# ANNUAL POLICY STATEMENT FOR THE YEAR 2004-05

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**Annual Policy Statement for the Year 2004-05**
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The policy documents of the Reserve Bank provide a framework for the monetary and other relevant measures that are taken from time to time and capture the rationale or the underlying factors at work that affect its macroeconomic assessments. The documents also set out the logic, intentions and actions related to structural and prudential aspects of the financial sector. This Statement broadly follows the pattern already set in previous years. It delineates and elaborates on various areas in which RBI has been taking measures from time to time and provides a focus on broad policies that are intended to be pursued for the year 2004-05, while retaining the flexibility to take specific measures promptly and effectively as the evolving circumstances warrant.

2. The Statement consists of three parts: (I) Review of Macroeconomic and Monetary Developments during 2003-04; (II) Stance of Monetary Policy for 2004-05; and (III) Financial Sector Reforms and Monetary Policy Measures. An analytical review of macroeconomic and monetary developments is also being issued, as in the past, as a separate document providing the necessary information and technical analysis with the help of simple charts and tables.

## I. Review of Macroeconomic and Monetary Developments during 2003-04

### Domestic Developments

3. The annual Statement on monetary and credit policy released on April 29, 2003 projected real GDP growth for 2003-04 at about 6.0 per cent for policy purposes. Based on a review of developments since then, the Reserve Bank had scaled up its projection of GDP growth from time to time, and expected a GDP growth of 7.0 per cent with an upward bias in January 2004. The advance estimate of GDP for 2003-04 released by the Central Statistical Organisation (CSO) in February 2004 has placed the GDP growth much higher at 8.1 per cent.

4. The higher GDP growth of 8.1 per cent during 2003-04 as against 4.0 per cent in the previous year reflects a rebound in agricultural production. GDP from agriculture and allied activities is estimated to have increased by 9.1 per cent during 2003-04 as against a decline of 5.2 per cent in the previous year. The overall growth of the industrial sector at 6.6 per cent is also higher than that of 6.2 per cent in the previous year reflecting higher growth in manufacturing as well as ‘electricity, gas and water supply’. The services sector has grown by 8.2 per cent as compared with 7.2 per cent in the previous year.

5. The annual inflation rate as measured by variations in the wholesale price index (WPI), on a point-to-point basis, declined from 6.5 per cent at end-March 2003, *albeit* with intra-year variations, to 4.5 per cent by end-March 2004. The reduction in inflation during 2003-04 reflects lower price increase in primary articles and in the fuel group. Prices of primary articles (weight: 22.0 per cent) increased by 1.7 per cent as compared with an increase of 6.1 per cent in the previous year. Similarly, there was a lower increase of 2.7 per cent in the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) as compared with an increase of 10.8 per cent in the previous year. On the other hand, prices of manufactured products (weight: 63.7 per cent) registered a higher increase of 6.3 per cent as compared with an increase of 5.1 per cent in the previous year.

6. Excluding 'fuel, power, light and lubricants' group (weight: 14.2 per cent), the annual inflation worked out to 4.9 per cent as against 5.4 per cent in the previous year. The rate of inflation, excluding food articles and the fuel group (weight: 29.6 per cent), stood at 6.0 per cent as compared with 6.6 per cent in the previous year.

7. The annual rate of inflation during 2003-04, as measured by increase in WPI on an average basis, was higher at 5.4 per cent as compared with 3.4 per cent in the previous year. Annual inflation as measured by variations in the consumer price index (CPI) for industrial workers, on a point-to-point basis, was lower at 3.5 per cent during 2003-04 as compared with 4.1 per cent in the previous year. On an average basis, inflation as reflected in CPI was also marginally lower at 3.9 per cent during 2003-04 as compared with 4.0 per cent in the previous year.

8. According to the latest available data, annual inflation based on WPI on a point-to-point basis, was lower at 4.2 per cent, as on May 1, 2004 as compared with 6.9 per cent a year ago. However, on an annual average basis, WPI inflation was higher at 5.2 per cent as compared with 3.9 per cent.

9. During 2003-04, money supply ($M_3$) increased by 16.4 per cent (Rs.2,81,147 crore) as compared with 12.8 per cent (Rs.1,91,177 crore) in the previous year, after adjusting for mergers. The growth in aggregate deposits of scheduled commercial banks at 17.3 per cent (Rs.2,21,078 crore) was higher than that of 13.4 per cent (Rs.1,47,822 crore) in the previous year, adjusted for mergers. The expansion in currency with the public was also higher at 16.7 per cent (Rs.45,376 crore) as compared with 12.7 per cent (Rs.30,587 crore) in the previous year. As regards the sources of change in $M_3$, the increase in bank credit to the commercial sector at 13.3 per cent (Rs. 1,18,986 crore) during 2003-04 was higher than the increase of 11.5 per cent (Rs. 87,897 crore), net of mergers, in 2002-03. The banking sector's net foreign exchange assets increased by 30.9 per cent (Rs. 1,21,589 crore) on account of an increase of 35.2 per cent (Rs. 1,26,169 crore) in net foreign exchange assets of RBI. The growth in net bank credit to government was, however, lower at 10.0 per cent (Rs. 67,538 crore) than that of 14.4 per cent (Rs. 84,865 crore) in the preceding year. This is attributable to the substantial decline [by Rs.75,772 crore (Rs. 31,499 crore during 2002-03)] in the net RBI credit to Government in the wake of substantial open market operations (OMO) undertaken by RBI to sterilise the impact of large forex inflows.

10. The year-on-year $M_3$ growth, according to the latest available data, was 16.1 per cent by end-April 2004, as compared with 11.8 per cent a year ago. Aggregate deposits of scheduled commercial banks increased by 17.1 per cent as compared with 12.2 per cent. Currency with the public increased by 15.9 per cent as compared with 11.4 per cent.

11. The increase in reserve money during 2003-04 at 18.3 per cent (Rs.67,368 crore) was higher than that of 9.2 per cent (Rs.31,091 crore) in the previous year. As regards the components of reserve money, currency in circulation rose by 15.8 per cent (Rs.44,550 crore) as compared with 12.6 per cent (Rs.31,499 crore) in the previous year. The year-on-year growth in reserve money at 13.2 per cent and in bankers' deposits with RBI at 3.3 per cent on the last Friday of 2003-04 (March 26, 2004) were broadly reflective of the trend in these variables. As regards the sources of reserve money, RBI's foreign currency assets (adjusted for revaluation) increased by Rs.1,41,428 crore on top of an increase of Rs.82,089 crore in the previous year. The expansionary impact of foreign currency assets, however, was neutralised to a large extent by substantial OMO including sustained repo operations under the liquidity adjustment facility (LAF). Consequently, the net RBI credit to the Central Government declined by 67.3 per cent (Rs.76,065 crore) on top of a decline of 20.1 per cent (Rs.28,399 crore) in the previous year. RBI's credit to banks and commercial sector also declined by Rs.2,728 crore due to comfortable market liquidity as compared with a decline of Rs.6,468 crore in the previous year. The ratio of net foreign assets (NFA) to currency rose from 126.8 per cent at end-March 2003 to 148.1 per cent by end-March 2004 reflecting large accretion to reserves.

12. According to the latest data, year-on-year increase in reserve money was 13.3 per cent, as on May 7, 2004 as compared with 8.9 per cent a year ago.

13. Scheduled commercial banks' credit recorded an increase of 14.6 per cent (Rs.1,06,167 crore) during 2003-04 as compared with 16.1 per cent (Rs.94,949 crore), net of mergers, in the previous year. However, food credit declined by Rs.13,518 crore compared with a decline of Rs.4,499 crore in the previous year on account of the higher off-take of foodgrains. The buffer stock of foodgrains declined from 32.8 million tonnes at end-March 2003 to 20.7 million tonnes (up to April 1, 2004).

14. According to the latest data, year-on-year increase in bank credit was 18.2 per cent by end-April 2004 as compared with 13.8 per cent a year ago.

15. Non-food credit increased by 17.6 per cent (Rs.1,19,685 crore) during 2003-04 as compared with 18.6 per cent (Rs.99,448 crore), net of mergers, in the previous year. The year began with a slack in credit off-take that persisted during the first five months. Credit expansion in the subsequent months has been quite vigorous. While the growth in non-food credit was led by the housing and retail sectors, industrial credit picked up from September 2003. A significant feature of credit growth has been the substantial flow of bank credit to the priority sector which

showed an increase of Rs. 52,279 crore or about 25 per cent. Bank credit for both housing and infrastructure increased by about 42 per cent each.

16. According to the latest available data, the year-on-year increase in non-food bank credit was 20.5 per cent by end-April 2004 as compared with 16.4 per cent a year ago.

17. The total flow of funds from the scheduled commercial banks to the commercial sector including banks' investment in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper etc., increased by 15.1 per cent (Rs.1,17,008 crore) as against 17.9 per cent (Rs.1,10,501 crore), net of mergers, in the previous year. The total flow of resources to the commercial sector including capital issues, American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) and borrowings from financial institutions was higher at Rs.1,73,789 crore as compared with Rs.1,33,631 crore in the previous year.

18. The growth in industrial credit had declined during April-August 2003 but there has been a distinct improvement since then. Expansion in industrial credit was higher by about 32 per cent during September-March as compared with that during the corresponding period of the preceding year. During 2003-04, there has been a substantial increase in credit flow to the infrastructure industries, viz., roads and ports, power and telecommunications. There has also been a discernible increase in credit flow to industries like electricity, drugs and pharmaceuticals, food processing and computer software. The traditionally important industries like cotton textile, jute textile, gems and jewellery, paper and paper products, tea and construction have, in particular, also witnessed higher credit flows. On the other hand, industries like petroleum, cement and iron and steel witnessed significant decline in bank credit.

19. The Central Government revised the net market borrowings downwards in the Interim Budget to Rs.82,982 crore (gross Rs.1,44,491 crore) as against the originally budgeted net borrowings of Rs.1,07,194 crore (gross Rs.1,66,230 crore). The actual net borrowings by Central Government during 2003-04 were Rs.88,816 crore (gross Rs.1,47,636 crore). The state governments' net borrowings were Rs.46,376 crore (gross Rs.50,521 crore). During 2003-04, the combined net market borrowings of the Centre and States were Rs.1,35,192 crore (gross Rs.1,98,157 crore).

20. The weighted average cost of Central Government borrowings through primary issuance of dated securities declined by 163 basis points from 7.34 per cent in 2002-03 to 5.71 per cent during 2003-04. The weighted average maturity of dated securities issued during 2003-04 at 14.94 years was higher as compared to 13.83 years in the previous year.

21. During 2003-04, the state governments' net market borrowings at Rs.46,376 crore were significantly higher than in the previous year (Rs.30,933 crore) mainly on account of Rs.26,623 crore towards the debt swap

scheme mutually agreed between the Central Government and state governments towards repayment of high cost debt of the States to the Centre.

22. The persistence of a large government borrowing programme has implications for efficient monetary and debt management. The banking system already holds government securities to the extent of 41.5 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.2,69,777 crore which is much higher than the annual gross borrowings of the Government. Such large holdings of government securities by banks entail significant interest rate risk as the yields on government securities are already at their historically low levels. It is, therefore, essential to pursue fiscal consolidation, promptly and with resolve, from a medium-term perspective. The fiscal deficit of the Central Government for 2003-04 was revised to Rs.1,32,103 crore as against the budget estimate of Rs.1,53,637 crore. All key deficit indicators are placed lower than their corresponding budgeted levels. The aim is to achieve a balance in the revenue account by 2007-08, as envisaged in the Fiscal Responsibility and Budget Management Act (FRBMA), 2003.

23. The reduction in fiscal deficit in 2003-04 has occurred due to revenue buoyancy, containment of revenue expenditure, some cut-backs on capital expenditure and higher realisation of disinvestment proceeds. There is, however, a paramount need to step up capital expenditure notwithstanding the outcome of the revised estimates for 2003-04 and projections for 2004-05.

24. At the shorter end of the market, the weighted average call money rate declined by 149 basis points from 5.86 per cent in March 2003 to 4.37 per cent in March 2004 and further to 4.28 per cent by mid-May 2004. Similarly, the cut-off yields on 91-day and 364-day Treasury Bills also declined by 151 and 144 basis points from 5.89 per cent each in March 2003 to 4.38 and 4.45 per cent, respectively, in March 2004. The yields on government securities with 1-year residual maturity declined by 96 basis points from 5.50 per cent to 4.54 per cent during the period. The yields on 91-day and 364-day Treasury Bills were 4.42 per cent and 4.45 per cent, respectively, as on May 12, 2004.

