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INDUSTRY OUTLOOK

AUGUST 2020 RBI'S BI-MONTHLY MONETARY POLICY STATEMENT- CONTEXTUALLY SIGNIFICANT

25 August 2020

1. PERSPECTIVE

The bi-monthly August's monetary policy was formulated in challenging circumstances. The incipient recovery discernible in June 2020 after the disconcerting crash of April 2020 seemed to have plateaued because of restrictive conditions in many States. Widespread deceleration was manifested in subdued industrial activity, contracting PMI in both manufacturing and services, tepid construction activity, sharp contraction in cargo and air passenger traffic, etc. Agriculture seems to be doing reasonably well with monsoon rainfalls starting strongly in June and July. However, growth in agriculture alone would be grossly inadequate to keep GDP growth positive. In the case of agriculture in India, there is an asymmetry: while it accounts for about 56 per cent of employment, it only contributes 15 per cent to the GDP. Hence 3 per cent growth in agriculture would only contribute 0.45 per cent to GDP growth. Evidently, this is a very small figure in the overall macro context and the recovery is likely to be gradual and calibrated from Q2 of FY21. But the agriculture sector has important forward and backward linkages and is an important determinant of demand revival in rural areas, which can make or mar industries, such as, FMCG, tractors, etc.

India's animal spirits remain fragile despite the economy reopening. The well-known maxim of res ipsa loquitor — facts speak for themselves — demonstrates this proposition. The rapidly declining private corporate investment, growing inventory of manufacturing setup, poor performance of services sector increased unemployment in organized sector and quick fall in corporate tax revenue. Loan moratorium and household and corporate sector pressures have caused sharp revenue shortfall and liquidity crunch. The slow credit off-take of banking sector has been further aggravated because of COVID-19 with negative credit off-take, which hampers the process of resuscitation of the economy. There has been a significant decline in corporate rating as well as sovereign investment grade rating. Consumer confidence index has been dented, which has severely affected purchase of goods and services along with housing market. There has been a significant inventory gathering of readymade houses, which have impacted banking sector as well. Given these trends and tendencies, GDP in FY21 is certain to take a hit because of muted domestic activity and weak external demand.

Given this macro-economic scenario and the evolving risks to economic activity, the RBI and the Government of India intervened swiftly to turn around the asset prices, narrow the credit spread, improve the investor's sentiment and pacify the financial volatility. The adverse impact of the real sector has transmitted to banking and financial sector and led to erosion of bank capital, reduction of profitability and increasing the vulnerability of banking sector to NPA. The stock market sentiment has improved leading to reverse flow of capital from developed and other emerging markets to India. However, the COVID impact together with the prolonged 8-quarter slowdown of India's GDP created an unprecedented crisis for Indian economy. This medical cum economic emergency on top of the double whammy of the demonetization and the rolling out of the Goods and Services Tax (GST) has severely dented the MSME sector because of lack of cash-flow, low demand and stuck working capital.

Against this backdrop, the RBI's Monetary Policy Committee (MPC) unanimously voted for keeping the policy repo rate unchanged at 4 per cent and the reverse repo rate unchanged at 3.35 per cent after two emergency cuts even though the economy faces a sharp contraction due to the Covid-19 virus.

II. POLICY STANCE

The MPC also decided to "continue with the accommodative stance of monetary policy as long as necessary to revive growth, mitigate the impact of COVID-19 while ensuring that inflation remains within the target" zone in the spirit of 'whatever it takes'. The RBI Governor said, "given the uncertainty surrounding the inflation outlook and extremely weak state of the economy in the midst of an unprecedented shock from the ongoing pandemic, the MPC decided to keep the policy rate on hold".

III. MUNDELL'S "IMPOSSIBLE TRINITY"

The Mundell-Fleming's theory of the "impossible trinity" demonstrates that a country cannot have highly mobile capital flows, a fixed exchange rate and its own domestic monetary policy simultaneously. The concept of the "impossible trinity" associated with Professors Mundell and Fleming makes it necessary to look at the issue of capital mobility in examining the effects of monetary and fiscal policy in an open economy.

