For the Year July 1, 1997 to June 30, 1998[*]

PART ONE : ECONOMIC REVIEW

0.1 Following impressive economic performance for three consecutive years, the year 1997-98 was marked by a relative slowdown in real economic activity despite improvements in a number of other macro indicators. Primarily due to negative growth in agricultural output, the real GDP growth in 1997-98 was placed lower at 5.1 per cent as compared with an average growth of over 7 per cent in the preceding three years. The external position of the economy, however, continued to be good, notwithstanding the deceleration in merchandise trade. The external current account deficit in relation to GDP is estimated to be about 1.7 per cent during 1997-98 and the foreign exchange reserves stood at US $ 29.4 billion at end-March 1998. Reflecting the slowdown in activity, the receipts position of the Centre recorded a sharp decline, resulting in a rise in gross fiscal deficit to 6.1 per cent of GDP in 1997-98 from 5.2 per cent in 1996-97. The increase in the government's borrowings from the banking system coupled with capital flows pushed up the broad money growth above its long-term trend of about 17 per cent (Appendix Table I.1). Nevertheless, there was a distinct moderation in the inflation rate to about 5 per cent and an all-round softening of interest rates.

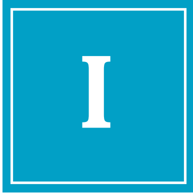
0.2 The international environment faced by the Indian economy during the year under review is characterised by a number of developments which impacted on the country's economic performance as well as on macroeconomic management. While the world output growth at 4.1 per cent in 1997 continued to be as much as in 1996, the South-East Asian crisis which erupted in August 1997 has dampened the global economic prospects in 1998. More importantly, the crisis has underscored the need for closer supervision and regulation of banks and other financial institutions, and for exchange rate management for purpose of preserving international competitiveness and confidence in the economy. The overall volume of world trade expanded by 9.4 per cent in 1997, significantly higher than 6.6 per cent recorded in 1996, but there was a significant decline in the US dollar prices of manufactures, oil and non-fuel primary commodities. Prices of manufactures declined sharply by 9.2 per cent – the steepest in the decade – while prices of oil declined by 6 per cent. While the latter development provided some relief to oil importers including India, the fall in the prices of manufactures has meant low export realisation, in view of the fact that India's exports consist predominantly of manufactured items. Consumer price inflation moved downward in both advanced and developing countries.

0.3 Net private capital flows to developing countries declined in 1997 reflecting developments in South-East Asian crisis. Direct foreign investment and portfolio investment, as well as other net investment flows to Asia, have declined substantially.

0.4 The developments in the domestic economy during 1997-98 need to be seen in the light of the pressures in the foreign exchange market between November 1997 and January 1998. These pressures were required to be contained by monetary policy measures that impact on the liquidity position and through it, the interest rates. The developments in the economy in the first quarter of 1998-99, however, have to be viewed also in the light of other domestic and international developments.

0.5 It is against this backdrop that the following Section focuses on major monetary, external sector and financial sector policies undertaken during the year 1997-98 together with those measures which have been taken in early 1998-99. A detailed chronological account of policy measures is presented in the Annexure for ready reference.

[*] While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data are updated to June 1998 and in some vital areas, information beyond end-June 1998 is also discussed. For the purpose of analysis, and for providing proper perspectives on policies, reference to past years as also to prospective periods wherever necessary have been made in this Report.



MONETARY AND ECONOMIC POLICY ENVIRONMENT

DOMESTIC MONETARY MANAGEMENT

1.1 The monetary policy announcements during 1997-98 and for the first half of 1998-99 attempted to address long-term structural issues while simultaneously pursuing short-term policy measures to take care of the specific economic situation. The long-term policies focussed on institutional changes to lend a measure of manoeuvrability in the management of liquidity in the economy and to bring about a closer integration of markets in order to improve efficiency in the allocation of resources. Besides, a number of measures were taken to improve the credit delivery mechanism, to effect reduction in the cost of funds and to further financial sector reforms.

1.2 In the area of institutional changes, the year 1997-98 proved to be eventful. The elimination of automatic monetisation of the fiscal deficit was effected by discontinuing issuance of *ad hoc* Treasury Bills. A scheme of ways and means advances (WMA) for the Union Government was put in place to facilitate meeting the mismatches between receipts and expenditures, effective April 1, 1997. This provided flexibility to the central bank in the conduct of monetary policy. The 91-day tap Treasury Bills, which carried a fixed discount rate of 4.6 per cent as the *ad hocs*, lost their relevance after the elimination of *ad hocs,* and were, therefore, discontinued. The rate of interest on WMA to the Central Government during 1997-98 (for any quarter) was set as a transitional measure, at three percentage points below the average of the implicit yield at the cut-off price of 91-day Treasury Bill auctions held during the previous quarter. Since April 1998, however, the interest rate on WMA has been linked to the Bank Rate as in the case of state governments.

1.3 The Reserve Bank continued to make conscious efforts to promote the use of indirect policy instruments in the conduct of monetary policy. Instruments such as cash reserve ratio (CRR) and sectoral (export) and general refinance, were, however, continued and were used to meet specific circumstances. Liquidity management or addressing the contagion effects of the South-East Asian crisis were, for instance, the main focus of interest for monetary policy making. Open market operations, including repo operations in conjunction with the Bank Rate provided the main planks of monetary management. Besides, the Bank has explicitly preferred to adopt a multiple-indicator approach wherein movements not only in money supply but also in a host of economic variables will be tracked for policy responses.

1.4 Repos were often used to absorb surplus liquidity as well as to provide information on short-term liquidity conditions. Besides, daily fixed rate repos, of 3-4 days tenor, first introduced on November 29, 1997, tended to set a floor to inter-bank call money rates, and helped to reduce wide fluctuations in the call money markets since refinancing facility linked to the Bank Rate operates as a ceiling. In view of the growing links between money and foreign exchange markets, open market operations including repos, refinancing mechanism, CRR and Bank Rate were used for countering the spill-over effects of South-East Asian crisis. Given the economic environment engendered by the currency crises in the South-East Asian region, the proposal to reduce CRR by two percentage points, envisaged in October 1997, could not materialise in full during 1997-98. On the other hand, CRR was raised with effect from December 6, 1997 and January 17, 1998 to siphon off liquidity and control the arbitrage opportunities that arose on account of relatively low call money rates and gains in the foreign exchange market. This measure was supplemented by other measures on January 16, 1998 such as a hike in both Bank Rate and repo rate by two percentage points, reduction in access to refinance facilities, and an increase in interest rate surcharge on bank credit for imports. These measures were successful in restoring orderly conditions in the forex market. With the stabilisation of conditions in the foreign exchange market, the

Reserve Bank could in March and April of 1998 reverse most of the January 16, 1998 measures in stages.

