Press Release

October 26, 2004

RBI Governor announces Mid-term Review of Annual Policy Statement for the year 2004-05

Highlights

The statement follows the pattern already set in the previous years both in outline and substance.

Domestic Developments

- GDP growth projection for 2004-05 placed in the range of 6.0-6.5 percent as against the earlier expectation of 6.5-7.0 per cent.
- Annual inflation, as measured by point-to-point variations in the wholesale price index, rose from 4.6 per cent at end-March to 8.3 per cent in end-August but has since come down to 7.1 per cent by October 9, 2004.
- The point-to-point inflation rate based on WPI for the year 2004-05 is projected at around 6.5 per cent for policy purposes as against of 5.0 per cent projected earlier.
- Money supply (M_3) growth in this fiscal year (up to October 1, 2004) lower at 5.4 per cent as compared with 7.8 per cent in the previous year.
- Projected expansion of money supply (M_3) for 2004-05 retained at 14.0 per cent.
- A robust increase in non-food credit by 11.5 per cent in this fiscal year (up to October 1, 2004) as compared with an increase of 6.0 per cent in the previous year.
- The Central Government has completed gross market borrowings of Rs.75,044 crore in the fiscal year (up to October 21, 2004), which is 49.8 per cent of the budgetary amount.
- The Central Government has completed net market borrowings of 29.0 per cent of the budgeted amount up to October 21, 2004.
- The market borrowing programme in the remaining part of the year needs to be calibrated carefully in view of strong credit demand.
- Financial markets have remained generally stable though the government securities market tended to show some nervousness in recent months.
- The market interest rates have displayed some upward movement, particularly at the longer end.

- Banks advised to prepare themselves to implement the capital charge for market risk as envisaged under Basel II norms in a phased manner by end-March 2006.

External Developments

- Although global economic recovery is gaining strength, there is some increase in downside risk primarily on account of persistence of uptrend in global oil prices.
- The exchange rate of the rupee depreciated vis-à-vis US dollar, Euro, Pound sterling and Japanese yen by October 21, 2004.
- Foreign exchange reserves increased by US $ 7.6 billion from US $ 113.0 billion at end-March 2004 to US $ 120.6 billion as on October 21, 2004.
- India's exports during April-September 2004 increased by 24.4 per cent in US dollar terms, while imports rose faster by 34.3 per cent. The higher trade deficit reflects high oil imports bill as also the growth in overall import demand.
- The current account remained in surplus consecutively over the past three years, the current account in the first quarter of 2004-05 also posting a surplus of US $ 1.9 billion.

Overall Assessment

- The pick-up in investment activity and significant growth in non-food credit appear to be broad based and are not temporary phenomena.
- As the magnitude and persistence of supply shock was partly unanticipated, demand management seems to invite closer attention, particularly for stabilising inflationary expectations in a credible manner.
- While the Reserve Bank will continue to pursue stability, the markets should be prepared for the uncertainties.
- Challenges for the rest of the year would broadly remain the same as in the first half of the year with equal weight being given to maintaining growth momentum and stabilizing inflationary expectations.

Stance of Monetary Policy

- The overall stance of monetary policy for 2004-05 will be provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy, while placing equal emphasis on price stability.
- RBI to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth.
- RBI to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

Financial Sector Reforms and Monetary Policy Measures

- Bank Rate kept unchanged at 6.0 per cent.
- Repo Rate increased by 25 basis points to 4.75 per cent.
- Revised Liquidity Adjustment Facility to operate with overnight fixed rate repo and reverse repo.
- Ceiling on Interest Rates on NRE Deposits raised by 50 basis points over US dollar LIBOR/SWAP rates of corresponding maturities.
- Banks may fix the ceiling on interest rates on FCNR(B) deposits on monthly basis.
- Minimum tenor of retail domestic term deposits reduced to 7 days.
- Limit on advances under priority sector enhanced for improving credit delivery to the agriculture sector.
- Restrictive provisions of service area approach to be dispensed with except for government sponsored programme.
- Banks to increase their disbursements to small and marginal farmers under special agricultural credit plans (SACP) by March 2007.
- Private sector banks are urged to formulate SACPs from the year 2005-06, targeting an annual growth rate of at least 20-25 per cent.
- Composite loan limit for SSI entrepreneurs enhanced from Rs.50 lakh to Rs.1 crore.
- Investment by banks in securitised assets pertaining to SSI sector be treated under priority sector.
- Banks may now extend direct finance to housing sector up to Rs.15 lakh under priority sector lending.
- Banks may finance distressed urban poor to prepay their debt to non-institutional lenders.
- IBA to look into the suggestions made by NCAER for the Kisan Credit Card scheme and take remedial action.
- RIDF X has been established with a corpus of Rs.8,000 crore (as announced in the Union Budget for 2004-05).
- Report of the Special Group on Debt Restructuring Mechanism for Medium Enterprises be placed in public domain.

- RBI has constituted Empowered Committees to focus on operational issues related to better functioning of Regional Rural Banks and to provide clarifications on regulatory issues.

- Report of the Task Force for reviving the rural co-operative banking institutions is expected shortly.

- Banks are urged to keep up the momentum of lending to agriculture.

- Bank finance to NBFCs for second hand assets.

- Many banks announced gold card scheme for exporters.

- Report of Working Group on Credit Enhancement by State Governments is expected shortly.

- Further move towards pure inter-bank call/notice money market.

- The minimum maturity period of CP is reduced to 7 days.

- IPAs to report issuance of CP on the NDS platform by the end of the day.

- Group to suggest rationalisation and standardisation of processing, settlement and documentation of CP issuance.

- Automated value-free transfer of securities between market participants and the CCIL facilitated.

- The Report of the Group on Negotiated Dealing System (NDS) is being placed in the public domain.

- Capital Indexed Bonds to be introduced during the year 2005-06 in consultation with the Government.

- The Report of the Working Group on Primary Dealers to be placed before the TAC.

- Settlement of OTC Derivatives through CCIL expected to be operationalised by March 2005.

- Group on Corporate Debt is expected to submit its Report in January 2005.

