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April 18, 2006

**RBI Governor announces Annual Policy Statement for the year 2006-07**

## Highlights

- **Focus on credit quality and financial market conditions for maintaining macroeconomic, in particular, financial stability.**
- **Monetary and interest rate environment enabling growth momentum consistent with price stability.**
- **Bank Rate, Reverse Repo Rate, Repo Rate and Cash Reserve Ratio kept unchanged.**
- **GDP growth projection for 2006-07 at 7.5-8.0 per cent.**
- **Inflation to be contained within 5.0-5.5 per cent during 2006-07.**
- **$M_3$ projected to expand by around 15.0 per cent for 2006-07. In normal circumstances, the policy preference would be for maintaining a lower order of money supply growth in 2006-07.**
- **Deposits projected to grow by around Rs.3,30,000 crore for 2006-07.**
- **Adjusted non-food credit projected to increase by around 20 per cent, implying a calibrated deceleration from a growth of around 30 per cent ruling currently.**
- **Appropriate liquidity to be maintained to meet legitimate credit requirements, consistent with price and financial stability.**
- **Ceiling interest rate on non-resident (external) rupee deposits raised to US dollar LIBOR/SWAP plus 100 basis points.**
- **Ceiling interest rate on export credit in foreign currency raised to LIBOR plus 100 basis points.**
- **Provisioning for standard advances raised to 1.0 per cent for personal loans, capital market exposures, residential housing beyond Rs.20 lakh and commercial real estate loans.**
- **Risk weight on exposures to commercial real estate raised to 150 per cent.**
- **Exposure to venture capital funds treated as part of capital market exposure and assigned with higher risk weight of 150 per cent.**
- **'When issued' market in Government securities announced.**
- **Primary Dealers to be permitted to diversify their activities.**
- **Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy at this juncture will be:**
    - **to ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt**

**manner on any signs of evolving circumstances impinging on inflation expectations.**

- **to focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability.**
- **to respond swiftly to evolving global developments.**

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Dr. Y. Venugopal Reddy, Governor, in a meeting with Chief Executives of major commercial banks today presented the annual policy Statement for 2006-07. The Statement consists of two parts: Part I. Annual Statement on Monetary Policy for the Year 2006-07; and Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2006-07.

## Domestic Developments

- The upward revision of real GDP growth to 7.5-8.0 per cent in the Third Quarter Review of January 24, 2006 turned out to be in alignment with the advance estimate of the Central Statistical Organisation at 8.1 per cent for 2005-06, up from 7.5 per cent in the previous year.

- Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year basis, was 4.0 per cent at end-March 2006 and 3.5 per cent as on April 1, 2006 after receding from a peak of 6.0 per cent on April 23, 2005.

- The average price of the Indian basket of international crude varieties (comprising Brent and Dubai Fateh) ruled at around US $ 60.1 per barrel in January-March, 2006 higher by 30.2 per cent than a year ago.

- After excluding the end-March effect, the year-on-year $M_3$ growth was 16.2 per cent (Rs.3,77,238 crore) in 2005-06 (March 31, 2006 over April 1, 2005) as compared with 12.1 per cent (Rs.2,42,260 crore), net of conversion, in the previous year.

- Excluding the end-March effect, the year-on-year increase in aggregate deposits during 2005-06 (March 31, 2006 over April 1, 2005) was 16.9 per cent (Rs.3,02,534 crore) as against an increase of 12.8 per cent (Rs.1,92,269 crore), net of conversion, in the previous year.

- Excluding the end-March build-up, the year-on-year increase in non-food bank credit during 2005-06 (over April 1, 2005) was 30.8 per cent (Rs.3,42,493 crore) on top of 27.5 per cent (Rs.2,21,602 crore), net of conversion, a year ago.

- Financial markets remained generally stable during 2005-06 although interest rates firmed up in all segments and the uncollateralised overnight call market experienced persistent tightness during the last quarter of the year.

- A noteworthy and desirable development during the year was the substantial migration of money market activity from the uncollateralised call money segment to the collateralised market repo and collateralised borrowing and lending obligations (CBLO) markets.

- The total overhang of liquidity as reflected in outstandings under the Liquidity Adjustment Facility (LAF), the Market Stabilisation Scheme (MSS) and surplus cash balances of the Central Government taken together declined from an average of Rs.1,14,192 crore in March 2005 to Rs.74,334 crore in March 2006.

- For the first time since 1969, investment by SCBs in Government and other approved securities declined by Rs.11,576 crore in 2005-06 in contrast to an increase of Rs.49,373 crore, net of conversion, in 2004-05.

