

Prices and Monetary Management

4

CHAPTER

As the world economy has begun to stabilize in the aftermath of the global crisis, inflation has re-emerged as a major concern particularly in the fast-recovering developing economies. At present, the major pressure on prices is emanating from the food and energy sectors both at global and domestic levels. However, the risk of its slippage into the core sector has increased and needs to be mitigated proactively. Notwithstanding slow recovery in the advanced economies, international commodities particularly, oil, food, industrial inputs, and metals have witnessed rising prices towards the end of 2010. International crude prices also briefly crossed US\$ 90 a barrel in the wake of an unusually cold winter, putting pressures on the Government to take a relook at domestic fuel prices. The renewed inflationary pressure became evident in December 2010 as headline wholesale price index (WPI) inflation increased to 8.4 per cent from 8.1 per cent in November 2010. However, in January 2011 it has moderated to 8.2 per cent. In addition to fuel, metal and mineral prices are also putting pressure on the domestic economy. Food inflation in particular has remained stubbornly in double digits for over a year now, which has welfare costs. There is need to remain cautious and be prepared to take proactive steps as the emerging scenario warrants, with the objective of bringing down inflation. Going forward, inflation is likely to moderate in line with the monetary tightening measures taken by the Reserve Bank of India and other steps taken by the Government to address the supply-side bottlenecks.

PRICES

Main features of the new WPI series

4.2 A new WPI series with 2004-05 base was released on 14 September 2010. A representative commodity basket comprising 676 items has been selected and weighting diagram derived for the new series. The total number of price quotations has also increased from 1918 in the old series to 5482 in the new series, indicating better representation of the prices in the wholesale markets. Sector-wise price quotations have increased from the old to new series from 455 to 579 in primary group and from 1391 to 4831 in the manufactured products group. A comparison of the weighting diagram and number of commodities between the old and new series for the major groups is drawn in Table 4.1.

4.3 Some of the important items included in the new series basket are flowers, lemons, and crude petroleum in primary articles and ice cream, canned meat, palm oil, readymade/instant food powder, mineral water, computer stationery, leather products, scooter / motorcycle tyres, polymers, petrochemical intermediates, granite, marble, gold and silver, construction machinery, refrigerators, computers, dish antenna, transformers, microwave ovens, communication equipment (telephone instruments), TV sets, VCDs, washing machines, and auto parts in manufactured products.

General wholesale price situation

4.4 During the first half of 2009-10, the headline year-on-year inflation remained significantly low at 0.36 per cent on account of sharp increases in prices recorded in 2008-09. The second half of 2009-10

Table 4.1 : Major Changes in the Weights and Commodities in the Revised WPI Series

Items	Weights		No. of Commodities		
	New Series (base: 2004-05)	Old Series (base: 1993-94)	New Series (base: 2004-05)	Old Series (base: 1993-94)	New Items Added/ Revised
All Commodities	100.00	100.00	676	435	417
Primary Articles	20.12	22.03	102	98	11
Food Articles	14.34	15.40	55	54	1
Non-Food & Minerals	5.78	6.63	47	44	10
Fuel and Power	14.91	14.23	19	19	0
Manufactured Products	64.97	63.75	555	318	406
Food Products	9.97	11.54	57	41	25
Non-Food Products	55.00	52.21	498	277	381

Source : The Office of the Economic Adviser, Ministry of Commerce and Industry.

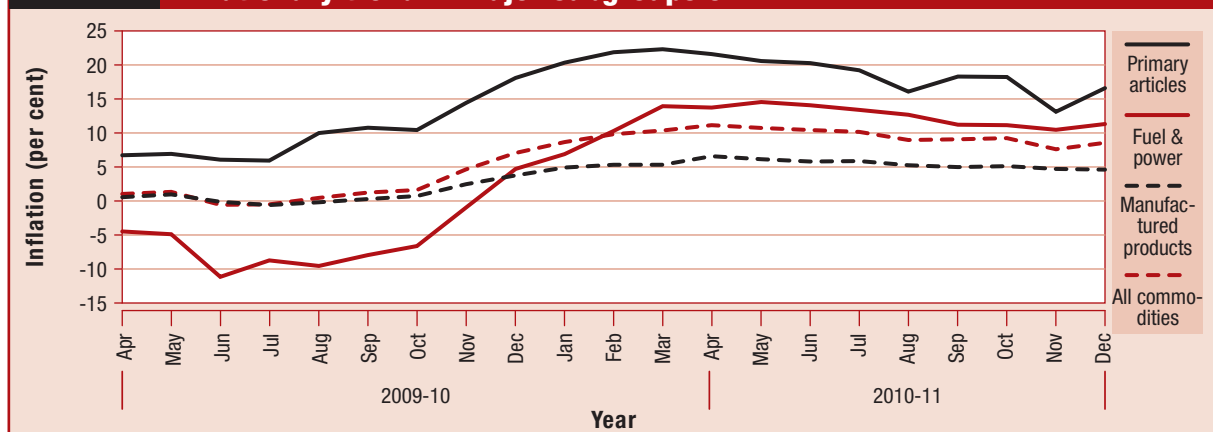
showed increasing food prices on account of unfavourable agricultural supply conditions coupled with the waning of base effect, leading to sharp increase in inflation. Thereafter, the headline WPI inflation reached 10.23 per cent in March 2010.

4.5 Financial year 2010-11 started with 11 per cent headline inflation in April 2010. During 2010-11, the monsoon situation has been better than last year. As per the Second Advance Estimates, production of foodgrains in 2010-11 is likely to be 232.07 million tonnes as compared to 218.11 million tonnes last year. However, demand pressures became visible in early 2010.

4.6 At disaggregate level, the price behaviour of three major commodities groups has been in marked contrast to the previous year when inflation remained low on account of global decline in commodity prices. From March to July 2010, headline inflation remained in double digits. The major contributors to this were primary articles

whose inflation hovered in the range of 14.7 per cent to 21.5 per cent and fuel which recorded inflation in the range of 10.3 per cent to 14.4 per cent. However, the inflation in manufactured products remained in the lower range of 4.5 to 6.4 per cent during the current year (Figure 4.1).

4.7 The Government is committed to ensuring availability of cooking fuels to the common man at affordable prices. In view of the importance of household fuels, namely kerosene and domestic liquefied petroleum gas (LPG), the Government has decided that the subsidies on these products will be continued. The PDS Kerosene and Domestic LPG Subsidy Scheme 2002 as well as the Freight Subsidy (for Far-flung Areas) Scheme 2002 have been extended till 31 March 2014. However, in order to reduce the burden of under-recoveries, it has been decided to increase the retail price of public distribution system (PDS) Kerosene by ₹ 3 per litre and of domestic LPG by ₹35 per cylinder, at Delhi, with corresponding increases in other parts

Figure 4.1 Inflationary trend in major subgroups of WPI

of the country. Prices of petrol and diesel, both at the refinery gate and retail level, will be market determined. However, it is proposed that increase in prices of diesel will be staggered over time to minimize the overall impact on the poor and vulnerable. It has also been decided that in case of a high rise and volatility in international oil prices, Government will suitably intervene in the pricing of petrol and diesel.

Average trends in WPI inflation

4.8 The ten-year average of headline WPI inflation was around 5.3 per cent from 2000-01 to 2009-10; in this decade 2000-01, 2003-04, 2004-05, 2006-07, and 2008-09 had higher inflation relative to the decadal average. In the current financial year, the average inflation (April–December 2010) of 9.4 per cent was also much higher than the decadal rate. The ten-year average inflation in fuel was around 8.9 per cent. The major portion of that was contributed by the high inflation of 2000-01. The years 2003-04, 2004-05, 2006-07, and 2008-09 also witnessed high inflation in manufactured products mainly on account of high prices of raw materials such as basic metal alloys and metal products, non-metallic mineral products, and machinery and machine tools. The year 2008-09 was different from the previous three years as inflation in all the three sectors remained high on account of high international fuel and commodity prices. The year 2009-10 was an abnormal one due to global slowdown and unfavourable monsoon. Notwithstanding, the average inflation was 3.6 per cent backed by negative inflation in fuel. In the current financial year (2010-11), overall average inflation from April-December 2010 at 9.4 per cent, is the highest recorded in the last ten years (Table 4.2).

Food Inflation in WPI

4.9 The food index consists of two sub components, namely primary food articles and manufactured food products. The overall weight of the composite food index in the WPI is 24.31 per cent, comprising primary food articles with a weight of 14.34 per cent and manufactured food products with a weight of 9.97 per cent. A major concern in the domestic economy has been a sharp rise in food price inflation during the year 2010-11. The WPI food inflation has moderated to 8.59 per cent in December 2010 after reaching its peak of 20.22 per cent in February 2010. Of its two components, primary food price inflation touched a historic high

Table 4.2 : Annual Average Inflation Rate-based on WPI

(per cent)				
Year	Primary Articles	Fuel & Power	Manufactured Products	All Commodities
Weights(%)	20.12	14.91	64.97	100
2000-01	2.8	28.5	3.3	7.2
2001-02	3.6	8.9	1.8	3.6
2002-03	3.3	5.5	2.6	3.4
2003-04	4.3	6.4	5.7	5.5
2004-05	3.7	10.1	6.3	6.5
1st 5 Years'				
Average	3.5	11.9	3.9	5.2
2005-06	4.3	13.5	2.3	4.3
2006-07	9.6	6.5	5.6	6.5
2007-08	8.3	0.0	4.9	4.8
2008-09	11.0	11.6	6.2	8.0
2009-10	12.7	-2.1	1.8	3.6
2nd 5 Years'				
Average	9.2	5.9	4.1	5.5
Decadal				
Average	6.4	8.9	4.0	5.3
2009-10				
(Apr.-Dec.)	9.8	-5.8	0.7	1.7
2010-11				
(Apr.-Dec.)P	18.0	12.3	5.3	9.4

Source: The Office of the Economic Adviser, Ministry of Commerce and Industry.

Note: P—Provisional

in the revised series at 21.9 per cent in February 2010, thereafter declining to 9.4 per cent in November 2010 and once again rising to 13.6 per cent in December 2010 (Table 4.3). However, manufactured food products exhibited a decline in inflation from 19.3 per cent in December 2009 to 0.4 per cent in December 2010. Among food items, sharp rise in prices was observed in onions, fruits, eggs, meat and fish, and milk. The prices of foodgrains, however, remained low on the back of good monsoons with a year-on-year inflation of -2.6 per cent in December 2010.

Main drivers of food inflation

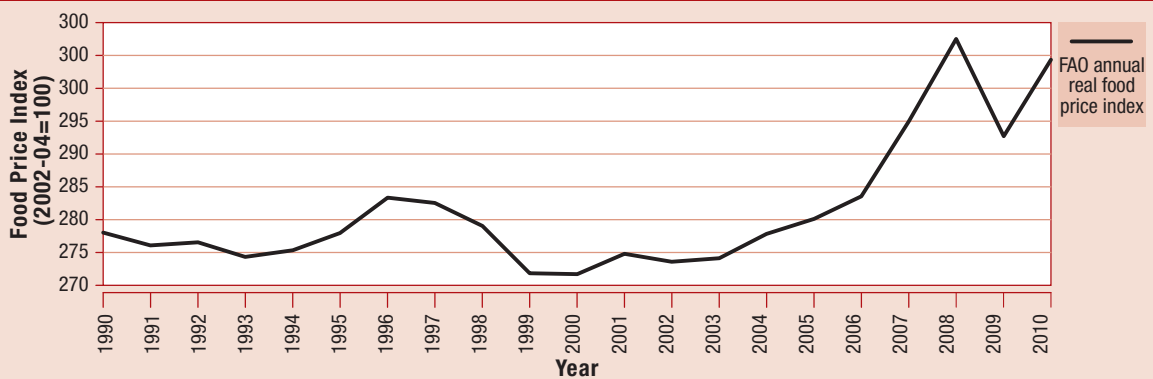
4.10 In 2010-11, inflation in primary food articles was mainly driven by rice, vegetables, potatoes, onions, fruits, milk, eggs, meat and fish, condiments and spices, and tea. However, the WPI of manufactured food products with 2004-05 base is in the comfortable zone. It was 142.7 in December 2010 as against 142.2 in December 2009. This has marginally increased due to vanaspati oil, groundnut oil, sunflower oil, rice bran extraction,

Box 4.1: An Unexpected Surge in Food Inflation

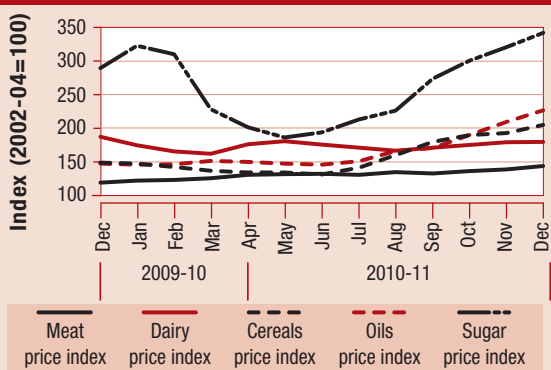
Food inflation has been unexpectedly high in recent weeks – driven by surging prices of vegetables, fruits, dairy, oilseeds, and spices. It was unexpected because good rainfall in 2010 was expected to bring down prices. It did: for cereals (wheat, rice) and pulses, which together provide most of the energy and protein intake of households in India, especially of the poor. But the surging prices of other foods caused the overall food inflation to rise. Given the critical importance of food in India’s setting – with high rates of malnutrition and household food spending accounting for above 40 per cent of total household expenditure (versus some 7-8 per cent in richer countries) – we disentangle in this Box the relative importance of some competing and popular sets of explanations or factors.

(1) Rising International Prices – Demand-Supply Shocks or Generalized Commodity Surge? There was a sudden surge in global food prices in 2006-08, which subsequently crashed with the global financial crisis. Prices, however, again started surging since late 2009, and have now surpassed the 2008 peak – led by sugar, oils and fats, and cereals (but not dairy and meat). What is driving this global increase? A July 2010 study (Baffes and Hanjotis) looking at the previous 2006-08 price rise provides evidence that it was due to a generalized commodity price rise, especially in oil, itself caused by a world awash with liquidity and a falling dollar. It also provides evidence that it was not, as popular explanations would have us believe, because of (1) rising demand in emerging markets (such as China and India); (2) a shift to biofuels; and (3) a trend rise (because price variability dominates any trend). Nevertheless, the previous 53 per cent fall in real food prices between 1975 and 2001 was probably overdone and some adjustment was inevitable. The 2009-10 price resurgence is very similar. Everything from a poor summer wheat harvest in Russia to the recent Australian floods, dry spell in Argentina, Indonesian flooding, poor US maize yields, and rising demand in China and India is being blamed – but sudden price rises of this magnitude across such a variety of food products are difficult to attribute to any specific supply or demand problem except in the context of a generalized commodity price surge (whose solutions lie elsewhere).

