CAN RBI CUT RATES AS COVID-19 FEAR ESCALATES?

UNHEDGED RISK OF COVID-19 SPREADS

- The novel COVID-19 outbreak (COVID-19), has spread rapidly across more than 84 countries and territories. There are currently 95,488 confirmed cases and 3,286 deaths from the coronavirus COVID-19 outbreak as of March 05, 2020. The cases of death are also spreading across the countries led by China (3013), followed by Italy (107) and Iran (92). In India, 30 cases have been found, of which 3 have recovered. Compared to the outbreak of SARS Coronavirus 2003 the proportion of damage done by COVID-19 is expected to be much greater. Thus economic loss arising out of the outbreak is expected to exceed the best figures of $40 Billion estimated for SARS 2003 and could be at $46 bn.

- Since the outbreak of SARS 2003 virus, the policy response to containing such risk has evolved considerably. However, interactions between economic model and models of epidemiology are not well understood due to deep uncertainty about these phenomena. As a result the impact of epidemics has been considerably under-researched in economics and there is no theoretical framework giving a precise ordering of whether monetary policy will be more potent than fiscal policy though the outbreak will have erosion of demand due to adverse labour market outcome on account of morbidity and mortality. However there is also an embedded adverse supply shock angle as China is the supplier of many critical inputs in the global supply chain of manufacturing. In this respect (possible) pandemic shock is not comparable to other types of crisis. Hence only a rate cut in current situation will only lead to asset bubble and possibly no correction in demand.

- Interestingly, monetary policy actions like rate cuts in developed countries are for a particular reason. Since the early 1980s, the behaviour of asset prices has posed a continuing concern to central banks in developed economies in their formation of monetary policy. This dichotomy of protecting the so called “wealth effect” and become accommodative to growth poses a huge challenge to central bank in developed markets and hence the coordinated rate cuts. However, the share of retail investor participant as proportion to total investors is only 11% in India while the same is close to 50% in US, 42% in Italy and 20% in Singapore. If this is so, we 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.

- We rather believe the arguments of RBI cutting rates has more to do with coordinated policy actions by the Central Banks. With inflation unlikely to move materially below 6% till June (February inflation numbers could though move below 7%!) and Indian real central bank policy rate being the lowest in India (negative) after Poland, talks of a premature RBI rate cut gaining precedence is surprising. This apart, coordinated monetary policy actions though sound good but exits are always not coordinated and thus causes market disruptions.

- On the positive side, supply chain disruption has created clear opportunities for sectors such as textile and pharmaceutical for India. In pharma sector, the current situation is an opportunity to increase domestic API production. With global realisation of geographic concentration risk in API production in China, even with 3% cost difference the Indian pharma will remain competitive. Other sectors that can benefit from exports are ceramics, homeware, fashion and lifestyle goods, textiles, engineering goods, furniture, chemicals, engineering goods and marine products. Also, We find asymmetric evidence of oil prices impact with the current decline benefitting us more. For $1 increase in crude there is a 2bps impact on inflation while $1 decrease in crude prices there is a 3bps impact.

HISTORY OF PANDEMIC & STOCK MARKETS

- Historically, stock markets reaction to such epidemics and fast-moving diseases is often short-lived. According to Dow Jones Market Data, the S&P 500 posted a gain of 14.59% after the first occurrence of SARS back in 2002-03, based on the end of month performance for the index in April, 2003. About 12 months after that point, the broad-market benchmark was up 20.76%.

- SARS resulted in a total of about 8,100 people being sickened during the 2003 outbreak, with 774 people dying, according to WHO data. The SARS outbreak started in November and lasted until July, which only hints at seasonality. Similarly, MERS began in September 2012 in Saudi Arabia, where temperatures are generally high. Unlike SARS, it was never fully contained. The novel coronavirus has also begun to circulate locally in the Middle East. But whether SARS and MERS were truly seasonal or if this virus will imitate SARS is not very clear.

- We cannot draw any fixed conclusions about the effects of pandemics upon stock-market performance. Equity markets react unpredictably to the unknown; nevertheless, such events should not be examined in isolation, but viewed in common with other prevailing market conditions.

