

**Statement by Dr. Y. Venugopal Reddy,
Governor, Reserve Bank of India
on Mid-term Review of Annual Policy
for the year 2004-05**

The policy documents of the Reserve Bank capture the rationale of monetary, structural and prudential measures introduced from time to time against the background of an assessment of macroeconomic and monetary developments. In the process, the approach of greater transparency and better communication contributes towards an effective consultation process in policy making. This Statement on Mid-term Review of the Annual Policy for the year 2004-05 follows the pattern already set in the previous years. It consists of three parts: (I) Mid-term Review of Macroeconomic and Monetary Developments in 2004-05; (II) Stance of Monetary Policy for the Second Half of 2004-05; and (III) Financial Sector Reforms and Monetary Policy Measures.

**I. Mid-term Review of Macroeconomic and
Monetary Developments in 2004-05**

Domestic Developments

2. The annual policy Statement released on May 18, 2004 projected real GDP growth for 2004-05 in the range of 6.5-7.0 per cent on the assumption of normal monsoon, sustained growth of the industrial sector and good performance of exports. As per the India Meteorological Department (IMD), the South-West monsoon rainfall has been 87 per cent of its long period average. Rainfall was normal in 23 out of 36 meteorological sub-divisions of the country, but it was deficient in the remaining 13 sub-divisions. Output of major *Kharif* crops this year may be lower than their corresponding levels last year. It is, however, anticipated that *Rabi* crops would be favourable. While the prospects are still somewhat unclear, the current assessments clearly indicate that agricultural growth of 3.0 per cent, projected earlier, will not materialise.

3. There are indications that the prospects for growth in industrial output have improved. The index of industrial production (IIP) increased by 7.9 per cent during April-August 2004 as compared with the increase of 5.9 per cent in the corresponding period of the previous year. There are signs of sustained growth in the production of basic goods, capital goods, intermediate goods and consumer durables. The index of six major infrastructure industries increased by 5.6 per cent during April-August 2004 as compared with the increase of 4.2 per cent in the corresponding period of the previous year. Further, India's exports continue to

remain buoyant. Exports increased by 24.4 per cent in US dollar terms during April-September 2004 as against 8.1 per cent in the corresponding period of the previous year.

4. According to the revised estimates by the Central Statistical Organisation (CSO), real GDP increased by 8.2 per cent during 2003-04 as against 4.0 per cent during 2002-03. The data available for the first quarter of 2004-05 show that real GDP increased by 7.4 per cent as against 5.3 per cent in the first quarter of the previous year. While the CSO estimate of GDP for the first quarter is consistent with the earlier projected growth of 6.5-7.0 per cent for the full fiscal year, the deficient rainfall in some parts of the country and its impact on *Kharif* crop impart a downward bias to this growth projection. In addition, the higher oil prices tend to have an adverse impact on GDP growth. At the same time, the improved prospects for growth in industrial output and continued buoyancy in exports are likely to have a positive impact on growth. On the whole, while the picture is not very clear, it may be reasonable to place the overall GDP growth for the year 2004-05 in the range of 6.0 to 6.5 per cent as against the earlier expectation of 6.5-7.0 per cent, assuming that the combined downside risks of high and uncertain oil prices, and sudden changes in international liquidity environment remain manageable. India would thus remain among the faster growing economies in the world in 2004-05.

5. Various business expectation surveys including RBI's own assessment point to a reasonable air of optimism regarding growth. The corporate results continue to be good and cash flows so generated may get translated into higher investment. Non-food credit growth remains strong. Private corporate investments are expected to be higher. The overall economic environment remains supportive of investment and capacity building, given the economy's resilience to withstand shocks. While exports of services remain buoyant, there is growing confidence for exporting manufactured goods. There is significant acceleration in international business and investor confidence in India.

6. During 2004-05, scheduled commercial banks' credit increased by 11.3 per cent (Rs.95,120 crore) up to October 1, 2004 which was substantially higher than the increase of 4.0 per cent (Rs.28,927 crore) in the corresponding period of last year. Food credit increased by Rs.2,677 crore as against a decline of Rs.12,107 crore in the previous year reflecting a turn-around of about Rs.14,800 crore. Non-food credit posted a robust increase of 11.5 per cent (Rs.92,443 crore) as compared with an increase of 6.0 per cent (Rs.41,034 crore) in the corresponding period of the previous year. The incremental non-food credit-deposit ratio was as high as 96 per cent as against 38 per cent in the corresponding period of the previous year.

7. In the recent years, the impetus to credit growth has emanated from non-agriculture non-industrial sectors, particularly, housing, small transport operators and retail loans. The detailed information on sectoral deployment of credit available from banks reveals that over

two-thirds of credit flow during the current financial year (up to August 2004) have been on account of retail, housing and other priority sector loans. More recent information available up to September 2004 points to a revival of industrial credit. Among industries, discernible increase is observed in petroleum, infrastructure, electricity, construction, metal & metal products, drugs & pharmaceuticals, gems & jewellery and automobiles.

8. While credit expanded, scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., declined by 4.8 per cent (Rs.4,255 crore) up to October 1, 2004 as compared with a decline of 1.1 per cent (Rs.1,043 crore). Notwithstanding the decline in such investments, the total flow of resources from scheduled commercial banks to the commercial sector increased substantially by 9.9 per cent (Rs.88,188 crore) up to October 1, 2004 as compared with the increase of Rs.39,991 crore in the corresponding period of the previous year. The year-on-year growth in resource flow was also higher at 20.9 per cent as against 14.3 per cent a year ago. Scheduled commercial banks' investments in instruments issued by financial institutions (FIs) and mutual funds this year declined by Rs.2,570 crore as against an increase of Rs.6,204 crore in the previous year. The total flow of resources to the commercial sector including capital issues, global depository receipts (GDRs)/american depository receipts (ADRs) and borrowings from banks and FIs increased by Rs.1,08,510 crore up to October 1, 2004 as compared with Rs.66,863 crore in the corresponding period of the previous year.

9. In the current financial year up to October 1, 2004, money supply (M_3) increased by 5.4 per cent (Rs.1,07,657 crore) as compared with 7.8 per cent (Rs.1,33,901 crore) in the corresponding period of the previous year. On an annual basis, growth in M_3 at 14.0 per cent was, however, higher than 11.9 per cent in the previous year. Aggregate deposits of scheduled commercial banks rose by 6.4 per cent (Rs.96,598 crore) as compared with an increase of 8.3 per cent (Rs.1,06,782 crore) in the corresponding period of the previous year. The lower deposit growth this year could be mainly attributed to reduction in non-resident Indian (NRI) deposits with the banking system. On an annual basis, the growth in aggregate deposits at 15.4 per cent was, however, higher than that of 11.7 per cent a year ago. Overall, while M_3 growth has reverted from its peak level of 16.2 per cent at the beginning of the year to a level envisaged in the annual policy Statement, the possibility of a higher M_3 growth in the event of continued strong credit growth and overhang of liquidity cannot altogether be ruled out.

10. Reserve money increased by 0.6 per cent (Rs.2,535 crore) in the current financial year up to October 15, 2004 as compared with an increase of 0.9 per cent (Rs.3,216 crore) in the corresponding period of the previous year. While currency in circulation increased by 4.3 per cent (Rs.14,036 crore) as compared with 6.6 per cent (Rs.18,758 crore) in the corresponding period of the previous year, bankers' deposits with RBI decreased by 12.4 per cent (Rs.12,930

crore) as compared with an increase of 18.9 per cent (Rs.15,763 crore). As regards the sources of reserve money, net RBI credit to the Central Government declined by Rs.21,395 crore as compared with a decline of Rs.53,466 crore in the corresponding period of the previous year. On the other hand, RBI's net foreign currency assets (adjusted for revaluation), increased by Rs.30,604 crore on top of an increase of Rs.62,945 crore during the corresponding period of the previous year. RBI's credit to banks and commercial sector continued to decline because of reduced reliance on the standing facilities on account of comfortable liquidity conditions. The year-on-year increase in reserve money was 17.9 per cent as on October 15, 2004 as compared with 10.9 per cent a year ago.

11. Annual inflation, as measured by variations in the wholesale price index (WPI), on a point-to-point basis, rose from 4.6 per cent at end-March to 8.3 per cent by end-August 2004. It has since come down to 7.1 per cent by October 9, 2004. On an average basis, annual inflation based on WPI was 6.2 per cent as on October 9, 2004 as compared with 4.9 per cent a year ago. At a disaggregated level, prices of primary articles (weight: 22.0 per cent) increased by 4.3 per cent, the same rate as in the previous year. Among primary articles, high increase in prices was observed mainly for iron ore, tea and oilseeds. Similarly, increase in prices of 'fuel, power, light and lubricants' group (weight: 14.2 per cent) at 10.7 per cent was higher than that of 5.7 per cent during the corresponding period of last year. Among 'fuel, power, light and lubricants', increase in prices was across the board - in coal, petrol, diesel, aviation turbine fuel and naphtha. Prices of manufactured products (weight: 63.7 per cent) increased by 7.1 per cent as compared with 5.1 per cent last year. Among manufactured products, a significant increase in prices was observed in basic metals & alloys, non-metallic mineral products and non-electrical machinery.

12. In order to isolate the impact of supply shock, a contextual analysis of WPI reveals that as on October 9, 2004, the annual price increases were relatively high in the case of four commodities which have a combined weight of 12.6 per cent in WPI: iron ore (290.0 per cent), iron & steel (26.5 per cent), mineral oils (16.8 per cent) and coal mining (16.2 per cent). Excluding these four items, the WPI inflation rate works out to 4.2 per cent as on October 9, 2004, on a point-to-point basis, as against 3.8 per cent in the previous year.

13. In the international oil markets, Brent, WTI and Dubai Fateh varieties have recorded average prices of US \$ 49.7, US \$ 53.1 and US \$ 38.7 per barrel in October (up to October 22), registering increases of about 66.0 per cent, 65.3 per cent and 40.0 per cent, respectively, since January and 47.1 per cent, 44.5 per cent and 28.5 per cent, respectively, since April 2004. Subsequent to the increase in imported crude prices, domestic petro-product prices have been raised, though not as sharply. Since January 2004, domestic diesel and petrol prices (average of prices in four metros) have gone up by about 13.4 per cent and 10.5 per

cent, respectively. However, the pass through of crude oil prices is still to be completed and is likely to remain the most critical factor influencing the domestic inflation in the medium-term.

14. Internal exercises suggest that in the absence of policy intervention, every US dollar increase in crude oil prices could potentially add 15 basis points to WPI inflation as a direct effect and another 15 basis points as indirect effect. In the hypothetical situation of passing on the entire increase in international oil prices since January to the domestic customers, the mineral oils price index would have registered an annual increase of about 27 per cent by October 9, 2004 as against the actual increase of about 17 per cent. As a result, the headline inflation which is presently at 7.1 per cent would have increased by another 1.1 percentage points due to the direct impact and further by 1.1 percentage points, with a lag, due to indirect impact. The impact of higher international oil prices has been partly cushioned by fiscal measures such as cuts in excise and customs duties. It may not be inappropriate to assume that similar burden sharing will continue to enable moderation of the incidence of oil price shocks in future, recognising that headroom available for absorbing the burden both by fisc and oil companies gets progressively reduced.

15. It may be recalled that the annual policy Statement had assumed the annual inflation rate at around 5.0 per cent by the end of 2004-05, on the basis of point-to-point variation in WPI. This projection was made at a time when IMD had predicted a normal monsoon for the current year. The Statement had drawn attention to the underlying risks to inflation emanating from international oil and commodity prices given the pass through of international prices to domestic inflation. The Statement had also cautioned about the potential inflationary impact of persistence of excess liquidity on aggregate demand. In retrospect, the magnitude and persistence of supply shocks was beyond what was anticipated by many. While there are uncertainties regarding the future course of international commodity prices, particularly oil prices, it is now clear that the year-end inflation projection will exceed what was anticipated at the beginning of the financial year. On current assessment, assuming that there would be no further major supply shock and liquidity conditions remain manageable, the point-to-point year-end inflation based on WPI for the year 2004-05 could be placed around 6.5 per cent.

