

Monetary Stability Helps India to Weather Financial Shocks.

By John Greenwood

Overview

- The Reserve Bank of India (RBI) has never focused explicitly on controlling money growth. Nevertheless, over the past four years it has done a remarkably good job of keeping M3 money growth stable and inflation low, with the result that the Indian stock exchange has been an outstanding performer.
- In contrast to the high and volatile profiles of money and inflation in previous years, Indian policymakers at the RBI have succeeded over the past decade in bringing down money growth to a fairly stable 10% p.a. , with inflation falling to average around 5% p.a., marginally over the current 4% inflation target.
- Monetary analysis depends on there being a stable relationship between broad money growth (M3 in India) and overall spending or nominal GDP growth. While such a relationship has existed over lengthy periods such as 1998-2010, there have also been major shifts, for example in the last decade 2014-2023.
- In such circumstances policymakers need to be able to fall back on a range of supporting policy instruments. In this article I focus on three areas: the management of the RBI's balance sheet, avoidance of the accumulation of excess debt in the economy, and ensuring that the balance of payments and the currency do not become separate sources of instability.
- Through their policies in these three areas the Indian authorities have built a framework that has enabled the economy to overcome both internal and external shocks over the past few years.
- India has not succeeded in avoiding shocks altogether. The abrupt demonetisation of the 500 and 1000 INR banknotes in 2016, the crisis in the NBFC sector in 2018-19, and the onset of Covid are just three examples in recent years.

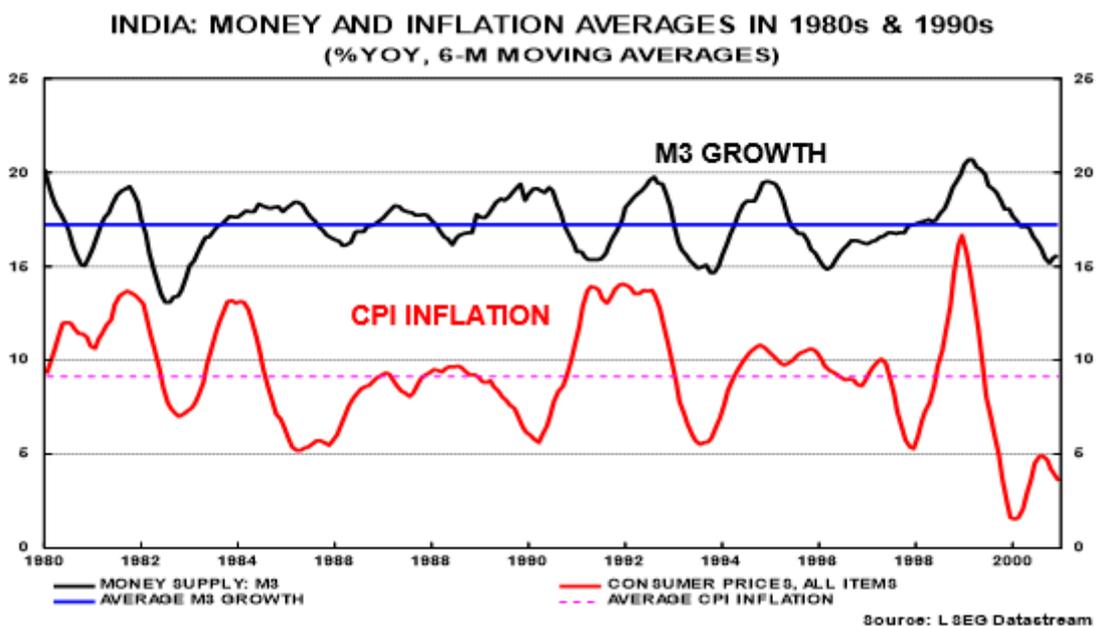
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Introduction

The Reserve Bank of India (RBI) has never focused explicitly on controlling money growth. Nevertheless, since the founding of the RBI in 1935, Indian M3 growth has had a major impact on inflation and the exchange rate. In the 1980s and 1990s, for example, money growth and inflation were both relatively high and relatively erratic. As shown in Figure 1, over the two decades 1980-99, M3 growth averaged 17.2% p.a., ranging between 12% and 22%. Indian CPI inflation averaged 9.1% p.a. over the same period, ranging between 19% and 0%. In part this high degree of variability of the overall price level was due to the high weighting given to food items within the CPI, especially items such as vegetables affected by the annual monsoon rains.

