Macroeconomic constrains to financial sector development

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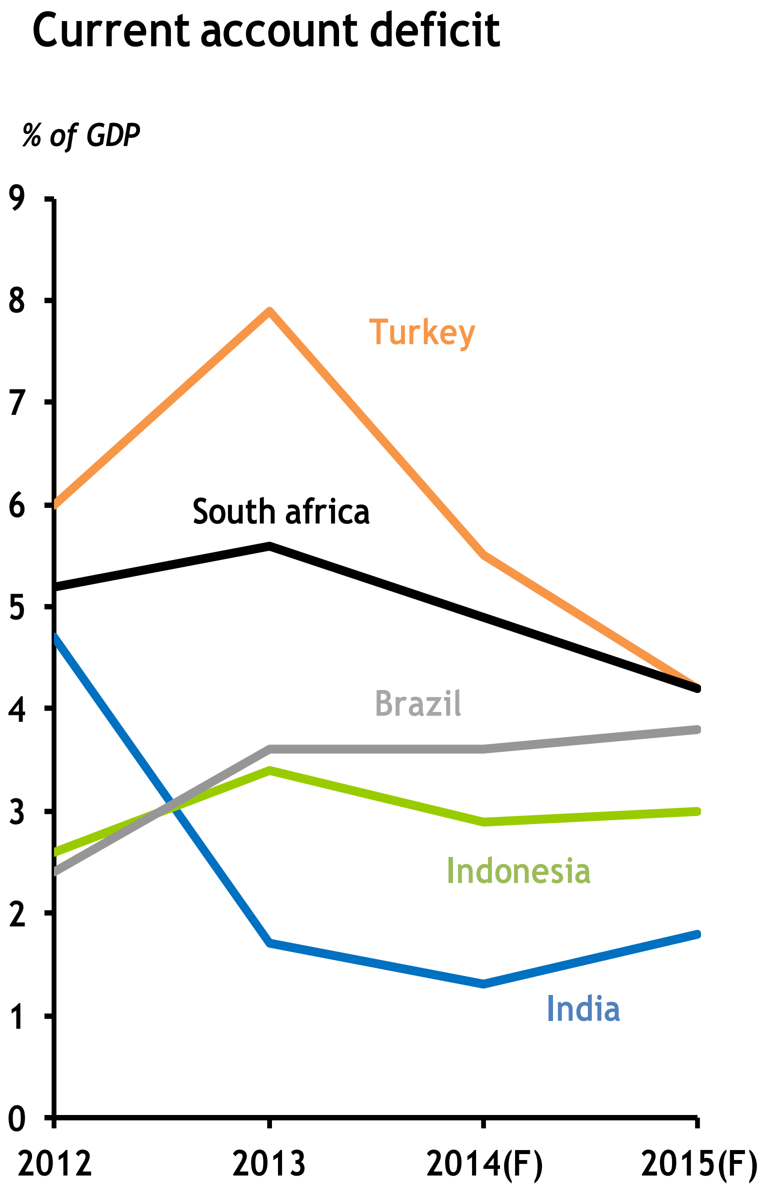
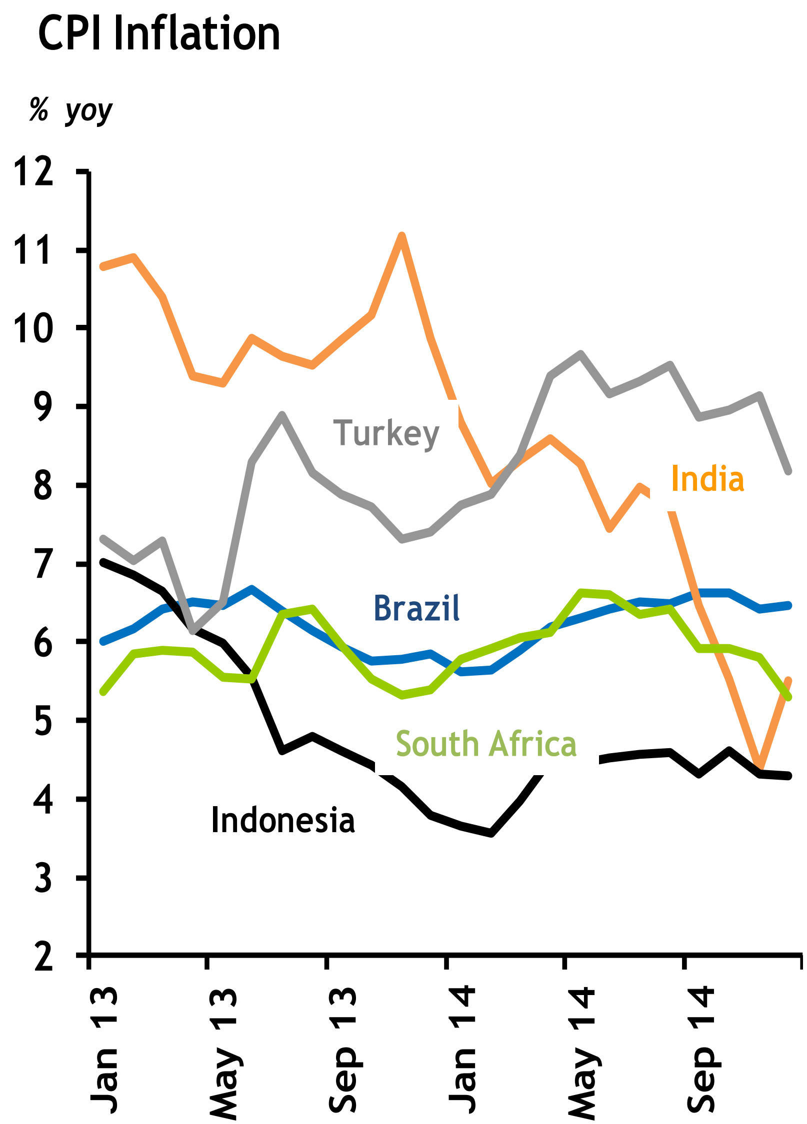
Macro-stability at last





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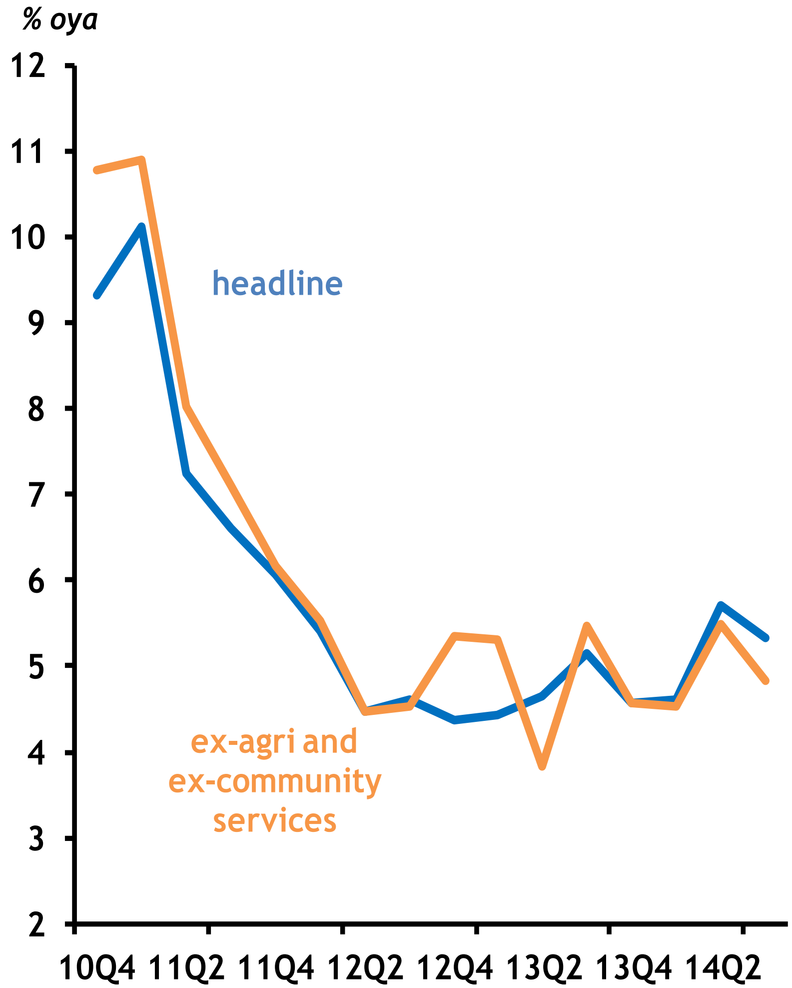
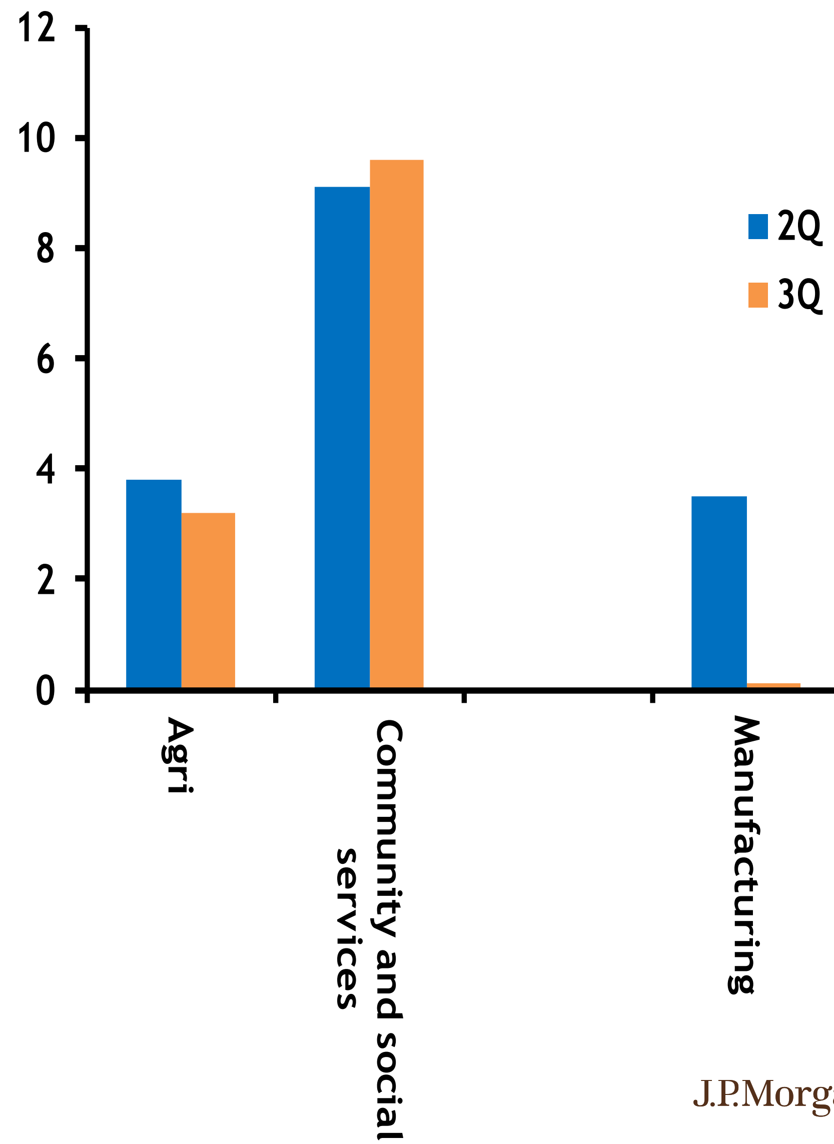
…but growth remains in a funk

India: GDP growth



1H growth driven by agri and government

% oya



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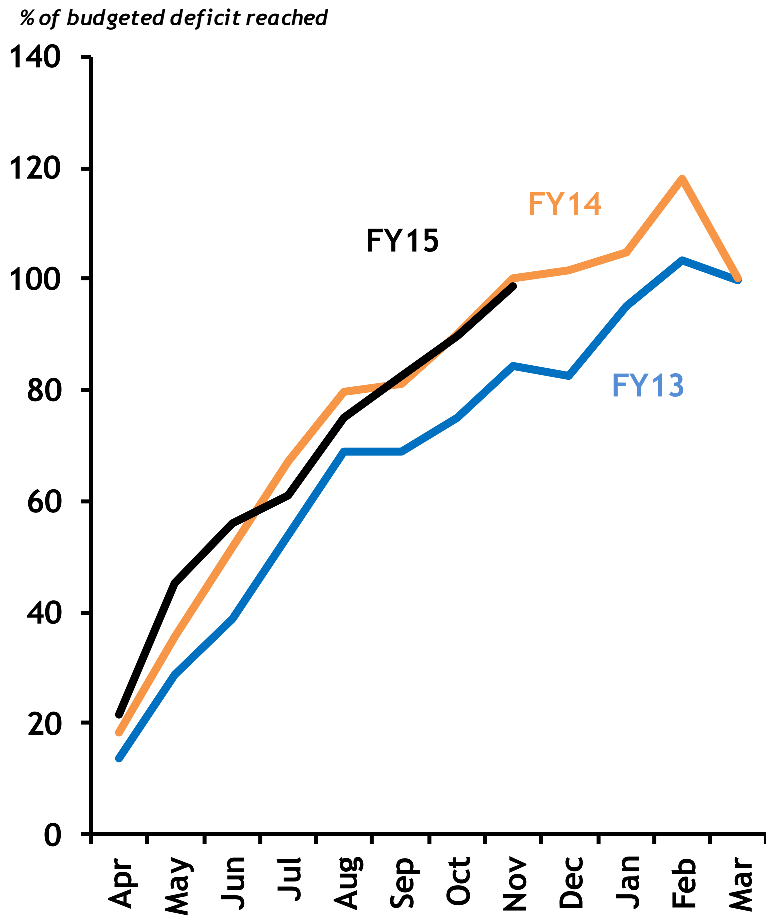
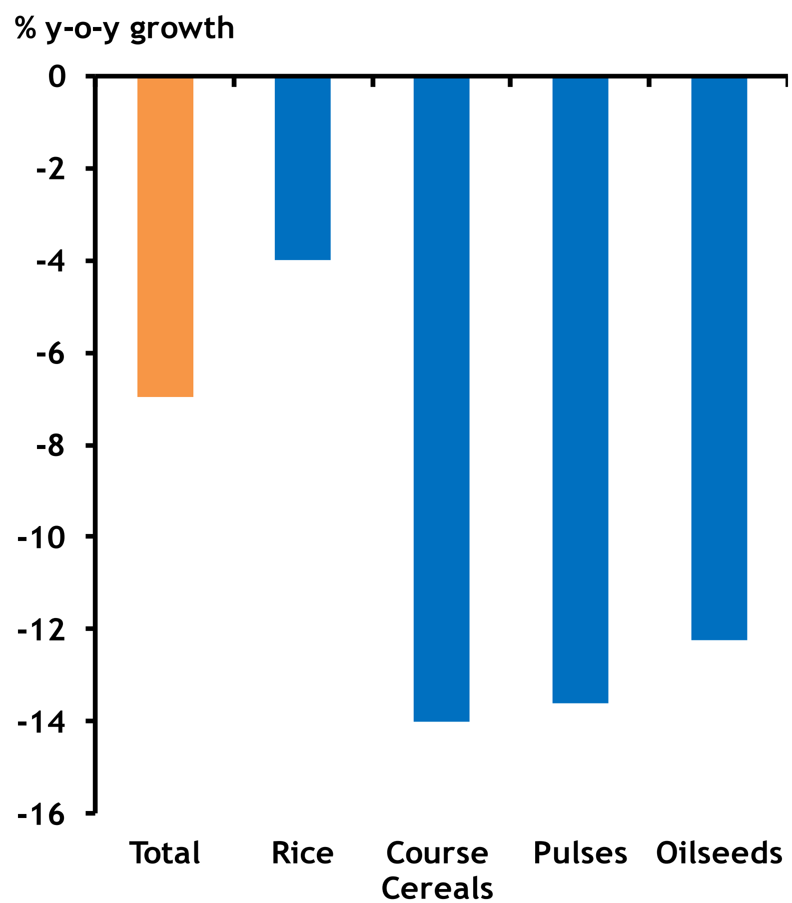
…and agri and fiscal drags are on their way

