RESERVE BANK OF INDIA

Second Quarter Review of Monetary Policy 2009-10

(Including Review of Developmental and Regulatory Policies)

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ACRONYMS

ADRs	-	American Depository Receipts
AFCs	-	Asset Finance Companies
AFS	-	Available for Sale
ALM	-	Asset Liability Management
ARR	-	Automated Regulatory Reporting
ASP	-	Application Service Provider
ATM	-	Automated Teller Machine
BC	-	Business Correspondent
BCBS	-	Basel Committee on Banking Supervision
BE	-	Budget Estimates
BEI	-	Business Expectation Index
BPL	-	Below Poverty Line
BPLRs	-	Benchmark Prime Lending Rates
BSE	-	The Stock Exchange, Mumbai
CARE	-	Credit Analysis and Research Limited
CBLO	-	Collateralised Borrowing and Lending Obligation
CBS	-	Core Banking Solution
CCF	-	Credit Conversion Factor
CCIL	-	Clearing Corporation of India Limited
CDs	-	Certificates of Deposit
CDS	-	Credit Default Swap
CGFTMSE	-	Credit Guarantee Fund Trust for Micro and Small Enterprises
CI	-	Confidence Interval
CIS	-	Commonwealth of Independent States
CP	-	Commercial Paper
CPI	-	Consumer Price Index
CPI-IW	-	Consumer Price Index for Industrial Workers
CPI-UNME	-	Consumer Price Index for Urban Non-Manual Employees
CRAR	-	Credit to Risk-Weighted Assets Ratio
CRISIL	-	Credit Rating Information Services of India Limited
CSO	-	Central Statistical Organisation
CTS	-	Cheque Truncation System
DCC	-	District Consultative Committee

DGA	-	Duration Gap Analysis
DICGC	-	Deposit Insurance and Credit Guarantee Corporation
DTL	-	Demand and Time Liabilities
DvP	-	Delivery versus Payment
EBT	-	Electronic Benefit Transfer
ECAIs	-	External Credit Assessment Institutions
ECBs	-	External Commercial Borrowings
ECR	-	Export Credit Refinance
EMEs	-	Emerging Market Economies
EXIM Bank	-	Export-Import Bank of India
FAO	-	Food and Agriculture Organisation
FCCBs	-	Foreign Currency Convertible Bonds
FDI	-	Foreign Direct Investment
FICCI	-	Federation of Indian Chambers of Commerce & Industry
FIIs	-	Foreign Institutional Investors
FSB	-	Financial Stability Board
FSU	-	Financial Stability Unit
G-20	-	Group of Twenty
GBP	-	Great Britain Pound
GDP	-	Gross Domestic Product
GDRs	-	Global Depository Receipts
GFSR	-	Global Financial Stability Report
GSDP	-	Gross State Domestic Product
HFCs	-	Housing Finance Companies
HFT	-	Held for Trade
HLCCFM	-	High Level Coordination Committee on Financial Markets
HSBC	-	Hongkong and Shanghai Banking Corporation
HTM	-	Held to Maturity
IBA	-	Indian Banks' Association
ICCL	-	Indian Clearing Corporation Limited
ICT	-	Information and Communication Technology
IDBI SASF	-	Industrial Development Bank of India Stressed Asset Stabilisation Fund
IDRBT	-	Institute for Development and Research in Banking Technology
IIP	-	Index of Industrial Production

IMF	-	International Monetary Fund
INR	-	Indian Rupee
IOSCO	-	International Organisation of Securities Commissions
IRFs	-	Interest Rate Futures
IT	-	Information Technology
LABs	-	Local Area Banks
LAF	-	Liquidity Adjustment Facility
LIC	-	Life Insurance Corporation
M_3	-	Broad Money
MFIs	-	Micro-Finance Institutions
MFs	-	Mutual Funds
MICR	-	Magnetic Ink Character Recognition
MIS	-	Management Information System
MoU	-	Memorandum of Understanding
MSEs	-	Micro and Small Enterprises
MSS	-	Market Stabilisation Scheme
NABARD	-	National Bank for Agriculture and Rural Development
NBFCs	-	Non-Banking Financial Companies
NBFCs-ND-SI	-	Systemically Important Non-Deposit Taking NBFCs
NCAER	-	National Council for Applied Economic Research
NCDs	-	Non-Convertible Debentures
NDS	-	Negotiated Dealing System
NDTL	-	Net Demand and Time Liabilities
NECS	-	National Electronic Clearing Service
NEFT	-	National Electronic Funds Transfer
NHB	-	National Housing Bank
NIMC	-	National Implementing and Monitoring Committee
NPAs	-	Non-Performing Assets
NREGA	-	National Rural Employment Guarantee Act
NSCCL	-	National Securities Clearing Corporation Limited
NSE	-	National Stock Exchange
NSM	-	Note Sorting Machines
OECD	-	Organisation for Economic Co-operation and Development
OMO	-	Open Market Operation
OTC	-	Over-the-Counter

OTS	-	One-Time Settlement
PACS	-	Primary Agricultural Credit Society
PCO	-	Public Call Office
POS	-	Point-of-Sale
PSB	-	Public Sector Bank
PSLC	-	Priority Sector Lending Certificate
Q	-	Quarterly
RBI	-	Reserve Bank of India
RE	-	Revised Estimates
REER	-	Real Effective Exchange Rate
RM	-	Reserve Money
RRBs	-	Regional Rural Banks
RTGS	-	Real Time Gross Settlement
SCBs	-	Scheduled Commercial Banks
SDLs	-	State Development Loans
SDRs	-	Special Drawing Rights
SEBI	-	Securities and Exchange Board of India
SHGs	-	Self-Help Groups
SIDBI	-	Small Industries Development Bank of India
SLBC	-	State Level Bankers' Committee
SLR	-	Statutory Liquidity Ratio
SMEs	-	Small and Medium Enterprises
SPV	-	Special Purpose Vehicle
STRIPS	-	Separate Trading for Registered Interest and Principal of Securities
TAC	-	Technical Advisory Committee
TGA	-	Traditional Gap Analysis
UCBs	-	Urban Co-operative Banks
UK	-	United Kingdom
US	-	United States of America
WEO	-	World Economic Outlook
WPI	-	Wholesale Price Index
Y-o-Y	-	Year-on-Year

Reserve Bank of India
Second Quarter Review of Monetary Policy 2009-10

By
Dr. D. Subbarao
Governor

The global economy has begun to recover from the deep recession set off by the financial crisis. This recovery is underpinned by output expansion in emerging market economies (EMEs), particularly those in Asia. The pace and shape of recovery, however, remain uncertain.

2. In fact, the global economic outlook presents a mixed picture. On the positive side, world output, as per the International Monetary Fund (IMF) estimates, has expanded by 3 per cent in the second quarter (quarter-on-quarter, annualised), manufacturing activity has picked up, trade is recovering, financial market conditions are improving, and risk appetite is returning. A sharp recovery in equity markets has enabled banks to raise capital to repair their balance sheets. In the US, home prices appear to be stabilising. Capital flows to EMEs have resumed. Most importantly, the anxiety and nervousness that pervaded the financial markets during the height of the crisis are being replaced by a sense of calm.

3. On the negative side, there are concerns that the recovery is fragile. The second quarter improvement is essentially the outcome of policy-induced stimulus. Going forward, the impact of the stimulus will fade away and inventory rebuilding may lose momentum. In advanced economies, private consumption remains constrained by continuing job losses, sluggish income growth and dented confidence. Even as output is recovering, unemployment is expected to increase to over 10 per cent in the US and the Euro area. Investment is also expected to remain weak due to ruptured balances sheets, excess capacity and financing constraints. Bank collapses are continuing. World trade remains below its year ago level, notwithstanding recent quarter-on-quarter improvement.

4. Reflecting this mixed trend which has a small bias towards the positive, the IMF projected, in its October 2009 World Economic Outlook (WEO), that the rate of contraction of the world economy in 2009 will be 1.1 per cent, an upward revision from its projection of a contraction of 1.4 per cent made in its July 2009 WEO. However, the IMF expects the ensuing global recovery to be slow. In its latest Economic Outlook (September 2009), the Organisation for Economic Co-operation and Development (OECD) projects the pace of activity to remain weak well into 2010 on account of numerous headwinds. On balance, while global economic prospects have improved since the First Quarter Review in July 2009, uncertainties remain about the pace and sustainability of economic recovery.

5. The Indian economy, which slowed down significantly during the second half

of 2008-09, largely due to the knock-on effect of the global financial crisis, has begun to stabilise. This is despite the continuing contraction in exports and the worst drought since 1972. Performance of the industrial sector has improved markedly in recent months. Both domestic and external financing conditions are on the upturn. Capital inflows have revived. Activity in the primary capital market has picked up and funding from non-bank domestic sources has eased. Liquidity conditions have remained easy and interest rates have softened in the money and credit markets.

6. At the same time, there are several negative indications. Private consumption demand is yet to pick up. Agricultural production is expected to decline due to lower *Kharif* foodgrain production. Services sector growth remains below trend. Bank credit growth continues to be sluggish. There are also clear signs of rising inflation stemming largely from the supply side, particularly from food prices.

7. This *Second Quarter Review of Monetary Policy for 2009-10* is thus set against the backdrop of incipient signs of recovery in the global economy and improving prospects for the domestic economy. The Review is organised in two parts. Part A covers *Monetary Policy* and is divided into three sections: Section I provides an assessment of the *Macroeconomic and Monetary Developments*; Section II defines the *Stance of Monetary Policy*; and Section III sets out *Monetary Measures*. Part B covers the *Developmental and Regulatory Policies and* is organised into seven sections: Financial Stability (Section I), *Interest Rate Policy* (Section II), *Financial Markets* (Section III), *Credit Delivery Mechanism and other Banking Services* (Section IV), *Financial Inclusion* (Section V), *Regulatory Measures for Commercial Banks* (Section VI) *and Institutional Developments* (Section VII). Part A of this Statement should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday.

Part A. Monetary Policy

I. Macroeconomic and Monetary Developments

Global Outlook

Real GDP

8. Global economic performance improved during the second quarter of 2009 prompting the IMF to reduce the projected rate of economic contraction in 2009 from 1.4 per cent made in July 2009 to 1.1 per cent in its latest World Economic Outlook (WEO) released in early October 2009. The IMF has also revised upwards the projection of global growth for 2010 to 3.1 per cent against the earlier projection of 2.5 per cent in its July Update (Table 1).

9. In the US, the macroeconomic signals are mixed. Real GDP in Q2 of 2009 contracted by 0.7 per cent, a significant improvement over the contraction of 6.4 per cent in Q1 of 2009, largely due to positive contribution from government spending. Home prices have shown signs of stabilisation. On the negative side, the

Table 1: Projected Global GDP Growth (%)

Country/Region	2009	2010
US	(-)2.7	1.5
UK	(-)4.4	0.9
Euro Area	(-)4.2	0.3
Japan	(-)5.4	1.7
China	8.5	9.0
India	5.4	6.4
Emerging and Developing Economies	**1.7**	**5.1**
World	**(-)1.1**	**3.1**

Source: World Economic Outlook, IMF, October 2009.

unemployment rate rose to 9.8 per cent in September 2009 and is expected to rise further. Consumer sentiment dipped on apprehensions about the economy, job and income prospects.

10. Economic indicators in the euro area continue to be weak. Real GDP contracted by 4.9 per cent in Q1 and by 4.8 per cent in Q2 of 2009. Unemployment rose to 9.6 per cent in August 2009 and retail sales dipped further. Although consumer and business confidence improved in Q3 of 2009, these are yet to move into positive territory. Real GDP in the UK contracted by 5.5 per cent in Q2 of 2009 and by 5.2 per cent in Q3 of 2009. Unemployment in the UK rose to 7.9 per cent in July-August 2009. Real GDP in Japan expanded by 2.3 per cent in Q2 2009 after negative growth for almost a year. Though output is stabilising and consumer and business confidence are improving, industrial outlook remains uncertain with big companies planning to cut capital outlays. Overall, OECD's Composite Leading Indicators for August 2009 show signs of recovery in most of the economies, especially in France and Italy.

Inflation

11. Global commodity prices have rebounded ahead of global recovery. The Food and Agriculture Organisation (FAO) Food Price Index rose in August-September 2009. Along with volatile food prices, industrial metal and gold prices have firmed up in Q3 of 2009. Gold prices have reached record levels on account of significant weakening of the US dollar during the quarter. Crude oil prices have been steady with a firm undertone during the quarter reflecting the balance of expectations of an economic recovery and higher oil consumption in the future against weak current demand and high inventories. Despite these trends, consumer price inflation in most developed and emerging market economies (other than India) remains negative/low due mostly to large output gaps. The WEO of October 2009 projects consumer price inflation in advanced countries to remain low, rising from 0.1 per cent in 2009 to 1.1 per cent in 2010. Consumer price inflation in emerging and developing economies is projected to decline from 5.5 per cent in 2009 to 4.9 per cent in 2010. In sharp contrast, in India, CPI inflation has not only remained elevated, but has indeed hardened in recent months reflecting higher food prices (Table 2).

Financial Markets

12. The wide array of supportive central bank actions and pronouncements have aided in the easing of money markets and the narrowing of corporate bond spreads.

Table 2: Cross-country CPI Inflation: Year-on-Year (%)

Country	September 2008	March 2009	September 2009
US	4.9	(-)0.4	(-)1.3
UK	5.2	2.9	1.1
Euro Area	3.6	0.6	(-)0.3
Australia	5.0	2.5	1.5 @
Japan	2.1	(-)0.3	(-)2.2 #
China	4.6	(-)1.2	(-)0.8 #
India*	9.8	8.0	11.7 #
Korea	5.1	3.9	2.2
Brazil	6.3	5.6	4.3
Russia	15.0	14.0	10.7

* CPI for industrial workers.
@ June 2009.
# August 2009.

Source: Official websites of respective countries and Bloomberg.

Share prices have rebounded in all major markets. Most major banks in the US and Europe have reported profits recently after the large losses incurred during 2008. On the negative side, credit offtake has fallen in 2009 in a number of advanced economies as corporates reduced debt levels in an environment of tighter credit standards by lenders. There are concerns, as highlighted by the Global Financial Stability Report (GFSR) of the IMF, that the transfer of financial risks to fiscal authorities could crowd out the private sector and undermine the sustainability of public sector finances.

Monetary Policy Measures

13. Central banks in all the major developed economies, barring Australia, continued with easy monetary policy and have held policy rates steady in recent months. They have also continued with measures to provide liquidity and other support to alleviate stress in the financial markets following the crisis. In the current cycle, the Reserve Bank of Australia has been the first G-20 central bank to raise its policy rate (Cash Rate) by 25 basis points to 3.25 per cent on October 6 on the back of diminished risk of serious economic contraction. The Reserve Bank of New Zealand has withdrawn some temporary emergency liquidity facilities put in place during the financial crisis of 2008.

Emerging Market Economies

14. In its October WEO, the IMF projects the real GDP growth of emerging and developing economies to decelerate to 1.7 per cent in 2009 (1.5 per cent projected in the July Update) from 6.0 per cent in 2008, before rebounding to 5.1 per cent in 2010. The IMF does not expect the rebound to be evenly spread across the EMEs; there will be a divergence between Asian and non-Asian EMEs as the rebound would be driven by China, India and other emerging Asian economies. Emerging markets that had little direct exposure to the financial meltdown have displayed significant economic momentum in Q3 of 2009, *albeit* slower than the rapid pace of Q2. China's export volumes have been growing, including recently to the US and Europe, leading to improvement in China's trade surplus. Growth in industrial production and fixed asset investment in China is estimated to have improved and its longer-term prospects have remained strong. In contrast, Latin America, Eastern Europe and Commonwealth of Independent States (CIS) are all expected to face contraction in 2009 and sluggish growth in 2010, while the Middle East is projected to grow moderately.

