

RBI Governor announces Mid-term Review of Monetary and Credit Policy for the year 2000-2001

Highlights

- **No changes in monetary policy measures such as Bank Rate and CRR.**
- **As per current indications, RBI expects interest rate environment to remain stable. RBI to ensure adequate availability of liquidity and credit to support growth.**
- **Money supply growth, reserve money and government borrowing are on trajectory. RBI urges a strong framework to build up positive expectations on the fiscal front.**
- **LAF will continue to be operated in a flexible manner.**
- **New guidelines for banks' participation in capital market.**
- **New norms for valuation of banks' investments.**
- **EEFC facility to continue.**
- **Much greater flexibility to corporates to raise resources through commercial paper. Transferability of CDs made easier.**
- **Measures to improve credit delivery mechanisms, technology upgradation, further deregulation and rationalisation of procedures.**

In a meeting with Chief Executives of major commercial banks, Dr. Bimal Jalan, Governor, Reserve Bank of India presented a Mid-term Review of Monetary and Credit Policy for 2000-2001. After a review of domestic and external developments, Governor mentioned that RBI will continue to endeavour to maintain a stable interest rate environment. As per present indications, the liquidity conditions are likely to remain adequate to meet the demand for commercial credit from industrial and other sectors. Governor added that the Reserve Bank would also provide appropriate liquidity as necessary through its LAF.

Domestic Developments

2. On the domestic front, overall, the outlook for agricultural supplies was comfortable while the industrial production showed a lower growth compared to last year. Governor mentioned that taking into account the estimates of Central Statistical Organisation for the first quarter of 2000-01 at 5.8 per cent, the real GDP growth during 2000-01 could be placed in the range of 6.0 – 6.5 per cent as against the projection of 6.5 – 7.0 per cent indicated in the April policy statement.

3. On the inflation front, he said that while a close watch had to be kept, the overall demand/supply conditions in respect of sensitive commodities and manufactured goods remained comfortable. The annual inflation rate, excluding the effect of 'fuel, power, light and lubricants group' worked out to only 2.44 per cent. The inflation for the year as a whole was likely to be close to the average of last two years.

4. Governor indicated that the growth of money supply and aggregate deposits of scheduled commercial banks in the current financial year were on the expected trajectory and the projected growth in M_3 was likely to remain around 15 per cent; and the increase in aggregate deposits would be of the order of Rs.1,25,000 crore as envisaged in the April statement. There had been a shift in the sources contributing to the reserve money expansion which was mainly due to increase in net RBI credit to central government this year compared to the growth in net foreign exchange assets and credit to commercial sector in the last year. Reserve money expansion was expected to remain moderate and significantly lower.

5. The statement mentioned that there had been a significant pick up in bank credit and other flows to the commercial sector from the banking system.

6. While reviewing the borrowing programme of the central government, Governor mentioned that the normal pace was maintained and RBI continued to combine auction issues with acceptance by private placement of dated securities of the Government, consistent with market conditions.

7. The centre's fiscal deficit upto August 2000 showing an improvement compared to last year, contributed by a large increase in revenue receipts and a marginal increase in expenditure, was encouraging. Governor mentioned that the budgetary outlook remained uncertain on account of pace of progress in receipts from disinvestments and the budgetary outgo to meet the shortfall in the oil pool account. He emphasised that it was absolutely essential to contain the borrowing programme within the budgeted levels and added that a reduction in the borrowing programme would be desirable to keep the interest rate outlook positive and stable.

8. While enumerating the several initiatives taken in recent years with regard to internal debt management policy, the statement observed that it was necessary for a strong framework to be put in place to build up positive expectations on the fiscal front. Governor hoped that the proposed Fiscal Responsibility Legislation would address this issue.

External Developments

9. Reviewing the developments in the external sector, it was mentioned that there had been marked changes in the external environment since April. The year 1999-2000 was a good year inasmuch as the foreign currency assets of India increased by US \$ 5.54 billion and forex markets were generally stable. However, the period from about mid-May to early August 2000 proved to be difficult for the management of the external sector. The forex markets were affected by considerable uncertainty. Since the middle of August 2000, Governor said, the situation had shown some improvement, and forex markets and reserve levels had been relatively stable.

