Monetary and credit policy

3.10 Monetary policy formulation has become more complex, particularly in the context of changing magnitude and composition of capital flows to developing countries. Private capital flows now account for bulk of the long term capital flows. Private capital flows have increased significantly in recent years. In 2003-04, the conduct of monetary policy in India had to address the issue of surge in capital flows leading to increased purchase of foreign currency by the RBI, and consequent expansion of reserve money and money supply. In 2003-04, foreign exchange assets of the RBI (adjusted for revaluation) increased by Rs. 1,41,428 crore as compared with an accretion of Rs. 82,090 crore in 2002-03, resulting in excess liquidity. The liquidity was contained through open market sale of Government securities held by the RBI and repos under the LAF.

3.11 There was no change in the stance of the monetary and credit policy in 2003-04. The stance maintained its focus on providing adequate liquidity to meet credit needs and supporting investment demand in the economy, while continuing a vigil on movements in the price level. The policy also laid stress on the maintenance of a soft and flexible interest rate regime within the framework of macroeconomic stability. The annual policy statement had placed the growth rate of GDP at 6.0 per cent on the assumption of a satisfactory monsoon and rainfall at around 96 per cent of the long period average. Inflation was assumed to remain in the range of 5.0 to 5.5 per cent. Consistent with the projection of GDP growth and inflation, broad money growth in 2003-04 was projected at 14.0 per cent. Non-food credit was projected to increase by 15.5 to 16.0 per cent to facilitate and sustain the growth in the industrial sector. Monetary management in the first half of 2003-04 was broadly in conformity with the stance announced in the annual policy statement. A surge in foreign exchange reserves and lower demand for credit had put pressure on liquidity management. The cash reserve ratio was reduced from 4.75 per cent to 4.50 per cent in June 2003 augmenting the lendable resources of banks by about Rs.3,500 crore.

3.12 The mid-year review of the monetary and credit policy left the Bank Rate and CRR unchanged. The review placed GDP growth in 2003-04 in the range of 6.5-7.0 per cent as compared with the growth of 6.0 per cent projected in the annual policy. Projection of Inflation was lowered from the range of 5.0-5.5 per cent to 4.0–4.5 per cent. Main features of the annual monetary and credit policy and the mid-year review are summarised in Box 3.2.

Annual policy statement 2004-05

3.13 The stance of monetary policy for 2004-05 has remained the same as in 2003-04. The stance, as indicated by the RBI in its annual policy statement (May 18, 2004) will be provision of adequate liqudity to meet

Box 3.2 : Monetary and credit policy 2003-04

A: Annual policy statement

- Bank rate reduced by 25 basis points to 6.0 per cent effective from the close of business on April 29, 2003.
- Cash reserve ratio (CRR) reduced by 25 basis points from 4.75 per cent to 4.50 per cent effective from June 14, 2003.
- Payment of interest on a monthly basis on eligible CRR balances maintained by banks with the RBI from April 2003.
- Continued extension of refinance facility to eligible export credit remaining outstanding under post-shipment credit beyond 90 days and up to 180 days.
- Multiplicity of rates under the Liquidity Adjustment Facility (LAF) rationalised.
- With a view to enhancing transparency in the pricing of loan products and ensuring that prime lending rate (PLR) reflects actual costs, banks advised to announce a benchmark PLR taking into account their actual cost of funds, operating expenses and minimum margin to cover regulatory requirement of provisioning/ capital charge and profit margin.
- Eligibility of dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, for advances up to Rs. 20 lakh, under priority sector lending.
- Banks free to extend direct finance to the housing sector up to Rs.10 lakh in rural and semi-urban areas as part of priority sector lending.
- Stage II of the transition to a pure inter-bank call/notice money to be effective from fortnight beginning June 14, 2003 where non-bank participants allowed to lend, on average in a reporting fortnight, up to 75 per cent of their average daily lending in call/notice money market during 2000-01.
- Indian corporates and resident individuals to be permitted to invest in rated bonds/fixed income securities of listed eligible companies abroad, subject to certain conditions.

