V. Financial Markets

Steady monetary easing in the face of fiscal austerity measures in advanced economies boosted global investor sentiments since Q4 of 2012. Notwithstanding the recent fallout of Cyprus, international financial markets posted significant gains, especially in Japan following its recent policy stimulus and in the US on the back of improved economic data. However, improved financial conditions are yet to translate into a sustained recovery in economic activity. Strong FII inflows, especially in H2 of 2012-13 augured well for the Indian equity market and the rupee, although the market movements were also conditioned by domestic slowdown and governance concerns. Primary equity market, however, remain subdued. Its recovery depends on improvement in macroeconomic fundamentals, continued fiscal consolidation and revival of global growth.

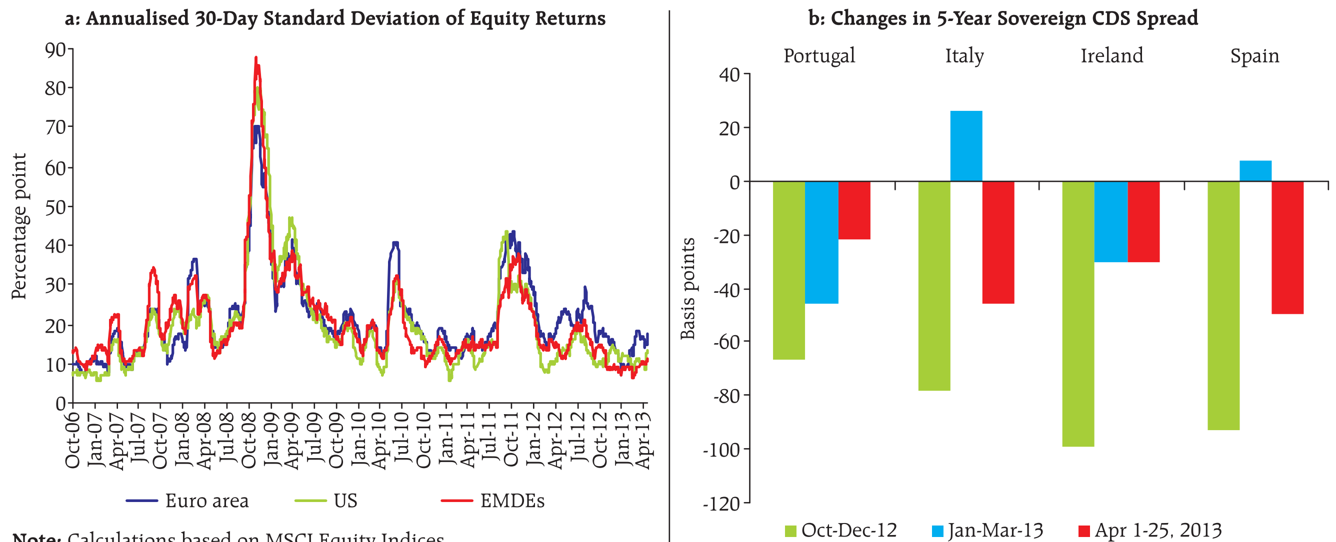
Global financial market conditions improve supported by receding tail risks

V.1 The easing of financial market tensions that began in Q3 of 2012 continued through March 2013 as policy actions contributed to reducing tail risks to the global economy, which still remain significant. Policy accommodation in the euro area through the launch of the European Central Bank (ECB) bond buying programme, the bailout of Greece and the unveiling of a road map for the euro area banking union have been instrumental in limiting the downside risks. The IMF's Global Financial Stability Report of April 2013 has noted that global financial and market conditions have improved appreciably in the past six months due to monetary stimulus and liquidity support. However, further actions and balance sheet repairs are necessary to entrench financial stability.

V.2 In the US, the fiscal cliff has kicked in with moderate intensity. It will lead to a large predicted reduction in the budget deficit and consequent slowdown of the US economy. The three main components of the fiscal cliff involve partial tax increases that became operational in January 2013, "sequestrations" or the spending reductions since March 2013 and the debt ceiling which would kick in from May 19, 2013 if no agreement is reached. Slowdown resulting from strong fiscal tightening could have ramifications for financial markets across the globe.

