Statement by Dr. Bimal Jalan, Governor, Reserve Bank of India on Monetary and Credit Policy for the year 2003-04

The Statement consists of three parts: (I) Review of Macroeconomic and Monetary Developments during 2002-03, (II) Stance of Monetary Policy for 2003-04, and (III) Financial Sector Reforms and Monetary Policy Measures.

2. A technical and analytical review of macroeconomic and monetary developments is also being issued as a separate document. This document provides the necessary information and technical analysis in greater detail with the help of simple charts and tables.

I. Review of Macroeconomic and Monetary Developments during 2002-03

Domestic Developments

3. The Central Statistical Organisation (CSO) recently released the latest estimates of national income for the year 2001-02. According to these estimates, the growth rate of real GDP in 2001-02 at 5.6 per cent was marginally higher than envisaged earlier, i.e. 5.4 per cent. This was mainly due to an upward revision in growth rates of the manufacturing, trade, transport and communication sectors. Growth rate of the services sector was revised upwards from 6.2 per cent to 6.5 per cent and that of industrial sector from 2.9 per cent to 3.2 per cent. However, the growth rate of agriculture and allied activities remained steady at 5.7 per cent.

4. For the year 2002-03, the mid-term Review of Monetary and Credit Policy released on October 29, 2002 had projected the GDP growth in the range of 5.0 to 5.5 per cent taking into account available data on the performance of the South-West monsoon. The advance estimates for **2002-03**

released by the CSO in January 2003 has placed **GDP growth at 4.4 per cent,** which reflects an estimated decline in the output from agriculture and allied activities by as much as 3.1 per cent. The earlier projection in the Reserve Bank's mid-term Review of October 2002 was based on a much lower decline of 1.5 per cent in agricultural output. The overall growth performance of the industrial sector, as per CSO advance estimates, at 5.8 per cent is, however, much higher than that of 3.2 per cent in the previous year. The services sector is estimated to grow by 7.1 per cent as against 6.5 per cent in the earlier year, mainly on account of higher growth in construction, domestic trade and transport sectors. The CSO has also placed the growth of financing, real estate and business services sector at 6.5 per cent for 2002-03 as compared with 4.5 per cent in 2001-02.

5. The annual rate of inflation as measured by variations in the wholesale price index (WPI), on a point-to-point basis, remained below 4.0 per cent up to mid-January 2003 and rose thereafter to 6.2 per cent by end-March 2003 mainly on account of increase in prices of non-food articles and mineral oils. During 2002-03, the prices of manufactured products (weight: 63.7 per cent) registered an increase of 4.8 per cent compared with no increase in prices in the previous year. Prices of primary articles (weight: 22.0 per cent) showed an increase of 5.9 per cent as against an increase of 3.9 per cent in the previous year. Similarly, there was a higher increase of 10.8 per cent in "fuel, power, light and lubricants" group (weight: 14.2 per cent) as against an increase of 3.9 per cent a year ago. Besides fuel items, the steep increase in prices of oilseeds, sugarcane and cotton have been major items in the overall price rise in 2002-03. In the WPI basket, while some items are affected by drought conditions, others have sharply responded to external supply shocks. The weight of such items, where prices have increased very sharply, works out to 15.4 per cent. Excluding the price increases due to such items (mineral oils, oilseeds, edible oils, oil cakes and fibres) from the basket, the inflation rate

works out to 2.7 per cent on a point-to-point basis at the end of March 2003 as compared with 1.5 per cent last year.

6. The annual rate of inflation in 2002-03 as measured by the increase in WPI, on an average basis, for the year as a whole was, however, lower than that in the previous year: 3.3 per cent as against 3.6 per cent a year ago. On an average basis, the annual change in consumer price index for industrial workers (up to February 2003) was identical to the previous year at 4.1 per cent.

7. Monetary and credit aggregates for the year 2002-03 reflected the impact of mergers that took place in the banking industry. During 2002-03, the growth in **money supply (M_3)** was 15.0 per cent (Rs.2,24,576 crore) as against 14.2 per cent (Rs.1,86,782 crore) a year ago. However, net of mergers, M_3 increased by 12.1 per cent (Rs.1,81,984 crore) which was well within the projected trajectory. Among the components, growth in aggregate deposits of scheduled commercial banks (SCBs) at 12.2 per cent net of mergers (16.1 per cent with mergers), was lower than that of 14.6 per cent in the previous year. The expansion in currency with the public was lower at 12.5 per cent (Rs.30,263 crore) as against 15.2 per cent (Rs.31,849 crore) in the previous year.

8. An important feature of monetary developments during 2002-03 was the lower increase in reserve money despite a sharp increase in foreign exchange assets of RBI. The increase in **reserve money** during 2002-03 was 9.2 per cent (Rs.30,960 crore) as compared with an increase of 11.4 per cent (Rs.34,659 crore) observed in the previous year. While currency in circulation rose by 12.5 per cent (Rs.31,338 crore) as compared with an increase of 15.0 per cent (Rs.32,769 crore) in the previous year, bankers' deposits with RBI declined by 1.0 per cent (Rs.801 crore) as compared with an increase of 3.3 per cent (Rs.2,670 crore). On the sources side, RBI's net foreign exchange assets rose by 35.7 per cent (Rs.94,275 crore) compared with an increase of 33.9 per cent (Rs.66,794 crore) in the previous year. On the other hand, net domestic assets of RBI declined on account of a fall in both net RBI credit to government and

credit to banks and commercial sector. Notwithstanding RBI's subscription to fresh government dated securities of Rs.36,175 crore, net RBI credit to the Central Government actually declined by Rs.25,369 crore due to net open market sales of government securities of Rs.53,780 crore. RBI's claims on banks and commercial sector also showed a fall of Rs.6,468 crore as compared with a decline of Rs.9,575 crore in the previous year reflecting comfortable liquidity conditions.

9. A favourable development during 2002-03 has been a sustained increase in credit flow to the commercial sector reflecting industrial recovery. During 2002-03, **non-food credit** of scheduled commercial banks (SCBs) registered a high growth of 26.2 per cent (Rs.1,40,144 crore) and, net of mergers, it rose by 17.8 per cent (Rs.95,599 crore), as against an increase of 13.6 per cent (Rs.64,302 crore) in the previous year. The incremental non-food credit-deposit ratio during 2002-03 at 79 per cent is the highest recorded over the last five years. This is indicative of the fact that a substantial part of lendable resources of banks has been deployed for productive purposes. This is also borne out by the strong growth of 10.3 per cent in demand deposits in 2002-03, which is mainly used for working capital requirements. The increase in total flow of funds from SCBs to the commercial sector during 2002-03, including banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., was also higher at 24.5 per cent (Rs.1,51,569 crore) as against 12.7 per cent (Rs.69,483 crore) in the previous year. The total flow of resources to the commercial sector, including capital issues, global depository receipts (GDRs) and borrowings from financial institutions was at Rs.1,88,262 crore as compared with Rs.1,42,082 crore in the previous year.

10. The feedback on industry-wise credit flows received from banks for 2002-03 (April-February) reveals that, at a disaggregated level, there was significant increase in credit to iron & steel, other metal & metal products, cotton & jute textiles, electricity, paper & paper products, fertilisers, drugs &

pharmaceuticals, cement, gems & jewellery, construction, food processing, computer software, power and roads & ports. On the other hand, decline in credit was observed in coal, all engineering, sugar, tobacco & tobacco products, telecommunications and petroleum.

11. As a result of subdued procurement due to lower foodgrains production, and higher off-take of foodgrains, the buffer stock of foodgrains declined from 54.5 million tonnes on March 1, 2002 to 36.2 million tonnes as on March 1, 2003. Consequently, there was a decline in **food credit** of Rs.4,499 crore during 2002-03 as against an increase of Rs.13,987 crore in the previous year. The large buffer stock with the Government acted as a deterrent to price increase of food items as also the general price level in the wake of severe drought conditions witnessed during the year.

12. According to the revised estimates in the Union Budget, the **fiscal deficit** of the Central Government for 2002-03 was Rs.1,45,466 crore as against the budget estimate of Rs.1,35,524 crore. During 2002-03, net market borrowings of the Central Government at Rs.1,04,118 crore (gross Rs.1,51,126 crore) was higher than the budget estimate by Rs.8,259 crore but lower than the revised estimate by Rs.8,747 crore. The state governments' net market borrowings of Rs.13,622 crore for 2002-03 were supplemented by additional borrowings of Rs.15,442 crore. Although the combined slippage in the borrowings of the Centre and States was as much as Rs.23,701 crore, it did not exert undue pressure on interest rates due to decline in the demand for food credit, reduction in CRR, comfortable liquidity position resulting from the foreign exchange inflows and judicious debt management by RBI. As such, the weighted **average cost of government borrowings** through primary issuances of dated securities at 7.34 per cent during 2002-03 was lower by 210 basis points than that of 9.44 per cent in the previous year. While unfavourable effects of large fiscal deficits on the interest rate scenario have not so far been evident, it is necessary, in a medium-term perspective, to aim at fiscal

consolidation and substantially lower fiscal deficits to facilitate efficient monetary and debt management operations.

13. During 2002-03, the state governments accessed the market for additional borrowings for an amount of Rs.15,442 crore in two tranches. This amount includes Rs.10,000 crore for the debt swap scheme mutually agreed between the Central Government and state governments towards repayment of high cost debt of States to the Centre. Though repayment of high cost debt is desirable, large borrowings for this purpose, in addition to high level of approved market borrowings for other purposes, put pressure on interest rates. The timing of issuance and pricing of the securities also become difficult, particularly during periods when there is a bunching of borrowing requirements for various purposes. These difficulties are compounded if there are periodic defaults by some States or their PSUs in meeting their guarantee obligations. It is of utmost importance that overall borrowing requirements are kept at a reasonable level, and that all sovereign obligations, including guarantees, are fully honoured on time.

14. As emphasised in various policy Statements, overall monetary management becomes difficult when a large and growing borrowing programme of the Government puts pressure on the absorptive capacity of the market. The banking system already holds government securities of about 39 per cent of its net demand and time liabilities (NDTL) as against the statutory minimum requirement of 25 per cent. In terms of volume, such holdings above the statutory liquidity ratio (SLR) amounted to Rs.1,95,974 crore in March 2003 which is much higher than the gross borrowings of the Government. Further, such a scenario exposes banks to substantial interest rate risk which has adverse implications for sustained financial stability. In addition, the increasing interest payments have raised concerns about the sustainability of a large public debt. A reduction in fiscal deficit would release resources for infrastructure and industrial financing, which in turn would help in realising the long-term potential of the economy. Fiscal consolidation will also have a

favourable effect on inflationary expectations and hence on the interest rate scenario in the economy.

15. The two-way movement in interest rates during 2002-03, has confirmed that banks should in their interest take steps to build up investment fluctuation reserves in a smooth and phased manner for better risk management. It may be recalled that in January 2002, RBI proposed that banks should build up **investment fluctuation reserve (IFR)** to a minimum of 5 per cent of their investment portfolio under the "held for trading" and "available for sale" categories, by transferring the gains realised on sale of investments within a period of five years. They were also advised to make adequate provisions for unforeseen contingencies in their business plans, and to fully take into account the implications of changes in the monetary and external environment on their operations. In the light of their own risk assessment, banks are free to build up higher percentage of IFR up to 10 per cent of their portfolio depending on the size and composition of their portfolio, with the concurrence of their Boards.

