

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

VIII

MONETARY AND CREDIT POLICY
OPERATIONS

8.1 The conduct of monetary policy during 2003-04 was guided by the objective of 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. Ensuring macroeconomic stability was a concurrent objective with intensified monitoring of price movements, in view of the hardening of international commodity prices, especially crude oil, and the likely impact of the liquidity overhang in the system. Strong capital inflows posed a challenge for monetary management. The Reserve Bank responded with a policy mix of sterilisation, prepayment of external debt and liberalisation of foreign exchange transactions to maintain monetary conditions in line with the overall objectives. The need to fortify monetary management with additional instruments of sterilisation in the context of the large volume of capital inflows led to the institution of a Market Stabilisation Scheme (MSS). Interest rates on non-resident deposits were gradually aligned with those prevailing in the international markets in view of the rapid expansion in banks' external liabilities. These measures were reinforced by refinements in the Liquidity Adjustment Facility (LAF) scheme to strengthen the operating procedure of monetary policy. The Reserve Bank undertook parallel initiatives to improve the credit delivery system, especially in respect of agriculture and small and medium enterprises (SMEs).

8.2 This Section surveys the Reserve Bank's monetary and credit policy operations during 2003-04. A review of monetary policy operations sets out the dilemmas posed by the evolving monetary conditions. It also delineates the strategy adopted to balance the stance in support of growth against the need to ensure orderly conditions in financial markets and to contain potential inflationary pressures from persistent capital inflows and rising international oil and commodity prices. A review of interest rate policy profiles the measures undertaken to impart flexibility to the interest rate structure and to enhance transparency in the pricing

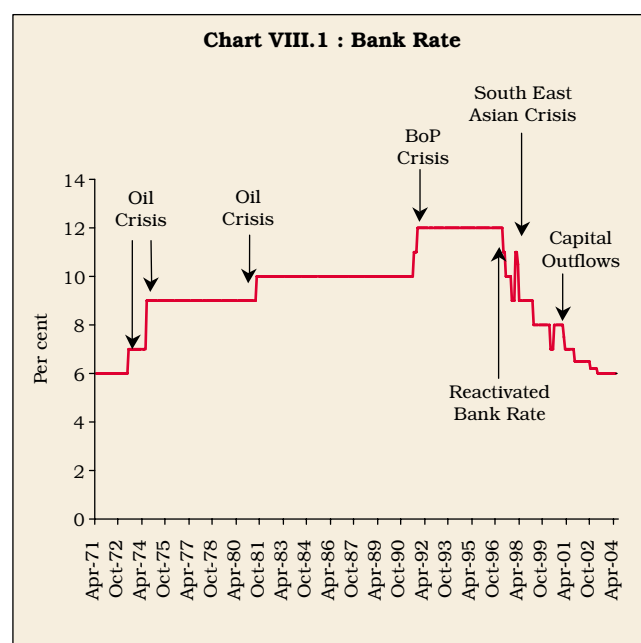
of bank loans. The Section also presents the policy initiatives undertaken by the Reserve Bank during the year to strengthen the credit delivery system.

MONETARY POLICY OPERATIONS

Monetary Measures

Bank Rate

8.3 The Bank Rate was reduced by 25 basis points (bps) to 6.0 per cent effective April 30, 2003 – the lowest level since May 1973 (Chart VIII.1).



Repo Rate

8.4 The repo/reverse repo rates in the auctions under the LAF signal the Reserve Bank's monetary policy stance. The Reserve Bank reduced the repo rate by 50 bps to 4.5 per cent effective August 25, 2003 (Table 8.1).

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MONETARY AND CREDIT POLICY OPERATIONS
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Table 8.1: Movement in LAF Rates

(Per cent)

Month	2003-04		2002-03		2001-02		2000-01	
	Repo	Reverse Repo	Repo	Reverse Repo	Repo	Reverse Repo	Repo	Reverse Repo
1	2	3	4	5	6	7	8	9
April	5.0	7.0	6.0	–	6.75-7.0	8.75-9.00		
May	5.0	7.0	6.0	8.0	6.5-6.75	8.75		
June	5.0	–	5.75	–	6.5	8.5	–	9.0-14.0
			(June 27)					
July	5.0	7.0	5.75	–	6.5	8.5	7.0-8.0	9.0-10.0
August	4.5	–	5.75	–	6.5	–	8.0-15.0	15.0-16.0
	(August 25)							
September	4.5	–	5.75	–	6.5	8.5	10.0-13.0	13.5
October	4.5	–	5.50	–	6.5	8.5	8.0-9.75	10.25
			(Oct. 30)					
November	4.5	–	5.50	7.5	6.5	8.5	8.0	10.0
				(Nov. 12)				
December	4.5	–	5.50	–	6.5	8.5	8.0	10.0
January	4.5	–	5.50	7.5	6.5	–	–	10.0
February	4.5	–	5.50	7.5	6.5	8.5	7.5-8.0	10.0
March	4.5	6.0	5.0	7.0	6.0	8.0	7.0-7.5	9.0
		(March 29)	(March 3)		(March 5)			

– : No repo/reverse repos.

8.5 The scope of the LAF was progressively enlarged to price primary liquidity at the reverse repo rate. Effective the fortnight beginning December 27, 2003 the ratio of the “normal” standing facility available at the Bank Rate and the “back-stop” standing facility linked to the reverse repo rate was modified to one-third and two-third (*i.e.*, ratio of 1:2) from one-half each (*i.e.*, ratio of 1:1). The entire quantum of export credit refinance and the liquidity support available for primary dealers was made available at a single rate, *i.e.*, the reverse repo rate, effective March 29, 2004.

8.6 Cross-country experience suggests that central banks influence short-term interest rates by directly fixing the interest rate on central bank accommodation and indirectly by open market operations (OMO) which, in turn, affect the price of primary liquidity. The Reserve Bank has adopted a balanced and flexible stance in this regard in recent years in response to the evolving situation. Fixed repo rate auctions, introduced in November 1997, were replaced in June 2000 with auctions under the LAF, in which interest rates emerged from the market bids. In effect, however, the LAF turned out to be a *de facto* fixed rate auction as market participants did not usually bid at a price different from the prevailing repo rate. In order to provide a clearer signal to the market,

fixed rate repo auctions were reintroduced in March 2004. Also, the maturity period of repos was increased to 7 days, while for reverse repos it was retained on overnight basis. Furthermore, the spread between the repo rate and the reverse repo rate was reduced by 50 bps to 150 bps with effect from March 29, 2004. At the time of introduction of the revised LAF scheme, it was indicated that the Reserve Bank will continue to have the discretion to conduct overnight or longer-term repo auctions at fixed or variable rates depending on market conditions and other relevant factors. Accordingly, on an assessment of the prevailing situation, the Reserve Bank decided to reintroduce overnight fixed rate repos at 4.5 per cent under the LAF from August 16, 2004 while continuing with 7-day and 14-day repos and overnight fixed rate reverse repos.

Cash Reserve Ratio

8.7 The Reserve Bank continued to pursue its medium-term objective of reducing the cash reserve ratio (CRR) to the statutory minimum level of 3.0 per cent of banks’ net demand and time liabilities (NDTL). In line with this policy stance, there was a cut in the CRR by 25 bps on June 14, 2003 (Table 8.2).

Table 8.2: Cash Reserve Ratio

(Amount in Rupees crore)

Month	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	4.5	0	5.0	0	7.5	0	8.25	-1,900
August	4.5	0	5.0	0	7.5	0	8.5	-1,900
September	4.5	0	5.0	0	7.5	0	8.5	0
October	4.5	0	5.0	0	7.5	0	8.5	0
November	4.5	0	4.75	3,500	5.75	6,000	8.5	0
December	4.5	0	4.75	0	5.5	2,000	8.5	0
January	4.5	0	4.75	0	5.5	0	8.5	0
February	4.5	0	4.75	0	5.5	0	8.25	2,050
March	4.5	0	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.

Eligible CRR balances maintained by banks with the Reserve Bank are paid interest on a monthly basis starting from April 2003.

