Ecowrap

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WE NEED A DIFFERENT PLAYBOOK IN MANAGING THE YIELDS IN POST COVID SCENARIO

Issue No. 21, FY21

Date: 16 June 2020

Central Banks across the world are now looking at the prospects of a deliberate financial repression to manage the enormous increase in public debt. Globally, in the US, after the outbreak of World War II, there was capping of long-term and short-term bond yields, as a means to stabilize the government bond markets and also to curb the cost of financing expenses for the war, and this tradition has continued till date also. For example, the Bank of Japan (BoJ) adopted in late 2016 Yield Curve Control, in which it sought to peg the yield on 10-year Japanese Government Bonds (JGBs) at 0%. However, there are also downsides to such as the exit strategy has to be carefully calibrated taking into account fiscal management considerations. For example, as the example of the post World War II accord shows (between US Government & Treasury) attempt to exit from such caps would generate capital losses impacting financial stability. This apart, the direct management of the entire yield curve increases the scope for dominance of the fiscal policy over monetary, a path India has carefully avoided since 1997 when it gave up monetization.

However, the extraordinary times that we are living in right now makes it difficult to be fixated to a rigid dogma. As of now, the total consolidated net borrowing of the Government is at Rs 18.9 lakh crores of which even in the best case scenario, the market could absorb only about Rs 13.8 lakh crore, leaving a gap of Rs 5.12 lakh crore for the RBI to fill in. The Government has also been doing switches at regular intervals and that is impacting the duration in the market and hence long term yield movements. We are assuming that the demand for banks could reach an all time high of Rs 5.91 lakh crore, but that is clearly contingent on the assumption of almost minimal credit growth in FY21 (less than 5%) and thus banks continuing to hold 27% in SLR. It is also interesting to see whether the bank have adequate risk appetite at such low yields. For this the RBI also needs to increase the HTM limit from the current 18% by 2%, that could potentially add Rs 3.2 lakh crore to bank treasury holdings.

So what are the options before the RBI and the Government in such unprecedented circumstances? **First,** we believe that there is adequate scope for repo rate to decline by at least 100 basis points from the current levels. With inflation set to decline precipitously from the current levels to below 3%, average growth during FY21-22 to be less than 1% and given that asset quality of Indian banks as per RBI own study is sensitive to real rates apart from a reservation credit growth, we believe aggressive rate cuts could limit the cost of Government borrowings.

Second, while we would not recommend interest rate caps in the Indian context, unless the situation deteriorates drastically, RBI could at least communicate to the market that it is comfortable with a risk spread of 10 year yields and repo rate over a certain level, say 100 basis points.

Third, there has been a perceptible decline in money multiplier in the Indian context. Thus it is unlikely that a direct monetization if used as a policy option will have any inflationary consequences. The increase in digital transactions has also played a critical role in the decline in money multiplier, which has changed the composition of financial saving of households away from currency to some extent, which is however a subject of future research.

In summary, we believe that time has now come for RBI and the Government not to be fixated to a traditional dogma as reports of second wave in some countries clearly shows we are in for a long haul, as India has also not seen the worst yet on COVID!

GOVERNMENT BORROWINGS & LIQUDITY SITUATION

- In the current COVID-19 outbreak, RBI has taken a slew of liquidity measures to support the business and economy. With the various liquidity measures, the system liquidity position has turned to huge surplus of Rs 5 lakh crore in May, compared to Rs 3 lakh crore in March. The liquidity surplus now stands at Rs 4 lakh crore till 10 Jun'20. The Gross Borrowings of the Centre and States is Rs 21.6 lakh crore, with net borrowings at Rs 18.9 lakh crore.

