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April 07, 2015

First Bi-monthly Monetary Policy Statement, 2015-16

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 7.5 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
- continue to provide liquidity under overnight repos at 0.25 per cent of bank-wise NDTL at the LAF repo rate and liquidity under 7-day and 14-day term repos of up to 0.75 per cent of NDTL of the banking system through auctions; and
- continue with daily variable rate repos and reverse repos to smooth liquidity.

Consequently, the reverse repo rate under the LAF will remain unchanged at 6.5 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 8.5 per cent.

Assessment

Since 2014-15's sixth bi-monthly monetary policy statement of February, a moderate and uneven global recovery is emerging, with economies being buffeted (or supported) by currency fluctuations and commodity prices. Growth in the United States is likely to have been weak in the first quarter of calendar 2015, partly because of US dollar appreciation, but is expected to strengthen. The Euro area has started to show modest improvement, supported by a boost to demand from lower crude prices and the depreciation of the euro as well as easing financial and credit conditions following the commencement of quantitative easing. With the waning of the impact of the consumption tax increase, growth turned positive in Japan in Q4 of 2014 and consumer confidence and exports picked up. However, retail sales and industrial production contracted, indicating that the outlook is still weak. Growth continues to slow in China amidst financial fragilities and macroeconomic imbalances. This will have regional and global ramifications, although the softness in international commodity prices is providing some offset for net importers while adversely impacting net exporters. Global growth is likely to firm up through 2015 and 2016, supported by stronger recovery in the advanced economies (AEs) and soft energy prices. Downside risks mainly emanate from the slowdown in China, geopolitical risks surrounding oil prices and the uneven effects of currency and commodity price movements.

Global financial markets have been boosted by expectations of normalisation of US monetary policy being pushed back into late 2015, monetary policy stances turning highly accommodative in other AEs, and several emerging market economies (EMEs) easing policy rates to address growth concerns. Long-term yields have declined to all-time lows on weak

inflation expectations, compression of term premiums and the safe haven allure of US Treasuries. Ultra low interest rates and reduction in risk premia have raised most asset prices to record highs, and have pushed investors to riskier assets such as equity and lower rated debt instruments. Exchange rates have experienced large and volatile movements, with the US dollar strengthening against most currencies. Among EMEs, markets have tended to discriminate against those with relatively weaker fundamentals and/or oil exporters. Nevertheless, with high portfolio flows to EMEs, risks from sudden shifts in market sentiment have increased.

Domestic economic activity is likely to have strengthened in Q4. Second advance estimates of the Ministry of Agriculture suggest that the contraction in food grains production in 2014-15 may turn out to be less than earlier anticipated. However, the adverse impact of unseasonal rains and hailstorms in March is still unfolding. Initial estimates indicate that as much as 17 per cent of the sown area under the *rabi* crop may have been affected though the precise extent of the damage remains to be determined. The growth in allied activities is likely to remain strong as in the recent past, though it remains to be seen whether it will fully compensate the decline in food grains output.

The industrial sector, and in particular, manufacturing appears to be regaining momentum, with the growth of production in positive territory for three consecutive months till January. While basic goods production has been expanding steadily since November 2013, capital goods output has been relatively lumpy and volatile, and more positive readings are needed to be confident about a durable pick-up in investment demand. The persisting contraction in consumer durables production for over two years could be reflecting the underlying weakness in consumption demand as well as higher imports.

Mixed signals are coming from the service sector. While the national accounts statistics seem to suggest that consumption demand for services is robust relative to the demand for goods, and purchasing managers perceive activity expanding on new orders, various coincident indicators of services sector activity including railway and port traffic, domestic and international passenger traffic, international freight traffic, tourist arrivals, motorcycle and tractor sales as well as bank credit and deposit growth remain subdued.

