

# Money and Capital Markets

## Stance of Monetary Policy

- Reverse repo rate 5.50 per cent
- Repo rate 6.50 per cent
- Bank rate 6.0 per cent
- Cash reserve ratio 5.0 per cent

## Policy Developments

In the Mid-term Review of 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 24 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. India needs both a low inflation, low interest rate regime.

In developed economies a 2.5 per cent inflation rate with the fund rate at about 3.0 per cent is considered favourable for sustaining a reasonably high growth rate.

For India, we feel this could be a percentage point higher for both. But this cannot be achieved quickly if opportunities are missed. Once such opportunity came during 2001-03 when oil prices had crashed and domestic inflation was well below 3 per cent (Fig M.1).

The overall macroeconomic management strategy at present appears to place greater stress on monetary policy, instead of focusing on the role of the government and its fiscal stance. The tendency to target interest rates for fighting supply driven inflation needs to be resisted as it becomes a stumbling block to aligning the interest rate structure quickly to interna-

tional levels.

The point should also be noted that at present India is closing the interest rate gap not because Indian rates are coming down but because international rates are going up. This strategy will reduce our ability to bring down the rates at a later stage.

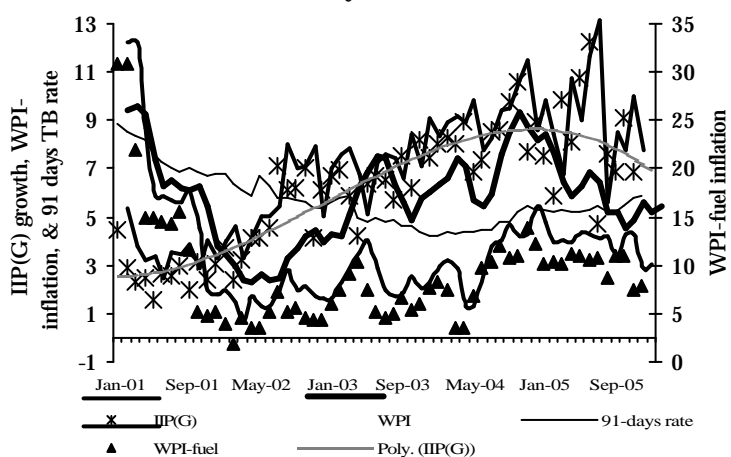
Indeed, we believe that instead of following the international trend, the current decrease in the interest rate differential should be treated as blessing in disguise for controlling capital inflows.

It is also a moot point if it is advisable to follow the US cycle as there is no clear cut demand driven business cycle in the Indian economy. In time, demand factors will start dominating, but that is not the case now.

Even in the US, supply side inflation is never fought entirely with the interest rate (Fig M.2). The Fed did not raise the

RBI increased both reverse repo and repo rate again by 25 basis points on January 24, 2006

**Fig M.1: IIP, Inflation and policy interest rate (91-days TB) in India**



interest rate during the fuel-led inflation and the resulting crash in production during December 2002 and February 2003. On the contrary, it reduced the target federal fund rate (Fig M.1).

The recent increases in the target Fed rates appear to be guided by an overheating economy, whereby the Fed wants to discourage resource deployment. Do we too need to do the same?

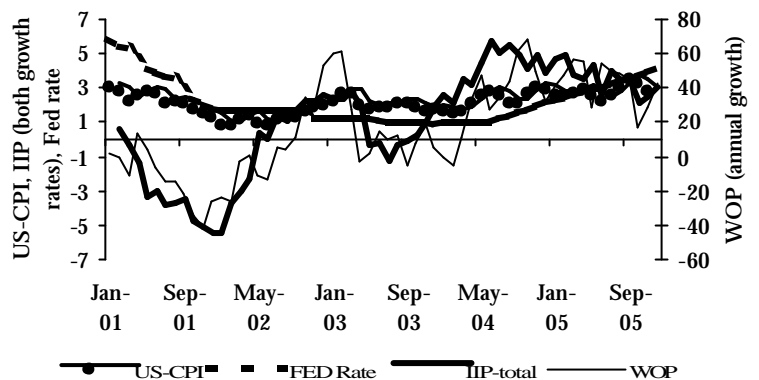
The majority view in the committee for open market operations in the US during recent periods suggests that the Federal Fund Rate is likely to remain at the current level for some time — if not be stronger even if there is slowdown in industrial growth (Fig M.2) because of the commitment to price stability.

