PRESS RELEASE

RESERVE BANK OF INDIA
www.rbi.org.in
www.rbi.org.in\hindi
e-mail: helpprd@rbi.org.in

PRESS RELATIONS DIVISION, Central Office, Post Box 406, Mumbai 400001
Phone: 2266 0502 Fax: 2266 0358, 2270 3279

October 31, 2006

RBI Governor announces Mid-term Review of Annual Policy for 2006-07

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

Highlights

- Repo Rate increased to 7.25 per cent from 7.0 per cent.
- The flexibility to conduct overnight repo or longer term repo including the right to accept or reject tender(s) under the LAF, wholly or partially is retained.
- Reverse Repo Rate, Bank Rate and CRR kept unchanged.
- GDP growth forecast at around 8.0 per cent during 2006-07.
- Inflation to be contained within 5.0-5.5 per cent during 2006-07.
- Monetary and credit growth expected to be higher than the initial projections.
- 'When issued' trading to be extended to fresh issues of Central Government securities.
- Scheduled commercial banks and primary dealers to be allowed to cover their short positions in Central Government securities within an extended period of five trading days.
- Resident individuals would be free to remit up to US $ 50,000 per financial year as against the earlier limit of US $ 25,000.
- Foreign exchange earners may retain up to 100 per cent of their foreign exchange earnings in their Exchange Earners' Foreign Currency accounts.
- Authorised dealer banks may borrow funds from their overseas branches and correspondent banks (including borrowing for export credit, external commercial borrowings (ECBs) and overdrafts from their Head Office/Nostro account) up to a limit of 50 per cent of their unimpaired Tier I capital or US $ 10 million, whichever is higher.
- Borrowers eligible for accessing ECBs can avail of an additional US $ 250 million with average maturity of more than 10 years under the approval route.
- Prepayment of ECB up to US $ 300 million without prior approval of the Reserve Bank.
- Authorised dealer banks may allow remittances on behalf of their customers up to 15 per cent of the average annual sales/income or turnover during the last two financial years or up

to 25 per cent of their net worth, whichever is higher, for initial expenses, and remittances up to 10 per cent of the average annual sales/income or turnover during the last two financial years for recurring expenses. They may also permit remittances for acquisition of immovable property for the overseas office, within these limits.

- The existing limit of US $ 2 billion on investments in Government securities by foreign institutional investors (FIIs) to be enhanced in phases to US $ 3.2 billion by March 31, 2007.
- The extant ceiling of overseas investment by mutual funds of US $ 2 billion is enhanced to US $ 3 billion.
- Importers to be permitted to book forward contracts for their customs duty component of imports.
- FIIs to be allowed to rebook a part of the cancelled forward contracts.
- Forward contracts booked by exporters and importers in excess of 50 per cent of the eligible limit to be on deliverable basis and cannot be cancelled.
- Authorised dealer banks to be permitted to issue guarantees/letters of credit for import of services up to US $ 100,000 for securing a direct contractual liability arising out of a contract between a resident and a non-resident.
- Lock-in period for sale proceeds of the immovable property credited to the NRO account to be eliminated, provided the amount being remitted in any financial year does not exceed US $ one million.
- Banks, with approval of their boards, may formulate a transparent policy for providing One Time Settlement facility to those farmers whose accounts have been rescheduled/ restructured due to natural calamities as also those who have defaulted on account of circumstances beyond their control.
- For opening small accounts, banks need to seek only a photograph of the account holder and self-certification of address.
- Indian banks having presence outside India and foreign banks to migrate to the Basel II framework effective March 31, 2008 and other scheduled commercial banks to migrate in alignment but not later than March 31, 2009.
- Prudential limit on credit and non-credit facilities to Indian Joint Ventures/Wholly Owned Subsidiaries abroad to be enhanced to 20 per cent of unimpaired capital funds.
- Financially sound Urban Co-operative Banks (UCBs) registered in States that have signed MoU with the Reserve Bank and those registered under the Multi-State Co-operative Societies Act, 2002 to be allowed to convert existing extension counters into full-fledged branches.
- Non-banking financial companies (NBFCs) to be allowed to issue co-branded credit cards with banks without risk sharing and to market and distribute mutual fund products.

