

Money and Capital Markets

Stance of Monetary Policy

- Reverse Repo rate 5.25 per cent
- Repo rate 6.25 per cent
- Bank rate 6.0 per cent
- Cash reserve ratio 5.0 per cent

Policy developments

The context of monetary policy has changed. It has now taken into account the apprehension of rising inflation during the second half of 2005-06, the possibility of a hike in domestic oil prices, the sharp rise in international interest rates during April 2004 to September 2005 and closing the gap between domestic and international rates to just about one per cent (Fig M.1). There was reason to suspect that the government did not want to see higher interest rates but the Mid-term Review of Annual Policy Statement of the RBI has increased both reverse repo rate as well as repo rate by 25 basis points.

One of the reasons cited is rise in the housing prices. Housing sector loans contribute just about 8 per cent of the non-food credit. But it is well to bear in mind that it is not the interest rate alone that affects housing demand. Several other factors, including income tax benefits have a bearing on it. Also, the limits on housing loans for priority sector lending was raised to 15 lakh, which has motivated banks to concentrate on metropolitan cities and get the priority sector obligations fulfilled quickly. It is easy and sufficient availability of housing loan that has raised demand rather than low interest rates alone. Clear-

ly this is not the major guiding factor for the central bank.

Inflationary pressures expected from the oil prices are a supply driven phenomenon, which squeezes the output anyway. Creating a further demand constraint by tightening the monetary policy will reduce

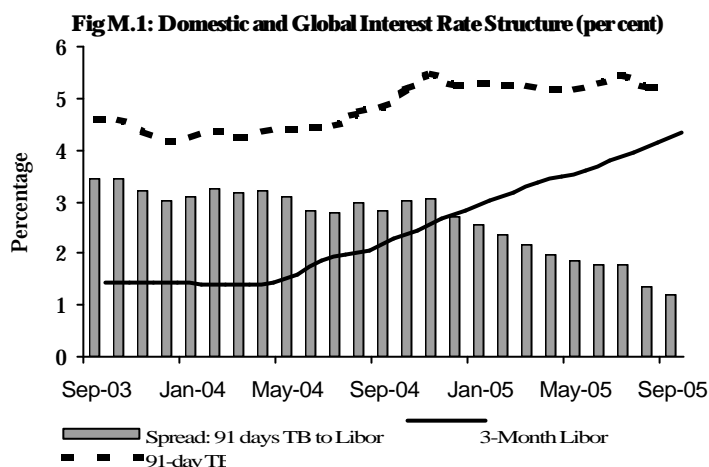
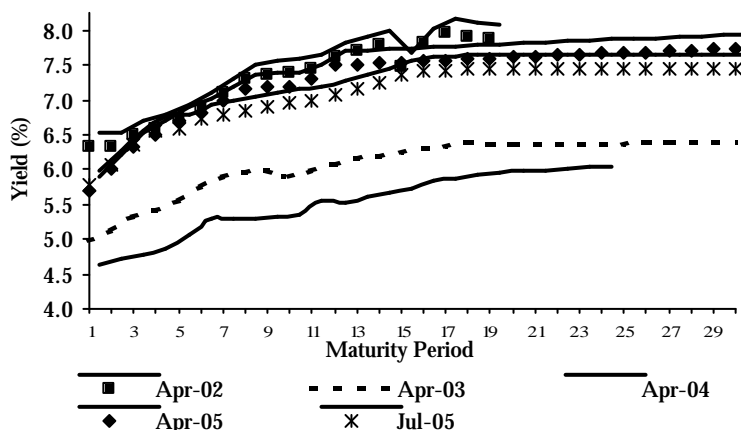


Fig M.2: Yield to Maturity of SGL Transactions in Central Government Dated Securities



output more than it curbs inflation, particularly in a demand constrained economy. Fiscal measures would have been better a better option but are not available to the RBI. There is a case for better coordination between monetary and fiscal policy for optimal outcomes.