Given the fact that the Fed gives equal weight to economic growth and inflation, there is a smaller likelihood of it easing monetary policy. This assessment is based on the following state of economy:

1. The ongoing round of tightening was preceded by a sustained accommodative policies followed through out 2002, which continued up until May 2004, and therefore, it may be prudent to watch the economy for a while;
2. There are views that the United States economy was quite near its potential, therefore slackness may trigger the inflation again; and
3. The underlying fundamentals did not show signs of weakening in the economy and therefore, proactive policy may not be required.

In the Indian context, Fig M.1 clearly shows that increases in the interest rate in tandem with the input cost been followed by some deterioration in growth; the high peaks in IIP growth are base effects, while general trend is downwards during the second half of 2005-06. The rise in interest

**Fig M.2: IIP, Inflation and Policy Interest Rate (Federal Fund Rate) in United States**



rate has hit back the consumer durable as well as consumer non-durables growth. The average growth in intermediates production during July-November 2005 has dropped to 2.6 per cent as against 5.3 per cent growth last year. The infrastructure has grown by just about 3.6 per cent on an average as against 7.1 per cent last year during July-November 2005. This is unlike the situation in the United States where consumer market is reported to be strong. Of course not all the slow down can be placed at the door of higher interest rate.

We do not have financial instruments such as inflation-adjusted bonds or a system of inflation expectations survey to judge market/public sentiments about expected inflation. However, some idea can be drawn from observing the yield curves. The October 2005 yield curve has shifted upwards only marginally with respect to July 2005 with a flatter middle and long ends (Fig M.3). 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 at 4.8 percentage points (Fig M.4). Thus, inflationary expectations in the market appear to be subdued.

Liquidity concerns are also not well founded. Commercial banks have reduced the proportion of demand and time deposits as cash in hand, and almost 90 per

The October 2005 yield curve has shifted upwards only marginally with respect to July 2005 with a flatter middle and long ends

cent of the liquid assets are kept with the RBI while the average call money rate is inching above the reverse repo rate. Further, Following the India Millennium Deposit (IMD) redemption in December 2005, current liquidity conditions are likely to be tight as reflected in increasing call money rate and the RBI will have to inject liquidity via the LAF auctions and unwinding of securities under the MSS or reduce CRR or do all of these.

Therefore, there was no compelling reason for the RBI to raise rates. On the contrary, taking advantage of low inflation, it should have softened the cost of finance. The real lending rate is too high if measured by the PLR.

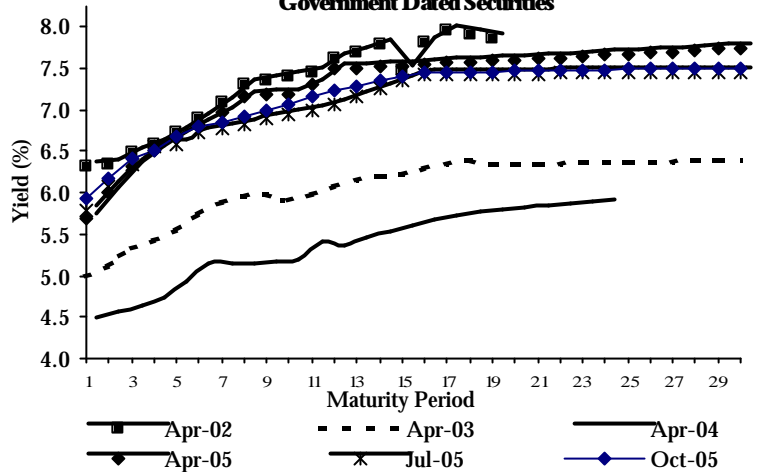
Despite this the growth of capital goods sector appears to dominate all other sector in terms of growth during July-November 2006, which is an indication of possible supply constraint.

