

Money and Capital Markets

Policy developments

In recent months, the Reserve Bank (RBI) has been relying on the surprise element in its combat against inflation. The latest manifestation was the unanticipated announcement of Saturday, March 30, 2007, increasing the Repo Rate by 25 basis points along with a hike of 0.5 percentage point in the Cash Reserve Ratio (CRR), to be effective in two instalments. This was done even as the annual policy announcement on money and credit was around the corner, possibly to avoid stock market reactions. With that, the Repo Rate reached 7.75 per cent, while the Reverse Repo Rate was maintained at 6 per cent. Thus, the spread is now further widened. This is an explicit message to commercial banks: increase the cost of lending.

With this, the Repo Rate has been increased by 200 basis points and the Reverse Repo by 125 basis points from the respective levels of 5.75 and 4.75 of April 29, 2005, i.e., the beginning of the tightening cycle. Meanwhile, the CRR is slated for a hike to 6.25 per cent beginning April 14, 2007 and to 6.50 with effect from April 28 2007. In effect, interest rates are expected to soar, affecting particularly the housing portfolio of the banking sector.

It is important to realise the effects on the housing sector. Not only interest rates are higher, but the policy also requires banks to maintain additional reserves against housing loans. The 180-

month floating rate loans, which were given to most worthy borrowers at the rate of 7.5 per cent in 2004-05, have now got to be repaid in 451 instalments at around 11 per cent rate of interest. The consequences are huge, both for borrowers and lenders. The effects could only be neutralised if floating rates went below the 7.5 per cent-mark, and stayed there for a substantial period.

However, the accelerating inflation has defied all the firepower of the monetary policy. To control spiralling prices, the government had no option but take recourse to fiscal measures like oil price cuts and slashing import duties and moral suasion during the final quarter of 2006-07. That was but unavoidable because, the inflation was largely supply-driven.

The adverse effect of monetary tightening is likely to appear through inadequate expansion of potential capacity, leading to further rise in prices. This is all the more possible, given the infrastructure constraints and acceleration in remittances.

Between June 2005 and June 2006, core inflation was pretty much below 3 per cent. In fact it stayed below 4 per cent till September 2006, notwithstanding the rising rate of inflation (Figure M1) in the mineral oil and food segments. However, it began to inch up steadily after April 2005 when monetary tightening was introduced. Now it has caught up with

headline inflation. The build-up in core inflation could be caused by the lagged effect of oil price inflation and supply constraints - overheating is an unlikely factor. The world oil price rise has now slowed down and there is a large content of the base effect in the month-to-month annual inflation rate. Therefore, even without monetary intervention, the next few months could have witnessed some stability in inflation.

The financial year is likely to end with an average headline wholesale price index (WPI) inflation of 5.5 per cent, which was 5.3 per cent until February 2007 (Fig-

ures M.2).

Periodic interest rate hikes have led to deceleration in the growth of consumption expenditure. This is reflected in the slow-down of the growth of the Index of Industrial Production for consumer goods. This is also apparent in the recent melt-down in manufacturing stock prices. Now, the growth of capital goods too is slowing down. In fact it became negative (Fig M.3) in January 2007 on a Y-o-Y basis. With increasing cost of capital and possible fall in consumption, industry would be hit by low profitability, which is detrimental to sus-

