Monetary and credit policy

3.24 Continued high levels of crude oil prices during the first half of the year and rising primary commodity prices in the international market impacted price developments in the domestic economy. Considering the emerging trends, the objectives and overall stance of policy announced by the RBI in its Annual Policy Statement for 2006-07 were: (i) to ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations, (ii) to focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic stability and, in particular, financial stability, and (iii) to respond swiftly to evolving global developments. (Box 3.1)

3.25 In consonance with the declared policy objectives, the RBI on June 8, 2006 raised the repo/reverse-repo under LAF by 25 basis points each, thereby retaining the spread between repo and reverse-repo rates at 100 basis points.

3.26 After careful and continuous monitoring of both domestic and global economic parameters, policy response by RBI was suitably attuned in the First Quarter Review of the Annual Policy Statement 2006-07 announced on July 25, 2006. While keeping other policy rates unchanged, effective July 25, 2006, the repo and reverse-repo rates were raised by 25 basis points each to 7.00 per cent and 6.00 per cent, respectively, to combat emerging inflationary expectations.

3.27 In the Mid-Term Review of the Annual Policy Statement of October 31, 2006, RBI indicated that it will ensure appropriate liquidity in the system to meet all legitimate demand for credit, particularly for productive purposes, consistent with the objective of price and financial stability. Monetary stance was calibrated to address the emerging situation in the system and (a) to ensure a monetary and interest rates environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations, (b) to maintain the emphasis on macroeconomic and, in particular, financial stability, and (c) to consider promptly all possible measures as appropriate to the evolving global and domestic situation. On consideration of macroeconomic as well as monetary conditions, only the repo rate was further raised by 25 basis points to reach 7.25 per cent effective October 31, 2006. Retaining the reverse-repo rate at 6.00 per cent resulted in a widening of repo-reverse repo spread to 125 basis points. (Box 3.1)

3.28 RBI, in the Third Quarter Review of the Annual Statement on Monetary Policy for 2006-07 (January 31, 2007), reiterated its resolve to keep inflation as close as possible to the declared range of 5.00-5.50 per cent at the earliest, while maintaining the medium-term goal to rein in inflation at 5.0 per cent. The review also spelt out the following three important issues in the conduct of monetary policy: (i) demand pressures appearing to have intensified, reflected in rising inflation, high money and credit growth, elevated asset prices, strains on capacity utilisation, some indications of wage pressures and widening of trade deficit; (ii) increased supply-side pressures evident from prices of primary articles; and (iii) the need of the policy to contend with lagged response of productive capacity and infrastructure to the ongoing expansion in investment. It was once again

Box 3.1: Annual Policy Statement for the Year 2006-07

A: Annual Policy Statement for the Year 200 6-07

- Bank rate kept unchanged at 6.0 per cent.
- Reverse Repo Rate and Repo Rate kept unchanged at 5.5 per cent and 6.5 per cent, respectively.
- Cash Reserve Ratio (CRR) kept unchanged at 5.00 per cent.
- Ceiling interest rate on non-resident (external) rupee deposits raised to US dollar LIBOR/SWAP plus 100 basis points.
- Ceiling interest rate on export credit in foreign currency raised to LIBOR plus 100 basis points.
- Provisioning for standard advances raised to 1.0 per cent for personal loans, capital market exposures, residential housing beyond Rs.20 lakh and commercial real estate loans.
- Risk weight on exposures to commercial real estate raised to 150 per cent.
- Exposure to venture capital funds treated as part of capital market exposure and assigned with higher risk weight of 150 per cent.
- 'when issued' market in Government securities announced.
- Primary Dealers to be permitted to diversify their activities. The ceiling on interest rates on non-resident (external) rupee deposits for one to three years maturity raised by 25 basis points to 100 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity with immediate effect.

