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RBI MONETARY POLICY EXPECTATIONS

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RBI'S OCTOBER 2021 POLICY EXPECTATIONS

The COVID 19 pandemic caused widespread devastation to lives and livelihoods all across the world but thankfully post-pandemic, growth is gaining traction. The COVID19 has highlighted issues of disparate demand and supply divergence, patchy access to countries with low production costs and irregular vaccination. Hence as the FSDC stressed, constant vigil is imperative. The FSDC's discussion of various mandates, viz., financial stability, financial sector development, inter-regulatory coordination, financial literacy and inclusion and macro-prudential supervision stressed continuous vigil by Government and all regulators on financial conditions.

Economic complexity theory and EU's pandemic resilience has to be considered for a comprehensive assessment. Last year the EU's leaders agreed on a huge fiscal package 'Next Generation EU' to aid post pandemic recovery. Path-breaking work at LSE, Harvard, NIESR, etc. shows economic theory as a tool for evaluating design for recovery and resilience plans.

The 11th Annual EY/ IIF Global Bank Risk Management Survey highlights increased significance of credit risk, anticipating a new resilience-centred wave of regulations; reducing the cost of risk management by data, technology and innovation; sustaining organisational culture in a hybrid model; and accelerating digitization.

With the possibility of two-track global recovery losing steam because of gradual petering out of central banks' support measures, delta COVID variant and China's tech crackdown, global financial markets are disquieted with possible volatility.

There has been some debate whether Evergrande's free fall is a Lehman moment. Evergrande's default probability triggered by zooming debt (uncannily similar to US, Europe pre 2008) powered financial market expansion. Chinese debt rose by 100 per cent to 260per cent of GDP- 2/3 of global increase. Mortgages 1/3 of GDP (40 per cent of bank assets) generating a property bubble. Evergrande's $305 billion debt is 0.6 per cent of total credit but domino effect devastating; US mortgage market peaked at $ 600 billion.

The Techsector rose from 20 per cent in 2016 to 40 per cent of Chinese GDP. This is inadequate to "lean against the wind"- Chinese companies repaying $1.3 trillion debt in 12 months; lending by 128 banks and 121 non-banking institutions; non delivery of 1.6 million properties; 80 per cent share price fall. Truly scary! Debt fuelled capitalism has inherent problems-vigil needed.

There is also a need to closely look at funding finance and environmental, social and governance (ESG) movement. Going ahead, the G-20 nations science academies stressed improved global preparedness for future pandemics by creating a global network of surveillance; promote distributed manufacture and delivery of diagnostics, drugs, vaccines, medical supplies and equipment; and launch an intergovernmental Convention to detect early signs of potential pandemics. This is contextually significant.

While global growth is on track, India is in focus. The OECD visualizes global GDP growth at 5.7 per cent in 2021, 4.5 per cent in 2022 with higher vaccination, the Government and the Central Bank support. India is poised to once again become the fastest growing economy in the world. This thesis can be substantiated by a plethora of studies from all over the world. For example, the OECD projected that India is expected to grow at a real GDP of 9.7 per cent in 2021-22, largely because of a low base.

However, the Indian economy is expected to get on track to a long-term high growth trajectory, with a brisk growth of 7.9 per cent in 2022-23. Similarly, the UNCTAD Report 2021 shows global growth at 5.3 per cent in 2021. The UNCTAD projected 7.2 per cent growth for India in 2021 but the growth could decelerate to 6.7 per cent next year because of stressed policy environment-fiscal front and exacerbated trade balance.

The ADB reduced its FY 22 GDP forecast from 11 to 10 per cent because of downside pandemic risks and raised inflation forecast from 5 to 5.5 per cent. The ADB's optimism stems from reopening economy, PMI, recovering consumption, govt. spending and exports. Higher inflation is due to global oil prices, gas and diesel tax, double-digit CPI for pulses and vegetable oil. Despite this sense of all around cautious optimism, it has to be realized that the ascent will be protracted, uneven and uncertain with output and employment gaps in emerging market and developing economies (EMDEs).

The Indian economy grew by a record 20.1 per cent in the April-June quarter this fiscal, aided by a low weak base of last year and a sharp rebound in the manufacturing and services sectors in spite of a devastating second wave of Covid-19. The improvement in the Indian economy is certainly on. The RBI's paper demonstrates falling COVID19 cases, rising economy with improving manufacturing and moderating contraction of services was spurred by ample liquidity. Aggregate demand rose by pent-up demand post unlock; supply improving with normal monsoon and rising sowing.

