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RBI's POLICY EXPECTATION- UNCHANGED RATES AND STANCE

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The RBI's August 2023 Policy would be formulated against a mixed backdrop-both global and domestic. Let us hit some of the high spots.

Global Setting

The IMF projected global growth to decelerate from 3.4 % in 2022 to 2.8 % in 2023 with risks heavily skewed to downside and high chances of a hard landing. Growth could remain at 3% in 2024-28. Anaemic growth in 2023 stems from aggressive monetary policy to curb inflation, impact of deteriorating financial conditions, Russia Ukraine war and growing economic fragmentation. Renewed thrust on growth, productivity, financial inclusion and inequalities in income and wealth and addressing high inflation and financial fault-lines are needed. The BIS Annual Report (2023) cogently argued to use all instruments to meet twin challenges of high inflation and financial fault-lines. Fiscal and prudential policies must move in tandem to help stabilise economy and financial sector.

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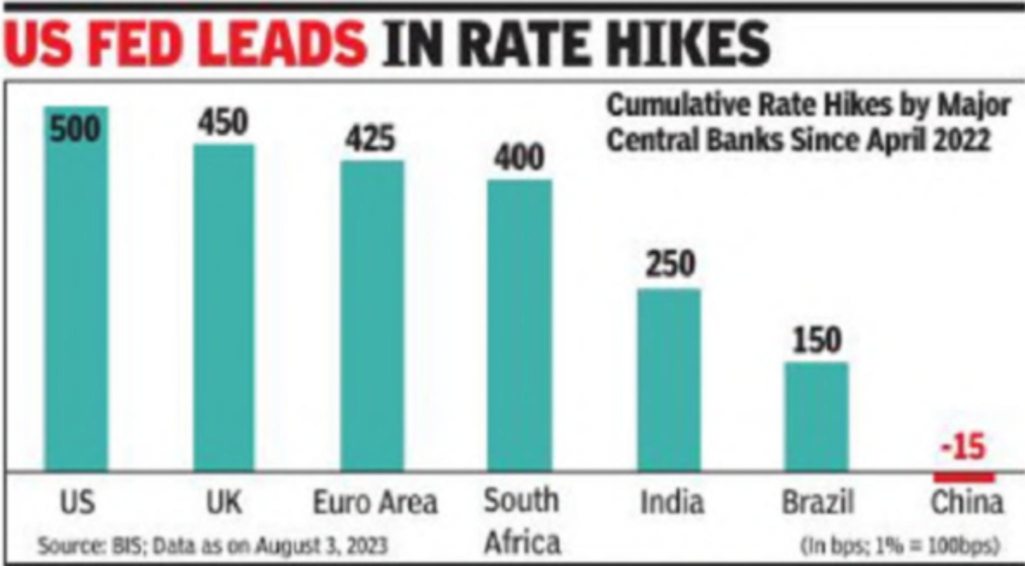
This makes it necessary to assess the key vulnerabilities the global financial system is exposed to while putting in policies that may mitigate systemic risks, thereby contributing to global financial stability and sustained economic growth. This Policy comes soon after the US Federal Reserve, the European Central Bank, and the Bank of England raised interest rates to check inflation.



The external sector risks are gradually abating though spill-over risks continued to haunt emerging economies, including India. Though US Federal Reserve and EU hiked interest rates in July 2023 and Fitch downgraded US debt, the inflation is receding and growth is gaining traction.

Country/Region	CPI Inflation (YoY %)
CHINA	0.0%
THAILAND	0.2%
SWITZERLAND	1.6%
TAIWAN	1.8%
SPAIN	2.3%
SOUTH KOREA	2.3%
SAUDI ARABIA	2.7%
CANADA	2.8%
US	3.0%
INDONESIA	3.1%
PORTUGAL	3.1%
BRAZIL	3.2%
RUSSIA	3.2%
JAPAN	3.3%
FRANCE	4.3%
SINGAPORE	4.5%
NETHERLANDS	4.6%
INDIA	4.8%
MEXICO	5.1%
EUROZONE	5.3%
PHILIPPINES	5.4%
SOUTH AFRICA	5.4%
AUSTRALIA	5.4%
NEW ZEALAND	6.0%
ITALY	6.0%
IRELAND	6.1%
GERMANY	6.2%
FINLAND	6.3%
UK	7.9%
SWEDEN	9.3%
POLAND	10.8%
TURKEY	38.2%
ARGENTINA	116%
VENEZUELA	429%

Source: Creative Planning, Truflation, Federal Reserve Bank of Cleveland

The US inflation went down from 4.0 % in May 2023 to 3.0 % 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. Accordingly, the central banks in major economies still remain hawkish till the inflation falls to targeted levels. As a result, the global stock markets and overseas investment in many parts are vulnerable to policy change-led volatility exacerbating market risks.