Fiscal deficit



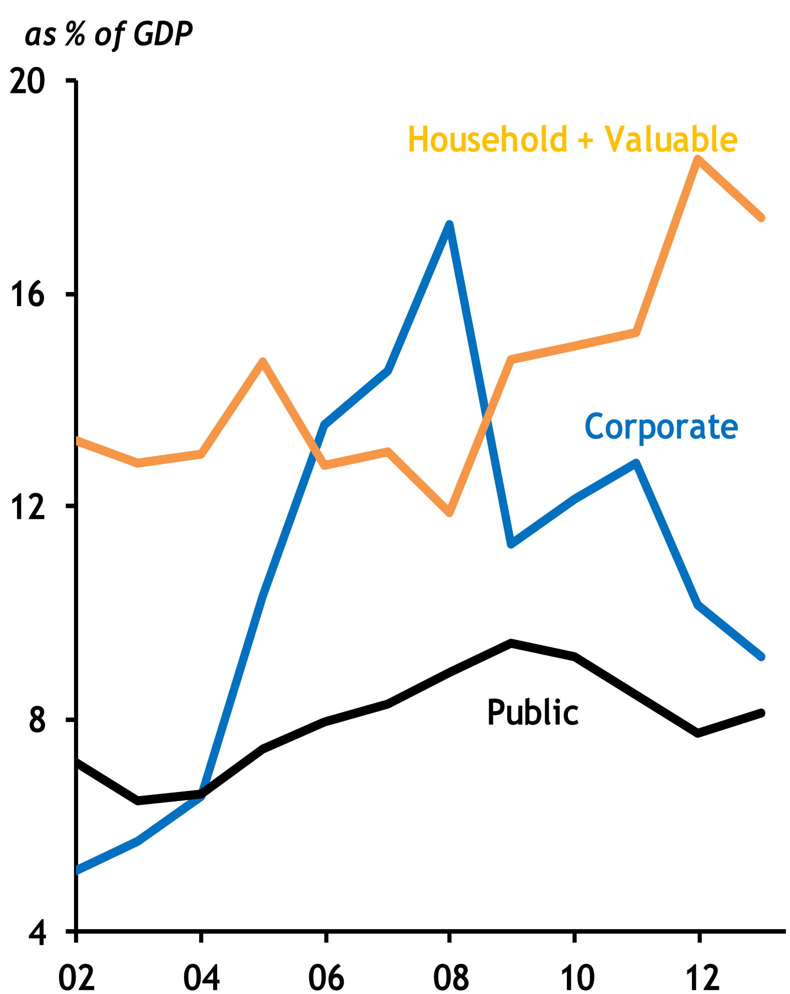
Kharif crop: first advance estimates



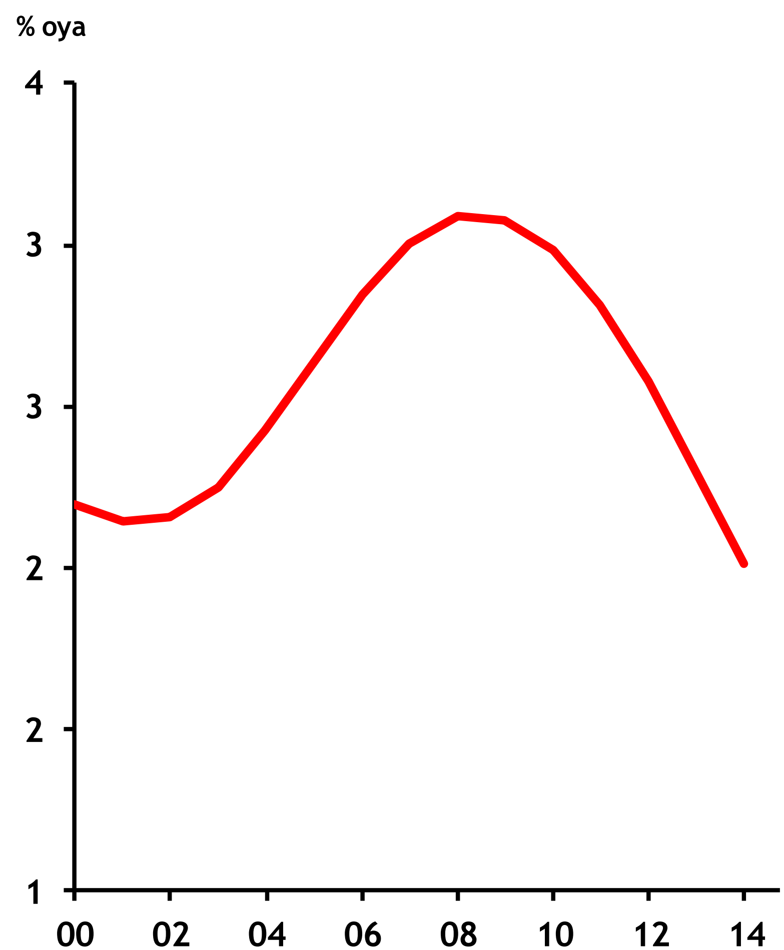
Source : CSO, CEIC, JPM Calculations

Private investment remains the key

Its the compsoition, silly!



India: Productivity growth (TFP)



Source : CSO, CEIC, JPM Calculations

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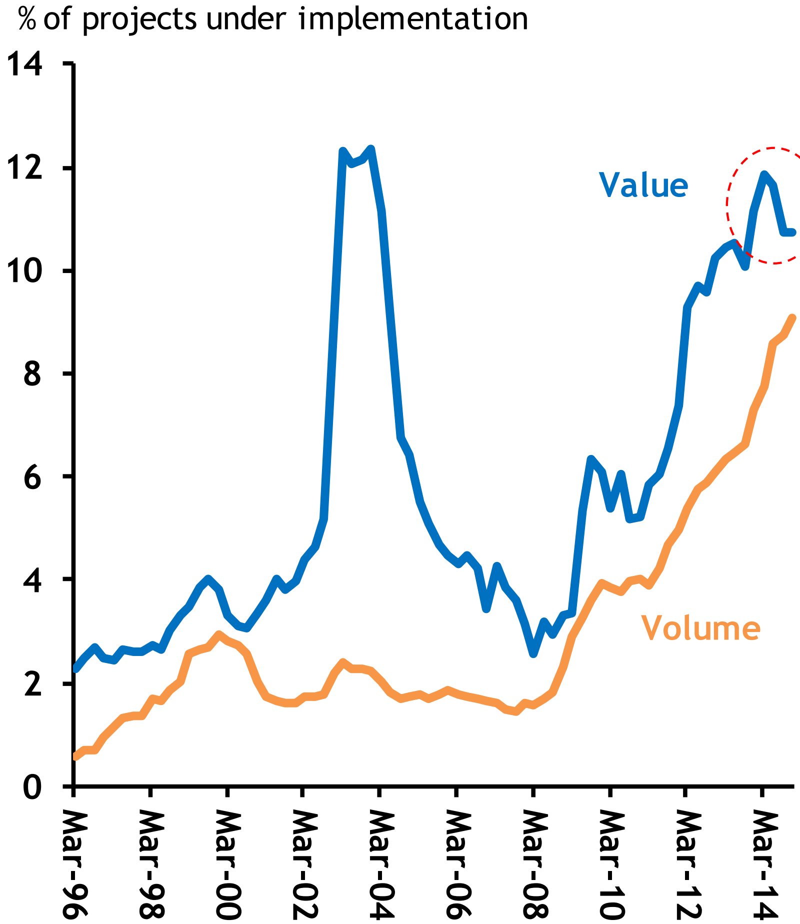
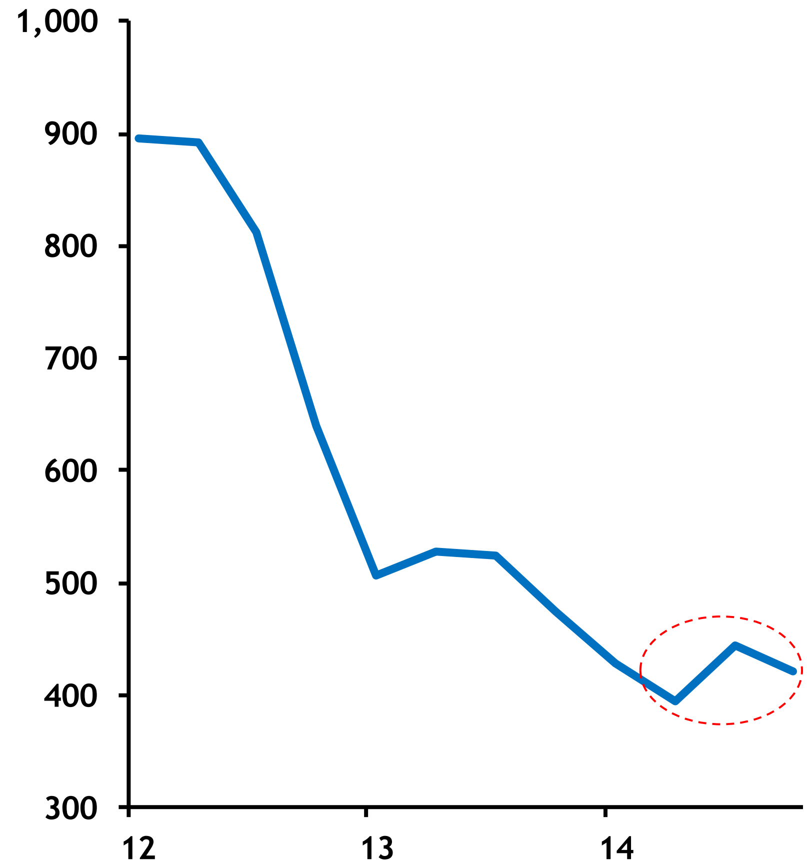
Implementation bottlenecks are the key; green shoots?

Stalled Projects



Project starts

No of projects announced



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Almost half the slowdown due to implementation bottlenecks and associated loss of confidence

Decomposition of Slowdown from 2010 to 2013	
	ppts
Actual Growth Slowdown (ex agri, com serv)	695.0
Slowdown that can be explained	660.0
percent explained by	(%)
Slowing Trading Partner Growth	10.0
Higher Oil Prices ($)	11.0
Real Interest Rates	35.0
Implementation Bottlenecks (proxied by stalled projects)	28.0
Investor Confidence (proxied by projects starts)	16.0
Supply Bottlenecks and investor confidence	44.0

Source : JPM Calculations

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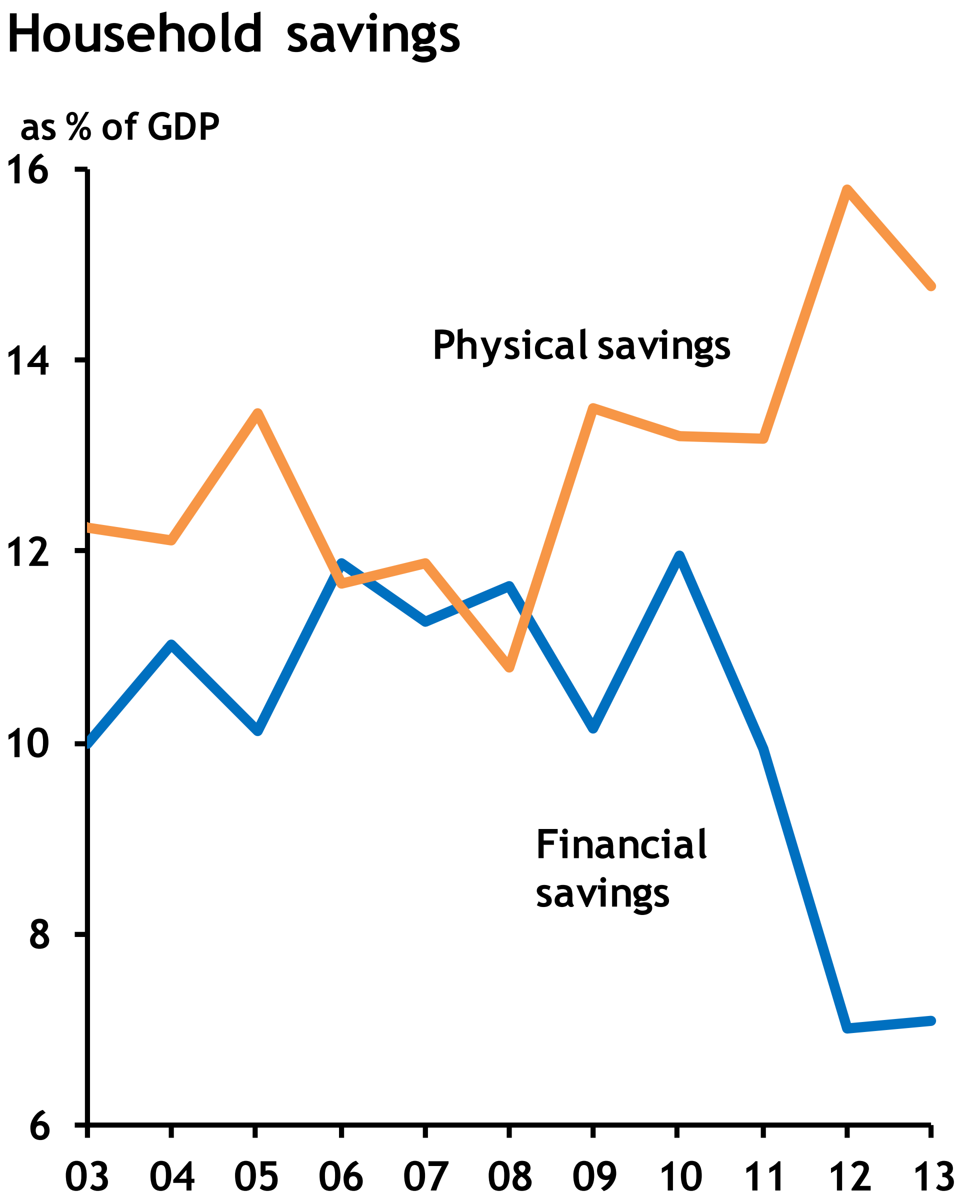
But are we ready to finance a recovery in capex?