Retail inflation measured by the year-on-year changes in the revised consumer price index (CPI) firmed up for the third successive month in February as favourable base effects dissipated, despite the price index remaining virtually flat since December. The still elevated levels of prices of protein-rich items such as pulses, meat, fish and milk kept food inflation from following the seasonal decline in prices of vegetables and fruits. The prices of items such as sugar and edible oil moderated in consonance with the downturn in global commodity prices. Fuel inflation edged up for the second month in a row due to the increase in prices of electricity and firewood.

Inflation excluding food and fuel fell successively in the nine months till February. A large part of this disinflation has been on account of the slump in international crude oil prices feeding through into domestic prices of petrol and diesel that are included under the category transport and communication. Inflation in respect of housing has also eased in the revised CPI, in part reflecting methodological and coverage improvements. Furthermore, upside pressures affecting prices of services such as education, health and other services have also fallen on account of weak demand conditions. The rate of growth of rural wages has come off substantially from the double digit levels that prevailed up to November 2013. Firms are also reporting a substantial easing of input price pressures, barring the most recent purchasing manager surveys. Reflecting past disinflation, inflation expectations of

households are in single digits, although they too exhibit some firming up in Q4 in response to the turning up of food and fuel inflation during January-February.

Since the shift in the monetary policy stance in January towards accommodation, the Reserve Bank has moved to ensure comfortable liquidity conditions through pro-active liquidity management, including fine-tuning operations on week days and access to the MSF and fixed rate reverse repo on Saturdays. This has helped to smooth the liquidity frictions that characterise events such as advance tax payments and balance sheet dates, keeping the money market rates anchored to the repo rate. In order to alleviate the pressures that build up in March on account of frictional factors, the Reserve Bank augmented its liquidity management instruments by engaging in repos of maturities ranging from 8 to 28 days cumulating to an outstanding amount of ₹1430 billion (including support from the MSF of ₹416 billion) at end-March in addition to regular 14-day term repo auctions and fixed rate overnight repos. The availability of liquidity can be gauged from the fact that in March, average daily liquidity returned by market participations through variable/fixed rate reverse repos amounted to ₹293 billion.

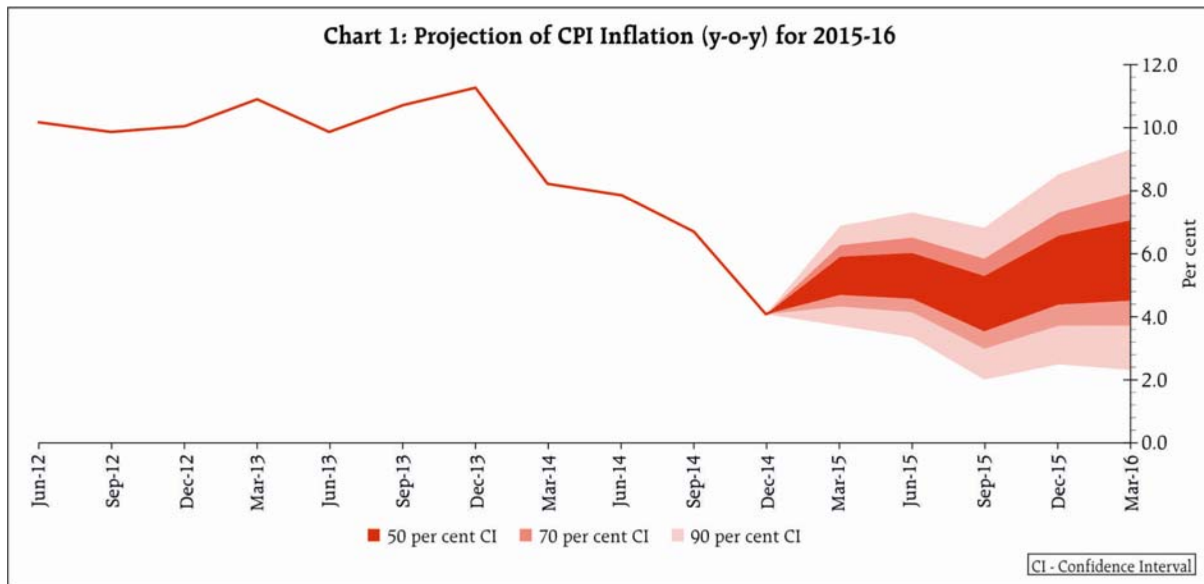
Export performance has been progressively weakening and contraction set in on both non-oil and petroleum product exports since December 2014. Fragile external demand conditions and the softness in international commodity prices have taken a heavy toll, as in several other EMEs in Asia. In particular, price realisations have been eroded, despite export volumes going up. With the Indian rupee gaining in real effective terms, export margins are coming under pressure for those exporters without substantial imported inputs. Net terms of trade gains and compression in imports of petroleum products have narrowed the trade deficit in the last three months to its lowest level since 2009-10. Gold imports remained contained; although non-oil non-gold imports grew at a modest pace in these months, they may be reflecting substitution effects in view of the sluggishness in domestic manufacturing.