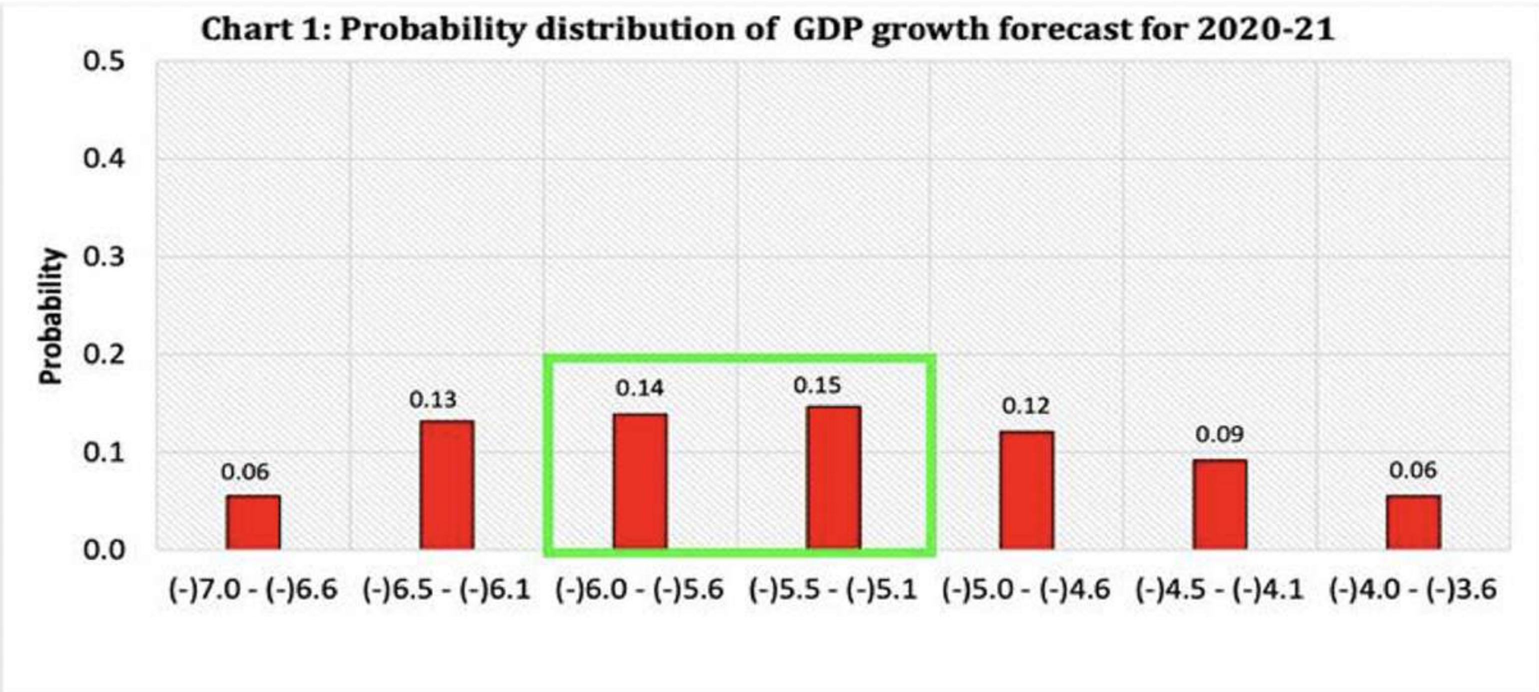
IV. GROWTH OUTLOOK

The global economic activity remains fragile, even as the financial markets have been buoyant. At the global level with a stabilization in the size of the balance sheets of the Federal Reserve and the European Central Bank, liquidity in the markets does not seem to be a concern. In fact, in the US, the monetary base grew by almost 23 per cent year-on-year in June and globally, the monetary base increased by around $8 trillion since the start of the pandemic. At this stage, central banks prefer to press the pause button to gauge the evolving shape of the economy but their next move would presumably be conditioned by further easing rather than tightening. Further, even if central banks stay still, fiscal stimulus is expected to act as a strong relay and support the recovery.

While economic activity had started to recover post the lifting of nationwide restrictions, fresh infections have restrained resumption in activity with states enforcing localised lockdowns. Several high-frequency indicators have lost steam because of state-wide lockdowns to curb the rampaging virus. The recovery of the rural economy is expected to be robust, buoyed by the progress in kharif sowing. Manufacturing firms expect domestic demand to recover gradually from Q2, but consumer confidence was more pessimistic in July relative to the preceding round of the Reserve Bank's survey. All these forces and factors are certain to lead to a contraction for the first time in 41 years.

While the MPC justifiably held that in an environment of unprecedented stress, supporting recovery of the economy assumes primacy in the conduct of monetary policy, it refrained from giving an specific number and couched its assessment in generalities : "taking into consideration the above factors, real GDP growth in the first half of the year is estimated to remain in the contraction zone. For the year 2020-21 as a whole, real GDP growth is also estimated to be negative. An early containment of the Covid-19 pandemic may impart an upside to the outlook. A more protracted spread of the pandemic, deviations from the forecast of a normal monsoon and global financial market volatility are the key downside risks".

There is widespread consensus that the Indian economy could contract between 5 per cent and 6 per cent in FY 21 (Chart 1).



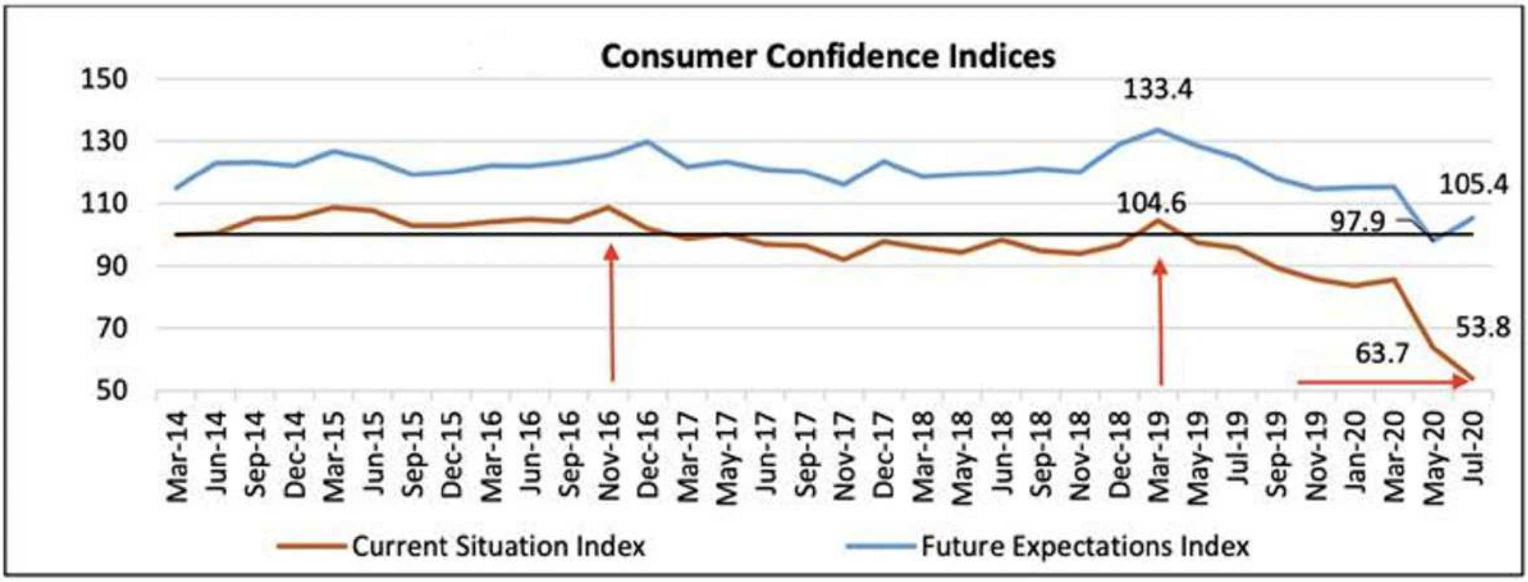
V. BROAD-BASED CONTRACTION

Rural areas are witnessing green shoots and are likely to perform much better than urban areas. Monsoon and the far-reaching agriculture reforms are widely expected to drive the rural economy. Government support to the rural has ranged from grain transfers, direct cash transfers to women using Jan-Dhan accounts, increased crop procurement, PM Kisan payments, and increased allocation for NREGA.