This, however, does not mean that the administered rate for small savers should be aligned with low interest rate regime. The government will have to play the role of intermediary for the small savers until the financial market is ready to take care of small savings on equitable returns.

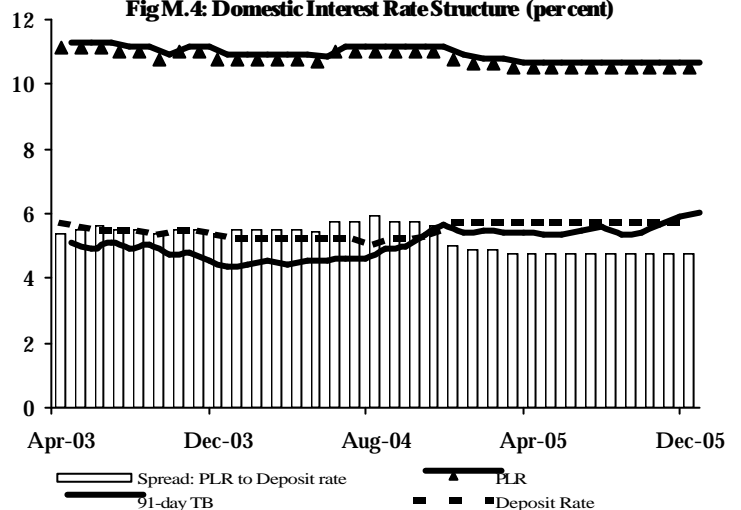
One of the reasons cited for raising the interest rate was the increasing prices of the residential housing. Sometimes the RBI also follows the market to align its rates, which suggests a policy lag, and the housing sector may not reflect overall credit market. The increased interest rate on borrowings would have been offset by the appreciation of asset prices and that is where the recent growth in money appears to have circulated.

This is reflected in the relatively high growth of 31.2 per cent in non-food credit in November 2005 on year on year (Y-o-Y) basis as compared to a growth rate of 31.6 per cent in March 2004, while the corresponding figures for IIP growth are

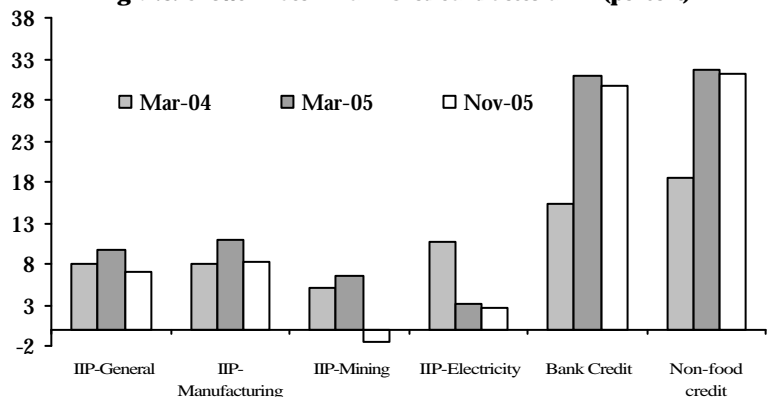
**FigM.3: Yield to Maturity of SGL Transactions in Central Government Dated Securities**



**FigM.4: Domestic Interest Rate Structure (per cent)**



**FigM.5: Growth Rate in Bank Credit and Sectoral IIP (per cent)**



6.9 and 9.8 per cent respectively, indicating a fall in the real output elasticity (Fig M.5).

