Indian economy and banking sector: Shape of things and way forward

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After an optimistic start to 2021, growth sentiment has rapidly turned around as India battles the ferocious second wave of the pandemic. The learnings from the previous wave has ensured that all the stakeholders – Government, Corporates and Individuals - seem to be much better prepared to handle the pandemic with lesser impact on livelihood. However, the uncertainty from localized lockdowns, its longevity and the disruption caused to supply chains are by no means negligible and has moved the focus back on monetary and fiscal policy response.

As a first line of defense, RBI-MPC has been swift enough to move towards a more open ended "state-based guidance" from an earlier "time based exit" of its accommodative stance. Though the RBI in its last MPC meeting retained the GDP growth projection at 10.5% for FY22, the intensity of the second wave pandemic has clearly opened up downside risk. In this context, the unanimity among policy makers to support durable recovery has reinforced the "lower for longer" outlook on policy rates. It was also interesting that the minutes of the MPC meeting released on 22nd April was far more dovish in is language, tonality and focus than the policy itself that was announced on 7th April. Clearly the exponential pick up in infections and the intensity of the uncertainty in the ensuing period probably played a very important part in this dovish shift.

To complement the MPC's accommodative stance, the RBI has also reaffirmed ample system liquidity to ensure congenial financial conditions. Continuing with its record of innovative and unconventional measures, RBI unveiled a "Government Security Acquisition Program" (GSAP v1) wherein it has committed upfront acquisition of a specified amount of government securities in a specified period of time. The first acquisition tranche of INR 1.0 trillion during Q1FY22 is approx. 30% and 40% of gross and net supply respectively by the central government during that period. The RBI has stated that the program cedes discretion in the interest of supporting the market while assisting market participants to plan their engagement with the sovereign borrowing in a better way. Even as RBI acknowledged the associated risks in form of asset price inflation, currency depreciation and capital flight, it has stated that the balance of risks lies in favor of G-SAP 1.0 to support financial conditions, keep borrowing costs low for the central government and ultimately pave the way for a durable economic recovery. To drive the message loud and clear, the Governor himself stated that GSAP 1.0, as the name itself indicated, suggests that more versions are likely to come.

The new GSAP program strongly reinforces the RBI commitment for "an orderly evolution of the yield curve as a public good". While the front end of the yield curve is anchored through elongated accommodative guidance and ample system liquidity provision, the long end curve is managed through balance sheet operations. This two-pronged strategy along with sector specific support program by RBI is also helping Indian corporates raise cheaper resources through market borrowings and thereby manage refinancing risk. As yields for top rated borrowers continue to remain low and stable, the liquidity is ensuring market financing availability for corporates lower down the credit curve. Moreover, a fast-normalizing current account deficit and a more balanced foreign reserve accretion profile is likely to ease the RBI's hand in managing the sovereign borrowing program. The RBI's persistent focus and purchases of the benchmark 10y bond has also helped telegraph a stable yield environment. Given that the 10y IGB yields have traded in a relatively narrow range and centered around 6.0% despite the huge borrowing program, firming global commodity prices and rise in developed market yields, it underlies the success of RBI's market operations. We believe that rise in growth risks and elevated uncertainty amid the ongoing pandemic situation implies that the RBI's "influence" on IGBs yield could persist in the near term.

However, even as central banks across the globe continue to remain highly accommodative in a bid to push growth, there is a debate raging now whether the global inflation pickup is transient or persistent and will it accelerate the normalization process from systemic central banks. Though it is too early to judge at this moment, some of these factors which have kept global inflation low over the last many years may now be waning. Prominent among these were globalization and technological enhancement, which somewhat weaken the bargaining power of labor and pricing power of domestic firms and led to an increase in overall factor productivity. The pandemic has rekindled the need to have domestic production capacities which may accelerate the trend towards de-globalization and reshoring of supply chains. There is a growing risk that such a fallout may lead to increased costs and lower productivity, bringing an end to the low inflation era.

In the near term, the sharp rise in global commodity prices and inflationary expectations have raised the risk on the external account. However, we believe that exit strategies from systemic central banks will be well telegraphed and more predictable as compared to 2013 taper tantrum. This may provide a window to RBI to recalibrate / delay its normalization strategy which is ultimately necessitated given that real policy rates are in deep negative territory and the policy rate differentials with the US are far lower than historical averages. Nevertheless, the policy normalization will be contingent upon how effectively we navigate the vaccination strategy balanced with the containment of the infection spread. All things considered, as of now, we believe that RBI will remove its enhanced forward guidance in Q3 and increase the reverse repo rate in Q4FY22 to normalize policy rate corridor.

To conclude, the world has seen enormous coordination between fiscal and monetary authorities to deal with the current crisis and RBI policy response is no exception. It is equally important that to nurture the recovery process, the policy supports are not prematurely withdrawn. However, the strength and pace of the global recovery is uneven and largely hinges on the speed of inoculation, extent and effectiveness of policy support and country-specific structural factors. In this global backdrop, the path ahead for RBI will necessitate careful trade-offs between lifting near-term activity and addressing medium-term challenges. Moreover, dealing with high public debt requires a two-pronged approach. First and foremost, governments need to safeguard fiscal sustainability through credible roadmap and structural reforms to boost trade, competitiveness and productivity. Second, a credible monetary policy framework lies at the core of debt management. Without low and stable inflation, it would be difficult to keep borrowing costs low for the government and elongate the debt maturity profile. By preferring continuity and consistency with the inflation mandate, India has shown its intent to consolidate the gains in terms of a decline in inflation volatility through more credible anchoring of inflation expectations. Last but not the least, with all major central banks so heavily invested in the economic recovery, central bank "speak" and "reading the sub text" of central bank statements will assume paramount importance in determining how easy or difficult it will be for markets to prepare for the road to normalization in rates across the world.

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