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RBI PRE-POLICY EXPECTATIONS

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PERSPECTIVE

The COVID 19 devastated lives and livelihoods across the development spectrum. It has sometimes been compared to the global financial crisis (GFC) of October 2008 and even the Great Depression of 1929 in terms of the debilitating hit to income, output and employment-both globally and domestically. But there is a clear consensus that it was even far more serious than these two catastrophic events.

The woeful inadequacies of the global financial system required simultaneously stimulating the economy to enhance aggregate demand, avoiding protectionism and strengthening international financial institutions through cross-border investment, trade and banking.

The new rules of the game and transformed global financial architecture necessitated a rehabilitation of the global economy and fostering of investment and trade in the new normal. Bold fiscal policy measures and hefty stimulus packages- upto 20 per cent of GDPs- announced from March 2020 to contain savage macro-economic effects, prevent a free fall of their economies and markets and craft a better tomorrow. These measures included fiscal packages, relaxation of monetary and macro-prudential rules, and liquidity injection into the banking system. Synchronized measures with a sense of immediacy by central banks and governments restored a modicum of normalcy in financial markets.

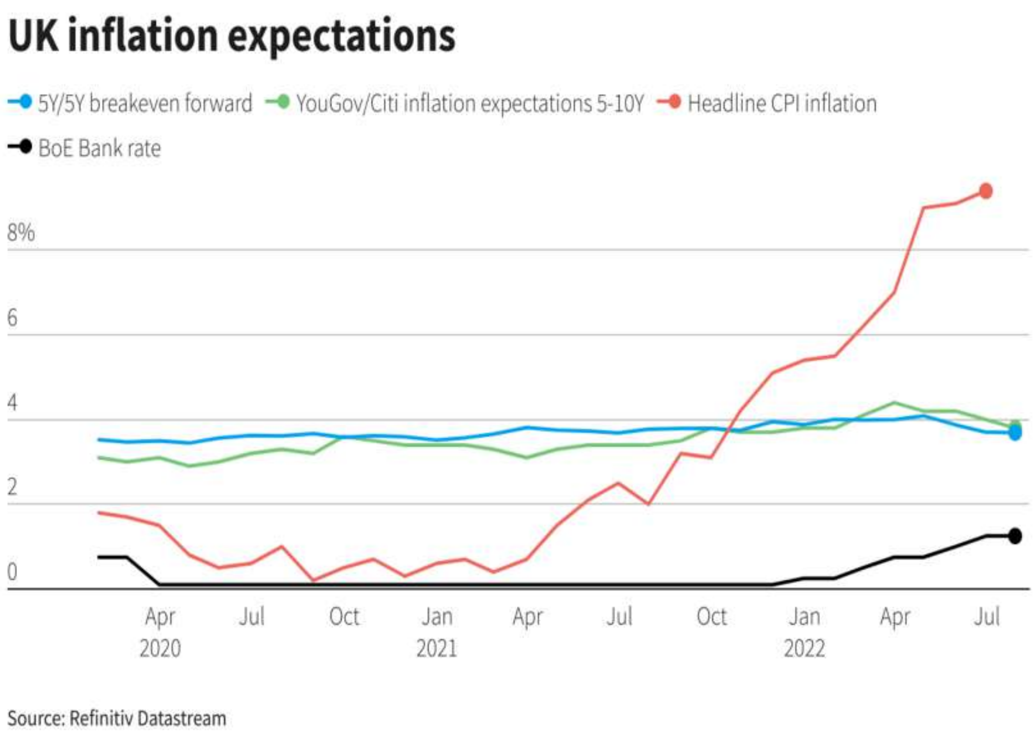
GLOBAL SETTING

The IMF reduced US growth forecast; recession is, however, not imminent. The IMF reduced its growth forecast for 2022 from 3.7 per cent in April to 2.9 per cent in June because rising interest rate to compress demand, new COVID19 variants, supply-chain disruptions, spike in food and fuel prices, 40-year high inflation. Still it would "narrowly" avoid recession. Turbulent times ahead.

Exceptionally uncertain global outlook is marked by Ukraine war and high debt. IMF's MD stressed check on inflation, coordinated fiscal and monetary policies to tame inflation and greater global cooperation to address multiple crises, viz., food security, poverty and climate change.

