3

Monetary and Banking Developments

Developments in the monetary sector during 2006-07 continued to reconcile the twin needs of facilitating the momentum of economic growth and containing inflation. This is to be viewed in the context of the performance of the economy in the immediately preceding year. Growth at 9.0 per cent in 2005-06 surpassed expectations of around 7.0 per cent and in the range of 7.0-7.5 per cent projected by the Reserve Bank of India (RBI) at the time of formulation of monetary policy in the Annual Policy Statement of 2005-06 in April, 2005 and the Mid-term Review of the Policy Statement in October 2005, respectively. In the first two quarters of the current year also, growth at 8.9 per cent and 9.2 per cent respectively has come as a pleasant surprise. Headline inflation, on a point-to-point basis and measured by the wholesale price index (WPI), remained at 4.1 per cent at end-March 2006, below the range of 5.0-5.5 per cent projected by RBI in April 2005. In spite of the benign impact of softening world crude oil prices in the current year, inflation continued to show some stubborn supply-side-induced hardening tendencies and reached a peak of 6.73 per cent on February 3, 2007.

3.2 Reflecting the higher economic growth, growth in broad money (M_3) at 17.0 per cent during 2005-06 was higher than the 12.3 per cent observed during 2004-05 (Table 3.1). The gathering momentum of growth got reflected and was also sustained by growth in credit to the commercial sector, up from the robust 26.0 per cent during the previous year to 27.0 per cent in 2005-06. Based on the emerging trends, for the purposes of monetary policy formulation for 2006-07, RBI had factored in real GDP growth in the range of 7.5-8.0 per cent and year-on-year inflation rate in the range of 5.0-5.5 per cent, and projected M_3 expansion at around 15.0 per cent.

3.3 With indications that growth was buoyant, in the Mid-Term Review of the Annual Policy Statement (October, 2006), projection for real GDP growth for 2006-07 was revised by RBI to around 8.0 per cent. Simultaneously, the overshooting of inflation beyond the expected path required a careful calibration of policy to tame inflation without hurting the gathering momentum of growth.

3.4 Monetary developments in 2006-07 so far have been characterised by (a) continued robust expansion in the credit–particularly non-food credit by scheduled commercial banks (SCBs); (b) a pick-up in the growth of deposits with SCBs but lower than the corresponding growth in credit; (c) a turn around in investment in approved securities for the purpose of the statutory liquidity ratio (SLR), from a declining to an increasing trend between 2005-06 and 2006-07; and (d) continued growth in foreign exchange assets of the banking sector through inflows of foreign exchange reserves.

3.5 During the current year, on January 19, 2007, year-on-year growth in M_3 and credit to the commercial sector at 21.1 per cent and 26.9 per cent, respectively were considerably higher than not only the 15.6 per cent and 26.6 per cent respectively observed on January 20, 2006, but also higher than 15.0 per cent and 20.0 per cent, respectively envisaged in the Annual Policy Statement for 2006-07. There have been some recent signs of the steady expansion in credit running into a situation of tight liquidity. During December, 2006, with liquidity injected under repo [liquidity adjustment facility (LAF)] at Rs.358,955 crore and that absorbed under reverse-repo at Rs. 314,865 crore, the net injection of liquidity in the system was Rs. 44,090 crore.

Monetary trends and developments

Broad money supply (M_3)

3.6 During 2005-06, M_3 expanded by 17.0 per cent, up from Rs.2,332,667 crore on April 1, 2005 to Rs. 2,729,536 crore at end-March 2006 (Table 3.1). Even after taking into account the existence of 27 reporting fortnights in 2005-06, this expansion was considerably higher than the expansion of 12.3 per cent during 2004-05 and than the growth rate of 14.5 per cent projected in the April 2005 Annual Policy Statement. With M_3 growing faster than nominal GDP in recent years, the velocity of money (ratio of nominal GDP to the average M_3 stock during the year) has declined from 1.62 during 2001-02 to 1.47 during 2004-05 and further to 1.45 during 2005-06.

3.7 Among the components of M_3, demand deposits grew the highest (26.1 per cent compared to 10.3 per cent in 2004-05), followed by currency with the public (16.4 per cent compared to 13.0 per cent in 2004-05) and time deposits (15.4 per cent compared to 12.4 per cent in 2004-05). The high growth of demand deposits was mainly due to higher capital mobilisation in the primary market, increased non-food credit by banks, and large mobilisation by domestic mutual funds being temporarily parked in demand deposits pending utilisation. The sharp pick up in time deposits in the second quarter of 2005-06 reflected both the small base in the previous year as well as the rise in deposit rates of interest.

3.8 Net bank credit to commercial sector remained the main source of M_3 growth. Credit continued to grow steadily for the second year in succession, with an expansion of Rs. 359,702 crore in 2005-06 following Rs. 264,099 crore in 2004-05. There was a change, however, in the food and non-food composition of credit between the two years. Non-food credit by SCBs expanded by 31.8 per cent (Rs. 354,192 crore) in 2005-06 compared to 27.5 per cent (Rs. 221,602 crore) in 2004-05. Food credit increased marginally by Rs. 674 crore in 2005-06 compared to Rs.5,160 crore in 2004-05 thereby registering an increase of 1.7 per cent. With credit outpacing GDP in growth terms, net domestic credit as a proportion of GDP increased from 52.7 per cent at end-March 2000 to 64.1 per cent at end-March 2003 and further to 69.0 per cent at end-March 2006.

3.9 To bridge the widening gap between the growth of credit and deposits, the banks have been funding the credit growth partly by reducing their investment portfolio through sale of Government securities above SLR requirement and liquidating their non-SLR investments. The gilt portfolio of SCBs, after increasing by Rs. 52,031 crore during 2004-05, declined by Rs. 19,514 crore during 2005-06. On March 31, 2006, SLR portfolio of SCBs was 31.0 per cent of their net demand and time liabilities (NDTL), down from 38.0 per cent a year ago. Non-SLR investments, which had increased by Rs.5,992 crore during 2004-05, declined by Rs. 10,256 crore during 2005-06.

3.10 During the current financial year up to January 19, 2007, M_3 expanded by Rs. 342,170 crore (12.5 per cent over end-March 2006) as compared to the expansion of Rs. 203,542 crore (8.7 per cent) during the corresponding period of the previous year. On a year-on-year basis, on January 19, 2007, M_3 expansion was even higher at Rs. 535,497 crore (21.1 per cent) compared to the expansion of Rs.343,007 crore (15.6 per cent) on the corresponding date of the previous year.

3.11 Currency with the public during the current financial year (up to January 19, 2007) increased by 14.2 per cent, marginally higher than 13.7 per cent during the corresponding period of 2005-06. On a year-on-year basis, growth in currency with public was 16.9 per cent as on January 19, 2007 compared to 16.3 per cent on January 20, 2006.

3.12 There was a change in the behaviour of demand and time deposits between 2005-

06 and the current year so far. Up to January 19, 2007, demand deposits with banks declined by Rs. 7,238 crore over the end-March 2006 level to Rs.397,986 crore. Such deposits had increased by Rs. 18,537 crore during the same period of previous year. On a year-on-year basis, growth in demand deposits on January 19, 2007 was lower at 17.1 per cent compared to 28.9 per cent on the corresponding date of last year. On the other hand, with interest rates firming up and availability of tax benefits under section 80C of the Income tax Act for deposits with maturity of five years and above, growth of time deposits accelerated between 2005-06 and the current year so far. On a financial year basis, time deposits increased by 15.3 per cent as of January 19, 2007 compared to 8.4 per cent during the corresponding period of 2005-06. On a year-on-year basis, the acceleration was even sharper with growth at 22.8 per cent on January 19, 2007 compared to 13.4 per cent on January 20, 2006.

