Monetary And Credit Policy For The Year 1999-2000

The Statement consists of three parts: (I) Review of Macro-economic and Monetary Developments during 1998-99, (II) Stance of Monetary Policy for 1999-2000 and (III) Changes in Monetary and Credit Policy measures.

I. Review of Macro-economic and Monetary Developments: 1998-99

Domestic Developments

2. According to the preliminary estimates of the Central Statistical Organisation (CSO),the GDP growth in 1998-99 is likely to be 5.8 per cent as compared with a growth rate of 5.0 per cent for 1997-98. The increase in the growth rate in 1998-99 is largely due to the turnaround in the output from 'agriculture and allied activities' from (-) 1.0 per cent in 1997-98 to 5.3 per cent in 1998-99, and to the continued good performance of the services sector. The manufacturing sector is estimated to have registered only a modest growth. The index of industrial production during the first eleven months of 1998-99 showed an increase of only 3.9 per cent as compared with the growth of 6.9 per cent in the corresponding period of the preceding year.

3. In the monetary and credit policy statement of April 1998, the growth rate of GDP was projected to be in the region of 6.5 to 7.0 per cent in 1998-99. In the October statement, in view of continued slow down in industrial activities, the growth projection was lowered to 6.0 per cent. As per the latest estimates, the actual outcome in terms of rate of growth is thus likely to be somewhat lower than anticipated.

4. The rate of inflation on a point to point basis, as measured by the Wholesale Price index (WPI), was placed at 5.0 per cent at the end of 1998-99 as compared with 5.3 per cent in 1997-98. The actual outcome in respect of inflation was in line with the projected rate of 5-6 per cent in the April statement. It was also in line with expectations in October when the inflation rate, which had increased sharply during September-October 1998 due to supply problems in respect of a few agricultural commodities, was expected to reverse itself in the subsequent months of the year.

5. During 1998-99, the annual on a point-to-point basis growth in M_3 was 17.8 per cent as against 17.9 per cent in 1997-98. Expansion of primary liquidity at the end of the year was higher than the last year's rate, with reserve money increasing by 14.5 per cent as against an increase of 13.2 per cent in the previous year. Aggregate deposits of the scheduled commercial banks increased by 18.5 per cent as against 19.7 per cent in the previous year. It may be mentioned that almost the entire increase in the aggregate deposits was due to increase in time deposits (over Rs.1,00,000 crore) partly on account of the reduction in the maturity period of term deposits from 30 days to 15 days. The sharp increase in time deposits may also reflect the increase in personal disposable income due to implementation of the Pay Commission recommendations which could have added to financial savings in various forms, including time deposits.

6. The conventional non-food bank credit showed a lower expansion of Rs.37,594 crore

(12.1 per cent) as against an increase of Rs.40,789 crore (15.1 per cent) in the previous year. The total flow of funds from scheduled commercial banks to the commercial sector including banks' investment in bonds/debentures/shares issued by public sector undertakings and private corporate sector and commercial paper, etc., may be placed at Rs.54,304 crore as against an increase of Rs.53,377 crore in the corresponding period of the previous year. Total resource flow to the commercial sector including capital issues, GDRs and borrowings from financial institutions would be lower at Rs.1,04,635 crore than that of Rs.1,06,100 crore in the previous year.

7. Food credit expansion during the year was of the order of Rs.4,331 crore as against Rs.4,889 crore in the previous year. Scheduled commercial banks' investments in government securities increased by Rs.35,787 crore during the year as against Rs.28,067 crore in the previous year. The share of lending to Government in the overall deployment of resources by the scheduled commercial banks during the year was substantially larger than in the

8. As per Revised Estimates in the Union Budget, gross fiscal deficit of the Central Government (inclusive of small savings) for 1998-99 was higher at 6.5 per cent of GDP as against the budgeted figure of 5.6 per cent. (Gross fiscal deficit for 1998-99 would work out to 4.5 per cent, excluding small savings and on the basis of the new series of GDP.) As a result, gross market borrowing exceeded the budgeted level by around Rs.15,000 crore. The net market borrowing was Rs.62,903 crore for the year 1998-99 and gross market borrowing was Rs.93,953 crore (as against the budgeted level of Rs.79,376 crore).

9. Continuing large fiscal deficits year after year in 1990s have led to sharp increases in repayment obligations and a reduction in average maturity profile of outstanding public debt. In 1991-92, the gross and net borrowing of the Central Government stood respectively at Rs.8,988 crore and Rs.8,001 crore in a ratio of 1 : 0.89. Thus, for every rupee of fresh borrowing, the Government received 89 paise in net terms. In 1998-99, the gross and net borrowing stood respectively at Rs.93,953 crore and Rs.62,903 crore in a ratio of 1 : 0.67. Thus, the net receipt for every rupee of borrowing is now only 67 paise. Yet another consequence of larger borrowing is the very high increase in interest payments on public debt touching Rs. 43,712 crore in 1998-99 (RE). Interest payments on public debt in 1991-92 were only Rs. 14,021 crore. Obviously, this process cannot go on indefinitely.

10. The enlarged borrowing programme of government has also put pressure on the absorptive capacity of the market. The banking system now holds government securities of around 33 per cent of its net demand and time liabilities as against the minimum requirement of 25 per cent. In terms of volume, holdings above the Statutory Liquidity Ratio (SLR) amount to Rs. 56,000 crore which is almost equivalent to the net borrowing budgeted for 1999-2000.

11. Despite large scale gross borrowing by the Government, contrary to market expectations at the beginning of the financial year, the medium and long-term interest rates during the course of the year remained fairly stable. In order to moderate the adverse impact of Government's large borrowing programme on interest rates, in June 1998, the Reserve Bank had announced its intention to accept private placement of government securities from time to time (in the event of markets' bids being at substantially higher levels due to uncertainties in the market) and release

them to the market as conditions improved. This approach, namely, of accepting private placement and combining it with active Open Market Operations (OMO), proved effective in meeting large borrowing requirements of the government without causing undue pressure on interest rates. The yield on medium term Government paper (of 5-year maturity) in March 1999 was only 12 basis points higher than in April 1998. The yield on 10-year paper in March 1999 was actually 5 basis points lower than in April 1998. However, it is obvious that sooner or later, the pressure on market interest rates will become unavoidable unless fiscal deficit of the Government and its borrowing requirements are kept within reasonable limits.