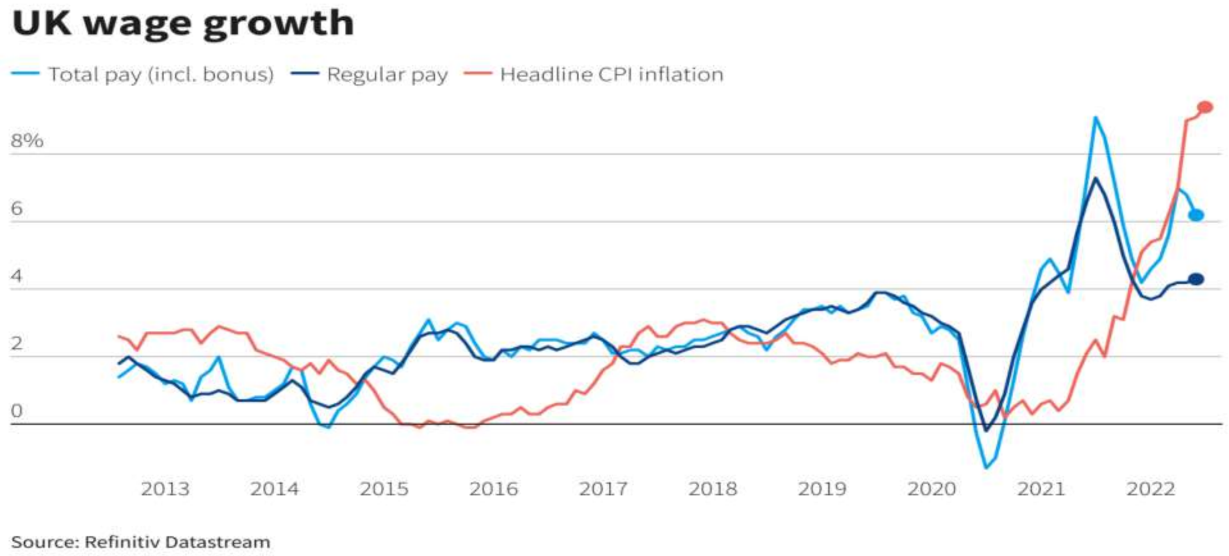
The Fed Reserve Chairman Jerome Powell sees Central Bank keep hiking interest rates to tame inflation and US recession was "certainly a possibility". There is distinct possibility of a downturn in US's economy in next two years. US's inflationary spiral reached a 40-year high of 9.1 per cent in June 2022 (8.6 per cent in May). This unacceptable situation has accentuated the Fed's hawkish stance with hikes of about 125 bps in July-August being on the cards.

S&P Global's final manufacturing Purchasing Managers' Index (PMI) for the euro zone fell to 49.8 in July from June's 52.1, its first time below the 50 mark since June 2020. Production fell in all euro zone countries other than the Netherlands with sharp dips in Germany, France and Italy. Last month, the European Central Bank raised interest rates by more than expected as concerns about the spiralling inflation were considered more important than growth pangs. There may be no more good days ahead. The Central bankers' aggressiveness stems from imminent end of low rates and low inflation post Ukraine war and COVID 19. There is ubiquitous gloom and doom seen in deteriorating US consumer confidence amidst inflationary spiral and surging inflation in Euro zone. Britain's main inflation measure hit a 40-year high of 9.4 per cent in June with the dreaded possibility of inflation peaking at 12 per cent.



Source: Reuters

With such high inflation expectations becoming self-fulfilling, there could be concomitant increases in the wage bill, thereby triggering an ominous vicious cycle of inflation and slow growth-a truly harrowing mix, if ever there was one!



Source: Reuters

The macroeconomic scenario in UK is characterized by slow growth and high inflation. UK's growth rose 0.5 per cent in May 2022. Inflation in US rose to a new 40 year high. Europe's high inflation and bleak economic prospects reduced € to the level of the $- first time in two decades. There is no silver bullet to address enduring macroeconomic concerns in UK but there has to be a much greater thrust on productivity (0.4 per cent in UK since 2008- half of growth in 25 OECD countries), high growth and reduced inequalities for steady growth in UK.

Price of freedom? UK's PM held "price of freedom is worth paying". But there is a steep price- average June inflation in Estonia 22 per cent (3.7 per cent last year), Lithuania 20.5 per cent (3.5per cent), Latavia 19 per cent (2.7per cent). #Eurozone's average inflation rose to 8.6 per cent exacerbating miseries. There is a compelling need to adroitly manage growth-inflation trade off.

