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RBI Governor announces Mid-term Review of Annual Policy for 2007-08

Dr. Y. Venugopal Reddy, Governor, presented the Mid-term Review of Annual Policy for the Year 2007-08 today in a meeting with Chief Executives of major commercial banks. The Mid-term Review consists of two parts: Part I Mid-term Review of the Annual Statement on Monetary Policy for the Year 2007-08; and Part II Mid-term Review of the Annual Statement on Developmental and Regulatory Policies for the Year 2007-08.

Highlights

• Bank Rate, Repo Rate and Reverse Repo Rate kept unchanged.

• 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.

• CRR increased by 50 basis points to 7.5 per cent effective fortnight beginning November 10, 2007.

• GDP growth forecast retained at 8.5 per cent during 2007-08, assuming no further escalation in international crude prices and barring domestic or external shocks

• Inflation to be contained close to 5.0 per cent during 2007-08 while resolving to condition expectations in the range of 4.0-4.5 per cent, with a medium-term objective of inflation at around 3.0 per cent.

• Moderating net capital flows so that money supply is not persistently out of alignment with indicative projection of 17.0-17.5 per cent.

• Covering of 'Short-sale' and 'When Issued' transactions to be permitted outside the Negotiated Dealing System – Order Matching (NDS-OM) system.

• Systemically important non-deposit taking NBFCs (NBFC-ND-SI) to be considered as 'qualified entities' for accessing the NDS-OM using the Constituents' Subsidiary General Ledger (CSGL) route.

• Reinstatement of the eligible limits under the past performance route for hedging facility to be permitted.

• Oil companies to be permitted to hedge foreign exchange exposures by using overseas over-the-counter (OTC)/ exchange traded derivatives up to a maximum of one year forward.

• Importers and exporters having foreign currency exposures to be allowed to write covered call and put options in both foreign currency/ rupee and cross currency and receive premia.

• Authorised Dealers (ADs) to be permitted to run cross currency options books subject to the Reserve Bank's approval.

• ADs to be permitted to offer American options as well.

• Working Group to be constituted for preparing a road-map for migration to core banking solutions (CBS) by Regional Rural Banks (RRBs).

• RRBs and State/ Central Cooperative Banks to disclose their capital-to-risk weighted assets ratio (CRAR) as on March 31, 2008 in their balance sheets.

• A road-map to be evolved for achieving the desired level of CRAR by these banks.

• High Level Committee to be constituted to review the Lead Bank Scheme.

• Financial assistance to RRBs for implementing information and communication technology (ICT) based solutions.

• Working group to be constituted to lay down the road-map for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS).

• Besides general market risk, specific risk, especially the credit risk arising out of deficient documentation or settlement risk to be covered under the supervisory process.

• Action plan to be drawn up for implementation of National Electronic Clearing Service (NECS) with centralised clearing and settlement at Mumbai.

Domestic Developments

• Real GDP growth during the first quarter of 2007-08 is placed at 9.3 per cent as against 9.6 per cent in the corresponding quarter a year ago.

• The year-on-year (Y-o-Y) wholesale price index (WPI) inflation eased from its peak of 6.4 per cent on April 7, 2006 to 3.1 per cent by October 13, 2007.

• The average price of the Indian 'basket' of international crude has increased to US $ 80.0 per barrel as on October 23, 2007 from US $ 72.1 per barrel in July-September, 2007.

• The Y-o-Y CPI inflation for industrial workers showed a sharp increase to 7.3 per cent in August 2007 as against 6.3 per cent a year ago.

• The Y-o-Y growth in money supply (M_3) was higher at 21.8 per cent on October 12, 2007 than 18.9 per cent a year ago.

• The Y-o-Y growth in aggregate deposits at Rs.5,69,061 crore (24.9 per cent) was higher than that of Rs.3,88,528 crore (20.4 per cent) a year ago.

• Total credit exhibited a Y-o-Y growth of Rs.3,81,333 crore (23.3 per cent) as on October 12, 2007 on top of an increase of Rs.3,66,463 crore (28.8 per cent) a year ago.

• The Y-o-Y growth in total resource flow from scheduled commercial banks (SCBs) to the commercial sector was 22.1 per cent, over and above the growth of 28.0 per cent a year ago.

