

Monetary and credit policy

3.14 In its Annual Policy Statement for 2005-06, the RBI delineated the objectives of its monetary and credit policy stance as (i) provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability; (ii) consistent with the above, pursuit of an interest rate environment conducive to macroeconomic and price stability, and maintaining the momentum of growth; and (iii) consideration of measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations. After the announcement of the Annual Policy Statement for 2005-06 on April 28, 2005, the fixed reverse-repo rate was raised by 25 basis points to 5.0 per cent with effect from April 29, 2005. The Annual Policy Statement 2005-06 also stated that effective and vibrant communication with the economic agents would be improved through quarterly reviews of the annual statement. The first quarterly review was released in July 2005. On review of the macroeconomic outlook, the RBI had kept the projections regarding real GDP and rate of inflation unchanged.

3.15 In its Mid-Term Review of the Annual Policy Statement of 2005-06, coinciding with the second quarter review, the RBI on October 25, 2005 reiterated the policy thrust enunciated in April, underscored the need for ensuring an interest rate environment that is conducive to meet genuine credit needs and also support export and investment demand in the economy for maintaining the growth momentum; and the need for maintaining vigil on the price level owing to the rising trend of international crude oil prices. With effect from October 26, 2005, both fixed repo and fixed reverse repo rates under LAF were raised by 25 basis points to 6.25 per cent and 5.25 per cent, respectively. However, the Bank Rate was kept unchanged at 6.0 per cent. RBI also announced several measures for improving the credit delivery mechanism; and strengthening the prudential norms, and structural and regulatory framework for enhancing the robustness of the financial system etc. (Box 3.1)

3.16 On the basis of review of macroeconomic and monetary developments for the purpose of monetary management, the

RBI in the third quarterly review of the Annual Policy Statement 2005-06 (January 24, 2006), had projected real GDP growth for 2005-06 higher in the range of 7.5-8.0 per cent based on the current assessment of a pick up in agricultural output and the momentum in industrial and services sectors, and kept inflation estimate unchanged in the range of 5.0-5.5 per cent. The advance estimates of the real GDP for 2005-06, released by the Central Statistical Organisation (CSO) on February 7, 2006, had placed the growth at 8.1 per cent. M_3 expansion is expected higher than 14.5 per cent as projected in April 2005. Based on growth and inflation expectations, barring the emergence of unexpected sectoral developments in the economy, the overall monetary stance has been articulated in the third quarter review of the Annual Policy Statement 2005-06 as: (a) to maintain the emphasis on price stability with a view to anchoring inflationary expectations; (b) to continue to support export and investment demand in the economy for maintaining the growth momentum by ensuring a conducive interest rate environment by macroeconomic, price and financial stability; and (c) to provide appropriate liquidity to meet genuine credit needs of the economy with due emphasis on quality. Bank Rate has been kept unchanged at 6.0 per cent. Fixed reverse-repo rate was revised upward by 25 basis points to 5.50 per cent with effect from January 24, 2006 and the spread between fixed repo rate and fixed reverse-repo rate was kept at 100 basis points. Accordingly fixed repo rate was placed at 6.50 per cent.

Interest rates

3.17 With the steady increase in credit to the commercial sector in recent times, most of liquidity injection by the RBI at short end of the market is through the fixed repo transactions under LAF. The importance of the Bank Rate, reintroduced in April 1997 to signal monetary policy stance, may have declined. Bank Rate has been kept unchanged at 6.0 per cent since April 2003, while the fixed repo and fixed reverse-repo rates under LAF have undergone several changes.

3.18 Money markets during 2005-06 have been largely marked by comfortable liquidity conditions, with average daily call money rates generally anchored to the reverse repo rate till October 2005. The average weighted call money rate was 5.01 per cent during April-

Box 3.1: Annual Policy Statement for the Year 2005-06

A: Annual Policy Statement for the Year 2005-06

- Bank rate kept unchanged at 6.0 per cent.
- Fixed Repo Rate under LAF kept unchanged at 6.0 per cent.
- Reverse Repo Rate increased by 25 basis points to 5.00 per cent, from 4.75 per cent.
- Cash Reserve Ratio (CRR) kept unchanged at the present level of 5.00 per cent.
- With effect from the fortnight beginning June 11, 2005, non-bank participants, except PDs, would be allowed to lend, on average in a reporting fortnight, up to 10 per cent of their average daily lending in call/notice money market during 2005-06.
- With effect from August 6, 2005, non-bank participants, except PDs, would be completely phased out from the call/notice money market.
- With effect from the fortnight beginning April 30, 2005, the benchmark for fixing prudential limits on exposures to call/notice money market in the case of scheduled commercial banks would be linked to their capital funds (sum of Tier I and Tier II capital).
- From April 30, 2005, all NDS members are required to report their term money deals on NDS platform.
- The minimum maturity period of certificates of deposit (CDs) reduced from 15 days to 7 days with immediate effect.
- In order to facilitate further deepening of the government securities market, it is proposed to permit sale of government securities allotted in primary issues with and between Constituent's Subsidiary General Ledger CSDL account holders also on the same day.
- It is proposed to raise the ceiling of overseas investment by Indian entities in overseas joint ventures and/or wholly owned subsidiaries from 100 per cent to 200 per cent of their net worth under the automatic route.
- It is proposed to accord general permission to authorised dealers (ADs) to open foreign currency accounts of the project offices set up in India by foreign companies and operate the accounts flexibly.
- A Working Group was constituted by RBI to evolve guidelines for voluntary merger of banking companies.