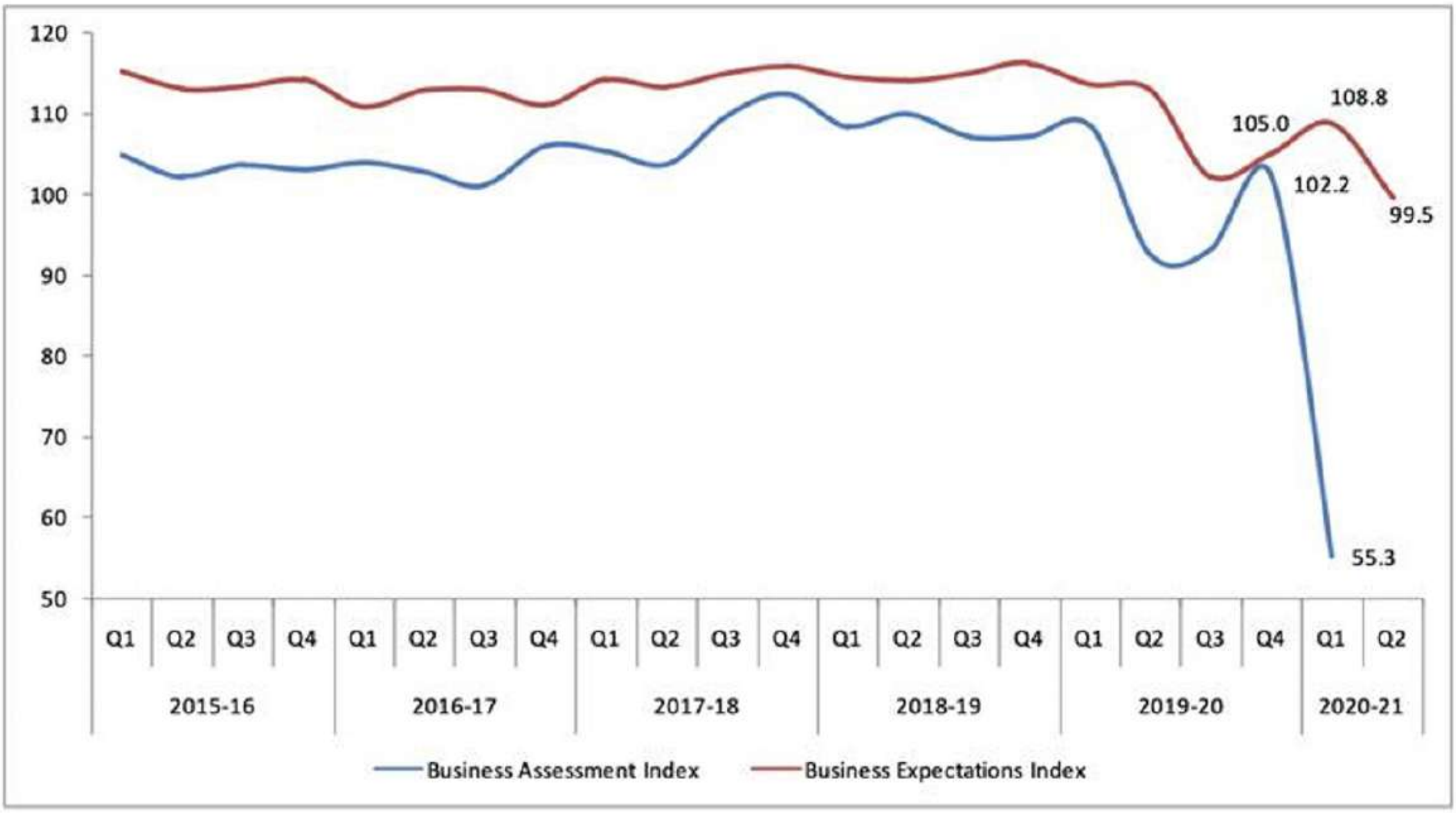
India's Central government expenditure-to-GDP ratio at 13.04 per cent in 2018-19 is among the lowest in the world. This inadequate Central government expenditure largely stems from the low tax-to-GDP ratio of 10.9 per cent in 2018-19. A low tax-to-GDP ratio poses significant challenges for the government to spend money on creating necessary infrastructure in the economy and raise investment. It has also to be realised that given the myriad overarching dimensions of COVID 19, a stronger rural sector can assuage the ongoing economic damage caused by the crisis and not obviate it.

A survey of over 5,300 households across 13 major cities in India on the economic situation, income, spending, employment and the price level revealed a sharp fall of the consumer confidence index continues to an all-time low of 54 in July 2020 (Chart 2).