25. The weighted average discount rate on commercial paper (CP) (61-90 days) declined by 134 basis points from 6.53 per cent in March 2003 to 5.19 per cent in March 2004. It declined further to 5.08 per cent by mid-April 2004. An interesting development in the money market during the year has been that the volumes (one leg) in market repo have increased from a daily average of about Rs.2,000 crore in April 2003 to about Rs.4,100 crore in March 2004. The repo volume has further gone up to about Rs.5,200 crore in April 2004 and the market repo rate at 3.7 per cent was lower as compared with the overnight call money rate. Similarly, the average daily volumes in the CBLO (collateralised borrowing and lending obligation) market, a money market instrument offered by Clearing Corporation of India Ltd. (CCIL), have also picked up from under Rs.40 crore in March 2003 to about Rs.2,500 crore by April 2004.

26. The yields on securities with 5-year and 10-year residual maturities declined by 114 and 106 basis points, respectively, from 5.92 and 6.21 per cent in March 2003 to 4.78 and 5.15 per cent, respectively, by March 2004. Similarly, the yields on securities with 20-year residual maturity declined by 84 basis points from 6.69 per cent in March 2003 to 5.85 per cent in March 2004. The yields on 5-year, 10-year and 20-year securities have slightly moved up to 4.87 per cent, 5.20 per cent and 5.80 per cent, respectively, by mid-May 2004.

27. With the reduction in yields being larger at the shorter end, the tenor spread in the government securities increased marginally. The spread between government securities with a residual maturity of 20-year and 1-year widened from 119 basis points in March 2003 to 131 basis points in March 2004. However, the spread between securities with residual maturity of 10-year and 1-year narrowed from 71 basis points in March 2003 to 61 basis points in March 2004. The spread between yields of 20-year and 1-year was 132 basis points, while that for 10-year and 1-year was 72 basis points by mid-May 2004.

28. In line with the trend in yields in the government securities market, the yields on corporate paper also declined. The yield on AAA-rated corporate bond declined from 6.79 per cent in March 2003 to 5.60 per cent in March 2004. Along with yields, the credit spreads narrowed slightly over the year. For example, the spread between AAA-rated corporate bonds and the yield on government securities for 5-year residual maturity narrowed from 87 basis points in March 2003 to 82 basis points in March 2004 before widening to 91 basis points by mid-May 2004.

29. The term deposit rates of public sector banks for maturities up to 1-year moved down from a range of 4.00-6.00 per cent in March 2003 to 3.75-5.25 per cent by April 2004. Similarly, the interest rates on term deposits over 1-year have declined from a range of 5.25-7.00 per cent to 5.00-5.75 per cent during the period. During 2003-04, the spread between typical deposit rates of tenor of 15-29 days and over 3-years offered by public sector banks remained unchanged at 175 basis points. Overall, there has been a considerable flattening of the term structure of deposit rates during the last three years.

30. Despite a fall in deposit rates and lowering of the cost of funds, the range of prime lending rates (PLRs) of public sector banks remained sticky. In view of the downward stickiness of PLRs, the scheme of Benchmark PLR (BPLR) was mooted in the annual policy Statement of April 2003 to address the need for transparency in banks' lending rates as also to reduce the complexity involved in pricing of loans. For smooth implementation of the new system by banks, as announced in the mid-term Review of November 2003, the Indian Banks' Association (IBA) issued a circular to its member banks outlining broad parameters to be followed by banks for the computation of BPLR. Almost all commercial banks have since announced their BPLR in place of the earlier system of tenor-linked PLR. The range of BPLR for public sector banks is lower at 10.25-11.5 per cent as compared with their earlier PLR range of 10.0-12.25 per cent. Public sector banks have reduced their rates by 25 to 100 basis points

while announcing their BPLR. The compression in the range of PLRs of foreign and private sector banks is more evident, moving from a wide range of 6.75-17.5 per cent in March 2003 to 10.5-14.85 per cent by March 2004.

31. As at end-March 2004, public sector banks' median (representative) lending rate for the demand and term loans (at which maximum business is contracted), in the range of 11.0-12.75 per cent and 11.0-13.25 per cent, respectively, exhibited some moderation as compared with their corresponding levels of 11.5-14.0 per cent and 12.0-14.0 per cent, respectively, in March 2003.

32. The movement in interest rates during 2003-04 corroborates the view that banks should, in their interest, take steps to build up investment fluctuation reserves (IFR) 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 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.

33. Considerable progress has been made in developing the Indian banking sector into a vibrant, sound and well-functioning system. The Reserve Bank's persistent efforts towards strengthening of regulatory and supervisory norms to induce greater accountability and market discipline amongst the participants, adoption of international benchmarks as appropriate to Indian conditions, improvement in management practices and corporate governance, and upgradation of the technological infrastructure have enabled the banking system to emerge as a stronger, efficient and resilient system to meet global competition. There has been substantial progress in the implementation of asset-liability management and risk management systems in banks leading to efficient internal control system, improved treasury management and higher profitability. The response of the financial sector to RBI's initiatives has been encouraging and has resulted in improved prudential banking parameters such as increased capital adequacy and declining net NPA ratios, reinforcing its stability. This has also been endorsed by international rating agencies with an upgradation in their rating. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards.

34. The dynamics of monetary management in an increasingly open economy was clearly evident during 2003-04. Some of the key aspects are as follows: First, even when the domestic interest rates remained consistent with domestic inflation, it engendered large capital inflows in the wake of expectations over promising economic gains. Second, substantial liberalisation of capital and current account transactions further reinforced capital inflows. Third, domestic inflation reflected to a significant extent the 'pass through' effects of international price trends.

35. The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements for credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active management of liquidity through OMO including LAF, and using other policy instruments at its disposal flexibly, as and when the situation warrants. In this context, the operationalisation of Market Stabilisation Scheme (MSS) has given an additional instrument for liquidity and monetary management.

**External Developments**

36. The global economic recovery has broadened and strengthened faster than expected last November. The International Monetary Fund (IMF), in its latest update on the world economy in April 2004, has projected world output to grow by 4.6 per cent in 2004, which is higher than the earlier projection of 4.1 per cent. During 2005, the world output growth is expected to remain robust at 4.4 per cent. The growth in volume of world trade is projected to pick up from 4.5 per cent in 2003 to 6.8 per cent in 2004. In the US, the growth momentum is expected to be sustained. Though recovery in the Euro area is slow, the growth outlook seems to be improving. Growth in the UK has been gaining ground and growth prospects in Japan, reinforced by foreign and domestic demand, have improved. In recent years, emerging markets have been major drivers of world growth.

37. Though the prospects for growth in global output and trade have distinctly brightened, several uncertainties still persist. The firmness in global oil prices, volatility among major currencies and cyclical factors arising out of a pick-up in economic activity increase the upside risks of inflation. While some central banks have started raising interest rates, such movement in rates would have an impact on the financial markets. Such changes are, however, not only difficult to forecast but also build in uncertainties, with possibilities of significant influence on capital flows to emerging markets. Apart from the possible global implications of interest rate uncertainties, the volatility among major currencies and their impact on capital flows and on the financial sector would remain the major concern for emerging economies. On balance of considerations, the expected pick-up in the global economy could contribute to the overall growth of the Indian economy and, in this regard, the efficacy of macro-policies in carefully managing the impact of global transition from low interest rates and currency imbalances to a more sustainable regime gains relevance. There is, however, no room for complacency in view of the uncertainties in the manner in which such transition will be managed by leading economies in the world. Hence, the Indian participants in financial markets, corporates and financial intermediaries are advised to be vigilant and to be well prepared with appropriate risk-mitigation measures. Incidentally, to the extent international interest rates impinge on domestic interest rates, it is also pertinent to take into account the relative term structures of interest rates.

38. During 2003-04, the Indian foreign exchange market witnessed orderly conditions despite payments of US $ 5.2 billion in October 2003 on account of redemption of Resurgent India Bonds (RIBs). The exchange rate of the rupee which was at Rs.47.50 per US dollar in March 2003 appreciated by 9.5 per cent to Rs.43.39 per US dollar by

March 2004, but depreciated by 3.1 per cent against the Euro, 5.9 per cent against Pound sterling and 4.4 per cent against Japanese yen during the period.

39. India’s foreign exchange reserves increased by US $ 37.6 billion from US $ 75.4 billion at end-March 2003 to US $ 113.0 billion by end-March 2004. The foreign currency assets rose by US $ 35.5 billion from US $ 71.9 billion to US $ 107.4 billion during the same period. During the year, the Reserve Bank made available foreign currency of US $ 5.2 billion to the State Bank of India (SBI) for redemption of RIBs. In addition, the Reserve Bank also made available US $ 6.8 billion to the Government for repayment of certain high cost foreign currency loans from both multilateral and bilateral sources. In these transactions, since equivalent amount of government securities were issued to the Reserve Bank on private placement basis, there was no monetary impact and the aggregate debt position of the Government also remained unchanged.

40. India’s foreign exchange reserves have increased further by US $ 5.6 billion from US $ 113.0 billion in end-March 2004 to US $ 118.6 billion by May 7, 2004.

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

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

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

- A judicious policy for management of the capital account.

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

43. During 2003-04, India’s exports in US dollar terms increased by 17.1 per cent as compared with 20.3 per cent in the previous year. Imports showed a higher increase of 25.3 per cent as compared with 17.0 per cent in the previous year. While the growth of oil imports was lower at 14.3 per cent as compared with 26.1 per cent in the

previous year, non-oil imports showed a higher increase of 29.4 per cent as compared with 13.7 per cent in the previous year. As a result of higher imports and lower exports, the trade deficit widened to US $ 13.7 billion as compared with US $ 7.4 billion in the previous year.

44. At a further disaggregated level, non-oil imports excluding gold and silver increased by 26.2 per cent during 2003-04 (April-December) as compared with a lower increase of 19.0 per cent in the corresponding period of the previous year. Import of capital goods showed an increase of 34.5 per cent comparable with a similar increase of 33.9 per cent in the corresponding period of the previous year, reflecting revival of investment demand. Growth in exports was largely driven by manufactured goods, particularly engineering goods, chemicals & related products, gems & jewellery and petroleum products.

45. The current account of the balance of payments, which had remained in surplus consecutively in the previous two years, showed a surplus of US $ 3.2 billion during April-December 2003. The trade deficit (on payments basis) of US $ 15.0 billion was more or less offset by private transfers of US $ 14.4 billion. In addition, there was a significant increase of US $ 17.8 billion in net capital inflows comprising mainly foreign investment (US $ 10.1 billion), NRI deposits (US $ 3.5 billion) and other capital (US $ 3.4 billion). As a result, the net accretion to foreign exchange reserves, including valuation changes, amounted to US $ 26.4 billion during April-December 2003. Going by current indications, India would register a current account surplus during 2003-04 for the third year in succession.

46. The most distinguishing feature of the external sector during 2003-04 relates to the large capital flows with its inevitable implications for the conduct of domestic monetary policy and exchange rate management. The degree of impact of such flows on domestic monetary policy, however, depends largely on the kind of exchange rate regime that the authorities follow. In a fixed exchange rate regime, excess forex inflows, resulting from current and capital account surpluses or net surpluses, would perforce need to be taken to forex reserves to maintain the desired exchange rate parity. In a fully floating exchange rate regime, the exchange rate would itself adjust according to demand and supply conditions in the foreign exchange market, and there would be no need to take such inflows into the forex reserves. In such a scenario, in the presence of heavy forex inflows, it is possible that the exchange rate may appreciate significantly, though appreciation *per se* may not automatically restore equilibrium in the balance of payments. While in practice, the central banks do intervene in the forex markets in all countries, there are some features in emerging markets where a more intensive approach to intervention may be warranted in the context of large inflows. In emerging markets, capital flows are often relatively more volatile. Such volatility imposes substantial risks on the market agents and for the economy as a whole. Where the exchange rate is essentially market determined, but the authorities intervene in order to contain volatility and reduce such risks, some difficult choices need to be made. First, a choice has to be made whether to intervene or not to intervene in the forex market; and second, if the choice is made to intervene, then the authorities may have to decide on the appropriate extent of such intervention.

47. While choices made depend on a number of considerations, the key issue before the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or whether such inflows are temporary and subject to reversal. In practice, however, such determination is difficult to achieve. Since external capital flows cannot be easily predicted and can also reverse even in the presence of sound fundamentals, monetary authorities have to make choices on day-to-day exchange rate and monetary management. When the monetary authority intervenes in the foreign exchange market through purchases of foreign exchange, it injects liquidity into the system through the corresponding sales of domestic currency. Conversely, when it sells foreign exchange, domestic liquidity is absorbed from the system. Such operations in the foreign exchange market cause unanticipated expansion or contraction of base money and money supply, which may not necessarily be consistent with the prevailing monetary policy stance. The appropriate management of monetary policy may require the monetary authorities to consider offsetting the impact of such foreign exchange market intervention, partly or wholly, so as to retain the intent of monetary policy. Most techniques to offset the impact of forex inflows can be classified as either market based or non-market based. The market-based approach involves financial transactions between the central bank and the market, which leads to withdrawal or injection of liquidity, as the case may be. The non-market based approach involves the use of quantitative barriers, rules or restrictions on market activity, which attempt to keep the potential injection of liquidity outside the domestic financial system. The market-based approach aimed at neutralising part or whole of the monetary impact of foreign inflows is termed as sterilisation.

