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RBI PRE-POLICY EXPECTATIONS

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GLOBAL SETTING

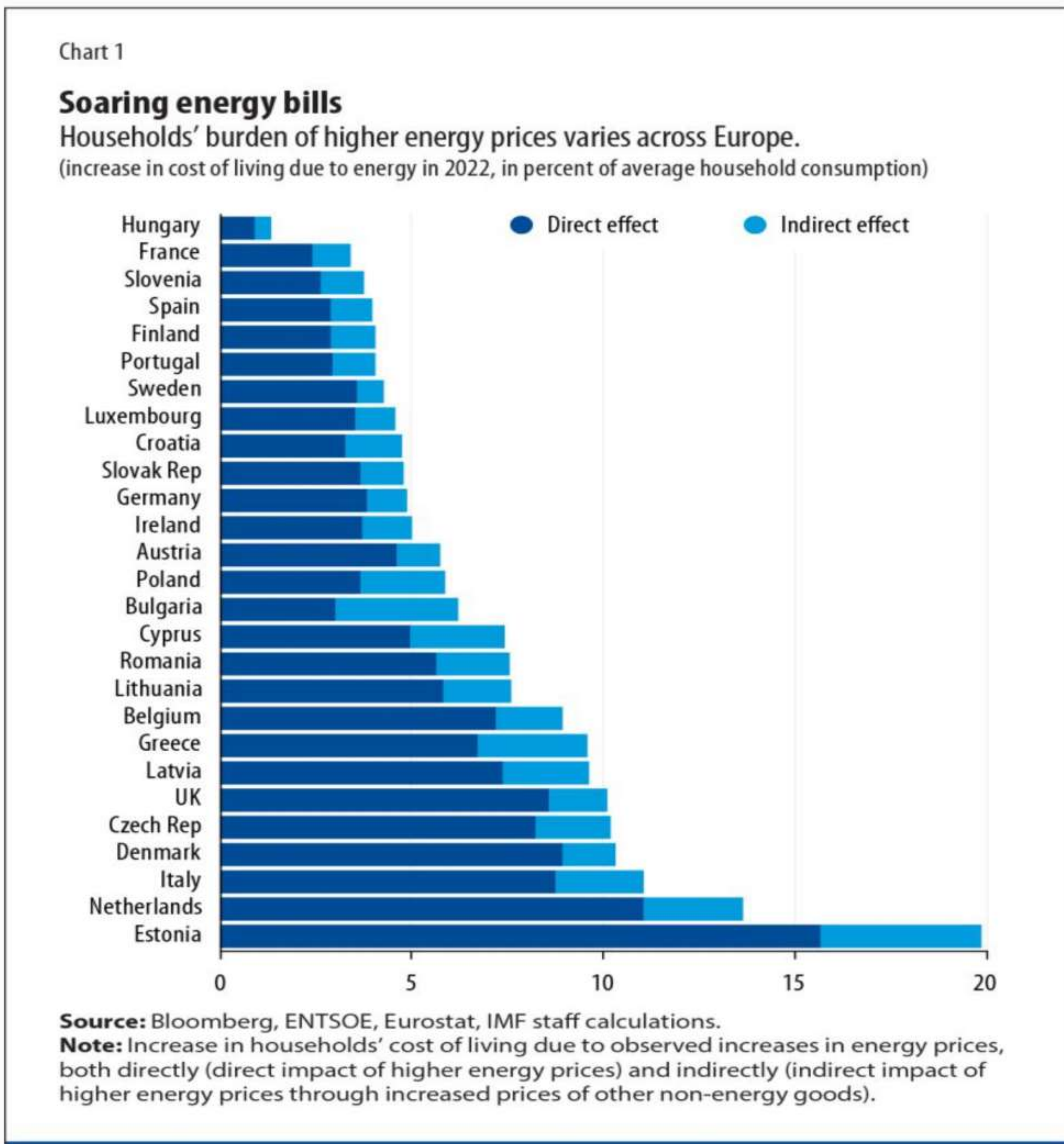
The International Monetary Fund (IMF) on October 11, 2022 forecasted global growth to slow from 6 per cent in 2021 to 3.2 per cent in 2022 and 2.7 per cent in 2023. This globally synchronized deceleration stems from a contraction of GDP in the USA in the first half of 2022, a Euro zone contraction in the second half of 2022, persistent real income squeeze on households and demand together with higher mortgage rates. The Chinese economy has been debilitated by the double whammy of rolling lockdowns post COVID-19 outbreaks and a rising property sector crisis. What makes matters worse is "the lingering effect of three powerful forces: the Russian invasion of Ukraine, a cost-of-living crisis caused by persistent and broadening inflation pressures, and the slowdown in China", thereby raising the spectre of a recession. The toxic mix of spiralling inflation, surging interest rates and the unfolding energy crisis substantiates the recessionary thesis. The magnitude and scale of recession would be a function of imminent changes to taxes, government spending, energy prices and global cues.

