

Money and Capital Markets

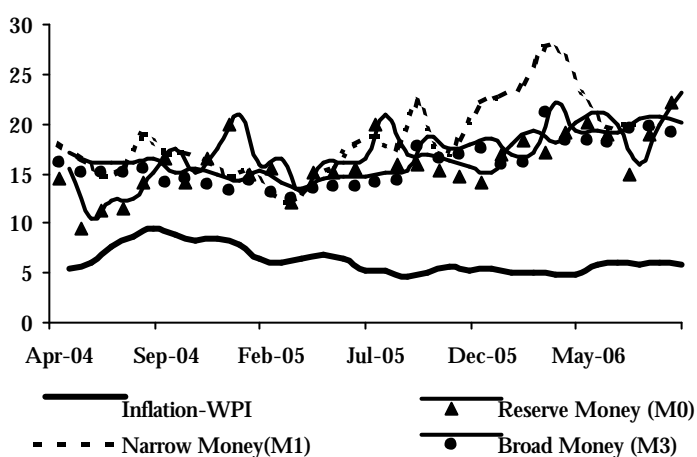
Monetary Movements: the beginning of fiscal dominance

The Y-o-Y growth in broad money during 2006-07Q2 was 19.16 per cent, as against 17.74 per cent during 2005-06Q2. During the same periods narrow money and reserve money grew by 19.23 and 22.18 per cent as against 22.22 and 15.82 (Table M.1 and Fig M.1). The growth rate of narrow money is less than the growth rates obtained at the end of fiscal year 2005-06. However, the reserve money is growing at alarming rate despite slow down in growth of the foreign exchange assets.

Net Reserve Bank Credit to the Government (NRBCG) in 2005-06 had declined by 238.17 per cent, as against a decline of 140.03 per cent during FY 2004-05. However, the situation appears to have reversed now. There has been significant increase of Rs 44966 crore in NRBCG between 2006-07Q1 and 2006-07Q2. In fact, the government deposits with the RBI, which had increased in the past as an essential outcome of foreign exchange management through MSS is a thing of past. Now, the RBI has started to finance government leading to sharp increase in reserves money growth, increasing beyond the growth rate of net foreign exchange assets of the RBI.

The foreign exchange reserves (FER) touched US\$164.95 billion on October 13, 2006 adding over US\$13 billion to the stock of end-March 2006. The

Fig M.1: Growth rates in monetary aggregates and WPI based inflation



Y-o-Y growth was 21.4 per cent (in rupee terms) during 2006-07Q2, as against a 15.42 per cent in 2005-06Q2 (Table M.1). The inflow, which slowed down significantly due to softening of interest rate differential between domestic and international rates (Figure M6), has started showing higher growth rate, partly on account of base effect and partly due to increase in NRI deposits. Thus, both foreign as well as domestic assets are on rise in the reserve money. The only factor that appears to dampen the growth of reserve money is increases in non-monetary assets possibly due to valuation effect.

Comparing the growth rate of monetary aggregates and the inflation during recent years, there is evidence of increase in absorptive capacity in the economy.

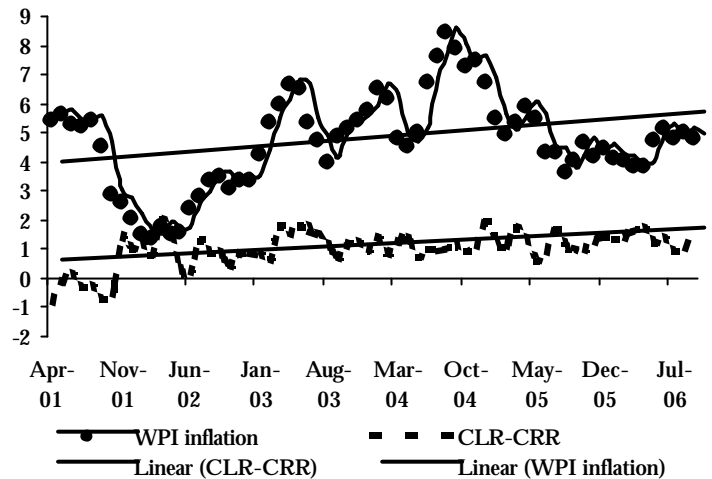
During 2006-07 the growth in real GDP is expected to lie between 7.5 and 8.0 per cent, which is comparable to 8.1 per cent obtained last year. With positive expectations about the sustained high growth rate, the investment is picking up and therefore, the monetary authorities should be careful in delineating the supply side and demand side effects. The productivity growth could absorb part of oil shocks, which is reflected in almost stationary state of core inflation for last several months.

