Monetary and Credit Policy Continuity, Context, Change and Challenges Address by Dr.Y.V.Reddy, Deputy Governor, at Reserve Bank of India, Chennai, on May 2, 1998

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Monetary and credit policy has, recently been attracting serious public attention and interest. The media, the intellectuals, the business community and in fact, people in almost all walks of life in India have been showing interest in understanding the policy and its implications and the manner in which it affects them. There is also a close observation of the stance of policy by international financial community, especially, investors and non-resident Indians. What explains this interest?

First, as a result of the reform process, the extent of supply of money and credit, the cost and conditions at which the amounts are available are increasingly being determined by market forces, which respond to the policies of the Reserve Bank of India (RBI). This is equally applicable to the availability of credit to Government as well, in view of the termination of the system of ad hoc Treasury Bills since the end of 1996-97.

Second, all over the world, central banks' policies have gained in influence and the Reserve Bank of India's policies are no exception to the global trend.

Third, in our country also, there has been a growing national awareness about the need to accord autonomy to monetary policy-making authorities.

Fourth, the Reserve Bank has recently demonstrated that, while conforming to national priorities, the actual and detailed conduct of monetary policy would remain, by and large insulated from temporary domestic uncertainties.

Finally, the opinion makers in India and abroad look to RBI as a credible entity which could be relied upon for a meaningful and authentic analysis of the state of the economy, and for helping decision-making process of economic agents.

Incidentally, since this (i.e., Monetary and Credit Policy for first half of 1998-99) is the first policy of RBI Governor Dr. Jalan, there has been more than ordinary interest in the policy.

In view of the emerging interest, it is necessary to explain in detail some aspects of the latest monetary policy, specifically the backdrop, the identifiable tasks, the elements of continuity, contextual response, and change. This will be supplemented with some clarification on "perceived gaps" in the policy and I will conclude this presentation with the possible challenges before the RBI, banking industry and the corporate sector.

Backdrop

The backdrop to the latest monetary and credit policy has been described in a comprehensive and analytical manner in the Governor's statement of the policy. To recall, the major developments in 1997-98 were:

First, growth in GDP was 5.0 per cent as against the projected rate of 6.0 per cent in October 1997, and the actual of 7.5 per cent in the preceding year.

Second, inflation was contained at 5.0 per cent as against the projection of 6.0 per cent, and 6.9 per cent in 1996-97

Third, there was higher than projected growth of money supply (M3) in relation to growth in GDP, being 17.0 per cent (projected: 15.0 - 15.5 per cent), as against 16.0 per cent in the previous year.

Fourth, contrary to popular impressions, there was substantial increase in financial flows from the banking system to corporate sector despite slowdown in industrial growth. The total flow of funds from the banking system grew by 17.6 per cent (i.e., Rs.51,353 crore) in 1997-98 as against only 12.2 per cent (i.e. Rs.31,566 crore) in 1996-97.

Fifth, the market borrowing programme of the Union Government was higher in 1997-98 compared to the budgeted amount. The Reserve Bank's support to Central Government in net terms amounted to Rs.12,914 crore.

Sixth, there was unanticipated uncertainties in foreign currency markets, and RBI had to actively intervene to reduce volatility and maintain orderly conditions in forex markets. The process had its impact on money markets and interest rates. This is reflected in the fact that nominal interest rates which had generally indicated a southward tilt during the major part of the year were subjected to interruption.

Finally, the export growth was low, consistent with world trends (being 2.6 per cent in the first eleven months of 1997-98) in US dollar terms. This is well below our performance in the recent past and our expectations.

Tasks

Against this backdrop, what could the Monetary and Credit Policy do during the year 1998-99? What are the short-term economic considerations evolving the policy for the current year?

a. Acceleration in industrial investment and output. GDP growth rate for 1998-99 could go up to 6.5 -7.0 per cent from the last year's estimated 5 per cent consistent with the potential rate of 7 to 8 per cent.
b. Maintenance of inflation rate in the range of 5 to 6 per cent so as not to alter inflationary expectations.
c. Reduction in interest rates.
d. Improvement in credit delivery mechanisms, particularly for agriculture and for medium and small sectors.
e. Laying the foundations for what may be called second generation reforms in the financial sector.

The stance of policy will have to take into account possible fiscal stance which will be unfolded in the regular Budget and its influence on liquidity management, and respond to international developments and the continuing uncertainties in this regard.

Design of the Measures

In designing the measures to perform these tasks, we have to be conscious of the need to maintain some continuity for reasons of policy credibility.

