

October 30, 1998

Mid-Term Review of Monetary and Credit Policy for 1998-99

Dr. Bimal Jalan, Governor, Reserve Bank of India, today announced "Mid-Term Review of Monetary and Credit Policy for 1998-99" covering a mid-term review of macro-economic and monetary developments in 1998-99 besides setting out the stance of monetary policy for the second half of 1998-99. He also outlined measures to carry forward the monetary and financial sector reforms.

As announced earlier, in April 1998, no changes have been made in short-term measures like the Bank Rate, cash reserve ratio and Repo rate as part of this policy. These measures will, however, continue to be subject to change at short notice in the light of actual domestic and external sector developments.

Domestic Developments

At present, there is some uncertainty about the extent of likely increase in agricultural production during the year as some parts of the country have been affected by floods and late rains. Taking this factor into account, a rate of growth of 3 per cent in agricultural production over the depressed level of 1997-98 seems a reasonable estimate at this point of time, pending further confirmation about the effect of late rains. As regards industrial growth, although there are some incipient signs of recovery, it is not yet clear whether the rate of growth in industrial output will be substantially higher than last year's growth of 6.5 per cent. Allowing for the turnaround in agriculture and some recovery in industrial production, at present the best estimate for GDP growth for 1998-99 is the region of 6 per cent (as compared with 5.1 per cent in 1997-98). In view of the global slow-down in economic activity, this order of growth will place India as one of the very few countries, developed or developing, which will show a relatively high positive rate of growth during the current year.

The Governor mentioned that the rate of inflation, currently ruling at over 8 per cent, was significantly higher. So far the increase in the rate of inflation is concentrated in a few primary commodities, particularly fruits and vegetables and edible oils. Expressing the hope that with the arrival of the new crop and the beginning of the period of seasonal decline in prices, the annual rate of inflation could decelerate in the next few months, he added that recent trends in inflation were a matter of concern, and there could be no room for complacency.

The Governor mentioned that the higher rate of growth of 10.1 per cent in money supply (M3) during the current financial year upto October 9, 1998 as compared with 7.3 per cent in the corresponding period of the previous year was partly due to inflows of receipts on account of Resurgent India Bonds (RIBs). The strong growth in money supply was reflective of the sharp increase in aggregate deposits in particular time deposits of scheduled commercial banks.

There was a substantial increase in food credit extended by scheduled commercial banks. Food credit has expanded by Rs.3,464 crore (upto October 9, 1998) as against Rs.1,455 crore in the corresponding period of last year, reflecting in part the increase in food procurement operations and the build-up of buffer stocks of foodgrains. Non-food credit has also shown a substantial increase during the current year. Most of the increase has taken place in the last two fortnights (upto October 9, 1998). The increase in non-food credit to the commercial sector by scheduled commercial banks was of the order of Rs.6,972 crore (2.2 per cent) in the current financial year upto October 9, 1998 as against Rs.4,686 crore (1.7 per cent) in the corresponding period of last year. The total resources

flow to commercial sector including banks' investments in shares and debentures, capital issues, borrowings from financial institutions, etc., have shown a sharper increase. Scheduled commercial banks' investments in commercial paper, shares, debentures, etc., increased by Rs.8,787 crore in the current financial year so far as compared with Rs.8,506 crore in the comparable period of last year. Together with such investments, the total flow of resources from the scheduled commercial banks to the commercial sector went up by Rs.15,759 crore (4.6 per cent) compared with Rs.13,192 crore (4.5 per cent) in the corresponding period of 1997-98. The total resources flow to commercial sector including capital issues, GDRs and borrowings from financial institutions was much higher at Rs.41,792 crore upto October 9, 1998 as against Rs.34,645 crore in the corresponding period of last year.