Domestic Outlook

15. The Indian economy posted a growth of 6.1 per cent for Q1 of 2009-10. This is higher than the expansion of 5.8 per cent in Q4 of 2008-09, but lower than the expansion of 7.8 per cent in the corresponding first quarter of 2008-09. The year-on-year (y-o-y) deceleration in growth was broad-based covering all the three major sectors, *viz.*, agriculture, industry and services (Table 3).

Agriculture

16. The south-west monsoon rainfall this year (June 1- September 30) was 23 per cent lower than the long-period average, the weakest since 1972. Twenty three of the 36 meteorological sub-divisions recorded deficient rainfall. The entire central and northern India received deficient rainfall. The Reserve Bank's production-weighted rainfall index for 2009 was 73, significantly lower than the index number 104 for 2008. According to the latest information of progress of *Kharif* sowing, the acreage under paddy declined by 15.7 per cent and that under oilseeds by 5.2 per cent.

17. The share of agriculture in GDP has been declining over time, and as of 2008-09, it was 17.0 per cent. However, experience shows that a deficient rainfall can have a disproportionate impact on overall economic prospects and on the sense of well-being. Poor output will push up prices and depress rural labour incomes. Given the inter-sectoral supply-demand linkages, the knock-on impact on the industrial and services sectors can also be significant. The large stock of foodgrains of 44.3 million tonnes with public agencies, improved supply management, and the social safety net programmes could mitigate the adverse effects to an extent.

Industry

18. The industrial sector has shown clear signs of revival in recent months. The index of industrial production (IIP) increased at a higher rate of 5.8 per cent during April-August 2009 as compared with a growth of 4.8 per cent in the corresponding period of the previous year and 0.6 per cent growth in the second half of 2008-09. While the basic, intermediate and consumer durable goods sectors witnessed higher growth, the performance of the capital goods and consumer non-durable sectors was relatively modest. The core infrastructure sector, with a

Table 3: Real GDP Growth (%)

Sector	Financial Year		Quarterly Growth Rates (y-o-y)		
	2007-08	2008-09	2008-09		2009-10
			Q1	Q4	Q1
Agriculture	4.9	1.6	3.0	2.7	2.4
Industry	7.4	2.6	5.1	(-)0.5	4.2
Services	10.8	9.4	10.0	8.4	7.7
Overall GDP	**9.0**	**6.7**	**7.8**	**5.8**	**6.1**

Source: Central Statistical Organisation (CSO).

weight of 26.7 per cent in the IIP, posted a growth of 4.8 per cent during April-August 2009, up from 3.3 per cent in the corresponding period of the previous year. The leading indicators of industrial production, both quantitative and qualitative, also point to revival of industrial activity in the months ahead.

Services

19. The performance of the services sector during April-July 2009 continued to follow the pattern witnessed in Q4 of 2008-09. Trade-related services such as cargo handled at major sea and airports continued to show deceleration/negative growth reflecting contraction of trade. The number of passengers handled at international terminals increased, *albeit* marginally, while the number of passengers handled at domestic terminals declined. Other domestic activity related services such as communication and construction have begun to show signs of upturn. The railway revenue-earning freight traffic recorded good growth.

Demand Components of GDP

20. Continuing the trend witnessed since Q2 of 2008-09, the two major components of demand, *viz*., private final consumption expenditure and gross fixed capital formation (with a combined weight of around 88 per cent) decelerated further in Q1 of 2009-10. Government consumption, which had increased sharply in Q3 and Q4 of 2008-09 due to the fiscal stimulus measures and the Sixth Pay Commission payouts, also decelerated in Q1 of 2009-10. While the direct impact of fiscal stimulus is waning, its indirect impact on private consumption and investment will persist for some more time. External demand continues to remain weak, whereas net exports turned positive in Q1 of 2009-10 because of a sharper decline in imports than in exports as compared with Q1 of 2008-09 (Table 4).

Table 4: Demand Components of GDP

Item	Financial Year		Q1	Q4	Q1
	2007-08	2008-09	2008-09		2009-10
Year-on-Year Growth Rate (%)					
Private Final Consumption Expenditure	8.5	2.9	4.5	2.7	1.6
Government Final Consumption Expenditure	7.4	20.2	(-)0.2	21.5	10.2
Gross Fixed Capital Formation	12.9	8.2	9.2	6.4	4.2
Net Exports	(-)36.7	(-)41.2	(-)75.9	(-)30.8	231.8
Share in GDP (%)					
Private Final Consumption Expenditure	57.2	55.5	58.0	51.4	55.6
Government Final Consumption Expenditure	9.8	11.1	9.6	13.4	9.9
Gross Fixed Capital Formation	31.6	32.2	32.2	31.6	31.6
Net Exports	(-)4.3	(-)5.8	(-)1.3	(-)2.9	1.6

Source: Central Statistical Organisation (CSO).

Corporate Performance

21. Sales of the private non-financial corporate sector declined marginally (0.9 per cent) in Q1 of 2009-10 on a year-on-year basis as also in comparison with Q4 of 2008-09 (1.7 per cent). In the wake of the downturn, firms responded quickly to the changed cyclical conditions by reducing their inventories around Q2 of 2008-09. Now, with the onset of recovery in Q1 of 2009-10, the upturn is characterised by an increase in the stocks to sales ratio. Year-on-year growth in net profits also witnessed a turnaround in Q1 of 2009-10 after registering negative growth in the preceding three quarters (Table 5).

Business Confidence

22. The Reserve Bank has been conducting a quarterly Industrial Outlook Survey of manufacturing companies since 1998. The survey tracks business expectations for the current quarter and business outlook for the following quarter. The latest round of the survey conducted during July-August 2009 showed a turnaround in the business sentiment. The assessment for Q2 of 2009-10 showed continuing upturn with a 7.8 per cent increase in the Business Expectations Index (BEI) over the previous quarter. Considerable improvement was noted in key indicators such as production, order books and capacity utilisation. The financing conditions were also reported to be better.

23. The outlook of manufacturing companies for Q3 of 2009-10 maintains its upward trend, with the BEI moving up to 116.4 from 109.9 in the previous quarter. The respondents expect production and capacity utilisation to improve further, working capital finance requirement to grow, the cost of raw materials to rise and pricing power to return to them. On the back of improved demand conditions, the manufacturing companies also expect further improvement in their employment situation. The findings of the Reserve

Table 5: Performance of the Private Corporate Sector

Item	Full Year		Q1	Q4	Q1
	2007-08	2008-09	2008-09		2009-10
Growth Rate (%)					
Sales	18.6	17.2	29.3	1.9	(-)0.9
Expenditure	19.4	19.5	33.5	(-)0.5	(-)4.4
Consumption of Raw Materials	18.4	18.5	36.1	(-)7.4	(-)13.4
Staff Cost	22.4	19.5	23.2	11.0	8.2
Gross Profits	24.9	(-)4.2	11.9	(-)8.8	5.8
Net Profits	26.0	(-)18.4	6.9	(-)19.9	5.5
Ratio (%)					
Interest to Sales	2.5	3.1	2.4	3.2	2.8
Gross Profit to Sales	14.9	13.3	14.5	13.7	15.7
Net Profit to Sales	9.8	8.1	9.7	8.1	10.2

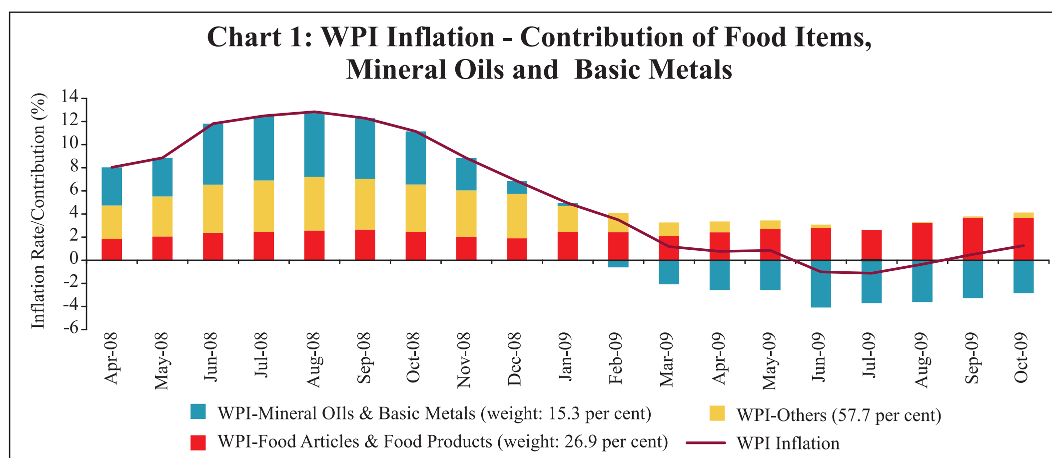
Bank's Industrial Outlook Survey are broadly consistent with business confidence surveys conducted by other agencies such as FICCI, NCAER, HSBC-Markit and Dun and Bradstreet.

Inflation

24. The headline inflation, as measured by year-on-year variations in the wholesale price index (WPI), which remained negative during June-August 2009 due to the base effect, returned to positive territory in September 2009. WPI inflation was 1.21 per cent on October 10, 2009 as compared with 11.30 per cent a year ago, and 0.84 per cent at end-March 2009. During the current financial year (up to October 10, 2009), WPI has increased by 5.95 per cent reflecting higher food price inflation aggravated by deficient monsoon.

25. The upside risk of deficient monsoon rainfall projected in the First Quarter Review of July 2009 has since materialised and prices of primary food items and manufactured food products have risen due to short supply. During the current financial year (up to October 10, 2009), the increases in prices of wheat (3.5 per cent) and rice (5.9 per cent) were relatively low as supply side pressures were mitigated by the comfortable levels of foodgrain stocks with public agencies which stood at 44.3 million tonnes as on October 1, 2009 as against the minimum stock norm of 16.2 million tonnes. However, large increases were recorded in prices of vegetables (59.3 per cent), tea (30.7 per cent), sugar, *khandsari and gur* (28.7 per cent), egg, meat and fish (25.3 per cent), pulses (19.2 per cent), *jowar* (14.9 per cent), condiments and spices (14.2 per cent), milk (7.0 per cent) and fruits (5.2 per cent).

26. The current inflationary pressures, as WPI moves from negative to positive territory, are quite different from the inflationary pressures witnessed in April-October 2008. Although both inflation episodes are driven by supply side pressures, the inflation in 2008 was triggered largely by a sharp increase in the prices of basic metals and mineral oils. In contrast, during the current episode, price pressures are emanating from domestic sources reflecting increase in prices of food articles and food products (Chart 1).



27. At a disaggregated level, WPI inflation rates of food articles, essential commodities and manufactured food products are currently in double digits and are ruling much above their trend levels (Table 6).

28. The recent contrarian movements in the WPI and CPI inflation rates have raised questions about the correlation between them. In the short-term, inflation rates based on WPI and CPIs could be different due to differences in coverage and weights. However, these differences even out over time as wholesale price changes are followed by changes in the retail prices. For example, in the five year period 2003-08, the average inflation based on consumer price index for industrial workers (CPI-IW) of 4.83 per cent was not very different from the average WPI inflation of 4.99 per cent.

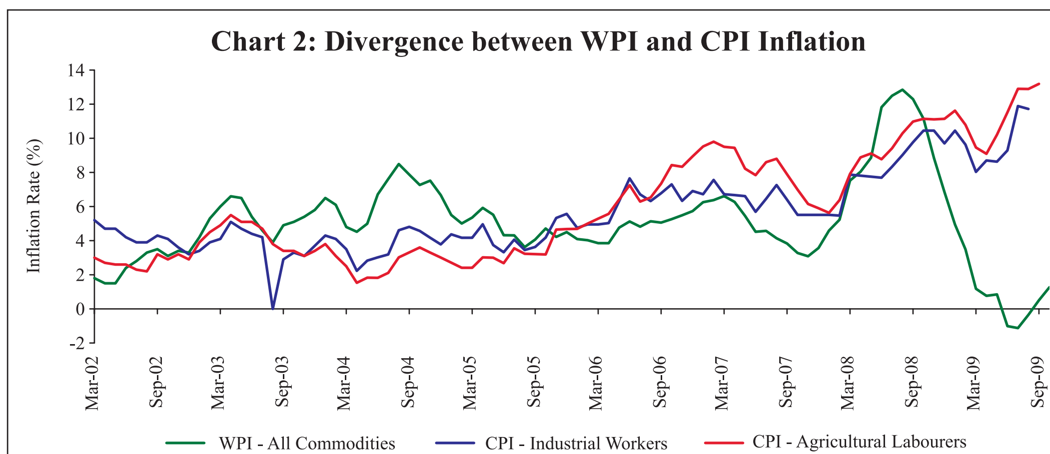
29. The first occasion in the recent past when CPI inflation diverged significantly from WPI inflation was in mid-2004. The divergence between the two inflation rates persisted thereafter but remained within a relatively narrow range. However, the divergence has widened in the recent period with WPI inflation turning negative even as CPI inflation crossed double digits (Chart 2). Several factors account for this phenomenon. One, food prices, which have higher weightage (in the range of 46-69 per cent) in the CPI measures than in WPI (26 per cent), have risen sharply in the recent period. Two, miscellaneous group (representing services) in various CPIs (weights in the range of 12-24 per cent)

Table 6: Annual Inflation Rate (Y-o-Y) (%)

Wholesale Price Index (WPI)	October 11, 2008	October 10, 2009
WPI - All Commodities	11.30	1.21
WPI - Primary Articles	12.56	8.62
WPI - Food Articles	10.17	13.34
WPI - Fuel Group	14.49	(-) 6.80
WPI - Manufactured Products	9.53	1.26
WPI - Manufactured Food Products	8.82	16.06
WPI - Essential Commodities*	8.66	17.82
WPI - Excluding Fuel	10.43	3.48
WPI - Excluding Food Articles and Fuel	10.50	0.96
Consumer Price Indices (CPIs)	**September 2008**	**September 2009**
CPI - Industrial Workers #	9.02	11.72
CPI - Urban Non-manual Employees #	8.54	12.88
CPI - Agricultural Labourers	10.98	13.19
CPI - Rural Labourers	10.98	12.97

* Essential commodities (weight in WPI: 17.8 per cent) include rice, wheat, jowar, bajra, pulses, potatoes, onions, milk, fish-inland, mutton, chillies (dry), tea, coking coal, kerosene, atta, sugar, gur, salt, hydrogenated vanaspati, rape & mustard oil, coconut oil, groundnut oil, long cloth/sheeting, dhoties, sarees & voiles, household laundry soap and safety matches.

Pertains to August.



have also exhibited significant price pressures; these services are not included in WPI. Three, prices of metals, which do not form part of the CPI group, have declined sharply, thereby accentuating the divergence between CPI and WPI inflation rates. Four, while a strong base effect pushed WPI inflation into negative territory during June-August 2009, there was no base effect in play for CPI inflation.

30. Inflation based on the CPI for industrial workers (IW) and urban non-manual employees (UNME) has also witnessed a one-time step-up reflecting significant upward revision in imputed prices of rent-free houses emanating from the Sixth Pay Commission Award. Notwithstanding the current wide divergence between the two sets of price indices, CPI inflation tracks the essential commodities component of WPI inflation quite closely indicating that current CPI inflation is essentially driven by food prices (Chart 3).

