Y V Reddy: A policy update

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the book release, “Accelerating growth and poverty reduction” by Dr Arvind Virmani, in New Delhi, 7 April 2004.

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Friends,

I have great pleasure in participating in this book release function. The Academic Foundation has provided yeomen service in bringing out this book, which is very valuable and special for several reasons. It is essential to note that the title of the book reminds us that the focus of accelerating growth should be on poverty reduction. The writing displays a high degree of objectivity. Of particular interest to students and policy-makers is that it presents, in a coherent, consistent and pragmatic manner, the problems and prospects of the Indian economy along with an array of specific solutions. The book demonstrates a deep understanding of the dynamics of economic policy-making in India. Among the new generation of top economists in India Dr. Virmani holds a special position and it is good that his ideas are being presented to a wider audience by Academic Foundation.

I have worked with Dr. Arvind Virmani very closely, particularly in the management of external sector. His contributions to the reforms of external sector, specially LERMS and current account convertibility, are immense. I have personally benefited from his thorough and incisive analysis of issues and options. But more than that I have great personal regard and affection for him.

In my capacity as Governor, RBI let me take this opportunity to place before you an update on our policy. As you may be aware, I had provided an update on the outlook of the Indian economy on January 7, 2004. Today, I will provide an update covering developments in three areas, viz., (i) money and credit, (ii) financial markets and external sector and (iii) follow-up measures to announcements in the November 2003 policy statement.

Money and credit

Expansion in broad money (M_3), aggregate deposit and non-food credit has been slightly above the parameters set out in the April 2003 policy, but have been largely in consonance with the broad expectations. Broad money in 2003-04 expanded by 16.0 per cent (up to March 19, 2004), as compared with 13.4 per cent (net of mergers), in the corresponding period last year. Reserve money expansion up to March 26, 2004 has also been higher at 13.1 per cent as compared with 9.2 per cent in the corresponding period of the previous year, mainly due to capital inflows. The bulk of the inflows have been sterilised through open market operations (OMO) including the Liquidity Adjustment Facility (LAF). This is reflected in contraction of net RBI credit to the government by Rs. 88,698 crore (up to March 26, 2004), substantially offsetting the pressures on monetary expansion emanating from external sector. Aggregate deposits of scheduled commercial banks have expanded by 17.3 per cent up to March 19, 2004.

Non-food credit expansion in 2003-04 has been of the order of 17.6 per cent, which though slightly lower than 18.6 per cent growth (adjusted for mergers) seen a year before, is in line with expectations set out in the April 2003 policy. The year 2003-04 began with a slack in credit offtake that persisted during the first five months. Credit expansion in subsequent months has been quite vigorous. As a result, Rs. 1,19,684 crore incremental credit has been made available in the full year against Rs. 99,448 crore in the year before. In fact, since September 2003, non-food credit expansion has been higher by 38 per cent than in the corresponding period of the previous year.

Credit expansion in 2003-04 appears to have been led by the housing and retail sectors. This has helped generate new demand for consumer durables, basic and intermediate products, as also new services. The resulting pickup in consumer demand seems to have improved production activity.

Industrial credit has also expanded since September 2003, although at a slower pace. Slower industrial credit expansion this year, in part, reflects the shift in corporate financing pattern in recent years with increased reliance on internal financing alongside increasing accent on external borrowing.

A significant feature of the credit growth this year has been the substantial flow of bank credit to the priority sector which showed an increase of Rs. 33,720 crore or about 16 per cent in the first

10 months of 2003-04, for which data are presently available. Bank credit for housing had increased by 33 per cent, while that for infrastructure by 25 per cent in the same period.

Financial markets and external developments

The financial markets have continued to remain generally stable. The call money rate declined from 6.3 per cent at end-March 2003 to 4.3 per cent by end-March 2004. Reflecting the easy liquidity conditions, the average daily absorption in the repo transactions under the Liquidity Adjustment Facility (LAF), increased substantially during last two months, averaging over Rs. 50,000 crore. It had averaged Rs. 25,800 in the first quarter of 2003-04. The overhang of liquidity has largely persisted as a result of continued capital inflows.

In general, yields in the government securities market have fallen during 2003-04. The yield on 10-year paper declined by 106 basis points from 6.21 per cent as at end-March 2003 to 5.15 per cent by end-March 2004. The repo rate cut by 50 basis points from 5.0 per cent to 4.5 per cent on August 25, 2003 was in tandem with market yields. The policy-stance helped in maintaining a generally stable environment in the government securities market.