- The ceiling on MSS raised from Rs.60,000 to Rs.80,000 crore.

- A study Group to be constituted for strengthening OMO framework.

- Guarantee by ADs for trade credit liberalised.

- Time limit for export realisation relaxed for EOUs.
- Booking of forward contracts by exporters/importers relaxed.
- An internal Group on forex market constituted.
- RBI to undertake fresh survey on impact of trade related measures.
- RBI would prepare draft guidelines for implementation of Basel II norms and place them in the public domain.
- A second Draft Guidelines on Ownership and Governance will be put in public domain soon.
- Necessary instructions on "Fit and Proper" criteria issued to private sector banks.
- All cases of penalty imposed by RBI as also strictures/directions arising out of inspection will be placed in the public domain.
- Temporary risk containment measures prescribed on housing and consumer loans.
- Banks to comply with prudential guidelines on non-SLR securities.
- Prudential norms for classification of doubtful assets for FIs announced.
- Approaches for supervision of DFIs and large NBFCs proposed.
- Dissemination of credit information by CIBIL for improving asset quality of banks.
- To constitute a Working Group on conflicts of interest in the Indian financial services sector.
- A vision document for the future role of UCBs is being evolved.
- The Standing Advisory Committee on UCBs chaired by Deputy Governor, RBI would meet on a quarterly basis in future.
- Detailed guidelines on road map for RNBCs would be issued.
- Non-banking Finance Companies encouraged to consider phasing out their public deposits consistent with international practice.
- Enhancement of Capital Base for Asset Reconstruction Companies to 15 per cent of assets acquired or Rs. 100 crore, whichever is less.

- The Report of the Technical Group on Refinancing Institutions is expected by December 2004.

- The first lot of the data series under CDBMS to be released on November 1, 2004.

- The draft vision document on Payment and Settlement System be placed in the public domain for feedback and discussions.

- The draft regulation to set up the Board for Payment and Settlement Systems submitted to the Government for notification in the Gazette.

- The national settlement system is expected to be operationalised in early 2005.

- To constitute a Working Group on risk mitigation for Indian retail payment system to submit its Report by November 2004.

- Existing per transaction limits for ECS and EFT being dispensed with effective November 1, 2004.

- Working Group for regulatory mechanism for cards to be constituted.

- CBDT to grant refunds up to Rs.25,000 through Electronic Clearing System (ECS) facility at select centres.

- A High Powered Committee constituted for streamlining the systems and procedures for transmission of data on excise duty and service tax.

- A revised draft report on International Financial Standards and Codes is being placed in the public domain.

RBI Governor announces Mid-term Review of Annual Policy Statement for the year 2004-05

Dr. Y. Venugopal Reddy, Governor, in a meeting with Chief Executives of major commercial banks today presented the Mid-term Review of Annual Policy Statement for 2004-05. At the outset, Governor explained that the intention of policy documents is to capture the rationale of monetary, structural and prudential measures introduced by the Reserve Bank from time to time. In the process, the approach of greater transparency and better communication contributes towards an effective consultation process in policy making. Governor mentioned that the Statement follows the pattern already set in the previous years.

Domestic Developments

GDP Growth in 2004-05

Taking into account the deficient monsoon in 13 out of 36 metrological subdivisions and its possible impact on kharif output, improved prospects for growth in industrial output and continued buoyancy in exports *vis-à-vis* the likely adverse impact of higher oil prices on GDP growth, it may be reasonable to place the overall GDP growth for the year 2004-05 in the range of 6.0-6.5 per cent as against the earlier expectation of 6.5-7.0 per cent assuming that the combined downward risk of high and uncertain oil price and sudden change in international liquidity environment remain manageable.

Non-food Credit

Governor observed a robust increase in non-food credit by 11.5 per cent (Rs. 92,443 crore) up to October 1, 2004 as compared with an increase of 6.0 per cent (Rs. 41,034 crore) in the corresponding period of the previous year. The total flow of resources to the commercial sector from banks and FIs increased substantially by Rs.1,08,510 crore as compared with Rs.66,863 crore in the corresponding period of the previous year. Detailed information on sectoral deployment of credit reveals that over two-thirds of the credit flows has been on account of retail, housing and other priority sector loans. Also, a discernible increase of industrial credit was observed in respect of petroleum, infrastructure, electricity, construction, metal & metal products, drug & pharmaceuticals, gems & jewellery and automobiles industries.

Monetary Indicators

Referring to monetary indicators, Governor said that money supply during the current financial year (up to October 1, 2004) increased by 5.4 per cent as compared with 7.8 per cent in the previous year. On an annual basis, the growth in M_3 at 14.0 per cent was, however, higher than 11.9 per cent in the previous year. Aggregate deposit of commercial bank registered a lower growth mainly due to reduction on non-resident Indian (NRI) deposits with the banking system. The reserve money increased by 0.6 per cent in the current financial year up to October 15, 2004 as compared with an increase of 0.9 per cent in the corresponding period of the previous year.

Inflation Rate

Annual inflation, as measured by variations in the wholesale price index (WPI) on a point-to-point basis, rose from 4.6 per cent at end-March to 7.1 per cent by October 9, 2004. On an average basis, annual inflation based on WPI was 6.2 per cent as on October 9, 2004 as compared with 4.9 per cent a year ago. Governor explained that excluding four items viz., iron ore, iron and steel, mineral oils and coal mining which registered relatively high inflation rate, the WPI inflation rate works out to 4.2 per cent as on October 9, 2004, on a point-to-point basis, as against 3.8 per cent in the previous year. Governor pointed out that the impact of higher international oil prices so far has been partly cushioned by fiscal measures such as cuts in excise and customs duties. On current assessment, assuming that there would be no further major supply shock and liquidity conditions remain manageable, Governor felt that the point-to-point year-end inflation based on WPI for the year 2004-05 could be placed around 6.5 per cent instead of 5.0 per cent projected earlier. Governor, however, pointed out that the CPI inflation has been lower than the WPI inflation in the recent past reflecting difference in coverage and lower increase in prices of food items. He observed that a similar discrepancy has been observed between producer price indices and consumer price indices for most countries except for countries in the euro area.

