## Monetary and Credit Policy

3.8 The salient monetary and credit policy measures in the current financial year are summarised in Box 3.1. A major challenge in the conduct of monetary policy has been the need to strike a balance between monetary easing to facilitate credit growth and the need to guard against inflationary pressures likely to emerge from monetary stimulus unmatched by growth in the real sector. The Reserve Bank has been following a multiple indicator approach in recent years, which provides necessary flexibility in responding to developments in financial markets, including foreign exchange markets. While broad money (M3) growth is still used as an important information variable, other indicators like the inflation rate, interest rate, credit flow, fiscal deficit, and the balance of payments (BOP) position are juxtaposed with output for drawing policy perspectives.

### Monetary Policy Stance

3.9 As stated by RBI in its Annual Monetary and Credit Policy (MCP) statement (April 19, 2001), its monetary policy stance for 2001-02 has been to facilitate adequate flow of credit for supporting higher real Gross Domestic Product (GDP) growth through the revival of investment demand, and to maintain a stable interest rate environment, with preference for softer interest rates as warranted by the emerging economic and financial conditions. Assuming revival of the industrial sector, a reasonable monsoon, and good performance of exports, the growth rate of real GDP was placed at 6.0 to 6.5 per cent for the purpose of monetary policy formulation. The rate of inflation was assumed to be within 5.0 per cent and the projected expansion in M3 was about 14.5 per cent . The projected M3 growth of 14.5 per cent is consistent with a 14.5 per cent rate of growth in aggregate deposits of Scheduled Commercial Banks (SCBs), and 16.0 to 17.0 per cent growth in non-food credit, inclusive of their investment in debt/equity instruments issued by both the public and private sectors and bills rediscounted with financial institutions.

3.10 A review of macroeconomic and monetary developments during the first half of 2001-02 as a part of the mid-term review of MCP

**TABLE 3.3**
**Sources of Change in Reserve Money**

| | Outstanding as on March 31, 2001 | Variations during[1] | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Financial Year | | | Annual | | Financial Year | | | Annual | |
| | | 2000-01 Mar.31 to Mar.31 | 2000-01 Mar.31 to Jan.12 | 2001-02 Mar.31 to Jan.11 | 2000-01 Jan. 14 to Jan. 12 | 2001-02 Jan. 12 to Jan. 11 | 2000-01 Mar.31 to Mar.31 | 2000-01 Mar.31 to Jan. 12 | 2001-02 Mar.31 to Jan. 11 | 2000-01 Jan. 14 to Jan. 12 | 2001-02 Jan. 12 to Jan. 11 |
| | | (Rs.crore) | | | | | (per cent) | | | | |
| 1. Net RBI credit to Government[2] | 1,53,877 | 5,613 | 10,131 | -2,119 | 3,826 | -6,637 | 3.8 | 6.8 | -1.4 | 2.5 | -4.2 |
| 2. RBI credit to banks[3] | 12,965 | -3,820 | -2,372 | -3,909 | 5,302 | -5,358 | -22.8 | -14.1 | -30.2 | 58.2 | -37.1 |
| 3. RBI credit to commercial sector[4] | 13,287 | -1,983 | -2,148 | -5,677 | 4,879 | -5,512 | -13.0 | -14.1 | -42.7 | 59.2 | -42.0 |
| 4. Net foreign exchange assets of RBI[5] | 1,97,175 | 31,295 | 22,218 | 39,576 | 35,374 | 48,653 | 18.9 | 13.4 | 20.1 | 23.2 | 25.9 |
| 5. Government's currency liabilities to the public | 5,354 | 776 | 488 | 549 | 631 | 836 | 16.9 | 10.7 | 10.2 | 14.2 | 16.5 |
| 6. Net non-monetary liabilities of RBI | 79,345 | 9,123 | 14,395 | 20,640 | 14,967 | 15,368 | 13.0 | 20.5 | 26.0 | 21.5 | 18.2 |
| 7. Reserve Money (1+2+3+4+5-6) | 3,03,311 | 22,757 | 13,922 | 7,779 | 35,045 | 16,614 | 8.1 | 5.0 | 2.6 | 13.5 | 5.6 |

1. Variations are worked out on the basis of March 31 data after closure of Governments accounts. Figures for 2000-01 and 2001-02 are provisional.
2. Includes special securities.
3. Includes claims on NABARD.
4. Excludes, since the establishment of NABARD, its refinance to banks.
5. Variations are inclusive of appreciation in the value of gold following its revaluation close to the international market price since October 17, 1990. Such appreciation has a corresponding effect on RBI's net non-monetary liabilities.
6. Constituent items may not add to total because of rounding.

