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RBI'S JUNE 2023 POLICY-LIKELY TO STAY THE COURSE

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Global Perspective

There seems to be a fair measure of consensus across the board about decelerating global growth. The IMF projected global growth to decelerate from 3.4 per cent in 2022 to 2.8 per cent in 2023 with risks heavily skewed to the downside and high chances of a hard landing. Growth could remain at 3 per cent 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 & wealth is needed to perceptibly alter the ground realities.

Gathering storms at the global level were reflected in the US debt crossing the Lakshman Rekha. US debt breached borrowing cap of $ 31.381 trillion on Jan. 19, 2023, an artificially imposed cap that lawmakers have increased roughly 80 times since the 1960s.It was feared that with the US being unable to pay its bills, including interest and other payments, the US government would have been unable to issue new debt and this would have triggered a financial crisis. This unprecedented situation necessitated "extraordinary measures" to avoid a catastrophic default for at least the next few months. Treasury Secretary Janet Yellen wrote in a letter to House Speaker Kevin McCarthy "[T]he period of time that extraordinary measures may last is subject to considerable uncertainty, including the challenges of forecasting the payments and receipts of the U.S. Government months into the future".

The "*extraordinary measures*" included stopping contributions and investment redemptions for government workers' retirement and health care funds, giving the government enough financial space to handle its day-to-day expenses until roughly June. This move caused consternation whether the U.S. can avert a potential economic crisis.

Difficult times are seen ahead; red flags abound. Germany slipped in recession. Higher energy prices contracted Germany's GDP by 0.5 per cent in October- Dec. 2022 and by 0.3 per cent in Jan.-March 2023. Recession is on in Germany, other major economies could follow suit. Recession is, however, ruled out in India in 2023. In case of countries like the USA and the UK, where inflation shot upto a 4/5 decade high, there are some indications of the inflationary pressures subsiding to a limited extent. But going ahead, there could be some pain with greater tightening albeit to a limited extent. The effect of inflation on public finances needs to be clearly examined. The IMF shows inflation temporarily improves fiscal balances because nominal revenues rise but primary expenditures rise with a lag. Inflation spikes also lead to a persistent reduction in debt to GDP ratios.

Asia's economy is expected to grow 5 per cent faster than developed economies by end 2023. Morgan Stanley justifiably maintains that the Asian economies are likely to outperform developed economies by 5 per cent by end 2023 because of banking stress in US and Europe. In this evolving situation, the economies of China, Japan, India and Indonesia are likely to power the Asian growth. The issue of growing global LPG export capacity is of considerable contextual significance. Natural gas is same globally but prices vary sharply because of extraction, transportation & technology. The IMF shows natural gas capacity is likely to rise by 50 per cent in coming years. This would reduce fragmentation in fuel markets and foster greater energy security.

Concerns in Banking and Finance

The collapse of First Republic Bank (FRB) after Silicon Valley Bank & Signature Bank revealed dangers of interest rate risk, perils of concentration risk & need for stress tests. While no systemic risk is seen, eternal vigilance is clearly needed to navigate the difficult times ahead.

Indian Macroeconomic Scenario

India's steady growth is here to stay. With softening inflation, strong macros, healthy corporate sector balance-sheets, structural reforms & sound external sector, growth of 6.5 per cent FY 24 is on. This thesis can also be substantiated by Morgan Stanley's Report entitled *India Equity Strategy and Economics: How India Has Transformed in Less than a Decade*. This Report brings to the fore the cataclysmic changes brought about in India in the last nine years. This Report clearly substantiated the thesis "*this India is different from what it was in 2013. In a short span of 10 years, India has gained positions in the world order with significant positive consequences for the macro and market outlook*". The ten big changes highlighted by Morgan Stanley relate to