48. Conceptually distinct, but operationally overlapping steps in the sterilisation process are: (a) decision of the monetary authority to intervene by substituting foreign currency with domestic currency in case of excess capital inflows, and (b) decision to intervene further in the bond or money market to substitute domestic currency so released out of the intervention in forex market with bonds or other eligible paper. While OMO involving sale of securities constitute the commonly used instrument of sterilisation, there are several other instruments available to offset the impact of capital inflows on domestic money supply as explained below. There are, however, occasions when it is difficult to distinguish the normal liquidity management operations of a central bank from its sterilisation operations.

49. Among the other important policy responses that can be used to manage large capital inflows are:

*(a)* *Trade liberalisation*: Trade liberalisation could have the effect of increasing imports leading to a higher trade and current account deficit and this would enable the economy to absorb the capital inflows. Trade liberalisation is generally irreversible and hence may not be suitable for dealing with temporary or reversible capital inflows. Furthermore, rapid trade liberalisation can also lead to additional capital inflows which may have the effect of actually making the current account deficit unsustainable in the future when such capital inflows slow down or reverse. Thus, decisions on trade liberalisation have to be based on the overall view of the economy and not just on issues related to forex inflows, although inflows may provide some comfort in terms of timing the transition to a more liberal trade regime.

(b) *Investment Promotion*: Absorption of capital flows for growth promoting purposes can be considered through measures designed to facilitate greater investment in the economy. Implementation of such measures would be desirable to reduce the current account surplus or expand the relatively low level of current account deficit, leading to productive absorption of capital flows. Such measures would become progressively effective over a period of time.

(c) *Liberalisation of the Capital Account*: Liberalisation of outflows under the capital account can be considered while taking advantage of the excess forex inflows, particularly, with regard to the timing for such action. The liberalisation of outflows can also have the effect of increasing inflows further, if it reinforces the positive sentiment relating to the host country.

(d) *Management of External Debt*: Pre-payment of external debt can be used to reduce the accretion to forex reserves. Such pre-payment is attractive provided the cost differential between the domestic and external debt is adequate after taking into account the associated costs of pre-payment like penalties and other charges. Measures can also be taken to moderate the access of corporates and intermediaries to additional external debt. Such measures would generally be of the non-market variety involving reinforcement of the capital control regime.

(e) *Management of Non-Debt Flows:* Non-debt flows consist of foreign direct investment (FDI) and portfolio investments. The FDI decisions are taken in a medium-term perspective, and are accorded higher priority in the hierarchy of capital flows; thus, there is very little reason to restrict FDI flows. In the case of portfolio investment flows, once such flows are permitted there are few quantitative or price instruments that are available to impede them without seriously undermining market sentiment.

(f) *Taxation of Inflows*: Price-based measures to restrict forex inflows could include the imposition of a “Tobin” type tax. Such a tax has rarely been practised as it is too blunt an instrument to be used for discouraging forex inflows. It does not distinguish between the different types of flows or transactions, whether permanent or temporary, debt or non-debt, long-term or short-term, or between export receipts or import payments. Furthermore, to be effective, “Tobin” type taxes have to be implemented across countries; otherwise, there may be opportunities for circumvention. Moreover, a “Tobin” type tax is of limited use where forex inflows are largely related to underlying transactions, as is the case in India.

(g) *Use of Foreign Exchange Reserves*: As foreign exchange reserves rise, it is often suggested that such reserves can be used for "productive" domestic activities through on-lending in foreign currencies to residents. If the reserves are used in such a fashion domestically, they are not then available as forex reserves. Furthermore, if the use of such reserves were through domestic credit provision for rupee expenditure, the forex resources so used would again end up in the forex reserves. Such an action would be equivalent to not on-lending the foreign exchange resources in the first place. If the reserves are on-lent for overseas operations, this could lead to encumbrance on the reserves and once again they would not be characterised as reserves. Considerations of safety and liquidity that are essential for forex reserves would also be compromised if forex reserves were used in such a fashion.

50. The recent movement of the exchange rate of the rupee has drawn attention to the external competitiveness of the economy and hence, a reference to the real effective exchange rate (REER) is appropriate. Briefly stated, REER has no relevance for day-to-day operations of RBI, but cannot be ignored when considered in the medium to longer term. As mentioned in the mid-term Review of October 1998, “the estimation of REER raises several methodological issues, e.g., the choice of a basket of currencies, the choice of the base period, the choice of trade-based weights, and the choice of a price index”. While REER may not be an adequate guide for exchange rate movements in the short-run, as explained by my predecessor, Dr. Bimal Jalan, “the long-run competitiveness of an economy needs to be measured in relation to a multiple currency basket, and in relation to major trading partners over a reasonably long period of time”.

51. The annual policy Statements and mid-term Reviews of RBI continue to express concern over unhedged foreign currency borrowings by corporates which could impact their overall financial status leading to instability in the financial system under severe uncertainties. In this context, the mid-term Review of October 2001 stressed the importance of banks’ monitoring of large unhedged foreign currency exposures of corporates. Despite such exhortations, it was observed that hedging of such exposures was not ensured by banks. In the mid-term Review of November 2003, banks were advised to adopt a policy which explicitly recognises and takes account of risks arising out of foreign exposures of their clients. Accordingly, banks were advised that all foreign currency loans above US $ 10 million or such lower limits as may be deemed appropriate *vis-à-vis* the banks’ portfolio of such exposures could be extended by them on the basis of a well laid out policy of their Boards except in cases of export finance and loans extended for meeting forex expenditure. Banks should, therefore, ensure hedging of significant but avoidable risks to corporate balance sheets on account of their forex exposures which might also possibly impact the quality of banks’ assets.

**Overall Assessment**

52. In sum, from an overall policy perspective and a qualitative assessment of major developments during 2003-04, some of the areas that need to be kept in view for the year 2004-05 could be as follows:

(a) It is necessary to recognise that growth in GDP during 2003-04 had both cyclical and structural elements. The cyclical elements pertain to global recovery which may continue along with a rebound in agriculture. There are several structural factors which impart robustness and resilience to the Indian economy. These include positive effects of the enabling policy environment and investment in infrastructure on competitiveness and business confidence. While services have been leading in their global reach, manufacturing industry is also showing signs of global presence. Thus, assuming normal monsoon conditions, in spite of several uncertainties, especially in the global economy, and unless there are totally unanticipated shocks, there are reasons to expect that in terms of growth in GDP in 2004-05, India will continue to be among the top performers globally.

(b) In regard to prices, there is an overhang of problems on account of oil prices and large domestic liquidity, partly reflecting global liquidity. However, in view of India's proven resilience to shocks, reasonable levels of food stocks coupled with prospects for a good monsoon, and the comfortable foreign exchange reserves, the price situation during 2004-05 is unlikely to cause concern to macro stability; but both on welfare considerations and impact on inflationary expectations, a very close watch is needed on the implications of global and other developments for India.

(c) Some pick-up in credit in the later part of the year 2003-04 is a source of satisfaction and indications are that the pick-up will continue. However, there is a need for significant efforts to overcome the bottlenecks in flow of bank credit to agriculture and small & medium enterprises (SMEs). More important, a steep step-up in investment activity in infrastructure, whether in public or private sectors, would augment the prospects for credit off-take for productive sectors. While the growth in consumer credit and housing credit have contributed positively to the economy so far, the quality and the pace of such growth in future need attention.

(d) The financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the banks. The performance is creditworthy in view of the absorption of overhang problems by public sector banks and tightening of prudential norms for the banks. The commercial banks are poised to reach global standards. The restructuring of Development Finance Institutions (DFIs) is under way and the contemplated restructuring of rural banking sector should help the process of enhancing the quality, purposiveness and reach of banking in India.

(e) During 2003-04, financial markets around the world were on the upswing, with equity valuations rising in both developed countries and emerging markets. With the increase in international liquidity, the spread on emerging market debt decreased significantly. The major issue that has now arisen for 2004-05 relates to the continuing macroeconomic imbalances in the United States, and their possible consequences on the rest of the world in addition to geo-political uncertainties. These concerns include the impact on asset prices that could emerge internationally from any tightening of monetary policy that may take place in the coming months and on commodity prices, particularly oil. The Indian financial markets, on the whole, have exhibited relative stability throughout the period of financial sector reforms which have been carried out in a carefully calibrated and phased manner. On current reckoning, despite some uncertainties, there is reason to have confidence in the ability of the Indian financial markets to continue exhibiting such stability relative to other markets in emerging economies. Whereas the Reserve Bank will continue to provide a policy environment that avoids excessive and destabilising volatility as a public good, market participants are expected to take into account the portfolio risks arising from any unexpected developments and provide adequately for them.

(f) The external sector has strengthened over the years. While the trade deficit has increased, the current account is in surplus largely due to remittances from non-resident Indians. The impressive increase in import of capital goods gives rise to the hope of accelerated investment activity. The level of reserves is adequate to absorb the volatility of capital flows that could arise from the global uncertainties in bond and currency markets. The outlook for the external sector does accord comfort to the conduct of public policies.

## II. Stance of Monetary Policy for 2004-05

53. The overall stance of monetary policy in 2003-04 as outlined in the policy Statement of April 2003 and reiterated in the mid-term Review of November 2003 continues to be 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 with the present stance of preference for a soft and flexible interest rate environment within the framework of macroeconomic stability.

54. Monetary management during 2003-04 was conducted broadly in conformity with the stance of the policy set out for the year. First, in terms of macroeconomic outcome, the GDP growth rate turned out to be better than anticipated largely on account of a rebound in agricultural production. Second, while the inflation outcome was

generally in line with the expectations in the policy, there were significant intra-year variations that had implications for the financial market. Third, while interest rates softened further, rates at the longer-end had firmed up slightly during the later part of the year. Fourth, though non-food credit growth was subdued at the beginning of the year, it picked up subsequently. Fifth, the deposit growth and money supply growth were higher than the projections made at the beginning of the year. Sixth, the money and government securities markets have been, by and large, stable. Seventh, the movements in exchange rate continue to be orderly despite sharp depreciation of the US dollar vis-à-vis other major currencies. Eighth, there was a relatively large increase in foreign exchange reserves reflecting sustained capital inflow and an upgradation of sovereign ratings. Ninth, the domestic business outlook continues to remain buoyant. Notwithstanding the favourable outcomes, monetary management faced severe challenges in maintaining stable liquidity conditions and in reining in inflationary expectations, which were successfully met.

55. The overall assessment of the developments during 2003-04 and the outlook for 2004-05, on a qualitative basis, provide grounds for optimism. First, in terms of growth of GDP, India may continue to be among the top performers globally. Second, the price situation is unlikely to cause concern to macro stability, though a very close watch is warranted. Third, credit delivery, in particular to agriculture, small & medium enterprises and infrastructure is critical to sustain growth. Fourth, the financial sector exhibits growing strength, efficiency and stability. Finally, current status of as well as the outlook for the external sector accords comfort to the conduct of public policies.

56. The stance of monetary policy will depend on several factors, and among them are: (a) prospects for the real sector, especially growth in GDP; (b) inflationary expectations; and (c) global developments.

57. The India Meteorological Department (IMD) in its forecast of South-West monsoon for the current year has placed the expected rainfall at 100 per cent of its long-term average. With a normal monsoon, the growth in agriculture can be assumed to be at the trend growth rate of about 3 per cent and further assuming that industry and services sectors maintain their current growth momentum, the real GDP growth during 2004-05, in the normal course, could be 6.5 per cent. If the acceleration in growth noticed during the third quarter of 2003-04 is sustained, the real GDP growth during 2004-05 could well be higher at around 7.0 per cent. For the present, for the purpose of monetary policy formulation, real GDP growth for 2004-05 may be placed in the range of 6.5 to 7.0 per cent, assuming sustained growth in the industrial sector, normal monsoon and good performance of exports. The realisation of such a rate of growth would signify a structural acceleration in growth rate of the economy.

58. Given the ‘pass through’ of international price trends to domestic inflation, the inflation rate during 2004-05 is likely to be influenced to a significant extent by international oil prices and trends in commodity prices. In addition, the lagged effect of persistence of excess liquidity on aggregate demand cannot be ignored as it could have some potential inflationary impact. In view of the current trends, assuming no significant supply shocks and

appropriate management of liquidity, the inflation rate in 2004-05, on a point-to-point basis, may be placed at around 5.0 per cent.

