IV. MONETARY AND LIQUIDITY CONDITIONS

With moderation in headline inflation, the Reserve Bank eased the repo rate by 25 basis points in May 2013 on top of a 100 bps rate cut during 2012-13. During Q1 of 2013-14, liquidity conditions improved considerably and broad money growth broadly remained in line with the indicative trajectory. Credit growth decelerated with the slack in economic activity and deterioration in asset quality. The Reserve Bank took a slew of measures during July 2013 with a view to alter monetary and liquidity conditions and thereby to restore stability in the forex market. Going forward, the monetary policy will be conditioned by the need to maintain stable macro-economic environment by moving towards attaining external and internal balance and to support growth, while anchoring inflation expectations.

The Reserve Bank undertakes monetary policy measures to curb forex volatility

IV.1 The stance of the Reserve Bank's monetary policy for 2013-14 has been shaped to address risks to growth and guard against re-emergence of inflation while maintaining overall macro-financial stability. On the back of empirical evidence that inflation below threshold level is conducive to sustained growth, the Reserve Bank has emphasised low and stable inflation in promoting growth over the long term. In 2012-13, after frontloading a 50 bps policy rate reduction, the Reserve Bank strived to address sluggish credit growth and tight liquidity conditions with a series of calibrated measures that included cuts in the CRR and SLR and ₹1.5 trillion in outright OMO purchases, besides large accommodation provided through LAF repos. With headline inflation moderating, the Reserve Bank reduced the repo rate by 25 bps in May 2013, over and above the 50 bps reduction in Q4 of 2012-13. With capital outflows, wide current account deficit and high consumer price inflation the Reserve Bank kept the repo rate

Table IV.1: Movements in Key Policy Variables

(per cent)

Effective since	Reverse Repo Rate	Repo Rate	Marginal Standing Facility@	Cash Reserve Ratio*	Statutory Liquidity Ratio*
1	2	3	4	5	6
May 03, 2011	6.25 (+0.50)	7.25 (+0.50)	8.25 (+0.50)	6.00	24
June 16, 2011	6.50 (+0.25)	7.50 (+0.25)	8.50 (+0.25)	6.00	24
July 26, 2011	7.00 (+0.50)	8.00 (+0.50)	9.00 (+0.50)	6.00	24
September 16, 2011	7.25 (+0.25)	8.25 (+0.25)	9.25 (+0.25)	6.00	24
October 25, 2011	7.50 (+0.25)	8.50 (+0.25)	9.50 (+0.25)	6.00	24
January 28, 2012	7.50	8.50	9.50	5.50 (-0.50)	24
March 10, 2012	7.50	8.50	9.50	4.75 (-0.75)	24
April 17, 2012	7.00 (-0.50)	8.00 (-0.50)	9.00 (-0.50)	4.75	24
August 11, 2012	7.00	8.00	9.00	4.75	23 (-1.00)
September 22, 2012	7.00	8.00	9.00	4.50 (-0.25)	23
November 03, 2012	7.00	8.00	9.00	4.25 (-0.25)	23
January 29, 2013	6.75 (-0.25)	7.75 (-0.25)	8.75 (-0.25)	4.25	23
February 09, 2013	6.75	7.75	8.75	4.00 (-0.25)	23
March 19, 2013	6.50 (-0.25)	7.50 (-0.25)	8.50 (-0.25)	4.00	23
May 03, 2013	6.25 (-0.25)	7.25 (-0.25)	8.25 (-0.25)	4.00	23
July 15, 2013	6.25	7.25	10.25 (+2.00)	4.00	23

*: Per cent of net demand and time liabilities. @: With effect from Feb 13, 2012 Bank Rate was aligned to MSF rate.
Note: Figures in parentheses indicate changes in percentage points.

unchanged in the mid-quarter review of the monetary policy, 2013-14 (Table IV.1) subsequently, in order to restore stability in the forex market, the Reserve Bank has taken several measures since mid-July 2013, which, include: (i) hike in Marginal Standing Facility rate/Bank Rate; (ii) restriction on banks' access to funds under LAF repo; (iii) OMO sales; (iv) maintenance of minimum daily CRR balances by SCBs at 99 per cent of the requirement; (v) capping of PDs' access to LAF at 100 per cent of their individual net owned funds; and (vi) restrictions on gold import.