V.3 Financial markets are now pricing in the impact of large fiscal and monetary stimuli provided by the new Japanese government. This includes a stimulus package of 10 trillion yen to boost growth and overcome deflation. The Bank of Japan set a higher inflation target

Chart V.1: Trends in Global Markets



Note: Calculations based on MSCI Equity Indices.
Source: Datastream.

Source: Bloomberg.

and committed to spend 60-70 trillion yen in each of the next two years to buy bonds and other assets, while doubling its monetary base in the same period. The large dose of quantitative easing (QE) in Japan that exceeds the size of the QE by the US Fed is impacting financial markets in several ways. In the currency market, yen depreciated sharply since the stimulus announcements. If it leads to sustained dollar appreciation, it can impact Indian markets through the exchange rate channel. Over time, the Japanese stimulus could impact global commodity prices upwards.

V.4 Following the above policy actions, financial market volatilities have been dampened and appear to be at the lowest levels since 2007 (Chart V.1a). Further, G-sec yields of troubled euro area economies have come down sharply and, as a result, the cost of borrowing has declined, which should facilitate the fiscal adjustments.

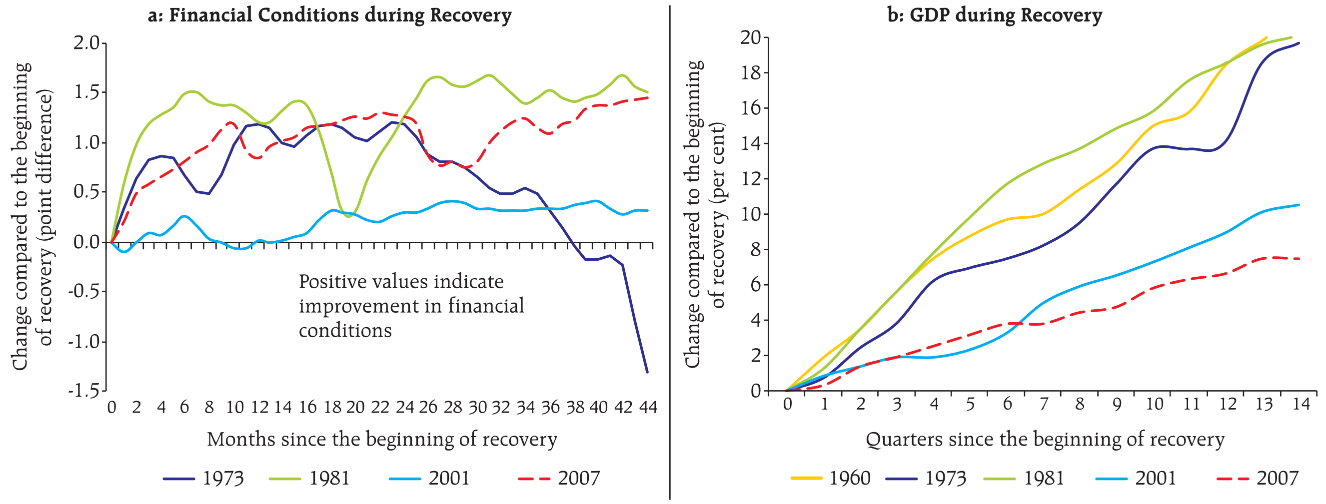
V.5 Credit default swap (CDS) spreads for troubled euro area economies declined notably since H2 of 2012 (Chart V.1b). Improved risk perceptions have translated into better market access. In January 2013, Portugal returned to the international long-term debt market for the first time since 2011. The improvement in bank funding conditions allowed hundreds of euro area banks to repay higher-than-expected long term refinancing operation (LTRO) funding to the ECB since January 2013.

V.6 Stress still remains in the euro area in some form, as was evident from the recent case of Cyprus, which became the fourth euro area member to receive a bailout after Greece, Ireland and Portugal (or the fifth, if the partial bailout for Spanish banks is also counted). The €10 billion bailout deal with international lenders on March 25, 2013 which avoided a controversial levy on bank accounts would force large losses on big deposits in Cyprus' two largest banks. Elsewhere in Europe, a banking crisis in Slovenia looms large.