59. As regard the global developments, recovery appears more sustainable now and there is greater resilience in emerging economies. It is essential to recognise that interest rates in major economies are likely to harden while the adjustments in currency imbalances would continue to take place. Oil prices seem to persist at the current high level though they could move sharply in either direction. The geopolitical uncertainties impacting the international oil economy do not show any signs of waning. Thus, while there are significant positive indications of economic recovery, there are noticeable uncertainties and risks that should be reckoned with while designing the stance of monetary policy. In particular, the policy should take cognisance of the prospect that a significant trade deficit would continue with accelerated exports as well as imports, while recognising that its impact on the current account will, as in the past, be compensated by the remittances from non-resident Indians. The policy should also be prepared for the persistence of large capital flows.

60. Consistent with the real growth of GDP and inflation, the projected expansion of money supply ($M_3$) for 2004-05 is placed at 14.0 per cent. In tune with this order of growth in $M_3$, increase in aggregate deposits of scheduled commercial banks is set at Rs.2,18,000 crore which is higher by 14.5 per cent over its level in the previous year. Non-food bank credit adjusted for investment in commercial paper, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 16.0-16.5 per cent. This magnitude of credit expansion is expected to meet adequately the credit needs of all the productive sectors of the economy.

61. For the year 2004-05, the interim Union Budget has placed the gross fiscal deficit at 4.4 per cent of GDP and the market borrowing programme of the Centre is budgeted at Rs.90,502 crore (net) and Rs.1,50,956 crore (gross). Taking into account the normal market borrowings of State Governments, RBI expects to conduct debt management without serious pressure on overall liquidity and interest rates within the monetary projections for 2004-05.

62. The global factors at this juncture point in two directions for India. In view of the widespread anticipation that international interest rates may rise, there may be a case for raising policy interest rates. However, such an increase may have an adverse impact on investment demand which has shown signs of pick-up after prolonged sluggishness. A case can also be made out for lowering interest rates to foster investment activity domestically in the given context of capital flows on the assessment that interest rates in large economies may not rise soon or to a significant extent and the risks of inflationary pressures do not materialise. An assessment of domestic factors, which are admittedly more relevant for India, points to stability but in the leading economies of the world, there is a greater potential for tightening rather than easing of monetary policies.

63. Monetary policy would continue to enhance the integration of various segments of the financial market, improve credit delivery system, nurture the conducive credit culture and improve the quality of financial services. There is also a need to consolidate the gains obtained in recent years from reining in inflationary expectations given the volatility in the inflation rate during 2003-04. It is important to appreciate that sustained efforts over time helped to build confidence in price stability and that inflationary expectations can turn adverse in a relatively short time if noticeable adverse movements in prices take place. While the economy has the resources and resilience to withstand supply shocks, the possible consequences of continued abundance of liquidity need to be monitored carefully. As such, the inflationary situation needs to be watched closely and there could be no room for complacency on this count.

64. In sum, according to the present assessment, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and assuming that the underlying inflationary situation does not turn adverse, the overall stance of monetary policy for 2004-05 will be:

- Provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level.

- Consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and, macroeconomic and price stability.

## III. Financial Sector Reforms and Monetary Policy Measures

65. The financial sector now operates in a more competitive environment than before and intermediates relatively large volumes of international financial flows. Simultaneously, domestic financial markets have also developed with increasing integration among the various segments. Further, there has been a large increase in cross-border trade and investment in recent years. Consequently, monetary policy formulation has become complex and, in particular, has to be alert to a possible build-up of financial imbalances and thus needs to explore ways and means of containing such shocks. In this context, the annual policy Statements as well as mid-term Reviews of RBI, continue to emphasise the structural and regulatory measures that support financial resilience and reinforce the ability of institutions to play an effective role. The main objectives of these measures have been to increase the operational effectiveness of monetary policy, redefine the regulatory role of RBI, strengthen the prudential and supervisory norms and develop the institutional infrastructure.

66. The mid-term Review of November 2003, announced several initiatives related to credit culture, credit delivery, and credit pricing, as also depositor interests. The policy, *inter alia*, stated: (i) in this regard, it is imperative that a conducive credit culture is nurtured among financial intermediaries, corporates and households; (ii) the fact of overall rigidity in the downward movement of lending rates as well as inadequacy in quality of service to some sections coupled with reduction in deposit rates requires introspection and immediate action on the part of all financial intermediaries; and (iii) while credible actions, particularly by the commercial banks, would be essential, innovative measures by all concerned would have to be considered in due course to ensure adequate progress in credit delivery accompanied by appropriate transparency in credit pricing.

67. As the financial sector matures and becomes more complex, the process of deregulation must continue, but in such a manner that all types of financial institutions are strengthened and financial stability of the overall system is safeguarded. As deregulation gathers force, the emphasis on regulatory practice has to shift towards effective monitoring and assurance of implementation of regulations. In order to achieve these regulatory objectives, corporate governance within financial institutions must be strengthened, and internal systems need to be developed to ensure this shift in regulatory practice. Furthermore, as financial institutions expand and grow more complex, it is also necessary to ensure that the quality of service to customers, especially the common person, is focused on and improved.

68. While the focus will continue to be on the design of measures in pursuance of the objectives mentioned above and their effective implementation, there are some areas in the financial system that would need special attention during 2004-05. First, it is necessary to articulate in a comprehensive and transparent manner the policy in regard to ownership and governance of both public and private sector banks keeping in view the special nature of banks. This will also facilitate the ongoing shift from external regulation to internal systems of controls and risk assessments. Second, from a systemic point of view, inter-relationships between activities of financial

intermediaries and areas of conflict of interests need to be considered. Third, in order to protect the integrity of the financial system by reducing the likelihood of their becoming conduits for money laundering, terrorist financing and other unlawful activities and also to ensure audit trail, greater accent needs to be laid on the adoption of an effective consolidated know your customer (KYC) system, on both assets and liabilities, in all financial intermediaries regulated by RBI. At the same time, it is essential that banks do not seek intrusive details from their customers and do not resort to sharing of information regarding the customer except with the written consent of the customer. Fourth, while the stability and efficiency imparted to the large commercial banking system is universally recognised, there are some segments which warrant restructuring. The recent experience with the urban co-operative banks (UCBs) led to the enforcement of strict prudential parameters, but the issue of multiple control in this sector needs to be addressed and restructuring commenced. Similarly, issues relating to co-operative banking structures, regional rural banks (RRBs), non-banking financial companies (NBFCs) and development finance institutions (DFIs) have to be considered. In particular, the regulatory and supervisory arrangements should conform to best practices, in the interests of retail depositors and integrity of the payment system. The strategies for further progress in the banking sector as a whole would thus involve restructuring in some segments, consolidation in the larger commercial banking system, enhancement of governance and of internal control systems and, above all, further deregulation accompanied by focused monitoring and effective supervision. Fifth, in the context of the strategies mentioned above, the role of the legal system assumes importance and there is a need for collaborative efforts to provide an enabling legal structure to bring about appropriate transformation in the financial sector.

69. In order to ensure timely and effective implementation of the measures, RBI has been adopting a consultative approach before introducing policy measures. The Reserve Bank, in addition to the existing channels of consultations, has instituted suitable mechanisms to deliberate upon various issues so that the benefits of financial efficiency and stability percolate to the common person and the services of the Indian financial system can be benchmarked against international best standards in a transparent manner. This section reviews the implementation of some policy measures and proposes measures in the light of progress so far and in addition, indicates measures addressing institutional improvements.

## Monetary Measures

### *(a) Bank Rate*

70. In the annual policy Statement of April 2003, the Bank Rate was reduced from 6.25 per cent to 6.0 per cent with effect from the close of business on April 29, 2003. On a review of the macroeconomic developments, it is considered desirable to leave the Bank Rate stable (at 6.0 per cent) at present.

***(b) Repo Rate***

71. Following the announcement in the mid-term Review of November 2003, the liquidity adjustment facility (LAF) was reviewed, taking into account the recommendations of the internal group constituted for the purpose and suggestions from the market participants and experts. The revised scheme came into effect from March 29, 2004. As per the revised scheme, 7-day fixed rate repo auctions are conducted on a daily basis. It was indicated that the repo rate will be fixed by the Reserve Bank from time to time.

72. On a review of macroeconomic developments, it is considered desirable to keep the 7-day repo rate at 4.5 per cent at present. It may, however, be indicated that under the revised Scheme, RBI will continue to have the discretion to conduct overnight repo or longer term repo auctions at fixed rates or at variable rates depending on market conditions and other relevant factors. The Reserve Bank will also have the discretion to change the spread between the repo rate and the reverse repo rate as and when appropriate.

***(c) Liquidity Adjustment Facility – Revised Scheme***

73. Following its announcement in the mid-term Review of November 3, 2003, the "Report of the Internal Group on Liquidity Adjustment Facility" was put in public domain on December 2, 2003 for wider dissemination and comments. Thereafter, the Report was discussed extensively with market participants and experts. Taking into account the recommendations of the Internal Group and the suggestions from the market participants and experts, the revised LAF scheme was operationalised effective March 29, 2004 through: (i) 7-day fixed rate repo conducted daily and (ii) overnight fixed rate reverse repo conducted daily, on weekdays. Further, in order to enable market participants to meet their prior commitments based on their existing operations, the 14-day repo, conducted on a fortnightly interval, is being continued with the existing features, for some time. The international usage of "Repo" and "Reverse Repo" terms would be adopted, but from a future date after giving market participants adequate time for system changes.

74. Considering the prevailing situation, the rate for the 7-day repo was retained by RBI at 4.50 per cent per annum. The reverse repo rate continues to be linked to the repo rate though at a lower spread of 150 basis points. Accordingly, the reverse repo rate was reduced to 6.00 per cent per annum with effect from March 29, 2004. Simultaneously, in order to rationalise the existing structure of provision of liquidity facility from RBI, the entire amount of export credit refinance to banks and liquidity support to primary dealers (PDs) was made available at a single rate, at the reverse repo rate.

75. The Internal Group had proposed introduction of a standing deposit facility (SDF) to provide more flexibility to RBI's repo facility as also to impart a floor to the movement of call money rates. However, on a detailed examination, it has been held that RBI Act, 1934 does not permit RBI to borrow on clean basis and pay interest

thereon. The Reserve Bank agrees with the proposal, but this has to await amendment to the relevant provisions of the RBI Act, 1934.

76. With regard to remuneration of eligible cash balances under CRR at its present level at the Bank Rate, the Internal Group recommended that such remuneration was not justifiable. The Group argued that “no remuneration is appropriate to make CRR most effective”. However, considering the present situation, the Group proposed that such remuneration should be delinked from the Bank Rate and placed at a rate lower than the repo rate.

**Interest Rate Policy**

***Prime Lending Rate and Spread***

77. Following the announcement in the mid-term Review of November 2003, the Indian Banks’ Association (IBA) advised its member banks to announce a benchmark PLR (BPLR) taking into account (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, with the approval of their Boards keeping in view the operational requirements. The banks, however, have the freedom to price their loan products below or above their BPLR and offer floating rate products by using market benchmarks in a transparent manner. Almost all commercial banks have adopted the new system of BPLR and the rates are lower in the range of 25-200 basis points from their earlier PLRs.

78. While there is intense competition among banks to lend to large top-rated borrowers, other borrowers with long standing relationship with banks and good credit record do not get the benefit of lower rates. It is considered desirable that banks should align the pricing of credit to assessment of credit risk so that credit delivery and credit culture is improved. As such, risk profiling of borrowers is also required for allocation of capital under Basel II apart from being desirable from the point of view of risk management and efficient use of capital. Hence, banks may take steps for putting in place comprehensive and rigorous risk assessment of borrowers using the database available with them, as also other internal and external factors so that the pricing of credit is related to risk more appropriately.

**Credit Delivery Mechanism**

79. It has been the endeavour of the Reserve Bank to create a conducive environment for banks to provide adequate and timely finance at reasonable rates without procedural hassles to different sectors of the economy. In continuation of several initiatives taken in this direction, some specific measures are proposed as under:

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

80. As indicated in the mid-term Review of November 2003, an Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof.V.S. Vyas) was constituted by RBI. The Committee has since submitted its interim Report covering the following areas: (i) mandatory lending to agriculture by scheduled commercial banks; (ii) expanding outreach of banks in rural areas; (iii) reducing cost of credit to agricultural borrowers; (iv) non-performing asset (NPA) norms in agricultural finance; and (v) impediments in flow of credit to disadvantaged sections. The detailed recommendations and various responses are being put in the public domain. In the meantime, some of the recommendations of the interim Report have been accepted by RBI for implementation which are as under:

***(i) Loans for Storage Facilities***

81. At present, loans for construction and running of storage facilities (warehouse, market yards, godowns, silos and cold storages) in the producing areas and loans to cold storage units located in rural areas and not registered as SSI units used for hiring are treated as indirect finance to agriculture. In order to further enhance credit flow to build up storage facilities, it is proposed that:

- Loans to storage units, including cold storage units, which are designed to store agricultural produce/products, irrespective of their location, would be treated as indirect agricultural finance under priority sector.

