Mr. Rangarajan elucidates the monetary and credit policy of the Reserve Bank of India for the first half of the 1997-98 financial year Address by the Governor of the Reserve Bank of India, Mr. C. Rangarajan, at the Madras Chamber of Commerce and Industry at Chennai on 19/4/97.

I would like to take this opportunity given to me to speak to you this afternoon to focus on the monetary and credit policy for the first half of 1997-98 which was announced a few days ago. It may be useful at the outset to review the major developments during 1996-97.

2. The growth rate of broad money (M3) in 1996-97 was 15.6 per cent which was within the targetted band of 15.5 - 16.0 per cent. The real GDP is expected to have grown by 6.8 per cent. The inflation rate as measured by the change in the Wholesale Price Index was 7.3 per cent on a point-to-point basis. A notable feature of 1996-97 was that the money and foreign exchange markets were generally calm in contrast with the turbulence witnessed in these markets in the previous year. A strong growth in bank deposits, coupled with substantial reduction in cash reserve requirements resulted in abundant liquidity in the system. However, the off-take of bank credit was subdued. Short-term money market rates have moved down as a result of the easy liquidity conditions. Lending rates are known for their stickiness and remained at high levels during the first half of 1996-97 but softened later. There has been a strong accretion to the foreign exchange reserves. The slow growth in non-food bank credit, the persistence of relatively high lending rates despite comfortable liquidity in the banking system and the acceleration of inflow of funds from abroad call for active monetary and exchange rate management by the Reserve Bank.

3. While the overall growth momentum has been sustained in 1996-97, divergent trends were observed in various sectors with agricultural output showing an impressive recovery and industrial growth slowing down. Even within the industrial sector, the decline in growth rates in mining and electricity sectors was sharp. The inflation rate at 7.3 per cent was a matter of concern. While manufacturing prices rose only by 5.1 per cent, primary articles recorded an increase of 8.3 per cent. During 1996-97, procurement of foodgrains was low, while the off-take was high. With the result, buffer stocks of foodgrains fell from 23.3 million tonnes at the end of March 1996 to 18.6 million tonnes at the end of January 1997. The decline in wheat stocks was sharper.

4. The target for expansion in M3 during 1996-97 was set at 15.5 - 16.0 per cent. During the financial year 1996-97, M3 increased by 15.6 per cent as compared with 13.7 per cent in 1995-96. Aggregate deposits of scheduled commercial banks showed a strong growth of Rs.697.8 billion (16.1 per cent) during 1996-97 as compared with a modest increase of Rs.469.6 billion (12.1 per cent) during 1995-96. However, the increase in non-food credit of scheduled commercial banks by Rs.247.1 billion (10.1 per cent) during 1996-97 was substantially lower than that of Rs.449.4 billion (22.5 per cent) during 1995-96. The depressed capital markets seemed to have played a role inasmuch as there has to be some balance between debt and equity. Equity raised by the corporates was significantly lower in 1996-97 than in 1995-96. Investments by banks in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper increased by Rs.65.8 billion in 1996-97 as compared with a decline of Rs.1.62 billion in the previous year. Thus, the total resource flow from banks to the commercial sector inclusive of loans and advances as well as investments in bonds/debentures/shares amounted to Rs.312.9 billion as against Rs.447.7 billion in 1995-96. Investments by scheduled commercial banks in Government securities showed a quantum jump with an increase of Rs.268.6 billion during 1996-97 as compared with the increase of Rs.145.4 billion during 1995-96.

5. One of the major objectives of financial sector reform has been to eliminate financial repression which is inherent in an administered interest rate structure and significant strides have been made in this direction. This process of change which began in late 1980s has not been abrupt but gradual. During this period, considerable degree of freedom has been given to banks to determine both deposit and lending rates. Following moderation in the inflation rates in 1995-96 and 1996-97 and the reductions in cash reserve ratio, there has been a conspicuous reduction in both deposit rates and lending rates of banks as also spreads over the prime lending rates (PLR). In July 1996, some public sector banks reduced their PLR by 0.5 percentage point. However, as a number of banks were charging lending rates far higher than PLR, banks were directed in the monetary policy announcement of October 1996 that along with the announcement of their PLR, they should, with the approval of their respective Boards, also announce the maximum spread over the PLR for all advances other than consumer credit. The public sector banks have since reduced their PLR further from 16.5 per cent in March 1996 to 14.0 - 15.5 per cent by March 1997 and spreads in the rate of 2.5 - 4.0 percentage points were announced. During 1996-97, many banks had also brought down interest rates on term deposits by 1 to 2 percentage points on the shorter end of their maturity spectrum with a view to reducing the average cost of deposits.

