Infomerics Valuation And Rating Pvt. Ltd.

SEBI REGISTERED / RBI ACCREDITED / NSIC EMPANELLED
CREDIT RATING AGENCY

Dr. Manoranjan Sharma
(Chief Economist)

RBI'S DECEMBER POLICY: ON THE HORNS OF A DILEMMA

04 December 2024

In the last few years, the RBI has largely been following a data-driven and evidence-based approach in its pursuit of a contextually relevant Policy, a Policy stemming from the concerns at the time of formulation and an attempt to arrive at judicious Policy prescriptions. With an uncanny ability to connect the dots and draw meaningful inferences, it is not difficult to predict the shape of things likely to come as I have done repeatedly for the last several years.

But this time is different, the choices are not so stark and we are confronted with the cognizable Shakespearean dilemma of "to be or not to be". No wonder, then, opinion about the Policy move is divided: some believe that a rate cut is necessary to shore up a flagging economy; others maintain that given the ravages of the inflationary spiral, an unchanged rate would best serve the objectives of the central bank.

Be that as it may, let me share my perception of the global cues and the macroeconomic setting. For, the decisions of the central bank are seldom made in isolation, in silo; they are part of a broader holistic framework, banking is India in microcosm. Let us hit the high spots for a comprehensive assessment and perspective.

Global Scenario

The global economy is characterized by imminent uncertainty. It has been hit by geopolitical fractures, economic fragmentation, financial turbulence, significant central bank interest rate hikes to restore price stability, and a withdrawal of fiscal support amidst higher debt-to-GDP ratios and unsustainable debt dynamics. The US economy's performance has been solid, with the real gross domestic product (GDP) increasing by 2.8 % in Q3 of 2024 compared to a 3.0 % increase in Q2 of 2024. The increase in the Q 3 largely stemmed from increases in consumer spending, exports, federal government spending, and business investment. Imports also rose.

Interest rates in the United States at 20-year highs fell steadily from their peak in 2022, inducing the Fed to reduce its key rate by a half-point in September and a quarter-point in November. The Fed indicated in September that it expected to announce another quarter-point cut later this month. Yet inflation continues to exceed the Fed's target level, making things uneasy. In October, "core" inflation, which excludes volatile food and energy costs, rose 2.8% year-on-year, up from 2.7% in September. The dollar has appreciated sharply against other world currencies.

To be sure, there is no imminent threat of a systemic debt crisis but the susceptibility of low and middle-income countries to high debt servicing costs may be tested. Despite these and other concerns of considerable contemporary significance, the global economy has been resilient at 3.2 % during 2023 and 2024 and 3.3 % in 2025.

With the global economy defying fears of stagflation or recession, there are reasons for concern but not for alarm in the disruptive scenario of today's VUCA (volatility, uncertainty, complexity, and ambiguity) world characterized by the growth of technology, increasing globalization with rising protectionism, the Russia-Ukraine war, the Middle Eastern situation, and President-elect Donald Trump's tariff threats.

Decelerating GDP Growth

India has successfully transitioned from a part of the 'Fragile Five' a decade ago to a 'bright spot' in the global economy. With decelerating growth, low investor confidence, a dozen Indian billionaires going bust, and unsustainably high and mounting defaults and delinquencies, the Indian economy was on the edge of the precipice. Things have turned around now and there is an upswing in the Indian economy. India has been the fastest-growing major economy for the third successive year. India contributed 16 % to the global growth in 2023. India's growth rate of 7.2 % in FY 23 was the second-highest among the G20 countries and almost twice the average for emerging market economies (EMEs) that year.

A digital revolution, a renewed capex cycle, a well-capitalized banking system, robust credit growth, an upturn in the housing sector, rising domestic consumption, robust investment, growing services exports, and "digitalization-driven productivity gains" are force multipliers. India would consolidate its global heft through important transformative drivers on demand (consumer boom, ascendant middle class, and green transition) and supply (demographic dividend, greater access to finance, and streamlined infrastructure - both physical and digital). Thus the remarkable Indian odyssey is well on course to achieve its rightful place in the comity of nations.

With no possibility of recession, reflecting macroeconomic resilience and dynamism, India is at a crossroads. At this defining moment, India has to simultaneously focus on maintaining macroeconomic stability and carrying forward structural reforms meaningfully and effectively. This process has strengthened India's economic resilience despite global headwinds and structural obstacles.

But there are persisting challenges to enhance the share of manufacturing in India's GDP vis-a-vis average in low and middle-income countries; adequately capitalize on the inherent labor and skill cost advantages to develop large-scale labor-intensive manufacturing; simplify complex land and labor laws; provide productive employment and to absorb out-migration of labor from agriculture; strong macroeconomic fundamentals including low and stable rates of inflation and a falling fiscal deficit. Structural reforms must drive economic reforms, and inclusive growth and address health, education, and employment concerns.