South Korea's factory activity fell for the first time in almost two years while Japan saw its slowest growth in activity in 10 months amid persistent supply chain disruptions. Caixin's survey showed that the industrial production in China contracted unexpectedly in July with the virus resurfacing marring demand outlook; property sales plummeted 33.4 per cent in July versus 88.9 per cent rise in June; economic stagnation could be a possibility in the second half of 2022 .

Reconciling energy needs with environmental concerns. High fuel prices led to fragile growth, 8 per cent global inflation, lower standards of living and political hits. Straddling energy needs and climate concerns requires a knife edge equilibrium- thrust on fossil fuels, guaranteed contracts with sufficient return on capital, state support for cleaner projects.

An accent on renewables requires greater reach, capacity and storage of grids, design of power grids and markets, annual $5 trillion investment. In sum, a short term plan of survival to intermesh with medium term plans of cleaner and more efficient energy and rising renewables. Failure is not an option.

INDIAN SCENARIO

The worst is clearly behind us post the COVID 19 pandemic and India is once again on a high growth trajectory. However, heightened geopolitical tensions-Russia-Ukraine war; volatile prices of oil and gold; overleveraged non-financial sectors, viz., elevated debt levels among governments, businesses and households; elevated logistics cost and interest cost, volatile capital flows and exchange rate volatility and the scramble for safe haven and the attendant correction in asset prices. The emergence of newer variants and monkey-pox also cause concern.

The GDP growth for FY 23 is seen at about 7.5 per cent. The emerging process and pattern of the growth Indian economy is broad-based and resilient. Factors, such as, ebbing infections and improving consumer confidence are likely to bolster private consumption.

With the COVID 19 pandemic receding rapidly, macroeconomic growth in India is gaining traction and India is once again on a high growth path. According to the latest World Economic Outlook published by the International Monetary Fund, GDP growth of 7.4 per cent in India (growth projections slightly pared because of less favourable external conditions and the rapid policy tightening by the RBI) is projected to be one of the highest among major economies in FY 23. Further, India is likely to record sustained growth of 7-8 per cent (in real terms) till FY 27.

The continuance of demographic dividend, services export opportunities, domestic demand potential, ascendancy of the middle class and India's emergence as an attractive investment destination are certain to act as tailwinds for the Indian economy and facilitate a take-off into sustained growth. Strengthened physical sector in terms of the length of the highways, reduced peak energy deficit, improved logistics efficiency, a renewed thrust on exports and investments are likely to provide an impetus to macroeconomic growth and structural transformation. Given the enabling environment, the growth triggers and the dynamics of development, we expect the GDP of the Indian economy to surge from ₹ 127.41 lakh crores (at constant prices) and ₹ 158.99 lakh crores (at current prices) as at end March 2022 to rise to ₹ 156.07 lakh crore (at constant prices) and ₹ 220.69 lakh crore (at current prices) as at end March 2027.

MACROECONOMIC BACKDROP

Challenges-enhancing the share of manufacturing in India's GDP vis-a-vis average in low and middle-income countries; adequately capitalizing on inherent labor and skill cost advantages to develop large-scale labor intensive manufacturing; simplifying complex land and labour laws; providing productive employment, to absorb out-migration of labour from agriculture; and strong macroeconomic fundamentals including low and stable rates of inflation and a falling fiscal deficit.

India is better placed than most countries to avoid stagflation. This is clearly reflected in leading indicators, such as, tax collections; higher corporate bond issuance suggests business recovery; capital market -BSE 60,000 levels, FPI inflows comprising debt, equity; core sector output; and forex reserves. This is why the Finance Ministry's Report stressed managing short-term-risks (fiscal deficit, economic growth, inflation, current account deficit, Rupee value) without sacrificing "hard earned macroeconomic stability". This makes it necessary to rationalize non-capex expenditure because of fears of gross fiscal deficit spiraling beyond the budgeted level. Clearly, India is at a lower risk of stagflation than most countries.