### Banking

The banking sector is moving forward to greater efficiency and, thanks to efforts by the RBI, prudential norms are being implemented carefully. The provisional numbers show considerable improvements in terms of a fall in non-performing assets (NPA), capital to risk weighted asset ratio (CRAR) and prof-

itability (Table M.1).

Despite the higher risk weight assigned to housing loans, the CRAR for the scheduled commercial banks at the end of March 2005 was almost at the same level (12.9-12.8 per cent) as that of March 2004, which is well above the required ratio of nine per cent. Only two banks have reported less than the required number. Other institutions such as Development Financial Institutions (DFI), Scheduled Urban Cooperative Banks (SUCB), Primary dealers (PD),

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

	Stock	Annual Growth			Quarterly Growth	
	(Rs. crores)	(end of period)	(end of period)	(end of period)	(Y-o-Y, end of period)	(Y-o-Y, end of period)
	Dec-05	Mar-03	Mar-04	Mar-05	2004-05 Q3	2005-06 Q3
1. Reserve Money	535327	9.16	18.32	12.06	19.98	14.07
2. Narrow Money	736345	12.00	21.76	12.07	14.74	22.08
3. Broad Money	2529286	14.66	16.60	12.52	13.27	17.56
4. Major Components	0	0.00	0.00	0.00	0.00	0.00
(a) Currency in Circulation	406609	12.49	15.91	12.66	12.37	15.83
(b) Currency with the Public	394775	12.79	16.17	12.77	13.55	15.50
(c) Demand Deposit	341570	10.96	29.29	11.23	16.33	30.69
(d) Time Deposit	1792942	15.70	14.63	12.70	12.44	16.06
(e) Other Deposit	4659	14.88	71.90	15.10	24.27	1.55
5. Major Sources of M3	0	0.00	0.00	0.00	0.00	0.00
(a) NRBCG	-14071	-21.08	-62.61	-140.03	-63.75	-176.75
(b) NBCG	767934	27.21	25.91	10.75	7.54	7.35
(c) NBCC	1521132	18.34	13.23	25.80	25.89	25.57
(d) NFEA of Banking sector	683680	26.58	33.75	23.30	23.78	12.83
6. Major Sources of M0	0	0.00	0.00	0.00	0.00	0.00
(a) NFEA with RBI	614250	35.71	37.80	24.14	23.29	8.64
(b) Net Domestic assets	-78923	-85.56	-634.63	116.42	42.50	-17.89
7. Ratios						
(a) M3/M0	4.72	4.66	4.59	4.61	4.58	4.72
(b) M1/M0	1.38	1.28	1.32	1.32	1.29	1.38
(c) Deposit/RM	4.00	3.93	3.88	3.89	3.86	4.00
(d) NFEA (RBI)/RM	1.15	0.97	1.13	1.25	1.20	1.15
(e) NFEA (RBI)/CC	1.51	1.27	1.51	1.66	1.61	1.51
(f) NBCG/M3	0.30	0.32	0.35	0.34	0.33	0.30
(g) NBCC/M3	0.60	0.52	0.51	0.57	0.56	0.60
(h) Credit/Deposit #	0.69	0.57	0.56	0.65	0.63	0.69
(h) Non-Food Credit/Deposit#	0.67	0.53	0.53	0.62	0.60	0.67

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

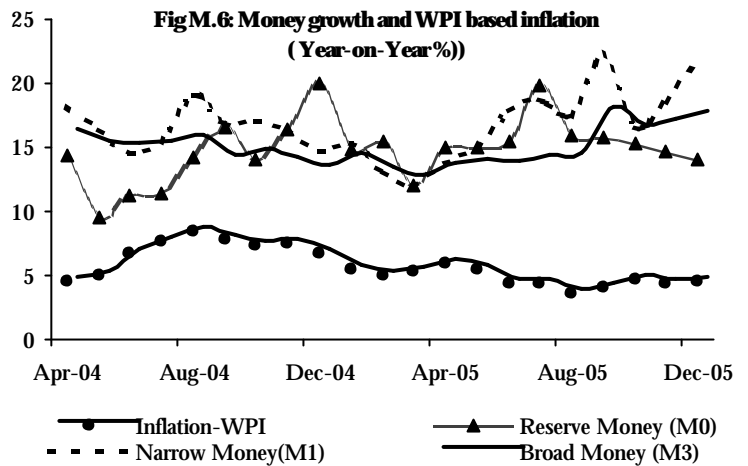
have in fact improved their CRAR.

