RBI nudges for growth in monetary policy

Fiscal measures, however, may be necessary to offset the structural challenges

Executive Summary:

Acuité Ratings believes that the Government needs to consider fiscal measures to revive the growth momentum of the economy, which has witnessed a significant slowdown over the last six months. RBI has already adopted important steps to reverse the impact of the slowdown through an intensely accommodative monetary policy, along with regulatory tweaks to incentivise bank lending. However, the structural challenges in monetary transmission and heightened credit aversion are important challenges that need effective remedies. Therefore, timely fiscal measures may be necessary to improve the consumption and investment climate, and to put back the economy in the growth orbit of 7-8 per cent.

Clearly, a global slowdown is evident with almost all the major developed and emerging economies recording a decline in GDP growth in the first two quarters of the current calendar. Heightened trade conflicts, particularly between USA and China, Brexit overhang in the European Union and the geo-political risks from re-imposition of sanctions on Iran are some of the key factors that have aggravated the global slowdown. Some of these economies have already begun to pursue a vigorously accommodative monetary policy with quick rate cuts and ample liquidity infusion.

The headwinds in the Indian economy are also increasingly visible with the latest figures of IIP (index of industrial production) slowing down to 3.6 per cent in Q1FY20 as compared to 5.1 per cent in Q1FY19. Acuité Ratings has revised its growth forecast for India downwards to 6.9 per cent for FY20 given the data emerging from the high frequency indicators. Nevertheless, the other key macro-economic parameters for the Indian economy remain fairly stable mainly the inflation rate, the current account deficit and the foreign exchange reserve position. This, in our opinion, enables the government to adopt a few fiscal measures to rev up the economy. While the fiscal deficit target for the current year is at 3.3 per cent, there is a strong case for relaxation on this matter.

The need for fiscal measures arises all the more given the structural challenge today in effective monetary transmission and the increasing credit aversion among the banker and the investor community. The continuing large NPA overhang and the health of the banking sector is making rate transmission difficult, as evident in the modest rate cuts being effected by the banks in response to RBI's measures. Further, it has also built a credit aversion in the system accentuated by a few large defaults in the debt capital markets. This continues to slow down credit delivery to the corporate and the MSME sectors. We are of the opinion that the Government should mull steps such as tax incentives for key sectors and a rapid step up in infrastructure investments to improve the consumer and investor sentiments; thereby, helping rebuild the growth momentum.

Acuité Ratings believe that RBI has adopted significant steps to reverse the increasing impact of the economic slowdown witnessed in India over the last six months. An intensely accommodative monetary policy along with regulatory tweaks to incentivise bank lending should help to improve the consumption and the investment climate. With the fourth repo rate cut of 35 bps, the aggregate reduction has been to the extent of 110 bps in the current calendar year; leading to the benchmark 10-year government bond yields dropping from 7.5 per cent to 6.4 per cent during this period (Feb – August 2019). However, the structural challenges in monetary transmission and the heightened credit aversion are important challenges that need effective remedies.

RBI's Monetary Policy Committee (MPC) has decided to cut the repo rates by 35 bps during its third bi-monthly meeting in the current fiscal. Hence, the repo rate now stands at 5.40 per cent, while the reverse repo stands at 5.15 per cent; the accommodative stance has not only been maintained but also further reinforced. Importantly, the unconventional figure of 35 bps reflects RBI's strong intent to signal a lower interest rate regime and its confidence in medium term stability of inflation rates.

Global Slowdown

The Monetary Policy Committee (MPC) has been cognisant of both domestic as well as external developments that have constrained economic growth. Global slowdown has been clearly a source of concern, in the backdrop of China-US trade conflict and the oil price risks emanating from political implications of the Iranian nuclear deal reversal. The global slowdown is so extensive that almost all DMs including US, Japan, UK and European Union have recorded subdued GDP expansion in Q2, and fixed investment outlook has been less than optimal. The same trend has been witnessed in EME peers such as Russia, Brazil and China. The latter, which today plays an important role in the global economic landscape, has been significantly impacted given the trade war escalations and yuan devaluations, which are eating into country's export earnings. Consequently, the global monetary policy remains benign with most central banks maintaining an easy monetary stance. The situation is characterised by falling yields on capital and money market issuances and in general, a high liquidity environment.

Domestic Growth Headwinds

On the domestic front, the economic slowdown is increasingly evident across sectors. In terms of industrial output, a slowdown is witnessed in both manufacturing as well as services. Industrial output as recorded by the IIP has shown moderation in most categories, including capital goods, consumer durables as well as construction activity. The eight core industries, which are roughly 40 per cent of the IIP have also portrayed a suboptimal expansion, primarily constricted by cement, petroleum refining, crude oil and natural gas. While the OBICUS survey suggests that capacity utilisation levels are near normal at 76 per cent, signs of capital expenditure are still weak. The weakened demand for consumer durables such as vehicles and electronics as well as a contraction in construction activity has been detrimental to India's service-oriented economy. Interestingly, the PMI for both manufacturing and services, however, showed signs of recovery in July on the back of new orders and employment opportunities.

