Report of the Central Board of Directors on the working of the Reserve Bank of India for the year ended June 30, 2014 submitted to the Central Government in terms of Section 53(2) of the Reserve Bank of India Act, 1934

RESERVE BANK OF INDIA ANNUAL REPORT 2013-14

RESERVE BANK OF INDIA

www.rbi.org.in

GOVERNOR

LETTER OF TRANSMITTAL

Ref.No.SYD.551/02.16.001/2014-15

August 21, 2014
Shravana 30,1936 (Saka)

The Finance Secretary
Government of India
Ministry of Finance
New Delhi – 110 001

Dear Sir:

In pursuance of Section 53(2) of the Reserve Bank of India Act, 1934, I have the pleasure in transmitting the following documents:

(i) A copy of the Annual Accounts for the year ended the June 30, 2014 signed by me, the Deputy Governors and the Chief General Manager, and certified by the Bank's Auditors; and

(ii) Two copies of the Annual Report of the Central Board on the working of the Bank during the year ended June 30, 2014.

Yours faithfully

[Raghuram G. Rajan]

Central Office Building, Shahid Bhagat Singh Marg, Mumbai - 400 001, India
Tel : +91 22 2266 0868 / 2266 1872 / 2266 2644 Fax : +91 22 2266 1784 E-mail : governor@rbi.org.in

CENTRAL BOARD / LOCAL BOARDS

GOVERNOR

Raghuram G. Rajan

DEPUTY GOVERNORS

Harun R. Khan

Urjit R. Patel

R. Gandhi

S.S. Mundra

DIRECTORS NOMINATED UNDER SECTION 8 (1) (b) OF THE RBI ACT, 1934

Anil Kakodkar

Kiran S. Karnik

Nachiket M. Mor

DIRECTORS NOMINATED UNDER SECTION 8 (1) (c) OF THE RBI ACT, 1934

Y. H. Malegam

Dipankar Gupta

G. M. Rao

Ela Bhatt

Indira Rajaraman

Y.C. Deveshwar

Damodar Acharya

DIRECTOR NOMINATED UNDER SECTION 8 (1) (d) OF THE RBI ACT, 1934

Arvind Mayaram

Gurdial Singh Sandhu

MEMBERS OF LOCAL BOARDS

WESTERN AREA

Kiran S. Karnik

EASTERN AREA

Nachiket M. Mor

Anila Kumari

Sharif Uz-zaman Laskar

NORTHERN AREA

Anil Kakodkar

Kamal Kishore Gupta

Mihir Kumar Moitra

A. Naveen Bhandary

SOUTHERN AREA

K. Selvaraj

Kiran Pandurang

As on July 31, 2014

PRINCIPAL OFFICERS

(As on August 13, 2014)

EXECUTIVE DIRECTORS	Deepak Mohanty
	P. Vijaya Bhaskar
	B. Mahapatra
	G. Padmanabhan
	Jasbir Singh
	Deepali Pant Joshi
	N.S. Vishwanathan
	U.S. Paliwal
	Chandan Sinha
CENTRAL OFFICE	
Central Vigilance Cell	Surekha Marandi, Chief Vigilance Officer
Customer Service Department	Arun Pasricha, Chief General Manager
Department of Banking Operations and Development	Sudarshan Sen, Chief General Manager-in-Charge
Department of Banking Supervision	P.R. Ravi Mohan, Chief General Manager-in-Charge
Department of Communication	Alpana Killawala, Principal Press Relations Officer
Department of Currency Management	B.P. Vijayendra, Principal Chief General Manager
Department of Economic and Policy Research	B.M. Misra, Principal Adviser
Department of Expenditure and Budgetary Control	Rajesh Verma, Principal Chief General Manager
Department of External Investments and Operations	M. Sarkar Deb, Chief General Manager
Department of Government and Bank Accounts	S. Ganeshkumar, Chief General Manager-in-Charge
Department of Information Technology	P. Parthasarthy, Adviser
Department of Non-Banking Supervision	K.K. Vohra, Principal Chief General Manager
Department of Payment and Settlement Systems	Vijay Chugh, Principal Chief General Manager
Department of Statistics and Information Management	A.K. Srimany, Officer-in-Charge
Financial Markets Department	G. Mahalingam, Principal Chief General Manager
Financial Stability Unit	S. Rajagopal, Chief General Manager
Foreign Exchange Department	B.P. Kanungo, Principal Chief General Manager
Human Resource Management Department	R.L. Das, Chief General Manager-in-Charge
Inspection Department	M. Sebastian, Principal Chief General Manager
Internal Debt Management Department	R.G. Warriar, Chief General Manager
Legal Department	Mona Anand, Legal Adviser
Monetary Policy Department	M.D. Patra, Principal Adviser
Premises Department	S. Venkatachalam, Chief General Manager-in-Charge
Rajbhasha Department	Ramakant Gupta, General Manager
Risk Monitoring Department	M. Rajeshwar Rao, Chief General Manager
Rural Planning and Credit Department	A. Udgata, Principal Chief General Manager
Secretary's Department	Bazil Shaikh, PCGM & Secretary
Urban Banks Department	A.K. Bera, Principal Chief General Manager
COLLEGES	**PRINCIPALS**
College of Agricultural Banking, Pune	Meena Hemchandra
Reserve Bank Staff College, Chennai	Uma Subramaniam
OFFICES	**REGIONAL DIRECTORS**
Chennai	J. Sadakkadulla
Kolkata	R.N. Kar
Mumbai	S. Ramaswamy
New Delhi	Deepak Singhal
BRANCHES	
Ahmedabad	P.C. Sahoo
Bangalore	Uma Shankar
Bhopal	Murli Radhakrishnan
Bhubaneswar	P.K. Jena
Chandigarh	Rashmi Fauzdar
Dehradun	R.L. Sharma
Guwahati	S.S. Barik
Hyderabad	K.R. Das
Jaipur	Sathyan David
Jammu	K.K. Saraf
Kanpur	Shekhar Bhatnagar
Lucknow	Supriya Pattnaik
Nagpur	J.M. Jivani
Patna	M.K. Verma
Shimla	I.S. Negi
Thiruvananthapuram	Nirmal Chand
	OFFICERS-IN-CHARGE
Agartala	Anil K. Sharma, General Manager (O-i-C)
Belapur	Ajay Michyari, General Manager (O-i-C)
Gangtok	Manabendra Misra, General Manager (O-i-C)
Kochi	C.V. George, General Manager (O-i-C)
Panaji	Jaikish, General Manager (O-i-C)
Raipur	Sanjeev Sharma, General Manager (O-i-C)
Ranchi	Saurav Sinha, General Manager (O-i-C)
Shillong	Amar Nath, General Manager (O-i-C)
Srinagar	Ramesh Chand, Deputy General Manager-in-Charge

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LIST OF ABBREVIATIONS

ABIs	- Authorised Bank Investors
AD	- Authorised Dealer
ADF	- Automated Data Flow
ADR	- American Depositary Receipt
ADR	- Asset Development Reserve
AEs	- Advanced Economies
AFA	- Additional Factor of Authentication
AFO	- Auto Fail Over
AFS	- Available For Sale
AIFI	- All India Financial Institution
AML	- Anti-Money Laundering
ANBC	- Adjusted Net Bank Credit
APMC	- Agricultural Produce Marketing Committee
ARC	- Asset Restructuring Companies
ARMS	- Audit and Risk Management Sub-Committee
ASI	- Annual Survey of Industries
ATBs	- Auction Treasury Bills
ATM	- Automated Teller Machine
AUM	- Assets Under Management
BBPOUs	- Bharat Bill Payment Operating Units
BBPS	- Bharat Bill Payment Services
BC	- Business Correspondent
BCBS	- Basel Committee on Banking Supervision
BCM	- Business Continuity Management
BCs	- Business Correspondents
BCSBI	- Banking Codes and Standards Board of India
BE	- Budget Estimates
BFS	- Board for Financial Supervision
BIC	- Bank Investment Company
BIS	- Bank for International Settlements
BO	- Banking Ombudsman
BPCL	- Bharat Petroleum Corporation Limited
BPO	- Business Process Outsourcing
BPR	- Business Process Re-engineering
bps	- Basis Points
BPSS	- Board for Regulation and Supervision of Payment and Settlement Systems
BR Act	- Banking Regulations Act
BRICS	- Brazil, Russia, India, China, South Africa
BRICS-CRA	- BRICS Contingent Reserve Arrangement
BRBNMPL	- Bharatiya Reserve Bank Note Mudran Pvt. Ltd.
BSBDAs	- Basic Savings Bank Deposit Accounts
BSE	- Bombay Stock Exchange
BTN	- Bhutan Currency
CAB	- College of Agricultural Banking
CAD	- Current Account Deficit
CAFRAL	- Centre for Advanced Financial Research and Learning
CBLO	- Collateralised Borrowing and Lending Obligation
CBS	- Core Banking Solution
CCB	- Committee of the Central Board
CCCB	- Counter Cyclical Capital Buffer
CCI	- Cabinet Committee of Investment
CCIL	- Clearing Corporation of India Ltd.
CCPs	- Central Counterparties
CD	- Certificate of Deposits
CDS	- Current Daily Status
CE of OBE	- Credit Equivalent Amount of Off-Balance Sheet Exposures
CERSAI	- Central Registry of Securitisation Asset Reconstruction and Security Interest of India

LIST OF ABBREVIATIONS

CET-1	- Common Equity Tier 1 capital
CFSA	- Committee on Financial Sector Assessment
CGRA	- Currency and Gold Revaluation Account
CHRS	- Comprehensive Human Resource System
CICs	- Credit Information Companies
CICs	- Core Investment Companies
CISO	- Chief Information Security Officer
CIT	- Cash in transit
CMBs	- Cash Management Bills
CoR	- Certificate of Registration
CP	- Commercial Papers
CPC	- Cheque Processing Centre
CPI	- Consumer Price Index
CPSIPS	- Core Principles for Systemically Important Payment Systems
CPSS	- Committee on Payment and Settlement Systems
CR	- Contingecy Reserve
CRA	- Credit Rating Agency
CRAR	- Capital to Risk weighted Assets Ratio
CRGFTLIH	- Credit Risk Guarantee Fund Trust for Low Income Housing
CRILC	- Central Repository of Information on Large Credits
CRR	- Cash Reserve Ratio
CSDs	- Central Securities Depositories
CSO	- Central Statistics Office
CTS	- Cheque Truncation System
DBT	- Direct Benefit Transfer
DCC	- District Consultative Committee
DCCBs	- District Central Co-operative Banks
DCCO	- Date of Commencement of Commercial Operations
DCs	- Data Centres
DDs	- Demand Drafts
DEA Fund	- Depositor Education and Awareness Fund
DICGC	- Deposit Insurance and Credit Guarantee Corporation
DIF	- Deposit Insurance Fund
DLRC	- District Level Review Committee
DR	- Disaster Recovery
DRG	- Development Research Group
D-SIBs	- Domestic - Systemically Important Banks
DTL	- Demand and Time Liability
DUKPT	- Derived Unique Key Per Terminal
EBT	- Electronic Benefit Transfer
ECBs	- External Commercial Borrowings
ECCS	- Express Cheque Clearing Systems
ECR	- Export Credit Refinance
ECS	- Electronic Clearing Service
EDMS	- Electronic Document Management System
EEA	- Exchange Equalisation Account
EKP	- Enterprise Knowledge Portal
EMDEs	- Emerging Market and Developing Economies
EME	- Emerging Market Economy
EMI	- Equated Monthly Installment
EMV	- Europay, MasterCard and Visa
EoI	- Expression of Interest
EPC	- Engineering, Procurement and Construction
ERM	- Enterprise Risk Management
ETCD	- Exchange Traded Currency Derivative
EU	- European Union
EURIBOR	- Euro Interbank Offered Rate

LIST OF ABBREVIATIONS

EXIM Bank - Export Import Bank
FC-XIII - Thirteenth Finance Commission
FCA - Foreign Currecy Asset
FCI - Food Corporation of India
FCNR(B) - Foreign Currency (Non-resident) Accounts (Banks)
FCVA - Forward Contracts Valuation Account
FDI - Foreign Direct Investment
Fed - Federal Reserve
FEDAI - Foreign Exchange Dealers' Association of India
FER - Foreign Exchange Reserve
FI - Financial Inclusion
FII - Foreign Institutional Investor
FIMMDA - Fixed Income Money Market and Derivatives Association of India
FIPs - Financial Inclusion Plans
FLCs - Financial Literacy Centres
FMI - Financial Market Infrastructure
FNV - Forged Notes Vigilance
FPI - Foreign Portfolio Investment
FPO - Follow On Public Offer
FRA - Financial Resolution Authority
FRBM Act - Fiscal Responsibility and Budget Management Act
FSB - Financial Stability Board
FSDC - Financial Stability and Development Council
FSI - Financial Soundness Indicators
FSLRC - Financial Sector Legislative Reforms Commission
FSR - Financial Stability Report
FSWM - Financially Sound and Well Managed
FX - Foreign Exchange
GAG - GIRO Advisory Group
GARCH - Generalised AutoRegressive Conditional Heteroskedasticity
GB - Gigabyte
GCC - General Credit Card
GDP - Gross Domestic Product
GDR - Global Depositary Receipt
GFCE - Government Final Consumption Expenditure
GFCF - Gross Fixed Capital Formation
GFD - Gross Fiscal Deficit
GoI - Government of India
G-Sec - Government Securities
GST - Goods and Services Tax
HFT - Held For Trading
HLAC - High Level Advisory Committee
HP - Hodrick-Prescott
HPCL - Hindustan Petroleum Corporation Ltd.
HQLAs - High Quality Liquid Assets
HR - Human Resources
HTM - Held To Maturity
IADI - International Association of Deposit Insurers
IBA - Indian Banks' Association
ICRIER - Indian Council for Research and International Economic Relations
ICT - Information and Communication Technology
IDFs - Infrastructure Debt Funds
IDRBT - Institute for Development and Research in Banking Technology
IFC - Indian Financial Code
IFCs - Infrastructure Finance Companies
IIBM - Indian Institute of Bank Management
IIBs - Inflation indexed bonds
IINSS-C - Inflation Indexed National Saving Securities–Cumulative

LIST OF ABBREVIATIONS

IIP	- Index of Industrial Production
IIT	- Indian Institute of Technology
IMD	- India Meteorological Department
IMPS	- Immediate Payment Service
INR	- Indian Rupee
IOC	- Indian Oil Corporation
IORWG	- International Operational Risk Working Group
IOSCO	- International Organisation of Securities Commission
IP	- Internet Protocol
IPDI	- Innovative Perpetual Debt Instruments
IPO	- Initial Public Offering
IPS	- Intrusion Prevention System
IRA	- Investment Revaluation Account
IRD	- Interest Rate Derivative
IRF	- Interest Rate Future
IRS	- Interest Rate Swaps
IS	- Information Security
IS	- Information System
ISI	- Indian Statistical Institute
iSOC	- Information Security Operations Centre
IT	- Information Technology
ITBs	- Intermediate Treasury Bills
ITSC	- Information Technology Sub-Committee
JLF	- Joint Lenders Forum
JV	- Joint Venture
KCC	- Kisan Credit Card
KLEMS	- Capital, labour, energy, material and services
KYC	- Know Your Customer
LAB	- Local Area Bank
LAF	- Liquidity Adjustment Facility
LBS	- Lead Bank Scheme
LCR	- Liquidity Coverage Ratio
LEI	- Legal Entity Identifiers
LIBOR	- London Interbank Offered Rate
LLP	- Limited Liability Partnership
LOBOM	- Lower of Book and Market Value
LOU	- Local Operating Unit
LPA	- Long Period Average
LPG	- Liquified Petroleum Gas
LPVR	- Least Present Value of Revenue
LRS	- Liberalised Remittance Scheme
LSAP	- Large-Scale Asset Purchase Programme
LSE	- London School of Economics
LTD	- Long Term Deposits
LTV	- Loan To Value
MAF	- Medical Assistance Fund
mcm/d	- Million Cubic Metres a day
MFI	- Micro-Finance Institutions
MGNREGA	- Mahatma Gandhi National Rural Employment Guarantee Act
MIBID	- Mumbai Interbank Bid Rate
MIBOR	- Mumbai Interbank Offered Rate
MICR	- Magnetic Ink Character Recognition
MICs	- Market Infrastructure Companies
MMS	- Mail Messaging Solution
MoSPI	- Ministry of Statistics and Programme Implementation
MoU	- Memorandum of Understanding
MPC	- Monetary Policy Committee
MSEs	- Micro and Small Enterprises
MSF	- Marginal Standing Facility
MSMEs	- Micro, Small and Medium Enterprises
MSP	- Minimum Support Price

LIST OF ABBREVIATIONS

MTM - Mark-to-Market
MTSS - Money Transfer Service Scheme
NAB - New Arrangement to Borrow
NABARD - NAtional Bank for Agriculture and Rural Development
NACH - National Automated Clearing House
NBFC - Non-Banking Financial Company
NBFC-NDs - Non-Deposit Accepting NBFCs
NBFC-SI - Non-Banking Financial Companies - Systemically Important
NBFI - Non-bank Financial Institution
NCD - Non-Convertible Debentures
NCFE - National Centre for Financial Education
NDA - Net Domestic Asset
NDS-CALL - Negotiated Dealing System- call money market
NDS-OM - Negotiated Dealing System- Order Matching
NDTL - Net Demand and Time Liabilities
NECS - National Electronic Clearing Service
NFA - Net Foreign Asset
NEFT - National Electronic Fund Transfer
NGO - Non-Governmental Organisation
NG-RTGS - Next Generation RTGS
NHAI - National Highways Authority of India
NHB - National Housing Bank
NIBM - National Institute of Bank Management
NIM - Net Interest Margin
NOFHCs - Non-Operating Financial Holding Companies
NPA - Non Performing Asset
NPCI - National Payments Corporation of India
NRE - Non-Resident External
NRO - Non-Resident Ordinary
NSE - National Stock Exchange
NSSO - National Sample Survey Organisation
OBCs - Other Backward Classes
OD - Overdraft
ODI - Overseas Direct Investment
OLS - Ordinary Least Square
OMCs - Oil Marketing Companies
OMO - Open Market Operations
OSMOS - Off-Site Monitoring and Surveillance
OTC - Over The Counter
PCA - Prompt Corrective Action
PCI-DSS - Payment Card Industry Data Security Standards
PD - Primary Deficit
PDS - Public Distribution System
PDs - Primary Dealers
PFCE - Private Final Consumption Expenditure
PFCVA - Provision for Forward Contracts Valuation Account
PFMIs - Principles for Financial Market Infrastructures
PMDO - Pooled Municipal Debt Obligation
PIN - Personal Identification Number
PKI - Public Key Infrastructure
PLF Plant Load Factor
PMG - Project Monitoring Group
POS - Point of Sale
POs - Payment Orders
PPIs - Prepaid Payment Instruments
PPP - Public Private Partnership
PSB - Public Sector Banks
PSEs - Public Sector Enterprises

LIST OF ABBREVIATIONS

PSL - Priority Sector Lending
PSOs - Payment System Operators
PSS - Perimeter Security Solution
PvP - Payment vs Payment
QCCP - Qualified Central Counterparty
QE - Quantitative Easing
QFIs - Qualified Foreign Investors
QIBs - Qualified Institutional Buyers
RBI - Reserve Bank of India
RBIA - Risk-Based Internal Audit
RBIWPS - Reserve Bank of India Working Paper Series
RBS - Risk Based Supervision
RBSC - Reserve Bank Staff College
RC - Reconstruction Companies
RCCP - Recommendations for Central Counterparties
RDA - Rupee Drawing Arrangement
RE - Revised Estimates
RECS - Regional Electronic Clearing Service
REER - Real Effective Exchange Rate
REITs - Real Estate Investment Trusts
RFCA - Revaluation of Forward Contracts Account
RFID - Radio-Frequency Identification
RIDF - Rural Infrastructure Development Fund
RMBS - Residential Mortgage Backed Securities
ROC - Regulatory Oversight Committee
RRB - Regional Rural Bank
RSSS - Recommendations for Securities Settlement Systems
RTGS - Real Time Gross Settlement
RTI Act - Right to Information Act
RTP - Reserve Tranche Position
RWA - Risk Weighted Assets
SAA - Swap Amortisation Account
SAARC - South Asian Association for Regional Cooperation
SAF - Supervisory Action Framework
SARFAESI - Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SC - Securitisation Companies
SCB - Scheduled Commercial Bank
SCs - Scheduled Castes
SDL - State Development Loan
SDLs - State Development Loans
SDRs - Special Drawing Rights
SEACEN - South East Asian Central Banks
SEBI - Securities Exchange Board of India
SFRC - State Finance Regulatory Commission
SHGs - Self-Help Groups
SIFMI - Systemically Important Financial Market Infrastructure
SLBC - State Level Bankers Committee
SLCCs - State Level Coordination Committees
SLR - Statutory Liquidity Ratio
SMA - Special Mention Accounts
SMEs - Small and Medium Enterprises
SMS - Short Message Service
SPARC - Supervisory Program for Assessment of Risk and Capital
SPC - SAARC Payment Council
SRO - Self-Regulatory Organisation
SSSs - Securities Settlement Systems
StCBs - State Co-operative Banks
STRIPS - Separately Traded Registered Interest and Principal Securities

LIST OF ABBREVIATIONS

STs	- Scheduled Tribes
SWIFT	- Society for World Wide Inter-Bank Financial Tele-Communication
SWMA	- Special Ways and Means Advances
TARC	- Tax Administration Reforms Commission
T-Bills	- Treasury Bills
TCE	- Trade Receivables and Credit Exchange
TDS	- Tax Deducted at Source
TFP	- Total Factor Productivity
TIBOR	- Tokyo Interbank Offered Rate
TLE	- Terminal Line Encryption
TRAI	- Telecom Regulatory Authority of India
TReDS	- Trade Receivables Discounting System
TRs	- Trade Repositories
UCBs	- Urban Cooperative Banks
UIDAI	- Unique Identification Authority of India
UIP	- Uncovered Interest Parity
UKPT	- Unique Key Per Terminal
UMP	- Unconventional Monetary Policies
UPS	- Uninterruptible Power Supply
UPSS	- Usual (principal + subsidiary) status
USD	- US Dollar
USSD	- Unstructured Supplement Service Data
V3F	- Variable Voltage Variable Frequency
VC	- Video Conferencing
VIX	- Volatility Index
VWA	- Volume Weighted Average
WADR	- Weighted Average Discount Rate
WAEIR	- Weighted Average Effective Interest Rate
WALR	- Weighted Average Lending Rate
WGRRFI	- Working Group on Resolution Regime for Financial Institutions
WLAs	- White Label ATMs
WMA	- Ways and Means Advances
WOS	- Wholly Owned Subsidiary
WPI	- Wholesale Price Index
XBRL	- eXtensible Business Reporting Language

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*For the Year July 1, 2013 to June 30, 2014**

PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

During 2013-14, amid slow growth and high inflation, the Indian economy had to contend with serious challenges to external stability emanating from an unsustainably high current account deficit (CAD), capital outflows and consequent exchange rate pressures. Several measures taken by the Reserve Bank and the government helped stabilise the economy. With greater political stability, commitment to fiscal consolidation, strengthening of the monetary policy framework and better policy implementation, GDP growth is expected to be around 5.5 per cent in 2014-15 from the sub-5 per cent growth in the preceding two years. The disinflationary momentum that set in since December 2013 has taken inflation to a lower trajectory, broadly in line with the Reserve Bank's projections. However, downside risks to growth and upside risks to inflation arise from the sub-normal monsoon and the geopolitical situation in the Middle East. To secure a sustainable growth of at least 7 per cent over the medium term, microeconomic policies that improve activity levels and productivity will be needed so that they can work in tandem with a supportive macroeconomic regime with a reasonably positive real interest rate, low inflation, moderate CAD and low fiscal deficit.

I.1 The Indian economy stands at crossroads that could take it from a slow bumpy lane to a faster highway. Some acceleration is likely in 2014-15 that could take the growth to around 5.5 per cent. Deficiency in rainfall during the 2014 monsoon season so far poses some downside risks, but overall growth in 2014-15 is likely to be better than previous year with likely revival in industrial and construction activities. The improvement in the monsoon since mid-July will also help contain crop output losses. With greater political stability and a supportive policy framework, investment could turn around. The economy is poised to make a shift to a higher growth trajectory.

I.2 Enabling this shift in gear requires policies in support of sustainable growth. The economy had to face serious challenges to stability in 2013-14 emanating from exchange rate pressures amid capital outflows, persistence of near double digit inflation, fiscal imbalances and a decline in investment. This prompted the Reserve Bank and the government to take several measures to stabilise the economy. Monetary and fiscal policies, therefore, need to maintain caution during 2014-15 so that the gains in macro-stability are preserved and the disinflationary momentum gathers traction. In the near term, the objective of macroeconomic policies should be to secure a sustainable recovery.

* While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2014. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

Meanwhile, microeconomic policies covering reforms in the areas of industry, services, international trade, labour markets, public sector management, financial markets and competition are needed to work towards improving activity levels and productivity, thus shaping improved supply responses that can help enhance the growth potential. This approach can deliver a sustainable growth of at least 7 per cent in a non-inflationary manner once global growth normalise.

ASSESSMENT OF 2013-14

I.3 The year 2013-14 was marked by continued slow growth, modest gains in containing inflation, reduction of fiscal deficits, correction in the current account gap and further deterioration in the asset quality of banks. The economy coped with challenges on growth, inflation and financial stability front through several government policy initiatives and the Reserve Bank's role in this is documented in the rest of the chapters of this Report that cover the review of economic policies (Part I) and Reserve Bank operations (Part II). As the year progressed, it became clear that the macroeconomic fragilities were getting under control and the outlook for 2014-15 appeared to be better.

Growth continues to be slow with contraction in mining and manufacturing

I.4 After two consecutive years of moderation, GDP growth improved marginally in 2013-14 due to a rebound in the growth of 'agriculture and allied activities' and electricity, besides buoyant activity in 'financing, insurance, real estate and business services'. While the value added in mining and manufacturing contracted, services sector growth remained unchanged. The low overall growth reflected contracting fixed investment and slowing consumption, though there was an improvement in export growth aided by rupee depreciation and contraction in imports due to subdued demand conditions and policies to dissuade gold imports.

I.5 The weak business sentiment, infrastructure bottlenecks, low public investment, domestic political uncertainty and an uneven global recovery led private fixed investment to contract. The uncertainty in the legal and regulatory framework in key areas such as environmental clearances, land acquisition and use of natural resources, especially mining activity, added to the low business confidence and affected investments in the economy. Private final consumption expenditure moderated on account of low income growth and high inflation. Macro instability, however, diminished considerably with the narrowing of the twin deficits- both current account and fiscal- and the gradual reduction in inflation.

Inflation declined during latter months of 2013-14, but remains above the level that could secure sustainable growth

I.6 Headline consumer price index (CPI) inflation generally increased during June-November 2013 driven largely by food price increases. The spike in vegetable prices, especially of onions, led to CPI inflation peaking at 11.2 per cent in November 2013. Food price corrections, largely on account of seasonal moderation in vegetable prices drove a subsequent fall in CPI inflation to 8.3 per cent in March 2014. Apart from the pressure from rising food prices, the sharp depreciation of the rupee in the H1 of 2013-14 led to pass-through effects, especially in the case of freely priced fuel products. Staggered revisions in administered prices of diesel also added to inflationary impulses. Even more worryingly, CPI excluding food and fuel segment inflation remained sticky at around 8 per cent for most of 2013-14. Double digit inflation in housing and 'others' sub-category, which largely includes services, were the major drivers of inflation in this segment.

I.7 Food price pressures witnessed in 2013-14 despite a normal monsoon raised concerns over supply chain inefficiencies as well as the need for

improving the agro-marketing infrastructure in the country. Sharp swings in vegetable prices often have a destabilising impact on inflation expectations and concomitantly raise the general level of prices. Increased input costs, driven by sticky nominal wages in rural areas partly fuelled by high food inflation and full indexation of Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) wages, also pointed to the role of wage-price spiral in keeping inflation elevated and persistent. Administered price revisions in fuel, have pushed up inflation in the short run, but have also reduced fiscal pressure and thereby medium-term inflation risks.

Twin deficit risks tamed in 2013-14

I.8 Twin deficit concerns that were the source of macro-economic fragilities during 2011-12 and 2012-13 moderated during 2013-14. Central government finances continued to improve in 2013-14 with the gross fiscal deficit (GFD) at 4.5 per cent of GDP lower than 4.8 per cent budgeted for the year and also realised for 2012-13. Containing GFD at this level helped in demand management and in providing credibility to the fiscal consolidation commitment in a year when risks of contagion came to the fore.

I.9 However, notwithstanding the headline numbers, some concerns about the quality of fiscal adjustment remain. Achievement of budgetary targets was made possible by a sharp cutback in expenditures and higher non-tax revenues, aided in a large part by higher dividend receipts from various public sector enterprises (PSEs) and public sector banks (PSBs). While many PSEs were already cash rich with inadequate investment plans, it is important to ensure that this practice does not affect the internal financing or reserves of the public enterprises that could hamper their investments in the future.

I.10 Non-plan expenditure remained broadly at the budgeted level, although expenditure on major subsidies exceeded budgetary targets. Capital expenditure was lower than budget estimates by 18 per cent. Cuts in capital outlays have potential adverse implications for growth in the medium-term, as public investment is critical to crowd-in private investment against the backdrop of two years of subdued private sector activity.

I.11 The external sector adjustment over the year was even more remarkable. Though the current account deficit was large in Q1 of 2013-14 at 4.9 per cent of GDP, a correction in CAD subsequently helped compress full year CAD to 1.7 per cent of GDP. This transformation after two years of wide CAD was brought about by a confluence of domestic policy efforts and better global conditions, with a resultant steep fall in imports and some improvement in exports. Imports declined mainly due to a fall in gold imports induced by a significant decline in international gold prices and policy curbs on its imports. Similarly, softening of international commodity prices such as oil, fertilisers and coal along with a slowdown in the domestic economy contributed to a fall in imports. The improvement in exports was supported by improvements in partner countries' growth and a more depreciated rupee.

PROSPECTS FOR 2014-15

I.12 The year 2014-15 has begun on a promising note. Index of Industrial Production (IIP) growth is beginning to look up, while inflation on an average, so far, has been lower than in the corresponding period of the previous year. Monetary policy is providing a more stable environment in terms of interest rates, liquidity and credit conditions, with tangible efforts to improve resource flow to productive sectors. The latter includes cuts in statutory liquidity ratio (SLR) and exemptions from regulatory pre-emptions such as cash reserve ratio (CRR), SLR and priority sector lending (PSL) for issuing long-term bonds to finance loans to infrastructure and affordable housing.

I.13 The Union Budget aims to keep the economy on the path of fiscal consolidation. However, strict adherence to fiscal discipline to avoid overshooting of expenditures and concerted efforts to mobilise tax and non-tax revenues, as also strong efforts on non-debt capital receipts will be necessary to attain these fiscal targets.

I.14 Export growth has improved, while capital inflows remain adequate. Further, there has been a healthy accretion to foreign exchange reserves that helps insulate the economy against prospective shocks that may be transmitted onshore. The spike in global oil price following the civil war in Iraq was transitory. Upside risks to the oil prices, however, remain in the event of underlying geopolitical tensions resurfacing more strongly in the Gulf region. Overall, the exchange rate has been stable so far in 2014-15.

Growth outlook for 2014-15

I.15 The Indian economy could grow in the range of 5 to 6 per cent in 2014-15 with risks broadly in balance around the central estimate of 5.5 per cent. This is broadly in line with the projections made by the Reserve Bank at the start of 2014-15, though risks to the central estimate were more on the downside at that point. Signs of improvement in mining and manufacturing activity, expected pickup in investment, improved availability of financial resources to private sector with lower draft of government on financial savings of the households amid fiscal consolidation, improved external demand and stabilising global commodity prices are expected to support recovery. However, downside risks could play out if global recovery slows, geopolitical tensions intensify or monsoon weakens again in the rest of the season.

I.16 All-India cumulative rainfall deficiency in the current monsoon season till August 13, 2014 was placed at 18 per cent of the long period average (LPA), as against an excess of 12 per cent in the corresponding period last year. There has been a marked improvement in the monsoon since mid-July when the deficiency was 43 per cent.

I.17 Area sown under *kharif* crops (till August 14) was 2.3 per cent lower than the normal and was 8.9 per cent higher than the 2009 drought year. Based on the sowing data, it appears that the drop in output may now be restricted mainly to coarse cereals and pulses. The reservoir water levels provide comfort. As on August 13, the level in the 85 major reservoirs was 14 per cent higher than the average over the last 10 years, though it was 12 per cent lower than last year's level on the comparable date.

I.18 Even if the rainfall is normal in the rest of the monsoon season, some rainfall deficiency will stay. However, its adverse impact on growth, inflation, fiscal and trade deficits is expected to be small as on the current reckoning, the deficiency in quantitative and qualitative terms is likely to be much less than that in 2009 (Box I.1). Moreover any shortfall in *kharif* could be substantially made good by the *rabi* crop. On an average basis for the last five years, *rabi* crop accounted for 50.7 per cent of total foodgrains output. As such, the odds are that agriculture and allied sector could make a positive contribution to overall growth as was the case even in 2009-10.

I.19 In case the monsoon weakens again in the rest of the season, there is risk of modest adverse impact on electricity production. This is because reservoir levels could fall short of their full capacities. However, overall prospects for electricity generation remains encouraging despite the likelihood of hydro-power generation decelerating from 18.6 per cent growth registered in the previous year. Hydro-power accounts for about 14 per cent of the total power supply. In the thermal segment that accounts for nearly 82 per cent of power generation, new capacities planned for the year are expected to add 8.9 per cent to overall installed thermal capacity. Similarly, installed nuclear power

Box I.1
Low Rainfall and Its Consequences

The India Meteorological Department (IMD) in August 2014 updated its forecast of southwest monsoon rainfall to 87 per cent of the long period average (LPA), from 93 per cent given in June 2014. The probability of monsoon to be deficient (< 90 per cent) is now less at 68 per cent. Till August 13, 2014 cumulative rainfall was 82 per cent of LPA. Prospects of drought in some parts of the country exist.

There is no unique definition of a drought. However, droughts are classified as meteorological droughts, hydrological droughts and agricultural droughts. IMD focuses on meteorological droughts and classifies all-India drought years as those with overall rainfall deficiency of 10 per cent or more and drought area exceeding 20 per cent of the total plain areas.

While, Indian agriculture has become more resilient in recent years, rainfall deficiency and its uneven distribution over time and space continues to have a significant bearing on crop production. Historically, whenever rainfall was deficient by 10 per cent or more, *kharif* foodgrains production, mainly rice and coarse cereals, declined. Major *rabi* crops being well irrigated were less impacted (Table 1).

Since 1980, there have been four all-India drought years as per the IMD's definition (Table 2). In all these years, foodgrains production declined, but the extent of decline ranged between 2 to 18 per cent (6 to 23 per cent in the case of rice). WPI food inflation was above 9 per cent, except for 2002-03 when off-take jumped by 59.2 per cent. Low rainfall can also have adverse consequences for rural demand, overall growth and, fiscal and trade balance. Agro imports constituted only 2.6 per cent of total imports in 2013-14, but an additional impact can come from lower agro exports that constituted 13.6 per cent of India's total exports.

The marked improvement in monsoon since mid-July 2014 has reduced the likelihood of 2014-15 being a drought year but the final outcome would depend on the spatial distribution of rainfall in the rest of the season.

Table 1: IMD Rainfall Index and Crop Production

Year	IMD Rainfall Index (Per cent of LPA)	Production Growth (Per cent)									
		Rice	Wheat	Coarse Cereals	Pulses	Foodgrains (FG)	*Kharif* FG	*Rabi* FG	Oilseeds	Cotton	Sugarcane
1982-83	86	-11.5	**14.3**	-10.7	3.0	-2.8	-11.9	10.6	-17.2	-4.4	1.7
1986-87	87	-5.1	-5.8	2.4	-12.4	-4.7	-5.9	-3.0	4.1	-20.8	9.0
1987-88	81	-6.1	4.2	-1.8	-6.4	-2.1	-7.0	4.1	**12.2**	-7.7	5.7
2002-03	81	-23.1	-9.6	-21.9	-16.8	-17.9	-22.2	-13.1	-28.2	-13.8	-3.3
2004-05	86	-6.1	-4.9	-11.0	-11.9	-7.0	-11.7	-1.2	-3.3	19.7	1.4
2009-10	78	-10.2	0.1	-16.2	0.6	-7.0	-12.0	-1.9	-10.2	7.8	2.6

Note: shaded cells show high growth in certain crops in certain years as the *rabi* crop could substantially offset *kharif* crop losses.

Table 2: Rainfall, foodgrains and food inflation in drought years

Drought Year	Per cent of LPA					(Y-o-Y change in per cent)					
	IMD Rainfall Index					Foodgrains Production	Foodgrains (PDS)			Food Inflation	
	June	July	August	September	Jun-Sep		Procurement	Off-take	Stocks	WPI	CPI-IW
1982-83	83	77	109	68	86	-2.8	9.1	16.1	0.3	11.1	6.7
1987-88	78	71	96	75	81	-2.1	-25.0	18.1	-51.7	9.0	7.8
2002-03	109	46	98	87	81	-17.9	-8.9	59.2	-35.7	1.8	2.4
2009-10	53	96	74	80	78	-7.0	4.4	23.7	21.9	15.3	15.2
Memo item											
2014-15	57	90	96#		87#						

#: IMD Forecast.

capacity is expected to go up by 41.8 per cent during the year. Thus, any losses in hydro-power are expected to be more than fully compensated by increased thermal and nuclear power and electricity production could register reasonably good growth.

I.20 Overall, the economy may grow faster than in the previous year, with acceleration in mining, manufacturing, construction and trade, hotels, transport and communication sectors. These four segments account for 50 per cent of GDP compared with about 15 per cent in case of agriculture, forestry and fishing, and electricity.

I.21 The business and investment climate in the economy is improving with the formation of a stable government at the Centre, a comparatively lower inflation and an improvement in global growth. Coincident indicators such as automobile sales, railway freight traffic, cargo handled at ports and foreign tourist arrivals are pointing towards some recovery in the services sector and automobile sales have shown signs of a turnaround.

I.22 The Union Budget 2014-15 is supportive of both investment and savings. Measures taken include an increase in the personal income tax exemption limit that will increase disposable income and increase in investment limit under section 80C of the Income Tax Act as well as the annual ceiling limit in the Public Provident Fund that will encourage savings and improve financing of investment. The proposal to increase the deduction limit on account of interest on loan with respect to self-occupied house property is also expected to increase households' physical savings. The Reserve Bank has complemented these measures by providing incentives for encouraging the flow of bank credit to infrastructure and affordable housing.

Inflation outlook for 2014-15

I.23 After remaining above 8 per cent during April-May 2014, CPI inflation (y-o-y) moderated to 7.5 per cent in June 2014 largely driven by the favourable base effect. However, inflation increased to 8.0 per cent in July 2014 as prices of vegetables increased substantially on the back of deficient monsoon rainfall. The sequential changes in food prices also indicated a significant inflation build-up in select components such as fruits, protein-rich items like eggs, fish, meat, milk and pulses during Q1 of 2014-15. CPI excluding food and fuel inflation, however, eased to 7.4 per cent in July 2014 from close to 8 per cent in April and May 2014.

I.24 Some stability in the exchange rate, has, mitigated the risk to inflation from exchange rate pass-through during 2014-15 so far. Global crude oil prices (Indian basket) declined from above US$ 110 per barrel, witnessed in June 2014 on account of geopolitical tensions in the Middle East, Ukraine, and supply outages in Libya to about US$ 105 per barrel in the latter half of July 2014. However, given the tight demand-supply balance, any risk to crude oil supply could have a large impact on prices and as such remains an upside risk going forward.

I.25 The revisions in administered prices during 2014-15, which include railway fare and freight fares apart from the staggered increases in diesel prices, could exert some pressure on generalised price levels. However, much of this will reflect the release of suppressed inflation in the past and, therefore, is desirable to keep medium term inflation under control. Moreover, the smaller increases in the minimum support prices (MSPs) will help somewhat in restraining food price pressures.

I.26 Overall, there are no significant departures in the inflation outlook from the baseline inflation trajectory indicated by the Reserve Bank at the start of 2014-15, when it committed to a disinflationary glide path of taking CPI inflation to 8 per cent by January 2015 and 6 per cent by January 2016. The Reserve Bank, in its Third Bi-Monthly Monetary Policy Statement, 2014-15 in August 2014 indicated that inflation at 8 per cent in early 2015 seems likely. Subsequent data release in terms of a higher CPI inflation driven by vegetable price spike indicate that the upside risks to this assessment persist. However, some of the increase in food prices could

be temporary and there are early indications that the price corrections are underway in select items like tomato. Also, recent decline in oil prices could partly offset the pressure from food prices. While inflation trends during the rest of 2014-15 will also be conditional on several risk factors and the timing and extent of further revisions in administered prices, the inflation projections for 2014-15 remain in reach. Though the balance of risks around the medium-term inflation path, and especially the target of 6 per cent by January 2016 are still to the upside, the Reserve Bank remains committed to supporting the disinflationary process.

Fiscal and current account gaps likely to remain contained in 2014-15

I.27 Going forward, the fiscal deficit is likely to reduce further in 2014-15. The budgetary targets are realisable, though concerted efforts will be necessary to achieve these targets. The CAD though is likely to widen from the levels in 2013-14, is expected to remain within the sustainable level. As such, the risks associated with twin deficit risks are expected to stay moderate.

I.28 The economy is well set on the course of fiscal correction since H2 of 2012-13. The intent to lower the GFD ratio to 3.6 per cent in 2015-16 and further to 3.0 per cent in 2016-17 is both feasible and reasonable. Lowering the revenue deficit, however, is proving to be difficult and will require further expenditure cuts and better targeting of subsidies. In this regard, much is expected from the Expenditure Reforms Commission announced in the budget. Expenditure restraints will be necessary during 2014-15, in particular, concerted attention is necessary during the course of year to ensure quick pass-through of global crude oil price changes to domestic prices of petroleum products so that oil subsidies are kept at the budgeted level of ₹634 billion. As such, early measures for more flexible domestic prices of diesel, liquified petroleum gas (LPG) and fertilisers are warranted.

I.29 Budgetary projections critically hinge on mobilisation efforts on the receipts side of the budget. In view of the assumed growth of 19.8 per cent growth in gross tax revenues during 2014-15 over the provisional accounts figures for 2013-14 and implied tax buoyancy of 1.5, the actual outcome of the budget will depend on efforts for widening the tax base and improving tax compliance. An early implementation of the recommendation of the Tax Administration Reforms Commission (TARC) will facilitate the process. Given that a revenue loss of ₹147 billion is estimated as the net effect of the tax proposals, achieving the estimated tax buoyancy will require concerted efforts. Achieving excise and customs duty projections will hinge upon a significant pick-up in economic growth during the year. More importantly, while the increased disinvestment target of ₹634 billion compared with ₹569 billion in the Interim Budget is realisable, it will require quick and timely action, while market conditions stay encouraging.

I.30 On the external sector side, with upside risks to oil prices due to geopolitical developments and improvements in domestic demand, a rise in imports can be expected. Therefore, the policy shift towards full pass-through of international oil prices to retail prices of diesel and other products will help limit demand and imports. Similarly, though the restrictions on import of gold for genuine trade purposes may merit a gradual withdrawal, the process for which has already begun, steps to channel investment demand for gold into financial assets need to be strengthened.

I.31 Admittedly, higher exports will also be critically important for avoiding undue expansion of the trade deficit. While the exchange rate of the rupee should remain competitive, sector-specific issues that hamper exports should be brought under sharper policy focus. In this context, the proposal to set up an Export Promotion Mission is a right step, envisaging better coordination among different stakeholders responsible for facilitating

exports. Though, the external sector now appears to be far more resilient than before, particularly with moderation of CAD and the stabilisation of rupee, one needs to be vigilant against market turbulence in the event of quicker monetary tightening by advanced economies than has been priced in by global investors. The rebuilding of foreign exchange reserves in recent months will help India buffer the economy against potential shocks.

SOME CHALLENGES FOR THE INDIAN ECONOMY IN THE SHORT AND MEDIUM TERM

I.32 The Union Budget on July 10, 2014 provided for several incentives to boost investment and growth that could help in reviving the economy over the medium term. As these supply-side policy changes seep through the economy, macro-stability and sustainable growth hinge on several medium term issues. A selected few are covered below:

Lowering high food inflation through supply-side management

I.33 High food price inflation has emerged as a major challenge for macroeconomic policy in recent years. The phenomenon of rising food prices in India has been attributed to a number of factors both from the supply and demand side. For medium-term management of food inflation, following measures could be considered:

i) The long-term elasticity of market prices to MSP is close to unity for most food crops implying that increases in MSPs eventually get passed on to market prices. While MSPs are usually fixed on a cost plus approach, this spiral calls for a relook at the agricultural price policy in the wake of persistent food price increases.

ii) Against this backdrop, increases in wage costs have been a major factor pushing up the cost of production in agriculture in recent years. A host of factors such as movement of labour into construction, implementation of the MGNREGA and its indexation to the CPI for Agricultural Labourers (AL) and, falling labour force participation rates in particular for women could explain the increase in rural wages in the recent period. While the increase in wages could be desirable from a social welfare point of view, wage increases in excess of productivity growth lead to a wage-price spiral and make food inflation a self-perpetuating cycle. The impact is not confined to food prices alone. Such a cycle, in turn, raises the prices of non-food commodities and services as well. Inflationary expectations go up and, in general, get built into wage and other contracts. In this context, the Union Budget proposal to focus MGNREGA on works that are more productive, asset creating and substantially linked to agriculture and allied activities will help. For wage increases under rural employment programmes to be non-inflationary, they cannot exceed the enhancements in labour productivity.

iii) Amid inefficiencies in the supply chain, short-term supply disturbances often driven by weather related issues, usually lead to spiralling prices in the case of select food articles. This volatility is a major issue as these price movements often impact inflationary expectations, feeding further into generalised inflation. This requires supply-side responses such as increasing storage and warehousing facilities, as also cold storage facilities for perishable food, besides more competitive marketing structures.

iv) The Union Budget has emphasised the need to set up a national market to bring in competition and integration across markets for the benefit of both farmers and consumers. State governments will also be encouraged

to develop farmers' markets in towns to enable farmers to sell their produce directly. The Agricultural Produce Marketing Committee (APMC) Acts will need to be suitably re-oriented for the purpose.

v) Trade should play an important and predictable role. The export window should be shut only in extremis so as to give farmers to gain from international trade and get a fair chance of higher realisation in an open economy. Imports should also be used liberally in anticipation of scarcity, and should not be delayed until scarcity hits the market (where it is typically too late to import). This will also improve consumer welfare.

Strengthening the monetary policy framework and transmission

I.34 A strong, transparent, predictable and effective monetary policy framework is needed to deliver low inflation. Greater central bank credibility on inflation allows it to use monetary policy in a counter-cyclical fashion. With the annual average consumer price inflation touching double digits or near for the last six years, establishing a credible nominal anchor to rein in inflation and anchor inflation expectations assumes importance. Against this backdrop, the Reserve Bank of India constituted the Expert Committee to revise and strengthen the Monetary Policy Framework (Chairman: Dr. Urjit Patel) (henceforth, the Expert Committee). The monetary policy framework had not received comprehensive attention since the change to the monetary targeting framework in the mid-1980s and to a more eclectic multiple indicator approach in 1998. Meanwhile, several countries have adopted inflation targeting with instrument independence for their central banks. In many cases, this has helped deliver low inflation. While some of these countries neglected financial stability with attendant costs that came to fore during the global financial crisis, flexible inflation targeting and financial stability are not mutually exclusive goals. In fact, low inflation helps secure monetary as well as financial stability.

I.35 Considering the above, the Reserve Bank and the government will need to work towards a new framework. Several committees including the High Powered Expert Committee on Making Mumbai an International Financial Centre, Committee on Financial Sector Reforms, the Financial Sector Legislative Reforms Commission (FSLRC) and the Expert Committee have made recommendations for a new framework. In this backdrop, the changes that need to be considered, *inter alia* are:

i) The objectives of monetary policy.

ii) The operating framework including the possible setting up of a Monetary Policy Committee.

iii) The methods of establishing accountability of the central bank for targets and ensuring its operational independence to meet the targets.

I.36 Following the Expert Committee's recommendation, the Reserve Bank in January 2014 adopted a glide path for disinflation based on a CPI inflation which is representative for all India (CPI-Combined). The index is of recent vintage in terms of its base and is available with minimal lag for policy purposes. The Reserve Bank has also been changing the monetary policy operating framework keeping in view the recommendation of the Expert Committee. While the new monetary policy framework is expected to work towards better inflation management, the eventual outcome will also depend on the efforts to remove impediments in monetary transmission (Box III.3).

Fiscal adjustment through revenue augmentation

I.37 Fiscal consolidation since H2 of 2012-13 has essentially focused on expenditure cutting

backed by one offs in revenue. While there is significant scope for further pruning and better targeting of subsidies, the fiscal consolidation ahead could be additionally supported by higher revenue mobilisation. The major gains so far have been made on the expenditure side, with revenue expenditure getting reduced by 2.0 percentage points of GDP over 2009-10 to 2013-14 (Provisional Accounts). Gross tax revenue showed a relatively moderate improvement of 0.6 percentage points of GDP over the same period.

I.38 Revenue to GDP ratio for India is lower than that of advanced countries and major emerging market and developing economies (EMDEs). For instance, general government revenues were just over 20 per cent of GDP in 2013-14, about half the average for advanced economies at 37 per cent. However, this essentially reflects the low per capita income and level of development in the economy. As such, raising tax rates to increase tax buoyancy may not result in dynamic optimisation of revenues as it could disincentivise savings, investment and growth. However, there is scope to increase the tax base and improve tax compliance, for example, through reform of the indirect tax regime. In this context, the most important tax reform that is on the anvil is the Goods and Services Tax (GST). It would transform the indirect tax regime to a more efficient one and help raise additional revenues over a period of time by improving tax compliance.

I.39 Improving tax administration will help as general government tax receipts accounts for over 80 per cent of revenue receipts in India. For increasing tax collections, it is important to improve tax efficiency and tax buoyancy. Tax efficiency can be improved through minimisation of distortions by broadening the tax base, targeting negative externalities and strengthening tax compliance. The recently constituted Tax Administration Reform Commission can play an important role in improving transparency and efficiency in tax administration. The list of services exempted from service tax has been shortened over the years, but scope for further reduction exists. Further reforms in direct taxes are needed keep in view the principles are efficiency, equity and effectiveness. However, it is important that these changes do not adversely affect saving and investment behaviour.

I.40 Low returns on government investments in public sector undertakings, insufficient returns on the use of natural resources and inadequate disinvestment receipts also contribute to low revenue mobilisation. These should be addressed to put India's public finances on a firmer footing. Revamping the process of disinvestment to enable quicker decisions and engaging professional expertise available in the market will help. Engagement of professional merchant bankers with proven track records and measurable performance yardsticks with market-related fees and incentives is needed in this context. These merchant bankers could quickly handle the process of road shows and putting together the prospectus so as to complete the entire process of budgeted disinvestment as quickly as possible. This nimble-footed approach will benefit from favourable market conditions, and also help in unlocking the true value for PSEs. Further, the government also needs to give a thought to privatising some PSEs which are not yielding due returns. This is typically the case where the PSEs suffer from capital misallocations and corporate governance issues. More broadly, improvements in corporate governance and a greater management focus on improving firm values will increase government realisation from disinvestment.

Strengthening infrastructure by improving contractual arrangements for private sector

I.41 Despite concerted efforts by the government, the revival of interest in infrastructure investment has been rather modest. Therefore, further initiatives have been taken in the Union Budget 2014-15 in consultation with the Reserve

Bank. The Reserve Bank has followed up on the budgetary announcements and, as stated earlier, allowed banks to raise funds for lending to infrastructure sector without regulatory requirements such as CRR, SLR and priority sector lending targets. The Union Budget has also sought to improve infrastructure through measures related to public private partnership (PPP) and setting up of a National Industrial Corridor Authority in order to coordinate the development of industrial corridors with smart cities linked to transport connectivity. The Budget aims at providing incentives for Real Estate Investment Trusts (REITs) as well as announced the setting up of Infrastructure Investment Trust (a modified REITs type structure) in order to attract long term finance from foreign and domestic sources for PPP and infrastructure projects. The budgetary provision for the Pooled Municipal Debt Obligation (PMDO) was enhanced from ₹50 billion to ₹500 billion with the extension of the facility by five years to March 31, 2019.

I.42 However, the PPP model in India has come under strain during the cyclical downturn, partly due to aggressive bidding by private sector firms facing competitive pressures. Their unrealistic assumptions that the economy will keep growing at a high rate have been belied. Cyclical downturns had not been adequately built in the project mathematics. At the same time, contractual arrangements with the private sector provided little flexibility and have worked to dampen private sector interest in infrastructure investments during difficult macroeconomic conditions. Some firms have also exacerbated the problems of liquidity and leverage by showing inflexibility in asset sales by sitting on large land banks or other assets. These problems need to be quickly resolved by a flexible approach, both from the government and the private sector. In this context, a more focussed initiative to revive the infrastructure sector, *inter alia*, by improving contractual arrangements with private sector is needed (Box I.2).

I.43 Given the infrastructure deficit, a large opportunity awaits the private sector for participation in the growth of the infrastructure sector. These opportunities exist in road, railways, ports and power sectors. Improved contractual arrangements can rekindle interest in this space and help the investment cycle to turn around soon.

Box I.2
Rethinking Contractual Arrangements with Private Sector in Infrastructure

While infrastructure expenditure is vital for growth, it is a challenge to balance it with fiscal restraint, which remains a policy imperative. This could be partly addressed by the private sector, but many such existing investments are facing problems.

The banking system, which has largely financed private involvement in infrastructure, is showing the resultant strain. While stressed advances of the scheduled commercial banks (SCBs) have declined marginally to 10.0 per cent of the total advances in March 2014 from 10.2 per cent in September 2013, they remain high. Five sub-sectors, *viz*., infrastructure, iron and steel, textiles, mining (including coal) and aviation services, that account for about 24 per cent of total advances, comprise over half of stressed assets. Of these, asset quality in iron & steel and infrastructure has worsened most sharply. While share of advances to infrastructure continued growing, *albeit* slowly (the share of the other four sub-sectors have declined), from 13.5 per cent in March 2011 to 14.4 per cent, in March 2014; infrastructure as a share of stressed assets, has risen sharply, from 8.4 per cent to 29.2 per cent. This implies that the stress rate of infrastructure, which was much less than the average, is now over twice that of the overall portfolio. Over a fifth of all infrastructure advances are stressed and in stress tests of credit risk exposure to sectors, infrastructure impacts banks most severely on account of potential losses on future assumed impairments.

It is important to avoid a repeat of the past, where a push for infrastructure projects, many of which later stalled, resulted in accelerated growth in gross NPAs. Furthermore,

(Contd...)

while early detection and prompt corrective action (PCA), concerted recovery efforts, and a more supportive legal infrastructure, *etc*. can help to address issues of asset quality, it is necessary to also revamp the contractual relationship between private firms and the government in the infrastructure sector.

The nature of contracts with the government determines the risk allocation to the private sector in infrastructure. The broad principle is to allocate such risks as can be controlled or managed by the private sector to them, but many current contracts do not fully reflect this principle. In power generation, the bids allowed bidders to assume exchange rate and fuel cost risks, without enforcing suitable hedging. This led to large scale renegotiation. In roads, the transfer of traffic risk, known as unpredictable, highly variable and outside the control of the private sector, could have been avoided. Given that the high leverage of construction firms in the road sector amid environmental and land acquisition issues has tempered the private sector's interest in PPP bidding, measures such as premium rescheduling, cancelling and rebidding of contracts and recourse to engineering, procurement and construction (EPC) contracting has become necessary. The perception is that Port concessions are designed to charge users more than needed; a number of them have been challenged in courts. Similarly structured airport concessions have had to be renegotiated.

Pension and insurance companies have consequently been reluctant to lend to infrastructure projects, which their regulators, prudently, given the experience so far, perceive as excessively risky. Total lending by them is thus limited, even as there is substantial growth in assets under management (AUM). A better distribution of risk will allow them to increase their participation and could bring in substantial additional funding into the sector.

A wholesale reversion to works contracts may be undesirable, not only fiscally, but because infrastructure PPPs are needed to increase accountability and leverage private management and implementation capacity. Based on learning from existing projects, revamped contract arrangements that limit risk transfer to project costs and controllable revenue items and use of innovations like Least Present Value of Revenue (LPVR) bids, *e.g.* for electronically tolled roads, may be examined.

Revamped infrastructure contracts also need to factor in the possibility of renegotiation and include mechanisms that clearly lay out the process to be followed in such an event. This will reduce the advantages of those who bid unreasonably in the expectation of being able to renegotiate better terms subsequently. Also, a more level playing field will help to attract foreign direct investment (FDI) into the sector.

Removing obstacles and improving access to finance

I.44 It is not enough for the banking system to support growth by channelling the household financial surplus to meet the investment needs of corporations. While financial deepening in itself is important, the distribution of finance is also important. Access to finance for those who are ignored or crowded out of the credit markets but can make use of it for productive purposes is an equally important element in supporting growth and more inclusive development. Obstacles to finance for small businesses due to information asymmetry and other frictions in the credit market and to individuals due to poverty, lack of collateral, geographical reach or education have been major policy challenges.

I.45 A number of studies have shown that financing is a greater obstacle for small and medium enterprises (SMEs) than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the SME sector more than that of large companies. Cross-country surveys appear to suggest that external finance and external financing premium constitutes a significant impediment for their operations and growth. These financing constraints vary across firm size with empirical evidence suggesting that financing constraints lower firm growth by a much higher percentage for small firms as compared with large firms, and these magnitudes are, by no means, non-negligible.

I.46 In the Indian case, there is overdependence of SMEs on trade credit. Lowering information

asymmetry through improved credit reporting, and greater competition and productivity enhancements in banks to lower intermediation costs, are necessary to improve credit flow to SMEs.

I.47 The financial inclusion programme of the Reserve Bank is detailed in Chapter IV. However, while improving access to finance is no doubt an important public policy goal, the prerequisite for sustaining any public policy programme lies in its financial viability. Microfinance institutions and small regional rural banks can certainly help in furthering access to finance. However, they cannot on their own bridge the gaps. We need sound and well capitalised financial institutions to take up the agenda. Therefore, we need mainstreaming of financial inclusion. Banks will not lend to the unbanked unless they find such lending financially viable. This cannot happen unless transaction costs come down. Surveys suggest that transaction costs for small sized loans are considerably higher than that for larger loans. One possible solution lies in harnessing technology to lower transaction costs and thus facilitating inclusion. Competition will also help, not just through more bank licensing but also by encouraging NBFCs and other businesses with the necessary capabilities and reach.

I.48 India is a knowledge economy that has a large and expanding pool of engineers and software professionals. However, we have not fully reaped technology for financial inclusion in relation to the potential. It is true that financial illiteracy, low incomes, volatile incomes, availability of collateral and lack of credit history come in the way of financial inclusion in a meaningful way, but lack of product innovation and appropriate technology use constitute the most important hurdle in promoting financial inclusion. Greater use of technology and increased competition could help as has been seen in the case of the telecom industry earlier. The Industry grew exponentially in just 10 years taking the mobile phone user base to nearly 1 billion and paving the way in sharp reduction in long distance call rates.

Managing the NPA cycle to improve soundness of the banking system

I.49 The credit quality of banks has deteriorated notably over the last three years. Gross NPAs increased from 2.4 per cent of gross advances in March 2011 to 4.4 per cent in December 2013, before declining somewhat to 4.1 per cent in March 2014. Net NPAs to net advances showed similar trends and stood at 2.2 per cent in March 2014. The capital adequacy ratio (CRAR) also declined from 15.0 per cent in December 2009 to 13.0 per cent in March 2014.

I.50 This deterioration in NPAs occurred for both Public Sector Banks and Foreign Banks. In March 2014, PSBs' gross and net NPA ratio stood at 4.7 per cent and 2.7 per cent, respectively. Private sector banks' gross NPA ratio declined despite economic downturn to 1.9 per cent in March 2014 from 2.5 per cent in March 2011. Their net NPA ratio has marginally increased from 0.6 per cent in March 2011 to 0.7 per cent in March 2014.

I.51 Compared over time and across countries, India's NPAs are not high. Historically, the gross NPA ratio was at 12.0 per cent in March 2001. It had declined sharply to 2.4 per cent in June 2008 on the back of stringent prudential regulations and high growth in the economy. The global financial crisis started the cycle of deterioration. This was compounded by the growth slowdown and emergence of sector specific problems, especially in power, road and airlines industries. Exposure to certain group firms that became excessively leveraged has also contributed to weakening asset quality. Further, it would be imprudent to focus only on the NPA ratio since restructured loans are also significant.

I.52 The experience with the current NPA cycle has several lessons. First, there is need for

countercyclical capital buffers and dynamic provisioning to deal with cyclical economic movements. The Reserve Bank asked banks to make floating provisions in 2006 and 2007 that could be set off in bad times. However, a comprehensive move in the direction of dynamic provisioning emerged only in 2012 when it released a discussion paper. Given that the banks were already in the low phase of the NPA cycle, building new buffers required more time. However, following extensive discussions with stakeholders, the Reserve Bank in February 2014 asked banks to develop necessary capabilities to compute their long term average annual expected loss for different asset classes, for switching over to the dynamic provisioning framework as asset quality improves.

I.53 Second, there is need to focus more closely on the restructuring of standard loans. Restructured standard advances for all scheduled commercial banks increased from 2.5 per cent of gross advances in June 2011 to 5.9 per cent in March 2014. In response, the Reserve Bank made debt restructuring norms more stringent and loans recast after April 1, 2015 will need to be classified as NPAs. Also, from June 2013, the provisioning requirement for fresh standard restructured advances has been increased to 5 per cent from 2.75 per cent, for the interim period. It has also been decided that promoters of firms will have to bring in 20 per cent of the erosion of the net present value, compared with 15 per cent earlier.

I.54 Similarly, while encouraging the process of recovery of distressed assets through asset reconstruction firms (ARCs), the Reserve Bank is taking steps to ensure that distressed asset sales to ARCs genuinely transfer risks from the banks. This is especially important as there has been a sharp rise in asset sales to ARCs during 2013-14 (Table VI.3). In order to tone up the regulatory framework for the securitisation companies and reconstruction companies, the Reserve Bank in August 2014 increased the mandatory minimum holding in securities receipts from 5 per cent of the securities receipts issued by them to 15 per cent of the securities receipts of each class in each scheme, while granting them more time for due diligence. The regulatory amendments made are expected to improve recovery prospects of ARCs, support price discovery and enhance transparency. Overall, functionally efficient ARCs are needed, especially as recovery through the SARFAESI and debt recovery tribunals has been weak.

I.55 The Reserve Bank remains committed to improving the ability of financial and non-financial firms to cope with distress in a manner that is consistent with the financial stability over the medium and long run. Taking into account cyclical considerations, it will continue its efforts to improve the asset quality.

II ECONOMIC REVIEW

Macroeconomic risks arising from domestic weakness and global uncertainty came to the fore during 2013-14 following the US Fed's indication that it would taper its large-scale asset purchase programme. The Reserve Bank responded through several policy actions to mitigate the risks to macro-financial stability. It aimed at containing exchange rate volatility, compressing the current account deficit (CAD) and rebuilding buffers. It also accorded primacy to containing inflation, the persistence of which over the years had caused several macroeconomic imbalances. Though these measures helped in stabilising the economy, keeping it on a disinflationary path, the slowdown continues to pose policy challenges into 2014-15. The economy requires policies that address growth through increased productivity, as well as greater investment and use of labour.

II.1 THE REAL ECONOMY

Growth slows to sub-5 per cent for the second consecutive year, but growth may increase from here

II.1.1 Real GDP growth improved marginally to 4.7 per cent in 2013-14 from 4.5 per cent in 2012-13, recording a sub-5 per cent growth for the second consecutive year (Chart II.1). In the absence of a clear legal and regulatory framework in key areas such as natural resources, especially mining activity, environmental clearances and land acquisition, business confidence dipped and affected investments in the economy. Consumption also decelerated on the back of the growth slowdown. However, growth may increase from here, with a moderate-paced recovery likely in 2014-15. Recovery in growth would essentially come from an improvement in the investment climate through better governance, transparent, effective and efficient regulatory and legal regimes, gains in technical efficiency, institutional improvements, improved labour mobility and other reforms. Better business sentiment, anticipating such improvements following the elections, is a welcome development.

II.1.2 In 2013-14, the agriculture sector's rebound to an above trend growth rate on the back of a normal monsoon, supported overall growth. The industrial sector contracted, while services sector growth remained unchanged at the previous year's level. Structural impediments, high inflation and domestic policy uncertainties continued to weigh down growth prospects.

Chart II.1: Growth in Real GDP

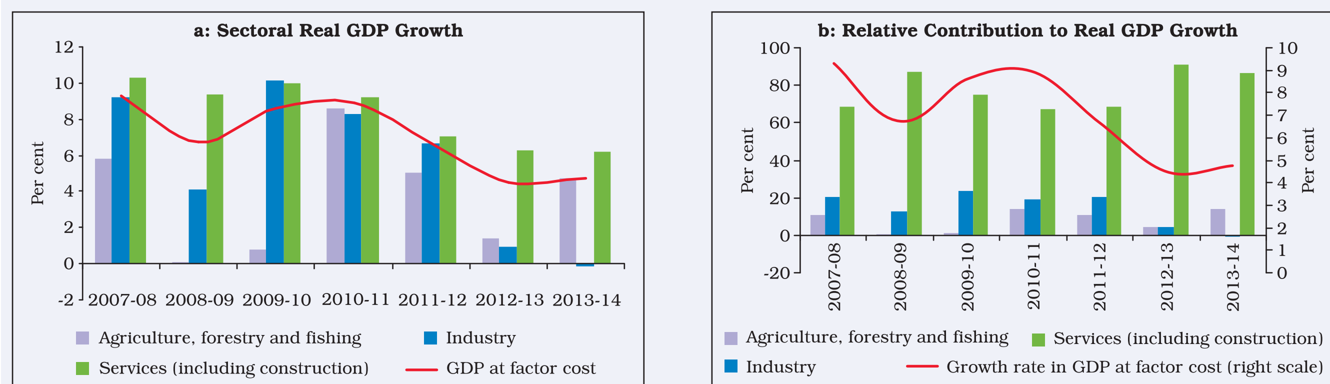
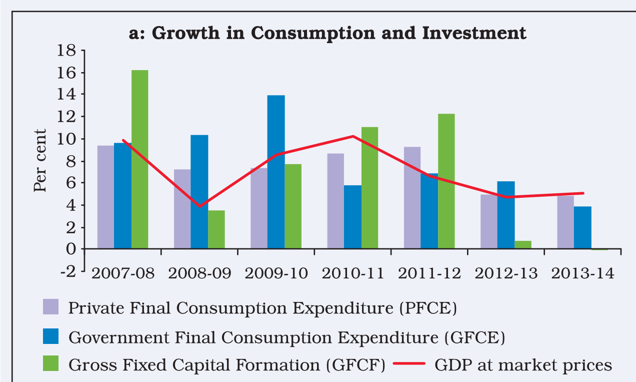
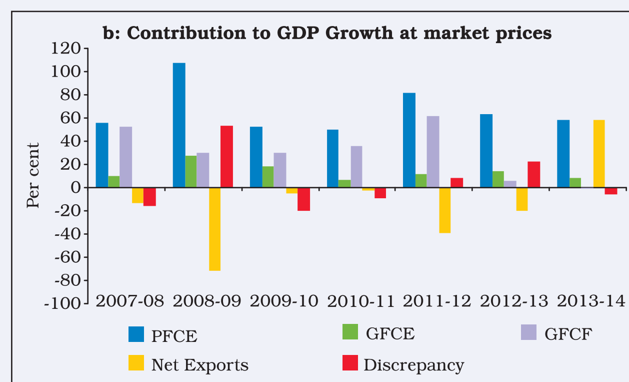


Chart II.2: Growth in Real GDP at Market Prices





Continued deceleration in consumption and sluggish investment

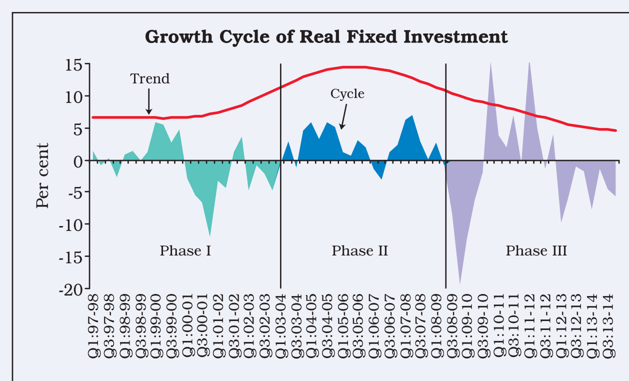
II.1.3 The growth in real GDP at market prices increased modestly to 5 per cent during 2013-14 led by a pickup in exports coupled with a decline in imports (Chart II.2a). The contribution of net exports to overall growth increased significantly in 2013-14 (Chart II.2b). In contrast, there was a slowdown in the pace of growth of the private final consumption expenditure (PFCE) mainly due to the persistence of inflation and slackening of disposable incomes, notwithstanding higher growth in agriculture.

II.1.4 Real fixed investment growth decelerated for the second consecutive year and turned negative in 2013-14 (Chart II.3a). Statistical measures indicate that while the trend growth rate of real fixed investment had peaked in mid-2005-06, it declined markedly thereafter largely on account of the structural bottlenecks that choked investments. The cyclical component also showed a substantial downturn in recent years (Box II.1).

Box II.1
Investment Cycles in India and the Recent Downturn

Empirical evidence suggests that both structural and cyclical factors have caused investment to slow down in recent years. Moreover, these two factors have reinforced each other. The trend component has declined since mid-2005-06, largely reflecting the impact of structural impediments. The empirical analysis based on quarterly data over the past fourteen years also reveals that fiscal imbalances, fuel inflation, world growth (as a proxy for external demand) and the monetary policy stance impact the cyclical component of real fixed investment growth.

The trend component of real investment in India was estimated using the Hodrick-Prescott (HP) filter on the deseasonalised series of real gross fixed capital formation (GFCF) adopting a growth cycle approach. The cyclical component of investment was extracted by subtracting the estimated trend growth from its actual growth over the period 1997-98:Q1 to 2013-14:Q4. The series of the growth cycle



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and trend growth of real fixed investment is shown in the chart below. The time period was divided into three phases, based on the generally evolving path of real GDP growth, *i.e.,* Phase I (1997-98:Q1 to 2002-03:Q4), Phase II (2003-04:Q1 to 2008-09:Q2) and Phase III (2008-09:Q3 to 2013-14:Q4).

