

PART TWO : THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

VIII

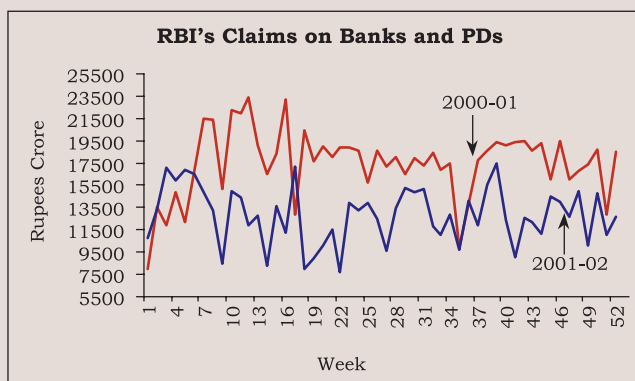
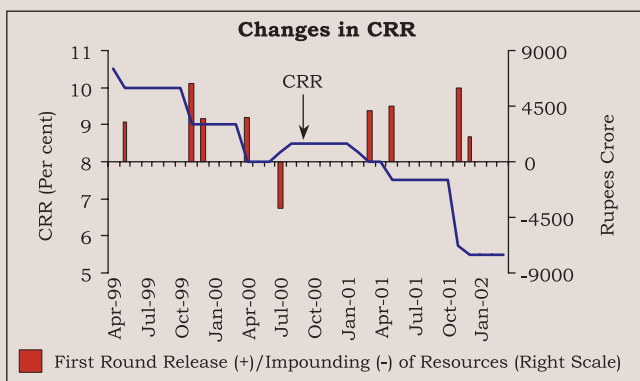
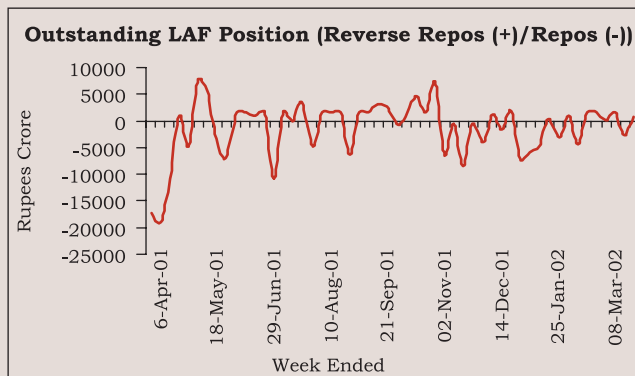
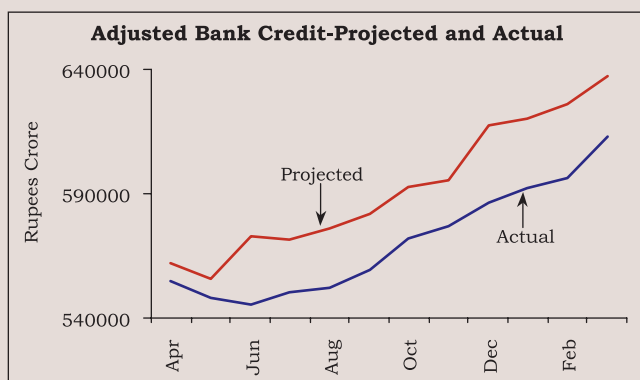
MONETARY AND CREDIT POLICY OPERATIONS

8.1 During 2001-02, monetary policy in India was committed to support the revival of investment demand in continuation of the stance adopted since 1997. The policy preference for softer interest rates and easier liquidity conditions was signaled through successive cuts in the Reserve Bank's key interest rates and in the CRR (Chart VIII.1). Market responses to policy signals were facilitated by an environment of flexibility created by reductions in important administered interest rates in the system, particularly those on small savings. Given the importance of credit for industrial activity, augmenting the availability of credit and improving the channels of credit flows assumed policy priority. Sufficient and stable liquidity remained the operating target for policy. Liquidity Adjustment Facility (LAF) operations combined with strategic open market operations

(OMO) have evolved into the principal operating procedure of monetary policy in the short run to ensure the adequate availability of liquidity consistent with the genuine credit requirements of the economy. Orderly development of financial markets including the technological and institutional infrastructure, and financial sector reforms were carried forward during the year. Even though inflation turned benign particularly in the second half of the year, price stability remained an abiding concern; in general, the stance of monetary policy was dominated by a sense of precaution in the context of unforeseen shifts in the inflationary outlook and the risk of external shocks in an uncertain international environment.

8.2 In April 2001, monetary and credit policy for 2001-02 was framed in the context of a projection of real GDP growth of 6.0 to 6.5 per cent on the basis of

Chart VIII.1 : Indicators of Monetary Policy - 2001-02



an anticipated revival in industrial growth and exports, and favourable prospects for agriculture. The fiscal deficit was budgeted at 4.7 per cent of GDP, providing a working estimate of the Government borrowing programme. The current account deficit in the balance of payments was expected to remain well within 2 per cent of GDP. With the deepening of the global slowdown, a decline in exports in the first half of the year and the industrial recovery failing to materialise, the real GDP growth projection was revised to 5.0 to 6.0 per cent in the mid-term review in October 2001. The rate of inflation was assumed to remain within 5 per cent. Expansion in broad money was projected at 14.5 per cent with the same order of increase for commercial bank deposits. Accordingly, non-food commercial bank credit inclusive of non-SLR investments was projected to increase by 16.0 to 17.0 per cent which was expected to be adequate to accommodate a revival of aggregate demand. Besides these summary indicators, a host of macro-economic and financial variables were monitored under the multiple indicator approach adopted for guiding the conduct of monetary policy in India whereby, high frequency data on both quantum and rate variables are juxtaposed with output data for drawing policy perspectives. The behaviour of these key indicators was broadly consistent with projections/expectations (Table 8.1).

Table 8.1 : Indicators - Expected and Outcome for 2001-02

Indicator	Expected	Outcome
1	2	3
Real GDP Growth (per cent)	5.0-6.0 *	5.4 #
WPI Inflation Rate (average basis) (per cent)	Within 5.0 per cent	3.6
Current Account Deficit (as per cent to GDP)	Well within 2.0	+ 0.3 @
Broad Money Growth (per cent)	14.5	14.2 P
Commercial Bank Deposit Growth (per cent)	14.5	14.6
Adjusted commercial bank non-food credit growth (per cent)	16.0-17.0	12.7 P

CSO's Revised Estimates. P Provisional.
* Revised in October 2001 @ + Indicates surplus.

