NEWSLETTER

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FIRST BI-MONTHLY MONETARY POLICY STATEMENT, 2015-2016

Dr. Raghuram G. Rajan, Governor, RBI, on April 07, 2015 declared the First Bi-Monthly Monetary Policy Statement, 2015-2016

COMPARISON AND RATIONALE OF POLICIES

1. 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.

Hence, 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.

2. Assessment

Since the previous year, 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

- 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

- 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, a few highlights of which are discussed below:

- 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.
- 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
- Export performance has been progressively weakening and contraction set in on both non-oil and petroleum product exports since December 2014
- 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.

3. Policy Stance and Rationale

- 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 focused 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.
- The outlook for growth is improving gradually. Comfortableliquidity 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.
- The accommodative stance of monetary policy will be maintained, but monetary policy actions will be conditioned by incoming data.
  - o the Reserve Bank will await the transmission by banks of its front-loaded rate reductions in January and February into their lending rates
  - o 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.
  - o 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.
  - o 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.

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.

1. Monetary Policy Framework

- Consists of Macroeconomic Outlook, Prices and Costs, Demand and Output, Financial Markets and Liquidity Conditions and External Environment
- Short term lending rate (repo) is unchanged at 7.5 pc
- Cash Reserve Ratio unchanged at 4 pc
- Statutory Liquidity Ratio at 21.5 pc
- Estimation of GDP growth at 7.8% in FY 16
- CPI inflation to dip to 4 c in August 2015

2. 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
- The Countercyclical Capital Buffers (CCCB) 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.
- 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 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.
- 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.
- 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.

3. 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.

- 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).

- 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.

- 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.

4. Access to Finance

- The Reserve Bank had constituted an Internal Working Group to revisit the Priority Sector guidelines. 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.

- 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.

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

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