Secondly, the measures should meet the immediate tasks, largely dictated by the backdrop of previous year's economic conditions or anticipated developments during the current year. That constitutes contextual response which we will address separately a little later.

Thirdly, foundations have to be laid to improve the financial sector so as to enhance its efficiency in meeting the national aspirations of moving on to a higher growth trajectory with stability and social justice.

Fourthly, the capacity of the system, especially the institutional structures to respond to the challenges that could be thrown up by the proposed measures has to be reckoned.

Continuity

Let me start with a narration of the significant elements of continuity.

1. The basic twin objectives of monetary policy remains, the same, i.e., to achieve price stability and to ensure flow of adequate credit to the productive sectors of the economy. The relative emphasis on one or the other would, however, depend on the prevailing conditions.
2. Monetary targeting is continued, as money demand functions have remained, by and large, fairly stable in our country. However, with financial innovations, the dominance of the effect of income on demand for money could undergo a change in future and it would, therefore, be necessary to give attention to other variables.
3. Operating procedures of monetary policy have not been altered. Reserve requirements exist and refinance is still being made available. The long-term goal for cash reserve ratio (CRR) is to reach 3 per cent, but in the short-term, it will continue to be used flexibily as a monetary policy tool. Interest rate signals are operated through the Bank Rate changes. Repos/Reverse Repos will continue to be used to manage liquidity, influencing in the process market interest rates. In brief, the broad range of instruments will be the same, though there would, as always, be refinements in their use. The relative emphasis or actual recourse to each instrument will, no doubt, change during the year to reflect structural changes taking place in the economy and prevailing circumstances.

It will be useful, to briefly recall, the measures that clearly signify continuity in the reform process. The widening, deepening and integrating of different segments of the financial markets, is being continued. Thus, it is recognised that development of money market continues to be important to the RBI since the transmission channels of liquidity and interest rate effects of monetary policy are felt with limited lags. Call money market in particular is crucial, but the level playing field is absent despite a large number of participants. It would probably be necessary to make the call money market a pure inter-bank money market since we cannot afford systemic risks, but in the short-term, the market needs to have greater flexibility. Therefore, easier norms have been announced for routing of funds through PDs for lending. This would further help corporates with large balances to deploy their funds in short-term and get some return. Since the minimum period of deposits has been reduced to 15 days, the minimum lock in period was also reduced for CDs and units of MMMFs to 15 days. This is also intended to help holders of surplus funds for short periods to obtain some return, even though it could erode the float available to banks at present.

Government Securities Market is yet another important segment of the financial market. It is well recognised that a zero-risk yield curve which is credible and transparent is of crucial importance for efficient functioning of financial markets. We have already introduced Treasury Bills with varying maturities while rationalising the auction system, and allowed FIIs to invest in Government Dated Securities within limits. As a continuation of these efforts, we are reintroducing 182-Day Treasury Bills, so that there is a wide range of options, viz., 14-Day, 28-Day, 91-Day, 182-Day and 364-Day Treasury Bills. This should help the development of short-term yield curve. Further, FIIs are now being allowed to invest, within the approved limits, in Treasury Bills for the reasons mentioned in the latest monetary policy. We also proposed some changes in the system of liquidity support to PDs to give them operational freedom and assist them to operate smoothly in the secondary markets. Prior to this development, PDs had to earmark securities for repo transactions. Now, they merely need to ensure prescribed minimum value of securities with RBI as collateral.

The process of deregulation of interest rates has been given a significant thrust in the current policy, which should add to the convenience of customers, infuse more competition and enhance efficiency. Thus, to provide banks with greater flexibility for their asset liability management and avenues of deployment of short-term funds, the minimum period of term deposit has been reduced to 15 days. The penalty structure for premature withdrawal, which can, as per the current policy, be decided by banks, will give greater maneuverability for banks in their ALM. In response to requests from bankers who felt that cost of transaction differs by size, banks are now permitted to prescribe varying rates of interest for different sizes of deposits. Finally, lending rates on loans up to Rs. 2 lakh have been partially deregulated bringing the position closer to the system prevalent in cooperative banks and RRBs, where these interest rates stand totally deregulated. The increase in ceiling for lending against shares and the increase in the minimum level up to which investments have to be marked to market are further steps in the direction already indicated in earlier policies.

All these measures reflect steadfastness in our approach towards reform process which is gradual and well orchestrated, and a movement towards an accepted direction to achieve well-defined goals.

