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Mid-term Review of Monetary and Credit Policy : 2002-03

Dr. Bimal Jalan, Governor, in a meeting with the Chief Executives of major commercial banks presented the Mid-term Review of Monetary and Credit Policy for 2002-03. The Statement covered a review of macroeconomic and monetary developments and a series of measures for developing technological and institutional infrastructure of the financial sector and for improving the credit delivery system.

Reviewing GDP growth for 2002-03, the Governor said that while the Central Statistical Organisation's estimate for the first quarter of the current year is in line with the projected rate of growth of 6.0 to 6.5 per cent for the year as a whole, the rate of growth in GDP will be lower in view of the poor rainfall in some parts of the country. With indications of recovery in industrial production, substantially higher growth in infrastructure industries and impressive export performance, the Governor said that the overall GDP growth for the year 2002-03 is likely to be 5.0 to 5.5 per cent as against the earlier projection of 6.0 to 6.5 per cent. There has been an improvement in the growth of non-food bank credit this year reflecting better outlook for industrial growth. Food credit, however, declined on account of lower procurement and higher off-take of foodgrains.

The Governor mentioned that the annual inflation, on a point-to-point basis, was 2.8 per cent on October 12, 2002 as against 3.0 per cent a year ago. While the deficiency in rainfall caused pressure on the prices of many agricultural commodities, the domestic inflation outlook still looks comfortable and the inflation rate is likely to be around 4.0 per cent, which is in line with the expectations in the annual policy Statement of 2002-03**.**

Highlighting the developments in the world economy, the Governor said that the prospects for recovery in the world economy, now appears to be somewhat slower than that anticipated earlier. However, in terms of relative performance, India and China are anticipated to perform better than the global trend.

The Governor further indicated that India's foreign exchange reserves have increased sharply from US $ 45.2 billion as on October 26, 2001 to US $ 64.0 billion by October 25, 2002, an increase of US $ 18.8 billion.

The Governor stated that the monetary policy stance for 2002-03 announced in the policy Statement of April 2002 would continue for the remaining half of the year. Referring to interest rate flexibility, the Governor said that banks were urged to devise schemes for encouraging depositors to convert their existing long-term fixed rate past deposits into variable rate deposits. It is expected that such efforts would, over time, enable banks to reduce to some extent, the downward inflexibility in the interest rate structure.

HIGHLIGHTS

- RBI pegs GDP growth at 5.0 to 5.5 per cent despite drought conditions.
- Bank Rate reduced by 0.25 percentage point.
- CRR reduced by 0.25 percentage point.
- Substantial increase in flow of bank credit to industries. Upturn in industrial production and buoyancy in exports to sustain growth
- Money supply (M3) contained within the projected trajectory of 14 per cent.
- Decline in reserve money despite large increase in foreign exchange reserves and significant primary support to government borrowing programme.
- Bulk of the government borrowing programme completed at lower interest cost and with longer maturity.
- Inflation to remain benign around 4 per cent despite drought and pressures on oil prices.
- Sharp reduction in interest rates on various types of government and corporate papers.
- Reduction in effective lending rates of banks.
- Reserves build up at a low effective cost without adding to external debt. The increase in reserves reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows.
- RBI to continue the monetary policy stance for 2002-03 announced in April 2002 for the remaining half of the year.
- Monetary and prudential measures towards flexibility.

Monetary Measures

(a) Bank Rate : The bank rate has been reduced by 0.25 percentage point from 6.50 per cent with effect from the close of business of October 29, 2002. Commenting on the bank rate reduction, the Governor stated that under the circumstances, as the present level of the bank rate as well as call money and other money market rates were quite comfortable and there was a sizeable gap between these rates and the average lending rates of banks, no useful purpose would be served by a further reduction in the bank rate in the near future. Unless circumstances change, the policy bias in regard to the bank rate is to keep it stable at the present level at least until the end of the financial year.

