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

VIII MONETARY AND CREDIT POLICY OPERATIONS

8.1 Monetary and Credit Policy for the year 2002-03 was formulated against the backdrop of comfortable liquidity conditions, a benign inflation environment and growing strength in the balance of payments and international reserves. The objective of revitalising investment demand dominated the conduct of monetary policy even while maintaining a continuous vigil on inflation. Accordingly, the policy stance remained accommodative with a commitment to ensure adequate liquidity to meet credit demand. A preference for softening of interest rates and greater flexibility in the interest rate structure in the medium-term was retained with changes in policy rates envisaged in response to the evolving liquidity and credit situation. Despite a modest recovery in industrial activity nurtured by the co-movement of non-food bank credit, the drastic shift in macroeconomic conditions due to the onset of the drought necessitated a pre-emptive easing in the monetary policy setting. Mitigating the deleterious effects of the drought on farm output and rural incomes emerged as a dominant concern. Amidst excess supply conditions in the financial markets, a decisive easing of monetary policy was signalled through cuts in the repo rate (June and October, 2002 and March 2003), in the Bank Rate (October, 2002) and in the CRR (June and November, 2002). Interest liabilities on farm loans were deferred and agricultural loans were rescheduled to provide a measure of financial relief to the drought affected areas. Improvements in the channels of bank credit flow to various sectors were facilitated by providing greater flexibility to banks in meeting allocations of lending to the priority sector, housing, the small scale sector, micro finance vehicles and rural infrastructure. Contending with large capital inflows engaged monetary policy throughout 2002-03. Efforts to sterilise the expansionary impact of the capital flows took the form of large open market sales and continuous repo operations under the LAF.

8.2 The October 2002 Mid-term Review maintained the stance of the Annual Policy Statement of April 2002 while revising the macroeconomic outlook in the context of the drought. It drew upon the softening of interest rates in the first half of the year to pursue the downward movement further on a sustainable basis. An important objective was to prevent resurgence of inflationary pressures on account of the policy stimulus to growth.

MONETARY POLICY OPERATIONS

Interest Rate Policy

Bank Rate

8.3 Since 1997, the Bank Rate has been reactivated as the principal signalling device of the monetary policy stance across the interest rate structure in consonance with inflationary expectations and the liquidity situation. The Bank Rate was reduced in stages to 6.25 per cent in October 2002, the lowest rate since May 1973, and by a further 25 basis points in April 2003. The Bank Rate has been reduced by 500 basis points in the last five years. This is the sharpest reduction in the Bank Rate since Independence (Table 8.1).

Repo Rate

8.4 With the institution of the Liquidity Adjustment Facility (LAF), the repo rate has functioned as an informal floor for money market rates, providing a powerful signal to the market about the policy

Table 8.1 : Adjustments in Bank Rate

(Per cent)

Effective Date	Rate
1	2
January 17, 1998	11.0
March 19, 1998	10.5
April 3, 1998	10.0
April 29, 1998	9.0
March 2, 1999	8.0
April 2, 2000	7.0
July 22, 2000	8.0
February 17, 2001	7.5
March 2, 2001	7.0
October 23, 2001	6.5
October 29, 2002	6.25
April 29, 2003	6.0

Table 8.2 : Movement in LAF Rates

(Per cent)

Month	2002-03			2001-02			2000-01		
	Repo Rate	Reverse Repo	Spread@	Repo Rate	Reverse Repo	Spread@	Repo Rate	Reverse Repo	Spread@
1	2	3	4	5	6	7	8	9	10
April	6.0	–	0.58	6.75-7.0	8.75-9.00	0.50			
May	6.0	8.0	0.90	6.5-6.75	8.75	1.40			
June	5.75 (June 27)	–	0.29	6.5	8.5	0.74	–	9.0- 14.0	6.08
July	5.75	–	0	6.5	8.5	0.69	7.0-8.0	9.0-10.0	0.02
August	5.75	–	-0.03	6.5	–	0.44	8.0-15.0	15.0-16.0	-0.15
September	5.75	–	0	6.5	8.5	0.80	10.0-13.0	13.5	-0.09
October	5.50 (Oct. 30)	–	-0.02	6.5	8.5	0.90	8.0-9.75	10.25	0.49
November	5.50	7.5 (Nov. 12)	-0.05	6.5	8.5	0.47	8.0	10.0	1.28
December	5.50	–	0.08	6.5	8.5	0.58	8.0	10.0	0.76
January	5.50	7.5	0.16	6.5	–	0.13	–	10.0	2.04
February	5.50	7.5	0.21	6.5	8.5	0.23	7.5-8.0	10.0	1.47
March	5.0 (March 3)	7.0	0.86	6.0 (March 5)	8.0	0.97	7.0-7.5	9.0	0.74

– No repo/reverse repos
@ Spread is calculated as the difference between monthly average call rate and repo rate in percentage points.
LAF was introduced with effect from June 5, 2000.

preference on interest rates. Ample liquidity conditions drove down money market rates frequently below the repo rate during 2002-03 prompting a 25 basis point reduction in the repo rate in June 2002, followed by another 25 basis point paring in October 2002 and a 50 basis point cut in March 2003. The repo rate has been adjusted downwards from 8.0 per cent in March 1999 to 5.0 per cent in March 2003. Repo and reverse repo rates are decided through daily auctions conducted without any pre-announced rate and bids are accepted on a multiple price basis. Since the institution of the LAF, repo rates have anchored money market rates during periods of ample liquidity with the reverse repo rate as anchor in periods of tightness (Table 8.2).

Deposit Rates

8.5 Banks have the freedom to fix interest rates on term deposits, with flexibility in offering interest rates as approved by their Boards. The only regulated rate is on savings deposit accounts with cheque facility. The reduction in administered interest rates on small savings announced in the Union Budget 2003-04 and moderate inflation enabled a 50 basis point reduction in the savings deposit rate to 3.5 per cent per annum from March 1, 2003.

8.6 Given the reductions in the policy rates and the significant softening of money market rates and gilt yields, banks were encouraged to popularise flexible deposit rate schemes for new deposits. In order to facilitate the conversion of fixed rate deposits into variable rate schemes, banks were advised to pay depositors at the contracted rate for the period of deposit already run and waive the penalty for premature withdrawal if the same deposit was renewed at the variable rate.

Lending Rates

8.7 The downward rigidity in lending rates is reflected in spreads over the prime lending rates (PLRs). Unconscionably wide spreads are unwarranted in a period of low inflation. Moreover, they adversely impact the overall credit portfolio of banks and obscure the appropriate pricing of loans. In this context, banks were required to announce the maximum spread over the PLR for all advances except consumer credit. Information on maximum and minimum rates charged to borrowers is also required to be provided (Box VIII.1).

8.8 Banks were encouraged to switch to the all cost concept of pricing loans by explicitly declaring processing charges and service charges. In order to enhance transparency, a benchmark PLR was advocated for banks, taking into account their actual cost of funds, operating expenses, a minimum margin to cover regulatory requirement of provisioning/

Box VIII.1

Spreads around Prime Lending Rate

With the deregulation of lending rates since the early 1990s a striking characteristic of loan pricing behaviour among banks has been the wide dispersion in and around the Prime Lending Rates (PLRs). The resistance of banks to pass on some of the gains of a lower interest rate regime to borrowers has evoked concern in successive monetary policy statements since October 1996.

In the interest of customer protection and also to infuse healthy competition among banks under condition of full information/transparency, the Reserve Bank has institutionalised a system of collecting actual lending rates from scheduled commercial banks [excluding Regional Rural Banks (RRBs)] under a special quarterly return since June 2002. Information is sought on the range of the interest rates on rupee export credit as well as other types of bank credit. Banks are advised to ignore extreme values in the lending rates (up to 5 per cent of advances on either side) while submitting the information. Banks also furnish the range of interest rates in which there is concentration of loan contracts (say, 60 per cent or more) so as to obtain a sense of the general trend in lending rates. Consolidated information on actual lending rates for various bank-groups disseminated at the Reserve Bank's website reveals that only a few banks effected marginal reduction in the interest rate spreads on term loans on non-export credit. Furthermore, both PLRs and spreads varied widely across bank-groups during 2002-03. Efforts at ensuring information symmetry for the market has been reflected in a modest decline and convergence of spreads on export credit (Table).

Table : Lending Rates of Scheduled Commercial Banks

	Term Loan*		Export Credit #	
1	2	3	4	5
Category	March, 2003	June, 2002	March, 2003	June, 2002
Public Sector Banks	6.00-16.25	8.50-16.50	7.50-12.50	7.25-12.50
Private Sector Banks	5.80-23.00	6.92-22.50	7.25-16.50	7.00-16.50
Foreign Banks	5.00-20.00	5.00-19.50	5.25-16.00	9.00-16.00

* : Interest Rates on advances (above Rs.2 lakh) other than export credit (interest rate range excluding 5 per cent of business contracted at extreme rate).