12. It is also significant that the above strategy (i.e., private placement combined with active OMO) did not lead to an undue expansion of Reserve Bank's credit to Central Government and the reserve money. In fact, latest data show that RBI credit to Central Government during 1998-99 may be somewhat lower than the previous year. As on April 16, 1999, i.e., a week before the final closing of Government accounts for 1998-99, the net RBI credit to Central Government was Rs. 12,565 crore as against Rs. 12,914 crore in 1997-98.

13. Developments during the past year illustrate the dilemma faced by monetary authorities in a situation of uncertain macro-economic outlook in respect of inflation and growth, alongside high monetary growth. When the current rate of inflation is low, a high rate of growth in money supply nevertheless warrants tightening of liquidity (and increase in interest rates) in order to dampen aggregate demand and to avoid potential problems. However, if growth of output is also low, tightening of money supply during a period of relatively low inflation may result in a further loss of output. This in turn could result in lower revenue and the need for Government to borrow further. A similar dilemma arises when inflation rate accelerates because of supply shocks which are expected to be temporary. This, for example, was the situation last year when, until October, inflation was accelerating due to lower availability of a few primary commodities. The Reserve Bank at that time chose not to tighten monetary policy in the expectation that the price rise would reverse itself later in the year when agricultural supplies improve. In retrospect, this judgement turned out to be correct. However, if it had not, and inflation had accelerated further, monetary policy would have required much sharper tightening in the subsequent months of the year.

14. There are thus no simple objective or 'quantitative' answers to monetary policy dilemmas of this type in the short-run. There is no option but to carefully balance conflicting considerations, and for the monetary authority to be prepared to reverse its 'stance' of policy if actual outcome happens to be substantially different from what was expected. As the past experience in India and indeed in other countries, including industrial countries, shows, flexibility in respect of monetary policy may have to be exercised in both directions, i.e., tightening as well as loosening as circumstances warrant.

External Developments

15. The 18-month period since September 1997 has presented major challenges for management of the external sector. The East Asian crisis, while showing some signs of abatement, continues to be a matter of concern. In addition, Russia was affected by a severe crisis in August 1998 which had global repercussions. Brazil came under severe pressure earlier

this year, and economic outlook in Japan as well as Europe continues to be uncertain. In addition to the unfavourable external situation, after the Pokhran test last year, India was also confronted with certain other developments. Among these developments were: the economic sanctions imposed by several industrial countries, the suspension of fresh multilateral lending (except for some sectors), the downgrading by international rating agencies and the reduction in investment by Foreign Institutional Investors (FIIs). Faced with these and other unfavourable developments, the Reserve Bank had to, from time to time, take recourse to monetary and other measures in order to bring about orderliness in the foreign exchange market.

16. Viewed against the above background, developments in respect of both the exchange rate of the rupee as well as movements in foreign exchange reserves have been reasonably satisfactory. At the end of the financial year 1998-99, despite pessimistic prognostications by several experts and market operators, foreign currency assets of the country have increased significantly in both absolute and net terms (i.e., excluding forward liabilities). In absolute terms, the increase in foreign exchange reserves during the year was US $ 3.1 billion. After excluding forward liabilities, the increase during the year was US $ 4.1 billion. Since August 20, 1998, when certain measures were announced by the Reserve Bank to stabilise the forex market, the increase in reserves has been even more impressive. The increase was US $ 5.5 billion in absolute terms and US $ 6.2 billion net of forward liabilities. At the present level, foreign exchange reserves substantially exceed the total stock of short-term and portfolio flows. As a matter of cautious policy, India will continue to keep its short-term as well as forward liabilities at a low level in relation to the size of its reserves.

17. The day to day movements in exchange rates are market-determined and will continue to remain so. The primary objective of the Reserve Bank in regard to the management of the exchange rate is to maintain orderly conditions in the foreign exchange market, and to curb destabilising and self-fulfilling speculative activities. To this end, as in the past, the Reserve Bank will continue to monitor closely the developments in the financial markets at home and abroad, and take such monetary and administrative actions as may be considered necessary from time to time.

18. During 1998-99, the current account deficit is likely to be about 1.0 per cent of GDP, much lower than that recorded in 1997-98 (1.6 per cent). In the year 1999-2000, the current account deficit is projected to be around 1.5 per cent of GDP.

19. An area of current concern in regard to balance of payments relates to the growth of exports. During 1998-99 (upto February), exports have declined by about 2 per cent in US dollar terms. While this is partly attributable to sluggish growth in world trade, the importance of accelerating the growth of exports cannot be over-emphasised. An important priority for the current year, therefore, would have to concentrate on taking all possible measures to provide maximum support to export efforts. In line with this objective, the Reserve Bank had announced a series of measures in February 1999 to make available export credit in foreign currency to exporters at internationally competitive interest rates (with a maximum spread of 1.5 per cent over the LIBOR). Among the new measures to improve the delivery of such credit to exporters are: the provision of ‘On Line credit’ to exporters, the extension of ‘Line of Credit’ for longer duration for exporters with good track record, the peak/non-peak credit facilities to exporters, the

permission for inter-changeability of pre-shipment and post-shipment credit and meeting the term loan requirements of exporters for expansion of capacity and the moderni-sation of machinery and upgradation of technology. Necessary relaxations have also been made in the procedure for handling of export documents, fast track clearance of export credit at specialised branches of banks and introduction of a system of periodical submission of statement of LCs or export orders. These measures should help in ensuring timely availability of export credit in foreign currency and removing procedural hassles.

20. A committee of bankers has also been set up to ensure that procedural problems coming in the way of 'exporters', particularly small exporters, from utilising these new facilities are removed forthwith. This committee will interact closely with branch managers as well as exporters, particularly in locations where there is concentration of small and medium scale exporters.

21. Exporters are also being currently provided post-shipment and pre-shipment credit in rupee terms at a concessional rate of 10 per cent. While this rate, in nominal rupee terms would appear higher than the prevailing international interest rates, the foreign currency forward premium in forex market in India is also higher at around 7 per cent for 6 months. An exporter can thus avail of rupee pre-shipment credit at 10 per cent and sell expected export earnings in the forward market, effectively reducing interest cost to only around 3 per cent. Exporters now have the choice of reducing their interest costs to (or below) international levels either through this route or by availing of foreign currency loans.

