V FINANCIALMARKETS

5.1 A broad based rally in global financial markets in 2003-04 was characterised by rising equity prices, decline in bond spreads, a rebound in financial flows to emerging markets, improved corporate finances and increased appetite for risks by investors. The Morgan Stanley Capital International (MSCI) World index gained 23 per cent in 2003 and a further 3 per cent during the first two months of 2004. The pattern of investment flows generally implied an allocation of funds away from relatively low-yielding assets in favour of riskier investments. Equity and debt prices in emerging markets outperformed most other markets. A combination of abundant liquidity and improved fundamentals buoyed global asset prices. Net issuances in international debt securities markets were distinctly higher at US $ 1,467 billion in 2003, as compared with US $ 1,011 billion in 2002, and were made largely by emerging market economies.

5.2 Against this background, financial markets in India were also characterised by ample liquidity during 2003-04 mainly due to persistent external capital flows. A steady appreciation of the rupee against the US dollar in the spot segment of the foreign exchange market generated unidirectional upside expectations which dominated the forward segment. In the Government securities market, there was a persistent rally in prices, interrupted by open market operations (OMO) and a hardening of inflation expectations in the last quarter of the year. In the market for bank credit, falling deposit rates nudged the stickier lending rates down. Equity markets regained vibrancy with intermittent corrections.

5.3 This Section sets out developments in various segments of domestic financial markets in 2003-04. In respect of the money market, it highlights synchronous movement of key interest rates and their ruling at sub-repo levels. As regards the Government securities market, the review points to the softening of yields during the year with the yield curve steepening in the second half of the year in the wake of rising inflationary expectations, hardening of international interest rates and profit booking by investors. Yields on corporate bonds declined alongside a widening of spreads. In the credit market, the focus is on the pick-up in activity with banks cutting deposit and lending rates, the latter exhibiting downward inflexibility. Introduction of the benchmark prime lending rate (BPLR) system by banks in the fourth quarter of the year led to some rationalisation in prime lending rates. An overview of the foreign exchange market shows the impact of persistent excess supply conditions - the rupee faced upward pressure *vis-á-vis* the US dollar throughout the year and the forward premia turned into discounts in the third quarter before firming up marginally towards the close of the year. The profile of capital markets reflects a revival in the primary segment, particularly in the public issues market, significantly higher resource mobilisation by mutual funds and a turnaround in the financial assistance disbursed by financial institutions. The secondary segment of the capital market remained generally buoyant, attracting a record flow of foreign institutional investment (Table 5.1).

MONEY MARKET

Call/Notice Money Market

5.4 Activity in the call/notice money market ebbed during 2003-04 with call rates ruling persistently below the LAF repo rate, except in isolated episodes. The surplus liquidity at the beginning of the year drew heavy bidding at the LAF repo auctions (Appendix Table V.1). Call rates inched up in June 2003, with the outflows on account of the usual end-of-the-quarter advance tax payments by corporates and market borrowings by the Centre and the State Governments. Consequent upon a reduction in the cash reserve ratio (CRR) by 25 basis points in June 2003 and continuing external capital inflows, call rates eased and settled below the repo rate in July 2003 (Chart V.1).

5.5 Market participants built up surplus cash positions in anticipation of redemption of Resurgent India Bonds (RIBs) leading to the Reserve Bank trebling the notified amount of 91-day Treasury Bills in the auctions during August-September 2003. Call rates turned somewhat volatile for a brief period in August 2003. With the 50 basis points cut in the LAF repo rate on August 25, 2003 stability returned to the market, accompanied by a softening of call rates. Advance tax outflows, unsettled expectations surrounding the RIB redemptions and a build up of surplus cash balances of the Government with the Reserve Bank led to some edging up of call rates towards the last week of September 2003, prompting the Reserve Bank to

Table 5.1: Financial Markets at a Glance

	Call Money		Gilt	Foreign Exchange				Liquidity Management		Equity			
Month	Average Daily Turnover (Rs. crore)	Average Call Rates* (Per cent)	Turnover in Govt. Securities (Rs. crore)+	Average Daily Inter-bank Turnover (US $ million)	Average Exchange Rate (Rs. per US $)	RBI's net Foreign Currency Sales (-)/ Purchases(+) (US $ million)	Average Forward Premia 3-month (Per cent)	Net OMO Sales(-) Purchases (+) (Rs. crore)	Average Daily Repos (LAF)# (Rs. crore)	Average Daily BSE Turnover (Rs. crore)	Average Daily NSE Turnover (Rs. crore)	Average BSE Sensex**	Average S & P CNX Nifty**
1	2	3	4	5	6	7	8	9	10	11	12	13	14
2003-04													
April	17,338	4.87	2,26,803	5,585	47.38	1,432	2.08	-7	27,372	1,041	2,449	3037	965
May	18,725	4.87	2,99,933	5,960	47.08	2,342	1.10	-5,569	25,223	1,072	2,604	3033	963
June	20,544	4.91	3,00,504	5,837	46.71	897	2.76	-44	24,805	1,187	2,933	3387	1069
July	18,698	4.90	3,04,587	5,920	46.23	3,146	2.65	-57	42,690	1,434	3,429	3665	1150
August	19,556	4.83	4,09,539	5,983	45.93	2,352	2.25	-11,546	39,995	1,817	4,267	3978	1261
September	20,584	4.50	2,65,848	6,862	45.85	2,345	0.91	-5,107	31,373	2,032	4,698	4315	1369
October	23,998	4.64	3,89,968	7,672	45.39	1,593	0.02	-13,986	13,569	2,288	5,026	4742	1506
November	15,156	4.38	1,77,063	6,795	45.52	3,449	(-) 0.002	-69	21,182	2,251	4,644	4951	1580
December	15,276	4.40	1,81,991	6,207	45.59	2,888	(-) 0.30	-132	32,020	2,492	5,017	5425	1740
January	14,189	4.43	1,81,619	7,306	45.46	3,294	0.50	-5,228	38,539	3,125	6,394	5954	1906
February	9,809	4.33	1,39,130	7,171	45.27	3,357	0.51	-35	46,244	2,709	5,722	5827	1849
March	12,422	4.37	2,22,685	8,018	45.02	3,382	0.62	-69	54,915	2,308	4,767	5613	1780
2004-05													
April	12,916	4.29	3,00,864	10,118 P	43.93	7,427	-0.35	-253	75,218	2,243	5,048	5809	1848
May	10,987	4.30	1,92,264	8,521 P	45.25	-220	-1.33	-116	74,502	2,188	4,710	5205	1640
June	10,972	4.35	1,75,802	7,741 P	45.51	-413	0.93	-60	61,981	1,681	3,859	4824	1506
July	8,632	4.31	1,30,400	7,684 P	46.04	-1,180	2.25	-230	57,876	1,793	4,265	4973	1568

OMO : Open Market Operations. + : Outright turnover in Central Government dated securities. LAF : Liquidity Adjustment Facility.
BSE : The Stock Exchange, Mumbai. NSE : National Stock Exchange of India Ltd. P : Provisional.
* : Average of daily weighted average call money borrowing rates. ** : Average of daily closing indices. # : Outstanding

reduce the notified amount of 91-day Treasury Bills. Contrary to initial apprehensions, redemption of RIBs on October 1, 2003 did not strain the money market with liquidity conditions remaining comfortable. OMO sales and a series of 28-day repo auctions conducted by the Reserve Bank in the second half of October caused call rates to spike above 6.0 per cent towards the end of the month. Liquidity generated by large capital inflows brought down call rates to sub-repo levels for the remaining part of the year with some isolated dips in February 2004 due to unsterilised capital flows. Over the year, volatility in the call/notice money market declined and was accompanied by a reduction in turnover on account of abundant liquidity (Table 5.2). A part of call/notice money market activity migrated to the repo market (outside the LAF) and to the Collateralised Borrowing and Lending Obligations (CBLO) segment on account of cheaper availability of funds *vis-á-vis* the call/notice money market. Primary dealers (PDs), whose demand is related to the volume of the Government's market borrowing programme, emerged as the largest class of borrowers in the call/notice money market in 2003-04.

5.6 The year 2004-05 commenced with large volumes of liquidity in the system keeping the call rates below the repo rate during April 2004. Despite absorptions under the Market Stabilisation Scheme (MSS) and advance tax outflows in June, liquidity conditions continued to remain comfortable as reflected in large outstanding volumes under the LAF.

Chart V.1 : Call Rate and Repo Rate

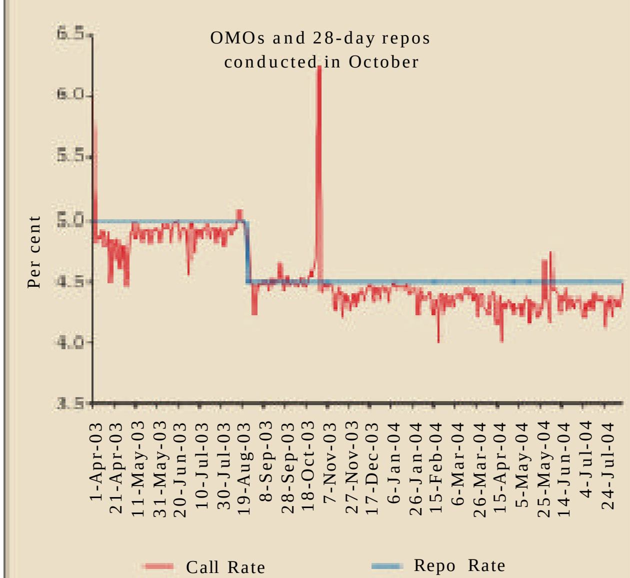


Table 5.2: Call/Notice Money Market Borrowing Rates – Summary Statistics

	Low				High				Weighted Average			
	Min. (percent)	Max. (percent)	Avg. (percent)	CV	Min. (percent)	Max. (percent)	Avg. (percent)	CV	Min. (percent)	Max. (percent)	Avg. (percent)	CV
1	2	3	4	5	6	7	8	9	10	11	12	13
2002-03	**0.50**	**6.50**	**4.59**	**0.17**	**5.20**	**20.00**	**6.36**	**0.15**	**5.01**	**10.35**	**5.89**	**0.09**
2003-04	**1.00**	**5.25**	**3.39**	**0.18**	**4.50**	**12.00**	**4.89**	**0.13**	**3.99**	**6.21**	**4.62**	**0.06**
April	1.00	5.25	2.94	0.38	5.05	12.00	5.73	0.30	4.50	6.03	4.87	0.07
May	1.80	4.00	3.32	0.25	5.00	5.25	5.10	0.01	4.46	4.97	4.87	0.02
June	2.00	4.00	3.60	0.15	4.88	5.50	5.11	0.02	4.56	4.99	4.91	0.02
July	2.25	4.00	3.70	0.14	5.00	5.50	5.07	0.02	4.75	4.97	4.90	0.01
August	3.00	4.05	3.70	0.10	4.55	6.25	5.09	0.06	4.22	5.07	4.83	0.05
September	3.00	4.00	3.50	0.04	4.55	5.10	4.70	0.03	4.42	4.64	4.50	0.01
October	1.00	4.00	3.32	0.16	4.60	7.00	5.13	0.15	4.44	6.21	4.64	0.09
November	1.50	3.52	3.12	0.14	4.50	4.70	4.60	0.01	4.21	4.50	4.38	0.02
December	2.00	3.75	3.25	0.12	4.50	4.97	4.55	0.02	4.30	4.47	4.40	0.01
January	2.00	3.85	3.52	0.14	4.50	6.50	4.59	0.08	4.23	4.49	4.43	0.01
February	2.00	3.85	3.32	0.17	4.50	4.85	4.55	0.02	3.99	4.42	4.33	0.02
March	2.00	3.97	3.29	0.15	4.50	4.60	4.53	0.01	4.21	4.44	4.37	0.01
2004-05												
April	1.00	3.80	3.09	0.22	4.50	4.55	4.52	0.01	4.01	4.42	4.29	0.02
May	2.00	3.75	3.14	0.17	4.50	7.50	4.61	0.12	4.16	4.67	4.30	0.02
June	2.50	4.00	3.51	0.10	4.50	6.25	4.61	0.07	4.18	4.74	4.35	0.02
July	2.00	3.80	3.41	0.10	3.51	4.80	4.48	0.04	4.13	4.41	4.31	0.01

Min.: Minimum. Max: Maximum. Avg.: Average. CV: Coefficient of Variation.

