

Disconnect between financial markets and real sector growing: RBI report

Report says despite broad stability in financial markets, pandemic could amplify financial vulnerabilities, including corporate and household debt burden in the case of severe economic contraction

Anup Roy | Mumbai July 26, 2020 Last Updated at 14:52 IST

Some segments of the financial markets may have moved faster than economic realities suggest, thanks to the stimulus measures taken by global central banks, and this may pose a challenge to financial stability.

The Financial Stability Report (FSR), while warning about such concerns in a broad context, did not directly mention India, but the situation is not very different here. Perhaps that is why Reserve Bank of India (RBI) governor Shaktikanta Das emphasised this point. There has been a “growing disconnect between the movements in certain segments of financial markets and real sector activity,” Das wrote in his foreword to the report.

The FSR elaborated that in India, financial markets have broadly stabilised in response to fiscal and monetary stimulus, and adequate levels of foreign exchange reserves provide a buffer. Certainly, a key objective of the policy response has been “to keep financial markets from freezing up, financial intermediaries unstressed and functioning normally, and



the lifeblood of finance flowing, especially to the vulnerable and disadvantaged, while preserving financial stability and restoring strong, sustainable and inclusive growth.”

But, “the pandemic has the potential to amplify financial vulnerabilities, including corporate and household debt burdens in the case of severe economic contraction,” the FSR said.

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Sensex, the benchmark equity index of BSE, has risen about 3,000 points in the past one month even as the central bank has projected a contraction in gross domestic product for the fiscal 2020-21. Economists peg the economic contraction by 4-10 per cent, and say the first quarter GDP can easily drop by 10-20 per cent as nationwide lockdown crimped economic activities.

Bond yields meanwhile, have fallen in tandem with the 135 basis points repo rate cut by the central bank since January 2019, while unprecedented liquidity

measures meant that bond yields have remained soft even in the face of a Rs 12 trillion borrowing programme by the centre alone. High frequency indicators point to a sharp dip in demand beginning March across both urban and rural segments, the report noted, adding, central Government finances are likely to suffer some deterioration in 2020-21, “with fiscal revenues badly hit by COVID-19 related disruptions even as expenditures come under strain on account of the fiscal stimulus.” State finances will suffer even more due to the additional burden of lower federal transfers.

While portfolio flows turned negative in March, it has picked up in May and June as yield chasing investors poured in easy money in emerging markets, including in India. But the FSR noted that this money is also liable for sudden reversal on risk-off sentiments. In the global financial landscape, there is a fear of dollar shortage impeding the economic recovery, while fall in global yields meant that institutional investors such as investment funds, pension funds, and life insurers have sought riskier and more illiquid investments to earn their targeted return.

RATINGS OF PRIVATE CORPORATES

Special Mention Accounts (SMA 1 & 2) ratings (%)

	Dec 2018	Mar 2019	Jun 2019	Sep 2019	Dec 2019	Mar 2020
AAA	2.1	0	0	0.7	0	1.8
AA	11.1	2.8	0.2	1.2	1.9	0.2
AA and above	13.1	2.8	0.2	1.9	1.9	1.9
A	9.1	14.6	7.8	3.8	5.6	13.4
BBB	15.6	16.5	13.2	16.4	15	18.8
BB	17.1	12.8	18	15.8	18.1	9.3
B	7.2	5.5	6.6	6.5	9.7	6.9
C	1.2	1.1	3.1	0.5	0.8	1.7
D	20.5	23.9	26.9	30.5	19.1	24.0
Unrated	16.1	22.8	24.2	24.7	29.7	24.0

Source: Financial Stability Report

The corporate sector in India is also not doing any good either. The performance of the private corporate sector deteriorated in successive quarters of 2019- 20 and the contraction during the last quarter was particularly severe due to the COVID-19 pandemic. An analysis of special mention account by RBI found that most of the vulnerable companies are lying below AA rating.

During the year, nominal sales and net profits of 1,640 listed private non-financial companies declined (y-o-y) by 3.4 per cent, dipping 10.2 per cent in the fourth quarter alone, and 19.3 per cent (65.4 per cent in Q4), respectively, despite the corporate tax rate reduction of September 2019, which brought down the effective tax rate by nearly 3 per cent y-o-y in 2019-20, the FSR noted, adding, “this poor performance was led by the manufacturing companies, as services sector companies, especially those in the IT sector remained in positive terrain.”

Deleveraging by the private corporate sector over the recent years stalled during the second half of 2019-20 as debt to asset ratios increased due to higher borrowings. The FSR noted that the incremental borrowings were used to create financial assets, such as loans and advances to subsidiary or other companies and financial investments, and not for capex formation.

Banks therefore turned risk averse and the wholesale credit growth in fiscal 2019-20 has been only 2.79 per cent, even as banks relied on retail for an aggregate credit growth of 6.1 per cent at the end of the fiscal.

“For the fiscal year as a whole, there is still heightened uncertainty about the duration of the pandemic. As such, the downside risks to growth remain significant and full restoration in economic activity would be contingent upon the support for robust health infrastructure, recovery in demand conditions and fixing of supply dislocations, in addition to the state of global factors like trade and financial conditions,” the FSR noted.

The International Monetary Fund (IMF) in June also warned of a tightening of global financial conditions, and noted that asset prices have buoyed up on the back of ‘swift, bold and unprecedented’ policy measures, leading to disconnect between “financial market optimism and the weakening of the real economy,” with sudden risk-on-risk-off shifts in sentiment. This has exposed other financial system vulnerabilities, such as limiting market access for some economies, which are facing refinancing risks.