3.13 Credit to the commercial sector during the current year up to January 19, 2007 had expanded by Rs. 272,357 crore compared to the expansion of Rs. 215,797 crore during the same period of the previous year. In percentage terms, however, the growth rate during the current financial year was only marginally lower at 16.1 per cent compared to 16.2 per cent during the same period of the previous year. On a year-on-year basis, growth of credit to the commercial sector on January 19, 2007 was up only to 26.9 per cent from 26.6 per cent on January 20, 2006. Credit to the commercial sector has remained the single most important source of M_3 growth in 2005-06 and in the current year so far. On a financial year (year-on-year) basis, it contributed 10.0 (16.4) percentage points to the overall M_3 growth of 12.5 (21.1) per cent in the current year up to January 19, 2007.

3.14 During the current year up to January 19, 2007, net bank credit to Government expanded by Rs.40,270 crore (5.2 per cent) compared to the expansion of Rs. 33,827 crore (4.5 per cent) during the corresponding period of 2005-06. On a year-on-year basis, on January 19, 2007, net bank credit to Government expanded by Rs. 26,828 crore (3.4 per cent), compared to the increase of Rs. 20,281 crore (2.7 per cent) on January 20, 2006. During the current year, upto January 19, 2007, net RBI credit to Central Government expanded only by Rs. 6,963 crore compared to Rs.55,578 crore in the corresponding period of last year; on year-on-year basis this declined by Rs.15,241 crore on January 19, 2007 compared to an increase of Rs.16,341 crore on January 20, 2006 (Table 3.1).

Reserve money (M_0)

3.15 M_0 expansion, during 2005-06 at Rs. 83,931 crore (Table 3.2) was substantially higher than the increase of Rs. 52,623 crore in 2004-05. At end-March, M_0 at Rs. 5,73,066 crore in 2006 was up 17.2 per cent from Rs.4,89,135 crore at end-March 2005. During the whole of 2004-05, M_0 had grown only by 12.1 per cent.

3.16 Like in 2004-05, expanding net foreign exchange assets (NFA) of the RBI continued to be the main source of M_0 increase in 2005-06, albeit with reduced intensity. Compared to Rs. 128,377 crore (26.5 per cent) during 2004-05, NFA during 2005-06 expanded by only Rs. 60,193 crore (9.8 per cent), partly due to the redemption of India Millennium Deposits. Net domestic assets (NDA) of the RBI, the other source of M_0 variation, which had declined by Rs. 75,754 crore in 2004-05, increased by Rs.23,738 crore — mainly due to net RBI credit of Rs. 26,111 crore to Government — during 2005-06. In contrast to an increase in Government's deposits with RBI of Rs.72,558 crore on account of large issuances under the market stabilization scheme (MSS) during 2004-05, a temporary suspension of MSS from mid-November 2005 had led to a decline of Rs. 14,541 crore in Centre's deposits with the RBI during 2005-06. NFA contributed only 12.3 percentage points of the 17.2 per cent growth of M_0 during 2005-06 compared to the 29.4 percentage points of 12.1 per cent growth of M_0 during 2004-05. In contrast, contribution of NDA to growth of M_0 was a mere 4.9 percentage points in 2005-06 compared to a negative

Table 3.1 : Sources of change in money stock (M_3)

Items	Outstanding balances as on Mar. 31, 2006	Outstanding balances as on Jan. 19, 2007	Variations during Apr. 1 2005 to Mar. 31 2006	Apr. 1 2005 to Jan. 20 2006	Mar. 31 2006 to Jan. 19 2007	Jan. 21 2005 to Jan. 20 2006	Jan. 20 2006 to Jan. 19 2007	Apr. 1 2005 to Mar. 31 2006	Apr. 1 2005 to Jan. 20 2006	Mar. 31 2006 to Jan. 19 2007	Jan. 21 2005 to Jan. 20 2006	Jan. 20 2006 to Jan. 19 2007
1	2	3	4	5	6	7	8	9	10	11	12	13
				Rs. crore						*Percent*		
I. M_1 (Narrow Money)	825246	865538	142693	65463	40292	131783	128769	20.9	9.6	4.9	21.4	17.2
II. M_3 (Broad Money) (1+2+3+4)	2729536	3071706	396869	203542	342170	343007	535497	17.0	8.7	12.5	15.6	21.1
1. Currency with the public	413143	471845	58272	48663	58702	56532	68311	16.4	13.7	14.2	16.3	16.9
2. Demand deposits with banks	405224	397986	83861	18537	-7238	76179	58086	26.1	5.8	-1.8	28.9	17.1
3. Time deposits with banks	1904290	2196166	254176	138079	291876	211224	407973	15.4	8.4	15.3	13.4	22.8
4. "Other" deposits with RBI	6879	5709	560	-1737	-1170	-928	1127	8.9	-27.5	-17.0	-16.8	24.6
III. Sources of change in money stock (M_3)												
1. Net bank credit to Governemnt (A+B)	769092	809362	20385	33827	40270	20281	26828	2.7	4.5	5.2	2.7	3.4
A. RBIs' net credit to Governent	8136	12242	35798	54985	4106	13136	-15081					
(i) Central Government	5160	12123	33374	55578	6963	16341	-15241					
(ii) State Governments	2976	119	2424	-593	-2857	-3205	160					
B. Other banks credit to Government	760956	797120	-15413	-21158	36164	7145	41909	-2.0	-2.7	4.8	1.0	5.5
2. Bank credit to commercial sector (A+B)	1690961	1963318	359702	215797	272357	324977	416262	27.0	16.2	16.1	26.6	26.9
A. RBIs' credit to commercial sector	1387	1907	-3	950	520	450	-433	-0.2	68.3	37.5	23.8	-18.5
B. Other banks' credit to commercial sector	1689574	1961411	359705	214847	271837	324527	416695	27.0	16.2	16.1	26.6	27.0
3. Net foreign exchange assets of the banking sector	726194	835577	78291	7812	109383	56163	179862	12.1	1.2	15.1	9.4	27.4
4. Government's currency liabilities to the public	8754	8054	1306	1216	-700	1228	-610	17.5	16.3	-8.0	16.5	-7.0
5. Banking sector's net non-monetary liabilities other than time deposits	465466	544604	62817	55110	79138	59642	86845	15.6	13.7	17.0	15.0	19.0
Memorandum Items												
1. Money multiplier (M_3)	4.76	4.79						-	-	-	-	-
2. Velocity of money	1.45											
3. Net domestic assets	2003341	2236130	318576	195730	232789	286844	355635	18.9	11.6	11.6	18.0	18.9
4. Net domestic credit	2460053	2772680	380087	249624	312627	345258	443090	18.3	12.0	12.7	17.4	19.0

Note:1. All figures are provisional. RBI data relate to end March after closure of Government accounts. Variations in respect of scheduled commercial banks (SCBs) are based on data for last reporting Friday of March. SCBs time deposits include Rs17, 945 crore on account of proceeds from RIB (Resurgent India Bonds), since August 28,1998 and Rs 25, 662 crore from India Millennium Deposits (IMDs) since November 17, 2000.

2. Financial year variations during 2006-07 so far is worked out from March 31, 2006, whereas the corresponding financial year variation during 2005-06 is worked out from April 1, 2005.