\# : Pre-shipment credit for 181 to 270 days.

capital charge and the profit margin. Since all other lending rates can be determined with reference to the benchmark PLR, the system of tenor-linked PLR is to be discontinued. These initiatives are expected to bring flexibility to the interest rate structure in India and to align it with macroeconomic conditions (Box VIII.2).

Interest Rates on Export Credit

8.9 With a view to encouraging competition among banks and also to increase flow of credit to the export sector, interest rates on rupee denominated export credit were liberalised. A ceiling rate on rupee export credit linked to the relevant tenor prime lending rate (PLR) was introduced, giving banks the freedom

Box VIII.2

The Structure of Interest Rate in India : Responses to Policy Shifts

The reduction of interest rates in India has been constrained by 'stickiness' observed in the short-term. Between March 2000 and March 2003 while deposit rates for over three years maturity fell by as much as 425 basis points, short-term deposit rates (up to 90 days) declined by only 50 to 100 basis points. This phenomenon which is coincident with a flattening of the yield curve in the Government securities market, is attributable to several factors.

The reduction in the administered interest rates on small savings and provident funds enabled the decline in long-term interest rates. Stickiness in short-term interest rates is associated with the floor set by the LAF as well as a preference for short-term deposits by banks to gain flexibility in asset-liability management (ALM). Prudential limits on call borrowing and lending accentuated the demand for short-term deposits.

Structural impediments to flexibility in the interest rate structure include the high carrying costs of long-term deposits mobilised in the past by banks at fixed interest rates and non-performing assets. Long-term deposits (over 1 year) contracted at fixed rates constitute around 70 per cent of the aggregate deposits of the banking system. Advances in the form of short-term credit at fixed rate constitute around 40 per cent of the total loan portfolio. There is also a lack of depositor interest in flexible deposit schemes in an environment of low inflation and falling nominal interest rates. The carrying cost of NPA and the tendency to load additional risk premium against possibilities of further accumulation of NPAs forces up lending rates. Besides NPAs, persistence of high operating costs also results in a significant drag on commercial banks' ability to lower lending rates.

to charge rates below the prescribed rate from May 5, 2001. The ceiling interest rates on rupee export credit were reduced by one percentage point across the board, effective from September 26, 2001. The ceiling rate of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days was deregulated with effect from May 1, 2003. In the period ahead, the ceiling rates on pre-shipment credit up to 180 days and post-shipment credit up to 90 days will also be deregulated to encourage greater competition among banks for export credit.

8.10 In April 2002, the ceiling rate on export credit in foreign currency was reduced to LIBOR plus 0.75 percentage points from LIBOR plus 1.00 percentage point with a view to improving export competitiveness. Exporters were encouraged to avail of foreign currency loans. Banks were allowed to use borrowed foreign currency funds as well as foreign currency funds generated through buy-sell swaps in the domestic foreign exchange market for extending foreign currency denominated loans to exporters (Table 8.3).

Interest Rates on Non-Resident Deposits

8.11 Interest rates on foreign currency repatriable deposits under the FCNR(B) scheme are adjusted from time to time in alignment with movements in international interest rates as well as to slow down exceptionally large inflows under these accounts. In April 2002, the ceiling rates on FCNR(B) deposits were revised downwards from LIBOR to LIBOR/SWAP rates of corresponding maturities minus 25 basis points. In April 2003, the minimum maturity period of fresh NRE deposits was raised from 6 months to 1 year in alignment with the maturity structure of FCNR(B) deposits. Effective July 17, 2003, the interest rates on fresh NRE deposits for one to three years should not exceed 250 basis points above the LIBOR/SWAP rates for US dollar of corresponding maturity. This was done to provide consistency in interest rates offered to NRIs

Table 8.3 : Interest Rates on Export Credit

(Per cent)

Period	Pre-shipment/ Post-shipment Rupee Export Credit (up to 180 days/ 90 days)	Period	Export Credit in Foreign Currency
1	2	3	4
March-2001	10.0	Mar-01	LIBOR+1.5 PP
May-2001	≤ PLR-1.5 PP	Apr-01	LIBOR+1.0 PP
September-2001	≤ PLR-2.5 PP	Apr-02	LIBOR+0.75 PP
March-2003	≤ PLR-2.5 PP	Mar-03	LIBOR+0.75 PP

PP : Percentage points.

Reserve Requirements

Cash Reserve Ratio

8.12 The cash reserve ratio (CRR) remains an important instrument for modulating liquidity conditions. The medium-term objective is, however, to reduce CRR to the statutory minimum level of 3.0 per cent. Accordingly, on a review of developments in the international and domestic financial markets, a 75 basis point reduction in the CRR during June to November, 2002 was followed by a further 25 basis points cut from June 14, 2003 taking the level of the CRR down to 4.5 per cent. The minimum daily maintenance of CRR was raised to 80 per cent of the average daily requirement for all the days of the reporting fortnight with effect from the fortnight beginning November 16, 2002. This was subsequently lowered to 70 per cent with effect from the fortnight beginning December 28, 2002. The payment of interest on eligible CRR balances maintained by banks was changed from quarterly basis to monthly basis from April 2003. The CRR has been almost halved since April 2000 resulting in cumulative release of first round resources of over Rs.33,500 crore (Table 8.4).

Statutory Liquidity Ratio

8.13 The statutory liquidity ratio (SLR) to be maintained by all scheduled commercial banks remains unchanged at a minimum of 25 per cent of net demand and time liabilities (NDTL) since October 1997. As a prudential measure to strengthen the urban co-operative banks (UCBs), the proportion of SLR holding in the form of government and other approved securities to NDTL has been increased in a phased manner. From April 1, 2003, all scheduled UCBs have to maintain the entire SLR holdings of 25 per cent of NDTL in government and other approved securities only. Similarly, regional rural banks (RRBs) were required to maintain their entire SLR holdings in government and other approved securities by March 31, 2003 with SLR holdings of RRBs in the form of deposits with sponsor banks maturing beyond March 31, 2003 being reckoned for the SLR till maturity. The maturity proceeds of such deposits would have to be converted into government securities for RRBs not reaching the 25 per cent minimum level of SLR in Government securities by that time.

Table 8.4 : Cash Reserve Ratio

(Amount in Rupees crore)

	2003-04		2002-03		2001-02		2000-01	
	CRR (Per cent)	Amount*	CRR (Per cent)	Amount*	CRR (Per cent)	Amount*	CRR (Per cent)	Amount*
1	2	3	4	5	6	7	8	9
April	4.75	0	5.5	0	8.0	0	8.0	7,200
May	4.75	0	5.5	0	7.5	4,500	8.0	0
June	4.5	3,500	5.0	6,500	7.5	0	8.0	0
July			5.0	0	7.5	0	8.25	-1,900
August			5.0	0	7.5	0	8.5	-1,900
September			5.0	0	7.5	0	8.5	0
October			5.0	0	7.5	0	8.5	0
November			4.75	3,500	5.75	6,000	8.5	0
December			4.75	0	5.5	2,000	8.5	0
January			4.75	0	5.5	0	8.5	0
February			4.75	0	5.5	0	8.25	2,050
March			4.75	0	5.5	0	8.0	2,050

* Amount stands for first round release (+)/ impounding (-) of resources through changes in the cash reserve ratio.

Standing Liquidity Facilities

8.14 The medium-term objective of monetary policy is to move away from sector-specific refinance facility. Of the two standing facilities, *viz.*, export credit refinance (ECR) and collateralised lending facility (CLF) available to scheduled banks from the Reserve Bank, the latter was withdrawn with effect from October 5, 2002. ECR is provided on the basis of banks' eligible outstanding rupee export credit, both at the pre-shipment and post-shipment stages. From April 1, 2002, ECR is provided to scheduled banks to the extent of 15 per cent of the outstanding export credit eligible for refinance at the end of the second preceding fortnight. Apportionment of normal and back-stop facilities was changed from the initial ratio of 67:33 to 50:50 from November 16, 2002. Although refinance entitlements declined during the year, this did not impact on market liquidity as utilisation of standing facilities remained very low.

8.15 The methodology for fixation of the rate for the back-stop facility was rationalised with effect from April 30, 2003. Accordingly, the back-stop interest rate is at the reverse repo cut-off rate at which funds were injected earlier during the day in the regular LAF auctions. Where no reverse repo bid is accepted, the back-stop interest rate would generally be 2.0 percentage points over the LAF repo rate of the day. On the days when no bids for repo or reverse repo auctions are received/accepted, the back-stop interest rate would be decided by the Reserve Bank on an *ad hoc* basis.

8.16 In a specific situation of a financially sound bank facing sudden liquidity problems, particularly outside the normal LAF auction timings and on days when auctions are not held, the Reserve Bank at its discretion, may extend temporary liquidity support at an interest rate 4.0 percentage points above the reverse repo rate prevailing on that day (or a rate as may be decided by the Reserve Bank), against eligible securities with adequate margin and other appropriate conditions. On April 12, 2003 the Reserve Bank extended a temporary special collateralised liquidity facility of Rs.809 crore under section 17(4)(a) of RBI Act, 1934 against the collateral of excess SLR securities with a margin of 10 per cent for four days to a particular bank to tide over temporary liquidity problems on account of adverse market sentiments and sudden withdrawal of large deposits. The amount was repaid on April 16, 2003.

