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## First Bi-monthly Monetary Policy Statement, 2014-15

By Dr. Raghuram G. Rajan, Governor

### Part A: Monetary Policy

#### Monetary and Liquidity Measures

On the basis of an assessment of the current and evolving macroeconomic situation, it has been decided to:

- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 8.0 per cent;
- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.0 per cent of net demand and time liability (NDTL); and
- increase the liquidity provided under 7-day and 14-day term repos from 0.5 per cent of NDTL of the banking system to 0.75 per cent, and decrease the liquidity provided under overnight repos under the LAF from 0.5 per cent of bank-wise NDTL to 0.25 per cent with immediate effect.

Consequently, the reverse repo rate under the LAF will remain unchanged at 7.0 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 9.0 per cent.

#### Assessment

Since the Third Quarter Review of January 2014, global activity appears to have moderated on slower growth in the US, the UK and Japan, continuing sluggishness in the Euro area and a subdued pick-up in emerging and developing economies, restrained by the uncertain external demand environment as well as by localised cyclical and structural constraints. For a number of emerging markets, further tightening of external financing conditions and renewed volatility of capital flows are the biggest risks to their outlook. Going forward, global growth is likely to strengthen in the rest of the year, with risks tilted to the downside.

Domestically, real GDP growth continued to be modest in Q3 of 2013-14, with some strengthening of activity in services such as trade, hotels, transport and communication, and financing, real estate and business services. Despite some positive movement in more recent data, industrial activity continues to be a drag on the economy, with retrenchment in both consumption and investment demand reflected in the contraction of output of consumer durables as well as capital goods. In the quarters ahead, the boost provided by robust agricultural production in 2013 may wane. Moreover, the outlook for the 2014 south-west monsoon appears uncertain. Sluggishness in industrial activity, exports and several categories of services underlines the need to revitalise productivity and competitiveness.

Retail inflation measured by the consumer price index (CPI) moderated for the third month in succession in February 2014, driven lower by the sharp disinflation in food prices, although prices of fruits, milk and products have started to firm up. Excluding food and fuel, however, retail inflation remained sticky at around 8 per cent. This suggests that some demand pressures are still at play.

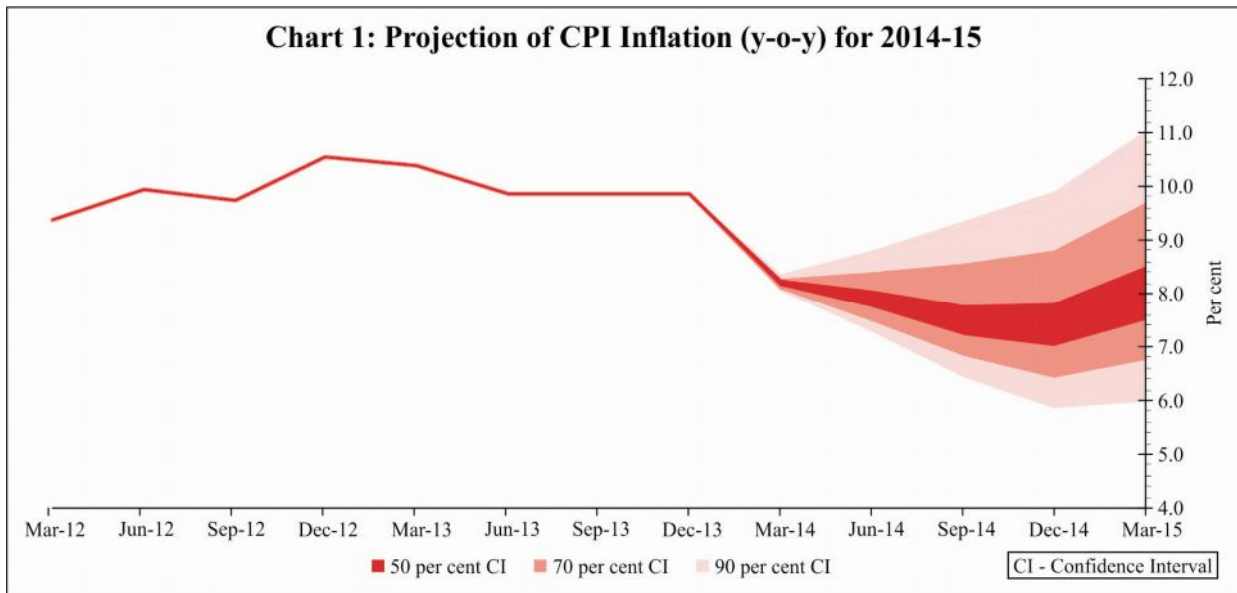
The merchandise trade deficit was 22 per cent lower in April-February 2013-14 than its level a year ago, due to the large decline in non-oil imports. The steady narrowing of the trade deficit over the year has shrunk the current account deficit (CAD) to 0.9 per cent of GDP in Q3 of 2013-14. For the year as a whole, the CAD is expected to be about 2.0 per cent of GDP. Most recently, however, export growth has slowed, partly because of slowdown in demand in partner countries as well as a softening of prices of exports of petroleum products and gems and jewellery (offset by a reduction in the prices of oil and gold imports). Whether the export slowdown persists as global growth picks up once again remains to be seen. In February, there was a turnaround in portfolio flows as investors largely priced in the effects of taper by the US Fed and responded to economic and geo-political developments in emerging markets with re-allocations. With sustained inflows in the form of portfolio flows, foreign direct investment (FDI) and external commercial borrowings, external financing conditions turned comfortable. Inflows, augmented by repayments by public sector oil marketing companies of their foreign currency obligations to the Reserve Bank during March, have led to an increase in reserves.

