Money & Capital Markets

The then Finance Minister, in his 2000-01 budget speech, had indicated the need to amend the Banking Regulation Act, 1949, and the Reserve Bank of India Act, 1934, in order to meet the challenges posed by the reforms in the financial sector, particularly those leading to competition, consolidation and convergence, on the one hand, and the freedom and space for the RBI to develop and apply new instruments for the conduct of monetary policy, on the other. At times, the NCAER has also been voicing such concerns through writings in this space. It has been argued that banking policy needs to be redefined quickly in order to produce world-class banks in terms of operational size and efficiency. However, it took several years to introduce the required Bills in Parliament. Following the present Finance Minister's budget speech of 2005-06, the required Bills were introduced in the Lok Sabha on May 13, 2005, and thereafter they were referred to the Standing Committee of Parliament. The Standing Committee submitted its report in December 2005 and the Bills are pending before Parliament for consideration and passage. These pieces of legislation are important and need to be quickly passed. The twin Bills are expected to cover the following aspects:

- to remove the lower and upper bounds to the statutory liquidity ratio (SLR) and provide flexibility to the RBI to prescribe prudential norms;
- to remove the limits of the cash reserve ratio (CRR) to facilitate more flexible conduct of monetary policy;
- to enable the RBI to lend or borrow securities by way of repo, reverse repo or otherwise;
- to allow banking companies to issue preferential shares, since preferential share capital can be treated as regulatory capital under specified circumstances as per Basel norms; and
- to introduce specific provisions to enable the consolidated supervision of banks and their subsidiaries by the RBI in consonance with the international best practices in this regard.

There is no policy direction on merger or privatisation of public sector banks.

While the above reforms are essential to conduct monetary policy more independently, it falls short of provisions that will enable Indian banks to achieve the operational level comparable to world leaders. There is no policy direction on merger or privatisation of public sector banks. It is important to set out the mechanism of consolidation when banking assets are fragmented among large number of small (by international standards) public sector banks. On the other hand, the private sector banks, which hold only a minor portion of assets, could consolidate only if public sector banks are privatised.

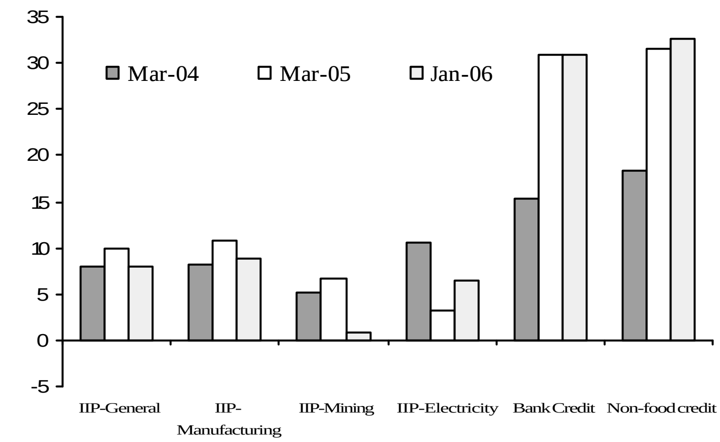
A related issue to be considered is that of overburdening of the RBI with the twin roles of policy setting, and supervision and enforcement of the regulatory norms. These two aspects of banking are entirely different and require specialised skills. There is no doubt that the RBI is doing a good job on both fronts; yet, there could be marked improvement and value addition by constituting a Banking Commission to supervise, and penalise banks for offences against violation of policy norms set by the RBI. Doing this will separate the activities of policy determination, execution and supervision, and, therefore, allow for more independence and credibility.

So far as the amendments in the RBI Act, 1934, are concerned, sooner it is done, better it would be, as they are much needed for ensuring flexibility in taking policy stances by the RBI.