Asset Price Inflation

31. Asset prices have risen sharply in the recent period. Stock prices have increased by more than 70 per cent during the current financial year to date. After showing some correction in the latter part of 2008 and early part of 2009, real estate prices have risen significantly in major cities. Commodity

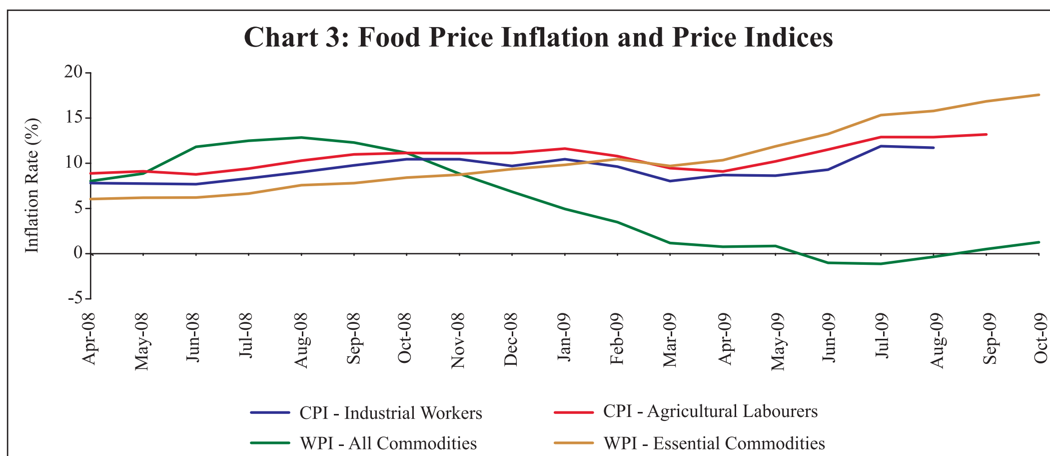


Table 7: Fiscal Position of the Central Government

Item	% of GDP		Actual during April-August	
	2008-09 (RE)	2009-10 (BE)	2008-09 (% of RE)	2009-10 (% of BE)
1. Gross Tax Revenue	11.8	10.9	30.3	26.2
2. Total Expenditure	16.9	17.4	31.0	33.6
3. Fiscal Deficit	6.2*	6.8	35.8	45.5
4. Revenue Deficit	4.6*	4.8	40.6	54.9
5. Primary Deficit	2.6*	3.0	38.1	62.8

* As per provisional accounts released by the Controller General of Accounts.
BE – Budget Estimate RE – Revised Estimate

prices in India have also hardened in recent months. Reflecting the firm trend in the global market, gold prices in India surged, especially after August 2009, and reached a level of Rs.16,035 per 10 grams on October 23, 2009, up from Rs. 15,105 at end-March 2009.

Fiscal Scenario

32. In the first five months of 2009-10 (April-August), the revenue deficit of the Central Government was 54.9 per cent of the budget estimate, while the fiscal deficit was 45.5 per cent (Table 7).

33. As per budget estimates, the combined net borrowing requirements of the Central and State Governments for 2009-10 will be 34 per cent higher than the already elevated level of actual borrowings during 2008-09 (Table 8).

34. A major challenge for the Reserve Bank, as indicated in the First Quarter

Table 8: Borrowings of the Central and State Governments

(Rs. crore)

Item	2007-08 Actual	2008-09 Actual	2009-10 Budget Estimates
Central Government			
Gross Market Borrowings $	1,88,215	3,18,550	4,91,044
Net Market Borrowings	1,08,998	2,98,536	3,97,957
State Governments			
Net Market Borrowings	56,224	1,03,766	1,40,000*
Total Net Market Borrowings	**1,65,222**	**4,02,302**	**5,37,957**

$ Pertain to dated securities and 364-day Treasury Bills.

* Estimated. The State Governments have been allowed to borrow an additional 0.5 per cent of gross state domestic product (GSDP) as part of the fiscal stimulus package in 2008-09 and another 0.5 per cent of GSDP in the Union Budget 2009-10, raising their budgeted borrowings in 2009-10 to 4.0 per cent of GSDP.

Review of July 2009, has been the management of the large government market borrowing programme in a non-disruptive manner. For this purpose, the Reserve Bank initiated several measures, some of which were unconventional. First, the Reserve Bank front-loaded the borrowing programme for 2009-10 as credit offtake by the private sector is usually low in the first half. Second, MSS securities of the order of Rs.28,000 crore were de-sequestered. Third, the Reserve Bank resorted to active liquidity management by way of unwinding of MSS securities and purchase of securities through pre-announced calendar of open market operations (OMO). The unwinding of MSS securities through redemption was of the order of Rs.42,000 crore during the first half of the year. Besides, as against the OMO announcement of an indicative amount of Rs.80,000 crore through the auction route for the first half of 2009-10, the actual purchases were Rs.57,487 crore, the shortfall from projection being on account of easy liquidity conditions. Feedback from the market participants indicates that the OMO provided considerable comfort.

35. The Central Government has already completed net market borrowing of Rs. 3,19,911 crore (as much as 80.4 per cent of the budget estimate) through dated securities during 2009-10 (up to October 26, 2009) (Table 9). In addition, the State Governments also mobilised Rs.58,683 crore (net) through the market borrowing programme. Because of the front-loading of the market borrowing programme, net issuances under the Central Government borrowing programme in the remaining period of 2009-10 will be Rs.62,464 crore (Table 9). Given the current level of liquidity, it should be possible to complete this borrowing programme smoothly.

Table 9: Central Government Borrowings during 2009-10: Dated Securities

(Rs. crore)

Item	Full Year (Planned)	First half (Actual)	Second Half		
			Planned	Actual (up to Oct. 26, 2009)	Balance
Gross Market Borrowings**	**4,18,000**	**2,95,000**	**1,23,000**	**30,000**	**93,000**
Less: Repayment	53,136	33,089	19,500	0	19,500
Net Market Borrowings**	**3,64,864**	**2,61,911**	**1,03,500**	**30,000**	**73,500**
Less: OMO Purchases	57,487*	57,487	*	0	*
Add: MSS (Net) **	(-)53,036	(-)42,000	(-)11,036	0	(-)11,036
Net Supply of Fresh Securities	**2,54,341**	**1,62,424**	**92,464**	**30,000**	**62,464**

* Rs. 80,000 crore of OMO purchases were planned for the first half of 2009-10. The Reserve Bank would conduct open market operations during the second half of the current fiscal year as and when considered necessary.

** Excluding the amount raised through MSS de-sequestering.

36. Despite the large government borrowing programme, the weighted average yield of dated securities issued under the Central Government borrowing programme in 2009-10 (up to October 26, 2009) at 7.14 per cent was lower than the yield of 8.81 per cent averaged for the corresponding period of the previous year. However, the yield on the 10-year government securities rose from 7.01 per cent at end-March to 7.47 per cent in early-September 2009 with increased volatility. Subsequently, it stabilised around 7.35 per cent by mid-October 2009. The Reserve Bank also varied the maturity profile of debt issuances tailored to market appetite. The weighted average maturity of securities issued during 2009-10 (up to October 26, 2009) was 11.0 years as compared with the average maturity of 15.5 years in the corresponding period of the previous year. Market participants indicate that had there not been active liquidity and maturity profile management by the Reserve Bank, the yield perhaps would have been significantly higher.

Monetary Conditions

37. Growth in monetary aggregates during 2009-10 (up to October 9, 2009) has evolved broadly in line with the projections. The year-on-year growth in reserve money (RM) turned negative reflecting the 400 basis points reduction in the cash reserve ratio (CRR) of banks during October–January 2008-09, which reduced the banks' balances with the Reserve Bank. Adjusted for the first round impact of changes in the CRR, reserve money growth was positive, but lower than in the previous year (Table 10).

38. The money supply (M_3) growth on a year-on-year basis at 18.9 per cent as on October 9, 2009 remained above the indicative projection of 18.0 per cent set out in the First Quarter Review of July 2009. The main source of M_3 expansion was bank credit to the government reflecting large market borrowings of the Government. This is in contrast to what happened in 2008-09, when bank credit to the commercial sector and net foreign

Table 10: Annual Variations in Monetary Aggregates (%)

Item	2008-09 (October 10, 2008)	2009-10 (October 9, 2009)
Reserve Money	28.8	(-)4.0
Reserve Money (adjusted for CRR changes)	20.6	14.3
Currency in Circulation	21.4	15.4
Money Supply (M_3)	20.9	18.9
M_3 (Policy Projection)	16.5-17.0 *	18.0 **
Money Multiplier	4.44	5.5
Ratio of Net Foreign Exchange Assets of RBI to Currency	210.6	175.9

* Projection as indicated in the Annual Policy Statement 2008-09 (April 2008).

** Projection as indicated in the First Quarter Review of Monetary Policy 2009-10 (July 2009).

Table 11: Growth in Major Sources of Money Supply as of October (%)

Item	Financial Year		Year-on-Year	
	2008-09 (October 10)	2009-10 (October 9)	2008-09 (October 10)	2009-10 (October 9)
Money Supply (M_3)	7.7	8.0	20.9	18.9
Net Bank Credit to Government	10.1	12.4	16.8	44.9
Bank Credit to Commercial Sector	9.8	4.1	27.4	10.7
Net Foreign Exchange Assets of the Banking Sector	4.2	(-) 1.4	30.0	(-) 1.2

exchange assets of the banking sector drove the expansion of M_3 (Table 11).

39. Monetary management during 2009-10 has been informed by the continued need to provide liquidity to mitigate the adverse impact of the global financial crisis and to complete the large market borrowing programme of the Government in a non-disruptive manner. The phenomenon of substitution of foreign assets by domestic assets, which began in the second half of 2008-09, continued during the first two months of the current year. This trend, however, reversed after May 2009, when capital inflows revived on a net basis. Liquidity conditions have remained comfortable since mid-November 2008. During 2009-10 (up to October 23, 2009), the average daily amount absorbed by the Reserve Bank under the LAF window was of the order of Rs.1,20,000 crore, indicating a large surplus with the banking system, equivalent to 2.7 per cent of the net demand and time liabilities (NDTL).

Financing Conditions

Bank Credit

40. Non-food credit by scheduled commercial banks (SCBs) decelerated significantly, with the growth rate (y-o-y) falling to 11.2 per cent this year (as on October 9, 2009) from 29.4 per cent a year ago. On a financial year basis (up to October 9, 2009) too, the growth in scheduled commercial banks' non-food credit at 4.3 per cent is significantly lower than the growth of 10.5 per cent in the corresponding period of last year.

41. Several factors have contributed to the slowdown in non-food bank credit. One, overall credit demand from the manufacturing sector slowed down reflecting a decline in commodity prices and drawdown of inventories. Two, corporates were able to access non-bank domestic sources of funds and external financing – which had almost dried up during the crisis – at lower costs. Three, unlike in the previous year, oil marketing companies reduced their borrowings from the banking sector as oil prices moderated. Four, a significant amount of bank finance has gone to the corporate sector through banks' investment in units of mutual funds. Five, banks have also reined in credit to the retail sector due to the perceived increased risk on account of the general slowdown. This credit retrenchment was more pronounced in the case of foreign banks and

Table 12: Bank Group-wise Deposits and Credit Growth (Y-o-Y) as of October (%)

Bank Group	2008-09 (October 10, 2008)	2009-10 (October 9, 2009)
	Deposits	
Public Sector Banks	23.6	24.4
Foreign Bank Group	23.2	11.5
Private Bank Group	14.1	6.1
Scheduled Commercial Banks*	21.5	20.0
	Credit	
Public Sector Banks	32.7	15.3
Foreign Bank Group	32.9	(-) 15.9
Private Bank Group	19.7	2.5
Scheduled Commercial Banks*	29.5	10.8

* Including RRBs.

private banks. This is evident from bank group-wise analysis, which shows that credit from private banks slowed down sharply, while that from foreign banks actually contracted (Table 12). Thus, despite ample liquidity in the system, non-food bank credit expansion slowed down.

42. Banks used the ample liquidity available with them to make large investments in government securities and also fairly sizeable investments (of the order of Rs.92,000 crore during the current financial year so far) in units of mutual funds. Consequently, commercial banks' investments in SLR securities (including securities acquired under the LAF) increased to 30.4 per cent of their NDTL as on October 9, 2009, up from 25.7 per cent a year ago. Net of LAF collateral securities, banks' SLR investments were at 27.6 per cent of NDTL as on October 9, 2009.

43. As per data at a disaggregated level drawn from 49 banks accounting for 95 per cent of total bank credit, the year-on-year growth in bank credit to industry as of August 2009 was lower than that in the previous year. While the credit flow to agriculture, real estate and NBFCs remained high, it was lower for housing (Table 13).

Total Flow of Financial Resources to the Commercial Sector

44. During the peak of the crisis (Third Quarter Review of January, 2009), it was noted that the flow of resources to the commercial sector from both bank and non-bank sources had contracted. While bank credit continues to decelerate as indicated earlier, there has been a turnaround in financing from non-bank sources. The resource flow from non-bank sources increased in Q2 of 2009-10 with increase in foreign direct investment, pick-up in primary issues, increased support from insurance companies, and large investment by mutual funds in non-gilt debt instruments. While the resource flow from

Table 13: Annual Sectoral Flow of Credit

Sector	As on August 29, 2008 (y-o-y)			As on August 28, 2009 (y-o-y)		
	Amount (Rs.crore)	% share in total	Variations (%)	Amount (Rs.crore)	% share in total	Variations (%)
Agriculture	41,185	8.5	18.6	67,228	21.8	25.6
Industry	2,30,229	47.5	32.9	1,66,121	53.8	17.9
of which:						
Micro and Small	23,865	4.9	20.1	40,146	13.0	28.1
Real Estate	20,580	4.2	43.1	28,353	9.2	41.5
Housing	29,872	6.2	12.4	14,668	4.8	5.4
NBFCs	26,443	5.5	51.8	23,837	7.7	30.8
Overall Credit	**4,84,805**	**100.0**	**26.5**	**3,08,718**	**100.0**	**13.3**

Note: Data are provisional and relate to select banks which cover 95 per cent of total non-food credit extended by all scheduled commercial banks.

the non-bank sources was marginally higher in 2009-10 (up to October 9), the total flow of financial resources to the commercial sector declined in comparison with the corresponding period of 2008-09 due to slowdown in bank credit (Table 14).

Interest Rates

45. In response to the crisis, the Reserve Bank has effected a substantial reduction in policy rates beginning October 2008: the repo rate by 425 basis points and the reverse repo rate by 275 basis points. The CRR was also reduced by 400 basis points of NDTL of banks (Table 15).

46. Taking cues from the reduction in the Reserve Bank's policy rates and easy liquidity conditions, all public sector banks and most private sector banks have reduced their deposit and lending rates. The reduction in the term deposit rates between October 2008 and October 1, 2009 has been

Table 14: Total Flow of Financial Resources to the Commercial Sector

(Rs.crore)

Item	Full Year		Financial Year so far (up to October 9)	
	2007-08	2008-09	2008-09	2009-10
From Banks	4,44,807	4,21,091	2,40,092	1,07,861
From Other Sources*	5,64,558	4,68,567	2,28,119	2,30,130
Total Resources	**10,09,365**	**8,89,658**	**4,68,211**	**3,37,991**
Memo Item:				
Mutual Funds Investment in Debt (non-Gilt) Instruments	88,457	(-) 32,168	19,896	1,01,956

* Includes borrowings from financial institutions (including LIC) and NBFCs as well as resources mobilised from the capital market and by way of ECBs, FCCBs, ADRs/GDRs, FDI and short-term credit as per the latest available data, adjusted for double counting.

Table 15: Monetary Easing by the Reserve Bank since October 2008

Item	As on (%)		Reduction (basis points)
	Early October 2008	October 2009	
Repo Rate	9.00	4.75	425
Reverse Repo Rate	6.00	3.25	275
Cash Reserve Ratio (% of NDTL)	9.00	5.00	400

in the range of 175-350 basis points by public sector banks, 100-375 basis points by private sector banks and 125-300 basis points by five major foreign banks. The reduction in the range of BPLRs was 125-275 basis points by public sector banks, followed by 100-125 basis points by private banks and 125 basis points by five major foreign banks (Table 16).

