

Annual Policy Statement
for the year 2005-06

Reserve Bank of India
Mumbai

Annual Policy Statement for the Year 2005-06
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The policy Statements of the Reserve Bank provide a framework for the monetary, structural and prudential measures that are taken from time to time against the background of an assessment of macroeconomic and monetary developments. In order to provide a distinctive focus between monetary policy and developmental policies, the format of presentation of this Statement has been modified while broadly following the pattern already set in previous years.

2. The Statement consists of two parts: Part I. Annual Statement on Monetary Policy for the Year 2005-06; and Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2005-06. An analytical review of macroeconomic and monetary developments was issued, a day in advance, as a supplement to Part I of the Statement providing the necessary information and technical analysis with the help of simple charts and tables.

3. There will be a Mid-term Review of the annual policy Statement in October, as in the past, covering both Part I and Part II of the Statement. In addition, there will be a First Quarter Review of Part I of the Statement in July and a Third Quarter Review in January. While the annual Statement and the Mid-term Review will continue, as in the past, to be presented in the meeting with bankers, the quarterly reviews will be released to the Press. The proposed quarterly reviews of monetary policy should provide the opportunity for structured communication with markets on a more frequent basis while retaining the flexibility to take specific measures as the evolving circumstances warrant. Tentatively, for the current financial year, the dates planned for the First Quarter Review, the Mid-term Review and the Third Quarter Review are July 26, 2005, October 25, 2005 and January 24, 2006, respectively.

Part I. Annual Statement on Monetary Policy for the Year 2005-06

The annual Statement on Monetary Policy for the Year 2005-06 consists of three Sections: I. Review of Macroeconomic and Monetary Developments during 2004-05; II. Stance of Monetary Policy for 2005-06; and III. Monetary Measures.

I. Review of Macroeconomic and Monetary Developments during 2004-05

Domestic Developments

4. The mid-term Review of the annual policy Statement released on October 26, 2004 had placed the real GDP growth for 2004-05 in the range of 6.0-6.5 per cent, lower than 6.5-7.0 per cent anticipated earlier in the annual policy Statement. The downward revision was prompted by the combined downside risk of high and uncertain oil prices and deficient monsoon rainfall on GDP growth.

5. The advance estimate of GDP released by the Central Statistical Organisation (CSO) in February 2005 has placed the GDP growth at 6.9 per cent during 2004-05, which is higher than the expectations of the mid-term Review but consistent with the projections of the annual policy Statement. The GDP growth of 6.9 per cent during 2004-05 is on top of a higher increase of 8.5 per cent in the previous year. During 2004-05, GDP from agriculture and allied activities is estimated to have increased by 1.1 per cent, despite deficient monsoon, as compared with 9.6 per cent in the previous year. GDP growth from the industrial sector at 8.3 per cent is higher than 6.5 per cent in the previous year reflecting higher growth in manufacturing. The services sector has expanded by 8.6 per cent as compared with 8.9 per cent in the previous year.

6. The annual inflation rate as measured by variations in the wholesale price index (WPI), on a point-to-point basis, peaked from 4.6 per cent at end-March 2004 to 8.7 per cent by end-August 2004 after which it registered a steady decline. As at end-March 2005, the annual point-to-point inflation

rate stood at 5.0 per cent as compared with 4.6 per cent a year ago. The inflation rate turned out as projected in the annual policy Statement, but lower than the mid-term Review projection of 6.5 per cent. It may, however, be noted that the inflation rate would have been higher but for successful policy interventions which included fiscal as well as monetary measures, and, more importantly, the full pass-through of higher oil prices has not taken place. During 2004-05, the prices of manufactured products (weight: 63.8 per cent) registered an increase of 4.5 per cent as compared with 6.7 per cent in the previous year. The prices of primary articles (weight: 22.0 per cent) increased by 2.5 per cent as compared with 1.6 per cent in the previous year. There was a higher increase of 9.2 per cent in prices of 'fuel, power, light and lubricants' group (weight: 14.2 per cent) as compared with 2.5 per cent in the previous year.

7. On an average basis, the annual rate of inflation during 2004-05 was higher at 6.4 per cent as compared with 5.4 per cent in the previous year. The prices of manufactured products, on an average, increased by 6.1 per cent as compared with 5.6 per cent in the previous year. The prices of primary articles increased, on an average, by 3.8 per cent as compared with 4.2 per cent in the previous year. The prices of 'fuel, power, light and lubricants' group increased, on an average, by 10.0 per cent as compared with 6.3 per cent in the previous year.

8. The movements in WPI inflation rate during 2004-05 largely reflected the sharp increase in prices of a number of key commodities. In order to segregate the impact of supply shocks, the mid-term Review of October 2004 had made a contextual analysis of WPI on account of the increase in prices of four commodities, viz., iron ore, iron & steel, mineral oils and coal mining (combined weight of 12.6 per cent in WPI). The WPI inflation rate, excluding these four items, works out lower at 2.0 per cent on a point-to-point basis, as against 3.3 per cent a year ago. On an average basis, it was 3.1 per cent as against 3.7 per cent in the previous year. Excluding only mineral oils (weight: 7.0 per cent), WPI inflation works out to 3.5 per cent as against 4.7 per cent in the previous year. On an average basis, it was 4.8 per cent as against 4.6 per cent in the previous year.

9. During 2004-05, oil prices in the international markets remained high and volatile. The average price of a basket of major international crude varieties (Brent, WTI and Dubai Fateh) at around US \$ 41.3 per barrel was about 42.3 per cent higher as compared with the average price of US \$ 29.0 per barrel in the previous year. In contrast, the average domestic price of petrol and diesel increased by only 17.5 per cent over the previous year. Admittedly, a part of the impact of increase in global oil prices on domestic oil prices was cushioned by fiscal measures such as cuts in excise and customs duties and a part was absorbed by domestic oil companies.

10. The point-to-point inflation rate based on consumer price index (CPI) for industrial workers was 4.2 per cent in February 2005 as compared with 4.1 per cent a year ago. On an average basis, CPI inflation was 3.8 per cent during 2004-05 (up to February) as compared with 3.9 per cent a year ago.

11. Monetary and credit aggregates for the year 2004-05 reflect the impact of conversion of a financial institution into a bank. During 2004-05, money supply (M_3) increased by 12.8 per cent (Rs.2,57,058 crore), net of conversion, as compared with 16.9 per cent (Rs.2,90,569 crore) in the previous year. The growth in aggregate deposits of scheduled commercial banks (SCBs) at 14.1 per cent (Rs.2,11,963 crore), net of conversion, was lower than 17.5 per cent (Rs.2,23,563 crore) in the previous year. The lower deposit growth could be partly attributed to reduction in non-resident Indian (NRI) deposits with the banking system. Deposit growth, adjusted for NRI deposits, was 16.3 per cent (Rs.2,20,509 crore), net of conversion, as against 18.3 per cent (Rs.2,09,147 crore) in the previous year. The expansion in currency with the public was also lower at 13.3 per cent (Rs.42,016 crore) as compared with 16.1 per cent (Rs.43,827 crore) in the previous year.

12. As regards the sources of change in M_3 , the increase in bank credit to the commercial sector at 21.7 per cent (Rs.2,21,870 crore), net of conversion, was higher than the increase of 13.5 per cent (Rs.1,21,494 crore) in the previous year. On the other hand, net bank credit to government increased by 0.9 per cent (Rs.6,638 crore) as against an increase of 9.9 per cent (Rs.67,143 crore) in the preceding year. This is attributable to the substantial decline in the net RBI credit to the Central Government. Banking sector's net foreign exchange assets increased by 23.8 per cent (Rs.1,25,412 crore)

primarily on account of an increase of 26.5 per cent (Rs.1,28,377 crore) in net foreign exchange assets of RBI.

13. The increase in reserve money during 2004-05 at 12.1 per cent (Rs.52,616 crore) was lower than the increase of 18.3 per cent (Rs.67,451 crore) in the previous year. As regards the components of reserve money, currency in circulation rose by 12.7 per cent (Rs.41,621 crore) as compared with 15.8 per cent (Rs.44,555 crore) in the previous year. Among the sources of reserve money, RBI's foreign currency assets (adjusted for revaluation) increased by Rs.1,15,044 crore as compared with an increase of Rs.1,41,428 crore in the previous year. The expansionary impact of foreign currency assets, however, was neutralised to a large extent by substantial recourse to the market stabilisation scheme (MSS) in conjunction with reverse repo operations under the liquidity adjustment facility (LAF). Consequently, the net RBI credit to the Central Government declined by Rs.50,646 crore (adjusted for the Government's deposit balances under MSS with RBI) as compared with a decline of Rs.76,065 crore in the previous year. The balances under MSS, to sterilise the impact of forex inflows, stood at Rs.64,211 crore at end-March 2005. RBI's credit to banks and commercial sector declined by Rs.833 crore as compared with a decline of Rs.2,728 crore in the previous year. The ratio of net foreign exchange assets (NFEA) to currency rose from 148.1 per cent in March 2004 to 166.2 per cent in March 2005 reflecting accretion to reserves on a continuous basis. Adjusted for MSS, the ratio of NFEA to currency was 148.8 per cent in March 2005.

14. Scheduled commercial banks' credit registered a strong increase of 26.0 per cent (Rs.2,18,623 crore), net of conversion, during 2004-05 as compared with 15.3 per cent (Rs.1,11,570 crore) in the previous year. Food credit increased by Rs.5,159 crore as against a decline of Rs.13,518 crore in the previous year. Non-food credit increased by 26.5 per cent (Rs.2,13,464 crore), net of conversion, as compared with 18.4 per cent (Rs.1,25,088 crore) in the previous year. The incremental non-food credit-deposit ratio was as high as 100.7 per cent, net of conversion, as compared with 56.0 per cent in the previous year. Incremental investment-deposit ratio fell commensurately to 25.1 per cent from 58.2 per cent in the previous year, thereby accommodating the higher credit demand to a large extent.