Call rates remained generally easy, hovering in the range of 4.0-4.5 per cent during 2004-05 (up to July) except for some firming up during the late hours on May 28 and June 4 due to heavy outflow of funds on account of MSS operations. Turnover in the call money market declined during May, June and July 2004, reflecting the continued shifts in activity away from the uncollateralised segment. Call rates firmed up for a few days during the second week of August 2004 due to outflow of funds on accounts of surplus balances of Central Government with the Reserve Bank, auctions of Central Government dated securities and withdrawal of funds by mutual funds due to redemption pressure. Call rates returned to sub-repo levels by mid-August 2004.

Term Money Market

5.7 Recent money market reforms encompassing development of the repo market, introduction of exposure limits for banks in the call/notice money market segment and the calibrated phase out of non-banks from the call market have begun to infuse vibrancy into various money market segments. The average daily turnover in the term money market rose by 52 per cent to Rs.519 crore in 2003-04 from 341 crore in 2002-03, driven by the reform measures (Table 5.3). During the year 2004-05 (up to July 2004), the average daily turnover declined to Rs.288 crore.

Certificates of Deposit

5.8 The significant increase in the outstanding amount of certificates of deposit (CDs) in 2003-04 essentially reflected issuances by some banks with low deposit bases. Furthermore, the exemption of investments in CDs by banks from the restrictions on non-SLR investments below one year also supported the CD market. The reduction in stamp duty on CDs, effective March 1, 2004 and withdrawal of the facility of premature closure of deposits in respect of CDs were other factors that boosted activity in the market, providing greater opportunity for secondary market trading. Investment in CDs by mutual funds also increased on account of their improved funds position. An encouraging development was that some banks got their CDs rated for gaining better access to the market even when such rating was not mandatory under the extant guidelines. The typical discount rate (for 3-month maturity) on CDs softened from 7.20 per cent in mid-April 2003 to 5.50 per cent by end-August 2003 and further to 4.96 per cent by mid-March 2004 in

Table 5.3: Activity in Money Market Segments (other than Call/Notice Money)

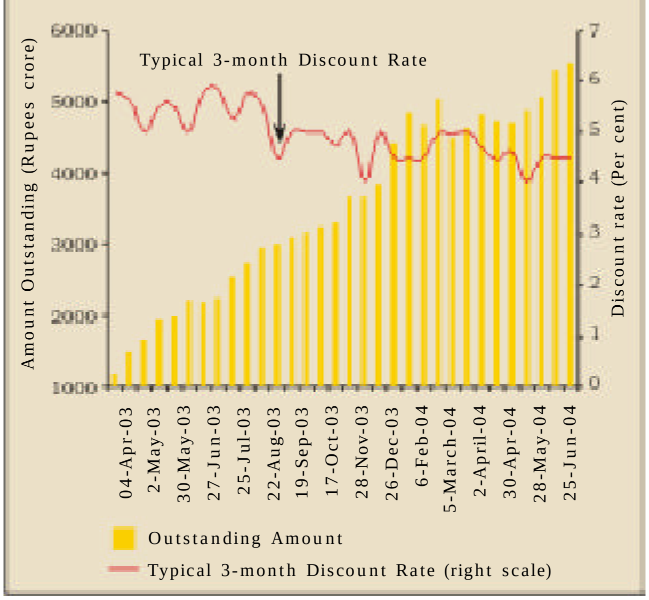
(Rupees crore)

Month	Average Daily Turnover in Term Money Market	Average Daily Turnover in Repo Market (Outside Reserve Bank)	Commercial Paper (Outstanding Amount)	Certificates of Deposit (Outstanding Amount)	Commercial Bills Rediscounted by Commercial Banks	Forward Rate Agreements/ Interest Rates Swaps (Notional Amount)	Average Daily Turnover in Collateralised Borrowing and Lending Obligation (CBLO)
1	2	3	4	5	6	7	8
2003-04							
April	604	5,575	5,994	1,485	164	2,49,449	47
May	455	5,591	6,820	1,996	334	2,84,048	41
June	610	6,481	7,108	2,183	393	2,93,127	37
July	573	9,669	7,557	2,466	364	3,05,409	126
August	644	9,528	7,646	2,961	693	3,14,708	16
September	772	9,525	7,258	3,098	644	3,33,736	234
October	543	11,542	6,845	3,321	354	3,83,866	156
November	428	12,910	7,956	3,666	429	4,05,102	248
December	403	12,939	8,762	3,830	469	4,31,597	363
January	482	15,426	9,562	4,419	791	4,86,571	708
February	343	12,660	9,379	4,656	1,234	4,89,701	1,693
March	376	13,378	9,131	4,461	305	5,18,260	2,506
2004-05							
April	325	15,195	9,706	4,725	330	5,13,760	2,496
May	372	15,932	10,328	4,860	370	6,11,595	3,872
June	274	17,517	10,910	5,438	n.a.	n.a.	4,015
July	182	19,226	10,898	n.a.	n.a.	n.a.	4,508

n.a. : Not available.

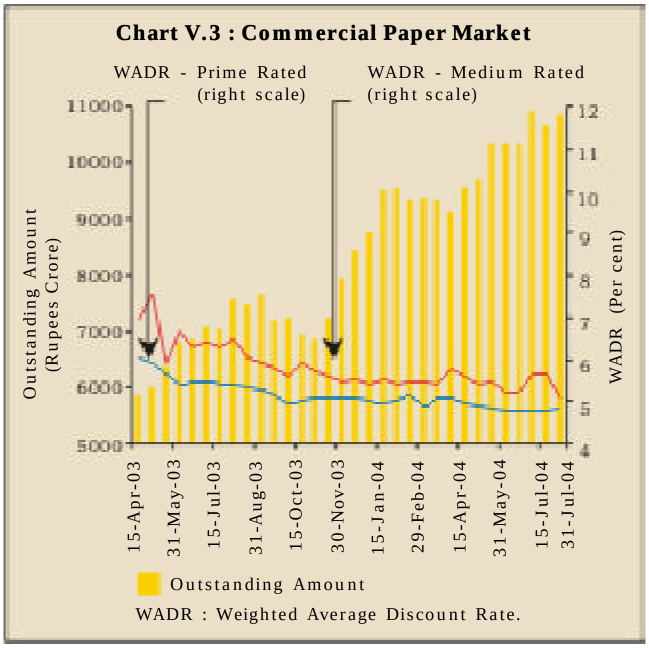
line with the general softening of interest rates (Chart V.2). During 2004-05 (up to June 25, 2004), the discount rate further softened to 4.5 per cent. The outstanding CDs continued to increase during the first quarter of 2004-05 (Appendix Table V.2).

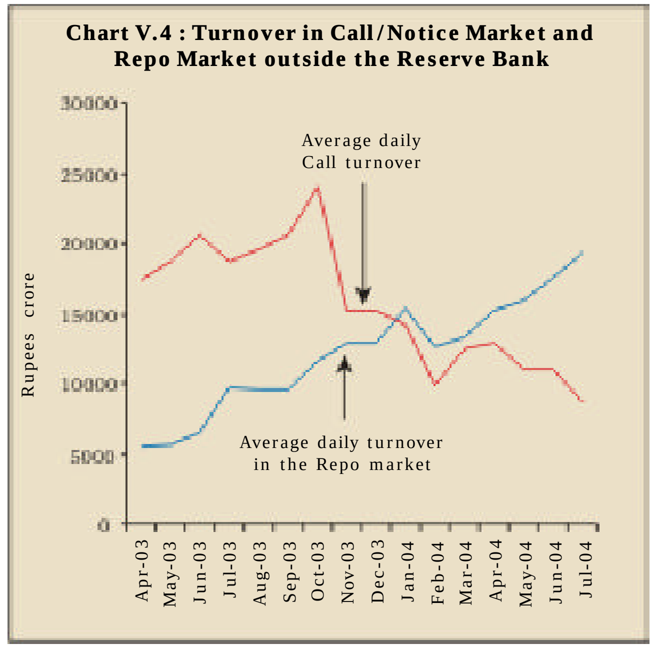
Chart V.2 : Certificates of Deposit Market



Commercial Paper

5.9 Easy liquidity conditions prompted companies to mobilise large volume of funds through commercial paper (CP). The outstanding amount of CP increased by about 59 per cent during 2003-04 (Appendix Table V.3). The issuance of CP picked up from mid-November 2003 on account of increased interest by mutual funds and banks in the wake of the guidelines by the SEBI and the Reserve Bank barring investments in non-SLR debt securities with original maturity up to one year except in CP and CDs (Chart V.3). Furthermore, reduction in stamp duty on CP also buoyed up the market. The discount rates on CP joined other short-term rates in easing through the year from a range of 5.25-8.15 per cent to 4.70-6.50 per cent. During 2004-05 (up to end-July 2004), the discount rates further declined to 4.60-5.60 per cent. The weighted average discount rate (WADR) also declined from 6.20 per cent at the beginning of April 2003 to 5.11 per cent as at end of March 2004 and further to 4.86 per cent as at end-July 2004. The spread of the WADR between the prime-rated and medium-rated companies narrowed from 162 basis points as at end-April 2003 to 73 basis points by end-March 2004 but increased marginally to 87 basis





points by end-June 2004. The spread, however, again narrowed to 29 basis points by end-July 2004. The most preferred maturities of CP were 'up to 90 days' and '181 days and above'. The share of manufacturing and other companies in the average outstanding amount of CP stood lower at 22 per cent in 2003-04 (35 per cent in 2002-03), while the shares of finance/ leasing companies and financial institutions rose to 49 per cent and 29 per cent, respectively, from 41 per cent and 24 per cent, a year ago.

5.10 The market for CP continued to remain buoyant during 2004-05 (up to end-July 2004) with issuances of CP aggregating Rs.8,052 crore as against Rs.7,293 crore during the corresponding period of the previous year. The share of 'manufacturing and other companies' and financial institutions in the outstanding amount of CP stood lower at 24 per cent and 15 per cent, respectively, while that of finance/leasing companies was higher at 61 per cent.