At the moment long-term rates are orderly and flat, but at a much higher level in comparison to April 2004 (Fig M.2).

The liquidity situation does not appear excessively alarming. Commercial banks have reduced the proportion of demand and time deposits as cash in hand, and almost 90 per cent of the liquid assets are kept with the RBI, which justifies the average call money rate being slightly below the reverse repo rate.

With lower inflation at the moment, the real rates are also much higher compared to April 2004. Raising the policy rates will thus have an impact on investment decisions, which appear to have slowed down, although only marginally, as compared to 2004-05. IIP-capital goods increased by an average growth of 11.9 per cent during April-August 2005-06 (as against 13 per cent growth rate recorded during the same recorded during the same period last year).

However, the increased interest rate on borrowings seems 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 high growth of 33.7 per cent in non-food credit in August 2005 on year on year (Y-o-Y) basis as compared to a growth rate of 30.5 per cent in March 2005, while the corresponding figures for IIP growth are 7.4 and 9.8 per cent respectively, indicating a fall in the real output (Fig M.3).

If oil prices are not raised, oil companies may cut back transfers to the government, calling for more borrowings from the commercial banks, which in turn may harden interest rates anyway. Therefore,

Fig M.3: Growth Rate in Bank Credit and Sectoral IIP (per cent)

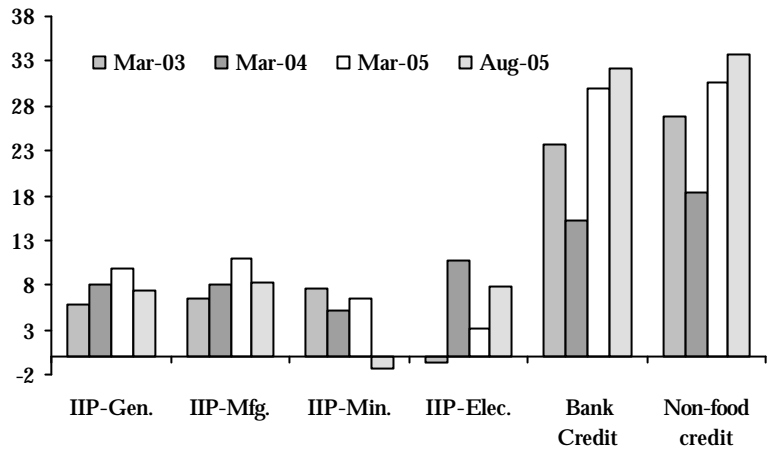
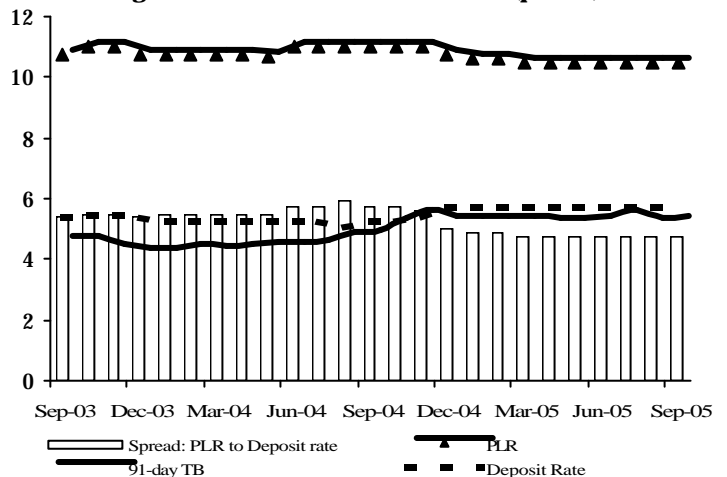


Fig M.4: Domestic Interest Rate Structure (per cent)



both routes of hardening interest rate are possible, the difference being that the latter will be market determined, while the former, policy determined.

