## Mid-Term Review of Monetary and Credit Policy for the Year 2003-04

The Statement on Mid-term Review of Monetary and Credit Policy consists of three parts: I. Mid-term Review of Macroeconomic and Monetary Developments in 2003-04; II. Stance of Monetary Policy for the Second Half of 2003-04; and III. Financial Sector Reforms and Monetary Policy Measures.

2. This Statement follows the pattern already set in the previous years – both in outline and in substance. As has been the practice in the past, and as emphasised by my predecessor, Dr. Bimal Jalan, monetary measures have to be taken promptly and effectively, to respond to the rapid developments in both the domestic and global markets. At the same time, the Annual Monetary and Credit Policy announced in April/May and the Mid-term Review in October/ November serve several purposes: as a framework for or supplement to the monetary and other relevant measures that are taken from time to time to capture events affecting macroeconomic assessments, in particular relating to fiscal management as well as seasonal factors; and to set out the logic, intentions and actions related to the structural and prudential aspects of the financial sector in our country. Further, the biannual Statements add to greater transparency, better communication and contribute to an effective consultation process.

### I. Mid-term Review of Macroeconomic and Monetary Developments in 2003-04

### Domestic Developments

3. The annual Statement on monetary and credit policy released on April 29, 2003 projected GDP growth of about 6.0 per cent for the year 2003-04, based on the assumption of rainfall at around 96 per cent of its long period average, recovery in agricultural output by over 3.1 per cent coupled with continuance of the upturn in the industrial sector. There have been a number of developments since then that are likely to have a positive impact on the growth rate. First, according to the India Meteorological Department (IMD), the South-West monsoon this year has been widespread and better than that anticipated earlier. Second, industrial growth continues to remain satisfactory. Third, export growth appears to have been sustained, although at a rate lower than the high rate of last year; however, improved prospects for global recovery should provide fresh impetus to export growth. It is noteworthy that non-oil imports have increased reflecting strengthening of domestic demand. Fourth, business expectations are positive. In addition, the underlying financial conditions of inflation, interest rates and liquidity, supported by the current policy stance, are expected to provide a favourable environment for higher growth.

4. The official estimate of the Central Statistical Organisation (CSO) for GDP growth available for the first quarter of 2003- 04 (5.7 per cent) is marginally higher than that in the corresponding quarter of the previous year (5.3 per cent). The behaviour of the South-West monsoon this year was better than that in the last four years: cumulative rainfall was 102 per cent of normal and spatial distribution showed that 33 out of 36 meteorological sub-divisions received normal or excess rainfall. Taking into account the

performance of the South-West monsoon, it is expected that agricultural GDP during the current year would exhibit a high growth after the decline of 3.2 per cent last year. During April-August 2003, the Index of Industrial Production (IIP) increased by 5.6 per cent, which is higher than 5.2 per cent recorded in the corresponding period of the previous year. There are indications of sustained growth in the production of basic goods, capital goods and consumer goods. During April-September 2003, while growth in exports at 10.0 per cent in US dollar terms was lower than 18.0 per cent in the corresponding period of the previous year, growth in imports was higher at 21.4 per cent as against 9.2 per cent in the corresponding period of the previous year.

5. On current reckoning, based on the growth prospects across the sectors of the economy, and assuming the continuance of good performance in industry and some acceleration in exports reflecting the anticipated global economic recovery, it is reasonable to expect an overall GDP growth of 6.5 to 7.0 per cent, with an upward bias, for the year 2003-04, as compared with the earlier projection of around 6.0 per cent.

6. Scheduled commercial banks' credit increased by 3.2 per cent (Rs.23,196 crore) up to October 17, 2003 as compared with an increase of 6.5 per cent (Rs.38,571 crore), net of mergers, in the corresponding period of last year. Food credit declined by Rs.15,328 crore as compared with a decline of Rs.1,273 crore in the previous year. Non-food credit increased by 5.7 per cent (Rs.38,524 crore) as compared with an increase of 7.4 per cent (Rs.39,844 crore), net of mergers, in the corresponding period of the previous year. Some new trends in the credit market are noteworthy. In recent years, retail credit has grown significantly, particularly to the housing sector. The Reserve Bank has also recently removed the interest rate restriction of the prime lending rate (PLR) being the floor rate for loans to the retail and personal segment. This measure should provide further impetus to retail lending. Nevertheless, keeping in view the intense competition in this sector, banks need to sharpen their risk assessment techniques so as to guard against any adverse impact on credit quality.

7. As regards industrial credit, the feedback on industry-wise credit flows received from banks for April-September 2003 reveals that, at a disaggregated level, there was a discernible increase in credit to tea, jute textiles, gems & jewellery, computer software and infrastructure. On the other hand, decline in credit was observed in coal, petroleum, iron & steel, mining, rubber and rubber products, automobiles and food processing.

8. Scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., declined by 2.6 per cent (Rs.2,432 crore) up to October 17, 2003 as compared with an increase of 10.6 per cent (Rs.8,561 crore) in the corresponding period of the previous year. Together with such investments, the total flow of resources from scheduled commercial banks to the commercial sector increased by 4.7 per cent (Rs.36,631 crore) as against a higher increase of 7.8 per cent (Rs.48,071 crore), net of mergers, in the corresponding period of the previous year. The year-on-year growth in resource flow was also lower at 13.9 per cent as against 16.0 per cent, net of mergers, a year ago. Scheduled commercial banks' investments in instruments issued by financial institutions and mutual funds this year (up

to October 17, 2003) increased by Rs.6,423 crore as compared with a lower increase of Rs.4,626 crore in the corresponding period of the previous year. At Rs.55,045 crore, the total resource flow to the commercial sector including capital issues, Global Depository Receipts (GDRs)/American Depository Receipts (ADRs) and borrowings from financial institutions during the financial year so far (up to October 17, 2003) is comparable with increase of Rs.55,697 crore in the corresponding period of the previous year.

9. In the current financial year up to October 17, 2003, money supply (M3) increased by 7.4 per cent (Rs.1,27,747 crore) as compared with 8.1 per cent (Rs.1,21,384 crore) in the corresponding period of the previous year, after adjusting for mergers. On an annual basis, growth in M3 at 11.9 per cent was within the projected level, but lower than that of 14.0 per cent in the previous year. The aggregate deposits of scheduled commercial banks rose by 8.2 per cent (Rs.1,04,988 crore) as compared with an increase of 9.1 per cent (Rs.1,00,635 crore) in the corresponding period of the previous year. On an annual basis, growth in aggregate deposits at 11.7 per cent was lower than that of 14.5 per cent a year ago. Overall, the growth in M3 and deposits has been within the projected level envisaged at the beginning of the year in the annual policy Statement.

10. RBI's net foreign currency assets (adjusted for revaluation), increased significantly by Rs.63,873 crore up to October 24, 2003, a figure much higher than the increase of Rs.38,452 crore during the corresponding period of the previous year. Despite such large inflows, reserve money increased by only 3.5 per cent (Rs.12,762 crore) in this year so far, as against an increase of 0.4 per cent (Rs.1,191 crore) in the corresponding period of the previous year. This was mainly due to substantial open market operations (OMO) by the Reserve Bank. Consequently, the net RBI credit to the Central Government showed a larger decline of 41.0 per cent (Rs.46,300 crore) than the decline of 15.7 per cent (Rs.22,219 crore) in the corresponding period of the previous year. RBI's credit to banks and commercial sector also declined due to their reduced reliance on the standing facilities emanating from comfortable liquidity conditions.

11. As regards the components of reserve money, bankers' deposits with RBI decreased by 13.4 per cent (Rs.11,160 crore) up to October 24, 2003 as compared with a decline of 14.2 per cent (Rs.11,956 crore) in the corresponding period of the previous year reflecting the impact of reduction in cash reserve ratio (CRR). Currency in circulation increased by 8.1 per cent (Rs.22,893 crore), a rate higher than the 5.1 per cent (Rs.12,688 crore) in the previous year.

12. It may be recalled that the annual policy Statement had projected, for policy purposes, the inflation rate to be in the range of 5.0-5.5 per cent, on a point-to-point basis, at the end of 2003-04. This projection was made at a time when inflation was accelerating and had touched 6.7 per cent during the first week of April 2003. Moreover, there were considerable uncertainties over the movements of international oil prices in the aftermath of the Iraq war, and the behaviour of the South-West monsoon was unclear. Notwithstanding these concerns, the Reserve Bank had assessed that the inflation rate would moderate. Accordingly, the Reserve Bank had proposed to continue with the policy stance of maintaining adequate liquidity in the system and a soft interest rate

environment. On the price scenario, the developments have been in the direction visualised through a forward-looking approach by the Reserve Bank in April 2003.