Repurchase Agreements (Outside the LAF)

5.11 Tightening of prudential norms relating to the call exposure of banks and gradual phasing out of non-bank participants from the call market led to increased activity in the repo market (outside the LAF) (Chart V.4). During 2003-04, the monthly average volume of repo transactions increased by 69.6 per cent to Rs.79,628 crore over the previous year. The share of repo in total transactions (outright and repos) increased to 36.8 per cent in 2003-04 from 30.6 per cent in 2002-03. Apart from banks, mutual funds and financial institutions were the main participants in the repo market (outside the LAF). The repo rates ranged between 3.00 per cent and 5.05 per cent during the year barring occasional spikes.

5.12 The volume of repo transactions increased by 43.7 per cent to Rs.1,49,000 crore in July 2004 over end-March 2004 as compared with 1.0 per cent in the corresponding period of the previous year due to sizable deployment by mutual funds, private banks and financial institutions. Interest rates in most of the transactions ranged from 3.0 per cent to 4.5 per cent. Average share of repo transactions in the total market volume during the year 2004-05 (up to July 2004) also improved to 51.9 per cent as compared with 25.5 per cent in the corresponding period of the previous year.

Forward Rate Agreements (FRAs)/Interest Rate Swaps (IRS)

5.13 There was a sharp increase in the volume in FRAs/IRS market during 2003-04, both in terms of number of contracts and outstanding notional principal amounts. The number of contracts rose from 9,363 to 19,867, while the outstanding amount rose from Rs.2,42,983 crore to Rs.5,18,260 crore during the period April 4, 2003 to March 19, 2004. The participation in the market was broad based and included public sector banks, PDs, foreign banks and private sector banks. In a majority of these contracts, the National Stock Exchange-Mumbai Inter-bank

Box V.1
Evolution of Money Market in India

The evolution of the money market in India could be traced to the late 1980s when the Working Group on Money Market (Chairman: N. Vaghul) made a series of recommendations for developing various segments of the money market. The administered interest rate system in the money market was dismantled. A series of measures were undertaken to build the institutional infrastructure for the money market. The Discount and Finance House of India (DFHI) was established in 1988 to promote secondary market activity in money market instruments, followed by a system of primary dealers in 1996 as a mechanism for developing the gilt market. The segment for Certificates of Deposit came into being in 1989. The money market expanded further to cover segments for Commercial Paper (1990), Repos with Reserve Bank (1992), Market Repos, Forward Rate Agreements/Interest Rate Swaps (1999) and Collateralised Borrowing and Lending Obligation (CBLO) (2003). The development of the payment system infrastructure was strengthened with the formation of the Clearing Corporation of India Ltd. (CCIL) in April 2002, introduction of the Negotiated Dealing System (NDS) in February 2002 and the implementation of real time gross settlement (RTGS) system from April 2004.

The profile of the money market has also been changing in the recent period. There have been indications of a more balanced development of the money market. Participants have been increasingly switching from the uncollateralised call/notice money market to the collateralised segments, driven by standardisation of accounting practices, broad basing of eligibility criteria, the gradual phasing out of non-banks from the call market and lower CRR requirements. In recent years, although the call money and the repo markets continued to be dominated by a few top lenders, they were not able to extract monopoly rents as call rates and market repo rates persistently ruled below the Reserve Bank's repo rate. While mutual funds have emerged as the largest supplier of funds in the repo and the CBLO markets, PDs are increasingly becoming the major borrowers in the call/notice money market.

The integration of various segments of the money market has improved after the introduction of the Liquidity Adjustment Facility (LAF). The correlation coefficient between interest rates of CDs, CPs, 91-day Treasury Bills and repo rate with the call money rate improved steadily from 0.32, 0.54, 0.61 and 0.36, respectively, during the period April 1993 to May 2000 to 0.93, 0.90, 0.95 and 0.87 during June 2000 to June 2004. Correlation coefficients turned out to be lower after netting out the repo rate reflecting the influence of the LAF in promoting money market integration. The integration of money market segments was further validated by confirmation of the existence of cointegrated relationships among money market rates. The degree of cointegration has strengthened in the recent period, *i.e.*, June 2000 to June 2004.

Reference

1. Reserve Bank of India (1987), *Report of the Working Group on the Money Market.*

Offered Rate (NSE-MIBOR) and Mumbai Inter-bank Forward Offered Rate (MIFOR) were used as the benchmarks. Other benchmark rates used were secondary market yields of the Government securities with residual maturity of one-year and primary cut-off yield on 364-day Treasury Bills. Activity in FRAs/ IRS is expected to pick up after the regulatory and prudential norms for over-the-counter (OTC) and exchange traded derivatives are harmonised by the Reserve Bank. During 2004-05, the number of contracts rose further to 23,331 and the outstanding amount moved up to Rs.6,11,595 crore as on May 28, 2004.

Collateralised Borrowing and Lending Obligation

5.14 Collateralised Borrowing and Lending Obligation (CBLO) was operationalised as a money market instrument through the Clearing Corporation of India Limited (CCIL) on January 20, 2003. The CBLO can have an original maturity between one day and up to one year. Activity in this segment has gradually picked up in recent months with increasing supply of funds from mutual funds and demand for funds by banks and primary dealers. The daily average turnover in CBLO increased from Rs.47 crore in April 2003 to Rs.2,506 crore in March 2004. By March 2004, about 50 members were admitted to the CCIL's CBLO segment. To encourage activity in this segment, banks' borrowings through CBLO were exempted from CRR, subject to banks maintaining the minimum CRR of 3 per cent. During 2004-05 (up to July 2004), the daily average turnover increased substantially to Rs.4,508 crore with the weighted average rate working out to 3.96 per cent (Box V.1).

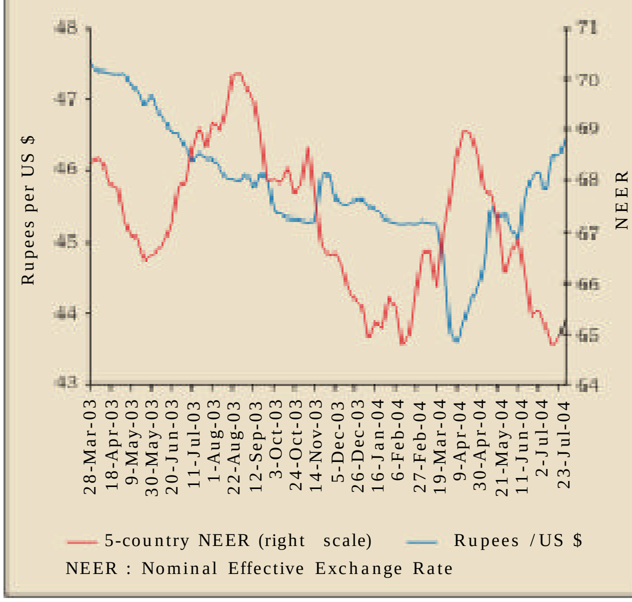
FOREIGN EXCHANGE MARKET

5.15 Excess supply conditions dominated the foreign exchange market during the major part of 2003-04, reflecting a sustained expansion of the current account surplus in the balance of payments and a surge in capital inflows. Large scale purchases by the Reserve Bank to absorb excess supplies in the foreign exchange market assuaged the strong upward pressures on the exchange rate. Despite these interventions, the Indian rupee appreciated by 9.3 per cent against the US dollar during 2003-04. This was counter balanced by the weakening of the rupee against other major currencies in tandem with the US dollar. Consequently, the depreciation of the rupee in terms of the nominal effective exchange rate was relatively muted (Chart V.5).

5.16 In cross-currency trade, the rupee weakened against both the Euro and the Pound sterling, reflecting the movements of the rupee against the US dollar and movement of the US dollar *vis-á-vis* other major international currencies. While the US dollar depreciated against the Euro, Pound sterling and Japanese yen by 11.4 per cent, 14.3 per cent and 11.7 per cent, respectively, the Indian rupee depreciated against these three currencies by 3.2 per cent, 6.0 per cent and 4.3 per cent, respectively, over the year (Chart V.6).

5.17 Market sentiment remained buoyant during the first quarter of 2003-04 against the backdrop of rising foreign exchange reserves, stable international crude oil prices and the US dollar's weakness against other major currencies. Strong supplies came from higher exports, remittances and foreign institutional investments. Despite robust imports, demand for credit was deflected from the domestic market by an increasing recourse to relatively low cost external commercial borrowings and trade credits. The rupee gained against the US dollar, appreciating by 2.2 per

Chart V.5 : Exchange Rate of the Rupee



cent in spite of net purchases of US $ 4.7 billion by the Reserve Bank during the first quarter (Table 5.4 and Appendix Table V.4).

5.18 The rupee ranged between Rs.45.71 and Rs.46.49 per US dollar and appreciated by 1.4 per cent against the US dollar during the second quarter of 2003-04. Although steady inflows from foreign funds and other sources continued, uncertainties in the foreign exchange market and the Reserve Bank's net market purchases of US $ 7.8 billion kept the rupee range-bound. An imposition of ceiling on interest rate on non-resident external rupee (NRE) deposits in July followed by a lowering of interest rate ceiling in September and banning of investment by overseas corporate bodies (OCBs) owned by non-resident Indians (NRIs)/persons of Indian origin (PIOs) in the Indian stock market fuelled speculative expectations

Chart V.6 : Movement of Currencies

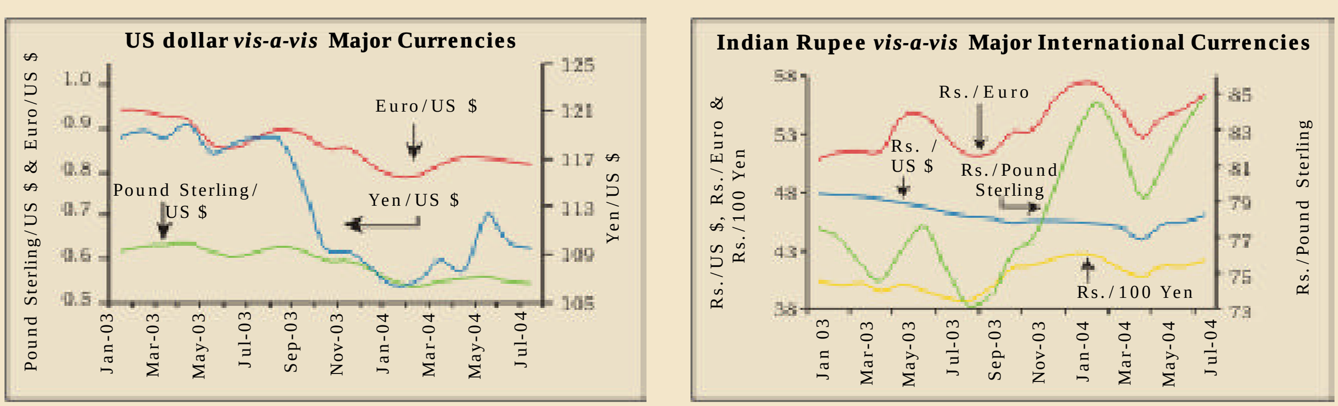


Table 5.4: Purchases and Sales of US dollars by the Reserve Bank

(US $ million)