The trend growth in GFCF declined significantly from 14.5 per cent in H2 of 2005-06 to below 5 per cent in 2013-14. In Phase I, the rate of investment growth alternated, exceeding and remaining below trend for nearly the same number of quarters. On the other hand, the investment growth generally remained above trend in Phase II but dipped below trend for the larger part in Phase III. The cyclical component of real investment growth dipped and turned negative especially since Q1 of 2012-13. The cyclical component of real investment growth and real GDP growth showed fairly strong co-movement (statistically significant correlation of +0.62), implying that falling investment growth and GDP growth, as evident in the recent period, are related.

In line with the observation on following trend growth in investment a recent study by Anand and Tulin (2014) also highlights the importance of economic policy uncertainty and deteriorating business confidence in the recent investment slowdown. Interest rates appears to explain a smaller portion of investment slowdown.

Further work will be necessary to examine the contribution of specific factors, like delays in land acquisition and environment clearances, reduction in the marginal productivity of capital despite lower real interest rates, weak business confidence and policy uncertainty that may have adversely impacted the growth rate of real investment.

Reference

Anand Rahul and Tulin Volodymyr (2014), 'Disentangling India's Investment Slowdown', IMF working paper WP/1447.

II.1.5 The rate of gross capital formation (investment rate) declined for the second consecutive year to 34.8 per cent in 2012-13 as compared to 35.5 per cent in 2011-12 and 36.5 per cent in 2010-11(Chart II.3b). The sectoral composition of fixed investment shows that the private corporate sector accounted for most of the reduction in the overall investment rate in recent years particularly in 'machinery and equipment' (Table II.1). On the other hand, fixed investments of the public and household sectors which are concentrated in 'construction' remained somewhat less volatile.

Productivity changes may have had a significant impact on growth

II.1.6 Over the previous decade, productivity changes may have had a significant impact on the growth rate for the Indian economy. India KLEMS (Capital, Labour, Energy, Material and Services) project study has shown significant productivity improvements in the previous decade up to 2008-09 (Box II.2). Much of this period overlapped the high growth phase in the Indian economy. Though estimates are not available for the subsequent

Chart II.3: Trend in Investment

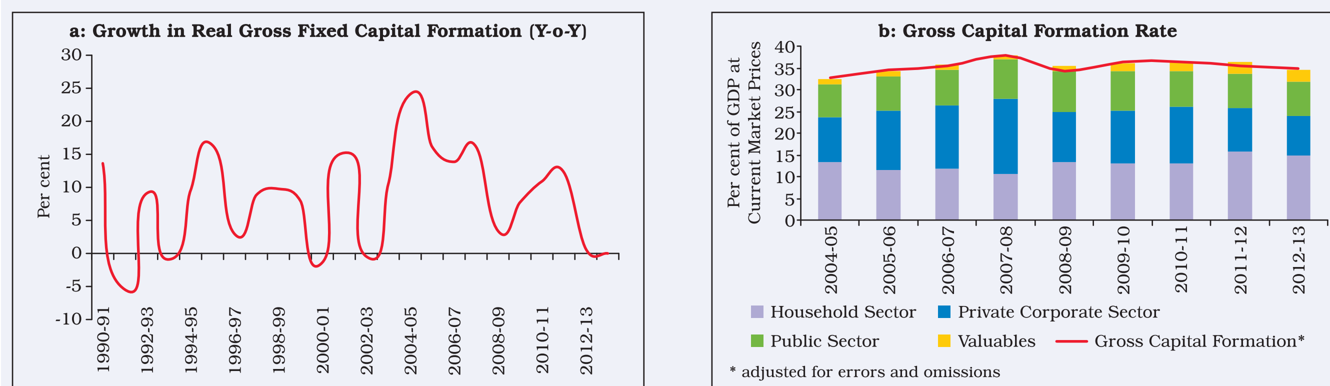

Table II.1: Gross Fixed Capital Formation

(as percentage of GDP at current market prices)

Year	Public Sector			Private Corporate Sector			Household Sector		
	Construction	Machinery & equipment	**Total**	Construction	Machinery & equipment	**Total**	Construction	Machinery & equipment	**Total**
1	2	3	4	5	6	7	8	9	10
2008-09	5.6	2.9	**8.5**	2.2	8.1	**10.3**	10.3	3.1	**13.5**
2009-10	5.5	2.9	**8.4**	2.5	7.7	**10.2**	9.8	3.3	**13.2**
2010-11	5.1	2.7	**7.8**	2.9	7.5	**10.4**	9.1	3.5	**12.7**
2011-12	4.7	2.4	**7.1**	2.7	6.8	**9.4**	10.4	4.9	**15.2**
2012-13	5.4	2.4	**7.8**	2.4	6.0	**8.5**	9.7	4.4	**14.1**

Source: Central Statistics Office.

years, the increase in capital-output ratios during 2011-12 to 2013-14 suggests that productivity improvements have not continued at the same pace over the last three years.

Household financial saving rate stays low in 2013-14

II.1.7 The Reserve Bank's preliminary estimates showed that the household financial saving rate

Box II.2
Productivity Growth in India

Productivity improvement remains an important contributory factor in the overall growth process. Empirical studies relating to productivity growth in India largely relate to the 1980s and 1990s. While these studies differ in terms of the methodology used, some of the studies based on the growth accounting framework, reveal that there was a sharp acceleration in the rate of total factor productivity (TFP) growth in the Indian economy after 1980. Further, the rate of growth in TFP in the post-reform period is found to be even higher than that in the 1980s, mainly due to improved productivity performance of the services sector.

Recent estimates on TFP growth for 26 industries and at the aggregate level have been prepared for the period 1980-81 to 2008-09 under the aegis of India KLEMS research project (RBI, 2014) which indicate that the TFP increased significantly in the 2000s (up to 2008-09) as compared to the previous two decades. The increase in TFP at the economy level in the 2000s was primarily due to manufacturing, electricity and services sectors. In agriculture and mining sectors, however, the rate of TFP growth decelerated in the 2000s. In the case of construction, the steep fall in TFP growth during 1980-99 was largely arrested in the 2000s.

Looking at the reasons for productivity growth, the opening up of the economy post-1991 has been identified as an important factor which resulted in a significant jump in services sector productivity which continued during the 2000s. The electricity sector is found to have economised on the use of energy and services input in 2000s raising the value added per kilowatt hour of production. The manufacturing sector has seen a more broad-based phenomenon of productivity growth with 8 out of 14 industries showing faster productivity growth during 2000-08. The liberal market reforms in the 1990s seem to have helped in the accumulation of capital in some segments of manufacturing immediately after the reforms, while opening up to foreign technology and import of capital goods might have translated into better productivity gains in the latter period (2000s) (Das, 2014). In some other studies, increase in manufacturing productivity in 2000s has been attributed to factors, such as, removal of trade barriers and increasing openness. Infrastructure facilities as well as labour market conditions also exerted a significant influence on technical efficiency and productivity growth of manufacturing industries in India.

As productivity might have been adversely impacted over the last 3 years, going forward, removing infrastructure bottlenecks and labour market rigidities holds the key to improving output growth *vis-à-vis* factor accumulation. Continuing relocation of labour out of low productivity sectors to high productivity sectors is also akin to increase in productivity. In India, although there is some migration from agriculture, there is a need to create further employment opportunities in industrial and services sectors to ensure gainful employment of migrated labour and for enhancing overall productivity level.

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Period wise trend growth rate of Total Factor Productivity by broad sector (using labour input and capital service)

Sector	1980-2008	1980-1999	2000-2008
1	2	3	4
Agriculture, Hunting, Forestry, Fishing	1.52	1.78	0.71
Mining and Quarrying	-0.24	0.22	-1.59
Manufacturing	0.73	0.04	2.76
Electricity, Gas and Water Supply	2.96	1.14	6.93
Construction	-3.31	-4.19	-0.69
Services	1.84	1.74	2.14
Total Economy	**1.40**	**1.11**	**2.26**

Source: KLEMS database available at www.rbi.org.in

The recent thrust to infrastructure spending is expected to boost productivity along with employment. Further, the opening up of various sectors to FDI will promote greater competition and productivity.

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Das Deb Kusum (2014), 'Productivity Growth in India under Different Policy Regimes 1980-2012', Presentation at Third World KLEMS Conference, Tokyo, Japan, June.

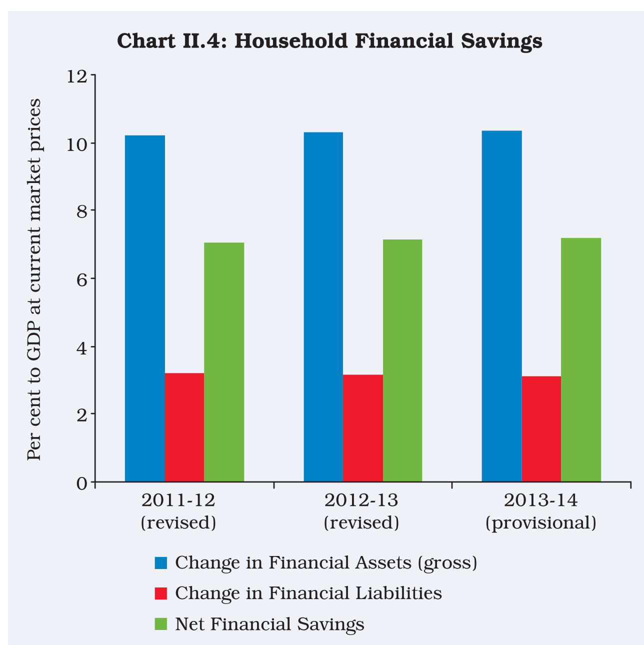
Reserve Bank of India (2014), 'Estimates of Productivity Growth for Indian Economy', KLEMS project report, http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/EPGIKLEMS110614, June 11, 2014.

remained low during 2013-14, increasing only marginally to 7.2 per cent of GDP in 2013-14 from 7.1 per cent of GDP in 2012-13 and 7.0 per cent of GDP in 2011-12 (Chart II.4). During 2013-14, households increased their saving in deposits (especially with commercial banks) and small savings, while that in currency and mutual funds declined (Table II.2).

Table II.2 : Financial Saving of the Household Sector

Item	Per cent to Gross Financial Saving				₹ billion			
	2010-11	2011-12 (R)	2012-13 (R)	2013-14 (P)	2010-11	2011-12 (R)	2012-13 (R)	2013-14 (P)
1	2	3	4	5	6	7	8	9
A. Change in Financial Assets (Gross Financial Saving)	100.0	100.0	100.0	100.0	10,518	9,215	10,437	11,741
a. Currency	13.0	11.5	10.7	8.7	1,371	1,062	1,116	1,018
b. Deposits	49.9	59.1	56.6	58.8	5,248	5,445	5,906	6,908
i) With Commercial Banks	46.5	53.4	51.1	53.1	4,886	4,923	5,338	6,233
ii) With Cooperative Banks and Societies	3.0	3.6	3.9	4.2	311	336	412	489
iii) With Non-banking Companies	0.5	2.0	1.5	1.6	51	186	157	185
iv) Trade Debt (Net)	0.6	0.5	0.3	0.4	68	45	32	48
c. Shares and Debentures	-0.4	-0.3	4.1	2.9	-43	-28	430	337
of which :								
i) Private Corporate Business	0.6	0.4	0.4	0.3	68	41	44	31
ii) Banks	0.1	0.0	0.1	0.0	8	1	7	5
iii) Bonds of Public Sector Undertakings	0.1	0.0	0.0	0.8	8	1	2	92
iv) Mutual Funds (including UTI)	-1.1	-1.2	3.4	1.8	-116	-106	350	210
d. Claims on Government	2.7	-2.4	-0.8	0.4	287	-219	-83	46
i) Investment in Government securities	0.0	0.1	0.0	0.0	3	5	5	4
ii) Investment in Small Savings, *etc.*	3.4	-2.4	-0.7	0.6	361	-218	-73	75
e. Life Insurance Funds	20.0	21.3	17.3	17.0	2,101	1,958	1,803	1,996
of which :								
i) Life Funds of LIC and private insurance companies	19.9	21.2	17.2	16.6	2,095	1,955	1,800	1,943
f. Provident and Pension Funds	13.4	10.3	11.7	11.6	1,410	949	1,223	1,359
B. Change in Financial Liabilities					2,804	2,870	3,213	3,555
C. Net Financial Saving of Household Sector (A-B)					7,713	6,345	7,224	8,186

R: Revised Estimates. P: Preliminary Estimates.
Note : Components may not add up to the totals due to rounding off.



Gross domestic saving rate declines further in 2012-13

II.1.8 The gross domestic saving rate as per Central Statistics Office's (CSO's) estimates declined to 30.1 per cent in 2012-13 from 31.3 per cent in 2011-12, mainly on account of a decline in the rate of household physical savings (Table II.3). The saving rate dipped to the lowest in the past 9 years and has accentuated macroeconomic imbalances. The household saving rate had generally hovered around 23 per cent since 2003-04. Following a one-off sharp increase to 25.2 per cent in 2009-10, it declined to 21.9 per cent in 2012-13. This decline was led by a reduction in the household financial saving rate that dipped sharply from 12 per cent in 2009-10 to 7.1 per cent in 2012-13.

Agricultural sector rebounds in 2013-14

II.1.9 After a subdued performance in 2012-13, agriculture emerged as the driver of growth during 2013-14. The south-west monsoon was 6 per cent above the long period average (LPA) and the north-east monsoon was 18 per cent above LPA. As per the Fourth Advance Estimates, foodgrains production during 2013-14 is placed at 264.8 million tonnes, 3.0 per cent higher than in 2012-13 (Table II.4).

Table II.3: Gross Domestic Savings: Sector-wise

(As percentage to GDP at current market prices)

	Average (2005-06 to 2007-08)	2008-09	2009-10	2010-11	2011-12	2012-13
1	2	3	4	5	6	7
Gross domestic saving (1+2+3)	**35.0**	**32.0**	**33.7**	**33.7**	**31.3**	**30.1**
1. Household sector (i+ii)	23.0	23.6	25.2	23.1	22.8	21.9
(i) Financial saving (Net)	11.6	10.1	12.0	9.9	7.0	7.1
(ii) Saving in physical assets (Gross)	11.4	13.5	13.2	13.2	15.8	14.8
2. Private corporate sector (i+ii)	8.3	7.4	8.4	8.0	7.3	7.1
(i) Joint Stock Companies	7.8	7.0	7.9	7.6	6.9	6.7
(ii) Cooperative Banks and Societies	0.5	0.4	0.4	0.4	0.4	0.4
3. Public sector	3.7	1.0	0.2	2.6	1.2	1.2
Of which:						
a) Government administration (including quasi govt. bodies)	-0.9	-2.8	-3.1	-0.5	-2.0	-1.9
b) Non-departmental enterprises	4.0	3.3	2.8	2.8	2.9	2.8

Note : Household financial saving is arrived at by netting out of household's financial liabilities from their gross investment in financial assets. Household physical saving is shown in gross terms *i.e.* inclusive of depreciation.

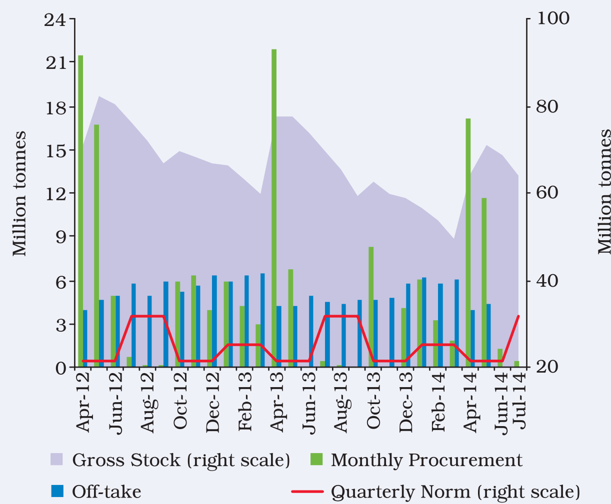
Source: Central Statistics Office.

Table II.4 : Agricultural Production 2013-14

(in million tonnes)

Crop	2012-13	2013-14*	Percentage Change
1	2	3	4
Foodgrains	**257.1**	**264.8**	**3.0**
Rice	105.2	106.5	1.2
Wheat	93.5	95.9	2.6
Coarse Cereals	40.0	43.1	7.8
Pulses	18.3	19.3	5.5
Oilseeds	**30.9**	**32.9**	**6.5**
Groundnut	4.7	9.7	106.4
Rapeseed & Mustard	8.0	8.0	0.0
Soyabean	14.7	12.0	-18.4
Cotton #	**34.2**	**36.6**	**7.0**
Jute & Mesta ##	**10.9**	**11.6**	**6.4**
Sugarcane (Cane)	**341.2**	**350.0**	**2.6**

*: Fourth Advance Estimates as on August 14, 2014.
#: Million bales of 170 kgs. each.
##: Million bales of 180 kgs. each.
Source: Ministry of Agriculture, GoI.



Note: 1. Data for off-take is up to May 2014 and stock as at end-July, 2014.
2. Off -take data are monthly figures.
3. Data for procurement is up to July 31, 2014.

Food security management assumes importance in the face of a sub-normal monsoon

II.1.10 Though it is still early to assess the quantum, 2014-15 may not be as favourable for agriculture growth as last year (see also Box I.1 in Chapter 1). If managed well, the current stocks of rice and wheat (63.8 million tonnes at end-July 2014) are adequate to meet food security and buffer requirements despite a sub-normal monsoon (Chart II.5). However, it may prove a challenge to bring down price pressure for perishable food items, in particular, vegetables and fruits. Further reforms are necessary covering the entire gamut of food management. This could cover the unbundling of functions of the Food Corporation of India (FCI) and the removal of perishable items from the ambit of the agricultural produce marketing committee (APMC) Act, with adequate safeguards to farmers. The latter will be a significant step towards instilling competition and price discovery.

Industrial sector contracted in 2013-14

II.1.11 Industrial sector declined during 2013-14. This was only the third instance since 1951-52, when the Indian industry recorded contraction, the previous instances being 1979-80 (during the second international oil crisis) and 1991-92 (fallout of the Gulf war and the external payments crisis). Moderation in demand, both domestic and global, and rising input costs adversely affected industrial performance during 2013-14. The contraction in the industrial sector was reflected in mining and manufacturing sectors and more than offset strong growth in the electricity sector. Including 2013-14, mining sector has contracted for 3 consecutive years. Contraction in the manufacturing sector reflected poor investment demand and weakness in consumer spending.

II.1.12 As per the use-based classification, the production of capital goods and consumer durables declined, reflecting subdued investment and consumption demand (Table II.5). However, the performance of intermediate goods and consumer non-durable goods segment improved during the year.

Table II.5: Index of Industrial Production (IIP)

(Per cent)

	Weight	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Apr-Jun 2014
1	2	3	4	5	6	7	8	9	10	11	12
Overall IIP	**100.0**	**8.6**	**12.9**	**15.5**	**2.5**	**5.3**	**8.2**	**2.9**	**1.1**	**-0.1**	**3.9**
Sectoral Classification											
Mining	14.2	2.3	5.2	4.6	2.6	7.9	5.2	-2.0	-2.3	-0.6	3.2
Manufacturing	75.5	10.3	15.0	18.4	2.5	4.8	8.9	3.0	1.3	-0.8	3.1
Electricity	10.3	5.2	7.3	6.3	2.7	6.1	5.5	8.2	4.0	6.1	11.3
Use-Based Classification											
Basic goods	45.7	6.1	8.9	8.9	1.7	4.7	6.0	5.5	2.5	2.1	7.6
Capital goods	8.8	18.1	23.3	48.5	11.3	1.0	14.8	-4.0	-6.0	-3.6	13.9
Intermediate goods	15.7	6.6	11.5	7.3	0.0	6.0	7.4	-0.6	1.6	3.1	3.1
Consumer goods	29.8	10.7	16.1	17.6	0.9	7.7	8.5	4.4	2.4	-2.8	-3.6
Consumer durables	8.5	16.2	25.3	33.1	11.1	17.0	14.2	2.6	2.0	-12.2	-9.6
Consumer non-durables	21.3	8.6	12.3	10.2	-5.0	1.4	4.2	5.9	2.8	4.8	0.7

Source: Central Statistics Office.

II.1.13 Industrial output data for Q1 of 2014-15 shows an improvement over the corresponding period last year. Growth of Index of Industrial Production (IIP) during Q1 of 2014-15 at 3.9 per cent is the highest in last 11 quarters. Further, the acceleration in exports growth is expected to provide a boost to industrial recovery.

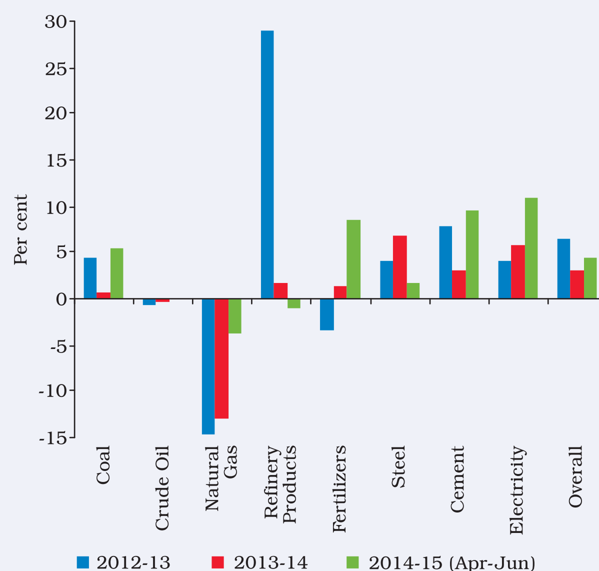
II.1.14 Growth in the eight core industries decelerated to 3.1 per cent during 2013-14, compared to 6.5 per cent in the previous year (Chart II.6). Three consecutive years of contraction in natural gas production from the KG-D6 block from 56 mcm/d in 2010-11 to 14 mcm/d in 2013-14 has adversely affected capacity utilisation of gas based thermal power plants while crude oil production continued to suffer from ageing oil fields and delay in the execution of new oil-field projects. However, electricity generation accelerated during the year driven mainly by hydel power. Thermal power generation decelerated during 2013-14.

II.1.15 Growth in the eight core industries growth, however, improved during Q1 of 2014-15 to 4.6 per cent from 3.7 per cent in the corresponding period in the previous year. The turnaround was caused by growth acceleration in the production of coal, fertilisers, cement and electricity, as also markedly lower contraction in natural gas output. Growth in steel and refinery products decelerated.

Slowdown seen in planned corporate investment amid economic slowdown

II.1.16 Fixed investment plans of the corporate sector slowed down during 2013-14. The Reserve

Chart II.6: Growth in the Index of Eight Core Industries



Bank's data on the time phasing details of the major projects, which were sanctioned financial assistance by banks and other financial institutions or raised funds through external commercial borrowings (ECBs)/ foreign currency convertible bonds (FCCBs) or domestic equity issuances, indicated that investment intentions of 1,065 companies were to the tune of ₹2.5 trillion in 2013-14. This was lower by 17.9 per cent than the revised estimate for 2012-13. Investment in 2013-14 was mainly envisaged in 'power', 'metal & metal products', 'textiles', 'cement' and 'construction' industries.

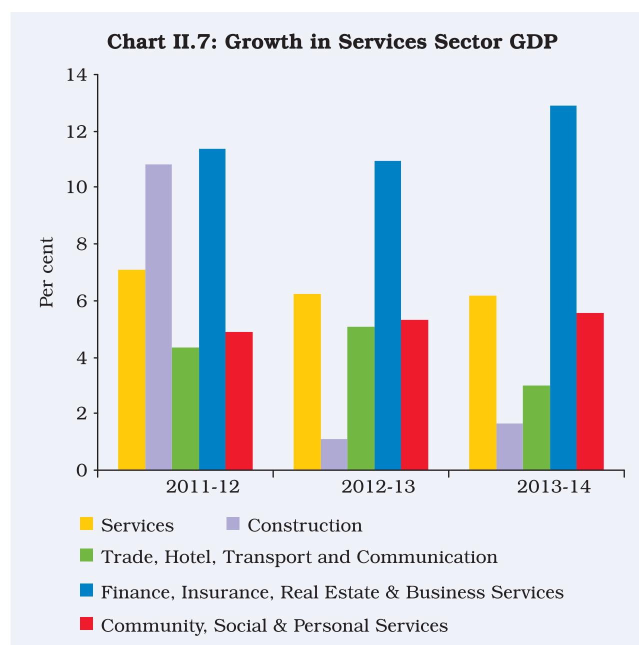
II.1.17 Based on the investment plans up to 2013-14, the capital expenditure envisaged in 2014-15 aggregated ₹1.2 trillion, which implies that for improving the level of aggregate capital expenditure in 2014-15 from that of 2013-14, a capital expenditure of more than ₹1.2 trillion will need to come from new investment intentions of the private corporate sector in 2014-15. This could be realised as forward looking surveys and economic indicators along with rising business confidence provide hope that the decline in private corporate investment could be arrested in 2014-15.

Services sector stayed weak in 2013-14

II.1.18 Growth of services sector during 2013-14 was mainly driven by the sub-sector 'financing, insurance, real estate & business services' which grew in double digits followed by 'community, social & personal services' (Chart II.7). However, the construction sector suffered a major setback in the last 2 years on account of the economic slowdown (Appendix Table 2). A recovery in domestic services such as transport, trade and logistics is contingent upon the recovery of the domestic economy.

II.1.19 Various lead indicators of the services sector for 2014-15 signal improvement in most segments except steel consumption and commercial vehicle sales. Trade and transport related indicators like cargo handled at ports, foreign tourist arrivals and civil aviation show improved prospects.

Chart II.7: Growth in Services Sector GDP



However, moderation in steel consumption indicates a sluggish outlook for the construction sector. Weak consumer spending on the back of elevated inflation and interest rates has affected the automobile sector. However, there has been some pickup in passenger car sales during May-July of 2014-15.

Persistent efforts to address infrastructural constraints, though revival remains modest

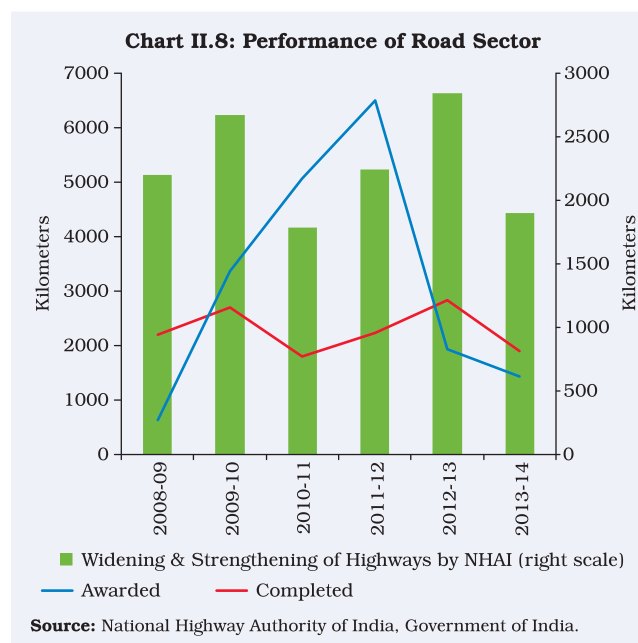
II.1.20 In the last few years, infrastructure sector has been experiencing sluggish growth mainly due to macro economic factors and policy gridlock coupled with sector specific bottlenecks. However, over the last one year, the government attempted several reforms aimed at reviving the sector *viz.*, streamlining approvals through the Cabinet Committee on Investments (CCI), increasing domestic availability of coal supply through fuel supply agreements and coal imports at a cost-plus basis, streamlining coal block auctioning, financial restructuring of state electricity distribution companies and gas pricing guidelines. These supply-side measures have yielded some benefits, though more efforts will be needed to turnaround the investment in the sector. Along with supply side

constraints, of late, the power sector is also facing demand side pressures, associated with both slow growth as well as the financial weaknesses of most of the state and privately owned electricity distribution companies, which has made them reluctant to buy power. This has led to many power producers operating at sub-optimal capacities. Plant load factor (PLF) of thermal power plants declined to 65.6 per cent during 2013-14 from 70.3 per cent recorded in the previous year, putting pressure on the profitability of power producers. In addition, several power projects have been stuck due to issues such as environment clearances and land acquisition.

II.1.21 For the last 2 years, the road sector seems to be experiencing stagnancy. Notwithstanding several sector-specific measures, the road sub-sector failed to attract private investment during 2013-14, partly due to increased leverage of many construction firms operating in this area and partly due to difficulties in land acquisition, obtaining environmental clearances and concerns about the financial viability of the projects. There were only few takers for public private partnership (PPP) projects for roads in 2013-14; less than 1,500 km was awarded under the engineering, procurement and construction (EPC) mode. During 2013-14, the National Highways Authority of India (NHAI) recorded a growth that was 33.2 per cent lower than that during the same period in the previous year with regard to the strengthening/widening of national highways (Chart II.8). During the current financial year, the new government has set a target of 8,500 km of national highway construction; with the majority to be awarded through the EPC route.

II.1.22 A series of governmental initiatives were taken in 2013-14 to boost infrastructure investment. These included establishment of the CCI and the Project Monitoring Group (PMG) to expedite the clearance of key mega infra projects, enactment of new legislation for land acquisition, rehabilitation and resettlement, treating debts due to the lenders

Chart II.8: Performance of Road Sector



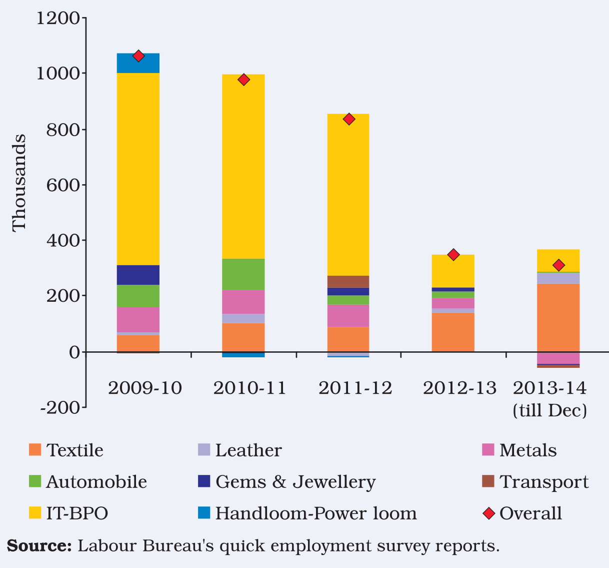
Source: National Highway Authority of India, Government of India.

as ‘secured’ loan in the case of PPP projects, relaxation of external commercial borrowing (ECB) norms for infrastructure finance companies and facilitation of infrastructure debt funds (IDFs). However, these initiatives yielded limited benefits. Since its inception PMG has undertaken the resolution of issues pertaining to projects worth ₹5.8 trillion. A majority of the projects resolved by PMG were in the power sector followed by coal projects and related mainly to fuel supply agreements. However, as on May 1, 2014, of the 727 central sector infrastructure projects (worth ₹1.5 billion and above) monitored by the Ministry of Statistics and Programme Implementation (MoSPI), about 39 per cent of the projects were reported to be delayed and 41 per cent were without any specific date of commissioning. The cost overruns of these projects continue to remain high at 20 per cent.

Employment generation during 2013-14 showed mixed trends

II.1.23 India being a highly populated developing economy, employment generation serves as an important indicator of inclusive and sustainable

Chart II.9: Employment generation in export-oriented sectors (annual change)



Source: Labour Bureau's quick employment survey reports.

growth. The quarterly employment surveys conducted by the Labour Bureau for select export-oriented sectors reveal that there was a significant moderation in the rate of employment generation in 2012-13, though some improvement was seen in 2013-14. Employment generation in the IT-BPO sector has been declining over the years while the textile sector saw an increase, especially in 2013-14 (till December) (Chart II.9). Some private data sources of employment in the organised sector also present a mixed picture during 2013-14. The third Annual Employment-Unemployment Survey for 2012-13 conducted by Labour Bureau showed that the unemployment rate was 4.0 per cent on UPSS[1]. Unemployment rate in urban areas at 5.3 per cent was higher than 3.5 per cent in rural areas. The latest Annual Survey of Industries' (ASI) results pertaining to 2011-12 indicated that there was a fall in the growth rate of organised sector employment in 2011-12 over the previous year.

Real activity set to improve in 2014-15

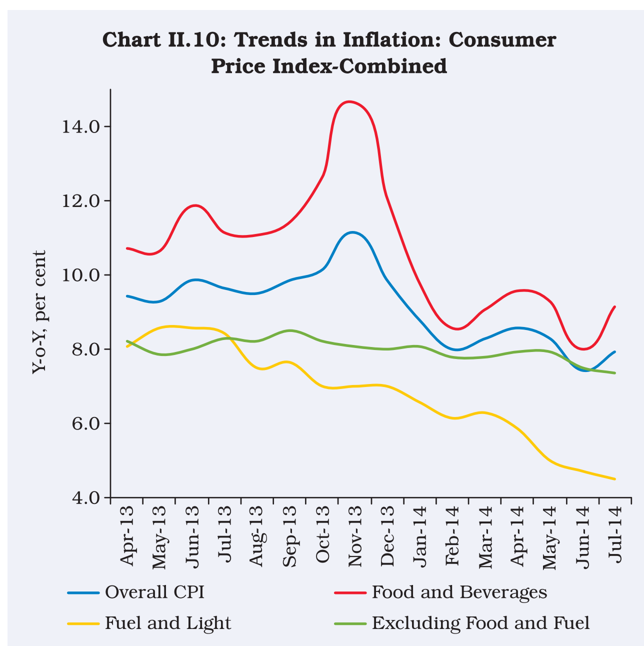
II.1.24 Stronger business sentiments, improved consumer confidence and increased capital inflows in the recent quarters appears to indicate a start to a modest recovery in the growth of the economy. The key priority is to enhance the growth rate of the economy by addressing structural impediments that are constraining investment activity in the economy.

II.2 PRICE SITUATION

Headline CPI inflation moderated during 2013-14 but remains high with pressure from food prices and other second round effects

II.2.1 Inflation in terms of consumer price index (CPI) eased during the period December 2013 to February 2014, declining to 8.0 per cent after remaining above 9 per cent for 22 successive months and touching a high of 11.2 per cent in November 2013. The moderation in consumer price inflation resulted from a sharp correction in food prices. However, the disinflationary momentum has not gathered strength as decline in food prices was temporary and second round effects from high food inflation continue to exert pressures on the general price level. CPI excluding food and fuel inflation showed considerable persistence at an elevated level during H1 of 2013-14, followed by a fall from 8.5 per cent in September 2013 to 7.8 per cent in March 2014 and further to 7.4 per cent in July 2014 (Chart II.10). This decline in a component that has exhibited stickiness was supported by a tight monetary policy stance. Going forward, while growth revival on a sustainable basis will remain an objective, inflation risks will need to be factored in. Given the unsatisfactory progress of south-west

[1] UPSS-Usual (principal + subsidiary) status- The UPSS measure takes into account the activity accounting for a majority of a person's time over the year as well as the activity undertaken on a short term basis.



monsoon so far and its impact on food prices, as also risks emanating from potential crude oil price shocks, upside risks persist to the disinflationary glide path set out by the Expert Committee to revise and strengthen the monetary policy framework (Chairman: Dr. Urjit Patel) (to 8.0 per cent by January 2015 and 6.0 per cent by January 2016).

II.2.2 Food and beverages group in CPI, with a weight of 47.6 per cent contributed more than half to headline inflation during 2012-13 and 2013-14. The main contributors to food inflation, however, changed over time as cereals prices dominated during 2012-13, whereas it was the spike in vegetable prices that kept food inflation high during 2013-14. Notwithstanding the pressure from the food group, the contribution of CPI excluding food and fuel inflation remained persistent. Monetary policy response during the second half of 2013-14 was aimed at anchoring inflation expectations and containing second round impact in the wake of such persistence. The Reserve Bank increased the repo rate under Liquidity Adjustment Facility (LAF) by a total of 75 basis points to 8.0 per cent during September 2013 to January 2014.

Insights into disinflation momentum since December 2013 suggest more is required to tame inflation

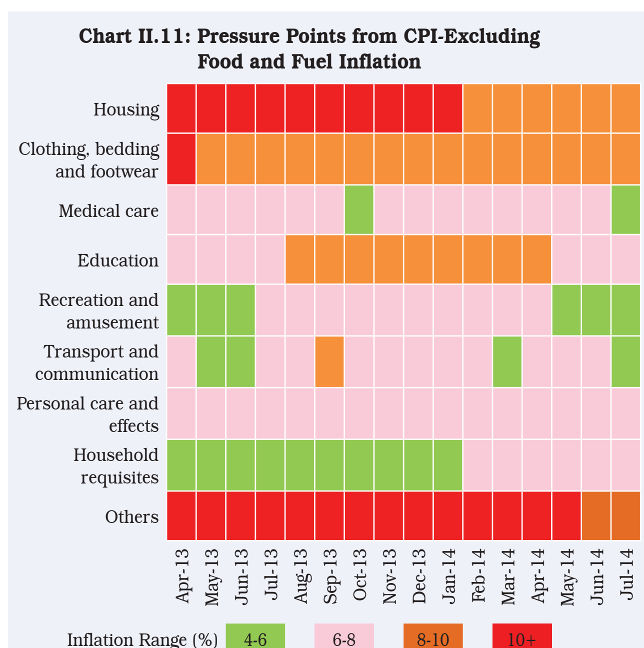
II.2.3 CPI inflation moderated during December 2013-February 2014, driven largely by seasonal moderation in vegetable prices. CPI-Combined inflation remained above 8 per cent till May 2014 but declined to 7.5 per cent in June 2014 on account of favourable base effect. It, however, rebounded to 8.0 per cent in July 2014 as vegetable prices went up by 16.9 per cent over the month. Though some moderation in CPI excluding food and fuel inflation is visible in recent months, the extent of moderation warranted by the significant growth slowdown is yet to manifest in CPI. Such rigidity in the core component of inflation points to the inertial nature of inflation feeding into the elevated inflation expectations, which would necessitate credible anti-inflationary monetary policy to provide a nominal anchor and break the inflation persistence.

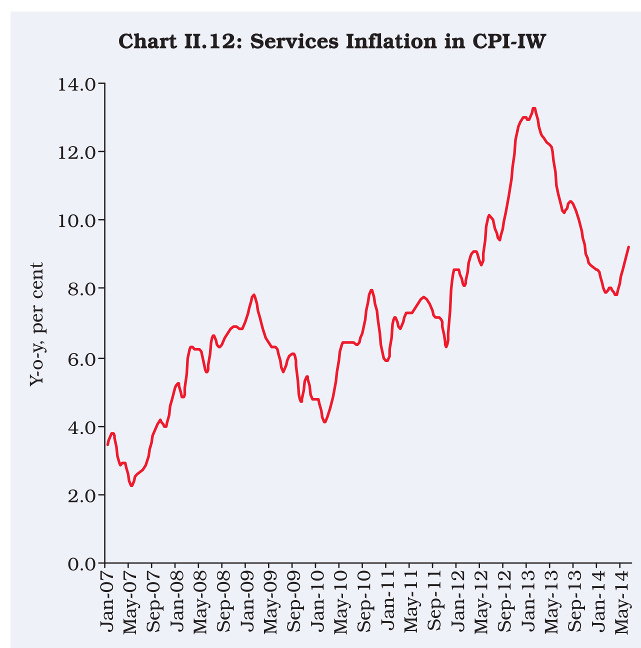
Services led components drive CPI excluding food and fuel inflation

II.2.4 The stickiness in CPI inflation excluding food and fuel emanated from the pressures from housing, transport and communication and services led components such as medical care, education and stationery, household requisites and 'others' sub-category, which includes charges paid to barbers, beauticians, washer-men, tailors and iron-men. High inflation in the services constituents reflected the role of wage pressures and other second round effects. The disaggregated data in this respect suggest that prices of most of the items grew in a band of 6-8 per cent, while the 'others' sub-category grew at more than 10 per cent during 2013-14 (Chart II.11). Inflation in the housing sub-group declined to 8.9 per cent in July 2014 after remaining in double digits during 2012 and 2013.

Services inflation starts to taper

II.2.5 Given that more than 60 per cent of India's GDP emanates from services, understanding





movements in services prices is critical to gauge the growth-inflation dynamics. Also, much of the services are labour intensive and, therefore, the second round effects from wage-price spiral could be much stronger in services inflation. The CPI-Combined data do not have a separate services category. However, the miscellaneous sub-category that largely represents services has shown considerable inflation persistence. Using the disaggregated information on 32 individual price series for services available from CPI-Industrial Workers (IW), a composite service price index was constructed to assess the trends in services inflation. Inflation trends available from this index indicate moderation in services inflation beginning March 2013, though its level continues to remain high at over 8 per cent (Chart II.12).

II.2.6 One key indicator of inflation persistence is inflation expectations. As highlighted in the report of the Expert Committee to revise and strengthen the monetary policy framework (Chairman: Dr. Urjit Patel), the elevated and entrenched nature of inflation expectations in India – as measured by the RBI's households' surveys – is likely a key reason why elevated inflation currently co-exists with negative output gaps. The results of the Inflation Expectations Survey of Households (IESH) indicate that household inflation expectations continued to remain elevated at double digit level during 2013-14. As per the latest IESH Round 36 (*i.e.*, April – June 2014), the short-term inflation expectations in terms of median for next three months moved up marginally whereas the one-year ahead median inflation expectations of households decreased fractionally as compared with the previous quarter. Also, about 72 per cent (75 per cent in the last round) and 74 per cent (77 per cent in the last round) of the respondents expected double digit inflation rates for three-month ahead and one-year ahead period, respectively (Box II.3).

Volatility in inflation pointed to supply side rigidities

II.2.7 Volatility in prices, especially of select food items continues to pose a major challenge to managing inflation. It is observed that since January 2012 both inflation and volatility in vegetable prices has been the highest across the food items (Chart II.13). Inflation in the case of cereals, milk,

Box II.3
Trends in Inflation Expectations: Evidence from Survey Based Measures in India

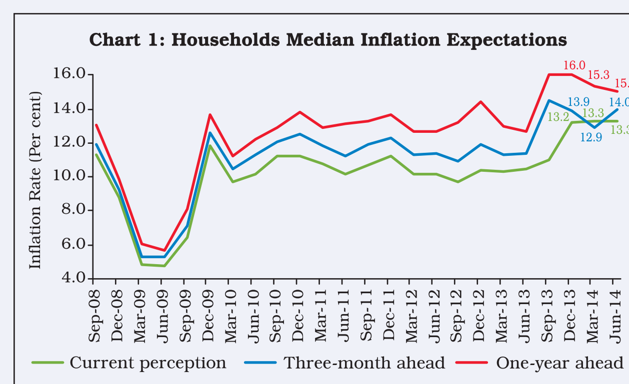
Forward looking monetary policy attaches a lot of importance to inflation expectations as inflation expectations of economic agents significantly influence their inter-temporal as well as current economic choices. High inflation expectations could lead workers to bargain for higher wages, thereby putting cost pressure on prices leading to high actual inflation resulting in a wage-price spiral. Monetary policy, by committing to a credible anti-inflationary stance, endeavours to influence inflation expectations so that they remain anchored at levels close to the target/medium term objective (Mohanty, 2012). Well-anchored inflation expectations imply that inflation expectations are relatively insensitive to incoming data, *i.e.,* the long-run expectation of inflation of public changes little, in a period witnessing inflation that is higher than their long-run expectation (Bernanke, 2007). Central banks in most advanced as well as emerging economies, especially those which operate with an inflation targeting framework, place emphasis on assessment and outlook for inflation expectations in their monetary policy communication.

Unlike the economic variables, inflation expectations are not directly observable, and therefore would have to be either derived from other indicators or measured using survey based methods. From the financial market data, the differential yields between ordinary and inflation-indexed government bonds of similar maturity as well as the shape of the yield curve throws light on the expected rate of inflation. The survey based approach for measuring inflation expectations could be in the form of direct survey of households, survey of producers' outlook on input and output prices or survey of professional forecasters.

In India, the absence of time series data on inflation indexed bonds limits the source of information on inflation expectations. The yield spreads, on the other hand, are influenced by the outlook relating to government borrowing programme, statutory g-sec holding requirements on banks and inflation expectations. Therefore, a lot of emphasis has been placed on survey based measures of inflation expectations. In the recent period, the Reserve Bank has been conducting qualitative and quantitative surveys at quarterly frequency to assess the inflation expectations for India. These surveys cover households, producers and professional forecasters.

The Inflation Expectations Survey of Households (IESH) initiated in September 2005 elicits qualitative and quantitative responses for three-month ahead and one-year ahead period on expected price changes. The Technical Advisory Committee on Surveys constituted in 2009 by the Reserve Bank regularly deliberates on the concept, methodology and data quality and suggests methodological improvements in the survey. It is recognised that inflation expectations of households are subjective and are based on individual consumption baskets and hence may differ from the official inflation numbers released periodically by the government. The households' expectations are generally observed to be higher than the official inflation estimates (Chart 1). The near-term, *i.e.*, three-month ahead inflation expectations of the households are believed to be a better indicator of consumer expectations as compared with one-year ahead expectations, which have wider variations.

The Reserve Bank has been conducting the survey of professional forecasters (SPF) since September 2007. The forecasters provide medium-term (5-year ahead) and long-term (10-year ahead) quantitative forecasts of inflation. As the professional forecasters consider all the available information, both past and future, their expectations could be considered more rational than that of households.



The professional forecasters survey suggests a fall in the inflation expectations and the medium-term CPI inflation has been trending down in the recent period. The 5-year and 10-year ahead median CPI inflation expectations in the latest survey round released in July 2014 have fallen to 7.0 per cent and 6.0 per cent, from 7.75 per cent and 7.0 per cent, respectively, in the survey round released in January 2014. Such a fall in long-term inflation expectations augurs well for the economy at a time when the central bank seeks to build its credibility in aiming to lower inflation further.

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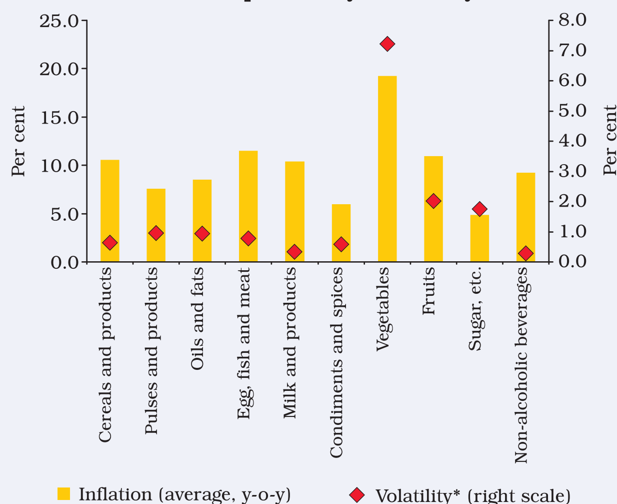
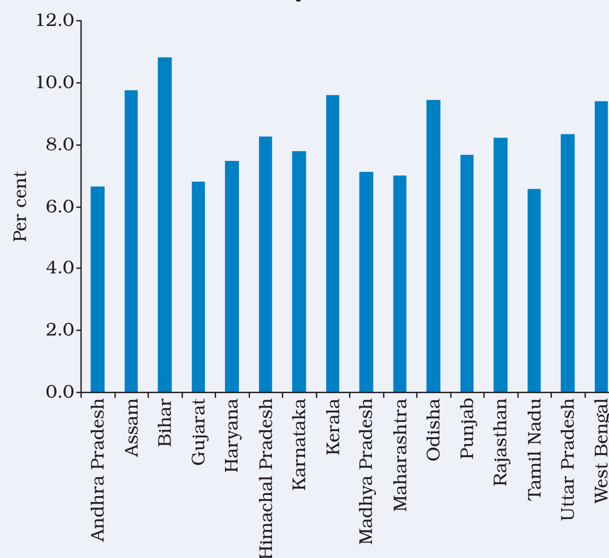
Chart II.13: Inflation and Price Volatility in CPI Food Group: January 2012-July 2014



* Volatility is defined as standard deviation of difference in log of price index.

Chart II.14: CPI Inflation Across Major States: July 2014



egg, fish and meat remained, on an average, at double digit level and exhibited low volatility indicating that the pressures in these commodities were persistent.

II.2.8 Apart from the large volatility, there is also significant variation in inflation across the states in the country (Chart II.14). Empirical results suggest that although over time prices tend to converge across regions in India, inflation spikes are usually associated with increase in variability in inflation across regions pointing to region-specific factors playing a role (Box II.4).

Box II.4
Regional Inflation Dynamics in India

Given large differences in economic structure in a diverse country like India, there could be a number of region specific factors that influence inflation dynamics. Economic literature has identified several reasons for inflation differentials among regions within a common currency area (Hendrikx and Chapple, 2002). Following a food price shock, it is likely that inflation pressure is more severe in areas where the share of food in total consumption is high and also in areas which depend on imports from rest of the country for consumption. Disparities in the product and labour market structures could also lead to inflation differentials across regions. If a country is experiencing a phase of economic integration between regions within the country, the Balassa-Samuelson effect could result in inflation differentials as the productivity differentials between tradable and non-tradable sectors in a region will lead to inflation pressures. Variation in transport costs could be another source of inflation differentials.

Monetary policy is primarily focused on price stability at the aggregate level, but heterogeneous price movements at the regional level and inflation differentials could have a significant impact on monetary policy efficacy. Large inflation differences can create real interest rate deviations across regions with uniform nominal interest rate across the country. If inflation is manifested by demand pressures, this would imply that the regions with high aggregate demand may further fuel inflation due to prevailing lower real rate of interest (Cecchetti *et al*, 2002). Therefore, regional dispersion of inflation is an important input that may be useful in designing the appropriate policy response.

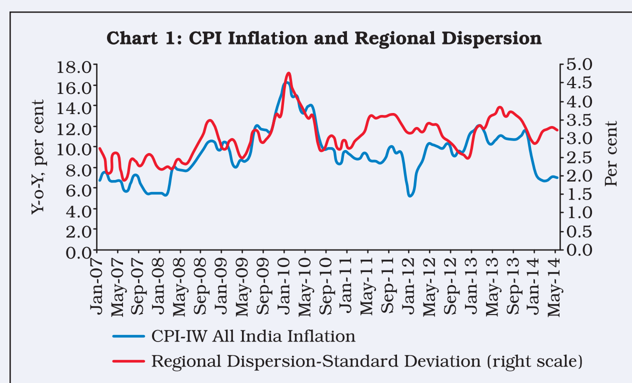
The trends in regional dispersion are analysed using the data for Consumer Price Index for Industrial Workers (CPI-IW), which give detailed information on price movements across 78 centres in the country. A plot of the inflation trends

(Contd....)

in CPI-IW and the regional dispersion in inflation as measured by the standard deviation indicates that there is considerable co-movement between the two and most of the inflation spikes are also associated with increase in regional inflation dispersion (Chart 1). This shows that region specific supply and demand factors play a crucial role in shocks to inflation.

Notwithstanding the disproportionate impact of supply-side shocks on inflation across regions, an important issue is whether, over the long-run, price levels across regions within the country converge. The law of one price and product and factor mobility, over time, should lead to price equalisation between regions. Empirical evidence in the case of euro area supports the law of one price. Applying panel unit root tests on monthly CPI-IW data for India from April 1990 to January 2014, it is found that the price level deviations from national average do not have a common unit root. This shows that, following a deviation from the national average, price level in a particular region reverts. This implies that the law of one price holds for India as well and the role of aggregate demand management policies like monetary policy remains significant in controlling inflation.

Chart 1: CPI Inflation and Regional Dispersion



References

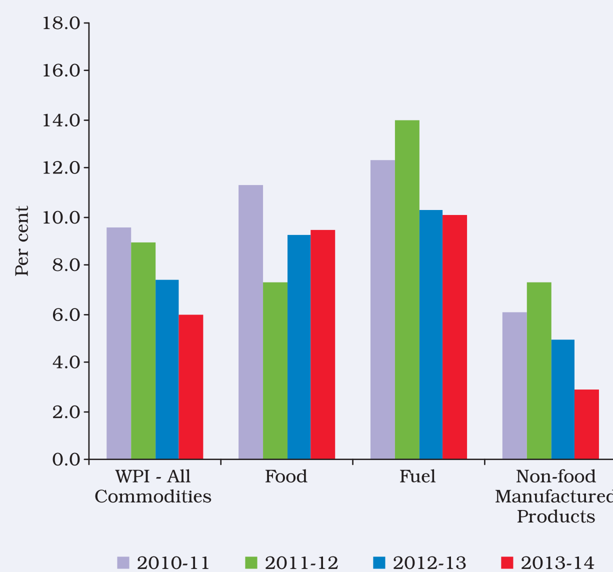
Hendrikx, Maarten and Bryan Chapple (2002). “Regional Inflation Divergence in the Context of EMU,” *MEB Series 2002-19*, Netherlands Central Bank, Monetary and Economic Policy Department.

Cecchetti, Stephen G., Nelson C. Mark and Robert J. Sonora (2002). “Price Index Convergence among United States Cities”, *International Economic Review*, Vol. 43, No. 4.

WPI Inflation too showed moderation during 2013-14

II.2.9 Average wholesale price index (WPI) inflation during 2013-14 at 6.0 per cent was significantly lower than 7.4 per cent during the previous year (Chart II.15 and Appendix Table 3). Whereas inflation in food articles picked up, inflation in the fuel group remained persistent. The decline in overall inflation in terms of the WPI was largely driven by the fall in average inflation in non-food manufactured products, reflecting weak pricing power of the Indian corporate. Softer global commodity prices, especially of metals played a significant role in keeping inflation low in this segment. However, on a year-on-year basis, non-food manufactured product inflation steadily edged up from 2.2 per cent in July 2013 to 4.0 per cent in March 2014 reflecting input cost pressures. Subsequently, it declined to 3.6 per cent in July 2014.

Chart II.15: Trends in Wholesale Price Index Inflation



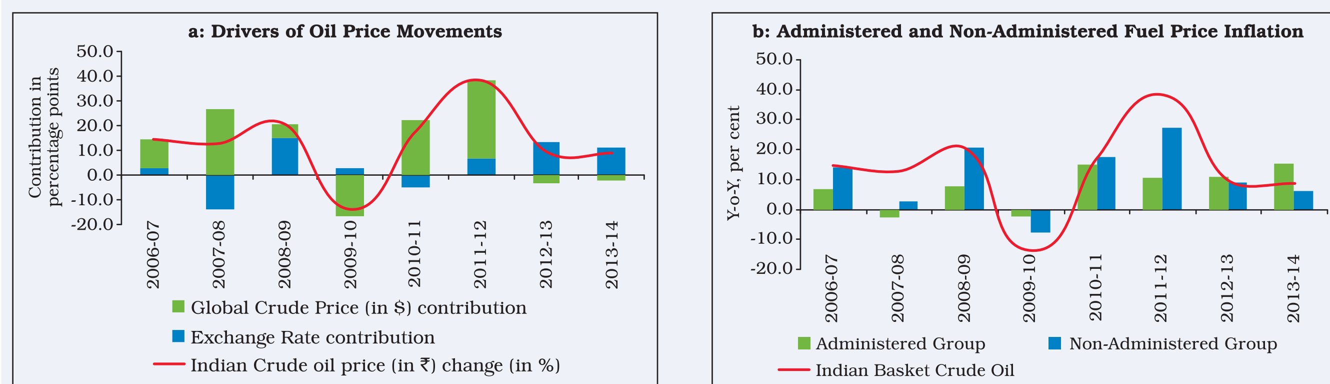
Administered fuel price revisions reduced suppressed inflation, but the process remains incomplete

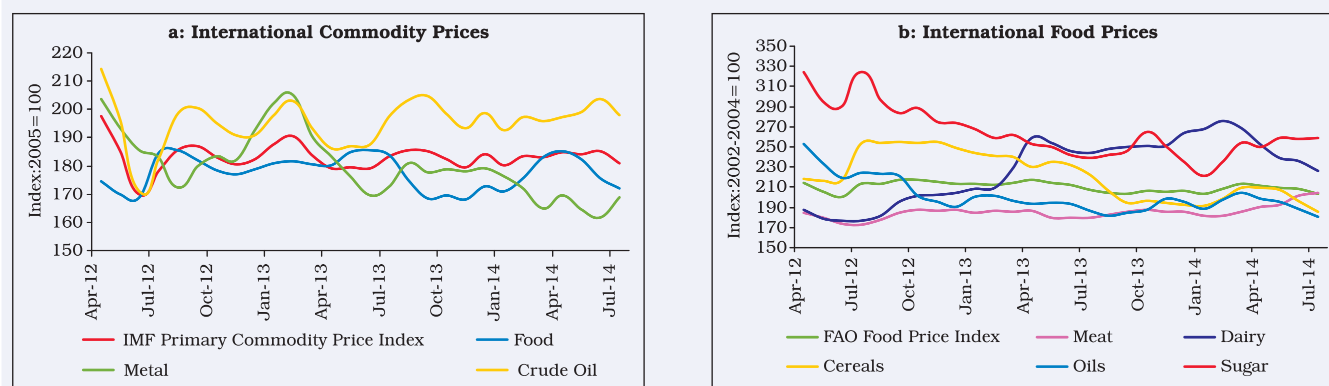
II.2.10 Although international crude prices (Indian basket) declined by about 2 per cent in dollar terms in 2013-14 over the previous year, sharp rupee depreciation since May 2013 and an increase in international crude oil prices resulted in a rebound in WPI fuel inflation to double digit level during 2013-14 (Chart II.16). Administered prices were adjusted in a staggered manner during the course of the year, especially for diesel. The hike in electricity prices in August and December 2013 exerted further pressure on the fuel group inflation. The revision in administered petroleum prices has caused some reduction in the extent of under-recoveries of the Oil Marketing Companies (OMCs). The estimated under-recovery of the OMCs during 2013-14 was high at ₹1.4 trillion, of which 45 per cent was on account of diesel. Currently, the OMCs are incurring daily under recovery of ₹2.26 billion (effective August 1, 2014) on the sale of diesel, PDS kerosene and domestic LPG. Geopolitical developments in the Middle East and Ukraine remain an upside risk to global crude prices with significant implications for inflation and under-recoveries. These will need to be managed by greater flexibility in domestic prices and adequate budgetary provisions.

Global inflation remained diverse among advanced and emerging economies

II.2.11 Globally, inflation pressures vary across advanced and the emerging economies. In advanced economies, inflation remained low aided by range-bound commodity price movements, large spare capacity and high unemployment during 2013-14. Emerging market and developing economies (EMDEs), on the other hand, witnessed inflationary pressures driven by a weaker exchange rate and domestic supply side factors. Many central banks in EMDEs were faced with the trade-off arising from a combination of slowing economic growth and stubborn inflationary pressures. In view of high inflation and exchange rate depreciation, many central banks in the EMDEs including Turkey, Ukraine, Russia, Indonesia and Brazil hiked policy rates. In the case of advanced economies, the US Fed began tapering in a calibrated manner in view of a strengthening economic recovery. The European Central Bank (ECB) introduced negative deposit rate to encourage bank lending for business activity.

Chart II.16: Global and Domestic Fuel Price Movements





Global commodity prices remained range-bound but exchange rate depreciation during H1 of 2013-14 led to some pass-through effects

II.2.12 Global commodity prices continued to soften amid improved supply and weak demand conditions in 2013-14 (Chart II.17). Global crude oil prices witnessed some uptick during H1 of 2013-14 driven by supply outages but declined in H2 of 2013-14 on account of easing supply concerns and tepid demand conditions. Metal prices edged down in 2013-14 aided by surplus supplies and slowing demand in emerging economies, particularly in China and India. The Food and Agriculture Organisation (FAO) food price index declined by 1.6 per cent in 2013 as large supplies pushed down the international prices of commodities such as cereals, oils and sugar.

II.2.13 Global commodity prices, especially of crude oil have remained volatile in 2014-15 so far on account of factors including supply disruptions from Libya, the Ukraine crisis and political developments in Iraq. Brent crude oil spot prices averaged US$111.9/barrel in June 2014 but improved supply prospects in Libya led to subsequent correction in Brent crude oil prices to below US$104 per barrel in early-August 2014. Further, sustained softer prices of non-oil commodities, especially metals offset some of the inflation risks. Weather-related concerns and increased geopolitical tensions have caused global prices of some cereals, especially wheat, maize and barley to firm up during February-April 2014.

Inflation expected to be range-bound during 2014-15 but risks remain

II.2.14 The pick-up in CPI inflation after significant moderation during December 2013-February 2014, especially in July 2014 driven by shocks to food prices indicates that the concerns on inflation are far from over. The unsatisfactory progress of south-west monsoon so far could further exacerbate pressures on food prices as is evident from the spikes witnessed in prices of certain vegetables such as tomato. Such pressures could drive inflation expectations up, necessitating policy actions to contain inflation and mute the second round effects unless supply side actions mitigate price pressures. Global commodity prices may remain range-bound, but pressure on crude oil prices from geopolitical tensions, especially in Iraq could be a major upside risk. With the marked reduction in external sector risks that have imparted stability to the rupee exchange rate, the likelihood of exchange rate pass-through pressures on domestic inflation have receded. However, administered price revisions, particularly in the case of fuel will need to continue in order to reduce the fiscal burden, which will also add some upside pressures on prices in the near-term. Over the medium term, however this will help lower inflation and inflation expectations. The persistence of negative output gap despite a fall in potential output growth should support the disinflation momentum going forward.

II.3 MONEY AND CREDIT

Tapering signal posed challenges to conduct of monetary policy in H1 of 2013-14

II.3.1 The monetary policymaking during 2013-14 can be demarcated into three distinct phases. The easing cycle that began in January 2012 was followed by a 125 basis points (bps) reduction in the repo rate during April 2012 to May 2013. This phase was interrupted by large and sudden capital outflows. The trigger for such huge volumes of outflows emanated from the May 2013 communication by the US Fed regarding the possible tapering of its quantitative easing (QE) in the following months. Uncertainty about the timing and quantum of the tapering led to large capital outflows from emerging market and developing economies (EMDEs), particularly those with high current account deficits (CAD) and high inflation, including India.

II.3.2 EMDEs had to actively tighten their monetary policy stance so as to stem capital outflows and also rely on foreign exchange interventions. The anticipated impact of QE tapering on global liquidity, withdrawal of cross-border capital flows and their effect on asset prices put downward pressure on the rupee, especially in the presence of a large and unsustainable CAD.

Monetary policy challenges from spillovers were not unique to India; significant contagion felt across EMDEs

II.3.3 The monetary policy of central banks in large advanced economies (AEs) spilling over to emerging markets were evident from the developments during 2013-14. The experience of such spillovers provides a rationale for greater policy coordination in this arena (Box II.5).

II.3.4 Facing risks of currency turmoil that could spill over to various forms of macro-financial

Box II.5
The risks from exiting unconventional monetary policies for emerging markets

Spillovers from the unwinding of unconventional monetary policies of the US Fed to the emerging markets economies (EMEs) occurred in significant intensity during 2013-14. Empirical evidence from the in-house research work in the Reserve Bank suggests a clear relationship between the US VIX and the volatility in various financial markets in EMEs, including India. US VIX is a widely tracked measure of volatility in the US equity markets.

Unconventional monetary policy generally refers to non-standard monetary measures. These measures include large-scale asset purchase programmes (LSAPs) also known as quantitative easing (QE) that change the size and composition of a central bank's balance sheet, such as through purchasing less credit worthy, illiquid private sector securities. It also includes forward guidance provided by the central banks to move expectations on long-term interest rates. For all practical purposes, even the policy rates at or near zero lower bound (ZLB) of nominal interest rates constitute unconventional measures. The Bank of Japan has resorted to QE since 2001. Since 2008, it has been joined by the US Fed and the Bank of England in resorting to a significant dose of unconventional monetary policy measures.

In 2013-14, a mere indication by the Fed on tapering of the QE resulted in stronger spillovers to EMEs. The response to the actual tapering under which the US Fed has reduced its QE asset purchases from US$85 billion a month to US$25 billion so far (up to August 2014) was relatively muted. However, risks of further spillovers remains if the US monetary policy tightening cycle takes an uncertain turn or significant tightening occurs in a relatively short span. In the past, several but not all of these tightening cycles have witnessed a significant impact on bond yields, currencies and equities in global financial markets.

In February 1994, when the Federal Open Market Committee (FOMC) indicated the start of the tightening, Federal funds rate rose by 300 bps in a year. There was a severe negative reaction in bonds in both AEs and EMEs, though in the case of equities it were essentially the EMEs equities that got battered. The spillovers also resulted in the occurrence of the Mexican peso crisis of 1994-95. The EMEs bond market spreads over US treasuries reached a high, up to 1500 bps in some cases at that stage. Regarding the spillovers from the tapering in 2013, Eichengreen and Gupta (2013) indicated that the largest impacts of the tapering were felt by countries

(Contd....)

that allowed exchange rates to run up in the earlier period in expectation of continuous Federal Reserve's easing. Countries with larger markets experienced more depreciation pressures and macroeconomic fundamentals like budget deficit, public debt, level of reserves and GDP growth rates which provided little insulation to countries that came under depreciation pressure during the summer of May 2013.

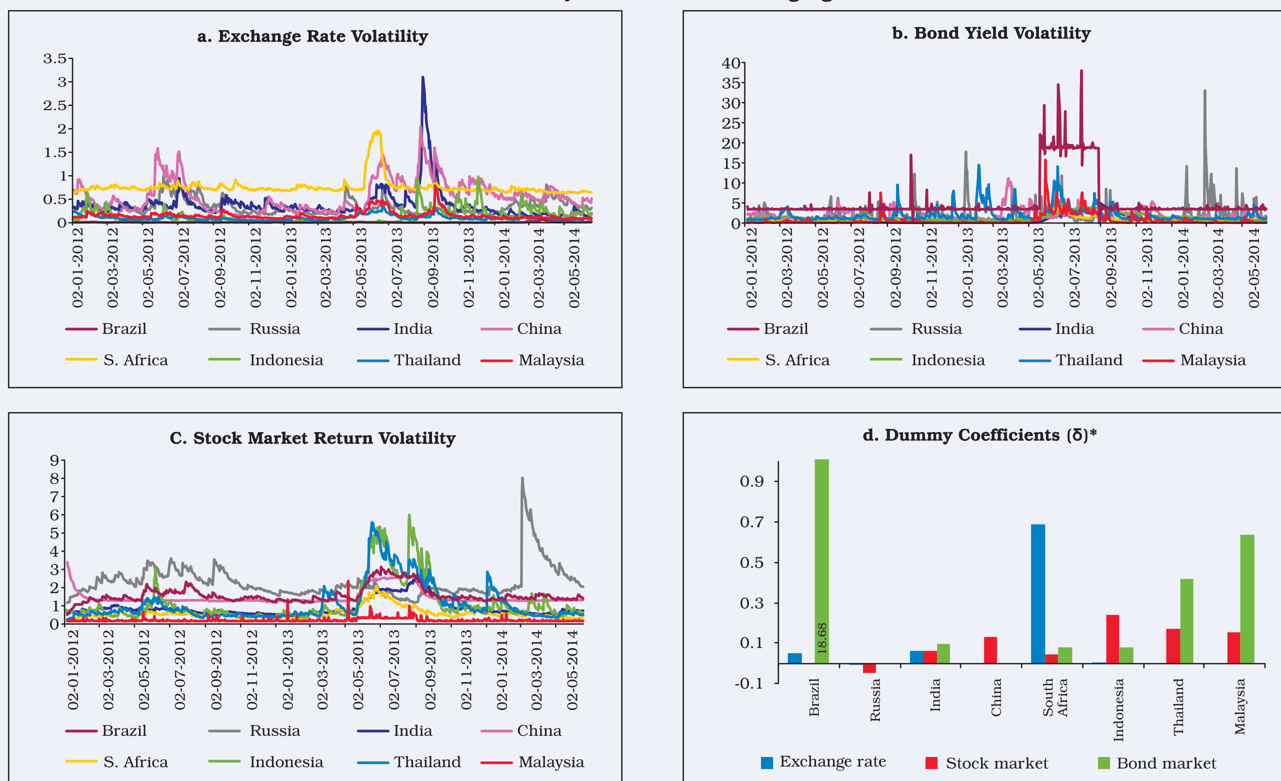
Besides currency depreciation pressures, financial market volatilities resulting from the QE taper have been a major concern in the policy arena especially for emerging market economies (EMEs). Following literature on clustering of financial markets volatility, an augmented GARCH(1,1) model was used to model the daily volatility of stock market returns, percentage change in the exchange rate (USD as the base currency) and changes in benchmark (10-years) yield for BRICS and a set of Asian emerging markets.

These estimations use daily data from January 2012 to May 2014. A dummy variable that takes value one for *Fed's tapering talk*, that is, May 22, 2013 to August 2013 otherwise zero was introduced in the volatility equation. The estimated conditional variance series are given in Chart 1.

The GARCH volatility estimates in most of the emerging market countries indicate a spillover in currency, bond and equity markets of the *Fed's tapering talk* during May to August 2013. Uncertainty about the magnitude of the taper and fears of future rate hikes led to the withdrawal of capital flows from emerging markets in this period. The estimated dummy variable coefficients were mostly significant and positive, indicating that the increase in volatility in the EMEs was due to the uncertainty surrounding the possibility and magnitude of QE withdrawal.

Rey (2013) in her Jackson Hole paper emphasised the role of a global financial cycle in capital flows, asset prices and credit growth, which co-moves with the VIX. Her central argument is the existence of the 'irreconcilable duo' rather than the 'impossible trinity', implying that independent monetary policies are only possible with managed capital accounts. The paper adds that one of the policy options to cope with the dilemma is to act on the policies of a large source country that generates these cycles (such as that from QE). However, these source countries are unlikely to agree to this. To further examine Rey's proposition during the

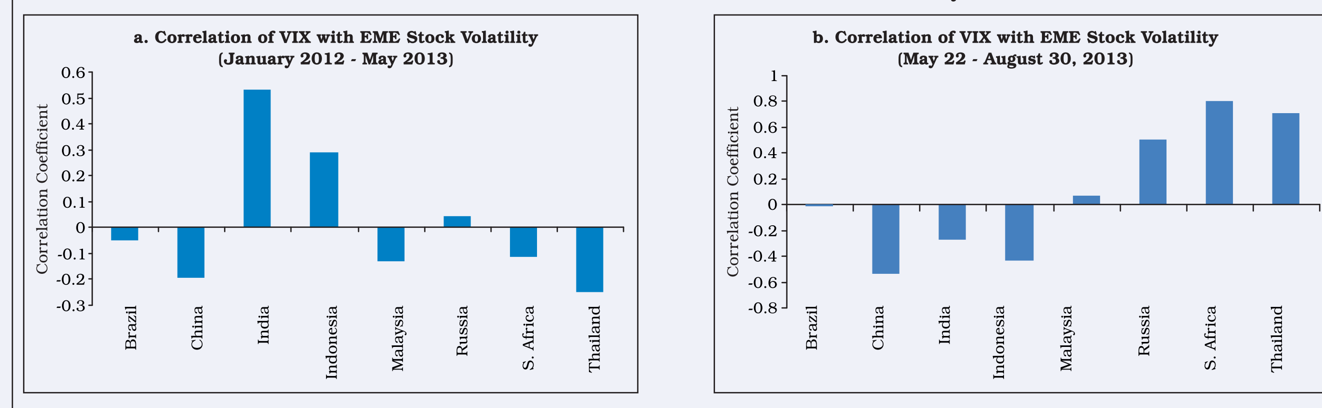
Chart 1 : Volatility Estimates for Emerging Markets



Note: In Chart d, statistically not significantly different from zero δ-coefficients are plotted as zero.

