Monetary and credit policy

3.12 The monetary policy framework in India has substantially changed during the past few years. The shift is from direct to indirect instruments of monetary policy. Changes in Bank Rate, CRR and Repo rates have emerged as important instruments signalling interest rate changes and influencing liquidity. The liquidity adjustment facility (LAF) combined with open market operations (OMO) emerged as a major tool of liquidity management in the economy. The shift towards indirect instruments has provided the monetary authority with greater flexibility in the conduct of monetary policy. Indirect instruments have also enabled the RBI to promptly respond to emerging situations without any major shift in policy. The indirect instruments rely more on market forces and help in the development of the financial market.

3.13 The stance of monetary and credit policy for 2002-03 remained more or less the same as in 2001-02. The stance, as articulated by the RBI in its Annual Policy Statement (April 29, 2002), is to provide adequate liquidity to meet credit growth and support investment demand in the economy, while continuing a vigil on movements in price level. In line with the above, the Annual Policy Statement indicated that the present stance on soft interest rates and emphasis on imparting greater flexibility to the interest rates structure would continue. The Annual Policy Statement had placed the growth rate of GDP in 2002-03 at 6.0–6.5 percent based on indications of a recovery of industrial production and expectations of a higher growth of the agricultural sector than in the previous year. The projected expansion in broad money for 2002-03 was placed at 14.0 percent and the rate of inflation was assumed to remain lower than 4.0 percent. Monetary policy in the first half of the year was largely in conformity with the Annual Policy Statement. Interest rates eased and a stable interest rate regime was maintained throughout the first half of the year. The yields on Government securities market remained at a lower level. There was adequate liquidity in the banking system which helped the Government to complete its major borrowing programme at a lower cost. Adequate liquidity resulted in lower cost of funds to the industry. In its Mid-Term Review, RBI proposed to continue with the overall stance of monetary policy announced in April, 2002. Taking into account the likely shortfall in the production of foodgrains this year because of deficient rainfall, RBI in its Mid-Term Review had indicated that the overall GDP growth for the year 2002-03 was likely to be in the range of 5.0 to 5.5 percent as against the earlier projection of 6.0 to 6.5 percent. Important features of the Annual Policy Statement and Mid-Term Review are listed out in Box 3.1.

Interest rates

3.14 Over the years, there has been a downward trend in interest rates facilitated by moderate inflation and adequate liquidity in the economy. In recent years, the stance of monetary policy has remained on imparting greater flexibility to the interest rate structure with a preference for soft interest rate regime under normal circumstances while keeping a close vigil over the movements of prices. The reduction in Bank Rate by 475 basis points during the last five years has considerably facilitated the downward trend in interest rates. The reduction in CRR by as much as 625 basis points during the last four and a half years improved the liquidity position of the banking system. Over the years, interest rates have been deregulated with the exception of interest on saving deposits and export credit. The RBI in its Mid-Term Review has proposed deregulation of interest rates on rupee export credit in two phases. In the first phase, interest rates on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days is proposed to be deregulated from May 1, 2003. In the second phase, it is proposed to consider whether the ceiling rates of pre-shipment credit up to 180 days and post-shipment credit up to 90 days can be discontinued.

3.15 Trends in interest rates presented in Table 3.3 reveal softening of interest rates. These trends indicate that reduction in lending rates has not kept pace with the reduction in

