recession in the developed
world, for the better part of 2009-10, meant a sluggish export recovery and a slowdown in financial flows into the economy. Yet, over the span of the year, the economy posted a remarkable recovery, not only in terms of overall growth figures but, more importantly, in terms of certain fundamentals, which justify optimism for the Indian economy in the medium to long term.

The advance estimate of GDP growth at 7.2 per cent for 2009-10, falls within the range of 7 +/- 0.75 projected nearly a year ago in the Economic Survey 2008-09. With the downside risk to growth due to the delayed and sub-normal monsoons having been contained to a large extent, through the likelihood of a better-than-average Rabi agricultural season, the economy has responded well to the policy measures undertaken in the wake of the global financial crisis. While the GDP at factor costs at constant 2004-05 prices, is placed at Rs 44,53,064 crore, the GDP at market prices, at constant prices, is estimated at Rs 47,67,142 crore. The corresponding figures at current prices are Rs 57,91,268 crore and Rs 61,64,178 crore respectively. It is worthwhile to note here that the growth rates of GDP at market prices, at constant 2004-05 prices, in 2008-09 and 2009-10 at 5.1 per cent and 6.8 per cent have been considerably lower than the growth rates of GDP at factor cost. This is due to the significant decline in net indirect taxes (i.e. indirect taxes minus subsidies) in the said years on account of the fiscal stimulus implemented by the Government, which included tax relief to boost demand and increase in the expenditure on subsidies.

The recovery in GDP growth for 2009-10, as indicated in the advance estimates, is broad based. Seven out of eight sectors/sub-sectors show a growth rate of 6.5 per cent or higher. The exception, as anticipated, is agriculture and allied sectors where the growth rate is estimated to be minus 0.2 per cent over 2008-09. Sectors including mining and quarrying; manufacturing; and electricity, gas and water supply have significantly improved their growth rates at over 8 per cent in comparison with 2008-09. The construction sector and trade, hotels, transport and communication have also improved their growth rates over the preceding year, though to a lesser extent. However, the growth rate of community, social and personal services has declined significantly, though it continues to be around its pre-global crisis medium-term trend growth rate.
Financing, insurance, real estate and business services have retained their growth momentum at around 10 per cent in 2009-10. In terms of sectored shares, the share of agriculture and allied sectors in GDP at factor cost has declined gradually from 18.9 per cent in 2004-05 to 14.6 per cent in 2009-10.

During the same period, the share of industry has remained the same at about 28 per cent, while that of services has gone up from 53.2 per cent in 2004-05 to 57.2 per cent in 2009-10.

The growth rates in per capita income and consumption, which are gross measures of welfare in general, have declined in the last two years. This is a reflection of the slowdown in the overall GDP growth. While the growth in per capita income, measured in terms of GDP at constant market prices, has declined from a high of 8.1 per cent in 2007-08 to 3.7 per cent in 2008-09 and then recovered to 5.3 per cent in 2009-10, per capita consumption growth as captured in the private final consumption expenditure (PFCE) shows a declining trend since 2007-08 with its growth rate in 2009-10 falling to one third of that in 2007-08. The rate of Gross domestic savings (GDS) on the new series increased from 32.2 per cent in 2004-05 to 36.4 per cent in 2007-08 before declining to 32.5 per cent in 2009-10.

The year-on-year WPI inflation rate has been fairly volatile in 2009-10. It was 1.2 per cent in March 2009 and then declined continuously to become negative during June-August 2009, assisted in part by the large statistical base effect from the previous year. It turned positive in September 2009 and accelerated to 4.8 per cent in November 2009 and further to 7.3 per cent in December 2009. For the fiscal year so far (March over December 2009) WPI inflation is estimated at 8 per cent.