Month	Purchases(+)	Sales (-)	Net@ (+/-)	Cumulative (over end-March)	Outstanding Net Forward Sales (-) / Purchases (+) (end of month)
1	2	3	4	5	6
2003-04					
April	2,943	1,511	1,432	(+)1,432	(+)3,281
May	3,978	1,636	2,342	(+)3,774	(+)4,186
June	1,879	982	897	(+)4,670	(+)3,866
July	6,096	2,950	3,146	(+)7,815	(+)4,549
August	3,712	1,360	2,352	(+)10,167	(+)4,803
September	6,574	4,229	2,345	(+)12,512	(+)1,412
October	6,821	5,228	1,593	(+)14,105	(+)981
November	4,029	580	3,449	(+)17,554	(+)518
December	3,373	484	2,888	(+)20,442	(+)740
January	4,322	1,028	3,294	(+)23,735	(+)1,101
February	5,520	2,163	3,357	(+)27,092	(+)763
March	6,171	2,789	3,382	(+)30,473	(+)1,392
2004-05					
April	10,759	3,332	7,427	(+) 7,427	(+) 311
May	3,220	3,440	(-) 220	(+) 7,207	(+)125
June	970	1,383	(-) 413	(+) 6,793	(+) 115
July	0	1,180	(-)1,180	(+) 5,614	(+) 115

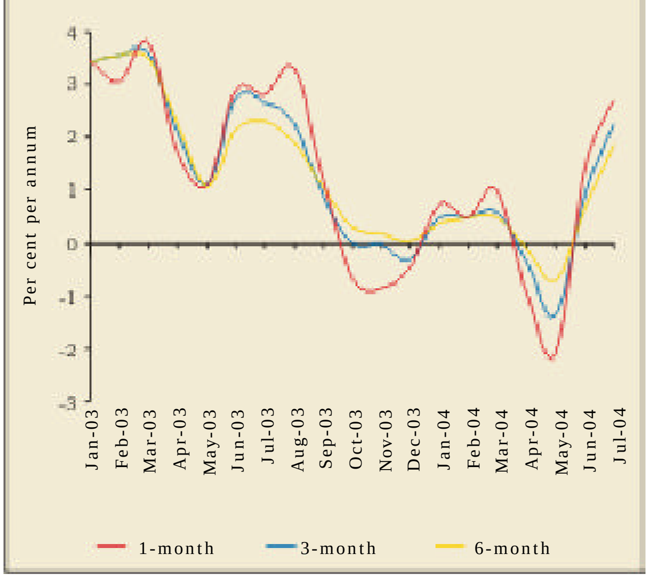
(+) : Implies purchases including purchase leg under swaps and outright forwards.
(-) : Implies sales including sale leg under swaps and outright forwards.
@ : Includes transactions under the Resurgent India Bonds (RIBs) and India Millennium Deposits (IMDs).
Note : This table is based on value dates.

of a slowdown in inflows. Furthermore, the building up of *nostro* balances in the run up to the redemption of the Resurgent India Bonds (RIBs) in early October 2003 exerted some pressure on the foreign exchange market. The Reserve Bank undertook forward purchases throughout the first half of 2003-04 in preparation of the RIB repayments. Strong export proceeds coupled with heavy inflows from FIIs helped to maintain easy liquidity conditions.

5.19 Forward premia fell as exporters continued to book forward sales in response to the strengthening of the rupee in the spot market. Easy liquidity conditions in the domestic money market also exerted downward pressure and the 3-month and the 6-month forward premia declined by 253 basis points and 184 basis points, respectively, during July-September 2003 (Chart V.7).

5.20 The smooth redemption of the RIBs, followed by the return flow of some part of the redemption proceeds, strengthened the rupee considerably in the first week of October 2003, aided by the continuing weakness of the US dollar against most major currencies. Sustained US dollar demand from corporates and importers amidst fears of slowdown in inflows on account of tightening of the external commercial borrowing (ECB) guidelines drove the

Chart V.7 : Forward Premia/Discount
(Monthly Averages)



rupee down by 59 paise or 1.3 per cent against the US dollar between November 14 and end-November 2003. It, however, bounced back against the US dollar in early December 2003 and the undertone in foreign exchange trading remained firm throughout the month on sustained investment flows from FIIs, steady inward remittances and a positive sovereign rating assigned by Standard & Poor's. The rupee moved in a narrow range of Rs.45.26-45.94 per US dollar and appreciated by 0.5 per cent during the third quarter of 2003-04, restrained by purchases of US $ 7.9 billion by the Reserve Bank.

5.21 In the forward segment, premia fell sharply across the maturity spectrum into discounts during November and December 2003 as exporters continued to offload forward positions. In January 2004, forward discounts turned into slender premia of less than 1.0 per cent for all maturities.

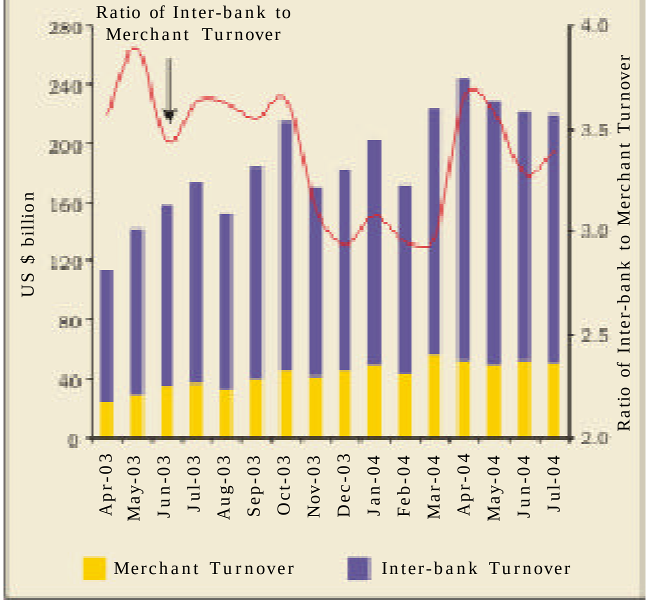
5.22 Liberalisation of the ECB regime, the impact of large export receivables, sustained FII inflows and upgrading of the country's long-term foreign currency rating by the Moody's Investor Services buoyed up the rupee in the last quarter of 2003-04 causing it to appreciate sharply by 5.0 per cent against the US dollar.

5.23 The Reserve Bank made net spot purchases of US $ 30.5 billion during the year. Outstanding net forward purchases, however, declined to US $ 1.4 billion at end-March 2004 from US $ 2.4 billion at end-March 2003, reflecting unwinding of forward purchases by the Reserve Bank built up to ensure smooth redemption of the RIBs.

5.24 Excess supply conditions ruled in the merchant segment. Net market purchases by authorised dealers (ADs) in the spot segment increased from US $ 512 million in April 2003 to US $ 2,692 million in March 2004 and from US $ 866 million in April 2003 to US $ 3,449 million in October 2003 in the forward segment before declining to US $ 1,695 million in March 2004. The average monthly turnover in the merchant segment of the foreign exchange market increased to US $ 40.5 billion in 2003-04 from US $ 27.0 billion in 2002-03. In the inter-bank segment, banks took positions in response to the merchant activity. The average monthly turnover in the inter-bank segment was high at US $ 134.2 billion as against US $ 103.0 billion in 2002-03. Consequently, the average monthly total turnover increased sharply to US $ 174.7 billion in 2003-04 from US $ 130.0 billion in the previous year. The inter-bank to merchant turnover ratio hovered in the range of 2.9-3.9 during the year, indicating orderly market conditions (Chart V.8).

5.25 The rupee came under pressure during May 2004 and reached Rs.45.96 per US dollar on May 17, 2004 on account of turbulence in the equity market, cash dollar shortage and rising global oil prices. FIIs sold heavily in the Indian equity market on that day. The Reserve Bank closely monitored

Chart V.8 : Foreign Exchange Market Turnover



developments across various financial market segments. A Task Force was constituted to keep a vigil on market developments. The Reserve Bank assured the market that it would continue to sell dollars through banks for augmenting supply in the foreign exchange market or would intervene directly to meet any demand-supply mismatches at the prevailing market rates. Furthermore, it was indicated that FIIs would remain free to reduce or increase their exposure in the Indian equity market at the prevailing market rates. The ADs, acting on behalf of these FIIs, were allowed to approach the Reserve Bank to buy foreign exchange at the prevailing market rates. The depreciation of the rupee continued in June-July 2004 on account of slowdown in capital inflows and higher demand for foreign exchange by corporates. As a result, the rupee depreciated by 6.5 per cent during April-July 2004 and traded in the range of Rs.43.57 – Rs.46.45 per US dollar.

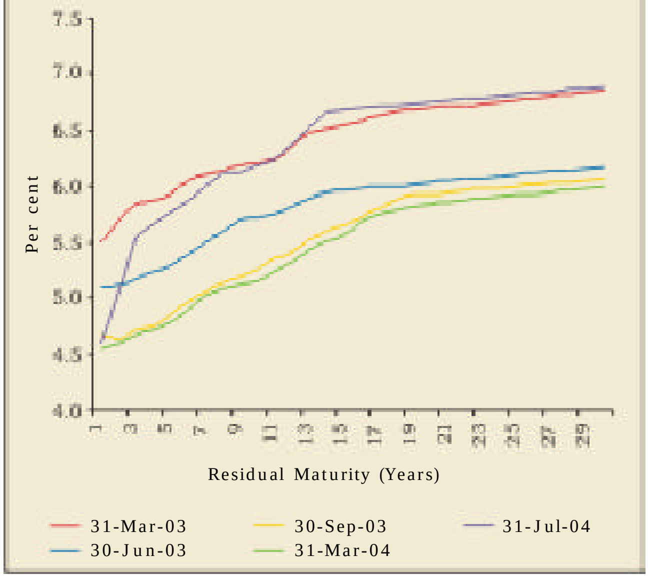
5.26 The forward market reflected the developments in the spot segment of the foreign exchange market during 2004-05 (up to August 13). The forward premia turned into discounts at the commencement of the year and the three-month forward premia dipped to 2.30 per cent by May 13, 2004, reflecting substantial forward sales by exporters. The forward rates, however, turned into premia thereafter as the exchange rate depreciated against the US dollar, import demand picked up and international oil prices steadily edged up. The three-month forward premia touched 2.98 per cent on August 13, 2004.

GOVERNMENT SECURITIES MARKET

5.27 Activity in the Government securities market was characterised by a sustained softening of yields during 2003-04. The benchmark 10-year yield declined by 106 basis points as compared with 115 basis points in 2002-03. The decline in yields was more pronounced for Government securities with maturity up to 14 years. During 2003-04, the aggregate volume of transactions in the Central and the State Government dated securities and Treasury Bills (outright as well as repos) increased by 36.0 per cent to Rs.26,39,897 crore, of which outright transactions constituted 63.8 per cent (Appendix Table V.6).

5.28 The yield curve flattened during the first half of 2003-04. Easy liquidity and benign inflationary expectations fuelled persistent rallies in prices of Government securities which was halted in August 2003 when the notified amount of 91-day Treasury Bills was raised to Rs.1,500 crore from Rs.500 crore and open market sales were conducted to absorb excess liquidity. The repo rate reduction on August 25, 2003 boosted market sentiment with the 10-year yield declining to 5.23 per cent on August 26 from 5.6 per cent on August 23, 2003. The yield spread between the securities of 10-year and 20-year tenors widened as shorter-term rates fell sharply in response to the repo rate cut (Box V.2). The announcement of a truncated calendar of issuance of the Government securities for the second half of 2003-04 (Rs.25,000 crore as against an expectation of Rs.60,000 crore) and expectations of a further repo rate cut in the wake of reduction in NRE deposit rates lifted market sentiment, bringing down short-term yields during the second quarter (Chart V.9).

