

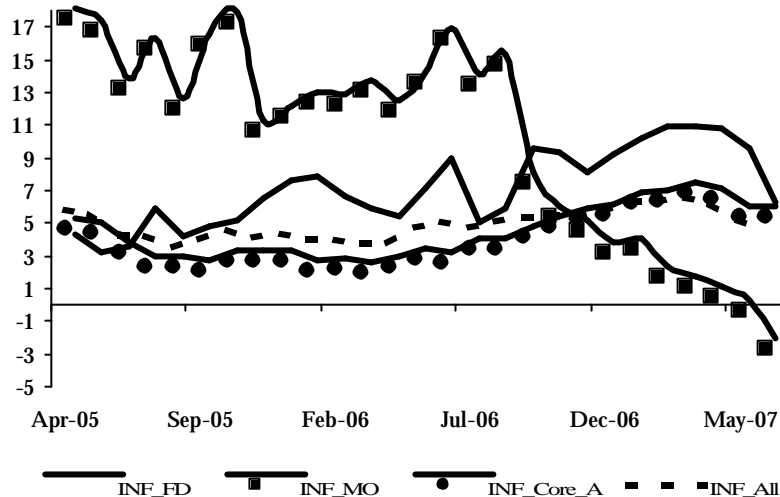
# Money and Capital Markets

## Policy developments

Quantity control is back at the centre stage of the Monetary Policy stance. With the quarterly review of the Monetary and Credit Policy, Reserve Bank of India has raised the CRR by a whopping 0.5 percentage points to the level of 7 per cent with effect from August 4, 2007. The key reasons appear to be a liquidity overhang caused by the unabated inflow of foreign capital and heavy withdrawals by the central government during the past few months. With first quarter estimates of GDP growth from the Central Statistical Organisation indicating a slow down, concerns of overheating appear to have eased out.

With comfortable headline inflation of below 5 per cent, it is time to take stock what we have achieved and what we have lost during the course of the tightening cycle of the monetary policy. Since April 29, 2005, which was the start of the tightening cycle, the Repo Rate has been increased by 200 basis points and the Reverse Repo Rate hiked by 125 basis points from the levels of 5.75 and 4.75 per cent respectively. The CRR has been raised to 7 per cent. In effect, the interest rates have risen to a level where the risk of non-performing assets, particularly in the housing portfolio of the banking sector, has become real. And, RBI had rightly announced some respite on borrowings of less than Rs 20 Lakh.

Fig M.1 Headline WPI, oil price (INF\_MO), food price (INF\_FD) and core (non-oil non-food) inflation



What has the tightening cycle done to inflation thus far? The story is captured in data (Figure M.1). Is the recent fall in headline inflation effect of monetary tightening or is it mainly due to easing in supply side pressures, food prices and a deflation in oil prices? On the other hand, the core inflation still remains as strong as it was six months back.

Beginning June 2005, core inflation was pretty much below 3 per cent up to June 2006 and remained below 4 per cent up to September 2006, despite increasing inflation in the mineral oil and food segments (Figure M.1). However, since the start of monetary tightening in April 2005, it kept inching up and has now marched ahead of headline inflation.

Why has the tight policy failed to restrain core inflation so far? It appears that the build up in core inflation could be due to the lagged effect of oil price inflation as well as supply constraints but not from overheating. The world oil price inflation has now clearly slowed down and there is a large content of the base effect in the month-to-month annual inflation. Therefore, the following months may anyway see some stability in inflation even without monetary intervention.

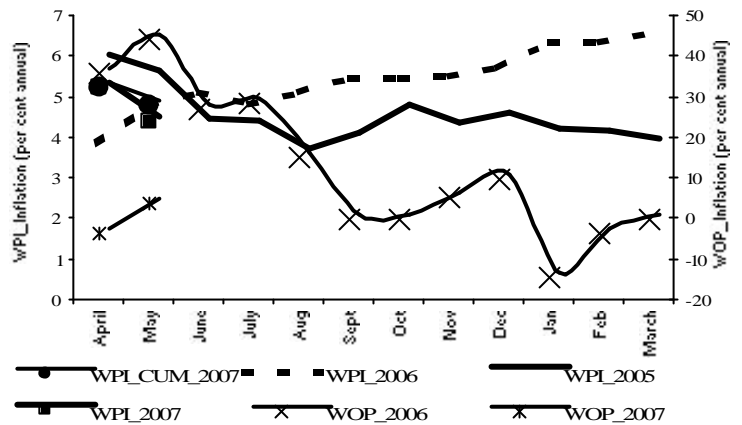
Nevertheless, the monetary policy targets have not been wide off the mark as the financial year ended with an average headline wholesale price index (WPI) inflation below 5.5 per cent (Figures M.2).

