Will the rate cuts trickle down to industry?

RBI’s massive repo rate cut is not unlike the one seen in 2008. But this time, the uncertainty factor casts a doubt on lending behaviour.

RAHUL MAZUMDAR

While great uncertainty remains in the current scenario, it has become clear that our economy will soon face severe disruptions. The RBI has come on the front foot and made some unprecedented announcements to ensure liquidity in the market and bring comfort to the financial system.

The massive rate cut of 75 bps at one shot has been akin to the one taken during the global financial crisis. While the sentiments could be the same, the underlying current is significantly different. Back in 2008, it was a liquidity issue, with the workforce ready to put in hours. However, as we stand now with the inevitable panacea of ‘social distancing’, a large economic cost will be incurred with ramifications across industries.

There was a liquidity crunch in 2008, to which the RBI responded by almost halving the repo rate in a matter of just six months to 4.75 per cent (Chart 1). India, too, responded swiftly, and the quarterly GDP saw an upswing after just two quarters of tepid growth (Chart 2). Fiscal measures were also taken, which allowed for traction in economic activities. This will, perhaps, be difficult to replicate now.

Lending boost

The RBI has, like in the past, used its monetary space to cut the repo rate. The cut in reverse repo is a welcome step encouraging banks to lend – the question, however, remains whether the banks will extend the same when the chips in the economy are already down, and more so, if there will be any genuine takers.

Given the current environment, capex investments are unlikely to see any green shoots, as there are labour disruptions amidst the scare. The RBI’s latest Business Expectations Index (BEI) is almost at its 12-month low and will fall further. Data since January 2019 shows that quarterly growth of new investment projects has largely defied the purpose of repo rate decline (Chart 3) in the past, and have even failed to encourage non-food credit growth (Chart 4).

The lower repo rate should also lead to a decline in the MCLR, making home loans cheaper, but given the uncertainty in jobs and how the crisis will pan out, apprehensions remain.

Besides this, there has been unreliability in transmission of repo cuts by the banks to the final customers. The RBI perhaps realises this to continue, and hence has been directly intervening in the market to ensure liquidity at this juncture. Hopefully, the reduction in reverse repo rate would encourage the banks to hold on to liquidity and be ready to lend more.

As it seems now, the coronavirus is here to stay for at least another full quarter, and its economic repercussions will be felt for at least another two quarters, pulling the economy significantly down. Hence, the risk of a public health crisis spinning into a financial crisis would remain very high, and this at a time when the Indian economy is already suffering a downturn. India’s growth story, which has already taken a beating in the last few quarters, will become increasingly uncertain as investors become more risk-averse due to the pandemic.

Rate cuts would be inevitable in the months to come, amidst the anaemic growth prospects in India and globally. However, the MPC may also ascertain the absorption capacity of the industry to meaningfully benefit from all the good it is doing. Unfortunately, the bottomline will only be realised after the virus is contained.

Though not in the present context, a negative implication of the reduced rates will be on the banks’ fixed deposit earnings, which will get further squeezed and may concern the senior citizens who largely depend upon it. It may close in with the inflation figures.

Global measures

Going forward, the RBI may look at some of the other extra-ordinary measures being taken in other parts of the globe. Austria has announced the issuance of Covid-19 bonds, which will be used primarily to finance the €4-billion Covid-19 emergency aid fund. On the other hand, the US Federal Reserve will finance an SPV to lend to companies, so that they are better able to maintain business operations and capacity whilst providing a bridge financing of four years. Borrowers may choose to defer interest and principal payments during the first six months of the loan, in order to have additional cash in hand to pay employees and suppliers.

The RBI may also like to make room in some of its prudential norms in an unusual financial year, which is yet to begin.

This unfolding of a health crisis will lead to an economic one; it could perhaps be the RBI’s black swan moment to overcome.

The writer is an Economist with Exim Bank. The views are personal.