13. The annual rate of inflation as measured by variations in the wholesale price index (WPI), on a point-to-point basis, remained high in the range of 6.3-6.9 per cent during the first two months of this year. Thereafter, it has declined to 5.0 per cent by October 18, 2003. Annual inflation for ‘fuel, power, light and lubricants’ group (weight: 14.2 per cent) at 4.8 per cent this year was similar to last year. Prices of primary articles (weight: 22.0 per cent) increased by 5.1 per cent as against 2.5 per cent last year. Among primary articles, the increase in prices was mainly observed in non-food articles such as oilseeds and fibres. Prices of manufactured products (weight: 63.7 per cent) increased by 5.1 per cent as compared with 2.7 per cent last year. Among manufactured products, increase in prices was observed in edible oils, tea & coffee, cotton textiles, basic metals and alloys.

14. The annual policy Statement had identified certain commodities (weight:15.4 per cent) where prices were affected by either drought conditions or external supply shocks. Excluding the price increases due to such items (mineral oils, oilseeds, edible oils, oil cakes and fibres) from the WPI basket, the inflation rate worked out to 4.3 per cent as on October 18, 2003 as against 2.9 per cent at end-March 2003. Annual inflation, as measured by variations in the Consumer Price Index (CPI) for industrial workers, on a point-to-point basis, has remained moderate at 2.9 per cent in September 2003 as against 4.3 per cent a year ago.

15. On an annual average basis, WPI inflation was 4.9 per cent as on October 18, 2003 as against 2.3 per cent a year ago. The annual average CPI inflation was 3.9 per cent by September 2003 as against 4.6 per cent a year ago.

16. The probability of emergence of any undue pressure on prices during this year appears to be low on current indications. First, the good monsoon and expected recovery of agricultural production would have a favourable impact on prices of agricultural commodities. Second, the comfortable stocks of foodgrains and foreign exchange reserves would facilitate better supply management in the unlikely event of price pressures in agricultural commodities. Third, the prices of ‘fuel, power, light and lubricants’ so far have remained moderate in the absence of any renewed pressure on international oil prices, particularly in the wake of reduction in geopolitical tensions in the Middle-East. Fourth, both M3 and reserve money growth have remained subdued. On the basis of the above and in the absence of any serious adverse shocks, especially on the oil front, the inflation rate may turn out to be lower than the range of 5.0 to 5.5 per cent envisaged in the annual policy Statement. It is reasonable, therefore, to project for policy purposes the point-to-point annual rate of inflation by end 2003-04 to be in the range of 4.0-4.5 per cent, with a possible downward bias. The Reserve Bank would continue to closely monitor the price behaviour leaving no room for complacency on the inflation front.

17. The Union Budget for 2003-04 placed the net and gross market borrowings of the Central Government at Rs.1,07,194 crore and Rs.1,66,230 crore, respectively. The

Central Government completed net market borrowings of Rs.67,317 crore (62.8 per cent of the budgeted amount) and gross borrowings of Rs.1,01,035 crore (60.8 per cent of the budgeted amount) up to end-October 2003. Further, an amount of Rs.14,434 crore was raised in lieu of the securities bought back under the buyback auction of high-coupon government securities. Taking into account the amount of Rs.32,602 crore received from States under the debt-swap scheme, the market borrowing programme as per the indicative calendar of the Central Government for the second half of 2003-04 has been reduced. Prevailing liquidity conditions facilitated the Government to borrow at a substantially lower cost during 2003-04 than in the previous year. The weighted average yield on government borrowings through dated securities at 5.87 per cent this year, so far, has been significantly lower than 7.34 per cent last year by 147 basis points. As part of the debt management strategy, RBI combined auction issues with acceptance by private placement of dated securities consistent with market conditions.

18. The gross fiscal deficit of the Central Government at Rs.81,014 crore up to September 2003 was higher by about 40.3 per cent over the corresponding period of last year and constituted 52.7 per cent of the budget estimate for the current year. Revenue deficit of the Central Government at Rs.65,427 crore up to September 2003 was higher by about 37.4 per cent over the corresponding period of last year and accounted for about 58.3 per cent of the budget estimate for the whole year. The state governments have prepaid Rs.32,602 crore of central government debt by borrowing from the market (Rs.22,089 crore) and also utilising a part of the additional receipts under small savings (Rs.10,513 crore). Such market borrowings by the state governments were in addition to the normal market borrowings of Rs.16,663 crore (up to end-October 2003). The persistence of large aggregate borrowing of the Central and state governments continues to be a matter of concern. Such concerns arise both out of a possible adverse impact on the desired acceleration in growth that is consistent with stability, and also from possible implications for efficient monetary and debt management. It is, therefore, essential to pursue, promptly and with resolve, fiscal consolidation from a medium-term perspective. There is need for efforts in the direction of widening the revenue base, rationalisation of expenditures, and above all enhancing productivity of public investments, already made or to be made, in both commercial and social sectors. In this regard, the highest priority being accorded to eliminate revenue deficits at the Centre and States is welcome.

19. Scheduled commercial banks' investment in government and other approved securities at Rs.87,754 crore this year (up to October 17, 2003) has been higher than Rs.72,110 crore, net of mergers, in the corresponding period of the previous year. Commercial banks hold government and other approved securities much in excess of the prescribed statutory liquidity ratio (SLR). The excess holding of SLR securities at Rs.2,53,474 crore, constitutes 16.6 per cent of net demand and time liabilities (NDTL) of banks. Thus, for the banking system as a whole, the effective SLR investment at 41.6 per cent of NDTL is much higher relative to the statutory minimum of 25 per cent.

20. During 2003-04 so far, financial markets have remained generally stable and interest rates have softened further with liquidity in the system. First, average daily absorption through repo transactions under LAF during the year (up to end-October 2003) was

higher at Rs.29,310 crore as against Rs.13,836 crore in the corresponding period of the previous year. Second, the average call money rate moved down from 5.86 per cent in March 2003 to 4.64 per cent by October 2003. Third, the 91-day and the 364-day Treasury Bill rates have declined from 5.89 per cent each to 4.94 and 4.72 per cent, respectively. Fourth, the yield on government securities with 10-year residual maturity declined from 6.21 per cent to 5.11 per cent. Fifth, the public sector banks have reduced their deposit rates over one year from a range of 5.25-7.00 per cent in March 2003 to 5.0-6.0 per cent by October 2003. However, while lending rates for prime corporates and activities like housing have declined significantly, noticeable reduction is yet to take place in regard to other segments.

21. As indicated in the annual policy Statement of April 2002, in order to have greater degree of transparency in regard to actual lending rates, banks were advised to provide information on maximum and minimum interest rates charged to their borrowers. According to the information supplied by the banks and placed on the RBI website, the median lending rates on demand and term loans levied by public sector banks remained unchanged in a range of 11.5-14.0 per cent between March and June 2003. The range of prime lending rates (PLRs) of public sector banks remained unchanged at 9.0- 12.25 per cent although 14 public sector banks have lowered their PLRs by 25-75 basis points between March and October 2003.

22. The risk premium on private sector bonds, as measured by the yield spread between highly rated corporate paper and government securities, has declined. For example, the spread between AAA-rated corporate bonds of 5 years and the yield on government securities of similar maturity narrowed from 87 basis points in March 2003 to 65 basis points by October 2003.

23. The Reserve Bank will continue to ensure that adequate liquidity is maintained in the system so that all legitimate requirements for credit are met consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity through open market operations (OMO) as well as liquidity adjustment facility (LAF), and using the policy instruments at its disposal flexibly, as and when the situation warrants.

**External Developments**

24. The prospects for the world economy have improved since April 2003 when the annual policy Statement was presented. Several uncertainties relating to the Iraq war, impact of SARS, and volatility in oil prices have turned out to be short-lived. Reflecting these developments, oil prices reverted to lower levels although they have recovered somewhat thereafter. Financial markets, which were in a state of flux, especially equity markets, have also rebounded in many countries. Interest rates in several countries have continued to decline to historically low levels. While the outlook on Euro area remains flat, there are signs of pick up in growth in the US and recovery in Japan. Emerging markets in Asia are staging a strong recovery and both India and China are expected to record large expansion in output. Some acceleration in growth is also anticipated for

Africa and Latin America. Notwithstanding these favourable developments, the world economic outlook continues to face some downside risks. While uncertainties in the world economy have persisted for some time now, the Indian economy in recent times has not only showed considerable resilience to shocks but also demonstrated good economic performance on the domestic and external fronts.

