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February 3, 2015

Sixth 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 7.75 per cent;
- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.0 per cent of net demand and time liabilities (NDTL);
- reduce the statutory liquidity ratio (SLR) of scheduled commercial banks by 50 basis points from 22.0 per cent to 21.5 per cent of their NDTL with effect from the fortnight beginning February 7, 2015;
- replace the export credit refinance (ECR) facility with the provision of system level liquidity with effect from February 7, 2015;
- continue to provide liquidity under overnight repos of 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 term repo and reverse repo auctions to smooth liquidity.

Consequently, the reverse repo rate under the LAF will remain unchanged at 6.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 8.75 per cent.

Assessment

2. Since the fifth bi-monthly monetary policy statement of December 2014, the International Monetary Fund (IMF) has revised its forecasts for growth in 2015 and 2016 downwards. However, these forecasts are higher than the estimates for 2014. In the United States, growth moderated towards the end of 2014, with the boost to consumption demand from the fall in crude prices more than offset by the drag on net exports from a strong US dollar. In the Euro area, economic conditions have deteriorated in an environment of deflationary pressures, political tensions in Greece and still-elevated levels of unemployment. Demand in Japan is only just beginning to recover from the impact of the consumption tax increase last year, notwithstanding massive monetary and fiscal accommodation. The yen’s depreciation, however, is helping support exports. In China, growth is slowing because of a weakening property market and excess capacity in several industries. This has prompted targeted measures to ease financial constraints faced by corporations and banks. In other

emerging market economies (EMEs), growth has weakened sharply for oil exporters, whereas inflationary pressures, subdued investment appetite and a neutral fiscal stance continue to dampen growth in non-oil exporters.

3. The announcement of massive quantitative easing by the European Central Bank (ECB) in late January has reinvigorated financial risk taking, boosting stock markets across the world, even though many market participants have read the softness in crude prices and the ECB's announcement as signifying a weaker global economic outlook. Along with the growing belief that the US Fed will stay on hold longer than previously thought, bond yields in advanced economies (AEs) have fallen to historic lows. Financial markets remain vulnerable to uncertainty surrounding monetary policy normalization in AEs as well as possibly weaker growth in China and oil exporting EMEs.

4. The revision in the base year for GDP and GDP calculation methods will mean some revision in GDP growth numbers for 2014-15 as well as in GDP forecasts. Domestic activity is likely to have remained subdued in Q3 of 2014-15, mainly reflecting the shortfall in the *kharif* harvest relative to a year ago. Agricultural growth is likely to pick up in Q4 with the late improvement in the north-east monsoon and in *rabi* sowing. Nevertheless, growth expectations should be tempered as lead indicators such as tractor and motorcycle sales and slowing rural wage growth all point to subdued rural demand.

5. The improvement in industrial activity in November 2014 was broad-based, but continuing contraction in consumer goods production underscores the persisting weakness in consumption demand (even while raising questions about measurement of production). Advance indicators of industrial activity - indirect tax collections; non-oil non-gold import growth; expansion in order books; and new business reported in purchasing managers surveys - point to a modest improvement in the months ahead. Policy initiatives in land acquisition, as well as efforts underway to unlock mining activity and to widen the space for foreign direct investment in defence, insurance and railways, should create a more conducive setting for industrial revival. Faster clearances are also helping in resuscitating stalled projects. The improvement in business confidence is visible in a pick-up in new investment intentions, especially in transportation, power and manufacturing.

6. In the services sector, the purchasing managers' survey indicates slower activity, especially in new orders. However, other indicators of the services sector including foreign tourist arrivals, automobile sales, cargo handled at ports, and railway freight traffic suggest improvement. Overall, growth prospects will be contingent upon a turnaround in investment and a durable improvement in the business climate to complement the upsurge in business optimism. The sharp reduction in oil prices as well as in inflation is likely to increase personal disposable incomes and improve domestic demand conditions in the year ahead.

7. Retail inflation, measured by year-on-year changes in the consumer price index (CPI), edged up in December on the expected reversal of favourable base effects that had tempered upside pressures since June. A slight softening of cereal prices and a sharp seasonal fall in vegetables prices moderated the trajectory of headline inflation, despite persistent firmness in the prices of protein-rich items such as milk, meat and pulses. However, seasonal increases in vegetable prices, which typically set in around March, have to be monitored carefully. In the fuel category, prices of constituents such as electricity, coal and cooking gas remained stable in the absence of administered revisions. Consequently, the CPI registered a monthly decline for the first time since February 2014.

