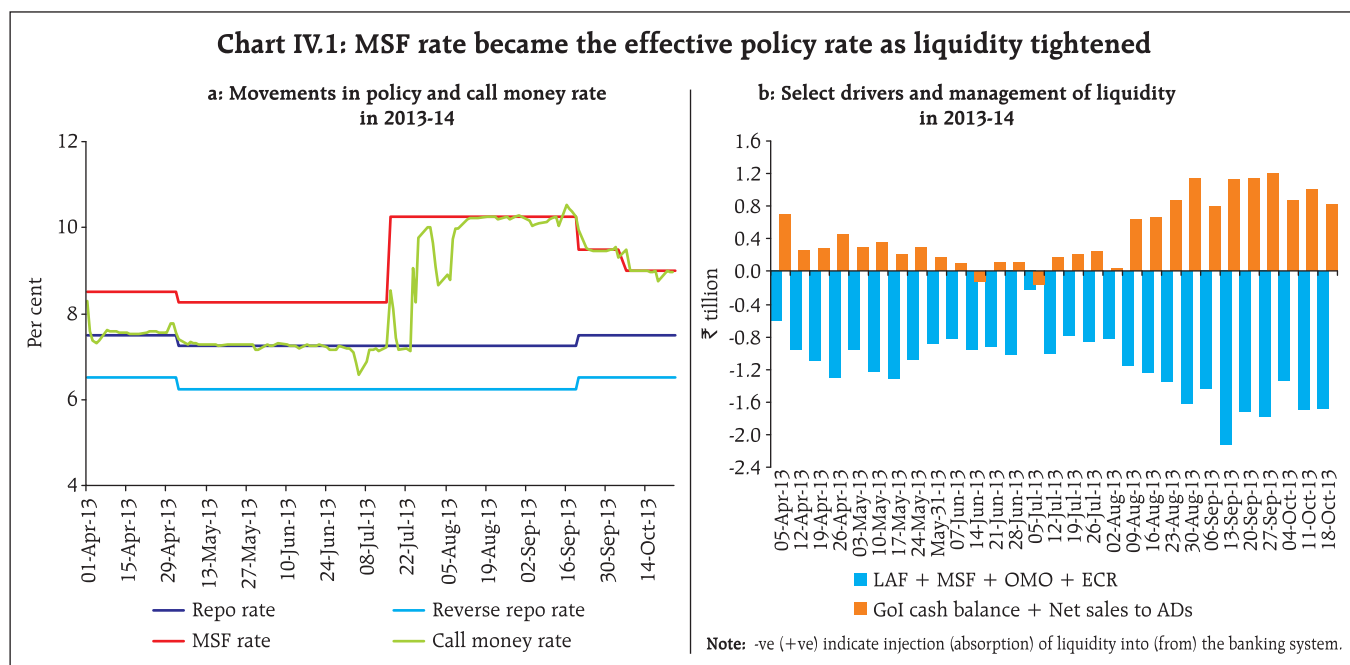


IV. Monetary and Liquidity Conditions

Monetary and liquidity conditions were tightened through exceptional liquidity measures in order to contain exchange market pressures and dampen volatility in the forex market. The MSF rate which was raised by 200 bps in July 2013, became the effective policy rate. With the ebbing of exchange market pressures, these measures are being rolled back in a calibrated manner. Notwithstanding the tightening, significant primary liquidity injection was done through LAF, MSF and OMO, besides increase in recourse to standing re-finance facilities. Money supply growth has been largely in line with the indicative trajectory. Credit growth has accelerated since mid-July, partly due to the substitution of costlier money market sources of finance by corporates with bank credit. Going forward, with the normalisation of exceptional monetary measures under way, incremental calibration will be shaped by changes in the growth-inflation balance, keeping macroeconomic stability in consideration.