15. As observed in the mid-term Review of October 2004, 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. While credit flow to these sectors continues to remain buoyant, more recent indications are that credit to agriculture and industry has also picked up.

16. During 2004-05 (April-February), agricultural credit increased by 23.1 per cent as compared with 15.0 per cent in the corresponding period of the previous year. The flow of credit to industry increased by 12.6 per cent as compared with 3.5 per cent in the corresponding period of the previous year. The increase in credit flow to the infrastructure industries, viz., roads, ports, power and telecommunications was 38.6 per cent as compared with an increase of 33.2 per cent in the corresponding period of the previous year. There has also been a discernible increase in credit flow to industries like food processing, cotton textiles, iron & steel, other metal & metal products, drugs & pharmaceuticals, gems & jewellery, automobiles, petroleum, electricity and construction.

17. While there was substantial increase in credit extended by scheduled commercial banks (SCBs) during 2004-05, their investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., declined by 2.9 per cent (Rs.2,573 crore), net of conversion, as compared with a decline of 3.9 per cent (Rs.3,669 crore) in the previous year. The total flow of funds from SCBs to the commercial sector, including their investments, increased by 23.6 per cent (Rs.2,10,891 crore), net of conversion, as against 15.7 per cent (Rs.1,21,419 crore) in the previous year. As such, flow of funds to the commercial sector during 2004-05 exceeded the growth of 19.0 per cent anticipated in the mid-term Review of October 2004.

18. During 2004-05, the Central Government's net market borrowings at Rs.46,050 crore (gross Rs.1,06,501 crore) were significantly lower than such borrowings in the previous year. This could be partly attributed to receipts by the Centre from the States under the debt swap scheme (DSS). The state governments prepaid Rs.16,943 crore of central government debt through additional market borrowings over and above the prepayment from their

small savings collection under DSS. Market borrowings by state governments under DSS were in addition to their normal market borrowings of Rs.15,649 crore (net) [Rs.20,772 crore (gross)] and Rs.1,387 crore for prepayment of RIDF loans to NABARD. During 2004-05, the combined market borrowings of the Centre and States were Rs.80,029 crore (net) [Rs.1,45,603 crore (gross)] with lower RBI support in the form of devolvement and private placement at Rs.1,197 crore due to comfortable liquidity conditions.

19. In addition to the normal market borrowings, the Central Government raised Rs.65,481 crore (face value) under MSS for sterilisation purposes. Overall, the net resources raised through government securities (Centre, States and MSS) amounted to Rs.1,45,510 crore during 2004-05 as compared with Rs.1,35,192 crore (Centre and States) in the previous year.

20. The weighted average cost of Central Government borrowing through primary issuance of dated securities rose by 40 basis points to 6.11 per cent in 2004-05 from 5.71 per cent in the previous year. The weighted average maturity of the dated securities issued during 2004-05 was lower at 14.13 years as compared to 14.94 years in the previous year.

21. The persistence of a large government borrowing programme has implications for efficient monetary and debt management. With a pick up in credit demand, the banking system reduced its holding of government securities as a share of its net demand and time liabilities (NDTL) from 41.3 per cent in March 2004 to 38.5 per cent in March 2005. Such holdings of government securities, however, continue to be in excess of the statutory minimum requirement of 25 per cent of NDTL. In terms of volume, such holdings above the statutory liquidity ratio (SLR) amounted to Rs.2,60,582 crore in March 2005.

22. During 2004-05, there was a slippage in the key deficit indicators for 2004-05 from their budgeted levels. Moreover, the Union Budget sets a 'pause' for deficit indicators in 2005-06 as envisaged in the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 keeping in view the impact of implementation of the recommendations of the Twelfth Finance Commission (TWFC) which implies substantially higher devolution to States. It is, however, essential to pursue fiscal consolidation with resolve to realise

the long-term potential of the economy. In this context, the parameters set out in FRBM Act coupled with the recommendations of TWFC provide a basis for fiscal consolidation within the federal structure.

23. During 2004-05, financial markets remained generally stable, though interest rates showed some intra-year upward movement. At the shorter end of the market, the weighted average call money rate increased by 40 basis points from 4.37 per cent in March 2004 to 4.77 per cent by March 2005. Similarly, the cut-off yields on 91-day and 364-day Treasury Bills also increased by 95 and 122 basis points from 4.37 per cent and 4.44 per cent to 5.32 per cent and 5.66 per cent, respectively, by March 2005. The yields on government securities with 1-year residual maturity increased by 97 basis points from 4.54 per cent to 5.51 per cent by March 2005. The weighted average discount rate on commercial paper (CP) of 61 to 90-days maturity increased by 73 basis points from 5.11 per cent to 5.84 per cent by March 2005.

24. An interesting development in the money market during 2004-05 was the increase in the relative size of the collateralised segment vis-à-vis the uncollateralised segment. The combined average daily transactions of market repo and collateralised borrowing and lending obligation (CBLO) was proportionately higher than those in the uncollateralised call/notice money market. The spread between call money rates and market repo rates narrowed from around 60 basis points in April 2004 to around 10 basis points by February 2005. The spread, however, widened to around 40 basis points in March 2005 on account of increase in market liquidity. Institutional and technological changes such as operationalisation of Clearing Corporation of India Limited (CCIL), negotiated dealing system (NDS), real time gross settlement (RTGS), delivery versus payment (DvP) III mode of settlement in government securities and rollover of repo have lowered transaction costs, reduced settlement risks, enhanced transparency and facilitated the ease of transaction. This is reflected in increasing collateralisation of transactions and better alignment of interest rates in the money market.

25. The yield on government securities with 5-year residual maturity increased by 158 basis points from 4.78 per cent in March 2004 to 6.36 per cent in March 2005. The yield on securities with 10-year maturity increased by

150 basis points from 5.15 per cent to 6.65 per cent in March 2005. Similarly, the yield on securities with 20-year residual maturity increased by 114 basis points from 5.85 per cent to 6.99 per cent during the same period.

26. As the longer-term yields exhibited sharper movements, the tenor spread in the government securities revealed intra-year variations. The spread between securities with residual maturities of 1-year and 10-year widened from 61 basis points in March 2004 to 114 basis points in March 2005. Similarly, the spread between government securities with residual maturities of 1-year and 20-year widened from 131 basis points in March 2004 to 148 basis points in March 2005.

27. While the yield curve steepened during 2004-05, the interest rate movement was orderly notwithstanding the sharp upward movement noticed during the third quarter of the financial year. For example, the average call money rates had peaked to 6.30 per cent and the yield on 10-year government securities had touched 7.31 per cent in November on account of adverse expectations emanating from uncertainties on the inflation front but the rates moderated in the subsequent period. Overall, despite large excess liquidity in the system, interest rates moved upwards reflecting uncertainties in oil prices, upward trend in global interest rates and increasing domestic demand for credit.

28. In line with the trend in yields in the government securities market, the yields on corporate papers also increased. The yield on 5-year AAA-rated corporate bond increased from 5.60 per cent in March 2004 to 7.14 per cent by March 2005. The spread between yields of AAA-rated corporate bond and government securities for 5-year residual maturity, however, narrowed from 82 basis points in March 2004 to 76 basis points by March 2005.

29. The term deposit rates offered by the public sector banks for maturities up to one year moved from a range of 3.75-5.25 per cent in March 2004 to 2.75-6.0 per cent in March 2005. The interest rates on term deposits over one year moved from a range of 5.00-6.00 per cent to 4.75-7.00 per cent during this period. The spread between typical deposit rates of 15-29 days and over 3-year tenor offered by public sector banks widened to 200 basis points in March 2005 from 175 basis points a year ago.

30. The benchmark prime lending rates (BPLRs) of public sector banks moved from a range of 10.25-11.50 per cent in March 2004 to 10.25-11.25 per cent in March 2005. BPLRs of foreign and private sector banks moved from a range of 11.00-14.85 per cent and 10.50-13.00 per cent in March 2004 to 10.00-14.50 per cent and 11.00-13.50 per cent, respectively, in March 2005.

31. During 2004-05, a substantial part of banks' lending was at sub-BPLR rates given the competitive conditions in the credit market. The share of sub-BPLR lending in total lending of commercial banks, excluding export credit, increased from about 50 per cent in March 2004 to over 60 per cent by March 2005. As at end-March 2005, public sector banks' median (representative) lending rate for the demand and term loans (at which maximum business is contracted), in the range of 9.00-12.50 per cent and 8.35-12.00 per cent, respectively, exhibited moderation as compared with their corresponding levels of 11.00-12.75 per cent each in March 2004. The movement in lending rates was in the desired direction keeping in view the concern expressed in the mid-term Review of November 2003 regarding the observed rigidities in the downward movement of lending rates.

32. The Reserve Bank has been persistently drawing the attention of banks to interest rate risks. Accordingly, banks were advised in January 2002 to build up investment fluctuation reserves (IFR) to a minimum of 5 per cent of their investment portfolio under the 'held for trading' (HFT) and 'available for sale' (AFS) categories, by transferring the gains realised on sale of investments within a period of five years. As at end-February 2005, banks have built up IFR up to 3.9 per cent. In September 2004, RBI allowed banks to exceed the ceiling of 25 per cent of investments included under 'held to maturity' (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 of NDTL. Further, in the mid-term Review of October 2004, banks were advised to prepare themselves to implement the capital charge for market risk as envisaged under Basel norms in a phased manner by end-March 2006.