Chart V.9 : Yield Curves for Central Government Dated Securities



5.29 In the second half of 2003-04, inflationary expectations hardened the yields at the long end of the maturity spectrum. The lowering of the cut-off yields in the auction of 364-day Treasury Bills drove down the 10-year yield of the Government securities to a low of 4.95 per cent on October 16, 2003. OMO sales and a series of 28-day repos under the LAF in the second fortnight of October checked possible rallies. Spreads widened and the yield curve

Box V.2
Dynamics of Yield Curve

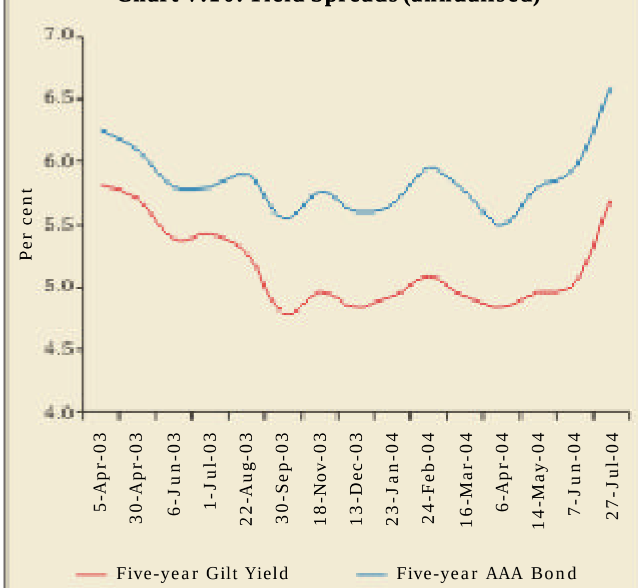
A yield curve, which is a graphical presentation of yields on securities of various maturities of a debt instrument with the 'same' default risk at a point of time, provides a snapshot of the term structure of interest rates in the market. Typically, yield curves slope upwards with interest rates rising as the tenor of the security increases. The yield curve shifts with a change in generalised perception about interest rates. The slope of the yield curve tends to be influenced by monetary policy action. Typically, when monetary policy is eased and short-term policy rates are reduced, the yield curve tends to get steeper. The curvature of the yield curve may change temporarily on account of specific demand-supply factors pertaining to particular tenors of a security.

An orderly evolution of the Government securities market in India has enabled a maturing of the yield curve into a smooth locus across one to 30-year tenors; however, a progressive flattening of the curve in recent years has engaged the attention of market participants, researchers and the policy makers alike. The narrowing of yield spreads in the 2-year to 10-year residual maturity segment (from 183 basis points to 63 basis points) and in the 10-year to 20-year segment (from 95 basis points to 77 basis points) during the period September 2001 to May 2004 made the yield curve in India one of the flattest internationally. The presence of a massive liquidity overhang accentuated the flattening of the yield curve, encouraging market participants to demand longer tenor securities so as to increase the duration of their portfolio and scale up potential capital gains amidst softening of interest rates. The Government's tendency to minimise the rollover risk by elongation of the maturity profile of the Government securities in falling interest rate conditions was in consonance with institutional participants' increasing demand for longer tenors. Some steepening of the yield curve was, however, witnessed at the time of easing of monetary measures such as the cut in the repo rate. The yield curve,however flattened as the long term yields fell in the wake of surplus liquidity conditions.

steepened by December 2003. Uncertainty about policy responses for managing capital flows and the edging up of inflation rates during January-February 2004 prompted a switch in portfolios. This, in turn, led to a decline in turnover and an upward shift of the yield curve. Turnover recovered in March 2004 as fuller information on the MSS became available to market participants.

5.30 During 2004-05 (up to August 16), yields at the longer end started edging up from May 2004, reflecting market uncertainty, expectation of raising of interest rate by the US, rising international crude oil prices and increase in the inflation rate. The yield curve steepened by end-June 2004 as market participants factored in the 25 basis points hike in the Federal Reserve's target rate. Turnover increased sharply in April, reflecting the MSS operations and auctions of dated Government securities by the Reserve Bank but declined subsequently. With the inching up of inflation and market apprehensions about possible measures to control inflation, the yield on the benchmark 10-year paper touched a peak of 6.73 per cent on August 11, 2004. However, the announcement of the reintroduction of one-day repo, effective August 16, 2004 calmed market sentiment, bringing down the yield of the 10-year security to 6.57 per cent. The yield spread between the Government securities and AAA-rated corporate bonds widened during 2003-04, reflecting market uncertainty about modification of norms relating to non-SLR investments (Chart V.10). The yield spread, which had narrowed in April 2004, widened further to about 91 basis points by July 2004.

Chart V.10: Yield Spreads (annualised)



CREDIT MARKET

5.31 Bank deposit rates were driven down across maturities during 2003-04 by easy liquidity conditions. Bank lending rates also declined but on a relatively muted scale, reflecting their inherent rigidity due to high cost of deposits contracted in the past and the overhang of non-performing assets (NPAs), along with some other structural factors. A sizeable portion of bank loans was extended at rates below the prime lending rates (PLRs). Sub-PLR lending (excluding exports, the bulk of which is at sub-PLR) constituted about half of the total outstanding advances above Rs.2 lakh by the banking system. Spreads around PLRs of public sector banks (PSBs) narrowed marginally by the last quarter of 2003-04. The benchmark prime lending rates (BPLRs), implemented through the operational guidelines issued by the Indian Banks' Association (IBA) in November 2003, is expected to improve transparency and to reduce complexity in pricing of loans. As on April 2004, almost all banks have adopted the new system of benchmark PLRs, which were significantly lower than earlier PLRs on cash credit or overdraft. During the period March 2003 and March 2004, the range of BPLR moderated by 25-200 basis points from the existing PLRs. Banks overwhelmingly adopted BPLRs by abandoning the system of tenor-linked PLR. The BPLRs of public sector banks moved in the range of 10.25-11.50 per cent in June 2004 (Table 5.5).

Non-Banking Financial Companies

5.32 Public deposits, as reported by 875 non-banking financial companies (NBFCs) [including residuary non-banking companies (RNBCs)] stood at Rs.20,100 crore as on March 31, 2003. Of the total public deposits, 23.3 per cent were contracted at interest rates of up to 10 per cent, followed by 41.7 per cent at interest rates between 10 per cent to 12 per cent and the remaining 35.0 per cent at interest rates between 12 per cent to 14 per cent. According to the quarterly information relating to large NBFCs (including RNBCs) with a public deposit base of Rs.20 crore and above, the aggregate public deposits of 24 reporting companies amounted to Rs.17,750 crore as at the end of March 2004, as against Rs.17,915 crore for 30 reporting companies as at end-March 2003. The information in respect of NBFCs/RNBCs having public deposits of Rs.500 crore and above shows that their number declined from four as at end-March 2002 to three as at end-March 2003. Although the number of companies

Table 5.5: Movements in Deposit and Lending Rates

(Per cent)

	June 2004	March 2004	December 2003	September 2003	June 2003	March 2003
1	2	3	4	5	6	7
1. Domestic Deposit Rate						
Public Sector Banks						
a. Up to 1 year	3.50-5.25	3.75-5.25	3.75-5.25	3.75-5.50	4.00-5.75	4.00-6.00
b. More than 1 year and up to 3 years	5.00-5.75	5.00-5.75	5.00-5.75	4.75-6.00	5.00-6.25	5.25-6.75
c. More than 3 years	5.25-5.75	5.25-6.00	5.25-6.00	5.25-6.25	5.25-6.50	5.50-7.00
Private Sector Banks						
a. Up to 1 year	3.00-6.00	3.00-6.00	3.00-6.25	3.00-7.00	3.00-7.00	3.50-7.50
b. More than 1 year and up to 3 years	5.00-6.50	5.00-6.50	5.00-7.00	5.50-7.50	5.50-7.75	6.00-8.00
c. More than 3 years	5.25-7.00	5.25-7.00	5.50-7.00	5.75-8.00	6.00-8.00	6.00-8.00
Foreign Banks						
a. Up to 1 year	2.75-7.50	2.75-7.75	2.75-7.75	3.00-7.75	3.00-7.75	3.00-7.75
b. More than 1 year and up to 3 years	3.25-8.00	3.25-8.00	3.35-8.00	3.50-8.00	3.50-8.00	4.15-8.00
c. More than 3 years	3.25-8.00	3.25.800	3.50-8.00	3.75-8.00	4.50-8.00	5.00-9.00
2. Prime Lending Rate#						
Public Sector Banks	10.25-11.50	10.25-11.50	9.00-12.25	9.00-12.25	9.00-12.25	9.00-12.25
Private Sector Banks	9.75-13.00	10.50-13.00	7.50-15.50	8.00-15.50	7.00-15.50	7.00-15.50
Foreign Banks	11.00-14.85	11.00-14.85	4.55-17.50	4.80-17.50	5.45-17.50	6.75-17.50
3. Actual Lending Rate*						
Public Sector Banks	n.a.	4.00-16.00	5.75-16.00	5.75-16.00	5.00-16.00	6.00-16.25
Private Sector Banks	n.a.	4.50-22.00	3.00-23.00	3.00-23.00	4.95-23.00	5.18-23.00
Foreign Banks	n.a.	3.75-23.00	3.00-22.00	5.00-22.00	5.00-23.00	5.40-20.00

\# : Prime Lending Rate for March and June 2004 are benchmark PLRs.

* : Interest rate on non-export demand and term loans above Rs.2 lakh excluding lending rates at the extreme 5 per cent on both sides.

n.a. : Not available.

remained the same in 2003-04, public deposits held by them declined by Rs.464 crore on account of repayment during the year (Table 5.6).

Table 5.6: NBFCs/RNBCs with Public Deposits Base of Rs.500 crore and above

As on March 31	No.of NBFCs/RNBCs	Public Deposits (Outstanding - Rs. crore)	Growth (Per cent)
1	2	3	4
2002	4	14,237	–
2003	3	15,707	10.32
2004	3	15,243	-2.95

EQUITY AND DEBT MARKETS

5.33 The capital market experienced generally buoyant conditions during 2003-04. Resource mobilisation from the public issues market increased, though this could not compensate for the decline in activity in the private placement market. Resource mobilisation by mutual funds witnessed a substantial increase. Assistance sanctioned and disbursed by financial institutions rose sharply after a gap of two years. The secondary market witnessed a strong rally led by a large institutional support, particularly from the FIIs due to attractive valuations *vis-á-vis* other emerging market economies. The stock market turned somewhat volatile during 2004-05 with turbulent conditions on May 17, 2004.

Primary Market

5.34 A long period of lacklustre activity and waning investor interest was dispelled in 2003-04 by signs of revival in the public issues segment (Table 5.7 and Chart V.11).

