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RBI Governor announces Annual Policy Statement for the year 2005-06

Dr. Y. Venugopal Reddy, Governor, in a meeting with Chief Executives of major commercial banks today presented the annual policy Statement for 2005-06. At the outset, Governor mentioned that in order to provide a distinctive focus between monetary policy and developmental policies, the format of presentation of this Statement has been modified while broadly following the pattern already set in previous years. Accordingly, he stated that there will be a Mid-term Review of the annual policy Statement in October, as in the past, covering both Part I and Part II of the Statement. In addition, there will be a First Quarter Review of Part I of the Statement in July and a Third Quarter Review in January. While the annual Statement and the Mid-term Review will continue to be presented in the meeting with bankers, the quarterly reviews will be released to the Press to facilitate structured communication with markets on a more frequent basis while retaining the flexibility to take specific measures as the evolving circumstances warrant.

Domestic Developments

GDP Growth in 2004-05

Reviewing GDP growth for 2004-05, Governor said that the advance estimate of GDP released by the CSO in February 2005 has placed the GDP growth at 6.9 per cent during 2004-05, on top of a higher increase of 8.5 per cent in the previous year.

Inflation Rate

The annual inflation rate as measured by variations in the wholesale price index (WPI), on a point-to-point basis, stood at 5.0 per cent as at end-March 2005 as compared with 4.6 per cent a year ago. Governor indicated that the inflation rate would have been higher but for successful policy interventions which included fiscal as well as monetary measures, and, more importantly, the full pass-through of higher oil prices has not taken place. On an average basis, the annual rate of inflation during 2004-05 was higher at 6.4 per cent as compared with 5.4 per cent in the previous year. The WPI inflation rate, excluding iron ore, iron & steel, mineral oils and coal mining works out lower at 2.0 per cent on a point-to-point basis, as against 3.3 per cent a year ago. On an average basis, it was 3.1 per cent as against 3.7 per cent in the previous year.

The point-to-point inflation rate based on consumer price index (CPI) for industrial workers was 4.2 per cent in February 2005 as compared with 4.1 per cent a year ago. On an average basis, CPI inflation was 3.8 per cent during 2004-05 (up to February) as compared with 3.9 per cent a year ago.

Monetary Indicators

Referring to monetary developments, Governor said that during 2004-05, money supply (M₃) increased by 12.8 per cent (Rs.2,57,058 crore), net of conversion, as compared with 16.9 per cent (Rs.2,90,569 crore) in the previous year. The growth in aggregate deposits of scheduled commercial banks (SCBs) at 14.1 per cent (Rs.2,11,963 crore), net of conversion, was lower than 17.5 per cent (Rs.2,23,563 crore) in the previous year partly due to reduction in non-resident Indian (NRI) deposits with the banking system. The increase in reserve money during 2004-05 at 12.1 per cent (Rs.52,616 crore) was lower than the increase of 18.3 per cent (Rs.67,451 crore) in the previous year. RBI's foreign currency assets (adjusted for revaluation) increased by Rs.1,15,044 crore as compared with an increase of Rs.1,41,428 crore in the previous year. The expansionary impact of foreign currency assets, however, was neutralised to a large extent by substantial recourse to the market stabilisation scheme (MSS) in conjunction with reverse repo operations under the liquidity adjustment facility (LAF). The ratio of net foreign exchange assets (NFEA) to currency rose from 148.1 per cent in March 2004 to 166.2 per cent in March 2005 reflecting accretion to reserves on a continuous basis.

Non-food Credit

Non-food credit increased by 26.5 per cent (Rs.2,13,464 crore), net of conversion, as compared with 18.4 per cent (Rs.1,25,088 crore) in the previous year. The incremental non-food credit-deposit ratio was as high as 100.7 per cent, net of conversion, as compared with 56.0 per cent in the previous year. Incremental investment-deposit ratio fell commensurately to 25.1 per cent from 58.2 per cent in the previous year, thereby accommodating the higher credit demand to a large extent. In the recent years, the impetus to credit growth has emanated from non-agriculture non-industrial sectors, particularly, housing, small transport operators and retail loans. Credit to agriculture and industry has also picked up. The total flow of funds from SCBs to the commercial sector, including their investments, increased by 23.6 per cent (Rs.2,10,891 crore), net of conversion, as against 15.7 per cent (Rs.1,21,419 crore) in the previous year. As such, flow of funds to the commercial sector during 2004-05 exceeded the growth of 19.0 per cent anticipated in the mid-term Review of October 2004.

Government Borrowings

Governor observed that during 2004-05, the Central Government's net market borrowings at Rs.46,050 crore (gross Rs.1,06,501 crore) were significantly lower than such borrowings in the previous year partly due to receipts by the Centre from the States under the debt swap scheme (DSS). During 2004-05, the combined market borrowings of the Centre and States were Rs.80,029 crore (net) [Rs.1,45,603 crore (gross)] with lower RBI support in the form of devolvement and private placement at Rs.1,197 crore due to comfortable liquidity conditions. In addition to the normal market borrowings, the Central Government raised Rs.65,481 crore (face value) under MSS for sterilisation purposes. Overall, the net resources raised through government securities (Centre, States and MSS) amounted to Rs.1,45,510 crore during 2004-05 as compared with Rs.1,35,192 crore (Centre and States) in the previous year. The weighted average cost of Central Government borrowing through primary issuance of dated securities rose by 40 basis points to 6.11 per cent in 2004-05 from 5.71 per cent in the previous year. The weighted average maturity of the dated securities issued during 2004-05 was lower at 14.13 years as compared to

14.94 years in the previous year. With a pick up in credit demand, the banking system reduced its holding of government securities as a share of its net demand and time liabilities (NDTL) from 41.3 per cent in March 2004 to 38.5 per cent in March 2005. Such holdings of government securities, however, continue to be in excess of the statutory minimum requirement of 25 per cent of NDTL of the order of Rs.2,60,582 crore in March 2005. The Union Budget sets a 'pause' for deficit indicators in 2005-06 as envisaged in the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 keeping in view the impact of implementation of the recommendations of the Twelfth Finance Commission (TWFC) which implies substantially higher devolution to States. Governor, however, underscored that it is essential to pursue fiscal consolidation with resolve to realise the long-term potential of the economy.