Turning to liquidity, envisaging pressures from large currency demand and tax outflows from mid-March, a 21-day term repo of ₹500 billion was conducted on March 14 and 7-day term repo auctions of ₹100 billion on March 19 and 26, in addition to the regular 14-day term repo of ₹400 billion on March 21. A 5-day term repo for a notified amount of ₹200 billion was conducted on March 28 to facilitate non-disruptive banking operations during the annual closing of accounts. Access to the MSF on March 29 and 31 (holidays) was also allowed for this purpose. The Reserve Bank will continue to monitor the liquidity conditions and actively manage liquidity to ensure adequate flow of credit to the productive sectors.

### **Policy Stance and Rationale**

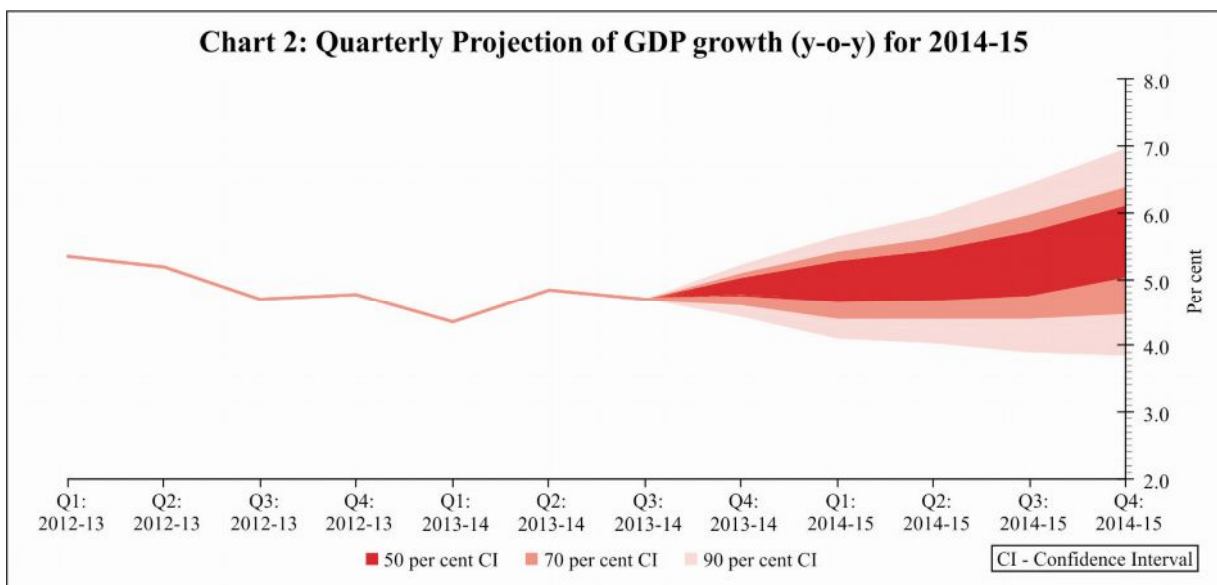
Since December 2013, the sharper than expected disinflation in vegetable prices has enabled a sizable fall in headline inflation. Looking ahead, vegetable prices have entered their seasonal trough and further softening is unlikely. Meanwhile, CPI inflation excluding food and fuel has remained flat.

