RBI Governor announces
Monetary and Credit Policy for the year 1999-2000

April 20, 1999

- Liquidity to be Easy – CRR reduced by 0.5 percentage point
- A New Interim Liquidity Adjustment Facility introduced
- More Measures for Development of Money, Repo, Government Securities and Debt Markets
- Interest Rates Rationalised
- Prudential Measures strengthened
- New Measures for Micro credit, Venture Capital and Infrastructure Financing

Dr.Bimal Jalan, Governor, Reserve Bank of India, today in a meeting with the Chief Executives of banks announced the Monetary and Credit Policy for the year 1999-2000. In his statement, Governor, after presenting a review of macro-economic developments during 1998-99, spelt out the stance of the policy for the current year and announced an array of measures. While no changes have been made in Bank Rate and repo rate, CRR has been reduced by 0.5 percentage point. Other measures related to development of money, government securities and debt markets, strengthening of prudential norms, rationalisation of interest rates and introduction of a new liquidity adjustment facility.

Domestic Developments

The Governor recalled that in April 1998, the growth rate of GDP was projected to be in the region of 6.5 to 7.0 per cent which, in view of continued slow down in industrial activities, was lowered to 6.0 per cent in October 1998. Governor said that the actual outcome was likely to be somewhat lower than anticipated. According to the preliminary estimates of the Central Statistical Organisation (CSO), the GDP growth in 1998-99 is likely to be 5.8 per cent as compared with a growth rate of 5.0 per cent for 1997-98. The actual outcome in respect of inflation was, however, in line with the projected rate of 5 to 6 per cent in the April 1998 statement, he added.

The Governor mentioned that during 1998-99, the annual growth in M_3 on a point-to-point basis was 17.8 per cent as against 17.9 per cent in 1997-98. Expansion of primary liquidity during 1998-99 was higher than in the preceding year, with reserve money increasing by 14.5 per cent as against an increase of 13.2 per cent in the previous year. Aggregate deposits of the scheduled commercial banks increased by 18.5 per cent as against 19.7 per cent in the previous year, time deposits accounting for the entire increase.

The Governor mentioned that the conventional non-food bank credit showed a lower expansion of Rs.37,594 crore (12.1 per cent) as against an increase of Rs.40,789 crore (15.1 per cent) in the previous year. The total flow of funds from banks to the commercial sector including banks' investment in bonds/debentures/shares issued by public sector undertakings and private corporate sector and commercial paper, etc., however, was Rs.54,304 crore as against an increase of Rs.53,377crore in the corresponding period of the previous year, he added.

The Governor mentioned that gross market borrowing of the government exceeded the budgeted level by around Rs.15,000 crore and amounted to Rs.93,953 crore during the year 1998-99. The net market borrowing was Rs.62,903 crore.

The Governor observed that the continuing large fiscal deficits year after year in 1990s have led to sharp increase in repayment obligations and a reduction in average maturity profile of outstanding public debt. In 1991-92, the ratio of gross to net borrowing of the Central Government was 1 : 0.89 which in 1998-99 stood at 1 : 0.67, implying a 22 paise decline in the net receipt for every rupee of borrowing in this period. Mentioning about the increasing interest payments on public debt which touched Rs.43,712 crore in 1998-99 (RE) rising from Rs.14,021 crore in 1991-92, the Governor said that this process could not go on indefinitely.

During 1998-99, despite large scale gross borrowings by the Government, contrary to market expectations at the beginning of the year, the medium and long-term interest rates had remained fairly stable. Mentioning about the Reserve Bank's approach in managing the large government borrowing without causing undue pressure on interest rates, the Governor said that in June 1998, the Reserve Bank had announced its intention to accept private placement of government securities from time to time (in the event of markets' bids being at substantially higher levels due to uncertainties in the market) and release them to the market as conditions improved.

He further added that it was also significant that the strategy of private placement combined with active OMO did not lead to an undue expansion of Reserve Bank's credit to Central Government and the reserve money.

While alluding to the effective working of this approach, the Governor stated that sooner or later, the pressure on market interest rates would become unavoidable unless fiscal deficit of the Government and its borrowing requirements were kept within reasonable limits..