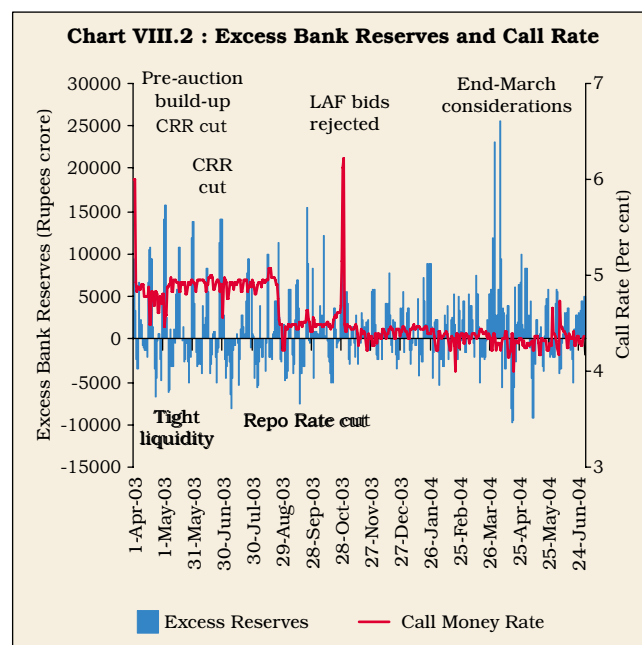
Liquidity Management

8.8 The Reserve Bank continued to modulate market liquidity through a mix of repo operations under the LAF and outright OMO. Barring fluctuations relating to primary auctions and the usual year-end switch to balances with the Reserve Bank, daily fluctuations in banks' excess reserves (defined as the excess balances over and above the CRR stipulation) with the Reserve Bank remained range-bound for the greater part of 2003-04 (Chart VIII.2). This imparted stability to the interest rate environment during the year.

8.9 During 2003-04, the Reserve Bank stepped up sterilisation operations through outright open market sales and LAF repo operations. As capital flows persisted, the Reserve Bank's stock of Government securities for OMO and the LAF was augmented by i) conversions of the available stock of non-marketable special securities into marketable paper; and ii) private placements of Government paper against the release of foreign exchange for the prepayment of the Government's external debt. Persistent and sizeable cash balances of the Government with the Reserve Bank in the second half of the year were invested in gilts, preventing their use in OMO. The reduction of Government paper in the Reserve Bank's portfolio necessitated a switch from outright OMO to repo operations thereby burdening

the instrument of day-to-day liquidity management with the absorption of liquidity of an enduring nature.

8.10 The scope of sterilisation operations is circumscribed by the Reserve Bank of India Act, 1934 for three reasons. First, the Reserve Bank is not allowed to borrow beyond its paid-up capital of Rs.5 crore without collateral. This requires Government securities to be furnished as underlying collateral in repo operations under the LAF. Second, since the Government cannot statutorily receive interest on surplus balances with the Reserve Bank under the Act, it typically 'buys back' Government paper from the Reserve Bank and saves



on interest payments. Third, the Reserve Bank cannot issue its own paper under the extant provisions of the Act. The stock of marketable Government paper with the Reserve Bank being finite can, thus, affect the extent of its monetary policy operations.

8.11 In this context, the Reserve Bank appointed two groups, viz., a Working Group on Instruments of Sterilisation and an Internal Group on Liquidity Adjustment Facility to search for alternative instruments of sterilisation (Box VIII.1). On the basis of the recommendations of the Working Group on the Instruments of Sterilisation, the MSS was instituted in April 2004 (refer to Box I.2 of Section I). In terms of the scheme, the Government issues securities to mop up the excess liquidity emanating from the Reserve

Bank's operations in the foreign exchange market and parks the proceeds in an identifiable cash account, viz., the MSS account to be maintained and operated by the Reserve Bank. As a result, the primary liquidity generated by the accretion to the Reserve Bank's foreign currency assets is counter-balanced by a reduction in the Reserve Bank's net credit to the Centre.

8.12 The course of management of capital flows reflected the constraints within which the Reserve Bank had to operate. In this regard, sterilisation operations during 2003-04 and the first quarter of 2004-05 could be divided into three distinct phases in terms of the relative shifts in reliance on instruments used (Table 8.3).

Box VIII.1 Instruments of Sterilisation

The Reserve Bank's Working Group on the Instruments of Sterilisation (Chairperson: Smt. Usha Thorat) examined options that would augment the Reserve Bank's ability to sterilise capital inflows. Against the background of international experience and the existing financial and legal structure, the Working Group recommended a two-pronged approach for strengthening and refining the existing instruments and exploring new instruments appropriate in the Indian context to sterilise foreign exchange inflows. The appropriate mix of instruments would depend on the prevailing circumstances, the associated costs and benefits and the opportunity cost of not using sterilisation as a policy option. The major recommendations of the Group include:

Existing instruments

- The use of open market operations as an instrument of sterilisation.
- As outright transactions entail the permanent absorption of liquidity and transfer of market risk to participants, the alternative of using the existing stock of securities for longer-term repos (up to 3 to 6 months) could also be considered.
- It is not desirable to use the LAF as an instrument of sterilisation on an enduring basis, although it could supplement other instruments for limited periods.
- Surplus balances of the Government could be maintained with the Reserve Bank without any payment of interest. This would entail a review of the 1997 agreement between the Government and the Reserve Bank under which the Reserve Bank transfers securities to the Government account in lieu of interest payments.
- The use of CRR as an instrument of sterilisation should not be ruled out under extreme conditions of excess liquidity and when other options are exhausted.

New instruments requiring amendments to the Reserve Bank of India Act

- The Group favoured the institution of a standing deposit-type facility with flexibility in determination/remuneration of CRR balances so that interest can be paid on deposit balances actually maintained by scheduled banks with the Reserve Bank.
- Although many emerging market economies issue central bank paper to absorb liquidity, the Group did not find it desirable to pursue the option of such issuance. Central bank bills tend to concentrate the entire cost of sterilisation in the central bank's balance sheet. Cross-country experience suggests that the resultant financial impairment often erodes the ability of the monetary authority to conduct liquidity operations. Besides, the existence of two sets of risk-free paper - gilts and central bank bills - tends to fragment the market.

New instruments which do not require legislative amendments

- The Group recommended the institution of a Market Stabilisation Scheme (MSS). Proceeds of Government paper issued under the MSS to mop up liquidity generated on account of the accretion to the Reserve Bank's foreign assets would be parked with the Reserve Bank to neutralise the monetary impact of capital flows. Based on this recommendation, a Memorandum of Understanding was signed between the Government and the Reserve Bank on March 25, 2004 providing for the issuance of Treasury Bills and dated securities within an overall ceiling of Rs.60,000 crore, subject to review, if necessary.

Reference

Reserve Bank of India (2004), "Report of the Working Group on Instruments of Sterilisation", *Reserve Bank of India Bulletin*, April.

Table 8.3: Phases of Reserve Bank's Liquidity Management Operations

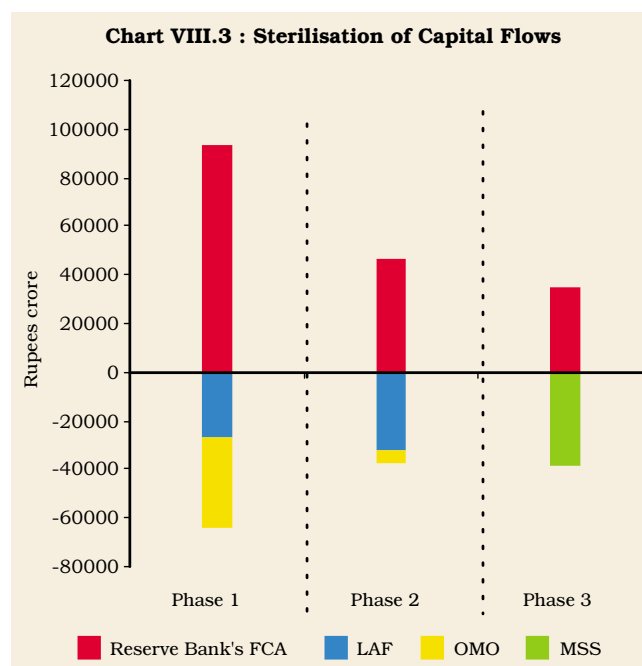
Item	(Rs. crore)		
	April 1- December 26, 2003	December 27, 2003- March 26, 2004	March 27- June 25, 2004
1	2	3	4
1. RBI's Foreign Currency Assets (adjusted for revaluation)	93,334	46,171	34,971
2. Repos (net) (under LAF)	27,075	31,910	-35
3. OMO sales (net)	36,517	5,332	429
4. MSS	-	-	37,812
5. Currency	29,914	14,896	14,042
6. Others (residual)	8,106	-15,601	-17,274
6.1 Surplus cash balances of the Centre with the Reserve Bank	13,135	-6,685	-18,577
Bank Reserves # (1-2-3-4-5-6)	-8,278	9,634	-3

: Excludes vault cash with banks.

