# Monetary and Credit Policy: Issues and Perspectives by Dr. Y.V.Reddy, Deputy Governor, Reserve Bank of India at Discussion Meeting organised by Indian Merchants' Chamber Economic Research and Training Foundation Mumbai on November 17, 1997

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**Issues and Perspectives**

Chairman and friends, it gives me great pleasure to be with you today for this discussion. Dr.Jhaveri, for whom I have high personal regard, has been insisting for quite some time that I address this forum. We agreed that this would be an appropriate occasion to share with you the thought process that went into the design of measures announced in the recent monetary and credit policy.

First, I will explain to you the backdrop under which the monetary policy measures were announced and illustrate how the tasks were defined and the measures seek to achieve the tasks, i.e., why we did what we did ? Incidentally, I would touch upon why we did not implement some measures or why some measures were introduced in a restrained manner, i.e., why not more ? Finally, a few important considerations relating to future reforms could be flagged, i.e., what next ?

**Backdrop**

As this audience is aware, monetary policy in India aims to achieve the twin objectives of maintaining reasonable price stability and ensuring availability of adequate bank credit to support the growth of the real sector. The relative emphasis in each policy depends upon the prevailing conditions.

The monetary and credit policy for the slack season, i.e. April policy, I consider, is the main or annual policy, since it reflects coordination with fiscal policy and Budget exercises of Government of India - including shared perceptions on macro aggregates. To briefly recall, on the basis of the real GDP growth of 6.0 - 7.0 per cent, the slack season monetary policy of April 1997 sought to maintain broad money (M3) expansion in the range of 15.00 - 15.50 per cent to keep the inflation rate at around 6.0 per cent in 1997-98. Consistent with the estimated growth in M3, the working estimate of the growth of aggregate deposits of scheduled commercial banks was placed at Rs.80,000 crore (16.0 per cent). The expansion in net scheduled bank credit including investments in bonds/debentures/shares of PSUs and private corporate sector was projected at 20.0 - 21.0 per cent. Against this backdrop, measures were introduced in that policy to give greater freedom to banks in the dispensation of credit. Efforts were also aimed towards widening, deepening and integration of financial markets. Above all, the Bank Rate was reactivated as a signal for money market interest rates.

On May 30, 1997, the Committee on Capital Account Convertibility submitted its report, setting out the approach to CAC in India, sketching out the international experience, examining the preconditions/signposts relevant for the institution of CAC in India and presenting the road map for CAC in India.

In June, 1997, with a view to aligning the Bank Rate to the changing conditions, we reduced the Bank Rate by one percentage point to 10.0 per cent. Thereafter, on a review of the prevailing monetary and credit situation and the developments in the foreign exchange market, we deregulated the interest rates on term deposits under Non-Resident (External) Rupee (NRE) Accounts scheme and reduced interest rates on post-shipment credit by one percentage point, in September 1997

The mid-term policy in October 1997 noted that macro-economic indicators remained satisfactory since April 1997. M3 moved in the projected trajectory showing an increase of 7.4 per cent up to October 10, 1997; the year-on-year growth was 15.6 per cent. Growth in deposits was strong at 7.5 per cent up to October 10. There was a significant drop in the inflation rate despite the oil price hike. The year-on-year increase in the Wholesale Price Index was 4.1 per cent as on October 4, 1997 as compared with 6.5 per cent a year ago. Interest rates, across maturities and instruments showed a marked downward movement. Following the two percentage points reduction in Bank Rate since April 1997, there was a corresponding reduction in deposit rates. Many public sector banks had brought down their Prime Lending Rates (PLR) by one percentage point to 13.5-14.5 per cent. Private sector banks and foreign banks also had brought down their PLRs. Yet, non-food bank credit had shown a growth of only 1.3 per cent during the financial year up to October 10, 1997. But, measures implemented in the policy gave a thrust to bank investments in PSU and corporate bonds and debentures and commercial paper which increased by Rs.8,315 crore as on that date as compared with a lower order of increase of Rs.1,259 crore during the corresponding period of the previous year. Corporates also availed of external commercial borrowings on a substantial scale. Conditions on the capital market remained sluggish. The monsoon conditions assured that agricultural performance would continue to be satisfactory. Industrial production in the first four months was sluggish. Export growth was also somewhat tardy at 2.9 per cent in US dollar terms up to August 1997 while import growth was 7.6 per cent. Deceleration in the growth of trade was perceptible. Exchange rates remained stable barring a brief period. Foreign currency assets of the RBI increased by US$3.7 billion reflecting the strength of the capital account. The budgeted borrowing programme of States was completed while almost the whole of the programme of the Centre was also completed. Investments in Government securities was substantially higher. There was a perceptible decline in net RBI credit to Central Government.