The Governor mentioned that gross market borrowing requirement of the Central Government estimated for 1998-99 accounted for a substantial portion of the incremental deposits in the banking system. In order to minimise the impact of such high borrowing requirements on the interest rate outlook, Governor recalled the Reserve Bank's indication on June 11, that it will take private placements and then release securities to the market gradually and he added that this approach has worked reasonable well. A major part of the market borrowing was completed by October 29, 1998 with only a modest increase in the yields of medium to long-term securities. Governor welcomed Government's firm intention to contain the fiscal deficit and its borrowing requirements, to the levels announced in the Budget for 1998-99, and stressed that significant reduction in fiscal deficit over the next 2-3 years should be a high national priority.

External Developments

The period since the April monetary and credit policy was announced has presented major challenges for management of the external sector. The East Asian economic crisis, which appeared to be coming under control during the earlier part of the year, continues to remain serious. The contagion spread to Russia in August and could affect some Latin American countries as well. The economic outlook in Japan appears uncertain. Equity, bond and forex markets in the united States and Europe has also been affected. Although there has been some upward movement in global stock markets in the past fortnight, the world economy, as whole, continues to be faced with considerable uncertainty. In addition to the unfavourable external situation, India was also confronted with certain other developments after the Pokhran test. Among these developments were the economic sanctions imposed by certain industrial countries, the suspension of fresh multilateral lending (except for some sectors), the downgrade by rating agencies, and the reduction in net investment of foreign institutional investors.

Viewed against the above background, developments in respect of India's foreign exchange market have been orderly and generally satisfactory. A major positive development has been the success of the Resurgent India Bonds (RIBs) floated by the State Bank of India. Foreign currency resources amounting to US \$ 4.2 billion were raised under the RIB scheme. India's present foreign currency assets are higher than at the beginning of January 1998 in both gross and net terms (i.e., after excluding forward liabilities). Considering the unfavourable international environment, this is a matter of some satisfaction. The level of reserves also substantially exceeds the total stock of short-term debt and portfolio flows. As a matter of cautious policy, India has kept its short-term as well as forward liabilities at a low level in relation to the size of its reserves.

Governor drew attention to the reduction in interest rates on export credit and to the corresponding reduction in refinance rate. This concession is effective upto end-March 1999. On June 11, 1998, the Reserve Bank had advised banks to charge a spread of not more than 1.5 percentage points over LIBOR on foreign currency loans (as against 2.0/2.5 percentage points over LIBOR prior to this date). Such foreign currency loans can be

serviced out of foreign currency export receipts. Exporters are advised to make maximum use of this facility. Banks are also requested to make this facility easily accessible without any procedural hassles.

In order to create an exporter-friendly environment, the Reserve Bank will be setting up a Working Group of bankers to study the procedures and working of the credit delivery system for exports including those in respect of foreign currency loans and to make suggestions for reducing the repetitive documentation requirements and to improve the quality of non-fund based services to exporters. The objective would be to make available export credit “on line”, including foreign currency loans mentioned above, on the basis of performance with minimum paper work, and provide related services efficiently. The Working Group will also review the operation of the EEFC scheme with a view to removing procedural problems.

Stance of Monetary Policy for October 1998 – March 1999

Dwelling on the stance of monetary policy for the second half of 1998-99 the Governor said that at the present juncture RBI faced a monetary policy dilemma as reflected in the need to reduce monetary expansion while at the same time nurturing real growth. While a case could be made out for monetary tightening at the present juncture, in view of high growth in money supply, he felt that nothing should be done to dampen emerging signs of incipient recovery in the real sector. For the time being, there will be no change in the CRR or interest rates. RBI will continue to manage liquidity through Open Market Operations and repo operations and with the policy of flexible use of interest rate instruments to signal its stance.

Monetary and Financial Sector Reforms

Drawing attention to the strength of the banking sector, the Governor mentioned that as a part of economic reforms, since the early nineties, the capital adequacy and other prudential norms of banks have been strengthened and currently are close to the international standards. The quality and standards of supervision have also been upgraded substantially under the direction of a separate Board for Financial Supervision under the aegis of the Reserve Bank of India. Barring the performance of a selected few weak banks, whose problems are being addressed separately, the improvement in the banking sector as a whole is impressive. In terms of inherent robustness, it is well recognised that the Indian banking system’s exposure to real estate or shares is negligible, while open foreign currency exposure limits are severely restricted. Their off-balance sheet liabilities are also very small due to regulatory restrictions and a relatively large part of banking system’s assets are in secure investments particularly in Government and approved securities. These features of the Indian banking system are important strengths and contribute to their long-term financial viability.