Improved financial conditions slow to translate into real activity

V.7 Notwithstanding the improvement in financial conditions, it remains to be seen whether it can translate into eventual real sector recovery. Current upturn in financial conditions in the US has been at par or better than the financial sector improvements seen in the previous recoveries. Yet, the current real sector expansion has remained relatively weak (Chart V.2). The main reason is the deleveraging by the financial and household sectors as the collapse in

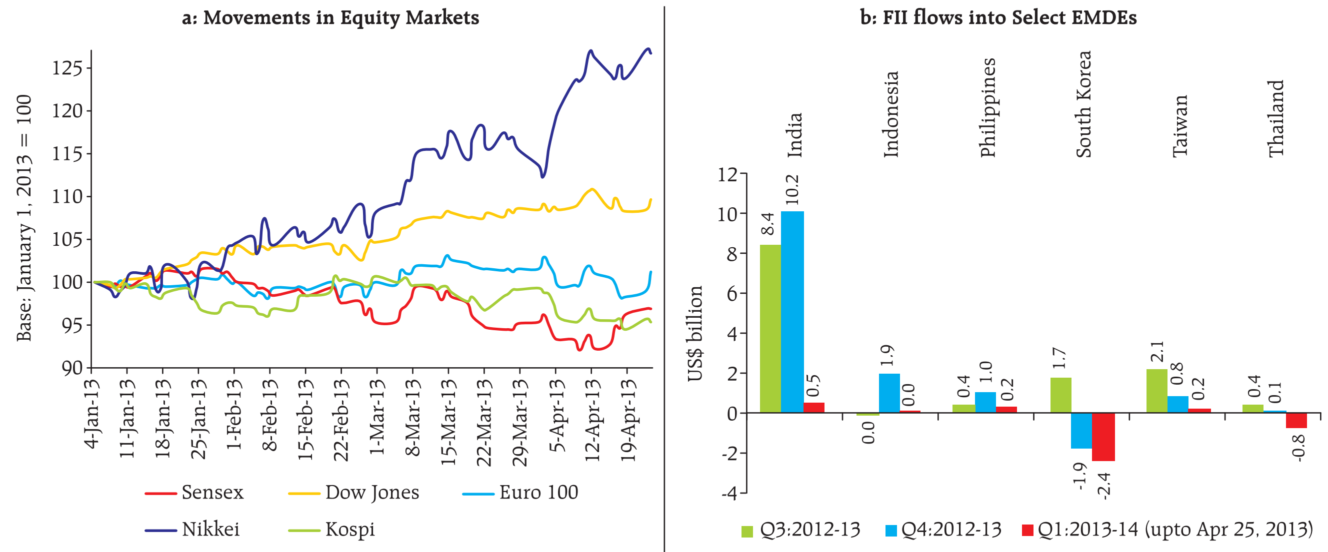
Chart V.2: Current US Economic Recovery Compared with Previous Recoveries



Notes: 1: Years indicate years of start of recession. 2: Recovery month/quarter as officially announced by NBER. 3: Current recovery from 2007 recession started in June 2009 (Q2 2009). 4: FCI for 1960 is not available.

Source: Calculations based on data from Datastream, BEA, Minneapolis Fed, St. Louis Fed.

Chart V.3: Trends in Equity Indices and FII Flows



Source: Bloomberg. **Source:** Bloomberg.

housing prices following the financial meltdown severely damaged their balance sheets.

Policy interventions boost global equity markets; India weighed down by weak macroeconomic performance

V.8 The Japanese equity market posted the highest increase in Q4 of 2012-13 boosted by recent monetary easing. The US equity indices (both Dow Jones and S&P 500) rose to an all time high following improved economic data, such as employment, and some recovery in the housing sector. However, the European and emerging market and developing economies' (EMDEs) equity markets including that of India have underperformed. Domestic factors such as slowdown in economic growth, persistent inflationary pressures, and high current account deficit despite strong FII inflows added to the downward pressures on Indian markets (Chart V.3).