Table M.1: Changes in Monetary Aggregates and their Components

	Stock	Annual Growth			Quarterly Growth		Monthly Growth	
	(Rs. crores)	(end of period)	(end of period)	(end of period)	(Y-o-Y, end of period)	(Y-o-Y, end of period)	(Y-o-Y, end of period)	(Y-o-Y, end of period)
	Feb-07	Mar-04	Mar-05	Mar-06	2005-06 Q3	2006-07 Q3	Feb-06	Feb-07
1. Reserve Money	669883	18.32	12.06	17.15	14.07	20.45	18.37	21.30
2. Narrow Money	920854	21.76	12.07	27.69	22.08	17.55	24.19	19.66
3. Broad Money	3142001	16.60	12.52	21.10	17.56	19.35	16.18	21.84
4. Major Components								
(a) Currency in Circulation	498105	15.91	12.66	16.78	15.83	17.35	17.98	17.62
(b) Currency with the Public	482332	16.17	12.77	16.13	15.50	16.98	17.52	17.31
(c) Demand Deposit	438522	29.29	11.23	41.86	30.69	18.20	32.84	22.35
(d) Time Deposit	2221147	14.63	12.70	18.45	16.06	20.09	13.33	22.76
(e) Other Deposit	4889	71.90	15.10	7.83	1.55	20.80	-5.10	-5.16
5. Major Sources of M3								
(a) NRBCG	-32	-62.61	-140.03	-238.17	-176.75	242.32	1315.22	-100.13
(b) NBCG	808701	25.91	10.75	-3.82	7.35	0.18	0.33	7.46
(c) BCC	2009932	13.23	25.80	27.29	25.57	26.74	27.80	26.74
(d) NFEA of Banking sector	879140	33.75	23.30	9.95	12.83	14.31	7.63	32.95
6. Major Sources of M0	0	0.00	0.00	0.00	0.00	0.00	0.00	0.00
(a) NFEA with RBI	852997	37.80	24.14	9.82	8.64	27.24	6.71	36.31
(b) Net Domestic assets	-183114	-634.63	116.42	-19.18	17.89	-73.30	38.67	-149.00
7. Ratios								
(a) M3/M0	4.68	4.59	4.61	4.76	4.72	4.68	4.67	4.69
(b) M1/M0	1.34	1.32	1.32	1.44	1.38	1.34	1.39	1.37
(c) Deposit/RM	3.97	3.88	3.89	4.05	4.00	3.97	3.93	3.98
(d) NFEA (RBI)/RM	1.21	1.13	1.25	1.17	1.15	1.21	1.13	1.27
(e) NFEA (RBI)/CC	1.64	1.51	1.66	1.56	1.51	1.64	1.48	1.71
(f) NBCG/M3	0.25	0.35	0.34	0.27	0.30	0.25	0.29	0.26
(g) NBCC/M3	0.64	0.51	0.57	0.60	0.60	0.64	0.61	0.64
(h) Credit/Deposit #	0.74	0.56	0.65	0.72	0.69	0.74	0.71	0.74
(h) Non-Food Credit/Deposit#	0.72	0.53	0.62	0.70	0.67	0.72	0.69	0.72

NFEA Net Foreign Exchange assets with RBI, NRBCG Net Reserve bank credit to government, NBCG Net other Bank credit to government, NBCC Net Bank credit to commercial sector. # Refers to Bank credit by commercial sector, includes food credit. All ratios are end period. Source: RBI

taining the investment cycle. In the absence of a sustained consumption and investment boom (Figure M3), the fear of the economy getting heated up was quite unfounded.

It is also doubtful whether the recent actions of the RBI have resulted in the curbing of inflationary expectations. The RBI lacks a credible way to find expected inflation independent of policy action, while the financial depth of the economy is still shallow. The increases in the Repo Rates have lifted the yield curves. The January 2007 curve is about two percentage points above the March 2005 curve (Figure M4) even at the longer end. Developments at the shorter ends are, however, a reflection of the recent auction of dated securities by the RBI.

The commercial banks delayed their reactions to the RBI's policy intervention. Finally, they responded by increasing the prime lending rates (Figure M5), although the call money rate acted quickly by making housing loans costlier. Banks started selling SLR (statutory liquidity ratio) securities and reduced the spread between the Deposits Rate and the PLR (possibly under competition) to meet the private sector's credit off-take. Since RBI uses credit off-take as one of the indicators of overheating, it was not satisfied with the slow tightening process, particularly with credit for the housing sector remaining strong. Therefore, the most direct instrument of CRR has been used. But, surprisingly, there has been no let-up in the growth of base money, which keeps the money multiplier almost constant (Table M.1) with little reduction since March 2006.

With accelerating PLR, the loans are expected to be more costly and less affordable for the poor and middle class. Rentals are likely to increase, to the detri-

ment of consumption expenditure.

The other reason for monetary tightening is, often, stated as the rise (Figure M6) in the international interest rate. This is even less convincing given the fact that the Indian economy is faced, on the one hand, with a problem of plenty in terms of its foreign exchange reserves, while, on the other, the outflow of capital is effectively controlled.

It may be noted that the short-term interest rate, which was inching towards harmony with the world interest rate, has reverted to its old divergence. The interest rate differentials are touching the levels struck during early 2005. In fact, the international rate, as indicated by LIBOR, has softened since June 2006 and is stable for the past few months. This, however, has put pressure on the rupee in recent months on a month to month (M-o-M) basis, making imports cheaper and exports less competitive.

Comparing the growth rates of monetary aggregates and the inflation during recent years, there is evidence of increase in the absorptive capacity of the economy. During 2006-07, the growth in real GDP was expected to lie between 8.5 and 9 per cent, compared to 9.1 per cent obtained last year with the investment rate estimated at about 33 per cent. This clearly means a fall in the incremental capital to output ratio (ICOR) from the previous years. With positive expectations about sustained high growth rate, the investment could pick up under a favourable policy environment. Therefore, the monetary authorities should be sensitive in delineating the effects on the supply and demand sides. Productivity growth could also have absorbed a part of the oil shock.