(i) Narasimham Committee II

In consultation with the Government of India, the Reserve Bank has finalised its views on a large number of specific recommendations made by the Committee. In implementing the recommendations, the Reserve Banks recognised the immediate resource management problems of banks and, therefore, decided to phase them over a period of time. Some of the important decisions are as follows:

- The minimum capital to risk asset ratio is being raised from the existing 8 per cent to 9 per cent from the year ending March 31, 2000.
- Income recognition and provisioning norms on Government guaranteed advances are being brought on par with those on other advances from 2000-

2001.

- Investments in Central/State Government securities or in securities guaranteed by them have hitherto been assigned zero risk weight. Provisioning requirements are being introduced for standard assets from March 31, 2000, and the time frame for categorising an advance as doubtful debt is being shortened with the provisioning norms to be achieved in two phases during 2000-2001 and 2001-2002.
- With effect from the year ending March 31, 2000, Government/approved securities will carry a risk weight of 2.5 per cent. An additional risk weight of 20 per cent on investments in the government guaranteed securities of Government undertakings which do not form part of the market borrowing programme is being introduced with effect from the financial year 2000-2001. In respect of the outstanding stock of such securities in the portfolio as on March 31, 2000, banks will implement this decision in two phases of 10 per cent each in 2001-2002 and 2002-2003.
- The risk weight for Government guaranteed advances which go into default is being introduced from March 31, 2000.
- Foreign exchange open positions will carry 100 per cent risk weight with effect from March 31, 1999.

In implementing the recommendations of the Narasimham Committee, care has been taken to phase them in a manner that reduces the risk exposures of banks, strengthens financial soundness and contributes to improved profitability outlook.

(i) **Risk Weights and Exposure Norms on Securities of Public Financial Institutions**

While investments in bonds/securities of some of the Public Financial Institutions (PFIs) carry zero risk weight due to their status as 'Approved Securities' under the special statutes governing them, investments in bonds/debentures of certain other PFIs carry 100 per cent risk weight as the relevant Act/Statute does not confer the status of an 'Approved Security'. With a view to removing this anomaly, risk weights on investments in bonds/debentures of PFIs as defined under Section 4A of the Companies Act, 1956 (and certain other FIs notified by RBI) are being given a uniform risk weight of 20 per cent.

- It has also been decided that henceforth investments by banks in bonds or debentures of a corporate guaranteed by a PFI will be treated as an exposure by banks on the PFI and not on the corporate as is the practice at present. Consequently, for the purpose of calculation of exposure norms, the exposure of the bank on the PFI guaranteeing the bond or debenture issued by corporates will be 100 per cent, whereas the exposure by the PFI on the corporate will be to the extent of 50 per cent.
- In case of advances guaranteed by the Government, non payment of guaranteed amount or a default in interest/principal would now attract risk weights.

(iii) **Payment and Settlement System**

In order to bring about operational efficiency, speed, better accuracy and timeliness of payment transactions as also to contain financial risk in the national payments system, the Reserve Bank has gone in for a reliable communication backbone through the establishment of VSAT- network which will be expanded in phases and over time, to encompass the entire financial sector. This network would also help to design a strategy to move towards real time gross settlement (RTGS) system. The Reserve Bank has already instituted a Payment System Group (PSG) and a VSAT user Group to deal with issues

relating to RTGS system. The Reserve Bank will take major initiatives under the guidance of a high level National Payments Council which will be set up soon.

Money Market

The RBI took a view on some specific suggestions by the Narasimham Committee II relating to money market.