16. Annual inflation, as measured by variations in the consumer price index (CPI) for industrial workers, on a point-to-point basis, was 4.6 per cent in August 2004 as against 3.1 per cent a year ago. On an annual average basis, inflation as reflected in CPI was 3.4 per cent in August 2004 as against 4.0 per cent a year ago.

17. During the current year, the CPI inflation has remained significantly lower than WPI inflation. While this could largely be attributed to the difference in coverage, the pass through effect of international prices has considerably weakened the association between the two inflation rates. The CPI inflation has been lower than the WPI inflation in the recent past

reflecting lower increase in prices of food items. On the other hand, prices of certain industrial raw materials and manufactured products which rose sharply, do not get reflected in CPI basket directly. However, CPI inflation could be impacted by WPI inflation with a lag.

18. The Union Budget for 2004-05 placed the net and gross market borrowings of the Central Government at Rs.90,365 crore and Rs.1,50,817 crore, respectively. The Central Government completed net market borrowings of Rs.26,233 crore (29.0 per cent of the budgeted amount) and gross market borrowings of Rs.75,044 crore (49.8 per cent of the budgeted amount) up to October 21, 2004. Taking into account the receipts from states under the debt-swap scheme, the market borrowing programme as per the indicative calendar of the Central Government for the second half of 2004-05 was reduced. The weighted average yield on government borrowings through dated securities at 5.76 per cent this year so far (up to October 21, 2004) has been lower than 5.90 per cent last year. The lower cost of government borrowings so far this year could be attributed to two interrelated factors: First, lower volume of first half borrowings than usual on account of carry forward of surplus cash balance of Rs.26,669 crore at end-March 2004 into this year, reduced the borrowing requirements. Second, proportionately higher subscription emanated from market participants other than the traditional source of banks. While the Government could borrow at a lower cost so far, keeping in view larger than usual borrowing slated for the second half of the year, the market borrowing programme in the remainder of the year needs to be calibrated carefully in view of strong credit demand. It is, therefore, critical to ensure that there is no slippage in fiscal deficit.

19. Revenue deficit of the Central Government at Rs.62,906 crore was higher by about 3.5 per cent by August 2004 over the corresponding period of last year and accounted for about 82.6 per cent of the budget estimate for the whole year. The gross fiscal deficit of the Central Government at Rs.52,509 crore up to August 2004 was higher by about 20.8 per cent over the corresponding period of last year and constituted 38.2 per cent of the budget estimate for the current year. The state governments have prepaid Rs.13,781 crore of central government debt through additional market borrowings under the debt swap scheme. Such market borrowings by the state governments were in addition to the normal market borrowings of Rs.9,362 crore (up to October 21, 2004). Further, the states have prepaid to the Centre from their small savings collection.

20. In the recent period, there have been some instances of under-subscription to the state government issues despite easy liquidity conditions. This inadequate response on the part of the market participants once again underlines the need for prudent fiscal management at the state level to ensure completion of the approved borrowings of the state governments. In this context, the persistence of large aggregate borrowing of the Central and state governments continues to be a matter of concern in terms of its possible adverse impact on the desired acceleration in growth that is consistent with stability, as also from the point of view of ensuring

efficient monetary and debt management. Nevertheless, there have been certain positive developments in this regard which could moderate the complexities in the medium-term. First, there were efforts towards framing of draft model of fiscal responsibility legislation at the state level. Five states have already enacted fiscal responsibility legislation and a few others are in the process of doing so. Second, the Central Government has also framed the Fiscal Responsibility and Budget Management (FRBM) Rules, effective July 5, 2004, unveiling the road map for fiscal consolidation.

21. In recent years, scheduled commercial banks' investment in government and other approved securities has been much in excess of the required statutory liquidity ratio (SLR) of 25 per cent. As at end-March 2004, such excess SLR securities at Rs.2,67,328 crore constituted 16.3 per cent of net demand and time liabilities (NDTL) of banks. However, during the current year, scheduled commercial banks' investment in government and other approved securities at Rs.27,435 crore (up to October 1, 2004) was lower than that of Rs.76,705 crore in the corresponding period of the previous year partly on account of pick-up in credit demand. Consequently, commercial banks' excess holding of SLR securities was reduced to Rs.2,61,299 crore or 14.7 per cent of NDTL. Notwithstanding this reduction, the effective SLR investment at 39.7 per cent of NDTL for the banking system as a whole, continues to be high relative to the statutory minimum of 25 per cent. As credit demand is expected to remain buoyant this year, lower appetite for SLR securities has implications for government borrowings in an environment of market determined interest rates.

22. As indicated in the annual policy Statement, the market stabilisation scheme (MSS) was introduced to absorb liquidity of a more enduring nature by way of sterilisation through issuances of Treasury Bills/dated government securities. During 2004-05, liquidity absorption through MSS was Rs.54,146 crore up to October 21, 2004. With the issuance of MSS, the repo volumes tendered under liquidity adjustment facility (LAF) declined from an average of Rs.70,523 crore in April to Rs.13,805 crore in October 2004 (up to October 21). The liquidity that remained sterilised declined from an average of about Rs.81,260 crore in April to Rs.67,321 crore in October (up to October 21). In addition to MSS and repo, surplus balances in the Central Government account with the Reserve Bank also helped in sterilising excess liquidity from time to time. Notwithstanding some decline in surplus liquidity during the year, the overhang of liquidity continues to remain substantial.

23. During 2004-05 (April to October 21, 2004), financial markets have remained generally stable though interest rates have displayed some upward movement, particularly at the longer end. First, the average call money rate increased from 4.29 per cent to 4.57 per cent. Second, the 91-day and the 364-day Treasury Bill rates moved up from 4.42 per cent and 4.45 per cent to 5.20 per cent and 5.49 per cent, respectively. Third, the yield on government securities with 1-year residual maturity increased from 4.51 per cent to 5.51 per cent. Fourth, the yield on

government securities with 10-year and 20-year residual maturities increased from 5.14 per cent and 5.76 per cent to 6.72 per cent and 7.16 per cent, respectively. As a result, the spread between 10-year and 1-year government securities moved up from 63 basis points to 121 basis points. Similarly, the spread between 20-year and 1-year government securities increased from 125 basis points to 165 basis points.

24. The weighted average discount rate on commercial paper (CP) of 61 to 90-day maturity increased from 5.08 per cent in April to 5.12 per cent by mid-October 2004. The market repo rate increased from 3.70 per cent to 4.52 per cent with an increase in daily volume from Rs.5,065 crore (one leg) to Rs. 5,587 crore. The average daily volume of CBLO (collateralised borrowing and lending obligation) increased significantly from Rs.2,500 crore to Rs.8,736 crore with an increase in CBLO rate from 3.8 per cent to 4.51 per cent. The typical interest rate on 3-month certificates of deposit (CD) increased from 4.45 per cent in April to 5.25 per cent by October 2004. However, public sector banks reduced their rates for deposits of over 1-year from a range of 5.0-6.0 per cent to 4.75-5.75 per cent.

25. As indicated in the annual policy Statement, commercial banks have announced their benchmark prime lending rates (BPLRs) as advised by the Indian Banks' Association (IBA). The new system of BPLR imparts greater transparency in determination of lending rates while giving complete flexibility to banks to price their loan products either on fixed or floating basis. The BPLRs of public sector and foreign banks remained unchanged in the range of 10.25-11.50 per cent and 11.00-14.85 per cent, respectively, during April-September 2004. The BPLRs for private sector banks, however, moved from a range of 10.50-13.00 per cent in April to a range of 9.75-13.00 per cent by September 2004. The representative (median) lending rates on demand and term loans (at which maximum business is contracted) of public sector banks were in the range of 10.50-12.75 per cent in June as against 11.0-12.75 per cent in March 2004.

26. The risk premium on private sector bonds, as measured by the yield spread between highly rated corporate paper and government securities, has reduced. For example, the spread between AAA-rated corporate bonds of 5 years and the yield on government securities of similar maturity declined from about 80 basis points in April to about 50 basis points by October 2004.

27. The Reserve Bank has been persistently drawing attention of banks to interest rate risks. Accordingly, banks were advised in January 2002 to build-up investment fluctuation reserve (IFR) to a minimum of 5.0 per cent of their investment portfolio. As at end-March 2004, banks had built up IFR up to 3.0 per cent. With the recent trend in interest rates, some of the risks have crystallised. However, there has been some cushion for banks given the conservative accounting norms which do not permit banks to recognise unrealised gains in their

portfolio, while requiring them to provide for any known depreciation in their value. Against this background and pending a review of existing guidelines on banks' investment portfolio, RBI allowed banks to exceed the ceiling of 25 per cent of investments included under HTM category by shifting some of their investments in SLR securities from the HFT/AFS categories to HTM category at the lowest of the acquisition cost or prevailing market value or book value, subject to a maximum of 25 per cent SLR securities to be held in HTM. Consistent with international standards that do not place any cap on HTM category, such a move was considered advisable taking into account the statutory nature of the 25 per cent SLR while ensuring prudence and transparency in valuation on transfer to HTM. While the earlier prescription was relatively more conservative, the recent changes recognised the dynamic interface with the interest rate cycles. While RBI recognises the need for continuing to build up IFR, banks were advised to prepare themselves to implement the capital charge for market risk as envisaged under Basel II norms in a phased manner by end-March 2006.

External Developments

28. The International Monetary Fund (IMF) in September 2004 projected world output to grow by 5.0 per cent in 2004 and 4.3 per cent in 2005. Global recovery is backed by world trade that has been projected by the IMF to grow in volume terms by 8.8 per cent in 2004 and 7.2 per cent in 2005. However, the downside risks have increased primarily on account of persistence of uptrend in global oil prices.

29. With the ongoing growth rebound, the US Fed has started moving monetary policy to its neutral level by raising the overnight target policy rate thrice by 25 basis points each since June to 1.75 per cent by September 2004. Bank of England has raised its policy rate by 125 basis points in stages since November 2003 to 4.75 per cent by August 2004, largely on account of domestic concerns on asset price inflation. Similarly, central banks in other countries such as Hong Kong SAR, Mexico, Poland, Russia, Singapore, Switzerland and Thailand have raised policy rates during 2004. In euro area, growth has been relatively subdued and the key policy rate has been left unchanged at 2.0 per cent since June 2003. Bank of Japan has indicated that it would be continuing with the current policy of quantitative easing till such time as the consumer price deflation ends on a sustainable basis. In fact, central banks in some countries such as Argentina, Brazil, South Africa and Sweden have reduced their policy rates during 2004. Overall, therefore, while the central banks displayed mixed reactions in terms of preferences for soft, neutral and hardening biases, the choice of a specific stance by a country/region seems to have been preponderantly guided by its own domestic economic considerations.

30. Notwithstanding the strengthening of growth momentum, global demand for oil and higher oil prices have outpaced expectations. In international oil markets, crude prices have

risen to record nominal highs and the uptrend continues with increased volatility. In addition, tight inventory position and greater geopolitical uncertainties have encouraged speculative activities in the futures markets. If this scenario continues, it will significantly undermine the global growth prospects, with a disproportionately larger burden on oil importing emerging markets like India. Admittedly, the current oil shock is not as intense as the previous major oil shocks consequent on a reduction in the oil intensity of global output. For example, in the earlier oil price shocks, nominal crude oil prices had increased by 252 per cent during 1973-74, 179 per cent during 1978-80, 58 per cent during 1989-90 and 57 per cent during 1999-2000. Nevertheless, oil prices continue to be a key determinant of global economic prospects. International crude prices have already risen over 60 per cent since January 2004. As developing countries have not reduced their dependence on oil as much as developed countries, they remain particularly vulnerable. The International Energy Agency (IEA) has warned that a US \$ 10 price increase per barrel of oil sustained over one year could trim about 0.8 per cent of Asia's overall economic growth. The IMF has estimated that US \$ 5 per barrel increase in oil prices would reduce global growth by about 0.3 percentage point after one year.