(Contd...)

Chart 2 : Correlation of VIX with EME Stock Volatility



tapering of QE, an analysis of the US-VIX and the estimated GARCH volatility for the 8 emerging stock markets (including BRICS) indicate changes in the correlations during the taper announcement period. Chart 2 plots the changes in magnitude and signs of stock market volatility correlation during the Fed tapering talk (May-August 2013) indicating the impact of tapering on emerging stock markets.

Rajan (2014) has pointed out that the current 'non-system' in international monetary policy as a source of substantial risk, and argued for more consideration by source countries to the effect that their policies will have on other countries. The adverse effect of such a feedback loop might be minimised by greater coordination among systemically important central banks, multilateral arrangements for liquidity provision, better micro-prudential measures, or independent assessors who could analyse such policies and come to a judgement on whether they follow the rule of the game. These measures could minimise the snowballing of adverse feedback spillovers of QE-withdrawal taking the locus towards a globally optimal monetary policy framework. While international monetary policy coordination where AE central banks prepare the markets and allow gradual adjustments remains the first best policy choice, EMEs domestic policy responses will need to gear up to convince markets on stable inflation, smooth exchange rate adjustments and effective micro and macro-prudential policies.

References:

Eichengreen, Barry and Poonam Gupta (2014), 'Tapering talk: the impact of expectations of reduced federal reserve security purchases on emerging markets', *Policy Research Working Paper Series* 6754, The World Bank.

Rajan, Raghuram G. (2014), 'Competitive monetary easing: is it yesterday once more?', *RBI Monthly Bulletin*, 1-12, available at: http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=886

Rey, Helen (2013), 'Dilemma not Trilemma: The global financial cycle and monetary policy independence', Paper presented at the 25th Jackson Hole symposium, Wyoming, August.

stability and endanger growth over the medium term, the Reserve Bank gave priority to stabilisation of the rupee. In this the second phase, it effected a 200 bps hike in the Marginal Standing Facility (MSF) rate in July 2013 among other measures (see Box III.2, Chapter 3 for chronology of events), thereby increasing the spread between the repo and the MSF rates to 300 bps. With the MSF rate acting as the effective policy rate, the cost of money market funds in the economy increased significantly. Caps on access to the LAF window and an increased average daily CRR requirement (initially to 99 per cent from 70 per cent, and thereafter to 95 per cent) contributed to the tightening domestic liquidity situation and increasing the cost of speculation (Chart II.18a). Increasing domestic interest rates was important to prevent narrowing of the spread that could have accelerated debt

outflows given that FII debt flows are found to be particularly sensitive to monetary policy variables (see Box II.6).

Monetary and liquidity conditions re-calibrated to address rising inflation challenges in H2 of 2013-14

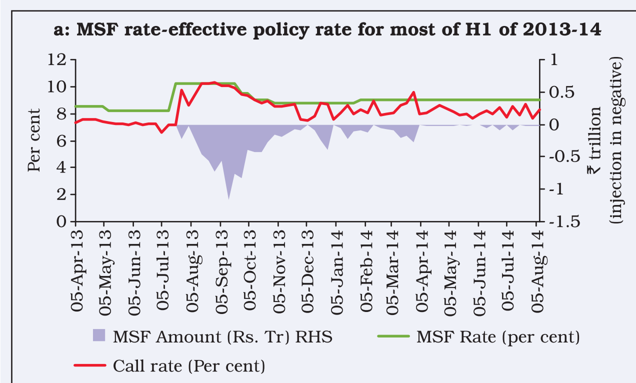
II.3.5 While the pressures on the exchange market were effectively managed by timely measures including the forex swap facility for banks and oil companies, their gradual withdrawal and the calibrated normalisation of the interest rate corridor helped restore stability to the financial markets. However, increasing inflationary pressures and the possible impact on the long term valuation of the rupee, warranted a shift in the policy stance beginning October 2013. In view of the upturn in inflation and elevated inflation expectations and in order to avert the adverse impact of low real rates on financial savings, the Reserve Bank raised the repo rate by 50 bps during September-October 2013 even as the MSF rate was lowered so as to restore the interest rate corridor spread to 100 bps.

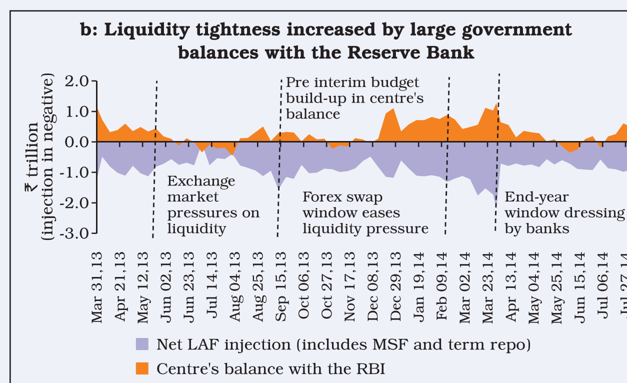
II.3.6 In order to rebuild buffers in the face of uncertainty regarding the global interest rate cycle and financial conditions, the Reserve Bank offered a forex swap window (September 4-November 30, 2013) for banks' overseas borrowing and non-resident deposit (FCNR(B)) funds, resulting in capital inflows in excess of US$ 34 billion through the swap facility. These facilities not only proved to be timely in strengthening external resilience but also helped in easing domestic liquidity significantly, which was reflected in under-utilisation of limits by the banks under overnight LAF repo and export credit refinance (ECR), a steady decline in access to MSF and the parking of excess liquidity with the Reserve Bank through reverse repos.

II.3.7 In order to prevent liquidity tightening measures from adversely impacting financing conditions and with a view to keeping a check on the long-term interest rates in the system, the Reserve Bank conducted OMO purchase auctions that led to net liquidity injection to the tune of about ₹520 billion during the year in addition to injection under LAF and MSF. Although access to overnight liquidity through LAF was restricted, variable rate term repos were introduced with 7 and 14 day tenors.

II.3.8 However, the build up of large surplus cash balances of the government with the Reserve Bank up until the interim budget (February 2014) caused the liquidity situation to tighten again. Despite the subsequent spending by the government, the year-end pressures on liquidity on account of annual closure of bank accounts caused the net recourse to LAF (including term repo and MSF) to shoot up to around ₹2 trillion at the end of the year (Chart II.18b). During 2014-15 so far, liquidity

Chart II.18: Liquidity conditions remained generally tight in 2013-14





conditions have remained broadly stable barring intermittent tightening of liquidity conditions on account of build up of government cash balances maintained with the Reserve Bank.

Enhanced liquidity injection, revaluation gains lead to more balanced net domestic assets (NDA)-net foreign assets (NFA) led expansion in monetary aggregates

II.3.9 Following inflows under swap facilities, the increase in reserve money during 2013-14 was supported by a more balanced NDA-NFA mix as compared with the skewed trend in recent years on the sources side (Chart II.19a).

II.3.10 The broad money growth remained largely in line with the indicative trajectory of 13 per cent for 2013-14. However, netting out the impact of the flows into FCNR(B) deposits through the forex swap facility, the growth in aggregate deposits of residents was lower at around 11 per cent and the corresponding resident money growth (NM3) was also lower. Near static deposit rates have also dampened the pace of deposit mobilisation (Chart II.19b).

II.3.11 Scheduled commercial banks (SCBs') credit off-take and deposit growth at around 14 per cent in 2013-14 remained comparable to that in 2012-13. The closing of the gap between credit and deposit helped reduce the pressure on liquidity.

Uncertainty, slowdown and banking sector asset quality remain a drag on credit off-take

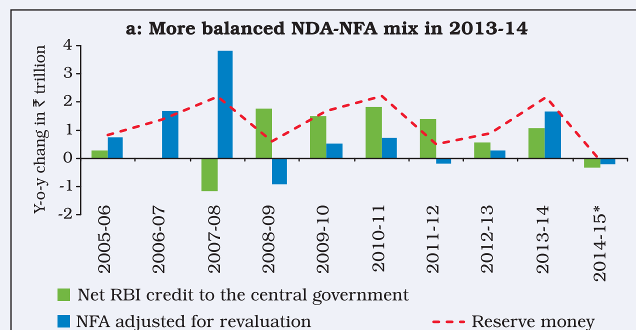
II.3.12 In line with the cyclical downturn, the banking sector has been passing through a challenging phase with deterioration in asset quality, increased provisioning requirements and decelerating profitability indicators. These factors have contributed to increased risk aversion, affecting credit off-take adversely. Although the gross NPAs to the gross advances ratio has increased y-o-y, especially in public sector banks, the pace of growth in NPAs has moderated recently, though it is too early to be confident that the worst is over (See Table VI.2 for banking asset quality indicators).

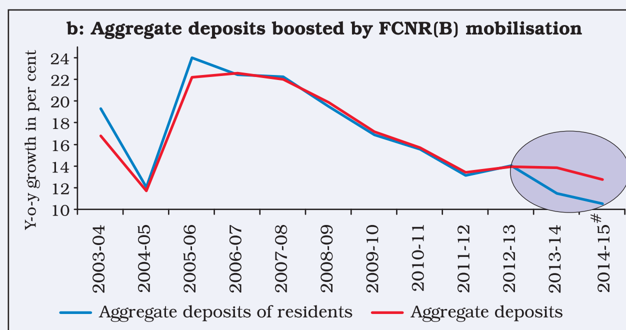
Non-food credit growth led by services, personal loans

II.3.13 The y-o-y credit growth to the industrial sector moderated during 2013-14 to 13.1 per cent as compared to 15.1 per cent in the previous year. Deceleration in credit growth was observed particularly in mining, chemicals, cement and textiles. However, credit flow was higher in construction, rubber and plastic, leather and paper.

II.3.14 The y-o-y credit growth in services and personal loans was at around 16 per cent. While personal loans continued to be led by housing and vehicles there was a significant pick-up in consumer

Chart II.19: Variations in Monetary Aggregates

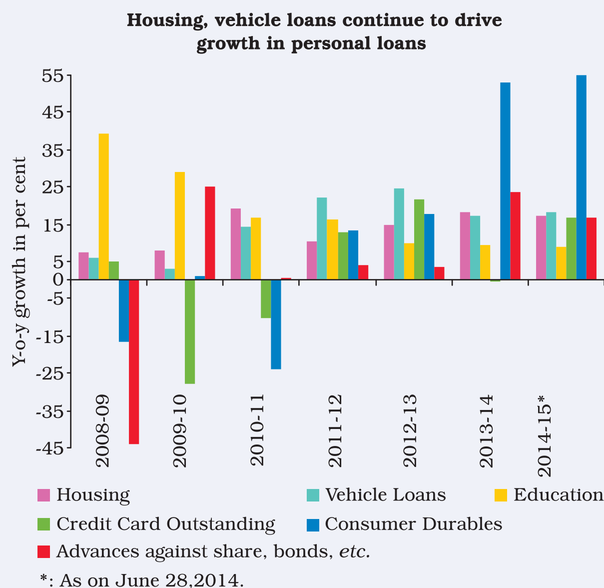




*: Up to June 25, 2014. #: Up to July 25, 2014

Note: Since July 2014 definition of Net RBI credit to the central government changes following Technical Committee recommendation (Chairman: Shri Y. H. Malegam).

Chart II.20: Trends in Sectoral Deployment of Credit



*: As on June 28,2014.

durables and advances to individuals against shares and bonds (Chart II.20).

II.3.15 Monetary and liquidity policies in 2013-14 were shaped by twin risks emanating from external vulnerability and domestic inflation pressures amid downward sticky inflation expectations. While the monetary policy measures along with external sector measures helped in containing external sector risks in the near-term, inflation remains a major threat in achieving sustainable growth and currency stability. The Reserve Bank increased the repo rate in January 2014 to control inflation, anchor inflation expectations and mute their second round effects in line with the disinflationary path as recommended by the Expert Committee to Revise and Strengthen the Monetary Policy Framework. Further, in pursuance of the committee's recommendation to de-emphasise overnight 'guaranteed-access' windows for liquidity management and progressively conducting liquidity management through term repos, the Reserve Bank reduced access to overnight repos under LAF while compensating with a commensurate expansion of the market's access to term repos from the Reserve Bank to improve the transmission of policy impulses across the interest rate spectrum.

II.4 FINANCIAL MARKETS

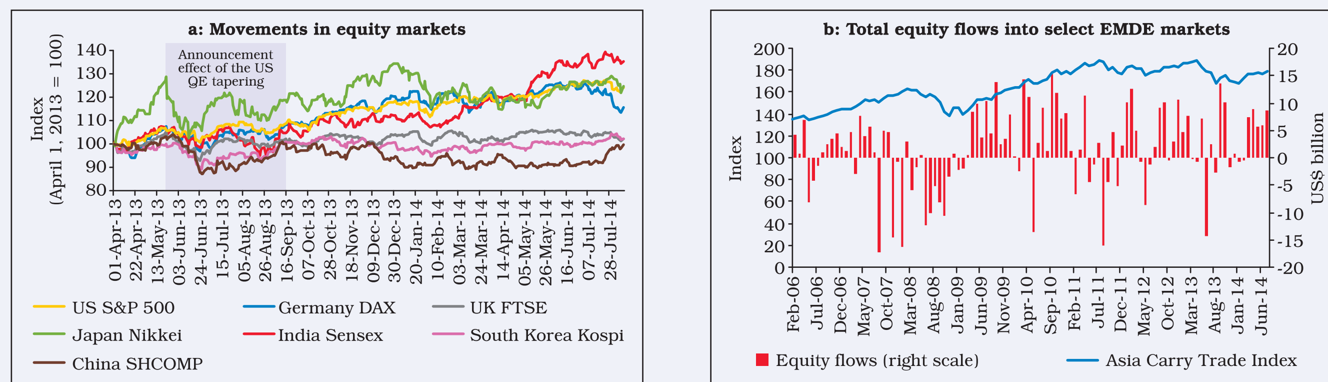
Global financial markets continue to be liquidity driven, withstand the US taper and Ukraine crisis

II.4.1 The year was marked by a spell of sharp increase in financial market volatility since May 2013 and a subsequent fall since September 2013. The US taper indication impacted the Indian financial markets, however, rebuilding buffers by the time the actual taper and the Ukraine crisis took place helped contain spillovers. While the unexpected strife in Iraq appears manageable so long as geopolitical uncertainties do not extend to the south of Iraq or the rest of the region, its ramifications are still unfolding and continued vigilance is warranted.

II.4.2 Overall, policy rate hikes by emerging market and developing economies (EMDEs) helped maintain the large bond interest rate spreads with advanced economies (AEs), thus helping to stem outflows. After initial volatility, markets stabilised both in AEs and EDMEs. In the face of low growth and inflation and the prevailing easy monetary conditions in the AEs, the prices of riskier assets such as equity rose further in 2013-14, while bonds rallied as fears of imminent exit from accommodative monetary policies receded.

II.4.3 Although uncertainties about possible increases in policy rates in AEs, the on-going Iraq crisis and the slowdown in the Chinese economy persist, the measured and predictable pace of the US tapering programme, optimism in developed markets and policy commitments for supporting economic growth in the euro area have calmed financial markets. A number of equity markets including those in the US, Europe and EMDEs have recorded historical highs during 2014-15 so far. Driven by investors' search for yield, carry trade flows to EMDEs remained large, but exhibited a downward trend aided by some unwinding during May-June 2014 (Chart II.21).

Chart II.21: Global Markets Recover as Uncertainties Reduce



Note: 1. Select EMDEs include India, Indonesia, Philippines, South Korea, Taiwan and Thailand.
2. The Asian Carry Trade Index measures the cumulative total return of a buy-and-hold carry trade position that is long four Asian currencies (Indian rupee, Indonesian rupiah, Philippine peso and Thai baht) that are fully funded with short positions in the US dollar. It is assumed that the investment is in three-month money market securities, with each of the four Asian currencies assigned an equal weight in the currency basket.

Source: Bloomberg.

Global asset prices factor low risk premium

II.4.4 The recent surge in global equity markets has come amidst low global growth and inflation and slower earnings growth particularly in the US, suggesting that equity markets are pricing assets with a very low risk premium. With economic growth in the US and the UK expected to improve in the near future, there is a risk that central banks may start increasing policy interest rates earlier than what was previously assessed. Irrespective of whether this happens or not, markets may start pricing rate hikes, which in turn may lead to increased uncertainty and higher volatility. Further, an increase in interest rates in the US may trigger a reversal in carry trade flows to EMDEs leading to higher volatility in the forex, equity and bond markets (Box II.6).

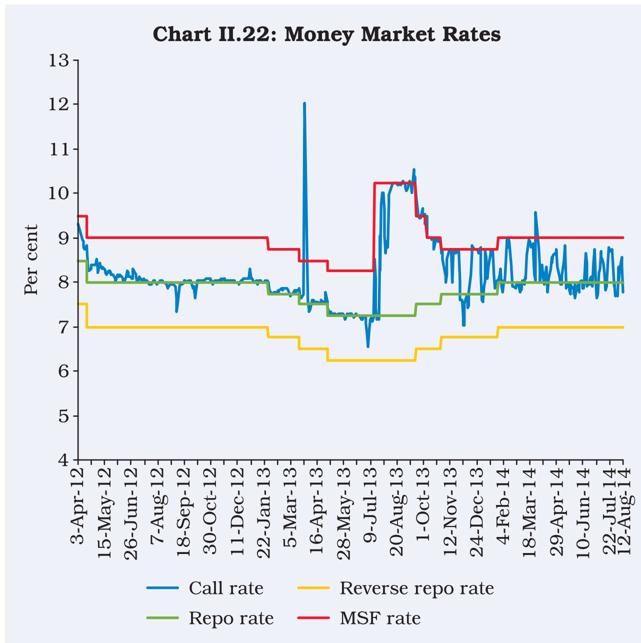
Indian markets price increased risks in H1 followed by quick risk containment in H2 of 2013-14

II.4.5 During 2013-14, the Indian financial markets were marked by periods of intense volatility, particularly during May-August 2013 (accompanying taper related announcements). As bond yields in the AEs, particularly the US, rose sharply, the attractiveness of their fixed income securities *vis-à-vis* those of the EMDEs improved and triggered large-scale sell-offs in domestic financial markets by foreign institutional investors (FIIs), causing intense volatility. Weak macroeconomic fundamentals added to the volatility in the Indian markets, but the impact was largely in line with that of other EDMEs. Opening of forex swap windows combined with restrictions on gold imports restored confidence in the markets immediately. In addition, exceptional liquidity measures to contain volatility and their quick withdrawal helped restore stable market conditions in a sustainable way by September 2013 (see also Section II.3 and Chapter 3).

Money market rates stay firm

II.4.6 Money markets tracked the liquidity conditions and policy rates adjustments during the year. The marginal standing facility (MSF) rate became the effective policy rate after the Reserve Bank placed a cap on the amount provided under the repo window of the liquidity adjustment facility (LAF) as part of the tightening measures to manage exchange rate volatility during July-September 2013. Thereafter, the call rate generally moved

Chart II.22: Money Market Rates



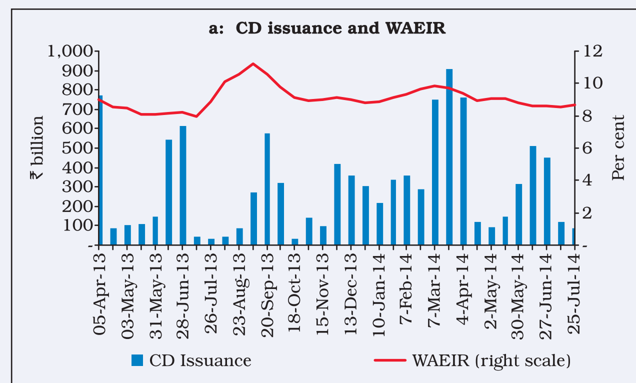
within the corridor set by the reverse repo and MSF rates as the Reserve Bank introduced auction-based variable rate term repo to ensure adequate liquidity (Chart II.22). The weighted average call and collateralised borrowing and lending obligation (CBLO) rates increased to 9.97 per cent and 9.90 per cent respectively in September 2013 from 7.76 per cent and 7.36 per cent respectively in July 2013. However, a calibrated unwinding of exceptional monetary measures during September-October 2013 coupled with easing liquidity conditions on the back of large capital inflows under the forex swap facilities contributed towards the softening of money market rates and led to the restoration of stable conditions in the market. During 2014-15 so far, the money market has remained orderly with the rates moving within the corridor set by the reverse repo rate and the MSF rate.

II.4.7 The average fortnightly issuance of certificate of deposits (CDs) and commercial papers (CPs) decreased in 2013-14 (Chart II.23). The weighted average effective interest rate (WAEIR) of aggregate CD issuances increased to 9.74 per cent at end-March 2014 from 9.24 per cent at end-March 2013. The weighted average discount rate (WADR) of CPs increased to 9.92 per cent at end-March 2014 from 9.77 per cent at end-March 2013. However, reflecting easing short term liquidity conditions, both CD and CP rates decreased to 8.69 per cent in July 2014.

G-sec yields rose during 2013-14, while the yield curve remained flat with inversions at few maturities

II.4.8 G-sec yields softened in the early part of the year reflecting some moderation in domestic inflation and easing of global commodity prices. The 10-year generic yield touched a low of 7.12 per cent on May 24, 2013 compared with 7.99 per cent at end-March 2013. However, following the tapering indication by the US Federal Reserve (Fed) and the subsequent monetary and liquidity tightening measures announced by the Reserve Bank, the yields firmed up. The 10-year generic

Chart II.23: Trends in CD and CP Segments



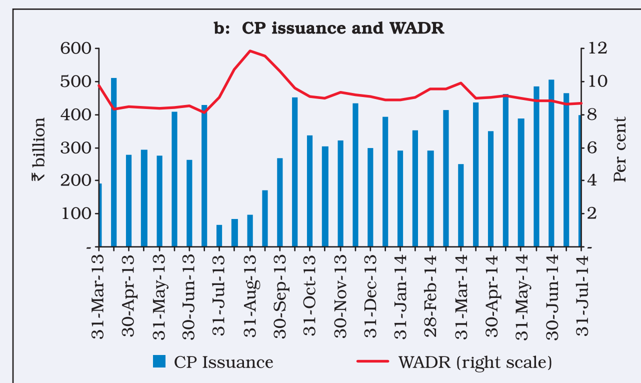
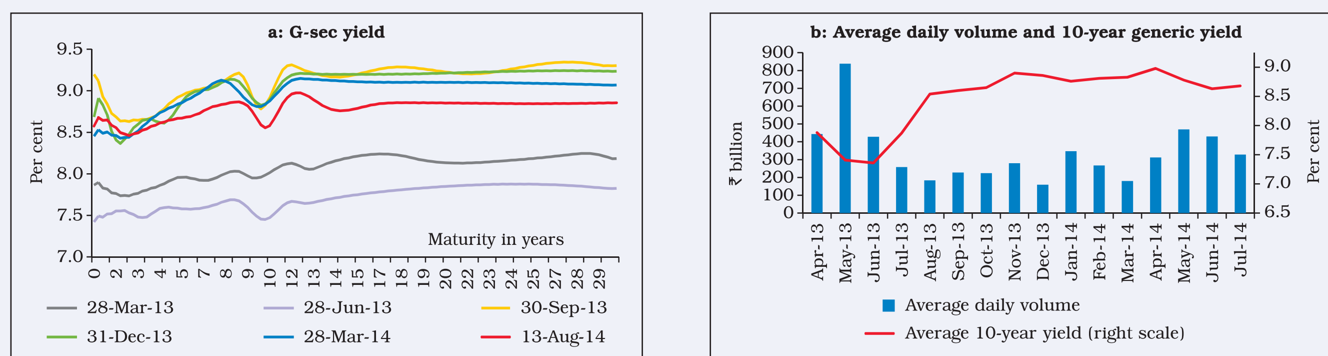


Chart II.24: Trends in the G-sec Market



Source: FIMMDA.

yield peaked at 9.27 per cent on August 19, 2013. However, yields softened thereafter on the back of open market operation (OMO) purchases in August 2013 and on gradual unwinding of exceptional measures to tighten liquidity. Subsequently, relatively higher government borrowings and continued monetary tightening with a view to containing inflation capped the downward movement. The 10-year generic yield closed the fiscal year higher at 8.84 per cent.

II.4.9 Yields have softened during 2014-15 so far reflecting easing of the US treasury yields, active buying by institutional investors, moderation in inflation, improvement in the fiscal situation and growing positive market expectations about government policy after the general elections. The gains had, however, been negated to an extent in June 2014 due to growing geopolitical tension in the Gulf region. The 10-year generic yield stood lower at 8.55 per cent on August 13, 2014 *vis-a-vis* its level at end-March 2014. The yield curve flattened at the longer end as compared to the previous year and the average volume generally varied inversely with the movement of the 10-year G-sec yield (Chart II.24).

Liquidity in the secondary market has improved in recent years

II.4.10 Liquidity in the secondary market for G-secs has improved considerably in recent years. The annualised turnover ratio of outright transactions in the central G-secs has increased. The issuance strategy during the past focused on building volumes under benchmark maturities with a view to improving secondary market liquidity. The Reserve Bank has developed an interest rate derivative market for making the debt market more vibrant and liquid. The re-launch of interest rate futures (IRFs) on a cash settled basis in December 2013 will further augment secondary market activity.

Exchange rate pressures contained in the year, recent appreciation reflects market optimism, stronger fundamentals

II.4.11 The Rupee came under severe pressure after the signalling of tapering of quantitative easing by the US Fed in May 2013, reaching an all-time low of ₹68.36 (RBI reference rate) against the US$ as on August 28, 2013. The Rupee began its recovery thereafter responding to the measures taken by the Reserve Bank and the government and a contraction in current account deficit (CAD). It moved in a range of ₹60.1 to ₹63.0 during Q4 of 2013-14 and appreciated further in Q1 of 2014-15. A cross-country comparison shows that the Rupee performed better than some other peer economies (Table II.6).

FII flows into India remain volatile

II.4.12 During 2013-14, capital inflows through foreign institutions remained highly volatile. The

Table II.6: Movements in Cross-Country Exchange Rates against the US dollar

(Per cent)

	End-Aug 2013 over end-Jun 2013	End-Dec 2013* over end-Aug 2013	Aug 12, 2014 over end-Dec 2013*
1	2	3	4
Argentine Peso	-5.0	-13.1	-21.1
Brazilian Real	-7.3	0.2	3.3
Chinese Yuan	0.1	1.1	-0.8
Euro	1.2	4.1	-3.2
Indian Rupee	**-10.3**	**7.4**	**1.3**
Indonesian Rupiah	-9.1	-10.6	4.5
Malaysian Ringgit	-3.7	0.2	3.1
Mexican Peso	-2.4	2.1	-0.6
Russian Rouble	-1.6	1.6	-9.3
South African Rand	-3.1	-1.6	-1.6
South Korean Won	3.5	5.2	2.4
Thai Baht	-3.0	-2.3	2.3
Turkish Lira	-5.3	-4.1	-1.6

*: Data for end-December 2013 pertain to December 30, 2013.

tapering announcement by the US Fed in May 2013 led to heavy outflows by FIIs from equity and debt markets, aggregating to around US$ 13 billion till August 2013 (Box II.6). However, flows to the equity segment turned positive in September following policy initiatives, and remained positive thereafter, boosting equity indices, except for a marginal outflow in January 2014 when the US Fed actually commenced a reduction in asset purchases. FII flows in the debt segment, however, continued to remain volatile (Chart II.25).

Domestic equity market indicators improved; some sector-specific indices outperformed the broader indices

II.4.13 The equity market remained subdued during May-August 2013, but started recovering following a number of reform measures announced since September 2013. During H2 of 2013-14, the BSE Sensex and the NSE Nifty recorded gains of 20.2

Box II.6
Understanding Foreign Institutional Investor Debt and Equity Flows in India

Concerns about portfolio flows from foreign institutional investors (FIIs) centre around the destabilising effects of 'hot' money inflows during boom periods followed by retrenchment in crises. These concerns have led policy makers around the world to consider restrictions on FII flows, especially in times of macroeconomic stress. A recent Centre for Advanced Financial Research and Learning (CAFRAL)-Reserve Bank study on FII flows into the debt and equity segments of the Indian capital market during 2006 to 2014 has found that: there is moderate correlation between flows into equity and debt and the correlation is indistinguishable from zero when purged of common economic drivers. Flows in the two segments share relatively few common co-determinants apart from past exchange rate movements. Neither equity nor debt flows Granger cause the other.

Past depreciation of the Rupee and other emerging market flows explain equity flows while domestic monetary variables such as interest rates and term spreads, besides Rupee depreciation drive debt flows (Chart 1 and 2). Impulse response functions suggest that most economic effects on equity flows decay within 1-3 months in a roughly exponential

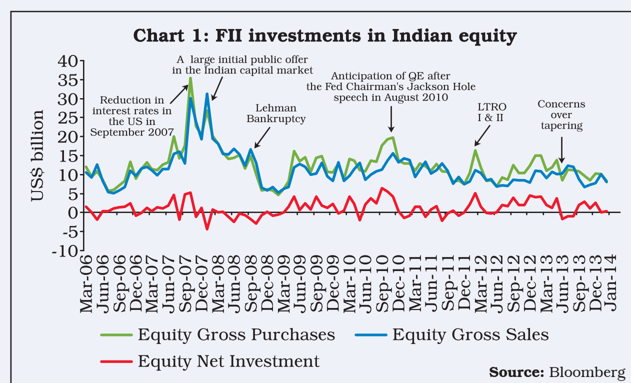


Chart 1: FII investments in Indian equity

Source: Bloomberg

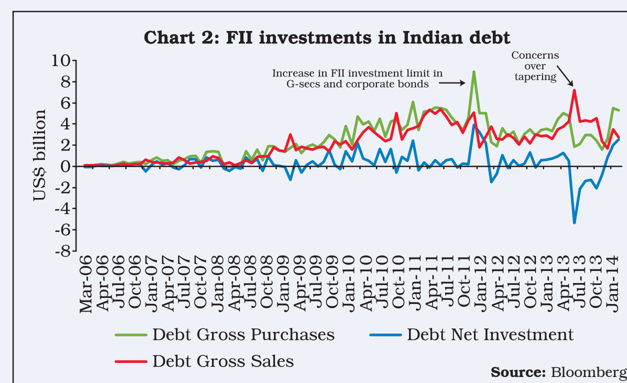


Chart 2: FII investments in Indian debt

Source: Bloomberg

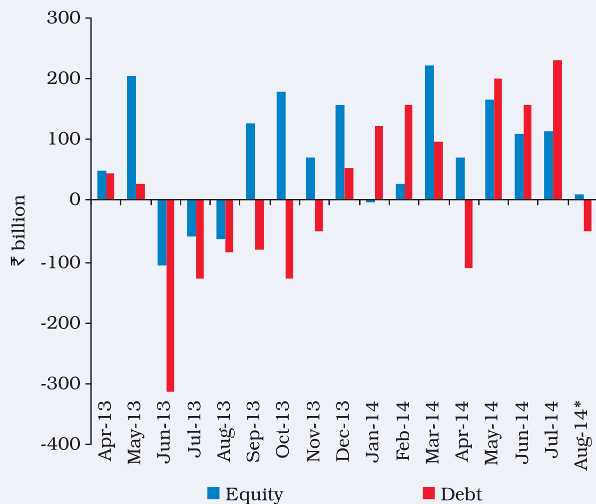
(Contd....)

fashion. For debt markets, positive shocks to domestic term spreads and past bond returns result in FII inflows, while positive shocks to inflation and other emerging market flows lead to FII outflow.

Past stock market returns were found to be the main drivers of sharp spikes in flows, especially reversals in equity markets. Few variables explain surges, while negative stock returns, higher treasury bill yields and a more upward sloping term structure influence equity reversals.

Spikes in FII flows in the debt market are influenced by domestic interest rates, term structure and partly by exchange rates, indicating that even domestic monetary variables matter for debt market inflows (see also para II.3.4). Sharp retractions in flows, particularly debt flows, followed the US talk of tapering of quantitative easing. The results suggest that the US monetary policy spillover is transmitted internationally and one channel is through the markets for sovereign debt.

Chart II.25: Net FII flows in the equity and debt segments

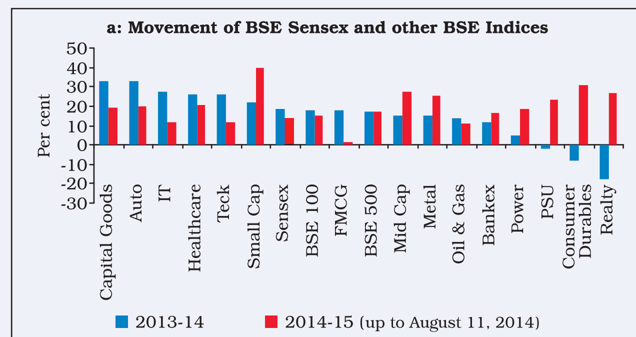


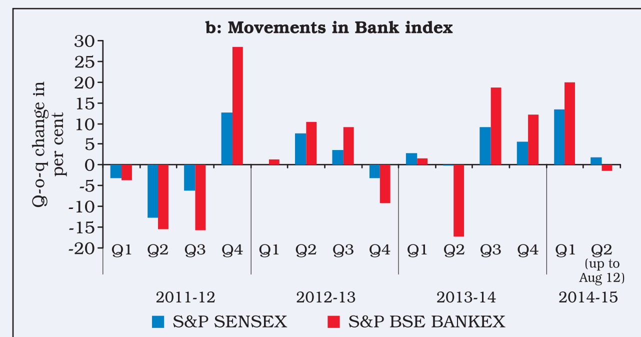
*: up to August 8, 2014
Source: SEBI.

per cent and 22.5 per cent, respectively on expectations of formation of a stable government after the Lok Sabha elections in May 2014. Better than expected earnings results of some blue chip companies, revival of FII inflows and announcement by the US Fed to maintain adequate liquidity in the system also aided market sentiment. Except for a brief spell in January 2014, when the domestic equity market recorded correction amidst the US Fed's reduction of asset purchases and eruption of a political crisis in Ukraine, the markets continued their upward trend. Among the sectoral indices, BSE capital goods, BSE auto, BSE IT, BSE healthcare and BSE teck outperformed the benchmark index during 2013-14, while broader indices such as BSE 100 and BSE 500 under-performed (Chart II.26).

II.4.14 During 2014-15 so far (up to August 13, 2014), both the BSE Sensex and the S&P CNX Nifty have increased by 15.8 and 15.4 per cent, respectively on account of buying by FIIs following the formation of a stable government at the centre and initiation of various economic reforms, good

Chart II.26: Trends in the Equity Market





Source: Bloomberg

quarterly earnings results by major companies, improvement in macroeconomic indicators and positive global cues due to easing of geopolitical tensions and crude oil prices.

II.4.15 Concerns over the asset quality of banks and corporate governance arising from ownership structures of public sector banks, amongst other things have contributed to the low performance of the BSE Bankex since end-March 2013. However, recent regulatory initiatives and reform measures have helped its recovery and it has continued to outperform the benchmark index since H2 of 2013-14. The global crisis highlighted the risks of contagion from bank balance sheets across countries and called for higher standards in regulation to check system-wide stability issues with particular attention to the banking industry. Taking a cue from the crisis, regulatory capital has been beefed up across countries including in India. Nonetheless, the dynamic global developments call for a more robust institutional structure for the banking industry (Box II.7).

Box II.7
Structure of the Banking Industry – A Global Perspective

It is important to review the banking structure in India with a view to enabling it to cater to the needs of a growing and globalising economy as well as furthering financial inclusion. The global financial crisis of 2008 prompted many economies to review their banking structures.

Recently, based on its own research, the World Bank (2013) espoused a balanced view on the debate on state involvement in financial sector in the aftermath of the crisis. It argued that evidence suggests that the state needs to encourage contestability through healthy entry of well-capitalised institutions and timely exit of insolvent ones. While the crisis may have fuelled criticisms of 'too much competition' in the financial sector, leading to instability, research suggests that factors such as a poor regulatory environment and distorted risk taking incentives promote instability rather than competition itself.

Other empirical studies suggest that the banking structure in a country evolves in response to the quantum and types of demand for banking services. These demands, in turn, depend on the country's economic, demographic and geographical features.

In this backdrop, it is important to consider India's banking structure with a cross-country comparison based on some banking indicators (Table 1). These indicators capture size, inclusiveness, ownership pattern, concentration and soundness.

While the Indian banking sector compares favourably in terms of a low concentration ratio and the reasonable soundness indicators, it has some distance to cover in terms of inclusiveness, efficiency, size and ownership. The public sector owns a disproportionately large share of the total

Table 1: Structure of banking industries across select economies

Country	Advanced economies						Emerging market and developing economies				
	Denmark	France	Germany	Italy	UK	USA	Brazil	China	***India***	Russia	South Africa
1. No. of banks (per 100,000 persons)	2.2	1.1	2.3	1.3	0.5	2.1	0.1	0.02	***0.01***	0.7	0.1
2. Banking assets as per cent of GDP	245.0	368.0	124.0	204.0	607.0	84.0	105.0	189.0	***80.0***	75.0	130.0
3. No. of bank branches (per 100,000 adults)	38.7	41.3	15.5	66.0	24.2	35.2	45.5	-	***10.5***	36.8	10.5
4. % of public sector in banking assets	1.0	2.0	32.0	0.1	26.0	0.0	44.0	-	***74.0***	41.0	0.1
5. % of foreign entities in banking assets	21.0	12.0	12.0	18.0	18.0	-	18.0	-	***7.0***	18.0	28.0
6. Concentration ratio (per cent)	81.9	62.7	78.1	63.1	57.6	35.4	62.6	50.8	***28.9***	31.7	77.7
7. NIM (per cent)	1.1	1.0	0.8	1.4	1.5	3.6	5.0	2.9	***3.1***	4.0	2.8
8. Credit/deposit ratio (per cent)	-	131.6	90.0	141.7	-	63.4	115.7	251.4	***75.8***	110.5	110.1
9. CRAR (per cent)	17.2	12.3	16.4	12.7	15.7	14.7	16.3	12.7	***13.1***	14.7	15.1

Note: 1. Data relate to 2011.
2. Concentration ratio refers to the share of top three banking institutions in total assets of the banking industry.
3. NIM – Net interest margin; CRAR - Capital to risk weighted assets ratio.

Source: Financial Structure Database, World Bank; Financial Access Survey, IMF; Barth *et al.*, 2013; Financial Soundness Indicators, IMF; BankScope Database.

(Contd....)

banking industry, thus diluting the advantage of low concentration. NIMs are also high in the face of low competition and come in the way of efficiency.

This underscores the need for increasing the number of banking institutions, especially in the private sector. The discussion paper on ‘Banking Structure in India - The Way Forward’ released by the Reserve Bank in August 2013, advocated fresh bank licensing on a ‘continuous authorisation’ basis rather than a ‘stop and go’ licensing policy, though with stringent entry norms to encourage only well-qualified entities. It also spelt out a reoriented tiered banking structure for India having a few large banks with domestic and international presence, several mid-sized niche banks, regionally focused urban cooperative and regional rural banks and a large number of small privately owned local banks. The committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Dr Nachiket Mor) submitted its report in January 2014 and recommended a vertically differentiated banking structure in which banks specialise in one or more of 3 functions - payments, credit delivery and retail deposit taking. The committee, thus, recommended the licensing of new categories of specialised banks including payments banks and wholesale banks. Although regionally focussed small banks continue to have a strong appeal for inclusion, the committee noted that they may have low demonstrated stability in the Indian context. The committee also recommended the development of robust solutions *vis-à-vis* regulation, supervision, risk management and governance of the existing regionally focussed banks before any new ones are created (also see Box VI.4).

As part of reorienting India’s banking structure, the Reserve Bank undertook a mammoth exercise that culminated in granting ‘in-principle’ approval to 2 applicants: IDFC Limited and Bandhan Financial Services Private Limited, to set up banks under the Guidelines on Licensing of New Banks in the Private Sector issued on February 22, 2013. These two applicants were also recommended as suitable for grant of ‘in-principle’ approval by the High Level Advisory Committee (HLAC) (Chairman: Dr Bimal Jalan), set up by the Reserve Bank. HLAC’s recommendation that the application of the Department of Posts be considered separately in consultation with the Government of India has also been accepted by the Reserve Bank. Going forward, more regular licences, *i.e.,* virtually ‘on tap’, would be provided.

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Reserve Bank of India (2013), Discussion Paper on ‘Banking Structure in India - The Way Forward.’

Reserve Bank of India (2014), ‘Committee on Comprehensive Financial Services for Small Businesses and Low Income Households.’

The World Bank (2013), ‘Rethinking the Role of State in Finance’, *Global Financial Development Report*.

Subdued primary market in 2013-14, but may improve ahead

II.4.16 During 2013-14, the initial public offering (IPO) segment had only one mega issue by Just Dial. Resource mobilisation through the primary market segment remained subdued due to sluggish investment activity and higher volatility in the secondary market. Private placements of non-convertible debentures (NCDs) also declined. However, public issues of debt increased by 150 per cent to a record high of ₹424 billion in 2013-14 mainly on account of higher resource mobilisation by public sector entities through tax free bonds (Table II.7, Appendix Table 4). Going forward, in 2014-15, the primary equity market may improve backed by an already buoyant secondary market. In order to revive the primary market, the Securities and Exchange Board of India (SEBI) announced a slew of measures related to IPOs and offer-for-sale including 25 per cent public shareholding norms for public sector undertakings as also issued guidelines for Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts.

Housing prices rose at a moderate pace

II.4.17 Housing prices as captured by the Reserve Bank’s House Price Index had been growing at an average rate of over 20 per cent

Table II.7: Primary Capital Market Mobilisation Shows Some Improvement

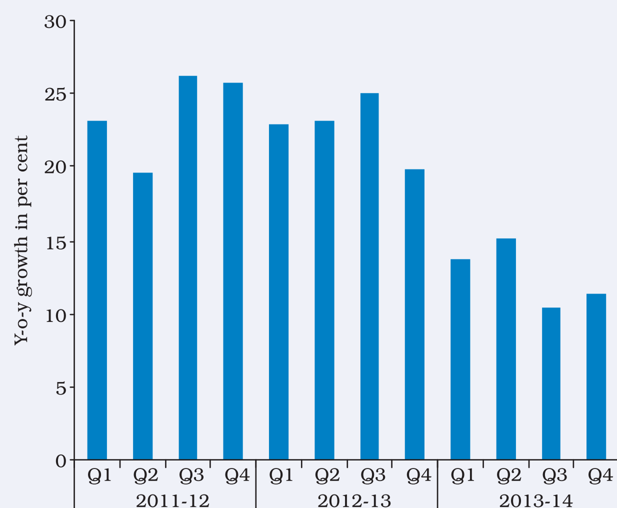
(₹ billion)

Category	2012-13	2013-14	2013-14*	2014-15*
1	2	3	4	5
a. Public Issues (i)+ (ii)	219.2	510.8	10.8	15.9
i) Public issues (Equity) *of which*	49.4	86.9	9.4	2.4
IPOs	49.4	12.4	9.4	2.4
FPOs	0.0	74.6	0.0	0.0
ii) Public issues (Debt)	169.8	423.8	1.3	13.4
b. Rights issue	89.4	45.76	4.2	7.3
Total Equity Issues (i +b)	**138.8**	**132.7**	**13.6**	**9.7**
c. ADR / GDR	10.4	1.2	1.2	0.0
d. Mutual fund mobilisation (net)	765.4	537.8	956.1	863.7
1. Private sector	637.9	488.4	773.8	780.0
2. Public sector	127.5	49.4	182.3	83.7
e. Private placement in corporate debt market	3,614.6	2,760.5	509.7	1,107.8
f. QIP	160.0	136.6	42.9	71.6

*: April-June.
Source: SEBI.

(y-o-y) in the past 3 years. However, the pace of growth slowed in 2013-14 with an average growth in the all-India index at 12.6 per cent reflecting a correction in trends on the back of subdued demand (Chart II.27).

Chart II.27: Movement in the Housing Price Index



Note: All India index is a weighted average of city indices; weights based on population proportion. The base year 2010-11 = 100.

II.5 GOVERNMENT FINANCES

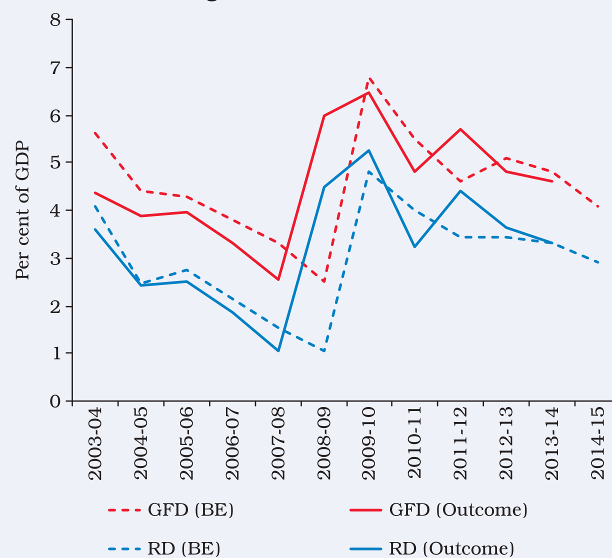
Continuation of fiscal consolidation in 2013-14 as reflected in improvement in key deficit indicators

II.5.1 Fiscal consolidation is key for maintaining both internal and external stability. The twin deficit risks that loomed large during H1 of 2012-13 were brought under control by lowering the fiscal gap since H2 of 2012-13. Recognising the spillover of high fiscal deficit into larger CAD was an important motivation for the central government to continue the fiscal consolidation process in 2013-14, even though this was also needed from the perspective of aggregate demand management and its inflationary implications. Notable gains in containment of key deficit indicators in 2013-14 are apparent in the provisional accounts (PA) (Chart II.28). In terms of ratio of GDP, revenue deficit (RD), gross fiscal deficit (GFD) and primary deficit (PD) were placed lower at 3.2 per cent, 4.5 per cent and 1.2 per cent, respectively (Appendix Table 5).

Quality of fiscal consolidation and transparency in fiscal accounting remain a concern

II.5.2 Notwithstanding the progress in achieving deficit targets, there are concerns regarding the

Chart II.28: Deficit Indicators - Budget Estimate *vs* Outcome



quality of fiscal consolidation and transparency in fiscal accounting. Fiscal consolidation in 2013-14 *vis-à-vis* budget estimates (BE) was mainly achieved through reduction in capital expenditure and plan revenue expenditure, necessitated by a significant shortfall in tax revenues and disinvestment proceeds. Gross tax revenues suffered a shortfall of 7.9 per cent from the budgeted level in 2013-14, primarily due to lower indirect tax collections which were affected by industrial slowdown, deceleration in services sector growth and lower imports. Non-tax revenues exceeded the budgetary targets, aided in large part by *ad hoc* dividend receipts from various public sector enterprises (Table II.8).

II.5.3 Both capital expenditure and capital outlay, as per cent of GDP, were lower in 2013-14 (PA) than their budgeted levels. Non-defence capital outlay during 2013-14 was lower at 0.8 per cent of GDP than 1.1 per cent budgeted for the year. Cutback in capital expenditure has potential adverse implications for growth prospects in the medium term.

Table II.8: Fiscal Performance of the Central Government

(Per cent of GDP)

Variables	2004-08 (Avg)	2007-08	2008-10 (Avg)	2010-2014 (Avg)	2013-14 (PA)
1	2	3	4	5	6
Non debt receipts	**10.4**	**11.1**	**9.5**	**9.5**	**9.3**
Tax revenue	7.8	8.8	7.5	7.2	7.2
Non-tax revenue	2.1	2.1	1.8	1.8	1.8
Non debt Capital Receipts	0.4	0.2	0.3	0.4	0.4
Total Expenditure	**13.8**	**13.6**	**15.8**	**14.4**	**13.8**
Revenue Expenditure	11.9	11.9	14.1	12.7	12.1
Capital Expenditure	1.9	1.7	1.7	1.8	1.7
Gross Fiscal Deficit	**3.4**	**2.5**	**6.2**	**5.0**	**4.5**
Adjusted GFD*	**3.9**	**3.1**	**7.2**	**5.0**	**4.5**

*: GFD adjusted for bonds *issued in lieu* of subsidies. Avg: Average.

Note: Total expenditure, capital expenditure and non-debt capital receipts have been adjusted for pre-payment to National Small Savings Fund in 2004-05 and transactions relating to transfer of Reserve Bank's stake in State Bank of India (SBI) to the Government in 2007-08.

II.5.4 Curtailment of expenditures through unpaid/deferred subsidies also helped to meet the deficit targets in 2013-14. This practice shifts the expenditure burden to subsequent years leading to fiscal imbalances over time. There is, therefore, a need for improving fiscal accounting and transparency.

Further fiscal consolidation needed over the medium-term based on both expenditure cutting and revenue augmentation

II.5.5 Further strides are needed on the fiscal consolidation front despite recent gains. Scope exists for expenditure reorientation by curtailing subsidies and increasing public investment. Subsidies accounted for nearly 23 per cent of the total non-plan spending during 2013-14. Notwithstanding some progress over the last 2 years in bringing subsidy expenditure under control, further expenditure reduction can be achieved through better targeting of subsidies, more frequent price revisions in domestic LPG and controlled fertilisers and by considerably limiting interest subventions. Of the remaining expenditure, it is important to preserve and increase expenditure on human and physical capital in order to improve the economy's growth potential (Table II.9).

II.5.6 Given that compressing expenditure alone may not deliver the targets set under the amended Fiscal Responsibility and Budget Management (FRBM) Act and could, beyond a point, hamper growth prospects, the fiscal strategy in the coming years has to accord greater focus to revenue augmentation. There has hardly been any improvement in the gross tax revenue-GDP ratio of the central government, notwithstanding the gradual withdrawal of fiscal stimulus. Barring personal income tax and service tax, all the major

Table II.9: Select Items of Expenditure of the Central Government

(Per cent of GDP)

Components	2004-08 (Avg)	2007-08	2008-10 (Avg)	2010-14 (Avg)	2013-14 (RE)
1	2	3	4	5	6
Committed Expenditure#	4.7	4.4	4.9	4.4	4.6
Defence	2.1	1.8	2.1	1.9	1.8
Subsidies@	1.9	2.0	3.2	2.4	2.3
Non-Plan Grants to States	0.7	0.7	0.7	0.6	0.5
Expenditure on physical and human capital*	2.0	2.6	2.9	2.2	2.0
Of which:					
Human Capital	1.2	1.2	1.9	1.4	1.2
Physical Capital	0.8	1.4	1.0	0.8	0.8

#: Indicates expenditure on interest payments, pension and pay and allowances.

@: Includes special securities issued in lieu of subsidies.

*: Indicates capital outlay and expenditure on education, health and rural development.

taxes as a percentage of GDP were significantly lower in 2013-14 than the level achieved in the pre-crisis year of 2007-08 (Table II.10). It is, therefore, imperative to improve the gross tax-GDP ratio through tax reforms, widening of the tax base and better tax administration, to make further progress in fiscal consolidation. A more effective strategy for disinvestment that takes into account evolving market conditions and proper pricing of natural resources will also help to augment the resources of the government.

Table II.10: Gross Tax Revenue Raised by Central Government

(Per cent of GDP)

Components	2004-08 (Avg)	2007-08	2008-10 (Avg)	2010-14 (Avg)	2013-14 (PA)
1	2	3	4	5	6
Gross Tax Revenue	**10.6**	**11.9**	**10.2**	**10.1**	**10.0**
Corporation Tax	3.1	3.9	3.8	3.6	3.5
Income Tax	1.7	2.1	1.9	1.9	2.1
Customs Duty	1.9	2.1	1.5	1.6	1.5
Union Excise Duty	2.8	2.5	1.8	1.7	1.5
Service Tax	0.7	1.0	1.0	1.2	1.4

Union Budget 2014-15 relies on buoyant tax revenues and higher disinvestment to reduce the fiscal gap

II.5.7 The Union Budget for 2014-15 has envisaged further reduction in key deficit indicators relative to GDP through higher non-debt receipts-GDP ratio which would more than offset a marginal increase in total expenditure-GDP ratio. With the expected growth of 19.8 per cent in overall tax revenues[1], the gross tax revenue-GDP ratio is budgeted to improve by 0.6 percentage points to 10.6 per cent during 2014-15. Non-debt capital receipts are budgeted to increase by 84.6 per cent in 2014-15 mainly due to a sharp growth in disinvestment proceeds.

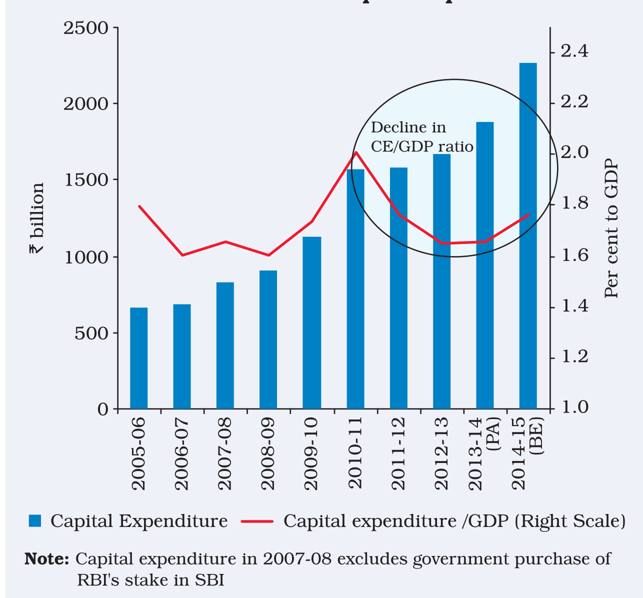
Non-plan expenditure to moderate in 2014-15 through containment of subsidies; capital expenditure budgeted to increase

II.5.8 Total expenditure is budgeted to increase by 14.8 per cent in 2014-15. Non-plan expenditure-GDP ratio is budgeted to decline by 0.3 percentage points to 9.5 per cent in 2014-15, mainly by containing subsidies. Among the other major non-plan expenditure items, while growth rates in interest payments and grants to states are envisaged to decelerate sharply in 2014-15, growth in defence expenditure is budgeted to show a moderate increase. Although plan expenditure is budgeted to increase at a significantly faster pace than non-plan expenditure, it will still remain less than one-third of the total expenditure.[2]

[1] All comparisons of 2014-15(BE) are with respect to 2013-14 provisional accounts.

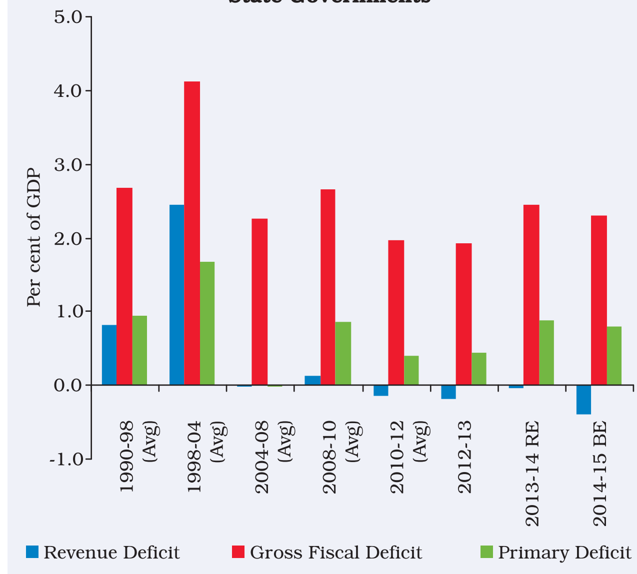
[2] The actual plan expenditures in 2012-13 and 2013-14 were lower than their budgeted levels by 20.6 per cent and 18.4 per cent, respectively.

Chart II.29: Trend in Capital Expenditure



Note: Capital expenditure in 2007-08 excludes government purchase of RBI's stake in SBI

Chart II.30: Key Deficit Indicators of State Governments



II.5.9 Capital expenditure as per cent of GDP is budgeted to increase marginally to 1.8 per cent in 2014-15, still below 2 per cent attained in 2010-11 (Chart II.29).

States performed better in the second phase of fiscal consolidation

II.5.10 States resumed their fiscal consolidation in 2010-11 consequent to the amendments in their FRBM Acts in line with the targets set by the Thirteenth Finance Commission (FC-XIII) (Chart II.30). Fiscal consolidation during 2010-13 was largely revenue-led, with significant increases in both own tax revenue as well as current transfers from the Centre, the latter reflecting the enhancements recommended by FC-XIII. The aggregate expenditure-GDP ratio was higher than that in the earlier high growth period of 2004-08 mainly on account of a sharp increase in development expenditure, particularly social sector expenditure.

Some deterioration in state government finances was seen in 2013-14, while improvement is budgeted in 2014-15

II.5.11 The consolidated fiscal position of state governments[3] indicates an increase in the GFD-GDP ratio to 2.4 per cent in 2013-14 (RE) from 1.9 per cent in 2012-13 due to an increase in aggregate expenditure, which more than off-set the increase in revenue receipts. Revenue surplus during the year was negligible as against a surplus of 0.2 per cent of GDP in 2012-13. The capital outlay-GDP ratio during 2013-14 (RE) increased by 0.4 percentage points over that in the previous year.

II.5.12 The BE for 2014-15 indicates a decline in the GFD-GDP ratio by 0.1 percentage point over 2013-14 (RE) mainly due to an increase in revenue receipts through higher current transfers from the Centre. The expenditure pattern shows that the committed expenditure-GDP ratio (comprising interest payments, administrative services and

[3] Based on budgets of 26 state governments for 2014-15, of which 5 are vote on account.

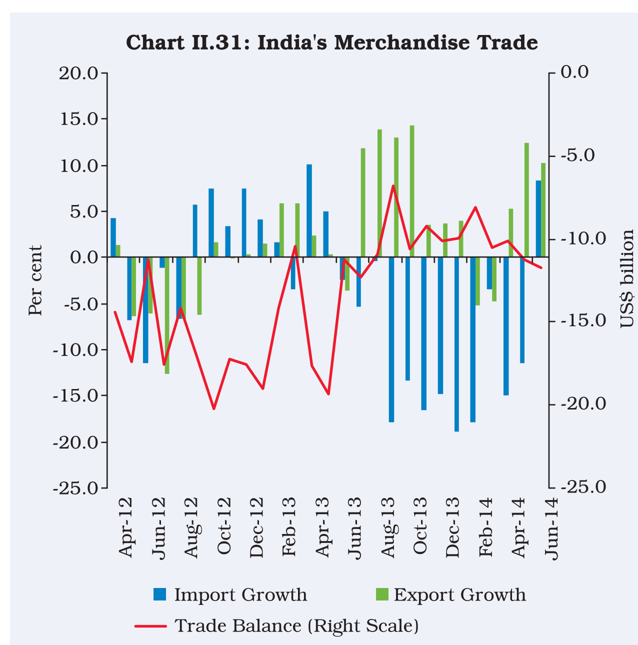
pension) will broadly remain unchanged during 2014-15 (BE), while overall expenditure as a ratio to GDP is budgeted to increase.

Combined fiscal deficit shows deterioration in 2013-14

II.5.13 The combined gross fiscal deficit of the Centre and the states is placed higher at 7.0 per cent of GDP in 2013-14 (RE) as compared to 6.8 per cent in 2012-13. The decline in the fiscal deficit of the central government by 0.2 percentage points during 2013-14 (RE) was more than off-set by the sharp increase in the fiscal deficit of states by 0.5 percentage points. In 2014-15 (BE), the combined fiscal position is, however, budgeted to improve, reflecting the process of fiscal consolidation, both at the Centre as well as state levels. The combined fiscal deficit in 2014-15 (BE) is placed lower at 6.4 per cent of GDP (Appendix Table 6). Adherence to this target will be important as high fiscal deficit financed through debt issuances and the resultant public debt accumulation have an adverse impact on the economy, both in the short-run as well as the long-run.

II.6 EXTERNAL SECTOR

II.6.1 India's external sector underwent a major adjustment in 2013-14. After widening to a historical annual high of 4.7 per cent of GDP during 2012-13, the current account deficit (CAD) narrowed sharply in 2013-14 aided by a lower trade deficit. A modest recovery in exports and a sharp fall in imports, particularly gold imports, helped in improving India's trade balance. Following a lower trade deficit accompanied by robust growth in services export and stable flows of remittances, CAD declined to 1.7 per cent of GDP in 2013-14 (Chart II.31, Appendix Table 1). Various proactive policy measures undertaken by policy authorities helped in mitigating external sector vulnerabilities and containing CAD within sustainable limits.



Modest recovery in exports albeit under-performance of some major sectors

II.6.2 Reflecting the lagged impact of rupee depreciation and modest recovery in some trade partner economies, India's exports started improving in July 2013. However, the uptrend in exports was halted in February-March 2014 before it resumed in Q1 of 2014-15. Exports mainly benefitted from greater demand from Saudi Arabia, Iran, China, the US, EU countries and Japan (Table II.11). Although export demand in a majority of the sectors witnessed an upturn, exports in the gems and jewellery sector declined both due to a fall in international prices of gold and silver and lower demand in select economies such as UAE. In fact, the robust trend in demand for gems and jewellery from major destinations, *viz.*, the US, Hong Kong and Belgium was nullified by a sharp decline in exports to UAE. Similarly, broadly reflecting a fall in gross refinery margins in the first three quarters of 2013-14, India's exports of petroleum products to Singapore, UAE and the Netherlands moderated significantly.

Table II.11: Major Destinations of Export Growth in 2013-14

Country	Exports (US$ billion)		Contribution to Export Growth (%)		Major Commodities
	2012-13	2013-14	2012-13	2013-14	
1	2	3	4	5	6
US	36.2	39.1	-25.6	24.3	Gems and jewellery, petroleum products and marine products
Saudi Arabia	9.8	12.2	-73.8	19.8	Petroleum products, rice and transport equipments
Iran	3.4	4.9	-17.1	12.8	Rice basmati, oil meals and primary and semi-finished iron and steel
China	13.6	15.0	85.1	11.9	Cotton fabric, petroleum products and transport equipment
EU	50.4	51.7	38.4	10.5	Readymade garments, chemicals, leather and gems and jewellery
Tanzania	2.2	3.5	-9.9	10.6	Petroleum products

Source: DGCI&S.

Lower imports largely reflective of domestic economic slowdown and policy measures

II.6.3 Imports moderated significantly in 2013-14 reflecting the impact of the domestic economic slowdown, policy measures and fall in international prices of key import commodities. For instance, various policy measures and fall in international prices stemmed the import of gold in 2013-14. With a significant fall in natural gas prices in 2013, the international prices of fertilisers also eased, which limited the growth of India's fertiliser import bill. India's lower demand for imports of iron and steel items was attributed to various factors such as depreciation of the rupee and improved domestic supply. The slowdown in domestic economic activity and the delay in the implementation of various infrastructure projects probably reduced the demand for capital goods imports (Table II.12). Notwithstanding that international crude oil prices fluctuated due to geopolitical concerns and output disruptions (in Libya and Nigeria) on the supply side and changing growth prospects in major economies on the demand side, the average crude oil price (Indian basket) fell by 2.3 per cent, keeping India's oil import bill relatively contained in 2013-14.

Lower CAD but no complacency as risks may resurface

II.6.4 The recent upturn in exports and resumption of FII flows augur well for India's overall balance of payments in 2014-15. As per provisional estimate for Q1 of 2014-15, India's net export of services stayed almost stable at the level of Q1 of 2013-14. However, going forward, certain upside risks to CAD, that had fallen significantly in 2013-14, cannot be ruled out. Potential risks to India's balance of payments could emanate from both domestic and global factors. First, as economic slack diminishes with recovery in the domestic economy, the upturn in the investment cycle will require higher non-oil non-gold imports, which already seem to be underway since May 2014. Second, speedy easing of norms for gold imports could lead to a widening of CAD in 2014-15. In fact, growth in gold imports turned positive in June 2014 after a span of 11

Table II.12: Sector-wise Decline in Imports

Sector	Imports (US$ billion)		Relative Contribution to Import Decline (%)
	2012-13	2013-14	
1	2	3	4
Gold and Silver	55.7	32.1	58.0
Edible Oils	11.2	9.3	4.7
Fertilisers	9.1	6.5	6.3
Iron and steel	11.0	7.9	7.5
Machinery	27.6	23.6	9.8
Transport Equipment	17.2	15.0	5.4
Project goods	6.6	4.5	5.0
Total Imports	**490.7**	**450.1**	

Source: DGCI&S.

months. Third, even though international crude oil prices were earlier projected to stay low with gradual easing of the supply side, the re-emergence of geopolitical risks, particularly in Iraq and Russia's on-going tensions with Ukraine, may keep oil prices relatively firm and thus have implications for India's oil import bill. This may pose upward risks to India's CAD. Fourth, notwithstanding a modest recovery in exports on the back of stronger global demand and adjustment of the rupee exchange rate in 2013-14, downside risks continue due to uncertainty about the global growth outlook. Lastly, some sector specific issues, particularly relating to drugs and pharmaceuticals, iron ore and coal need redressal to ensure a better trade balance.

Net FII flows turned positive since December 2013

II.6.5 Quantitative easing (QE) by advanced countries in recent years boosted foreign portfolio inflows significantly in India mainly reflecting higher growth and interest rate differentials. After the US Fed's indication on QE tapering in May 2013, net FII flows retreated largely from the debt segment during June to November 2013. However, since the actual tapering of QE announced in December 2013, FII flows have remained broadly intact. This essentially reflects considerable improvement in India's external sector with CAD falling below a sustainable level, a build-up of forex reserves owing to special swap schemes offered by the Reserve Bank (during September-November 2013) and stability in the rupee exchange rate. Further, growing prospects of a better policy environment with a stable central government in place may also have boosted the confidence of foreign investors. However, going forward, FII flows may remain prone to volatility with expected tightening of monetary policy in the U.S., if domestic fundamentals do not improve and/or external sector risks re-emerge.

BRICS-CRA to help in managing short-term BoP pressures

II.6.6 On July 15, 2014 Brazil, Russia, India, China and South Africa signed an international treaty establishing the BRICS Contingent Reserve Arrangement (CRA), in Fortaleza, Brazil. The initiative to implement the CRA was officially launched in June 2012 by the BRICS leaders at the sidelines of the G-20 Summit that took place in Los Cabos, Mexico. The CRA complements and reinforces the global financial safety net, which comprises the IMF, regional financial arrangements and bilateral swap agreements between central banks, in addition to the countries' own international reserves. The initial total committed resources under the CRA will be US$100 billion. The CRA will become effective only after fulfilling all the legal requirements for its entry into force. It will then provide support through liquidity and precautionary instruments.

Increase in India's external debt in 2013-14, but not an immediate challenge

II.6.7 India's external debt as at end March 2014 increased by US$ 31.2 billion over the year, mainly led by the special swap scheme introduced by the Reserve Bank for commercial banks to mobilise FCNR(B) and overseas borrowings. The borrowings under the Swap Scheme in combination with a decline in CAD and revival in equity flows helped in building up foreign exchange reserves (Appendix Table 2). In line with greater recourse to debt creating flows, India's external debt and net external liabilities have risen in recent years (Table II.13 and Chart II.32). However, since the incremental external debt during 2013-14 was mainly long-term in nature, it does not pose an immediate concern for India's external vulnerability. Moreover, with increase in foreign exchange reserves in H2 of 2013-14, most external sector vulnerability indicators have improved.

Rupee in real terms continues to be above base year level

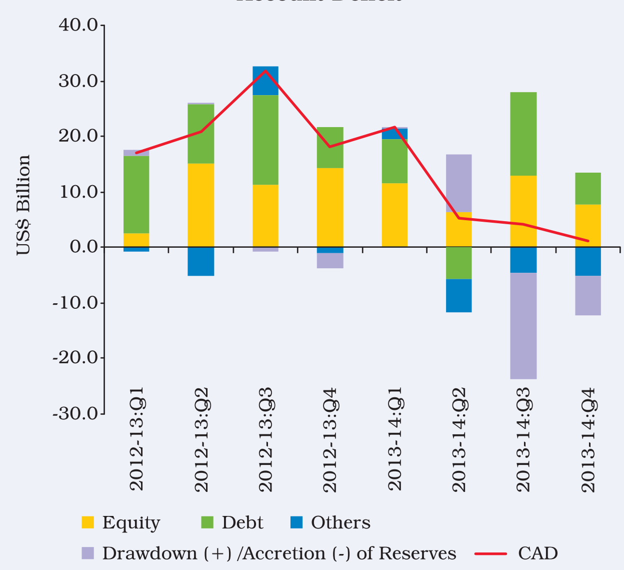
II.6.8 Following indications of QE tapering by the US Fed coinciding with growing concerns about high CAD, the rupee depreciated sharply during June to August 2013. Subsequent policy actions undertaken both by the Reserve Bank and the

Table II.13: External Sector Vulnerability Indicators

(per cent)

Indicator	End-Mar 2011	End-Mar 2012	End-Mar 2013	End-Mar 2014
1	2	3	4	5
1. External Debt to GDP	18.2	20.5	22.0	23.3
2. Ratio of Short-term to Total Debt (Original Maturity)	20.4	21.7	23.6	20.3
3. Ratio of Short-term to Total Debt (Residual maturity)#	40.6	40.9	42.1	39.6
4. Ratio of Concessional Debt to Total Debt	14.9	13.3	11.1	10.5
5. Ratio of Reserves to Total Debt	95.9	81.6	71.3	69.0
6. Ratio of Short-term Debt to Reserves	21.3	26.6	33.1	29.3
7. Ratio of Short-term Debt (Residual maturity) to Reserves#	42.3	50.1	59.0	57.4
8. Reserves Cover of Imports (in months)	9.5	7.1	7.0	7.8
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	4.4	6.0	5.9	5.9
10. External Debt (US$ billion)	317.9	360.8	409.4	440.6
11. International Investment Position (IIP) (US$ billion)	-207.0	-264.7	-326.7	-331.6
12. IIP/GDP ratio	-11.9	-14.8	-17.6	-17.6
13. CAD/GDP ratio	2.8	4.2	4.7	1.7

#: RBI estimate.



government, however, augured well for rupee stabilisation. The appreciating trend in the nominal value of the rupee was reflected in the real effective exchange rate too as inflation (CPI) remained higher in India compared to its trading partners (Box II.8). Rupee, in terms of both 6 and 36 currency baskets, continued to be above the base level in 2004-05 (Chart II.33).