IV.2 Cumulatively, there has been a 125 bps reduction in the policy rate since the start of 2012-13. The transmission of monetary easing enabled the Weighted Average Lending Rates (WALR) based on all borrowal accounts to decline by 41 bps during 2012-13 (Table IV.2). The modal deposit rate and the modal base rate of the banks declined by 11 bps and 50 bps, respectively. More recent data suggest that the WALR of fresh rupee loans sanctioned by reporting banks declined considerably during April-June 2013. The softening of rates on fresh loans were visible in the commercial vehicle segment and housing loans under both personal and commercial segments.

IV.3 During Q1 of 2013-14, with the increase in the government's spending, liquidity conditions eased. Moreover, the Reserve Bank conducted two OMO purchase auctions during the first quarter, injecting liquidity to the tune of ₹165 billion. An increase in the currency in circulation and in banks' excess balances maintained with the Reserve Bank led to the withdrawal of liquidity from the banking system during the quarter (Chart IV.1(a) and (b)).

Liquidity conditions eased in Q1 of 2013-14

IV.4 Liquidity condition improved in April 2013, which was followed by a marginal increase in the liquidity deficit during May 2013 mainly on account of an increase in the currency in circulation. Liquidity conditions again improved in June 2013, with the liquidity deficit staying within the Reserve Bank's comfort zone of (–1) per cent of

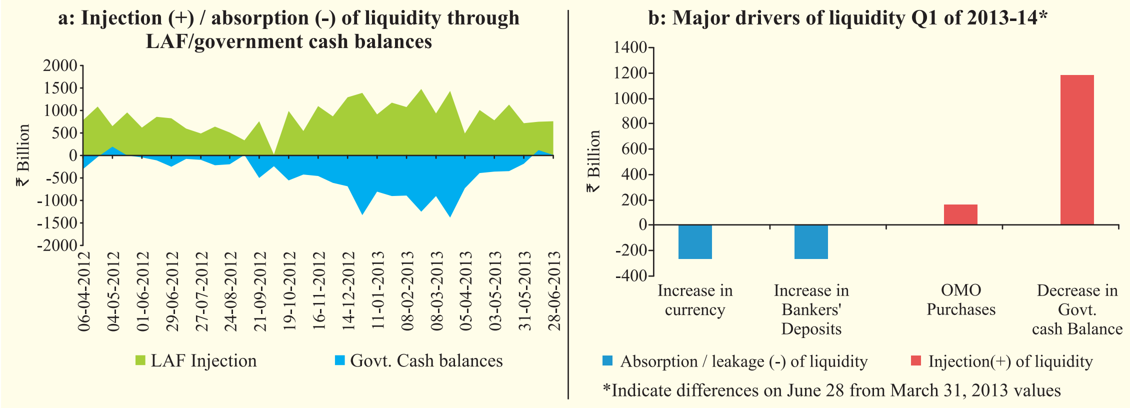
Table IV.2: Deposit and Lending Rates of Banks

(Per cent)

Items	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	June-13
1	2	3	4	5	6	7
1. Domestic Deposit Rate (1-3 year tenor)						
i) Public Sector Banks	9.00-9.75	8.75-9.50	8.50-9.30	8.50-9.10	8.75-9.10	8.00-9.10
ii) Private Sector Banks	8.00-10.50	8.00-10.00	8.00-9.75	8.00-9.75	8.00-9.65	8.50-9.50
iii) Foreign banks	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.60	3.60-9.88
Modal Deposit Rate of SCBs (all tenors)	***7.42***	***7.40***	***7.29***	***7.33***	***7.31***	***7.26***
2. Base Rate						
i) Public Sector Banks	10.00-10.75	10.00-10.50	9.75-10.50	9.75-10.50	9.70-10.25	9.70-10.25
ii) Private Sector Banks	10.00-11.25	9.75-11.25	9.75-11.25	9.70-11.25	9.70-11.25	9.60-11.25
iii) Foreign Banks	7.38-11.85	7.38-11.85	7.25-11.75	7.20-11.75	7.20-14.50	7.20-14.00
Modal Base Rate of SCBs	***10.75***	***10.50***	***10.50***	***10.50***	***10.25***	***10.25***
3. Weighted Average Lending Rate (WALR)*						
i) Public Sector Banks	12.65	12.36	12.29	12.19	12.14	12.06
ii) Private Sector Banks	12.31	12.42	12.32	12.14	12.13	12.01
iii) Foreign Banks	11.86	12.00	11.64	11.51	12.10	12.24
WALR of SCBs	***12.54***	***12.35***	***12.26***	***12.14***	***12.13***	***12.07***