Policy developments

In the Mid-term Review of the Annual Policy, the RBI had increased both the reverse repo rate and the repo rate by 25 basis points. This was raised again on January 25, 2005 by 25 basis points, on the grounds that inflation lies just round the corner*. In the past, we have been critical of the policy of raising interest rates. The CRR has also been raised during this period. The CRR stands at five per cent as compared to 4.5 per cent in March 2004. On inflation front, the year 2004-05 had ended with WPI-based average inflation of 6.5 per cent as against 5.5 per cent during 2003-04. However, the year 2005-06 ended with inflation of just about 4.4 per cent. However, our position is that the low inflation is predominantly an outcome of less than the trend growth rate in monetary aggregates during the last years and a base effect of high prices during last year coupled with good monsoon and less due to the interest rate policy. What appears missing from

Fig M.1: Growth Rate in Bank Credit and Sectoral IIP



banks' sight is the high growth in currency with the public and demand deposit, and a moderate growth in time deposit. This is reflected relatively in the marginal growth in non-food credit and a fall in the broad money multiplier (Table M.1). The growth figures for the IIP do not seem to be in conformity with the credit growth either (Fig M.1). After peaking in the first quarter, it has declined during the next two quarters. We strongly feel that the RBI should not have raised the interest rate. It will have enough opportunities to raise the interest rate during the coming year as inflation is going to be out of the threshold boundary.

The CRR in March 2006 was at five per cent as compared to 4.5 per cent in March 2004

It is also not true that the RBI has been able to set the expectations right. The yield curve is shifting upwards (Fig M.2), and in fact it appears that the RBI is giving wrong signals. The January 2006 yield curve has moved up with respect to July 2005 position with a flatter short end while July 2005 position was much above March 2004 position.

The growth pattern of the IIP does not seem to be in conformity with the credit growth

The commercial banks are facing difficult situation in credit delivery, a fact reflected in sharp increase in credit to deposit ratio from 0.62 in 2004-05 to 0.70 in 2005-06. The PLR is almost stagnant, while spread between PLR and the deposit

*However, in annual policy for the year 2006-07, all policy rates remained same rate is softened (Fig M.3). In a way, it would have been welcome from the point of view of the banking efficiency, provided it was not a fall out of the increases in policy rates. There is pressure on the housing loans and it is likely to fuel the real estate prices further much to the agony of the RBI. The apex bank must realise that there is shortage of homes in every segment of the society and as the income grows quality of house will improve and prices will increase. Raising interest rates cannot control this; making housing more affordable can however soften it. Housing remains a necessity and it will take quite some time in becoming a luxury item. So long the housing loans are predominantly retail in nature and adequately collateralised, there should not be problem unless large-scale defaults are reported, which certainly is not the case.

