

Money and Capital Markets

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The Reserve Bank of India (RBI)'s response to inflationary pressures during the second and third quarters of 2004-05 was to use instruments that affected liquidity in the banking system without directly raising the cost of borrowing. Thus, the fixed reverse repo rate was increased from 4.5 per cent to 4.75 per cent, while the repo rate was maintained at six per cent. The cash reserve ratio (CRR) now stands at five per cent, as compared to 4.5 per cent in March 2004.

The year 2004-05 ended with whole-sale price index (WPI) based average inflation of 6.5 per cent, as against 5.5 per cent during the previous year. The average inflation during April-May 2005 was just about 5.6 per cent on a year-on-year (Y-o-Y) basis, which is about the same level as from the last quarter of 2004-05. During this period there was no hike in domestic oil prices, while the import duty on oil was reduced.

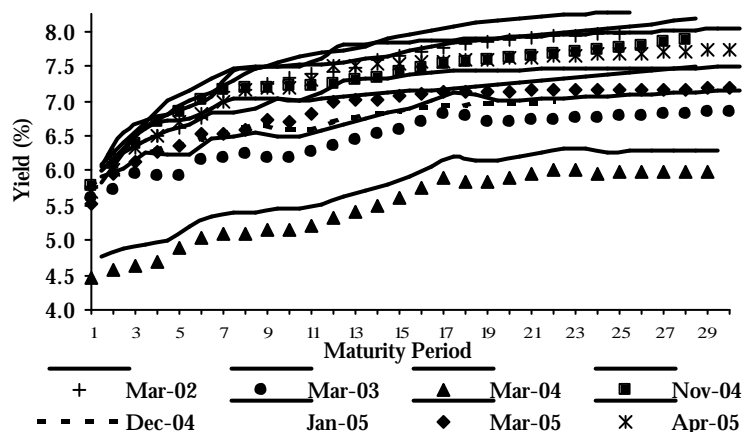
However, in line with the credit policy for 2005-06, the RBI has raised the reverse repo rate by 0.25 percentage points to 5.00 per cent, thus reducing the spread between reverse repo and repo rate to one percentage point. The market responded with a hardening of the call money rate from 3.75-4.85 per cent on April 20, to 4.40-5.25 per cent as on June 17, 2005. This is indicative of the fact that liquidity concerns were not very well founded. The annual growth numbers for monetary aggregates during 2004-05 also do not suggest the possibility of any such excessive increases. The average inflation is well within the so-called threshold limit and is likely to go down further

with a better-than-expected monsoon. It is already hovering around 4 per cent. The economy needs a low interest rate/low inflation regime. Therefore, this is the time to soften the interest rate.

The April 2005 yield curve has shifted up with respect to March 2005 (Fig M.1), with a steeper short end and flatter long end, by almost 0.5 percentage points at the long end. This is almost the same position as it was in November 2004. The prime-lending rate (PLR) to the private sector has remained at the same level as that of March 2005, maintaining the spread between the deposit rate and PLR (Fig M.2). Inflationary explanations have been fuelled by this monetary tightening, and the latter needs to be reversed.

Despite the lowering of inflation during last quarter of 2004-05, the RBI remained concerned about the inflows of foreign investment, particularly in the equity market. The

Fig M.1: Yield to Maturity of SGL Transactions in Central Government Dated Securities



market stabilisation process led foreign exchange reserves (FER) to cross US\$ 141.2 billion on April 1, 2005, adding over US\$ 28 billion from the end of March 2004. However, since then the FER has declined to US\$ 136.90 billion as of July 8, 2005. The Y-o-Y growth was 24.14 per cent (in rupee terms) during 2004-05, as against a 37.8 per cent in 2003-04 (Table M.1), which further declined to 12 per cent for the month of May. The Y-o-Y growth for May 2004 was 40 per cent. Thus, the inflow appears to have slowed down in view of the softening of the interest rate differential between international dollar deposit rates and 91-days treasury-bills rates from 3.1 percent-