8.13 During the first phase, *i.e.*, April-December 2003, the Reserve Bank continued to absorb the liquidity emanating from capital inflows by deploying an almost even mix of open market outright sales (amounting to 39.1 per cent of the accretion of the Reserve Bank's foreign assets) and the LAF (29.0 per cent). In the second phase, *i.e.*, January-March 2004, the burden of sterilisation fell on the LAF, which offset almost 70 per cent of the accretion to the Reserve Bank's foreign currency assets. In the third phase, *i.e.*, during the first quarter of 2004-05, the MSS emerged as the primary mechanism of liquidity management (Chart VIII.3). Adding the balances parked in repos under the LAF and the paper issued under the MSS, the total liquidity overhang in the system exceeded Rs.1,00,000 crore or 5.0 per cent of broad money by end-June 2004.

Liquidity Adjustment Facility

8.14 The LAF is the Reserve Bank's primary instrument for modulating liquidity and transmitting interest rate signals to the market. Besides the usual function of day-to-day liquidity management, the LAF was increasingly used as an instrument of sterilisation during 2003-04. As a result, the average daily repos outstanding were consistently higher than those in 2002-03. Although the Reserve Bank adjusted the quantum of primary liquidity in the first half of the year



by occasionally rejecting bids, all bids were, by and large, accepted in the second half of the year as the pressure from persistent capital inflows intensified (Table 8.4).

8.15 LAF repo operations were conducted to mop up the usual spurt in liquidity at the beginning of the year. Bids ebbed in May and June as the Centre's market borrowing programme gathered momentum. Repo bids soared – both in number and average size – in July with the easing of liquidity conditions, reinforced by the return flow of advance tax payments and the seasonal easing in cash demand. A 50 bps cut in the repo rate in August 2003 briefly closed the differential with the call rate and caused a temporary lull in repo biddings. A mix of open market sales and a series of 28-day repos to rationalise expectations were reflected in some reduction in LAF repos in October. Repo bids picked up again from November with the persistence of capital inflows as well as the gradual cessation of outright OMO. Accordingly, LAF repo operations had to not only provide an anchor to call rates but also act as the main sterilisation instrument. This pushed up the average daily repo outstanding to Rs.54,915 crore in March 2004, despite an outflow of over Rs.25,000 crore during March 26-31, 2004 on account of the build-up of bank reserves and transfer of the proceeds of ONGC disinvestment to the Government's account with the Reserve Bank (Chart VIII.4).

8.16 The pressure on the LAF began to build up in April 2004 due to strong capital inflows as well as

Table 8.4: Repo/Reverse Repo Bids under LAF

Month	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
2003-04								
April	17	0	15	2	1	0	1	0
May	19	0	18	1	1	0	1	0
June	20	0	18	2	0	0	0	0
July	23	0	22	1	1	0	1	0
August	20	0	19	1	0	0	0	0
September	21	0	19	2	0	0	0	0
October	22	2	19	1	1	1	0	0
November	19	0	19	0	0	0	0	0
December	22	0	22	0	0	0	0	0
January	21	0	21	0	1	1	0	0
February	18	0	17	1	0	0	0	0
March	21	0	21	0	1	0	1	0
2004-05								
April	19	0	19	0	0	0	0	0
May	20	0	20	0	0	0	0	0
June	21	0	21	0	1	0	1	0
July	23	0	23	0	0	0	0	0

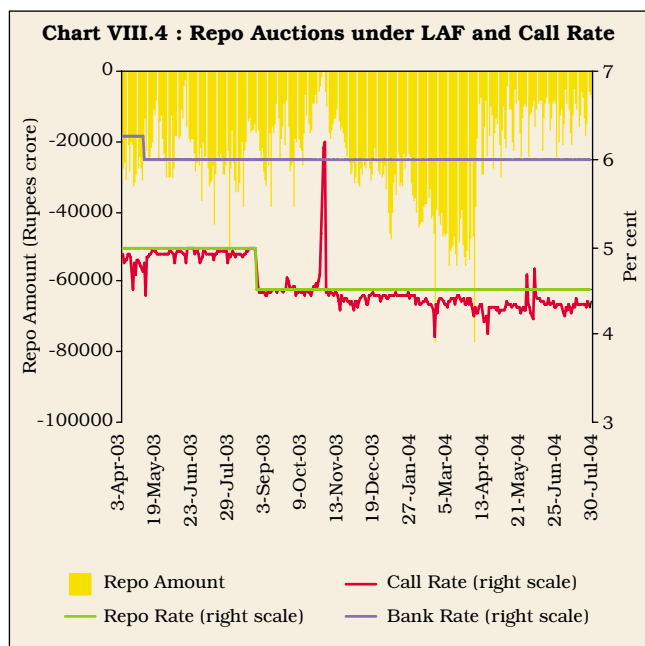
the usual seasonal easing in credit demand. As a result, outstanding LAF repos jumped to an average of over Rs. 74,000 crore during April and May 2004. The pressure on the LAF window started abating by June due to a combination of factors such as seasonal currency demand, the beginning of the Government's borrowing programme, slowdown in capital inflows and the switch to the MSS.

8.17 The Reserve Bank introduced a revised LAF scheme on March 29, 2004 based on the recommendations of the Internal Group on LAF (Box VIII.2). Daily repo/reverse repo variable rate auctions were replaced by 7-day fixed rate repo auctions and daily fixed rate reverse repo auctions, with a spread of 150 bps. The 14-day variable rate multiple price repo auctions, however, would continue for some time, but would be phased out in due course.

Open Market Operations

8.18 The Reserve Bank continued to supplement LAF absorptions with outright open market sales. The Reserve Bank is required to have a sufficient stock of Government paper to modulate liquidity through OMO. The ratio of open market sales by the Reserve Bank to the addition to the gilt portfolio dropped to about 50 per cent during 2003-04 from an average of 90 per cent in the preceding five years following a switch to LAF operations (Table 8.5).

8.19 The Reserve Bank conducted five rounds of open market operations during 2003-04. OMO sales in May mopped up the surge in domestic liquidity emanating from capital inflows in the preceding two months. These operations resumed in August and early September after the Reserve Bank replenished its stock of marketable paper by converting non-



Box VIII.2

Internal Group on Liquidity Adjustment Facility

The Reserve Bank's Internal Group on Liquidity Adjustment Facility made a number of recommendations to enhance the efficacy of liquidity management.

- Daily LAF auctions could be replaced by weekly auctions conducted on a daily basis to enable balanced development of various segments of the money market with the flexibility to conduct overnight repo auctions if the situation so warrants.
- Fixed rate LAF auctions could replace variable rate auctions to enhance the ability of the Reserve Bank to transmit policy signals, *albeit* with the flexibility to use the variable price auction format, if necessary.
- The ambit of LAF operations could be enlarged by linking the entire liquidity support, including refinance, to the reverse repo rate.
- The timing of LAF auctions could be shifted to the middle of the day from 10.30 am to enable sufficient inter-play of market liquidity, especially with the provision of intra-day liquidity with the operationalisation of the real time gross settlement (RTGS) system.
- The LAF should primarily modulate liquidity of a somewhat "temporary" nature at the margin on a day-to-day basis.

- A standing deposit facility should be instituted with due amendments in the Reserve Bank of India Act, 1934 to accord the Reserve Bank greater flexibility in LAF operations as also to provide a floor to the interest rate corridor.
- Pending legislative amendments, the possibility of modifying the current CRR prescription to accommodate a standing deposit-type facility with placement of deposits at the discretion of banks could be explored; remuneration on the standing deposit-type facility would be below the repo rate.
- The Bank Rate should be aligned to the reverse repo rate under normal circumstances. In the event of introduction of a standing deposit facility, the interest rate corridor in the money market would be defined by the Bank Rate/reverse repo rate as the ceiling and the standing deposit facility rate as the floor.