Government Borrowings

The Central Government has completed net market borrowings of Rs.26,233 crore (29.0 per cent of the budgeted amount) and gross market borrowings of Rs.75,044 crore (49.8 per cent of the budgeted amount) up to October 21, 2004. The weighted average yield on government borrowings through dated securities at 5.76 per cent this year so far (up to October 21, 2004) has been lower than 5.90 per cent last year. The lower cost of government borrowings so far this year could be attributed to lower volume of first half borrowings than usual on account of carry forward of surplus cash balance of Rs.26,669 crore at end-March 2004 into this year and proportionately higher subscription emanated from market participants other than the traditional source of banks. Keeping in view larger than usual borrowing slated for the second half of the year, the market borrowing programme in the remainder of the year needs to be calibrated carefully in view of strong credit demand. It is, therefore, critical to ensure that there is no slippage in fiscal deficit. Governor expressed his concern over the persistence of large aggregate borrowing of the Central and state governments, while indicating the positive developments in terms of enactment of fiscal responsibility legislation by five states and the framing of the Fiscal Responsibility and Budget Management (FRBM) Rules by the Centre, effective July 5, 2004 for fiscal consolidation.

Banks' Investments

Scheduled commercial banks' excess investment in SLR securities at Rs.2,67,328 crore constituted 16.3 per cent of net demand and time liabilities (NDTL). However, during the current year, scheduled commercial banks' investment in government and other approved securities at Rs.27,435 crore (up to October 1, 2004) was lower than Rs.76,705 crore in the corresponding period of the previous year partly on account of pick-up in credit demand. Even then, with effective SLR investment at 39.7 per cent, lower appetite for SLR securities against expected credit pick-up has implications for government borrowings in an environment of market determined interest rates.

Market Stabilisation Scheme

During 2004-05, liquidity absorption through MSS was Rs.54,146 crore up to October 21, 2004. With the issuance of MSS, the repo volumes tendered under liquidity adjustment facility declined from an average of Rs.70,523 crore in April to Rs.13,805 crore in October 2004 (up to October 21). The liquidity that remained sterilised declined from an average of about Rs.81,260 crore in April to Rs.67,321 crore in October (up to October 21). In addition to MSS and repo, surplus balances in the Central Government account with the Reserve Bank also helped in sterilising excess liquidity from time to time. Notwithstanding some decline in surplus liquidity during the year, the overhang of liquidity continues to remain substantial.

Interest Rate

Governor observed that financial markets have remained generally stable though interest rates have displayed some upward movement, particularly at the longer end. He indicated that commercial banks have announced their benchmark prime lending rates (BPLRs) as advised by the Indian Banks' Association (IBA). He pointed out that representative (median) lending rates on demand and term loans (at which maximum business is contracted) of public sector banks was 10.50-12.75 per cent in June 2004. While emphasising the need for continuing to build up Investment Fluctuation Reserve (IFR), pending a review of existing guidelines on banks’ investment portfolio, Governor explained that RBI allowed banks to exceed the ceiling of 25 per cent of investments included under HTM category by shifting some of their investments in SLR securities from the HFT/AFS categories to HTM category at the lowest of the acquisition cost or prevailing market value or book value, subject to a maximum of 25 per cent SLR securities to be held in HTM. Governor indicated that banks were advised to prepare themselves to implement the capital charge for market risk as envisaged under Basel II norms in a phased manner by end-March 2006.

External Developments

Global Economic Prospects

Governor indicated that though the global recovery is gaining strength, some risks have increased, primarily on account of persistence of uptrend in global oil prices, with a disproportionately larger burden on oil importing emerging markets like India given the increasing oil intensity and lower energy efficiency. Under these circumstances coupled with ongoing growth rebound, some central banks hiked their policy rates, while some other central banks reduced them. Overall, therefore, the choice of a specific interest rate stance by a country/region seems to have been largely guided by its own domestic economic considerations. Another major downside risk facing the global economy continues to emanate from global imbalances and the associated possibility of disruptive currency adjustments and persistent structural problems in the euro area and Japan.

Forex Market Remains Stable

The Indian forex market generally witnessed orderly conditions during the current financial year so far (April-October 2004). The exchange rate of the rupee, which was

Rs.43.39 per US dollar at end-March 2004, depreciated by 5.2 per cent to Rs.45.77 per US dollar by October 21, 2004. It also depreciated by 7.9 per cent against Euro, by 4.3 per cent against Pound sterling and by 1.9 per cent against Japanese yen during the period.

Reserve Increases

Foreign exchange reserves increased by US $ 7.6 billion from US $ 113.0 billion at end-March 2004 to US $ 120.6 billion as on October 21, 2004. Governor indicated that the overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of the balance of payments (BoP), and has endeavoured to reflect the 'liquidity risks' associated with different types of flows and other requirements. Taking these factors into account, India's foreign exchange reserves are at present comfortable and consistent with the rate of growth, the share of the external sector in the economy and the size of risk-adjusted capital flows. In view of the level of comfort provided by the international financial architecture, apart from considering reserves as an insurance against volatility in capital flows, there is need to provide cushions against shocks arising from uncertain monsoon conditions in the real sector, variations in global oil prices in the external sector and high levels of public debt in the fiscal arena. There is considerable merit in taking a national balance sheet approach to the external sector and to provide cushions through official reserves in response to increasing external liabilities on account of the private sector. Further, it is useful to recognise the comfort and the confidence provided to the investors by the level of reserves in the context of volatility in capital flows.

Referring to the recent debate in the media on the need for exchange rate adjustment, Governor explained that in a scenario of uncertainty facing the authorities in determining temporary or permanent nature of inflows, it is prudent to presume that such flows are temporary till such time that they are firmly established as of a permanent nature.