• Banks' holdings of Government and other approved securities increased to 30.0 per cent of their net demand and time liabilities (NDTL) as on October 12, 2007 from 28.0 per cent at end-March 2007.

• The overhang of liquidity under the LAF, MSS and the Central Governments' cash balances taken together increased to Rs.2,22,582 crore by October 24, 2007 from Rs.85,770 crore at end-March 2007.

•The Government of India, in consultation with the Reserve Bank, revised the ceiling under MSS for the year 2007-08 from Rs.1,10,000 crore to Rs.1,50,000 crore on August 8, 2007 and further to Rs.2,00,000 crore on October 4, 2007.

• During the second quarter of 2007-08, financial markets remained generally stable with conditions of abundant liquidity and interest rates moderated in almost all segments of the financial system.

• During April–October 2007, public sector banks (PSBs) decreased their deposit rates, particularly at the upper end of the range for various maturities, by 25-60 basis points.

• During April-October 2007, the benchmark prime lending rates (BPLRs) of private sector banks moved from a range of 12.50-17.25 per cent to 13.00-16.50 per cent.

• The range of BPLRs for PSBs and foreign banks, however, remained unchanged at 12.50-13.50 per cent and 10.00-15.50 per cent, respectively, during this period.

• The BSE Sensex increased from 13,072 at end-March 2007 to 19,243 on October 26, 2007.

• The gross market borrowings of the Central Government through dated securities at Rs.1,27,060 crore (Rs.1,17,548 crore a year ago) during 2007-08 so far (up to October 26) constituted 67.3 per cent of the budget estimates (BE) while net market borrowings at Rs.75,387 crore (Rs.65,951 crore a year ago) constituted 68.7 per cent of the BE.

External Sector

• Merchandise exports rose by 18.2 per cent in US dollar terms during April-August 2007 as compared with 27.1 per cent in the corresponding period of the previous year while import growth was higher at 31.0 per cent as compared with 20.6 per cent in the previous year.

• Non-oil imports rose by 44.3 per cent (10.9 per cent a year ago); oil imports, however, slowed down to 6.0 per cent (44.5 per cent), mainly on account of moderation in the price of the Indian basket of crude oil by 0.5 per cent during April-August 2007.

• India's foreign exchange reserves increased by US $ 62.0 billion during 2007-08 and stood at US $ 261.1 billion on October 19, 2007.

• The rupee appreciated by 10.3 per cent against the US dollar, by 2.4 per cent against the euro, by 5.4 per cent against the pound sterling and 7.1 per cent against the Japanese yen during the current financial year up to October 26, 2007.

Global Developments

• The downside risks to the global economic outlook have increased from a few months ago, accentuated by the recent financial market turmoil, firm inflationary pressures and high and volatile crude prices.

• According to the IMF's World Economic Outlook (WEO) released in October 2007, the forecast for global real GDP growth on a purchasing power parity basis has been retained at 5.2 per cent for 2007 as in the July 2007 update, down from 5.4 per cent in 2006, but forecast for 2008 has been revised down to 4.8 per cent in October from 5.2 per cent in the July 2007 update.

• In the US, real GDP growth had risen to 3.8 per cent in the second quarter of 2007 as compared with 2.4 per cent a year ago - The IMF's October 2007 WEO expects the US economy to grow at 1.9 per cent in 2007 and 2008 as against 2.9 per cent in 2006.

• There was a sudden fall in credit market confidence in late July brought on by the spread of risks from exposure to the US sub-prime mortgages with credit crunch spreading into corporate bond markets and equity markets.

• The European Central Bank and the US Federal Reserve, which have intervened since August 9 by providing liquidity to the inter-bank market, were joined by central banks in Canada, Japan, Australia, Norway and Switzerland.

•Bank of England has provided liquidity support to a mortgage lending bank, while giving a blanket guarantee to depositors on the safety of their deposits.

• Several central banks have cut policy rates during the third quarter of 2007 after financial markets were significantly affected by turbulence, such as the US Federal Reserve, the Banco Central do Brasil, Bank Indonesia (BI) and the Bank of Thailand.

• The central banks that have tightened their policy rates include the European Central Bank; the Bank of England; the Bank of Japan; the Bank of Canada; the Reserve Bank of Australia; the Reserve Bank of New Zealand; the People's Bank of China; the Bank of Korea; the Banco de Mexico; and the Banco Central de Chile.

