State of the Economy

RBI Bulletin May 2022

Clouds of geopolitical conflict in Europe shroud global economic prospects, with volatile commodity prices and supply chain disruptions worsening the outlook. Heightened inflationary pressures have prompted central banks to tighten rates, leading to elevated risk averse behaviour by investors in emerging economies (EMEs). The International Monetary Fund (IMF) in its April 2022 release of the World Economic Outlook (WEO) cut its global growth forecast for 2022 relative to its January 2022 projection by 0.8 percentage points to 3.6 per cent. Inflation is expected to surge higher in contrast.

The Indian economy consolidated its economic recovery in contrast to global trends, with uptick in its high frequency indicators, including record collection in goods & services tax (GST). Inflation pressures however became more widespread across commodity groups, causing the Monetary Policy Committee (MPC) to raise its policy rate by 40 basis points (bps) to 4.4 per cent. Coupled with the RBI's decision to increase the cash reserve ratio (CRR) by 50 bps to 4.5 per cent, this is estimated to suck out ₹87000 crore from the banking system, emphasizing the withdrawal of accommodation in the policy stance.

The World Bank's commodity outlook forecasts a sharp increase in commodity prices through 2022. Global activity indicators took a downturn across sectors, primarily reflecting the lockdown in China. On the trade front, the World Trade Organization (WTO) also scaled down its projection for merchandise trade volume growth to 3 per cent, from 4.7 per cent earlier. Plans to phase out Europe's dependence on Russian oil led to upward price pressures on the commodity prices. Gold prices received a boost from safe haven demand and inflation hedge from investors. Wheat and corn prices remained elevated due to export restrictions from several countries in the wake of the Ukraine-Russia conflict.

Global equity markets have seen widespread selloffs since the beginning of April over uncertainty regarding the pace of unwinding by the major central banks. Bond yields in the US have hardened at both the short end and long end of the yield curve, flattening it. The US dollar also appreciated due to the Fed's continued hawkish stance, while major EME currencies depreciated due to capital outflows. Monetary policy actions and stances appear to be synchronising across countries, with more AE and EME central banks undertaking rate hikes. Downside risks to global growth have increased alongside upside risks to global inflation rising the spectre of stagflation in several countries. For EMEs, the outlook is fragile, and employment and output could remain below pre-pandemic levels through 2026 reflecting deep scarring.

Domestic macroeconomic conditions continued to gain strength as activity started to normalise in spite of a pick-up in COVID-19 infections in some parts of the country since the second fortnight of April. Signs of recovery in overall demand conditions has broadened. Semiconductor shortages, high metal prices and lockdown in China lengthened waiting times for passenger vehicles in April 2022. Consequently, domestic sales of passenger vehicles moderated. Rural demand strengthened with the farm sector anticipating normal monsoons. On the external front, India's merchandise exports registered a robust growth of 30.7 per cent. Export growth was broad-based, as 8 out of 10 major commodity groups accounting for around 70 per cent of exports grew on a y-o-y basis. Import growth was also broad-based, as 9 out of 10 major commodity groups accounting for more than 75 per cent of imports recorded an expansion on a y-o-y basis.

The agriculture and allied sector is poised to perform well in the forthcoming Kharif season, with the official forecast of a normal south-west monsoon (SWM) and the increase in non-urea fertiliser subsidy announced by the Union Government. Wheat procurement during the Rabi Marketing Season (RMS) 2022-23 so far (since April 2022) has been lower, reflecting the loss in yields due to an early summer onset, private traders' procurement, farmers selling in agriculture wholesale markets (mandis) and farmgate sales to meet the strong export demand from Egypt, Turkey and other African countries. Consequently, the Central government decided to restrict export of wheat, except in case of irrevocable letter of credit and requests from neighbouring / food-deficit countries.

Headline CPI inflation rose to 7.8 per cent in April from 7.0 per cent in March on account of an acceleration across all major groups. Food and beverages inflation was the main driver, while fuel inflation also increased sharply. Liquidity conditions evolved in line with the overall stance of monetary policy, with the focus on withdrawal of accommodation as set out in April policy and reinforced through the repo rate and CRR increases. The bulk of surplus liquidity was mopped up through variable rate reverse repo (VRRR) auctions. Overnight money market rates firmed up towards the SDF rate, with the tri-party repo rate briefly breaching it. The interest rates on 3-month certificates of deposit (CDs) and 3-month commercial paper (CP) after softening intermittently in the second half of April due to low issuances amidst steady inflows to mutual funds, resumed upward momentum, thereafter, surging past the MSF rate. Bond yields exhibited a hardening bias beginning the second half of April 2022, with the rise in the US treasury yields also weighing on market sentiment. The policy rate hike also brought about an upward shift in the yield curve. The bearishness in G-sec market spilled to corporate bond market wherein yields experienced synchronised hardening across maturity profile and rating spectrum. The lagged impact of past monetary policy actions, forward guidance on the accommodative stance of monetary policy and surplus liquidity in the system facilitated transmission of policy rates to lending rates. The extent of pass-through to the weighted average lending rate (WALR) on outstanding loans was higher than on fresh rupee loans.