Exports of services, particularly, software and travel have provided a silver lining and have helped to hold down the current account deficit (CAD) which has narrowed in Q3. This improvement has likely extended into Q4. As a result, capital inflows – mainly portfolio flows into domestic debt and equity markets and foreign direct investment – have exceeded the external financing requirement and enabled accretion to the foreign exchange reserves which reached an all-time peak of US$ 343 billion as on April 3, 2015. These reserves, including forward purchases that will be delivered over the next few months, provide some buffer against potential capital outflows when monetary policy normalisation in AEs commences. Good macroeconomic policy will, of course, be the critical first line of defence in retaining investor confidence.

Policy Stance and Rationale

In 2015 so far, the inflation path has evolved along the projected path after a sizable undershoot of the January 2015 target. CPI inflation is projected at its current levels in the first quarter of 2015-16, moderating thereafter to around 4 per cent by August but firming up to reach 5.8 per cent by the end of the year (Chart 1). There are upside risks to the central projection emanating from possible intensification of *el niño* conditions leading to a less than normal monsoon; large deviations in vegetable and fruit prices from their regular seasonal patterns, given unseasonal rains; larger than anticipated administered price revisions; faster closing of the output gap; geo-political developments leading to hardening of global commodity prices; and spillover from external developments through exchange rate and asset price channels. However, at this juncture, these upside risks appear to be offset by

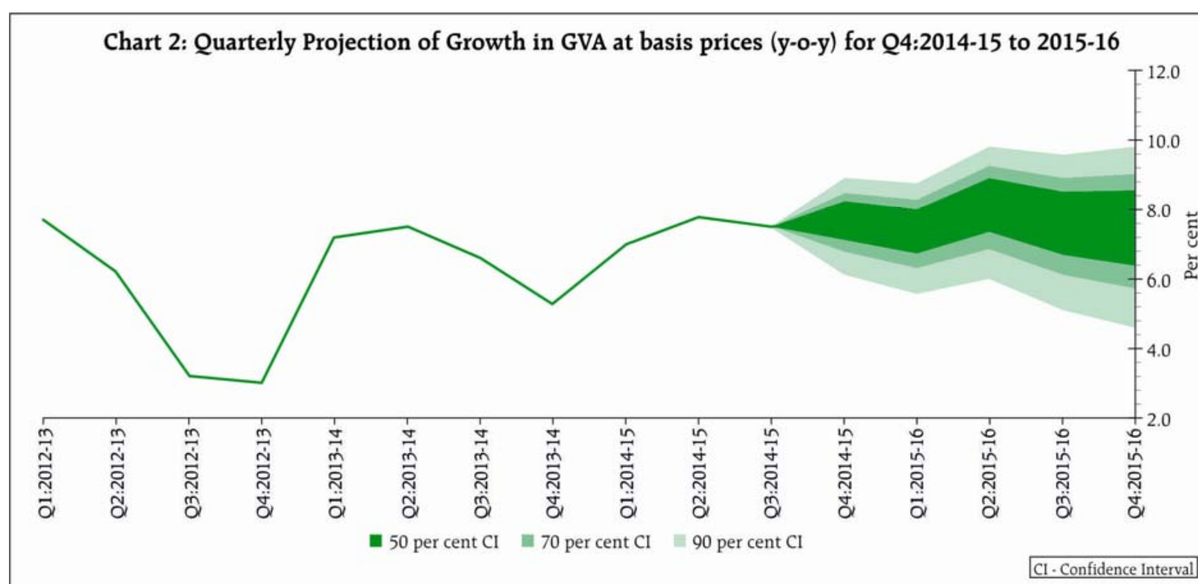
downsides originating from global deflationary/disinflationary tendencies, the still soft outlook on global commodity prices; and slack in the domestic economy.