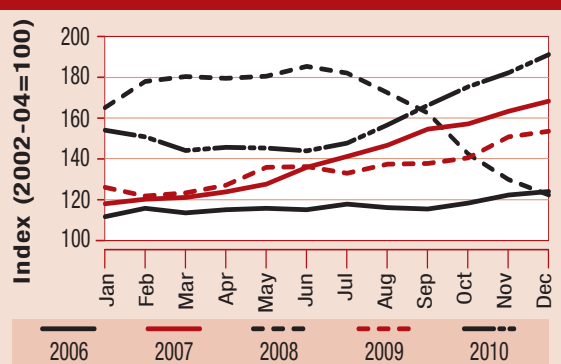
FAO Annual Real Food Price Index



Food Commodity Price Indices



FAO Food Price Index



(2) Is India buffeted by rising international prices? While some spillovers of global prices to Indian markets are inevitable, world trade in agriculture is often very thin, with large trade restriction and tariff wedges between domestic and international prices. While domestic food prices cannot be fully insulated from global ones, local markets do differ,

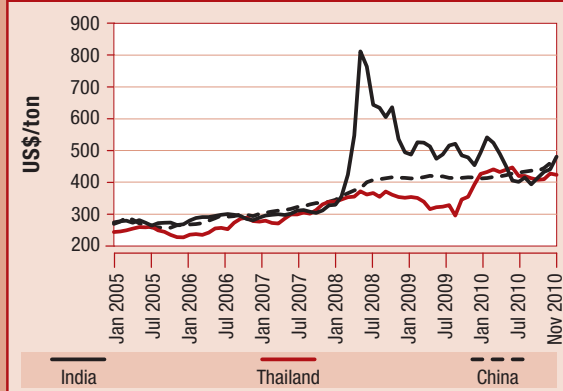
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(Box 4.1 Continued)

Wholesale price of wheat, India and Brazil



Wholesale price of rice: India, Thailand and China

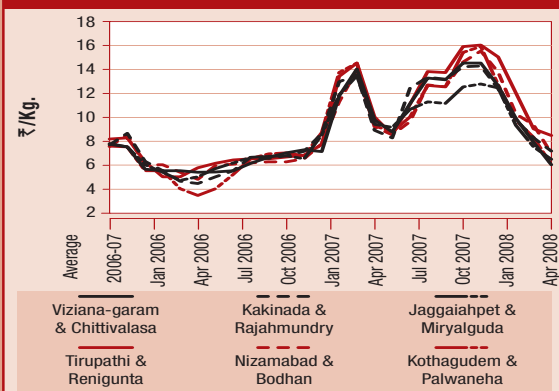


the volatility of global prices is far greater than that of domestic prices, and India's prices have been much more stable, avoiding the highs and lows. Indeed, recent cereals prices have been declining in India relative to global ones.

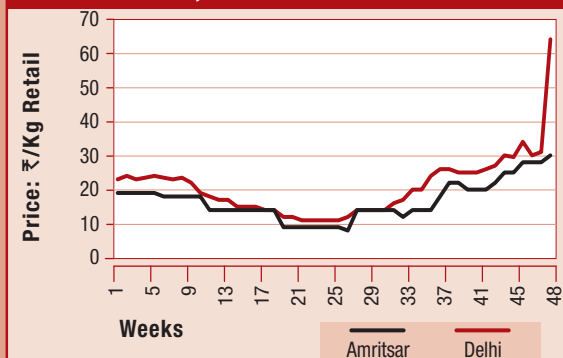
(3) So, what caused the unexpected surge in non-cereal prices? Fundamentals versus uncompetitive markets.

One popular explanation for suddenly rising prices of vegetables, spices, dairy, and similar products is rising incomes in India driving prices higher, as consumers are presumed to be shifting from low-value products to higher value ones (consistent with Engel's Law). While this may certainly be true as a general demand-side explanation, it merits deeper examination because of two other factors: (1) the sudden spike in prices; and (2) the generally high supply elasticities in such products that should prevent this. Instead, consistent with what is evident globally, when some unexpected supply or demand shocks happen, it is often easier for commodity prices to spike temporarily—unrelated to fundamentals and driven sometimes by local cartelization or other conditions such as sudden flows of speculative capital into thin commodity futures markets. The case of onion prices is a good example of the former, and spices of the latter. Onion prices surged from Rs 15 per kg to over Rs 80 per kg over a matter of weeks, attributed popularly to the effects of extended rainfall and damaged crop in Nashik. However, onions are in fact grown all over India, and the all-India market is generally well-behaved and competitive—in that local prices converge to national ones. However, in the presence of unanticipated supply or demand shocks, local onion markets do fragment and become much more 'ill-behaved' and it is possible to observe sudden temporary spikes and divergence that is more consistent with local cartelization conditions, supported by cascading entry barriers along the supply chain (including the restrictions of the Agricultural Produce Marketing Act [APMC] and the restrictions and fees at mandis). Fundamentals, however, catch up, as evident in onion prices crashing in recent weeks to about Rs. 25/kg at the retail level and even lower at wholesale market. Similar conditions apply in commodity exchanges where sudden speculative activity can drive futures prices temporarily higher—until supplies and fundamentals bring spot and hence futures prices back to reality. Even vegetable prices (such as tomatoes), which had risen dramatically, are easing back, as supply catches up.

"Well behaved" and convergent regional series of onion retail prices, Andhra Pradesh, 2006-2008

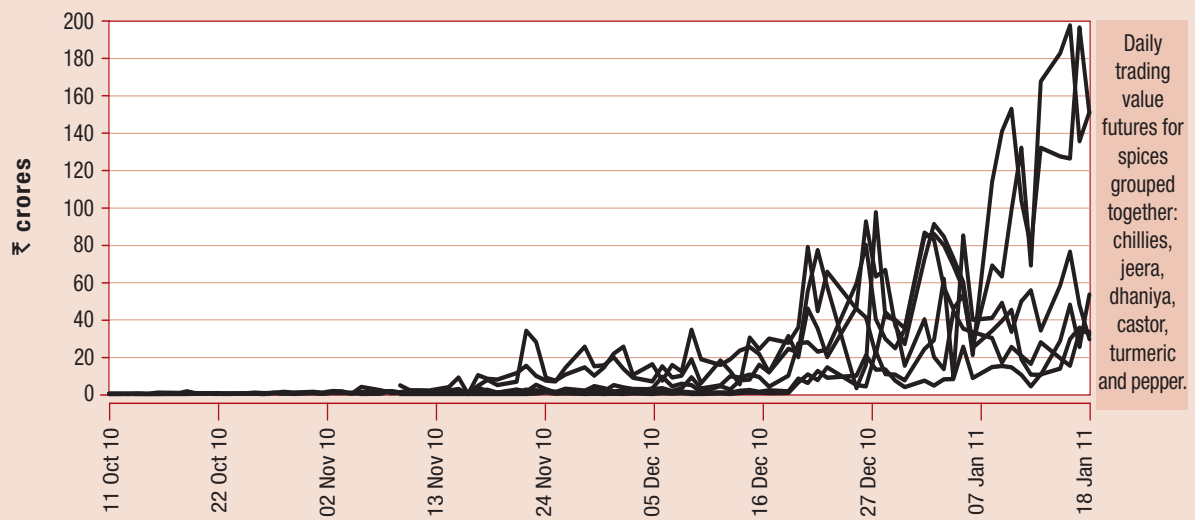


Temporarily less "well-behaved" weekly retail onion price movements, Northern India, Delhi versus Amritsar, Dec 2009 - Dec 2010



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(Box 4.1 Continued)

Daily trading value futures surge for spices

References: John Baffes and Tassos Haniotis (2010), 'Placing the 2006/08 Commodity Price Boom into Perspective', Policy Research Working Paper 5371, The World Bank. Food and Agriculture Organization (FAO), Global food price monitor, 14 January 2011 and Global Information and Early Warning System (GIEWS) Country Data.

Table 4.3 : Monthly Break-up of WPI Food Inflation

Wt%	(per cent)							
	All Commodities		(A) Food Articles		(B) Food Products		(A+B) Food Combined	
	100		14.34		9.97		24.31	
Period	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11
Apr.	0.89	11.00	8.69	20.49	8.86	9.09	8.76	16.09
May	1.21	10.60	8.91	21.37	10.12	7.09	9.37	15.85
Jun.	-0.71	10.28	11.28	20.97	9.05	6.13	10.42	15.30
Jul.	-0.62	10.02	12.74	18.48	8.46	7.34	11.10	14.31
Aug.	0.31	8.82	14.36	14.96	10.73	4.58	12.97	11.06
Sep.	1.09	8.93	13.92	16.29	12.08	3.62	13.21	11.49
Oct.	1.48	9.12	12.47	14.64	12.97	3.75	12.66	10.56
Nov.	4.50	7.48P	16.73	9.41P	17.94	0.57P	17.17	6.11P
Dec.	6.92	8.43P	20.76	13.55P	19.30	0.35P	20.21	8.59P
Jan.	8.53		20.19		19.16		19.80	
Feb.	9.68		21.85		17.68		20.22	
Mar.	10.23		20.65		15.11		18.50	

Source: The Office of the Economic Adviser, Ministry of Commerce and Industry.

Note: P—Provisional.

Table 4.4 : Main Drivers of Food Inflation

Items	Weight%	WPI			y-o-y	y-o-y	*Financial	Financial
					Inflation	WC	year	year
		Dec.	Mar.	Dec.	Dec.	Dec.	inflation	WC
		2009	2010	2010	2010	2010	Apr.	Dec.
		2009	2010	2010	2010	2010	Dec.	2010
		2009	2010	2010	2010	2010	2010	2010
All Commodities	100.00	132.9	135.8	144.1	8.43	100.00	6.11	100.00
Primary Articles	20.12	162.2	165.9	188.9	16.46	47.96	13.86	55.75
Primary Food Articles	14.34	164.6	163.6	186.9	13.55	28.55	14.24	40.25
Rice	1.79	164.5	163.3	166.4	1.16	0.30	1.90	0.67
Wheat	1.12	180.8	172.8	171.6	-5.09	-0.92	-0.69	-0.16
Pulses	0.72	212.1	198.9	189.0	-10.89	-1.48	-4.98	-0.85
Vegetables	1.74	180.0	132.0	224.9	24.94	6.96	70.38	19.43
Potatoes	0.20	240.1	105.4	176.3	-26.57	-1.15	67.27	1.72
Onions	0.18	268.2	171.3	391.1	45.82	1.95	128.31	4.71
Fruits	2.11	136.0	145.6	163.8	20.44	5.23	12.50	4.62
Milk	3.24	151.0	167.2	178.5	18.21	7.95	6.76	4.41
Eggs, Meat, & Fish	2.41	164.3	172.1	195.9	19.23	6.81	13.83	6.92
Condiments & Spices	0.57	202.7	204.9	270.6	33.50	3.45	32.06	4.50
Tea	0.11	165.8	129.1	156.7	-5.49	-0.09	21.38	0.37
Manufactured Food	9.97	142.2	141.7	142.7	0.35	0.45	0.71	1.20
Sugar	1.74	185.7	183.6	167.3	-9.91	-2.85	-8.88	-3.41
Vanaspati	0.71	107.3	108.5	119.6	11.46	0.79	10.23	0.96
Oil, Groundnut	0.30	133.0	131.5	147.8	11.13	0.40	12.40	0.60
Oil, Sunflower	0.17	115.8	112.5	128.4	10.88	0.20	14.13	0.33
Rice Bran Extraction	0.09	210.3	210.4	231.2	9.94	0.17	9.89	0.23
Tea & Coffee Process	0.71	148.6	140.7	160.4	7.94	0.75	14.00	1.69
Malt Liquor	0.15	150.9	150.4	167.1	10.74	0.22	11.10	0.31

Source: The Office of the Economic Adviser, Ministry of Commerce and Industry.

Note: WC – weighted contribution.

tea and coffee process, and malt liquor. The movement of index, inflation, and their contribution to overall inflation among food groups, may be seen in Table 4.4.

4.11 Core inflation is a measure of inflation that excludes items that face volatile price movement, notably food and energy. It is, therefore, a preferred tool for framing long-term policy. Core inflation, which was 0.55 per cent in November 2009, reached its peak in April 2010 at 8.07 per cent (Table 4.5). Thereafter it has moderated in response to monetary measures taken by the Reserve Bank of India (RBI). However, inflation in non-food manufactured products (weight 55.00 per cent) had not increased much and remained in the range of 5.1 to 5.9 per cent in the current financial year. Notwithstanding, year-on-year inflation in the composite non-food index (weight 75.7 per cent) has increased to 8.36 per cent in December 2010 after moderating to 7.96

per cent in September 2010 from 9.18 per cent in April 2010.

4.12 Main items of concern in non-food inflation are raw cotton, raw jute, raw silk, copra, castor seed, sunflower, raw rubber, copper ore, zinc, iron ore, cotton textiles, petrochemical intermediate, and industrial machinery and machine tools. Movement of index of non-food components in the WPI is presented in Figure 4.2.

4.13 In the fuel and power group the major contribution to inflation is from mineral oils accounting for over 90 per cent (Table 4.6).

Annual inflation as per different price indices

4.14 The inflation in terms of the consumer price index for industrial workers (CPI-IW) remained in double digits from July 2009 to July 2010. The inflation in terms of the CPI-AL (Agricultural

Table 4.5 : Movement in WPI Non-food Inflation during 2010-11

	(per cent)					
	Non-food Composite Index	Non-food Articles	Minerals	Fuel & Power	Core inflation	Non-food Manufactured
Weight	75.69	4.26	1.52	14.91	60.78	55.00
Apr.2010	9.18	18.08	34.56	13.61	8.07	5.92
May-10	8.71	14.76	25.34	14.42	7.27	5.77
Jun.2010	8.47	15.83	22.08	13.92	7.09	5.55
Jul. 2010	8.43	15.30	31.60	13.26	7.16	5.41
Aug.2010	7.97	15.81	23.77	12.55	6.77	5.21
Sep.2010	7.96	20.75	26.77	11.06	7.13	5.09
Oct.2010	8.57	25.74	29.38	11.02	7.91	5.25
Nov.2010	8.02	23.22	21.54	10.32	7.40	5.41
Dec.2010	8.36	22.31	27.69	11.19	7.60	5.34

Source: The Office of the Economic Adviser, Ministry of Commerce and Industry.

Note: Core Index= Total WPI— (Total food+ Fuel & power).

Figure 4.2 Movement of non-food WPI during 2010

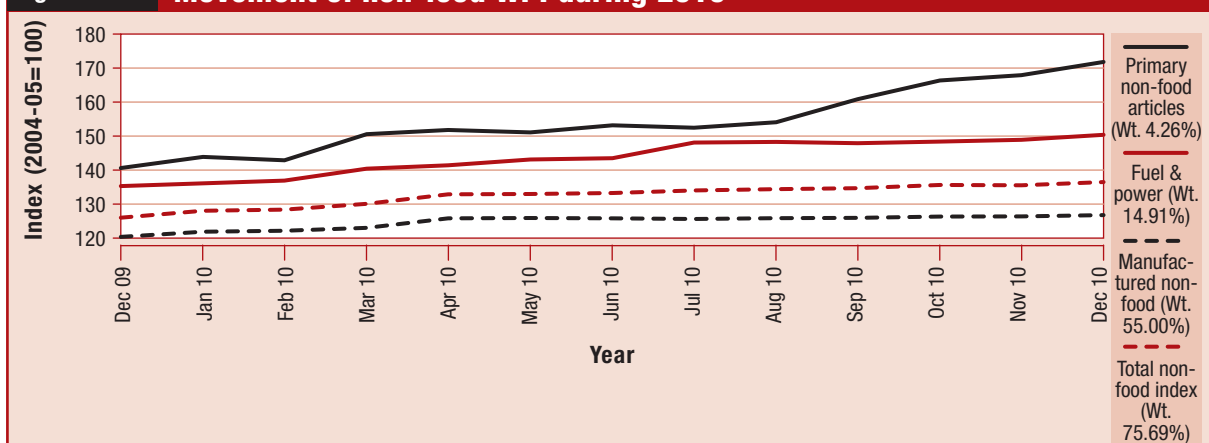


Table 4.6: Index and Contribution of Fuel and Power (disaggregated to overall inflation)

Items	Weight %	WPI:2004-05=100			Dec.2010/Dec.2009		Dec.2010/Mar.2010	
		Dec. 2009	Mar. 2010	Dec. 2010	Y-o-Y Inflation	Y-o-Y WC	FY Inflation	FY WC
Fuel & Power	14.91	135.0	140.1	150.1	11.19	20.10	7.14	17.96
Coal	2.09	162.7	163.0	163.0	0.18	0.06	0.00	0.00
Mineral Oils	9.36	138.6	146.6	160.5	15.80	18.31	9.48	15.68
Electricity	3.45	108.6	108.6	114.0	4.97	1.66	4.97	2.25

Source: The Office of the Economic Adviser, Ministry of Commerce and Industry.

