

# Money and Capital Markets

*Both money and capital markets exhibited lower volatility during the third quarter compared to the second quarter, primarily because the global environment was less turbulent and hence the overhang from external forces was also markedly less pronounced. Surprisingly, the much-awaited announcement of tapering by the US Federal Reserve on 18 December 2013 did not have the tumultuous impact witnessed earlier in the year when mere talk of the possibility of such tapering in May 2013 led to mayhem in both markets.*

## Monetary conditions

Monetary conditions in the third quarter were far more comfortable than in the second quarter. Unlike in the second quarter when talk of Fed tapering had resulted in a sharp fall in the exchange rate of the rupee *vis-a-vis* the dollar, compelling the RBI to go on for exceptional monetary measures, the third quarter was relatively quiet. Following the return of stability on the forex front, early to mid-September, the RBI began a process of normalisation. Thus the Marginal standing Facility (MSF) rate at which banks are allowed to borrow over and above the amount borrowed under the Liquidity Adjustment Facility (LAF) was reduced in three steps to 8.75% between 20 September 2013 and 29 October 2013, even as the repo rate was increased in two steps of 25 basis points each to 7.75% to contain inflation and inflation expectations.

Meanwhile healthy capital inflows under the RBI's swap facilities for overseas borrowings by banks and non-resident deposit accounts eased liquidity conditions and helped bridge the gap between credit and deposit growth. There were brief periods of tight liquidity as when advance tax payments were made late December, but overall liquidity conditions were comfortable, thanks in part to the RBI conducting a number of open market operations (OMOs). Apart from two OMOs that together injected Rs 161 billion into the system during the quarter under review, the RBI also conducted variable seven day and 14 day repos to the extent of 0.5% of the banking

system's net demand and time liabilities (NDTL). Subsequently it also conducted two 28 day repos in January 2014 to further ease liquidity pressures.

These liquidity enabling measures resulted in a large build up in two major sources of reserve money, net foreign assets and net credit to the centre. The increase in net credit to the government, the fallout of LAF, MSF, OMO and term repo operations, moderated towards the end of the quarter following the build-up in government cash balances with the RBI on account of advance tax payments and a slower pace of government spending. Overall, reserve money increased by Rs 542 billion. Money supply grew 14.5% by mid January 2014 as against 12.9% during Q2 of 2013-14.

## Credit growth

Credit disbursement slowed down in the third quarter with credit to both agriculture and industry recording a slowdown in credit offtake. Overall credit growth to industry decelerated from 15.2% last year to 14.1%, led by sectors such as petroleum, mining and gems and jewelry. Nonfood credit growth declined from a peak of 18.1% early September to 15% by early January, in line with the RBI's indicative trajectory of 15%.

The decline in credit growth was partly a reflection of subdued investment sentiment among corporate, in line with slower GDP growth as well as growing risk aversion among banks faced with a growing burden of non-performing assets. Asset-quality indicators have been slipping since 2011-12, with public sector

banks which account of the bulk of bank lending, showing much greater deterioration in asset quality compared to foreign and private sector banks.

Meanwhile, the banking system's provision coverage ratio (PCR) has dropped below 50 % compared with 70 % just two years ago. As on March 2013, the impaired asset ratio of public sector banks had risen to 12.1 % from 6.8 % in 2009 according to the RBI deputy governor, KC Chakrabarty. The comparable ratio for old private banks was 6.8%, for new private ones 5.3% and for foreign banks, 6.4%.

RBI data suggest the situation of provision coverage for stressed assets (NPAs and restructured assets) is even worse. The PCR for NPAs plus restructured loans for the banking sector as a whole fell to 30.25 % in March 2013 from 34.47 % as at the end of March 2009. For public-sector banks, the combined PCR fell even more sharply, from 38.4 % in 2009 to 27.71% over the same period.

However, the slight improvement in the slippage ratio (ratio of bad loans to total loans) seen towards the latter half of the quarter under review, is a happy augury and holds the promise of a reversal in the trend.