Contextual

In a dynamic world, movement towards goals needs to take into account the prevailing circumstances. Let me illustrate this point. The current monetary policy had to respond to domestic and international developments. In the domestic arena, the major challenge was to ensure flow of adequate credit to finance productive activities and at the same time preserve the hard-won gains in regard to inflationary expectations. Gaining confidence with regard to maintenance of price stability takes years but it can be lost by events in a single year. In the international arena, the implications of the recent East Asian crisis cannot be wished away. We took special measures in January 1998 to contain volatility in exchange markets, and now as orderly conditions in the market have been restored, there has arisen the need to unwind the measures.

As stated earlier, the primary task is to accelerate industrial investment and output, keeping inflation in the range of 5-6 per cent. It was felt that M3 growth of 15.0 - 15.5 per cent in 1998-99, consistent with GDP growth of 6.5 to 7 per cent, would be enough taking into consideration the comfortable/easy liquidity conditions at the beginning of 1998-99.

The market borrowing programme of Government indicated in the Interim Budget is high as admitted by the Finance Minister as well. RBI support to Government, therefore, needs to be contained so that there is some reduction in the monetised deficit of Government, as a proportion of GDP. Bank Rate has been brought down by one percentage point to act as a signal that near normal conditions have been restored in forex markets.

CRR is not changed now since there is ample liquidity. There is no point in releasing CRR at a time when huge volumes of banks' funds are in repos.

To signal a fillip to export sector which has been an area of concern, RBI cut pre-shipment rates and restored export refinance limits at the reduced rates so that banks have adequate funds at assured margins below prescribed lending rates for exports.

In response to the unprecedented situation arising out of the recent Asian crisis, a number of initiatives have been taken. Thus, the contextual response to this had to take the shape of changes or new initiatives.

Change

There are, broadly, four areas of change, viz., the strategy, the instruments, specific measures, and foundations for reform.

(i) Strategy

The strategy of monetary policy explicitly states the need to respond flexibly in a dynamic situation - a need that was felt and a strategy that had actually to be used in 1997-98. A more formal view has been taken of the changed circumstance and the need for flexibility. Thus, while specific measures will be announced as and when need arises to respond to evolving situation, the practice of bi-annual statements will continue. The Annual Policy at the beginning of financial year (April) will give greater importance to structural measures and announcement of short-term measures, if any, as part of the Annual Policy Statement will be only coincidental. The Policy Statement for the Second Half of year (October) will be confined to mid-year review. It will review monetary developments and suggest structural changes only if necessary and take up short-term measures, if they happen to coincide.

(ii) Instruments

As regards instruments, the present monetary policy has equipped itself with a range of short-term instruments with maturities ranging between 14 to 364 days. The RBI has also an option to conduct one-day repos and reverse repos in addition to the present 3-4 days repos. It has also strengthened its armoury to conduct repos on fixed rate basis or auction basis. The system of daily repos and reverse repos will ensure that liquidity in the system and the short-term interest rates are influenced more effectively by the deliberate policy of the RBI.

(iii) Specific Measures

In the foreign exchange market, for the first time, RBI has used differential ceilings for interest rates as a tool for encouraging long term FCNR B deposits and discouraging short-term deposits. This objective could have been achieved by imposing differential CRR for varying maturities of FCNR B deposits to signal our policy stance, but interest rate as a tool is a direct price based instrument, likely to be effective in differentiating deposits by maturity through an appropriate rate structure.

In order to avoid pressures on balance sheets of corporates, in the event of exchange rate volatility, and to obviate the consequent transmittal of exchange risk as a credit risk to banks, the policy advises banks to monitor unhedged positions of banks. This would help provide the required freedom to participants to take advantage of market developments, while alerting banks to exercise caution and prudence and to maintain well balanced exposures.

(iv) Second Generation Reforms

In terms of financial sector reforms, the need to consider the next phase of reforms has been recognised. In fact, this was the central theme of the Bank Economists' Conference held last year. A few issues that have clearly come up in recent times relate to credit delivery to agriculture and small industry, problems of weak banks, non-performing assets and the relative roles of banks and financial institutions.

The recommendations of the Working Group for Harmonising the Role and Operations of DFIs and Banks (Khan Committee), the Committee on Banking Sector Reforms (Narasimham Committee), the High Level Committee on Agricultural Credit Through Commercial Banks (Gupta Committee) and the High Level Committee to Improve Delivery System and Simplify Procedures for SSI (Kapur Committee) will all pave way for changes in the institutional structure of the financial system. The policy has indicated that while some recommendations can be accepted, on some fundamental issues involving structural changes, the RBI will prepare a discussion paper to enable wider debate. By flagging a discussion paper; the current policy has signified initiation of a consultative process. It is also useful to recognise that those measures suggested by the Committees which are within the purview of RBI and which could be implemented forthwith have already been taken up. For example, follow-up measures on lending to agriculture fall in this category. Similarly, Narasimham Committee's recommendations on greater freedom to banks on lending rates, reducing the minimum maturity for term deposits to 15 days, reducing the minimum lock-in period for Certificates of Deposit and units of Money Market Mutual Funds to 15 days; 100 per cent mark to market in three years and allowing foreign institutional investors' access to Treasury Bills have already found a place in this policy.