Box II.8
Information Content from the CPI-based REER

In order to ensure better comparability of India's external competitiveness *vis-à-vis* its trading partners, the Reserve Bank released the CPI based real effective exchange rate (REER) in April 2014. REER is a summary indicator for assessing the real value of a country's currency against the basket of trading partners of the country. REER is a frequently used variable in both theoretical and applied economic research and policy analysis for assessing the equilibrium value of a currency, change in external competitiveness, responsiveness of trade flows to price changes and incentives for reallocating production between the tradable and non-tradable sectors. In literature, there are a number of alternative measures of real exchange rates. For computation of relative prices, indices based on consumer prices, producer prices, GDP deflator and unit labour costs are often used. Each of these measures of relative prices has its own pros and cons.

Till recently, in the absence of a representative consumer price index (CPI) for India, the Reserve Bank was providing the REER index (6 and 36 currencies) using the wholesale price index (WPI) and consumer price indices (CPI) for partner countries. However, with the availability of an all India CPI index, the Reserve Bank began computing and releasing data on REER using this new CPI (combined) for India. With greater focus on CPI inflation as the primary objective of domestic monetary policy, it is pertinent to have an alternative index of REER based on CPI.

The methodology used to construct the CPI based REER index (both trade and export weights) is discussed in RBI (2014).

In line with the fall in the nominal value of the rupee, CPI based REER has also shown depreciation since

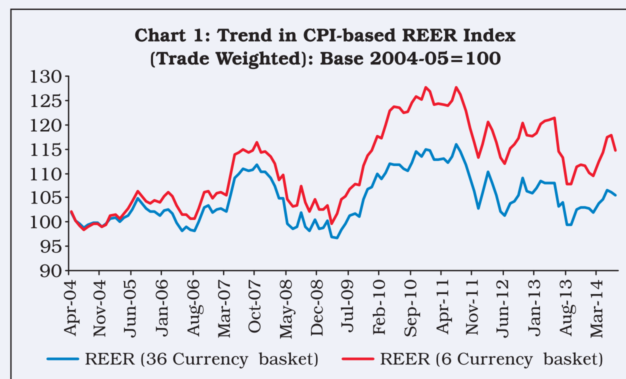
(Contd....)

2011-12 (Table 1 and Chart 1). However, given that the CPI based inflation differential with trade partner countries continues to be high, the REER of rupee is still above the base year level. Further, the REER based on the 6 currency basket is higher than that based on the 36 currency basket. This is mainly due to the CPI based inflation differential being higher with the former group of countries (mainly advanced economies in the 6 currency basket) than with the latter group of economies (36 currency basket) which also includes emerging and developing economies.

Table 1: CPI based REER (Trade weighted)

	CPI-36 Currency Basket	CPI-6 Currency Basket	₹ per US Dollar	CPI Inflation (%)
1	2	3	4	5
2004-05	100.0	100.0	44.9	4.0
2005-06	102.4	104.4	44.3	3.7
2006-07	100.8	103.8	45.3	6.8
2007-08	109.2	113.4	40.2	5.9
2008-09	99.7	103.9	45.9	9.2
2009-10	103.9	110.7	47.4	10.6
2010-11	112.7	124.5	45.6	9.5
2011-12	110.3	121.2	47.9	9.5
2012-13	105.6	117.1	54.4	10.2
2013-14	103.3	112.4	60.5	9.5
2014-15Q1	106.1	116.2	59.8	8.1

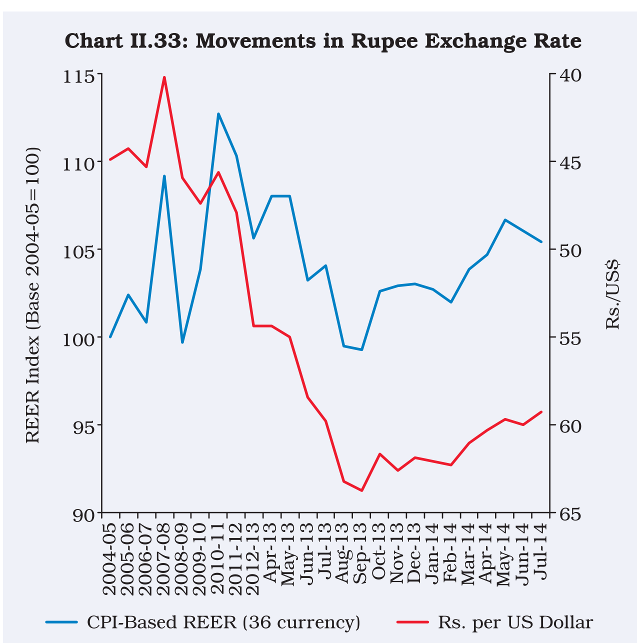
Chart 1: Trend in CPI-based REER Index (Trade Weighted): Base 2004-05=100



References:

Reserve Bank of India (2014), 'Real Effective Exchange Rate based on CPI as Price Index for India', *RBI Monthly Bulletin*, April.

Chart II.33: Movements in Rupee Exchange Rate



Key policy priorities for managing external sector risks

II.6.9 Lower CAD, surge in foreign exchange reserves and exchange rate stability are signs of a more resilient external sector. A modest improvement in external sector indicators, however, does not warrant any policy complacency. Spillovers from renewed external pressures through the trade channel and/or financial channel may resurface and thus pose a challenge for India's external sector. The policy focus should be on improving domestic macroeconomic fundamentals so as to minimise such spillovers. In particular, policy attention is required for (i) redressal of sector-specific structural issues impeding exports, (ii) low inflation for supporting the stability of the rupee and to enhance external competitiveness, and to reduce investment demand for gold, (iii) easing of binding supply constraints in certain sectors (for example, POL, coal and fertilisers) that are critical for the domestic economy and can induce a surge in total imports, (iv) a conducive business environment to ensure a better mix of capital flows for CAD financing by attracting stable non-debt creating flows, and (v) improved governance.

PART TWO: THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

III MONETARY POLICY OPERATIONS

The monetary policy stance changed significantly over three distinct phases during 2013-14. The monetary easing that started in 2012-13 continued up to mid-July 2013, which was the first phase. The second phase, from mid-July to September 2013, was a period when exceptional monetary measures were taken for addressing exchange market pressures. These were, however, normalised quickly by end-November 2013. Alongside normalisation, monetary policy also turned increasingly anti-inflationary in the third phase starting in September 2013, with CPI inflation and inflation expectations persisting at elevated levels. The monetary policy framework witnessed key changes during the year reflecting implementation of some of the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework, particularly adopting the CPI (combined) as the key metric of inflation for conducting monetary policy, explicit communication of a glide path for disinflation, transition to a bi-monthly monetary policy cycle beginning 2014-15, progressive reduction in access to overnight liquidity under LAF at the fixed repo rate and a corresponding increase in access to liquidity through term repos and introduction of variable tenor term repos.

Monetary policy operations: context and rationale

III.1 In 2013-14, concerns about the slowdown in growth significantly weighed on monetary policy. However, the unprecedented shock to the external sector following the announcement of the tapering of the unconventional monetary policy in the US warranted a mid-course adjustment in the policy stance and exceptional measures to curb market volatility. Even as external pressures abated and stability returned to the foreign exchange market which enabled normalisation of these measures, unrelenting inflationary pressures driven by persisting food inflation necessitated a tightening of the policy stance with a clear focus on containing second round effects and stabilising inflation expectations.

III.2 In the monetary policy statement of May 3, 2013 the Reserve Bank reduced the key policy rate by 25 basis points (bps) to 7.25 per cent, carrying forward the process of policy easing set in place in January 2012. However, it noted that monetary easing by itself without addressing the supply bottlenecks in the economy may not be sufficient for revival of growth. While sluggishness in growth was expected to persist through 2013-14, risks to inflation were seen as mounting from multiple fronts with little space for further monetary easing going forward.

III.3 By the mid-quarter review of June 17, 2013, external sector vulnerabilities had become a key variable in determining the monetary policy stance. Given the evolving uncertainties on the external front and rising risks to the inflation path, the Reserve Bank kept the key policy rate unchanged in the First Quarter Review of July 2013 as well but undertook a number of exceptional measures to address exchange market pressures (see Box III.1).

III.4 The mid-quarter review of September 20, 2013 brought a reversal of the monetary policy

stance as upside risks to the inflation trajectory materialised with the pass-through of fuel price increases, which were compounded by a sharp depreciation of the rupee and rising international commodity prices alongside highly elevated food inflation. With the inflation trajectory showing signs of inching upwards over the rest of the year beyond what was initially projected, the key policy repo rate was increased by 25 bps from 7.25 per cent to 7.5 per cent.

III.5 By the Second Quarter Review of October 29, 2013, there were strong indications that consumer price inflation was likely to remain elevated in the months ahead and was likely to exceed 9 per cent even after accounting for seasonal moderation in food inflation. In such a context, monetary policy action was considered necessary to break the spiral of rising price pressures, and thereby curb the erosion of financial savings and strengthen the foundations of growth. The key policy repo rate was increased by 25 bps from 7.5 per cent to 7.75 per cent. This monetary policy stance was expected to strengthen the environment for growth by fostering macroeconomic and financial stability.

III.6 In the mid-quarter review of December 18, 2013 the Reserve Bank kept key policy rates unchanged. The decision to pause, even as inflation remained above the Reserve Bank's comfort level, was guided by a concern for preventing an overly reactive policy action and waiting for more data to gauge the direction of the inflation trajectory.

III.7 The Expert Committee to Revise and Strengthen the Monetary Policy Framework, which submitted its report on January 21, 2014 had recommended a 'glide path' for disinflation that set an objective of 8 per cent consumer price index (CPI) inflation by January 2015 and 6 per cent CPI inflation by January 2016. With the Reserve Bank's baseline projections indicating upside risks to 8 per cent CPI inflation by January 2015, an increase in the policy rate by 25 bps to 8 per cent was necessitated in the Third Quarter Review of January 28, 2014 to set the economy securely on the recommended disinflationary path. Following the recommendation of the committee, it was also announced that thereafter monetary policy reviews would be undertaken in a bi-monthly cycle.

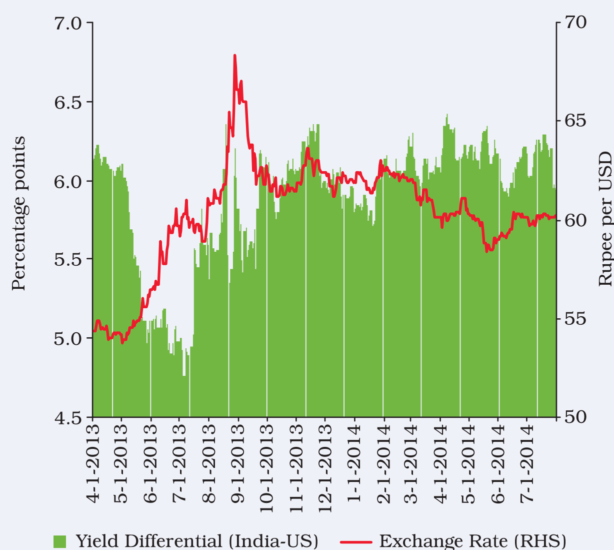
III.8 The first bi-monthly monetary policy statement announced on April 1, 2014 re-affirmed that the monetary policy stance was focused on keeping the economy on the disinflationary glide path recommended by the committee. With the inflation trajectory evolving along the intended glide path it was decided to keep the key interest rates unchanged, while allowing the rate increases undertaken during September 2013 through January 2014 to work their way through the economy. The policy statement noted a number of risks to the central forecast, primarily the risks to food inflation emanating from a less-than-normal monsoon due to possible *El Nino* effects. The policy statement also anticipated a baseline real GDP growth projection of 5 to 6 per cent in 2014-15, up from a little below 5 per cent in 2013-14, with downside risks to the central estimate of 5.5 per cent. The bi-monthly monetary policy statements on June 3, 2014 and August 5, 2014 maintained the stance. To give banks more freedom to expand credit to the non-government sector, while balancing the financing needs of the government given the medium-term fiscal consolidation roadmap, the statutory liquidity ratio (SLR) was reduced by 50 bps each in the second and third bi-monthly policy reviews of 2014-15.

Monetary policy response to spillovers from the Fed's taper talk

III.9 The Fed's taper talk in May/June 2013 altered global monetary and financial conditions dramatically with spillovers in the Indian markets bringing to the fore the challenge of conducting monetary policy in a globalised world. With unexpectedly significant hardening of long-term yields in the US, the yield differential (between 10-year G-sec yields in India and the US) fell from more than 6.2 percentage points before May 2013 to less than 5 percentage points in June and July 2013 (Chart III.1).

III.10 Given India's large current account deficit (CAD) and concerns about its financing in the event

Chart III.1: Yield Differential (10-year G-sec: India-US) and Exchange Rate Movement



of an earlier than expected normalisation of the US monetary policy, a sudden reversal of capital flows led by interest rate differential sensitive debt flows triggered unidirectional expectations and herding in the exchange market. Heightened risks from large depreciation posed threats to both price and financial stability. The policy response was multi-pronged: i) curbing exchange market speculation and volatility through both administrative measures and tightening monetary conditions; ii) bolstering self-insurance through reserve accumulation and access to swap lines so as to reverse unidirectional expectations and instil confidence; and iii) containing the current account deficit so as to economise on external financing. This calibrated policy response was anchored by the monetary policy stance (Box III.1 and III.2).

Box III.1
Monetary Policy Response to Exchange Market Pressures

The monetary approach to the exchange rate highlights the role of money as a key determinant of the exchange rate. Excess money supply in the economy relative to what may be necessary for sustainable non-inflationary growth can cause either higher inflation (if prices are flexible) or a lower interest rate (if the asset market is flexible), both of which can in turn cause the exchange rate to depreciate. Exchange rate depreciation, therefore, can be the result of an easy monetary policy stance adopted in the past. Accordingly, a tighter monetary policy may be warranted to manage a condition of intense exchange market pressure.

Uncovered interest parity (UIP) holds that if a country has a higher interest rate relative to the rest of the world, its exchange rate is expected to depreciate. In practice, however, higher interest rates can lead to currency appreciation, and hence the UIP puzzle. The UIP puzzle has several explanations such as imperfect asset substitutability, non-rational expectations, time varying risk premium and the peso problem (that is, when market prices reflect the low possibility of a large change). Moreover, UIP assumes perfect capital mobility, besides domestic and foreign bonds being perfect substitutes. As a result, risk premium is also assumed to be zero. In reality, however, risk premium is both non-zero and time varying, that is, foreign investors in EMEs would expect a risk premium, and their 'risk on-risk off' behaviour can make the risk premium time varying, which in turn could be influenced by both domestic and external macro-financial developments, including monetary policy settings. Unconventional monetary policies (UMPs) of advanced economies, and the Fed's taper talk in May 2013 altered the risk premiums in both advanced and emerging economies, in turn impacting exchange rate expectations and capital flows.

In India, the monetary policy response to exchange market pressures was manifested in the form of increase in effective money market interest rates by 300 bps, besides tighter access to central bank liquidity. Other supportive policy measures including foreign exchange market interventions, two swap schemes to bolster foreign exchange reserves, the special swap arrangement for oil marketing companies (OMCs) and revised guidelines on gold imports contributed to the effectiveness of exceptional monetary measures. The experience with managing exchange market pressures in 2013-14 underscores the relevance of monetary policy as an instrument of exchange rate stabilisation, even though in normal times, monetary policy may not pursue any exchange rate objective and allow market fundamentals in terms of interest rate differentials and inflation differentials to condition the path of exchange rate.

RBI's exceptional monetary measures to address exchange market pressures

III.11 After the Fed's announcement on May 22, 2013 of a possible beginning of the end of quantitative easing (QE) and the upsurge in US longer term treasury yields, the exchange rate of the Indian rupee came under intense pressure as portfolio debt investments reversed on flight to safety. On June 19, 2013 the Fed provided more explicit forward guidance on moderating its asset purchases in measured steps starting later in the year, and unwinding QE by mid-2014. The rupee, which had already depreciated from ₹55.04 (RBI reference rate) on May 21, 2013 to ₹58.74 by then, crossed the market's psychological resistance level of ₹60 per US dollar in the first week of July. On July 15, 2013, three specific monetary measures were announced to tighten liquidity conditions: (a) the marginal standing facility (MSF) rate was fixed at 300 bps above the repo rate, as against the normal spread of 100 bps; (b) access to overnight liquidity from the RBI at the repo rate under the liquidity adjustment facility (LAF) was restricted to 1 per cent of net demand and time liabilities (NDTL) of the banking system; and (c) announcement of open market sales of ₹120 billion (Box III.2).

Box III.2
Changes in Monetary Policy Operating Framework

Over the last two decades, central banks have veered round to conducting monetary policy through a single short-term interest rate as a policy rate that it controls through open market operations (OMOs). These OMOs are conducted under an operating framework that typically includes liquidity infusion/absorption through repurchase agreements (repos) or outright transactions in eligible securities between the central bank and the market participants. The operating procedures, however, vary across countries and over time and evolve with financial market development, macroeconomic and market conditions.

Since May 2011, the Reserve Bank of India has shifted to a single signaling policy rate – the repo rate. Under the operating framework, the Reserve Bank sought to align the call money rate, which is its operating target, with its policy rate. It used LAF as a principal instrument for this objective. Banks, in practice, had an unlimited access to liquidity under the LAF repo window subject to collateral availability. Like other central banks, the Reserve Bank aimed at keeping liquidity in a small deficit, as cross-country experience suggested that this strengthens transmission. Empirical findings for India also indicated that a liquidity deficit of around one per cent of NDTL improves policy transmission across the interest rate spectrum. Along with the adoption of repo as the single policy rate in the middle of the interest rate corridor of 200 bps, a new marginal standing facility (MSF) was instituted from which scheduled commercial banks could borrow overnight at 100 bps above the repo rate. The Reserve Bank also used outright OMOs to bring about enduring changes in liquidity.

Since 2013-14, further changes have been made in the operating procedures from time to time in conjunction with other measures, especially in the backdrop of exchange rate volatility following the Fed's tapering indication on May 22, 2013 and the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework in January 2014 (see Table 1 for chronology of events).

Table 1: Major Monetary Measures by the Reserve Bank: July 2013 onwards

Monetary Policy Tightening to Address Exchange Rate Volatility	
July 15, 2013	• The MSF rate (and the Bank Rate) was re-calibrated to 300 bps above the repo rate to 10.25 per cent. • The overall allocation of funds under the LAF limited to 1.0 per cent of the NDTL of the banking system with effect from July 17, 2013. The allocation to individual banks to be made in proportion to their bids, subject to the overall ceiling. • Announcement of OMO sales of ₹120 billion
July 17, 2013	• As a contingency measure and in anticipation of redemption pressures on mutual funds, the Reserve Bank opened a dedicated Special Repo window for a notified amount of ₹250 billion for liquidity support to mutual funds at the Bank Rate.
July 18, 2013	• OMO sales of ₹25 billion.
July 23, 2013	• Minimum daily CRR balances to be maintained by SCBs increased from 70 per cent to 99 per cent of the requirement, effective from the fortnight beginning July 27, 2013. • Capping of primary dealers' access to LAF at 100 per cent of their individual net owned funds.

(Contd....)

July 24, 2013	• Overall limit for access to LAF by each individual bank was capped at 0.5 per cent of its own NDTL outstanding as on the last Friday of the second preceding fortnight.
August 14, 2013	• Deregulation of interest rates on Non-Resident (External) Rupee (NRE) deposits and Non-Resident Ordinary (NRO) accounts. Banks had the freedom to offer interest rates on such deposits without any ceiling up to February 28, 2014. • The interest rate ceiling on deposits held in foreign currency non-resident (banks) {FCNR(B)} of maturity 3-5 years was enhanced by 100 bps to LIBOR/SWAP plus 400 bps. The ceiling was restored to LIBOR/SWAP plus 300 bps after February 28, 2014. • Banks were advised that with effect from fortnight beginning August 24, 2013, incremental FCNR (B) deposits as also NRE deposits with reference base date of July 26, 2013, and having maturity of three years and above, mobilised by banks was exempted from maintenance of CRR and SLR. This facility was available for deposits mobilized up to March 7, 2014.
August 20, 2013	• Extant regulations required banks to bring down their SLR securities in held to maturity (HTM) category from 25 per cent to 23 per cent of their NDTL in a progressive manner in a prescribed time frame. The requirement stood at 24.5 per cent as at end-June 2013. It was decided to relax this requirement by allowing banks to retain SLR holdings in HTM category at 24.5 per cent until further instructions. • In addition, banks were allowed to spread over the net depreciation, if any, on account of mark to market (MTM) valuation of securities held under available for sale (AFS)/held for trading (HFT) categories over the remaining period of the financial year in equal installments.
August 23, 2013	• OMO purchase of ₹62.3 billion.
August 28, 2013	• A forex swap window to meet the entire daily dollar requirements of three public sector oil marketing companies (IOC, HPCL and BPCL) was opened with effect from August 28, 2013. Under the swap facility, Reserve Bank undertook sell/buy USD-INR forex swaps for fixed tenor with the oil marketing companies through a designated bank.
August 30, 2013	• OMO purchase of ₹62.3 billion.
July/August/September 2013	• RBI auctioned Government of India Cash Management Bills.
September 4, 2013	• The RBI offered a window to the banks to swap fresh FCNR(B) dollar funds, mobilised for a minimum tenor of three years and over at a fixed rate of 3.5 per cent per annum for the tenor of the deposit. Also, the extant overseas borrowing limit of 50 per cent of the unimpaired Tier I capital was raised to 100 per cent and borrowings mobilised under this provision can be swapped with the RBI at a concessional rate of 100 bps below the ongoing swap rate prevailing in the market. The scheme was open up to November 30, 2013.
Normalisation of the Monetary Policy	
September 20, 2013	• The MSF rate was reduced by 75 bps from 10.25 per cent to 9.5 per cent. • The minimum daily maintenance of the CRR was reduced from 99 per cent of the requirement to 95 per cent effective from the fortnight beginning September 21, 2013. • The policy repo rate under the LAF was increased by 25 basis points from 7.25 per cent to 7.5 per cent with immediate effect.
October 7, 2013	• The MSF rate was reduced by 50 bps from 9.5 per cent to 9.0 per cent. • Additional liquidity was provided through term repos of 7-day and 14-day tenor for a notified amount equivalent to 0.25 per cent of NDTL of the banking system through variable rate auctions on every Friday beginning October 11, 2013. • OMO purchase of ₹99.7 billion.
October 29, 2013	• The MSF rate was reduced by 25 bps from 9.0 per cent to 8.75 per cent. • The policy repo rate under the LAF was increased by 25 bps from 7.5 per cent to 7.75 per cent. • As a result, the corridor between the MSF and reverse repo rates was restored to (+/-) 1 per cent of repo rate. • Liquidity provided through term repos of 7-day and 14-day tenor increased from 0.25 per cent of NDTL of the banking system to 0.5 per cent.
November 18, 2013	• OMO purchase of ₹61.6 billion. • To ease the liquidity stress to Micro and Small Enterprises (MSE) sector, refinance of an amount of ₹50 billion made available to the Small Industries Development Bank of India (SIDBI) under the provisions of Section 17(4H) of the RBI Act, 1934. The refinance is available against receivables, including export receivables, outstanding as on November 14, 2013 onwards. The facility is available at the prevailing 14-day term repo rate for a period of 90 days. The refinance facility is available for a period of one year up to November 13, 2014. • In order to enhance credit delivery to the medium sector, incremental credit including export credit extended to the medium enterprises, has been included as eligible priority sector lending by the scheduled commercial banks (excluding RRBs) over the outstanding credit as on November 13, 2013. The facility is available up to March 31, 2014 and is within the overall target of 40 per cent.
December 18, 2013	• The policy repo rate under the LAF at 7.75 per cent and CRR at 4.0 per cent of NDTL were kept unchanged.
January 22, 2014	• OMO purchase of ₹94.8 billion.

(Contd....)

Monetary Measures to Anchor Inflation Expectations – Implementation of the Recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework	
January 28, 2014	• The policy repo rate under LAF was increased by 25 bps from 7.75 per cent to 8.0 per cent. Consequently, the reverse repo rate stood adjusted at 7.0 per cent, and the MSF rate and the Bank Rate at 9.0 per cent. CRR was kept unchanged. • Enunciation of the "glide path" for disinflation that sets an objective of 8 per cent CPI inflation by January 2015 and 6 per cent CPI inflation by January 2016, as indicated by the Expert Committee to Revise and Strengthen the Monetary Policy Framework. • Monetary policy reviews to be undertaken in a bi-monthly cycle going forward.
April 1, 2014	• Liquidity provided under 7-day and 14-day term repos was increased from 0.5 per cent of NDTL of the banking system to 0.75 per cent of NDTL, and liquidity provided under overnight repos under the LAF was reduced from 0.5 per cent of bank-wise NDTL to 0.25 per cent.
June 3, 2014	• The liquidity provided under the export credit refinance (ECR) facility was reduced from 50 per cent of eligible export credit outstanding to 32 per cent. Commensurately, a special term repo of 0.25 per cent of NDTL of banks was done. • The SLR of scheduled commercial banks was reduced by 50 bps from 23.0 per cent to 22.5 per cent of their NDTL with effect from the fortnight beginning June 14, 2014.
August 5, 2014	• The SLR of scheduled commercial banks was reduced by 50 bps from 22.5 per cent to 22.0 per cent of their NDTL with effect from the fortnight beginning August 9, 2014. • In order to enable banks greater participation in financial markets, the HTM ceiling reduced to 24 per cent of NDTL with effect from the fortnight beginning August 9, 2014.
Since January 2014, variable rate term repo auctions of varied tenors (1-day, 3-day, 5-day, 7-day, 9-day, 21-day and 28-day) in addition to the regular 7-day and 14-day auctions, have been conducted from time to time, based on assessment of liquidity. Since June 2014, two 4-day term reverse repo auctions have been conducted.	

The primary objective of the increased reliance on term repos is to improve the transmission of policy impulses across the interest rate spectrum. The term repo has evolved as a useful indicator of underlying liquidity conditions. It also allows market participants to hold liquidity for a longer period, thereby providing the impetus for engaging in term transactions in the market, evolving market-based benchmarks for pricing various financial products and also improving efficiency in cash/ treasury management. This has also helped to move away from sector-specific refinance towards a more generalised provision of system liquidity without preferential access to any particular sector or entity.

III.12 On July 23, 2013, a review of domestic liquidity conditions suggested that these conditions were not tight enough to have the desired impact on the foreign exchange market. Accordingly, further tightening measures were announced: (a) the overnight limit for access to liquidity from RBI at the repo rate under LAF was restricted to 0.5 per cent of NDTL of each bank; and (b) banks were required to maintain a minimum daily CRR balance of 99 per cent of the requirement, as against the earlier flexibility of dropping to 70 per cent of the requirement on any single day while meeting the CRR requirement on average over the fortnight. On August 8, 2013, the RBI, in consultation with the government, announced the auction of cash management bills (CMBs) of ₹220 billion every week, aimed at draining out liquidity in the short-end of the market spectrum. These measures helped in keeping the money market conditions tight, with money market rates rising to around the MSF rate (that is, 300 bps higher than the repo rate). Thus, the MSF rate became the effective policy rate during this period. Besides exceptional monetary measures, other policy measures were also used for addressing exchange market pressures such as three swap windows for NRI deposits, banks and oil marketing companies (OMCs) respectively, restrictions on gold imports and revising interest rates on NRI deposits.

Calibrated withdrawal of exceptional measures

III.13 With a view to facilitating an adequate flow of credit to the productive sectors of the economy, it became necessary to contain the upward pressure on G-sec yields transmitted by the exceptional measures through open market purchases of ₹ 80 billion announced on August 20, 2013. As stability returned to the exchange market,

RBI started a calibrated normalisation of the exceptional monetary measures in its mid-quarter review of September 20, 2013. External risks also eased somewhat when the Fed surprised markets by holding off tapering on September 18, 2013. Normalisation of the exceptional measures in terms of restoring the normal spread of 100 bps above the repo rate for MSF was achieved by the end of October 2013 through cumulative reduction in the MSF rate by 150 bps in three steps alongside an increase in the repo rate by 50 bps in two steps of 25 bps each to reinforcing the anti-inflation stance of the monetary policy.

New monetary policy framework and operating procedure

III.14 In India, the monetary policy framework has evolved over time in consonance with the structure of the economy. The large panel of indicators under the multiple indicator approach was perceived to be inadequate for providing a clearly defined nominal anchor for monetary policy creating uncertainty about what guided RBI's policy decisions. In light of this, the Expert Committee to Revise and Strengthen the Monetary Policy Framework, with a mandate for revising and strengthening the monetary policy framework and making it transparent and predictable, recommended the adoption of the CPI (combined) as the measure of inflation and as the nominal anchor for monetary policy in India. The current operating framework is premised on a target for borrowed reserves (relative to NDTL of banks), and the call rate close to the policy rate and bound between the reverse repo rate and the MSF rate. By virtue of being synchronised with the reserve maintenance cycle, term repo is gaining market acceptability and has turned out to be a useful indicator of underlying liquidity conditions, as variable rate auctions enable price discovery of the term premium.

Monetary policy transmission

III.15 Though the impact of the change in policy rate is still unfolding, transmission of policy rate to deposit and lending rates of banks is relatively less pronounced as compared to money market rates reflecting the presence of structural rigidities in the credit market (Box III.3, Table III.1).

Box III.3
Factors Impeding Smooth Monetary Policy Transmission

The efficacy of monetary policy depends on the nature of development and market integration, which affects the transmission. It is also characterised by long and variable lags and asymmetry in response to policy impulses, making it difficult to predict the effect of monetary policy. In the wake of the global crisis, the efficacy and credibility of the framework increasingly came under the spotlight, especially due to the coexistence of high inflation and low growth. Issues relating to factors impeding smooth monetary policy transmission were extensively analysed in the Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework.

While the monetary policy transmission channels could be broadly classified as interest rate, credit, exchange rate and asset prices, empirical evidence for India indicates that the impacts are feeble for the asset price channel and the exchange rate channel. While the interest rate channel is the major source of monetary policy transmission, medium to long term rates such as bank deposit and lending rates exhibit asymmetrical responses to policy rate changes under varied market conditions, responding relatively faster in liquidity deficit conditions than in surplus conditions.

The factors impeding smooth monetary policy transmission to the credit market include rigidities in re-pricing for fixed deposits, the large size of government borrowings, practice of yearly resetting of interest rates on small savings linked to G-sec yields, interest rate subventions that break the link between monetary policy and lending rates, preferential tax benefits on fixed maturity plans of debt mutual funds of tenor one year or more *vis-a-vis* fixed deposits of corresponding maturities, high level of NPAs, an oligopolistic credit market and a significant presence of informal finance. These factors effectively dampen the policy rate transmission to the final outcome, by making alternate investment vehicles more attractive, especially during periods of monetary easing.

Reference:

RBI (2014). Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (Chairman: Dr. Urjit R. Patel), January.

Table III.1: Asymmetry in Transmission in Different Phases of Monetary Policy Cycles
(To Deposit and Lending Rates of Banks)

(Per cent)

Items	Mar 10	Mar 12	Mar 13	Jun 13	Sept 13	Dec 13	Mar 14	Jun 14	Variation (Percentage Points)		
									Tightening Phase (March 19, 2010 to April 16, 2012)	Easing Phase (April 17, 2012 to July 15, 2013)	Tightening Phase** (Since July 16, 2013)
1	2	3	4	5	6	7	8	9	10	11	12
Policy Rate (Repo Rate)	5.00	8.50	7.50	7.25	7.50	7.75	8.00	8.00	3.75	-1.25	0.75
CRR	5.75	4.75	4.00	4.00	4.00	4.00	4.00	4.00	-1.00 @	-0.75	0.00
Call Rate	3.83	9.02	7.58	7.10	11.41	7.51	7.64	7.43	4.98	-1.51	0.59
CBLO Rate	3.01	8.12	7.51	6.34	8.67	7.38	7.75	7.51	5.43	-2.34	1.60
Market Repo Rate	2.65	7.63	7.75	6.75	10.03	7.85	8.22	8.18	6.12	-1.49	1.23
91-Days Treasury Bill	4.27	8.97	8.06	7.41	10.32	8.63	8.99	8.51	4.53	-1.29	1.05
3-Month CP Rate	6.10	11.61	9.61	8.50	10.85	9.10	10.01	8.88	4.24	-2.17	0.52
3-Month CD Rate@	5.48	11.06	9.14	8.11	10.40	8.74	9.55	8.57	4.36	-2.08	0.65
5-Year Corporate Debt Yield	8.61	9.47	8.96	8.55	9.90	8.75	9.73	9.23	0.93	-0.71	0.38
10-Year Corporate Debt Yield	6.61	9.77	9.01	8.66	10.84	9.77	9.75	9.00	3.13	-1.02	0.22
2-Year G-Sec Yield	6.16	8.04	7.76	7.45	8.89	8.54	8.67	8.33	1.87	-0.35	0.64
3-Year G-Sec Yield	6.82	8.27	7.85	7.51	8.87	8.49	8.73	8.37	1.34	-0.57	0.72
5-Year G-Sec Yield	7.54	8.46	7.94	7.52	8.95	8.78	8.92	8.52	1.05	-0.84	0.74
10- Year G-Sec Yield	7.92	8.36	7.91	7.34	8.57	8.85	8.80	8.64	0.64	-1.10	1.13
Median Deposit Rate	5.15	7.46	7.42	7.48	7.78	7.75	7.74	7.74	2.31	0.00	0.28
Median Base Rate *	7.75	10.50	10.20	10.20	10.25	10.25	10.25	10.25	2.75	-0.35	0.25
WALR (Outstanding Rupee Loans)	10.53	12.64	12.27	12.20	12.31	12.25	12.19	12.20	2.13	-0.44	0.00
WALR (Fresh Rupee Loans)	–	–	11.54	11.46	12.03	11.73	11.64	11.67	–	–	0.13

*: Base Rate system was introduced from July 1, 2010. **: Data are till end-June 2014. WALR: Weighted Average Lending Rate.
@: CRR was cut to create the desirable liquidity conditions ahead of the repo rate cuts in next easing phase. – : Not available.
Note: Policy rate, deposit and base rates are at end-month while money and bond market rates are monthly average.
Sources: Bloomberg and the Reserve Bank of India.

III.16 During the downward phase of the interest rate cycle, fixed rate high cost outstanding deposits prevent banks from reducing loan rates as they want to maintain their net interest margins (NIMs). This is in contrast to what is experienced during the upward phase of the interest rate cycle when banks are prompt in raising their lending rates. The current tightening phase has been an exception in that there has been a muted response in lending rates, which appears to reflect the sharp deceleration in economic activity and the consequential sluggishness in credit demand. However, based on data collated from January 2013 on fresh rupee loans sanctioned by banks, the transmission of policy signals appears to be more pronounced (Tables III.1 and III.2).

Table III.2: Deposit and Lending Rates of SCBs (Excluding RRBs)

(Per cent)

Month-end	Repo Rate	Median Term Deposit Rate	Weighted Average Lending Rate (WALR)	
			Outstanding Rupee Loans	Fresh Rupee Loans
1	2	3	4	5
Mar-13	7.50	7.42	12.27	11.54
Jun-13	7.25	7.48	12.20	11.46
Sep-13	7.50	7.78	12.31	12.03
Dec-13	7.75	7.75	12.25	11.73
Mar-14	8.00	7.74	12.19	11.64
Jun-14	8.00	7.74	12.20	11.67
Variation (Percentage Points) (March-14 over March-13)	**0.50**	**0.32**	**-0.08**	**0.10**

Table III.3: Sectoral Median Lending Rates of SCBs (Excluding RRBs)
(at which 60 per cent business is contracted)

(per cent)

Month-end	Home	Vehicle	Agriculture	SME	Credit Card	Education
1	2	3	4	5	6	7
Mar-13	11.25	12.71	11.63	12.99	27.07	13.00
Jun-13	11.20	12.50	11.50	12.98	24.12	13.06
Sep-13	11.20	12.30	11.86	13.00	24.74	13.13
Dec-13	11.24	12.25	11.81	12.90	25.24	13.13
Mar-14	11.27	12.19	11.70	12.73	25.00	12.88
Jun-14	11.13	12.13	11.63	12.71	27.34	12.88
Variation (Percentage Points) (March-14 over March-13)	**0.02**	**-0.52**	**0.07**	**-0.26**	**-2.07**	**-0.12**

Deposit and lending rates

III.17 The transmission of monetary easing during 2012-13 and 2013-14:Q1 enabled the weighted average lending rate (WALR) on the outstanding rupee loans extended by scheduled commercial banks (excluding RRBs) to decline by 37 bps during 2012-13 and further by 7 bps during 2013-14:Q1. The median term deposit rate of the banks declined by 4 bps to 7.42 per cent during 2012-13 while it increased by 6 bps during 2013-14:Q1. Following the exceptional measures taken by the Reserve Bank in Q2 of 2013-14, both deposit and lending rates had firmed up by September 2013 (Table III.2). With the ebbing of pressures on the exchange rate, the Reserve Bank rolled back these measures in a calibrated manner and, therefore, lending rates softened in H2 of 2013-14. On balance, while lending rates were by and large sticky during the year, SCBs' median term deposit rate rose by 32 bps over the year, although it remained almost unchanged in the second half.

Sectoral lending rates

III.18 The pass-through of the cumulative monetary policy actions during the tightening phase of the monetary policy cycle was not visible in the lending rates of most of the select sectors, reflecting the banks' weak pricing power on account of subdued economic activity (Table III.3).

Improving monetary policy transmission

III.19 In order to address the structural impediments to monetary policy transmission, the Expert Committee to Revise and Strengthen the Monetary Policy Framework recommended several measures which, *inter alia*, include reduction in SLR to a level consonant with the requirements of the liquidity coverage ratio (LCR) prescribed under the Basel III framework; the government eschewing suasion and directives to banks on interest rates; more frequent intra-year resets of interest rates on small saving instruments, with built-in automaticity linked to benchmark G-sec yields; treating all fixed income financial products on par with bank deposits for the purposes of taxation and tax deducted at source (TDS); reducing subventions on the interest rate for lending to certain sectors; developing a culture of establishing external benchmarks for setting interest rates for pricing of financial products; consistency of the Reserve Bank's liquidity management operations with the stance of monetary policy signaled through a change in the policy rate; close coordination between the settings of monetary policy and macro-prudential policies; and linking of OMOs solely to liquidity management.

IV CREDIT DELIVERY AND FINANCIAL INCLUSION

The Reserve Bank in pursuit of its commitment to financial inclusion took several initiatives to expand the reach of formal banking facilities to all. The roadmap to provide banking outlets in unbanked villages with less than 2,000 population has been drawn and allotted to banks. Acknowledging the problem of financial exclusion in metropolitan cities, the Lead Bank Scheme was extended to 16 metropolitan districts. Having created a robust infrastructure for promoting access, the focus of the next stage of the financial inclusion plans is on stepping up usage of bank accounts. Our policies have enhanced financial inclusion by addressing imperfections in the supply of financial services and increasing demand for financial services through financial literacy initiatives that raise awareness and lead to more responsible use of finance.

IV.1 The Reserve Bank has taken various steps to improve flow of credit to all the productive sectors of the economy. The main challenge is to bring those sections of society that are financially excluded into the ambit of the formal financial system. Various initiatives have been taken in this area including the rollout of financial inclusion plans (FIPs), enhancing the scope of the business correspondent (BC) model, improving credit delivery procedures with respect to the micro and small enterprises (MSE) sector and encouraging the adoption of information and communication technology (ICT) solutions.

CREDIT DELIVERY

Performance in achievement of priority sector lending targets

IV.2 The priority sector comprises of a vast section of the population engaged in sectors such as agriculture, MSEs, education and housing. As per the extant guidelines on priority sector lending, a target of 40 per cent of adjusted net bank credit (ANBC) or credit equivalent amount of off-balance sheet exposures (CE of OBE), whichever is higher, as on March 31 of the preceding year, has been prescribed for lending to the priority sector by domestic scheduled commercial banks and foreign banks with at least 20 branches. For foreign banks with less than 20 branches, the target for lending to the priority sector is 32 per cent of ANBC or CE of OBE, whichever is higher, as on March 31 of the preceding year. The performance of private sector banks has been better, as compared to public sector and foreign banks (Table IV.1).

IV.3 As per the data received from the banks, 10 out of 26 public sector banks, 4 out of 20 private sector banks and 1 out of 39 foreign banks could not achieve the target of the overall priority sector as on March 31, 2014.

Flow of credit to the agricultural sector

IV.4 Agriculture credit is one of the major drivers of agricultural production. With the objective of making credit available to farmers, the government has been fixing targets for flow of credit to agriculture by the banking sector every year. The target for 2013-14 was fixed at ₹7,000 billion. Credit to the agriculture sector has been higher than

Table IV.1: Priority Sector Advances

(Amount in ₹ billion)

As on March 31	Public Sector Banks	Private Sector Banks	Foreign Banks
1	2	3	4
2013	12,822 (36.2)	3,274 (37.5)	849 (35.1)
2014	16,190 (39.4)	4,645 (43.9)	907 (35.8)

Notes: 1. Figures in brackets are percentages to ANBC or CE of OBE, whichever is higher, in the respective groups.
2. The data for 2014 is provisional.

Table IV.2: Target and Achievement for Agricultural Credit

(Amount in ₹ billion)

Year	Target	Achievement
1	2	3
2010-11	3,750	4,683
2011-12	4,750	5,110
2012-13	5,750	6,074
2013-14	7,000	7,116*

*: Provisional.
Source: National Bank of Agriculture and Rural Development (NABARD)

targets in recent years (Table IV.2). However, credit by cooperative banks and regional rural banks (RRBs) has been less than their respective targets (Table IV.3).

Interest subvention scheme has mixed outcomes; recovery of direct agriculture advances needs improvement

IV.5 The government introduced the interest subvention scheme in 2006-07 for short-term crop loans up to ₹0.3 million, which has been continuing ever since with minor variations. Currently, it is providing interest subvention to banks, RRBs and cooperative banks with respect to short term production credit up to ₹0.3 million provided they make available the credit at the ground level at 7 per cent per annum. Besides, an additional interest subvention of 3 per cent per annum is also provided for farmers who repay the loans in time making the effective rate of interest for such farmers at 4 per cent. From 2013-14, the subvention is available to private sector SCBs with respect to loans given by their rural and semi-urban branches.

Table IV.3: Bank Group-wise Target and Achievement for Agricultural Credit: 2013-14

(Amount in ₹ billion)

Agency	Target	Achievement*
1	2	3
Commercial Banks	4,750	5,090
Cooperative Banks	1,250	1,199
RRBs	1,000	827
Total	**7,000**	**7,116**

*: Provisional.
Source: NABARD/Indian Banks Association/PSBs.

Table IV.4: NPAs-Agriculture Loans

(₹ billion)

Year	Agriculture Loans (Outstanding as on March 31)	Gross NPAs (Agriculture)*	Ratio of Gross NPAs (Agriculture) to Agriculture Loans (Outstanding as on March 31)
1	2	3	4
2008	3,081	97	3.2
2009	3,744	72	1.9
2010	4,636	104	2.2
2011	5,072	167	3.3
2012	5,802	248	4.3
2013	6,428	302	4.7
2014*	7,792	340	4.4

*: Provisional.

IV.6 The subvention scheme is limited to farmers availing crop loans of up to ₹0.3 million. Interest subvention as an incentive for prompt repayment has not helped in improving the asset quality in the agriculture sector. The non performing assets (NPAs) ratio in agriculture loans have been rising and stood at 4.4 per cent as on March 31, 2014 (Table IV.4). The recovery of agriculture advances has been almost stagnant at around 75 per cent and needs improvement (Table IV.5).

Rationale for the revised General Credit Card (GCC) scheme

IV.7 During the FIP review meetings held with banks during May-July 2013, it was observed that

Table IV.5: Recovery of Direct Agriculture Advances

(₹ billion)

Year	Total Demand	Total Recovery	Per cent of Recovery to Demand
1	2	3	4
2011	1,822	1,383	75.9
2012	1,918	1,429	74.5
2013	2,596	1,976	76.1

the data reported by the banks under GCC was not showing entrepreneurial credit extended to individuals. In order to enhance the coverage of the GCC scheme to ensure greater credit linkages for all productive activities within the overall priority sector guidelines and to capture all credit extended by banks to individuals for non-farm entrepreneurial activities, GCC guidelines were revised on December 2, 2013. The revised scheme does not prescribe any ceiling on the loan amount as long as the loan is for non-farm entrepreneurial activity and is otherwise eligible for classification under priority sector whereas the old scheme stipulated a limit of ₹25,000 for an individual. Further, the credit extended under the revised scheme is for non-farm entrepreneurial activities whereas under the old scheme, there was no such insistence on purpose or end use of credit.

Kisan Credit Cards (KCC) scheme

IV.8 The KCC scheme was revised in May 2012 and all the banks were advised to issue smart cards to all farmers. As on September 30, 2013 of the about 20.0 million operative cards, around 4.9 million were smart cards issued by public and private sector banks.

Flow of credit to micro, small and medium enterprises

IV.9 Credit to the MSE sector by scheduled commercial banks (SCBs) registered a growth of 23.1 per cent in 2013-14 (Table IV.6).

Table IV.6: Credit to Micro and Small Enterprises by SCBs

As on end March	Outstanding Credit to the MSE sector		MSE credit as per cent of ANBC
	Number of accounts (in million)	Amount outstanding (₹ billion)	
1	2	3	4
2013	11.2 (13.1)	6,872.1 (30.2)	14.8
2014	12.4 (10.7)	8,461.3 (23.1)	15.6

Note: 1. Data for 2014 are provisional.
2. Figures in parentheses indicate y-o-y change in per cent.
Source: Scheduled commercial banks

Implementation of the Lead Bank Scheme (LBS)

IV.10 The Monetary Policy Statement for 2013-14 stated that the challenge of financial exclusion is also widespread in metropolitan areas, especially among the disadvantaged and low income groups. To facilitate doorstep banking for the excluded segment of the urban poor and to provide an institutional mechanism for coordination between the government and the banks, it was decided to bring all districts in metropolitan areas under LBS. Accordingly, lead bank responsibility was assigned to designated banks in 16 districts in metropolitan areas, thus bringing the entire country under the scheme. The processes of grass root level credit planning are initiated and monitored through Block Level Bankers' Committee, District Consultative Committee (DCC), District Level Review Committee (DLRC) and State Level Bankers' Committee (SLBC). In these fora, bankers as well as government agencies meet at a common platform to address impediments and facilitate enablers of development. While important issues that impact the whole state are discussed in SLBCs, issues of concern specific to the district are resolved in DCC meetings.

Lead bank responsibility for districts

IV.11 As on end March 2014, lead bank responsibility was assigned to designated banks in 671 districts in the country as compared to 644 districts as at end March 2013. In the seven new districts formed in Gujarat, Dena Bank, Bank of Baroda and State Bank of India were assigned lead bank responsibility. Bank of India was assigned lead bank responsibility in the one new district in Madhya Pradesh and the State Bank of India was assigned lead bank responsibility in all the 4 new districts in Meghalaya. Further, 16 districts in metropolitan areas of Chennai (1), Delhi (11), Hyderabad (1), Kolkata (1) and Mumbai (2) were also brought under LBS during 2013-14.

FINANCIAL INCLUSION

Roadmap for providing banking outlets in unbanked villages

IV.12 The Reserve Bank continued efforts to create a conducive and enabling environment for access to financial services to extend door step banking facilities in all the unbanked villages in a phase-wise manner. During Phase I, 74,414 unbanked villages with population more than 2,000 were identified and allotted to various banks through SLBCs for coverage through various modes, that is, branches, BCs or other modes such as ATMs and satellite branches etc. All these unbanked villages have been covered by opening banking outlets comprising 2,493 branches, 69,589 BCs and 2,332 through other modes.

IV.13 In Phase II, under the roadmap for provision of banking outlets in unbanked villages with population less than 2,000, about 4,90,000 unbanked villages have been identified and allotted to banks for coverage in a time bound manner by March 31, 2016. As per the progress reports received from SLBCs, banks had opened banking outlets in 183,993 unbanked villages by March 2014, comprising 7,761 branches, 163,187 BCs and 13,045 through other modes. The Reserve Bank is closely monitoring the progress made by the banks under the roadmap.

Financial inclusion plan and its performance evaluation

IV.14 The Reserve Bank has encouraged banks to adopt a structured and planned approach to financial inclusion (FI) with commitment at the highest levels through preparation of board approved FIPs. The first phase of FIPs was implemented over 2010-13. The Reserve Bank has used FIPs to gauge the performance of banks under their FI initiatives. With the completion of the first phase, a large banking network has been created and a large number of bank accounts have also been opened (Table IV.7). However, it has been

Table IV.7: Financial Inclusion Plan-Summary Progress of all Banks including RRBs

Particulars	Year ended March 2010	Year ended March 2013	Year ended March 2014	Progress April 2013 - March 2014
1	2	3	4	5
Banking Outlets in Villages – Branches	33,378	40,837	46,126	5,289
Banking Outlets in Villages – Branchless Mode	34,316	2,27,617	3,37,678	1,10,061
Banking Outlets in Villages –Total	67,694	2,68,454	3,83,804	1,15,350
Urban Locations covered through BCs	447	27,143	60,730	33,587
Basic Savings Bank Deposit A/c through branches (No. in million)	60.2	100.8	126.0	25.2
Basic Savings Bank Deposit A/c through branches (Amt. in ₹ billion)	44.3	164.7	273.3	108.6
Basic Savings Bank Deposit A/c through BCs (No. in million)	13.3	81.3	116.9	35.7
Basic Savings Bank Deposit A/c through BCs (Amt. in ₹ billion)	10.7	18.2	39.0	20.7
BSBDAs Total (No. in million)	73.5	182.1	243.0	60.9
BSBDAs Total (Amt. in ₹ billion)	55.0	182.9	312.3	129.3
OD facility availed in BSBDAs (No. in million)	0.2	4.0	5.9	2.0
OD facility availed in BSBDAs (Amt. in ₹ billion)	0.1	1.6	16.0	14.5
KCCs – (No. in million)	24.3	33.8	39.9	6.2
KCCs – (Amt. in ₹ billion)	1240.1	2623.0	3684.5	1061.5
GCC- (No. in million)	1.4	3.6	7.4	3.8
GCC - (Amt. in ₹ billion)	35.1	76.3	1096.9	1020.6
ICT A/Cs-BC- Transaction - (No. in million) (During the year)	26.5	250.5	328.6	328.6
ICT A/Cs-BC- Transactions - (Amt. in ₹ billion) (During the year)	6.9	233.9	524.4	524.4

Note: Figures in column 5 might not tally due to rounding off of numbers.

observed that the accounts opened and the banking infrastructure created has not seen substantial operations in terms of transactions. In order to continue with the process of ensuring meaningful access to banking services to the excluded, banks were advised to draw up fresh three-year FIPs for 2013-16. Banks were also advised that the FIPs prepared by them are disaggregated and percolate down to the branch level so as to ensure the involvement of all the stakeholders in FI efforts and also to ensure uniformity in the reporting structure under FIPs. The focus under the new plan is now more on the volume of transactions in the large number of accounts opened. A brief of the performance of banks under FIP up to March 31, 2014 is:

i) The number of banking outlets has gone up to nearly 3,84,000. Out of these, 1,15,350 banking outlets were opened during 2013-14.

ii) Nearly 5,300 rural branches were opened during the last one year. Out of these, nearly 4,600 branches were opened in unbanked rural centres (Tier V and Tier VI centres).

iii) Nearly 33,500 BC outlets were opened in urban locations during the year taking the total number of BC outlets in urban locations to 60,730 as at the end of March 2014.

iv) More than 60 million basic savings bank deposit accounts (BSBDAs) were added during the last year taking the total number of BSBDAs to 243 million.

v) With the addition of 6.2 million small farm sector credits during 2013-14, there are 40 million such accounts as on March 31, 2014.

vi) With the addition of 3.8 million small non-farm sector credits during 2013-14, there are 7.4 million such accounts as on March 31, 2014.

vii) Nearly 328 million transactions were carried out in BC-ICT accounts during the last year as compared to 250 million transactions during 2012-13.

IV.15 Though, the number of BC-ICT transactions has shown a considerable increase during the last year the average transaction per account still remains low. The focus of monitoring is now more on usage of these accounts through issue of more credit products through the channel. The Reserve Bank also issued guidelines to strengthen the BC model (Box IV.1).

Box IV.1
Guidelines for Strengthening the BC Model

With the objective of ensuring greater financial inclusion and increasing the outreach of the banking sector, the Reserve Bank permitted banks to utilise the services of intermediaries in providing financial and banking services through the use of business correspondents (BCs).

As reported by the banks under their financial inclusion plans nearly 2,48,000 BC agents had been deployed by banks as on March 31, 2014 which are providing services through more than 3,33,000 BC outlets. Nearly 117 million basic saving bank deposit accounts (BSBDAs) opened through BCs remained outstanding as on March 31, 2014. Though the number of BC-ICT transactions showed considerable increase, it was observed that the increase in the volume of transactions was not commensurate with the increase in the number of BCs engaged and the accounts opened through them. A review of the BC model highlighted that the cash management system followed by the banks for BC operations was one of the major impediments in the scaling up of the BC model.

In order to facilitate the scaling up of the BC model, the Reserve Bank recently issued the guidelines asking bank boards to: (i) review the operations of BCs at least once every six months with a view to ensuring that the requirement of pre-funding of corporate BCs and BC agents should progressively taper down; and (ii) review the remunerations of BCs and lay down a system of monitoring by the top management of the bank. It also directed that the cash handled by BCs be treated as the bank's cash and the responsibility for insuring this cash should rest with the bank.

FINANCIAL LITERACY

Reserve Bank up-scales financial literacy activities

IV.16 The overall objective of the Reserve Bank's financial literacy strategy is to achieve financial inclusion by creating awareness about the formal financial system. The Reserve Bank's financial literacy efforts are channelled through banks in the form of a mass scale literacy campaign which includes conducting financial literacy camps in unbanked locations. For this purpose, all the financial literacy centres (FLCs) and rural branches of SCBs are advised to undertake financial literacy activities in the form of awareness camps at least once a month. For this, the Reserve Bank has devised model architecture for conducting the financial literacy camps in three stages starting with generating awareness in the first stage, account opening in the second stage and monitoring the usage of accounts in the third stage. In order to ensure consistency in the messages reaching the target audience of financially excluded people by the FLCs, the Reserve Bank has issued comprehensive financial literacy material consisting of a Financial Literacy Guide, a Financial Diary and a set of 16 posters which is now available in 13 languages. The Reserve Bank has advised all banks including RRBs to use the financial literacy material as standard curriculum to impart basic conceptual understanding of financial products and services.

IV.17 A review of the progress made by FLCs reveals that 514 FLCs were added during 2012-14 taking the total number of FLCs from 428 as at end of March 2012 to 942 as at end March 2014 (Table IV.8). These FLCs are creating awareness about banking products and services through indoor and outdoor activities.

IV.18 In order to assess the efficacy of the activities conducted by FLCs, a quick study was conducted in October 2013 on the impact of their awareness programmes. The study was spread across 46 districts in 23 states; 730 participants who had attended financial literacy camps during the last year were interviewed. The findings of the study revealed that almost all the participants (99 per cent) had got linked to the formal banking system with a saving account (89 per cent) being the most used banking product and 44 per cent of the participants had availed of credit products. Remittances and direct benefit transfer (DBT) were the least used (20 per cent) products. Based on the findings, banks have been advised to create awareness about various products and services available so as to increase their usage.

Table IV.8: Activities Undertaken by Financial Literacy Centres

Particulars	During year ended March 2013	During year ended March 2014
1	2	3
No. of Outdoor Activities conducted	40,838	56,985
Outdoor activities- No. of persons participated	1,733,198	3,178,425
Indoor activities- No. of persons participated	483,980	647,643
Total No. of persons participated - Outdoor & Indoor activities	**2,217,178**	**3,826,068**

IV.19 The National Centre for Financial Education (NCFE) has been set up for implementing the National Strategy for Financial Education which has been prepared under the aegis of the Financial Stability and Development Council (FSDC). NCFE will create standard financial education material that can be accessed through its website (www.ncfeindia.org). Literacy material prepared by the Reserve Bank has also been placed on this website.

Recommendations of Committee on Comprehensive Financial Services for Small Businesses and Low Income Households

IV.20 The committee (Chair: Dr Nachiket Mor) was set up by the Reserve Bank to enhance financial inclusion and deepening. The Committee laid down the following vision as part of its recommendations: (i) Universal Electronic Bank

Account (UEBA) for all Indians above the age of 18, (ii) ubiquitous access to payment services and deposit products at reasonable charges, (iii) sufficient access to affordable formal credit, (iv) universal access to a range of deposit and investment products at reasonable charges, (v) universal access to a range of insurance and risk management products at reasonable charges, and (vi) right to suitability. The main recommendations are listed in Box IV.2.

Box IV.2
Recommendations of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households

Promoting financial inclusion and enhancing financial depth are among the key developmental agendas of the Reserve Bank. Despite various efforts channelled to achieving these goals through cooperative banks, nationalisation of banks, self-help groups, regional rural banks, or business correspondents, the success has been limited and progress uneven on a regional and sectoral basis. With a view to reviewing the existing strategies for achieving financial inclusion; designing principles to develop institutional frameworks and regulation; and developing a comprehensive monitoring framework to track the progress made, the Reserve Bank in September 2013, set up a Committee on Comprehensive Financial Services for Small Business and Low Income Households (Chair: Dr Nachiket Mor) which submitted its report in January 2014.

The report observed that nearly 90 per cent of small businesses had no links with formal financial institutions while 60 per cent of the rural and urban population did not have a functional bank account, and much of the credit needs of the economy came from the informal sector. Difficulties of access and absence of a positive real return on financial savings had accelerated the move away from financial assets to physical assets and unregulated providers. This indicates a visible demand for a wide range of financial services by small businesses and low-income households. Concerted efforts are needed to ensure the achievement of several key goals such as universal access to a bank account; a ubiquitous payments infrastructure; and a base level access to all the other financial products such as credit and insurance within a relatively short period of time.

Against this backdrop, the major recommendations of the committee relating to banks include:

- Providing a universal bank account to all Indians (over 18 years) by January 1, 2016.
- Vertically differentiated banking system with payments banks for deposits and payments and wholesale banks for credit outreach with relaxed entry point norms of ₹0.5 billion.
- Adjusted priority sector lending target of 50 per cent against the current 40 per cent with sectoral and regional weights based on the level of difficulty in lending.
- Transfer of risks and liquidity through markets and strengthening the internal risk assessment capabilities of key refinance institutions.
- Differential provisioning norms for each asset class and public disclosure of stress tests by banks.

Major recommendations of the committee relating to non banks financial companies (NBFCs) include:

- Consolidation of multiple NBFC definitions into two categories: (i) core investment companies (CICs) and (ii) all other NBFCs.
- Restoring permission for non-deposit accepting NBFCs (NBFC-NDs) to act as business correspondents (BCs) of a bank based on the operational criterion chosen by the bank.
- Partial convergence of NBFC and bank regulations with regard to non performing assets (NPA) norms, provisioning for standard assets and inclusion under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI).
- Clear framework to address wholesale funding constraints of NBFCs to be developed by the Reserve Bank and Securities Exchange Board of India (SEBI) involving guidelines for qualified institutional buyers (QIBs) and accredited individual investors permitting external commercial borrowings (ECBs) in Indian rupees (INR) for all institutions and for linking the eligibility for ECB in other currencies to size and capacity to absorb

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foreign exchange risk instead of to specific NBFC categories.

- Putting in place better on-going risk measures with proper disclosure of stress test results and adoption of core banking solution (CBS), besides better off-site supervision.
- The total borrowing limit for the small borrower segment to be increased to ₹0.1 million across all lenders, including bank-lending to this segment.
- To set up a new category of institutions called wholesale banks and permit NBFCs to transition into wholesale consumer banks or wholesale investment banks with access only to wholesale (not retail) deposits subject to monitoring and reporting requirements. An active market for priority sector lending (PSL) assets is to be created so that banks and NBFCs can actively trade PSL assets between themselves.
- Creation of State Finance Regulatory Commission (SFRC) by merging existing state government-level regulators and adding functions like the regulation of NGO-MFIs and local money services business.

Draft guidelines for “Licensing of Payments Banks” and “Licensing of Small Banks” have been since issued in July 2014 for furthering financial inclusion. Small banks will provide basic banking products such as deposits and supply of credit, but in a limited area of operation. Payments banks will leverage on technology and provide a limited range of products such as acceptance of demand deposits and remittances of funds with a widespread network of access points particularly in remote areas.

V DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

The Reserve Bank continued with its efforts to further develop financial markets and strengthen their regulation. Initiatives in this respect included introduction of inflation indexed bonds and cash-settled interest rate futures. It also endeavoured to improve liquidity in the G-sec market. A slew of measures were taken to encourage capital inflows amid a widening of the CAD and foreign exchange market pressures. Risks to the financial system from global and internal spillovers were carefully monitored and appropriate measures were taken to mitigate them. Going forward, reforms of financial benchmarks are planned.

V.1 In the face of increased capital flows following uncertainties from the possible timeline for commencement of the US QE tapering risk since end-May 2013, several measures undertaken by the government and the Reserve Bank successfully restored stability to the currency markets. Efforts were also made by the Reserve Bank for developing other financial markets so as to enhance monetary policy transmission, furthering product innovations in the markets and creating an investor friendly climate to attract stable capital flows.

V.2 In order to ensure the robustness and credibility of the financial system and to minimise the risks therein, a continuous monitoring and review framework needs to be in place. Financial benchmarks provide a quick and convenient way to monitor the system and have a significant bearing on the stability of the financial system in view of the huge volume of financial contracts referenced to or valued through such benchmarks. To ensure their credibility, the Reserve Bank constituted a Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar) to analyse the financial benchmarks in the Indian context (Box V.1).

Box V.1
Reforms in Financial Benchmarks

Financial benchmarks are mainly used for pricing, settlement and valuation of financial contracts. Recent global developments with regard to manipulation of several key global benchmarks, *viz.* London Inter-bank Offered Rate (LIBOR), Euro Inter-bank Offered Rate (EURIBOR), Tokyo Inter-bank Offered Rate (TIBOR) and the London 4 PM FX fixing, *etc.*, have raised serious concerns about the reliability of the financial benchmarks. Several international standard setting bodies, national regulators, central banks and self-regulatory bodies have announced comprehensive measures and governing principles for reforming financial benchmarks. Notables among them are the Wheatley review of LIBOR (September 2012), the European Securities Market Authority-European Banking Authority's Principles for Benchmark Setting Processes in the European Union (June 2013) and International Organisation of Securities Commission (IOSCO)'s report on Principles for Financial Benchmarks (July 2013).

Building on the cross-country experience, the Committee on Financial Benchmarks (Chairman: Shri P. Vijaya Bhaskar) constituted by the Reserve Bank undertook an in-depth analysis of the existing benchmark setting methodology and governance framework of major Indian rupee interest rate and foreign exchange benchmarks. It identified the major benchmarks based on their extent of usage and relevance and found the existing system to be generally satisfactory. It recommended several measures for strengthening the benchmark quality and setting methodology and governance framework for benchmark administrators, calculation agents and submitters.

Major recommendations relating to benchmark quality and setting methodology include:

i) Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Foreign Exchange

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Dealers' Association of India (FEDAI) to administer the Rupee interest rate and foreign exchange benchmarks respectively, with primary responsibility for the entire setting process.

ii) Benchmark calculations may be based on observable transactions, wherever available, as the first layer of inputs subject to an appropriate threshold. Executable bids and offers, subject to appropriate threshold and polled submissions, may be used as the second and third layer of inputs respectively in terms of hierarchy of inputs.

iii) Overnight Mumbai Inter-bank Bid Rate (MIBID) – Mumbai Inter-bank Offered Rate (MIBOR) setting may be shifted from the existing polling-based method to volume weighted average (VWA) of trades executed between 9-10 am on the Negotiated Dealing System-Call (NDS-CALL).

iv) FIMMDA to coordinate the transition of legacy contracts referenced to the National Stock Exchange (NSE) MIBID-MIBOR through multilateral and bilateral amendment agreements, as appropriate.

v) Construction of the government security (G-sec) yield curve to be based on the VWA of trades executed over a longer time window in place of the last traded yields.

vi) In the absence of the required trading volume in state development loans (SDLs), the spread discovered in the last two SDL auctions, subject to appropriate qualifying criteria, may be used in place of the existing fixed 25 bps spread.

vii) The RBI reference rate may be based on VWA of actual transactions executed during a sufficiently longer time window in place of the existing polling method.

viii) The unused benchmarks may be phased out by the respective administrators.

Major recommendations relating to the governance framework include:

i) Administrators may formulate a comprehensive code of conduct for submitters specifying the hierarchy of data inputs for submission, pre-submission validation and post-submission review of inputs, *etc.*, and may oversee compliance by submitters.

ii) To overcome possible conflicts of interest with the benchmark setting process arising out of the current governance structure, FIMMDA and FEDAI may create an independent structure, either jointly or separately, for administration of the benchmarks.

iii) Calculation agents may appoint personnel with appropriate level of seniority and clear accountability to be responsible for calculating the benchmark; establish robust pre- and post-calculation controls; institute appropriate confidentiality protocols with respect to information received by or produced by them; subject calculation function to periodic internal and external audit and submit periodic confirmation to the administrator.

iv) Benchmark submitters may have an internal board approved policy for governance of the submission process; establish an effective conflicts of interest policy and whistle blowing policy; appoint clearly accountable personnel responsible for submissions; institute a maker-checker system to ensure integrity of submissions; subject the submission process to periodic internal audits and external audits where appropriate and submit periodic confirmation to the administrator.

The committee recommended suitable amendments to the RBI Act to empower the Reserve Bank to determine policy with regard to benchmarks used in money, G-sec, credit and foreign exchange markets in India and to issue binding directions to all agencies involved in benchmark setting.

The Reserve Bank has since advised FIMMDA and FEDAI to take necessary steps to implement the recommendations of the committee. Guidelines specifying the measures to be implemented by banks and primary dealers (PDs) acting as benchmark submitters for strengthening their governance frameworks have been issued. Benchmark submission activities of banks and PDs including their governance framework for submission are being brought under the Reserve Bank's on-site and off-site supervision.

GOVERNMENT SECURITIES MARKET

V.3 The Reserve Bank has taken various measures to develop government securities (G-secs) and interest rate derivatives (IRDs) markets through initiatives like introducing inflation indexed bonds, cash settled 10-year interest rate futures (IRF) and trading of separately traded registered interest and principal of securities (STRIPS) on NDS-Order Matching (NDS-OM); consolidating securities through buyback and switches; gradual upward revision of the investment limit for foreign institutional investors (FIIs) in

G-secs; reducing the held to maturity portfolio to 24 per cent of net demand and time liabilities; and in principal approval to the Clearing Corporation of India Limited (CCIL) for introducing an electronic swap execution facility with central counterparty for interest rate swap trades.

V.4 The limit for investment in G-secs available to FIIs/qualified foreign investors (QFIs)/foreign portfolio investors (FPIs) has been enhanced by US$ 5 billion by correspondingly reducing the amount available to long term investors from US$ 10 billion to US$ 5 billion within the overall limit of US$ 30 billion. The incremental investment limit should be invested in G-secs with a minimum residual maturity of 3 years.

FOREIGN EXCHANGE MARKET

V.5 In order to address the issues of widening current account deficit (CAD) and curbing the volatility in the domestic forex market emanating from sudden outflows, the Reserve Bank and the Government of India initiated a number of measures during the year which broadly aimed at reducing the import of gold; encouraging portfolio investments, particularly in the debt segment; rationalising external commercial borrowings (ECBs); moderating outflows through overseas direct investments (ODIs) by residents; and curbing the speculative intent of market players. With return of stability in the Rupee-Dollar exchange rate, restrictions with respect to remittances under ODIs and by individuals were largely withdrawn.

Current account

Curbs on gold import to dampen CAD

V.6 To stem the pressure on CAD from the growing gold import bill, a slew of measures were taken to moderate the demand for gold for domestic use. These *inter alia* included: (i) increase in customs duty on gold imports, (ii) prohibition of import of gold in the form of coins and medallions, and (iii) direction to all nominated banks and other entities to ensure that at least 20 per cent of every lot of gold import was exclusively made available for exports. With these measures, gold imports were brought significantly under control during 2013-14.

Centralised export data processing and monitoring system initiated

V.7 A comprehensive export data processing and monitoring system was put in place from March 1, 2014 for effective monitoring, easier tracking and reconciliation of export transactions. To capture all export transactions, this centralised automated export transaction system was developed with a single master database for all exports. Shipping data with customs' authorities will form the base for all subsequent export follow-up processes. These data will be shared with the stakeholders involved to monitor both receipt of export documents and repatriation of export proceeds using banking channels.

Other rationalisation measures

V.8 A comprehensive set of new regulations issued to boost merchant trade included: (i) rationalisation of time limit for completion of a transaction cycle within 9 months, without any outlay of foreign exchange beyond 4 months, (ii) short-term credit (suppliers or buyers) for merchant trade transactions be made available to the extent not backed by advance remittances for the export leg, including the discounting of the export-leg letter of credit. Third party payment was enabled for export/import of goods/software transactions subject to a firm irrevocable purchase order/ tripartite agreement else requiring documentary evidence indicating the circumstances leading to third party payments.

Outward remittances

V.9 With effect from May 19, 2014 a limited liability partnership (LLP), registered under the Limited Liability Partnership Act, 2008 (6 of 2009), was notified as an 'Indian party' for undertaking ODI.

V.10 The limit on financial commitments by an Indian party for making ODIs was reduced from 400 per cent of their net worth (as on the date of the last audited balance sheet) to 100 per cent under the automatic route with effect from August 2013 which was subsequently restored in July 2014 with stability returning to the foreign exchange market, with an additional condition that any financial commitment exceeding US$ 1 billion in a financial year would require prior approval of the Reserve Bank.