31. Another major downside risk facing the global economy continues to emanate from global imbalances and the associated possibility of disruptive currency adjustments and persistent structural problems in the euro area and Japan. The US fiscal balance has deteriorated rapidly from a surplus position in 2000 to a large deficit which has added to the pressures for an expanding current account deficit. Further, the fiscal correction in some euro area countries has been less than anticipated. Many emerging markets are experiencing current account surpluses *vis-à-vis* the US. The fiscal deficit in the US, which was earlier being financed by the domestic private sector, is now being substantially financed by central banks of Asia. The twin deficits in the US economy constitute a major challenge confronting the international community.

32. The deflationary expectations that prevailed over last two years have now given way to some inflation concerns in most advanced economies, though the consumer price inflation as well as core inflation still remains at relatively low levels. The concern over inflationary impact of global oil prices, however, remains muted mainly because of three factors: First, the productivity gains in many economies have helped build resilience to shocks. Second, increasing trade liberalisation has given the opportunity to source goods and services from least cost sources; resultant competition in tradable goods has lowered consumer prices. Third, the oil intensity of global output has reduced over time. However, if current hardening of global oil prices persists, it could feed through input costs and transport costs that could also impact landed prices of traded goods. If general prices or inflation expectations are impacted, wage costs could rise, which in turn could lead to persistence of price pressures. Conversely, there is a view that oil prices would moderate with easing of demand pressures given the long positions in the futures market.

33. The impact of rising oil prices depends on the structure of the economy and the stage of the business cycles in which it is placed. For oil importing emerging markets like China and India, the impact would be relatively more significant given the increasing oil intensity and lower energy efficiency. Nevertheless, the global macroeconomic environment, in spite of the increase in the oil prices and some hardening of interest rates, remains supportive of international capital flows.

34. The broadening of global recovery has had a positive impact on the health of financial intermediaries. External financing conditions for emerging markets have also improved. New issuance through bonds, equities and syndicated loans, by either sovereign borrowers or corporate borrowers in emerging market countries so far this year, has been higher than last year. Global financial markets today appear largely stable with efforts being made to reduce bad loans in several countries, and equity markets turning less volatile. Moreover, international financial markets have remained calm despite some transition to higher interest rates. Interest rate forward markets suggest that if rate hikes in future remain modest, markets could adjust without much negative effect.

35. The Indian forex market generally witnessed orderly conditions during the current financial year so far (April-October 2004). The exchange rate of the rupee, which was Rs.43.39 per US dollar at end-March 2004, depreciated by 5.2 per cent to Rs.45.77 per US dollar by October 21, 2004. It also depreciated by 7.9 per cent against Euro, by 4.3 per cent against Pound sterling and by 1.9 per cent against Japanese yen during the period. Foreign exchange reserves increased by US \$ 7.6 billion from US \$ 113.0 billion at end-March 2004 to US \$ 120.6 billion as on October 21, 2004.

36. In recent years, the annual policy Statements as well as mid-term Reviews have attempted to bring into sharper focus the main lessons emerging from our experience in managing the external sector during periods of external and domestic uncertainties. As articulated in the policy Statements in the recent years, the broad principles that have guided exchange rate management are:

- Careful monitoring and management of exchange rates without a fixed target or a pre-announced target or a band. Flexibility in the exchange rate together with ability to intervene, if and when necessary.
- A policy to maintain a level of foreign exchange reserves which takes into account not only anticipated current account deficits but also 'liquidity at risk' arising from unanticipated capital movements.
- A judicious policy for management of the capital account.

37. As pointed out in all the recent policy Statements, the overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of the balance of payments (BoP), and has endeavoured to reflect the 'liquidity risks' associated with different types of flows and other requirements. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Taking these factors into account, India's foreign exchange reserves are at present comfortable and consistent with the rate of growth, the share of the external sector in the economy and the size of risk-adjusted capital flows.

38. It is necessary to take a medium-term view of the macroeconomic outlook, in particular the external sector, in arriving at the desirable level of reserves. In this regard, the potential for different magnitudes of current account deficit, as the GDP growth accelerates, should be recognised. In view of the level of comfort provided by the international financial architecture, apart from considering reserves as an insurance against volatility in capital flows, there is need to provide cushions against shocks. These could arise from uncertain monsoon conditions in the real sector, variations in global oil prices in the external sector and high levels of public debt in the fiscal arena. There is considerable merit in taking a national balance sheet approach to the external sector and to provide cushions through official reserves in response to increasing external liabilities on account of the private sector. Further, it is useful to recognise the comfort and the confidence provided to the investors by the level of reserves in the context of volatility in capital flows.

39. Managing capital flows is an issue closely related to the level of reserves. The annual policy Statement had listed the important policy responses that could be used to manage large capital inflows. A critical issue in this regard is a view on whether the capital flows are temporary or permanent in nature. The recent episode of large capital flows prompted a debate in the media on the need for exchange rate adjustment. In a scenario of uncertainty facing the authorities in determining temporary or permanent nature of inflows, it is prudent to presume that such flows are temporary till such time that they are firmly established to be of a permanent nature.

40. India's exports during April-September 2004 increased by 24.4 per cent in US dollar terms as compared with 8.1 per cent in the corresponding period of the previous year. India's merchandise export growth surpassed that of most Asian countries during this period. Imports rose faster by 34.3 per cent as against an increase of 21.0 per cent in the corresponding period of last year. Oil imports increased by 57.8 per cent as compared with 6.4 per cent. Non-oil imports increased by 25.8 per cent as against 27.4 per cent. The overall trade deficit widened to US \$ 12.7 billion from US \$ 7.4 billion in the corresponding period of the previous year. The higher trade deficit this year, in substantial part, reflects the high oil imports bill in the wake of

the hardening of international prices and also the growth in import demand emanating from a pick-up in economic activity as reflected in higher capital goods imports.

41. Destination-wise, India's exports to almost all the major regions/country groups recorded sharp improvement during April-June 2004. Exports to developing countries in Asia increased by about 40 per cent. Among the major partner countries, significant increases in exports were recorded in respect of Belgium, France, the UK, the US, the UAE, China, Hong Kong SAR, South Korea and Singapore.

42. The current account of the BoP had remained in surplus consecutively over the past three years. The first quarter of 2004-05 also posted a current account surplus of US \$ 1.9 billion. The trade deficit (on payments basis) of US \$ 6.3 billion was more than offset by invisibles, including private transfers, of US \$ 8.2 billion. In addition, there was a significant increase of US \$ 5.6 billion in net capital inflows comprising mainly foreign direct investment (US \$ 1.2 billion), commercial borrowings (US \$ 1.2 billion) and short-term credit (US \$ 1.6 billion). As a result, the net accretion to foreign exchange reserves, excluding valuation effects, amounted to US \$ 7.5 billion during April-June 2004.

43. During the second quarter of 2004-05, however, there are indications that the continuing uptrend in imports may result in the current account being only marginally in surplus assuming continued robust growth of merchandise exports and invisible earnings. Net capital inflows have moderated from the level recorded in the first quarter. While it is difficult to anticipate the behaviour of capital flows in the wake of the global geopolitical uncertainties, the positive sentiment on India should augur well for continued buoyancy, but some moderation should not be ruled out in view of turning of the global interest rate cycle.

44. The distinguishing features of the external sector during 2004-05 could be summed up as follows: First, import growth, both on oil and non-oil accounts, has been higher. While the former is reflective of higher international oil prices, the latter reflects the revival of investment demand as capital goods imports are strong. Second, exports have increased at a stronger pace and could maintain the momentum, given the positive outlook on global trade. Third, the trade deficit, however, may widen essentially on account of higher oil prices. Fourth, invisibles, particularly personal remittances, are expected to maintain the tempo on account of rebound in global growth and expanding activity in oil exporting Middle East countries. Fifth, the current account balance, which has remained in surplus over the last three years, may still show a marginal surplus. Sixth, capital inflows are expected to remain buoyant, *albeit* with some moderation relative to the previous year. Seventh, there could be a structural shift in capital inflows with more of foreign direct investment and short-term trade credit, the latter reflecting increasing openness and competitiveness of the industrial sector. Eighth, accretion to NRI deposits may slow down responding to alignment of interest rates with international rates.

Finally, it is reasonable to expect that accretion to reserves will continue, *albeit* not at the same pace as last year. Thus, management of liquidity arising out of external flows will continue to be challenging.

45. The annual policy Statements and mid-term Reviews have been continuously expressing concern over the unhedged foreign currency exposures of corporates in view of its implications for financial stability in the event of unforeseen adverse conditions. In the mid-term Review of November 2003, banks were advised to adopt a policy, which explicitly recognises and takes into account risks arising out of foreign currency exposures of their clients. Accordingly, it was advised that all foreign currency loans above US \$ 10 million or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures could be extended by banks on the basis of a well laid out policy of their Boards except in cases of export finance and loans for meeting forex expenditure. A recent study of select banks on the implementation of such prudential norms revealed that though most banks have adopted policies mandated by their Boards, banks often rely on 'natural hedge' available with their customers. Further, information on the total exposure of the corporate clients was also not readily available with banks. In view of the systemic risk, banks are encouraged to obtain information from their large borrowers on their unhedged forex exposures, so that the banks, in turn, can assess the risk of their own exposure to such corporates on an on-going basis.

Overall Assessment

46. In sum, from an overall policy perspective and in qualitative terms, some of the areas that need further attention could be as follows:

- (a) A striking development during the year relates to growth of non-food credit in the first half, which is traditionally a slack season for credit off-take: credit during the first half typically accounts for 20-40 per cent of the total credit for the year as a whole. A noticeable feature in the recent years was the subdued growth in non-food credit, though the second half of 2003-04 witnessed some pick-up. In addition to the liquidity conditions, the mid-term Review of November 2003 had addressed credit delivery as one of the central themes. While expressing a sense of satisfaction with credit growth in the later part of 2003-04, the annual policy Statement had anticipated credit pick-up to continue, and had accordingly stressed continuation of efforts to stimulate credit growth. A review of developments so far in the current year confirms that there has been a revival of investment activity. There is some evidence of expansion plans being brought forward and scaling up of production plans. To the extent manufacturing industry is showing signs of robust growth, the credit needs will witness higher growth than that in the past which was dominated by growth in the services sector. As a result of the current policy thrust, credit to agriculture is also picking up from its low base and

could initiate greater credit penetration by displacing non-institutional lenders. The fast growing housing and consumer credit sectors also represent some degree of higher penetration, but the quality of lending needs to be ensured. Overall, the pick-up in investment activity and growth in non-food credit appear to be broad based and are not temporary phenomena. These favourable outcomes point to the need for enabling liquidity conditions and a continued thrust on credit delivery to the productive sectors of the economy.