The Indian foreign exchange market generally continued to witness orderly conditions. During the year, the exchange rate of rupee, over the end-March 2003 level appreciated by 9.5 per cent against US dollar, while it depreciated by 3.1 per cent against the euro, 5.9 per cent against the Pound sterling and 4.4 per cent against the Japanese yen. Significant depreciation of US dollar against other major currencies prompted adjustments in world currencies and this was also reflected in the exchange rate of the rupee.

The balance of payments position remains comfortable despite widening of the trade deficit. According to trade data (on shipment basis), exports in US dollar terms during April-February 2004 increased by 14.7 per cent, over and above an increase of 17.2 per cent witnessed in the preceding year. Export growth has, however, been better in recent months. Imports have expanded by 26.3 per cent, as compared with 17.3 in the previous year. Detailed commodity data available till December 2003 show that during the first three quarters of the current financial year, non-oil, non-gold import increased by 26.2 per cent as compared with an increase of 19.0 per cent in the corresponding period last year. The trade deficit (on shipment basis), in the current financial year up to February 2004 has nearly doubled to about US$ 15.5 billion, compared with US$ 8.0 billion, in the corresponding period of the preceding year. Notwithstanding the widening of the trade deficit, the current account remained in surplus due to robust invisible earnings. In the first three quarters of 2003-04, for which data are available, the current account surplus was US$ 3.2 billion, higher than US$ 2.9 billion in the corresponding period a year ago.

Capital inflows continue to remain robust. In the recent period, reserve accretion has been largely reflecting both comfortable liquidity prevalent in the global economy and the underscoring of confidence by the international community in the Indian economy. During 2003-04, the foreign exchange reserves increased by US$ 36 billion to US$ 111.7 billion as at end-March 2004.

During 2003-04, the significant increase in forex reserves has been accompanied by (i) smooth redemption of US$ 5.5 billion of Resurgent India Bonds (RIB), (ii) prepayment of certain high-cost foreign currency loans of the Government of India amounting to US$ 3.7 billion and (iii) India participating in the IMF’s financial support to Burundi, Brazil and Indonesia to the extent of US$ 561 million.

The data available regarding sources of accretion of reserves for the first three quarters show that foreign investments (direct and portfolio) increased by US$ 10.1 billion. NRI deposit flows added US$ 3.5 billion against US$ 2.4 billion last year. Short-term credits have also risen to US$ 2.4 billion from meagre US$ 0.4 billion. The level of the reserves now roughly equals the external debt of US$ 112.1 billion.

Follow-up measures

The Reserve Bank set up two internal groups, one on Liquidity Adjustment Facility (LAF) and the other on Instruments of Sterilisation. Based on the recommendations in these respects and the feedback from market participants, the RBI worked closely with Government to facilitate fine-tuning of the operating procedures and instruments to meet the new challenges. A memorandum of understanding

(MOU) was signed between the Government of India and the Reserve Bank on March 25, 2004 detailing the rationale and operational modalities of the *Market Stabilisation Scheme* (MSS). Under the MSS scheme, the government has agreed to the issuance of Treasury Bills and dated government securities with an overall ceiling of Rs. 60,000 crore for the year 2004-05. If the outstanding amount of issues under MSS touches a threshold limit of Rs. 50,000 crore, the ceiling and the threshold are subject to review. Following the MOU, an indicative schedule for issuance of such securities covering the first quarter of 2004-05 with a total auction amount of Rs. 35,500 crore has already been announced. The indicative schedule for auctions under MSS is subject to variations if market conditions so warrant. These securities would be managed and maintained by the Reserve Bank and would be no different from other gilts, except that the proceeds from these would remain with the Reserve Bank. Thus, the MSS provides an additional instrument of liquidity management to the Reserve Bank, without segmenting the government securities market. It would help in absorbing enduring liquidity in the system and in the process facilitate LAF to focus on day-to-day monetary and liquidity management.

We have also announced some changes in the LAF scheme. The revised scheme provides for daily 7-day repo and daily overnight fixed rate reverse repo, both to be conducted on week days. The 14-day repo is being retained for the time being. The spread between repo rate and reverse repo rate has been reduced from 200 basis points to 150 basis points, with the 7-day repo rate at 4.5 per cent and overnight reverse repo rate at 6.0 per cent. Also, the entire amount of support under the standing liquidity facilities for export credit refinance for banks and liquidity support to primary dealers (PDs), is now available at a single rate, viz., the reverse repo rate. This would result in some reduction in costs of funds for banks and PDs.

