Monetary Policy Response to an External Shock such as COVID-19

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The Covid-19 pandemic is undoubtedly one of the most serious health and humanitarian crises that mankind has had to deal with since the end of World War II. Even as we await a vaccine/ antidote with bated breath and cheer on our medical professionals dealing with the current healthcare situation, we have to be cognizant of the profound implications that the pandemic will have on our economy. India was witnessing a period of growth moderation when the pandemic hit us and brought to fore some of the challenges underlying our economic management. To their credit, economic policymakers wasted no time in turning into first responders firefighting the downturn caused by the pandemic. Developed countries could afford large fiscal packages but emerging market economies did not have that luxury and had to rely on the monetary policy authority to do much of the heavy lifting.

RBI came out with a series of monetary and regulatory measures to support the economy and stabilize the financial system and markets. Some of the major policy decisions by RBI are outlined below:

1. The policy repo and reverse repo rates have been reduced by 115bps and 155bps respectively.
2. Targeted long-term repo operations (TLTRO) for investment in corporate bonds alongside protection from MTM provisioning
3. Reduction in Cash Reserve Ratio by 100bps
4. Open market operations to purchase bonds infused liquidity to the tune of INR 1.5 trillion
5. Moratorium on term loan interest payments with relaxation in asset classification norms
6. Extension in implementation of countercyclical capital buffer by a year

The financial markets welcomed the steps by RBI and bond yields along with high-rated credit spreads have come off the highs in late-March to trade at multi-year lows. Now that we have addressed the immediate challenges to financial stability, the focus must shift to the more structural challenges facing the financial system. Lower borrowing costs and surplus liquidity may not be sufficient to spur growth as banks hibernate in risk-aversion mode. RBI has to move swiftly to mitigate the core stresses in banking and non-banking balance sheet while the government spends to keep demand going in the interim. The next steps from RBI can be bucketed in to the following three action points:

1. Print and Spend: The pandemic has not just resulted in a demand slump but also caused wide spread disruptions in the supply chain. The latter is showing up in our inflation numbers with CPI remaining at elevated levels making it difficult for a numerical inflation-targeting MPC to further cut rates. RBI has very well managed the revised government borrowing program but the markets will need some certainty on borrowing rates over the near-term horizon. The government will have to spend more this year, but with a clear roadmap to bringing down fiscal deficit over a reasonable timeframe which will likely assuage rating agencies' concerns. Part of the enhanced spending will include cash handouts but we have to ensure that no permanent entitlements are created. The hard-earned gains made by the inflation-targeting regime over the last 5 years should be protected and we must be careful not to repeat the mistakes made post-GFC. An effort has to be made by the authorities to simplify the fiscal arithmetic and make it more transparent. RBI is allowed to purchase government bonds in the primary market as per the 'escape clause' in the current FRBM Act and the time to implement that is now.
2. Clean up of stressed assets: The undeniable fact of our times is that the financial system has been facing a credit stress since late 2018 and it is clearly unable to support our growth ambitions in its current shape. The pandemic will also create new NPAs with the RBI estimating that bank NPAs could rise from 8.5% in March 2020 to 12.5% by March 2021. We need to de-clog the balance sheets of our lenders and prepare them to start lending again in the post Covid-19 world. It is time for another round of comprehensive Asset Quality Review (AQR) of not just banks' balance sheets but also that of NBFCs. The AQR has been necessitated by the defaults over the last 2 years and reduced trust in in outstanding credit ratings. Banks and NBFCs will need to unburden their bad loans and house them in a 'bad bank'. The ownership of the 'bad bank' will remain with the participating financial institutions but management has to be left to professionals. Most of these assets will go through the IBC process but some of the assets can be revived and sold later as going concerns. Clearly, banks cannot perform the above duties and also conduct normal lending activities

simultaneously. The clean-up will necessitate large-scale capital raising and the Governor has already exhorted banks to raise capital on an anticipatory basis. The Yes Bank revival plan and the successful capital raise by the bank should inspire confidence among both depositors and the capital markets. The public sector banks will need the bulk of the capital and 'print and spend' will partly take care of the same.

3. Unwinding of extraordinary measures: Even as RBI uses both conventional and unconventional tools to navigate the economy through the current crisis it has to be mindful of the need to unwind many of the steps once the economy is able to get back on its feet. Debt monetization, FX purchases and TLTROs will keep banking liquidity in surplus mode for at least the next few years. The regulator must not allow a new round of credit-binge or asset bubbles fueled by cheap liquidity. The Governor has spoken about 'calibrated' unwinding of some of the crisis-time measures and has cautioned markets that lowering of reverse repo rate should be seen as a 'transient arrangement'. Some of the regulatory measures like moratorium and pause in CCB implementation will also need to be phased out. The roadmap needs to be in place and should be unveiled without delay once we enter the post-pandemic phase.