The Reserve Bank tightened liquidity during Q2 of 2013-14, raising rupee funding costs to curb forex volatility

IV.1 Faced with a sharp depreciation of the rupee consequent on the sudden surge in capital outflows following indications of tapering of the US Fed's quantitative easing programme, the Reserve Bank hiked short-term interest rates and compressed domestic money market liquidity as a first line of defence. The measures taken included a 200 basis points (bps) hike in the marginal standing facility (MSF) rate to 10.25 per cent; a cap on daily LAF borrowing to 0.5 per cent of NDTL of respective banks as against the earlier practice of unlimited access against excess SLR holdings; and a hike in the minimum daily cash reserve ratio (CRR) requirement to 99 per cent from 70 per cent of the requirement. Weekly auctions of cash management bills (CMBs) were also conducted to drain out the liquidity. These measures moved up the call rate to the MSF rate, making the latter the effective policy rate in line with policy intent (Chart IV.1a).



IV.2 With tighter liquidity, the average daily liquidity injection under LAF (including MSF) increased from ₹526 billion in July 2013 to ₹1,131 billion in September 2013. The increase in government cash balances with the Reserve Bank and advance tax outflows also contributed towards the tightening of liquidity in September 2013. The liquidity tightening measures shifted the entire yield curve upwards with inversion visible at the short-end in line with the policy objective. It also led to a sizeable increase in corporate bond yields and commercial paper (CP) discount rates. In order to prevent liquidity conditions from becoming too tight, which would have excessively impacted financing conditions, the Reserve Bank undertook two OMO purchase auctions in August 2013 injecting primary liquidity of ₹125 billion (Chart IV.1b). Additional liquidity of ₹247 billion was also injected on a temporary basis by providing two-day funds to banks through the MSF on Saturday (September 14, 2013) to counter the effect of advance tax outflows.

Exceptional liquidity measures being rolled back in a calibrated manner as exchange rate pressures ease

IV.3 Taking into account the easing of the exchange rate pressures since September 2013 and evolving macroeconomic conditions, the Reserve Bank in its Mid-Quarter Monetary Policy Review (September 20, 2013) moved towards normalising monetary measures. In order to reduce the costs of funds, it reduced the MSF rate by 75 bps to 9.5 per cent. The minimum daily CRR balance maintained by the banks was reduced to 95 per cent of the requirement from 99 per cent to provide banks with the flexibility to better manage their liquidity situation. However, considering inflation risks, the repo rate was increased by 25 bps to 7.5 per cent. The Reserve Bank also signalled its intention to normalise the conduct and operations of monetary policy and to revert to the LAF repo rate as the operational policy interest rate.

IV.4 As stable financial market conditions persisted, the MSF rate was further lowered by 50 bps to 9.0 per cent with effect from October 7, 2013. In continuation