Increases in interest rates have decelerated consumption expenditure as well as expenditure on capital goods (Figure M.3). With increasing cost of capital and a possible fall in consumption growth, corporate profits would be affected adversely. That is likely to slow down investment growth (Figure M.3) and capacity expansion, thereby leading to the hardening of prices. This is all the more possible, given the infrastructure constraints and acceleration in remittances and therefore fiscal interventions remain important.

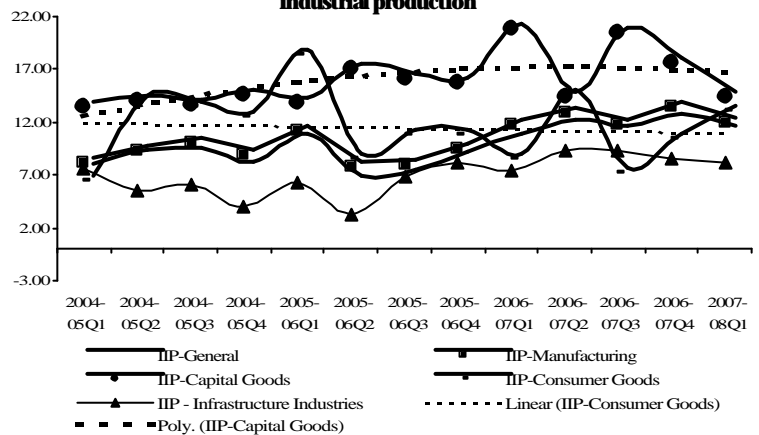
The increases in the Repo Rates have lifted the yield curves. The March-May 2007 curves are about 2.5 percentage point above even the short end of the March 2005 curve and about one percentage point above the longer end (Figure M.4). Thus, during the first quarter of 2007-08, the yield curve is almost flat all along. Commercial banks have been mobilising deposits at high interest rates in the short term, while long terms interest rates are tied to the expected inflation.

The disconnect between market and the RBI action was reflected in the delayed response of the commercial banks

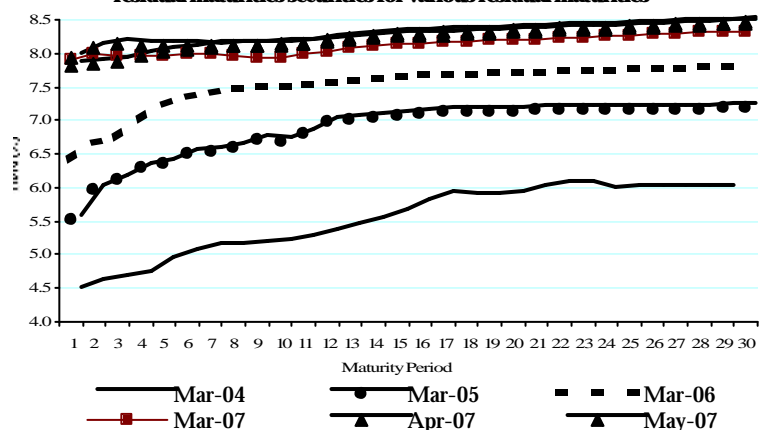
**Fig M.2: Monthly progress in headline WPI- Inflation during 2004-07**



**Fig M.3: Annual growth in selected segments of the index of industrial production**



**Fig M.4: Month-end yield to maturity of SGL transactions in central government dated securities for various residual maturities securities for various residual maturities**

