

# The Great Covid Conundrum – A viral update on the market and economy

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## Introduction

The report presents a general overview of the financial markets during this pandemic period and measures taken by the central banks particularly in the USA and here in India.

As the report progresses, it focuses upon the condition of the Indian economy and what the Government and the Reserve Bank of India is trying to achieve.

Given the dire condition of the Indian economy, the findings presented in the report will help in getting a hindsight of it.

## Executive Summary

### An update on the happenings of the financial markets (USA and India)

The stock market crash across the world due to the Covid-19 pandemic was one of the biggest stock market crashes in history. Stock prices in emerging economies suffered more than developed economies with Brazil (-48%), India (-39%), South Africa (-48%) suffering the most. Stock prices in Australia did not suffer as much but they continued to lag the rally that happened afterwards. On the other hand, stock prices in the US did suffer in the initial meltdown but were resilient enough to make a sharp U-turn that was mainly driven by the NASDAQ index (+65%).

### Rates and Yields

The Federal Reserve was proactive enough to cut the policy rate sharply and in quick succession as the crisis was starting to unfold. On the other hand, the Reserve Bank of India took some time – close to a month – during which they were taking cues from the Federal Reserve and after which they too started to slash its policy rates.

As a result of the policy rate cuts, the yield on T-Bills and Bonds in both the countries loosened resulting in significant capital gains for debt investors.

### Commodities

The price WTI futures contract plunged into the negative for the first time in history as demand hit rock-bottom and storage tanks filled up leading to extremely high storage cost. Brent crude prices too fell as Saudi Arabia's state oil company Aramco cut the October selling prices for its Arab light oil forecasting softening demand.

### Safe Haven

Safe haven investment - namely Gold (XAU/USD), Bitcoin and the Japanese Yen – did provide hedge for the market turbulence during the initial period but recently have done very little to hedge out the downfall in equity markets during the September downturn signaling that investors are preferring to hold cash for now.

Bitcoin behaved much like equity, flowing along with the volatility in the equity market. Hence, it failed to act like a safe haven.

### Sectoral outlook

Sectoral/Industrial winners in a post-pandemic economy:

Information technology, Healthcare, Ed tech, Computer/Smartphone, Online retail.

Sectoral/Industrial losers in a post-pandemic economy:

Realty, Air transport, Banks, Retail.

## Measures taken by the central bank – USA

The US central bank has been proactive in taking bold steps in order to blunt the impact of Covid crisis. It lowered the Fed Funds Rate target by 50 bps to 1 to 1.25% followed by another rate cut in quick succession of 100 bps to 0 to 0.25%. It announced a \$700 billion QE plan to support the flow of credit to households and businesses followed by another \$300 billion for unlimited purchase corporate bonds, treasury bonds and MBS and \$2.3 trillion of financing into businesses and revenue-pinch governments. It also opened “swap lines” to the central banks of nations such as Australia, Japan, Mexico, and Norway although it was argued that there was a geo-political motive behind it.

## Measures taken by the central bank – INDIA

The RBI has been taking cues from the US central bank’s policies and measures in dealing with the crisis. It reduced its policy repo rate by 115 basis points (from 5.15% to 4.00%). Apart from this, it conducted auctions of TLTRO (Targeted Long-Term Repo Operations) for a total amount up to INR 2 lakh crore, reduced the cash reserve ratio and liquidity coverage ratio for banks. These liquidity measures injected liquidity of INR 4.74 lakh crore (~USD 63 billion) to the system.

The other crucial measures it took was to allow the lenders a loan moratorium of three months starting March which later got extended to the month of September and, increasing the threshold of default under section 4 of the IBC from Rs 1 lakh to Rs 1 crore with the intention to prevent triggering of insolvency proceedings against MSMEs.