Note: Y-on-Y—year-on-year.

WC- Weighted Contribution

Labourers) and CPI-RL (Rural Labourers) had reached double digits in May 2009 and continued so until July 2010. Further, inflation in terms of the CPI-AL and CPI-RL was higher than inflation based on the CPI-IW during all these months. In August 2010, the inflation in terms of all price indices has

come down to single digit for the first time in 15 months (Table 4.7).

4.15 At 9.47 per cent, inflation in the CPI-IW has substantially declined in December 2010 from its peak of 16.22 per cent in January 2010. The CPI

Table 4.7 : Year-on-Year Inflation Based on Different Consumer Price Indices

Month	WPI (2004-05=100)		CPI(IW) (2001=100)		CPI(AL) (1986-87=100)		CPI(RL) (1986-87=100)	
	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11
	APR.	0.89	11.00	8.70	13.33	9.09	14.96	9.09
MAY	1.21	10.60	8.63	13.91	10.21	13.68	10.21	13.68
JUN.	-0.71	10.28	9.29	13.73	11.52	13.02	11.26	13.02
JUL.	-0.62	10.02	11.89	11.25	12.90	11.02	12.67	11.24
AUG.	0.31	8.82	11.72	9.88	12.89	9.65	12.67	9.66
SEP.	1.09	8.93	11.64	9.82	13.19	9.13	12.97	9.34
OCT.	1.48	9.12	11.49	9.70	13.73	8.43	13.51	8.45
NOV.	4.50	7.48P	13.51	8.33	15.65	7.14	15.65	6.95
DEC.	6.92	8.43P	14.97	9.47	17.21	7.99	16.99	8.01
JAN.	8.53		16.22		17.57		17.35	
FEB.	9.68		14.86		16.45		16.45	
MAR.	10.23		14.86		15.77		15.52	
Average (Apr-Mar)	3.57		12.37		13.91		13.76	

Source: Labour Bureau, Shimla and the Office of the Economic Adviser, Ministry of Commerce and Industry.
Note: P : Provisional.

maintained higher levels last year relative to the WPI, mainly because of the larger weight assigned to food items. In consumer price indices, food items contribute a weight of 46.20 per cent in the CPI-IW and 69.15 per cent in the CPI-AL as against 24.31 per cent in the WPI. The food inflation has decelerated after reaching its peak in January 2010. As a result CPI inflation rates have gone down substantially.

Disaggregated Consumer Price Inflation

4.16 Analysis at this level has assumed importance in view of the fact that the current phase

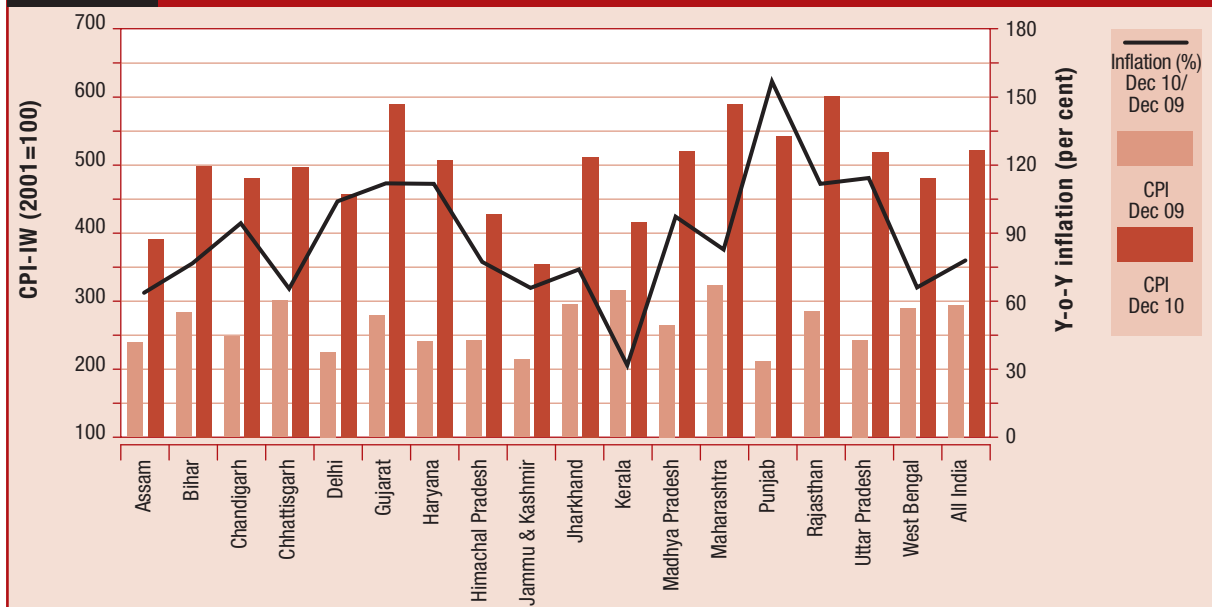
of relatively high inflation is concentrated in food, pan, supari, tobacco and intoxicants, and housing. Two major contributors to high CPI-IW inflation were food and housing. The housing sector is the third major contributor after food and the miscellaneous group, having a 15.3 per cent weight in the CPI-IW commodities basket. However, the average inflation (April-December 2010) was lower than in the corresponding period last year (Table 4.8).

4.17 The non-food inflation in CPI-IW has increased during April-December 2010 to 11.64 per cent as against 8.78 per cent in the corresponding period last year. During April-December 2010, food

Table 4.8 : Quarterly Inflation Trend in CPI-IW by Major Commodity Groups (Base: 2001=100)

	Weights	2009-10			2010-11				
		Apr.- Jun.-	Jul. Sep.	Oct. Dec.	Apr.- Jun.-	Apr.- Jul.-	Jul.- Oct.-	Oct.- Apr. - Dec.	
General index	100.00	8.87	11.75	13.06	11.67	13.66	10.31	9.16	10.96
Food Group	46.20	11.47	13.97	16.56	14.70	13.99	10.34	7.01	10.29
Pan, Supari, Tobacco & Intoxicants	2.27	7.44	8.80	7.86	8.34	12.93	12.13	11.26	12.10
Fuel & Light	6.43	4.59	3.02	3.91	4.08	6.00	11.26	10.84	9.41
Housing	15.27	5.97	22.06	22.06	16.82	33.1	21.08	21.08	24.68
Clothing, Bedding & Footwear	6.57	4.14	4.38	4.22	4.34	4.51	5.51	7.05	5.70
Miscellaneous Group	23.26	7.11	5.95	4.30	6.11	5.03	4.72	5.35	5.03
Total Non-food	53.80	6.45	9.64	9.62	8.78	13.33	10.27	11.42	11.64

Source: Labour Bureau, Shimla.

Figure 4.3 Onions movement in Dec 2010: state wise CPI and Y-o-Y inflation

inflation has declined to 10.29 per cent as compared to 14.70 per cent during the corresponding period last year (Table 4.8). Inflation in the CPI-IW has increased in December 2010 to 9.47 per cent as against 8.33 per cent in November 2010. Food inflation in the CPI-IW has also increased to 7.98 per cent in December 2010 from 5.35 per cent in November 2010.

4.18 Inflation in fruits and vegetables and onions based on the CPI-IW in December 2010 was 15.3 per cent and 77.6 per cent respectively as against 22.77 per cent and 45.82 per cent respectively based on the WPI. State-wise CPI-IW and year-on-year inflation in December 2010 for onions shows

unprecedented rise in inflation in the northern region, particularly Punjab (Figure 4.3).

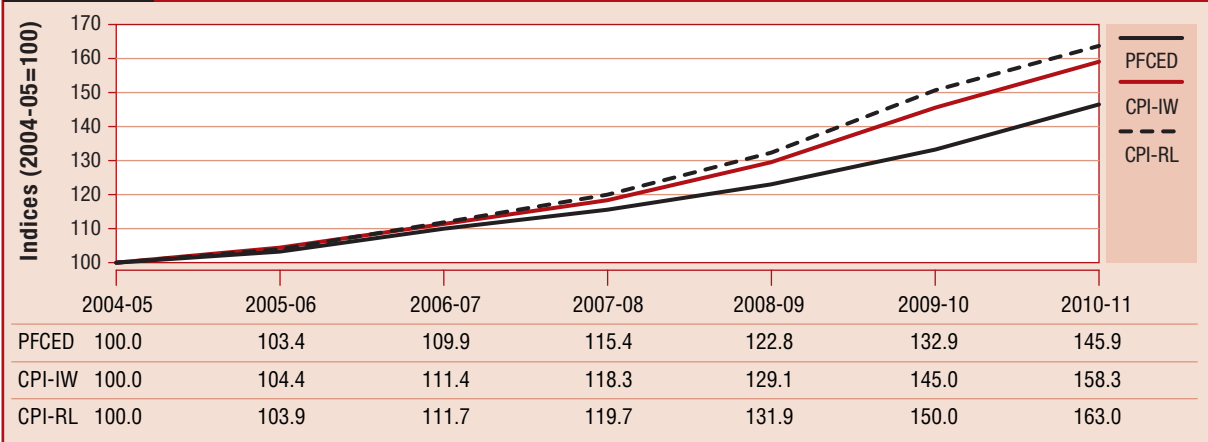
Introduction of CPI-Urban and CPI-Rural

4.19 The Central Statistics Office (CSO) has taken up a new initiative of compilation of CPI (urban), CPI (rural), and CPI (rural+urban) for all States/UTs and all India by considering all sections of the urban and rural population. These indices would reflect the true picture of price behaviour of various goods and services consumed by the urban and rural population. Box 4.2 is a short note on the CPI (urban), CPI (rural), and national CPI giving salient features of this new series of indices.

Box 4.2 : New Series of CPI numbers

1. The CSO has taken an initiative for compilation of new series of urban, rural, and combined (rural+urban) CPI at State/UT/all India level with increased scope and coverage.
2. CPI (rural) and CPI (urban) would be compiled for each State/UT as well as at all India level. Weighting diagrams (consumption pattern) of the indices have been derived from the results of the National Sample Survey (NSS) 61st round of Consumer Expenditure Survey (2004-05).
3. In urban areas, all cities/towns having population (2001 Population Census) more than 9 lakh and all state/UT capitals not covered therein were selected purposively. In all 310 towns have been selected either on purposive or random basis from which 1114 quotations (price schedules) are canvassed every month.
4. In rural areas, with a view to having a manageable workload and considering that the CPI (rural) would provide the price changes for the entire rural population of the country, a total of 1183 villages have been selected at all India level. The broad criterion of selection of villages is to have representation of all the districts within the State/UT and therefore two villages from each district adjusted based on rural population of the State/UT have been selected randomly from different *tehsils*.
5. The CSO has also decided to bring out a national CPI by merging CPI (urban) and CPI (rural) with appropriate weights, as derived from NSS 61st round of Consumer Expenditure Survey (2004-05) data.
6. The Technical Advisory Committee on Statistics of Prices and Cost of Living (TAC on SPCL) in its 49th meeting held on 10 November 2010 decided to take 2010 (January-December) as the base year for a new CPI (urban), CPI (rural) and CPI (rural+urban) series. Indices for January 2011 are likely to be released by February 2011.

Figure 4.4 Annual trend in price indices and PFCED



Sources: Labour Bureau and CSO

Note: The PFCED for 2010-11 is based on advance estimates, CPI-IW and CPI-RL for 2010-11 are for the period April-December 2010.

Private Final Consumption Expenditure Deflator (PFCED)

4.20 The gross domestic product (GDP) or gross domestic income (GDI) is the market value of all final goods and services produced within a country in a given period. It is often positively correlated with the standard of living. Movement of the consumption pattern of a country can be analysed through its deflator generated by the Private Final Consumption Expenditure (PFCE) at current prices over constant prices base 2004-05. Annual price indices data for the CPI-RL, CPI-IW and PFCED from 2004-05 onwards indicate an upward swing in the standard of living (Figure 4.4).

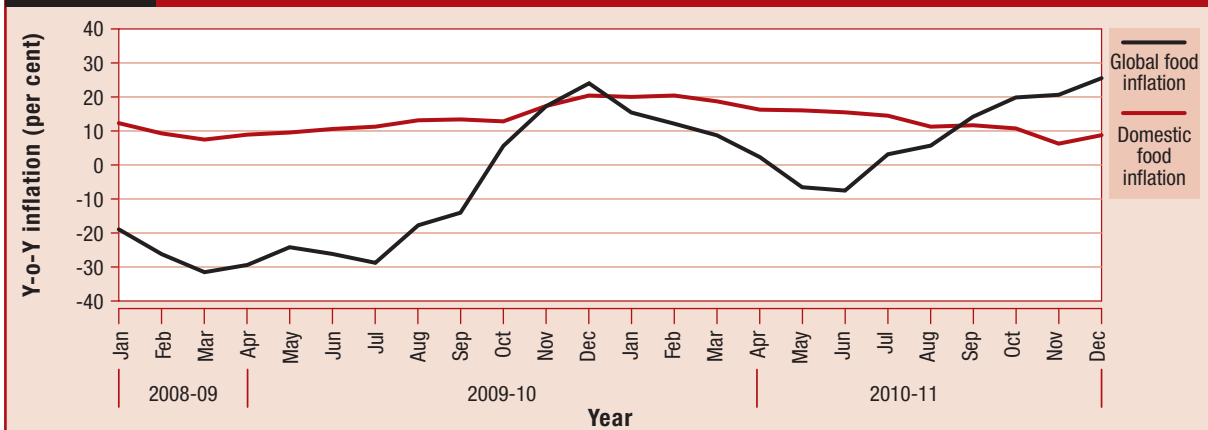
4.21 Price changes may cause consumers to switch from buying one good to another. Whereas the fixed basket CPI does not account for altered spending habits caused by price changes, the PFCE

deflator’s ability to account for such substitutions makes it the preferred measure of inflation. The CPI-RL represents rural areas, where price indices are reigning higher than the CPI-IW in response to improvements in purchasing power and consumption pattern on account of various employment generation schemes of the Government like the Mahatma Gandhi National Rural Employment Guarantee Scheme (MNREGS).