The recent period has witnessed significant divergence in the WPI and CPI inflation rates, principally on account of the larger weights assigned to the food basket in the CPIs and due to the fact that retail prices are relatively sticky downwards. Thus, due to the sharp increase in essential commodity prices, while all the four CPIs remained elevated since March 2008, rising gradually from about 7 to 8 per cent (month-on-month) to around 15 to 17 per cent in December 2009, WPI inflation first
went up from around 8 per cent to 13 per cent, then turned negative during June to August 2009 before rising again to over 7 per cent in December 2009.

As measured by the aggregate deflator for GDPMP, inflation has been estimated at 3.6 per cent in 2009-10 as per the advance estimates. Consumer inflation, as measured by the deflator for the PFCE, is estimated at 6.4 per cent in 2009-10, as per the advance estimates. The global economy, led by the Asian economies especially China and India, has shown signs of recovery in fiscal 2009-10. While global trade is gradually picking up, the other indicators of economic activity such as capital flows, assets and commodity prices are more buoyant. However, there has been improvement in the balance of payments situation during 2009-10 over 2008-09, reflecting higher net capital inflows and lower trade deficit.

Since the outbreak of the global financial crisis in September 2008, the RBI has followed an accommodative monetary policy. In the course of 2009-10, this stance was principally geared towards supporting early recovery of the growth momentum, while facilitating the unprecedented borrowing requirement of the Government to fund its fiscal deficit. The fact that the latter was managed well with nearly two-thirds of the borrowing being completed in the first half of the fiscal year not only helped in checking undue pressure on interest rates, but also created the space for the revival of private investment demand in the second half of the year.

The transmission of monetary policy measures continues to be sluggish and differential in its impact across various segments of the financial markets.

The downward revisions in policy rates announced by the RBI post-September 2008 got transmitted into the money and G-Sec markets; however, the transmission has been slow and lagged in the case of the credit market. Though lending rates of all categories of banks (public, private and foreign) declined marginally from March 2009 (with benchmark prime lending rates [BPLR] of scheduled commercial banks [SCBs] having declined by 25 to 100 basis points), the decline was not sufficient to accelerate the demand for bank credit. Consequently, while borrowers have turned to alternate sources of possibly cheaper finance to meet their funding needs, banks flush with liquidity parked their surplus funds under the reverse repo window.
There has been continuous moderation in the growth in broad money (M3) from around 21 per cent at the beginning of the fiscal year to 16.5 per cent as of mid-January 2010 and it has remained below the indicated growth projection for the period. While in the first half of the year, credit to the Government remained the key driver of money growth, since the third quarter of 2009-10 that too has moderated.

Demand for bank credit/non-food credit remained muted during 2009-10. It was only from November 2009 that some signs of pick-up became evident. On financial-year basis, growth in non-food credit remained negative till June 2009. It is also noteworthy that growth in aggregate deposits has remained higher than the growth in bank credit during 2009-10. The lower expansion in credit relative to the significant expansion in deposits during 2009-10 has resulted in a decline in the credit-deposit ratio from 72.4 in end March 2009 to 70.8 in mid-January 2010, though with some signs of revival since December 2009.

Growth in sectored deployment of gross bank credit on a year-on-year basis (as on November 20, 2009) shows that retail credit has not picked up during 2009-10. While growth in credit to agriculture remained more or less the same as on the corresponding date of the preceding year, for the other broad sectors—industry, personal loans and services—growth in credit decelerated as compared to the corresponding period of the preceding year. The contribution of non-bank credit sources increased from 52 per cent in 2008-09 to nearly 61 per cent in 2009-10. This increase in flow of funds from non-banking sources was both from domestic and foreign sources and is indicative of structural rigidities that affect the monetary transmission mechanism particularly in respect of the credit markets.

A major concern was regarding the possibility of a rise in unemployment due to the slowdown of the economy. On the whole, for the period October 2008 to September 2009, there may have been a net addition of 1.51 lakh jobs in the different sectors. Under the NREGA, which is a major rural employment initiative, during the year 2009-10, 4.34 crore households have been provided employment so far.
This is only a brief report of the major monetary measures during the period of our study, i.e. from 1991 to 2010. Now, we can have a look into its policy implementations in detail in the ensuing chapters.

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