Monetary and Credit Policy

3.12 Though M3 growth exceeded projected levels during each of the previous three years, the monetary and credit policy for 1999-2000 indicated the desirability of aiming at a lower M3 growth in 1999-2000 than the rate of growth of 15.0 to 15.5 percent projected for the previous two years. However, keeping in view the likely adverse impact of an unduly restrictive monetary and credit policy on Government's market borrowing requirements as well as on the general growth prospects, RBI indicated a marginally higher M3 growth in the range of 15.5 to 16.0 percent for 1999-2000.The broad money growth of 15.5 – 16.0 percent indicated for 1999-2000 assumes a GDP growth rate of 6-7 percent and an inflation rate of about 5 percent per annum. The year–on –year growth in M3 as on January 14, 2000, was 16.6 percent, which was more than the projected range of M3 growth. Consistent with the projected M3 growth, RBI has given expansion in aggregate deposits of scheduled commercial banks (SCBs) at Rs. 1,18,500 crore or 16.5 percent in 1999-2000 over 1998-99. However, as on January 14, 2000, the year-on-year growth in aggregate deposits of SCBs was marginally lower at 16.2 percent. Non-food bank credit including investments in commercial papers, shares/debentures/bonds of PSUs and private corporate sector has been projected by RBI at 18 percent in 1999-2000. The observed year-on-year growth in the total flow of funds comprising non-food credit and investment in the debt/equity instruments was 18.1 percent as on January 14, 2000. Availability of credit of the projected order is expected to cater to the credit requirements of the productive sectors of the economy.

3.13 The financial sector reforms announced as part of the monetary and credit policy for 1999-2000 (Box 3.2) include the interim liquidity adjustment facility (ILAF) through repos and lending against collateral of Government of India Securities (Box 3.3), and introduction of rupee derivatives to enable market players to hedge interest rate risks. In order to ensure adequate liquidity for promoting industrial revival, the policy statement also announced reduction in CRR to 10.0 percent with effect from the fortnight beginning May 8, 1999.The mid-term review of monetary and credit policy for 1999-2000 announced further reduction in CRR by 1 percentage point in two phases involving half-a-percentage point reduction each with effect from the fortnights beginning November 6 and November 20, 1999 respectively.

Multiple Indicators and Instruments

3.14 Experience in monetary management during 1998-99 revealed the need for monitoring a multiple set of indicators for the conduct of monetary policy, especially in the context of a significant increase in volatility of the exchange rate, a spurt in inflation rate for most part of the year (mainly caused by adverse supply shocks), and a slow down in industrial growth. Monetary policy is implemented through a network of financial intermediaries and markets. In a complex financial system, the effects of monetary policy on output and inflation are transmitted through various segments of the financial markets, by way of changes in interest rate, exchange rate and other asset prices as well as changes in the volume of money and credit in economy. The precise way in which policy actions feed through the financial and economic systems represents the transmission mechanism while the various effects constitute the channels of policy. In India, the transmission mechanism and channels have been influenced by gradual financial sector liberalisation involving increasing exposure of the balance sheets of banks and corporates to market forces, steady diffusion of financial innovations, growing degree of openness of the economy and liberalisation of domestic product and asset markets. These developments and the need to coordinate between the short-term objective of market stabilisation and the long-term objective of growth and inflation control have warranted an approach based on a multiple set of indicators. The projected M3 growth, which provides a broad indicator of the stance of liquidity conditions, has been supplemented by other indicators such as interest rates, exchange rate, fiscal and external positions and flow of financial resources for purposes of monetary management. The multiple indicator approach has the advantages of broad-basing monetary policy operations on a large set of information and providing flexibility in the conduct of monetary management. The Reserve Bank has been using both direct and

