MONETARY AND BANKING DEVELOPMENTS

The monetary and credit policy for 1997-98 sought to target broad money growth in the range of 15.0 -15.5 per cent on the basis of a projected real GDP growth rate of about 6 per cent and an assumed inflation rate of the same order. The broad money growth of 17.0 per cent during 1997-98 was higher than that in the previous financial year (16.0 %). Expansion in narrow money at 10.5 per cent in 1997-98 was, however, lower than that in 1996-97 (11.9%). Increase in reserve money by 13.1 per cent during 1997-98 was much higher than the increase of 2.9 per cent during the previous financial year. The lower order of increase in the monetary base in 1996-97 must, however, be viewed in the context of the significant cut in Cash Reserve Ratio(CRR) from 14 per cent to 10 per cent of the Net Demand and Time Liabilities(NDTL). The resulting increase in lendable resources of banks to the tune of Rs.17,850 crore meant decrease in the ratio of reserves to deposits,which was reflected in the increase in broad money multiplier from 3.1 as on March 31,1996 to 3.5 as on March 31,1997.The proposal to effect further CRR reduction by two percentage points in eight phases of 0.25 percentage point each was deferred after the first two phases in the third quarter of 1997-98.In fact, the policy measures undertaken by the RBI (November,1997 to January,1998) led to increase in CRR from 9.5 per cent to 10. 5 per cent before this was reduced to 10.25 per cent and 10.00 per cent with effect from the fortnight begnning from March 28,1998 and April 11,1998 respectively.

2. The deceleration in industrial production remained a source of concern in 1997-98. The growth in non-food credit at 14.2 per cent in 1997-98 was, however, higher than that in the previous financial year by 3.3 percentage points. Liberalisation measures like withdrawal of instructions concerning Maximum Permissible Bank Finance (MPBF) and the resulting freedom for commercial banks to assess working capital requirements on the basis of methodology evolved by them, removal of prescriptive norms for consortium lending, further rationalisation of CRR and SLR and greater deregulation of the interest rate regime facilitated this rise. Besides, the significant expansion in banks' investments in commercial paper and other financial instruments like shares,bonds and debentures of both the public sector undertakings and the private corporate sector complemented the more traditional forms of credit off-take in the country. Measures like exclusion of banks' investment in preference shares/non convertible debentures/ bonds of private corporate bodies from the 5 per cent ceiling of investment of previous year's incremental deposits contributed to the increase in the flow of investible resources from banks to the commercial sector . As a result, there was an increase in the total flow of funds comprising both non-food credit and investment to the commercial sector. While the total flow of funds from commercial banks to the commercial sector increased by Rs.51,991 crore or 17.9 per cent in 1997-98, the corresponding increase in the previous financial year was much lower at Rs.30,949 crore or 11.9 per cent. This coupled with the growth in sanctions and disbursements by All India Financial Institutions augurs well for industrial revival.

Monetary Trends and Developments

3. As indicated earlier, monetary and credit policy for 1997-98 rested on the premise of a projected real GDP growth of about 6 per cent and an acceptable order of inflation rate of around

6 per cent. The concern on the price front was reflected in the marginal reduction in the annual growth rate of 15.0-15.5 per cent for broad money (M3) set for 1997-98 *vis-a-vis* 1996-97 (15.5-16.0 per cent) .The freedom and flexibility for the RBI in pursuing its monetary policy was enhanced in the past three financial years(1994-95 to 1996-97) by the prescription of the year-end and within-the- year ceiling on the net issue of ad hoc Treasury bills that financed the budget deficit of the Centre. The move for greater control on automatic monetisation of deficit was carried to its logical conclusion when the issue of ad hoc Treasury bills gave way to the new system of Ways and Means Advances (WMAs) from April 1, 1997. Unlike ad hoc Treasury bills, the new system does not constitute a source of financing fiscal deficit because the WMAs are only meant to serve as a means of meeting temporary mismatches between the receipts and expenditure of the Central Government. The Central Government did not approach the RBI for WMAs for the larger part of 1997-98.