Figure 1. The 1980s and 1990s were years of high money growth and high inflation.

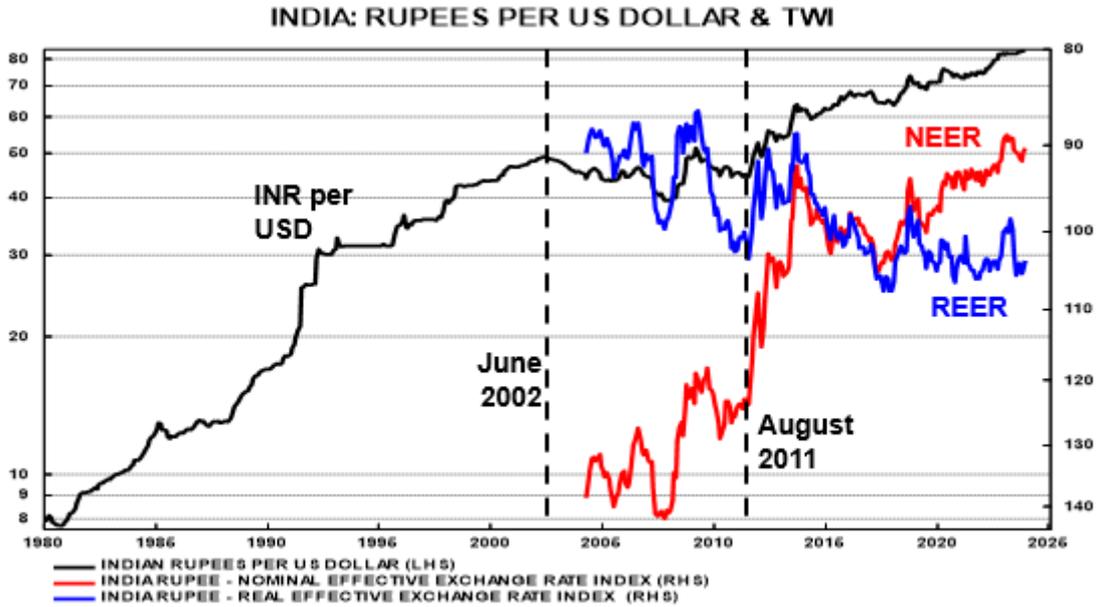


Reflecting the relatively high and persistent inflation in the 1980s and 1990s, the Indian rupee steadily depreciated from a level of around INR 7.75-8.00 per USD in 1980 to INR 49 by June 2002 (Figure 2, PTO), a depreciation of about 84%. However, the start of tighter monetary policy in the sense of slower growth of M3 from the second half of 2000 onwards (see below) brought some stability to the currency until August 2011, when another period of steady depreciation set in again, though this time at a slower rate. Since August 2011, the rupee has depreciated against the USD from INR 45 to around INR 83 in January 2024, a depreciation of about 46%.

Using trade-weighted indices available from 2004, the INR has depreciated on a nominal basis, but has been more stable on a real effective exchange rate basis.

The purpose of this article is to explore the remarkable and surprising stability in India's macroeconomic management over the past decade.

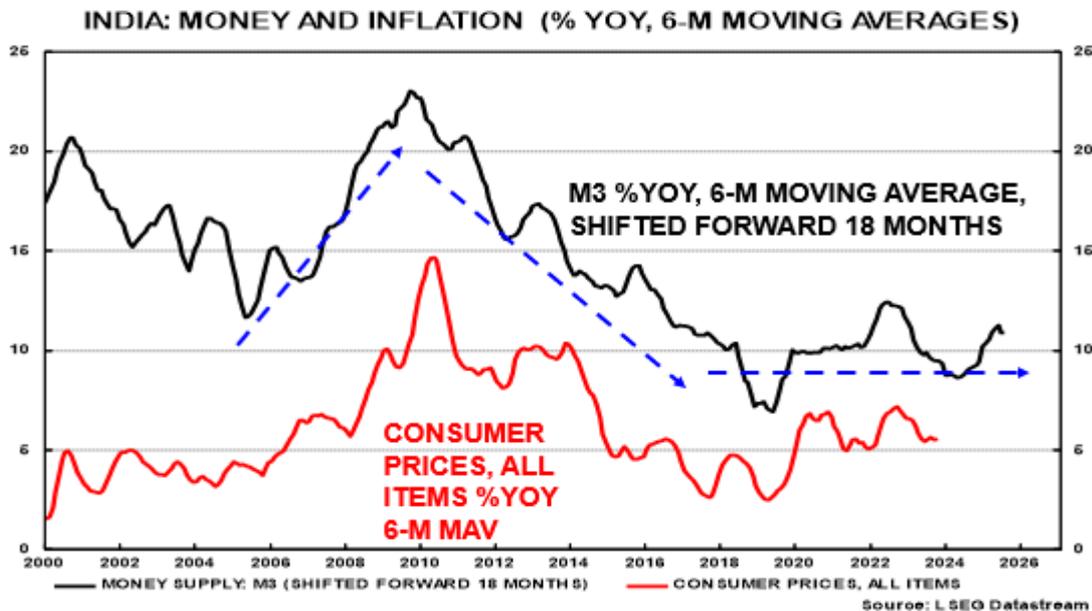
Figure 2. Currency depreciation has reflected M3 growth and inflation.