FPIs remained net sellers in April 2022 in the domestic market, amidst inflationary pressures, oil price surges, incoming information on policy normalisation in major AEs and geopolitical tensions. Net FPI outflows in the month to the tune of US$ 4.1 billion were largely driven by the sell-off in the equity market.

As part of its efforts to develop a consumer-friendly and robust payment ecosystem, the Reserve Bank has consolidated and updated the guidelines concerning the issuance of cards and conduct of operations by card issuers in India. These regulations simplify the extant regulatory environment relating to the card system, mandate issuers to take explicit consent of customers regarding the provision of card-related services and handling of their data, allow NBFCs to issue credit cards without a banking partner subject to the prior approval of the Reserve Bank, and strengthen the grievance redressal mechanism.

In conclusion, the global growth outlook appears grim as geopolitical tensions linger, commodity prices remain elevated and withdrawal of monetary accommodation gathers speed. Emerging economies face risks of capital outflows and higher commodity prices feeding into inflation prints. The Indian economy's recovery remains resilient, however, it faces challenges in building from the scars of the pandemic through larger investments in health and productivity of the human capital. Improving infrastructure, ensuring low and stable inflation and maintaining macroeconomic stability are critical for reviving animal spirits and spurring growth.

Source:
https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=21001

Growth Maximising External Debt of India

Dr. Gopinath Tulasi and Thangjam Rajeshwar Singh; RBI Bulletin May 2022

Apart from domestic savings, countries resort to external debt to grow faster. However, a large stock of external debt makes the country more vulnerable to global shocks and dent growth prospects. The study focuses on linkage between external debt and economic growth and estimates growth optimising level of external debt by using different models such as nonlinear multivariate regression, spline regression model, threshold regression model and smooth transition regression model.

As per Word Bank, external debt can be classifies into long-term debt, short-term debt and IMF credit. The long-term debt is further divided into public & publicly guaranteed debt (PPG - borrowing from multilateral and bilateral sources) and private nonguaranteed debt (PrNG). In terms of share in the total external debt, the PPG accounted for over 80 per cent through the decades till 2000. After the conscious decision to pre-pay high-cost multilateral and bilateral loans, the share halved to 38 per cent (2006) and further down to 34.2 per cent at the end of 2020. Conversely, reforms and liberalisation of 1990s allowing greater private corporate participation and modernization of the manufacturing sector by allowing greater access to foreign technology and foreign capital pushed the share of PrNG up from 15 per cent to 46.5 per cent by 2020.

Typically, countries facing scarcity of capital, supplement domestic savings with external borrowing to fund larger investments. However, debt overhang and crowding-out challenges arise when a country's debt levels exceed its ability to repay in future, with the expected rise in debt service pre-empting the country's output. Such impact on growth can be realised through lower volume of investment and efficiency of investment. Thus, authors of the article used different methods to measure optimum level of external debt for growth maximisation. It was observed that the inflexion point or the growth-maximising external debt to GDP ratio threshold is estimated in the range of 23.4 per cent to 23.6 per cent.

The actual external debt to GDP ratio as at end-December 2021 is estimated at 20 per cent, indicating a potential space to promote growth enhancing external debt by about 3 percentage points of GDP, equivalent to additional US$ 90 billion of debt at the current level of India's GDP. As India aims at higher, sustainable and inclusive growth, the need for attracting larger external debt flows within the estimated threshold may be assessed along with other external vulnerability parameters so that the growth objective is pursued while preserving overall macro-stability.

Source:
https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=21003

Financial Stocks and Flow of Funds of the Indian Economy 2019-20

Anupam Prakash, Kaustav K Sarkar, Ishu Thakur, Sapna Goel; RBI Bulletin, May 2022

Mapping of sectoral financial flows is based on information aggregated from individual balance sheets of respective economic entities. The sectoral flows are captured from snapshots of the holdings and issuance of various financial instruments and counterparty positions at the end of the financial year. The financial net worth of each sector is derived by netting out outstanding external financial liabilities from outstanding financial assets. Being prime savers in the economy and lenders to other sectors, households enjoy the highest financial net worth followed by financial corporations (Fcs), whereas general government (GG) and non-financial corporations (NFCs) have consistently remained in a deficit position in the economy.

The financial resource gap of the domestic economy, measured by the net acquisition of financial assets less net increase in financial liabilities, narrowed in 2019-20. Households and GG continued to be the largest lender and borrower in the economy, respectively. Net flows to GG from other depository corporations (ODCs) and other financial corporations (OFCs); and to private non-financial corporations (PvNFCs) from rest of the world (RoW) increased in 2019-20. Loans and advances remained the most preferred instrument for deployment of resources, followed by currency and deposits. A major proportion of investments of OFCs and the Reserve Bank were in debt securities. Investment via equity and investment funds were dominated by investments from corporates and RoW. Currency and deposits remained the preferred investment avenues for the households followed by insurance, pension and provident funds.