Consumer confidence indices

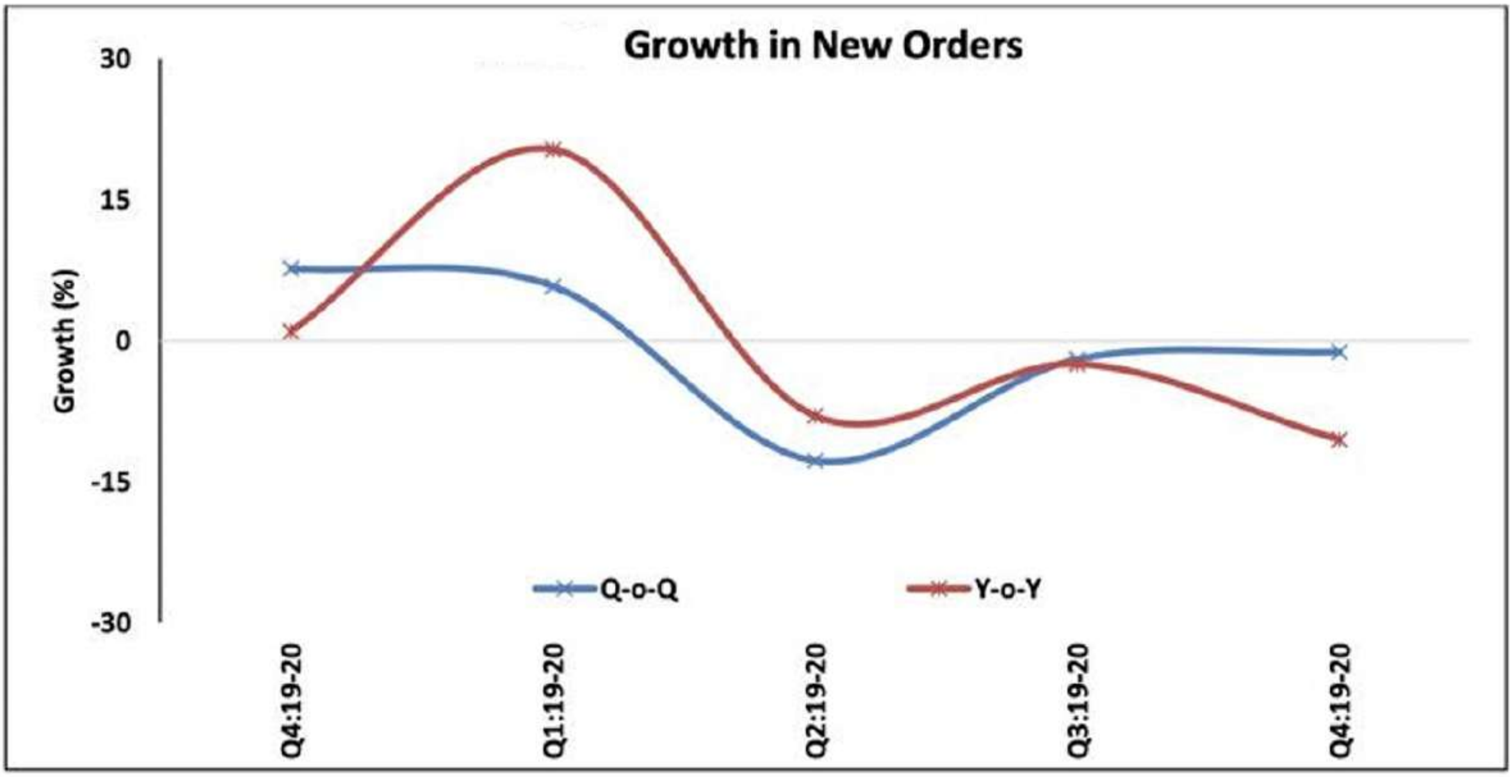


The business confidence of Indian manufacturing companies for Q1 of FY 21 and their expectations for Q2 of FY 21 reveal disconcertingly that the current business confidence index fell sharply to an all-time low at 55.3 in Q1 from 102.2 in the previous quarter (Chart 3).