BOX 3.2

Monetary and Credit Policy Measures : 1999-2000

A. April-September, 1999

- CRR reduced from 10.5% to 10.0% w.e.f. May 8, 1999; lendable resources of banks increased by Rs. 3250 crore.
- Interim Liquidity Adjustment Facility (ILAF) through repos and lending against collateral of Government of India Securities has replaced the general refinance facility w.e.f. April 21, 1999.
- UTI, LIC, IDBI and other non-bank participants allowed to access money market for short term liquidity through repos so as to enable them to exit money market in a planned/gradual way.
- MMMFs allowed to offer "Cheque writing facility" to investors.
- Guidelines for interest rate swaps and forward rate agreements issued.
- Operational guidelines issued to SCBs and AIFIs for financing of infrastructure projects
- Banks allowed to operate different PLRs for different maturities.
- Banks allowed to offer fixed rate for all term loans in conformity with ALM guidelines.
- Wherever the deposit rate is in excess of PLR, advances to depositors against fixed deposits by banks allowed without reference to PLR ceiling.
- Board of Directors allowed to delegate necessary powers to ALM Committee for fixing interest rates on deposits and advances, subject to reporting to the Board immediately thereafter.
- With effect from the year ending March 31, 2000, banks advised to classify a minimum of 75% of their securities as current investments.
- Bank's/FI's investment in Tier-II Bonds issued by other banks, subjected to a ceiling of 10% of bank's/FI's total capital.
- Board of Directors allowed to prescribe detailed rules for determining the date of commencement of commercial production.

B. Mid-Term Review

- CRR reduced from 10% to 9% in two installments of half-a-percentage point each with effect from November 6 and November 20, 1999 respectively increasing lendable resources by Rs. 7000 crore; a lag of two weeks in the maintenance of stipulated CRR by banks introduced.
- The minimum maturity of FCNR(B) deposits raised from six months to one year.
- Incremental CRR of 10% on increase in liabilities under FCNR(B) Scheme (over the level as on April 11, 1997) withdrawn w.e.f November 6, 1999 increasing lendable resources by Rs.1061 crore.
- Interest rate surcharge of 30% on import finance withdrawn.
- The minimum rate of 20% interest on overdue export bills withdrawn; banks allowed to decide appropriate rate of interest on overdue export bills.
- Permission granted to non-bank entities to lend in the call/notice money market by routing their operation through PDs extended up to June, 2000.
- MMMFs brought within the purview of SEBI Regulations; banks and FIs required to seek clearance from RBI for setting up MMMFs; MMMFs to be set up as separate entities in the form of Trusts only.

indirect instruments in the conduct of monetary policy, though the reliance on the former has been gradually brought down with a growing importance of the Bank Rate, repo rate and open market operations in recent years.

High Monetary Growth *vis-à-vis* low inflation

3.15 The inadequacy of exclusive reliance on broad money growth is also reflected in the coexistence of high monetary growth and low inflation. A number of factors explain this phenomenon. First, preliminary empirical evidence in the Indian context indicates considerable lag in the transmission of monetary policy. Secondly, the recent episode of low inflation appears to be a new phenomenon because the average decadal inflation rate in India moved in a narrow range from 8.0 percent to 9.0 percent during 1970-71 to 1998-99. Thirdly, the intra-year movement in inflation rate during 1998-99 involved two distinct phases: (a) seasonal price rise during April to September,1998, largely contributed by the price rise in primary articles accounting for nearly one-third of the total weight of WPI, and (b) a gradual fall since October, 1998. Greater competition from imports and sharp decline in world manufacturing prices have also contributed to low inflation.