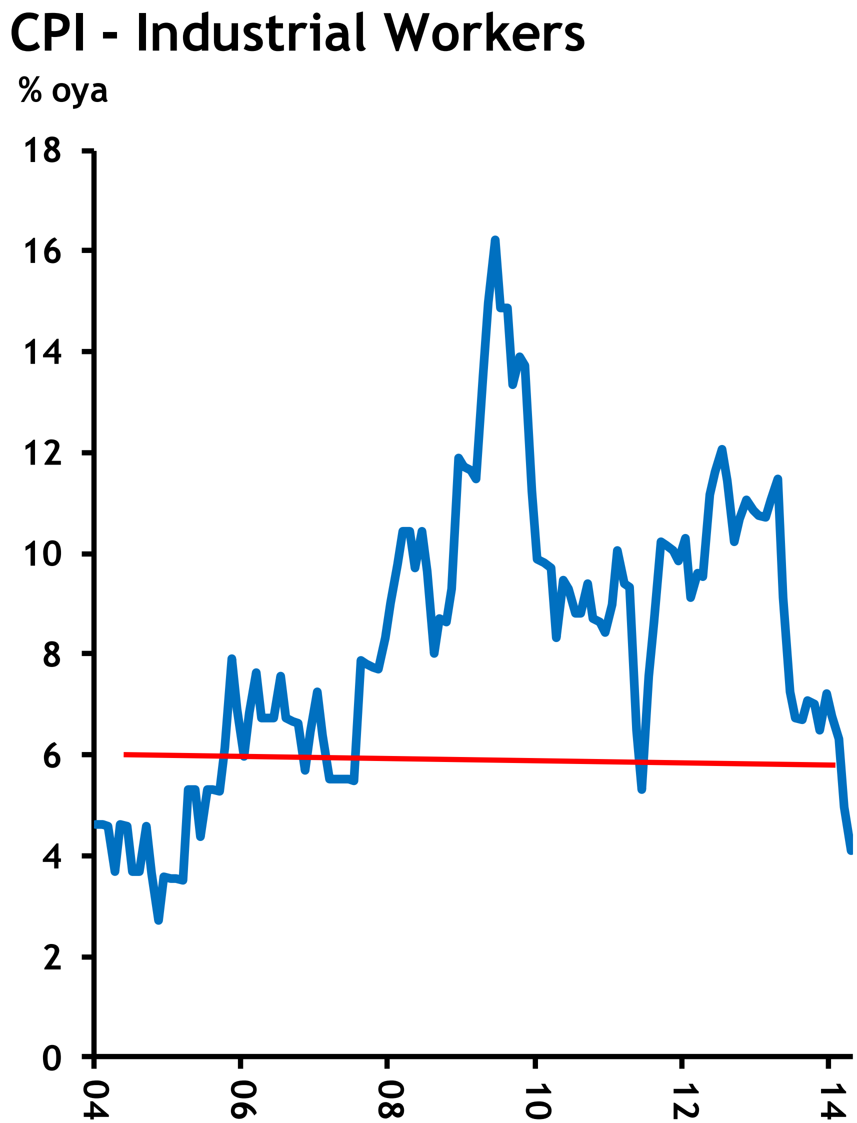
- How good a job is the financial system currently doing of "allocative efficiency"?
  - When infrastructure projects are cleared, will they be easily financed?
  - Can a capex recovery be financed from domestic savings?
- Is financial stability an issue?
  - Is there a build-up of underlying vulnerabilities?
  - Are segmented markets, and the absence of a bond-currency-derivative market nexus, responsible?

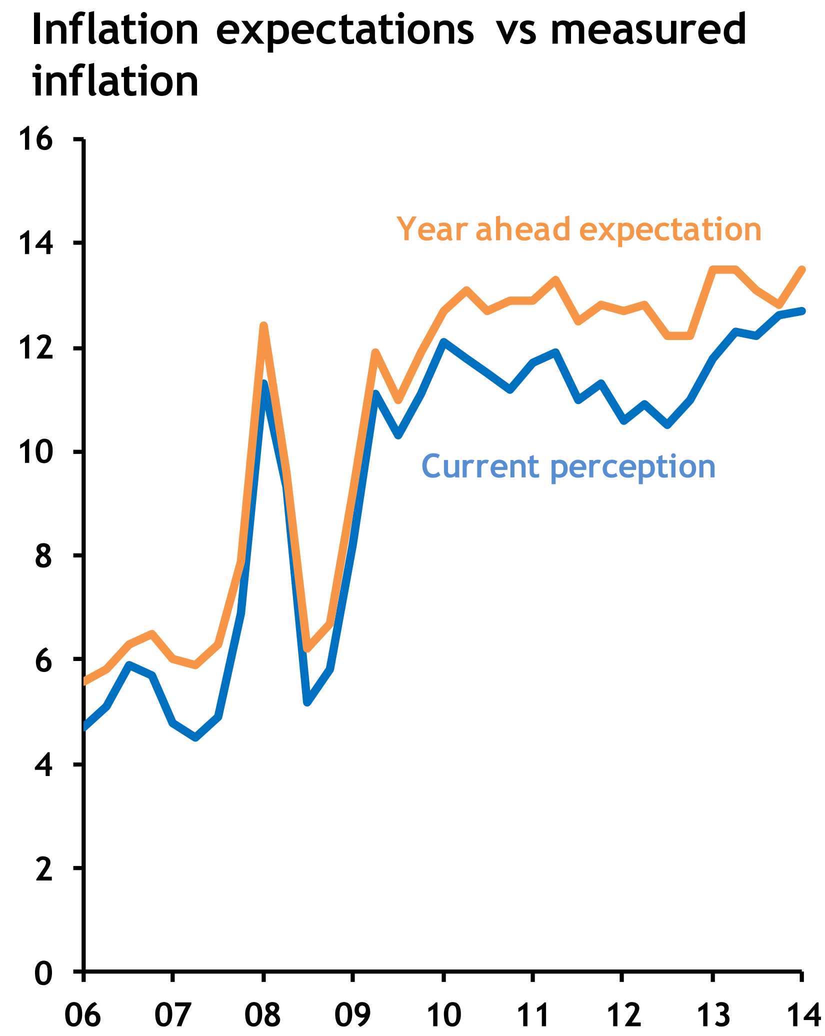
Symptom 1: A financial disintermediation post-Lehman



- Both "access" (financial inclusion) to financial assets and "attractiveness" of assets are drivers
- But the latter is a secular phenomenon and cannot explain sharp drop-off in recent years

Driver 1: Stubbornly high inflation and inflation expectations…





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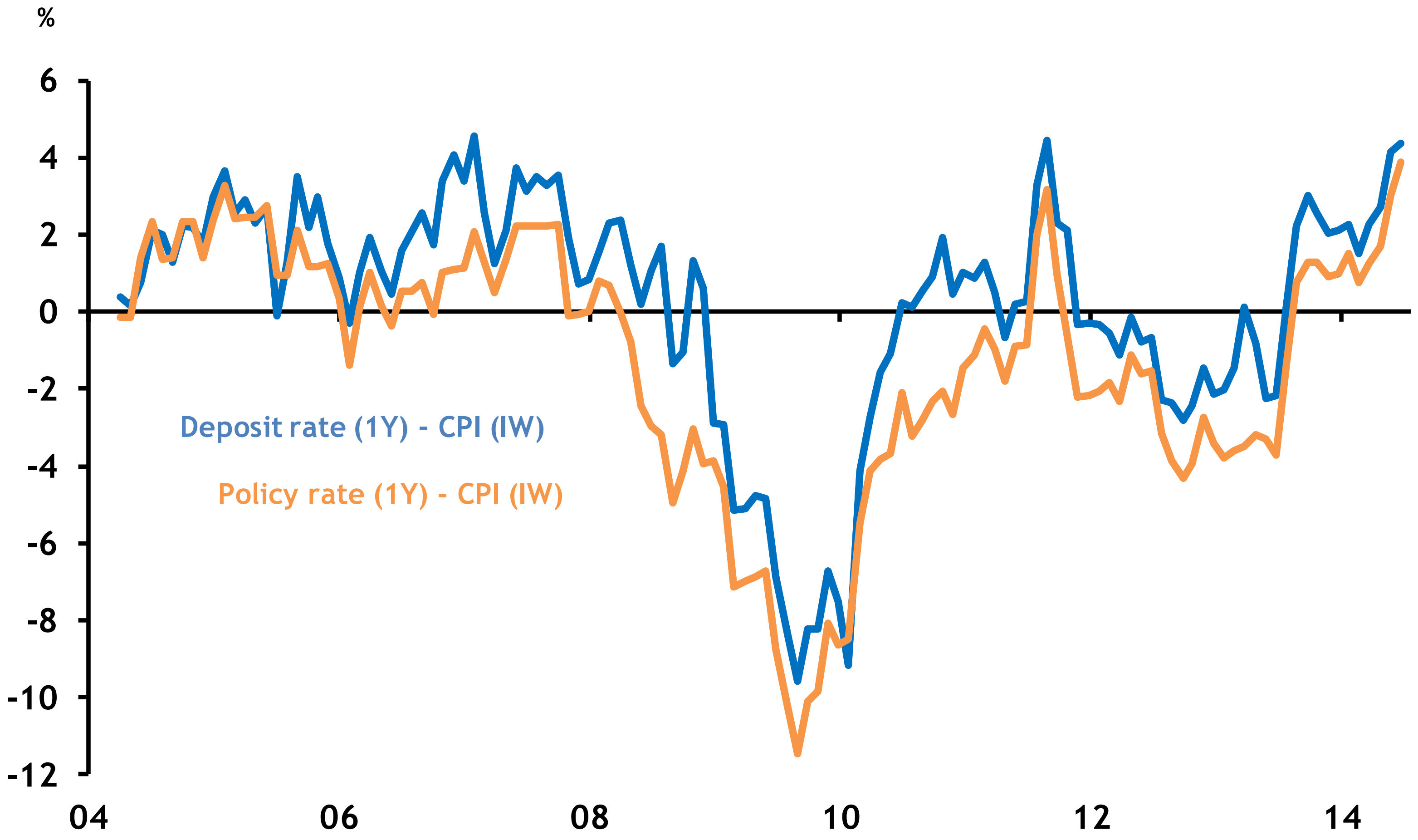
Resulted in consistently negative real rates of return on financial assets

Real deposit and policy rates



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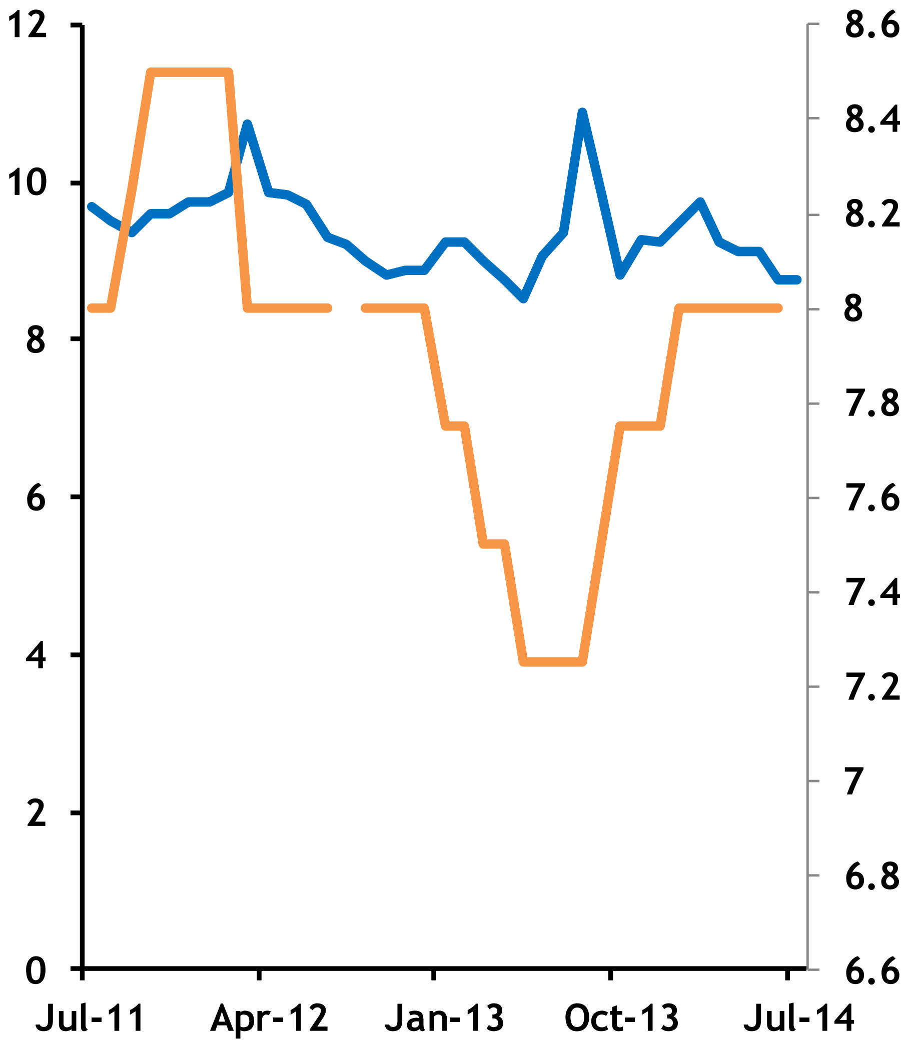
And resulted in asymmetric monetary transmission