- (b) Growth in GDP is likely to be less than originally projected mainly due to deficient monsoon conditions and partly due to high and volatile oil prices, despite a better than anticipated outlook for manufacturing industry and export demand. The initiation of accelerated growth in manufacturing industry amidst global competitive pressures is a positive development and needs to be supported by policy to ensure its momentum. It is worth noting that manufacturing provides a good base for tax revenues in India. In view of the impressive business confidence, both domestically and internationally, it would be prudent for the policy to be predicated on an efficient and growing manufacturing sector, with resultant higher demands for credit.
- (c) In regard to prices, the annual policy Statement had referred to the overhang of problems on account of oil prices and large domestic liquidity. As it turned out, while overhang of excess liquidity was being managed, a supply shock emanated out of global developments, mainly on account of oil and a few other key commodities like iron & steel. Some pressures were anticipated, but not the magnitude of the supply shock and its persistence. Current indications are that the situation of uncertainty, high and volatile oil prices may persist during the rest of the year. Further, the full impact of oil price increases is yet to be absorbed in domestic prices. The supply factors, therefore, will continue to dominate the price situation, while demand management seems to invite closer attention than before, particularly for stabilising inflationary expectations in a credible manner. It is also necessary to recognise the risks of stronger adjustments that may be needed if less than adequate adjustments are made at the appropriate time, though the timing, the magnitudes as well as the instruments are based as much on judgements as on facts and projections.
- (d) The financial markets have, by and large, exhibited stability. The equity markets, which exhibited exceptional volatility in mid-May, have settled down to a normal state. The money market and forex market continue to be stable. The government securities market has tended to show some nervousness in recent months and was characterised by an overall bearish sentiment. Several inter-related aspects might have contributed to such a sentiment. First, the market was in need of correction from excessive optimism; second, there was an unexpected surge in inflation; third, the sharp increase in non-

food credit has also put some pressure on expectations; fourth, the global environment has tended towards some hardening of interest rates in recent months. While these developments were not fully unanticipated, and RBI had invited attention to them in the annual policy Statement, some market participants appear to have been less than fully prepared as the events unfolded. The Reserve Bank will continue to give some weight to consideration of stability but the markets should be prepared for the uncertainties. The extent of liquidity available as well as the strength of the external sector provides cushions against any undue pressure on financial markets. The market participants, in particular banks, have acquired some experience and considerable expertise in facing the uncertainties inherent in a market economy.

- (e) Conduct of monetary policy, in the best of times, is complex since it has to be forward looking and based on current and sometimes outdated data relative to rapid changes. Additional complexities arise in the case of an emerging market which is transiting from a closed to a progressively open economy. The overhang of liquidity impacts on the pace of change in the stance of monetary policy as also on the effectiveness of some operating instruments. Currently, the combination of factors that complicate monetary management includes: globally transmitted supply shock; less than normal monsoon conditions; persistence of liquidity overhang; and long-awaited pick-up in non-food credit. The policy has been responding to the evolving circumstances based on analysis and some judgements. First, in November 2003, there was a widespread expectation of further progress in soft bias in interest rate regime. A view was taken that the interest rate cycle had reached the bottom. Second, a judgement had to be made on capital flows in the early part of the current calendar year as to what part of the capital inflows should be treated as temporary. In this regard, the fact that international financial markets react asymmetrically to the same magnitude of growth in forex reserves (positively) and to the depletion in forex reserves (very negatively) cannot be lost sight of. Third, empirical evidence indicates that the perceptions of the financial markets in the context of changes in political executives in the Government cannot be ignored while monitoring developments. Fourth, when some central banks start moving from easy to more neutral policy and hike policy interest rates, there is an inevitable impact on Indian financial markets. In response to these developments, decisions have to be made on an ongoing basis, about the weight to be given to stability in financial markets relative to the possible costs of not altering the approaches. Fifth, when faced with a severe oil-shock, the first of its kind in the liberalised market-oriented environment in a semi-open economy, the governing thought in making judgements is the harmonisation of the communications and policy responses of RBI along with corresponding fiscal and corporate initiatives. Thus, the conduct of policy in the first half of the year was characterised by responses to developments on an ongoing and measured basis, giving appropriate weights,

contextually, to global and domestic factors, to growth and price stability, to efficiency and financial stability and to over-riding concerns for the common person. Operationally, it is expected that the challenge for the rest of the year would broadly remain the same, viz., management of liquidity in tune with the draining of the overhang, progress of borrowing programme of the Government, the evolving domestic and global situation, especially oil prices and global interest rate environment, but with equal weight to considerations of maintaining growth momentum and stabilising inflationary expectations.

II. Stance of Monetary Policy for the Second Half of 2004-05

47. The annual policy Statement of May 2004 had indicated that, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and assuming that the underlying inflationary situation does not turn adverse, the overall stance of monetary policy for 2004-05 will be:

- 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.
- 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.

48. Monetary management in the first half of 2004-05 was conducted broadly in conformity with the monetary policy stance announced in the annual policy Statement. However, monetary management faced severe challenges on two counts. One, overhang of liquidity. Two, acceleration in headline WPI inflation beyond the anticipated level with implications for inflationary expectations. While capital inflows were not at the level of the previous year, the carry forward of liquidity into the current fiscal was over Rs.81,000 crore. The liquidity balance was complicated further by a sharp increase in reserve money in the previous year emanating largely from build-up of excess cash balances by commercial banks towards the close of the year, in fact in the last week of March 2004.

49. The Reserve Bank sought to manage the liquidity essentially through two instruments, viz., MSS and LAF. As the volumes under MSS rose, the visible liquidity under LAF declined. The reduction of liquidity under LAF helped in stabilising the yield curve at the shorter end. This was evident from the CBLO rates, market repo rates and overnight call money rates inching closer to the LAF repo rate. It was, however, noticed that there was some bunching of liquidity due to the 7-day minimum tenor of LAF repo which imparted volatility to short-term rates, particularly around the time of primary auctions of government securities. Accordingly, overnight fixed rate repo under LAF was introduced in August, in place of overnight variable rate repo discontinued in April, to smoothen liquidity flow and contain volatility. While the excess liquidity has come down with the combined effect of a slowdown in capital inflows and better domestic absorption on account of higher credit demand, it still remains substantial at around Rs.67,000 crore as reflected in the combined volume of MSS and LAF.

50. There has been an understandable impact of the inflation scenario during the current year on the government securities market. As the headline WPI inflation accelerated, government debt market reacted with considerable volatility and an overall downward movement in the gilt prices. However, markets tended to stabilise as the causes of inflation and policy responses became apparent. Consultations with banks and the prudential guidelines on classification of investment portfolio of banks into held to maturity (HTM) category issued in September also helped to reassure the markets.

51. The upward pressure on WPI inflation largely emanated from trends in international commodity prices, particularly oil. As the WPI commodity basket covers the tradable items, it rose faster than the CPI. Unlike most countries, WPI continues to be the headline inflation rate in India for various reasons. However, the increasing openness of the economy has widened the wedge between WPI and CPI. Similar divergence between price indices at the producers' level and the consumers' level has been noticed for most countries except for countries in the euro area. As between the international and domestic factors, the former continues to be dominant in explaining the increase in WPI. The international factors relate primarily to prices of oil, iron ore, coal mining and iron & steel but also, to some extent, financial markets, including interest rates and exchange rates.

52. It may be necessary to capture some nuances in outlook for and measurement of inflation and their relationship with policy response in the current context of inflationary expectations. On the issue of outlook, the rapid increases in productivity and trade liberalisation enabling the globally least-cost producer to influence setting of prices, have tended to impart a downward bias. On the issue of appropriate index of inflation, analysts point out that WPI in India is similar to producers' price index (PPI) in other countries and that, in other countries, the headline inflation is usually the CPI. More important, internationally, empirical evidence shows that WPI or PPI tends to be more volatile than CPI.

53. In this context, a recount of the divergence between WPI and CPI could be instructive. Over the last five years, average WPI inflation was 4.6 per cent and CPI inflation was lower at 3.9 per cent. In the recent years, the year-on-year WPI inflation rate was higher in the range of 6.0-9.0 per cent during most parts of 2000-01. Again, inflation remained high in the range of 6.0-7.0 per cent for sometime during 2003-04. As these inflationary episodes were considered to be largely caused by supply side factors, the inflation rate reversed itself quickly once the supply situation stabilised.

54. While the headline inflation responds to both supply shocks and demand pressures, the nature of response could be quite different. The response of inflation to supply shocks is quick but transient. The response to demand shocks on the other hand, is more subtle but persistent. As indicated in the annual monetary and credit policy Statement of April 2001, a

factor which complicates the conduct of monetary policy during certain periods is the difficulty encountered in precisely assessing the potential inflationary pressures based on the available data for the current period. While there are uncertainties, it is perhaps useful to look at the recent inflation history for an assessment of inflationary expectations.

55. In the context of current inflation scenario, an issue of policy interest for financial management by banks and other market participants is whether, after a sharp decline in the past four years, the interest rate cycle has turned. As is well known, the outcome for interest rates depends mainly on the outlook for inflation, growth prospects and investment demand and it is not possible to predict short-run movements in interest rates, either up or down, without taking cognizance of possible movements in all other macroeconomic variables. These variables are also subject to unanticipated changes because of unforeseen domestic or external developments. However, the system has to recognise interest rate cycles and strengthen risk management processes to cope with eventualities so that financial stability could be maintained and interest rate movements could be passed in a non-disruptive manner.

56. As the overall assessment of the current inflation scenario shows that it is largely supply induced, the monetary authorities have to balance the pros and cons of using monetary policy instruments as a means of stabilising inflationary expectations. At the present juncture, the concern over inflation is a global phenomenon and different monetary authorities have responded differently, essentially tailoring their policy response according to their specific situations.

57. Given the large informal sector and the fact that a vast majority of population is not hedged against inflation, determined efforts are needed to contain inflationary expectations. In this context, careful assessment of facts and reasons on an ongoing basis is important for appropriate policy response: First, while the annual policy Statement had anticipated some upswing in prices, the actual increase was higher than expected. Second, the pick-up in inflation was predominantly a result of supply shock with global factors playing a critical part, though domestic factors such as liquidity overhang and monsoon conditions also played a role. Equally important, it is necessary to communicate the assessments and policy responses from time to time in a credible manner, both for financial markets and inflationary expectations.

58. Subsequent to the announcement of the annual policy Statement, the following calibrated responses were taken: First, the Reserve Bank communicated its assessment of the nature of inflation to the market on several occasions. Second, given the supply induced nature of inflation, the Government responded with fiscal measures, particularly relating to oil. The fiscal actions and some responses from corporates on moderating the exercise of their pricing power were part of the measured but harmonised responses along with monetary policy actions in liquidity management. Third, in order to enable the Reserve Bank to address the

overhang of liquidity, the Government raised the ceiling of MSS from Rs.60,000 crore to Rs.80,000 crore. Fourth, for a more flexible management of liquidity, overnight fixed rate repo under LAF was introduced. Fifth, CRR was raised by one-half of one percentage point to 5.0 per cent. This measure reduced the liquidity in the banking system by about Rs.9,000 crore. Further, the interest rate on eligible CRR balances was delinked from the Bank Rate and was reduced to 3.5 per cent per annum. However, Reserve Bank will continue to pursue its medium-term objective of reducing CRR to its statutory minimum of 3.0 per cent. The Reserve Bank chose to increase the CRR, partly for absorbing liquidity in the system, but more importantly for signalling the Bank's concern at the unacceptable levels of inflation so that inflationary expectations are moderated while reiterating the importance of stability in financial market conditions.

59. The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity through OMO including LAF, MSS and CRR, and using the policy instruments at its disposal flexibly, as and when the situation warrants.

60. In the Part I of this Review, detailed discussions have been presented on the likely levels of major macroeconomic and monetary aggregates after assessing the relevant factors. In light of the discussion, for the purpose of monetary management: (i) GDP growth in 2004-05 is placed in the range of 6.0 to 6.5 per cent as against 6.5-7.0 per cent envisaged earlier under certain assumptions; (ii) inflation, on a point-to-point basis, could be around 6.5 per cent as against 5.0 per cent projected earlier; (iii) expansion in M_3 would be around 14.0 per cent as projected earlier; (iv) growth in aggregate deposits would be Rs.2,18,000 crore as projected earlier; and (v) non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., is expected to increase by around 19.0 per cent, higher than 16.0-16.5 per cent projected earlier; the higher credit expansion could be accommodated without putting undue pressure on money supply because of lower borrowing of the Government from the banking sector; in the eventuality of government borrowings being larger, unwinding of MSS would facilitate such borrowings.

61. Since the announcement of the annual policy Statement in May 2004, the world economic outlook has remained stable though there are some positives and some concerns in the domestic economy: GDP growth may turn out to be slightly lower; whereas WPI inflation has firmed up, CPI inflation remains moderate; interest rates in the money and government securities markets have increased; interest rates in the bank credit and deposit markets have remained stable; the forex market also remained stable; expansion in money supply is within the trajectory and excess liquidity has remained sterilised; credit demand has been far more

than anticipated; business outlook is turning out to be increasingly positive; the current account may still show a marginal surplus and capital inflows remain somewhat buoyant.