6. Reflecting the easy liquidity conditions during 1996-97, there has been a significant softening of money market interest rates. At the short end of the market, the rates have come down sharply and have ruled generally low as compared with the levels prevailing in 1995-96. The typical call money rates ruled low in the range of 2.00 - 5 per cent in the recent period. The rate on 91-day Treasury Bills came down from 12.97 per cent at the beginning of April 1996 to 7.96 per cent in March 1997. Similarly, the rate on 364 day Treasury Bills declined from 13.12 per cent in April 1996 to 10.10 per cent in March 1997. The typical rates of discount on Certificates of Deposits (CDs) and Commercial Paper (CP) have also declined sharply since end-March 1996. There was also some softening of coupon rates on long-term Government bonds.

7. The stance of monetary policy in 1997-98 would be to achieve the twin objectives of maintaining reasonable price stability and ensuring availability of adequate bank credit to support the growth of the real sector. The economy is still subject to inflationary pressures. There is need for continued caution on the price front and this would require a moderation in monetary expansion consistent with the expected real growth. There is also the need for developing the Bank Rate as reference rate to signal policy stance of the Reserve Bank. This would require rationalisation of the interest rate structure and linking of interest rates to the Bank Rate. There is an urgency to step up the flow of bank credit. This would need streamlining and improving credit delivery system by giving greater freedom to banks. Besides, banks must endeavour to bring down the interest rates by reducing the spreads. The money, foreign exchange and government securities markets need to be further developed and integrated.

8. In regulating money supply growth in the coming year, the Reserve Bank will have to reckon with the impact of capital inflows. If capital inflows remain strong, the Reserve Bank must take care to see that the resultant reserve money expansion after taking into account the net RBI credit to the Central Government does not exceed a level that is consistent with the expansion in money supply justified by the growth of the real sector.

9. Given the real Gross Domestic Product (GDP) growth of 6.0 - 7.0 per cent, monetary policy would seek to maintain the expansion in M3 in the range of 15.0 - 15.5 per cent to keep the inflation rate at around 6 per cent in 1997-98. The projected increase in money supply may be reviewed and revised depending upon macro-economic developments. On the

basis of the projected increase in M3, the working estimate of the growth of aggregate deposits of scheduled commercial banks is placed at Rs.800 billion (16.0 per cent). The expansion in net scheduled commercial bank credit including such investments as in bonds/debentures/shares of Public Sector Units (PSUs) and private corporate sector, is envisaged to be of the order of 20.0 - 21.0 per cent. The policy measures which are being announced have been so framed that banks will have adequate resources to meet all the genuine productive requirements of the economy.

10. Broadly speaking, the current monetary and credit policy seeks to achieve four objectives. The various measures announced as part of the policy can be brought under these four objectives. The first objective of course is to maintain a reasonable degree of price stability and moderate inflationary pressures in the system by regulating money supply. As indicated earlier, the target rate of growth of M3 is set in the range of 15 - 15.5 per cent. With a real rate of growth between 6 and 7 per cent, this would enable us to keep the inflation rate around 6 per cent.