OMO PURCHASE & MONETIZATION REQUIRED TO FULFIL DEMAND-SUPPLY GAP

- With total net borrowing rising to Rs 18.9 lakh crore, the question of fulfilling the demand supply gap arises. Of the total banks would demand Rs 5.91 lakh crore, insurance companies around Rs 2.84 lakh crore, mutual funds Rs 1.10 lakh crore and FPI around Rs 38,000 crore and rest by others, totalling to Rs 13.77 lakh crore.
- We are assuming that the demand for banks could reach an all time high of Rs 5.91 lakh crore, but that is clearly contingent on the assumption of almost minimal credit growth in FY21 (less than 5%) and thus banks continuing to hold 27% in SLR, with a 10% growth in NDTL. It is also interesting to see whether the bank have adequate risk appetite at such low yields. For this the RBI may have to increase the HTM limit from the current 18% by 2%, that could potentially add Rs 3.2 lakh crore to bank treasury holdings.
- Thus, we believe RBI would have to still provide around Rs 5.12 lakh crore through OMO purchase or direct monetisation of deficit. While the former is monetization of debt by using banks as the financial intermediary, the latter is monetization of deficit. While both involves printing of money, the latter may be used as a last resort as it leaves money in the hands of the Government for direct spending.
- Another issue is the negative carry for the banks which is arising due to difference in the reverse repo and deposits rates. **Hence the question of hour is that with rising Government borrowing and negative carry for Banks should India go for managing the yield?**

Market Borrowings (Rs lakh crore)

Centre	FY 18	FY19	FY20 (RE)	FY21 Revised
Gross Borrowing	5.88	5.7	7.1	12.0
Repayments	1.37	1.5	2.4	1.2
Net Borrowing	4.51	4.2	4.7	10.8
State				
Gross Borrowing	4.19	5.4	6.3	9.6
Repayments	0.78	1.3	1.5	1.5
Net Borrowing	3.41	4.1	4.8	8.1

Source: SBI Research

Note: 1. Repayment as on 08.06.2020 and updated with switch amount of Rs 0.20 Lakh crore on June 15. ***2.*** State government additional borrowing has been taken as 0.75% of GDP, which has been conditionally hiked to 5% of GDP)

Demand Supply of G-sec (Rs lakh crore)

Demand from Banks	5.91
Demand from non-Bank PDs	0.15
Demand from PFs	1.89
Demand from Insurance companies	2.84
Demand from MFs	1.10
FPI Demand	0.38
Demand from Co-op banks	0.38
Demand from others	1.13
Total Demand from various players	**13.77**
Total Supply (Net borrowing of Centre and State)	**18.90**
Minimum Gap to be filled (through RBI OMO Purchases & Monetisation)	**5.12**

Source: SBI Research, Others include State Governments, Pension Funds, PSUs, Trusts, HUF/Individuals etc.

FINANCIAL REPRESSION THROUGH CAPPING OF YIELDS : *GLOBAL EXPERIENCE*

- In the US, after the outbreak of World War II, there was capping of long-term and short-term bond yields, as a means to stabilize the government bond markets and also to curb the cost of financing expenses for the war, as inflationary pressures and increasing government deficit were exerting upward pressure on long-term interest rates. During the time when ceilings on short term treasury rates were effective in limiting the private sector interest rates, such as on corporate bonds. However, as later inflation surged to about 20% the cap on short-term interest rates was abolished while that on long-term interest rates was maintained until the beginning of the 1950s.
- UK also had conducted Government bond purchases to support the government bond price after the war. Although later the focus shifted to bank rate, Government bond purchases that aimed to curb the pace at which the Government bond interest rates rise, were conducted intermittently for more than twenty years until 1971.
- More recently, the Bank of Japan (BoJ) adopted in late 2016 Yield Curve Control, in which it sought to peg the yield on 10-year Japanese Government Bonds (JGBs) at 0%, in an effort to stimulate Japan's economy. Whenever the market yields on JGBs rise above the target range, the BoJ purchases bonds to push the yield back down.
- These instances show that the Central Banks have successfully influenced the yield curve by directly targeting the long and/or short term interest rate as long as it does not lead to inflationary pressures.
- However, there are certain issues which need to be kept in mind. One is controllability of the interest rates or their effectiveness as a measure to tackle adverse shocks. The other is the exit strategy which has to be done taking into account fiscal management considerations.

