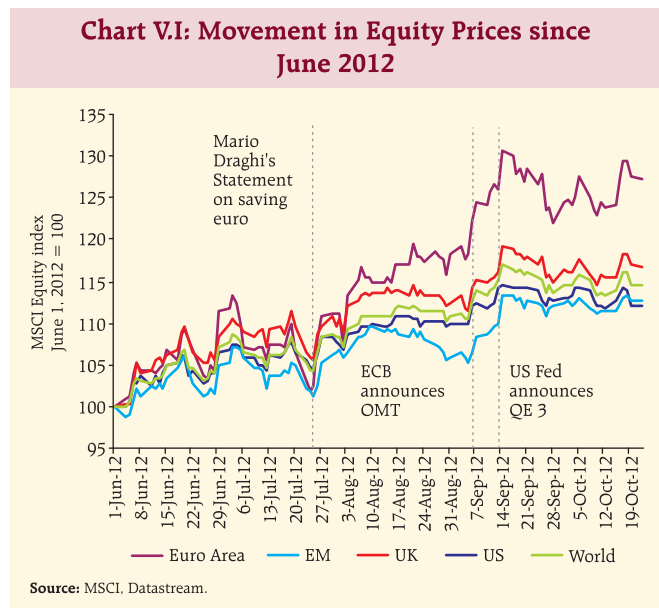


## V. Financial Markets

The sovereign debt overhang continued to cause strains in global financial markets. Significant monetary easing measures in the advanced economies ameliorated conditions temporarily, but credit and liquidity risks are still high. On the domestic front, the recently announced policy reform measures have induced investor optimism and led to enhanced market activity. The rupee witnessed a short spell of appreciation following the policy initiatives, though it somewhat weakened in recent weeks. However, the primary capital market, which still remains subdued, is unable to provide capital-raising options, and bring down the leverage ratios for firms to revive investments.

### Central banks' actions revive sentiments, but risks remain

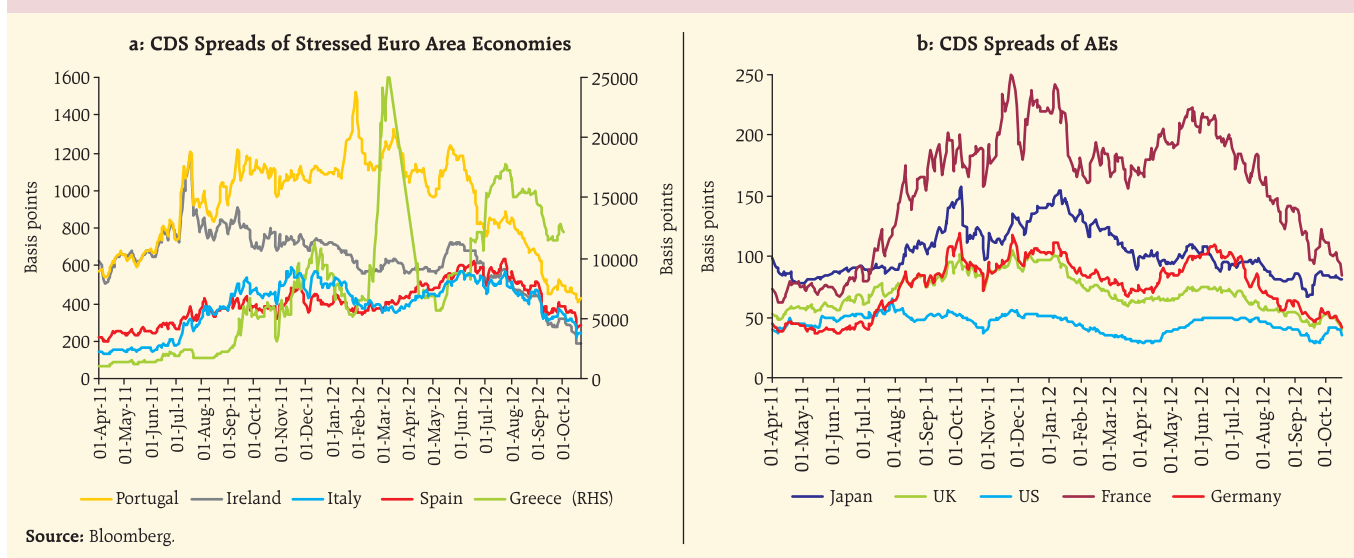
V.1 Global financial markets, which had undergone renewed turmoil for most part of Q1 of 2012-13, witnessed reduced stress since end-July. This followed the ECB President's statement on July 26, 2012 - that within its mandate, the ECB is ready to do whatever it takes to preserve the euro. Later, equity markets rallied in the financial markets following the September 2012 announcements of "sterilised" outright monetary transactions (OMT) by the ECB and an "open-ended" quantitative easing (QE-3) by the Fed (Chart V.1). The