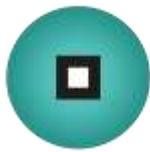


Section 1. The Emergence of Monetary Stability, 2014-2023

Beginning under Governor D. Subbarao (2008-13), money growth started to slow down (Figure 3), although this was a byproduct of other policies, notably less borrowing from the banks by the union government. M3 growth had peaked at 25.4% year-on-year in February 2008, but by the end of Subbarao’s tenure in September 2013 the M3 growth rate had halved to about 12%. Under his successor, Raghuram Rajan (2013-16), M3 averaged just under 12% p.a., which is to say that the heavy lifting in bringing down inflation was done mainly by Governor Subbarao, not by Governor Rajan. However, taken together the RBI Governorships of Rajan, Urjit

Figure 3. Since 2005, M3 has been a good predictor of inflation.

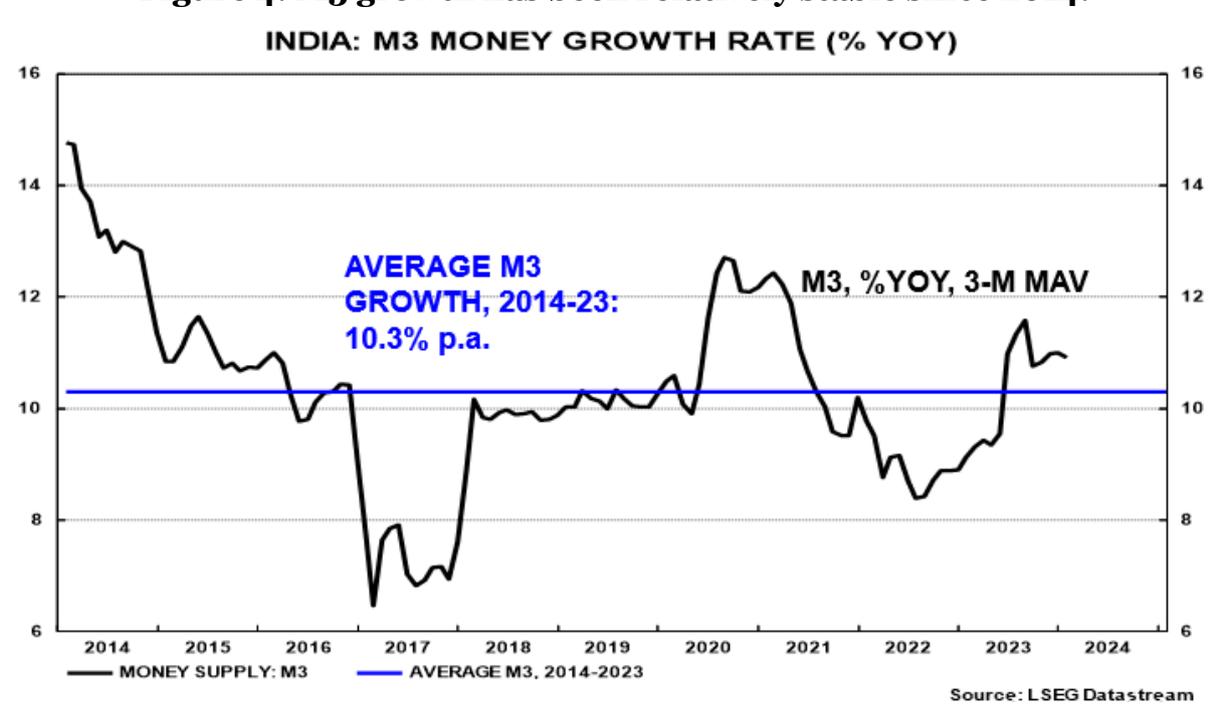




Patel (2016-18) and the current Governor, Shaktikanta Das (from Dec 2018), have produced a remarkable slowdown (mid-2008 until about 2012) and subsequently, stability in M3 growth which has averaged 10.3% p.a. in the ten years 2014-23. This is despite the “demonetisation” episode of November-December 2016, the NBFC (Non-Bank Financial Company) crisis of 2018-19, and two brief deviations of M3 from the steady 10% growth rate – a downward shift in M3 in 2017 and an upward shift in 2020-21.

