

MONETARY POLICY

4.22 The changes in the domestic and global economy, impacting the price level and financial stability, pose serious challenges in the conduct of monetary policy. The major thrust of the monetary policy has been to facilitate the growth of the economy in a non-inflationary environment. The Annual Policy Statement (APS) and its quarterly reviews by the Reserve Bank of India (RBI) are the principal modes of communicating policy signals to the system.

4.23 The APS for 2006-07 (April 2006) was formulated in the wake of higher real GDP growth and with a relatively lower rate of inflation than the preceding year. The APS 2006-07 had placed real GDP growth in the range of 7.5 to 8 per cent, rate of inflation in the range of 5 to 5.5 per cent. Broad money (M_3) was expected to expand by around 15 per cent and non-food credit growth was assumed at 20 per cent. Actual performance of these parameters during 2006-07 was in fact much higher. Real GDP growth was 9.6 per cent, annual rate of inflation was 5.9 per cent, M_3 grew by 21.3 per cent and non-food credit by 28.4 per cent.

4.24 The year 2006-07 was marked by a surge in headline inflation during January 2007, volatility in financial markets in the fourth quarter of 2006-07 and sizeable swings in liquidity. In spite of hardening of interest rates, the industrial sector was buoyant, leading to rapid expansion in non-food credit. The high level of capital inflows, which

led to surge in the net foreign exchange assets (NFA) of the RBI, had implications for rupee liquidity in the system. In response, changes were made in the repo and reverse-repo rates. By March 31, 2007, the fixed repo rate was raised to 7.75 per cent. Cash Reserve Ratio (CRR) was also raised by 25 basis points on four occasions during the year, thereby bringing it to 6 per cent on March 3, 2007 (Table 4.19).

4.25 Against this background, RBI articulated its monetary policy stance for 2007-08 in APS (April 2007). The policy recognized the need to manage the transition to a higher growth path while at the same time containing inflationary pressures. For policy purposes, the RBI assumed that real GDP for the year to grow at 8.5 per cent, inflation close to 5 per cent, and monetary expansion in the range of 17-17.5 per cent. The Annual Policy Statement placed primacy on price and financial stability. It also focused on greater credit penetration and financial inclusion.

4.26 The RBI in its mid-term review of the APS 2007-08 reiterated the policy stance announced in April 2007 with an additional resolve "to be in readiness to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusual heightened global uncertainties, and the unconventional policy responses to the developments in financial markets". During the year the RBI changed its policy rates from time to time excepting the bank rate (Box 4.1).

Box 4.1 Annual Policy Statement for the Year 2007-08**Annual Policy Statement at a glance**

- Reverse repo rate and repo rate kept unchanged at 6 per cent and 7.75 per cent, respectively.
- Cash Reserve Ratio (CRR) hiked to 6.50 per cent earlier with effect from the fortnight beginning April 28, 2007, prevailing from 6.25 per cent.
- Ceiling interest rate on NR(E)RA deposits reduced by 50 basis points to LIBOR/SWAP rates.
- Ceiling interest rate on FCNR(B) deposits reduced by 50 basis points to LIBOR minus 75 basis points.
- Average cut-off yield on 182-day Treasury Bills to be used as a benchmark rate for floating rate bonds.
- Overseas investment limit (total financial commitments) for Indian companies enhanced to 300 per cent of their net worth.
- Listed Indian companies limit for portfolio investment abroad in listed overseas companies enhanced to 35 per cent of net worth.
- Aggregate ceiling on overseas investment by mutual funds enhanced to US\$ 4 billion from US\$ 3 billion.
- Prepayment of external commercial borrowings (ECBs) without prior RBI approval increased to US\$ 400 million.
- Limit for individuals for any permitted current or capital account transaction increased from US\$ 50,000 to US\$ 1,00,000 per financial year in the liberalized remittance scheme.
- Risk weight on residential housing loans to individuals for loans up to Rs. 20 lakh reduced to 50 per cent as a temporary measure.
- Ceiling rate of interest payable by NBFCs (other than RNBCs) on deposits raised by 150 basis points.

Mid-term review

- CRR increased by 50 basis points to 7.5 per cent effective fortnight beginning November 10, 2007.
- Covering of "Short-sale" and "When issued" transactions to be permitted outside the Negotiated Dealing System-Order Matching (NDS-OM) system.
- Reinstatement of the eligible limits under the past performance route for hedging facility to be permitted.
- Oil companies to be permitted to hedge foreign exchange exposure by using overseas over-the-counter (OTC)/exchange traded derivatives up to a maximum of one year forward.
- Importers and exporters having foreign currency exposures to be allowed to write covered call and put options in both foreign currency/rupee and cross currency and receive premia.