In conclusion, it appears that the negative effects of raising interest rates could outweigh the positive one of control-

ling inflation. The extent of the monetary policy's effectiveness in reducing inflation remains in doubt due to simultaneous action on several fronts, including those of high growth in reserve money while tightening the CRR.

Increases in inflation could also be attributed to the Y-o-Y softening of the Rupee against the Dollar, which, in turn, added to the oil price inflation in the domestic market, albeit with a positive spin off in terms of the impressive export growth. Both the six-country nominal exchange rates (NEER) as well as real exchange rate index (REER) continued to depreciate (Fig M.7) on an Y-o-Y basis. However, much of it would depend on the extent of sterilisation of foreign currency inflows.

With increasing interest rate differentials, the foreign exchange inflows would increase and the currency is likely to be stronger during early 2007-08.

Monetary Movements:

The Y-o-Y growth in broad money at the end of February 2007 was 21.8 per cent, as against 16.18 per cent obtained at the end of February 2006. During the same period, narrow money and reserve money grew by 19.66 and 21.3 per cent as against 24.19 and 18.37 (Table M.1 and Fig M.8). The growth rate of narrow money has fallen considerably and it would be helpful in containing inflationary pressure during 2007-08. However, the reserve money is growing at a relatively higher rate than the recent trend growth rates.

Net Reserve Bank Credit to the Government (NRBCG) has declined by 100 per cent as of February 2007, as against an increase of 242.3 per cent obtained at the end of Q3 of 2006-07. There was a significant increase of Rs 34,097 crore in NRBCG between Q3 of

2005-06Q3 and Q3 of 2006-07, while the net government borrowing from the commercial banks during this period was almost nil. But, as of February 2007, it has increased by 7.46 per cent on an Y-o-Y basis.

A reasonable domestic content is desired in the sources of reserve money supply from the point of view of conducting monetary policy. Therefore, RBI is justified in availing all the possible opportunities to accumulate domestic assets. However, high growth in reserve money for accommodating fiscal deficits is likely to create inflationary pressures during the months to come. A slower growth during Q3 of 2006-07, as compared to Q2 of 2006-07, was a welcome sign but it has accelerated during the fourth quarter.

Foreign exchange reserves (FER) touched \$196 billion on March 16, 2007 adding over \$44.34 billion to the stock of end-March 2006. Of this \$44.34 billion increase, \$18.7 billion was added during January-February 2007. In rupee terms, the Y-o-Y growth was 36.31 per cent in February 2007 as against 6.71 per cent recorded in February 2006. (Table M.1) The inflow, which has slowed down significantly due to the softening of the interest rate differential between domestic and international rates (Figure M6), has started posting higher growth. This was due in part to the base effects and also due to external commercial borrowings, the valuation effect and investments in banking capital and NRI deposits. Thus, foreign assets are again on the rise.

The foreign exchange assets of the banking sector as a whole increased by 32.95 per cent as of February 2007 on an Y-o-Y basis as against 7.63 per cent growth recorded in February 2006. The year 2006-07 began with 23.8 per cent growth during the first quarter but it

could not be sustained during the second and third quarters. However, it recovered during the fourth quarter with increasing interest rate differentials. Foreign exchange stock in the banking sector stood at Rs 8,79,140 crore at the end of February 2007, and each rupee in circulation is now backed by the equivalent of Rs 1.76 in foreign currency.

The net bank credit to the government (NBCG) is almost static on an Y-o-Y basis, as compared to an increase of 10.75 per cent recorded during 2004-05. With increased CRR, the liquidation of SLR securities by the banks could go up. If SLR limits are not revised in time, it could lead to increase in demand for government securities and consequent hikes in bond prices, affecting the balance sheet of the banks adversely. This will also distort the yield curve and send wrong signals.

On the other hand, the Y-o-Y growth in bank credit to the commercial sector (BCC) grew at 26.74 per cent during February 2007 compared to 27.80 per cent during February 2006. Similar growth was recorded during Q3 of 2006-07.

Liquidity concerns:

Commercial banks increasingly prefer higher liquidity levels. This tendency could have been caused by the need to meet the competition as well as deal with the uncertainty of financial demands created by sustained high economic growth rate (Figure 9). However, effective cash holdings stood at 6.8 per cent of time and demand liability as against the average of 5.625 per cent required by the CRR. One should note that these liquidities are created after selling government securities, because the growths in demand deposits have not kept pace with the credit off take.