However, if government decides to borrow from the RBI, the latter will have much needed domestic assets to sterilise foreign inflows to the desired extent required by the movements in prices and the exchange rate. We believe this to be the better option where ripples of expectation errors can be avoided.

The July 2005 yield curve has shifted downward with respect to April 2005 by almost 0.25 percentage points with a flat-

Table M.1: Select Financial Indicators of the banking sector

	Period	Scheduled Commercial	DFIs	PDs	NBFCs	SUCBs
CRAR	Mar-2004	12.9	22.0	42.7	26.8	11.0
	Mar-2005	12.8	22.8	54.3	22.9	12.7
Gross NPAs to Gross Advances	Mar-2004	7.4	16.4	n.a.	8.2	30.4
	Mar-2005	5.2	11.5	n.a.	8.1	24.9
Net NPAs to Net Advances	Mar-2004	2.9	10.5	n.a.	2.4	20.8
	Mar-2005	2.0	3.7	n.a.	3.4	8.9
Return on Total Assets	2003-04	1.1	-0.2	5.9	2.5	0.4
	2004-05	0.9	1.1	-1.8	n.a.	0.3
Return on Equity	2003-04	19.3	-1.2	19.9	13.6	n.a.
	2004-05	14.0	4.8	-5.1	n.a.	n.a.
Cost/Income Ratio	2003-04	45.6	0.2	16.9	14.1	24.9
	2004-05	49.3	0.2	297.0	n.a.	25.5

Notes: n.a. : Not available.

Note:1. Data for March 2005 are provisional.

2. Data for NBFCs pertain to deposit-taking NBFCs having an asset size of Rs.10 crore and above. Data for 2005 in respect of NBFCs pertain to the period ended September 2004.

3. Data for scheduled commercial banks pertain to domestic operations only and may not tally with the balance sheet data.

4. Data in respect of DFIs as on March 2005 do not include IDBI due to its conversion into a banking company.

5. In regard to UCBs, data for CRAR relate to 52 scheduled UCBs while other data relate to 53 scheduled UCBs (out of 55). Data scheduled UCBs are based on Off-site Surveillance statements

Source: RBI, Annual Report (2004-05)

ter middle and long parts. 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.

Banking

It should also be noted that 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 profitability (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 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), have in fact improved their CRAR.

The NPA for the SCBs measured on gross basis has fallen from 7.4 per cent of gross advances in 2004-05 to 5.2 per cent in 2004-05. Similar improvements are visible in all other segments of institutions. However, this has possibly led to a slight increase in operating expenses, which has eroded the return on equity of the commercial banks from 19.3 per cent

The context of monetary policy has changed to take into account the apprehension of rising inflation during second half of 2005-06

to 14.0 per cent, despite hardening of interest rates between March 2004 to March 2005. However, the return on total assets has fallen only marginally from 1.1 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 to more realistic profitability.

Monetary Movements and Credit Off-Take

Year on year (YoY) growth in broad money during 2005-06Q2 was 15.57 per cent as against 14.13 per cent during 2004-05Q2. During the same periods narrow money grew by 18.98 and 16.88 per cent (Table M.2 Fig M.5). If long-term trend growth rate of about 14 per cent were to be maintained, this could be considered a little on the high side given last year's growth rates in broad and narrow aggregates of about 13.28 and 13.5 per cent respectively.

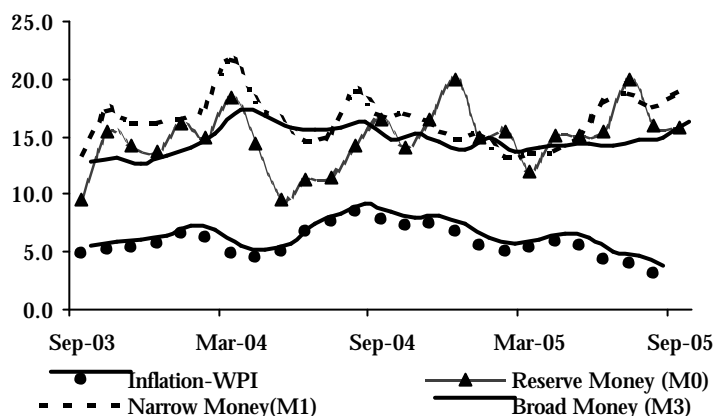
Net Reserve Bank credit to the government (NRBCG) in 2005-06Q2 declined sharply.