S&P 500 Indices Movement

<table>
<thead>
<tr>
<th>Epidemic</th>
<th>Month end</th>
<th>6-month % change of S&amp;P</th>
<th>12-month % change of S&amp;P</th>
</tr>
</thead>
<tbody>
<tr>
<td>HIV/AIDS</td>
<td>Jun-81</td>
<td>-0.3</td>
<td>-16.5</td>
</tr>
<tr>
<td>Pneumonic plague</td>
<td>Sep-94</td>
<td>8.2</td>
<td>26.3</td>
</tr>
<tr>
<td>SARS</td>
<td>Apr-03</td>
<td>14.59</td>
<td>20.76</td>
</tr>
<tr>
<td>Avian flu</td>
<td>Jun-06</td>
<td>11.66</td>
<td>18.36</td>
</tr>
<tr>
<td>Dengue Fever</td>
<td>Sep-06</td>
<td>6.36</td>
<td>14.29</td>
</tr>
<tr>
<td>Swine flu</td>
<td>Apr-09</td>
<td>18.72</td>
<td>35.96</td>
</tr>
<tr>
<td>Cholera</td>
<td>Nov-10</td>
<td>13.95</td>
<td>5.63</td>
</tr>
<tr>
<td>MERS</td>
<td>May-13</td>
<td>10.74</td>
<td>17.96</td>
</tr>
<tr>
<td>Ebola</td>
<td>Mar-14</td>
<td>5.34</td>
<td>10.44</td>
</tr>
<tr>
<td>Measles/Rubella</td>
<td>Dec-14</td>
<td>0.2</td>
<td>-0.73</td>
</tr>
<tr>
<td>Zika</td>
<td>Jan-16</td>
<td>12.03</td>
<td>17.45</td>
</tr>
<tr>
<td>Measles/Rubella</td>
<td>Jun-19</td>
<td>9.82%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: SBI Research
IMPOSSIBLE OF CORONAVIRUS 2003 the proportion of damage done by COVID-19 is expected to be much greater. Thus economic loss arising out of the outbreak is expected to exceed the best figures of $40 Billion estimated for SARS 2003 with approximately $46 being spent to contain the spread of the virus. This does not include the economic cost due to economic disruption in various sectors transport services, tourism and manufacturing.

Since COVID-19 that was first reported from Wuhan, China, most of the currencies have declined. Typically, for INR March is a good month, as remittances, from both overseas citizens and companies, tend to buoy the exchange rate but the March 2020 could be hard on the exchange rate and the rupee’s sharp drop to below 73 per dollar is evidence of this. Offshore non-deliverable forwards are already predicting a further fall by the end of this month.

Tracing key commodity prices from January, it appears that except for fertilizer and precious metals, the price of all the commodities have declined on possible erosion of demand. The trend is expected to continue.

MACRO POLICY RESPONSES

Since the outbreak of SARS 2003 virus, the first in interconnected globalised world, the policy response to containing such risk has evolved considerably. However, interactions between economic model and models of epidemiology are not well understood due to deep uncertainty about these phenomena. As a result the impact of epidemics has been considerably under-researched in economics.

Research so far indicates that economic cost of infectious disease outbreak propagates through shifts in private and nonprivate medical costs, income forgone as a result of disease-related morbidity and mortality, decline in consumer demand, especially for travel and retail sales service and reduce confidence or increased country risk premium. Volatility in financial markets, cost incurred due to unexpected breach of contract may also be included.

Thus macro policy response in wake of health emergency depends on location and country specific factors. In COVID-19 so far fiscal policies have been a dominant tool but monetary policy is now being used. However there is no theoretical framework that can give a precise ordering of whether monetary will be more potent than fiscal policy. In the extant case, there is no doubt that outbreak will have erosion of demand due to adverse labour market outcome on account of morbidity and mortality.

As the data on pattern of infection is becoming available, the COVID-19 has an average incubation period of 7-8 days before full symptoms emerge. After this time average time for cure or death is close to 14 days. Thus a typical patient takes 21 days to emerge out of infection or is eliminated from the population. Thus despite the low fatality rate of close to 3% (mostly in higher age bracket), long quarantine period and recover time is major cause economic disruption.

However there is also an embedded adverse supply shock angle as China is the supplier of many critical inputs in the global supply chain of manufacturing. In this respect (possible) pandemic shock is not comparable to other types of crisis. Hence only a rate cut in current situation will only lead to asset bubble and no correction in demand.