€500 billion permanent bailout fund, the European Stability Mechanism (ESM), launched on October 8, 2012, further boosted market sentiments.

V.2 Global risk-aversion among investors appeared to have eased since September with the credit default swap (CDS) spreads declining after the announcement of the policy measures (Chart V.2). Borrowing costs for euro area countries, especially Spain and Italy, have also fallen.

**Chart V.2: Trends in Global Financial Markets**



V.3 Even after improvements in financial market conditions, elevated bond yields in the euro area periphery compared to core euro area yields, signal continued concerns about risks in the euro area.

### Domestic money market rates eased reflecting improved liquidity conditions

V.4 In India, the financial market witnessed some stress during Q1 of 2012-13 with the equity markets underperforming and the rupee depreciating amid moderation in capital inflows. However, financial market conditions improved significantly during Q2. Amidst comfortable liquidity conditions, the call money rate remained in line with the policy repo rate, even during the period of advance tax collections in September (see Chart IV.3).

V.5 The rates in the collateralised segments (*i.e.*, CBLO and market repo) moved in tandem with the call rate, but generally remained below it during Q2 of 2012-13. There was a shift in market volume in favour of CBLO and away from the call money in the overnight money market during Q2 (Table V.1).

V.6 Banks and primary dealers continued to be the major borrowers in the collateralised segment during Q2. While mutual funds (MFs) continued to be the major lenders in the CBLO segment, their share in total lending declined in the market repo segment. Nationalised banks emerging as the major lenders in the latter segment during the quarter.

V.7 With lower demand for funds amidst credit slowdown, there has been a near 55 per cent q-o-q decline in the average fortnightly issuance of certificates of deposits (CDs) to around ₹185 billion in Q2, and the weighted average effective interest rate (WAEIR) on CDs declined to 8.4 per cent in September 2012 from 9.3 per cent in June 2012.

V.8 The corporate sector increased its average fortnightly issuance of commercial papers (CPs) by around 22 per cent (q-o-q) to ₹330 billion during Q2. The weighted average discount rate (WADR) on CPs declined to 9.0 per cent in September 2012 from 10.1 per cent in June 2012. 'Leasing and finance' and 'manufacturing companies' remained the major issuers of CPs. The yields on auction Treasury Bills (TBs) eased till October 23, 2012 in line with the declining short-term interest rates.

### G-sec yields decline marginally reflecting improved liquidity conditions

V.9 Yield movements during Q2 of 2012-13 were range bound, though with a softer bias. Yields softened significantly in July 2012 mainly due to improved liquidity conditions and expectations that the monetary policy may be eased following market perceptions of abating inflationary pressures on the domestic front, and global cues of further slowdown in world economy. However, yields rose sharply on July 31, 2012, reacting to the Reserve Bank's policy announcement of a one percentage point cut in the SLR to 23 per cent while leaving the policy rate unchanged (Chart V.3).

**Table V.1: Average Daily Volume in Domestic Financial Markets**

(₹ billion)

	Money Market						Bond Market		Forex Market inter-bank (US\$ mn)	Stock Market ##
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificates of Deposits*	G-Sec**	Corporate Bond#		
1	2	3	4	5	6	7	8	9	10	11
Mar-12	-1574.3	175.1	111.8	379.8	911.9	4195.3	98.6	26.1	20.6	152.3
Jun-12	-913.0	151.8	180.4	375.9	1258.1	4251.7	257.6	29.5	18.4	117.3
Jul-12	-481.1	146.4	173.3	381.9	1732.3	4155.3	220.1	28.2	18.9	115.8
Aug-12	-462.2	129.5	183.3	459.4	1878.9	4029.8	178.4	27.8	19.0	117.9
Sep-12	-517.1	142.8	185.1	502.4	1705.8	3571.9	260.1	36.4	20.2	142.8