25. The Indian forex market generally witnessed orderly conditions during the current financial year (April-October 2003). The exchange rate of the rupee which was Rs.47.50 per US dollar at end-March 2003 appreciated by 4.8 per cent to Rs.45.32 per US dollar by end-October 2003 but depreciated by 2.3 per cent against Euro, 2.5 per cent against Pound sterling and 4.2 per cent against Japanese yen during the period. Foreign exchange reserves increased by US $ 17.2 billion from US $ 75.4 billion in end-March 2003 to US $ 92.6 billion by end-October 2003.

26. In recent years, the annual policy Statements as well as mid-term Reviews have attempted to bring into sharper focus the main lessons emerging from our experience in managing the external sector during periods of external and domestic uncertainties. The broad principles that have guided exchange rate management are:

- Careful monitoring and management of exchange rates without a fixed target or a pre-announced target or a band. Flexibility in the exchange rate together with ability to intervene, if and when necessary.

- A policy to build a higher level of foreign exchange reserves which takes into account not only anticipated current account deficits but also “liquidity at risk” arising from unanticipated capital movements.

- A judicious policy for management of capital account.

27. As pointed out in the recent policy Statements, the overall approach to the management of India’s foreign exchange reserves in recent years has reflected the changing composition of the balance of payments, and has endeavoured to reflect the “liquidity risks” associated with different types of flows and other requirements. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Taking these factors into account, India’s foreign exchange reserves are at present comfortable and consistent with the rate of growth, the share of the external sector in the economy and the size of risk-adjusted capital flows.

28. During this period, the payments obligation on account of redemption of Resurgent India Bonds (RIBs) of US $ 5.5 billion was discharged without any adverse impact either on Indian financial market or on reserves. The management of RIB redemption was carefully weaved into India’s reserve management policy in close co-ordination with the State Bank of India (SBI). Accordingly, redemption of these bonds was carried out smoothly on October 1, 2003 without causing any stress on domestic liquidity, interest rates and exchange rate. While RBI made available the foreign currency requirements of SBI on the date of redemption, SBI had built up adequate amount of rupee resources to

fund foreign currency purchases from RBI. In order to smoothen the impact of the redemption over time, RBI had contracted forward foreign currency assets which took care of a major portion of the requirements. The balance requirements were met out of the foreign exchange reserves. Overall, although RIB redemption was large in magnitude, it had little impact on the reserves as well as domestic markets including money, foreign exchange and securities markets.

29. India's exports during the first half of the current financial year increased by 10.0 per cent in US dollar terms as compared with 18.0 per cent in the corresponding period of the previous year. During the same period, imports rose faster by 21.4 per cent as against an increase of 9.2 per cent in the corresponding period of last year. Oil imports increased by 6.3 per cent in US dollar terms as compared with 12.6 per cent in the corresponding period of the previous year. Non-oil imports increased by 28.0 per cent as against an increase of 7.8 per cent in the corresponding period of the previous year. As a result, the overall trade deficit at US $ 7.1 billion during April-September 2003 was higher than the deficit of US $ 3.5 billion in the corresponding period of the previous year. The higher trade deficit this year, in substantial part, reflects growth in import demand emanating from a pick-up in economic activity as reflected in higher capital goods imports.

30. The current account of the balance of payments, which had remained in surplus consecutively in the previous six quarters, showed a deficit of US $ 1.2 billion during April-June 2003. The trade deficit (on payment basis) of US $ 5.9 billion was offset to a large extent by private transfers of US $ 4.2 billion. In addition, there was a significant increase of US $ 6.4 billion in net capital inflows comprising mainly foreign investment (US $ 2.8 billion), NRI deposits (US $ 1.7 billion) and external loans (US $ 1.2 billion). As a result, the net accretion to foreign exchange reserves, including valuation change, amounted to US $ 6.7 billion during the first quarter of 2003-04. While for well-known reasons it is difficult to anticipate the behaviour of capital flows, the positive sentiment on India should augur well for continued buoyancy, but some moderation should not be ruled out if the stance of monetary policies in leading industrial economies were to transit from soft or neutral to a relatively tighter regime.

31. Some adjustments have been made in the recent past regarding policies relating to interest rates on non-resident deposits in response to changing conditions in the financial markets. A ceiling of 250 basis points above the corresponding US dollar LIBOR/ Swap rates was placed on the interest rates on fresh non-resident external (NRE) deposits effective July 17, 2003 which was reduced to 100 basis points on September 15, 2003 and further to 25 basis points on October 18, 2003. In addition, after a review of the investment activities of Overseas Corporate Bodies (OCBs), in consultation with Government of India, they were derecognised as a distinct eligible class of investors in India with effect from September 16, 2003. They will now be treated on par with any other foreign investors. Consistent with the objectives of Offshore Banking Units (OBUs) located in Special Economic Zones (SEZs), their exposure to the Domestic Tariff Area (DTA) has been restricted to a limit of 25 per cent of their previous working day's total liabilities only, under the scheme of External Commercial Borrowings (ECBs), subject to FEMA regulations. Further, a bank cannot borrow from its OBU. These guidelines were

put into effect on October 10, 2003.

**Overall Assessment**

32. In sum, from an overall policy perspective and in qualitative terms, the major developments since April 2003 and consequently the areas that may need further attention for policy purposes can be as follows:

(a) The macroeconomic environment has improved during the year with a positive outlook on both the domestic and external fronts. The growth prospects are better, the inflation outlook remains benign, the interest rates and foreign exchange reserves are at comfortable levels and there is adequate liquidity in the system. This optimism is also reflected in business confidence surveys conducted by various agencies including RBI's own internal assessment. Further, the strengthening of business fundamentals is being reinforced by upgrades in corporate credit ratings. The assessment of the international community, including rating agencies, on India's growth prospects has turned more positive.

(b) The point-to-point WPI inflation is expected to moderate by the end of the year. However, annual inflation as measured by the WPI, has been higher this year so far than the corresponding period last year both on an overall basis and excluding the commodities affected by either drought conditions or external supply shocks (mineral oils, oilseeds, edible oils, oil cakes and fibres). While the economy has resources as well as resilience to withstand supply shocks, the possible consequences of continued abundance of liquidity need to be monitored carefully. The gains obtained in recent years from the reining in of inflationary expectations need to be consolidated and reinforced. It is important to appreciate that sustained efforts over time helped to build confidence in price stability and that inflationary expectations can turn adverse in a relatively short time if noticeable adverse movements in prices take place. Hence, a continued emphasis on vigil on the price level is essential.

(c) The investment climate has improved during the year which is reflected in the functioning of various segments of the financial market. With comfortable liquidity, the call and term money market rates have hovered around the repo rate. The yield curve which has been flattening for most part of the year, steepened somewhat following the repo rate cut on August 25, 2003. The foreign exchange market remained stable. While the rupee appreciated against the US dollar, it depreciated against other major currencies. The capital market has also experienced heightened activity for several reasons such as abundant global and domestic liquidity, general upward trend in stock prices worldwide and attractiveness of valuations of stocks in India. It is reported that large-scale corporate restructuring has already taken place and productivity gains harnessed to a significant degree out of investments made in the restructuring of industry, and in this light there could be a revival of investment demand at this juncture.

(d) Financial market sentiments are stronger now compared to the beginning of the year. However, there is need for continuous and careful monitoring since in the upturn of the business cycle there could be overshooting of markets. It is important for the financial intermediaries to note the cautionary views expressed in the previous policy Statements that, in case the present market conditions change, it may be appropriate to take monetary measures that may not be in consonance with the present easy conditions. Keeping these realities in view, it is particularly important for banks and financial institutions to make adequate allowance for unforeseen contingencies in their business plans, and to take full account of the implications on their operations of possible changes in the monetary and external environment.

(e) The health of the financial sector continued to improve during the period. The Reserve Bank's sustained efforts in implementing prudential norms in a phased manner and in strengthening the supervision and monitoring of banks in line with international best practices, have enhanced the outlook of the financial sector. Improvements have taken place in asset quality, profitability, capital adequacy and efficiency of banks, and financial institutions (FIs) are being strengthened. While concerns still remain with regard to the functioning of a segment of the financial sector comprising cooperative banks and NBFCs, the overall resilience of the banking and financial sector is encouraging.

(f) Whereas credit growth remained subdued till August 2003, there are since some signs of pick-up in non-food credit. On the supply side, RBI has been pursuing policies to ensure the availability of adequate credit to productive sectors,besides maintaining a soft interest rate stance so as to support investment demand. On the demand side, the financing requirement of large corporates has eased because of financial restructuring, improvements in productivity, optimisation of inventory cycles, better cash flow management, access to alternative sources of funds such as external commercial borrowings and a higher dependence on internal resources. As growth in large corporates usually provides spinoffs for small and medium enterprises (SMEs), including ancillary units, the credit requirement of this sector may be expected to increase gradually now. Banks can also tap the large demand for funds arising from the capital requirements of the infrastructure sector – especially power, ports and roads – provided the regulatory and other institutional factors ensure cost recovery. Similarly, credit demand from the agricultural sector may also rise with increasing commercialisation, provided the domestic trading environment as well as relevant transport, storage facilities etc., are improved expeditiously. To fully exploit the emerging opportunities, there is a need to further improve institutional as well as incentive mechanisms in banks to strengthen credit delivery to SMEs, infrastructure and agriculture. In this regard, it is imperative that a conducive credit culture is nurtured among financial intermediaries, corporates and households.