Foreign exchange assets of the banking sector increased by 14.52 per cent during 2005-06Q2 on YoY basis, as against 30.57 per cent growth recorded during 2004-05Q2. The stock of foreign exchange in the banking sector was at Rs 66,2891 crore on September 16, 2005 and each rupee in circulation is now backed by 1.75 rupees equivalent of foreign currency.

Growth in net other bank credit to government (NBCG) was lower at 8.78 per cent during 2005-06Q2 on a YoY basis as compared to 13.24 per cent recorded during 2004-05Q2. As a result, the effective SLR stood at 38.81 as against 41.35 per cent of 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 28.04 per cent

during 2004-05Q2, compared to 20.11 per cent during 2004-05Q2. The ratio of non-food credit to deposits also increased from 0.56 to 0.64 during this period. As noted earlier, however, the growth numbers for overall commercial sector credit is not reflected in the IIP.

Fig M.5: Money growth and WPI based inflation (Year-on-Year%)



Foreign Exchange Reserves and the Exchange Rate

Foreign exchange reserves (FER) crossed US\$ 143 billion on Sept 30, 2005, adding just about 1.545 billion to stock of end-March 2005 as against an addition of US\$ 6.62 billion to the stock between end-March 2004 and Sept 2004. The YoY growth was 14.52 per cent (in rupee terms) during second quarter of 2005-06 as against a 30.57 per cent in 2004-05Q2 (Table M2).

This is in line with expectations discussed in last year's second quarterly report. June 2004 recorded a fall in NRI deposits and same trend is likely to continue with the hardening of international dollar deposit rates and the resulting fall in interest rate differentials during the last three months (Fig M.1).

2004-05 ended with net NRI deposit outflow of US\$ 1,069 million as against net inflow of US\$ 3,641 during 2003-04. However, 2005-06Q1 witnessed direct

Policy rates will have an impact on investment decisions

investment of US\$ 1,186 million and portfolio investment of US\$ 864 million, as against corresponding numbers of US\$ 814 million and US\$ 82 million respectively during 2004-05Q1 (RBI bulletin).

The overall current account after witnessing a surplus for the last three years, went into deficit during 2004-05. The deficit increased from the second quarter to the third quarter with a mild surplus witnessed during the fourth quarter. This had its impact on exchange rate movements.

On a YoY basis the five-country nominal exchange rate index (NEER) started depreciating in June through till December 2004, moving after that in both directions. The five-country real exchange rate (REER) index, has on the other hand appreciated YoY (Fig M.6).

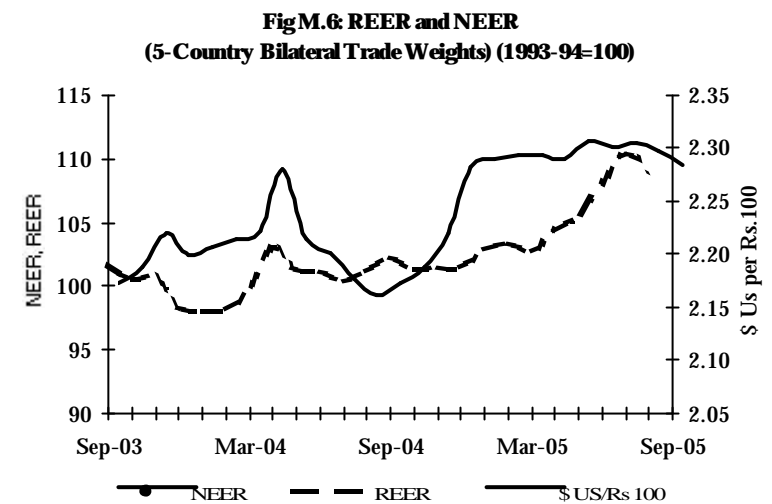
Since June 2005 both REER and NEER have shown strong appreciation on YoY basis despite orderly inflation. This can be attributed partly to a slow-down in sterilisation but it is mostly due to a low base effect.

