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COVID-19 COULD ADVERSELY AFFECT OUTPUT & PRICES: POLICIES SHOULD BE BOTH MONETARY AND FISCAL

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India has till date responded quite well to the COVID-19 crisis, though the financial markets have been significantly impacted. Though India has already taken plethora of steps to prevent the spread of corona virus, **all eyes are now on the rise in active cases in the current week and next, as global experience shows the jump in second week of active cases is around 7 times compared to first week. We thus expect aggressive social distancing to be implemented by Government and States immediately.**

What will be the possible impact of COVID-19 on output and prices?

On the demand side, inoperability analysis for three sectors namely Transport, Tourism and Hotels show significant impact on demand and hence output. On an aggregate basis, we estimate that the impact of a 5% inoperability shock could be 90 basis point on GDP from Trade, Hotel and Transport and Transport, Storage and Communication segment, that could be spread over FY20 and FY21, with a larger impact in FY21.

On the supply side China is an important source of critical inputs for many sectors. Supply shock is akin to higher price of inputs which in turn affects the price of all the commodities up the supply chain. **The impact of supply perturbations in the system in terms of cost-price increase** in output due to increase in prices of value-added input brought about by shutdown in China or assumed price escalation of 5% **is maximum for - chemical and chemical products, electrical and non-electrical goods, metals and metal products, textiles and transport equipment (7-8% increase in prices).**

A simultaneous demand and supply shock to the economy will also have implications for the banking sector. **The demand side shock is expected to lead to an output loss of 1.2% in banking and insurance combined.**

We believe that in the current COVID-19 outbreak a combination of monetary and fiscal policy could be the best option.

In particular, on the monetary side, the first best option is maintaining a proactive liquidity regime and facilitating stability in financial markets through unconventional measures. The monetary stance may be eased temporarily through a rate cut by RBI to accommodate the possible surge in liquidity demand and shock-related price increases. An adequate supply of cash notes to banks needs to be ensured that can meet a sudden increase in the demand for liquidity. RBI may also need to consider a degree of prudential forbearance in specific sectors like hotel, aviation, transport, metal, auto components and textiles. Furthermore, given the risk of using currency notes in times of pandemic, incentivizing digital payments further could be an effective solution in the current circumstances.

We believe the arguments of RBI cutting rates has more to do with coordinated policy actions by the Central Banks. More crucially, deposit rate cuts (and hence lending rate) beyond a point is counterproductive and actually creates perverse flows into liability products that are offering higher interest rates. This could always be a recipe for future problems, if assets and liabilities are not properly matched, as the experience of Yes Bank shows. Also, pandemic shock has an embedded adverse supply shock angle as China is the supplier of many critical inputs. **Hence only a rate cut in current situation with no fiscal measures will lead to asset bubble and possibly no correction in demand. Concomitantly, there is need to revive consumer demand.**

On the fiscal side the nearly 30% fall in crude oil prices could lower the petrol prices by Rs12/litre and diesel prices by Rs10/litre in India from their present prices. **The additional revenue accruing to Centre from increasing the excise duty (Rs 35,000-Rs 40,000 crores) could be spent on providing relief to people at the lower strata who will lose income because of shutdown of commercial activity in states.**

After the success of today's $2 billion USD/INR Sell Buy swap (RBI received bids worth $4.67 billion), RBI has announced one more round of USD/INR Sell Buy swap. This is a welcome move as it will address dollar shortage and also push up the forward premia in the process. This could discourage speculation and clearly address the pounding of Indian markets with FII selling around $9.2 billion beginning 20th Feb.

Interestingly, the mix of corona has affected population: age wise, shows that maximum fatality (74%) has been in the 65+ age group. This has the potential to lead to a demographic change the world over!

RATE CUT ACROSS CENTRAL BANKS: IS IT FAIR FOR RBI TO JOIN BANDWAGON?