62. Looking forward, the overhang problems arising out of high international oil prices and continued high domestic liquidity continue, *albeit* with some moderation. There are considerable uncertainties regarding the future course of oil prices and how the shock would turn out to be globally and how it could be absorbed domestically. The increase in international oil prices is yet to be reflected fully in the domestic economy. The secondary effect of oil price increase is not yet very apparent. The large first half increase in domestic credit is likely to be sustained in the rest of the year.

63. In sum, consistent with the developments during the first half of the year, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and keeping in view the inflationary situation, the overall stance of monetary policy for the second half of 2004-05 will be:

- Provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability.
- Consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth.
- To consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

III. Financial Sector Reforms and Monetary Policy Measures

64. The annual policy Statements as well as mid-term Reviews of RBI have been focusing on the structural and regulatory measures to strengthen the financial system. In the context of opening up of the economy, as deregulation continues, the emphasis on regulatory practices has shifted towards effective monitoring and assurance of implementation of regulations. In this direction, the measures aim at increasing the operational effectiveness of monetary policy, redefining the regulatory role of RBI, strengthening the prudential and supervisory norms and developing the institutional infrastructure. The management of financial sector over the years has been oriented towards rebalancing between efficiency and stability and sound public policies for successful economic integration. The Reserve Bank is continuously working towards consolidating the gains of the financial sector reforms by further broadening the consultative process. While the emphasis, at this stage, is on reinforcing corporate governance within financial institutions, the focus is also on enhancing the credit delivery mechanism and facilitating ease of transactions by the common person. This Section reviews the progress of implementation of the measures already taken and proposes some further measures to carry forward the process of financial sector reforms.

Monetary Measures

(a) *Bank Rate*

65. In the annual policy Statement of April 2003, the Bank Rate was reduced from 6.25 per cent to 6.0 per cent with effect from the close of business on April 29, 2003. On a review of the macroeconomic developments, it is considered desirable to leave the Bank Rate stable (at 6.0 per cent) at present.

(b) *Repo Rate*

66. In view of the current macroeconomic and overall monetary conditions, it has been decided:

- To increase the fixed repo rate by 25 basis points under the liquidity adjustment facility (LAF) of the Reserve Bank effective from October 27, 2004 to 4.75 per cent from 4.50 per cent.

67. The reverse repo rate will continue to be linked to the repo rate, as at present. However, the spread between the repo rate and the reverse repo rate is reduced by 25 basis

points from 150 basis points to 125 basis points with effect from October 27, 2004. Accordingly, the fixed reverse repo rate under LAF will continue to remain at 6.0 per cent.

68. As already announced, it is proposed to switchover to the international usage of the terms 'repo' and 'reverse repo' effective October 29, 2004. With such a switchover, the fixed reverse repo rate will be 4.75 per cent and the repo rate will be available with a spread of 125 basis points at 6.0 per cent.

(c) Revised Liquidity Adjustment Facility

69. As indicated in the annual policy Statement, a revised liquidity adjustment facility (LAF) scheme was operationalised effective March 29, 2004 on the basis of recommendations of an Internal Group on LAF after extensive discussions with market participants and experts. The Group had observed that "it would be desirable to de-emphasise the passive sterilisation attribute of the LAF repo facility so that it could emerge as the exclusive policy signaling rate". The operationalisation of MSS to absorb liquidity of more enduring nature has considerably reduced the burden of sterilisation on the LAF window. Accordingly, the repo volumes tendered under LAF declined markedly from an average of Rs.70,523 crore in April 2004 to Rs.4,010 crore as on October 21, 2004. With a view to enhancing further the effectiveness of LAF and to facilitate liquidity management in a flexible manner, it is proposed that:

- Liquidity adjustment facility (LAF) scheme would be operated with overnight fixed rate repo and reverse repo with effect from November 1, 2004. Accordingly, auctions of 7-day and 14-day repo (reverse repo by international parlance) would stand discontinued from November 1, 2004.

70. The Reserve Bank will continue to have the discretion to conduct overnight/longer term repo/reverse repo auctions at fixed rate or at variable rates depending on market conditions and other relevant factors. In addition, as already advised, LAF participants are required to switchover to the international usage of the terms 'repo' and 'reverse repo' effective October 29, 2004. Accordingly, absorption of liquidity by the Reserve Bank in the LAF window will be termed as 'reverse repo' and injection of liquidity as 'repo'.

Interest Rate Policy

(a) Ceiling on Interest Rates on NRE Deposits

71. With a view to aligning interest rates on Non-Resident (External) Rupee (NRE) deposits with international interest rates, ceiling on NRE deposit rates linked to the US dollar LIBOR/SWAP rates of corresponding maturities was introduced effective July 17, 2003. The

ceiling interest rates on NRE deposits have since been revised from time to time. On a review, it is proposed:

- To raise the ceiling on NRE interest rates to LIBOR/SWAP rates of US dollar of corresponding maturities plus 50 basis points from the existing level of US dollar LIBOR/SWAP rates.

(b) Fixation of Interest Rates on FCNR(B) Deposits

72. At present, interest rates are fixed on weekly basis for FCNR(B) deposits, while interest rates are fixed on monthly basis in respect of NRE deposits. Based on the suggestions received from banks and with a view to bringing in consistency in the procedure of fixing interest rates, it is proposed that:

- Banks may fix the ceiling on interest rates on FCNR(B) deposits on monthly basis for the following month based on rates prevailing as on the last working day of the preceding month. The ceiling interest rates on FCNR(B) deposits, however, would continue to be at LIBOR/SWAP minus 25 basis points as hitherto.

(c) Reduction of Tenor of Domestic Term Deposits

73. At present, while the minimum maturity of wholesale domestic term deposits (Rs.15 lakh and above) is 7 days, it continues to be 15 days for retail domestic term deposits (under Rs.15 lakh). In order to provide uniformity in the tenor of term deposits, it is proposed that:

- Banks, at their discretion, can reduce the minimum tenor of retail domestic term deposits (under Rs.15 lakh) from 15 days to 7 days.

74. Banks, however, would continue to have the freedom to offer differential rates of interest on wholesale domestic term deposits of Rs.15 lakh and above as at present.

Credit Delivery Mechanism

75. In continuation of several measures taken to create a conducive environment for banks to provide adequate and timely finance at reasonable rates to different sectors of the economy, and keeping in view the imperative need for removal of bottlenecks in credit delivery mechanism, the following measures/initiatives are proposed:

(a) Service Area Approach: Removal of Restrictive Provisions

76. As recommended by the Vyas Committee, with a view to facilitating banks to improve their credit delivery mechanism, it is proposed:

- To dispense with the restrictive provisions of service area approach except for government sponsored programmes.

77. Modalities and operational guidelines will be issued in consultation with the Government and NABARD.

(b) Priority Sector Lending

(i) Enhanced Lending to Agriculture and Distribution of Inputs

78. As recommended by the Vyas Committee, with a view to further improving credit delivery to the agriculture sector, it is proposed:

- To increase the limit on advances under priority sector for dealers in agricultural machinery from Rs. 20 lakh to Rs.30 lakh and for distribution of inputs for allied activities from Rs.25 lakh to Rs.40 lakh.

(ii) Enhanced Lending to Small and Marginal Farmers

79. As recommended by the Vyas Committee, in order to improve flow of credit to small and marginal farmers, it is proposed that:

- Banks should make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under special agricultural credit plans (SACP) by March 2007.

(iii) Special Agricultural Credit Plans

80. With a view to achieving the priority sector lending target for agriculture, public sector banks are required to formulate SACP. In order to enhance flow of credit to agriculture, it is proposed to extend the SACP mechanism to private sector banks. Accordingly:

- All private sector banks are urged to formulate special agricultural credit plans from the year 2005-06, targeting an annual growth rate of at least 20-25 per cent of credit disbursements to agriculture.

(iv) Enhancement of Composite Loan Limit to SSI Units

81. At present, banks extend composite loans to SSIs through a 'single window' system for fixed assets and working capital requirements up to a limit of Rs.50 lakh. In order to facilitate smooth flow of credit to SSIs, it is proposed:

- To enhance the composite loan limit for SSI entrepreneurs from Rs.50 lakh to Rs.1 crore.

(v) Investment by Banks in Securitised Assets Pertaining to SSI Sector

82. In order to encourage securitisation of loans to SSI sector, it is proposed that:

- Investments made by banks in securitised assets representing direct lending to the SSI sector would be treated as their direct lending to SSI sector under priority sector, provided the pooled assets represent loans to SSI sector which are reckoned under priority sector and the securitised loans are originated by banks/financial institutions.

(vi) Housing Loan: Enhancement of Ceiling

83. At present, banks' direct finance for housing up to Rs.10 lakh in rural and semi-urban areas is treated as priority sector lending. In order to further improve flow of credit to the housing sector, it is proposed that:

- Banks, with the approval of their Boards, may extend direct finance to housing sector up to Rs.15 lakh, irrespective of location, as part of their priority sector lending.

(c) Financing of Distressed Urban Poor

84. With a view to bringing in urban poor into formal financial system, it is proposed that:

- Banks may advance loans to distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group security.

(d) Micro-finance

85. The Reserve Bank has taken a number of initiatives, over the years, for mainstreaming micro-credit and enhancing the outreach of micro-credit providers. As on end-March 2004, about 1.1 million self help groups (SHGs) were linked to banks covering 16 million poor

families. Total flow of credit was Rs.3,900 crore with an average loan of Rs.36,000 per SHG and Rs.2,400 per family. Banks are encouraged to further strengthen this process.

86. As per announcement in the Union Budget for 2004-05, credit linking of 5.85 lakh SHGs needs to be completed by March 2007. Specific steps are being taken to identify district level bottlenecks in regions where linkage has been relatively low.

(e) Kisan Credit Card Scheme: Follow-up of Survey

87. Over the years, the kisan credit cards (KCC) scheme has been modified to include term loans for agriculture and allied activities besides a reasonable amount of credit to meet the consumption needs. Public sector banks have issued 14.42 million KCCs up to end-July 2004.

88. As indicated in the annual policy Statement, the National Council of Applied Economic Research (NCAER), conducted a national impact assessment survey of KCC scheme. The survey identified areas where further fine-tuning is needed, viz., restrictions imposed on the issuance of KCCs by security conscious banks; restrictions on the use of KCCs only at card issuing branches; non-availability of incentives/rewards to borrowers for timely repayments; low credit limits to meet the farmers' requirements and low awareness level regarding the provision of the personal accident insurance scheme. With a view to further improving the flow of credit to agricultural sector under the scheme, IBA has been advised to look into these suggestions and take remedial action.

(f) Rural Infrastructure Development Fund: Status

89. The rural infrastructure development fund (RIDF) was established in NABARD to extend credit to state governments for developing rural infrastructure. The total allocation under RIDF (I to X) since its inception was Rs.42,000 crore with total disbursement of Rs.21,742 crore. As announced in the Union Budget for 2004-05, RIDF X has been established with a corpus of Rs.8,000 crore.

(g) Debt Restructuring Mechanism for Medium Enterprises

90. As indicated in the annual policy Statement, a Special Group was constituted (Chairman: Shri G. Srinivasan) to formulate a mechanism for restructuring the debt of medium sector enterprises on the lines of the corporate debt restructuring (CDR), with members from SIDBI and commercial banks. The Group is expected to submit its Report soon which will be placed in the public domain.

(h) Regional Rural Banks

91. Regional rural banks (RRBs) are an important instrument for purveying rural credit. In order to strengthen RRBs: weak RRBs were recapitalised, lending to non-target group was relaxed, deposit and lending rates were deregulated. The Reserve Bank has constituted Empowered Committees in its Regional Offices with members drawn from NABARD, sponsor banks, conveners of SLBCs and state governments to ensure that the RRBs adhere to good governance and comply with prudential regulations. The Committees would also focus on operational issues and provide clarifications on regulatory issues. State governments are being requested to remove discrimination between RRBs and co-operative banks in matters of stamp duty, mortgage fee etc. State governments are also being requested to accord approval of merger of RRBs within the state, sponsored by the same bank, as and when approached with such proposals. Sponsor banks are advised to provide support to their RRBs in matters relating to efficient management, training of staff, computerisation and networking of their activities.