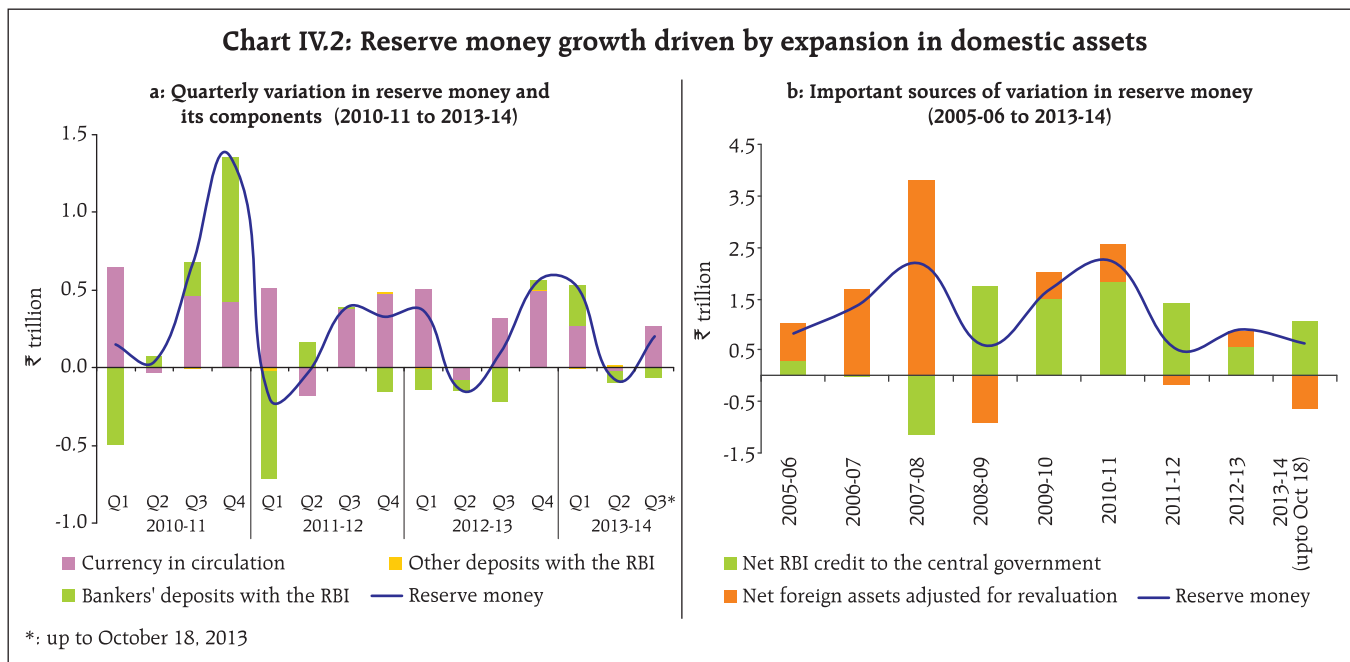
of the Reserve Bank's assurance on adequate liquidity, an OMO purchase auction was conducted on October 7, 2013 injecting liquidity of around ₹100 billion. As an additional liquidity enhancing measure and for developing the term money market, the Reserve Bank introduced weekly variable rate term repos of 7-day and 14-day tenors for an amount equivalent to 0.25 per cent of the NDTL of the banking system. As a result, total access to funds from the Reserve Bank augmented to 1.25 per cent of NDTL (*i.e.*, about ₹ 1 trillion) consisting of 0.5 per cent of NDTL under the overnight repo, about 0.5 per cent of NDTL under export credit re-finance (ECR) facility and 0.25 per cent of NDTL under term repo. The banks can also meet any further demand for liquidity through MSF. The first round of 7-day term repo was conducted on October 11, 2013 (₹190 billion) followed by 14-day term repo on October 18, 2013 (₹195 billion). As a result of these measures, the liquidity situation eased in October 2013.

Reserve money growth boosted by primary liquidity injection

IV.5 Reserve money growth picked up in recent months to 8 per cent y-o-y as at mid-October, while the same adjusted for CRR changes was around 10 per cent. Liquidity injections through LAF, MSF and OMOs have aided the increase in Reserve Bank's net credit to the central government. Though net foreign assets (adjusted for revaluation) on the sources side registered a decline during the year, it was more than offset by the increase in the Reserve Bank's net credit to the centre (Chart IV.2).

Broad money growth is in line with trajectory

IV.6 Money supply growth hovered around 12.5 per cent y-o-y during H1 of 2012-13, broadly in line with the indicative trajectory of 13 per cent for 2013-14, and is currently at 13.2 per cent (October 4, 2013). Currency expansion that had been lower in H1 of 2013-14 has picked up in October reflecting festive demand (Chart IV.3a). On the sources side, bank credit to the commercial sector has picked-up since middle of Q2 (Table IV.1). Consequently, the wedge between the growth in bank credit and aggregate deposit of



scheduled commercial banks (SCBs) widened to about 4 percentage points at the end of Q2 (Chart IV.3b).

Credit off-take accelerates with greater recourse to bank finance by corporates

IV.7 Non-food credit growth increased from 14.0 per cent y-o-y on July 12, 2013 to 17.9 per cent on October 4, 2013, markedly higher than the indicative trajectory

of 15 per cent. In part, this trend was supported by corporate firms substituting their market borrowings, especially through CPs, by bank borrowings (Table IV.2). This substitution occurred as money market rates, including discount rates on CPs firmed up and primary market conditions remained subdued.