On a month-on-month (MoM) 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, better news about the monsoon almost all over the country and a fall in inflation, the BSE Sensex scaled a lifetime high of 8799.96 on 4 October 2005, a gain of about 33 per cent since April 2005, despite oil prices not showing any sign of reversal (Fig M.7).

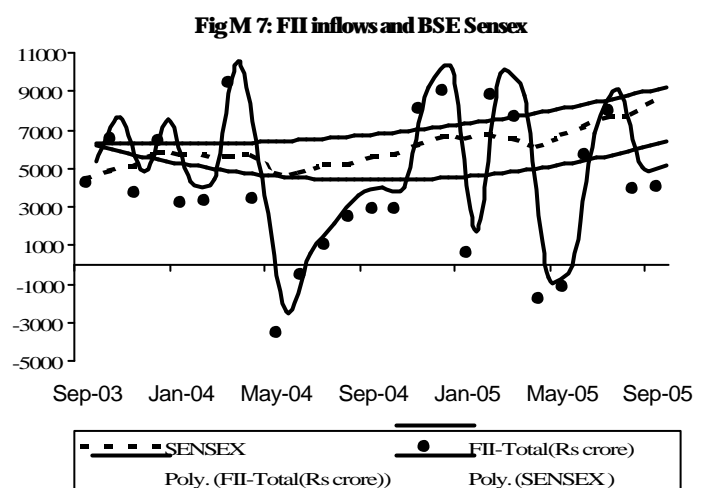
However, during October 2005, there was a major correction with the BSE Sen-



sex closing at 8075 as on 20 October 2005. Interestingly, all these movements are in tandem with emerging market trends. These corrections could also very well be in response to nominal depreciation of the currency or a fear of interest hike, leading to reduction in profitability of Indian firms.

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 so far. However, there is an increasing trend in the amount of investment, which is

Since June 2005 both REER and NEER have shown strong appreciation on YoY basis



parallel to the trend in the BSE trend.

But the important difference to note is that the fluctuations in the BSE are not as marked as in the FII movements. This suggests that there is something more than the FII story to drive the Sensex. Domestic investors are equally bullish. The regulator SEBI and the RBI have therefore, rightly initiated close watch on the sources of funds that are being invested to ensure the vulnerability of the financial system/protect the financial system against vulnerability?

The second important observation in FII movements is that there are fewer episodes of net withdrawals. It is also important to note that the P/E ratio observed during the boom period of January-April 2004 was as high as 20 as compared to about 17 during the recent months, which is marginally higher than commonly desired level of 16 (Fig M.8).

With the recent correction the market has achieved this level. This means that investors are not ready to pay a higher price for every unit of expected return. Yet, the Sensex keeps rising, where most of the gains are recorded in the manufacturing, capital goods and technology segments (Fig M.9 and M.10) 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. Clearly, investors seem to be moderate on expected returns yet optimistic about Indian economy.

The first quarter results of several key players have been good. Indeed the overall performance of the corporate sector during 2004-05 in terms of growth in PAT has been 37.2 per cent, which is very close to the 35.6 per cent obtained during 2003-04. These indicators suggest that the recent spurt in the Sensex is likely to be based on strong fundamentals.

