CENTRAL BANK'S MPC MUST WEIGH RISKS OF FINANCIAL INSTABILITY

EXPERT VIEW

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With the interim budget out, all eyes are now on the Monetary Policy Committee's (MPC) decision that will be announced on 7 February.

As the central government was not able to meet its fiscal deficit target for the second consecutive year in 2018-19 and its gross market borrowings have risen by a huge 24% to ₹7.10 trillion, there have been recommendations for a more conservative monetary policy.

Experts see a risk to inflation from the expansionary fiscal policy focusing exclusively on consumption.

But is the worry justified? Let us look at the evolving dynamics on inflation, aggregate demand and growth. The headline consumer price index (CPI) inflation has crashed by 240 basis points (bps) to 2.2% so far in fiscal year (FY) 2019.

The food sector has seen sustained deflation since October, after staying very lowly positive for several months.

Mandi prices are declining in most states across different kharif crops. The agrarian situation is seriously worrisome in Maharashtra, Andhra Pradesh, Tamil Nadu, Bihar, Gujarat, Kerala, Jharkhand, Assam and Uttarakhand. Weak rural demand has pushed rural CPI way below 2% in the past two months. Global Brent prices have eased from their monthly average of $83 a barrel in September 2018, to $63 in February, 2019. Even core CPI has eased by 50-60 bps from its peak level in July.

Growth in consumer non-durables (largely consumed in rural belts) has been weak year-on-year throughout FY19. Auto makers witnessed worst festive sales in five years in FY19. Growth in industrial and core industrial production fell to its lowest in 17-18 months in November-December 2018. Growth in investment projects announced has been continuously negative quarter-on-quarter since March 2017.

What shattered the real sector picture seriously during FY19 was the liquidity crisis for non-banking financial companies (NBFCs) since mid-September 2018, after Infrastructure Leasing and Financial Services Ltd (IL&FS) defaulted on its repayments. While several well-functioning NBFCs got trapped by tight liquidity and rapid sell-offs in the equity markets, mutual funds with heavy investments in NBFCs faced increased redemption pressures. This has significantly increased the risk of financial sector instability.

A credit slowdown by NBFCs after the IL&FS debt defaults is a serious blow to India's growth trajectory, as NBFCs had taken care of nearly one-third of incremental credit to retail and small businesses in the past three years. While the liquidity crunch has eased from its peak level due to the Reserve Bank of India's (RBI) aggressive open market operations (OMOs), loanable funds are still not available to NBFCs at reasonable rates. There is still caution surrounding relatively smaller players regarding their ability to raise or repay money and asset-liability management. Moreover, there is tremendous potential for normalization of banks' lending rates to NBFCs in the context of overall liquidity comfort.

Against this backdrop, we want the MPC to explicitly factor in financial stability considerations in its monetary policy response. Globally, it is increasingly felt that introduction of an explicit inflation target does not mean all other economic policy objectives were to have "zero" weight in monetary policy.

We do not see the budget to be inflationary, given the weak aggregate demand and expected growth slowdown triggered by soft lending by NBFCs and continued capital challenges for public sector banks (PSBs). The ongoing trends in CPI have opened up space for both a rate cut of 25 bps and change in policy stance to "neutral" on 7 February within the given framework. The OMOs undertaken in FY19 were huge and have covered ~90% of the government's market borrowings. It would help if the MPC also gives a transparent road map for OMOs for FY20 to avoid any kind of market disruption.

The ongoing trends in CPI have opened up space for a rate cut of 25 basis points

To make policy transmission more effective, the MPC can urge the RBI to create a market for providing liquidity against corporate bonds (along the lines of collateralized borrowing and lending obligations and Clearcorp Repo Order Matching System) to correct a disproportionate rise in "liquidity premia" and deepen the bond market.

In the statement on developmental and regulatory policies, RBI can announce a few measures that can reduce the cost of bank borrowings for NBFCs, such as linking the risk weights to actual ratings of loan companies (engaged in retail financing) and deferment of guidelines on large corporate framework (applicable from 1 April, 2019) by one more year. Last, but not the least, the RBI may consider setting up a repo window for mutual funds against their holdings of AAA and AA+ NBFCs to provide a back stop facility and comfort to the market in case of redemption pressure or distress sales at distorted prices.

Since transparency is an important part of effective monetary policy, it is desirable that the MPC can be as explicit as possible about its views on the links between monetary policy and financial stability in the upcoming policy announcement.

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