(b) Repo Rate : The repo rate under the liquidity adjustment facility (LAF) of the Reserve Bank to be made available from October 30, 2002, has been reduced by 0.25 percentage point. Subsequently, the auction method for repos will continue as previously. The Governor clarified that while repo auctions are conducted without any preannounced rate and bids are accepted on the basis of uniform price method, the Reserve Bank has retained the option to switch over to fixed rate repos on overnight basis. The Reserve Bank would continue to use this flexibility of switching over between the options so as to make efficient use of the LAF system in the daily liquidity management.

(c) Cash Reserve Ratio : As a further step in moving towards the statutory level of cash reserve ratio (CRR) of 3.0 per cent, the Governor proposed :

- To reduce CRR from 5.0 per cent to 4.75 per cent from the fortnight beginning

November 16, 2002. (With this, CRR has been reduced by as much as 3.75 percentage points over the past two years).

- To raise the minimum daily maintenance of CRR of banks to 80 per cent of required amount with effect from the fortnight beginning November 16, 2002. The minimum level of 80 per cent would be applicable for all the days in a reporting fortnight.

(d) *Interest on Cash Balances Maintained with RBI under CRR* : The Reserve Bank would pay interest on eligible CRR balances on a monthly basis from April 2003. In order to facilitate this, banks have been urged to put in place proper technology including adoption of the software package which will help them to transmit Form A data directly to the Reserve Bank.

(e) *SLR of RRBs :*

- Statutory liquidity ratio (SLR) holdings of regional rural banks (RRBs) in the form of deposits with sponsor banks maturing beyond March 31, 2003 may be retained till maturity. These deposits may be converted into government securities, on maturity, in case the concerned RRBs have not achieved the 25 per cent minimum level of SLR in government securities by that time.
- Although deposits with sponsor banks contracted before April 30, 2002 would be reckoned for SLR purpose till maturity, RRBs are advised to achieve the target of maintaining 25 per cent SLR in government securities out of the maturity proceeds of such deposits with sponsor banks as well as from their incremental public deposits at the earliest.

Interest Rate Policy

(a) *Interest Rate Flexibility : The* Governor said that the recent monetary policy Statements have been drawing attention to factors causing rigidities in the structure of interest rates, particularly in the lending rates of commercial banks. There has been some improvement with regard to non-performing assets (NPAs), operating expenses and cost of funds of commercial banks. In order to further improve flexibility, banks have been given freedom to decide the period of reset on variable rate deposits.

(b) *Prime Lending Rate and Spread :* The Governor explained that in the current environment of low inflation, unreasonably wide spreads could adversely affect the overall credit portfolio of banks. Furthermore, very wide spreads provide opportunities for nontransparency. In order to ensure appropriate pricing of loans, banks are encouraged to review both their prime lending rates (PLRs) and spreads and align spreads within reasonable limits around PLR subject to approval of their Boards.

(c) *Interest Rates on Deposits by Co-op Banks/RRBs/LABs :* The Governor indicated that interest rates on deposits have been deregulated except deposits in savings bank accounts, which is currently prescribed by the Reserve Bank. However, discretion was given to regional rural banks (RRBs)/local area banks (LABs) and co-operative banks (urban/central/state) to pay additional interest. In order to remove these anomalies, the Governor has suggested :

- Sponsor banks may not pay interest on the current accounts maintained by RRBs with them.
- Co-operative banks may not pay interest on current accounts.
- RRBs/LABs and co-operative banks may not pay any additional interest on the savings bank accounts over and above what is payable by commercial banks.

(d) Interest Rates on Export Credit : With a view to encouraging competition among banks and also to increase flow of credit to export sector, the Governor proposed to liberalise interest rates on rupee export credit in two phases. Accordingly, in the first phase, it is proposed that :

- The ceiling rate of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days would be deregulated with effect from May 1, 2003. Banks would have freedom to charge PLR or sub-PLR rates subject to their Boards's approval.
- In the second phase, with effect from a date to be announced later, it would be considered whether the ceiling rates on pre-shipment credit up to 180 days and post-shipment credit up to 90 days should also be discontinued to encourage greater competition in the interest of exports.