V.11 In August 2014, the prescribed limit for remittances under the liberalised remittance scheme (LRS) for any permitted capital and current account transaction or a combination of both were reduced from US$ 200,000 to US$ 75,000 per financial year. The LRS window, however, was expanded by permitting resident individuals to make ODIs to set up/acquire joint ventures (JVs)/wholly owned subsidiaries (WOS) abroad within the limit prescribed under LRS. With stability returning to the foreign exchange market, the eligible limit was enhanced to US$ 125,000 in June 2014 without end-use restrictions except for prohibited transactions such as margin trading.

V.12 With a view to facilitating travel requirements of residents travelling abroad and non-residents visiting India, the value of Indian currency for all travelers, except citizens of Pakistan and Bangladesh was fixed at ₹25,000.

Inward remittances

Foreign direct investment (FDI)

V.13 As part of the liberalisation measures, in September 2013 the Reserve Bank allowed non-residents (other than portfolio investors) to acquire shares on the stock exchange under the FDI scheme in a listed Indian company complying with the Securities Exchange Board of India's (SEBI) substantial acquisition of shares and takeover regulations.

V.14 Unlisted companies in India were allowed to raise capital abroad without the requirement of prior or subsequent listing in India. The scheme is initially for a period of 2 years, subject to conditionality and review thereafter. The optionality clause was permitted in equity shares and compulsorily and mandatorily convertible preference shares/ debentures to be issued to a person resident outside India under the FDI scheme without any assured return subject to certain conditions.

V.15 To enhance the effectiveness of the FDI policy and provide clarity on ownership and control, guidelines were issued on downstream investments in Indian companies including those by an Indian company that is not owned and/or controlled by resident entities. To make foreign investments in government and corporate debt more investor friendly, existing limits were rationalised to remove maturity restrictions and lock in period stipulations.

V.16 A new investor class, FPIs subsuming the existing regulatory framework for FIIs and QFIs with streamlined know your customer (KYC) procedures was introduced. In April 2013 investment limits in treasury bills (T-bills) was capped at US$ 5.5 billion. In June 2013 the limit for long term investors was increased by US$ 5 billion to US$ 30 billion so that the investment limits curtailed at the shorter end are available for longer maturities. The limit for long term investors was further increased in January 2014 to US$ 10 billion within the overall limit of US$ 30 billion. In July 2014, the sub-limit of US$ 10 billion has been modified as mentioned in paragraph V.4 above.

V.17 In order to further encourage longer term flows, in April 2014 all eligible foreign investors, including FPIs were permitted to make investments in dated G-secs having residual maturity of one year and above. Existing investments in T-bills and dated G-secs with less than one year residual maturity were allowed to be tapered off on maturity/ sale.

V.18 General permission was granted to Indian companies to issue non-convertible/redeemable preference shares or debentures to non-resident shareholders including the depositories that act as

trustees for the American depositary receipt (ADR)/ global depositary receipt (GDR) holders, by way of distribution as bonus from its general reserves. This scheme of arrangement must be approved by an Indian court under the provisions of the Companies Act, subject to no objections from the income tax authorities. On subsequent listing of such instruments, registered FPIs were allowed to invest on a repatriation basis in such instruments, within the overall limit of US$ 51 billion earmarked for corporate debt.

V.19 To widen the avenues for FDI investments, LLPs were allowed FDI under the government approval route in sectors where 100 per cent FDI is allowed without any FDI linked performance related criteria.

Swap facility to enhance banks' overseas borrowing

V.20 With a view to augmenting capital inflows and providing additional avenues of overseas funds, overseas borrowing limits for authorised dealer (AD) category-I banks was raised to 100 per cent of their unimpaired Tier I capital as at the close of the previous quarter or US$ 10 million, whichever is higher, against the prevailing limit of 50 per cent. AD banks were also allowed to borrow from international/multilateral financial institutions for a limited period between September 11, 2013 and November 30, 2013 with the option of entering into a swap transaction with the Reserve Bank. The swaps were available at a concessional rate of a 100 basis points below the market rate for all fresh borrowings with a minimum tenor of one year and a maximum tenor of 3 years.

Liberalisation in inward remittance schemes

V.21 The scope of the Rupee drawing arrangement (RDA), one of the official channels for receiving inward remittances, has been further expanded. Additional activities permitted include (a) direct payment of bills to the utility service providers and tax authorities in India and (b) equated monthly installment (EMI) payments in India to banks and non-banking financial companies (NBFCs) for repayment of loans. Further, the limit on trade transactions permitted under the scheme was also increased from ₹200,000 to ₹500,000 per transaction.

V.22 To facilitate receipt of remittances directly into the bank account of the beneficiary even if held with a bank other than the recipient bank, remittances through the Money Transfer Service Scheme (MTSS) or RDA were allowed to be transferred to the beneficiary bank account through electronic mode such as the National Electronic Fund Transfer (NEFT) and the Immediate Payment Service (IMPS) provided the account is compliant with KYC guidelines. This facility will aid in expanding the network and also reduce cash transactions to some extent.

External commercial borrowings (ECBs)

V.23 With a view to strengthening foreign capital inflows in the infrastructure sectors: (a) the definition of the infrastructure sector was expanded for the purpose of availing ECBs; (b) NBFCs - asset finance companies were permitted to avail of ECBs under the automatic/approval routes to finance the import of infrastructure equipment for leasing to infrastructure sectors; and (c) the ECB limit for NBFCs – infrastructure finance companies was raised from 50 per cent to 75 per cent of their owned funds, including the outstanding ECBs under the automatic route, and beyond 75 per cent of their owned funds under the approval route and their hedging requirement for currency risk was reduced from 100 per cent to 75 per cent of exposure.

V.24 The benefits under the US$ 10 billion scheme, which allows borrowers who are consistent forex earners to raise ECB to refinance Rupee loans taken from domestic banks, was extended to companies which have established JVs/WOS/have acquired assets overseas.

V.25 Permission for credit enhancement by eligible non-resident entities (multilateral/regional

financial institutions, government owned development financial institutions and direct/ indirect foreign equity holder(s)), that was earlier available exclusively for the infrastructure sector was extended to all borrowers eligible to raise ECB under the automatic route.

V.26 Eligible domestic subsidiaries of foreign companies were permitted to avail ECB with minimum average maturity of 7 years for general corporate purposes from their foreign equity holder companies subject to certain conditions.

Pilot float of Rupee bonds

V.27 As a pilot measure, the International Finance Corporation was permitted to float Rupee denominated bonds in overseas markets for an amount of ₹620 billion. These bonds were linked to the Indian rupee, but had to be subscribed to and settled in a foreign currency. This was the first approval granted by Reserve Bank for such bond issuance. All issuances received strong interests from global investors.

DERIVATIVES MARKET

Introduction of cash settled IRFs on 10-year G-secs

V.28 The working group on enhancing liquidity in the G-sec and IRD markets examined IRF markets in detail and recommended introducing cash settled 10-year IRFs subject to appropriate regulations like restricted participation, entity-based open position limit and price band. Directions on cash settled IRFs on 10-year G-sec were issued on December 5, 2013. In consultation with market participants and SEBI, two variants: (a) coupon bearing G-secs as underlying, that is, single bond IRF on 10-year G-secs, and (b) coupon bearing notional 10-year G-secs with the settlement price based on a basket of securities as underlying have been permitted for cash settled futures on 10-year G-secs. Exchanges have been permitted to launch contracts on any or both of the variants. All three authorised exchanges (NSE, the Bombay Stock Exchange and the Multi Commodity Exchange) introduced cash settled IRF on 10-year G-secs in January 2014.

V.29 The market is still in the nascent stage as many of the market participants are yet to put in place appropriate systems and procedures. It is, however, expected that as the market develops all regulated entities will start taking active positions in the IRF market for the better management of interest rate risks.

Restrictions on currency derivative trading to curb volatility

V.30 In the face of exchange market pressures, trading volumes in the domestic exchange traded currency derivatives rose reflecting the volatile conditions since the end of May 2013. To restore some order in the market, SEBI, in consultation with the Reserve Bank of India, imposed restrictions in the currency derivatives market *viz*., increase in the initial and extreme loss margins and reduction in the open position limits of clients and non-bank trading members. AD category-I banks were not allowed to carry out any proprietary trading in currency futures/exchange traded currency options markets, except on behalf of their clients.

Measures to provide flexibility to market participants to hedge exchange risk

V.31 As market conditions stabilised in the foreign exchange markets beginning Q3 of 2013-14, in order to provide operational flexibility with respect to current and capital account transactions, exporters (importers) were allowed to cancel and rebook forward contracts to the extent of 50 per cent (25 per cent) of the contracts booked in a financial year for hedging their contracted export (import) exposures. Subsequently, all forward contracts with respect to all current account transactions as well as capital account transactions with a residual maturity of one year or less were allowed to be freely cancelled and rebooked. Forward contracts booked by FIIs/QFIs/other portfolio investors are allowed to be rolled over on

or before maturity, and once cancelled are allowed to be rebooked up to the extent of 10 per cent of the value of the contracts cancelled.

V.32 The requirement that all forward contracts booked under this facility (by both exporters and importers) be on a fully deliverable basis has also been relaxed. Contracts booked up to 75 per cent of the respective eligibility limits are allowed to be cancelled with the exporter/importer entitled to the loss or gain as the case may be. However, contracts booked in excess of 75 per cent of the eligible limit will be on a deliverable basis and cannot be cancelled, implying that in the event of cancellation, the exporter/importer shall have to bear the loss but will not be entitled to receive the gain.

Liberalisation in the foreign exchange derivatives market

V.33 FPIs are now permitted to access the exchange traded currency derivative (ETCD) market up to a threshold level and conditional access beyond it. Residents' access to ETCD has also been rationalised. Policy measures have been initiated to bring about some convergence in the over-the-counter (OTC) and the exchange traded markets. AD category-I banks are also permitted to take proprietary position in the ETCD market. Due to volatile market conditions, the banks were earlier temporarily prohibited from doing so. Banks can now also off-set their OTC positions in the futures market and vice-versa.

V.34 Restrictions imposed in December 2011 on foreign exchange markets have also been lifted almost entirely. The facility of rebooking of cancelled contracts has been restored. While compulsory delivery under the past performance route has also been done away with, the limits for exporters have been restored completely and the same for the importers have been kept at 50 per cent of the limit assessed.

V.35 Following the recommendations of the Technical Committee on Services/Facilities for Exporters (Chairman: Shri G. Padmanabhan) regarding rationalisation of the documentation process, AD category-I banks were allowed to obtain an annual certificate from statutory auditors while offering hedging products under the contracted exposure route to their customers. This measure is expected to ease the burden of documentation in the process of hedging exchange risks.

VI REGULATION, SUPERVISION AND FINANCIAL STABILITY

The five years since the onset of the global financial crisis have seen policymakers across the globe strive to rebuild their financial systems to ensure robustness and mitigate contagion risks with a view to preventing future crises. In addition to strengthening the regulatory and supervisory framework, the Reserve Bank has also focused on mitigating risks amid asset quality concerns in the banking and non-banking space. It has set up early warning mechanisms and facilitated mechanisms for continuous monitoring of the credit quality of borrower accounts. It has initiated the process of countercyclical buffers to ensure financial soundness. NBFCs, in general, have a wider reach to the otherwise less banked customers and hence play a crucial role in promoting financial inclusion. Therefore, they also warrant careful supervision and regulation so as to ensure customer protection.

VI.1 Contagion risks from international banks' balance sheets during the global financial crisis and the spillover effects on to sovereign balance sheets that got highlighted in the euro area crisis thereafter underscore the importance of a policy framework in ensuring financial stability. The recent exchange market pressures that were witnessed following the announcement of the US tapering of quantitative easing in the face of a weak domestic economy and stressed assets scenario of the banking sector brought to the fore the fragilities of the domestic market prompting sustainable macro-prudential solutions from Indian policymakers.

VI.2 In its efforts to foster a resilient financial system to ensure systemic stability, the Reserve Bank proactively stepped up measures to identify risky credit, to track and monitor such disbursals and to appropriately pre-empt delinquency, and where unavoidable to ensure quick and cost-effective retrieval processes so as to prevent losses and a possible system-wide contagion. It also strove to implement a fairer regime of credit pricing across bank and non-bank sectors. Initiatives for enhancing customer services and improving banking awareness and reach continue to hold priority in the Reserve Bank's agenda on regulatory and supervisory measures.

FINANCIAL STABILITY ASSESSMENT

Asset quality of banks remains under stress due to a cyclical downturn, sector specific issues

VI.3 The soundness and asset quality parameters of the banking sector deteriorated during the year (Table VI.1). These indicators, however, showed signs of improvement during the last quarter. The capital to risk weighted assets ratio (CRAR) declined during 2013-14. Liquidity and profitability indicators continued to show stress.

VI.4 Various banking stability measures based on co-movements in bank equity prices indicate that the distress dependencies within the banking system that were rising since Q2 of 2013-14, have remained stable since January 2014. Stress tests assuming severe stress conditions show that although the system level CRAR of scheduled commercial banks (SCBs) remains well above the regulatory minimum, there is a need for higher provisioning to meet the expected losses under adverse macroeconomic conditions. However, under normal conditions further significant deterioration seems unlikely.

Implementation of FSDC and FSB reforms on course

VI.5 The sub-committee of the Financial Stability and Development Council (FSDC) is examining

ways for developing an account aggregation facility that will enable a customer to view all his/her financial assets at one location. It is also coordinating with financial sector regulators towards uniform implementation of certain recommendations of the Financial Sector Legislative Reforms Commission (FSLRC) that do not require legislative amendments/ new legislations. The sub-committee, which met thrice during July 1, 2013 and June 30, 2014 is also pursuing the implementation of various reforms in India which have been agreed to under G-20 deliberations. In this regard, various inter-agency implementation groups have been set up (Box VI.1).

Box VI.1
Implementation of Internationally Agreed Reforms in India

The Financial Stability Board (FSB) was established in 2009 to coordinate the work of national financial authorities and international standard setting bodies at the international level and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. Since then, the FSB has proposed a vast spectrum of regulatory and supervisory reform measures which on the basis of their scope can be broadly grouped as measures/reforms: (a) to end too-big-to fail syndrome; (b) to establish safe and secure markets and market infrastructure; (c) to address the issue of shadow banking; and (d) to establish macro-prudential frameworks.

As a signatory of G-20 and a member of the FSB, India is committed towards implementing the reforms that have been agreed to in the post-crisis international environment. The sub-committee of the Financial Stability and Development Council (FSDC) acts as a facilitator between various agencies and authorities in each jurisdiction to oversee the implementation of the reforms. It has set up inter-regulatory/inter-agency implementation groups in several critical areas with the mandate of identifying the way forward with regard to implementation of the reforms, the details of which are as follows:

- A working group on effective resolution regimes for financial institutions (Chairmen: Shri Anand Sinha and Dr Arvind Mayaram) has recommended that there should be a separate comprehensive legal framework providing necessary tools to resolve issues relating to all financial institutions and financial market infrastructures irrespective of the existing statutes governing various types of financial institutions. It also proposes the constitution of a single Financial Resolution Authority that is institutionally independent of the regulators/supervisors and the government. Other recommendations include initiating resolution action in a timely and speedy manner; avoiding erosion of value and minimising costs of resolution, while ensuring continuity of essential financial services such as payments and clearing and settlement; protecting depositors, insurance policyholders and client funds/assets through protection schemes and ensuring imposition of losses to shareholders and unsecured creditors.
- The recommendations of the Implementation Group for Over the Counter (OTC) Derivatives and Market Reforms (Chairman: R. Gandhi) are at various stages of implementation with timelines extending up to March 2015.
- The Clearing Corporation of India Ltd. has been identified to set up facilities to issue globally compatible legal entity identifiers; it is in the process of setting up the requisite technological infrastructure.
- The inter-regulatory/inter-agency Shadow Banking Implementation Group, is presently working on (i) assessing the compliance position of all the financial sector regulators in their regulatory domain *vis-à-vis* FSB policy guidelines; (ii) preliminary gap analysis to identify reform measures that can be implemented and those where implementation is not desirable; (iii) reasons for identifying certain reform measures as not desirable given the 'comply or explain' framework; and (iv) tentative timelines for implementing reforms.
- The inter-agency group on reducing reliance on credit rating agencies (CRAs) has observed that though there were references to CRA ratings in the regulations of respective segments of the financial sector, these served as a supplementary input for risk assessment. Market participants are, therefore, expected to do their due diligence prior to investments, such that there is no mechanistic reliance on CRAs.

ASSESSMENT OF THE BANKING SECTOR

Trends in key financial soundness indicators

VI.6 Slowdown in the domestic economy has caused strains on a number of companies/projects resulting in higher non-performing assets (NPAs) and restructured accounts in the Indian banking system in recent years. This has impacted bank profitability as evident from the dwindling return on assets. Increased provisioning requirements to cover delinquencies and rise in operating expenses (reflected in an increase in the cost-income ratio) adversely affected bank profitability, especially in 2013-14 (Table VI.1).

VI.7 The return on equity declined in most segments on account of lower profitability coupled with fresh infusion of capital post the implementation of Basel III capital norms since April 1, 2013. Though the all-India financial institutions (AIFIs) show improvements in their efficiency parameters, they also seemed to post weak performance in 2013-14 with respect to other parameters. To put in place an early warning system for prompt

Table VI.1: Select Financial Indicators

(Per cent)

Item	End-March	Scheduled Commercial Banks (SCBs)	Scheduled Urban Co-operative Banks (UCBs)	All India Financial Institutions (AIFIs)	Primary Dealers (PDs)	Deposit taking NBFCs	NBFCs-ND-SI
1	2	3	4	5	6	7	8
CRAR #	2013	13.9	12.7	19.9	39.4	22.3	28.0
	2014	13.0	12.6	17.8	48.6	22.2	28.3
Core CRAR #	2013	10.3				19.0	24.3
	2014	10.1				17.8	25.0
Gross NPAs to Gross Advances	2013	3.4	5.4	0.6		2.5	3.5
	2014	4.1	5.4	0.6		3.1	4.0
Net NPAs to Net Advances	2013	1.7	1.3	0.2		0.8	1.6
	2014	2.2	1.6	0.1		1.0	2.0
Return on Assets	2013	1.1	0.9	1.0	1.5	2.7	2.1
	2014	0.8	0.7	0.9	1.9	2.7	2.2
Return on Equity	2013	12.9		9.5	10.1	15.4	8.6
	2014	9.5		8.8	13.3	15.0	8.8
Efficiency (Cost/Income Ratio)	2013	46.2	50.4	17.0	27.2	72.2	73.9
	2014	48.0	56.1	18.8	30.6	76.5	72.1
Interest Spread (Per Cent)	2013	1.9		2.0		3.6	5.3
	2014	1.9		1.9		3.7	5.6
Liquid Assets to Total Assets	2013	28.8	33.6			9.1	4.8
	2014	28.4	35.2			10.7	4.8
Restructured Assets to Gross Advances	2013	5.8	0.5				
	2014	5.9	0.6				

#: Mar-13 as per Basel II and Mar-14 as per Basel III.

Note: 1. Core CRAR is calculated as Tier-I Capital/Total Risk Weighted Assets.
2. Liquid assets include cash and bank balances and investments in government securities.
3. Audited data for NABARD, SIDBI and EXIM for the year ended March 31, 2013.
4. Audited data for NHB for the year ended June 30, 2013; in case of NHB the financial year is July to June.
5. Un-audited data for March 31, 2014 for NABARD, SIDBI and NHB and audited data for EXIM.

Source: OSMOS returns (SCBs); Off-site surveillance returns (UCBs); PD returns (PDs); COSMOS returns (NBFCs); data received from FIs.

recognition of impending stress in the face of growing NPAs, the Reserve Bank issued a framework for revitalising distressed assets in January 2014. Under the proposals of the framework, the Central Repository of Information on Large Credits (CRILC) has been set up set up (Box VI.2).

Box VI.2
Framework for Revitalising Distressed Assets in the Economy: Pivotal Role for CRILC

Asymmetry in information is a fundamental challenge that impacts the quality of banks' credit risk assessment and supervisors' ability to track emerging credit risks in the system. With a mandate of activating and coordinating the mechanism to manage stressed assets in the economy so that transparent credit information becomes available for sound risk management and financial stability, the Reserve Bank introduced the 'Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy' in January 2014. The framework outlines a corrective action plan to incentivise: (i) early identification of problematic accounts, (ii) timely restructuring of accounts that are considered to be viable, and (iii) lenders taking prompt steps for recovery or sale of unviable accounts.

The Reserve Bank set up the Central Repository of Information on Large Credits (CRILC) in April 2014 to collect, store and disseminate credit data to lenders. CRILC's essential objective is to enable banks to take informed credit decisions and early recognition of asset quality problems by reducing information asymmetry. CRILC captures borrower-wise details of funded and non-funded exposures including investments.

Banks are required to furnish credit information to CRILC on all their borrowers having aggregate fund-based and non-fund based exposure of ₹50 million and above with them. Notified systemically important non-banking financial companies and NBFC-Factors will also be required to furnish such information. In addition, banks are required to furnish details of all current accounts of their customers with outstanding balance (debit or credit) of ₹10 million and above. Lenders in India covered under the framework are also required to report the external commercial borrowings extended by their overseas branches/offices to Indian borrowers.

In order to capture early warning signals of financial distress faced by borrowers, the framework requires banks to report, among others, special mention accounts' (SMAs) status of the borrower to CRILC on a real time basis. While, SMA-1 (principal or interest overdue between 31-60 days) and SMA-2 (principal or interest payments overdue between 61-90 days) will be based on past due criteria, SMA-0 will contain non-past due accounts showing signs of incipient stress. When a bank reports a borrower as SMA-2 to CRILC, an auto flash report is sent to all other banks having exposure to that borrower so that the lenders can take necessary steps to form a joint lenders forum (JLF) and take necessary corrective actions as laid down in the framework.

The option under the corrective action plan by the JLF will generally include: (i) rectification, (ii) restructuring, and (iii) recovery. Forming a JLF will be mandatory for distressed borrowers engaged in any type of activity, with aggregate fund based and non-fund based exposure of ₹1 billion and more. Restructuring can be carried out either under the corporate debt restructuring mechanism or under JLF, but if not found to be feasible, JLF will initiate recovery measures. While incentives have been proposed to encourage lenders to agree collectively and quickly on resolution plans, non-adherence to regulatory guidelines has been disincentivised by way of accelerated provisioning.

For restructuring of dues of listed companies, lenders may be *ab-initio* compensated for their loss/sacrifice (diminution in fair value of account in net present value terms) by way of issuance of equities of the company upfront, subject to extant regulations and statutory requirements. Disincentives have also been proposed for: (i) willful defaulters and non-cooperative borrowers, making their future borrowings more expensive, and (ii) for auditors, advocates and valuers who provide incorrect opinions about borrowers and their assets leading to deterioration in the asset quality of banks.

The framework also prescribes more liberal regulatory treatment of asset sales and incentives for asset restructuring companies in order to improve the stress asset reconstruction and rehabilitation market. Necessary regulatory circulars on the proposals of the framework have been issued by the Reserve Bank. The framework became operational from April 1, 2014.

Table VI.2: Indicators

(Per cent)

	Gross NPA Ratio		Net NPA Ratio		Restructured Structured Advances to Gross Advances	
	Mar-13	Mar-14	Mar-13	Mar-14	Mar-13	Mar-14
1	2	3	4	5	6	7
Public sector banks	3.8	4.7	2.0	2.7	7.2	7.2
Private sector banks	1.9	1.9	0.5	0.7	1.9	2.3
Foreign banks	3.0	3.9	1.0	1.1	0.2	0.1
Aggregate	**3.4**	**4.1**	**1.7**	**2.2**	**5.8**	**5.9**

Source: Off-site returns covering domestic operations of banks.

NPAs came to the fore for some banks, but health of the banking sector remains satisfactory

VI.8 The asset quality of the banking system showed deterioration during 2013-14 mainly reflecting the performance of public sector banks (PSBs). Not only were the gross and net NPA ratios of PSBs more than the industry averages, but they also accounted for about 92 per cent of the restructured standard advances (Table VI.2).

VI.9 The increase in the level of restructured standard advances since 2012-13 reflects potential hidden stress in the quality of loan assets. The improvement in NPAs during Q4 of 2013-14 needs to be cautiously examined in the face of the increased offload of loans to asset restructuring companies (ARCs) by banks (Table VI.3).

Increasing share of non-priority sector advances in NPAs

VI.10 The non-priority sector has contributed more in the deterioration of the loan asset quality of the banking sector in recent years. The proportion of aggregate gross NPAs in the priority sector to the gross NPAs of the system stood at 36 per cent at end-March 2014, down from about 40 per cent last year. Within the priority sector, the NPA ratio has risen for the medium and small industry segment (Table VI.4).

Major industry segments account for an over one-third share of total NPAs

VI.11 About 47 per cent of the aggregate credit outstanding by the banks was to the industrial sector, which alone accounted for over 58 per cent

Table VI.3: Loan Sales to ARCs

(₹ billion)

Bank Group	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
1	2	3	4	5	6	7	8	9
Public sector banks	-	0.2	0.2	3.2	0.1	1.6	32.0	121.0
Private sector banks	1.0	0.9	1.6	2.7	0.5	4.4	3.7	5.9
Foreign banks	0.1	0.4	1.2	1.7	0.2	-	-	0.1
All Banks	**1.1**	**1.5**	**3.0**	**7.6**	**0.8**	**6.0**	**35.7**	**127.1**

Note: Data show flows during the quarter.
Source: Off-site returns covering domestic operations of banks.

Table VI.4: Gross NPAs Across Sectors

(as per cent of gross advances to the sector)

	Mar-11	Mar-12	Mar-13	Mar-14
1	2	3	4	5
Agriculture	3.3	4.3	4.7	4.4
Medium & Small Enterprises	3.6	4.0	5.1	5.2
Other Priority Sector	4.0	4.4	3.0	3.0
Total Priority Sector	3.6	4.2	4.4	4.4
Non Priority Sector	1.8	2.3	3.0	4.0
Total	**2.4**	**2.9**	**3.4**	**4.1**

Source: Off-site returns covering domestic operations of banks.

of gross NPAs of the system as at end-March 2014. Gross advances to six industries - infrastructure, metal & products, textiles, chemical & chemical products, engineering industries and mining & quarrying - constituted 30 per cent of total advances and 36 per cent of gross NPAs.

Retail credit increases, but NPAs decline

VI.12 Retail credit increased marginally to form 19 per cent of gross credit as at end-March 2014, with individual housing loans as its largest component (47 per cent) followed by personal loans (36 per cent) and auto loans (14 per cent). Notwithstanding the marginal increase in retail loans outstanding, gross NPAs in retail credit fell to 2.0 per cent as compared to 2.3 per cent last year. This was also significantly lower than the overall gross NPA ratio.

MAJOR DECISIONS TAKEN BY THE BOARD FOR FINANCIAL SUPERVISION

VI.13 The Board for Financial Supervision (BFS) constituted in 1994, remains the principal guiding force behind the Reserve Bank's supervisory and regulatory initiatives. The BFS met 11 times during July 2013 and May 2014. This inspection cycle covered 49 banks under the CAMELS approach and 28 banks under the risk based supervision (RBS) approach. The annual financial inspection memoranda with respect to all banks and AIFIs programmed for inspection during 2013-14 had been submitted to the BFS by April 2014. Baseline supervisory review of 15 foreign banks with small operations in India was also placed before the BFS.

VI.14 Some of the major issues discussed with the BFS this year pertain to broadening the capital base of select SCBs, process of supervisory stress testing of commercial banks, on-lending of the rural infrastructure development fund, subsidiarisation of foreign banks in India, quality of the management information system and data integrity, governance issues, faulty incentive structures/practices in banks for cross-selling insurance products, arbitrary interest rate charges, deficiencies relating to un-reconciled export bills for collection, rising stress in asset quality and need for periodic inspection of credit information companies.

VI.15 As directed by the BFS, the process of levying penalty was reviewed and a revised procedure for imposing penalty under the Banking Regulations Act (BR Act), 1949 was laid out. A thematic study on the modus operandi and action taken by banks in fraud cases involving an amount of ₹500 million and more was also undertaken by the Reserve Bank.

VI.16 Inspection of a nationalised bank indicated a sizeable increase in its NPAs, especially slippages and write-offs. The BFS directed a special scrutiny to determine the cause and also the measures taken by the bank to overcome this position. With regard to a major fraud reported by some banks, the BFS directed that a joint study be undertaken with the Securities and Exchange Board of India (SEBI) to find the lapses on the part of the bank and the company. A forensic audit was also initiated.

VI.17 With regard to scheduled urban cooperative banks (UCBs), the BFS reviewed 42 summaries of inspection reports, summaries of financial highlights for 30 UCBs rated between A+ and B- and 12 UCBs rated between C+ and D. The proposal to revise the norms for including licensed UCBs in the Second Schedule to the Reserve

Bank of India Act (RBI Act), 1934 was approved. The BFS also called for a staggered deadline for migration to core banking solutions (CBS) across all UCBs depending on their deposit sizes.

VI.18 Based on a review of the status of 23 unlicensed district central cooperative banks (DCCBs), the BFS recommended initiation of regulatory action against these banks. On a review of the functioning of regional rural banks (RRBs), the BFS directed that a minimum CRAR of 9 per cent for all RRBs from March 31, 2014 should be prescribed. Further, the exemption from mark-to-market norms with respect to the statutory liquidity ratio (SLR) securities granted to RRBs since 1995 was withdrawn. The BFS also directed to prescribe a minimum CRAR of 9 per cent for state cooperative banks (StCBs) and DCCBs to be achieved by March 31, 2017 in a phased manner and approved issuance of long term deposits (LTDs) and innovative perpetual debt instruments (IPDIs) by StCBs/DCCBs for capital augmentation.

VI.19 In the non-bank financial companies (NBFCs) segment, the issues considered by the BFS included involvement in the gold loan business, self-regulatory organisation (SRO) for micro-finance institutions (MFIs), filing of records with the Central Registry of Securitisation Asset Reconstruction and the Security Interest of India (CERSAI), prohibiting from contributing capital to any partnership firm or being a partner in partnership firms and private placements by NBFCs. All NBFCs were advised that no advances should be granted against bullion/primary gold and gold coins.

COMMERCIAL BANKS

Regulatory initiatives

Efforts to bring about a fairer regime of pricing of credit

VI.20 Despite policy efforts to usher in transparency and rationality in the credit pricing framework, there have been certain concerns from the customer service perspective. These mainly relate to downward stickiness of interest rates, discriminatory treatment of old borrowers *vis-à-vis* new borrowers and arbitrary changes in spreads. In response, the Reserve Bank constituted a working group (Chairman: Shri Anand Sinha) comprising members from banks, the Indian Banks' Association (IBA), academia and the Reserve Bank to examine the issues related to discrimination in credit pricing and to recommend measures for a transparent and appropriate pricing strategy under a floating rate regime.

VI.21 Its major recommendations include: (i) move towards computation of base rate on the basis of the marginal cost of funds by banks, particularly those with lower weighted average maturity of deposits; (ii) ensuring that any price differentiation is consistent with a bank's credit pricing policy factoring risk adjusted return on capital by the board of the bank; (iii) framing an internal policy of the bank spelling out the rationale for and range of the spread in case of a given borrower, as also delegation of powers with respect to loan pricing; (iv) ensuring no increase in the spread charged to an existing customer, except in case of deterioration in the credit risk profile of the customer; and (v) setting the reset interest rate periodicity in floating rate loan covenants with resets allowed on those dates only.

VI.22 The other recommendations include: (i) a sunset clause for benchmark prime lending rate contracts so that all the contracts thereafter are linked to the base rate; (ii) developing a new benchmark for floating interest rate products, *viz.* the Indian banks' base rate by IBA and its periodic dissemination; (iii) giving benefit of interest reduction on the principal on account of pre-payments on the day the money is received by the bank without waiting for the next equated monthly installment (EMI) cycle date to effect the credit;

(iv) offering the choice of 'with exit' and 'sans exit' options for customers at the time of entering the contract with regard to retail loans; and (v) calling for a more robust grievance redressal system in banks that is responsive to customers' needs.

VI.23 Further, the Reserve Bank may penalise banks which do not put in place adequate measures, as evidenced by repeated complaints. The working group also made recommendations to bring in greater transparency enabling comparability across banks and informed decision making by customers. The public comments received on the report are under examination and guidelines will be issued to banks in due course.

Capital and provisioning requirements for exposures to entities with unhedged foreign currency exposure

VI.24 As exchange rate volatility may affect the health of the banking system through spillover effects from the corporate sector, it has been proposed to increase the risk weight and provisioning requirement on banks' exposures to entities having excessive unhedged forex exposure positions. The guidelines issued in January 2014 provide the methodology to compute incremental provisioning and capital requirements.

Recent developments on implementation of Basel III

VI.25 While all 27 jurisdictions that comprise the Basel Committee had implemented Basel III capital regulations as at April 2014, India implemented Basel III with a delay of three months (from April 1, 2013 instead of January 1, 2013 as originally scheduled) to align the implementation schedule with the beginning of the financial year.

VI.26 The Reserve Bank has extended the end date for full implementation of Basel III capital regulations by one year (to March 31, 2019) to provide some lead time to banks on account of potential stresses on asset quality and consequential impact on the performance/ profitability of the banks. With the extension, full implementation of Basel III in India will slightly exceed the internationally agreed end date of January 1, 2019. With regard to the introduction of countercyclical capital buffers in India, an internal working group is following up on public comments on its draft report (Box VI.3).

Box VI.3
Basel III: Countercyclical Capital Buffer

In the aftermath of the financial crisis in 2008, the group of central bank governors and heads of supervision showed a commitment to introducing a countercyclical capital buffer (CCCB) framework (September 2009). Subsequently, in December 2010, the Basel Committee on Banking Supervision (BCBS) published 'Guidance for national authorities operating countercyclical capital buffer' to propose a framework for dampening excess cyclicality of minimum regulatory capital requirements arising out of the Basel II framework, with an aim of maintaining a flow of funds from banks to the real sector in economic downturns by using capital accumulated in good times.

Moreover, in boom times as the banks will be required to shore up capital, they may be restrained from extending indiscriminate credit. The BCBS guidance proposes a credit to GDP gap (difference of credit to GDP ratio from its historical trend) as the main indicator to decide on the starting point for imposition of CCCB. However, BCBS also mentions that national supervisors may take into consideration other supplementary indicators which may be used in conjunction with the credit to GDP gap to impose CCCB which may go up to 2.5 per cent of the total risk weighted assets of a bank. To operationalise the CCCB framework in India, an internal working group (Chairman: Shri B. Mahapatra) was constituted at the Reserve Bank. Triggering the CCCB too early out of excessive caution may involve sacrificing growth while complacency and failure to trigger a buffer decision may lead to the building up of pressure.

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Given this context, the working group tried to dovetail the CCCB framework prescribed by the Basel Committee to Indian conditions, proposed suitable modifications where required and recommended the following in its December 2013 draft report on the implementation of the CCCB framework in India:

- While the credit to GDP gap will be used for an empirical analysis to facilitate the CCCB decision, it may not be the only reference point for banks in India and the credit to GDP gap may be used in conjunction with other indicators like growth in gross NPA (GNPA).
- The lower threshold (L) of the CCCB framework when the buffer is activated may be set at 3 percentage points of the credit to GDP gap, provided its relationship with GNPA remains significant and the upper threshold (H) may be kept at 15 percentage points of the credit to GDP gap.
- CCCB shall increase linearly from 0 to 2.5 per cent of the risk weighted assets (RWAs) of the bank based on the position of the gap within the threshold range (between 3 and 15 percentage points). However, if the gap exceeds H, the buffer will remain at 2.5 per cent of the RWA, and there is no buffer requirement if the gap falls below L.
- Supplementary indicators will include the incremental credit-deposit ratio for a moving period of 3 years, the industry outlook assessment index and the interest coverage ratio. These variables need to be considered along with their correlation with the credit to GDP gap.
- The CCCB decision may be pre-announced with a lead time of 4-quarters and the Reserve Bank may apply discretion in terms of use of indicators while activating or adjusting the buffer. The framework may be operated in conjunction with a sectoral approach that has been successfully used in India over a period of time. For all banks operating in India, CCCB will be maintained on a solo basis as well as on a consolidated basis in India.
- The same set of indicators that are used for activating CCCB may be used to arrive at a decision for CCCB's release phase. However, instead of a stringent rules-based approach, flexibility in terms of use of judgment and discretion may be provided to the Reserve Bank for operating CCCB's release phase. Further, the entire CCCB may be released promptly at a single point in time.

The final report will be placed on the Reserve Bank's website after suitable modifications following comments received from various stakeholders on the draft. The Reserve Bank issued its final guidelines on 'Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards' on June 9, 2014. These guidelines take into account the phase-in arrangement, definition of LCR, high quality liquid assets (HQLAs), liquidity risk monitoring tools and LCR disclosure standards as proposed in the BCBS standards. Accordingly, LCR will be introduced on January 01, 2015 but the minimum requirement will be set at 60 per cent and rise in equal annual steps to reach 100 per cent by January 01, 2019. The guidelines also take into account the range of HQLAs available in the Indian financial markets and their liquidity *vis-à-vis* the liquidity instruments prescribed in the BCBS standard.

Keeping this in view, G-secs up to 2 per cent of net demand and time liabilities have been allowed to be included as Level 1 HQLAs. Further, while covered bonds, residential mortgage backed securities (RMBS) and corporate debt securities (including commercial paper) of rating between A+ and BBB- have not been included as Level 2 HQALs, eligible common equity shares with 50 per cent haircut have been allowed to be included as Level 2B HQLAs. A quantitative impact study conducted by the Reserve Bank in December 2013 on a sample of banks to assess their preparedness for the Basel III liquidity ratios indicates that the average LCR for these banks varied from 54 per cent to 507 per cent.

Framework for domestic-systemically important banks (D-SIBs)

VI.27 The draft D-SIB framework in India which was released for public comments in December 2013 tries to ensure that the probability of failure of a bank with higher systemic importance is reduced by requiring additional capital and also subjecting these banks to other stringent regulatory/supervisory measures. The draft framework discusses the proposed methodology to be adopted by the Reserve Bank for identifying D-SIBs and the quantum of additional common equity Tier 1 capital (CET-1) applicable to such banks. The identification methodology is largely based on an indicator-based approach being used by BCBS to identify global SIBs. The indicators proposed to assess D-SIBs are size,

Table VI.5: Draft Framework for D-SIBs

(as a percentage of risk weighted assets)

	Bucket 5 (Empty)	Bucket 4	Bucket 3	Bucket 2	Bucket 1
1	2	3	4	5	6
Additional CET 1 requirement	1.0	0.8	0.6	0.4	0.2

Source: Draft D-SIB framework released in December 2013.

interconnectedness, lack of substitutability and complexity, with more weights given to size. The interconnectedness, substitutability and complexity indicators are further divided into multiple indicators. Based on systemic importance scores, banks will be classified into 4 buckets (Table VI.5). Depending on the bucket where a D-SIB is classified into, an additional CET-1 requirement (between 0.2 to 0.8 per cent of risk weighted assets) will be applicable to it.

Committee to review the governance of boards of banks in India

VI.28 In its initiatives for improving corporate governance practices in banks, the Reserve Bank constituted a committee of experts (Chairman: Dr P.J. Nayak) to review board governance standards for banks in India. The main recommendations of the committee (May 2014) are: (i) strengthening the governance structure of PSBs by removing constraints such as dual regulation (by the Ministry of Finance and the Reserve Bank), manner of appointment of directors to boards, (ii) fully empower boards in PSBs, (iii) setting up of an autonomous Bank Investment Company (BIC) to hold equity stakes in banks; and (iv) the transition for these should be in three phases.

VI.29 Other recommendations pertain to withdrawal of Reserve Bank's nominees on the boards of PSBs; separation of CMDs' posts into executive MD and non-executive chairman; creation of a specific category of investors in banks called authorised bank investors (ABIs); raising of the ceiling for promoter investors' stake to 25 per cent; permitting private equity funds including sovereign wealth funds to take a controlling stake of up to 40 per cent in distressed banks and increasing the limit for voting rights to 26 per cent. Recommendations of the committee are being examined taking into account the comments received from banks, IBA and the public.

Licensing of new banks in the private sector

VI.30 In-principle approvals were given to two new applicants in April 2014 to set up banks under the guidelines on licensing of new banks in the private sector issued on February 22, 2013. Going forward, the Reserve Bank intends to use this licensing exercise to revise the guidelines appropriately and move to give licences more regularly, that is, virtually 'on tap'. Building on the discussion paper on 'Banking Structure in India-The Way Forward' (August 2013), draft guidelines for 'Payment Banks' and 'Small Banks' were placed on the Reserve Bank website in July 2014.

Supervisory initiatives

Risk-based supervision's initial experience and the way forward

VI.31 In line with the BFS directives, 28 banks have been assessed under the RBS framework (SPARC – Supervisory Program for Assessment of Risk and Capital) beginning 2013-14. These banks account for approximately 60 per cent of the banking sector's assets and liabilities and cover a cross-section of banks (on an ownership basis). The SPARC framework is a departure from the compliance oriented and point-in-time performance based assessment carried out under CAMELS and CALCS.

VI.32 SPARC's design enables evaluation of present and future risks with a view to identifying concerns building up in a bank or the system and intervening appropriately in a timely manner. The continuous nature of supervision under SPARC entails on-going interaction between banks and

supervisors and is not limited to periodic meetings/ inspections. The SPARC framework is designed to have greater off-site assessment, monitoring and supervision with focused on-site inspections in identified concern and risk areas.

Cross-border supervision and cooperation

VI.33 The Reserve Bank has been entering into bilateral Memoranda of Understanding (MoUs) with overseas supervisors for effective cross-border supervision and cooperation in accordance with extant domestic legal provisions and BCBS principles. It has made substantial progress in supervisory information sharing and cooperation within jurisdictions where Indian banks are operating by entering into MoUs.

Institution of supervisory colleges

VI.34 Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. The Reserve Bank has been actively participating in supervisory colleges conducted by overseas home regulators of foreign banks operating in India. In its capacity as the home country supervisor, the Reserve Bank set up supervisory colleges for Bank of India and Bank of Baroda in February 2014. These are in addition to those already set up earlier for State Bank of India and ICICI Bank Ltd. These supervisory colleges are likely to emerge as a key tool for consolidated supervision in the context of significant and growing overseas operations of Indian banks.

Inspection of overseas branches of Indian banks

VI.35 Global operations of Indian banks are spread across 54 countries. In order to assess the financial position, systems and control of overseas branches, inspection of 8 banks in 5 overseas jurisdictions covering almost 60 per cent of the total overseas assets of Indian banks was undertaken in 2012-13. In 2013-14, inspection of 6 banks in 6 jurisdictions covering another 20 per cent of the total overseas assets was undertaken.

Thematic review of adherence to KYC/ AML norms conducted in 36 banks

VI.36 In the wake of allegations against banks by an online media portal, a thematic review of adherence to Know Your Customer (KYC)/anti-money laundering (AML) norms in 36 banks (foreign, private sector and public sector) was conducted in two spells. The first review in April 2013 included 29 banks and the second in May 2013 included 7 banks. Follow-up action concluded in July and August 2013 respectively. Monetary penalties were imposed on 28 of the 36 banks and the remaining were issued caution letters.

Development of the OSMOS system in a XBRL environment

VI.37 In order to facilitate user friendliness and for incorporating advances in technology while keeping pace with regulatory changes and emerging supervisory requirements, the off-site monitoring and surveillance (OSMOS) system set up in 1997, is being re-developed. Although the scope and coverage of the returns generated through OSMOS have been periodically reviewed and updated, the advantages of the eXtensible Business Reporting Language (XBRL) environment for data reporting need to be incorporated in OSMOS and select other returns to ensure efficient data collection, maintain quality and integrity of data and improve data accessibility for robust supervision.

URBAN COOPERATIVE BANKS

Revised criteria for qualifying as financially sound and well managed

VI.38 The criteria for UCBs to be classified as financially sound and well managed (FSWM) were modified with effect from October 1, 2013 in keeping with the improvement in the performance indicators of the sector. The change envisaged that besides other parameters, UCBs with gross

NPAs of less than 7 per cent and net NPAs of not more than 3 per cent will qualify as FSWM as against the earlier condition of net NPAs of less than 5 per cent.

Extension of the disclosure requirements to Tier I UCBs

VI.39 Tier II UCBs had earlier been advised to disclose certain information as 'Notes on Accounts' to their balance sheets along with several other additional disclosures. The disclosure requirements have been extended to Tier I UCBs also from the year ended March 31, 2014.

Inclusion of primary UCBs in the Second Schedule to the RBI Act, 1934

VI.40 Applications from UCBs for inclusion in the Second Schedule to the RBI Act, 1934 will be considered on fulfilling certain criteria such as demand and time liabilities (DTL) of not less than ₹7.5 billion on a continuous basis for one year; CRAR of minimum 12 per cent; continuous net profit for the previous 3 years; gross NPAs of 5 per cent or less; compliance with cash reserve ratio (CRR)/SLR requirements; and no major regulatory and supervisory concerns.

Migration to core banking solutions (CBS)

VI.41 As at end-March 2014, of the 1,589 UCBs, 510 had implemented CBS fully while 465 had done so partially. The revised timeframe for implementing CBS for Tier I UCBs (other than unit banks) is June 30, 2014, for unit banks it is December 31, 2014 while for Tier II UCBs, it stays unchanged.

Conditional approval to grant unsecured loans to priority sectors

VI.42 In order to promote lending to priority sectors and to provide impetus to the objective of financial inclusion, UCBs fulfilling certain conditions and with prior approval of the Reserve Bank, have been allowed to grant unsecured loans up to ₹10,000 for productive purposes up to 15 per cent of total assets. Such loans granted by UCBs will be exempt from the aggregate ceiling on unsecured exposure of 10 per cent of total assets.

Select guidelines relating to market operations

VI.43 Well managed UCBs can undertake intra-day short selling of government securities (G-secs) with the permission of the Reserve Bank. Intra-day short sales will provide increased liquidity to the

Table VI.6: State-wise Progress in Mergers/Acquisitions of UCBs

States	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Total
1	2	3	4	5	6	7	8	9	10	11
Maharashtra	2	12	14	16	6	7	8	1	1	67
Gujarat	2	2	6	2	2	2	4	1	4	25
Andhra Pradesh		1	3	1	3	2	1			11
Karnataka			2	1						03
Punjab		1								1
Uttarakhand			1	1						2
Chhattisgarh				1		1				2
Rajasthan					2		1			3
Madhya Pradesh										
Uttar Pradesh						1		1		2
Total	**4**	**16**	**26**	**22**	**13**	**13**	**14**	**3**	**5**	**116**

G-sec market and is also relatively less risky as compared to the normal short sale where the short sale position is carried over to the next day exposing UCBs to market risks. UCBs have been permitted to invest in eligible market infrastructure companies such as the Clearing Corporation of India Ltd. (CCIL), the National Payments Corporation of India Ltd. (NPCIL) and the Society for World Wide Inter-Bank Financial Telecommunication (SWIFT).

Consolidation of UCBs through mergers/ acquisitions

VI.44 With regard to consolidation of UCBs through merger of weak entities with stronger ones, the Reserve Bank received 183 proposals for mergers up to March 2014 and it had issued 134 NOCs/sanctions of which 116 have been notified for mergers by respective RCS/CRCS.

VI.45 The maximum number of mergers were in Maharashtra, followed by Gujarat and Andhra Pradesh (Table VI.6). Guidelines for transfer of assets and liabilities of UCBs to commercial banks were issued in February 2010.

RURAL COOPERATIVES AND REGIONAL RURAL BANKS

Status of state and central cooperative bank licenses

VI.46 The Committee on Financial Sector Assessment (Chairman: Dr Rakesh Mohan) in 2009 recommended a non-disruptive phasing out of unlicensed cooperative banks by March 31, 2012. However, in view of the large number of cooperative banks functioning without licenses (17 out of 31 StCBs and 296 out of 371 DCCBs), the Reserve Bank relaxed the licensing norms. The revised norms include: (i) minimum CRAR of 4 per cent, and (ii) no/rare default in CRR/SLR requirement for the last one year. As at end-March 2014, 23 DCCBs (Uttar Pradesh-16, Maharashtra-3, Jammu & Kashmir-3 and West Bengal-1) remain unlicensed and appropriate regulatory action is being initiated by the Reserve Bank.

Prescription of minimum CRAR for StCBs/DCCBs

VI.47 Although the CRAR framework was introduced in StCBs/DCCBs in December 2007, no minimum level of CRAR had been prescribed. Based on the BFS approval, a minimum CRAR of 9 per cent has been prescribed for StCBs and DCCBs. A roadmap has also been laid down for achieving a minimum CRAR of 7 per cent on an on-going basis by March 31, 2015 and 9 per cent by March 31, 2017. Since StCBs/DCCBs have limited avenues for mobilising additional capital resources, they have been permitted to issue LTDs (subordinated) and IPDIs with the prior approval of the Reserve Bank.

Migration to core banking solutions (CBS)

VI.48 As at end-June 2014, of the 32 StCBs, 30 had implemented CBS fully while 2 had done so partially. Out of 371 DCCBs, 317 had implemented CBS fully while 31 had done so partially, and remaining 23 banks are unlicensed. StCBs and DCCBs have been advised to complete CBS implementation by September 30, 2014.

Amalgamation of RRBs

VI.49 In the current phase of amalgamation beginning October 1, 2012 geographically contiguous RRBs within a state under different sponsor banks are to amalgamate so as to have just one RRB in medium sized states and 2 or 3 RRBs in large states. Accordingly, 44 RRBs have been amalgamated into 18 new RRBs within 12 states bringing down their effective number to 56. Consequent to the amalgamation, 13 RRBs have been included in the Second Schedule of the RBI Act, 1934 while 31 erstwhile RRBs have been excluded.

Prescription of minimum CRAR of 9 per cent for RRBs

VI.50 As per the recommendations of the Committee on Recapitalisation of RRBs for Improving CRAR (Chairman: Dr K.C. Chakrabarty),

38 RRBs had been fully recapitalised to the extent of ₹21 billion as on March 31, 2014.After the amalgamation and recapitalisation of weak RRBs, the CRAR position of the RRBs as on March 31, 2013 was reviewed. A minimum CRAR of 9 per cent on an on-going basis was prescribed for all RRBs with effect from March 31, 2014.

Guidelines for classification and valuation of investments by RRBs

VI.51 RRBs were exempted from application of the mark-to-market (MTM) norms with respect to SLR securities till March 31, 2013 and were allowed to classify their entire investment of SLR securities under 'held to maturity' (HTM). However, on review, RRBs have been advised to introduce MTM norms with respect to SLR securities beyond 24.5 per cent of DTLs held in the HTM category with effect from April 1, 2014 and to classify their investments into three categories: HTM, held for trading (HFT) and available for sale (AFS).

THE DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION

VI.52 A wholly owned subsidiary of the Reserve Bank, the Deposit Insurance and Credit Guarantee Corporation (DICGC) extends deposit insurance to all banks including local area banks (LABs), RRBs and cooperative banks across India. The number of registered insured banks as at end-March 2014 stood at 2,145 comprising 89 commercial banks, 58 RRBs, 4 LABs and 1,994 cooperative banks. The present limit of deposit insurance in India is ₹100,000. As at end-March 2014, 92 per cent (1,370 million) of the total number of accounts were fully protected by DICGC, as against the international benchmark[1] of 80 per cent. Amount-wise, the ₹24 trillion insured deposits accounted for 31 per cent of the total assessable deposits as against the international benchmark of 20 to 40 per cent. At the current level, the insurance cover works out to 1.3 times per capita income.

VI.53 During 2013-14, the aggregate claims settled by DICGC were nearly half (₹1 billion with respect to 51 cooperative banks) of those settled last year. The Deposit Insurance Fund (DIF) for claim settlement of depositors of banks taken into liquidation/reconstruction/amalgamation stood at ₹406 billion as on March 31, 2014 yielding a reserve ratio (DIF/insured deposits) of 1.7 per cent. The DIF accumulates from the transfer of DICGC's annual surplus net of taxes.

IADI steering committee meeting on revision of core principles

VI.54 The core principles for effective deposit insurance systems were issued in June 2009 by the International Association of Deposit Insurers (IADI) and BCBS. In order to review and update the core principles and to develop a proposed set of revisions, IADI established an internal steering committee in February 2013. The final revised set of core principles is expected to be released shortly.

NON-BANKING FINANCIAL COMPANIES

Protection of depositors' interests

VI.55 To ensure timely payment of deposit liabilities all deposit taking companies have been tightly regulated by the Reserve Bank fairly successfully. However, recent episodes like the 'Saradha Scam' have underscored the need to go beyond a regulatory and supervisory focus on regulated entities to malfeasance in the unregulated space. With a multiple regulator set up in the non-banking sector, the Reserve Bank has taken several initiatives to increase public awareness and ensure clarity on legislative reforms and their effective enforcement.

[1] Accepted as a rule of thumb at the First Annual Conference of the International Association of Deposit Insurers (IADI) in Basel, Switzerland in May 2002.

VI.56 The measures taken by the Reserve Bank to achieve these twin objectives *inter alia* include a joint advertising campaign in the mass media with the Ministry of Consumer Affairs and the Ministry of Corporate Affairs to increase public awareness, organising town hall events and country-wide investor awareness campaigns, particularly in Tier II and III cities, strengthening the existing inter-regulatory coordination mechanism through state level coordination committees (SLCCs) for better and effective enforcement of existing legislations including the option to take coordinated action to deal with malpractices. The Reserve Bank has also written to all the state governments for enacting the Protection of Interest of Depositors' Act that facilitates speedy action against unauthorised acceptance of deposits.

Guidelines with respect to private placement of non-convertible debentures (NCDs)

VI.57 The Reserve Bank recently observed large-scale issuances by NBFCs, often on tap from retail investors through NCDs with features similar to those of public deposits. In order to bring NBFCs on par with other financial entities as far as private placements are concerned, they have been advised to: (i) restrict the maximum number of subscribers to the private placements of NCDs, (ii) put in place their board's *approved* policy for resource planning which will *inter alia* cover the planning horizon and the periodicity of private placements, and (iii) the minimum subscription amount for a single investor has been stipulated at ₹2.5 million and in multiples of ₹1 million thereafter.

Modifications in pricing of credit by NBFCs-MFI

VI.58 The revised interest rates charged by NBFCs-MFI (effective from Q1 of 2014-15) will be the cost of funds plus margin as per extant guidelines or the average base rate of the 5 largest commercial banks by assets multiplied by a factor of 2.75, whichever is lower. The average of the base rates of the 5 largest commercial banks (with respect to the size of domestic assets) indicated by the Reserve Bank on the last working day of the previous quarter will determine interest rates for the ensuing quarter.

Ensuring financial stability

VI.59 Unlike commercial banks, deposits form a very small component of the overall liability of NBFCs as they predominantly rely on institutional sources including bank borrowings and capital/ money markets for their funding requirements. Risk to financial stability from the sector emanates from these inter-linkages between NBFCs and other financial intermediaries and their funding dependencies. Accordingly, the regulatory guidelines are tuned towards discouraging a higher degree of leverage and having adequate capital buffers so as to ensure that any stress on their balance sheets is absorbed rather than transmitted to the financial system. Some of the regulatory and supervisory instructions issued in 2013-14 are set out in the following paragraphs.

Lending against security of a single product–gold jewellery

VI.60 Following the recommendations of the working group (Chairman: Shri K.U.B. Rao) set up to study issues related to gold imports and gold loans of NBFCs in India, guidelines were issued to all NBFCs (excluding PDs). The loan to value (LTV) ratio for loans against the collateral of gold jewellery was raised to 75 per cent from 60 per cent with effect from January 08, 2014.

Restructuring of advances by NBFCs

VI.61 As indicated in the Second Quarter Review of Monetary Policy 2013-14 (October 29, 2013), the extant instructions on restructuring of advances by NBFCs have been reviewed in view of the recommendations of the working group (Chairman: Shri B. Mahapatra) to review prudential guidelines

on restructuring of advances by banks and financial institutions. Accordingly, mere extension of date of commencement of commercial operations (DCCOs) up to a specified period will not tantamount to restructuring for infra, non-infra and commercial real estate projects, although it will attract provisioning norms for all new loans and stocks of loans. A special asset classification benefit will be made available to corporate debt restructuring and consortium cases including a small and medium enterprises (SME) debt restructuring mechanism, apart from infrastructure and non-infrastructure project loans subject to certain conditions. The special asset classification benefit will, however, be withdrawn with effect from April 1, 2015 with the exception of that on provisions related to changes in DCCOs with respect to infrastructure as well as non-infrastructure project loans. Early recognition of financial distress has been institutionalised through CRILC (Box VI.2).

Credit enhancement in securitisation transactions

VI.62 In order to provide some capital relief to the originators, banks and NBFCs have been allowed a reset of credit enhancement in securitisation transactions, depending on the overall performance of the transactions and factors such as the credit quality of the securitised assets, pool characteristics and nature of underlying assets.

Buyback of assets from SCs/RCs by defaulters and acquisition of assets by SCs/RCs from sponsor banks

VI.63 Securitisation companies (SCs)/ reconstruction companies (RCs) which were not permitted to acquire any NPAs from their sponsor banks on a bilateral basis are now allowed to do so but only through participation in auctions conducted by sponsor banks. Promoters of the defaulting company/borrowers or guarantors are allowed to buy back their assets from the SCs/ RCs provided such a buy back minimises the cost of litigation and time, arrests further diminution in the value of the assets and helps in the resolution process.

Committee on comprehensive financial services for small businesses and low income households

VI.64 The committee (Chairman: Nachiket Mor) made several recommendations regarding NBFCs (see Box IV.2). Before taking a view on allowing more entities into the sector, the Reserve Bank decided to keep in abeyance for a period of one year (from April 2014), issuing of certificates of registration (CoR) to companies proposing to conduct non-bank financial institution (NBFI) business in terms of Section 45 I(a) of the RBI Act, 1934. Exceptions to this were CoR applications already received by the Reserve Bank on or before March 31, 2014, CoR applications that may be submitted by prospective systemically important core investment companies, infrastructure finance companies, infrastructure debt fund companies and NBFCs proposing to conduct microfinance business.

VI.65 As part of the guidelines issued by the Reserve Bank for granting new banking licenses, non-operating financial holding companies (NOFHCs) were notified as a separate category of NBFCs. NOFHCs will hold the bank as well as all other financial services' companies regulated by the Reserve Bank or other financial sector regulators, possible under existing regulatory framework.

Other risk mitigating measures

VI.66 The existing definition of 'infrastructure lending' for NBFCs has been harmonised with that of the master list of infrastructure sub-sectors notified by the Government of India. With a view to capturing the reach and geographical spread of institutions in the sector, a branch information return has been introduced for all the existing NBFCs.

VI.67 NBFCs are allowed to set up 'White Label ATMs' upon obtaining a NOC from the Reserve Bank. Three key parameters involved are

continuous profitability, maintaining the required CRAR on an on-going basis and absence of any major supervisory concerns.

VI.68 With an objective of filtering out companies that may be doing NBFI business without having a valid certificate of registration issued by the Reserve Bank, it was decided to find out the number of finance companies operating in the country as per the records of the Ministry of Corporate Affairs and those registered with the Reserve Bank. A *prima facie* analysis of the financials of some of these companies appears to meet the principal business criteria[2] for registration and appropriate action is envisaged for such companies.

CUSTOMER SERVICE

Complaints received and disposed

VI.69 To facilitate fair practices and ethical treatment of customers of banking services across the country, the Reserve Bank has undertaken multiple initiatives. Major among these are the institution and development of the Banking Ombudsmen (BO) scheme that provides a free and easy grievance redressal avenue for bank customers. While efforts are on to increase awareness about its presence in rural and semi-urban areas, the scheme remains highly successful for nearly 2 decades, having addressed over 70,000 complaints annually (Box VI.4).

Box VI.4
Grievance Redressal Mechanism in Banks and the Banking Ombudsman Scheme

The Reserve Bank has created institutional arrangements like the office of the Banking Ombudsman (BO), the Banking Codes & Standards Board of India (BCSBI), customer service committees of the boards in banks, a standing committee on customer service, a customer service committee at the controlling office/branch level, nodal department/nodal officer for customer service, grievances redressal cell and the customer service department for enhancing the quality of customer services in the banking industry.

To facilitate easy access to customers and also to offer a fair and quick resolution of complaints, banks are required to: (i) keep a complaints register at a prominent place in their branches to enable customers to register their complaints, (ii) have a system of acknowledging the complaints, when received through letters, (iii) fix a timeframe for resolving the complaints received at different levels, (iv) prominently display at branches the names and contact details of officials entrusted to redress complaints, and (v) place a complaint form on the home page of the bank's website.

To ensure an individual bank board's oversight on the internal grievance redressal mechanism, banks have been advised to place a review of complaints before their boards/ customer service committees along with an analysis of the complaints received. It has been mandated that their boards provide exclusive time to review and deliberate on issues concerning customer services. Banks have also been advised to set up branch-level customer service committees with representation from different segments of customers.

The Banking Ombudsman Scheme

With a view to providing a hassle-free alternative dispute redressal mechanism at the apex level free of cost, the Reserve Bank introduced the BO scheme in June 1995 under Section 35A of the Banking Regulation (BR) Act, 1949, and it is in operation in 15 BO offices across India. Since its introduction, the scheme has been revised four times (2002, 2006, 2007 and 2009) to keep pace with the changing banking scenario.

Customers can approach the BO citing deficiency in banking services on 27 grounds including issues related to credit cards, internet banking, deficiencies in providing promised services by both the bank and its sales agents, levying service charges without prior notice to the customers, non-adherence to the fair practices code adopted by individual banks and non-adherence to BCSBI's code of bank's commitment to customers. The BO scheme is applicable to all commercial banks, regional rural banks and scheduled primary cooperative banks operating in India. The

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[2] Elaborated through our press release number 1998-99/1269 dated April 8, 1999.

complainants can file their complaints in any form, including online submission through the Reserve Bank website.

On an average, BO offices receive over 70,000 complaints annually, mainly from customers from metro/urban areas, accounting for about 72 per cent of the total complaints received during 2013-14. Some of the reasons attributed to the greater share of complaints from metro and urban areas are greater availability of banking services, financial literacy and expectation levels of bank customers and greater awareness about the scheme among residents of these areas as compared with their counterparts in semi-urban and rural areas.

The Reserve Bank and the BO offices continue with their efforts to spread awareness for the scheme in rural and semi-urban areas through awareness campaigns/outreach activities and town hall events.

Uniformity in intersol charges

VI.70 In order to ensure that bank customers are treated fairly and reasonably without any discrimination and in a transparent manner at all branches of banks/service delivery locations under the CBS environment, banks were advised to follow a uniform, just and transparent pricing policy and not discriminate between their customers in the home branch and in non-home branches.

Simplifying norms for periodical updation of KYC

VI.71 KYC norms have been simplified to reduce the practical difficulties/constraints expressed by bankers/customers in this regard. For obtaining/ submitting fresh KYC documents for periodic updation at frequent intervals, banks were advised to conduct a full KYC exercise at a less frequent interval for medium and low risk accounts. Requirement of submission of address proof were current address differed from permanent address has been removed for opening a bank account or for updation of information for an existing account, if the customer submits an 'Officially Valid Document' giving his details of his permanent address. The information available from Unique Identification Authority of India (UIDAI) as a result of the e-KYC process has been made acceptable as an 'Officially Valid Document' under the Prevention of Money Laundering Act.

Enhancement of customer service for ATM transactions

VI.72 With a view to enhancing efficiency in automated teller machine (ATM) operations, banks were advised to display messages regarding non-availability of cash in ATMs before a transaction is initiated, displaying the ATM ID clearly in the ATM premises, making forms for lodging ATM complaints available within the ATM premises and also displaying the name and contact details of officials with whom the complaint can be lodged.

VI.73 Banks were also instructed to make available sufficient toll-free telephone numbers for lodging complaints/reporting and blocking lost cards to avoid delays and also attend to requests on priority, proactively register the mobile numbers/e-mail IDs of their customers for sending alerts and enable time out sessions for all screens/ stages of ATM transactions.

Other customer benefitting measures

VI.74 With a view to ensuring fairness and equity in the charges levied by banks for sending SMS alerts to customers, banks have been advised to leverage the technology available with them and with telecom service providers to ensure that such charges are levied on all customers on an actual usage basis.

VI.75 Banks have been prohibited from levying penal charges for non-maintenance of minimum balance in any inoperative account. The additional services available to such inoperative accounts may, however, be withdrawn based on inactivity. Banks have been restricted from levying foreclosure charges/pre-payment penalties on all floating rate term loans sanctioned to individual borrowers.

VI.76 With a view to promoting financial inclusion and also bringing uniformity among banks in opening and operating minors' accounts, banks have been advised that a savings/fixed/recurring bank deposit account can be opened by a minor of any age through his/her natural or legally appointed guardian. Minors above the age of 10 years can open and operate savings bank accounts independently, if they so desire.

BANKING CODES AND STANDARDS BOARD OF INDIA

VI.77 The Banking Codes and Standards Board of India (BCSBI) set up by the Reserve Bank serves as an autonomous and independent body and sets the minimum standards for banking services in India for individuals and micro and small enterprises. It has laid out two codes: Code of Bank's Commitment to Customers and the Code of Bank's Commitment to Micro and Small Enterprises, with the former has been revised for the second time in January 2014.

VI.78 BCSBI also monitors the implementation of codes by member banks through branch visits and interaction with bank customers, and banks are accordingly rated based on their compliance. BCSBI continued its efforts to increase awareness about the codes by participating in town hall meets and in awareness programmes organised by the BO and other banks apart from conducting 'customer meets'.

Implementation of recommendations of FSLRC

VI.79 The Reserve Bank is in the process of implementing the non-legislative recommendations of the FSLRC Report (March 2013) . Nonetheless,

Box VI.5:
Implementation of Recommendations of FSLRC

The Financial Sector Legislative Reforms Commission (FSLRC) was set up in March 2011 '*with a view to rewriting and cleaning up the financial sector laws to bring them in tune with the current requirements*'. The Commission submitted its report on March 22, 2013. In its report, the Commission has proposed a financial regulatory architecture comprising seven agencies.

Agencies	Responsibilities
Reserve Bank of India (RBI)	• Monetary policy • Microprudential supervision of and consumer protection with reference to banking and payment systems
Unified Financial Agency (UFA)	• Microprudential supervision of and consumer protection with reference to all financial firms (other than those of banking and payment systems) • Regulation of organised financial trading
Financial Sector Appellate Tribunal (FSAT)	Hear appeals against RBI for its regulatory functions, the UFA, decisions of the FRA and some elements of the work of the Resolution Corporation.
Resolution Corporation	DICGC will be subsumed into the Corporation which will work across the financial system
Financial Redressal Agency (FRA)	A nationwide machinery for handling consumers complaints against all financial firms
Public Debt Management Agency (PDMA)	An independent agency to manage public debt
Financial Stability and Development Council (FSDC)	FSDC reconstituted as a statutory agency with executive powers and with modified functions in the fields of systemic risk and development.

The Commission also produced a draft "Indian Financial Code" - a non-sectoral and principle-based single legislation for the financial sector. The Commission suggested laying the foundation for financial regulatory process around four themes, *viz*., clarity on objectives and avoiding conflicts of interest; precisely defined powers; operational and political independence; and accountability mechanisms through a process of judicial oversight.

The Commission's report is one of the most important and well researched reports in Indian financial history. It provides a welcome emphasis on consumer protection and suggests setting up of new institutions such as the Resolution Corporation which are much needed. There are many merits in the overall approach adopted by

(Contd...)

the Commission – a non-sectoral approach to financial sector regulation, principle based law, focus on regulatory independence and accountability, the principles of neutrality and competition, structured process of regulation making, *etc.* The Commission's recommendations on improved corporate governance and transparency of the regulators are welcome.

The FSLRC has laid out the need for focussed attention on consumer protection. In particular, it has highlighted the responsibility of financial institutions in determining the suitability of products sold to a consumer. One could debate whether consumer protection should be within the sectoral regulator or in a new Financial Redressal Authority (FRA). While the former structure will allow the sectoral regulator to acquire information quickly and adapt regulations if necessary, the latter structure will allow redressal for products spanning multiple regulators. On balance, perhaps we should first strengthen consumer protection departments in sectoral regulators before embarking on FRA to fill gaps.

The proposal to set up a Resolution Corporation which will facilitate the resolution of failing financial firms at the least cost to the exchequer is also much needed. The Working Group of the Resolution Regime for the financial sector in India, set up by the FSDC, has offered details on such an agency. Some proposals of the FSLRC in this regard will, however, need to be carefully reviewed so as to ensure that depositors' interests remain protected and the Resolution Corporation's powers to examine financial firms does not duplicate or overlap with that of the regulators.

The broad approach set out by the FSLRC for the monetary policy process accords with the thinking in the Reserve Bank. The FSLRC's emphasis on the need for a clear monetary framework was followed by the report of the Reserve Bank's Expert Committee to Strengthen and Revise the Monetary Policy Framework (Chairman: Dr. Urjit Patel). The accountability structures for monetary policy proposed in the Report are broadly acceptable. However, some tweaking with regard to the composition of the Monetary Policy Committee and its constitution as an executive body will be needed. The proposed enhanced role for the government in monetary policy making also need to be discussed. The Reserve Bank has flagged these issues with the Government of India.

The Reserve Bank has already commenced implementing several recommendations of the FSLRC which are governance enhancing in nature and which do not require legislative changes. These recommendations relate to consumer rights and protection, the process of regulation making, accountability, constitution and selection process for the members of regulator's board, functioning of the Boards, greater transparency in reporting and performance evaluation, capacity building, *etc.* Following the suggestion to move to a time defined (90 days) approval process, the Reserve Bank has published the 'Timelines for Regulatory Approvals' and 'Citizens' Charter' for delivery of services. As recommended in the Report, all investigations in the Reserve Bank are conducted within a time bound process and with systems in place to review any investigation exceeding the timeline. The Reserve Bank is in process of further fine tuning the investigation process. Two Committees constituted by the Reserve Bank are examining the kind of capacity building necessary within the Reserve Bank and in the financial market segments regulated by it, both for the staff and also for the directors on the Boards of banks and other regulated entities. Thus, several recommendations, to the extent that they do not require legislative changes, are already in the process of being implemented by the regulators.

Yet there are residual concerns, some of which are outlined below:

Proposed regulatory architecture

The first set of concerns relate to the proposed regulatory architecture. The Commission's proposals appear to be inadequately substantiated in some respects, such as the rationale for, and analysis of the costs and benefits of, creating new institutions and breaking up existing ones. The Commission discusses the synergies which could be realized in bringing together some regulators. There is, however, no discussion on the synergies which will be lost by dismantling other regulators. There is little empirical analysis of the costs and benefits of the proposed regulatory architecture, despite the Commission's emphasis on rigorous cost benefit analysis as the foundation of all regulation making.

