Monetary and credit policy

3.14 In India, while the basic objectives of monetary policy, namely, price stability and adequate credit flow to the productive sectors of the economy, have remained the same, the operating environment has changed significantly. As pointed out in the RBI's Report on Currency and Finance 2003-04, there is an increasing focus on the maintenance of financial stability in the context of better linkages between various segments of the financial markets including money, Government securities and forex markets. Managing the capital flows has emerged as an important concern of monetary policy. The phasing out of adhoc treasury bills and their automatic monetisation in 1997 imparted a lot of flexibility to the RBI in monetary management. Simultaneously, however, reserve flows through the balance of payments and increase in the prices of crude petroleum in the international markets have posed new challenges for monetary policy. As indicated earlier, in the current year, the two major constraints facing monetary management were carry forward of excess liquidity of over Rs.81, 000 crore from the previous year and rise in inflation following the rising international prices of petroleum crude.

3.15 The annual policy statement for 2004-05 had placed the growth of GDP in 2004-05 in the range of 6.5 to 7.0 per cent, on the assumption of sustained growth in industrial sector, normal monsoon and good performance of exports. On the assumption of no significant supply shocks and appropriate management of liquidity, inflation rate in 2004-05, on a point-to-point basis, was placed at around 5.0 per cent.

3.16 M_3 in 2004-05 is projected to expand by 14.0 per cent. Non-food credit adjusted for investment in commercial paper, shares/ debentures/bonds of public sector undertakings (PSUs) and private corporate sector was projected to increase by 16.0 to 16.5 per cent in the annual policy statement of May 2004. This magnitude of credit expansion was expected to adequately meet the credit needs of all the productive sectors of the economy.

3.17 Contrary to the assumptions underlying the annual policy statement for 2004-05, the south west monsoon turned out to be deficient by 13 per cent in the current year. There was a surge in inflation following the rise in international oil and metal prices. The carry forward of liquidity compounded matters. With a view to addressing these issues, the RBI increased the CRR by 50 basis points, in two stages, to 5.0 per cent, thus bringing down the liquidity in the banking system by about Rs. 9,000 crore. The interest rate on eligible CRR balances was de-linked from the Bank Rate and was reduced to 3.5 per cent per annum. The Government of India raised the ceiling of MSS from Rs. 60,000 crore to Rs. 80,000 crore on August 26, 2004 to enable the RBI to effectively deal with the problem of overhang of liquidity. As the inflation was supply induced, the Government also reduced the duty rates on petroleum products twice in the year 2004-05.

3.18 Taking the above developments into account, the RBI in its mid-term review of the annual policy statement for 2004-05 (October 26, 2004), revised its GDP growth projection in 2004-05 from a range of 6.5 to 7.0 per cent to 6.0 to 6.5 per cent. Inflation projection on a point to point basis was raised upwards to 6.5 per cent from around 5.0 per cent projected earlier. RBI has not effected any change in its earlier projection of M_3 and aggregate deposit target of commercial banks. Considering credit growth in the first half, the projection of adjusted non-food bank credit has been revised to 19.0 per cent from 16.0 to 16.5 per cent projected earlier. The mid-term review increased the fixed reverse repo rate by 25 basis points under the LAF to 4.75 per cent from October 27, 2004. The mid-term review also proposed a switch over to the international usage of the terms repo and reverse repo effective October 29, 2004. In the mid-term review, RBI proposed reduction in the spread between the reverse repo rate and repo rate by 25 basis points from 150 basis points to 125 basis points. Accordingly, the fixed repo rate under LAF will continue to remain at 6.0 per cent. The RBI has continued with its policy of active demand management of liquidity through OMOs, including the LAF, MSS and CRR, and using the policy instruments at its disposal flexibly, as and when the situation warrants consistent with the objective of price stability. At the same time, RBI has also been ensuring adequate liquidity in the system so that all legitimate requirements of credit to maintain the growth momentum are met. The other important policy initiatives announced in the mid-term review relate to raising the ceiling on NRE interest rates, reduction of tenure of domestic term deposits, dispensing with the restrictive provisions of service area approach for delivery of agricultural credit, and measures for improving credit delivery to agriculture and small-scale industry (SSI) sectors (Box 3.1).