16. The monetary policy stance in recent years has underlined the Reserve Bank's commitment to maintain **adequate liquidity** in the market with a preference for **soft interest rates** to the extent the evolving situation warrants. During 2002-03, it was possible to maintain adequate liquidity on account of sustained inflows of foreign exchange and decline in demand for food credit. As the inflationary situation remained benign for the most part of the year, it was feasible to maintain a soft interest rate environment despite a high level of government borrowing. This is evident from the fact that the call money rate declined from 6.97 per cent in March 2002 to 5.86 per cent by March 2003. The discount rate of prime-rated CP (61-90 days) showed an even sharper decline by 302 basis points from 9.02 per cent to 6.00 per cent between March 2002 and March 2003. The cut-off yields on 91-day and 364-day Treasury Bills declined from 6.13 per cent and 6.16 per cent, respectively, in March 2002 to 5.89 per cent each by March 2003. An interesting development during the year

has been that the interest rates in money market instruments converged to a narrow band of 5.5 to 6.0 per cent reflecting easy liquidity conditions.

17. There was also a distinct downward drift in **secondary market yields** on government securities across the maturity spectrum during the year. The yield on government securities with 1-year residual maturity declined by 60 basis points from 6.10 per cent in March 2002 to 5.50 per cent by March 2003. There was a sharper decline of 115 basis points in yield on government securities with 10-year residual maturity from 7.36 per cent in March 2002 to 6.21 per cent by March 2003. The term structure of interest rates reveals a flattening of the yield curve with long-term interest rates declining more sharply than the short-term rates. For example, the spread between the yields on 10-year government securities and 91-day Treasury Bills narrowed from 123 basis points in March 2002 to 32 basis points by March 2003 reflecting moderation of inflationary expectations.

18. Interestingly, **yields on non-government bonds** witnessed a sharper reduction than yields on government securities during 2002-03, and yields on such bonds are now closer to sovereign bonds than was the case earlier. For example, the spread between the prime-rated CP (61-90 days) and 91-day Treasury Bills narrowed from 289 basis points in March 2002 to 11 basis points by March 2003. In the case of longer maturities also, the risk premium on the private sector bonds has fallen sharply as measured by the yield spread between highly rated corporate paper and government securities for residual maturity of 5 years. For example, the spread between AAA-rated corporate bonds and the yield on government securities narrowed from about 177 basis points in March 2002 to about 87 basis points by March 2003.

19. It is necessary to impart greater flexibility to the interest rate structure in India consistent with the underlying macroeconomic conditions. Further progress in this direction could be made if banks move over to a **variable interest rate structure** on longer term deposits as early as possible. Since interest rates could vary in both directions, depending on the phase of business

cycle and inflationary outlook, a variable interest rate regime on long-term deposits does not necessarily imply lowering of the average interest rate earned by depositors over a period of time (as compared with a fixed rate regime, which favours old deposits over new deposits when interest rates are coming down, and *vice versa* when rates are moving in the opposite direction). In addition, banks need to reduce their operating costs over time by improving productivity and increasing their volume of lending. This should be possible with proper upgradation of technology in areas which, at present, are contributing to higher costs because of relatively low productivity.

20. The **term deposit rates** of public sector banks for maturities up to 1-year moved down from a range of 4.25-7.50 per cent in March 2002 to 4.00-6.00 per cent by March 2003. The reduction in deposit rates was more pronounced for longer term deposits as the public sector banks have reduced their deposit rates above 1-year from a range of 7.25-8.75 per cent in March 2002 to 5.25-7.00 per cent by March 2003. While the typical short-term deposit rate (15-29 days) of the public sector banks declined by 50 basis points during 2002-03, the rate for longer term deposits (over 3 years) declined by as much as 200 basis points. As a result, there has been a flattening of the term structure of deposit rates. The typical interest rate on 3-month and 1-year certificates of deposit (CDs) also declined from 7.38 per cent and 10.0 per cent in March 2002 to 5.25 per cent and 5.75 per cent, respectively, by March 2003.

21. In consonance with lower cost of funds, banks have reduced their **prime lending rates** (PLRs). The PLRs of public sector banks declined from a range of 10.0-12.5 per cent in March 2002 to 9.0-12.25 per cent by March 2003. The public sector banks reduced their PLRs in the range of 25-125 basis points, private sector banks by 50-225 basis points and foreign banks by 15-325 basis points. The number of public sector banks whose PLR was 11.5 per cent or below, has gone up from 10 to 22 between March 2002 and March 2003.

22. In the present interest rate environment, it is not reasonable to keep very high spreads over PLR. In the annual policy Statement of April 2002, RBI

had urged banks to review their **spreads over PLR** and reduce them wherever they were unreasonably high. In response, a number of banks have reduced their spreads over PLR. The number of banks charging maximum spread of less than 4 per cent over PLR increased from 2 in March 2002 to 15 by March 2003 in the case of public sector banks, from 5 to 12 in the case of private sector banks and from 12 to 14 in the case of foreign banks. One major public sector bank has reduced the maximum spread over PLR to 2.5 per cent.

23. In recent years, there has been a persistent **downward trend in the interest rate structure** reflecting moderation of inflationary expectations and comfortable liquidity situation. Changes in policy rates reflected the overall softening of interest rates as the Bank Rate has been reduced in stages from 8.0 per cent in July 2000 to 6.25 per cent by October 2002, which is the lowest rate since May 1973. Similarly, the repo rate has been moderated from 8.0 per cent in March 1999 to 5.0 per cent by March 2003. Simultaneously, the weighted average call money rate has come down from over 13.06 per cent in August 2000 to 5.86 per cent by March 2003.

24. In the annual policy Statement of 2002, RBI had spelt out its intention of collecting the **maximum and minimum interest rates** on credit advanced by banks and place the same in public domain with a view to enhancing transparency. Accordingly, bank-wise lending rates have been placed on the RBI website (www.rbi.org.in) for the quarters ended June, September and December 2002.

25. Liberalisation in the domestic economy combined with the increasing integration of the domestic markets with the international financial market poses new challenges for monetary management. It involves constant monitoring of both domestic and international indicators and fine-tuning of policies in line with the evolving conditions. Though the **overall monetary conditions** are at present comfortable in the light of moderate inflation, easy liquidity and soft interest rate environment, the Reserve Bank will continue to keep a constant watch on the domestic and external situation to conduct its monetary

management and also to provide more robustness to the country's financial architecture.

External Developments

26. According to the latest estimates of the International Monetary Fund (IMF), the growth rate for the world economy in 2002 was slightly higher than estimated earlier (3.0 per cent as against 2.8 per cent). For the current year 2003, IMF has projected a growth rate of 3.2 per cent for the **world economy**. The growth in volume of world trade is projected to pick up from 2.9 per cent in 2002 to 4.3 per cent in 2003.

27. The uncertainty regarding the economic outlook, however, remains high due to the ongoing geopolitical tensions. Its adverse impact on the oil markets could have a negative impact on economic activity throughout the world, particularly on oil importing emerging markets.

28. An important lesson emerging from the disturbances in the global financial market last year has been the role of sound macroeconomic policies and financial sector reforms in strengthening the resilience of the financial sector to external shocks. In addition to increasing the effectiveness of the system, efficient regulatory environment and good disclosure norms constitute the crucial confidence-building measures for the financial sector. Macroeconomic policies will have to continue to focus on strengthening the fundamentals of the economy, financial stabilisation and promoting good corporate governance to aid the long-run welfare gains.

29. Despite adverse external developments, India's foreign exchange reserves continued to record healthy growth during 2002-03 on account of improvement in the current account as well as strong capital and other inflows. **India's foreign exchange reserves** increased by as much as US $ 21.3 billion from US $ 54.1 billion in end-March 2002 to US $ 75.4 billion by end-March 2003. Of these, foreign currency assets rose by US $ 20.8 billion. This is the

highest increase recorded in a single year and has occurred despite substantial increase in the international oil prices and other unfavourable developments, like lower international capital flows to developing countries during the period.

30. It may be noted that **major sources of foreign exchange reserves** during the current fiscal year have been: (a) surplus in current account, (b) increase in other capital and (c) valuation changes in reserves. A recent study by RBI has revealed that, contrary to popular impression, there is no evidence to show that available arbitrage opportunities have caused the accretion to foreign exchange reserves. Almost the entire addition to reserves, in the last few years, has been made without increasing the overall level of external debt. The cost of accretion to reserves has also not been found to be very significant, as most of the increase is due to non-debt inflows.

31. 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 recent experience has once again highlighted the need for developing countries to keep a continuous vigil on market developments, and the importance of building adequate safety nets that can withstand the effects of unexpected shocks and market uncertainties. In this context, India's current **exchange rate policy** seems to have stood the test of time. It has focused on the management of volatility without a fixed rate target and the underlying demand and supply conditions are allowed to determine the exchange rate movements over a period in an orderly way. Despite several unexpected adverse developments on the external and domestic front, India's external situation has remained strong. The Reserve Bank will continue to follow the approach of watchfulness, caution and flexibility by closely monitoring the developments in the financial markets at home and abroad. It will co-ordinate its market operations carefully, particularly in regard to the forex market with appropriate monetary, regulatory and other measures as

considered necessary from time to time. It is heartening to note that recent international research on viable exchange rate strategies in emerging markets has also lent considerable support to the exchange rate policy followed by India.

32. India's sustained efforts to build an adequate level of foreign exchange reserves in the last few years have also been fully vindicated by recent developments. As pointed out in previous policy Statements, the overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of 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. Such factors, *inter alia*, include: the size of the current account deficit; the size of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investment and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks; and movements in the repatriable foreign currency deposits of non-resident Indians (NRIs). Taking these factors into account, India's foreign exchange reserves are at present more than comfortable.

33. The substantial growth in reserves in the recent period has generated a welcome debate regarding the costs and benefits of holding reserves. In any **cost-benefit analysis of holding reserves**, it is essential to keep in view the objectives of holding reserves, which, *inter alia*, cover: (a) maintaining confidence in monetary and exchange rate policies; (b) enhancing the capacity to intervene in forex markets; (c) limiting external vulnerability so as to absorb shocks during times of crisis; (d) providing confidence to the markets that external obligations can always be met; and (e) reducing volatility in foreign exchange markets. Sharp exchange rate movements can be highly disequilibrating and costly for the economy during periods of uncertainty or adverse expectations, whether real or imaginary. For developing countries,

these economic costs are likely to be substantially higher than the net financial cost, if any, of holding reserves. In this context, it is important to note that in India, in the last few years, almost the whole addition to reserves has been made without increasing the overall level of external debt. The increase in reserves largely reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows. Even after taking into account foreign currency denominated NRI flows (where interest rates are linked to LIBOR), the financial cost of additional reserve accretion in India in the recent period is quite low, and is likely to be more than offset by the return on additional reserves.

34. It may also be mentioned that most of the increase in reserves in the recent period is through net purchases by RBI in the domestic forex market for which an equivalent amount of domestic currency has been released to the concerned domestic entities, including public sector units, corporates and individuals. The decision on the use of this **counterpart domestic currency** released by RBI (i.e., for investment, deposits or as liquid assets etc.) is the responsibility of the above mentioned entities and, not that of RBI, or for that matter, the Government. Needless to add that to the extent that this counterpart local currency is used by recipient entities for further investment in the economy, the impact on industrial demand and growth would be favourable.

35. Strong foreign exchange reserves and low interest rates in the domestic markets have helped the Government to prepay certain foreign currency loans from the Asian Development Bank (ADB) amounting to US $ 1.36 billion and from the World Bank amounting to US $ 1.67 billion. These foreign debts were substituted with domestic debt amounting to Rs.13,000 crore by issuing securities on private placement basis to RBI. These external loans were repaid on February 24 and 27, 2003. The above transactions did not have any fiscal or monetary impact as it was a substitution of external sovereign debt with domestic sovereign debt placed with RBI. Corporate bodies have also taken advantage of low international interest rates in prepaying a part of their external commercial borrowings (ECBs). A study by RBI has estimated that during April-

December 2002, corporates have prepaid ECBs amounting to US $ 595 million. The total prepayment of ECBs during the last three years by corporates amounted to US $ 1.1 billion and the saving in the interest burden on account of the prepayment was about US $ 90 million.

36. The broad principles that have guided India after the Asian crisis of 1997 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 deficit but also 'liquidity at risk' arising from unanticipated capital movements.
- A judicious policy for management of the capital account.