The real and worrisome concerns triggered by the triad of Russia's invasion of Ukraine, the cost-of-living crisis and China's economic slowdown make for an economically, geopolitically and ecologically "volatile" period. The grim situation in Europe is reminiscent of "the sick man of Europe".

Ms. Gita Gopinath, the IMF's first Deputy Managing Director stressed that geo-economic fragmentation and protectionism was undermining economic growth, with some 30 countries restricting trade in food, energy, and other commodities since Russia's invasion of Ukraine. All these factors, which deplete resilience of the real economy, strongly suggest that things could get worse before they get any better.

The IMF's Global Financial Stability Report also stressed a deteriorating economic outlook. "The global environment is fragile with storm clouds on the horizon" because of the cumulative effects of China's debilitating "zero-Covid policy" and the disarray in the property market. For emerging markets and developing economies, the shocks of 2022 will "re-open economic wounds that were only partially healed following the pandemic".

Increasing energy prices have raised the cost of living for the average European household significantly. As winter approaches, some of the most vulnerable households in Europe are forced to take a call between heating and eating unless policymakers act-clearly a Hobson's choice.



Recession is on in UK as also candidly admitted by Chancellor Hunt. GDP is expected to rise by 4.2 per cent this year, but fall by 1.4 per cent in 2023 and grow by 1.3 per cent, 2.6 per cent and 2.7 per cent in next 3 years. Inflation is likely to fall from 9.1 per cent this year to 7.4 per cent next year and then fall steeply.

Belt tightening in the UK is reflected in the Chancellor Hunt's fiscal prudence move to reassure financial markets and induce monetary tightening by the Bank of England with crippling impact on the households. With on-going recession likely to last a year, fiscal support for vulnerable households and businesses sorely needed.

These are hard times and a prudent fiscal policy to reduce inflation. IMF shows government policy trade- offs in response to food and energy price spike. The US's experience of late 1980s suggests a restrained fiscal policy; help to vulnerable sections without raising aggregate demand that drive risks raising inflation.

INDIAN MACROECONOMIC BACKDROP

India's growth is here to stay. India will still be the second-fastest growing economy in G20 in FY23 after Saudi Arabia as per OECD. The country is expected to remain a growth outperformer in the medium term with an average GDP growth of 6.6 per cent between fiscals 2024 and 2026, versus 3.1 per cent globally as estimated by IMF. India is expected to drive global growth with doubling of its GDP from $ 3.4 trillion now to $ 8.5 trillion over next decade, accent on investment, exports and employment, GST, corporate tax cuts, PLIs and larger formal economy. This is the way to go.

Tax collections are on a roll. India's total tax collections could surge to ₹ 31 lakh crore- well over budgeted ₹ 27.6 lakh crore in FY 23 because of inflation, better corporate profitability and windfall profit taxes on oil companies. Expanded and broadened tax base is necessary. The National Statistical Office's numbers showed that the economy grew by 6.3 per cent in Q 2 GDP. This 6.3 per cent GDP growth in Q 2 of FY 23 was on expected lines but concerns of monetary tightening, global slowdown and decelerating manufacturing persisted.