High frequency domestic growth indicators have improved quickly post the second wave and early signs of recovery broadening with improvement in service-related indicators. But contact-intensive sectors are likely to struggle because of the persisting fear of a potential third wave. The upcoming festival season should, however, push demand and hasten recovery.

The Monthly Economic Report of August 2021 of the Ministry of Finance, Government of India highlights India's "resilient V-shaped recovery". The Report does well to marshal a wealth of economic and financial data and information to clearly bring out "broad-based and swift recovery of both demand and supply-side components". While the overall macro-economy augurs well for sustained development, this process needs to be carefully monitored because of the ongoing process of vaccination, fears of a third wave of COVID19 and Delta variant concerns, low base of the last year and the skewed southwest monsoon in terms of its spatial and temporal distribution. Going forward, cyclical ascent, enabling policy eco-system and a resuscitating global economy augur well for India. Clearly, the worst seems to be behind us and with dynamism, flexibility and resilience, India is likely to steadily move ahead.

Cushman and Wakefield 2021 Global Manufacturing Risk Index shows India to be second-most sought-after manufacturing destination- next to China, ahead of US. Land and labour reforms, lower economic and political risks and resilient manufacturing needed to consolidate India's position.

Digital disruption powered by lockdowns, restricted movement of people and goods, social distancing norms; rising significance of artificial technologies, block-chain, cloud services, robotic processes, distributed ledger technology. Financial start-ups, collaboration and incubation are needed to accelerate structural transformation.

The Government has put in place an ambitious asset monetization plan. National Monetization Pipeline (NMP) comprising "brownfield" projects, viz., power plants, roads, railways and stadiums would raise Rs. 6 lakh crore till FY 25 but the underlying land will not form part of the process. This is an innovative mechanism to create more assets.

There has to be a sustained improvement in financial position of banks. CRAR of SCBs rose to 16.03 per cent and provision coverage ratio to 68.86 per cent in March 2021. Macro stress tests reveal that GNPAs of SCBs could rise from 7.48 per cent in March 21 to 9.8 per cent in March 22 (baseline scenario) and 11.22 per cent (severe stress scenario). There is a need to bolster capital and liquidity of banks.

Disruptive changes necessitate banking transformation. Banking will remain but banks may not survive the onslaughts of Amazon's presence in financial services, Walmart's and Google's entry into financial services business, UPI's disruption of payment services, etc. Fasten your seat belts, turbulent times ahead!

We cannot solve today's challenges with yesterday's mindset. Paradigm shift needed in the banking sector to reorient with the VUCA times and stay ahead of the curve. The task ahead is difficult but doable.

Bank credit is yet to gain steam. With better operational efficiency and robust deposit growth, banks did well in Q1. Despite stress in retail loans, asset deterioration contained, recovery improved, restructuring manageable and incremental provision reduced. But risk aversion, stringent underwriting and credit to MSMEs causes concern.

On a year-on-year (y-o-y) basis, non-food bank credit growth stood at 6.7 per cent in August 2021 as compared to 5.5 per cent in August 2020.The highlights of the sectoral deployment of bank credit are:

• Credit to agriculture and allied activities continued to perform well, registering an accelerated growth of 11.3 per cent in August 2021 as compared to 4.8 per cent in August 2020.

• Credit growth to industry picked up to 2.3 per cent in August 2021 from 0.4 per cent in August 2020. Size-wise, credit to medium industries registered a robust growth of 63.4 per cent in August 2021 as compared to 4.4 per cent last year. Credit to micro and small industries accelerated to 10.1 per cent in August 2021 from a contraction of 1.1 per cent a year ago, while credit to large industries contracted by 1.7 per cent in August 2021 as compared to a growth of 0.5 per cent a year ago.

• Within industry, credit growth to 'all engineering', 'chemical and chemical products', 'gems and jewellery', 'infrastructure', 'mining and quarrying', 'paper and paper products', 'petroleum coal products and nuclear fuels', 'rubber, plastic and their products' and 'textiles' accelerated in August 2021 as compared to the corresponding month of the previous year. However, credit growth to 'beverage and tobacco', 'basic metal and metal products', 'cement and cement products', 'construction', 'food processing', 'glass and glassware', 'leather and leather products', 'vehicles, vehicles parts and transport equipment' and 'wood and wood products' decelerated/contracted.