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

	Stock (Rs.crores)	Annual Growth (end of period)				Quarterly Growth (Y-o-Y, end of period)			
	Mar-06	Mar-03	Mar-04	Mar-05	Mar-06	2005-06 Q1	2005-06 Q2	2005-06 Q3	2005-06 Q4
1. Reserve Money	573036	9.16	18.32	12.06	17.15	15.53	15.82	14.07	17.15
2. Narrow Money	784641	12.00	21.76	12.07	21.41	17.88	22.22	22.08	21.41
3. Broad Money	2624117	14.66	16.60	12.52	16.42	13.61	17.74	17.56	16.42
4. Major Components									
(a) Currency in Circulation	430540	12.49	15.91	12.66	16.78	13.72	13.07	15.83	16.78
(b) Currency with the Public	420331	12.79	16.17	12.77	18.15	13.83	11.64	15.50	18.15
(c) Demand Deposit	364310	10.96	29.29	11.23	25.41	23.38	36.14	30.69	25.41
(d) Time Deposit	1839476	15.70	14.63	12.70	14.42	12.01	16.06	16.06	14.42
(e) Other Deposit	6985	14.88	71.90	15.10	7.83	35.42	29.51	1.55	7.83
5. Major Sources of M3									
(a) NRBCG	24836	-21.08	-62.61	-140.03	-238.17	-180.82	-421.16	-176.75	-238.17
(b) NBCG	746224	27.21	25.91	10.75	-3.82	3.92	7.93	7.35	-3.82
(c) BCC	1629944	18.34	13.23	25.80	27.29	27.02	30.71	25.57	27.29
(d) NFEA of Banking sector	682784	26.58	33.75	23.30	5.16	8.65	14.14	12.83	5.16
6. Major Sources of M0									
(a) NFEA with RBI	672983	35.71	37.80	24.14	9.82	9.58	15.42	8.64	9.82
(b) Net Domestic assets	-99947	-85.56	-634.63	116.42	-19.17	-12.41	13.88	-17.89	-19.17
7. Ratios									
(a) M3/M0	4.58	4.66	4.59	4.61	4.58	4.75	4.97	4.72	4.58
(b) M1/M0	1.37	1.28	1.32	1.32	1.37	1.36	1.41	1.38	1.37
(c) Deposit/RM	3.86	3.93	3.88	3.89	3.86	4.01	4.25	4.00	3.86
(d) NFEA (RBI)/RM	1.17	0.97	1.13	1.25	1.17	1.21	1.25	1.15	1.17
(e) NFEA (RBI)/CC	1.56	1.27	1.51	1.66	1.56	1.54	1.65	1.51	1.56
(f) NBCG/M3	0.28	0.32	0.35	0.34	0.28	0.33	0.32	0.30	0.28
(g) NBCC/M3	0.62	0.52	0.51	0.57	0.62	0.57	0.58	0.60	0.62
(h) Credit/Deposit #	0.72	0.57	0.56	0.65	0.72	0.65	0.66	0.69	0.72
(h) Non-Food Credit/Deposit#	0.70	0.53	0.53	0.62	0.70	0.62	0.64	0.67	0.70

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

Despite lowering of inflation, the RBI remained concerned about the inflows of foreign investment, particularly in the equity market. The market stabilisation process has led foreign exchange reserves (FER) to touch US$151.6 billion on March 31, 2006 adding over US$10 billion to the stock of end-March 2005. The Y-o-Y growth was 9.82 per cent (in rupee terms) during 2005-06, as against 24.14 per cent in 2004-05 (Table M.1). The inflow appears to have slowed down in view of the softening interest rate differential between domestic and international rates (Fig M.4). Maintaining a lower rate in Indian market would automatically help solve some of the problems associated with the inflows and improve the absorption of capital in the economy.

Lower 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 six-country nominal exchange rate (NEER), as well as real exchange rate index (REER), has appreciated during the fourth quarter (up to February) of 2005-06 (Fig M.5) by 2.7 and 4.4 per cent respectively. With slow down in external inflows and deficit in current accounts, the currency is likely to develop depreciating tendency during 2006-07.

Fig M.2: Month-end Yield to Maturity of SGL Transactions in Central Govt. Dated Securities for Various Residual Maturities

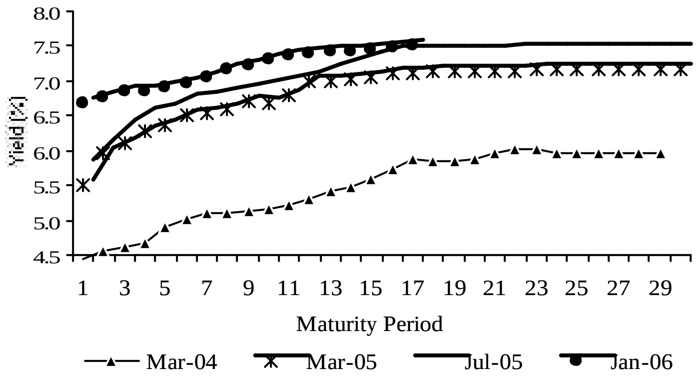


Fig M.3: Interest Rate Structure: PLR, Deposit Rate, 91 Day Treasury Bill Rates and Spread between PLR and Deposit Rate