Liquidity Adjustment Facility

8.17 The Liquidity Adjustment Facility (LAF), introduced in June 2000, has evolved as a flexible instrument to modulate short-term liquidity and to ensure stable conditions in the overnight/call money market. The LAF operates through repo and reverse repo auctions, thereby setting a corridor for the short-term interest rates that is consistent with monetary policy objectives. Changes in procedures of the LAF have been effected to improve operational efficiency and to move gradually from a system of segmented refinance to a more fungible system of liquidity adjustment at market related rates (Box VIII.3).

Box VIII.3

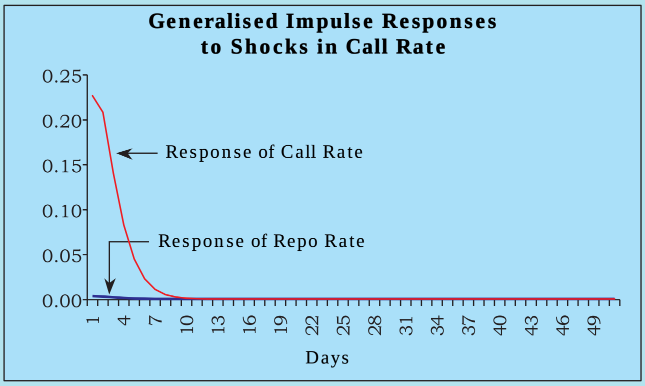
Monetary Marksmanship : Steering Financial Markets

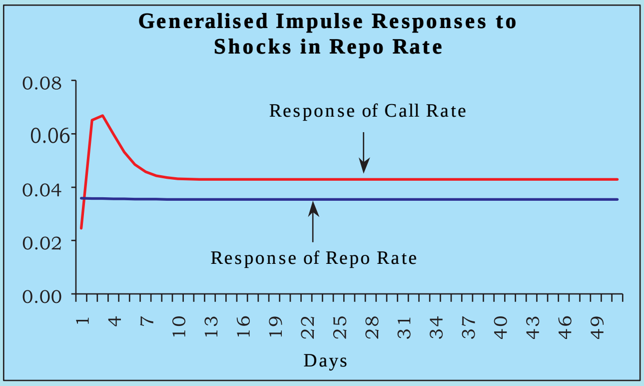
The growing sophistication of financial markets, driven by financial innovations and cross-border capital flows has impinged on monetary policy operating procedures and transmission mechanisms. Consequently, monetary authorities all over the world have had to modify short-term operational targets and instruments to steer financial market rates and liquidity consistent with policy goals.

A few stylised facts emerge from a survey of monetary policy operating procedures across central banks. First, there has occurred a progressive reduction in direct instruments of monetary control. Secondly, central banks have been engaging more actively in liquidity management in a more market based environment. Liquidity management has largely been implemented through discretionary market operations at the expense of standing facilities. Thirdly, reversed transactions, especially against domestic currency denominated assets (*e.g.* repos), have emerged as the main policy tool. Finally, there has been increased transparency in policy signals regarding desired interest rate levels. The key policy rates are essentially the overnight inter-bank rate or the "tender rate" applicable to regular operations, mainly repurchase transactions.

Developments in India in the last decade point to a greater integration of various segments of the financial sector. In 1999, an interim liquidity adjustment facility (ILAF) was introduced as a step towards a full-fledged liquidity adjustment facility (LAF), which has evolved in stages since June 2000. An important objective underlying the establishment of the LAF is the maintenance of orderly conditions in the overnight market by providing an informal corridor of the repo and the reverse-repo rates. An analysis of daily data indicates that the number of days on which the call money exceeded the upper corridor declined from 27 during 2000-01 to 16 during 2002-03. As regards the call rate falling below the corridor, the number of such days increased from 32 during 2000-01 to 91 during 2002-03. Importantly, the differential between the two rates declined sharply from 43 basis points to only five basis points over the same period.

Granger-causality tests, based on daily data for 2002-03, suggest that it is the repo rate that leads to subsequent changes in call money rates. Reverse causality from call rates to repo rates is not supported. A two variable Vector Auto Regression (VAR) comprising repo rates and call rates suggests a long-run underlying relationship between the repo rate and call rates. A fairly rapid adjustment of call rates to the repo rates following episodes of disturbance is evident. Call rates initially tend to overshoot their long-run level but revert rapidly and the adjustment process is complete within a week. In contrast, the shocks to call rates have a negligible impact on the repo rates (Charts). The findings suggest that LAF has been effective in steering financial markets towards desired objectives.





The key issue confronting the conduct of monetary policy through LAF operations is to transmit short-term interest rate signals to the long-end of the yield curve. This will determine the efficacy of monetary policy in pursuit of macroeconomic stabilisation. Some preliminary results from work in progress indicate that during April 2000 to March 2003, a 100 basis points reduction in the Bank Rate led to about 40 basis points moderation in the prime lending rate in the same month and by another 38 basis points in the subsequent months. As regards the pass-through to yields on government securities, a 100 basis points reduction in the Bank Rate induced a moderation of 66 basis points in the yield on 10-year Government paper in the same month. Thus, policy signals have an impact on the yield curve and the PLR in the desired direction *albeit* at less than the desired pace.

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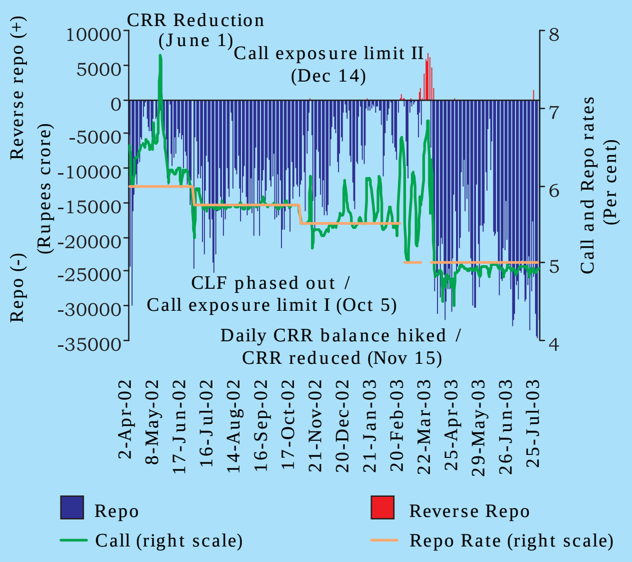
2. Lamfalussy, B. Alexander (1994), 'Central Banking in Transition', Per Jacobson Lecture, London.

8.18 The LAF was actively used during 2002-03 to manage the injections of liquidity due to large capital inflows. Easy liquidity conditions in the market were reflected in the large repo bids received. The average daily repo bid amount received at overnight repo auctions was significantly higher at Rs.10,315 crore as against only Rs.162 crore for reverse repos (Chart VIII.1).

Chart VIII.1 : Repo, Reverse Repo Auctions under LAF and Call Rates



8.19 Comfortable liquidity conditions at the beginning of 2002-03 elicited substantial repo bids which, however, declined in May. The Reserve Bank responded by announcing the advancement of the CRR cut by a fortnight to June 1, 2002 which helped remove liquidity concerns and improved market sentiment. This was accompanied by private placements of government securities with the Reserve Bank, assuaging market pressures. Call rates remained a shade above the repo rate for most of June 2002. They, however, touched sub-repo levels during the last week of the month. The reduction in the repo rate on June 27, 2002 buoyed up market sentiment.

8.20 Repo bidding was heavy during July-October 2002 but the Reserve Bank accepted these bids only partially in most of the auctions (Table 8.5). Repo volumes came down in November-December due to sterilisation operations. The call rate continued to hover around the repo rate till about the middle of December.

8.21 Liquidity tightened from mid-December due to investment of Centre's surplus in its own securities (which would have otherwise flowed into the financial markets). Two successive tranches of tap issues of State loans in February-March, 2003 and advance tax outflows put further pressure on market liquidity. Average repo amounts accepted were correspondingly

Table 8.5 : Acceptance/Rejection of Repo/Reverse Repo Bids under LAF

Period	Repo				Reverse Repo			
	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
2002-03								
April	20	0	15	5	1	0	1	0
May	12	1	2	9	2	1	1	0
June	22	1	8	13	0	0	0	0
July	25	0	4	21	0	0	0	0
August	22	0	6	16	0	0	0	0
September	20	0	9	11	0	0	0	0
October	21	0	7	14	0	0	0	0
November	19	3	10	6	1	0	1	0
December	24	0	21	3	1	1	0	0
January	23	0	19	4	2	1	1	0
February	17	0	15	2	4	0	4	0
March	19	2	16	1	11	1	8	2
2003-04								
April	17	0	15	2	2	1	1	0
May	19	0	18	1	3	2	1	0
June	20	0	18	2	1	1	0	0
July	23	0	22	1	1	0	1	0

lower during January-March 2003. The repo rate cut on March 3, 2003 improved liquidity. Due to ample liquidity in the system during June-November 2002, the 14-day repo bids were relatively large but dried up from December 2002 onwards when liquidity tightened (Table 8.6).