Interest rates

3.19 The RBI has been following a policy stance of imparting flexibility to the interest rate structure. Concerned over the downward rigidity of lending rates, even while deposit rates were coming down, RBI advised banks to announce their benchmark prime lending rates (BPLRs) based on their actual cost of funds, operating expenses and a minimum margin to cover regulatory requirement. In response to this policy directive, all banks put in place a system of BPLRs in 2003-04. The BPLRs of five major banks are lower by 25 to 50 basis points in December, 2004 compared to the rates prevailing a year ago. During the current year, there has been a marginal firming up of deposit rates by 25 basis points. Interest rates on housing loans have firmed up marginally in the current year for banks. Call money rates firmed up from the second half of the year, reflecting lower liquidity on account of large increase in bank credit. The Bank Rate

Box 3.1: Annual policy statement 2004-05

A: Annual policy statement (May 18, 2004)

- Bank rate kept unchanged at 6.0 per cent.
- Repo rate kept unchanged at 4.5 per cent.
- Revised LAF scheme operationalised.
- The entire amount of export credit refinance to banks and liquidity support to primary dealers made available at the reverse repo rate.
- Almost all commercial banks have adopted the new system of BPLR and the rates are lower in the range of 20-200 basis points from their earlier PLRs
- Banks advised to put in place comprehensive and rigorous risk assessment to relate pricing of credit to risk more appropriately.
- Recommendations of the interim Report of Vyas Committee accepted for implementation in respect of: (a)loans for storage facilities under priority sector lending, (b) securitised agricultural loans as priority sector lending, (c) waiving margin/security requirement for certain agricultural loans up to a limit, (d) NPA for crop loans aligned to crop seasons.
- Micro-finance institutions not to be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.
- Development of mechanism for debt restructuring for medium enterprises on the lines of corporate debt restructuring.
- Definition of infrastructure lending broadened to include: (i) construction relating to projects involving agro-processing and supply of inputs to agriculture, (ii) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality; and (iii) construction of educational institutions and hospitals.
- Working group constituted for Credit Enhancement by State Governments for financing infrastructure.· Gold Card Scheme for exporters drawn-up.
- To rationalise structure of regional rural banks various options under consideration of the Government and other stakeholders. Vyas committee is also looking into these aspects.
- Limit on the lending of non-bank participants in the call/notice money market reduced to 45 per cent effective June 26, 2004.
- Automated value free transfer of securities between market participants and the CCIL facilitated. The ECB limit enhanced to US$ 500 million under automatic route with minimum average maturity of 5 years. End-use for ECBs enlarged to include overseas direct investment in Joint Ventures/Wholly Owned Subsidiaries to enable them to become global players.
- Resident individuals already permitted to remit freely up to US$ 25,000 per calendar year for any current or capital account transaction.
- Indian corporates and partnership firms allowed to invest overseas up to 100 per cent of their net worth.
- Banks allowed to float long-term bonds to finance infrastructure.
- The extant limit on unsecured exposures for banks withdrawn.
- With effect from April 1, 2005 exposures on all Public Financial Institutions (PFIs) to attract a risk weight of 100 per cent.
- Banks required to maintain capital charge for market risk in respect of securities held for trading by March 31, 2005.
- Banks would be required to maintain capital charge for market risk in respect of the securities included under available for sale category by March 31, 2006.
- Banks to draw a road map for moving towards Basel II by December 31, 2004.
- Banks to make higher provisioning for NPAs in “doubtful more than three years” category.
- Risk based supervision extended to more banks.
- RBI expects most commercial banks to join the RTGS system by June 2004.
- Single window services for all transactions in RBI cash department.
- Operationalisation of On-line Tax Accounting System by June 2004.

B: Mid-term review (October 26, 2004)