Reference

Reserve Bank of India (2004), "Report of the Internal Group on Liquidity Adjustment Facility", *Reserve Bank of India Bulletin*, January.

marketable special securities in its portfolio into tradable paper. A fourth round took place in October, funded by draws from repo operations following the conversion of the available stock of special securities

in September. A final round of OMO sales took place in January 2004 to supplement the LAF operations in sterilising the large accretion to the Reserve Bank's NFA (Table 8.6).

Table 8.5: 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)	OMO Sales by Reserve Bank	Net Addition to Stock (6-7)	Outstanding Holding by Reserve Bank (end period)*	Memo : Net Repos Outstanding
1	2	3	4	5	6	7	8	9	10
1996-97	3,698	–	623	–	4,321	11,206	-6,885	6,666	2,300
1997-98	7,028	6,000	467	20,000	33,495	8,081	25,414	31,977	4,202
1998-99	8,205	30,000	–	–	38,205	26,348	11,857	42,212	400
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	1,355
2001-02	6 79	28,213	5,084	–	33,976	35,419	-1,443	41,631	4,355
2002-03	5,175	31,000	–	40,000	76,175	53,780	22,395	63,866	2,415
2003-04	–	21,500	–	61,818	83,318	41,849	41,469	1,04,066	34,795
2004-05 (up to August 14)	217	–	–	–	217	716	-499	1,03,975	32,665

* : Inclusive of securities sold under the LAF and the investment of the Centre's surplus.

MONETARY AND CREDIT POLICY OPERATIONS

Table 8.6: Monthly Primary Liquidity Flows and Open Market Operations

(Rupees crore)

Month	RBI's Foreign Currency Assets#			Net RBI Credit to Centre			RBI's Initial Subscription			Net OMO Sales		
	2004-05	2003-04	2002-03	2004-05	2003-04	2002-03	2004-05	2003-04	2002-03	2004-05	2003-04	2002-03
1	2	3	4	5	6	7	8	9	10	11	12	13
April	32,608	3,817	3,076	-29,230	9,706	11,976	0	0	10,000	253	7	5,307
May	202	15,626	1,330	-7,038	-2,926	1,838	0	5,000	10,018	116	5,569	1,524
June	350	4,500	3,739	6,240	-6,346	-12,359	0	0	2,000	60	44	189
July	946	13,865	8,820	-8,530	-19,847	8,122	0	0	1,157	218	57	6,538
August		11,550	7,828		-24,023	-19,083			0	0	11,526	7,025
September		6,417	6,233		-9,874	-8,594			0	0	5,089	6,355
October		13,124	7,949		6,494	-8,074			0	0	14,024	71
November		10,775	11,887		-8,172	-1,192			0	0	69	11,073
December		13,661	11,223		-14,166	-8,616			0	0	132	4,549
January		11,723	9,375		4,420	-3,288			9,500	0	5,178	10,995
February		14,610	11,062		-17,738	-6,206			7,000	0	85	88
March		21,760	-434		6,407	17,077			0	13,000	69	66

: Adjusted for revaluation.

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

Market Stabilisation Scheme

8.20 The Market Stabilisation Scheme (MSS), operationalised in April 2004, has emerged as a key instrument of liquidity management. The issuance under the MSS in April 2004 amounted to Rs. 23,000 crore reflecting the bunching of capital flows. An unscheduled auction amounting to Rs. 5,000 crore of dated securities under the MSS was held on April 8, 2004 to counter-balance the large accretion to the Reserve Bank's foreign currency assets (Rs.16,746 crore during April 1-9, 2004). The total stock of Treasury Bills and dated securities issued under the MSS amounted to Rs.39,730 crore by end-June 2004, in excess of the indicative allocation of Rs.35,500 crore for the quarter April-June 2004. With the abatement of capital inflows in May-June, funds invested in the MSS (Rs. 16,730 crore) essentially reflected a drawdown of the surplus parked in the LAF (Rs. 15,000 crore).

8.21 A schedule for issuances amounting to Rs.36,500 crore (including the rolling over of Rs.19,500 crore under 91-day Treasury Bills issued during the first quarter) for the second quarter ending September 2004 was issued on June 29, 2004. The total amount raised under the MSS amounted to Rs. 46,480 crore by August 14, 2004, inclusive of Rs.20,000 crore raised through dated securities with a residual maturity of up to 2.5 years.

Interest Rate Policy

Lending Rates

8.22 The Reserve Bank continued to take policy initiatives to impart a greater degree of flexibility to

the interest rate structure. In order to enhance transparency in pricing of loan products by banks, the April 2003 Monetary and Credit Policy Statement advised banks to announce their benchmark prime lending rates (BPLRs), taking into account the actual cost of funds, operating expenses and a minimum margin to cover the regulatory requirement of provisioning/capital charge and a profit margin. Following a series of meetings with banks for expeditious implementation, the BPLR guidelines were modified into an operationally flexible framework. The November 2003 Mid-Term Review of Monetary and Credit Policy clarified that banks have the freedom to price their loan products based on time-varying term premia and relevant transaction costs using market benchmarks in a transparent manner. On November 25, 2003 the Indian Banks' Association (IBA) advised its member banks to announce BPLRs. By April 2004, almost all commercial banks had adopted the new system of BPLR.

8.23 Banks were permitted to determine rates of interest on loans and advances for purchase of consumer durables to individuals against shares and debentures/bonds and other non-priority sector personal loans without reference to prime lending rates (PLR) and regardless of the size of the loan.

Interest Rates on Export Credit

8.24 The reductions in the interest rate ceiling on pre-shipment rupee export credit up to 180 days and

post-shipment credit up to 90 days to PLR *minus* 250 bps on September 24, 2001 were extended up to April 30, 2005. Interest rates on foreign currency export credit are linked to a ceiling related to the London Inter-Bank Offered Rate (LIBOR)/SWAP rates (*i.e.*, at LIBOR *plus* 75 bps). Banks are permitted to arrange lines of credit from overseas banks/financial institutions to augment foreign currency funds for onlending to exporters. Such borrowings by authorised dealers for financing export credit are kept outside the stipulated limit on their overseas foreign currency borrowings.

Interest Rates on Non-resident Deposits

8.25 With a view to providing consistency in interest rates offered on non-resident deposits, an interest rate ceiling linked to the LIBOR/SWAP rates was imposed on NRE deposits in stages during 2003-04. The ceiling on interest rate on fresh (and renewals of) term deposits for one to three years under the NRE scheme was placed at 250 bps above the LIBOR/SWAP rates for the US dollar of corresponding maturity, effective July 17, 2003. The differential was further reduced to 100 bps, effective September 15, 2003 and by 25 bps effective October 18, 2003 and was finally closed, effective April 17, 2004 in pursuance of the recommendations of the Internal Group on External Liabilities of Scheduled Commercial Banks (Box VIII.3). Furthermore, the NRE savings deposit rate was capped at a maximum of LIBOR/SWAP rates for six months' maturity on US dollar deposits effective April 17, 2004. No *lien* of any type, direct or indirect,

is permitted against these deposits. The Foreign Currency Non-Resident (Banks) {FCNR(B)} deposit rate continues to be linked to LIBOR/SWAP rates (at LIBOR/SWAP rates of corresponding maturities *minus* 25 bps). The Union Budget for 2004-05 proposed the withdrawal of exemptions on interest income from NRI deposits, effective September 1, 2004.

Rationalisation of Interest Rates on Small Savings

8.26 The rationalisation of small saving schemes and the interest rates paid thereon remains an important policy priority in view of the high fiscal cost and in terms of the implications for the interest rate structure. In this context, the Union Government constituted an Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Saving Instruments (Chairman: Dr. Rakesh Mohan) on January 24, 2004. Recommendations of the Committee in respect of introduction of a Senior Citizens Savings Scheme and discontinuation of the Deposit Scheme for Retiring Employees and 6.5 per cent Saving Bonds 2003 (non-taxable) have been implemented with some modifications (Box VIII.4).