***(ii) Investment by Banks in Securitised Assets***

82. With increasing emphasis on securitisation of agricultural loans, it is proposed that:

- Investment by banks in securitised assets representing direct (indirect) lending to agriculture would be treated as their direct (indirect) lending to agriculture under priority sector, provided the securitised loans are originated by banks and financial institutions.

***(iii) Agricultural Loans - Waiver of Margin/Security Requirements***

83. At present, in the case of agricultural loans above Rs.10,000, banks are free to keep margin and security. Keeping in view the importance of flow of credit to agriculture, in particular to the smaller borrowers who may not have the necessary assets as collateral, it is proposed that:

- Banks may waive margin/security requirements for agricultural loans up to Rs.50,000 and in the case of agri-business and agri-clinics for loans up to Rs.5 lakh.

### *(iv) NPA Norms for Agricultural Finance*

84. As per the extant norms, advances granted for agricultural purposes are treated as NPA where interest and/or instalment of principal remain unpaid after it has become due for two harvest seasons but for a period not exceeding two half years. However, in the case of longer duration crops, the current prescription of not exceeding two half years is inadequate. In order to align the repayment dates with harvesting of crops, it is proposed that:

- A loan granted for short duration crops will be treated as an NPA if the instalment of the principal or interest thereon remains unpaid for two crop seasons beyond the due date.

- A loan granted for long duration crops will be treated as an NPA if the instalment of the principal or interest thereon remains unpaid for one crop season beyond the due date.

- All the above prescriptions of crop loans would also be applicable, *mutatis mutandis*, to agricultural term loans.

### *(b) Micro-finance*

85. As indicated in the mid-term Review of November 2003, on the basis of the recommendations of the four informal groups, RBI advised banks to provide adequate incentives to their branches for financing self help groups (SHGs) in a hassle-free manner. The banks were further advised that the group dynamics of the working of SHGs may be left to themselves and need not be regulated.

86. The Vyas Committee also examined the role of micro-finance in poverty alleviation and adoption of the SHGs approach in extending banks' outreach to the disadvantaged sectors. In view of the need to protect the interests of depositors and on the basis of the recommendations of the Committee's Interim Report, the following proposal has been accepted by RBI for implementation. Accordingly:

- Micro-finance institutions (MFIs) would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.

### *(c) Kisan Credit Card Scheme*

87. The public sector banks have issued 3.07 million Kisan Credit Cards (KCC) during 2003-04 as against the target of 3 million. So far, public sector banks have issued 13.2 million cards under the scheme.

88. As indicated in the mid-term Review of November 2003, a survey for assessing the impact of the KCC scheme was entrusted to the National Council of Applied Economic Research (NCAER), New Delhi. The Report is expected shortly. The Reserve Bank intends to follow up on the Report for making the KCC scheme more farmer friendly in terms of ease of access to bank credit, with better coverage.

### *(d) Policy Framework for Small and Medium Enterprises*

89. Following the announcement in the mid-term Review of November 2003, a Working Group on Flow of Credit to SSI Sector (Chairman: Dr.A.S. Ganguly) was constituted which has since submitted its Report. A list of recommendations of the Group together with responses thereto is being put in the public domain. In the meantime, it is proposed that:

- In order to enable the banks to determine appropriate pricing of loans to small and medium enterprises, development of a system of proper credit records is useful. For this purpose, Credit Information Bureau of India Ltd. (CIBIL) would work out a mechanism, in consultation with RBI, SIDBI and IBA. Further, a mechanism for debt restructuring on the lines of the Corporate Debt Restructuring (CDR) is proposed to be developed for medium enterprises. A special Group would be constituted by RBI to suggest appropriate operational guidelines in this regard.

### *(e) Widening the Scope of Infrastructure Lending*

90. The critical importance of the infrastructure sector was indicated in the annual policy Statement of April 2003. On a review, it is proposed:

- To expand the scope of definition of infrastructure lending to include the following projects/sectors: (i) construction relating to projects involving agro-processing and supply of inputs to agriculture; (ii) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality; and (iii) construction of educational institutions and hospitals.

### *(f) Working Group on Credit Enhancement by State Governments*

91. Keeping in view the importance of infrastructure financing at the State level, in consultation with the state finance secretaries, a Working Group on Credit Enhancement by State Governments for financing infrastructure has been constituted with members drawn from the Government, state governments, select banks, FIs and RBI.

### *(g) Gold Card Scheme for Exporters*

92. The Government (Ministry of Commerce and Industry), in consultation with RBI had indicated in the Exim Policy 2003-04 that a Gold Card Scheme would be worked out by RBI for creditworthy exporters with good track record for easy availability of export credit on best terms. Accordingly, in consultation with select banks and exporters, a Gold Card Scheme has been drawn up. The salient features of the Scheme are: (i) all creditworthy exporters, including those in small and medium sectors with good track record would be eligible for issue of Gold Card by individual banks as per the criteria laid down by the latter; (ii) banks would clearly specify the benefits they would be offering to Gold Card holders; (iii) requests from card holders would be processed quickly by banks within a prescribed time-frame; (iv) 'in-principle' limits would be set for a period of 3 years with a provision for stand-by limit of 20 per cent to meet urgent credit needs; (v) card holders would be given preference in the matter of granting of packing credit in foreign currency; and (vi) banks would consider waiver of collaterals and exemption from ECGC guarantee schemes on the basis of card holder's creditworthiness and track record.

***(h) Status and Restructuring of Regional Rural Banks***

93. As at the end of March 2003, there were 196 regional rural banks (RRBs) with over 14,000 branches covering 516 districts with deposits of about Rs.48,900 crore, advances of about Rs.20,700 crore and investments of about Rs.28,400 crore. The gross NPAs of RRBs stood at Rs.3,200 crore, 14.4 per cent of their total loans.

94. With a view to rationalising the structure of RRBs and to move towards greater viability, various restructuring options are under consideration of the Government and other stakeholders, viz., state governments and sponsor banks. The Vyas Committee is also looking into the aspect of restructuring of RRBs and would explore various options for making appropriate recommendations to the Government.

***(i) Status and Restructuring of Co-operative Banks***

95. As at end-March 2004, out of 30 State Co-operative Banks (SCBs) and 366 District Central Co-operative Banks (DCCBs), 13 SCBs and 73 DCCBs were licensed by RBI. Most of these banks were established prior to March 1, 1966 when the Banking Regulation Act, 1949 was made applicable to co-operative banks. As per the information made available by NABARD, the deposits with the SCBs and DCCBs stood at about Rs.39,000 crore and Rs.73,000 crore, respectively, in March 2003. As at the end of March 2004, 143 out of 366 DCCBs and 7 out of 30 SCBs had not complied with the minimum requirement of paid-up capital and reserves of Rs.1 lakh.

96. Whereas RBI has taken up the matter with the concerned state governments for initiating remedial measures, the Government is considering a restructuring plan for weak co-operative banks. A scheme to revitalise the co-operative credit structure, envisaging an outlay of about Rs.15,000 crore, to be shared between the Central and state governments in an appropriate ratio, has been announced. The Government has proposed that this scheme would be initiated as soon as the revised regulatory framework has been put in place.

## Money Market

97. Keeping in view the importance of the money market in providing an equilibrating mechanism for evening out short-term surpluses and deficits in the financial system, the following further measures are proposed:

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

98. At present, non-bank entities could lend, on average in a reporting fortnight, up to 60 per cent of their average daily lending in call/notice money market during 2000-01. In view of further market developments as also to move towards a pure inter-bank call/notice money market, it is proposed that:

- With effect from the fortnight beginning June 26, 2004, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 45 per cent of their average daily lending in call/notice money market during 2000-01.

99. However, as indicated in the earlier policy Statements, 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) Collateralised Borrowing and Lending Obligation***

100. As indicated in the annual policy Statement of April 2003, collateralised borrowing and lending obligation (CBLO) was operationalised as a money market instrument through the Clearing Corporation of India Ltd. (CCIL) in January 2003. The daily average turnover in CBLO has increased from about Rs.40 crore in March 2003 to about Rs.2,500 crore in April 2004. The total membership of CCIL's CBLO segment stood at 55 in April 2004. With a view to encouraging further development of this segment, it is proposed to:

- Facilitate automated value-free transfer of securities between market participants and the CCIL.

## Government Securities Market

101. The Reserve Bank has taken significant steps, in consultation with market participants, to further broaden and deepen the government securities market. These include issuance of uniform accounting norms for repo and reverse repo transactions, extension of repo facility to gilt account holders, facility for anonymous screen-based order-driven trading system for government securities on stock exchanges, introduction of exchange-traded interest rate derivatives on the National Stock Exchange (NSE), relaxation in regulation relating to sale of securities by permitting sale against an existing purchase contract, facilitating the roll over of repos and switch over to the DVP III mode of settlement. In this direction, the following further initiatives are proposed:

### *(a) Review of the Negotiated Dealing System*

102. The negotiated dealing system (NDS) introduced in February 2002 has helped in achieving paperless and straight through clearing and settlement of the transactions in government securities market through the CCIL as a central counterparty. The system has also brought in transactional efficiency and transparency by dissemination of information on market deals and imparted liquidity and depth to the government securities market as reflected in the finer price discovery and market turnover. Keeping in view the encouraging developments and based on the experience gained over time, RBI has constituted a Working Group (Chairman: Dr. R.H. Patil) to review the performance of NDS in the context of its operational efficiency and suggest improvements and enhancements in hardware and software systems and functionalities, including introduction of anonymous screen-based order matching system. The Group is expected to submit its Report shortly.

### *(b) Clearing of OTC Interest Rate Derivatives by CCIL*

103. A central counterparty based clearing arrangement for OTC derivatives would reduce counterparty risk and extend the benefits of netting. Accordingly, in order to strengthen the OTC derivatives market and to mitigate the risks involved, a clearing arrangement through CCIL is being considered.

### *(c) Trade in Non-SLR Securities - Settlement and Information*

104. Prudential guidelines on banks' investment in non-SLR securities require banks to report all "spot" transactions in listed and unlisted non-SLR securities on the NDS and settle through CCIL from a date to be notified by RBI. CCIL is working out an arrangement for settlement on non-guaranteed basis and dissemination of information relating to trades in listed as well as unlisted non-SLR debt instruments by NDS members.

### *(d) Capital Indexed Bonds*

105. In December 1997, a 5-year Capital Indexed Bond (CIB) was initially introduced. It is now proposed, in consultation with the Government, to reintroduce a modified CIB with structured features of similar instruments prevalent internationally. While the CIB would be issued with market determined real coupon rate that would remain fixed during the currency of the bonds, it would offer inflation-linked returns to the investors. A discussion paper on CIBs, detailing the product features, is being put in public domain.

### *(e) Market Stabilisation Scheme*

106. A Memorandum of Understanding (MoU) detailing the rationale and operational modalities of the Market Stabilisation Scheme (MSS) was signed between the Government of India and RBI on March 25, 2004. The intention of MSS is essentially to differentiate the liquidity absorption of a more enduring nature by way of sterilisation from the day-to-day normal liquidity management operations. It was proposed to issue Treasury Bills/dated government securities under MSS by way of auctions that would have the same features of the existing bills/securities. The Reserve Bank would notify the amount, tenure and timing of such issuance and for the year 2004-05, the ceiling on the outstanding obligations of the Government by way of issuance of such bills/securities under MSS is initially placed at Rs.60,000 crore but is subject to revision through mutual consultation. The bills/securities issued under MSS are matched by an equivalent cash balance held by the Government in a separate identifiable cash account maintained and operated by RBI and such balances would be appropriated only for the purpose of redemption and/or buy-back of the Treasury Bills and/or dated securities issued under the MSS. The impact on revenue/fiscal balance of the Government would be only to the extent of the payment of interest and discount, net of premium and accrued interest, on bills/securities issued under MSS. The receipts and payments towards interest, premium and discount would be shown separately in the Union Budget. In order to provide transparency and stability to the financial markets, to begin with, an indicative schedule for issuance of Treasury Bills/dated securities for Rs.35,500 crore under MSS for the quarter April-June 2004 was released on March 25, 2004. Treasury Bills and dated securities with a face value of Rs.27,000 crore were issued under the MSS up to May 14, 2004, out of which dated securities amounted to Rs.15,000 crore.