Growth in India is steadily gaining traction and there has been an improvement in development indicators, such as, per-capita income, poverty, life expectancy, nutrition, and infant mortality. With most parts of GDP crossing pre-pandemic levels, recession can safely be ruled out in India. Bloomberg's econometric model, which is based on several factors, viz., housing permits, consumer survey data, gap between 10-year and 3-month Treasury yields, shows India, unlike some Asian countries, has zero probability of slipping into recession. Clearly, growth is here to stay This thesis can be substantiated by the fact that unlike Sri Lanka, fiscal deficits have been contained within manageable proportion, the exchange rate has depreciated relatively lesser compared to emerging market economies (EMEs), focus of the monetary policy on low inflation and the phased opening of financial capital flows. Hence a sense of déjà vu like the Sri Lankan story is ruled out in India. But it needs to be highlighted, as done by the RBI, that there are 5 most stressed indebted States (Punjab, Rajasthan, Bihar, Kerala and W.B.) with a debt- GSDP ratio over 35 per cent).

Hence urgent corrective steps are needed at the macro level in general and at the level of these States in particular to reduce non-merit goods expenditure. The culture of unbridled welfarism - freebies-at the cost of globally accepted benchmarks choke transformation, vitiate development, adversely effect macro-economy, life quality and social cohesion. No free lunch is sustainable over medium term.

Of late, both the direct and indirect tax collections in India have been doing very well. For example, the GST collections are on a roll. Surging GST collections of ₹1.49 lakh crore for July 2022 (second highest ever) reflect GST's stabilisation and rising macroeconomic growth. GST revenues for FY 23 could exceed ₹ 18 lakh crore. Way to go!

According to the India Meteorological Department (IMD), India is likely to receive an average rainfall in August and September. This would have a salubrious impact on farming to boost growth and generate jobs. IMD defines average, or normal, rainfall as between 96 per cent and 104 per cent of a 50-year average of 89 cm (34 inches) for the four-month season beginning in June. But some rice-growing states in India's east may receive sub-average monsoon rains.

India's industrial production rose the highest in July because of robust growth in new orders and output as demand improved with reducing price pressures. The Manufacturing Purchasing Managers' (S &P Global), which rose sharply to 56.4 in July from June's 53.9 suggested the Indian economy has remained resilient, despite concerns over faster interest rate hikes, massive capital outflows, a weakening rupee and a rapidly decelerating global economy.

India's eight core sectors' output growth moderated to 12.7 per cent in June, from 18.1 per cent in May, with all sectors, except crude oil, registering an uptick in production with the growth being particularly pronounced in coal, cement, electricity and refinery products. While the disaggregated trends are mixed, the broad-based moderation in the growth rate to 12.7per cent from 19.3 per cent in May is largely attributable to the 'normalising base' effects from 2021 amid the second COVID-19 wave.

The RBI warned that the higher risk appetite of NBFCs led to "their size, complexity and interconnectedness" posing a "potential threat" to India's financial stability. The RBI reduced regulatory arbitrage of large NBFCs making them almost on par with banks in regulatory oversight.

In the overarching context of macro-economic development, moving up the innovation value chain acquires strategic significance. The Ministry of Science and Technology shows gross expenditure on R&D (GERD) is 0.7 per cent of India's GDP with its GDP per capita being 43 (in current PPP $). Further, over half of this expenditure stems from government. Hence, innovation has to be enhanced and broad-based. In sum, the Indian economy is recovering but concerns persist necessitating synchronized measures to fully broad-base growth and to make it sustainable over the long haul.

INFLATIONARY SPIRAL

There are real and challenging concerns, viz., 6.7-6.9 per cent fiscal deficit, 3 per cent Current Account deficit, sticky CPI inflation of over 6 per cent, the Rupee trading at 80 to the US Dollar, decelerating growth and high unemployment. These and other aspects need a revisiting policy options and structural reforms to meet 'the revolution of rising expectations'. The inflationary WPI and CPI spiral causes concern with WPI and CPI inflation rising to 15.18 per cent (3-month low) and 7.01 per cent (breaching the 6 per cent threshold since January 2022), respectively, in June 2022. The CPI inflationary in June 2022 came in slightly lower than 7.04 per cent in May (7.79 per cent in April) but was still well beyond the RBI's tolerance limit of 2-6 per cent.

Disconcertingly inflation has exceeded the medium-term target of 4 percent for 32 consecutive months and five straight months above the 6 percent upper-bound of the RBI's 2-6 percent tolerance range. What makes matters worse is that the global scenario, which is characterized by the rise in interest rates, high commodity prices and the Russia-Ukraine war, is uncertain and challenging. In view of the challenging global and domestic landscape, there is little possibility of inflation return to below 6 per cent before the second half of FY23. With both WPI and CPI at elevated levels, further RBI hikes are on and a careful monitoring is needed.