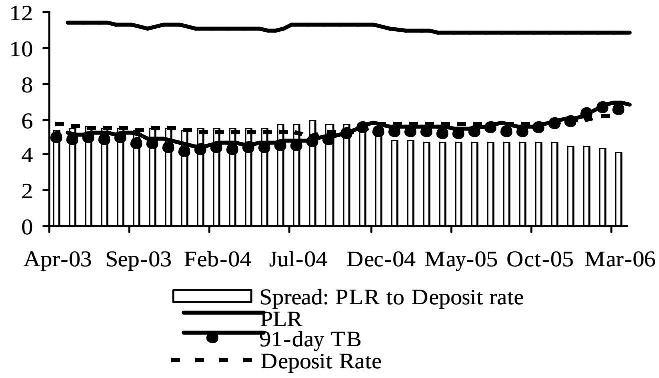
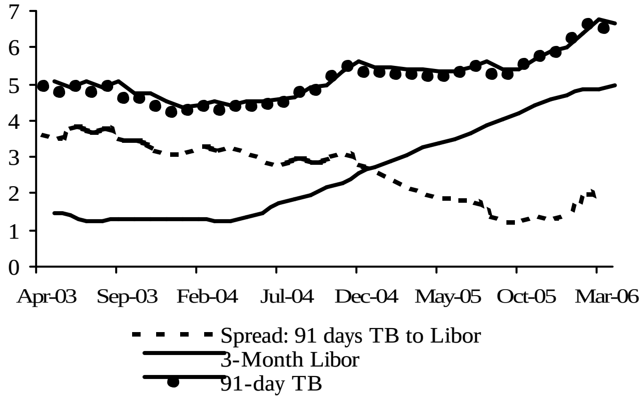


Fig M.4: Interest Rate Structure: 91 Day Treasury Bill Rates and 3 month Libor and spread between them



Monetary Movements and Credit Off-take

The Y-o-Y growth in broad money during 2005-06 was 16.42 per cent, as against 12.52 per cent during 2004-05. During the same periods, narrow money and reserve money grew by 21.41 and 17.15 per cent respectively. (Table M.1 and Fig M.6).

The broader aggregates of money did not slow down despite liquidity control measures taken after the Mid-year Review of credit policy when CRR and reverse repo rates were increased. During 2005-06, the growth in real GDP is expected to be 8.1 per cent as against 7.5 per cent last year; the inflationary pressure is also likely to build up during next year but for the developments in the oil prices and fiscal restraint.

Net Reserve Bank Credit to the Government (NRBCG) in 2005-06 declined by 238.17 per cent, as against 140.03 per cent during FY 2004-05. In fact, deposits with the government have increased, which are now an essential outcome of foreign exchange management through MSS. Foreign exchange assets of the banking sector increased by 5.16 per cent only during 2005-06 on Y-o-Y basis, as against 23.3 per cent growth recorded during 2004-05. Foreign exchange stock in the banking sector stood at Rs 6,82,784 crore on March 17, 2006 and each rupee in circulation is now backed by 1.6 rupees equivalent of foreign currency.

There was a decline in the bank credit to government (NBCG) by 3.82 per cent during 2005-06 on a Y-o-Y basis, as compared to an increase of 10.03 per cent during 2004-05. The reason appears to be liquidity consideration and diversification of the institutional investment in Shares/ Debentures/ Bonds/ Commercial Papers. On the other hand, the Y-o-Y growth in bank credit to the commercial sector (BCC) grew at 27.29 per cent during 2005-06 compared to 25.80 per cent during 2004-05.