33. The equity market during 2004-05 passed through its peak and trough, moving from a low on May 17 to record its all-time high in March.

A strong macroeconomic outlook, positive investment climate, continued investment support by foreign institutional investors (FIIs), and encouraging corporate financial results were the main factors driving the market sentiment during 2004-05. However, an intra-year rise in inflation, deficient monsoon rainfall, outlook in the global financial markets and volatility in international oil prices were the main factors that led to some uncertainties.

Developments in External Sector

34. During 2004-05 (up to February), India's exports in US dollar terms increased by 27.1 per cent as compared with 16.4 per cent in the previous year. Imports showed a higher increase of 36.4 per cent as compared with 25.0 per cent in the previous year. While the increase in oil imports was even higher at 44.6 per cent as compared with 15.7 per cent in the previous year, non-oil imports showed an increase of 33.3 per cent as compared with 28.8 per cent in the previous year. Consequently, the trade deficit widened to US \$ 23.8 billion as compared with US \$ 13.7 billion in the previous year.

35. At a further disaggregated level, non-oil trade balance registered a deficit of US \$ 4.8 billion during 2004-05 (April-January) as against a surplus of US \$ 1.3 billion in the corresponding period of the previous year. Non-oil imports, excluding gold and silver, increased by 33.8 per cent as compared with an increase of 24.8 per cent in the corresponding period of the previous year. Import of gold and silver increased by 60.8 per cent over and above a growth of 50.9 per cent in the corresponding period last year. Import of capital goods showed an increase of 32.1 per cent as compared with an increase of 30.1 per cent in the corresponding period of the previous year, reflecting strength of investment demand. Growth in exports was generally broad-based with primary products showing an increase of 24.7 per cent and manufactured goods expanding by 22.2 per cent; particularly, engineering goods, gems & jewellery and chemicals were the key drivers in manufacturing exports.

36. The current account of the balance of payments (BoP) had remained in surplus consecutively over the past three years (2001-04). During 2004-05 (April-December), the current account showed a deficit of US \$ 7.4 billion as against a surplus of US \$ 4.8 billion in the corresponding period of

the previous year, reflecting widening of trade deficit. The trade deficit (on payments basis) of US \$ 28.4 billion was partially offset by net invisible receipts of US \$ 21.0 billion. Major items of net invisible receipts included software services (US \$ 12.2 billion) and private transfers (US \$ 15.5 billion). However, increase in capital inflows more than offset the current account deficit. While net invisible receipts remain robust, the current account for the year as a whole is likely to exhibit a deficit on account of widening of trade deficit.

37. The net capital inflows at US \$ 20.7 billion during April-December 2004 comprised portfolio investment (US \$ 5.1 billion), direct investment (US \$ 2.2 billion), external commercial borrowings (US \$ 4.1 billion), short-term credit (US \$ 2.7 billion) and other capital (US \$ 4.3 billion), while NRI deposits registered net outflows (US \$ 1.3 billion). As a result, net accretion to foreign exchange reserves, including valuation changes, amounted to US \$ 18.2 billion during April-December 2004.

38. During 2004-05, the Indian foreign exchange market witnessed orderly conditions with Rupee exhibiting two-way movements. The Rupee came under some pressure during April-July 2004 on account of adverse developments in the Indian equity market, rising global oil prices and a fall in capital inflows. The exchange rate of the Rupee which stood at Rs.43.39 per US dollar at end-March 2004 depreciated by 6.6 per cent to Rs.46.45 per US dollar by end-July 2004. The Rupee recovered and stood at Rs.43.75 per US dollar at end-March 2005. During 2004-05, the Rupee depreciated by 0.8 per cent against the US dollar, 6.2 per cent against Euro, 3.1 per cent against Pound sterling but appreciated by 1.9 per cent against Japanese yen. India's foreign exchange reserves increased by US \$ 28.5 billion from US \$ 113.0 billion at end-March 2004 to US \$ 141.5 billion by end-March 2005.

39. The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary. The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and

endeavours to reflect the “liquidity risks” associated with different types of flows and other requirements.

Developments in the Global Economy

40. The world economy expanded by 5.1 per cent during 2004 recording its highest growth rate since the mid-1970s. The International Monetary Fund (IMF) has projected the world economic growth to slow to 4.3 per cent during 2005 and 4.4 per cent in 2006. Even this pace of expansion is higher than the average growth recorded in the last two decades. The buoyancy in the world economy has been aided by productivity gains, cost cutting by corporates, trade expansion, financial stability, benign inflation and low interest rates. Global economic expansion has been largely driven by accelerated growth in the US, some newly industrialized Asian economies, Commonwealth of Independent States (CIS) and other emerging markets and developing countries, especially, Russia, China and India. Growth in sub-Saharan Africa has also distinctly improved.

41. Consumer price inflation in the US has increased over last two years, but remained low in the Euro area, Japan and other advanced economies. Inflation in other emerging markets and developing countries also declined to 5.7 per cent in 2004 from 6.0 per cent in the preceding year, with perceptible decline in Africa, central and eastern Europe, CIS countries and Latin America. Inflation in developing Asia, however, increased from 2.6 per cent in 2003 to 4.2 per cent in 2004 with inflation in China edging up from 1.2 per cent to 3.9 per cent. Nevertheless, general inflation has remained low in spite of sharp increase in commodity prices in 2004 with oil prices rising by over 30 per cent and non-fuel commodity prices rising by nearly 19 per cent. Going forward, the risks that inflation may turn out to be higher and growth lower than currently anticipated has increased.

42. The rise in oil prices appears to have a large permanent component and this makes it important to factor in the second round effects in assessing the inflationary impact. As per IMF estimates, a permanent US \$ 5 per barrel increase in oil prices was expected to lower global GDP growth by up to 0.3 percentage points. However, the adverse impact on growth was not apparent during 2004 because the oil price increase reflected acceleration in demand. The large increase in export earnings of oil-exporting countries

have supported strong growth and have resulted in fiscal and current account surpluses in these countries. While some non-oil producing countries have benefited from strong growth in oil-producing countries, higher oil prices have the potential for adverse balance of payments effects and could lead to substantial adjustment in domestic consumption with attendant adverse impact on growth. If capacity pressures seen in some industries persist and labour market conditions tighten, inflationary pressures could emanate both from the demand and supply side. Overhang of liquidity in some emerging markets, fuelled by large capital flows amidst global external imbalances could also accentuate inflationary pressures.

43. Risks to growth arise from current account and fiscal imbalances and excessive leveraging in some advanced economies which has necessitated current account and exchange rate adjustments. Global expansion has been largely imbalanced with hesitant recovery amidst structural rigidities in some advanced economies, leaving the prospects of global growth in near term somewhat uncertain. Current account deficit of advanced economies has widened to 1.0 per cent of GDP, with the US running a deficit as high as 5.7 per cent of GDP. Fiscal gaps in the US, the Euro area and Japan remain large. Unemployment rates in advanced economies have declined very little in relation to pick up in economic activity. Currency adjustments are still not over in spite of 20 per cent real effective exchange rate depreciation of the US dollar over last two years and a 13 per cent appreciation in the Euro. Policy rates have been raised in the US but are still below the neutral level in major advanced economies, except the UK. Short-term market interest rates in advanced economies have hardened by more than 50 basis points in the first quarter of 2005. Though long-term interest rates have not moved as much, the transmission could follow. While net private capital flows to emerging markets increased sharply by 32 per cent in 2004 to nearly US \$ 200 billion, the levels may not be sustained in the coming years. If unanticipated macroeconomic or geopolitical developments occur against this background, the extent of required adjustment could get amplified.

44. The global financial system today is far more stable than in the latter half of the 1990s as a result of robust world economic growth over the past three years and good corporate earnings. The financial institutions addressed issues

arising out of bad loan problems and strengthened their capital base as well as risk management systems. In the emerging market economies, improved economic fundamentals coupled with enhanced policy credibility resulted in a series of upgrades on sovereign credit ratings. This has contributed to the benign financial market conditions and tightening of spreads. However, world financial markets are known to be characterised by multiple equilibria where good state of markets could change into a bad state within a very short period. Abundant global liquidity and low short-term interest rates over the past few years have also contributed to asset price rise and leveraging of corporate and household balance sheets in several parts of the world, covering both the emerging and the matured markets. Furthermore, considering that economic expansion may be at a very advanced stage of business cycle in some systemically important matured markets, it may be difficult to sustain the current high levels of corporate earnings. There is an even greater need now to keep a vigil on potential bubbles in the asset markets since real estate market valuations have, in the recent past, been supported by low-interest consumer debt. Current equity valuations, which still look good in most markets, could move very quickly if corporate earnings drop. Currency adjustments have proceeded in an orderly manner over last two years, but if required adjustments in current account and fiscal gaps of advanced economies do not take place over the next few years, interest rates may have to rise to clear the markets. In such an event, the impact on balance sheets could be much larger than is currently being anticipated. Finally, if oil prices continue to firm up at a pace seen so far in 2005, financial markets could see a major reaction as pace of economic activity slackens, corporate earnings fall and external imbalances sharpen.

45. Over the years, India's commercial and financial linkages with the rest of the world has been increasing with trade liberalisation and openness on the capital account. This is reflected in the transmission of international impulses to the real sector and domestic financial markets. Trends in international prices have now significant influence on domestic prices. Indian corporates and institutions are increasingly accessing international markets with consequent asset diversification. While this process has provided important opportunities, it has also brought in new challenges and risks, necessitating fine-tuning of macro policies in a much broader context.