Table 3.2 : Sources of change in reserve money(M_0)

Items	Outstanding balances as on		Variations during					Percentage variations				
	Mar 31, 2006	Jan. 19, 2007	2005-06	Year-on-year		Financial year so far		2005-06	Year-on-year		Financial year so far	
				20 Jan 06 over 21 Jan 05	19 Jan 07 over 20 Jan 06	20 Jan 06 over 31 Mar 05	19 Jan 07 over 31 Mar 06		20 Jan 06 over 21 Jan 05	19 Jan 07 over 20 Jan 06	20 Jan 06 over 31 Mar 05	19 Jan 07 over 31 Mar 06
1	2	3	4	5	6	7	8	9	10	11	12	13
				Rs. Crore					Per cent			
Reserve Money(M_0)	573066	641790	83931	69213	106846	45809	68724	17.2	14.9	20.0	9.4	12.0
A: Components of Reserve Money												
a. Currency in circulation	430676	488251	62015	59241	71015	48575	57575	16.8	16.5	17.0	13.2	13.4
b. Bankers' deposits with RBI	135511	147830	21515	10900	34704	-870	12319	18.9	10.7	30.7	-0.8	9.1
c. "Other" deposits with RBI	6879	5709	401	-928	1127	-1896	-1170	6.2	-16.8	24.6	-29.3	-17.0
B: Sources of Resrve Money												
1. Net RBI credit to Government	8136	12242	26111	13136	-15081	45298	4106					
2. RBI credit to banks	5795	7804	537	-150	1720	826	2009	10.2	-2.4	28.3	15.7	34.7
3. RBI credit to commercial sector	1387	1907	-3	450	-433	950	520	-0.2	23.8	-18.5	68.3	37.5
4. Net foreign exchange assets of RBI	672983	787321	60193	54490	172487	2044	114338	9.8	9.7	28.1	0.3	17.0
5. Government's currency liablities to the public	8754	8054	1306	1228	-610	1216	-700	17.5	16.5	-7.0	16.3	-8.0
6. Net non-monetray liabilities of RBI	123990	175537	4214	-60	51237	4524	51547	3.5	0.0	41.2	3.8	41.6
Memo items:												
1. Net domestic assets of RBI	-99917	-145531	23738	14723	-65641	43765	-45614	-542.8	-15.6	82.2	-838.6	203.8
2. Net domestic credit by RBI	15318	21953	26645	13436	-13794	47074	6635	-60.0	60.2	-38.6	-72.7	-58.1

contribution of (-) 14.6 percentage points in the previous year.

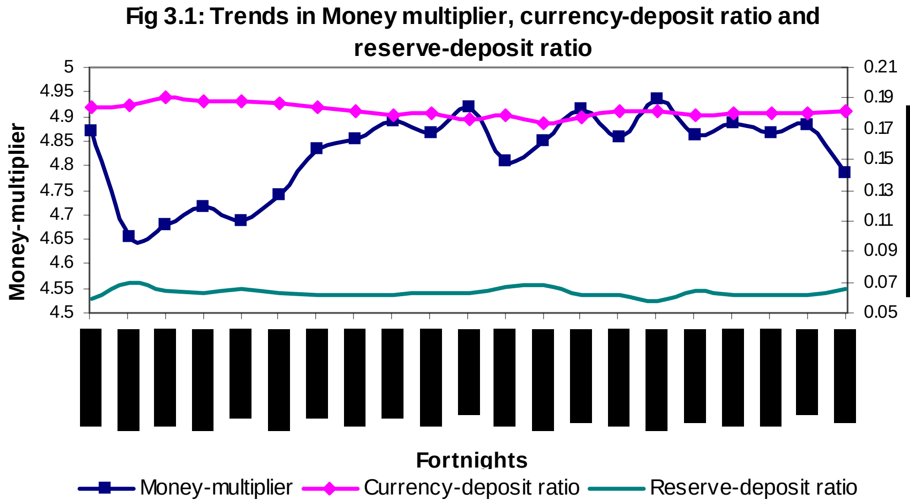
3.17 NFA of RBI has continued to be the main driver of M_0 expansion even during the current year, with such NFA expanding by Rs. 114,338 crore as on January 19, 2007 over the end-March 2006 level of Rs. 672,983 crore thereby contributing 20.0 percentage points to the overall 12.0 per cent growth in M_0. During the same period of the previous year, that is between end-March 2005 and January 20, 2006, NFA had expanded only by Rs. 2,044 crore.

3.18 On a year-on-year basis, M_0 expanded by 20.0 per cent on January 19, 2007, considerably higher than 14.9 per cent observed on January 20, 2006, to reach Rs. 641,790 crore. Such year-on-year growth in M_0 was mainly due to robust growth in the NFA of the RBI at 28.1 per cent on January 19, 2007 which was nearly thrice the growth of 9.7 per cent observed a year ago, matched by a sharp year-on-year decline in the NDA of the RBI of Rs. 65,641 crore compared to an increase in RBI's NDA of Rs. 14,723 crore on the corresponding date of the previous year (Table 3.2). The contributions of NFA and NDA of the RBI to the 20.0 per cent growth of M_0 on a year-on-year basis on January 19, 2007 were 32.2 percentage points and (-) 12.3 percentage points, respectively.

3.19 Reflecting these developments, the share of NFA in M_0 and in currency in circulation declined from 125.3 per cent and 166.2 per cent, respectively, to 117.4 per cent and 156.3 per cent, respectively, between end-March 2005 and end-March 2006. In a reversal of this trend in the current financial year, these ratios rose to 122.7 per cent and 161.3 per cent, respectively, on January 19, 2007 from 114.9 and 147.4 per cent, respectively, on January 20, 2006.

3.20 Sustained faster growth of M_3 relative to that of M_0 in recent years has resulted in the money multiplier ($\frac{M_3}{M_0}$) steadily increasing from 4.43 at end-March 2002 to 4.60 at end-March 2005, 4.76 at end-March 2006 and further to 4.79 on January 19, 2007 (Figure 3.1). Between January 20, 2006 and January 19, 2007, while the currency-deposit ratio declined to 0.181 from 0.189, the reserve-deposit ratio increased to 0.065 from 0.062, reflecting partly the effect of the recent hike in the cash reserve ratio (CRR) by the RBI.

Fig. 3.1 **Trends in Money Multiplier, Currency-Deposit Ratio and Reserve-Deposit Ratio**



Liquidity management

3.21 Unwinding of the Central Government surplus balances with the RBI during the current financial year and continued intervention by the RBI in the foreign exchange market to maintain orderly conditions led to an increase in the liquidity in the system. This was also reflected in higher bids offered and accepted by RBI through reverse-repo transactions under LAF. During 2006-07, up to September 8, 2006, RBI had not received any bid for repo and the continuous flow of funds under reverse-repo indicated a comfortable liquidity position. Thereafter, with the onset of the festival season, demand for currency increased, and high credit expansion together with outflows on account of advance tax started to affect the overall liquidity condition in the system. In response, RBI, under repo transactions, accommodated Rs.275 crore on September 15, 2006 and Rs. 5,010 crore on September 29, 2006. Such accommodations intensified during October 2006, and on six occasions, RBI injected liquidity under repo transactions: Rs. 35 crore on October 13, Rs. 1000 crore on October 19, Rs. 1,585 crore on October 20, Rs. 1,465 crore on October 23, Rs. 10 crore on October 26, and Rs. 330 crore on October 27. However, with liquidity absorption under reserve-repo simultaneously on, in net terms, there was injection of liquidity under LAF only on October 20, October 23 and October 26, 2006.

