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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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29-04-1998

Monetary and Credit Policy For the First Half of 1998-99

- Monetary Policy to support growth in 1998-99.
- Sufficient credit to be available for industrial revival.
- Bank Rate reduced by 1 percentage point.
- Concessions for exporters.
- A number of reform measures introduced to give greater
- freedom to banks and further reforms of financial system.
- Credit Policy to be more flexible. Annual monetary policy
- announcements to lay stress on structural measures.

Dr. Bimal Jalan, Governor, Reserve Bank of India, today unveiled his `Monetary and Credit Policy for the First Half of 1998-99'. The statement contained many structural measures, in response to the important changes taking place in the regulatory framework for financial markets and a few short-term credit policy measures.

Macro-economic Developments in 1997-98

While reviewing the economic developments in 1997-98, the Governor stated that broad money (M3) growth at 17.0 per cent was significantly higher than the expansion of 16.0 per cent in the previous year. He explained that the increase was on account of a substantial expansion of domestic credit to both, government and commercial sectors, and an increase in the net foreign exchange assets of the banking system. Gross market borrowings of the Central Government were also high, he added. Aggregate deposits of scheduled commercial banks increased by 18.9 per cent as compared with an increase of 16.5 per cent in 1996-97. The conventional non-food credit of scheduled commercial banks expanded by 14.2 per cent in 1997-98 as against 10.9 per cent in the previous year. Including the investments in bonds/debentures/shares of the corporates and commercial paper, etc., the increase in non-food credit was 17.6 per cent as compared with that of 12.2 per cent in 1996-97.

GDP

Pointing out to the advance estimates of the Central Statistical Organisation, according to which, the real GDP growth was estimated to have slowed down to 5.0 per cent in 1997-98, the Governor stated that the deceleration in industrial growth was marked. This was a matter of concern for the growth of incomes in the economy as well as for the development of the financial sector. It had repercussions also on the financial position of industrial enterprises, which in turn adversely affects both the demand for and recovery of credit from the banking sector.

Inflation

The Governor noted that the annual rate of inflation in 1997-98 on a point-to-point basis was lower at 5.0 per cent than that of 6.9 per cent recorded in the preceding year. This, the Governor said, was welcome as it provided some needed room for manoeuvre in respect of monetary and fiscal policy in 1998-99. He, however, emphasized that the maintenance of the rate of inflation at the level witnessed in 1997-98 would depend critically on sustained growth of output in the economy and a careful and productive use of financial resources, both in the public and private sectors, for capital investment rather than for higher current consumption or fiscal subsidies. This was particularly true as the growth of liquidity in 1997-98 was higher than envisaged and the growth of industrial output was lower. The Governor urged that in this situation, concerted efforts were required on the part of all economic agents to accelerate investment and output in the economy.

Exchange Rate

Referring to the developments in some of the Asian currencies, the Governor stated that they exerted significant pressures on the exchange rate of the rupee in the second half of 1997-98. A package of strong monetary measures was, therefore, introduced on January 16, 1998. The Governor pointed out that the impact of these measures on the external position of the country was favourable. During 1997-98, the foreign currency assets of the Reserve Bank increased by US $ 3.6 billion. Since January 16, 1998, the foreign currency assets increased by US $ 2.5 billion up to March 31, 1998. Net of outstanding forward sales and purchases, the increase in foreign currency assets at end-March 1998 was US $ 2.2 billion over the financial year. On the same basis, the increase was US $ 3.1 billion between January 16, 1998 and end-March 1998.

An important lesson of the developments in the exchange markets, the Governor stated, is that all countries, and developing countries in particular, have to be constantly watchful of the developments that may adversely affect exchange markets. There can be no room for complacency in this regard. He added that for monetary and other measures to be effective, it is also necessary to take hard decisions early rather than allow matters to get out of hand and then try to control them. While closer links among different segments of financial markets were desirable for improving allocative efficiency, they also posed new challenges for monetary management.