II. Stance of Monetary Policy for 2005-06

46. During 2004-05, monetary policy faced difficult challenges which prompted a change in the stance in the mid-term Review of October 2004. First, there was a carry forward of excess liquidity of over Rs.81,000 crore. Second, the headline WPI inflation accelerated beyond the anticipated level during the first half of the year. Third, the seasonal decline in food prices did not materialise fully, perhaps stemming from deficient monsoon. Fourth, international commodity prices remained high and volatile. Fifth, internationally, monetary policy stance in a number of countries was transiting from highly accommodative to a neutral level. Sixth, the pass-through of international commodity price pressures to domestic inflation had implications for inflationary expectations. Seventh, given the uncertainties, the reaction of financial markets was adverse. As interest rates were at historically low levels, the upside risk was high. There was sharp upward movement in interest rates towards the middle of the year which ensued a selling pressure in government securities market. Eighth, the equity markets touched a low on May 17 which had an adverse impact on sentiments very temporarily and markets bounced back very quickly thereafter. Finally, these developments occurred at a time when industrial growth was looking up after a prolonged period of sluggishness and non-food credit was also picking up. In the event, the Reserve Bank had to balance the considerations of growth while containing inflationary expectations. Given the role of supply factors in the nature of inflation, the response was in concert with the Government. In signalling its commitment to price stability, the Reserve Bank switched its stance from a 'very close watch on the movements in the price level' in the annual policy Statement to 'equal emphasis on price stability' in the mid-term Review. Similarly, liquidity management for the purpose was emphasised with a switch from a provision of 'adequate liquidity' to 'appropriate liquidity'. The policy measures were also calibrated to evolving circumstances with a view to stabilising inflationary expectations.

47. During 2004-05, the following steps were taken in a measured and calibrated manner. First, the Reserve Bank communicated its assessment of the supply-induced nature of inflation to the market on several occasions. Second, the market was sensitised to the differential behaviour of inflation

at the producers' and the consumers' level, the former being higher as observed in a number of other oil-importing countries. Third, the Government responded with fiscal measures, particularly by reducing customs and excise duties on oil. Fourth, corporates also responded positively by moderating the exercise of their pricing power. Fifth, 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. Sixth, for a more flexible management of liquidity, overnight fixed rate reverse repo under LAF was introduced. Seventh, CRR was raised by one-half of one percentage point to 5.0 per cent. Eighth, the remuneration of CRR was delinked from the Bank Rate and was reduced to 3.5 per cent to enhance its effectiveness as a monetary instrument. Ninth, banks were allowed to transfer their investment into HTM category up to their statutory minimum SLR requirement after providing for depreciation. While this measure provided an opportunity to banks to interface with interest rate cycles, at a macro level, it helped in maintaining financial stability. Finally, the fixed reverse repo rate under LAF was raised by 25 basis points to 4.75 per cent. However, the repo rate and the Bank Rate were left unchanged at 6.0 per cent signalling the short-term nature of upward inflationary pressures. The financial markets responded positively to the package of measures and, consequently, interest rates stabilised towards the last quarter of the year, *albeit* at higher levels, but lower than their intra-year highs registered during the middle of the year. Moreover, credit flow to the commercial sector remained uninterrupted and the government borrowing programme could be completed smoothly.

48. In the conduct of monetary policy, the Reserve Bank was faced with the challenge of reconciling two dominant views. As inflation was supply induced, it was argued that direct monetary policy action may be premature keeping in view the fact that industry was coming out of a sluggish phase. On the other hand, the deterioration in inflation expectations on the basis of observed acceleration in headline inflation, accompanied by sharp movements in market interest rates, tested the resolve of the central bank on price stability. Since such a deterioration occurred under conditions of overhang of excess liquidity, strong credit growth, incomplete pass-through of oil price shock and uncertainties about its second round effects, the other argument was in favour of monetary policy response to contain inflationary expectations.

The received wisdom, with the hindsight of oil price shocks of the 1970s and the 1980s, is that in the face of a significant supply shock, it is not prudent for monetary policy to be overly accommodative. Moreover, globally, monetary policy was transiting in a number of countries from excessive accommodation towards a neutral position on inflation concerns. On balance of considerations, the Reserve Bank raised CRR and the reverse repo rate moderately to signal its strong commitment to price stability. In this context, it is important to note that higher levels of sustainable growth is feasible only in an enabling environment of stable prices.

49. Monetary management during second half of 2004-05 was conducted broadly in conformity with the stance of the policy set out for the second half of the year. In terms of macroeconomic outcome during 2004-05, first, the GDP growth rate turned out to be better than anticipated largely on account of higher than expected growth from agricultural sector. More importantly, GDP growth was characterised by a pick up in industrial activity which, if sustained, could lift India to a higher growth trajectory. Second, the inflationary outcome, though consistent with the anticipation at the beginning of the year, turned out to be more favourable than the perception of the mid-term Review due to moderation in prices of primary and manufactured products as well as cushioning of the oil price impact. Third, while interest rates in money and government securities markets rose intra-year, they stabilised during the later part of the year *albeit* at higher levels. Fourth, the pick up in non-food credit growth was generally sustained and distribution of credit became broad-based across sectors during the later part of the year. More importantly, the expansion of credit did not trigger an increase in lending rates. Fifth, the term deposit rates showed some increase. Sixth, money supply growth turned out to be lower than the projections made at the beginning of the year. Seventh, though the exchange value of the rupee vis-à-vis the US dollar depreciated at the beginning of the year, it recovered and exhibited greater two-way movement. Eighth, the trade deficit widened significantly reflecting a deficit on non-oil trade balance and higher oil imports. Ninth, though net invisible receipts are buoyant, the current account of balance of payments which remained in surplus for consecutive three years is turning into a deficit during 2004-05 reflecting adverse trade balance. While invisibles, such as private remittances have lent support to the current account, the

trade account has particular relevance as it reflects the competitiveness of the underlying industrial structure and the degree of openness. Tenth, capital flows resumed after a brief pause resulting in significant increase in foreign exchange reserves during the year. Finally, corporate results and the domestic business outlook continue to remain positive.

50. Against the background of developments during 2004-05, the stance of monetary policy will depend on several factors, including macroeconomic prospects, global developments and the balance of risks. First, the outlook for growth in 2005-06, which should be noticeably better than the previous year, may get moderated by the conditions in oil markets which remain tight. Second, if the impact of mineral oil prices on WPI is isolated, the underlying inflationary pressures appear moderate. The supply factors will continue to dominate the price situation, while demand management seems to invite close attention. Third, the non-food credit during 2004-05 recorded its second highest growth in 55 years. There is evidence of increase in credit-elasticity of GDP and credit penetration. Hence, adequate credit growth needs to be ensured for productive sectors and the borrowing programme of governments accommodated, while closely assessing the implications for demand-management to maintain macro and price stability. In these circumstances, the liquidity management becomes critical. The interest rate outlook should take into account these domestic challenges but the increasing integration warrants some attention to global factors. Fourth, the borrowing programme of the Centre was unusually low in 2004-05. While the borrowing programme for 2005-06 is significantly higher than the previous year, it is in line with the magnitudes in 2002-03 and 2003-04, though the credit growth was sluggish in those years. Fifth, the current account, which was in surplus for three consecutive years, is turning into a deficit. The capital account continues to be in surplus in a significant way. Current indications are that these trends will continue in 2005-06 and, consequently, the external sector will exhibit strength and resilience, though unanticipated, globally-transmitted shocks cannot be ruled out.

51. The India Meteorological Department (IMD) in its forecast of South-West monsoon for the current year has placed the expected rainfall at 98 per cent of its long period average. With a normal monsoon, the growth in agriculture can be assumed to be around 3 per cent. Further, it is expected

that industry and services sectors would maintain their current growth momentum while absorbing the impact of oil prices. The real GDP growth during 2005-06, on the basis of above assumptions, could be placed around 7.0 per cent for the purpose of monetary policy formulation.

52. A factor that 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. First, the liquidity overhang which was reduced to a significant extent by December 2004, has since increased to levels witnessed at the beginning of 2004-05. Second, the international oil prices have again turned volatile with an upward pressure. Third, besides oil, the other primary commodity prices remain firm in international markets. Fourth, the full pass-through of international oil prices to domestic price has not taken place and fiscal manoeuvrability on this front is getting limited. Fifth, credit growth continues to remain buoyant. Finally, as against these factors, it must be recognised that there is evidence of increasing productivity in several sectors in the economy that could moderate pressures on prices. The level of food stocks and forex reserves provide cushions against some price increases. Further, the contextual analysis of WPI excluding mineral oils, on a point-to-point basis in 2004-05, worked out to 3.5 per cent as against 4.7 per cent in the previous year, which gives some indication of supply shock elements of WPI as distinct from what may be construed as core components of inflation. In view of these considerations governing current trends, the inflation rate in 2005-06, on a point-to-point basis, may be placed in a range of 5.0-5.5 per cent subject to the growing uncertainties on the oil front both in regard to global prices and their domestic absorption.

53. Consistent with the real growth of GDP and inflation, the projected expansion of money supply (M_3) for 2005-06 is placed at 14.5 per cent. In tune with this order of growth in M_3 , increase in aggregate deposits of scheduled commercial banks is set at Rs.2,60,000 crore which is higher by 15.0 per cent over its level in the previous year. Non-food bank credit including non-SLR investments of banks is projected to increase by around 19.0 per cent. This magnitude of credit expansion is expected to meet adequately the credit needs of all the productive sectors of the economy.

54. For the year 2005-06, the Union Budget has placed the fiscal deficit at 4.3 per cent of GDP and the net market borrowing programme of the Centre is budgeted at Rs.1,10,291 crore as compared with Rs.46,050 crore in the previous year. While the borrowing programme of the Centre is much higher than that in the previous year, taking into account the normal market borrowing programme of States and the comparable level of borrowings of Centre and States in the years prior to 2004-05, the Reserve Bank expects to conduct debt management within the monetary projections for 2005-06 barring unexpected developments. In this regard, there is scope for accommodating continued growth in credit needs as well as the higher borrowing programme to the extent it is possible to unwind MSS to provide appropriate liquidity consistent with macro objectives.