Capital Market

The Finance Minister in his 2006-07 budget made fewer moves towards reforming the capital market. However, there are clear provisions to make transactions costlier due to increase in securities transaction tax by 25 per cent across the board. The capital gains tax

Fig M.5: REER and NEER (6-Country Bilateral Trade Weights) Base : 2003-04 (April-March) = 100

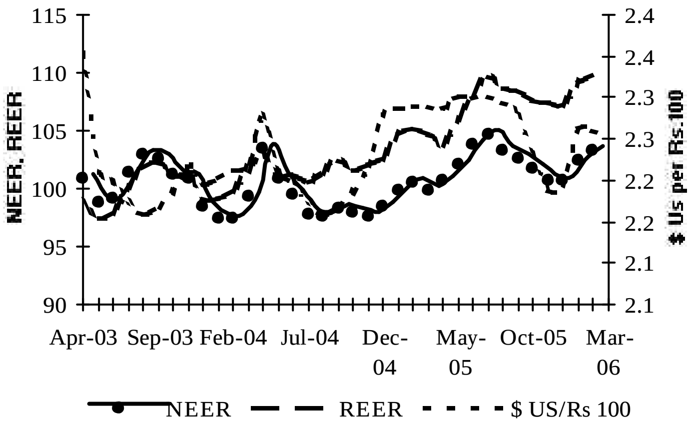
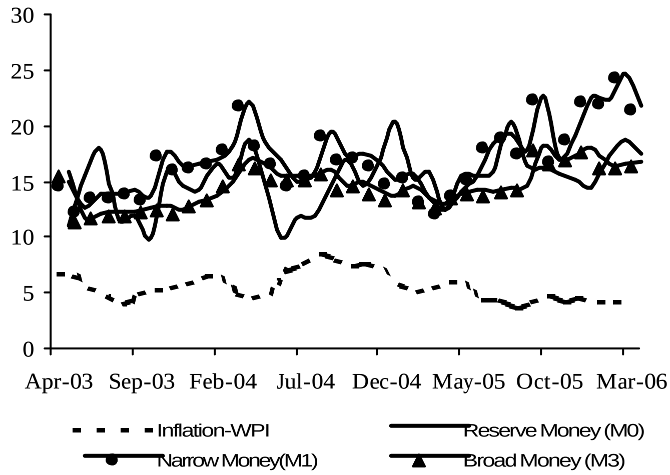


Fig M.6: Growth rates in Monetary aggregates and WPI Based Inflation



remains zero per se but it will be included in calculations of book profits and the resulting minimum alternative tax (MAT). The MAT rate has been increased to 10 per cent from 7.5 per cent. This coupled with the increase in services tax rate from 10 per cent to 12 per cent could have adversely affected the market sentiments but for the following sops extended to Foreign Institutional Investors (FIIs) and Mutual Funds (MF).

- Increase in the limit on FII investment in Government securities from $1.75 billion to $2 billion and FII investment in corporate debt from $0.5 billion to $1.5 billion;

- Increase in the ceiling on aggregate investment by mutual funds in overseas instruments from $1 billion to $2 billion with the requirement of 10 per cent reciprocal share holding done away with;
- To allow a limited number of qualified Indian mutual funds to invest, cumulatively up to $1 billion, in overseas exchange traded funds;
- To set up an investor protection fund under the aegis of SEBI, funded by fines and penalties recovered by SEBI. This will bolster confidence among retail investors who should be the key drivers of the capital market; and
- To develop corporate bond market

The BSE Sensex attained a lifetime high of 11356.95 points in the intraday trades on March 31, 2006. The Sensex crossed the 8000 mark on September 8, 2005 and the 10000 mark on February 8, 2006 and since then it has been rising.

Apart from few corrections, the upsurge continued crossing the 11000 mark on March 27, 2006. As of March 31, 2006, the Sensex recorded a growth of 77.1 per cent on Y-o-Y basis (Fig M.7 to M.9). The BSE-FMCG and BSE-CG groups of stocks have registered relatively higher growth (Fig M.8 and M.9).