Box 3.1 : Monetary and credit policy 2002-03

A. Annual Policy Statement

- Cash Reserve Ratio (CRR) reduced from 5.5 per cent to 5.0 per cent effective from June 15, 2002. (Later advanced to June 1, 2002), augmenting the lendable resources of banks by Rs. 6,000 crore.
- Banks advised to introduce flexible interest rate system for all new deposits and to devise schemes for encouraging depositors to convert their existing long term fixed rate deposits into variable rate deposits.
- Banks to announce the maximum spread over PLR for all advances other than consumer credit.
- Banks advised to review the present maximum spread over PLR and reduce them wherever they are unreasonably high. Banks to provide information on deposit rates for various maturities and maximum and minimum interest rates charged to their borrowers.
- Banks urged to switch over to “All Cost” concept for borrowers by explicitly declaring processing and service charges.
- The ceiling rate on export credit in foreign currency reduced to Libor + 0.75 percentage point from the present Libor + 1.0 percentage point.
- Banks to report to RBI, the maximum and minimum lending rates to exporters.
- Stipulation of minimum lending rate (MLR) withdrawn for all Cooperative banks and freedom to determine their lending rates.
- Ceiling rate on FCNR (B) deposits reduced from Libor/Swap rates to Libor/Swap rates for corresponding maturities minus 25 basis points.
- Banks allowed to borrow up to 25 per cent of their unimpaired tier I capital from overseas markets. The limit of 15 per cent of unimpaired tier I capital for investment in overseas markets raised to 25 per cent.
- The limit for financing of distribution of inputs for allied agricultural activities such as cattle feed/poultry feed, etc. under priority sector, credit limit for marketing of crops by farmers raised.
- Banks allowed to increase the limit of dispensation of collateral requirement for loans to small scale industries from Rs. 5 lakh to Rs. 15 lakh.

B. Mid-Term Review

- Bank Rate reduced from 6.50 per cent to 6.25 per cent effective close of business on October 29, 2002.
- Repo Rate under the liquidity adjustment facility to be available on October 30, 2002 reduced by 0.25 percentage point.
- CRR reduced from 5.0 per cent to 4.75 per cent effective fortnight beginning November 16, 2002.
- Banks required to maintain a minimum of 80 per cent of the required CRR on a daily basis instead of a minimum of 50 per cent of the required reserves in the first week and a minimum of 65 per cent in the second week of the reporting fortnight effective beginning November 16, 2002. Subsequently, effective fortnight beginning December 28, 2002 the minimum daily requirement was reduced to 70 per cent of the required CRR.
- Cooperative banks, regional rural banks and local area banks encouraged not to pay any additional interest on savings accounts over and above what is payable by commercial banks.
- Cooperative banks encouraged not to pay interest on current accounts.
- Interest rate on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days to be deregulated from May 1, 2003.
- Freedom to issue certificates of deposits on floating rate basis by banks and financial institutions.
- Limit on advances to dealers in drip irrigation and agricultural machinery located in rural/semi-urban areas, overall limit in respect of small business and individual credit limit to artisans, village and cottage industries raised.
- Credit limit of housing loans for repairing damaged houses raised.

Table 3.3 : Trends in interest rates

(percent per annum)

Interest Rate	30-Mar-01	11-Jan-02	29-Mar-02	10-Jan-03
1	2	3	4	5
Bank Rate	7.00	6.50	6.50	6.25
IDBI[1]	12.50	12.50	12.50	12.50
PLR[2]	11.0-12.0	11.0-12.00	11.00-12.00	10.75-11.50
Deposit Rate[3] (> one year)	8.50-10.0	7.50-8.50	7.50-8.50	5.50-6.50
Call Money (Borrowings) (low/high)[4]	6.80/13.50	4.54/7.30	5.00/19.00	3.50/7.00
CDs	6.30-11.50	6.20-9.50	5.00-10.03	4.71-6.50*
CPs	8.75-11.25	7.40-9.75**	7.41-10.25	5.70-7.50#
91-day T-Bills	8.50	6.83	6.13	5.39
364 days T-Bills	8.96	7.00	6.16	5.41

 # Relates to January 15, 2003.

*** Relates to December 27, 2002.**

**** Relates to January 15, 2002.**

Notes: 1. Minimum Term Lending Rate (MTLR).

2. Prime Lending Rate relates to five major banks.

3. Deposit rate relates to major banks for term deposits of more than one year maturity.

4. Data cover 90-95 per cent of total transactions reported by participants.

the deposit rates. The stipulation of the RBI that banks should move to an all-cost concept and that they should reduce spread over PLR may soften the lending rate structure. One noticeable development in the current year is the sub-PLR lending by commercial banks on a large scale. The sub-PLR lending of the banking system now constitutes over one third of their total lending.With sub-PLR lending and reduction in maximum spread over PLR, lending rates have effectively softened during the current year.