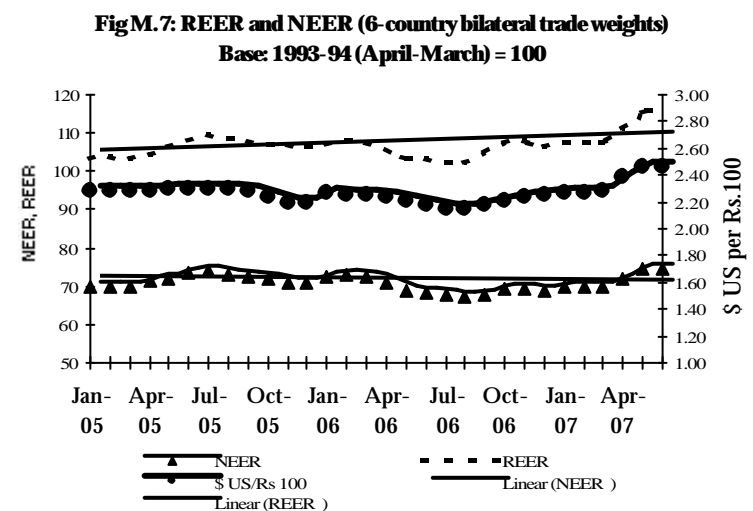
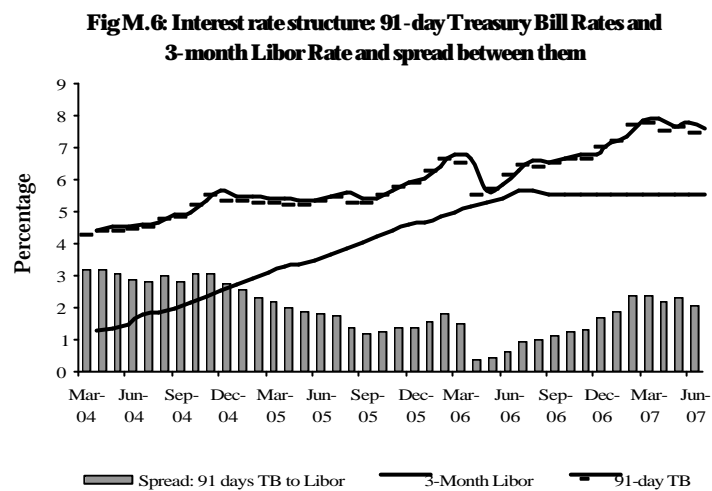
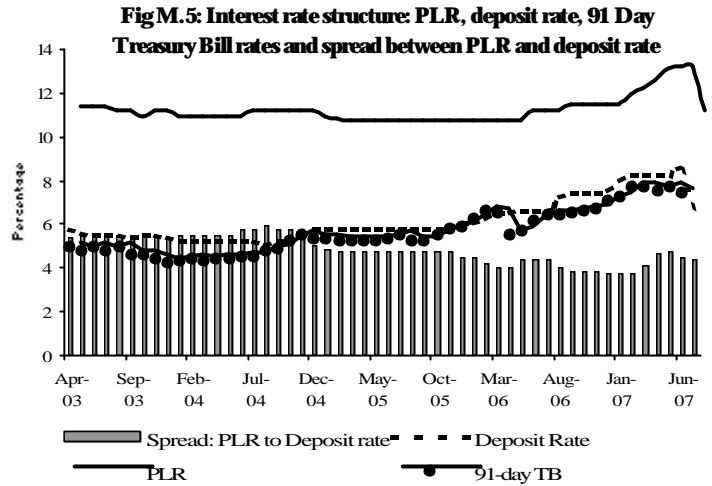


to the policy intervention. They came back with an increase in the prime lending rates (Figure M.5), although the call money rate did respond quickly - and adversely. Before long, housing loans were made costlier. Banks, started selling SLR (statutory liquidity ratio) securities, and reduced the spread between deposits rate and the PLR (possibly under competition) to meet the private sector's credit demand. Use of the most direct instrument of CRR has pulled down the money multiplier from 4.76 in March 2006 to 4.58 at the end of the first quarter of 2007-08 (Table ).

The short-term interest rate, which was inching towards world interest rates, has diverged widely from its set path. In fact, the international rate, as indicated by LIBOR, has softened since June 2006 and is stable for few months now. This, however, has put pressure on the rupee during the recent months on a month to month (M-o-M) basis, making imports cheaper and exports less competitive. Both the six-country nominal exchange rates (NEER) as well as real exchange rate index (REER) have appreciated during the first quarter of 2007-08 by 9.5 per cent and 12.2 per cent respectively (Figure M.7).