Money Supply

4. The expansion in broad money in 1997-98 was higher than that in the previous financial year.While the increase in narrow money in 1997-98 was lower than that in 1996-97,the reserve money growth in 1997-98 was far above that in 1996-97 (Table 3.1).

TABLE 3.1

Money Growth in 1996-97 and 1997-98

(Per cent)

Money	1996-97	1997-98
Broad	16.0	17.0
Narrow	11.9	10.5
Reserve	2.9	13.1
M3 Multiplier@	3.5	3.6

@ As at end-March

5. Analysis of broad money growth(Table 3.2) revealed deceleration in the growth of currency with the public and acceleration in the growth of time deposits.As regards the sources of change in money stock(M3) ,growth in both net bank credit to Government and bank credit to commercial sector in 1997-98 was higher at 14.4 per cent and 14.3 per cent respectively than that in 1996-97 at 11.9 per cent and 9.1 per cent respectively.

6. Analysis of reserve money growth (Table 3.3) revealed that both the net RBI credit to Central Government (monetised deficit) and addition to net foreign exchange assets of RBI contributed significantly to expansion by 13.1 per cent in reserve money as against only 2.9 per cent in 1996-97. The increase in reserve money in the earlier part of 1997-98 emanated largely from the accretion to the RBI's net foreign exchange assets while its increase during the later half of the year was contributed principally by the increase in the monetised deficit.

Credit

7. Inspite of easy liquidity situation in the banking system, credit off-take continued to be low, which reflected not only low demand for credit but also banks' preference for low or even zero risk credit. Indeed, the first quarter of 1997-98 witnessed negative growth of 1.9 per cent in non-food credit, which improved to 2.6 per cent in the second quarter before deceleration to 2.0 per cent in the third quarter. There was acceleration in the flow of non-food credit by 11.3 per cent in the fourth quarter of 1997-98.The flow of non-food credit to commercial sector was also supplemented by higher investments in the equity and debt instruments of both the private sector and public sector units. Net bank credit to Government registered significant expansion during the financial year 1997-98. Net RBI credit to Central Government increased by 14.4 per cent in 1997-98 in contrast to a much smaller increase of 1.6 per cent in 1996-97.The growth in other banks' credit to Government(investment in Government Securities) in 1997-98 (20.5%) was only marginally lower than that in 1996-97(18.2 per cent).In fact,in absolute terms increase in other banks' credit to Government at Rs.29,888 crore in 1997-98 exceeded that in 1996-97(Rs.27,962 crore). This enabled the Central Government to complete most of its budgeted market borrowing by September 1997.

Bank Rate

8. The Reserve Bank took steps to strengthen the Bank Rate as a policy instrument for transmitting signals of monetary and credit policy. It will also serve as a reference rate for other interest rates in the financial markets. The need for a reference rate has become stronger, given the policy shift from direct instruments of monetary

TABLE 3.2

Sources of Change in Money Stock (M3)

Variations during[1]