1.5 The stance of monetary policy in 1998-99 reflect developments in 1997-98 and the broad economic objectives of attaining real GDP growth of 6.5-7.0 per cent for 1998-99 and inflation rate of 5-6 per cent. Accordingly, M_3 growth has been projected at 15.0-15.5 per cent. The Bank Rate and the repo rate have emerged as signals for the movements in interest rates in the economy, thereby providing a greater range of instruments to the Reserve Bank. The Reserve Bank remains committed to a gradual shift in emphasis in the operating procedures of monetary policy from direct instruments of monetary control to indirect ones simultaneously taking note of developments in financial markets, including forex market, and liquidity situation. Therefore, the Reserve Bank increasingly relied on indirect instruments to direct ones during 1997-98. The formulation of monetary policy requires information on an array of indicators such as data on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, interest rates, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis. The information base, once developed, will enable the formulation of a clear-cut interest rate channel of transmission effects of monetary policy.

1.6 In view of the changing dimensions and depth of the financial sector, consequent to the introduction of reforms, the Reserve Bank had set up a Working Group on 'Money Supply : Analytics and Methodology of Compilation' (Chairman : Dr. Y.V.Reddy) in December 1997 to examine the analytical aspects of monetary survey. The Group submitted its Report in June 1998 and a Core Group has been constituted to implement the recommendations. The major recommendations of the Group are highlighted in Box IX.7 in Part Two of this Report.

EXCHANGE RATE MANAGEMENT

1.7 The year 1997-98 posed a severe challenge for the exchange rate management in the face of the threat of external contagion and domestic uncertainty. Excess supply conditions in the foreign exchange market which characterised 1996-97 spilled over into the period April-August 1997. A measure of market surplus is given by the net cumulative purchases of US $ 5.4 billion by the Reserve Bank during April-August 1997. However, despite strong fundamentals, partly as a result of the South-East Asian crisis, the rupee weakened in the last week of August.

1.8 The market was driven by downside expectations created largely in the backwash of the currency turmoil in South-East Asia and political developments within the country. Speculative activity accentuated the leads and lags in receipts and payments. Over the quarter October-December 1997 there was a nominal depreciation of the spot exchange rate by about 7.6 per cent. During the quarter ended December 1997, there was a significant spurt in the demand for forward cover to hedge large exposures which had remained uncovered.

1.9 To signal the stance of the Reserve Bank on the desired pace and degree of market correction, interventions in the spot and forward segments of the exchange market were supplemented by several monetary measures in November 1997 and thereafter (Box I.1). The November-December measures and the embodied signals helped in stabilising the exchange rate. With the restoration of normalcy during the last week of December 1997, the hike in the interest rate on post-shipment rupee export credit beyond 90 days and up to 6 months from 13 per cent to 15 per cent announced on November 26, 1997 was withdrawn, effective January 1, 1998 and the position prevailing as on November 26, 1997 was restored. After a short period of normalcy, however, nervous sentiment began to flare up in the foreign exchange market. The Reserve Bank undertook stringent monetary measures on January 16, 1998 to curb speculative activity and ward off any threat of contagion.

1.10 Towards the end of January 1998 stability returned to the exchange market. The nominal exchange rate stabilised at about Rs.38.92 against the US dollar and moved down gradually to trade in a narrow band around Rs.39.5 per US dollar by March 1998. A measure of confidence in exchange rate management was visible in the resumption of capital flows. In 1997-98, India added US $ 2.9 billion to its reserves.

Box I.1

Policy Measures following the South-East Asian Currency Crisis

Announcement Date		POLICY MEASURES
1997		
Nov.	**26**	• Interest rate on post-shipment rupee export credit on usance bills for a total period beyond 90 days and up to six months was increased by 2 percentage points to 15.0 per cent per annum for the period exceeding 90 days.
	28	• CRR cuts announced in the monetary and credit policy for the second half of 1997-98 were deferred.
Dec.	**2**	• CRR on NDTL of scheduled commercial banks (excluding RRBs) was raised by 50 basis points to 10.0 per cent. Incremental 10.0 per cent CRR on NRE and NRNR deposit schemes was withdrawn.
	17	• Banks were to charge a minimum interest rate of 20 per cent per annum on overdue export bills. • An interest rate surcharge of 15 per cent of the lending rate was imposed on bank credit for imports.
1998		
Jan.	**16**	• The Bank Rate was raised by two percentage points to 11.0 per cent per annum. • CRR on NDTL of scheduled commercial banks (excluding RRBs) was raised by 50 basis points to 10.5 per cent. • General refinance to scheduled commercial banks was reduced to 0.25 per cent of the fortnightly average outstanding aggregate deposits in 1996-97 (as against one per cent earlier). Export credit refinance limit for scheduled commercial banks was halved to 50 per cent of the increase in the outstanding export credit over the level of such credit as on February 16, 1996. • Liquidity support to primary dealers *via* reverse repos with the Reserve Bank was made discretionary. • The interest rate surcharge on bank credit for imports (except export related imports) was raised from 15 per cent of the lending rate to 30 per cent.

1.11 As a fall out of intensification of the South-East Asian currency turmoil accentuated by the weakening yen, and international reaction to the nuclear test in May 1998, the rupee came under another bout of pressure in May 1998 necessitating policy responses to stabilise the foreign exchange market.

Refinance Facilities

1.12 As a move towards further rationalisation of export credit refinance to banks and in the context of introduction of a new general refinance facility, effective April 26, 1997, scheduled commercial banks were provided export credit refinance to the extent of 100 per cent of the increase in outstanding export credit eligible for refinance over the level of such credit as on February 16, 1996. However, for a brief period from January 17, 1998 to May 8, 1998, export credit refinance limit was reduced to 50 per cent, in order to reduce access to liquidity in the context of the measures on the foreign exchange market. The refinance limit was restored to 100 per cent effective the fortnight beginning May 9, 1998. As a temporary measure, scheduled commercial banks were to be provided export credit refinance at 2.0 percentage points below the Bank Rate between August 6, 1998 and March 31, 1999.

1.13 The general refinance facility, to enable banks to tide over temporary liquidity shortages, is provided for two blocks of four weeks each. The interest rate is at the Bank Rate for the first four weeks and at 'Bank Rate *plus* one percentage point' for the second block of four weeks. Effective January 17, 1998, banks were provided general refinance equivalent to 0.25 per cent as against the earlier access limit of one per cent of each bank's fortnightly average outstanding aggregate deposits in 1996-97.