Stance for Monetary Policy for 1998-99

Dwelling on the stance of monetary policy in 1998-99, the Governor said that it has to reflect developments that have taken place during the previous year, and the broad economic objectives for the current year. According to him among the developments that have to be taken into account were: higher than the projected growth of money supply in relation to growth in GDP in 1997-98; substantial increase in financial flows from banks to the corporate sector despite a slowdown in industrial growth; higher market borrowing requirements of the Government; and continued uncertainty in external currency and product markets.

Among the important short term economic objectives were: the need to accelerate industrial investment and output in the economy; maintenance of low rates of inflation; continued pursuit of financial reform; reduction in interest rates; and improvement in credit delivery mechanisms, particularly for agriculture and medium and small sectors. The Governor considered the task of achieving a balance among different objectives as not easy and stated that it would require constant vigilance on the monetary front.

The Governor observed that given the rising shares of the industrial and services sectors in GDP and the more recent experience, it had become increasingly evident that the Indian economy has the potential of attaining a growth rate of 7 - 8 per cent per year over the medium-term. For the immediate future, i.e., 1998-99, however, the Governor emphasised that a growth rate of 6.5 to 7.0 per cent was needed to be achieved in order to realise this potential. He noted that at the beginning of the current financial year, liquidity is comfortable. This is evidenced in the large outstandings of repos with the Reserve Bank which are readily available to the banking system. At the close of business on April 27, 1998, such repos amounted to Rs.8,529 crore.

The Reserve Bank will ensure that sufficient credit is available to permit realisation of the growth potential. At the same time, it is desirable that the inflation rate remains at current levels. On this basis, a reasonable target for M3 growth in 1998-99 was fixed in the range of 15.0 to 15.5 per cent. The Governor stated that this order of growth in money supply should be sufficient to ensure that availability of credit is not a constraint on growth of output in the economy. The Governor advised the banks to plan their credit operations on this assumption and assured that, barring unexpected developments on the price front or in the foreign exchange markets, sufficient liquidity would be available in the current year to finance additional productions.

The Governor regarded the financial reforms introduced since 1992 as being highly significant. The deregulation and liberalisation of the system have paved the way for the emergence of open market operations and interest rate as important instruments in the conduct of monetary policy, he stated and noted that institutional measures have also been undertaken to promote greater integration of financial markets. The Governor assured that efforts in this direction will continue.

Monetary and Credit Policy Measures

Stating that in view of several important changes that have taken place in the regulatory framework for financial markets, greater importance to structural measures would henceforth be given in the credit and monetary policy statement at the beginning of the financial year. The Governor emphasised that as a matter of policy, such structural measures will not normally be changed in the course of the year and will also be expected to continue over the medium-term. Short-term measures, such as changes in the Bank Rate, Cash Reserve Ratio (CRR), repo rates, access to refinance, etc., may also be included if proposed changes in these variables happen to coincide with the timing of the April statement, he added. The Governor hoped that it would be understood that these short-term credit and regulatory measures are subject to change at short notice in the light of actual developments and the emerging external market conditions. The credit policy statement for the second half of the year will generally be confined to a review of monetary developments in the first half of the year and to such changes as may be necessary in monetary projections during the second half of the year.

(a) Structural Measures

Alluding to the two monetary policy statements last year, in April and October 1997, which contained a number of measures to widen and deepen the financial markets, the Governor stated that the process is needed to be continued in order to further this process and to provide greater flexibility to banks in regard to certain aspects pertaining to deposits and lending rates. He stated that it is proposed to continue the process of further enhancing the efficiency of the money markets and the government securities markets and to introduce further refinements in repo and reverse repo transactions being undertaken by the Reserve Bank to regulate liquidity conditions in the market.

Money Market

The Governor announced that with effect from May 9, 1998, the following measures will be put into effect:

- The minimum size of operation per transaction by entities routing their lendings through primary dealers (PDs) in the call money market will be reduced from Rs.5 crore to Rs.3 crore.