The RBI's recent Annual Report stressed addressing supply-side bottlenecks, calibrating monetary policy to reduce inflation and boost capital spending. Inflation has been partly offset by removing customs duty on imports of raw cotton, reduced fuel taxes, rising exports steel duty, restricting sugar exports, etc. But these measures had a limited impact of about 60 bps on inflation.

In an incisive analysis, the IMF demonstrated that high global inflation stems from supply-chain bottlenecks, shift in demand from services to goods, aggregate stimulus and post pandemic recovery, shock to labour supply and supply shocks to energy and food because of Ukraine war.

The IMF stressed countries should allow hikes in food and fuel prices to pass-through to domestic prices since food prices make up 44 per cent of consumption in low income countries, 28 per cent in emerging market economies and 16 per cent in advanced economies. But in this process of pass-through there has to be an accent on the needs of the most vulnerable sections of the society. The IMF's study on food prices in Sub-Sahara Africa shows external factors drive food price inflation but domestic factors can reduce their impact. Hence, a fFocus on monetary and fiscal policy, overall economic environment and transport constraints is needed.

SOME OTHER IMPORTANT AREAS

With 17 per cent rise in exports to $37.9 billion and 51 per cent rise in imports to $ 63.6 billion, trade deficit surged to $ 25.63 billion in June 2022. The deficit of $ 45-50 billion in balance of payments requires an accent on value added exports, increase container manufacturing and incentivise exports.

There is also the issue of the steady decline in the external value of the rupee, which exacerbates the inflationary pressures and negates the benefits of some softening in global commodity prices. US Dollar rose to its highest level since Dec. 2002 against a basket of currencies. Despite the steps taken by the RBI to draw foreign fund inflows, the rupee's southward move continued. The rupee fell 7 percent against the dollar, so far, in 2022 because of high global commodity prices, foreign fund flows and the RBI's limited maneuverability in the forex market because of falling forex reserves.

But it has to be realized that the Euro fell by 13 per cent, the British pound by 11 per cent and the Japanese yen by 16 per cent. In Asia also, the South Korean won, Philippines peso, Thai baht and Taiwanese dollar all fell more than the rupee against the US dollar thereby leading to an appreciation of the rupee against all these currencies.

The RBI's Strategic Decision to permit international trade settlement in Rupee is welcome. The RBI's market-determined exchange rate will help the Rupee go to scale, boost exports, facilitate Rupee trade, reduce foreign exchange risks for traders, ease payment issues with Russia, reduce the risk of forex fluctuation and dampen Dollar demand. The global ramifications of an alternative to SWIFT transcend India Russia oil deals, strengthen India's clout in international financial market and strengthen India's position in the comity of nations and is a prelude to full Rupee convertibility.

CHALLENGES BANKING

Banks in India are a microcosm of the broader domestic economy. With the Indian economy gaining steam and bank NPAs steeply declining to a six-year low of 5.9 per cent as of March 2022, bank credit in India is expected to grow at a fast clip. With a CAGR (compound annual growth rate) of about 10 per cent in bank lending, we expect bank lending to surge from ₹ 120.54, lakh crore as at end March 2022 to about ₹ 200 lakh crore as at end March 2027.

Financial sector regulators and the Government have initiated a slew of policy measures to enable the banking sector to withstand the rigors of the 'new normal'. At the present juncture, bank credit growth significantly outpaces deposits growth.

Credit growth, which has been driven by working capital and term loans and loans to MSMEs, in FY 23 has been at an impressive 14 per cent year –on-year (6.5 per cent last year). Post pandemic, sustained growth in advances needed.

As at end March 2022, capital adequacy ratio of Indian banks rose to a record high of 16.7 per cent while NPAs declined to a six year low of 5.9 per cent. The RBI's FSR has clearly brought out a marked improvement in asset quality of banks. RBI's FSR shows banks GNPAs and NNPAs fell from 7.4 per cent and 2.4 per cent to 5.9 per cent (6-year low) and 1.7 per cent in March 2022. Higher credit and declining stock of NPAs may improve GNPAs to 5.3 per cent by March 2023. But most PSBs are still saddled with high NPAs, and subdued growth prospects. SCB is, however, not a monolithic category; there are significant differences across PSBs and private banks and even within these two groups. But on the whole, private banks are better placed.