Interest Rates

Bank Rate

1.14 During 1997-98, the Bank Rate was reactivated to serve as a reference rate as well as an effective signalling mechanism to reflect the stance of monetary policy. To this end, interest rates on accommodation from the Reserve Bank were linked to the Bank Rate. Reflecting the prevailing liquidity conditions, the Bank Rate was reduced in three steps of one percentage point each in April, June and October, 1997 to '9.0 per cent per annum', effective October 22, 1997 (Appendix Table I.2). The Bank Rate was, however, raised to '11.0 per cent per annum', effective January 17, 1998, as a part of a package of monetary policy measures to contain the contagion effect of the South-East Asian crisis. As the forex market

stabilised, the Bank Rate was lowered twice by one half of one percentage point each on March 19, 1998 and April 3, 1998 and further by one percentage point to 9.0 per cent effective April 29, 1998, thus restoring the rate to the one prevailing before January 17, 1998. The use of the Bank Rate as an active instrument of policy could be gauged from the fact that it was changed as many as five times during 1997-98, the number of changes effected being the highest during any financial year so far (it was changed twice during 1935-36 and 1991-92).

Deposit Rates

1.15 The ceiling on interest rate on domestic term deposits for maturity of 30 days and up to one year was linked to the Bank Rate at 'Bank Rate *minus* two percentage points per annum' between April 16, 1997 and October 21, 1997. Effective October 22, 1997, the rate was delinked from the Bank Rate and banks were given freedom to determine the interest rates on term deposits of 30 days and over. With a view to providing a channel for deploying short-term funds, the minimum period of maturity of term deposits was reduced from 30 to 15 days, as a part of the policy announcement made on April 29, 1998. Besides, banks were permitted to determine their own penal interest rates for premature withdrawal of domestic term deposits. Restriction on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of such deposits was also removed in case of deposits of Rs.15 lakh and above.

1.16 The interest rates on term deposits under NRE Accounts of over one year were freed effective April 16, 1997 and were aligned with rates on domestic term deposits. The ceiling interest rate on NRE term deposits of 6 months and up to one year was linked to the Bank Rate for a brief period (April 16 - September 12, 1997) and was prescribed at 'Bank Rate *minus* 2 percentage points per annum'. Effective September 13, 1997, banks were given freedom to fix their own interest rates on NRE term deposits of six months and over. Effective April 29, 1998, banks were permitted to determine their own penal interest rates for premature withdrawal of NRE term deposits as in the case of FCNR(B) deposits, and were permitted to fix interest rates in respect of NRE and FCNR(B) deposits that are overdue for periods exceeding 14 days subject to these deposits being renewed. As regards FCNR(B) deposits, banks were given freedom to determine their own rates subject to ceilings prescribed by the Reserve Bank, effective April 16, 1997. Effective October 22, 1997, the ceiling rates, however, were prescribed at the relevant LIBOR/swap rate prevailing on the last working day of the previous week for relevant maturity and currency. Effective April 29, 1998, the interest rate ceiling on FCNR(B) deposits of one year and above was increased by 50 basis points to encourage banks to mobilise long-term deposits and that on such deposits below one year was reduced by 25 basis points in order to discourage short-term external liabilities in the light of the experiences of the South-East Asian countries.

Lending Rates

1.17 As a part of the process of deregulating interest rates on credit limits of up to Rs.2 lakh and in view of the decline in the PLRs of banks, effective October 22, 1997, the lending rates for credit limits ranging Rs.25,000-Rs.2 lakh was changed from a fixed rate of 13.5 per cent to a ceiling of 13.5 per cent. In order to remove the disincentive to the flow of credit to small borrowers of Rs.2 lakh and below, effective April 29, 1998, the interest rates on credit limits of Rs.2 lakh and below, were not to exceed the prime lending rate (PLR) which is available to the best borrowers of banks.

1.18 With a view to giving banks more freedom to determine their interest rates, banks were allowed in October 1997, to prescribe separate prime term lending rates (PTLRs) on term loans of 3 years and above, with approval of their Boards. It was announced on April 29, 1998 that all advances against domestic term deposits would be at an interest rate equal to PLR or less.

1.19 As a matter of rationalisation, multiple prescriptions relating to loans against FCNR(B) deposits, loans out of FCNR(B) pools and loans against foreign currency were dispensed with on October 21, 1997. Interest rates on FCNR(B) related lendings were made consistent with lending rates for rupee advances in general, since October 22, 1997.

1.20 Effective October 22, 1997, interest rates on pre-shipment rupee export credit up to 180 days was reduced from 13.0 per cent per

annum to 12.0 per cent per annum and on such credit beyond 180 days and up to 270 days, the interest rate was reduced from 15.0 per cent per annum to 14.0 per cent per annum (Appendix Table I.3). Effective April 30, 1998, interest rates on pre-shipment rupee export credit up to 180 days and that on credit up to 90 days against incentives receivable from the government covered by ECGC guarantee were further reduced from 12.0 per cent to 11.0 per cent per annum. As a part of the move to giving greater operational freedom to banks and also considering the willingness of banks to charge lower rates of interest in cases where export proceeds are realised in shorter periods, effective April 16, 1997, the interest rate on post-shipment rupee export credit up to 90 days was modified from '13.0 per cent per annum' to 'not exceeding 13.0 per cent per annum'. This interest rate was further reduced to 'not exceeding 12.0 per cent per annum' and 'not exceeding 11.0 per cent per annum' effective June 26, 1997 and September 13, 1997, respectively.

1.21 In the context of the developments in the external sector and in order to quicken the realisation of export proceeds, effective November 27, 1997, the interest rate on post-shipment rupee export credit for period beyond 90 days and up to six months was increased from 13.0 per cent to '15.0 per cent per annum'. The rate, however, was restored to '13.0 per cent per annum', applicable for the period beyond 90 days, effective January 1, 1998.

1.22 In the context of the developments in the foreign exchange market, effective December 18, 1997, banks were required to charge interest, applicable from the date of advance, at 20 per cent per annum (minimum) on overdue export bills. An interest rate surcharge of 15 per cent of the lending rate was imposed on bank credit for imports on December 18, 1997 which was further raised to 30.0 per cent on January 17, 1998.

1.23 As a temporary measure, for the period August 6, 1998 to March 31, 1999, the interest rates on pre-shipment rupee export credit and post-shipment rupee export credit were reduced by 2.0 percentage points. Further, in respect of post-shipment rupee export credit up to 90 days, the ceiling rate on post-shipment rupee export credit of 'not exceeding 11.0 per cent per annum' was replaced by a fixed rate of 9.0 per cent.