55. Monetary policy would continue to enhance the integration of various segments of the financial market, improve credit delivery, nurture credit culture and enhance the quality of financial services. Given the volatility in the inflation rate during 2004-05, there is also a need to consolidate the gains obtained in recent years from reining in inflationary expectations. It is important to appreciate that, while sustained efforts over time have helped to build confidence in price stability, inflationary expectations can turn adverse in a relatively short time if noticeable adverse movements in prices take place. In the world economy, after a prolonged period of low inflation, there are signs that inflation may be edging up. The global oil markets continue to remain tight with higher prices and increased volatility. Credible commitment of policy to fight inflation is critical to stop translation of higher oil prices into wage-price spirals. In addition, the international prices of non-oil primary commodities may continue to remain firm. On the domestic front, the manoeuvrability on oil prices is getting limited and corporates have a higher probability of gaining their pricing power with a better industrial outlook. The pricing pressure, if it were to occur from the supply side, could get complicated by continuing overhang of excess domestic liquidity. While the economy has the resilience to withstand supply shocks, the upside risks do exist. As such, the inflationary situation needs to be watched closely and there could be no room for complacency on this count.

56. In the context of current inflation scenario, an issue of policy interest for financial management by banks and other market participants is whether the interest rate cycle has turned from the low observed during 2003-04. 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 transited in a non-disruptive manner. In this regard, it is instructive to observe global trends as the Indian economy is progressively getting linked to the world economy. While there is an overhang of domestic liquidity, partly mirroring abundant global liquidity, the trends in global interest rates, inflation expectations and investment demand would also have some relevance in the evolution of the domestic interest rates. It will, therefore, be desirable to contain inflationary pressures to stabilise domestic financing conditions both for the governments and the private sector.

57. 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 MSS, LAF and CRR, and using the policy instruments at its disposal flexibly, as and when the situation warrants.

58. In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the inflationary situation, the overall stance of monetary policy for the year 2005-06 will continue to be as set out in the mid-term Review of October 2004, namely:

- 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. Monetary Measures

(a) Bank Rate

59. In the mid-term Review of October 2004, the Bank Rate was kept unchanged at 6.0 per cent. 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) Reverse Repo Rate

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

- To increase the fixed reverse repo rate by 25 basis points under the liquidity adjustment facility (LAF) of the Reserve Bank effective from April 29, 2005 to 5.00 per cent from 4.75 per cent.

61. The repo rate will continue to be linked to the reverse repo rate, as at present. However, the spread between the reverse repo rate and the repo rate is reduced by 25 basis points from 125 basis points to 100 basis points with effect from April 29, 2005. Accordingly, the fixed repo rate under LAF will continue to remain at 6.0 per cent.

(c) Cash Reserve Ratio

62. The cash reserve ratio (CRR) of scheduled banks is currently at 5.00 per cent. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, on a review of the current liquidity situation, it is felt desirable to keep the present level of CRR (5.00 per cent) unchanged.

First Quarter Review

63. The First Quarter Review of this part of the annual policy Statement will be undertaken on July 26, 2005 and will contain such other changes/ measures as may be necessary.

Part II. Annual Statement on Developmental and Regulatory Policies for the Year 2005-06

64. A stable and efficient financial sector is essential for sustained economic growth. In this context, the annual policy Statements as well as mid-term Reviews of RBI have been continuously focusing on the developmental and regulatory measures to strengthen the financial system. The policy Statements also discern the links among monetary, credit and regulatory policies involving the overall structural transformation of the real and financial sectors. The emphasis has been on safeguarding the financial stability of the overall system through effective monitoring and assurance of implementation of regulations. In this direction, the overall approach has been that of reorienting the role of RBI for improving institutional soundness, strengthening the regulatory and supervisory processes in alignment with international best practices and developing the necessary technological and legal infrastructure. While the approach towards the reforms has been gradual and relevant to the context, consultative processes and appropriate sequencing of measures have succeeded in aiding growth, avoiding crises, enhancing efficiency and imparting resilience to the system. The aim is to move towards a system that is responsive to the needs of the common person.

65. In order to reinforce stability of the overall system and to serve the common person, the emphasis of the policy Statement, at this stage, is on certain key areas. First, it is useful to debate the current regulations on interest rates and stipulations relating to priority sector in terms of their contemporary effectiveness in delivering adequate credit at appropriate prices. Second, to facilitate a balanced development of the financial system, it is necessary to further develop money, forex and government securities markets. Third, there is a need to bridge the financing gaps in agriculture and in small and medium enterprises in order to enhance credit delivery. Fourth, from a systemic point of view, sound corporate governance practices, better risk management and adherence to prudential norms within the financial sector need to be encouraged. Fifth, in order to strengthen the payment and settlement systems, a roadmap for development and application of technology in the financial sector in the medium-term becomes important. Finally, as financial institutions expand and become more complex,

it is imperative to ensure availability of quality services to all sections of the population.

66. In order to have focused attention on the identified areas for policy purposes, this Annual Statement on Developmental and Regulatory Policies for the Year 2005-06 consists of five Sections: I. Interest Rate Prescriptions; II. Financial Markets; III. Credit Delivery Mechanisms; IV. Prudential Measures; and V. Institutional Developments.

I. Interest Rate Prescriptions

67. The deregulation of financial markets in the recent years has improved the competitive environment in the financial system and strengthened the transmission mechanism of monetary policy. Sequencing of interest rate deregulation has been an important component of the reform process which has imparted greater efficiency in resource allocation. The process has been gradual and predicated upon institution of prudential regulation of the banking system, market behaviour, financial opening and, above all, the underlying macroeconomic conditions. The interest rates have been largely deregulated except for (i) savings deposit accounts, (ii) non-resident Indian (NRI) deposits, (iii) small loans up to Rs.2 lakh and (iv) export credit.

68. The annual policy Statement of 2002 had weighed the option of deregulation of interest rate on savings accounts but the time was not considered opportune considering that bulk of such deposits are held by households in semi-urban and rural areas. It has, however, been argued that deregulation will facilitate better asset-liability management for banks and competitive pricing to benefit the holders of savings accounts. As regards NRI deposits, interest rate ceilings on FCNR(B) deposits are linked to LIBOR/SWAP rates of corresponding foreign currencies, while NRE deposit rates are linked to US dollar LIBOR/SWAP rates. These stipulations have been put in place taking into account their implications for the banking system and the management of the capital account.

69. As regards lending rates, given the limited ability of small borrowers to manage interest rate risk and for ensuring availability of credit at reasonable rates, interest rate ceiling on small loans up to Rs. 2 lakh is linked to BPLR. The contrary view is that given the competitiveness in the credit market, high

share of sub-BPLR lending and increasingly broad-based credit structure, availability of credit to all segments of the economy at a price consistent with their risk profiles becomes important. Further, it is argued that lending rate regulation has dampened larger flow of credit to small borrowers. In addition, the current regulation seems to have imparted an element of downward rigidity to BPLR. It may be noted that RRBs and co-operative banks are free to determine their lending rates and there are no restrictions on lending rates of micro-finance institutions (MFIs).

70. Interest rate regulation on export credit has been favoured for making available credit to exporters at internationally competitive rates. The annual policy Statement of April 2002 had indicated that “linking of domestic interest rates on export credit to PLR has become redundant in the present circumstances as effective interest rates on export credit in rupee terms is substantially lower than the PLR”. The mid-term Review of October 2002 had mooted deregulation of interest rate on rupee export credit in phases to encourage greater competition in the interest of exports. One view is that in the light of competitive lending rates in the economy, it is important to ensure that regulated interest rates should not restrict credit flow to all segments of exporters with different risk profiles.

71. While there is merit in moving forward to impart greater competitiveness and depth to the activities of the financial system by further deregulating interest rates in some segments which have hitherto remained regulated for various reasons found relevant at different stages, it is proposed to continue with *status quo* as various issues pertaining to above regulations on interest rates are being debated.

II. Financial Markets

Money Market

Framework for Development of Money Market

72. Money market provides a focal point for the central bank’s operations in influencing system liquidity and thereby transmitting the monetary policy impulses. The broad policy objectives that are being pursued for the development of money market include ensuring stability in short-term interest

rates, minimising default risk and achieving a balanced development of various segments of the money market. In order to review the recent developments and current status of money market in the context of evolving monetary policy framework, fiscal scenario, regulatory regime and extent of financial integration, both domestic and external, a Technical Group on Money Market was constituted. The Report of the Group was discussed in the Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC) and certain recommendations have been accepted for implementation. Accordingly, the following measures are proposed:

(i) Call/Notice/Term Money Market

- With effect from the fortnight beginning June 11, 2005, non-bank participants, except PDs, would be allowed to lend, on average in a reporting fortnight, up to 10 per cent of their average daily lending in call/notice money market during 2000-01.
- With effect from August 6, 2005, non-bank participants, except PDs, would be completely phased out from the call/notice money market.
- With effect from the fortnight beginning April 30, 2005, the benchmark for fixing prudential limits on exposures to call/notice money market in the case of scheduled commercial banks would be linked to their capital funds (sum of Tier I and Tier II capital).
- From April 30, 2005, all NDS members are required to report their term money deals on NDS platform.
- A screen-based negotiated quote-driven system for all dealings in call/notice and term money market transactions is proposed.

(ii) Market Repo

- An electronic trading platform for conduct of market repo operations in government securities, in addition to the existing voice based system, to be facilitated.
- Participation in market repo facility in government securities for non-scheduled urban co-operative banks (UCBs) and listed companies

having gilt accounts with scheduled commercial banks will be allowed subject to eligibility criteria and safeguards.