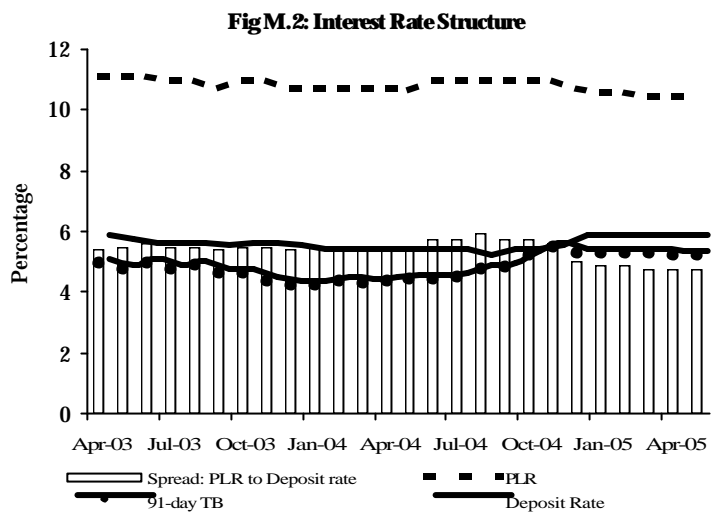


Table M.1: Changes in monetary Aggregates and their Components

	Stock (Rs.crores)	Annual Growth (end of period)			Monthly Growth (% Change, Y-o-Y)				
		May-05	March-03	March-04	March-05	Apr-04	May-04	Apr-05	May-05
1. Reserve Money	490660	9.16	18.32	12.05	14.43	9.52	15.08	15.04	
2. Narrow Money	663887	12.00	21.76	13.50	18.21	16.47	13.69	15.05	
3. Broad Money	2346415	14.66	16.60	13.28	16.13	15.14	13.49	13.78	
4. Major Components									
(a) Currency in Circulation	389780	12.49	15.91	12.66	15.70	13.96	12.66	13.61	
(b) Currency with the Public	377500	12.79	16.17	13.29	16.11	14.55	12.73	13.73	
(c) Demand Deposit	286387	10.96	29.29	13.76	21.02	19.17	14.92	16.84	
(d) Time Deposit	1678959	15.70	14.63	12.94	15.45	14.94	13.04	12.75	
(e) Other Deposit	4326	14.88	71.90	15.19	23.97	54.91	18.10	13.75	
5. Major Sources of M3									
(a) NRBCG	-16067	-21.08	-62.61	-127.16	-89.50	-96.55	-108.97	-477.25	
(b) NBCG	782340	27.21	25.91	10.58	26.78	26.95	5.43	5.15	
(c) BCC	1326967	18.34	13.23	25.26	13.30	13.30	26.02	28.31	
(d) NFEA of Banking sector	641524	26.58	33.75	23.82	39.17	35.96	18.41	12.87	
6. Major Sources of M0									
(a) NFEA with RBI	602316	35.71	37.80	24.14	44.29	40.50	17.90	12.06	
(b) Net Domestic assets	-111656	-85.56	-634.63	116.43	-527.99	-1718.69	32.37	0.58	
7. Ratios									
(a) M3/M0	4.78	4.66	4.59	4.64	4.76	4.64	4.68	4.78	
(b) M1/M0	1.35	1.28	1.32	1.34	1.33	1.34	1.33	1.35	
(c) Deposit/RM	4.01	3.93	3.88	3.91	4.01	3.91	3.94	4.01	
(d) NFEA (RBI)/RM	1.23	0.97	1.13	1.25	1.26	1.25	1.22	1.23	
(e) NFEA (RBI)/CC	1.55	1.27	1.51	1.66	1.63	1.66	1.60	1.55	
(f) NBCG/M3	0.33	0.32	0.35	0.34	0.34	0.34	0.33	0.33	
(g) NBCC/M3	0.57	0.52	0.51	0.56	0.56	0.56	0.56	0.57	
(h) Credit/Deposit #	0.64	0.57	0.56	0.64	0.63	0.64	0.63	0.64	
(h) Non-Food Credit/Deposit#	0.62	0.53	0.53	0.61	0.60	0.61	0.61	0.62	

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

age points in November 2004 to 1.9 percentage points in May 2005 (Fig M.3).