1. Supply-side Policy Reforms

2. Formalisation of the Economy

3. Real Estate (Regulation and Development) Act

4. Digitalizing Social Transfers

5. Insolvency and Bankruptcy Code

6. Flexible Inflation Targeting

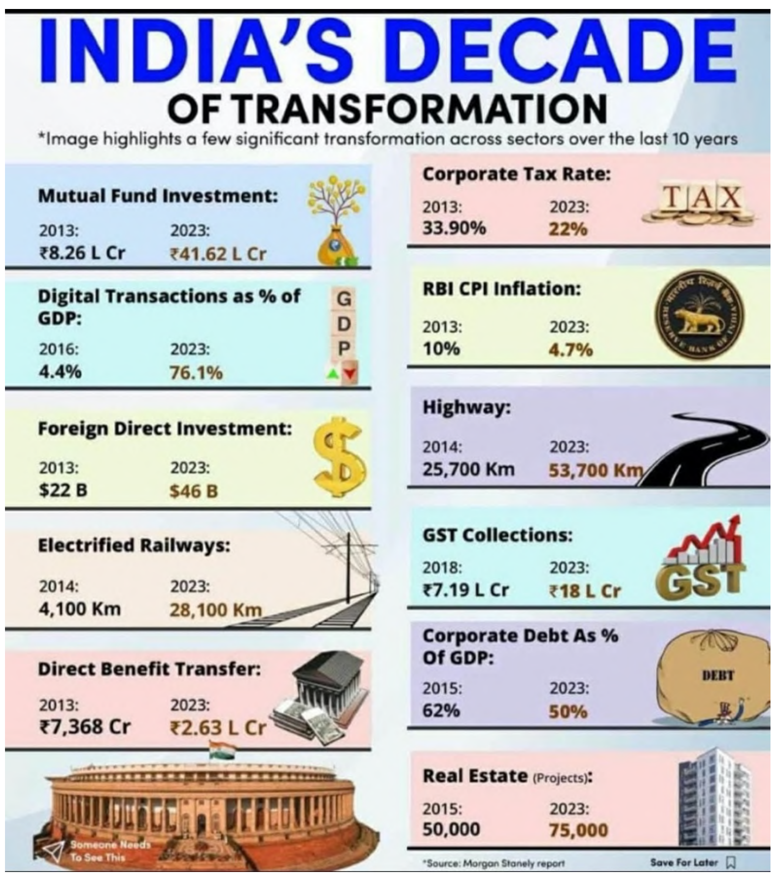
7. Focus on FDI

8. India's 401(k) Moment

9. Government Support for Corporate Profits

10. MNC Sentiment at Multiyear High

Ridham Desai, Managing Director, Morgan Stanley India highlighted that India's corporate tax is now comparable to its peers. He emphasised that infrastructure development has also gained momentum over the past eight years, including the significant expansion of national highways, growth in broadband subscribers, and electrification of railway routes. In terms of the formalisation of the economy, he pointed out that GST collections have been consistently increasing and digital transactions now contribute to over 76 per cent of the GDP. Dr. Desai stressed "*we expect a new cycle in manufacturing and capex, as we estimate the share of both to rise in GDP by approximately 5 ppt by 2031*". He also expects India's export market share to rise to 4.5 per cent by 2031, nearly twice from 2021 levels, with gains across goods and services exports. An increase in India's per capita income will also have major implications for change in the consumption basket, with an impetus to discretionary consumption.



Emerging Gross Domestic Product (GDP) Growth

There seems to be a convergence among multilateral and domestic agencies that India continues to be on a high growth path as reflected in the provisional estimates of the National Statistical Office (NSO) recently, real GDP growth for 2022-23 at 7.2 per cent. Buoyed by robust growth in private consumption and sustained pick-up in private investment, India is certain to be one of the fastest-growing economies in 2023-24. The services sector accounts for well over half of India's GDP. Asia's third-largest economy expanded 6.1 per cent in Q4 making it one of the fastest growing emerging markets.

The uptick in India's GDP growth was largely due to rising investment, particularly the government's capex push. Apart from the increase in government investment, a modest "*crowding-in*" of private investment is likely in FY 24 leading to a multiplier effect on the economy by creating employment, eventually generating consumption demand.

Gross fixed capital formation, which reflects investment, rose 8.9 per cent in Q4 and 11.4 per cent in FY 23 because of the central government's accent on capex and some catching up by states. However, private consumption grew modestly by 2.8 per cent in the fourth quarter. Sequentially, consumption grew just 0.5 per cent in Q 4 after contracting 2 per cent in the previous three months.