Interest Rate

During 2004-05, financial markets remained generally stable, though interest rates showed some intra-year upward movement. Governor noted that an interesting development in the money market during 2004-05 was that the combined average daily transactions of market repo and collateralised borrowing and lending obligation (CBLO) was proportionately higher than those in the uncollateralised call/notice money market. Overall, despite large excess liquidity in the system, interest rates moved upwards reflecting uncertainties in oil prices, upward trend in global interest rates and increasing domestic demand for credit. The benchmark prime lending rates (BPLRs) of public sector banks moved from a range of 10.25-11.50 per cent in March 2004 to 10.25-11.25 per cent in March 2005. The share of sub-BPLR lending in total lending of commercial banks, excluding export credit, increased from about 50 per cent in March 2004 to over 60 per cent by March 2005. The Reserve Bank has been persistently drawing the attention of banks to interest rate risks. As at end-February 2005, banks have built up IFR up to 3.9 per cent. In September 2004, RBI allowed banks to exceed the ceiling of 25 per cent of investments included under 'held to maturity' (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 of NDTL. Further, in the mid-term Review of October 2004, banks were advised to prepare themselves to implement the capital charge for market risk as envisaged under Basel norms in a phased manner by end-March 2006.

Capital Market

The equity market during 2004-05 passed through its peak and trough moving from a low on May 17 to record its all-time high in March. A strong macroeconomic outlook, positive investment climate, continued investment support by foreign institutional investors (FIIs), and encouraging corporate financial results were the main factors driving the market sentiment during 2004-05. However, an intra-year rise in inflation, deficient monsoon rainfall, outlook in the global financial markets and volatility in international oil prices were the main factors that led to some uncertainties.

External Developments

Exports and Imports

During 2004-05 (up to February), India's exports in US dollar terms increased by 27.1 per cent as compared with 16.4 per cent in the previous year. Imports

showed a higher increase of 36.4 per cent as compared with 25.0 per cent in the previous year. Consequently, the trade deficit widened to US \$ 23.8 billion as compared with US \$ 13.7 billion in the previous year.

Balance of Payment

The current account of the balance of payments (BoP) had remained in surplus consecutively over the past three years (2001-04). During 2004-05 (April-December), the current account showed a deficit of US \$ 7.4 billion as against a surplus of US \$ 4.8 billion in the corresponding period of the previous year, reflecting widening of trade deficit. However, increase in capital inflows more than offset the current account deficit. While net invisible receipts remain robust, the current account for the year as a whole is likely to exhibit a deficit on account of widening of trade deficit. Net accretion to foreign exchange reserves, including valuation changes, amounted to US \$ 18.2 billion during April-December 2004.

Foreign Exchange Market

Governor noted that during 2004-05, the Indian foreign exchange market witnessed orderly conditions with Rupee exhibiting two-way movements. The exchange rate of the Rupee which stood at Rs.43.39 per US dollar at end-March 2004 depreciated by 6.6 per cent to Rs.46.45 per US dollar by end-July 2004. The Rupee recovered and stood at Rs.43.75 per US dollar at end-March 2005. Governor re-emphasized that the exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary.

Global Developments

The world economy expanded by 5.1 per cent during 2004 recording its highest growth rate since the mid-1970s. The International Monetary Fund (IMF) has projected the world economic growth to slow to 4.3 per cent during 2005 and 4.4 per cent in 2006. General inflation has remained low in spite of sharp increase in commodity prices in 2004 with oil prices rising by over 30 per cent and non-fuel commodity prices rising by nearly 19 per cent. Governor expressed his concern that the rise in oil prices appears to have a large permanent component and this makes it important to factor in the second round effects in assessing the inflationary impact. Further, he indicated that risks to growth arise from current account and fiscal imbalances and excessive leveraging in some advanced economies which has necessitated current account and exchange rate adjustments. Policy rates have been raised in the US but are still below the neutral level in major advanced economies. While net private capital flows to emerging markets increased sharply by 32 per cent in 2004 to nearly US \$ 200 billion, the levels may not be sustained in the coming years. If unanticipated macroeconomic or geopolitical developments occur against this background, the extent of required adjustment could get amplified.

Over the years, India's commercial and financial linkages with the rest of the world has been increasing with trade liberalisation and openness on the capital account. While this process has provided important opportunities, it has also brought in new challenges and risks, necessitating fine-tuning of macro policies in a much broader context.

Stance of Monetary Policy for 2005-06

During 2004-05, monetary policy faced difficult challenges which prompted a change in the stance in the mid-term Review of October 2004. First, there was a

carry forward of excess liquidity of over Rs.81,000 crore. Second, the headline WPI inflation accelerated beyond the anticipated level during the first half of the year. Third, the seasonal decline in food prices did not materialise fully. Fourth, international commodity prices remained high and volatile. Fifth, internationally, monetary policy stance in a number of countries was transiting from highly accommodative to a neutral level. Sixth, the pass-through of international commodity price pressures to domestic inflation had implications for inflationary expectations. Seventh, given the uncertainties, the reaction of financial markets was adverse. Eighth, the equity markets touched a low on May 17. Finally, these developments occurred at a time when industrial growth was looking up after a prolonged period of sluggishness and non-food credit was also picking up. In the event, the Reserve Bank had to balance the considerations of growth while containing inflationary expectations. Given the role of supply factors in the nature of inflation, the response was in concert with the Government. In signalling its commitment to price stability, the Reserve Bank switched its stance from a 'very close watch on the movements in the price level' in the annual policy Statement to 'equal emphasis on price stability' in the mid-term Review. Similarly, liquidity management for the purpose was emphasised with a switch from a provision of 'adequate liquidity' to 'appropriate liquidity'. The policy measures were also calibrated to evolving circumstances with a view to stabilising inflationary expectations.