Money markets remained orderly, despite year-end liquidity pressures

V.9 Tight liquidity conditions caused marginal increase in the average call money rate to 8.03 per cent in Q3 of 2012-13. However, following the reduction in the policy (repo) rate in the Third Quarter Review of Monetary Policy Statement 2012-13 (January 29, 2013), the average call money rate declined to 7.91 per cent in Q4. The year-end scramble for funds by banks pushed the weighted average daily call rate above the formal corridor on March 28, 2013 to around 12 per cent (maximum rate was 18 per cent), and it has since reverted to hover around the repo rate (Chart V.4). The rates in the collateralised segments (*i.e.,* CBLO and

Chart V.4: Movement in Call Money Rate

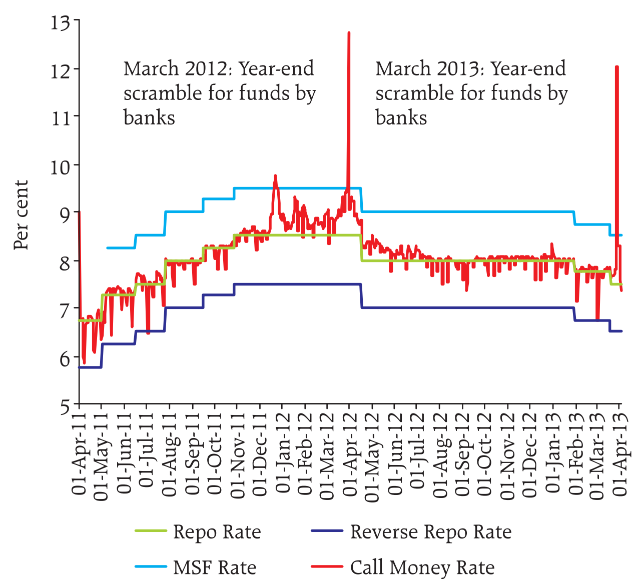


Table V.1: Average Daily Volume in Domestic Financial Markets

(in ₹ billion)

Month	Money Market						Bond Market		Forex Market inter-bank (US$ bn)	Stock Market ##
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificate of Deposits*	G-sec**	Corporate Bond#		
1	2	3	4	5	6	7	8	9	10	11
Mar-12	-1,574	175	112	380	912	4,195	99	26	21	152
Jun-12	-913	152	180	376	1,258	4,252	258	30	19	117
Sep-12	-517	143	185	502	1,706	3,572	260	36	21	143
Dec-12	-1,231	142	147	398	1,818	3,328	197	39	19	139
Jan-13	-930	170	192	456	1,998	3,251	466	25	20	128
Feb-13	-1,136	158	246	431	1,923	3,011	355	29	19	134
Mar-13	-1,093	194	216	480	1,093	3,896	307	43	23	133

*: 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, (-) ve sign indicates injection of liquidity into the system.

market repo) moved in tandem with the call rate, but generally remained below it during 2012-13.

V.10 Against a backdrop of slow deposit mobilisation, the demand for certificates of deposit (CDs) persisted, with the average gross fortnightly issuance of CDs remaining high and aggregating to around ₹332 billion in 2012-13. The average gross fortnightly issuance of commercial paper (CP) stood higher at around ₹318 billion. The outstanding amount of CP issued by corporates increased from ₹0.9 trillion at end-March 2012 to around ₹1.1 trillion at end-March 2013 (Table V.1).

Primary yield on dated central G-sec declines, boosted by favourable market conditions

V.11 The gross market borrowing of the central government through dated securities during 2012-13 to the tune of ₹5.6 trillion was successfully completed, and that for 2013-14 has been budgeted slightly higher at ₹5.8 trillion. The weighted average maturity of the dated securities issued increased over the year, while the primary yields declined in view of the favourable market conditions and lower interest rate regime for long dated securities (Table V.2).

V.12 Also, 27 states and the Union Territory of Puducherry raised ₹1.8 trillion on a gross basis in 2012-13. The weighted average yield firmed mainly on account of increase in gross market borrowing by states. Consequently, the weighted average spreads for SDL issuances over the corresponding GoI security increased.

