Monetary and Credit Policy

3.8 The important reforms/ measures undertaken in the current financial year are summarised in Box 3.1. As in previous years, the monetary policy stance lays emphasis on provision of sufficient credit for growth without causing inflationary pressures in the economy.

BOX 3.1

Monetary & Credit Policy 2000-01

A. Annual Policy Statement

- Implementation of full-fledged LAF in three stages; in the first stage additional CLF for banks and Level II support for PDs were replaced by variable rate reverse repo auctions while fixed rate repos were replaced by variable rate repos with same day settlement with effect from June 5, 2000; in the second stage, CLF for banks and Level I support for PDs to be replaced by variable rate repo/reverse repo auctions; some minimum support to PDs to continue but at interest rate linked to the variable rate in the daily repo auctions; in the third stage repo operations through electronic transfer to be introduced.
- Permission to non-bank entities for routing transactions through PDs extended up to December 2000.
- Interest rates implied in the forex forward market allowed as a benchmark for interest rate swaps in addition to the existing domestic money and debt market rates.
- The minimum maturity for CDs reduced from 3 months to 15 days.
- The stipulated minimum 85 per cent of the CRR to be maintained on daily basis reduced to 65 per cent with effect from May 26,2000
- Flexibility to offer all loans on fixed or floating rates allowed; current swap rates quoted on any on-line trading system also allowed as ceiling in respect of FCNR(B) deposits.
- Freedom to banks to offer differential rates of interest on NRE deposits on size group, as in the case of domestic deposits. In the case of FCNR(B) deposits, the differential rates permitted within the overall ceiling prescribed.
- To provide more deployment avenues and to exploit the synergy between the lending expertise of a few banks with the vast net work of the others, banks allowed to lend gold to other nominated banks.
- Banks/subsidiaries allowed insurance business through joint venture up to 50 per cent holding subject to : (a) minimum networth of Rs. 500 crore, (b) minimum CRAR of 10 per cent, (c) reasonable level of NPAs, (d) consecutive net profit for the last three years and (e) satisfactory track record of performance of subsidiaries; banks not meeting these criteria can take up insurance business without risk participation provided they meet criteria stipulated at (b),(c) and (d) above
- Tenor-linked PLR permitted; flexibility to offer all loans on fixed or floating rates allowed ;current swap rate quoted on any on-line trading system allowed in respect of FCNR(B) deposits.

B. Mid-Term Review

- Guidelines for issue of CPs relaxed;CP issues delinked from working capital
- Restriction on transferability of CDs withdrawn
- EEFC facility restored to earlier entitlements of 70 per cent of inward remittances in case of EOUs and units in EPZs,STPs,or EHTPs and up to 50 per cent in others. The limits for respective entitlement were halved to 35 per cent and 25 per cent in August, 2000.
- Draft guidelines for constituents' SGL accounts issued;switchover to the order-driven, screen-based trading in Gilt securities in all stock exchanges in due course
- Revised categorisation and valuation of banks' investment portfolio with effect from September 30,2000
- Provisioning of standard assets allowed for calculation of Tier II capital;Past due concept withdrawn;decision to review revised credit exposure to individual/group borrowers
- Limit on bank financing in equities and investment in shares increased to 5 per cent of the outstanding advances of the bank of the previous March as against the existing limit of 5 per cent of incremental deposits
- Deregulation of penal interest rates on defaulting borrowers
- Permission to select corporates to route call money transactions through Primary Dealers extended upto June, 2001.
- The existing margin of 15 per cent in respect of free sale sugar withdrawn and margins to be decided by the banks based on their commercial judgement.

RBI's decision to continue with this policy stance needs to be viewed from the following perspective. According to RBI's assessment at the time of formulation of the Monetary and Credit Policy for 2000-2001 (April 27, 2000), the prospects for achieving the stated objective looked reasonably promising. The policy statement also noted the budget stance of reining in the overall fiscal deficit and called for expeditious adjustment of important administered prices, including prices of petroleum products so as to keep fiscal deficit under reasonable control.