However, though a domestic content is desired in the sources of reserve money supply, such a high growth in reserve money by printing currency is likely to create inflationary pressures during months to come.

Foreign exchange assets of the banking sector increased by 9.95 per cent only during 2005-06 on Y-o-Y basis as against 23.3 per cent growth recorded during 2004-05. 2006-07 started with recovery of 23.8 per cent during first quarter but it could not be sustained in the second quarter. Foreign exchange reserves stock in the banking sector fell to Rs 727,733 crore at the end of 2006-07Q2, a decline of 7.4 per cent over Rs.785,710 crore recorded in June 2006 and each rupee in circulation is now backed by 1.6 rupees equivalent of foreign currency.

There is clear fall in the investment interest of banking sector in government bonds. Period ending 2006-07Q2, the holding has gone down to 31.6 per cent of time and demand liability as against 37.6 per cent during 2005-06Q2 and required SLR of 25 per cent. The bank credit to government (NBCG) declined by 3.82 per cent during 2005-06 on a Y-o-Y basis, as compared to an increase of 10.75 per cent recorded during 2004-05. A similar sentiment appears to continue during the current year with 2006-07Q2 recording a marginal rate of growth

Fig M.2: Trend of liquidity holding against required rate of CRR and WPI based inflation



of 0.30 per cent as against 7.93 per cent obtained during 2005-06Q2. The key reason appears to be liquidity considerations 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 and a similar growth of 28.22 is recorded during 2006-07Q2.

It appears that the preference of commercial banks to keep higher liquidity has increased, possibly, in order to meet the competition and the uncertainty of financial demands created by the high growth rate of the economy on a sustained basis (Fig M.2). The effective cash holding (CLR in Figure 2) stood at 6.62 per cent of time and demand liability as against 5.0 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 off take.

Interest Rate Policy developments

The second quarterly report of the RBI has now been released. There has been

no change in the reverse repo rate or CRR. But the repo rate at which RBI lends short-term funds to the banks has been increased by 25 basis points to 7.25. In the first quarterly report of the current financial year released on 25th July the Reserve Bank (RBI) increased both the reverse repo rate and the repo rate by 25 basis points over and above the surprise hike of the same magnitude on 9th June 2006 immediately following the upward revision of petrol and diesel prices by the government. The CRR was maintained at five per cent. The decision of that time was in line with the arguments to stay in line with the global developments in the financial markets and the cycle of monetary tightening in the United States and other developed countries and some of the emerging market economies (Fig M.3). The RBI had also shown concerns for high growth in credit by the commercial banks, which appeared to be used as proxy for overheating.

The core inflation is pretty stationary around 3.2 per cent since June 2006 despite increasing inflation in the mineral oil and food segments (Fig M.4). The cumulative headline inflation has averaged below 5.0 per during 2006-07 Q2 (Fig M.5). The world oil price inflation is clearly slowing down and there is large content of base effect in month-to-month annual inflation.

The main culprits in driving the headline inflation are the mineral oil prices and the food prices. Both being supply side effects requiring careful treatment, preferably from the fiscal side, because investment conditions need to be sustained.

Increases in interest rates have curtailed the consumption expenditure as reflected in the slow down of the growth in index of industrial production for the consumer goods. And, now the growth of capital goods is showing signs of slower growth. Buoyed by the growth prospects the indus-