Open Market Operations

8.22 Net open market sales (including sales to State Governments for investment of durable surplus/ reinvestment of maturity proceeds, investments in Consolidated Sinking Fund and Guarantee Redemption Fund) were higher during 2002-03 than in the previous year and in excess of the Reserve Bank's net subscription to primary issuance of government securities by Rs.17,605 crore. During April 2002, two OMO auctions for an aggregate amount of Rs.5,280 crore were conducted to stem the sharp fall in yields as well as to absorb liquidity from the system. The OMO sales of May 31-June 1, 2002 were conducted to neutralise the impact of the CRR cut of 50 basis points on June 1, 2002. OMO sales were undertaken during July and August, 2002 for sterilisation operations consequent to large inflows of foreign capital. Large OMO sales continued during November 2002-January 2003 to absorb excess market liquidity (Table 8.7). In the current year, an OMO sale was conducted on May 29, 2003, for an amount of Rs.5,367 crore to absorb the excess liquidity in the system. Further, an amount of Rs.11,470 crore was absorbed through OMO sale on August 14, 2003.

8.23 In order to ensure that a sufficient stock of marketable securities would be available in the portfolio of the Reserve Bank for conducting OMO from time to time, the Government of India converted Rs.40,000 crore of 4.6 per cent Special Securities issued earlier to the Reserve Bank into marketable securities of various maturities (3 years to 18 years) at the prevailing yields. Further, on June 12, 2003 the Government of India converted Rs.20,000 crore of Government of India Treasury Bills (Conversion) Special Securities held by the Reserve Bank into dated securities, *viz.*, 5.48 per cent Government Stock 2009, 6.05 per cent Government Stock 2019 and 6.17 per cent Government Stock 2023 for notified amounts of Rs.5,000 crore, Rs.7,000 crore and Rs.8,000 crore, respectively (Table 8.8).

Table 8.6 : Outstanding Injection (+)/ Absorption (-) through LAF Operations

(Rupees crore)

As at end of	2003-04	2002-03	2001-02
1	2	3	4
April	-22,315	-525	-11,375
May	-21,075	-12,285	4,310
June	-27,467	-24,710	–
July	-40,480	-11,965	1,875
August		-16,680	–
September		-15,865	1,410
October		-24,108	2,735
November		-15,640	-2,020
December		-5,494	250
January		-2,450	-1,110
February		-9,090	–
March		-2,415	-3,605

Note : 1. Includes fortnightly repos introduced since November 5, 2001.
2. Figures with a negative sign indicate net outstanding LAF repo balance.
3. Data based on March 31 for March and last reporting Fridays for all other months.

Table 8.7 : Primary Liquidity Flows and Open Market Operations

(Rupees crore)

Fiscal year flow up to	RBI's Net Foreign Currency Assets			Net RBI Credit to Centre			RBI's initial subscription			Net OMO Sales		
	2003-04	2002-03	2001-02	2003-04	2002-03	2001-02	2003-04	2002-03	2001-02	2003-04	2002- 03	2001-02
1	2	3	4	5	6	7	8	9	10	11	12	13
April	2,139	5,177	3,060	9,706	11,976	5,067	0	10,000	12,000	7	5,307	60
May	24,336	11,265	3,805	6,780	13,814	20,774	5,000	20,018	12,000	5,576	6,831	5,083
June	22,710	19,279	7,187	434	1,455	19,523	5,000	22,018	21,000	5,620	7,020	10,929
July	33,740	27,402	8,738	-19413	9,577	11,849	5,000	23,175	21,000	5,677	13,558	16,020
August		32,163	14,613		-9,506	5,828		23,175	21,679		20,583	16,056
September		38,898	17,169		-18,100	-617		23,175	21,679		26,938	24,914
October		46,060	19,545		-26,174	4,268		23,175	21,679		27,009	22,275
November		59,073	27,813		-27,366	11,225		23,175	25,679		38,082	22,321
December		73,664	34,936		-35,982	-5,386		23,175	25,679		42,631	30,187
January		86,468	40.918		-39,270	97		23,175	25,679		53,626	30,270
February		95,758	48,437		-45,476	-2,479		23,175	25,679		53,714	30,293
March		94,275	66,794		-28,399	-5,150		36,175	28,892		53,780	30,335

Note : Data based on March 31 for March and last reporting Friday for all other months.

Table 8.8 : Reserve Bank's Holdings of Central Government Dated Securities

(Rupees crore)

Year	Devolvement on Reserve Bank	Private Placement taken by Reserve Bank	OMO Purchases by Reserve Bank	Conversion of Special Securities into dated securities	Total addition to Stock of Reserve Bank 's investments (2+3+4+5)	Open Market Sales by Reserve Bank	Net Addition to Stock (6-7)	Outstanding Holding by the Reserve Bank (end period)*
1	2	3	4	5	6	7	8	9
1996-97	3,698	–	623	–	4,321	11,206	-6,885	6,666
1997-98	7,028	6,000	467	20,000	33,495	8,081	25,414	31,977
1998-99	8,205	30,000	–	–	38,205	26,348	11,857	42,212
1999-00	–	27,000	1,244	–	28,244	36,614	-8,370	35,190
2000-01	13,151	18,000	4,471	–	35,622	23,795	11,827	41,732
2001-02	679	28,213	5,084	–	33,976	35,419	-1,443	40,927
2002-03	5,175	31,000	–	40,000	76,175	53,780	22,395	55,438
2003-04 (Up to August 14)	–	5,000	–	20,000	25,000	17,194	7,806	83,574@

@ As on August 1, 2003. * Inclusive of securities sold under LAF.

CREDIT DELIVERY

8.24 Socio-economic objectives have governed the design of credit policies in India consistent with the imperatives for a vibrant and viable banking system. An important and abiding goal of monetary policy is to improve the credit delivery mechanism by simplifying procedures, encouraging decentralised decision making and enhancing competition. Increasing the functional freedom of banks has had beneficial effects in channelising bank credit to the priority sector and in particular to agriculture, small business, weaker sections and SSI. The rural credit system, specifically, has been the focus of policy.

Priority Sector Lending

8.25 Several measures were put in place to improve the credit delivery mechanism in the priority sector: (i) the limit on advances granted to dealers in drip irrigation/sprinkler irrigation system/ agricultural machinery, irrespective of their location, was increased from Rs.10 lakh to Rs.20 lakh under priority sector lending for agriculture; (ii) the existing overall limit of Rs.10 lakh in respect of small business was increased to Rs.20 lakh without any ceiling for working capital in order to augment credit flow to small business; (iii) the individual credit limit to artisans, village and cottage industries was increased to Rs.50,000 from the existing limit of Rs.25,000; (iv) loans to the Agri-Clinics and Agribusiness centres were included under the priority sector as 'direct finance' to agriculture; (v) para-banking activities such as leasing and hire purchase financing undertaken departmentally by banks were also classified as priority sector advances, provided the beneficiaries satisfy priority sector norms; (vi) the limit for direct housing finance was increased from Rs.5 lakh to Rs.10 lakh in rural and semi-urban areas.

8.26 Public sector banks, private sector banks and foreign banks as groups achieved the overall target, for priority sector lending (Table 8.9). The large increase in private banks' priority sector credit was primarily on account of two banks.

Housing Finance

8.27 The Statement on Monetary and Credit Policy for 2002-03 recognised the growing importance of the housing sector and its forward and backward linkages with other sectors of the economy. Banks were encouraged to increase the flow of credit to this sector.

Table 8.9 : Priority Sector Advances

(Amount in Rupees crore)

As on Last Reporting Friday	Public Sector Banks	Private Sector Banks	Foreign Banks
1	2	3	4
Mar-1998	91,319 (41.9)	11,614 (40.9)	6,940 (34.3)
Mar-1999	1,07,200 (43.5)	14,295 (41.3)	8,270 (37.1)
Mar-2000	1,27,807 (43.6)	18,348 (39.4)	9,699 (34.5)
Mar-2001	1,46,546 (43.0)	21,550 (38.1)	11,835 (34.1)
Mar-2002	1,71,185 (43.1)	21,530 (38.8)	13,414 (34.2)
Mar-2003*	2,03,095 (42.5)	34,674 (45.2)	14,596 (33.9)

Notes : 1. Figures in brackets are percentages to the 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.

* Data are provisional.

Banks were advised to allocate a minimum of 3.0 per cent of incremental deposits for housing. Moreover, the term loans extended by banks to intermediary agencies against the loans sanctioned by them were allowed to be reckoned as part of housing finance. Also, investment in bonds issued by HUDCO and the NHB exclusively for financing of housing is reckoned for priority sector targets.