With recent hikes in federal fund rates, this differential is likely to reduce further. Thus, maintaining a lower rate in the Indian market would automatically help solve some of the problems associated with the inflows while motivating investment. However, this is likely to reduce the surpluses in balance of payments.

During the last quarter of 2004-05, the monetary policy had rightly shown more concerns to rising inflation as compared to exchange rate management. In fact, control on inflation could also be attributed to hardening currency, which has in turn reduced oil prices in the domestic market, albeit at the cost of rising imports and deterioration of the current account. Both the five-country nominal effective exchange rate (NEER) as well as real effective exchange rate (REER) index, which had an upward trend during fourth quarter of 2004-05, have now reduced, appreciating during the first quarter of 2004-05 (Fig M.4). In fact the NEER depreciated by 2.3 per cent in April 2005 on a Y-o-Y basis, while the rupee remained strong against the dollar. Clearly, inflation still remains a concern when compared to that prevailing among trading partners and may only be brought down slowly.

Yet, given the prospects of a good monsoon and relatively lower inflation, of the order of 4.5 per cent, a cut in interest rates might be strategically more pragmatic, especially in order to achieve a low interest -low inflation regime.

Monetary Movements and Credit Off-Take

The Y-o-Y growth in broad money (M3) during 2004-05 was 13.28 per cent, as against 16.6 per cent during 2003-04. During the same periods narrow money (M1) grew by 13.5 and 21.76 per cent and reserve money (M0) grew by 12.05 and 18.32 per cent (Table M.1 and Fig M.5). As against this, the growth figures for May 2005 for M3, M1 and M0 are 13.78, 15.05 and 15.04 per cent, respectively.

Thus, the broader aggregates of money have slowed down considerably following the liquidity control measures taken during the last nine months. Partly due to this

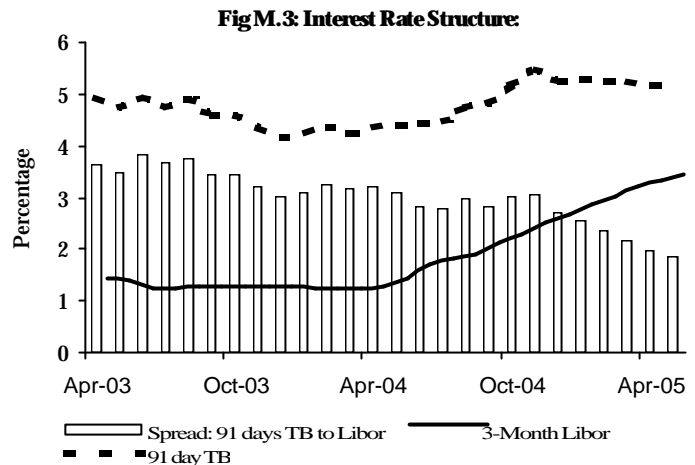


Fig M.4: Effect of Exchange Rates: REER and NEER (5-Country Bilateral Trade Weights) (2002-03=100)