There are risks to the central forecast of 8 per cent CPI inflation by January 2015 stemming from a less-than-normal monsoon due to possible *el nino* effects; uncertainty on the setting of minimum support prices for agricultural commodities and the setting of other administered prices, especially of fuel, fertiliser and electricity; the outlook for fiscal policy; geo-political developments and their impact on international commodity prices. There will also be a downward statistical pull on CPI inflation exerted by base effects of high inflation during June-November 2013. It is critical to look through any transient effects, including these base effects, which could temporarily soften headline inflation during 2014 (Chart 1).



The Reserve Bank's policy stance will be firmly focussed on keeping the economy on a disinflationary glide path that is intended to hit 8 per cent CPI inflation by January 2015 and 6 per cent by January 2016. At the current juncture, it is appropriate to hold the policy rate, while allowing the rate increases undertaken during September 2013-January 2014 to work their way through the economy. Furthermore, if inflation continues along the intended glide path, further policy tightening in the near term is not anticipated at this juncture.

Contingent upon the desired inflation outcome, real GDP growth is projected to pick up from a little below 5 per cent in 2013-14 to a range of 5 to 6 per cent in 2014-15 *albeit* with downside risks to the central estimate of 5.5 per cent (Chart 2). Lead indicators do not point to any sustained revival in industry and services as yet, and the outlook for the agricultural sector is contingent upon the timely arrival and spread of the monsoon. Easing of domestic supply bottlenecks and progress on the implementation of stalled projects already cleared should brighten up the growth outlook, as would stronger anticipated export growth as the world economy picks up.



In pursuance of the Dr. Urjit R. Patel Committee's recommendation to de-emphasise overnight "guaranteed-access" windows for liquidity management and progressively conduct liquidity management through term repos, the Reserve Bank

has decided to further reduce access to overnight repos under the LAF while compensating fully with a commensurate expansion of the market's access to term repos from the Reserve Bank. The primary objective is to improve the transmission of policy impulses across the interest rate spectrum. The term repo has evolved as a useful indicator of underlying liquidity conditions. It also allows market participants to hold liquidity for a longer period, thereby providing the impetus for engaging in term transactions in the market, evolving market-based benchmarks for pricing various financial products and also improving efficiency in cash/treasury management.

Liquidity conditions have tightened in March, partly on account of year-end 'window dressing' by banks, though an extraordinary infusion of liquidity by the Reserve Bank has mitigated the tightness. The Reserve Bank will propose measures to reduce such practices.

The second bi-monthly monetary policy statement is scheduled on Tuesday, June 3, 2014.

### **Part B: Developmental and Regulatory Policies**

This part of the Statement reviews the progress on various developmental and regulatory policy measures announced by the Reserve Bank in recent policy statements and also sets out new measures.