- The minimum lock-in period for Certificates of Deposit (CDs) and units of Money Market Mutual Funds(MMMFs) will be reduced from 30 days to 15 days.

Government Securities Market

The Governor said that the following measures have been taken to further deepen the market:

- The practice of reverse repos with Primary Dealers in specified securities has been dispensed with and instead, liquidity support against the security of holdings in Subsidiary General Ledger (SGL) accounts will be provided.

- 182-Day Treasury Bill auctions on a fortnightly basis have been reintroduced.

- The periodicity of holding 364-Day Treasury Bill auctions will be on a monthly basis as against the present arrangement of fortnightly auctions. * Foreign institutional investors (FIIs) will be permitted to the purchase/sell Treasury Bills within the overall approved debt ceilings. FIIs are currently allowed to operate in all dated Government Securities in the primary and secondary markets, including those with remaining maturities of less than one year. Their entry into the Treasury Bills market was deferred pending rationalisation of auction procedures. In the light of monetary policy of October 1997, the RBI has recently commenced preannouncement of notified amounts in respect of Treasury Bill auctions and exclusion of non-competitive bids from the notified amounts. In view of this development, FIIs have been permitted to purchase/sell treasury bills. Treasury Bills normally carry a low rate of interest, but they provide an opportunity for temporary absorption of liquid funds pending investment in longer-term securities.

  Pointing out that in the recent months, repos were used to absorb or provide liquidity in the market and to signal changes in interest rates, the Governor proposed to use both, fixed interest and auction based repos, as appropriate. The Governor also stated that in addition to the current three-day and four-day repos, the Reserve Bank will, in due course, use one-day repos (including reverse repos) to absorb (or infuse) liquidity into the system.

Deposit and Lending Rates

In order to provide greater freedom to banks in respect of several aspects of their deposit/lending operations, the Governor proposed the following measures:

- The minimum period of maturity of term deposits will be reduced from 30 to 15 days.

- Banks will be permitted to determine their own penal interest rates for premature withdrawal of domestic term deposits. This will apply in respect of fresh and renewal of deposits. Banks will ensure that the depositors are made aware of the applicable penal rate along with the deposit rate.

- Banks will be permitted to determine their own penal interest rates for premature withdrawal of NRE deposits as in the case of FCNR(B) deposits. This relaxation will apply in respect of fresh and renewal of deposits and depositors would need to be informed of the applicable penal rate.

- Although interest rates on domestic term deposits were deregulated in 1997, a restriction was imposed on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of such deposits. In response to representations received from banks, this restriction is being removed and bank boards will henceforth lay down the policy in this regard.

- In order to remove the disincentive to the flow of credit to small borrowings below Rs.2 lakh, instead of prescribing a specific rate uniformly for all banks, it is being stipulated that the interest rates on loans below Rs.2 lakh should not exceed the Prime Lending Rate (PLR), which is available to the best borrowers, of the concerned bank.

- All advances against term deposits should be at an interest rate equal to PLR or less.

  The Governor stated that the recent international developments have reiterated the problems related to short-term external liabilities and large unhedged positions of corporates in some of the East Asian countries. Even though such liabilities are very low in India at present, the Governor said that the Reserve Bank would seek to further encourage the banks to mobilise long-term deposits, while simultaneously discouraging them to mobilise short-term deposits. The Governor has accordingly decided that:

- The interest rate ceiling on Foreign Currency Non-Resident Accounts (Banks)(FCNR(B)) deposits of one year and above will be increased by 50 basis points and that on such deposits below one year will be reduced by 25 basis points. * Banks will be permitted to fix their own overdue interest rates in respect of Foreign Currency Non-Resident Accounts (Banks)(FCNR(B)) and Non-Resident (External) Rupee Accounts (NRE) deposits, subject to these deposits being renewed.

- As part of risk management, banks will be advised to monitor unhedged exposures of their clients by building in adequate risk evaluation procedures in their credit appraisal system.