Details

Domestic Developments

- Real GDP growth during the first quarter of 2006-07 is placed at 8.9 per cent as against 8.5 per cent in the corresponding quarter a year ago.
- The year-on-year (Y-o-Y) wholesale price index (WPI) inflation eased from its recent peak of 5.5 per cent on June 17, 2006 to 5.3 per cent by October 14, 2006.
- The average price of the Indian 'basket' of international crude has come down to US $ 58.9 per barrel as on October 27, 2006 from US $ 67.3 per barrel in April-June, 2006.
- The Y-o-Y CPI inflation for industrial workers was placed far higher at 6.3 per cent in August 2006 as against 3.5 per cent a year ago.
- The Y-o-Y growth in money supply (M3) was higher at 19.0 per cent on October 13, 2006 than 16.8 per cent a year ago.
- The Y-o-Y growth in aggregate deposits at Rs.3,93,849 crore (20.7 per cent) was higher than that of Rs.2,98,229 crore (18.6 per cent) a year ago.
- Non-food credit exhibited a Y-o-Y growth of Rs.3,76,105 crore (30.5 per cent) as on October 13, 2006 on top of an increase of Rs.2,97,903 crore (31.8 per cent) a year ago.
- The incremental non-food credit-deposit ratio during the current year so far, has declined to 77.7 per cent from 105.8 per cent a year ago.
- Banks' holdings of Government and other approved securities fell to 29.8 per cent of net demand and time liabilities as on October 13, 2006 from 34.7 per cent a year ago.
- The average liquidity overhang under the LAF, MSS and Centre's surplus cash balances increased from Rs.89,786 crore in April-June to Rs.92,354 crore in July-September before declining to Rs.85,196 crore in October (up to October 23).
- Financial markets continued to remain stable and orderly in the second quarter of 2006-07 although interest rates have firmed up in almost all segments.
- During April-October, 2006 public sector banks (PSBs) raised their deposit rates by 50-75 basis points (bps). The maximum deposit rates of private sector and foreign banks increased by 50-175 bps but the minimum deposit rates declined by 50-150 bps.
- The weighted average BPLR of PSBs and private sector banks increased from 11.18 per cent and 12.80 per cent in June to 11.33 per cent and 12.89 per cent, respectively, in September. The same for foreign banks remained stable at around 12.66 per cent.
- The BSE Sensex rallied with intermittent corrections to reach 12,907 on October 27, 2006.
- Central Government's gross borrowings at Rs.98,000 crore (Rs.84,000 crore a year ago) through dated securities during 2006-07 so far (up to October 27) constituted 63.2 per cent of the budget estimates (BE) while net market borrowings at Rs.62,986 crore (Rs.51,370 crore a year ago) constituted 54.3 per cent of the BE.

External Sector

- Exports increased by 22.9 per cent in US dollar terms during April-September, 2006 as against 34.1 per cent in the corresponding period of the previous year. Imports rose by 19.0 per cent as against 46.6 per cent in the corresponding period last year.

- Oil import bill increased by 36.8 per cent, reflecting the hardening of international crude oil prices (prior to the recent softening); non-oil import growth decelerated to 11.0 per cent from 48.5 per cent in the corresponding period last year.

- India's foreign exchange reserves increased to US $ 166.2 billion on October 20, 2006 up from US $ 151.6 billion at end-March, 2006 (including valuation effects).

- The rupee depreciated by 1.4 per cent against the US dollar, 5.5 per cent against the euro, 9.0 per cent against the pound sterling and 0.5 per cent against the Japanese yen during the current financial year so far (up to October 27, 2006).

Global Developments

- According to the IMF's World Economic Outlook, global real GDP growth in purchasing power parity terms is expected to pick up from 4.9 per cent in 2005 to 5.1 per cent in 2006 before easing back to 4.9 per cent in 2007.

- In the US, real GDP growth was 1.6 per cent in the third quarter (July-September) as compared with 5.6 per cent and 2.6 per cent in the first and second quarters, respectively.

- The strength of the global economy has been accompanied by upward pressure on commodity prices till the first half of 2006.

- Following the re-pricing of risks in May-June, investor optimism seems to have returned to most equity markets and, more significantly, to the emerging markets.