Global and domestic inflation

4.22 From April 2009 global food prices showed much lower volatility than the WPI-based domestic food inflation. However, a higher volatility was seen in international food inflation from September 2010 as compared to domestic food inflation in India. Costlier imports could push up domestic inflation (Figure 4.5 and Table 4.9).

Figure 4.5 Global and domestic food inflation



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Table 4.9 : Domestic and Global Y-o-Y Inflation Trend (per cent)

(base: 2004-05=100)

Commodity	Domestic Dec-09	Global Dec-09	Domestic Mar-10	Global Mar-10	Domestic Dec-10	Global Dec-10
Agriculture	18.5	28.5	20.6	17.8	15.3	27.8
Beverages	6.5	27.8	8.2	23.0	5.3	32.4
Energy	4.6	55.4	13.8	60.1	11.2	19.7
Fats & Oils	-0.7	34.6	3.3	18.2	5.0	35.4
Fertilizers	7.0	-41.7	6.2	-27.1	5.5	39.6
Food	20.2	23.8	18.5	8.5	8.6	25.3
Grains	19.5	5.0	13.2	-10.3	-2.6	25.3
Metal & Minerals	-7.1	42.8	3.4	41.4	12.4	38.6
Non-fuel	7.4	27.8	9.6	23.0	7.9	32.4
Raw Materials	11.1	36.5	26.1	44.0	24.1	45.8
Timber	-1.3	-9.2	8.8	-5.6	50.3	13.4
Other Raw materials	18.3	88.4	44.2	91.1	33.6	63.5
Other Food	16.3	30.7	7.0	16.9	-0.5	10.2

Sources : Pink sheet of the World Bank and the Office of the Economic Adviser, Ministry of Commerce and Industry.

4.23 A comparison of the global food inflation and WPI-based domestic food inflation gives the actual picture of food inflation (Table 4.9).

4.24 During the current year, high inflation in food articles is not unique to India and is widespread. The domestic food price situation could get exacerbated by the increase in global food prices because of dependency on import of some food items like edible oils. Current growth and inflation trends warrant persistence with an anti-inflationary monetary stance.

Housing Price Index (NHB- RESIDEX)

4.25 As one of the most populous and fastest-growing countries in the world, India has promising conditions for a vibrant housing market with considerable growth potential. The housing sector contributes more than 9 per cent of national employment. Housing finance in India, however, remains underdeveloped. The challenge in the Indian housing market is primarily in the low and moderate income segments. Though there is no lack of demand for housing, there is shortage of credit flow.

4.26 RESIDEX was first launched in 2007 by the National Housing Bank (NHB) to provide an index of residential prices in India across cities and over time. Initially a pilot study was conducted with 2001 as base year during the period 2001- 05 to capture the trend of price movements in residential property.

The pilot study covered 5 cities, namely Bengaluru, Bhopal, Delhi, Kolkata, and Mumbai. Thereafter, compilation of RESIDEX has been expanded to ten more cities, namely Ahmedabad, Faridabad, Chennai, Kochi, Hyderabad, Jaipur, Patna, Lucknow, Pune, and Surat. RESIDEX is now being updated on a quarterly basis with 2007 as base year. The latest data cover 15 cities and have been updated up to June 2010 (April – June).

4.27 The movement in prices of residential properties has shown a mixed trend in the 15 cities covered under the NHB RESIDEX in the first half of 2010. Residential housing prices in 10 cities have shown an increasing trend compared to the base year. They are Surat, Mumbai, Lucknow, Ahmedabad, Chennai, Pune, Kolkata, Patna, Faridabad and Bhopal. However, the 5 cities that have shown correction in prices in first half of 2010 are Jaipur, Bengaluru, Kochi, Delhi and Hyderabad. Jaipur has shown the maximum price correction in residential property prices (Figure 4.6).

Measures to contain inflation

4.28 The Government monitors the price situation regularly as price stability remains high on its agenda. Measures taken to contain prices of essential commodities include selective ban on exports and futures trading in foodgrains, zero import duty on select food items, permitting import

Box 4.3 : Measures to Contain Inflation, Particularly Food Inflation

(A) Monetary Measures

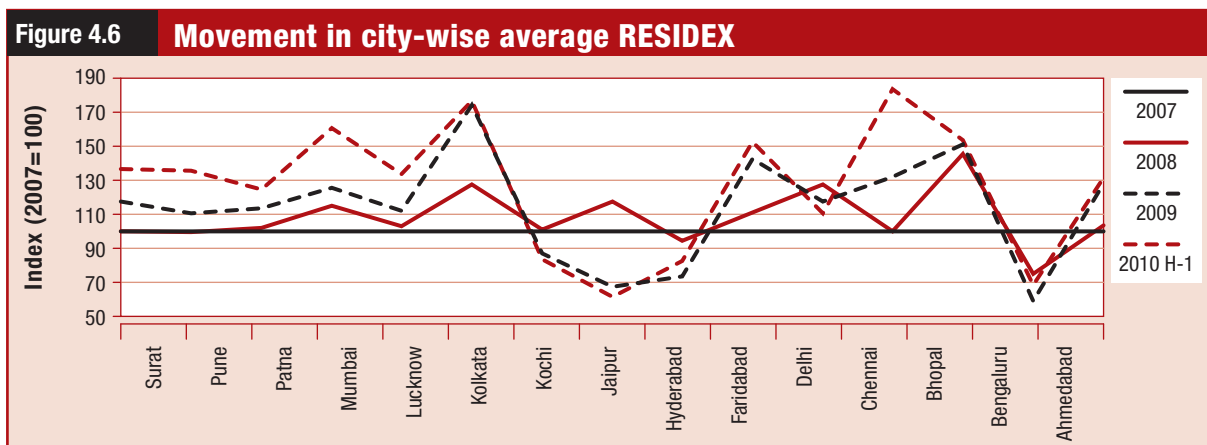
As part of the monetary policy review, the RBI has taken suitable measures to moderate demand to levels consistent with the capacity of the economy to maintain its growth without provoking price rise. It has already raised its key policy rates several times and has narrowed the liquidity adjustment facility (LAF) corridor to reduce volatility of rates. The economy has witnessed aggressive tightening since March 2010. As per the announcement of the RBI on 25 January 2011, the repo rate and reverse repo rate are 6.5 per cent and 5.5 per cent respectively.

(B) Fiscal Measures

1. Import duties reduced to zero on rice, wheat, pulses, edible oils (crude), butter, and ghee and to 7.5 per cent on refined and hydrogenated oils and vegetable oils;
2. Import of raw sugar allowed at zero duty under open general licence (OGL).

(C) Administrative Measures

1. Levy obligation in respect of all imported raw sugar and white/refined sugar removed.
2. Export of non-basmati rice, edible oils (except coconut oil and forest based oil) and pulses (except Kabuli chana) banned.
3. Minimum export price (MEP) used to regulate exports of onion (at US\$1200 per tonne for December 2010) and basmati rice (at US\$900 per MT);
4. Futures trading in rice, urad, and tur suspended by the Forward Market Commission.
5. Stock limit orders extended in the case of pulses, paddy, and rice up to 30 September 2011 and edible oil and edible oilseeds up to 31 March 2011.
6. Export of Onion (all varieties) not permitted with effect from 22 December 2010 until further orders.
7. Full exemption from basic custom duty, special additional duty and education cess provided to onions and shallots with effect from 21 December 2010.
8. NAFED and NCCF to undertake sale of onions at Rs 35 per kg from their retail outlets at various locations, with suitable budgetary support to be provided for this purpose.
9. Other measures with a wider horizon include the following:
 - a. A scheme to support the State Governments in the setting up of farmers' mandis and mobile bazaars and improve the functioning of civil supplies corporations and cooperatives will be finalized urgently.
 - b. The existing PDS will be suitably strengthened through computerization and other steps, including opening more procurement windows across the country.
 - c. State Governments would be urged to review the APMC Acts and, in particular, consider exempting horticultural products from their purview thereby mitigating marketing and distribution bottlenecks in this crucial sector. State Governments will also be urged to consider waiving *mandi* tax, octroi, and other local levies which impede smooth movement of essential commodities, as well as to reduce commission agent charges.
 - d. Investment will be encouraged in supply chains, including provisions for cold storages, which will be dovetailed with organized retail chains for quicker and more efficient distribution of farm products, minimizing wastage. The DIPP, Department of Food and Public Distribution, Ministry of Food Processing Industries, and the Planning Commission will jointly work out schemes for this purpose.
 - e. An Inter-Ministerial Group (IMG) has been set up under the Chief Economic Adviser, Ministry of Finance, to review the overall inflation situation, with particular reference to primary food articles. The IMG will, inter alia, review production/ rainfall trends and build an institutional machinery to read warning signals, assess international trends, recommend action on the fiscal, monetary, production, marketing, distribution, and infrastructure fronts to prevent price spikes, and suggest measures to strengthen collection and analysis of data and forecasting.
 - f. The Committee of Secretaries under the Cabinet Secretary will review the prices situation with individual States, and advise the Departments concerned of the Central Government to maintain close coordination with State agencies to get direct feedback with a view to taking suitable remedial measures on a fast track.



of pulses and sugar by public-sector undertakings, distribution of imported pulses and edible oils through the PDS, and release of higher quota of non-levy sugar. In addition, State Governments are empowered to act against hoarders of food items by holding in abeyance the removal of restrictions on licensing, stock limits, and movement of food articles under the Essential Commodities Act 1955. Some of the important anti-inflationary measures taken are given in Box 4.3.

MONETARY DEVELOPMENTS DURING 2010-11

4.29 In response to the global financial crisis beginning mid-September 2008, the RBI adopted an accommodative monetary policy stance that helped instil confidence among market participants and ensure that the economy recovered as quickly as possible. The Indian economy exhibited acceleration in the momentum of recovery during the course of 2009-10. Despite a deficient monsoon, the expansionary monetary and fiscal stance adopted in response to the global crisis contributed to the recovery. After remaining subdued during the first half of the year, headline inflation spiked in the second half, initially driven by high food prices but turning more generalized over successive months. In view of rising food inflation and the risk of it impinging on inflationary expectations alongside the consolidating recovery, the RBI stated a clear shift in stance from 'managing the crisis' to 'managing the recovery' and announced the first phase of exit from the expansionary monetary policy in its Second Quarter Review of October 2009 by terminating some sector-specific facilities and restoring the statutory liquidity ratio (SLR) of

scheduled commercial banks (SCBs) to its pre-crisis level.

4.30 As there were clear signs that the recovery was consolidating, it was felt that the main policy instruments were at levels more consistent with a fast recovering economy than a crisis economy and it was imperative therefore to carry forward the process of exit from an accommodative policy stance. Taking this consideration into account, during 2010-11 the RBI raised the policy rates six times whereby the repo rate under the LAF has cumulatively been increased by 175 basis points (bps) to stand at 6.5 per cent and the reverse repo rate by 225 bps to 5.5 per cent. The RBI has moreover retained the cash reserve ratio (CRR) at 6 per cent of the net demand and time liabilities (NDTL) of banks. Thus in 2010-11, the persistently high inflation above the comfort level of the RBI, together with growth buoyancy, necessitated that the monetary policy focus remain on containing inflation and inflationary expectations.

4.31 The RBI indicated in its First Quarter Review of Monetary Policy (27 July 2010) that it will now undertake mid-quarter reviews roughly at the interval of one and half months after each quarterly review. By instituting these, it was the Bank's intention to take the surprise element out of off-cycle actions. Accordingly, the Reserve Bank announced the mid quarter monetary policy review on 16 September 2010 and 16 December 2010.

4.32 In 2010-11, the RBI continued its policy of maintaining adequate liquidity in the system so that all legitimate credit requirements for productive purposes were met, consistent with the objective of price and financial stability. The management of liquidity was achieved through appropriate use of

open market operations (OMOs), the Market Stabilization Scheme (MSS), LAF, and a slew of special facilities. While the overall liquidity in the system has remained in deficit consistent with the policy stance, the extent of tightness has been beyond the comfort level of the RBI of (+)/(-) 1 per cent of NDTL, mainly due to the persistence of large Government cash balances. In addition, the liquidity deficit has been accentuated by structural factors such as significantly above-trend currency expansion and relatively sluggish growth in bank deposits even as the credit growth accelerated in 2010-11. While the liquidity deficit improved transmission of monetary policy signals with several banks raising deposit and lending interest rates, excessive deficits induce unpredictability in both availability and cost of funds, making it difficult for the banking system to sustain credit delivery.

4.33 In view of the persistent liquidity pressures, the RBI in November 2010 implemented some measures such as additional liquidity support to SCBs under the LAF up to 2.0 per cent of their NDTL, continuation of the second LAF (SLAF), and OMO purchase of Government securities. Subsequently in the mid quarter review, 16 December 2010, the RBI reduced the SLR of SCBs from 25 per cent of their NDTL to 24 per cent with effect from 18 December 2010. Furthermore, it decided to conduct OMO auctions for purchase of government securities for an aggregate amount of ₹ 48,000 crore in the next one month. It was also clearly communicated that as the economy expands, it needs primary liquidity, which will have to be provided in a manner consistent with the monetary policy stance. Such provision of liquidity should not be construed as a change in the monetary policy stance since inflation continues to remain a major concern.

4.34 To sum up, the underlying growth momentum of the Indian economy remains strong. Even as inflation has moderated, it remains significantly above the comfort level of the RBI. Moreover, risks to inflation remain on the upside, both from domestic demand and higher global commodity prices. There is, therefore, a need for continued vigilance on the inflation front against the build-up of demand-side pressures. A major challenge for the RBI in recent times has been liquidity management. It is the RBI's endeavour to alleviate the liquidity pressure in a manner consistent with the monetary policy stance of containing inflation and anchoring inflationary expectations.

¹For the period up to 19 November 2010.

4.35 The current monetary policy stance, as indicated in the Bank's Second Quarter Review (November 2010) was as follows:

- a. Contain inflation and anchor inflationary expectations while being prepared to respond to any further build-up of inflationary pressures.
- b. Maintain an interest rate regime consistent with price, output, and financial stability.
- c. Actively manage liquidity to ensure that it remains broadly in balance, with neither a surplus diluting monetary transmission nor a deficit choking off fund flows.

In the same document the RBI observed that 'based purely on current growth and inflation trends, the Reserve Bank believes that the likelihood of further rate actions in the immediate future is relatively low'. This indication of pause will not deter it from taking further policy actions if required and, accordingly, it also indicated that 'however, in an uncertain world, we need to be prepared to respond appropriately to shocks that may emanate from either the global or domestic environment'. In continuation of that announced policy, and renewed inflationary pressures, especially in food prices, the RBI raised policy rates again in January 2010 by 25 bps in their Third Quarter Review.

Trends in Monetary Aggregates

4.36 During the year 2010-11, the growth rates of reserve money (M_0) and narrow money (M_1)¹ have been higher as compared to the preceding year while broad money (M_3) growth has been lower (Table 4.10). The moderation in growth of narrow and broad money is largely on account of the deceleration in growth of deposits, both demand and time (up to 3 December 2010).

Reserve Money (M_0)

4.37 During 2010-11, on a financial-year basis, M_0 expanded by 8.4 per cent (up to 10 December 2010), compared to an increase of 1.6 per cent during the corresponding period of the preceding year (Table 4.11).

4.38 The net foreign assets (NFA) of the RBI increased by 6.1 per cent during this period, as against an increase of 1.5 per cent during the corresponding period of the previous year. On a year-on-year basis, as on 11 December 2010, the NFA of the RBI marginally increased by 0.6 per cent compared to a 6.8 per cent increase a year earlier (Figure 4.7).