According to the Bureau of Economic Analysis (BEA), the real GDP of the US grew at an annualized rate of 2.4% in Q2 of 2023.

While inflation may fall marginally below 5 % by the end 2023, there are extensive concerns of weak economic growth and risks that inflationary pressures were becoming more embedded in the economy. Higher interest rates help dampen inflation but also economic growth by making it more expensive for consume₹ and businesses to borrow to buy homes, cars, or equipment. This trade-off makes the task of increasing interest rates high enough to contain the inflationary spiral, without debilitating the macro-economy so that the economies do not slip into recession, high unemployment and deflation onerous.

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

DOMESTIC ECONOMY

The IMF's MD stressed that India is a bright spot globally. Domestic policy priorities must stress curbing inflation with monetary policy staying the course, rebuilding fiscal buffers with protection for the most vulnerable and growth enhancing reforms. Growth enhancing reforms must focus on rebuilding domestic economic resources, greater quality spend, building deep capital markets and improving environment for private investment-both domestic and foreign. This is challenging but doable.

The IMF shows India with a GDP of US $ 3.75 billion is the 5th largest economy globally. But India's per capita income US $ 2,600 is way behind US ($ 80, 030), China ($ 13, 720), Japan ($35,390), UK ($46,310), etc. The IMF shows India to grow by 6.1% in 2023 and 6.3% in 2024. Accelerated growth over the long haul needed to bridge the chasm in per capita income between India and advanced economies. Hence an accelerated growth in per capita income is needed.

The RBI has projected real GDP growth for FY 24 at 6.5 %. The RBI is likely to maintain a similar growth projection in the policy. Going ahead, growth despite decelerating global economy and tight monetary policy, would be robust because of an accent on infrastructure, strong investment, and the efficiency gains from harnessing digital infrastructure.

Similarly, Goldman Sachs forecasted India to be the second largest economy by 2075 because of favourable demographics, innovation and technology, higher capital investment and rising worker productivity. India's dependency ratio is one of the lowest among regional economies. India's growth would be driven by innovation, rising worker productivity and capital investment. Rising savings rate, rising incomes, deeper financial sector development and infrastructure development augur well. However, labour participation rate in India must increase.

Despite heightened global uncertainty, the Indian economy continues to be on a high growth and resilient path. India's GDP is likely to nearly double in the next seven yea₹ to $6 trillion, and per capita income will increase to $4,000 by 2030. India's GDP currently stands at about $3.5 trillion and per capita income at $2,450 during CY 2022. India's drivers of growth will be consistent policy reforms, macro stability, healthy financial sector, large share of working population, digitalisation and political stability, public capex push. Several states are likely to be far wealthier than the national average by 2030 and household consumption expenditure may be similar to India's current GDP levels by then. These include states like Telangana, Delhi, Karnataka, Haryana, Gujarat and Andhra Pradesh, among others.

According to the United Nations, 415 million Indians moved out of poverty in the 15-year period between 2005-2006 and 2019-2021. The latest update of the global Multidimensional Poverty Index (MPI), which was released by the United Nations Development Programme (UNDP) and the Oxford Poverty and Human Development Initiative (OPHI) at the University of Oxford, said that 25 countries, including India, successfully halved their global MPI values within15 years. Meanwhile, the Standard Chartered Bank Research said that demand for consumer durables will increase especially amid a push for digitisation by 2030, while the manufacturing base will likely get better as demand outlook improves. "Political stability, reforms have created a conducive environment for sustaining growth," the report said. However, vulnerability to climate risk events is high.