Taking cognisance of these trends, the monetary and credit policy of October 1997 marginally altered the expectation of GDP growth rate for 1997-98 closer to 6.0 per cent and retained the money supply growth target of 15.0-15.5 per cent as also the estimate of increase in aggregate deposits. Recognising the changes in asset-portfolio mix of the banks, the estimated growth in non-food credit was combined with investments (in bonds/ debentures/shares of PSUs and private corporate sector and CP) and was targeted at to 20.0 per cent for 1997-98.

There was a also a perception that while larger corporates had easier access to resources, middle corporates were starved of bank resources. Select activities such as trading were also in need of credit flows. Incidentally, the policy could not ignore some lessons from global developments - in particular the criticality of the health of financial sector and the potential volatility of capital flows under certain circumstances.

**Tasks**

The tasks set for monetary and credit policy for the second half of 1997-98 were derived from this environment. Broadly speaking, the tasks were:

First, it sought to augment the lendable resources of banks.

Second, it signified thrust on reduction of direct methods of monetary control and initiated the use of interest rates for transmitting monetary stance signals.

Third, it contained measures aimed at reducing the cost of resources and preserving the profitability of banks.

Fourth, it aimed at enhancing the delivery of credit.

Fifth, it persevered with the reform and integration of the financial markets.

Now, let me get into the specific measures to demonstrate how they seek to achieve the set objectives.

**Augmenting the Lendable Resources of Banks**

You may recall that the Narasimham Committee had proposed that the Reserve Bank progressively reduce the use of CRR. While there has been a shift from the direct methods of monetary control to indirect instruments, the RBI has been using the instrument of CRR in a flexible manner to serve its monetary policy objectives. The Report of the Committee on Capital Account Convertibility also indicated that the banking system continues to face very high reserve requirements relative to international standards, which acts as a tax on the banking system with implications on the spreads. The Committee recommended the reduction in the average effective CRR to 8 per cent in 1997-98. As part of financial sector reforms and with a view to releasing further resources to the banking system for lending, the CRR was recently reduced by 2 percentage points.

You would appreciate that the direction, viz., reduction in CRR was dictated by the reform agenda. The extent, viz., 2 per cent; the phasing, viz., in eight phases; and the caution, viz., that reduction in CRR during February and March is contingent on the monetary and price situation at that time, reflect judgments in the current context. We also take account of significant positive impact on banks' incomes and profitability, whenever CRR is reduced, at prevailing levels of compensation. The objective of further reductions to reach the statutory minimum of 3 per cent need to be pursued, but the pace would depend on the monetary developments in future.

The Narasimham Committee had also recommended the reduction in SLR to 25 per cent which had already more or less been achieved. The effective SLR required to be maintained was slightly higher than 25 per cent. In the recent past, banks have been maintaining SLR in excess of the stipulations. The current situation, it was felt, was ideal to rationalise the prescriptions on SLR and simplify the multiple prescriptions into a single or uniform SLR prescription of 25 per cent.