In the Second Quarter Review of Monetary Policy 2013-14 announced in October 2013, the Reserve Bank set out a five-pillar framework to guide its developmental and regulatory measures. Noteworthy progress has since been made in implementing measures within this framework.

Some of the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (Chairman: Dr. Urjit R. Patel) have been implemented including adoption of the new CPI (combined) as the key measure of inflation, explicit recognition of the glide path for disinflation, transition to a bi-monthly monetary policy cycle, progressive reduction in access to overnight liquidity under the LAF at the fixed repo rate and corresponding increase in access to liquidity through term repos, and introduction of longer tenor term repos.

On strengthening banking structure, which is the second pillar, the High Level Advisory Committee (Chairman: Dr. Bimal Jalan) has recently submitted its recommendations to the Reserve Bank on the licensing of new banks. The Reserve Bank will announce in-principle approval for new licences after consulting with the Election Commission. Immediately afterwards, the Reserve Bank will start working on the framework for on-tap licensing as well as differentiated bank licences, building on the Discussion Paper on "Banking Structure in India – The Way Forward" placed on the Reserve Bank's website in August 2013 and using the learning from the recent licensing process. The intent is to expand the variety and efficiency of players in the banking system while maintaining financial stability. The Reserve Bank will also be open to banking mergers, provided competition and stability are not compromised.

Progress has been made on a number of regulatory and supervisory measures. Based on the comments/feedback received on the draft framework for dealing with domestic systemically important banks (D-SIBs), the final framework is proposed to be issued by end-May 2014. As the liquidity coverage ratio (LCR) stipulated by the Basel Committee becomes a standard with effect from January 1, 2015 it is proposed to issue guidelines relating to Basel III LCR and Liquidity Risk Monitoring tools by end-May 2014. Updated guidelines on stress testing, drawing from Basel Committee on Banking Supervision (BCBS) principles and subsequent global developments, were issued in December 2013. Capital and provisioning requirements on banks' advances to corporates with unhedged foreign currency

exposures were specified in January 2014. The draft report of the Internal Working Group (Chairman: Shri B. Mahapatra), which was constituted to operationalise the countercyclical capital buffer framework in India, was placed on the Reserve Bank's website for comments in December 2013. On the basis of the recommendations of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Dr. Nachiket Mor) to encourage banks to actively manage their exposures to various sectors, including priority sectors, it is proposed to prescribe certain additional disclosure requirements in the financial statements by end-June 2014.

Following industry-wide concerns about asset quality and the consequential impact on the performance/profitability of banks, the Reserve Bank has extended the transitional period for full implementation of Basel III Capital Regulations in India up to March 31, 2019, instead of as on March 31, 2018. This will also align full implementation of Basel III in India closer to the internationally agreed date of January 1, 2019.

The Reserve Bank has moved over to risk-based supervision (RBS) for scheduled commercial banks (SCBs), starting with banks that were more prepared. Based on the experience gained from the completion of Phase I and the feedback received on the RBS framework from banks, the framework is being fine-tuned. Banks are also being advised to assess their risk management architecture, practices, related processes and management information systems (MIS) to facilitate their switch over to RBS in Phase II.

As regards the third pillar on the broadening and deepening of financial markets, Inflation Indexed National Saving Securities (IINSSs) for retail investors were issued in December 2013. To expand investor demand, certain design changes are required. Some such as an increase in the limit for individual investors and trusts have been implemented. Others such as tradability (and consequently, the benefit of indexation for capital gains tax) and issuance of securities with regular coupon flows are being contemplated. Cash settled single bond 10 year Interest Rate Futures (IRFs) were introduced by stock exchanges in January 2014. The Reserve Bank will shortly issue guidelines that would allow banks to offer partial credit enhancements to corporate bonds. As recommended by the Working Group on Enhancing Liquidity in the Government Securities and Interest Rate Derivatives Markets (Chairman: Shri R. Gandhi), the Reserve Bank proposes to introduce a market making scheme for primary dealers (PDs) by allocating specific securities to PDs and ensuring continuous availability of prices, with a suitable framework for assessing the performance of PDs. It will also examine the possibility of limited re-repo/re-hypothecation of "repoed" government securities, subject to appropriate risk control measures.

The Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar) submitted its report in February 2014. The Committee has recommended several measures/principles to be adopted in respect of major Indian rupee interest rate and foreign exchange benchmarks to strengthen their quality, the methodology by which they are set and the governance framework. Banks and PDs are being advised to strengthen their governance frameworks on benchmark submissions, subject to the supervisory review of the Reserve Bank. Other recommendations will be implemented in consultation with the Fixed Income, Money Market and Derivatives Association (FIMMDA) and Foreign Exchange Dealers Association of India (FEDAI).

The Reserve Bank will continue to work to ease entry while reducing risk to foreign investors from the volatility of flows. The modalities for allowing FIIs to hedge their currency risk by using exchange traded currency futures in the domestic

exchanges are being finalised in consultation with the Securities and Exchange Board of India (SEBI). In order to enhance hedging facilities for foreign investors in debt instruments, it is proposed to allow them to hedge the coupon receipts falling due during the next 12 months. Rebooking of cancelled contracts in case of contracted exposures has been fully restored. It is further proposed to allow all resident individuals, firms and companies with actual foreign exchange exposures to book foreign exchange derivative contracts up to US\$ 250,000 on declaration, subject to certain conditions.

Revised regulations under Foreign Exchange Management Act (FEMA) for a simplified foreign portfolio investor (FPI) regime have been notified in March 2014. The Reserve Bank also proposes to simplify the know-your-customer (KYC) procedures for opening bank accounts by FPIs. The Reserve Bank has also been rationalising and expanding limits for FPI investments in debt markets. To encourage longer maturity flows, investment limits in Treasury Bills were capped at US\$ 5.5 billion in April 2013, even while the limit for long-term investors was increased by US\$ 5 billion in June 2013. As a further step towards encouraging longer-term flows, investments by FPIs in G-Secs shall henceforth be permitted only in dated securities of residual maturity of one year and above, and existing investment in Treasury Bills will be allowed to taper off on maturity/sale. The overall limit for FPI investment in G-Secs will, however, remain unchanged at US\$ 30 billion, so the investment limits vacated at the shorter end will be available at longer maturities. As regards foreign direct investment (FDI), it has been decided to withdraw all the existing guidelines relating to valuation in case of any acquisition/sale of shares and accordingly, such transactions will henceforth be based on acceptable market practices. Operating guidelines will be notified separately.

A comprehensive IT-based system namely, Export Data Processing and Monitoring System (EDPMS) for effective monitoring, easier tracking and reconciliation of export transactions was launched in February 2014. The data will be shared among the stakeholders/agencies involved, and will allow more timely and detailed information on exports as well as prevention of export-related fraud.

On financial inclusion, the fourth pillar, the recommendations of the Mor Committee on accelerating the flow of credit to those at the bottom of the pyramid and enlargement of catchment area of the Business Correspondents (BCs), including through possible inclusion of new entities as BCs, are under examination. To overcome the challenge of cash management of BCs which is impeding the scaling up of the BC model, the Reserve Bank will collate best practices and issue a fresh set of guidelines to commercial banks.

The Reserve Bank has released a concept paper on Trade Receivables and Credit Exchange for micro, small and medium enterprises (MSMEs) in March 2014 on its website for public feedback. The model outlined in the paper envisages a credit exchange with both primary and secondary market segments that will help address problems faced by the MSME segment on delayed payments and dependency on their corporate buyers. After receiving feedback, the Reserve Bank will work towards implementation.

With a view to ensuring fair and transparent credit pricing and to give a fillip to the flow of credit to micro and small enterprises (MSEs) borrowers, it would be desirable for SCBs to provide differential interest rates for MSEs and other borrowers whose loans are covered under the credit guarantee scheme. SCBs are encouraged to undertake a review of their loan policy governing extension of credit facilities to the MSE sector and should consider using Board approved credit scoring models in their evaluation of the loan proposals of MSE borrowers.