According to official data, real GDP growth averaged 5.6% p.a. between 1980 and 2000, but since 2000, real GDP growth has stepped up a tad to average 6.6% p.a.

Figure 4. M3 growth has been relatively stable since 2014.



To gain a clearer picture of how much money growth India needs to achieve its inflation target we need to consider the equation of exchange. Currently the RBI’s inflation target is 4% (with an upper tolerance level of 6% and a lower tolerance level of 2%) for the 5-year period April 1, 2021 to March 31, 2026. The answer requires calculating the appropriate, or optimal, broad money growth rate for the given, target inflation rate from the rate of change form of the equation of exchange:

$$\Delta M3 = -\Delta V + \Delta y + \Delta P$$

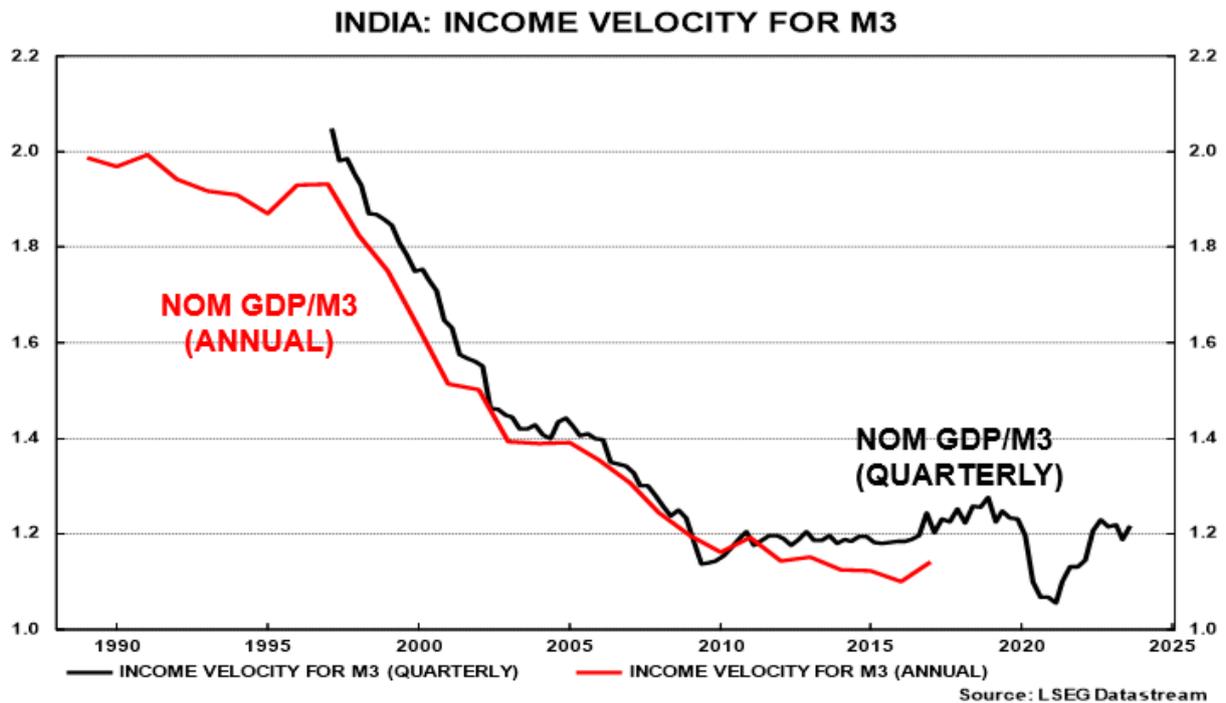
where ΔV is the expected annual change in income velocity, Δy is potential real GDP growth, and ΔP is the inflation target (4% for India). Using average rates of change for India based on the period 2000-2023 we have:

$$\Delta M3 = -(-1.6) + 6.6 + 4 = 12.2\% \text{ p.a.}$$

This suggests that the average M3 growth rate since 2014 of 10.3% (in Figure 4) has been marginally too low, which implies that inflation should have been lower than it has been. However, the fact is that CPI inflation has averaged 5.2% (i.e. above the 4% target, though still within the tolerance band) over the more recent period 2014-23.

The reason, it turns out, is that velocity, instead of declining at 1.6% p.a. has remained flat (Figure 5), providing some headroom for inflation to exceed the 4% target even at an average 10.3% M3 growth rate. In short, although the equation of exchange gives us broad guidance on appropriate M3 growth, deviations of velocity from its trend can disrupt these monetary formulae in the medium term.

Figure 5. The downward trend in income velocity for M3 has been interrupted.



Other possible reasons why India's inflation has been able to exceed the RBI target even without excess money growth include the extensive methodological and statistical revisions of India's GDP statistics in recent years, and inappropriate weightings of the components of the CPI.

My provisional conclusion is that the RBI, while not focused specifically on controlling M3 growth (or any other monetary aggregate), has been sensitive and alert to any signs of trouble brewing either in the financial markets or in the real economy, and has done enough to keep inflation broadly under control. The outlook is therefore promising. With relatively stable money growth (as in Figures 3 & 4) inflation is highly unlikely to emerge suddenly or on such a scale that it could cause problems for the RBI. Nevertheless, the central bank will likely retain its guarded and cautious attitude towards any disruption in the financial markets.

Section 2. Stable money helps to minimise other potential problems.

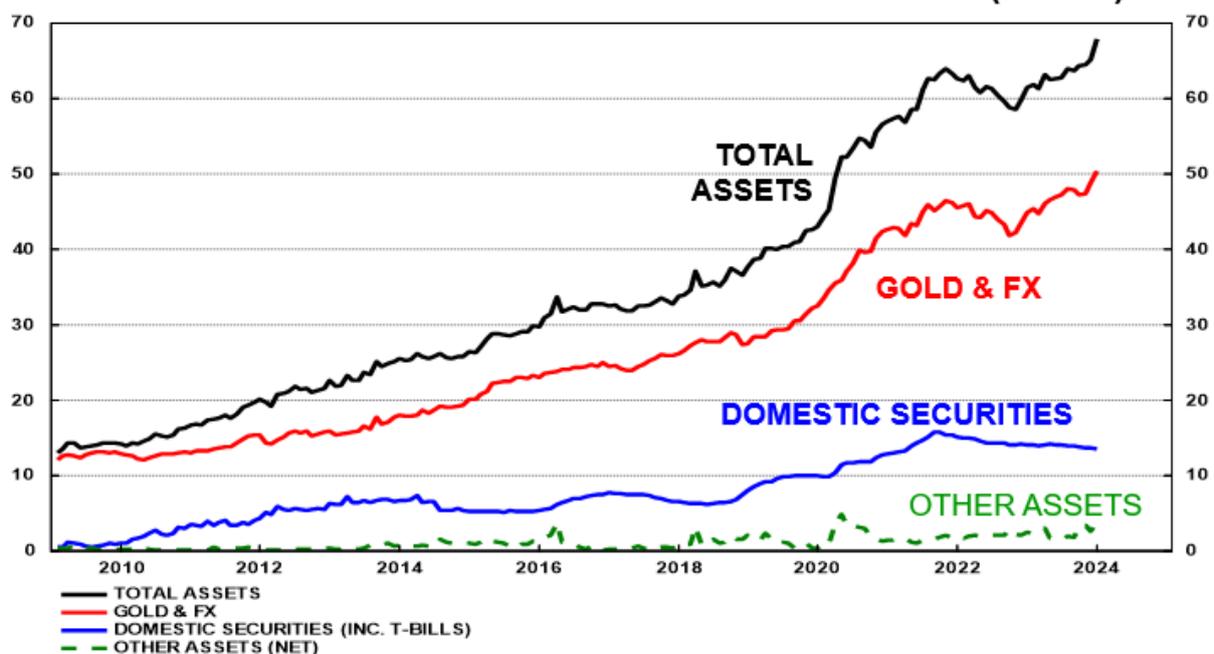
While monetary stability is the foundation for low and stable inflation, there are several other key factors that can contribute to keeping the economy on an even keel. Among the most important are three which I will tackle here: (1) the size and composition of the central bank's balance sheet, (2) a relatively low level of indebtedness across the major sectors of the economy, and (3) the external balance of payments and the stability of the currency.