- Co-ordinated fiscal and monetary easing is the current prescription across the world over the rising pace of Covid-19 infections outside of China (around 80,000 confirmed cases reported outside China in 125 countries). In just two weeks US has slashed the interest rates to almost zero and launched a $700 billion stimulus programme in a bid to protect the economy from the effect of coronavirus. The countries that are affected severely from Covid-19 are also providing fiscal stimulus. Australia has announced $11.4 billion, Italy ($28 billion), UK ($39 billion), EU (€25 billion) to weather coronavirus impact. China also called for targeted easing measures and cuts in bank reserve requirement ratios (RRR) to shore up lending to small and micro businesses and reduce financing costs. The RRR cuts will release at least 300 billion yuan ($43.1 billion) into the banking system.
- We believe the arguments of RBI cutting rates has more to do with coordinated policy actions by the Central Banks. However, if RBI does cut and that too by a large amount then the current favourable interest rate differential (in US in the last one month the 10 Yr G-sec yields has declined by around 80 bps) could turn adverse and result in capital outflows. Second, coordinated monetary policy actions though good but exits are always not coordinated and thus causes significant market disruptions. Third, deposit rate cuts beyond a point is counterproductive and actually creates perverse flows into liability products that are offering higher interest rates. This could always be a recipe for future problems, if assets and liabilities are not properly matched, as the experience of Yes Bank shows. Fourth, pandemic shock is not comparable to other types of crisis as we have an embedded adverse supply shock angle as China is the supplier of many critical inputs . Hence only a rate cut in current situation will only lead to asset bubble and possibly no correction in demand.
- We thus believe in the current COVID-19 outbreak, conventional monetary policy like rate cuts in India might be the second best option. The first best option will be still maintaining a proactive liquidity regime and facilitating stability in financial markets through unconventional measures in conjunction with Government undertaking fiscal measures (the recent example is the RBI's announcement of next rounds of rupee-dollar swaps and LTRO).

Recent Rate Cuts by Central Banks

Country		Cut in %	Rate in %	Date
USA	Funds Rate	-1.00	0-0.25%	Mar 15, 2020
Norway	Key Policy Rate	-0.50	1.00%	Mar 13, 2020
Canada	Target ON Rate	-0.50	0.75%	Mar 13, 2020
Iceland	7-d Deposit Rate	-0.50	2.25%	Mar 11, 2020
UK	Bank Rate	-0.50	0.25%	Mar 11, 2020
Serbia	Key Policy Rate	-0.50	1.75 %	Mar 11, 2020
Mauritius	Key Repo Rate	-0.50	2.85%	Mar 10, 2020
Argentina	Benchmark Rate	-2.00	38.00%	Mar 05, 2020
Canada	Target ON Rate	-0.50	1.25%	Mar 04, 2020
Jordan	CBJ main Rate	-0.50	3.50%	Mar 04, 2020
Kuwait	Discount Rate	-0.25	2.50%	Mar 04, 2020
Australia	Cash Rate	-0.25	0.50%	Mar 03, 2020
Saudi Arabia	Repo Rate	-0.50	1.75%	Mar 03, 2020
USA	Funds Rate	-0.50	1.00-1.25	Mar 03, 2020
Bahrain	Key Policy Rate	-0.50	1.75%	Mar 03, 2020
Hong Kong	Base Rate	-0.50	1.50%	Mar 03, 2020
Malaysia	ON Policy Rate	-0.25	2.50%	Mar 03, 2020

Source: SBI Research

Global Fiscal Policy Response

South Korea	A stimulus package of 11.7 trillion won ($9.8 billion)
Panama	Dedicated $2.5 million for virus response
Japan	Approved a financial aid package worth 1 trillion yen ($9.6 billion) for small and medium-sized enterprises as well as self-employed workers
Australia	Plans to spend $11.42 billion to try to stave off a recession
Italy	Earmarked 25 billion euros (nearly $28 billion), including delaying tax and mortgage payments by families and businesses
UK	Announced a 30 billion-pound ($39 billion) stimulus package
USA	A $8.3 billion emergency coronavirus aid package. Further, President Trump has proposed a payroll tax holiday. The plan could result in $840 billion in lost revenue if it lasted through the end of 2020, and more than $1 trillion if it lasted a full year
EU	Announced €37 billion Coronavirus investment initiative
France	Government will spend tens of billions of euros, will compensate virus-related salary losses for "99%" of workers, because of closure
Germany	Germany pledged unlimited cash to businesses hit by the coronavirus
Austria	4 billion euros ($4.4 billion) immediately made available to offer bridge loans and credit guarantees
Sweden	Launched coronavirus crisis package worth more than $30 billion
Switzerland	Made 10 billion Swiss francs ($10.5 billion) available in immediate assistance to support businesses hit

