Monetary policy can't combat the COVID-19 impact

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"A rate cut can help to boost sentiment but that will be transient as the market's reaction after the Fed rate cut proves"

The huge 50 basis points cut in rates by the U.S. Federal Reserve on Tuesday to lift economic sentiment hit by COVID-19 has disrupted central banking worldwide. Even as analysts debate whether a monetary policy response is the right strategy, central banks across the world are feeling the pressure to follow suit to the largest rate cut by the Fed since 2008.

Central banks of Australia and Malaysia have cut rates already while others such as the Bank of Japan, Bank of England and the European Central Bank are contemplating joining the caravan.

First line of defence

With monetary policy turning out to be the de facto first line of economic defence against the ill-effects of the virus, the focus in India has turned to the Reserve Bank of India's response. Yields on 10-year government securities fell by as much as 0.12% on Wednesday in the hope of a rate cut by the RBI and they stayed soft on Thursday. But what are the central bank's options? Unlike other countries, the legal framework in India after the setting up of the Monetary Policy Committee (MPC) is such that the RBI cannot unilaterally adjust rates. The MPC will have to meet and deliberate on the situation before the call to cut rates is taken and such a call will have to be based on an assessment of inflation in the economy. But is a rate cut the right response?

The first order impact on the global economy of the spreading virus is disruption to trade and to global supply chains. With China being the factory of the world, the clampdown in that country has already disrupted supplies of products ranging from cell phone components to bulk drugs and auto components. Factory lines across the world could freeze as supply chains get disrupted.

The United Nations Conference on Trade and Development has estimated that global merchandise exports could shrink by $50 billion due to the impact of the virus. Compared to the total world merchandise exports of $19.48 trillion (2018) the shrinkage appears small but it could just be the beginning.

Monetary policy is excellent to address demand shocks but is a blunt tool when it comes to addressing supply-side issues. People may be encouraged to spend more due to a rate cut but what will they spend on if products go scarce, travel convulses and public spaces such as movie theatres and malls become no-go areas?

Pressure on RBI

A rate cut can, at best, help to boost sentiment but that again will be transient as the market's reaction after the Fed rate cut proves. The Swedish central bank's deputy governor Anna Breman has rightly questioned the logic of a rate cut as a response to the coronavirus impact pointing out that an expansionary monetary policy cannot improve the situation.

Yet, sentiment being what it is, the RBI may find itself under increasing pressure to act. Given the MPC constraint, it may well choose to do what it did in the February monetary policy-- unleash other weapons in its armoury to give the same effect as a rate cut. Thus, we may well see the central bank announcing another tranche of long-term repo operation, akin to the $1 lakh crore that it announced in February. That will mean that banks will gain access to three-year funds at the repo rate of 5.15%, much lower than the market rate. And then, there's Operation Twist which the RBI employed to good effect in December, softening rates at the long end of the yield curve.

But it's doubtful if any of these measures can address the hit to economic growth. The virus has undoubtedly surfaced at a very wrong time for the Indian economy which is showing hesitant signs of a return to growth. The impact will be felt on more than one front. Industries such as pharmaceuticals, electronics and automobiles could be headed for trouble given their high dependence on Chinese inputs. While the government is said to be formulating a response, including the possibility of airlifting supplies, the practicality of this solution needs to be watched as also its impact on costs for the industries concerned.

Possible fall in exports

The bigger problem could be from a fall in exports, which accounts for 20% of the GDP. If the developed world tips into recession due to the virus, exporters of products ranging from petroleum and textiles to leather and gems and jewellery will feel the heat.

The offsetting factor, of course, will be a lower oil import bill due to the sharp fall in oil prices. This may also have a benevolent effect on inflation. But there will be other headaches for the central bank if the developed world embarks on monetary expansion. The RBI will be faced with the challenge of staunching inflows of hot money coming in search of the higher returns available in India.

But as with every crisis, there's also opportunity here. Economic growth is bound to suffer in the short-term but there could be long-term spin-offs if domestic industry and government get their acts right. Supply chains can be localised through fresh investments and India can bid to be an alternative to China in the global value chain.

The COVID-19 crisis has only underlined in red the lesson that global corporations learnt when trade war broke out between the U.S. and China-- the global supply chain needs alternative options to China. India is eminently qualified to assume that role. If only our policymakers and industrialists rise up to the challenge.

Expected Questions (Prelims Exams)

Q. Consider the effects of Corona virus on Indian economy:

1. Increase in oil prices
2. Reduction in tourism
3. Electronic and automobile sector affected
4. Positive effect on demographic dividend

Code:-

(a) 1, 2 and 3 (b) 2 and 3

(c) 2, 3 and 4 (d) 1, 3 and 4

Note: Answer of Prelims Expected Question given on 06 March., is 1 (c)

Expected Questions (Mains Exams)

Could the US Federal Reserve's change in monetary policy be considered a logical step in view of the effects of corona virus or COVID-19 on the global economy other than global health? What will be its impact on India?

(250 words)

Note: - The question of the main examination given for practice is designed keeping in mind the upcoming UPSC main examination. Therefore, to get an answer to this question, you can take the help of this source as well as other sources related to this topic.