## Keeping up with RBI

### Fiscal Stability Report

The Reserve Bank of India releases the Financial Stability Report (FSR) every six months. In it, the RBI elaborates on the trends & progress in the banking system of India

The core take-away from the report was that:

1. [Globally](#), government debt as a % GDP has reached an unprecedented level.
2. [For emerging markets](#), most notably, household’s debt has seen an uptick since the financial crisis coupled with low savings rate.
3. The report states 52% of all customers from scheduled commercial banks (like HDFC and SBI) [opted to defer their loan repayments](#)—about 56% of all outstanding loans. On the other hand, 80% of MSMEs have opted for the moratorium through Public banks while for private banks it is half of it.
4. [An uptick in downgrading by CRAs](#), especially for MSMEs, signaling the operational and financial distress facing them.
5. Covid panic led [to high outflow of capital from India](#) depicting risk averse nature of FII for emerging markets, as evident from financial crisis (2008) and taper tantrum.
6. [Rupee was the worst performing](#) “Asian currency” for the period.
7. [Credit growth of Scheduled commercial banks](#) continues to be dismal, mainly characterized by a robust but slowing retail credit growth across bank groups, coupled with decelerating wholesale credit growth.
8. Both Net borrowings (as a per cent of nominal GDP) and G-Sec 10-year yield has been on a [downward trajectory since 2011-12](#).
9. Capital Adequacy ratio for [PSBs](#) has been on the lower side coupled with the highest GNPA and lowest provision coverage ratios among SCBs’.

### A key point from RBI's annual report

- The RBI's balance sheet **increased by 30%**, or Rs 12,31,888 crore, from Rs 41,02,905 crore to Rs 53,34,793 crore.
- The year ended with an **overall surplus of Rs 57,128 billion** which was transferred to the government

### What the RBI is trying to do?

- Its focus is on the high frequency indicators - namely PMI, GST collections and E-way bills – which have shown a sharp recovery signaling a rebound in economic activity.
- Price stability is the core agenda. It fears sustained rise in prices may be attributable to cost-push inflation due to shortage of labors. But inflation targeting may be difficult, the reason being the index chosen to target inflation – CPI which is skewed towards food and fuel prices.
- The RBI has been fighting a tug-of-war with the bond market investors to keep bond yields in check and prevent them from surging amid rising worries about the government overshooting its fiscal deficit and the trajectory of inflation, which is breaching the upper end (6%) of RBI's mandate.
- It has tweaked its loan restructuring policy whereby in case of default, instead of classifying them as NPAs, the banks can offer a moratorium period of two years or the restructuring of the loan.

### “Impossible trinity” trilemma.

India is facing this trilemma which are mentioned in a decreasing order of control as follows:

- Monetary autonomy: RBI follows an independent monetary policy and keeps a constant control over the interest rate.
- Free capital mobility: Occasionally, it controls capital flows, and
- Exchange rate management: Usually, it allows a free-floating exchange rate.

### The RBI is doing all it can, now the focus shifts to the government.

Rs 20 lakh crore (\$265 billion, 10% of India's GDP) **Covid-19 economic package** announced by Finance Minister Nirmala Sitharaman. Some of the important measures taken were:

- Collateral-free loans, backed by the central government, of up to Rs 3 lakh crore have been introduced for MSMEs.
- Up to Rs 20,000 crore liquidity support through subordinate debt for stressed MSMEs.
- A fund of funds of up to Rs 50,000 crore for equity support to MSMEs with growth potential

### 10 or 01?

There was a **debate** going on about the actual fiscal support provided by the government. Although the headline stimulus package showed a staggering package of 20 trillion (\$267 billion), corresponding to roughly 10% of India's FY21 GDP (estm.), 90% of the total package comprised of credit guarantee and liquidity support measure thereby leaving actual fiscal support of only 10% or 1% of the estm. FY.21 GDP.

## Fiscal deficit + Moody's rating.

India's fiscal deficit reached 109% of the full-year target in the first five months of the ongoing financial year as the government's finances were stretched by the ongoing coronavirus pandemic situation. It is important to note that, according to CAG, the actual fiscal deficit may be much higher than the reported fiscal deficit, owing to off-budget borrowings. The combined fiscal deficit of the Centre and states may reach up to 12 per cent of the GDP.

Moody's Corporation downgraded India's sovereign rating to Baa3 from Baa2 along with maintaining the negative outlook although the downgrade was not because of the impact of the pandemic rather due to reasons such as ineffective implementation of key reforms, low impact of policies implemented and failing to meet fiscal deficit target coupled with a steady accumulation of government debt.