There are also some inconsistencies in the Commission's approach. While, on the one hand, it suggests regulation of organised trading of financial products and commodities trading should be centralised with one regulatory agency, regulation of NBFCs, which perform bank-like activities, is not proposed to be with the banking regulation. There are instances where the Commission proposes to entrust an agency with a certain responsibility but leaves the powers for exercising the tools necessary for discharging the responsibility with another agency. For example, the Reserve Bank has responsibility for managing the internal and external value of the rupee, and more broadly, for macroeconomic stability. The ability to shape capital inflows is now recognised as part of the macro-prudential tool kit. Yet, by suggesting taking away control over inward capital inflows, more specifically debt flows, from the Reserve Bank, the FSLRC takes away an important tool from the Reserve Bank.

There are strong arguments, especially stemming from the experiences of the global financial crisis, for the powers of macro prudential regulation, regulation of systemically

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important financial firms, regulation of all deposit taking and credit institutions, regulation of debt oriented capital inflows, regulation of money, government securities, debt and forex markets, and the management of public debt remaining with the central bank. These arguments have been underweighted by the FSLRC.

The Commission's approach to certain segments of regulation could be inimical for the financial sector given the economy's stage of development. A case in point is the implied position that all current account transactions should be totally free of regulation. Again, while the proposed approach to neutrality and competition is commendable, such an approach towards foreign banks and foreign entities needs some moderation and caution. The overall approach of increasing competition needs to be weighed against the considerations of the health of financial firms and of financial stability. The proposals that certain financial service providers like hedge funds, private equity funds, venture funds and micro financial institutions need not be microprudentially regulated appear to overlook recent global developments in this regard. Regulators across the world collect data from regulated entities based on their fiduciary relationship with such entities. The recommendation prohibiting regulators from obtaining information directly from the regulated entities is restrictive and against global best practices. The proposal to leave the objectives of monetary policy open to repeated review will preclude the central bank from acquiring monetary credibility. Such objectives should be clearly specified by the Act and approved by the Parliament.

Judicial oversight

The FSLRC mentions that regulators are "mini states" with powers of the legislature, executive and judiciary encapsulated within a single entity. It proposes an elaborate checks and balances mechanism consisting of objective standards of governance for regulators, a structured regulation process, a performance measurement mechanism and oversight by a judicial tribunal.

Checks and balances are certainly needed. There are already checks and balances in place, including review by constitutional courts like high courts through writ petitions. Senior-most officers of the regulator are appointed, and can be removed, by the government. Proposals by the Commission with regard to an annual report by the regulators are welcome suggestions which will add to the accountability and oversight over regulators.

The proposal to create an FSAT, however, and to subject everything that a regulator does – framing of regulation, policy decisions, the decision-making process, even the exercise of regulatory judgement – carries serious dangers of excessive legal oversight. A regulator often seeks to fill in gaps in laws, contracts and even regulations by exercising sound judgment based on experience. But not everything the regulator does can be proven in a court of law and it would be counterproductive to put in place a mechanism wherein every regulatory decision is second-guessed. These dangers are particularly pronounced in a developing country where the combination of a slow moving legal system and an inexperienced tribunal could slow down the process of regulation making and introduce distortions in the system.

In any country, and especially a developing economy like ours, a healthy respect for the regulator is a critical part of the regulator's toolkit of checks and balances for the regulated. By making the regulator's every action subject to checks by the private sector is tantamount to depriving the power of the regulator to command, even to influence good behaviour.

The Commission lays a great deal of emphasis on according the strongest independence to the central bank. Its recommendations, however, do not add up to that; rather they may constrain any independence which the regulator enjoys currently.

Regulation and principle-based law

The Commission's proposal on non-sectoral approach carries the risk of excessive generalization. Globally, there are different sets of prudential norms for different sectors (*e.g.* Basel norms for banking, solvency norms for insurance, *etc.*). The sectoral approach is proposed to be at the level of regulation, which will result in a "mammoth superstructure" of regulations super-imposed over a "slender base of law"[3].

Again, a principle-based law, while bringing in a new approach, passes the responsibility of rule-making to the regulators which should primarily be the responsibility of the legislators. It entails many challenges in interpreting the law and could lead to unnecessary litigation, with avoidable additional cost on the financial system. It may be useful to start in a measured way in a small area of regulation than to move across the board towards principle-based regulation.

Indian Financial Code – Gaps

The draft Indian Financial Code is comprehensive, but will require significant efforts before it can be accepted as law. The Commission, for reasons not explained, has sought to redefine accepted terms such as banking, deposits, government securities, *etc.* The resulting definitions are open to wide interpretation. There are also some differences between the recommendations and observations in the Report and the draft Model Law. These also need to be reconciled. Finally, some gaps will have to be filled if the legislation is to be effective.

[3] Dissent note to the FSRLC Report by Shri P. J. Nayak

the overall recommendations need to be carefully assessed keeping in view balancing the regulator's freedom to evolve with changing needs of the economy while ensuring customer protection (Box VI.5). With a view to ensuring a more robust financial system and mitigating the risks therein, the Reserve Bank will continue in its endeavour to support and nurture the banking and non-banking sectors while considering customer protection and satisfaction.

VII PUBLIC DEBT MANAGEMENT

The Reserve Bank could conduct debt management operations during the year in an orderly manner despite facing challenges emanating from exchange rate volatility and inflationary pressures. Under the switch operations in G-secs, some of the near term maturing debt with institutional investors was switched to long-term debt. Also, buyback of debt from the market was undertaken through reverse auctions. These actions contributed to strengthening the maturity structure of the government debt, improving liquidity in the debt market and mitigating rollover risks.

VII.1 The central government's high borrowing requirement during 2013-14 along with inflationary pressures and adverse market conditions on account of exchange rate volatility were the major challenges in debt management during the year. Notwithstanding these challenges,borrowing programme was conducted in a smooth and orderly manner in co-ordination with the government. The debt management strategy focused on elongating maturity with a view to containing rollover risk, given the limited scope to issue securities in the less than 10 years maturity buckets. It also undertook switching operations whereby short-term debt was replaced with longer maturity debt to reduce rollover risks. It also conducted the buyback of short-term debt to reduce short-term redemption pressure. The borrowing programmes of state governments were also conducted smoothly.

DEBT MANAGEMENT OF THE CENTRAL GOVERNMENT

Market Borrowings

VII.2 The gross and net amounts raised through dated securities in 2013-14 were marginally higher than the amount raised in the previous year (Table VII.I). As compared to 2004-05, the Centre's net market borrowings stood 10 times higher. The volatile market conditions, particularly during July-September 2013-14, posed further challenges. The Reserve Bank switched to uniform price auctions in dated GoI securities to enhance market participation in uncertain market conditions. As compared to the previous year, there was a marginal increase in cost (8.45 per cent *versus* 8.36 per cent) and higher devolvement on primary dealers (securities of ₹175 billion in 26 auctions as compared to ₹18 billion in 3 auctions during the previous year).

VII.3 To ease the redemption pressure for financial year 2014-16, switch operations in G-secs for ₹317 billion were carried out with institutional investors. Buyback of short-term securities amounting to ₹156 billion from the market was completed through reverse auctions in March 2014.

VII.4 The average maturity of debt issuances (based on original maturity) during 2013-14 increased to 15.1 years from 13.5 years in 2012-13.

Table VII.1: Gross and Net Market Borrowings of the Central Government #

(₹ billion)

Item	2004-05	2011-12	2012-13	2013-14*	2014-15 (BE)*
1	2	3	4	5	6
Net Borrowings	460	4,364	4,674	4,685	
	(905)	(3,430)	(4,790)	(4,840)	(4,612)
Gross Borrowings	803	5,100	5,580	5,635	
	1,248	(4,171)	(5,696)	(5,790)	(6,000)

#: Issuances through dated securities. *: Excludes buyback / switches.
Note: Figures in parentheses are budget estimates.

Table VII.2: Central Government's Market Loans-A Profile#

(yield in per cent / maturity in years)

Year	Range of YTMs at Primary Issues			Issues during the year			Outstanding Stock (As at end-March)	
	under 5 years	5-10 years	Over 10 years	Weighted Average Yield	Tenor of securities (Range)	Weighted Average Maturity	Weighted Average Maturity	Weighted Average Coupon
1	2	3	4	5	6	7	8	9
2008-09	7.71-8.42	7.69-8.77	7.77-8.81	7.69	6-30	13.80	10.45	8.23
2009-10	6.09-7.25	6.07-7.77	6.85-8.43	7.23	5-15	11.16	9.82	7.89
2010-11	5.98-8.67	7.17-8.19	7.64-8.63	7.92	5-30	11.62	9.78	7.81
2011-12	8.21-8.49	7.80-10.01	8.25-9.28	8.52	7-30	12.66	9.60	7.88
2012-13	8.82-8.21	7.86-8.76	7.91-8.06	8.36	5-30	13.50	9.67	7.97
2013-14	7.22-9.00	7.16-9.40	7.36-9.40	8.45	6-30	15.05	10.00	7.98

YTM: Yield to Maturity. #: Excludes issuances under MSS.

The weighted average maturity of the outstanding stock (based on residual maturity) increased to 10 years as on March 31, 2014 from 9.7 years as on March 31, 2013. The weighted average yield of dated securities issued (primary market) during the year increased by 9 bps to 8.45 per cent in 2013-14 from 8.36 per cent in 2012-13. The weighted average coupon on the outstanding stock of government dated securities (excluding inflation indexed bonds of ₹65 billion) increased marginally to 7.98 per cent as on March 31, 2014 from 7.97 per cent as on March 31, 2013 (Table VII.2).

VII.5 During 2013-14, 57 per cent of the market borrowings were raised through issuance of dated securities with residual maturity of more than 10 years (Table VII.3). To mitigate the bunching risk, the share of securities with more than 15-year maturity in the total issuance was increased to 33.4 per cent during the year from 26.5 per cent during 2012-13. Commensurately, the share of securities with less than 5-year maturity was reduced from 8.4 per cent to 2.0 per cent during 2013-14.

VII.6 The actual gross market borrowings of the central government for 2013-14 were reduced from the budgeted amount of ₹5,790 billion to ₹5,635 billion (97.3 per cent of the budgeted amount) as compared to ₹5,580 billion raised in 2012-13. As per the Union Budget 2014-15, the gross market borrowings through dated securities are placed at ₹6,000 billion, an increase of 6.5 per cent over the

Table VII.3: Issuance of GoI Dated Securities - Maturity Pattern

(Amount in ₹ billion)

Residual Maturity	2011-12		2012-13		2013-14	
	Amount raised	Percentage to total	Amount raised	Percentage to total	Amount raised	Percentage to total
1	2	3	4	5	6	7
Less than 5 years	180	3.50	470	8.42	110	1.95
5 -9.99 years	2,340	45.88	1,910	34.23	2,305	40.91
10-14.99 years	1,230	24.12	1,730	31.00	1,340	23.78
15 -19.99 years	650	12.75	270	4.84	930	16.50
20 years & above	700	13.73	1,200	21.51	950	16.86
Total	**5,100**	**100.0**	**5,580**	**100.00**	**5,635**	**100.00**

previous year (₹5,635 billion) while net borrowings are budgeted lower at ₹4,612 billion, a decline of 1.6 per cent over ₹4,685 billion. Market borrowings of ₹2,700 billion have been completed up to August 04, 2014. Weighted average yield during the period increased to 8.84 per cent from 7.75 per cent in the same period of 2013-14, while weighted average maturity declined to 14.14 years from 14.49 years.

VII.7 The yields on treasury bills hardened during the year reflecting a change in the monetary policy stance. Subsequent to the liquidity tightening measures introduced in mid-July 2013, yields peaked to 12.02 per cent, 12.01 per cent and 10.46 per cent, respectively, for 91-day, 182-day and 364-day T-bills. Primary market yields on the same stood at 8.86 per cent, 8.86 per cent and 8.89 per cent, respectively, at the last auction held in March 2014 which were higher by 67, 85 and 110 basis points than the respective yields at end-March 2013.

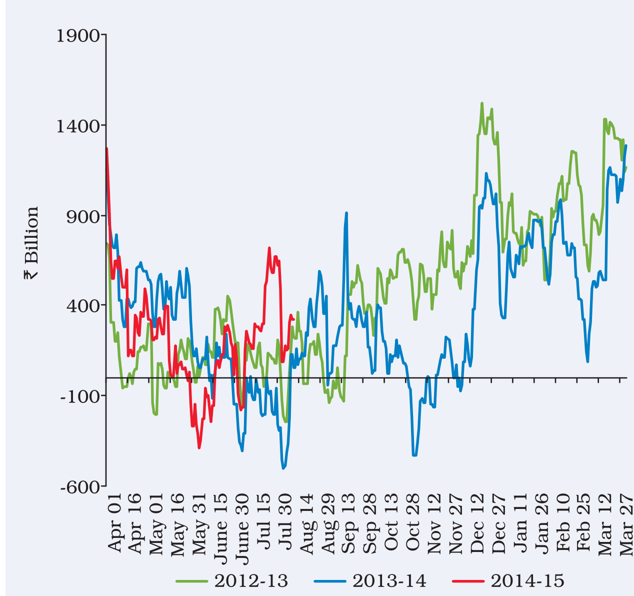
VII.8 Cash management bills (CMBs) were issued for ₹1,072 billion during July-September 2013 to manage the cash requirements of the government as well as to calibrate system liquidity for exchange rate management. The yield on CMBs ranged from 10.36 per cent to 12.28 per cent.

VII.9 Inflation indexed bonds (IIBs) for institutional investors were launched in June 2013 for an aggregate amount of ₹65 billion during 2013-14. IIBs for retail investors, namely, Inflation Indexed National Saving Securities–Cumulative (IINSS-C), were launched in December 2013. The response to these bonds was subdued due to its timing coinciding with the issue of various tax free bonds by PSUs, some of its design features and lack of product awareness among retail investors.

Cash Management

VII.10 The Government of India started the year 2013-14 with a surplus cash balance of ₹1,166 billion, but it took recourse to ways and means advances (WMA) on June 12, 2013 due to its expenditure commitments (Chart VII.1). It availed of WMA on ten occasions before building a positive balance starting December 7, 2013. Such a positive balance was maintained till end-March. The government ended the fiscal year with cash balances at ₹1,284 billion. During 2013-14, the government availed of WMA for 42 days and OD for 9 days (on 3 occasions) as compared to WMA for 40 days and no OD in the previous year.

Chart VII.1: Cash Balance of the Government of India



VII.11 During 2013-14, WMA limits were fixed at ₹300 billion for April 1-September 30, 2013 and ₹200 billion for October 1, 2013- March 31, 2014. WMA limit for the first half of the financial year 2014-15 has been fixed at ₹350 billion.

DEBT MANAGEMENT OF STATE GOVERNMENTS

Market Borrowings

VII.12 The net allocation under the market borrowing programme for state governments for 2013-14 was placed at ₹2,185 billion. Taking into account the repayments of ₹321 billion, the gross allocation amounted to ₹2,506 billion. State governments raised a gross amount of ₹1,967 billion in 2013-14 as against ₹1,773 billion in the

Table VII.4: States' Market Borrowings

(₹ billion)

Item	2011-12	2012-13	2013-14	2014-15
1	2	3	4	5
Net Allocation	1,459	1,881	2,185	NA
Additional Allocation	157	0	0	NA
Maturities during the year	220	306	321	
Gross Allocation	1,835	2,187	2,506	NA
Gross Sanctions under Article 293 (3)	1,634	1,861	2,174	898*
Gross Amount Raised during the Year	1,586	1,773	1,967	599*
Net Amount Raised during the Year	1,366	1,467	1,646	440*
Amount Raised during the year as a % of Total Sanctions	97	95	90	67*
SDLs outstanding (at the end of the period)	7,424	9,291	10,418	NA

*: Up to 31st July, 2014.

previous year (Table VII.4). Two states (Assam and Odisha) did not participate in the market borrowing programme in 2013-14 as against one state (Odisha) in 2012-13. Twelve states did not utilise their full sanctions in 2013-14 as against 11 such states in 2012-13.

VII.13 The weighted average yield of state government securities issued during the year stood higher at 9.18 per cent as compared to 8.84 per cent during the previous year, tracking the general interest rate movements. The weighted average spread over the central government's weighted average yield increased to 75 bps during the year from 71 bps during the previous year. The actual market borrowings of state governments were broadly in alignment with the quantum indicated at the beginning of each quarter.

VII.14 During 2013-14, 26 tranches of auctions, spread over all the months of the year, were held for state governments' market borrowing programmes as compared with 28 tranches in the previous year. On an average, 10 state governments participated in an auction in 2013-14 as compared to 8 in 2012-13. As in the previous year, in addition to regular 10 year maturity bonds, SDLs of varying maturities of 4 and 5 years were issued and the response to them was good.

Cash Management

VII.15 The aggregate WMA limit at ₹102 billion for states, including the Union Territory of Puducherry was revised by 50 per cent of the existing limit from November 11, 2013 to ₹154 billion. The rate of interest on WMA, special drawing facility (SDF) and OD continued to be linked to the repo rate. The monthly average utilisation of SDF, WMA and OD by the states is given in Table VII.5.

VII.16 As compared to previous year, 2013-14 witnessed 13 states resorting to WMA as against 8 states, 13 states resorting to SDF against 9 states and 8 states resorting to OD against 6 states. The aggregate WMA limit for the state governments inclusive of the Union Territory of Puducherry is placed at ₹153.6 billion for the year 2014-15.

VII.17 The surplus cash balances of state governments are automatically invested in 14-day intermediate treasury bills (ITBs) of the central government. The Government of India continued to remunerate ITBs at a fixed rate of 5 per cent. The daily average investment in 14-day ITBs declined by about 15 per cent to ₹726 billion from ₹849 billion last year. States' outstanding investments in ITBs stood at ₹862 billion as at end-March 2014 as against ₹1,181 billion as at end-March 2013. The daily average investment of state governments in

Table VII.5: Utilisation of WMA/OD and Investment of State Governments (Average monthly outstanding)

(₹ billion)

Months	SDF#			WMA			Overdraft			Total		
	2012-13	2013-14	2014-15*	2012-13	2013-14	2014-15*	2012-13	2013-14	2014-15*	2012-13	2013-14	2014-15*
1	2	3	4	5	6	7	8	9	10	11	12	13
April	5.0	0.8	9.1	4.0	3.1	7.8	3.0	1.9	4.1	12.0	5.8	21.0
May	1.0	0.6	1.8	0.3	1.5	5.8	0.0	0.3	1.0	1.4	2.4	8.6
June	0.6	5.7	2.4	2.0	5.0	6.6	0.2	1.9	1.0	2.8	12.6	10.0
July	2.0	1.9	0.1	2.0	2.9	5.2	0.8	0.6	0.3	4.8	5.4	5.6
August	0.6	3.3		1.0	2.7		0.3	2.9		1.9	8.9	
Sept	4.0	3.3		4.0	1.8		2.0	0.6		10.0	5.7	
Oct	5.0	7.2		4.0	3.8		1.0	0.1		10.0	11.1	
Nov	5.0	0.8		4.0	0.0		1.0	0.0		10.0	0.8	
Dec	4.0	1.5		4.0	3.7		2.0	0.0		10.0	5.2	
Jan	0.6	6.9		1.0	5.2		0.1	1.0		1.7	13.1	
Feb	0.1	0.7		3.0	4.1		2.0	0.3		5.1	5.1	
Mar	0.9	0.2		1.6	4.0		4.9	2.8		7.4	7.0	

Note: Interest rate on SDF: 1 per cent below repo rate; WMA: repo rate for a period of 1-90 days and 1 per cent above repo rate for the period beyond 90 days; and OD: 2 per cent above repo rate for OD up to 100 per cent of WMA and for OD exceeding 100 per cent of WMA at 5 per cent above the repo rate.

#: With effect from June 23, 2014, the nomenclature of special ways and means advances has been changed to special drawing facility (SDF).

***:** Up to 31st July, 2014.

auction treasury bills (ATBs) increased to ₹597 billion from ₹441 billion in the previous year. The outstanding investment of state governments in ATBs at end-March 2014 was higher at ₹463 billion as against ₹286 billion at end-March 2013.

VII.18 The central government's Budget 2014-15 projected a moderate increase in gross market borrowings over the previous year. Continuing with the active debt management strategy adopted during 2013-14, the Budget has also made a provision of switching/buyback of debt. With the macroeconomic conditions manifesting signs of stability and inflationary pressures somewhat moderating, the market borrowings programme during 2014-15 is likely to be conducted smoothly.

VII.19 Nevertheless, debt management during 2014-15 may have to deal with other evolving challenges, *viz.*, reduction in the statutory liquidity ratio (SLR) for banks which provides demand for government securities (G-secs), likely pick-up in private credit off-take on the back of improvements in the economy and limited issuance space below 10 years maturity arising from huge redemption pressures in this bucket.

VIII CURRENCY MANAGEMENT

Demand for banknotes and coins followed the rising trend as in the past years. The Reserve Bank continued to focus on strengthening currency exchange facility for the public at bank branches closer to them. The scheme of incentives and penalties was revised upwards to improve customer service by banks as also by expanding the activities covered with emphasis on technological support in the issue and distribution of currency. The Reserve Bank constantly endeavours to maintain the confidence of the public through supply of good quality banknotes and coins as also by enlarging the distribution network to ensure last mile connectivity.

VIII.1 Currency management being a core function of the central banks, commands a high degree of visibility as people often tend to judge their efficacy from the ease of continuous access to and quality of banknotes in their possession. Issue of banknotes and management of currency is one of the core functions of the Reserve Bank of India. Section 22 of the Reserve Bank of India Act, 1934, confers upon the Reserve Bank the sole right to issue banknotes. Rupee coins (₹1, 2, 5 and 10) and 50 paise coins, though issued by the Government of India, are put into circulation only through the Reserve Bank. Currency management involves planning and designing of currency and ensuring its integrity and availability by issuing/withdrawing it in appropriate quantities with a view to maintaining the standard of its quality.

BANKNOTES IN CIRCULATION

VIII.2 Demand for banknotes and coins continued to rise in 2013-14 despite the increased use of technology driven non-cash modes of payment during the recent period. At the close of March 2014, the value of the banknotes in circulation stood at ₹12,829 billion registering an increase of 10.1 per cent over end-March 2013. The volume of banknotes in circulation during the same period increased to 77 billion pieces, an increase of 5.2 per cent (Table VIII.1).

Table VIII.1: Banknotes in Circulation

Denomi-nation	Volume (million pieces)			Value (₹ billion)		
	Mar 2012	Mar 2013	Mar 2014	Mar 2012	Mar 2013	Mar 2014
1	2	3	4	5	6	7
₹2&₹5	11,540	11,624	11,698	45	46	46
	(16.6)	(15.8)	(15.1)	(0.4)	(0.4)	(0.4)
₹10	23,002	25,168	26,648	230	252	266
	(33.2)	(34.2)	(34.5)	(2.2)	(2.2)	(2.1)
₹20	3,510	3825	4,285	70	77	86
	(5.1)	(5.2)	(5.5)	(0.7)	(0.6)	(0.7)
₹50	3,488	3,461	3,448	174	173	172
	(5.0)	(4.7)	(4.5)	(1.6)	(1.5)	(1.3)
₹100	14,119	14,421	14,765	1,412	1,442	1,476
	(20.3)	(19.6)	(19.1)	(13.4)	(12.4)	(11.5)
₹500	10,256	10,719	11,405	5,128	5,359	5,702
	(14.8)	(14.6)	(14.7)	(48.7)	(46.0)	(44.4)
₹1,000	3,469	4,299	5,081	3,469	4,299	5,081
	(5.0)	(5.9)	(6.6)	(33.0)	(36.9)	(39.6)
Total	**69,384**	**73,517**	**77,330**	**10,528**	**11,648**	**12,829**

Note: Figures in parentheses represent the percentage share in total.

COINS IN CIRCULATION

VIII.3 The rising trend in coins in circulation over the past years continued during 2013-14 as well. The coins in circulation increased by 8.2 per cent and 13.1 per cent in terms of volume and value, respectively (Table VIII.2).

Table VIII.2: Coins in Circulation

Denomi-nation	Volume (million pieces)			Value (₹ billion)		
	Mar 2012	Mar 2013	Mar 2014	Mar 2012	Mar 2013	Mar 2014
1	2	3	4	5	6	7
Small Coin	14,785	14,788	14,788	7	7	7
	(19.0)	(17.4)	(16.1)	(5.3)	(4.6)	(4.1)
₹1	34,414	35,884	38,424	34	36	38
	(44.1)	(42.4)	(41.9)	(25.6)	(23.5)	(21.9)
₹2	18,201	22,113	24,823	36	44	50
	(23.3)	(26.1)	(27.1)	(27.1)	(28.8)	(28.9)
₹5	9,981	10,675	11,577	50	53	58
	(12.8)	(12.6)	(12.7)	(37.2)	(34.6)	(33.5)
₹10	648	1,267	2,017	6	13	20
	(0.8)	(1.5)	(2.2)	(4.8)	(8.5)	(11.6)
Total	**78,029**	**84,727**	**91,629**	**133**	**153**	**173**

Note: Figures in parentheses represent the percentage share in total.

CURRENCY OPERATIONS

VIII.4 The Reserve Bank discharged its currency management function during the year through a network of 19 issue offices, a currency chest at Kochi; 4,183 currency chests (including sub-treasury offices) and 3,967 small coin depots of commercial, urban co-operative and regional rural banks spread across the country (Table VIII.3).

Table VIII.3: Currency Chests and Small Coin Depots as at end-March 2014

Category	No. of Currency Chests	No. of Small Coin Depots
1	2	3
Treasuries	11	0
State Bank of India	2,103	2,036
SBI Associate Banks	769	767
Nationalized Banks	1,149	1,018
Private Sector Banks	139	134
Co-operative Banks	2	2
Foreign Banks	5	5
Regional Rural Banks	5	5
Total	**4,183**	**3,967**

VIII.5 The Reserve Bank continues to gradually withdraw from retail distribution of currency by ensuring easier access to exchange facilities to the customers through nearby bank branches. Banks have been advised to strengthen their distribution systems and procedures so as to cater to the growing needs of the common man. As on May 31, 2014 there was a decrease of 80 per cent, 94 per cent and 77 per cent in the distribution of banknotes, coins and adjudication of mutilated banknotes respectively from the Reserve Bank counters as compared to the position prevailing on January 01, 2013. Simultaneously, distribution of banknotes, coins and adjudication of mutilated banknotes from counters of identified bank branches increased by 222 per cent, 85 per cent and 19 per cent respectively during the same period.

VIII.6 To ensure that banks have a more pronounced stake in the distribution of banknotes and coins and also to facilitate their uninterrupted supply in places other than metropolitan and urban centres, a scheme on the lines of the lead bank scheme (LBS) has been formulated to allot specific areas (districts/states) to individual banks. On a pilot basis, all regional offices of the Reserve Bank (except Mumbai and New Delhi) have identified one district and a bank each for implementation of LBS for currency management. The scheme relies on the willingness and enthusiasm of banks to be nodal banks for currency management. The identified lead bank is responsible for ensuring that the genuine needs of people for clean banknotes and coins are appropriately met through proper coordination with currency chests and small coin depots situated in that area. On the basis of the experience gained, it is proposed to take the process forward.

VIII.7 With a view to effectively meeting the growing demand for banknotes and coins in the country, banks were permitted to explore the possibility of engaging the services of business correspondents (BCs) and cash in transit (CIT) entities for distribution of banknotes and coins.

VIII.8 As a move towards mitigation of risk arising out of multiple series of banknotes in circulation, at the request of the Government of India, the Reserve Bank has set in process the withdrawal from circulation all banknotes issued prior to 2005 as they have fewer security features as compared to banknotes printed after 2005. The withdrawal exercise is in conformity with the standard international practice of not having multiple series of banknotes in circulation at the same time. The Reserve Bank has been withdrawing these banknotes in a routine manner through banks. These banknotes can be freely exchanged at any bank branch till January 1, 2015. The procedure to be followed after January 1, 2015 will be communicated by the Reserve Bank in due course. Banks were sensitised to ensure the withdrawal in a smooth and non-disruptive manner without causing any inconvenience to the public. Frequently asked questions (FAQs) with appropriate answers were also listed on the Reserve Bank's website.

CLEAN NOTE POLICY

Indent and supply of banknotes and coins

VIII.9 The Reserve Bank places indents for coins and banknotes with the mints and presses respectively on the basis of econometric models which factor in, *inter alia*, real GDP growth prospects, rate of inflation and disposal rate of denomination-wise soiled banknotes. Accordingly, the supply of banknotes was increased from 19.1 billion pieces in 2012-13 to 20.9 billion pieces in 2013-14 (an increase of 9.5 per cent) (Table VIII.4). The supply of coins also increased during the period by 11.6 per cent over the previous year to 7.7 billion pieces (Table VIII.5).

Table VIII.4: Indent and Supply of Banknotes by the Presses to the Reserve Bank
(April-March)

Denomi-nation	Volume (million pieces)						
	2011-12		2012-13		2013-14		2014-15
	Indent	Supply	Indent	Supply	Indent	Supply	Indent
1	2	3	4	5	6	7	8
₹5	0	2	-	-	-	-	-
₹10	5,700	6,252	12,094	5,506	12,164	9,467	8,000
₹20	600	1,045	1,060	1,154	1,203	935	2,300
₹50	1,200	949	1,182	1,626	994	1,174	2,100
₹100	6,100	5,079	5,704	6,675	5,187	5,131	5,200
₹500	2,000	2,330	3,985	3,002	4,839	3,393	5,400
₹1,000	2,000	1,927	746	1,141	975	818	1,500
Total	**17,600**	**17,584**	**24,770**	**19,103**	**25,362**	**20,918**	**24,500**

Table VIII.5: Indent and Supply of Coins by the Mints to the Reserve Bank
(April-March)

Denomi-nation	Volume (million pieces)						
	2011-12		2012-13		2013-14		2014-15
	Indent	Supply	Indent	Supply	Indent	Supply	Indent
1	2	3	4	5	6	7	8
50 Paise	70	107	50	6	50	40	40
₹1	1,600	1,480	4,177	1,572	5,418	3,092	6,000
₹2	2,900	3,343	2,741	3,742	3,546	2,424	4,000
₹5	800	761	1,586	615	1,819	1,393	2,000
₹10	1,000	403	1,000	943	1,200	728	1,460
Total	**6,370**	**6,094**	**9,554**	**6,878**	**12,033**	**7,677**	**13,500**

Disposal of soiled banknotes

VIII.10 During 2013-14, around 14.2 billion pieces of soiled banknotes were disposed of as against a target of around 17 billion pieces. For 2014-15, a target of around 17 billion pieces has been fixed keeping in view the disposal capacity available and the trend of actual disposal during the last 3 years (Table VIII.6).

Table VIII.6: Disposal of Soiled Banknotes by the Reserve Bank
(April-March)

Volume (million pieces)

Denomination	2011-12	2012-13	2013-14
1	2	3	4
₹1,000	375	450	511
₹500	1,994	2,263	2,405
₹100	5,577	5,627	4,972
₹50	1,578	1,357	1,398
₹20	562	609	725
₹10	3,584	3,752	4,128
Up to ₹5	101	72	48
Total	**13,772**	**14,130**	**14,187**

COUNTERFEIT NOTES

VIII.11 To ensure proper and prompt reporting of counterfeit notes in order to check the menace of counterfeiting of banknotes, the Reserve Bank continued to emphasise on installation of note sorting machines in chests/branches and creation of forged notes vigilance (FNV) cells in all the banks. To instill confidence of the public in the banknotes in circulation and with a view to controlling and mitigating the risk of financial loss as also loss of reputation, banks have been advised to re-align their cash management in such a manner so as to ensure that cash receipts in denominations of ₹100 and above are not put into re-circulation without the banknotes being machine processed for authenticity. The Reserve Bank also introduced an incentive-penalty system relating to detection and reporting of counterfeit notes by banks.

VIII.12 During 2013-14, 488,273 pieces of counterfeit notes were detected of which 468,446 pieces (95.9 per cent) were detected by commercial bank branches while 19,827 pieces (4.1 per cent) were detected at the Reserve Bank offices (Table VIII.7). During 2013-14, the detection of counterfeit notes of ₹1,000 and ₹100 increased by 11.8 per cent and 9.8 per cent respectively, whereas that of ₹500 denomination decreased by 10.3 per cent, as compared to the previous year (Table VIII.8). This data, however, does not include the counterfeit notes seized by the police and other enforcement agencies.

Table VIII.7: Number of Counterfeit Notes Detected
(April-March)

(No. of pieces)

Year	Detection at		Total
	Reserve Bank	Other banks	
1	2	3	4
2011-12	37,690 (7.2)	4,83,465 (92.8)	5,21,155
2012-13	29,200 (5.9)	4,69,052 (94.1)	4,98,252
2013-14	19,827 (4.1)	468,446 (95.9)	488,273

Note: Figures in parentheses represent the percentage share in total.

Table VIII.8: Denomination-wise Detection of Counterfeit Notes in the Banking System (April-March)

(No. of pieces)

Denomination in ₹	2011-12	2012-13	2013-14
1	2	3	4
2 & 5	–	2	1
10	126	321	157
20	216	221	87
50	12,457	9,759	6,851
100	123,398	108,225	118,873
500	301,678	281,265	252,269
1,000	83,280	98,459	110,035
Total pieces	**521,155**	**498,252**	**488,273**
Notional Value in ₹ billion	**0.25**	**0.25**	**0.25**

Note: Data does not include counterfeit notes seized by the police and other enforcement agencies.

EXPENDITURE ON SECURITY PRINTING AND DISTRIBUTION

VIII.13 With a view to obviating the need for making repeated logistical and security arrangements for transportation of banknotes thereby reducing the costs, as also for ensuring speedy movement of treasure, a scheme of direct remittance of banknotes from note printing presses to currency chests is being progressively pursued by the Reserve Bank. During 2013-14 (July-June), an expenditure of ₹32.1 billion was incurred on security printing as compared to ₹28.7 billion during 2012-13 (July-June).

IX PAYMENT AND SETTLEMENT SYSTEMS AND INFORMATION TECHNOLOGY

Imperative to the greater adoption of electronic payments are speed, efficiency and security, as also creating trust and safety of operations in the minds of the users. In line with its vision of encouraging electronic payments in the country and achieving a less-cash society, the Reserve Bank continued its endeavours in making the payment systems safer and more secure, gearing its policies towards addressing risks, if any, in the payment systems. Several initiatives for infrastructure enhancement during the year included introduction of white label ATMs, cardless cash withdrawal facility for unbanked persons, introduction of next generation RTGS and enhancing the capacity of the NEFT system for larger volumes and efficiency. The trend of greater acceptance of electronic payments over paper cheques by the general public received further boost during the year.

IX.1 The efforts made by the Reserve Bank in migrating to electronic payments are reflected in the high volumes witnessed under various electronic payment systems during the year (Table IX.1). Alongside acceptance of electronic payments, the volumes processed under paper-

Table IX.1: Payment System Indicators - Annual Turnover

Item	Volume (million)			Value (₹ billion)		
	2011-12	2012-13	2013-14	2011-12	2012-13	2013-14
1	2	3	4	5	6	7
Systemically Important Financial Market infrastructures (SIFMIs)						
1. RTGS	55.0	68.5	81.1	539,307.5	676,841.0	734,252.4
Total Financial Markets Clearing (2+3+4)	**1.9**	**2.3**	**2.6**	**406,071.2**	**501,598.5**	**621,569.6**
2. CBLO	0.1	0.2	0.2	111,554.3	120,480.4	175,261.9
3. Government Securities Clearing	0.4	0.7	0.9	72,520.8	119,948.0	161,848.2
4. Forex Clearing	1.3	1.4	1.5	221,996.1	261,170.1	284,459.5
Total SIFMIs (1-4)	**56.9**	**70.8**	**83.7**	**945,378.7**	**1,178,439.5**	**1,355,822.0**
Retail Payments						
Total Paper Clearing (5+6+7)	**1,341.9**	**1,313.7**	**1,254.0**	**99,012.1**	**100,181.8**	**9,3014.8**
5. CTS	180.0	275.0	589.3	15,103.7	21,779.5	44,203.1
6. MICR Clearing	934.9	823.3	439.0	65,093.2	57,504.0	31,129.8
7. Non-MICR Clearing	227.0	215.3	225.7	18,815.1	20,898.3	17,681.8
Total Retail Electronic Clearing (8+9+10+11+12)	**512.5**	**694.1**	**1,108.3**	**20,575.3**	**31,881.1**	**47,856.3**
8. ECS DR	164.7	176.5	192.9	833.6	1,083.1	1,268.0
9. ECS CR	121.5	122.2	152.5	1,837.8	1,771.3	2,492.2
10. EFT/NEFT	226.1	394.1	661.0	17,903.5	29,022.4	43,785.5
11. Immediate Payment Service (IMPS)	0.1	1.2	15.4	0.4	4.3	95.8
12. National Automated Clearing House (NACH)	-	-	86.5	-	-	214.8
Total Card Payments (13+14+15)	**678.1**	**931.7**	**1,262.1**	**1,562.5**	**2,051.5**	**2,576.3**
13. Credit Cards	320.0	396.6	509.1	966.1	1229.5	1539.9
14. Debit Cards	327.5	469.1	619.1	534.3	743.4	954.1
15. Prepaid Payment Instruments (PPIs)	30.6	66.1	133.9	62.0	78.7	82.4
Total Retail Payments (5 to 15)	**2,532.4**	**2,939.5**	**3,624.4**	**121,149.9**	**134,114.4**	**143,447.4**
Grand Total (1-15)	**2,589.3**	**3,010.2**	**3,708.0**	**1,066,528.5**	**1,312,554.0**	**1,499,269.4**

- : Not applicable

Note:
1. Real time gross settlement system (RTGS) includes customer and inter-bank transactions only.
2. Settlement of government securities clearing and forex transactions is through the Clearing Corporation of India Ltd. (CCIL).
3. Banks from 27 Magnetic Ink Character Recognition (MICR) Cheque Processing Centres (CPCs) and 67 non-MICR CPC locations; 20 MICR CPCs and 3 non-MICR CPC locations; and 21 MICR CPCs and 1 non-MICR CPC locations are participating in CTS-Chennai, Mumbai and New Delhi Grids respectively. Consequent upon migration of total cheque volume to cheque truncation system (CTS) in various CPC locations, the total number of MICR CPCs in the country reduced from 66 to 19 (as on May 21, 2014).
4. The figures of cards are for transactions at point of sale (POS) terminals only.
5. The NACH system was started by National Payments Corporation of India (NPCI) (in December 29, 2012), to facilitate inter-bank, high volume, electronic transactions which are repetitive and periodic in nature.
6. Figures in the columns might not add up to the total due to rounding off of numbers.

based clearing systems, relative to other non-cash payment means, continued to show a declining trend. Overall, the payment and settlement systems registered a healthy growth in volumes at 23.2 per cent and value at 14.2 per cent during 2013-14.

TRENDS IN PAYMENT SYSTEMS

Paper clearing

IX.2 The on-going endeavour and efforts to migrate from paper to electronic payments had a positive impact, leading to a reduction in paper-based transactions in volume as well as in value terms. During 2013-14, in volume terms paper-based transactions accounted for 34.6 per cent (43.4 per cent during 2012-13) of total non-cash transactions. In terms of value too, the share of paper-based transactions reduced to 6.3 per cent (7.6 per cent during 2012-13).

IX.3 The cheque clearing system at present mainly comprises: (i) the grid based cheque truncation[1] system (CTS) at Chennai, Mumbai and New Delhi, (ii) MICR CPCs at 19 large centres, and (iii) express cheque clearing systems (ECCS) at 1,339 smaller centres. Grid-CTS clearing facilitate clearing of all cheques drawn on bank branches within the grid jurisdiction as local cheques, thus eliminating the levy of speed clearing charges/outstation cheque collection charges, etc. As of May 2014, the introduction of grid CTS had enabled migration of the entire volume of 47 MICR centres to the grid centre, thus leading to their closure. The ECCS application package is used at centres with low volumes and also enables 'local' level clearing for participating banks at that centre.

Electronic payments

IX.4 During 2013-14, the RTGS processed around 81 million transactions valued at ₹734 trillion. As on April 30, 2014 the number of RTGS-enabled bank branches stood at 109,506.

IX.5 As on April 30, 2014, the national electronic funds transfer (NEFT) facility was available at 111,619 branches of 158 banks. During 2013-14, NEFT handled 661 million transactions valued at around ₹44 trillion. In March 2014, NEFT processed a record volume of 82.8 million transactions.

IX.6 During 2013-14, the electronic clearing service (ECS) debit-handled 193 million transactions valued at around ₹1,268 billion and ECS credit processed 152 million transactions valued at around ₹2,493 billion. With the gradual expansion of the regional electronic clearing service (RECS) operations, the volumes at many ECS centres have completely subsumed to RECS centres. The number of ECS centres now stands at 34 in addition to the 12 RECS centres in various centres and the national electronic clearing service (NECS) in Mumbai.

IX.7 During 2013-14, 509 million transactions valued at ₹1,539 billion were transacted through credit cards, while 619 million transactions valued at ₹954 billion were undertaken through debit cards.

IX.8 During the year, mobile banking services handled 95 million transactions valued at around ₹60 billion.

White label ATMs (WLAs)

IX.9 To supplement the efforts of banks in providing banking services to people in unbanked/under-banked areas, non-bank establishments were permitted to install and operate ATMs with greater focus on Tier III to Tier VI centres. Out of the 18 applicants, 12 entities were given in-principle approval, of which 6 entities have been granted final authorisation to install ATMs. A total of 1,960 WLAs had been deployed as on April 30, 2014.

[1] Image-based clearing.

Authorisation of payment systems

IX.10 During 2013-14, with the addition of 17 new entities, the number of authorised payment system operators grew to 58, comprising prepaid payment instrument issuers, cross-border money transfer service providers, WLA operators, ATM networks and card payment networks besides CCIL and the National Payments Corporation of India (NPCI). In addition, 8 other entities were issued 'in-principle authorisation' to issue and operate prepaid payment instruments (PPIs). During the year, 3 payment system operators (PSOs) issuing PPIs were put under the 'winding down' process. Operations of one overseas principal engaged in the cross-border in-bound remittance service under money transfer service scheme (MTSS) ceased completely due to non-compliance of guidelines. NPCI which operates the 24x7 Immediate Payment Service (IMPS) was accorded permission to introduce multiple settlement sessions. In-principle approval was also given for setting up cardless cash withdrawal systems (Box IX.1).

POLICY INITIATIVES

Cheque clearing systems: Checks and balances

IX.11 Over the years, the Reserve Bank first automated all clearing houses for settlement purposes and then leveraged the core banking solution (CBS) of banks for enabling processing of outstation cheques locally under speed clearing. Later, CTS and grid-based CTS were introduced for building further efficiency in cheque clearing. However, even after years, non-CTS 2010 standard cheques continued to be presented at CTS grids posing risks. A system of separate clearing at less frequent intervals was hence introduced at the 3 grid CTS locations from January 1, 2014 for non-compliant cheques still in circulation. Banks were advised against the continued use of post-dated cheques in locations where the ECS facility was available.

Box IX.1
Cardless Cash Withdrawal Facility for Unbanked Persons

During the year, 2 entities were granted 'in-principle authorisation' to set up a payment system in India which will facilitate unbanked persons to withdraw remittances initiated by 'senders/remitters' from their bank accounts. The proposition behind the cardless service is to enable bank account holders to transfer/remit funds, within permissible limits, to an unbanked beneficiary using a mobile number as the identification of the receiver and pin codes for enabling withdrawal. The service will be made operational on submission of system audit reports by the said entities. A brief schema of the approved systems is given below.

Remittance will be possible by an account holder to a non-account holder using the internet or his debit card at an ATM. The sender will use any participating bank's ATM to transfer funds to the receiver by activating a special button. Thereafter he will be prompted to provide the following information:

- Receiver/beneficiary's mobile number
- 4-digit sender code of his choice
- Amount to be remitted
- Own (sender's) mobile number

The beneficiary will be able to withdraw the money in full at any of the ATMs of the participant banks using a set of pin codes - one received from the bank and the other from the remitter. At the ATM, the beneficiary will need to activate the special button and provide the following information:

- His own (receiver) mobile number
- The sender's code (received on phone/short message service (SMS) from remitter)
- The transaction pin (generated by the bank and sent to him by SMS)
- The amount (also received from the bank and remitter by SMS)

On successful completion of the transaction, the remitter will get an SMS of successful delivery of the value. The service will be chargeable to the sender. The withdrawal can also be enabled through a micro ATM (hand held device with a business correspondent (BC)) to extend the reach of the system.

IX.12 As a customer service measure, banks were advised that cheque return charges should be levied only in cases where the customer is at fault and responsible for such returns, and not otherwise. An arrangement of uniform holidays was put in place at the 3 grid-CTS locations for streamlining the procedures and ensuring faster cheque realisations across different states covered by the grid.

Enhancing efficiency and security of electronic payments

IX.13 The NEFT system was enhanced for handling larger volumes and efficiency. To improve customer service, banks were advised to adhere to the NEFT procedural guidelines concerning charges to customers, adherence to return discipline, facilitation of remittance for walk-in customers and *suo moto* payment of compensation for delayed credit or return.

IX.14 Banks were advised to facilitate quicker lodging of complaints relating to ATM transactions and proactively registering mobile numbers/e-mail IDs of customers for sending alerts. As a fraud control measure, banks were also advised to enable time-out sessions for all screens/stages of ATM transactions keeping in view the time required for such functions in the normal course.

IX.15 The facility of e-KYC for opening accounts, available to banks, was also extended to non-bank entities authorised to issue PPIs. PPI guidelines, first issued in April 2009 were amended and consolidated in March 2014. To address the concerns of operational risks, the revised guidelines tightened the entry point norms in terms of capital and net worth requirements for entities seeking authorisation as issuers of PPIs, outlining the permissible debits and credits to escrow accounts which were put in place to ensure protection of customer funds.

IX.16 To ensure safety and security of card payments, the Reserve Bank has mandated the migration to Europay, MasterCard and Visa (EMV) chip and personal identification number (PIN) for all international cards as also the need for a PIN for all debit card transactions at point of sale (POS) terminals. While these requirements were to be complied by card issuing banks, similar requirements were placed on the banks which have installed card acceptance infrastructure for compliance to payment card industry data security standards (PCI-DSS), terminal line encryption (TLE) and unique key per terminal (UKPT)/ derived unique key per terminal (DUKPT) security. Banks were also advised that customer losses accruing on account of non-adherence were to be borne by the banks responsible for such losses. Over a period of time, both card-not-present and card-present transactions have been strengthened through the use of the additional factor of authentication (AFA).

IX.17 As on May 31, 2014, 86 banks, including 10 RRBs and 19 UCBs, had been permitted to launch mobile banking services (Box IX.2).

Clearing Corporation of India Limited (CCIL)

IX.18 The Reserve Bank issued a policy document on 'Regulation and Supervision of Financial Market Infrastructure' (FMI) describing in detail the criteria for designating a FMI, its oversight and other related aspects. CCIL has been advised to adopt the principles for financial market infrastructures (PFMIs) issued jointly by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commission (IOSCO). CCIL was declared a qualified central counterparty (QCCP) in the Indian jurisdiction on January 1, 2014.

IX.19 During the year, CCIL has been granted several permissions/approvals: i) doing away with physical exchange of confirmation for trades in the currency options, ii) commencement of interest rate swaps (IRS) guaranteed settlement, iii) in-principle approval for introduction of the payment *vs* payment (P*v*P) model in USD/INR settlement, and iv) portfolio compression in USD-INR forex

Box IX.2
Technical Committee on Mobile Banking

With a view to leveraging the high mobile density in the country and to study the feasibility of providing an affordable means of carrying out payment transactions to enhance the financial inclusion objective through this medium, a Technical Committee on Mobile Banking was constituted under the Chairmanship of Shri B. Sambamurthy. The committee submitted its report in January 2014.

The committee identified the challenges faced by banks in providing mobile banking services to customers, including customer enrolment, technical issues and SMS/unstructured supplement service data (USSD)/application-based mobile banking. The report emphasised the need for a standardised and simplified procedure for registration/authentication of customers, a cohesive awareness programme and adoption of a common application platform across all banks to be delivered to the customers independent of the handset being used. The report has indicated the use of SMS and USSD with encryption technology for providing the necessary level of security in financial transactions.

The issuance of necessary guidelines by the Telecom Regulatory Authority of India (TRAI) prescribing the optimum service parameters, as also the ceiling on transaction costs for extension of the USSD services by telecom operators to banks and their agents, has been appreciated and the committee has recommended that the implementation of TRAI's regulations must be expedited by all the stakeholders.

forward trades for members. CCIL is being monitored for compliance against PFMIs. PFMI suggests that 'FMIs may use the assessment methodology to periodically conduct, full or partial, self-assessments of observance of the principles'. Accordingly, CCIL has been advised to carry out self-assessment against the 'PFMIs-disclosure framework and assessment methodology' document issued by CPSS-IOSCO in December 2012.

IX.20 As per the on-going monitoring, CCIL was advised to carry out a comprehensive review of its bye-laws, rules and regulations. CCIL had reviewed its bye-laws and rules and regulations with respect to forex forwards and IRS segments (Box IX.3). The amendments include a new chapter on

Box IX.3
Forex Forward Trade Compression

Trade compression is a risk mitigating process carried out by reducing the notional amount of trades outstanding in the market by a process of termination/partial termination of economically redundant trades. By trade compression, members off-set between the trades, which causes significant reduction in their outstanding trades and associated risks.

Members who desire to participate in the portfolio compression exercise have to indicate to the service provider their willingness and acceptance of the defined parameters. The participants generally specify a threshold limit for mark-to-market (MTM) loss/gain caused due to the early termination of trades and the trades eligible for early termination based on these tolerances. This involves execution of a mathematical algorithm to arrive at the optimum solution. The compressions are executed as 'cycles'. Generally, the live cycle is preceded by a mandatory trial run and the entire exercise is spread over 4 to 5 business days.

The benefits arising from this new strategy include reduction of counterparty credit risks, operational risks, costs, risk weighted assets and balance sheet size of the financial institutions. Portfolio compression is recognised globally as an important risk mitigating tool. Periodic portfolio compression will eliminate the capital charge for risk weighted assets appearing on the balance sheets of banks/ financial institutions.

CCIL, based on the approval of the Reserve Bank has been providing trade compression for interest rate swaps (IRS) only.

CCIL has now been accorded approval for carrying out portfolio compression in USD-INR forex forward trades for members of the segment. CCIL will remain responsible for settlement of all these trades whether through portfolio compression or at the time of settlement of those trades on maturity.

bankruptcy in CCIL, bye-laws which cover CCIL default and members' right to set-off in such circumstances.

Oversight of payment systems

IX.21 The oversight framework is based on three parameters: monitoring, assessment and inducing change. It is managed through self-assessment by the authorised entity, evaluation of the self-assessment and on-site inspection by the supervisors, complemented by off-site monitoring and market intelligence.

Committee on Payment and Settlement Systems (CPSS)

IX.22 CPSS promotes the safety and efficiency of payments, clearing, settlement and related arrangements, thereby supporting financial stability and the wider economy. It serves as a forum for central bank cooperation in related oversight, policy and operational matters including the provision of central bank services. India continues to be a member of this important forum.

PFMI implementation and monitoring

IX.23 In April 2012, CPSS and IOSCO issued the 'Principles for Financial Market Infrastructures' (PFMIs) (Box IX.4). The scope of PFMIs is to enhance safety and efficiency in payments, clearing, settlement and recording arrangements, and more broadly to limit systemic risks and foster transparency and financial stability. CPSS and IOSCO members are required to strive to adopt PFMIs in their respective jurisdictions. CPSS-IOSCO started the process of monitoring the implementation of PFMIs with the intention of promoting consistency in implementation across jurisdictions. The first stage of implementation monitoring (Level-I) assessed whether the jurisdictions have completed the process of

Box IX.4
Financial Market Infrastructure Framework

Financial market infrastructure (FMI) is defined as a multilateral system among participating institutions including the operator of the system, used for the purposes of clearing, settling or recording payments, securities, derivatives or other financial transactions. The term FMI generally refers to systemically important payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs) and trade repositories (TRs) that facilitate the clearing, settlement and recording of financial transactions.

As a member of the Financial Stability Board (FSB) and of CPSS, the Reserve Bank is committed to the adoption and implementation of the 'Principles for Financial Market Infrastructures' (PFMIs). The policy on supervision and regulation of FMIs regulated by RBI describes in detail the criteria for designating a FMI, applicability of PFMIs to FMIs, oversight of FMIs and other related aspects. Hitherto the oversight was based on international standards such as Core Principles for Systemically Important Payment Systems (CPSIPS), Recommendations for Securities Settlement Systems (RSSS) and Recommendations for Central Counter Parties (RCCP).

In line with international developments, and as indicated in the 'Payment Systems in India: Vision 2012-15', the Reserve Bank has adopted the standards set out in PFMIs for regulating and supervising FMIs under the aegis of the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS). All the FMIs determined by the Reserve Bank are expected to comply with PFMI requirements as applicable to them. The FMIs regulated by RBI are RTGS, SSS, CCIL and Negotiated Dealing System-Order Matching (NDS-OM). RTGS and SSS for government securities are owned and operated by the Reserve Bank.

The assessment of FMIs, including those operated by the Reserve Bank, will be against the PFMIs as per the document 'PFMIs-Assessment Methodology' published by CPSS-IOSCO in December 2012.

The oversight of FMIs is carried out through a combination of off-site supervisions which include self-assessment, call for information, system of alerts, external and/or internal audits of control measures and prior approval of changes, on-site inspection and other measures which include periodic meetings with the boards and the senior managements of FMIs to discuss developments, oversight concerns and expectations.

adopting the legislation and other policies for implementing the 24 principles for FMIs and the responsibilities for authorities.

IX.24 The purpose is to identify gaps between implementation measures and the principles, keeping in mind the materiality of the impact of the gaps. In the Level-1 assessment report, India was rated[2] as '1' in adopting PFMI principles and '4' in adherence to the responsibilities of FMIs in the survey results published in August 2013. Consequently, steps were taken by the Reserve Bank as also by the Securities and Exchange Board of India on making it public on adoption and applicability of PFMIs to the FMIs. The second round of the survey was published in May 2014 wherein India has been rated '4' for both adherence to principles as also responsibilities.

Legal Entity Identifier (LEI) and Local Operating Unit (LOU)

IX.25 The Reserve Bank is a member of the Regulatory Oversight Committee (ROC) as also its executive committee. CCIL has been accorded approval to act as a LOU for issuing globally compatible LEIs in India. As a LOU, CCIL will be issuing unique identifier codes to all eligible and desirous legal entities participating in the financial market.

SAARC Payment Council (SPC) meeting

IX.26 The Reserve Bank hosted the 14th meeting of the SPC in Kerala on December 9, 2013. SPC came out with a roadmap for developing payment systems in the SAARC region and identified 8 major areas of focus: i) implementation/improvement in high-value payment and settlement systems; ii) development of electronic retail payment systems; iii) risk mitigation measures for payment and settlement systems; iv) promotion of competition among market participants/access to new participants; v) improvement in the legal and regulatory framework; vi) improvement in the governance structure; vii) commencement of a financial literacy programme (first programme was subsequently held in Nepal on the sidelines of the 15th SPC meeting in May 2014); and viii) improvement of cross-border payment and settlement systems. Further, SAARC formed a technical committee and came out with a concept paper on the harmonisation of payment systems in the region, covering two areas for harmonised payments: i) card payments: inter-connectivity of main switches of ATMs of a country to route cross-border transactions; and ii) connecting e-payment gateways to enable integration of POS gateways between regional countries for acceptance of payment cards.

INFORMATION TECHNOLOGY INITIATIVES FOR THE BANKING SYSTEM

Automated data flow

IX.27 Under automated data flow (ADF), banks were advised to submit automated returns to ensure flow of data from their CBS or other IT systems to the Reserve Bank in a straight-through manner without any manual intervention. To ensure continuity and sustenance of ADF implementation, banks have been advised to set up internal returns governance groups to constantly monitor progress.

Next-generation real time gross settlement system (NG-RTGS)

IX.28 The new RTGS system was launched on October 19, 2013. The system settled a record number of 0.48 million transactions on March 28, 2014. Globally, it is for the first time that the ISO 20022 message formats are being used for transmitting RTGS messages. The RTGS system

[2] Rating Level 1: Draft implementation measures not published; Rating Level 2: Draft implementation measures published; Rating Level 3: Final implementation measures published; Rating Level 4: Final implementation measures fully in force; and Rating Level NA: No implementation measures needed (that is, not applicable).

is highly scalable with new functionalities *viz*. advance liquidity features including a gridlock resolution mechanism and hybrid settlement facility, facility to accept future value dated transactions and options to process multi-currency transactions. The new RTGS system provides 3 access options to participants: thick-client, web-API (through INFINET or any other approved network) and the payment originator module. Participants have the choice to decide on the mode of participation in the system based on the volume of transactions and the cost of setting up the infrastructure. With implementation of the new RTGS system, the old RTGS system ceases to exist and the RTGS System Regulations 2013 have replaced the RTGS (Membership) Business Operating Guidelines, 2004 and RTGS (Membership) Regulations, 2004.

Report on 'Enabling Public Key Infrastructure (PKI) in Payment System Applications'

IX.29 The Reserve Bank constituted a group in September 2013 to prepare an approach paper for enabling PKI for payment system applications in India. The group comprised representatives from banks, the IDRBT-Certifying Authority, the Controller of Certifying Authority and departments of the Reserve Bank. The group also interacted with Indian Banking Association (IBA). The final report of the technical committee was released in April 2014.

IX.30 The report recommended the need for all banks' internet banking applications to create an authentication environment for a password-based 2-stage authentication as well as a PKI-based system for authentication and transaction verification for online banking transactions and its implementation in phases. It also suggested that banks provide the option to their customers for enabling PKI for their online banking transactions.

INFORMATION TECHNOLOGY WITHIN THE RESERVE BANK

IT Sub-Committee (ITSC) to the Central Board

IX.31 ITSC was constituted to advise the Reserve Bank on its overall IT strategy, infrastructure, applications and security and to oversee the implementation of the recommendations of the IT vision document 2011-17. ITSC met twice during the year focusing on issues relating to procedures to be followed for implementing IT projects, need for enterprise architecture, strengthening the role of the chief information security officer (CISO), an information security (IS) audit, an IT subsidiary of IDRBT, IS policy guidelines and disaster recovery (DR) drills conducted by the Reserve Bank.

Information security policy for the Reserve Bank

IX.32 The revised information security policy and related sub-policies have been approved by ITSC. The operational guidelines relevant to administer the policy were released in April 2014.

The electronic document management system (EDMS)

IX.33 A steering committee to implement EDMS with an objective of organising the documents in a systematic manner in electronic form has been formed. An approach paper for time bound implementation of EDMS has been prepared.

Enterprise knowledge portal (EKP)

IX.34 The revamped EKP with advanced features including interactive functionalities to enhance knowledge sharing initiatives in the Reserve Bank was inaugurated in November 2013. It provides a more focussed approach to knowledge sharing efforts in the Reserve Bank and has recorded increased level of visits by its staff.

Upgrading of the video conferencing (VC) system

IX.35 The work related to VC upgradation, which would *inter alia* provide for executive VC rooms at select locations, classroom VC facility in training colleges, high definition technology for better quality, video streaming facility and video-on-demand facility has been rolled out at almost all identified locations within the Reserve Bank.

Perimeter security solution (PSS)

IX.36 PSS aims to provide a mechanism to protect the information systems in the Reserve Bank from all threats/attacks from the external cyber world. The solution includes routers, switches, firewalls, intrusion detection and prevention systems. The project was implemented in two separate phases. In the first phase, procurement and replacement of networking components such as switches, routers and implementing auto fail over (AFO) of switches was completed and in the second phase operationalisation of firewalls and intrusion prevention system (IPS) was completed.

Information security operations centre (iSOC)

IX.37 An advanced iSOC system to proactively detect security related incidents which have an impact on the Reserve Bank, other banks and the financial sector and manage and coordinate responses to such incidents is being implemented in the Reserve Bank. An expression of interest (EoI) for supplying, installing, configuring, maintaining and operating iSOC has been issued. The project is expected to be completed by December 2015.

Mail messaging solution (MMS)

IX.38 The Reserve Bank's corporate MMS was reinforced with an advanced archival solution to provide better access, storage and retrieval of mails to the users. With archival facility, it will be possible to retrieve any mail from MMS. The solution will also eliminate the need for regular increase in mail box size for users at frequent intervals. Archival will also facilitate retention of mails to fulfil legal/statutory requirements. The process to upgrade MMS has also been initiated and is expected to be completed by March 2015.

Committee on data standardisation

IX.39 The Reserve Bank's IT vision 2011-17 document emphasised the importance of both quality and timeliness of data for its processing into useful information for MIS and decision making purposes. To achieve this, uniform data reporting standards are of vital importance. A committee has been constituted for data standardisation which *inter alia* will bring about synergy and uniformity in the areas of data reporting.

X GOVERNANCE, HUMAN RESOURCES DEVELOPMENT AND ORGANISATIONAL MANAGEMENT

The multiplicity of the functions and increasing complexities in the operating environment necessitated continued efforts by the Reserve Bank to upgrade its human resources. Apart from maintaining high governance standards, focus was also placed on capacity building, further improving communication and transparency and fine-tuning the organisational framework. The Bank continued to encourage research and knowledge sharing through publications, conferences, seminars and outreach programmes. To ensure business continuity and effectively managing the other risks faced by it, the Reserve Bank has undertaken several initiatives toward enterprise-wide risk management. These are expected to lower operational risks and strengthen the central bank's ability to meet various contingencies, should they arise, thus providing services in the nature of public goods.

X.1 The Reserve Bank continued to strengthen its human resources by recruiting new staff as well as through imparting training to existing staff members. The Reserve Bank's communication policy focussed on transparency, dissemination of knowledge to a wider public and creating awareness about the financial risks faced by them in their day-to-day lives. There was increased recourse to use of technology in attaining the intended objectives of the communication policy. Another major focus of the initiatives for the organisational framework was on operational risk management and ensuring business continuity through the enterprise-wide risk management (ERM) framework. Considerable progress was made during 2013-14 towards making the ERM framework fully functional.

INITIATIVES FOR IMPROVED GOVERNANCE

Governance Structure

X.2 The Reserve Bank of India being the central bank of the country is driven by the principles of public interest, transparency and public accountability and considerations of equity and fairness as well as to become responsive to the needs of the common person and to move towards diversity and inclusiveness. Accordingly, in the Reserve Bank the governance structure is represented by the Central Board of Directors as the apex body, which aims to ensure that the Reserve Bank's general policy, strategy, administration and business are attuned to the role assigned to it and meet the challenges before the country's economy. The Governor presides over the meetings of the Central Board and he is assisted by four Deputy Governors and nine Executive Directors in managing the affairs of the Reserve Bank.

X.3 As against the full strength of 21 Directors, the Central Board presently has 17 Directors with four positions rendered vacant due to retirements/ resignations. Besides, the Bank has four Local Boards constituted by the Government for the Northern, Southern, Eastern and Western areas of the country. The Government of India appoints/ nominates the Directors to the Central Board and Members to the four Local Boards. At present the Central Board has three Committees (Committee of the Central Board, Board for Financial Supervision and Board for Regulation and Supervision of Payment and Settlement Systems) and four sub-committees (Audit and Risk Monitoring Sub-Committee, Human Resource Management Sub-Committee, Building Sub-Committee and Information Technology Sub-Committee) of the Central Board.

Meetings of the Central Board and its Committees

X.4 With a view to improving governance, efforts have been made to make the meetings of the Board and its Committees streamlined, focused and effective. The number of meetings of the Central

Board has been reduced to the statutory minimum and technology is being leveraged to save resources and time. The Central Board held six meetings during 2013-14 (July 2013-June 2014). Of these, four were held at the traditional centres (Chennai, Mumbai, Kolkata and New Delhi) and two at non-traditional centres (Raipur, Shimla). Shri P. Chidambaram, Hon'ble Finance Minister addressed the post vote-on-account meeting of the Central Board held on March 7, 2014 in New Delhi. Discussions at meetings of the Central Board covered matters pertaining to general superintendence and direction of the affairs of the Reserve Bank and issues relating to its role in supporting socioeconomic goals and development of the nation in line with its mandate.

X.5 Forty six weekly meetings of the Committee of the Central Board (CCB) were held during the year (July 2013 to June 2014) in Mumbai. The Committee attended to the current business of the Reserve Bank, including approval of the Bank's weekly accounts pertaining to the Issue and the Banking Departments.

X.6 On the sidelines of the Central Board's meetings held at various places, the Governor interacted with the Chief Ministers and senior officials of state governments, commercial banks and financial institutions in the respective states. In general, discussions with these officials covered issues like extension of banking services in unbanked/under-banked areas, use of information technology (IT) enabled banking services/measures to promote financial inclusion, enhancing credit flow, electronic benefit transfer (EBT) schemes, developing self-help groups (SHGs), improving the credit-deposit ratio and currency management issues.

DIRECTORS/MEMBERS OF THE CENTRAL BOARD/LOCAL BOARDS-CHANGES

Nominations

X.7 Shri Gurdial Singh Sandhu, Secretary, Department of Financial Services, was nominated as a Director on the Central Board with effect from April 1, 2014 vice Shri Rajiv Takru under Section 8(1)(d) of the RBI Act, 1934. Shri Azim Premji ceased to be Director of the Central Board with effect from September 20, 2013.

X.8 Shri K. Venkatesan, Shri D. V. Salgaocar and Shri J. B. Patel ceased to be Members of Western Area Local Board with effect from January 27, 2014 and Dr Ram Nath ceased to be Member of the Northern Area Local Board with effect from February 18, 2014 in terms of the provisions of Section 9(3) of RBI Act, 1934.

Appointments

X.9 Shri R. Gandhi was appointed as Deputy Governor of the Bank with effect from April 3, 2014; and he assumed office on the same day.

X.10 Harun R. Khan has been re-appointed as Deputy Governor with effect from July 4, 2014 for a period of two years or until further orders, whichever is earlier.

X.11 Shri S.S. Mundra has been appointed as Deputy Governor of the Bank for three years from the date of his taking over, that is, July 31, 2014 or until further orders, whichever is earlier. He took charge of the office of Deputy Governor on the same day.

Retirements/Resignations

X.12 Shri Anand Sinha laid down office as Deputy Governor of the Reserve Bank on January 20, 2014 on expiry of his term.

X.13 Dr K.C. Chakrabarty demitted office of the Deputy Governor of the Reserve Bank on April 25, 2014.

X.14 Professor M.V. Rajeev Gowda ceased to be a member of the Southern Area Local Board of the Bank and also a Director of the Central Board consequent upon his election to the Rajya Sabha with effect from June 12, 2014 in terms of the provisions of Section 11(5) of the RBI Act, 1934.

Appointment/Retirement of Executives

X.15 Shri S. Karuppasamy, Executive Director, retired from service as at the close of business on January 31, 2014.

X.16 Shri G. Gopalakrishna, Executive Director voluntarily retired from the Reserve Bank on April 20, 2014.

X.17 Shri N.S. Vishwanathan, Shri U.S. Paliwal and Shri Chandan Sinha, PCGMs were promoted as Executive Directors with effect from April 25, 2014.

Visits of Foreign Dignitaries

X.18 During the year, 38 delegations from 20 countries visited the Bank. The delegations interacted with the top management on a wide spectrum of issues including reviews of the global economic scenario, framework for sustainable and balanced global growth, mutual trade and bilateral relations as well as the Bank's policy initiatives in different areas of its functioning. The list of the foreign dignitaries who visited the Reserve Bank during 2013-14 is given in Annex I.

INITIATIVES IN COMMUNICATION PROCESSES

X.19 Transparency, timeliness and credibility have been the mainstay of the Reserve Bank's communication strategy. A wide range of information in the form of notifications, press releases, data and speeches is disseminated through the Bank's website. In its effort to reach out to the maximum number of stakeholders, the Reserve Bank also uses available technology. Monetary policy communication, including the Governor's live statement and press conference, for instance, are now being disseminated through mobile phones along with live streaming of the announcements on monetary policy through television channels and webcasting.

X.20 During the year, the Reserve Bank issued over 2,500 press releases.The total size of the website increased to almost 75 GB. Feedback being an important part of the Reserve Bank's communication activity, 3 draft reports and 5 draft guidelines on regulatory as well as market related issues were released on the website for public comments.

Awareness campaigns held during the year

Non-Banking Finance Companies (NBFC) Depositors

X.21 The Reserve Bank undertook an awareness campaign for NBFC depositors after some fraudulent deposit schemes came to light during the year. The awareness programme involved publication of 'frequently asked questions' on the entire gamut of issues relating to NBFCs and a series of advertisements beginning September 2, 2013. As the next step, the Reserve Bank brought together on a public platform all the regulators of NBFCs in a town hall in Chandigarh to interact with customers of these companies. The objective of this initiative was to sensitise the regulators and the public about issues relating to NBFCs. The Reserve Bank also collaborated with the Ministry of Corporate Affairs and Department of Consumer Affairs for joint campaigns. Two rounds of advertisements were released in the same set of 217 newspapers published in 11 vernacular languages (apart from English and Hindi). The publicity campaign will be an on-going exercise.

Fictitious Offers

X.22 To spread awareness about fictitious offers, the Reserve Bank of India released two rounds of advertisements in English, Hindi and 11 regional language newspapers on an all-India basis (the first round covered 608 newspapers on April 9, 2013 and the second round covered 210 newspapers on June 19, 2013). This was done jointly with the Department of Consumer Affairs, in the Ministry of Consumer Affairs under its '*Jago Grahak Jago*' series. The Reserve Bank also issued notice warnings in May 2014 about the fake website in its name started by some unknown persons offering various banking facilities and asking members of

the public to apply online for opening 'RBI savings accounts'. To widen the reach of the awareness campaign on fictitious offers, audio spots of 30-seconds each on the fictitious offers were broadcast on 59 All India Radio (including *Vividh Bharti* Channels) and 145 private FM radio stations of 22 private FM channels.

Inflation Indexed Bonds

X.23 To create awareness about inflation indexed national savings securities-cumulative (IINSS-C), the Reserve Bank released one introductory advertisement and 3 follow-up advertisements during December 21-31, 2013 in 14 languages in 23 largest circulating newspapers and again in 46 newspapers in 13 languages including English and Hindi during March 2014. An awareness programme was carried on popular radio FM channels and in investors' conferences.

Self-assessment

X.24 Broadly, the Reserve Bank's communication on monetary policy was successful in sensitising financial market participants and in improving the acceptance of its monetary policy stance. However, some gaps were identified in communication during the period of financial market stress in H1 of 2013-14 while assessing its communication policies internally. The Reserve Bank intends to follow-up its internal assessment with an institutionalised process of assessing its communication policies.

Seminars

X.25 In order to enhance the reach of its publications, the Reserve Bank conducted 4 outreach seminars covering the 4 zones of the country during the year. The seminars were attended by students from colleges, universities and senior faculty members.