## Foreign Exchange Market

107. In order to simplify the systems and procedures further for providing better customer services and to continue with the liberalisation process in the external sector, a number of steps were taken. The status and progress regarding certain specific areas and further measures are detailed below:

### *(a) Housing Loan in Rupees to NRIs/PIO*

108. At present, non-resident Indians (NRIs)/persons of Indian origin (PIO) can avail of housing loans in rupees from authorised dealers or housing finance institutions approved by the National Housing Bank (NHB). The loans can be repaid by the borrowers either by way of inward remittances through normal banking channel or by debit to NRE/FCNR(B)/NRO/NRNR/NRSR accounts or out of rental incomes derived from the property. As a further measure of liberalisation, it is proposed:

- To allow the borrower's close relatives in India to repay the instalment of such loans, interest and other charges, if any, directly to the concerned authorised dealers/housing finance institutions.

### *(b) External Commercial Borrowings - Relaxation*

109. As a sequel to the announcement of the Government on enhancing the limits for external commercial borrowings (ECBs) and with a view to replacing temporary measures relating to ECBs with more transparent and simplified policies and procedures, a review of the ECB guidelines was undertaken by RBI. The main objective of the revised policy is to promote investment in the real sector including infrastructure. The ECB limit has been enhanced to US $ 500 million under the automatic route with minimum average maturity of 5 years. End use for ECBs was enlarged to include overseas direct investment in Joint Ventures (JVs)/Wholly Owned Subsidiaries (WOS) in order to facilitate corporates to become global players. Further, banks and financial institutions that had participated in the textile or steel sector restructuring packages as approved by the Government were permitted, under the approval route, to avail ECB to the extent of their investment in the package and assessment by RBI on prudential norms.

### *(c) Remittance Scheme for Resident Individuals – Liberalisation*

110. Resident individuals are now permitted to remit freely up to US $ 25,000 per calendar year, for any current or capital account transaction or a combination of these. Under this facility, resident individuals would be free to acquire, hold moveable property or shares or any other assets outside India, open, maintain and hold foreign currency account with a bank outside India for making remittance, without RBI's approval. The facilities under the scheme are in addition to those already available for private travel, business travel, gift remittances, donations, studies, medical treatment, etc., as allowed under Foreign Exchange Management Act (FEMA).

### *(d) Overseas Investment*

111. In order to enhance the strategic presence of Indian corporates overseas, Indian corporates and partnership firms have been allowed to invest overseas up to 100 per cent of their net worth. Further, resident

corporates and registered partnership firms have been allowed to undertake agricultural activities overseas including purchase of land incidental to this activity either directly or through their overseas offices (other than through JVs/WOS within the overall limit available for investment overseas under the automatic route).

### *(e) Internal Group on External Liabilities of Banks*

112. In order to review comprehensively the status of external liabilities of scheduled commercial banks, and to examine various policy issues arising therefrom, an Internal Group on External Liabilities of Scheduled Commercial Banks was constituted by RBI which submitted its Report in April 2004. On the basis of the recommendations of the Group, RBI has implemented the following measures:

(i) The interest rates on NRE term deposits for one to three years were reduced to LIBOR/SWAP rates for US dollar of corresponding maturity, effective April 17, 2004.

(ii) The ceiling on interest rate on NRE savings deposits was fixed at six-month US dollar LIBOR/SWAP rate; and no lien on these accounts, direct or indirect, would be permitted.

(iii) Entities other than authorised dealers or authorised banks were disallowed, effective April 24, 2004, from accepting fresh deposits from non-resident Indians, received either through fresh inward remittances or by debit to their NRE/FCNR(B) accounts.

The Report of the Internal Group is being put in the public domain.

## Prudential Measures

113. In the areas of regulation and supervision, RBI is committed to continuing the process of adopting international best practices tempered with sufficient flexibility on account of the differences in the country's institutional framework and capacity, so as to minimise the burden on banks and financial institutions. The Reserve Bank's comments on the third consultative document on the New Capital Accord on the basis of the quantitative impact studies (QIS3) undertaken in co-ordination with select banks also brought out the need for greater flexibility on account of the different levels of preparedness of the banking system. Guidelines on country risk management, consolidated accounting and supervision, corporate governance, prudential supervisory reporting system and concurrent audit for UCBs and issue of fair practices code for lenders are some of the measures aimed at convergence with the global standards. Building of investment fluctuation reserve, guidelines on non-SLR investment portfolio of banks, time-bound action plan for compliance with KYC procedures, provisioning for NPAs on proposed sale to securitisation/reconstruction companies and draft guidelines on credit derivatives were aimed at mitigating the various risk exposures of the banking sector.

114. Introduction of the prompt corrective action framework and move towards risk based supervision would not only strengthen the supervisory process and focus on areas of vulnerability, but also improve the reliability and robustness of risk management, management information and supervisory reporting systems of banks. While off-shore banking units were permitted to be opened, norms for banks' entry into insurance agency business were liberalised and existing procedures for allotment and transfer of shares in private banks were streamlined. Important Committees have been constituted to improve credit delivery to the needy sectors. Furthermore, a Standing Technical Advisory Committee has been constituted to look into the area of financial regulation. Another Group was appointed to devise a monitoring system for systemically important financial intermediaries. The constitution of the Standing Committee on Procedures and Performance Audit on Public Services and ad hoc committees on Procedures and Performance Audit on Customer Services in banks aim to provide a mechanism to support broad based improvement in customer services with an emphasis on transparency and simplification of procedures. In this direction, the following further measures are proposed:

***(a) Long-term Bonds for Infrastructure Financing***

115. It was proposed in the annual policy Statement of April 2003 to issue suitable policy guidelines for banks enabling them to raise long-term resources from the market which are not in the nature of subordinated debt. In this context, in order to boost infrastructure lending, it is proposed:

- To allow banks to raise long-term bonds with a minimum maturity of 5 years to the extent of their exposure of residual maturity of more than 5 years to the infrastructure sector.

***(b) Withdrawal of Limits on Unsecured Exposures***

116. At present, banks are required to limit their commitments by way of unsecured exposure in such a manner that 20 per cent of a bank's outstanding unsecured guarantees plus the total of its outstanding unsecured advances should not exceed 15 per cent of its total outstanding advances. In order to extend further flexibility to banks on their loan policies, it is proposed:

- To withdraw the extant limit on unsecured exposures to enable banks' Boards to fix their own policy on unsecured exposures.

- Banks would be required to make an additional provision of 10 per cent, i.e., a total provision of 20 per cent of the total outstanding advances in the substandard category to cover expected loss on unsecured exposures.

- Provision at the level of 100 per cent for unsecured exposures in doubtful and loss categories will continue as hitherto.

***(c) Prudential Credit Exposure Limits***

117. At present, banks are allowed to assume single or group borrower credit exposure up to 15 and 40 per cent of capital funds (i.e., Tier I & Tier II Capital) respectively, with an additional allowance of 5 and 10 per cent of capital funds for infrastructure sector exposure. However, banks having difficulty in complying with the prudential credit exposure limits can approach RBI for approval, on a case by case basis. In the light of the liberalised access of borrowers to ECBs and their ability to raise resources through capital/debt market, it has been decided to discontinue the practice of giving case by case approval. Accordingly, it is proposed that:

- Banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to the borrower up to a maximum of further 5 per cent of capital funds, subject to the borrower consenting to the banks making appropriate disclosures in their Annual Reports. The additional allowance of 5 and 10 per cent of capital funds for single and group borrowers, respectively, for the infrastructure exposure would continue.

- Exposures of banks that are fully guaranteed by the Government of India would be exempt from the purview of credit exposure norms.

- Banks would phase out the excess exposures beyond the prescribed limits either by increasing capital funds or reducing exposures by March 31, 2005.

***(d) Risk Weight for Exposure to Public Financial Institutions***

118. At present, exposures of banks/FIs to specified public financial institutions (PFIs) attract a risk weight of 20 per cent for capital adequacy purposes. The financial positions of PFIs are divergent. As such, preferential treatment to PFIs for capital adequacy purposes on a privileged basis is not justified. Accordingly, it is proposed that:

- With effect from April 1, 2005, exposures on all PFIs will attract a risk weight of 100 per cent.

***(e) Capital Charge for Market Risk***

119. In the annual policy Statement of April 2002, banks were advised to adopt the Basel norm for capital charge for market risk. As a further step in this direction, RBI issued draft guidelines on computing capital charge

for market risk to select banks seeking their comments. In this context, with a view to ensuring smooth transition to Basel II norms, it is proposed to phase the implementation of capital charge for market risk over a two year period as under:

- Banks would be required to maintain capital charge for market risk in respect of their trading book exposures (including derivatives) by March 31, 2005.

- Banks would be required to maintain capital charge for market risk in respect of the securities included under available for sale (AFS) category by March 31, 2006.

***(f) Preparation for Implementing the New Capital Accord (Basel II)***

120. The Basel Committee on Banking Supervision (BCBS) would be issuing the New Capital Accord (Basel II) by end-June 2004 which is expected to be implemented by the end of 2006. As a well-established risk management system is a pre-requisite for implementation of advanced approaches under Basel II, it is proposed that:

- Banks should examine in-depth the options available under Basel II and draw a road map by end-December 2004 for migration to Basel II and review the progress made thereof at quarterly intervals. The Reserve Bank will be closely monitoring the progress made by banks in this direction.

***(g) Country Risk Management***

121. It was indicated in the annual policy Statement of April 2003 that a review would be made after one year taking into account the experience of banks in implementing the guidelines on country risk management issued in February 2003. Effective from March 31, 2003, these guidelines were applicable in respect of countries where a bank has an exposure of 2.0 per cent or more of its assets. The Reserve Bank has since reviewed the position and it is proposed:

- To extend the guidelines to countries where a bank has an exposure of 1.0 per cent or more of its assets with effect from the year ending March 31, 2005.

***(h) Provisioning Requirement for NPAs***

122. At present, banks are required to make provisions on NPAs on a graded scale based on the age of the NPA. However, in respect of 'doubtful assets for more than three years', the provisioning requirement on the secured portion remains unchanged at 50 per cent, till it is identified as a loss asset. With the enactment of the

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the chances/extent of recovery of an asset reducing over a period of time, it is essential that banks expedite recovery of NPAs. Accordingly, it is proposed:

- To introduce graded higher provisioning requirement according to the age of NPAs, which are included under 'doubtful for more than three years' category, with effect from March 31, 2005.

***(i) Wilful Defaulters – Clarification on Process***

123. At present, banks/FIs are required to form a Committee of higher functionaries headed by the Executive Director for classification of borrowal accounts as wilful defaulters and create a redressal mechanism in the form of a Committee headed by the Chairman & Managing Director for giving a hearing to borrowers who have grievance on their classification as 'wilful defaulters'. Representations have been received that redressal of grievance after the event is not fair in view of the damage to the reputation that cannot be easily reversed. The suggestion was that an opportunity be provided to the defaulter to be heard before being declared as such. It is, therefore, clarified that:

- The classification of borrowal accounts and the redressal mechanism are two distinct processes, comprising (i) identification of defaults as wilful with clear-cut reasons; and (ii) providing an opportunity to the borrower to make a representation before being classified as a wilful defaulter.

***(j) Dissemination of Credit Information – Role of CIBIL***

124. Since June 2002, compilation and dissemination of credit information covering data on defaults to the financial system have been taken over by Credit Information Bureau of India Ltd. (CIBIL) from RBI. The Reserve Bank had issued instructions to banks/FIs to obtain the consent of all their borrowers for dissemination of credit information to enable CIBIL to compile and disseminate credit information. However, many banks have not taken effective measures to comply with the instructions in a comprehensive manner which is a matter of concern. The Reserve Bank accords highest priority to the development of an efficient credit information system and would be closely monitoring the progress in this regard. With a view to developing a sound financial system, it is proposed that:

- The Boards of banks/FIs should review the measures taken for furnishing credit information in respect of all borrowers to CIBIL and report compliance to RBI.

- Credit Information Bureaus, like credit rating agencies, are critical for the operation of the financial system and, in many ways, have a privileged relationship with the regulator. As such, it is desirable that the objective should be to move towards a sufficiently diversified ownership with no single entity owning more than 10 per cent of the paid-up capital in the first stage, and 5 per cent later.

