Reserve Bank of India
Second Quarter Review of Monetary Policy 2013-14

By
Dr. Raghuram G. Rajan
Governor

Part A. Monetary Policy

Monetary and Liquidity Measures

Following an assessment of the evolving macroeconomic situation, the Reserve Bank has decided to:

- reduce the marginal standing facility (MSF) rate by 25 basis points from 9.0 per cent to 8.75 per cent with immediate effect;
- increase the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.5 per cent to 7.75 per cent with immediate effect
- keep cash reserve ratio (CRR) unchanged at 4.0 per cent of net demand and time liability (NDTL); and
- increase the liquidity provided through term repos of 7-day and 14-day tenor from 0.25 per cent of NDTL of the banking system to 0.5 per cent with immediate effect.

Consequently, the reverse repo rate under the LAF stands adjusted to 6.75 per cent and the Bank Rate stands reduced to 8.75 per cent with immediate effect. With these changes, the MSF rate and the Bank Rate are recalibrated to 100 basis points above the repo rate.

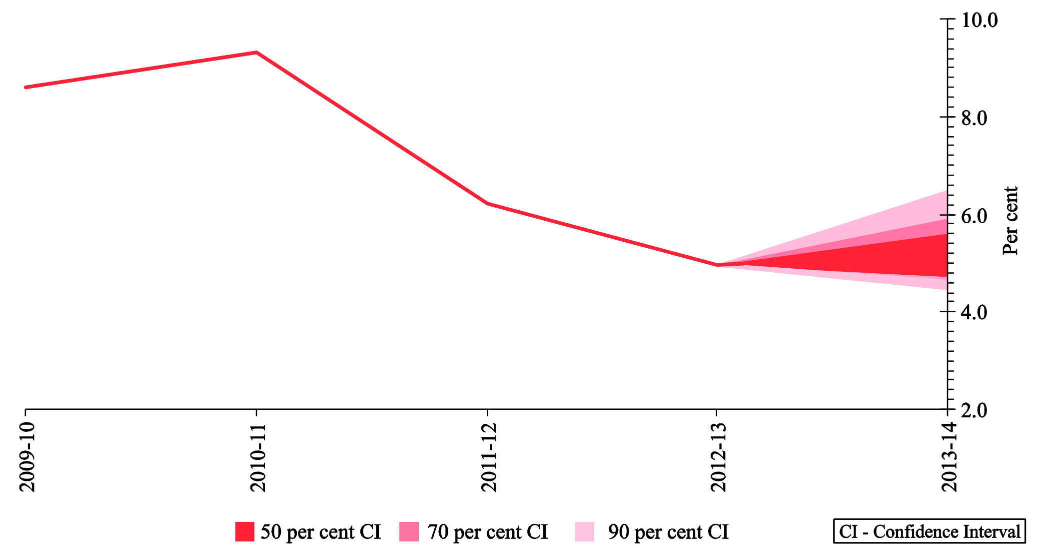
Assessment

2. Since the Mid-Quarter Review in September, the outlook for global growth has improved modestly, with fiscal concerns abating in the US and lead indicators of activity firming up in the Euro area and the UK.

3. In emerging and developing economies, the prospect of delay in the taper of the Federal Reserve's bond purchases has brought calm to financial markets, and capital flows have resumed. Nevertheless, headwinds to growth from domestic constraints continue to pose downside risks, and vulnerabilities to sudden shifts in the external environment remain.

4. In India, industrial activity has weakened, with a contraction in consumer durables and tepid growth in capital goods reflecting the ongoing downturn in both consumption and investment demand. Strengthening export growth and signs of revival in some services, along with the expected pick-up in agriculture, could support an increase in growth in the second half of 2013-14 relative to the first half, raising real GDP growth from 4.4 per cent in Q1 to a central estimate of 5.0 per cent for the year as a whole (Chart 1). The revival of large stalled projects and the pipeline cleared by the Cabinet Committee on Investment may buoy investment and overall activity towards the close of the year.