Transmission of policy rates to lending rates has not taken place so far despite weak credit off take and the front loading of two rate cuts. With little transmission, and the possibility that incoming data will provide more clarity on the balance of risks on inflation, the Reserve Bank will maintain *status quo* in its monetary policy stance in this review.

The Monetary Policy Framework Agreement signed by the Government of India and the Reserve Bank in February 2015 will shape the stance of monetary policy in 2015-16 and succeeding years. The Reserve Bank will stay focussed on ensuring that the economy disinflates gradually and durably, with CPI inflation targeted at 6 per cent by January 2016 and at 4 per cent by the end of 2017-18. Although the target for end-2017-18 and thereafter is defined in terms of a tolerance band of +/- 2 per cent around the mid-point, it will be the Reserve Bank's endeavour to keep inflation at or close to this mid-point, with the extended period provided for achieving the mid-point mitigating potentially adverse effects on the economy. As outlined above, several favourable forces are at work, consistent with the change in the monetary policy stance towards accommodation effected from January. The Reserve Bank's intent is to allow the disinflationary momentum to spread through the economy, but remain vigilant about any resurgence of inflationary pressures that may destabilise the progress towards the inflation objectives set in the Agreement.

The outlook for growth is improving gradually. Comfortable liquidity conditions should enable banks to transmit the recent reductions in the policy rate into their lending rates, thereby improving financing conditions for the productive sectors of the economy. Along with initiatives announced in the Union Budget to boost investment in infrastructure and to improve the business environment, these factors should provide confidence to private investment and, together with the conducive outlook on inflation, deliver real income gains to consumers and lower input cost advantages to corporates. GDP growth estimates of the CSO for 2014-15 already project a robust pick-up, but leading and coincident indicators suggest a downward revision of these estimates when fuller information on real activity for the last quarter becomes available. Uncertainty surrounding the arrival and distribution of the monsoon and unanticipated global developments are the two major risks to baseline growth projections. Assuming a normal monsoon, continuation of the cyclical upturn in a supportive policy environment, and no major structural change or supply shocks, output growth for 2015-16 is projected at 7.8 per cent, higher by 30 bps from 7.5 per cent in 2014-15, but with a downward bias to reflect the still subdued indicators of economic activity (Chart 2).



Going forward, the accommodative stance of monetary policy will be maintained, but monetary policy actions will be conditioned by incoming data. First, the Reserve Bank will await the transmission by banks of its front-loaded rate reductions in January and February into their lending rates. Second, developments in sectoral prices, especially those of food, will be monitored, as will the effects of recent weather disturbances and the likely strength of the monsoon, as the Reserve Bank stays vigilant to any threats to the disinflation that is underway. The Reserve Bank will look through both seasonal as well as base effects. Third, the Reserve Bank will look to a continuation and even acceleration of policy efforts to unclog the supply response so as to make available key inputs such as power and land. Further progress on repurposing of public spending from poorly targeted subsidies towards public investment and on reducing the pipeline of stalled investment will also be helpful in containing supply constraints and creating room for monetary accommodation. Finally, the Reserve Bank will watch for signs of normalisation of the US monetary policy, though it anticipates India is better buffered against likely volatility than in the past.