1 Y deposit versus Repo

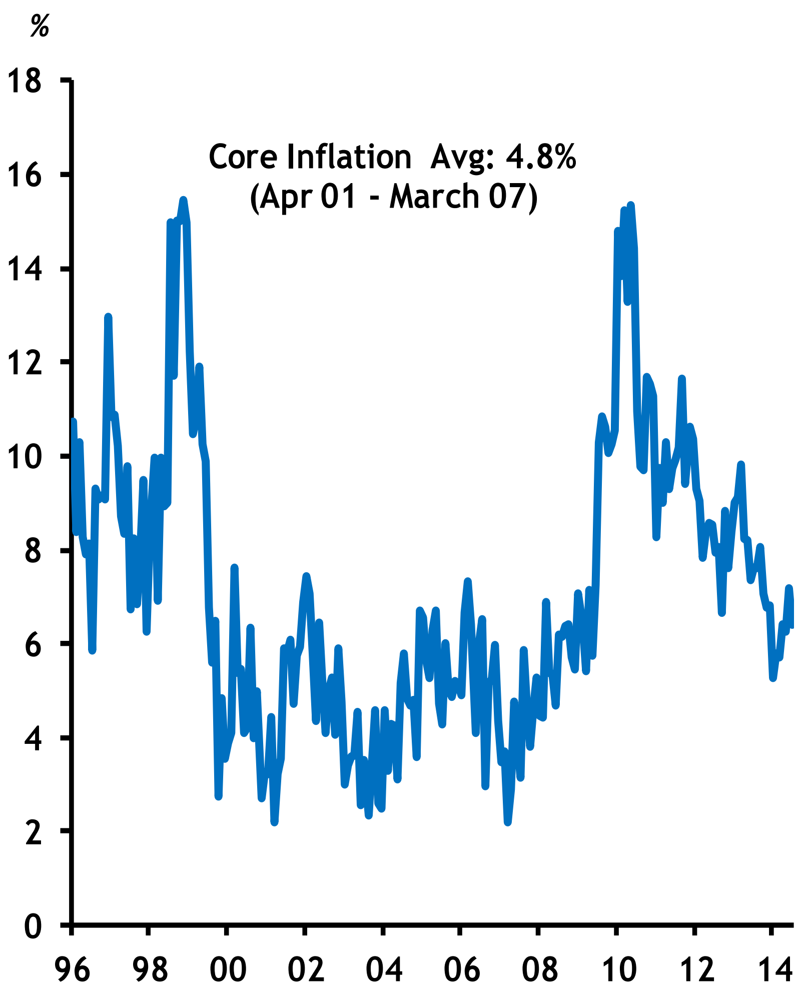


- Banks were reluctant to cut deposit rates for fear of triggering financial disintermediation

- PSU banks constrained by “deposit” targets

Implications for monetary policy: speculating on a neutral rate

India: Core CPI (IW)



India: Real policy rates

Source : MOSPI, Bloomberg, CEIC

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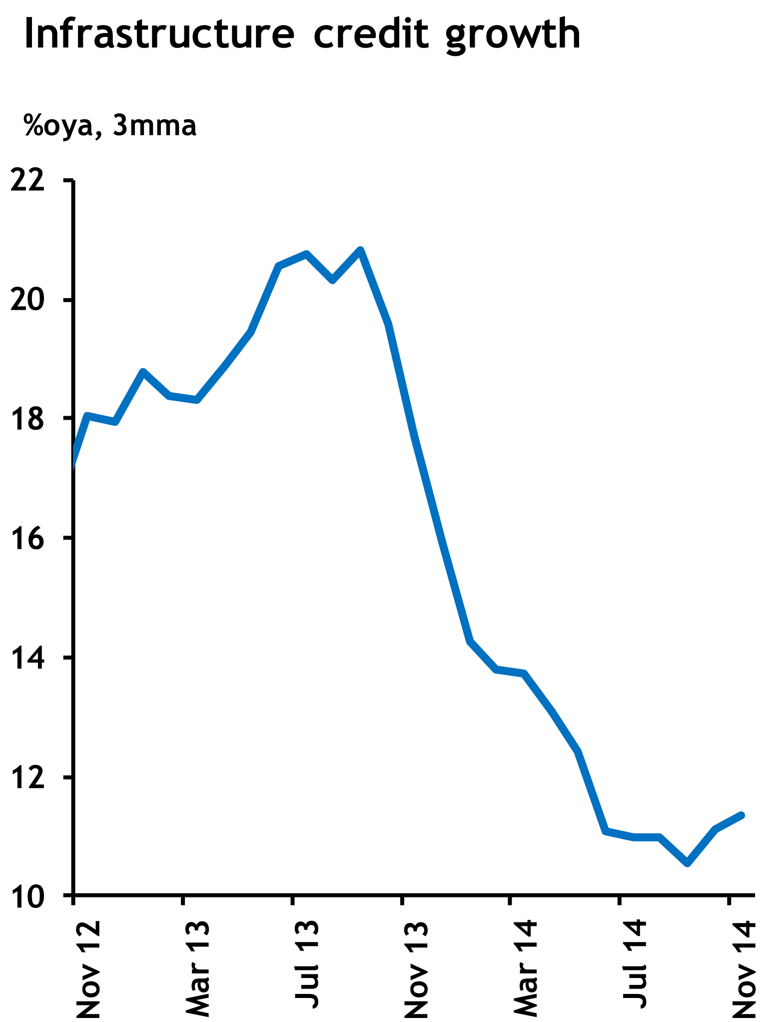
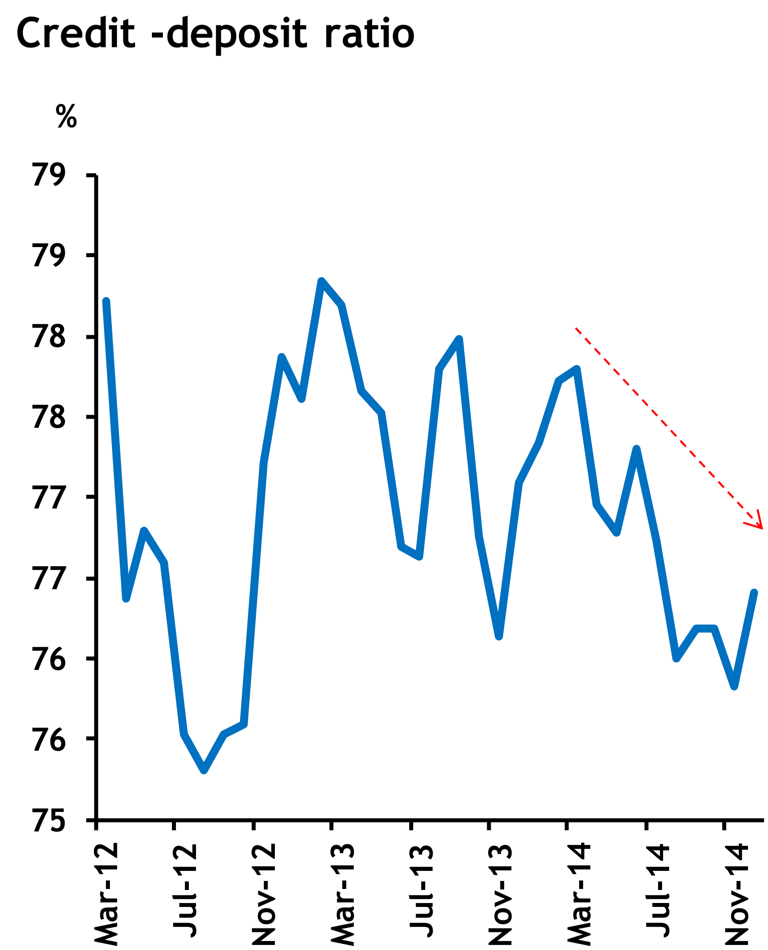
Implication: limited space to ease unless inflation remains at current levels

Uncomfortable monetary arthimetic		
% average	**FY02-FY07**	**FY15-FY17**
Assumed potential growth (% oya)	7.3	6.5
Realised inflation (% oya)	4.5	6.0
Growth-real rate gap	4.7	4.7
Derived real rate	2.6	1.8
Implied policy rate	**7.1**	**7.75-8.0**

- Real rates need to stay positive for financial development
- Else any pick-up in investment will rely disproportionately on foreign, not domestic, savings pressurizing the CAD
- The higher the potential growth, the higher the needed real rate

Symptom 2: But even as financial savings pick up, great reluctance to lend on the part of banks





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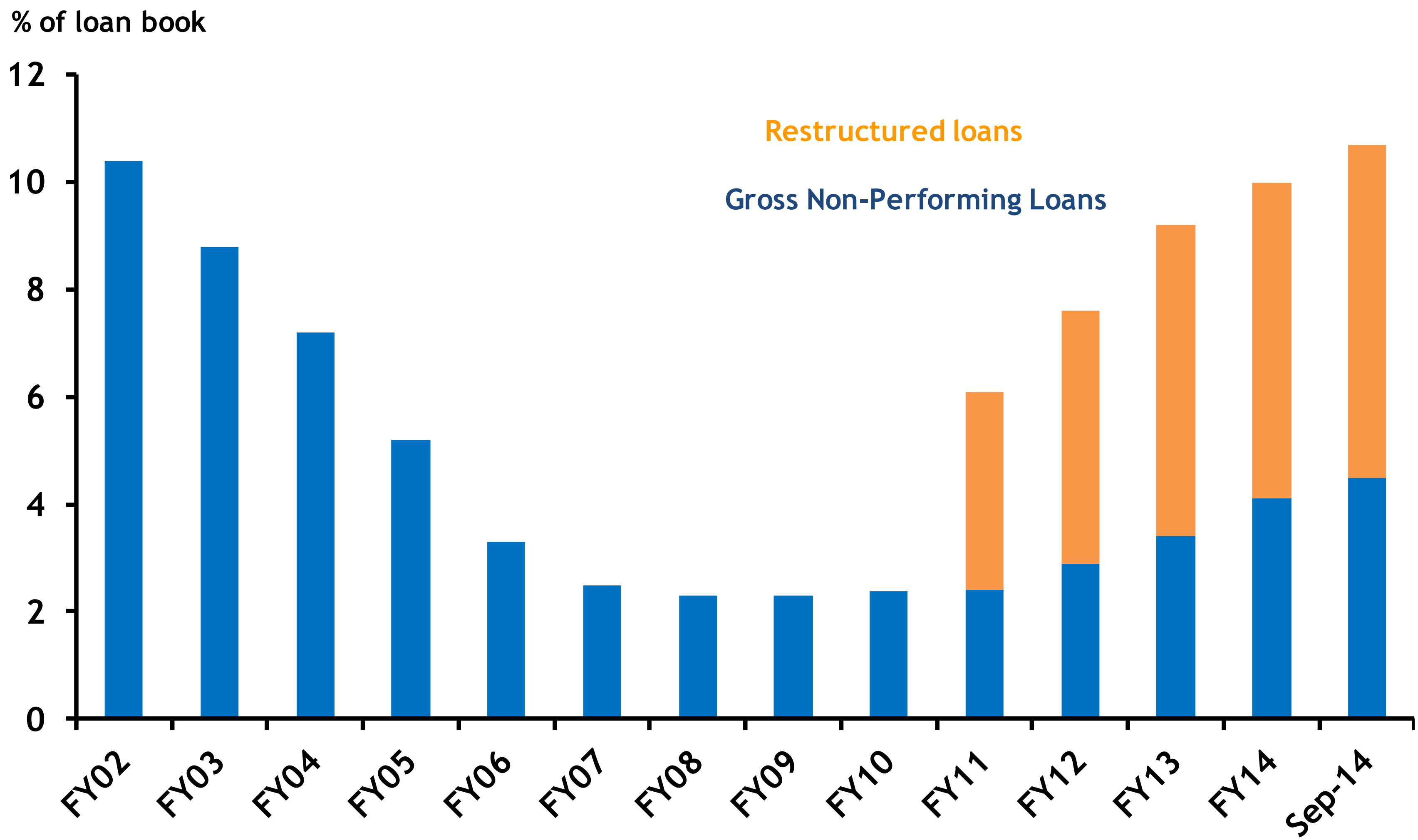
Balance sheet problem – NPAs driving risk aversion; cyclical or structural ?