With further depreciation of currency, there may be reversal of flows and it is

Fig.M.8: BSE sensex(at close) and P/E ratio

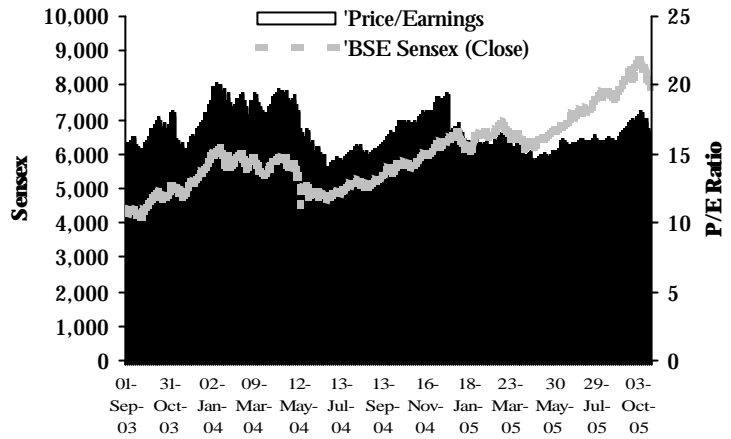


Fig.M.9: Group-wise Growth in BSE Sensex(%, Y-o-Y)

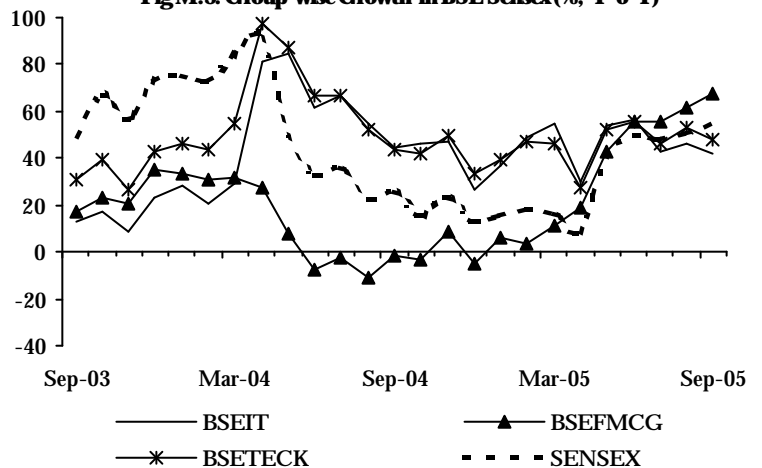
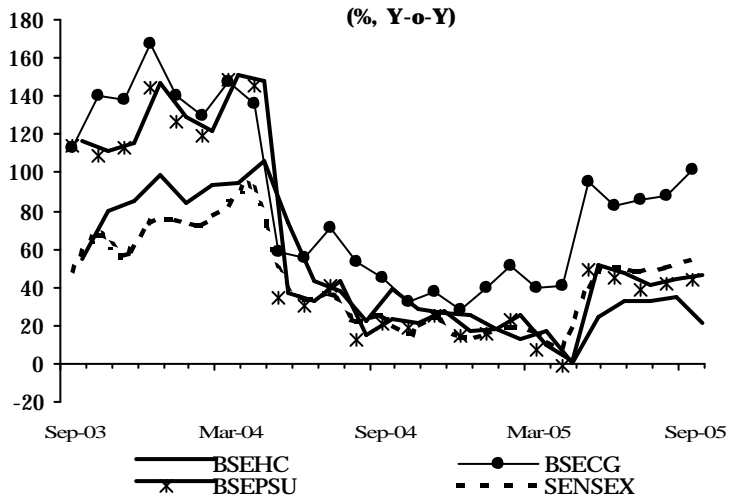


Fig.M.10: Group-wise Growth in BSE sensex(%, Y-o-Y)



important that there is strong supervision to keep up the confidence.