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 to be taken for strengthening the banking structure; broadening and deepening financial markets and extending the reach of financial services to all.

I. Monetary Policy Framework

Steps taken to revise the monetary policy framework are documented in the accompanying Monetary Policy Report.

II. Banking Structure

The Basel Committee on Banking Supervision issued the final rules on the Net Stable Funding Ratio (NSFR) in October 2014. The Reserve Bank has already started phasing in implementation of the Liquidity Coverage Ratio (LCR) from January 2015 and is committed to the scheduled implementation of NSFR from January 1, 2018 for banks in India. The Reserve Bank proposes to issue draft guidelines on NSFR by May 15, 2015.

Guidelines on Countercyclical Capital Buffers (CCCB) were issued on February 5, 2015. They advised that the CCCB would be activated as and when circumstances warrant, and that the decision would normally be pre-announced with a lead time of four quarters. The framework envisages the credit-to-GDP gap as the main indicator which may be used in conjunction with other supplementary indicators such as the incremental credit-deposit (C-D) ratio for a moving period of three years, the industrial outlook survey (IOS) assessment index and the interest coverage ratio. A review and empirical testing of these indicators was carried out to assess whether activation of the CCCB is warranted. It was concluded that the overall situation does not warrant imposition of CCCB at this point of time.

In July 2014, banks were allowed to issue long term bonds (LTBs), with exemptions from certain regulatory pre-emptions, for lending to (i) long-term projects in infrastructure sub-sectors, and (ii) affordable housing. However, cross-holding of such bonds amongst banks is currently not permitted. On a review, it has been decided to allow banks to invest in such bonds issued by other banks, subject to the following conditions:

i) banks' investment in these bonds will not be treated as 'assets with the banking system in India' for the purpose of calculation of NDTL; and

ii) any single bank's holding of bonds in a particular issue will be subject to certain limits in relation to the bond issue size. Its aggregate holding of such bonds will also be subject to certain limits in relation to its own assets.

iii) LTBs held for trading will reduce the bank's priority sector and liquidity benefits obtained from its own issuance of LTBs.

Detailed guidelines in this regard will be issued shortly.

For monetary transmission to occur, lending rates have to be sensitive to the policy rate. With the introduction of the Base Rate on July 1, 2010 banks could set their actual lending rates on loans and advances with reference to the Base Rate. At present, banks are following different methodologies in computing their Base Rate – on the basis of average cost of funds, marginal cost of funds or blended cost of funds (liabilities). Base Rates based on marginal cost of funds should be more sensitive to changes in the policy rates. In order to improve the efficiency of monetary policy transmission, the Reserve Bank will encourage banks to move in a time-bound manner to marginal-cost-of-funds-based determination of their Base Rate. Detailed guidelines will be issued shortly.

The Financial Benchmarks India Pvt. Ltd., jointly floated by the Fixed Income Money Market and Derivatives Association of India (FIMMDA), the Foreign Exchange Dealers' Association of India (FEDAI) and the Indian Banks' Association (IBA), has been established as an independent benchmark administrator. This administrator will start operations by end-May 2015. Once it starts publishing various indices of market interest rates, the Reserve Bank will explore the possibility of encouraging banks to use the indices as an external benchmark for pricing bank products.

The Reserve Bank has been prescribing a comprehensive 'Calendar of Reviews' to be deliberated by the boards of banks, with significant additions to the calendar over the years. Time spent on reviews reduces the leeway for the board to discuss issues of strategic importance for banks such as product market strategy and risk management. The Committee to Review Governance of Boards of Banks in India (Chairman: Dr. P.J.Nayak) recommended that discussions in the boards of banks need to be upgraded and greater focus should be on strategic issues. It is, therefore, proposed to do away with the mandatory calendar of reviews and instead, replace it with the seven critical themes prescribed by the Nayak

Committee namely, business strategy, financial reports and their integrity, risk, compliance, customer protection, financial inclusion and human resources, and leave it to the banks' boards to determine other list of items to be deliberated and periodicity thereof.