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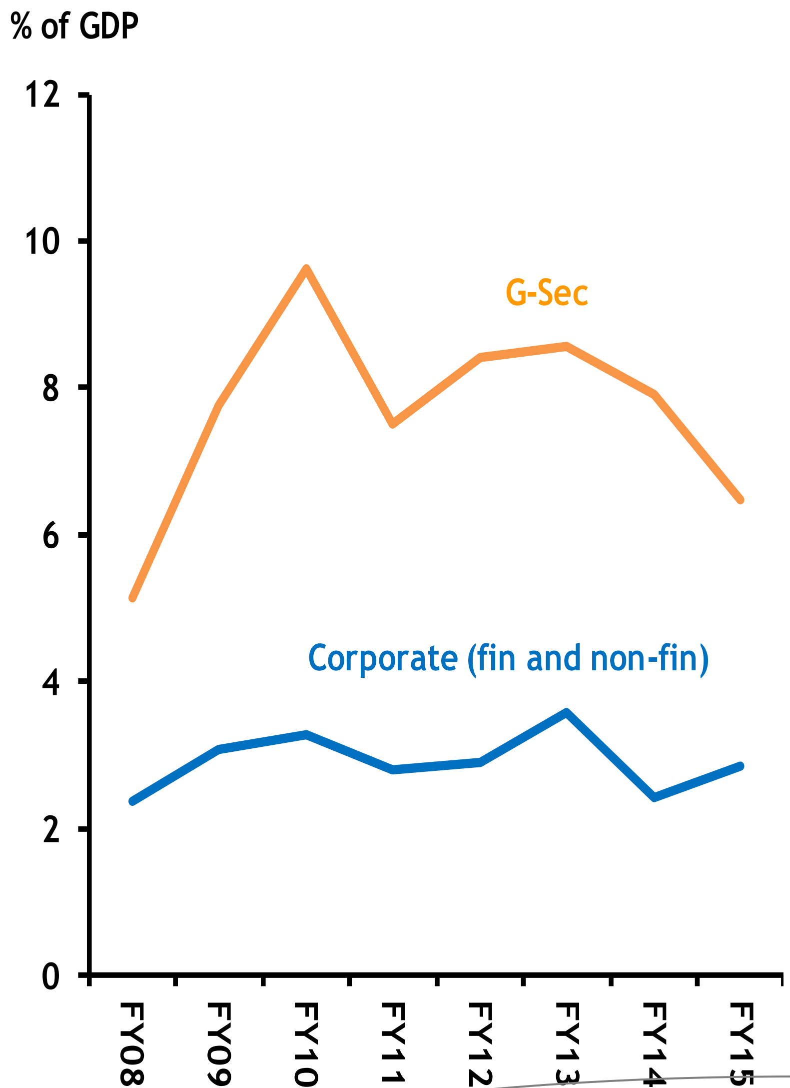
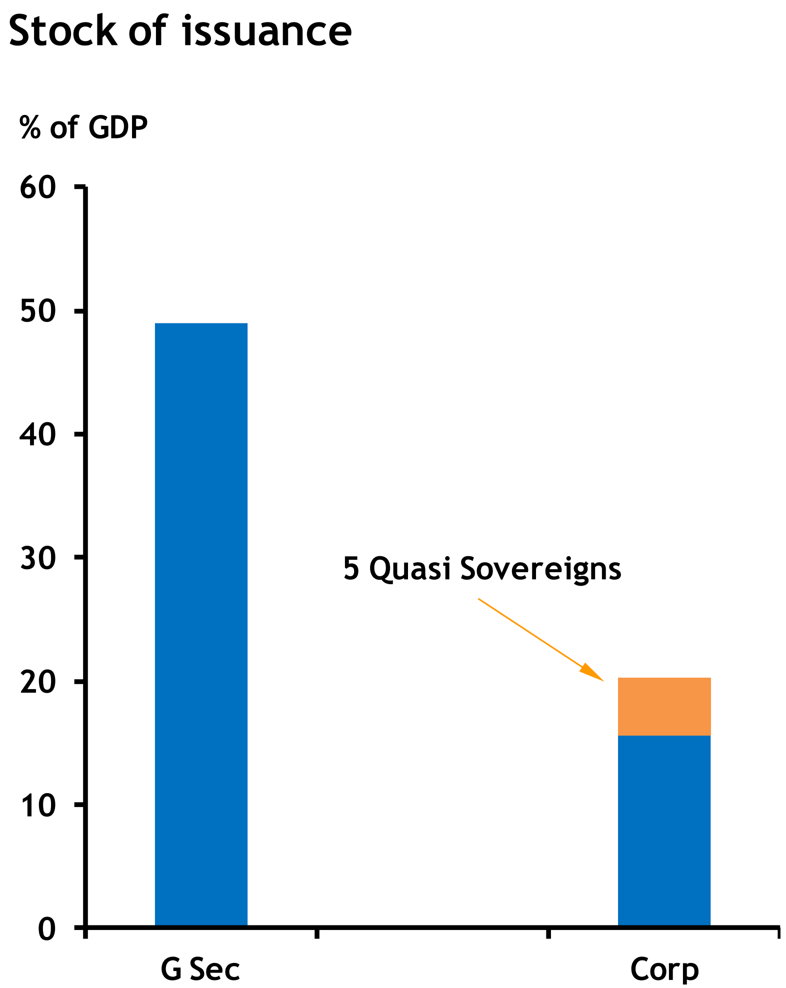
Bank reforms needed but there's a more fundamental issue at hand

- Microeconomic issues afflicting public sector banks is well known and don't need repetition:
  - Governance reforms within PSBs
  - Did they systematically mis-price risk?
  - How do we improve real/financial restructuring and debt recovery
- More fundamentally: banks ill-suited to make long-term infrastructure investments given the ALM mismatch
- Fiscal constraints: current civilian capex of central govt budget = 1% of GDP
- Cannot escape the need for a vibrant corporate bond market ?

Driver 2: A shallow corporate bond market





G-sec/Corp. mix is both a symptom but also cause of the problem

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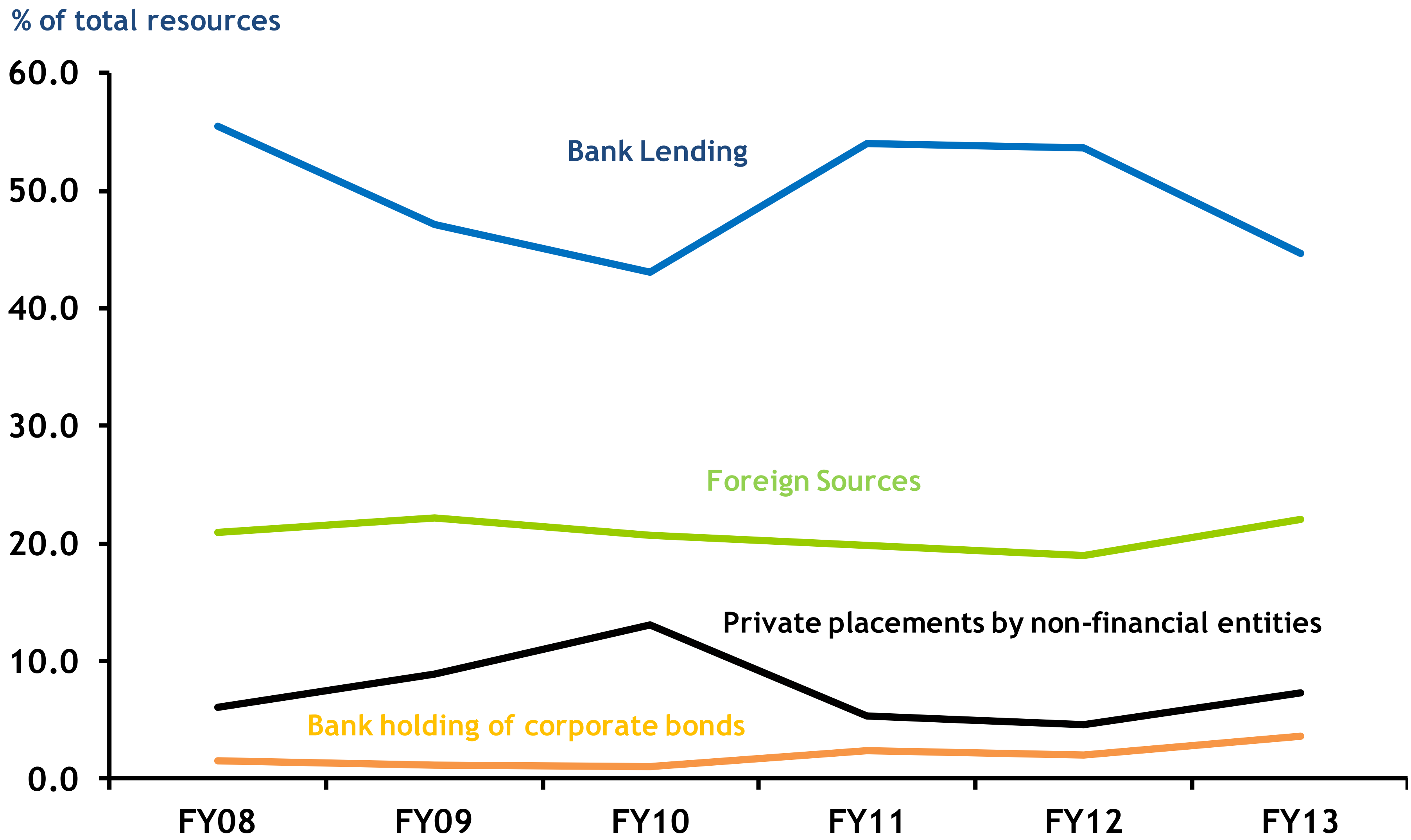
Corporate bonds constitute a very small fraction of fund-flow to non-financial entities



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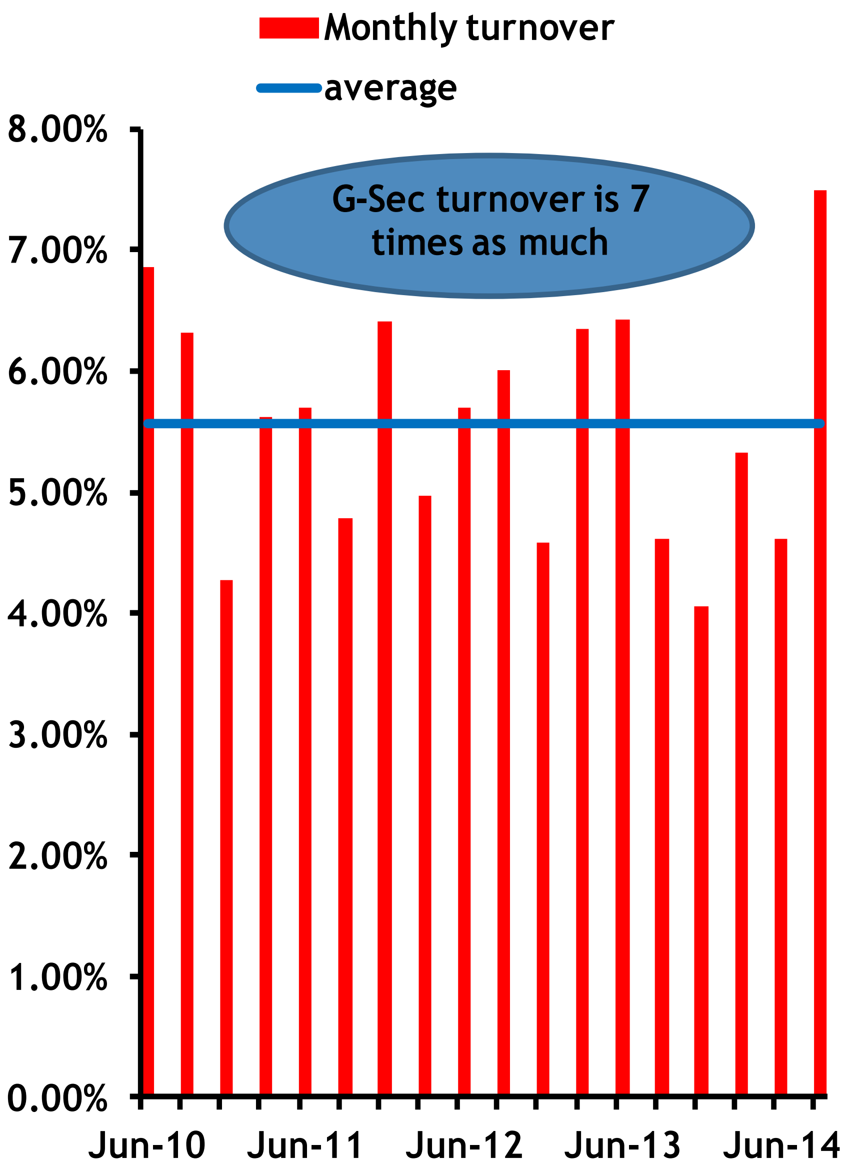
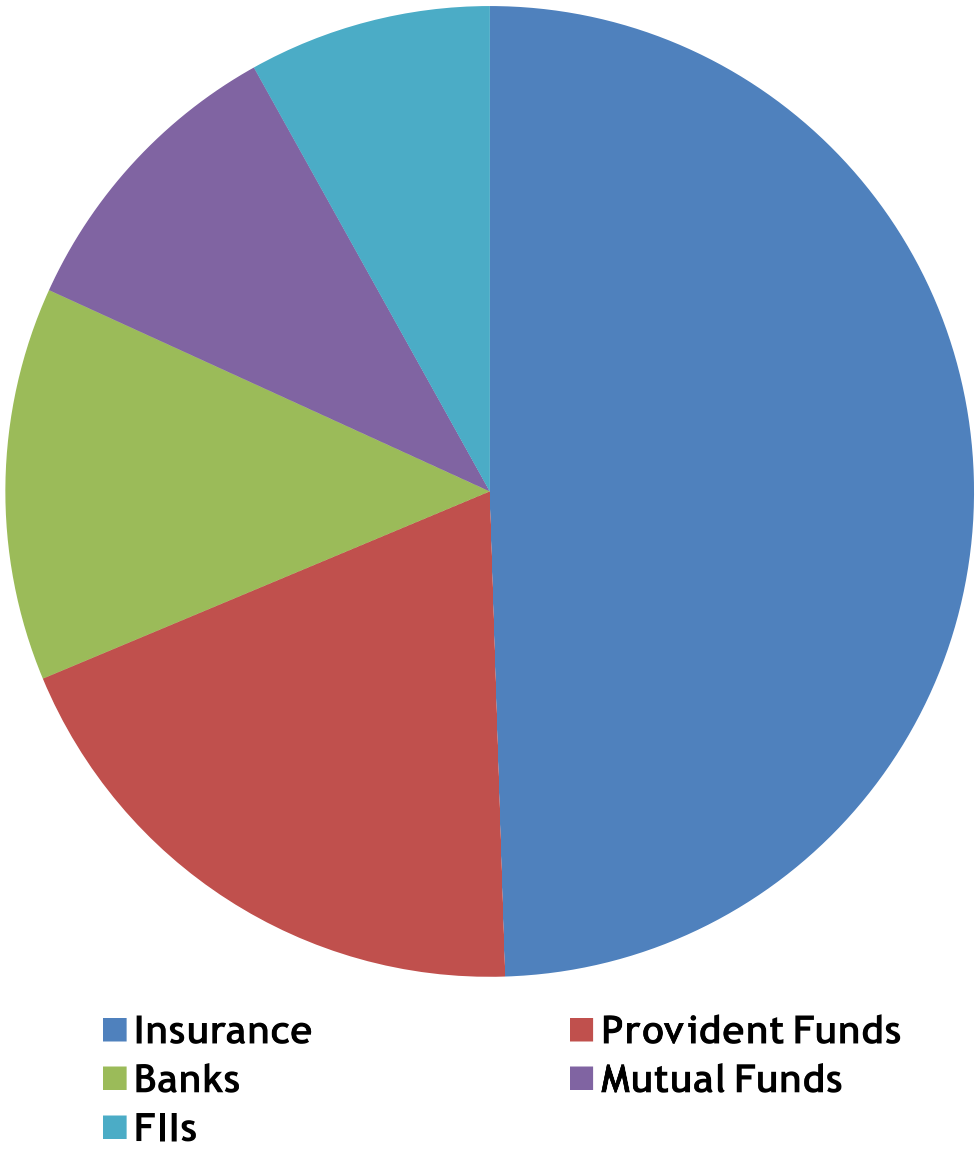
Low turnover and secondary market liquidity



