Reserve Bank of India's Pandemic Responses

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RBI's Pandemic Responses

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Extraordinary time requires extraordinary policy responses. As the Reserve Bank of India Governor Shri Shaktikanta Das puts it upfront, RBI has responded to pandemic with "whatever it takes to" narrative and has done "heavy lifting" in terms of policy rates adjustments, liquidity infusion and the regulatory mechanisms. The covid-19 is a dual crisis - a public health crisis and a macroeconomic crisis. Through the Great Lockdown strategy, we have systematically flattened the curve and moved to V-shaped growth recovery. However, strengthening fiscal and monetary linkages are crucial for the sustainability of the economic recovery.

The pandemic economics of central banks is twofold. One is the focus on measures that relate to instantaneous economic "firefighting": for instance, how to adjust the policy rates and also to ensure liquidity infusion into the system to stabilize the market reactions. The second is the long-term policy imperatives, including the regulatory mechanisms. As this crisis is of an unprecedented scale, it calls for unprecedented policy responses. The central banks have responded to the crisis within a "life versus livelihood" framework. This note analyses the pandemic responses by the central bank and its new monetary policy framework of inflation targeting; and concludes with policy suggestions.

In India, the Great Lockdown was announced by the Prime Minister on March 25th, 2020. Subsequently, *AtmaNirbha*r package, an economic stimulus package was announced in an iterative manner. To put things in perspective, in India, an agreement on a "new monetary framework" was signed between the Government of India and the RBI in February 2016, by which the single objective of our monetary policy is "price stability," based on inflation-targeting rules. This policy transition from the discretion of the RBI governor to a rule-based monetary policy stance has enabled the central bank to focus only on inflation containment. However, in the time of pandemic, in its response to the economic growth slowdown and other economic uncertainties, RBI has expanded its policy interventions beyond inflation containment to liquidity management and also in regulatory roles. Yet another point to be considered is the central bank's independence — "operational independence" — after the constitution of a Monetary Policy Committee (MPC) in India in 2016. The role of the RBI governor in taking crucial monetary policy decisions has been taken over by the MPC, based on their voting. As per Section 45ZL of the Reserve Bank of India Act, 1934, the RBI shall publish, on the fourteenth day after every meeting of the MPC, the minutes of the proceedings of the meeting which shall include the resolution adopted in the meeting, the vote of each MPC member, and the decisions regarding the policy rates, whether to increase, decrease, or maintain the status quo rates. In March 2021, the new monetary policy framework is being revised ; and the Report of Currency and Finance (RCF) published by RBI in early March 2021 endorsed that new monetary policy framework may be continued to another five years. The rationale of RCF policy recommendation was based on the empirical evidence that CPI inflation has remained within the agreed upper bound of 6 per cent. In other words, the agreed nominal anchor for inflation in India is 4 per cent with a band of +/_2 percent. However, RCF suggests to re-examine the MPC related operational clauses.

The paper is organized into six sections. Section 1 analyses the pandemic packages announced by RBI, as part of AtmaNirbhar package. Section II deals with the recent announcements by Monetary Policy Committee in February 2021; and the "revised" monetary policy framework. Section III looks into the impact of liquidity infusion by analyzing the statistics relate to credit deployment; and other monetary-macro parameters. Section IV analyses the capital flows, against the backdrop of the fiscal stimulus announcements in the US. Section V concludes with policy suggestions.

I The RBI’s pandemic package announcements

As part of AtmaNirbhar package, on May 22, 2020, on the basis of an urgent offline meeting of the MPC — before their regular meeting — the RBI responded to the COVID pandemic by reducing the repo rate under the liquidity adjustment facility (LAF) by 40 basis points, to 4.0%, with immediate effect. This was a further reduction from the 4.40% announced in March 2020 (the repo rate is the rate at which banks borrow funds from the Reserve Bank against eligible collateral). The reverse repo rate is the rate at which banks park their surplus funds with the RBI under the liquidity adjustment facility (LAF). The reverse repo rate under the LAF stands reduced to 3.35% from 3.75%. These rates were introduced in June 2000. Since then, the repo rate has remained the reference rate for signaling the monetary policy stance. The Cash Reserve Ratio (CRR) is cut by 100 bps in May 2020. The Marginal Standing Facility (MSF) rate (overnight borrowing facility from the central bank for further liquidity) and the Bank Rate stand reduced to 4.25% from 4.65%. The MPC also decided to continue with the “accommodative stance” and their decisions are taken with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4%, within a band of +/- 2 %.