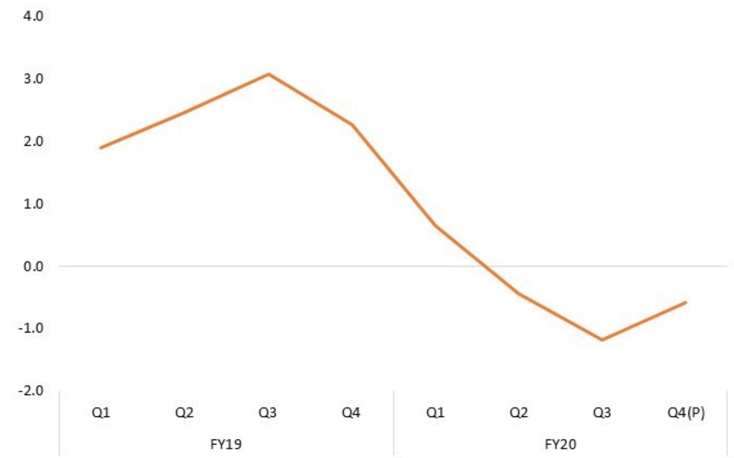
IMPACT OF CORONAVIRUS ON INDIAN ECONOMY IN TERMS OF OUTPUT & PRICES

- As the number of cases of COVID-19 in India rise, the economic impact is expected to accrue from supply chain risk which may link up with exports as in pharmaceutical sectors. On the direct exports side a set of commodities may see some disruption where China is important export destination.
- On the demand side adverse demand shock is expected to hit sector such as air transport, tourism and hotels, which in turn will affects other sectors. Thus depending upon the degree of forward and backward linkage of a sector (domestic and global) the impact of the COVID-19 will vary across sectors.
- **On the demand side, inoperability analysis for three sectors namely Transport, Tourism and Hotels show significant impact on demand and hence output**. Based on the intersectoral linkages which capture the forward and backward linkages the top three sectors besides these three that will be immediately affected by COVID-19 containment measures include Fuel minerals, Electricity and Water and Rubber, Plastic, Coke and Petroleum products.
- For example, in 2018, India received 10.6 million foreign tourists with the annual growth of 5.2%. Indian garnered $28.6 billion (Rs 1.94 lakh crore) foreign exchange earnings from tourism in 2018, with a yoy growth of 4.7% (in dollar terms). The proposed travel ban for 1 month will have severe impact on foreign tourists arrival and earnings. Based on above numbers we can estimate that India will lose around 2-3 million tourists in 2020 that will lead to loss of $5-7 billion foreign exchange earnings. We also believe that domestic train and air traffic will also get hit from this. On an average 25 million persons uses airplanes and 300 million uses trains monthly for travelling. A 10% reduction will lead to loss of revenue of Rs 3,500 crore on a monthly basis.
- Considering these numbers on an aggregate basis, we estimate that the impact of a 5% inoperability shock could have an 90 basis point impact on GDP from Trade, Hotel and Transport and Transport, Storage and Communication segment, that could be spread over FY20 and FY21, with a larger impact in FY21.
- **On the supply side China is an important source of critical inputs for many sectors**. The lockdown in China has resulted in supply disruption for sectors such as Chemical and Chemical products, Electrical and Non-electrical goods, Metals and Metal Products and Textiles. **Supply shock is akin to higher price of inputs which in turn affects the price of all the commodities up the supply chain.**
- **The impact of supply perturbations in the system in terms of cost-price increase** in production output due to increase in prices of value-added input brought about by degraded supply resulting from shutdown in China or assumed price escalation of 5% **is maximum for - chemical and chemical products, electrical and non-electrical goods, metals and metal products, textiles and transport equipment.**

