Infomerics Ratings

Infomerics Valuation And Rating Pvt. Ltd.

SEBI REGISTERED / RBI ACCREDITED / NSIC EMPANELLED
CREDIT RATING AGENCY

Mr. Vipin Malik,
(Chairman, Infomerics Ratings)

Dr. Manoranjan Sharma
(Chief Economist)

RBI'S OCT 2023 POLICY – STAYING THE COURSE

29 September 2023

GLOBAL PERSPECTIVE

The global situation is challenging because of shifting global trade dynamics, incipient global demand, commodity price fluctuations, pandemic recovery and geo-politics. Geo-politics is marked by high inflation, deteriorating financial conditions, Russia Ukraine war and growing economic fragmentation. The financial system is constrained by higher inflation, rising interest rates and stress in financial markets.

Fragile and skewed global growth, mounting debt levels, digital divide and digital transition, more frequent shocks & constrained policy choices across countries necessitate not more of the same approach but a rejigging of multilateral institutions. There is, therefore, an urgent need to reshape multilateral institutions.

The World Economic Outlook (WEO), July 2023 shows global growth to fall from an estimated 3.5 % in 2022 to 3 % in both 2023 and 2024, while global headline inflation is expected to fall from 8.7 % in 2022 to 6.8 % in 2023 and 5.2 % in 2024. China's central bank cut the one-year loan rate by 15 bps to 2.5 %, which was followed by July 2023 data- weak consumer spending, declining investment, and increasing unemployment. Further, Russia's central bank hiked its major interest rate from 8.5 % to 12 % after the rouble crashed to an over 16-month low against the dollar.

The Fed Reserve hiked its key policy rate by 25 bps to 5.25 % on July 26. Bank of England also raised its key rate for the 14th time by 25 bps on August 3 to check its stubbornly high inflation. The US inflation reduced from 4 % in May 2023 to 3 % in June 2023. UK inflation also decreased to 7.9 % in June 2023 from 8.7 % in May 2023. However, inflation in Japan increased slightly from 3.2 % in May to 3.3 % in June 2023. Hence, global stock markets and overseas investment across geographies are vulnerable to policy change-led volatility exacerbating market risks.

US ECONOMY IN 'UNCHARTED WATERS'?

The US economy is confronted with a challenge "unlike any other" with the Fed facing the largest chasm between inflation and the target federal funds rate since March 2022. Despite highest interest rate post January 2001, unemployment rate remains stable and low.
CPI rose marginally from June's 3 % to 3.2 % in July. The annual "core" CPI fell to 4.7 % in July from 4.8 % in June largely because of rising housing costs. But inflation could rise again because several data points exceed expectations.

CHINA'S ECONOMIC MODEL 'WASHED UP ON THE BEACH'?

There has been steady deceleration in the Chinese economy, particularly triple whammy of a worsening property slump, weak consumer spending and tumbling credit growth. The People's Bank of China (PBC) attempted to stimulate credit demand. The PBC, however, kept the five-year rate unchanged amid broader depreciating currency concerns. But further widening of China's yield differentials with other major economies could trigger yuan selloffs and capital flight.

IMPACT ON EMERGING MARKET ECONOMIES (EMEs)

The EMEs face onslaughts of a stronger Dollar. The IMF shows negative spill-overs from US Dollar appreciating to 20-year high disproportionately impacted EMEs vis-a-vis smaller advanced economies. Flexible exchange rates and anchored inflation expectations are needed to withstand the onslaughts of a 'new abnormal'.

MACROECONOMIC BACKDROP

With improved crop sowing, uneven monsoon, good industrial growth, healthy balance sheets of banks and corporates, supply chain normalization, buoyant services activity, buoyant aggregate demand and rising investment, real GDP growth for 2023-24 is seen 6.5 %. Despite crude oil averaging about $80-85 per current account deficit (CAD)for FY 24 could be contained in the band of 1.8-2.0 %. The overall macro situation marks a paradigm shift from a twin balance sheet problem to a twin balance sheet advantage and places India in an advantageous position in the comity of nations.

India's trade deficit widened to 10-month high of $ 24.16 billion in August 2023 because of 40 % higher buying of gold in festival season. India's trade deficit needs careful monitoring because of its implications for current account deficit and balance of payments.

India's direct taxes are on a roll. Net direct taxes rose by 23.5 % yoy to ₹ 8.65 trillion (corporate taxes ₹ 4.16 trillion, individuals ₹ 4.47 trillion) upto Sep. 16 in FY 24 because of macroeconomic growth traction, higher profitability of companies in Q2, system driven and enforcement action.

Robust tax collections well over 10 % growth target in FY 24 will support government spend and contain fiscal deficit.

Despite July CPI inflation rising to 7.44 % (though falling to 6.83% in August 2023), weak global demand, volatile global financial markets, geopolitical tensions and geo-economics fragmentations, India is among one of the fastest growing economies. The RBI's forward-looking surveys reveal that economic growth will be sustained until FY25 with the real Gross Fixed Capital Formation (GFCF) rising to 7.4 % in FY25 from 6.8 % in FY24.