Educational Visits to the Reserve Bank

X.26 The Department of Communication has been organising educational visits to the Reserve Bank since 2006 as part of its financial literacy initiatives. Over the years the visits have been gaining popularity among colleges and management schools. Between July 2013 and June 2014, the Department conducted 40 such visits covering over 2,000 students. The participation was mainly from schools, colleges, non-governmental organisations (NGOs), senior citizens groups, women's group and also students from foreign universities.

Research and Endowment Schemes

X.27 Research publications of the Reserve Bank's staff *viz.*, the Reserve Bank Occasional Papers and the web-based Reserve Bank of India Working Paper Series (RBIWPS) continued as major platforms for disseminating in-house technical and analytical research on a wide array of macroeconomic and policy issues. In order to take the research initiatives forward, the Reserve Bank, in February 2014, allowed its staff to publish jointly authored papers with external researchers in the RBIWPS and Reserve Bank Occasional Papers, which were earlier restricted to Reserve Bank staff members only. Under RBIWPS, initiated in March 2011, 56 papers covering a wide range of issues had been uploaded till June 2014.

X.28 In addition to in-house research, the Reserve Bank encourages and promotes external research activities in academic and research institutions through endowment scheme including establishing RBI professorial chairs in universities/ research institutions, funding medium-term research projects/conferences/workshops/ seminars/publication of journals/scholarship scheme for faculty members from academic institutions and organising development research group (DRG) studies (collaborative). So far, 40 DRG studies have been published and 4 papers under scholarship schemes for faculty members from academic institutions have been completed.

X.29 The Reserve Bank of India under the *Programme Funding Scheme* has initiated the ISI-RBI (DSIM) Research Collaboration, wherein Indian Statistical Institute (ISI), Kolkata has agreed to work on four proposals for validation and improvement of various surveys undertaken by the Bank for a

period of one year. The Bank awarded the first fellowship in the series under the Prof. K.N. Raj Memorial National Fellowship Scheme, instituted in 2012 to Dr. Ravi Kanbur, Professor of Economics, Cornell University, USA for research on 'Informality: Causes, Consequences and Policy Responses'. The research paper was released by the Bank in June 2014.

HUMAN RESOURCE INITIATIVES

Initiatives towards training and skills enhancement

X.30 The Reserve Bank imparts necessary knowledge and skill upgradation to develop its human resources' technical and behavioural skills. The 6 training establishments of the Bank, *viz.*, Reserve Bank Staff College (RBSC), Chennai, College of Agricultural Banking (CAB), Pune and four Zonal Training Centres at Mumbai, New Delhi, Kolkata and Chennai cater to its internal training requirements (Table X.1).

Training at external institutions

X.31 The Reserve Bank deputed 798 officers during 2013-14 to training programmes, seminars and conferences organised by external management/banking institutions in India. It also deputed a number of Class III and Class IV employees for training in external institutions in India during the year. The Bank also deputed 530 officers abroad to attend various training courses, seminars, conferences and workshops conducted by banking and financial institutions and multilateral institutions (Table X.2).

Table X.1 : Reserve Bank Training Establishments-Programmes Conducted

Training Establish-ment	2011-12 (July-June)		2012-13 (July-June)		2013-14 (July-June)	
	No. of Pro-grammes	No. of Partici-pants	No. of Pro-grammes	No. of Partici-pants	No. of Pro-grammes	No. of Partici-pants
1	2	3	4	5	6	7
RBSC, Chennai	125	2,492	126	2,676	140	3,302*
CAB, Pune	190	5,647	164	5,105	168	5,149@
ZTCs (Class I)	116	2,098	116	2,526	116	2,559
ZTCs (Class III)	35	639	64	1,492	92	2,006
ZTCs (Class IV)	65	1,237	58	1,184	56	1,076

*: Includes 58 foreign participants.
@: Includes 48 foreign participants.

Table X.2: Number of Officers Trained in External Training Institutions in India and Abroad

Year	No. of officers trained in India (external institutions)	No. of officers trained abroad
1	2	3
2011-12	1,072	511
2012-13	874	510
2013-14	798	530

X.32 Seven officers of the Bank availed study leave under different schemes for pursuing higher studies during the year. Further, 442 employees pursued select part-time/distance education courses during 2013-14.

SAARC Finance Scholarship

X.33 Effective 2013, the Reserve Bank introduced a scholarship scheme for officials of central banks/ministries of finance of South Asian Association for Regional Cooperation (SAARC) member countries for pursuing higher studies in economics in identified universities/institutions in India. Under the scheme, the Bank selected 2 officials, one each from the Bangladesh and Maldives Monetary Authority, for pursuing Ph.D. in Economics and Masters in Economics respectively during 2014-15.

*South East Asian Central Banks (*SEACEN)

X.34 The Bank, which became a member of SEACEN in January 2013, actively participated in its research activities during the year and has deputed one officer as a 'Visiting Research Economist' to lead research studies in 'Building on the Counter Cyclical Buffer Consensus: Asian Empirical Test'.

Grants and Endowments

X.35 For supporting activities in the fields of research, training and consultancy for the banking and financial sector during 2013-14, the Reserve Bank provided financial support of ₹ 220 million to the Indira Gandhi Institute of Development Research (IGIDR), Mumbai; ₹ 60.5 million to the Centre for Advanced Financial Research and Learning (CAFRAL), Mumbai; ₹ 15.9 million to the National Institute of Bank Management (NIBM), Pune; ₹5.10 million to the Indian Institute of Bank Management (IIBM), Guwahati; and ₹ 10 million for setting up the London School of Economics (LSE) India observatory and the IG Patel Chair.

RBIQ

X.36 In 2013, RBIQ, an all-India inter-school quiz launched in 2012, was held at 42 different locations all over India with zonal and national finals in Mumbai, with almost 2,000 schools and 4,000 students participating in it. The telecast of the zonal and national finals on Doordarshan's national channel also gave substantial publicity to the event and the Bank's efforts in putting it together.

INITIATIVES IN ORGANISATION MANAGEMENT

X.37 Apart from skill enhancement of its existing staff, the Reserve Bank also undertook initiatives towards strengthening its organisational framework and acquiring new talent during the year.

Industrial Relations

X.38 For a healthy relationship between the management and workmen, the Reserve Bank held periodic meetings with recognised associations/ federations of officers and employees/workers during the year to discuss matters related to staff welfare and service conditions. The employee-management relationship remained healthy and peaceful during the year.

Right to Information (RTI) Act, 2005

X.39 The Reserve Bank received 7,041 requests for information and 1,130 first appeals under the RTI Act during the year, all of which were attended to. The Bank conducted 4 training programmes at its training centre for its staff on RTI Act.

Recruitments

X.40 During 2013 (January-December), the Reserve Bank recruited 574 employees. Of this, 92 belonged to Scheduled Castes (SCs) and 39 to Scheduled Tribes (STs) categories, constituting 22.8 per cent of the total recruitment (Table X.3).

Staff Strength

X.41 The Reserve Bank's total staff strength as on December 31, 2013 was 17,360 as compared to 17,714 as on end-December 2012. Of the total staff strength, 20.1 per cent belonged to Scheduled Castes and 7.0 per cent belonged to Scheduled Tribes (Table X.4).

X.42 During 2013 (January-December), the Reserve Bank's management and the representatives of the All India Reserve Bank Scheduled Castes/Scheduled Tribes and the Buddhist Federation met 4 times and discussed issues relating to the implementation of the reservation policy in the Reserve Bank. The representation of other backward classes (OBCs) (recruited after September 1993) in the Reserve Bank stood at 1,513 as on December 31, 2013. Of these, 429 were in Class I, 554 in Class III and 530 in Class IV. The total strength of ex-servicemen in

Table X.3: Recruitment by the Reserve Bank -2013*

Category of recruitment	Category-wise strength				
	Total	*of which*		Percentage	
		SC	ST	SC	ST
1	2	3	4	5	6
Class I	90	10	9	11.1	10.0
Class III	406	71	28	17.5	6.9
Class IV	78	11	2	14.1	2.6
a) Maintenance Attendant	16	2	0	12.5	0.0
b) Others	62	9	2	14.5	3.2
Total	**574**	**92**	**39**	**16.0**	**6.8**

*: January-December.

Table X.4: Staff Strength of the Reserve Bank

Category	Category-wise strength						Per cent to total strength	
	Total Strength		SC		ST		SC	ST
	Dec 31, 2012	Dec 31, 2013	Dec 31, 2012	Dec 31, 2013	Dec 31, 2012	Dec 31, 2013	Dec 31, 2013	Dec 31, 2013
1	2	3	4	5	6	7	8	9
Class I	8,132	7,864	1,154	1,133	563	499	14.4	6.3
Class III	3,716	3,916	603	586	395	252	15.0	6.4
Class IV	5,866	5,580	1,874	1,764	660	463	31.6	8.3
Total	**17,714**	**17,360**	**3,631**	**3,483**	**1,618**	**1,214**	**20.1**	**7.0**

Note: SC: Scheduled Castes. ST: Scheduled Tribes.

the Reserve Bank as of end-December 2013 stood at 923. Out of these 178 are in Class I, 145 in Class III and 600 in Class IV. The total number of physically handicapped employees in Class I, Class III and Class IV cadres in the Reserve Bank stood at 200, 92 and 99 respectively at end-December 2013.

X.43 The total staff strength as on June 29, 2014 was 17,334 as compared with 17,449 a year ago. The category-wise composition of the staff strength is given in Table X.5.

X.44 The office/location-wise distribution of staff strength indicates that the Reserve Bank's offices in Mumbai (including the central office departments) with 29.5 per cent of total staff strength continued to have the maximum number of staff members followed by Kolkata at 8.4 per cent, Chennai at 7.1 per cent and New Delhi at 6.5 per cent (Table X.6).

Comprehensive Human Resource System (CHRS) Project

X.45 The Reserve Bank has undertaken a project to carry out business process re-engineering (BPR) of prevailing human resource (HR) systems and implementing a comprehensive human resource system for it. A consultant has been engaged for the BPR exercise and also for providing end-to-end consultancy for implementing the project. The consultant has submitted a BPR report and suggested various changes in the existing HR processes. The Reserve Bank has formed an internal group to examine these suggestions. It has also been decided to set up a centralised processing centre to facilitate the processing of all HR related operations. A system integrator has been identified for the purpose. The project is likely

Table X.5: Category-wise Actual Staff Strength
(as on June 29, 2014)

Class	Actual Strength
1	2
Class I	
1. Senior Officers in Grade F	96
2. Senior Officers in Grade E	333
3. Senior Officers in Grade D	306
4. Officers in Grade C	1,097
5. Officers in Grade B	1,449
6. Officers in Grade A	4,466
7. Treasurer	3
8. Deputy Treasurer	2
9. Assistant Treasurer	0
10. Executive Interns	69
Total (A)	**7,801**
Class III	
1. Senior Assistant	262
2. Assistant	1,888
3. Secretarial Assistant	47
4. Word Processor Assistant	210
5. Special Assistant (Teller)	964
6. Class III (Others)	367
Total (B)	**3,738**
Class IV	
1. Maintenance Staff	1,545
2. Service Staff	3,357
3. Technical Staff	157
4. Other Staff	736
Total (C)	**5,795**
Total Strength in the Reserve Bank (A+B+C)	**17,334**

Table X.6 : Reserve Bank's Office-wise Staff Strength
(as on June 29, 2014)

Office (including sub-offices)	Class I	Class III	Class IV	Total
1	2	3	4	5
Agartala	5	3	0	**8**
Ahmedabad	300	177	233	**710**
Bangalore	452	163	233	**848**
Belapur	138	59	197	**394**
Bhopal	167	97	126	**390**
Bhubaneswar	157	94	184	**435**
Chandigarh	197	70	130	**397**
Chennai	487	339	399	**1,225**
Dehradun	22	5	2	**29**
Gangtok	7	0	0	**7**
Guwahati	210	134	202	**546**
Hyderabad	327	135	263	**725**
Jaipur	253	127	193	**573**
Jammu@	97	46	61	**204**
Kanpur	242	167	298	**707**
Kochi	37	37	27	**101**
Kolkata	537	428	498	**1,463**
Lucknow	178	77	127	**382**
Mumbai	650	354	1042	**2,046**
Nagpur	258	194	253	**705**
New Delhi	578	234	321	**1,133**
Panaji, Goa	18	2	3	**23**
Patna	192	108	218	**518**
Pune-CAB-CRDC-ITP	67	24	79	**170**
Raipur	18	4	0	**22**
Ranchi	15	7	0	**22**
Shillong	7	3	0	**10**
Shimla	12	3	0	**15**
Thiruvananthapuram	214	93	144	**451**
Total	**5,842**	**3,184**	**5,233**	**14,259**
CODs #	**1,959**	**554**	**562**	**3,075**
Grand Total	**7,801**	**3,738**	**5,795**	**17,334**

CAB : College of Agricultural Banking.
CRDC: Central Records and Documentation Centre.
ITP : IMF Training Programme, Pune.
@ : Includes Srinagar Sub-Office.
# : Central office departments including DICGC.

to be completed in 2014-15 in two phases; first phase will cover implementation of payroll and benefit administration from a centralised location and second phase will cover recruitment, talent management and training and development modules.

Code on Ethics & Governance

X.46 Integrity has been one of the core strengths of the Reserve Bank. Beginning November 2013, the Bank adopted an ethics code, titled 'ethics@ work'. This code, applicable to all employees at all levels in the Bank, seeks to explicitly inform both the new entrants and the serving staff members about the ethical standards expected of them.

Dealing with Sexual Harassment Complaints

X.47 The Reserve Bank had introduced a formal Grievance Redressal Mechanism in 1998 to deal with complaints of sexual harassment of women, in compliance with the Supreme Court Guidelines of August 13, 1997. These guidelines need to be revisited in conformity with the provisions of the Sexual Harassment of Women at Workplace (Prohibition, Prevention and Redressal) Act, 2013 and Sexual Harassment of Women at Workplace (Prohibition, Prevention and Redressal) Rules, 2013. The Bank is, therefore, in the process of preparing a new comprehensive set of guidelines for dealing with such complaints. These guidelines are proposed to be issued during 2014-15.

Rajbhasha

X.48 The Reserve Bank kept up its efforts towards promoting the use of Hindi in its working during 2013-14. Apart from meeting the statutory requirements of the Rajbhasha Policy, all statutory and other publications were published in bi-lingual form. The revised edition of the Banking English-Hindi Glossary was reprinted during the year in view of an increased demand for it.

X.49 The Bank organised a number of inter-bank and internal Hindi competitions as well as several Hindi functions during the year. The two days Rajbhasha Officers' Conference was held in May 2014 and a one-day Rajbhasha seminar on translation was held in October 2013 at Reserve Bank Staff College (RBSC), Chennai. An annual report covering the activities of the department was also published for the first time.

X.50 The Bank conducted intensive Hindi typing training programmes for staff members other than typists (including officers) during the year and 120 trainees successfully passed the Hindi typing examination conducted by the Government of India. Two special issues of '*Banking Chintan-Anuchintan'* a quarterly Hindi magazine on banking containing original Hindi articles, were published during the year. One special issue on *Grahak Seva* (October-December 2013) and the other to mark the completion of 25 years of the publication of the magazine were also released. This was in addition to the quarterly newsletter *Rajbhasha Samachar* and a Hindi booklet on noting titled *Tippan Margdarshika.*

X.51 The Parliamentary Committee on Official Language visited the Bank's central office on July 3, 2013 in order to inspect the progress made in the use of Hindi. The committee appreciated the overall performance of the Bank with regard to implementation of the Rajbhasha Policy and gave some suggestions to improve the use of Hindi.

Management of the Reserve Bank Premises

X.52 The Premises Department looks after the maintenance and upgradation of physical infrastructure of the Bank, with the department's major focus on strengthening the security system, undertaking environment friendly initiatives and improving its electrical infrastructure.

Improvements in physical security infrastructure

X.53 The Bank has started work on putting in place an integrated security system in the central office building in Mumbai. The existing closed circuit television (CCTV) systems will be replaced by an internet protocol (IP) based CCTV system in a phased manner in all offices within the next 2 years. In order to enhance the perimeter security in the Bank's central office premises, an access control card based turnstile system has been commissioned and a similar system will be installed in the other offices also. To provide enhanced security in the cash handling areas in the Bank's premises, a shooting bolt interlocking system is being implemented in all the offices after its successful completion in the Mumbai regional office. Installation of the radio frequency identification (RFID) system for vehicle entry in the Bank's premises has been taken up as a pilot project in the Bangalore office.

Green initiative

X.54 In order to conserve natural resources, to protect the environment and also to improve employee wellness and productivity, a green policy for the Bank has been formulated and has been placed before the Committee of the Central Board for approval.

X.55 In order to harness solar energy and for reducing carbon emissions, a pilot project of installing a grid interactive rooftop solar power plant (2x6.24 KWp) was undertaken for one of the Bank's office building in Mumbai. The plant was commissioned in July 2013. The power plant has generated 14,000 units of electricity amounting to a reduction of about 11,000 kg of CO_2. Subsequently, Chennai office has also commissioned a solar power plant of 10 KWp capacity. Such projects are being taken up for other offices in a phased manner.

Upgradation of electro-mechanical systems

X.56 In order to save energy and mitigate fire risks in offices, energy efficient centralised uninterruptible power supply (UPS) systems for the entire office have been commissioned in all the offices of the Bank.

X.57 In order to improve energy efficiency and ride quality, energy efficient variable voltage variable frequency (V3F) lifts have been installed in the Ahmedabad office and work is in progress in other offices at Thiruvananthapuram, Kochi, New Delhi and the Bank's colonies in Mumbai at Dhanastra, Malad, Gokuldham and Vasant Vihar.

The procurement process for replacing lifts in the Bhopal office is in progress. Work of installing an energy efficient central air-conditioning system at the Reserve Bank offices in Patna and Nagpur has been completed.

ENTERPRISE-WIDE RISK MANAGEMENT IN THE BANK

X.58 The Reserve Bank is exposed to a sizeable amount of risk in the course of performing its public policy functions. In order to strengthen its internal risk management systems, the Reserve Bank rolled out the ERM framework in 2012, which comprises of a 'risk governance structure'[1] as well as a 3-tier 'risk management structure' [2].This framework will enable the Bank to take a holistic view of the risks faced by it at an organisational level and to manage these risks in conformity with its risk policies and risk tolerance limits.

X.59 A combination of a top-down and a bottom-up approach is being pursued in implementing the ERM framework. As a part of the top-down approach, the top risks of the Reserve Bank have been identified and articulated. Further, ERM risk policies and methodologies are also being put in place to bring about uniformity in identifying and assessing risks across the Bank. As a part of the bottom-up approach, preparing risk registers for business areas has started.

X.60 During the year, the Risk Monitoring Department introduced a Risk Assessment Methodology for Operational Risk to enable the various business areas to assess and rate operational risks on a uniform basis and also to enable the preparation of heat maps. A Risk Glossary and a Risk Taxonomy were prepared to provide a common language for identifying and classifying risks across the Bank. Also, guidelines and computerised formats have been issued by the Risk Monitoring Department for preparing risk registers and also for strengthening risk-related MIS. An online incident reporting format has also been put in place for creating an institutional memory of incidents/near misses. Concomitantly, efforts have been made to strengthen the risk culture in the Bank. Towards this end, teams of risk officers have been appointed in all central office departments/regional offices with well defined roles and responsibilities. In order to ensure that the development of the risk management framework is in line with international best practices, the Reserve Bank joined the International Operational Risk Working Group (IORWG) in 2014. IORWG is a group of 57 central banks that provides a platform for sharing best practices and approaches in risk management in central banks.

X.61 With regard to financial risks, on the balance sheet of the Bank a sound counterparty risk management regime is in place; most exposures are backed by high quality collateral. Market risk is managed by portfolio optimisation techniques. In the case of the monetary/exchange rate policy operations, the Reserve Bank does not weigh the risks/costs of its policy actions while deciding upon the course of action, as balance sheet considerations remain subordinate to monetary and financial stability considerations. The Reserve Bank, nevertheless, does maintain an overarching view of risks faced by it to ensure that it has the financial resilience to absorb these risks. The Bank maintains

[1] The risk governance structure comprises of the Central Board at the apex level, supported by the Audit and Risk Management Sub-Committee of the Board (chaired by an Independent Director of the Bank) and the Risk Monitoring Committee which is a top-level executive committee headed by the Deputy Governor-in-charge of RMD.

[2] The risk management structure refers to the 3-tier structure comprising of the business area which is the first line of defence and is primarily responsible for managing its risks while the risk monitoring and the risk assurance (audit /inspection) functions represent the second and third lines of defence, respectively.

contingency reserve for meeting various risks including those arising from monetary/exchange rate policy operations.

X.62 Given the importance of the business continuity management (BCM) function, a dedicated BCM framework has been approved to strengthen the Reserve Bank's existing business continuity processes and the Bank is in the process of putting this in place. This framework will also provide it with the capability to recover and continue with its operations, following any disruptive event.

Internal audit/inspection in the Bank

X.63 In order to accomplish its objectives, the Bank adopts a systematic and disciplined approach to examining, evaluating and reporting on the adequacy and reliability of its risk management, internal controls and governance processes under a robust risk-based internal audit (RBIA) framework and provides regular feedback to the Audit and Risk Management Sub-Committee (ARMS) of its Central Board. Apart from assessment of risks in operations, the 'value for money' approach to audit built on the 3E principles of economy, efficiency and effectiveness has been adopted as a fundamental attribute of the RBIA methodology. The Inspection Department carried out audit/inspection of 16 regional offices (including branch offices), 9 Banking Ombudsman offices, 14 central office departments and one training establishment during the year. All financial operations of the Bank are covered under the concurrent audit system. The Bank's currency management functions and processes were evaluated end to end through a vertical audit process. As a part of the regular RBIA, information system (IS) audits were also conducted at all the offices (including 3 data centres) during the year.

X.64 The Bank also carries out vulnerability assessment-penetration testing (VA-PT) of its information technology systems, website and databases as a part of the RBIA framework. A compliance audit of VA-PT of the human resource management system and the public website of the College of Agricultural Banking was also carried out during the year. Considering the revamped IS architecture with enhanced security features, a system of self-assessment certification of IT applications/systems used by regional offices/ departments using internal resources has been introduced in five metro centres replacing the erstwhile continuous assurance audit arrangement.

X.65 The ARMS, which is mandated to assist the Central Board in its oversight function by reviewing and monitoring the inspection and audit process, held four meetings during the year at quarterly intervals and reviewed the internal audit function of the Bank and gave general directions.

Further initiatives planned to turn the Bank into an exemplary central bank

X.66 In 2013-14, the Bank continued to take initiatives to meet the challenges faced by a central bank operating in a continuously evolving financial and economic environment. The Bank has planned several further initiatives to turn itself into an exemplary central bank amongst the global bests. In this direction, it has taken internal initiatives to draw a blueprint for organisational restructuring to better serve the evolving financial sector which in turn can foster growth with stability in the country. As part of this, it is proposed to adopt a cluster approach by clubbing closely related work-areas. This will bring greater managerial synergies and also allow the staff to better develop their expertise in various key work-areas. The Bank is also focussing on assessing its human resources in relation to newer challenges being faced by the central bank by bringing about changes in HR policies to improve motivational levels and to align organisational resources with the evolving work content and policy orientation for greater efficiency. With a view to create a talent and leadership pipeline, the Reserve Bank plans to reorient its

training and capacity building policies and strengthen the training and development ecosystem in the ensuing year through a bouquet of training programmes focusing on cutting edge functional knowledge and skills and a broad set of behavioural competencies. With a view to effectively managing operational and financial risks and ensuring business continuity, the Bank is in the process of identifying key risks in various areas which will become the focus of its internal risk management strategies. The initiatives towards implementing the enterprise-wide risk management framework in this regard are in line with international best practices. The Bank also plans to bring out a vision statement to provide a clear exposition of its core purposes and values or shared principles which may guide organisational decisions and employee actions. Core purposes could include those related to macroeconomic and financial stability, while principles depicting organisational values could include public interest, integrity, independence of views, transparency and accountability, responsiveness, exploration and innovation, besides pursuit of excellence. The most fundamental change being advocated is in terms of instituting a governance framework for monetary policy decision making in the backdrop of contemplated revised monetary policy framework.

XI RESERVE BANK'S VISION AND AGENDA FOR 2014-15

The Reserve Bank intends to further improve the financial sector through a series of initiatives that rest on five pillars. Its work agenda includes working with the government to strengthen the monetary policy framework. To strengthen the banking structure, the Reserve Bank will put in place a system for licensing differentiated banks and move towards on-tap licensing of universal banks. Several complementary steps, like refining priority sector guidelines and KYC norms are also under consideration. The Reserve Bank will continue its efforts to broaden and deepen financial markets through an array of initiatives. Besides, ongoing efforts will reinforce the regulatory and supervisory regimes, with a view to reducing distress in financial and non-financial firms.

XI.1 In mid-2013-14, the Reserve Bank set itself a medium-term agenda of transforming the financial sector, to turn it into a stronger, deeper, more efficient and inclusive system. This agenda was built on five pillars. The approach encompasses: (i) strengthening the monetary policy framework; (ii) increasing diversity and competition in banking industry while improving governance in existing banks; (iii) broadening the choice of financial instruments, and deepening and enhancing liquidity in financial markets; (iv) improving access to finance; and (v) reinforcing the financial system's ability to cope with stress.

Towards improving Monetary Policy Framework and Transmission

Disinflation Path and Implementation of a New Monetary Policy Framework

XI.2 As explained in Chapter I, high and persistent inflation has become a key risk to the growth outlook and to overall macroeconomic stability. The Reserve Bank has set out a disinflation path, with the goal of containing consumer price index CPI inflation to 8 per cent by January 2015 and 6 per cent by January 2016. The outlook segment of Chapter I spells out the Reserve Bank's approach to strengthening the monetary policy framework and addressing impediments to the transmission of monetary policy. It intends to take this approach forward in coordination with the government, recognising the government's efforts to augment supply capacity, as well as the Reserve Bank's traditional focus on managing aggregate demand. Both the supply and demand side approaches are necessary for lowering inflation. As such, monetary, fiscal and structural policies have to play complementary roles in containing inflation. The Union Budget for 2014-15, by stressing adherence to the fiscal consolidation path and providing direction for addressing supply constraints, will help the Reserve Bank follow the disinflationary path laid out in the January 2014 Monetary Policy Statement, viz., containing CPI inflation to 8 per cent by the beginning of 2015 and 6 per cent by the beginning of 2016.

XI.3 The Finance Minister's 2014-15 budget speech indicated the government's commitment to putting in place a modern monetary policy framework in consultation with the Reserve Bank. Implementation of the proposed new monetary policy framework could go a long way in building monetary policy credibility and anchoring inflation expectations.

Improving forecasting and analytical capabilities through state-of-the-art modelling exercises

XI.4 The forecasting and analytical abilities of a central bank are essential to understand inflation and growth dynamics, as also transmission of monetary policy. Recognising this, the Reserve

Bank has an agenda to develop an array of models that can serve as a useful support for monetary and macroeconomic policy formulation and analysis. Like many other central banks, the attempt will be to develop such models through dedicated technical teams over the medium-term.

Efforts to strengthen the banking structure

Towards a more competitive, efficient and heterogeneous banking structure

XI.5 A heterogeneous banking system can meet varied customer needs in a more efficient manner. It can offer a wider range of customer services that can enhance consumer welfare as different banks can operate differently based on their reach, liquidity, capitalisation and market power considerations. Overall, the banking system can become more competitive and efficient as it becomes more varied.

XI.6 The first Bi-monthly Monetary Policy Statement for 2014-15 dated April 1, 2014 stated that the Reserve Bank will start working on the framework for differentiated bank licences and on-tap universal licenses, building on the discussion paper on "Banking Structure in India - The Way Forward" and using the learning from the recent licensing process. This was also reaffirmed in the Union Budget 2014-15. Differentiated banks serving niche interests are contemplated to meet credit and remittance needs of small businesses, the unorganised sector, low income households, farmers and migrant workers.

XI.7 Accordingly, the Reserve Bank in mid-July 2014 issued separate draft guidelines for licensing of Small Banks and Payment Banks. After obtaining comments and suggestions from the stakeholders, the final guidelines are expected to be issued later in the year.

Basel III Leverage Ratio Framework

XI.8 The experience drawn from the global financial crisis suggests that the build-up of excessive on-balance sheet, as well as off-balance sheet leverage in the banking system was at the core of the financial fragilities those were witnessed. In this context, based on recent recommendations by the Basel Committee on Banking Supervision (BCBS), the Reserve Bank will issue revised guidelines on the leverage ratio. Any final adjustments to the Basel III leverage ratio will be carried out by 2017, with a view to migrating to a Pillar 1 treatment of advanced minimum capital and liquidity requirements on January 1, 2018. In addition to the framework for leverage ratio, the Reserve Bank is also finalising a framework for counter-cyclical capital buffers taking into account BCBS's recommendations on the same.

Review of the exposure limits for single/group borrowers

XI.9 In order to contain the maximum loss a bank could face in the event of a sudden failure of a counterparty or a group of connected counterparties and retain its solvency, the Reserve Bank has put in place single and group borrower exposure limits. BCBS revised its standards on large exposures in April 2014, under which the exposure limits for 'single' and 'group of counterparties' were kept at 25 per cent of Tier I capital. Our current exposure limits to a group of borrowers is much higher at 40 per cent of capital funds (plus 10 per cent for infrastructure finance). It is proposed to review the exposure norms in 2014-15, to gradually align them with the revised global standards. The tightening of exposure norms will also help in risk mitigation during cyclical downturns as banks exposure under the framework will be more granular and diversified to a large number of unrelated counterparties rather than being concentrated to a handful of large and related counterparties.

Improving the soundness of non-bank financial intermediaries

XI.10 While banks are unique in financial system as they provide checkable deposit facilities and have credit creation capacity, non-bank financial

companies (NBFCs) occupy a vital position in the financial system by providing niche services at low intermediation costs. The Reserve Bank is at present engaged in reviewing the extant regulatory framework for NBFCs, keeping in view the developments in the sector, the recommendations made by various committees and suggestions made by Financial Sector Legislative Reforms Commission (FSLRC). Certain changes are being envisaged with a view to appropriately aligning regulation of similar activities by different financial intermediaries. Consequently, some of the areas being reviewed include prudential regulations with a view to strengthening core capital, asset classification and provisioning norms, acceptance of deposits, corporate governance, consumer protection and enhanced reporting, disclosures and transparency for the sector. In addition, the Reserve Bank is engaged in taking suitable steps to strengthen the supervisory framework.

XI.11 Other measures that are envisaged include examining the avenues available for resource raising by NBFCs with a view to enhancing availability of funding for the sector. The issue of raising of debentures through private placements will be relooked at in view of the revised regulations on private placements under the Companies Act 2013. The Reserve Bank also proposes to carry forward the work of the G-20 and Financial Stability Board (FSB) on shadow banking so as to identify possible areas of interconnectedness and entities that can pose risks to the formal financial sector.

XI.12 In the wake of recent revelations of unauthorised acceptance of deposits by some companies, the Reserve Bank is intensifying its publicity and customer awareness initiatives to educate the public on and the necessity of exercising appropriate diligence before depositing money with any entity. The State Level Coordination Committees (SLCCs) are being strengthened to allow for greater sharing of information between financial sector regulators and state governments and for facilitating coordinated action against recalcitrant entities. Further, steps are underway to strengthen the market intelligence function which is of particular significance for effective supervision of this sector.

Fortifying the supervisory framework for urban cooperative banks

XI.13 Urban cooperative banks (UCBs) were brought under the Supervisory Action Framework (SAF) with effect from March 1, 2012. The framework envisages pre-emptive action if the key financial indicators of a UCB deteriorate. It is proposed to strengthen SAF to identify problems and initiate corrective action at an early stage.

XI.14 The guidelines for mergers/amalgamations of UCBs that were framed during 2005-10 to facilitate consolidation and emergence of strong entities and for providing an avenue for non-disruptive exit of weak/unviable entities in the co-operative banking sector will also be reviewed. Efforts will be made to put in place a mechanism to facilitate mergers/takeovers of assets and liabilities of negative net worth banks without the acquiring bank having to bear the burden of the loss. At present, conversion of a UCB into a commercial bank is not permitted. The Reserve Bank plans to engage with the Government of India for enabling legal changes to help large and willing multi-state urban cooperative banks to convert themselves into commercial banks.

Improving stress testing

XI.15 Over the next few years, the Reserve Bank will make efforts to further improve its tools for stress testing of banks by including a wider array of indicators. The Reserve Bank has over the last three years developed considerable capacity and a well-established stress testing framework, but this could be refined further especially in a multi-factor setting. The Reserve Bank has been disseminating

its stress results through its Financial Stability Report (FSR) that is published twice a year - June and December. The Reserve Bank also publishes its statutory Report on Trends and Progress of Banking in India. Henceforth, it intends to bring the latter as part of the December FSR for better synergy in publications.

Making financial markets deeper, wider and more liquid

XI.16 Deeper, wider, more liquid and efficient financial markets provide support to growth. To make this process more efficient and transparent, the Reserve Bank plans to undertake reforms in financial markets, set up an over the counter (OTC) derivatives trade repository and take several other steps in support of the debt management strategy.

Reforms in financial benchmarks

XI.17 In line with the recommendations of the Committee on Financial Benchmarks (Chairman: P. Vijaya Bhaskar), the Reserve Bank has advised Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Foreign Exchange Dealers' Association of India (FEDAI) to jointly set up an independent body for administrating major Rupee interest rate and foreign exchange benchmarks. The objective is to overcome the conflicts of interest in the benchmark setting process arising out of their current governance structure. The proposed independent body will implement the recommendations of the Committee on Financial Benchmarks and will ensure compliance with the International Organisation of Securities Commission (IOSCO) Principles on Financial Benchmarks. The benchmarks submission activities of the banks and primary dealers (PDs), including their governance arrangements for submissions, will be brought under the Reserve Bank's on-site and off-site supervision system.

OTC derivatives trade repository

XI.18 An appropriate public dissemination system will be instituted at Clearing Corporation of India Ltd. (CCIL) for disclosing the price and volume information relating to major inter-bank OTC foreign exchange (FX) derivatives, such as FX forwards and options, reported to the trade repository. This will help promote greater transparency and reduce information asymmetry.

Development of debt markets

XI.19 With a ₹6 trillion market-borrowing programme, sovereign debt markets assume a vital role in the conduct of fiscal policies and have spillover effects, including that on interest rates and the exchange rate. The Reserve Bank plans to articulate a comprehensive Debt Management Strategy with sound international practice, extending maturities to cater to the requirements of diverse investors, undertaking consolidation of public debt and reducing rollover risk through active switch / buyback operations.

XI.20 Improving the liquidity of the G-sec markets also remains a priority. In this context, a review of the guidelines for short sale and repo/reverse repo in G-secs is planned with a view to introducing limited re-repo/re-hypothecation of "repoed" government securities. Possible ways to revitalise market-making by PDs will also be examined. Introduction of the swap execution facility with central counterparty (CCP) in the interest rate swap (IRS) market will be a focus area during 2014-15. Upgradation of the NDS order-matching (NDS-OM) platform would be initiated with the objective of having faster throughput, enhanced functionalities, rich user interface and internationally compatible message formats. The feasibility of international settlements for Indian sovereign debt securities will also be examined.

Rationalisation of foreign exchange management

XI.21 Even though the current account deficit (CAD) has improved since Q2 of 2013-14, the need for robust capital flows in a capital deficit economy

like India assumes importance to bridge the saving-investment gap. Against this backdrop, foreign exchange management will evolve keeping in view long-term objectives as well short-term developments in the external sector.

XI.22 The specific areas that will engage the Reserve Bank's attention include: (i) simplifying the foreign investment regime to ensure that it is user-friendly to all stakeholders; (ii) reviewing the scope of external commercial borrowings; and (iii) reviewing the foreign exchange derivative market to enhance its width and depth. With this in view, the proximate objective is to consolidate and rationalise extant regulations so as to provide a simple, comprehensive and transparent regime. The Reserve Bank's action plan includes a review of the borrowing regime for the infrastructure sector. A framework for multilateral agencies as well as Indian infrastructure financing companies to access the international market through rupee denominated bonds will also be explored.

XI.23 The foreign exchange market needs more products to help participants manage their foreign exchange risk. Non-residents, can also be granted greater access thereby taking the process of capital account liberalisation further. Foreign portfolio investors (FPIs) have now been granted access to the domestic exchange traded derivative markets. Further rationalisation of the procedure would be considered based on experience. Over the medium term, extending access to the OTC market to international stakeholders could also be considered. Besides, options market could be expanded over the coming years to allow market participants hedge more easily and cheaply.

Improving access to finance and protecting consumer interests

Improving access to finance

XI.24 Over the past several years, the Reserve Bank's efforts to improve access to finance for poor people and small enterprises have yielded positive results . Yet, in view of the sheer enormity of the task, these efforts have to go much further. Efforts will be made to use innovative products, technology, telecom infrastructure and the biometric data base of the government to onboard customers and improve accessibility to bridge the gap between performance and potential. The 'Know Your Customer' (KYC) guidelines will be re-examined with a view to making banking more friendly, while at the same time ensuring that it does not weaken anti-money laundering requirements. Priority sector guidelines have not kept pace with changing economic priorities and may lead to less efficient use of resources. During the course of the year, priority sector guidelines will be reviewed.

XI.25 In order to continue with the process of ensuring further penetration of banking services to the financially excluded people, banks were advised in January 2013 to draw up fresh 3-year financial inclusion plans (FIPs) for the period 2013-16. The focus under the new plan was to ensure increase in the volume of transactions, especially in Business Correspondents-Information and Communication Technology (BC-ICT) accounts, by increasing the flow of credit to small value customers, as greater use of technology is key to lowering transaction costs and making financial inclusion a viable proposition.

XI.26 Financial inclusion efforts will be supported by initiatives in the area of payment systems. Efforts will be made to provide a fillip to mobile banking in the country so as to leverage the potential of the high mobile density that exists in the country. Necessary groundwork will be undertaken to put in place standards for customer on-boarding, security of transactions and redressal of customer grievances, besides engaging with stakeholders to explore the feasibility of having a standardised application for mobile banking across banks.

XI.27 The empowered committees on micro, small and medium enterprises (MSMEs) set up at the

Reserve Bank's regional offices will be asked to more closely monitor and review the progress of restructuring / rehabilitation of sick MSE units to help in early detection of sickness in MSE units and their timely revival. Further, in order to provide quick and efficient financing options for the MSME segment, it is proposed to set up an electronic Trade Receivables Discounting System (TReDS). This system will bring together the MSMEs, their corporate buyers as well as financiers and reduce the constraints faced by the MSME segment in liquidity management.

Use of technology and payment systems to facilitate finance

XI.28 The actionable agenda for 2014-15 for payment and settlement systems will include putting in place the guidelines and operational parameters for a pan-India bill payment system which will facilitate anytime, anywhere system of making bill payments. Also, the consolidation of payment systems which offer similar services or cater to the needs of same market segments (for instance, electronic clearing service (ECS) and National Automated Clearing House (NACH) will be taken up.

Plan to frame comprehensive consumer protection regulations

XI.29 Regulation of any industry is guided by considerations of lowering risks, encouraging competition and adoption of fair practices to protect the interest of producers as well as consumers. The vulnerability of consumers, particularly retail consumers of services provided by financial intermediaries, including banks, is well recognised. Therefore, there is a pressing need for the creation of a unified consumer protection framework which will apply to all segments of the financial system. During 2014-15, the Reserve Bank proposes to frame comprehensive consumer protection regulations based on domestic experience and global best practices. A Charter of Customer Rights in collaboration with various stakeholders in the banking sector will be formulated. The charter is expected to act in future as a comprehensive financial consumer code which will better protect consumers of financial products and ensure that they have the necessary information available to make responsible financial decisions.

Planned initiatives on currency management

XI.30 The Reserve Bank is planning several initiatives with a view to improving currency management and providing better services for the common man. It is expected to launch the field trial of plastic notes by next year. The Reserve Bank is also looking at other alternatives for improving the life of banknotes. In view of the continuous increase in the number of notes in circulation, the Reserve Bank will harness technological advancements in the areas of storage, transport and distribution as also to set up a fully automated cash processing centre as a pilot project. It also proposes to introduce new series banknotes in order to take advantages of the latest innovations in the currency note printing technology and to stay ahead of counterfeiters, as also redesign coins to make them user friendly and long lasting. The Reserve Bank is also bringing about improvements in packing currency notes so as to make handling more labour friendly.

Improving the financial system's ability to cope with distress

XI.31 It is important to improve the financial system's ability to cope with stress and distress by not only providing for counter-cyclical buffers, but also by directly dealing with stress through effective resolution regimes. The Reserve Bank in 2013-14 has taken several initiatives in this regard and plans to carry the agenda forward by strengthening the corporate debt restructuring mechanism, credit information and the resolution regime.

XI.32 The Working Group on Resolution Regime for Financial Institutions (WGRRFI) after taking into consideration the key attributes for Effective Resolution Regimes advocated by the FSB submitted its report in January 2014. It assessed the need of a resolution regime for all financial institutions and financial market infrastructure (FMI) other than those owned and operated by the Reserve Bank of India, with an eye on overall financial stability. In coordination with FSDC, the Reserve Bank intends to take the process forward by seeking necessary legal and institutional changes and by creating of a resolution fund.

Research initiatives by the Bank

XI.33 A successful policy agenda and its implementation, broadly encompassing the five pillars mentioned earlier, needs research support. Accordingly, a research agenda has been drawn in the Reserve Bank. In the area of monetary policy, studies will cover aspects of desirable monetary frameworks and monetary transmission. In the area of banking the studies will cover the problem of deterioration in asset quality, capital raising for banks in the context of Basel III and systemically important banks. On access to finance, the credit portfolio of Indian banks will be analysed to understand the reach of finance to small borrowers. In the domain of corporate distress the reasons behind the rise in NPAs and impact of exchange rate volatility on corporate balance sheets will be explored. Other studies that are contemplated relate to the external sector, fiscal policy, financial integration, investment cycles and wealth effects.

XI.34 The research staff of the Reserve Bank has also explored possibilities for research collaboration with the in-house experts and visiting academics at the Centre for Advanced Financial Research and Learning (CAFRAL). Of particular interest are the subjects related to financial markets and exchange rates.

XI.35 The Reserve Bank is also planning to revamp the statistical data and information management system, with an emphasis on single point data collection, processing and dissemination. The objective is to improve data governance practices not only in the Reserve Bank but the banking sector as a whole. This will involve rationalisation and harmonisation of data across various returns, and data submission through XBRL (eXtensible Business Reporting Language) without manual intervention. For data sharing within and outside the Reserve Bank, a more structured data dissemination policy is envisaged. These initiatives in the areas of research and statistics are expected to improve analytical assessment in support of policy and operations in the Reserve Bank.

XII THE RESERVE BANK'S ACCOUNTS FOR 2013-14

The balance sheet size of the Reserve Bank increased by about 10 per cent during the year ending June 30, 2014. This was mainly due to the expansion of the foreign currency assets, which increased by about 15 per cent. Gross income of ₹646.17 billion for the year 2013-14 registered a fall of 13.10 per cent over 2012-13, while total expenditure fell by 4.9 per cent from ₹125.49 billion to ₹119.34 billion. The year ended with an overall surplus of ₹526.79 billion, representing a decrease of 14.75 per cent over the previous year. The entire surplus was transferred to the government, making it the largest ever transfer by the Reserve Bank.

XII.1 The balance sheet of the Reserve Bank is largely a reflection of the activities that is carried out in pursuing its currency issue function and its monetary and reserve management policy objectives. In recognition of the need for greater comparability and transparency, the Reserve Bank has been progressively moving towards greater disclosures in its financial statements. Accordingly, the key financial results of the Reserve Bank's operations during 2013-14 along with the supporting notes to the accounts and statement of significant accounting policies are set out in the following paragraphs.

XII.2 The year 2013-14 witnessed an overall increase in the size of the balance sheet by ₹2,337 billion, *i.e.*, 9.8 per cent from ₹23,907 billion as on June 30, 2013 to ₹26,244 billion as on June 30, 2014. The increase in the asset side was mainly due to increase in foreign currency assets (FCA), impact of depreciation of the US dollar against other major currencies in which the Reserve Bank's FCA are held and depreciation of the rupee against the US dollar adjusted for fall in the value of gold reserves on the asset side. The increase in the liabilities side was mainly due to a rise in currency in circulation and accretion to the Currency and Gold Revaluation Account (CGRA). At the close of the year, the domestic assets constituted 33.0 per cent of total assets while the foreign assets constituted the remaining 67.0 per cent as against 36.2 per cent and 63.8 per cent, respectively as on June 30, 2013.

XII.3 A Technical Committee constituted in 2012-13 to review the form of presentation of the Balance Sheet and Profit & Loss Account [Chairman: Shri Y. H. Malegam (Technical Committee I)] observed that the existing policies relating to reserves, provisioning and accounting norms needed to be examined in detail. As a follow up, another Technical Committee [Chairman: Shri Y. H. Malegam (Technical Committee II)] was constituted during 2013-14 to review the level and adequacy of internal reserves and surplus distribution policy of the Reserve Bank of India. Based on the detailed studies, the Technical Committee II recommended that since the balances in the Contingency Reserve (CR) and the Asset Development Reserve (ADR) are currently in excess of the buffers needed, there was no need to make any further transfers to CR and ADR. Accordingly, no transfers have been made to CR and ADR this year, and the entire surplus of ₹526.79 billion was transferred to the Central Government making it the largest ever surplus transfer by the Reserve Bank. The Technical Committee-I had made several recommendations relating to the format and contents of the Balance Sheet and Profit & Loss Account of the Reserve Bank. These recommendations covered the manner of reporting of items in the balance sheet, generation of a single balance sheet for Issue and Banking Departments, depiction of each balance sheet head in a single line supported by detailed schedules (instead of the present practice of reporting only some items

with detailed breakups in the balance sheet while explaining composition of other items in the accounts chapter), reclassification and grouping of certain items with a view to having better presentation of all material items in the financial statements. The Board of the Bank has accepted these recommendations for implementation in the year 2014-15. The merger of the Balance Sheets is dependent on the notification by the Central Government; this will be taken forward with the Central Government. Amendments to the format of the Profit & Loss Account would entail amendments to Regulation 22 of the Reserve Bank of India General Regulations, 1949; hence these would be implemented in the year 2014-15 after the revised Balance Sheet format is notified by the Central Government and the revised regulations are approved by the Central Board and notified by the Central Government.

XII.4 The major recommendations of the Technical Committee II include (a) changes in the method of revaluation of the rupee securities from the Lower of Book and Market Value (LOBOM) to fair valuation and (b) accounting for foreign exchange forward contracts. The recommendations also elucidate the various risks and the buffers required to take care of the risks arising out of future appreciation in the exchange value of the rupee, future depreciation in the market price of gold and market value of investments in foreign securities, operational & systemic risks, buffers required for further capital expenditure and investment in subsidiaries & associated enterprises. The recommendations also outline the approach to be followed for transfer of surplus to the Government.

XII.5 The Balance Sheet and the Profit and Loss Account for the year 2013-14 are as under.

RESERVE BANK OF INDIA
BALANCE SHEET AS AT 30th JUNE 2014
ISSUE DEPARTMENT

(₹ thousands)

2012-13	LIABILITIES	2013-14	2012-13	ASSETS	2013-14
	Notes held in the			**Gold Coin and Bullion:**	
80,169	**Banking Department**	**110,271**	674,316,432	(a) Held in India	**649,775,377**
12016,157,427	**Notes in Circulation**	**13445,160,518**	–	(b) Held outside India	**–**
			11329,100,584	**Foreign Securities**	**12783,310,039**
12016,237,596	**Total Notes Issued**	**13445,270,789**	12003,417,016	**Total**	**13433,085,416**
			2,356,280	**Rupee Coin**	**1,721,073**
			10,464,300	**Government of India Rupee Securities**	**10,464,300**
			–	**Internal Bills of Exchange and other Commercial Paper**	**–**
12016,237,596	**Total Liabilities**	**13445,270,789**	12016,237,596	**Total Assets**	**13445,270,789**

BANKING DEPARTMENT

(₹ thousands)

2012-13	LIABILITIES	2013-14	2012-13	ASSETS	2013-14
50,000	**Capital paid-up**	**50,000**	80,169	**Notes**	**110,271**
65,000,000	**Reserve Fund**	**65,000,000**	296	**Rupee Coin**	**209**
220,000	**National Industrial Credit (Long Term Operations) Fund**	**230,000**	63	**Small Coin**	**73**
1,960,000	**National Housing Credit (Long Term Operations) Fund**	**1,970,000**		**Bills Purchased and Discounted :**	
			-	(a) Internal	**-**
			-	(b) External	**-**
			-	(c) Government Treasury Bills	**-**
	Deposits				
	(a) Government		3395,014,738	**Balances Held Abroad**	**3726,756,685**
1,002,895	(i) Central Government	**1,000,207**			
424,847	(ii) State Governments	**424,661**			
	(b) Banks		7276,101,007	**Investments**	**7767,331,027**
3391,427,816	(i) Scheduled Commercial Banks	**3469,155,998**			
32,038,844	(ii) Scheduled State Co-operative Banks	**37,292,739**		**Loans and Advances to :**	
55,210,206	(iii) Other Scheduled Co-operative Banks	**63,307,042**	146,610,000	(i) Central Government	**-**
2,241,459	(iv) Non-Scheduled State Co-operative Banks	**4,807,554**	21,449,487	(ii) State Governments	**6,656,600**
90,595,353	(v) Other Banks	**102,670,889**		**Loans and Advances to:**	
165,973,592	**(c) Others**	**213,885,518**	187,170,300	(i) Scheduled Commercial Banks	**294,173,000**
			–	(ii) Scheduled State Co-operative Banks	**-**
			1,650,000	(iii) Other Scheduled Co-operative Banks	**1,337,500**
1,873,179	**Bills Payable**	**373,489**	–	(iv) Non-Scheduled State Co-operative Banks	**-**
			–	(v) NABARD	**-**
			8,236,648	(vi) Others	**68,662,500**
				Loans, Advances and Investments from National Industrial Credit (Long Term Operations) Fund:	
				(a) Loans and Advances to:	
			–	(i) Industrial Development Bank of India	**–**
			–	(ii) Export Import Bank of India	**–**
8082,855,793	**Other Liabilities**	**8838,232,625**	–	(iii) Industrial Investment Bank of India Ltd.	**–**
			–	(iv) Others	**–**
				(b) Investments in bonds/ debentures issued by:	
			–	(i) Industrial Development Bank of India	**–**
			–	(ii) Export Import Bank of India	**–**
			–	(iii) Industrial Investment Bank of India Ltd.	**–**
			–	(iv) Others	**–**
				Loans, Advances and Investments from National Housing Credit (Long Term Operations) Fund:	
			–	(a) Loans and Advances to National Housing Bank	**–**
			–	(b) Investments in bonds/debentures issued by National Housing Bank	**–**
			854,561,276	**Other Assets**	**933,372,857**
11890,873,984	**Total Liabilities**	**12798,400,722**	11890,873,984	**Total Assets**	**12798,400,722**

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30th JUNE 2014

(₹ thousands)

2012-13	INCOME		2013-14
455,635,749	**Interest, Discount, Exchange, Commission,** *etc.*		**646,169,713**
455,635,749	**Total**		**646,169,713**
	EXPENDITURE		
25,725	**Interest**		**35,690**
58,595,877	**Establishment**		**43,244,344**
30,613	**Directors' and Local Board Members' Fees and Expenses**		**30,963**
640,702	**Remittance of Treasure**		**712,554**
28,066,536	**Agency Charges**		**33,254,472**
28,724,406	**Security Printing (Cheques, Note forms,** *etc.***)**		**32,135,816**
228,203	**Printing and Stationery**		**209,279**
818,627	**Postage and Telecommunication Charges**		**839,866**
1,503,660	**Rent, Taxes, Insurance, Lighting,** *etc.*		**1,223,092**
30,139	**Auditors' Fees and Expenses**		**24,221**
36,316	**Law Charges**		**45,594**
2,390,152	**Depreciation and Repairs to Bank's Property**		**2,658,472**
4,404,794	**Miscellaneous Expenses**		**4,924,898**
125,495,750	**Total**		**119,339,261**
330,140,000	**Available Balance**		**526,830,452**
	Less: Contribution to:		
	National Industrial Credit (Long Term Operations) Fund	10,000	
	National Rural Credit (Long Term Operations) Fund[1]	10,000	
	National Rural Credit (Stabilisation) Fund[1]	10,000	
	National Housing Credit (Long Term Operations) Fund	10,000	
40,000			**40,000**
330,100,000	**Surplus payable to the Central Government**		**526,790,452**

1. These funds are maintained by the National Bank for Agriculture and Rural Development (NABARD).

S. Ganesh Kumar	**S. S. Mundra**	**R. Gandhi**	**Urjit R. Patel**	**Harun R. Khan**	**Raghuram G. Rajan**
Chief General Manager	Deputy Governor	Deputy Governor	Deputy Governor	Deputy Governor	Governor

INDEPENDENT AUDITORS' REPORT

TO THE PRESIDENT OF INDIA

Report on the Financial Statements

We, the undersigned Auditors of the Reserve Bank of India (hereinafter referred to as the "Bank"), do hereby report to the Central Government upon the Balance Sheet of the Bank as at June 30, 2014 and the Profit & Loss Account for the year ended on that date (hereinafter referred to as "financial statements"), which have been audited by us.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and correct view of the state of affairs and results of operations of the Bank in accordance with the requirements of the provisions of the Reserve Bank of India Act, 1934 and Regulations framed thereunder and the accounting policies and practices consistently followed by the Bank. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and correct view and are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the Bank's preparation and correct presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to explanations given to us and as shown by the books of account of the Bank, the Balance Sheet read with Significant Accounting Policies is a full and fair Balance Sheet containing all necessary particulars and is properly drawn up in accordance with the requirements of the provisions of the Reserve Bank of India Act, 1934 and Regulations framed there under so as to exhibit true and correct view of the state of affairs of the Bank

Other Matters

We report that we have called for information and explanation from the Bank which was necessary for the purpose of our audit and such information and explanation have been given to our satisfaction.

We also report that the financial statements include the accounts of eighteen Accounting Units of the Bank which have been audited by Statutory Branch Auditors and we have relied on their report in this regard.

For Haribhakti & Co., LLP
Chartered Accountants
(ICAI Firm Registration No. 103523W)

Dilip B. Desai
Partner
Membership No.300-53078

For CNK & Associates, LLP
Chartered Accountants
(ICAI Firm Registration No. 101961W)

Gautam Nayak
Partner
Membership No. 38127

Place: New Delhi

Date: August 10, 2014

STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES FOR THE YEAR ENDED JUNE 30, 2014

1. General

1.1 The Reserve Bank of India was established under the Reserve Bank of India Act, 1934 (the Act) “to regulate the issues of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage”.

1.2 The main functions of the Bank are:-

a) Issue of Bank notes.

b) Management of the monetary system.

c) Regulation and supervision of banks and Non –Banking Finance Companies (NBFCs).

d) Acting as a lender of the last resort.

e) Regulation and supervision of the Payment and Settlement Systems.

f) Maintaining and managing the country’s foreign exchange reserves.

g) Acting as a banker to the banks and the Governments.

h) Acting as the manager of the debt of the Governments.

i) Regulation and development of foreign exchange market.

j) Developmental functions including in the areas of rural credit and financial inclusion.

The Act requires that the issue of Bank notes should be conducted by the Bank in an Issue Department which shall be separate and kept wholly distinct from the Banking Department and the assets of the Issue Department shall not be subject to any liability other than the liabilities of the Issue Department. The Act requires that the assets of the Issue Department shall consist of gold coins, gold bullions, foreign securities, rupee coins and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department. The Act requires that the liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Government of India and Bank notes for the time being in circulation.

2. Significant Accounting Policies

I. Convention

The financial statements are prepared in accordance with the Reserve Bank of India Act, 1934 and the notifications issued thereunder and in the form prescribed by the Reserve Bank of India General Regulations, 1949 and are based on historical cost except where it is modified to reflect revaluation.

The accounting practices and policies followed in the financial statements are consistent with those followed in the previous year unless otherwise stated.

II. Revenue Recognition

Income and expenditure are recognised on accrual basis except dividend, which is accounted for on receipt basis and penal interest that is accounted for only when there is certainty of realisation. Only realised gains are recognised.

Balances unclaimed and outstanding for more than three clear consecutive years in certain transit accounts including Drafts Payable Account, Payment Orders Account, Sundry Deposits Account, Remittance Clearance Account and Earnest Money Deposit Account are reviewed and written back to income. Claims in this respect are considered and charged against income in the year of payment.

Income and expenditure in foreign currency are recorded at the exchange rates prevailing on the last business day of the week/month/ year as applicable.

III. Gold & Foreign Currency Assets and Liabilities

Transactions in gold and foreign currency assets and liabilities are accounted for on settlement date basis.

a) Gold

Gold is revalued on the last business day of the month at 90 per cent of the daily average price quoted by London Bullion Market Association for the month. The rupee equivalent is determined on the basis of the exchange rate prevailing on the last business day of the month. Unrealised gains/losses are credited/debited to the Currency and Gold Revaluation Account (CGRA).

b) Foreign Currency Assets and Liabilities

All foreign currency assets and liabilities (excluding foreign currency received under the swaps that are in the nature of repos) are translated at the exchange rates prevailing on the last business day of the week, month and the year, except in cases where rates are contractually fixed. Exchange gains and losses arising from such translation of foreign currency assets and liabilities are accounted for in CGRA and remain adjusted therein.

Foreign securities, other than Treasury Bills, are marked to market as on the last business day of each month except certain "held to maturity" securities, which are valued at cost. Appreciation or depreciation, if any, is recorded in the Investment Revaluation Account (IRA). Credit balance in IRA is carried forward to the subsequent year. Debit balance, if any, at the end of the year in IRA is charged to the Profit and Loss Account and the same is reversed to the credit of the Profit & Loss Account on the first working day of the succeeding financial year.

Foreign Treasury Bills and Commercial Papers are carried at cost as adjusted by amortisation of discount. Premium or discount on foreign securities is amortised daily. Profit/loss on sale of foreign currency assets is recognised with respect to the book value. In the case of Foreign Treasury Bills, Commercial Papers and Foreign Securities, profit & loss is recognised with reference to the amortised cost. Further, on sale/redemption of foreign dated securities, valuation gain/loss in relation to the securities sold, lying in IRA, is transferred to the Profit & Loss Account.

c) Forward/Swap Contracts

The accounting policy for forward contracts has undergone a change during the year as suggested by Technical Committee II. Accordingly, forward contracts entered into by the Bank as part of its intervention operations are, from this year onwards, revalued on a yearly basis (on June 30). While MTM gain is to be credited to the 'Foreign Exchange Forward Contracts Valuation Account' (FCVA), a balance sheet head, with contra debit to Revaluation of Forward Contracts Account (RFCA), MTM loss would be debited to the FCVA with contra credit to the Provision for Forward Contracts Valuation Account (PFCVA). On maturity of the contract, the actual gain or loss would be recognised in the Profit & Loss account and the unrealised gains/losses previously recorded in the FCVA, RFCA and PFCVA would be reversed. While the balance in the RFCA represents the net unrealised gain on valuation of forward contracts entered into as part of intervention operations, the balance in the PFCVA represents the net unrealised loss on valuation of such contracts.

In the case of swaps at off-market rates that are in the nature of repo, the difference between the future contract rate and the rate at which the contract is entered into is amortised over the period of the contract and recorded in the Profit & Loss account with contra to Swap Amortisation Account. Further, the amounts received under these swap are not subject to periodic revaluation.

While FCVA and PFCVA form part of "Other Liabilities", RFCA forms part of "Other Assets".

IV. Rupee Securities

Rupee securities, other than Treasury Bills, held in the Issue and Banking Departments, are valued at lower of book value or market price (LOBOM). Where the market price for such securities is not available, the rates are derived based on the yield curve prevailing on the last business day of the month as notified by the Fixed Income Money Market and Derivatives Association of India (FIMMDA). Depreciation in value, if any, is adjusted against current interest income.

Treasury Bills are valued at cost.

Securities received as collateral under Repurchase Agreement (Repo) and Marginal Standing Facility (MSF) are held in the Reserve Bank's books at face value.

V. Shares

Investments in shares are valued at cost.

VI. Fixed Assets

Fixed Assets are stated at cost less depreciation.

Depreciation on computers, microprocessors, software (costing ₹0.1 million and above), motor vehicles, furniture, *etc*., is provided on straight-line basis at the following rates.

Asset Category	Rate of depreciation
Motor vehicles, furniture, *etc.*	20 per cent
Computers, Microprocessors, Software, *etc.*	33.33 per cent

Amortisation of premium on leasehold land and depreciation on building is provided on written-down value basis at the following rates.

Asset Category	Rate of depreciation/ amortisation
Leasehold Land and Building(s) constructed thereon	Proportionate to lease period but not less than 5 per cent
Building(s) constructed on Freehold Land	10 per cent

Fixed Assets, costing less than ₹1,00,000 (except easily portable electronic assets) are charged to the Profit and Loss Account in the year of acquisition.

Valuable but easily portable electronic assets, such as, laptops, *etc.* costing more than ₹10,000 are capitalised.

Individual items of computer software costing ₹1,00,000/- and above are capitalised and depreciation is calculated at the applicable rates. Depreciation is provided on year-end balances of the Fixed Assets.

VII. Employee Benefits

The liability on account of long term employee benefits is provided based on an actuarial valuation under the 'Projected Unit Credit' method.

NOTES TO THE ACCOUNTS

Basis of preparation

XII.6 The financial statements of the Reserve Bank are prepared in accordance with the Reserve Bank of India (RBI) Act, 1934 and the notifications issued there under and in the form prescribed by the Reserve Bank of India General Regulations, 1949. As per the current practice, Reserve Bank prepares two balance sheets, one for the Issue Department relating exclusively to its currency management responsibility and the other for the Banking Department reflecting the impact of all other functions of the Reserve Bank.

Liabilities and Assets of the Issue Department

Issue Department – Liabilities

XII.7 The liabilities of the Issue Department reflect the quantum of currency notes in circulation. Section 34(1) of the Reserve Bank of India Act requires that all bank notes issued by the Reserve Bank since April 1, 1935 and the currency notes issued by the Government of India before the

commencement of operations of the Reserve Bank, be part of the liabilities of the Issue Department. The currency notes in circulation increased by 11.9 per cent during 2013-14 to ₹13,445.16 billion as compared with an increase of 8.9 per cent during 2012-13 and 13.8 per cent in 2011-12.

Issue Department – Assets

XII.8 The eligible assets of the Issue Department for backing its currency liabilities consist of gold (coins and bullion), foreign securities, rupee coin, Government of India securities (which remained unchanged at ₹10.46 billion), internal bills of exchange and other commercial papers. The Reserve Bank holds 557.75 metric tonnes of gold of which 292.26 metric tonnes are held as an asset of the Issue Department and the balance 265.49 metric tonnes is treated as part of the other assets of the Banking Department. The value of gold held in the Issue Department decreased by 3.6 per cent from ₹674.31 billion as on June 30, 2013 to ₹649.78 billion as on June 30, 2014, reflecting declining international bullion prices (Table XII.1). Consequent upon an increase in the total liabilities of the Issue Department, there was an increase in the supporting assets held in the form of foreign securities from ₹11,329.10 billion as on June 30, 2013 to ₹12,783.31 billion as on June 30, 2014. The value of Rupee coins of the Issue Department decreased from ₹2.36 billion as on June 30, 2013 to ₹1.72 billion as on June 30, 2014, registering a decrease of 27.1 per cent. There was no change in the holding of the Government of India Rupee securities which remained at ₹10.46 billion.

Table XII.1: Holding of Gold

	As on June 30,2013		As on June 30,2014	
	Value in ₹ billion	Volume in metric tonnes	Value in ₹ billion	Volume in metric tonnes
1	2	3	4	5
Gold held in Issue Department	674.31	292.26	649.78	292.26
Gold held in Banking Department (under 'Other Assets')	612.54	265.49	590.24	265.49
Total	**1,286.85**	**557.75**	**1,240.02**	**557.75**

Liabilities and Assets of the Banking Department

Banking Department – Liabilities

i) Capital

The Reserve Bank was constituted as a private shareholders' bank in 1935 with an initial paid-up capital of ₹0.05 billion. The bank was nationalised with effect from January 1, 1949 and its entire ownership remains vested in the Government of India. The paid-up capital continues to be ₹0.05 billion as per section 4 of the RBI Act.

ii) Reserve Fund

The original Reserve Fund of ₹0.05 billion was created in terms of section 46 of the Reserve Bank of India Act as contribution from the Central Government for the currency liability of the then sovereign government taken over by the Reserve Bank. Thereafter, an amount of ₹64.95 billion was credited to this Fund from out of gains on periodic revaluation of gold up to October 1990, taking it to ₹65 billion. The accumulation in the fund has been static since then and gain/loss on account of valuation of gold and foreign currency is booked in the Currency and Gold Revaluation Account (CGRA) which is part of the head 'Other Liabilities' in the balance sheet.

iii) National Industrial Credit (Long Term Operations) Fund

Created in July 1964, under section 46C of the RBI Act with an initial corpus of ₹100 million, the fund witnessed annual contribution from the Reserve Bank for financial assistance to eligible financial institutions. Since 1992-93, a token amount of ₹10 million is being contributed each year to the Fund from the Bank's income; the same practice has been

followed for the year 2013-14 as well and the balance in the fund stood at ₹230 million as on June 30, 2014.

iv) National Housing Credit (Long Term Operations) Fund

Set up in January 1989 under section 46D of the RBI Act for extending financial accommodation to the National Housing Bank, the initial corpus of ₹500 million has been enhanced by annual contributions from the Reserve Bank thereafter. From the year 1992-93, only a token amount of ₹10 million is contributed each year from the Profit & Loss Account (Income Statement) to the Fund. The balance in the fund stood at ₹1,970 million as on June 30, 2014.

v) Contribution to other Funds

It may be noted that there are two other Funds constituted under section 46A of the RBI Act, *viz.*, National Rural Credit (Long Term Operations) Fund and National Rural Credit (Stabilisation) Fund for which a token contribution of ₹10 million each is made every year to the National Bank for Agriculture and Rural Development (NABARD).

vi) Deposits

These represent the cash balances maintained with the Reserve Bank by the Central and State Governments, banks, All India financial institutions, such as, Export Import Bank (EXIM Bank) and NABARD, foreign central banks, international financial institutions, balance in different accounts relating to the Employees' Provident Fund, Gratuity and Superannuation Funds and balance in the newly established Depositor Education and Awareness Fund (DEA Fund). This Fund was created during the year for promotion of depositors' interest and for such other purposes which may be necessary for the promotion of depositors' interests as specified by the Reserve Bank from time to time. The balance in the DEA Fund was ₹27.95 billion as on June 30, 2014. Total deposits stood at ₹3,892.54 billion as on June 30, 2014 as compared with ₹3,738.92 billion as on June 30, 2013, registering an increase of 4.1 per cent.

- *Deposits – Government*

The Reserve Bank acts as banker to the Central Government in terms of sections 20 and 21 and as banker to the State Governments by mutual agreement in terms of section 21(A) of the Reserve Bank of India Act. Accordingly, the Central and the State Governments maintain deposits with the Reserve Bank. The year-end closing balances of deposits maintained by the Central and State Governments at ₹1.00 billion and ₹0.42 billion respectively totalling ₹1.42 billion were at almost the same level as at the end of the previous year.

- *Deposits – Banks*

Banks maintain balances in their current accounts with the Reserve Bank to provide for the Cash Reserve Ratio (CRR) requirements and for working funds to meet payment and settlement obligations. The total bank deposits as on June 30, 2014 stood at ₹3,677.24 billion as compared with ₹3,571.51 billion as on June 30, 2013, registering an increase of 3.0 per cent during the year.

- *Deposits - Others*

There was an overall increase of 28.9 per cent in other deposits during the year 2013-14, mainly on account of higher accumulated retirement benefits and newly established DEA Fund. The details are given in the Table XII.2.

vii) Bills Payable

The Reserve Bank provides remittance facilities for its constituents and also meets its own payment requirements through issue of

Table XII.2: Deposits –Others

(₹ billion)

Particulars	As on June 30	
	2013	2014
1	2	3
I. Rupee Deposits from the Foreign Central Banks and the Foreign Financial Institutions	15.33	11.56
II. Deposits from the Indian Financial Institutions	0.70	2.53
III. Deposits placed by Mutual Funds	0.02	0.01
IV. Accumulated Retirement Benefits (i+ii)	141.02	161.72
(i) Provident Fund	36.10	38.62
(ii) Gratuity and Superannuation Fund	104.92	123.10
V. Depositor Education and Awareness (DEA) Fund	0.00	27.95
VI. Miscellaneous	8.90	10.11
Total	**165.97**	**213.88**

Demand Drafts (DDs) and Payment Orders (POs) (besides electronic payments mechanisms). The balance under this head represents the un-encashed DDs/ POs and remittances under the erstwhile Remittance Facility Scheme, 1975. The total amount outstanding under this head decreased from ₹1.87 billion as on June 30, 2013 to ₹0.37 billion as on June 30, 2014 mainly due to reduction in remittance of funds through DD/ POs reflecting the growing popularity of electronic modes of payment.

viii) Other Liabilities

The major components of 'other liabilities' are internal reserves and provisions. While CR and ADR are created from the Bank's realised profit, the remaining components of 'Other Liabilities', such as, CGRA, Investment Revaluation Account (IRA) and Foreign Exchange Forward Contracts Valuation Account (FCVA) [previously Exchange Equalisation Account (EEA)] represent unrealised gains/losses. Other Liabilities increased from ₹8,082.86 billion as on June 30, 2013 to ₹8,838.23 billion as on June 30, 2014, reflecting a rise of 9.3 per cent mainly on account of accretion to the CGRA (Table XII.3).

a) Contingency Reserve (CR)

It represents the amount set aside on a year-to-year basis for meeting unexpected and unforeseen contingencies, including depreciation in the value of securities, and risks arising out of monetary/exchange rate policy operations, systemic risks and any risk arising on account of the special responsibilities enjoined upon the Bank.

b) Asset Development Reserve (ADR)

The Asset Development Reserve, created in 1997-98, represents the amounts provided out of profits each year to meet internal capital expenditure and make investments in subsidiaries and associated institutions.