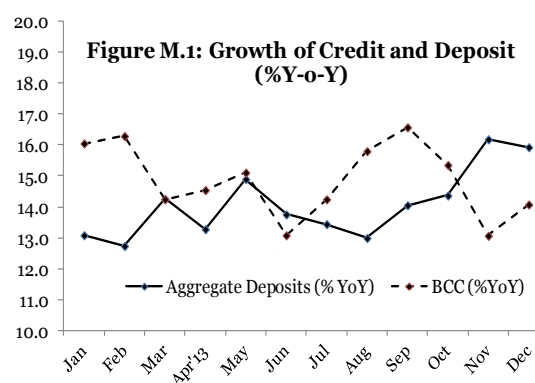
Ironically, the weighted average lending rate of banks has declined during the third quarter, despite two consecutive hikes in the RBI's repo rate in September and October 2013. This could result in a pick-up in credit offtake from banks. However, much will depend on factors such as political uncertainty, lack of policy clarity, speed and certainty in decision-making. These are seen as far more critical to determining business sentiment as compared to interest rates, despite the clamour over higher interest rates raised by chambers of commerce.

### Deposit growth

Following the strong growth in FCNR(B) balances consequent on the RBI's concerted efforts to attract dollar deposits, deposit growth, year-on-year, finally out-

stripped credit growth. However, adjusted for the FCNR (B) effect, deposit growth in the third quarter continued to lag credit growth as in the earlier quarters, reflecting the declining interest of retail depositors in bank deposits, given negative real rates of interest across the spectrum of maturities. The spate of tax-free bond issues, offering attractive rates of interest during the quarter under review has, doubtless, also eaten into banks' deposit base.

As with lending rates, deposit interest rates moderated somewhat towards the end of by the quarter reflecting more comfortable liquidity conditions. Nonetheless, they are still higher than at the beginning of the current fiscal.



### Monetary action

In its mid-quarter monetary policy review on 18 December 2013, the RBI maintained *status quo* on rates despite the fact that inflation numbers available at the time of the review showed a sharp increase at both the wholesale and retail level. Indeed the RBI opted to keep rates unchanged though the CPI had peaked at 11.24 % (subsequently revised down to 11.16%) and WPI too had touched a high of 7.52% even though in its previous review, late October, the RBI had hiked the repo rates on the grounds that inflation was higher than the bank's comfort level. In the January policy review, however, the RBI chose to hike rates another 25 basis points (the third increase since September 2013) to eight per cent on the grounds that inflation rates were still elevated. The hike, which went against consensus

opinion of a pause in the rate hiking cycle, was sought to be justified on the grounds that the RBI cannot pause in its efforts to ensure financial and monetary stability, even as the slowdown in the economy was getting 'increasingly worrisome' and growth is 'likely to lose momentum in Q3'.

Though the RBI governor, Raghuram Rajan, justified his action, which was prima facie at odds with what he had stated in his previous mid-quarter review in December when he opted for status quo on rates, not many have bought his argument. The decision was, in all probability, guided more by the desire to set inflation on a 'glide path' to a level of 4% +/- 2% over a two year time frame in line with the Urjit Patel Committee recommendations.

**Though financial markets were relatively calm during the third quarter compared to the second, the US Fed announcement of a further tapering by \$ 10 billion a month beginning February is likely to create some short-term volatility even though it is good news, long-term, since it signals faith in the strength of US recovery.**