8.3 During the year, efforts towards improving the transmission of monetary policy impulses were intensified. Operating procedures of monetary policy were further refined in order to provide greater operational flexibility to market participants and to develop the LAF as the primary instrument of liquidity adjustment and also as the key interest rate signal

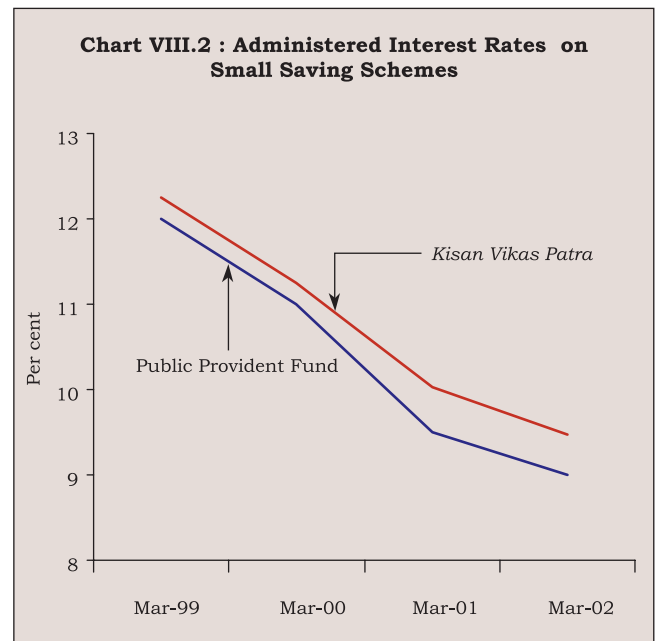
for the short-term money market. These changes encompassed standing liquidity facilities including export credit refinance, maintenance requirements under CRR and auction procedures under the LAF. The episodes of uncertainty in market sentiment during 2001-02 were counteracted with direct injections of primary liquidity by the Reserve Bank.

MONETARY POLICY OPERATIONS

Interest Rate Policy

Bank Rate

8.4 The stance of monetary policy was signaled in February and March 2001 with two successive cuts of 50 basis points each in the Bank Rate. With the further slowing down of industrial activity and exports, the Bank Rate was reduced by another 50 basis points to 6.50 per cent with effect from October 23, 2001, its lowest level since May 1973. A prospective cut of up to 50 basis points was indicated in the Policy Statement for 2002-03 if warranted by the overall credit and liquidity situation and if the inflation rate continued to remain low. In the recent period, a flexible interest rate environment has been created by reductions in key administered interest rates (Chart VIII.2).



Repo Rates

8.5 Comfortable liquidity conditions during April 2001 were reflected in daily average repo outstanding amount rising to Rs.10,968 crore from Rs.3,952 crore during March 2001. In response, the repo rate declined from 7 per cent to 6.75 per cent on April 27,

2001. As liquidity conditions eased during May 2001, the repo cut-off rate further decreased by 25 basis points to 6.50 per cent on May 28, 2001. Liquidity conditions remained easy thereafter for the rest of the year, except for brief spells in September, October and November 2001, when the Reserve Bank injected liquidity through reverse repos. The cut-off rate on repo remained at 6.5 per cent until March 5, 2002. Against the backdrop of downward revisions in the small saving interest rates, the Reserve Bank signaled a 50 basis cut in the repo rate on March 5, 2002 by conducting a fixed rate overnight repo auction at 6.0 per cent, which prevailed in subsequent LAF auctions till it declined further by 25 basis points to 5.75 per cent on June 27, 2002.

Lending and Deposit Rates

8.6 Interest rate policy has been focusing on imparting greater flexibility to the rate structure so that interest rates evolve in alignment with the behaviour of domestic economic activity and international macroeconomic and financial conditions. Banks are advised to reduce the maximum spreads over their prime lending rates (PLR) so that credit may be available to the borrowers at reasonable interest rates. In the interests of customer protection as also to encourage competition, banks are required to announce the maximum spread over PLR to the public along with the announcement of their PLR. Banks are also required to provide information on deposit rates for various maturities, effective annualised return to the depositor and maximum and minimum interest rates charged to their borrowers. Furthermore, banks have been urged to switch over to "all cost" concept for borrowers by explicitly declaring the processing charges, service charges, *etc.* to borrowers. As regards deposit rates, banks are encouraged to introduce flexible interest rate systems for all new deposits with resets at six-monthly intervals while a fixed rate option is also available to depositors. They are advised to consider paying the depositors at the contracted rate for the period of deposit already run and waive the penalty for premature withdrawal, if the same deposit is renewed at the variable rate. In order to provide greater flexibility to co-operative banks in a competitive environment, the stipulation of minimum lending rate (MLR) for all co-operative banks was withdrawn.

8.7 With progressive deregulation of interest rates, banks have considerable flexibility in setting their deposit and lending rate structures. Except for savings deposits on which the interest rate is fixed at

4 per cent, banks are free to offer fixed or floating rates linked to an anchor rate. In the April 2001 Policy Statement, they were allowed to offer fixed deposit schemes to senior citizens at fixed rates of interest relatively higher than normal deposits of any size. On the lending side, banks are free to prescribe their own PLRs across various tenors and also to lend at sub-PLR rates. In effect, the PLR ceased to be a floor rate for loans above Rs.2 lakh after the April 2001 policy announcement, although it continues to operate as a ceiling for loans up to Rs.2 lakh, taking on the role of a benchmark.

Interest Rates on Export Credit

8.8 The priority attached to reversing the export slowdown was reflected in a rationalisation of the export credit interest rate structure. Banks were required to indicate the interest rate on rupee export credit as a ceiling rate for all categories linked to the PLR. The ceiling rate for pre-shipment credit up to 180 days was set at 150 basis points below the PLR. In September 2001, the ceiling rate on export credit was reduced by a further 100 basis points across the board with the proviso that the ceiling rates would be readjusted upward by 100 basis points after September 2002. The effective interest rates, adjusted for the forward premium on export proceeds, declined to around 2-3 per cent and accordingly, active consideration is being given to the delinking of the interest rates on rupee export credit from the PLR.

8.9 The ceiling rate on export credit in foreign currency was reduced by 50 basis points to 100 basis points above the LIBOR in the April 2001 Policy announcement. In order to make the interest rate even more competitive, the ceiling rate on foreign currency loans was further reduced to LIBOR *plus* 75 basis points in the April 2002 Policy Statement.

FCNR(B) Interest Rates

8.10 The interest rates on FCNR(B) deposits were revised downwards by 50 basis points and set at LIBOR/SWAP rates for corresponding maturities in April 2001. In the April 2002 policy announcement, they were reduced further to LIBOR/SWAP *minus* 25 basis points for the corresponding maturities.

Cash Reserve Ratio

8.11 The Reserve Bank has been pursuing its medium-term objective of reducing the CRR to its statutory minimum level of 3.0 per cent by gradually

reducing the CRR from 11.0 per cent in August 1998 to 7.5 per cent by May 2001. In the October 2001 mid-term review, the CRR of scheduled commercial banks [excluding Regional Rural Banks (RRBs)] was reduced by 200 basis points to 5.5 per cent of their net demand and time liabilities (NDTL). All exemptions were withdrawn, except on inter-bank liabilities, for the computation of NDTL (for requirement of maintenance of CRR) with effect from the fortnight beginning November 3, 2001. In the annual Policy Statement of April 2002, a 50 basis point reduction in the CRR was announced, bringing it to 5.0 per cent beginning June 15, 2002. On a review of the liquidity conditions the CRR reduction was advanced to June 1, 2002. The CRR would continue to be used in both directions for liquidity management in addition to other instruments.