**Interest Rate Signals for Transmitting Monetary Policy Stance**

Sustained low rates of inflation lead to lower inflationary expectations and pave the way for bringing down nominal rates of interest. The yields on Treasury Bills and long-dated securities had shown steep falls both in the primary and secondary markets, reflecting lower inflationary expectations. The rate of inflation was low during 1996-97 and continued to be low during 1997-98. Hence, in order to recognise this trend and to have a signalling effect on other interest rates in the financial sector, the Bank Rate had to be reduced. The reduction in Bank Rate would expectedly act as a signal of lowering interest rates in the economy and translate into lower deposit and lending rates. The real issue at this juncture was not whether to reduce, but, by how much to reduce. A judgment was made that one per cent reduction would be appropriate, given all the factors - though some in the media argued for more and a few for less.

On the deposits side, barring the savings rate, the term deposit rates for maturity of 30 days to one year and interest rates on FCNR-B deposits, all other rates were already free. Interest rates on NRE deposits had recently been freed in September 1997. As part of the liberalisation process, therefore, the RBI in this policy, deregulated the interest rates on domestic term deposit rates while maintaining the minimum period of maturity at 30 days. This again, was an important decision since we had a choice between a justifiable ceiling on interest rate linked to Bank Rate and total freeing. Once we judged that the Bank Rate by itself, is a good and effective signal, formal prescription appeared redundant.

The minimum maturity is another area where there were three options. Status quo, abolition, and a reduction to 15 days. After deliberation, status quo was maintained to enable the banking system, especially public sector banks to cope up with total deregulation of rates. Removal of the minimum period could result in volatility of funds as depositors would tend to move funds into term deposits out of current accounts frequently, thereby adding to the cost of funds of the banks.

The RBI also partly deregulated interest rates on FCNR(B) deposits which was being fixed subject to ceilings prescribed by the RBI from time to time. The overall objective of the RBI was to keep the cost around or below LIBOR/Swap. A view was, therefore, taken that we can as well make the objective explicit, though this would remove an instrument with the RBI to moderate or enhance flows through prescribed ceiling while providing flexibility to banks to fix their own interest rates subject to such a ceiling of LIBOR/Swap. This enables banks flexibility in terms of cost of funds, deposit mix and better asset-liability management. What is more important is interest rates could be fixed or floating and it was easy to take this decision once we gave up RBI's prescriptions. We are aware that some procedural clarifications are needed here.

Incidentally, the issue of interest rate on Savings Accounts was also examined. The developments in interest rates all around and increasing tendency to operate them virtually as Current Accounts would suggest a reduction in these rates. Such reduction could help banks to reduce their costs of deposits. However, the savings account is an important source of comfort to millions of middle class, rural, semi-urban savers. Also, even as it is, the cost of these deposits is less than other resources to banks except current account. The interest rates on Small Savings Scheme of Government continue unchanged. Even in the banking community, the opinion was very evenly divided. One alternative was to reduce interest on savings accounts with cheque facilities and increase the rate on non-cheque facilities - but experience suggests that this would be a messy arrangement. Finally, we could deregulate these interest rates also, but the response of the banking system to such a move is not clear, and we in the RBI just could not absolve ourselves of some responsibility to the investors of small savers at this stage.

On the lending side, reduction in interest rates on pre-shipment export credit was a measure of rationalisation. In an endeavour to promote exports, the lending rates for export related activities are normally kept below the PLR for other general advances. The post-shipment rupee export credit had gradually been brought down but the pre-shipment credit remained at slightly higher levels. In order to align the interest rate on pre-shipment credit with other falling interest rates, the RBI brought it down across-the-board by one percentage point.