22. Exporters currently enjoy a facility to retain a portion of their earnings to be utilised for certain purposes under the scheme of Exchange Earners' Foreign Currency (EEFC) accounts. Over a period, improvements have been made in the EEFC scheme by enhancing the retention percentage as also purposes for which the balances in the account can be utilised. Presently, the entitlement is 50 per cent for all foreign exchange earners and 70 per cent for exporters coming under the categories of export oriented units (EOUs) or of those who operate in export processing zones, etc. These balances can be presently utilised for all trade related expenses outside India as also for payment to residents in foreign exchange in consideration of supply of goods and services, and approved capital account transactions. In response to suggestions received from exporters, the facility to issue cheques against EEFC balances is also being granted with effect from May 1, 1999. Banks in India, having such accounts, will be authorised to issue separate cheque books for operation of these accounts.

23. At present, one of the conditions subject to which Indian exporters are allowed to open trading offices abroad is that the trading offices should not create any financial liabilities, contingent or otherwise on the Head Office in India. The Reserve Bank has been receiving representations from trade bodies to permit overseas trading offices to avail of credit facilities abroad to enable their overseas offices to expand their activities. It has been decided to grant approvals for loans/guarantees in respect of overseas offices of export houses/trading houses/Star Trading Houses/Super Star Trading Houses provided the terms of such loans/ guarantees are reasonable.

24. The Government of India and Reserve Bank of India have from time to time liberalised

various facilities to Foreign Institutional Investors (FIIs), Foreign Direct Investors and Non-Resident Indians (NRIs). In line with the objective of simplifying administrative procedures and making these facilities investor friendly, the Reserve Bank last year completely dispensed with the need to apply for prior permission in respect of approved foreign direct investments or investments permitted under the automatic route. Recently, the Reserve Bank has announced certain major procedural simplifications in respect of NRI deposits and other financial transactions. With these changes, NRIs will not have to seek specific permission of the Bank for most transactions and will enjoy the same or better facilities than domestic residents for operating bank accounts in India.

25. A Regulation Review Authority has recently been set up to which foreign investors as well as NRIs, in addition to Indian citizens/institutions, can make suggestions for review of any regulation or requirement of RBI which affects them.

26. With effect from June 11, 1998, Foreign Institutional Investors were permitted to take forward cover from Authorised Dealers to the extent of 15 per cent of their existing investment as on that date. Any incremental investment over the level prevailing on June 11, 1998 was also made eligible for forward cover. It is learnt that not much use has been made of this facility so far. The Reserve Bank will encourage FIIs to take full advantage of this facility. As a simplification measure, the above mentioned limits will henceforth apply to FIIs' outstanding investments as on March 31, 1999. In other words, 15 per cent of outstanding investment on March 31, 1999 as well as the entire amount - 100 per cent - of any additional investment made after this date will be eligible for forward cover. As a measure of further liberalisation, until further notice, any FII which has exhausted the limits mentioned above can apply to RBI for additional forward cover for a further 15 per cent of their outstanding investments in India at the end of March 1999. Applications for further additional limits can be made more than once after the earlier limits have been exhausted. It may be mentioned that a case-by-case approach for approval of *additional* limits would be preferred in order to avoid building up of large unutilised positions. This should reduce the risk arising from these positions being suddenly activated in the event of unexpected volatility in the forex markets.

II. Stance of Monetary Policy for 19992000

27. A major challenge for monetary policy in 1999-2000 is the need to reconcile the conflicting objectives of restraining the overall growth of liquidity in order to ensure price-stability, and at the same time facilitating the flow of adequate bank credit for productive sectors of the economy in order to improve growth. If industrial growth picks up, this may also help in restraining the Government's demand for additional credit from the banking sector.

28. The annual rate of inflation, after reaching a high of 8.8 per cent on September 26, 1998 has come down to 4.6 per cent in the week ended April3, 1999. Whether this trend will continue will not be known until July-August when the monsoon position would become clearer. Assuming a normal monsoon, and the absence of unanticipated supply shocks, it should be possible to maintain reasonable price stability during the current year without taking recourse to monetary measures. The fact that international commodity prices are expected to remain relatively soft should also contribute to the objective of maintaining price stability. Another

positive factor is that at present India's foreign exchange reserves are at a record level. The current level of buffer stock of foodgrains, wheat and rice at about 11 million tonnes and at 12 million tonnes respectively, is also a source of comfort for supply management.

29. Keeping the above considerations in view and the paramount need to raise industrial growth, the current stance of monetary policy will continue to be in the direction of facilitating adequate availability of liquidity along with stable medium and long-term interest rates, with policy preference for softening to the extent circumstances permit. This stance of monetary policy was reflected in the measures announced by the Reserve Bank on March 1, 1999. The repo rate was reduced by 2 percentage points and the Bank Rate and the Cash Reserve Ratio were reduced by 1 percentage point and one-half of one percentage point, respectively. Banks and financial institutions have also subsequently announced their decisions to lower prime lending rates.

30. During the past 18 months, the Bank Rate, repo rate and Cash Reserve Ratio (CRR) levels have been used more than once to meet short-term monetary policy objectives in the light of emerging domestic and external situations. The Bank Rate and short-term repo rate announced by RBI have been increasingly perceived by the markets as signals for movements in market rates of interest, in particular the call money rates. This development is significant in that it increases the range of instruments available to RBI for influencing developments in the money and term money markets. In particular, while movements in the Bank Rate should not be too frequent , the short-term repo rate can be varied much more flexibly, in both directions, to influence the flow and cost of funds in the short run. The variation in CRR has also served as one of the important instruments for regulating liquidity in the economy, and the recent experience shows that intra-year variations in CRR have been effective in meeting the short-term challenges in domestic money and forex markets. While the long-term objective of monetary policy will continue to be in the direction of reducing the average level of CRR, in the short-term, the level of CRR could be varied in both directions depending on the assessment of the overall monetary situation.

31. As pointed out in the preceding section, during 1998-99, the Reserve Bank had, in view of uncertainty in financial markets, deliberately adopted a policy of accepting private placement of Government securities initially and then unloading Government securities in the market through active Open Market Operations (OMO). This policy has proved to be a considerable success as large government borrowing requirements during the year were met with little or no increase in medium and long-term interest rates. The policy of careful management of Government borrowing requirements through a combination of auctions, private placement and OMO, will, therefore, need to be persevered with. However, it is obvious that in view of the large stock of outstanding Government debt with banks and other institutions, the above combination of policies would succeed in maintaining a stable interest rate environment only if Government's market borrowing requirements are kept within reasonable limits.