Capital Market

The BSE Sensex experienced its much-awaited correction of 15.3 per cent between February 8 and March 5, 2007 after attaining a lifetime high level of 14,652 on

February 8, which was obtained by registering a growth of 123 per cent on Y-o-Y (Figure M10). The meltdown was supported by a correction of about 10 per cent in the composite index of emerging market economies between February 26 and March 5, 2007, which has broadly recovered since then. It may be noted that the Indian market had demonstrated significant resilience during January despite a net FII outflow of Rs 2,766 crore in December and Rs 1,682 crore in January (Figure 11), which had led to about 7 per cent correction during the second week of December. However, February ended with a net inflow of Rs 8,194 crore. Therefore, the February-March correction, which happened in spite of huge inflows, could be considered as more based on fundamental problems rather than sentiments. Tightening of monetary policy through direct instruments and the resultant hardening of interest rates across the board, with no sign of substantial softening in the inflationary trend, has caused much panic. Most affected stocks belong to manufacturing, metals, auto, PSU, and health care (Figures 12 & 13).

Threats of a ban on trading promissory notes and a hike in CRR, which could erode profitability of banking sector, are also responsible factors. The December correction was big but short-lived. However, a quick resurge is not healthy either. In fact, the correction in emerging market economies as a whole does not appear to be complete given the long rally during recent months.

In terms of growth, all the sectors have suffered heavily (Figures M12 and M13). The recent movements have led to increase in volatility and uncertainty. The P/E ratio is much above the long-term trend. Even if one argues in favour of improved sentiments and robustness, more corrections cannot be avoided. The patterns of peaks and trough indicate that the correction is not yet complete (Figure M10).

Figure M1: Headline WPI, oil price, food price and core (non-oil non-food) inflation

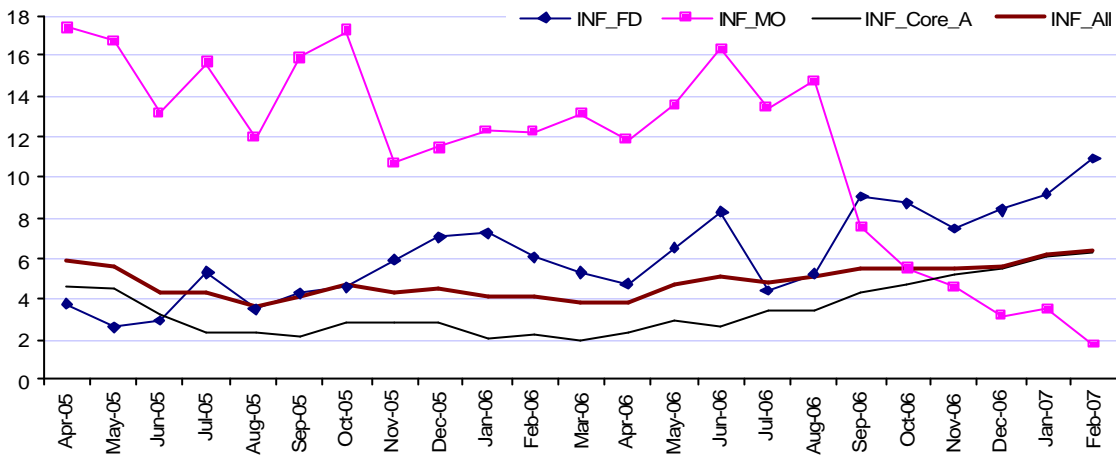
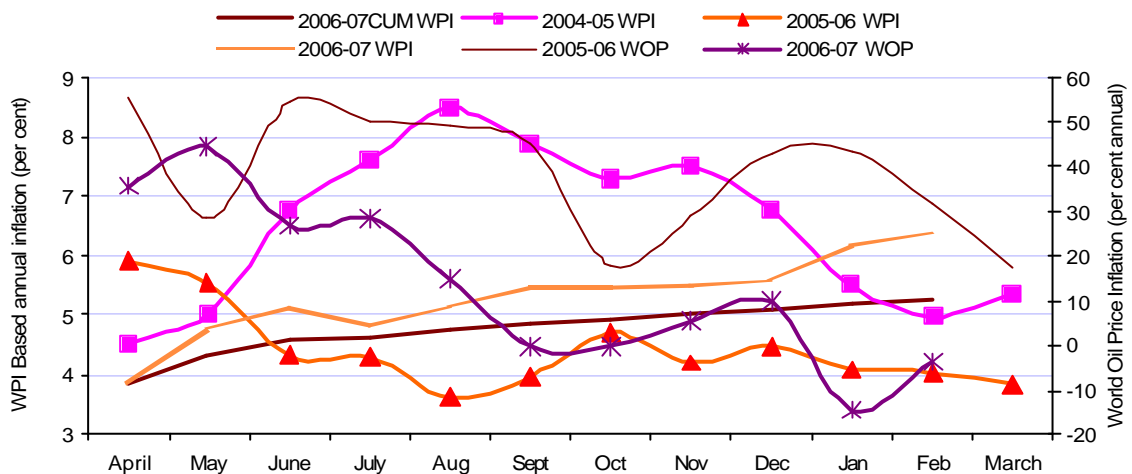
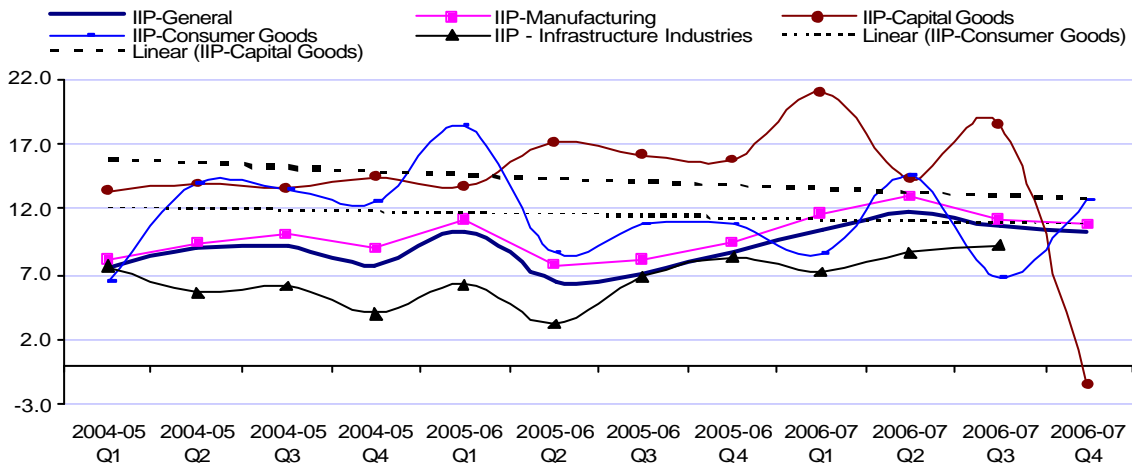


