A Study on Economic Performance, after a new RBI Governor Ride

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Abstract
The RBI announced its first bi-monthly monetary policy and kept its policy interest rate unchanged, as expected. The RBI kept its repo rate at 8%, reverse repo rate at 7%, bank rate and marginal standing facility rate at 9%. In addition RBI did not touch the reverse ratios, CRR at 4% and SLR at 23%.

The RBI clearly indicated that its policies will be inflation focused, especially on CPI. The RBI clearly stated that it was intending to target 8% CPI inflation by January 2015 and 6% by January 2016. Keeping that in focus and the current inflation, the RBI decided to left the rate unchanged. Besides, RBI clarified that if the inflation remained with envisioned targets, it would not tighten the policy in near term. After taking charge as Governor of RBI, Raghuram Rajan has brought a drastic change in the Economy. His monetary policies have responded as he had expected. During a span of six month the fundamentals of economy have started performing well because of monetary policy formulated by RBI. This paper focuses on the monetary policy formulated by the new RBI governor and their impact on the key fundamental of economy.

Raghuram Rajan took over as the new Governor of the Reserve Bank of India (RBI) on 4th September 2013. Mr. Rajan, 50, an economics professor who also served as chief economist at the International Monetary Fund, took charge from the outgoing Governor Dr. Subbarao. New RBI Governor Raghuram Rajan came out with a slew of measures, including more trade settlement in Indian rupees to rescue the battered financial markets and hinted at a shift in focus from inflation control, doggedly pursued by his predecessor, to boosting growth. Shortly after he took over as the 23rd Governor of the reserve Bank of India (RBI), Raghuram Rajan, addressed the media with a prepared statement in which he laid out a detailed road map for his innings in the short term, which he called a "big initial package."

He had his guns ready and fired right away on the day he took over. He endorsed transparency and financial stability in addition to issues related to inclusive growth and development. A range of measures were announced that included elimination of license requirements for new bank branches, appointment of committee to assess RBI’s approach to financial inclusion, allowing rebooking of cancelled forward exchange contracts by exporters and importers, issue of cash settled ten year interest rate future contracts, interest rate futures on overnight interest rates, special concessional window for swapping FCNR (B) dollars, increase in foreign borrowing limit of banks to 100 per cent of unimpaired Tier I capital, etc.

On Financial Infrastructure front, he expressed an intention to implement Electronic Bill Factoring Exchanges to facilitate prompt bill payment facility to Micro Small and Medium Enterprises (MSMEs). He acknowledged the need to have Debt Recovery Tribunals and Asset Reconstruction Companies for efficient loan recoveries.

For households, the governor announced that they will issue Inflation Indexed Savings Certificates, come out with national GIRO-based Bill Payment System to facilitate bill payments any time, start mini ATMs operated by non-bank entities for better financial access.
Five pillars’ to strengthen banking system

Reserve Bank of India Governor Raghuram Rajan unveiled his five-point plan to overhaul the RBI's developmental measures over the next few quarters.

1. Clarifying and strengthening the monetary policy framework.
2. Strengthening banking structure through new entry, branch expansion, encouraging new varieties of banks, and moving foreign banks into better regulated organisational forms.
3. Broadening and deepening financial markets and increasing their liquidity and resilience so that they can help allocate and absorb the risks entailed in financing India’s growth.
4. Expanding access to finance to small and medium enterprises, the unorganised sector, the poor, and remote and underserved areas of the country through technology, new business practices, and new organisational structures; that is, we need financial inclusion.
5. Improving the system’s ability to deal with corporate distress and financial institution distress by strengthening real and financial restructuring as well as debt recovery.

Key Financial Indicators after Raghuram Rajan’s taking over
(From Sep-2013 to April-2014)

These measures were well received by markets as the key economic indicators improved swiftly. Depreciating rupee that had been a cause of concern for some time, gained considerably from a low of Rs 68 per dollar on August 2013, 62.58 per dollar on September 2013 and 60.36 on April 2014.

Sensex rode on investor expectations of favourable policies by the RBI and rallied to 19,379.77 points in September 2013, eventually crossing the psychological mark of 20,000 points and reached 22,417.8 points in August 2014. Forex reserves also remained stable during the time. Gold imports remained low at 7 tons in September 2013 and imports of just 4.5 metric tonnes (MT) in April, lowest for April in the last six years helping India's current account deficit. Wholesale price index (WPI) inflation cooled off quite significantly for the month of February 2014. It came in at a 9 month low and in fact cooled off to 4.68 percent versus 5.1 percent on a month-on-month basis and 5.7 in March 2014.