(e) Flexibility in the Repayment of Export Credit : Repayment/ prepayment of pre-shipment credit would henceforth be permitted subject to mutual agreement between the exporter and the banker. For this purpose, balances held in the exporter's exchange earners' foreign currency (EEFC) account can also be used.

(f) Interest Rate on FCNR (B) Deposits : The Governor stated that banks are free to decide foreign currency non-resident (banks) [FCNR(B)] deposit rates denominated in Japanese Yen which may be equal to or less than LIBOR/SWAP rates of corresponding maturities till further notice. Interest rate ceiling on FCNR (B) deposits denominated in other currencies would remain unchanged at the prevailing level of LIBOR/SWAP rates of corresponding maturities minus 25 basis points.

Money Market

The Governor indicated that a number of structural measures had been initiated to ensure balanced development of various segments of the money market as also to preserve integrity and transparency. While implementing these measures, it is desirable to take cognisance of the progress of developments made in other markets/payments system infrastructure, e.g., the repo market, operationalisation of negotiated dealing system (NDS)/Clearing Corporation of India Limited (CCIL), etc. In this context, the Governor announced additional measures as follows :

(a) Rationalisation of Standing Facilities : With the emergence of LAF as the primary instrument for modulating systemic liquidity on a day to day basis, the usage of export credit refinance (ECR) facility has gone down substantially in the recent period. With a view to furthering the process of phasing out sector-specific standing facility in an environment of low CRR, the Governor stated that apportionment of normal and back-stop facilities which is presently in the ratio of two-thirds to one-third (67:33) would be changed to one-half (50:50)

each from the fortnight beginning November 16, 2002.

(b) Certificates of Deposit : With a view to providing more flexibility for pricing of certificates of deposit (CDs) and giving additional choice to both investors and issuers, banks and financial institutions (FIs) have been permitted to issue CDs on floating rate basis provided the methodology of computing the floating rate is objective, transparent and market-based.

(c) OTC Rupee Derivatives : In order to enlarge the menu for managing interest rate risks for banks and other financial intermediaries as well as corporates in the rupee derivatives market, the Governor proposed to set up a Working Group with appropriate representations from the market to look into, *inter alia*, the possible ways of extending types of derivatives that are available in the foreign currency segment to rupee derivatives. The Group will also review the guidelines for OTC rupee derivatives in India and suggest further developments in this market.

Government Securities Market

The Governor said that in an effort to provide further transparency and stability in the government securities market, a number of measures have been put in place by the Reserve Bank during 2002-03 so far. These measures, *inter alia,* include an announcement of a half-yearly calendar for Government of India dated securities, holding of government securities by both wholesale and retail investors in dematerialised form, arranging NDS data almost on real-time basis on the Reserve Bank website for market participants, etc. The Reserve Bank has also been making sustained efforts to increase the investor base of government securities market by encouraging retailing of government securities and making CSGL account holders eligible for the repo market. It is also attempting to impart greater flexibility to both issuers and investors of government securities through introducing STRIPS, floating rate bonds and bonds with call/put option. In this direction, the Governor announced further initiatives as under -

(a) Trading in Stock Exchanges : In order to enlarge the number of participants and to provide countrywide access to government securities, it is proposed to introduce anonymous screen based order driven trading in government securities on the stock exchanges.

(b) Extension of Repo to CSGL Account Holders : Repo eligibility has been extended to select category of non-SGL account holders with adequate safeguards to ensure 'delivery versus payment' and transparency.

(c) Uniform Accounting of Repo/Reverse Repo Transactions : As banks are not following an uniform accounting system for repo/ reverse repo transactions, draft guidelines on 'Uniform Accounting Norm for Repo Transactions' on the lines suggested by a Sub-Group of TAC have been circulated to banks and FIMMDA for their comments.

(d) Development of the Repo Market : In order to facilitate phasing out of non-bank participants from call/notice money market as also to impart more flexibility to the repos market, the Governor proposed to permit rollover of repos using the same securities between the same counterparties.