10. Dwelling on the various factors such as 'expectations', 'bandwagon effect' and volatility in capital flows which he said played a major role in exchange rate movements, the statement observed that it was not possible to come to a definitive conclusion about the relative role of different factors in explaining the behaviour of forex markets in India during May – August 2000.

11. Recalling the measures taken in May, July and August this year, Governor mentioned that it might be argued that a recourse to one or two measures more intensively would have been more appropriate, or alternatively the rupee exchange rate could have been allowed to

depreciate much more sharply to “find its own level”. But, he observed that, while at times the underlying causes of exchange market volatility were easy to diagnose, often the precise cause and the degree of volatility as well as its duration were difficult to estimate or forecast. Therefore, he said that in the situation prevailing in our exchange markets during May-August 2000, and based on a continuous analysis of the evolving situations, recourse to a combination of measures was preferred so that the adverse impact on the rest of the economy could be minimised. He further observed that a reliance on one or two measures (e.g., sharp monetary tightening or unchecked depreciation of the exchange rate, and/or unlimited use of reserves) could have had unacceptable longer term consequences for the economy and the financial system, including a much greater risk of non-reversible destabilisation.

12. Referring to the recent debate that it would be appropriate if, during periods of excess capital flows or capital surge (as experienced during some months in 1999-2000, and also earlier), the rupee were allowed to appreciate substantially (rather than the RBI absorbing part or whole of the excess supply), the statement recognised the theoretical merit of the argument. In reality, however, the situation was somewhat more complicated as it was not clear whether greater volatility in exchange rates, and continuing sharp depreciation within a very short period during periods of excess demand, would stabilise expectations or destabilise currency markets beyond the levels of tolerance. Recalling his April statement, Governor observed that the recent international experience particularly during the period of the East Asian crisis, had highlighted the fact that emerging market economies have to largely rely on their own resources during external exigencies as there was no “lender of the last resort” to provide additional liquidity at short notice. As such, it was felt that while two-way movements in currency were certainly desirable and no attempt should be made to provide a “floor” when there were excess capital inflows, it was necessary to keep the above considerations in view in order to guard against unexpected contingencies.

13. A lesson of experience, not only in India but also in other countries, was that given the nature of foreign exchange markets and uncertainty in the direction of capital flows in a floating rate environment, the situation and outlook could change dramatically within short periods and extreme caution and care needed to be exercised in the management of the exchange rate and foreign exchange reserves.

14. While calling for vigilance and caution against uncertainties arising on account of high international crude oil prices, Governor listed the favourable factors for India that included continued good performance of exports, particularly software exports; a comfortable level of foreign exchange reserves; a favourable outlook for foreign direct investment in certain important sectors (such as, Information Technology and Telecommunications); a relatively low level of external commercial debt, particularly short-term debt; and a positive outlook for sustained economic growth. He emphasised that no effort should be spared to take maximum advantage of these positive factors, and to further accelerate the process of growth with particular emphasis on exports.

15. The statement observed that despite the substantial increase in the oil import bill, increase in exports and invisible receipts was expected to keep the current account deficit for the year 2000-01 at less than 2.0 per cent of GDP.

16. Governor explained the several measures that had been introduced to ensure timely delivery of credit to exporters and remove procedural hassles. The various suggestions received from export organisations and exporters were examined by the Bankers’ Group and banks are being advised to implement the recommendations of the Group.

17. In April, Reserve Bank had invited reactions of NRIs on the actual working of the simplified procedures introduced in the last two years and suggestions for further improvement. Governor indicated that most of the responses had been highly positive, and no special problems in the operation of these schemes were reported.

18. Referring to several initiatives taken by the Government to encourage the flow of Foreign Direct Investment (FDI) on mutually beneficial basis, Governor mentioned that “in principle” or prior approval of the Reserve Bank was no longer required for any FDI and ECB proposals satisfying Government guidelines.

Stance of Monetary Policy for the Second Half of 2000-2001

19. Discussing the stance of monetary policy for the second half of 2000-2001, it was noted that the change in the course of monetary measures had elicited a fair amount of comments and debate. Governor mentioned that the possibility of “a change in course” and “tightening of monetary policy” in the event of a change in the domestic or international situation was specifically recognised in the April policy statement. He also added, based on the recent historical experience, that central banks changing course in response to the emerging situations was often unavoidable. He emphasised that it was essential for market participants to take greater recourse to appropriate asset-liability and risk management techniques in order to take account of unanticipated changes in monetary conditions and the interest rate outlook.