8. Inflation excluding food and fuel declined for the second consecutive month in December. This was largely on account of the declining prices of transport and communication since August, reflecting the impact of plummeting international crude

oil prices; and softer commodity prices more generally. Inflation in respect of miscellaneous services and housing, however, declined more moderately. Weak domestic demand has restrained corporates' pricing power and inflationary pressures in the non-food non-fuel category. Near-term as well as longer-term inflation expectations of households dropped to single digits for the first time in 21 quarters. Benign expectations are also mirrored in surveys of professional forecasters and industry conducted periodically by the Reserve Bank.

9. Active liquidity management operations under the revised framework adopted in early September have ensured that liquidity conditions have generally remained comfortable. Money market rates have evolved in close alignment with the policy repo rate, excluding occasional pressures around days of advance tax outflows and quarter-end tightness. Overnight variable rate repo/reverse repo auctions announced early in the day give markets advance intimation of the Reserve Bank's assessment on system-wide liquidity needs for the day, allowing fine tuning of liquidity. This also reduces the need for other sector specific windows. The average daily net borrowings under the LAF (including term repos, reverse repos and MSF) have been around ₹ 850 billion in December and January.

10. Easing inflationary pressures strengthened the impact of comfortable liquidity conditions on market interest rates; sovereign and corporate bond yields declined by 50 basis points and more in Q3. However, despite a generalised fall in the cost of funds, banks have yet to pass through these effects, as also the effects of the policy rate cut on January 15, into the spectrum of lending rates.

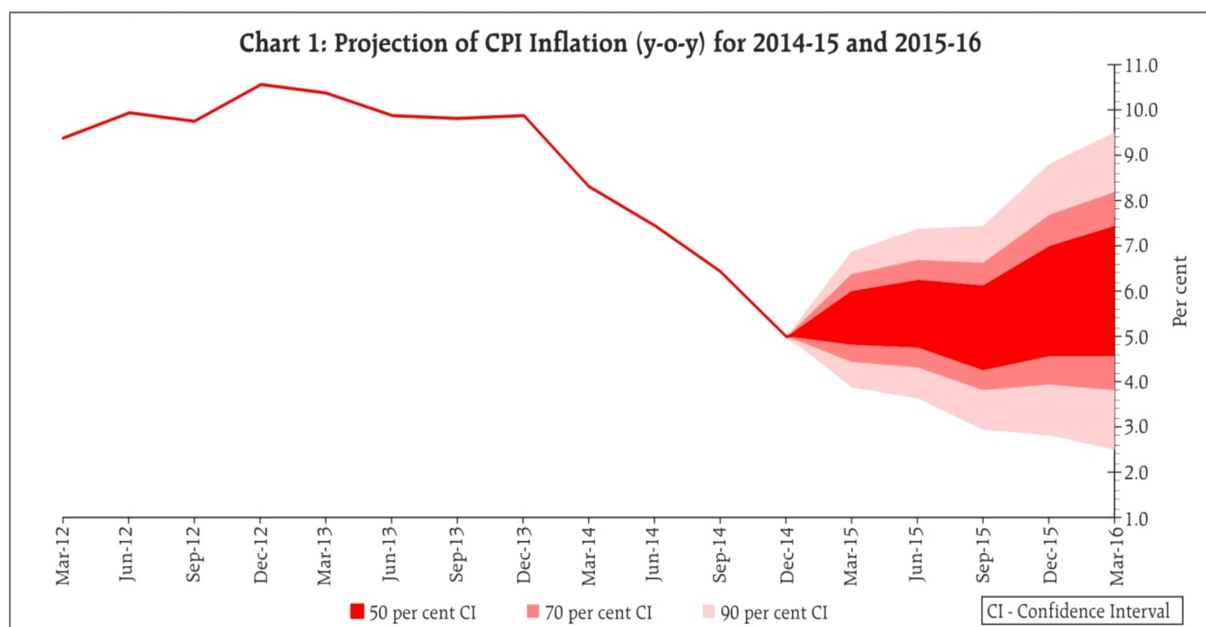
11. With the slump in international crude prices taking its toll on exports of petroleum products, and non-oil export growth also decelerating sharply, merchandise exports shrank in Q3 of 2014-15 after two consecutive quarters of growth. Export performance has been hamstrung by weak global demand conditions and the persisting fall in unit value realisations. The real appreciation of the rupee may also have had some effect. The fall in international crude prices translated into a sizable saving on account of POL imports, despite a pick-up in import volumes in Q3. Gold imports also moderated, coming off the seasonal cum pent-up demand spurt in September-November. On the other hand, non-oil non-gold import growth remained firm and in positive territory, extending a run that began in May. Although overall imports declined in December, they recorded an expansion for Q3 as a whole on the back of the earlier rise in gold and non-oil non-gold items. As a consequence, the trade deficit widened in Q3 relative to the preceding quarter. The estimate of the current account deficit (CAD) for 2014-15 is currently placed at 1.3 per cent of GDP, significantly lower than earlier projections. The CAD has been comfortably financed by net capital inflows, mainly in the form of buoyant portfolio flows but also supported by foreign direct investment inflows and external commercial borrowings. Accordingly, there was accretion to India's foreign exchange reserves to the tune of USD 6.8 billion in Q3.