During 2004-05, the following steps were taken in a measured and calibrated manner. First, the Reserve Bank communicated its assessment of the supply-induced nature of inflation to the market on several occasions. Second, the market was sensitised to the differential behaviour of inflation at the producers' and the consumers' level. Third, the Government responded with fiscal measures, particularly by reducing customs and excise duties on oil. Fourth, corporates also responded positively by moderating the exercise of their pricing power. Fifth, the Government raised the ceiling of MSS from Rs.60,000 crore to Rs.80,000 crore. Sixth, overnight fixed rate reverse repo under LAF was introduced. Seventh, CRR was raised by one-half of one percentage point to 5.0 per cent. Eighth, the remuneration of CRR was delinked from the Bank Rate and was reduced to 3.5 per cent to enhance its effectiveness as a monetary instrument. Ninth, banks were allowed to transfer their investment into HTM category up to their statutory minimum SLR requirement after providing for depreciation. Finally, the fixed reverse repo rate under LAF was raised by 25 basis points to 4.75 per cent. The financial markets responded positively to the package of measures and, consequently, interest rates stabilised towards the last quarter of the year, *albeit* at higher levels, but lower than their intra-year highs registered during the middle of the year. Moreover, credit flow to the commercial sector remained uninterrupted and the government borrowing programme could be completed smoothly.

In the conduct of monetary policy, the Reserve Bank was faced with the challenge of reconciling two dominant views. As inflation was supply induced, it was argued that direct monetary policy action may be premature keeping in view the fact that industry was coming out of a sluggish phase. On the other hand, the deterioration in inflation expectations occurred under conditions of overhang of excess liquidity, strong credit growth, incomplete pass-through of oil price shock and uncertainties about its second round effects, the other argument was in favour of monetary policy response to contain inflationary expectations. On balance of considerations, the Reserve Bank raised CRR and the reverse repo rate moderately to signal its strong commitment to price stability.

Against the background of developments during 2004-05, the stance of monetary policy will depend on several factors, including macroeconomic prospects, global developments and the balance of risks. First, the outlook for growth in 2005-06, may get moderated by the conditions in oil markets which remain tight. Second, if the impact of mineral oil prices on WPI is isolated, the underlying inflationary pressures appear moderate. Third, the non-food credit during 2004-05 recorded its second highest growth in 55 years. Hence, adequate credit growth needs to be ensured for productive sectors and the borrowing programme of governments accommodated. Fourth, while the borrowing programme for 2005-06 is significantly higher than the previous year, it is in line with the magnitudes in 2002-03 and 2003-04, though the credit growth was sluggish in those years. Fifth, the current account, which was in surplus for three consecutive years, is turning into a deficit. The capital account continues to be in surplus in a significant way. Current indications are that these trends will continue in 2005-06 and, consequently, the external sector will exhibit strength and resilience, though unanticipated, globally-transmitted shocks cannot be ruled out.

Considering all these issues, the real GDP growth during 2005-06, could be placed around 7.0 per cent for the purpose of monetary policy formulation. The inflation rate in 2005-06, on a point-to-point basis, may be placed in a range of 5.0-5.5 per cent subject to the growing uncertainties on the oil front both in regard to global prices and their domestic absorption.

Consistent with the real growth of GDP and inflation, the projected expansion of money supply (M_3) is placed at 14.5 per cent and aggregate deposits of scheduled commercial banks at 15.0 per cent over. Non-food bank credit including non-SLR investments of banks is projected to increase by around 19.0 per cent. This magnitude of credit expansion is expected to meet adequately the credit needs of all the productive sectors of the economy.

The Reserve Bank expects to conduct debt management within the monetary projections for 2005-06 barring unexpected developments. Given the volatility in the inflation rate during 2004-05, there is also a need to consolidate the gains obtained in recent years from reining in inflationary expectations.

The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity through OMO including MSS, LAF and CRR, and using the policy instruments at its disposal flexibly, as and when the situation warrants.

In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the inflationary situation, the overall stance of monetary policy for the year 2005-06 will continue to be as set out in the mid-term Review of October 2004, namely:

- 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.

Monetary Measures

a) Bank Rate – Kept unchanged at 6.0 per cent.

(a) Reverse Repo Rate

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

- To increase the fixed reverse repo rate by 25 basis points under the liquidity adjustment facility (LAF) of the Reserve Bank effective from April 29, 2005 to 5.00 per cent from 4.75 per cent.

The repo rate will continue to be linked to the reverse repo rate, as at present. However, the spread between the reverse repo rate and the repo rate is reduced by 25 basis points from 125 basis points to 100 basis points with effect from April 29, 2005. Accordingly, the fixed repo rate under LAF will continue to remain at 6.0 per cent.

b) Cash Reserve Ratio – Kept unchanged at 5.0 per cent.

First Quarter Review of Part I would be undertaken on July 26, 2005 while retaining the flexibility to take specific measures as the evolving circumstances warrant.

Developmental and Regulatory Policies for the Year 2005-06

Governor emphasized that the overall approach has been that of reorienting the role of RBI for improving institutional soundness, strengthening the regulatory and supervisory processes in alignment with international best practices and developing the necessary technological and legal infrastructure.