20. He observed that the external outlook principally in respect of crude oil prices as also the domestic inflationary outlook were somewhat uncertain. Taking these factors as well as Government’s borrowing requirements into account, liquidity conditions were likely to remain adequate during the rest of the year. The banking system was not expected to face any difficulty in meeting fully the demand for commercial credit from industrial and other sectors. Reserve Bank also stood ready to provide appropriate liquidity through its Liquidity Adjustment Facility (LAF) as necessary.

21. While it would continue to be the endeavour of the RBI to maintain a stable interest rate environment, Governor emphasised that it would be prudent for banks and financial institutions to make sufficient allowances for unforeseen contingencies, including possible changes in monetary measures in their business operation plans.

22. While stating that LAF introduced since June 5, 2000 was being effectively used to influence short-term interest rates by modulating day-to-day liquidity conditions and to contain volatility in foreign exchange market, Governor said that the LAF would continue to be operated in a flexible manner, both in terms of the applicable rates and tenors, in keeping with the developments in financial markets.

Financial Sector Reforms and Monetary Policy Measures

23. Governor briefly reviewed the progress made so far in respect of structural measures initiated by the Bank in the recent past to improve the functioning of the various segments of financial markets and announced modifications to some of them. He pointed out that as far as possible, changes proposed, had been decided after extensive consultations with experts

and market participants and suggestions made by commentators in media as well as specialised journals.

The following measures were announced in the Statement :

24. Development of Money Market

- Considering the fact that the repo market was yet to be broad-based in terms of instruments and participants, it has been decided to extend the specific permission granted to select corporates to route call money transactions through Primary Dealers (PDs), which is available now upto December, 2000 for a further period of six months, i.e., upto June 2001. As regards other Financial Institutions and Mutual Funds which are currently permitted to lend directly in the call/notice money market, a Group will be constituted to suggest a smooth phasing out by a planned reduction in their access to call/notice money market.
- Taking into account the suggestions received from participants, on a draft of the revised guidelines circulated in July 2000, the guidelines on issue of Commercial Paper (CP) were issued. The new guidelines are expected to provide considerable flexibility to participants and add depth and vibrancy to the CP market while at the same time ensuring prudential safeguards and transparency. In particular, the guidelines will enable companies in the services sector to more easily meet their short-term working capital needs.
- With a view to providing flexibility and depth to the secondary market, the restriction on transferability period for CDs issued by both banks and financial institutions is withdrawn.
- In order to improve the functional efficiency of the market, the rating is made mandatory for the term deposits accepted by all-India financial institutions with effect from November 1, 2000.

25. Government Securities Market

After reviewing the varied measures taken, the following further measures for development of government securities market are introduced:

- With a view to encouraging investors to hold securities in scrip-less form and to ensure that entities holding securities in custody employ practices and procedures so that the constituents' securities are appropriately accounted and kept safe, a set of guidelines governing the maintenance of the Constituents' SGL Accounts is issued.
- Reserve Bank of India would specify the date for switchover to order-driven screen-based system for trading in government securities on the stock exchange, in consultation with SEBI. It will be applicable to all Stock Exchanges on which banks and FIs can operate.

26. Prudential Measures

- Banks were advised in October 1998 to make a general provision on standard assets of a minimum of 25 basis points from the year ended March 31, 2000. It is proposed to include the general provision on standard assets in Tier 2 capital.
- The Report of the Informal Group on Valuation of Banks' Investment Portfolio was circulated among banks and the guidelines have now been finalised keeping in view the comments and suggestions received from them. The revised guidelines are in consonance with the best international practices on categorisation and valuation of investments and are effective from the half-year ended September 30, 2000.
- In order to bring more transparency to the balance sheets of public sector banks and as a further step towards consolidated supervision and to provide additional disclosures, public sector banks should also annex the balance sheets of their subsidiaries to their balance sheet beginning from the year ending March 31, 2001.
- Due to the improvements in the payment and settlement systems, recovery climate, upgradation of technology in the banking sector, etc., the concept of "past due" is being dispensed with, effective March 31, 2001.
- After a review of current practices regarding credit exposure limits vis-à-vis international best practices, it has been decided to prepare a detailed Discussion Paper on the subject which is expected to be finalised by December 2000. Based on the comments and suggestions on the issues, and followed by an interaction with banks, RBI will take a final view on the approach that should be adopted with a view to making it effective from March end 2002.