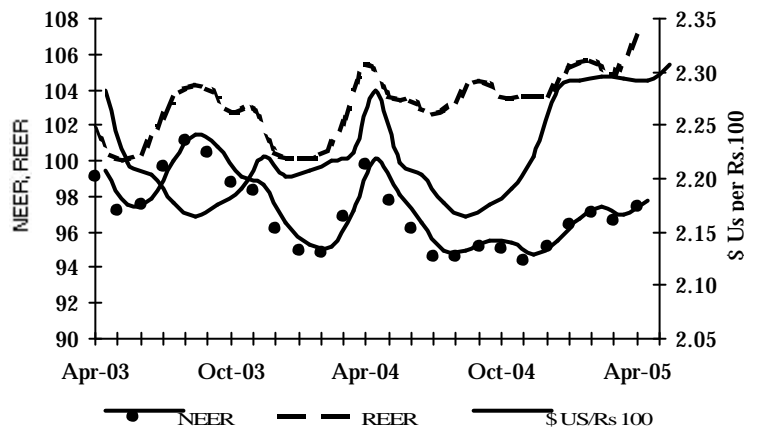
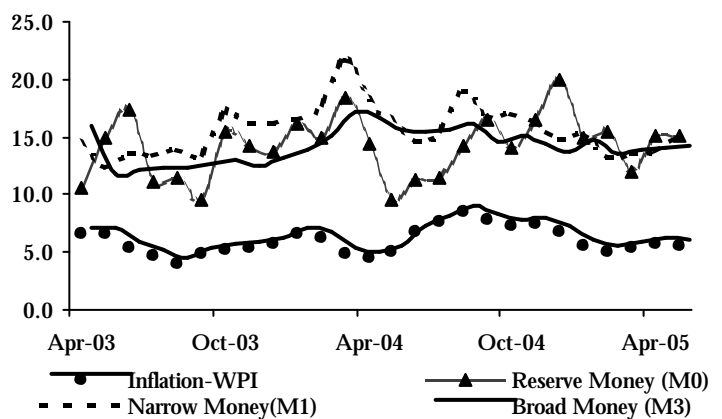


Fig M.5: Growth Rates in Monetary Aggregates and WPI based inflation (% Change, Y-o-Y)



and complemented by the control on oil prices, the inflationary pressure has eased out considerably. However, the fear of an oil price hike looms large, which is reflected in the term structure of the interest rate.

Net Reserve Bank Credit to the Government (NRBCG) in 2004-05 declined by 127.16 per cent, as against a decline of 62.61 per cent during 2003-04. This decline has further increased to 477.25 per cent in May 2005. In fact, government deposits with the RBI increased as an essential outcome of the Market Stabilisation Scheme (MSS).

Foreign exchange assets of the banking sector increased by 12.87 per cent in May 2005 as against increases of 23.82 per cent during 2004-05 and 33.75 per cent growth recorded during 2003-04 on a Y-o-Y basis.

Growth in net other bank credit to government (NBCG) was lower at 5.15 per cent during May 2005, as against 10.58 per cent during 2004-05 and 25.91 per cent recorded during 2003-04 on a Y-o-Y basis. Of late, commercial banks are reported to have sold government bonds to other financial institutions, while they have increased investment in Shares/ Debentures/ Bonds/ Commercial Papers.

The Y-o-Y growth in bank credit to the commercial sector (BCC) grew at 28.31 per cent in May 2005, as against growth rates of 25.26 per cent during 2004-05 and 13.23 per cent during 2003-04 on Y-o-Y basis. Thus, credit growth continues to be strong despite the hike in interest rates.

The non-food credit by commercial banks has grown by 30.5 per cent on Y-o-Y basis during 2004-05, as against an overall credit growth of 29.9 per cent (Fig M.6). This has further increased to 33.7 per cent on a Y-o-Y basis during May 2005, as against overall credit growth of 32.3 per cent, commensurate with a strong growth in the manufacturing sector.

Capital Market

In the face of the surge in foreign institutional investment (FII) inflows, the

good news about the monsoon almost all over the country and a fall in inflation, the BSE