(g) Apart from subdued credit growth, which will continue to cause concern unless the anticipated pick-up materialises, the fact of overall rigidity in the downward movement of lending rates as well as inadequacy in quality of service to some sections coupled with reduction in deposit rates requires introspection and immediate action on the part of all financial intermediaries. Trends in the flow and composition of savings as well as availability of credit to some highly productive and socially critical sectors should be a matter of importance to all in the financial system. While credible actions, particularly by the commercial banks, would be essential, innovative measures by all concerned may have to be considered in due course if adequate progress in credit delivery accompanied by appropriate transparency in credit pricing is not observed soon.

(h) It is necessary to appreciate that with continued positive developments in the external sector during the year over the significant progress made in recent years, substantial strength has been imparted to the economic management of our country by the virtual elimination of the binding forex constraints experienced since 1956. The strong external sector performance of India is reflected not only in the comfortable level of reserves but also in the quality emanating from non-debt creating flows. The more competitive external orientation of the economy adds to further strength. These positive developments in the external sector, accompanied by price stability and stable financial markets accord comfort to the conduct of public policies.

## II. Stance of Monetary Policy for the Second Half of 2003-04

33. The annual policy Statement of April 2003 had indicated that, according to the present assessment and barring the emergence of any adverse and unexpected developments in the various sectors of the economy, the overall stance of monetary policy for 2003-04 will be:

- Provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level.

- In line with the above, to continue with the present stance of preference for a soft and flexible interest rate environment within the framework of macroeconomic stability.

34. Monetary management in the first half of 2003-04 was largely in conformity with the monetary policy stance announced in the annual policy Statement. A steady increase in net foreign currency assets of RBI in the face of subdued credit demand created a situation of excess liquidity throughout the first-half of the year posing a major challenge for liquidity management. The Reserve Bank, therefore, had to manage liquidity actively through open market operations (OMO) and through the liquidity adjustment facility (LAF) in order to maintain a stable interest rate environment. The average daily absorption through repo transactions under LAF during the year so far (up to end-October 2003) amounted to Rs.29,310 crore as against an average of Rs.13,836 crore in the corresponding period of the previous year. The interest rates in money market and government securities market ruled lower than at the beginning of the financial year. More than 60 per cent of the market borrowing programme of the Government could be completed at a much lower cost, with longer maturities and without any adverse impact on the general interest rate structure. In tandem with market trends and with the anticipation of better growth and inflation prospects, the LAF repo rate was reduced from 5.0 per cent to 4.5 per cent on August 25, 2003. Notwithstanding the comfortable liquidity position emanating from the foreign exchange build up, RBI made further

progress towards its medium-term objective of reduction in the cash reserve ratio (CRR). The CRR was reduced from 4.75 per cent to 4.5 per cent in June 2003 augmenting the lendable resources of banks by about Rs.3,500 crore.

35. In the Part I of this Review, detailed discussions on the likely levels of major monetary aggregates have been presented after assessing the relevant factors. In the light of the discussion, for the purpose of monetary management, (i) GDP growth in 2003-04 is placed at 6.5 to 7.0 per cent, with an upward bias, as against 6.0 per cent envisaged earlier; (ii) inflation, on a point-to-point basis could be in the range of 4.0-4.5 per cent, with a downward bias, as against 5.0 to 5.5 per cent projected earlier; (iii) expansion in M3 would be around 14.0 per cent as projected earlier; (iv) growth in aggregate deposits would be Rs.1,79,000 crore as projected earlier; and (v) non-food bank credit including investments in bonds/ debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., is expected to increase by about 15.5 -16.0 per cent, as projected earlier.

36. Since announcement of the annual policy Statement in April 2003, the world economic outlook has improved; GDP growth is placed higher; the outlook for inflation is more benign; expansion in money supply is within the trajectory; and financial markets, especially forex markets, are stable though they displayed more than usual activity. The flow of credit has been less than anticipated so far though more recent indications point towards improvement in the remaining part of the year. While capital flows are stronger, current account is possibly turning to deficit. Consistent with these developments, it is proposed to continue with the overall stance of monetary policy announced in the annual policy Statement for the remaining half of the current year.

## III. Financial Sector Reforms and Monetary Policy Measures

37. The annual policy Statements as well as mid-term Reviews of RBI have been focusing on the structural and regulatory measures to strengthen the financial system. These measures have been guided by the objectives of increasing operational efficacy of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening prudential norms, and developing technological and institutional infrastructure. This section reviews the progress of implementation of the measures initiated so far and proposes some further measures to meet the emerging challenges in the financial sector.

38. The emphasis at this stage is on continuance of measures already taken with an accent on implementation, facilitating ease of transactions by the common person, further broadening of the consultative process and continued emphasis on institutional capacity to support growth consistent with stability in a medium-term perspective. It is also proposed to consider strengthening of the credit delivery system within the existing institutional framework so that financing gaps do not seriously constrain the desired acceleration in growth.

### Monetary Measures

***(a) Bank Rate***

39. In the annual policy Statement of April 2003, the Bank Rate was reduced from 6.25 per cent to 6.0 per cent with effect from the close of business on April 29, 2003. It was also indicated that unless the domestic and international circumstances change, the policy bias in regard to the Bank Rate is to keep it stable until the mid-term Review of 2003-04.

40. On a review of the macroeconomic developments, it is considered desirable to leave the Bank Rate unchanged (at 6.0 per cent) at present.

***(b) Cash Reserve Ratio***

41. In the annual policy Statement of April 2003, the cash reserve ratio (CRR) was reduced from 4.75 per cent to 4.50 per cent effective fortnight beginning June 14, 2003.

42. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, on a review of the current liquidity situation, it is felt desirable to keep the present level of CRR (4.50 per cent) unchanged.

***(c) Review of Liquidity Adjustment Facility***

43. Pursuant to the recommendations of the Narasimham Committee on Banking Sector Reforms (1998), the liquidity adjustment facility (LAF) was operationalised on June 5, 2000 following its announcement in the annual policy Statement of April 2000. It was envisaged at that time that the LAF would help the short-term money market interest rates to move within a corridor and impart stability, facilitating emergence of a short-term rupee yield curve. It was also indicated therein that the LAF would be reviewed in the light of actual experience.

44. Keeping in view subsequent developments in the financial market as also in technology, an Internal Group reviewed the operations of LAF in a cross-country perspective. The draft Report of the Internal Group was discussed in the Technical Advisory Committee on Money and Government Securities Markets (TAC) recently and has been revised in the light of discussions. In view of the fact that LAF has emerged as a monetary policy instrument of RBI for modulating system liquidity, the "Report of the Internal Group on Liquidity Adjustment Facility" is being placed on the RBI website *www.rbi.org.in* for wider dissemination and comments. The guidelines on LAF will be finalised taking into account the suggestions received on the Report.

**Interest Rate Policy**

***Prime Lending Rate and Spread***

45. In the annual policy Statement of April 2003, banks were advised to announce a benchmark PLR with the approval of their Boards, taking into consideration: (i) actual

cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirements of provisioning and capital charge, and profit margin. It was also indicated that the system of determination of benchmark PLR by banks and the actual prevailing spreads around the benchmark PLR would be reviewed in September 2003.

46. Accordingly, the issues relating to the implementation of the system of benchmark PLR were discussed with select banks and the Indian Banks Association (IBA). The IBA has made the following suggestions: (i) permitting separate PLRs for working capital and term loans, (ii) continuation of the practice of multiple PLRs, (iii) flexibility in offering fixed or floating rate loans based on time-varying term premia and market benchmarks, (iv) flexibility in pricing of consumer loans, and (v) accounting for transaction costs for different types of loans.

47. It is clarified that since lending rates for working capital and term loans can be determined with reference to the benchmark PLR by taking into account term premia and/ or risk premia, a need for multiple PLRs may not be compelling. It is also clarified that banks have the freedom to price their loan products based on time-varying term premia and relevant transaction costs. Banks may price floating rate products by using market benchmarks in a transparent manner.

48. As IBA has indicated broad agreement with the approach proposed for the benchmark PLR, IBA may advise its members suitably, keeping in view the operational requirements.