In each of these areas there are feedback mechanisms that can work to undermine monetary stability. In India's case I will argue that each has either been kept under control directly or has been prevented indirectly by monetary control from becoming a systemic problem.

Section 2.1. The RBI's balance sheet

The primary way in which the central bank's balance sheet can contribute to monetary instability is if the size of the balance sheet grows too rapidly in relation to the economy or real GDP. Normally this will happen as a result of rapid growth of the domestic assets of the central bank (loans to banks, loans to the government, or holdings of domestic securities etc), though it can happen if the central bank holds down the exchange rate, thereby generating large foreign exchange inflows that must be exchanged for domestic currency or bank deposits.

Figure 6. The RBI's assets are still dominated by foreign exchange.
RESERVE BANK OF INDIA: BALANCE SHEET - ASSETS (INR TN)



In the case of the RBI (Figure 6) the growth of its total assets has been dominated by the growth of gold and foreign exchange, while domestic securities have grown only very slowly over most of the last 15 years. Although the foreign assets' share has declined from 93% in early 2009 to 72% today, the increase in the domestic share

has mostly been slow and gradual (from 7% to 28%). The moderate growth of the RBI's domestic assets is related to the prevalent view among Indian officials that the country must build up its stock of foreign assets to guard against external shocks. Indian leaders like to quote the size of the nation's foreign currency reserves (currently \$616 billion, or close to \$600 per capita – nearly one quarter of per capita income). The philosophy of building up foreign reserves also reinforces the policy of maintaining a highly risk-averse stance towards the balance of payments and the currency (see Section 2.3 below).

Section 2.2. India's comparatively low level of indebtedness

The second way in which monetary or financial stability can be undermined is if debt is allowed to build up too rapidly, either within the banking system (thereby creating excess money) or outside the banking system (as in China). Mostly India has avoided this problem, though the experience of two serious failures in the Non-Bank Financial Companies (NBFC) sector in 2018-19 brought India close to a precipice.