SEBI has already made changes to IPO allotments to bring more transparency into the process, by doing away with discretion. Major changes include a five per cent reservation for domestic mutual funds in primary offerings and a 10 per cent upfront margin for all institutional bids. Mutual funds will also be allowed to bid separately under the qualified institutional bidders (QIBs) category. The board percentages specified for each investor category will remain unchanged, with the quota for QIBs, high networth individuals and retail investors at 50 per cent, 15 per cent and 35 per cent, respectively. Of the 50 per

cent kept for QIBs, five per cent will now be reserved for mutual funds registered with SEBI. In the remaining 45 per cent, too, mutual funds are allowed to compete. Besides, all institutional investors will be required to provide margin money of 10 per cent along with their applications. Earlier, they were required to pay only on allotment.

Similarly, the RBI has asked banks and non-banking finance companies (NBFCs) to provide information on their advances against shares, in an attempt to check whether all the guidelines have been followed in lending. Steps taken by both institutions should be taken in right earnest.

Modified ECB norms

On 31 August 2005, the Ministry of Finance modified terms and conditions regarding raising funds from overseas market, which include:

- Prior or simultaneous listing in domestic stock exchange made mandatory for unlisted companies seeking to issue foreign currency convertible bonds and ordinary shares through global depository receipts, which have not yet accessed these routes.
- Unlisted companies, which have already issued global depository receipts/foreign currency convertible bonds in the international market, required to list in the domestic market on making profit beginning (with) financial year 2005-06 or within three years of such issue of global depository receipts/foreign currency convertible bonds, whichever is earlier.
- An Indian company, which is not eligible to raise funds from the Indian capital market including a company which has been restrained from accessing the securities market by SEBI will not be eligible to issue foreign currency convertible bonds and ordinary shares through global depository receipts.
- Erstwhile overseas corporate bodies, who are not eligible to invest in India through the portfolio route and entities prohibited to buy, sell or deal in securities by SEBI will not be eligible to subscribe to foreign currency convertible bonds and ordinary shares through global depository receipts.

Table M.2: 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)
	Sept-05	March-03	March-04	March-05	2004-05 Q2	2005-06 Q
1. Reserve Money	496561	9.16	18.32	12.05	16.52	15.82
2. Narrow Money	682630	12.00	21.76	13.50	16.88	18.98
3. Broad Money	2423710	14.66	16.60	13.28	14.13	15.57
4. Major Components						
(a) Currency in Circulation	377813	12.49	15.91	12.66	13.51	13.07
(b) Currency with the Public	370361	12.79	16.17	13.29	15.00	13.61
(c) Demand Deposit	312269	10.96	29.29	13.76	19.66	26.04
(d) Time Deposit	1741080	15.70	14.63	12.94	13.12	14.28
(e) Other Deposit	5652	14.88	71.90	15.19	-2.46	29.51
5. Major Sources of M3						
(a) NRBCG	-26306	-21.08	-62.61	-127.16	-83.24	-348.85
(b) NBCG	794738	27.21	25.91	10.58	13.24	8.78
(c) NBCC	1411041	18.34	13.23	25.26	20.11	28.04
(d) NFEA of Banking sector	662891	26.58	33.75	23.82	30.57	14.52
6. Major Sources of M0						
(a) NFEA with RBI	623018	35.71	37.80	24.14	32.73	15.42
(b) Net Domestic assets	-126457	-85.56	-634.63	116.43	186.92	13.88
7. Ratios						
(a) M3/M0	4.88	4.66	4.59	4.64	4.89	4.88
(b) M1/M0	1.37	1.28	1.32	1.34	1.34	1.37
(c) Deposit/RM	4.15	3.93	3.88	3.91	4.14	4.15
(d) NFEA (RBI)/RM	1.25	0.97	1.13	1.25	1.26	1.25
(e) NFEA (RBI)/CC	1.65	1.27	1.51	1.66	1.62	1.65
(f) NBCG/M3	0.33	0.32	0.35	0.34	0.35	0.33
(g) NBCC/M3	0.58	0.52	0.51	0.56	0.53	0.58
(h) Credit/Deposit #	0.55	0.57	0.56	0.64	0.58	0.66
(h) Non-Food Credit/Deposit	0.53	0.53	0.53	0.61	0.56	0.64

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