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Bond, currency markets to be surprised on lack of direct cash outflow from stimulus

The liquidity support to Discoms is quite positive for the generating companies.

The bond and currency market will be pleasantly surprised at the lack of a significant direct cash outflow from the package and will respond positively.

By B Prasanna

The uniqueness of the Covid-19 crisis lies in the unprecedented combination of demand, supply and confidence shocks that has transmitted to financial markets from the real economy. The Indian Government is using a multi-pronged approach to minimise the spread of the pandemic, address health related issues and give support to the economy while the RBI has been taking multiple steps to keep the financial system operating as usual.

The Rs 20 lakh crore stimulus package announced by the prime minister has a vision of using the four Ls – Land, Labour, Liquidity and Laws – to convert this crisis in to an opportunity of India. The finance minister provided us with a glimpse of the vision by announcing steps on Wednesday and Thursday with the promise of more to come. The first package was focussed on providing liquidity support - both to business and individuals as well as facilitating financial institutions to provide credit support to the economy. The message was clear - the liabilities are shifting from the private sector to sovereign and the Government is stepping in to bridge the credit risk aversion that existed in the market economy post the Covid crisis.

Guarantees by the sovereign, including partial guarantees and provisioning of liquidity support form the bulk of the stimulus package so far with direct cash outgo from these measures at under Rs 20,000 crore as per our initial estimates. The second package on the other hand was focussed on migrant labourers, urban poor, lower middle-income classes and farmers. The highlight of the second package was the portability of ration cards across states (One Nation One Ration Card scheme).

A vast majority of the Indian poor migrate away from their place of birth in search of employment, and lose accompanying benefits. The need for portability of benefits across states is a very important step in the right direction. On the whole the first two stimulus packages seem to be clearly addressed to the parts of the economy where the stimulus is needed the most while at the same being conscious and responsible about directly loosening the purse string.

MSME lifeline

The MSME sector, the lifeline of our Economy, has got a lot going for them in this package. Infusion of equity capital and subordinated debt capital through Fund of Funds and a Credit Guarantee Fund Trust respectively are good measures that will probably take some time to be effective. The most important however is the measure aimed at providing credit guarantee cover to banks and NBFCs for on-lending to MSMEs.

The Government has clearly understood on what is needed to revive the much required credit cycle for this sector in an environment of increased risk aversion and trust deficit and has stepped up to bridge that gap. This measure will make it quite attractive for banks to move out of their excess SLR holdings and provide loans to MSME's (which are now government guaranteed). Interesting all of this liquidity will likely come back to the banking channels in different forms as they flow their way through the working capital requirements of these MSME's. We expect this NDTL creation to start bringing down excess SLR but not reduce system liquidity drastically. More importantly it would enable spread compression in the loan markets and enable these MSME's to raise debt at cheaper cost.

The measures announced for the NBFCs are heartening as well, specifically targeted towards easing their cash flows, addressing stretched working capital cycles and making liquidity accessible to entities that were deprived of access to debt capital so far. This is expected to provide much-needed flow of credit to lower rated NBFCs. FM's explicit reference to borrowers rated AA and below, as well as unrated borrowers, acknowledges the ground realities. This move could lead to further spread compression in the low rated corporate paper as well.

The liquidity support to Discoms is quite positive for the generating companies as it will help their customers (State utilities) to pay their outstanding dues. As per reports, generating companies had a receivable of Rs 900 billion till March end 2020. This will help Banks with lending to few state Generating companies as their cash flow improve. This liquidity will however be provided by Government owned companies like PFC/REC leading to higher borrowings by these companies in the market but the fiscal impact on Central Government will be negligible.

The big challenge

The country and the world faces an unparalleled crisis leading to multi decade lows in industrial production, service activity, unemployment rates and confidence indicators. We live with the hope that the recovery post the lockdown would be supported by inventory re-building and return in consumer confidence to support the services sector. In this regard the measures announced on Wednesday and Thursday would tide to some extent the cash-flow and liquidity mismatches faced by industry and in-turn provide support to the productive capacity to realise the potential output of the economy.

Both the first and the second package are not expected to put further untoward strain on the fiscal numbers. At this stage we do not expect additional borrowing as funding of this deficit could be done through higher market borrowing (already announced) and higher reliance on T-bills.

On rate action we believe that there is scope for further cuts by the MPC along with higher quantum of cuts done through the reverse repo. This will compliment the current measures announced as we believe the liquidity surplus in the banks will now be channelized towards the real economy through lending to MSMEs, which will address the much needed liquidity issues facing the real economy.

The bond and currency market will be pleasantly surprised at the lack of a significant direct cash outflow from the package and will respond positively. While the bond yield curve has witnessed a bullish steepening of late on account of easy liquidity/rate cuts accompanied by fiscal fears, these packages will lead to a bull flattening. Yields on the long end would be influenced by how well RBI manages the huge government bond auctions every Friday and whether RBI steps up its OMO purchases and Operation Twist programs even as other sources of funding including deficit monetisation still seems to be under consideration. Short end yields will also continue to trend lower with the RBI pressing for more liquidity and lower rates.

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