However, it is also important to note that the P/E ratio of Sensex stocks is almost 21, which is substantially higher than commonly desired level of 16 (Fig M.7). This situation is continuing for more than a month and a major correction is now overdue.

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 of Indian stocks. The FII movement has

Fig M.7: Movements in BSE Sensex (at close) and P/E Ratio

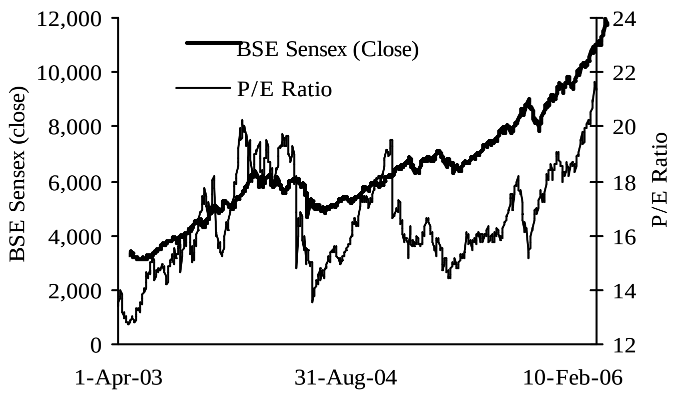


Fig M.8: Group-wise Growth in Stock Indices (% Y-o-Y)

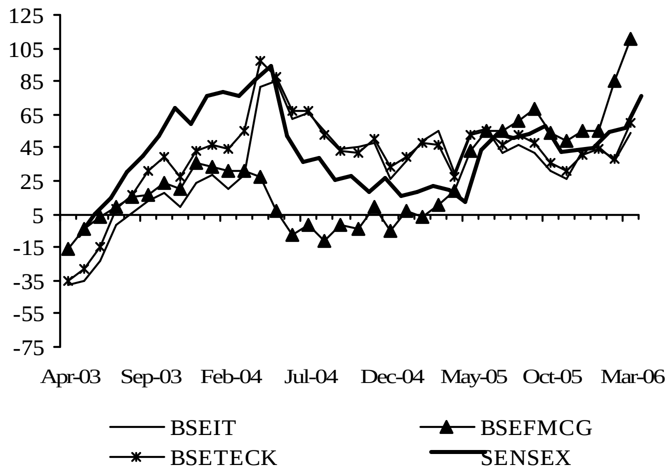
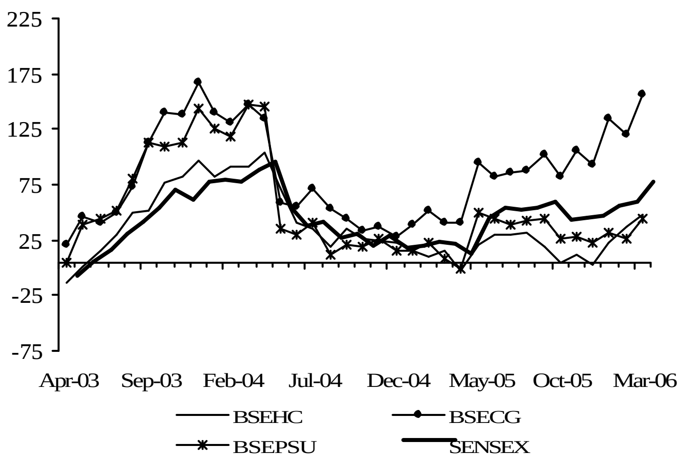


Fig M.9: Group-wise Growth in Stock Indices (% Y-o-Y)



shown high fluctuations during 2005-06. However, there is an increasing trend in the amount of investment, which however, is flatter than the trend in the Sensex movements. This suggests that there is something more than the FII story to drive the Sensex. Domestic investors, particularly the mutual funds are more equally bullish. The regulator SEBI and the RBI have therefore, rightly initiated closer watch on the sources of funds that are being invested to ensure the vulnerability of the financial system/protect the financial system against vulnerability.