3.22 With year-on-year inflation stubbornly above 5 per cent since early-August 2006, on October 31, 2006, the RBI in its Mid-Term Review announced measures to stem inflationary expectations and also to contain the credit off-take at the desired growth rate of 20.0 per cent stipulated in the Annual Policy Statement of April, 2006. The repo rate was raised by 25 basis points to 7.25 per cent. On December 8, 2006, it was further announced that the CRR rate would be hiked by one-half of one percentage point on net demand and time liabilities (NDTL) in two stages effective from December 23, 2006 (5.25 per cent) and January 6, 2007 (5.50 per cent). The CRR increase, which was expected to absorb about Rs. 13,500 crore from the banking sector, together with the continued high credit growth, introduced some strain on the liquidity in the system from mid-December 2006. In fact, liquidity injection into the system under LAF during December, 2006, amounted to Rs. 44,090 crore (injection under repo of Rs.3,58,955 crore exceeding absorption under reverse-repo of Rs. 3,14,865 crore). Though the LAF had been in an injection mode between January 8, 2007 to February 7, 2007, subsequently the liquidity in the system increased as reflected in absorptions under reverse-repo. In the light of the emerging liquidity situation and inflationary expectations, RBI announced on February 13, 2007 further hike in CRR by 25 basis points each effective from the fortnights beginning February 17 and March 3, 2007. This is expected to absorb Rs. 14,000 crore from the banking system.

3.23 The liquidity in the system was also addressed during 2006-07 by MSS operations. Outstanding balance under MSS, after increasing from Rs. 29,062 crore (1.0 per cent of M_3) on March 31, 2006 to a high of Rs. 42,364 crore (1.5 per cent of M_3) on August 25, 2006, started declining thereafter to reach Rs. 40,491 (1.3 per cent of M_3) on January 19, 2007.

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).

Banking policy and trends

3.39 Union Budget for 2006-07 announced interest rate relief at two percentage points on the principal amount up to Rs. 1 lakh on crop loans availed of by the farmers for *Kharif* and *Rabi* seasons 2005-06. Conforming to the announcement, banks were advised on March 9, 2006 to credit the amount of relief to the borrower’s account before March 31, 2006 and seek reimbursement thereafter. Out of a grant of Rs. 1,700 crore, funds aggregating Rs.840 crore were placed with the National Bank for Agriculture and Rural Development (NABARD) and NABARD settled claims aggregating to Rs. 500.65 crore to cooperative banks and regional rural banks (RRBs) upto

December 31, 2006 and balance of Rs. 339.35 crore was remitted to Government of India (GOI). In compliance with the 2006-07 budget announcement, PSBs and RRBs, were advised by the RBI on June 5, 2006 that, with effect from *Kharif* 2006-07, Government would provide them interest rate financial assistance of 2 per cent per annum in respect of short-term production credit up to Rs. 3 lakh provided to farmers. This amount of financial assistance is calculated on the amount of crop loan disbursed from the date of disbursement/drawal up to the date of payment or up to the due date, i.e. March 31, 2007, for the *Kharif* and June 30, 2007 for the *Rabi,* respectively, whichever is earlier. This financial assistance is available on the condition that they make available short-term credit at ground level at 7 per cent per annum. This subvention was available only to short-term production credit disbursed by RRBs out of their own funds and excludes such credit as supported by refinance from NABARD. Subsequently, GOI extended the interest subvention at rate of 2 per cent on the own involvement of banks in crop loan lendings at 7 per cent to cooperative banks also.

3.40 Banks were advised to formulate a transparent policy, with the approval of their Boards, for providing ‘One Time Settlement’ facility to those farmers whose accounts have been rescheduled/restructured due to natural calamities as also for those who have defaulted on account of circumstances beyond their control.

3.41 Banks were further advised in July 2006 to ensure that loan accounts of farmers, which are overdue as on July 1, 2006 be rescheduled on the lines of the package of Relief Measures to the Vidarbha Region in Maharashtra announced by the Prime Minister and the interest thereon (as on July 1, 2006) be waived. Fresh finance was to be ensured to such farmers. The total amount of credit of Rs. 1,275 crore envisaged to be released by banks was allocated by Bank of Maharashtra (as the Maharashtra State Level Bankers’ Committees (SLBC) convenor), among the banks functioning in the relevant districts of the Vidarbha region.

3.42 In order to mitigate distress of farmers in the 31 debt-stressed districts of Andhra Pradesh, Maharashtra, Karnataka and Kerala, GOI has announced a rehabilitation package in respect of agriculture credit. The components of the package are (a) the entire interest on overdue agricultural loans as on July 31, 2006 will be waived and all farmers will have no past interest burden as on that date, so that they will be immediately eligible for fresh loan from the banking system, (b) the overdue loans of the farmers as on July 31, 2006 will be rescheduled over a period of 3-5 years with one-year moratorium, and (c) an additional credit flow will be ensured in these 31 districts through the banking sector. The burden of waiver of overdue interest on agricultural loans will be shared equally by the Central and State Governments.

3.43 The Annual Policy Statement of RBI for 2006-07 envisaged that banks’ total exposure to venture capital funds (VCFs) will be treated as part of capital market exposure and assigned a higher risk weight of 150 per cent. In August 2006, banks were advised that all exposures to VCFs (both registered and un-registered) would be deemed at par with equity, and hence would be reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity-linked instruments as well as ceiling for overall capital market exposure), and the limits prescribed for such exposure would also apply to investments in VCFs.

3.44 During the year, it was also announced that for opening small accounts banks need to seek only a photograph of the account holder and self-certification of address. Outstanding balances in these accounts at any time will be limited to Rs. 50, 000 and the total transactions limited to Rs.200,000 in one year.

3.45 To protect customers’ rights, enhancing the quality of customer service and strengthening grievance redressal mechanism in banks, RBI initiated several measures on an ongoing basis. To facilitate customer service in banks under a single window, RBI set-up a separate Customer Service Department (CSD) in July 2006. Its main functions, among other things, include:

(i) disseminating instructions/information relating to customer service and grievance redressal by banks; (ii) administering the Banking Ombudsman (BO) scheme; (iii) acting as a nodal department for the Banking Codes and Standards Board of India (BCSBI); ensuring redressal of complaints received directly by the RBI on customer service in banks; and (iv) liaising between banks, Indian Banks Association (IBA), BO offices and the regulatory departments within RBI on matters relating to customer service and grievance redressal.

3.46 After taking into account the state of preparedness of the banking sector, RBI allowed banks some more time to put in place appropriate systems so as to ensure full compliance with BASEL II. Indian banks having presence outside India and foreign banks operating within India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under BASEL II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under BASEL II in alignment with them, but in any case not later than March 31, 2009.

Financial performance

3.47 High sustained growth was observed in credit extended by SCBs in 2005-06; the growth in non-food credit extended by SCBs during 2005-06 was 31.8 per cent which was higher than the growth of 27.5 per cent in 2004-05. The aggregate deposits, on the other hand, grew by 18.1 per cent in 2005-06 compared to 12.8 per cent in 2004-05. This led the banks to fund loans and advances by increased resort to borrowings and offloading of Government and other approved securities. SCBs also accessed the capital market for this purpose as well as to strengthen their capital base: Rs.11,067 crore was raised from the equity market during 2005-06; in addition, Rs.30,151 crore was raised through 97 issues by private placement as compared to Rs.15,219 crore raised through 87 such issues in 2004-05.