### Monetary Movements

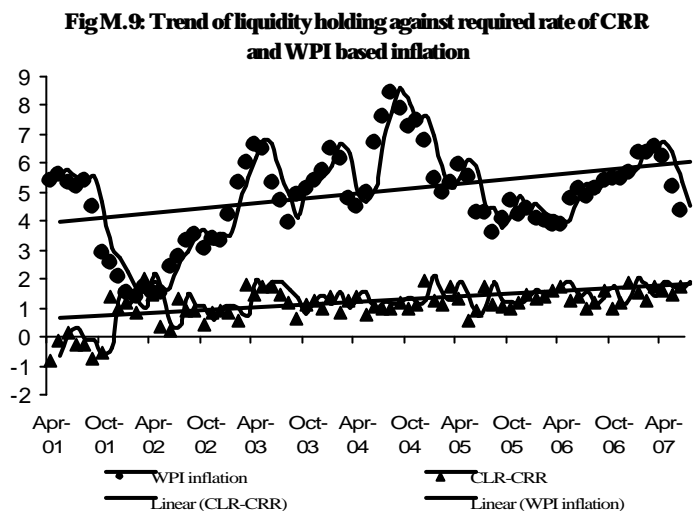
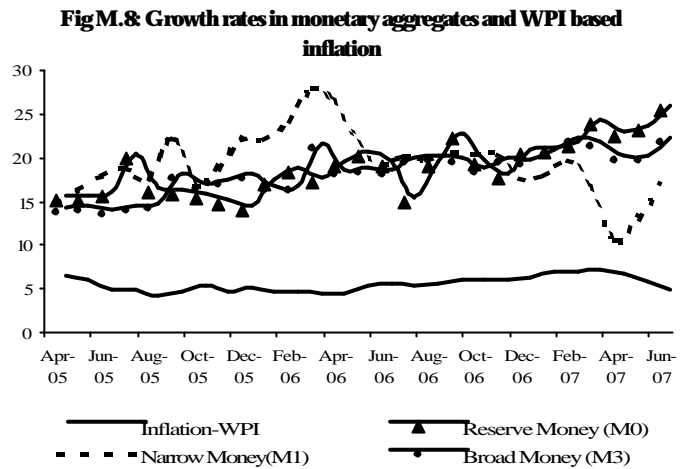
The Y-o-Y growth in broad money at the end of the first quarter of 2007-08 was 21.69 per cent, as against 18.01 per cent obtained at the end of 2006-07. During the same period, narrow money and reserve money grew by 16.71 and 25.40 per cent as against 19.30 and 18.99 per cent respectively (Table M.1 and Fig M.8). The growth rate of narrow money has reduced considerably and it would be helpful in containing inflationary pressure during 2007-08. However, reserve money is still growing at a relatively higher rate than the recent trend growth rates.



Foreign exchange reserves (FER) touched \$222 billion on July 20, 2007, adding over \$22.86 billion to the stock of end-March 2007 and \$58.70 billion over the stock of July 2006. Most of this increase took place during January-February 2007. In rupee terms, the first quarter of 2007-08 recorded annual growth of 16.18 per cent as against 24.90 per cent growth recorded during 2006-07Q1 (Table M.1). The inflow (in rupee terms), which had accelerated during the fourth quarter of 2006-07, has slowed down in recent months due to the hardening of the rupee against the dollar. There were other reasons too -- softening of the interest rate differential between domestic and international rates (Figure M.6) partly on account of base effects and other reasons namely restrictions on external commercial borrowings, valuation effect and investments in banking capital and NRI deposits.

The banking sector's foreign exchange assets increased by 10.41 per cent as of June 2007 on a Y-o-Y basis against 23.80 per cent growth recorded in June 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. The foreign exchange stock in the banking sector stood at Rs 8,67,526 crore at the end of June 2007 -- less than the February level by Rs 11,614 crore. Thus, each rupee in circulation is now backed by Rs 1.68 in foreign currency.

The net bank credit to the government (NBCG) increased by 12.28 per cent during the first quarter of 2007-08 on a Y-o-Y basis, as compared to an increase of 0.96 per cent recorded during 2006-07. With increased CRR, the liquidation of SLR securities by the banks has increased. The SLR investment of the banking sec-