Financial Markets

Money and G-Sec Markets

47. As a result of the monetary easing and policy rate reductions beginning September 2008, interest rates have declined across the term structure in the domestic financial markets. The call money

Table 16: Movements in Deposit and Lending Rates

(Per cent)

Interest Rates	October 2008 (%)	March 2009 (%)	April 20, 2009 (%)	October 15, 2009 (%)	Variation as on October 15, 2009 (basis points)	
					Over October 2008	Over April 20, 2009
Term Deposit Rates						
Public Sector Banks						
a) Up to 1 year	2.75-10.25	2.75-8.25	2.75-8.00	1.00-6.75	175-350	125-175
b) 1 year up to 3 years	9.50-10.75	8.00 -9.25	7.00-8.75	6.25-7.50	325	75-125
c) Over 3 years	8.50-9.75	7.50-9.00	7.25-8.50	6.50-8.00	175-200	50-75
Private Sector Banks						
a) Up to 1 year	3.00-10.50	3.00-8.75	3.00-8.50	2.00-7.00	100-350	100-150
b) 1 year up to 3 years	9.00-11.00	7.50-10.25	7.50-9.50	5.25-8.00	300-375	150-225
c) Over 3 years	8.25-11.00	7.50-9.75	7.50-9.25	5.75-8.25	250-275	100-175
Five Major Foreign Banks						
a) Up to 1 year	3.50-9.50	2.50-8.00	2.50-8.00	2.25-6.50	125-300	25-150
b) 1 year up to 3 years	3.60-10.00	2.50-8.00	2.50-8.00	2.25-7.50	135-250	25-50
c) Over 3 years	3.60-10.00	2.50-8.00	2.50-8.00	2.25-7.50	135-250	25-50
BPLR						
Public Sector Banks	13.75-14.75	11.50-14.00	11.50-13.50	11.00-13.50	125-275	50
Private Sector Banks	13.75-17.75	12.75-16.75	12.50-16.75	12.50-16.75	100-125	0
Five Major Foreign Banks	14.25-16.75	14.25-15.75	14.25-15.75	14.25-15.50	125	25

Table 17: Interest Rates - Monthly Average (%)

Instrument/Segment	October 2008	March 2009	July 2009	October 2009*
Call Money	9.90	4.17	3.21	3.18
CBLO	7.73	3.60	2.78	2.51
Market Repo	8.40	3.90	2.81	2.67
Certificates of Deposit (CDs)	10.00	7.53	4.96	3.60
Commercial Papers (CPs)	14.17	9.79	4.71	4.29
91-day Treasury Bills	8.13	4.77	3.22	3.23
10-year Govt. Security	7.80	6.57	7.00	7.33
Modal BPLR of PSBs	14.00	12.50	12.00	12.00

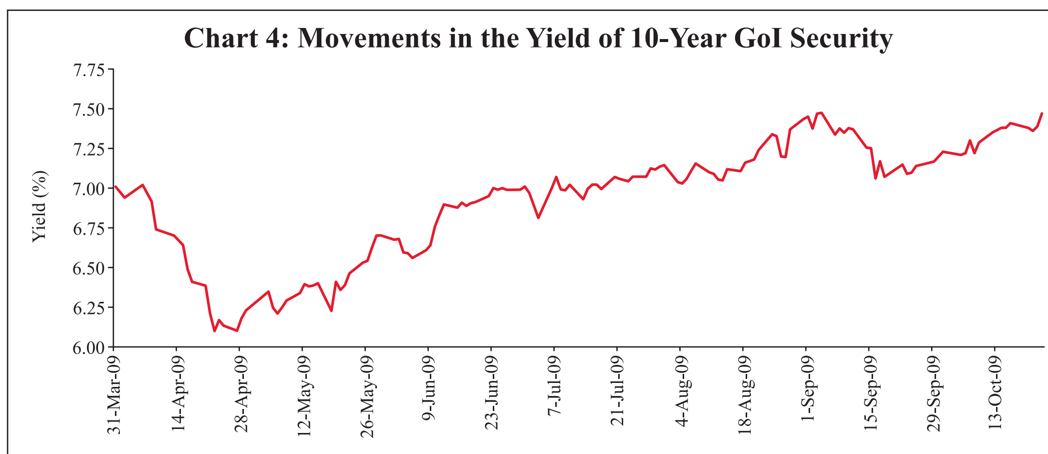
* Average up to October 23, 2009.

rates have remained near or below the lower bound of the LAF corridor since November 2008. Primary yields on Treasury Bills have also moderated (Table 17).

48. The yield on government securities moved up with increased volatility during the early part of the year in the face of a large borrowing programme of the Central and State Governments. There was a sudden surge in bond yields in late August due to change in market sentiment with the yield on 10-year Government security moving up by 42 basis points during August 13 - September 3, 2009. However, the yield stabilised subsequently on assurances by the Reserve Bank that it would manage liquidity conditions and market borrowing programme of the Government in a non-disruptive manner (Chart 4).

49. Presently, banks are permitted to hold statutory liquidity ratio (SLR) securities up to 25 per cent of their demand and time liabilities (DTL) in the 'held to maturity' (HTM) category of investments. Recently, there has been some debate on the need to raise this limit on the ground that such a relaxation will mitigate the upward pressure on G-Sec yields, and consequently on the overall interest rate regime. The Reserve Bank considered the

Chart 4: Movements in the Yield of 10-Year GoI Security

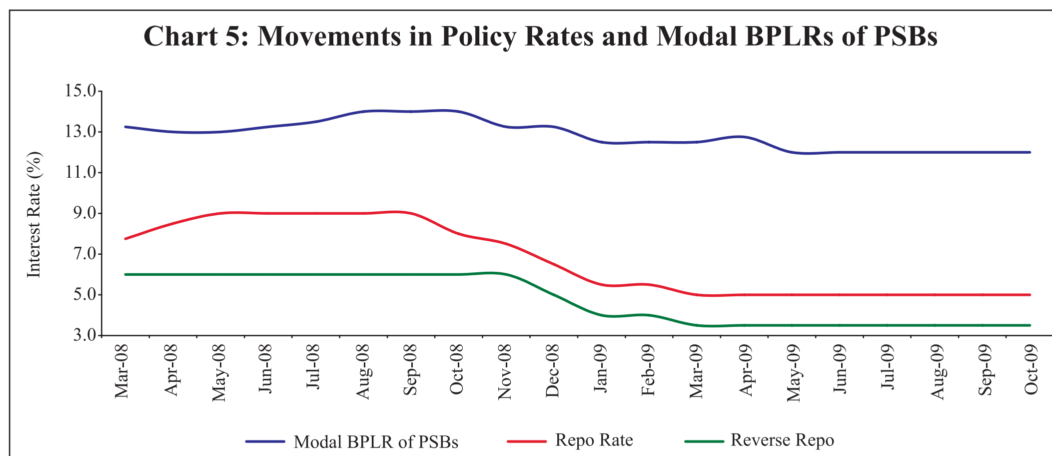


advisability of raising the HTM limit. It may be recalled that in 2004-05 banks were allowed to shift SLR securities to the HTM category as a one-time measure subject to the total SLR securities held in the HTM category capped at 25 per cent of their DTL. This limit was kept unchanged even as the SLR was reduced from 25 per cent to 24 per cent in November 2008. As the HTM ratio is already higher than the prescribed SLR, it is not considered desirable to further raise the HTM ratio.

Transmission Mechanism

50. The changes in the Reserve Bank's policy rates were quickly transmitted to the money and debt markets. However, transmission to the credit market was slow due to several structural rigidities in the system, especially fixed interest rate deposit liabilities. As bank deposits, contracted in the past at high rates, have started to mature and banks have significantly reduced their term deposit rates, the transmission of lower policy rates to the credit market has improved. In this context, it should be recognised that the movement in the benchmark prime lending rates (BPLRs) does not fully and accurately reflect the changes in effective lending rates as nearly two-thirds of banks' lending takes place at sub-BPLR rates. As such, the true movements in lending rates of banks are better captured in the weighted average lending rates of banks. Rough estimates show that the effective average lending rate for scheduled commercial banks declined from 12.3 per cent in March 2008 to 11.1 per cent by March 2009 – the latest period for which data are available (Chart 5). Further, data from select banks, as a proxy measure for effective lending rates, suggest that weighted average yield on advances declined from 10.6 per cent in March 2009 to 10.3 per cent in June 2009.

51. The analysis by the Working Group on BPLR (Chairman: Shri Deepak Mohanty), which submitted its Report on October 20, 2009, has demonstrated that though there was considerable divergence in weighted average lending rates in 2004 among the various bank-groups, these have tended to converge in the recent period. The Group has recommended the introduction of a Base Rate system.



Foreign Exchange Market

52. The foreign exchange market remained orderly during 2009-10 (up to October 23, 2009) with the rupee exhibiting a two-way movement against major currencies. During the current financial year, the rupee appreciated by 9.7 per cent against the US dollar and 2.6 per cent against the Japanese yen, whereas it depreciated by 5.7 per cent against the pound sterling and 3.2 per cent against the euro (Chart 6). In terms of the real exchange rate, the six-currency trade-based real effective exchange rate (REER) (1993-94=100) moved up from 96.3 at end-March 2009 to 104.2 by October 23, 2009.

Equity Market

53. During the current financial year (up to October 23, 2009), the secondary segment of the domestic capital market has remained buoyant. The stock market staged a smart recovery reflecting large net FII inflows due to the optimistic outlook for the Indian economy. FIIs made net purchases of US$ 13.8 billion in 2009-10 (up to October 21, 2009) in the Indian equity market as against net sales of US$ 8.6 billion in the corresponding period of 2008-09. The BSE Sensex rose from 9,709 at end-March 2009 to 16,811 on October 23, 2009, showing an increase of 73.1 per cent during 2009-10 to date.

Chart 6: Movement in Exchange Rates

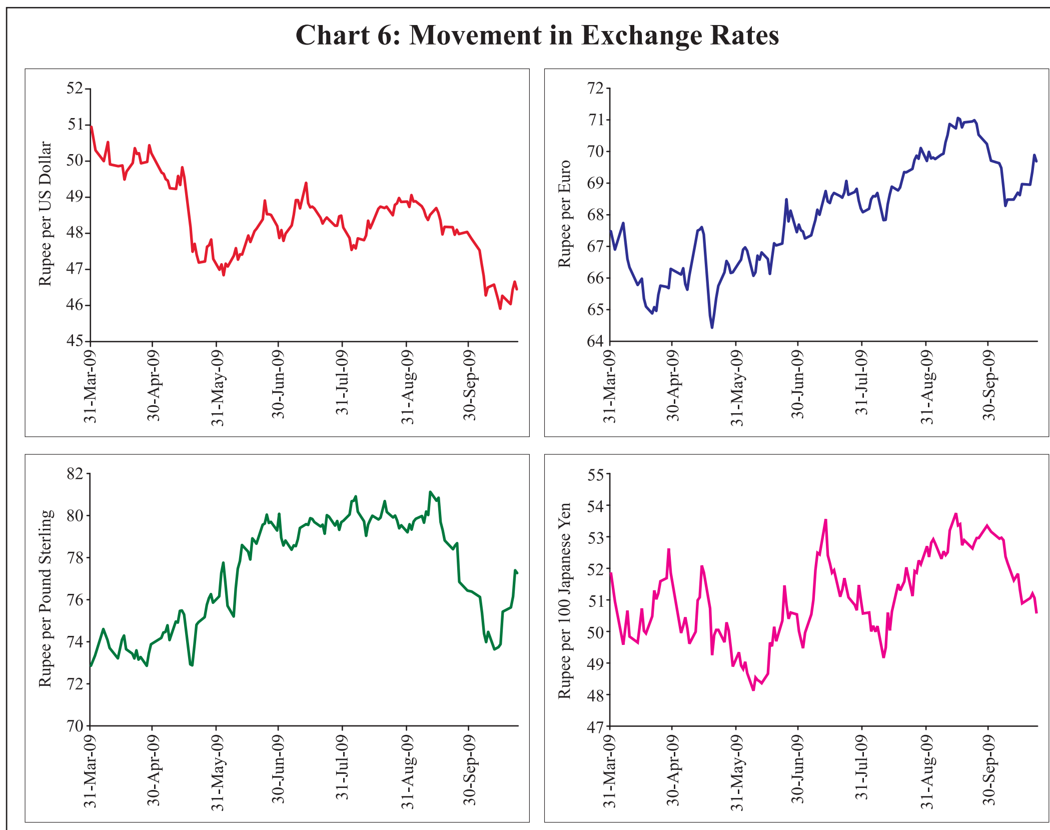


Table 18: India's Balance of Payments

(US$ billion)

Item	Full Year		2008-09		2009-10
	2007-08	2008-09	Q1	Q4	Q1
Exports	166.2	175.2	49.1	39.8	38.8
Imports	257.8	294.6	80.5	54.4	64.8
Trade Balance	(-)91.6	(-)119.4	(-)31.4	(-)14.6	(-)26.0
Invisibles, net	74.6	89.6	22.4	19.3	20.2
Current Account Balance	(-)17.0	(-)29.8	(-)9.0	4.7	(-)5.8
Net Capital Account	108.0	9.1	11.1	(-)5.3	6.7
Overall Balance #	92.2	(-)20.1	2.2	0.3	0.1
Memo:					
As percentage of GDP					
Trade Balance	(-)7.8	(-)10.3			
Current Account Balance	(-)1.5	(-)2.6			
Net Capital Inflows	9.2	0.8			

Overall balance includes current account balance, net capital account and errors and omissions.

External Sector

54. India's external account has remained comfortable during the current financial year. Merchandise trade contracted due to depressed external demand and slowdown of the domestic economy, with imports declining more than exports. The trade deficit narrowed down to US$ 26.0 billion in Q1 of 2009-10 from US$ 31.4 billion in Q1 of 2008-09. However, trade deficit in Q1 of 2009-10 was higher than US$ 14.6 billion in Q4 of 2008-09 partly due to a rise in crude oil prices (Table 18). The current account deficit at US$ 5.8 billion in Q1 of 2009-10 was also lower compared to the deficit of US$ 9.0 billion in Q1 of 2008-09; a current account surplus of US$ 4.7 billion was recorded in Q4 of 2008-09. The capital account showed a turnaround from a negative balance in the last two quarters of 2008-09 to a positive balance of US$ 6.7 billion during Q1 of 2009-10.

Table 19: Variation in Foreign Exchange Reserves

Period	Variation (US$ billion)
Full Year	
2004-05	28.6
2005-06	10.1
2006-07	47.6
2007-08	110.5
2008-09	(-)57.7
Financial Year (up to October 16)	
2008-09	(-)35.8
2009-10	32.9

55. In 2009-10 to date, foreign exchange reserves have increased by US$ 32.9 billion, including allocation of SDRs (US$ 5.2 billion) by the IMF, and were at US$ 284.8 billion as on October 16, 2009 (Table 19).

56. The management of foreign exchange reserves is guided by the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows.

II. Stance of Monetary Policy

57. As a part of the accommodative monetary policy followed since mid-September 2008, the Reserve Bank has provided ample rupee and dollar liquidity and maintained a market environment conducive for the continued flow of credit to productive sectors at lower cost. The important measures initiated include reduction of the policy rates under the LAF to their historically low levels, lowering of reserve requirements, institution of sector-specific liquidity facilities and a forex swap facility, relaxation in the ECB guidelines, countercyclical prudential measures of adjustment in risk weights and provisioning, and conditional special regulatory treatment for restructured assets.

Liquidity Impact

58. Consistent with its accommodative monetary stance, the Reserve Bank expanded its domestic assets through open market operations (OMO) and unwinding of market stabilisation scheme (MSS) securities to provide primary liquidity to support the required monetary expansion. Several measures taken by the Reserve Bank since mid-September 2008 have augmented actual/potential liquidity in the system on the aggregate by Rs.5,85,000 crore.

59. As a result of the extraordinary monetary easing by the Reserve Bank, the banking system has been awash with liquidity since November 2008. This is reflected most prominently in the absorption under the LAF window of a daily average of almost Rs.1,20,000 crore. The utilisation of the several refinance facilities instituted by the Reserve Bank too has been low, further evidencing the ample liquidity situation. Interest rates in all the markets have declined significantly over the last one year as detailed before. The transmission of lower policy rates to the credit market has materialised with a lag. With most commercial banks reducing their deposit rates, the cost of funds has declined enabling banks to reduce their BPLRs. The effective lending rates have also come down as nearly three-fourths of bank lending takes place at rates below their BPLRs as alluded to before.