Balance of Payments

India's exports during April-September 2004 increased by 24.4 per cent in US dollar terms as compared with 8.1 per cent in the corresponding period of the previous year. Imports rose faster by 34.3 per cent as against an increase of 21.0 per cent in the corresponding period of last year. Oil imports increased by 57.8 per cent as compared with 6.4 per cent, while non-oil imports increased by 25.8 per cent as against 27.4 per cent. The overall trade deficit widened to US $ 12.7 billion from US $ 7.4 billion in the corresponding period of the previous year. The higher trade deficit this year, in substantial part, reflects the high oil imports bill in the wake of the hardening of international prices and also the growth in import demand emanating from a pick-up in economic activity as reflected in higher capital goods imports.

Governor pointed out that the current account of the BoP had remained in surplus consecutively over the past three years. The first quarter of 2004-05 also posted a current account surplus of US $ 1.9 billion. The net accretion to foreign exchange reserves, excluding valuation effects, amounted to US $ 7.5 billion during April-June 2004. During the second quarter of 2004-05, however, there are indications that the continuing uptrend in imports may result in the current account being only marginally in surplus assuming continued robust growth of merchandise exports and invisible earnings. Net capital inflows have moderated from the level recorded in the first quarter. While it is difficult to anticipate the behaviour of capital flows in the wake of the global geopolitical uncertainties, the positive sentiment on India should augur well for continued buoyancy, but some moderation should not be ruled out in view of turning of the global interest rate cycle.

Overall Assessment

Governor observed that a striking development during the year relates to growth of non-food credit in the first half, which is traditionally a slack season for credit off-take. A review of developments so far in the current year confirms that there has been a revival of investment activity. To the extent manufacturing industry is showing signs of robust growth, he felt that the credit needs will witness higher growth than that in the past. As a result of the current policy thrust, credit to agriculture is also picking up from its low base and could initiate greater credit penetration by displacing non-institutional lenders. The fast growing housing and consumer credit sectors also represent some degree of higher penetration, but the quality of lending needs to be ensured. Overall, the pick-up in investment activity and growth in non-food credit appear to be broad based and are not temporary phenomena. These favourable outcomes point to the need for enabling liquidity conditions and a continued thrust on credit delivery to the productive sectors of the economy.

Governor pointed out that the initiation of accelerated growth in manufacturing industry amidst global competitive pressures is a positive development and needs to be supported by policy to ensure its momentum.

Governor stated that although a supply shock emanated out of global developments, mainly on account of oil and a few other key commodities like iron & steel were anticipated, its magnitude and persistence were not. As the full impact of oil price increases is yet to be absorbed in domestic prices, the supply factors will continue to dominate the price situation, while demand management seems to invite closer attention than before, particularly for stabilising inflationary expectations in a credible manner.

Governor indicated that various segments of financial markets have, by and large, exhibited stability. The government securities market showed some nervousness as well as bearish sentiments. This was attributed to several inter-related issues such as (a) the market was in need of correction from excessive optimism, (b) there was an unexpected surge in inflation, (c) the sharp increase in non-food credit has also put some pressure on expectations, and (d) the global environment has tended towards some hardening of interest rates in recent months. Despite RBI inviting attention to these issues in the annual policy Statement, some market participants appear to have been less than fully prepared as the events unfolded. In this context, he emphasized that while the Reserve Bank will continue to give some weight to consideration of stability, the markets should be prepared for the uncertainties.

Governor indicated that the conduct of monetary policy, in the best of times, is complex since it has to be forward looking and based on current and sometimes outdated data relative to rapid changes. Additional complexities arise in the case of an emerging market, which is transiting from a closed to a progressively open economy. Currently, the combination of factors that complicate monetary management includes: globally transmitted supply shock; less than normal monsoon conditions; persistence of liquidity overhang; and long-awaited pick-up in non-food credit. The policy has been responding to the evolving circumstances based on analysis and some judgements. First, there was a widespread expectation of further progress in soft bias in interest rate regime in November 2003, when a view was taken that the interest rate cycle had reached the bottom. Second, a judgement had to be made on capital flows in the early part of the current calendar year as to what part of the capital inflows should be treated as temporary. In this regard, he pointed out the fact that international financial markets react asymmetrically to the same magnitude of growth in forex reserves (positively) and to the depletion in forex reserves (very negatively) cannot be lost sight of. Third, empirical evidence indicates that the perceptions of the financial markets in the context of changes in political executives in the Government cannot be ignored while monitoring developments. Fourth, when some central banks start moving from easy to more neutral policy and hike policy interest rates, there is an inevitable impact on Indian financial markets. In response to these developments, decisions have to be made on an ongoing basis, about the weight to be given to stability in financial markets relative to the possible costs of not altering the approaches. Fifth, when faced with a severe oil-shock, the first of its kind in the liberalised market-oriented environment in a semi-open economy, the governing thought in making judgements is the harmonisation of the communications and policy responses of RBI along with corresponding fiscal and corporate initiatives. Thus, the conduct of policy in the first half of the year was characterised by responses to developments on an ongoing and measured basis, giving appropriate weights, contextually, to global and domestic factors, to growth and price stability, to efficiency and financial stability and to over-riding concerns for the common person. Operationally, it is expected that the challenge for the rest of the year would broadly remain the same, viz., management of liquidity in tune with the draining of the overhang, progress of borrowing programme of the Government, the evolving domestic and global situation, especially oil prices and global interest rate environment, but with equal weight to considerations of maintaining growth momentum and stabilising inflationary expectations.

Stance of Monetary Policy for the Second Half of 2004-05

Governor stated that monetary management in the first half of 2004-05 was conducted broadly in conformity with the monetary policy stance announced in the annual policy Statement. However, monetary management faced severe challenges on overhang of liquidity as well as the acceleration in headline WPI inflation beyond the anticipated level with implications for inflationary expectations.

The Reserve Bank sought to manage the liquidity essentially through two instruments, viz., MSS and LAF. As the volumes under MSS rose, the visible liquidity under LAF declined. The reduction of liquidity under LAF helped in stabilising the yield curve at the shorter end. This was evident from the CBLO rates, market repo rates and overnight call money rates inching closer to the LAF repo rate. It was, however, noticed that there was some bunching of liquidity due to the 7-day minimum tenor of LAF repo, which imparted volatility to short-term rates, particularly around the time of primary auctions of government securities. Accordingly, overnight fixed rate repo under LAF was introduced in August to smoothen liquidity flow and contain volatility. While the excess liquidity has come down with the combined effect of a slowdown in capital inflows and better domestic absorption on account of higher credit demand, it still remains substantial at around Rs.67,000 crore as reflected in the combined volume of MSS and LAF.