Policy Stance and Rationale

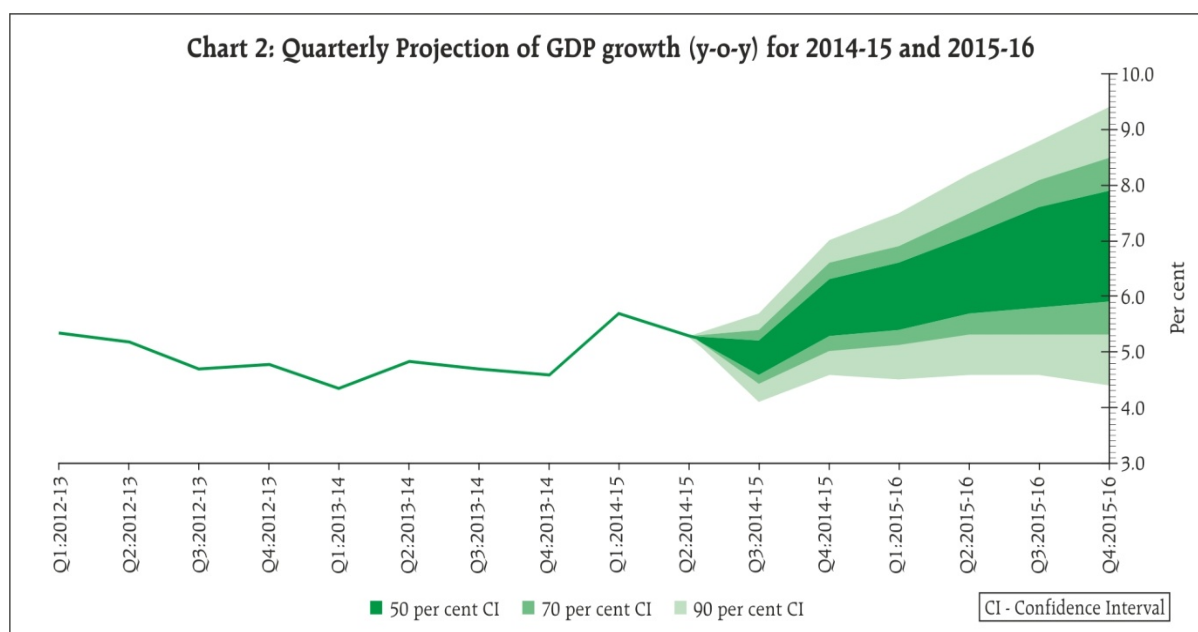
12. By and large, inflation dynamics have so far been consistent with the assessment of the balance of risks by the Reserve Bank's bi-monthly monetary policy statements, although with some undershooting relative to the projected path of disinflation. While inflation declined faster than expected due to favourable base effects during June-November, the upturn in December turned out to be muted relative to projections. Augmenting these data with survey data on falling inflationary expectations as well as data on weak commodity prices and muted rural wage growth, the Reserve Bank projected that it would meet its objective of 6 per cent CPI inflation by January 2016. Having committed in public statements to initiate a change in the monetary policy stance as soon as incoming data permitted, the Reserve Bank cut the policy rate on January 15, 2015.