Overall rainfall exceeded long period average because of wetter July. But regional skew is on with lower rainfall in Deccan Plateau and the East. Kharif sowing 2% lower than last year with maize (-5.6%), rice (-6.1%) and pulses (-13.3 %) taking the hit. With parts of U.P., Bihar, Assam, Karnataka and TN likely to get less than normal rainfall in July, sowing of paddy and pulses could take a greater hit leading to higher food inflation. Food inflation needs careful monitoring.

India's IIP rose by 5.2 % in May 2023 (4.5 % in April) mainly because of good show by manufacturing and mining sectors. Manufacturing grew by 5.7 %, mining by 6.4 % and electricity by 0.9 %. Steady industrial growth is needed.

The GST collections in July 2023 came in at ₹. 1, 65, 000 crore suggesting a yearly GST collection well in excess of ₹. 18 lakh crore. The fiscal deficit was contained at 25.3 % of the budgetary estimate. Foreign portfolio investments (FPI) inflows remained positive; equity markets show mixed but overall, a positive outlook. India's foreign exchange reserves increased sequentially to US $ 609 billion on June 14.

The rupee during the same period saw a modest depreciation while remaining largely range bound at ₹.82.

Bank credit growth to MSMEs decelerated in Q1 on a year-on-year basis because of risk averseness in the banking sector. The credit to medium industries in June grew by 13.2 % (47.8 % last year) and micro and small industries by 13 % (29.2 % a year ago).

In absolute terms, the gross bank credit outstanding to medium industries at June-end was ₹ 2,63,440 crore compared to ₹ 2,32,776 crore in June last year. In the case of micro and small industries, the credit outstanding in June was ₹ 6,25,625 crore against ₹ 5,53,675 crore in the corresponding month of 2022. In May, the credit to medium industries grew by 18.9 % (42.9 % last year) and micro and small industries by 9.5 % (32.7 % a year ago). According to another set of RBI data for April, loan growth of medium industries was 19.1 % against 53.7 % last year. The growth in the case of micro and small industries was 9.7 % in April 2023 compared to 29.8 % in the year-ago month.

While there was a double-digit growth in bank credit to MSMEs, which suggested hassle-free institutional finance to MSMEs, individual MSMEs continue to be constrained by the processes and procedures (e.g., collateral requirements, limited credit history and high-interest rates) and the lackadaisical approach of the banking system in lending to MSMEs. This thesis can be substantiated by the fact that the Expert Committee on Micro, Small and Medium Enterprises, constituted by the RBI in December 2018, estimated the overall credit gap in the MSME sector to be between ₹ 20 and ₹ 25 lakh crore.

The GNPAs of MSMEs stood at ₹ 1,31,928 crore at March-end, down from ₹ 1,54,094 crore a year ago and ₹ 1,82,114 crore in March 2021. In an attempt to improve credit flow to MSMEs, the credit limit for Guarantee Coverage under Credit Guarantee Scheme for Micro and Small Enterprises has been enhanced from ₹ 2 crore to ₹ 5 crore and the annual guarantee fees have been reduced by 50 % with effect from April 01, 2023. Also, under the Atmanirbhar Bharat packages, the government has announced a Fund of Funds to infuse ₹ 50,000 crore equity in MSMEs, which have the potential and viability to grow.

BANKING LANDSCAPE

Banks have hit a purple patch. The RBI' Financial Stability Report (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 % and1 %, respectively in March 2023, lowest since 2015. Similarly, return on assets (RoA) rose steeply from a negative 0.2 % in 2018 to a healthy 1.1 % in 2023. But there is a manifest need to maintain the growth momentum in profits by a broad spectrum strategy.

In this overarching setting, Public sector banks (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 the last eight financial years. The government infused ₹ 3,10,997 crore to recapitalise PSBs from 2016-17 to 2020-21. The reforms focused on credit discipline, ensured responsible lending and improved governance. Besides, there was technology adoption, amalgamation of banks and the general confidence of bankers.

Bank lending also seems to be in a roll. In aggregate terms, bank loans advanced 16.3% in June. Retail loans climbed more than a fifth on year, supported mainly by home and vehicle loans, the latest central bank data showed. Bank loans to non-bank lenders climbed, and so did the disbursements to large companies. India's resilient consumer demand, which most experts believe will ensure sustained economic expansion for the world's most populous country for decades, was evident in the latest granular data on loans as buyers of homes, cars, vacations or college education helped garner a disproportionate share for retail customers in total bank credit.