Measures have been taken to expand banking services to the financially excluded sections of society with the appropriate application of technology. The GIRO Advisory Group (GAG) has recommended a tiered structure approach for a centralised bill payment system that will enable inter-operability viz., (a) Bharat Bill Payment System (BBPS) and (b) Bharat Bill Payment Operating Units (BBPOUs). The recommendations of the GAG report are under examination. A Technical Committee (Chairman: Shri B. Sambamurthy) set up to examine the challenges being faced by banks in taking mobile banking forward for achieving financial inclusion submitted its report in January 2014. This was placed in the public domain for feedback. The recommendations of the Committee will be examined closely, and plans for the way forward will be discussed with stakeholders.

Consumer protection is an integral aspect of financial inclusion. The Reserve Bank proposes to frame comprehensive consumer protection regulations based on domestic experience and global best practices. In the interest of their consumers, banks should consider allowing their borrowers the possibility of prepaying floating rate term loans without any penalty. Banks should also not take undue advantage of customer difficulty or inattention. Instead of levying penal charges for non-maintenance of minimum balance in ordinary savings bank accounts, banks should limit services available on such accounts to those available to Basic Savings Bank Deposit Accounts and restore the services when the balances improve to the minimum required level. Banks should not levy penal charges for non-maintenance of minimum balances in any inoperative account. Banks should also limit the liability of customers in electronic banking transactions in cases where banks are not able to prove customer negligence.

Under the fifth pillar, on improving the system's ability to deal with corporate distress and financial institution distress by strengthening real and financial restructuring as well as debt recovery, the Reserve Bank issued a framework for revitalising distressed assets in the economy in January 2014. The framework lays down guidelines for early recognition of financial distress, steps for prompt resolution and fair recovery for lenders. It envisages centralised reporting and dissemination of information on large credits, early formation of lenders' forums and incentives for lenders and borrowers to agree on resolution and disincentives for both in the event of failure to act in a timely way. Improvements in the current restructuring process such as an independent evaluation of large value restructuring with a focus on viability and fair sharing of gains and losses between promoters and creditors have been mandated. Finally, a more liberal regulatory treatment of distressed asset sales, particularly to asset reconstruction companies, has been provided. The framework will be fully effective from today.

Following the announcement in the Second Quarter Review of October 30, 2013, a Working Group (Chairmen: Dr. Arvind Mayaram and Shri Anand Sinha) on a Resolution Regime for Financial Institutions was constituted, which submitted its report in January 2014. The Group has, *inter alia*, recommended the setting up of a single Financial Resolution Authority (FRA), an early supervisory intervention mechanism in the form of prompt corrective action (PCA) framework for all financial institutions and a separate comprehensive legal framework providing necessary powers and tools for orderly resolution of all financial institutions irrespective of ownership. The Group's report will be disseminated for comments.

An overhaul of the extant regulatory framework for non-banking financial companies (NBFCs) is underway to align it with several important developments which have taken place in the financial sector. It is, therefore, proposed to keep in abeyance, subject to certain exceptions, issue of Certificate of Registration (CoR) for conducting NBFC business, except in the public interest, till an appropriate regulatory

framework is put in place for the NBFC sector. Detailed notification will be issued separately.

Going forward, this five-pillar approach will continue to guide the design and calibration of developmental measures. With competition in the banking sector set to increase, financial markets will play a complementary role, allowing banks to trade their long term assets and match the maturity profile of assets and liabilities. Simultaneously, the Reserve Bank will strive to increase the reach of financial services to everyone, however remote or small, by using technology, new products, and new entities to link people up to the formal financial system. Priority sector lending will become an effective vehicle to promote greater financial access. Concomitantly, the Reserve Bank will take steps for early recognition and resolution of distress with a focus on putting real assets back to work in their best use.

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