13. The Reserve Bank also indicated that *"key to further easing are data that confirm continuing disinflationary pressures. Also critical would be sustained high quality fiscal consolidation…".* Given that there have been no substantial new developments on the disinflationary process or on the fiscal outlook since January 15, it is appropriate for the Reserve Bank to await them and maintain the current interest rate stance.

14. The upside risks to inflation stem from the unlikely possibility of significant fiscal slippage, uncertainty on the spatial and temporal distribution of the monsoon during 2015 as also the low probability but highly influential risks of reversal of international crude prices due to geo-political events. Heightened volatility in global financial markets, including through the exchange rate channel, also constitute a significant risk to the inflation assessment. Looking ahead, inflation is likely to be around the target level of 6 per cent by January 2016 (Chart 1). As regards the path of inflation in 2015-16, the Reserve Bank will keenly monitor the revision in the CPI, which will rebase the index to 2012 and incorporate a more representative consumption basket along with methodological improvements.



15. The outlook for growth has improved modestly on the back of disinflation, real income gains from decline in oil prices, easier financing conditions and some progress on stalled projects. These conditions should augur well for a reinvigoration of private consumption demand, but the overall impact on growth could be partly offset by the weaker global growth outlook and short-run fiscal drag due to likely compression in plan expenditure in order to meet consolidation targets set for the year. Accordingly, the baseline projection for growth using the old GDP base has been retained at 5.5 per cent for 2014-15. For 2015-16, projections are inherently contingent upon the outlook for the south-west monsoon and the balance of risks around the global outlook. Domestically, conditions for growth are slowly improving with easing input cost pressures, supportive monetary conditions and recent measures relating to project approvals, land acquisition, mining, and infrastructure. Accordingly, the central estimate for real GDP growth in 2015-16 is expected to rise to 6.5 per cent with risks broadly balanced at this point (Chart 2). The revised GDP statistics (base 2011-12) released on January 30 along with advance estimates for 2014-15 expected on February 9, 2015 will need to be carefully analysed and could result in revisions to the Reserve Bank's growth projections for 2015-16.



16. With liquidity conditions remaining comfortable, the recourse to export credit has been low – less than 50 per cent of the limit on monthly average basis since October 2014. In pursuance of the Dr. Urjit R. Patel Committee's recommendation to move away from sector-specific refinance, the ECR limit has been gradually lowered since June 2014. Continuing with this rationalisation, it has been decided to merge the facility with system level liquidity provision with effect from February 7, 2015. The Reserve Bank would continue to meet system wide liquidity needs as per the revised liquidity adjustment framework announced on August 22, 2014.

17. In order to create space for banks to expand credit, the SLR is being reduced from 22.0 per cent of NDTL to 21.5 per cent. Banks should use this headroom to increase their lending to productive sectors on competitive terms so as to support investment and growth.

Part B: Developmental and Regulatory Measures

18. Developmental and regulatory measures are put in place by the Reserve Bank periodically within the organising framework of the five-pillar approach announced in October 2013 in the Second Quarter Review of Monetary Policy for 2013-14. The measures set out in this part of the statement emphasise broadening and deepening financial markets; fortifying banking structure; and dealing with stress in banking assets by putting projects back on track.

I. Financial Markets

19. The Reserve Bank reduced the eligibility limit for foreign exchange remittances under the Liberalised Remittance Scheme (LRS) to USD 75,000 in 2013 as a macro-prudential measure. With stability in the foreign exchange market, this limit was enhanced to USD 125,000 in June 2014 without end-use restrictions, except for prohibited foreign exchange transactions such as margin trading, lotteries and the like. On a review of the external sector outlook and as a further exercise in macro-prudential management, it has been decided to enhance the limit under the LRS to USD 250,000 per person per year. Furthermore, in order to ensure ease of transactions, it has also been decided in consultation with the Government that all the facilities for release of exchange/ remittances for current account transactions available to resident individuals under Schedule III to Foreign Exchange Management (Current Account Transactions) Rules 2000, as amended from time to time, shall also be subsumed under this limit.