37. Considerable flexibility has been given to the corporates over a period to hedge their forex exposure in the market. It is, however, observed that a noticeable portion of the corporate foreign currency commitments remain unhedged by the corporates on the basis of their perceptions of the market and these could impact their overall financial status in case of unexpected developments. In earlier policy Statements, RBI has urged banks which have large exposure to such corporates to put in place a system for monitoring such unhedged external liabilities.

38. A related issue that has been raised recently in the media and through expert comments by market participants relates to the **movement of forward market premia**. The premia have shown considerable downward movement in recent weeks. Thus, as of April 25, 2003, the 6-month forward premia on US dollar was only 2.1 per cent (annualised rate) as compared with 5.9 per cent a year ago and 3.4 per cent at the beginning of January 2003. The sharp downward movement in forward premia has occurred because, at present,

there seems to be a rush to sell dollars in the forward market by exporters and other entities in anticipation of further appreciation of the rupee *vis-à-vis* US dollar. In response to this expectation, there is also a rush to "borrow" dollars (for repayments later) and convert these into rupees now. If the rupee does appreciate, the borrowers of dollars expect to make a financial gain (as fewer rupees would be required to repay the "borrowed" dollars). This phenomenon is also reflected in banks going "short" on dollars during intra-day and inter-day foreign currency trades.

39. While the demand for "borrowing" dollars for repayments later is strong, for the same reason, the demand by corporates and others for "purchasing" dollars in exchange for rupees in the spot and forward markets has become weaker. This has resulted in corporates and other market participants having larger "unhedged" exposures on their future dollar obligations. It has also led to some postponement of forward demand for dollars. These two phenomena, i.e. higher incentive to sell or "borrow" dollars and lower demand for actual purchase of spot or forward dollars have, *inter alia*, in combination put pressure on the forward premia.

40. The Reserve Bank has received various suggestions from banks and other market participants to meet the demand for "borrowed" dollars, arising from expectations of continued rupee appreciation. It has been suggested that banks should be permitted a higher level of foreign borrowings (over and above the present limit of 25 per cent of unimpaired Tier I capital), and/or higher inflows of foreign currency deposits should be encouraged (by increasing, for example, the ceiling interest rate on FCNR deposits which is, at present, 0.25 percentage point below LIBOR).

41. While RBI will continue to operate in the spot and forward markets as per its foreign exchange management policies, RBI is not in favour of increasing the **unhedged borrowings by corporates**, and short term forex liabilities of banks in order to meet the demand for "borrowed" dollars that is arising from

expectations regarding future movements in dollar-rupee exchange rate. To put at rest market speculations about RBI's stance in this regard, it is clarified that:

- At present, there is in fact an excess supply of US dollars in both the spot and forward markets to meet all genuine transactions and investment demand by corporates, banks and others. There is no shortage of foreign currency availability in the market.

- One-way expectations of exchange rate or premia may not always be fulfilled. Present unhedged exposures seem to be on account of expectations on unconstrained appreciation of rupee. Movements in respect of exchange rates may not, however, be unidirectional. This can be seen from the movement of the Euro against the US dollar from 0.9606 to 1.1087 between September 17, 2002 and March 11, 2003, from 1.1087 to 1.0501 between March 11 and March 21, 2003 and from 1.0501 to 1.0997 between March 21 and April 25, 2003. Similar movements have also been observed in the case of pound sterling/US dollar rate.

- For these reasons, it is of utmost importance, particularly in relatively thin developing country markets, that foreign currency exposures by corporates and others are largely hedged or covered against anticipated foreign currency earnings. It may be recalled that a part of the problem that many emerging economies have faced in the past has been due to excessive unhedged foreign currency exposures in a country during periods when movement in exchange rate was absent (due to fixed exchange rate policy) or currency was appreciating.

42. The Reserve Bank has been encouraging banks to improve the export credit delivery system in order to provide timely and adequate credit to the export sector. Following the **survey on exporters' satisfaction** conducted

with the help of National Council of Applied Economic Research (NCAER), a small committee was constituted with officers from RBI, banks and Export Credit Guarantee Corporation of India Ltd. The Committee has so far visited 10 centres in the country from where large scale exports are taking place and had discussions with bankers to sensitise the need for bringing about improvements in the export credit delivery system. Reports received from banks reveal that the suggestions made by NCAER have been largely complied with. Exports being an important sector of the economy, banks should continue to pursue customer-friendly export credit delivery system.

43. The performance of India's **exports** during 2002-03 has been encouraging despite the continued global slowdown. Exports in US dollar terms increased by 16.7 per cent during 2002-03 (April-February) as against a decline of 0.7 per cent in the corresponding period of the previous year. Imports showed an increase of 16.3 per cent as compared with a marginal increase of 0.8 per cent in the corresponding period of the previous year. While oil imports registered a significant increase of 26.5 per cent on account of steep increase in the international oil prices as against a decline of 13.0 per cent in the previous year, non-oil imports showed an increase of 12.5 per cent as compared with an increase of 7.3 per cent in the corresponding period of the previous year.

44. At a further disaggregated level, non-oil imports excluding gold and silver increased by 17.6 per cent during 2002-03 (April-December) as compared with a lower increase of 6.0 per cent in the corresponding period of the previous year reflecting improved industrial outlook. As a result of higher imports, the trade deficit widened to US $ 7.8 billion during 2002-03 (April-February) from US $ 6.8 billion in the corresponding period of the previous year despite acceleration in exports. However, higher services exports, such as software and buoyant inward remittances during 2002-03 (April-December), resulted in the current account of the balance of payments showing a surplus of US $ 2.8

billion as against a deficit of US $ 0.7 billion in the corresponding period of the previous year. Going by current indications, India would be showing a current account surplus during 2002-03 for the second year in succession.

45. With a view to liberalising further 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, RBI *inter alia*, announced several important measures relating to current and capital accounts. A list of measures announced subsequent to the presentation of mid-term Review of October 2002 is given in the **Annex.**

46. Pursuant to the announcement made in the Budget 2003-04 and moving further towards liberalisation of capital account, RBI has also implemented the following measures:

- Prepayment of ECBs under automatic route out of local resources/ market purchases allowed without any limit.

- Indian companies with a proven track record permitted to make overseas investment in a foreign entity engaged in any bonafide business activity, up to 100 per cent of their networth, within the overall ceiling of US $ 100 million, by way of market purchases.

47. 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 to periodic discussions, several Working Groups were set up to consider proposed new measures that were likely to have wide impact on the financial sector, especially the banking sector and also for examining 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 an **Annex** to this Statement.

II. Stance of Monetary Policy for 2003-04

48. The overall **stance of monetary policy in 2002-03** outlined in annual policy Statement of 2002 was as follows:

- 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 the present stance on interest rates including preference for soft interest rates.
- To impart greater flexibility to the interest rate structure in the medium-term.

49. In line with its monetary policy stance, liquidity conditions during the year were very comfortable. This is evident from the higher average volume of repo tenders under the liquidity adjustment facility (LAF) during the year. The average outstanding volume of LAF repo was higher around Rs.11,300 crore during 2002-03 as compared with Rs.3,500 crore during 2001-02. Though the real GDP growth turned out to be lower than that expected in the annual policy Statement of April 2002 because of widespread drought, the Reserve Bank continued with the policy of ensuring adequate liquidity in the financial system for supporting industrial revival noticed during the year.

50. The sharp accretion to foreign currency assets of RBI posed some challenges for **liquidity management** during the year. During 2002-03, the net foreign currency assets of RBI (net of revaluation) increased by as much as Rs.82,090 crore. The monetary impact of such large inflows had to be neutralised by conduct of substantial outright OMO sales. The net outright OMO sales of government securities were Rs.53,780 crore during the year. As

a result, the reserve money expansion was Rs.30,960 crore. Despite the intervention of RBI through sterilisation, the interest rate did not firm up as adequate liquidity could be maintained in the system through judicious LAF operations of RBI.

51. Notwithstanding the comfortable liquidity position emanating from the foreign exchange build up, RBI made further progress in meeting its medium-term objective of reduction in the cash reserve ratio (CRR). The CRR was reduced from 5.5 per cent to 5.0 per cent in June 2002 and further to 4.75 per cent in November 2002 augmenting the lendable resources of banks by about Rs.10,000 crore.

52. In order to stabilise interest rate expectations, the Reserve Bank had signalled its intention, in advance, of reducing the Bank Rate by up to half a percentage point (50 basis points) in the annual policy Statement of April 2002 if warranted by the evolving liquidity and credit situation. After reviewing the liquidity and monetary conditions, the Bank Rate was reduced by 25 basis points to 6.25 per cent, and repo rate under the LAF was also reduced by 25 basis points to 5.5 per cent in the mid-term Review of October 2002. The repo rate under the LAF was further reduced to 5.0 per cent on March 3, 2003.

53. As inflation remained benign for most part of the year, despite the impact of drought and higher oil prices, there was general reduction in market interest rates. The overnight call money rates remained stable and almost overlapped the repo rate. The yields on 91-day and 364-day Treasury Bills and dated government securities of various maturities ruled much lower than yields at the beginning of the financial year. This enabled the large market borrowing programme of the Government to be completed at a low cost without unduly affecting the general interest rate structure. During the last three years (March 2000 - March 2003), the yields on 91-day Treasury Bills, 364-day Treasury Bills and government securities of residual maturity of 10 years have declined

substantially from 9.17 per cent, 9.93 per cent and 10.85 per cent in that order to the level of 5.89 per cent, 5.89 per cent and 6.21 per cent, respectively.

54. Despite drought conditions and volatility in international oil prices, the inflation rate remained benign till January 2003 but has picked up since then. The point-to-point inflation rate in 2002-03 (on March 29, 2003) was significantly higher at 6.2 per cent (as compared with 1.6 per cent on March 30, 2002). The recent price increase was, however, confined to a few commodities – essentially mineral oils (because of the Iraq war), and drought-related items (oilseeds, edible oils, oil cakes and fibres). Excluding price increase due to such items (with an aggregate weight of 15.4 per cent), the inflation rate for the remaining basket works out to 2.7 per cent as compared with 1.5 per cent last year. Considerable uncertainties still remain on the inflation front due to current geopolitical uncertainties. Further, from the viewpoint of the domestic economy, the progress of the South-West monsoon is important so that supply constraints, which could have an adverse impact on inflation, do not emerge. Movements in international oil prices over the next few months cannot also be predicted as there are uncertainties in the aftermath of the Iraq war. As such, the inflationary situation needs to be watched closely. There is no room for complacency on this account. For the present, however, it is proposed to continue with the policy of maintaining adequate liquidity in the system and a soft interest rate environment. In case demand pressures emerge and the inflationary situation worsens, which hopefully will not be the case, the present monetary policy stance may have to be reviewed.

55. The monetary policy framework has changed over the recent period in response to reforms in the financial sector. The Reserve Bank's endeavour has been to enhance the allocative efficiency of the financial sector, preserve financial stability and improve the transmission mechanism of monetary policy by moving from direct to indirect instruments. A number of steps have been taken to ensure balanced development of various segments of

the financial market as also to preserve its integrity and transparency. The operationalisation of the Clearing Corporation of India Limited (CCIL), negotiated dealing system (NDS), introduction of collaterialised borrowing and lending obligation (CBLO), prudential limits on uncollateralised call/notice money market and encouragement of collateralised repo transactions, and introduction of interest rate options would increase the depth of the financial market. This process would get a further boost with the operationalisation of the real time gross settlement (RTGS) system.

56. The Reserve Bank is committed to the implementation of the “Core Principles for Effective Banking Supervision” drawn up by the Basel Committee on Banking Supervision. In order to achieve full compliance with these principles, steps have been taken in a phased manner, to move towards a system of consolidated supervision, for enhancing the role of external auditors, strengthening corporate governance, internal controls and audit procedures, increasing transparency and disclosure in the balance sheets of banks. An off-site monitoring system was introduced gradually and extended to cover co-operative institutions also.