B : Mid-term Review of Annual Policy Statement for the year 2006-07

- Repo Rate increased to 7.25 per cent from 7.0 per cent.
- Reverse Repo Rate and Bank Rate kept unchanged at 6.0 per cent.
- CRR kept unchanged at 5.0 per cent.
- "when issued' trading to be extended to fresh issues of Central Government securities.
- Scheduled commercial banks and primary dealers allowed to cover their short positions in Central Government securities within an extended period of five trading days.
- Resident individuals would be free to remit up to US $ 50,000 per financial year as against the earlier limit of US $ 25,000.
- Foreign exchange earners may retain up to 100 per cent of their foreign exchange earnings in their Exchange Earners' Foreign Currency accounts.
- Borrowers eligible for accessing ECBs can avail of an additional US $ 250 million with average maturity of more than 10 years under the approval route. Prepayment of ECB up to US $ 300 million without prior approval of the Reserve Bank.
- The existing limit of US $ 2 billion on investments in Government securities by foreign institutional investors (FIIs) to be enhanced in phases to US $ 3.2 billion by March 31, 2007.
- The extant ceiling of overseas investment by mutual funds of US $ 2 billion enhanced to US $ 3 billion.
- Importers permitted to book forward contracts for their customs duty component of imports.
- FIIs allowed to rebook a part of the cancelled forward contracts.
- Forward contracts booked by exporters and importers in excess of 50 per cent of the eligible limit to be on deliverable basis and cannot be cancelled.
- Authorised dealer banks to be permitted to issue guarantees/letters of credit for import of services up to US $ 100,000 for securing a direct contractual liability arising out of a contract between a resident and a non-resident.
- Indian banks having presence outside India and foreign banks to migrate to the Basel II framework effective March 31, 2008 and other scheduled commercial banks to migrate in alignment but not later than March 31, 2009.
- Prudential limit on credit and non-credit facilities to Indian Joint Ventures/Wholly Owned Subsidiaries abroad enhanced to 20 per cent of unimpaired capital funds.

stated that to maintain price stability, RBI would use all policy instruments including CRR, LAF and MSS to modulate liquidity in the system so that all legitimate requirements of credit are met, particularly of the productive sectors of the economy. For the rest of the period, barring the emergence of any adverse and unexpected developments in the economy, the overall stance of monetary policy will be to (a) reinforce the emphasis on price stability and well anchored inflation expectations while ensuring an interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum, (b) re-emphasise credit quality and orderly conditions in the financial markets for securing macroeconomic and, particularly, financial stability while simultaneously pursuing greater credit penetration and financial inclusion, (c) respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectation and the growth momentum. To further strengthen anti-inflationary measures, RBI on January 31, 2007 once again raised repo rate under LAF by 25 basis points from 7.25 percent to 7.50 percent. RBI, on a further review of the domestic economic parameters, once again revised real GDP growth estimates for 2006-07 from around 8.0 per cent to 8.5-9.0 per cent. However, advance estimates of real GDP growth for 2006-07 released by the Central Statistical Organisation (CSO) on February 7, 2007 places the real GDP growth at 9.2 per cent for 2006-07.

3.29 Reducing the CRR is a medium-term objective of the RBI, and the CRR had been reduced gradually from its peak of 15 per cent of NDTL in 1992 to 4.5 per cent by June 2003. The Reserve Bank of India (Amendment) Bill 2006 has been enacted June, 2006. The amendment to the sub-section (1) of section 42 of the Reserve Bank of India Act 1934, vests RBI with the power to prescribe CRR for scheduled banks without any floor or ceiling rate thereby removing the statutory minimum CRR limit of 3.0 per cent. In response to the emerging macroeconomic conditions, on December 8, 2006, and February 13, 2007 hikes in the CRR were announced.

3.30 To create an enabling environment for further deepening and facilitating growth of the Government securities market, RBI during 2006-07, initiated measures such as (a) expanding ‘when issued’ trading in the case of fresh issues of Central Government securities on a selective basis; and (b) allowing scheduled commercial banks and primary dealers to cover their short positions in the Central Government securities within an extended period of five trading days and to deliver a shorted security by borrowing it through the repo market.