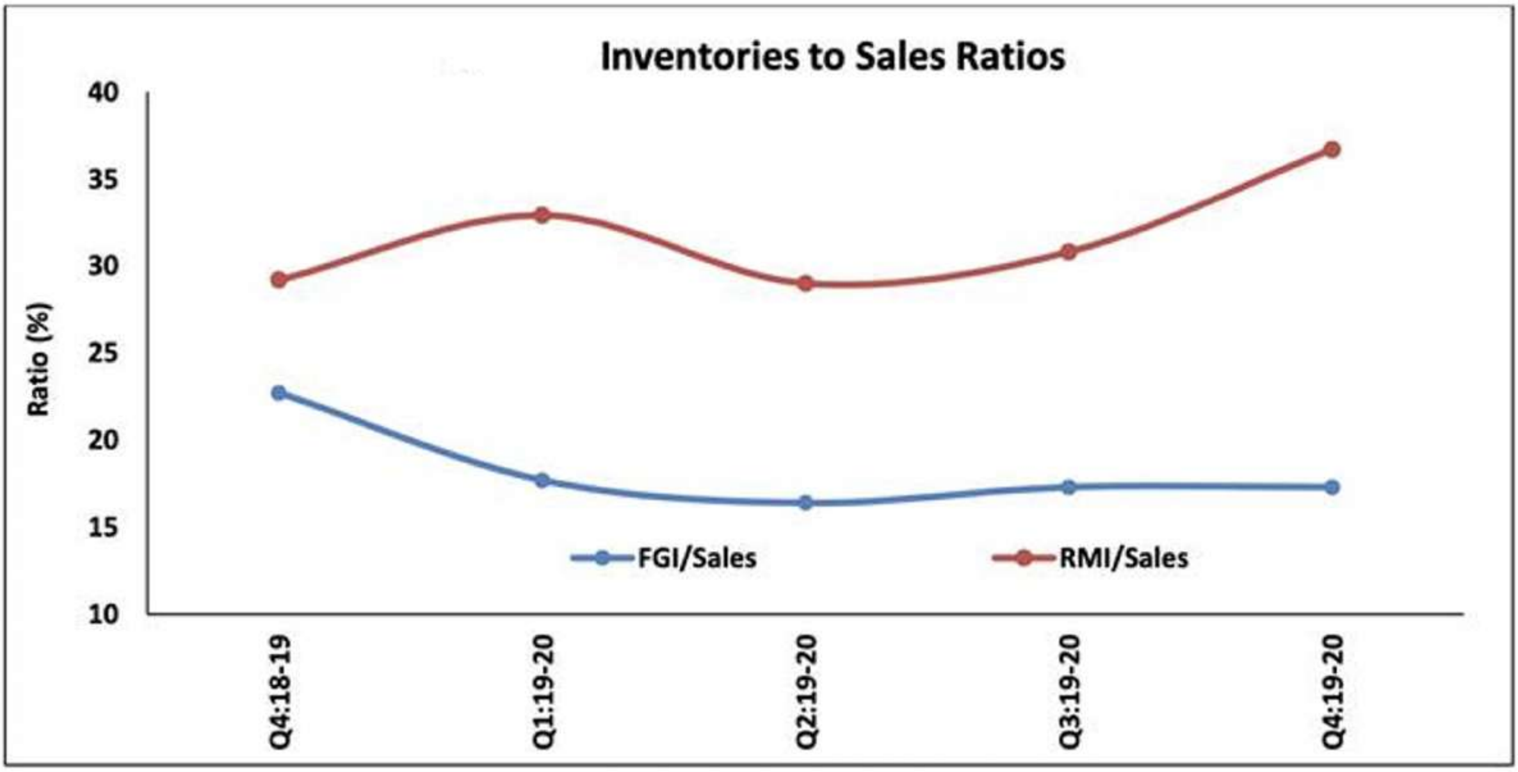


Business confidence of Indian manufacturing companies

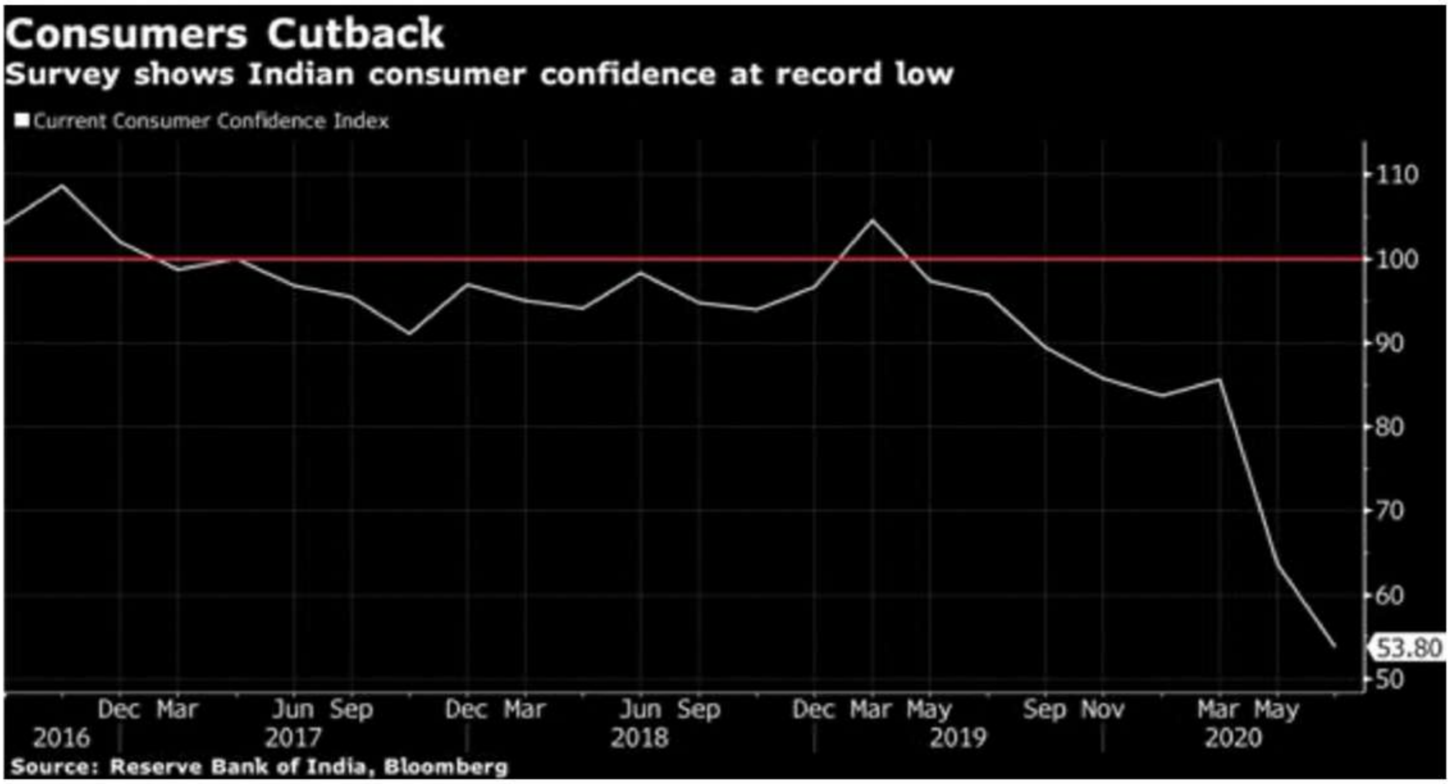
The RBI's OBICUS (Order Books, Inventories and Capacity Utilisation Survey) for the quarter January-March 2020 covering 364 manufacturing companies reveal contraction and stagnant quarter-on-quarter growth even before the onset of the Covid 19 in India (Chart 4) .



The rising “ratio of raw material inventory to sales” from Q2 of FY 20 reflects a clear deceleration in the Indian economy even prior to Covid 19 (Chart 5).



The RBI’s survey unmistakably brought out that consumer confidence plumetted to a record low in India last month with citizens growing more pessimistic about their jobs, incomes and spending. Consumers were, however, cautiously optimistic about the coming year. The survey is conducted in over 13 Indian cities and covers more than 5000 households.



What is prognostically alarming is that despite the impressive showing by the rural economy, the debilitating manifestatations of the pandemic are here to stay at least for a year. Some such aspects of the business not being as usual reale to little signs of early containment of COVID 19, a clear deterioration in consumer sentiment in the July survey, external demand headwinds stemming from a recessionary global economy and shrinking global trade and heightened tensions with China, who is India's large trading partners and also a source of inbound foreign capital. In view thereof, the GDP is certain to contract in FY 21 driven by muted domestic activity and weak external demand. Former Prime Minister Dr. Manmohan Singh spelt out three steps to stem the damage of the coronavirus pandemic.The government must "ensure people's livelihoods are protected and they have spending power through significant direct cash assistance". The Centre must also make adequate capital available for businesses through "government-backed credit guarantee programmes". Lastly, the government should fix the financial sector through "institutional autonomy and processes." "High borrowing" would increase India's debt to GDP ratio, but if borrowing "can save lives, borders, restore livelihoods and boost economic growth, then its worth it". "We must not be shy of borrowing but we must be prudent on how we use that borrowing".

Dr. Singh also warned against India following some other nations in becoming more protectionist – imposing high trade barriers duties on imports. India's trade policy over the last three decades had brought "enormous economic gains to not just the top but across all sections of our population". "I do not want to use words like 'depression' in a cavalier fashion," Dr Singh said, but a "deep and prolonged economic slowdown" was "inevitable".