Measures Relating to Improving Credit Delivery System

Loan System for Delivery of Bank Credit

1.24 In order to introduce an element of discipline in the utilisation of bank credit, especially by large borrowers, a uniform level of 80 per cent 'loan component' was prescribed in October 1997, for all borrowers with working capital credit limits of Rs.10 crore or above. It was also indicated that no further increase in loan component was intended. As regards borrowers with a credit limit of less than Rs.10 crore, the level of loan and cash credit component was left to be decided by banks and their customers. Where strict application of loan system creates difficulties for the borrowers, it was recognised that banks would need to be allowed, with the approval of their respective Boards, to identify those business activities that could be exempted from the loan system. The loan system was also modified to enable banks to fix the minimum period of loan and spread over various maturities, subject to rollovers. Financing banks were also permitted to allow borrowers to invest their short-term temporary surplus funds in CPs, CDs and in term deposits with banks.

Consortium Lending

1.25 In order to introduce further flexibility in the credit delivery system, it was decided in April 1997 that it would no longer be obligatory for banks to form a consortium even if the credit limit of the borrower exceeded Rs.50 crore. As an alternative, banks could adopt the syndication route, irrespective of the quantum of credit involved, provided the arrangements suit borrowers and the financing banks.

Assessment of Working Capital Requirements

1.26 As a part of the package of monetary policy measures announced on April 15, 1997, all instructions relating to maximum permissible bank finance (MPBF) were withdrawn and banks were given freedom to assess working capital requirements of borrowers within the prudential guidelines and exposure norms. Banks were required to evolve their own methods to assess the working capital requirement of borrowers – the turnover method or the cash budget system or the MPBF system with necessary modifications or any other system. The loan policy in respect of each

broad category of industry is, however, required to be laid down by every bank with the approval of respective Boards. However, the Reserve Bank instructions relating to directed credit (such as priority sector, exports *etc.*), quantitative limits on lending (such as against shares and for consumer durables *etc.*) and prohibition of credit (such as bridge finance, rediscounting of bills earlier discounted by NBFCs, *etc.*) continue to apply. In respect of small-scale industries in April 1997, banks were required to assess working capital needs of borrowers on the basis of 20 per cent of the projected annual turnover of SSI units having working capital limits of up to Rs.2 crore; this limit was enhanced to Rs.4 crore in the Union Budget 1998-99.

Selective Credit Controls

1.27 On a review of price-output developments, selective credit controls on wheat was reintroduced for a period of three months (April 8-July 7, 1997). The minimum margin on advances against stocks of wheat was set at 45 per cent for 'mills/processing units' and 'against warehouse receipts' and at 60 per cent for 'others'. The level of credit ceiling was set at 100 per cent of the peak level of credit availed by concerned parties in the three year period ended 1995-96 (November - October).

1.28 Effective October 22, 1997, the minimum margin on levy sugar was prescribed lower at 10.0 per cent than that of 15.0 per cent on free sale sugar as the levy sugar is valued at the government notified price and is not subject to price fluctuation.

BANKING SECTOR REFORMS

1.29 In April 1998, the Reserve Bank proposed to further strengthen the existing capital adequacy, income recognition and provisioning norms as well as the disclosure and auditing requirements of banks and achieve greater transparency in banking operations and bring these up to or exceed international standards, after taking into account the recommendations of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) (Box I.2) which are currently under examination. The Union Budget 1998-99 announced the implementations of some of the important recommendations of the Narasimham Committee which include i) strengthening of debt recovery tribunals and setting up of more tribunals to cover all states; ii) setting up on a pilot basis of Asset Reconstruction Companies for recovery of dues of banks with high NPAs; iii) raising of the minimum required capital adequacy ratio for banks from the present 8 per cent to 9 per cent by end-March 2000 and thereafter to 10 per cent; and iv) setting up of an Expert Group to propose precise legal amendments in the key laws to make the provisions consistent with modern financial and banking practices.

1.30 Another Working Group (Chairman: Shri S.H. Khan) constituted by the Reserve Bank in December 1997, to examine the harmonisation of the role and operations of development financial institutions (DFIs) and banks, submitted its Report in April 1998. The major recommendations of the Group are highlighted in Box IX.4 in Part Two of this Report. In this context, a 'Discussion Paper' is being prepared which would contain the Reserve Bank's proposals for bringing about greater clarity in the respective roles of banks and financial institutions and for greater harmonisation of facilities and obligations applicable to them, taking into account those recommendations of the Narasimham Committee which have a bearing on the issues considered by the Working Group.

Capital Adequacy and Recapitalisation of Banks

1.31 Out of the 27 public sector banks, 25 banks achieved the minimum CRAR as at the end of March 1997. The Government contributed a sum of Rs.2,700 crore during 1997-98 towards recapitalisation of three banks, *viz.* Canara Bank (Rs.600 crore), Indian Bank (Rs.1,750 crore) and UCO Bank (Rs.350 crore); the amounts were invested in 10 per cent 'Nationalised Banks (non-transferable) Special Security'. The Punjab National Bank returned Rs.138.33 crore of its equity capital to the Government in order to improve its earnings per share (EPS) before going for a public issue of shares. Further, three public sector banks *viz.,* Corporation Bank (Rs.304 crore), State Bank of Travancore (Rs.90 crore) and State Bank of Bikaner and Jaipur (Rs.65.94 crore) accessed the capital market. Punjab National Bank and State Bank of Hyderabad were also permitted to approach the market. Four public sector banks (Punjab and

Box I.2

Major Recommendations of the Second Narasimham Committee Report on Banking Sector Reforms

The Committee on Banking Sector Reform with Mr. M. Narasimham as Chairman, popularly known as the second one by the same Chairman on the same/related subject, was constituted on December 26, 1997 to review the record of financial sector reforms of the Narasimham Committee on Financial System (1991), and to suggest remedial measures for strengthening the banking system, covering areas of banking policy, institutional structure, supervisory system, legislative and technological changes.

The major recommendations of the Committee are summarised below:

A. Strengthening the Banking System

To strengthen the banking system, the Committee recommended an increase in the minimum capital adequacy ratio (CRAR) to 10 per cent by 2002. Besides, the entire portfolio of Government securities should be marked to market in three years. Also, a 5 per cent weightage is to be assigned for Government and other approved securities to hedge against market risk. Net NPAs have to be brought down to below 5 per cent by 2000 and to 3 per cent by 2002. However, banks with international presence should reduce gross NPA to 5 per cent and 3 per cent by 2000 and 2002, respectively and net NPAs to 3 per cent and 0 per cent, respectively. The Committee proposed Asset Reconstruction Company (ARC) to tide over the backlog of NPAs. In case of prudential norms relating to income recognition, the present norm of 180 days should be brought down to 90 days in a phased manner by 2002. As regards asset classification, an asset may be classified as 'doubtful' if it is in the substandard category for 18 months in the first instance and eventually for 12 months and 'loss' if it has been so identified but not written off. These norms which should be regarded as the minimum, may be brought into force in a phased manner.