With better operational efficiency and robust deposit growth, banks did well. Despite stress in retail loans, asset deterioration contained, recovery improved, restructuring manageable and incremental provision reduced. But risk aversion and stringent underwriting causes concern. Banks need to support growth while being wary of accounts turning bad. Hence a strengthening of regulatory and supervisory framework is on the cards.

Heightened risk aversion induces banks to refrain from lending except to better-rated companies. While banks have surplus liquidity, several important sectors continue to get adequate credit because of risk aversion triggered by demand and supply side shocks, diminished consumer confidence, NPAs and consequently pronounced risk aversion.

NBFCs are re-orienting their growth strategy. With a clear upward bias on the interest rate, the NBFCs are expanding credit to shore up their margins because of 35-40 bps higher borrowing cost post May 4, 2022. The Government spending on infra and good monsoon would drive growth the growth of NBFCs.

There have been sweeping changes in the cooperative sector. Computerisation of about 63,000 functional Primary Agricultural Credit Societies (PACS) with a budget of ₹2516 crore (GoI ₹ 1528 crore) would raise the number of PACS to 3 lakh by 2025 and benefit 13 crore farmers. Such historic changes would make PACS "viable" and "multidimensional" involve not just ₹2500 crore but ₹ 3.19 lakh crore by GoI, State Govts. and NABARD. PACS broadened by 20 new options, reduced surcharge from 12 per cent to 7 per cent for PACS with earnings of ₹ 1-10 crore, reduced MAT.

The entry of big fintech firms in financial services is fraught with risks. The RBI Governor stressed entry of big fintechs in financial services can create systemic risks- over leverage, inadequate credit assessment, competition, data protection and sharing, operational resilience of critical services, etc. Well said, Sir.

The RBI's May 2022 Report highlights private investment, higher government capital expenditure, improved infrastructure, low and stable inflation and macroeconomic stability to drive economic growth in these challenging domestic and global times. Way to go.

POLICY ACTION

This Policy would be formulated against a challenging domestic and global economic backdrop. The global scenario is characterised by synchronized global growth slowdown, tight US labor markets, rising current account deficit, and the distinct possibility of stagflation.

The case for a rate hike stems from the fact that the existing repo rate of 4.9 per cent is still below the pre-Covid level of 5.15 per cent (the RBI slashed the repo rate by 115 bps from 5.15 per cent to 4 per cent). In view thereof and the evolving growth-inflation trade-off, we expect:

1. The RBI Governor to continue with the hiking of the rate. In conformity with ECB and US Fed's rate hike, we expect the policy rate to rise by 35-50 bps on top of the 90 basis points hike (40 basis points in an off-cycle move in May and 50 basis points in June) effected in the rates in the current rate cycle. This would be the third consecutive policy rate hike) in conformity with the avowed objective of a calibrated withdrawal from the accommodative stance. To provide a sense of perspective, it is important to recapitulate here that the Federal Reserve raised the rate by 225 bps in CY22. While the Fed, the White House and economists maintain that the economy is not in recession based on broader measures of activity, Treasury yields are pricing in bad news with U.S. 10-year Treasury yields falling 33 basis points in July, marking the largest monthly decline since March 2020.

2. We do not visualize a return to the accommodative policy stance any time soon.

3. We expect the RBI to be hawkish because of the inflationary pressures in the economy.

FUTURE POLICY RATE ACTION

We expect that the August 2022's rate hike in sync with the Fed would be followed by another 25 bps rate hikes in the next two meetings. Difficult times ahead.

CONCLUDING OBSERVATIONS

The sustained growth of the Indian economy over the long haul requires a renewed thrust on its four engines of growth — domestic consumption, government expenditure, private investment and exports Creating jobs is critical to recovery together with boosting demand. But skilling for jobs is imperative. India's gig economy employment could rise from present 13 million 7-fold to 90 million by next decade. Driving this momentum requires flexible and continuous learning, changed pedagogy, communication, information literacy, creativity, critical thinking and industry partnerships. Both the Government and the RBI have to work together as in development to accomplish broad-based objectives of development.

While this rate hike move in India would certainly impart an upward bias to the interest rate, we do not expect this rate hike to lead to further transmission in bank rates immediately because of significant reduction in systemic liquidity. Uncertain times and global dynamics necessitate caution and vigil.