

Outlook

3.62 Broad objectives and parameters of the monetary and credit policy for 2003-04 have been met. An overall assessment of the developments during 2003-04 and prospects for 2004-05, provide grounds for optimism. However, the hardening of the international prices of oil and non-oil commodities and the persistence of large capital inflows are likely to remain important issues which could affect monetary conditions in 2004-05. Sterilisation of capital flows through open sale of Government securities involves quasi-fiscal costs in the form of the difference between the interest rate on domestic securities and return on foreign exchange reserves. Sterilisation, if it exerts an upward pressure on the interest rates, could result in attracting more foreign currency inflows, thus necessitating more intervention by the monetary authority. Sterilisation, at best, is a temporary policy instrument to address to inflows. With the improvement in macro-economic situation, it is likely that the present surge in capital flows will continue in the medium term. Therefore, in the medium to long term, policy initiatives aimed at improving the country's absorptive capacity need to be put in place.

3.63 Interest rates have been softening in recent years. However, a major concern with regard to interest rates is the downward rigidity observed in lending rates. Lending rates have remained sticky and have not fallen as much as the deposit rates. As a result, interest spread of commercial banks witnessed an increase during 2001-02 and 2002-03. Lending rates declined markedly for large top rated borrowers, which have access to funds at sub-PLR rates. However, lending rates have not declined commensurately for other borrowers. The RBI's advice to commercial banks to put in place a system of BPLRs and bank's subsequent announcement of BPLRs, which were lower than their earlier PLRs somewhat addressed the problem. The Reserve Bank has also advised that banks should align the pricing of credit to the assessment of credit risk so that credit delivery and credit culture is improved. Measures already taken and being taken by the RBI for improving the credit delivery mechanism are expected to further ease the rigidities in lending rates. This will help to strengthen and sustain the current revival in the industrial sector.