Figure 7. India's domestic debt low by international standards

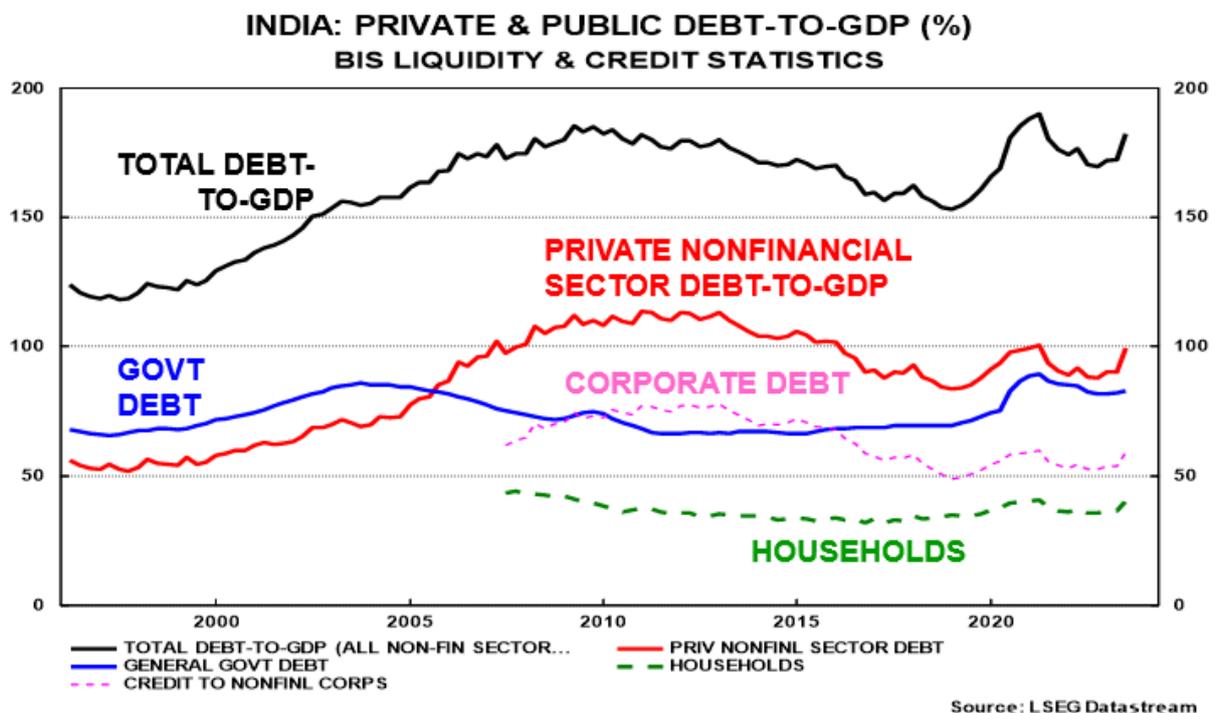


Figure 7 shows the BIS data for domestic indebtedness in India. The gradual build-up of debt between about 2000 and 2010 should perhaps have caused alarm bells to ring, but fortunately government debt was simultaneously reduced from 2003 to 2011, meaning that the overall total (in black) slowed somewhat, peaking in 2009. Between 2003 and 2009 it was primarily corporate debt that led the overall increase, and then it started to decline between 2013 and 2019.

Subsequently, there are two main episodes to explain. First, there is the NBFC crisis of 2018-19, and second there is the upturn of indebtedness resulting from the Covid pandemic.

During the early 2000s nonbank financial companies grew rapidly, accounting for about one quarter of the assets of the financial system (banks and non-banks together) and as much as half of the lending growth in India during 2015–17. When two large NBFCs defaulted on outstanding debt (IL&FS in September 2018 and DHFL in June 2019), the strains in the NBFC sector spilled over into the financial and real sectors, creating a credit crunch and raising concerns about the exposure of banks to NBFCs.

Almost immediately, lending by NBFCs came to a standstill. Mutual funds, which had been big buyers of commercial paper issued by NBFCs withdrew their funding, with one provider (Templeton) shuttering six debt funds. These market dislocations led to a steep rise in money market spreads. Intervention by the RBI to provide liquidity to banks (guiding them to take stakes in or lend to NBFCs) together with a series of cuts in the repo rate from 6.5% in January 2019 to 5.15% by November 2019 (Figure 8, circled) did not prevent NPLs in the sector rising and capital ratios falling. The RBI has therefore been compelled to strengthen regulation and supervision of the sector.

Figure 8. The NBFC crisis forced the RBI to cut rates and supply liquidity before Covid.



Overall, the NBFC crisis did not show up as faster M3 growth (Figure 4), although it may help to explain the upturn in RBI balance sheet growth in 2018-19 (Figure 6).

