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Looking beyond the rate cut

Credit guarantees from government, deficit financing by the RBI and an HTM hike for banks are the only solutions that can get the wheel of credit and investment rolling

Uncertain times call for the use of unconventional policy tools and the Reserve Bank of India (RBI), under Governor Shaktikanta Das, scores highly on these criteria. Tools like long-term repo operations, targeted long-term repo operations, special open market operations (OMOs), and refinancing facilities are now the cornerstone of the current policy regime. Expectations were building up on more such tools to be used by the RBI during the scheduled policy announcement, which was just two weeks away. While the policy action announced on Friday would be described by many as underwhelming, the timing took the market by surprise, leading to the desired positive impact.

Looking beyond the obvious rate cuts and the regulatory easing, we delve into a few features that are worth noting.

First is the tacit assumption by the governor that the economy is likely to contract for the full year, perhaps for the first time in the last 40 years. The policy document uses the words "depressed" for Q1 and "subdued" for Q2 while expecting the momentum of recovery to pick up only in Q4. This, in a nutshell, explains why the Monetary Policy Committee (MPC) is focusing on the downside risks to growth and dismissing any short-term upside risks to inflation coming from supply-side shocks.

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Second is the extent of the rate cut. By doing a 40 basis points cut, and not 50, is the MPC suggesting that there might not be much space for conventional accommodation? With the inflation rate expected to broadly average 4 per cent towards the end of the year, the real policy rate is already zero while the MPC minutes in the past have suggested that it needs to be mildly positive. We do believe that this stage of the economic cycle requires the real rate to be negative and that the MPC needs to cut more, irrespective of the inflation trajectory. This is likely to be the fulcrum of the debate over the next month or so, and will influence the next policy decision most.

Third is the intent to showcase a forward guidance outlining the use of both conventional and unconventional policy tools, depending on the evolving situation. We expect continued RBI support to counter any increase in yields in the near term and this could be in the shape of operation twist, OMO purchase calendar, the increase in the held-to-maturity (HTM) limit for banks, and deficit monetisation. The RBI is clearly keeping some space for aggressively using of such tools if the situation were to get worse on the borrowing front.

Fourth is the reference to managing central and state borrowing in the least disruptive manner. With this statement, is the RBI strongly alluding to the possibility of an OMO for state development loans (though it will involve navigating a political landmine of addressing different states)? Allowing states to draw funds from the Consolidated Sinking Fund is also likely to benefit the states by way of reducing their current fiscal year's redemptions but will asymmetrically benefit states, such as Maharashtra and Odisha in comparison to states like Uttar Pradesh and Rajasthan. This step, along with the recent increase in the Ways and Means Advances limits for states and front-loading of tax devolution by the central government, would ease some of the cash flow issues faced by states. Being sub-sovereign, state government borrowing is the critical link between the borrowing cost of the sovereign and the corporate sector, and we are happy to note that the RBI is actively covering these risks as well.

What does all this mean for the markets? The fact that the RBI has still not disclosed its cards fully on the deficit-financing debate and the OMO calendar means that in the near term the sovereign yield curve is likely to remain steep. The short end will be well supported with the operative interbank rate (TREPS) likely to trade more consistently in the 2 per cent handle, given the flood of banking system liquidity, which currently stands above the ₹7-trillion mark. Long-dated securities have had a brief respite, with fiscal announcements finally getting out of the way and any additional borrowing requirements would now possibly arise only in the second half of the fiscal year. But given the heavy supply, if further RBI action to absorb some of it is not forthcoming, the curve will steepen further.

Where do all these actions leave us on the transmission debate? The cumulative impact of the RBI's easing and liquidity measures seems to have lowered the rates in the corporate bond market, at least in the short end. Papers of good-rated companies and non-banking financial companies and having up to three-year maturities have seen a significant reduction in yield and can be expected to come down further. These downward movements in yield and the provision of multiple liquidity windows have also reduced the pressure faced by the mutual fund industry. Moreover, we expect this transmission to feed into lending rates of banks as well, thus validating the objective of the policymakers in easing financial conditions and reducing the overall cost of capital for the economy.

For the sake of future policy measures, the key is to realise that the financial system problems, around this time, cannot be addressed by monetary and liquidity measures alone. Banks do not need any more liquidity but require preserving capital, and hence, measures to alleviate credit risks and market risks in the balance sheet of banks become important. In this respect, credit guarantees from the government and deficit financing by the central bank and an HTM hike for banks are the only solutions that can address these risks and get the wheel of credit and investment rolling.

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