CREDIT DELIVERY

8.27 The Reserve Bank assigns the highest priority to nurturing a conducive credit culture among financial intermediaries, corporates and households. Credit delivery, in particular, to agriculture, SMEs and infrastructure is critical to sustain growth. In these sectors, the issue of availability of credit is often as

Box VIII.3

Internal Group on External Liabilities of Scheduled Commercial Banks

The Internal Group on External Liabilities of Scheduled Commercial Banks recommended that the current reserve and liquidity requirements on non-resident Indian (NRI) deposits may be left unaltered, as they are aligned to domestic deposits. Interest income from NRI deposits may be made taxable on the lines of domestic deposits, consistent with current account convertibility. The acceptance of NRI deposits should be restricted to authorised dealers only. Acceptance of NRI deposits by non-banking financial companies and non-financial corporates could be phased out.

The Group recommended an alignment of the pricing of non-resident external (NRE) deposits with rates of return in the international market. The NRE savings deposit rate could be delinked from the domestic savings deposit rate, with a ceiling of one-month LIBOR/SWAP rates on US dollar deposits. Furthermore, the Group recommended that the premium available on interest rates on NRE term deposits could be

withdrawn to restrict the ceiling to the LIBOR of the corresponding maturity. The Resident Foreign Currency (RFC) deposit scheme could be made non-interest bearing as is the case with the Exchange Earners' Foreign Currency (EEFC) and RFC(D) accounts. Although the existing Non-Resident Ordinary (NRO) term/recurring deposits may be allowed to be maintained till maturity, fresh NRO deposits may have the nature of current/savings accounts only. For better availability of export credit in foreign currency, the ceiling on interest on such credit should be deregulated. If complete deregulation was not considered feasible, the interest rate ceiling should be raised by 50 basis points to LIBOR *plus* 125 basis points.

Reference

Reserve Bank of India (2004), "Report of the Internal Group on External Liabilities of Scheduled Commercial Banks", *Reserve Bank of India Bulletin*, July.

Box VIII.4

Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Saving Instruments

The Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Saving Instruments (Chairman: Dr. Rakesh Mohan), which submitted its report in May 2004, addressed three broad issues within its overall terms of reference, viz., (i) suggesting appropriate benchmarking and spread rules for administered interest rate, (ii) rationalising existing saving schemes particularly in respect of tax treatment in the light of the recommendations made by the Expert Committee to Review the System of Administered Interest Rates and Other Related Issues (Chairman: Dr. Y. V. Reddy) in 2001, and (iii) designing a structure of the proposed *Dada-Dadi* (Senior Citizens) Scheme as announced by the Finance Minister on January 9, 2004.

After considering alternative benchmarks like the inflation rate, bank deposit rate, Bank Rate, and yields on Government securities, the Committee decided to continue with Government securities (G-sec) yields as the most suitable benchmark in line with the suggestion made by the Reddy Committee as they are mostly market determined, signal a measure of expected (rather than past) inflation and would facilitate rationalisation of interest rates on various schemes. However, in order to impart stability to the benchmark, the Committee recommended that the benchmark could be calculated on a weighted average basis, with weights of 0.67 to G-sec yields for the previous year and 0.33 to yields for the year before that. Furthermore, a fixed illiquidity premium of 50 basis points over the average benchmark yields was also retained on similar lines as suggested by the Reddy Committee. The Committee expressed concern over the sharply falling yields over the past few years due to excess liquidity in the financial market and suggested an inter-year movement of interest rate fluctuations within a band of 100 basis points to address the immediate concern of savers.

The Committee was in favour of continuing most of the small saving schemes as these are popular in rural and semi-urban areas due to convenience, habitual preference and ease of transactions as well as more intensive penetration of post offices as compared with the branch network of

commercial banks. However, in the interest of rationalising existing saving schemes, the Committee recommended discontinuance of a few saving instruments offered by the Government where investments are primarily motivated by tax benefits available under Section 88 and Section 10 of the Income Tax Act. Accordingly, it recommended discontinuance of National Savings Certificates (VIII Issue), Deposit Scheme for Retiring Employees and 6.5 per cent Gol (Tax Free) Savings Bond (2003). The Committee also recommended the discontinuance of the *Kisan Vikas Patra* in which tax is not deducted at source and therefore, could lead to potential difficulties from the viewpoint of tax management. In this respect, the Committee also emphasised the need to explore ways and means of making tax deductible at source (TDS) provisions effectively applicable to taxable bonds. The Committee, however, observed that the Public Provident Fund (PPF), which also enjoys similar tax benefits, could be retained in its present form for sometime as it provides income security, especially in the unorganised sector. Similarly, other post office schemes catering to the needs of small savers, particularly in rural and semi-urban areas, were recommended to continue in their present form.

The Committee recommended a structure for the *Dada-Dadi* Scheme designed to improve the welfare of senior citizens. The interest rate on the Scheme could be 100 basis points higher than the average benchmark for other small saving instruments. The tenor could be shorter at three years to ensure liquidity. The Scheme would be taxable in terms of Section 80L of the Income Tax Act so that senior citizens at the lower end of the tax bracket, *ipso facto*, obtain higher returns. An individual ceiling of Rs. 20 lakh was proposed on investment.

Reference

Government of India (2004), "Report of the Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Savings Instruments", *Reserve Bank of India Bulletin*, August.

important as the cost of credit, especially as the rates of interest on alternative sources of finance from the informal sector are prohibitively high. It is in this context that the Reserve Bank continued to pursue initiatives to ensure flow of adequate bank credit at reasonable rates of interest.

8.28 The monetary and credit policy has taken several initiatives to improve the credit delivery mechanism and credit flows to different sectors. Pursuant to the announcements in the November 2003 Mid-Term Review of the Monetary and Credit

Policy, the Reserve Bank constituted an Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) and a Working Group on Flow of Credit to SSI Sector (Chairman: Dr. A.S. Ganguly) to recommend measures to improve the credit delivery mechanisms for agriculture and SMEs, respectively.

8.29 A package of measures including withdrawal of limits on unsecured exposures of banks and improvement in the credit information system available

with the Credit Information Bureau (India) Limited (CIBIL) was introduced to complement the process of refinements in the credit delivery mechanism from the supply side. Banks were encouraged to align the pricing of credit with the assessment of credit risk in order to improve credit delivery and pass on the benefit of lower rates to borrowers with good track records.

Priority Sector Lending

8.30 Several measures were taken to improve the credit delivery mechanism in the priority sector through raising of loan limits and expanding the definition of the priority sector. Investment limits in plant and machinery for 13 items of the stationery sector and 10 items of the drugs and pharmaceuticals sector in addition to hosiery and hand tools (which figure in the list of items reserved for manufacture in the small scale industries sector) were enhanced from Rs. one crore to Rs. five crore for the purpose of classification under priority sector advances. Furthermore, the limit for uncollateralised loans to SSI units with good financial positions and track record was increased from Rs.15 lakh to Rs.25 lakh (with the approval of the appropriate authority in the banks). All new loans granted by banks to non-banking financial companies (NBFCs) for the purpose of on-lending to the SSI sector were reckoned as priority sector loans. Banks are allowed to extend direct finance to the housing sector up to Rs.10 lakh in rural and semi-urban areas as a part of priority sector lending. Moreover, educational loans up to the ceiling of Rs.7.5 lakh for studies in India and Rs.15 lakh for studies abroad were treated as priority sector advances. As indicated in the Union Budget, 2004-05 commercial banks have agreed to waive the need for collateral for educational loans up to Rs. 7.5 lakh in place of Rs. four lakh earlier, subject to satisfactory guarantee on behalf of the student. A Gold Card Scheme was introduced for easy availability of export credit on the best terms to creditworthy exporters with good track record to step up export credit offtake.

8.31 Foreign banks are required to make good the shortfall in priority sector targets and sub-targets by depositing an equivalent amount with the Small Industries Development Bank of India (SIDBI) for a period of one year. The interest rate on deposits of foreign banks placed with the SIDBI was reduced to the Bank Rate, *i.e.*, 6.0 per cent from 6.75 per cent, with effect from November 3, 2003.