57. In addition to the initiatives in areas of regulation and supervision, RBI continues to foster institutional structures and mechanisms which would strengthen the existing financial infrastructure. These include setting up of a Credit Information Bureau (CIB), introduction of a mechanism for corporate debt restructuring (CDR), NPA management, technology upgradation and legal aspects. Banks and financial markets have responded well to RBI’s regulatory and advisory initiatives. The perceptible improvement recorded by banks is reflected in certain key performance parameters, viz. reduction in net NPA ratio and increase in the capital adequacy ratio.

58. The fiscal deficit of the Central Government, which was budgeted at 5.3 per cent of GDP for 2002-03, was revised upwards to 5.9 per cent. For the year **2003-04, the fiscal deficit** is placed at 5.6 per cent of GDP and the market

borrowing programme of the Centre is estimated at Rs.1,66,230 crore (gross) and Rs.1,07,194 crore (net). While the market borrowing programme in respect of some States has come under stress, RBI hopes to conduct debt management without serious pressure on overall liquidity and interest rates unless there is a change in the overall macroeconomic situation due to unanticipated domestic or external developments.

59. For the purpose of monetary policy formulation, **real GDP growth in 2003-04** is placed at about 6.0 per cent after taking into account the current trends in the various macroeconomic factors. Subject to satisfactory spatial distribution, if rainfall is around 96 per cent of the long term average (as per advance forecast released by India Meteorological Department on April 16, 2003), recovery in agricultural output may be over 3.1 per cent during 2003-04 (which is the estimated decline in output during 2002-03). A recovery in agricultural output coupled with the continuance of the upturn in the industrial and the services sectors should help in achieving the projected growth for 2003-04.

60. While assessing the inflationary outlook for 2003-04, the following major developments in the economy will have to be borne in mind:

- The higher base level of prices at the end of March 2003.
- The expected decline in oil prices (which had picked up during the last quarter of 2002-03).
- Expectation regarding behaviour of the monsoon in 2003-04.

Based on the present assessment of relevant factors, the **inflation rate in 2003-04** on a point-to-point basis may be placed in the range of 5.0 to 5.5 per cent. As pointed out earlier, the increase in inflation in the last quarter for 2002-03 was dominated by certain commodities such as edible oils, oil cakes and mineral oils. While prices of edible oils increased sharply because of drought,

domestic mineral oil prices increased substantially in the wake of the sharp rise in international oil prices. The prices of these items are, as of now, expected to decline during the course of the year. It is important to initiate measures which, through a strong "pass through" effect, will help to soften the prices of commodities which showed unusual rise last year. Timely domestic action would help in further reducing the projected rate of inflation, which would be highly desirable for monetary and financial management.

61. Consistent with the expected GDP growth and inflation, the projected expansion in broad money (M_3) for 2003-04 is placed at 14.0 per cent. As the projected expansion of money supply is on a higher base, including the mergers that took place in the banking industry, the volume of liquidity would be adequate to meet the credit needs of the productive sectors of the economy. Consistent with this order of growth in M_3, an increase in aggregate deposits of scheduled commercial banks is set at Rs.1 ,79,000 crore. Non-food bank credit including investments in commercial paper, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 15.5-16.0 per cent, which should be adequate to facilitate the sustenance of growth in industrial activity during 2003-04.

62. The Bank Rate changes, combined with CRR and repo rate changes, have emerged as important tools of liquidity and monetary management. The LAF has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a more flexible manner and, in the process, providing a corridor for the call money market. The prudential limits placed on banks and PDs in their operations in the call money market, and gradual phasing out of non-banks from the call money market, are expected to bring integrity to this market, contribute to development of repo/term money market and further help to strengthen the channels of monetary transmission. With most of the procedural and technological upgradation being put in place, RBI's efforts to make LAF more effective will continue. The Reserve Bank will also

continue its efforts to bring about development and smooth functioning of the financial markets.

63. An issue of policy interest for financial management by banks and other market participants is whether, after a sharp decline in the past 2-3 years, interest rates have bottomed out. As is well known, the **outcome for interest rates** depends heavily on the outlook for inflation, growth prospects and investment demand and it is not possible to predict short-run movement in interest rates, either up or down, without taking cognizance of possible movements in all other macroeconomic variables. These variables are also subject to unanticipated changes because of unforeseen domestic or external developments.

64. On balance of probabilities, given normal conditions and overall stability in macroeconomic environment, in view of several structural constraints, the present nominal and real interest rates are relatively low. There may not be significant potential for further sizeable downward movement in interest rates. Some important structural factors that contribute to inflation and nominal interest rates in India – which are generally somewhat higher than those in industrial or fast-growing emerging market economies – are:

(a) the fixation of some food and other procurement prices by the Government which has an important impact on determining the prices of these items, which have a high weightage in price indices;

(b) the need for adjusting several administered food and other subsidies that increase the burden on current expenditure, which contributes to continuing high fiscal deficit; and

(c) the existence of relatively rigid wage structures with built-in inflation related increases in wages, dearness allowances etc. in the organised sector.

65. The above structural factors, which are generally not prevalent in most industrial and emerging market economies, impart an upward bias to sustained price increases from year to year, particularly during the upward phase of the business cycle. It is important to continue efforts over the medium-term to reduce the impact of these factors in order to facilitate greater downward flexibility and a sustainable soft interest rate climate.

66. In sum, as per 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.

III. Financial Sector Reforms and Monetary Policy Measures

67. A vibrant, resilient and competitive financial sector is vital for sustaining the reform process in the real sector of the economy. As such, 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.

68. A key element of financial sector reforms has been the strengthening of the regulatory and supervisory framework on an ongoing basis. With a paradigm shift from micro-regulation to prudential regulation and macro-management, emphasis has been placed on promoting financial stability through developing sound risk management systems and enhancing transparency and accountability. While progress has been made in setting out signposts for what needs to be done, it has to be recognised that macroeconomic and financial conditions tend to change swiftly, posing new

challenges. It is, therefore, important to put in place corrective strategies along with implementation and enforcement mechanisms.

69. In order to achieve the above objectives, RBI has been adopting a policy of **extensive consultations** with experts and market participants before introducing policy measures. Such discussions help in ensuring timely and effective implementation of the measures in accordance with international best practices.

70. Against this background, 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.

Monetary Measures

71. In view of macroeconomic and overall monetary conditions and consistent with announcements made by the Finance Minister regarding certain administered interest rates, RBI reduced the interest rate on savings account from 4.0 per cent to 3.5 per cent effective from March 1, 2003. The repo rate under LAF made available on March 3, 2003 was reduced from 5.5 per cent to 5.0 per cent and thereafter the cut-off rate is being decided at each auction.

(a) Bank Rate

- It is proposed to reduce the Bank Rate by 0.25 percentage point from 6.25 per cent to 6.0 per cent with effect from the close of business today (April 29, 2003).

72. The Bank Rate has been reduced from 11.0 per cent to 6.0 per cent, i.e. by 500 basis points in the last five years. This is the sharpest reduction in the Bank Rate since independence. 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 October 2003.

(b) Cash Reserve Ratio

73. The Reserve Bank has been pursuing the medium-term objective of reducing cash reserve ratio (CRR) of banks to the statutory minimum level of 3.0 per cent. In this direction, CRR was gradually reduced from 11.0 per cent in August 1998 to 4.75 per cent by November 2002. In line with this medium-term objective, it is now proposed to:

- Reduce CRR further from 4.75 per cent to 4.50 per cent effective fortnight beginning June 14, 2003.

74. With this reduction, CRR would have been reduced by 4.0 percentage points in the last three years. It may be mentioned that in case there is an unexpected change in the liquidity conditions in the next few weeks, RBI may advance the effective date of the above reduction.

(c) Payment of Interest on eligible CRR Balances on Monthly Basis

75. In the mid-term Review of October 2002, in response to a suggestion made by banks, RBI had announced that interest on eligible CRR balances maintained by banks with RBI would be paid on monthly basis, with effect from an appropriate date, as against the present practice of quarterly rests. Accordingly, the first such interest payment will be made for the month of April 2003 covering the fortnights ended April 4, 2003 and April 18, 2003 in the month of May 2003. Pursuant to this, RBI has suitably modified the interest claim statement to be submitted by banks.

(d) Export Credit Refinance Facility

76. In the mid-term Review of October 2002, it was indicated that interest rates on post-shipment rupee export credit beyond 90 days and up to 180 days

would be deregulated with effect from May 1, 2003. In response to the suggestion received from the exporting community, in the present uncertain geopolitical environment, it has been decided:

- To continue extending refinance facility to eligible export credit remaining outstanding under post-shipment rupee credit beyond 90 days and up to 180 days.

This measure will be reviewed again in October 2003.

(e) Back-stop Facility

77. Banks are eligible for standing facilities (export credit eligible for refinance) and PDs are eligible for collateralised liquidity support from RBI subject to certain limits. These limits are split into a "normal" facility (constituting one-half of the total standing facility), which is available at the Bank Rate, and a "back-stop" facility (constituting the remaining half of the standing facility) available at a variable rate determined by RBI from time to time. At present, the "back-stop" interest rate is higher than the repo/reverse repo/ NSE-MIBOR rates.

78. In order to increase the efficacy of liquidity adjustment facility (LAF) operations, it is desirable to rationalise the multiplicity of rates at which liquidity is absorbed/injected. Accordingly, it is proposed that:

- The "back-stop" interest rate will be at the reverse repo cut-off rate at which funds were injected earlier during the day in the regular LAF auctions.
- Where no reverse repo bid is accepted as part of LAF auction, the "back-stop" interest rate will generally be 2.0 percentage points over the repo cut-off rate of the day under LAF.

- On the days when no bids for repo or reverse repo auctions are received/accepted, the “back-stop” interest rate will be decided by RBI on an *ad hoc* basis.

79. With the above changes, it is expected that the “back-stop” interest rate will be lower by 1.0 percentage point over the present “back-stop” rate. This should benefit banks (as well as borrowers) using this facility.

80. Over time, LAF has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a more flexible manner. Nevertheless, in some very rare and unusual circumstances, a situation may arise when a bank faces a sudden and unforeseen liquidity problem particularly outside the normal LAF auction timings and on days on which such auctions are not held. In such exceptional and unforeseen circumstances, RBI at its discretion, may extend liquidity support to such a bank if the said bank is otherwise financially sound, and after taking into account other relevant factors. The liquidity support in such exceptional circumstances will be made available only for a minimum number of days required to overcome the unexpected liquidity pressure. As this exceptional financing has to be availed only in rare circumstances, an interest rate of 4.0 percentage points above the reverse repo rate prevailing on that day (or a rate as may be decided by RBI) will be charged. Such liquidity support will be available against eligible securities with adequate margin and other conditions as RBI may consider appropriate.

Interest Rate Policy

(a) Prime Lending Rate and Spreads

81. At present, commercial banks decide the lending rates to different borrowers (with credit limit of over Rs.2 lakh) subject to the announcement of prime lending rate (PLR) as approved by their Boards. In order to enhance transparency in banks’ pricing of their loan products as also to ensure that the

PLR truly reflects the actual costs, banks are advised to consider the following suggestions for determination of their benchmark prime lending rate:

- Banks should take into account their (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, while arriving at the benchmark PLR. Banks should announce a benchmark PLR with the approval of their Boards.

- As is already the case, the benchmark PLR would continue to be the ceiling rate for credit limit up to Rs.2 lakh.

- Since all other lending rates can be determined with reference to the benchmark PLR arrived at, as above, by taking into account term premia and/or risk premia, the system of tenor-linked PLR may be discontinued. These premia can be factored in the spread over or below the PLR. The effective date for discontinuation of the tenor-linked PLR would be further discussed with banks and a decision will be announced separately in due course.

82. In the interest of customer protection and to have greater degree of transparency in regard to actual interest rates charged to borrowers, banks should continue to provide information on maximum and minimum interest rates charged alongside the benchmark PLR.