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

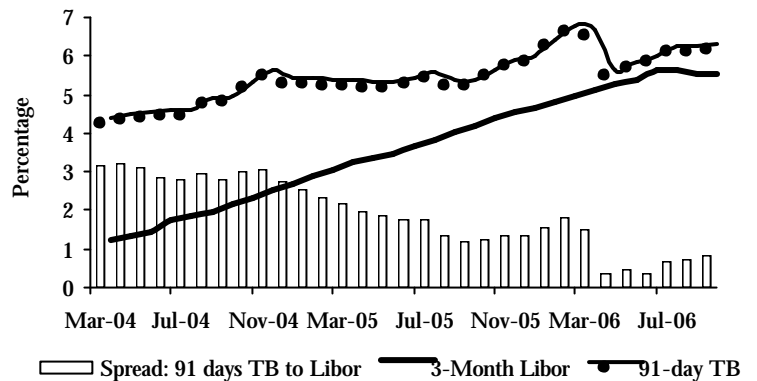


Fig M.4: Headline WPI, oil price, food price and core inflation in India

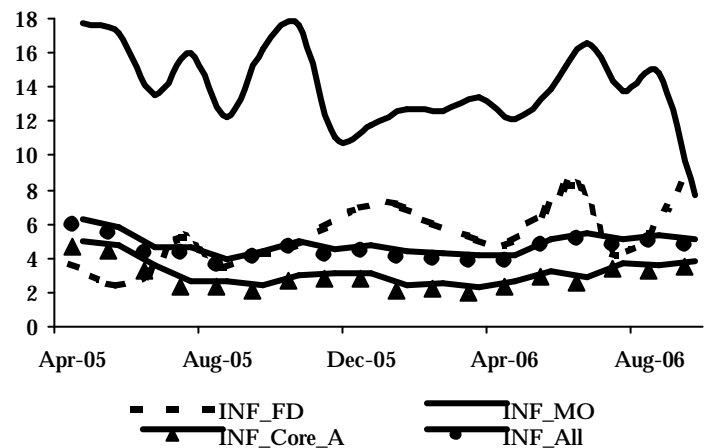
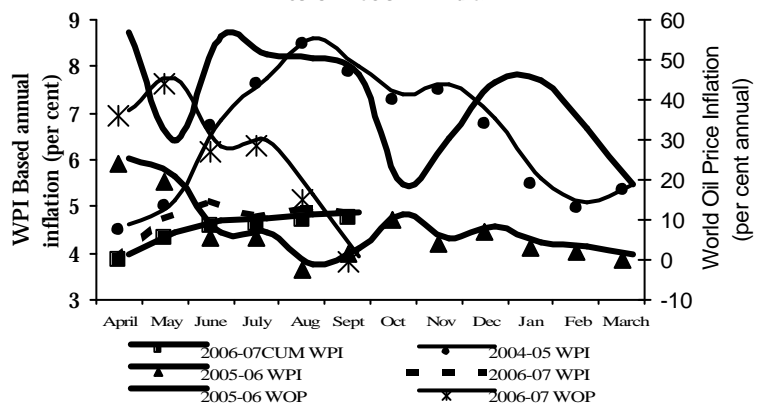


Fig M.4: Headline WPI, oil price, food price and core inflation in India



try has been mobilising investment for creating capacity as reflected in the sustained growth of capital goods production (Fig M.6). With increasing cost of capital and fall in consumption, the industry will be faced with potentially excess capacity and low profitability. The fear of economy getting heated up is not strong in absence of consumption boom.

The past increases in the repo rates have lifted the yield curve, by about one percentage point since March 2006 particularly, at the longer ends (Fig M.7).

Increases in inflation could also be attributed to softening of rupee against US\$, which has in turn increased oil prices in the domestic market, albeit with a spin off in terms of impressive increase in export. Both the six-country nominal exchange rates (NEER) as well as real exchange rate index (REER) continue to depreciate (Fig M.8). With federal fund rate tagged at higher level, and the resulting appreciation of US\$ against other currencies, slow down in external inflows to India and deficit in its current account, the rupee is likely to maintain depreciating tendency during 2006-07.

Capital Market

The BSE Sensex attained a lifetime high of 12994.45 in the intra-day trades on October 17, 2006 surpassing the May 11, 2006 record of 12,671.11 registering a growth of 158 per cent on Y-o-Y basis. The May 11, 2006 record was followed by a FII withdrawal of Rs. 7,541 crore from the market leading to a crash of the stock prices to a level of 8799 on 14 June 2006 (Fig M.9 & Fig M.10). Since then the FII sentiments appears to have restored in the face of good news of robust economic growth, and encouraging corporate results.