## BOX 3.1
## Monetary & Credit Policy 2001-02

**A. Annual Policy Statement**

- Banks allowed to lend over Rs.2 lakh at sub-PLR rates to creditworthy borrowers, including exporters, based on a transparent and objective policy approved by the respective boards. PLR would serve as the ceiling interest rate for loans up to Rs.2 lakh.
- The interest paid on eligible cash balances maintained with RBI under CRR requirement increased from 4 per cent to 6 per cent with effect from April 21,2001.
- With effect from May 19,2001, CRR was reduced from 8.0 per cent to 7.5 per cent, thereby augmenting lendable resources of banks by Rs. 4,500 crore.
- Banks allowed to formulate fixed deposit schemes for senior citizens offering higher and fixed rates of interest as compared to normal deposits of any size
- To facilitate better asset liability management (ALM), banks allowed discretion to disallow premature withdrawal of large deposits except in respect of individuals and HUFs, subject to informing the depositors in advance.
- The period of renewal of overdue term deposits at interest rate prevailing on maturity date made 14 days ; for overdue period exceeding 14 days, banks allowed to prescribe their own interest rates.
- With effect from the year ending March 31, 2004, loans with interest and /or instalments of principal remaining overdue for more than 90 days to be classified as non-performing assets (NPAs); banks advised to make additional provisions from the year ending March 31, 2002, to facilitate smooth transition to the new norm.
- Exposure limit for single borrower reduced from 20 per cent to 15 per cent of capital funds with effect from March 31,2002; and for groups the limit reduced from 50 per cent to 40 per cent of capital fund with effect from the same date. For financing infrastructure projects, the group limit is extendable up to 50 per cent.
- Banks advised to incorporate a condition in the loan agreement to obtain the consent of the borrowers to disclose their names in the event of default.
- Banks advised to engage in biannual circulation of the list of defaulters in respect of doubtful and loss assets of Rs. one crore and above
- Private banks asked to satisfy certain minimum standards like minimum number of full time partners, number of CAs exclusively associated and the strength of professional audit staff in respect of audit firms recommended by them with effect from 2001-02
- To ensure greater security to depositors and members of urban cooperative banks(UCBs), interim prudential measures announced; direct or indirect lending by UCBs to individuals or corporates against security of shares stopped with immediate effect; existing lending to stock brokers or direct investment in shares to be unwound; borrowing from call money market limited to 2 per cent of aggregate deposit at the end of the previous financial year; increase in SLR holdings of scheduled UCBs from 15 to 20 per cent with effect from March 2002 and from 10 to 15 per cent for non-scheduled UCBs with deposit base of Rs. 25 crore and more, and from zero to 10 per cent for other non-scheduled UCBs; UCBs not to increase their term deposit balances with other UCBs.