83. The Reserve Bank proposes to review the system of determination of benchmark PLR by banks and the actual prevailing spreads around the benchmark PLR in September 2003.

(b) Non-Resident External (NRE) Deposits

84. At present, banks can offer FCNR(B) deposits in foreign currency and non-resident external (NRE) deposits in domestic currency to non-resident

Indians. Both schemes are now fully repatriable. Whereas the maturity period in case of FCNR(B) scheme is 1-3 years, in case of NRE deposits, the minimum maturity is 6 months. Banks are free to offer fixed and floating rates in both the schemes. The interest rates on FCNR(B) deposits are subject to a ceiling of LIBOR/Swap rates for the corresponding maturities minus 25 basis points, and thus conform to global interest rates in foreign currency deposits in US dollars, pound sterling, euro etc. Similarly, the interest rates offered by banks on NRE rupee deposits are also more or less at par with domestic interest rates on rupee deposits.

85. In order to provide uniformity in the maturity structure for all types of repatriable deposits whether they are in foreign currency or in rupees, it is proposed that:

- The maturity period of fresh NRE deposits, with immediate effect, will be 1 to 3 years in line with FCNR(B) deposits. This will also apply to NRE deposits renewed after their present maturity period.

Credit Delivery Mechanism

(a) Priority Sector Lending

(i) Liberalisation of credit for drip irrigation/sprinkler irrigation system/ agricultural machinery

86. In the mid-term Review of October 2002, the limit on advances granted to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, located in rural/semi-urban areas was increased from Rs.10 lakh up to Rs.20 lakh under priority sector lending for agriculture. As the scheme has been of benefit to the farming community, the following further liberalisation is proposed:

- Dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, would be eligible for such advances, under priority sector lending for agriculture.

(ii) Housing loans

87. At present, the quantum of direct housing loans for construction of houses by individuals to be counted under priority sector advances is Rs.5 lakh in rural and semi-urban areas and Rs.10 lakh in urban and metropolitan areas. In view of increasing demand for housing in rural and semi-urban areas, and to improve financing to housing sector in these areas, it has been decided that:

- Banks, with the approval of their Boards, will be free to extend direct finance to the housing sector up to Rs.10 lakh in rural and semi-urban areas as part of priority sector lending.

(b) Survey on KCC

88. As indicated in the mid-term Review of October 2002, a survey for assessing the impact of kisan credit cards (KCC) Scheme has been awarded to the National Council of Applied Economic Research (NCAER), New Delhi. The impact assessment survey would cover all regions.

(c) Relief for Drought affected Farmers

89. Guidelines for relief measures by banks in the districts notified by the state governments as drought affected were issued in November 2002. Accordingly, banks were advised: (i) not to recover any amount either by way of principal or interest during the year 2002-03 in respect of *Kharif* crop loans, (ii) to convert the principal amount of crop loans into term loans to be recovered over a minimum period of five years in the case of small and marginal farmers and four years in the case of other farmers and (iii) to defer interest due on crop loans and not to charge interest on the deferred interest.

90. In order to mitigate further the hardship of farmers in drought affected states, the Government has decided, as a one-time measure, to waive completely, the first year's deferred interest liability on *Kharif* loans in those states. This instalment of deferred interest, which is to be waived by banks would be reimbursed by the Government. No interest would be charged on the

deferred interest, and the balance of the deferred interest would be recovered in reasonable instalments.

(d) Guidelines on Infrastructure Financing – Relaxation in Regulatory and Prudential Aspects

91. In view of the critical importance of the infrastructure sector as also the high priority being accorded to this sector, certain relaxations relating to regulatory and prudential aspects were allowed to banks to boost credit flow to this sector. These measures, *inter alia*, include: (i) enhancing the scope of definition of infrastructure lending, (ii) relaxing the prudential single borrower exposure limit from 15 per cent to 20 per cent of capital funds in respect of infrastructure companies providing infrastructure facilities, (iii) assigning a concessional risk weight of 50 per cent on investment in securitised paper satisfying certain conditions pertaining to an infrastructure facility, (iv) permitting lending to special purpose vehicles (SPVs) in the private sector, registered under Companies Act for directly undertaking viable infrastructure projects subject to certain conditions and (v) lending to promoters, with certain safeguards and where appropriate, for acquiring a controlling stake in existing infrastructure companies. Detailed instructions in this regard to banks have already been issued by RBI.

(e) Micro-finance

92. Micro-credit institutions and self-help groups (SHGs) have been recognised as important vehicles for generation of income and delivery of credit to self-employed persons. The Reserve Bank has been emphasising on flow of bank credit to micro-enterprises in rural and semi-urban areas set up by vulnerable sections of society including women. A number of steps have been initiated in this regard and banks were advised to provide maximum support to SHGs. Further, in order to put in place a more vibrant micro-finance delivery environment, as indicated in the mid-term Review of October 2002, RBI had a wide-ranging interface with a cross-section of micro-finance providers.

Pursuant to these interactions, four informal Groups have been set up by RBI to look into various issues relating to: (i) structure and sustainability; (ii) funding; (iii) regulations and (iv) capacity building for micro-finance delivery. The Reserve Bank will discuss the recommendations of the informal Groups in a wider forum for possible implementation.

Money Market

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

93. It may be recalled that the annual policy Statement of April 2001 highlighted the intention to move towards a pure inter-bank call/notice money market in four stages by gradually phasing out non-bank participation. In stage I, non-bank participants were allowed to lend, on average in a reporting fortnight, up to 85 per cent of their average daily lending during 2000-01. The implementation of stage I has not caused any strain on the market or created undue volatility in call/notice money rate. Except for the Life Insurance Corporation of India, which has large liquid funds and is also subject to certain prudential constraints in investing its large surpluses in other non-bank institutions, by and large, most non-bank institutions have not faced any difficulty in adhering to the stage I guidelines.

94. Subsequently, in the annual policy Statement of April 2002, it was stated that RBI would announce the date of effectiveness of stage II, wherein non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 75 per cent of their average daily lending in call money market during 2000-01, depending on the date when NDS/CCIL becomes fully operational. In view of the encouraging developments in NDS/CCIL, it would be desirable to accelerate the process of moving towards a pure inter-bank call/notice money market and facilitate further deepening of repo market. Accordingly, it is proposed that:

- Stage II of the transition to a pure inter-bank call/notice money market will be effective from the fortnight beginning June 14, 2003, wherein non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 75 per cent of their average daily lending in call/notice money market during 2000-01.

95. However, in case a particular non-bank institution has genuine difficulty in developing proper alternative avenues for investment 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) Reporting of Call/Notice Money Market Transactions on NDS Platform

96. Negotiated dealing system (NDS), which has become operational since February 2002, enables on-line dealing and dissemination of trade information relating to instruments in money, government securities and foreign exchange markets. Membership in NDS is open to all institutions which are members of INFINET and are maintaining subsidiary general ledger (SGL) Account with RBI. These include banks, financial institutions (FIs), primary dealers (PDs), insurance companies, mutual funds and any other institution as admitted by RBI. At present, all deals in government securities, call/notice/term money, CDs and CP executed among NDS members have to be reported automatically through NDS, if the deal is done on NDS and within 15 minutes of concluding the deal, if done outside NDS. However, it has been observed that a very sizeable proportion of daily call/notice money market deals is not reported by members on NDS as stipulated. With a view to improving transparency and strengthening efficiency in the market, it is proposed that:

- From the fortnight beginning May 3, 2003, it would be mandatory for all NDS members to report all their call/notice money market deals on NDS. Deals done outside NDS should be reported within 15 minutes on NDS,

irrespective of the size of the deal or whether the counterparty is a member of the NDS or not.

- Full compliance with the reporting requirement to NDS will be reviewed in September 2003. In case there is repeated non-reporting of deals by an NDS member, it will be considered whether non-reported deals by that member should be treated as invalid with effect from a future date.

(c) Introduction of New OTC Rupee Derivatives

97. Following the announcement in the mid-term Review of October 2002, RBI had constituted a Working Group on Rupee Derivatives (Chairman: Shri Jaspal Bindra) with appropriate representations from Securities and Exchange Board of India (SEBI), banks, PDs, mutual funds and RBI. The scope of the Group was later expanded to cover the issues relating to exchange-traded interest rate derivatives in addition to the issues on over-the-counter (OTC) interest rate derivatives. The Group felt that in order to further deepen the money market and enable market participants to manage and control interest rate risk, certain new rupee derivative instruments could be introduced – both OTC and exchange-traded. Accordingly, it is proposed that, to begin with:

- Less complex OTC interest rate rupee options should be permitted in the first phase which include vanilla caps, floors and collars, European Swaptions, call and put options on fixed income instruments/ benchmark rates and unleveraged structured swaps based on overnight indexed swaps (OIS) and forward rate agreements (FRAs) where the risk profile of such structure is similar to that of the building blocks.

- Scheduled commercial banks, financial institutions and PDs would be allowed to both buy and sell options; corporates may sell options initially without being the net receivers of premium.

98. Detailed guidelines for operationalising the recommendations of the Working Group would be issued in consultation with market participants.

(d) Commercial Paper

99. Banks and FIs have the flexibility to provide credit enhancement for a commercial paper (CP) issue by way of standby assistance/credit, back-stop facility etc., based on their commercial judgment subject to the prudential norms as applicable and with specific approval of their Boards. Further, the present guidelines do not provide for credit enhancement for a CP issue in the form of an unconditional and irrevocable guarantee to be given by non-bank entities such as a corporate. In order to provide further flexibility to both issuers and investors in the CP market, it is proposed that:

- Non-bank entities including corporates may provide unconditional and irrevocable guarantee for credit enhancement for CP issue as long as (i) the issuer fulfils the eligibility criteria prescribed for issuance of CP, (ii) the guarantor has at least one notch higher credit rating than the issuer by an approved credit rating agency, (iii) the offer document for CP should properly disclose: the networth of the guarantor company; the names of the companies to which the guarantor has issued similar guarantees; the extent of the guarantees offered by the guarantor company and the conditions under which the guarantee will be invoked.

- Banks are allowed to invest in CP guaranteed by non-bank entities provided their exposure remains within the regulatory ceiling as prescribed by RBI for unsecured exposures.

Detailed guidelines on procedures and documentation in this regard will be issued by Fixed Income Money Market and Derivatives Association of India (FIMMDA).

(e) Collateralised Borrowing and Lending Obligation

100. The mid-term Review of October 2002 had announced the proposal to promote collateralised borrowing/lending operations by market participants to reduce their reliance on call/notice money market. Accordingly, collateralised borrowing and lending obligation (CBLO) has been operationalised as a money market instrument through Clearing Corporation of India Limited (CCIL) on January 20, 2003. The regulatory provisions and accounting treatment for CBLO are the same as those applicable to other money market instruments, but the operations in CBLO are exempted from CRR, subject to the bank maintaining minimum CRR of 3 per cent. In addition, securities lodged in the gilt account of the bank maintained with CCIL under constituents' subsidiary general ledger (CSGL) facility for CBLO remaining unencumbered at the end of any day are reckoned for SLR purposes by the concerned bank. As on March 31, 2003, 32 members have been admitted in CCIL's CBLO segment, of which, 23 members have been activated by CCIL. The total volume in CBLO during January-March 2003 stood at Rs.1,703 crore amounting to an average daily volume of Rs.30 crore.

Foreign Exchange Market

(a) Overseas Investment by Mutual Funds – General Permission

101. At present, mutual funds are allowed to invest in ADRs/GDRs of Indian companies and rated foreign debt instruments/equity within an overall cap of US $ 1.0 billion with the permission of SEBI and RBI. In order to simplify the procedure and to facilitate expeditious processing of investment proposals, it is proposed:

- To accord general permission to mutual funds for their overseas investments within the cap, once SEBI's approval has been obtained. This general permission will be available until further notice.