In order to reinforce stability of the overall system and to serve the common person, the emphasis of the policy Statement, at this stage, is on the following key areas

- To debate the current regulations on interest rates and priority sector in terms of their contemporary effectiveness in delivering adequate credit at appropriate prices.
- To facilitate a balanced development of the financial system, it is necessary to further develop money, forex and government securities markets.
- To bridge the financing gaps in agriculture and in small and medium enterprises in order to enhance credit delivery.
- Sound corporate governance practices, better risk management and adherence to prudential norms within the financial sector.
- A roadmap for development and application of technology in the financial sector in the medium-term.
- To ensure availability of quality services to all sections of the population.

Interest Rate Prescriptions

The interest rates have been largely deregulated except for (i) savings deposit accounts, (ii) non-resident Indian (NRI) deposits, (iii) small loans up to Rs.2 lakh and (iv) export credit.

While there is merit in moving forward to impart greater competitiveness and depth to the activities of the financial system by further deregulating interest rates in some segments which have hitherto remained regulated for various reasons found relevant at different stages, it is proposed to continue with *status quo* as various issues pertaining to above regulations on interest rates are being debated.

Financial Markets

Money Market

In order to review the recent developments and current status of money market in the context of evolving monetary policy framework, a Technical Group on Money Market was constituted. The Report of the Group was discussed in the Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC). Accordingly, the following measures are proposed.

Call/Notice/Term Money Market

- With effect from the fortnight beginning June 11, 2005, non-bank participants, except PDs, would be allowed to lend, on average in a reporting fortnight, up to 10 per cent of their average daily lending in call/notice money market during 2000-01.
- With effect from August 6, 2005, non-bank participants, except PDs, would be completely phased out from the call/notice money market.
- With effect from the fortnight beginning April 30, 2005, the benchmark for fixing prudential limits on exposures to call/notice money market in the case of scheduled commercial banks would be linked to their capital funds (sum of Tier I and Tier II capital).
- From April 30, 2005, all NDS members are required to report their term money deals on NDS platform.
- A screen-based negotiated quote-driven system for all dealings in call/notice and term money market transactions is proposed.

(ii) Market Repo

- An electronic trading platform for conduct of market repo operations in government securities, in addition to the existing voice based system to be facilitated.
- Participation in market repo facility in government securities for non-scheduled urban co-operative banks (UCBs) and listed companies having gilt accounts with scheduled commercial banks will be allowed subject to eligibility criteria and safeguards.

(iii) Certificates of Deposit

- The minimum maturity period of certificates of deposit (CDs) reduced from 15 days to 7 days with immediate effect.

The Report of the Group is being placed on RBI website for wider dissemination. Introduction of asset-backed commercial paper (ABCP) and additional intra-day LAF would be considered in future in consultation with market participants.

Optionality in OTC rupee derivatives would be considered, once legal clarity to OTC derivatives is provided and appropriate accounting standards are put in place.

Government Securities Market

(b) Central Government Securities Market: Medium-term Framework

In terms of the stipulation of FRBM Act, RBI will not be participating in primary issuance of government securities with effect from April 1, 2006. In order to address these emerging needs and equip RBI as well as the market participants appropriately, a Technical Group on Central Government Securities Market was constituted. Earlier, another Group (Chairman: Dr.R.H. Patil) had examined the role of primary dealers (PDs) in the government securities market. The Reports were discussed in TAC. Accordingly, the following measures are proposed:

- The number of actively traded securities need to be enlarged to enhance liquidity and improve pricing in the market. It is proposed to consolidate debt and build up large liquid securities in consultation with the Government while continuing the programme of reissuances.
- Post-FRBM, RBI will reorient government debt management operations while simultaneously strengthening monetary operations. This will entail functional separation between debt management and monetary operations within RBI. For this purpose, RBI will have discussions with market players on the modalities and procedures of market operations.
- The settlement system for transactions in government securities will be standardised to T+1 basis.
- The Reserve Bank would continue to resort to multiple and uniform price methods flexibly in the auction of government securities.
- Permitted structures of PD business will be expanded to include banks which fulfil certain minimum criteria subject to safeguards and in consultation with banks, PDs and the Government.

The recommendations of the Technical Group on restructuring the underwriting obligations of PDs, allowing PDs exclusivity in primary auctions, introduction of 'When Issued Market' and limited short selling in government securities would be considered in consultation with the Government.

(c) Sale of Government Securities: Relaxation

In order to facilitate further deepening of the government securities market, it is proposed:

- To permit sale of government securities allotted in primary issues with and between CSGL account holders also on the same day.

(d) Market Borrowings of State Governments

The Twelfth Finance Commission (TWFC) recommended that the Centre should not act as a financial intermediary for future lending to the States and allow them to approach the market directly to raise the loan portion of the funds. As this would have major implications for the market borrowing programmes, RBI would facilitate smooth transition of the process in consultation with the Central and the state governments. As a first step, consultations were held with State Finance Secretaries on April 8, 2005.

Foreign Exchange Market

(a) Forex Market Group: Medium-term Framework

An internal Group constituted by RBI reviewed forex market liberalisation in select emerging markets and examined the current regulatory regime in the light of liberalisation in related sectors to identify areas for further liberalisation. The Report of the Group was discussed in TAC. As recommended by the Group, the following measures are proposed:

- Cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of tenor, to be allowed.
- Banks to be allowed to approve proposals for commodity hedging in international exchanges from their corporate customers.
- The closing time for inter-bank foreign exchange market in India to be extended by one hour up to 5.00 p.m.
- Dissemination of additional information including traded volumes for derivatives such as foreign currency-rupee options to the market.