8.32 Commercial banks achieved the overall target for priority sector lending (Table 8.7). This was facilitated by (i) higher lending by banks to individuals

Table 8.7: Priority Sector Advances

(Rupees crore)

As on last reporting Friday of	Public Sector Banks	Private Sector Banks	Foreign Banks
1	2	3	4
March 1999	1,04,094 (39.2)	13,947 (41.3)	8,268 (36.5)
March 2000	1,27,478 (40.3)	18,368 (38.0)	9,934 (35.2)
March 2001	1,49,116 (43.7)	21,567 (36.7)	11,572 (33.5)
March 2002 P	1,71,185 (43.1)	25,709 (40.9)	13,414 (34.0)
March 2003 P	2,03,095 (42.5)	36,705 (44.4)	14,848 (33.9)
March 2004 P	2,45,501 (43.9)	52,629 (47.3)	17,651 (34.2)

P : Provisional.

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

directly for housing and indirectly for investment in bonds issued by the National Housing Bank (NHB)/ Housing and Urban Development Corporation (HUDCO) for housing (*i.e.*, indirect lending); (ii) retail trade by public sector banks; and (iii) lending to direct housing in the case of private sector banks. Nine private sector banks and two public sector banks did not achieve the overall priority sector lending target of 40 per cent as on the last reporting Friday of March 2004.

8.33 Several recommendations of the *interim* report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System were implemented by the Reserve Bank in its Annual Policy Statement for 2004-05. Loans for storage units (including cold storage) for storing agricultural produce/products, irrespective of their location, are to be reckoned as indirect agricultural advances under the priority sector. Investment by banks in securitised assets representing direct or indirect advances to agriculture would be treated as direct/indirect lending to agriculture under the priority sector, provided that securitised loans are originated by banks and financial institutions. Banks were advised to waive margin/security requirements for agricultural loans up to Rs.50,000 and in the case of agri-business and agri-clinics, for loans up to Rs.five lakh. Non-performing asset (NPA) norms for agricultural finance, including agricultural term loans, were modified with a view to aligning the repayment dates with the harvesting of crops (Box VIII.5). According to the modified norms, a loan will be treated

Box VIII.5

Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System

The Reserve Bank's Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) submitted its report in June 2004. The major recommendations of the Committee are:

- A comprehensive review of mandatory lending to agriculture by commercial banks to enlarge direct lending programmes for greater integration of investment credit and production credit.
- A road map for public sector and private sector banks to reach a level of direct lending at 13.5 per cent of net bank credit - within the overall limit of 18.0 per cent of total agricultural lending - within a period of four years with an *interim* target of 12 per cent in two years.
- Special Agricultural Credit Plan (SACP) to be restricted to direct lending and extended to private sector banks.
- The share of small and marginal farmers in agricultural credit to be raised to 40 per cent of disbursements under the Special Agricultural Credit Plan (SACP) by the end of the Tenth Plan period.
- Expanding the outreach of banks in rural areas by enlarging retail lending to agriculture, externalising retailing through corporate dealer networks, organisational

innovations, offering hedging mechanisms to the farmers, providing legal backing to tenancy to facilitate access to credit, capacity building of borrowers, greater use of information technology, procedural simplifications and modifications in the service area approach.

- Reduction in cost of agricultural credit through enhancing the cost effectiveness of agricultural loans, especially in terms of cost of raising funds, transaction cost and risk cost.
- Non-performing asset (NPA) norms in agricultural credit to be attuned to the cash flow of the farmer, coinciding with the harvesting/marketing of the crop.
- Impediments to the flow of credit to disadvantaged borrowers to be mitigated through reduction in cost of borrowing, revolving credit packages, procedural simplifications, involvement of *Panchayati Raj* institutions and extension of micro finance.

Reference

Reserve Bank of India (2004), "Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System", *Reserve Bank of India Bulletin*, August.

as an NPA if the instalment of principal or interest remains unpaid for two crop seasons beyond the due date in the case of loans for short duration crops and one crop season beyond the due date in the case of loans for long duration crops.

Micro Finance

8.34 Self-help Groups (SHGs) contribute to development of human and social capital. The number of SHGs linked to banks under the SHG-bank linkage programme aggregated 10,79,091 as on March 31, 2004 of which 90 per cent were exclusively women groups (Table 8.8). The cumulative disbursement of bank loans to SHGs amounted to Rs. 3,904 crore as on March 31, 2004 to around 16 million families. This translates to an average loan per SHG at Rs. 36,179 and the average loan per family at Rs. 2,412.

8.35 The Reserve Bank stepped up efforts to nurture micro finance initiatives. Based on the recommendations of the four Groups on issues relating to structure and sustainability, funding, regulation and capacity building of micro finance institutions, banks were advised to provide adequate incentives to their branches for financing SHGs, establishing linkages and adopting simple and easy procedures to suit local conditions. The ambit of

micro finance was extended to include consumption expenditure. Banks were also advised that the group dynamics of the SHGs need not be regulated. There was also no need to impose or insist upon formal structures. Micro finance institutions are not allowed to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.

Credit to Agricultural Sector

8.36 The share of agricultural advances of public sector banks in outstanding bank credit has remained stable in recent years (Table 8.9). Disbursements by public sector banks under the Special Agricultural Credit Plan were Rs. 42,211 crore against the projection of Rs. 42,576 crore during 2003-04.

8.37 Some new private sector banks also stepped up agricultural advances. The recovery of direct agricultural advances of public sector banks continued to remain stable (Table 8.10).

8.38 Several initiatives have been taken in pursuance of the objective set in the Union Budget for 2004-05 to achieve a doubling of the flow of credit to agriculture in three years. Banks were advised to reschedule/restructure debts as on March 31, 2004,

Table 8.8: Self-Help Groups and Bank Linkages

(Amount in Rs. crore)

Region/ State	Commercial Banks		Regional Rural Banks		Co-operative Banks		Total	
	No. of SHGs	Bank Loans	No. of SHGs	Bank Loans	No. of SHGs	Bank Loans	No. of SHGs	Bank Loans@
1	2	3	4	5	6	7	8	9
<i>Northern Region</i>								
Haryana	744	7.9	1,563	6.7	37	0.1	2,344	14.6
Himachal Pradesh	5,156	10.0	2,281	4.5	5,791	17.0	13,228	31.5
Punjab	724	3.6	216	1.6	708	3.0	1,648	8.3
Jammu and Kashmir	606	1.6	371	0.6	263	1.4	1,240	3.6
Rajasthan	12,476	25.4	16,996	38.1	4,374	9.8	33,846	73.4
New Delhi	90	0.9		0.0		0.0	90	0.9
Sub-total	19,796	49.4	21,427	51.6	11,173	31.4	52,396	132.4
<i>North Eastern Region</i>								
Assam	1,809	6.1	8,529	10.2	368	0.5	10,706	16.9
Manipur	162	0.5	63	0.1		0.0	225	0.6
Meghalaya	67	0.6	117	0.0	10	0.0	194	0.6
Sikkim	27	0.1	0	0.0	5	0.0	32	0.1
Tripura	63	0.0	714	0.5	73	0.0	850	0.5
Nagaland	0	0.0	24	0.3	0	0.0	24	0.3
Arunachal Pradesh	150	0.5	53	0.4	22	0.1	225	1.0
Mizoram	1	0.0	21	0.2	0	0.0	22	0.2
Sub-total	2,279	7.8	9,521	11.7	478	0.7	12,278	20.2
<i>Eastern Region</i>								
Bihar	5,197	13.7	10,916	16.6	133	0.4	16,246	30.8
Jharkhand	7,841	30.3	4,806	11.2		0.0	12,647	41.5
Orissa	25,959	41.4	43,506	72.3	8,123	13.8	77,588	127.5
West Bengal	10,676	11.1	13,946	20.8	27,063	28.5	51,685	60.5
Andaman and Nicobar Islands	5	0.1		0.0	66	0.3	71	0.3
Sub-total	49,678	96.5	73,174	121.0	35,385	43.0	1,58,237	260.5
<i>Central Region</i>								
Madhya Pradesh	11,087	30.4	13,486	24.1	2,522	5.6	27,095	60.0
Chattisgarh	1,283	1.0	5,879	5.1	2,634	1.8	9,796	7.9
Uttar Pradesh	25,860	51.5	51,005	115.0	2,345	5.1	79,210	171.6
Uttaranchal	7,067	25.9	1,581	6.2	2,260	4.7	10,908	36.8
Sub-total	45,297	108.8	71,951	150.5	9,761	17.1	1,27,009	276.3
<i>Western Region</i>								
Goa	208	1.1		0.0	98	0.7	306	1.8
Gujarat	9,826	14.6	4,595	8.0	1,553	2.8	15,974	25.5
Maharashtra	18,769	65.5	12,514	32.0	7,252	16.1	38,535	113.6
Sub-total	28,803	81.3	17,109	40.0	8,903	19.6	54,815	140.9
<i>Southern Region</i>								
Andhra Pradesh	2,46,123	1,142.6	1,30,470	554.7	8,983	31.1	3,85,576	1,728.4
Karnataka	38,605	100.7	37,087	109.5	28,174	73.5	1,03,866	283.6
Kerala	21,378	78.6	5,365	13.6	6,985	30.7	33,728	122.9
Tamil Nadu and Pondicherry	86,463	589.2	39,894	225.7	24,829	124.1	1,51,186	939.0
Sub-total	3,92,569	1,911.1	2,12,816	903.4	68,971	259.4	6,74,356	3,073.9
Grand Total	5,38,422	2,254.8	4,05,998	1,278.3	1,34,671	371.1	10,79,091	3,904.2