The need to bring in professionalism to the boards of banks cannot be overemphasized. In order to attract and retain professional directors, it is essential that they are appropriately compensated. Public sector banks follow guidelines issued by the government in this regard. The remuneration of the part-time Chairmen of private sector banks are approved specifically for each bank under the current statutory provisions. However, there is no guidance on remuneration to other non-executive directors of private sector banks. Therefore, it is proposed:

i) to issue guidelines to private sector banks on a policy on remuneration for the non-executive directors (other than part-time Chairman) that will reflect market realities and will be within the parameters specified in the Banking Regulation Act 1949 and the Companies Act, 2013; and

ii) to discuss with the Government the adoption of a similar remuneration policy for the non-executive directors of the public sector banks.

With a view to enlarging the scope of urban co-operative banks for expanding their business, it has been decided to allow financially sound and well managed (FSWM) scheduled urban co-operative banks, which are CBS-enabled and having minimum net worth of ₹100 crore, to issue credit cards. Detailed guidelines in this regard will be issued separately.

Similarly, with a view to providing greater freedom to state co-operative banks to expand their business and to provide technology-enabled services to their customers, it has been decided to permit state co-operative banks satisfying certain eligibility criteria to set up off-site ATMs/mobile ATMs without obtaining prior approval from the Reserve Bank. Detailed guidelines in this regard will be issued separately.

III. Financial Markets

Several steps have been taken by the Reserve Bank to promote liquidity in the government securities (G-sec) market as recommended by the Working Group on Enhancing Liquidity in the Government Securities and Interest Rate Derivatives Markets (Chairman: Shri R. Gandhi). These include, *inter alia*, a) conduct of G-sec auctions at both uniform price and multiple price formats; b) change of the settlement cycle of primary auctions for treasury bills (T-bills) from T+2 to T+1 basis; and c) re-issuance of state development loans.

As part of continuing measures to promote liquidity, the Reserve Bank will formulate a scheme for market making by primary dealers in semi-liquid and illiquid government securities. Details of the scheme will be worked out and implemented in consultation with market participants within the next three months.

Although the G-sec market is predominantly institutional in nature, the Reserve Bank has initiated several steps to promote retail/individual investments, such as the non-competitive bidding scheme, and enabling access to the Negotiated Dealing System-Order Matching (NDS-OM). To increase participation of the retail and mid-segment investors in the G-sec market, gilt account holders (GAHs) were also extended web-based access to NDS-OM (secondary market trading platform) and NDS-auction platform (primary market platform)

earlier. Auctions of G-secs have since moved to a more robust CBS platform (e-Kuber). Accordingly,

i) it is now proposed to introduce a similar web-based solution for participation of all mid-segment / retail investors having gilt accounts on the e-Kuber platform. The facility is expected to be made available within the next three months.

ii) Considering the need to tap private savings through G-secs, retail investors/individuals could be provided direct access to both primary and secondary market platforms without any intermediary. Hence, it is proposed to explore the creation of alternate channels of distribution (e-Distribution Channels) for G-secs by the Reserve Bank.

iii) The Reserve Bank has been in consultation with all stakeholders to enable seamless movement of securities from subsidiary general ledger (SGL) form to demat form and *vice versa* to promote trading of G-secs on stock exchanges. Concomitantly, it has also been decided to provide demat account holders a functionality to put through trades on NDS-OM. As implementation of these reforms involves multiple agencies, it is proposed to constitute an Implementation Group with representatives from all stakeholders to roll out the measures within a period of six months.

iv) The non-competitive bidding facility available to retail investors is currently applicable only to auctions of dated securities other than Treasury Bills. In the case of Treasury Bills, a different type of non-competitive bidding is permitted only for State governments, eligible provident funds, select foreign central banks and sovereign wealth funds. It is proposed to allow non-competitive bidding facility in Treasury Bills to individuals as well. Details of the facility will be worked out and implemented in consultation with the Government of India.