- A number of central banks have raised their policy rates, *inter-alia*, in the UK, Euro area, Australia, China and Korea. Some central banks have put a pause on policy rates, notably in the US, Canada, Japan, Malaysia, Thailand, Singapore, Chile, Mexico and Turkey. A few central banks have eased monetary policy, such as in Indonesia and Brazil.

Overall Assessment

- While global growth has been strong and broad-based, there are some indications of moderation like the cooling of the US housing market and the potential drainage of liquidity from financial markets. While global inflation conditions have not worsened, potential price pressures persist in the wake of the firming up of food and metal prices, the uncertainty surrounding international crude prices and the monetary overhang. While geopolitical risks continue to cast a shadow, it is necessary to recognise that global risks have not changed significantly from the time of the First Quarter Review of July, 2006.

- On the domestic front, there is a pick-up in the momentum of growth which also appears to be spreading across all constituent sectors. Financial markets have exhibited stable and orderly conditions. The current account deficit has been well-managed so far.

- There are indications of growing demand pressures and potential risks from rapid credit growth, strains on credit quality and elevated asset prices. High levels of monetary expansion and the evolution of the liquidity situation need to be continuously monitored for any signs of risks to inflation.

- At the current juncture, for policy purposes, the two major issues that exert conflicting pulls are exploration of signs of overheating firming up to warrant a policy response, and, the impact of lagged effects of earlier policy action on the evolution of macroeconomic developments.

Stance of Monetary Policy

- The GDP growth is forecast to be at around 8.0 per cent during 2006-07 as against 7.5-8.0 per cent projected in the Annual Policy Statement and the First Quarter Review.

- Containing the Y-o-Y inflation rate for 2006-07 in the range of 5.0-5.5 per cent assumes policy priority in terms of watchful monitoring and appropriate policy responses.

- The growth in monetary and credit aggregates is expected to be higher than the initial indicative projections. It is, however, important to reiterate the concerns expressed in the First Quarter Review and take careful note of the higher expansion in money supply, deposits and credit while assessing liquidity conditions.

- The increasing importance of global factors, by itself, would not warrant any change in the policy stance at this stage, though the evolving monetary policy actions of major economies need to be watched.

- In the domestic economy, there are signs of demand pressures in addition to possible transient supply constraints in respect of primary commodities.

- The Reserve Bank will ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank will continue with its policy of active demand management of liquidity through open market operations (OMO) including the 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 in the period ahead will be:

    - To ensure a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations.

    - To maintain the emphasis on macroeconomic and, in particular, financial stability.

    - To consider promptly all possible measures as appropriate to the evolving global and domestic situation.

Monetary Measures

- Repo Rate under the LAF is increased by 25 basis points from 7.0 per cent to 7.25 per cent with immediate effect.

- The Reserve Bank retains the option to conduct overnight repo or longer term repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.

- Reverse Repo Rate and Bank Rate have been kept unchanged at 6.0 per cent.
- CRR has been kept unchanged at 5.0 per cent.

Developmental and Regulatory Policies

Financial Markets

- It is proposed to extend the 'When issued' trading in the case of fresh issues of Central Government securities on a selective basis.
- It is proposed to allow scheduled commercial banks and primary dealers to cover their short positions in Central Government Securities within an extended period of five trading days and to deliver a shorted security by borrowing it through the repo market.
- Resident individuals would be free to remit up to US $ 50,000 per financial year for any current or capital account transaction or a combination of both, as against the earlier limit of US $ 25,000. The existing facilities for gifts, donations and investment by resident individuals in overseas companies would be subsumed under this revised limit.
- All categories of foreign exchange earners may retain up to 100 per cent of their foreign exchange earnings in their Exchange Earners' Foreign Currency accounts.
- Large turnkey/project exporters/service exporters with satisfactory track record may operate one foreign currency account with inter-project transferability of funds/machinery in any country, subject to specified reporting requirements.
- Large turnkey/project exporters/service exporters with good track record may deploy their temporary cash surpluses in either short-term bank deposits or AAA-rated short-term paper abroad, subject to monitoring by the authorised dealer bank(s).
- The stipulation regarding recovery of market value of machinery from the transferee project is withdrawn; however, such transfer of machinery should be reported to and monitored by the authorized dealer bank(s)/approving authority.
- Authorised dealer banks may borrow funds from their overseas branches and correspondent banks (including borrowing for export credit, external commercial borrowings (ECBs) and overdrafts from their Head Office/Nostro account) up to a limit of 50 per cent of their unimpaired Tier I capital or US $ 10 million, whichever is higher, as against the earlier overall limit of 25 per cent (excluding borrowing for export credit). Short-term borrowings up to one year or less should not exceed 20 per cent of unimpaired Tier I capital within the overall limit of 50 per cent.
- Borrowers eligible for accessing ECBs can avail of an additional US $ 250 million with average maturity of more than 10 years under the approval route, over and above the existing limit of US $ 500 million under the automatic route, during a financial year.
- Prepayment of ECB up to US $ 300 million, as against the earlier limit of US $ 200 million, will be allowed by authorised dealer banks without prior approval of the Reserve Bank subject to the stipulated minimum average maturity period as applicable to the loan.
- Authorised dealer banks may allow remittances on behalf of their customers up to 15 per cent of the average annual sales/income or turnover during the last two financial years or up