**Credit Delivery Mechanism**

49. In continuation of several initiatives taken, and keeping in view the recent developments in credit flows to different sectors, some specific measures are proposed as under:

***(a) Priority Sector Lending***

*(i) Credit Facilities for Small Scale Industries*

50. In the annual policy Statement of April 2002, the loan limit for dispensation of collateral requirement was increased from Rs.5 lakh to Rs.15 lakh. In order to further improve the flow of credit to small scale industries (SSIs), it is proposed that:

- Banks may, on the basis of good track record and the financial position of the SSI units, increase the loan limit from Rs.15 lakh up to Rs.25 lakh (with the approval of their Boards) for dispensation of collateral requirement.

*(ii) Deposits of Foreign Banks with SIDBI*

51. At present, foreign banks are required to deposit an amount equivalent to the shortfall in their priority sector target with Small Industries Development Bank of India (SIDBI) at

an interest rate of 6.75 per cent. In order to increase the flow of credit to SSIs and to rationalise the interest rates, it is proposed that:

- The interest rate on the deposits of foreign banks placed with SIDBI towards their priority sector shortfall will be at the Bank Rate.

- SIDBI will take appropriate steps to ensure that priority sector funds are utilised expeditiously and benefits of reductions in interest rates passed on to the borrowers.

*(iii) Lending by Banks to NBFCs*

52. As indicated in the annual policy Statements of April 1999 and 2000, bank loans to non-banking financial companies (NBFCs) for the purpose of on-lending to agriculture, tiny sector and small road and water transport operators are reckoned under priority sector lending. On a suggestion from a Chamber of Commerce, and with a view to further enhancing the credit flow to SSI sector, it is proposed that:

- All new loans granted by banks to NBFCs for the purpose of on-lending to SSI sector would also be reckoned under priority sector lending.

***(b) Advisory Committee on Flow of Credit to Agriculture and Related Activities***

53. It has been the endeavour of RBI to improve the agricultural credit delivery mechanism by simplifying procedures, encouraging decentralised decision-making and enhancing competition. In order to progress further in meeting the credit needs of the agricultural sector, it is proposed to constitute an Advisory Committee to suggest short-term and medium-term measures to enhance credit flow to this sector. While assessing the progress made in implementation of Vyas Committee, the Committee would, *inter alia*, look into the role of National Bank for Agriculture and Rural Development (NABARD) in the development of the sector; the present structure and deployment of rural infrastructure development fund (RIDF); role of RRBs; and incentive and attitudinal aspects of credit delivery. It would suggest appropriate changes in the institutional and procedural arrangements for the smooth flow of credit to agriculture. The Committee is expected to address the issue of credit delivery to farmers, especially small farmers, tenants, labourers, supplies of inputs to agriculture and purchases of output. The Committee would explore the scope for involving innovative location-specific catalytic agents to bridge the gap between banking institutions and the demand for timely credit in rural areas, for investment in working capital and consumption smoothing. The Committee is also expected to help in capturing new technological developments in the cause of improving credit delivery.

***(c) Working Group on Flow of Credit to SSI Sector***

54. The small scale industries (SSI) sector occupies an important position in the Indian economy and provides employment and income generation. Keeping in view the credit

needs of this sector, it is proposed to constitute a Working Group to assess the progress made in implementation of Kapur Committee and Gupta Committee recommendations and suggest ways to improve credit flow considering, in particular, the backward and forward linkages of this sector with large corporates. The Group will also look into methods of utilisation of priority sector shortfall deposits with SIDBI and suggest appropriate institutional arrangement for enhancing the credit delivery on a timely basis and in adequate measure to SSIs.

***(d) Micro-finance***

55. As indicated in the annual policy Statement of April 2003, RBI constituted four informal groups to examine various issues concerning micro-finance delivery. On the basis of the recommendations of the groups, it is proposed that: (i) banks should provide adequate incentives to their branches in financing the self help groups (SHGs) and establish linkages with them making the procedures absolutely simple and easy while providing for total flexibility in such procedures to suit local conditions; (ii) the group dynamics of working of the SHGs may be left to themselves and need neither be regulated nor formal structures imposed or insisted upon; (iii) the approach to micro-financing of SHGs should be totally hassle-free and may include consumption expenditures to enable smoothing of consumptions as needed relative to time-profile of income flows; (iv) NABARD should reinforce its commitment to maintaining and enhancing the flow to micro-finance while simplifying the process; and (v) NABARD should devise mechanisms to ensure sharing of experiences among the bank branches that are closely involved in extending micro-finance.

***(e) Survey on Kisan Credit Card (KCC)***

56. As indicated in the annual policy Statement of April 2003, the survey for assessing the impact of the Kisan Credit Card (KCC) scheme was awarded to the National Council of Applied Economic Research (NCAER), New Delhi. The NCAER has since launched the survey and the report is expected by December 2003.

***(f) Infrastructure Financing***

57. As indicated in the annual policy Statement of April 2003, on account of the high priority accorded by the Government to the infrastructure sector, RBI has taken a number of measures with a view to providing incentives to banks to increase their credit flow to the infrastructure sector. These measures have given the initial impetus to the infrastructure sector as evident from a sharp increase in flow of bank credit to this sector during this year. Though financing requirement is large, the long-term potential for larger investments and better credit-recycling would, no doubt, depend on commercial viability based on assured systems of cost recovery.

**Money Market**

58. A number of money market reforms were undertaken in recent years to preserve the

integrity of the financial market and to enable a balanced development of various segments of the financial market. Some further steps in the implementation of measures already announced are now proposed:

***(a) Moving towards Pure Inter-bank Call/Notice Money Market***

59. Following the recommendations of Narasimham Committee II, in the annual policy Statement of April 2001, the intention to move towards a pure inter-bank call/notice money market by gradually phasing out the non-bank participation was announced. In the annual policy Statement of April 2003, daily lending of non-bank participants in call/notice money market was reduced from 85 per cent to 75 per cent. In view of further market developments as also to move towards a pure inter-bank call/ notice money market, it is proposed that:

- With effect from the fortnight beginning December 27, 2003, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 60 per cent of their average daily lending in call/notice money market during 2000-01. The time-table for further phasing out of non-bank participation will be announced in consultation with market participants.

60. In case a particular non-bank institution has genuine difficulty in developing proper alternative avenues for deployment of excess liquidity because of its size, RBI may consider providing temporary permission to lend a higher amount in call/notice money market for a specific period on a case-by-case basis.

***(b) Rationalisation of Standing Facilities***

61. Banks are eligible for standing facility (export credit eligible for refinance) and PDs are eligible for collateralised liquidity support from RBI subject to certain limits. These limits are split into “normal” facility and “back-stop” facility. With the emergence of the liquidity adjustment facility (LAF) as an effective instrument in modulating system liquidity, in the mid-term Review of October 2002, the apportionment between “normal” and “backstop” facilities was changed to one-half each. In view of current liquidity conditions, the utilisation of these facilities by banks and PDs has been negligible. In order to move further towards phasing out sector-specific standing facilities as also to rationalise the rates at which liquidity is injected into the system, it is proposed that:

- The “normal” and “back-stop” standing facilities will be available in a ratio of one-third to two-thirds (33:67) from the fortnight beginning December 27, 2003.

***(c) Primary Dealers’ Access to Call/ Notice Money Market***

62. Following the annual policy Statement of April 2002, it was announced in July 2002 that access of PDs to borrow in call/notice money market would be gradually reduced in two stages subject to certain market developments. With a view to develop further the

repo market as also to ensure a balanced development of various segments of money market, it is proposed that:

- With effect from February 7, 2004 PDs will be allowed to borrow, on average basis in a reporting fortnight, upto 200 per cent of their net owned funds (NOF) as at end-March of preceding financial year.

63. Any PD which has genuine difficulties in adhering to the above schedule may approach RBI for appropriate reasonable dispensation with full justification for extension of period of compliance sought.

***(d) Reporting of Call/Notice Money Market Transactions on NDS Platform***

64. As indicated in the annual policy Statement of April 2003, it is mandatory for all NDS members to report all their call/notice money market deals on NDS. Deals done outside NDS should also be reported within 15 minutes of the deal irrespective of the size of the deal or whether the counterparty is a member of the NDS or not. In order to facilitate the NDS members to report their deals among the NDS members and with non-NDS members, RBI has amended the software incorporating the necessary changes and distributed it amongst NDS members in July 2003. As a result of this, there has been significant increase in the reporting of deals. Complete dissemination of trade information relating to money, government securities and foreign exchange markets will improve transparency and strengthen efficiency in the market. In this direction, all NDS members should report their deals as soon as the deals are concluded.