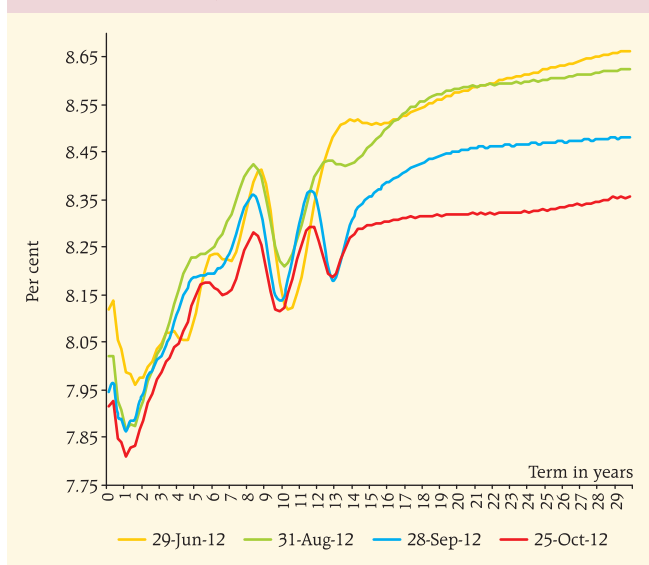
\*: Outstanding position.

\*\* : Average daily outright volume traded in central government dated securities.

# : Average daily trading in corporate bonds. ## : Average daily turnover in BSE and NSE.

Note: In column 2, (-) sign indicates injection of liquidity.

Chart V.3: Movement in G-sec Yield



V.10 After some intermittent softening, the yields again hardened in mid-August following worse-than-expected inflation outcome, but the movement was checked by expectations of weak growth numbers for Q1 of 2012-13. Better-than-expected growth numbers, however, caused yields to temporarily firm up, but adherence to the budgetary numbers in the auction calendar for H2 of 2012-13 softened opening yields on September 28, 2012. However, profit booking eroded the gains. Concerns about fiscal slippage have kept yields largely flat during October 2012.

V.11 Around 72 per cent of the budgeted borrowing programme of the central government through dated securities amounting to ₹4,090 billion has been accomplished so far. The weighted average maturity of dated securities issued up to October 23, 2012, increased to 13.6 years. There has been a general downward movement in the primary market yield during the financial year so far. The weighted average yield of primary auctions stood at 8.43 per cent (Table V.2). Investor sentiment, however, was largely sustained. The bid-cover ratio stood in the range of 1.4 to 4.1.

V.12 During 2012-13 so far, 25 states have raised ₹905.3 billion on a gross basis. The weighted average yield firmed up to 8.94 per cent as the yield spreads for 10-year state development loans issuances over the

Table V.2 : Issuances of Central and State Government Dated Securities

Item	2011-12	2012-13*
1	2	3
<b>Central government</b>		
Gross amount raised (₹ billion)	5,100.0	4,090.0
Devolvement on primary dealers (₹ billion)	121.1	18.3
Bid-cover ratio (range)	1.4-5.1	1.4-4.1
Weighted average maturity (years)	12.7	13.6
Weighted average yield (per cent)	8.5	8.4
<b>State government</b>		
Gross amount raised (₹ billion)	1,586.3	905.3
Cut-off yield range (per cent)	8.4-9.5	8.7-9.3
Weighted average yield (per cent)	8.8	8.9

\* Up to October 23, 2012.

corresponding Government of India security, increased to 42-84 bps compared to a spread of 25-42 bps for the corresponding period of the previous year.

### Deposit and lending rates exhibit stickiness

V.13 Following the reduction in the CRR in two steps by 125 bps during January-March 2012 and the reduction in the repo rate by 50 bps effective April 17, 2012, the modal deposit rate for scheduled commercial banks (SCBs) declined by 11 bps to 7.29 per cent during Q2 of 2012-13 while the modal base rate of SCBs continued to remain at 10.50 per cent (Table V.3).

V.14 In general, there has been a convergence in average deposit and lending rates across public and private sector banks. The reduction in the CRR by 25 bps with effect from September 22, 2012, may also help in softening deposit and lending rates further. A few banks, mostly public sector banks, have already reduced their base rates.