@ : Includes an amount of Rs.69.8 crore provided to 1,71,669 existing SHGs.

Source : National Bank for Agriculture and Rural Development (NABARD).

of farmers who have suffered production and income losses on account of successive natural calamities during the past five years, provided the State Government concerned declared such districts as calamity affected. Banks were also advised to

formulate guidelines on one-time settlement of debt of small and marginal farmers who have been declared defaulters by June 24, 2004 and have become ineligible for fresh credit. Banks are required to review all cases of small and marginal farmers

Table 8.9: Outstanding Agricultural Advances

(Rupees crore)

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
1999	37,632	14.2	3,467	9.1
2000	45,296	14.3	4,023	8.3
2001	53,571	15.7	5,634	9.6
2002 P	63,082	15.9	8,022	8.5
2003 P	73,507	15.3	11,873	10.8
2004 P	86,127	15.4	17,594	12.3

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

where credit has been denied on the sole ground that a loan account was earlier settled through compromise or write-offs by September 30, 2004. In order to mitigate the acute distress that farmers might be facing due to the heavy burden of debt from non-institutional lenders (such as money lenders) and to provide them relief from such indebtedness, banks were advised to advance loans to such farmers against appropriate collateral or group security.

Rural Infrastructure Development Fund (RIDF)

8.39 Domestic scheduled commercial banks are required to deposit shortfalls in lending to the priority sector/agricultural lending targets in the Rural Infrastructure Development Fund (RIDF) established with the National Bank for Agriculture and Rural Development (NABARD). The lending and deposit rates in respect of undisbursed amounts of RIDF IV to IX were restructured with effect from November 1, 2003 in order to provide a disincentive to banks for not achieving the agricultural lending target. Banks will be paid interest at 6 per cent per annum in respect of the undisbursed amounts of RIDF IV to VII uniformly and at varying rates of interest between the Bank Rate and Bank Rate *minus* 3 percentage points in respect

Table 8.10: Recovery of Direct Agricultural Advances by Public Sector Banks

(Rupees crore)

Year ended June	Demand	Recovery	Overdues	Percentage of Recovery to Demand
1	2	3	4	5
2000	20,215	14,058	6,158	69.5
2001	22,429	15,540	6,889	69.3
2002	24,561	17,758	6,803	72.3
2003	28,940	21,011	7,929	72.6

of RIDF VIII and RIDF IX. The State Governments are required to pay interest at 7 per cent per annum in respect of RIDF IV to VII uniformly and at the Bank Rate *plus* 0.5 percentage points in respect of RIDF VIII and IX. In the case of RIDF VIII and IX, rates of interest on deposits will continue to be inversely linked to the shortfall in lending to agriculture. In pursuance of the announcement made in the Union Budget, 2004-05 the RIDF X has been operationalised with a *corpus* of Rs.8,000 crore for the year 2004-05. The lending and deposit rates in respect of RIDF X will be as applicable to RIDF IX.

Kisan Credit Cards

8.40 Banks were advised to intensify plans for issuing *Kisan Credit Cards* (KCCs) to all eligible borrowers by March 2004 to enable them to purchase agricultural inputs and draw cash for production needs. During 2003-04, public sector banks issued 30.9 lakh cards, exceeding the target of 30 lakh. Banks can provide a personal insurance package to KCC holders – as with other credit cards – to cover against accidental death or permanent disability up to a maximum amount of Rs.50,000 and Rs.25,000, respectively, with the premium burden to be shared by the card holder and issuing institution. Scheduled commercial banks (excluding RRBs) have begun implementing the Personal Accident Insurance Scheme formulated by the NABARD.

8.41 The Reserve Bank commissioned the National Council for Applied Economic Research (NCAER) for conducting a National Impact Assessment Survey to assess the weaknesses of the KCC Scheme and to offer suggestions to make it more effective in providing adequate and timely credit to agriculture (Box VIII.6). The Survey was carried out in 11 representative States, covering a sample of 4,337 KCC holders, 865 non-holders of KCC and 433 bank branches.

Credit to Women

8.42 Public sector banks were advised to lend up to at least 5 per cent of their net bank credit to women by end-March 2004. The credit extended by all public sector banks stood at 4.7 per cent of overall net bank credit. At end-March 2004, 19 banks achieved the annual target.

Credit to SSIs

8.43 The Reserve Bank continued to take steps to enlarge the flow of credit to small scale industries (SSIs). Total credit provided by public sector banks to SSIs worked out to 10.4 per cent of net bank credit

Box VIII.6

Kisan Credit Card (KCC) Scheme - National Impact Assessment Survey (NIAS)*Advantages derived from the Scheme*

- Augmentation in flow of credit to the agriculture sector.
- About 6 per cent decrease in cost of borrowings for farmers after they were given KCCs.
- Cost of borrowings for KCC holders from formal sources about 3 per cent lower than those for non-KCC holders.
- Significant drop in the number of borrowers depending exclusively on informal sources for their short-term credit needs.
- Reduction in cost of borrowings from informal sources by about 3 per cent.
- Significant saving in time spent in taking short-term agricultural loans.

- Decline in cost of delivering credit due to simplification in procedures.

Scope for fine tuning

- Banks still impose too many undue restrictions on the issuance of KCCs.
- Cardholders are unable to use KCCs in branches other than the ones issuing them due to the restrictions imposed by banks.
- Generally, there are no incentives/rewards for timely payments.
- Credit limits sanctioned by banks are largely inadequate.
- Awareness/implementation level in respect of the Personal Accident Insurance Scheme is quite low.

and 23.7 per cent of the total priority sector advances as at end-March 2004. 497 specialised SSI branches were operationalised by banks to implement the policy directive of having at least one such branch in every district and centre having a cluster of SSI units.

8.44 Credit extended by scheduled commercial banks to 1,67,980 sick SSI units stood at Rs.5,706 crore as at end-March 2003. Of these, 3,626 units were found to be viable, with their outstanding bank credit at Rs.625 crore (11.0 per cent). Banks placed 993 units involving outstanding credit of Rs.382 crore (6.7 per cent) under nursing programmes.

8.45 The Working Group on Flow of Credit to SSI Sector (Chairman: Dr. A.S. Ganguly) submitted its report to the Reserve Bank in May 2004 (Box VIII.7).

Credit to Khadi and Village Industries Commission

8.46 A consortium of select public sector banks led by the State Bank of India was formed to provide credit to the *Khadi* and Village Industries Commission (KVIC) at an interest rate of 1.5 per cent below the average prime lending rates of five major banks in the consortium. Out of Rs.738 crore disbursed, an amount of Rs.342.4 crore was outstanding at end-March 2004.

Government Sponsored Schemes

8.47 A total number of 8,75,690 *Swarozgaris* received bank loans amounting to Rs.1,275 crore (and Government subsidy amounting to Rs. 698 crore) under the *Swarnajayanti Gram Swarozgar Yojana* (SGSY) during 2003-04. Of the *Swarozgaris* assisted,

4,01,142 (45.8 per cent) belonged to scheduled castes and scheduled tribes, 4,62,230 (52.8 per cent) were women and 8,316 (1.0 per cent) were physically handicapped. Under the *Swarna Jayanti Shahari Rozgar Yojana* (SJSRY), disbursements amounting to Rs. 173.4 crore were made in 58,800 cases (out of 73,877 applications sanctioned) during the year. Besides, Rs. 12.8 crore were disbursed in 7,429 cases out of 9,140 applications sanctioned under the Scheme of Liberation and Rehabilitation of Scavengers (SLRS) during 2003-04.