Table 3.4 : Working results of scheduled commercial banks

Items	Public sector banks		Foreign banks		Old pvt. sector banks		New pvt. sector banks		SCBs	
	2004-05	2005-06	2004-05	2005-06	2004-05	2005-06	2004-05	2005-06	2004-05	2005-06
Rs. Crore										
A. Income	144567	160946	13036	17435	10525	11729	22107	32099	190236	222209
I) Interest Income	120365	137614	9170	12236	9275	10359	16990	24301	155801	184510
II) Other income	24202	23332	3866	5199	1250	1370	5117	7797	34435	37698
B. Expenditure	129125	144407	11054	14367	10089	10852	19010	27990	169278	197616
I) Interest expended	68764	80272	4042	5150	5673	6236	10600	15261	89079	106919
II) Intermediation cost	37041	41532	4417	5625	2611	3123	6064	8450	50133	58729
III) Provisions and contingenies	23319	22603	2595	3592	1806	1493	2345	4279	30065	31968
C. Operating profit	38761	39142	4577	6661	2242	2369	5443	8388	51023	56560
D. Net profit (A-B)	15442	16539	1982	3069	436	876	3098	4109	20958	24593
E. Net interest income (Spread)	51601	57342	5129	7086	3602	4123	6390	9041	66722	77591
F. Total assets	1692681	1926334	153636	201586	133470	149749	294421	421659	2355509	2787892
As Per cent of total assets										
A. Income	8.5	8.4	8.5	8.6	7.9	7.8	7.5	7.6	8.1	8.0
I) Interest Income	7.1	7.1	6.0	6.1	6.9	6.9	5.8	5.8	6.6	6.6
II) Other income	1.4	1.2	2.5	2.6	0.9	0.9	1.7	1.8	1.5	1.4
B. Expenditure	7.6	7.5	7.2	7.1	7.6	7.2	6.5	6.6	7.2	7.1
I) Interest expended	4.1	4.2	2.6	2.6	4.3	4.2	3.6	3.6	3.8	3.8
II) Intermediation cost	2.2	2.2	2.9	2.8	2.0	2.1	2.1	2.0	2.1	2.1
III) Provisions and contingenies	1.4	1.2	1.7	1.8	1.4	1.0	0.8	1.0	1.3	1.1
C. Operating profit	2.3	2.0	3.0	3.3	1.7	1.6	1.8	2.0	2.2	2.0
D. Net profit (A-B)	0.9	0.9	1.3	1.5	0.3	0.6	1.1	1.0	0.9	0.9
E. Net interest income (Spread)	3.0	3.0	3.3	3.5	2.7	2.8	2.2	2.1	2.8	2.8
F. Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo item										
1. Operating expenses as per cent of net income	48.9	51.5	49.1	45.8	53.8	56.9	52.7	50.2	49.6	50.9

3.48 During 2005-06, the total income of SCBs increased by 16.8 per cent compared to 3.5 per cent in 2004-05. However, as a proportion of assets, income at 8.0 per cent in 2005-06 was marginally lower than 8.1 per cent in 2004-05. Interest income, which is the major source of income of SCBs, grew sharply by 18.4 per cent in 2005-06 as against 7.9 per cent in the previous year, largely owing to increased volumes of credit and hardening of interest rates. 'Other income' grew by 9.5 per cent as compared to a decline of 12.9 per cent in 2004-05.

3.49 Expenditure of SCBs registered substantial growth of 16.7 per cent in 2005-06 compared to 4.8 per cent in 2004-05. Due to higher borrowing cost, interest expended by SCBs increased sharply by 20.0 per cent compared to 1.7 per cent in the previous year. Non-interest income increased by 17.1 per cent compared to 14.7 per cent in the previous year. Accordingly, banks' burden (excess of non-interest expenditure over non-interest income) increased marginally to 0.7 per cent of assets in 2005-06 from 0.6 per cent in 2004-05; the efficiency ratio —defined as operating expenses as a percentage of net interest income plus non-interest income — deteriorated from 49.6 per cent to 50.9 per cent between 2004-05 and 2005-06.

3.50 With the favourable impact of increased interest income, overall operating profit of SCBs registered a growth of 10.9 per cent in 2005-06 as against a decline of 3.0 per cent in 2004-05. Operating profits of all bank groups (consisting of State bank group, nationalised banks, other public sector banks, foreign banks etc.) increased in 2005-06 except for the nationalised banks whose operating profit marginally declined to Rs.23,011 crore in 2005-06 from Rs. 23,121 crore in 2004-05. Operating profits for SCBs, as a proportion of total assets, declined to 2.0 per cent during 2005-06 from 2.2 per cent in 2004-05. (Table 3.4)

Interest spread

3.51 Net interest income or spread — defined as the difference between interest income and interest expenses — of SCBs as a proportion of total assets remained unchanged at 2.8 per cent in 2005-06, substantially higher than the standard international norm. The spread of foreign banks increased to 3.5 per cent in 2005-06 from 3.3 per cent in 2004-05, and that of PSBs and old private banks was 3.0 per cent and 2.8 per cent, respectively, in 2005-06 as compared to 3.0 per cent and 2.7 per cent, respectively, in 2004-05. (Table 3.4)

Non-performing assets (NPAs) of the banking sector

3.52 Improved industrial climate and new options available to banks for dealing with bad loans helped in recovering a substantial amount of NPAs in 2005-06 (Table 3.5). Such recoveries during 2005-06 were more than fresh accruals. Gross NPAs of SCBs, which had declined by Rs.5,414 crore in 2004-05, fell by a further amount of Rs. 7,558 crore in 2005-06. Aggregate amount recovered and written-off increased to Rs. 28,717 crore during 2005-06 from Rs. 25,007 crore in the previous year. NPAs of SCBs, at 1.9 per cent

Table 3.5 : Non-performing assets of scheduled commercial banks

Items	Gross NPAs (Rs. Crore)			Percentage to gross advances			Percentage to total assets		
	2003-04	2004-05	2005-06	2003-04	2004-05	2005-06	2003-04	2004-05	2005-06
Bank group									
1. Public Sector	51538	48399	42106	7.8	5.5	3.7	3.5	2.7	2.1
2. Private Sector	10355	8782	7782	5.8	4.4	2.4	2.8	2.1	1.4
3. Foreign	2894	2192	1927	4.6	2.8	1.9	2.1	1.4	1.0
4. SCBs(1+2+3)	64787	59373	51815	7.2	5.2	3.3	3.3	2.5	1.9
Bank group	**Net NPAs (Rs. Crore)**			**Percentage to net advances**			**Percentage to total assets**		
1. Public Sector	19335	16904	14561	3.1	2.0	1.3	1.3	1.0	0.7
2. Private Sector	4128	4212	3161	2.4	2.2	1.0	1.1	1.0	0.6
3. Foreign	933	639	808	1.5	0.8	0.8	0.7	0.4	0.4
4. SCBs(1+2+3)	24396	21755	18530	2.8	1.9	1.2	1.2	0.9	0.7

of total assets at end-March 2006, were substantially lower than the 2.5 per cent observed a year ago. The operations of the Assets Reconstruction Company (India) Limited (ARCIL) during 2005-06 helped in NPA recovery. ARCIL acquired 559 cases of NPAs, with total dues of Rs.21,126 crore, from 31 banks/financial institutions (FIs).

Capital adequacy ratio

3.53 With important measures for improving capital adequacy such as (a) application of capital charge for market risk from March 2006, (b) a sharp increase in risk weighted assets on account of higher credit growth, and (c) increase in risk weights for personal loans, real estate and capital market exposure, the overall capital to risk weighted assets ratio (CRAR) for all SCBs was 12.3 per cent at end-March 2006. Though marginally lower than 12.8 percent at end March 2005, the ratio has remained substantially higher than the stipulated minimum of 9.0 per cent.