But it causes concern that the top 50 wilful defaulters including Gitanjali Gems Limited, Era Infra Engineering Limited, REI Agro Limited, and ABG Shipyard Limited owe ₹ 87,295 crore to banks and financial institutions. Of this, top 10 wilful defaulters owe ₹ 40,825 crore to schedule commercial banks (SCBs). SCBs have written off an aggregate amount of ₹ 10,57,326 crore during the last five financial years (RBI provisional data for FY 2022-23).

While the banking industry has continuously innovated to enhance customer experiences and streamline operations, the pace of technological transformation (e.g., artificial intelligence, machine learning (ML) algorithms blockchain, Internet of Things (IoT) cloud computing, advanced analytics, etc.) has quickened in the last few years. The shifting paradigms have led to redefining customer engagement, and eventually unlocking new avenues for sustained growth and profitability. But there has to be an accent on cyber-security and fraud prevention and regulatory compliance.

McKinsey and Co. have argued that slower deposit growth, likely decline in fee income, rising operational expenses and increasing number of so called credit tested customers is likely to impact bank profitability in the next couple of years. It expects banks' return on asset (RoA) to drop to 0.80% to 1% range in the next two years from 1.1% at the end of fiscal 2023. Hence, there is a strong case for investment in tech and talent.

LENDING AND DEPOSIT RATES

The borrowing cost which started rising in May last year has stabilised with RBI keeping the repo rate unchanged at 6.5 % since February when it was raised from 6.25 %. In case the RBI maintains the status quo, there will be no change in external benchmark lending rates (EBLR) that are linked to the repo rate, giving relief to borrowers as their equated monthly instalments (EMIs) will not rise. However, borrowers, whose loans are linked to MCLR (marginal cost of fund-based lending rate), may find some upward revisions. Banks have already raised their deposit rates and are unlikely to increase them any further.

SYSTEM LIQUIDITY

Banking liquidity remained in surplus at ₹ 2.8 lakh crore in early August 2023. The surplus liquidity is on account of the return of ₹ 2,000 banknotes to the banking system. The RBI had withdrawn ₹ 2,000 notes from circulation in May this year. As on July 31, ₹ 3.14 lakh crore, or 88 % of these notes, have returned to the banking system. The domestic banking system liquidity is likely to remain adequate with the RBI's decision to withdraw ₹ 2,000 notes, and as the RBI continues to build foreign exchange (FX) reserves on the back of strong equity inflows.

The RBI is also unlikely to ease liquidity, given the volatility in the foreign exchange market. The rupee has fallen to a two-and- a-half-month low, with the dollar gaining against major currencies last week.

Domestic equities have seen $16 billion in foreign institutional investo₹ (FII) inflows from May to July while the RBI has been leaning against any inflows and have added around $18 billion to FX reserves since May. The yield on the benchmark 10-year government bond has risen since the last policy and is currently trading above the 7% mark.

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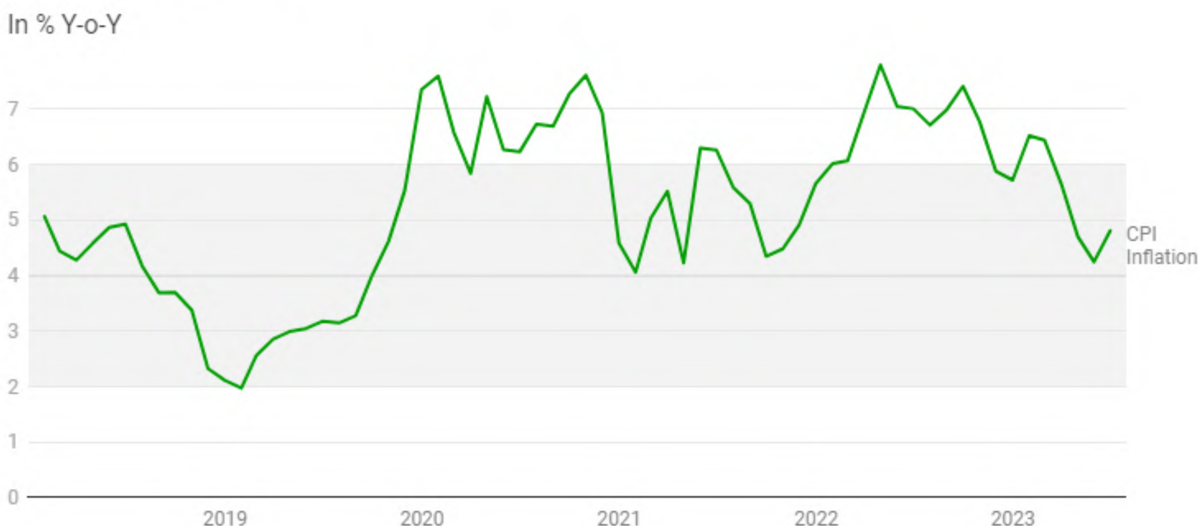
INFLATION FORECAST