Figure 2: Monthly progress in headline WPI- Inflation during 2004-07



Note: CUM mean cumulative average inflation

Figure M3: Annual growth in selected segments of the index of industrial production



Note: 2006-07Q4 data contains one month information only

Fig M4: Month-end Yield to Maturity of SGL Transactions in Central Government Dated Securities for Various Residual Maturities

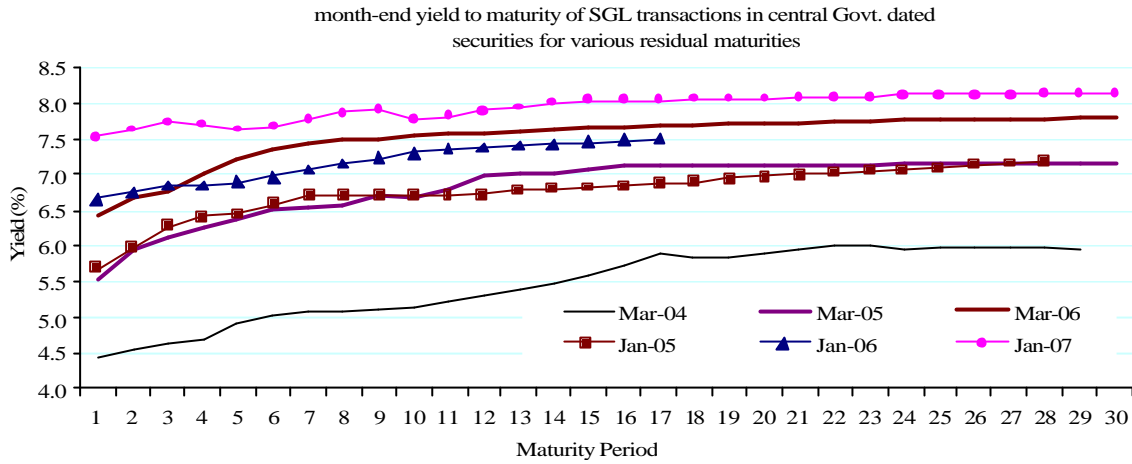


Fig M.5: Interest Rate Structure: PLR, Deposit Rate, 91 Day Treasury Bill Rates and Spread between PLR and Deposit Rate