5.35 The bulk of resource mobilisation (71.4 per cent) from the public issues market in 2003-04 was

Chart V.11 : Resource Mobilisation in the Primary Market

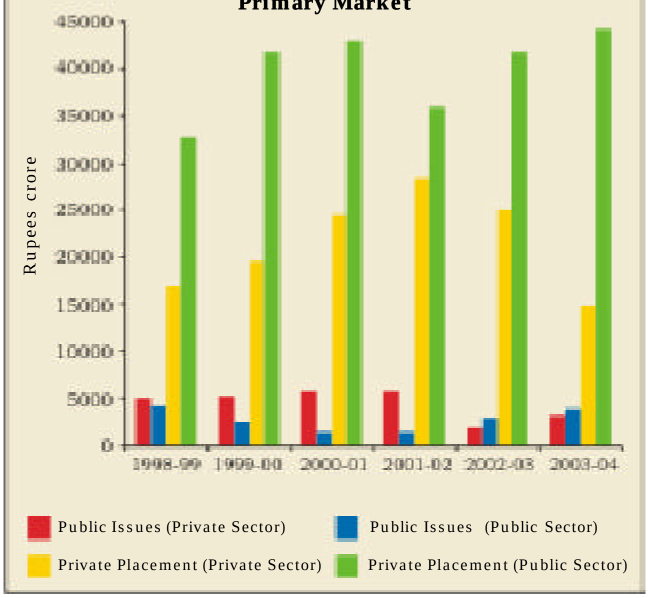


Table 5.7: Mobilisation of Resources from the Primary Market*

(Rupees crore)

Item	2003–04P		2002–03	
	No. of Issues	Amount	No. of Issues	Amount
1	2	3	4	5
A. Prospectus and Rights Issues				
1. Private Sector (a+b)	**27**	**3,210** (70.9)	**9**	**1,878** (-67.0)
a) Financial	3	1,251	4	1,236
b) Non–financial	24	1,959	5	642
2. Public Sector (a+b+c)	**8**	**3,980** (33.2)	**8**	**2,989** (110.5)
a) Public Sector Undertakings	–	–	–	–
b) Government Companies	1	100	–	–
c) Banks/Financial Institutions	7	3,880	8	2,989
3. Sub Total (1+2)	**35**	**7,190** (47.7)	**17**	**4,867** (-31.6)
B. Private Placement +				
1. Private Sector (a+b)	**578**	**14,866** (-40.7)	**877**	**25,077** (-12.4)
a) Financial	291	9,178	327	9,454
b) Non–financial	287	5,688	550	15,623
2. Public Sector (a+b)	**222**	**44,349** (5.9)	**267**	**41,871** (15.5)
a) Financial	123	25,879	157	20,407
b) Non–financial	99	18,470	110	21,464
3. Sub Total (1+2)	**800**	**59,215** (-11.5)	**1,144**	**66,948** (3.2)
C. Total (A+B)	**835**	**66,405** (-7.5)	**1,161**	**71,815** (-0.2)
Memo Item:				
Euro Issues	**18**	**3,098** (-9.6)	**11**	**3,426** (43.6)

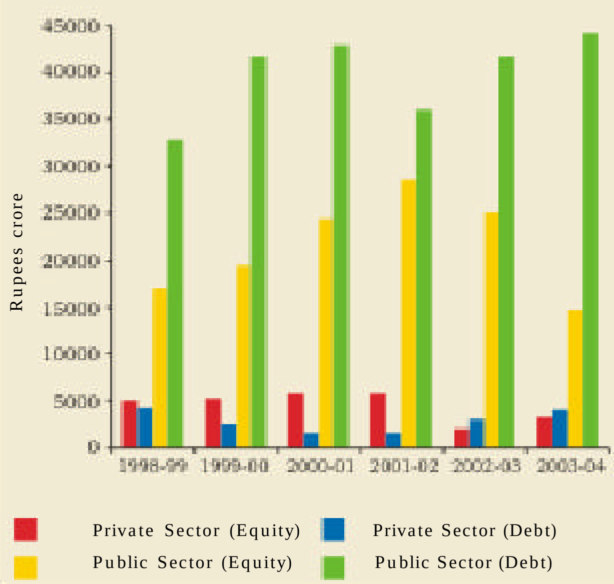
* : Including both debt and equity. P : Provisional. – : Nil/Negligible.
+ : Estimates based on information gathered from arrangers, financial institutions and newspaper reports.
Note : Parenthetic figures represent percentage variations over the previous year.

by banks and financial institutions. Four public sector banks floated equity issues aggregating Rs.950 crore during 2003-04. In addition, there were six bond issues aggregating Rs.4,181 crore by the IDBI (Rs.2,930 crore from three issues) and the ICICI Bank (Rs.1,251 crore from three issues). The share of equity issues in total resource mobilisation increased sharply in 2003-04 in comparison with the previous year (Appendix Table V.9 and Chart V.12).

5.36 Initial public offerings (IPOs) picked up in 2003-04, accounting for about 26 per cent (Rs.1,854 crore) of total resources mobilised by way of prospectus and rights issues. The post-listing performance of recently issued IPOs is encouraging (Box V.3). A variant of a stabilisation scheme was introduced by the SEBI in August 2003 drawing from the experiences of the US, the UK and Canada.

5.37 Resource mobilisation from the private placement market declined during 2003-04. This decline needs to be placed in the context of stringent disclosure norms prescribed by the SEBI on September 30, 2003 for this segment, which had remained almost unregulated until then. Public sector entities (mainly financial intermediaries) continued to dominate the private placement market in 2003-04, accounting for

Chart V.12: Public Issues Market – Instrument Type



Box V.3

Post-listing Performance of IPOs

Initial public offering (IPO) refers to the first sale of stock by a private company to the public. Although both initial and subsequent public offerings result in expanding the equity base of a company, these issues are distinct in many ways. Investors participating in the equity offerings by listed companies take informed decisions based on details about the company that are already available in the market place. In the case of an IPO, however, the availability of information regarding the past performance of the company and its track record is generally inadequate and, therefore, lacks credibility. This information asymmetry may lead to the problems of moral hazard and adverse selection.

A large number of IPOs were floated in the Indian market in the mid-1990s following the introduction of free pricing. This boom in IPOs, however, faded mainly due to lower than expected performance of the issues. Prices of many issues, floated at high premia, declined significantly after listing. Investors also suffered heavy losses as several companies which made IPOs vanished. Investor confidence suffered a further setback in the late 1990s due to a sharp decline in the prices of technology stocks *albeit* in tandem with the world-wide 'tech' stock meltdown.

Preliminary empirical evidence regarding the variation of IPO share prices for the period 2001-02 to 2003-04 indicates that share prices of about 75 per cent of IPOs improved upon listing. The variation was measured as the percentage change between the offer price and the market price of the scrips after six months. Stringent entry and disclosure norms introduced by the SEBI have had a significant impact on the quality of issues entering the market as well as their post-listing performance.

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1. Jain, B.A. and O. Kini (1994), "The Post Issue Operating Performance of IPO Firms", *Journal of Finance,* 49.
2. Loughran, Tim, and Jay R. Ritter (1995), "The New Issues Puzzle", *Journal of Finance,* 50(1), March.
3. Ritter Jay R. (1991), "The Long-Run Performance of Initial Public Offerings", *Journal of Finance*, 46.

75.0 per cent of the total resource mobilisation. Resource mobilisation by financial intermediaries (both public and private sector) increased by 17.4 per cent to Rs.35,057 crore, while that by non-financial companies declined sharply by 34.9 per cent to Rs.24,158 crore.

5.38 Resources raised by Indian corporates from the international capital market by way of Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) declined marginally during 2003-04 (see Table 5.7). With a view to integrating the Indian capital market with the international capital markets and to enable Indian investors to diversify risk, foreign companies were allowed to access the Indian capital market by way of Indian Depository Receipts (IDR) (Box V.4).

Box V.4

Indian Depository Receipts

In terms of the Companies (Issue of Indian Depository Receipts-IDRs) Rules, 2004 notified by the Government on February 23, 2004 a company incorporated outside India can issue IDRs subject to the following: (i) the pre-issue paid-up capital and free reserves of the issuing company should be at least US $ 100 million with an average turnover of US $ 500 million during the preceding three financial years; (ii) the company has been making profits for at least five years preceding the issue and has been declaring dividend of not less than 10 per cent each year in this period; and (iii) the pre-issue debt-equity ratio is not more than 2:1. The issuing company may or may not have established any place of business in India. The issuing company would also have to fulfill the eligibility criteria stipulated by the SEBI and obtain necessary approvals from local authorities.

According to the IDR Rules, the issuing company shall appoint an overseas custodian bank, a domestic depository and a merchant banker for the purpose of issue of IDRs. The underlying shares will be delivered to an overseas custodian bank which will authorise the domestic depository to issue IDRs. IDRs will not be redeemable into the underlying equity shares for a period of one year from the date of issue. IDRs issued by any company in any financial year shall not exceed 15 per cent of its paid-up capital and free reserves. The IDRs will have to be denominated in Indian rupees, irrespective of the denomination of the underlying securities.

IDRs will be listed on one or more recognised stock exchanges having nation wide trading terminals in India and may be purchased, possessed and freely transferred by persons resident in India as defined under the Foreign Exchange Management Act, 1999 (FEMA). IDRs can be transferred and redeemed, subject to the provisions of the FEMA.

Mutual Funds

5.39 Resource mobilisation by mutual funds (net of redemptions) increased sharply to Rs.47,684 crore during 2003-04 from Rs.4,583 crore during 2002-03 due mainly to a sharp rise in resources mobilised by private sector mutual funds to Rs.42,873 crore from Rs.12,122 crore. The Unit Trust of India (UTI) also experienced net inflow of funds (Table 5.8).

Table 5.8: Net Resource Mobilisation by Mutual Funds

(Amount in Rupees crore)

Item	2003-04		2002-03	
	No. of Schemes	Amount	No. of Schemes	Amount
1	2	3	4	5
1. Unit Trust of India	41	1,050*	59	-9,434
2. Public Sector Mutual Funds	64	3,761	70	1,895
3. Private Sector Mutual Funds	362	42,873	324	12,122
Total (1 to 3)	**467**	**47,684**	**453**	**4,583**

* : Data for 2003-04 relate to UTI Mutual Fund for the period February 01, 2003 to March 31, 2004 (also refer to footnote of Table 5.10)

Notes : 1. Data are provisional and compiled on the basis of information received from respective mutual funds.
2. For UTI, the data relate to net sales (with premium), including reinvestment sales. For other mutual funds, figures represent net sales under all schemes.
3. Data exclude amounts mobilised by off-shore funds and through rollover schemes.

Table 5.9: Scheme-wise Resource Mobilisation by Mutual Funds

(Rupees crore)

Year	Equity-Oriented	Debt-Oriented	Balanced	Total
1	2	3	4	5
2002-03	43	5,781	-1,628	4,196
2003-04	7,219	39,603	-13	46,809

Source: Securities and Exchange Board of India (SEBI).

5.40 The bulk of the resources mobilised by mutual funds have traditionally been in the form of debt-oriented schemes. This trend continued in 2003-04 (Table 5.9).

5.41 Debt-oriented schemes accounted for about 45 per cent of the total assets under management of mutual funds at end-March 2004 (Table 5.10).