3.54 The CRAR of new private sector banks improved from 12.1 per cent at end-March 2005 to 12.6 per cent at end-March 2006. In respect of foreign banks, while it declined from 14.0 per cent to 13.0 per cent, it was still higher than the overall CRAR of 12.3 per cent observed for all SCBs. Nationalised banks' CRAR registered a decline from 13.2 per cent at end-March 2005 to 12.3 per cent at end-March 2006.

Technological developments in banks

3.55 The banking sector in India is adapting itself to rapid innovations in technology particularly on the information based technology front to impart efficiency in providing wide range of products and services to the public at large. Computerisation of banking operations had received high importance in 2005-06. Since September 1999 to March 2006, PSBs incurred an expenditure of Rs.10,676 crore on computerisation and development of communication networks. Out of 27 PSBs, branches of as many as 10 PSBs were 100 per cent computerised, while more than 50 per cent branches of 12 banks were computerised by end-March 2006.

3.56 The number of branches providing 'core banking solutions' (CBS) in recent years is increasing rapidly. Under CBS, a number of services are being provided such as 'anywhere banking', 'everywhere access', and quick transfer of funds in an efficient manner and at reasonable cost. New private sector banks, foreign banks and a few old private sector banks have already put in place CBS; PSBs are increasingly adopting similar system. The total number of branches of PSBs offering CBS increased from 11.0 per cent as on March 31, 2005 to 28.9 per cent as on March 31, 2006.

3.57 Total number of Automated Teller Machines (ATMs) installed by the banks were 21,147 at end-March 2006. Nationalised banks with 7,165 ATMs were the largest providers of the ATM service followed by new private banks (6,112), SBI group (5,443), old private banks (1,547) and foreign banks (880).

Bank credit

3.58 With credit growing by 30.8 per cent in 2005-06, credit-deposit (C-D) ratio of the SCBs was sharply up from 64.7 per cent at end-March 2005 to 71.5 per cent at end-March 2006. With buoyant credit growth, the C-D ratio has continued to grow during the current year so far, and was 74.0 per cent on January 19, 2007 compared to 70.0 per cent on the corresponding date of the previous year.

3.59 Higher-than-expected GDP growth, particularly in manufacturing, appears to be driving the demand for non-food credit. Non-food credit by SCBs expanded by Rs. 259,435 crore during the current year up to January 19, 2007, substantially higher than the Rs. 212,176 crore observed during the corresponding period of the previous year.

Investments

3.60 SCBs' investment portfolio consist of: (i) SLR investments, comprising of investment in Government and other approved securities, and (ii) non-SLR investments comprising of commercial papers, shares, bonds and debentures issued by the corporates. Compared to an increase of Rs. 49,373 crore during 2004-05, SLR investments by SCBs declined by Rs. 22,809 crore during 2005-06. The decline in 2005-06 was mainly through an offloading of Government securities worth Rs. 19,514 crore and was for funding the growing demand for credit.

3.61 As a proportion of NDTL, SLR investment by SCBs is, by law, required to be at least 25 per cent, but such investments by SCBs are normally above this limit. While it had come down from 38.0 per cent at end-March 2005 to 31.3 per cent at end-March 2006, it continued to be considerably higher than the statutory requirement of 25.0 per cent.

3.62 During the current financial year up to January 19, 2007, with a hike in the deposits rates and consequent pick-up in deposit growth, SLR investment increased sharply by Rs. 41,837 crore (of which, Rs. 36,754 crore in Government securities) compared to a decline of Rs.24,881 crore (of which, Rs.22,885 crore in Government securities) during the corresponding period of 2005-06. Nevertheless, with SLR investments growing slower than deposits, SLR investments as a proportion of deposits declined to 31.8 per cent on January 19, 2007 compared to 36.8 per cent a year ago. As on January 19, 2007, SLR investment by SCBs was Rs. 759,291 crore — with investment in Government securities at Rs.737,496 crore.

Sectoral deployment of bank credit

3.63 Credit to agriculture and allied sector expanded by Rs. 49,602 crore (39.9 per cent) in 2005-06 compared to an increase of Rs. 33,728 crore (37.3 per cent) in the previous year. Credit to industry (large and medium) increased by Rs.110,435 crore (31.6 per cent) in 2005-06, compared to the expansion of Rs. 101,737 crore (41.2 per cent) in 2004-05. Credit to small scale industries was higher by Rs. 16,757 crore (22.6 per cent) compared to Rs. 8,334 crore (12.7 per cent) in 2004-05. Credit to housing loans expanded by Rs.50,882 crore (38.0 per cent) in 2005-06 compared to Rs.81,927 crore (157.6 per cent) in 2004-05. While loans to real estate during 2005-06 increased by Rs.12,832 crore compared to Rs. 7,969 crore extended during 2004-05, the growth rate of 94.7 per cent in 2005-06 was lower than the corresponding growth rate of 142.9 per cent observed during the previous year.

Table 3.6 : Sectoral deployment of gross bank credit

	Outstanding balances at the end of				Variations during[1]					
	2004-05	2005-06	September 2005	September 2006	2004-05	2005-06	Sep.06 over Sep.05	2004-2005	2005-06	Sep.06 over Sept.05
	(Rs. crore)							Per cent		
I. Gross bank credit	1045954	1433728	1194588	1576982	281571	387774	382394	36.8	37.1	32.0
1. Public food procurement credit	41121	40691	40327	33458	5160	-430	-6869	14.3	-1.0	-17.0
2. Gross non-food Bank Credit	1004833	1393037	1154261	1543524	276411	388204	389263	37.9	38.6	33.7
(a) Priority sectors (i+ii+iii)[2]	374953	509886	427646	536747	111119	134933	109101	42.1	36.0	25.5
i. Agriculture[3]	124269	173871	140194	186527	33728	49602	46333	37.3	39.9	33.0
ii. Small scale industry	74189	90946	77827	94934	8334	16757	17107	12.7	22.6	22.0
iii. Other priority sector	176495	245069	209625	255286	69057	68574	45661	64.3	38.9	21.8
(b) Medium and large industries	348947	459382	403686	501960	101737	110435	98274	41.2	31.6	24.3
(c) Wholesale trade (excluding food procurement)	31559	39661	30534	43509	6692	8102	12975	26.9	25.7	42.5
(d) Other sectors	249374	384108	292395	461308	56863	134734	168913	29.5	54.0	57.8
of which:										
(1) Housing	133908	184790	152286	209099	81927	50882	56813	157.6	38.0	37.3
(2) Consumer durables	8976	8167	9211	9574	702	-809	363	8.5	-9.0	3.9
(3) Real estate loans	13546	26378	18047	35574	7969	12832	17527	142.9	94.7	97.1
(4) Loans to individuals[4]	4101	5210	4323	4485	2081	1109	162	103.0	27.0	3.7

Note : Data is provisional; accounts for 90 per cent of bank credit of all SCBs.
1. As on the last reporting Friday of the year.
2. Excluding investments in eligible securities.
3. Indrect finance not included.
4. Against shares and debentures/bonds

3.64 Provisional data on sectoral deployment of non-food credit for the first half of 2006-07 indicates the continuation of the trend of broadening outreach of such credit across the various sectors witnessed during the earlier year, On September 29, 2006, the year-on-year increase in credit to agriculture and allied activities was Rs. 46,333 crore or 33.0 per cent and to industry (large and medium) was Rs.98,274 crore or 24.3 per cent. On a year-on-year basis, housing loans as well as loans to real estate continued to expand at a faster rate of 37.3 per cent and 97.1 per cent, respectively. (Table 3.6).