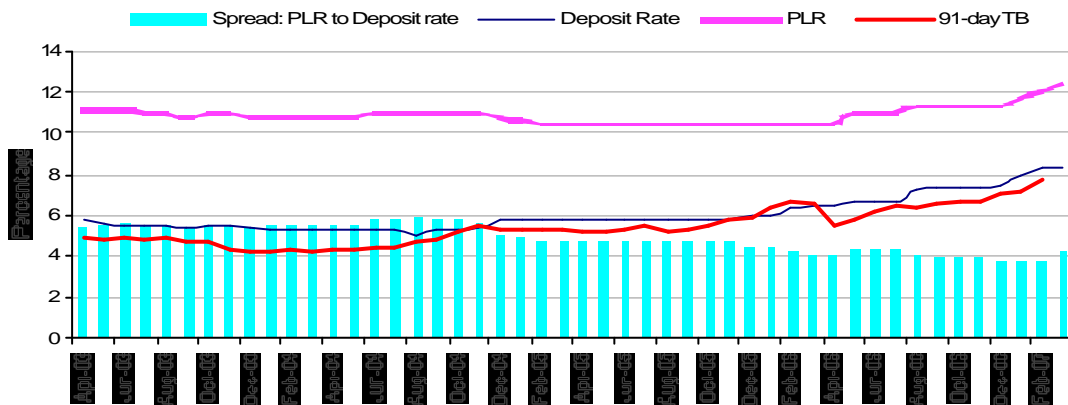


Figure M.6: Interest rate structure: 91-day Treasury bill rates and 3-month Libor rate and spread between them

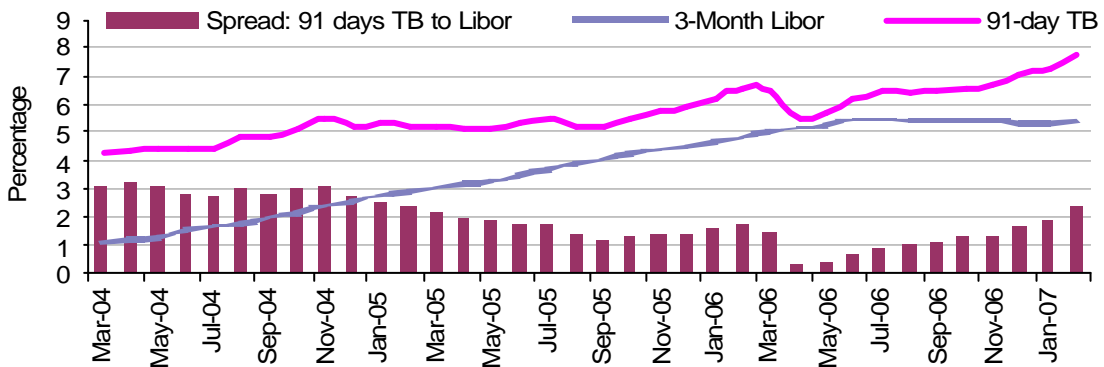


Fig M.7: REER and NEER (6-Country Bilateral Trade Weights) Base: 1993-94 (April-March) = 100