The NPA for the SCBs measured on gross basis has fallen from 7.2 per cent of gross advances in 2003-04 to 5.2 per cent in 2004-05 and this improvement is seen across all the segments of the banking sector. However, this has possibly led to a slight increase in operating expenses, which has eroded the return on equity of the commercial banks from 20.64 per cent (March 2004) to 15.84 per cent (as of March 2005). Softening of PLR and hardening of deposit rate during this period (Fig M.4) may have played their parts. However, the return on total assets has fallen only marginally from 1.2 per cent to 0.90 per cent in 2004-05. Maintaining the interest rate policy will motivate banks and financial institutions to adjust their operations and consolidate.

**Monetary Movements and Credit Off-take**

Year on year (YoY) growth in broad money during 2005-06Q3 was 17.56 per cent as against 13.27 per cent during 2004-05Q3. During the same periods narrow money grew by 22.08 and 14.74 per cent (Table M1, Fig M.6). If the long-term trend growth rate of about 14 per cent were to be maintained, this could be considered only a little on the high side given last year's growth rates in broad and narrow aggregates of about 12.07 and 12.52 per cent respectively.

The high growth in narrow money is a reflection of increasing requirement of liquid money. For example, public has to maintain larger sums in their savings bank accounts to meet instalments on ever growing consumer loans. This has little to do with the interest rate differential between fixed deposits and savings deposit rates. More important is the appreciation in real assets prices, suggesting inadequate supply of real assets while availability of credit is easier.



Net Reserve Bank credit to the government (NRBCG) in 2005-06Q3 declined by 176.75 per cent, as against a decline of 63.75 per cent during FY 2004-05Q3.

Foreign exchange assets of the banking sector increased by 12.83 per cent during 2005-06Q3 on YoY basis, as against 23.78 per cent growth recorded during 2004-05Q3. The stock of foreign exchange in the banking sector was at Rs 68,3680 crore on December 31, 2005 and each rupee in circulation is now backed by 1.70 rupees equivalent of foreign currency.

Growth in net other bank credit to government (NBCG) was lower at 7.35 per cent during 2005-06Q3 on a YoY basis as compared to 7.54 per cent recorded during 2004-05Q3. As a result, the effective SLR stood at 36.06 as against 39.77 per cent of net demand and time liability (NDTL), much higher than the required minimum of 25 per cent. On the other hand YoY growth in net other bank credit to the commercial sector (NBCC) was 25.57 per cent during 2004-05Q3, compared to 25.89 per cent during 2004-05Q3. The ratio of non-food credit to deposits also increased from 0.60 to 0.67 during this period. As noted earlier, however, the growth numbers for overall com-

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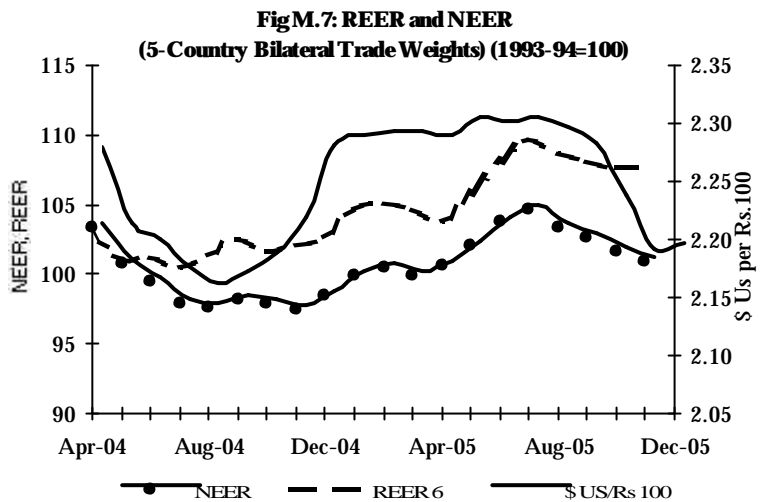
mercial sector credit is not reflected in the IIP.