B. Systems and Methods in Banks

To bring about efficiency in banks, the Committee recommended a number of measures. These include, revision of operational manual and its regular updation, simplification of documentation systems, introduction of computer audit, and evolving of a filtering mechanism to reduce concentration of exposures in lending and drawing geographical/ industry/ sectoral exposure norms with the Board's concurrence. Besides, the Committee has suggested induction of one more whole time director in nationalised banks in view of changing environment. As outsourcing of services would improve productivity, it suggested the same may be introduced in the fields of building maintenance, cleaning, security, despatch of mail, computer-related work, *etc.* subject to relevant Laws.

The Committee suggested a reduction in the minimum stipulated holdings of the Government/Reserve Bank in the equity of nationalised banks/State Bank of India to 33 per cent.

In regard to tenure of a Chief Executive of a bank, the Committee indicated a minimum period of three years but the reasonable length of tenure to be not less than five years.

C. Structural Issues

The Committee recommended that after the convergence of activities between DFIs and banks over a period of time, they should get converted into banks, resulting in the existence of only two intermediaries *viz.*, banks and non-banks. While mergers between strong financial institutions would make sense, the weak banks in the system will have to be given a revival package subject to a set of criteria.

The licensing of new private sector banks needs a review for their enhancement, while foreign banks will have to be encouraged to extend their operations on certain norms.

All appointments of chairmen, managing directors and executive directors of public sector banks and financial institutions, should be determined by an Appointments Board. The Committee felt the urgent need to raise the competency levels in public sector banks by resorting to a lateral induction of talented personnel. It also felt that the remuneration structure should be flexible and market driven.

The Committee recommended the corporatisation of IDBI. It also desired that the minimum net worth of NBFCs should at the same time be raised to Rs.2 crore progressively. For purposes of registration with the Reserve Bank, however, the minimum limit for networth has been doubled to Rs.50 lakh. Besides, no deposit insurance corporation for NBFCs was proposed.

The Committee proposed prudential and regulatory standards besides new capital norms for Urban Co-operative Banks (UCBs).

D. Integration of Financial Markets

The Committee recommended that banks and primary dealers alone should be allowed in the inter-bank call and notice money markets. Non-bank financial institutions would get access to other forms of instruments in money market like bill rediscounting, CPs, Treasury Bills, *etc.* It also suggested opening the Treasury Bill market to foreign institutional investors for broadening its base.

E. Rural and Small Industrial Credit

The Committee proposed review and strengthening of the operation of rural financial institutions (RFIs) in terms of appraisal, supervision and follow-up, loan recovery strategies and development of bank-client relationships in view of higher NPAs in public sector banks due to directed lending. In regard to capital adequacy requirements, RRBs and co-operative banks should reach a minimum of 8 per cent capital to risk weighted assets ratio over a period of 5 years. It also proposed that all regulatory and supervisory functions over rural credit institutions should rest with the Board for Financial Regulation and Supervision (BFRS).

(Contd......)

(.......Concld.)

F. Regulation and Supervision

The Committee made a suggestion that the 'Basle Core Principles of Effective Bank Supervision' should be regarded as the minimum to be attained. It should be made obligatory for banks to take into account risk weights for market risks to facilitate soundness and stability of the system.

For effective conduct of monetary policy by the Reserve Bank, delineation of supervision/ regulation from monetary policy is required implying that the Executive associated with monetary authority should not be in the Supervisory Board, to avoid weakening of monetary policy or banking regulation and supervision. The process of separating BFS from the Reserve Bank would need to be initiated and to supervise the activities of banks, financial institutions and NBFCs, a new agency in the name of BFRS would have to be formed. With a view to achieving an integrated system of supervision over the financial system, the Committee recommended bringing urban co-operative banks within the ambit of the BFS.

G. Legal and Legislative Framework

The Committee recommended the amendment to RBI Act and Banking Regulations Act with regard to the formation of BFRS. It also gives more autonomy and powers to public sector banks (Nationalisation Act). As wide ranging changes in the legal framework affecting the working of the financial sector are sought by the Committee, an expert Committee could be constituted comprising representatives from the Ministry of Law, Banking Division, Ministry of Finance, the Reserve Bank of India and some outside experts.

Sind Bank, Bank of India, Syndicate Bank and Dena Bank) were permitted to raise subordinated debt amounting to Rs.1,060 crore through private placement for inclusion under Tier II capital for capital adequacy purposes.

Prudential Accounting Norms

1.32 The Reserve Bank reiterated its earlier guidelines for classifying agricultural advances as NPAs, keeping in view the agricultural practices and the time taken for marketing of crops; banks were advised in March 1998 that effective 1997-98, advances granted for agricultural purposes may be treated as NPA if interest and/or principal remains unpaid, after it has become past due for two harvest seasons but for a period not exceeding two half years (as against two quarters earlier fixed for 1997-98). The mark to market proportion of the approved securities was enhanced further from 60 per cent in 1997-98 to 70 per cent in 1998-99 and would be raised progressively to 100 per cent over the next three years with a view to moving towards the international best practice of marking all investments to the market. Further, banks which have marked to market their securities at a higher percentage than prescribed were not to lower the proportion of current categories of securities later.

Rural Credit

1.33 The Reserve Bank advised all public sector banks to prepare Special Agricultural Credit Plans from 1994-95. For the financial year 1996-97, disbursements to agriculture under the Plan aggregated Rs.12,782.53 crore as against the target of Rs.14,253.43 crore. During 1997-98, disbursements to agriculture under the plan was Rs.14,808.35 crore against the target of Rs.16,069.04 crore.

1.34 A Rural Infrastructural Development Fund (RIDF) with a corpus of Rs.2,000 crore was constituted at NABARD in April 1995 for giving loans to state governments and state owned corporations for quick completion of on-going projects relating to medium and minor irrigation, soil conservation, watershed management and other forms of rural infrastructure. Subsequently, RIDF-II and RIDF-III were established during 1996-97 and 1997-98, respectively, each with a corpus of Rs.2,500 crore. Table 1.1 provides details of the loans sanctioned and disbursed to state governments under RIDF-I, II and III. The Union Budget 1998-99 has made an enhanced allocation of Rs.3,000 crore for RIDF IV. The availment of RIDF funds has been low in comparison to sanctions largely due to difficulties in identifying relevant projects by some state governments and lack of budgetary support where only part funding is envisaged from RIDF. Moreover, there are delays in the completion of formalities for drawal of funds and in completing preliminary work in respect of irrigation projects where land acquisition as well as tendering procedures are required. In order to speed up disbursal from RIDF funds, NABARD has advised state governments to review their respective position and initiate necessary steps to adhere to the time schedule.

1.35 The process of rehabilitation and recapitalisation of RRBs, initiated in 1994-95, was carried forward. During 1997-98, 90 RRBs were given capital support to the extent of Rs.200 crore and a further allocation of Rs.264.65 crore has been made for 1998-99.