Interest Rates

3.16 Keeping in view the overall improvement in market conditions, RBI announced in March

BOX 3.3

Interim Liquidity Adjustment Facility (ILAF)

In line with the recommendation of Narasimham Committee (II) to provide RBI support to market through liquidity adjustment facility involving periodic/daily resetting of Repo and Reverse Repo Rates, RBI introduced ILAF with effect from April 21, 1999 in place of the General Refinance Facility. Pending the upgradation of technology and legal/procedural changes required to switch over to a system of electronic transfer and settlement, ILAF through repos and lending against collateral of Government of India securities would serve as an interim arrangement towards the transition to a full-fledged liquidity adjustment facility. This facility enables RBI to inject liquidity into the market at various interest rates, and absorb it, whenever necessary, at the fixed repo rate so as to promote stability in money market interest rates. The fortnightly average utilisation under ILAF, including export credit refinance, ranged between Rs. 4119 crore and Rs.8,476 crore during April-December 3,1999. The Primary Dealers (PDs) availed the liquidity facility within their overall limits., and their daily outstanding ranged between Rs. 86 crore and Rs. 8025 crore during the same period. In practice, ILAF is operated through a combination of repo, collateralised lending, OMO and export credit refinance. The main features of ILAF are:—

- Collateralised lending facility (CLF) upto 0.25 percent of the fortnightly average outstanding aggregate deposits in 1997-98.
- CLF available for two weeks at the Bank Rate.
- Additional collateralised lending facility (ACLF) for an equivalent amount of CLF available at Bank Rate plus 2 percentage points.
- CLF and ACLF for beyond two weeks subject to an additional rate of 2 percent.
- Cooling period of two weeks after CLF/ACLF at penal rate (since dispensed with based on feedback from market participants).
- To facilitate systematic adjustment in liquidity, restriction on participation in money market (during the period of availing liquidity) withdrawn.
- Scheduled commercial banks eligible for export credit refinance facility at the Bank Rate with effect from April 1, 1999.
- Liquidity support against the collateral of Government securities, based on bidding commitment and other parameters available to PDs at Bank Rate for a period of 90 days.
- Additional liquidity support against Government securities to PDs for two weeks at the Bank Rate plus 2 percentage points.
- Absorption of liquidity in the market would continue to be in the form of fixed rate repos.
- The above mentioned facilities to be supplemented by OMOs by the RBI.

1999 a package of measures aimed at lowering interest rates in the economy against the backdrop of an enabling environment created by the Union Budget for 1999-2000.The RBI package consisted of reduction in Bank Rate by one percentage point from 9 percent to 8 percent, reduction in the fixed rate repo from 8 percent to 6 percent, and CRR reduction from 11 percent to 10.5 percent. These measures in turn led to a sharp decline in the cut-off yields on 14-day, 91-day and 364-day Treasury Bills. Interest rates in the credit market reflected the trends in the government securities and money markets. The credit market rates moved in line with the funds position, which was generally easy owing to sluggish growth in demand for credit. As regards the short end of the market, repo rate and the Bank Rate are now perceived by the markets as signals for movements in interest rates, particularly the call money rates. The ILAF has also helped in keeping the money market interest rates range-bound. The significant improvement in liquidity conditions during the current financial year has averted upward pressure on interest rates. The trends in interest rates may be seen from Table 3.4.

TABLE 3.4

Interest Rate Trends

(Per cent per annum)

Interest Rate	As on 22-1-99	3-4-99	21-1-2000
1. Bank Rate	9.00	8.00	8.00
2. MTLR	14.00	13.50	13.50
3. PLR	12.75-13.00	12.00 - 12.50	12.00 - 12.50
4. Deposit Rate	9.00-11.50	8.00 - 10.50	8.00 - 10.50
5. Call Money (low/high)	8.50 - 35.00	7.75 - 8.60	7.90 - 8.50
6. CDs	8.50-17.50[1]	8.00 - 12.50[2]	8.50 - 11.00[4]
7. CPs	9.80-13.00[1]	9.10 - 13.25[3]	9.05 - 11.65[5]

MTLR : Medium Term Lending Rate (IDBI's rate)
PLR : Prime Lending Rate (5 major public sector banks)
1. As on 15-1-1999 2. As on 26-3-1999 3. As on 31-3-1999
4. As on 17-12-1999 5. As on 15-1-2000