### Foreign Exchange Reserves and the Exchange Rate

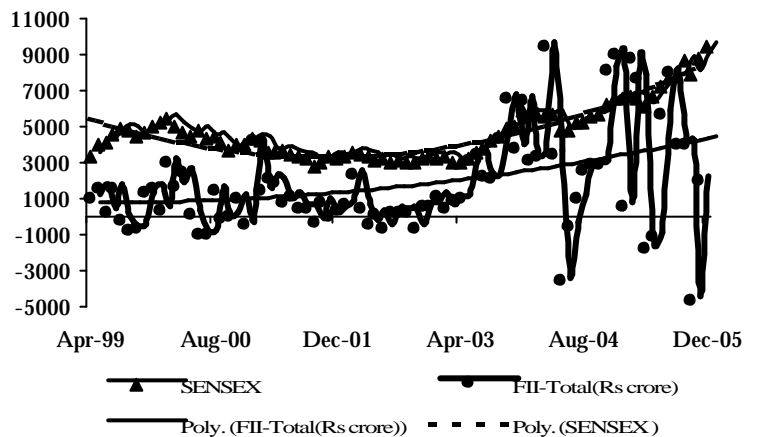
Foreign exchange reserves (FER) stood at US\$ 137.2 billion on December 31, 2005, a fall of about US\$ 0.733 billion in the stock of end-March 2005 but there was an addition of US\$ 6.03 billion to the stock of end-March 2004. The YoY growth was 8.64 per cent (in rupee terms) during third quarter of 2005-06 as against a growth of 23.29 per cent in 2004-05Q3 (Table M.1). The net change in the stock during December 23, 2005 and January 6, 2006 was a decrease of about US\$ 7.8 billion after taking into account currency rate effects. Most of it is due to the outflows on account of the maturity of India Millennium Deposit mobilised during November 2002. The SBI had started mobilising the fund at premium interest rates, which has pushed the call rates to go beyond 7 per cent, highest in recent months.

Fiscal 2004-05 ended with net NRI deposit outflow of US\$ 962 million as against net inflow of US\$ 3641 million during 2003-04. However, with increasing domestic interest rates in India, the NRI deposits saw net inflow of US\$ 174 million during April-September 2005 as against an outflow of US\$ 653 million during last year (RBI bulletin).

The overall current account after witnessing a surplus for the last three years went into deficit during 2004-05 with a few intermittent episodes of surpluses but again it has gone in to deficit during first and second quarters of 2005-06 with increasing amounts of US\$ 5296 and US\$ 7660 million respectively. This had its impact on exchange rate movements. On a Y-o-Y basis the six-country nominal and real exchange rate indices (NEER and REER) started depreciating in August 2005 (Fig M.7) after experi-



**Fig M. 8 : FII Inflows and BSE Sensex Movement**



encing strong appreciation during June-July, which is mainly on account of base effects.

On a month-on-month (M-o-M) basis, the Indian rupee has recorded depreciation against the US dollar since August, which may cause some concern to profit-seeking foreign institutional investors (FIIs), but that should not worry the monetary authority at the moment when the stock market is booming and needs correction anyway.