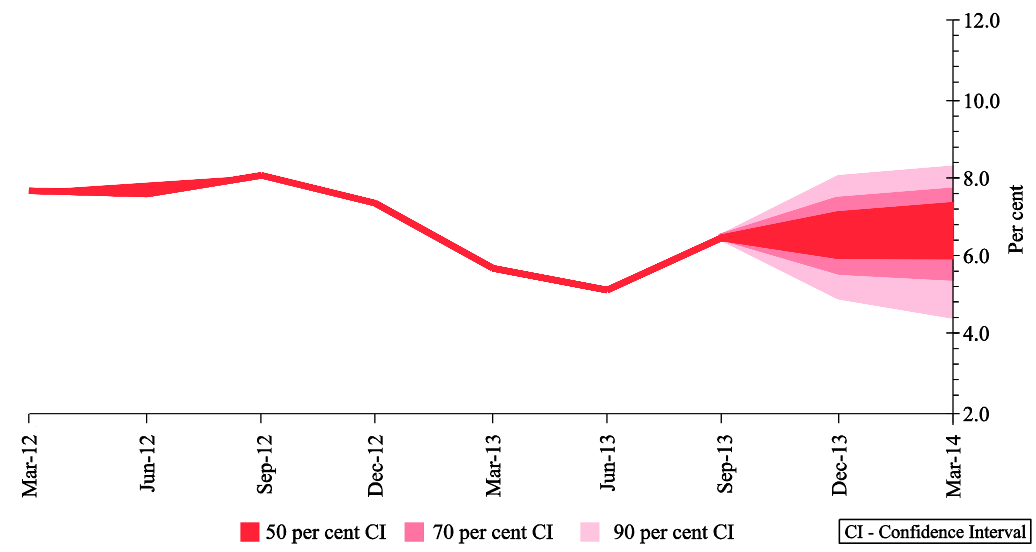
Chart 1: Projection of GDP growth (y-o-y) for 2013-14



5. In the meantime, with many large entities holding back on payments, liquidity pressures are building up on small and medium enterprises. A number are facing conditions of financial distress. Remedies partly lie in the speed-up of government and public sector payments, and on measures to channel credit to small and medium enterprises.

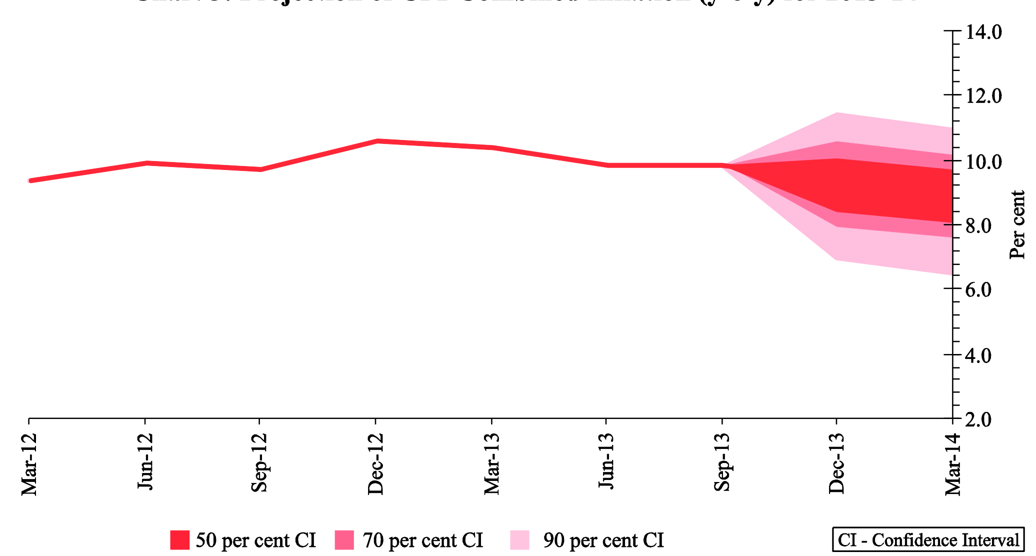
6. Inflation measured by the wholesale price index (WPI) rose in September for the fourth month in succession. The pass-through of rupee depreciation into prices of manufactured products is acting, along with elevated food and fuel inflation, to offset possible disinflationary effects of low growth. While food price pressures may ease with the arrival of the *kharif* harvest and the usual seasonal moderation, overall WPI inflation is expected to remain higher than current levels through most of the remaining part of the year (Chart 2), warranting an appropriate policy response.