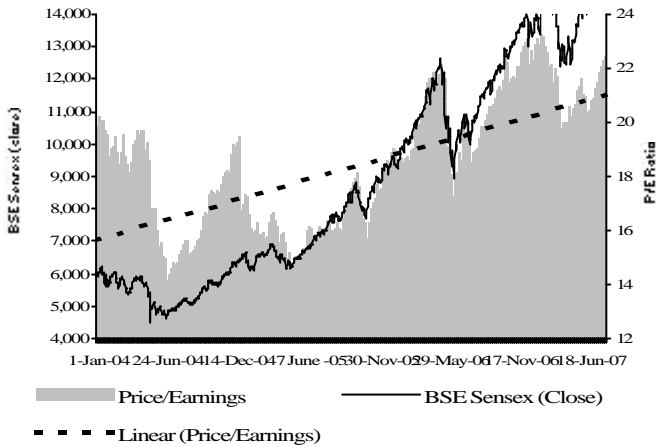
tor has gone down to about 30 per cent of time and demand deposits from a level of 33 per cent a year ago.

However, the Y-o-Y growth in bank credit to the commercial sector (BCC) grew at 22.50 per cent during the first quarter of 2007-08 Q1 compared to 27.37 per cent during the corresponding period of 2006-07. Thus, there has been a considerable fall in the private sector's credit offtake growth.

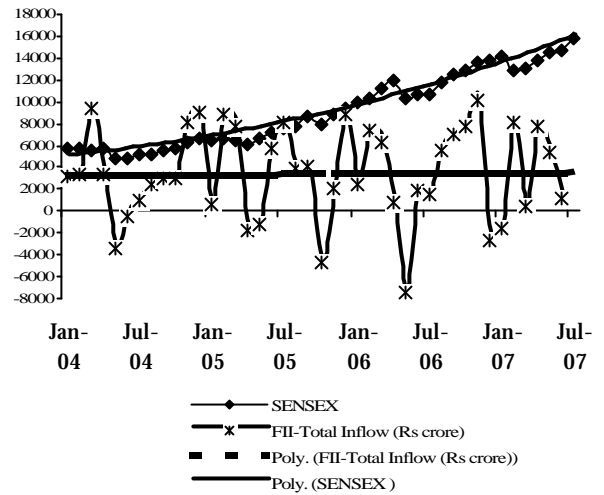
#### Liquidity situation and possible impact on lending rates

At the end of the first quarter of

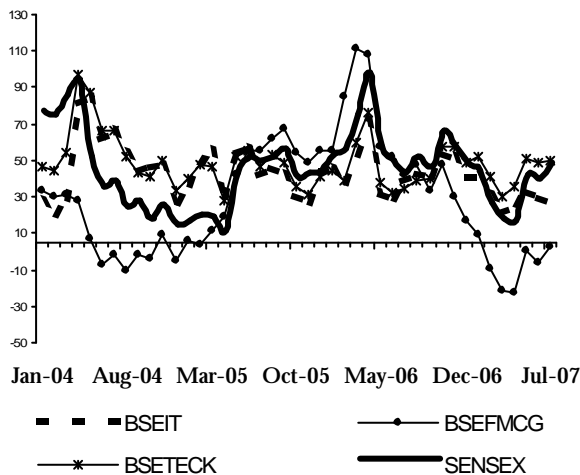
**Fig M.10: Movements in BSE sensex (at close) and the P/E ratio**



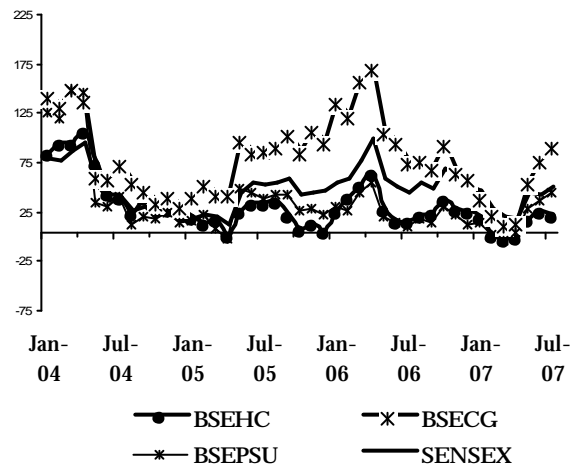
**Fig M.11: FII investment and movements in Sensex**



**Fig M.12: Group-wise growth of Stock Indices (% y-o-y)**



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



2007-08, effective cash holding stood at about 8 per cent of time and demand liability as against the average 6.125 per cent required by the CRR. One should note that these liquidities are created after selling government securities, because the growth in demand deposits have not kept pace with the credit offtake (Figure M.9). With a comfortable liquidity position, the overnight inter bank call money rate has come down. It is expected that this liquidity overhang would cause some of the lending rates to soften, even if the policy rates are unchanged.