8.12 From April 21, 2001, the interest rate paid on eligible balances under the CRR was increased to 6 per cent with a medium term objective of aligning it with the Bank Rate. Subsequently, in the mid-term review of October 2001, eligible cash balances of CRR are remunerated at the Bank Rate. From August 11, 2001, the inter-bank term liabilities of original maturity of 15 days and up to one year were exempted from the prescription of minimum CRR requirement of 3.0 per cent.

Liquidity Adjustment Facility

8.13 In recent years, the thrust of monetary management has shifted towards development of indirect instruments of monetary policy to enable the Reserve Bank to transmit liquidity and interest rate signals in a flexible manner. The Liquidity Adjustment Facility (LAF), operated through daily repo and reverse repo auctions, is assigned the objectives of meeting day to day liquidity mismatches in the system but not funding requirements, restricting volatility in

short-term money market rates and steering these rates consistent with monetary policy objectives.

8.14 In the second stage of LAF starting from May 8, 2001, rationalisation in the operating procedures of LAF was effected. The minimum bid size was reduced from Rs.10 crore to Rs.5 crore to enable small level operators to participate in LAF auctions. The auction format for LAF was changed from the uniform price auction method to the multiple price auction method to ensure more responsible bidding (Table 8.2). The timing for LAF auctions was advanced by 30 minutes with a view to providing additional time to the unsuccessful bidders in LAF auctions to cover up their positions in the short-term money market. A system of information dissemination on aggregate cash balances maintained by scheduled commercial banks with Reserve Bank on a cumulative basis during the reporting fortnight was introduced with a view to stabilising market expectations and dampening volatility in call rates. Further, the Reserve Bank has the option to introduce longer-term repos up to 14 days and the flexibility to resort to fixed rate repos on overnight basis. Since February 15, 2002, the members of Negotiated Dealing System (NDS) submit LAF bids in electronic form instead of physical form.

8.15 The medium-term objective is to move gradually towards a full fledged LAF and to do away with various sector-specific standing liquidity facilities. Towards this end, the new stage of LAF was introduced in synchronisation with the rationalisation of standing liquidity facilities. The switchover to the modified operating procedures so far has been smooth (Chart VIII.3).

8.16 The transition to the new operating mechanisms of the LAF during May 8-23, 2001 was facilitated by injections of liquidity through reverse repo auctions. The average daily reverse repo bids accepted during the

Table 8.2 : Evolution of Liquidity Adjustment Facility

Effective since	Measure
1	2
April 21, 1999	The Reserve Bank announced introduction of an Interim Liquidity Adjustment Facility (ILAF) through repos and lending against collateral of Government of India securities.
June 5, 2000	The Additional Collateralised Lending Facility (ACLF) for banks and Level II support to Primary Dealers (PDs) were replaced by a full-fledged Liquidity Adjustment Facility (LAF) operating through variable rate repo/reverse repo auctions with same day settlement.
May 8, 2001	Standing liquidity facilities were split into normal and backstop components effective May 5, 2001. The uniform price auction format was replaced with multiple price auction format. The timing for LAF auctions and announcement of results was advanced by 30 minutes. The minimum bid size for LAF was reduced from Rs.10 crore to Rs.5 crore. Additional options were provided to the Reserve Bank to switch over to overnight fixed rate repos and to introduce longer term repos.

MONETARY AND CREDIT POLICY OPERATIONS

Chart VIII.3 : Evolution of Liquidity Adjustment Facility

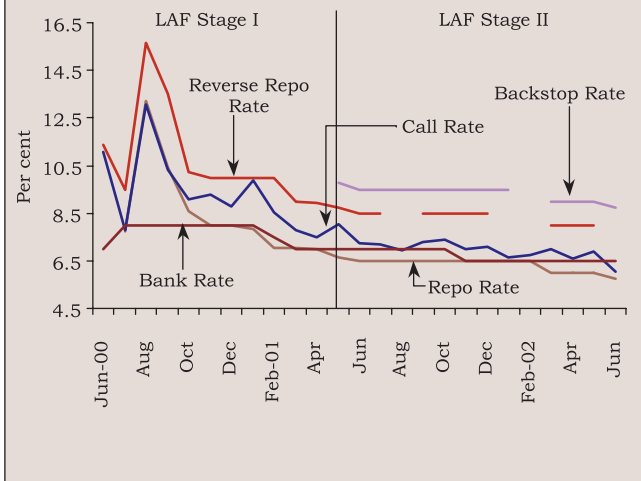
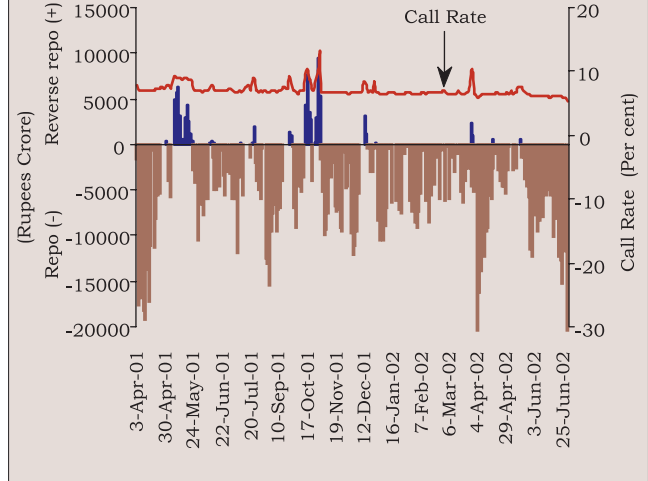


Chart VIII.4 : Repo, Reverse Repo Auctions under LAF and Weighted Average Call Rates



period were around Rs.2,699 crore, ranging between Rs.50 crore and Rs.6,215 crore (Chart VIII.4).

8.17 The LAF operations in the subsequent period from May 24, 2001 could be divided into three phases on the basis of prevailing liquidity conditions, viz., phase I from May 24, 2001 to October 15, 2001, phase II from October 16, 2001 to November 2, 2001 and phase III from November 3, 2001 onwards.

8.18 The transition was followed by a phase of easing of liquidity conditions facilitated by the release of liquidity

of around Rs.4,500 crore on account of the CRR cut on May 19, 2001 and overdrawn WMA position of Government. During phase I (May 24, 2001 to October 15, 2001), the call money rate remained generally stable and moved within the corridor of repo and reverse repo rates. The informal corridor to the call money rate provided by the LAF rates was, by and large, effective throughout the year except for brief spells. The bids were generally accepted in full; partial acceptances of repo bids were resorted to on a few occasions in response to some hardening in the call rates (Table 8.3). The average

Table 8.3 : Acceptance/Rejection of Repo/Reverse Repo Bids under LAF

Period	Repo Bids				Reverse Repo Bids			
	No. of days bids were received	No. of days all bids were rejected	No. of days of full acceptance of bids	No. of days of partial acceptance of bids	No. of days bids were received	No. of days all bids were rejected	No. of days of full acceptance of bids	No. of days of partial acceptance of bids
1	2	3	4	5	6	7	8	9
2001								
April	17	2	14	1	3	1	1	1
May	12	4	5	3	13	1	0	12
June	13	1	11	1	3	1	1	1
July	10	0	6	4	6	0	6	0
August	10	1	9	0	0	0	0	0
September	6	0	6	0	4	2	1	1
October	10	2	8	0	8	1	1	6
November	17	0	17	0	2	0	0	2
December	12	2	10	0	5	1	3	1
2002								
January	21	0	21	0	0	0	0	0
February	20	3	17	0	1	0	1	0
March	16	11	0	5	2	0	2	0
April	20	0	15	5	1	0	1	0
May	12	1	2	9	2	1	1	0
June	20	0	8	12	0	0	0	0
July	23	0	4	19	0	0	0	0

daily repo bids accepted during the period was at around Rs.4,534 crore, ranging from Rs.5 crore to Rs.15,500 crore.