Manufacturing contracted by 4.3 per cent. In the April-June quarter, the economy had grown 13.5per cent, primarily owing to a low base in the previous pandemic-hit year. However, 10.4 per cent rise in gross fixed capital formation, 14.7 per cent in trade, transport, hotels, 18 per cent in gross taxes augur well.

Growth in eight infrastructure industries, such as, crude oil, natural gas, refinery products and cement contracted, but the second quarter growth was in line with our expectations. But 4.6 per cent growth in agriculture evoked some discussions. The kharif crop was affected adversely due first to drought conditions and then untimely rains. Possibly, this was offset by the enhanced contribution of livestock, fishing and forestry segments. Other redeeming features of the economy included growth in the services sector and considerably higher private consumption in Q 2.

There has been good GDP growth in India despite global concern. Global economy grew by 2.9 per cent in 2022; to grow by 2 per cent in 2023. The Indian economy is likely to achieve 6.8 per cent growth in FY 23 because of largely domestically driven economy, 13.3 per cent share of exports in India as against 37.4 per cent in China and demographic dividend. But steep decline in exports causes concern. After about 2 years, India' exports turned negative (-16.6 per cent to $ 29.8 billion in Oct.) mainly due to global demand slowdown. Imports rose 6 per cent to $ 56.7 billion because of crude oil, cotton, fertiliser and machinery; trade deficit widened to $ 26.9 billion. Sustained exports growth needed.

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Moderately brisk growth, easing inflation can be substantiated by the Finance Ministry's October report. This report stressed that India would grow moderately briskly because of macroeconomic stability despite monetary tightening, which could reduce stock prices, weaker currencies and higher bond yields enhancing government's borrowing costs. Kharif crops to ease inflation and raise jobs.

There is, however, a sectoral skew in India's growth. Earnings growth in Q2 FY 23 was led by BFSI (banking, financial services and insurance), automobiles and telecom. Banks are on a roll because of surging credit, rising interest rates and significantly reduced NPAs. Metals, oil and gas and select consumer durable firms underperformed restricting the growth of Nifty50 companies. Overall steady growth is on but growth needs to be more broad-based to propel India to a higher and more sustainable orbit.

In this overarching macro-economic and industrial landscape, it is important for Indian companies to focus on steady cash flows; not valuations. Chandrasekaran, Chairman, Tata Sons, stressed that entrepreneurs should focus on steady cash flows rather than valuations. Raising capital to enhance business capability needed. Digital, supply chains, energy transitions and global geopolitics are likely to drive India onwards. Government spending contracted in Q 2. The Centre's fiscal deficit at 45.6per cent of the Budget target in the first seven months of the current financial year reflects a healthy concern for prudent Budget management despite rising expenditure to shore up the economy.

The BSR Sensex reached a record high of 62,887, 23per cent up from the low of 50,921 in mid-June. The significant inflow of foreign portfolio investment, entry of domestic money in the share markets through systematic investment plans and mutual funds and the inculcation of the investment habit among people, especially the younger segment in the wake of the low returns on post office and banking instruments is welcome and needs to be sustained.

Non-food credit growth almost doubled from 8.7 per cent in March 2022 to 16.4 per cent in September 2022. This kind of a pick-up in credit growth is strongly suggestive of the macro-economy gaining traction and-what is more important- persisting high credit demand. Perils of e-banking in India have increasingly come to the fore in India. With Indian banks recording 248 successful data breaches by hackers and criminals, banks must focus on secure credentials, specialised talent, sufficient funds, adequate knowledge and training of staff, secure 3rd party services and streamlining infrastructure. Quick action is needed on this front.

UNSUSTAINABLY HIGH INFLATION ACROSS THE DEVELOPMENT SPECTRUM

In an Address on November 10, 2022, Ms. Kristalina Georgieva, MD, IMF, succinctly summed up the greatly disconcerting situation as follows: "inflation is at multi-decade highs with rising food and energy prices, persistent supply chain disruptions and mounting debt vulnerabilities".