Table 1.1 : RIDF : Loans Sanctioned and Disbursed
(As at end-March 1998)

(Amount in Rupees crore)

	Year of Establish-ment	Corpus	Loans Sanc-tioned	Loans Dis-bursed
1	2	3	4	5
RIDF-I	1995	2,000	1,765 (21)	1,457 (20)
RIDF-II	1996	2,500	2,617 (16)	925 (16)
RIDF-III	1997	2,500	2,668 (18)	269 (17)
Total		**7,000**	**7,050**	**2,651**

Figures in brackets indicate the number of states.

In order to allow a greater role to sponsor banks in the ownership and management of RRBs, the entire responsibility of monitoring and guiding RRBs was transferred to sponsor banks in November 1997. In addition, other policy measures such as relocation, conversion or merger of loss making branches of RRBs, release of certain loss making RRBs from the service area responsibilities and freedom to invest in capital market instruments are expected to bring about a positive turnaround and sustainable viability of RRBs.

1.36 In order to provide an institutional mechanism in private sector for promoting rural savings as well as channelising adequate credit for promoting rural viable economic activities, a proposal to set up Local Area Banks (LABs) was announced in the Union Budget for 1996-97. 212 proposals were received up to June 30, 1998, of which, 124 have been disposed of. 'In principle' approval was accorded for formation of three LABs, one each in Maharashtra, Karnataka and Andhra Pradesh. However, due to lack of promoters' compliance of terms and conditions laid down in 'in principle' approval, no licence was issued. Another five proposals are in an advanced stage of scrutiny for grant of 'in principle' approval and the remaining 83 proposals are at various stages of processing.

1.37 The share capital of NABARD was raised by Rs.500 crore to Rs.1,500 crore in 1997-98 and proposed to be increased further by Rs.500 crore during 1998-99 with the contribution of Rs.100 crore and Rs.400 crore, respectively, by the Central Government and the Reserve Bank, increasing the share of the Reserve Bank and the Central Government to Rs.1,450 crore and Rs.550 crore, respectively. The increase in capital would enable NABARD to effectively leverage its equity and mobilise additional resources for investment credit. The Reserve Bank sanctioned a credit limit of Rs.5,700 crore under General Line of Credit (GLC) to NABARD for 1997-98, consisting of Rs.4,850 crore under GLC I (for seasonal agricultural operations) and Rs.850 crore under GLC II (for various approved other short-term purposes).

1.38 In respect of agricultural credit, several policy initiatives were initiated to simplify the delivery mechanism so as to accelerate the flow of credit to the agricultural sector in the light of the recommendations of the Committee on Agricultural Credit through Commercial Banks (Chairman : Shri R.V. Gupta). These include greater flexibility and discretion to the lending banks in matters of collateral, margin, security, dispensation of 'no dues certificates', introduction of a composite cash credit limit to cover the farmers' production, post-harvest and household requirements, *etc.* In the light of the recommendations, necessary guidelines have been issued to banks. The Indian Banks' Association was also requested to work out simplified application forms of agricultural loans, and banks were advised to delegate sufficient powers to their branch managers.

Credit to Small Scale Industries

1.39 To further simplify the system for extending credit to small scale industries (SSI), the limit on investment in the plant and machinery in the SSI sector was enhanced by the government from Rs.60 lakh (Rs.75 lakh in the case of export oriented and ancillary unit) to Rs.3 crore and for the tiny sector from Rs.5 lakh to Rs.25 lakh and banks were advised to ensure that out of the funds available to all segments of the SSI sector, 40 per cent is made available for units with investment in plant and machinery up to Rs.5 lakh, 20 per cent for units with investment between Rs.5 lakh and Rs.25 lakh and the remaining 40 per cent for other SSI units. With a view to ensuring prompt settlement of dues of SSI units, as also to encouraging bills culture, banks were advised to ensure that effective January 1, 1998, not less than 25 per cent of the total inland credit purchases of the borrowers were to be through bills drawn on them by concerned sellers.

1.40 The Union Budget 1997-98 announced a scheme under which the banking system would provide Rs.1,000 crore on a consortium basis to the *Khadi* and Village Industries Boards (KVIBs). Those banks which have not achieved the priority sector lending target of 40 per cent even after allocation of their contribution to RIDF were included in the consortium. As at end-July 1998, an amount of Rs.510 crore was disbursed by the consortium under the scheme.

1.41 The Reserve Bank appointed a one man Committee (Chairman: Shri S.L. Kapur) to suggest measures for improving the delivery system and simplification of procedures for credit to SSI sector. The Committee submitted its report on June 30, 1998. The major recommendations have been outlined in Box IX.6 in Part Two of this Report.

Non-banking Financial Companies (NBFCs)

1.42 Following the amendments to the Reserve Bank of India Act, 1934 in March 1997, as detailed in last year's Annual Report, the Reserve Bank had introduced a new regulatory framework for non-banking financial companies (NBFCs) in January 1998. NBFCs have been divided into three broad categories, *viz*., (i) those accepting public deposits (as defined in the Companies (Acceptance of Deposits) Rules, 1975 and the RBI Act) (ii) those not accepting public deposits and (iii) core investment companies not accepting public deposits. The focus of the regulatory and supervisory attention is on the first category. While the NBFCs can accept public deposits only if they satisfy the pre-conditions of possessing net owned funds of at least Rs.25 lakh (inclusive of preference shares which are compulsorily convertible into equity), obtain a minimum investment grade credit rating and meet the mandatory compliance with prudential norms, the maximum interest payable on such deposits has been restricted to 16.0 per cent per annum. Capital adequacy requirement has been raised to 10 per cent to be achieved by March 31, 1998 and 12 per cent by March 31, 1999. While the liquid assets requirement will now be applicable to public deposits only, the ratio of liquid assets to public deposits is 12.5 per cent effective from April 1, 1998 and will go up to 15 per cent from April 1, 1999. A comprehensive mechanism of off-site supervision of the NBFCs is under implementation although NBFCs having large public deposits will be subject to annual on-site inspection.

Task Force on NBFCs

1.43 A Task Force has been set up in August 1998 to examine the emerging issues relating to the NBFCs, under the Chairmanship of Special Secretary (Banking), Ministry of Finance. The members of the Task Force include a Deputy Governor of the Reserve Bank, representatives of the Department of Company Affairs, Ministry of Law and two state governments. The terms of reference of the Task Force are i) to examine the adequacy of the present legislative framework; ii) to devise improvements in procedure relating to customer complaints; iii) to consider the need, if any, for a separate regulatory agency; and iv) to see whether state governments could be involved in the regulation of NBFCs. The Task Force is expected to submit its report by mid-September 1998.