8.19 In phase II (October 16, 2001 to November 2, 2001), the liquidity conditions tightened for a short span on account of the State Government securities' floatation on October 10, 2001. Reverse repo auctions were used to contain hardening of call money rates during this period. The average daily reverse repo bids accepted during the period was at around Rs.3,619 crore, ranging from Rs.30 crore to Rs.9,525 crore.

8.20 Large capital inflows, the cuts in CRR effected on November 3, 2001, December 29, 2001 and June 1, 2002 and overdrawn position in Government accounts, engendered ample liquidity conditions in phase III (November 3, 2001 to July 31, 2002). The one-day repo bids were generally accepted in full till March 4, 2002. On March 5, 2002, the overnight fixed rate repo was introduced to signal a repo rate cut by 50 basis points. Following the CRR cut effective from June 1, 2002, the repo rate further declined by 25 basis points to 5.75 per cent on June 27, 2002. Given the easy liquidity conditions, a fortnightly repo auction was introduced on November 5, 2001 in addition to the regular repo auctions although bids were accepted only on a few occasions. In the fortnightly repo, the average amount accepted during June-July 2002 was Rs. 3,623 crore.

Standing Liquidity Facilities

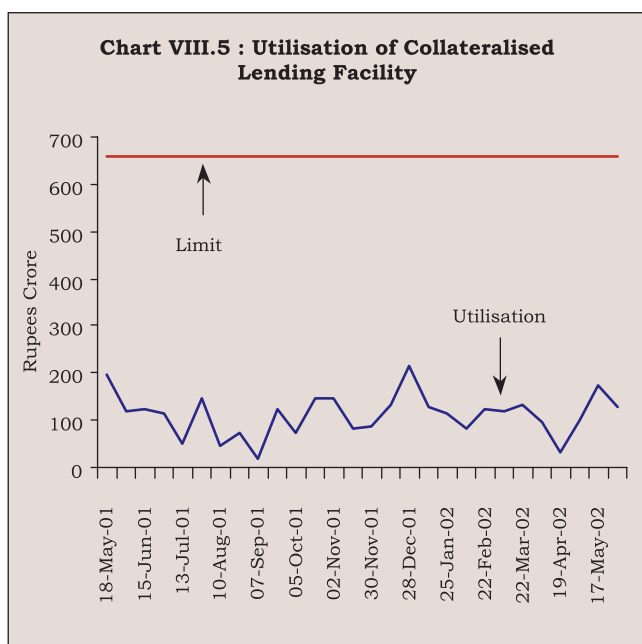
8.21 Consistent with the medium-term objective of conducting liquidity management only through the LAF, the standing liquidity facilities comprising Export Credit Refinance (ECR) and Collateralised Lending Facility (CLF) to banks, and liquidity support to PDs were split, effective May 5, 2001, into (i) a normal facility available at the Bank Rate constituting two-thirds of the total limit under the facility, and (ii) the remaining one-third in the form of a backstop facility available at a variable daily rate of 1 percentage point above the reverse repo cut-off rate in LAF auctions or 2-3 percentage points above the repo rate in the absence of reverse repo rates or 1-3 percentage point above NSE-MIBOR when no bids for repo/reverse repo auctions have been received/accepted (Table 8.4).

Collateralised Lending Facility

8.22 The extent of liquidity support available to each bank out of the CLF, under which liquidity is provided against the collateral of Government of India dated securities/Treasury Bills held in excess of their SLR requirement, has been stipulated at 0.125 per cent of its fortnightly average outstanding aggregate deposits in 1997-98. As against the overall limit for the system at Rs.657 crore, the average utilisation of this facility in 2001-02 was Rs.124 crore (Chart VIII.5).

Table 8.4 : Rationalisation of the Standing Liquidity Facilities for Banks

Effective since	Measure
1	2
February 8, 1996	The scheme of refinance against post-shipment credit denominated in US dollars (PSCFC) was withdrawn. Refinance against eligible PSCFC was allowed to continue. Banks were provided Export Credit Refinance against the rupee denominated credit only.
July 6, 1996	The refinance facility against government securities was withdrawn.
April 26, 1997	General Refinance facility was introduced.
September 22, 1998	Special liquidity facility was operated from September 22, 1998 to March 31, 1999 to tide over unanticipated liquidity problems of those scheduled commercial banks which were temporarily deploying the rupee resources available against Resurgent India Bonds (RIBs) in government securities sold by the Reserve Bank through the open market operations.
April 21, 1999	General refinance facility was withdrawn and replaced by a collateralised lending facility (CLF) providing accommodation up to 0.25 per cent of the fortnightly average outstanding aggregate deposits in 1997-98 which was made available for two-week period at the Bank Rate. An Additional Collateralised Lending Facility (ACLF) for an equivalent amount of CLF was made available at the Bank Rate <i>plus</i> two percentage points. CLF and ACLF availed for periods beyond two weeks were subject to a penal rate of 2 per cent for an additional two weeks.
December 1, 1999	A special liquidity support facility was operated from December 1, 1999 to January 31, 2000 to enable banks to meet any unanticipated additional demand for currency in the context of century date change.
June 5, 2000	ACLF was withdrawn with the introduction of the LAF.
May 5, 2001	Export Credit Refinance and CLF were split into two parts in approximately 2:1 ratio, <i>viz.</i> , normal facility constituting two-thirds of the total limit provided at the Bank Rate and a backstop facility constituting one-third at a variable daily rate linked to the cut-off rates in regular LAF auctions/NSE - MIBOR.
October 5, 2002	CLF would be phased out completely.



8.23 With the progressive development of the inter-bank repo market and operationalisation of Clearing Corporation of India Limited (CCIL), limits for the CLF would be reduced by 50 per cent with effect from the fortnight beginning July 27, 2002 and will be withdrawn completely by the fortnight beginning October 5, 2002. The option to reintroduce the CLF in the future has, however, been retained.