**Foreign Exchange Market**

***(a) Unhedged Forex Exposures of Corporates***

65. As indicated in the mid-term Reviews of October 2001 and 2002 and reiterated in the annual policy Statement of April 2003, RBI has been expressing concern over unhedged foreign currency borrowings by corporates. However, it is noticed that despite such exhortations, hedging has not been ensured. This may entail significant but avoidable risks to some corporate balance sheets, possibly impacting the quality of banks' assets in some cases. In view of this it has been decided that, henceforth, all foreign currency loans by banks above US  10 million, can be extended only on the basis of a well laid out policy of the Board to ensure hedging, except in following cases:

- Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount.

- Where the forex loans are extended for meeting forex expenditure.

***(b) Export Follow-up***

66. Exporters are normally required to realise the full value of export proceeds within 180 days of shipment. For exporters who are unable to realise the outstanding export dues, powers have been delegated to authorised dealers (ADs) to permit write-off up to 10 per cent of the total export proceeds realised by the concerned exporter during the preceding calendar year subject to certain conditions. Further, Status Holder exporters are permitted, on their own, to write off outstanding export proceeds up to an annual limit of 5 per cent of their average annual realisation during the preceding three years. To provide full flexibility to all exporters, it has been decided that:

- Beginning January 1, 2004, all exporters may write off outstanding export dues on their own and may also extend the normal period of realisation beyond 180 days on their own provided the aggregate value of such write-off and delay in realisation does not exceed 10 per cent of their export proceeds in a calendar year.

67. It may be noted that all other existing procedures in regard to GR forms, export credit and export incentives will remain unchanged. Any exporter who expects to exceed the 10 per cent limit for the calendar year as a whole should obtain authorisation as per existing practice to the extent of excess over 10 per cent before the end of calendar year. Where multiple banking facilities are utilised by exporters, the computation for the limit of 10 per cent would apply in respect of each AD. If any exporter exceeds the limit of 10 per cent by the end of the year, without prior authorisation, this facility will be denied after giving due notice.

***(c) Issue of Units of Mutual Funds –General Permission***

68. At present, Indian Asset Management Companies (AMCs) who launch off-shore funds abroad have to obtain SEBI’s approval for such schemes. They are also required to obtain RBI’s prior approval for issue of units, remittance of dividend and redemption of units. In order to provide single window clearance, in consultation with SEBI, it is proposed:

- To accord general permission to AMCs to issue units, remit dividend and redeem the units issued, once SEBI’s approval is obtained for launching off-shore funds, subject to reporting requirements.

**Government Securities Market**

69. The Reserve Bank has taken a number of measures in close consultation with market participants to further develop and deepen the government securities market. These include permission to gilt account holders to participate in repo market, issuance of guidelines for uniform accounting norms for repo and reverse repo transactions, facility for trading in the anonymous screen-based order driven system of stock exchanges and introduction of exchange-traded interest rate derivatives on the National Stock Exchange (NSE). With regard to operationalisation of STRIPS, RBI is in the process of drawing up the detailed specifications required for the development of software for stripping/

reconstitution. In order to further develop the repo market and facilitate introduction of DVP III as preferred mode of settlement, the issue relating to roll-over of repos was discussed in the TAC recently. In this direction, the following further measure is proposed:

***Sale of Government Securities –Relaxation***

70. At present, no sale transaction in a government security is permitted without the seller actually holding the security in its portfolio. The Reserve Bank has received frequent representations proposing that the extant stipulations may be relaxed which will help further development of the government securities market. Institutional development has also reduced settlement risk as most of the government securities transactions are now settled through Clearing Corporation of India Limited (CCIL) which guarantees the settlement. In order to facilitate deepening of the government securities market, it is proposed that:

- Sale of a government security, already contracted for purchase, would be permitted, provided, such purchase contract was either guaranteed by an approved central counterparty like CCIL or the counterparty thereof was RBI.

To facilitate operationalisation of the proposal, the settlement of government securities transactions would be switched over to the DVP III mode. It is proposed to review the working of above arrangements every month to consider modifications and continuance, as appropriate.

**Supervision and Monitoring**

71. Considerable progress has been made since April 2003 in enhancing the supervision and monitoring system of banks. First, pilot implementation of risk based supervision (RBS) process has been initiated in select banks. Further enhancement and refinement to the RBS approach would be considered, in consultation with banks after taking into account the results of the pilot exercise. Second, consequent to the switchover to consolidated accounting and supervision, consolidated prudential reports (CPRs) have been introduced on a half-yearly basis and the input module for off-site monitoring and surveillance system (OSMOS) has suitably been modified to incorporate CPRs. Third, a computerised fraud reporting and monitoring system (FRMS) has been introduced. Fourth, in order to comply with the review mandated by SEBI in respect of all listed companies including commercial banks, public sector banks have been advised to prepare quarterly reviews of accounts. Fifth, an informal RBI-SEBI Joint Group suggested methods for integrated system of alerts which would piece together disparate signals from different segments of the market to draw special attention to any unusual activity. The recommendations of the Group are under examination.

**Prudential Measures**

72. As part of the ongoing process of reforms, RBI has taken a number of proactive and

forward looking steps to strengthen the prudential framework and oversight functions. Preparing banks to adopt the New Basel Capital Accord is a major challenge in a series of such important steps. In this regard, seven banks participated in the Quantitative Impact Study (QIS 3) conducted by Basel Committee on Banking Supervision (BCBS) to assess the impact of the New Capital Accord. Taking into account the results of QIS 3, BCBS has released the third Consultative Paper (CP3) in April 2003. The Reserve Bank while forwarding its comments on CP3, has sought greater flexibility to national supervisors to implement the New Accord, keeping in view the different levels of preparedness of the banking system across the countries to adopt the New Accord. Further measures proposed in this area are as under:

***(a) Investment Fluctuation Reserve***

73. As indicated in the annual policy Statement of April 2002, with a view to building up adequate reserves to guard against possible reversal of the interest rate environment in future due to unexpected developments, banks were advised to build up an investment fluctuation reserve (IFR) of a minimum 5.0 per cent of their investments in the categories "Held for Trading" (HFT) and "Available for Sale" (AFS) within a period 5 years. As the risk perceptions of individual banks could differ in accordance with their portfolio composition, banks were also encouraged to build IFR up to a maximum of 10 per cent of their relevant portfolio, with the approval of their Boards. As at end-June 2003, total IFR amounted to only about Rs.10,000 crore and constituted 1.7 per cent of investments under relevant categories and 1.4 per cent of the total investments. While 12 banks are yet to make any provisions for IFR, 20 banks have built IFR up to 1.0 per cent and only 65 banks have IFR exceeding 1.0 per cent. Although, banks have time to achieve the stipulated 5.0 per cent, they are urged to quickly build up IFR so that they are better positioned to meet interest rate risks.

***(b) Prudential Norms for FIs***

74. As indicated in the annual policy Statement of April 2001, with effect from the year ended March 2002, assets of financial institutions (FIs) are treated as non-performing, if the interest and/or principal instalment remain overdue for a period of more than 180 days. However, in the case of banks, 90 days norm for recognition of loan impairment would be adopted from the year ending March 2004. In order to bring in convergence between the asset classification norms of FIs and banks, in line with international norms, it is proposed:

- To adopt the 90 days norm for recognition of loan impairment for FIs with effect from the year ending March 31, 2006. However, in order to mitigate the burden of additional provisioning arising out of adoption of the revised norm, FIs are permitted to phase out the required provisioning over a period of three years beginning from the year ending March 31, 2006, with a minimum of one-fourth of the additional provisioning being made each year.

***(c) Standing Technical Advisory Committee on Financial Regulation***

75. In recent years, a number of steps have been taken to strengthen the regulation of banks and non-bank financial entities, in consultation with banks and other market participants/regulators of financial markets. The financial sector now faces increasing challenges and complexities in the context of globalisation and risk management. In order to strengthen the consultative process and to place such a process on a continuing basis, it is proposed to constitute a Standing Technical Advisory Committee on Financial Regulation on similar lines as the RBI Technical Advisory Committee on Money and Government Securities Markets (TAC). The Committee would consist of experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. The Committee would examine the issues referred to it and advise RBI on regulations on an on-going basis covering banks and non-bank financial institutions and other market participants, in addition to the existing channels of consultations.

***(d) Monitoring of Systemically Important Financial Intermediaries (SIFIs)***

76. In consultation with the Chairman, SEBI and Chairman, IRDA, it has been decided to establish a special monitoring system for Systemically Important Financial Intermediaries (SIFIs). With increasing integration of financial markets, restructuring and consolidation in the financial sector, inter-linkages with subsidiaries and growing overlap of banking and non-banking activities of financial institutions, issues of systemic stability have acquired new dimensions that require a proactive stance so that the gains on financial stability are further strengthened. Hence, it has become necessary to set up a monitoring system in respect of SIFIs that would encompass: (i) a reporting system for SIFIs on financial matters of common interest to RBI, SEBI and IRDA; (ii) the reporting of intra-group transactions of SIFIs; and (iii) the exchange of relevant information among RBI, SEBI and IRDA. It has been agreed that, after co-opting a member from IRDA, the present RBI-SEBI Technical Committee, would propose a list of SIFIs and advise on a reporting system in a time-bound manner over the next three months.