## GST shortfall

The Centre failed to keep its promise of compensating the shortfall in state's tax revenue due to implementation of GST through the GST compensation fund. States were presented two options to resolve the issue of compensation shortfall:

- Option 1: Rs 1.1 Lakh crore representing the shortfall only due to GST rollout via a special window granted by the RBI.
- Option 2: Rs. 2.35 Lakh crore representing the total shortfall due to GST rollout + Covid 19 via open market borrowing meaning.

States had initially marked both the options as “untenable” as both their borrowings and consequent yield on the 10-year state development loans (SDLs) had but recently majority of the states have decided to go with Option 1.

## Fiscal responsibility

In the words of Dr. Raghuram Rajan: *“In India, what we can do is strengthen the commitment to a new fiscal responsibility bill, but also put in place targets for how much we will bring down debt over the medium term, become much more transparent about our budget. If instead, we try and contain the spending now, even though our deficits are big, we may impair longer term growth. And if we're doing this in order to maintain credit ratings, we may end up neither with credit ratings nor with growth”.*

## When nothing seems to work, there is always GOD

Finance Minister Nirmala Sitharaman said the economy is facing an Act-of-God-like situation, attributing the shortfall in GST collections to disruptions caused by Covid-19.

## An update on the happenings of the financial markets (USA and India)

### Indices and Performances Monitor

		INDEX (Country/Region)	Feb high	March Low	September	% Change (high to low)	%Change (low to present)
DEVELOPED MARKETS	America	S&P 500 (USA)	3,393.52	2,191.86	3,363.00	-35%	53%
		NASDAQ (USA)	7,161.73	6,940.72	11,418.06	-3%	65%
	Europe	FTSE 100 (U.K.)	7,547.65	4,841.50	5,866.10	-36%	21%
		DAX (GERMANY)	13,795.24	8,239.50	12,760.73	-40%	55%
DEVELOPING MARKETS	Latin America	Bovespa (BRAZIL)	117,700.50	61,690.53	94,603.38	-48%	53%
	Asia & Pacific	Nikkei 225 (JAPAN)	23,995.37	16,251.50	23,185.12	-32%	43%
		Sensex (INDIA)	41,709.30	25,650.80	38,067.93	-39%	48%
		Hang Seng (HONG KONG)	28,055.58	21,139.26	23,459.05	-25%	11%
		ASX 200 (AUSTRALIA)	6,191.10	6,096.80	5,815.90	-2%	-5%
	Africa	FTSE/JSE TOP 40 (S. AFRICA)	117,850	61,435	50,042	-48%	-19%

### Rates and Yields

India				
	Feb. 28	Mar. 27	May-22	Sep-18
Policy Repo Rate	5.15	4.4	4	4
Reverse Repo Rate	4.9	4	3.35	3.35
91-Day Treasury Bill	5.08	5.28	3.28	3.32
364-Day Treasury Bill	5.16	5.6	3.79	3.69
10-Year G-Sec Par Yield	6.65	6.73	5.75	6.03
INR-US\$ Spot Rate	72.19	74.84	75.79	73.3

USA						
	Feb. 20	March.3	Mar.15	Mar-23	May-22	Sep-18
Policy Rates	1.5	1	0	0	0	0
3 Month	1.58	0.95	0.24	0.02	0.12	0.1
2 year	0.86	0.71	0.36	0.28	0.17	0.14
10 year	1.39	1.02	0.73	0.76	0.66	0.7
30 year	2.01	1.67	1.34	1.33	1.37	1.45