***(k) Progress in Debt Recovery Tribunals***

125. The Recovery of Debts Due to Banks and Financial Institutions Act was enacted in 1993 to provide for the establishment of Tribunals for expeditious adjudication and recovery of debts due to banks and FIs. As at end-December 2003, out of 61,301 cases (Rs.88,876 crore) filed with Debt Recovery Tribunals (DRTs) by the banks, 25,510 cases (Rs.23,273 crore) have been adjudicated by them. The amount recovered so far through the adjudicated cases amounts to Rs.6,874 crore. On the basis of an internal review on the functioning of DRTs and in order to consider further improvements in this regard, RBI has requested the Government to set up a Working Group.

***(l) KYC and Privacy of Customer Relationship***

126. In the recent years, prevention of money laundering has assumed greater importance. In this direction, adoption of Know Your Customer (KYC) principle by banks is a step further towards combating money laundering and financing of terrorism. In August 2002, banks were advised to complete an appropriate KYC procedure for establishing identity by means of suitable documents and to ensure that adoption of such a procedure does not lead to denial of access to banking services for the general public. Further, in December 2002, banks were advised to review the accounts opened prior to August 2002 for compliance with the KYC norms and take necessary steps to complete the work in respect of all accounts in a phased manner by December 2004. In this context, it is advised that:

- Banks may fully adhere to the KYC policy adopted by their Boards for opening new accounts; they may limit its application to the existing accounts in such cases where the summation of the credit/debit transactions is more than Rs.10 lakh or where the banks suspect any unusual transactions.

- Banks may conduct KYC in all accounts belonging to trusts, intermediaries or where the accounts are operated through a mandate or power of attorney. The KYC procedure may be applied diligently to suit local conditions and should be completed by December 2004.

127. Banks have been advised that information collected by them for KYC purposes on a confidential basis should not be used for any other purpose such as cross-selling of products. Wherever banks desire to collect any information about the customer not relevant for KYC or for a purpose other than for KYC requirements, it should not form part of account opening form. Such information may be collected separately, purely on a voluntary basis after

explaining the objectives to the customer and taking his express consent for the specific uses to which such information could be put.

***(m) Banks' Investment in Non-SLR Securities***

128. In order to contain risks arising out of non-SLR investment portfolio of banks, in particular through the private placement route, the issue of regulation of private placement of corporate debt was discussed with SEBI. Consequent to the issuance of SEBI guidelines on Secondary Market for Corporate Debt Securities in September 2003, prudential guidelines on investment by banks in non-SLR securities were issued by RBI including, *inter alia,* prudential limits on banks' investment in unlisted non-SLR securities. Banks, whose investment in non-SLR securities are in excess of the prudential limits stipulated in the above guidelines, were given a transition period up to end-December 2004 for compliance. With effect from January 1, 2005, only banks whose investment in unlisted non-SLR securities are within the prudential limits will be allowed to make fresh investment in such securities up to the prudential limits.

***(n) Rationalisation of Vigilance Procedure in Public Sector Banks***

129. Under the extant arrangement of vigilance management in public sector banks, the Central Vigilance Commission (CVC) undertakes an enquiry in any transaction in which officers of the ranks of Scale III and above are suspected or alleged to have acted for an improper or corrupt purpose.

130. In view of the large number of cases handled under this arrangement and keeping in view the changing scenario in the banking industry, CVC has accepted the representation made by the Indian Banks' Association (IBA) and has decided that only such vigilance cases in which an officer of the level of Scale V and above is involved need to be referred to the Commission for advice. Vigilance cases involving an officer in Scale IV and below may be handled by the banks themselves to enable expeditious disposal of the references. The modified arrangement is expected to provide a conducive environment for staff in public sector banks to perform their duties consistent with normal commercial judgement.

***(o) Working Group on Financial Conglomerates***

131. It was proposed in the mid-term Review of November 2003 to set up a monitoring system for systemically important financial intermediaries. Accordingly, an inter-agency Working Group was constituted with a member each from RBI, SEBI and IRDA. The Group has since been renamed as the Working Group on Financial Conglomerates. The Group has suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-

regulatory exchange of information in respect of conglomerates. The Group has since submitted its Report which is being put in the public domain.

### *(p) Prompt Corrective Action*

132. As indicated in the annual policy Statement of April 2003, the scheme of Prompt Corrective Action (PCA) was put in place for a period of one year subject to review in December 2003. The scheme was reviewed by BFS and it has been decided to continue the PCA framework.

### *(q) Risk Based Supervision*

133. In the annual policy Statement of April 2003, it was indicated that RBI would introduce risk based supervision (RBS) on a pilot basis during 2003-04. The pilot RBS of 8 banks has since been completed and it has been decided to extend the RBS with some modifications to 15 more banks during the year 2004-05.

### *(r) Consolidated Supervision*

134. As indicated in the annual policy Statement of April 2003, final guidelines on consolidated accounting and supervision were issued to banks advising them to ensure strict compliance commencing from the year ended March 31, 2003. Further, banks were advised to prepare and submit consolidated prudential reports (CPR) to enable supervisory assessment of risks and adherence to certain prudential regulations on group basis. These reports are being reviewed by RBI on a half-yearly basis.

### *(s) Macro-prudential Indicators*

135. As part of the Reserve Bank’s initiatives in adopting best international practices for monitoring the stability of financial system in India, RBI has been compiling macro-prudential indicators (MPIs) from March 2000 onwards. As indicated in the annual policy Statement of April 2003, the salient features of the MPIs review for March 2002 was published in the Report on Trend and Progress of Banking in India. It has now been decided to publish the reviews on an annual basis.

## Urban Co-operative Banks

136. It has been the endeavour of RBI to develop the urban co-operative banking sector on sound lines in order to provide security to depositors as well as bridge the financing gaps for SSIs, SMEs and small borrowers. In this direction, the following measures are proposed:

### *(a) Status and Licensing of UCBs*

137. In the year 1993, before the liberalisation of licensing policy, there were 1,311 urban co-operative banks (UCBs) having deposits and advances amounting to Rs.11,108 crore and Rs.8,713 crore, respectively, which increased to 2,104 UCBs with deposits and advances of Rs.1,03,478 crore and Rs.61,930 crore, respectively, by end-December 2003. The NPAs of UCBs increased from 11.8 per cent of their total advances at end-March 1998 to 21.0 per cent by end-March 2003. As at end-December 2003, out of 2,104 UCBs, 176 were under liquidation and 636 had turned weak/sick.

138. After the liberalisation of licensing norms in May 1993, up to June 2001, 823 licences were issued and it was observed that 31 per cent of these newly licensed UCBs became financially unsound within a short period. Accordingly, the Reserve Bank constituted a screening committee consisting of outside experts in June 2001 to examine the applications for licences. The Committee has recommended that it should be made mandatory for all newly proposed UCBs to come into being through a process of graduation from a co-operative credit society on the strength of demonstrated and verifiable track record.

139. In the light of the above experience and in order to make the UCB sector strong, healthy and stable, it is proposed:

- To consider issuance of fresh licences only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, is put in place and a policy for improving the financial health of the urban co-operative banking sector is formulated early.

### *(b) Scheme of Reconstruction of UCBs*

140. In the recent past, several UCBs have faced problems resulting in closure of their operations. In respect of some UCBs, by virtue of commitments made by the Government, RBI approved a scheme of reconstruction subject to certain conditions. A review of the progress made on implementation of the scheme revealed that certain terms and conditions of the scheme, viz., infusion of funds and recovery of NPAs were not complied with. In the light of this experience, it is proposed:

- To consider only such schemes of reconstruction which envisage re-capitalisation by the stakeholders, viz., the shareholders/co-operative institutions/Government to the extent of achieving the prescribed capital adequacy norms, without infusion of liquidity through settlement of insurance claims by DICGC, and schemes which lay a clear road-map for reducing the NPA level to a tolerable limit within a stipulated time-frame.

## Working Group on Development Finance Institutions

141. As indicated in the mid-term Review of November 2003, a Working Group on Development Finance Institutions (Chairman: Shri N. Sadasivan) was constituted for addressing the regulatory and supervisory issues relating to the term-lending institutions and refinancing institutions and for improving the flow of resources to them. The Group examined, within the broader framework of regulation of NBFCs, various regulatory and supervisory aspects including access to short-term resources for the development finance institutions (DFIs) as a separate category. The Group also looked into various regulatory and supervisory aspects relating to NBFCs including residuary non-banking financial companies (RNBCs). The Group has since submitted its Report which is being put in the public domain.

## Review of the Regulatory and Supervisory Activities of the Apex Refinancing Institutions

142. Under the extant regulatory and supervisory framework of the financial sector, all-India apex refinancing institutions (RFIs) such as NABARD, NHB and SIDBI have regulatory and supervisory responsibilities, under the applicable statutes, in respect of certain segments of the Indian financial sector. These RFIs, in turn, are also regulated and supervised by RBI. The supervisory process of RBI, guided by prudential considerations, focuses primarily on the financial health of the institutions. It is important to distinguish their financial performance from their statutory responsibility of regulation and supervision. In order to ensure consistency and necessary convergence, while retaining the features unique to each activity in the regulatory and supervisory framework, it is considered desirable to undertake a study of the regulatory structure and supervisory systems and procedures adopted by these RFIs. Accordingly, it is proposed:

- To constitute a Technical Group with representatives of RBI, apex refinancing institutions (RFIs) and outside experts to evaluate the efficacy of the regulatory and supervisory systems deployed by the RFIs, identify the gaps, if any, and to make recommendations for strengthening the framework. The Group may submit its report within four months.

## Technology Upgradation

143. The Reserve Bank has made concerted efforts in developing a safe, secure and efficient payment and settlement system to enhance financial stability. In the process of improving the overall efficiency of the payment and settlement systems in the country, RBI, apart from performing the regulatory and oversight functions, has also undertaken promotional and institutional activities. These activities include developing and implementing magnetic ink character recognition (MICR) cheque processing system, Indian financial network (INFINET), electronic funds transfer (EFT) system, national electronic funds transfer (NEFT) system, electronic (debit and credit) clearing system (ECS), negotiated dealing system (NDS), securities settlement system (SSS), centralised fund

management system (CFMS) and real time gross settlement (RTGS) system. While MICR cheque processing system has been established in 39 centres in the country, preparatory work for developing a suitable software system for cheque truncation is in progress and a pilot project would be conducted in New Delhi by the end of 2004. Using the structured financial messaging system (SFMS), the current EFT system would be extended and accordingly the NEFT facility is scheduled to go on trial by July 2004. To provide straight-through-processing (STP) facilities to the current account holders of RBI, CFMS providing for electronic movement of funds is being implemented. Further, the Institute for Development and Research in Banking Technology (IDRBT) is setting up a National Financial Switch to facilitate apex level connectivity of other switches established by banks for electronic transfer of funds, and to act as an e-commerce payment gateway. The status and progress regarding certain specific areas and further measures are detailed below:

***(a) Electronic Clearing Service and Electronic Funds Transfer – Waiver of Service Charges***

144. With a view to promoting electronic funds transfer (EFT) and encouraging electronic clearing service (ECS), it is proposed to:

- Waive service charges on banks for both ECS and EFT transactions up to March 31, 2006.

***(b) Board for Payment and Settlement Systems***

145. As indicated in the annual policy Statement of April 2003, the Payment System Bill envisaged a special mechanism within RBI to exercise effective regulation and supervision of the various payment systems in the country at the apex level. Accordingly, it has been decided to set up a Board for Payment and Settlement Systems (BPSS), on the lines of the Board for Financial Supervision, which would function as a Committee of the Central Board, chaired by the Governor. The BPSS would lay down the policies for the regulation and supervision of payment and settlement systems, both paper-based and electronic, encompassing domestic and cross-border systems.

***(c) Real Time Gross Settlement System***

146. As indicated in the mid-term Review of November 2003, the standalone version of RTGS system, after elaborate testing was put under trial run. An external group of experts evaluated the policies, procedures, accounting and technology aspects of the system during this period. The live operations of RTGS system commenced on March 26, 2004 with the participation of 4 select banks and the system has since stabilised with 25 banks. Settlements of funds for inter-bank purposes and customer-related funds transactions are now put through the system. Further, the system also provides for collateralised repo based intra-day liquidity support to its members. It is expected that most of the commercial banks would be on the RTGS system by June 2004.

### *(d) Expert Group on Central Database Management System*

147. As proposed in the mid-term Review of November 2003, an Expert Group (Chairman: Prof. A. Vaidyanathan) was constituted to guide the process of placing the publishable segment of central database management system (CDBMS) in the public domain for the convenience of researchers, analysts and other users, keeping in view RBI's overall framework of data dissemination policy for users. The Group is expected to submit its report shortly.

### *(e) Working Group on Electronic Funds Transfer for Capital Market*

148. With a view to expanding the scope of electronic funds transfer (EFT) facilities and to provide solutions for faster movement of funds for capital market related transactions, a Working Group on Electronic Funds Transfer for Capital Market consisting of representatives from SEBI, Stock Exchanges, National Securities Depository Limited (NSDL) and IRDA has been constituted by RBI. The Group would assess the existing EFT facilities and make recommendations for increasing its coverage to facilitate T+1 settlement for the capital market.