Chart 2: Projection of WPI Inflation (y-o-y) for 2013-14



7. Retail inflation measured by the consumer price index (CPI) has also risen sharply across food and non-food constituents, including services, keeping inflation expectations high. Notwithstanding the expected edging down of food inflation, retail inflation is likely to remain around or even above 9 per cent (Chart 3) in the months ahead, absent policy action.

Chart 3: Projection of CPI-Combined Inflation (y-o-y) for 2013-14



8. Liquidity management has been calibrated to the system's requirements arising from the sharp pick-up in credit relative to deposit growth and festival-related demand for currency. Liquidity up to 0.5 per cent of bank-wise NDTL is available through overnight LAF repos. Furthermore, export credit refinance of up to 50 per cent of eligible export credit outstanding amounts to approximately 0.5 per cent of system-level NDTL. To provide market participants with additional access to primary liquidity, as well as greater flexibility in managing reserve

requirements, term repos of 7-day and 14-day tenor have been introduced to provide liquidity equivalent to 0.25 per cent of NDTL. As a result of the measures taken by the Reserve Bank to ease liquidity, the average drawal on the MSF has declined significantly from about ₹1.4 trillion in mid-September to ₹0.4 trillion by mid-October, and money market rates have fallen by 125 basis points. Going forward, however, the more durable strategy for mitigating mismatches between the supply of, and demand for, funds is for banks to step up efforts to mobilise deposits.

9. As regards the external sector, the improvement in export performance over the last two months, coupled with the contraction in non-oil import demand, has enabled a perceptible narrowing of the trade deficit with favourable implications for the current account deficit (CAD) going forward. Policy interventions have bridged the external financing gap. These factors have brought some calm to the foreign exchange market. However, normalcy will be restored to the exchange market only when the demand for dollars from public sector oil marketing companies is fully returned to the market.

Policy Stance and Rationale

10. From September, as steps to contain the CAD started taking effect in an improving external environment, volatility in the foreign exchange market ebbed and it became possible to unwind the exceptional liquidity tightening measures. Keeping in view the need to infuse liquidity into the system to normalise liquidity conditions, term repos will now be conducted for a total notified amount equivalent to 0.5 per cent of NDTL of the banking system. In addition, the MSF rate will be reduced by 25 basis points.

11. With the more recent upturn of inflation, and with inflation expectations remaining elevated anticipating the pass-through of exchange rate depreciation and ongoing adjustment in administered fuel prices, it is important to break the spiral of rising price pressures in order to curb the erosion of financial saving and strengthen the foundations of growth. It is in this context that the LAF repo rate has been increased by 25 basis points.

12. With the reduction of the MSF rate and the increase in the repo rate in this review, the process of re-aligning the interest rate corridor to normal monetary policy operations is now complete.

13. The policy stance and measures in this review are intended to curb mounting inflationary pressures and manage inflation expectations in a situation of weak growth. These will help strengthen the environment for growth by fostering macroeconomic and financial stability. The Reserve Bank will closely monitor inflation risk while being mindful of the evolving growth dynamics.

Mid-Quarter Review of Monetary Policy 2013-14

14. The next Mid-Quarter Review of Monetary Policy for 2013-14 will be announced through a press release on Wednesday, December 18, 2013.

Third Quarter Review of Monetary Policy 2013-14

15. The Third Quarter Review of Monetary Policy for 2013-14 is scheduled on Tuesday, January 28, 2014.

Part B. Developmental and Regulatory Policies

16. 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.

17. The Reserve Bank's developmental measures over the next few quarters will be built on five pillars. These are:

a. Clarifying and strengthening the **monetary policy framework**.

b. Strengthening **banking structure** through new entry, branch expansion, encouraging new varieties of banks, and moving foreign banks into better regulated organisational forms.

c. Broadening and deepening **financial markets** and increasing their liquidity and resilience so that they can help absorb the risks entailed in financing India's growth.

d. Expanding access to finance to small and medium enterprises, the unorganised sector, the poor, and remote and underserved areas of the country through measures to foster **financial inclusion.**

e. 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.

18. Action on the monetary policy framework will follow the submission of the Dr. Urjit Patel Committee report. A number of measures to strengthen bank structures and financial markets have already been announced, and more will follow as they are worked out. The strategy to expand financial inclusion will be informed by the Dr. Nachiket Mor Committee report, though significant efforts to explore the use of technology are already underway. Finally, some steps to improve restructuring and recovery will be announced soon.