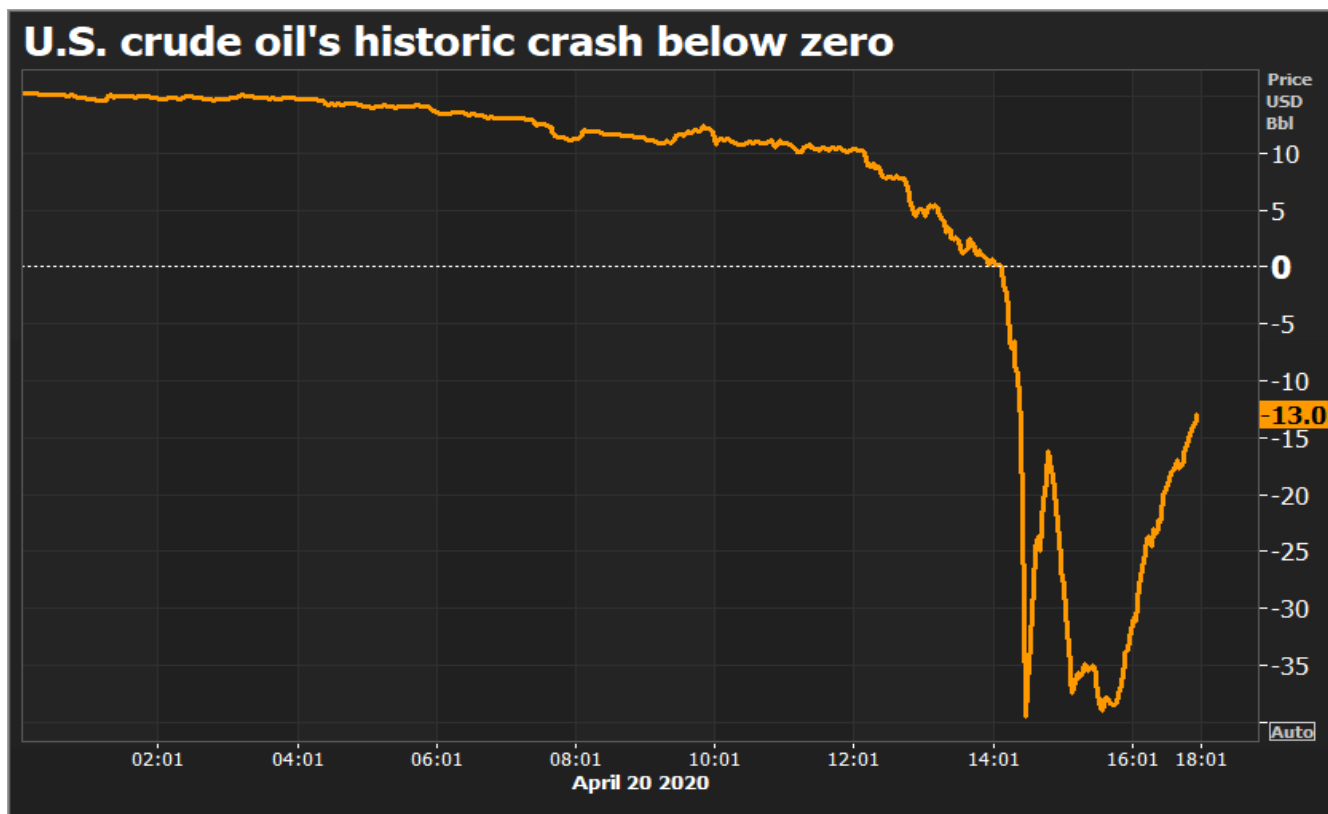


	FEB	MARCH	MAY	SEPTEMBER
Spread between USA and India 10-year yield	5.26	5.71	5.09	5.33
Moody's Seasoned Baa Corporate Bond Yield	3.5	5.1	3.8	3.4
Difference	1.76	0.61	1.29	1.93

Higher spread shows investors are already pricing in the growing riskiness of G-sec.

## Commodities

		Jan	Feb	March	April	September
Brent crude (BTI)	Spot	63.65	55.66	32.01	18.38	40.89
West Texas Intermediate (WTI)	Spot	57.52	50.54	29.21	16.55*	39.78



\*source: Reuters

**WTI** - The price WTI futures contract plunged into the negative for the first time in history. The long side (buyers) squared off their position instead of taking the delivery as demand hit rock-bottom and storage tanks filled up leading to extremely high storage cost.

**Brent crude** - Brent crude fell after reaching an interim high of \$45 as Saudi Arabia's state oil company Aramco cut the October official selling prices for its Arab light oil, a sign demand may be softening.