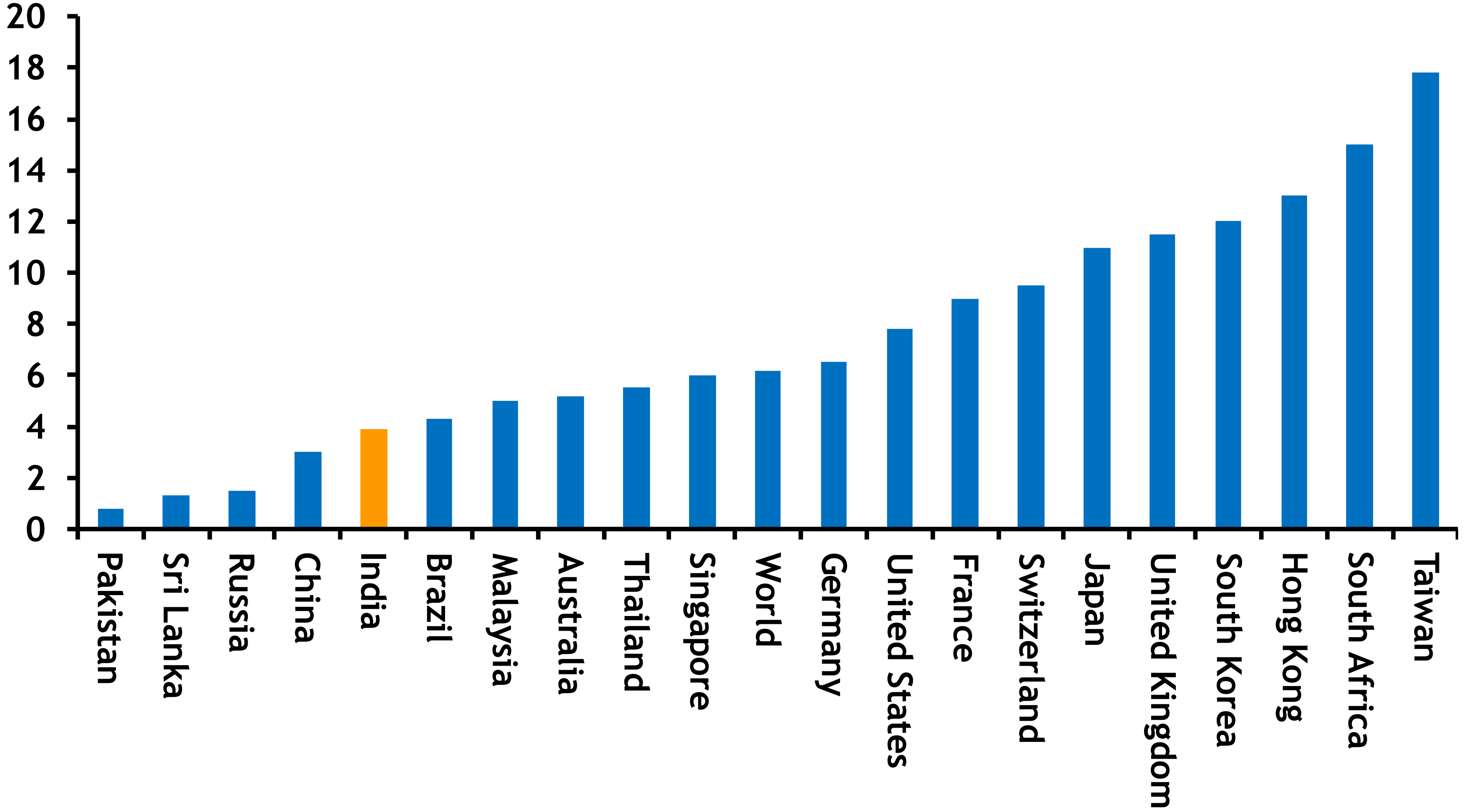
- "On-the-run" bid-ask spreads 2-5 bps for corp; 1 for G-secs; "off-the-run" 10-15 bps for corp bonds; 5 bps for G-secs
- Lower secondary market liquidity because of prevalence of buy-and-hold investors

Need a critical mass of heterogenous owners



- Expecting banks to hold a larger share is like asking the turkey to vote for Christmas
- FIIs key to secondary-market liquidity

Plethora of microeconomic distortions but long term contractual savings is key for depth



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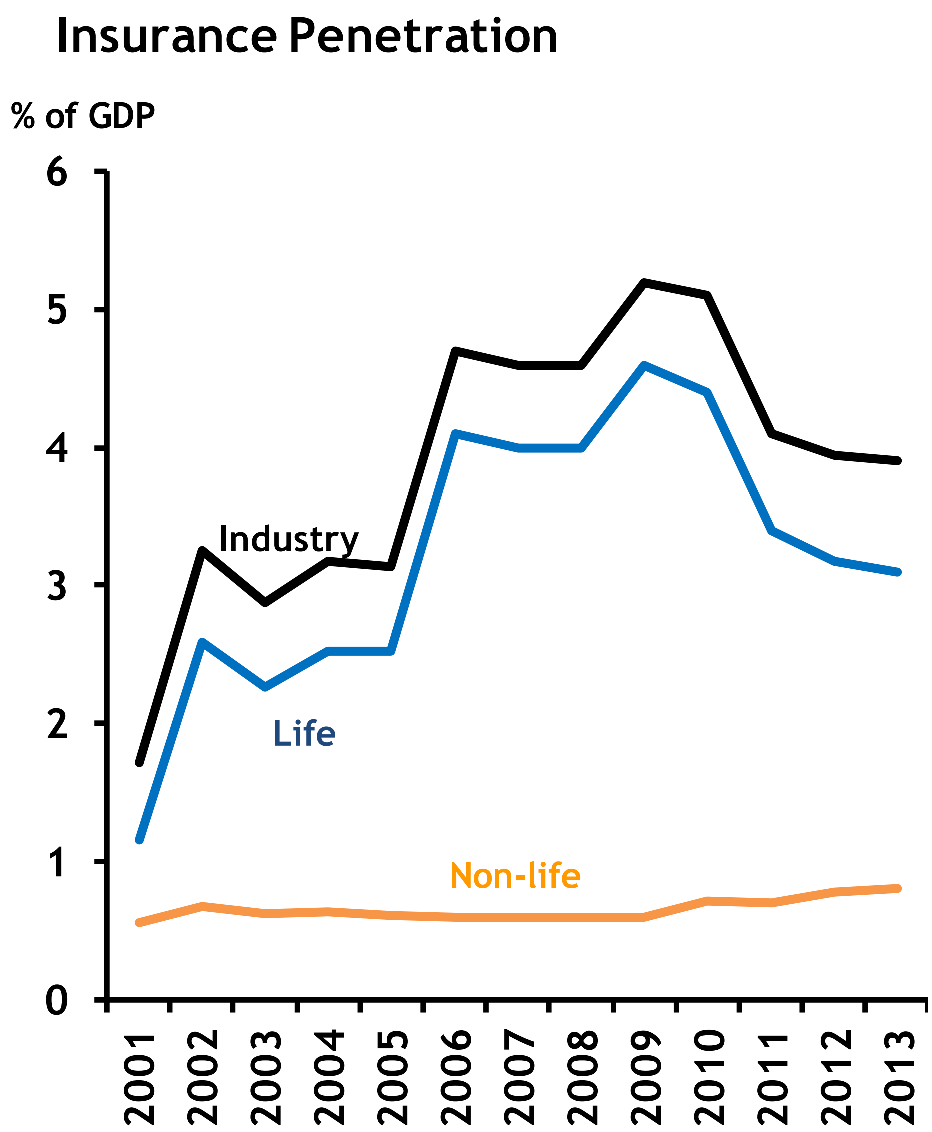
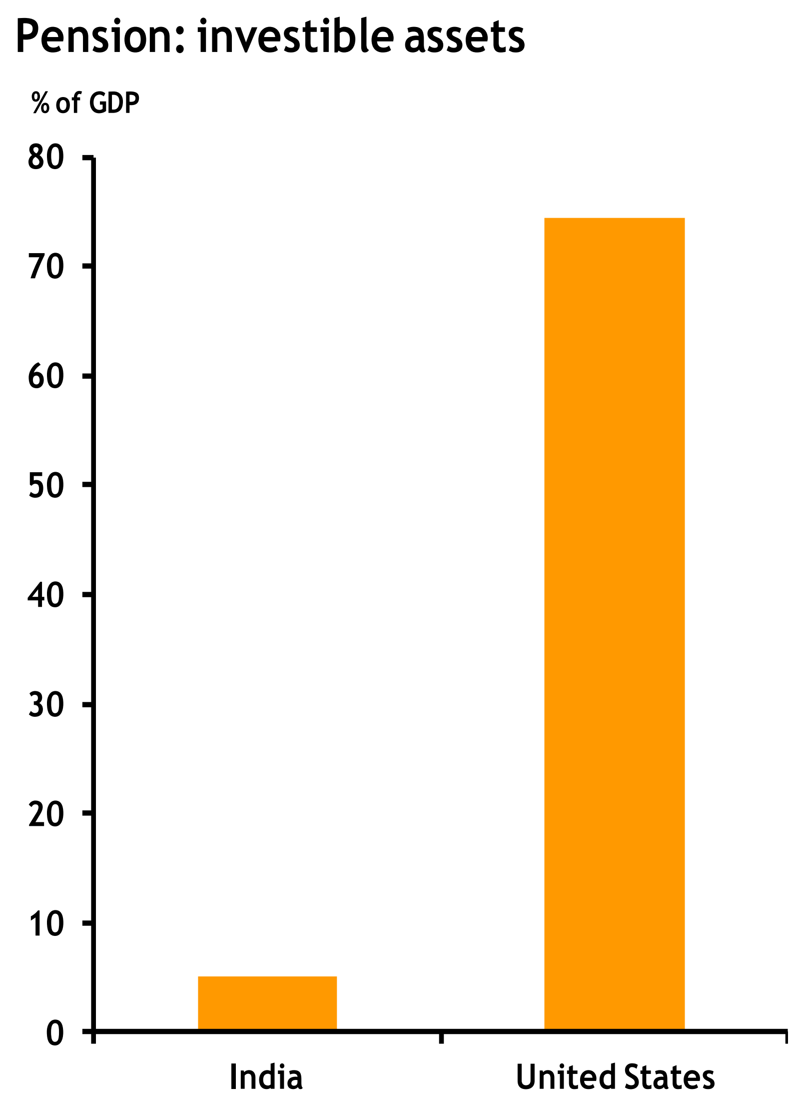
Need to boost market for long-term contractual savings





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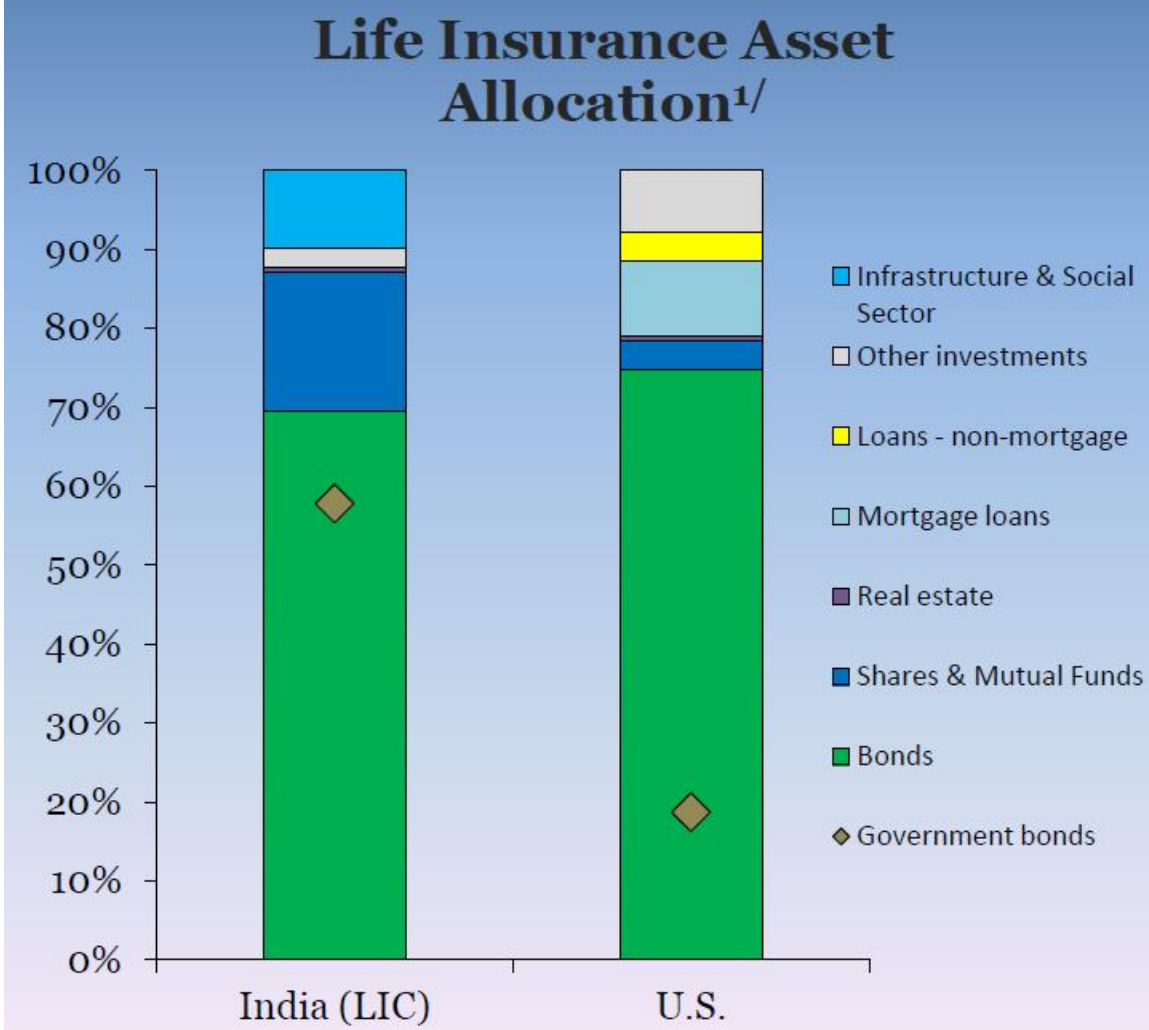
And reduce fiscal crowding out