3.31 A debt restructuring mechanism for small and medium enterprises (SMEs) and ‘one time settlement’ scheme for SME accounts were also devised subsequent to the announcement made by the Union Finance Minister for stepping up credit to SMEs. Other policy measures announced were aimed at: (a) further developing and integrating financial markets with a view to enhancing allocative efficiency; (b) improving and expanding credit delivery oriented towards financial inclusion and extension of financial services to the population; (c) strengthening the capital base of banks to prepare them to migrate to BASEL II norms and implement prudential measures in consonance with international best practices in the financial sector; and (d) keeping up the pace of liberalisation of the external sector within the framework for fuller capital account convertibility recommended by the Tarapore Committee (II) of the RBI for promoting economic growth, improving financial sector efficiency and providing opportunity for diversification of investments by residents.

Interest rates

3.32 The continued rapid expansion of bank credit during 2005-06 and not so fast growth in the deposits, in spite of ample liquidity in the system, had exerted pressure on lending and deposits rates of banks. The hardening of interest rates was more pronounced at the short-end. The spread between deposits of up to one year maturity and of those above three years offered by public sector banks (PSBs) narrowed down to 75 basis points at end-March 2006 from 100 basis points at end-

Table 3.3 : Trends in interest rates				
(Per cent per annum)				
	End-March		End-January	
Interest rates	**2005**	**2006**	**2006**	**2007**
Bank Rate	6.00	6.00	6.00	6.00
CRR	5.00	5.00	5.00	5.25
Weighted call money rate	4.72	6.64	7.40	7.76
BPLR				
a. Public sector banks	10.25-11.25	10.25-11.25	10.25-11.25	11.50-12.25
b. Private sector banks	11.00-13.50	11.00-14.00	11.00-13.50	11.75-15.50
c. Foreign banks	10.00-14.50	10.00-14.50	10.00-14.50	10.00-14.50
Deposits rate (more than one year maturity) #	5.25-6.25	6.00-7.00	5.50-6.50	7.25-8.50
CDs by SCBs	4.21-6.34	6.50-8.94	5.50-7.25	6.00-8.36
CPs by companies	5.20-7.25	6.69-9.25	6.20-7.75	7.74-10.00
Fixed repo rate	6.00	6.50	6.50	7.50
Fixed reverse-repo rate	4.75	5.50	5.50	6.00
Yield on				
91-Day TBs	5.32	6.11	6.11	7.56
182-Day TBs	*	6.61	6.22	7.75
364-Day TBs	5.66	6.42	6.17	7.70
10-year G-sec	6.67	7.51	7.20	7.73

 # Relates to major banks.
*** No auction was held for 182-day TBs during 2004-05.**

March 2005. The firming of the deposit rates also reflected increased competition from alternative instruments of savings. By January 19, 2007, rate for deposits of more than one year maturity at major banks was 7.25-8.50 per cent, up by in the range of 175-200 basis points over the January 20, 2006 level.

3.33 During 2005-06, the range of benchmark prime lending rates (BPLRs) of PSBs and foreign banks remained unchanged, while that of private sector banks firmed up by 50 basis points. Stiff competition in the credit market had led to banks lending at sub-BPLR rates. The share of sub-BPLR lending in total lending of commercial banks, excluding export credit and small loans, increased from 59.0 per cent at end-March 2005 to 69.0 per cent at end-March 2006 and further to 75.0 per cent at end-June 2006. During April-January 2006-07, the BPLRs of PSBs increased by 125-100 basis points. The range of interest rates for foreign banks remained unchanged during the period.