*: Based on Loan outstanding as on end-quarter.
Note: Data on WALR are provisional.

Chart IV.1: Liquidity and its Drivers



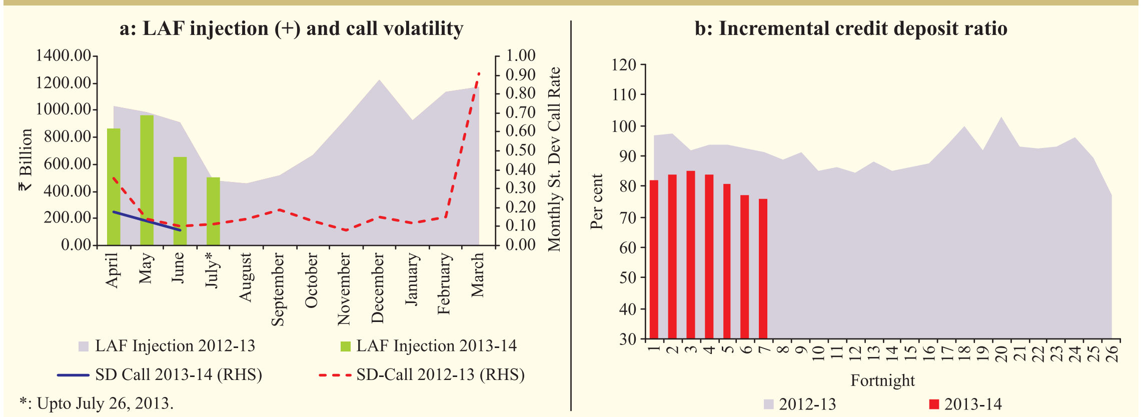
NDTL, despite quarter-end advance tax outflows from the banking system. Banks' recourse to liquidity from the Reserve Bank's LAF window also moderated as credit growth decelerated. Consequently, the incremental credit-deposit ratio has declined in Q1 of 2013-14 and the gap between deposit and credit has closed (Chart IV.2).

IV.5 Reflecting the comfortable liquidity conditions in Q1 of 2013-14, SCBs took recourse to MSF on only four occasions during the quarter and borrowed around ₹20 billion.

IV.6 However, global financial market developments following the signalling on likely tapering of QE in the US brought new risks to the fore, prompting monetary policy to recalibrate towards addressing them. The Fed signals triggered outflows of portfolio investment, particularly from the debt segment. This has led to significant depreciation of the rupee since end-May 2013.

IV.7 In face of rupee volatility the Reserve Bank announced measures on July 15, 2013 to restore stability to the foreign exchange market that had effects on the inter-bank liquidity. The MSF rate was re-calibrated at 300 basis points above the policy repo rate under the LAF. Further, the overall allocation of funds under LAF was capped at 1.0 per cent of the Net Demand and Time Liabilities (NDTL) of the banking system, with the cap reckoned at ₹750 billion. The Reserve Bank also conducted open market sales of G-secs withdrawing liquidity to the tune of ₹25 billion on July 18, 2013.