Perceived Gaps

While the policy has been favourably received by experts, and public in general, some observers perceived a few `gaps' in the policy. It will be useful to recognise the perceived gaps and analyse the implications. I will clarify why some of the measures were not implemented in the present policy.

First, the market expected a cut in CRR. As mentioned in the Policy, the long-term direction has to be to reduce the average CRR level. The main reason for not reducing the CRR at this stage is, as articulated in the policy, the comfortable liquidity position. It does not seem appropriate to release CRR when banks have been deploying large surplus funds in repos with the RBI. An announcement on a future schedule of CRR cuts could have given a sense of satisfaction to the markets, but, for reasons already explained, a deliberate view has been taken not to link the measures, which includes cut in CRR, to annual or mid-year announcements. There are good reasons for not committing to either a specified date for, or any particular magnitude of a reduction in CRR in the presence of domestic and international uncertainties. As clarified by Governor, subsequent to the policy announcement, appropriate reduction in the CRR would be made if needed.

Second, there were some expectations of roll back in General Refinance Limits (GRF) to the pre-January 1998 position. At the outset, it needs to be noted that the experience during 1997-98 has been that GRF has not been fully utilised by banks, reflecting easy liquidity conditions. On its part, the RBI would prefer to follow the CRR route rather than the refinance instrument to meet requirements for funds, because that would be in line with the policy to move to a lower CRR prescription. Further, as I have already mentioned, once the system of daily repos and reverse repos proposed to be introduced this year stabilises, there may be a need to review the continuation of GRF. Thus, there was no immediate compulsion to change GRF.

Third, there were also expectations of measures for the development of term money market. During the last year, a number of measures were introduced with a view to developing a term money market in India. Banks were exempted from maintaining CRR and SLR on inter-bank liabilities, subject to the maintenance of the statutory minimum of reserves on the net demand

and time liabilities. Even in this policy, the major measures that would help banks manage their resources more effectively and in the process assist the development of term money market relate to freedom given to banks to determine their own penalty structure on premature withdrawal of term deposits and the reduction of the minimum period of term deposits from 30 to 15 days. Moreover, as the CRR would over time move to the statutory minimum of 3 per cent, all liabilities including inter-bank liability of banks will be equal to it. It may also be desirable to make the inter-bank money market purely `inter-bank' in which case there will be level playing field among participants.

Fourth, there is a feeling in some quarters that the policy should have given a clear thrust for financing of infrastructure. For example, there have been representations for excluding infrastructure from the definition of net bank credit for purposes of priority sector advances. There are conflicting views on priority sector lending, ranging from total abolition, to elimination of sub-categories, on to increasing the share of priority sector advances or expanding the coverage in terms of sectors such as inclusion of infrastructure. A clear view needs to be taken about the effectiveness and scope of priority sector lending on which Narasimham Committee has made observations. Also, merely adding infrastructure to be eligible for priority sector within the existing ceiling may mean no additional flows, and if it does, it would be at the expense of agriculture or small industries, which is by itself not a desirable option. One has to explore whether there are other ways for RBI to encourage flows for infrastructure development without hurting financing of immediate productive activities. Prudential requirements would warrant RBI to recognise that in the banking system, liabilities are largely of short duration and financing of infrastructure would imply long-term assets which are relatively illiquid in the present state of financial markets. There are also issues of payment-risks in the absence of adequate cost recovery arrangements in utilities like Electricity Boards. The Infrastructure Development Finance Corporation which has been promoted by RBI along with Government only last year is in fact expected to play a leading role in financing infrastructure projects. To address these complex issues, Governor, RBI, has sponsored an Informal Group with chiefs of financial institutions and banks to address these issues. Naturally, RBI would respond with measures as and when circumstances warrant.