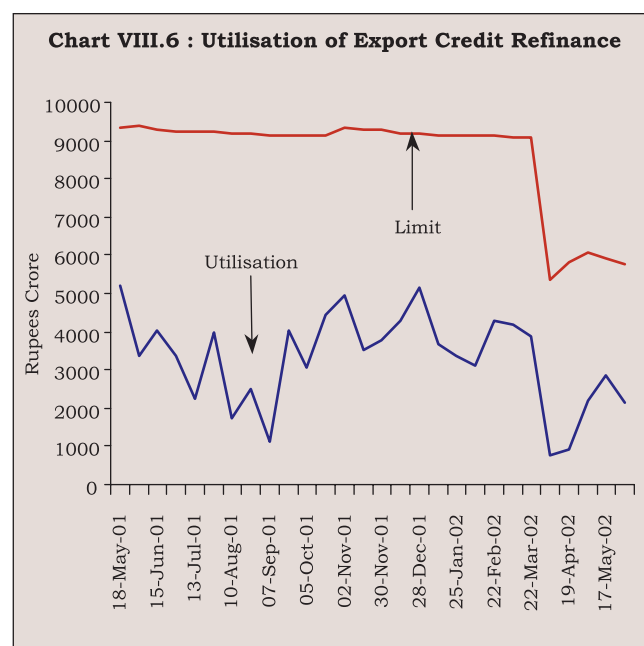
Export Credit Refinance

8.24 Beginning May 5, 2001 scheduled banks were provided export credit refinance to the extent of 15.0 per cent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight or the existing limits as on May 4, 2001, whichever was higher. The old formula, based on an increment of export credit eligible for refinance over the base date, did not reflect the extent of total credit support being provided by banks to exporters, especially in cases where the base level was high. The limit prevailing on May 4, 2001 constituted the minimum limit available to a bank up to March 31, 2002. Effective April 1, 2002, export credit refinance is being provided to scheduled banks at 15 per cent of their outstanding export credit eligible for refinance as at the end of the preceding fortnight.

8.25 The outstanding export credit decreased from Rs.45,387 crore as on March 23, 2001 to Rs.43,123 crore as on March 22, 2002 with its share in net bank credit dropping from 8.9 per cent to 7.4 per cent over this period (Appendix Table III.10). Accordingly, there

was a reduction in outstanding export credit eligible for refinance from the level of Rs.38,765 crore as on March 23, 2001 to Rs.35,461 crore as on March 22, 2002. Outstanding export credit increased to Rs. 47,166 crore as on July 26, 2002 with eligibility for refinance rising to Rs. 38,014 crore. Thus, the export credit refinance limit, which had gone up from Rs.7,192 crore as on March 23, 2001 to Rs.9,221 crore as on June 29, 2001 in response to the change in formula, declined subsequently to Rs.9,086 crore as on March 22, 2002 reflecting general sluggishness in export credit. It further declined to Rs. 5,702 crore as on July 26, 2002 due to the change in formula effective April 1, 2002. The daily average utilisation of export credit refinance facility remained subdued with the utilisation, on an average basis, working out to Rs.3,793 crore during 2001-02 as against a limit of Rs.9,014 crore (Chart VIII.6).

8.26 On September 24, 2001 the Reserve Bank announced a special financial package for a period of one year from October 1, 2001 with a view to providing bank credit at internationally competitive interest rates to large value export projects in a wide range of key industries which are internationally competitive. Credit is extended at a concessional rate of interest up to 365 days at pre-shipment as well as post-shipment stages as against the maximum periods of 270 days and 180 days, respectively, applicable for normal export credits. Furthermore, the rate of interest of export credit for the periods beyond 270 days and up to 365 days at pre-shipment stage is the same as for normal pre-shipment credit for the



period beyond 180 days and up to 270 days. Similarly, post-shipment credit is extended for periods beyond 180 days up to 365 days at the same rate of interest as applicable to normal post-shipment credit for the period beyond 90 days and up to 180 days.

8.27 Guidelines were issued to banks in January 2002 under which processing units in Agri-Export Zones would be provided packing credit for procuring and supplying inputs to the farmers to promote agri-exports.

Open Market Operations

8.28 Outright open market sales were conducted to neutralise the monetary impact of private placement of government securities with the Reserve Bank as also to sterilise foreign capital inflows (Table 8.5). The Reserve Bank's initial subscription amounted to Rs.21,000 crore during April-June 2001 as compared with Rs.6,961 crore during April-June 2000. The monetary impact could be partially offset with net open market sales of Rs.10,929 crore during April-June 2001 as compared with Rs.2,025 crore during April-June 2000. Open market sales were conducted thereafter to absorb excess liquidity in the system. The adverse reactions in the Indian financial markets in the wake of the terrorist attack on September 11, 2001 required the Reserve Bank to intervene more actively on the purchase side through a series of auctions - initially daily and subsequently weekly - from September 18, 2001 through October 3, 2001 in securities across the maturity spectrum to provide confidence and liquidity. Open market purchases of

Rs. 5,084 crore were made during September 18 to October 3, 2001. A private placement of Rs.3,213 crore was effected in March 2002 which was essentially a swap of loans and advances to development financial institutions under the National Industrial Credit (Long-Term Operations) Fund with long-term government bonds, and hence was cash neutral.

8.29 The year 2002-03 commenced with ample liquidity in the financial markets. The Reserve Bank conducted OMO sales amounting to Rs 20,583 crore during 2002-03 (up to August 17, 2002).

Credit Delivery

8.30 Credit delivery systems have been the focus of reforms since the 1990s with the objectives of augmenting the total volume of institutional credit and securing an equitable distribution of credit availability particularly for the weaker bidders in the credit market, both in terms of specific sections of society and regions. A concomitant objective has been to bring about substantive improvements in recoveries, reduce procedural delays and provide greater flexibility to banks.

Priority Sector lending

8.31 The scope of priority sector lending was expanded during the year to include financing of Agri-Clinics and Agri-business centres (indirect finance to agriculture) and financing of purchase of land by small and marginal farmers (direct finance to agriculture).

Table 8.5 : Reserve Bank's Net Foreign Assets, Net Reserve Bank Credit to the Centre, Reserve Bank's Initial Support to Market Borrowing and Open Market Operations

(Rupees crore)

Up to	Reserve Bank's Net Foreign Assets* (Cumulative)			Reserve Bank's Credit to Centre (Cumulative)			Reserve Bank's Initial Subscription (Cumulative)			Reserve Bank's Net OMO Sales (Cumulative)		
	2002-03	2001-02	2000-01	2002-03	2001-02	2000-01	2002-03	2001-02	2000-01	2002-03	2001-02	2000-01
1	2	3	4	5	6	7	8	9	10	11	12	13
April	3,076	794	1,753	11,976	5,067	13,507	0	12,000	0	5,307	60	36
May	5,470	2,341	779	13,814	20,774	11,077	20,018	12,000	515	6,831	5,083	36
June	9,209	7,107	-4,484	1,455	19,523	14,393	22,018	21,000	6,961	7,020	10,929	2,025
July	18,369	6,600	-5,413	9,577	11,849	17,479	23,175	21,000	19,506	13,558	16,020	7,991
August		10,550	-6,960		5,828	8,481		21,679	25,506		16,056	7,126
September		9,121	-6,605		-617	8,168		21,679	29,776		24,914	8,460
October		12,486	-7,352		4,268	24,359		21,679	30,151		22,275	8,527
November		21,206	3,121		11,225	14,154		25,679	30,151		22,321	20,063
December		27,242	12,816		-5,386	3,041		25,679	31,151		30,187	21,764
January		34,811	18,178		97	6,360		25,679	31,151		30,270	21,851
February		39,765	22,347		-2,479	6,932		25,679	31,151		30,293	21,852
March		57,994	27,201		-5,150	6,705		28,892	31,151		30,335	21,892

Note : Data for March pertain to March 31 and last reporting Friday for all other months.