(b) Investment by Indian Corporates/Individuals in Rated Bonds/Fixed Income Securities

102. At present, Indian corporates and resident individuals are permitted to invest in equities of listed companies abroad subject to certain conditions. It is proposed to extend this facility to debt instruments. Accordingly:

- Indian corporates and resident individuals will also be permitted to invest in rated bonds/fixed income securities of listed eligible companies abroad subject to certain conditions.

(c) Forward Cover for Inflows under Foreign Direct Investment

103. General permission has been accorded to banks to offer forward contracts to overseas investors to hedge their Foreign Direct Investment (FDI) to the extent of investments made in India. However, such FDI inflows are not permitted to be sold forward to banks. In order to provide greater flexibility to overseas investors and encourage flow of FDI, it is proposed:

- To allow overseas investors making long-term investments to hedge their forex exposures in India, pending investment, by entering into forward sale contracts with banks in India.

(d) Forward Cover for Forex Exposures where Settlement is in Rupees

104. At present, resident entities are not allowed to book forward cover in case of transactions denominated in foreign currency but settled in rupees. Keeping in view the exposures of such entities to exchange rate risk, it is proposed:

- To permit entities which have transactions denominated in foreign currency but settled in rupees to book forward contracts. Such contracts should be held till maturity and cash settlement would be made on the maturity date.

(e) Cross Currency Forward Cover for FCNR Deposits

105. At present, non-resident Indians (NRIs) and overseas corporate bodies (OCBs) can enter into forward contracts with rupee as one of the currencies to hedge the balances held in FCNR(B) or NRE Accounts. However, cross currency covers are not permitted for such deposits. In order to facilitate better risk hedging by NRIs and OCBs, it is proposed:

- To allow NRIs/OCBs to book cross currency forward contracts to hedge the balances held in their FCNR(B) accounts. However, contracts once cancelled cannot be rebooked.

(f) Forex Clearing

106. One of the major functions of CCIL is clearing and settlement of inter-bank dollar-rupee transactions. It offers a multilateral netting mechanism through a process of novation for inter-bank spot and forward dollar-rupee transactions. Live operations for clearing and settlement of spot and forward dollar-rupee transactions commenced on November 12, 2002. While the US dollar leg of transactions is settled through CCIL's account with its settlement agent in the US, the rupee leg is settled through the member banks' current accounts maintained with RBI, Mumbai.

107. During the period November 12, 2002 to March 31, 2003, 91 settlements have taken place covering 98,206 transactions amounting to over US $ 65 billion. CCIL has lines of credit amounting to US $ 275 million from a foreign bank and Rs.800 crore from 7 Indian banks to take care of any unforeseen contingency. This new facility for clearing and settling dollar-rupee transactions in India is likely to provide substantial cost and time benefits to banks.

Government Securities Market

108. The Reserve Bank has taken a number of initiatives in the recent past in developing and deepening the government securities market. Further, NDS has been made operational for enabling on-line trading and dissemination of

trade information on a near real-time basis. The supervision of PDs was strengthened with prescription of certain minimum disclosure norms and extending repo eligibility to CSGL/gilt account holders. The progress and recent developments in these directions are reviewed in the **Annex.**

Urban Co-operative Banks

109. As indicated in the mid-term Review of October 2002, a Committee set up by the Government (Chairman: Hon. Shri Anant Geete) had made a number of recommendations in its report on problems faced by Urban Co-operative Banks (UCBs). In pursuance of the recommendations made by the Committee and in consultation with the Government of India, certain relaxations are proposed in respect of gold loans, placement of deposits with other scheduled UCBs and limits on unsecured advances.

(a) 90 days Norm for Recognition of Loan Impairment – Exemptions

110. With a view to moving towards international best practices and to ensure greater transparency, commercial banks (including RRBs) and UCBs were advised to adopt 90 days norm for recognition of loan impairment from the year ending March 31, 2004. In response to the difficulties expressed by the UCBs and their federations in adopting this norm in respect of the large number of small loans and gold loans granted by them, it is proposed:

- To exempt both gold loans and small loans up to Rs.1 lakh from the 90 days norm for recognition of loan impairment. These loans would continue to be governed by the 180 days norm for classification as NPA.

(b) Facility for Placement of Deposits with other Scheduled UCBs

111. It was indicated in the annual policy Statement of April 2001 that UCBs would not be permitted to increase the term deposit balances with other UCBs and the outstanding deposits had to be unwound before end-June 2002. In

view of the difficulties expressed by UCBs in managing their short-term surplus funds while adhering to this prescription, it is proposed:

- To permit UCBs to place deposits with strong scheduled UCBs (other than banks classified as weak or sick) with certain conditions. Detailed guidelines in this regard are being issued separately.

(c) Enhancement of Limit in the Ceiling on Unsecured Advances

112. At present, a ceiling of Rs.25,000 for UCBs with demand and time liabilities (DTL) of less than Rs.10 crore and Rs.50,000 for UCBs with DTL of Rs.10 crore and above has been prescribed for granting unsecured advances to a single borrower/connected group. In order to provide greater flexibility, it is proposed to revise the ceiling on the unsecured advances by the UCBs as under:

Type of UCB	Ceiling on unsecured advances
(a) Non-scheduled UCBs with DTL of less than Rs.10 crore	Rs.50,000
(b) Non-scheduled UCBs with DTL of more than Rs.10 crore	Rs.1 lakh
(c) Scheduled UCBs	Rs. 2 lakh

The enhanced ceiling would not be applicable to weak/sick UCBs.

113. The aggregate of unsecured advances granted by a UCB to its members as a whole, would continue to be within the overall ceiling of 33 ? per cent of the bank's DTL as hitherto.

(d) Timely Compliance with Inspection Reports

114. At present, UCBs have to prepare a compliance report on the inspection report in a prescribed proforma and submit the same to the regional office of Urban Banks Department within a period of six months from the date of receipt of the inspection report. The Joint Parliamentary Committee (JPC)

which enquired into the stock market scam and matters relating thereto, recommended that:

"RBI must introduce a system whereby the irregularities pointed out in the annual inspection reports are removed by the banks and compliance report is submitted within a period of six months from the date of inspection".

- In line with the above recommendation of the JPC, it has been decided that UCBs would be given a maximum period of six months from the date of the inspection report to remove the irregularities pointed out in the inspection report in all respects, failing which RBI will invoke the penal provisions.

(e) Mandatory Concurrent Audit

115. At present, all scheduled and other UCBs with deposits of over Rs. 50 crore are required to introduce the system of concurrent audit. The JPC has recommended that:

"As an apex body, though it is not possible for RBI to monitor each and every transaction, it is essential that concurrent audit is conducted in the banks on a regular basis. The RBI may consider making this mandatory".

- In line with the above recommendation of the JPC, all UCBs are advised to introduce concurrent audit with immediate effect.

(f) Loans and Advances by UCBs to their Directors

116. In regard to loans and advances or other financial accommodation by UCBs to their directors, the JPC has recommended that:

"In order to prevent irregularities of the type surfaced in the case of some of the cooperative banks which were examined by the Committee, they are of the view that full ban on granting of loans and advances to the directors and their relatives, or the concerns in which they are interested needs to be

imposed. Appropriate legal procedures may be initiated to ensure that there is no conflict of interest in the grant of loans and advances to the directors and their relatives and the concerns in which they are interested".

- In line with the above recommendation of the JPC, UCBs, with immediate effect, should not grant loans and advances (both secured and unsecured) to directors, their relatives and firms/concerns/ companies in which they are interested.

Existing advances extended prior to April 29, 2003 may be allowed to continue up to the date when they are due. These advances should not be renewed or extended further.

Supervision and Monitoring

117. Progress made in respect of certain announcements made in the mid-term Review of October 2002 is reviewed below.

(a) Risk Based Supervision

118. It was indicated in the mid-term Review of October 2002 that certain management processes were initiated by RBI for switching over to risk based supervision (RBS) of banks during 2003. These processes included circulation of the risk profile template (RPT) for use by banks, training on RBS and compilation of RBS manual. In this context, a number of banks had undertaken an assessment of risks as per the RPT. A review of these assessments revealed that banks are capable of adopting the risk-profiling system on their own and the template can be used for risk analysis and in facilitating the process of switching over to RBS. An internal Group was also set up at the instance of Board for Financial Supervision (BFS) to assess the preparedness

of banks to switch over to RBS regime. The Group concluded that in terms of preparedness, banks could be segregated into three groups. The first group, where RBS can be implemented immediately, could include banks that have developed advanced risk management architecture, MIS and IT, internal control system and trained manpower. The second group which may require about six months to one year for implementing RBS, could comprise banks that have taken steps to remove the identified gaps in their systems, but are not yet fully ready. The third group would consist of banks which require more time than their counterparts in the second group. It is proposed to implement RBS of a few select banks on pilot basis during April-June 2003. Based on the experience gained, RBS would be extended to all banks in a phased manner.

(b) Prompt Corrective Action

119. As indicated in the mid-term Review of October 2002, an internal Group was set up to study the impact of the prompt corrective action (PCA) framework on select weak banks. On the basis of the impact study, the scheme of PCA was announced in December 2002 with the approval of Board for Financial Supervision (BFS) and the Government. In terms of the scheme, RBI would initiate certain structured action in respect of banks which have hit the trigger points in terms of capital to risk-weighted assets ratio (CRAR), net non-performing assets (NPA) and return on assets (ROA). The Reserve Bank, at its discretion, would also resort to additional discretionary actions under each of the trigger points. However, the PCA framework does not preclude RBI from taking any other action, as it deems fit, in addition to the corrective actions prescribed in the framework. The scheme of PCA has been put in place initially for a period of one year and would be reviewed in December 2003. Banks have been advised to place the scheme before their Boards and take necessary steps in advance in order to ensure that as far as possible, they do not come within the scope of PCA framework.

(c) Consolidated Accounting and Supervision

120. It was indicated in the mid-term Review of October 2002 that guidelines on consolidated accounting and supervision were being finalised in consultation with banks. On the basis of the feedback received, the guidelines were modified, wherever necessary. The final guidelines have been issued and banks were advised to ensure strict compliance commencing from the year ended March 31, 2003. The guidelines would be reviewed after one year from the date of implementation.

(d) Macro-prudential Indicators

121. It was indicated in the mid-term Review of October 2002 that the scope and coverage of macro-prudential indicators (MPIs) were enhanced in the review for the half-year ended March 2002 and the salient features of the MPI report would be published. Accordingly, the salient features of the MPI review for March 2002 was published in the Report on Trend and Progress of Banking in India 2001-02.

(e) Other Supervisory Initiatives

122. Other supervisory initiatives are as under:

(i) The Reserve Bank has issued, in December 2002, a guidance note on risk-based internal audit system to banks. Banks are advised to place the same before their Boards for initiating necessary steps for transition to the system in a phased manner.

(ii) Detailed guidelines for preventing slippage of NPA accounts from sub-standard to doubtful/loss category were issued to banks suggesting, *inter alia*, that banks can introduce a new asset category of “special mention accounts” in between “standard” and “sub-standard” accounts for their own internal monitoring and follow-up.

(iii) A comprehensive check-list for conducting computer audit recommended by the Committee on Computer Audit was circulated to banks and FIs. In addition, an Information System Audit Cell has been formed in RBI to scrutinise annual financial inspection (AFI) reports for initiating corrective action, if any, at an early stage. The Cell has also been entrusted with the work of updating the check-list with latest developments, revision of guidance notes for banks on risks and controls in computer and communication systems, and updating the Manual for inspection of banks in computerised environment on an ongoing basis.

Prudential Measures

123. The prudential norms are aimed at imparting strength to banks and financial institutions, inculcating greater accountability and market discipline and creating a secure and conducive environment for the smooth and effective functioning of the financial system. These norms cover not only capital adequacy, asset classification and provisioning but also exposure rules, accounting standards, transparency and disclosure, risk management and asset-liability management system. In this context, RBI's approach has been to benchmark the norms with international standards and introduce the same after extensive consultations. It has also been a standard practice to allow the participants to absorb changes incrementally without causing any major dislocation.

