Money and Prices

19. The annual rate of inflation, which was 6.7 per cent at the start of 1997-98, had fallen to an eleven-year low of 3.4 per cent by the end of August 1997. The concern (based on historical closed economy conditions) that the increase in the administered prices of petroleum products and electricity during the year would lead to cost push inflation proved unfounded. The deceleration in the rate of inflation from the beginning of the year reflected moderate money supply growth, sluggish demand, abundant agricultural supplies from high production in 1996-97 and competitive price discipline in an increasingly open economy.

20. The low inflation rate of less than 4 per cent was maintained up to end November 1997. Thereafter, there was a slight upward drift in the growth rate (caused by the increase in prices of some primary products) to over 5 per cent in December 1997 and close to 6 per cent in January 1998. By mid-February 1998, the annual inflation rate was just 5.4 per cent and this low growth rate was maintained through March with the year end inflation reaching 5 per cent (provisional). The average inflation for 1997-98 was 1.4 percentage point less than the average inflation in 1996-97.

21. The variance of sectoral price trends has declined during 1997-98. Price growth decelerated sharply for 'primary articles' and 'fuel, power, light and lubricants', and marginally for the 'manufactured products' group. The annual rate of price increase for 'fuel & power' decelerated from 16.9 per cent in 1996-97 to 9.4 per cent (in 1997-98) and for 'primary articles' from 7 per cent to 5.5 per cent. The rate of growth of manufactured goods' prices declerated to 3.8 per cent from 4.9 per cent in the previous year.

22. Prices of primary products, which include major essential commodities, rose only by 5.5 per cent on a point to point annual basis at the end of March 1998. Wheat prices, which had escalated very sharply in 1996-97 by about 31 per cent, have registered a decline of 11 per cent in 1997-98, bringing relief to the wheat consumers. The decline in the WPI of wheat can be attributed to higher production of wheat in 1996-97 Rabi and increased availability in the market due to imports contracted last year. The Targeted Public Distribution System replaced the erstwhile PDS from June 1997. Under the new system, a two-tier subsidised pricing system was introduced to benefit the poor. Under the system, each below poverty line (BPL) family is entitled to 10 Kgs. of foodgrains per month at specially subsidised prices. The State Governments were to streamline the PDS by issuing special cards to BPL families and selling essential articles under TPDS to them at specially subsidised prices with better monitoring of the delivery system.

23. The RBI set a lower indicative target of 15 to 15.5 per cent for broad money (M3) growth in 1997-98 based on a projected real GDP growth of about 6 per cent and an anticipated inflation rate of the same order. The expansion in broad money in 1997-98 at 17.0 per cent was higher than 16.0 per cent in the previous financial year.

24. The RBI's flexibility and autonomy in conducting monetary policy was enhanced by the new system of Ways and Means Advances introduced with effect from April 1997. This replaced the practice of issuing of ad-hoc treasury bills, which in earlier years resulted in automatic monetisation of the budget deficit.

25. The annual rate of expansion in reserve money till March 31, 1998 was far above that in the previous year. Expansion in reserve money in the financial year 1997-98 was 13.1 per cent, as against only 2.9 per cent during the previous financial year. The higher growth in reserve money in 1997-98 was largely due to increase in RBI's net foreign exchange assets and net RBI credit to the Central Government.

26. Despite the easy liquidity situation, especially in the first half of 1997-98, credit growth continued to be low because of weak demand for credit and banks' cautious approach to lending. Non-food credit, however, expanded by 14.2 per cent during 1997-98 as against 10.9 per cent growth in 1996-97. The total flow of funds from commercial banks to the commercial sector (comprising investments in equity, bonds, debentures, commercial paper and non-food credit) expanded by 17.9 per cent in 1997-98. In contrast, growth in total flow of funds was only 11.9 per cent in 1996-97.

27. In an effort to increase the depth of the call money market, the SLR and the CRR on inter-bank liabilities were removed from April 26, 1997. The SLR and CRR requirements with respect to total net time and demand deposit

liabilities (NDTL) however remain. The SLR was also simplified into a single uniform rate of 25 per cent on total NDTL with effect from October 25, 1997. Actual investment in government securities was, however, in excess of the SLR requirements, with banks' credit to government rising by Rs. 29888 crore. Banks preferred to invest in zero risk Government securities, given their concern to contain expansion in non-performing assets. This enabled the Central Government to complete most of its budgeted market borrowing by September 1997.

28. RBI reactivated the Bank Rate by making it a reference rate for key interest rates in the market and a signal for its monetary policy stance. A general refinance facility was introduced, under which Banks could avail up to 1 per cent of their fortnightly average aggregate outstanding deposits at an interest rate linked to the Bank Rate. The one percentage point reduction in the Bank Rate each in April, June and October 1997 was followed by reductions in banks' lending and deposits rates.

29. Developments in the external environment leading to speculative activity resulted in a temporary change in the direction of monetary policy during November-January, 1997-98. The CRR, which was reduced to 9.5 percent in November 1997, was raised to 10 per cent from December 6, 1997 and to 10.5 per cent from January 17 1998. The Bank Rate was increased by 2 percentage points to 11 per cent, simultaneously. The general refinance limit for banks was also reduced to 0.25 per cent of outstanding deposits, and the export credit refinance limit halved. These measures were reversed partially in March 1998, following more orderly conditions in the foreign exchange market.The Bank Rate, which was reduced to 10 per cent with effect from April 3, 1998, has further been reduced to 9 per cent with effect from April 30, 1998. The CRR was reduced to 10 per cent with effect from the fortnight beginning April 11, 1998.