There has been an understandable impact of the inflation scenario during the current year on the government securities market. As the headline WPI inflation accelerated, government debt market reacted with considerable volatility and an overall downward movement in the gilt prices. However, markets tended to stabilise as the causes of inflation and policy responses became apparent. Consultations with banks and the prudential guidelines on classification of investment portfolio of banks into held to maturity (HTM) category issued in September also helped to reassure the markets.

He further emphasised that the increasing openness of the economy has widened the wedge between WPI and CPI. Similar divergence between price indices at the producers' level and the consumers' level has been noticed for most countries except for countries in the euro area. As between the international and domestic factors, the former continues to be dominant in explaining the increase in WPI. The international factors relate primarily to prices of oil, iron ore, coal mining and iron & steel but also, to some extent, financial markets, including interest rates and exchange rates.

Given the large informal sector and the fact that a vast majority of population is not hedged against inflation, determined efforts are needed to contain inflationary expectations.

Governor explained that subsequent to the announcement of the annual policy Statement, the following calibrated responses were taken: First, the Reserve Bank communicated its assessment of the nature of inflation to the market on several occasions. Second, given the supply induced nature of inflation, the Government responded with fiscal measures, particularly relating to oil. The fiscal actions and some responses from corporates on moderating the exercise of their pricing power were part of the measured but harmonised responses along with monetary policy actions in liquidity management. Third, in order to enable the Reserve Bank to address the overhang of liquidity, the Government raised the ceiling of MSS from Rs.60,000 crore to Rs.80,000 crore. Fourth, for a more flexible management of liquidity, overnight fixed rate repo under LAF was introduced. Fifth, CRR was raised by one-half of one percentage point to 5.0 per cent. Further, the interest rate on eligible CRR balances was delinked from the Bank

Rate and was reduced to 3.5 per cent per annum. Governor assured that Reserve Bank will continue to pursue its medium-term objective of reducing CRR to its statutory minimum of 3.0 per cent. The Reserve Bank chose to increase the CRR, partly for absorbing liquidity in the system, but more importantly for signalling the Bank's concern at the unacceptable levels of inflation so that inflationary expectations are moderated while reiterating the importance of stability in financial market conditions.

Governor set out the major macroeconomic and monetary aggregates for the purpose of monetary management: (i) GDP growth in 2004-05 is placed in the range of 6.0 to 6.5 per cent as against 6.5-7.0 per cent envisaged earlier under certain assumptions; (ii) inflation, on a point-to-point basis, could be around 6.5 per cent as against 5.0 per cent projected earlier; (iii) expansion in M_3 would be around 14.0 per cent as projected earlier; (iv) growth in aggregate deposits would be Rs.2,18,000 crore as projected earlier; and (v) non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., is expected to increase by around 19.0 per cent, higher than 16.0-16.5 per cent projected earlier; the higher credit expansion could be accommodated without putting undue pressure on money supply because of lower borrowing of the Government from the banking sector; in the eventuality of government borrowings being larger, unwinding of MSS would facilitate such borrowings.

Governor summed up that consistent with the developments during the first half of the year, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and keeping in view the inflationary situation, the overall stance of monetary policy for the second half of 2004-05 will be:

- Provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability.
- Consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth.
- To consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

Financial Sector Reforms and Monetary Policy Measures

Governor said that while the emphasis at this stage is on reinforcing corporate governance within financial institutions, the focus is also on enhancing the credit delivery mechanism, facilitating ease of transactions by the common person and continuously working towards consolidating the gains of the financial sector reforms by further broadening the consultative process.

Monetary Measures

(a) Bank Rate ─ Kept unchanged at 6.0 per cent.

(b) Repo Rate

In view of the current macroeconomic and overall monetary conditions, it has been decided:

- To increase the fixed repo rate by 25 basis points under the liquidity adjustment facility (LAF) of the Reserve Bank effective from October 27, 2004 to 4.75 per cent from 4.50 per cent.

The reverse repo rate will continue to be linked to the repo rate, as at present. However, the spread between the repo rate and the reverse repo rate is reduced by 25 basis points from 150 basis points to 125 basis points. Accordingly, the fixed reverse repo rate under LAF will continue to remain at 6.0 per cent.

As already announced, it is proposed to switchover to the international usage of the terms ‘repo’ and ‘reverse repo’ effective October 29, 2004. With such a switchover, the fixed reverse repo rate will be 4.75 per cent and the repo rate will be available with a spread of 125 basis points at 6.0 per cent.

(a) Revised Liquidity Adjustment Facility

With a view to enhancing further the effectiveness of LAF and to facilitate liquidity management in a flexible manner, it is proposed that:

- Liquidity adjustment facility (LAF) scheme would be operated with overnight fixed rate repo and reverse repo with effect from November 1, 2004. Accordingly, auctions of 7-day and 14-day repo (reverse repo by international parlance) would stand discontinued from November 1, 2004.

Interest Rate Policy

(a) Ceiling on Interest Rates on NRE Deposits

With a view to aligning interest rates on Non-Resident (External) Rupee (NRE) deposits with international interest rates, ceiling on NRE deposit rates was linked to the US dollar LIBOR/SWAP rates of corresponding maturities. On a review, it is proposed:

- To raise the ceiling on NRE interest rates to LIBOR/SWAP rates of US dollar of corresponding maturities plus 50 basis points from the existing level of US dollar LIBOR/SWAP rates.

(b) Fixation of Interest Rates on FCNR(B) Deposits

Based on the suggestions received from banks and with a view to bringing in consistency in the procedure of fixing interest rates, it is proposed that:

- Banks may fix the ceiling on interest rates on FCNR(B) deposits on monthly basis for the following month based on rates prevailing as on the last working day of the preceding month. The ceiling interest rates on FCNR(B) deposits, however, would continue to be at LIBOR/SWAP minus 25 basis points as hitherto.