In the June 2023 Monetary Policy, the RBI revised its FY2024 inflation projection to 5.1 % from 5.2 % announced in April. The CPI inflation was expected to be at 4.6 % Q1; 5.2 % in Q2; 5.4 % in Q3; and 5.2 % in Q4. For July, inflation is likely to rise in the range of 6-6.8 % from 4.81 % in June.



Rising food prices may offset recent respite from inflation and could induce the RBI to stay hawkish and possibly raise its inflation projections for the ongoing July to September quarter as well as the full year 2023-24 and delay hopes of an interest rate cut.

The CPI inflation fell steeply to 25 month low of 4.25 % in May 2023-the 4th straight month of decline in CPI and the 3rd straight month of CPI in the MPC band of 2-6%-because of favourable base effects and moderating food prices. Despite normal monsoon, El Niño, volatile crude oil prices, high cereal and milk prices cause concern. But CPI inflation surged to 3-month high of 4.81 % in June 2023 (4.31 % in May, 7 % in June 2022) mainly because of hardening prices of cereals and pulses. But the CPI inflation was still below the RBI's upper tolerance limit of 6%. CPI was pushed higher than expected due to a less supportive base and a surge in vegetable prices. Food inflation spiked to 4.49% in June. With surging vegetable prices, CPI inflation could breach 6% in July because of a broad-based uptick in food prices, and could remain sticky in coming months.

Further, the threats of supply-side shocks, including El Nino persist making inflation management uneasy and requiring a greater role of the fiscal policy. India and Egypt are among the economies that are overall most vulnerable to El Nino's impact this year, according to an index by Standard Chartered Bank, taking into account the weight of the primary sector, the share of food in inflation baskets and a country's ability to offset through fiscal support. Careful inflation management is needed. Hence, the RBI is likely to give a renewed thrust on the need to maintain 'vigil' on inflation because of the compelling need to maintain low and stable inflation.

WHY NO CHANGE?

There are concerns over higher consumer price index (CPI) inflation, driven by an increase in prices of vegetables and pulses. But despite the US Federal Reserve and the European Central Bank hiking benchmark rates, the RBI may continue with its policy repo rate unchanged for the third consecutive time at 6.5 % and the policy stance of 'withdrawal of accommodation' amidst surplus liquidity in the banking system and the considerable uncertainty surrounding the near-term inflation outlook. The movement of the domestic inflation and the global cues that are suggesting a greater probability of a peak out of the US Fed's monetary tightening cycle would have a bearing on the form and substance of the forthcoming Policy pronouncements.

The vegetable price hike is transient and the impact of the last hike in February is still playing out because of the lag effect. But the tone and tenor of the Policy could be hawkish.

In the monetary policy announced in April, the MPC unanimously decided to pause the hike in the repo rate — the rate at which RBI lends money to banks to meet their short-term funding needs. This pause was announced after the repo rate was hiked by 250 basis points (bps) since May 2022.

In June policy, the central bank again left the repo rate unchanged at 6.5 %. A recent spike in international crude oil prices (11 % since June) due to supply cuts from the Organisation of the Petroleum Exporting Countries (OPEC) could also aggravate the inflationary pressures.

In sum, no tinkering with RBI Policy rates is likely. Despite US Fed Reserve and European Central Bank hiking benchmark rates, the RBI is likely to keep Policy rates unchanged in Aug. because domestic inflation is within the MPC band and favourable liquidity conditions post the withdrawal of ₹2,000 notes.