- The Reserve Bank concurs, in principle, with the Committee that the call/notice money market and term money market should be strictly restricted to banks and primary dealers and aims to ultimately move towards a pure inter-bank market including primary dealers. This will be implemented in a manner that the existing lenders in the market will have operational flexibility to adjust their asset-liability structure. Simultaneously, measures will be taken to widen the repo market and improve non-bank participation in a variety of their instruments.
- The RBI also agrees with the Committee's suggestion that there must be clearly defined prudent limits for banks' reliance on the money market.
- The RBI broadly agrees with the Committee's suggestion that the RBI support to the market should be through a Liquidity Adjustment Facility (LAF). It has been decided to initiate actions that will enable, in due course, to replace the present general refinance facility with LAF. Collateralised intra-day/over-night facility with adequate margin is also being considered to facilitate smooth operation of payment and settlement system.

Minimum period for Repo withdrawn

It has been decided to withdraw the restriction of the minimum period of 3 days for inter-bank ready-forward (repo) transactions effective from October 31, 1998.

Interest Rate Swaps to be introduced

With a view to enabling money market participants to hedge against interest rate risk arising out of asset-liability mismatches, it has been decided, in principle, to create an environment that would facilitate introduction of interest rate swaps. RBI will examine, in consultation with market participants, relevant aspects such as standard documentation, the back-up by underlying transactions between parties, the bench-mark rate and maturity, and prudential prescriptions before allowing the product in the market.

Government Securities Market

The Government securities market constitutes the principal segment of the debt market and serves as the benchmark for pricing corporate papers of varying maturities. It is proposed to introduce a uniform price auction method in respect of 91 day Treasury Bill auctions. Besides, the following recent initiatives for developing the Government securities market are required to be implemented.

- The move towards repeal of the Public Debt Act, 1944 and its replacement by the Government Securities Act.
- The proposed changes in the Securities Contracts (Regulation) Act, 1956 which will pave way for a more active repos market and introduction of new market features like when issued trading.

Regulation of Non-banking Financial Companies (NBFCs)

Pursuant to the amendment to the Reserve Bank of India Act 1934 by Parliament, RBI had instituted a comprehensive regulatory framework for NBFCs in January 1998. The Governor mentioned that the appropriate regulation of NBFCs is a complex task in view of the large number of NBFCs which are spread all over the country. The appropriate regulation of NBFCs is a complex task in view of the large number of NBFCs which are spread all over the country. NBFCs perform an important financing role in the economy particularly in respect of small scale and decentralised sector and provide important employment and entrepreneurial opportunities at the ground level. However, prevalence of unethical financial practices as well as lack of transparency in operations have also been marked in the case of some sections of the NBFC sector. These have resulted in widespread complaints from depositors about their functioning. Taking into account both the positive as well as the negative aspects of the NBFC sector, RBI and Government have been open to suggestions and advice from experts and market participants to further refine the regulatory framework for NBFCs, develop self-regulatory mechanism for smaller NBFCs, and improve operational effectiveness.

The Government had set up a Task Force to make further recommendations for effective regulation of the NBFC sector. The proposals of the Task Force are now under consideration of the Government and RBI will make appropriate changes in the regulatory framework as soon as decisions of the Government, including any legislative changes that may be required to give effect to Task Force recommendations become available. Until then, NBFCs are advised to strictly adhere to the current regulations in force. An investors' information programme is also being carried out by RBI to ensure that investors are fully aware of the prescribed ceiling on interest rates, disclosure requirements, unsecured nature of deposits and other features of NBFC operations.

Discussion Paper on Operations Of banks and Financial Institutions

In order to deliberate on issues relating to harmonising the operations of banks and financial institutions, the Reserve Bank of India (RBI) had, in December 1997, set up a Working Group comprising Chairmen of some commercial banks and development financial institutions under the Chairmanship of Shri S.H.Khan, the then Chairman of the Industrial Development Bank of India. The Group submitted its full report in May, 1998. As announced in the April Monetary and Credit Policy Statement, a "Discussion Paper" is under preparation, which would contain Reserve Bank's views on the Working Group's recommendations/suggestions. This paper will be circulated for discussion shortly. The final decision on the issues raised in this paper will be taken in the light of the suggestions/comments received on it.

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