(iii) Certificates of Deposit

- The minimum maturity period of certificates of deposit (CDs) reduced from 15 days to 7 days with immediate effect.

73. The Report of the Group is being placed on RBI website for wider dissemination. The recommendations of the Group on introduction of asset-backed commercial paper (ABCP) to further deepen the CP market and additional intra-day LAF to stabilise short-term interest rates would be considered in future in consultation with market participants. In addition, optionalities in OTC rupee derivatives would be considered, once legal clarity to OTC derivatives is provided and appropriate accounting standards are put in place.

Government Securities Market

*(a) Central Government Securities Market:
Medium-term Framework*

74. In terms of the stipulation of FRBM Act, RBI will not be participating in primary issuance of government securities with effect from April 1, 2006. In this context, the mid-term Review of October 2004 emphasised that open market operations (OMO) would become a more active policy instrument necessitating review of processes and technological infrastructure consistent with market advancement. In order to address these emerging needs and equip RBI as well as the market participants appropriately, a Technical Group on Central Government Securities Market was constituted. Earlier, another Group (Chairman: Dr.R.H. Patil) had examined the role of primary dealers (PDs) in the government securities market. The Reports were discussed in TAC and certain recommendations have been accepted for implementation. Accordingly, the following measures are proposed:

- The number of actively traded securities need to be enlarged to enhance liquidity and improve pricing in the market. It is proposed to consolidate debt and build up large liquid securities in

consultation with the Government while continuing the programme of reissuances.

- Post-FRBM, RBI will reorient government debt management operations while simultaneously strengthening monetary operations. This will entail functional separation between debt management and monetary operations within RBI. For this purpose, RBI will have discussions with market players on the modalities and procedures of market operations.
- The settlement system for transactions in government securities will be standardised to T+1 basis.
- The Reserve Bank would continue to resort to multiple and uniform price methods flexibly in the auction of government securities.
- Permitted structures of PD business will be expanded to include banks which fulfil certain minimum criteria subject to safeguards and in consultation with banks, PDs and the Government.

75. The recommendations of the Technical Group on restructuring the underwriting obligations of PDs, allowing PDs exclusivity in primary auctions, introduction of 'When Issued Market' and limited short selling in government securities would be considered in consultation with the Government.

(b) Sale of Government Securities: Relaxation

76. At present, sale of government securities allotted in primary issues can be entered into on the same day only between entities maintaining SGL account with RBI. In order to facilitate further deepening of the government securities market, it is proposed:

- To permit sale of government securities allotted in primary issues with and between CSGL account holders also on the same day.

(c) Market Borrowings of State Governments

77. The Twelfth Finance Commission (TWFC) recommended that the Centre should not act as a financial intermediary for future lending to the States. The Centre would release only the grant portion of central assistance of state plan to States and allow them to approach the market directly to

raise the loan portion of the funds. In case some fiscally weak States are unable to raise funds from the market, the Centre could borrow for on-lending to such States. The Centre has accepted in principle the recommendations and has proposed to implement it in phases, in consultation with RBI. As the implementation of the recommendations of TWFC would have major implications for the market borrowing programmes, RBI would facilitate smooth transition of the process in consultation with the Central and the state governments. As a first step, consultations were held with State Finance Secretaries on April 8, 2005.

Foreign Exchange Market

(a) Forex Market Group: Medium-term Framework

78. Since the onset of reforms in the early 1990s, significant liberalisation of the foreign exchange market has taken place and the process gained momentum after Sodhani Committee recommendations were accepted for implementation by RBI. The foreign exchange market is now deeper and wider as gauged in terms of parameters such as the range of products, participation, liquidity and turnover. As indicated in the mid-term Review of October 2004, an internal Group was set up to review comprehensively the initiatives taken by RBI in the foreign exchange market and identify areas for further improvements. The Group reviewed forex market liberalisation in select emerging markets and examined the current regulatory regime in the light of liberalisation in related sectors to identify areas for further liberalisation. The Report of the Group was discussed in TAC. As recommended by the Group, the following measures are proposed:

- Cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of tenor, to be allowed.
- Banks to be allowed to approve proposals for commodity hedging in international exchanges from their corporate customers.
- The closing time for inter-bank foreign exchange market in India to be extended by one hour up to 5.00 p.m.
- Dissemination of additional information including traded volumes for derivatives such as foreign currency-rupee options to the market.

79. The other recommendations of the Group pertaining to writing of covered options by corporates and hedging of economic risk of corporates in respect of their domestic operations arising out of changes in the landed cost of the imported substitutes of the commodities they consume/produce would be considered. The sequencing with regard to implementation of these measures will take into account the enabling conditions for further progress towards capital account convertibility, liberalisation in other sectors of the economy and the trend in overall balance of payments.

(b) Overseas Investment: Liberalisation

80. At present, under the automatic route, Indian entities are permitted to invest in overseas joint ventures and/or wholly owned subsidiaries up to 100 per cent of their net worth. With a view to promoting Indian investments overseas, it is proposed:

- To raise the ceiling of overseas investment by Indian entities in overseas joint ventures and/or wholly owned subsidiaries from 100 per cent to 200 per cent of their net worth under the automatic route.

(c) Foreign Currency Accounts by Foreign Companies in India: Liberalisation

81. At present, authorised dealers (ADs) are required to obtain RBI approval for opening of foreign currency accounts of the project offices set up in India by foreign companies. In order to further liberalise the procedure, it is proposed:

- To accord general permission to ADs to open foreign currency accounts of the project offices set up in India by foreign companies and operate the accounts flexibly.

III. Credit Delivery Mechanisms

(a) Flow of Credit to Agriculture

82. The Union Budget has proposed to increase the flow of credit to agriculture by 30 per cent during the year 2005-06. It has been the Reserve Bank's endeavour to enhance credit flow to agriculture by removing

bottlenecks in credit delivery. In this direction, as indicated in the annual policy Statement of May 2004 and the mid-term Review of October 2004, most of the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) have been implemented by RBI and NABARD. Other recommendations covering the target for direct and indirect lending for agriculture under priority sector lending, negotiable warehousing receipt system, setting up of agri-risk fund, computerisation of land records, permitting access to external commercial borrowing (ECB) and granting autonomy to NABARD are under examination of the Government. As at end-December 2004, public sector banks have issued 167.9 lakh Kisan Credit Cards (KCCs) with limits amounting to about Rs.46,000 crore. Cumulative sanctions and disbursements under various tranches of RIDF (RIDF I to X) amounted to about Rs.42,000 crore and Rs.24,000 crore, respectively, by February 2005. With a view to further increasing the flow of credit to agriculture, the following measures have been initiated:

- RBI has set up an Expert Group to formulate strategy for increasing investment in agriculture and the report is expected by end-May 2005.
- In order to make an assessment of customer satisfaction on credit delivery in rural areas by banks, it is proposed to conduct a survey with the help of an outside agency.
- Keeping in view the importance of post-harvest operations, it is proposed to increase the limit on loans to farmers through the produce marketing scheme from Rs.5 lakh to Rs.10 lakh under priority sector lending.
- There is a realisation amongst bankers that there are increasing business opportunities in financing agriculture, banks are, therefore, urged to continue their efforts to step up credit to agriculture.

(b) Micro-finance

83. The programme of linking self-help groups (SHGs) with the banking system has emerged as the major micro-finance programme in the country. Accordingly, the Union Budget has proposed to enhance the annual target

of credit linkage to 2.5 lakh SHGs during 2005-06. As at March 2005, over 14 lakh SHGs were linked to banks and total flow of credit to these SHGs was over Rs.6,300 crore. NABARD and banks have set a target of linking additional 5.85 lakh SHGs to banks by end-March 2007. In order to give further fillip to micro-finance movement, the following measures have been initiated:

- The Reserve Bank has enabled non-governmental organisations (NGOs) engaged in micro-finance activities to access ECBs up to US \$ 5 million during a financial year for permitted end-use, under automatic route, as an additional channel of resource mobilisation.
- As a follow-up of the Budget proposals, modalities for allowing banks to adopt the agency model by using the infrastructure of civil society organisations, rural kiosks and village knowledge centres for providing credit support to rural and farm sectors and appointment of micro-finance institutions (MFIs) as banking correspondents are being worked out.

(c) Credit Flow to Small Scale Industries

84. The small scale industries (SSI) sector plays a very important role in the development of the economy. While large industries have access to various sources of finance, the SSI sector has to primarily depend on finance from banks and other financial institutions. With a view to further smoothening the flow of credit, the following measures have been initiated:

- The Credit Information Bureau of India Ltd. (CIBIL) is working out a solution that would provide comprehensive credit reports on SSIs.
- The Reserve Bank is reviewing all its existing guidelines on financing small scale sector, debt restructuring, nursing of sick units, etc., with a view to rationalising, consolidating and liberalising them. Banks are urged to take the revised guidelines as indicative minimum requirement and the Boards of the banks are expected to formulate more liberal schemes as appropriate.
- Under a scheme to be drawn up by the RBI, banks will be encouraged to establish mechanisms for better co-ordination between

their branches and branches of SIDBI which are located in 50 clusters that have been identified by the Ministry of Small Scale Industries, Government of India. Under the scheme of strategic alliance (i) the existing branches of SIDBI redesignated as “Small Enterprises Financial Centres” (SEFC) will take up co-financing of term loan requirements of SSI units along with the bank branches and the working capital requirements of these units will be met by the banks; (ii) the expertise of the SIDBI in appraisal of credit requirements of SSI units will be leveraged by the branches of commercial banks, by payment of a nominal fee; (iii) SIDBI will provide other expert services to help the banks in simplifying the application forms, documentation and disbursement procedures, etc.; and (iv) the working of the scheme may be monitored and modified to suit the local conditions by the State Level Bankers’ Committee (SLBC) and, depending on the experience, the coverage of the scheme may be extended to more clusters. The services of SEFCs will be available for tiny industrial units also.