I. Developments and Policies: Banking Structure

Basel III Regulation on Countercyclical Capital Buffer

19. As part of the Basel III capital framework, an internal Working Group (Chairman: Shri B. Mahapatra) was constituted to operationalise the countercyclical capital buffer framework in India. It is proposed to:

- place the draft report of the group on the Reserve Bank's website by end-November 2013 for inviting comments/suggestions from various stakeholders.

Framework for Dealing with Domestic Systemically Important Banks

20. The Basel Committee on Banking Supervision (BCBS) provided a framework for dealing with domestic systemically important banks (D-SIBs) in October 2012. The D-SIBs framework is principle-based and provides broad guidance to national authorities on assessment of the systemic importance of banks and additional capital requirements of D-SIBs. It is proposed to:

- place a draft of the proposed framework for D-SIBs on the Reserve Bank's website by end-November 2013.

Guidelines on Stress Testing

21. The Reserve Bank had issued guidelines on stress testing in June 2007. These guidelines required banks to have a sound stress testing policy which will determine liquidity risk, interest rate risk, credit risk and foreign exchange risk under stressed scenarios. Drawing from the BCBS principles on the subject and subsequent global developments, it is proposed to:

- issue updated guidelines on stress testing by end-November 2013.

Unhedged Foreign Currency Exposures of Corporates

22. Unhedged foreign currency exposures of corporates are a cause for concern as they pose a risk to individual corporates as also to the entire financial system. Based on feedback received from industry participants, it is proposed to:

- issue final guidelines on unhedged foreign currency exposures by end-December 2013.

Periodicity of Payment of Interest on Rupee Savings/Term Deposits

23. As per extant instructions, banks are required to pay interest on savings deposits and term deposits at quarterly or longer intervals. As all commercial banks are now on core banking platforms, it has been decided to:

- give banks the option to pay interest on savings deposits and term deposits at intervals shorter than quarterly intervals.

Licensing of New Banks in the Private Sector - Constitution of High Level Advisory Committee

24. In terms of the guidelines for licensing of new banks in the private sector released on February 22, 2013 applications will be screened by the Reserve Bank to ensure *prima facie* eligibility, and thereafter, the applications will be referred to a High Level Advisory Committee (HLAC). The HLAC will devise its own procedures for screening the applications and submit its recommendations to the Reserve Bank for consideration. The decision to issue an *in-principle* approval for setting up of a bank will be taken by the Reserve Bank whose decision in this regard will be final.

25. The HLAC has been set up under the Chairmanship of Dr. Bimal Jalan, former Governor of the Reserve Bank with Smt. Usha Thorat, former Deputy Governor of the Reserve Bank, Shri C.B. Bhave, former Chairman, Securities and Exchange Board of India (SEBI) and Dr. Nachiket M. Mor, Director, Central Board of Directors of the Reserve Bank as members. The Committee will hold its first meeting on November 1, 2013.

Mode of Presence of Foreign Banks in India – Scheme of Subsidiarisation

26. As a sequel to the roadmap for presence of foreign banks in India released by the Reserve Bank in 2005 and pursuant to the announcement made in the Monetary Policy Statement of April 2010, the Reserve Bank released a Discussion Paper on the presence of foreign banks in India on January 21, 2011 factoring in the lessons from the crisis which favoured a subsidiary mode of presence from a financial stability perspective. Taking into account the feedback received from stakeholders, a scheme of subsidiarisation of foreign banks in India, guided by the two cardinal principles of reciprocity and single mode of presence, is being finalised. The Wholly Owned Subsidiaries (WOSs) would be given near-national treatment, including in the opening of branches.

27. While it will not be mandatory for existing foreign banks (*i.e.*, banks set up before August 2010) to convert into WOSs, they will be incentivised to convert into WOSs by the attractiveness of the near-national treatment afforded to WOSs. The initial minimum paid-up voting equity capital or net worth for a WOS shall be ₹5 billion. It is proposed:

- to issue the Scheme by mid-November 2013.