- During 2005-06, the Central Government's net market borrowings at Rs.95,370 crore were 86.5 per cent of the budgeted amount of Rs.1,10,291 crore and gross market borrowings of Rs.1,58,000 crore were 88.5 per cent of the budgeted amount of Rs.1,78,487 crore.

## External Developments

- In US dollar terms, merchandise exports increased by 24.7 per cent during 2005-06 as compared with 26.4 per cent in the previous year. Imports showed an increase of 31.5 per cent as compared with 36.4 per cent in the previous year.

- While the increase in oil imports was higher at 46.8 per cent as compared with 45.2 per cent in the previous year, non-oil imports showed an increase of 25.6 per cent as compared with 33.3 per cent in the previous year.

- India's foreign exchange reserves increased by US $ 10.1 billion from US $ 141.5 billion at end-March 2005 to US $ 151.6 billion by end-March 2006.

- The foreign exchange market remained orderly in 2005-06 with the exchange rate exhibiting two-way movements. During 2005-06, the rupee depreciated by 1.9 per cent against the US dollar but appreciated by 4.4 per cent against the euro, by 5.5 per cent against the pound sterling and by 7.5 per cent against Japanese yen.

## Global Developments

- Global growth moderated in the fourth quarter (Q4) of 2005, but is estimated to have risen to 4.8 per cent by the International Monetary Fund (IMF) for the full year in view of the broad-based expansion in economic activity.

- Though price stability has been maintained in major industrial countries in the face of the oil shock, risks loom large in the form of lagged second order effects of oil price increases, geopolitical tensions, the probability of disorderly and rapid adjustment of current account imbalances and the risks emanating from the housing market, particularly when the cycle turns down.

## Overall Assessment

- Macroeconomic and financial conditions have evolved as stronger than expected. Inflation has been contained well within the projected range as reflected in the relative stability of long-term interest rates. There are indications of improvement in the fiscal situation and the return to the path of correction set by the Fiscal Responsibility and Budget Management Rules. Global growth has also exhibited considerable resilience.

- Downside risks to the economic outlook internationally continue in the form high and volatile oil prices, geo-political tensions and supply shocks, elevated asset prices, global imbalances and tightening of monetary policy globally. In the domestic economy, non-food credit growth, deposit growth and money supply growth were higher than the projections. Asset prices have registered a substantial increase. Ensuring credit quality and increasing the pace of investment in infrastructure is important.

## Stance of Monetary Policy

- GDP growth may be placed in the range of 7.5-8.0 per cent during 2006-07 assuming accelerated growth in agriculture under normal monsoon conditions and barring domestic or external shocks.

- The policy endeavour would be to contain the year-on-year inflation rate for 2006-07 in the range of 5.0-5.5 per cent.

- The expansion in $M_3$ is projected at around 15.0 per cent for 2006-07 even though the policy preference would be for maintaining a lower order of money supply growth in 2006-07.

- The growth in aggregate deposits is projected at around Rs.3,30,000 crore in 2006-07.

- Year-on-year adjusted non-food credit is expected to increase by around 20 per cent, a calibrated deceleration from a growth of above 30 per cent ruling currently.

- It is necessary to keep in view the dominance of domestic factors as in the past but to assign more weight to global factors than before while formulating the policy stance.

- 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 and financial 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 all the policy instruments at its disposal flexibly, as and when the situation warrants.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy at this juncture will be:

    - to ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations.

    - to focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability.

    - to respond swiftly to evolving global developments.

## Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent.

- Reverse Repo Rate and Repo Rate kept unchanged at 5.5 per cent and 6.5 per cent, respectively.

- Cash reserve ratio (CRR) kept unchanged at 5.0 per cent.

**Developmental and Regulatory Policies**

## *Interest Rate Policy*

- *Status quo* be maintained on interest rate on savings bank deposits.

- The ceiling on interest rates on non-resident (external) rupee deposits for one to three years maturity raised by 25 basis points to 100 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity with immediate effect.

- The ceiling interest rate on export credit in foreign currency raised by 25 basis points to LIBOR plus 100 basis points from LIBOR plus 75 basis points with immediate effect.

## *Financial Markets*

- A screen-based negotiated quote-driven system for dealings in call/notice and term money market (NDS-CALL) to be launched shortly with participation by market constituents on a voluntary basis.

- 'When issued' (WI) market in Government securities being introduced shortly.

- Primary dealers permitted to diversify their activities as considered appropriate, in addition to their core business of Government securities, subject to limits.

- Ways and means advances (WMA) limits for the Central government be fixed on a quarterly basis as against half-yearly as hitherto.

- For consolidation of Central Government securities, identified illiquid securities to be bought from the secondary market by the Reserve Bank and once a critical amount of securities is acquired, they would be bought back by the Government to extinguish the stock.