VI. OBJECTIVES OF MONETARY POLICY IN INDIA

The broad objectives of monetary policy in India relate to maintenance of a reasonable degree of price stability and adequate expansion of credit to foster faster growth. But the relative emphasis on these objectives differs because of varying socio-economic requirements and priorities, level of development, etc.

On an analysis of various macroeconomic economic parameters, such as, inflation, liquidity, economic growth, industrial growth, banking development, fund inflows, the RBI adapts its key policy levers - repo rate, reverse repo rate, cash reserve ratio (CRR) to achieve the central banking objectives.

Historically, some of the basic concerns of monetary policy in India relate to price stability, adequacy, timeliness and cost of credit, liquidity and the external sector. Ultimately, monetary policy must be evaluated in an integrated framework in terms of the inter-relationship among money, credit, output and prices.

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls the supply of money, availability of money, and cost of money or rate of interest, to attain pre-determined objectives of growth and stability. Monetary policy is generally referred to as either being an expansionary or a contractionary policy. While an expansionary policy increases the total supply of money in the economy, a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to combat inflation (or cool an otherwise overheated economy).

Despite several variations, monetary policy is essentially aimed at strengthening the financial system, streamlining the credit delivery mechanism and institutional improvements to support growth consistent with stability in a medium-term perspective. Further, the issue of financial stability in the context of stronger linkages between various segments of the financial markets including money, Government securities and forex markets has also now emerged as an important concern of monetary policy.

VII. INFLATION OUTLOOK

In line with the time-tested objectives of the monetary policy, the RBI accords high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while sustaining the growth momentum. Domestic food inflation has remained elevated across most economies post the pandemic.The MPC, which met for the last time in its first four-year cycle, underscored the persistence of supply-chain disruptions with implications for both food and non-food inflation. Headline CPI of April-May 2020 are obscured by the spike in food prices and cost-push pressures. High food inflation together with the rise in fuel prices, personal effects, transport & communications etc. has also contributed towards high inflation.

The MPC expected headline inflation to remain elevated in Q2 and with inflation easing in the second half aided by favourable base effects. There also coud be the emergence of a more favourable food inflation outlook because of the bumper rabi harvest, favourable monsoon and moderate increase in minimum support prices of Kharif crops. Non-food inflation outlook remains uncertain as high petroleum prices could result in broad based cost pressures. The prices of fuels were inflated by higher excise and value-added tax and that was adding to inflationary pressure. The inflation rate of fuel and light rose from 2.69 per cent in June to 2.80 per cent in July.

Volatility in financial markets and rising asset prices also pose upside risks to the outlook. The MPC Statement held "taking into consideration all these factors, headline inflation may remain elevated in Q2:2020-21, but may moderate in H2:2020-21 aided by large favourable base effects".

The policy review by the MPC said, "a more favourable food inflation outlook may emerge as the bumper rabi harvest eases prices of cereals, especially if open market sales and public distribution offtake are expanded on the back of significantly higher procurement". "Nonetheless, upside risks to food prices remain." The abatement of price pressure in key vegetables is delayed and remains contingent upon normalisation of supplies. Protein-based food items could also emerge as a pressure point. Higher domestic taxes on petroleum products have resulted in elevated domestic pump prices and will impart broad-based cost-push pressures going forward. This aspect is worrisome. For as Mohan (2008) cogently argued: "In the final analysis, the efficacy of monetary policy has to be evaluated in terms of its success or otherwise in achieving the ultimate goals of price stability and moderation in the variability of the growth path".

The Preamble to the RBI Act defined RBI's objective "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". In line with this thought, the Urijit Patel Committee's report stated (January 21, 2014): "Drawing from the review of cross-country experience, the appraisal of India's monetary policy against the test of outcomes and the recommendations made by previous committees, the Committee recommends that inflation should be the nominal anchor for the monetary policy framework. This nominal anchor should be set by the RBI as its predominant objective of monetary policy in its policy statements. ...Subject to the establishment and achievement of the nominal anchor, monetary policy conduct should be consistent with a sustainable growth trajectory and financial stability" (RBI, 2014; p. 11; emphasis ours).

The Flexible Inflation Targeting Framework (FITF) was introduced in India post the amendment of the Reserve Bank of India (RBI) Act, 1934 in 2016. In accordance with the RBI Act, the Government of India sets the inflation target every 5 years after consultation with the RBI. The inflation target for the period between 5 August 2016 and 31 March 2021 has been mandated by the RBI Act, amended through the Finance Act, 2016 to be 4 per cent (+/- 2 per cent). The inflation target can be missed when:

1. The average inflation exceeds the upper tolerance level of the inflation target as predetermined by the Central Government for 3 quarters in a row.
2. The average inflation falls short of the lower tolerance level of the target inflation fixed by the Central Government beforehand for 3 consecutive quarters.

There is a real concern that retail inflation could well nreach the 6 per cent-mark in July and August. In the event of inflation averaging 6 per cent or higher for three consecutive calendar quarters, there would be the invocation of the statutory provision 45ZN in the RBI Act requiring the Governor to write a letter to the government explaining the breach. This would place the entire top management of the RBI and the MPC in poor light. This issue is also compounded by poor monetary transmission. The RBI Governor maintained that the central bank would remain "watchful for a durable reduction in inflation to use the available space to support the revival of the economy".

Source: RBI, Credit Suisse

The MPC held that since the National Statistical Office (NSO) did not have the inflation rates for April and May but gave the imputed index, the CPI figures for these two months marked a break in the CPI series. Were imputed inflation for April and May be used, inflation breaches 6 per cent for two consecutive quarters. But there is a strong case for the MPC in not considering the imputed CPI from the point of view of monetary policy.
The clear divergence between the wholesale price index (WPI) and CPI causes concern. As the WPI excludes services, it could be compared with agriculture and core CPI (which excludes food and fuels), excluding services. The WPI showed deflation in April, May, and June at 1.57 per cent, 3.21 per cent, and 1.81 per cent, respectively.The CPI was calculated in April on the basis of price quotes of 59.5 per cent of the items to be considered. This increased marginally to 63.1 per cent in May, e.g., the inflation rate in recreation and amusement was higher at 5.7 per cent in April and 5.5 per cent in May from 4.4 per cent in March. However, these activities were absent in April and May.