(i) Revival of Rural Co-operative Banks: Status

92. The Government has appointed a Task Force (Chairman: Prof. A. Vaidyanathan) to propose an action plan for reviving the rural co-operative banking institutions and suggest an appropriate regulatory framework for these institutions. The Task Force is expected to submit its Report shortly.

(j) Lending to Agriculture: Review of Progress

93. The Government announced a package of measures on June 18, 2004 aimed at doubling the agricultural credit in three years with a credit growth of 30 per cent for 2004-05. Pursuant to the announcement, RBI and IBA issued guidelines to commercial banks, while NABARD issued similar guidelines to co-operative banks and RRBs. These guidelines include: (i) debt restructuring and provision of fresh loans to farmers affected by natural calamities; (ii) one time settlement for small and marginal farmers; (iii) fresh finance for farmers whose earlier debts have been settled through compromise or write-off; and (iv) relief measures for farmers indebted to non-institutional lenders. While the progress is encouraging, banks are urged to keep up the momentum.

(k) Liberalisation of Bank Finance to NBFCs

94. In view of the expertise gained by NBFCs in financing second hand assets and to encourage credit dispensation, it is proposed that:

- Banks may, henceforth, extend finance to NBFCs against second hand assets financed by them, provided suitable loan policies duly approved by the banks' Boards are put in place.

(l) Gold Card Scheme for Exporters: Status

95. As indicated in the annual policy Statement, guidelines on gold card scheme for creditworthy exporters with good track record, for easy availability of export credit, were issued to banks. Most of the public sector banks and many private sector and foreign banks have since announced such schemes, offering better terms of credit and rates to the gold card holders.

(m) Report of Working Group on Credit Enhancement by State Governments

96. As indicated in the annual policy Statement, the Working Group on Credit Enhancement by State Governments, is examining the instruments of credit enhancement which the state governments could offer to improve the rating/borrower capability of state PSUs/SPVs in order to attract institutional financing for infrastructure projects. The Group is expected to submit its Report shortly.

Money Market

97. With a view to preserving the integrity of money market and making it more efficient, a number of measures were undertaken in recent years. Further measures in this direction are as under:

(a) Moving towards Pure Inter-bank Call/Notice Money Market

98. At present, non-bank entities could lend, on average in a reporting fortnight, up to 45 per cent of their average daily lending in call/notice money market during 2000-01. In view of further market developments as also to move towards a pure inter-bank call/notice money market, it is proposed that:

- With effect from the fortnight beginning January 8, 2005, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 30 per cent of their average daily lending in call/notice money market during 2000-01.

99. However, as indicated in the earlier policy Statements, in case a particular non-bank institution has genuine difficulty in developing proper alternative avenues for investment of

excess liquidity because of its size, RBI may consider providing temporary permission to lend a higher amount in call/notice money market for a specific period on a case by case basis.

(b) Commercial Paper

100. With a view to developing the commercial paper (CP) market further, a status paper was placed on RBI website which was discussed with market participants as well as in the Technical Advisory Committee on money, foreign exchange and government securities markets (TAC). Taking into account the suggestions and market response, the following measures are proposed:

- In order to provide an option to issuers to raise short-term resources through CP as also an avenue to investors to invest in quality short-term papers, the minimum maturity period of CP is reduced from 15 days to 7 days with immediate effect.
- In order to provide transparency and also facilitate benchmarking of CP issues, issuing and paying agents (PAs) would report issuance of CP on the negotiated dealing system (NDS) platform by the end of the day. The date of commencement of reporting would be finalised in consultation with market participants.
- With a view to moving towards settlement on T+1 basis, a Group comprising market participants would be constituted to suggest rationalisation and standardisation in respect of processing, settlement and documentation of CP issuance.

(c) Collateralised Borrowing and Lending Obligation

101. As proposed in the annual policy Statement, automated value-free transfer of securities between market participants and the CCIL was facilitated to further develop the collateralised borrowing and lending obligation (CBLO) segment.

Government Securities Market

102. The Reserve Bank has taken several structural and developmental measures for deepening and widening the government securities market. In this direction, some of the recent initiatives are highlighted below:

(a) Negotiated Dealing System: Next Step

103. As indicated in the annual policy Statement, a Working Group (Chairman: Dr.R.H. Patil) reviewed the performance of NDS in the context of its operational efficiency and recommended

an anonymous electronic screen based order matching trading system on the NDS. The Report of the Group is being placed in the public domain for wider dissemination.

(b) Introduction of Capital Indexed Bonds

104. As indicated in the annual policy Statement, a discussion paper on the capital indexed bonds (CIBs) was put on the websites of RBI and the Government for comments. In this regard, market conventions for secondary market trading and settlement of the bonds are being finalised in consultation with Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI). Suitable modifications in the PDO-NDS trading, clearing and settlement system are being undertaken. It is expected that CIBs could be introduced during the year 2005-06 in consultation with the Government.

(c) Working Group on Primary Dealers

105. In order to evaluate the role of Primary Dealers (PDs) in the government securities market with particular emphasis on their obligation and ability to cope with emerging risk and possible diversification of their balance sheets, a sub-group (Chairman: Dr.R.H. Patil) of the TAC was constituted. The Report of the sub-group is being placed before the TAC for advice to enable further action.

(d) Settlement of OTC Derivatives through CCIL: Status

106. As indicated in the annual policy Statement, 'in principle' approval was accorded to CCIL for implementation of a clearing arrangement for OTC derivatives. CCIL has since developed the pricing and risk models for this process, which are being fine-tuned on the basis of market feedback. The clearing arrangement is expected to be operationalised by March 2005.

(e) Group on Corporate Debt: Status

107. With a view to further developing the corporate debt market, a Group was constituted with members from RBI, SEBI and other market participants. The Group, *inter alia*, would examine the issues relating to primary issuances as well as growth of secondary market; regulatory aspects for the development of Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS); and trading, settlement and accounting of corporate debt securities. The Group is expected to submit its Report in January 2005.

(f) Market Stabilisation Scheme: Review

108. As indicated in the annual policy Statement, in order to facilitate sterilisation of excess liquidity in a transparent manner, market stabilisation scheme (MSS) was introduced in March 2004. The ceiling on the outstanding obligation of the Government under the scheme has been raised from Rs.60,000 to Rs.80,000 crore. The threshold level of the ceiling for further review is placed at Rs.70,000 crore. Treasury Bills and dated securities with a face value of Rs.54,146 crore were issued under the MSS up to October 21, 2004, out of which dated securities amounted to Rs.25,000 crore.

(g) Strengthening OMO Framework

109. The Fiscal Responsibility and Budget Management Act stipulates that, with effect from April 1, 2006, RBI's participation in primary issues of government securities will stand withdrawn. Consequently, open market operations (OMO) will become a more active instrument, warranting a review of processes and technological infrastructure consistent with market advancements. The Reserve Bank's intervention directly in the market or through PDs on a real time basis may become necessary. A Study Group will be constituted for strengthening OMO framework to address these emerging needs and equip RBI as well as the market participants appropriately.

Foreign Exchange Market

110. In order to further simplify the systems and procedures to offer better customer service as also to continue with the liberalisation process, the following measures are proposed:

(a) Issue of Guarantee for Trade Credits: Liberalisation

111. At present, authorised dealers (ADs) are required to obtain RBI approval for issue of guarantees, letters of undertaking or letters of comfort in favour of overseas suppliers or banks for their importer clients. In order to promote investment activity and to further liberalise the procedures relating to trade credits on imports, it is proposed:

- To accord general permission to ADs to issue guarantees/letters of comfort and letters of undertaking up to US \$ 20 million per transaction for a period up to one year for import of all non-capital goods permissible under Foreign Trade Policy (except gold) and up to three years for import of capital goods, subject to prudential guidelines.

(b) Export Oriented Units: Relaxation of Time Limit for Export Realisation

112. At present, all status holder exporters are permitted a time period of twelve months for realisation and repatriation of export proceeds. In line with the announcement made in Government's Foreign Trade Policy in September 2004, it is proposed that:

- 100 per cent EOUs and units set up under EHTPs, STPs and BTPs schemes would be permitted to repatriate the full value of export proceeds within a period of twelve months.

(c) Booking of Forward Contracts: Relaxation

113. At present, importers/exporters are permitted to book forward contracts on the basis of past performance (without production of the underlying documents) up to the average of their past three years' or the previous year's turnover, whichever is higher. While outstanding contracts under the facility at any point of time should not exceed 50 per cent of the eligible limit, contracts booked in excess of 25 per cent of the eligible limit are not allowed to be cancelled. Further, importers/exporters are required to approach RBI for approval of higher limits. In order to further liberalise the process, it is proposed:

- To increase the limit for outstanding forward contracts booked by importers/exporters, based on their past performance, from 50 per cent to 100 per cent of their eligible limit. However, the contracts booked in excess of 25 per cent of the eligible limits would be on deliverable basis.

(d) Forex Market Group

114. In order to review comprehensively the initiatives taken by RBI so far in the foreign exchange market and identify areas for further improvements, it is proposed to constitute an internal Group. The Group would look into the market developments and liberalisation process in terms of products/participants and their impact, regulatory regime in the current and evolving circumstances, international experience relating to markets and suggest appropriate approaches for further liberalisation. The Group would consult with market participants and the TAC and submit its Report within three months.

(e) Survey on Impact of Trade Related Measures

115. Over the years, RBI has taken a number of measures to reduce the cost of trade related transactions to exporters. A survey on transaction cost for exporters undertaken by EXIM Bank, in select ten sectors, revealed that transaction cost had decreased to 1-10 per cent of the export revenue from the earlier range of 10-15 per cent. In view of the substantial

relaxation and simplification of procedures in the recent period, it is proposed to undertake a fresh survey for evaluation of the impact of these measures on the transaction cost for exports.

Prudential Measures

116. Since announcement of the annual policy Statement, several steps have been taken for further deregulation while ensuring best prudential risk management practices. Guidelines for issue of long-term bonds by banks, introduction of graded higher provisioning according to the age of NPAs, increased risk weight for exposure to PFIs, enhanced coverage of country risk management guidelines, implementation of KYC norms to combat money laundering and financing of terrorism are steps to foster better risk management practices in banks. Further, enhancement of single and group borrowers exposure norms and relaxation on unsecured exposure limits have provided increased operational flexibility to banks to improve credit delivery. The Standing Technical Advisory Committee on Financial Regulation and the institution of a mechanism for inter-regulatory exchange of information would further enhance the transparency and consultative process. Further measures proposed in this area are as under:

(a) Migration to Basel II Norms: Next Steps

117. As indicated in the annual policy Statement, Basel Committee on Banking Supervision (BCBS) issued the New Capital Accord (Basel II) in June 2004. A seminar for the chief executives of select banks was conducted in July 2004 to sensitise banks on the framework, opportunities and challenges emerging out of Basel II norms. Banks were also advised to undertake a self assessment of their existing risk management systems taking into account the three major risks covered under Basel II and to concurrently initiate appropriate measures to upgrade them to match up to the minimum standards prescribed under Basel II. Further, in view of the complexities involved in migrating to Basel II, a Steering Committee comprising members from banks, IBA and RBI has been constituted. The Steering Committee would form sub-groups for purposes of assisting it on various matters. On the basis of the inputs received from the Steering Committee, RBI would prepare draft guidelines for implementation of Basel II norms and place them in the public domain.

(b) Draft Guidelines on Ownership and Governance

118. With a view to reducing concentration of shareholding and control in banks and ensuring corporate governance, a comprehensive policy framework for ownership and governance in private sector banks was issued and placed in public domain for wider discussion. Based on the responses received and dialogues with various stakeholders, a second draft on the policy framework has been finalised and will be put in public domain soon.