	Financial Year		Annual		Financial Year		Annual	
	1996-97 Mar.31 to Mar.31	1997-98 Mar.31 to Mar.31	1997-98 April 12 to April 11	1998-99 April 11 to April 10	1996-97 Mar. 31 to Mar. 31	1997-98 March. 31 to Mar. 31	1997-98 April 12 to April 11	1998-99 April 11 to April 10
				(Rs. crore)				*(Per cent)*
I.M1 (Money supply with the public)	25493	25352	27923	29653	11.9	10.5	12.9	12.2
II.M3 (Aggregate monetary resources)	96931	119360	101122	121478	16.0	17.0	16.6	17.1
i) Currency with the public	14264	13257	14242	12418	12.1	10.0	11.5	9.0
ii) Demand deposits with banks	11332	11732	15455	18426	12.2	11.2	17.8	18.4
iii) Time deposits with banks	71438	94008	73198	91825	18.4	20.4	18.6	19.6
iv) Other deposits with RBI	-103	363	-1775	-1191	-3.1	11.2	-28.9	-27.3
III. Sources of change in M3 (1+2+3+4-5)								
1.Net bank credit to Government (A+B)	30794	41663	27713	32703	11.9	14.4	10.4	11.0
A) RBI's net credit to Government (i+ii)[2]	2832	11774	-717	2654	2.3	9.5	-0.6	2.1
i) Central Government[3]	1934	14689	-1220	2735	1.6	12.2	-1.0	2.2
ii) State Governments	898	-2914	504	-81	34.8	-83.8	76.7	-7.0
B) Other banks' credit to Government	27962	29888	28430	30049	20.5	18.2	20.5	17.7
2. Bank credit to commercial sector (A+B)	31364	53940	33530	59164	9.1	14.3	9.8	15.8
A) RBI's credit to commercial sector[4]	-608	1938	-380	2049	-8.9	31.0	-5.9	33.5
B) Other banks' credit to commercial sector	31971	52001	33911	57115	9.5	14.1	10.1	15.5
3. Net foreign exchange assets of the banking sector[5]	23403	21026	20274	21490	28.5	19.9	25.7	20.3
4. Government's currency liabilities to the public	415	202	352	202	16.6	6.9	14.1	6.9
5. Banking Sector's net non-monetary liabilities other than time deposits	-10956	-2531	-19252	-7919	-13.2	-3.5	-23.5	-11.3

1. Data for RBI relate to March 31 after closure of Government Accounts except for March 31, 1998 for which data are before closure of Government accounts. Variations in respect of scheduled commercial banks are based on data for last reporting Friday of March.
2. Includes special securities.
3. Includes Rs.751.64 crore (equivalent of SDR 211.95 million) incurred on account of Reserve Asset subscription to the IMF towards the quota increase.
4. Excludes, since the establishment of NABARD on July 12, 1982, its refinance to banks.
5. Inclusive of appreciation in the value of gold following its revaluation close to international market price effective October 17, 1990. Such appreciation has a corresponding effect on RBI's net non-monetary liabilities.

TABLE 3.3

Sources of Change in Reserve Money

Variations during[1]

	Outstanding as on March 31, 1996	Financial Year 1996-97 Mar.31 to Mar.31	Financial Year 1997-98 Mar.31 to Mar.31	Annual 1997-98 Apr. 12 to Apr. 11	Annual 1998-99 Apr. 11 to Apr. 10	Financial Year 1996-97 Mar.31 to Mar.31	Financial Year 1997-98 Mar.31 to Mar.31	Annual 1997-98 Apr. 12 to Apr. 11	Annual 1998-99 Apr. 11 to Apr. 10
					(Rs.crore)				*(per cent)*
1. Net RBI credit to Government[2]	121349	2832	11774	-717	2654	2.3	9.5	-0.6	2.1
2. RBI credit to banks[3]	21955	-14950	91	-2788	-526	-68.1	1.3	-29.5	-7.9
3. RBI credit to commercial sector[4]	6855	-608	1938	-380	2049	-8.9	31.0	-5.9	33.5
4. Net foreign exchange assets of RBI[5]	74092	20773	21026	20275	21490	28.0	22.2	27.1	22.6
5. Government's currency liabilities to the public	2503	415	202	352	202	16.6	6.9	14.1	6.9
6. Net non-monetary liabilities of RBI	32297	2887	8831	1355	11573	8.9	25.1	4.1	33.9
7. Reserve Money (1+2+3+4+5-6)	194457	5576	26200	15388	14296	2.9	13.1	8.1	7.0

1. Variations are worked out on the basis of March 31 data after closure of Governments accounts except for 1997-98 for which data are before closure of Government accounts. Figures for 1996-97 and 1997-98 are provisional.
2. Includes special securities.
3. Includes claims on NABARD.
4. Excludes, since the establishment of NABARD, its refinance to banks.
5. Variations are inclusive of appreciation in the value of gold following its revaluation close to the international market price since October 17, 1990. Such appreciation has a corresponding effect on RBI's net non-monetary liabilities.