(c) Reduction of Tenor of Domestic Term Deposits

In order to provide uniformity in the tenor of term deposits, it is proposed that:

- Banks, at their discretion, can reduce the minimum tenor of retail domestic term deposits (under Rs.15 lakh) from 15 days to 7 days.

Credit Delivery Mechanism

(a) Service Area Approach: Removal of Restrictive Provisions

With a view to facilitating banks to improve their credit delivery mechanism, it is proposed:

- To dispense with the restrictive provisions of service area approach except for government sponsored programmes.

(b) Priority Sector Lending

(i) Enhanced Lending to Agriculture and Distribution of Inputs

With a view to further improving credit delivery to the agriculture sector, it is proposed:

- To increase the limit on advances under priority sector for dealers in agricultural machinery from Rs. 20 lakh to Rs.30 lakh and for distribution of inputs for allied activities from Rs.25 lakh to Rs.40 lakh.

(ii) Enhanced Lending to Small and Marginal Farmers

In order to improve flow of credit to small and marginal farmers, it is proposed that:

- Banks should make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under special agricultural credit plans (SACP) by March 2007.

(iii) Special Agricultural Credit Plans

In order to enhance flow of credit to agriculture, it is proposed to extend the SACP mechanism to private sector banks. Accordingly:

- All private sector banks are urged to formulate special agricultural credit plans from the year 2005-06, targeting an annual growth rate of at least 20-25 per cent of credit disbursements to agriculture.

(iv) Enhancement of Composite Loan Limit to SSI Units

In order to facilitate smooth flow of credit to SSIs, it is proposed:

- To enhance the composite loan limit for SSI entrepreneurs from Rs.50 lakh to Rs.1 crore.

(v) Investment by Banks in Securitised Assets Pertaining to SSI Sector

In order to encourage securitisation of loans to SSI sector, it is proposed that:

- Investments made by banks in securitised assets representing direct lending to the SSI sector would be treated as their direct lending to SSI sector under priority sector, provided the pooled assets represent loans to SSI sector which are reckoned under priority sector and the securitised loans are originated by banks/financial institutions.

(vi) Housing Loan: Enhancement of Ceiling

In order to further improve flow of credit to the housing sector, it is proposed that:

- Banks, with the approval of their Boards, may extend direct finance to housing sector up to Rs.15 lakh, irrespective of location, as part of their priority sector lending.

(c) Financing of Distressed Urban Poor

With a view to bringing in urban poor into formal financial system, it is proposed that:

- Banks may advance loans to distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group security.

(d) Micro-finance

As per announcement in the Union Budget for 2004-05, credit linking of 5.85 lakh SHGs needs to be completed by March 2007. Specific steps are being taken to identify district level bottlenecks in regions where linkage has been relatively low.

(e) Kisan Credit Card Scheme: Follow-up of Survey

With a view to further improving the flow of credit to agricultural sector under the KCC scheme, IBA has been advised to look into the suggestions made by NCAER as part of its national impact assessment survey and take remedial action.

(f) Rural Infrastructure Development Fund: Status

As announced in the Union Budget for 2004-05, RIDF X has been established with a corpus of Rs.8,000 crore.

(g) Debt Restructuring Mechanism for Medium Enterprises

A Special Group (Chairman: Shri G. Srinivasan) constituted to formulate a mechanism for restructuring the debt of medium sector enterprises is expected to submit its Report soon which will be placed in the public domain.

(h) Regional Rural Banks

The Reserve Bank has constituted Empowered Committees in its Regional Offices with members drawn from NABARD, sponsor banks, conveners of SLBCs and state governments to ensure that the RRBs adhere to good governance and comply with prudential regulations. The Committees would also focus on operational issues and provide clarifications on regulatory issues.

(i) Revival of Rural Co-operative Banks: Status

The Government has appointed a Task Force (Chairman: Prof. A. Vaidyanathan) to propose an action plan for reviving the rural co-operative banking institutions and suggest an appropriate regulatory framework for these institutions. The Task Force is expected to submit its Report shortly.

(j) Lending to Agriculture: Review of Progress

Pursuant to the announcement by the Government of a package of measures on June 18, 2004, RBI and IBA issued guidelines to commercial banks, while NABARD issued similar guidelines to co-operative banks and RRBs. While the progress is encouraging, banks are urged to keep up the momentum.

(k) Liberalisation of Bank Finance to NBFCs

In view of the expertise gained by NBFCs in financing second hand assets and to encourage credit dispensation, it is proposed that:

- Banks may, henceforth, extend finance to NBFCs against second hand assets financed by them, provided suitable loan policies duly approved by the banks' Boards are put in place.

(l) Gold Card Scheme for Exporters: Status

Most of the public sector banks and many private sector and foreign banks have since announced guidelines on gold card scheme for creditworthy exporters offering better terms of credit and rates to the gold card holders.

(m) Report of Working Group on Credit Enhancement by State Governments

The Working Group on Credit Enhancement by State Governments is examining the instruments which the state governments could offer to improve the rating/borrower capability of state PSUs/SPVs in order to attract institutional financing for infrastructure projects. The Group is expected to submit its Report shortly.

Money Market

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

In view of further market developments as also to move towards a pure inter-bank call/notice money market, it is proposed that:

- With effect from the fortnight beginning January 8, 2005, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 30 per cent of their average daily lending in call/notice money market during 2000-01.

(b) Commercial Paper

With a view to developing the commercial paper (CP) market further, after taking into account the suggestions and market response, the following measures are proposed:

- In order to provide an option to issuers to raise short-term resources through CP as also an avenue to investors to invest in quality short-term papers, the minimum maturity period of CP is reduced from 15 days to 7 days with immediate effect.

- In order to provide transparency and also facilitate benchmarking of CP issues, issuing and paying agents (IPAs) would report issuance of CP on the negotiated dealing system (NDS) platform by the end of the day. The date of commencement of reporting would be finalised in consultation with market participants.

- With a view to moving towards settlement on T+1 basis, a Group comprising market participants would be constituted to suggest rationalisation and standardisation in respect of processing, settlement and documentation of CP issuance.