Growth Projection

60. During the first quarter of 2009-10, real GDP recorded a growth of 6.1 per cent, lower than the growth of 7.8 per cent in the corresponding quarter of 2008-09, but marginally higher than the 5.8 per cent growth in the second half of 2008-09. The south-west monsoon rainfall this year has been the weakest since 1972 affecting both yield and acreage of agricultural crops. This will impact *Kharif* production and the performance of agricultural production during the *Rabi* season will be critical for supply management. On the whole, agricultural production in 2009-10 is expected to be lower than in last year.

61. While external demand has continued to contract, large fiscal and monetary stimulus measures have bolstered domestic consumption and helped the recovery in the industrial sector.

The prospects of the industrial sector have become more promising than they were at the time of the First Quarter Review. With the recovery in the stock market, the primary segment of the capital market has also witnessed increased activity in the recent period. This, combined with the easing of international financing conditions, augurs well for a pick-up in investment activity. The business confidence surveys also point to further improvement in outlook despite weak perception of export demand.

62. Various services sector activities, which have slowed down significantly in the recent period, should also catch up, *albeit* with a lag, in tandem with improved industrial growth. Assuming a modest decline in agricultural production and a faster recovery in industrial production, the baseline projection for GDP growth for 2009-10 is placed at 6.0 per cent with an upside bias (Chart 7). Thus, the GDP projection for 2009-10 for policy purposes remains unaltered from that made in the First Quarter Review of July 2009.

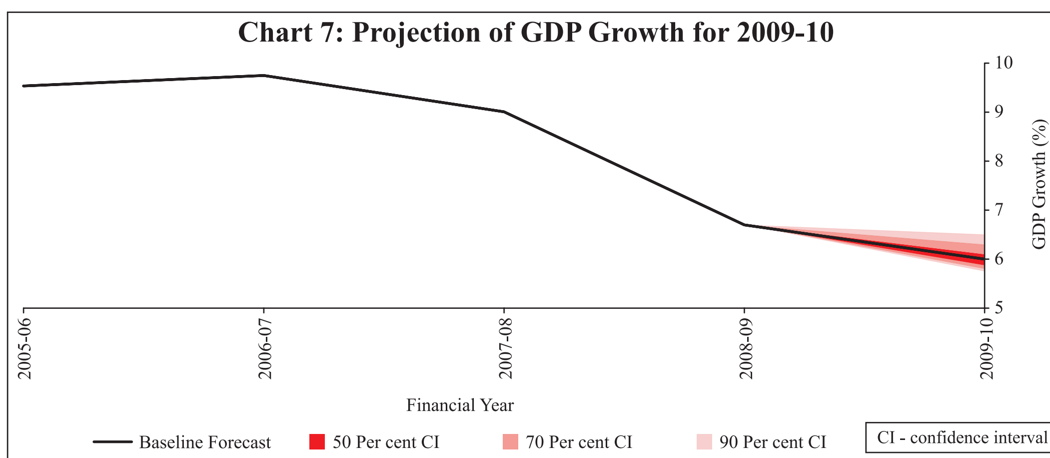
Inflation Projection

63. Headline WPI inflation turned negative during June-August 2009 due to the large statistical base effect. As anticipated in the First Quarter Review, WPI inflation has returned to positive territory, *albeit* a few weeks sooner than expected, in the wake of large increase in prices of food items and increase in global crude oil prices.

64. The upside risks on account of deficiency in monsoon rainfall indicated in First Quarter Review of July 2009 have now materialised as prices of food items have risen sharply. Going forward, *Rabi* crop prospects would be critical in shaping the path of food inflation. The large stock of foodgrains with public agencies should help mitigate any significant adverse impact due to supply constraints. The improved terms of trade for agriculture in recent years should provide an incentive to the sector.

65. Global commodity prices, which had bottomed out in early-2009, rebounded ahead of global recovery. The global oil prices present a mixed picture. Crude oil

Chart 7: Projection of GDP Growth for 2009-10



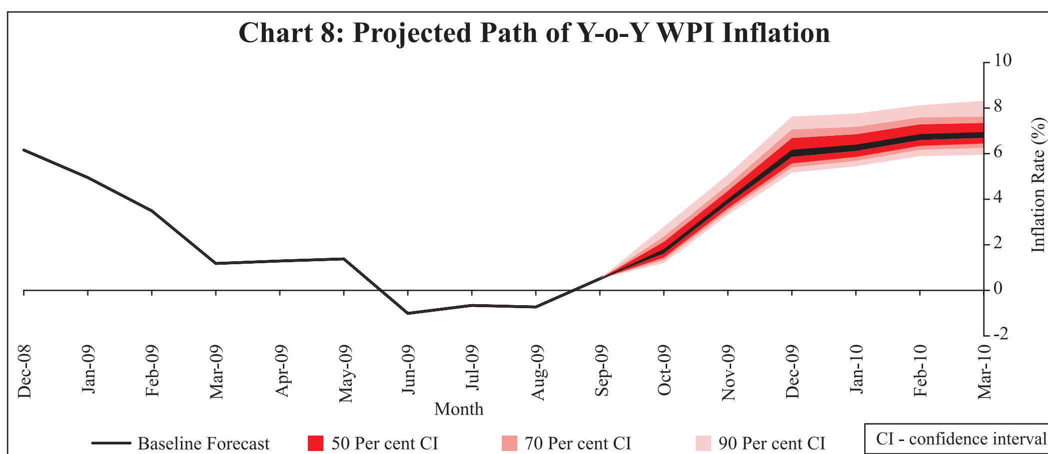
prices, which increased from their low levels of January-March 2009, have remained range-bound since June 2009. Large global liquidity due to easy monetary policy followed by major central banks has led to sizeable financialisation of the commodities market, especially for those products that are prone to demand supply gaps. These developments may induce greater volatility in commodity prices in the coming years.

66. Inflation assessment has become increasingly complex in recent times with the WPI inflation rate remaining negative or low and the various CPI inflation measures remaining close to or above the double digits for an extended period. CPI inflation has remained at an elevated level since March 2008 and did not decline as expected in line with fall in WPI inflation. Indeed, it hardened due to sharp increase in essential commodity prices. The situation was aggravated by the deficient monsoon rainfall and drought condition in several parts of the country. The Reserve Bank monitors an array of measures of inflation, both overall and disaggregated components, in conjunction with other economic and financial indicators, to assess the underlying inflationary pressures and articulates its policy stance in terms of WPI. The Government took a decision on October 19, 2009 to reduce the frequency of the current series of Wholesale Price Index (base:1993-94) from weekly to monthly. The available indices, WPI and the four measures of CPI, fail to adequately capture the underlying inflationary conditions because of inadequate coverage and also because the respective base years do not capture the changed production and consumption patterns. This underscores the need to expedite the revision of coverage and updating of the base year for the WPI series as also the proposed two consumer price indices, *i.e.,* CPI-Urban and CPI-Rural.

67. The First Quarter Review of July 2009 projected WPI inflation for end-March 2010 at around 5.0 per cent. The July Review indicated that the risk to this projection was on the upside. Though the year-on-year WPI inflation was 1.21 per cent as on October 10, 2009, it has already increased by 5.95 per cent on a financial year basis though some of the increase is seasonal and is likely to soften. However, the base effect, which resulted in negative WPI inflation during June-August 2009, is now expected to work in the reverse direction accentuated by high food prices. The Reserve Bank's quarterly inflation expectations survey for households indicates that while inflationary expectations remain contained, a majority of the respondents expect inflation rate to increase over the next three months as also over the next year.

68. Keeping in view the global trend in commodity prices and the domestic demand-supply balance, the baseline projection for WPI inflation at end-March 2010 is placed at 6.5 per cent with an upside bias (Chart 8). This is higher than the 5.0 per cent WPI inflation projected in the First Quarter Review of July 2009 as the upside risks have materialised.

69. As always, the Reserve Bank will endeavour to ensure price stability and anchor inflation expectations. The conduct of monetary policy will continue to



condition and contain perception of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration with the global economy.

Monetary Projection

70. The year-on-year growth in money supply (M_3) increased from 18.6 per cent in end-March 2009 to 18.9 per cent by October 9, 2009. A major source of M_3 expansion this year has been the banking system's financing of the large market borrowing of the Government, including OMO purchases by the Reserve Bank. The growth in bank credit to the commercial sector has moderated significantly to 10.7 per cent from the high level of 27.4 per cent a year ago.

71. The First Quarter Review of July 2009 raised the indicative trajectory of M_3 growth to 18.0 per cent from 17.0 per cent envisaged in the Annual Policy Statement of April 2009 to ensure that the increased government market borrowing programme did not crowd out the credit flow to the private sector. Over 80 per cent of the market borrowing programme for 2009-10 is now completed. In 2009-10 (up to October 9, 2009), credit has expanded by Rs.1,14,800 crore. Thus, to attain the projected growth of 20 per cent, banks will need to expand credit by Rs.4,40,000 crore in the remaining part of the year, which will be difficult unless demand for retail credit accelerates. Also, access of corporates to non-bank sources of financing, both domestic and international, has eased, which could lead to substitution of bank credit. While credit demand is expected to pick up during the second-half of 2009-10, attaining the projected growth of 20 per cent is unlikely.

72. Keeping in view the borrowing requirement of the government and of the commercial sector in the remaining period of 2009-10, the indicative projection of money supply growth of 18.0 per cent set out in July 2009 is revised downwards to 17.0 per cent. Consistent with this, aggregate deposits of scheduled commercial banks are projected to grow by 18.0 per cent. The growth in adjusted non-food credit, including investment in bonds/debentures/shares of public sector

undertakings and private corporate sector and CPs, is also revised downwards to 18.0 per cent from 20.0 per cent set out in the Annual Policy Statement and the First Quarter Review. Banks are urged once again to step up their efforts towards credit expansion while preserving credit quality which is critical for revival of growth.

Overall Assessment

73. There has been a discernible improvement in the global economic outlook since the First Quarter Review in July 2009. In India too, there are definitive indications of the economy reverting to the growth track. Accordingly, attention around the world, as also in India, has shifted from managing the crisis to managing the recovery.

74. The policy dilemma for India is different in some important respects from that of advanced economies as also other emerging market economies. First, most of these countries do not face an immediate risk of inflation. Indeed, in several advanced economies, the concerns were about a possible deflation, which are just about waning. On the other hand, India is actively confronted with an upturn in inflation – a rising WPI inflation and stubbornly elevated CPI inflation.

75. Second, advanced economies are faced with households, firms and financial institutions still struggling with their impaired balance sheets. Fortunately, we do not have this problem in India, but we still have the challenge of reviving domestic consumption and investment demand, the traditional, dominant drivers of our growth.

76. Third, somewhat related to the point above, India has traditionally been a supply constrained economy in contrast to advanced economies which are demand starved. We need, in particular, to expand the supply of infrastructure – power, roads, urban infrastructure and social infrastructure. The supply constraints which remained subdued during the crisis period owing to weak demand, will re-emerge and may indeed become binding.

77. Fourth and importantly, India is one of the few large emerging economies with twin deficits – fiscal and current account deficits. While our current account deficit is modest, and may even be benign given the investment requirements of the economy, there can be no two views about the need to make a responsible, credible and time-bound fiscal adjustment. The arguments for fiscal consolidation and rectitude are compelling and widely known, and need not be repeated here. But an issue of some immediate relevance is the critical need to downsize the government borrowing programme so as to help sustain a moderate interest rate regime. This is crucial for investment demand to pick up on which hinge our long-term economic prospects.

78. Around the world, there is an active, and at times animated debate on the timing and sequencing of exit from the expansionary monetary stance. 'Exit' is a central issue in our policy matrix too. As the Reserve Bank has indicated in several public statements, our current monetary stance is not the steady state and we need to reverse the expansionary stance. It is important to recognise though that the exit debate in India is qualitatively

different from that in other advanced and emerging economies because of the unique features of our macroeconomic context indicated above.

79. The precise challenge for the Reserve Bank is to support the recovery process without compromising on price stability. This calls for a careful management of trade-offs. Growth drivers warrant a delayed exit, while inflation concerns call for an early exit. Premature exit will derail the fragile growth, but a delayed exit can potentially engender inflation expectations.

80. The Reserve Bank has consulted a wide array of stakeholders in the run up to this policy review. Based on these consultations, the arguments for and against reversal of the expansionary monetary policy stance can be summarised as follows.

Arguments for Beginning Reversal of Monetary Easing

81. The most dominant argument for reversing monetary policy easing stems from the concern about inflation. WPI inflation has turned positive, the base effect which has kept WPI low so far is now gone and CPI inflation has remained stubbornly elevated. On a financial year basis, WPI has already increased by 5.95 per cent. Inasmuch as monetary policy acts with a lag, there is need to act now.

82. It is further argued that even though the current inflationary pressures are driven by food prices, they can strengthen expectations of higher inflation and lead to generalised inflation. The Reserve Bank's inflation expectations survey shows that households expect inflation to increase over the next three months as also one year. The lag with which monetary policy operates suggests that there is a case for tightening sooner rather than later.

83. Forceful arguments for early reversal of monetary policy also arise from liquidity concerns. The LAF window has been absorbing over Rs.100,000 crore on a daily basis since May 2009, save for a few days on account of temporary increases in government balances. This evidences the large amount of liquidity in the system which could potentially result in an unsustainable asset price build-up. There is already some evidence of excess liquidity feeding through asset prices with potential financial stability concerns. Further, capital flows have resumed. Given the limitations of the economy's current absorptive capacity, these flows will add to the overall domestic liquidity, further fuelling the asset price build-up. Large capital inflows and asset price inflation have the potential to feed on each other. From the liquidity dimension, it is further argued that the current large overhang of liquidity could engender inflation expectation even if credit demand remains subdued.

Arguments for Deferring Reversal of Monetary Easing

84. The dominant argument for continuing with the current monetary stance is that the recovery is as yet fragile. Exports are still on the decline and the recent improvement in industrial production overstates the recovery as part of it is due to the base effect and the one time impact of restocking inventory. Premature tightening will hurt the growth impulses.

On the other hand, it is imperative to continue with the accommodative stance to compensate for the decline in agricultural output and till there is firm evidence of sustained global recovery.

85. The second argument against an immediate reversal of monetary easing is that the current inflationary pressures are driven by supply side constraints, particularly food prices. Monetary policy is typically not an efficient instrument for reining in food price inflation. There could, of course, be concerns that rising food prices could spark inflationary expectations. But the probability of that is low as food prices are likely to ease in the coming months following the seasonal trend. The promising *Rabi* crop prospects also will reduce food price pressures. Under these circumstances, the downside risks to any tightening now are high with virtually no upside.

86. The third argument for maintaining the accommodative monetary stance for now is that any reversal at this stage will harden yields on government bonds putting upward pressure on interest rates and dampening both consumption and investment demand. This could seriously unravel the incipient recovery.

87. Finally, capital flows have resumed on the promise of India's growth prospects. It is argued that if we tighten ahead of other economies, the wider interest rate differential will become a perverse incentive for even larger capital flows. In managing capital flows in excess of the current account deficit, the economy will have to pay a cost which will be a combination of exchange rate appreciation, larger systemic liquidity and fiscal costs of sterilisation.

88. The Reserve Bank has studied these arguments. Some of the arguments are persuasive and some less so. The balance of judgment at the current juncture is that it may be appropriate to sequence the 'exit' in a calibrated way so that while the recovery process is not hampered, inflation expectations remain anchored. The 'exit' process can begin with the closure of some special liquidity support measures.

89. It will be recalled that in response to the crisis, like most other central banks, the Reserve Bank too instituted both conventional measures and unconventional measures. While reversing of conventional measures is not considered appropriate for now, many of the unconventional measures can be reversed immediately. The following measures constitute the first phase of 'exit'.