IV.8 Given the lacklustre domestic environment, banks need to ensure better credit management

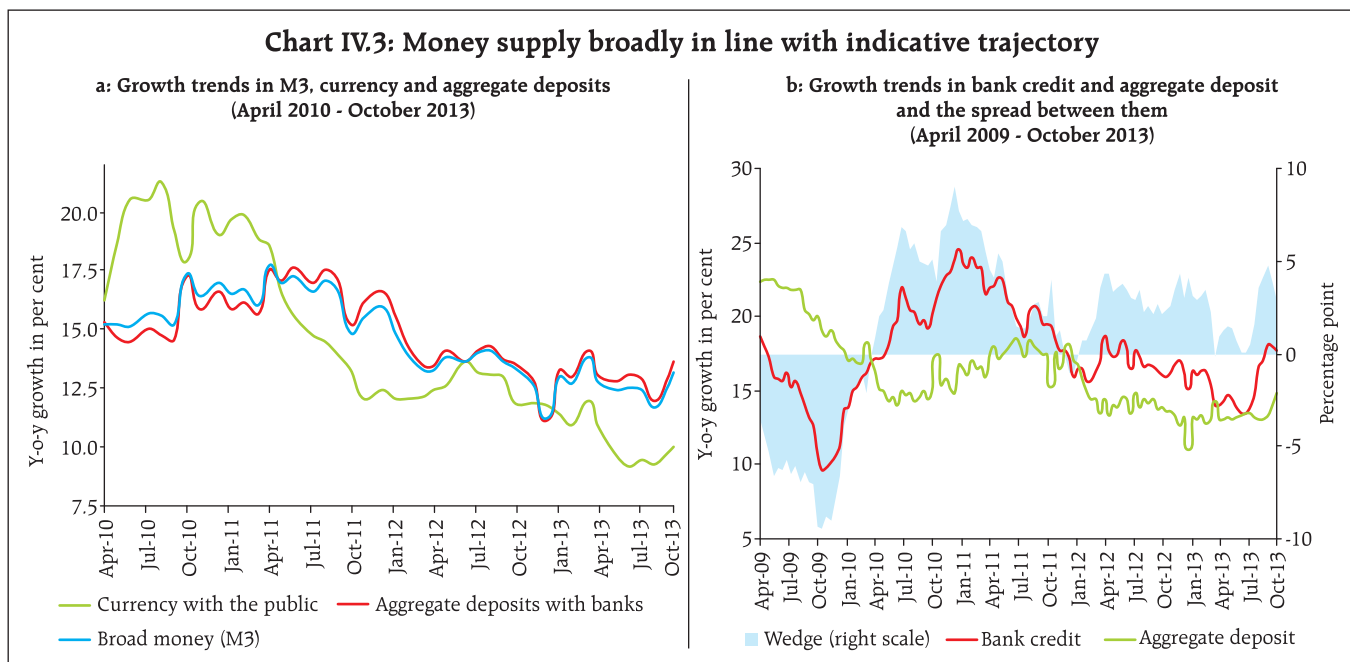


Table IV.1: Monetary Indicators

Item	Outstanding amount (₹ billion) 04-Oct-13	FY variations (per cent)		Y-o-Y variations (per cent)	
		2012-13	2013-14	05-Oct-12	04-Oct-13
1	2	3	4	5	6
Reserve Money (M₀)	15,793.3	2.5	4.3	5.3	8.0
Reserve Money (Adjusted)		3.6	4.0	12.4	9.9
Broad Money (M₃)	89,748.7	7.7	7.1	13.6	13.2
Main Components of M₃					
Currency with the Public	11,602.9	3.1	1.4	11.1	10.1
Aggregate Deposits	78,108.7	8.4	8.0	14.0	13.7
of which: Demand Deposits	7,605.0	-2.5	1.8	5.5	9.7
Time Deposits	70,503.7	9.8	8.7	15.0	14.1
Main Sources of M₃					
Net Bank Credit to Government	29,518.3	9.0	9.0	19.0	14.2
Bank Credit to Commercial Sector	60,468.6	4.8	6.7	16.2	16.4
Net Foreign Assets of the Banking Sector	16,936.9	-0.2	3.5	-0.4	9.9

Note: 1. Data are provisional.
2. Data for reserve money pertain to October 18, 2013.

practices when extending loans, keeping a careful watch on their asset quality. The Reserve Bank's initiative to collate large common exposures across banks and make available the credit registry data is expected to help mitigate this problem.