Sustained demographic dividend, services export opportunities, domestic demand potential, increasingly assertive middle class, and India's emergence as an attractive investment destination provide tailwinds for the Indian economy. Strengthened physical sector, viz., highways length, reduced peak energy deficit, improved logistics efficiency, a renewed thrust on exports and investments strengthen macroeconomic growth.

Leading development indicators include robust tax collections; higher corporate bond issuance suggesting business recovery; capital market levels; core sector output; and forex reserves. Hence, India could grow sustainably by 7-8 % over the long haul.

Against this canvas, India's GDP grew at a seven-quarter low of 5.4 % in July-September, 2024 (lower than 8.1 % growth in July-September, 2023 and 6.7 % in April-June, 2024) and caused some skepticism about the realizability of the RBI's upward revision of growth estimates to 7.2 % % in June from 7 % in April for FY 25. This deceleration occurred largely because of infirm manufacturing (deceleration to 2.2% growth year-on-year in July-September versus 7% growth in April-June), electricity and gas production, and contraction in mining. Weak urban consumption following a rise in food prices despite rising government spending and a "shrinking" middle segment causes concern. There were also factors like dropping company profits, falling wages, and inflation.

While this GDP growth is below the expectation of about 6.5 % growth in Q2, it is a temporary blip because of the forthcoming impact of healthy kharif sowing, good prospects for rabi crops, restored reservoir levels, rising government expenditure, and the festive season upswing. There could also be a recovery in rural demand because of robust agricultural performance and surging government spending. Hence, this is not a structural retrogression of any kind. Hence, there is no reason for alarm and India is well on course to achieve a GDP growth of over 6.5 % in FY 25. India remains among the fastest-growing major economies. Decelerating GDP growth would, however, make the RBI's task of adroitly managing the growth-inflation trade-off odious.

Unabating Inflationary Spiral

India's CPI inflation in October 2024 surged to a 14-month high of 6.21 % in October (the third consecutive month of rising inflation) because of a sharp rise in prices of food items, especially fruits, vegetables, meat and fish, and oils and fats. Food inflation rose to a 15-month high of 10.87 % in October from 9.24 % in September, and 6.61 % in the

preceding year. Food and beverages account for 45.86 % of the total weight of the Consumer Price Index (CPI).

What is prognostically alarming is the CPI inflation breaching (except in July and August 2024) the 4 % threshold in the 4+/- 2 % band of RBI's medium-term inflation target for 59 months. This real and worrisome concern led the RBI Governor Shaktikanta Das to stress in the October Monetary Policy Committee (MPC) meeting that the RBI cannot risk "another bout of inflation" necessitating more evidence of inflation aligning durably with the 4 % target.

While the RBI Act mandates price stability in terms of headline inflation i.e., 4 % +/- 2 %, food inflation is not largely amenable to the RBI measures. This preoccupation with inflation targeting has been criticized because of the slackening growth and the need to bolster growth. The Indian situation is markedly different from that of the developed countries, where the accent is on labour income; in India, action on the food price front impacts farmers' terms of trade and thus acquires political overtones.

Role of Banks

Banks are well-capitalized and well-regulated. With the Indian economy gaining steam, bank NPAs steeply declined to a 12-year low of 2.8 %, and net NPAs plummeted to 0.6 % as of March 2024, bank credit is rising. However, risk aversion, stringent underwriting, and credit to MSMEs cause concern. The Scheduled Commercial Bank (SCB) is, however, not a monolithic category; there are significant differences across public sector banks (PSBs) and private banks and even within these two groups.

The Make in India campaign provides an opportunity for banks to diversify their credit portfolio. But banks' credit off-take to manufacturers continues to languish. High manufacturing NPAs hamper channeling bank finance to support this campaign.

Bankers are wary of lending because MSME and Start-up Companies constitute high-risk lending, banks' unfamiliarity with lending to Start-up companies, lending to MSME without collaterals or inadequate collaterals is fraught with perceived risks, persisting issues of low capital base, ineffective management, low-quality products, etc. in MSMEs. This necessitates a sectoral and cluster-based approach in conformity with value chain and cash flow dynamics; and a product design approach.

Since bank credit growth consistently outpaced deposit growth, the RBI initiated several credit and macro-prudential measures, viz., higher risk weights on unsecured personal loans, a discussion paper on higher provisioning for project loans, and steps for digital lending. While these measures were well-intentioned, they reduced the credit growth rate from over 16 % in January to about 11 %. Credit and deposit growth are now largely in sync and both deposits and credit could grow at 11-12% during FY25.

Crystal Ball Gazing-Economic Statecraft

The RBI has kept the repo unchanged at 6.5 % since February 2023 and given the macro-economic landscape, we do not think this is the right time for tweaking this rate. As things stand, a rate cut is conceivable in February 2025.

There is, however, a strong case for a CRR cut to ease liquidity without spiking inflation. This would also provide banks with additional resources to support credit growth and strengthen financial stability.

The gathering growth pangs could induce a 20-30bps cut in the RBI's growth projections for FY25. We also anticipate that the neutral stance will continue.

Note: This article was published in The Economic Times on December 4, 2024.