(c) Collateralised Borrowing and Lending Obligation

Automated value-free transfer of securities between market participants and the CCIL was facilitated to further develop the collateralised borrowing and lending obligation (CBLO) segment.

Government Securities Market

(a) Negotiated Dealing System: Next Step

A Working Group (Chairman: Dr.R.H. Patil) reviewed the performance of NDS in the context of its operational efficiency and recommended an anonymous electronic screen based order matching trading system on the NDS. The Report of the Group is being placed in the public domain for wider dissemination.

(b) Introduction of Capital Indexed Bonds

It is expected that CIBs could be introduced during the year 2005-06 in consultation with the Government.

(c) Working Group on Primary Dealers

The Report of the sub-group (Chairman: Dr.R.H. Patil) evaluating the role of Primary Dealers (PDs) in the government securities market is being placed before the TAC for advice to enable further action.

(d) Settlement of OTC Derivatives through CCIL: Status

CCIL has developed the pricing and risk models for settling OTC derivatives which are being fine-tuned on the basis of market feedback. The clearing arrangement is expected to be operationalised by March 2005.

(e) Group on Corporate Debt: Status

With a view to further developing the corporate debt market, a Group was constituted with members from RBI, SEBI and other market participants. The Group is expected to submit its Report in January 2005.

(f) Market Stabilisation Scheme: Review

The ceiling on the outstanding obligation of the Government under the MSS has been raised from Rs.60,000 to Rs.80,000 crore with the threshold level for further review of the ceiling is placed at Rs.70,000 crore. Treasury Bills and dated securities worth Rs.54,146 crore were issued under the MSS up to October 21, 2004, out of which dated securities amounted to Rs.25,000 crore.

(g) Strengthening OMO Framework

The Fiscal Responsibility and Budget Management Act stipulates that effective from April 1, 2006, RBI's participation in primary issues of government securities will stand withdrawn. Accordingly, a study Group will be constituted for strengthening OMO framework to address the emerging needs and equip RBI as well as the market participants appropriately.

Foreign Exchange Market

(a) Issue of Guarantee for Trade Credits: Liberalisation

In order to promote investment activity and to further liberalise the procedures relating to trade credits on imports, it is proposed:

- To accord general permission to ADs to issue guarantees/letters of comfort and letters of undertaking up to US $ 20 million per transaction for a period up to one year for import of all non-capital goods permissible under Foreign Trade Policy (except gold) and up to three years for import of capital goods, subject to prudential guidelines.

(b) Export Oriented Units: Relaxation of Time Limit for Export Realisation

In line with the announcement made in Government's Foreign Trade Policy in September 2004, it is proposed that:

- 100 per cent EOUs and units set up under EHTPs, STPs and BTPs schemes would be permitted to repatriate the full value of export proceeds within a period of twelve months.

(c) Booking of Forward Contracts: Relaxation

In order to further liberalise the process of booking forward contracts, it is proposed:

- To increase the limit for outstanding forward contracts booked by importers/exporters, based on their past performance, from 50 per cent to 100 per cent of their eligible limit. However, the contracts booked in excess of 25 per cent of the eligible limits would be on deliverable basis.

(d) Forex Market Group

In order to review comprehensively the initiatives taken by RBI so far in the foreign exchange market and identify areas for further improvements, it is proposed to constitute an internal Group. The Group would consult with market participants and the TAC and submit its Report within three months.

(e) Survey on Impact of Trade Related Measures

In view of the substantial relaxation and simplification of procedures in the recent period, it is proposed to undertake a fresh survey for evaluation of the impact of the measures taken by RBI to reduce the transaction cost for exports.

Prudential Measures

(a) Migration to Basel II Norms: Next Steps

In view of the complexities involved in migrating to Basel II, a Steering Committee comprising members from banks, IBA and RBI has been constituted. On the basis of its inputs, RBI would prepare draft guidelines for implementation of Basel II norms and place them in the public domain.

(b) Draft Guidelines on Ownership and Governance

Based on the responses received and dialogues with various stakeholders on the policy framework for ownership and governance in private sector banks, a second draft has been finalised and will be put in public domain soon.

(c) Fit and Proper Criteria for Directors of Banks: Status

The Consultative Group of Directors of Banks and FIs (Chairman: Dr. A.S. Ganguly) had made a number of suggestions to strengthen the supervisory role of Boards of banks and FIs. Necessary instructions on the basis of the recommendations of the Group have already been issued to the private sector banks in this regard.

(d) Transparency: Public Disclosure of Penalties/Directions

In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks were advised on October 19, 2004 that all cases of penalty imposed by RBI as also strictures/directions on specific matters including those arising out of inspection will be placed in the public domain.

(e) Warehouse Receipts and Commodity Futures: Role of Banks

With a view to examining the role of banks in providing loans against warehouse receipts and evolving a framework for participation of banks in commodity futures markets, it is proposed:

- To set up a Working Group with members from RBI, IBA, Forward Markets Commission (FMC) and banks.

(f) Review of Corporate Debt Restructuring Mechanism

A Special Group was constituted to review the performance of the CDR mechanism and suggest further measures to make it more effective. The Group is expected to submit its Report by December 2004.

(g) Housing Loans and Consumer Credit: Temporary Risk Containment

It is observed in the recent past that the growth of housing and consumer credit has been very strong. As a temporary counter cyclical measure, it is proposed:

- To put in place, risk containment measures and increase the risk weight from 50 per cent to 75 per cent in the case of housing loans and from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards.

(h) Banks' Investment in Non-SLR Securities: Status

Prudential guidelines on non-SLR investments were issued to banks giving a transition period up to end-December 2004 for compliance. Accordingly, banks are urged to prepare themselves to comply with the prudential requirements within the prescribed timeframe.

(i) Prudential Norms for Classification of Doubtful Assets for FIs

With a view to moving closer to international best practices and ensuring convergence of the norms applicable to the FIs with those of the banks, it is proposed that:

- With effect from March 31, 2005, in respect of FIs, an asset would be classified as doubtful, if it remained in the sub-standard category for 12 months. FIs are permitted to phase out the consequent additional provisioning over a four-year period.