***(e) Standing Committee on Procedures and Performance Audit on Public Services***

77. The Reserve Bank renders services to the public in areas such as distribution and exchange of currency and coins; issuance, redemption and servicing of government securities and relief bonds; payments/receipts related to government transactions, etc. It has been the continuous endeavour of RBI to improve the quality of its public services to the common persons and reduce transaction costs as well as time both for RBI and the citizens/ organisations concerned. With the setting up of a Regulations Review Authority (RRA) and Grievances Redressal Cells at Regional Offices of RBI, there has been considerable improvement in this regard. In order to benchmark the current level of service, review the progress periodically, enhance the timeliness and quality, rationalise the processes taking account of technological developments, and suggest appropriate incentives to facilitate change on an ongoing basis, it is now proposed to set up a Standing Committee. The Standing Committee will have two functions: (i) to undertake procedure and performance audit on public services and regulatory clearances in RBI as described above, and (ii) advise and co-ordinate with the *Ad hoc* Committees on

Customer Services proposed below to be set up by banks for rationalisation of instructions on procedures prescribed by RBI that impinge on the customer services of banks. The Standing Committee will submit an annual report to RBI on its work to be placed before the Board of RBI.

***(f) Ad hoc Committees on Procedures and Performance Audit on Customer Services in Banks***

78. In order to support broad-based improvement in customer services in relation to various banking services, each commercial bank is advised to constitute an *Ad hoc* Committee to undertake procedures and performance audit on public services rendered by the bank. The Committees would look into simplification of procedures and practices with a view to safeguarding the interests of common persons, be they current or savings account holders, depositors or borrowers, from any unfair procedural practices by banks, *e.g.,* delayed credit of interest, handling of deceased accounts, release of mortgage documents, reversal of erroneous entries in credit cards, updation of passbooks, transparency of charges levied on customers, unilateral debits in the customer accounts, foreign exchange transactions, etc. The Committees would also review service to the customers in respect of: (i) meeting their demands for fresh/good notes and coins of all denominations, (ii) exchanging soiled notes, (iii) adjudicating mutilated notes, and (iv) accepting coins and notes either for transactions or in exchange. Further, the Committees would look into regulations and procedures prescribed by RBI that impinge on customer service of banks and make suitable recommendations for elimination/rationalisation and interact with the RBI Standing Committee on Procedures and Performance Audit on Public Services keeping in view the need to drastically reduce the cost and improve the ease of conducting transactions both for banks and customers. Each *Ad hoc* Committee is expected to complete its work in six months from the date of constitution.

***(g) Working Group on Development Finance Institutions***

79. Pursuant to the recommendation of the Narasimham Committee II, and the RBI Discussion Paper on “Harmonising the Role and Operations of Development Financial Institutions and Banks” released in January 1999 for wider public debate, the regulatory approach to Development Finance Institutions (DFIs) was spelt out in the annual policy Statement of April 2000. The approach so finalised, suggested that any DFI intending to transform into a bank, could approach RBI or convert itself into an NBFC. Since then, ICICI has completed the process of transition to a bank and IDBI is in the process of doing so. In order to address the regulatory and supervisory issues relating to remaining term lending institutions and refinancing institutions and for improving the flow of resources to them, it is proposed to set up a Working Group on Development Finance Institutions. The Group would examine, within the broader framework of regulation of NBFCs, various regulatory and supervisory aspects, including access to short-term resources for the DFIs as a separate category, and submit its report in four months.

***(h) Corporate Governance***

80. As indicated in the mid-term Review of October 2002, the Consultative Group of Directors of Banks and FIs (Chairman: Dr. A.S. Ganguly) had made several recommendations covering constitution and functioning of Boards, access to information to Board members, audit committees, internal control and financial reporting. Similar recommendations have also been made by the SEBI Committee for banks listed in stock exchanges. It is proposed, through a consultative process, to: (i) harmonise the approaches suggested by the Ganguly Committee and the SEBI Committee in regard to banks, and (ii) extend the above principles of good corporate governance practices to PDs, NBFCs and other financial institutions, as appropriate.

**Urban Co-operative Banks**

81. As indicated in the annual policy Statement of April 2003, following the recommendations of the Committee set up by the Government (Chairman: Hon. Shri Anant Geete), relaxation for classification of NPAs was given to urban co-operative banks (UCBs) in respect of gold loans and small loans, placement of investments with other scheduled UCBs and limits on unsecured advances. Further, in pursuance to the Joint Parliamentary Committee (JPC) recommendations, guidelines were issued for timely compliance with inspection reports, mandatory concurrent audit and sanction of loans and advances by UCBs to their Directors.

**Technology Upgradation**

82. The Reserve Bank has been playing a pivotal role in the upgradation of technology in the banking sector with the objective of putting in place a safe, secure, robust, efficient and integrated payment and settlement system that will function on-line in a real-time environment. The National Payment Council (NPC) with representation from the industry is an important part of this process. The Reserve Bank has also been making sustained efforts to implement an integrated and efficient payment system through: (i) integration of financial entities through the INFINET; (ii) encouraging retail electronic mode of payment including implementation of electronic funds transfer (EFT) system; (iii) establishing the negotiated dealing system (NDS) and (iv) introduction of real time gross settlement (RTGS) system. In addition, the funds transfer module of centralised fund management system (CFMS) would be implemented by December 2003. The national settlement system (NSS) is expected to be operational by June 2004 which would integrate the segmented clearing and settlement infrastructure in the country and enable more effective funds management by banks. Further measures in this direction are given below:

***(a) Implementation of RTGS***

83. As indicated in the annual policy Statement of April 2003, RBI has commenced implementation of a RTGS system in a phased manner. As a first stage, a demonstrable version of the RTGS system was implemented in June 2003, and hands-on practice was given to the officials of 104 banks. In the next stage, after acceptance testing and trial run, the standalone RTGS system is scheduled to be operationalised by January 2004. In

the final stage, a fully functional RTGS system is expected to be made operational by June 2004. This system would be fully integrated with the integrated accounting system of RBI. Banks and PDs are required to ensure complete readiness in terms of infrastructure, systems and procedures, and adequate trained manpower to effectively participate in the RTGS system. As RTGS services are to be offered by banks through their branch network, it is essential that banks should put in place necessary connectivity between their branches and the payment system gateway through which banks will interact with the RTGS system.

***(b) Intra-day Liquidity under RTGS***

84. With the commencement of RTGS, the likely increase in requirement of intra-day funds would necessitate provision of intra-day liquidity (IDL) to participants for a smooth and timely settlement process. The Reserve Bank would be providing collateralised intra-day liquidity support to the participants. In this context, RBI had a number of consultations with market participants in respect of criteria for fixation of limits for IDL, eligible collateral and other related issues. In order to facilitate smooth transition to RTGS environment, market participants are advised to devise strategies for efficient cash flow management.

**Central Database Management System**

85. The Reserve Bank has established a central database management system (CDBMS), an enterprise wide data warehouse, built around an integrated repository of current and historical data which serves as a state-of-the-art decision support system within RBI. The system is web-based and has been available for access and analysis to users in RBI since December 2002. It is proposed to place the relevant data in CDBMS in public domain for the convenience of researchers and other users. Accordingly, an Expert Group is being constituted to guide this process, particularly through an assessment of user requirements. It is expected that these data would become available on-line by end-June 2004.

**Conduct of Government Business**

***(a) Enhancement in Agency Arrangement***

86. Hitherto, public sector banks were authorised to undertake government business as agents of RBI. In order to provide a wider network for public convenience and timely conduct of government business, four private sector banks, *viz.*, HDFC Bank, UTI Bank, ICICI Bank and IDBI Bank were authorised to handle government transactions such as revenue collection, pension payments and expenditure related functions of all Central Government Ministries/Departments with effect from October 1, 2003. It is proposed to carefully review the efficiency and dependability of services being rendered by all the banks concerned, and also reset the commission payable capturing the economies of scale afforded by new technologies as well as greater competition.

***(b) On-line Tax Administration System***

87. At the request of the Central Board of Direct Taxes (CBDT), RBI has constituted a High Powered Committee for operationalising an On-line Tax Administration System (OLTAS). Under the OLTAS, tax collection by banks would be credited on-line to government account by the next day. Corresponding tax information would also flow on-line to the Income Tax data base. Successful pilot studies have already been conducted in eight major centres in respect of corporate tax assessees. The scope of the pilot studies will be widened progressively to cover individual assessees and more centres.