32. In the Monetary Policy Statement of April 1998, a mention was made of the Reserve Bank's intention to use multiple indicator approach for assessing the position of financial markets. The objective is to widen the range of variables that could be taken into account for monetary policy purposes rather than rely solely on a single instrument variable, such as, growth

in broad money (M_3). The experience of 1998-99 shows that money supply movements alone could not have provided adequate guidance for monetary policy initiatives during the year. The movements in money market rates of interest, exchange rates, foreign exchange reserves, credit to Government and commercial sector and fiscal position of the Government have been closely monitored and utilised for policy actions. The end result was that while liquidity conditions were kept easy, stability of prices, interest and exchange rates was also substantially secured, notwithstanding the increase in money supply.

33. It is against this background that there is a need for developing a robust short-term operational model, which takes into account the behavioural relationships among the different segments of the financial sector. Such an exercise would help improve understanding of the transmission mechanism of monetary policy in pursuit of objectives during the transition to greater financial integration. The changing dimensions of the financial sector also require that the collection of financial statistics in India is considerably enlarged. The recommendations of the Working Group on 'Money Supply: Analytics and Methodology of Compilation' have been helpful in this regard. Banks have been advised to provide data on their operations so that the compilation of money supply aggregates would be able to reflect better the liquidity position.

34. As highlighted in the previous section, monetary growth (M_3) in 1998-99 as well as in 1997-98 was well above the projected levels. Ideally, therefore, it would be desirable to aim at a lower M_3 growth in 1999-2000 than the rate of growth of 15.0 to 15.5 per cent projected for the previous two years. However, keeping in view the Government's market borrowing requirements, an unduly restrictive credit policy could militate against the need to enhance growth prospects. Keeping these considerations in view, a reasonable projection for M_3 growth in 1999-2000 would be in the range of 15.5 to 16.0 per cent. This range is well below the actual M_3 growth in each of the last three years.

35. Assuming normal monsoon and some recovery in industry, GDP growth in the current year is projected to be in the range of 6 to 7 per cent as compared with CSO's preliminary estimate of 5.8 per cent growth for the year 1998-99. Along with achieving this order of growth, an important macro-economic priority during the year would be to contain the inflation rate around the present level of about 5 per cent per annum (allowing, of course, for seasonal variations during the course of the year).

36. Consistent with a money supply growth of 15.5 to 16 per cent, a working estimate for the expansion in aggregate deposits of scheduled commercial banks is placed at Rs.1,18,500 crore (16.5 per cent) in 1999-2000. Non-food bank credit including investments in commercial paper, shares/debentures/ bonds of PSUs and private corporate sector is projected to increase by about 18 per cent. Availability of this order of credit should fully meet the demand of the productive sectors of the economy. Banks are advised to plan their credit operations on the assumption that sufficient liquidity would be available in the current year to finance additional production as per normal banking norms.

37. In sum, under normal circumstances - and barring unanticipated developments in domestic or international situation - the overall stance of policy for 1999-2000 will be: provision of reasonable liquidity; stable interest rates with policy preference for softening to the extent

circumstances permit; active debt-management, orderly development of financial markets, and further steps in financial sector reforms.

III. Financial Sector Reforms and Monetary Policy Measures

38. Monetary and Credit Policy statement of April and the ‘Mid-Term Review’ of October last year had focussed on ‘structural’ measures to strengthen the financial system and improve the functioning of various segments of the financial market. In the current year also, it is proposed to carry forward the direction of financial reforms initiated in recent years, keeping in view the actual experience in implementation, the current state of banks and financial institutions, and other pertinent developments.

39. As mentioned above, an immediate priority in the current year is to further facilitate the flow of credit to the commercial sector. In the past few months, the Reserve Bank has announced a number of measures to improve the credit delivery system particularly for agriculture, exports, small-scale industry and Information Technology. This statement briefly takes stock of the present position in this regard and announces certain further measures to improve credit delivery and reduce procedural problems. Another priority area in the current year is to ensure that our banking and payment systems are fully 'Y2K' compliant. As only a few months remain before the entire global financial system will be put to this test, the importance of paying the highest attention to this area can hardly be over-emphasised.

Cash Reserve Ratio

40. The Cash Reserve Ratio (CRR) to be maintained by scheduled commercial banks (excluding Regional Rural Banks) will be reduced by one-half of one percentage point from 10.5 per cent to 10.0 per cent effective fortnight beginning May 8, 1999. This reduction in CRR would augment the lendable resources of banks by about Rs.3,250 crore.

Interim Liquidity Adjustment Facility

41. In the October 1998 ‘Mid-Term Review’, it was indicated that the Reserve Bank broadly agrees with the Narasimham Committee’s suggestion that RBI support to the market should be through a Liquidity Adjustment Facility (LAF) operated by way of repo and reverse repos providing a reasonable corridor for market play. Pending further upgradation in technology and legal/ procedural changes to facilitate electronic transfer and settlement, it has now been decided to introduce an Interim Liquidity Adjustment Facility (ILAF) through repos and lending against collateral of Government of India securities. The features of this facility, are given below:

(i) The general refinance facility is being withdrawn with immediate effect. It will be replaced by a Collateralised Lending Facility (CLF) up to 0.25 per cent of the fortnightly average outstanding aggregate deposits in 1997-98 which will be available for two weeks at the Bank Rate. An Additional Collateralised Lending Facility (ACLF) for an equivalent amount of CLF will also be available at the Bank Rate plus 2 per cent. CLF and ACLF availed for periods beyond two weeks will be subject to a penal rate of 2 per cent for an additional two week period. There will be a cooling period of two weeks thereafter. The current restriction on participation in money market (during the period that such facilities are availed of) will

be withdrawn in order to facilitate systemic adjustment in liquidity.

(ii) Scheduled commercial banks are eligible for Export Credit Refinance Facility (ERF) at the Bank Rate (i.e., 8.0 per cent per annum) with effect from April 1, 1999. The existing facility for export refinance will continue.