- Mutual Funds, which are NDS members, permitted to access the NDS-OM module with immediate effect. Other MFs would be permitted access by opening temporary current/SGL accounts with the Reserve Bank.

- Large pension/provident funds like CBOT/Seamens'/Coal Miners' funds permitted to access the NDS-OM module by opening temporary current/SGL accounts with the Reserve Bank. The smaller funds would be allowed access through the CSGL route.

- State Governments to be encouraged to progressively increase the share of market borrowings under the auction route.

- States, at their discretion and initiative, be encouraged to develop an advance indicative open market borrowing calendar.

- Facility of non-competitive bidding (currently limited to Central Government dated securities) be extended to the primary auction of State Development Loans.

- Purchase and resale of State Development Loans by the Reserve Bank introduced under the overnight LAF repo operations.

- Standing Technical Committee (STC) to be constituted under the aegis of the State Finance Secretaries Conference to advise on the wide-ranging issues relating to the borrowing programmes of Central and State Governments through a consensual and co-operative approach.

- Working Group to be constituted to examine the relevant recommendations of the High Level Expert Committee on Corporate Bonds and Securitisation (Chairman: Dr. R.H. Patil) and suggest a roadmap for implementation.

- ADs to grant extension of time to realise export proceeds up to US $ 1 million beyond the prescribed period of six months.

- ADs to allow remittances towards initial and recurring expenses of branch offices of Indian entities up to 10 per cent and 5 per cent of the average annual sales/income or turnover during the last two accounting years, respectively.

- Advisory Group (Chairman: Shri Mohandas Pai) constituted to review all foreign exchange regulations relating to services and make appropriate suggestions for further clarification or simplification.

### *Credit Delivery Mechanisms and Other Banking Services*

- RRBs permitted to open/shift offices after obtaining clearance from the Empowered Committees (ECs); similarly, requests for conduct of foreign exchange business as limited authorised dealers (for current account transactions) be approved on clearance by the ECs.

- Working Group to be constituted to suggest measures for assisting distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme under the DICGC Act for such farmers.

- Technical Group to be constituted to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and make recommendations to State Governments for improving the legal and enforcement framework in the interest of rural households.

- SLBC convenors in all States/UTs advised to identify at least one district in their area for achieving 100 per cent financial inclusion by providing a ‘no-frills’ account and a general purpose credit card (GCC) on the lines of the initiative taken in Pondicherry.

- Banks to display and update, in their offices/branches as also on their websites, the details of various service charges in a format to be approved by the Reserve Bank.

- Working Group to be constituted to formulate a scheme for ensuring reasonableness of bank charges and to incorporate the same in the Fair Practices Code.

### *Prudential Measures*

- Legal amendments proposed to enable all banks in India to avail of the option of public issue of preference shares for raising capital.

- Working Group to be constituted to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR mechanism.

- General provisioning requirement raised on standard advances, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans from the present level of 0.40 per cent to 1.0 per cent.

- Risk weight on exposures to commercial real estate raised from 125 per cent to 150 per cent.

- Bank's total exposure to venture capital funds will form a part of its capital market exposure and banks should assign a higher risk weight of 150 per cent to these exposures.

### *Institutional Developments*

- Banks are encouraged to ensure compliance with the findings of periodical information systems (IS) audit on a time bound basis in order to maintain robustness of the IT system.

- A new Centralised Public Accounts Department System (CPADS) software is being put in place to facilitate processing requirements of the Government accounts maintained with the Reserve Bank.

- By end-June 2006, 20,000 branches are proposed to be covered under RTGS system.

- Scope of Task Forces for Urban Co-operative Banks (TAFCUBs) be widened to cover scheduled urban co-operative banks (UCBs) registered in the State concerned and a similar forum be set up for regulatory co-ordination in respect of scheduled UCBs registered under the Multi-State Cooperative Societies Act.

- Working Group to be constituted to identify alternate instruments/avenues for augmenting the capital funds of UCBs.

- Well managed scheduled and non-scheduled UCBs be allowed to open select off-site/on-site ATMs, based on the recommendation of the TAFCUBs.

- Sub-committee of the TAFCUB to be set up to review the progress made by the liquidator in settlement of claims, recovery of dues and repayment to DICGC and other creditors including depositors.

- SIDBI and the NABARD agreed to evolve a viable credit dispensation arrangement to provide resource support to NBFCs catering to the needs of SME sector and agri-related activities.

- STAR series numbering system to be adopted for replacement of defectively printed banknotes.

The First Quarter Review of Part I of the annual policy to be undertaken on July 25, 2006.

**Alpana Killawala**
Chief General Manager

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