124. The New Capital Accord, presently under consideration of the Basel Committee, aims at capturing major risks inherent in a bank's operations and envisages enhancement of risk sensitivity. In order to equip banks to identify, measure, monitor and control the various types of risks assumed by them, RBI has, over a period, issued various guidelines and guidance notes taking into account the overall ability of banks to adopt them. The Reserve Bank has also taken a number of proactive steps and rationalised various prudential norms to

prepare banks to understand the complexity and lessen the burden of costs involved in adhering to the international standards. These steps include phased provisioning, building up of investment fluctuation reserve (IFR) to guard against interest rate risks, refining asset-liability management systems with tolerance levels, assessing the impact of the proposed New Capital Accord on banks by conducting quantitative impact studies (QIS), relaxing exposure norms and permitting concessional risk weights in critical areas of importance and putting in place a sound 'know your customer' (KYC) policy and adopting anti-money laundering measures.

125. Taking into account the preliminary results of the QIS, the Basel Committee is fine-tuning risk weights assigned to banks' exposures to retail customers, small and medium enterprises (SMEs), residential mortgages, securitisation transactions, past due loans etc., reflecting the risk characteristics of these exposures. The Basel Committee is also considering entrusting the supervisors with discretion for estimating capital charge for operational risk appropriate to risk profile of the bank.

126. In view of global competition and progressive liberalisation in the external sector of the economy along with increasing capital account convertibility, banking sector will be facing new challenges. This process requires banks to build up effective and well co-ordinated long-term strategies to keep pace with reforms. Further measures in this direction are indicated below.

(a) Investment Fluctuation Reserve

127. At present, the investment fluctuation reserve (IFR) is treated as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets. As suggested by banks, and to give further relaxation in building IFR, it is proposed that:

- While IFR would continue to be treated as Tier II capital, it would not be subject to the ceiling of 1.25 per cent of the total risk-weighted assets. However, for the purpose of compliance with the capital adequacy norms, Tier II capital including IFR, would be considered up to a maximum of 100 per cent of total Tier I capital.

(b) Branch Licensing

128. In the recent period, the policy for commercial banks has been substantially liberalised. Banks' Boards have been empowered to decide on the policy and strategy for setting up of new branches, closing and shifting of existing branches, subject to certain conditions. In order to encourage more efficient banking services all over the country, it is proposed to provide further flexibility in the branch licensing policy. Accordingly:

- RBI will consider favourably any proposal for transfer of branches in rural and semi-urban centres from one commercial bank to another by mutual agreement. Banks will be expected to ensure that such mutually agreed transfers do not adversely affect the available banking services in that area.

(c) Policy for Raising Long-term Bonds by Banks

129. At present, banks are permitted to issue long-term subordinated debt in the nature of unsecured redeemable bonds which qualify for inclusion in Tier II capital. Apart from raising resources through Tier II capital bonds, in order to realign the portfolios from the asset-liability management angle, and to honour the long-term commitments, banks have expressed their desire to raise long-term resources from the market which are not in the nature of subordinated debt. It is proposed to accept this suggestion, and suitable policy guidelines for banks in this regard will be worked out in consultation with them.

(d) Provisioning in respect of NPAs which would be sold to Securitisation/Asset Reconstruction Companies

130. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, allows securitisation/reconstruction companies created under the Act, to purchase non-performing assets (NPAs) from banks. In order to facilitate sale of NPAs to securitisation/reconstruction companies, guidelines to banks and FIs have been issued covering, *inter alia,* (i) policy for sale of assets to securitisation/reconstruction companies approved by the Board; (ii) accounting treatment of sale of NPAs and investment in bonds, debentures, security receipts which may be offered by the securitisation/ reconstruction companies and valuation thereof; (iii) capital adequacy requirements and exposure norms applicable to the above investments; and (iv) disclosure requirements. It is envisaged that banks would be able to sell their NPAs to securitisation/reconstruction companies at considerable discount and the resultant shortfall, if any, in the net book value after deducting provisions held, would be required to be debited to the profit and loss account. Banks are, therefore, advised to build up provisions, significantly above the minimum regulatory requirements, for their NPAs particularly for those assets which they propose to sell to securitisation/reconstruction companies.

(e) Country Risk Management

131. It was indicated in the mid-term Review of October 2002 that draft guidelines on country risk management together with a ‘Note for Discussion’ were forwarded to banks and were also placed on the RBI website seeking comments and views. The guidelines were finalised in consultation with banks and have since been issued. These guidelines are applicable only in respect of countries where a bank has exposure of 2.0 per cent or more of its assets. Banks are advised to place the guidelines before their Boards and take appropriate steps for implementation. A review would be made after one year taking into account the experience of banks in implementing the guidelines.

Technology Upgradation

132. The Reserve Bank has assigned priority to the upgradation of technological infrastructure in the financial system. In this direction, the Payments System Vision Document, giving the nature and direction of reforms needed to achieve the vision, was set out. Substantial progress has been made since then for developing a modern, efficient, integrated and secure payment and settlement system for the financial services sectors. Modernisation of clearing and settlement through MICR based cheque clearing, popularising electronic clearing services (ECS) and integration of RBI-EFT scheme with funds transfer schemes of banks, introduction of centralised funds management system (CFMS) are significant milestones in this regard. Introduction of cheque truncation and imaging of paper-based cheques had also been envisaged to reduce the time lags in realisation of cheques. An efficient, cost-effective and dependable communication backbone – the INFINET – was established on which the structured financial messaging solution (SFMS) is being implemented. Further, RBI is monitoring on an ongoing basis the progress in respect of implementation of core banking solutions by banks, as the future of banking and finance revolves around meeting the challenges arising out of large scale growth in technology. This requires concerted efforts by all participants in the financial system to maximise efficiency and reduce costs. Further developments in this direction are reviewed in the **Annex**.

Developments in Currency Management System

133. Over the years, the growth in volume of currency has posed serious problems in regard to the currency management function of RBI in the areas of supply of notes, quality of notes and withdrawal of notes from circulation. Further, RBI has adopted a Clean Note Policy since 1999 towards improving the quality of notes in circulation. In order to maintain the quality of growing volume of notes in circulation, as a long-term measure, mechanisation of the

note processing and destruction activity was taken up at all issue offices of RBI. As this requires notes in an unstapled condition, RBI has advised banks not to use wire stapling.

134. Further, as part of customer service, banks have been advised to open certain currency chest branches on Sundays for providing note exchange facility and distribution of coins. Banks have also been advised to install note counting/note sorting machines at currency chests/major bank branches of adequate size. A Currency Link was set up at RBI website which covers various aspects related to Indian currency and coinage, images and security features of contemporary bank notes in the Mahatma Gandhi series, frequently asked questions (FAQs) and press releases on currency issues. Banks are advised to give wide publicity to the initiatives in the area of currency management for convenience of the public as also provision of good quality bank notes.

Legal Reforms

135. In the recent past, changes in the financial markets and advancement in information technology have necessitated changes in the legal structure. The mid-term Review of October 2002 listed out various proposals submitted to the Government for making the legal system more efficient to manage the emerging scenario. While legislative action has been completed in respect of certain proposals, some of the proposals are under consideration. Progress made in this direction is given in the **Annex**.

Mid-term Review

136. A review of the monetary and credit developments in the first half of the current year will be undertaken in October 2003. The mid-term Review will 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.

Mumbai

April 29, 2003

Annexes

I. Working Groups: Progress Report

II. Legal Reforms: Review of Developments

III. Technology Upgradation: Review of Developments

IV. Developments in Government Securities Market

V. Recent Foreign Exchange Liberalisation Measures: Current and Capital Accounts

Annex I. Working Groups: Progress Report

Flexibility in Interest Rate

As indicated in the mid-term Review of October 2002, banks were encouraged to make efforts to popularise flexible deposit schemes among the depositors as these were in the long-term interest of banks as well as depositors. Further, in order to improve flexibility in the interest rate, banks were given freedom to decide the period of reset on variable rate deposits. In this context, a Working Group has also been constituted (Chairman: Shri H.N. Sinor, Joint Managing Director, ICICI Bank Ltd.) with members from major banks and RBI to examine various issues concerning the deposit rates including floating rate of interest on fixed deposits.

Transparency and Accounting Standards

It was indicated in the annual policy Statement of April 2002 that a Working Group (Chairman: Shri N.D. Gupta, former President, ICAI) was constituted to identify compliance by banks, as also gaps in compliance with the accounting standards issued by the ICAI and recommend steps to eliminate/reduce the gaps. On the basis of recommendations of the Group, final guidelines were issued for compliance with effect from the accounting year ended March 31, 2003.

Progress in Corporate Debt Restructuring

As indicated in the mid-term Review of October 2002, a High Level Group (Chairman: Shri Vepa Kamesam, Deputy Governor) was constituted to review the operations of Corporate Debt Restructuring (CDR) scheme in order to identify the operational difficulties, if any, and suggest measures to make the scheme more efficient. Based on the recommendations of the High Level

Group and in consultation with the Government, a revised scheme of CDR was finalised and issued to banks for implementation.

Short-term Liquidity Forecasting Model

It was indicated in the mid-term Review of October 2002 that a short-term liquidity forecasting model was developed by RBI under the guidance of an Advisory Committee of academics and was operationalised for internal evaluation. The generic form of the model was made available on RBI website for suggestions and comments. The results of the model are being used by RBI for policy analysis and assessment since November 2002. The model is also back-tested routinely to validate its performance by comparing the forecasts with actuals. The model is being updated on an ongoing basis to improve its performance.

International Financial Standards and Codes

It was indicated in the annual policy Statement of April 2002 that the ten Advisory Groups constituted by the Standing Committee on International Financial Standards and Codes had submitted their reports. As indicated in the mid-term Review of October 2002, an internal Technical Group, constituted by the Standing Committee to assess India's position *vis-à-vis* international standards on 'market integrity' also submitted its report. Subsequently, a synthesis report covering the recommendations of all Advisory/Technical Groups was submitted to the Standing Committee. These reports, including the report of the Standing Committee, were placed on the RBI website for wider dissemination and comments.

Residential Mortgage Backed Securities

As indicated in the mid-term Review of October 2002, the Working Group (Chairman: Shri R.V. Verma, Executive Director, National Housing Bank) set up

to examine the modalities for widening the investor base, improving the quality of assets, creating liquidity for trading in mortgage backed securities (MBS) of housing finance companies (HFCs) and other related issues submitted its report in December 2002. The recommendations of the Group are under examination.

Annex II. Legal Reforms: Review of Developments

Legislations Enacted

- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Act No.54 of 2002).
- The Negotiable Instruments (Amendments & Miscellaneous Provisions) Act, 2002 (Act No.55 of 2002).
- The Prevention of Money Laundering Act, 2002 (Act No.15 of 2003).
- The Companies (Amendment) Act, 2002 (No.1 of 2003).
- The Companies (2nd Amendment) Act, 2002 (Act No.11 of 2003).
- Unit Trust of India (Transfer of Undertakings & Repeal) Act, 2002.
- The Multi-State Co-operative Societies Act, 2002.

Bills Under Consideration of the Parliament

- The Financial Companies Regulation Bill, 2000 (Bill No.196 of 2000).
- Banking Companies (Acquisition & Transfer of Undertakings) & Financial Institutions Laws (Amendment) Bill, 2000.
- The Fiscal Responsibility & Budget Management Bill, 2000.
- Industrial Development Bank (Transfer of Undertaking & Repeal) Bill, 2002.

Legislative Proposals Under Consideration of the Government

- Payment Systems Bill, 2002.
- Amendments to the Banking Regulation Act, 1949.
- Amendments to the Reserve Bank of India Act, 1934.
- Draft Bill on Credit Information Bureau Regulation.
- Bank Deposit Insurance Corporation Bill.
- Factoring of Debts due to Industrial & Commercial Undertaking Bill, 2002.