3.9 Based on a projected real GDP growth of 6.5 to 7.0 per cent and an assumed inflation rate of around 4.5 per cent, RBI projected M3 growth for 2000-01 at around 15 per cent. While the projected GDP growth was lowered marginally to 6.0-6.5 per cent, the projected M3 growth remained unchanged. The projected M3 growth implies (i) increase in aggregate deposits of Scheduled Commercial Banks (SCBs) by 15.5 per cent and (ii) increase in non-food credit, adjusted for investments in debt/equity instruments of industrial units in public and private sectors, by around 16.0 per cent. The year-on-year M3 growth as on January 12,2001 exceeded the indicated growth target of 15.0 per cent reflecting the inflows under IMDs. The year-on-year growth in deposits of SCBs as on the same date also exceeded the indicated growth rate of 15.5 per cent. This reflected the significant increase in time deposits of SCBs, which in turn mirrored the spurt on account of the IMD inflows. The year-on-year growth in the flow of non-food credit, including banks' investment in debt/equity instruments of industrial units, to the commercial sector was also higher at 18.1 per cent as on January 12, 2001 than the projected growth of 16.0 per cent.

Credit

3.10 Till January 12, 2001, non-food credit from SCBs registered a growth of 11.9 per cent compared with 10.5 per cent last year. The investment of banks in the debt and equity instruments of the public and private sector units, however, registered a growth of 13.7 per cent till December 2000, lower than the growth of 21.1 per cent in the corresponding period of 1999. This reflected a significant drop in investment in debt and equity instruments of the private corporate sector in the current financial year till December 29, 2000 *vis-à-vis* the corresponding period of 1999. The incremental investment of SCBs in the equity/debt instruments of the private corporate sector amounted to Rs. 1257 crore till December 29, 2000 compared with Rs. 4132 crore last year. Nevertheless, as this decline was more than offset by the increase in non-food credit, the total flow of funds from commercial banks to commercial sector comprising non-food credit as well as investment increased by 12.1 per cent till January 12, 2001, compared with a lower rate of 11.8 per cent last year. However, quarter-wise figures of the flow of non-food credit to the commercial sector during April-December 2000 revealed a decline in the second and third quarters of the current financial year *vis-a-vis* the corresponding quarters of previous financial year.

Credit flow *vis-à-vis* Industrial Growth

3.11 There has been growing concern over the deceleration in industrial production despite higher flow of non-food credit. The impression that a significant proportion of the incremental credit has gone to the oil sector has not been supported by figures. Till January 12, 2001, the flow of non-food credit to the petroleum sector declined by Rs.79 crore compared with an increase of Rs.210 crore in the corresponding period last year.

Interest Rates

3.12 The Prime Lending Rates (PLRs) of banks for commercial credit are entirely within the purview of the banks and are not set by the Reserve Bank (Box 3.2). The only domestic interest rates, which are subject to regulation, are the rate of interest on savings accounts, rates of interest on export credit and those governed by the Differential Rate of Interest (DRI) scheme. As regards lending rates, banks were given the freedom to offer all loans on fixed or floating rate basis, subject to PLR stipulations for loans above Rs. 2 lakh. For small loans upto Rs. 2 lakh PLR is the ceiling.

3.13 The RBI has made it known on many occasions that changes in key monetary instruments/variables would be effected at short notice in response to the developments in

BOX 3.2

Prime Lending Rates (PLRs) of Scheduled Commercial Banks (SCBs)