8.48 SHGs are considered eligible for financing under the Prime Minister's *Rozgar Yojana* (PMRY), effective December 8, 2003, provided all members individually satisfy the eligibility criteria laid down and total membership does not exceed twenty. There is also no ceiling on the loan amount. Assistance under the Scheme amounted to Rs. 629 crore for 1,04,733 beneficiaries during 2003-04. Of these, 16,340 (15.6 per cent of total) belonged to the scheduled castes and scheduled tribes, 15,054 (14.4 per cent) were women and 609 (0.6 per cent) were physically handicapped.

Differential Rate of Interest (DRI) Scheme

8.49 The outstanding advances of public sector banks under the DRI Scheme amounted to Rs. 315 crore in respect of 3.7 lakh borrowal accounts at end-March 2004, forming 0.1 per cent of the total outstanding advances as at the end of the previous year which were substantially lower than the stipulated target of 1.0 per cent of advances. Banks were advised to increase their lending under the Scheme.

Box VIII.7

Recommendations of the Ganguly Working Group

- Definition of the small and medium enterprises (SMEs) sector to be based on turnover. Tiny, small and medium enterprises could be redefined in terms of limits as under:
 Tiny : Turnover up to Rs. 2 crore;
 Small : Turnover of above Rs. 2 crore and up to Rs. 10 crore; and
 Medium : Turnover of above Rs.10 crore and up to Rs. 50 crore.
 - Lending to SMEs in identified clusters.
 - Rating mechanism for designated industrial clusters, designed jointly by CRISIL, IBA, SIDBI and SSI Associations.
 - Measures to promote corporate-linked SME cluster models by banks and FIs.
 - Proactive role by CIBIL to serve as an effective mechanism for exchange of information between banks and financial institutions for curbing growth of non-performing assets in the SME sector.
 - Setting up of a dedicated national level SME Development Fund by the SIDBI for exclusively undertaking venture and other development financing activities for SMEs. Banks could also contribute to the *corpus* created by the SIDBI (on risk-sharing basis) or alternatively, set up their own venture financing instruments.
 - Setting up of an independent Technology Bank for the SMEs by the SIDBI to facilitate technology transfer and provide services such as project evaluation, risk assessment and mitigation to SMEs adopting new technologies. Besides the SIDBI, banks may also contribute to the *corpus* of the proposed Technology Bank to ensure its commercial viability and play an active role in enhancing the capabilities and credit worthiness of the SME sector.
 - Promoting and financing special purpose vehicles (SPVs) by banks in the form of micro credit agencies dedicated to servicing SME clusters. Such micro credit intermediaries in the form of NBFCs (funded by individual or a group of banks but not permitted to accept public deposits) could credit rate and assess risk and serve as instruments for extending quick credit to SME clusters accredited to them.
 - Special dispensation for the North-East region and other backward areas such as adoption of model of mutual credit guarantee to address the problem of collateral, where village council guarantee is available. Coverage of all SSI units without any ceiling (of Rs.25 lakh) under the Credit Guarantee Fund Trust for Small Industries (CGTSI) scheme.
 - Revival of State Financial Corporations.
- In pursuance of these recommendations, the Reserve Bank instructed the CIBIL to work out a mechanism, in consultation with the Reserve Bank, the SIDBI, and the IBA, to develop a system of proper credit records to facilitate appropriate pricing of loans to SMEs. A special group is formulating a mechanism for debt restructuring for medium enterprises on the lines of the Corporate Debt Restructuring (CDR) scheme.

Reference

Reserve Bank of India (2004), "Report of the Working Group on Flow of Credit to Small Scale Industries Sector", *Reserve Bank of India Bulletin*, August.

Amendment of the NABARD Act, 1981

8.50 The NABARD Act, 1981 was amended in September 2003 enabling the NABARD to directly refinance district central co-operative banks (DCCBs). This is proposed to be implemented selectively in respect of DCCBs which comply with Section 11(1) of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies) and certain other conditions.

Relief for Drought Affected Farmers

8.51 Repayment of loans by farmers in drought-affected districts was deferred during 2002-03. In order to further mitigate the hardship of farmers in drought-affected States, it was decided to waive the first year's deferred interest liability - amounting to 20 per cent of the deferred interest - on *kharif* loans completely. This

instalment of deferred interest which is to be waived by banks would be reimbursed by the Government. No interest would be charged on the deferred interest and the balance of the deferred interest would be recovered in reasonable instalments.

Infrastructure Lending

8.52 The Reserve Bank extended several regulatory relaxations for infrastructure financing during the year. These measures, *inter alia*, included (i) enhancing the scope of definition of infrastructure lending to include construction activities involving agro-processing, supply of inputs to agriculture, preservation and storage of processed agro-products and perishable goods including testing facilities for quality and construction of educational institutions and hospitals; (ii) relaxing the prudential single borrower

exposure limit from 15 per cent to 20 per cent of capital funds in respect of infrastructure companies; (iii) assigning a concessional risk weight of 50 per cent on investment in securitised paper satisfying conditions pertaining to an infrastructure facility; (iv) permitting lending to private sector special purpose vehicles (SPVs) registered under the Companies Act for directly undertaking viable infrastructure projects; and (v) lending to promoters, with certain safeguards and where appropriate, for acquiring a controlling stake in existing infrastructure companies. A Working Group on credit enhancement by the State Governments for financing infrastructure at the State level was also constituted.

8.53 A critical limitation in extending long-term financing for infrastructure by banks is that their deposit liabilities are largely short-term. The Reserve Bank, therefore, allowed banks to raise long-term bonds with a minimum maturity of five years to the extent of their exposure of residual maturity of more than five years to the infrastructure sector.

Credit Package to Trade and Industry in the State of Jammu and Kashmir

8.54 A comprehensive package was framed during the year to ensure a large flow of credit to trade and industry in the State of Jammu and Kashmir with appropriate changes in the monitor mechanism. The package would be operative till end-March 2005. It covers, *inter alia*, (i) sanction of increased working capital facilities; (ii) review of all borrowal accounts within a period of 3 months; (iii) encouraging finance against accepted *hundies* (usance bills); (iv) extending concessional service tariffs for remittances; (v) honouring small fixed deposit receipts (up to Rs.10,000) of Kashmiri migrants at the designated branches without verifying details from the branch of origin against indemnity bonds, where necessary; (vi) allowing rescheduling of the repayment programme in deserving cases; and (vii) extension of liberal acceptance of credit/line of credit facilities.

Monetary Policy Stance for 2004-05

8.55 The Reserve Bank's Annual Policy Statement announced in May 2004 was framed against the backdrop of a macroeconomic assessment that provided grounds for optimism. Considering the India Meteorological Department's initial forecast of a normal monsoon and under the assumption of a sustained growth in the industrial sector and good performance of exports, real GDP growth for 2004-05 was placed in the range of 6.5 to 7.0 per cent. Taking into account the inflation trends and assuming no significant supply shocks and appropriate management of liquidity, the inflation rate in 2004-05, on a point-to-point basis, was placed at around 5.0 per cent. Given the 'pass through' of international price trends to domestic inflation, it was stated that the inflation rate during 2004-05 is likely to be influenced to a significant extent by international oil prices and trends in commodity prices. Consistent with the projected real GDP growth and inflation, expansion of money supply (M_3) for 2004-05 is placed at 14.0 per cent. Non-food bank credit adjusted for investment in CPs, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 16.0 – 16.5 per cent. The Mid-term Review of the Annual Policy would review the macroeconomic developments since the announcement of the Annual Policy and, if necessary, revise the projections.

8.56 Taking into account the assessment of the macroeconomy and assuming no unexpected exogenous shocks or adverse inflationary developments occur, the overall stance of monetary policy for 2004-05 is: (i) provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level, and (ii) consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and macroeconomic and price stability.