Chart IV.2: Liquidity Easing and Call Volatility



IV.8 While the above set of measures had a restraining effect on volatility with a concomitant stabilising effect on the exchange rate, based on a review of these measures, and an assessment of the liquidity and overall market conditions going forward, it was decided on July 23, 2013 to modify the liquidity tightening measures. The modified norms have set the overall limit for access to LAF by each individual bank at 0.5 per cent of its own NDTL outstanding as on the last Friday of the second preceding fortnight effective from July 24, 2013. Moreover, effective from the first day of the fortnight beginning from July 27, 2013 banks will be required to maintain a minimum daily CRR balance of 99 per cent of the average fortnightly requirement.

Reserve money adjusted for CRR changes grew at a reasonable pace

IV.9 During Q1 of 2013-14, y-o-y growth of reserve money picked up and was at 7.0 per cent compared with 5.6 per cent in Q1 of the previous financial year. Growth in currency in circulation decelerated, reflecting the impact of the economic slowdown. Bankers' deposits with the Reserve Bank, after having a negative y-o-y growth for 2012-13 mainly because of CRR cuts, recorded a low but positive y-o-y growth in Q1 of 2013-14. The reserve money, adjusted for the CRR changes, recorded a y-o-y growth at 10.2 per cent in Q1 of 2013-14 (Chart IV.3).

IV.10 On the sources side, the path of reserve money was influenced by both developments in the net domestic asset (NDA) and net foreign assets (NFA). In Q1, the Reserve Bank's net credit to the Centre increased because of the decline in the government's cash balances. However, this increase was matched by a decline in the LAF, which partially offset reserve money growth. The NFA, adjusted for revaluation, recorded a marginal decline over the quarter. On the components side, the expansion was matched by an increase in currency in circulation and in bankers' deposits.

Broad money growth remained broadly in line with indicative trajectory

IV.11 The y-o-y M_3 growth at 12.8 per cent was broadly in line with the indicative trajectory of 13.0 per cent for the 2013-14 (Chart IV.4). On the components side, a deceleration was observed in both the currency with the public and aggregate deposits. On the sources side, there was a marked deceleration in bank credit to the commercial sector as well as net bank credit to the government.

IV.12 The aggregate deposit growth, which generally decelerated during 2012-13 on account of near-zero real interest rates, continued to decelerate in Q1 of 2013-14 even with the increase in WPI-adjusted real interest rates on deposits. During Q1 of 2013-14, the

Chart IV.3: Trends in Reserve Money

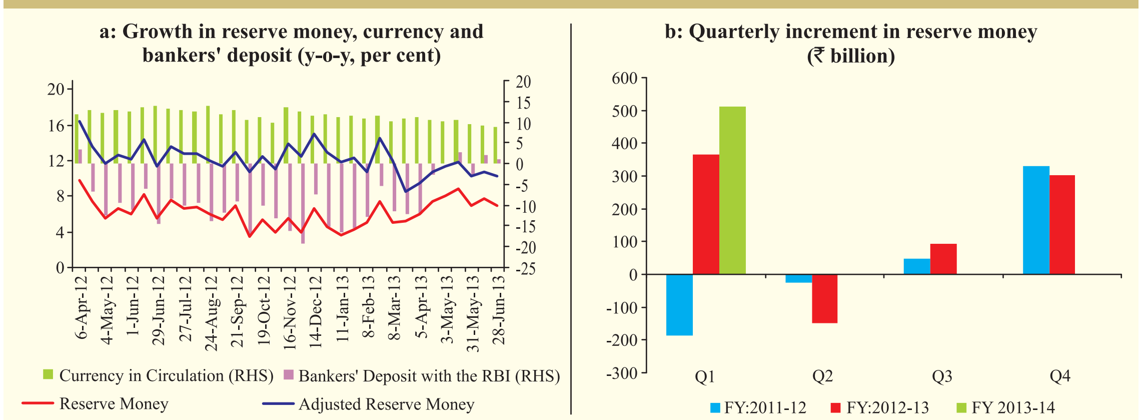
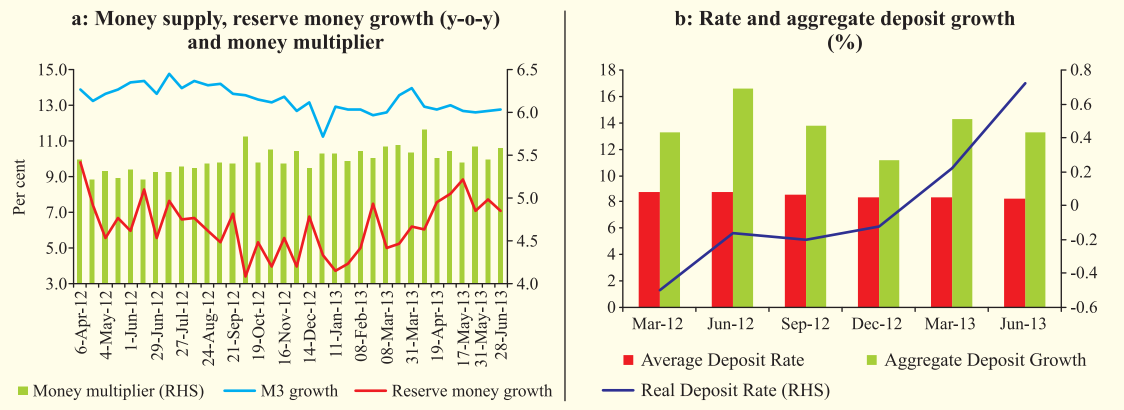