There were a number of representations from banks regarding the provision that banks should extend housing finance to intermediaries at 1.5 percentage points below the PLR. Many banks had reduced their PLRs to about 13.5 per cent after April 1997 and this stipulation implied that the intermediaries were able to access finance at very low rates for advances which were generally beyond Rs.2 lakh. Banks represented that many intermediaries were willing to access finance at PLR but this provision prevented them from doing so. In fact, it was argued that this provision, apart from unnecessarily prescriptive, was actually choking flows to the housing sector. Hence, as a part of the deregulation process and as a measure of rationalisation, we allowed banks to lend at different rates subject to the ceiling of PLR. Thus, while providing banks with a certain degree of flexibility, we had to assure that funds to this sector are available at lower rates.

Until this policy allowed banks to prescribe a separate Prime Term Lending Rate (PTLR) for term loans of 3 years and above, only a single PLR was allowed to be prescribed. In addition, banks were required to announce a spread over PLR. Some banks argued that the uniform spread to all maturities reflected only credit risk and not maturity risk. It was also argued that lending rates were sticky only because a single PLR was announced across different maturities. Operationally, it is possible to charge a premium over PLR for maturity risk but it was not considered to be desirable in the context of transparency. we, therefore, decided to allow banks to announce a separate PLR for term loans of three years and above. Traditionally, in our country, long-term loans are priced lower than working capital loans, though this meant an inverse yield curve. Recent announcements of lending rates by banks indicate a continuation of this practice.

**Reducing the Cost of Raising Resources**

A number of measures taken by the RBI impact the profitability of banks, but we have been urging the banks to pass on the benefit to customers. We have been carefully monitoring this since there is a perception in some quarters that banks are adding to their profitability. We note that banks, particularly, public sector banks, argue that the inherited large Non-Performing Assets (NPA) and huge overheads, especially, inflexible staff expenses make it difficult for them to lower the cost of lending. Further, the banks argue that effect of reduction in interest rates on lending is mostly instantaneous, while that on deposit rates is mostly operative after a lag, i.e., after existing deposits mature. This system worked to the advantage of banks as long as interest rates were rising but now that interest rates have taken a downturn, banks are at a disadvantage. The severity of the problem of lags would be moderated once we achieve stability in inflation and interest rates. For now, we have this given situation. We cannot ignore the health of banking system - especially balance sheets of banks and other financial intermediaries while ensuring effectiveness of our policy. So, we do look at impact of our policy on profitability.

To enable banks subserve the signal of immediate downward movement in interest rates, some action was needed, in addition to CRR reduction. This was in the form of some cushion in fixing interest rate on CRR balances payable by the RBI to banks.

The payment of interest on CRR balances is an issue which has generated some debate. I have recently addressed this issue elsewhere but I would like to reiterate them here. At the outset, let me recollect the views of Narasimham Committee in this regard that interest rate should be paid to banks on their CRR requirement above the basic minimum, broadly related to banks' average cost of deposits. Over the years, owing to fiscal policy considerations, corrective action was required in terms of high reserve ratio. Such a reserve ratio while providing monetary control, acts as a tax on banks' resources and results in higher interest rate spreads. Under the circumstances, in order to mitigate the excess burden on the banking sector, the RBI had to compensate banks by payment of interest on CRR in excess of the statutory minimum of 3 per cent. At some stage, it was decided not to pay interest on incremental CRR but emphasise more towards the objective of CRR reduction which serves the interests of banking system as also monetary policy. While this may seem a logically correct approach, the two-tier system (with a high rate of 10.5 per cent on balances relating to the pre-March 1990 period and nil thereafter) results in discrimination against newly established banks or those banks that increase their deposits at a rate higher than that of the system over a prolonged period of seven years. It is inevitable that it would take some time to reduce the CRR to the statutory minimum. During the transition to the reduction in CRR to the statutory minimum which will be contingent on moderate money supply expansion, there is a choice between the discriminatory two-tier formula and the non-discriminatory single rate.

The prevailing effective rate of interest on CRR balances for the system as a whole was about 3.5 per cent. By fixing it to a uniform rate of 4.0 per cent, most banks would benefit. With the downward trend in interest rates and the release of liquidity to the banking system, the slightly enhanced rate of interest on CRR would thus help act as a cushion against any possible impairment in profitability.