Easing trend in G-sec yield reversed at the year-end, reflecting limited policy space and tighter liquidity

V.13 Reflecting expectations of a reduction in policy rate, optimism about improvement in the fiscal situation, reduction in the primary issuances, and expectations of further measures from the government to rein in the fiscal deficit, G-sec yields eased in the beginning of Q4 of 2012-13. The continuation of OMO purchase auctions also added to the positive sentiment.

V.14 Nevertheless, yields hardened in Q4 of 2012-13, first in end-January after markets factored in limited space for monetary policy rate cuts and then in March due to tighter liquidity and fears that political uncertainty at the centre may impact capital inflows.

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

Item	2011-12	2012-13	2013-14*
1	2	3	4
Central Government			
Gross amount raised (₹ billion)	5,100	5,580	450
Devolvement on primary dealers (₹ billion)	121.13	18.28	-
Bid-cover ratio (range)	1.39-5.12	1.36-4.59	3.24-6.03
Weighted average maturity (years)	12.66	13.50	15.37
Weighted average yield (%)	8.52	8.36	7.95
State Government			
Gross amount raised (₹ billion)	1,586	1,773	82
Cut-off yield range (%)	8.36-9.49	8.42-9.31	8.24-8.51
Weighted average yield (%)	8.79	8.84	8.33
Weighted average spread (bps)	44	71	53

*: Data up to April 23, 2013.

The 10-year generic yield hardened from 7.86 per cent at end-February 2013 to 7.99 per cent at end-March 2013 (Chart V.5a).

V.15 G-sec yields have exhibited a softening bias in April 2013 on value buying, supported by lower reading of WPI inflation for March 2013, which aided market sentiment and strengthened the expectations of easing of policy rates. The softening of commodity prices also helped in easing of the yields. The ten year benchmark yield declined to 7.74 per cent on April 26, 2013. The traded volume in G-sec generally varied inversely with G-sec yields. Pricing in the weak macroeconomic performance, Q4 saw short-term yields persisting at levels higher than the 10-year yield (Chart V.5b).

Equity market pared some gains in Q4; FII flows continue to be strong

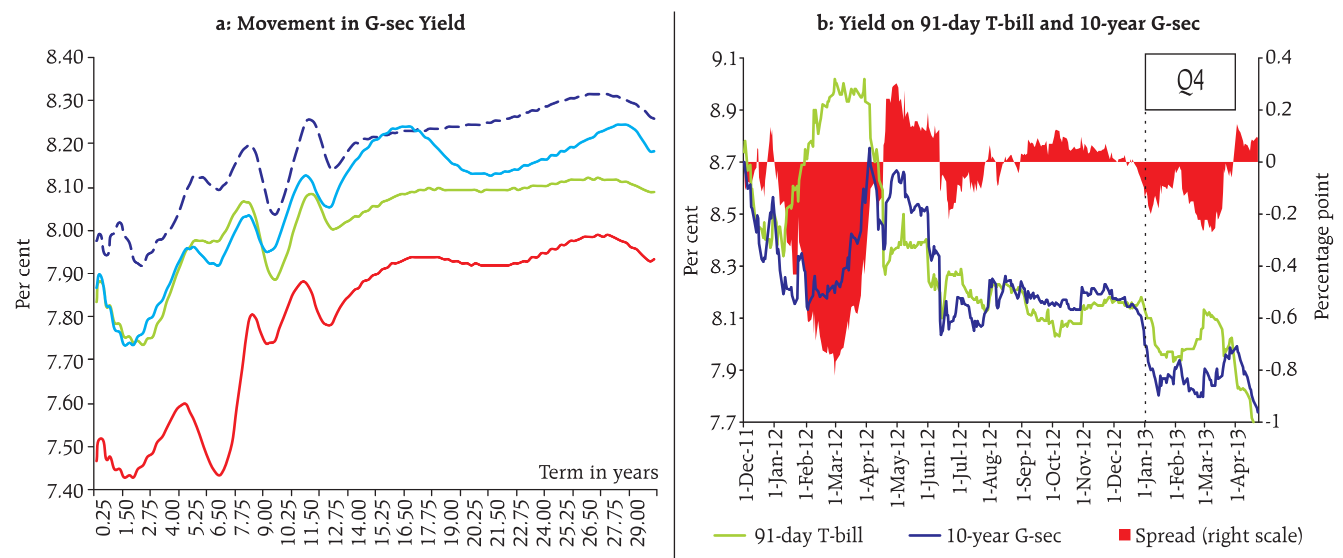
V.16 After witnessing a rally in Q3 of 2012-13, the domestic equity markets weakened during Q4, mainly on account of domestic political uncertainties at the centre in the wake of coalition politics process, slowdown in GDP growth and exports, and lower corporate earnings of some blue chip companies for Q3. During 2013-14 (up to April 26, 2013), BSE Sensex recorded gains of 2.4 per cent mainly on account of hopes of rate cut and fall in commodity prices.