A few international financial institutions were permitted to issue rupee bonds in overseas markets, subject to certain conditions. These issues have been received with interest. The appetite for rupee debt amongst international investors is a welcome development. In view of this, it is proposed to expand, in consultation with the Government of India, the scope of such bond issues by the international financial institutions as also to permit Indian corporates eligible to raise external commercial borrowing (ECB) through issuance of rupee bonds in overseas centers with an appropriate regulatory framework.

Under the present regulatory framework governing foreign exchange derivatives contracts under the Foreign Exchange Management Act, 1999 (FEMA), writing of options by the users on a standalone basis is not permitted. However, end-users can enter into option strategies of simultaneous buying and selling of plain vanilla European options, provided there is no net receipt of premium. With a view to encouraging hedging of forex exposures and enhancing the liquidity of the currency options market, it is proposed to permit Indian exporters and importers to write covered options on the basis of actual contracted forex exposure, subject to conditions. Detailed operating instructions shall follow separately.

IV. Access to Finance

The Reserve Bank had constituted an Internal Working Group to revisit the Priority Sector guidelines. The Working Group has since submitted its report, which was placed on the Reserve Bank's website for comments/suggestions.The Working Group has, *inter alia*, recommended specific sub-targets for small and marginal farmers and micro enterprises and inclusion of certain specific types of social infrastructure within the ambit of priority sector lending. The working Group has also recommended introduction of tradable Priority Sector

Lending Certificates as another instrument to manage deficit/surplus amongst the players within the system. The Reserve Bank will take a view on the recommendations in the light of feedback received and the guidelines in this regard will be issued shortly.

Taking into consideration the improvement in the Micro-Finance Institutions (MFI) sector and recommendations of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Dr. Nachiket Mor), there is a need to revise upwards the limit relating to total indebtedness of the borrower, eligible rural and semi-urban household annual incomes and loan amounts to be disbursed in the first cycle and in subsequent cycles as follows:

i) Total indebtedness of a borrower, excluding educational/ medical expenses, not to exceed ₹1,00,000 (raised from the current limit of ₹50,000).

ii) Loan disbursed to a borrower with a rural household annual income not exceeding ₹1,00,000 (enhanced from ₹60,000) or urban and semi-urban household income not exceeding ₹1,60,000 (enhanced from ₹1,20,000).

iii) Disbursement of the loan amount not to exceed ₹60,000 (enhanced from ₹35,000) in the first cycle and ₹1,00,000 (enhanced from ₹50,000) in subsequent cycles.

Detailed guidelines will be issued shortly.

Several measures have been taken to ensure the timely flow of funds to the infrastructure sector. One of them was to create a separate category of non-bank finance companies (NBFCs) called NBFC-infrastructure debt fund (NBFC-IDF). These NBFCs were allowed only to provide take-out finance for infrastructure projects in the Public Private Partnership (PPP) segment under a tripartite agreement involving, among others, the project authority. Certain regulatory dispensations were also given to these NBFCs. With a view to expanding the nature of projects to which they can lend, it is proposed to allow NBFC-IDFs to provide take-out finance for infrastructure projects that have completed one year of operation in the PPP segment without a tripartite agreement and to the non-PPP segment, subject to certain conditions. Detailed guidelines are being issued separately.

Looking ahead, the Reserve Bank’s developmental and regulatory policies will continue to be guided by the five-pillar approach to improve the efficacy of monetary and liquidity management, expand financial inclusion and carry forward banking sector reforms by adapting the best international practices to country-specific requirements.

The second bi-monthly monetary policy statement will be announced on June 2, 2015; the third bi-monthly monetary policy statement on August 4, 2015; the fourth bi-monthly monetary policy statement on September 29, 2015; the fifth bi-monthly monetary policy statement on December 1, 2015; and the sixth bi-monthly monetary policy statement on February 2, 2016.

Alpana Killawala
Principal Chief General Manager

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