All-India Financial Institutions

5.42 Select All-India Financial Institutions (AIFIs) have been permitted by the Reserve Bank to raise resources by way of term money borrowings, issue of CDs, CPs, acceptance of term deposits and inter-corporate deposits (ICDs) within the umbrella limit linked to their net owned funds. The outstanding aggregate amount of resources raised by financial institutions (IDBI, IFCI, EXIM Bank, SIDBI, IIBI, TFCI, NABARD, IDFC and NHB) by way of short-term money market instruments increased during 2003-04 (Table 5.11). It, however, declined marginally to Rs.6,207 crore by June 2004. Generally, CP was

Table 5.10: Assets under Management of Mutual Funds

(Amount in Rupees crore)

Instrument	End-March 2004	End-March 2003	End-March 2002	End-March 2001	End-March 2000
1	2	3	4	5	6
1. Debt	62,524	47,564	55,788	48,863	48,004
	(44.8)	(59.9)	(55.5)	(53.9)	(42.5)
2. Equity	23,613	9,887	13,852	13,483	30,611
	(16.9)	(12.4)	(13.8)	(14.9)	(27.1)
3. Money Market Instruments	41,704	13,734	8,069	4,128	2,227
	(29.9)	(17.3)	(8.0)	(4.6)	(2.0)
4. Government Securities	6,026	3,910	4,163	2,317	2,370
	(4.3)	(4.9)	(4.1)	(2.6)	(2.1)
5. Others	5,749	4,369	18,722	21,796	29,793
	(4.1)	(5.5)	(18.6)	(24.1)	(26.4)
6. Total	**1,39,616**	**79,464***	**1,00,594**	**90,587**	**1,13,005**
	(100.0)	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**
		1,09,299 @			

* : Following the bifurcation of the UTI (into the UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India), effective February 2003 data in respect of the Specified Undertaking of the Unit Trust of India have been excluded from the total assets under management of mutual funds from the year ended March 2003 onwards.

@ : Including the assets of Specified Undertaking of the Unit Trust of India.

Notes : 1. Others include balanced and equity linked saving schemes.
2. Figures in parentheses represent proportion to the total assets under management.

Source : Association of Mutual Funds in India (AMFI).

Table 5.11: Outstanding Amount Mobilised under Umbrella Limits by Select All-India Financial Institutions

(Rupees crore)

Instrument	March 2004	March 2003
1	2	3
Commercial Paper (CP)	2,740	1,425
Term Deposits	2,111	2,067
Inter - corporate Deposits	866	1,761
Certificates of Deposit (CD)	467	460
Term Money	300	245
Total	**6,483 (23,650)**	**5,958 (23,824)**

Note: Figures in parentheses denote 'Umbrella Limits.'

the preferred instrument followed by term deposits, term money and ICDs. Interest rates on all these instruments softened during the year, especially towards the end of the year.

5.43 Total resources mobilised by AIFIs by way of issue of rupee bonds/ debentures (including private placement and public issues - excluding erstwhile ICICI) rose sharply during 2003-04 as they took advantage of low interest rates. Some FIs such as IFCI and IIBI were not permitted to raise fresh borrowings from the market due to their deteriorating financial position. These FIs rolled over some of their existing bond liabilities. The weighted average maturity of the instruments issued by FIs was elongated, while the weighted average interest rate of resources raised across FIs eased during the year (Table 5.12).

5.44 Financial assistance sanctioned and disbursed by AIFIs increased sharply by 65.8 per cent and 24.5 per cent, respectively, during 2003-04. The increase in sanctions and disbursements by AIFIs points to an improvement in the investment climate (Appendix Table V.10).

Secondary Market

5.45 The stock market turned buoyant in 2003-04, ending a long subdued spell of over three years which began shortly after the BSE Sensex crossed the historical 6000-mark in intra-day trading in February 2000. The rally in equity prices, which began from end-May 2003, continued almost uninterrupted till January 2004 (Appendix Table V.11 and Chart V.13). It was sustained by large investments by FIIs against the background of improving fundamentals, strong corporate results and initiatives on the disinvestment front. The BSE Sensex crossed the 6000-mark again in January 2004. The uptrend was interspersed by several corrections from February 2004 in an environment of high uncertainty. Despite some downtrend in February 2004 and March 2004 due to political uncertainty, the BSE Sensex ended the year with net significant gains of over 83 per cent over the previous year.

5.46 The rally witnessed in 2003-04 was broad based and covered almost all the sectors, unlike the rally in 2000 which was largely confined to the technology sector. The broad based BSE 500 index (which includes several medium and small sized companies) increased by 109 per cent

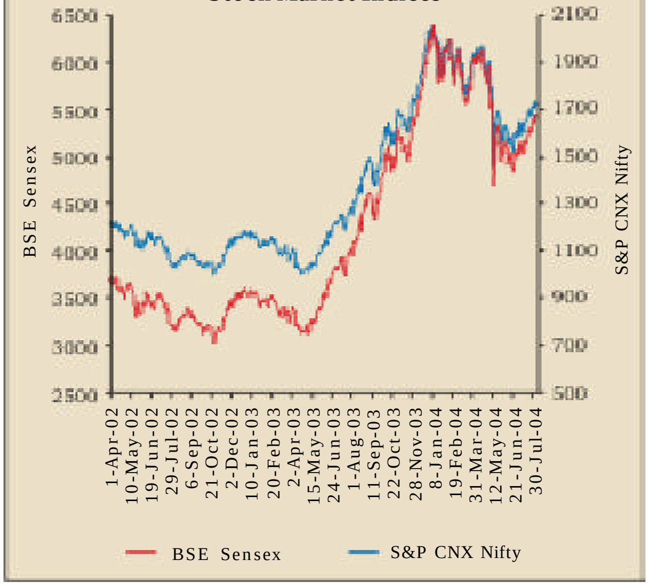
Table 5.12: Resources Raised by way of Bonds/Debentures* by Select All-India FIs

(Amount in Rupees crore)

Institution	Resources Raised		Total Borrowings Outstanding at end of		Weighted Average Cost of Funds (%)		Weighted Average Maturity (years)	
	2003-04	2002-03	March 2004	March 2003	2003-04	2002-03	2003-04	2002-03
1	2	3	4	5	6	7	8	9
IDBI	10,477	5,009	46,967	41,798	6.5	8.5	5.1	4.3
IFCI	–	267	17,564	20,203	8.2	9.6	3.2	2.2
IIBI	176	144	1,260	1,468	8.7	9.6	18.0	8.6
Exim Bank	2,025	2,505	11,920	5,424	5.9	8.9	6.7	6.1
NABARD	5,334	2,988	11,959	8,703	5.4	6.1	5.4	4.7
NHB	2,526	1,876	6,958	4,675	5.4	6.4	3.2	4.0
SIDBI	1,429	961	3,256	2,519	5.0	6.6	1.9	2.3
TFCI	102	93	546	632	8.6	10.1	10.0	8.5
IDFC	1,550	400	2,450	2,175	5.6	7.6	5.9	5.6
Total	**23,618**	**14,243**	**1,02,880**	**87,596**				

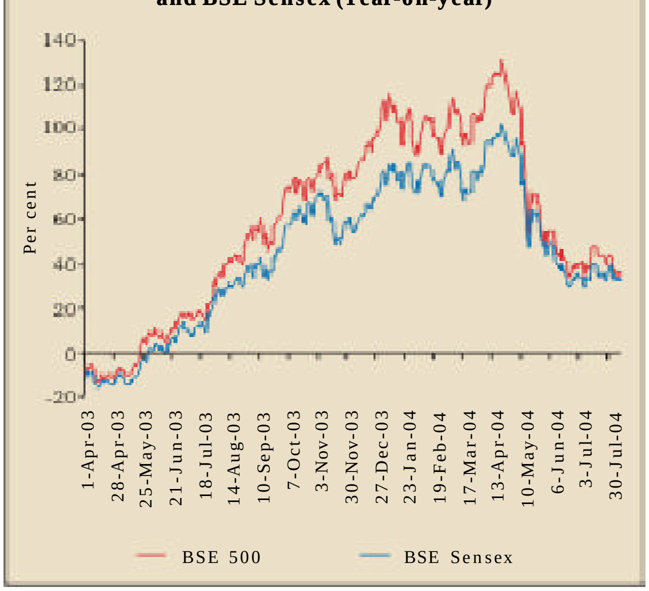
***** : Relate to rupee resources only.
Note : Data are provisional.
Source : Various Financial Institutions (FIs).

Chart V.13 : Movements in Major Indian Stock Market Indices



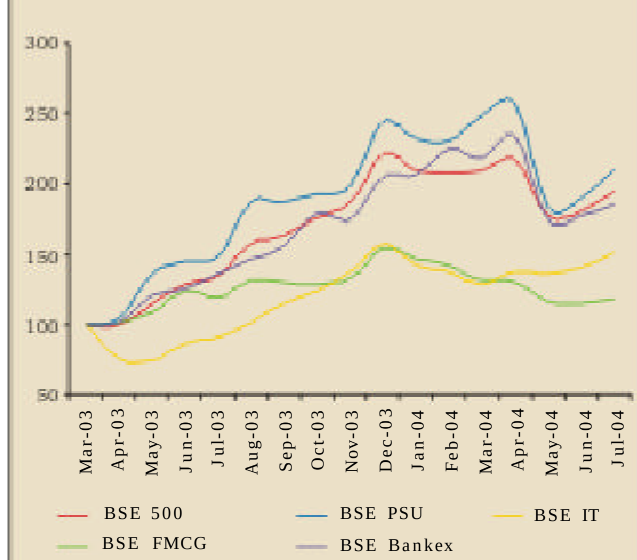
during the year as compared with the rise of 83 per cent in the BSE Sensex (which comprises 30 scrips) (Chart V.14).

Chart V.14 : Changes in BSE 500 Index and BSE Sensex (Year-on-year)



5.47 The rally encompassed almost all the sectors, *i.e.*, banking, PSU, fast moving consumer goods (FMCG) and IT (Chart V.15). The Indian stock market outperformed many other emerging market economies in Asia. In contrast to the Asian region, stock markets in many developed markets registered only modest gains (Table 5.13 and Chart V.16).

Chart V.15 : BSE 500 and Sectoral Indices*



* Normalised to March 2003 = 100

5.48 Movements in stock prices in India were accompanied by a rise in turnover. Market capitalisation of the BSE increased by 110 per cent during 2003-04 (Table 5.14). Despite sharp increase in share prices, the price-earning (P/E) ratio moved up only modestly, reflecting increased profitability of the corporate sector. Volatility in the stock markets, as measured by the coefficient of variation, however, increased during the year (Appendix Table V.12).

Table 5.13: Emerging Market Stock Indices

Country	Index	End-March 2004	End-March 2003	Percentage Variation
1	2	3	4	5
Indonesia	Jakarta Composite Index	735.68	398.0	84.8
India	BSE Sensex	5590.60	3048.72	83.4
Thailand	SET Composite Index	647.30	364.55	77.6
Taiwan	Taiwan Index	6522.19	4321.22	50.9
Malaysia	KLSE Composite Index	901.85	635.72	41.9
Philippines	PSE Composite Index	1424.33	1039.67	37.0

Source: Moneyline Telerate Information Services.