The Governor said that developments during the past year illustrate the dilemma faced by monetary authorities in a situation of uncertain macro-economic outlook in respect of inflation and growth, alongside high monetary growth. When the current rate of inflation is low, a high rate of growth in money supply nevertheless warrants tightening of liquidity (and increase in interest rates) in order to dampen the aggregate demand and to avoid potential problems. However, if growth of output is also low, tightening of money supply during a period of relatively low inflation may result in a further loss of output. This in turn could result in lower revenue and the need for Government to borrow further. He added that a similar dilemma arose when inflation rate accelerates because of supply shocks which are expected to be temporary. This, he said, was the situation last year when, until October, inflation was accelerating due to lower availability of a few primary commodities. The Reserve Bank at that time chose not to tighten monetary policy in the expectation that price rise would reverse itself later in the year when agricultural supplies improve. In retrospect, this judgement turned out to be correct. However, if it had not, and inflation had accelerated further, he said that the monetary policy would have required much sharper tightening in the subsequent months of the year.

The Governor felt that there were no simple objective or 'quantitative' answers to monetary policy dilemma of this type in the short-run. There is no option but to carefully balance conflicting considerations, and for the monetary authority to be prepared to reverse its earlier 'stance' of policy if actual outcome happens to be substantially different from what was expected. He observed that as the past experience in India and indeed in other countries, including industrial countries, shows flexibility in respect of monetary policy may have to be exercised in both directions, i.e., tightening as well as loosening as circumstances warrant.

External Developments

The Governor said that the 18-month period since September 1997 presented major challenges for management of the external sector. Faced with several unfavourable developments, the Reserve Bank had to, from time to time, take recourse to monetary and other measures in order to stabilise the situation in the foreign exchange market, he added.

The day to day movements in exchange rates he said were market-determined and would continue to remain so. The primary objective of the Government and the Reserve Bank in regard to the management of the exchange rate is to maintain orderly conditions in the foreign exchange market, and to curb destabilising and self-fulfilling speculative activities by some forex operators during certain periods in order to take advantage of prevailing uncertainties in the domestic or international situation. To this end, he said that as in the past, the Reserve Bank would continue to monitor closely developments in the financial markets at home and abroad, and take such monetary and administrative actions as may be considered necessary from time to time.

The Governor mentioned that an area of current concern in regard to balance of payments was the negative growth of exports, partly attributable to sluggish growth in world trade. An important priority for the current year, he said, was to take all possible measures to provide maximum support to export efforts.

The Governor informed that a committee of bankers has been set up to ensure that procedural problems coming in the way of ‘exporters’, particularly small exporters, from utilising these new facilities are removed forthwith. This committee, he said, will interact closely with branch managers as well as exporters, particularly in locations where there is a concentration of small and medium scale exporters.

Exporters currently enjoy a facility to retain a portion of their earnings to be utilised for certain purposes under the scheme of Exchange Earners Foreign Currency (EEFC) accounts. In response to suggestions received from exporters, Governor announced the facility to issue cheques against EEFC balances with effect from May 1, 1999. Banks in India, holding such accounts, will be authorised to issue separate cheque books for operation of these accounts. He further announced that the Reserve Bank would grant approvals for loans/guarantees in respect of overseas offices of export houses/trading houses/Star Trading Houses/Super Star Trading Houses provided the terms of such loans/guarantees were reasonable.

The forward cover facility for FIIs has been further liberalised and expanded with effect from June 11, 1998, FIIs were permitted to take forward cover from Authorised Dealers to the extent of 15 per cent of their existing investment as on that date. Any incremental investment over the level prevailing on June 11, 1998 was also made eligible for forward cover. The Governor announced that as a simplification measure, the above mentioned limits will henceforth apply to FIIs’ outstanding investments as on March 31, 1999. In other words, 15 per cent of outstanding investment on March 31, 1999 as well as the entire amount – 100 per cent – of any additional investment made after this date will be eligible for forward cover. He added that as a measure of further liberalisation, any FII which has exhausted the limits, can apply to RBI for additional forward cover for a further 15 per cent of their outstanding investments in India at the end of March 1999. Applications for further additional limits can be made more than once after the earlier limits have been exhausted.

II. Stance of Monetary Policy for 1999-2000

The Governor said that a major challenge for monetary policy in 1999-2000 is the need to reconcile the conflicting objectives of restraining the overall growth of liquidity in order to ensure price-stability, and at the same time facilitating the flow of adequate bank credit for productive sectors of the economy in order to improve growth. If industrial growth picks up, this may also help in restraining the Government's demand for additional credit from the banking sector, he added. Pointing out that the monetary growth (M_3) in 1998-99 as well as in 1997-98 was well above the projected levels, the Governor stated that ideally it would be desirable to aim at a lower M_3 growth in 1999-2000 than the rate of growth of 15.0 to 15.5 per cent projected for the previous two years. He, however, felt that keeping in view the Government's borrowing requirements, an unduly restrictive credit policy could militate against the need to enhance growth prospects. As such, he said, a reasonable projection for M_3 growth in 1999-2000 would be in the range of 15.5 to 16.0 per cent. Consistent with a money supply growth of 15.5 to 16 per cent, the Governor placed the working estimate for the expansion in aggregate deposits of scheduled commercial banks at Rs.1,18,500 crore (16.5 per cent). The Governor mentioned that under normal circumstances and barring unanticipated developments in the domestic and international situation, the Bank's endeavour would be in the direction of facilitating adequate availability of credit under a stable interest rate environment with policy preference for softening to the extent circumstances permit.