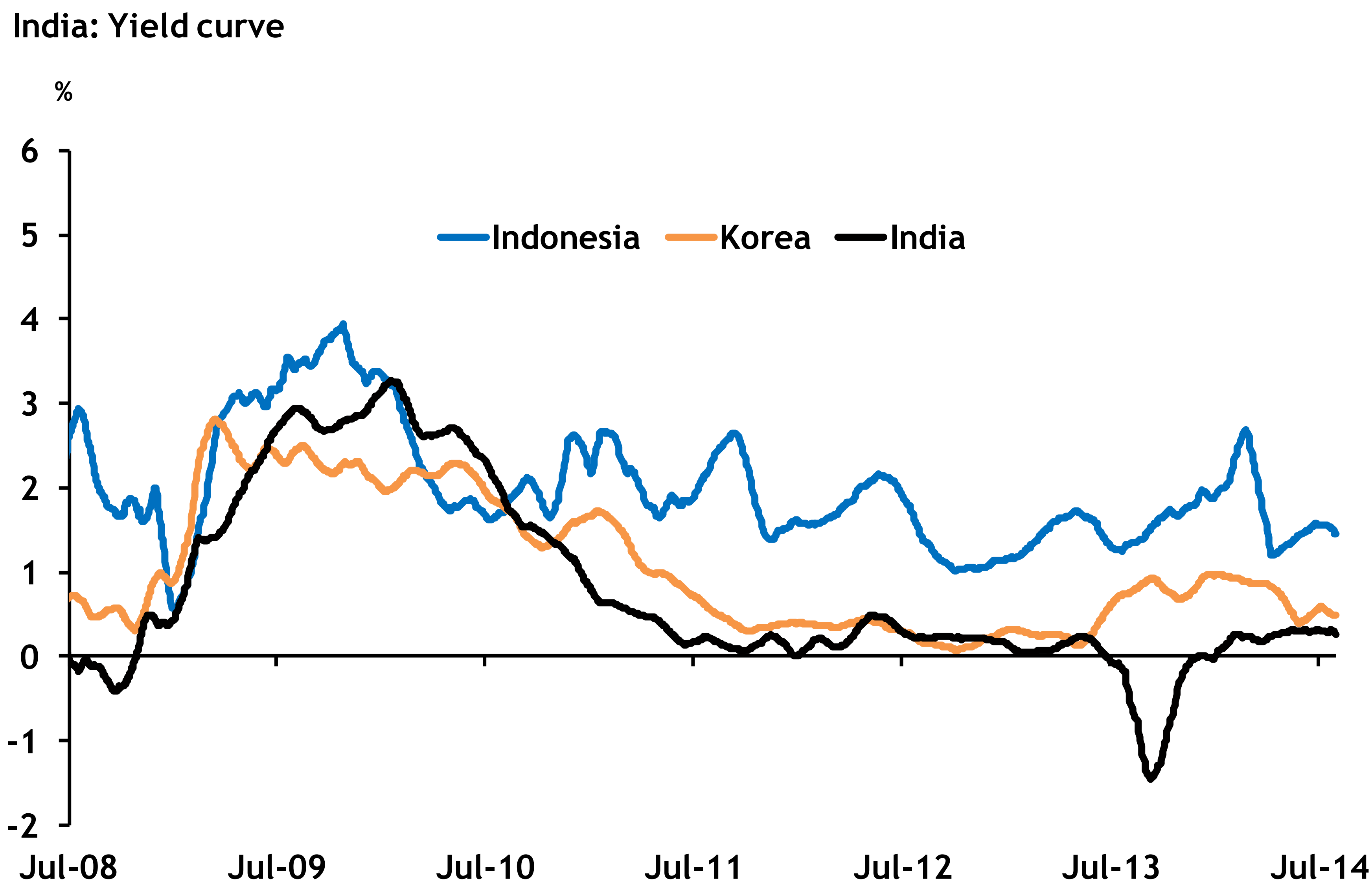


Life Insurance Company of India's (LIC) Asset Allocation:

- On first glance similar to U.S. Life Insurer's
- But LIC holds 40% more government bond
- Leaves room for re-allocation towards corporate bonds

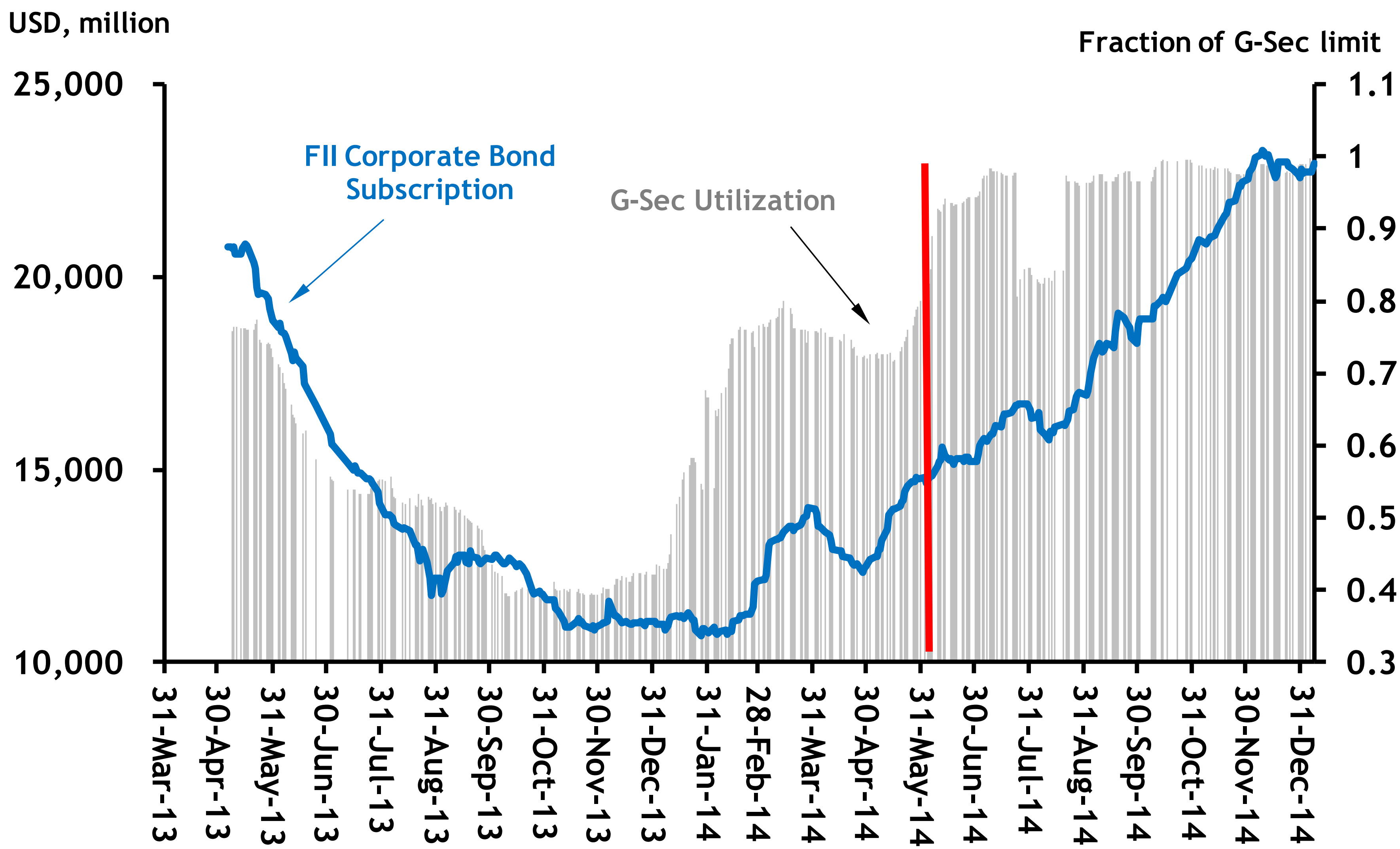
Source : Ratna Sahay, "India's Capital Markets", August 2014

Financial repression: a relatively flat yield curve disincentivizes long-term savings



Source : CSDS Post -poll

Crowding out: letting the data talk



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Corporate bond market: cutting to the chase

- Yes, a variety of micro constraints distortions – stamp duty, disclosure requirements, bankcrupty code
- But a necessary condition for market depth and development
  - Increasing market for long-term contractual savings (pension insurance)
  - Reducing fiscal deficits to reduce crowding out
  - Obviating the need for financial repression (SLRs, LIC)
  - Which, in turn, would reduce yield curve distortions and incentivize long-term savings

Source : CSDS Post -poll

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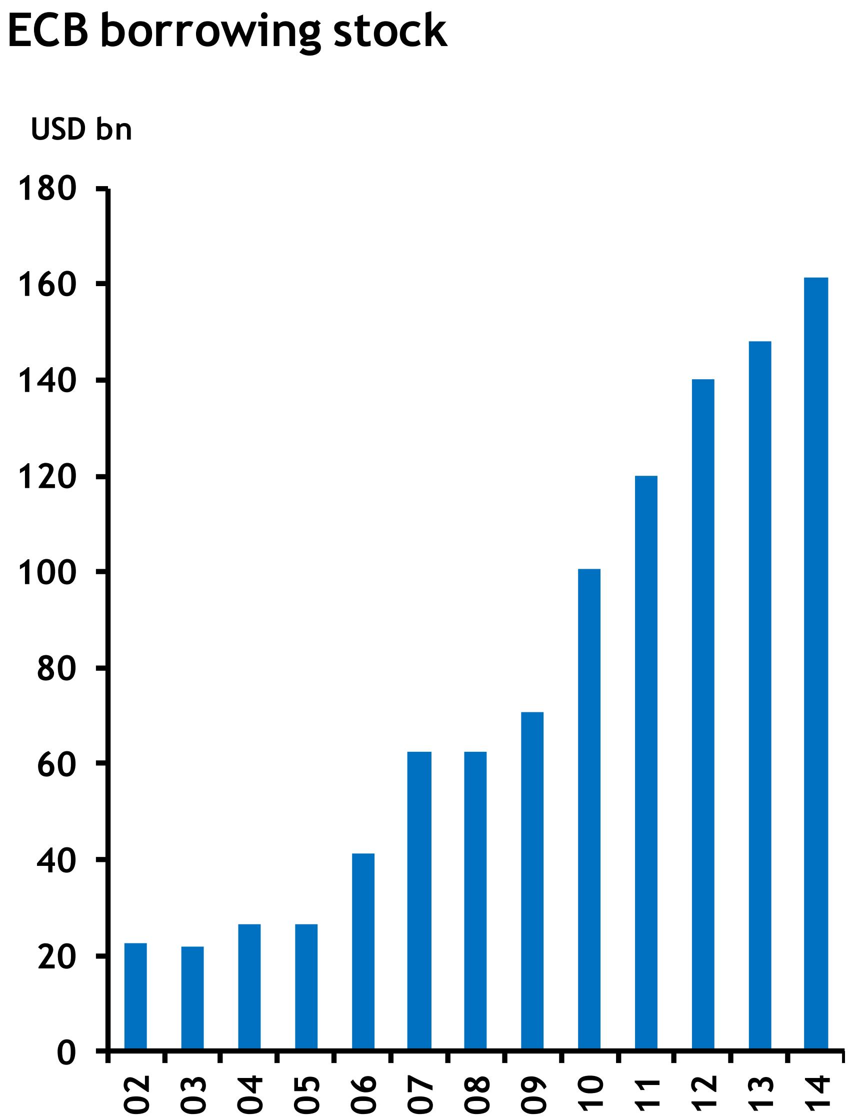
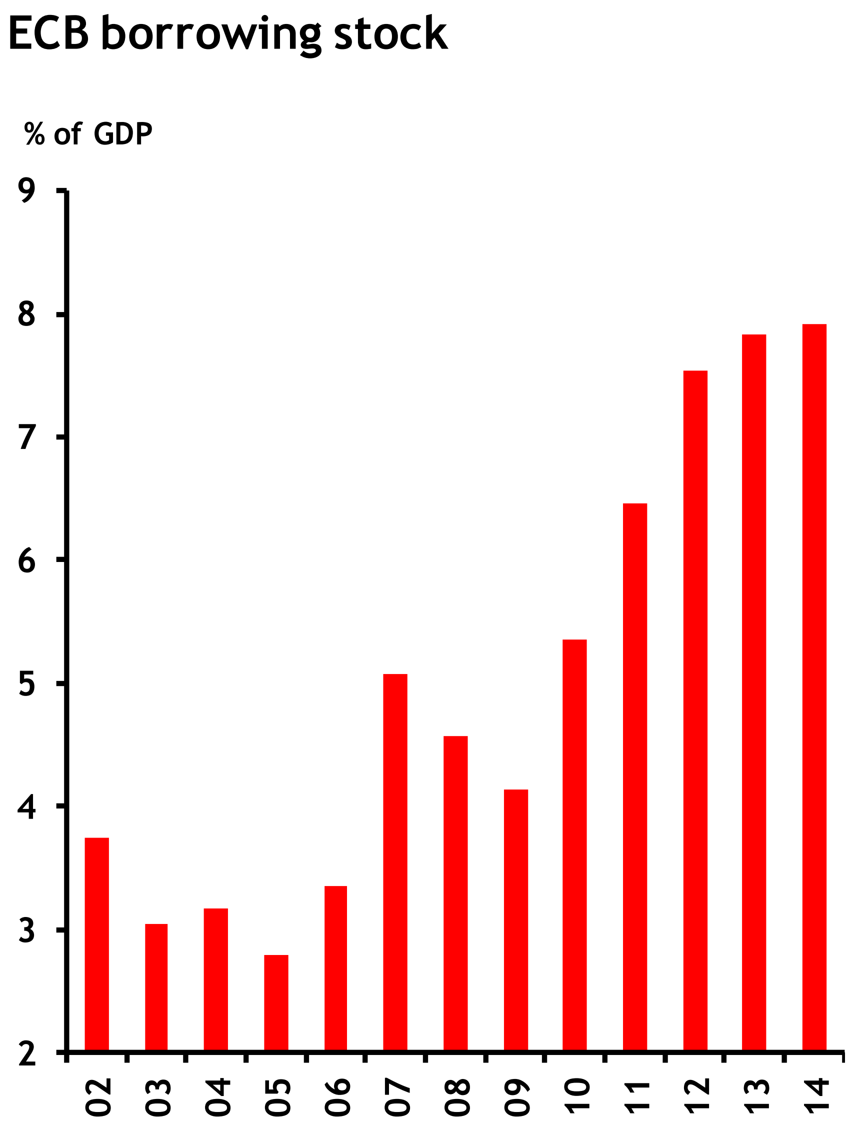
Financial stability: ground-hog day again?