27. Bank Financing of Equities and Investment in Shares

- Based on the feedback received from banks and other market participants on the RBI – SEBI Technical Committee report, the guidelines on bank financing of equities and investment in shares have been finalized and are issued. The RBI-SEBI Technical Committee will review the actual working of these new guidelines after six months, in consultation with select banks. If any changes in operational procedures and/or overall framework are required, the Committee's recommendations will be widely circulated and discussed with all concerned.

28. Review of Exchange Earners Foreign Currency A/cs (EEFC) Facility

On a review, in order to facilitate quick export-related payments and reduce transaction costs, it has been decided to restore fully the earlier entitlements of 70 per cent and 50 per cent respectively. Payments, which can be made from these accounts will also remain the same as before. However, the EEFC accounts will henceforth be held in the form of current accounts. The cheque-issuing facility against these accounts will continue to be available for convenience of exporters. No credit facilities, either fund based or non-fund based, will be provided by banks against the EEFC balances.

29. Credit Delivery Mechanisms

- Since the Boards have been empowered to decide the Prime Lending Rate as also the spread over PLR, to give further operational autonomy to the banks, banks will be free to decide penal interest. Banks may formulate transparent policy for charging penal interest rates, with the approval of their Boards.
- On a review of market conditions and with a view to providing the flexibility to banks in prescribing margins, it has been decided to withdraw the existing prescriptions under selective credit control on free sale sugar.
- In the context of the present policy of providing more flexibility and operational freedom to banks as well as government and other enterprises, it has been decided to undertake a review of consortium arrangements for food credit. A Committee representing banks, RBI, Government and FCI will be constituted for the purpose.
- A Working Group on Bills Discounting by Banks was constituted under the Chairmanship of Shri K.R. Ramamoorthy, to examine inter alia the possibility of extending bills discounting facility especially to services sector. Based on the feedback and in consultation with market participants, RBI will evolve suitable guidelines for implementation.
- Banks are advised to closely monitor the progress and make earnest efforts to implement programmes under Kisan credit cards, Swarnjayanti Gram Swarojgar Yojana (SGSY), Self Help Group (SHGs) and Small Scale Industries (SSI).

30. Non-Banking Financial Companies

Reserve Bank is working out the modalities in consultation with the associations of NBFCs, for formation of a Self Regulatory Organisation of NBFCs. Draft guidelines for asset liability management and formats of separate balance sheet for NBFCs have been circulated among the members of Informal Advisory Group on NBFCs for the views of industry. Further steps would be taken to put in place the disclosure norms and guidelines for risk management for NBFCs.

31. Technology Upgradation

- “Payment System Vision Document”, under preparation, will detail the payment system agenda proposed to be followed for the next 2/3 years.
- The Bank has established an internal Group on Internet Banking to identify the risks to the organization and the banking system; suggest an appropriate supervisory and legal framework; suggest measures for adoption of the international best practices; recommend adequate security systems in conformity with international standards; and suggest a clearing and settlement arrangement for electronic banking and electronic money transfers.
- In the four metros, the Reserve Bank is all set to introduce Greyscale Imaging Technology as a value added service being provided to the members of the Clearing House.

32. Legal Reforms

- In his budget speech in February 2000, the Union Finance Minister has underscored the need for according greater flexibility in the conduct of monetary policy. The Reserve Bank of India is working on proposals for amendments to Reserve Bank of India Act, 1934 and Banking Regulation Act, 1949 in this regard.

33. International Financial Standards and Codes

- It may be recalled that a Standing Committee on International Financial Standards and Codes was set up to identify and monitor the developments in global standards and codes. Advisory groups in ten major subject areas were set up in the beginning of this year to assist the Standing Committee. Of these ten, one group has submitted its final report while three others have submitted first part of their respective reports. The reports are available on the Bank's website (www.rbi.org.in). All the Advisory Groups are expected to finalise their Reports by end November 2000.

Regulation Review Authority

34. The Reserve Bank would like to take this opportunity to express its appreciation to bankers, experts, market participants and members of the public who have sent their suggestions to the Regulations Review Authority (RRA) set up by the Bank in April 1999. The RRA will formally cease to operate on March 31, 2001.

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