**Credit Delivery**

In April 1997, we had taken a number of measures to give greater freedom to banks and their customers. Response has been impressive in some areas such as use of CP, bonds and debentures, in financing large corporates. But, in some others such as abolition of MPBF, the response has been somewhat slow in instituting an alternate system to MPBF, signifying the importance of change as also capacity of the banking system to cope with the speed of reforms. We should recognise that there are no quick fixes to the issue of credit delivery; and even within what is possible in the system, institutional and attitudinal aspects should not be ignored.

In this policy, we have emphasised the need for change in attitudes and procedures - especially on financing to trade and services. In particular, we noticed that medium and small borrowers need to get at least as much advantage as large corporate borrowers do out of liberalisation, and it is this concern which led us make a specific mention in this policy, of different categories of borrowers - small, medium and large.

Other sectors which needed attention at this stage are housing and the road and water transport sectors due to their large multiplier effects. The policy increased the scope of bank lending to these sectors. Credit to small scale industrial units also require attention. SSI units have been representing that they have been experiencing problems on account of delayed receipt of payment from supplier corporates due to the latter's reluctance to abide by bill discipline. By specifying that not less than 25 per cent of the total inland credit purchases of the borrowers should through bills drawn on them by concerned sellers, the policy attempted to lubricate the manufacturing process as also promote the bill culture.

Industry had been representing that the bridge loans facility which was banned sometime back should be restored. Conditions in the primary market are hardly buoyant and there was a case for restoring the facility to corporates. But, one has to recognise that there needs to be two sides to a bridge; hence the need to proceed with caution. The measure suggested accepts the relevance of bridge loans both as an instrument and as a current need, but severe caution and limits have been placed. Whenever windows of opportunities arise, the banks and corporates can now promptly use this instrument.

**Integration of Financial Markets**

The April policy announced a number of measures to widen, deepen and integrate the financial markets. This policy aimed to foster the inter-linkages between the markets. A package of measures spanning the main components of the financial markets, viz., money market, government securities market and foreign exchange market were announced.

Reducing the minimum size of transaction in respect of corporates routing their funds in the money market through primary dealers, will increase the participants, provide greater flexibility and also increase the liquidity in the market. Similarly, reducing the minimum size of issue of certificates of deposit would offer more flexibility to banks. In this context, I wish to point out that banks have been representing that they may be allowed to offer different rates for deposits of uniform maturities for different customers depending on the size of the deposits. Reducing the size of issue of CDs would serve this purpose. Likewise, permitting MMMFs to invest in corporate bonds would provide added liquidity as also help increase the average return on their portfolios.

In the Government securities market, wide ranging measures were taken to improve transparency, increase the market players and increase the efficiency of market clearing mechanisms in the primary market and consequently improve the volume and depth in the secondary market. Introduction of uniform price auction for 91-day Treasury Bills and pre-announced notified amounts for all auctions, placing non-competitive bids outside the notified amounts, allowing FIIs to invest in government securities in addition to corporate bonds within 30 per cent debt component are some of the measures towards this end.

In the non-government debt market, perhaps, a momentous decision relates to permission to market participants to enter into repo transactions in PSU bonds and debt securities when dematerialised and traded on recognised stock exchanges. Our stand has been that if and when repo transactions in bonds have to be restored, transparency has to be ensured. Repos in the perceived form will bring about transparency and will also increase the liquidity in the market.

A number of measures were taken in the foreign exchange market to integrate it with the international market. In April, we allowed banks to borrow/invest upto a maximum extent of $ 10 million each in international markets. This decision was taken with a view to ensuring greater alignment of forward premia with the interest rate differentials. Banks have been asking us for higher limits. We believe it would be preferable to adopt a formula based approach for borrowing and lending as this would obviate the need for case by case approval. We also allowed banks to provide credit/non-credit facilities to Indian joint ventures abroad subject to a limit of 5 per cent of tier-1 capital and allowed Indian fund managers to invest in overseas market within an overall cap of $ 500 million and individual ceiling of $ 50 million. These measures and a few others which we introduced will pave the way towards further liberalisation of the capital account and are in line with the phase 1 recommendations of the CAC Report.