The RBI has responded to the COVID crisis by infusing liquidity into the system, to the tune of ₹5.66 lakh crore in May 2020 (up to May 20) from ₹4.75 lakh crore in April 2020. Within the liquidity package, 1,20,474 crore was injected through Open Market Operation (OMO) purchases and 87,891 crore through three Targeted Long-Term Repo Operation (TLTRO) auctions and one TLTRO 2.0 auction. In order to distribute liquidity more evenly across the yield curve, the Reserve Bank conducted one “operation twist” auction involving the simultaneous sale and purchase of government securities for 10,000 crore each on April 27, 2020.

In addition to infusing liquidity, the "regulatory easing" measures were announced to (i) promote credit flows to the retail sector and MSMEs and real estate developers; (ii) extend the regulatory benefits under the special liquidity facility for mutual funds (SLF-MF) scheme to all banks; (iii) extension of the loan moratorium and support for working capital financing till August; (iv) credit support to the exporters and importers; (v) extension of the tenure of the small business refinancing facilities; and (vi) increase the state's Ways and Means Advance (WMA) by 60% (compared to 30% earlier) to monetize the deficit.

The RBI has also encouraged monetary transmission mechanism of the policy rate cuts by widening the monetary policy rate corridor. It is determined by the reverse repo and MSF rates. The difference between these two rates, which was 50 bps is increased to 65 bps. With a reverse repo rate of 4%, it has become less attractive for banks to park their funds with the RBI. This is expected to nudge banks to lend more. Even after bringing the rates (for borrowing) down to almost unprecedented levels, there was a huge increase in the funds parked by commercial banks in the RBI's reverse repo account — which went up from ₹ 3 lakhs crores on March 27th to ₹8.4 lakhs crores by the end of April 2020. In addition to the policy rates adjustments and liquidity infusion, regulatory forbearance also has been announced in the monetary policy. A moratorium on term loans and working capital loans for three months is expected to provide relief to the borrowers. Similarly, deferment of implementation of the net stable funding ratio and last tranche of capital conservation buffer are expected to provide relief to the banking sector. Having examined the components of the first AtmaNirbhar package, the next section deals with the recent monetary macro announcements to tackle the pandemic.

II The Monetary Policy Committee and the revisions in New Monetary Framework

The ‘flexible inflation targeting’ followed under the new monetary policy framework (nmf) is due for revision by March-end. On February 26th 2021, Report of Currency and Finance (RCF) was released by RBI, which reviews the new monetary policy framework (nmf) - in the context of the review of inflation targeting due by March 2021 in India . As per the RCF, nmf is satisfactory and is appropriate for next five years. RBI RCF report highlighted that the primary focus of flexible inflation targeting (FIT) is on price stability and that augurs well for further opening of capital account and eventual internationalization of Indian rupee. The headline CPI inflation averaged 3.9 per cent in India during the period of nmf under review. The decline in the inflation volatility in India is highlighted by RCF as attesting to the success of FIT as the primary mandate of RBI. The RCF report stated that the present inflation anchor of 4 per cent with +/- 2 per cent band is appropriate for next five years. The Monetary Policy Committee (MPC) was constituted under nmf. The RCF highlights that the operational aspects of MPC need a review, regarding the processes of onboarding of MPC members, timings relate to release of MPC minutes etc.