IMPACT ON BANKING SECTOR

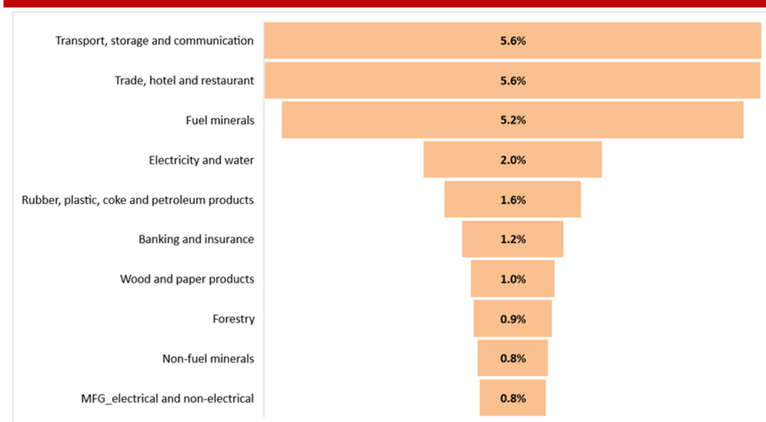
- A simultaneous demand and supply shock to the economy will have implications for the banking sector. **The demand side shock is expected to lead to an output loss of 1.2% in banking and insurance combined**.
- Furthermore erosion of demand will make it difficult to pass on the rise in input cost in the identified sectors up the supply chain or to final consumer. Thus unless there is demand support the margins are expected to shrink across board.

Exports Contribution to Expenditure GDP



Source: SBI Research

Output loss due to 5% inoperability shock to transport, tourism and hotels



Source: SBI Research

Price escalation due to uniform 5% inoperability supply shock

Source: SBI Research

SPREAD OF COVID-19 & ITS DEMOGRAPHIC IMPACT

- In India the number of active cases have rose to 114 with 15 fresh cases in a single day. When we analyze the occurrence of active cases in seven most affected countries apart from China, we have found out that in the second week, the number of cases jumps almost 7 times compared to the first week. In some countries like Iran and Spain even the active cases rose to 13 times in second week compared to the first week. Though India has already taken plethora of steps to prevent the spread of corona virus, all eyes are now on the rise in active cases in the current week and next.

CURRENCY NOTES & CORONA VIRUS

- In a report by CAIT indicated that currency notes carry micro-organisms that can cause diseases and infections. Experts have warned that several diseases, including urinary and respiratory tract infections, skin infections and recurrent meningitis, are being transmitted through currency notes. They can also contribute to causing septicaemia and toxic shock syndrome.
- As corona virus is an infectious disease which may spread by close contact of any person infected with such virus. Evidences suggests that currency notes are a source of infection and dangerous to health, more so because many of the pathogens on them are multi-drug resistant strains.
- For example, Microbiology and Applied Sciences in 2016, says that 86.4% of the 120 currency notes tested at the department of microbiology, Tirunelveli Medical College, Tamil Nadu, were contaminated with disease causing pathogens such as Klebsiella Pneumoniae, E.Coli , Staphylococcus aureus. The currency notes were collected from a variety of sources including doctors, banks, local markets, butchers, students and housewives.
- Another article in the International Journal of Advanced Research in 2016 reveals that 58% of bank notes carried disease causing pathogens. Hundred notes of Rs 100, 50, 20 and 10 denominations collected in Davanagere, Karnataka, were checked for the study.
- Prior to this , a scrutiny of 96 paper currency of various denominations from Rs 5 to Rs 500 and 48 coins, conducted at the departments of microbiology and pulmonary medicine, King George's Medical University, Lucknow, showed that almost all the samples were contaminated with bacteria, fungus and parasites. Notes of Rs 5 and Rs 10 were most highly contaminated. (*Indian Journal of Medicine and Public Health, July-Sept 2015*).
- Even if due precautions are taken, yet avoidance of cash usage cannot be avoided and as such it becomes one of the most easy carrier for spreading any virus. Therefore, immediate steps should be taken to check spreading of any virus through currency notes. Countries like UK, Australia and Canada have switched to polymer notes to reduce the risk of spreading infections through currency. Therefore, the possibilities of usage of polymer notes in India should also be examined.
- For the time being, alternative mode of payments including digital payments coupled with incentives and benefits to encourage more and more people for adoption and acceptance of alternate mode of payments in the larger interest of health of the country needs to be encouraged further.