Priority sector lending

3.65 The higher credit to agriculture and housing sector, which together constituted more than two-thirds of incremental priority sector lending, helped in the 36.0 per cent increase in priority sector lending in 2005-06 on top of an increase of 42.1 per cent in the previous year. Policy measures initiated by the Government and the RBI had facilitated higher credit to small scale industries, which registered an increase of 22.6 per cent in 2005-06 as compared to 12.7 per cent during the previous year. During 2006-07, the outstanding credit to the priority sectors as on September 29, 2006 was Rs. 536,734 crore compared to Rs.427,646 crore as on September 30, 2005.(Table 3.6)

Lending to sensitive sectors

3.66 A sharp increase in the exposure to the real estate sector during 2005-06 led to substantial lending to 'sensitive sectors' by SCBs. Overall exposure to sensitive sectors during 2005-06 was 18.9 per cent of aggregate bank credit, of which loans to real estate, capital market and commodities sectors in total credit were 17.2 per cent, 1.5 per cent and 0.3 per cent, respectively. Share of the real estate sector in such lending increased from 88.9 per cent to 90.8 per cent between end-March 2005 and end-March 2006 (Table 3.7).

Table 3.7: Lending to sensitive sectors by scheduled commercial banks

Sector		At end-March			
		2005	2006	2005	2006
		Rs. Crore		Per cent to total	
(i)	Capital market	15860	22077	9.7	7.7
(ii)	Real estate	145605	260223	88.9	90.8
(iii)	Commodities	2366	4391	1.4	1.5
	Total	**163831**	**286691**	**100.0**	**100.0**

Agricultural credit

3.67 During the Tenth Five Year Plan period, up to December 31, 2006, total flow of bank credit for agriculture and allied activities is Rs. 611,678.66 crore. Over the period (2002-03 to 2006-07), the share of commercial banks in total credit flow to agriculture and allied activities has increased, with significant increases from 2004-05 onwards.

3.68 As per the 'farm credit package' announced by the Government of India on June 18, 2004, for doubling the flow of credit to agriculture in the following three years, the target for institutional credit for agriculture by all agencies was fixed by ensuring a 30 per cent growth during 2004-05 over the previous

Table 3.8 : Flow of institutional credit to Agriculture

Rs. crore

Agencies	2002-03	2003-04	2004-05	2005-06	2006-07*
Co-operative Banks	23,716.38	26,958.79	31,424.23	39403.77	33,174.32
RRBs	6,069.79	7,581.15	12,404.00	15222.90	15,170.03
Commercial Banks	39,773.60	52,440.85	81,481.14	125858.90	1,00,998.81
Grand Total (1+2+3)	**69,559.77**	**86,980.79**	**1,25,309.37**	**1,80,485.57**	**1,49,343.16**

***** *Upto 31 December 2006***

year's achievement. With institutional credit flow to agriculture at Rs.125,309 crore in 2004-05, registering a growth of 44 per cent, it exceeded the target set by a wide margin (Table 3.8). The target for such credit flow was fixed at Rs.141,000 crore for 2005-06 on the basis of performance of the various agencies during 2004-05. With growth of 44 per cent, such credit of Rs. 180,485.57 crore again surpassed the target for 2005-06. During 2006-07 (up to December 31, 2006), the total flow of institutional credit at Rs.149,343.16 crore (provisional) constituted 85 per cent of the annual target of Rs.175,000 crore for the year.

Kisan credit card scheme

3.69 With a total of 642.49 lakh Kisan Credit Cards (KCCs) issued by the banking system as on December 31, 2006, the KCC Scheme introduced in August 1998 appears to have become a widely accepted mechanism for credit delivery to farmers (Table 3.9).

3.70 With a view to making KCC more user-friendly and comprehensive in its coverage of credit needs of the farmers through a single window, NABARD has further enlarged the scope of the KCC scheme to cover long-term loans for agriculture and allied activities as well. So far, the coverage of credit thereunder was restricted to short-term and medium-term loans. However, taking into consideration the nature of requirement of the clientele of State Co-operative Agriculture and Rural Development Bank (SCARDBs), the benefits of KCC scheme have been extended to the long-term borrowers of the co-operative credit structure too. This is also expected to pave the way for acceptance of KCC as a single window for comprehensive rural credit delivery.

Table 3.9 : Agency-wise KCCs Issued

(Lakhs)

Year	Co-operative Banks	PRBs	Comercial Banks	Total
1998-99	1.56	0.06	6.22	7.84
1999-00	35.95	1.73	13.66	51.34
2000-01	56.14	6.48	23.90	86.52
2001-02	54.36	8.34	30.71	93.41
2002-03	45.79	9.64	27.00	82.43
2003-04	48.78	12.75	30.94	92.47
2004-05	35.56	17.29	43.95	96.80
2005-06	25.98	12.49	41.65	80.12
2006-07#	15.48	10.4	25.68*	51.56
Total	**319.6**	**79.18**	**243.71**	**642.49**
% Share	***49.75***	***12.32***	***37.93***	***100.00***

*** Upto 30 June 2006 # upto December 31, 2006.**

3.71 Keeping in view the directive of the Government of India for doubling the flow of credit to agriculture sector, NABARD advised the co-operative banks and RRBs to identify and bring into their fold, such farmers, including defaulters, oral lessees, tenant farmers, share-croppers, etc., who may have been outside the fold of the scheme, for any reasons, as also new farmers. The co-operative banks and RRBs were advised to set realistic targets and cover all farmers under KCC by March 31, 2007.

3.72 Further, the banks have to ensure that KCCs continue to get renewed in a hassle-free manner and direct their efforts towards ensuring *'quality in operations'* on the KCCs. More importantly, banks have also to ensure that, henceforth, crop loans are routed only through KCCs.

Micro-finance

3.73 NABARD has been making continuous efforts through its micro-finance programme for improving the access of the rural poor to formal institutional credit. The Self Help Group (SHG) -Bank Linkage Programme was introduced in 1992 as a mechanism to provide the poor in rural areas, at their door-step, easy and self-managed access to formal financial services on a sustainable basis by enabling them to gain access to banking services in a cost-effective manner. In all, 547 banks (47 commercial banks, 158 RRBs and 342 co-operative banks) are now actively involved in the operation of this programme. As on March 31, 2006, bank loans of Rs.11,398 crore were availed of by 2,238,565 SHGs from the banking system (Table 3.10). As on March 31, 2006 the average bank loan per SHG was around Rs.50,917; the programme has enabled nearly 329 lakh poor

Table 3.10 : Progress of SHG-Bank linkage						
Year	New SHG financed by banks			Bank loan** (Rs. crore)		
	During the year		Cumulative	During the year		Cumulative
	No.	Growth (%)	No.	Amount	Growth (%)	Amount
2002-03	255,882	29	717,360	1,022.34	87	2,048.68
2003-04	361,731	41	1,079,091	1,855.53	81	3,904.21
2004-05	539,365	49	1,618,456	2,994.25	62	6,898.46
2005-06	620,109	15	2,238,565	4,499.09	50	11,397.55
2006-07#	237,927		2,476,492	2,114.31		13,511.86

**** Includes repeat loans to existing SHGs.**

 # As on 31.12.2006.

families in the country to gain access to micro-finance facilities from the formal banking system. During 2006-07, as against the target of 3.85 lakh new SHGs, as on December 31, 2006, as many as 2.38 lakh SHGs were credit-linked and bank loans of Rs.13,511.86 crore were disbursed.

Rural infrastructure development fund

3.74 The Rural Infrastructure Development Fund (RIDF) was announced by Government in 1995-96 to boost public sector investment in agriculture and rural infrastructure. The Fund was to be raised from the commercial banks to the extent of their shortfall in agricultural lending. The Fund has continued and the corpus is announced every year during the budget. So far, eleven tranches have been completed and RIDF-XII is on-going during the year 2006-07.