(iii) Liquidity support against collateral of government securities, based on bidding commitment and other parameters, will be available to Primary Dealers at the Bank Rate and the amounts will remain constant throughout the year. Each drawal will, however, be subject to the usual restriction of repayment within 90 days. The limits for individual PDs will be announced separately.

(iv) Additional liquidity support against collateral of government securities will also be provided to Primary Dealers for periods not exceeding two weeks at a time and the interest rate will be at the Bank Rate plus 2 per cent. The limits for individual PDs will be announced separately.

(v) Absorption of liquidity in the market will continue to be through fixed rate repos.

(vi) The above facilities will be supplemented by open market operations in government dated securities and treasury bills by RBI.

42. Thus, the ILAF would provide a mechanism by which liquidity would be injected at various interest rates, and absorbed when necessary at the fixed repo rate, so that the volatility in the money market is minimised and the market operates within a reasonable range.

Development of Financial Markets

Money Market

43. To improve the transmission mechanism of monetary policy and develop further the money and debt markets in the light of the recommendations made by the Narasimham Committee it has been decided to develop the repos market with appropriate regulatory safeguards, such as, Delivery Versus Payment (DVP), uniform accounting, valuation and disclosure norms and restricting repos to instruments held in dematerialised form with a depository. These prudential safeguards have been designed to ensure transparency and accountability as also increasing at the same time liquidity and depth in the securities market.

44. Accordingly, it has been decided to allow UTI, LIC, IDBI and other non-bank participants in the money market to access short term liquidity through repos thereby facilitating their cash management and gradual move out of the call money market.

45. Detailed guidelines to widen further the number of participants in the repos market through exchange traded repos in debt instruments held in demat form under a tri-party arrangement, with adequate safeguards to manage risks, are also being finalised and will be issued shortly.

46. 'Cheque writing facility' by Money Market Mutual Funds (MMMFs) provides more liquidity to unit holders and hence has been advocated in the interest of savers. It has been decided to accept this suggestion and permit MMMFs to henceforth, offer 'cheque writing' facility to their investors.

47. Annexure I gives details of the various measures for developing the money market.

48. To facilitate hedging of interest rate risks and ensuring orderly development of the derivatives market, guidelines for interest rate swaps and Forward Rate Agreements (FRAs) are being issued separately.

Government Securities Market

49. Increasing the depth and liquidity in the government securities market is critical to the development of the debt market. With the number of primary dealers having now increased to thirteen (after three PDs were recently given final approval), it is expected that the PDs will play a greater role in the absorption of the primary issues and in market making. Accordingly, in consultation with PDs, it has been decided (a) to obtain minimum bidding commitment from each PD for the auctions of Treasury Bills so that together they absorb 100 per cent of the notified amount, and (b) to offer an enhanced underwriting option to PDs for the entire notified amount in auctions of dated securities.

50. The market participants have suggested that there should be a greater certainty in the timing and quantum of primary issues so as to give them sufficient time to plan their investments in government securities. It is therefore proposed to announce a calendar for issue of Treasury Bills for the entire year. As announced in the Monetary and Credit policy for the first half of 1998-99, it is also proposed to introduce 182-day Treasury Bill which will be issued every fortnight as part of the calendar.

51. Consolidation of outstanding loans is necessary for ensuring sufficient volumes and liquidity in any one issue. Such consolidation also facilitates the emergence of benchmarks and development of the Separate Trading of Registered Interest and Principal of Securities (STRIPS). Accordingly, it is proposed to have the option of issuing new loans on price basis instead of on yield basis as is done currently.

52. In order to promote the retail market segment, the Reserve Bank has taken a series of steps like extension of liquidity support to setting up of mutual funds dedicated to government securities, establishment and enlargement of a number of primary and satellite dealers and permission given to banks to freely buy and sell government securities on outright basis, etc. An in-house Group has been set up to look into the ways and mechanics of giving a boost to retailing of government securities. The Reserve Bank and Government of India would work out a package which will include publicity compaigns as well.

53. The details of measures relating to government securities market are at Annexure II.

Rationalisation of Interest Rates

54. At present, on the deposit side, only the saving deposit rate (which is at 4.5 per cent per annum currently) is prescribed by RBI. Banks are otherwise free to offer interest rates on deposits of any maturity above 15 days. They are also free to offer a fixed rate or a floating rate on term deposits. On the lending side, after deregulation, banks are free to prescribe their own lending rates, including the Prime Lending Rate (PLR), after duly taking into consideration their cost of funds, transaction cost and minimum spread. The only lending rates now prescribed by the Reserve Bank are the concessional rates (below the PLR of the respective banks) for certain sectors like exports, small loans of upto Rs.2 lakh, and under the Differential Rate of Interest scheme (DRI). Banks now have sufficient flexibility to decide their deposit and lending rate structures and manage their assets and liabilities efficiently. With a view to providing some more flexibility, the following measures in respect of interest rates are being introduced.

55. The PLR system with a spread between PLR and the maximum lending rate that is determined by the banks' Boards has been in operation for some time now and has by and large served the purpose of ensuring transparency and objectivity. Banks are currently permitted to operate, two PLRs - one for short term and the other for long term loans. There have been requests from Banks and borrowers for tenor linked PLR, i.e., PLR for different maturities. It has been decided to provide banks with freedom to operate different PLRs for different maturities provided the transparency and uniformity of treatment originally envisaged continues to be maintained.

56. Similarly, industry, especially those investors requiring project finance, have been requesting for fixity of interest rates on term loans. It has been decided to permit banks to offer fixed rate loans subject to conformity to ALM guidelines.

57. At present banks cannot charge interest on advances against fixed deposits at rates exceeding PLR. While PLR has been coming down, the interest rates on deposits have remained unaltered on the existing deposits. In certain cases this has resulted in the interest rate on advances based on PLR being lower than the interest rate on the deposits themselves. In order to remove this anomaly, it has been decided that in all such cases of deposit rate being in excess of PLR, advances to depositors against fixed deposits can be made by banks without reference to the ceiling of PLR and banks can charge suitable interest rates. This will be applicable both for domestic and non-resident deposits.

58. Banks have been representing that the present requirement that all changes in deposit rates and lending rates should be approved by the Board of Directors of the bank restricts the ability of banks to respond promptly to changes in interest rate environment. Accordingly, it has been decided that the Boards of Directors of banks may delegate necessary powers to Asset Liability Management Committee for fixing interest rates on deposits and advances subject to reporting to the Board immediately thereafter.