Under the revised scheme, the Reserve Bank will, however, continue to have discretion to conduct overnight repo or longer term auctions at a fixed rate or at a variable rate depending on market conditions and other relevant factors. Reserve Bank will also have the discretion to change the spread between the repo rate and reverse repo rate as and when appropriate.

It is expected that these measures under LAF and the MSS will enable the Reserve Bank to improve liquidity management in the system, to maintain stability in the foreign exchange market and to conduct monetary policy in accordance with the stated objectives.

We have also encouraged banks to be more transparent on their interest rates. We have continued our efforts in this direction in a consultative manner and in the November 2003 policy review, had requested Indian Banks Association (IBA) to advise its members suitably on the implementation of a scheme of benchmark prime lending rate (BPLR), keeping in view the operational requirements. Since then, most of the banks have announced their BPLRs. They are lower by 25 to 100 basis points for the public sector banks. During the first three quarters of 2003-04, the range of interest rate on advances above Rs. 2 lakh (other than for export credit), at which substantial business is contracted has shown some decline.

The policy review had also focussed attention on credit delivery. It has been the endeavour of the Reserve Bank to improve credit delivery mechanisms for agriculture, small and medium enterprises (SMEs) and other priority sectors. Keeping this in view and in accordance with the policy statement, an 'Advisory Committee on Flow of Credit to Agriculture and Related Activities (Chairman: Prof. V.S. Vyas)' and a 'Working Group on Flow of Credit to SSI Sector (Chairman: Dr. A.S. Ganguly)' were constituted.

The Vyas Committee has made systematic efforts to reach out to as many stakeholders as possible by visiting different parts of the country. In smaller groups the committee members have met with representatives of commercial banks, cooperatives and RRBs, government administrators, NGO leaders and other knowledgeable persons in 15 states of the country. On the basis of these deliberations, the Committee is planning to submit its interim report shortly, covering issues such as rate of interest on agriculture credit, NPA norms in agricultural financing, outreach in the context of service area approach and micro finance. The Committee is also looking into institutional and structural aspects of NABARD and RRBs, as also the operation of Lok Nayak Jaiprakash Fund. The Ganguly Working Group is examining issues relating to credit flow to medium enterprises also. The Group has held meetings with select SSI Associations and experts.

The Reserve Bank has set up a 'Committee on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore)' and mirror *Ad hoc* Committees have been set up by each bank. The Committee set up by the Reserve Bank has submitted three Reports. The first Report covers foreign exchange transactions, the second covers Government transactions and the third deals with banking operations relating to deposit accounts and other facilities. All the three reports are focused on *Common Persons*. Concerned departments of Reserve Bank are examining the recommendations made in these reports. With the functioning of the Reserve Bank Committee and the *ad hoc* Committees it is expected that there would be perceptible improvement in customer services and a simplification of procedures and practices.

In order to strengthen regulation and supervision, a 'Standing Technical Advisory Committee on Financial Regulation' has been set up. The Committee has representation from banks, SEBI and non-bank financial sector, academics, etc. Since its constitution, the Committee's assistance and views have been sought on a wide range of regulatory issues. A Working Group on Systemically Important Financial Intermediaries (SIFIs), has been set up to look into the monitoring of financial conglomerates with members from Reserve Bank, SEBI and IRDA. The working group is expected to propose a list of financial conglomerates and advise on the monitoring and reporting system. In accordance with the policy announcement, a Working Group on Development Financial Institutions (DFIs) has also been constituted to examine the broader framework of regulation of NBFCs. The Group is expected to submit its report shortly.

After the initiation of reforms, the Reserve Bank has, over the years, taken several measures to develop the government securities market. In continuation of these new guidelines were announced on March 29, 2004 to switch over the settlement in government securities transactions to the DVP III mode. The modifications would enable sale of government securities on the day of purchase, reducing the price risk and improving the liquidity in government securities market. The changeover would also enable rollover of repos, facilitate non-banks to move away from the call money market and also enable banks to reduce their dependence on the call money market.

With a view to bringing about further institutional development and improve the operational efficiency of the financial system, the Reserve Bank has been developing the *Real Time Gross Settlement (RTGS) system* and this has since gone live. For the time-being inter-bank transactions are being put through for four select banks which have participated in the trial run and efforts are being made for entry of other banks after assessing their readiness. Customer related transfers will be enabled later under the system. Other eligible bank and primary dealer participants will join in due course. The RTGS is expected to significantly reduce settlement risks and improve the quality of financial intermediation. In addition, Electronic Funds Transfers (EFT) is already in place in 15 centres and the Special EFT scheme is also operational in 127 centres, together covering about 8,500 bank branches.