20. With a view to meeting the emerging needs of foreign direct investment in various sectors with different financing needs and varying risk perceptions as also to offer the investor some protection against downside risks, it has been decided in consultation with the Government of India to introduce greater flexibility in the pricing of instruments/securities, including an assured return at an appropriate discount over the sovereign yield curve through an embedded optionality clause or in any other manner. Guidelines in this regard will be issued separately.

21. The investment limit in Government securities by foreign portfolio investors (FPIs), registered with the Securities and Exchange Board of India (SEBI) is currently capped at USD 30 billion of which USD 5 billion is reserved for long term investors. The limit on investment in Government securities is now fully utilised. As a measure to incentivise long term investors, it has been decided in consultation with Government to enable reinvestment of coupons in Government securities even when the existing limits are fully utilised.

22. FPIs are currently permitted to invest in Government securities with a minimum residual maturity of three years. No such condition has been stipulated for their investments in corporate bonds. To harmonize requirements, it is decided in consultation with Government that all future investment by FPIs in the debt market in India will be required to be made with a minimum residual maturity of three years. Accordingly, all future investments within the limit for investment in corporate bonds, including the limits vacated when the current investment by an FPI runs off either through sale or redemption, shall be required to be made in corporate bonds with a minimum residual maturity of three years. Furthermore, FPIs will not be allowed to invest incrementally in short maturity liquid/money market mutual fund schemes. There will, however, be no lock-in period and FPIs shall be free to sell the securities (including those that are presently held with less than three years residual maturity) to domestic investors. Detailed operational guidelines will be issued by end-February 2015.

23. In the first bi-monthly monetary policy statement for 2014-15, the Reserve Bank announced the implementation of the recommendations of the Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar). The Bank has issued guidelines on the governance framework for benchmark submitters on April 16, 2014. The Fixed Income Money Market and Derivatives Association (FIMMDA) and Foreign Exchange Dealers Association of India (FEDAI) have since issued the Code of Conduct for benchmark submitters. An independent company named ''Financial Benchmarks India Pvt. Ltd", jointly floated by FIMMDA, FEDAI and Indian Banks' Association (IBA) for administration of the rupee interest rate and foreign exchange benchmarks, has been incorporated. As a further step towards strengthening the benchmark-setting methodology, it has been decided to work out the necessary infrastructural and transitional arrangements for shifting the overnight Mumbai Inter-Bank Offer Rate (MIBOR) from the existing polling based system to transaction based system of the Clearing Corporation of India Ltd. (CCIL) by April 2015.

24. In order to develop the money and Government securities markets, cash settled 10-year interest rate futures (IRF) contracts were permitted to be introduced by stock exchanges in December 2013. A cash settled IRF contract on 10-Year Government of India (GoI) Security was launched in January 2014 and has received an encouraging response. In order to provide market participants with greater flexibility to hedge their interest rate risk, it has been decided to permit stock exchanges to introduce cash settled IRF contracts on 5-7-Year and 13-15 year Government of India Securities. Detailed operational guidelines will be issued by end-March 2015.

25. In June 2014, FPIs were permitted to participate in the exchange traded currency derivatives (ETCD) market. Simultaneously, the regulatory regime for participation of domestic entities in the ETCD market was modified with the objective of bringing about parity between the ETCD and over-the-counter (OTC) markets. With a view to providing

greater flexibility to both FPIs and domestic participants in the ETCD market, it has been decided that:

- domestic entities and FPIs will henceforth be allowed to take foreign currency positions in the USD-INR pair up to USD 15 million per exchange without having to establish the existence of any underlying exposure. In addition, they shall be allowed to take foreign currency positions in EUR-INR, GBP-INR and JPY-INR pairs, all put together up to USD 5 million equivalent per exchange, without having to establish the existence of any underlying exposure. Domestic entities and FPIs who want to take a position exceeding the above limits in the ETCD market will have to establish the existence of an underlying exposure.
- for domestic participants who are importers of goods and services, the limit up to which they can take appropriate hedging positions in ETCD markets will be determined as 100 per cent of the higher of the (i) average of their last three years' imports turnover or (ii) the previous year's turnover, instead of 50 per cent at present.
- documentation and other administrative requirements for hedging on the ETCD markets are also being rationalised.

Detailed operational guidelines will be issued by end-March 2015.