The RBI retained the status quo on repo rate at 4 per cent in the MPC meeting on February 5, 2021 . The reverse repo rate was also status quo at 3.35 per cent. The marginal standing facility (MSF) rate and the Bank Rate stood at 4.25 per cent. There is fuel inflation, due to a surge in international crude prices and high taxation on petroleum by central and state governments. The MPC decided to retain the “accommodative stance” into the next financial year – to revive economic growth on a sustained manner and mitigate the impact of COVID-19 on the maroeconomy. These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 per cent within a band of +/- 2 per cent, while supporting growth.

III The Effectiveness of Liquidity Infusion: Empirical Estimates

The RBI has not yet started the "normalization procedure "by absorbing the liquidity infusion announced as part of pandemic package. The excess liquidity has created some pressure in the call money market. The call money rates are below the repo rates. However, the term structure of interest rates is crucial in the transmission of short run reference rates to long run rates of interest in the government guilt-edged securities market.

The recent credit deployment statistics showed that the non-food bank credit growth stood at 5.7 per cent in January 2021 as compared to 8.5 per cent in January 2020, on a year-on-year (y-o-y) basis. The credit growth to agriculture and allied activities grew to 9.9 per cent in January 2021 as compared to 6.5 per cent in January 2020. The credit to industry contracted by 1.3 per cent in January 2021 as compared to 2.5 per cent growth in January 2020. This is because of the contraction in bank credit to large industries by 2.5 per cent in 2021 January, as compared to 2.8 per cent growth in January 2020. The credit deployed to medium industries registered a robust growth of 19.1 per cent in January 2021 as compared to 2.8 per cent in January 2020. The credit to micro and small industries registered a growth of 0.9 per cent in January 2021 as compared to 0.5 per cent in January 2020.The acceleration in growth of bank credit in January 2021 compared to the growth in January 2020 was registered for the industrial sectors including mining and quarrying, food processing, textile, 'gems and jewelry, petroleum, coal products and nuclear fuels, 'paper and paper products, leather and leather products, and vehicles, vehicle parts and transport equipment. The deceleration of credit growth in January 2021 as compared to the growth in January 2020 was registered for industrial sectors including chemicals and chemical products, rubber plastic and their products; beverages and tobacco; basic metal and metal products; construction and 'infrastructure'. Within the services sector, the credit growth marginally decreased to 8.4 per cent in January 2021, compared to 8.9 per cent in January 2020. However, the credit to 'transport operators' and 'trade' continued to register accelerated growth. The credit growth in 'personal loans' decelerated to 9.1 per cent in January 2021 as compared to 16.9 per cent in January 2020.

The growth in M3 (broad money stock) decreased to a three-month low of 12.1 per cent in January 2021, due to a decline in the growth of time deposits to 9.7 per cent in January 2021. The growth in M1 (narrow money) increased from 19.6 per cent in December 2020 to 19.9 per cent in January 2021. The currency in circulation fell from 22.3 per cent in December 2020 to 21.4 per cent in January 2021.

The estimates from RBI's January 2021 *Financial Stability Report* shows that commercial banks' gross non-performing assets (GNPA) would increase from 7.5 per cent in September 2020 to 13.5 per cent by September 2021 under the 'baseline scenario' and to 14.8 per cent under the 'severe stress scenario'. This highlights "the need for proactive building up of adequate capital to withstand possible asset quality deterioration". Public infrastructure sector excluding electricity had a GNP Assets ratio of 12.6 per cent while electricity sector had a GNPA ratio of 11.2 per cent in September 2020. In the case of agriculture, GNPA ratio was at 9.6 per cent while that in services was at 6.9 per cent in September 2020. The GNPA in the retail sector had the lowest ratio at 1.7 per cent in September 2020.

The rate of interest provided by commercial banks on "term deposits" with a maturity of more than one year averaged 5.20 per cent, as per the data released by the RBI on 15 February 2021. The average yield on 10-year government bond increased slightly to 5.94 per cent in January 2021 (after retained at 5.89 per cent in November and December 2020). The MPC noted that financial markets remain buoyant, supported by easy monetary conditions, abundant liquidity and optimism from the vaccine rollout.