The other recommendations of the Group pertaining to writing of covered options by corporates and hedging of economic risk of corporates in respect of their domestic operations would be considered taking into account the progress towards capital account convertibility, liberalisation in other sectors of the economy and the trend in overall balance of payments.

(b) Overseas Investment: Liberalisation

With a view to promoting Indian investments overseas, it is proposed:

- To raise the ceiling of overseas investment by Indian entities in overseas joint ventures and/or wholly owned subsidiaries from 100 per cent to 200 per cent of their net worth under the automatic route.

(c) Foreign Currency Accounts by Foreign Companies in India: Liberalisation

In order to further liberalise the procedure, it is proposed:

- To accord general permission to ADs to open foreign currency accounts of the project offices set up in India by foreign companies and operate the accounts flexibly.

III. Credit Delivery Mechanisms

(a) Flow of Credit to Agriculture

With a view to further increasing the flow of credit to agriculture, the following measures have been initiated:

- RBI has set up an Expert Group to formulate strategy for increasing investment in agriculture and the report is expected by end-May 2005.
- In order to make an assessment of customer satisfaction on credit delivery in rural areas by banks, it is proposed to conduct a survey with the help of an outside agency.

- Keeping in view the importance of post-harvest operations, it is proposed to increase the limit on loans to farmers through the produce marketing scheme from Rs.5 lakh to Rs.10 lakh under priority sector lending.
- There is a realisation amongst bankers that there are increasing business opportunities in financing agriculture, banks are, therefore, urged to continue their efforts to step up credit to agriculture.

(b) Micro-finance

In order to give further fillip to micro-finance movement, the following measures have been initiated:

- The Reserve Bank has enabled non-governmental organisations (NGOs) engaged in micro-finance activities to access ECBs up to US \$ 5 million during a financial year for permitted end-use, under automatic route, as an additional channel of resource mobilisation.
- As a follow-up of the Budget proposals, modalities for allowing banks to adopt the agency model by using the infrastructure of civil society organisations, rural kiosks and village knowledge centres for providing credit support to rural and farm sectors and appointment of micro-finance institutions (MFIs) as banking correspondents are being worked out.

(c) Credit Flow to Small Scale Industries

With a view to further smoothening the flow of credit, the following measures have been initiated:

- The Credit Information Bureau of India Ltd. (CIBIL) is working out a solution that would provide comprehensive credit reports on SSIs.
- The Reserve Bank is reviewing all its existing guidelines on financing small scale sector, debt restructuring, nursing of sick units, etc., with a view to rationalising, consolidating and liberalising them. Banks are urged to take the revised guidelines as indicative minimum requirement and the Boards of the banks are expected to formulate more liberal scheme as appropriate.
- Under a scheme to be drawn up by the RBI, banks will be encouraged to establish mechanisms for better co-ordination between their branches and branches of SIDBI which are located in 50 clusters that have been identified by the Ministry of Small Scale Industries, Government of India. Under the Scheme of strategic alliance (i) the existing branches of SIDBI redesignated as "Small Enterprises Financial Centres" (SEFC) will take up co-financing of term loan requirements of SSI units along with the bank branches and the working capital requirements of these units will be met by the banks; (ii) the expertise of the SIDBI in appraisal of credit requirements of SSI units will be leveraged by the branches of commercial banks, by payment of a nominal fee; (iii) SIDBI will provide other expert services to help the banks in simplifying the application forms, documentation and disbursement procedures, etc.; and (iv) the working of the scheme may be monitored and modified to suit the local conditions by the State Level Bankers' Committee (SLBC) and, depending on the experience, the coverage of the scheme may be extended to more

clusters. The services of SEFCs will be available for tiny industrial units also.

(d) Credit Flow to Medium Enterprises

The Reserve Bank will explore modalities to meet the growing financial needs of medium enterprises. A simplified debt restructuring and rehabilitation mechanism is also being considered for the sector.

(e) Restructuring and Development of Regional Rural Banks

In order to reposition RRBs as an effective instrument of credit delivery in the Indian financial system, RBI is in the process of reviewing the performance of RRBs, exploring restructuring of RRBs through merger/ consolidation, changing of sponsor banks, reviewing minimum capital requirement and suggesting suitable measures for regulation, supervision and governance of RRBs.

(f) Priority Sector Lending

Since there are several issues that need to be considered in this regard, it is appropriate that these are debated and examined in depth.

IV. Prudential Measures

(a) Policy on Merger and Amalgamation of Banks

Based on the recommendations of the Working Group constituted by RBI in pursuance of the recommendations of the Joint Parliamentary Committee (JPC), and in consultation with the Government, it is proposed:

- To issue guidelines on merger and amalgamation between private sector banks and with NBFCs. The guidelines would cover: process of merger proposal, determination of swap ratios, disclosures, norms for buying/selling of shares by promoters before and during the process of merger and the Board's involvement in the merger process. The principles underlying these guidelines would also be applicable as appropriate to public sector banks, subject to relevant legislation.

(b) Supervision of Financial Conglomerates

With a view to monitoring intra-group transactions and exposures, a pilot process was initiated to obtain information from the designated entities of each FC by the principal regulators. In order to appropriately focus on monitoring of the process, in consultation with Chairman, SEBI and Chairman, IRDA, it is proposed:

- To hold a half-yearly discussion with the CEO of the designated entity, which would be convened by the lead regulator with other regulators, on the basis of available information for review and addressing concerns, if any.

(c) Interests of the Depositors

Depositors' interests form the focal point of the regulatory framework for banking in India and it has been appropriately enshrined at several places in the Banking Regulation Act, 1949. Furthermore, as per the Act, some of the considerations that are required to be taken into account while granting licence for banking business, is whether the affairs of the company are not being or are not likely to be detrimental to the interests of the depositors or prejudicial to public interest. In our country, the socio-economic profile for a typical depositor who seeks

safe avenues for his savings deserves special attention relative to other stakeholders in the banks.