Credit growth broad-based, uptick across sectors

IV.9 Data on sector-wise deployment of gross non-food bank credit of select SCBs indicate a build-up in credit to industries, services and also personal loan

category (especially, housing) (Chart IV.4a). Overall industrial credit growth (y-o-y) was at 17.6 per cent in end-September 2013, with sectors such as basic metals, chemicals, infrastructure, cement, gems and jewellery, wood and food processing registering an above industry-average growth (Chart IV.4b).

IV.10 With the Reserve Bank increasing the cost of borrowing under MSF, even while restricting the availability of accommodation under the LAF repo, the

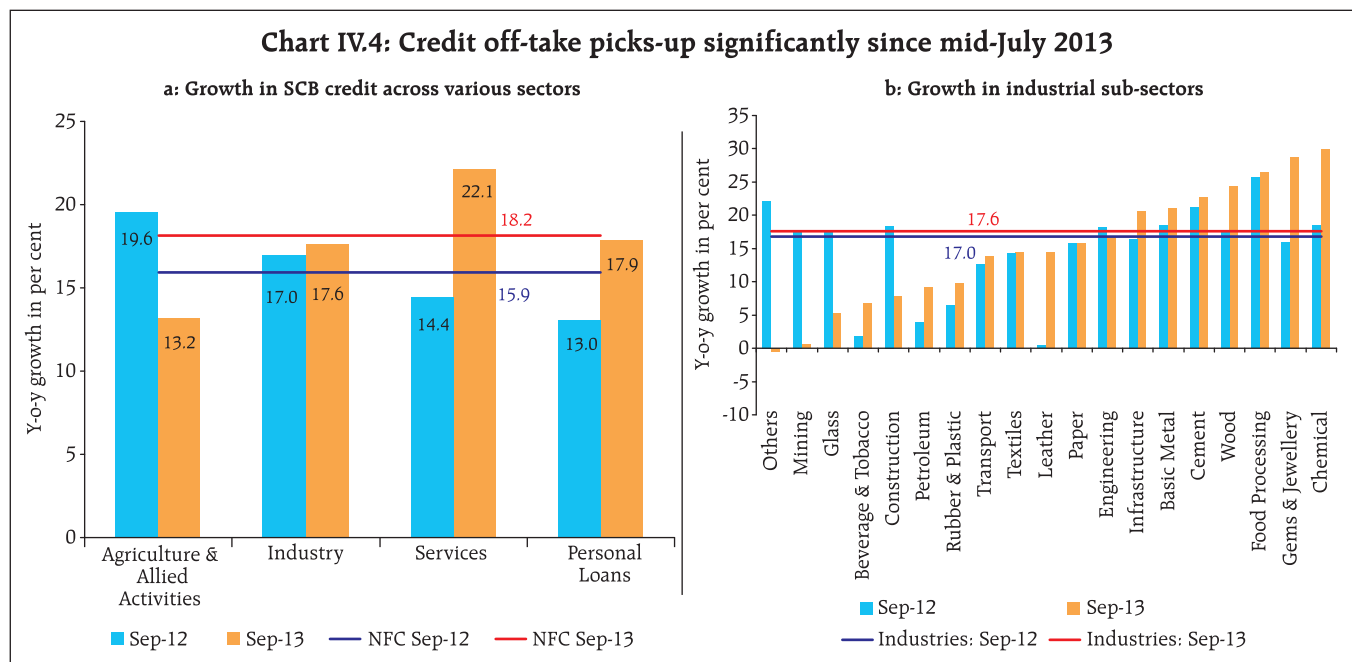


Table IV.2: Banking sources dominate resource flow to the commercial sector

(₹ billion)