8.28 Prudential requirements for housing finance by banks and investment by banks in securitised debt instruments of housing finance companies (HFCs) were liberalised to improve the flow of credit to the housing sector. Residential housing properties now attract a risk weight of 50 per cent as against 100 per cent stipulated earlier. A risk weight of 50 per cent was also assigned for the purpose of capital adequacy for investments in Mortgage-Backed Securities (MBS) of residential assets of HFCs supervised by the National Housing Bank (NHB). Such investments by banks are reckoned for inclusion in the prescribed housing finance allocation of 3.0 per cent. For the financial year 2002-03, each bank was required to compute its share of the housing finance allocation at 3.0 per cent of incremental deposits as on the last reporting Friday of March 2002 over the corresponding figure on the last reporting Friday of March 2001. In April 2003, banks were allowed to extend direct finance to the housing sector up to Rs.10 lakh to individuals in rural and semi-urban areas as part of priority sector lending. Banks had already been allowed to include loans upto Rs.10 lakh to individuals in urban/metropolitan centres for construction of houses as part of priority sector lending.

8.29 In India, the housing sector has assumed importance in recent years both on account of its growth generating potential in the context of investment demand and in view of the acute shortage of housing facilities in the country. Several fiscal incentives have been provided to boost housing demand (Box VIII.4).

Box VIII.4

Housing Finance : New Driver of Bank Credit

The importance of the housing sector in any economy is derived from its high employment potential and extensive backward and forward linkages. In addition to being one of the drivers of growth, the housing sector provides a relatively safe destination for bank credit on account of the lower than average rates of default in housing finance. Consequently, housing finance serves the dual purpose of leading recovery and providing a safe avenue for bank assets during periods of industrial slow down.

Housing shortage at the beginning of the Ninth Plan was estimated at 33 million units. According to a recent survey by the National Building Organisation, the total housing shortfall is estimated to be 19.4 million units of which 12.8 million is from rural areas and 6.6 million is from urban areas.

Pursuant to the announcement made by the Finance Minister in his budget speech of 2002-03, the National Housing Bank (NHB) initiated steps to set up a Mortgage Credit Guarantee Company which is envisaged as a joint venture having international partners and multilateral agencies with adequate experience in this field. This company will guarantee housing loans, thus proving lenders with protection against default by the borrowers. The target under the Golden Jubilee Rural Housing Finance Scheme was increased to 2.25 lakh for 2002-03 and the allocation of the *Indira Awas Yojna* is being increased by 13 per cent to Rs.1,725 crore for 2002-03. In addition, fiscal incentives in terms of income tax exemptions on interest paid and principal repaid on housing loans and on capital gains on NHB bonds have been provided.

The Reserve Bank has initiated a host of supply side measures to boost inflow of bank credit to the housing sector and to ensure the benefit of soft interest rates to borrowers:

- Contribution of Rs.100 crore to the equity capital of National Housing Bank (NHB), taking its authorised and paid-up capital to Rs.450 crore, fully subscribed by the Reserve Bank.
- Risk weight on loans against residential housing properties and Mortgage Backed Securities (MBS) of residential assets of HFCs supervised by the NHB reduced to 50 per cent from 100 per cent.
- Investments in MBS reckoned in the prescribed housing finance allocation of 3.0 per cent.
- Limit on housing loans for repairing damaged houses raised to Rs.1 lakh in rural and semi-urban areas and to Rs.2 lakh in urban areas.
- Direct finance to the housing sector up to Rs.10 lakh in rural and semi-urban areas as part of priority sector lending.

There has been a generalised decline in the interest rates charged by banks on housing loans. The rate of interest charged by the State Bank of India declined from 11 per cent in April 2002 to 9.5 per cent in May 2003. During the same period, there was a decline of 175 basis points in the interest rate charged by ICICI Bank.

As a result, there has been a surge in bank finance to the housing sector with credit flows to this sector increasing by 55 per cent in 2002-03. Housing loans extended by banks stood at 6.1 per cent of non-food gross bank credit at end-March 2003 as compared to 3.8 per cent at end-March 2001

(Contd....)

(Concld....)

and 4.6 per cent at end-March 2002. The growth of housing finance is expected to increase at much higher rates in the years ahead.

While the increase in disbursement of housing finance is heartening, cause for potential worry is that by lowering the lending rates, banks are approaching the cost of funds. In fact, banks set their lending rates lower on housing loans, and at times below PLR, due to lower risk weight. The interest rate on home loans is hovering in a range of 7.50-9.75 per cent, which is higher than the interest rate on longer term deposits of commercial banks by 1.5-3.75 percentage points. In most of the cases, banks are covering not more than 85 per cent of the cost of property within an overall ceiling of Rs.50 lakh, with differential margins separately on land and building of houses. Under these conditions, banks need to be on alert against an unbridled growth of housing finance and should take due precaution in the matter of interest rates, margin, reset period and documentation. Issues under active consideration include desirability of prescribing a benchmark rate for home loans.

Micro Finance

8.30 Micro-credit institutions and Self Help Groups (SHGs) are important vehicles for credit delivery to self-employed persons, particularly, women in rural and semi-urban areas. Issues relating to structure and sustainability, funding, regulations and capacity building for micro-credit delivery are engaging attention of the Reserve Bank. The objective has been to accelerate the flow of bank credit to micro-finance institutions while maintaining their decentralised, voluntary and non-bureaucratic character, particularly in rural and semi-urban areas. Considering the high recovery rate in respect of banks' advances to SHGs, unsecured advances given by banks to SHGs against group guarantees are currently excluded for the purpose of computation of the prudential norms on unsecured guarantees and advances.

8.31 With a view to facilitating smoother and more meaningful banking with the poor, a pilot project for purveying micro credit by linking Self-Help Groups (SHGs) with banks was launched by the NABARD in 1991-92. The scheme has since been extended to RRBs and co-operative banks. The number of SHGs linked to banks aggregated 7,17,360 as on March 31, 2003 with almost 40 per cent concentrated in Andhra Pradesh (Box VIII.5). This translated into an estimated 11.6 million very poor families brought within the fold of formal banking services. More than

Box VIII.5

Self-Help Group Linkage: The Andhra Pradesh Success Story

In India, as in other countries, micro credit groups are being recognised by policy authorities as an effective tool for achieving the distributional objectives of monetary policy. In the recent period, considerable emphasis has been placed on promotion of micro credit enterprises in view of perceived inadequacies of existing agencies in providing productive credit to those with little or no previous access to formal credit facilities. The Self-Help Group (SHG)-bank linkage model has emerged as the most dominant model of micro finance delivery in India.

A SHG is a registered or unregistered group of micro entrepreneurs with a homogenous social and economic background, voluntarily coming together to save small amounts regularly and mutually agreeing to contribute to a common fund to meet their emergency needs on mutual help basis. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment thereof. In fact, peer pressure has been recognised as an effective substitute for collaterals. Besides, financing through SHGs reduces transaction costs for both lenders and borrowers.

The Reserve Bank has put in place a facilitating environment for banks to promote SHGs. Nevertheless, progress has been uneven with significant strides towards access to bank credit and spread of micro finance across the country. The uneven spread could be gauged from the fact that almost 40 per cent of the SHGs are concentrated in Andhra Pradesh. The important role played by the State Government through District Rural Development Agencies (DRDAs) as Self-Help Promoting Institutions (SHPI) is the main reason for impressive growth in Andhra Pradesh. In other States, the role of SHPI is limited to Non-Government Organisations (NGOs) which leads to confinement of SHGs in the area of operation of these NGOs. Moreover, the Government in Andhra Pradesh had facilitated promotion of a large number of women's groups under Development of Women and Children in Rural Areas (DWCRA). The funding support received by the State Government under DWCRA helped in a massive expansion of the movement in the State. The Government of Andhra Pradesh also explored alternative options of making available access to resources to the rural poor women. Consequently, as at end-March 2003, the total number of credit linked SHGs stood at 2,81,338. Total bank loans extended to these SHGs exceeded Rs.975 crore, with commercial banks accounting for 62 per cent of the total linkage and 65 per cent of the credit extended, RRBs accounting for 35 per cent of the linkage and 33 per cent

(Contd....)

(Concld....)

of the credit and co-operatives accounting for the remaining 3 per cent of the linkage and 2 per cent of the credit. In consultation with the NABARD, the State Government attempted reorientation of the women's groups promoted under DWCRA on the lines and spirit of SHGs. This followed intensive capacity building and training support from the NABARD to the State and district-level officials for reorienting the entire movement, away from the subsidy culture to the savings-led, self-managed, participative micro-finance movement under the SHG-bank linkage programme. The SHGs cover a diverse range of activities including crop production, purchase of cloth/ yarn, weaving, share cropping, idli making, food processing, dairy, small business, fair price shops, bullock carts, draught animals, vegetable vending, saree business, pickle making, small hotels, bamboo basket making, tailoring and fruit vending. These efforts led to the emergence of large number of quality SHGs through the intervention of village animators, anganwadi workers, field-level Government functionaries as well as SHG leaders.