(c) *Fit and Proper Criteria for Directors of Banks: Status*

119. As indicated in the mid-term Review of October 2001, the Consultative Group of Directors of Banks and FIs (Chairman: Dr. A.S. Ganguly) had made a number of suggestions to strengthen the supervisory role of Boards of banks and FIs. Accordingly, banks were advised to place the Report before their Boards and implement the recommendations, which were within the regulatory ambit of RBI. Further, on the basis of the recommendations of the Group, private sector banks were advised: (i) to undertake a process of due diligence to determine the suitability of the person for appointment/continuing to hold appointment as a director on the Board, based upon qualification, expertise, track record, integrity and other 'fit and proper' criteria; (ii) to obtain necessary declaration and undertaking from the proposed/existing directors in a prescribed format; and (iii) to constitute Nomination Committees by their Boards to scrutinise such declarations. Necessary instructions have already been issued to the private sector banks in this regard.

(d) *Transparency: Public Disclosure of Penalties/Directions*

120. In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks were advised on October 19, 2004 that all cases of penalty imposed by RBI as also strictures/directions on specific matters including those arising out of inspection will be placed in the public domain.

(e) *Warehouse Receipts and Commodity Futures: Role of Banks*

121. Farmers are vulnerable to price risk and the emerging commodity futures exchanges in the country are expected to help minimise such risk. With a view to examining the role of banks in providing loans against warehouse receipts and evolving a framework for participation of banks in commodity futures markets, it is proposed:

- To set up a Working Group with members from RBI, IBA, Forward Markets Commission (FMC) and banks.

(f) *Review of Corporate Debt Restructuring Mechanism*

122. As indicated in the annual policy Statement of April 2003, the corporate debt restructuring (CDR) mechanism operationalised in March 2002 was last reviewed by a High Level Group (Chairman: Shri Vepa Kamesam). A recent review of the operation of the scheme revealed that nearly one-third of the units assisted under the scheme has improved their financial position. However, from the systemic point of view, issues relating to proper identification and successful implementation of packages along with other operational aspects

need to be addressed. Accordingly, a Special Group was constituted to review the performance of the CDR mechanism and suggest further measures to make it more effective. The Group is expected to submit its Report by December 2004.

(g) Housing Loans and Consumer Credit: Temporary Risk Containment

123. It is observed in the recent past that the growth of housing and consumer credit has been very strong. As a temporary counter cyclical measure, it is proposed:

- To put in place, risk containment measures and increase the risk weight from 50 per cent to 75 per cent in the case of housing loans and from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards.

(h) Banks' Investment in Non-SLR Securities: Status

124. As indicated in the annual policy Statement, prudential guidelines on non-SLR investments were issued to banks giving a transition period up to end-December 2004 for compliance. However, a study of select banks revealed that banks continue to have significant share of unlisted and unrated investments in their non-SLR portfolio. Accordingly, banks are urged to prepare themselves to comply with the prudential requirements within the prescribed timeframe.

(i) Prudential Norms for Classification of Doubtful Assets for FIs

125. With a view to moving closer to international best practices and ensuring convergence of the norms applicable to the FIs with those of the banks, it is proposed that:

- With effect from March 31, 2005, in respect of FIs, an asset would be classified as doubtful, if it remained in the sub-standard category for 12 months. FIs are permitted to phase out the consequent additional provisioning over a four-year period.

(j) Approach for Supervision of Financial Institutions

126. As indicated in the mid-term Review of November 2003, the Report of the Working Group on Development Finance Institutions (Chairman: Shri N. Sadasivan) was placed in the public domain for wider dissemination. On the basis of the recommendations of the Working Group and the feedback received thereon, the following approaches for supervision of the DFIs and large NBFCs are proposed:

- The Reserve Bank would continue to supervise NABARD, SIDBI, NHB and EXIM Bank as hitherto.
- The Reserve Bank would supervise DFIs which accept public deposits.
- DFIs and large NBFCs not accepting public deposits but having asset size of Rs.500 crore and above would be subject to limited off-site supervision by RBI.

(k) Dissemination of Credit Information by CIBIL

127. As indicated in the annual policy Statement, banks/FIs were advised to obtain the consent of all their borrowers for dissemination of credit information to enable Credit Information Bureau of India Ltd. (CIBIL) to compile and disseminate credit information. It was reported by a major nationalised bank that they have submitted credit information relating to 80 per cent of their eligible borrowers after obtaining necessary consents. Banks are urged to make persistent efforts in obtaining consent from all their borrowers, in order to establish an efficient credit information system, which would help in enhancing the quality of credit decisions and improving the asset quality of banks, apart from facilitating faster credit delivery.

(l) Working Group on Conflicts of Interest in the Indian Financial Services Sector

128. There is increasing concern internationally about the impact of the conflicts of interest in the financial sector. Legislative and regulatory measures have been adopted by different countries to ensure that conflicts of interest are not allowed to compromise the interest of stakeholders and public at large. These measures are intended to have positive impact on investor confidence, efficacy of the regulatory framework and, above all, the credibility of those associated with the financial services. Accordingly, in consultation with Chairman, SEBI and Chairman, IRDA, it is proposed:

- To constitute a Working Group on avoidance of conflicts of interest. The Working Group will identify the sources and nature of potential conflicts of interest, the international practices to mitigate this problem, the existing mechanisms in India in this regard and make recommendations for avoidance of such conflicts of interest. The Group would submit a Report in four months.

Urban Co-operative Banks

(a) Vision Document

129. The urban co-operative banks (UCBs) are playing a crucial role in the Indian financial system in channelising funds and bridging the financing gaps in respect of small and medium borrowers. As at end-March 2004, there were 1,926 UCBs with over 8,000 branches, with deposits accounting for 7.5 per cent of deposits of the banking system. Nearly 45 per cent of the UCBs accounting for 55 per cent of the deposit base of the sector are considered financially sound. In the context of the current economic scenario and problems faced by the co-operative banking sector, several initiatives were taken in consultation with the federations and associations of co-operative banks. These include: deferring the application of 90 day NPA norm for small loans and gold loans up to Rs.1 lakh by two years, giving additional time for meeting the prescribed provisioning requirements for assets classified in doubtful category, permission to transfer government and other approved securities up to 25 per cent to HTM category.

130. A vision document for the future role of UCBs is being evolved to ensure depositors' interests and avoid contagion while providing useful service to local communities. In regard to structural issues, RBI would be encouraging growth of strong and viable entities within the sector through consolidation. Further, RBI would continue to pursue with the state and Central governments regarding the issues that arise in their jurisdiction.

(b) Standing Advisory Committee on Urban Co-operative Banks

131. The Standing Advisory Committee on UCBs, a high powered body chaired by Deputy Governor, RBI, comprising members from the Government, select state governments, IBA, DICGC, NABARD and federations of UCBs advises RBI on matters relating to the UCB sector. With a view to reinforcing the consultative process in a more constructive manner, to address the structural/regulatory and supervisory issues relating to UCBs and facilitating the process of formulating future approaches for this sector, the Committee would meet on a quarterly basis in future.

Non-banking Finance Companies

(a) Road Map for Residuary Non-banking Companies

132. Residuary non-banking companies (RNBCs) are a class of NBFCs which accept public deposits from public and are required to invest 80 per cent of their deposits in the prescribed categories stipulated by RBI from time to time and the remaining 20 per cent at their discretion. Over a period, their deposits have grown substantially, with just two companies accounting for more than 80 per cent of total public deposits held by all NBFCs. In order to rationalise the pattern of the directed investments and address the systemic risk, and with a view to protecting depositors' interest, the level of investments in government securities was increased, and rating

and listing requirements in respect of other approved investments were introduced in June 2004. RNBCs were advised to reduce their discretionary investment to 10 per cent of their deposits by April 2005 and completely disperse with it from April 2006. RNBCs represented that the restriction on discretionary investments would affect their viability and also requested for some modifications in other prudential stipulations.

133. With a view to smoothening the process of transition of RNBCs to compliance with RBI's directions, the following approach is proposed:

- Investments of RNBCs in certificates of deposit of financial institutions which have a minimum rating of AA+ at the time of investment will be reckoned as eligible securities as long as they have minimum investment grade rating.
- Current account balances of RNBCs with commercial banks would be considered as eligible investments.
- The investments of RNBCs in bonds and debentures of companies which meet stipulated listing and rating requirements at the time of investment will be considered as ineligible investments if they migrate to below the investment grade rating.

134. In order to ensure that the depositors are served appropriately and systemic risks are avoided, RBI intends to focus on improvements in the functioning of RNBCs. These include: (i) transparency of operations, especially in the connected lending relationships; (ii) corporate governance standards including professionalisation of the Boards and ensuring 'fit and proper' criteria in consonance with the standards in banks; (iii) avoiding untenable rates of commission to agents; (iv) adherence to 'know your customer' rules through systems consistent with their business but subject to regulator's close oversight; and (v) customer service in terms of clear indication of the identifiable contact with the field agents so that matters such as unclaimed deposits are appropriately addressed. Detailed guidelines in regard to action to be taken by RNBCs on the above would be issued separately.

(b) Non-banking Financial Companies: Phasing out of Public Deposits

135. At present, NBFCs accepting public deposits are regulated and supervised by RBI. Over a period, the dependence of the NBFCs (other than RNBCs) on public deposits as part of their overall resources has declined. The deposits of NBFCs declined from Rs.6,500 crore in 2000-01 (17.2 per cent of their total liabilities) to Rs.3,400 crore in 2003-04 (12.7 per cent of the total liabilities). The number of deposit taking NBFCs has also reduced from 996 in 1997 to 577 by September 2004. Internationally, acceptance of public deposits is restricted to banks, and non-banks including NBFCs raise resources from institutional sources or by accessing capital market. NBFCs are encouraged to move in this direction in line with

international practices. The Reserve Bank will be holding discussions with NBFCs in regard to their plan of action for voluntarily phasing out of their acceptance of public deposits and regulations on banks' lending to NBFCs will be reviewed by RBI as appropriate.

(c) Asset Reconstruction Companies: Enhancement of Capital Base

136. The Reserve Bank has granted certificate of registration (CoR) to one more asset reconstruction company (ARC), ASREC (India) Limited. With this, RBI has so far granted CoR to three ARCs. In order that ARCs have a sound capital base and a stake in the management of the NPAs acquired, the requirement of owned funds for commencement of business has been stipulated as not less than 15 per cent of the assets acquired or Rs.100 crore, whichever is less.

Technical Group on Refinancing Institutions: Status

137. Following the announcement in the annual policy Statement, a Technical Group on Refinancing Institutions (Chairman: Shri G.P. Muniappan) was constituted with representatives of RBI, apex refinancing institutions and external experts. The Group would study the current regulatory framework and supervisory mechanism for financial entities regulated/supervised and refinanced by NABARD, NHB and SIDBI *vis-à-vis* those applicable to RBI regulated entities and make recommendations for bringing about appropriate convergence/harmonisation. The Report is expected to be submitted by December 2004.

Expert Group on Central Database Management System: Status

138. As indicated in the mid-term Review of November 2003, an Expert Group on Central Database Management System (CDBMS) (Chairman: Prof.A. Vaidyanathan) was constituted by RBI to guide the process of placing the publishable part of the CDBMS in the public domain for the convenience of researchers, analysts and other users. The Group has since submitted its Report and their recommendations are being put in the public domain. The Group also examined the process of release of data from the CDBMS to the public through a link (Database on Indian Economy) on RBI's website and, accordingly, it is proposed to release the first lot of the data series covering key macroeconomic aggregates effective November 1, 2004.