V.17 Key stock market indicators show that price to earnings (PE) and price to book value (PB) ratios declined in 2012-13 in comparison with the past two years. However, end-March 2013 data indicate that India is reasonably priced in terms of return on equity (ROE) and PB ratio compared to most other EMDEs (Chart V.6a)

V.18 The Indian financial market, in February 2013, had a new entrant *viz.*, the MCX Stock Exchange Limited (MCX-SX). It officially commenced operations with the launch of its flagship index SX40 comprising 40 blue chip companies, and is yet to gain significant market share.

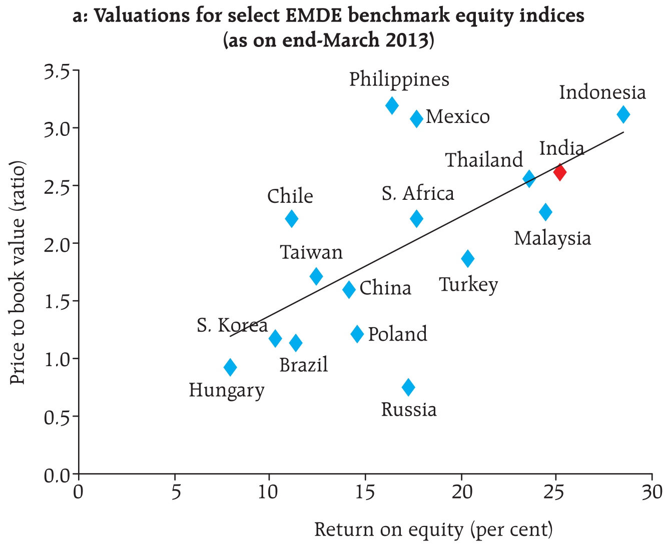
V.19 FIIs made net investments of ₹1.7 trillion in the capital market (both equity and debt) in 2012-13 compared with that of ₹0.9 trillion in the previous year. Their net investment in equity market was at ₹1.4 trillion compared with ₹0.4 trillion last year. Mutual funds (MFs) also made significantly higher net investments of ₹4.5 trillion in the capital market (both equity and debt) compared to ₹3.3 trillion last year (Chart V.6b).

Chart V.5: Trend in G-sec Yield

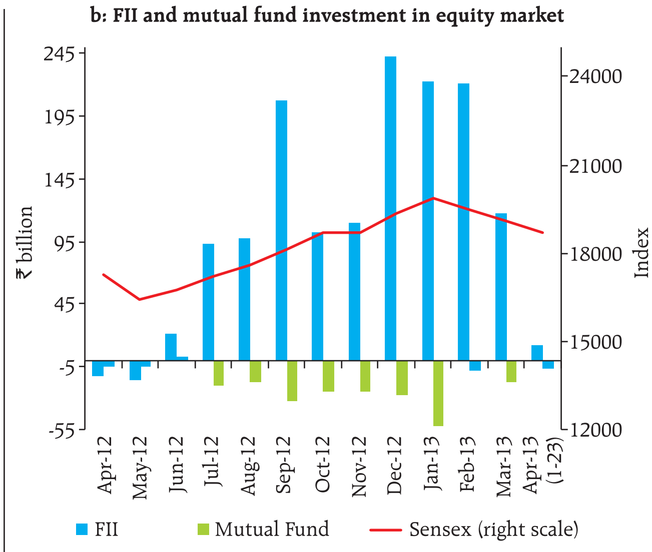


Source: Bloomberg.