After reorienting the groups on SHG principles, the Government of Andhra Pradesh also undertook a well-designed exercise of grading SHGs. Those qualifying as 'A' category SHGs were entrusted to banks for financing after proper screening and rating. Simultaneously, the banks were sensitised about the need for proper rating of SHGs by NABARD. Thus, a two-fold quality check was put in place - while the DRDAs have put in place a strong system of management information systems (MIS) emanating from the villages to clusters, blocks and aggregated at the district level, the NABARD has its own MIS based on the refinance being released to the banks. The SHGs are, thus, regularly monitored and their quality is maintained with adequate support from the State Government. The record of SHGs in Andhra Pradesh for timely payment is over 95 per cent.

90 per cent of the groups linked with banks are exclusive women groups and the scheme has more than 95 per cent on-time repayment record. Cumulative disbursement of bank loans to these SHGs stood at Rs.2,049 crore as on March 31, 2003, with an average loan of Rs.28,560 per SHG and Rs.1,766 per family. There are, at present, 48 commercial banks, 192 RRBs and 264 co-operative banks associated with the SHG-bank linkage programme. This programme presently covers 523 districts across the country with the total number of participating NGOs and other agencies currently involved in this linkage being 2,800 (Table 8.10).

Credit to Agricultural Sector

8.32 The share of outstanding agricultural advances of public sector and private sector banks in bank credit has remained stable in the recent years, with the share of private sector banks showing an increase at the end of March 2003 as a result of rise in agricultural advances of some of the new generation private sector banks (Table 8.11).

8.33 Since 1994-95, public sector banks prepare Special Agricultural Credit Plans (SACP) on an annual basis. During 2002-03, the disbursements to agriculture under these Plans were Rs.33,921 crore against a projection of Rs.36,838 crore. In the recent period, policy interventions for building institutional delivery mechanisms for credit to agriculture have been supplemented by location specific innovations which involve private sector initiatives (Box VIII.6).

8.34 The recovery of direct agricultural advances of public sector banks continue to remain stable; however, the percentage of recovery improved as at the end of June 2002 (Table 8.12).

Relief for Drought affected Farmers

8.35 Failure of the South-West monsoon resulted in shortage of rainfall in the sowing month of July 2002. Moreover, nearly 60 per cent of meteorological sub-divisions in the country received deficient/scanty rainfall. The adverse impact of the drought on the *kharif* crops hampered the loan repaying capacity of the farmers. They were not only unable to service their debts but also needed further loans during the season. In order to provide relief to the affected farmers, guidelines for relief measures by banks in the districts notified by the State Governments as drought affected were issued in November 2002. Banks were advised not to recover any amount either by way of principal or interest during the year 2002-03 in respect of *Kharif* crop loans. The principal amount of crop loans was converted into term loans to be recovered over a minimum period of five years in the case of small and marginal farmers and four years in the case of other farmers. Interest due on crop loans was allowed to be deferred with no charged interest on the deferred interest. As a one-time measure, the first year's deferred interest liability on *Kharif* loans was waived completely.

Kisan Credit Cards

8.36 Pursuant to the announcement made in the Union Budget for the year 2002-03, banks were

Table 8.10 : Self Help Group and Bank Linkages : End-March 2003

(Amount in Rupees crore)

Region/ state	Commercial Banks		Regional Rural Banks		Co-operative Banks		Total	
	No. of SHGs	Bank Loan	No. of SHGs	Bank Loan	No. of SHGs	Bank Loan	No. of SHGs	Bank Loan
1	2	3	4	5	6	7	8	9
A. Northern Region								
1. Haryana	359	2.6	1,165	4.3	–	–	1,524	6.9
2. Himachal Pradesh	3,451	4.5	1,365	2.4	4,059	10.1	8,875	17.1
3. Punjab	330	1.5	141	1.1	371	1.4	842	4.0
4. Jammu and Kashmir	405	0.8	315	0.5	168	1.1	888	2.4
5. Rajasthan	8,807	16.1	11,526	24.8	2,409	5.4	22,742	46.3
6. New Delhi	52	0.4	–	–	–	–	52	0.4
Sub Total	13,404	25.9	14,512	33.1	7,007	18.0	34,923	77.1
B. North Eastern Region								
7. Assam	282	0.3	3,158	4.2	37	0.1	3,477	4.5
8. Manipur	162	0.5	–	–	–	–	162	0.5
9. Meghalaya	62	0.6	117	Neg	–	–	179	0.6
10. Sikkim	24	0.1	–	–	–	–	24	0.1
11. Tripura	2	Neg	96	0.1	6	Neg	104	0.1
12. Nagaland	–	–	15	0.1	–	–	15	0.1
13. Arunachal Pradesh	108	0.2	–	–	–	–	108	0.2
Sub Total	640	1.6	3,386	4.4	43	0.1	4,069	6.0
C. Eastern Region								
14. Bihar	2,873	4.4	5,197	7.3	91	0.4	8,161	12.1
15. Jharkhand	4,518	19.5	3,247	7.1	–	–	7,765	26.7
16. Orissa	12,451	12.7	24,621	31.8	5,200	6.6	42,272	51.0
17. West Bengal	7,731	5.8	8,287	10.2	16,629	14.4	32,647	30.5
18. A and N Islands (UT)	–	–	–	–	48	0.2	48	0.2
Sub Total	27,573	42.5	41,352	56.4	21,968	21.5	90,893	120.5
D. Central Region								
19. Madhya Pradesh	5,054	13.0	8,326	13.6	1,891	4.1	15,271	30.7
20. Chhattisgarh	565	0.4	4,286	3.7	1,912	1.2	6,763	5.4
21. Uttar Pradesh	17,151	13.3	35,644	73.1	901	1.0	53,696	87.5
22. Uttaranchal	4,780	17.4	811	3.2	262	0.1	5,853	21.1
Sub Total	27,550	44.1	49,067	93.7	4,966	6.9	81,583	144.7
E. Western Region								
23. Goa	194	0.8	–	–	46	0.3	240	1.1
24. Gujarat	8,535	9.4	4,120	5.3	1,220	1.3	13,875	16.1
25. Maharashtra	14,989	41.3	9,339	20.4	3,737	8.0	28,065	69.7
Sub Total	23,718	51.6	13,459	25.7	5,003	9.6	42,180	86.9
F. Southern Region								
26. Andhra Pradesh	1,74,992	634.1	99,558	322.2	6,788	19.1	2,81,338	975.4
27. Karnataka	23,680	43.8	21,929	60.5	16,569	39.7	62,178	144.0
28. Kerala	14,068	40.3	4,218	9.1	2,726	15.1	21,012	64.5
29. Tamil Nadu and UTP	55,436	265.6	29,859	122.2	13,889	41.8	99,184	429.5
Sub Total	2,68,176	983.8	1,55,564	513.9	39,972	115.7	4,63,712	1,613.4
Total	**3,61,061**	**1,149.5**	**2,77,340**	**727.2**	**78,959**	**172.0**	**7,17,360**	**2,048.7**

Neg. : Negligible.
Components may not add up to the total due to rounding off.
Source : National Bank for Agriculture and Rural Development.

advised to issue Kisan Credit Cards (KCCs) to cover all eligible borrowers in the agricultural sector by March 2004. Public sector banks issued 10.1 million KCCs up to March 31, 2003. As announcement in the Union Budget 2001-02, banks are required to provide a personal insurance package to the KCC holders to cover them against accidental death or permanent disability up to a maximum amount of Rs.50,000 and Rs.25,000, respectively. The premium burden for this was to be shared by the card issuing institution(s) and the Kisan Credit Card holder(s) in a ratio of 2:1. The personal insurance package linked to KCCs was operationalised in July 2001.

8.37 The Reserve Bank has commissioned the National Council of Applied Economic Research

Table 8.11 : Outstanding Agricultural Advances

(Rupees crore)

As at End-March	Public Sector Banks		Private Sector Banks	
	Amount Outstanding*	% of Net Bank Credit	Amount Outstanding*	% of 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	9.1
2001	53,685	15.7	5,381	9.6
2002	63,083	15.8	5,406	9.5
2003	73,874	15.5	8,577	10.8

* : Data are provisional.

Note: The target for advances to agriculture is 18 per cent for the domestic banks.

(NCAER) to conduct a survey for assessing the effectiveness, coverage, weaknesses, and impact of the KCC Scheme. The impact assessment survey would cover all regions and would recommend appropriate policy actions to strengthen the scheme.