IV Capital Flows: The Impact of US $ 1.9 Trillion fiscal stimuli on RBI

With the announcement of Biden's $1.9 trillion pandemic relief package, the cumulative fiscal stimulus to tackle the covid-19 pandemic in US economy amounts to an iterative package of 25 per cent of GDP. The latest fiscal stimulus package includes direct cash payments of up to $1,400 for most American adults and a weekly top-up of up to $300 in federal unemployment benefits. This dependence on "fiscal dominance" to boost the economic growth in US is in sharp contrast with the macroeconomic policy response in the aftermath of the 2008 global financial crisis (GFC) when the monetary policy was used as the countercyclical policy tool.

When the monetary policy has limitations as a countercyclical policy tool in the time of pandemic, and also when many countries experience a "liquidity trap" situation and that the interest rates are zero bound or even negative, the "fiscal dominance" - this time around is understandable. Also, the fiscal conservatism aftermath to GFC was criticized whether it has been pro-growth or not. The impact of this US policy switch from monetary to fiscal policy stance mean for the central banks in the emerging economies like India needs to be analysed.

The Brookings Institute estimates that the fiscal stimulus package run by the US would boost US real GDP growth by about 4 percent at the end of 2021 and 2 percent at the end of 2022, relative to a projection that assumes no additional fiscal stimulus. As per their estimates, the US economy is expected converge the pre-pandemic GDP projection after the third quarter of 2021 and exceeding it by 1 percent in the fourth quarter. The OECD has also pushed up its estimate of global growth ex-post the US 1.9 trillion-dollar package. However, in the case of emerging economies, the impact is less certain than in the US (Anand and Chakraborty, 2021).

In event of a capital outflows, the RBI should let the currency depreciate as the first line of defense to preserve India's external competitiveness and intervene only to smoothen out extreme volatility. At this juncture, the RBI should avoid the temptation to increase interest rates at the expense of hurting the pace of economic recovery (Anand and Chakraborty, 2021).

V Conclusion and Policy Suggestions

In this macroeconomic uncertainty, how India will emerge from the effects of the pandemic depends largely on the effectiveness of the policy coordination between monetary and fiscal policies we design now. Monetary policy needs to play a proactive stabilizing role in this macroeconomic uncertainty. However, the announcements related to infusion of liquidity into banks and NBFCs without adequate fiscal policy coordination to boost demand may run the risk of increasing bad loans.

Stiglitz and Rashid (2020) pointed out that "today's excess liquidity may carry a high social cost. Beyond the usual fears about debt and inflation, there is also good reason to worry that the excess cash in banks will be funneled toward financial speculation." And he warns that this could lead to a "climate of increased (economic) uncertainty" and end up "discouraging both consumption and the investment needed to drive the recovery." This could lead into a "liquidity trap."

The fiscal and monetary policy coordination is crucial to avoid the liquidity trap situation or running into huge NPAs. The fiscal policy is required to stimulate demand to respond to the liquidity infusion programmes by the Central Bank. The 'flexible inflation targeting' followed under the new monetary policy framework (nmf) is due for revision by March-end. As suggested by the Report of Currency and Finance (RCF) was released by RBI, flexible inflation targeting (FIT) has contributed to price stability. FIT is also crucial for further opening of capital account and eventual internationalization of Indian rupee.

The headline CPI inflation averaged 3.9 per cent in India during the period of nmf under review. The decline in the inflation volatility in India is highlighted by RCF as attesting to the success of FIT as the primary mandate of RBI. This reinforces that the nmf may be continued for another five years. However, the empirical question of link between policy rates and gross capital formation in India needs further analysis to understand the effectiveness of nmf in stimulating investment and in turn growth. The RCF highlights that the operational aspects of MPC need a review, regarding the processes of onboarding of MPC members, timings relate to release of MPC minutes etc. These aspects relate to “operational independence” of central bank need further deliberations.

In event of a capital outflows, against the backdrop of Biden’s economic stimulus, the RBI should let the currency depreciate as the first line of defense to preserve India’s external competitiveness and intervene only to smoothen out extreme volatility. At this juncture, the RBI may avoid “interest rate defence” by increasing the interest rates at the cost of economic recovery .

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