* Net of revaluation of foreign currency assets.

All domestic scheduled commercial banks with shortfalls in their priority sector lending were advised to take appropriate steps to improve the flow of credit to the priority sector so as to achieve the target/sub-targets. The limit for financing of distribution of inputs for activities allied to agriculture under the priority sector was increased to Rs.25 lakh from Rs.15 lakh. The credit limit for farmers for marketing their produce (pledge financing) was increased from Rs.1 lakh to Rs.5 lakh and repayment schedules were extended to 12 months from 6 months earlier. In order to avoid double counting, sponsor banks were required to exclude funds provided to RRBs for on-lending to priority sector, while meeting the priority sector targets.

8.32 While public sector banks and foreign banks as a whole achieved their overall targets, viz., 40 per cent and 32 per cent of net bank credit, respectively, for priority sector lending, private sector banks fell short of their stipulated target, viz., 40 per cent (Table 8.6). The public and private sector banks with shortfalls in priority sector lending and/or agricultural lending as at end-March 2002 were advised to contribute to the Rural Infrastructure Development Fund (RIDF)-VIII established in NABARD with a corpus of Rs.5,500 crore, as announced in the Union Budget for 2002-03. In the case of RIDF-I to VI, the rate of interest on deposits placed in the Fund was uniform for all banks irrespective of the extent of their shortfall. Effective RIDF-VII, the rate of interest on RIDF deposits is linked to the banks' performance in lending to agriculture. Accordingly, banks

Table 8.6 : Priority Sector Advances

(in Rupees crore)

As on Last Reporting Friday of	Public Sector Banks	Private Sector Banks	Foreign banks
1	2	3	4
March 1998	91,319 (41.9)	11,614 (40.9)	6,940 (34.3)
March 1999	1,07,200 (43.5)	14,295 (41.3)	8,270 (37.1)
March 2000	1,27,807 (43.6)	18,348 (39.4)	9,699 (34.5)
March 2001	1,46,546 (43.0)	21,550 (38.1)	11,835 (34.1)
March 2002	1,71,185 (43.1)	21,530 * (38.8)	13,414 (34.2)

* As at end -September 2001

Notes: 1. Figures in brackets are percentage shares in net bank credit in the respective groups.
2. The target for aggregate advances to the priority sector is 40 per cent of the net bank credit for domestic banks and 32 per cent of net bank credit for the foreign banks.

receive interest at rates inversely related to their shortfall in agricultural lending. The foreign banks falling short of priority sector targets as at end-March 2002 have to deposit amounts equivalent to the shortfall with the Small Industries Development Bank of India (SIDBI) for one year.

Credit to Agricultural Sector

8.33 The disbursements to agriculture by public sector banks under the Special Agricultural Credit Plans (SACP) amounted to Rs.12,312 crore up to September 2001 as against a projection of Rs.30,883 crore for the year 2001-02. Although the outstanding amount of agricultural advances has been going up in case of public sector banks, their share in bank credit has not changed appreciably over the last three years (Table 8.7).

Table 8.7 : Outstanding Agricultural Advances

(Rupees crore)

As at end-March	Public Sector Banks		Private Sector Banks	
	Amount Out-standing	Share in Net Bank Credit (%)	Amount Out-standing*	Share in Net Bank Credit (%)
1	2	3	4	5
1998	34,304	15.7	2,746	9.7
1999	40,078	16.3	3,286	9.5
2000	46,190	15.8	4,481	9.6
2001	53,685	15.7	5,394	9.6
2002	63,083	15.8	N.A.	N.A.

* Includes entire indirect advances. N.A. Not Available.

Notes : 1. The target for advances to agriculture is 18 per cent of net bank credit for the domestic banks.
2. Indirect finance to agriculture is taken only to the extent of 4.5 per cent of net bank credit for computation of agricultural lending.

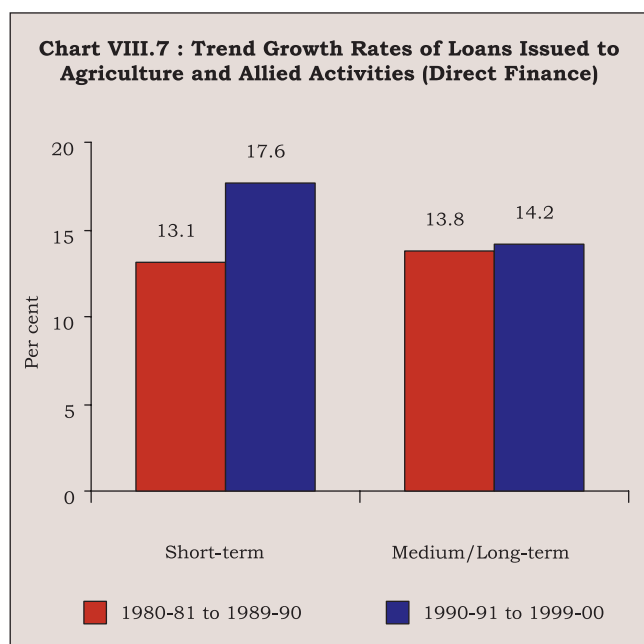
8.34 The recovery of advances made by public sector banks remained stable at around 70 per cent in the last two years (Table 8.8).

Table 8.8 : Public Sector Banks- Recovery of Direct Agricultural Advances

(Rupees crore)

Year ended June	Demand	Recovery	Overdues	Percentage of recovery to demand
1	2	3	4	5
1999	18,204	12,337	5,867	67.77
2000	20,216	14,058	6,158	69.54
2001	22,429	15,540	6,889	69.28

8.35 Disbursement of short-term loans to agriculture and allied activities registered a higher trend growth in the 1990s than during the 1980s (Chart VIII.7). The trend growth rate of medium/long-term loans, which are important for capital formation in agriculture, has shown only a marginal improvement. The shift in the composition of the agricultural loans towards short term loans reflects a growing "risk aversion" among banks in respect of medium/long-term loans which entail higher credit and market risk.