(e) Collateralised Borrowing and Lending Obligation : The Reserve Bank has been promoting collateralised lending/borrowing operations by market participants so that their reliance on call/notice money market may be reduced. In this direction, Collateralised Borrowing and Lending Obligation (CBLO), a product developed by CCIL for its members was considered. Accordingly, CBLO would be considered as a money market instrument with original maturity between one day and upto one year. There will be no restrictions on the minimum denomination as well as lock-in period for its secondary market transactions. The regulatory provisions for CBLO will be the same as applicable to other money market instruments. Since CBLO is fully collateralised by government securities, the risk weight as applicable to government securities for market risk will be applicable to CBLO. Detailed operating instructions in this regard would be issued by the Reserve Bank separately.

(f) NDS Data on website : The Governor announced that with the operationalisation of NDS, price and trade information on government securities and related data reported on NDS is now available on the Reserve Bank's website on real time basis.

Credit Delivery Mechanism

(a) Priority Sector Lending

In order to improve credit delivery to the priority sector, the Governor proposed :

Agriculture : Increase in the limit of advances granted to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, located in rural/semi-urban areas from Rs.10 lakh to Rs. 20 lakh under priority sector lending for agriculture.

Small Businees : Increase in credit limit sanctioned to small business from Rs.10 lakh to Rs.20 lakh without any ceiling for working capital. Banks would be free to fix individual limits for working capital depending upon the requirements of different activities.

Weaker Sections : Increase in the individual credit limit to artisans, village and cottage industries from Rs.25,000 to Rs.50, 000. The limits would be under the overall limit of 25 per cent advances to weaker sections under priority sector or 10 per cent of net bank credit.

Housing Loans : Increase in the limit of housing loans for repairing damaged houses from Rs.50,000 to Rs.1 lakh in rural and semi-urban areas and to Rs.2 lakh in urban areas.

(b) Micro Finance

Unsecured advances given by banks to self-help groups (SHGs) against group guarantees would be excluded for the purpose of computation of prudential norms on unsecured guarantees and advances until further notice. The matter would be reviewed after a year in the light of growth in aggregate unsecured advances and the recovery performance of advances to SHGs.

Urban Co-operative Banks

The Governor mentioned that the Reserve Bank had again drawn attention to the present system of dual/triple regulatory and supervisory control (involving centre, states and the Reserve Bank) and stated that it is not conducive to efficient functioning of cooperative banks in the interest of their depositors. A Committee under the Chairmanship of Hon. Minister of State for Finance, examined the issue and agreed that duality of control should be done away with and recommended that the Reserve Bank should be vested with full powers for regulation and supervision of UCBs.

Supervision and Monitoring

(a) *Risk Based Supervision :* The Governor stressed that the Reserve Bank would switch over to risk based supervision of banks by 2003 and accordingly certain change management processes were initiated by the Project Implementation Group formed for the purpose.

(b) *Consolidated Accounting and Supervision :* The Governor mentioned that in order to provide enabling provisions to facilitate consolidated accounting and quantitative methods under Indian conditions, a working arrangement with other regulators, viz., Securities and Exchange Board of India and Insurance Regulatory and Development Authority for sharing of information by way of Memorandum of Understanding is being explored.

Prudential Measures

(a) *Adoption of 90 days Norm for Recognition of Loan Impairment by SCBs /DCCBs :* With a view to moving towards international best practices and to ensure greater transparency, commercial banks were advised to adopt 90 days norm for recognition of loan impairment from the year ending March 31, 2004. In order to have a consistent and uniform approach towards all segments of the banking system, the 90 days norm has been extended to state cooperative banks (SCBs) and district central co-operative banks and (DCCBs) from the year ending March 31, 2006. To facilitate smooth transition, banks are advised to move over to charging interest on monthly rests from April 1, 2004.

(b) *New Capital Accord :* The Governor mentioned that the Reserve Bank is continuing its efforts towards obtaining international agreement on the proposals on the New Capital Accord so that in its final version due next year, it would provide sufficient flexibility for national regulation to take into account the differences in institutional framework and capacity in different countries, including developing countries.