- Bank rate kept unchanged at 6 per cent.
- Switching over to the international usage of the term repo and reverse repo from October 29, 2004.
- Fixed reverse repo rate under LAF increased by 25 basis points to 4.75 per cent from October 27, 2004. The spread between the repo and reverse repo rate reduced by 25 basis points to 125 basis points. Accordingly, the repo rate to remain at 6.0 per cent.
- LAF to be operated with overnight fixed rate repo and reverse repo. Accordingly, auctions of 7-day and 14-day reverse repo discontinued.
- With a view to aligning interest rates with international rates, interest rates on Non-Resident (External) Rupee (NRE) deposits raised to US Dollar LIBOR/SWAP rates of corresponding maturities plus 50 basis points.
- Fixation of ceiling on interest rates on FCNR (B) deposits to be shifted from weekly basis to a monthly basis.
- Banks given freedom to reduce the minimum tenor of retail domestic term deposits (under Rs.15 lakh) from 15 days to 7 days.
- To improve credit delivery, restrictive provisions of service area approach for banks dispensed with, except for Government sponsored programmes.
- The limit on advances under priority sector for dealers in agricultural machinery raised from Rs.20 lakh to Rs.30 lakh and for distribution of inputs for allied activities from Rs.25 lakh to Rs.40 lakh.
- Banks advised to make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under special agricultural credit plans (SACP) by March 2007.
- The mechanism of SACP extended to private sector banks. Private sector banks urged to formulate SACPs from the year 2005-06, targeting an annual growth of at least 20-25 per cent of credit disbursement to agriculture.
- Composite loan limit for SSI entrepreneurs enhanced from Rs. 50 lakh to Rs. 1 crore.
- Bank loans to housing sector up to Rs.15 lakh irrespective of location to be treated as part of their priority sector lending.
- The minimum maturity period of commercial paper reduced from 15 to 7 days.
- To promote investment activity, authorised dealers of foreign exchange permitted to issue guarantees/ letters of comfort up to US$ 20 million per transaction for a period up to one year for import of all non-capital goods permissible under the foreign trade policy and up to three years for import of capital goods, subject to prudential guidelines.
- 100 per cent Export oriented units and units set up under Electronics Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio Technology Parks (BTPs) schemes permitted to repatriate the full value of export proceeds within a period of twelve months.
- The limit of outstanding forward contracts booked by importers/exporters increased from 50 per cent to 100 per cent of their eligible limit.
- As a temporary counter-cyclical measure, the risk weight on housing loans to individuals and investments in Mortgage Backed Securities of Housing Finance Corporations (HFCs), supervised by National Housing Bank (NHB) increased from 50 per cent to 75 per cent and on consumer credit from 100 per cent to 125 per cent.
- Change in the norms for classification of doubtful assets of financial institutions (FIs) . With effect from March 31, 2005, an asset to be classified as doubtful, if it has remained in the sub-standard category for 12 months. FIs permitted to phase out the consequent additional provisioning over a four year period.
- Asset reconstruction companies (ARCs) required to have owned funds of not less than 15 per cent of the assets acquired or Rs. 100 crore, whichever is less for commencement of business.
- Banks advised to advance loans to distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group securities.
- Investments by banks in securitised assets representing direct lending to the SSI sector to be treated as their direct lending to SSI sector under priority sector, provided the pooled assets represent loans to SSI sector and originated by banks/financial institutions.

remained unchanged at 6.0 per cent in the current year. The repo rate (reverse repo rate since October 29, 2004) under LAF was raised by 25 basis points to 4.75 per cent from October 27, 2004. The spread between reverse repo and repo was narrowed by 25 basis points to 125 basis points (Table 3.3).

Table 3.3 : Trends in interest rates

(Per cent per annum)

Interest rate	March 26, 2004		January 23, 2004		January 21, 2005	
Bank rate	6.00		6.0		6.00	
CRR	4.50		4.50		5.00	
IDBI[1]	10.25		12.50		10.25	
PLR[2]	10.25-11.00		10.25-11.00		10.25-10.75	*
Deposit Rate[3](> one year)	5.00-5.50		5.00-5.50		5.25-6.25	*
Call money(Borrowings)(low/high)	3.00/4.50		3.49/4.70		4.00/5.25	**
CDs by SCBs	3.87-5.16	$	3.57-6.11		3.96-6.75	&
CPs by companies(at face value)	4.70-6.50	#	4.70-5.75	@	5.40-6.35	@@
91 days T-bills	4.37	#	4.24	$	5.37	#
364 days T-bills	4.44	#	438	$	5.77	##

*** Relates to January 14, 2005** **** Relates to January 28, 2005, & Relates to December 24, 2004**
@ Relates to January 31, 2004, **$ Relates to January 21, 2004**
@@ Relates to January 15, 2005 **# Relates to January 25, 2005**
Relates to January 19, 2005.

Notes : 1. Minimum term lending rate (MTLR).
2. Prime lending rate relates to five major banks.
3. Deposit rate relates to five major banks for term deposits of more than one year maturity.
4. Data cover 90-95 per cent of total transactions reported by participants.