(j) Approach for Supervision of Financial Institutions

On the basis of the recommendations of the Working Group on Development Finance Institutions (Chairman: Shri N. Sadasivan) and the feedback received thereon, the following approaches for supervision of the DFIs and large NBFCs are proposed:

- The Reserve Bank would continue to supervise NABARD, SIDBI, NHB and EXIM Bank as hitherto.

- The Reserve Bank would supervise DFIs which accept public deposits.

- DFIs and large NBFCs not accepting public deposits but having asset size of Rs.500 crore and above would be subject to limited off-site supervision by RBI.

(k) Dissemination of Credit Information by CIBIL

Banks are urged to make persistent efforts in obtaining consent from all their borrowers, in order to establish an efficient credit information system, which would help in enhancing the quality of credit decisions and improving the asset quality of banks, apart from facilitating faster credit delivery.

(l) Working Group on Conflicts of Interest in the Indian Financial Services Sector

In consultation with Chairman, SEBI and Chairman, IRDA, it is proposed:

- To constitute a Working Group on avoidance of conflicts of interest. The Working Group will identify the sources and nature of potential conflicts of interest, the international practices to mitigate this problem, the existing mechanisms in India in this regard and make recommendations for avoidance of such conflicts of interest. The Group would submit a Report in four months.

Urban Co-operative Banks

(a) Vision Document

A vision document for the future role of UCBs is being evolved to ensure depositors' interests and avoid contagion while providing useful service to local communities. Further, RBI would continue to pursue with the state and Central governments the issues that arise in their jurisdiction.

(b) Standing Advisory Committee on Urban Co-operative Banks

With a view to reinforcing the consultative process in a more constructive manner to address the structural/regulatory and supervisory issues relating to UCBs and facilitating the process of formulating future approaches for this sector, the Standing Advisory Committee on UCBs chaired by Deputy Governor, RBI would meet on a quarterly basis in future.

Non-banking Finance Companies

(a) Road Map for Residuary Non-banking Companies

With a view to smoothening the process of transition of RNBCs to comply with RBI's directions, the following approach is proposed:

- Investments of RNBCs in certificates of deposit of financial institutions which have a minimum rating of AA+ at the time of investment will be reckoned as eligible securities as long as they have minimum investment grade rating.

- Current account balances of RNBCs with commercial banks would be considered as eligible investments.

- The investments of RNBCs in bonds and debentures of companies which meet stipulated listing and rating requirements at the time of investment will be considered as ineligible investments if they migrate to below the investment grade rating.

However, in order to ensure that the depositors are served appropriately and systemic risks are avoided, RBI intends to focus on improvements in the functioning of RNBCs. Detailed guidelines in regard to action to be taken by RNBCs on the above would be issued separately.

(b) Non-banking Financial Companies: Phasing out of Public Deposits

The Reserve Bank will be holding discussions with NBFCs in regard to their plan of action for voluntarily phasing out of their acceptance of public deposits and regulations on banks' lending to NBFCs will be reviewed by RBI as appropriate.

(c) Asset Reconstruction Companies: Enhancement of Capital Base

In order that ARCs have a sound capital base and a stake in the management of the NPAs acquired, the requirement of owned funds for commencement of business has been stipulated as not less than 15 per cent of the assets acquired or Rs.100 crore, whichever is less.

Technical Group on Refinancing Institutions: Status

The Report of the Technical Group (Chairman: Shri G.P. Muniappan) on Refinancing Institutions is expected to be submitted by December 2004.

Expert Group on Central Database Management System: Status

The Expert Group on Central Database Management System (CDBMS) (Chairman: Prof.A. Vaidyanathan) has since submitted its Report and their recommendations are being put in the public domain. It is proposed to release the first lot of the data series covering key macroeconomic aggregates effective November 1, 2004.

Payment and Settlement Systems: Status

(a) Vision Document for Payment and Settlement Systems

RBI has taken steps to draft a document on 'Payment and Settlement Systems Vision for 2005-08' under the guidance of the National Payment Council. The draft document will be placed in the public domain for feedback and discussions.

(b) Board for Payment and Settlement Systems

The draft regulation to set up the Board for Payment and Settlement Systems has been submitted to the Government for notification in the Gazette.

(c) National Settlement System

The national settlement system which would link up different clearing houses managed by RBI and other banks for centralised settlement is expected to be operationalised in early 2005.

(d) Working Group on Risk Mitigation for Indian Retail Payment System

In order to put in place an appropriate risk mitigation mechanism for the retail payment systems as also to examine the operational implications of such a mechanism, a Working Group with representatives from RBI, IBA and banks has been constituted by RBI. The Group is expected to submit its Report by November 2004.

(e) ECS/EFT Transactions: Removal of Ceiling

In order to facilitate large scale usage of the electronic clearing system (ECS) and electronic funds transfer (EFT) schemes, the existing per transaction limits for ECS and EFT are being dispensed with effective November 1, 2004.

(f) Working Group for Regulatory Mechanism for Cards

While recognising the popularity of cards, regulatory and customer protection measures assume importance. Accordingly, it is proposed:

- To constitute a Working Group to look into the regulatory and customer protection aspects and suggest measures for card usage in a safe, secure and customer friendly manner.

Conduct of Government Business

(a) On-line Tax Accounting System: Status

CBDT has accepted RBI's suggestion for grant of refunds up to Rs.25,000 through Electronic Clearing System (ECS) facility at select centres in respect of individual tax payers.

(b) On-line Indirect Tax Accounting System: Status

The Reserve Bank has constituted a High Powered Committee (Chairman: Shri J.N. Nigam) with members drawn from the Government, IBA, State Bank of India, reputed information technology companies, NSDL and RBI for streamlining the present systems and procedures in regard to transmission of data pertaining to excise duty and service tax.

International Financial Standards and Codes

A review of the progress made on the implementation of the recommendations of the Reports of the 11 Advisory/Technical Groups was considered by a panel of advisers. Taking into account the suggestions of the panel, a revised draft report is being placed in the public domain.

Alpana Killawala
Chief General Manager

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