90. The statutory liquidity ratio (SLR), which was reduced from 25 per cent of demand and time liabilities to 24 per cent, is being restored to 25 per cent. The limit for export credit refinance facility [(under section 17(3A) of the RBI Act], which was raised to 50 per cent of eligible outstanding export credit, is being returned to the pre-crisis level of 15 per cent. The two non-standard refinance facilities: (i) special refinance facility for scheduled commercial banks under section 17(3B) of the RBI Act (available up to March 31, 2010), and (ii) special term repo facility for scheduled commercial banks (for funding to MFs, NBFCs, and HFCs) (available up to March 31, 2010) are being discontinued with immediate effect. Details in this regard are indicated in the subsequent sections of this Statement.

Policy Stance

91. On the basis of the above overall assessment, the stance of monetary policy for the remaining period of 2009-10 will be as follows:

- Keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments to stabilise inflation expectations.
- Monitor the liquidity situation closely and manage it actively to ensure that credit demands of productive sectors are adequately met while also securing price stability and financial stability.
- Maintain a monetary and interest rate regime consistent with price stability and financial stability, and supportive of the growth process.

92. In conclusion, it bears emphasis that the Reserve Bank is mindful of its fundamental commitment to price stability. It will continue to monitor the price situation in its entirety and will take measures as warranted by the evolving macroeconomic conditions swiftly and effectively.

III. Monetary Measures

Bank Rate

93. The Bank Rate has been retained unchanged at 6.0 per cent.

Repo Rate

94. The repo rate under the Liquidity Adjustment Facility (LAF) has been retained unchanged at 4.75 per cent.

Reverse Repo Rate

95. The reverse repo rate under the LAF has been retained unchanged at 3.25 per cent.

96. The Reserve Bank has the flexibility to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warrant.

97. The Reserve Bank retains the option to conduct overnight or longer term repo/ reverse repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibly including the right to accept or reject tender(s) under the LAF, wholly or partially, so as to make efficient use of the LAF in daily liquidity management.

Cash Reserve Ratio

98. The cash reserve ratio (CRR) of scheduled banks has been retained unchanged at 5.0 per cent of their net demand and time liabilities (NDTL).

99. The collateralised borrowing and lending obligation (CBLO) liabilities of scheduled banks were exempted from CRR prescription in order to develop CBLO as a money market instrument. Volumes in the CBLO segment have increased over the years, especially after the phasing out of the non-banks from the inter-bank market. The daily average volume in the CBLO segment, which was only Rs.6 crore in January 2003, is now over Rs.60,000 crore. Since the objective of developing CBLO as a money market

instrument has been broadly achieved, it is proposed that:

- liabilities of scheduled banks arising from transactions in CBLO with Clearing Corporation of India Ltd. (CCIL) will be subject to maintenance of CRR with effect from the fortnight beginning November 21, 2009.

Statutory Liquidity Ratio

100. In view of difficult macroeconomic situation and liquidity conditions in the global and domestic financial markets after the collapse of Lehman Brothers, the statutory liquidity ratio (SLR) of scheduled commercial banks (SCBs) was reduced from 25 per cent to 24 per cent of their NDTL with effect from November 8, 2008. The liquidity situation has remained comfortable since mid-November 2008 as reflected in the surplus funds being placed by banks daily in the LAF window of the Reserve Bank. Accordingly, it has been decided to:

- restore the SLR for scheduled commercial banks to 25 per cent of their NDTL with effect from the fortnight beginning November 7, 2009.

101. SCBs are currently maintaining SLR investments at 27.6 per cent of their NDTL, net of LAF collateral securities, and 30.4 per cent of NDTL, inclusive of LAF collateral securities. As such, the increase in the SLR will not impact the liquidity position of the banking system and credit to the private sector.

Third Quarter Review

102. The Third Quarter Review of Monetary Policy for 2009-10 will be undertaken on January 29, 2010.

Part B. Developmental and Regulatory Policies

103. The global financial crisis raised issues that we thought were settled and reopened questions that we thought had been answered. It also pointed to the egregious policies and practices in financial sector regulation and supervision. Reflecting the lessons of the crisis, there is now active debate and discussion at the global level on reforming the regulatory structures and supervisory processes. This is expected to be a continuous process with reform packages being agreed upon and finalised in a modular fashion on a regular basis over the next couple of years.

104. India has been less affected by the crisis than most other countries because of our relatively cautious policies, prudent regulation and effective supervision. Nonetheless, there are lessons from the crisis for India too, which include: (i) further strengthening regulation at the systemic and institutional levels; (ii) making our supervision more effective and value adding; and (iii) improving our skills in risk management. India has been an active participant at the global discussions. The task for us will be to reflect our point of view in the global debate and adapt the global policies and guidelines to the Indian situation on a dynamic basis. A task that the Reserve Bank has all along been performing but is now explicitly defined is monitoring and ensuring financial stability. Furthermore, we need to actively pursue the challenge of financial inclusion.

105. Reform is a continuous process. Over the last several years, the Reserve Bank has endeavoured to make reforms a consultative and participative endeavour. It is now standard practice for the Reserve Bank to consult stakeholders before policy reviews, seek comments from experts, place draft policy proposals on its website for feedback and to disseminate policies widely. We will continue to improve these practices.

106. A synopsis of the action taken and status of past policy announcements together with a listing of fresh policies is set out below.

I. Financial Stability

107. At the recently held G-20 Summit during September 24-25, 2009 in Pittsburgh, it was decided, among others, to make sure that the global regulatory system for banks and other financial firms reins in the excesses that led to the crisis and as such committed to: (i) raise capital standards; (ii) implement strong international compensation standards aimed at ending practices that led to excessive risk-taking; (iii) improve the over-the-counter (OTC) derivatives market; (iv) create more powerful tools to hold large global firms to account for the risks they take; and (v) ensure that standards for large global financial firms are commensurate with the cost of their failure. It was also agreed to reform the global architecture to meet the needs of the 21st century.

108. Keeping in view both international and domestic initiatives in the financial sector, the Annual Policy Statement of April 2009 indicated setting up of a Financial Stability Unit (FSU) in the Reserve Bank. Accordingly, the FSU was constituted in July 2009 drawing upon inter-disciplinary expertise from the regulatory, supervisory, statistics, economics and financial markets departments of the Reserve Bank. The FSU will: (i) conduct macro-prudential surveillance of the financial system on an ongoing basis; (ii) prepare financial stability reports; (iii) develop database of key variables which could impact financial stability and a time series of a core set of financial indicators; (iv) conduct systemic stress tests to assess resilience; and (v) develop models for assessing financial stability. The FSU also provides the secretariat to the Reserve Bank's representative in the Financial Stability Board (FSB). The FSU is expected to bring out the first Financial Stability Report by end-December 2009.

II. Interest Rate Policy

BPLR System: Review

109. The Annual Policy Statement of April 2009 proposed constituting a Working Group to review the present benchmark prime lending rate (BPLR) system and suggest changes to make credit pricing more transparent. Accordingly, a Working Group (Chairman: Shri Deepak Mohanty) was constituted in June 2009 and the Group submitted its Report on October 20, 2009. The Report of the Working Group was also placed on the Reserve Bank's website on the same day for comments and suggestions. The Reserve Bank will consider the recommendations after taking into account the feedback received on the Report.

III. Financial Markets

Financial Market Products

Interest Rate Futures

110. The Annual Policy Statement of April 2009 had indicated launching of exchange traded interest rate futures (IRFs) contracts on the 10-year notional coupon bearing Government of India bond. Accordingly, in consultation with the Securities and Exchange Board of India (SEBI), IRFs were introduced and the directions covering the framework for trading of IRFs on recognised exchanges were placed on the Reserve Bank's website in August 2009. The National Stock Exchange (NSE) commenced trading in IRFs on August 31, 2009.

Introduction of Repo in Corporate Bonds

111. The Reserve Bank had placed on its website, on September 17, 2009, the draft guidelines on repo in corporate bonds for comments/feedback. The draft guidelines were also deliberated by the Technical Advisory Committee (TAC) on

Money, Foreign Exchange and Government Securities Markets at its meeting held on September 23, 2009. With DvP-I (trade-by-trade) based clearing and settlement system for OTC trades in corporate bonds being operationalised by the clearing houses of the exchanges, repo in corporate bonds can now be introduced. Accordingly:

- final guidelines on repo in corporate bonds will be issued by end-November 2009.

Regulation of Non-Convertible Debentures (NCDs) of Maturity of Less than One Year

112. At present, issuance of non-convertible debentures (NCDs) with maturity of less than one year is not subjected to regulation by the SEBI or the Government of India. It was decided in the High Level Coordination Committee on Financial Markets (HLCCFM) that such instruments being 'money market instruments' needed to be brought under the regulation of the Reserve Bank. A Working Group with representation from the Reserve Bank and the SEBI was, therefore, set up to examine the issue. The Working Group, which has since submitted its Report, has recommended that the Reserve Bank may frame regulations on issuance of NCDs with maturity of less than one year, as they fall under the definition of 'money market instruments' of Chapter IIID of the Reserve Bank of India (Amendment) Act, 2006. The recommendations of the Working Group were discussed in the meeting of the TAC on Money, Foreign Exchange and Government Securities Markets on September 23, 2009 and it was agreed that the Reserve Bank may frame regulations on the lines of the guidelines for issuance of commercial paper (CP). Accordingly:

- draft guidelines are being formulated which will be placed on the Reserve Bank's website by end-November 2009 for comments/suggestions.

Introduction of Credit Default Swaps (CDS)

113. In 2007, the Reserve Bank had issued draft guidelines for introduction of credit default swaps (CDS) in India. However, the issuance of final guidelines was kept in abeyance keeping in view the role of credit derivatives in the recent financial crisis. It was considered appropriate to proceed with caution reflecting the lessons from the financial crisis in this regard. In order to align with the international work already conducted/ underway in the area of credit derivatives, and keeping in view the specifics of the Indian markets, it is proposed:

- to introduce plain vanilla OTC single-name CDS for corporate bonds for resident entities subject to appropriate safeguards. To begin with, all CDS trades will be required to be reported to a centralised trade reporting platform and in due course they will be brought on a central clearing platform.

114. The Reserve Bank is setting up an internal Group to finalise the operational framework in consultation with market participants.

Separate Trading for Registered Interest and Principal of Securities (STRIPS)

115. As indicated in the Annual Policy Statement of April 2009, the draft

guidelines on stripping/reconstitution of government securities were placed on the Reserve Bank's website on May 1, 2009 inviting comments/suggestions from market participants by May 29, 2009. Based on the feedback/suggestions received from the market participants, the guidelines have been finalised. Banks will be permitted to strip/reconstitute eligible securities held in their held to maturity (HTM)/available for sale (AFS)/held for trade (HFT) portfolios. Accordingly:

- STRIPS will be launched, as scheduled, during the current financial year.

Floating Rate Bonds (FRBs)

116. As announced in the Annual Policy Statement of April 2009, the issuance structure of floating rate bonds (FRBs) has been revised, addressing issues relating to product design. The FRBs will henceforth be issued by way of 'price-based' auction as against the earlier 'spread-based' auction. The revised issuance structure of FRBs has been built into the negotiated dealing system (NDS) auction platform, which was operationalised on May 11, 2009. Accordingly:

- floating rate bonds will be issued during the current financial year depending upon the market conditions and market appetite.

Expansion of Currency Pairs of Currency Futures Contracts

117. Currently, persons resident in India are permitted to trade in US dollar-Indian rupee (INR) currency futures contracts in three recognised stock exchanges. The combined average daily turnover of the contracts in all the three exchanges increased from US$ 1.1 billion in March 2009 to US$ 2.5 billion in September 2009. Market participants have been representing that trading of currency future contracts in other major currency pairs may also be permitted to facilitate direct hedging of their risk in such currencies. Accordingly, it is proposed:

- to permit the recognised stock exchanges to offer currency futures contracts in currency pairs of Euro-INR, Japanese Yen-INR and Pound Sterling-INR, in addition to US dollar-rupee contracts which are already permitted.

118. Necessary amendments to Currency Futures (Reserve Bank) Directions, 2008 are being made separately.

Guidelines on Forex, Commodity and Freight Derivatives

119. In light of the developments in the domestic and international financial markets and based on the feedback received from banks, market participants, industry associations and others, the existing guidelines on foreign exchange and commodity and freight derivatives overseas have been reviewed by an internal Group. The draft proposals were discussed in the meeting of the TAC on Money, Foreign Exchange and Government Securities Markets. Accordingly:

- the draft guidelines are being placed on the Reserve Bank's website by end-November 2009 for wider dissemination and comments/views.

Financial Market Infrastructure

Revision of Repo Accounting

120. The Annual Policy Statement of April 2009 had indicated issuance of revised guidelines on repo accounting taking into account comments on the draft guidelines earlier placed on the Reserve Bank's website for implementation from April 1, 2010. Accordingly:

- the final guidelines are under consideration and will be issued by end-November 2009.

Clearing and Settlement of OTC Trades in Corporate Bonds: Status

121. As announced in the Annual Policy Statement of April 2009, the clearing houses of the exchanges, *viz.,* National Securities Clearing Corporation Limited (NSCCL) and Indian Clearing Corporation Limited (ICCL) have been permitted to maintain transitory pooling accounts with the Reserve Bank for facilitating settlement of OTC transactions in corporate bonds in the real time gross settlement (RTGS) system on a DvP-I basis (*i.e.,* on a trade-by-trade basis). The Reserve Bank and SEBI have issued necessary instructions requiring specified regulated entities to clear and settle all OTC trades in corporate bonds through the NSCCL or ICCL with effect from December 1, 2009.

Money Market

Refinance/Special Liquidity Facilities

122. As indicated in the Annual Policy Statement of April 2009, the following liquidity facilities provided by the Reserve Bank to banks and financial institutions are available up to March 31, 2010: (i) the export credit refinance (ECR) facility (limit up to 50 per cent of eligible outstanding rupee export credit) under Section 17(3A) of the Reserve Bank of India Act (RBI); (ii) the special refinance facility for scheduled commercial banks [limit up to one per cent of net demand and time liabilities (NDTL) as on October 24, 2008] under Section 17(3B) of the RBI Act; (iii) special term repo facility to scheduled commercial banks for funding to mutual funds (MFs), non-banking financial companies (NBFCs) and housing finance companies (HFCs) [limit is in terms of relaxation in the statutory liquidity ratio (SLR) up to 1.5 per cent of NDTL]; (iv) refinance facility to Small Industries Development Bank of India (SIDBI), National Housing Bank (NHB) and Export- Import Bank of India (EXIM Bank) [under Section 17(4H), Section 17(4DD) and Section 17(4J), respectively, of the RBI Act]; and (v) the forex swap facility to banks for tenor up to three months.

123. A review of these facilities, indicated that the utilisation of these facilities has been low. Keeping this in view and taking into account the current liquidity conditions in the markets, it is proposed to take the following actions with immediate effect:

- to reduce the limit of export credit refinance facility from 50 per cent to 15 per cent of eligible outstanding rupee export credit extended under Section 17(3A) of the RBI Act;
- to discontinue the special refinance facility for scheduled commercial banks instituted under Section 17(3B) of the RBI Act;

- to discontinue the special term repo facility for scheduled commercial banks for funding to mutual funds, non-banking financial companies and housing finance companies; and
- to discontinue the forex swap facility of banks.

124. The refinance facility to SIDBI, NHB and EXIM Bank [under Section 17(4H), Section 17(4DD) and Section 17(4J), respectively, of the RBI Act] will continue to be in operation till the pre-announced date of March 31, 2010. However, these three financial institutions (FIs) will have to ensure that all outstandings are repaid by the close of business on March 31, 2010.