•A few central banks in Asia have used supplementary measures for tightening, besides increasing key policy rates. The only central bank that has kept policy rates steady is the Bank Negara Malaysia.

Overall Assessment

• Some positive elements in the global economy are (i) the global economy is strong and resilient; (ii) EMEs, by and large, have a better macro-environment than before; (iii) globally, corporate balance sheets are strong and less leveraged than in the past; (iv) large financial intermediaries are perhaps adequately capitalised to absorb the shocks of credit infirmities; and (v) the inflation environment has been, on the whole, benign.

• The global environment is fraught with uncertainties with international crude prices at new highs, having breached the level of US $ 90 per barrel while elevated food and metal prices would, in current circumstances, pass through to domestic inflation.

• The US Federal Reserve has been the most aggressive in terms of easing monetary policy, with a higher than expected rate cut, reflecting the concerns over impact of housing issues on consumption and, hence, growth.

• The most important issue for India is the possible impact of global financial market developments and policy responses by central banks in major economies.

• The immediate task for public policy in India, therefore, is to manage the possible financial contagion which is in an incipient stage with highly uncertain prospects of being resolved soon.

• On the domestic front, aggregate demand conditions have remained firm and on the uptrend.

• Key monetary aggregates, *i.e.,* reserve money and money supply have been running well above initial projections, reflecting the impact of higher than expected deposit growth and the exogenous expansionary effects of capital inflows as well as the drawdown of fiscal cash balances.

• The incomplete pass-through of international prices of crude, metals, food and commodities in general to consumer prices is indicative of suppressed inflation which carries destabilising potential into the future.

• The policy responses in the form of active liquidity management operations to modulate expansionary monetary and financial conditions were reflected in a generally orderly evolution of market liquidity.

• Since late July, global financial markets have experienced unusual volatility, strained liquidity and heightened risk aversion.

• While the trigger was the rising default rates on sub-prime mortgages in the US, the source of the problem was significant mis-pricing of risks in the financial system.

• Easy monetary policy, globalisation of liquidity flows, wide-spread use of highly complex structured debt instruments and inadequacy of banking supervision in coping with financial innovations also contributed to the severity of the crisis.

• At the current juncture and looking ahead, on the domestic front, the biggest challenge for monetary policy is the management of capital flows and the attendant implications for liquidity and overall stability.

• Yet another challenge is the rapid escalation in asset prices, particularly equity and real estate, which are significantly driven by capital flows.

• Over the next twelve to eighteen months, risks to inflation and inflation expectations would also continue to demand priority in policy monitoring.

Stance of Monetary Policy

• Real GDP growth in 2007-08 is placed at 8.5 per cent for policy purposes, as set out in the Annual Policy Statement of April 2007 and reiterated in the First Quarter Review.

• Policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08 and the resolve, going forward, would be to condition expectations in the range of 4.0-4.5 per cent so that an inflation rate of 3.0 per cent becomes a medium-term objective.

• Moderating the expansionary effects of net capital flows is warranted so that money supply is not persistently out of alignment with the indicative projections.

• The Reserve Bank will continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and open market operations (OMO) including the MSS and the LAF, 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 broadly continue to be:

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.
- To be in readiness to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusual heightened global uncertainties, and the unconventional policy responses to the developments in financial markets.

Monetary Measures

• The Bank Rate has been kept unchanged at 6.0 per cent.

• The repo rate under the LAF is kept unchanged at 7.75 per cent.

• The reverse repo rate under the LAF is kept unchanged at 6.0 per cent.

• The Reserve Bank has the flexibility to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warrant.

• The Reserve Bank retains the option to conduct overnight or longer term repo/reverse 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.

• CRR increased by 50 basis points to 7.5 per cent effective fortnight beginning November 10, 2007.

Developmental and Regulatory Policies

Financial Markets

• Non-Competitive Bidding Scheme in the Auctions of State Development Loans (SDLs) to be operationalised by March 31, 2008.

• Re-issuance of SDLs in the second half of 2007-08.

• The facility of new issuance structure for floating rate bonds (FRBs) is being built into the new Negotiated Dealing System (NDS) auction system being developed by the Clearing Corporation of India Limited (CCIL).