Chart IV.4: Broad Money and Deposit Movements



modal deposit rate of banks declined marginally by 5 bps, following a reduction in the repo rate and easing of liquidity conditions. The large increase in import of gold during Q1 of 2013-14 could indicate that some part of household savings was channelised to purchase the yellow metal, taking advantage of its lower prices. Time deposits, the largest component of aggregate deposits, decelerated further in Q1 of 2013-14 compared with the previous year (Table IV.3 and Chart IV.5).

IV.13 Despite a comfortable liquidity situation and a marginal decline in WALR during Q1 of 2013-14, SCBs' non-food credit growth remained below the Reserve Bank's indicative trajectory. On the demand side, the deceleration in domestic growth adversely affected the demand for credit in India. The deterioration in credit quality, on the other hand, impeded the supply of domestic credit (Table IV.4). The deceleration was observed across all bank groups, being high for PSBs and private sector banks, which jointly account for above 90 per cent of the SCB credit.

Risk aversion impacting credit, as asset quality concerns persist

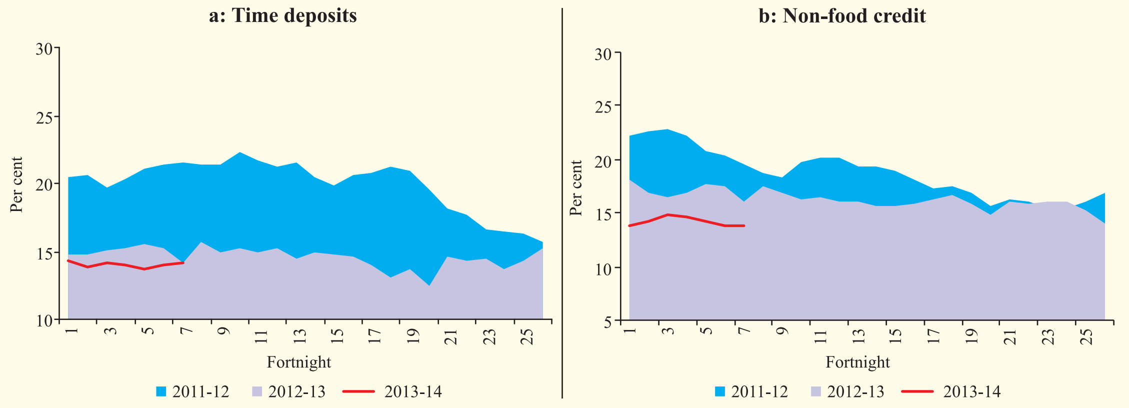
IV.14 Besides sluggish demand, a major factor that could have led to the low credit