Valuation of Banks' Investments in Approved Securities

The Governor recalled that in April 1992, the Reserve Bank had advised the banks to bifurcate their investments in approved securities into `permanent' and `current' categories. Over time, the ratio of current category in total investments has increased with a view to adopting prudent accounting standards and to move towards "mark to market" valuation of the investment portfolio. In order to continue with the trend, the Governor said that banks are required to classify a minimum of 70 per cent of their securities as `current' investments for the year ending March 31, 1999.

Advances Against Shares to Individuals

The Governor recalled that banks are allowed to grant advances against shares and debentures to individuals for meeting contingencies and needs of personal nature or for subscribing to rights or new issues of shares/debentures subject to a ceiling of Rs.10 lakh per borrower. Banks were also required to maintain a minimum margin of 50 per cent for advances against shares. The Governor announced that after reviewing the existing regulations, it has been decided to increase the ceiling to Rs.20 lakh if the advances were secured by dematerialised securities. The minimum prescribed margin against dematerialised shares would also stand reduced to 25 per cent.

Credit Delivery

The Governor mentioned that accelerating the flow of credit to agricultural sector and small scale industries, in particular, was important. The Governor indicated that in order to examine the problems faced by borrowers in these sectors, the Reserve Bank had, in December 1997 set up two one-man committees (consisting of Shri R.V.Gupta and Shri S.L.Kapur for agricultural and small scale industries, respectively). The Committee on Agricultural Credit has recently submitted its report and the Committee on Small Scale Industries is expected to submit its report in the next few days. It is proposed to make several procedural modifications in respect of agricultural credit in the light of the committee's recommendations.

Prudential Norms and Supervision of Banks

The Governor also indicated that the existing capital adequacy, income recognition and provisioning norms would be strengthened and in this context, specific decisions would be taken in the light of the recommendations of the High Level Committee on Banking Sector Reforms under the Chairmanship of Shri M.Narasimham. He proposed to move as early as possible towards full disclosure and transparency by banks and financial institutions in line with international best practices.

Role of Banks and Development Finance Institutions (DFIs)

The Governor said that the issues involved in moving towards the concept of "universal banking" and in harmonising the operations of term-lending institutions with banks were studied by a Working Group under the Chairmanship of Shri S.H.Khan, Chairman and Managing Director, Industrial Development Bank of India. These issues were important in a developing country like India where debt and securities markets were not fully developed and where financing of development projects, particularly infrastructure projects, presented special problems. Keeping these considerations in view, it is proposed to prepare a "Discussion Paper" on the subject, taking into account the recommendations of the Working Group and of the Narasimham Committee.

Credit Policy Measures

In order to achieve the above structural measures which were of a long term nature, the following credit policy measures were announced.

a) Bank Rate

- Bank Rate has been reduced by one percentage point from 10 per cent to 9 per cent with immediate effect.

b) Refinance Limits for Exports

- With effect from the fortnight beginning May 9, 1998 export credit refinance will be restored to 100 per cent (instead of present 50 per cent) of the increase in outstanding export credit eligible for refinance over the level of such credit as on February 16, 1996,

c) Rate of Interest on Exports

- Interest rates on pre-shipment export credit up to 180 days has been reduced from existing 12.0 per cent to 11.0 per cent with immediate effect.

- Interest rate against incentives receivable from government covered by ECGC guarantee in respect of pre-shipment credit up to 90 days has been reduced from the existing 12.0 per cent to 11.0 per cent with immediate effect.

The Governor said that in view of the prevailing easy liquidity conditions as reflected in the large outstandings of repos equivalent of Rs.8,529 crore as on April 27, 1998, he was not announcing a further cut in cash reserve ratio (CRR) at this point of time. He, however, assured the bankers that a change in CRR would be announced in case market conditions so warrant. All other credit measures will continue as before.

(Alpana Killawala)
General Manager

Press Release : 1997-98/1021