Government Securities Market

Auction Process of Government of India Securities: Status

125. As indicated in the Annual Policy Statement of April 2009, the specific notification for auction for sale of government securities along with the scheme for non-competitive bidding facility has been amended by the Government of India in consultation with the Reserve Bank. Accordingly, the remaining recommendations of the internal Working Group (Chairman: H.R. Khan) pertaining to the Reserve Bank such as: (i) withdrawal of the facility of bidding in physical form and submission of competitive bids only through the NDS; and (ii) submission of a single consolidated bid on behalf of all its constituents by the bank/primary dealer (PD) in respect of non-competitive bids, have been implemented with effect from May 22, 2009. The implementation of the recommendations of the Working Group has improved the efficiency of the auction process by reducing the time taken for announcement of the auction results, thereby enhancing the time available for trading in the auctioned securities.

Non-Competitive Bidding in the Auction of State Development Loans (SDLs): Status

126. In order to widen the investor base and enhance the liquidity for State Development Loans (SDLs), a scheme for non-competitive bidding in the auction of SDLs was notified by all State Governments on July 20, 2007. In pursuance of the announcement made in the Annual Policy Statement of April 2009, the scheme for non-competitive bidding in SDLs has been operationalised with effect from August 25, 2009. Under the scheme, up to 10 per cent of the notified amount of SDLs will be allotted to eligible individuals and institutions, subject to a maximum of one per cent of the notified amount for single bid per stock. An investor can submit only a single bid in an auction of SDL through a bank or PD.

IV. Credit Delivery Mechanism and Other Banking Services

Credit Flow to the MSE Sector

127. As indicated in the Annual Policy Statement of April 2009, the guidelines based on the Working Group on Rehabilitation of Sick SMEs (Chairman: Dr. K.C. Chakrabarty) were issued to scheduled commercial banks in May 2009. In pursuance of the guidelines, banks were advised to review/put in place

policies for the micro and small enterprises (MSEs), duly approved by their respective Boards with regard to: (i) loan policy governing extension of credit facilities; (ii) restructuring/rehabilitation policy for revival of potentially viable sick units/ enterprises; and (iii) non-discretionary one-time settlement scheme for recovery of non-performing loans. Other recommendations pertaining to the Government of India/State Governments/State Level Bankers' Committee (SLBC) convener banks were forwarded to them for necessary action. The regional offices of the Reserve Bank were advised to monitor the actions initiated by the State Governments/SLBC convener banks and discuss the progress in this regard in the SLBC meetings.

128. The Annual Policy Statement of April 2009 also proposed that the Standing Advisory Committee on MSEs would review the credit guarantee scheme. Accordingly, a Working Group (Chairman: Shri V. K. Sharma) was constituted to review the credit guarantee scheme of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGFTMSE) and also examine the feasibility of a 'whole turnover guarantee' for the MSE portfolio. The Working Group is expected to submit its report by end-December 2009.

Agricultural Debt Waiver and Debt Relief Scheme, 2008: Status

129. A scheme of agricultural debt waiver and debt relief for farmers with the total value of overdue loans being waived estimated at Rs.50,000 crore and a one-time settlement (OTS) relief on the overdue loans estimated at Rs.10,000 crore was announced in the Union Budget 2008-09. Out of this, Rs.28,000 crore was passed on to the National Bank for Agriculture and Rural Development (NABARD) for reimbursing the claims of regional rural banks (RRBs) and co-operatives and the remaining amount was earmarked for reimbursing the claims of scheduled commercial banks (SCBs), local area banks (LABs) and urban co-operative banks (UCBs). Till date, SCBs and UCBs have been reimbursed to the extent of 64.7 per cent of their 'debt waiver' claims.

Rural Co-operative Banks

Licensing of Co-operatives: Status

130. The Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) had recommended that rural co-operative banks which fail to obtain a license by 2012 should not be allowed to continue to operate. Accordingly, it was proposed, in the Annual Policy Statement of April 2009, to work out a roadmap for achieving this objective in a non-disruptive manner. The criteria for licensing of these banks have been drafted in consultation with the NABARD and action with regard to issuance of licenses has been initiated. At present, 17 out of 31 state co-operative banks, and 296 out of 371 central co-operative banks are unlicensed.

Revival of Rural Co-operative Credit Structure: Status

131. Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions

(Chairman: Prof. A. Vaidyanathan) and in consultation with the State Governments, the Government of India had approved a package for revival of the short-term rural co-operative credit structure. So far, as envisaged under the package, 25 States have entered into Memorandum of Understanding (MoU) with the Government of India and the NABARD. Twelve States have made amendments to their respective Co-operative Societies Acts. As on July 31, 2009, an aggregate amount of Rs.6,639 crore has been released by the NABARD as Government of India's share under the package to primary agricultural credit societies (PACS) in 10 States. The National Implementing and Monitoring Committee (NIMC) set up by the Government of India is monitoring the implementation of the revival package.

132. Furthermore, a study of the long-term co-operative credit structure was entrusted by the Government of India to the same Task Force. The Task Force submitted its report in August 2006. It was announced in the Union Budget 2008-09 that the Government of India and the State Governments have reached an agreement on the content of the package for the revival of the long-term co-operative credit structure. The cost of the package has been estimated at Rs.3,074 crore, of which the Central Government's share will be Rs.2,642 crore. The Government of India has constituted a Task Force (Chairman: Shri G. C. Chaturvedi) in September 2009 with representatives from the Reserve Bank and the NABARD to look into the various aspects of the long-term co-operative credit structure with regard to viability, relevance of a separate package and strategy for implementation.

Regional Rural Banks

Capital to Risk-weighted Assets Ratio (CRAR) for RRBs: Status

133. On the basis of the recommendations of the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla), the Annual Policy Statement of April 2009 proposed to introduce CRAR for RRBs in a phased manner, taking into account the status of recapitalisation and amalgamation. The Government of India has constituted a Committee (Chairman: Dr. K.C. Chakrabarty) with representatives from the Government, sponsor banks, RRBs and the NABARD to examine the financials of the RRBs and suggest a roadmap to raise the CRAR of RRBs to nine per cent by March 2012. The Committee is expected to submit its report by end-January 2010.

Amalgamation of RRBs: Status

134. Of the total number of 196 RRBs, 159 RRBs have been amalgamated into 46 new RRBs (sponsored by 27 banks and located in 26 States including one Union Territory). Since then one new RRB has also been established in the Union Territory of Puducherry. Accordingly, the total number of RRBs now functioning is 84.

Recapitalisation of RRBs: Status

135 The Union Budget 2007-08 announced that RRBs which have a negative net worth will be recapitalised in

a phased manner. The process of recapitalisation has since been completed with 27 RRBs having been fully recapitalised with an amount of Rs.1,796 crore as on July 31, 2009.

Technology Upgradation of RRBs: Status

136. With a view to enabling RRBs to adopt information technology (IT)-based solutions for financial inclusion, it was proposed in the Annual Policy Statement of April 2009 to work out, in consultation with the NABARD, the manner of providing assistance to RRBs for adopting information and communication technology (ICT) solutions for financial inclusion in districts identified as having high level of exclusion by the Committee on Financial Inclusion (Chairman: Dr. C. Rangarajan). To facilitate ICT implementation, there is a need to implement core banking solutions (CBS). In this context, the Report of the internal Working Group (Chairman: Shri G. Srinivasan) constituted by the Reserve Bank to prepare a roadmap for migration to CBS by RRBs was forwarded to all sponsor banks in October 2008 with an advice to implement the recommendations in respect of RRBs sponsored by them. The issue of sharing the funding cost of CBS project among the owners of RRBs, *viz.*, the Government of India, the State Governments and sponsor banks, is under examination by the NABARD.

Urban Co-operative Banks

Review of Regulatory and Supervisory Framework for UCBs: Status

137. The Annual Policy Statement of April 2009 proposed a review of the existing instructions on internal control, risk management system, asset-liability management (ALM) and disclosure norms as appropriate to UCBs as also to apply capital charge for market risk in respect of large-sized and systemically important UCBs. The review is underway.

Information Technology Support to UCBs: Status

138. Based on the recommendations of the Working Group (Chairman: Shri R. Gandhi), which looked into ways of supporting IT initiatives of the UCBs, a tentative action plan has been worked out. Taking into account a large number of small and unit UCBs and the lack of uniformity in the level of computerisation, the action plan envisages the minimum level of IT infrastructure to include computerised management information system (MIS) reporting and automated regulatory reporting (ARR). After a series of discussions with service providers, it has been decided to adopt the application service provider (ASP) model for providing IT support to UCBs. The modalities are being worked out in consultation with the Institute for Development and Research in Banking Technology (IDRBT).

Creation of Umbrella Organisation and Revival Fund for UCBs: Status

139. As indicated in the Annual Policy Statement of April 2008, a Working Group (Chairman: Shri V. S. Das) was constituted to suggest measures, including the appropriate regulatory and supervisory framework, to facilitate emergence of umbrella organisation(s) for the UCB sector

in the respective States. The Group has since submitted its Report.

DICGC-Supported Transfer of Assets and Liabilities of UCBs to Commercial Banks in Legacy Cases

140. As a part of the measures to strengthen the urban co-operative banking system, a scheme of amalgamation of weak UCBs with strong UCBs, with support from the Deposit Insurance and Credit Guarantee Corporation (DICGC), is considered by the Reserve Bank in cases involving UCBs having negative net worth as on March 31, 2007. However, in those cases, where proposals for amalgamation within the UCB sector are not forthcoming, it is proposed:

- to provide DICGC support to the scheme involving transfer of assets and liabilities (including branches) of legacy cases of urban co-operative banks to domestic scheduled commercial banks, provided the scheme ensures 100 per cent protection to depositors and DICGC support is restricted to the amount as provided under Section 16 (2) of the DICGC Act, 1961.

141. Detailed guidelines in this regard will be issued separately.

V. Financial Inclusion

Business Correspondent (BC) Model

142. As proposed in the Annual Policy Statement of April 2009, a Working Group (Chairman: Shri P. Vijaya Bhaskar) was constituted to examine the experience gained to date with the business correspondent (BC) model and to suggest measures to enlarge the category of persons that can act as BCs, keeping in view the regulatory and supervisory framework and consumer protection issues. The Group's Report has been placed on the Reserve Bank's website. Based on the Group's recommendations, it is proposed:

- to allow banks to appoint the following entities as BCs in addition to those permitted already: (i) individual *kirana*/medical/fair price shop owners; (ii) individual public call office (PCO) operators; (iii) agents of small savings schemes of Government of India/ insurance companies; (iv) individuals who own petrol pumps; (v) retired teachers; and (vi) authorised functionaries of well-run self-help groups (SHGs) linked to banks; and
- to allow banks to collect reasonable service charges from the customer in a transparent manner under their Board-approved policy for delivering the services through BC. This should be clearly explained to the customer.

143. Based on the experience gained, the working of the scheme will be reviewed after one year.

Pilot Project of SLBCs for 100 per cent Financial Inclusion

144. Of the total of 623 districts in the country, 431 districts have so far been identified for 100 per cent financial inclusion. Of these, 204 districts in 18 States and six Union Territories have reported having achieved the target. All

districts of Haryana, Himachal Pradesh, Karnataka, Kerala, Uttarakhand, Goa, Chandigarh, Puducherry, Daman & Diu, Dadra & Nagar Haveli and Lakshdweep have reported having achieved 100 per cent financial inclusion. The Reserve Bank had undertaken an evaluation study through external agencies in 26 districts of eight States claiming 100 per cent financial inclusion, to draw lessons for further action. The study reports had, *inter alia,* revealed that although the SLBCs had declared several districts as 100 per cent financially included, the actual financial inclusion was short of that. A large number of no-frills accounts are dormant, the number of transactions is small and ICT-based financial services are yet to reach many villages. The findings of the study were communicated to banks in January 2009 with an advice to take appropriate action.

Special Task Force in North-Eastern Region

145. The Annual Policy Statement of April 2009 had indicated the formulation of a scheme of providing financial support to banks by the Reserve Bank for setting up banking facilities at centres in the North-Eastern region which were found to be commercially viable by banks, provided the State Governments made available necessary premises and other infrastructural support. As its contribution, the Reserve Bank would bear one-time capital cost and recurring expenses for a limited period of five years as per the lowest bid offered by a bank. The Government of Meghalaya has since agreed to the proposal of providing premises and security. Accordingly, eight centres have been allotted to three public sector banks. Action has also been initiated in respect of other States in the region.

Quicker Adoption of Electronic Benefit Transfer (EBT) for Government Schemes

146. To encourage banks to adopt ICT solutions for enhancing their outreach, the Reserve Bank formulated a scheme to quicken the pace of adoption of the smart card-based electronic benefit transfer (EBT) mechanism by banks and rolled out the EBT system in the States that are ready to adopt the scheme. As per the scheme, the Reserve Bank would reimburse the banks a part of the cost of opening accounts with bio-metric access/smart cards at the rate of Rs.50 per account through which payment of social security benefits, National Rural Employment Guarantee Act (NREGA) payments and payments under other Government benefit programmes would be routed to persons belonging to below poverty line (BPL) families. The scheme is currently being implemented in Andhra Pradesh. So far, seven banks have been paid Rs.1.8 crore for smart cards issued by banks in Andhra Pradesh during July-December 2008. The process is at different stages of implementation in other States such as Karnataka and Uttarakhand and the scheme of partial reimbursement by the Reserve Bank has been extended by one year up to June 30, 2010. Banks are advised to work in co-ordination with the respective government departments at the Central and State levels to ensure that all State benefits are delivered to individuals only through bank accounts within a specific timeframe.

High Level Committee on Lead Bank Scheme

147. The High Level Committee on Lead Bank Scheme (Chairperson: Smt. Usha Thorat) submitted its draft report on May 21, 2009. The Report was placed on the Reserve Bank's website inviting comments from public and other stakeholders. Based on the feedback received, the Committee submitted its final report to the Reserve Bank on August 20, 2009 and the report was placed on the Reserve Bank's website on August 24, 2009. While the recommendations of the Committee are under consideration, it is proposed:

- to advise the lead banks to constitute a Sub-Committee of the District Consultative Committees (DCCs) to draw up a roadmap by March 2010 to provide banking services through a banking outlet in every village having a population of over 2,000, by March 2011. Such banking services may not necessarily be extended through a brick and mortar branch but can be provided through any of the various forms of ICT- based models, including through BCs.

Micro-finance: Status

148. The self-help group (SHG)-bank linkage programme has emerged as the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and co-operative banks. As on March 31, 2009, 4.2 million SHGs were operating with an outstanding bank credit of Rs.22,680 crore, up by 34 per cent over March 31, 2008. During 2008-09, banks financed 1.6 million SHGs, including repeat loans to existing SHGs, to the tune of Rs.12,254 crore. There were 6.1 million savings accounts of SHGs with banks as on March 31, 2009 with total deposits amounting to Rs.5,546 crore.

149. The role of micro-finance institutions (MFIs) in providing financial services to the poor is growing in importance. The banking sector has been extending loans to MFIs for on-lending to SHGs. During 2008-09, bank loans amounting to Rs.3,732 crore were disbursed to 581 MFIs, increasing the total outstanding loans to Rs.5,009 crore to 1,915 MFIs as on March 31, 2009.

Priority Sector Lending Certificates (PSLCs): Working Group

150. The Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan), *inter alia,* recommended introduction of priority sector lending certificates (PSLCs) for purchase by banks for achieving the priority sector lending target. According to the Committee's recommendation, PSLCs would be issued by registered lenders such as MFIs, NBFCs, co-operatives, and registered money lenders for the amount of loans granted by them to the priority sector, and also by banks for the amounts in excess of their stipulated priority sector lending requirements. These certificates could be traded in the open market, and banks having shortfall in meeting the priority sector lending targets could buy such certificates and thus meet the priority sector lending norms. The Committee further recommended that in the trading of PSLCs, the actual loans would continue to remain on the books of the original lender

unlike in outright purchase of loan assets. However, the buyer bank would show the amount in its priority sector lending requirements. The seller of PSLC, if it is a bank, will take it off its priority sector lending requirements even though it will continue to carry the loan on its books.