However, recent movements have led to increase in volatility and uncertain-

Fig M.6 Annual growth in selected segments of the index of industrial production

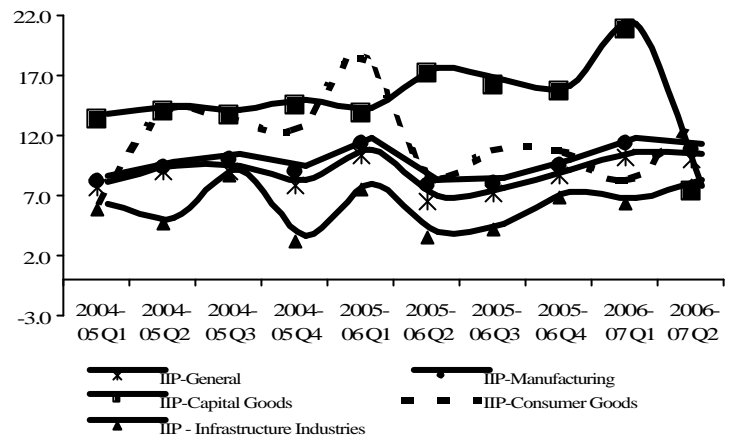


Fig M.7 Month-end Yield to Maturity of SGL Transactions in Central Government Dated Securities for Various Residual Maturities

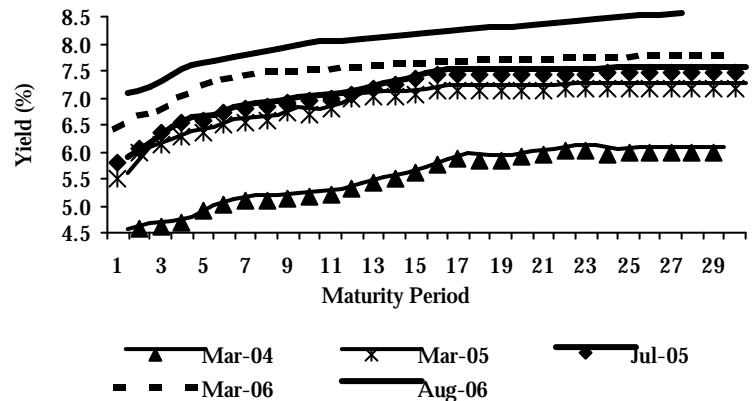
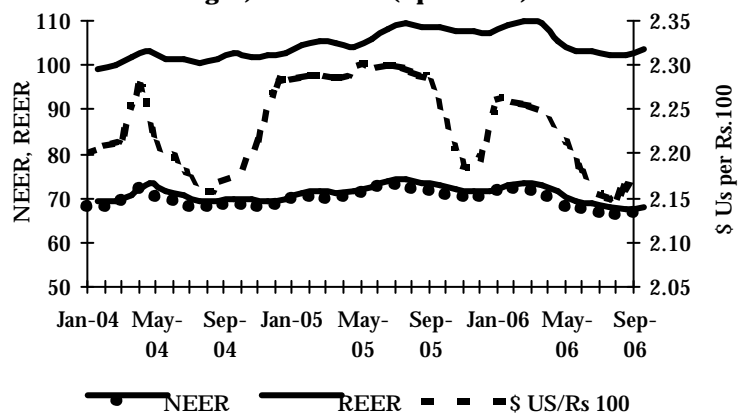


Fig M.8 REER and NEER (6-Country Bilateral Trade Weights) Base: 1993-94 (April-March) = 100



ties. The P/E ratio is much above long-term trend. The patterns of peaks and troughs indicate another correction may be in the offing. Fig M.11 & Fig M.12 show most of the growth in sensdex being driven by the capital goods sector. If the investment climate is not supported by policy environment performance of the capital goods sector will be adversely affected.

With softening of global oil prices the prospects of global growth have improved. Therefore, for the time being, the international investors may will take on extra risks instead of switching over to safe instruments. This may also reduce pressure on US\$ with consequent appreciation of other currencies.