Table IV.3: Monetary Indicators

Item	Outstanding Amount (₹ billion) 12-July-13	FY variations (per cent)		Y-o-Y variations (per cent)	
		2012-13	2013-14	13-July-12	12-July-13
1	2	3	4	5	6
Reserve Money (M_0)*	**15,364.3**	**3.8**	**1.4**	**9.6**	**3.8**
Reserve Money (Adjusted)*		**3.6**	**1.3**	**15.7**	**7.1**
Broad Money (M_3)	**87,567.9**	**5.4**	**4.5**	**14.8**	**12.8**
Main Components of M_3					
Currency with the Public	11,801.6	5.4	3.1	13.2	9.5
Aggregate Deposits	75,661.3	5.4	4.6	15.0	13.3
of which: Demand Deposits	7,392.1	-6.0	-1.0	7.1	10.6
Time Deposits	68,269.1	6.8	5.2	15.9	13.6
Main Sources of M_3					
Net Bank Credit to Government	29,737.5	8.1	9.8	20.0	16.0
Bank Credit to Commercial Sector	58,003.5	2.9	2.4	18.0	13.7
Net Foreign Assets of the Banking Sector	17,236.8	4.7	5.3	14.7	6.6

Note: 1. Data are provisional.
2. *: Data for Reserve Money pertain to July 19, 2013.

Chart IV.5: Path of Time Deposit and Non-food Credit Growth of SCBs



growth of public sector banks (PSBs) over the past quarters relates to deterioration in their asset quality. Asset quality indicators of the banking sector, which had suffered significantly during 2011-12, worsened in 2012-13. Although data indicate worsening asset quality across bank groups during 2012-13, it continued to be led by public sector banks (PSBs), which account for the major portion of bank advances (Table IV.5) Deterioration in both asset quality and in macroeconomic conditions resulted in risk aversion in the banking sector.

Sectoral deployment of credit indicates deceleration across most sectors

IV.15 An analysis of the sectoral deployment of credit based on data from select banks (which cover 95 per cent of total non-food credit extended by all SCBs) for June 2013 reveals that deceleration in credit growth was observed in all major sectors (*viz.,* agriculture, industry and services), except for personal loans. The y-o-y bank credit growth to industry moderated to 14.1 per cent in June 2013 from 20.7 per cent in June 2012. Deceleration in credit growth to industry was observed in all the major sub-sectors, barring food processing, textiles, leather & leather products, cement & cement products and infrastructure. Credit growth to industry excluding infrastructure was much lower, at 11.7 per cent in June 2013 compared with 22.4 per cent a year ago.

IV.16 During 2013-14 so far (up to July 12, 2013), the estimated total flow of financial resources from banks and non-banks, including external sources, to the commercial sector was slightly higher compared with the same period last year. Despite a decline in non-SLR investments by banks the flow of resources

Table IV.4: Credit Flow from Scheduled Commercial Banks (in ₹ billion)

Item Bank Credit	As on July 12, 2013 Outstanding Amount	Variation (y-o-y)			
		As on July 13, 2012		As on July 12, 2013	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1 Public Sector Banks*	39,175.8	4,900.6	16.5	4,581.7	13.2
2 Foreign Banks	2,794.1	406.5	19.9	344.3	14.1
3 Private Sector Banks	10,546.5	1,607.1	21.6	1,508.9	16.7
4 All Scheduled Com. Banks@	53,983.8	7,115.9	17.7	6,724.0	14.2

*: Excluding RRBs in public sector banks. @: Including RRBs.
Note: Data as on July 12, 2013 are provisional.