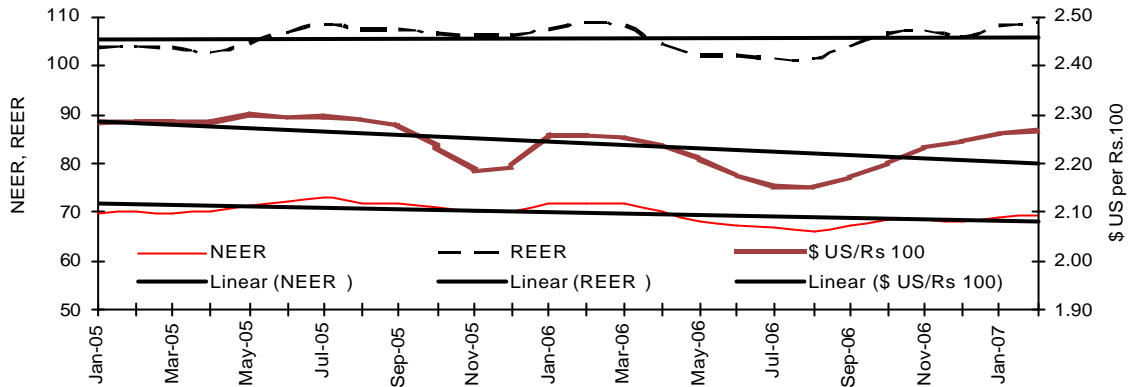


Fig M.8: Growth rates in monetary aggregates and WPI based inflation

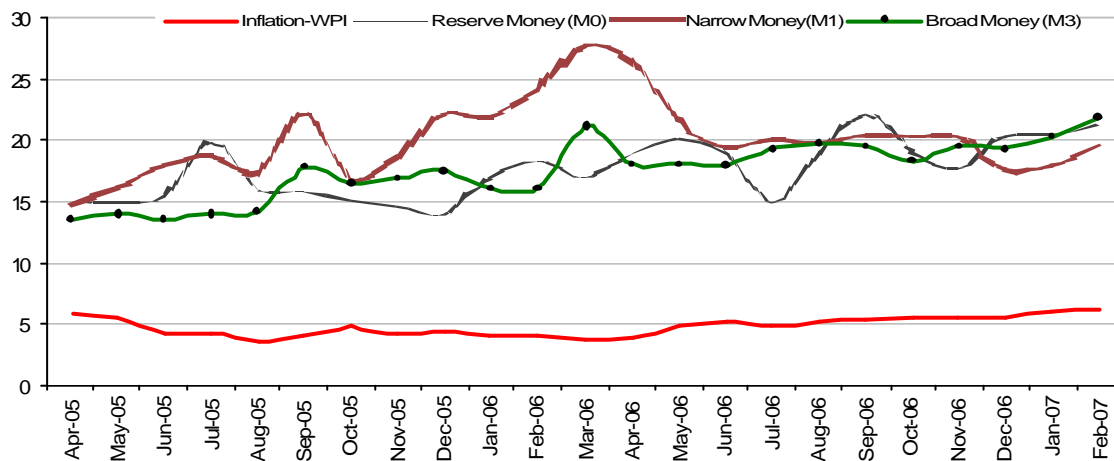
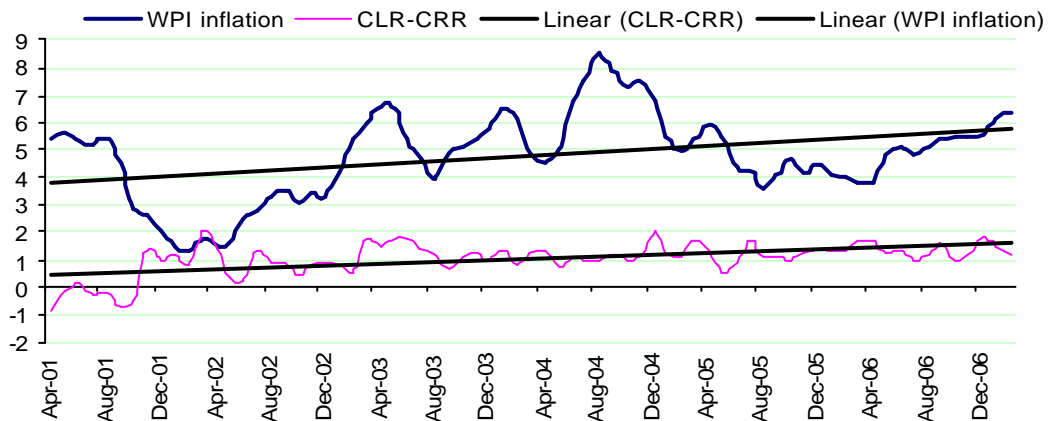


Fig M.9: Trend of liquidity holding against required rate of CRR and WPI based inflation



$$CLR = (\text{Cash in hand} + \text{Bankers Deposit with RBI}) / (\text{Time and Demand Deposits})$$