Fig M.6: Growth in Bank Credit and Sectoral IIP

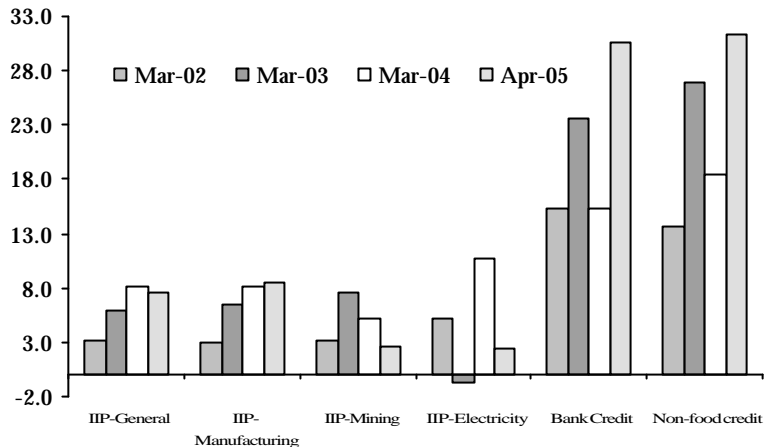


Fig M.7: Movement in BSE sensx (at close) and the P/E ratio

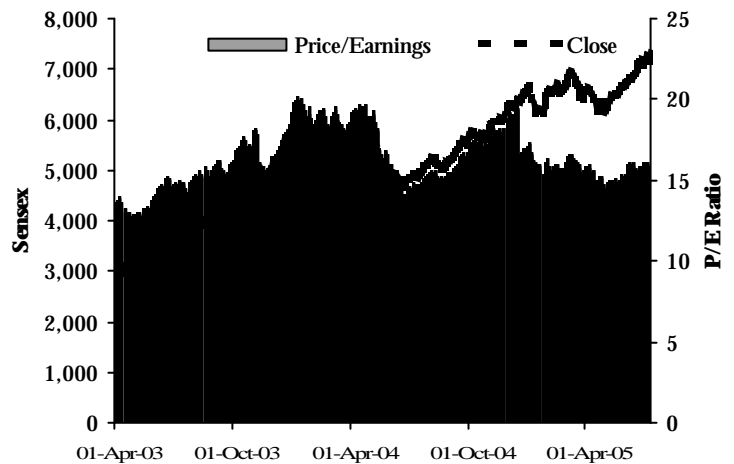
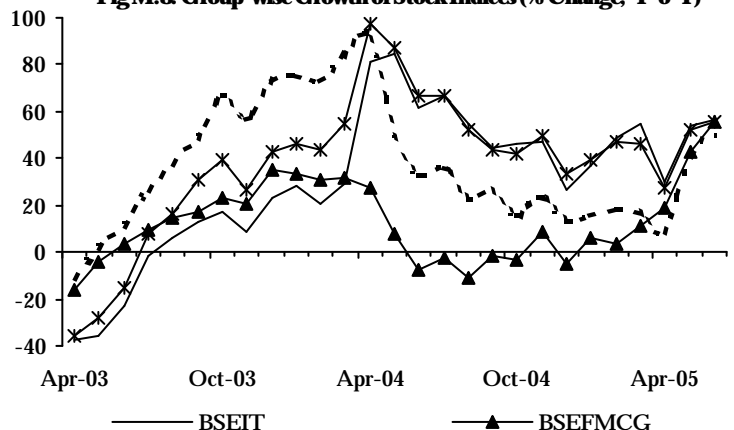
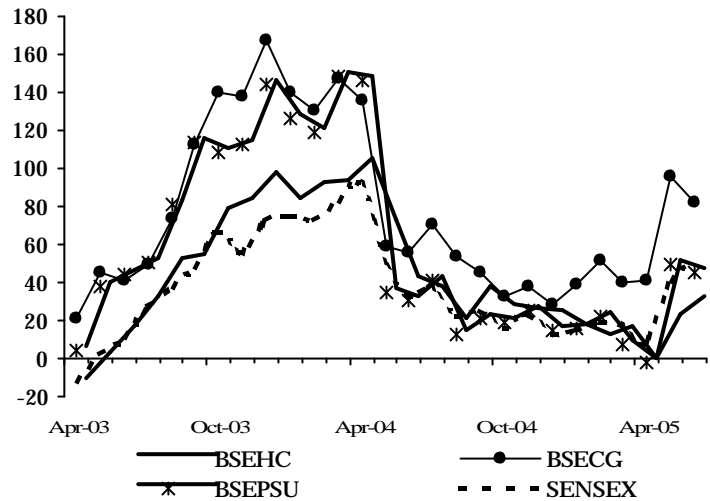


Fig M.8: Group-wise Growth of Stock Indices (% Change, Y-o-Y)