policy such as administered interest rates and reserve requirements to indirect instruments such as open market operations for monetary management. The reactivation of the Bank Rate should, therefore, be viewed as an effort to supplement various indirect instruments available at the disposal of the Reserve Bank. With effect from the close of business on April 15,1997 all interest rates on advances from the Reserve Bank have been specifically linked to the Bank Rate. The one percentage point reduction in the Bank Rate each in April, June, and October 1997 signalled the beginning of a low interest rate regime as these downward movements resulted in similar reductions in lending and deposit rates in the financial markets. Developments in the external environment leading to speculative activity in the exchange market resulted in a change in the direction of interest rate policy. The Bank Rate was increased by 2 percentage points to 11 per cent with effect from the close of business on January 16, 1998. However, this measure was designed to address specifically the unusual movements in the foreign exchange market. The RBI subsequently reviewed the monetary and credit situation and reduced the Bank Rate to 10.5 per cent and 10.0 per cent with effect from the close of business on March 18,1998 and April 2,1998 respectively.

Cash Reserve Ratio (CRR)

9. An important measure for developing the inter bank call money market was the removal of the reserve requirements on inter bank liabilities with effect from April 26, 1997. This also released Rs.950 crore and eased liquidity constraints. As against the earlier practice of including positive net inter-bank liabilities as part of NDTL for CRR, the new system effective from April 26, 1997 exempted them subject to a minimum of 3 per cent CRR on overall NDTL. As part of the monetary and credit policy for the second half of 1997-98, further reduction in CRR by two percentage points in eight phases of 0.25 percentage point each was also announced. The total addition to liquidity from this was estimated at about Rs. 9600 crore as each phase of CRR reduction would release about Rs. 1200 crore into the banking system. Of the eight phases, the first two phases were effected on October 25 and November 22, 1997 respectively. The monetary and credit policy for the second half of 1997-98 made it clear that the planned reduction in CRR in February and March, 1998 would be contingent on emerging monetary and credit conditions. The development in the external environment tending to speculative activity and the pressures induced in the foreign exchange market resulted in the deferment of further CRR reduction till January 31, 1998. The sale of US dollars resulted in contraction of liquidity. Subsequently, liquidity was further tightened by raising CRR to 10 per cent from December 6 ,1997 and to 10.5 per cent from January 17,1998. These increases in CRR impounded resources of banks by about Rs.5000 crore.However,based on a review of the monetary and credit situtation ,the RBI decided to reduce CRR to 10.25 per cent and 10.00 per cent from the fotrnight beginning from March 28,1998 and April 11,1998 respectively.

Statutory Liquidity Ratio (SLR)

10. Another measures to develop the call money market was the exemption of inter-bank liabilities from SLR with effect from April 26, 1997, subject to the statutory minimum based on overall NDTL. Further rationalisation was effected in October 1997 when the multiple SLR prescriptions were replaced by a single uniform SLR of 25 per cent for entire net demand and time liabilities (NDTL) of the scheduled commercial banks.

Interest Rates

11. Rationalisation of the interest rate regime continued in 1997-98. To achieve greater alignment across the overall interest rate structure further changes were effected. Interest rate on domestic term deposits with maturity of 30 days to one year was linked to the Bank Rate by stipulating interest rate on these deposits as “not exceeding Bank Rate minus 2 percentage points per annum” (*i.e.* 9.0 per cent) from April 16, 1997. Following a one percentage point cut in the Bank Rate, the effective ceiling rate for term deposit of maturity up to one year declined to 8 per cent with effect from June 26, 1997. This was followed by full freedom to determine the interest rates on term deposits of 30 days and over with effect from October 22,1997. In order to better align the interest rate and maturity structure of Non-Resident (External) Rupee term deposits with that of domestic term deposits, the interest rate on NRE term deposits with maturity of 6 months to one year was also brought under the same ceiling as prescribed for domestic term deposits of upto one year with effect from April 16,1997.Further, the interest rates on NRE term deposits of over