With Russia now delivering less than 20 per cent of 2021 levels, the price of natural gas rose over four-folds and food prices marked by an inflationary spiral. Hence, global inflation could peak in late 2022, increasing from 4.7 per cent in 2021 to 8.8 per cent; remaining "elevated for longer than previously expected."

Eurozone's inflation rose inter-alia because of higher energy and food prices to 10.7 per cent year-on-year in October 2022 from 9.9 per cent in September exacerbating pressure on the ECB to persist with rate hikes despite a diminishing global outlook.

The IMF maintains that global inflation is likely to decrease to 6.5 per cent in 2023 and to 4.1 per cent by 2024 because of tightening monetary policy by almost all central banks to check inflation and the "powerful appreciation" of the U.S. dollar against other currencies.

The US Federal Reserve is likely to hike interest rates by 50 basis points in the December policy, compared to an earlier projection of 75 basis points. This slowdown in interest rate hike is likely after the US Consumer Price Index eased to 7.7 per cent in October from 8.2 per cent in September, many analysts believe. The Federal Open Market Committee (FOMC) has kept a 2 per cent target for inflation over the long run. Since March this year, the US Fed has raised interest rates by 3.75 percentage points. It raised rates by 75 basis points in each of the last four meetings held between May and November, 2022.

INFLATION IN INDIA

India's CPI inflation eased to a three-month low of 6.77 per cent in October, which is the lowest in three months. Food inflation, which is responsible for nearly half the CPI basket, declined by 159 bps to 7.01 per cent. In September, the CPI inflation had accelerated to a five-month high of 7.41 per cent.

It, however, still exceeded the RBI's upper tolerance limit for the tenth consecutive month of 4 per cent (+- 2 per cent) and could, therefore, induce the RBI's Monetary Policy Committee to go for yet another repo rate hike. In October, the consumer price index eased to 6.77per cent but stays above RBI's limit. Inflation had jumped to a five-month high in September to 7.41per cent.

The RBI has hiked the repo rate by 50 bps each in the previous three policy reviews, apart from a 40-basis-point hike in an off-cycle monetary policy in May this year. The RBI has cumulatively raised the key policy rate by 190 basis points in the four back-to-back rate hikes since May to control inflation. By October-end 2022, banks have increased their EBLRs by 190 bps in tandem with the increase in the policy repo rate since May 2022. Further, banks have also increased their 1-year median marginal cost of funds-based lending rate (MCLR) by 85 bps from May to October 2022.

From October 1, 2019, all banks have to lend only at an interest rate linked to an external benchmark, such as RBI's repo rate or Treasury Bill yield. While the transmission of monetary policy has increased, the banks have raised the interest rates on term deposits by a much lower margin. The median term deposit rates (average card rates on retail deposits) on fresh deposits increased by 48 bps from May to October 2022. Banks have increased their bulk deposit rates higher than retail deposit rates. Across bank groups, transmission to lending and deposit rates of private sector banks (PVBs) has exceeded that of public sector banks (PSBs) in the current tightening period.

Credit growth for PVBs has been higher than for PSBs in the current interest rate tightening period beginning May this year. In view of the increase in credit demand, private banks have increased their lending and deposit rates to maintain higher net interest margins (NIMs).

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The CPI inflation is expected to glide down gradually to around 6 per cent by February 2023 and closer to 5 per cent in March 2023 despite the upside risks of rising commodity prices of global commodities, supply disruptions for perishables owing to excess rains, and robust demand for services.

RBI Deputy Governor Dr. Michael Debabrata Patra has said monetary policy can only hope to address future inflation, not today's inflation. Dr. Michael Debabrata Patra stressed monetary policy is by its nature a technical area of economic policy-making and it has to be forward-looking. Preparing monetary policy is a challenging task, especially in a volatile market like the current one where there are lagged data that are also reviewed frequently.