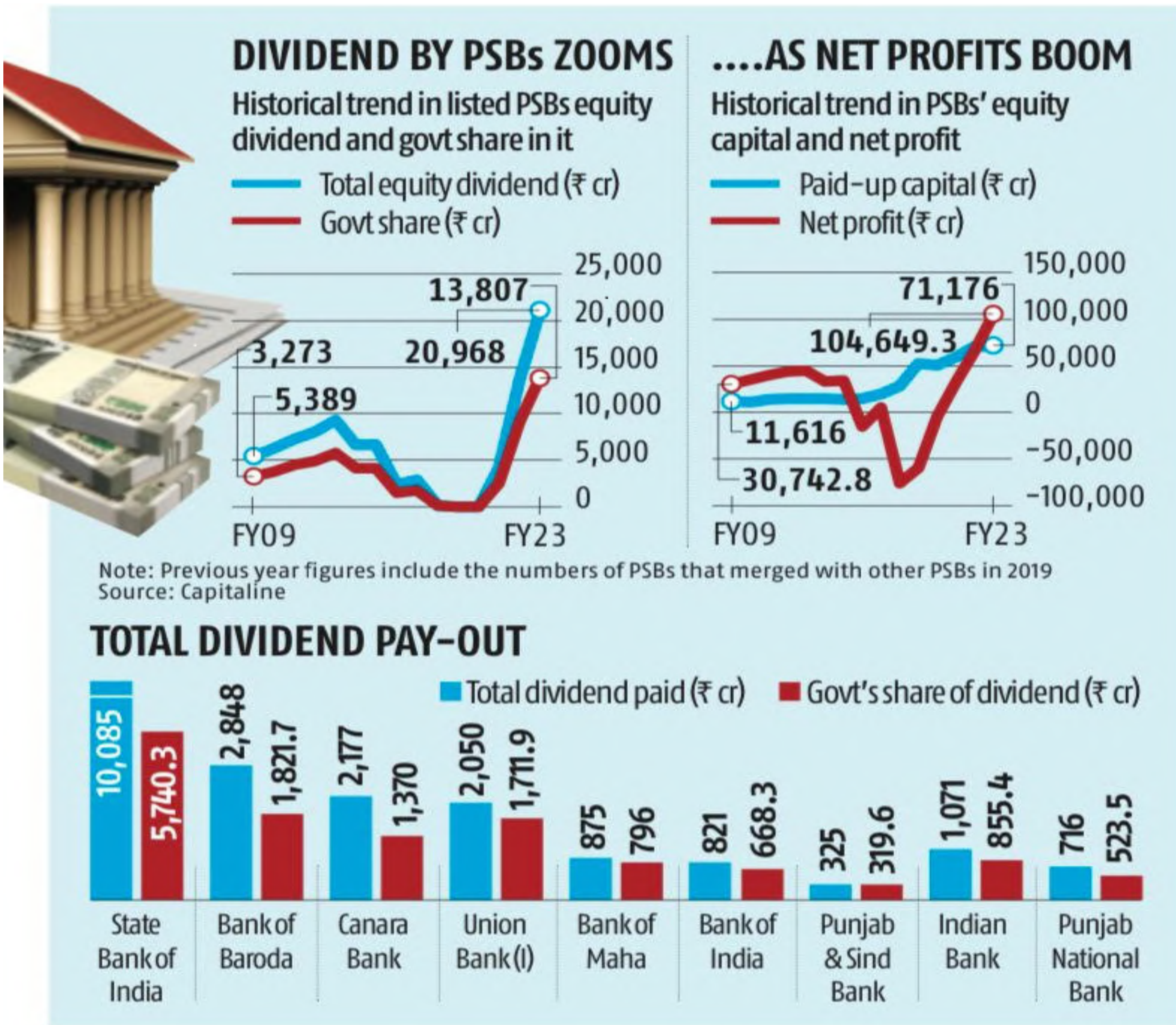
As the RBI Governor Shaktikanta Das pointed out with capacity utilisation in the manufacturing sector rising above 75 per cent, there is evidence of revival of private investment in certain sectors, e.g., steel and cement, engineering and capital goods, infrastructure (ports, airports, highways, etc.) and supply of technology and equipment, and in services sectors like hotels and transport. Resuscitation of private investments was on expected lines as manufacturing companies had used the recent pandemic years to deleverage their balance sheets by forgoing fresh investments. Growth of this order was achieved despite the RBI raising interest rates by 250 basis points since May 2022, in an attempt to contain the inflationary pressures, which breached the RBI's 2 per cent-6 per cent target range for most of 2022.

Other welcome indicators include India's manufacturing PMI rising to a 31-month high in May 2023, moderating raw material prices and the January-March quarter recording the highest-ever commitment of fresh investments totalling ₹ 14.6 lakh crore, spearheaded by private sector outlays of ₹ 10.5 lakh crore. These and other developments need to be looked at in the overarching context of this year's Budget with a record capital expenditure outlay of ₹ 10 lakh crore. Further, the government had slashed corporate tax rates in 2019. Over the last two years, India has also offered incentives on incremental sales to boost local manufacturing across sectors, viz., automobiles, white goods, and pharmaceuticals, to solar photovoltaic modules. Risks of lower rainfall due to El Niño, spike in food prices, decelerating global growth, geopolitical tensions and higher financial markets volatility persist.