Fifth, some observers have felt that capital markets ought to have been encouraged in this policy. During 1997-98, the RBI kept banks' investments in debentures and bonds of PSUs and corporates outside the 5 per cent limit, which has been very productive. In this policy, banks have been allowed to lend to individuals increased amounts against shares in dematerialised form. The policy has had to reckon with conflicting objectives here. After the recent experience with the Asian crisis, central banks have become adverse to encouraging lending in asset markets where prices have a potential to be volatile. The utilisation of existing limits is a factor in deciding the need for and extent of enhancement in such ceilings. The preference for dematerialisation reflects both learning from experiences of several malpractices, and a deliberate policy choice to encourage dematerialisation. If circumstances warrant, and depending on utilisation, further enhancement of limits could be considered favourably subject to prudential regulations.

Sixth, a suggestion has been made that the RBI could have provided a framework for encouraging financing of mergers and funding of takeovers. The issues involved in mergers and acquisition, entails more detailed examination and an overall policy framework needs to be evolved. In particular, banks in our country, as compared to financial institutions, may not have comparative advantage in this area to take a lead. Finally, there is an underlying philosophy of encouraging directly productive use of bank credit or use of bank finance for asset creation, and as such financing for uses such as industrial restructuring are exceptions rather than the rule in our banking system. A broader view of end-use of funds has, therefore, to be taken if such funding were to be encouraged. These issues need further careful examination.

Challenges Before the RBI

The measures announced have, as usual, thrown a number of challenges before the RBI and let me mention a few important ones.

It is essential to develop the physical infrastructure, and arrangements for growth of institutional financial markets to enable the transmission channels of monetary policy to be more effective than at present. The gradual movement towards indirect instruments of monetary control requires that interest rate channels are more effective. Physical infrastructure to facilitate screen based trading, in consultation with Primary Dealers' Association, should be put in place soon. The RBI has to ensure early repeal of the 1969 notification for allowing short selling of securities and usher in a when-issued market for Primary Dealers. The introduction of one-day repos and reverse repos would imply that RBI would have a better institutional apparatus to gauge liquidity in the system on a contemporaneous basis. Forecasting of liquidity would become a prerequisite for effective repo operations. The quality of forecasting could be enhanced by the implementation of the recently concluded recommendations of the Internal Group of the RBI on Liquidity Analysis and Forecasting. At the same time, a view needs to be taken of the best measure of money supply. It is expected that the Working Group on Money Supply would complete its work soon. A credible zero-risk yield curve will need to be developed so that other securities can be correctly priced off this curve. The review of Treasury Bills to rationalise the short end of the market would need to be completed soon. Implementation of institutional reforms, of-course, would require legal changes. Liberalisation of markets also means that RBI should recognise the importance of changes in the regulatory and supervisory framework to ward off systemic threats. The RBI should be able to react flexibly to emerging domestic and international developments, as the Asian crisis has demonstrated. This would require constant monitoring of a number of macro variables.

Challenges Before the Banking System

The measures introduced in this policy have facilitated increased competition among banks, particularly, those related to reduction of minimum maturity of deposits to 15 days and reduction in lock-in period of CDs and units of MMMFs. These measures will have the effect of increased competition among banks for mobilising resources. It will be a challenge before banks to tackle the implications for deposit mobilisation arising from the reduction in the minimum maturity of term deposits from 30 to 15 days to the extent the float funds of banks will be reduced. The freedom given to banks to offer varying interest rates for deposits of varying sizes will give depositors greater mobility across banks. Each bank will have to be alert to the situation. Banks will have to be careful while fixing their penalty structures for premature withdrawal of deposits. The rates should be fixed judiciously by each bank, taking into account that they could adversely affect spreads and profitability of banks unless efficiency is improved. Appropriate mechanisms will have to be mounted to prevent loss of income. Proper ALM mechanisms would also need to be instituted.

Challenges Before Corporates

Some of the measures introduced in this policy pose a number of challenges as well as opportunities to corporates. For instance, the reduction in the minimum maturity of term deposits and lock-in period on money market instruments to 15 days and the more flexible norms for lending through Primary Dealers in the call money market will exhort corporates to tone up their treasury management. With the freedom given to banks to charge their own penalty structures for premature withdrawal, corporates will have to plan their resources more carefully. Finally, the inexorable integration of domestic and international markets has increased the potential for volatility in the foreign exchange markets. Corporates will have to evolve clear strategies for hedging their forex markets and convince their bankers that they have adequately hedged their forex exposures.

Let me conclude with a word of appreciation to the officers and staff of the RBI who worked with a spirit of devotion, in formulating the monetary and credit policy. I am thankful to the senior officers of RBI, Chennai, the RBI Staff Training College and Dr.P.L.Sanjeeva Reddy, Secretary to Government of India for giving me the benefit of this interaction. Finally, I thank Dr.A.Prasad, who assisted me in the design and draft of this address.