to 25 per cent of their net worth, whichever is higher, for initial expenses, and allow remittances up to 10 per cent of the average annual sales/income or turnover during the last two financial years for recurring expenses. They may also permit remittances for acquisition of immovable property for the overseas office, within these limits.

- The existing limit of US $ 2 billion on investments in Government securities by foreign institutional investors (FIIs) will be enhanced in phases to US $ 2.6 billion by December 31, 2006 and further to US $ 3.2 billion by March 31, 2007.
- The extant ceiling of overseas investment by mutual funds of US $ 2 billion is enhanced to US $ 3 billion.
- Importers will be permitted to book forward contracts for their customs duty component of imports.
- It is proposed to allow FIIs to rebook a part, say, 25 per cent of the cancelled forward contracts, provided such contracts are supported by underlying exposure.
- Forward contracts booked by exporters and importers in excess of 50 per cent of the eligible limit (as against the earlier 25 per cent limit) have to be on deliverable basis and cannot be cancelled.
- It is proposed to permit authorised dealer banks to issue guarantees/letters of credit for import of services up to US $ 100,000 where the guarantee is intended to secure a direct contractual liability arising out of a contract between a resident and a non-resident.
- It is proposed to eliminate the lock-in period for sale proceeds of the immovable property credited to the NRO account, provided the amount being remitted in any financial year does not exceed US $ one million.
- It is proposed to dispense with the existing restrictions on the number of tie-ups by banks with exchange houses and the number of drawee branches for rupee drawing arrangements in respect of those banks having sound risk management systems.

Credit Delivery

- Consistent with the notification of the Micro, Small and Medium Enterprises Development Act, 2006, it is proposed to modify the definition of small-scale industry and micro and small enterprises engaged in providing or rendering of services for the purpose of priority sector lending.
- Banks, with approval of their boards, may formulate a transparent policy for providing One Time Settlement facility to those farmers whose accounts have been rescheduled/ restructured due to natural calamities as also those who have defaulted on account of circumstances beyond their control.
- For opening small accounts, banks need to seek only a photograph of the account holder and self-certification of address.

Prudential Measures

- Foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009.

- It is proposed to enhance the prudential limit on credit and non-credit facilities to Indian Joint Ventures/Wholly Owned Subsidiaries abroad extended by banks from the existing 10 per cent to 20 per cent of unimpaired capital funds (Tier I and Tier II capital).

Institutional Developments

- Banks are urged to harmonise their IT-based initiatives to ensure that the objective of greater financial inclusion is achieved.

- It is proposed to allow financially sound UCBs registered in States that have signed MoU with the Reserve Bank and those registered under the Multi-State Co-operative Societies Act, 2002 to convert existing extension counters into full-fledged branches.

- The Reserve Bank would place a model draft Fair Practices Code for consideration of Task Forces for UCBs (TAFCUBs) set up in the States that have signed MoUs for deliberation and adoption.

- It is proposed to allow NBFCs to issue co-branded credit cards with banks without risk sharing; and to market and distribute mutual fund products as agents of mutual funds.

- It is proposed to re-group as asset financing companies the NBFCs engaged in financing real/physical assets supporting economic activity such as automobiles and general purpose industrial machinery.

- The Committee on Financial Sector Assessment would undertake a self-assessment of financial sector stability and development.

Alpana Killawala
Chief General Manager

Press Release: 2006-2007/589