1	April-March		April 1 - October 4	
	2011-12	2012-13	2012-13	2013-14
	2	3	4	5
A. Adjusted Non-Food Bank Credit (NFC)	6,773	6,849	2,177	3,905
i) Non-food credit	6,527	6,335	1,919	4,036
<i>of which: petroleum and fertiliser credit</i>	116	141	-88	-111 \$
ii) Non-SLR investment by SCBs	246	514	257	-131
B. Flow from Non-Banks (B1 + B2)	5,383	7,335	3,267	2,365
B1. Domestic Sources	3,079	4,212	2,289	1,440
1. Public issues by non-financial entities	145	119	63	32 ^
2. Gross private placements by non-financial entities	558	1,038	268	305 *
3. Net issuance of CPs subscribed to by non-banks	36	52	898	147 &
4. Net Credit by housing finance companies	539	859	230	267 \$
5. Total gross accommodation by 4 RBI-regulated AIFIs – NABARD, NHB, SIDBI & EXIM Bank	469	515	71	116 ^
6. Systemically important non-deposit taking NBFCs (net of bank credit)	912	1,188	618	484 #
7. LIC's net investment in corporate debt, infrastructure and social sector	419	441	141	89 \$
B2. Foreign Sources	2,304	3,123	978	925
1. External commercial borrowings/FCCBs	421	466	88	181 ^
2. ADR/GDR issues, excluding banks and financial institutions	27	10	10	1 ^
3. Short-term credit from abroad	306	1,177	291	137 *
4. Foreign direct investment to India	1,550	1,470	589	606 \$
C. Total Flow of Resources (A + B)	12,156	14,184	5,443	6,270
<i>Memo: Net resource mobilisation by mutual funds through debt (non-gilt) schemes</i>	-185	830	500	230 ^

\$: Up to August 2013 ^: Up to September 2013 *: Up to June 2013 &: Up to mid-September 2013 #: Up to July 2013

modal deposit rate increased by 20 bps (q-o-q) during Q2 (Table IV.3). This rise was mainly with respect to short-term maturities of up to 180 days reflecting the tightening of liquidity conditions. Although the modal

Table IV.3: Deposit and lending rates of banks registered an increase in Q2 of 2013-14

(Per cent)

Items	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13#
1	2	3	4	5	6	7	8
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	8.00-9.50
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	8.50-10.00
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	3.50-11.00
Modal Deposit Rate of SCBs (all tenors)	7.42	7.40	7.29	7.33	7.31	7.26	7.46
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	9.80-10.25
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	9.80-11.50
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	6.70-14.00
Modal Base Rate of SCBs	10.75	10.50	10.50	10.50	10.25	10.25	10.25
3. Weighted Average Lending Rate (WALR)*							
i) Public Sector Banks	12.70	12.41	12.34	12.23	12.18	12.10	12.10
ii) Private Sector Banks	12.31	12.42	12.32	12.14	12.13	12.10	12.17
iii) Foreign Banks	11.86	12.00	11.64	11.51	12.10	12.24	12.66
WALR of SCBs	12.58	12.39	12.30	12.18	12.16	12.11	12.15

#: Data on WALR pertain to August 2013. *: Based on loan outstanding as at end-quarter.

Note: Data on WALR are provisional.

base rate remained unchanged at 10.25 per cent during Q2, the weighted average lending rate (WALR) on the outstanding bank loans increased marginally by 4 bps (q-o-q) to 12.15 per cent in August 2013. The WALR on fresh rupee loans sanctioned by banks increased sharply by 42 bps to 12.04 per cent in August 2013 from 11.62 per cent in June 2013.

Normalisation of exceptional measures underway, changes ahead will be conditioned by high inflation and low growth challenges

IV.11 The exceptional liquidity and monetary policy measures taken in the face of unprecedented exchange rate pressures were partially rolled back in the Mid-

Quarter Monetary Policy Review on September 20 and further on October 7, 2013. Both these moves have lowered the effective policy rate by 125 bps. The Reserve Bank has also ensured sufficient liquidity in the system through LAF, MSF and OMO over a period of time in line with its assurances. Consequently, base money growth has picked up. Credit growth has also accelerated. With the process of normalisation of monetary measures making headway, monetary policy ahead would depend on how growth-inflation dynamics evolve. Liquidity conditions will have to be maintained at an appropriate level keeping in view the persistence in CPI inflation as also the slack growth conditions.