B : Mid-term review

- No change in Bank Rate and CRR.
- Banks advised to increase loan limit without collateral to small scale industries with good track record and financial position from Rs. 15 lakh to Rs. 25 lakh.
- Interest on deposits of foreign banks placed with Small Industries Development Bank of India (SIDBI) towards their priority sector shortfall to be at the Bank Rate.
- All new loans granted by banks to Non-Banking Financial Companies (NBFCs) for on-lending to SSI sector to be reckoned for the purpose of priority sector lending.
- In a further move towards pure inter-bank call/notice money market, lending by non-bank participants reduced from 75 per cent to 60 per cent of their average daily lending in call/notice money market during 2001-02.
- In view of development of the repro market as also to ensure balanced development of various segments of the money market, PDs allowed to borrow, on an averge in a reporting fortnight, up to 200 per cent of their net owned funds (NOF) as at end-March of the preceding financial year with effect from February 7, 2004.
- Adoption of 90 day norm for recognition of loan impairment for financial institutions from the year ending March 31,2006 with a view to aligning asset classification norms of banks and financial institutions.
- Foreign currency loans by banks above US $ 10 million to be extended to corporates only on the basis of a well laid out policy to ensure hedging except for loans to finance exports and for meeting forex expenditure.

credit growth and support investment demand and export demand in the economy while keeping a very close watch on the movements in the price level. Consistent with above stance, RBI has indicated that it will pursue an interest rate environment that is conducive to maintaing the momentum of growth and macro-economic and price stability. The annual policy statement has placed the growth rate of GDP in 2004-05 in the range of 6.5 to 7.0 per cent, assuming sustained growth in industrial sector, normal monsoon and good performance of exports. On the assumption of no signficant supply shocks and appropriate managment of liqudity, inflation rate in 2004-05, on a point to point basis, is placed at around 5.0 per cent.

3.14 Money supply (M_3) in 2004-05 is projected to expand by 14.0 per cent. Consistent with projected expansion in M_3, increase in aggregate deposits of scheduled commercial banks is set at Rs. 2,18,000 crore, which is 14.5 per cent higher over its level in the previous year. Non-food credit adjusted for investment in commercial paper, shares/ debentures/bonds of PSUs and private corporate sector is projected to increase by 16.0 to 16.5 per cent in 2004-05. Some initiatives for augmenting credit to agriculture from institutional sources by over 30 per cent in 2004-05 were announced on June 18, 2004. RBI has indicated that this magnitude of credit expansion is expected to meet adequately the credit needs of all the productive sectors of the economy. Main features of the annual policy statement for 2004-05 are listed out in Box 3.3.

Interest rates

3.15 The RBI had continued its policy stance of soft interest rates and imparting greater flexibility to the interest rate structure. In consonance with this policy, RBI reduced the Bank Rate from 6.25 per cent to 6.0 per cent from April 29, 2003 and the CRR from 4.75 per cent to 4.50 per cent from June 14, 2003. Over

Box 3.3 : Annual policy statement 2004-05

- Bank Rate kept unchanged at 6.0 per cent.
- Repo rate kept unchanged at 4.5 per cent.
- A Gold Card Scheme for creditworthy exporters drawn up.
- Banks encourged to align the pricing of credit to assessment of credit risk to improve credit delivery and credit cutlure.
- The RBI accepted some recommendations of the interim Report of the Vyas Committee for implementation. These include, *inter-alia* loans for storage facilities under priority sector, securitised agricultural loans as priority sector lending, waiving margin/security requirements for certain agricultural loans up to a limit, NPA norms for crop loans aligned to crop seasons.
- Development of mechanism for debt restructuring for medium enterprises on the lines of corporate debt restructuring.
- Banks allowed to raise long-term bonds to finance infrastructure. Definition of infrastructure lending broadened and a Working Group constituted on Credit Enhancement by State Governments for financing infrastructure.
- Limit on the lending of non-bank participants in the call/notice money market reduced to 45 per cent effective June 26, 2004.
- The extant limit on unsecured exposures for banks withdrawn.
- Banks to draw a road map for migration to Basel II.
- Risk based supervision extended to more banks.
- Fresh licenses to UCBs only after a comprehensive policy.
- RBI sets up a Board for Payment and Settlement Systems.
- RTGS operationalised. RBI expects more commercial banks to join the RTGS system by June 2004.
- Reports of the Working Group on Financial Conglomerates, Working Group on Development Finance Institutions and Standing Committee on Procedures and Performance Audit on Public Services are being put in public domain.
- A panel of advisers reviewing the follow-up and future agenda on International Financial Standards and Codes.

