First Bi-Monthly Monetary Policy: April ‘14

Delivering to the market expectations, the RBI has decided to keep the policy repo rate under the Liquidity Adjustment Facility (LAF) unchanged at 8% in its first bi-monthly Monetary Policy Statement of FY15. CARE had also projected a “status quo” in interest rate for this credit policy.

This report firstly discusses the overall state of the economy with current statistics of key economic indicators and a trend analysis of inflation in FY14. Second, the first bi-monthly credit policy as released by the RBI is analyzed followed by a brief about the developmental and regulatory policies. The report is concluded by CARE’s analysis and view of the same.

State of the Economy

Indian economy appears to be in a more comfortable position at the start of Fiscal ‘15. Following is a brief glance over the key indicators to get a sense of the state of the economy.

- **GDP growth** stands at 4.6% as of Q3 FY14 with certain faint signs of the economy recovering.
- **IIP** growth has been negative for the last few months. However, as per the last estimate, IIP grew by 0.1% in January ‘14. The cumulative growth in IIP from April-January ‘14 stands nil compared with 1% over the corresponding period in FY13.
- Last recorded **WPI stood at 4.7% for February ‘14** as against a growth of 7.3% in February ‘13. This was the third consecutive month recording a fall in WPI.
- **CPI inflation also continued its downward trend to stand at 8.1% in February ‘14** compared with 10.91% in February ‘13.
- **Yields on 10 year GSecs** appear to have steadied at around 8.8% in recent times.
- **Rupee vis-à-vis the US dollar stands at Rs 60.09** as per RBI’s reference rate on 28th March ‘14. Note however, that Rupee has been appreciating against the US dollar over the last one week on account of a strong positive trend in domestic stocks and healthy FII inflows in India.
- **Total FOREX reserves** held by the RBI amount to US 2.98 million as on 21st March ‘14.

Inflation in FY14

Inflation has remained the biggest concern for policy makers in FY14. There are two distinct trends in both Wholesale Price Index (WPI) inflation and Consumer Price Index (CPI) inflation.

- Since June ‘13 onwards, both measures of inflation have been on a steady rise reaching their highest level in November 2013 with WPI at 7.5% and CPI at 11.7% driven largely by the extreme food inflation in the country.
- From December ‘13 onwards however there was some respite as inflation measures eased down finally owing to the reduction in food and vegetable prices. As of February ‘14, WPI stands at 4.7% and CPI at 8.1%, both lower than their corresponding level in April ‘13.
Highlights of the Monetary Policy

- Key policy rate i.e. repo rate under the Liquidity Adjustment Facility (LAF) kept status quo at 8%.
- Hence, the MSF rate (100 bps above repo rate) and Bank Rate also stands unchanged at 9% and the reverse repo under LAF also remains unchanged at 7%.
- Cash Reserve Ratio (CRR) of scheduled banks is kept the same at 4% of NDTL.
- Increase in the liquidity provided under 7-day and 14-day term repos to 0.75% of NDTL of the banking system from the previous level of 0.5% of NDTL.
- Decrease in the liquidity provided under the overnight repos under the LAF to 0.25% of NDTL from the previous level of 0.5% of NDTL with immediate effect.

Rationale for Monetary Policy stance

The RBI ascertains that at the current juncture it is appropriate to hold the policy rate at the existing level while allowing the rate hikes from September ‘13-January ‘14 to work their way through the economy.

- **Inflation remains focal point**: RBI’s policy stance is firmly focused on keeping the economy on the disinflationary glide path which was suggested by the Dr. Urjit Patel committee whereby the economy is intended to touch 8% retail inflation by January ‘15 and 6% by January ‘16. As of February ‘14, CPI inflation has moderated driven by the sharp disinflation in food prices, although prices of fruits, milk products have started to inch up. Additionally, non-food and fuel CPI inflation was also around 8% indicating demand pressure still at play. Lastly, food prices which have been on the decline may begin to rise now as they enter their seasonal trough.

- **GDP outlook**: Real GDP in FY15 although estimated at 5.5% is linked with a strong downward bias as the leading indicators do not ascertain a sustained revival in industry and services. Agriculture sector on the other hand is subject to the timely arrival and spread of monsoon which as of now is uncertain given the likely “El- Nino” effect at play. However, clearance of stalled projects and easing of domestic supply bottlenecks along with the anticipated growth in global exports should up domestic growth prospects to a limited extend.
• **Improve the transmission of policy impulses across the interest rate spectrum:** The motivation behind the reduction of liquidity through the overnight LAF is in line with the recommendation of Dr. Urjit Patel’s committee which suggested the de-emphasizing of the overnight “guaranteed-access” window for liquidity and rather progressively manage liquidity through term repos. This explains the increase in liquidity made available to the markets under the term repos from RBI.

The underlying idea is to allow market participants to hold liquidity for longer period and thereby provide an impetus for engaging in term transactions in the market and improving the efficiency in cash and/or treasury management.

**Developmental and Regulatory Policies**

Taking off from the five-pillar framework to guide the developmental and regulatory measures, following is a brief update regarding the progress made on these fronts.

1. **To Revise and strengthen the Monetary Policy Framework:** Some of the recommendation under the Dr. Urjit Patel led committee have been implemented including:
   - Adapting new CPI measure as the key measure of inflation.
   - Recognizing the glide path for disinflation
   - Transition to a bi-monthly monetary policy cycle (in line with data release)
   - Progressive reduction in the access to overnight repo borrowing.
   - Increasing access to liquidity through term repos
   - Introduction of longer tenor term repos.