Rural Infrastructural Development Fund (RIDF)

8.38 Both public sector and private sector banks, having shortfalls in lending to priority sector/ agriculture are allocated shares for contribution to the RIDF established with the NABARD for assisting State Governments/State-owned corporations in quick

Box VIII.6

Institutional Credit to Agriculture

As a Key sector of the Indian economy, agriculture receives priority in the credit delivery mechanism of the Reserve Bank. The process of rural credit delivery commenced with the introduction of co-operatives. A formidable institutional structure has since been raised over the years for financing rural development. Nationalisation of banks in 1969 signaled the need for redefining rural sector priorities. Concomitantly, advances to certain segments of the economy were classified as priority sector credit in March 1969. Public sector banks have been formulating Special Agricultural Credit Plans (SACP) under which the banks are required to fix self-set targets for achievement during the year (April-March). The targets are generally fixed by the banks with an increase of about 20 to 25 percent over the disbursement made in the previous year. With the introduction of SACP, the flow of credit to the agricultural sector by public sector banks has increased substantially. At present, a sub-target of 18 per cent of net bank credit has been stipulated for lending to the agriculture sector by domestic scheduled commercial banks. This is inclusive of both direct and indirect finance provided by banks. With a view to ensuring that the focus of the banks on the 'direct' category of agricultural advances does not get diluted, it was stipulated in 1993 that agricultural lendings under the 'indirect' category should not exceed one-fourth of the sub-target of 18 per cent, *i.e.*, 4.5 per cent of net bank credit. All agricultural advances under direct as well as indirect categories continue to be reckoned in computing performance under the overall priority sector lending target of 40 percent of net bank credit.

Both public sector and private sector banks' shortfall in lending to priority sector/agriculture are now allocated for contribution to the Rural Infrastructure Development Fund (RIDF) established with the NABARD. The RIDF has contributed to improvement of infrastructure like irrigation, roads and bridges. Funds in the RIDF would now increasingly be used for schemes which more directly benefit the farmers rather than contributing only to rural infrastructure improvement. The existing shelf of schemes under the RIDF is accordingly being re-examined and areas which need to be given priority for sanction, *e.g.*, irrigation, water and soil conservation are being identified. RIDF assistance has also been linked to agricultural/rural reforms in the States.

In the recent period, the Reserve Bank has sought to supplement the credit interventions for agriculture by a series of initiatives like expanding the scope of priority sector lending to include financing of Agri-Clinics and Agribusiness centers, and financing purchase of land by small and marginal farmers. This has been done with a view to supplementing the existing extension network to accelerate the process of technology transfer to agriculture and providing supplementary sources of input supply and services for which, by and large, farmers presently depend on State agencies. Introduction of the Capital Investment Subsidy Scheme, Cold Storage Scheme, Food Parks which now covers rural godowns and setting up of Watershed Development Fund has enabled substantial capacity generation.

Effective 1998-99, banks have been issuing Kisan Credit Cards to farmers on the basis of their land holdings so that the farmers can use them to readily purchase agricultural inputs such as seeds, fertilisers, pesticides and draw for their production needs. This scheme aims at adequate and timely support to the farmers for their cultivation needs including purchase of inputs in a flexible and cost-effective manner. Over the last couple of years, the Kisan Credit Card Scheme has emerged as an effective tool for catering to the short-term credit requirements of the farmers.

References

1. Government of India (2000): National Agricultural Policy Document.
2. Reserve Bank of India (1997): Report of High-level Committee on Agricultural Credit.

Table 8.12 : 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	20,215	14,058	6,158	69.54
2001	22,429	15,540	6,889	69.28
2002@	19,853	14,099	5,754	71.02

@ Provisional data in respect of 22 PSBs.

completion of on-going projects relating to medium and minor irrigation, soil conservation, watershed management and other forms of rural infrastructure. The IXth tranche of RIDF has been established with a corpus of Rs.5,500 crore.

8.39 In the case of RIDF-I to VI, the rate of interest on deposits placed in the Fund was uniform for all the 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 receive interest at rates inversely proportional to their shortfall in agricultural lending.

Credit to Women

8.40 Public sector banks were advised to earmark 5 per cent of their net bank credit as credit to women by the end of March 2004. At the end of March 2003, the aggregate proportion of credit to women in the portfolio of public sector banks stood at 3.9 per cent of net bank credit.

Credit to SSIs

8.41 At the end of March 2002, the outstanding scheduled commercial banks' credit to sick SSIs numbering 1,77,336 was Rs.4,819 crore. Of these units, 4,493 units were found to be viable and their outstanding bank credit amounted to Rs.416 crore. There were 1,67,574 non-viable units with outstanding bank credit of Rs.4,147 crore. Banks placed 621 units involving outstanding credit of Rs.89 crore under nursing programmes.

8.42 The total credit provided by public sector banks to small-scale industries (SSI) at the end of March 2003 was Rs.52,988 crore which formed 11.1 per cent of net bank credit and 26.1 per cent of the total priority sector advances of these banks. Out of these advances to SSI units, advances to cottage industries, artisans and tiny industries were Rs.26,939 crore, constituting 50.8 per cent of the advances to the SSI sector.

8.43 Public sector banks were advised to operationalise at least one specialised SSI branch in every district and centre having cluster of SSI units. At the end of March 2003, 417 specialised SSI bank branches were operationalised by the banks.

Credit to Khadi and Village Industries Commission

8.44 A consortium of select public sector banks was formed with the State Bank of India as the leader of the consortium to provide credit to the Khadi and Village Industries Commission (KVIC) under the consortium scheme of Rs.1,000 crore. 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 2003, an amount of Rs.357 crore was outstanding out of Rs.738 crore disbursed by the consortium under the scheme.

Government Sponsored Schemes

8.45 The total number of *Swarozgaris* assisted under the Swarnajayanti Gram Swarozgar Yojana (SGSY) during 2002-03 (up to February 2003) was 5,35,133. Bank credit amounting to Rs.781 crore and Government subsidy amounting to Rs.405 crore were disbursed under this scheme. Of the *Swarozgaris* assisted, 1,60,638 (30.0 per cent) were scheduled castes, 78,157 (14.6 per cent) were scheduled tribes, 2,57,664 (48.2 per cent) were women and 4,166 (0.8 per cent) were physically handicapped. The investment per family was Rs.22,169. Under the Swarna Jayanti Shahari Rozgar Yojana (SJSRY), a total of 16,628 applications were sanctioned during 2002-03, with disbursements amounting to Rs.41.7 crore made in 11,756 cases up to September 2002. The total number of applications sanctioned under the Scheme of Liberation and Rehabilitation of Scavengers (SLRS) during 2002-03 was 5,109. Out of this, disbursements amounted to Rs.7.3 crore in 4,253 cases as on December 31, 2002. Under the Prime Minister's Rozgar Yojana (PMRY), the number of applications sanctioned during 2002-03 was 2,26,572 involving an aggregate sanctioned amount of Rs.1,461 crore.

Differential Rate of Interest (DRI) Scheme

8.46 The outstanding advances of public sector banks under the DRI Scheme at the end of March 2003 amounted to Rs.300 crore in 3.7 lakh borrowal accounts, forming 0.1 per cent of the total advances outstanding as at the end of the previous year, which is substantially less than the target of 1.0 per cent.

Local Area Banks

8.47 The working of the Local Area banks (LAB) was reviewed during 2002-03 (Table 8.13). Attention was drawn to the weakness in the concept of the LAB model, particularly its size, capital base, inherent inability to absorb the losses which are bound to arise in the course of business, risk prone credit portfolio, inability to diversify and derisk the business model in view of size and location. It has been decided not to issue fresh licenses for establishment of LABs.

Table 8.13 : Deposits and Advances of Local Area Banks

(Rupees crore)

Item/Date	March 2003	December 2002	September 2002	June 2002
1	2	3	4	5
Deposits	113.3	106.8	102.6	99.6
Advances	76.9	70.3	67.5	66.9

Banking Ombudsman Scheme

8.48 The Banking Ombudsman Scheme, 1995 was announced in June 1995 under Section 35A of Banking Regulation Act, for expeditious and inexpensive settlement of customer complaints about the deficiencies in banking services. All commercial banks having business in India (except RRBs) and scheduled primary co-operative banks were covered under the scheme. The scheme has since been reviewed and notified in June 2002 as Banking Ombudsman Scheme, 2002. The revised scheme includes provision for establishment of a Review Mechanism, enlarging the ambit of the scheme to include RRBs and entrusting the work of arbitration involving amounts up to Rs.10.0 lakh to the Banking Ombudsman. The number of complaints received in the various Banking Ombudsman offices across the country during 2002-03 declined to 6,506 as compared with 7,022 in the previous year. The complaints pertained to collection of negotiable instruments, operation of deposit account and claim in respect of fraudulent withdrawals. During 2002-03, 2,132 complaints were rejected after scrutiny, 2,995 complaints were withdrawn/settled through conciliation, 36 complaints were settled by recommendations and awards were given in respect of 47 complaints.

Food Credit

8.49 Credit limits are authorised to the Food Corporation of India (FCI), State Governments and Union Territory authorities for procurement of foodgrains, to National Agricultural Co-operative Marketing Federation (NAFED) for procurement of pulses and oilseeds, and to the Jute Corporation of India (JCI) for raw jute procurement. The food credit provided under the consortium arrangement covers mainly rice/paddy and wheat. Procurement of coarse grains such as jowar, bajra, ragi, barley and maize is also covered at the specific instance of State Governments. In view of its size and national priority, food credit is taken as the first charge on the lendable resources of the banks and is made available without stipulation of any margin. The rate of interest charged is equal to the average of Prime Lending Rates (PLRs) of five major banks in the Food Consortium. The consortium arrangement is regulated by the Reserve Bank with regard to entry/exit of banks into/from the consortium, authorisation of food credit limits for procurement purposes, fixing percentage/shares of member banks in the consortium and the interest rate charged on food credit.