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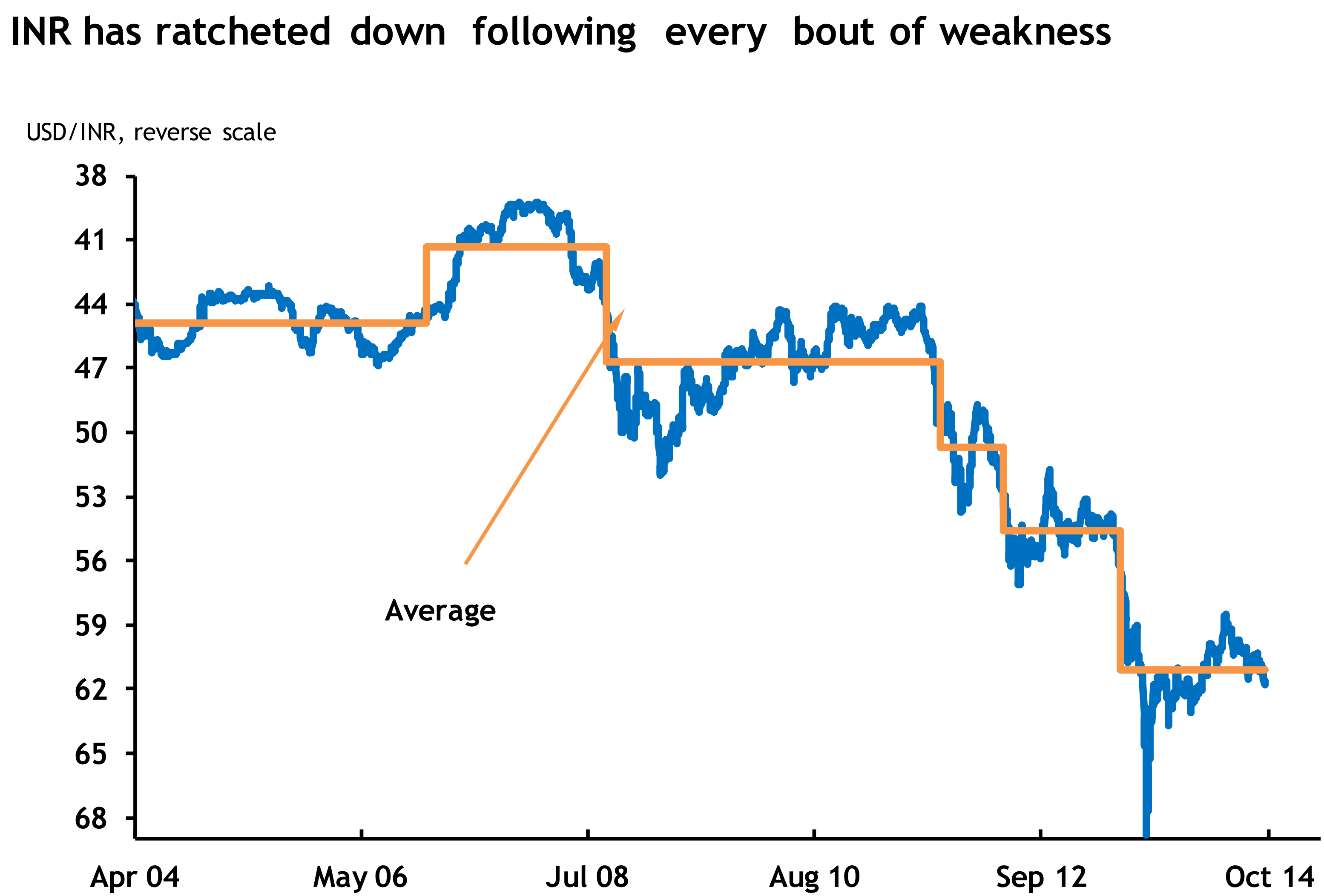
A constant ratcheting down



Source : Bloomberg

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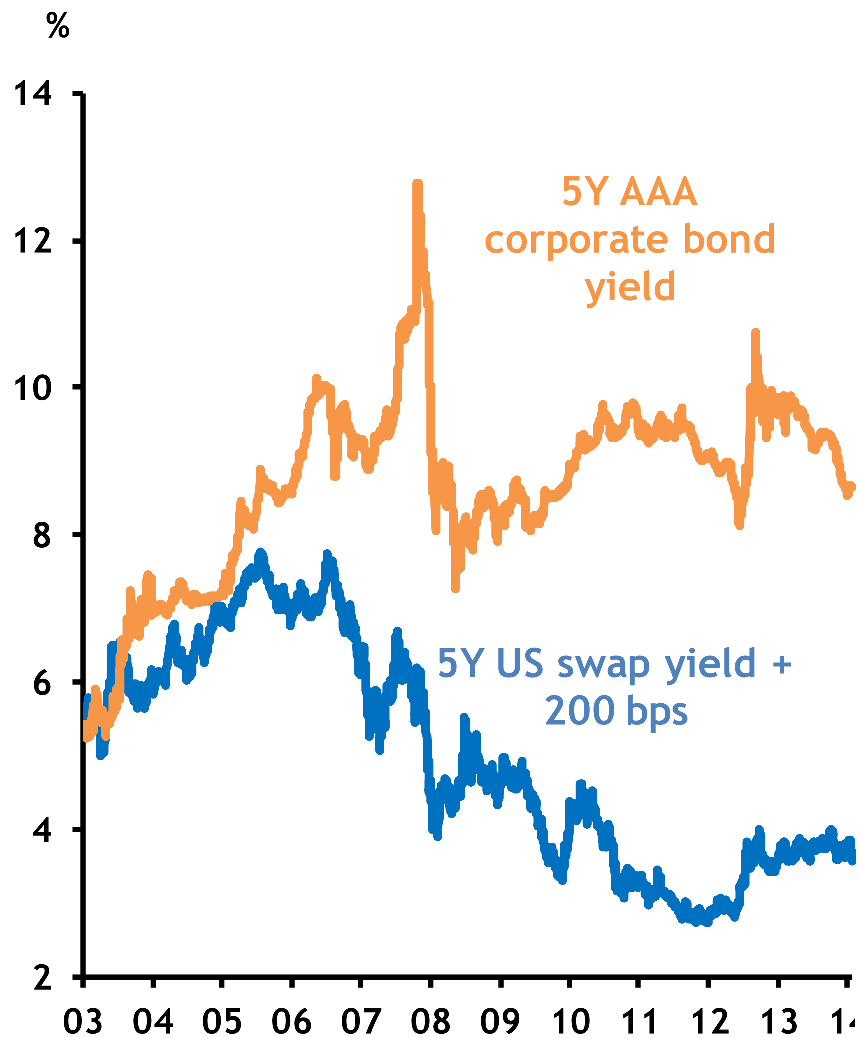
Segmented markets, breakdown of BCD nexus, and financial vulnerability concerns

Dollar vs INR borrowing cost



- "Margin of temptation"

(McKinnon's "super risk premium") not to hedge is large

Especially is you believe forwards always over-estimate spot in "normal times"

- Dangerous to liberalize ECBs for those without a natural hedge

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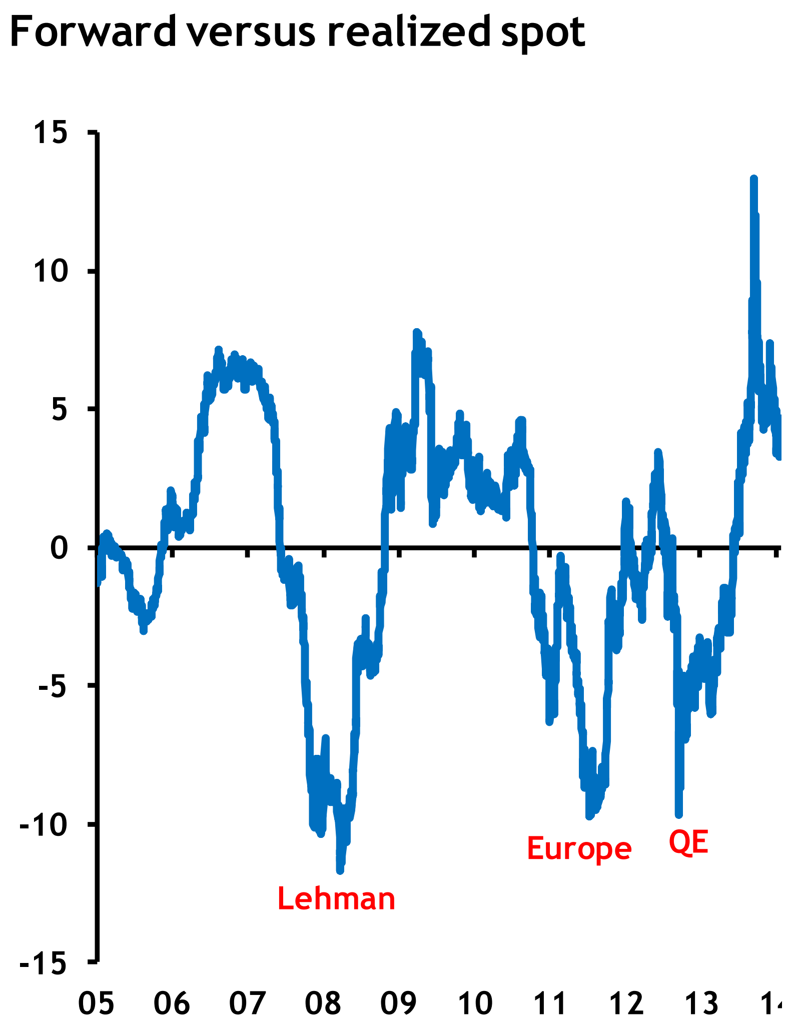
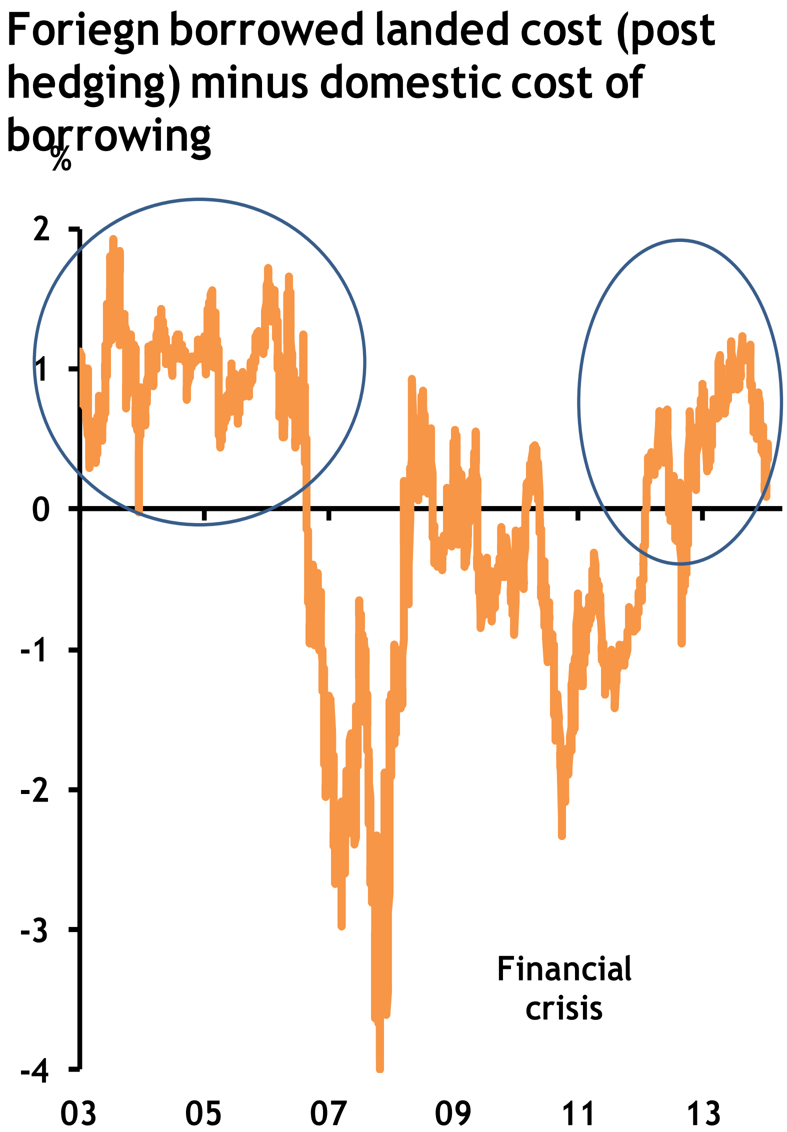
“Forwards over-predict spot in normal times”



- Should not be surprising
- Uncovered interest parity does not hold; but CIP expected to
- Existence of “currency risk premia”
- Risk neutral agents will stay uncovered

Segmented markets, breakdown of BCD nexus, and financial vulnerability concerns



- CIP completely breaks down in India
- Reflects segmented markets, lack of integration and incomplete capital account convertibility
- When "landed cost" higher than domestic cost, agents will stay open

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Putting it all together

- Growth remains weak
- Infrastructure and investment remain the key
- But fiscal constraints preclude the government from doing the heavy lifting
- Private investment is the key
- But this would need (over time)
    - Positive and appropriate real rates of return to boost financial savings
    - Greater contractual (pension/insurance) savings
        - Lower fiscal deficits
        - Reduced financial repression
        - A less-distorted yield curve

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