one year were freed with effect from the same date. Subsequently the interest rate was reduced by one percentage point effective June 26, 1997 consequent to a corresponding reduction in the Bank Rate. With effect from September 13,1997, interest rates on NRE deposits of six months and above were completely freed.As regards FCNR(B) deposits, banks were allowed to offer interest rates on such deposits subject to a ceiling prescribed by RBI from time to time effective April 16, 1997 and at rates not exceeding LIBOR (for relevant maturity and currency) with effect from October 22,1997.

12. Consequent upon the announcement of Credit Policy for the second half of 1997-98 on October 21, 1997 almost all scheduled commercial banks revised their deposit rates. The range, however, continued to be within the 5.0 – 13.0 per cent band. Subsequent to the measures undertaken in December 1997 and January 1998 there was hardening of deposit rates of scheduled commercial banks. Most of the banks raised their deposit rates for shorter maturity periods. Some of the foreign banks raised their deposit rates for shorter maturity by as much as 4.0 percentage points. As a result, the interest rates on deposits of maturity period up to one year were in the range of 5.0 to 20.0 per cent; this was raised subsequently to 6.0 per cent at the minimum level while the maximum interest rate on deposits was brought down to 16.0 per cent. This trend was,however,reversed with the cut in the Bank Rate announced by the RBI in March and April,1998 (Box 3.1).

13. Despite strong growth in bank deposits and CRR reduction, lending rates remained sticky during the first half of 1996-97.However, following significant cut in CRR, Prime Lending Rates (PLRs) of public sector banks softened to 14.5 - 16.0 per cent by March 1997 from 16.5 per cent in March 1996.The interest rate on bank advance of over Rs. 25,000 and up to Rs.2 lakh was prescribed at not exceeding 13.5 per cent per annum with effect from October 22,1997.With effect from the same date banks were also allowed to announce a separate Prime Term Lending Rate (PTLR) for term loans of three years and above. Consequently, a few banks fixed their PTLR in the range of 12.5 to 13.0 per cent as against the PLR of 12.5 to 13.5 per cent. In response to the monetary and credit policy measures put in place during December 1997 and January 1998, most of the major banks raised their PLR by one percentage point. The PLR of most of major banks ranged between 14.0 – 14.5 per cent. However,as in the case of deposit rates,the trend was reversed by the cut in the Bank Rate referred to earlier. In the recent period, the PLR of most of the major banks ranged between 13.5-14.0 per cent.

14. Call money rates fell from the range of 17.0 – 19.5 per cent as on March 22, 1996 to 4.0 – 5.8 per cent as on March 21, 1997, and thereafter ruled in the range of 0.10 – 10.5 per cent up to December 5, 1997. However, due to the volatility in the forex market and the Reserve Bank measures to counter it, call rates zoomed to a high of 120 per cent during the fortnight ended January 30, 1998. The fortnightly weighted average call money rate ranged from 0.44 per cent to 15.38 per cent in 1997-98 as against 1.40 per cent to 13.95 per cent in 1996-97. While the range of effective discount rates on Certificates of Deposit (CDS) declined from 7.0-15.8 per cent in March 1997 to 6.5-11.5 percent in December 1997, that on CPs declined from 11.3-12.5 percent in December 1997 to 8.5 to 11.5 percent in January 1998. These discount rates on CDs increased to 6.5-37.0 per cent by February 1998 and that on CPs to 13.2-16.8 per cent by March 1998, reflecting the measures initated by RBI in January 1998 to stem the volatility in the forex market. The interest rate movement since the second half of January 1998 reflected the impact of the RBI measures to protect the Rupee from speculative pressures.However, the pressure on call rates was eased with the reduction in both the Bank Rate and the CRR effected by the RBI in March and April,1998.