**Mid-Term Review**

- A reduction in the Bank Rate by 0.5 percentage points from 7.0 per cent to 6.5 per cent with effect from October 23, 2001.
- A reduction in CRR of all SCBs ( excluding RRBs) by 200 basis points from 7.50 per cent to 5.50 per cent by December 29,2001.
- All exemptions on the liabilities withdrawn except the interbank liabilities for the computation of net demand and time liabilities (NDTL) (for the purpose of CRR maintenance) with effect from November 3, 2001.The combined impact of these measures augmented lendable resources of the banking system by about Rs. 8,000 crore.
- Effective from November 3, 2001, the interest paid on eligible cash balances maintained with RBI under CRR requirement is at the Bank Rate.
- Freedom to banks to formulate simple, non-discriminatory and transparent schemes for settlement of old NPAs, based on the broad framework of the 1995 RBI guidelines.
- With effect from March 31, 2002 , Notes to Accounts in the balance sheets of banks to disclose (i) movement of provisions held towards NPAs and (ii) movement of provisions held towards depreciation on investments.
- Banks given freedom to change the composition of working capital by increasing the cash credit component beyond 20 per cent or the loan component beyond 80 per cent, in the case of working capital limits of Rs. 10 crore and above; banks to appropriately price these components, keeping in view the impact on cash and liquidity management
- Relaxations in the interim prudential measures announced in April for UCBs in response to representations; UCBs allowed to lend to individuals against shares; timeframe for achieving SLR and capital adequacy norms modified.

(October 22, 2001), indicated that it was feasible to maintain adequate liquidity in the market, primarily through flexible operation of repos and reverse repos under Liquidity Adjustment Facility (LAF) combined with Open Market Operations (OMO), when necessary. Notwithstanding a high level of market borrowing by the Government, it was also feasible to maintain a stable interest rate environment, with further softening of interest rates. Despite several uncertainties, the fundamentals of the economy as reflected in moderate inflation, stable and low interest rates, high foreign exchange reserves, large foodgrain stocks and competitive advantage of information technology related industries, are still strong. The prospects for agricultural growth during this year remain positive. The global and domestic inflationary outlook currently continues to be favourable. It was, therefore, proposed to continue with the overall stance of monetary policy announced in the MCP of April for the remaining half of the current year and ensure that all legitimate requirements for credit are met, consistent with price stability. Unless circumstances change unexpectedly, RBI proposed to endeavour to maintain the current interest rate environment.

### Bank Credit

3.11 Bank credit from SCBs comprising food credit and non-food credit increased at a lower rate of 10.6 per cent till January 11 in the current financial year compared with 14.3 per cent in the corresponding period of the previous year. The recent years have witnessed a significant acceleration in the growth of food credit, in response to the increase in the quantum as well as the price of foodgrains procured in support of the twin objectives of food security and price support. The share of food credit in outstanding bank credit on January 11, 2002 was higher at 9.4 per cent than that at 7.7 per cent a year ago. The share of food credit in incremental bank credit in the current financial year till January 11, 2002 was 24.3 per cent compared with 20.4 per cent in the corresponding period of the previous year. In absolute terms, increase in food credit up to January 11 in the current financial year was Rs.13,204 crore compared with Rs.12,726 crore in the corresponding period last year. In contrast, there was a deceleration in the growth of non-food credit, to 8.7 per cent till January 11,2002 from 12.1 per cent during the corresponding period last year, mirroring the weak demand for commercial credit owing to the economic slowdown, which has been aggravated by a global downturn of economic activity (Box 3.2).

### Investment

3.12 The non-SLR investment by banks also decelerated to 4.2 per cent till January 11 in the current financial year from 13.6 per cent in the corresponding period last year. Growth in the total flow of funds comprising both non-food credit and non-SLR investment, including bills rediscounted with financial institutions, to the commercial sector was lower at 8.1 per cent till January 11, 2002 as compared with 12.3 per cent in the corresponding period last year.

3.13 Investment by banks in government and other approved securities as on March 23, 2001 exceeded the SLR level by Rs. 1,06,000 crore. During the current financial year (up to January 11) investment in government securities by banks was substantially higher at Rs. 70,555 crore as compared with Rs. 49,909 crore in the corresponding period last year. The increase in

**BOX 3.2**

**Credit Flow and Industrial Growth**

Allowing for appropriate lags, credit flow and higher industrial growth rate are closely related. The Indian experience from 1995 to 1997 suggests that the high nominal PLRs do not always indicate a sluggish credit off-take. What is of relevance is the real interest rate, the expected real growth in the economy and the industry concerned. During 2001-02, the credit off-take did not pick up; the real interest rates remained high with inflation rate falling faster than interest rates. Deceleration in the demand for credit reflected the slowdown in the industrial activities and the depressed investment climate. Demand for credit is influenced by several other factors, such as agricultural growth, export demand and competitive strength of Indian firms apart from interest rates. Effective demand for credit pre-supposes effective demand for goods and services via increase in income which reflects the trend in real activity. This implies that poor off-take of credit is a symptom rather than a cause of deceleration in industrial growth. The commercial banks' investment in government securities which has exceeded the statutory levels, is reflective of the subdued conditions.