II. Restructuring

26. At present, implementation of large projects is complex and unforeseen events may cause delays in project implementation, leading to failure in achieving the originally envisaged date of commencement of commercial operations (DCCO). The Reserve Bank has allowed *vide* circulars dated March 31, 2010 and May 30, 2013, certain flexibility with regard to loans to projects under implementation, wherein DCCO of the projects under implementation along with repayment schedules for such loans are allowed to be shifted to a certain extent without adversely affecting the asset classification of such loans. However, in the case of projects which have been stalled primarily due to inadequacies of the current promoters/management, a change in ownership and management may be required to revive the project. In this context, the new promoters/developers may require additional time to revive/complete the stalled projects. In order to facilitate change in ownership and revival, it has been decided to provide further flexibility by allowing a further extension of the DCCO of such projects where a change of ownership takes place, without adversely affecting the asset classification of loans to such projects, subject to certain conditions. Operating guidelines in this regard will be issued shortly.

27. According to Section 19(2) of the Banking Regulation Act 1949, banks are allowed to hold shares in a company, whether as pledgee, mortgagee or absolute owner, up to an amount not exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of their own paid-up share capital and reserves, whichever is less. Banks can also acquire shares of a borrowing company by way of conversion of debt into equity, following prudential guidelines on restructuring of advances by banks and financial institutions, subject to conditions mentioned therein. However, the acquisition of shares of listed companies by conversion of debt or by any other means is required to conform to the Issue of Capital and Disclosure Requirements (ICDR) Regulations and the Substantial Acquisition of Shares and Takeovers (SAST) Regulations. Very often, the share prices of companies whose debt is being restructured, in accordance with the stipulations of ICDR Regulations are found to be not in consonance with their intrinsic value. This results in upfront allocation of disproportionate share of loss on restructuring to banks. In view of the above, the Reserve Bank is consulting with the SEBI for waiver, under certain specific circumstances, of the requirement of compliance with the ICDR and SAST Regulations, for conversion of debt into equity. Detailed guidelines will be issued within three months.

28. Under the Framework for Revitalising Distressed Assets in the economy, banks were allowed in February 2014 to reverse the excess provision on sale of non-performing assets (NPAs) to securitisation companies/reconstruction companies when the cash received (by way of initial sale consideration and/or redemption of security receipts/pass-through certificates) is higher than the net book value (NBV) of the asset, with a view to incentivising banks to recover appropriate value in respect of their NPAs, subject to certain conditions. This dispensation was, however, available on a prospective basis, *i.e.*, only with regard to NPAs sold on or after February 26, 2014. On a review and based on banks' representations in this regard, it has now been decided to extend the above dispensation to NPAs sold prior to February 26, 2014 also. Detailed guidelines to this effect will be issued shortly.

III. Banking and Financial Structure

29. Currently, banks are allowed to offer differential rates of interest on deposits on the basis of tenor for deposits less than ₹ one crore and on the basis of quantum for deposits of ₹ one crore and above. Banks are, however, not permitted to differentiate on the basis of any other parameter of the deposit contract. Furthermore, all deposits accepted from individuals and Hindu undivided family (HUF) up to ₹ one crore are callable *i.e.*, have the facility of premature withdrawal. This results in asset-liability management issues, especially under the Liquidity Coverage Ratio (LCR) requirement under the Basel III framework. It is, therefore, proposed to allow non-callable deposits. Callability in a deposit will then be a distinguishing feature for offering differential rates on interest on deposits. Detailed guidelines will follow shortly.

30. The final guidelines on payments banks and small finance banks as differentiated banks were placed on the Reserve Bank's website on November 27, 2014 and clarifications on the queries were released on January 1, 2015. The last date of receipt of applications was February 2, 2015. 72 applications for Small Finance Banks and 41 applications for Payments Banks were received up to the deadline for submission yesterday. This number excludes applications that might have been received at other venues. As stated in the guidelines, two External Advisory Committees (EACs) will evaluate the applications received for setting up of small finance and payments banks and thereafter make their recommendations to the Reserve Bank. The EACs for small finance banks and payments banks will be chaired by Smt. Usha Thorat, former Deputy Governor, Reserve Bank of India and Dr. Nachiket Mor, Director, Central Board of the Reserve Bank, respectively.

31. The first bi-monthly monetary policy statement for fiscal year 2015-16 is scheduled on Tuesday, April 7, 2015.

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Director

Press Release : 2014-2015/1619