III. Financial Sector Reforms and Monetary Policy Measures

The Monetary and Credit Policy statements of April and October last year had focussed on 'structural' measures to strengthen the financial system and improve the functioning of various segments of the financial market. In the current year also, the Governor has proposed to carry forward the direction of financial reforms initiated in recent years, keeping in view the actual experience in implementation, the current state of banks and financial institutions, and other pertinent developments.

The following monetary and credit policy measures were announced by the Governor today:

Cash Reserve Ratio Reduced

CRR has been reduced by 0.5 percentage point from 10.5 per cent to 10 per cent effective fortnight beginning May 8, 1999.

A New Interim Liquidity Adjustment Facility Introduced

With an intention to moving to Liquidity Adjustment Facility, as suggested by Narasimham Committee, pending further upgradation in technology and legal/procedural changes to facilitate electronic transfer and settlement, the Reserve Bank has introduced an Interim Liquidity Adjustment Facility (ILAF) through repos and collateralised lending. The features of this facility are given below:

(i) The general refinance facility is being withdrawn with immediate effect. It will be replaced by a collateralised lending facility (CLF) up to 0.25 per cent of the fortnightly average outstanding aggregate deposits in 1997-98 which will be available for two weeks at the Bank Rate. An additional collateralised lending facility (ACLF) for an equivalent amount of CLF will also be available at the Bank Rate plus 2 per cent. CLF and ACLF availed for periods beyond two weeks will be subject to a penal rate of 2 per cent for an additional two week period. There will be a cooling period of two weeks thereafter. The current restriction on participation in money market (during the period that such facilities are availed of) will be withdrawn in order to facilitate systemic adjustment in liquidity.

(ii) The existing facility for export refinance will continue.

(iii) Liquidity support against collateral of government securities, based on bidding commitment and other parameters, will be available to Primary Dealers at Bank Rate and the amounts will remain constant throughout the year. Each drawal will, however, be subject to the usual restriction of repayment within 90 days.

(iv) Additional liquidity support against collateral of government securities will also be provided to Primary Dealers for periods not exceeding two weeks at a time and the interest rate will be at Bank Rate plus 2 per cent.

(v) Absorption of liquidity in the market will continue to be through fixed rate repos.

(vi) The above facilities will be supplemented by open market operations in government dated securities and treasury bills by RBI.

More measures for development of Money, government securities and debt markets

Money Market

To improve the monetary policy transmission mechanism and develop further the money and debt markets in the light of the recommendations made by the Narasimham Committee, it has been decided to develop the repos market with appropriate regulatory safeguards. The prudential safeguards have been designed to ensure transparency and accountability while at the same time increasing liquidity and depth in the securities market.

UTI, LIC, IDBI and other non-bank participants in the money market will be allowed to access short term liquidity through repos thereby facilitating their cash management and gradual move out of the call money market.

Guidelines for interest rate swaps and forward rate agreements (FRAs) are being issued to facilitate hedging of interest rate risks and ensuring orderly development of the derivatives market.

MMMFs have been permitted to offer ‘cheque writing’ facility to their investors.

Government Securities Market

With a view to increasing the depth and liquidity in the government securities market for the development of the debt market and in which the PDs are expected to play a greater role in the absorption of the primary issues and in market making, it has been decided (a) to obtain minimum bidding commitment from each PD for the auctions of Treasury bills so that together they absorb 100 per cent of the notified amount, and (b) to offer an enhanced underwriting option to PDs for the entire notified amount in auctions of dated securities.

It is proposed to announce a calendar for issue of Treasury Bills for the entire year. As was announced in the Monetary and Credit policy for the first half of 1998-99, it is also proposed to introduce 182 day Treasury Bill which will be issued every fortnight as part of the calendar.

It is proposed to have the option of issuing new loans on price basis instead of on yield basis as done currently so as to consolidate outstanding loans for ensuring sufficient volumes and liquidity in any one issue and to facilitate the emergence of benchmarks and development of the STRIPS.

Interest rates Rationalised – Banks to have more operational flexibility.

Banks have been provided with the freedom to operate different PLR for different maturities provided the transparency and uniformity of treatment originally envisaged continues to be maintained.

Similarly, banks have been permitted to offer fixed rate loans subject to conformity to ALM guidelines.