Transfers to Contingency Reserve and Asset Development Reserve

As against the target of 12 per cent of total assets set for CR and the ADR together based on the recommendations of an Internal Study Group (Chairman: Shri V. Subrahmanyam) (1997), the CR and the ADR together constituted 9.2 per cent of the total assets of the Reserve Bank as on June 30, 2014; the position as at the end of the last five years is given in Table XII.4. Following the

Table XII.3: Details of Other Liabilities

(₹ billion)

Particulars	As on June 30	
	2013	2014
1	2	3
a. Contingency Reserve		
Balance at the beginning of the year	**1,954.05**	**2,216.52**
Add: Accretion during the year	262.47	0.00
Balance at the end of the year	**2,216.52**	**2,216.52**
b. Asset Development Reserve		
Balance at the beginning of the year	**182.14**	**207.61**
Add: Accretion during the year	25.47	0.00
Balance at the end of the year	**207.61**	**207.61**
c. Currency and Gold Revaluation Account		
Balance at the beginning of the year	**4,731.72**	**5,201.13**
Add: Net Accretion (+)/Net Depletion (-) during the year	(+) 469.41	(+) 520.50
Balance at the end of the year	**5,201.13**	**5,721.63**
d. Investment Revaluation Account		
Balance at the beginning of the year	**122.22**	**24.85**
Add: Net Accretion (+)/Net Utilisation (-)during the year	(-) 97.37	(+) 13.06
Balance at the end of the year	**24.85**	**37.91**
e. Foreign Exchange Forward Contracts Valuation Account (Previously known as Exchange Equalisation Account)		
Balance at the beginning of the year	**24.05**	**16.99**
*Transfer from Exchange Account/** MTM gain on forward contracts	16.99*	42.98**
Add: Net Accretion (+)/Net Utilisation (-) during the year	(-) 24.05	(-) 16.99
Balance at the end of the year	**16.99**	**42.98**
f. Provision for Payables	**18.43**	**16.55**
g. Surplus Transferable to the Government of India	**330.10**	**526.79**
h. Miscellaneous	**67.23**	**68.24**
i. Total (a to h)	**8,082.86**	**8,838.23**

recommendations of the Technical Committee II, no transfers to CR and ADR have been made for the year ended June 30, 2014.

c) Currency and Gold Revaluation Account (CGRA)

Unrealised gains/losses on valuation of Foreign Currency Assets (FCA) and gold due to movements in price of gold are not taken to the Profit & Loss Account but instead recorded under a balance sheet head named as the Currency and Gold Revaluation

Table XII.4: Balances in Contingency Reserve and Asset Development Reserve

(₹ billion)

As on June 30	Balance in CR	Balance in ADR	Total	CR and ADR as percentage to total assets
1	2	3	4=(2+3)	5
2010	1585.61	146.32	1731.92	11.3
2011	1707.28	158.66	1865.94	10.3
2012	1954.05	182.14	2136.19	9.7
2013	2216.52	207.61	2424.13	10.1
2014	2216.52	207.61	2424.13	9.2

Account (CGRA). CGRA represents the accumulated net balance of unrealised gains and losses arising out of valuation of FCA and gold and, therefore, its balance varies with the size of asset base, movement in the exchange rate and price of gold. During 2013-14, the balances in CGRA increased by ₹520.50 billion from ₹5,201.13 billion as on June 30, 2013 to ₹5,721.63 billon as on June 30, 2014 mainly due to the depreciation of US Dollar against other major currencies and of the rupee against the US Dollar.

d) Investment Revaluation Account (IRA)

The Reserve Bank marks to market the foreign dated securities at market prices on the last business day of each month and the unrealised gains/losses arising therefrom is transferred to the IRA. The balance in the IRA as on June 30, 2014 was ₹37.91 billion, as compared with ₹24.85 billion as on June 30, 2013. The increase in balance in this account was mainly due to market fluctuations.

e) **Foreign Exchange Forward Contracts Valuation Account (FCVA)***[previously known as Exchange Equalisation Account (EEA)]*

As per the revised accounting policy for forward contracts suggested by the Technical Committee II implemented during the year, the Exchange Equalisation Account (EEA) which was used for recording the MTM losses on outstanding forward contracts has been renamed as 'Foreign Exchange Forward Contracts Valuation Account' (FCVA) and both the MTM gains as well as losses on foreign exchange forward contracts that are entered into as part of the Bank's intervention operations are booked under this head of account. The amounts recorded in this account will be reversed on the maturity of the respective contracts. The balance in FCVA as on June 30, 2014 was ₹42.98 billion, as against a balance of ₹16.99 billion as on June 30, 2013. The position of balances in CGRA, FCVA & IRA for the last five years is given in Table XII.5.

Table XII.5: Balances in Currency and Gold Revaluation Account (CGRA), Foreign Exchange Forward Contracts Valuation Account (FCVA) *[previously Exchange Equalisation Account (EEA)]* **and Investment Revaluation Account (IRA)**

(₹ billion)

As on June 30	CGRA	FCVA*	IRA
1	2	3	4
2010	1,191.34	0.19	93.71
2011	1,822.86	0.01	42.69
2012	4,731.72	24.05	122.22
2013	5,201.13	16.99	24.85
2014	5,721.63	42.98	37.91

*EEA till 2012-13

f) Provision for Outstanding Expenses

An amount of ₹16.55 billion has been set aside as provisions for the year 2013-14; the corresponding figure for the year 2012-13 was ₹18.43 billion.

g) Surplus transferable to the Government of India

Under Section 47 of the Reserve Bank of India Act, after making provisions for bad and doubtful debts, depreciation in assets, contribution to staff and superannuation fund and for all matters for which provisions are to be made by or under the Act or that are usually provided by bankers, the balance of the profits of the Bank are required to be paid to the Central Government. Under Section 48 of the Reserve Bank Act, 1934 the Bank is not liable to pay income tax or super tax or any other tax on any of its income, profits or gains and is also exempt from payment of wealth tax. Accordingly, after adjusting the expenditure including the contribution of an amount of ₹40 million for the statutory funds, ₹526.79 billion represented the surplus

transferable to the government for the year 2013-14. The amount which was transferred to the Government on August 11, 2014 constituted 99.99 per cent of total surplus (before transfer to four funds) as compared with 37.2 per cent and 53.4 per cent in 2011-12 and 2012-13, respectively (Table XII.16). The amount was inclusive of ₹0.03 billion towards notional service tax payable on account of the MICR cheque processing charges on a self-assessment basis as was done in the earlier years and ₹12.69 billion as against ₹13.22 billion in the previous year, payable to the government towards the difference in interest expenditure borne by the Government consequent on conversion of special securities into marketable securities.

h) Miscellaneous

This is a residual head including sub accounts, such as, balances payable on account of leave encashment, reserve for interest earned on securities earmarked for the employee funds, the value of collateral held as margin for repo transactions, medical provisions for employees, *etc.* Miscellaneous liabilities stood at ₹68.24 billion as on June 30, 2014 as against ₹67.23 billion as on June 30, 2013.

Banking Department – Assets

XII.9 The assets of the Banking Department comprise Notes, Rupee Coin, Small Coin, Bills Purchased and Discounted, Balances Held Abroad, Investments, Loans and Advances and Other Assets. They are presented in the balance sheet in descending order of liquidity.

i) Notes, Rupee Coin and Small Coin

This is the stock of bank notes, one rupee notes, rupee coins of ₹1, 2, 5 and 10 and small coins kept in the vaults of the Banking Department to meet the day to day requirements of the banking functions conducted by the Reserve Bank. The value of this stock increased by 37.5 per cent from ₹0.08 billion as on June 30, 2013 to ₹0.11 billion as on June 30, 2014.

ii) Bills purchased and discounted

Though the Reserve Bank can undertake purchase and discounting of commercial bills under the RBI Act, no such activity has been undertaken in 2013-14; consequently, there was no such asset in the books of the Reserve Bank as on June 30, 2014.

iii) Foreign Currency Assets (FCA) and Foreign Exchange Reserves (FER)

The Foreign Currency Assets (FCA) of the Bank are reflected under the following heads in the Balance Sheet: (a) Balances Held Abroad in foreign currency, shown as a distinct item under the assets of the banking department (b) Foreign Securities (consisting of deposits, T- bills, Dated Securities and BIS / SWIFT shares) held as part of Banking Department's Investments and (c) Foreign Securities (consisting of Deposits, T-bills and dated securities) held as Issue Department assets as mentioned in paragraph on "Issue Department Assets".

Balances Held Abroad include (i) deposits with other central banks, (ii) deposits with the Bank for International Settlements (BIS), (iii) balances with foreign branches of commercial banks,(iv) investments in foreign treasury bills and securities and (v) Special Drawing Rights (SDR) acquired from the Government of India during the year. The position of FCA of the Bank for the last two years is given in Table XII.6.

The Foreign Exchange Reserves (FER) predominantly comprises FCA, besides gold, Special Drawing Rights (SDRs) and Reserve Tranche Position (RTP). Reserve Tranche Position in the IMF is not part of the Bank's balance sheet but are held by the Government

Table XII.6: Details of Foreign Currency Assets

(₹ billion)

Particulars	As on June 30	
	2013	2014
1	2	3
I. Held in Issue Department	11,329.10	12,783.31
II. Held in Banking Department		
(a) Included in Investments*	523.57	1,069.45
(b) Balances Held Abroad	3,395.01	3,726.76
Total	**15,247.68**	**17,579.52**

*: including Foreign Securities and Shares in BIS and SWIFT(items ii plus iii of Table XII.8)

@: including SDRs valued at ₹49.31 billion

Notes :
1. Uncalled amount on partly paid shares of the Bank for International Settlements (BIS) as on June 30, 2014 was ₹1.12 billion (SDR 12,041,250). The amount was ₹1.08 billion (SDR 12,041,250) in the previous year.
2. RBI has agreed to make resources available under the IMF's New Arrangements to Borrow (NAB) [which subsumes the earlier commitment of US$ 10 billion (₹600.93 billion) under the Note Purchase Agreement] up to a maximum amount of SDR 8,740.82 million (₹812.00 billion /US$ 13.51 billion). As on June 30, 2014, investments amounting to SDR 1,200.90 million (₹111.56 billion/US$ 1.86 billion) have been made under the NAB.
3. RBI has agreed to invest up to an amount, the aggregate of which shall not exceed US$ 5 billion (₹300.47 billion), in the bonds issued by India Infrastructure Finance Company (UK) Limited. As on June 30, 2014, the Reserve Bank has invested US$ 1,181 million (₹70.97 billion) in such bonds.
4. In terms of the Note Purchase Agreement (NPA) 2012 entered into by RBI with IMF, RBI would purchase SDR denominated Notes of IMF for an amount up to the equivalent of USD 10 billion (₹600.93 billion).
5. During the year 2013-14, the Reserve Bank and Government of India (GoI) entered into a MoU for transfer of SDR holdings from GoI to RBI in a phased manner. As on June 30, 2014, SDRs 530.80 million (₹49.31 billion; US$ 820.56 million) were held by the Bank.

of India and therefore not reflected in the Reserve Bank's balance sheet.The Foreign Exchange Reserves as at June 30, 2013 and June 30, 2014 in Indian Rupees & the US dollar, which is the numeraire for our foreign exchange reserves, were as under [Tables XII.7 (a) and (b)].

Table XII.7(a): Foreign Exchange Reserves in Rupee

(₹ billion)

	As on		Variation	
	June 30, 2013	June 30, 2014	Absolute	Per cent
1	2	3	4	5
Foreign Currency Assets (FCA)	15,247.69	17,530.21#	2,282.52	14.97
Gold	1286.86	1240.02@	(-) 46.84	(-) 3.64
Special Drawing Rights (SDR)	259.20	268.31	9.11	3.51
Reserve Position in the IMF*	130.67	103.23	(-) 27.44	(-) 21.00
Total Foreign Exchange Reserves (FER)	**16,924.42**	**19,141.77**	**2,271.35**	**13.10**

\# : Excludes SDR Holdings of the Reserve Bank amounting to ₹49.31 billion which is included under the SDR holdings.

@ : Of this, gold valued at ₹649.78 billion is held as an asset of Issue Department and gold valued at ₹590.24 billion is held under 'Other Assets' in the Banking Department.

* : Reserve Tranche Position in the International Monetary Fund (IMF), which was shown as a memo item from May 23, 2003 to March 26, 2004 has been included in the reserves from the week ended April 2, 2004.

Table XII.7(b): Foreign Exchange Reserves in USD

(USD billion)

	As on		Variation	
	June 30, 2013	June 30, 2014	Absolute	Per cent
1	2	3	4	5
Foreign Currency Assets (FCA)	254.37*	289.32**	34.95	13.74
Gold	21.55	20.63	(-) 0.92	(-) 4.27
Special Drawing Rights (SDR)	4.34	4.47	0.13	3.00
Reserve Position in the IMF	2.19	1.72	(-)0.47	(-) 21.46
Total Foreign Exchange Reserves (FER)	**282.45**	**316.14**	**33.69**	**11.93**

* : Excluding USD 950 million invested in bonds of IIFC (UK) and Bhutan currency (BTN) equivalent of USD 100 million received from Bhutan under a Currency Swap arrangement for SAARC countries. these are not considered as part of forex reserves.

** : Excluding USD 1,181 million invested in bonds of IIFC (UK) and SDRs equivalent to USD 820.56 million acquired by the Reserve Bank.

Table XII.8: Investments of the Banking Department

(₹ billion)

Investments	2012-13	2013-14
1	2	3
a) Government of India Rupee securities@	6,739.33	6,684.68
b) Foreign securities	520.90	1,066.69
c) Shares in BIS/SWIFT	2.67	2.76
d) Holdings in Subsidiaries / Associate Institutions	13.20	13.20
Total	**7,276.10**	**7,767.33**

@: includes ₹452.65 billion for the year 2013-14 and ₹454.02 for the year 2012-13 in the form of oil bonds issued by the Government of India.

iv) Investments

Investments of Banking Department given in Table XII.8 comprise the following:-

a) The Bank's holdings of Government of India (GOI) Rupee Securities came down from ₹6,739.33 billion in 2012-13 to ₹6,684.68 billion in 2013-14. The total rupee securities in the portfolio has gone down marginally during the year 2013-14 as the redemptions (of ₹236.38 billion) and change in GOI balances (of ₹182.85 billion) exceeded the purchases through OMO (of ₹302.83 billion). The Bank's own holdings of GOI Rupee securities was ₹5,663.32 billion; ₹951.42 billion represented the collateral received under Repurchase Agreement–Repo while ₹92.46 billion was the value of securities pertaining to the Marginal Standing Facility - (MSF) adjusted for securities given out under Reverse Repurchase Agreement-reverse repo of ₹22.52 billion.

b) Foreign securities represent debt of sovereigns and supranational institutions and other instrument or institution as approved by the Central Board of the Bank in accordance with the provisions of the Reserve Bank of India Act, 1934. A part of foreign securities are held in the Banking Department as asset earmarked to cover any future expansion in Issue Department liabilities.

c) Shares held in the Bank for International Settlements (BIS) and the Society for Worldwide Interbank Financial Telecommunication (SWIFT) amounting to ₹2.76 billion.

d) The details of holdings in subsidiaries / associate institutions as on June 30, 2014 are given in Table XII.9.

v) Loans and Advances

a) Central and State Governments

These loans take the form of Ways and Means Advances (WMA)extended in terms of section 17(5) of the Reserve Bank of India Act and Overdraft (OD) facilities, limits for which are fixed from time to time in consultation with the governments. No loans and advances to the Central Government were outstanding as on June 30, 2014; as on June 30, 2013, the corresponding figure was ₹146.61 billion. Loans and advances to the State Governments as on June 30, 2014 stood at ₹6.65 billion as compared with ₹21.45 billion as on June 30, 2013.

Table XII.9: Holdings in subsidiaries/associates

(Amount in ₹ million)

	Cost	% holding
1	2	3
(a) Deposit Insurance and Credit Guarantee Corporation (DICGC)	500.00	100.0
(b) National Bank for Agriculture and Rural Development(NABARD)	200.00	1.0
(c) National Housing Bank (NHB)	4,500.00	100.0
(d) Bharatiya Reserve Bank Note Mudran Pvt. Ltd. (BRBNMPL)	8,000.00	100.0
Total	**13,200.00**	–

b) Loans and advances to Commercial and Co-operative banks

These include refinance availed of from the Reserve Bank under the export credit refinance (ECR) facility against eligible outstanding export credit. The ECR refinance limit changes automatically with the outstanding eligible export credit, and the annual increase/decrease reflects increase/ decrease in actual utilisation of the facility by banks. Utilisation of the ECR increased from ₹188.82 billion as on June 30, 2013 to ₹295.51 billion as on June 30, 2014.

c) Loans and advances to NABARD

The Reserve Bank can extend loans to NABARD under section 17 (4E) of the RBI Act. Presently no loans are outstanding.

d) Loans and advances to others

The balance under this head represents loans to the Small Industries Development Bank of India (SIDBI), National Housing Bank (NHB) and Primary Dealers (PDs) amounting to ₹50 billion, ₹18.5 billion and ₹0.1 billion respectively. The facility extended in November 2013 to SIDBI was for one year with a 90 day tenure and a cut off rate pertaining to the immediately preceding 14 day term repo rate, payable at monthly rests. The facility for NHB was extended thirteen years ago at a rate of 6 per cent payable half-yearly. The liquidity support for PDs is primarliy provided so that they have enough reserves to participate in the primary auctions. The utilisation under this facility increased mainly due to increase in the borrowing programme of Government of India.

vi) Other Assets

'Other Assets' of Banking Department (Table XII.10) comprise fixed assets (net of depreciation), gold held abroad (265.49 metric tonnes), accrued income (mainly comprising interest income accrued on balance sheet date on the Bank's domestic and foreign investments), Swap Amortisation Account (SAA), Revaluation of Forward Contracts Account (RFCA) and miscellaneous assets. Miscellaneous assets comprise mainly loans and advances to staff, amount spent on projects pending completion, the margin offered for reverse repo transactions, security deposit paid, and items in transit representing inter-office transactions (through the RBI General Account), *etc.*

Table XII.10: Details of Other Assets

(₹ billion)

Particulars		As on June 30	
		2013	2014
1		2	3
I.	Fixed Assets (net of accumulated depreciation)	4.50	1.07
II.	Gold	612.54	590.24
III.	Accrued income (a + b)	223.88	222.46
	a. on loans to employees	2.98	0.66
	b. on other items	220.90	221.80
IV.	Swap Amortization Account	0.00	59.30
V.	Revaluation of Forward Contracts Account	0.00	42.85
VI.	Miscellaneous	13.64	17.45
	Total	**854.56**	**933.37**

Swap Amortisation Account (SAA)

Based on the recommendations of the Technical Committee II, in the case of swaps that are in the nature of repo at off-market rates, the difference between the future contract rate and the rate at which the contract is entered is being amortised over the period of the contract and held in the Swap Amortisation Account. The balance in this account as on June 30, 2014 was ₹59.30 billion.

Revaluation of Forward Contracts Account (RFCA)

As recommended by the Technical Committee II, in the case of forward contracts that are

Table XII.11: Gross Income

(₹ billion)

Item	2009-10	2010-11	2011-12	2012-13	2013-14
1	2	3	4	5	6
A. Foreign Sources					
Interest, Discount, Exchange	251.02	211.5	198.10	207.46	197.68
B. Domestic Sources					
(i) Interest	66.47	150.32	323.39	523.06	435.38
(ii) Other Earnings	11.35	8.88	10.27	13.05	13.11
Total: (i) + (ii)	77.82	159.20	333.66	536.11	448.49
C. Gross Income (A+B)	328.84	370.70	531.76	743.58	646.17
D. Transfer to Contingency Reserve	51.68	121.67	246.77	262.47	0
E. Transfer to Asset Development Reserve	5.50	12.35	23.48	25.47	0
F. Total Income(C-D-E)	271.66	236.68	261.51	455.64	646.17

entered into as part of intervention operations, the MTM gains have been recorded in this account to be reversed on the maturity of the underlying contracts. The balance in this account as on June 30, 2014 was ₹42.85 billion. The value of 'Other Assets' increased from ₹854.56 billion to ₹933.37 billion as on June 30, 2014, mainly on account of amortisation of off- market swaps and MTM gains on revaluation of forward contracts as indicated in above paragraphs.

ANALYSIS OF INCOME AND EXPENDITURE

Income

XII.10 The Reserve Bank's income is drawn from (i) Interest receipts, (ii) Discount, (iii) Exchange, (iv) Commission and (v) Others including Rent Realised, Profit or loss on sale of Bank's property and Provisions no longer required. Of these, Interest earnings forms the major portion supplemented by relatively small amounts of income from other sources, *viz.*, discount, exchange, commission and others. Details of the gross income and the earnings from domestic and foreign sources for the last five years are presented in Table XII.11.

Earnings from Foreign Sources

XII.11 The income from foreign sources which is derived from deployment of the foreign currency assets decreased by ₹9.78 billion (4.7 per cent) from ₹207.46 billion in 2012-13 to ₹197.68 billion in 2013-14. The rate of earnings on foreign currency assets was lower at 1.21 per cent in 2013-14 as compared with 1.45 per cent in 2012-13 due to low interest rates in the international markets during the year (Table XII.12).

Table XII.12: Earnings from Foreign Sources

(₹ billion)

Item	Year ended		Variation	
	June 30, 2013	June 30, 2014	Absolute	Per cent
1	2	3	4	5
Foreign Currency Assets (FCA)	15,247.68	17,579.52	2,331.84	15.29
Average FCA	14281.58	16,368.93	2,087.35	14.62
Earnings from FCA (interest, discount, exchange gain/loss, capital gain/loss on securities)*	207.46	197.68	(-) 9.78	(-) 4.71
Earnings from FCA as per cent of average FCA	1.45	1.21	-	-

* Earnings include swap premium of ₹59.30 billion during 2013-14

Earnings from Domestic Sources

XII.12 The net income from domestic sources decreased from ₹536.11 billion in 2012-13 to ₹448.49 billion in 2013-14, recording a fall of 16.3 per cent. A detailed break-up of the various components of domestic income is provided in Table XII.13. Inspite of the decrease in the total holding of Rupee securities (Table XII.8), the income from coupon receipts had gone up from ₹408.68 billion in 2012-13 to ₹470.53 billion in 2013-14 on account of net purchases of government securuites worth ₹302.83 billion in the year. However, the overall decrease was primarily on account of increase in depreciation booked on the Rupee securities from ₹55.38 billion in 2012-13 to ₹480.45 billion in 2013-14 (as yields generally hardened in 2013-14 as compared with the previous financial year).

XII.13 The net interest income from LAF and MSF increased from ₹64.90 billion in 2012-13 to ₹76.47 billion in 2013-14, largely on account of (i) increase in the MSF rate by 200 bps in July 2013 and (ii) significant portion of LAF borrowings being made through term repo window at rates higher than the prevailing repo rate.

XII.14 Interest income received on account of WMA/OD from the Centre for July 2013-June 2014 period stood higher at ₹3.22 billion as compared to ₹0.67 billion for the corresponding period during 2012-13. With the Centre availing of WMA for 52 days and OD for 10 days during the year as compared to WMA for 27 days and no OD in the previous year. The monthly average utilisation of WMA/OD by the Centre was ₹299.4 billion in 2013-14 as against ₹98.1 billion in 2012-13.

Table XII.13: Earnings from Domestic Sources

(₹ billion)

Item	Year ended		Variation	
	June 30, 2013	June 30, 2014	Absolute	Per cent
1	2	3	4	5
Domestic Assets	8,659.35	8,664.04	4.65	0.05
Weekly Average of Domestic Assets	**7,724.84**	**8,694.77**	**969.95**	**12.56**
Earnings (I + II+III)	**536.11**	**448.49**	**(-)87.62**	**(-)16.34**
I. Interest and other Securities Related Income				
i) Profit on Sale of Securities	85.47	331.37	245.90	287.70
ii) Net Interest on LAF operations	64.79	59.02	(-)5.77	(-)8.90
iii) Interest on MSF operations	0.11	17.45	17.34	15763.64
iv) Interest on holding of Domestic Securities	408.68	470.53	61.85	15.13
v) Depreciation	55.38	480.45	425.07	767.55
Total (i+ii+iii+iv-v)	**503.67**	**397.92**	**(-)105.75**	**(-)21.00**
II. Interest on Loans and Advances				
i) To Government (Central & States)	1.26	3.88	2.63	208.73
ii) To Banks & Financial Institutions	17.65	33.10	15.45	87.54
iii) To Employees	0.48	0.48	0.00	0.0
Total (i+ii+iii)	**19.39**	**37.46**	**18.07**	**93.19**
III. Other Earnings				
i) Discount	0.28	0.01	(-)0.27	(-)96.43
ii) Exchange	-	-	-	-
iii) Commission	11.13	12.57	1.44	12.94
iv) Rent realised, Profit or Loss on sale of Bank's property and Provisions no longer required.	1.64	0.53	(-)1.12	(-)68.29
Total (i+ii+iii+iv)	**13.04**	**13.11**	**0.06**	**0.46**

XII.15 As regards the States, the interest towards WMA/OD recovered for July 2013-June 2014 period was ₹0.66 billion as compared to ₹0.59 billion during 2012-13. This is attributable to marginally higher monthly average utilisation of WMA/OD by the States at ₹58.34 billion in 2013-14 as against ₹54.57 billion in 2012-13.

Expenditure

XII.16 The Reserve Bank incurs expenditure in the course of performing its statutory functions by way of agency charges/commission, security printing charges, expenses on remittance of treasure besides staff related and other expenses. The total expenditure of the Reserve Bank decreased by 4.9 per cent from ₹125.49 billion in 2012-13 to ₹119.34 billion in 2013-14. The expenditure is broadly categorised into three sub-groups; *viz.*, Interest Payment, Establishment Expenditure and Non-establishment Expenditure. The break-up of the major heads of expenditure is provided in Table XII.14.

i) *Interest Payment*

Interest paid during the year - representing the Bank's contribution by way of half-yearly interest credited to the employee welfare funds *viz.* Medical Assistance Fund (MAF) and Dr B.R. Ambedkar Fund, had risen marginally from ₹0.03 billion in 2012-13 to ₹0.04 billion in 2013-14.

ii) *Establishment Expenditure*

The establishment expenses decreased by 26.2 per cent from ₹58.59 billion in 2012-13 to ₹43.24 billion in 2013-14. This can be attributed to decrease in the contribution towards accrued liabilities of the gratuity and superannuation fund and other funds based on the actuarial valuation.The contribution for the year 2013-14 was ₹18.09 billion as against ₹35.32 billion in the previous year.The Bank's Investments equivalent to the balances in Provident Fund, Gratuity & Superannuation Fund and Leave Encashment Fund have been ear-marked for these Funds. Provident Fund and Gratuity & Superannuation Fund are held as 'Deposits' with the Bank. Leave Encashment liability is included under 'Other Liabilities'.

iii) *Non-Establishment Expenditure*

a) *Agency Charges*

There are four types of expenses booked under 'Agency Charges' as outlined in Table XII.15.

Table XII.14: Expenditure

(₹ billion)

Item	2009-10	2010-11	2011-12	2012-13	2013-14
1	2	3	4	5	6
I. Interest Payment	0.01	0.55	0.59	0.03	0.04
II. Establishment	19.87	23.01	29.93	58.59	43.24
III. Non-establishment	64.15	62.99	70.85	66.87	76.06
of which:					
(a) Agency charges/ commission	28.55	30.12	33.51	28.07	33.25
(b) Security printing charges	27.54	23.76	27.04	28.72	32.14
(c) Others	8.06	9.11	10.3	10.08	10.67
Total (I+II+III)	84.03	86.55	101.37	125.49	119.34

Table XII.15: Agency Charges

(₹ million)

	2012-13	2013-14
1	2	3
Agency Commission on Government Transactions	27,264.39	27,813.97
Underwriting Commission paid to the Primary Dealers	218.65	4,811.98
Sundries (Handling charges paid to banks for Relief/Savings Bonds subscriptions)	1.11	0.42
Fees paid to the External Asset Managers ,custodians *etc.*	582.38	628.11
Total	**28,066.53**	**33,254.47**

Agency Commission paid to banks

The Reserve Bank discharges the function of banker to the government through a large network of agency bank branches that serve as retail outlets for government transactions. The Reserve Bank pays commission to these agency banks at prescribed rates which were revised with effect from July 01, 2012. The agency commission paid to these banks on account of Government business for the year 2013-14 was ₹27.81 billion as compared with ₹27.26 billion for the year 2012-13, an increase of 2.02 per cent reflecting the growth in the volume of government business.

Underwriting Commission Fees paid to the Primary Dealers (PDs)

The expenditure on underwriting commission increased substantially as PDs quoted higher underwriting commission rates in view of adverse market conditions during the first half of the year.

Fees paid to the External Asset Managers, custodians etc.

Fees amounting to ₹0.63 billion were paid in 2013-14 to the external asset managers, custodians *etc.,* who are entrusted with the management of a small portion of the Reserve Bank's foreign exchange reserves as against ₹0.58 billion in 2012-13.

b) *Security printing*

The expenditure incurred on security printing charges (primarily for printing of currency notes) increased by 11.9 per cent from ₹28.72 billion in 2012-13 to ₹32.14 billion in 2013-14. This rise was mainly on account of an increase of 15.14 per cent in the total supply of banknote forms and a marginal increase in rates quoted by the Bharatiya Reserve Bank Note Mudran Pvt. Ltd. (BRBNMPL) for the currency notes supplied by them.

c) *Others*

Other non-establishment expenses consisting of the expenditure on account of remittance of treasure, printing and stationery, audit fees and related expenses, miscellaneous expenses, *etc.* increased marginally from ₹10.08 to ₹10.67 billion. An amount of ₹24.22 million was paid for audit fees and expenses during 2013-14 as fees and expenses for statutory audit, concurrent audit and special

Table XII.16: Trends in Gross Income, Expenditure and Net Disposable Income

(₹ billion)

Item	2009-10	2010-11	2011-12	2012-13	2013-14
1	2	3	4	5	6
a) Gross Income	328.84	370.70	531.76	743.58	646.17
b) Transfers to Internal Reserves (i+ii)	57.18	134.02	270.25	287.94	0.00
(i) Contingency Reserve	51.68	121.67	246.77	262.47	0.00
(ii) Asset Development Reserve	5.50	12.35	23.48	25.47	0.00
c) Net Income (a-b)	271.66	236.68	261.51	455.63	646.17
d) Total Expenditure	84.03	86.55	101.37	125.49	119.34
e) Net Disposable Income (c-d)	187.63	150.13	160.14	330.14	526.83
f) Transfer to funds*	0.04	0.04	0.04	0.04	0.04
g) Surplus transferred to the Government (e-f)	187.59	150.09	160.10	330.10	526.79
Transfer of Surplus to Government as per cent of Gross Income less Total Expenditure	76.6	52.8	37.2	53.4	99.99

* : An amount of ₹10 million each has been transferred to the National Industrial Credit (Long Term Operations) Fund, the National Rural Credit (Long Term Operations) Fund, the National Rural Credit (Stabilisation) Fund and the National Housing Credit (Long Term Operations) Fund during each of the five years.

audit for various purposes conducted in the Bank. Miscellaneous expenses mainly include contributions to various academic, training institutes, *etc.*

The trends over the last five years in Income, Expenditure and Net Disposable Income have been indicated in Table XII.16.

The previous year's figures have been regrouped / reclassified, wherever necessary, to conform to the current year's presentation.

Auditors

The statutory auditors of the Bank are appointed by the Central Government in terms of section 50 of the RBI Act, 1934.The accounts of the Reserve Bank for the year 2013-14 were audited by M/s. Haribhakti & Co. LLP, Mumbai and M/s CNK & Associates, LLP, Mumbai as the Statutory Central Auditors and M/s. S.K. Mehta & Co., New Delhi, M/s. P.K.F. Sridhar & Santhanam & Co., Chennai and M/s Lodha & Co., Kolkata as the Statutory Branch Auditors.

ANNEX I

VISITS OF FOREIGN DELEGATIONS TO THE RESERVE BANK OF INDIA DURING JULY 01, 2013 TO JUNE 2014

Sr. No.	Date of Meeting	Foreign Delegates/ Delegation	RBI Executives who met the delegates
1.	July 12, 2013	Mr. G Hoefdraad, Governor of Central Bank of Suriname	Dr. D. Subbarao, Governor, Shri Anand Sinha, Deputy Governor, Shri Deepak Mohanty, Executive Director and Shri B. Mahapatra, Executive Director
2.	August 14, 2013	Mr. Lee Joon-gyu, Ambassador of Republic of Korea to India	Dr. D. Subbarao, Governor
3.	September 13, 2013	Ms. FredrikaOrnbrant, Consul General of Sweden	Dr. Raghuram G. Rajan, Governor
4.	September 16, 2013	Mr. Baron Ehrenkrona, Ambassador and Senior Advisor to the Swedish Minister for Foreign Affairs	Shri G. Padmanabhan, Executive Director
5.	September 20, 2013	Mr. Gerry Grimstone, Chairman, City UK and Sir James Bevan, High Commissioner to India	Dr. Raghuram G. Rajan, Governor
6.	September 23, 2013	Mr. William Foster, Financial Attache to India, U.S. Department of Treasury	Shri B. Mahapatra, Executive Director
7.	September 23, 2013	Mr. William Foster, Financial Attache to India, U.S. Department of Treasury	Harun R. Khan, Deputy Governor
8.	September 24, 2013	Mr. William Foster, Financial Attache to India, U.S. Department of Treasury	Dr. Raghuram G. Rajan, Governor
9.	September 30, 2013	Mr. Alphonsus Stoelinga, Ambassador, Kingdom of Netherlands	Dr. Raghuram G. Rajan, Governor
10.	September 30, 2013	Mr. Francois Richier, Ambassador of France	Dr. Raghuram G. Rajan, Governor
11.	October 10, 2013	Mr. Peter Norman, Swedish Minister for Financial Markets	Harun R. Khan, Deputy Governor
12.	October 17, 2013	Mr. Alexander Stubb, Minister for European Affairs and Foreign Trade	Dr. Raghuram G. Rajan, Governor
13.	October 21, 2013	Mr. Michael D Carson, Macro Economic Analyst, Federal Reserve Bank of New York	Shri B. Mahapatra, Executive Director
14.	October 28, 2013	Rt. Hon. Daniel Alexander, Chief Secretary to the UK Treasury	Shri Anand Sinha, Deputy Governor and Shri Deepak Mohanty, Executive Director
15.	October 31, 2013	Mr. Karl Van den Bossche, Consul General of Belgium in Mumbai	Dr. Raghuram G. Rajan, Governor
16.	November 7, 2013	Mr. Freddy Svane, Danish Ambassador	Dr. Raghuram G. Rajan, Governor
17.	November 7, 2013	Mr. Alon Ushpiz, Ambassador of Israel in New Delhi	Dr. Raghuram G. Rajan, Governor
18.	November 8, 2013	Swedish Delegation from Ministry of Foreign Affairs	Shri G Padmanabhan, Executive Director
19.	November 16, 2013	Ms Julie Bishop, Australian Foreign Minister	Dr. Raghuram G. Rajan, Governor
20.	November 26, 2013	Mr. João Cravinho, Ambassador of the European Union	Dr. Raghuram G. Rajan, Governor
21.	November 26, 2013	Mr. Didier Reynders, Deputy Prime Minister and Minister of Foreign Affairs of Belgium	Dr. Raghuram G. Rajan, Governor
22.	January 7, 2014	Dr. Richard L Sandor, Chief Executive Officer, Enviornmental Financial Products LLC	Dr. Raghuram G. Rajan, Governor
23.	January 7, 2014	Mr. Hiroshi Ugai, Deputy Director General, International Department, Bank of Japan	Dr. Raghuram G. Rajan, Governor
24.	January 22, 2014	Rt. Hon. Alderman Fiona Woolf, The Lord Mayor, City of London	Dr. Urjit R Patel, Deputy Governor
25.	January 27, 2014	Mr. Mitsuhiro Furusawa, Vice Minister of Finance, International Affairs of Japan	Dr. Raghuram G Rajan, Governor, Dr. Urjit R. Patel, Deputy Governor
26.	February 11, 2014	Mr. Rundheersigh Bheenick, Governor, Bank of Mauritius	Dr. Raghuram G. Rajan, Governor

Sr. No.	Date of Meeting	Foreign Delegates/ Delegation	RBI Executives who met the delegates
27.	February 11, 2014	Mr. Patrick Suckling, Australian High Commissioner	Dr. Raghuram G. Rajan, Governor
28.	February 18, 2014	Mr. Gustavo de Aristegui, Ambassador of Spain to India	Dr. Raghuram G. Rajan, Governor
29.	February 28, 2014	Mr. Alphonsus Stoelinga, Ambassador to the Netherlands to India	Dr. Raghuram G. Rajan, Governor
30.	March 4, 2014	Dr. Oliver Letwin, UK Cabinet Minister	Dr. Raghuram G. Rajan, Governor
31.	March 27, 2014	Mr. Peter Haas, Consul General to India, U.S. Department of Treasury	Dr. Raghuram G. Rajan, Governor
32.	March 27, 2014	Mr. William Foster, Financial Attache`to India, US Department of Treasury	Dr. Raghuram G. Rajan, Governor
33.	April 17, 2014	U.S. Congress German Bundestag Delegation	Dr. Raghuram G. Rajan, Governor
34.	April 22, 2014	Dr. Yubaraj Khatiwada, Governor of Nepal Rashtra Bank	Dr. Raghuram G. Rajan, Governor, Shri G. Padmanabhan, Executive Director
35.	April 25, 2014	Mr. Takeshi YAGI, Ambassador of Japan to India	Dr. Raghuram G. Rajan, Governor, Shri B. Mahapatra, Executive Director
36.	May 22, 2014	Mr. Per Westerberg, Swedish Speaker of the Parliament	Dr. Raghuram G. Rajan, Governor, Shri B. Mahapatra, Executive Director
37.	June 10, 2014	Ms. Vicky Robertson, Deputy Chief Executive of the New Zealand Treasury	Dr. Raghuram G. Rajan, Governor
38.	June 19, 2014	Mr. Stewart Beck, High Commissioner, Canada	Dr. Raghuram G. Rajan, Governor

APPENDIX TABLE 1: MACROECONOMIC AND FINANCIAL INDICATORS

Item	Average 2003-04 to 2007-08 (5 years)	Average 2009-10 to 2013-14 (5 years)	2010-11	2011-12	2012-13	2013-14
1	2	3	4	5	6	7
I. Real Economy						
I.1 Real GDP at factor cost (% change)	8.7	6.7	8.9	6.7	4.5	4.7
I.2 Real GDP at market prices (% change)	8.8	7.0	10.3	6.6	4.7	5.0
I.3 Foodgrains Production (Million tonnes)	213.6	248.8	244.5	259.3	257.1	264.8
I.4 Food Stocks (Million tonnes)						
a) Procurement	38.4	60.8	56.8	66.4	72.2	50.8
b) Off-take	41.5	55.6	52.9	56.3	62.8	57.4
c) Stocks at end-March	18.6	50.1	44.4	53.4	59.8	49.5
I.5 Index of Industrial Production (% change)	11.2	3.5	8.2	2.9	1.1	-0.1
I.6 Core Industries (% change)	5.9	5.6	6.6	5.0	6.5	3.1
I.7 Gross Domestic Saving Rate (% of GDP at current market prices)	33.3	32.2#	33.7	31.3	30.1	..
I.8 Gross Domestic Investment Rate (% of GDP at current market prices)	33.6	35.8#	36.5	35.5	34.8	..
II. Prices						
II.1 Consumer Price Index (CPI) Combined (Average % Change)	..	..	..	..	10.2	9.5
II.2 CPI- Industrial Workers (average % change)	5.0	10.3	10.4	8.4	10.4	9.7
II.3 Wholesale Price Index (average % change)	5.5	7.1	9.6	8.9	7.4	6.0
III. Money and Credit						
III.1 Reserve Money (M0) (% change)	20.4	12.1	19.1	3.6	6.2	14.4
III.2 Broad Money (M3) (% change)	18.6	14.7	16.1	13.5	13.6	13.2
III.3 Scheduled Commercial Banks						
a) Aggregate Deposits (% change)	20.2	15.0	15.9	13.5	14.2	14.1
b) Bank Credit (% change)	26.7	16.7	21.5	17.0	14.1	13.9
IV. Financial Markets						
IV.1 Interest rates (%)						
a) Call / Notice Money rate	5.6	7.2	5.8	8.2	8.1	8.3
b) 10 year G-Sec yield	7.0	8.0	7.9	8.4	8.2	8.4
c) 91-Days T-bill yield			7.3	9.0	8.2	8.9
d) Weighted Average interest rate on Central Government Borrowings			7.9	8.5	8.4	8.5
e) Commercial Paper	7.7	8.4	8.6	9.8	9.2	9.3
IV.2 Liquidity (₹ billion)						
a) LAF Outstanding~	..	..	-1,060.1	-1,691.6	-1,236.4	-2,179.9
b) MSS Outstanding~~	..	..	0.0	0.0	0.0	0.0
c) Average Daily Call Money Market Turnover	184.9	255.3	177.3	267.0	323.6	302.3
d) Average Daily G-Sec Market Turnover$	77.1	241.4	142.4	171.3	325.1	429.0
e) Term Repo*						1,200.2
f) MSF*				52.8	70.0	737.4
V. Government Finances						
V.1 Central Government Finances (% of GDP)@						
a) Total Revenue Receipts	9.8	9.0	10.1	8.3	8.7	8.9
b) Total Expenditure	14.7	14.7	15.4	14.5	13.9	13.8
c) Gross Fiscal Deficit	3.6	5.3	4.8	5.7	4.8	4.5
V.2 State Finances@@						
a) Revenue Deficit (% of GDP)**	0.4	0.0	0.0	-0.3	-0.2	0.0
b) Gross Fiscal Deficit (% of GDP)**	2.7	2.2	2.1	1.9	1.9	2.4
c) Primary Deficit (% of GDP)**	0.3	0.7	0.5	0.4	0.4	0.9

APPENDIX TABLE 1: MACROECONOMIC AND FINANCIAL INDICATORS *(Concld.)*

Item	Average 2003-04 to 2007-08 (5 years)	Average 2009-10 to 2013-14 (5 years)	2010-11	2011-12	2012-13	2013-14
1	2	3	4	5	6	7
VI. External Sector						
VI.1 Balance of Payments						
a) Merchandise Exports (% change)	25.3	12.2	40.4	20.9	-1.0	3.9
b) Merchandise Imports (% change)	32.3	9.7	27.6	30.3	0.5	-7.2
c) Trade Balance/GDP (%)	-5.4	-8.9	-7.5	-10.1	-10.5	-7.9
d) Invisible Balance/GDP (%)	5.1	5.7	4.6	5.9	5.8	6.1
e) Current Account Balance/GDP (%)	-0.3	-3.2	-2.8	-4.2	-4.7	-1.7
f) Net Capital Flows /GDP(%)	4.6	3.7	3.7	3.6	4.8	2.6
g) Reserve Changes (BoP basis) (US $ billion) [(Increase (-)/Decrease (+)]	-40.3	-6.6	-13.1	12.8	-3.8	-15.5
VI.2 External Debt Indicators						
a) External Debt Stock (US$ billion)	156.5	357.9	317.9	360.8	409.4	440.6
b) Debt-GDP Ratio (%)	17.7	20.4	18.2	20.5	22.0	23.3
c) Import cover of Reserves (in Months)	13.9	8.5	9.5	7.1	7.0	7.8
d) Short-term Debt to Total Debt (%)	13.6	21.2	20.4	21.7	23.6	20.3
e) Debt Service Ratio (%)	8.3	5.6	4.4	6.0	5.9	5.9
f) Reserves to Debt (%)	113.7	85	95.9	81.6	71.3	69.0
VI.3 Openness Indicators (%)						
a) Export plus Imports of Goods/GDP	30.4	40.2	37.4	43.0	43.5	41.8
b) Export plus Imports of Goods & Services/GDP	40.8	52.2	49.5	54.8	55.7	54.1
c) Current Receipts plus Current Payments/GDP	46.6	58.3	55.1	60.4	61.8	60.5
d) Gross Capital Inflows plus Outflows/GDP	36.8	49.5	55.2	47.3	46.0	51.9
e) Current Receipts & Payments plus Capital Receipts & Payments /GDP	83.5	107.7	110.3	107.8	107.8	112.5
VI.4 Exchange Rate Indicators						
a) Exchange Rate (Rupee/US Dollar)						
End of Period	43.1	51.1	44.6	51.2	54.4	60.1
Average	44.1	51.2	45.6	47.9	54.4	60.5
b) 36 - Currency REER (% change)	3.1^^	0.8	8.5	-2.1	-4.3	-2.2
c) 36 - Currency NEER (% change)	1.7^^	-4.9	2.9	-6.6	-10.4	-7.7
d) 6 - Currency REER (% change)	4.4^^	1.8	12.4	-2.7	-3.4	-3.7
e) 6 - Currency NEER (% change)	1.6^^	-5.4	5.5	-8.1	-10.5	-10.4

.. : Not Available.
~ : LAF outstanding as on March 31 (negative means injection).
$: Average daily outright trading turnover in central government dated securities.
@ : Central Government figures for 2013-14 pertain to provisional accounts.
@@ : State Government figures for 2013-14 pertain to revised accounts.
** : Data from 2012-13 onwards are provisional and pertain to budgets of 26 state governments out of which 5 are vote-on-account.
# : Average of 2009-10 to 2012-13.
~~ : Outstanding as on last Friday of the financial year.
* : Outstanding as on March 31.
^^ : Average of period 2005-06 to 2007-08

Note: Real Effective Exchange Rate (REER) are based on CPI.

APPENDIX TABLE 2 : GROWTH RATES AND COMPOSITION OF REAL GROSS DOMESTIC PRODUCT – SUPPLY and EXPENDITURE

(At 2004-05 Prices)

(Per cent)

Sector	Growth Rate					Share in real GDP			
	Average 2009-10 to 2013-14	2010-11	2011-12	2012-13*	2013-14#	2010-11	2011-12	2012-13*	2013-14#
1	2	3	4	5	6	7	8	11	12
	Supply Side GDP								
1. Agriculture, forestry and fishing	**4.1**	**8.6**	**5.0**	**1.4**	**4.7**	**14.6**	**14.4**	**13.9**	**13.9**
of which :									
Agriculture	4.1[@]	9.5	5.3	0.9	..	12.4	12.3	11.8	..
2. Industry	**5.2**	**8.3**	**6.7**	**0.9**	**-0.1**	**20.3**	**20.3**	**19.6**	**18.7**
of which :									
a) Mining and quarrying	1.8	6.5	0.1	-2.2	-1.4	2.2	2.1	2.0	1.9
b) Manufacturing	5.6	8.9	7.4	1.1	-0.7	16.2	16.3	15.8	14.9
c) Electricity, gas and water supply	5.6	5.3	8.4	2.3	5.9	1.9	1.9	1.9	1.9
3. Services	**7.7**	**9.2**	**7.1**	**6.2**	**6.2**	**65.1**	**65.3**	**66.4**	**67.4**
of which :									
a) Construction	5.2	5.7	10.8	1.1	1.6	7.6	7.9	7.7	7.4
b) Trade, hotels, transport and communication	7.0	12.2	4.3	5.1	3.0	27.3	26.7	26.9	26.4
d) Financing, insurance, real estate and business services	11.0	10.0	11.3	10.9	12.9	17.3	18.0	19.1	20.6
e) Community, social and personal services	6.3	4.2	4.9	5.3	5.6	12.9	12.7	12.8	12.9
4. Gross Domestic Product at factor cost	**6.7**	**8.9**	**6.7**	**4.5**	**4.7**	**100.0**	**100.0**	**100.0**	**100.0**
Expenditure Side GDP									
1. Private Final Consumption Expenditure	7.0	8.7	9.3	5.0	4.8	58.5	60.0	60.1	60.0
2. Government Final Consumption Expenditure	7.3	5.8	6.9	6.2	3.8	11.0	11.1	11.2	11.1
3. Gross Fixed Capital Formation	6.3	11.0	12.3	0.8	-0.1	33.5	35.3	33.9	32.3
4. Change in Stocks	12.3	44.7	-43.4	-9.0	1.6	3.9	2.1	1.8	1.7
5. Valuables[$]	20.2	32.4	6.6	35.8	-31.6	2.4	2.4	3.1	2.0
6. Net Exports	-5.8	-3.7	-39.9	-11.0	32.1	-6.6	-8.6	-9.1	-5.9
a) Exports	8.8	19.6	15.6	5.0	8.4	22.6	24.5	24.6	25.4
b) Less Imports	7.7	15.6	21.1	6.6	-2.5	29.2	33.1	33.7	31.3
7. Discrepancies	52.2	43.7	-18.9	-50.2	28.1	-2.8	-2.1	-1.0	-1.2
8. GDP at Market Prices	**7.0**	**10.3**	**6.6**	**4.7**	**5.0**	**100.0**	**100.0**	**100.0**	**100.0**

* : First Revised Estimate. #: Provisional Estimate. ..: Not Available.

@ : The absolute figures for the sub sector 'Agriculture' is yet to be released by CSO for the year 2013-14, hence the average pertains to 2009-10 to 2012-13

$: In the Indian national accounts, valuables (including gold, gems and jewellery) are treated as a separate category (*i.e.,* other than fixed capital formation and change in stocks). This is in line with the United Nations' System of National Accounts (SNA), 1993 and 2008.

Source: Central Statistics Office.

APPENDIX TABLE 3: INFLATION, MONEY AND CREDIT

(Per cent)

Inflation									
Consumer Price Index (2010=100) (All India)	**Rural**			**Urban**			**Combined**		
	Weight	**2012-13**	**2013-14**	**Weight**	**2012-13**	**2013-14**	**Weight**	**2012-13**	**2013-14**
1	2	3	4	5	6	7	8	9	10
General Index (All Groups)	**100.0**	**10.1**	**9.6**	**100.0**	**10.4**	**9.4**	**100.0**	**10.2**	**9.5**
Food, beverages and tobacco	59.3	11.7	11.1	37.2	12.1	11.0	49.7	11.8	11.1
Fuel and light	10.4	7.9	7.4	8.4	9.7	7.3	9.5	8.5	7.4
Housing	..	..	..	22.5	11.3	10.4	9.8	11.3	10.4
Clothing, bedding and footwear	5.4	10.9	9.5	3.9	10.9	8.9	4.7	10.9	9.3
Miscellaneous	24.9	7.2	6.7	28	7.5	7.0	26.3	7.3	6.8
Excluding Food and Fuel	33.0	8.0	7.3	55.8	9.4	8.6	42.9	8.7	8.1
Other Price Indices	**Weight**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
1. Wholesale Price Index (2004-05=100)									
All Commodities	**100.0**	**6.6**	**4.7**	**8.1**	**3.8**	**9.6**	**8.9**	**7.4**	**6.0**
Primary Articles	20.1	9.6	8.3	11.0	12.7	17.7	9.8	9.8	9.8
of which : Food Articles	14.3	9.6	7.0	9.1	15.3	15.6	7.3	9.9	12.8
Fuel and Power	14.9	6.5	0.0	11.6	-2.1	12.3	14.0	10.3	10.2
Manufactured Products	65.0	5.7	4.8	6.2	2.2	5.7	7.3	5.4	3.0
Non-Food Manufactured Products	55.0	5.7	5.0	5.7	0.2	6.1	7.3	4.9	2.9
2. CPI- Industrial Workers (IW)	**100.0**	**6.7**	**6.2**	**9.1**	**12.4**	**10.4**	**8.4**	**10.4**	**9.7**
of which : CPI- IW Food	46.2	9.2	8.4	12.3	15.2	9.9	6.3	11.9	12.3
3. CPI- Agricultural Labourers	**100.0**	**7.8**	**7.5**	**10.2**	**13.9**	**10.0**	**8.2**	**10**	**11.6**
4. CPI- Rural Labourers	**100.0**	**7.5**	**7.2**	**10.2**	**13.8**	**10.0**	**8.3**	**10.2**	**11.5**

Money and Credit								
	2006-07	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Reserve Money (M0)	23.9	31.0	6.4	17.0	19.1	3.6	6.2	14.4
Currency in Circulation	17.3	17.2	17.0	15.7	18.8	12.4	11.6	9.2
Bankers' Deposits with RBI	45.6	66.5	-11.3	21.0	20.2	-15.9	-10.0	34.0
Narrow Money (M1)	17.1	19.4	9.0	18.2	10.0	6.0	9.2	8.3
Broad Money (M3)	21.7	21.4	19.3	16.9	16.1	13.5	13.6	13.2
Currency-Deposit Ratio	17.9	17.2	16.8	16.5	17.0	16.8	16.4	15.8
Money Multiplier*	4.8	4.7	4.3	4.9	4.8	4.7	5.2	5.5
GDP/M3*	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Scheduled Commercial Banks								
Aggregate Deposits	23.8	22.4	19.9	17.2	15.9	13.5	14.2	14.1
Bank Credit	28.1	22.3	17.5	16.9	21.5	17.0	14.1	13.9
Non-food Credit	28.5	23.0	17.8	17.1	21.3	16.8	14.0	14.2
Credit-Deposit Ratio	73.9	73.9	72.4	72.2	75.7	78.0	77.9	77.8
Credit-GDP Ratio	45.0	47.4	49.3	50.1	50.6	51.2	52.0	52.8

*: Ratio. .. : Not Available.
Note: Data refer to y-o-y change in per cent unless specified otherwise.

APPENDIX TABLE 4: CAPITAL MARKET - PRIMARY AND SECONDARY

(Amount in ₹ billion)

Items	2012-13		2013-14	
	No of Issues	Amount	No of Issues	Amount
1	2	3	4	5
I. PRIMARY MARKET				
A. Prospectus and Rights Issues*				
1. Private Sector (a+b)	**54**	**161.0**	**70**	**116.8**
a) Financial	12	44.5	26	60.6
b) Non-Financial	42	116.5	44	56.2
2. Public Sector (a+b+c)	**14**	**147.6**	**20**	**439.7**
a) Public Sector Undertakings	3	1.9	5	105.7
b) Government Companies	0	0	1	37.0
c) Banks/Financial Institutions	11	145.7	14	297.0
3. Total (1+2, i+ii, a+b)	**68**	**308.7**	**90**	**556.5**
Instrument Type				
(i) Equity	48	138.8	55	132.7
(ii) Debt	20	169.8	35	423.8
Issuer Type				
(a) IPOs	32	49.4	38	12.4
(b) Listed	36	259.3	52	544.1
B. Euro Issues (ADRs and GDRs)	**5**	**10.4**	**1**	**1.2**
C. Private Placement&				
1. Private Sector (a+b)		**1,412.8**		**1,188.9**
a) Financial		865.7		859.8
b) Non-Financial		547.1		329.0
2. Public Sector (a+b)		**1,889.2**		**2,710.4**
a) Financial		1,376.5		1,759.3
b) Non-Financial		512.7		951.1
3. Total (1+2, i+ii)		**3,302.0**		**3,899.2**
(i) Equity		66.8		272.1
(ii) Debt		3,235.3		3,626.4
D. Qualified Institutional Placement$	**45**	**160.0**	**17**	**136.6**
E. Mutual Funds Mobilisation (Net)#		**765.4**		**537.8**
1. Private Sector		637.9		488.4
2. Public Sector		127.5		49.4
II. SECONDARY MARKET				
BSE				
BSE Sensex: End-Period		18,835.8		22,386.3
Period Average		18,202.1		20,120.1
Price Earning Ratio@		16.9		18.3
Market Capitalisation to GDP ratio (%)		63.2		65.3
Turnover Cash Segment		5,487.7		5,216.6
Turnover Derivatives Segment		71,635.8		92,194.3
NSE				
S&P CNX Nifty: End-Period		5,682.6		6,704.2
Period Average		5,520.3		6,009.5
Price Earning Ratio@		17.6		18.9
Market Capitalisation to GDP ratio (%)		61.7		64.1
Turnover Cash Segment		27,082.8		28,084.9
Turnover Derivatives Segment		315,330.0		382,114.1

*: Excluding Offer for sale. -: Nil/Negligible. @: As at end of the period. #: Net of redemptions.
&: Provisional. $: Includes resource mobilisation from Institutional Placement Programme also.
Source: SEBI, NSE, BSE and various merchant bankers.

APPENDIX TABLE 5: KEY FISCAL INDICATORS

(As per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Primary Revenue Deficit	Gross Fiscal Deficit	Outstanding Liabilities@	Outstanding Liabilities$
1	2	3	4	5	6	7
Centre						
1990-91	3.9	3.2	-0.5	7.6	53.7	59.6
1995-96	0.8	2.4	-1.7	4.9	49.4	57.3
2000-01	0.9	3.9	-0.6	5.5	53.9	59.4
2007-08	-0.9	1.1	-2.4	2.5	56.9	58.9
2008-09	2.6	4.5	1.1	6.0	56.1	58.6
2009-10	3.2	5.2	1.9	6.5	54.5	56.3
2010-11	1.8	3.2	0.2	4.8	50.5	52.1
2011-12	2.7	4.4	1.4	5.7	50.0	51.7
2012-13	1.8	3.6	0.5	4.8	50.1	51.7
2013-14 RE	1.3	3.3	-0.1	4.6	49.2	50.9
2013-14 PA	1.2	3.2	-0.2	4.5	-	-
2014-15 BE	0.8	2.9	0.0	4.1	48.3	49.8
States*						
1990-91	1.7	0.9	-0.6	3.2	21.9	21.9
1995-96	0.7	0.7	-1.1	2.5	20.3	20.3
2000-01	1.7	2.5	0.2	4.0	27.3	27.3
2007-08	-0.5	-0.9	-2.9	1.5	26.6	26.6
2008-09	0.6	-0.2	-2.1	2.4	26.1	26.1
2009-10	1.2	0.5	-1.3	2.9	25.5	25.5
2010-11	0.5	0.0	-1.6	2.1	23.5	23.5
2011-12	0.4	-0.3	-1.8	1.9	22.1	22.1
2012-13	0.4	-0.2	-1.7	1.9	21.7	21.7
2013-14 RE	0.9	0.0	-1.6	2.4	21.5	21.5
2014-15 BE	0.8	-0.4	-1.9	2.3	21.3	21.3
Combined*						
1990-91	4.9	4.1	-0.2	9.1	62.9	68.9
1995-96	1.5	3.1	-1.7	6.3	59.4	67.3
2000-01	3.5	6.4	0.6	9.2	68.2	73.7
2007-08	-1.2	0.2	-5.0	4.0	69.5	71.4
2008-09	3.3	4.3	-0.8	8.3	69.7	72.2
2009-10	4.5	5.7	2.4	9.3	68.8	70.6
2010-11	2.4	3.2	-1.3	6.9	64.0	65.5
2011-12	3.2	4.1	-0.4	7.6	63.5	65.2
2012-13	2.3	3.4	-1.1	6.8	63.9	65.4
2013-14 RE	2.2	3.2	-1.6	7.0	63.7	65.4
2014-15 BE	1.7	2.6	-2.2	6.4	63.4	64.9

–: Not available. RE: Revised Estimates. BE: Budget Estimates. PA: Provisional Accounts.
*: Data from 2012-13 onwards are provisional and pertain to budgets of 26 state governments out of which 5 are Vote on Account.
@: Includes external liabilities of the centre calculated at historical exchange rates.
$: Includes external liabilities of the centre calculated at current exchange rates.

Note: 1. Data on combined deficit/liabilities indicators are net of inter-governmental transactions between the centre and the state governments *viz.*, (a) NSSF investment in state governments special securities (b) Loans and advance by the centre to states and (c) State governments' investment in centre's treasury bills.
2. Negative sign (-) indicates surplus in deficit indicators.

Source: Budget documents of the central and state governments.

APPENDIX TABLE 6: COMBINED RECEIPTS AND DISBURSEMENTS OF THE CENTRAL AND STATE GOVERNMENTS

(Amount ₹ billion)

Item	2009-10	2010-11	2011-12	2012-13	2013-14 RE	2014-15 BE
1	2	3	4	5	6	7
1 Total Disbursements	**18,521.2**	**21,451.5**	**24,217.7**	**26,832.0**	**31,781.6**	**35,399.9**
1.1 Developmental	10,628.1	12,677.0	14,209.4	15,653.7	18,592.9	20,470.9
1.1.1 Revenue	8,513.0	10,260.2	11,394.6	12,741.5	14,954.7	16,055.9
1.1.2 Capital	1,868.4	1,935.8	2,163.4	2,424.6	3,153.3	4,008.4
1.1.3 Loans	246.7	480.9	651.3	487.6	484.8	406.6
1.2 Non-Developmental	7,687.3	8,520.5	9,695.9	10,821.0	12,703.7	14,400.1
1.2.1 Revenue	7,086.9	7,765.9	8,923.6	9,963.0	11,627.6	13,129.7
1.2.1.1 Interest Payments	3,145.7	3,485.6	4,000.0	4,538.2	5,496.2	6,129.8
1.2.2 Capital	594.1	747.5	754.8	835.9	1,054.0	1,230.5
1.2.3 Loans	6.3	7.0	17.5	22.2	22.1	39.9
1.3 Others	205.8	254.0	312.4	357.2	485.1	528.9
2 Total Receipts	**18,458.1**	**21,535.6**	**24,540.6**	**27,570.2**	**31,287.4**	**35,036.3**
2.1 Revenue Receipts	12,105.6	15,788.2	16,926.8	19,613.2	23,404.5	26,430.4
2.1.1 Tax Receipts	9,846.1	12,500.7	14,427.5	16,856.8	19,192.2	22,099.1
2.1.1.1 Taxes on commodities and services	5,580.7	7,393.7	8,745.6	10,383.5	11,770.7	13,615.6
2.1.1.2 Taxes on Income and Property	4,249.3	5,087.2	5,654.1	6,442.3	7,390.9	8,449.5
2.1.1.3 Taxes of Union Territories (Without Legislature)	16.1	19.8	27.9	30.9	30.7	34.0
2.1.2 Non-Tax Receipts	2,259.5	3,287.5	2,499.3	2,756.5	4,212.2	4,331.3
2.1.2.1 Interest Receipts	257.5	250.8	288.7	354.9	359.6	358.7
2.2 Non-debt Capital Receipts	368.9	322.9	441.2	388.9	375.9	711.5
2.2.1 Recovery of Loans & Advances	115.0	82.1	253.7	128.9	112.9	63.9
2.2.2 Disinvestment proceeds	253.9	240.9	187.5	259.9	263.0	647.6
3 Gross Fiscal Deficit [1 - (2.1 + 2.2)]	**6,046.7**	**5,340.3**	**6,849.7**	**6,829.9**	**8,001.3**	**8,258.0**
3A Sources of Financing: Institution-wise						
3A.1 Domestic Financing	5,936.3	5,104.8	6,725.2	6,757.9	7,946.8	8,200.6
3A.1.1 Net Bank Credit to Government	3,918.5	3,147.1	3,898.3	3,352.8	3,295.9	..
3A.1.1.1 Net RBI Credit to Government	1,500.1	1,849.7	1,391.8	548.4	1,081.3	..
3A.1.2 Non-Bank Credit to Government	2,017.8	1,957.7	2,826.9	3,405.1	4,650.9	..
3A.2 External Financing	110.4	235.6	124.5	72.0	54.4	57.3
3B Sources of Financing: Instrument-wise						
3B.1 Domestic Financing	5,936.3	5,104.8	6,725.2	6,757.9	7,946.8	8,200.6
3B.1.1 Market Borrowings (net)	5,070.2	4,151.7	6,195.1	6,383.5	6,401.6	6,898.4
3B.1.2 Small Savings (net)	-374.6	-545.3	190.9	-85.7	-121.4	-34.3
3B.1.3 State Provident Funds (net)	355.4	362.4	334.3	312.3	253.8	353.0
3B.1.4 Reserve Funds	-155.7	35.6	178.5	-4.1	58.3	-153.5
3B.1.5 Deposits and Advances	175.7	342.9	122.1	27.2	78.9	61.3
3B.1.6 Cash Balances	63.1	-84.2	-322.9	-738.3	494.3	363.6
3B.1.7 Others	802.3	841.6	27.2	863.0	781.3	712.2
3B.2 External Financing	110.4	235.6	124.5	72.0	54.4	57.3
4 Total Disbursements as per cent of GDP	*28.6*	*27.5*	*26.9*	*26.5*	*28.0*	*27.5*
5 Total Receipts as per cent of GDP	*28.5*	*27.6*	*27.2*	*27.3*	*27.6*	*27.2*
6 Revenue Receipts as per cent of GDP	*18.7*	*20.3*	*18.8*	*19.4*	*20.6*	*20.5*
7 Tax Receipts as per cent of GDP	*15.2*	*16.0*	*16.0*	*16.7*	*16.9*	*17.2*
8 Gross Fiscal Deficit as per cent of GDP	*9.3*	*6.9*	*7.6*	*6.8*	*7.0*	*6.4*

..: Not Available.

Note: 1. Data for states from 2012-13 onwards are provisional and pertain to budgets of 26 state governments (excluding Arunachal Pradesh and Mizoram) out of which 5 are Vote on Account.

2. GDP data for 2013-14 and 2014-15 are Provisional Estimates and Budget estimates, respectively.

Source: Budget documents of central and state governments.

APPENDIX TABLE 7: INDIA'S OVERALL BALANCE OF PAYMENTS

(US $ million)

	2007-08	2008-09	2009-10	2010-11	2011-12 P	2012-13P	2013-14P
1	2	3	4	5	6	7	8
A. CURRENT ACCOUNT							
1 Exports, f.o.b.	166,163	189,001	182,442	256,159	309,774	306,581	318,607
2 Imports, c.i.f.	257,630	308,521	300,644	383,481	499,533	502,237	466,216
3 Trade Balance	-91,467	-119,521	-118,203	-127,322	-189,759	-195,656	-147,609
4 Invisibles, Net	75,730	91,603	80,022	79,269	111,604	107,493	115,212
a) 'Non-Factor' Services of which :	38,853	53,916	36,016	44,081	64,098	64,915	72,965
Software Services	36,942	43,736	48,237	50,905	60,957	63,504	66,958
b) Income	-5,068	-7,110	-8,038	-17,952	-15,988	-21,455	-23,028
c) Private Transfers	41,707	44,566	51,791	53,125	63,469	64,342	65,481
5 Current Account Balance	-15,738	-27,917	-38,181	-48,053	-78,155	-88,163	-32,397
B. CAPITAL ACCOUNT							
1 Foreign Investment, Net (a+b)	43,326	8,342	50,362	42,127	39,231	46,711	26,386
a) Direct Investment	15,893	22,372	17,966	11,834	22,061	19,819	21,564
b) Portfolio Investment	27,433	-14,031	32,396	30,293	17,170	26,891	4,822
2 External Assistance, Net	2,114	2,439	2,890	4,941	2,296	982	1,032
3 Commercial Borrowings, Net	22,610	7,860	2,000	12,160	10,344	8,485	11,777
4 Short Term Credit, Net	15,930	-1,986	7,558	12,034	6,668	21,657	-5,044
5 Banking Capital of which :	11,759	-3,246	2,083	4,962	16,226	16,570	25,449
NRI Deposits, Net	179	4,291	2,922	3,238	11,918	14,842	38,892
6 Rupee Debt Service	-121	-101	-97	-68	-79	-58	-52
7 Other Capital, Net @	10,969	-5,918	-13,162	-12,416	-6,929	-5,047	-10,761
8 Total Capital Account	106,585	7,396	51,634	63,740	67,755	89,300	48,787
C. Errors & Omissions	1,317	440	-12	-2,636	-2,432	2,689	-882
D. Overall Balance [A(5)+B(8)+C]	92,164	-20,080	13,441	13,050	-12,831	3,826	15,508
E. Monetary Movements (F+G)	-92,164	20,080	-13,441	-13,050	12,831	-3,826	-15,508
F. IMF, Net							
G. Reserves and Monetary Gold (Increase -, Decrease +) of which : SDR allocation	-92,164	20,080	-13,441	-13,050	12,831	-3,826	-15,508
Memo: As a ratio to GDP							
1 Trade Balance	-7.4	-9.8	-8.7	-7.5	-10.1	-10.5	-7.9
2 Net Services	3.1	4.4	2.6	2.6	3.4	3.5	3.9
3 Net Income	-0.4	-0.6	-0.6	-1.1	-0.9	-1.2	-1.2
4 Current Account Balance	-1.3	-2.3	-2.8	-2.8	-4.2	-4.7	-1.7
5 Capital Net (Excld. changes in reserves)	16.0	-1.0	4.8	4.5	2.9	5.0	3.4
6 Foreign Investment, Net	3.5	0.7	3.7	2.5	2.1	2.5	1.4

P: Provisional. PR: Partially Revised. R: Revised.

@: Includes delayed export receipts, advance payments against imports, net funds held abroad and advances received pending issue of shares under FDI.

Note: 1. Gold and silver brought by returning Indians have been included under imports, with a contra entry in private transfer receipts.
2. Data on exports and imports differ from those given by DGCI&S on account of differences in coverage, valuation and timing.

APPENDIX TABLE 8: FOREIGN DIRECT INVESTMENT FLOWS TO INDIA: COUNTRY-WISE AND INDUSTRY-WISE

(US $ million)

Source/Industry	2009-10	2010-11	2011-12 P	2012-13 P	2013-14 P
1	2	3	4	5	6
Total FDI	**22,461**	**14,939**	**23,473**	**18,286**	**16,054**
Country-wise Inflows					
Mauritius	9,801	5,616	8,142	8,059	3,695
Singapore	2,218	1,540	3,306	1,605	4,415
U.S.A	2,212	1,071	994	478	617
Cyprus	1,623	571	1,568	415	546
Japan	971	1,256	2,089	1,340	1,795
Netherlands	804	1,417	1,289	1,700	1,157
United Kingdom	643	538	2,760	1,022	111
Germany	602	163	368	467	650
UAE	373	188	346	173	239
France	283	486	589	547	229
Switzerland	96	133	211	268	356
Hong Kong SAR	137	209	262	66	85
Spain	125	183	251	348	181
South Korea	159	136	226	224	189
Luxembourg	40	248	89	34	539
Others	2374	1184	983	1540	1,249
Sector-wise Inflows					
Manufacture	5,143	4,793	9,337	6,528	6,381
Construction	3,516	1,599	2,634	1,319	1,276
Financial Services	2,206	1,353	2,603	2,760	1,026
Real Estate Activities	2,191	444	340	197	201
Electricity and other Energy Generation, Distribution & Transmission	1,877	1,338	1,395	1,653	1,284
Communication Services	1,852	1,228	1,458	92	1,256
Business Services	1,554	569	1,590	643	521
Miscellaneous Services	888	509	801	552	941
Computer Services	866	843	736	247	934
Restaurants & Hotels	671	218	870	3,129	361
Retail & Wholesale Trade	536	391	567	551	1,139
Mining	268	592	204	69	24
Transport	220	344	410	213	311
Trading	198	156	6	140	0
Education, Research & Development	91	56	103	150	107
Others	384	506	419	43	293

P : Provisional.
Note : Includes FDI through SIA/FIPB and RBI routes only.