Fig M10: Movements in BSE Sensex (at close) and the P/E ratio

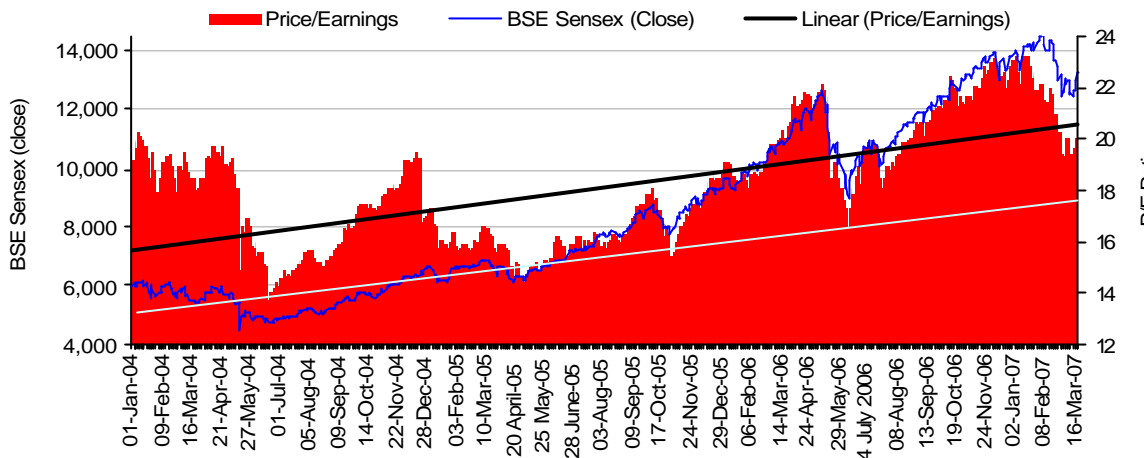


Fig M.11: FII investment and movements in Sensex

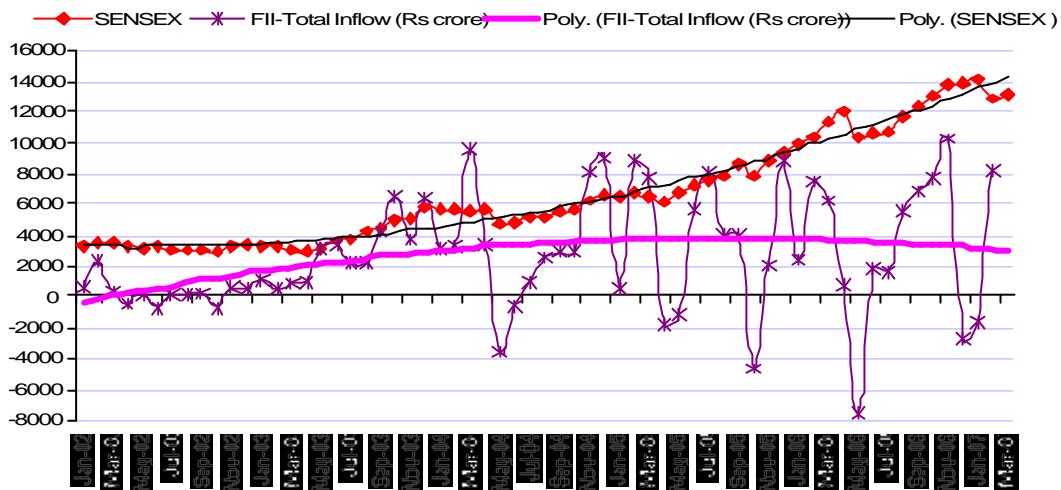


Fig M12: Group-wise growth of Stock Indices (% y-o-y)

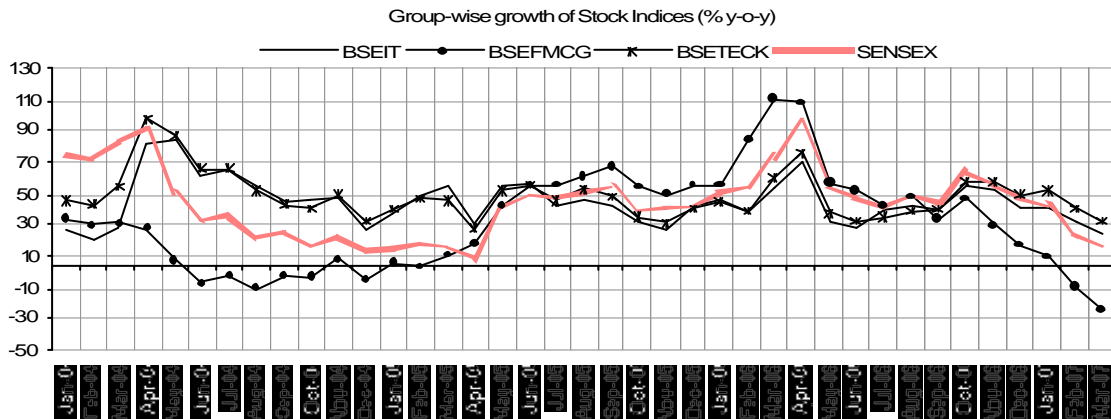


Fig M.13: Group-wise growth of Stock Indices (% y-o-y)