### Reform measures announced by the government boost investor sentiments and lead to appreciation of the Rupee

V.15 The rupee appreciated by 6.9 per cent in Q2 of 2012-13 (5.2 per cent in the month of September 2012 alone), driven by both global developments and domestic policy measures (See Table VII.1 and Chart V.4). However, since the second week of October 2012 the rupee has weakened. It stood at 53.63 on October 25, 2012.

**Table V.3: Deposit and Lending Rates of Banks**

(Per cent)						
Items	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sept-12
1	2	3	4	5	6	7
<b>1. Domestic Deposit Rate (1 - 3 year tenor)</b>						
i) Public Sector Banks	8.25-9.75	8.55-9.75	8.55-9.75	9.00-9.75	8.75-9.50	8.50-9.30
ii) Private Sector Banks	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.00	8.00-9.75
iii) Foreign Banks	3.50-10.00	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75
<b>Modal Deposit Rate (all tenors)</b>	<b>7.08</b>	<b>7.44</b>	<b>7.46</b>	<b>7.42</b>	<b>7.40</b>	<b>7.29</b>
<b>2. Base Rate</b>						
i) Public Sector Banks	9.25-10.00	10.00-10.75	10.00-10.75	10.00-10.75	10.00-10.50	9.75-10.50
ii) Private Sector Banks	8.50-10.50	9.70-11.00	10.00-11.25	10.00-11.25	9.75-11.25	9.75-11.25
iii) Foreign Banks	6.25-9.50	6.25-10.75	6.25-10.75	7.38-11.85	7.38-11.85	7.25-11.75
<b>Modal Base Rate</b>	<b>10.00</b>	<b>10.75</b>	<b>10.75</b>	<b>10.75</b>	<b>10.50</b>	<b>10.50</b>
<b>3. Median Lending Rate*</b>						
i) Public Sector Banks	9.50-14.50	10.50-15.25	10.25-15.25	10.60-15.35	10.50-15.50	-
ii) Private Sector Banks	9.25-15.00	9.00-15.25	10.00-15.50	10.50-15.50	10.63-15.38	-
iii) Foreign Banks	7.70-14.50	9.13-14.75	9.50-14.38	10.00-14.50	10.00-14.50	-

\*: Median range of interest rate on advances at which at least 60 per cent business has been contracted. -: Not available.

V.16 The Reserve Bank also undertook additional policy measures in September 2012 to facilitate capital inflows. These include enhancing the maximum permissible ECB for repayment of rupee loans and fresh rupee capital expenditure under the US\$ 10 billion scheme from 50 to 75 per cent of average foreign exchange earnings realised during the previous three years; permitting infrastructure companies to avail of trade credit up to a maximum period of five years for import of capital goods; and rationalising overseas direct investment by Indian entities in respect of annual performance returns.

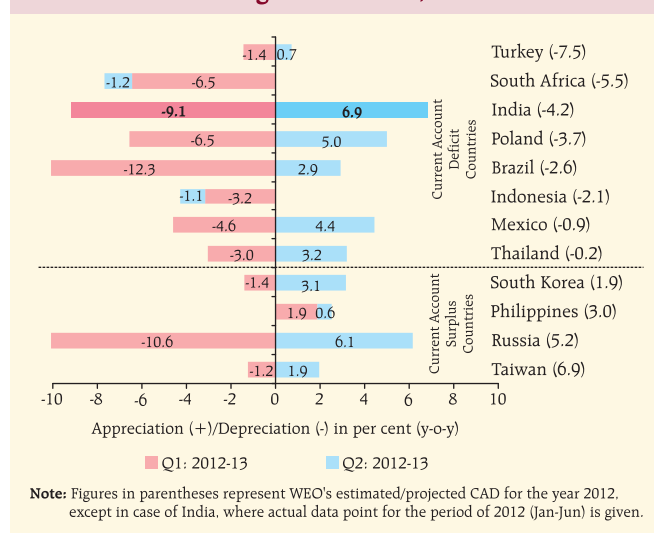
### Secondary equity markets improved with reform measures and FII inflows

V.17 In the recent period (up to October 25, 2012), the Indian equity market witnessed gains on a y-o-y basis. At a level of 18,758, the BSE Sensex is 8.7 per cent higher than it was at the same time last year. Market sentiments, turned positive due to improved global liquidity conditions, FII inflows and the recent policy measures announced by the government. However, governance issues and mixed Q2 results of some major companies pared some of the gains recorded earlier. During 2012-13 so far (up to October 23, 2012), FIIs made net investments of about ₹497 billion in the Indian equity market (Chart V.5).