The flow of currency in circulation, which had decelerated a year before, increased marginally, taking the currency-GDP ratio to 12.1 per cent. In keeping with the objective of financial stability, the Reserve Bank increased its holding of gold and foreign currency assets (FCAs). An increase in several liquidity augmenting measures by the Reserve Bank such as long-term repo operations (LTROs) and targeted LTROs in the latter half of the year led to an extension of loans and advances to other depository corporations (ODCs).

Deposits growth lost the steam across scheduled commercial banks (SCBs), co-operatives and deposit taking NBFCs (NBFCs-D), in the backdrop of a slowdown in GDP growth, with major moderation in co-operative banks. Competing asset classes became attractive due to easing of interest rates and solvency issues related to a private sector bank. On the assets side, reflecting both risk aversion and tepid demand in a slowing economy, credit outgo of SCBs decelerated while their investment in risk-free government securities improved. Credit growth of NBFCs-D also moderated while their investments - specifically in mutual funds accelerated. In case of deposit taking housing finance companies (HFCs-D), growth in their financial assets decelerated owing to a sharp decrease in loans and advances following increased stress in the real estate sector. The co-operative banking institutions however, registered an increase in financial assets, mainly driven by loans and advances extended to households. Capital infusion in public sector banks by the government received a boost. This was reflected in an increased liability of ODCs towards the government.

Within co-operatives, urban co-operative banks

(UCBs) relied chiefly on household deposits for their funds, whereas deposits from other co-operatives together with borrowings from OFCs aided the rural cooperative banks (RCBs) in financing their operations. Reliance on banks for funds rose for both NBFCs-D and HFCs-D. Issuance of debentures by HFCs-D also contracted during 2019-20. The ODCs' liability towards RoW contracted during the year because of the ongoing global economic slowdown and India experiencing one of the highest outflows amongst emerging market peers.

The financial assets and liabilities of OFCs contracted by 1.0 and 0.6 percentage points of GDP, respectively, in 2019-20. HFCs-ND witnessed a marginal contraction in their financial assets and liabilities whereas the growth in case of non-deposit taking NBFCs (NBFCs-ND) decelerated. Foreign liabilities of the NBFCs-ND rose owing to easing of external commercial borrowings (ECB) norms, which helped them in accessing foreign funds. Market prices of equity and investment funds in the balance sheets of OFCs contracted significantly owing to the stock market crash in February-March 2019-20. GG securities remained the favourable investment avenue for OFCs in recent years, coupled with intra-sectoral lending. The gross financial assets of insurance and provident funds continued their increasing trend, mainly driven by investment in government debt securities. The financial assets of pension funds increased with both the National Pension System (NPS) and the Atal Pension Yojana (APY) registering growth in their subscriber base. The incurrence of financial liabilities by PvNFCs exhibited an uptick along with asset acquisition. In terms of instruments, loans and borrowing from FCs has been the predominant source of finance for PvNFCs followed by equity. While the financial assets of GG improved marginally to 25 per cent of GDP, the financial liabilities amplified to 80 per cent, of which the liabilities of central government (CG) stood at 53 per cent of the GDP.

Growth in both financial assets and liabilities of the household sector weakened in 2019-20, with a sharper moderation in financial assets. As a result, the financial surplus of the household sector reduced slightly to 9.3 per cent of net national income (NNI). The rise in the household financial savings to 11.6 per cent of GDP in 2020-21 has already confirmed the ballooning of household financial assets, owing to reduction in discretionary expenditure and the associated surge in precautionary/forced saving despite stagnant/reduced income. The share of ODCs in the flow of financial assets soared to almost 21 per cent. This surge is expected to further strengthen in 2020-21, on account of feeble non-essential consumption spending, particularly in the first quarter. Furthermore, a steady flow of resources is maintained from the households to the insurance sector, which is likely to accentuate in 2020-21. The share of deposits and insurance has been gradually rising, accounting for almost 63 per cent of household financial assets followed by equity, currency, debt securities and investment in mutual funds. The shift in household's preference towards investment funds is also reflected in the secular rise in their outstanding asset value, which however, plummeted following massive sell-offs by foreign portfolio investors in March 2020.

India remained a net borrower from RoW in 2019-20, with reduced dependency compared to the previous year. Despite multiple headwinds, major sources of foreign capital increased, and net capital inflows were more than sufficient to finance the lower current account deficit (CAD). As at end-March 2020, two-third of RoW's total financial liabilities was towards the Reserve Bank in the form of reserve assets, particularly securities and deposits with other central banks. Besides reserve assets, around one-third was towards NFCs in the form of debt securities and equity. The liability of RoW primarily led by a surge in the Reserve Bank's subscription to debt securities issued abroad.

Going forward, various policy measures initiated to tide over the disruptions in the pandemic year 2020-21, would affect the net lending/borrowing position of the sectors. The allocation of SDR 12.57 billion to India by the IMF on August 23, 2021 would accordingly have implications for the financial accounts of the associated sectors. Policy initiatives like asset monetisation and higher infrastructure and capital expenditure by the central government could help improve asset quality of both the public and private nonfinancial corporations. While households and financial corporations are expected to continue generating higher financial surpluses, better balance sheet position of corporates and banks could facilitate higher flow of resources to the productive sectors of the economy supported by greater digitisation.

Source:
https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=21002