Fig M.9: Movements in BSE sensdex (at close) and the P/E ratio

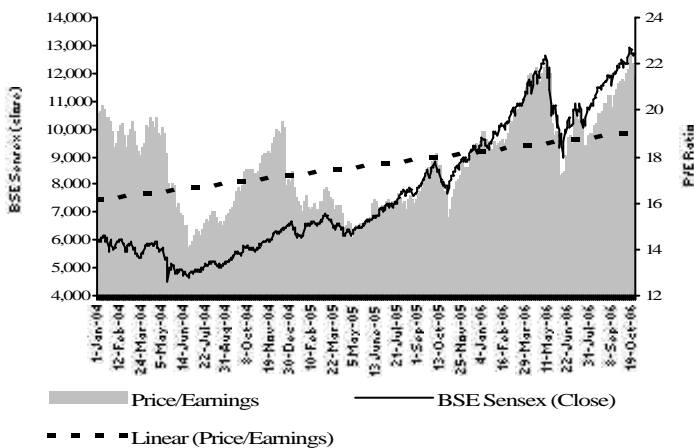


Fig M.10: FII investment and movements in Sensex

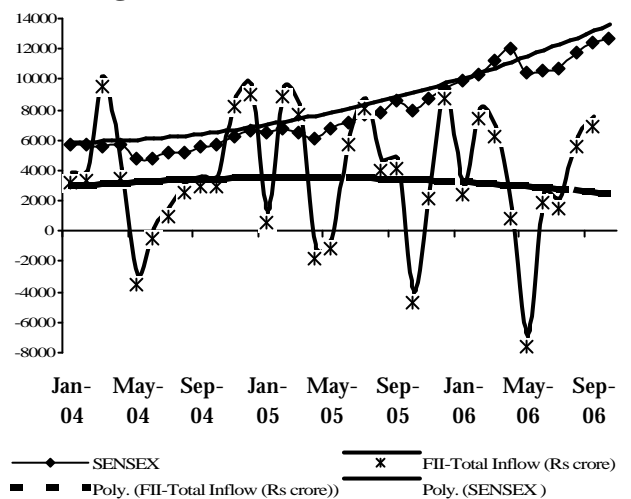


Fig M.11: Group-wise growth of Stock Indices (% y-o-y)

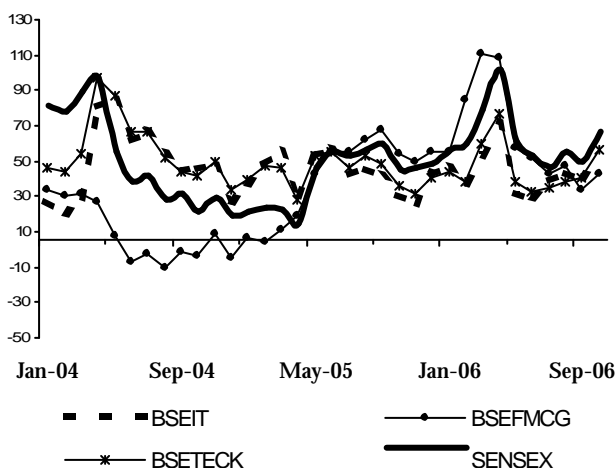


Fig M.12: Group-wise growth of Stock Indices (% y-o-y)