investment in Government securities was as much as 19.7 per cent as compared with an increase of 17.0 per cent last year. Growth in commercial banks' investment in Government securities and credit for food procurement, both guaranteed by the Government, and slowdown in non-food credit are matters of serious concern. The gross and net market borrowings of the Centre for the financial year 2001-02 are budgeted at Rs. 1,18,852 crore and Rs. 77,353 crore respectively. The net market borrowings are budgeted to finance as much as 66.5 per cent of the gross fiscal deficit. The net market borrowings of the Central Government amounted to Rs. 84,002 crore on January 18, 2002 exceeding the budget estimate by Rs. 6,649 crore. Faced with a poor offtake of credit from the commercial sector, banks have invested in Government securities beyond the SLR requirement. Excessive investment in Government paper may crowd out the flow of credit to the private sector, especially when the demand for non-food credit picks up with economic revival .

## Interest Rates

3.14 Since the introduction of Prime Lending Rates (PLRs) in 1994, the norms relating to the application of PLRs by SCBs have been substantially liberalised (Box 3.3). These included freedom for banks to declare their own PLRs along with spread, introduction of Prime Term Lending Rate (PTLR), freedom to offer tenor-linked PLRs and the flexibility to offer lending rates on a fixed or floating rate. At present, PLR serves as the ceiling rate for credit limits upto Rs. 2 lakh. In response to requests, banks have been given freedom to charge interest rates without reference to PLR for certain categories of loans/ credit like discounting bills, lending to intermediaries, etc. In keeping with international practices, and for providing further flexibility, banks have been allowed to lend at interest rates below their respective PLRs to creditworthy borrowers including exporters on the basis of a transparent policy approved by their respective Boards.

3.15. On a review of macroeconomic and monetary developments, the Bank Rate was reduced to 6.5 per cent with effect from October 23,2001. The PLRs of five major public sector banks softened from 12.00 - 12.50 per cent in December, 2000 to 11.00 - 12.00 per cent by December, 2001. Interest rates charged by SCBs on pre-shipment and post-shipment rupee export credit were reduced by 1.0 percentage point for six months ending on March 31,2002. The short-term interest rate represented by the yield on 91-

### BOX 3.3
### Prime Lending Rates (PLRs) of Scheduled Commercial Banks (SCBs)

- An 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 and the ceiling rate. During 1981-82 to 1987-88, RBI prescribed only the ceiling rate, which was progressively reduced in three steps from 19.5 per cent to 16.5 per cent. 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 per cent, was raised to 19.0 per cent in 1991-92 in response to the rise in inflation rate to 13.7 per cent. 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 October18, 1994 the lending rate was deregulated in respect of loans above Rs. 2 lakh.
- With effect from April 19, 2001, PLR has been converted to a benchmark rate for banks rather than treating it as the minimum rate.
- The following Table presents these trends in nominal PLRs and real PLRs.

(Percent per annum)

| Item | 1994-95 | 1995-96 | 1996-97 | 1997-98 | 1998-99 | 1999-2000 | 2000-01 | 2001-02 |
|---|---|---|---|---|---|---|---|---|
| Nominal PLR | 15.00 | 16.50 | 14.50 | 14.00 | 12.00 | 12.00 | 11.50 | 11.50 |
| Real PLR (WPI-General) | 2.40 | 8.50 | 9.90 | 9.60 | 6.10 | 8.70 | 4.30 | 7.30 |
| Real PLR (WPI-Manufacturing) | 2.70 | 8.00 | 12.40 | 11.10 | 7.60 | 9.30 | 8.20 | 9.20 |

Note: Real PLR rates have been worked out with reference to the 52 week average WPI.

day Treasury Bills declined by 125 basis points to 7.25 per cent between April and December 2001. At the long end of the yield curve, the secondary market yields on government paper in the range of 10-12 years have declined from 10.05 –10.41 per cent to 8.15 - 8.35 per cent during this period.