Table 4.10 : Movement of select monetary parameters

(per cent)

Items	Yearly Variation		Growth rates as on December 3, 2010			
	2008-09	2009-10	Financial-year basis		Year-on-year basis	
			2009-10	2010-11	2009-10	2010-11
M ₀	6.4	17	1.7	6.3	15.3	22.2
M ₁	9	18.6	5.1	3.1	18.3	16.5
M ₃	19.3	16.8	9.6	8.2	18.6	15.3

Source : RBI

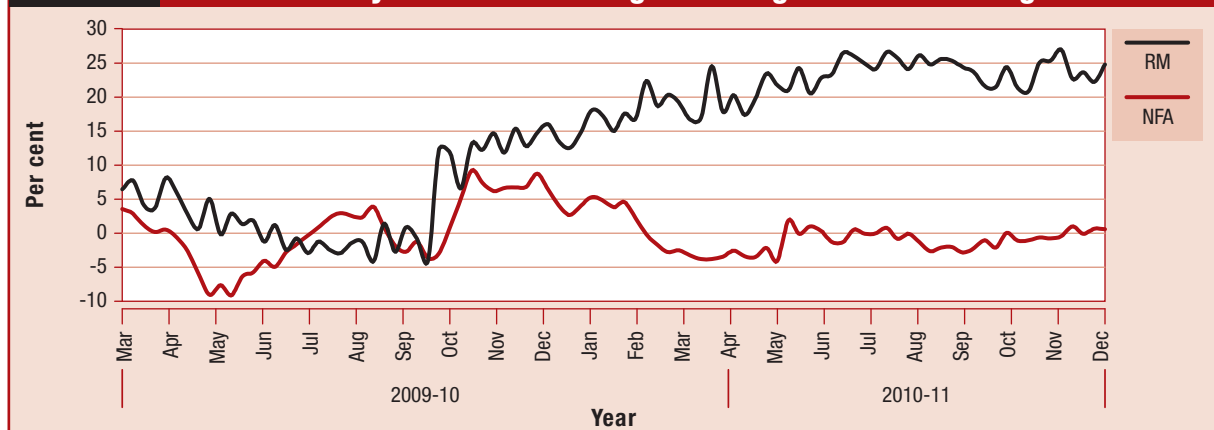
Table 4.11 : Sources of change in reserve money

(per cent)

	Growth rate				
		Financial-year basis		Year-on-Year	
		Dec. 11	Dec. 10,	Dec. 11	Dec. 10,
		2009	2010,	2009	2010
	over	over	over	over	
	2009-10	March 31,	March 31,	Dec. 12,	Dec. 11
		2009	2010	2008	2009
Reserve Money	17	1.6	8.4	12.8	24.8
A. Components					
a) Currency in Circulation	15.7	10.8	14	17.2	19
b) Bankers' Deposits with RBI	21	-19.6	-4.1	1.2	44.2
c) Other Deposits with RBI	-31.1	-34.4	0.3	-28	5.5
B. Select Sources of Reserve Money					
1. Net Foreign Exchange Assets of RBI	-3.8	1.5	6.1	6.8	0.6
2. Government's Currency Liabilities to the Public	12.1	7.7	4.4	10.6	8.6
3. Net Non-monetary Liabilities of RBI	-22.3	-1.5	17.1	19.5	-7.6

Source: RBI.

Figure 4.7 Reserve money and RBI net foreign exchange assets-annual growth rate



4.39 Net RBI credit to the Central Government increased by ₹ 70,856 crore during the financial year so far (up to 10 December 2010). This was mainly on account of increase in repo operations under the LAF and open market purchases of the Bank, partly offset by increase in the cash balances of the Central Government. On a year-on-year basis, increase in the net RBI credit to the Central Government, as on 10 December 2010, was ₹ 2,10,714 crore as against an increase of ₹ 98,273 crore a year earlier.

Narrow Money (M_1)

4.40 Narrow money (M_1) increased by 18.6 per cent in 2009-10 as compared to an expansion of 9.0 per cent during 2008-09. During 2010-11, M_1 growth has generally been higher than in 2009-10, though there was significant deceleration during the latest fortnight for which data are available (i.e., 3 December 2010). On a financial-year basis, M_1 increased by 3.1 per cent during the current year (up to 3 December 2010) compared to increase of 5.1 per cent during the corresponding period of the previous year. On a year-on-year basis, as on 3 December 2010, M_1 growth was 16.5 per cent as compared to 18.3 per cent a year earlier (Figure 4.8). During the current financial year (up to 3 December 2010), currency with the public expanded by 12.9 per cent (₹ 99,324 crore), compared to an increase of 9.8 per cent (₹ 64,962 crore) during the corresponding period of the previous year.

4.41 The other important component of M_1 , namely demand deposits with banks decreased by 7.3 per cent during the period up to 3 December 2010 as against a marginal increase of 0.1 per

cent during the corresponding period of the previous year. On a year-on-year basis, as on 3 December 2010, the growth of currency with the public was higher at 18.7 per cent as compared to 17.2 per cent a year earlier. For the same period, growth in demand deposits was 13.7 per cent as compared to 19.9 per cent a year earlier.

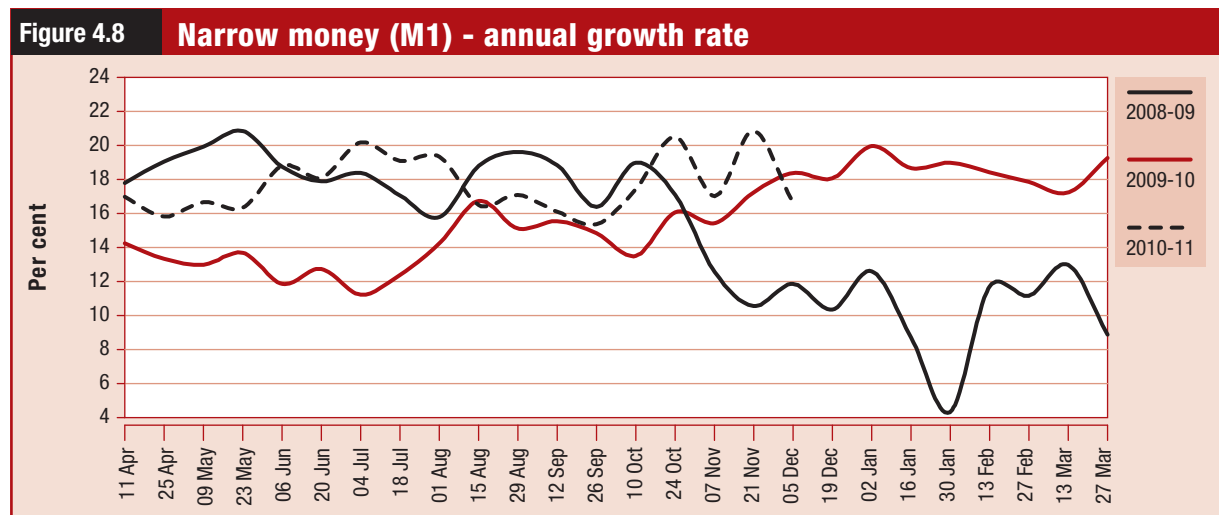
Broad money (M_3)

4.42 Broad money (M_3) supply increased by 16.8 per cent during 2009-10 which was lower than the 17.0 per cent indicative growth envisaged in the Annual Policy Statement of the Reserve Bank for 2009-10.

4.43 The main components and sources of broad money are indicated in Table 4.12.

4.44 Time deposits with banks during 2010-11 grew at a lower rate of 10.1 per cent (up to 3 December 2010) as compared to 11.2 per cent during the corresponding period of the previous year. On a year-on-year basis also, as on 3 December 2010, the growth in time deposits moderated to 14.9 per cent from 18.7 per cent a year earlier (Table 4.12).

4.45 During the current financial year 2010-11 (up to 3 December 2010) the growth in M_3 was 8.2 per cent as compared to 9.6 per cent during the corresponding period of the previous year. On a year-on-year basis, M_3 grew by 15.3 per cent on 3 December 2010, as against growth of 18.6 per cent on the corresponding date of the previous year (Table 4.12 and Figure 4.9). This is lower than the indicative 17.0 per cent target set in the Second Quarter Review of the Annual Policy Statement for 2010-11.



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Table 4.12 : Sources of Change in Money Stock (M_3)

	Growth Rate				
	31 March 2009 to 31 March 2010	31 March 2009 to 4 December 2009	31 March 2010 to 3 December 2010	5 December 2008 to 4 December 2009	4 December 2009 to 3 December 2010
	(per cent)				
I. M_1 (Narrow Money)	18.6	5.1	3.1	18.3	16.5
II. M_3 (Broad Money) (1+2+3+4)	16.8	9.6	8.2	18.6	15.3
1. Currency with the Public	15.4	9.8	12.9	17.2	18.7
2. Demand Deposits with Banks	22.8	0.1	-7.3	19.9	13.7
3. Time Deposits with Banks	16.1	11.2	10.1	18.7	14.9
4. Other' Deposits with RBI	-31.1	-33.7	9.1	-23.1	13.4
III. Sources of Change in Money Stock (M_3)					
1. Net Bank Credit to Government of which:	30.5	19.4	8.7	38.2	18.8
Other Banks' credit to Government	19.7	19.5	6.9	26.7	7.1
2. Bank Credit to Commercial Sector of which:	15.9	4.8	10.3	10.5	21.9
Other Banks' credit to Commercial Sector	16.3	5.1	10.3	10.4	22.0
3. Net Foreign Exchange Assets of the Banking Sector	-5.2	-0.3	5.3	9.0	0.1
4. Government's Currency Liabilities to the Public	12.1	7.7	4.4	10.6	8.6
5. Banking Sector's Net Non- monetary Liabilities Other than Time Deposits	16.0	15.1	9.9	23.4	10.8
Memo Items:					
1. Money Multiplier (M_3/M_0)	4.85				
2. Velocity of Money	1.20				
3. Net Domestic Assets	25.4	13.5	9.1	22.2	20.6
4. Net Domestic Credit	20.2	9.2	9.8	18.2	20.9

Source : RBI.

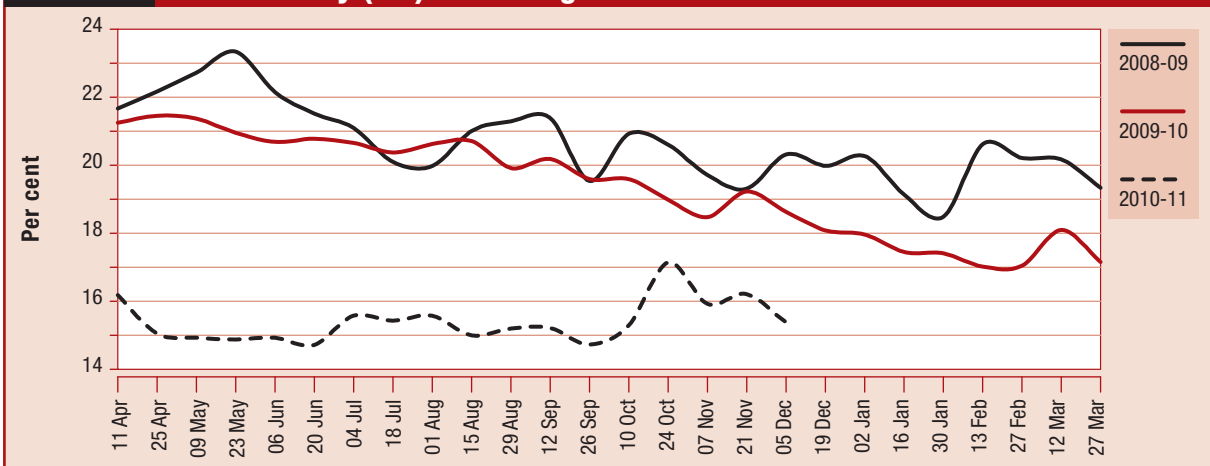
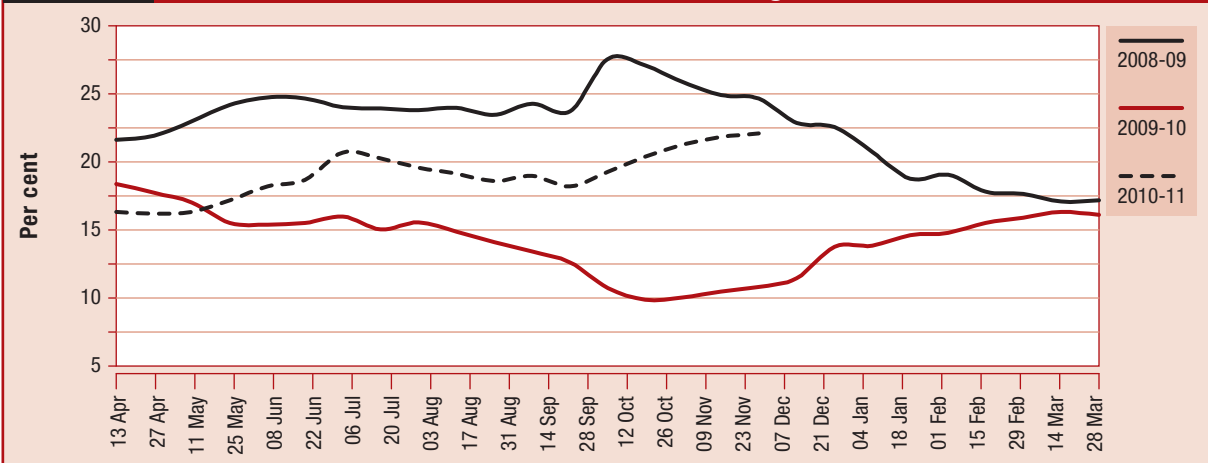
Figure 4.9 Broad money (M_3) - annual growth rate

Figure 4.10 Bank credit to commercial sector - annual growth rate



4.46 Among the sources of M_3 , however, bank credit to the commercial sector has been accelerating since November 2009 (Figure 4.10).

Money Multiplier

4.47 During 2009-10, the expansion in M_0 was higher than that in M_3 . Accordingly, the ratio of M_3 to M_0 (money multiplier) showed a decrease. At the end of March 2010, this ratio was 4.8, marginally lower than the end-March 2009 figure of 4.11. During the current financial year 2010-11, the money multiplier has generally shown a decreasing trend on account of reserve money registering a higher growth than broad money supply. As on 3 December 2010, the money multiplier was 4.9 compared to 5.2 on the corresponding date of the previous year (Figure 4.11).