8.50 The credit limits authorised for food procurement are disbursed by a consortium of 61 banks (State Bank of India (SBI), 7 Associate Banks of SBI, 19 other public sector banks, 14 private sector banks and 20 state co-operative banks) through the consortium leader, under a 'single window' system. The share of each bank is ordinarily determined by the Reserve Bank on the basis of its share in the fortnightly average aggregate deposits of all member banks, during the preceding financial year. The rate of interest charged is 11.05 per cent (effective January 1, 2003).

8.51 With the onset of the *kharif/rabi* season, State Governments and Union Territory Authorities provide cash flow statements indicating the projections/ estimates of the production, procurement and marketable surplus. Based on these estimates, credit limits to banks are authorised taking into account the Minimum Support Price (MSP) fixed by the Government as also the admissible costs of procurement such as mandi charges, statutory taxes, loading/unloading charges and transportation charges up to the point of storage. The outstandings in the food credit accounts are always required to be covered by the stocks valued at the lower of the procurement cost or issue price (Table 8.14).

Special Financial Package for Large Value Exports

8.52 The need for medium to long-term bank credit for large export projects at internationally competitive terms was examined in the light of export competitiveness of various products. Accordingly, a special financial package for large value exports of select internationally competitive products with high value addition was drawn up in consultation with the

Table 8.14 : Food Credit

(Rupees Crore)

	Rate of Interest (Per cent)	Outstanding as on	
		July 26, 2002	July 25, 2003
1	2	3	4
Food Credit	11.05	61,437	46,032
Scheduled Commercial Banks	(from 1.1.2003)	59,077	43,277
State Co-operative Banks		2,360	2,755
NAFED (for procurement of pulses and oilseeds)	10.65 (from 1.11.2002)	722	19
Jute Corporation of India (for procurement of raw jute)	11.10 (from 1.1.2003)	Nil	Nil

Government of India for a period of one year up to September 30, 2002. As the scheme was favourably received by the exporters, it was extended up to September 30, 2003.

Flexibility In Repayment Of Pre-Shipment Credit

8.53 Repayment/prepayment of pre-shipment credit is permitted subject to mutual agreement between the exporter and the banker. Packing credit, whether availed in rupees or in foreign currency, is allowed to be repaid out of balances in Exchange Earners Foreign Currency (EEFC) account as also from rupee resources of the exporter to the extent exports have actually taken place. Flexibility is provided to the exporter to convert the drawals under rupee pre-shipment credit into pre-shipment credit in foreign currency (PCFC).

Survey by National Council of Applied Economic Research (NCAER)

8.54 A Survey conducted by the NCAER for feedback on simplification of procedures for delivery of export credit as also the level of exporters' satisfaction with bank services concluded that the level of satisfaction of exporters is fair. A Committee was constituted to sensitise commercial banks about the need to bring about further improvements in the credit delivery system on the lines suggested by the NCAER survey. Reports from banks reveal that the banks have generally complied with the suggestions made by the NCAER.

Assessment of Monetary Policy during 2002-03

8.55 The conduct of monetary policy during 2002-03 was reasonably successful in the context of its objectives. There was a reduction in the deposit rates across all maturities. Longer-term deposit rates of commercial banks declined more sharply than the short-term rates. Deposit rates of private sector banks as well as foreign banks also declined during 2002-03. PLRs of public sector banks fell modestly to 9.0 - 12.25 per cent in March 2003. Sub-PLR lending of the banking system (excluding exports, the bulk of which is at sub-PLR rates) constituted over one-third of their total lending. As many as 47 banks (comprising 23 public sector banks, 7 foreign banks and 17 private banks) reduced their PLR in the second half of the year. Notwithstanding these reductions, the effective lending rates of commercial banks reflected high spreads. Non-food bank credit recovered significantly in consonance with the rise in industrial activity. Industrial outlook surveys suggest that inventory levels are balancing out and capacity utilisation is rising as firms are looking at fresh capital investments. As activity gathers momentum, working capital requirements are expected to be a major source of demand for bank credit (Box VIII.7).

Box VIII.7

Working Capital Cycles and Demand for Bank Credit

Working capital is critical for daily management of cash flows to settle bills, wages and other variable costs. The working capital cycle is the period of time which elapses between the point at which cash begins to be expended on the production of a product and the collection of cash from sale of the product to its customers. Typically, the cycle begins with the injection of cash which is utilised for making payments to the suppliers of raw materials, workers, *etc.* Between each stage of this working capital cycle, there is a time lag. The amplitude of the working capital cycle depends on the type of activity. In general, careful management of working capital is vital for any firm, particularly where the gestation lag between the production process and realisation of the receivables is substantial.

In a situation when the firm has incurred all expenditure associated with production but has not realised the value of its product, it is imperative that the firm manages its cash flows carefully to stay liquid and operational.

Working capital requirements can be financed from both internally generated resources (selling current assets) and externally acquired alternatives (borrowing or securing current assets). Mostly firms borrow on the strength of their current assets and the major sources of funds include trade credits, accruals, short-term bank loans, collateral papers, commercial papers and factoring accounts receivable. In a bank-based financial system, the loan from the bank by

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a corporate takes the form of line of credit or overdraft. This is an arrangement between the bank and its customers with respect to the maximum amount of unsecured credit the bank will permit the borrower firm. Besides this arrangement, there are other forms of short-term financing by raising resources directly from the market through issue of commercial paper.

In the Indian context, a major part of the working capital requirements are met by bank credit. Typically, periods of spurt in industrial activity are associated with surges in non-food bank credit, *albeit*, with some lag. These lags are more prolonged in a production based business rather than in service providing firms. Commercial paper (CP) has emerged as an important source of funding working capital needs; however, it is restricted to a few large companies with triple-A corporate ratings and does not enjoy wider market acceptability. Thus, bank credit in the form of cash credit (CC) and working capital demand loan (WCDL) continues to remain the principal source of working capital requirements. An analysis of the data for large borrowers showed that working capital credit which constituted nearly 65 per cent of the total bank credit in mid-1990s, came down to nearly 55 per cent in 2002.

The CC arrangement in India is a unique system, which is highly advantageous to the borrowers as the task of cash management of the borrowers is passed on to the lending banks. Since the borrowers are free to draw from the cash credit account at any time depending on their cash requirements, it results in uncertainty in the utilisation of the cash credit limit. As such, banks are required to maintain large cash / liquid assets or resort to borrowal from the call money market to meet the sudden demand for withdrawal by the borrowers. In April 1995, under the 'Loan System' of delivery of bank credit, the CC component was restricted to a maximum of 75 per cent of the Maximum Permissible Borrowed Fund (MPBF) in respect of cases where the MPBF was up to 20 crore, with a view to bringing about an element of discipline in utilisation of bank credit by large borrowers and for gaining better control over the flow of credit. The 'Loan System' aimed at minimising the risk of cash and liquidity management on the part of the banking system caused by the volatile movement in the CC component of working capital. It was extended in phases to cover large number of borrowers with the percentage of the loan component (WCDL) being gradually increased. In October 1997, the minimum level of the loan component was prescribed at 80 per cent in respect of borrowers with working capital credit limit of Rs.10 crore and above. In view of the improved environment of short-term investment opportunities available to both corporates and banks and the banks having put in place suitable risk management systems for covering liquidity and interest rate risks, banks were allowed to increase the CC component beyond 20 per cent in October 2001. Banks are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management.

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Monetary Policy Stance for 2003-04

8.56 The increasing integration of the domestic markets and the sensitivity to impulses from the international financial markets pose new challenges for the conduct of monetary policy especially to the commitment to maintain adequate liquidity in the market with a preference for soft and flexible interest rates to the extent the evolving situation warrants.

8.57 Monetary policy for the year 2003-04 is set in conditions characterised by large accretion to foreign exchange reserves and improving prospects for agriculture with the revised expectations of a normal monsoon. Accordingly, considerable optimism characterises the prospects of real GDP growth, which was initially projected at 6.0 per cent. Inflation is expected to be in the range of 5.0 to 5.5 per cent. Non-food bank credit adjusted for investments in commercial paper, shares/debentures/ bonds of public sector units (PSUs) and the private corporate sector is projected to increase by about 15.5-16.0 per cent in order to facilitate the sustenance of growth in industrial activity.

8.58 The overall monetary and macroeconomic conditions are, at present, satisfactory and in line with policy expectations. Nevertheless, the Reserve Bank would continue to keep a constant watch on the domestic and external situation. Monetary policy for 2003-04 is guided by the objective of provision of adequate liquidity to meet credit growth and support investment demand in the economy while monitoring carefully the movements in the price level. The policy stance continues to be one of preference for a soft and flexible interest rate environment within the framework of macroeconomic stability.