3.16. The September 11 events in the US and their effect on India's financial markets necessitated a quick response to ensure liquidity and confidence in markets. In order to stabilise domestic financial markets, RBI announced that it did not intend to shift its monetary policy stance in regard to keeping interest rates stable with adequate liquidity. RBI further assured the markets that it would be prepared to sell foreign exchange directly or indirectly, if it considered it necessary to do so, in order to meet any unusual supply-demand gaps that could arise because of the prevailing uncertainties. The assurance to the market coupled with other measures had the desired effect of moderating possible panic reactions and reducing volatility in financial markets, particularly in money, foreign exchange and government securities markets. However, RBI underlined two caveats so as to prevent complacency on the part of the bankers and market participants. First, these entities should explicitly take into account the possibility of a sudden change in the interest rate environment. The gains already obtained from declining interest rates should, therefore, be used for building up adequate reserves to guard against any possible reversal of the interest rate environment. Second, RBI called for a recognition that in view of certain structural characteristics of our financial system, the scope for further softening in lending rates by banks and other financial intermediaries is limited. For example, the practice of offering fixed interest rates on long-term deposits, high overhang of NPAs of public sector banks and large volume of market borrowing requirements of the Government reduced downward flexibility in the interest rate structure. The salient trends in different interest rates may be seen from Table 3.4.

**TABLE 3.4**
**Trends in Interest Rates**

**(Per cent per annum)**

| Interest Rate | March 24,2000 | January 5,2000 | March 23,2001 | January 4,2002 |
|---|---|---|---|---|
| Bank Rate | 8.00 | 8.00 | 7.00 | 6.50 |
| IDBI | 13.50 | 13.00 | 12.50 | 12.50 |
| PLR* | 12.00-12.50 | 12.00-12.50 | 11.00-12.00 | 11.00-12.00 |
| Deposit Rate* (> one year) | 8.50-10.50 | 8.50-10.00 | 8.50-10.00 | 7.50-8.50 |
| Call Money (Borrowings) | 5.70-9.50 | 8.30-11.00 | 4.00-7.70 | 4.72-9.00 |
| CDs | 7.50-12.00 | 8.50-11.00 | 5.50-11.00 | 5.00-9.50 |
| CPs | 10.00-12.00 | 9.90-12.27 | 8.75-11.25 | 7.20-11.65 |
| 91-day T.Bills | 9.17 | 8.75 | 8.50 | 6.83 |
| 364-dayT. Bills | 9.93 | 9.99 | 8.96 | 7.00 |

* Refers to five major public sector banks.
CDs: Certificate of Deposits; CPs : Commercial Papers

Notes: 1. A brief account of the evolution of interest rates charged by SCBs may be seen from Box 3.3
2. As on January 11, 2002, the interest rates on deposits according to maturity are indicated below:

(Per cent per annum)

| 15-29 Days | 30-45 Days | 46-60 Days | 61-90 Days | 91-179 Days | 180 Days | 1 year 2 years | 2 years- 3 years | More than 3 years |
|---|---|---|---|---|---|---|---|---|
| 4.25-5.25 | 4.75-5.50 | 5.25-6.50 | 5.25-6.50 | 5.75-7.00 | 6.50-7.50 | 7.50-8.00 | 7.50-8.50 | 8.00-9.00 |

3. As regards post office savings, the prevailing rate of interest on Post Office Saving Accounts (POSA) is 3.5 per cent, while on Post Office Time Deposits (POTD) it varies from 7.5 per cent for one-year maturity to 9.0 per cent for five-year maturity. For Public Provident Funds (PPF), the interest rate is 9.5 per cent while for Government Relief Bonds (5 years), it is 8.5 per cent. Box 4.7 in Chapter 4 summarises the recommendations of the "Expert Committee on Administered Interest Rates and Other Related Issues".