Chart V.16 : Movements in International Stock Indices

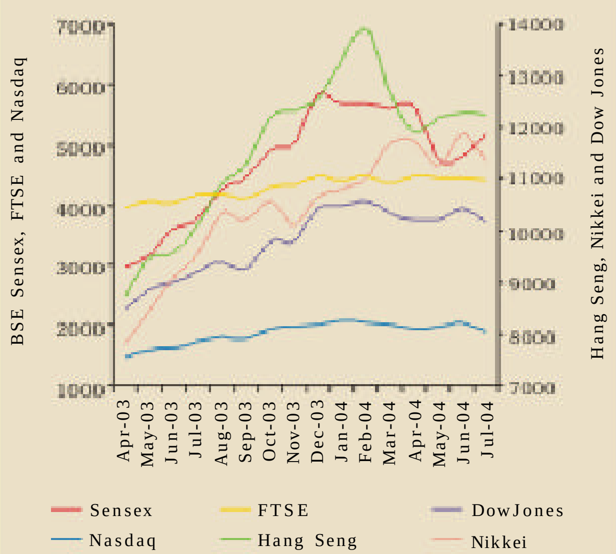
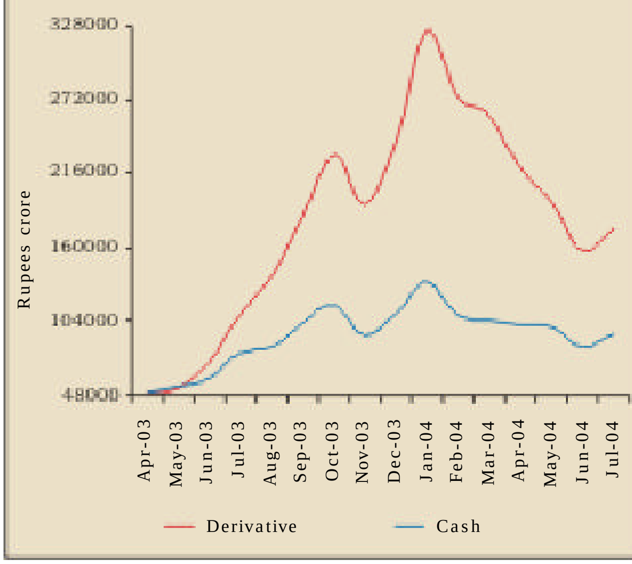


Chart V.17 : Turnover in Cash and Derivative Segments – NSE



5.49 A significant development during 2003-04 was an increased activity in the derivatives segment. With a five-fold increase in the turnover, the derivatives segment overtook the cash segment in NSE during the year (Appendix Table V.13 and Chart V.17).

Table 5.14: Indian Equity Markets

Indicator	BSE		NSE	
	2003-04	2002-03	2003-04	2002-03
1	2	3	4	5
1. BSE Sensex/ S&P CNX Nifty				
(i) Average	4492	3206	1428	1037
(ii) End-year	5591	3049	1772	978
2. Coefficient of Variation (per cent)	23.0	4.8	23.3	5.2
3. Price -Earning Ratio@	16.2	14.5	16.1	15.2
4. Price-Book Value Ratio@	2.9	2.2	3.1	2.6
5. Yield @ (per cent per annum)	2.0	2.2	2.1	2.1
6. Listed Companies #	5,528	5,650	909	673
7. Turnover (Rupees crore)	5,02,620	3,14,073	10,99,535	6,17,989
8. Market Capitalisation (Rupees crore) #	12,01,207	5,72,198	11,20,976	5,37,133

@ : Based on scrips included in the BSE Sensex and in the S&P CNX Nifty, respectively and are averages for the year.
# : As at end-March.
Source : The Stock Exchange, Mumbai (BSE) and the National Stock Exchange of India Limited (NSE).

5.50 Net equity investments by FIIs increased by as much as 1480.7 per cent during 2003-04. FII investment in debt instruments also increased sharply. The bulk of the funds by mutual funds during 2003-04 were deployed in debt instruments in keeping with the objective of most of their schemes. Unlike 2002-03, however, mutual funds made net purchases in equities in 2003-04 (Table 5.15). FIIs continued to be strong buyers in equities. Their investments in equities in April 2004 were the highest ever in any single month. They, however, turned net sellers in equities in May 2004 for the first time in 18 months in line with their operations in several other emerging market economies. FIIs again turned net buyers in equity between June 2004 and August 2004.

5.51 The SEBI allowed brokers to extend margin trading facility to their clients in April 2004 with a view to improving liquidity in the secondary market and to facilitate the process of price discovery (Box V.5).

Table 5.15: Trends in Institutional Investments

(Rupees crore)

Year	FIIs		Mutual Funds	
	Net Investment in Equity	Net Investment in Debt	Net Investment in Equity	Net Investment in Debt
1	2	3	4	5
2001-02	8,067	685	-3,796	10,959
2002-03	2,528	162	-2,067	12,604
2003-04	39,959	5,805	1,308	22,701

Source: Securities and Exchange Board of India (SEBI).

Box V.5

Margin Trading

Margin trading is an arrangement whereby an investor purchases securities by borrowing a portion of the purchase value from the authorised brokers by using securities in his portfolio as collateral.

The Securities Exchange Board of India (SEBI) has allowed member brokers to provide margin trading facility to their clients in the cash segment since April 1, 2004. Securities with mean impact cost of less than or equal to one and traded at least 80 per cent (+/-5 per cent) of the days during the previous 18 months would be eligible for margin trading facility. Only corporate brokers with "net worth" of at least Rs.3 crore would be eligible to participate. Brokers wishing to extend the facility of margin trading to their clients are required to obtain prior permission from the exchange(s) where the facility is proposed to be provided. The broker may use his own funds or borrow from scheduled commercial banks and/or NBFCs regulated by the Reserve Bank. At any point of time, total indebtedness of a broker for the purpose of margin trading is not allowed to exceed 5 times of his net worth as defined by the SEBI. The "total exposure" of a broker towards the margin trading facility shall be within the self-imposed prudential limit and shall not, in any case, exceed the borrowed funds and 50 per cent of "net worth". The exposure to any single client at any point of time is restricted to 10 per cent of the "total exposure" of the broker.

The margin arrangement has to be agreed upon between the authorised broker and the client subject to the SEBI guidelines prescribed on March 19, 2004. Initial and maintenance margin for the client shall be a minimum of 50 per cent and 40 per cent, respectively, which has to be paid in cash. Initial margin is the minimum amount, calculated as a percentage of the transaction value, to be placed by the client with the broker before the actual purchase. The maintenance margin is the minimum amount, calculated as a percentage of the market value of securities with respect to the last trading day's closing price to be maintained by the client with the broker. When the balance deposit in the client's margin trading accounts falls below the required maintenance margin, the broker shall promptly make the margin call. According to the current arrangement, the broker may liquidate the securities if: (i) the client fails to meet the margin call made by the broker; (ii) fails to deposit the cheques after the marginal call has been made; (iii) where the cheque deposited by the client has been dishonored; and (iv) if the client's deposit in the margin account (after adjustment for mark to market losses) falls to 30 per cent or less of the latest market value of the securities. The broker shall maintain separate client-wise accounts of the securities purchased on the basis of margin trading with depositories. The SEBI and stock exchange(s) have the right to inspect the books of accounts maintained by brokers with respect to the margin trading facility.

Earlier in September 2001, the Reserve Bank had allowed scheduled commercial banks to extend finance to brokers for the purpose of margin trading, subject to certain terms and conditions.

5.52 The stock market remained somewhat volatile during April-June 2004. The downtrend witnessed in February 2004 continued during March and April 2004. On May 17, 2004 the stock market in India witnessed turbulent conditions. The market opened the day on an extremely weak note and plunged by 16.6 per cent during intra-day trading before recovering partly. The market ended the day with a net loss of 11.1 per cent as compared with the previous day's close. The trading was halted twice during the day due to the application of the index-based circuit filters.

5.53 The turbulence in the market on May 17, 2004 was caused mainly by uncertainty relating to the formation of the new Government after the general elections. External factors such as rising oil prices and apprehensions of rise in international interest rates also contributed to the sudden reversal of market sentiment. The sharp decline in the Indian stock market on May 17, 2004 was, however, a temporary phenomenon and not due to change in fundamentals which continued to be strong. On May 17, 2004 a sharp decline was also observed in several other emerging markets in Asia such as South Korea (-5.14 per cent), Taiwan (-5.10 per cent) and Thailand (-4.61 per cent).

5.54 Orderly conditions in the Indian stock market were quickly restored. Appropriate risk management systems were in place to tide over the period without any recourse to exceptional financing. Also, market participants were assured by the Reserve Bank of liquidity to meet payment obligations in stock exchanges (Box V.6).

5.55 The announcement in the Union Budget 2004-05 with regard to imposition of Securities Transaction Tax (STT) affected the market sentiment adversely. The Union Budget also proposed to reduce the short-term capital gains tax from 30 per cent to 10 per cent, abolish the long-term capital gains tax and increase the FDI limit for telecommunication, civil aviation and insurance sectors. Moreover, the ceiling for FII investment in debt funds was increased from

Box V.6

Role of the Reserve Bank in Stock Market Volatility

The Reserve Bank monitors developments in the money, the foreign exchange and the Government securities markets as the monetary authority and as debt manager to the Government. With the progressive integration of various segments of financial markets, the Reserve Bank keeps a close watch on activity in the equity market to guard against any possible spillover of disturbances to the money, the Government securities and the foreign exchange markets. Accordingly, when the stock market turned volatile on May 17, 2004 the Reserve Bank closely monitored major settlement banks and stock exchanges concerned to ensure that the payment obligations in the exchanges were met smoothly. The Reserve Bank publicly announced its readiness to provide sufficient liquidity to banks for meeting all their payment obligations and intra-day requirements so that the payment settlement was carried out smoothly. It announced measures to enable banks to provide liquidity to brokers and foreign exchange to foreign institutional investors (FIIs).

A Task Force was constituted under the Executive Director, Financial Market Committee for providing clarifications and liquidity assistance. On the recommendation made by the Task Force, it was decided to restore, with immediate effect, the *status quo ante* on margins that banks have to maintain for financing against shares/IPOs/issue of guarantees. The Financial Market Committee decided that as soon as there is a circuit breaker there should be a trigger within the Reserve Bank to monitor different market segments and ensure adequate liquidity.

US $ 1 billion to US $ 1.75 billion. Notwithstanding these initiatives in the Union Budget and encouraging corporate results, the market conditions remained sluggish up to mid-July 2004. The revision in the proposed STT on July 21, 2004 helped in improving the market sentiment. The stock market has been witnessing revival since end-July 2004.

Developments in Wholesale Debt Market Segment of NSE

5.56 In the Wholesale Debt Market (WDM) segment of the NSE, 2,621 securities were available for trading as on March 31, 2004 as compared with 1,990 securities as on March 31, 2003. The turnover in the WDM segment increased by 23.2 per cent to Rs.13,16,096 crore in 2003-04. Transactions in dated securities accounted for 92.6 per cent of the total traded value for the year 2003-04. Total market capitalisation of the securities available for trading in the WDM segment aggregated Rs.12,15,864 crore as on March 31, 2004.

Outlook

5.57 The financial markets are expected to remain stable and orderly, although they would evolve with the overall macroeconomic conditions. Developments in international financial markets as they prepare for the reversal in the interest rate cycle in major countries will have a strong bearing on the behaviour of domestic financial markets. Markets have experienced comfortable liquidity conditions during the first quarter of 2004-05, notwithstanding signs of a slow down in external inflows. With call rates generally remaining at sub-repo levels, the turnover in this segment is expected to decline as the participants increase their presence in the other money market segments. There has been a modest depreciation of the exchange rate against the US dollar in the first quarter but expectations relating to the near-term continue to be indicative of stable conditions in the foreign exchange market. The domestic price situation and global interest rate movements would have implications for yields in the Government securities market in 2004-05. The equity market, which remained subdued since February 2004, displayed signs of revival since end-July 2004. It is important to note, however, that with the return of inflation worldwide and the raising of policy rates by several central banks, reversal of the existing ample international liquidity conditions would impact domestic financial markets. As interest rates transit to a more neutral level, market participants could face the need for re-balancing of portfolios.