### Capital Markets

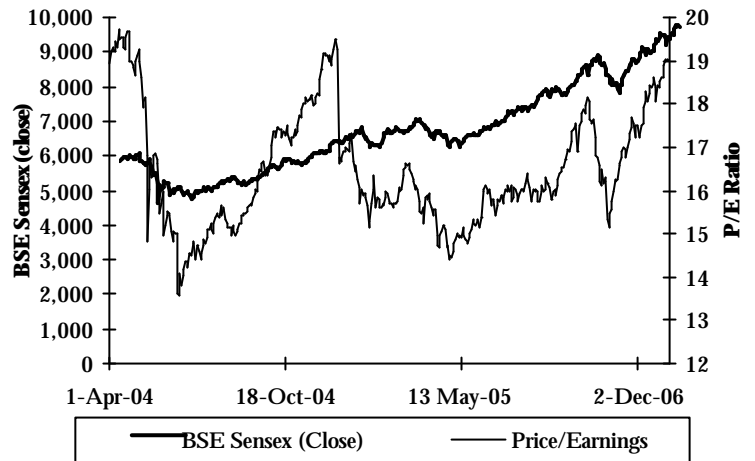
In the face of the surge in FII inflows (Fig M.8), better news about the monsoon almost all over the country and a fall in inflation, the BSE Sensex scaled a life-

time high of 9871 on January 27, 2006. Interestingly, all these movements are in tandem with emerging market trends. But, it is also important to note that the P/E ratio is almost approaching the level observed during the boom period of January-April 2004, as high as 20, which is substantially higher than commonly desired level of 16 (Fig M.9). The recent revelations about the misuse of DMAT system should be pointer of loopholes in the design and management of capital market regulation.

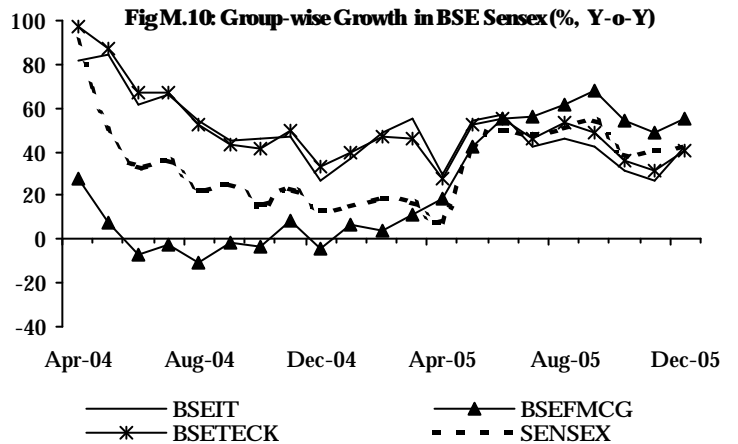
However, during October 2005, there was a major correction with the BSE Sensex closing at 7935 as on 20 October 2005. These corrections could also very well be in response to nominal depreciation of the currency and hike in the interest rate, leading to fear of reduction in profitability of Indian firms. Nevertheless the Sensex continues to be bullish with high growth coming in capital goods and manufacturing segments (Fig M.10 and M.11).

The turnaround in FII sentiment towards the Indian market was in line with that in emerging market economies. Ignoring high international oil prices, investors made all-round purchases in Indian stocks. The FII movement has shown high fluctuations during 2005. However, there is an increasing trend in the amount of investment, which is parallel to the trend in the BSE trend. But the important difference to note is that the fluctuations in the BSE is not as marked as in the FII movements and also the rate of growth of Sensex is much more than the trend growth in FII investment (Fig M.9). This suggests that FIIs alone do not drive the Sensex. Domestic investors are equally bullish. The regulator SEBI and the RBI have 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.

**Fig M.9: BSE Sensex Movement and P/E Ratio**



**Fig M.10: Group-wise Growth in BSE Sensex(%, Y-o-Y)**



**Fig M.11: Group-wise Growth in BSE sensex (% Y-o-Y)**