INSTITUTIONAL DEVELOPMENTS

Money Market

1.44 In April 1997 the minimum size of the issue of CDs to a single investor was reduced from Rs.25 lakh to Rs.10 lakh and in multiples of Rs.5 lakh. To broadbase the holdings of CDs, the minimum size of the issue of CDs was further reduced to Rs 5 lakh and in multiples of Rs.1 lakh in October 1997. The minimum maturity period for CPs and the lock-in period for CDs and MMMFs were reduced from 30 days to 15 days. With a view to making the scheme more flexible, MMMFs were also permitted in October 1997 to invest in rated corporate bonds and debentures, with a residual maturity of up to one year but within the ceiling of 3 per cent, which was earlier prescribed for CP, as a prudential measure. Satellite Dealers (SDs) were permitted to issue CP in June 1998.

1.45 With a view to providing depth to the call money market, effective April 26, 1997, the facility of routing transactions in the call money market was extended to all Primary Dealers (PDs). The minimum size of operation per transaction by entities routing their lendings through PDs in the call money market

was reduced from Rs.20 crore to Rs.10 crore in April 1997, to Rs.5 crore in October 1997 and further to Rs.3 crore, effective May 9, 1998.

1.46 In the interest of developing the secondary market in PSU bonds and private corporate debt securities and for providing liquidity to such instruments, it was decided to permit repos, among those who operate in repos in government securities, in dematerialised PSU bonds and private corporate debt securities.

Government Securities Market

1.47 As indicated earlier, the scheme of ways and means advances (WMA) was introduced, effective April 1, 1997 to accommodate temporary mismatches between government receipts and payments. For the year 1998-99, the government has lowered the limits for WMA. Furthermore, the interest rates on WMA have been delinked from the cut-off yield for 91-day Treasury Bills and linked to the Bank Rate. The scheme of 14-day Intermediate Treasury Bills was introduced by the government, effective April 1, 1997, to provide state governments, foreign central banks and special bodies an avenue to park their surplus funds. In order to facilitate cash management requirements of various segments of the economy, it was decided to introduce Treasury Bills of varying maturities. Accordingly, the Reserve Bank introduced auctioning of 14-day Treasury Bills on a weekly basis. With a view to deepening the market further, it was announced in April 1998 that the practice of reverse repos with PDs in specified securities would be dispensed with and, instead, liquidity support would be provided against the security of holdings in Subsidiary General Ledger (SGL) accounts. Furthermore, extension of repos/ reverse repos in respect of all Central Government dated securities and Treasury Bills, permission to non-bank SGL account holders to conduct reverse repos and introduction of a scheme for SDs to avail of liquidity support from the Reserve Bank and extension of the facility of ready forward transactions to SDs would enable the repos market to forge closer links between the money market and the securities market, besides increasing depth and liquidity in the market.

1.48 The market for government securities was widened further by permitting all FIIs, to invest in government dated securities and Treasury Bills within the permitted limit of 30 per cent for investment in debt securities in addition to the category of 100 per cent debt funds in both primary and secondary markets; approving nine entities to register as SDs; granting in-principle approval to two banks to set up subsidiaries dedicated predominantly to the securities business and in particular to the government securities market to be registered as SDs; and introducing a scheme of retailing of government securities by banks. In order to usher in greater transparency, effective April 1998, amounts for all auctions of Treasury Bills – as against only 91-day Treasury Bills earlier – are pre-announced and bids received from non-competitive bidders - state governments, provident funds and Nepal Rashtra Bank – are kept outside the notified amount.

1.49 Repos, initially conceived as an instrument to absorb liquidity from the banking system, has developed during the course of the year as an important policy indicator of liquidity conditions and for signalling interest rate movements. A fixed rate repo was introduced on November 29, 1997 and the rate quickly evolved itself into a floor to call rates. The importance of repo rate stems from the ease with which it can be utilised to give policy direction for short-term rates to move. In addition to the existing three-day and four-day repos, one-day repos (including reverse repos) to absorb (or infuse) liquidity into the system would be introduced by the Reserve Bank. Further, fixed interest and auction based repos, as appropriate would be used. With a view to eliminating the problem of 'winners' curse' and broaden the market participation, introduction of a uniform price auction method in respect of 91 day Treasury Bill auctions, as an experimental measure, was proposed.

Capital Market

Advances against Shares and Debentures/ Bonds

1.50 In view of the depressed state of the capital market, a number of policy initiatives were taken to enhance the role of the banking sector in reviving the market. Banks were permitted, within the ceiling of 5 per cent of incremental deposits of the previous year

prescribed for banks' investments in shares, to a) sanction bridge loans to companies against expected equity flows/issues for periods not exceeding one year and b) extend loans to corporates against shares held by them to enable them to meet the promoters' contribution to the equity of new companies in anticipation of raising resources. The approval of banks' Boards would, however, be necessary in both the cases. Further, the prescription of the minimum margin of 50 per cent on loans to individuals against preference shares and debentures/bonds of corporate bodies was withdrawn; although, the margin of 50 per cent prescribed in respect of equity shares was retained. Subsequently, the ceiling amount on advances against shares to individuals was increased from Rs.10 lakh to Rs.20 lakh against dematerialised securities while the minimum margin prescription was reduced from 50 per cent to 25 per cent for dematerialised shares.

Measures Relating to Banks' Investments

1.51 As a move towards further liberalisation, in April 1997 banks were allowed to exclude their investments in preference shares/ debentures/bonds of private corporate bodies from the limit of 5 per cent of the incremental deposits of the previous year; the limit would, however, be applicable in respect of investment in ordinary shares of corporate units, including public sector undertakings (PSUs).

Other Measures

1.52 For ensuring the development of capital market on sound lines, the Securities and Exchange Board of India (SEBI) initiated several measures during the year, which, *inter alia*, included advising all stock exchanges to set up Clearing Houses/Clearing Corporations and Settlement Guarantee Funds, introducing compulsory settlement of trades in eight securities by domestic FIs, banks, mutual funds and FIIs having minimum portfolio of securities of Rs.10 crore in dematerialised form and imposing a uniform intra-day price band of 10 per cent (later reduced to 8 per cent) on all securities on all exchanges. SEBI introduced rolling settlement (T+5) in respect of trading in the demat segment of all companies. Major recommendations of Chandratre Committee on delisting of securities were accepted by SEBI and accordingly delisting norms were tightened. SEBI decided that all publicly issued debt instruments regardless of the period of maturity would require rating by a credit rating agency. It advised all the stock exchanges that all the listed companies should publish unaudited financial results on a quarterly basis and that they should inform the stock exchanges immediately of all events which would have a bearing on the performance/operations of the company as well as price sensitive information. SEBI accepted the recommendations of the Committee on derivatives (Chairman: Shri L.C.Gupta) and permitted derivatives trading in Indian stock exchanges. The Union Budget 1998-99 announced to bring about necessary amendments to the Securities Contracts (Regulation) Act to enable trading of derivative instruments. With a view to curbing excessive volatility, SEBI introduced additional volatility margin system stipulating margins (over and above other existing margins) in a graded manner depending on the volatility of the scrip.