B: Mid-term Review of Annual Policy Statement for the year 2005-06

- Bank Rate kept unchanged at 6.0 per cent.
- Reverse Repo Rate increased by 25 basis points to 5.25 per cent, effective October 26, 2005. The spread between reverse repo rate and the repo rate under LAF maintained at 100 basis points.
- The cash reserve ratio (CRR) kept unchanged at 5.0 per cent.
- Screen-based negotiated quote-driven system for call/notice and term money markets and electronic trading platform for market repo operations in government securities are being developed by Clearing Corporation of India Ltd. (CCIL).
- Banks advised to fix their own targets for financing the SME sector.
- A debt restructuring mechanism for units in the SME sector, in line with the corporate debt restructuring (CDR) mechanism prevailing in the banking sector, has been formulated by the Reserve Bank.
- The Micro Finance Development Fund (MFDF) set up in the NABARD re-designated as the Microfinance Development and Equity Fund (MFDEF) and its corpus increased from Rs.100 crore to Rs.200 crore.
- Bank's aggregate capital market exposure restricted to 40 per cent of the net worth of the bank on a solo and consolidated basis; consolidated direct capital market exposure modified to 20 per cent of the bank's consolidated net worth.
- By end-March 2006, 15,000 branches are proposed to be covered by Real Time Gross Settlement System (RTGS) connectivity.
- The National Electronic Funds Transfer (NEFT) system would be implemented in phases for all networked branches of banks all over the country.
- The IBA advised its member banks to announce a benchmark prime lending rate (BPLR), with the approval of their boards.
- An Internal Working Group (Chairman: Shri C. S. Murthy) was set up by the Reserve Bank to review the existing policy on priority sector lending including the segments constituting the priority sector, targets and sub-targets and recommend changes as necessary.
- The Micro Finance Development Fund (MFDF), redesignated as the Micro Finance Development and Equity Fund (MFDEF), increased its corpus from Rs.100 crore to Rs.200 crore.
- In line with international standards, banks were advised to adopt the Standardised Approach for credit risk with effect from March 31, 2007. Banks are required to migrate to the New Capital Adequacy Framework with effect from March 31, 2007.

Table 3.3 : Trends in interest rates

(Per cent per annum)

| Interest rate | March 25, 2005 | January 21, 2005 | January 20, 2006 |
|-----------------------------------------|----------------|------------------|------------------|
| Bank rate | 6.00 | 6.00 | 6.00 |
| CRR | 5.00 | 5.00 | 5.00 |
| IDBI ¹ | 10.25 | 10.25 | 10.25 |
| BPLR ² | 10.25-10.75 | 10.25-10.75 | 10.25-10.75 |
| Deposits rate ³ (> one year) | 5.25-6.25 | 5.25-6.25 | 5.25-6.25 |
| Call money (borrowings)(low/high) | 3.85/5.60 | 2.25/5.25 | 4.50/7.95 |
| CDs by SCBs | 4.21-6.34 \$ | 3.91-6.26&& | 4.40-7.75 & |
| CPs by companies (at face value) | 5.20-7.25 # | 5.10-6.30@@ | 6.65-8.50 @ |
| Fixed repo rates | 6.00 # | 6.00 | 6.50 ## |
| Fixed reverse-repo rate | 4.75 # | 4.75 | 5.50 ## |
| 91 days T-bills | 5.37 | 5.32 | 6.69 \$\$ |
| 364 days T-bills | 5.61 | 5.77\$## | 6.30 \$# |

| | |
|-----------------------------------|-----------------------------------|
| \$ Relates to March 18, 2005. | & Relates to January 6, 2006. |
| # Relates to March 31, 2005, | ## Relates to January 27, 2006. |
| \$\$ Relates to January 25, 2006. | @ Relates to January 31, 2006. |
| @@ Relates to January 31, 2005. | \$# Relates to January 18, 2006. |
| && Relates to January 7, 2005. | \$## Relates to January 19, 2006. |

Notes: 1. Minimum term lending rate (MTLR).
2. Prime lending rate relates to five major banks.
3. Deposits 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.

October 2005. During the current financial year so far reverse repo rate has been revised upward by 25 basis points on three occasions in April 2005, October 2005 and further in January 2006. The call money rate also edged up accordingly by similar magnitudes. More recently as surplus liquidity was getting unwound, the call money rate has shown a tendency to firm up and traded above the repo rate on a few occasions. During November and December 2005 the average weighted call money rates were 5.79 per cent and 6.0 per cent, respectively, mainly due to advance tax outflows and IMDs redemption pressures.

3.19 Tightened liquidity position resulted in some hardening of yields on short- and medium-term money market instruments. The yield on 10-year benchmark G-sec, on market concerns about the continuous rise in international crude oil prices, rose sharply to 7.31 per cent on April 30, 2005 from 6.65 per cent on March 31, 2005. But with a decline in headline inflation, the yield on 10-year G-sec also started softening to decline to 6.94 per cent on June 1, 2005. However, with inflationary concerns and emerging tightening of liquidity in the system, yield started to rise again and was 7.30 per cent on February 3, 2006.