(c) *Banks' Entry into Insurance Business :* The Governor said that under the referral arrangement, banks provide physical infrastructure within their select branch premises to insurance companies for selling their insurance products to the banks' customers with adequate disclosure and transparency, and in turn earn referral fees on the basis of premia collected. Accordingly, a few banks have been permitted to enter into referral arrangements with insurance companies subject to certain conditions to protect the interests of their customers.

(d) *Technical Committee on Market Integrity* : The Governor mentioned that the Report of an internal Technical Group which assessed India's position vis-à-vis international standards on

‘market integrity’ has been placed on the Reserve Bank’s website for wider dissemination.

(e) Guidelines on ‘Know Your Customer’ Norms and Cash Transactions : Banks have been advised to put in place a sound ‘Know Your Customer’ policy, adopt anti-money laundering measures comprising systems and procedures for customer identification while opening accounts, institute internal control and audit mechanism, and lay down risk management and monitoring procedures.

(f) Offshore Banking Units in SEZs : The Reserve Bank has formulated a scheme of off-shore banking units in special economic zones (SEZs) as branches of banks operating in India and has obtained the approval of the Government.

(g) Non-SLR Investments by Banks and FIs : Draft prudential guidelines on management of non-SLR investment portfolio have been referred to the RBI-SEBI Technical Committee to take a view on disclosure and regulation of private placement.

(h) Country Risk Management : The Governor said that draft guidelines on country risk management together with a ‘Note for Discussion’ were forwarded to banks and were also placed on the Reserve Bank’s website seeking comments/views thereon.

(i) Investment Fluctuation Reserve : The Governor recalled that with a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future, banks were advised to build up Investment Fluctuation Reserve (IFR). As per the extant guidelines, banks are required to build up IFR of a minimum 5 per cent within a period of 5 years.

FOREX

Further Liberalisation of Forex Facilities

Resident Foreign Currency (Domestic) Account

As a step towards further liberalisation, it has been decided to allow a person resident in India to open, hold and maintain with an authorised dealer in India a foreign currency account. This account will be known as Resident Foreign Currency (RFC) [Domestic] Account and foreign exchange in the form of currency notes, bank notes and travellers cheques can be kept in this account by residents provided it has been acquired :

(a) while on a visit to any place outside India by way of payment for services not arising from any business in or anything done in India; or
(b) from any person not resident in India and who is on a visit to India, as honorarium or gift or for services rendered or in settlement of any lawful obligation; or
(c) by way of honorarium or gift while on a visit to any place outside India; or
(d) from an authorised person for travel abroad and represents unspent amount.

The account will be maintained in the form of current account with cheque facility and shall not bear any interest. There will be no overall limit on balances held in the account. The balance in the RFC (Domestic) Account may be used for any purpose under current foreign exchange regulations for resident Indians (e.g. travel, medical treatment abroad, gifts up to US$ 5,000, purchase of books directly or through the internet, education abroad, etc.).

Till now residents were required to surrender foreign exchange exceeding US$ 2,000 and convert it to Rupees. With the introduction of this facility, residents can either deposit foreign exchange acquired as indicated above in the RFC (Domestic) Account designated in any foreign currency or at their discretion, deposit in a Rupee account after conversion. The new facility is in addition to the existing facility of retaining US$ 2000 or its equivalent in the form of currency notes and/or travellers cheques.

Pending publication of the notification by the Government of India, requests received by authorised dealers for opening of RFC (domestic) accounts may be forwarded with recommendations to the concerned Regional Office of the Reserve Bank. While opening these accounts authorised dealers should, however, follow the same procedures, including 'Know Your Customer' guidelines as applicable for opening any other domestic account.

Forex Limit for Private Visits Abroad Enhanced

As a measure of further liberalisation, the limit of foreign exchange available to residents in one calendar year for one or more private visits abroad (except Nepal and Bhutan) has been enhanced from US$ 5,000 to US$ 10,000 or its equivalent. Applications, for release of foreign exchange exceeding US$ 10,000, however, require the prior permission of the Reserve Bank.

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