While the MPC did not sound alarmed at the slowdown, it remained unconvinced about the short-term nature of the current cycle. Accordingly, the expected growth for FY20 has been further trimmed to 6.9 per cent from the erstwhile 7.0 per cent. The figure is in line with Acuité's revised growth projections for the year. H1 FY20 growth has been therefore estimated to be in the range of 5.8-6.6 per cent and 7.3-7.5 per cent in H2. The lack of visibility on the capex cycle as well as the continuing asset quality problem in banks can be termed as possible reasons behind this retraction.

Inflation under control though with some upside risks

The most significant factor behind the unanimity on the rate cut decision has been the benign Consumer Price Index (CPI) figure, which has remained well within its target of 4 per cent. It is noted that inflationary tendencies continue to be submissive as both core and non-core numbers have remained passive. While CPI overall increased by 20 bps in June and food inflation rose by 40 bps to 2.4 per cent, thanks to certain food categories, fuel and core segments contracted. Protein-based food categories deserve a special mention given their upward pressure on the overall index. A rise in inflation of protein-based food items symbolises healthy consumption demand in discretionary categories. Amid slowdown fears, it is indeed heartening to note this development.

However, RBI's forward surveys on the other hand reveal that the consumer/ household expectation of inflationary tendencies remains low. In a six-month period, the expectation remains unchanged but diminishes by 20 bps in a one-year horizon. The normalisation of monsoon, especially in the second half has been a comforting factor for the committee and has played a significant role in the formulation of its favorable outlook on this front. Acuité nevertheless believes that there may be a moderate pressure on food inflation in the near to medium term since the acreage under cereals and pulses have dropped significantly in the current Kharif season, given the initial uneven distribution of rainfall; however, no sharp upsurge is likely in food inflation given the stocks from the years.

Adequate system liquidity

Post general elections, the money supply (M3) has been slowly treading back to normal levels as systemic liquidity returns. In the timeframe, via the Liquidity Adjustment Facility (LAF) and the Open Market Operations (OMO), the RBI has absorbed over Rs. 3.8 Lakh Cr of systemic liquidity between June and August. Meanwhile, in June there was an infusion of durable liquidity to the tune of Rs, 27,500 Cr, taking net absorption in the vicinity of Rs.3.52 Lakh Cr. There have also been instances of commercial banks drawing down their excess reserves with the RBI as apparent by the declines recorded in the M2.

Considered a credible gauge of liquidity, the Weighted Average Call Money Rate (WACR) has been found to be below the policy rate since June and expected to maintain a positive differential. This signifies surplus liquidity in the system and improving credit to deposit ratio. With a collective rate cut of over 110 bps of so far, the committee is positive about better transmission in the coming months and expects the Weighted Average Lending Rate (WALR) to come down further.

Key Structural Challenges

However, there are two structural challenges which need to be addressed for monetary policy measures to be truly effective. One is clearly the inherent constraints in the monetary transmission mechanism in our financial ecosystem. As reported by RBI, the actual rate revision in bank advances has only been to the extent of 29 bps as compared to 75 bps repo rate cut over the period Feb - July. Given the NPA scenario in banks and the high provisioning costs, they are firstly hesitant to reduce the spreads they charge to their borrowers particularly in the corporate and MSME sector. Secondly, it is a challenge to reduce the bank deposit rates in India as small savers depend on interest income and may switch to the Government savings schemes if the interest rate differentials increase further. While the linking of deposit rates with benchmark rates can help in better monetary transmission, its implementation by RBI and the banks may not be an easy task particularly in a declining interest rate regime.

The second, which has assumed increasing relevance in the current environment, is the increased risk aversion among bankers and investors. Although the credit growth in the system is reported at 12.2 per cent yoy, it has been largely due to the substitution of bond and Commercial Paper (CP) of high quality credits; the market of which have seen a material slowdown. With the NPA crisis in the background and headwinds in certain sectors such as NBFCs and the auto sector, the banks are wary of taking fresh exposures in corporates that are not rated very highly. The investors such as mutual funds have also cut down their investments in private sector papers, given the overhang of potential losses in some credit funds. The emerging data on slowdown is further aggravating the credit aversion in the system.

New lending push

RBI has attempted to address such lending aversion by providing several incentives to banks to step up their lending activity. The exposure limits to single NBFCs has been increased to 20 per cent of the tier 1 capital of banks in line with that of other sectors as compared to 15% per cent earlier. Further, bank lending to NBFCs for lending to the SME, agriculture and the housing sector in the ticket size up to Rs. 20 lakhs have been included in priority sector definition. This is expected to incentivise the banks to push up their lending to the NBFCs, particularly to the smaller ones that lend to SMEs and affordable housing. Another step has been to reduce the risk weight for consumer loans to 100 per cent from 125 percent, which can prompt banks to step up their exposure to retail loans either directly or through loan buy-outs from NBFCs.

Fiscal measures, however, need of the hour

Acuité believes that the monetary policy steps announced by RBI have to be complemented by a few targeted fiscal measures to invigorate the economy. The auto sector, for example, may require suitable incentives to sustain itself given its contribution to GDP and employment. The real estate sector which has particularly witnessed a gradual slowdown over the last few years, may need a push to add to the efforts already made by the government to encourage affordable housing. The infrastructure investments proposed in the Union Budget 2019 also need to be in a fast forward mode. This will have a positive impact on the economy through higher cement and steel consumption as well as employment generation.

About Acuité Ratings & Research Limited:
Acuité Ratings & Research Limited *(Erstwhile SMERA Ratings Limited)* is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 6000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Mumbai.

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