(d) Credit Flow to Medium Enterprises

85. In view of the fast changing market conditions and increasing competitiveness, there is an urgent need to upgrade the technology of small scale industries and their graduation to medium enterprise sector. The Reserve Bank will explore modalities to meet their growing financial needs. A simplified debt restructuring and rehabilitation mechanism is also being considered for the sector.

(e) Restructuring and Development of Regional Rural Banks

86. The Regional Rural Banks (RRBs) are conceived as institutions that combine the local feel and familiarity with rural problems, which the co-operatives possess, and the degree of business organisation as well as the ability to mobilise deposits, which the commercial banks possess. In view of their importance as purveyors of rural credit, the Union Budget 2004-05 emphasised that the sponsor banks would be accountable for the performance of their RRBs.

87. As indicated in the mid-term Review of October 2004, sponsor banks are being encouraged to merge the RRBs sponsored by them state-wise. A few proposals in this regard are at various stages of consideration. While the sponsor banks were advised that the appointment of Chairmen of their RRBs should be approved by the Management Committees of their Boards, the Government was requested to ensure that independent and professionally qualified persons are nominated to the Boards of RRBs to make them more vibrant and proactive.

88. In order to reposition RRBs as an effective instrument of credit delivery in the Indian financial system, RBI is in the process of reviewing the performance of RRBs, exploring restructuring of RRBs through merger/consolidation, changing of sponsor banks, reviewing minimum capital requirement and suggesting suitable measures for regulation, supervision and governance of RRBs.

(f) Priority Sector Lending

89. Prescriptions relating to priority sector lending have been modified from time to time, and generally the eligibility criteria have been enlarged to include several new areas. In December 2004, it was decided that only advances will be eligible, thus, beginning a phased withdrawal of eligibility of investments in bonds. There have been suggestions for a further review of the eligibility criteria and other related aspects.

90. One view is that lending to any infrastructure project should be made eligible for priority sector lending while making sub-targets fungible within the overall target. There is another view that enlargement of areas has resulted in loss of focus. It is also held that credit growth in housing, venture capital and infrastructure has been strong while it has been sluggish in agriculture and small industries. Further, it is argued that only sectors that impact large population, weaker sections and are employment-intensive such as agriculture, tiny and small industry should be eligible for priority sector. Since there are several issues that need to be considered in this regard, it is appropriate that these are debated and examined in depth.

IV. Prudential Measures

91. The Reserve Bank has taken several steps to strengthen the regulatory and supervisory framework of the financial sector. Further developments in this area are as under.

(a) Policy on Merger and Amalgamation of Banks

92. In pursuance of the recommendations of the Joint Parliamentary Committee (JPC), a Working Group was constituted by RBI to evolve guidelines for voluntary merger of banking companies. Based on the recommendations of the Group and in consultation with the Government, it is proposed:

- To issue guidelines on merger and amalgamation between private sector banks and with NBFCs. The guidelines would cover: process of merger proposal, determination of swap ratios, disclosures, norms for buying/selling of shares by promoters before and during the process of merger and the Board's involvement in the merger process. The principles underlying these guidelines would also be applicable as appropriate to public sector banks, subject to relevant legislation.

(b) Supervision of Financial Conglomerates

93. As indicated in the annual policy Statement of May 2004, the Working Group on Financial Conglomerates (FC) has identified 22 FCs. With a view to monitoring intra-group transactions and exposures, a pilot process was initiated to obtain information from the designated entities of each FC by the principal regulators. Such information was analysed and discussed amongst the principal regulators and a system for exchange of information among them has been put in place. In order to appropriately focus on monitoring of the process, in consultation with Chairman, SEBI and Chairman, IRDA, it is proposed:

- To hold a half-yearly discussion with the CEO of the designated entity, which would be convened by the lead regulator with other regulators, on the basis of available information for review and addressing concerns, if any.

(c) Interests of the Depositors

94. Depositors' interests forms the focal point of the regulatory framework for banking in India and it has been appropriately enshrined at several places in the Banking Regulation Act, 1949. In Section 5(ca) of the Act, "Banking Policy" has been defined as "any policy which is specified from time to time by the Reserve Bank in the interest of the banking system or in the interest of monetary stability or sound economic growth, having due regard to the interests of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources".

95. Furthermore, as per the Act, some of the considerations that are required to be taken into account while granting licence for banking business, in addition to ensuring the capacity of the bank to pay present and potential depositors in full, is whether the affairs of the company are not being or are not likely to be detrimental to the interests of the depositors or prejudicial to public interest. A licence to do banking business provides the entity the ability to accept deposits and access to deposit insurance for small depositors. Similarly, regulation and supervision by RBI enables these entities to access funds from a wider investor base and the payment and settlement systems provides efficient payments and funds transfer services. All these services, which are in the nature of public good, involve significant costs and are being made available only to ensure availability of banking and payment services to the entire population without discrimination.

96. Against this background, while policies relating to credit allocation, credit pricing and credit restructuring should continue to receive attention, it is inappropriate to ignore the mandate relating to depositors' interests. Further, in our country, the socio-economic profile for a typical depositor who seeks safe avenues for his savings deserves special attention relative to other stakeholders in the banks.

97. In the observations and recommendations of the Committee on Procedures and Performance Audit on Public Services (CPPAPS) (Chairman: S.S. Tarapore), on 'Banking Operations: Deposit Accounts and other facilities Relating to Individuals (Non-Business)', it was indicated: "The

bank's offerings are generally opaque – what is not charged is mentioned but what is charged is not mentioned – high hidden costs appear rampant and unjustified, thus banks enjoy undue enrichment. If a small customer goes to a bank and has a technical problem, anecdotal evidence suggests that he runs into enormous difficulties. The Committee notes with some sadness that there is substance in the widespread impression among the small depositor community that one needs to know someone higher-up for getting his/her job done. Intense depositor loyalty is the only plank on which the Indian banking systems is surviving. The banks have to understand that depositors are at the end of their tether and banks providing poor customer service will be punished by switching loyalty". The information suggests that in recent years banks are taking increasing recourse to non-deposit resources to fund their assets. Against this background:

- Banks are urged to refocus on deposit mobilisation and empower the depositors, by providing wider access and better quality of banking services.
- RBI will persist with its efforts to ensure quality of banking services, in particular, to small individual depositors.

(d) Financial Exclusion

98. There has been expansion, greater competition and diversification of ownership of banks leading to both enhanced efficiency and systemic resilience in the banking sector. However, there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, the banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis. Against this background:

- RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged.

- The nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person.
- Banks are urged to review their existing practices to align them with the objective of financial inclusion.

(e) Customer Service

99. Liberalisation and enhanced competition accord immense benefits, but experience has shown that consumers' interests are not necessarily accorded full protection and their grievances are not properly attended to. Several representations are being received in regard to recent trends of levying unreasonably high service/user charges and enhancement of user charges without proper and prior intimation. Among the complaints received are: charges for balance enquiry, cheque status verification, signature verification, address confirmation, photograph verification, punitive service charges for non-maintenance of minimum balance in savings accounts, transaction charges for reorder of cheque book and for cash transactions at the branch beyond a stipulated number, and diversion of customers to usage of ATMs including payment for cash transactions.

100. It is instructive in this regard to note that in Canada, the issue of bank service charges was the subject of a 1988 investigation conducted by the House of Commons Standing Committee on Finance. The Committee report set out a number of recommendations, which have subsequently been reflected in market practice. The Committee recommendations resulted in improved disclosure of service charges and the designation of Office of the Superintendent of Financial Institutions (OSFI) to handle and report on service charge complaints.

101. In the US, organisations such as Consumers' Union are fighting to create legislation that will help protect vulnerable consumers from price gouging on checking accounts. American consumer groups are against what they call is the "trap of never-ending bank fees that is impossible to escape". They are demanding 'lifeline banking' legislation, which will give consumers access to basic banking services and protect them from exorbitant

fees and surcharges for providing information such as signature and photograph verification. Several American states have implemented legislation for minimum no-frills services. Some states prohibit ATM surcharges.

102. In the UK, there exists an institutional arrangement whereby a separate board has been set up to oversee the code drawn up by the banks' association. The Banking Code of the British Bankers' Association (BBA) is a voluntary code, which sets standards of good banking practices for financial institutions to follow when they are dealing with personal customers in the UK. It provides valuable protection for customers on a day-to-day basis as also in the times of financial difficulty. The code applies to savings deposits and current accounts, card products and services, loans and overdrafts and payment services including foreign exchange. Taking account of all these considerations, it has been decided:

- To set up an independent Banking Codes and Standards Board of India on the model of the mechanism in the UK in order to ensure that comprehensive code of conduct for fair treatment of customers are evolved and adhered to.
- To issue appropriate guidelines to banks to ensure transparency and disclosure of information by the card issuing banks and customer rights protection including facilitating enforcement of such rights.
- To widen the scope of the Banking Ombudsman *inter alia* to cover all individual cases/grievances relating to non-adherence to the fair practices code evolved by IBA and adopted by individual banks.