The government's focus on capital expenditure in the recent budgets could be effective in stimulating private investment and domestic demand, with beneficial effects accruing over time. The RBI has shown that for public investment, the multiplier on private investment is 1.2 and on the GDP it is 1.7, over a three-year period. There are, however, issues of uncertain demand, inadequate improvement in ease of doing business, difficulty in accessing capital becoming and tighter working capital.

With Foreign Portfolio Investments (FPIs) surging to $ 4.5 billion in FY 24 on May 9, Indian equities outperformed MSCIEM Index by 4 per cent in April. India's 6 per cent steady growth, softening inflation, stable financial sector & recovering capex cycle augur well. Despite welcome rise in FPIs, stagflationary concerns across countries, sticky inflation and consequently monetary tightening in several countries, reduced FPIs in Taiwan, S. Korea, etc. cause concern. With relatively fair valuations, robust FPI inflows are likely to persist.

In a sagacious move, the RBI's gold reserves reached 794.64 tonnes. In line with moves of other Central Banks, the RBI's gold reserves rose by 5 per cent in FY 23 to reach 794.64 metric tonnes since gold is widely considered a more safe, secure & liquid asset to safeguard its return amid global uncertainty and rising inflation.



Inflation

Retail inflation is likely to move south in May 2023 from the 18-month low of 4.7 per cent in April 2023 despite the rise in milk and pulse prices as food prices dipped sharply. It thus remained within the RBI's comfort zone of 2-6 per cent for two consecutive months. The RBI is mandated to keep CPI at 4 per cent with a band of +/- 2 per cent.

Retail inflation is projected to moderate to 5.2 per cent in FY 24 in India as estimated by RBI in its April Monetary Policy meeting; with Q1 at 5.1 per cent; Q2 at 5.4 per cent; Q3 at 5.4 per cent; and Q4 at 5.2 per cent. While the GDP growth for FY 24 is projected to be at 6.5 per cent, it is likely that we may be in for an upgrade in the GDP growth numbers.

Surplus Liquidity

The RBI is likely to remain focused on its stance of 'withdrawal of accommodation' as liquidity conditions have turned surplus. The liquidity condition in the banking system has improved because of the deposit of ₹ 2000 banknotes which were withdrawn from circulation last month, higher government spending and the RBI's intervention in the forex market. On June 2, the net liquidity surplus in the banking system stood at ₹ 2.37 lakh crore.

RBI Repo Rate Changes 2023 -2005

Repo rate is defined as the rate of interest at which the RBI lends money to commercial banks. "Repo" stands for Repurchase Agreement or Repurchasing Option. Banks avail loans from the RBI by selling eligible securities. An agreement between the central bank and the commercial bank will be made to repurchase the securities at a price that is predetermined. This is done when banks face a shortage of funds or need to maintain liquidity in volatile market conditions. The RBI uses the repo rate to control inflation rates. The change in repo rate in India since October 2005 can be summed up as follows:

Effective Date	Rate	%Change
8 February 2023	6.50%	0.25%
7 December 2022	6.25%	0.35%
30 September 2022	5.90%	0.5%
5 August 2022	5.40%	0.5%
8 June 2022	4.90%	0.5%
May 2022	4.40%	0.4%
09 Oct 2020	4.00%	0.00%
06 Aug 2020	4.00%	0.00%
22 May 2020	4.00%	0.40%

27 March 2020	4.40%	0.75%
6 February 2020	5.15%	0.25%
07 August, 2019	5.40%	0.35%
06 June, 2019	5.75%	0.25%
04 April, 2019	6.00%	0.25%
07 February, 2019	6.25%	0.25%
01 August, 2018	6.50%	0.25%
06 June, 2018	6.25%	0.25%
02 August, 2017	6.00%	0.25%
04 October, 2016	6.25%	0.25%
05 April, 2016	6.50%	0.25%
29 September, 2015	6.75%	0.50%
02 June, 2015	7.25%	0.25%
04 March, 2015	7.50%	0.25%
15 January, 2015	7.75%	0.25%
28 January, 2014	8.00%	-0.25%
29 October, 2013	7.75%	-0.25%

20 September, 2013	7.50%	-0.25%
03 May, 2013	7.25%	-0.50%
17 March, 2011	6.75%	-0.25%
25 January, 2011	6.50%	-0.25%
02 November, 2010	6.25%	-0.25%
16 September, 2010	6.00%	-0.25%
27 July, 2010	5.75%	-0.25%
02 July, 2010	5.50%	-0.25%
20 April, 2010	5.25%	-0.25%
19 March, 2010	5.00%	-0.25%
21 April, 2009	4.75%	0.25%
05 March, 2009	5.00%	0.50%
05 January, 2009	5.50%	1.00%
08 December, 2008	6.50%	1.00%
03 November, 2008	7.50%	0.50%