3.34 At end-March 2006, the primary market yields of 91-day, 182-day and 364-day Treasury Bills (TBs) were 6.11 per cent, 6.61 per cent and 6.42 per cent, respectively. During the current year 2006-07, in the first auctions for these TBs held in April 2006, the primary market yields softened to 5.78 per cent, 6.14 per cent and 6.06 per cent, respectively. However, showing an increasing trend from May 2006, these TB yields rose gradually to 6.36 per cent, 7.78 per cent and 7.05 per cent, respectively, at end-June 2006; to 6.60 per cent, 7.78 per cent and 6.90 per cent, respectively, at end-September 2006; and further to 7.19 per cent, 7.30 per cent and 7.24 per cent, respectively, at end-December 2006. The yield for 91-day TBs, after remaining at 7.14 per cent at the first three weekly auctions of January 2007 started gradually creeping up; it was 7.39 per cent on January 24, 2007 and further hardened to 7.56 per cent on January 31, 2007. The yields on 182-Day and 364-Day TBs also showed hardening trends and were 7.75 per cent and 7.70 per cent, respectively, at end-January 2007. (Table 3.3).

3.35 The yield on 10-year residual maturity Government securities during 2005-06 hardened by 84 basis points to 7.53 per cent at end-March 2006, reflecting partly the rise in the yield of comparable maturity US security and the hardening of international crude oil prices. With liquidity tightening in the money market, the yield curve flattened with the spread between 1-year and 10-year yields narrowing to 98 basis points at end-March 2006.

3.36 During the early part of 2006-07, with a surge in the crude oil prices in the international market, tightening of monetary policy in the US and other economies, hike in domestic policy rates and expected issuance of oil bonds, yields on 10-year G-sec hardened further. It peaked at 8.39 per cent on July 11, 2006, and remained above 8.00 per cent up to August 23, 2006. It declined gradually to 7.38 per cent on December 5, 2006 in consonance with a rally in the price of US bonds of similar maturity, following a pause in the US Federal funds rate hike and downward movement in the crude oil prices in the world markets. This softening trend was reversed thereafter and, with continued high growth in bank credit and the announcement on December 8, 2006 of hikes in the CRR by 25 basis points each in two phases in the next 30 days to curb monetary accommodation of inflation, the yield started hardening. Yield increased from 7.39 per cent on December 8, to 7.53 per cent on December 11, to 7.68 per cent on December 14, 2006, 7.87 per cent on January 23, 2007 and softened to 7.73 per cent on January 31, 2007, before hardening again on February 14, 2007 to 8.08 per cent.

3.37 Corporate bond yields followed the same general trend as the yield on Government securities and other money market rates. The yield on 10-year AAA rated corporate bond hardened from 8.22 per cent on March 31, 2006 to 9.28 per cent on January 23, 2007. From 34 basis points on January 31, 2006 and 92 basis points on March 31, 2006, the spread over comparable G-sec yield widened to 141 basis points on January 31, 2007.

3.38 The weighted call money rate displayed considerable volatility. For example, on March 31, 2006, it suddenly shot up to 6.64 per cent from 5.95 per cent on the previous day, but eased thereafter to 5.43 per cent on June 2, 2006. On July 26, 2006, following the hike in the repo/reverse-repo rates by 25 basis points each the previous day, the rate rose sharply to 6.06 per cent. After remaining range-bound thereafter, with high credit growth continuing, transient liquidity pressures emanating from advance tax outflows hardened the rate to 7.25 per cent on September 29, 2006 and narrowed its spread over the repo rate to just 25 basis points. Up to December 12, 2006, the weighted call money rate remained within the repo/reverse-repo band of 6.00-7.25 per cent. However, from December 13, 2006 onward, for almost three fortnights, the rate breached the band with a peak of 16.78 per cent on December 29, 2006 in the wake of liquidity tightening due to hike of 25 basis points each in CRR effective the fortnights beginning December 23, 2006 and January 6, 2007, and the outflow on account of advance tax. With the tight liquidity conditions and sharp depletion of excess SLR holdings by SCBs, the scope for availing of the repo window of RBI under LAF got restricted; under the circumstances the call money market route was resorted to by the SCBs which resulted in increase in call money rates, as such operations are conducted without any collateral. As on February 6, 2007, the weighted call money rate was 7.83 per cent which was higher than the repo rate of 7.50 per cent. (Table 3.3).