### Financial markets

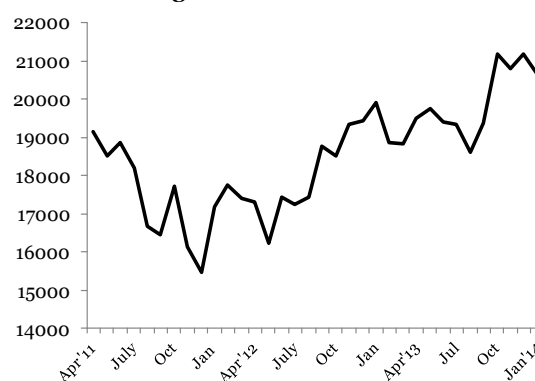
As with money markets, financial markets were less turbulent during the period under review. Postponement of tapering by the US Fed helped restore order in markets. Volatility, however, remained high and though the Sensex recovered strongly and indeed went on to touch an all time record of 21,374 on 22 January 2014, the underlying sentiment remained nervous. During 22 May to 30 August both the Sensex and the Nifty declined as FIIs withdrew US\$ 13 billion from domestic debt and equity markets. However, both indices increased by nine per cent during the third quarter compared to a decline in the previous quarter. From a 52-week low of 17,448.71 on 28 August 2013, the Sensex has risen 3,888.96 points or 22.28% by 22 January 2014.

FII behavior continued to be unpredictable. Initially FIIs were net sellers in the debt segment. However in December 2013 they turned net investors. MFs, however, continued to remain net sellers in the equity market but net buyers in the debt segment.

The primary market remained lacklustre during the quarter. The total amount raised through public and rights issues during the period April –December 2013 was Rs102.9 billion from 35 issues as against Rs 115 billion from 30 issues during the comparable period in the previous fiscal. The only silver lining was that 24 of the 25 IPOs during the period were from SMEs who mobilized Rs 2.5 billion.

Several investment houses turned overweight on India in November-December 2013. Nonetheless, the uncertainty on account of the forthcoming general elections continues to cast its cloud over sentiment in general.

Figure M.2: BSE Sensex



By late January, when this Review was going to print, fear was once again on the ascendant. The sharpest devaluation in 12 years of the Argentine peso, the dramatic fall in the Turkish lira and decline in other emerging market currencies has once again raised the spectre of another emerging markets' crisis, akin to what we saw in the late 1990s. The fear, triggered by talk that the US Fed might completely phase out its tapering by the end of the year, has set global investors on edge. The flight to safety might see portfolio investors flee EME shores. In a much-

awaited decision on 29 January 2014, the US Federal Reserve decided to continue its taper as originally announced – by \$ 10 billion a month – to \$ 65 billion beginning February. While the move signals greater confidence in US recovery and is long-term good news, in the short term it may spell further turmoil for emerging markets.

### **Box M.1.: Urjit Patel Committee recommendations**

The committee set up by the RBI Governor to review the monetary policy framework submitted its recommendations mid-January. The main recommendations of the committee relate to the choice of the consumer price index as the nominal anchor for the conduct of monetary policy. The nominal anchor or target for inflation is to be set at 4% with a band of +/- 2% in view of the vulnerability of the economy to supply/external shocks and the relatively large weight of food in the CPI and the need to devoid a deflationary bias in the conduct of monetary policy. The target is to be set in a two year time horizon.

For now the committee has suggested a transition to eight percent inflation over the next 12 months and six percent over the next 24 months before the formal adoption of the four percent target. In order to achieve this the Committee has called upon the government to work towards reducing its fiscal deficit target to three percent by 2016-17. This appears to be a tall order given that the government has repeatedly shifted the goal posts laid down in terms of the FRBM Act 2003.

The committee has also called for the introduction of new policy instruments to manage liquidity –variable rate repos of different maturities replacing the existing overnight repo as the main tool for managing liquidity – and the marginal standing facility being set as a truly penal rate. It has also called for the introduction of a new remunerated standing facility (similar to the MSF on the lending side) to absorb excess liquidity though it is unclear how this differs from the existing cash reserve ratio (CRR).

Among the other key recommendations are setting up a Monetary Policy Committee for monetary policy formulation, comprising the governor, deputy governor and executive director in charge of monetary policy in the RBI and two other members to be chosen by the governor, RBI; drastically reducing SLR; introducing 14 day variable rate repos that will over time replace fixed rate overnight repos; detaching OMOs from fiscal considerations and linking them solely to liquidity management and securing a binding commitment from the government regarding adherence to the target FD/GDP ratio of three per cent by 2016-17.