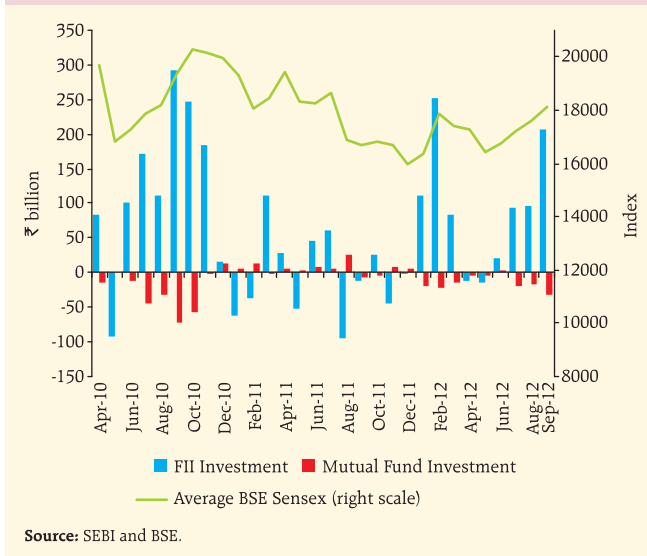
### IPO market continued to be sluggish

V.18 The primary market, on the other hand, showed mixed trends. Private placement and MFs witnessed substantial pick up during 2012-13 so far, while the IPO market remained sluggish. During April-August 2012, the total resources mobilised through private placement grew by about 73 per cent (y-o-y), while the net inflow of funds into MFs schemes grew by around 41 per cent on account of the base effect. The MF inflows to the liquid and income schemes were higher, on the back of improved liquidity conditions while they were net sellers in the equity segment.

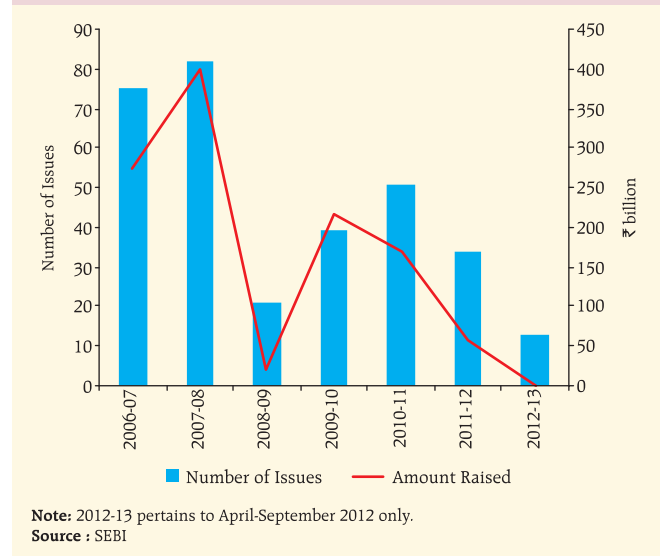
**Chart V.4: Select EDE Currency Movements against the US\$**



**Chart V.5: Institutional Investment**



**Chart V.6: Trends in the IPO market**



V.19 Both the number of issues and the amount raised through IPO issues are very low in comparison to the peak resource mobilisation achieved in 2007-08 (Chart V.6). Even the offer document *i.e.*, Draft Red Herring Prospectus, filed with SEBI during April-September 2012 declined by 90 per cent over the corresponding period in 2011-12. Many companies which had filed their offer document to raise funds have withdrawn their proposals and two IPOs have not been fully subscribed in 2012-13 so far.

V.20 The IPO market remained subdued due to weak investment demand arising from the slowdown in overall economic growth, persistent inflation and high fiscal and current account deficits. The IPO activity mirrored the trends in the secondary market, in line with cautious investor sentiments in the recent past. Second, many of the IPOs listed during 2011-12 are currently trading below their issue price. As on October 25, 2012, of the 34 IPOs listed in the equity market in 2011-12, 20 were trading below their issue price. Negative returns on IPO investments have adversely affected investor sentiments. Third, global IPO activities have also been subdued since 2011. During Q2 of 2012-13, the resources raised through global IPO markets were 48 per cent lower than in the previous quarter, even though the secondary equity market posted huge gains during this period.