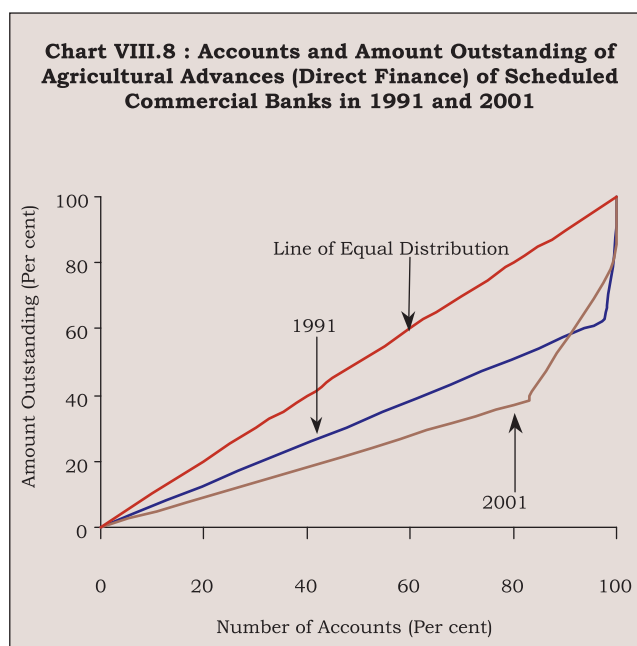
8.36 The growth of commercial banks' direct advances to agriculture remains skewed in favour of large borrowers (credit limit of over Rs.2 lakh) (Chart VIII.8).

Kisan Credit Card

8.37 Pursuant to the announcement made in the Union Budget for the year 2002-03, banks were advised to issue Kisan Credit Cards (KCCs) to cover all eligible borrowers in the agricultural sector by March 2004. Public sector banks issued 74.49 lakh KCCs up to March 31, 2002. The personal insurance package linked to KCCs was operationalised.

Special Package for Gujarat Riots

8.38 A special relief package for persons affected in riots in Gujarat was formulated and all banks were advised through State-level Bankers' Committee (SLBC) conveners to provide appropriate and timely relief to the affected persons.



Credit to Women

8.39 Public sector banks have been advised to earmark five cent of their net bank credit for women by the end of March 2004. At the end of March 2002, the share of credit to women in the portfolio of public sector banks stood at 3.25 per cent of their net bank credit.

Credit to SSIs

8.40 Following the report of a High Level Group, detailed guidelines were issued to banks for detection of sickness at an early stage and for taking remedial measures for the rehabilitation of sick SSI units identified as potentially viable. A unit is considered sick when any of the borrowal accounts of the unit remains sub-standard for more than six months or there is erosion in the net worth during the previous accounting year and the unit has been in commercial production for at least two years. While implementing the rehabilitation package, banks/FIs are required to conduct 'holding operations' for a period of six months to allow small-scale units to draw funds from cash credit accounts at least to the extent of their deposit of sale proceeds during the period of such 'holding operations'. The Reserve Bank also allowed banks to increase the limit of dispensation of collateral requirement of loans from the existing Rs.5 lakh to Rs.15 lakh in the case of units having good track record and financial position.

8.41 The total credit provided by public sector banks to small-scale industries (SSIs) by end-March 2002

which formed 12.5 per cent of net bank credit and 29.1 per cent of the total priority sector advances of these banks (Table 8.9). Advances to cottage industries, artisans, tiny industries, etc. at Rs.27,030 crore constituted 54.3 per cent of the advances to the SSI sector.

8.42 Public sector banks were advised to make concerted efforts to operationalise at least one specialised SSI branch in every district and centers having cluster of SSI units. As at the end of March 2002, 395 specialised SSI bank branches have been operationalised by the banks.

Table 8.9 : Advances to Small Scale Industry

(Amount in Rupees crore)

As at Last Reporting Friday	Public Sector Banks	Private Sector Banks	Foreign banks
1	2	3	4
March 1998	38,109 (17.5)	5,849 (20.6)	2,084 (10.3)
March 1999	42,674 (17.3)	6,493 (18.8)	2,460 (11.0)
March 2000	45,788 (15.6)	7,313 (15.7)	2,872 (10.2)
March 2001	48,445 (14.2)	8,158 (14.4)	3,716 (10.7)
March 2002	49,743 (12.5)	N.A.	4,561 (11.6)

N.A. Not Available.

Notes: 1. Figures in brackets are percentages to the net bank credit in the respective groups.

2. There is no target for advances to small-scale industry for domestic banks while the target for foreign banks is 10 per cent of net bank credit.

Credit to KVIC

8.43 The consortium scheme of Rs.1,000 crore continues under which a consortium of select public sector banks has been formed with the State Bank of India as the leader of the consortium to provide credit to the Khadi and Village Industries Commission (KVIC). These loans are provided at 1.5 per cent below the average prime lending rates of five major banks in the consortium. At the end of June 2002, an amount of Rs.374 crore was outstanding out of the Rs.738 crore disbursed under the scheme.

Differential Rate of Interest (DRI) Scheme

8.44 The outstanding advances of public sector banks under the DRI Scheme moved down from Rs.362.5 crore in 5.8 lakh borrowal accounts as at

end-March 2001 to Rs.351.1 crore in 6.1 lakh borrowal accounts as at end-March 2002. The DRI advances of the banks as at end-March 2002 formed 0.1 per cent of the total advances outstanding as at end-March 2001 which is substantially less than the target of 1.0 per cent.

Co-operatives

8.45 The recommendations made by the Task Force set up by the Government of India (Chairman: Shri Jagdish Capoor) to study the co-operative credit system and suggest measures for its strengthening were deliberated upon in the Conference of Chief Ministers in August 2001. As a sequel to these discussions, the Government constituted a Joint Committee in September 2001 under the chairmanship of Shri Vikhe Patil, the former Union Minister of State for Finance to examine the Task Force's recommendations further. The recommendations made by this Joint Committee are now under consideration. In the Union Budget for the year 2002-03, a provision of Rs.100 crore was made towards revitalisation assistance for the co-operatives by the Central Government.

Micro Credit

8.46 With a view to creating an enabling environment for effective provision of micro credit as a socially significant and commercially attractive mode of credit delivery as well as an effective 'anti-poverty' strategy all major participants, viz., banks, State Governments, NABARD, SIDBI and prominent NGOs are engaged in design and implementation of effective micro finance delivery interventions which can be integrated into an appropriate micro credit delivery system and response strategies fine-tuned appropriately. There are about 1,00,000 Primary Agricultural Co-operative Societies (PACS) across the country and keeping in view the tremendous possibilities of utilising the PACS as Self-Help Promoting Institutions (SHPIs), State Co-operative Banks (SCBs) have been asked to consider implementing effective SHG-bank linkage model(s), developing the PACS as micro finance conduits.

Local Area Banks

8.47 License to one local area bank (LAB) was granted in 1999 and to four such banks in 2000. The license in respect of one of these LABs was cancelled during 2002. As on March 31, 2002, aggregate deposits of these LABs stood at Rs.88.68 crore and their advances amounted to Rs.64.27 crore (Table 8.10).

Table 8.10 : Deposits and Advances of LABs

(Rupees crore)

Item/ Date	March 2002	December 2001	September 2001	June 2001
1	2	3	4	5
Deposits	88.68	86.80	72.95	64.20
Advances	64.27	64.11	55.13	45.95

Banking Ombudsman Scheme

8.48 The Banking Ombudsman Scheme, 2002 was notified in June 2002. The revised scheme includes provision for a "Reviewing Authority" to review the Ombudsman's award, enlarging the ambit of the scheme to include Regional Rural Banks (RRBs) and entrusting the work of arbitration involving amounts up to Rs.10.0 lakh to the Banking Ombudsman.