A MIX OF MONETARY & FISCAL POLICY ACTIONS ARE REQUIRED

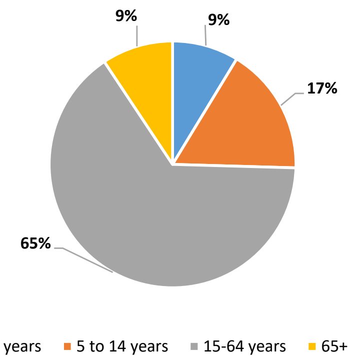
- There is no standard theory on how to tackle a pandemic situation. The policy prescription will depend upon the possible impact across the sectors due to inoperability in sectors impacted by the pandemic. A global package from the above analysis looks expensive as the importance of individual sectors in the overall forward-backward linkage is not the same. A sector specific response notably the strategic sectors along the domestic global supply chain appears more cost effective.
- Concomitantly, there is need to revive consumer demand. This may be done through an employment generating package targeting the efforts to contain spread of virus.
- We believe the ideal response should be a mix of monetary and fiscal. On the fiscal side the nearly 30% fall in crude oil prices could lower the petrol prices by Rs12/litre and diesel prices by Rs10/litre in India from their present prices. However, both Centre and States if not willing to cut fuel prices must not under any circumstances raise excise duty. Rather the additional revenue accruing to Centre could be spent on providing relief to people at the lower strata who will lose income because of shutdown of commercial activity in states.

Number of Active Cases in First Two Weeks

Country	1st Week	2nd Week	Increase in times
Italy	868	3747	4.3x
Iran	240	3268	13.6x
S. Korea	946	4209	4.4x
Spain	368	4831	13.1x
Germany	236	1704	7.2x
France	267	1996	7.5x
US	48	256	5.3x
Total of 7 countries	**2973**	**20011**	**6.7x**
Memo:			
India	114	-	-

Source: SBI Research

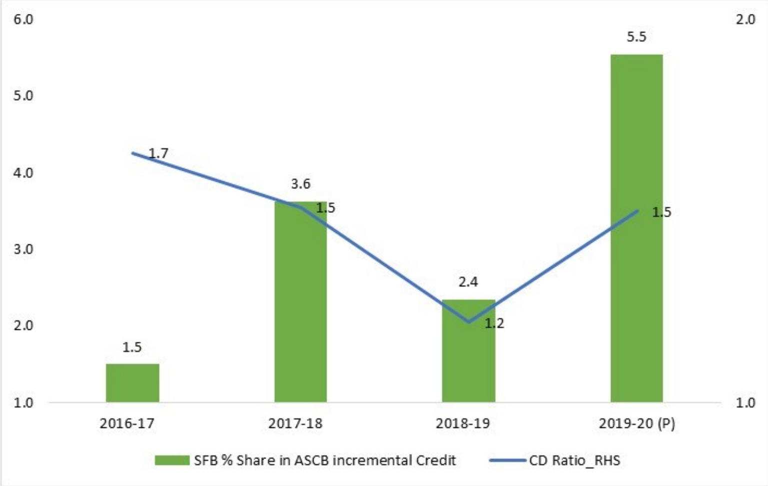
Distribution of Population by Age-group



SMALL BANKS IN INDIA

- Savings Bank Account is the most basic and oldest form of savings, which people use for their day to day activities. In the last decade, RBI has deregulated the interest rates and also banks innovated different types of savings bank products. Based on the type of SB account, they have offered different interest rates, free ATM transactions etc. However, some banks especially small private banks (including small finance banks) are offering a better interest rates on savings as well as fixed deposit when compared to other top lenders. SFB are offering in the range of 6-7% in SB while big banks are offering in the range of 3-4%.
- The small finance banks (SFBs) are the new generation banks and most of them were converted to banks from NBFC.s. These banks are similar to commercial banks and licenced by RBI, mandated to lend 75% of their total lending to the priority sector, which helps in financial inclusion. However, in a few year of their operations, the incremental credit share of the SFBs is estimated to increase to 5.5% in FY20, which indicates that these banks are performing aggressively. Further, the CD ratio of these SFBs stands at 1.51 in Q3FY20, which indicates that these banks are lending more than their deposits and may be financed by borrowings. As of Mar-2019, SFBs borrowings is 26% of their total liabilities, as against 10% for ASCBs.
- This makes us ponder whether deposit rate cuts beyond a point is counter-productive as there could be an uneven deposit flow across liabilities across entities. Already retail investors have gone searching for better returns and have burnt their fingers and we must avoid a repetition of the same.

SFBs % Share in ASCBs Incremental Credit



Source: SBI Research

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