Chart V.6: Trends in Indian Equity Markets



Source: Bloomberg.



Source: SEBI, BSE.

IT outperformed Sensex in Q4 of 2012-13

V.20 The BSE IT, which represents the IT sector of India, recorded q-o-q gains of 21 per cent compared with losses of 3 per cent by the BSE Sensex in Q4 of 2012-13. The influential factors were strong and better-than-expected quarterly earning results of major IT companies and the announcement of measures to boost exports in the services sector in the Union Budget 2013-14. Going forward, global economic conditions would continue to primarily shape the demand for the domestic IT sector, thereby conditioning their performance.

Resource mobilisation through mutual funds and QIPs gathered momentum

V.21 While resource mobilisation through public issues in the debt market, ADR/GDR and IPOs remained muted, MFs posted a pick-up led by private sector MFs in 2012-13 (Table V.3). After a period of fewer mobilisations through Qualified Institutional Placement (QIP) (introduced in 2006) in the recent past, ₹149 billion was mobilised through 43 issues in 2012-13 (up to February). Guidelines issued by the SEBI that require listed companies to achieve and maintain public shareholding at 25 per cent by June 2013 may further encourage resource mobilisation through this route. Private placements of corporate debt increased to ₹3.2 trillion raised through 2,288 issues in 2012-13 (up to February).

Higher mobilisation achieved through disinvestment of PSEs

V.22 The disinvestment programme of the Union Government generated higher mobilisation of about

Table V.3: Resource Mobilisation from the Primary Market

(₹ billion)

Category	2010-11	2011-12	2012-13
1	2	3	4
a. Public Issue (i) + (ii)	581	461	216*
i) Public Issue (Equity)	487	105	62*
of which: IPOs	356	59	62*
FPOs	131	46	0
ii) Public Issue (Debt)	95	356	154*
b. Rights Issue	95	24	82*
Total Equity Issues (i+b)	582	129	144*
c. Euro Issues (ADR/GDR)	94	27	10
d. Mutual Fund Mobilisation (net)	-494	-220	765
i) Private Sector	-192	-154	638
ii) Public Sector	-302	-66	127
e. Private Placement in Corporate Debt market	2,188	2,613	3,223*
f. QIP	259	22	149*
g. Disinvestment	221	139	240

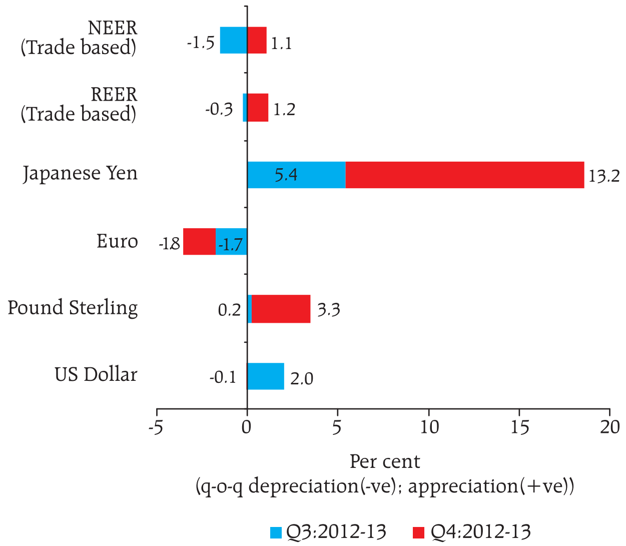
*: Data up to February 2013.
Source: SEBI and Department of Disinvestment, Ministry of Finance.

₹240 billion during 2012-13. Various public sector enterprises, *viz.*, NBCC, HCL, NMDC, OIL, NTPC, RCF, NALCO and SAIL, divested their stake, with NTPC mobilising the maximum amount of around ₹115 billion. The disinvestment programme for 2013-14 is budgeted higher at ₹400 billion.