the years, there has also been a softening of the repo rate. The repo rate witnessed moderation from 8.0 per cent in March 1999 to 4.5 per cent at present. Lower rates of inflation in recent years greatly facilitated the transition to a low interest rate regime. The soft interest rate regime was strengthened with the Government's decision to reduce rates of interest on public provident fund and small saving instruments effective from March, 2003. The RBI had reduced the interest rate on savings account, the only domestic deposit rate which continues to remain administered, from 4.0 per cent to 3.5 per cent per annum from March 1, 2003.

3.16 Between March 2002 and March 2004, deposit rates offered by major commercial banks on term deposits of more than one year maturity declined from a range of 7.50-8.50 per cent to a range of 5.00-5.50 per cent. In contrast, the prime lending rates (PLR) of five major commercial banks witnessed a smaller decline from a range of 11.00 –12.00 per cent to 10.25-11.00 per cent in the same period. The lending rates of banks by and large remained sticky as compared with the sharp fall in deposit rates. While corporates with good track record are able to access bank loans at below PLR, majority of borrowers are denied the benefit of falling deposit rates and the resultant lower cost of funds to banks. In order to enhance transparency in the pricing of loan products and to ensure that PLR reflects the actual cost, the RBI, had advised banks to announce BPLR taking into account actual cost of funds, operating expenses and a minimum margin to cover regulatory requirement. As at end-March 2004, almost all banks had adopted the new system of BPLRs, which were lower than their earlier PLRs by 25-100 basis points.

3.17 In order to provide consistency in interest rates offered to non-resident Indians, interest rates on NRE deposits were linked to LIBOR/SWAP rates for US Dollar from July 17, 2003. Interest rates on these deposits were reduced from 250 basis points above LIBOR/SWAP rates to 100 basis points above LIBOR/SWAP rates effective from September15, 2003 and further to 25 basis points above LIBOR/SWAP rates of corresponding maturity from October 18, 2003. From April 17, the above rate was further moderated to LIBOR/SWAP rate and it was stipulated that interest rate on NRE savings depoists should not exceed the LIBOR/SWAP rates for six-month maturity on US dollar deposits. Trends in interest rates are given in Table 3.3.

Table 3.3 : Trends in interest rates

(per cent per annum)

Interest rate	March 29, 2002	March 28, 2003	March 26, 2004
Bank rate	6.50	6.25	6.00
IDBI[1]	12.50	12.50	10.25
Prime lending rate (PLR[2])	11.00-12.00	10.75-11.50	10.25-11.00
Deposit rate[3] (> one year)	7.50-8.50	5.25-6.25	5.00-5.50
Call money (Borrowings) (low/high)[4]	5.00/19.00	4.00/8.25	3.00/4.50
CDs by SCBs	5.00-10.03 *	5.00-7.10	3.87-5.16 @
CPs by companies(at face value)#	7.41-10.25	6.00-7.75	4.70-6.50
91 days T-bills	6.13 **	5.89 ***	4.37 #
364 days T-bills	6.16 ****	5.89 *****	4.44 #

*** Relates to March 22, 2002** **** Relates to March 27, 2002**
***** Relates to March 26, 2003** ****** Relates to March 20, 2002**
******* Relates to March 19, 2003**
@ Relates to March 19, 2004. **# Relates to March 31, respective years.**

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.