II. Developments and Policies: Financial Markets

Retail Inflation Indexed Securities

28. The Union Budget, 2013-14 proposed to introduce instruments that will protect savings from inflation and provide an alternative to gold as an investment avenue for individuals.

Inflation indexed securities for retail investors of 10-year tenor would be linked to the new (combined) consumer price index. Eligible investors would consist of individuals, hindu undivided families (HUFs), trusts and charitable institutions. The rate of interest on these securities would comprise of a fixed rate plus inflation. Interest would be compounded half-yearly and paid cumulatively at redemption. These securities will be distributed through banks to reach out to the masses. Accordingly, it is proposed to:

- launch Inflation Indexed National Saving Securities (IINSSs) for retail investors in November/December 2013 in consultation with the Government of India.

Cash Settled 10-year Interest Rate Futures Contracts

29. In order to develop the money and government securities markets, it has been decided to introduce cash settled 10-year Interest Rate Futures (IRF) contracts. Product design and operational modalities are being discussed with all stakeholders, including market bodies and stock exchanges, and after taking into account their feedback, the Reserve Bank, in consultation with the SEBI, would:

- issue guidelines by mid-November 2013 and the product is expected to be launched by the exchanges by end-December 2013.

Credit Enhancements in Corporate Bonds

30. The corporate bond market in India currently lacks sufficient depth and liquidity. As a result, corporates have significant dependence on bank financing. Therefore, it is proposed to:

- allow banks to offer partial credit enhancements to corporate bonds by way of providing credit facilities and liquidity facilities to the corporates, and not by way of guarantee. Detailed guidelines in this regard will be issued separately.

Revision in the Timing of Marginal Standing Facility

31. With a view to facilitating settlement of electronic funds transfers as well as to reduce unnecessary volatility in reserve maintenance, it has been decided to:

- revise the timing of MSF operations. With effect from November 5, 2013 they will be conducted between 7.00 pm and 7.30 pm instead of between 4.45 pm and 5.15 pm.

Repo Facility for Mutual Funds

32. On July 17, 2013 the Reserve Bank had opened a special repo window for mutual funds with a view to enabling banks to meet the liquidity requirements of mutual funds. With the normalisation of exceptional measures and taking into consideration the improvement in liquidity conditions since then, it has been decided to close this window with immediate effect.

Technical Committee on Services / Facilities for Exporters

33. Some recommendations of the Technical Committee on Services/Facilities to Exporters (Chairman:
Shri G. Padmanabhan) such as an increase in the limit of e-commerce transactions and extending the time period for submission of documents under project exports, simplification of reporting requirement of forward contracts booked over-the-counter (OTC) and extending the limit for exporters to cancel and rebook the forward contracts have been accepted and necessary guidelines have been issued. Other recommendations are being analysed in coordination with government agencies/other stakeholders for implementation.

III. Developments and Policies: Financial Inclusion and Payment and Settlement Systems

General Credit Card Scheme

34. The coverage of the General Credit Card (GCC) Scheme is being revised to enhance credit linkage of individuals to all non-farm entrepreneurial activities within the rubric of the overall priority sector. It is expected that the revised scheme will give a fillip to flow of credit to small businesses and low income households. Detailed guidelines in this regard will be issued before mid-November 2013.

Roadmap for Provision of Banking Services in Unbanked Villages

35. State Level Bankers' Committees are mandated to prepare a roadmap covering all unbanked villages of population less than 2000 and to notionally allot these villages to banks for providing banking services. Accordingly, about 4,90,000 unbanked villages have been identified and allotted to various banks to be covered by March 2016.

Rural Co-operatives: Streamlining of Short-Term Co-operative Credit Structure

36. In January 2013, the Reserve Bank constituted an Expert Committee (Chairman: Dr. Prakash Bakshi) on the short-term co-operative credit structure. The recommendations taken up for implementation include, *inter alia*, improvement of governance and management of rural co-operatives, moving to Core Banking Solutions (CBSs) and setting up of a Working Group to examine human resources requirement of rural co-operative banks following the transition of state co-operative banks and district central co-operative banks to CBS.

Customer Service - Charges Levied by Banks for Sending SMS Alerts

37. With a view to ensuring reasonableness and equity in the charges levied by banks for sending SMS alerts to customers, banks are advised to leverage the technology available with them and the telecom service providers to ensure that such charges are levied on all customers on actual usage basis.