- SCBs continue to play a leading role in financial intermediation. The rates that they charge for prime borrowers, namely, PLRs, therefore assume considerable importance.
- Administrative interest rate regime existed during 1975-76 to 1994-95.The lending rate of banks evolved in three phases during this period. During 1975-76 to 1980-81, RBI prescribed both minimum lending rate (13.5 per cent) and the ceiling rate(19.5 per cent). During 1981-82 to 1987-88, RBI prescribed only the ceiling rate, which was progressively reduced in three steps from 19.5 percent up to 1982-83 to 16.5 per cent in 1987-88.During the third stage spanning 1988-89 to 1994-95, RBI switched over from a ceiling rate to a minimum lending rate.
- The minimum lending rate, which was initially fixed at 16.0 percent, was raised to 19.0 per cent in 1991-92 in response to the rise in inflation rate to 13.7 percent. With the deceleration in inflation rate to 8.4 per cent in 1993-94, the minimum lending rate was also lowered to 14.0 per cent in 1993-94.
- With effect from October 18, 1994 the lending rate was deregulated in respect of loans above Rs. 2 lakh.
- Since banks still constitute the most important financial intermediary in India, reduction in their PLRs would facilitate lower transaction costs, which account for a significant share in the cost of production in the productive sectors of the economy. The decline in PLR from 16.50 percent in 1995-96 to 12.50 percent in 1999-2000 is therefore encouraging.
- However, it is necessary to look at the trends in not only nominal PLRs but also real PLRs. The following Table presents the trends during 1994-95 to 1999-2000.

Year	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000
Nominal PLR	15.00	16.50	14.50	14.00	12.00	12.50
Real PLR	2.4	8.50	10.1	9.6	6.1	9.2

- Significant decline in the WPI-based annual average inflation rate from 12.6 percent in 1994-95 to 3.3 percent in 1999-2000 contributed to increase in real interest rates during the last six years (except in 1998-99).

financial markets both at home and abroad. Decline in inflation rate, unless accompanied by reduction in nominal interest rates, would not bring down the real interest rate. Keeping in view the decline in inflation rate as well as the importance of lower real interest rates in accelerating industrial growth and boosting India's competitiveness abroad, RBI announced the following measures on April 1, 2000.

- Bank Rate reduced from 8 per cent to 7 per cent.
- CRR reduced from 9 per cent to 8 per cent.
- Repo rate reduced from 6 per cent to 5 per cent.
- Savings deposit rate of SCBs reduced from 4.5 per cent to 4.0 per cent.

3.14 With the above reductions, the key rates fixed by RBI, *viz.* the Bank Rate, Repo Rate and the rate on savings deposits came down significantly to levels that were not too much out of line with ruling international rates. Most public sector banks announced a reduction in their lending and deposit rates. In the case of major public sector banks, deposit rates were reduced by 0.50 to 1.00 per centage point while prime lending rates (PLR) were reduced by 0.50 to 0.75 per centage point. However, the developments in financial markets both at home and abroad necessitated a slight reversal of this policy. In the US, the Federal Reserve raised the Federal Funds Target Rate by 175 basis points from 4.75 per cent in June 1999 to 6.50 per cent by May 2000. The European Central Bank also raised its refinance rate. In response to the growing pressure on the rupee in the forex market, the Reserve Bank raised the Bank Rate as well as CRR with a view to preventing arbitrage opportunities for market participants (Table 3.4). It is worth noting here that the Federal Reserve in the US effected a reduction in Federal Funds Target Rate by 50

TABLE 3.4

Interest Rate Trends

(Per cent per annum)

Interest Rate	As on 12-11-99	7-4-2000	26-1-2001
1. Bank Rate	8.00	7.00	8.00
2. MTLR	13.50	13.50	13.00
3. PLR	12.00-12.50	11.25-12.50	12.00 -12.50
4. Deposit Rate	8.00-10.50	8.00-10.50	8.50 -10.50
5. Call Money (low/high)	7.80-8.90	0.20-7.0	7.80-11.30
6. CDs	8.25-11.93	6.50-14.00	7.78-10.50
7. CPs	9.40-12.50	9.58-12.25	10.00-11.98
8. 91-day T.Bills	9.33	8.00	8.87
9. 364-day T.Bills	10.19	9.29	9.42

MTLR : Medium Term Lending Rate (IDBI's rate)

basis points in the first week of January, 2001.As part of its policy of monetary easing to cope with the threat of an economic slump, the Fed cut interest rate by another 50 basis points in the first week of February, 2001.