Indian rupee remained range-bound in Q4 of 2012-13

V.23 Various reform measures, *inter alia*, postponement of GAAR (General Anti Avoidance Rules) by two years, partial deregulation of diesel prices, liberalised FDI limits for certain sectors, rise in FII limits in corporate debt and G-sec market and announcement of fiscal consolidation path, further boosted the confidence of global investors in the Indian economy. Reflecting these developments, the rupee showed a modest appreciation in January 2013 which, however, came under pressure thereafter partly due to dollar demand from oil importing companies (Chart V.7). Overall, the rupee remained stable against the dollar in Q4 of 2012-13 over Q3. The rupee has been gaining strength since the second week of April 2013 as concerns regarding the CAD seem to have somewhat diminished on account of fall in international prices of crude oil and gold and positive trend in export.

Chart V.7: Movement of INR aginst Select Currencies, and Changes in Indices



V.24 As at end-March 2013, the rupee showed lower depreciation (y-o-y) compared to some other major EMDEs, such as Brazil, South Africa and Argentina. However sustained efforts to control the widening current account are required to bolster global confidence in the Indian economy and attract stable capital flows to enable smooth CAD financing. In the interim, corporates need to factor in the risks of unexpected currency volatilities and appropriately hedge a larger proportion of their currency exposures.

House prices continue to rise with increasing volumes

V.25 The annual growth in the Reserve Bank's quarterly House Price Index at all-India level has hovered around 20 per cent for the past eight quarters, with all cities, except Kanpur, registering positive growth in Q3 of 2012-13. Transaction volumes also picked up, registering an annual growth of over 14 per cent in Q3 (Table V.4).

Near-term risks from euro area reduced, domestic reform initiatives to boost investor sentiment in 2013-14

V.26 Despite weak global growth, the start of sequestration in the US and concerns about Italy and Cyprus, the global financial condition improved during Q4, mainly on account of central banks' QE measures. Steady commitment to accommodative monetary policy in the face of fiscal austerity in advanced economies (AEs) is likely to support investor sentiments in the short-run. However, the persistence of exceptionally low interest rates over the medium-run poses risks of re-emergence of financial sector imbalances and vulnerabilities. It is, therefore, important for the AEs to clean up their bank balance sheets at the earliest and for EMDEs such as India to build liquidity buffers to meet any shocks from contagion from the AEs should the tail risks materialise.

V.27 On the domestic front, the slow recovery envisaged in 2013-14 may support the financial

Table V.4: House Price and Transaction 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
House Price Index										
Q1:2012-13	231.8	217.3	140.2	176.6	179.4	204.2	133.9	171.9	144.9	188.6
Q2:2012-13	232.4	225.2	143.0	183.4	208.9	226.9	129.5	177.7	135.8	194.3
Q3:2012-13	248.5	247.8	147.9	187.8	221.6	247.3	149.2	179.4	117.0	206.8
Growth in per cent										
y-o-y	29.7	47.0	1.2	9.3	28.6	59.6	24.0	9.7	-16.4	26.0
q-o-q	6.9	10.1	3.4	2.4	6.0	9.0	15.2	1.0	-13.8	6.4
House Transactions Volume Index										
Q1:2012-13	153.2	133.6	81.6	140.1	151.9	98.2	80.9	296.7	154.9	134.6
Q2:2012-13	100.4	142.6	112.6	130.5	233.7	96.9	68.2	322.6	409.2	145.4
Q3:2012-13	96.3	128.2	119.4	172.4	113.3	88.8	79.6	354.8	495.9	147.2
Growth in per cent										
y-o-y	26.8	-34.5	41.2	31.4	-31.4	-18.4	-39.2	59.8	311.1	14.2
q-o-q	-4.1	-10.1	6.1	32.1	-51.5	-8.3	16.7	10.0	21.2	1.2

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

markets. However, macro-financial risks are rising as is evident from sub-par corporate earnings, deteriorating asset quality and stretched leverage in certain sectors, especially power and construction. However, sustained commitment to reforms and policy action could considerably lower this risk.