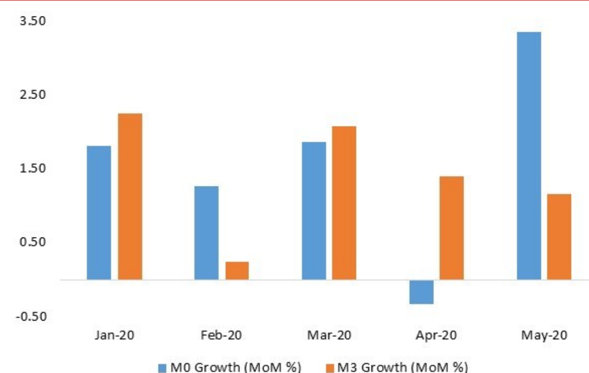
FINANCIAL REPRESSION : *INDIAN PRESPECTIVE*

- It is true that the fixing of long-term interest rates has its origins in the war financing and it has no link to monetary policy or its objectives. However, the current situation is worse than a war. Almost every country has been impacted from COVID-19 pandemic.
- We believe that in the Indian context the long-term yields that are currently hovering around 6% may increase further, as the Government borrowing will be high. Rise in yield will have impact on mark to market loss of banks. Hence it is better to cap the entire yield curve at some levels. This will stabilize the Government bond markets and curb the cost of financing of deficit.
- However, there are some ramifications of yield capping also: (i) it may jeopardize the RBI's autonomy as RBI will have to conduct OMOs to defend the cap, (ii) it requires necessary amendment in RBI Act as RBI Act only allows targeting inflation for the purpose of growth, (iii) depending upon the maturities the RBI will have multiple caps to defend unless all maturities are fixed at one rate. This is difficult to achieve as there are three objectives and one instrument and will have high cost of sterilisation, and (iv) RBI's existing stock of G-Sec may not be enough to defend the cap and volatility in exchange rate.
- While we would not recommend interest rate caps in the Indian context, unless the situation deteriorates drastically, RBI could at least communicate to the market that it is comfortable with a risk spread of 10 year yields and repo rate over a certain level, say 100 basis points.
- We also believe that there is adequate scope for repo rate to decline by at least 100 basis points from the current levels. With inflation set to decline precipitously from the current levels to below 3%, average growth during FY21-22 to be less than 1% and given that asset quality of Indian banks as per RBI own study is sensitive to real rates apart from a reservation credit growth we believe aggressive rate cuts could limit the cost of Government borrowings.

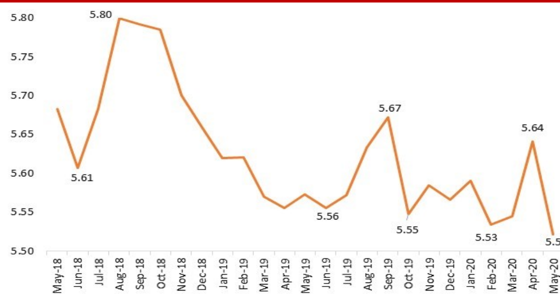
MONEY MULTIPLIER IS DECLINING

- Around the world, the central bank regulates the money supply in an economy, based on the GDP growth and inflationary situation. During this COVID-19 crisis, all the central banks are pumping huge amount of liquidity to support business and markets.
- In the current year so far (till 22 May), India's M3 grew by Rs 4.3 lakh crore, compared a de-growth of Rs 10,989 crore in the corresponding period. The components of M3 indicate a significant jump in currency with public (Rs 1.63 lakh crore, compared to last year growth of Rs 65,157 crore) and time deposits with banks (increased by Rs 4.36 lakh crore, compared to last year growth of Rs 1.25 lakh crore). Similarly, reserve money (M0) has increased by Rs 1.1 lakh crore till 29 May'20, compared to last year growth of RS 29,623 crore. Currency in circulation has increased by Rs 1.69 lakh crore, compared to last year growth of RS 60,554 crore.
- If we look the monthly trend of money multiplier, it is showing a declining trend since Aug'18, when it was at 5.80. The increase in digital transactions has also played a critical role in the decline in money multiplier, which has changed the composition of financial saving of households away from currency to some extent. In particular, there has been a substitution from currency and much of it has gravitated towards digital mode of payments.

Money Supply (M3) & Reserve Money (M0) MoM Growth (%)



Money Multiplier Declined in India



Source: SBI Research

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