(f) New Capital Adequacy Framework in India: Implementation

103. As indicated in the mid-term Review of October 2004, draft guidelines for implementation of the New Capital Adequacy Framework were formulated and placed on the RBI website. In order to maintain consistency and harmony with international standards, banks were advised to adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk with effect from March 31, 2007. The Reserve Bank may consider allowing some banks to migrate to Internal Rating Based (IRB) approach after developing adequate skills both in banks and at supervisory levels. As banks

would be allowed to adopt/migrate to the advanced approaches only with the specific approval of RBI, as a first step, banks which are aiming at adopting the advanced approaches should make an objective self-assessment of their fulfillment of the minimum criteria prescribed under Basel II.

104. As banks have two years lead-time to prepare themselves for Basel II, they are encouraged to focus on capacity building and undertake impact analyses. On the basis of the outcome of the impact studies, banks may put in place appropriate strategies and plans for raising fresh capital or augment capital through internal resources. Banks may also redefine their business strategy with a view to altering their profile of risk exposures or adopt a combination of both these approaches to meet the capital requirement.

105. Under the New Framework, banks adopting Standardised Approach would use the ratings assigned only by those credit rating agencies which are identified by RBI. The New Framework also recognises the responsibility of bank management in developing an Internal Capital Adequacy Assessment Process (ICAAP) that is commensurate with banks' risk profile and control environment. Banks are, therefore, required to focus on formalising and operationalising their ICAAP, which will serve as a useful benchmark while undertaking the parallel run with effect from April 1, 2006.

(g) Ownership and Governance in Private Banks

106. It was indicated in the mid-term Review of October 2004 that the second draft on the policy framework for ownership and governance in private sector banks would be put in public domain. Based on the feedback received on the draft guidelines and in consultation with the Government, RBI has since issued final guidelines. These guidelines focus on ensuring 'fit and proper' criteria, on a continuous basis in respect of investments, restructuring and consolidation in the banking sector and provide for observance of sound corporate governance principles. The Reserve Bank would enter into bank-wise dialogues to ensure a time-bound framework for compliance.

(h) Guidelines on Securitisation of Standard Assets

107. In the recent period, the market for securitisation of standard assets has grown significantly. In order to ensure orderly development of the market,

draft guidelines on securitisation of standard assets by banks/financial institutions and NBFCs were issued and placed on the RBI website for comments. On the basis of the feedback, the draft guidelines would be finalised.

(i) Guidelines on Purchase/Sale of Non-Performing Assets

108. With a view to further increasing the options available to banks for effectively addressing the issue of non-performing assets, draft guidelines were issued on sale/purchase of non-performing assets and comments thereon were sought from the banks by end-April 2005. The guidelines broadly cover the areas on procedure for purchase/sale of non-performing financial assets by banks including valuation and pricing aspects, prudential norms, and disclosure requirements, and would be finalised on the basis of feedback.

(j) Modification of CDR Mechanism

109. Performance of the corporate debt restructuring (CDR) mechanism has been reviewed and it has been decided to make changes in regard to criteria for the minimum exposure and number of lenders for deciding on CDR package; rationalisation of regulatory concessions; applicability of the extant instructions relating to asset classification only for the first restructuring of debt; and flexibility in exit option by allowing one time settlement (OTS). Draft circular is being put in the public domain for wider dissemination before taking final decisions.

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

110. As indicated in the mid-term of Review of October 2004, RBI has constituted a Working Group on Conflicts of Interest in the Indian Financial Services Sector (Chairman: Shri D.M. Satwalekar). The Report of the Group is expected by July 2005, which would be put in the public domain for wider dissemination before recommending for adoption.

V. Institutional Developments

Payment and Settlement Systems

(a) Payment and Settlement Systems: Action Points

111. As indicated in the mid-term Review of October 2004, a Vision Document for Payment and Settlement Systems was prepared by RBI under the guidance of the National Payment Council and was placed on the RBI website. Based on the feedback, a roadmap for upgradation of payment systems was drawn up for implementation in the next three years (2005-08). Some of the key action plans of the Document relate to a new umbrella organisation for retail payment systems, regulations for various modes of electronic credit transfers, risk mitigation measures to ensure settlement finality, efficiency enhancement measures, customer rights and services and rural reach. The Vision Document indicating action points would be placed in the public domain for wider dissemination by June 2005.

(b) Board for Regulation and Supervision of Payment and Settlement Systems

112. In continuation of the steps initiated by RBI for developing institutional framework for payment and settlement systems, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) was constituted as a Committee of the Central Board of RBI as notified in the Gazette of India on February 18, 2005. The BPSS would prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.

113. In order to assist BPSS in performing its functions, RBI constituted a new department, the Department of Payment and Settlement Systems (DPSS). With the constitution of DPSS, the functions of the Department of Information Technology (DIT) would be to formulate and to implement information technology policies for RBI as well as for the banking and financial systems in the country.

(c) Electronic Payment Products: Status and Proposed Action

114. The coverage of RTGS and ECS has increased significantly during last year. As on April 25, 2005, RTGS connectivity was available in 4,776 bank branches at 398 centres of the country. It is expected that about 10,000 branches would be covered by end-March 2006.

115. The Reserve Bank proposes operationalisation of National Electronic Funds Transfer (NEFT) System, which would enable T+0 settlement for all networked branches of banks all over the country for electronic transfer of funds. In order to facilitate non-networked branches of banks to transfer funds electronically, the NEFT (Extended) System would be implemented under which these branches could access NEFT-enabled branches of banks for transfer of funds.

(d) Reinforcing of Information Security

116. In view of the increasing dependence of the financial sector on internal and external networks for their operations, information security has assumed greater importance. In this direction, RBI has initiated several measures to ensure information security in banks. As indicated in the mid-term Review of October 2002, banks were encouraged to use Public Key Infrastructure (PKI) to protect information security. Since then inter-bank systems like RTGS, PDO/NDS/SSS, SFMS, and CFMS have been made PKI-compliant. Banks are encouraged to make increasing use of SFMS which is PKI-enabled for inter/intra bank transactions.

Information Technology

Technology Policy: Vision Document

117. The Reserve Bank has been guiding banks in implementation of information technology (IT) so as to provide for seamless integration across various entities in the financial sector. In order to facilitate the technology plans of the financial sector, RBI is preparing a Financial Sector Technology Vision Document, covering the medium-term policy perspectives. The draft of the Vision Document would be put in the public domain for wider dissemination. Based on the feedback, action points would be finalised.

Urban Co-operative Banks

(a) UCBs: Medium-term Framework

118. As indicated in the mid-term Review of October 2004, a draft 'Vision Document for Urban Co-operative Banks' was prepared keeping in view the heterogeneity of the sector in terms of size, area of operation, performance and strength and was placed on the RBI website. Based on the feedback, a medium-term framework for urban co-operative banks (UCBs) up to 2010 is being drawn up in order to facilitate the development of this sector into a strong and vibrant system comprising entities conforming to all prudential requirements. The medium-term framework would be placed in the public domain for wider dissemination and for implementation as appropriate. The Standing Advisory Committee for Urban Co-operative Banks is increasingly being used for continuous dialogue with the various stakeholders of the sector.

(b) Restructuring of Weak Scheduled UCBs

119. Keeping in view the importance of scheduled UCBs, RBI has begun a consultative process involving officials of the concerned state governments and banks for revitalising and rehabilitating the weak scheduled UCBs. The emphasis is on a time-bound programme for restructuring of UCBs by identifying the contours of their rehabilitation plan and setting up monitorable milestones. The Reserve Bank would be closely monitoring the achievements of the banks vis-à-vis the targets, at regular intervals, and initiating appropriate action with a view to protecting depositors' interests and avoiding systemic problems. The issues relating to large depositors, part conversion of deposits into equity, reduction of non-performing assets, human resources and technological development as also support from the state government would be examined. The option of merger/amalgamation could also be explored wherever necessary.

Non-banking Financial Companies

120. The non-banking financial companies (NBFCs) play a critical role as an instrument of credit delivery, particularly, in the small scale and retail sector in the remote areas. The emphasis has been on developing NBFCs

into a financially strong sector with improved skills and technology. In this context, RBI is examining the issue of smooth flow of bank finance to NBFCs.

Working Group on Computerisation of State Treasuries and On-line Connectivity

121. The Reserve Bank has constituted a Working Group on Computerisation of State Treasuries and On-line Connectivity to gather information on government receipts and payments with members drawn from four state governments and RBI to study the existing practices in treasury functions of various states, system of accounting of receipts and payments, level of computerisation in treasuries, scope for further computerisation and issues relating to uniform application software for treasury operations.

Standing Committee on Procedures and Performance Audit on Public Services

122. As indicated in the mid-term Review of November 2003, the Standing Committee on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore) constituted by RBI has submitted 14 Reports. Six Reports submitted by the Committee deal with matters relating to foreign exchange, government transactions, banking operations, currency management, regional assessment and benchmarking. Eight special Reports were submitted dealing with specific references made by RBI. Banks and RBI have implemented most of the recommendations of the Committee. The Standing Committee ceased its operations in March 2005. In order to facilitate regular monitoring, Ad hoc Committees in banks have been converted to permanent Standing Committees on Customer Service. A system for monitoring on a regular basis the customer services rendered by RBI offices is being put in place.

Legal Reforms: Review of Developments

123. The Reserve Bank, in co-ordination with the Government, has taken initiatives for necessary changes in the legal structure to strengthen the functioning of the financial system. The Credit Information Companies (Regulation) Bill, 2004 and Government Securities Bill, 2004 were introduced

in the Parliament. As indicated in the Union Budget, 2005-06, certain amendments to the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934 will be considered by the Government. In addition, the Payment and Settlement Bill is being finalised by the Board for Regulation and Supervision of Payment and Settlement Systems.

Mid-term Review

124. A review of the annual policy Statement will be undertaken on October 25, 2005 and will contain such other changes/measures as may be necessary in regard to developmental and regulatory policies for the second half of the year.

Mumbai

April 28, 2005