Dr. Patra pointed out "today, inflation is at levels not seen in four decades, impervious to aggressive and front-loaded monetary policy tightening across the world. The existential question being asked is whether the world is permanently shifting from a low-inflation environment to a high-inflation one. The time has come to review the objectives of monetary policy".

Dr. Patra said forecasts can be made into the future, but they are based on backward-looking information from one to three months ago. And they can be thrown off course by unanticipated shocks that hit them in the future. Goal variables were moving over time and so monetary policymakers have to take into account not their known positions but their uncertain future trajectory. "Then they have to shoot forward - getting the angle right is crucial to taking the shot".

In this challenging situation, monetary policymakers sift through an ocean of information - high-frequency indicators; forward-looking surveys; expectations of market participants, professional forecasters, and analysts; econometric models; sentiment analysis based on artificial intelligence and machine learning techniques; all as a part of trying to guess the likely future path of the goal variables.

There was a growing body of work on the new approach of textual analysis that is challenging economists and providing new insights into monetary policy decision-making.

POLICY ACTION

We see an enduring rate hiking process with a hike of 25-35 bps in the RBI's December 2022 Policy. The key policy rate hike this time will be less aggressive (25-35 basis points) as against 50 bps earlier. Despite decelerating growth, inflation in India, as indeed globally, continues to be the overriding concern.

FUTURE POLICY RATE ACTION

We expect that this rate hike would be followed by an extended pause because of the lagged impact of past rate hikes, liquidity tightening, and global macro scenario.

There is also a possibility that the MPC stance may shift from "withdrawal of accommodation" to "neutral".

PATHWAY TO THE FUTURE

Cognizable policy dilemmas involved in the testing financial stability environment bring to the fore the distinct possibility of further shocks triggering "market illiquidity, disorderly sell-offs, or distress". This unenviable situation would exacerbate poverty and deprivation and accentuate inequalities in distribution of income and wealth.

The IMF also highlighted that the risk of monetary, fiscal or financial policy "miscalibration" had "risen sharply," while the world economy "remains historically fragile" and financial markets are "showing signs of stress".

"The cumulative tightening of monetary policy" suggests a continued higher upward bias on interest rates though at a slower rate. While "front-loaded and aggressive monetary tightening" is needed, a "large" downturn is not "inevitable" because of tight labor markets in the U.S. and U.K. In the ultimate analysis, fiscal policy should work in tandem with monetary policy to contain inflation within manageable proportion in the overarching context of rising interest rates, sliding growth and volatile environment.

Heightened geopolitical tensions-Russia-Ukraine war, volatile prices of oil and gold; overleveraged non-financial sectors, viz., exchange rate volatility; elevated debt levels among governments, businesses and households; losses of jobs and incomes hamper global rebound and raise worrisome concerns of mounting global debt, risks to financial stability and resilient financial system.

Going forward, the pursuit of reduced inflation and a prudent fiscal policy requires successfully straddling conflicting policy choices and adroitly manage trade-offs. The lurking fear of stagflation necessitates robust growth, stronger macroeconomic frameworks, reduced financial vulnerabilities, and provision of safety nets to vulnerable groups to alleviate the impact of rising food and fuel prices without aggravating inflationary pressures and swerving away from the well-defined course of monetary policy.

INDIAN LANDSCAPE

In the evolving global order, which is certain to be characterized by a clear re-set, India is likely to surge ahead because of its rising size and scale making it the third-largest economy by 2027, with its GDP more than doubling from the current $3.4 trillion now to $8.5 trillion over the next decade, an accent on investment, exports and employment, GST, corporate tax cuts, production-linked incentives (PLIs) and progressively rising formal economy. India's market capitalization will surge from $3.4 trillion to $11trillion by 2032, the third largest globally because of compelling domestic and global factors, viz., a paradigm shift from redistribution to investment and job creation. Tailwinds include the rolling out of the goods and services tax (GST), corporate tax cuts, ascendant middle class and production-linked schemes (PLIs) to incentivize investment, catalyzing employment into the formal sector and enhancing productivity growth, thereby creating a virtuous cycle of sustained growth.