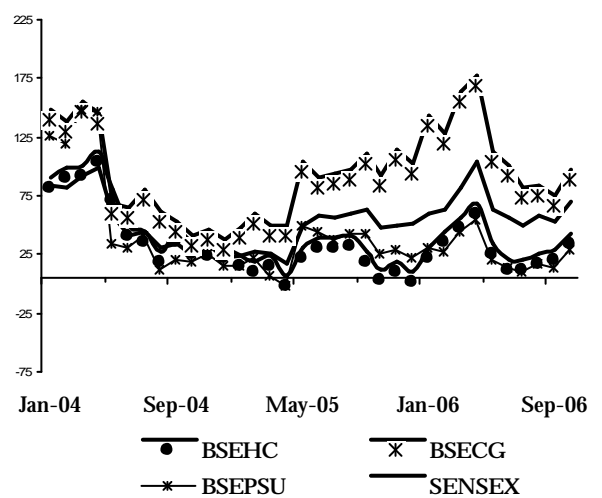


Table M.1: Changes in Monetary Aggregates and their Components

| | Stock (Rs.crores) | Annual Growth (end of period) | | | | | Quarterly Growth (Y-o-Y, end of period) | | | | |
|-------------------------------|----------------------|-------------------------------|---------|---------|---------|---------|---|------------|------------|------------|------------|
| | | Sep-06 | Mar-03 | Mar-04 | Mar-05 | Mar-06 | 2005-06 Q1 | 2005-06 Q2 | 2005-06 Q3 | 2006-07 Q1 | 2006-07 Q2 |
| 1. Reserve Money | 606692 | 9.16 | 18.32 | 12.06 | 17.15 | 15.53 | 15.82 | 14.07 | 18.99 | 22.18 | |
| 2. Narrow Money | 836467 | 12.00 | 21.76 | 12.07 | 27.69 | 17.88 | 22.22 | 22.08 | 19.64 | 19.29 | |
| 3. Broad Money | 2942417 | 14.66 | 16.60 | 12.52 | 21.10 | 13.61 | 17.74 | 17.56 | 18.13 | 19.16 | |
| 4. Major Components | | | | | | | | | | | |
| (a) Currency in Circulation | 451778 | 12.49 | 15.91 | 12.66 | 16.78 | 13.72 | 13.07 | 15.83 | 15.85 | 19.58 | |
| (b) Currency with the Public | 434686 | 12.79 | 16.17 | 12.77 | 16.13 | 13.83 | 11.64 | 15.50 | 16.91 | 19.44 | |
| (c) Demand Deposit | 401780 | 10.96 | 29.29 | 11.23 | 41.86 | 23.38 | 36.14 | 30.69 | 23.05 | 19.12 | |
| (d) Time Deposit | 2105949 | 15.70 | 14.63 | 12.70 | 18.45 | 12.01 | 16.06 | 16.06 | 17.52 | 19.11 | |
| (e) Other Deposit | 6383 | 14.88 | 71.90 | 15.10 | 7.83 | 35.42 | 29.51 | 1.55 | 35.99 | 12.93 | |
| 5. Major Sources of M3 | | | | | | | | | | | |
| (a) NRBCG | 11016 | -21.08 | -62.61 | -140.03 | -238.17 | -180.82 | -421.16 | -176.75 | 194.14 | 132.45 | |
| (b) NBCG | 790896 | 27.21 | 25.91 | 10.75 | -3.82 | 3.92 | 7.93 | 7.35 | 0.96 | 0.30 | |
| (c) BCC | 1846941 | 18.34 | 13.23 | 25.80 | 27.29 | 27.02 | 30.71 | 25.57 | 27.37 | 28.22 | |
| (d) NFEA of Banking sector | 727733 | 26.58 | 33.75 | 23.30 | 9.95 | 8.65 | 14.14 | 12.83 | 23.80 | 10.15 | |
| 6. Major Sources of M0 | 0 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | |
| (a) NFEA with RBI | 756221 | 35.71 | 37.80 | 24.14 | 9.82 | 9.58 | 15.42 | 8.64 | 24.90 | 21.38 | |
| (b) Net Domestic assets | -149529 | -85.56 | -634.63 | 116.42 | -19.18 | 12.41 | -13.88 | 17.89 | -53.74 | -18.24 | |
| 7. Ratios | | | | | | | | | | | |
| (a) M3/M0 | 4.85 | 4.66 | 4.59 | 4.61 | 4.76 | 4.75 | 4.97 | 4.72 | 4.72 | 4.85 | |
| (b) M1/M0 | 1.38 | 1.28 | 1.32 | 1.32 | 1.44 | 1.36 | 1.41 | 1.38 | 1.37 | 1.38 | |
| (c) Deposit/RM | 4.14 | 3.93 | 3.88 | 3.89 | 4.05 | 4.01 | 4.25 | 4.00 | 3.99 | 4.14 | |
| (d) NFEA (RBI)/RM | 1.25 | 0.97 | 1.13 | 1.25 | 1.17 | 1.21 | 1.25 | 1.15 | 1.26 | 1.25 | |
| (e) NFEA (RBI)/CC | 1.67 | 1.27 | 1.51 | 1.66 | 1.56 | 1.54 | 1.65 | 1.51 | 1.66 | 1.67 | |
| (f) NBCG/M3 | 0.27 | 0.32 | 0.35 | 0.34 | 0.27 | 0.33 | 0.32 | 0.30 | 0.28 | 0.27 | |
| (g) NBCC/M3 | 0.63 | 0.52 | 0.51 | 0.57 | 0.60 | 0.57 | 0.58 | 0.60 | 0.61 | 0.63 | |
| (h) Credit/Deposit # | 0.72 | 0.57 | 0.56 | 0.65 | 0.72 | 0.65 | 0.66 | 0.69 | 0.71 | 0.72 | |
| (h) Non-Food Credit/Deposit# | 0.70 | 0.53 | 0.53 | 0.62 | 0.70 | 0.62 | 0.64 | 0.67 | 0.69 | 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