11. The second objective is to expand the lendable resources of banks and also to bring about a reduction in the lending rates. The Cash Reserve Ratio (CRR) was lowered at different points of time during the previous year. The full impact of the reductions in the CRR effected last year will be seen in the current year. The CRR on inter-bank liabilities has been withdrawn as part of the policy. Apart from the impact this will have on the creation of an appropriate term deposit market, this will release about Rs.9500 million of lendable resources to banks. We have also introduced a general refinance facility which will be available to banks and this facility will be equivalent to one per cent of the demand and time liabilities of banks. All of these measures will have the impact of expanding the lendable resources of banks. The bank rate has been reduced from 12 per cent to 11 per cent to signal a reduction in the interest rate. We want the bank rate to emerge as an effective signal rate as well as a reference rate. To coincide with the reduction in bank rate, the term deposit rate for maturity of 30 days and upto one year has been reduced by one percentage point. The same rate has been made applicable to rates on term deposits of Non-Resident (External) Rupee Deposit accounts of maturity of over six months and upto one year. On Foreign Currency Non Resident Accounts (Banks) deposits, banks are free to determine interest rates subject to a ceiling prescribed by the RBI from time to time. Thus the various measures announced will have the effect of expanding the lendable resources of banks on the one hand and bringing about on the other a reduction in the deposit rates and consequently lending rates.

12. Responding to the policy announcement, a number of banks in the public sector banks have already reduced their PLR by 50-100 basis points to take it to 14 per cent. Needless to say the only enduring way to bring about a reduction in the interest rate is by keeping the inflation rate low and breaking inflationary expectations.

13. The third objective relates to the revamping of the credit delivery system which has become necessary for accelerating the credit flow from the banking system. A number of measures announced fall in this category. I would like to list the most important among them. The mandatory consortium requirements for credit limits of Rs.500 million and more has been dispensed with. Banks and their customers can now enter into a variety of arrangements including syndication subject of course to the exposure limits. Banks have been given full freedom to evolve their own methods of assessing the working capital requirements of borrowers. This should result in quicker decision making and speedier flow of funds from banks to their borrowers. The loan component of the working capital limits is being gradually enhanced. However, banks are now free to fix the maturity period of the loans on their own. The limits set on the extent of bank credit that can be made available to Non-Banking Financial

Companies (NBFCs) has been removed. This, however, applies only to NBFCs which have complied with the requirements of registration, credit rating and prudential norms. Banks hitherto have been permitted to invest 5 per cent of their incremental deposits of the previous year in shares and debentures. Debentures are now excluded from this limit so that this limit would be available exclusively for shares of corporates including PSUs. In the context of the present condition of the capital market, banks have been allowed to extend loans to corporates against shares held by them to enable such corporates to meet the promoters' contribution to the equity of new companies in anticipation of raising resources. The credit delivery system is thus sought to be improved.

14. The fourth objective is the improvement in the functioning of the various markets - money market, government securities market and the foreign exchange market. The important measures that relate to the money market are: removal of cash reserve ratio on the inter-bank liabilities; reduction in the minimum period of maturity for the commercial paper to 30 days; reduction in the minimum size of certificates of deposit and improved access to cash surplus entities through primary dealers. The Government securities market will benefit by the enlargement of instruments eligible for Repo transactions, allowing the entry of non-bank entities who are holders of SGL accounts with the Reserve Bank to enter into reverse Repo transactions and the introduction of Treasury Bills of varying maturities. In order to deepen and widen the foreign exchange market, certain measures have been taken. These include permission to book forward contracts on the basis of declaration of exposure, permission to Authorised Dealers to borrow upto US$ 10 million from abroad as well as to invest up to US$ 10 million abroad and permission given to Authorised Dealers to engage in Forex-Rupee current swap without the prior approval of RBI. The various measures taken in the area of market improvement will lead not only to the efficient functioning of the individual markets but also bring about a greater integration among them.

15. In order to facilitate greater flow of credit to agriculture, the share capital of National Bank for Agriculture and Rural Development (NABARD) as well as the General Line of Credit granted to NABARD by RBI have been increased. The simplified procedure of assessing the working capital needs on the basis of 20 per cent of the projected turn over is being extended to borrowers having working capital limits up to Rs.20 million as against Rs.10 million earlier. This should benefit a large number of Small Scale Industrial Units.

16. The measures announced cover a wide range and touch almost every part of the financial system. Some of the measures are directed towards improving the functioning of the various markets and bringing about a greater integration among them, which should reduce the volatility of the rates in these markets. These measures are in the nature of institutional and structural reforms. The improvements in the credit delivery system should remove the ‘chokes’ in the flow of credit.

17. All in all, the measures announced should have the effect of accelerating economic growth, keeping inflationary pressures under control and improving the flow of credit from the banking system to the various segments of the Indian economy.