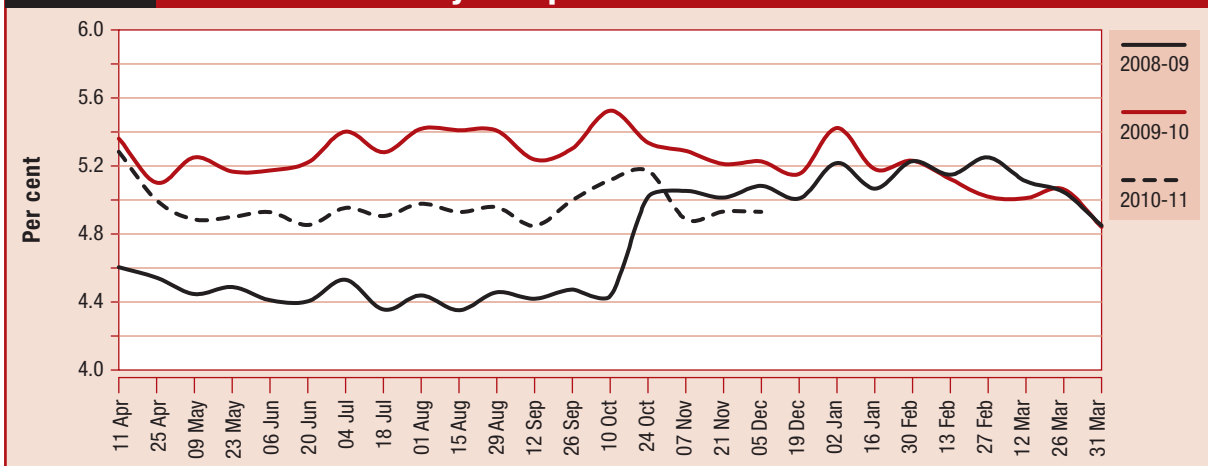
Movement in other monetary indicators

4.48 While the year-on-year money supply (M_3) growth at 16.5 per cent in December 2010 was

close to the indicative projection of 17 per cent, non-food credit growth at 24.4 per cent was much above the indicative projection of 20 per cent. Credit expansion in the recent period has been rather sharp, far outpacing the expansion in deposits. Rapid credit growth without commensurate increase in deposits is not sustainable, with banks having to rely on borrowing from the Central bank. As a result of injection of primary liquidity of over ₹ 67,000 crore through OMO auctions since early November 2010, the structural liquidity deficit in the system has declined significantly.

4.49 Monetary deepening, as measured by the ratio of average M_3 to the GDP, increased from 43.8 per cent in 1990-91 to 83.1 per cent in 2009-10. This could be attributed to the spread of banking services in the country and development of the financial sector. The monetization of the economy as measured by the ratio of average M_1 to the GDP

Figure 4.11 Movements in money multiplier



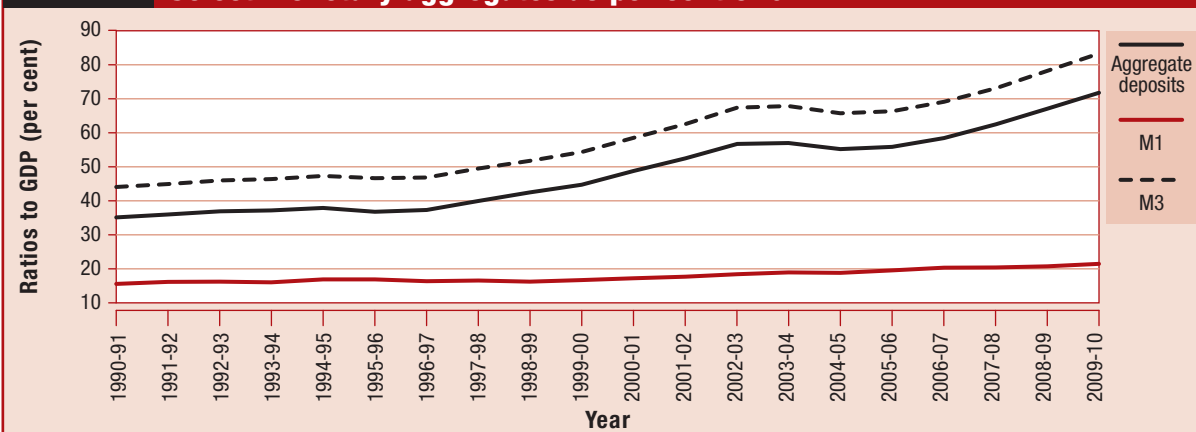
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Table 4.13 : Select monetary aggregates (ratios to GDP)

	As per cent of GDP at Market Prices (1999-2000 base)					
	Currency with public	Demand deposits with banks	Time deposits with banks	Aggregate deposits	M1	M3
1990-91	8.7	6.4	28.5	34.9	15.3	43.8
1991-92	8.8	6.9	28.8	35.7	15.9	44.7
1992-93	8.6	6.9	29.8	36.6	16	45.7
1993-94	8.8	6.6	30.3	36.9	15.7	46.1
1994-95	9.1	7.2	30.4	37.6	16.7	47.1
1995-96	9.4	6.7	29.8	36.5	16.6	46.4
1996-97	9.2	6.5	30.5	37	16.1	46.6
1997-98	9.3	6.7	33	39.7	16.3	49.2
1998-99	9.1	6.7	35.5	42.2	16	51.5
1999-00	9.5	6.8	37.7	44.5	16.4	54.1
2000-01	9.6	7.2	41.3	48.5	17	58.2
2001-02	10	7.4	44.9	52.2	17.5	62.3
2002-03	10.5	7.5	49	56.5	18.2	67.1
2003-04	10.7	7.8	48.9	56.7	18.7	67.6
2004-05*	10.4	8	47	55	18.5	65.5
2005-06*	10.3	8.8	46.8	55.6	19.3	66.1
2006-07*	10.5	9.4	48.8	58.2	20	68.9
2007-08*	10.5	9.5	52.7	62.2	20.1	72.8
2008-09*	11	9.3	57.5	66.8	20.4	77.9
2009-10*	11.4	9.7	61.9	71.5	21.2	83.1

Source : RBI.

Note:* Based on GDP data with 2004-05 as base.

Figure 4.12 Select monetary aggregates as per cent of GDP

has also shown an upward trend, albeit at a slower rate, during this period. In 1990-91, this ratio was

15.3 per cent and it increased to 21.2 per cent in 2009-10 (Table 4.13 and Figure 4.12).

LIQUIDITY MANAGEMENT

4.50 The Reserve Bank continued its active policy of liquidity management through the LAF, CRR, and OMOs. During 2010-11 so far, the centre's surplus balance with the RBI has been a key driver of autonomous liquidity. Currency in circulation has been another key determinant of autonomous liquidity. The LAF window of the Reserve Bank, which remained in surplus mode for nearly 18 months, switched into deficit mode towards end-May 2010 and largely maintained the trend subsequently.

4.51 The liquidity conditions changed significantly during the first quarter of 2010-11. The gradual moderation in volume of surplus liquidity in the system since February 2010 reflected the calibrated normalization of the monetary policy by the RBI. Accordingly, the LAF remained in the absorption mode, though the absorption volume declined gradually. To anchor inflation and prevent

further build-up of inflationary pressure, the RBI increased the repo and reverse repo rates as well as CRR by 25 bps each in April 2010 in the Annual Monetary Policy for 2010-11. The surplus liquidity in the domestic market gradually declined thereafter. A significant development was that the LAF window of the RBI, after remaining in surplus mode for nearly 18 months, switched into deficit mode towards the end of May 2010 mainly on account of 3G (3rd generation spectrum) and BWA (broadband wireless access) auctions and the consequent migration of liquidity to the Central Government's cash balance account with the RBI. In anticipation of temporary tightening of liquidity conditions, the RBI introduced measures allowing SCBs to avail of additional liquidity support under the LAF to the extent of up to 0.5 per cent of their NDTL and also access to the SLAF on a daily basis for the period 28 May - 2 July 2010. The average daily liquidity injection under the LAF during June 2010 was around ₹ 47,000 crore in contrast to the

Table 4.14 : Liquidity management

(₹ crore)

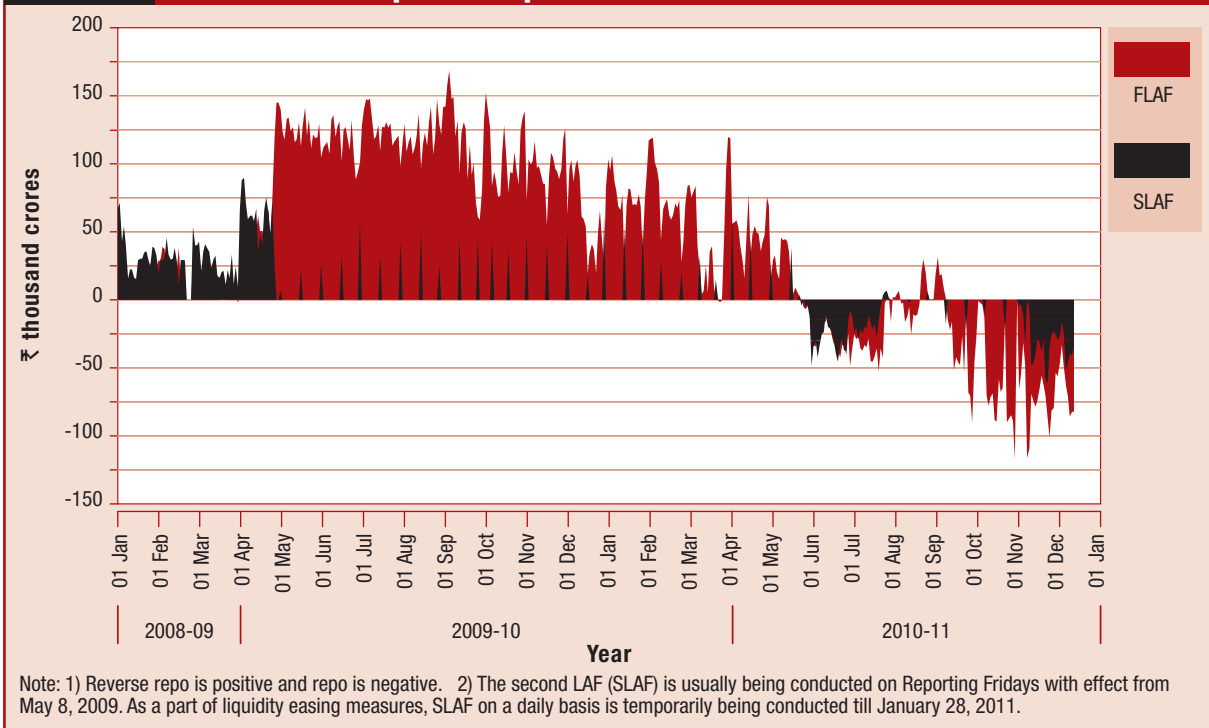
Outstanding as on last Friday of the month	LAF	MSS	Centre's surplus*	Total
2009				
January	54,605	1,08,764	-9166	1,54,203
February	59,820	1,01,991	-9603	1,52,208
March**	1485	88,077	16,219	1,05,781
April	1,08,430	70,216	-40412	1,38,234
May	1,10,685	39,890	-6114	1,44,461
June	1,31,505	22,890	12,837	1,67,232
July	1,39,690	21,063	26,440	1,87,193
August	1,53,795	18,773	45,127	2,17,695
September	1,06,115	18,773	80,775	2,05,663
October	84,450	18,773	69,391	1,72,614
November	94,070	18,773	58,460	1,71,303
December	19,785	18,773	1,03,438	1,41,996
2010				
January	88,290	7737	54,111	1,50,138
February	47,430	7737	33,834	89,001
March*	990	2737	18,182	21,909
April	35,720	2737	-28,868	9589
May	6215	317	-7531	-999
June	-74,795	317	76,431	1953
July	1775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-1,17,660	0	86,459	-31,201
November	-1,03,090	0	93,425	-9665

Note : * Excludes minimum cash balances with the RBI in case of surplus.

** Data pertain to 31March.

-ve sign under LAF indicates injection of liquidity through the LAF.

-ve sign under Centre's surplus indicates WMA /OD (ways and means advances/overdraft).

Figure 4.13 LAF reverse - repo and repo volume

average daily absorption of around ₹ 33,000 crore in May 2010 (Table 4.14 and Figure 4.13).

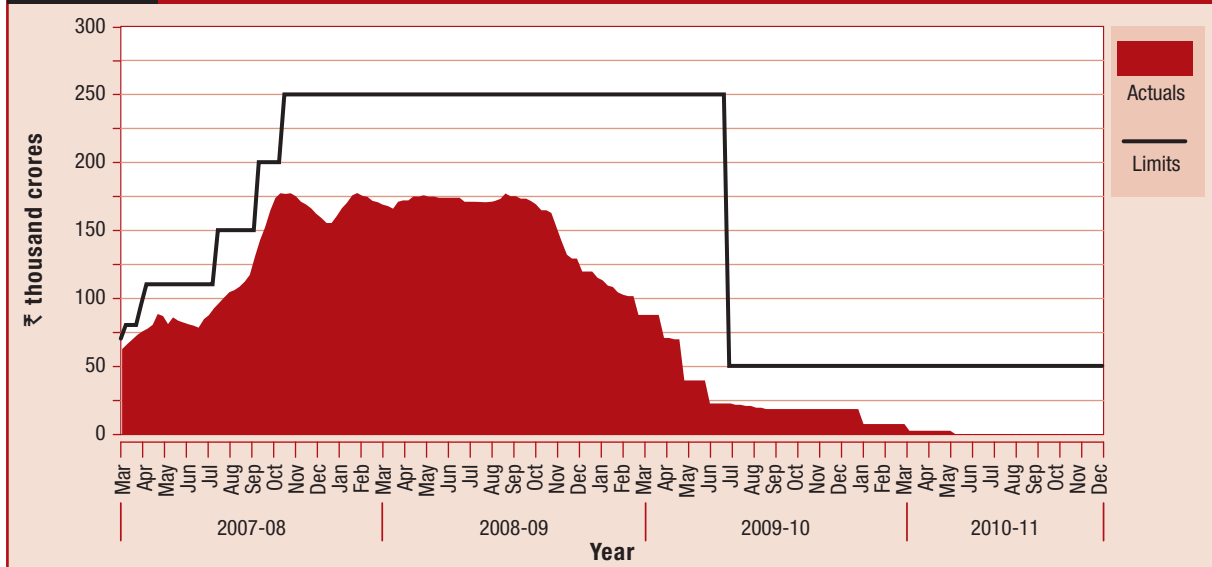
4.52 During the second quarter, July-September, of 2010-11, the liquidity conditions generally remained in deficit mode. On 2 July 2010, the RBI hiked the repo and reverse repo rates by 25 bps each to 5.50 per cent and 4.0 per cent respectively. With the persistence of deficit liquidity conditions, the Bank extended the liquidity-easing measures introduced earlier. The SCBs were permitted to avail of additional liquidity support under the LAF to the extent of up to 0.5 per cent of their NDTL². The SLAF on a daily basis was also extended till 16 July 2010. On an assessment of the prevailing overall liquidity conditions and with a view to providing flexibility to SCBs in liquidity management, the RBI further extended the SLAF on a daily basis till 30 July 2010. The average daily liquidity injection under the LAF remained at around ₹ 47,000 crore during July 2010. In view of the evolving inflationary scenario, the RBI raised the repo rate and reverse repo rate further by 25 bps and 50 bps, to 5.75 per cent and 4.50 per cent respectively in the First Quarter Review of Monetary Policy 2010-11

(announced on 27 July). The liquidity conditions improved in August 2010 (mainly on account of large pre-scheduled public debt redemptions on 28 July 2010), and the average daily net injection of liquidity declined to around ₹ 1000 crore during the month. After a brief period of surplus liquidity (from end-August to early September 2010), the liquidity conditions again switched to injection mode as liquidity migrated to Government account with the RBI on account of quarterly advance tax outflows. On the basis of assessment of the macroeconomic situation, the RBI increased the repo rate and reverse repo rate by 25 bps and 50 bps respectively in the mid-quarter monetary policy review (announced on 16 September 2010). The liquidity conditions remained tight in the second half of September 2010 as the surplus cash balances of the Centre started building up, and the average daily net outstanding liquidity injection was around ₹ 24,000 crore during the month.