## Developments in Currency Management System

149. The Reserve Bank continues to monitor the implementation of the Clean Note Policy to ensure that only good quality notes are in circulation. Since the mid-term Review of November 2003, a significant development has been the fall in demand of coins as a result of which the reverse flow of coins has started. The Reserve Bank has not only been accepting the surplus coins from the public in its Issue Offices, banks have also been advised to accept coins either by counting or by weighment. Further, RBI has introduced single window services for all transactions in its Cash Department. While RBI has introduced issuance of receipts for counterfeit notes tendered across its counters, banks have also been advised to implement the same.

## Conduct of Government Business

### *On-line Tax Accounting System*

150. As indicated in the mid-term Review of November 2003, RBI had constituted a High Powered Committee (HPC) for operationalising an On-line Tax Accounting System (OLTAS). Under the OLTAS, collection of direct taxes by banks would be credited on-line to the government account through transmission of tax payment data from banks to Central Accounts Section (CAS) of RBI and to the Tax Information Network (TIN) of the Income Tax Department. Pilot studies of OLTAS have been conducted successfully in 14 major cities since June 2003, and such studies have since been extended to cover all authorised bank branches. On the basis of the recommendations of HPC, the Central Board of Direct Taxes (CBDT) has simplified the challan form used for depositing tax and revised the systems and procedures for tax collection and reporting. OLTAS is expected to be

operationalised in June 2004. Further, CBDT would avail of electronic clearing scheme (ECS) facility of RBI for purposes of tax refunds up to Rs.25,000 to individual salaried taxpayers in 12 cities to begin with. This facility would be extended to other cities in due course.

**Standing Committee on Procedures and**

**Performance Audit on Public Services**

151. As indicated in the mid-term Review of November 2003, a Standing Committee was constituted on Procedures and Performance Audit on Public Services (Chairman:Shri S.S.Tarapore) to undertake procedures and performance audit on public services and regulatory clearances in RBI and to co-ordinate with the Ad hoc Committees on Customer Services set up by banks.

152. The Committee has since submitted four reports relating to individuals covering: (i) foreign exchange transactions; (ii) government transactions; (iii) banking operations relating to deposit accounts and other facilities; and (iv) currency management (non-business). The main thrust of the reports has been to bring about a change in RBI's policies and procedures in order to have ease of transactions for the common person. The Committee also emphasised that RBI should be a facilitator empowering the common person and safeguarding his rights in undertaking legitimate transactions.

***(a) Report on Foreign Exchange Transactions***

153. The recommendations of the Committee on exchange control matters relating to individuals were examined by RBI and some of the suggestions have since been implemented. These include: (i) changing the name of the department from Exchange Control Department to Foreign Exchange Department and reorienting it; (ii) allowing a liberalised scheme of personal remittance up to US $ 25,000 for residents; (iii) removing the restrictive clause relating to concessionality in ESOP scheme; and (iv) advising banks to initiate measures for providing trained staff at the first point of interface in AD branches.

***(b) Government Transactions Relating to Individuals***

154. In accordance with the Committee's recommendations on government transactions relating to individuals, RBI has initiated a number of steps to remove the deficiencies in the services provided by RBI and agency banks. The measures include: (i) increasing customer awareness of their rights; (ii) orienting banks' staff towards better customer service; (iii) reviewing existing policies and procedures for rationalisation and simplification; and (iv) enhancing the services provided by RBI offices and agency banks in areas such as operations of the relief/savings bonds and collection of taxes. Necessary instructions have been issued to banks reinforcing the need for enhancing customer services.

*(c) Banking Operations*

155. On the basis of the recommendations of the Committee on banking operations concerning deposit accounts and other facilities relating to individuals, the following measures have been implemented by RBI: (i) introduction of drop box facility for cheques and facility for acknowledgement of cheques through regular collection counters; (ii) delivery of cheque book over the counters on request; (iii) issue of statement of accounts at monthly intervals with details of various transactions; (iv) informing the existing account holders at least one month in advance of any change in the minimum balance in savings accounts and charges for non-maintenance thereof; and (v) agreeing to the request for opening of non-resident ordinary (NRO) accounts jointly with residents. Necessary instructions have been issued to banks in this regard.

156. The Reserve Bank is in agreement with the observations of the Committee on the disenfranchisement of the depositors as well as the need for thorough examination of operational procedures in the banks which are hampering settlement of claims of deceased depositors. It is proposed to advise banks to lay down a transparent and comprehensive policy setting out the rights of the depositors in general and small depositors in particular. The policy would also be required to cover all aspects of operations of deposit accounts, charges leviable and other related issues to facilitate interaction of depositors at branch levels. For settlement of claims of deceased depositors, a uniform procedure to be adopted by the banks to ease the constraints would be evolved in consultation with IBA.

*(d) Currency Management*

157. The Committee in its Report on Currency Management: Services Relating to Individuals (Non-business), commending the progress made in implementing the Clean Note Policy of RBI including the services to the common person, recommended a more proactive role on the part of RBI and the scheduled commercial banks to further expand the customer service with quality. The Reserve Bank has accepted almost all the recommendations of the Committee, and in many cases, necessary instructions have been issued to banks.

*(e) Ad hoc Committees*

158. A summary of recommendations contained in the first three reports together with RBI's preliminary responses on each of the recommendations have been forwarded to banks for responses from their Ad hoc Committees constituted for the purpose. The Committee has also had meetings with nodal officers of select banks to apprise the approach adopted by it and its expectations from them. The Committee's major recommendations in these four Reports and action taken by RBI for their implementation are being put in the public domain.

159. In order to make the process meaningful, banks are advised to associate non-officials in the Ad hoc Committees. Considering the progress made by the Ad hoc Committees constituted by banks and the need for

taking appropriate action in redesigning procedures and practices, the currency of these Ad hoc Committees has been extended for a further period of six months. The Reserve Bank accords highest priority to the service of common persons. It expects that the bank Boards would take this opportunity to streamline their procedures and processes towards fulfilling customers' expectations in terms of transparent and efficient service.

**Deposit Insurance**

160. It was indicated in the mid-term Review of November 2003 that a draft outline of the Banking Deposits Insurance Corporation (BDIC) Bill, 2003 to replace the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act, 1961 was submitted for consideration of the Government. The draft Bill is being revised on the basis of suggestions from the Government. In the meanwhile, DICGC has reviewed certain operational aspects such as premium on deposits and verification of deposit insurance claims by chartered accountants for disposal of the claims. The credit guarantee scheme of the Corporation has been discontinued as the credit institutions have gradually opted out of the scheme.

**International Financial Standards and Codes**

161. It was indicated in the annual policy Statement of April 2003 that the Report of the Standing Committee along with the Reports of the Advisory/Technical Groups on International Financial Standards and Codes were put in the public domain for wider dissemination. The recommendations of the Advisory/Technical Groups are being pursued by RBI, SEBI and IRDA relating to their respective areas. A review of the progress made so far in this direction was undertaken in order to identify areas where further action could be taken. The review also included recent developments in the international financial standards and codes in the areas of central bank money in payment system, risk management standards for central counterparties, foreign exchange reserves management, risk integration and risk transfer, money laundering, guidelines on KYC policy on a consolidated basis and the New Basel Capital Accord with a view to comparing Indian position *vis-à-vis* international standards. The review is being considered by a panel of advisers and is expected to be put in the public domain in two months.

**Annexes**

162. The liberalisation process has progressed further in the areas of external commercial borrowings, outward foreign direct investments, inward direct and portfolio investments, facilities for residents, students pursuing higher studies abroad and simplification of procedures. A list of measures relating to current and capital accounts announced subsequent to the presentation of the mid-term Review of November 2003 is given in Annex I.

163. Rapid changes in the financial sector in the areas of consolidation/merger, developments in markets/instruments/products coupled with innovation in information technology have necessitated changes in legal

infrastructure. The Reserve Bank in co-ordination with the Government has taken necessary initiatives in this direction and the progress made so far is given in Annex II.

**Mid-term Review**

164. As in the past, review of the annual policy Statement will be undertaken in October/November 2004. In addition to a review of macroeconomic and monetary developments, the mid-term Review will contain such other changes/measures as may be necessary in regard to policy and projections for the second half of the year.

**Mumbai**

**May 18, 2004**

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

***Corporates***

1. Foreign banks operating in India permitted to remit net profits/surplus (net of tax) in the normal course of business arising out of their Indian operations on a quarterly basis, to their Head Offices without prior approval of RBI.

2. Issue of equity shares permitted against lump-sum fee, royalty and outstanding external commercial borrowings (ECBs) in convertible foreign currency.

3. General permission granted to foreign entities for setting up of project offices in India. These project offices are permitted to open foreign currency accounts, if required, with RBI approval.

4. Importers/exporters permitted to book forward contracts on declaration basis, based on average of the past three years' export/import turnover or the previous year's turnover, whichever is higher.

5. General permission granted to foreign companies to establish branch offices/units in special economic zones (SEZs) to undertake manufacturing and service activities, subject to certain conditions.

6. With effect from April 1, 2004, submission of Declaration in Form GR/SDF/ PP/SOFTEX in respect of export of goods and software of value not exceeding US dollar 25,000 or its equivalent waived for exporters.

7. Limits for direct receipt of import bills/documents by non-corporate importers raised to US dollar 100,000 or its equivalent.

8. Resident corporates and registered partnership firms permitted to invest up to 100 per cent of their net worth in overseas JV/WOS without any separate monetary ceiling, subject to reporting in form ODR.

9. Resident corporates and registered partnership firms permitted to undertake agricultural activities overseas, including purchase of land incidental to this activity either directly or through their overseas offices (i.e., other than through JV/WOS) within the overall limit available for investment overseas under the automatic route.

10. Limit of export of goods by way of gift increased from Rs.1 lakh to Rs.5 lakh per annum.

11. General permission granted to Indian companies in India to grant loans in foreign currency to the employees of their branches outside India for personal purposes.

12. Indian corporates permitted to avail ECBs up to US dollar 500 million with minimum average maturity of 3 years for loans up to US dollar 20 million and minimum average maturity of 5 years for loans above US dollar 20 million. The end use for ECBs to include overseas direct investment in JV/WOS.

13. Credits for imports up to US dollar 20 million per transaction with a maturity period beyond one year and up to three years permitted only for import of capital goods.

14. Remittance of net salary of a citizen of India, who is on deputation to the office or branch of an overseas company in India, allowed for the maintenance of close relatives residing abroad.

***Investments***

1. Indian listed companies permitted to disinvest their investment in a JV/WOS abroad even in cases where such disinvestment may result in a write-off of the capital invested to the extent of 10 per cent of the previous year's export realisation.

2. Firms in India registered under the Indian Partnership Act, 1932 and having a good track record permitted to make direct investments under the automatic route outside India in an entity engaged in any bonafide business activity under the automatic route up to 100 per cent of its net worth.

3. Resident entities having overseas direct investments permitted to hedge the exchange risk arising out of such investments.

4. Authorised dealers (ADs) permitted to enter into forward/option contracts with residents who wish to hedge their overseas direct investments.

5. Multilateral Development Banks like International Finance Corporation (IFC), Asian Development Bank (ADB), etc. which are specifically permitted by the Government to float rupee bonds in India, permitted to purchase government dated securities.

6. Authorised dealers permitted to grant rupee loans to NRIs as per policy laid down by the bank's Board.

***Resident Individual***

1. Indian students studying abroad would be treated as Non-resident Indians (NRIs). While they would be eligible for all the facilities available to non-residents under FEMA, educational and other loans availed of by students as resident in India would be allowed to continue.

2. The limit for foreign exchange remittance for miscellaneous purposes without documentation formalities has been raised from US dollar 500 to US dollar 5000.

3. Resident individuals permitted to remit up to US dollar 25,000 freely per calendar year.

4. Resident beneficiaries permitted to open and credit the proceeds of the insurance claims/maturity/surrender value settled in foreign currency to their RFC (Domestic) Account.

## Annex II. Legal Reforms: Review of Developments

***Bills Passed by the Parliament***

- The Industrial Development Bank (Transfer of Undertaking and Repeal) Bill, 2003.
- The Sick Industrial Companies (Repeal Provisions) Repeal Bill, 2001.

***Bills under Consideration of the Parliament***

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

***Legislative Proposals under Consideration of the Government***

- Reserve Bank of India Act, 1934.
- Draft Bill on Credit Information Bureau Regulation.
- Bank Deposit Insurance Corporation Bill.
- Draft Bill on Government Securities.