Table IV.5: Bank Group Wise Asset Quality Indicators

	End March	All Banks	Foreign Banks	New Private Sector Banks	Old Private Sector Banks	Public Sector Banks
1	2	3	4	5	6	7
Gross NPAs to Gross Advances (%)	Mar-12	2.9	2.7	2.2	1.8	3.2
	Dec-12	3.7	2.9	2.0	2.2	4.2
	Mar-13	3.4	3.0	1.9	1.9	3.8
Net NPAs to Net Advances (%)	Mar-12	1.2	0.6	0.4	0.6	1.5
	Dec-12	1.7	1.0	0.5	0.9	2.1
	Mar-13	1.5	1.0	0.3	0.6	1.8
Restructured Std. Asset to Gross Advances (%)	Mar-12	4.7	0.1	1.1	3.5	5.7
	Dec-12	5.9	0.2	1.1	4.1	7.4
	Mar-13	5.7	0.1	1.2	3.8	7.1
CRAR	Mar-12	14.2	16.8	16.7	14.1	13.2
	Dec-12	13.5	17.2	17.1	13.4	12.0
	Mar-13	13.8	17.5	17.5	13.7	12.4
Slippage Ratio (%)	Mar-12	2.6	2.3	1.2	1.1	2.9
	Dec-12	2.9	1.9	1.4	1.5	3.3
	Mar-13	2.8	1.6	1.2	1.4	3.2

from banks was marginally higher due to increase in non-food credit by SCBs. Flow of resources from foreign sources was higher due to external commercial borrowings / FCCBs and higher foreign direct investment to India. The domestic non-bank sources declined on account of decrease in net issuance of CPs subscribed by non-banks, total gross accommodation by four Reserve Bank regulated AIFIs and net-investment by LIC (Table IV.6).

Table IV.6: Resource Flow to the Commercial Sector

(₹ billion)

	April-March		April 1 to July 12	
	2011-12	2012-13	2012-13	2013-14
1	2	3	4	5
A. Adjusted Non-Food Bank Credit (NFC)	**6,773**	**6,849**	**1,030**	**1,093**
i) Non-Food Credit	6,527	6,335	927	1,207
of which: petroleum and fertiliser credit	*116*	*141*	*-84*	*-114 &*
ii) Non-SLR Investment by SCBs	246	514	104	-113
B. Flow from Non-Banks (B1+B2)	**5,383**	**7,335**	**1,502**	**1,517**
B1. Domestic Sources	**3,079**	**4,212**	**1,267**	**1,134**
1. Public issues by non-financial entities	145	119	5	9 &
2. Gross private placements by non-financial entities	558	1,038 P	-	-
3. Net issuance of CPs subscribed to by non-banks	36	52	744	658
4. Net Credit by housing finance companies	539	859	60	87 &
5. Total gross accommodation by 4 RBI-regulated AIFIs: NABARD, NHB, SIDBI & EXIM Bank	469	515	36	-32 *
6. Systemically important non-deposit taking NBFCs (net of bank credit)	912	1,188	360	405 &
7. LIC's net investment in corporate debt, infrastructure and social sector	419	441	62	7 &
B2. Foreign Sources	**2,304**	**3,123**	**235**	**383**
1. External Commercial Borrowings/FCCBs	421	466	14	88 &
2. ADR/GDR Issues, excluding banks and financial institutions	27	10	0	0 &
3. Short-term credit from abroad	306	1,177	-	-
4. Foreign Direct Investment to India	1,550	1,470	221	295 &
C. Total Flow of Resources (A+B)	**12,156**	**14,184**	**2,532**	**2,610**
Memo:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	-185	830	195	411 &

Note: *: Up to June 2013 &: Upto May 2013 -: Not Available P : Provisional

Monetary policy to aim at stable macro-financial conditions

IV.17 The Reserve Bank, through its monetary policy, has been aiming to achieve a low and stable inflation environment that is conducive to growth. In this endeavour, during 2012-13 the Reserve Bank reduced the repo rate by 100 bps and injected liquidity through CRR and SLR cuts as also through OMOs. In continuation of its stance, the Reserve Bank in May 2013 reduced the repo rate by 25 bps and injected liquidity through OMOs during the first quarter of 2013-14. The transmission of the rate easing lowered nominal lending rates significantly in 2012-13. However, global currency market movements in June-July 2013 have prompted a re-calibration of monetary policy. Going forward, the Reserve Bank will endeavour to actively manage liquidity to reinforce monetary transmission that is consistent with the growth-inflation balance and macro-financial stability. It will also endeavour to maintain stable conditions by moving towards attaining external and internal balance.