4.53 The liquidity conditions tightened further in October 2010 on account of increase in Government surplus balances and currency in circulation due to festive season demand. The average daily net outstanding liquidity injection was around ₹ 62,000

²For any shortfall in maintenance of the SLR arising out of availment of this facility, banks were allowed seek waiver of penal interest.

Figure 4.14 Market stabilisation scheme



crore for the entire October 2010. However, the net liquidity injection crossed ₹ 1,00,000 crore on 29 October 2010. In order to ease the frictional liquidity pressure, the RBI announced certain temporary measures, namely conduct of special SLAF on 29 October and 1 November 2010, conduct of a special two-day repo auction under the LAF on 30 October 2010, and waiver of penal interest on shortfall in maintenance of SLR (on 30-31 October) to the extent of 1 per cent of NDTL for availing of additional liquidity support under the LAF. The RBI extended these liquidity-easing measures further and conducted SLAF on all days during 1-4 November 2010 and extended the waiver of penal interest on shortfall in maintenance of SLR (to the extent of 1 per cent of NDTL) for availing of additional liquidity support under the LAF till 7 November 2010. To contain inflation and anchor inflationary expectations, the RBI increased the repo and reverse repo rates by 25 bps each in the Second Quarter Review of Monetary Policy on 2 November 2010. Consistent with the stance of monetary policy and based on the assessment of prevailing and evolving liquidity conditions, the RBI conducted purchase of government securities under its OMOs for an aggregate amount of ₹ 12,000 crore on 4 November 2010 and accepted an aggregate amount of ₹ 8352 crore in that auction. The high deficit liquidity conditions continued in November 2010 with the persistence of high Government balances and rise in currency in circulation. On 9 November 2010, the RBI has re-introduced liquidity-easing measures (SLAF on a daily basis, the waiver of penal interest

on shortfall in maintenance of the SLR to the extent of 1 per cent of NDTL for availing of additional liquidity support under the LAF), to remain in force till 16 December 2010. The average daily net liquidity injection during the month was around ₹ 99,300 crore. The liquidity conditions have remained in high deficit so far in December 2010 (till 20 December) as huge quarterly advance tax payments have increased the liquidity stress in the system. The RBI conducted purchase of Government securities through auction as part of its OMOs for an aggregate amount of ₹ 12,000 crore each on 9 December 2010 and 15 December 2010; and accepted an aggregate amount of ₹ 10,120 crore and ₹ 11,706 crore respectively in the auctions. The average daily net outstanding liquidity injection was around ₹ 1,10,000 crore during 1-20 December 2010.

4.54 While the overall liquidity in the system has remained in deficit consistent with the policy stance, the extent of tightness has been beyond the comfort level of the RBI. The RBI decided to (i) reduce the SLR of SCBs from 25 per cent of their NDTL to 24 per cent with effect from 18 December 2010; (ii) conduct OMO auctions for purchase of Government securities for an aggregate amount of ₹ 48,000 crore in the next one month. These two measures are expected to inject liquidity of the order of ₹ 48,000 crore on an enduring basis. The reduction of the SLR will free securities and once banks can borrow at the LAF window with these excess SLR securities, borrowers can shift from costlier sources to the LAF window (Figure 4.14 and Table 4.15).

Table 4.15 : Call money market

	Call Turnover (₹ crore)	Call Rate (per cent)^	LAF (₹ crore)#	MSS (₹ crore)*
2009-10				
Mar.2009	23,818	4.17	33,360	88,077
Apr.2009	21,820	3.28	1,01,561	75,146
May2009	19,037	3.17	1,25,728	45,955
Jun.2009	17,921	3.21	1,23,400	27,140
Jul.2009	14,394	3.21	1,30,891	22,159
Aug.2009	15,137	3.22	1,28,275	19,804
Sep.2009	16,118	3.31	1,21,083	18,773
Oct.2009	15,776	3.17	1,01,675	18,773
Nov-09	13,516	3.19	1,01,719	18,773
Dec.2009	13,302	3.24	68,522	18,773
Jan.2010	12,822	3.23	81,027	9944
Feb.2010	13,618	3.17	78,661	7737
2010-11				
Mar.2010	17,624	3.51	37,640	3987
Apr.2010	16,374	3.49	57,150	2737
May2010	16,786	3.83	32,798	922
Jun.2010	14,258	5.16	-47,347	317
Jul.2010	18,954	5.54	-46,653	254
Aug.2010	15,916	5.17	-1048	0
Sep.2010	17,212	5.50	-24,155	0
Oct.2010	17,840	6.39	-61,658	0
Nov.2010	17,730	6.81	-99,311	0

Source : RBI.

Notes : ^ : Average of daily weighted call rate. * : Average of weekly outstanding MSS.

: Average daily absorption under LAF.

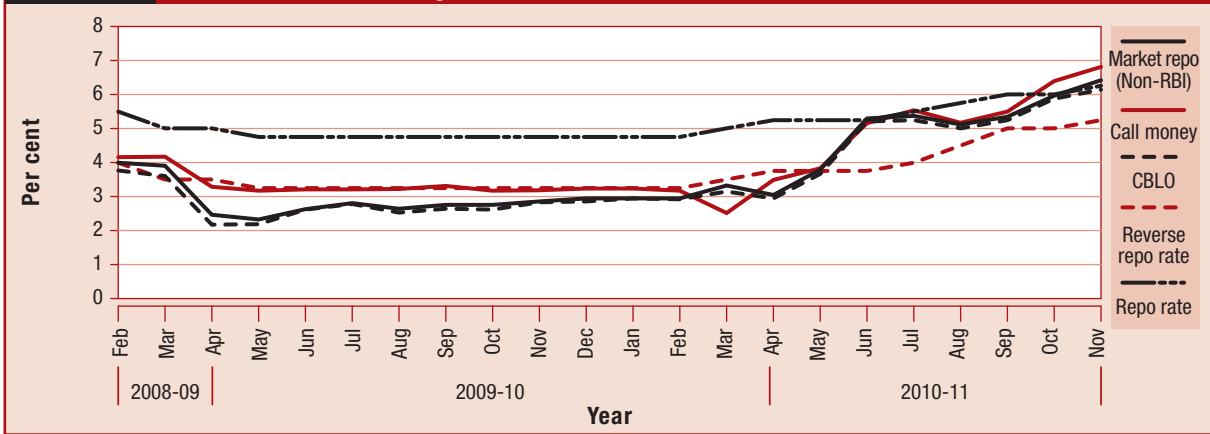
MONEY MARKET

4.55 The money market generally remained orderly during 2010-11. At the commencement of the financial year 2010-11, the call rate mostly remained around the lower bound of the informal LAF corridor up to May 2010. With the tightening of liquidity conditions since end-May 2010, reflecting migration of liquidity to the Central Government account with the RBI on account of 3G auction/ advance tax payments, the call rate firmed up. The average daily call rate for the first quarter was at 4.16 per cent. It hovered around the upper bound of the LAF corridor till July 2010 as deficit liquidity conditions persisted due to the high Central Government cash balances. The call rate declined towards the end of August and early September with the change in liquidity conditions. However, it again firmed up from the middle of September 2010 and breached the upper bound of the informal LAF corridor in the second

half of the month reflecting the onset of high deficit liquidity conditions. The average call rate increased to 5.40 per cent in the second quarter (Table 4.15). The call rate has mostly remained above the upper bound of the corridor in the third quarter of 2010-11 so far, reflecting the increased liquidity stress in the system. The average call rate was 6.59 per cent in the third quarter of 2010-11 (till 20 December 2010) (Figure 4.15).

4.56 The rates in the collateralized segments have continued to move in tandem with the call rate, albeit below it, so far during 2010-11. The weighted average interest rate in the collateralized segment of the money market increased to 5.20 per cent during the second quarter from 3.97 per cent in the first quarter of 2010-11. Transaction volumes in the collateralized borrowing and lending obligation (CBLO) and market repo segments remained high during this period, reflecting active market

Figure 4.15 Movement of money market rates



conditions. Banks continued to remain the major group of borrowers in the collateralized segments whereas mutual funds (MFs) remained the major group of lenders of funds in these segments. The collateralized segment of the money market continued to remain the dominant segment, accounting for more than 80 per cent of the total volume so far during the year.

Certificates of Deposit (CDs)

4.57 Though the average gross issuance of CDs was high during 2010-11 so far, the amount of CDs outstanding declined, indicating decline in net issuances. The amount of outstanding CDs issued by SCBs declined marginally from ₹ 3,41,054 crore at the end of March 2010 to ₹ 3,32,982 crore at the end of November 2010. The outstanding amount constituted 7.45 per cent (as on 19 November 2010) of aggregate deposits of CD-issuing banks with significant inter-bank variation. During April-November 2010, the average issuance was of the order of around ₹ 22,000 crore as compared to around ₹ 11,000 crore during the same period of the last financial year. The effective interest rate in respect of aggregate CD issuances increased from 6.07 per cent at the end of March 2010 to 8.16 per cent as on 19 November 2010.

Commercial Paper (CP)

4.58 During 2010-11 so far, the commercial paper (CP) market has also picked up and the size of fortnightly issuance increased significantly. The outstanding amount of CP issued by corporates has shown an increasing trend from ₹ 75,506 crore at the end of March 2010 to ₹ 1,12,003 crore at the end of September 2010 and ₹ 1,17,793 crore at the end of November 2010. The weighted average

discount rate (WADR) of aggregate CP issuances increased from 6.29 per cent at the end of March 2010 to 7.82 per cent at the end of September 2010, and reached 12.22 per cent at the end of November 2010. The shares of 'leasing and finance companies', 'manufacturing companies', and 'other financial institutions' in total outstanding CPs were at around 50 per cent, 39 per cent, and 11 per cent respectively at the end of November 2010 (Table 4.16).

Treasury Bills (T-Bills)

4.59 T-Bills issuances during the year 2010-11 were modulated according to the cash management requirements of the Government as well as evolving market conditions. The notified amounts for competitive auctions of T-Bills were reduced during the first two quarters of the fiscal year. The outstanding stock of T-Bills went down from ₹ 1,34,500 crore on 31 March 2010 to ₹ 1,26,269 crore on 31 December 2010, after taking into account a rise in non-competitive allotment. The primary market yields for T-Bills of different tenors (91 days, 182 days, and 364 days) moved up during the year largely influenced by the liquidity conditions and monetary policy action by the RBI. The yield behaviour during 2010-11 vis-à-vis 2009-10 is shown in Figures 4.16, 4.17, and 4.18.

Cash Management

4.60 During the year, a new short-term instrument, named cash management bill (CMB), was introduced in May 2010. CMBs are non-standard, discounted instruments issued for maturities of less than 91 days, to meet the temporary cash-flow

Table 4.16 : Activity in money market segments

(₹ crore)

Year/ month	Average daily volume (one leg)				Money market rate [^] (per cent)	Term money	Commercial paper		Certificates of deposit	
	Call	Market repo	CBLO	Total			Out- stand- ing	WADR (per- cent)	Out- stand- ing	EIR (per- cent)
Apr.2009	10910	20545	43958	75413	2.41	332	52881	6.29	210954	6.48
May.2009	9518	22449	48505	80472	2.34	338	60740	5.75	218437	6.2
Jun.2009	8960	21694	53553	84207	2.69	335	68721	5	221491	4.9
Jul.2009	7197	20254	46501	73952	2.83	389	79582	4.71	240395	4.96
Aug.2009	7569	23305	57099	87973	2.62	461	83026	5.05	232522	4.91
Sep.2009	8059	27978	62388	98425	2.73	381	79228	5.04	216691	5.3
Oct.2009	7888	23444	58313	89645	2.70	225	98835	5.06	227227	4.70
Nov.2009	6758	22529	54875	84162	2.87	191	103915	5.17	245101	4.86
Dec.2009	6651	20500	55338	82489	2.91	289	90305	5.40	248440	4.92
Jan.2010	6411	14565	50571	71547	2.97	404	91564	4.80	282284	5.65
Feb.2010	6809	19821	63645	90275	2.95	151	97000	4.99	309390	6.15
Mar.2010	8812	19150	60006	87968	3.22	393	75506	6.29	341054	6.07
Apr.2010	8187	20319	50891	79397	3.03	345	98769	5.37	336807	5.56
May.2010	8393	17610	42274	68277	3.72	338	109039	6.85	340343	5.17
Jun.2010	7129	9481	31113	47723	5.22	447	99792	6.82	321589	6.37
Jul.2010	9477	12011	29102	50590	5.33	385	112704	6.93	324810	6.69
Aug.2010	7958	15553	45181	68692	5.05	281	126549	7.32	341616	7.17
Sep.2010	8606	15927	53223	77756	5.29	617	112003	7.82	337322	7.34
Oct.2010	8920	14401	43831	67152	5.96	712	149620	12.15	343353	7.67
Nov.2010	8865	9967	32961	51793	6.31	415	117793	12.22	332982	8.16

Source: RBI.

Notes: ^ Average of daily weighted call rate.

Figure 4.16 Cut-off yields in the auctions of 91-day T-bills

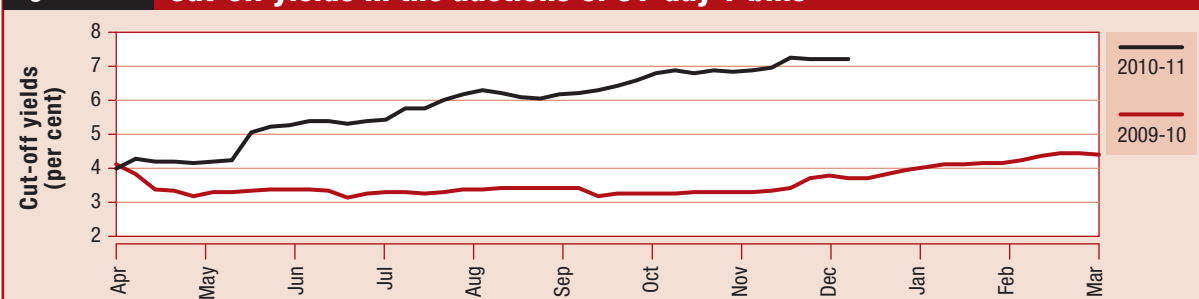
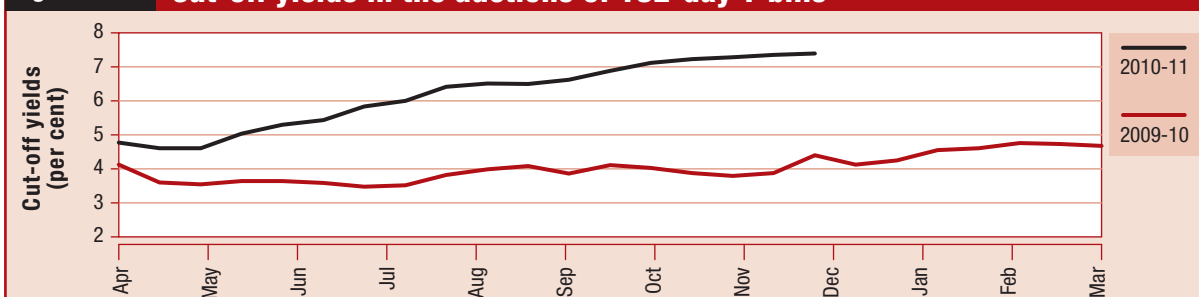
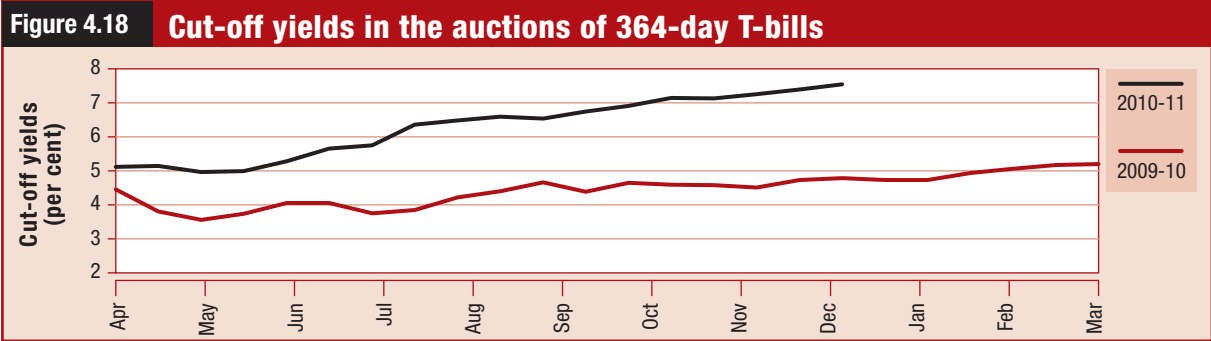


Figure 4.17 Cut-off yields in the auctions of 182-day T-bills





mismatches of the Government. During 2010-11, CMBs were issued twice in May 2010 for an aggregate amount of ₹12,000 crore, with a maturity of five and four weeks, respectively.