• The Reserve Bank is committed for permitting market repos in corporate bonds, once the corporate debt markets develop and the Reserve Bank is assured of availability of fair prices, and an efficient and safe settlement system based on delivery versus payment (DvP) III and Straight Through Processing (STP) is in place.

• Covering of 'Short-sale' and 'When Issued' transactions to be permitted outside the Negotiated Dealing System – Order Matching (NDS-OM) system.

• Systemically important non-deposit taking NBFCs (NBFC-ND-SI) to be considered as 'qualified entities' for accessing the NDS-OM using the Constituents' Subsidiary General Ledger (CSGL) route.

• The facility of permitting all exporters to earn interest on their Exchange Earners' Foreign Currency (EEFC) accounts to the extent of outstanding balances of US $ 1 million per exporter is extended up to October 31, 2008 and banks are free to determine the rate of interest.

• Reinstatement of the eligible limits under the past performance route for hedging facility provided that supporting underlying documents are produced during the term of the hedge undertaken.

• Oil companies to be permitted to hedge their foreign exchange exposures to the extent of 50 per cent of their inventory volume as at the end of the previous quarter by using overseas over-the-counter (OTC)/ exchange traded derivatives up to a maximum of one year forward.

• Importers and exporters having foreign currency exposures to be allowed to write covered call and put options in both foreign currency/ rupee and cross currency and receive premia.

• Authorised Dealers (ADs) to be permitted to run cross currency options books, subject to the Reserve Bank's approval.

• ADs to be permitted to offer American options as well.

Credit Delivery

- Internal Working Group to be constituted to examine the recommendations of the Committee on Agricultural Indebtedness (Chairman: Dr. R. Radhakrishna) relevant to the banking system in general and the Reserve Bank, in particular.

- Working Group to be constituted with representatives from the Reserve Bank, the NABARD, sponsor banks and RRBs for preparing a road-map for migration to core banking solutions (CBS) by RRBs.

- RRBs and State/ Central Cooperative Banks should disclose the level of CRAR as on March 31, 2008 in their balance sheets. A road-map may be evolved for achieving the desired level of CRAR by these banks.

- Working Group to be constituted to study the recommendations of Sengupta Committee report on 'Conditions of Work and Promotion of Livelihood in the Unorganised Sector' relevant to the financial system and suggest an appropriate action plan for implementation of acceptable recommendations.

- High Level Committee to be constituted to review the Lead Bank Scheme.

- Proposed to prepare a concept paper on financial literacy-cum-counseling centres detailing the future course of action.

- Financial assistance to RRBs for implementing information and communication technology (ICT) based solutions, including installation of solar power generating devices for powering ICT equipment in remote and under-served areas.

Prudential Measures

- Final guidelines on *Credit Default Swaps* would be issued by end-November 2007.

- Banks are urged to follow prescribed specific considerations while engaging recovery agents. Abusive practices followed by banks' recovery agents would invite serious supervisory disapproval.

- Constitution of a working group to lay down the road-map for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators, consistent with the framework envisaged in the Basel Committee on Banking Supervision (BCBS).

- In order to enhance the effectiveness of the banking supervisory system, the process of consolidated supervision to be integrated with the financial conglomerate monitoring mechanism for bank-led conglomerates.

- It is proposed to cover, besides general market risk, specific risk, especially the credit risk arising out of deficient documentation or settlement risk, under the supervisory process.

Institutional Developments

- Banks are urged to ensure that adequate disaster recovery systems are put in place to fully comply with the requirements.

- Banks are urged to draw up time-bound action plans for implementation of CBS across all their branches.

- An action plan to be drawn up for implementation of National Electronic Clearing Service (NECS) using the existing infrastructure of National Electronic Funds Transfer (NEFT) system with centralised clearing and settlement at Mumbai.

- Working group to be constituted comprising representatives of the Reserve Bank, State Governments and the Urban Cooperative Banks (UCBs) to examine the various areas where IT support could be provided by the Reserve Bank to UCBs.

- The Committee on Financial Sector Assessment (CFSA) (Chairman: Dr.Rakesh Mohan; Co-Chairman: Dr.D.Subbarao) submitted an interim report delineating its approach and reviewing the progress of work to the Finance Minister and Governor, Reserve Bank of India in July 2007. The CFSA is expected to complete the assessment by March 2008 and lay out a road-map for further reforms in a medium-term perspective.

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