2. **To Strengthen Banking Structure:** High level advisory committed under Dr. Bimal Jalan recently submitted its recommendations to the RBI. RBI is to announce the in-principle approval for new licenses after consulting the Election Commission. There is considerable progress made on other regulatory and supervisory measures such as:
   - Final framework for domestic systematically important banks to be ready by end-May 2014
   - Issue guidelines relating to Basel three Liquidity Coverage Ratio (LCR) and Liquidity Risk Monitoring tolls by end-May ‘14.
   - Guidelines on stress testing were issued in December ‘13.
   - Capital provisioning and requirements on banks’ advances to corporates with unhedged foreign currency exposures was specified in January ‘14.
   - On the basis of the recommendations of the committee on Comprehensive Financial Services for Small Business and Low Income Households to encourage banks to actively manage their exposures to various sectors, it is proposed to prescribe additional disclosure requirements in the financial statements by end-June ‘14.
   - RBI extended the transitional period for the full implementation of Basel three Capital Regulations in India up to 31st March ‘19.
   - RBI has adopted risk based supervision (RBS) for scheduled commercial banks.
   - Banks are advised to assess their risk management architecture, practices and related processes.

3. **To broaden and deepen financial markets:**
   - Inflation Indexed National Saving Securities (IINSSs) for retail investors were issued in December ‘13.
   - Cash settled single bond 10 year Interest Rate Futures (IRFs) were introduced by stock exchanges in January ‘14.
RBI proposes to introduce market making scheme for primary dealers in order to assess the performance of primary dealers.

The committee under Shri P. Vijaya Bhaskar recommended several principles to be adopted in respect of major Indian rupee interest rate and foreign exchange benchmarks to strengthen their quality.

RBI in consultation with SEBI is finalizing the modalities for allowing FIIs to hedge their currency risk by using exchange traded currency futures in the domestic exchanges.

RBI proposes to simplify Know Your Client (KYC) procedures for opening bank accounts by Foreign Portfolio Investors.

RBI is rationalizing and expanding limits for FPI investments in debt markets.

- While the overall limit for FPI investments in GSecs remain unchanged at $ 30 bn, investments by FPIs in GSecs will be permitted only in dated securities of residual maturity of one year and above.
- FPI investment limits in Tbills have been capped at $ 5.5 billion in April ’13 while the limit for longer term investors was increased by $ 5 bn in June ’13.

4. Financial Inclusion: Recommendation put forward by the Nachiket Mor committee on accelerating flow of credit to those at the bottom of the pyramid and enlargement of catchment area of the Business Correspondents (BCs) are being analyzed.

- Scheduled Commercial Banks are advised to provide differential interest rates for MSEs and other borrowers whose loans are covered under the credit guarantee scheme in order to give a fillip to the flow of credit to MSE borrowers.
- Measures have been undertaken to expand banking services to the financially excluded sections.
- RBI proposes to frame comprehensive consumer protection regulations.

5. To Improve System’s ability to deal with corporate distress and financial institution distress:

- RBI issued a framework for Strengthening Financial restructuring as well as debt recovery.
- A working group for Regulation Regime for Financial Institutions head by Dr. Arvind Mayaram submitted its report in January ’14 wherein it recommended the setting up of a single Financial Resolution Authority, an early supervisory intervention mechanism and a separate legal framework.
- As regards the NBFC sector, they are to be issued Certificates of Registration (CoR) for conducting NBFC business till an appropriate regulatory framework is put in place.

CARE’s view:

- Growth in credit and deposits even as investments moderate:
  - Growth in credit in FY14 as of 7th March 2014 stands at 12.9% compared with the growth rate of 12.1% over the same period in FY13. It would probably end at around 14% for the year. Given the expectation of 5-6% growth in GDP, growth in credit should be around 15% in FY15.
  - Deposits grew at 14% in FY14 so far vis-à-vis the growth of 12.7% during the corresponding time window in FY13. For the coming year, assuming that inflation will moderate only gradually, growth would be retained at 14%. It must be remembered that the deposits growth this year has been supported a lot by the inflow of over $ 30 bn through FCNR (B) deposits.
• **Liquidity conditions for FY15 based on information available so far**

Government borrowings cumulate to Rs 5.97 lakh crore in FY15. Rs 1.90 lakh crore are likely to come in as redemptions which is significantly higher than Rs 1.40 lakh cr in FY14. Net borrowings are to be lower in FY15 at Rs 4.07 lakh crore as against Rs 4.23 lakh crore last year. For the first half of the year, borrowings are to be Rs 3.68 lakh crore. This would not put untoward pressure on liquidity as there would be around Rs 80,000 crore of redemption of Government paper during this period. Therefore, liquidity should be neutral and interest rates stable. 10-years GSec yield should remain range bound in the 8.6-8.8% range though sentiment relating to the political scene could move the rates in either direction. The RBI’s unchanged stance and fairly conservative view on inflation should guide rates in this range.

**Forward Outlook:**

Given the current policy stance of the RBI, **CARE’s expectation is that RBI will continue with its inflation focus.** However, RBI may not revert to a tight monetary policy as long as inflation remains in the current range. However, if a possible El Nino leads to adverse effects on output and prices, then the RBI would most definitely increase rates. **Assuming a normal monsoon, CARE’s view is that there would be a cut in interest rates, in the second half of the year – with the likelihood increasing in Q4 as the RBI has spoken of an immediate target of CPI inflation of 8% in January 2015. A maximum of 50 bps may be expected in the best case scenario.**

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