The Committee on Procedures and Performance Audit on Public Services (CPPAPS) (Chairman: S.S. Tarapore) expressed its dissatisfaction over treatment of ordinary depositors by banks.

Accordingly Governor proposed that,

- Banks are urged to refocus on deposit mobilisation and empower the depositors, by providing wider access and better quality of banking services.
- RBI will persist with its efforts to ensure quality of banking services, in particular, to small individual depositors.

(d) Financial Exclusion

There are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. Against this background:

- RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged.
- The nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person.
- Banks are urged to review their existing practices to align them with the objective of financial inclusion.

(e) Customer Service

Liberalisation and enhanced competition accord immense benefits, but experience has shown that consumers' interests are not necessarily accorded full protection and their grievances are not properly attended to.

Taking account these considerations, it has been decided:

- To set up an independent Banking Codes and Standards Board of India on the model of the mechanism in the UK in order to ensure that comprehensive code of conduct for fair treatment of customers are evolved and adhered to.
- To issue appropriate guidelines to banks to ensure transparency and disclosure of information by the card issuing banks and customer rights protection including facilitating enforcement of such rights.
- To widen the scope of the Banking Ombudsman *inter alia* to cover all individual cases/grievances relating to non-adherence to the fair practices code evolved by IBA and adopted by individual banks.

(f) New Capital Adequacy Framework in India: Implementation

In order to maintain consistency and harmony with international standards, banks were advised to adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk with effect from March 31, 2007. The Reserve Bank may consider allowing some banks to migrate to Internal Rating Based (IRB) approach after developing adequate skills both in banks and at supervisory levels. Under the New Framework, banks adopting Standardised Approach would use the

ratings assigned only by those credit rating agencies which are identified by RBI. Banks are also required to focus on formalising and operationalising their an Internal Capital Adequacy Assessment Process which will serve as a useful benchmark while undertaking the parallel run with effect from April 1, 2006.

(g) Ownership and Governance in Private Banks

Based on the feedback received on the draft guidelines on the policy framework for ownership and governance in private sector banks, RBI in consultation with the Government has since issued final guidelines. The Reserve Bank would enter into bank-wise dialogues to ensure a time-bound framework for compliance.

(h) Guidelines on Securitisation of Standard Assets

In order to ensure orderly development of the market, draft guidelines on securitisation of standard assets by banks/financial institutions and NBFCs were issued and placed on the RBI website for comments. On the basis of the feedback, the draft guidelines would be finalised.

(i) Guidelines on Purchase/Sale of Non-Performing Assets

With a view to further increasing the options available to banks for effectively addressing the issue of non-performing assets, draft guidelines were issued on sale/purchase of non-performing assets and comments thereon were sought from the banks by end-April 2005. The guidelines would be finalised on the basis of feedback.

(j) Modification of CDR Mechanism

Performance of the corporate debt restructuring (CDR) mechanism has been reviewed. Draft circular is being put in the public domain for wider dissemination before taking final decisions.

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

The Report of the Working Group on Conflicts of Interest in the Indian Financial Services Sector (Chairman: Shri D.M. Satwalekar) is expected by July 2005, which would be put in the public domain for wider dissemination before recommending for adoption.

V. Institutional Developments

Payment and Settlement Systems

(a) Payment and Settlement Systems: Action Points

Based on the feedback on the Vision Document for Payment and Settlement Systems, a roadmap for upgradation of payment systems was drawn up for implementation in the next three years (2005-08). The Vision Document indicating action points would be placed in the public domain for wider dissemination by June 2005.

(b) Board for Regulation and Supervision of Payment and Settlement Systems

A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) was constituted as a Committee of the Central Board of RBI as notified in the Gazette of India on February 18, 2005.

(c) Electronic Payment Products: Status and Proposed Action

The Reserve Bank proposes operationalisation of National Electronic Funds Transfer (NEFT) System, which would enable T+0 settlement for all networked

branches of banks all over the country for electronic transfer of funds. In order to facilitate non-networked branches of banks to transfer funds electronically, the NEFT (Extended) System would be implemented.

(d) Reinforcing of Information Security

In view of the increasing dependence of the financial sector on internal and external networks for their operations, information security has assumed greater importance. In this direction, RBI has initiated several measures to ensure information security in banks. Banks are encouraged to make increasing use of SFMS which is PKI-enabled for inter/intra bank transactions.

Information Technology

Technology Policy: Vision Document

In order to facilitate the technology plans of the financial sector, RBI is preparing a Financial Sector Technology Vision Document which would be put in the public domain for wider dissemination. Based on the feedback, action points would be finalised.

Urban Co-operative Banks

(a) UCBs: Medium-term Framework

A draft 'Vision Document for Urban Co-operative Banks' was prepared keeping in view the heterogeneity of the sector in terms of size, area of operation, performance and strength and was placed on the RBI website. Based on the feedback, a medium-term framework for urban co-operative banks (UCBs) up to 2010 is being drawn up. The medium-term framework would be placed in the public domain for wider dissemination and for implementation as appropriate. The Standing Advisory Committee for Urban Co-operative Banks is increasingly being used for continuous dialogue with the various stakeholders of the sector.

(b) Restructuring of Weak Scheduled UCBs

Keeping in view the importance of scheduled UCBs, RBI has begun a consultative process involving officials of the concerned state governments and banks for revitalising and rehabilitating the weak scheduled UCBs. The option of merger/amalgamation could also be explored wherever necessary.