Payment and Settlement Systems Electronic Bill Payments System - GIRO Advisory Group

38. Following the report of the Committee for Implementation of GIRO Based Payment System highlighting the need for an electronic bill payment system based on a GIRO model for payment of dues of essential services, insurance premia, utility payments, taxes, university fees, examination fees and the like, a GIRO Advisory Group (Chairman: Prof. Umesh Bellur) has been constituted with representation from banks and other stakeholders. The Group is expected to submit its report by end-December 2013.

Technical Committee on Expansion of Access to Mobile Banking

39. A Technical Committee (Chairman: Shri B. Sambamurthy) has been constituted to examine various options/alternatives, including the feasibility of encrypted SMS-based funds transfer using an application which can run on any type of handset, for expansion of mobile banking in the country. The Committee is expected to submit its report by end-December 2013.

Security and Risk Mitigation Measures for Card Present and Electronic Payment Transactions

40. The Reserve Bank has advised banks to put in place by end-June 2013 security features in order to secure card transactions and the electronic banking infrastructure. A review of banks' preparedness in this regard indicates that technical glitches are hampering the transition to the desired environment. Accordingly, a one-time extension has been granted to stakeholders.

Cash Pay-out from Prepaid Payment Instruments Issued by Non-bank Entities

41. In order to further popularise prepaid payment instruments (PPIs) and facilitate remittance of funds by people not having bank accounts, a pilot is being planned with select non-bank PPI issuers to study the technological and operational feasibility of allowing cash pay-out (remittance) from PPIs issued by non-bank entities using Aadhaar based bio-metric authentication. The broad technical, operational and functional parameters of the pilot are being finalised in consultation with participants and the pilot is expected to go live before end-March 2014.

IV. Restructuring

Non-Banking Financial Companies (NBFCs): Restructuring Guidelines

42. The Reserve Bank's Working Group (Chairman: Shri B. Mahapatra) reviewed prudential guidelines on restructuring of advances by banks and financial institutions and relevant guidelines to banks have been issued. As NBFCs are also part of the financial

institutions that lend to the sectors where restructuring benefits are now available, either as part of a consortium or otherwise, it has been decided to:

- review the extant instructions on restructuring for NBFCs and issue guidelines in the matter by end-November 2013.

V. Institutional and Other Developments

Recommendations of the Financial Sector Legislative Reforms Commission (FSLRC)

43. It is proposed to implement the following recommendations of the FSLRC pertaining to consumer protection and capacity building:

- All instructions relating to consumer services/consumer protection would be consolidated and will be placed on the Reserve Bank's website as a single group of instructions by end-March 2014 and they will be examined for gaps, if any.
- A Committee will be set up by the Reserve Bank to examine capacity building, including basic and job specific knowledge requirements and examine whether a system of formal certification is warranted for certain job descriptions within the Reserve Bank and in the financial entities and market segments regulated by it.
- The Reserve Bank will examine its own public facing services and institute time-bound response guidelines where feasible and not already in place. Such guidelines will be placed on the Reserve Bank's website by January 2014.

Currency Management: Distribution of Banknotes and Coins

44. Banks were advised to explore the possibility of meeting the growing demand for banknotes and coins in the country through Business Correspondents (BCs) and consider engaging the services of Cash in Transit (CIT) entities to address last mile connectivity issues. Instructions have been issued on September 10 and October 10, 2013, permitting banks to include distribution of banknotes and coins in the scope of activities which may be undertaken by BCs/CITs.

45. Banks have also enhanced their capacity to take over the retail function of distribution of notes and coins and adjudication of mutilated notes. They have so far identified 805 bank branches for the purpose. Correspondingly, the distribution level across the Reserve Bank's counters has decreased by 61 per cent and 64 per cent for notes and coins, respectively, and the adjudication of notes by 51 per cent.

Detection and Reporting of Counterfeit Banknotes

46. In view of the recommendation of the Department-related Parliament Standing Committee (DPSC) to introduce a scheme of incentives in order to encourage banks to report counterfeit notes detected by them, instructions were issued to banks on June 27, 2013 on the procedure to be followed and compensation to banks for detection of counterfeit notes and penalty for non-detection/reporting thereof.

Mumbai
October 29, 2013