The index value of this service was also higher at 146.5 points in April and 146.8 points in May against 143.7 points in March. Inflation numbers were higher than the ones calculated by the NSO because food items, which have a higher weighting of over 45 per cent in the CPI, were consumed more than it was done normally.

The RBI also announced a major restructuring package for stressed MSME loans (rescheduling of loans scheme). The Governor announced a Rs 10,000 crore additional special liquidity facility for the housing sector and smaller non-bank finance companies (NBFCs). To deal with economic disruptions caused by COVID-19, RBI allowed lenders to implement a resolution plan for corporate loans without change of ownership. Also, MSME borrowers were allowed restructuring of debt.

VIII. ONE-TIME RESTRUCTURING OF LOANS

The RBI Governor Shaktikanta Das said."...it has been decided to provide a window under the June 7th Prudential Framework to enable lenders to implement a resolution plan in respect of eligible corporate exposures - without change in ownership - as well as personal loans, while classifying such exposures as standard assets, subject to specified conditions". The regulatory approach has to be "dynamic, proactive and balanced". In addition to the provision for restructuring of large corporate loans and personal advances, stressed MSME borrowers will also be allowed to restructure their debt provided they were classified as standard on March 31, 2020. This window will be available till March 2021.

This restructuring scheme is restricted to borrowers facing Covid-19 stress. The framework shall not be available for exposures to financial sector entities as well as central and state governments, local government bodies and any body corporate established by an act of parliament or state legislature.

Eligibility Criteria

Accounts which were in default for not more than 30 days as of March 1 will be eligible for such restructuring. All other stressed accounts will have to follow June 2019 framework for resolution. Subsequenly a panel was set up under KV Kamath, the former head of the New Development Bank set up by the BRICS to draw up the details of this scheme. The other members of the committee are Diwakar Gupta (effective September 1, 2020, after the completion of his term as Vice President, ADB), TN Manoharan (effective August 14, 2020, after the completion of his term as Chairman, Canara Bank), Ashvin Parekh, Strategy Advisor and CEO of Indian Banks' Association, as the Member Secretary. The committee will give recommendations on the required financial parameters, along with the sector specific benchmark ranges which need to be factored into the resolution plans. This committee will also validate the resolution plans for accounts with cumulative debt of Rs 1,500 crore and above. The committee shall check and verify that all the processes have been followed by the parties concerned as desired without interfering with the commercial judgments exercised by the lenders. For cases where the aggregate debt is over Rs 100 crore, the lending institutions will have to obtain an independent credit evaluation for the resolution plan from a recognised credit rating agency.

Some of the salient features of this Scheme are as under:

1. One-time restructuring plan may be invoked any time before December 31, 2020 and must be implemented within 180 days of invocation.
2. Lending institutions are required to sign an inter-creditor agreement ahead of the restructuring.
3. Lenders who do not sign inter-creditor agreements within 30 days of invocation of resolution plan shall attract 20 per cent provisions.
4. In a multiple banking or consortium lending arrangement, if 60 per cent of the lenders by number and 75 per cent by value do not sign the ICA, then the invocation would be considered as lapsed.
5. The one time restructuring scheme can then not be invoked for such cases again.
6. Lending institutions may allow for extension of the residual tenor of the loan, with or without payment moratorium, by a period not more than two years.
7. In cases where a loan is converted into other instruments, such debt instruments with terms similar to the loan, shall be counted as part of the post-resolution debt.
8. Conversion to any other non-equity instrument will lead to the value of that portion of debt being written down to Re 1.
9. In cases where there are multiple banking or consortium banking arrangement, all disbursements made to the borrowers by the banks and payments made by the borrowers to banks shall be routed through an escrow account maintained with one of the lending institutions.
10. The account will continue to be standard asset after implementation of the plan.
11. Lenders shall have to keep additional 10 per cent provisions against post resolution debt.
12. The monitoring period period begins from the date of implementation till the point in time when the borrower pays back at least 10 per cent of the residual debt. In case a borrower is in default with any of the lending institutions during the monitoring period, a review period of 30 days gets triggered. If the default is not resolved within this review period, the account is classified as NPA by all lenders involved. Lenders can write back half of the provisions held against restructured accounts after the borrower pays back at least 20 per cent of the residual debt. The remainder of the provisions can be written back after another 10 per cent of the residual debt is repaid, without the account slipping into NPA.
13. Banks will be required to publish disclosures with respect to the number of accounts where a one time-restructuring plan is implemented and the outstanding loans to such accounts, on a quarterly basis starting March 31, 2021. They will also be required to disclose the quantum of loans which were classified as standard after the restructuring plan, but later slipped to NPA during the monitoring period, on a half yearly basis starting September 30, 2021.

IX. SME LOAN RESTRUCTURING

A one-time restructuring scheme for MSMEs would only be applicable to MSMEs with outstanding debt worth up to Rs 25 crore. Restructuring plans for such MSMEs will have to be implemented before March 31, 2021. For accounts which are restructured under these guidelines, banks will have to set aside aside additional provisions worth 5per cent, over and above what they already hold. The one time restructuring scheme was originally announced in January 2019 and then extended again in February 2020. The guidelines were extended further to provided additional support to MSMEs owing to Covid-19 and to harmonise restructuring guidelines across borrower categories.

Additionally, RBI announced following measures primarily aimed for revival of economic activity and to reduce the stress on borrowers impacted due to pandemic:

1. Allowed restructuring of Micro Small and Medium Enterprises (MSMEs) loans provided the borrower's account was classified as standard with the lender as on March 1, 2020.
2. Broaden the scope of Priority Sector lending (PSL) to include start-ups, increased limits for renewable energy, increased the target for lending to 'Small and Marginal Farmers' and 'Weaker Sections' and assigned higher weight for incremental PSL credit in the identified districts.

X. RETAIL LOANS RESTRUCTURING

A one-time restructuring scheme shall also be applicable for personal loans. All loans extended by lending institutions to individual borrowers shall be covered under this framework. Lenders will not be allowed to restructure loans they have granted to their own personnel or staff, under this framework. Accounts classified as standard and not in default for more than 30 days as on March 1 shall be eligible for restructuring. The invocation of the resolution plan can be done at any time before December 31, 2020 and will have to be implemented within 90 days of such an invocation. Lending institutions may allow rescheduling of payments, conversion of any interest accrued, or to be accrued, into another credit facility, or, granting of moratorium, based on an assessment of income streams of the borrower, subject to a maximum of two years.