BANKING LANDSCAPE

RBI's FSR shows that greater recovery post the enactment of the IBC, 2016 and rejigging of loans portfolio from corporate loans to personal loans led to GNPAs and NNPAs declining to 3.9 % and 1 %, respectively in March 2023, the lowest since 2015. Similarly, return on assets (RoA) rose steeply from a negative 0.2 % in 2018 to a healthy 1.1 % in 2023.

PSBs performed remarkably well with profit of ₹ 34,774 crore for Q 1of FY 24. Resuscitating measures included the 4R's strategy of recognition, resolution, recapitalisation and reforms, NPAs of banks plummeted to a 10-year low at 3.9 % of total advances. Simultaneously, banks recovered bad loans worth over ₹ 8.6 lakh crore in last eight years. The government infused ₹ 3,10,997 crore to recapitalize PSBs from 2016-17 to 2020-21. With credit discipline, ensured responsible lending and improved governance, there has been greater technology adoption, consolidation of banks and upbeat bankers.

Bank loans rose 16.3 % in June. Retail loan growth of over 20 % raises concerns of concentration risk and higher sectoral NPAs. But with growth in bank credit, low NPAs and adequate capital and liquidity buffers, the Indian financial sector is stable and resilient.

NO GENERALIZED INFLATION

India's CPI inflation rose to 4.81 % in June after hitting a 25-month low of 4.25 % in May on an annual basis, driven by food prices which accounts for 40 % of consumer price basket. Higher July food inflation stemmed not wholly (e.g., increase in prices of cereals and pulses) but largely from tomato price increases. Shortly after the August Policy announcement, CPI inflation in India reached a 15-month high of 7.44 % and breached the RBI's 6 % upper limit for the first time since October 2022 because of both seasonal (prices of vegetables, particularly tomatoes) and structural inflation (inelastic demand for cereals despite changing weather patterns, lower production and higher distribution of cereals, declining government's cereal stocks). Uncertainties making for an elevated near-term inflation outlook also stem from El Niño conditions, global food prices and crude oil prices raising annual inflation projection to 5.4 % with price rise set to exceed 5 % for the rest of the year.

At 6.83 %, the retail inflation for August 2023 is 61 basis points lower than July's 15-month high of 7.44 %. But it still breached the tolerance threshold of the RBI. This is the fourth instance when the retail inflation rate or the CPI has breached the RBI's upper limit of 2-6 % in 2023 and the seventh instance since July 2022. The RBI mainly factors in retail inflation while deciding the Repo rate. What an alchemy it is that while soaring food prices seem to be coming under manageable proportions, crude oil prices jumped by 11 % to $ 93 per barrel post April 2023 because of coordinated supply cuts by the OPEC cartel.

Annual retail inflation would, however, be contained within the RBI's upper threshold level of 6 % because of the lagged monetary policy transmission of cumulative rate hike of 250 bps effected by the MPC in six instances since May 2022, resilience in local manufacturing and services activity and broad-based decline in food, energy, and core inflation, excluding food and fuel. But things could get worse before they get any better with there being some near-term blips before inflation reaches the midpoint of the inflation target of 4 % by Q2 of FY25. Both the monetary and fiscal policy must work in tandem to contain the inflationary spiral with timely supply side interventions to 'limit the severity and duration of such shocks'.

BANKING LIQUIDITY

Surplus liquidity rose to ₹ 1.7 lakh crore to ₹ 1.8 lakh crore because of return of ₹2000 banknotes, RBI's surplus transfer to the government, pick up in government spending and capital inflows. Hence RBI imposed an incremental cash reserve ratio (I-CRR) of 10 % on increase in net demand and time liabilities (NDTL) between May 19, 2023, and July 28, 2023 to absorb surplus liquidity.
The RBI's phased discontinuance of I-CRR shows that the RBI is not behind the curve. Now that surplus liquidity has dissipated and the festival October-December season is on, this is welcome, particularly because historically, liquidity gets squeezed in October-December.
It's difficult to say how this decision will pan out in the long-run because as Lord JM Keynes famously said a century ago "we are all dead". In the short and medium-term, we do not see this decision impacting the rate of interest on deposits significantly. The rate of interest of deposits of individual banks in the commercial banking area in the present deregulated environment is a function of the system's liquidity, asset-liability mismatches in different maturity buckets, avenues for credit deployment, the projected size of the balance-sheet and its composition, etc. However, this decision would be beneficial for the borrowers because loan pricing may not rise.

This is important because in the commercial banking system in India, there is an asymmetry in pricing of deposits and loans. The past experience of commercial banking in India clearly brings out that in case of liquidity shortages, loan rates rise quickly whereas it is not always so the other round.

CONCLUSION

With sticky retail inflation (6.83 % -August 2023, 7.44 % July 2023- trending downwards but still breaching the MPC's threshold of 6 %) and the US Fed's persisting hawkish stance, the RBI is likely to keep the Repo Rate (6.5 % since Feb. 8, 2023) unchanged for the 4th successive time.
Complex inflation management is necessary in these challenging times- times of globally synchronized slowdown, heightened geo-political tensions, oil prices rising to $93 per barrel, surging debt levels and growing economic fragmentation- reminiscent of the Chinese curse "may you live in interesting times!"