3.75 Though the initial thrust had been on irrigation projects, the development of rural roads and bridges has received a major boost since the time of RIDF-II. Subsequently, many other activities were gradually added to the list of eligible activities under RIDF. The activities, which have been made eligible for loans from RIDF, include rural roads and bridges; irrigation, mini and small hydel projects; community irrigation wells; soil conservation, watershed development and reclamation of waterlogged areas; flood protection; drainage; forest development; market yard, godowns, *apna mandi*, rural *haats* and other marketing infrastructure; cold storages; seed/agriculture/horticulture farms; plantation and horticulture; grading and certifying mechanisms such as testing and certifying laboratories; fishing harbour/jetties; riverine fisheries; animal husbandry; modern abattoir; drinking water supply; infrastructure for rural educational institutions; public health institutions; construction of toilet blocks in existing schools and “pay and use” toilets in rural areas; village knowledge centres; desalination plants in coastal areas; infrastructure for information technology in rural areas; and construction of anganwadi centres.

3.76 The total corpus of RIDF (Tranches I to XII) aggregated to Rs.60,000 crore. The cumulative amount sanctioned and disbursed to State Governments up to January 25, 2007, was Rs. 58,795.36 crore and Rs. 34,643.87 crore, respectively. During 2006-07 up to January 25, 2007, amount sanctioned and disbursed was Rs. 7,810.85 crore and Rs. 3,306.60 crore, respectively. The first five tranches of RIDF (I to V), have since been closed and the phasing/period of implementation in respect of projects under RIDF VI to IX tranches has been extended up to March 31, 2007. The scheduled dates of closure of RIDF X , XI and XII are March 31, 2007, 2008 and 2009 respectively.

Non-banking financial companies (NBFCs)

3.77 The number of applications received by RBI for grant of certificate of registration

Table 3.11 : Number of non-banking financial companies registered with RBI		
End-June	All NBFCs	NBFCs accepting public deposits
1999	7,855	624
2000	8,451	679
2001	13,815	776
2002	14,077	784
2003	13,849	710
2004	13,764	604
2005	13,261	507
2006	13,014	428

(CoR) as NBFCs till end-March 2006 was 38,244, out of which, 13,141 applications (net of cancellation), including 423 applications (net of cancellation) of public deposit accepting companies (NBFCs-D), were authorised to accept/hold public deposits. At end-June 2006, the total number of NBFCs registered with RBI was 13,014 (net of cancellation). (Table 3.11).

3.78 With the exit of many NBFCs from the public deposits taking business, the number of NBFCs-D has steadly declined. As at end June 2006, NBFCs-D were 428. The number of Residuary Non-Banking Financial Companies (RNBFCs) remained unchanged at 3 at end-March 2006.

3.79 During 2005-06, assets and public deposits of reporting NBFCs increased by Rs. 2,394 crore and Rs.2,316 crore, respectively. Net owned funds of NBFCs increased by Rs.562 crore during 2005-06, despite a decline in the number of reporting NBFCs. Deposits of reporting NBFCs at end-March 2006 were marginally lower at 1.1 per cent of aggregate deposits of SCBs compared to 1.2 per cent at end-March 2005.

3.80 Total assets/liabilities of NBFCs (excluding RNBFCs) at end-March 2006 were Rs.35,561 crore, down marginally by 1.2 per cent from Rs.36,003 crore at end-March 2005. Such assets/liabilities had increased by 9.9 per cent during 2004-05. There were major changes in the composition of assets and liabilities as well in 2005-06. On the liability side, paid-up capital as well as public deposits of these companies declined by 11.7 per cent and 32.1 per cent, respectively, during 2005-06. On the asset side, Bill Discount business in 2005-06 registered a substantial decline of 90.4 per cent compared to an increase of 7.8 per cent during 2004-05; their SLR investment declined by 41.3 per cent during 2005-06 compared to an increase of 31.0 per cent during 2004-05 and decline of loans and advances was 27.8 per cent compared to an increase of 3.1 per cent in the previous year.

3.81 In 2005-06, a significant decline in fee-based income (61.2 per cent) and only a marginal increase in fund-based income (5.3 per cent) resulted in stagnancy of the overall income of NBFCs (marginal decline of 0.1 per cent) compared to an increase in overall income of 5.8 per cent in 2004-05. Concomitantly, expenditure registered an increase of 13.0 per cent in 2005-06 mainly because of an increase of 31.6 per cent in operating expenses. Net profit after tax of NBFCs in 2005-06 was only Rs. 152 crore compared to Rs.572 crore in 2004-05, representing a decline of 73.4 per cent compared to an increase of 7.7 per cent in 2004-05.

3.82 Gross NPAs as a proportion of gross advances as well as net NPAs as a proportion of net advances of reporting NBFCs (excluding RNBFCs, Mutual Benefit Companies (MBCs) and Miscellaneous Non-Banking Companies (MNBCs)) at end-March 2006 declined sharply to 2.4 per cent and 0.4 per cent, respectively, compared with 8.2 per cent and 2.4 per cent, respectively at end-March 2005.

3.83 The number of NBFCs (excluding RNBFCs, MBCs and MNBCs) with less than the minimum regulatory CRAR of 12.0 per cent declined from 64 at end-March 2005 to 19 at end-March 2006. The number of NBFCs with CRAR more than 30 per cent also declined from 280 at end-March 2005 to 252 at end-March 2006.

All India financial institutions (AIFIs)

3.84 Financial assistance sanctioned and disbursed by AIFIs, which in recent years had witnessed sharp decline, exhibited a steady increase during 2005-06. Financial assistance sanctioned was higher at Rs. 27,239 crore during 2005-06 compared to Rs. 19,606 crore during 2004-05. Disbursement of Rs.20,523 crore during 2005-06 was also higher than the disbursement of Rs. 15,323 crore during 2004-05.(Table3.12)

3.85 Both in sanctions and disbursements, the investment institutions have provided assistance at levels higher than the development finance institutions.

Table 3.12 : Assistance by AIFIs

Rs. crore

Items	April-March	
	2004-05	2005-06
A. Sanctions		
(a) DFI*	9,202	12,074
(b) Investment Institutions@	10,404	15,165
AIFIs (a+b)	19,606	27,239
B. Disbursements		
(a) DFI*	6,351	9,323
(b) Investment Institutions@	8,972	11,200
AIFIs (a+b)	15,323	20,523

*** Relating to IFCI, SIDBI, IIBI, IVCF, ICICI Venture and TFCI.**

@ Relates to LIC and GIC. Data for 2005-06 pertain only to LIC.

Note: All data are provisional.

Source: RBI

Outlook

3.86 The rapid rise in credit growth in recent years has reflected and also helped the growth momentum of the economy. Both credit as well as money, as a proportion of GDP, are low in India by international standards. Hence, they will continue to outpace GDP in terms of growth in the years to come. But, it is unlikely that they will grow as fast as they have in the recent past.

3.87 Monetary policy will continue to face the challenge of taming inflation while not hurting the gathering momentum of growth. The challenge on the inflation front is compounded by the supply-side nature of the basic impetus. Addressing the inflation-related supply-side problem of primary commodities requires a continuation of the move to integrate the rural sector in general and agriculture in particular with the organised financial sector. Increasing the outreach of the banking system to these hitherto neglected sectors remains a major unfinished task of economic reform. Furthermore, with buoyant capital flows through the balance of payments, monetary and credit policies will have to steer a careful path of maintaining the international competitiveness of domestic economic activities.