Industrial Policy

1.53 With reference to the industrial policy, 1997-98 witnessed continuation of the reform process initiated in July 1991. Five industries were delicensed and the investment limit for plant and machinery was enhanced to Rs.3 crore from Rs.60 lakh/ Rs.75 lakh for small-scale sector industrial undertakings/ancillary industrial undertakings. Correspondingly, the limit for tiny sector was raised to Rs.25 lakh from Rs.5 lakh. 15 items which were earlier reserved exclusively for manufacture in the small-scale sector had been de-reserved. Equity investments up to 100 per cent by NRIs had been permitted in high priority industries which include metallurgy, infrastructure and mining. In addition, the number of industries eligible for foreign direct investment under the automatic approval was increased.

Trade Policy

1.54 The revised Export and Import (EXIM) Policy, 1997–2002 signalled continuation of India's efforts to move towards a more open trade regime. In line with the policy to undertake phased removal of quantitative restrictions on India's exports and imports, a large number of import items have been shifted from the Restricted List to the Open General List while some items have been shifted from the Restricted List to the Special Import Licence

List. With regard to exports, quantitative restrictions including licensing requirements on certain agricultural items have been relaxed. The emphasis of the current trade policy has been to move towards a trust-based system whereby issuance of advance licences to all status holders has been made automatic on the basis of information furnished by them. Exporters of agricultural and allied products, gems and jewellery, electronics and software, project goods, pharmaceutical products and holders of internationally recognised quality certificates have been provided with special incentive measures. To encourage participation of smaller players in export activities, the minimum threshold limits for availing facilities under a number of schemes have been reduced. Such schemes include duty-free import under Export Promotion Capital Goods (EPCG) Scheme and value addition requirement under advance licences with actual user condition. Minimum requirements on net foreign exchange earning by Export Oriented Units and Export Processing Zones in agricultural and allied sector and export requirement by export and various trading houses have been revised downwards. Schemes have been initiated to improve infrastructural facilities. Improvement of facilities to the bonded warehouses is one such step. Norms and administrative procedures relating to foreign trade have been simplified, the power to administer such steps have been decentralised and the agents associated with foreign trade have been given greater autonomy in conducting their business.

Foreign Exchange Market

1.55 In order to enhance integration between domestic and overseas money markets, authorised dealers (ADs) were permitted from April 1997 to borrow up to US $ 10 million from their overseas offices/correspondents without any conditions on end use and repayment of such borrowings. Simultaneously, ADs were also permitted to invest funds in overseas money market instruments up to US $ 10 million. In October 1997, in order to move over to a system which links the ceilings to the unimpaired Tier I capital, banks were allowed to borrow from overseas money markets/invest in overseas money markets up to a maximum extent of 15 per cent of their unimpaired Tier I capital. Prior to April 1997, ADs were required to satisfy themselves, before booking of forward contracts, that there is an underlying exposure through documentary evidence; it was decided in April 1997 to allow exporters and importers to take forward cover without the requirement of documentary evidence subject to certain conditions. In order to provide a hedging mechanism to entities who run long-term exposures, ADs were permitted to arrange foreign currency swaps between corporates and also run a swap book subject to open position/ gap discipline. From April 1997, corporate exporters were permitted to extend trade-related advances to their importer – clients without prior approval of the Reserve Bank provided such an advance is made out of Exchange Earners' Foreign Currency (EEFC) account and the total outstandings of such advances in respect of an EEFC account does not exceed US $ 3 million per account. In order to contain speculative activities in the foreign exchange market, the facility granted to ADs in April 1997 to offer forward contracts based on past performance and declaration of an exposure was suspended in December 1997 and forward contracts were allowed based only on documentary evidence. Earlier, ADs were permitted to undertake swaps and invest nostro balances in excess of 15 per cent of Tier I capital, subject to overall gap discipline prescribed by the Reserve Bank. In December 1997, overnight investments from nostro accounts were included in the 15 per cent unimpaired Tier I capital limit for overseas investments by ADs. In June 1998, banks were advised to limit their positions to genuine requirements. Furthermore, ADs were advised not to arbitrage between the money and foreign exchange markets which could add additional volatility in the markets. FIIs were allowed forward exchange cover facility for equity investments for 'incremental investment' (over and above the investment in equity prevailing at the end of business on June 11, 1998). FIIs were also permitted to invest in Treasury Bills.

Foreign Direct Investment

1.56 Foreign direct investment was allowed into the area of financial services during the year through the Foreign Investment Promotion Board. Fifteen non-bank financial services (merchant banking, underwriting, portfolio management services, investment advisory services, financial consultancy, stock broking, asset management, venture capital, custodial

services, factoring, credit reference, credit rating, leasing and finance, housing finance and forex broking) were identified in which foreign direct investment was permitted under guidelines relating to minimum capitalisation norms, schedule of capitalisation and domestic equity participation. In a drive to simplify procedures for foreign direct investment under the 'automatic' route of the Reserve Bank and in respect of cases already approved by the Government of India, the need for approaching the Reserve Bank for permission for inward remittance of foreign exchange and issue of shares in India to foreign investors was obviated and subsumed under the general permission given by the Reserve Bank to accept foreign investment under the policy guidelines of the Government of India. However, these companies will have to file the required documents with the concerned Regional Office of the Reserve Bank within 30 days after the issue of shares to the foreign investors. In view of the successful working of this hassle free and transparent automatic scheme, the Government included 13 additional categories of industries/items under services sector for equity participation up to 51 per cent, 3 items relating to mining activity up to 50 per cent and 9 categories of industries and activities up to 74 per cent.

External Commercial Borrowings

1.57 The policy for external commercial borrowing (ECB) is subject to continuous review as part of a prudent external debt management strategy. The demand for external resources for new investment as well as for expansion of existing capacity is modulated through lengthening the maturity profile of loans, annual ceilings on access, prioritisation of end-use and monitoring of costs. In the light of the South-East Asian financial crisis and its impact on international markets, the need for according importance to infrastructure and export sectors as thrust areas, shifts in the policy for external commercial borrowing were effected in April 1998. The average maturity for ECB for exporters and the shipping sector was reduced from 7 years to 5 years for proposals above US $ 15 million in view of the specific requirements of these two sectors. As a part of guidelines for 1998-99, across –the –board prepayment facility was permitted up to 20 per cent of the balance outstanding of each ECB for all maturities. However, in July 1998, keeping in view certain market developments, it was decided not to entertain fresh requests for prepayment until a further review of the policy.