Central Government Borrowing

4.61 The Union Budget 2010-11 placed the net market borrowings (through dated securities) requirement of the Central Government at ₹ 3,45,010 crore as against ₹ 3,97,957 crore raised during the previous year. Including repayments of ₹ 1,12,133 crore, gross market borrowings were estimated at ₹ 4,57,143 crore (as compared to ₹ 4,51,000 crore raised in the previous year, including MSS de-sequestering of ₹ 33,000 crore). The actual issuances during the first half of the current year amounted to ₹ 2,84,000 crore (as against issuances of ₹ 2,95,000 crore, excluding MSS de-sequestering of ₹28,000 crore, during the corresponding period of the previous year). The issuance calendar for dated securities released on 23 September 2010 proposed to raise ₹ 1,63,000 crore during the second half of the year, indicating a reduction of ₹10,000 crore from the budget estimate.

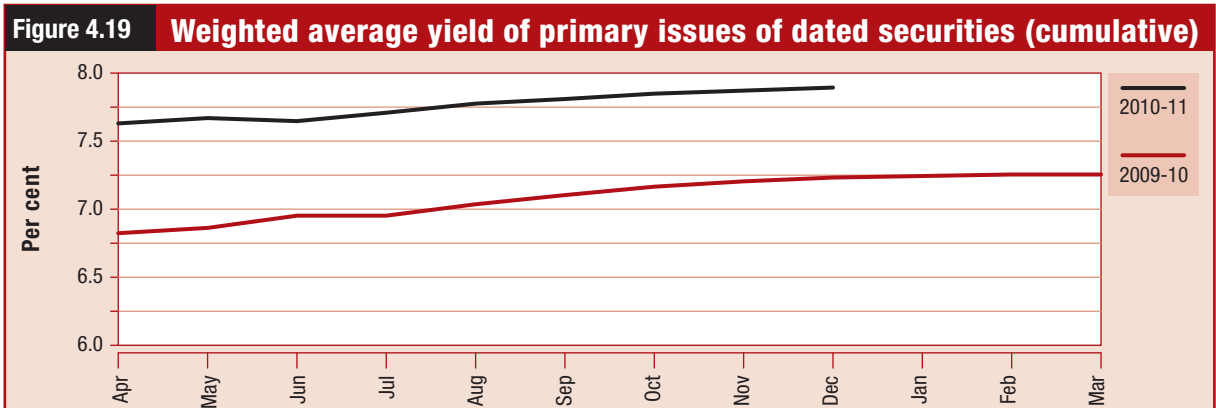
4.62 The gross borrowings requirement in 2010-11 remained high as in the previous year. The market borrowings programme is, however, carried out in a

smooth and non-disruptive manner. During the year, the Government undertook buy-back operations whereby securities worth ₹11,767 crore were bought back.

4.63 During 2010-11 (up to 31 December 2010), gross market borrowings raised through dated securities by the Central Government were Rs 3,84,000 crore (net ₹2,98,342 crore) as against ₹3,83,000 crore (excluding issuances under the MSS) (net ₹ 3,46,911 crore) raised during the corresponding period of the previous year. The weighted average maturity of dated securities issued during the year (up to 31 December 2010) was moderately higher at 11.54 years as compared to 11.15 years for issues during the corresponding period of the previous year. The weighted average yield of dated securities during 2010-11 (up to 31 December 2010) increased to 7.87 per cent from 7.21 per cent during the corresponding period of the previous year (Figure 4.19).

Yields on 10-year Government Securities

4.64 Secondary market yields on Government securities remained in a broad range during the year. Monetary policy, inflation concerns, and supply issues were the major factors influencing yields on government securities.



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4.65 Intra-year movements in yields on Government securities could be attributed to various factors. The upward movement in the month of April 2010 was mainly on account of supply pressure in the wake of front-loading of the market borrowings programme.

4.66 In the month of May, concerns regarding high fiscal deficit receded due to higher-than-budgeted collections from auction of 3G and BWA licences. The improved sentiments drove down yields in the month of May. The impact of the improved sentiments, however, was offset by concerns of high inflation and policy tightening by the Reserve Bank. In the third quarter of the current financial year, tight liquidity conditions remained a major factor putting upward pressure on yields. The 10-year yield, which was at 7.87 per cent on 31 March 2010, went up to 7.94 per cent on 31 December 2010.

State Government Borrowings

4.67 Twenty-two State Governments have raised an aggregate amount of ₹ 74,104 crore on a gross basis up to end-December 2010 as compared to ₹ 1,00,085 crore raised by 25 State Governments during the corresponding period of the previous year. The cut-off yields have ranged between 8.05 and 8.58 per cent as compared to 7.04 and 8.49 per cent during the corresponding period of the previous year. The weighted average yield worked out to 8.36 per cent up to end-December 2010 as compared to 8.02 per cent during the corresponding period of 2009-10 and 8.11 per cent for the year as a whole. The spread between the yield on State Development Loans (SDLs) and the 10-year benchmark Government of India securities stood lower at 32-69 bps up to December 2010 as compared to 45-129 bps during the corresponding period of the previous year. It is expected that the calibrated strategies adopted for the market borrowings programme of the Government of India and the State Governments would ensure its completion in a non-disruptive manner.

MONETARY POLICY STANCE DURING 2010-11

4.68 The accommodative monetary policy which was pursued beginning mid-September 2008 instilled confidence in market participants, mitigated the adverse impact of the global financial crisis on the economy, and ensured that it started recovering

ahead of most other economies. However, in view of the rising food inflation and the risk of it impinging on inflationary expectations, the Reserve Bank embarked on the first phase of exit from the expansionary monetary policy in October 2009 itself. By April 2010, available data suggested that the recovery was firmly in place, though inflationary pressures accentuated. Accordingly, both repo and reverse repo rates as well as the CRR were increased by 25 bps each. The monetary policy stance in April 2010 was guided by the following three considerations. First, the need to move in a calibrated manner in the direction of normalizing the policy instruments in a scenario where real policy rates were still negative. Second, the need to ensure that demand-side inflation did not become entrenched. Third, the need to balance the monetary policy imperative of absorbing liquidity while ensuring that credit was available to both the Government and private sector. Significant developments took place subsequent to the announcement of the monetary policy in April 2010. Though recovery was consolidating, developments on the inflation front raised several concerns. The upward revision in administered fuel prices on 25 June 2010 was also expected to influence inflation in the months ahead. Accordingly, the repo and reverse repo rates under the LAF were increased by 25 bps each on 2 July 2010. In the interests of consolidating and of more broad-based domestic recovery and with the

Table 4.17 : Revision in Policy Rates

Effective Date	Repo rate	Reverse Repo rate	(per cent)
			CRR
2009			
05.01.2009	5.50	4.00	
17.01.2009			5.00
05.03.2009	5.00	3.50	
21.04.2009	4.75	3.25	
2010			
13.02.2010			5.50
27.02.2010			5.75
19.03.2010	5.00	3.50	
20.04.2010	5.25	3.75	
24.04.2010			6.00
02.07.2010	5.50	4.00	
27.07.2010	5.75	4.50	
16.09.2010	6.00	5.00	
02.11.2010	6.25	5.25	
25.01.2011	6.50	5.50	

then level of consumer price inflation in double digits, the First Quarter Review of the RBI (July 2010) upwardly revised the baseline projection of real GDP growth for the year to 8.5 per cent and raised the projection for WPI inflation for March 2011 to 6.0 per cent (Table 4.18). Consistent with this assessment, the repo rate was increased by 25 bps and reverse repo by 50 bps. The monetary policy actions were intended to moderate inflation by reining in demand pressures and inflationary expectations, maintain financial conditions conducive to sustaining growth, generate liquidity conditions consistent with more effective transmission of policy actions, and reduce the volatility of short-term rates in a narrower corridor. Given the context of the changing liquidity dynamics, particularly between surplus and deficit modes, it was proposed to set up a working group to review the operating procedure of the RBI's monetary policy, including the LAF. It was also announced that mid-quarter reviews of monetary policy would be made in June, September, December, and March. The changes in policy rates since 2009 are brought out in Table 4.17.

Quarterly Reviews

4.69 As decided in the First Quarter Review, on the basis of assessment of the macroeconomic situation, the RBI in its Mid-Quarter Review on 16 September 2010 decided to increase the repo rate under the LAF by 25 bps from 5.75 per cent to 6.0 per cent and the reverse repo rate by 50 bps from 4.5 per cent to 5.0 per cent.

4.70 The Second Quarter Review of Monetary Policy for 2010-11 (released on 2 November 2010) noted that the fragile and uneven nature of the recovery and large unemployment in advanced

economies raised concerns about the sustainability of the global turnaround whereas the Indian economy was operating close to the trend growth rate, driven mainly by domestic factors. However, notwithstanding some moderation in recent months, headline inflation in India remained significantly above its medium-term trend and well above the comfort zone of the RBI (Table 4.18). Accordingly, the RBI further increased the repo rate by 25 bps to 6.25 per cent and the reverse repo rate also by 25 bps to 5.25 per cent on (2 November 2010). The CRR has been retained unchanged at 6 per cent of the NDTL of banks.

4.71 The RBI in its Third Quarter Review of the Monetary Policy (25 January 2011) indicated that its stance is shaped by four important considerations:

- Inflation is clearly the dominant concern. Even as the rate itself remains high, the reversal in the direction of inflation is striking. Primary food articles inflation has risen again sharply. Non-food articles inflation and fuel inflation are already at elevated levels. Non-food manufacturing inflation has remained sticky. There are signs of food and fuel price increases spilling over into generalised inflation.
- Second, there has been a sharp rise in global commodity prices which has heightened upside risks to domestic inflation.
- Third, growth has moved close to its pre-crisis trajectory even in the face of an uncertain global recovery.
- Fourth, the uncertainty with regard to global recovery has reduced.

Table 4.18: Indicative Projections of Macro Parameters for 2010-11 by the RBI

	Indicative projections for growth rates (per cent)			
	Annual Policy 2010-11 (April 20, 2010)	First Quarter Review (July 27, 2010)	Second Quarter Review (November 2, 2010)	Third Quarter Review (Jan. 25, 2011)
GDP growth	8.0	8.5	8.5	8.5
WPI inflation	5.5**	6.0**	5.5	7.0
Money supply growth (M ₃)	17.0	17.0	17.0	17.0
*Adjusted non-food credit	20.0	20.0	20.0	20.0

Notes : * Includes investment by SCBs in bonds/debenture/shares of public-sector undertakings, private corporate sector, and CP.

** Old series.

4.72 On the basis of the assessment of the existing macroeconomic scenario, the RBI retained the bank rate at 6.0 per cent and the CRR of scheduled banks at 6.0 per cent of their NDTL; increased the repo rate under the LAF by 25 bps from 6.25 per cent to 6.5 per cent; and the reverse repo rate under the LAF by 25 bps from 5.25 per cent to 5.50 per cent. On the basis of an assessment of the liquidity situation, the RBI extended additional liquidity support to the SCBs under the LAF to the extent of up to 1 per cent of their NDTL, till 8 April 2011. For any shortfall in maintenance of the SLR arising out of availment of this facility, banks were allowed to seek waiver of penal interest purely as an ad hoc measure.

CHALLENGES AND OUTLOOK

4.73 Inflation is clearly the dominant concern. Average headline inflation in April-December 2010-11 at 9.4 per cent is the highest ever in the decadal average. This is also true of annual average inflation based on the WPI, for primary food articles, fuel and power, and manufacturing products. During the current financial year, even as the rate itself remains uncomfortably high, the reversal in the direction of inflation in December is also striking. After some moderation between August and November 2010, inflation rose again in December 2010 on account of sharp increase in the prices of primary food articles and the recent spurt in global oil prices. Non-food manufacturing inflation has also remained sticky, reflecting buoyant demand conditions. However, in January 2011, headline inflation has come down to 8.23 per cent and it is expected that this trend may continue in the next two months.

4.74 Going forward, the inflation outlook will be shaped by the food price situation and the demand-side pressures in the economy. Rise in food inflation

has not only persisted for quite some time, but has also been rather sharp. High inflation in food articles is not unique to India, it has spiked in many other countries as well. The domestic food price situation could be exacerbated by the increase in global food prices because of dependency on import of some food items like edible oils. Current growth and inflation trends warrant persistence with an anti-inflationary monetary stance.

4.75 The issue of maintaining an environment where the cost and availability of credit is supportive of growth momentum, while ensuring that inflation falls back to more comfortable target levels, will be at the centre stage of policy consideration in the near term. This has to be seen in the context of more than expected inflation in the recent past, relative stickiness of prices, especially of food, and building of wider inflationary expectations in the economy, even as monetary policy tools are being used proactively to manage demand and dampen inflationary pressures in the economy. The concurrent consolidation of fiscal deficits will, however, be essential as it is expected to ease the conduct of effective monetary policy in the near future. The reduced fiscal deficits will permit greater availability of credit to sustain growth, while tighter monetary policy starts to transmit its impact in reducing inflationary pressures. The transmission of monetary policy, however, comes with a lag. Inflationary pressures in the economy are also emanating in part from supply-side constraints, especially in food and other primary articles, as well as the transmission of higher global food, oil, and other commodity prices. These considerations therefore are complicating the issue in the near term. If external commodity negative price shocks build further, the dilemmas will become greater. Therefore, the policy challenge of maintaining the growth momentum in the economy with price stability is going to remain a key focus area for monetary policy and macroeconomic management.