Sensex scaled a lifetime high of 7211 on July 1, 2005, a gain of about 42 per cent since April. This, despite the net FII outflow of Rs. 2922 crore during April-May 2005 (Table M.2). The turnaround in FII sentiment towards the Indian market was in line with that in the emerging market economies. Ignoring high international oil prices, investors made all-round purchases in Indian stocks. Market analysts are now interested in the movement of the Sensex. However, the recent hike in the Federal Fund Rate is likely to dampen the preferences of FII towards emerging markets. In fact, the Sensex had achieved a level of about 6200 on January 14, 2004, which was a growth of 85.7 per cent on a Y-o-Y basis over previous years but at that time the economy was expected to attain a high growth rate of over eight per cent. That momentum was lost during the subsequent

Fig.M.9: Group-wise Growth of Stock Indices (% Change, Y-o-Y)



months and the Sensex dropped to a low of 4848 on July 15, 2004 (Fig M.7). It may be noted that the Price to Earning (P/E) ratio at around 20 was also much high during the early

Table M.2: Capital Market Indicators (Rs crore)

	2002-03	2003-04	2004-05	2004-05 (Apr-May)	2005-06 (Apr-May)
Cap-issue (Domestic*)	40495	52628	59916	6614	5521
Equity*	3009	21272	28114	4334	3008
Debt*	33561	30761	31424	2280	2508
Preferential*	648	20	379	0	4
Offshore*	633	3883	15107	3285	3922
FII Net Investment	2586	48967	42920	-82	-2922
Daily Turnover (BSE)@	4988	7881	8083	4389	3718
Market Capitalization (BSE)#	2408420	4142044	5704098	2278478	3418987
Growth rate (y-o-y) %					
Cap-issue (Domestic*)	2002-03	2003-04	2004-05	2004-05 (Apr-May)	2005-06 (Apr-May)
Cap-issue (Domestic*)	-10.72	29.96	13.85	244.05	-16.52
Equity*	-0.16	606.88	32.16	8501.79	-30.58
Debt*	-15.19	-8.34	2.16	23.13	10.00
Preferential*	329.08	-96.89	1777.49	-100.00	-
Offshore*	-72.02	513.18	289.10	-	19.39
FII Net Investment	-70.43	1793.48	-12.35	-101.98	-3484.79
Daily Turnover (BSE)@	-1.48	58.00	2.56	109.10	-15.29
Market Capitalization (BSE)#	11.81	71.98	37.71	84.72	50.06

* Total for the period, @ Period average, # End of the period.

Source: CMIE

months of 2004, compared to a value of about 16 during recent months. This means that investors are not ready to pay a higher price for every unit of expected return. Yet the Sensex keeps rising, with most of the gains recorded in the manufacturing and technology segments (Fig M.8 and Fig M.9). This, despite the fact that the performance of the manufacturing sector in terms of growth in profit after tax (PAT) fell from 66.7 per cent in 2003-04 to 40.7 per cent in 2004-05. In the last quarter assessments, a cautionary note was raised about the behaviour of FII towards the Indian market and it was anticipated that the Sensex should stabilise around the 5500 mark by middle of this financial year. But there is no sign of immediate reversals in the Sensex, which crossed the 7300 mark on 11 July 2005. The P/E ratio is hovering around 14-16 per cent since April 2005. Clearly, investors seem to be moderate on expected returns, yet optimistic

about the Indian economy. Indeed the overall performance of the corporate sector during 2004-05 in terms of growth in PAT has been 37.2 per cent, almost at the same level as the 35.6 per cent obtained during 2003-04. However, the growth in new project investment in 2004-05 is reported to be 78.1 per cent as against 48.3 in 2003-04. These indicators tend to suggest that the recent spurt in the Sensex is likely to be based on strong fundamentals. However, it has been reported that the sources of FII flows are concentrated in Japan and Taiwan through India-specific funds. Such concentrated investment is likely to reverse very quickly, whenever it does so. Therefore, regulators need to be careful. Much will depend on the first quarter results of the corporate sector. If these results match expectations and last year's performance, the Sensex could stabilise at the current level. If not, it will have to correct, and in that case it might witness a freefall.

Investor expectations seem to be moderate about expected returns, yet optimistic about the Indian economy