IMPACT OF CORONAVIRUS ON INDIA: POSITIVES COULD ALSO OUTSTRIP NEGATIVES

Although number of cases of COVID-19 in India are currently less, new cases are being reported. 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, commodities that may see temporary disruption include cotton, diamonds to Hong Kong, import of auto parts and certain items critical to solar projects.

On the demand side, adverse demand shock is expected to hit sector such as air transport which in turn will affect other sectors. In the case of India, a temporary drop in air transport demand will impact petroleum products, utilities and business services the most. 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. The sectors with very high backward linkages include Rubber, Plastic, Coke and Petroleum Products, Construction and Metals and Metal Products.

However, supply chain disruption has created clear opportunities for sectors such as textile and pharmaceutical for India. In the pharma sector, the current situation is an opportunity to increase domestic capacity of API production. With global realisation of geographic concentration risk in API production in China, even with 3% cost difference the Indian pharma will remain competitive. Other sectors that can benefit from exports are ceramics, homeware, fashion and lifestyle goods, textiles, engineering goods, furniture, chemicals, engineering goods and marine products.
OIL PRICE RISE/FALL IMPACT ON CPI IS LARGER THAN A RISE

- The rise and fall of global crude oil prices has different impact on headline CPI in India and the impact is higher when crude prices decline than the rise in prices. We segregated the last two years into two phases i.e., Jun’17 to Oct’18 (rising crude prices) and Nov’18 to Feb’20 (declining crude prices).
- The crude oil prices has started rising from $45 per barrel in Jun’17 to $80 in Oct’18 and there after it again cooled off to $45 in Feb’20. When we looked at CPI data since the crude prices started soaring up, we found that till crude was $80 the change in weighted contribution to inflation was 50 bps. But after Nov’18 to Feb’20, when crude went below $55, the weighted contribution declined from 57 bps to 27 bps (change is –30 bps). In other words, For $1 increase in crude there has been 2bps impact on inflation while $1 decrease in crude prices there has been 3bps impact.

RESPONSE BY THE CENTRAL BANKS ACROSS THE COUNTRIES: WILL RBI JOIN THE BANDWAGON?

- The pace of easing from Central banks has accelerated in February. US Fed has cut its benchmark policy rates by 50 bps to 1 to 1-1/4 percent. This is the first time in over 11 years that the Fed has cut policy rates by 50 bps or more. The last time was in Dec’2008, when the rates were lowered by 75 bps. The Fed’s move came just after the G7 central bankers issued a statement that they would use all policy tools to achieve strong sustainable growth and safeguard against downside risks.
- Malaysia and Australia have already cut rates while Central Banks in Britain, Japan and France have signalled willingness to ease policy measures. RBI has indicated that it stands ready to safeguard the country’s banking system from financial and market risks stemming from the spread of Covid-19, citing expectations of “coordinated policy action” by Central Banks.
- We believe the arguments of RBI cutting rates has more to do with coordinated policy actions by the Central Banks. We find it surprising that with inflation unlikely to move materially below 6% till June (February inflation numbers could though move below 7%) and real central bank policy rate being the lowest in India after Poland, talks of a premature rate cut has gained so much precedence. This apart, coordinated monetary policy actions though good but exits are always not coordinated and thus causes market disruptions.
- Interestingly, monetary policy actions in developed countries are for a particular reason. Since the early 1980s, the behaviour of asset prices has posed a continuing concern to central banks in developed economies in their formation of monetary policy. For instance, the world-wide collapse in equity prices in 1987, the property price cycles in several industrial countries during the second half of the 1980s and the sharp decline in bond prices in 1994 were all to a large extent unexpected and may have established a new asset price environment.
- This dichotomy of protecting the so called “wealth effect” and become accommodative to growth poses a huge challenge to central bank in developed markets. The wealth effect refers to the phenomenon in which individuals spend more when stock prices increase. Thus, increases in consumer spending are directly correlated to increases in the value of stock portfolios.
- However, the flow of household saving to stock market is pretty low in India compared to other developed/developing countries. Share of retail investor participant in Equity Market (%) is not a priced publication of the Bank. The opinion expressed is of Research Team and not necessarily reflect those of the Bank or its subsidiaries. The contents can be reproduced with proper acknowledgement. The write-up on Economic & Financial Developments is based on information & data procured from various sources and no responsibility is accepted for the accuracy of facts and figures. The Bank or the Research Team assumes no liability if any person or entity relies on views, opinion or facts & figures finding in Ecowrap.

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Retail Investor Participant in Equity Market (%)