151. Preliminary discussions indicated that there are both merits and demerits of the proposal. Therefore, it is proposed:

- to constitute a Working Group to examine the issues involved in the introduction of priority sector lending certificates and make suitable recommendations.

VI. Regulatory Measures for Commercial Banks

Relaxations in Branch Authorisation Policy

152. As announced in the Annual Policy Statement of April 2009, a Working Group (Chairman: Shri P. Vijaya Bhaskar) was constituted to review the extant branch authorisation policy with a view to providing greater flexibility to banks for opening branches to enhance banking penetration and promote financial inclusion. The Group has since submitted its report. Taking into consideration the Group's recommendations, it is proposed to liberalise the extant branch authorisation policy for domestic scheduled commercial banks (other than RRBs) as under:

- Domestic scheduled commercial banks (other than RRBs) will now be free to open branches in Tier 3 to Tier 6 centres as identified in the Census 2001 (with population up to 50,000) under general permission.
- Opening of branches by domestic scheduled commercial banks (other than RRBs) in Tier 1 and Tier 2 centres (with population over 50,000) will continue to require prior authorisation.
- Banks may plan their branch expansion in Tier 3 to Tier 6 centres in such a manner that at least one-third of such branches are in the underbanked districts of underbanked States as will be notified separately by the Reserve Bank. This would be one of the criteria in the Reserve Bank's consideration of proposals by domestic scheduled commercial banks (other than RRBs) to open branches in Tier 1 and Tier 2 centres. In considering such proposals, the Reserve Bank would, in addition, take into account banks' performance in financial inclusion, priority sector lending and level of customer service, among others.

Enhancements to the Basel II Framework

153. In July 2009, the Basel Committee on Banking Supervision (BCBS) had finalised enhancements and revisions in certain areas of the Basel II framework. The enhanced/ revised guidance of BCBS is contained in their three documents, *viz*., Enhancements to the Basel II Framework; Revisions to the Basel II Market Risk Framework; and Guidelines for Computing Capital Charge for Incremental Risk in the Trading Book. These enhancements and revisions are intended to strengthen the framework and respond to lessons learnt from the financial crisis.

154. The enhancements and revisions now stipulated by BCBS are, however, mostly applicable to advanced approaches of the Basel II framework. Banks in India have implemented standardised/basic approaches contained in the framework. However, wherever those enhancements and revisions are applicable to standardised/basic approaches, it is proposed:

- to issue detailed guidelines as appropriate for implementation by banks operating in India by end-November 2009.

Introduction of Duration Gap Analysis for Asset Liability Management

155. The Reserve Bank had issued guidelines on asset liability management in February 1999, which, *inter alia*, covered aspects relating to interest rate risk measurement. These guidelines to banks approached interest rate risk measurement from the 'earnings perspective' using the traditional gap analysis (TGA). To begin with, the TGA was considered as a suitable method to measure interest rate risk. The Reserve Bank had, however, indicated its intention to shift to modern techniques of interest rate risk measurement such as duration gap analysis (DGA), simulation and value-at-risk over a period of time, when banks acquire sufficient expertise and sophistication in this regard. Since banks have gained considerable experience in implementation of the TGA and have become familiar with the application of the concept of duration/modified duration while applying standardised duration method for measurement of interest rate risk in the trading book, this is an opportune time for banks to adopt the DGA for management of their interest rate risk. With this move, banks would migrate to the application of the 'economic value perspective' to interest rate risk management. Accordingly, it is proposed:

- to issue detailed guidelines on the use of DGA for management of interest rate risk by end-November 2009 .

Review of Capital Adequacy Norms for Take-out Financing

156. At present, the credit conversion factor (CCF) for off-balance sheet exposure of the take-out financing institution, which captures that institution's unconditional commitment during the period up to the take-out event, is 100 per cent. The CCF for conditional take-out has been fixed at a lower level of 50 per cent reflecting the uncertainty regarding the take-out event due to the conditional nature of the agreement. The existing capital adequacy treatment of take-out financing is in conformity with the capital adequacy treatment of forward asset purchases under both Basel I and Basel II. The issue has been reconsidered and it is proposed:

- to allow banks to build up capital for take-out exposures in a phased manner.

157. Detailed guidelines in this regard are being issued separately.

Commercial Real Estate Exposures

158. In view of large increase in credit to the commercial real estate sector over the last one year and the extent of restructured advances in this sector, it would be prudent to build cushion against

likely non-performing assets (NPAs). Accordingly, it is proposed:

- to increase the provisioning requirement for advances to the commercial real estate sector classified as 'standard assets' from the present level of 0.40 per cent to 1 per cent.

Review of Adequacy of Loan Loss Provisions

159. At present, the provisioning requirements for NPAs range between 10 per cent and 100 per cent of the outstanding amount, depending on the age of the NPAs, the security available and the internal policy of the bank. Since the rates of provisioning stipulated by the Reserve Bank for NPAs are the minimum and banks can make additional provisions subject to a consistent policy based on riskiness of their credit portfolios, it has been observed that there is a wide heterogeneity and variance in the level of provisioning coverage ratio across different banks. With a view to improving the provisioning cover and enhancing the soundness of individual banks, it is proposed:

- to advise banks to augment their provisioning cushions consisting of specific provisions against NPAs as well as floating provisions, and ensure that their total provisioning coverage ratio, including floating provisions, is not less than 70 per cent. Banks should achieve this norm not later than end-September 2010.

Banks' Exposure to NBFCs Engaged in Infrastructure Financing: Review of Risk Weights

160. At present, the risk weight for banks' exposure to systemically important non-deposit taking NBFCs (NBFCs-ND-SI) is 100 per cent. However, asset finance companies (AFCs) within the NBFCs-ND-SI category carry a risk weight based on credit ratings. As indicated in para 178 in Section VII of this part, NBFCs engaged in financing of infrastructure would henceforth be classified in a new category called infrastructure NBFCs. Since financing by such NBFCs would essentially result in the creation of physical infrastructure, it is proposed:

- to link the risk weights of banks' exposure to such NBFCs to the credit rating assigned to the NBFC by external credit assessment institutions (ECAIs).

Lock-in Period and Minimum Retention for Securitisation Exposures

161. To ensure that the originators do not compromise on due diligence of assets generated for the purpose of securitisation, it was proposed in the Annual Policy Statement of April 2009 to stipulate a minimum lock-in period for bank loans before these were securitised. It was also proposed to lay down minimum retention criteria for the originators as another measure to achieve the same objective. Accordingly, it is proposed:

- that the minimum lock-in period for all types of loans would be one year before these can be securitised; and
- that the minimum retention by the originators will be 10 per cent of the pool of assets being securitised.

162. The international work, especially in the European Union and the US regarding the minimum retention criteria, is still underway. The Reserve Bank will

issue detailed guidelines on the manner of computation of the one year lock-in period and other operational details keeping in view the international norms being developed.

Compensation Practices

163. Compensation practices, especially of large financial institutions, were one of the factors which contributed to the recent global financial crisis. The FSB has brought out certain principles for sound compensation practices. The principles call for effective governance of compensation, and for compensation to be adjusted for all types of risk, to be symmetric with risk outcomes, and to be sensitive to the time horizon of risks. These principles, which have been endorsed by the G-20, should be the guiding tenets for devising compensation schemes for all employees in a financial institution. The Reserve Bank is working on the FSB principles for sound compensation and it is proposed:

- to issue suitable guidelines to private sector and foreign banks with regard to sound compensation policies.

Liquidity Risk

164. The Annual Policy Statement of April 2009 proposed to place the draft circular on liquidity risk management, as also the guidance note on "Liquidity Risk Management" on the Reserve Bank's website by mid-June 2009. This was deferred. Keeping in view active discussions underway at the global level on liquidity risk management as the BCBS is also in the process of enhancing the modalities for adopting the integrating risk management system, it is now proposed:

- to issue a draft circular reflecting these changes by end-December 2009.

Stress Testing

165. The Annual Policy Statement of April 2009 proposed upgradation of the stress testing guidelines once BCBS finalises the paper on 'Principles for Sound Stress Testing Practices and Supervision'. In this context, the guidelines issued to banks in June 2007 are required to be enhanced in the light of the final paper issued by BCBS and taking into account international work/initiatives in the area of stress testing, particularly that being done by the IMF and the FSB. It is proposed:

- to issue guidelines to banks on stress testing by end-January 2010.

Credit Rating Agencies: Status

166. It was indicated in the Annual Policy Statement of April 2009 that the Reserve Bank will liaise with the SEBI on the issue of rating agencies' adherence to Code of Conduct Fundamentals of the International Organisation of Securities Commissions (IOSCO). Accordingly, in order to review rating agencies' continued accreditation under Basel II, the Reserve Bank conducted meetings with Credit Rating Information Services of India Ltd. (CRISIL), ICRA Ltd., Credit Analysis and Research Ltd. (CARE) and Fitch. The Reserve Bank has also initiated discussions with the SEBI to assess the rating agencies' compliance with the enhanced Code of Conduct Fundamentals of the IOSCO.

VII. Institutional Developments

Payment and Settlement Systems

Guidelines for Pre-paid Payment Instruments in India

167. As indicated in the Annual Policy Statement of April 2009, SCBs and non-bank entities, which complied with the eligibility criteria, were permitted to issue pre-paid payment instruments. Furthermore, in August 2009, other entities were also permitted to issue mobile phone based semi-closed system pre-paid instruments for a maximum value of Rs.5,000.

Electronic Payment Systems

168. Between end-March 2009 and end-September 2009, the branch network of national electronic funds transfer (NEFT) enabled banks increased from 54,200 to 60,839 and the RTGS enabled branches increased from 55,000 to 60,144. The average number of daily transactions handled by the RTGS network increased from 80,000 to 90,000.

National Electronic Clearing Service

169. As indicated in the Annual Policy Statement of April 2009, the volume of transactions through national electronic clearing service (NECS), introduced in September 2008, is gradually increasing. As at end-September 2009, 114 banks with 30,780 branches have been participating in NECS.

Customer Service at ATMs

170. The Reserve Bank received a number of complaints from bank customers regarding debit of their accounts even though ATMs had not disbursed cash for various reasons. In order to improve customer service, the Reserve Bank advised all banks to reimburse to the customers the amount wrongfully debited on account of failed ATM transactions within a maximum period of 12 days from the date of receipt of customer complaint. In case a bank fails to re-credit the customer's account, it is required to pay compensation of Rs.100 per day to the aggrieved customer. The amount of compensation is credited to the customer's account on the same day the bank credits the amount of the failed ATM transaction.

Facility to Use ATMs of other Banks: Rationalisation

171. The Reserve Bank had advised that customers could use the ATMs of other banks for cash withdrawal free of charge with effect from April 1, 2009. This led to a quantum increase in ATM transactions, especially small value cash withdrawal transactions, which tended to impair the viability of operations. The Indian Banks' Association (IBA), therefore, approached the Reserve Bank with suggestions to rationalise the facility in order to achieve a balance between optimising customer convenience and mitigating operational difficulties. Taking into account all the relevant issues, the Reserve Bank agreed to the IBA's suggestions of: (i) extending the access of ATMs of other banks to only customers having savings bank accounts; (ii) pegging a cap of Rs.10,000 per withdrawal at ATMs of other banks; and (iii) permitting only five free transactions per month at ATMs of other

banks. These instructions came into effect from October 15, 2009.

Mobile Payments

172. With the issuance of the operative guidelines for mobile payments on October 8, 2008, the Reserve Bank has so far granted approval to 32 banks to provide mobile banking facilities to their customers.

Cheque Truncation System

173. The Annual Policy Statement of April 2009 indicated that the Reserve Bank will continue to take steps towards extending the cheque truncation system (CTS) across the country. In pursuance of this, effective July 1, 2009, all cheque volumes at New Delhi migrated to CTS and accordingly magnetic ink character recognition (MICR) clearing (both at SBI and the Reserve Bank) was discontinued. Furthermore, action to roll-out CTS at Chennai has been initiated and it is proposed that New Delhi and Chennai would act as backup for each other. With effect from July 1, 2009, a fee of Rs.0.50 per instrument each from the presenting bank and from the paying bank in the CTS has been introduced. Presently, CTS is handling around 6,00,000 instruments every day.

Cash Withdrawal at Point-of-Sale (POS)

174. Cash is predominantly used for small value payments and as such there is always a need for availability of currency. The use of debit cards at point-of-sale (POS) terminals at different merchant establishments has been steadily on the rise. The number of POS terminals in the country at the end of August 2009 was 4,87,024. As a further step towards enhancing customer convenience in using plastic cards, cash withdrawals up to Rs.1,000 per day at POS terminals have been allowed for all debit cards issued in India.

The Payment and Settlement Systems Act, 2007

175. As indicated in the Annual Policy Statement of April 2009, all payment system providers/operators, including credit card issuing companies and entities engaged in money transfer activity, require authorisation as per the Payment and Settlement Systems Act, 2007. Accordingly, 30 payment system service providers providing service in India have been granted certificate of authorisation by the Reserve Bank by end-September 2009.

Currency Management

176. The High Level Group on Currency Management (Chairperson: Smt Usha Thorat) constituted by the Reserve Bank submitted its Report in August 2009. The Group has, *inter alia,* emphasised the importance of using modern technology and security systems for stocking, processing and distribution of currency to ensure adequate availability of genuine and clean notes to the public. With a view to encouraging banks for giving due priority to the above objective, it is proposed:

- to mandate banks to install note sorting machines in all their branches in a phased manner in terms of a roadmap to be approved by the Reserve Bank; and
- to have the responsibility of currency management entrusted to a nodal official in each bank, who shall be a senior functionary at a level not less than that of a General Manager and who will be accountable for the obligations cast upon currency chests by the Reserve Bank.

177. Detailed guidelines based on the report of the Working Group are being issued separately.

Non-Banking Financial Companies

Classification of NBFCs-ND-SI: Infrastructure Companies

178. NBFCs-ND-SI engaged predominantly in the infrastructure financing have represented to the Reserve Bank that there should be a separate category of infrastructure financing NBFCs in view of the critical role played by them in providing credit to the infrastructure sector. Currently, the Reserve Bank classifies NBFCs under three categories, *viz.,* asset finance companies, loan companies and investment companies. It has now been decided to:

- introduce a fourth category of NBFCs as 'infrastructure NBFCs', defined as entities which hold minimum of 75 per cent of their total assets for financing infrastructure projects.

179. Detailed instructions, including eligibility criteria, are being issued separately.

Repossession of Vehicles by NBFCs

180. The Annual Policy Statement of April 2009 had emphasised that NBFCs should have a built-in repossession clause (in respect of repossession of vehicles) and also detailed provisions with regard to terms and conditions for ensuring transparency in the contract/loan agreement with the borrower which will be legally enforceable. Accordingly, NBFCs were advised the broad framework in respect of terms and conditions of the contract/loan agreement, *viz.,* (i) notice period before taking possession; (ii) circumstances under which the notice period can be waived; (iii) the procedure for taking possession of the security; (iv) a provision regarding final chance to be given to the borrower for repayment of loan before the sale/auction of the property; (v) the procedure for giving repossession to the borrower; and (vi) the procedure for sale/auction of the property. Furthermore, NBFCs were urged to make available a copy of such terms and conditions to the borrowers at the time of sanction/ disbursement of loans, which may form a key component of such contracts/loan agreements.

Special Liquidity Facility for Eligible NBFCs-ND-SI

181. The special liquidity facility for eligible NBFCs-ND-SI for meeting the temporary liquidity mismatches through the Industrial Development Bank of India Stressed Asset Stabilisation Fund (IDBI SASF) Trust, which was notified as a special purpose vehicle (SPV) for undertaking the operation, was extended for eligible papers issued by NBFCs up to September 30, 2009. The SPV will cease to make fresh purchases after December 31, 2009 and will recover all dues by March 31, 2010. The facility was availed of to the extent of Rs.750 crore and was repaid fully by July 7, 2009.

Mumbai

October 27, 2009