Non-banking Financial Companies

The non-banking financial companies (NBFCs) play a critical role as an instrument of credit delivery. In this context, RBI is examining the issue of smooth flow of bank finance to NBFCs.

Working Group on Computerisation of State Treasuries and

On-line Connectivity

The Reserve Bank has constituted a Working Group on Computerisation of State Treasuries and On-line Connectivity to study the existing practices in treasury functions of various states, system of accounting of receipts and payments, etc.

Standing Committee on Procedures and Performance

Audit on Public Services

The Standing Committee on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore) constituted by RBI has ceased its operations in March 2005. In order to facilitate regular monitoring, Ad hoc

Committees in banks have been converted to permanent Standing Committees on Customer Service. A system for monitoring on a regular basis the customer services rendered by RBI offices is being put in place.

Legal Reforms: Review of Developments

The Credit Information Companies (Regulation) Bill, 2004 and Government Securities Bill, 2004 were introduced in the Parliament. As indicated in the Union Budget, 2005-06, certain amendments to the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934 will be considered by the Government. In addition, the Payment and Settlement Bill is being finalised by the Board for Regulation and Supervision of Payment and Settlement Systems.

Mid-term Review

A review of the annual policy Statement will be undertaken on October 25, 2005.

Alpana Killawala
Chief General Manager

Press Release: 2004-2005/1124

Annual Policy Statement for 2005-06 - Highlights

The Statement consists of two parts: Part I. Annual Statement on Monetary Policy for the Year 2005-06; and Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2005-06. An analytical review of macroeconomic and monetary developments was issued, a day in advance, as a supplement to Part I of the Statement providing the necessary information and technical analysis with the help of simple charts and tables.

The format of presentation of this Statement has been modified to include a First Quarter Review in July and a Third Quarter Review in January besides, as in the past, a Mid-term Review of the annual policy Statement in October, to facilitate structured communication with markets on a more frequent basis.

Domestic Developments

- During 2005-06, real GDP growth projected at around 7.0 per cent, inflation rate in a range of 5.0-5.5 per cent and M₃ at 14.5 per cent
- GDP growth for 2004-05 placed at 6.9 per cent.
- Inflation rate stood at 5.0 per cent as at end-March 2005.
- Money supply (M₃) increased by 12.8 per cent.
- RBI's foreign currency assets increased by Rs.1,15,044 crore. The expansionary impact of foreign currency assets was neutralised to a large extent by substantial recourse to the MSS in conjunction with reverse repo operations under LAF.
- Non-food credit increased by 26.5 per cent. Total flow of funds from SCBs increased by 23.6 per cent exceeding the growth of 19.0 per cent anticipated in October 2004.
- Combined market borrowings of the Centre and States were lower.
- During 2004-05, financial markets remained generally stable. While interest rates in money and government securities markets rose intra-year, they stabilised in the later part of the year, *albeit* at higher levels.
- While the share of sub-PLR lending rose, lending rates remained stable.
- Combined daily transactions of market repo and CBLO was higher than those in the uncollateralised call/notice money market.

External Developments

- Exports in US dollar terms increased by 27.1 per cent while Imports by 36.4 per cent leading to widening of trade deficit to US \$ 23.8 billion during 2004-05 (upto February).
- During 2004-05 (April-December), current account showed a deficit of US \$ 7.4 billion as against a surplus of US \$ 4.8 billion in the corresponding period of the previous year,
- Net accretion to foreign exchange reserves, including valuation changes, amounted to US \$ 18.2 billion during April-December 2004.
- Indian foreign exchange market witnessed orderly condition with rupee exhibiting two-way movements.

Global Developments

- Though world economy is projected to slow to 4.3 per cent in 2005, expansion is above trend.
- Oil price appears to have larger permanent component.
- Risk to growth arises from current account and fiscal imbalances necessitating exchange rate adjustment.
- The global financial system is stable but risks have increased.

Stance of Monetary Policy

- Overall stance of monetary policy for the year 2005-06 will continue to be as set out in the mid-term Review of October 2004 which includes: (i) Provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability, (ii) consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth and (iii) to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent
- Reverse Repo Rate increased by 25 basis points to 5.0 per cent.
- Cash Reserve Ratio kept unchanged at 5.0 per cent.

Developmental and Regulatory Policies

- *Status quo* on the administered interest rates on (i) savings deposit accounts, (ii) non-resident Indian (NRI) deposits, (iii) small loans up to Rs.2 lakh and (iv) export credit.
- Effective June 11, 2005, non-bank participants would be allowed to lend up to 10 per cent of their average daily lending in call/notice money market during 2000-01.
- Effective August 6, 2005, non-bank participants would be completely phased out from the call/notice money market.

- Effective April 30, 2005, the benchmark for fixing prudential limits on exposures to call/notice money market in the case of scheduled commercial banks would be linked to their capital funds (sum of Tier I and Tier II capital).
- From April 30, 2005, all NDS members are required to report their term money deals on NDS platform.
- A screen-based negotiated quote-driven system for all dealings in call/notice and term money market transactions is proposed.
- An electronic trading platform for conduct of market repo operations in government securities, in addition to the existing voice based system to be facilitated.
- Participation in market repo facility in government securities for non-scheduled urban co-operative banks (UCBs) and listed companies having gilt accounts with scheduled commercial banks will be allowed subject to eligibility criteria and safeguards.
- The minimum maturity period of certificates of deposit (CDs) reduced from 15 days to 7 days with immediate effect.
- Consolidation of debt and building up of large liquid securities in consultation with the Government while continuing the programme of reissuances.
- Post-FRBM, functional separation between debt management and monetary operations within RBI. For this purpose, RBI will have discussions with market players on the modalities and procedures of market operations.
- The settlement system for transactions in government securities will be standardised to T+1 basis.
- The Reserve Bank would continue to resort to multiple and uniform price methods flexibly in the auction of government securities.
- Expansion of PD business structure to include banks which fulfil certain minimum criteria subject to safeguards and in consultation with banks, PDs and the Government.
- To permit sale of government securities allotted in primary issues with and between CSGL account holders also on the same day.
- Following the recommendation of the Twelfth Finance Commission, RBI would facilitate the smooth transition of States' market borrowing through consultation with the Central and the state governments.
- Cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of tenor, to be allowed.
- Banks to be allowed to approve proposals for commodity hedging in international exchanges from their corporate customers.
- The closing time for inter-bank foreign exchange market in India to be extended by one hour up to 5.00 p.m.
- To raise the ceiling of overseas investment by Indian entities in overseas joint ventures and/or wholly owned subsidiaries from 100 per cent to 200 per cent of their net worth under the automatic route.