Rajan maintained that controlling inflation was important which eventually provided a growth environment pretty much in line with his predecessor’s line of thinking. He made up for the increase in interest rate to some extent by rolling back the rate on Marginal Standing Facility (MSF rate is the rate at which the RBI lends emergency funds to the banks) to 9.5 per cent from 10.25 per cent earlier0020(it helped reduce the cost of funds to banks and hence their lending rates).
The current account deficit narrowed to USD 26.9 billion (3.1 percent of GDP) in the first half (April-September) of 2013-14 from USD 37.9 billion (4.5 percent of GDP) in the first half of 2012-13. It was down to USD 4.2 billion (0.9 percent of GDP) in Q3 from USD 31.9 billion (6.5 percent of GDP) a year earlier as merchandise exports picked up and imports moderated, particularly gold imports. Since, recently the government had cleared various stalled projects, their implementation would promote the growth. In addition the world economy is improving, inevitably the export will improve. RBI projected the GDP for 2013-14 little below 5% and expecting to accelerate to 5-6% in 2014-15; considering the various downside risks RBI is expecting it to be 5.5%. Further RBI is confident that CAD would be 2% of GDP for whole year, which was a nuisance for RBI and Government since last year. The pervious monetary and fiscal policies had paid off and, RBI and Government able to contain the CAD.

The RBI has set five pillars framework to guide its development and regulatory measures.

- RBI has adopted some of the recommendations of Dr. Urijit R. Patel Committee report, including the acceptance of the CPI (Combined) for the primary measure of inflation, bi-monthly monetary policy review etc.
- RBI has also stated that it would work to give licences more regularly and set different categories of bank licences that would attract more participants.
- RBI has also increased the limit for individuals and trusts in Inflation Indexed Bond to attract the general public. Banks are allowed to offer partial credit enhancements to corporate bondholders. In addition, the RBI would allow Foreign Portfolio Investors to hedge their currency risks through exchange traded currency futures after consulting SEBI. RBI has also simplified the KYC norms for Foreign Portfolio Investors.
- The RBI has proposed to construct a comprehensive consumer protection regulations based on domestic experience and international best practices. RBI has also stated that banks should no levy penalty for not maintaining the minimum balance in saving account and inoperative accounts.
- RBI had issued a framework to revitalize distressed assets in the economy in January 2014. The framework included the guidelines for early recognition of financial distress, steps for resolution and recovery from lenders.

In its Macroeconomic and Monetary Developments report for FY15, the RBI indicated that growth seems to be recovering as the twin deficits (fiscal and current account) have narrowed and the currency has stabilised meaningfully.

In the last three months, headline inflation has cooled off significantly due to softening food prices, but vegetable prices are unlikely to ease further as they approach the end of a seasonal correction. However, sticky core inflation holds upside risks due to fuel hikes, high wages and supply chain bottlenecks, which is likely to hurt growth levels.

The RBI has implemented the Urjit Patel Committee’s recommendation to make CPI the nominal anchor for inflation, but anticipates several risks to the 8% target set forth for Jan’15.

The RBI policy seems to corroborate the broad market view that economic stability is dependent on macroeconomic rebalancing backed by coordinated quality fiscal and monetary policies. While the recent deceleration in inflation, gain in INR and lower CAD provide optical relief, we believe, it is still early to reverse gear on policy rates and any further action on interest rates would depend on sustainability of recent INR appreciation and equity market buoyancy would need to be reassessed once the elections are over.

Overall, we believe that RBI will ensure higher real interest rates and hence, we see limited scope for monetary policy easing in the very near term. We hence expect the RBI to hold interest rates for a longer period of time, possibly for the next 6 to 12 months.
Conclusion:
The Government has acted well in trying to reduce our current account deficit. The RBI has instilled confidence in the market about our exchange rate. There’s stability and volatility is much less. Thus, we hope that as far as CAD is concerned we will remain in a reasonable bound. It is in a much better shape than what it was around 7-8 months ago.

In this short span of time, Raghuram Rajan has introduced/announced many initiatives, most of them yielding positive reactions from markets. Whether this is first aid or permanent solution, is too soon to tell.

The RBI could make price stability its main objective, thus making clear inflation will be its priority although the central bank is expected to retain its current objectives of supporting growth and financial stability.

Reference:
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