EXPERT VIEW

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ROADMAP NEEDED FOR RBI'S POLICY NORMALIZATION

The Reserve Bank of India's (RBI's) response to the covid-induced economic crisis so far is optimum and well-calibrated. It also resorted to several "unconventional" measures to address market dislocations.

Financial conditions eased across segments with front-loaded cuts in the policy repo rate and large system-wide and targeted liquidity injections. Persistence of surplus liquidity significantly reduced borrowing costs. While some transmission happened through bank lending rates, transmission through short-term rates, and three- to five-year bond yields was more pronounced.

Besides the standard tools, other RBI measures like asset purchase schemes, opening up of a special liquidity window for the mutual fund industry, regulatory forbearance, loan moratoriums and restructuring of debt significantly eased the pain in the financial sector.

Global monetary easing coupled with the central bank's timely stabilization measures led to a return of foreign portfolio inflows (mostly in equity segments) after record outflows in March. Strong capital inflows and a weak dollar led to nearly 4%-plus appreciation of the rupee between April and September despite the central bank's continuous dollar buying to build up forex reserves.

However, there are a few concerns. Despite the RBI's multi-pronged response, credit growth is muted due to concerns over lending risks, and the sovereign bond market is again on tenterhooks.

The gilt players remain wary of high Consumer Price Index (CPI) inflation prints primarily on account of supply-side disruptions and higher taxes on fuels, and the huge supply of government papers as the central government's gross market borrowings are pegged at ₹12 trillion. If we add to that the state governments' borrowings requirement, the total amount will be closer to ₹22 trillion this year versus last year's ₹13 trillion.

> **Despite RBI's response, credit growth is muted due to concerns over lending risks**

This has created tremendous nervousness in government and corporate bond markets as there is uncertainty about how RBI would ensure smooth absorption of these borrowings.

This nervousness is reflected in the recent shift of the yield curve.

While the yield on 10-year Government of India (GoI) paper remains fairly anchored due to RBI measures, yields on four- to six-year GoI papers have hardened. Consequently, yields on AAA-rated corporate bonds with three to five years tenor have hardened by 22 to 30 basis points during the past one month.

Uncertainty over the bond supply absorption by the market is keeping "term premia" elevated even if liquidity remains in a surplus mode.

The other lingering fear is of a sovereign rating downgrade if growth does not pick up as expected, creating further challenges to the government's revenue receipts.

Against this backdrop, what is expected of the monetary policy committee (MPC) and the central bank in the upcoming policy review?

First, there is no scope for a further policy rate cut in calendar year 2020 due to very high CPI inflation. But the MPC is expected to give its own projections of growth and inflation for FY21 and Q1, FY22.

For the past three consecutive policy meetings, the MPC has refrained from providing inflation and growth forecasts citing data issues. This time, it can at least give the ranges by attaching probabilities. This is a must as its outlook for the macroeconomic situation plays an important role in explaining the motivation for its current policy decisions. It also influences inflation expectations.

Second, the RBI should give a clear framework on the size and length of its ongoing and planned quantitative easing programme that would support government borrowings. This will greatly help in reducing the element of uncertainty that has created an upside bias in bond yields despite surplus liquidity.

Third, while "quantitative easing" of this scale was needed for near-term stabilization, if pursued intensively without developing a tapering roadmap, there is a serious risk in the medium term of inflation overshooting and debt distress.

Even before the pandemic, our public debt-to-gross domestic product (GDP) ratio was in excess of 70%, which is likely to go up to 85%-plus in the current year.

Tackling the covid-induced recession is paramount currently, whatever the fiscal cost. And RBI's fiscal financing is the need of the hour. However, developing a clear-cut roadmap now itself to return to pre-pandemic monetary policy will go a long way in protecting investor confidence and avoiding future disruption.

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