**Policy changes contemplated to support the capital market**

V.21 Apart from the policy reform measures mentioned earlier, the Kelkar Committee on 'Roadmap for Fiscal Consolidation' has made suggestions to revive the disinvestment programme. The Deepak Parekh Committee has suggested setting up infrastructure debt funds to boost infrastructure financing.

V.22 The SEBI has also taken various measures to revive mutual fund investments and IPO activity. MF companies will now have to shift to the 'one plan per scheme' model. Also, a proposal has been made for a mandatory 'safety net' to protect the interests of small investors. Further, substantial QE programmes of AEs along with low interest rates will boost global liquidity and revive FII inflows to the IPO market. FII inflows and reform measures that are fuelling the uptrend in the secondary market, may also have a positive impact on the IPO market.

**Housing prices remain firm with rising volumes**

V.23 The Reserve Bank's quarterly House Price Index, based on data for 9 cities, indicates a q-o-q increase of 6.7 per cent at the all-India level. The annual increase in house prices show a marginal moderation in Q1, while the transaction volume grew by 9.3 per cent (Table V.4).

**Table V.4: House Price and Transactions Volume Indices (Base Q4:2008-09 = 100)**

Quarter	Mumbai	Delhi	Bengaluru	Ahmedabad	Lucknow	Kolkata	Chennai*	Jaipur	Kanpur	All India
1	2	3	4	5	6	7	8	9	10	11
<b>House Price Index</b>										
Q1:2011-12	191.6	152.8	116.9	152.3	149.3	157.0	106.3	161.1	135.4	152.0
Q2:2011-12	206.1	153.0	116.0	162.8	159.2	159.0	113.9	165.1	138.3	157.8
Q3:2011-12	191.7	168.6	146.1	171.8	172.3	155.0	120.3	163.5	140.0	164.1
Q4:2011-12	224.7	195.3	140.6	177.2	169.7	158.4	117.0	164.4	148.7	176.9
Q1:2012-13	231.8	217.3	140.2	176.6	179.4	204.2	133.9	171.9	144.9	188.6
Growth in per cent										
Y-o-Y	21.0	42.2	19.9	15.9	20.2	30.1	25.9	6.7	7.1	24.1
Q-o-Q	3.1	11.3	-0.3	-0.3	5.7	28.9	14.5	4.6	-2.5	6.7
<b>House Transactions Volume Index</b>										
Q1:2011-12	89.5	149.4	100.8	134.3	93.9	107.9	80.3	243.1	208.4	123.2
Q2:2011-12	79.0	165.5	123.5	154.1	106.7	139.2	85.5	239.1	131.1	129.1
Q3:2011-12	75.9	195.9	84.6	131.2	165.1	108.9	130.9	222.0	120.6	128.9
Q4:2011-12	108.6	149.8	70.8	122.2	153.0	128.5	99.0	247.5	172.1	126.5
Q1:2012-13	153.2	133.6	81.6	140.1	151.9	98.2	80.9	296.7	154.9	134.6
Growth in per cent										
Y-o-Y	71.2	-10.6	-19.0	4.3	61.8	-9.0	0.7	22.0	-25.7	9.3
Q-o-Q	41.1	-10.8	15.3	14.6	-0.7	-23.6	-18.3	19.9	-10.0	6.4

**Note:** \* Chennai index is based on both residential and commercial properties.  
All India index is a weighted average of city indices, weights based on population proportion.

### **Investor confidence picks up, but further macro-financial improvement is necessary**

V.24 With the continued slowdown in global growth, global investor sentiments remain muted, despite the recent bout of activity aided by policy measures, both global and domestic. Pending long-term solutions for the euro area crisis, global uncertainties continue to dominate. Nevertheless, the excess global liquidity in

the wake of monetary easing measures by AEs, is expected to flow into emerging and developing economies (EDEs) in search of higher returns.

V.25 By pushing through a series of much awaited reform measures, the government has signalled a break in policy stasis. With the promise of more measures to follow, investor scepticism seems to have abated. However, further improvement in macro-financial conditions would be necessary.