Prudential Measures

59. As a part of economic reforms, since the early nineties, the capital adequacy and other prudential norms of banks have been strengthened and currently are close to international

standards. In terms of inherent robustness, it is also well recognised that the Indian banking system's exposure to real estate or shares is negligible, while open foreign currency exposure limits are severely restricted. Their off-balance sheet liabilities are also very small due to regulatory restrictions while a relatively large part of banking system's assets are in secure investments particularly in government and other approved securities. These are important strengths of the Indian banks which contribute to the long-term financial viability of the banking system as a whole.

60. In the 'Mid-Term Review' of October 1998, certain important changes recommended by the Narasimham Committee in respect of prudential norms, risk weights and exposure norms were announced. These changes were designed to reduce the risk exposure of banks, strengthen their financial soundness, and contribute to improved profitability outlook. As a continuation of this process, the following measures are being notified shortly:

(i) With a view to adopting prudent accounting standards and moving towards 'mark to market' valuation of the investment portfolio, banks were advised to classify a minimum of 70 per cent of their investment in approved securities as current investments for the year ending March 1999. With effect from the year ending March 31, 2000, banks will have to classify a minimum of 75 per cent of their securities as current investments.

(ii) Banks were recently permitted to issue subordinated debt instruments for augmenting their Tier II Capital. It has been observed that there has been a high level of cross-holding of such instruments among banks and financial institutions, without necessarily leading to accretion of capital to the financial system. It has been decided that a bank's or a financial institution's investment in Tier II bonds issued by other banks be subjected to a ceiling of 10 per cent of the bank's or FI's total capital.

61. At present, in respect of advances where terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production, banks are required to classify them as sub-standard for at least two years of satisfactory performance under the re-negotiated or rescheduled terms. Banks have represented that in certain situations (e.g. cyclical downturn) where loans have been rescheduled, but where borrowers have started servicing their loans on a regular basis after a short gap, the prescribed waiting period of two years is much too long. It has been decided that the waiting period of two years may be reduced to one year (or four quarters) if the interest and instalment of loans have been serviced regularly as per the terms of rescheduling.

62. Banks and financial institutions, as well as borrowers, have represented that detailed prescription by the Reserve Bank regarding the concept of 'commencement of commercial production' is creating operational difficulties. This is more so in the case of services and infrastructure sectors where commencement of production is difficult to pinpoint. The position has been reviewed and as part of the process of moving away from micro-level regulations, the Reserve Bank has decided that henceforth it will be left to the Board of Directors of each bank to prescribe detailed rules for determining the date of commencement of commercial production of units.

63. The Reserve Bank has already issued guidelines to banks for setting up of Asset

Liability Management (ALM) systems. It is proposed to issue ALM guidelines to financial institutions as well. A draft of the proposed guidelines will be separately circulated to financial institutions for comments before finalisation.

Micro Credit and Venture Capital

64. Micro-credit Institutions and Self-Help Groups (SHG) are important vehicles for delivery of credit to self-employed persons, particularly women in rural and semi-urban areas. RBI, therefore, attaches particular importance to the work of NABARD and public sector banks in this area. A special cell, manned by a senior officer from the commercial banking sector with practical experience in this area, is being set up in RBI in order to liaise with NABARD and micro-credit institutions for augmenting the flow of credit to this sector. The time frame for the cell to complete its work will be one year and its proposals will be given the highest attention.

65. Several institutions engaged in micro credit have represented that interest rates applicable to bank loans extended to micro-credit organisations should be left free to be decided by banks as per normal policy and should not be linked to the interest rate ceiling applicable for direct small loans to individual beneficiaries. It is proposed to accept this suggestion. While direct loans below certain levels by banks will continue to be subject to the interest rate ceiling as prescribed by RBI from time to time, interest rates applicable to loans given by banks to micro-credit organisations or by these organisations to their members/beneficiaries will be left to their discretion. It is clarified that interest rates and other terms in respect of Government sponsored programmes, such as IRDP, will remain as they are, and there will be no change in applicable interest rate ceilings in respect of loans under Government programmes.

66. Incremental credit given to NBFCs by banks for on-lending to small road and water transport operators and to units in tiny sector of industry, over March 31, 1999, will also qualify for priority sector status.

67. In order to encourage the flow of finance for venture capital, the overall ceiling of investment by banks in ordinary shares, convertible debentures of corporates and units of mutual funds, etc., which is currently at 5 per cent of their incremental deposits will stand automatically enhanced to the extent of banks' investments in venture capital. It has also been decided to include investments in venture capital in priority sector lending.

Credit for Infrastructure

68. The Reserve Bank of India has been addressing important aspects of financing of infrastructure projects in view of the national importance attached to infrastructure development. RBI has finalised operational guidelines, in consultation with select banks and financial institutions for extending credit for such projects. Banks/FIs will be free to sanction term loans for technically feasible, financially viable and bankable projects undertaken by both public and private sector undertakings subject to prescribed criteria. Four broad modes of financing have also been identified, viz., financing through funds raised by way of subordinated debt, entering into take-out financing, direct financing through rupee term loans, deferred payment guarantee, foreign currency loans, etc., and investments in infrastructure bonds. These have been set in the

framework of asset-liability management and prudential exposure norms. Banks are also being permitted to issue inter-institutional guarantee subject to certain norms.

69. To ensure timely and adequate availability of credit, banks/FIs are advised to clearly delineate the procedure for approval of loan proposals and institute a suitable monitoring mechanism for reviewing applications pending beyond the specified period. Banks/FIs are urged to ensure close coordination with each other as also other agencies concerned in order to avoid repetitive appraisals and delays, and set up a mechanism for monitoring the project implementation.

Settlement Advisory Committee

70. Banks have taken several measures to reduce their NPAs through recovery drive, compromise settlements, etc. Guidelines have also been issued to banks in 1995 for entering into compromise settlements for recovery of NPAs. It has been represented that the present system and procedure of compromise settlement as it operates in reality, is often long drawn, discretionary and cumbersome. Accordingly, Government has directed public sector banks to set up Settlement Advisory Committees (SACs) so that chronic cases, specially those relating to the small sector, are settled in a timely and speedy manner. Accordingly, a scheme for Settlement Advisory Committee (SAC) has been finalised by RBI and details are being released separately.