**Capital market**

Comparing the global stock market performance (in terms of Morgan Stanley's Country Index) over a longer period of about four years (since July 28, 2003), Indian stocks appear to be among the frontrunners. As of July 25, it recorded growth of 464 per cent over July 28, 2003 as compared to 433 per cent growth in BRIC economies and 446 per cent growth in Latin American emerging markets. It also compares favourably with China's growth of about 397 per cent. Thus, the boom in the Indian market is both

a part of a global trend and a result of its own fundamental strengths. Notably, the growth in the American market has been lower -152 per cent - in comparison to the European Monetary Union, which recorded a growth of 222 per cent.

The Indian market is more integrated with international trends and, therefore, the role of risk management and supervisory alacrity has increased. In this context, it is argued that the increasing P/E ratio away from the trend is a matter of concern. The market is certainly overpriced (Figure M.10).

In fact, the BSE Sensex experienced the much awaited correction of 542 points on July 27, 2007 after attaining a lifetime high of 15,795 on July 25, registering a growth of 51.7 per cent on a Y-o-Y (Figure M.10). Most affected stocks belong to manufacturing, auto, PSU, and

health care (Figures M.12 & M.13). The meltdown was supported by a correction in the composite index of emerging market economies. It may be noted that the Indian market had demonstrated significant resilience during the recent past, despite a net FII outflow of Rs 2,766 crore in December and Rs 1,682 crore in January (Figure 11), which led to a 7 per cent correction during the second week of December. However, the first quarter of 2007-08 received a net increase of Rs 14,153 crore. The tightening of monetary policy through direct instruments and the resulting hardening of interest rates across the board (with no sign of substantial softening in the core inflation), remains a cause of concern for investment.

**Table M1: Changes in monetary aggregates and their components**

	Stock	Annual Growth			Quarterly Growth	
	(Rs. crores)	(end of period)			(Y-o-Y, end of period)	
	Jun-07	Mar-05	Mar-06	Mar-07	2006-07	2007-08
					Q1	Q1
1. Reserve Money	740703	12.06	17.15	23.73	18.99	25.40
2. Narrow Money	940967	12.07	27.87	16.79	19.30	16.71
3. Broad Money	3388916	12.52	21.10	21.27	18.01	21.69
<b>4. Major Components</b>						
(a) Currency in Circulation	515804	12.66	16.78	17.10	15.85	14.71
(b) Currency with the Public	501223	12.77	16.12	17.02	16.86	14.24
(c) Demand Deposit	439744	11.23	42.26	16.57	22.35	19.67
(d) Time Deposit	2447949	12.70	18.38	23.22	17.49	23.72
(e) Other Deposit	5513	15.10	7.83	7.19	35.99	-18.12
<b>5. Major Sources of M3</b>						
(a) NRBCG	-19731	-140.03	-238.17	-111.28	194.14	-340.95
(b) NBCG	876884	10.75	-3.82	11.03	0.96	12.28
(c) BCC	2098299	25.80	27.29	30.27	27.37	22.50
(d) NFEA of Banking sector	867526	23.30	9.95	21.33	23.80	10.41
<b>6. Major Sources of M0</b>						
(a) NFEA with RBI	868043	24.14	9.82	28.70	24.90	16.18
(b) Net Domestic assets	-127340	116.42	-19.18	57.23	-53.74	18.63
<b>7. Ratios</b>						
(a) M3/M0	4.58	4.61	4.76	4.67	4.71	4.58
(b) M1/M0	1.27	1.32	1.44	1.36	1.36	1.27
(c) Deposit/RM	3.91	3.89	4.05	4.00	3.98	3.91
(d) NFEA (RBI)/RM	1.17	1.25	1.17	1.22	1.26	1.17
(e) NFEA (RBI)/CC	1.68	1.66	1.56	1.72	1.66	1.68
(f) NBCG/M3	0.26	0.34	0.27	0.25	0.28	0.26
(g) NBCC/M3	0.62	0.57	0.60	0.64	0.62	0.62
(h) Credit/Deposit #	0.71	0.65	0.72	0.74	0.71	0.71
(h) Non-Food Credit/Deposit#	0.69	0.62	0.70	0.72	0.69	0.69

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