20 October, 2008	8.00%	1.00%
30 July, 2008	9.00%	-0.50%
25 June, 2008	8.50%	-0.50%
12 June, 2008	8.00%	-0.25%
30 March, 2007	7.75%	-0.25%
31 January, 2007	7.50%	-0.25%
30 October, 2006	7.25%	-0.25%
25 July, 2006	7.00%	-0.50%
24 January, 2006	6.50%	-0.25%
26 October, 2005	6.25%	00.00

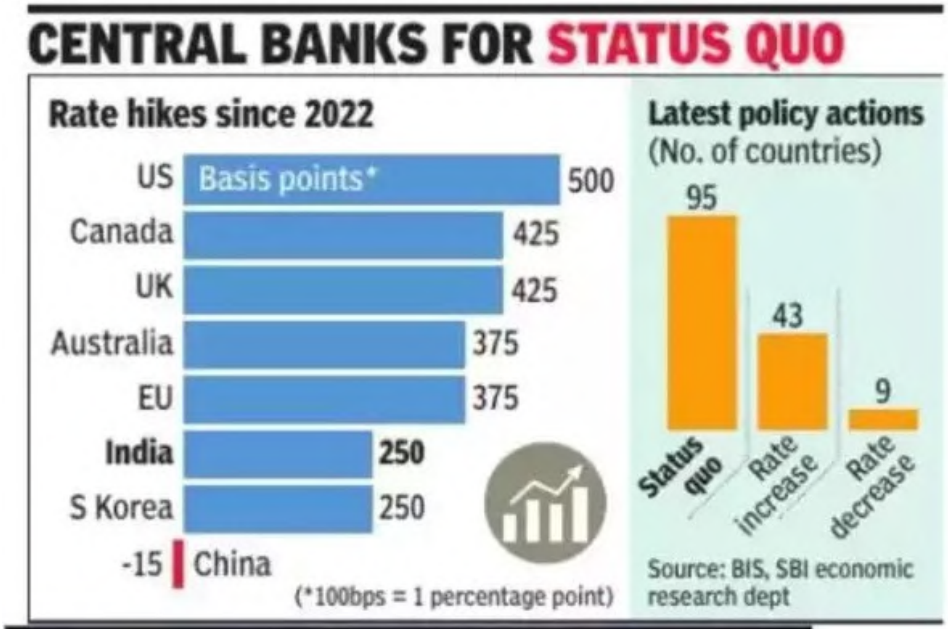
The Repo rate is used by the RBI to check the flow of money in the market. When the market is hit by inflation, RBI increases the Repo rate. An increased Repo rate denotes that the banks who borrow money during this period from the RBI will have to pay higher interest. This discourages the banks to borrow money, which in turn, reduces the supply of money in the market and helps negate the inflation. Similarly, the Repo rates are decreased in the case of a recession.

The interest rate that the RBI offers to commercial banks that deposit money in the RBI treasury is known as the reverse repo rate. Repo rate always exceeds the Reverse repo rate.

Marginal Cost of funds based Lending Rate (MCLR) is a reference rate which is used internally for ascertaining the interest rate which can be levied by the banks on loans. But the Repo rate is an interest rate which is determined by the RBI and charged against the funds lent by the RBI to commercial banks and all other financial institutions.

Why Pause?

Almost all central banks hiked rates since April 2022 with the cumulative hikes being US 500 bps, Hong Kong 450 bps, Canada 425 bps, UK 425 bps, Australia 375 bps and EU 375 bps.



Since the RBI had already raised rates by 250 bps since May 2022 and 135 bps higher than the pre-pandemic repo rate of 5.15 per cent; the dip in **CPI** inflation from a three-month high 6.52 per cent in January 2023 to 6.44 per cent in February 2023; and the "*downside risks from financial stability concerns*"- "*unprecedented uncertainties in geopolitics, economic activity, price pressures and financial markets*" (e.g., banking turmoil manifested in the crash of the Silicon Valley Bank, Credit Suisse Group AG), it refrained from any such hike in April 2023 even though inflation continued to breach the tolerance level of 6 per cent.

Barring the April pause, the RBI raised the repo rate by 250 basis points cumulatively to 6.5 per cent since May 2022 to check the inflationary spiral. Raising interest rates is a monetary policy instrument that typically helps suppress demand in the economy, thereby helping the inflation rate decline.

Crystal Ball Gazing

We expect the RBI to maintain status quo on the Repo rate, the stance continued withdrawal of accommodation and a downward revision of the inflation rate because of the evolving growth-inflation trade-off.