XI. REVISED GOLD LOAN GUIDELINES

The case for restructuring, resolution and enhanced gold loan proposals originated from the sheer magnitude of the pandemic's devastation wrought on the finances of firms and households. The RBI revised its guidelines for gold loans by increasing the loan-to-value ratio from 75 per cent to 90 per cent to help stressed borrowers unlock more value. The enhanced loan-to-value ratio will be applicable up to March 31, 2021. Thereafter, the ratio will reverse to the earlier limit of 75 per cent for all fresh gold loans sanctioned on and after April 1, 2021. This measure will benefit both the borrowers and the banks: while it would help borrowers borrowers facing a resource and cash crunch, banks will also be happy to swell this portfolio because of gold's relative safety and its consideration as a safe haven. But banks and NBFCs need effective risk management practices to ensure this easing is used effectively.

KPMG's January 2020 report estimated India's gold loan market at around Rs 3.5 lakh crore as of March, and is expected to reach Rs 4.62 lakh crore by 2021-22. While the national level penetration of gold loans is low at 5.5 per cent of the total gold holdings in India as of 2019, gold loans are important in the southern States of Kerala, Tamil Nadu, Karnataka, Andhra Pradesh and Telengana. Gold holdings in India are primarily concentrated in rural pockets, with more than two-thirds of the nation's total gold demand emerging from these communities. KPMG rightly stressed "due to an emotional value associated with gold jewellery, people rarely sell them to meet their immediate finance needs. As an alternative, they pledge gold ornaments as collateral and secure a short-term loan". Around 65 per cent of the gold loan market is controlled by unorganised money lenders, while organised lenders like banks or non-bank lenders have a 35 per cent market share.

The stability of the financial sector needs to be safeguarded even as loan terms are reset to protect otherwise viable businesses. Financial instability runs the inherent risk of devastating the macro-economy.

XII. SCOPE FOR MORE RATE CUTS

There were some expectations of the RBI cutting interest rates further but the MPC was dissuaded by the rising retail inflation and inadequate monetary transmission. The RBI judiciously decided to keep its powder dry at this juncture because of the "extreme uncertainty", which characterized the likely nature of inflation and economic activity. Since the "unprecedented shock" from the pandemic had left the economy stressed, the RBI said that while the monetary policy committee recognised the primacy of supporting a recovery, it could not be oblivious to its inflation targeting mandate.

The CPI rose to 6.09 per cent in June from 5.84 per cent in March, breaching the RBI's medium-term target range of 2-6 per cent. Further, the MPC had already cut repo rate by by 40 bps to 4 per cent in May. Thus the MPC had already slashed the repo rate cumulatively by 115 bps in the last seven months. There were also factors like the Repo rate being close to effective lower bound, the steady downward movement of deposit rates and a fear of foreign outflows in case of reducted inflation differentials.

The Governor stressed that the RBI was ready to act on rates once a durable reduction in inflation was sighted. But the present projections do not cause us to be sanguine. This thesis can be substantiated both by the the latest round of households' expectations of price gains in an RBI survey and the RBI's own internal evaluation. Consequently, there is limited space for further monetary policy action. Asessments about future rate cuts range from an an incremental 15 basis points to 50 basis points rate cuts depending on the headline CPI inflation's glide down to 4 per cent. But the MPC stressed that it must be used judiciously to maximise the beneficial effects for underlying economic activity.

XIII. CONCLUDING OBSERVATIONS

Gazing into the crystal ball and predicting the shape of things likely to come is fraught with dangers and uncertainties. There is, however, no doubt that every thing is not hunky dory and going forward, liquidity measures will be increasingly important with real and worrisome indications of 'crowding-out' of private investment because of heavy borrowings by the Centre and States under the revised borrowing plans. Given the certainty of macro-economic contraction, quadrupled balance-sheet problem (infrastructure companies and banks, plus NBFCs and real estate companies), the issues of credit risk, credit crisis and credit risk aversion will occupy centre-stage. But the RBI is committed to keeping necessary safeguards in place to maintain financial stability.

RBI's status quoist decision resulted in Gsec yields rising by 3 to 6 bps across the curve. The one-time restructuring should significantly reduce the stress on borrowers and would also provide relief to financial institutions. Over the past few months, apart from reduction in policy rates, RBI has been conducting operation TWIST ('Operation Twist' launched by the RBI on 23 December 2019 implies that the government or the country's Monetary Authority; sells the short term securities and buys long term securities simultaneously through Open Market Operations (OMO). Hence in the operation twist; the short term securities are converted into long term securities), LTROs (Long Term Repo Operations), TLTROs (Targeted Long Term Repos Operations), Open Markets Purchases (OMOs), etc. to ease the financial condition and improve liquidity.

The RBI Governor stressed the need to provide an impetus to the domestic macro-economy. With room for policy rates to fall further, the RBI could take further conventional and unconventional policy measures to mitigate the severity of the impact of the ongoing COVID 19.
Other factors like weak oil prices, positive outlook on balance of payment, benign inflation outlook, lower global rates and easing liquidity by major central banks augur well for yields in India. However, the overhang of large supply of Government securities (Central and State) especially at the longer end, excess SLR investments within the banking system, sharp reversal in oil prices, high near term inflation, etc. are persisting risks. Accordingly, yields at the longer end of the curve are likely to be range-bound in the foreseeable future. Hence the short to medium end of the yield curve could offer better risk adjusted returns. Further, driven by high liquidity and improving sentiments, corporate credit spreads have eased significantly from recent highs. However, considering the risk rewards, bond spreads of select issuers are still trading at attractive levels and opportunities still exist in select pockets.

Thus in view of the evolving macro-economic situation and the growth-inflation trade-off, the Governor took the right call by holding the rates steady at this juncture for managing the "impossible trinity". While in the medium term, both the monetary and fiscal policy must move in tandem, the fiscal policy has to play a more active role.

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