In cases of deposit rate being in excess of PLR, advances to depositors against fixed deposits can be made by banks without reference to the ceiling of PLR. This will be applicable both for domestic and non-resident deposits.

The Boards of Directors of banks have been permitted to delegate necessary powers to Asset Liability Management Committee for fixing interest rates on deposits and advances, so as to enable banks to respond promptly to changes in interest rate environment.

Prudential Measures strengthened

In the Mid-term review of October 1998, certain important changes recommended by the Narasimham Committee in respect of prudential norms, risk weights and exposure norms were announced. As a continuation of this process, following further measures are being notified shortly:

(i) With effect from the year ending March 31, 2000, banks will have to classify a minimum of 75 per cent of their securities as current investments.

(ii) Banks' and financial institutions' investment in Tier II bonds issued by other banks will be subjected to a ceiling of 10 per cent of the bank's and FI's total capital.

The waiting period of two years in respect of advances where terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production is reduced to one year (or four quarters) if the interest and instalment of loans have been serviced regularly as per the terms of rescheduling.

As part of the process of moving away from micro-level regulations, the Reserve Bank has decided that henceforth it will be left to the Board of Directors of each bank to prescribe detailed rules for determining the date of 'commencement of commercial production' of units instead of following the detailed prescription laid down by the Reserve Bank.

The Reserve Bank proposes to issue ALM guidelines to financial institutions.

Micro Credit and Venture Capital

A special cell, manned by a senior officer from the commercial banking sector with practical experience in this area, is being set up in RBI in order to liaise with NABARD and micro-credit institutions for augmenting the flow of credit to micro-credit institutions and Self-Help Groups. The time frame for the cell to complete its work will be one year and its proposals will be given top priority.

Interest rates applicable to loans given by banks to micro-credit organisations or by these organisations to their members/beneficiaries will be left to banks' discretion.

The overall ceiling of investment by banks in ordinary shares, convertible debentures of corporates and in units of mutual funds, etc., which is currently at 5 per cent of their incremental deposits will stand automatically enhanced to the extent of Banks' investments in venture capital. Investments in 'venture capital' would also qualify for inclusion in priority sector lending.

Incremental credit given to NBFCs by banks for on-lending to small road and water transport operators and to units in tiny sector of industry, over March 31, 1999 will qualify for priority sector status.

Credit for Infrastructure - Guidelines

The RBI has finalised operational guidelines, in consultation with select banks and financial institutions for extending credit for infrastructure projects. Banks/FIs will be free to sanction term loans for technically feasible, financially viable and bankable projects undertaken by both public and private sector undertakings subject to prescribed criteria. Banks are also being permitted to issue inter-institutional guarantee subject to certain norms.

Settlement Advisory Committee – Scheme finalised

A scheme for Settlement Advisory Committee (SAC) has been finalised by RBI under which public sector banks may set up SACs for compromise settlement of NPAs of small sector, which will be in addition to the existing compromise settlement procedure for large and medium scale borrowers.

Regulation of Non-Banking Financial Companies (NBFCs)

In respect of new NBFCs, which are incorporated on or after 20th April 1999 and which seek registration with RBI, the requirement of minimum net owned funds has been raised to Rs. 2 crore. This stipulation will not apply to NBFCs which are already registered with RBI or whose applications are presently under consideration.

Accommodation from RBI to State Co-operative Banks at lower rates.

State Co-operative Banks will be provided accommodation from the Reserve Bank towards general banking business at the Bank Rate instead of the previous Bank Rate plus 2.5 percentage points.

Urban Co-operative Banks

The Reserve Bank will appoint a High-Power Committee to review the performance of the urban co-operative banks and suggest measures for strengthening this vital sector.

Payment and Settlement System and Y2K Compliance

The Reserve Bank will expand the VSAT based network in order to ensure that both funds and non-funds business are placed on an on-line basis as soon as possible. A National Payments Council with a Deputy Governor as the Chairman and representative membership is being constituted. It is planned to have real time gross settlement (RTGS) system in place in the next 15 to18 months.

The financial sector has responded reasonably well to the Reserve Bank's initiative in September 1997 to take necessary action to be Y2K compliant. Regular meetings between the banks and RBI in recent months have helped to give confidence that the system would not carry the Y2K risk. The information about the Y2K compliance position in the financial sector is being shared with the groups working on Y2K compliance in the rest of the economy.

Mid-term Review

A review of credit and monetary developments in the first half of the current year will be undertaken in October 1999. This mid-term review will generally be confined to a review of monetary developments and to such changes as may be necessary in monetary policy and projections for the second half of the year.

Alpana Killawala
General Manager

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