Regulation of Non-Banking Financial Companies (NBFCs)

71. Pursuant to the amendment of the Reserve Bank of India Act, 1934 by the Parliament, RBI had instituted a comprehensive regulatory framework for NBFCs in January 1998. Out of about 8,802 applications of NBFCs which were eligible for registration on the basis of minimum Net Owned Funds (NOF) of Rs.25 lakh, registration has been granted to 7,555 NBFCs of which only 584 NBFCs have been permitted to accept public deposits and applications of 1,030 companies have been rejected. As many as 28,676 companies with NOF below Rs.25 lakh, as provided in the Act, have been given time upto January 8, 2000 to achieve the minimum NOF. Following the report of the Vasudev Committee, a number of changes have also been made in the regulatory framework for NBFCs in the light of the experience gained, so as to facilitate orderly growth of NBFCs. RBI has also launched a public information campaign so that depositors should satisfy themselves about the genuineness and soundness of NBFCs before they deposit their savings with them. RBI will continue to closely monitor the effectiveness of the regulatory framework for the NBFCs.

72. An examination of the data collected by RBI during the process of registration of the existing NBFCs has revealed that an important problem in their effective functioning is the low level of NOF of most NBFCs. Low capitalisation reduces their ability to withstand cyclical fluctuations in business and limits their ability to provide a minimum level of service to depositors as well as borrowers. Under the Act, RBI has been vested with the powers of enhancing the minimum NOF of NBFCs to Rs. 2 crore (as against the minimum limit of Rs.25 lakh at present). In respect of *new* NBFCs, which are incorporated on or after April 20, 1999 and which seek registration with RBI, it is proposed to raise the requirement of minimum NOF to Rs. 2 crore. This stipulation will not apply to NBFCs which are already registered with RBI or

whose applications are presently under consideration.

State Co-operative Banks

73. State Co-operative Banks are at present provided accommodation from the Reserve Bank towards general banking business such as clearing adjustments, liquidity, etc., at 'Bank Rate *plus* 2.5 percentage points'. Henceforth, it has been decided to provide such accommodation to State Cooperative Banks at the Bank Rate.

Urban Co-operative Banks

74. Co-operative banks, both in urban and rural areas, are a vital component of the institutional structure for providing banking services. In respect of urban co-operative banks, pursuant to the recommendations of the Marathe Committee (1992), the Reserve Bank has followed a liberal licensing policy. As a result, the urban co-operative banking structure has grown phenomenally in the recent past. Currently, there are as many as 1900 urban co-operative banks in the country. While a number of these are performing well, and are viable and profitable, a fair number are showing signs of persistent weaknesses in their portfolio. There are also certain other issues relating to entry point norms, uneven growth in different geographical regions, and branch licensing policy which require fresh consideration. In order to examine these and other relevant issues, it has been decided to appoint a High Power Committee to review the performance of the urban cooperative banks and suggest measures for strengthening this vital sector.

Payment and Settlement System and Y2K Compliance

75. In the last policy statement, the objective of moving eventually to an integrated payment and settlement system was mentioned. Towards this end, a number of initiatives have been taken. The VSAT (Very Small Aperture Terminal) based network is going to be in operation soon, and messaging standards and common applications to be on use on the network are being finalised. EFT (Electronic Fund Transfer) guidelines are being made user-friendly along with adequate security in place. Electronic clearing service both for credits and debits to cover bulk low value transactions such as dividend/ interest payments and collection of electricity bills, etc., is being expanded. The MICR cheque processing centres at the four metropolitan cities are being replaced by modern, state-of-the-art scaleable systems. Some public sector banks have set up MICR cheque processing centres in a number of other cities. The Reserve Bank will expand the VSAT based network in order to ensure that both funds and non-funds business are placed on an on-line basis as soon as possible. A National Payments Council with a Deputy Governor as the Chairman and representative membership is being constituted. It is planned to have Real Time Gross Settlement (RTGS) system in place in the next 15 to18 months.

76. The financial sector has responded reasonably well to the Reserve Bank's initiative in September 1997 to take necessary actions to be Y2K compliant. In March 1998, a Working Group under the Chairmanship of a Deputy Governor was set up to monitor the Y2K compliance on a monthly basis. The status on it was published in December 1998 by the Reserve Bank of India and was placed on the RBI website. Regular meetings between the banks and RBI in recent

months have helped to give confidence that the system would not carry the Y2K risk. The Chief Executives of banks are requested to continue to bestow high personal attention in the remaining part of the year to ensure that business continuity into the new millenium is assured. Besides, as a matter of caution, contingency plans would need to be set in place by banks quickly and reports on the same be forwarded to the Reserve bank. The information about the Y2K compliance position in the financial sector is being shared with the groups working on Y2K compliance in the rest of the economy.

Mid-term Review

77. A review of credit and monetary developments in the first half of the current year will be undertaken in October 1999. This mid-term review will generally be confined to a review of monetary developments and to such changes as may be necessary in monetary policy and projections for the second half of the year.

Annexure I

Measures for Developing the Money Market

(a) Call/Notice Money Market

It was indicated in the 'Mid-Term Review' of October 1998 that the Reserve Bank agrees, in principle, with the suggestion of the Narasimham Committee II and aims to ultimately move towards a pure inter-bank call/ notice/ term money market, including primary dealers. This will be implemented in a manner that the existing lenders in the market will have operational flexibility to adjust their asset-liability structure. Accordingly, the following measures are being introduced:

- First, with a view to enabling non-bank participants to deploy their short-term resources it has been decided to widen the repo market. Non-bank participation in a variety of other instruments will also have to be improved.

- Secondly, taking into consideration the transitional problems, it has also been decided to continue with the present system of permitting financial institutions and mutual funds to lend in the call/notice money market for some more time along with permission to participate in the repos market spelt out separately in this Statement. This measure is expected to give financial institutions and mutual funds some time to adjust their asset-liability structure and also help them to redeploy their short-term surpluses in other money market instruments.

- Thirdly, with a view to mitigating the problems of non-bank entities, the exact timeframe for phasing out the non-bank participants from the inter-bank call/notice money market will be synchronised with the development of the repos market and worked out after a review of developments in the next six months.

- Fourthly, it has been decided that permission given to non-bank entities to lend in the

call/notice money market by routing their call/ notice money market operations through Primary Dealers will be available only upto end- December 1999.