- To accord general permission to ADs to open foreign currency accounts of the project offices set up in India by foreign companies and operate the accounts flexibly.
- RBI has set up an Expert Group to formulate strategy for increasing investment in agriculture.
- It is proposed to conduct a survey to assess customer satisfaction on credit delivery in rural areas by banks with the help of an outside agency.
- It is proposed to increase the limit on loans to farmers through the produce marketing scheme from Rs.5 lakh to Rs.10 lakh under priority sector lending.
- Banks are urged to continue their efforts to step up credit to agriculture.
- The Reserve Bank has enabled NGOs to access ECBs up to US \$ 5 million during a financial year for permitted end-use, under automatic route.
- As a follow-up of the Budget proposals, modalities for allowing banks to adopt the agency model for providing credit support to rural and farm sectors and appointment of MFIs as banking correspondents are being worked out.
- CIBIL is working out a solution that would provide comprehensive credit reports on SSIs.
- The Reserve Bank is reviewing all its existing guidelines on financing small scale sector, debt restructuring, nursing of sick units, etc., with a view to rationalising, consolidating and liberalising them. Banks are urged to take the revised guidelines as indicative minimum requirement and the Boards of the banks are expected to formulate more liberal scheme as appropriate.
- Under a scheme to be drawn up by the RBI, banks will be encouraged to establish mechanisms between their branches and branches of SIDBI which are located in 50 clusters that have been identified by the Ministry of Small Scale Industries, Government of India for enhancing credit to small industries.
- The Reserve Bank will explore modalities to meet the growing financial needs of medium enterprises.
- RBI is in the process of reviewing the performance of RRBs and exploring restructuring of RRBs.
- Issues regarding priority sector lending need to be debated and examined in depth.
- To issue guidelines on merger and amalgamation between private sector banks and with NBFCs. The principles underlying these guidelines would also be applicable as appropriate to public sector banks, subject to relevant legislation.
- Half-yearly discussion with the CEO of the financial conglomerate convened by the lead regulator with other regulators.
- Banks are urged to refocus on deposit mobilisation and empower the depositors, by providing wider access and better quality of banking services.
- RBI will persist with its efforts to ensure quality of banking services, in particular, to small individual depositors.

- RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged.
- The nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person.
- Banks are urged to review their existing practices to align them with the objective of financial inclusion.
- To set up an independent Banking Codes and Standards Board of India on the model of the mechanism in the UK in order to ensure that comprehensive code of conduct for fair treatment of customers are evolved and adhered to.
- To issue appropriate guidelines to banks to ensure transparency and disclosure of information by the card issuing banks and customer rights protection including facilitating enforcement of such rights.
- To widen the scope of the Banking Ombudsman *inter alia* to cover all individual cases/grievances relating to non-adherence to the fair practices code evolved by IBA and adopted by individual banks.
- In order to maintain consistency and harmony with international standards, banks advised to adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk with effect from March 31, 2007. The Reserve Bank may consider allowing some banks to migrate to Internal Rating Based (IRB) approach after developing adequate skills both in banks and at supervisory levels.
- The Reserve Bank would enter into bank-wise dialogues relating to ownership and governance in private banks to ensure a time-bound framework for compliance.
- On the basis of the feedback, the draft guidelines on securitisation of standard assets would be finalised.
- The guidelines on sale/purchase of non-performing assets would be finalised on the basis of feedback.
- Draft circular on CDR is being put in the public domain for wider dissemination before taking final decisions.
- The Report of the Working Group on Conflicts of Interest in the Indian Financial Services Sector (Chairman: Shri D.M. Satwalekar) would be put in the public domain for wider dissemination before recommending for adoption.
- The Vision Document for Payment and Settlement Systems indicating action points would be placed in the public domain for wider dissemination.
- A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) was constituted as a Committee of the Central Board of RBI as notified in the Gazette of India on February 18, 2005
- The Reserve Bank proposes to operationalise National Electronic Funds Transfer (NEFT) System and NEFT (Extended).

- Banks are encouraged to make increasing use of SFMS which is PKI-enabled for inter/intra bank transactions.
- In order to facilitate the technology plans of the financial sector, RBI is preparing a Financial Sector Technology Vision Document which would be put in the public domain.
- A medium-term framework for UCBs up to 2010 would be placed in the public domain for wider dissemination and for implementation as appropriate.
- RBI has begun a consultative process involving officials of the concerned state governments and banks for revitalising and rehabilitating the weak scheduled UCBs.
- RBI is examining the issue of smooth flow of bank finance to NBFCs.
- The Standing Committee on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore) constituted by RBI has ceased its operations in March 2005. In order to facilitate regular monitoring, Ad hoc Committees in banks have been converted to permanent Standing Committees on Customer Service.
- First Quarter Review of Part I to be undertaken on July 26, 2005.