Housing Finance

8.49 With a view to further improving the flow of credit to the housing sector, the risk weight on bank loans against residential housing properties was reduced to 50 per cent against 100 per cent stipulated earlier and investments by banks in mortgage-backed securities (MBS) of residential assets by housing finance companies (HFCs) recognised and supervised by National Housing Bank (NHB) have also been assigned a risk weight of 50 per cent. Investments by banks in MBS is allowed to be reckoned for inclusion in the prescribed allocation of 3 per cent of incremental deposits towards housing finance.

Loan System for Delivery of Bank Credit

8.50 The Reserve Bank reviewed the guidelines relating to the 'Loan System' for bank credit. Effective October 25, 2001, banks are free to change the composition of working capital by increasing the cash credit component beyond 20 per cent for working capital limits of Rs.10 crore and above. Banks are expected to appropriately price each of the two components of working capital finance, viz., cash credit and loan components, taking into account the impact on their cash and liquidity management.

Infrastructure Financing

8.51 Operational guidelines on financing of infrastructure projects were issued to banks/financial institutions on April 23, 1999 addressing important aspects involved in the financing of infrastructure projects such as the criteria for financing, the type of financing, the appraisal, the regulatory compliance/concerns, the administrative arrangement and the inter-institutional guarantees.

8.52 As per instructions issued in February 2002 banks/FIs are, *inter alia*, required to undertake due diligence on the viability and bankability of infrastructure projects undertaken by Government owned entities where financing is by way of term-loans or investment in bonds issued by them to ensure efficient utilisation of resources and creditworthiness of the projects financed. Banks are required to ensure that State Government guarantees may not be taken as substitute for satisfactory credit appraisal and there should be proper credit appraisal and close monitoring of the projects financed. Banks/FIs are also required to ensure that loans granted to/ investment in PSUs are not used for financing the budgets of the State Governments. Banks were permitted to issue guarantees favouring other lending institutions, as an exception, in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow up of the project. The additional exposures of 10 per cent in group exposure limits earlier restricted to projects in four specified infrastructure sectors, viz., roads, power, telecommunications and ports was extended to projects in all infrastructure sectors.

Food Credit

8.53 The outstanding food credit (wheat, paddy/rice and coarse grain) as on August 8, 2002 was Rs.61,332 crore as against Rs.53,219 crore as on August 8, 2001. The Reserve Bank also authorises credit limits for the National Agricultural Co-operative Marketing Federation of India Ltd. (NAFED) for procurement of oilseeds and pulses under Price Support Scheme. The credit to the NAFED is disbursed through the State Bank of India only. As on August 8, 2002 the outstanding credit to NAFED stood at Rs.656 crore.

Financial Assistance to Wood and Panel based Industry in the North Eastern Region

8.54 Owing to extraneous circumstances, the operations of the wood and panel based industry in the North Eastern Region were adversely affected during the last four years, resulting in closure of a number of units during this period. Banks were advised on November 22, 2001 to extend financial assistance by way of a rehabilitation package to such of the manufacturing units in the industry as are considered potentially viable by them. The rehabilitation package involves funding of the unrealised portion of interest in the existing borrowal accounts by way of Funded Interest Term-Loan (FITL) and conversion of irregular portion of

cash credit into Working Capital Term Loan (WCTL). Both FITL and WCTL have a repayment period of 7 years inclusive of a moratorium period of 2 years and carry interest at the rate applicable to normal term loans. Banks have also been advised to assess and provide, as per their lending norms, fresh need-based working capital assistance to the manufacturing units in the industry. The package would be applicable only to units considered as potentially viable by the banks and should have the approval of term-lending institutions.

The Monetary Policy Stance for 2002-03

8.55 In April 2002, the monetary and credit policy for the year 2002-03 was announced conditional upon the real GDP growth placed at 6.0 - 6.5 per cent, the rate of inflation assumed slightly lower than 4.0 per cent and indicative projections of broad money growth and aggregate deposit growth of scheduled commercial banks at 14.0 per cent each. Non-food credit (inclusive of non-SLR investments) projected to increase by about 15.0 - 15.5 per cent which is expected to adequately meet the credit needs of the productive sectors of the economy. With the fiscal deficit of the Central Government for 2002-03 budgeted at 5.3 per cent of GDP and the consequent size of the borrowing programme, it is expected that debt management could be conducted without serious pressure on overall liquidity and interest rates. In recent months, however, the market borrowing programme in respect of some States has come under stress.

8.56 Easy liquidity conditions and softer interest rate environment make the present overall monetary conditions reasonably comfortable. However, as the experience of recent years confirms, monetary management has now become much more complex because of factors such as the on going integration of financial markets across the world, the phenomenal increase in financial turnover, liberalisation of the economy, and the rapidity with which unanticipated domestic and international tremors get transmitted to financial markets across the world because of the new technology. Changes in economic circumstances may make it necessary to take appropriate monetary measures, which may not be in consonance with the current easy liquidity conditions.

8.57 Accordingly the Reserve Bank will continue to maintain the current interest rate environment with a bias towards softer interest rate regime in the medium-term unless circumstances change unexpectedly. The long-

term objective would be towards realignment of interest rates on all types of debt instruments, both the government and private sector, within a narrow band. The overall stance of monetary policy for 2002-03 would be focused on the following: (i) provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level; (ii) continuing the present stance on interest rates including preference for soft interest rates; and (iii) imparting greater flexibility to the interest rate structure in the medium-term.

8.58 A key element in the efficient conduct of monetary policy in the years ahead is balanced development of various constituents of the money market in an environment of greater transparency and market discipline. Phasing out non-bank participants from the call/notice money market and activating the repo market are the most significant policy initiatives for the future evolution of the money market. It is expected that these measures would, in turn, facilitate the development of other segments, *i.e.*, the corporate bond market, the swap market and the term-money market. Further refinement of the LAF would involve the existing standing liquidity facilities being subsumed within the LAF. Deregulation of interest rates on export credit in domestic currency will encourage competition among banks and facilitate the phasing out the export credit refinance.

8.59 The interest rate structure should become more flexible over the medium-term and increasingly reflect the underlying inflationary situation. In the emerging environment characterised by heightened competition and more rigorous standards of transparency, it is critical for banks to improve productivity, reduce establishment costs and correct misalignment of interest rates.

8.60 In order to stabilise the short-term interest rates so that call money rate may move in a flexible corridor of repo - reverse repo rates, liquidity assessment on a daily basis becomes crucial. With a view to designing a formal framework for day to day liquidity assessment and for evaluation of the interactions between financial markets and monetary policy measures, the Reserve Bank, under the guidance of an advisory group of eminent economists, has developed a short-term operational model to guide monetary policy operations. The model has also been placed on the Bank's website for wider dissemination and public debate. The model is planned to provide likely scenarios and alternative intervention strategies aimed at stabilising short-term rates in money, securities and foreign exchange markets.