A key issue in the channel of transmission of monetary policy is the extent to which a policy induced change in interest rate affects all short-term money market rates, and in turn spread to the entire spectrum of interest rates. The propagation of monetary policy actions along the term structure of interest rates depends upon various factors, including the structure of the money market. There is demand from the market to permit corporates and financial institutions to participate both as borrowers and lenders in the call money market. A number of issues arise in this context, mainly from the point of view of minimising systemic risks. It may not be desirable to allow corporates to transmit their asset-liability mismatches and business risks in the inter-bank call money market. I understand that in many countries, the inter-bank call money market is purely for inter-bank participants. Permitting FIs/corporates in the interbank call money market also raises the question of level-playing field among participants. At present, FIs are not subject to prudential liquidity requirements. They have recently been allowed to mobilise resources at more liberal and competitive terms. It would be prudent to subject them to liquidity requirements. The question is one of timing and phasing of the requirement so as not to abruptly disrupt their existing structures and the market.

Owing to the easy liquidity conditions in the money market, banks have opted not to use the refinance facility. Perhaps, we have to consider operating one-day repos and reverse repos at market determined rates or through offering two-way quotes in Treasury Bills in the secondary market, to influence the liquidity and interest rates in the market.

There are many more measures that have been suggested, formally through representations or meetings of our Advisory Committees informally in interactive sessions and through the powerful media. We look at each of them very seriously and we readily concede that some of them are eminently desirable. But, in implementing some measures, a few participants would be able to take advantage, while many participants may need time to cope. So we, take up these measures relating to markets, somewhat carefully, ensuring that other regulatory procedures and systems are well equipped. So, let us assure you all that many more, perfectly justifiable suggestions will be implemented soon, but let us be sure that all of us, especially the market participants, are ready for them.

**What Next ?**

I am sure that you do not expect me to predict the monetary policy measures in the future, but I have shared with you frankly, the thinking process that goes into our monetary and credit policy. Let me conclude with some important considerations that should normally continue to govern next steps.

First, financial sector reform cannot afford to race very much ahead of real sector reform; and financial sector cannot carry the burden of changing the whole economy. Dr.C.Rangarajan, our Governor, has lucidly expressed this in his address to the Ahmedabad Management Association last month where he said "accelerating the growth momentum on a continuous basis, will depend on how quickly and effectively the various segments of the economy respond to the various policy initiatives and emerging investment opportunities in the economy."

Second, the pace of change in policy takes account of the expectations of the market participants, but only to the extent that they are consistent with other policies and practicable.

Third, we should reckon what market participants, especially the larger players can cope with, given the institutional and attitudinal rigidities. So, pace of reform depends on response from market participants also. Recent initiatives at forming voluntary bodies among PDs and debt market participants is a welcome feature.

Fourth, over a period, we have in place a variety of institutions, viz., banks, FIs, NBFCs, etc., and we cannot ignore, especially in transition, the level playing field argument easily - however difficult it is to ensure and define such a field.

Fifth, financial markets and institutions are not evenly developed in all parts of the country. We should recognise this, especially, when policy directly affects rural and semi-urban areas.

Sixth, we have to learn from global experience and respond to global developments from time to time. For instance, the recent policy makes a pointed reference to guidelines to banks on asset-liability management in recognition of the recent internationally demonstrated link between the soundness of the financial system and maintaining macroeconomic stability.

Finally, we often hear that some of our measures are not consistent, in a text-book sense or that they are contradictory. The reality in our country, at this juncture, has elements of contradictions due to imperfect as well as segmented market. Our policy response cannot, therefore, be based on an unrealistic assumption of consistent reality.

Thank you.