88. A decision has also been taken to pay tax refunds through the electronic clearing services (ECS) to assessees in select cities where banks presently offer this facility. To begin with, as a pilot project, tax refunds up to Rs.25,000 are proposed to be made through the ECS to the beneficiaries in these select cities.

**Developments in Currency Management**

89. As indicated in the annual policy Statement of April 2003, the Clean Note Policy adopted by RBI was further facilitated by special measures and mechanisation of note processing activity in all the Issue Offices of RBI. In order to support the system for handling notes in a de-stapled condition, banks were advised to provide necessary infrastructure like note banding machines and note counting/sorting machines. While most of the currency chests have de-stapled the stock of stapled notes, a number of banks have given wide publicity regarding non-stapling of note packets. In order to expand distribution channels for fresh notes and coins and withdraw soiled notes from circulation, banks were also advised to increase the number of currency chests and small coin depots, accept soiled notes and coins in exchange, offer facilities for adjudication of mutilated notes and stock their ATMs adequately. In addition, RBI has also adopted an innovative procedure of using Post Offices for distribution of coins. The Reserve Bank accords a very high value to the convenience of common persons and while the phenomenal progress made in the recent period by banks is appreciated, further progress in this regard is urged, as a collaborative effort between RBI and banks.

**Deposit Insurance**

90. It was indicated in the mid-term Review of October 2002 that a joint team of officials from the Government, RBI and Deposit Insurance and Credit Guarantee Corporation (DICGC) studied the Federal Deposit Insurance Corporation (FDIC) model and other regulatory and supervisory agencies in the US in order to evolve a suitable system for India for converting DICGC into the Bank Deposit Insurance Corporation (BDIC) as announced in the Union Budget 2002-03. Based on the team’s report, a draft outline of the BDIC Bill 2003 to replace the DICGC Act 1961 was submitted for consideration of the Government.

**Annexes**

91. The movement of cross-border capital flows, especially in the areas of outward

foreign direct investment, inward direct and portfolio investment, non-resident deposits and external commercial borrowing were liberalised further. A list of measures relating to current and capital accounts announced subsequent to the presentation of annual policy Statement of April 2003 is given in Annex I**.**

92. In recent years, the Reserve Bank has been undertaking extensive consultations with banks, market participants and experts before deciding on major policy issues relating to the financial sector. In addition, several Working Groups were set up to consider proposed new measures that were likely to have significant impact on the financial sector and to examine various policy issues. Where necessary, the reports of the Working Groups were also put on the RBI website for wider dissemination and for inviting comments. The details of the progress made in respect of certain Working Groups constituted recently are given in Annex II.

93. The sweeping changes in the financial sector and the innovations in information technology have underpinned the need for corresponding changes in the legal structure. The Reserve Bank in co-ordination with the Government has taken necessary initiatives in this direction and the progress made so far is given in Annex III.

**Mumbai**
**November 3, 2003**

## Annex I. Recent Foreign Exchange Liberalisation Measures: Current and Capital Accounts

### *Corporates*

1. Banks permitted to offer foreign currency-rupee options.

2. All companies, irrespective of the extent of foreign equity in the shareholding, are permitted on the automatic approval route to make royalty payments at 8 per cent on exports and 5 per cent on domestic sales without any restriction on the duration of royalty payments.

3. Remittance of premium for the rejection risk insurance policies taken by exporters for export of seafood and other perishable food/food products from an insurer outside India permitted.

4. Authorised dealers (ADs) allowed to grant permission to exporters for opening/hiring of warehouses abroad initially for one year and renewal thereof subject to certain conditions.

5. Units in domestic tariff areas (DTAs) allowed to make payment in foreign currency towards goods supplied to them by units in special economic zones (SEZs).

6. Limits for submission of documentary evidence of all import remittances made into

India enhanced from US $ 25,000 to US $ 1,00,000. For select importers the limit for accepting exchange control (EC) copy of bill of entry for import remittances enhanced from US $ 1,00,000 to US $ 1 million.

**Capital Accounts**

7. Revised directions have been issued liberalising and simplifying the procedure for imports.

8. Project/service exporters allowed to pay their Indian suppliers/ service providers in foreign currency from their foreign currency accounts maintained in India for execution of such projects.

9. Realisation of export proceeds up to 360 days from the date of shipment allowed for export of books on consignment basis.

10. General permission accorded to Indian companies, to grant rupee loans to their employees who are non-resident Indians or persons of Indian origin for personal purposes including purchase of housing property in India.

***Resident Individuals***

1. Limits for release of foreign exchange for employment abroad, emigration, maintenance of close relatives abroad, education abroad increased to US $ 1,00,000 on the basis of self declaration.

2. Limit for release of foreign exchange for medical treatment abroad without estimate from a hospital/doctor increased from US $ 50,000 to US $ 1,00,000.

3. Limit for remittance towards consultancy services from outside India raised from US $ 1,00,000 to US $ 1 million per project.

4. Resident individuals maintaining a foreign currency account with an AD in India or a bank abroad are free to obtain international credit cards issued by overseas banks and other reputed agencies. While no monetary ceiling is fixed by RBI for remittance under the facility, the applicable limit would be the credit limit fixed by the card issuing banks.

5. Diplomatic missions, diplomatic personnel and non-diplomatic staff of foreign embassies allowed to maintain foreign currency deposit accounts.

6. Resident individuals permitted to take interest free loan from close relatives residing outside India up to US $ 250,000 with a minimum maturity period of one year.

7.Balances in the exchange earners foreign currency (EEFC) and resident foreign currency (domestic) RFC(D) accounts allowed to be credited to NRE/ FCNR(B) accounts, at the option of the account holders consequent upon change of their residential status from resident to non-resident.

***Investments***

1. Existing non-resident shareholders allowed to apply for issue of additional equity shares or preference shares or convertible debentures over and above their rights entitlements and the investee company can allot the same, subject to the condition that the overall issue of shares to non-residents in the total paid-up capital of the company does not exceed the sectoral cap.

2. Foreign institutional investors (FIIs) permitted to trade in exchange-traded derivative contracts approved by SEBI subject to the limits prescribed by the latter.

3. Non-resident Indians (NRIs) permitted to invest in exchange-traded derivative contracts approved by SEBI out of INR funds held in India on non-repatriable basis subject to the limits prescribed by SEBI.

4. Foreign Embassy/Diplomat/Consulate General allowed to purchase/sale immovable property in India other than agriculture land/plantation property/farm houses.

## Annex II. Working Groups: Progress Report

***Flexibility in Interest Rate***

It was indicated in the annual policy Statement of April 2003 that a Working Group was constituted (Chairman: Shri H.N. Sinor) with members from major banks and RBI to examine various issues concerning the deposit rates including floating rate of interest on fixed deposits. The recommendations of Working Group are being examined.

***Short-term Liquidity Forecasting Model***

As indicated in the annual policy Statement of April 2003, the short-term liquidity forecasting model developed by RBI under the guidance of an Advisory Committee of academics was operationalised for internal evaluation. The results of the model are being used by RBI for policy analysis and assessment since November 2002. The generic form of the model has been made available on RBI website for suggestions and comments. Performance of the model is being monitored and is being updated on an on-going basis.

***Cheque Truncation Model for India***

As indicated in the mid-term Review of October 2002, a Working Group (Chairman: Dr. R B. Barman, Executive Director) on cheque truncation and e-cheques was set up to examine various models of cheque truncation and to suggest an appropriate model suitable for the Indian conditions. The major recommendations of the Group are: (i) truncation of physical cheques at the place of first deposit (presenting bank) and settlement on the basis of the current structure of the MICR fields, (ii) targeting the four metro centres in the first phase including all banks and all clearings at a centre from a cut-off date, (iii) single agency or individual drawee banks as the points of storage and (iv) public key infrastructure (PKI) for protection of data and image flow over the network. It is proposed to implement the project on a pilot basis in a metro centre within a year.

## Annex III. Legal Reforms: Review of Developments

### *Bills Passed by the Parliament*

- Fiscal Responsibility and Budget Management Act, 2000.
- National Bank for Agriculture and Rural Development (Amendment) Act, 2003.
- Central Vigilance Commission Act, 2003.

### *Bills Under Consideration of the Parliament*

- Financial Companies Regulations Bill, 2000.
- Banking Regulation (Amendment) Bill, 2003.
- Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003.

### *Legislative Proposals Under Consideration of the Government*

- Payment and Settlement Systems Bill, 2002.
- Amendments to Reserve Bank of India Act, 1934.
- Draft Bill on Credit Information Bureau Regulation.
- Bank Deposit Insurance Corporation Bill.