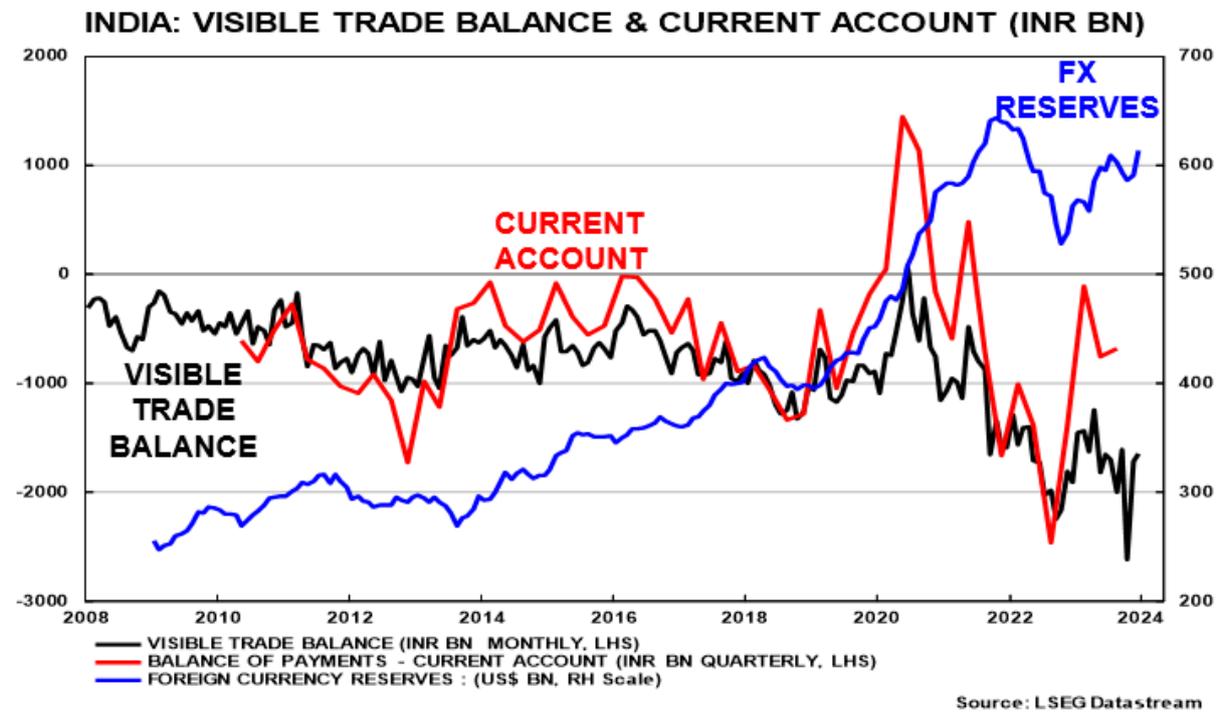
The other episode was Covid itself which, as Figure 7 showed, led to increased debt ratios in the corporate and government sectors as well as the household sector. Some of this was no doubt due to the sharp downturn in GDP, as suggested by the subsequent declines in the debt ratios as the economy recovered. However, we will

not know the full extent of the increased indebtedness for another year or two. Meantime, the NBFCs are still in convalescent mode.

Section 2.3. The balance of payments and currency

India has operated with persistent trade and current account deficits since 2000. Figure 9 shows a couple of rare occasions when the current account moved into surplus during the early phases of the Covid crisis when the demand for imports fell as a result of the lockdown or return-to-home orders. However, this was before the economy started to recover and the price of oil surged (with the start of the Ukraine war in February 2022). These later developments have pushed the current account back into deficit and the visible trade balance has been mirroring that deterioration.

Figure 9. Persistent trade and current account deficits convey underlying structural weakness.



The point to be noted here is that these trade and current account deficits would be even greater if RBI policy was less tight. The main improvement (in 2020-21) was associated with a decline in the volume of domestic activity in India, and hence in import demand. It is true that some of the lesser improvements have resulted from episodes of RBI tightening, but the country is not yet fully geared up to take on some of its East Asian competitors. In this sense, tight money cannot be a permanent substitute for structural changes such as further deregulation and opening of the trade sector.

As Figure 9 shows, the current account deficit has narrowed in recent quarters, but the deterioration in the trade accounts suggests the improvement may not be sustained.

Conclusion.

The Indian stock market has performed remarkably well over the past four years since the onset of Covid. This is down to (A) a successful and consistent monetary policy that has kept broad money (M3) growth stable around 10% p.a. and inflation near the 4% target. Supporting this stance, (B) three subsidiary strands of policy have been: (1) the discipline of controlling the size and composition of the central bank's balance sheet, (2) maintaining a relatively low level of indebtedness across the major sectors of the economy, and (3) preventing the external balance of payments from deteriorating, and thereby maintaining at least moderate stability of the currency.

As detailed above, these achievements have come despite the NBFC crisis in the financial system (in 2018-19) and persistent weakness in the balance of payments. As long as the RBI can maintain the current regime of moderate money growth and low inflation, the environment for further progress in the stock market seems promising, though not guaranteed.

Summary and Investment Conclusions

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- India has not succeeded in avoiding shocks altogether. The abrupt demonetisation of the 500 and 1000 INR banknotes in 2016, the crisis in the NBFC sector in 2018-19, and the onset of Covid are just three examples in recent years.



- Indian equities have had a strikingly successful run in the period since the Covid. Valuations are high but not extreme. The PE ratio of the Nifty 50 is at just over 22 times historic earnings, in line with medium- or longer-term averages.
- After such a lengthy period of appreciation it would be a surprise to see a repeat performance.
- The best one can hope for is that stable macroeconomic management is maintained – along the lines outlined in this report – and that there are no nasty shocks about to strike.

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