(b) Repos and Reverse Repos

At present, all scheduled commercial banks, co-operative banks, Primary Dealers and Satellite Dealers are permitted to undertake ready forward transactions in all Central Government securities including Treasury Bills provided the transactions are settled through SGL Accounts maintained at the Public Debt Office of the Reserve Bank of India, Mumbai. Non-bank entities as notified by the Central Government have also been permitted to lend money through reverse repos to other eligible participants. An internal sub-group of the Technical Advisory Committee on Government Securities Market recently looked into various aspects of the repos market, including issues such as the legal status, the regulatory framework and standardisation of accounting practices. In view of the recommendations of the sub-group, it is proposed that:

- Non-bank entities which are currently permitted to undertake reverse repos will henceforth be permitted to borrow money through repos on par with banks and Primary Dealers.

- To help develop the term money market as also the inter-bank money market as a purely 'inter-bank' market, it is clarified that the Reserve Bank would impose no restriction on the maximum period for which repos can be undertaken.

In the Monetary and Credit Policy for the First Half of 1997-98, it was decided to allow repos in such bonds which are held in demat form and where transactions are done on recognised stock exchanges. In so far as repos in PSU bonds and other corporate bonds are concerned, the proposals in the recent budget to abolish stamp duty on transfer of debt instruments within the depository mode will facilitate active repos in these instruments.

- The Reserve Bank proposes to allow repos in government securities (including State government securities), PSU bonds and other bonds of corporates and all India financial institutions held in demat form in depositories and transactions done in authorised stock exchanges provided certain critical conditions relating to ensuring daily mark to market, margin calls, delivery versus payment, etc. are fulfilled.

  Detailed guidelines will be issued shortly.

(c) Money Market Mutual Funds (MMMFs)

It has been observed that some liquid schemes of private sector mutual funds have started offering 'cheque writing' facility recently. Such a facility provides more liquidity to unit holders and hence has been advocated in the interest of savers. Hence, it is considered useful to give definitive framework for such a facility.

- It has, therefore, been decided to permit MMMFs to henceforth, offer 'cheque writing' facility to their investors. MMMFs being non-banks, cannot provide this facility directly. The 'cheque writing' facility has to be in the nature of a tie-up arrangement with a bank and subject to conditions that are being detailed separately.

Annexure II

Measures for Developing Government Securities Market

a) Dated Government Securities

Presently, the issuance of Government dated securities through auction is on the yield basis. This implies that each time the Government enters the market for borrowing, a new loan is issued with a separate nomenclature. This system has resulted in large number of issuances with differing coupons and interest payment dates affecting the liquidity in any one issue. In order to facilitate evolving benchmark securities and reissuance of existing Government dated securities, there have been suggestions from the market participants to consolidate the outstanding loans. This has been endorsed by the Technical Advisory Committee on Government Securities market as well.

- It is, therefore, proposed to exercise the option, whenever considered appropriate, of issuing Government dated securities on a price-basis.

It has been widely recognised that in order to widen and deepen the Government securities market, it is essential to diversify the investor base. In this context, retailing of the Government securities market assumes critical importance. Reserve Bank of India has already established a system of Primary Dealers and satellite dealers and liquidity support by RBI has been made available to them. Recently, the number of Primary Dealers have been increased. The RBI has announced special liquidity support for dedicated gilt funds. Banks have been allowed to freely buy and sell Government securities on an outright basis and retail Government securities to non-bank clients without any restriction on the period between the sale and purchase. With a view to enabling the dematerialisation of securities of retail holders, NSDL, SHCIL and NSCCL have been allowed to open SGL account with RBI.

- In order to further encourage the retail segment of the market, the Reserve Bank and the Government of India would jointly work out a package which will include promotion and publicity campaigns, etc.

b) Treasury Bills

While announcing the monetary and credit policy for the first half of 1998-99, a proposal was made to reintroduce 182-day Treasury Bills on a fortnightly basis. Due to market uncertainty, the same could not be implemented.

- It has been decided to commence auctions of 182-day Treasury Bills consistent with a calendar of issue for Treasury Bills.

At present, Treasury Bills of various maturities (viz., 364 days, 91 days and 14 days) are issued on auction basis. The 364-day bills are issued on fortnightly basis whereas 91-day and 14-day Treasury Bills are issued every week. While the date of issuance of the bills is known to the market in advance the information regarding the notified amount is announced prior to each

auction. A normally constant notified amount (with discretion to RBI to change the notified amounts if essential) in the Treasury Bill segment would be helpful in evolving a meaningful benchmark for pricing of money market instruments.

- Accordingly, it has been decided that the auction of 14-day and 91-day Treasury Bills will be held on a weekly basis (with the day of auction on Friday and day of payment on Saturday) and the auction of 182-day Treasury Bills and 364-day Treasury Bills will be held on a fortnightly basis (day of auction on Wednesday and day of payment on Thursday). The notified amounts in respect of the Treasury Bills auctions will be pre-announced for the whole year separately.

At present the State Governments are permitted to invest their surplus funds in 14-day and 91-day Treasury bills as non-competitive bidders. In order to give further fillip to the Treasury bills market as also to provide the State Governments more flexibility in their investments of surplus funds, it has been decided to permit the State Governments to put bids on non-competitive basis in the auctions for 182-day and 364-day Treasury bills as well.

- It has also been decided to allow the State Governments to avail of Special Ways and Means Advances (WMA) against the collateral of their investments in Treasury Bills in addition to their holdings in dated Government of India securities as at present.

c) System of Underwriting by PDs

Three new primary dealers have been given final approval, taking the total number of PDs to thirteen. With sufficient competition amongst the PDs it is expected that PDs will take on a larger role in the primary and secondary markets. The liquidity support arrangements detailed in the policy will help PDs to make markets and minimise volatility in security prices.

The system of underwriting is being changed to facilitate larger absorption by PDs and keeping in view RBI's ultimate objective of moving away from the primary market.

- In the case of auctions for Treasury bills, each PD will be required to make a minimum bidding commitment for each auction, which would be indicated in the beginning of the year as a percentage of the notified amount. The minimum bidding commitment of all PDs taken together is expected to absorb 100 per cent of the issue. In the case of dated securities, the present system will be retained except that against 50 per cent currently being offered for underwriting, it is proposed to allow PDs to underwrite 100 per cent of the notified amounts.