Payment and Settlement Systems: Status

139. The Reserve Bank has taken a number of initiatives in order to put in place a safe, secure, efficient and integrated real time payment and settlement system. The latest service offer from RBI, the real time gross settlement (RTGS) system, provides for an electronic based settlement of inter-bank and customer based transactions, with intra-day collateralised liquidity

support from RBI to the participants of the system. The RTGS system has also been enabled for straight through processing (STP) of customer transactions without manual intervention. Currently, there are 92 member banks participating in RTGS transactions with average daily turnover of about Rs.24,000 crore. As of now, banks offer RTGS payment services through 1,095 branches located in 141 cities and towns. This coverage is expected to increase to 3,000 branches in 275 centres by the year end. The coverage will be extended to about 500 centres comprising commercially important centres, capital market intensive centres and e-commerce centres.

140. The progress made in specific areas and further initiatives in this regard are detailed below:

(a) Vision Document for Payment and Settlement Systems

141. In view of the substantial progress made in the payment and settlement system as envisioned in the 'Payment System Vision Document 2001-04', RBI has taken steps to draft a document on 'Payment and Settlement Systems Vision for 2005-08' under the guidance of the National Payment Council. The draft document will be placed in the public domain for feedback and discussions. It is envisaged that the document will be implemented from April 2005.

(b) Board for Payment and Settlement Systems

142. It was indicated in the annual policy Statement that RBI would set up a Board for Payment and Settlement Systems (BPSS) that would lay down the policies for the regulation and supervision of the payment and settlement systems encompassing the domestic and cross-border systems. The constitution of the Board will ensure more effective regulation and supervision of the various payment and settlement systems in the country. The draft regulation to set up the BPSS has been submitted to the Government for notification in the Gazette.

(c) National Settlement System

143. As indicated in the annual policy Statement of April 2003, RBI proposes to introduce the national settlement system (NSS) in a phased manner, by linking up different clearing houses managed by RBI and other banks for centralised settlement at one place, with a view to helping the banks to efficiently manage their funds and to eliminate avoidable movement of funds around various centres for settlement purposes. It will also help RBI to closely monitor the liquidity position of the banks. In the first phase, the settlement for various clearings in the four metro cities would be accounted for under the NSS. The NSS is expected to be operationalised in early 2005.

(d) Working Group on Risk Mitigation for Indian Retail Payment System

144. At present, all retail payment systems, both paper-based and electronic-based, are settled on a deferred net settlement basis. Such settlement has credit, liquidity and operational risks that could lead to settlement failures. In order to put in place an appropriate risk mitigation mechanism for the retail payment systems as also to examine the operational implications of such a mechanism, a Working Group with representatives from RBI, IBA and banks has been constituted by RBI. The Group is expected to submit its Report by November 2004.

(e) ECS/EFT Transactions: Removal of Ceiling

145. In order to facilitate large scale usage of the electronic clearing system (ECS) and electronic funds transfer (EFT) schemes for large value money transfers and to meet the requirements of various segments of the financial sector including the securities markets, the existing per transaction limits for ECS and EFT are being dispensed with effective November 1, 2004.

(f) Working Group for Regulatory Mechanism for Cards

146. In recent years, plastic cards (credit, debit and smart cards) have gained greater acceptance and momentum as a medium of financial transactions. Banks are issuing either their own cards or cards under affiliation with international card issuing institutions. The volume and value of transactions undertaken using these cards have increased significantly. While recognising the popularity of cards, regulatory and customer protection measures assume importance. Accordingly, it is proposed:

- To constitute a Working Group to look into the regulatory and customer protection aspects and suggest measures for card usage in a safe, secure and customer friendly manner.

Conduct of Government Business

(a) On-line Tax Accounting System: Status

147. As indicated in the annual policy Statement, On-line Tax Accounting System (OLTAS) was operationalised in June 2004. Under the OLTAS, 15 offices of RBI, and 11,699 authorised branches of 31 agency banks transmit daily data on income/corporate tax collected by them to the tax information network (TIN) hosted by National Securities Depository Ltd. (NSDL). The income tax challan form has also been simplified and made into a single copy challan.

148. In order to simplify the refund procedures and ensure better customer service, RBI has suggested to Central Board of Direct Taxes (CBDT) to do away with advice based refunds. CBDT has accepted RBI's suggestion for grant of refunds up to Rs.25,000 through Electronic Clearing System (ECS) facility at select centres in respect of individual tax payers.

(b) On-line Indirect Tax Accounting System: Status

149. At the request of the Central Board of Excise and Customs (CBEC), a system similar to OLTAS has been envisaged for streamlining the present systems and procedures in regard to transmission of data pertaining to excise duty and service tax. The Reserve Bank has constituted a High Powered Committee (Chairman: Shri J.N. Nigam) with members drawn from the Government, IBA, State Bank of India, reputed information technology companies, NSDL and RBI for this purpose.

International Financial Standards and Codes

150. As indicated in the annual policy Statement, a review of the progress made on the implementation of the recommendations of the Reports of the 11 Advisory/Technical Groups constituted by the Standing Committee on International Financial Standards and Codes was considered by a panel of advisers. Taking into account the suggestions of the panel, a revised draft report is being placed in the public domain.

Annex

151. The details of the progress made in implementation of recommendations of major Committees/Working Groups are given in the Annex.

Mumbai

October 26, 2004

Annex. Working Groups: Progress Report

Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof.V.S. Vyas)

As indicated in the mid-term Review of November 2003, an Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof.V.S. Vyas) was constituted by RBI. The Report of the Committee was placed on the RBI website. Several recommendations of the Committee including those relating to the target for direct and indirect lending for agriculture under priority sector lending, negotiable warehousing receipt system, setting up of rural development and self-employment institutes, agri-risk fund and micro-finance cells, computerisation of land records, permitting access to ECB and granting autonomy to NABARD are being examined by Government of India and NABARD. Other recommendations of the Committee which have been accepted and implemented by RBI are detailed below:

- Measures announced in the annual policy Statement for the year 2004-05 on (i) loan for storage facilities, (ii) investment by banks in securitised assets, (iii) waiver of margin/security requirements on agricultural loans up to Rs.50,000 and (iv) NPA norms for agricultural finance.
- Banks were advised to initiate action in regard to: (i) entering into tie-ups with major tractor and farm machinery manufacturers for financing the agriculturists in a cost-effective manner; (ii) compliance with RBI's directives on simplification of procedures, forms for applications, rationalisation of internal returns, delegation of powers, introduction of new loan products and margin money; (iii) systems and procedures to make lending cost-effective as well as saving avoidable expenses for borrowers; (iv) evolving suitable credit products/packages for small borrowers; (v) reducing information gaps by providing checklist of documents required for loans; (vi) exploring the financing models for oral lessees such as self help groups (SHG) and joint liability groups (JLG); (vii) complaints regarding delays/refusal to open savings bank accounts of SHGs, inadequate/delayed credit support, and impounding of SHG savings as collateral for loans; (viii) preparing long-term plans in consultation with state governments for wasteland/watershed development and providing resource support; (ix) posting technical staff at head/controlling offices and changing the mindset of bankers with regard to agricultural lending; (x) appointment of direct selling agents subject to guidelines to be approved by their Boards; (xi) financing good working primary agricultural credit societies (PACS); (xii) formulating time-bound programme for using IT in general branches; (xiii) designing an appropriate incentive structure for prompt repayment; (xiv) associating with contract farming subject to availability of proper legal and regulatory framework in different states.

***Working Group on Flow of Credit to SSI Sector
(Chairman: Dr. A.S. Ganguly)***

As indicated in the mid-term Review of November 2003, a Working Group on Flow of Credit to SSI Sector (Chairman: Dr. A.S. Ganguly) was constituted by RBI. The Report of the Working Group was placed on the RBI website. Recommendations of the Group on definition of SME sector, role of CGTSI, repealing of SFC Act and privatisation of SFCs, rating mechanism for industrial clusters, conversion of Technology Bureau of Small Enterprises into an independent Technology Bank are under consideration of the Government of India, SIDBI, CGTSI and IBA. Recommendations on venture capital financing, exploring ways for credit flow to SME sectors through special purpose vehicles (SPVs), extending financial assistance to NGOs and MFIs and working out innovative models for securitisation of the MFI receivable portfolio, and credit rating and risk assessment of SMEs accredited to them by micro-credit intermediaries in the form of NBFCs are under examination of RBI. Other recommendations of the Working Group which were implemented by RBI are detailed below:

- Banks to identify new clusters and adopt cluster-based approach for financing SME sector.
- Lead Banks to consider sponsoring specific projects as well as widely publicise the successful working models of NGOs.
- Banks operating in the North East Region encouraged to consider sanctioning higher working capital limits to SSIs for maintaining higher level of inventory.
- Banks to explore new instruments for promoting rural industry and to improve the flow of credit to rural artisans, industries and rural entrepreneurs.

Working Group on Financial Conglomerates

As indicated in the mid-term Review of November 2003, an inter-agency Working Group on Financial Conglomerates was constituted by RBI with a member each from RBI, SEBI and IRDA. The report of the Group was placed on the RBI website. The action initiated in this regard is as under:

- Twenty four conglomerates have been identified for the purpose and the first report based on the format recommended by the Group is under compilation.

- A nodal cell has been established at RBI for smooth implementation of the framework. Technical Committee with representatives from all three regulators has been interacting and addressing issues arising out of the reporting requirements.

***Standing Committee on Procedures and Performance Audit on Public Services
(Chairman: Shri S.S. Tarapore)***

As indicated in the mid-term Review of November 2003, a Standing Committee on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore) was constituted by RBI. The four Reports of the Committee, viz., Reports on Foreign Exchange Transactions, Government Transactions Relating to Individuals, Banking Operations and Currency Management along with action taken reports of RBI were placed on the RBI website. The recommendations of the Committee which have already been implemented by RBI are detailed below:

Report on Exchange Control Relating to Individuals

- The name of Exchange Control Department changed to Foreign Exchange Department effective January 31, 2004.
- Simplified application cum declaration form introduced for drawal of foreign exchange.
- FAQs and printed pamphlets on important facilities issued.

Report on Government Transactions Relating to Individuals

- Citizens' charter revamped and displayed in RBI's public departments with brochures, available with all offices.
- Applications standardised for savings bonds containing features and subscribers' rights with regard to services thereunder introduced in all offices/agencies.
- Regional Offices to organise customer meets and customer service orientation training for staff and conduct on the spot verification of arrangements provided by agency banks.
- New Delhi and Chennai offices to implement, on pilot basis, issue of post-dated interest warrants in the case of senior citizens.

Report on Banking Operations

- Ad hoc Committees/CEOs of banks advised to take necessary action for adoption of IBA's model deposit policy by all banks.
- Banks to constitute a Customer Service Committee of the Board/at the Apex level, to address issues such as formulation of deposit policy for the bank, establishment of product approval process, operation of deceased depositor's accounts, survey of depositor satisfaction and the triennial audit of customer services.
- Banks advised to include in their deposit policy that changes in any instruction on the operation of the senior citizens' deposit accounts should be confirmed to the depositor within a month.
- Banks to remove unfair practices in respect of despatch of cheque books through courier, to avoid inscrutable entries in pass books/statement of accounts, not to include in the account opening form information collected for purposes other than KYC.
- Ad hoc committees to examine the working of enquiry counters in the banks.
- Banks to examine the recommendation for appointment of Quality Assurance Officers in their banks. Ad hoc Committees of banks are to take necessary action in this regard.
- Regional offices to constitute a Group on Customer Service for ongoing monitoring of the quality of the customer service provided by the banks in their region.
- Incognito visits by RBI officers to bank branches to assess the level of customer services. RBI to consider giving weightage to depositors' complaints while evaluating a bank's performance.
- Banks to develop a comprehensive and transparent policy on collection of cheques and interest compensation for delayed collection in line with the instructions issued by RBI from time to time. Changes, if any, in the policy to be intimated to the customers promptly.

Report on Currency Management

- Banks and Regional Offices to ensure compliance regarding recommendations of the Report on services to common persons.

- Revised draft citizen's charter put on the RBI website and circulated among RBI offices/banks.
- Note refund rules with simplified explanations put on the RBI website.
- Currency chest agreement is being revised.
- The bank branches maintaining small coin depot advised to freely accept uncurrent coins.