- Proposal to replace the Public Debt Act, 1944 with a new Government Security Act.
- Amendments to State Bank of India Act, 1955 & State Bank of India General Regulation 1955.
- Amendments to State Bank of India (Subsidiary Banks) Act, 1959.
- The Urban Co-operative Banks Supervisory Authority Act, 2001.
- Proposal for Divesting the RBI Shareholding in the Capital of SBI, NHB & NABARD.
- Proposal for Legislation on Financial Fraud (Investigation, Prosecution, Recovery & Restoration of Property).

Annex III. Technology Upgradation: Review of Developments

Implementation of Centralised Funds Management System

The centralised funds management system (CFMS) provides for a centralised viewing of balance positions of the account holders across different accounts maintained at various locations of RBI. While the first phase of the system covering the centralised funds enquiry system (CFES) has been made available to the users, the second phase comprising the centralised funds transfer system (CFTS) would be made available by the middle of 2003. So far, 54 banks have implemented the system at their treasuries/funds management branches.

Certification and Digital Signatures

The mid-term Review of October 2002 indicated the need for information security on the network and the use of public key infrastructure (PKI) by banks. The Controller of Certifying Authorities, Government of India, have approved the Institute for Development and Research in Banking Technology (IDRBT) as a Certification Authority (CA) for digital signatures. Consequently, the process of setting up of registration authorities (RA) under the CA has commenced at various banks. In addition to the negotiated dealing system (NDS), the electronic clearing service (ECS) and electronic funds transfer (EFT) are also being enhanced in terms of security by means of implementation of PKI and digital signatures using the facilities offered by the CA.

Committee on Payment Systems

In order to examine the entire gamut of the process of reforms in payment and settlement systems which would be culminating with the real time gross settlement (RTGS) system, a Committee on Payment Systems (Chairman: Dr. R.H. Patil) was set up in 2002. The Committee, after examining

the various aspects relating to payment and settlement systems, submitted its report in September 2002 along with a draft Payment Systems Bill. The draft Bill provides, *inter alia,* a legal basis for netting, apart from empowering RBI to have regulatory and oversight powers over payment and settlement systems of the country. The report of the Committee was put on the RBI website for wider dissemination. The draft Bill has been forwarded to the Government.

Multi-application Smart Cards

Recognising the need for technology based payment products and the growing importance of smart card based payment flows, a pilot project for multi-application smart cards in conjunction with a few banks and vendors, under the aegis of the Ministry of Communications and Information Technology, Government of India, has been initiated. The project is aimed at the formulation of standards for multi-application smart cards on the basis of inter-operable systems and technological components of the entire system.

Special Electronic Funds Transfer

As indicated in the mid-term Review of October 2002, national EFT (NEFT) is being introduced using the backbone of the structured financial messaging system (SFMS) of the IDRBT. NEFT would provide for movement of electronic transfer of funds in a safe, secure and quick manner across branches of any bank to any other bank through a central gateway of each bank, with the inter-bank settlement being effected in the books of account of banks maintained at RBI. Since this scheme requires connectivity across a large number of branches at many cities, a special EFT (SEFT) was introduced in April 2003 covering about 3000 branches in 500 cities. This has facilitated same day transfer of funds across accounts of constituents at all these branches.

National Settlement System

The clearing and settlement activities are dispersed through 1,047 clearing houses managed by RBI, the State Bank of India and its associates, public sector banks and other institutions. In order to facilitate banks to have better control over their funds, it is proposed to introduce national settlement system (NSS) in a phased manner.

Real Time Gross Settlement System

As indicated in the mid-term Review of October 2002, development of the various software modules for the RTGS system is in progress. The initial set of modules is expected to be delivered by June 2003 for members to conduct tests and familiarisation exercises. The live run of RTGS is scheduled towards the end of 2003.

Annex IV. Developments in Government Securities Market

Calendar for Issuance of Dated Securities

The system of releasing the calendar for issuance of Government of India dated securities every half-year was introduced in 2002-03. These calendars were generally adhered to with some minor deviations with regard to the timing of the auctions, amounts raised and also the tenor of the security from the scheduled issuances. An indicative calendar for the first half of the financial year 2003-04 was issued on March 31, 2003.

Consolidation of Debt of Government of India

The Reserve Bank has been resorting to consolidation of securities since 1999 through reissuance of existing securities. In line with this process, 19 out of 31 securities issued during 2002-03 were reissues. Out of an amount of Rs.1,25,000 crore (gross) raised through dated securities under the market borrowing programme of the Central Government, an amount of Rs.74,000 crore (59 per cent of the gross amount) represented reissuances.

As at the end of March 2003, out of 117 outstanding marketable government securities of Rs.6,73,905 crore, 29 securities with outstanding stock of Rs.10,000 crore or more account for 54 per cent. RBI will continue to undertake such passive consolidation through reopenings.

The Government of India has also announced in Budget 2003-04 its intention to offer a buy-back of loans contracted under the high cost regime of the past and issue new securities at current market yield. The buy-back will be entirely on a voluntary basis from banks that are in need of liquidity, or encashing the premium for making provisions for their non-performing assets (NPAs) thereby improving their balance sheets. Such switch operations would also result in consolidation of debt. The details of the schemes are being worked out by the Government in consultation with RBI.

The Government of India also introduced a debt swap scheme in order to restructure state governments' debt. This policy measure will help in reduction of the interest burden of the States by prepayment to the Centre out of the proceeds of fresh market borrowings and additional resources out of full allocation of small savings collections to the States. In 2002-03, Rs.10,000 crore were raised as market loans for this purpose. The debt swap scheme is expected to continue for the next few years depending on market conditions and liquidity position.

Trading on Stock Exchanges

In order to enlarge the number of participants and to provide country-wide access to trading in government securities, a scheme of anonymous screen-based order-driven trading in government securities on the stock exchanges in accordance with the accepted best practices relating to trading and settlement was announced in Budget 2002-03. Accordingly, a facility has been provided to buy and sell government securities through the stock exchanges (NSE, BSE and OTCEI) with effect from January 16, 2003.

Extension of Repo to CSGL Account Holders

Earlier, only subsidiary general ledger (SGL) account holders with RBI, Mumbai, were permitted to enter into ready forward (repo) transactions in government securities and Treasury Bills. In order to increase the investor base of repo market coupled with the need to make call/notice money market a pure inter-bank market, RBI has now permitted non-SGL account holders to enter into repos in government securities including Treasury Bills, effective from March 3, 2003. The non-SGL account holders can now enter into ready forward contracts through their gilt accounts maintained with the custodians under the constituents’ subsidiary general ledger (CSGL) facility, subject to certain guidelines.

Government Securities Lending Scheme of CCIL

Clearing Corporation of India Limited (CCIL) has been a major facilitator of transactions in the government securities market as it provides guaranteed settlement of trades. To ensure smooth settlement, CCIL has been permitted by RBI to enter into arrangements with select members to borrow required government securities from them under its Securities Lending Scheme.

Guidelines for Uniform Accounting of Repo/ Reverse Repo Transactions

The Reserve Bank has issued guidelines for uniform accounting norms for repo and reverse repo transactions in consultation with market participants.

Rollover of Repos

In the mid-term Review of October 2002, the proposal to allow rollover of repo contracts using the same securities between the same counterparties was announced. On completion of modifications in settlement related systems, the rollover of repos will be permitted subject to proper safeguards.

Operationalisation of STRIPS

The Reserve Bank has accepted the recommendations of the Working Group on operational and prudential guidelines on STRIPS for dates for consolidation of coupon strips (March/September 25 and May/November 30). In order to consolidate coupon volume, it has been decided to issue new securities to the extent feasible. The primary dealers (PDs) which meet certain financial criteria laid down for this purpose will be authorised to undertake stripping and reconstitution of securities. The Reserve Bank will act as a registry for stripped bonds. The accrued discount value of the STRIPS along with the book value of the same will be reckoned for SLR purposes. FIMMDA will publish the market rates for stripped zero coupon bonds on a monthly basis for valuation and tax purposes. At present, RBI is in the process of drawing up

the detailed specifications required for the development of the stripping/reconstitution module in the public debt office (PDO)/negotiated dealing system (NDS).

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

Corporates

1. Exporters are permitted to extend trade related loans/advances to overseas importers out of their exchange earners' foreign currency (EEFC) balances without any ceiling.
2. General permission is given to entities in the special economic zones (SEZs) to undertake hedging transactions in the international commodity exchanges/markets to hedge their commodity price risk on import/export on "stand-alone" basis.
3. A unit in domestic tariff area (DTA) can receive foreign exchange out of the foreign currency account of a unit in SEZs which is permitted to be treated as eligible for credit to its EEFC account.
4. The limit for advance remittance without bank guarantee for import of goods into India raised.
5. Indian corporates having overseas offices permitted to acquire immovable property outside India for their business as also staff residential purposes with prior permission of RBI.
6. Indian companies are allowed to retain abroad funds raised through American Depository Receipts (ADRs)/Global Depository Receipts (GDRs), for any period to meet their future forex requirements.
7. Considerable liberalisation and simplification has been made in procedures for foreign exchange transactions and reporting system in several areas such as disinvestment of shares through issue of ADRs/GDRs, transactions covering life insurance/reinsurance, documentary evidence for imports, write-off of unrealised export bills, reporting system for foreign exchange transactions by banks etc.

8. Swap transactions enabling customers to hedge their foreign exchange exposures allowed without any limit.
9. Rebooking of cancelled contracts by customers is freely permitted in respect of all foreign exchange exposures falling due within one year.

Resident Individuals

1. Residents have been allowed to open resident foreign currency (RFC) (Domestic) accounts without any ceiling.
2. Resident individuals are permitted to remit foreign exchange for acquisition of foreign securities under employees' stock option plan (ESOP) scheme without any monetary limit.
3. Release of foreign exchange for private visits increased.
4. Resident shareholders of Indian companies are permitted to offer their shares for conversion to ADRs/GDRs and to receive the sale proceeds either in foreign currency or by way of credit to their EEFC/ RFC(Domestic) accounts or to their rupee accounts in India at their option.

Non-resident Indians

1. Non-resident Indians (NRIs)/persons of Indian origin (PIOs) and foreign nationals are permitted to remit up to US $ 1 million per calendar year out of balances held in non-resident ordinary (NRO) accounts/sale proceeds of assets for the purpose of education, medical expenses etc.
2. The lock-in period for repatriation of sale proceeds of immovable property (other than agricultural land/farm house/plantation property) purchased in India by NRIs/PIOs removed.

3. Authorised dealers (ADs) are permitted to issue international credit cards (ICCs) to NRIs/PIOs and to remit refund of funds received for purchase of shares.

Further Facilities for Investments

Investments Abroad

1. Resident individuals, listed Indian companies and mutual funds are permitted to invest in certain listed companies abroad.
2. Investment norms for undeployed FCNR(B) funds in overseas markets further liberalised.
3. Banks are allowed to invest their unimpaired Tier I capital in overseas money market or debt instruments without any percentage or absolute limit subject to approval by their Board of Directors.
4. Indian companies can invest abroad funds raised through ADRs/GDRs in bank deposits/certificates of deposit (CDs), Treasury Bills and other monetary instruments pending repatriation/utilisation of such funds.

Foreign Investments in India

1. Indian companies are allowed to remit the redemption proceeds of the non-convertible debentures (NCDs)/partial-convertible debentures (PCDs) issued by them to NRIs/OCBs without prior permission of RBI.
2. The foreign institutional investors (FIIs) are permitted to hedge the market value of their entire investment in equity as on a particular date without any reference to a cut-off date.
3. General permission has been accorded to ADs to offer forward contracts to persons resident outside India to hedge the investments made by them in India.
4. Foreign banks in India are allowed to hedge their Tier I capital in Indian books without any restriction on timing of the hedge transactions.