• Credit growth to the services sector moderated to 3.5 per cent in August 2021 from 10.9 per cent in August 2020, mainly due to contraction in credit growth to NBFCs and commercial real estate.

• Personal loans registered an accelerated growth of 12.1 per cent in August 2021 as compared to 8.5 per cent a year ago, primarily due to faster credit growth in housing, vehicle loans and loans against gold jewellery.

With the economy gaining steam, banks must steadily improve in terms of Capital to Risk Assets Ratio (CRAR), GNPAs and NNPAs, operating and net profit, return on assets (RoA), risk management, digitization and efficiency to foster a virtuous cycle of regenerative broad-based growth.

There has to be a welcome thrust on broad-based credit. Bank credit is languishing at 5-7 per cent. This is why there has to be a sharper focus on auto, farm, education and personal loans required. FM's over 400 district credit outreach by banks from October to help the momentum of stimulus packages. Over Rs. 4.94 lakh crore disbursed by banks between Oct. 2019 to March 2021 through such efforts.

Credit upto Rs. 1.5 lakh crore is to be given to borrowers through NBFC-MFIs. Special attention on eastern India-Jharkhand, WB and Odisha is required because of low C-D ratio. Broad-based credit is a pre-requisite to enhance both growth and equity.

The COVID19 has catalyzed payment digitization and banking services. The World Economic Forum (WEF) reveals surging digitization across countries- China, India, Indonesia, Israel, Russia, US, Brazil, Spain and France. Surging digitization in payment and banking services has been driven by quick, convenient and cheap remittance. This process is certain to gain momentum in the days ahead.

There seems to be a disconnect between the real economy and the capital market with the Sensex breaching the psychological barrier of 60,000. The Sensex zoomed from 30,000 to 60,000 level in over six years on receding COVID19 fears manifesting a bull-run. The Sensex's surge has been powered by rising vaccination, accommodative monetary policy, strong corporate results because of reducing debt, steady exchange rate, Rs. 96,615 crore net foreign inflows and large buying by retail investors through mutual funds. Rs. 72,700 crore raised by 41 IPOs post mid-Dec.

Historically Sensex rose from 1,000 on July 25, 1990 to 30,000 on March 4, 2015. Zooming BSE Sensex (outperforming EM peers significantly, NIFTY50 Index rose by 26 per cent this year to be 35 per cent above its historical average. With $3.44 trillion equity market capitalization, India is the 6th largest stock market. Rising consumer demand, higher growth, low historic interest rates, recovering manufacturing and surging vaccination could drive the BSE even higher. But the swift rise in select scrips and stimulus glide path of the Fed Reserve cause new normal concerns.

Despite the disconnect between the real economy and the capital market, accelerating digitization, 'financialization' of assets and mobilization of savings for stocks would deepen and broad-base the capital market and the Sensex could conceivably scale new peak. Macroeconomic risks stem from higher vulnerability to a correction. But despite headwinds, India's long-term growth story is here to stay driven by both cyclical and structural factors. Hence cautious optimism is needed on the capital market front.

The Rupee recovered from 75.2 in April; it is now largely range-bound 74 to 74.9. The Rupee depreciation is possible because of US' unemployment rate falling from 5.9 per cent June to 5.4 per cent July, the RBI's mopping up of excess liquidity together with normalizing policy and aggressive Fed stance.

The forex market is clouded by higher Delta cases in Asia, FII withdrawal and China's factory output plummeting to a 17-month low because of spiralling costs and extreme weather together with stringent regulation. Some volatility in the Rupee vis-a-vis the USD is possible over the near term making constant monitoring imperative.

With persisting delayed growth concerns, the RBI, despite high or even rising inflation, is likely to adopt status quoist policy in October's bimonthly-policy. With evolving growth inflation dynamics, the RBI is likely to

· hold rates steady

· continue with accommodative stance.

· and indicate liquidity unwinding measures because of surplus liquidity.

But high inflation, accommodative monetary policy, unchanged rates and incipient growth could lead to stagflationary concerns.