Along with-it BP released its annual energy outlook warning that pandemic and the urgency for climate change will see an earlier than expected decline for the demand leading to a demand for fossil fuels plateauing in the next 2-3 years.

**Outlook:** Prices unlikely to reach pre-Covid levels in medium term amid falling demand and shadow inventory. It will help ease the pressure on India's already deteriorating fiscal numbers.

### Safe Haven

	FEB	MARCH	APRIL	AUG.	SEPTEMBER
<i>XAU/USD</i>	1,585.13	1,571.31	1,685.05	1,969.75	1,885.44
<i>GOLD 1 kg - Oct futures</i>	41,397.00	43,255.00	44,906.00	51,701.00	50,404.00
<i>Bitcoin</i>	8,543.70	6,412.50	8,629.00	11,644.20	10,751.98
<i>JPY/USD</i>	0.009252	0.0092985	0.0093295	0.009441	0.009484

Recently, safe havens have done very little to hedge out the downfall in equity markets during the September downturn signalling that investors are preferring to hold cash now. All these cash may flow into emerging equity markets.

The rise in gold prices can be attributed to investor's search for yield as the yield on the world's safest asset (US Treasury) dry up viz-a-viz a safe asset during this pandemic situation which appreciates in value and provides an effective hedge against inflation. The rise in demand for Gold ETFs especially in the west is fueling the rally. Although the demand for gold has dropped towards jewellery and industrial purpose, prices remain buoyant backed by investment demand.

India is seeing a fall in demand for physical gold given the rise in unemployment and tight credit disbursement by banks, gold-backed loans are becoming an important source of credit.

**Bitcoin** behaved much like equity, flowing along with the volatility in the equity market. Hence, **it failed to act like a safe haven.**

### Why JPY is considered a safe haven?

1. The Japanese govt. had already introduced policy measures to better deal with the failure of banks even before the financial crisis took place. It helped Japan enter the financial crisis (2007-2008) with a relatively stable banking system.
2. The Bank of Japan was a pioneer in launching unconventional monetary policies like quantitative easing and near-zero interest rates to revive the economy.

**Hence, it gives the "impression" of a safe haven asset to investors and traders.**

Given the recent rally in gold, retail investors can look at the following ETFs to get some exposure in gold as an asset class:

Gold ETF	AUM (In Rs. Crore)	1 Year Returns in %	3 Year Returns (In %)
Nippon Gold ETF	2290.17	27.81	11.33
SBI Gold ETF	626.71	27.43	11.08
HDFC Gold Exchange Traded Fund	615.09	26.53	11.29



## Sectoral outlook

SECTORS	JAN	FEB	MARCH	APRIL	SEPT	%Change (JAN - MARCH)	% Change (MARCH- present)	YTD
	INDEX							
Consumer discretionary	3806.24	3533.1	2566.3	2915.44	3,637.46	-32.6	41.7	-4.43
FMCG	11641.54	10963.84	10254.89	10770.7	11,051.22	-11.9	7.8	-5.07
Energy	4778.52	4449.03	3650.13	4629.56	6,367.48	-23.6	74.4	33.25
Finance	6846.92	6435.08	4299.86	4892.57	4,985.99	-37.2	16.0	-27.18
Health care	13957.01	13480.1	12148.57	15332.39	19,799.24	-13.0	63.0	41.86
Industrials	3030.33	2683.14	1867.17	2115.49	2,602.52	-38.4	39.4	-14.12
Basic material	2794.68	2581.29	1852.25	2175.08	2,763.47	-33.7	49.2	-1.12
Realty	2526.17	2123.91	1353.65	1450.37	1,671.43	-46.4	23.5	-33.84
Utilities	1815.54	1643.98	1316.21	1483.98	1,461.42	-27.5	11.0	-19.50
Telecom	1178.61	1182.77	971.61	1133.68	1,035.11	-17.6	6.5	-12.18
Information technology	15871.46	14987.2	12842.72	14235.04	19,979.89	-19.1	55.6	25.89

### POST-COVID POTENTIAL WINNER (Industries)

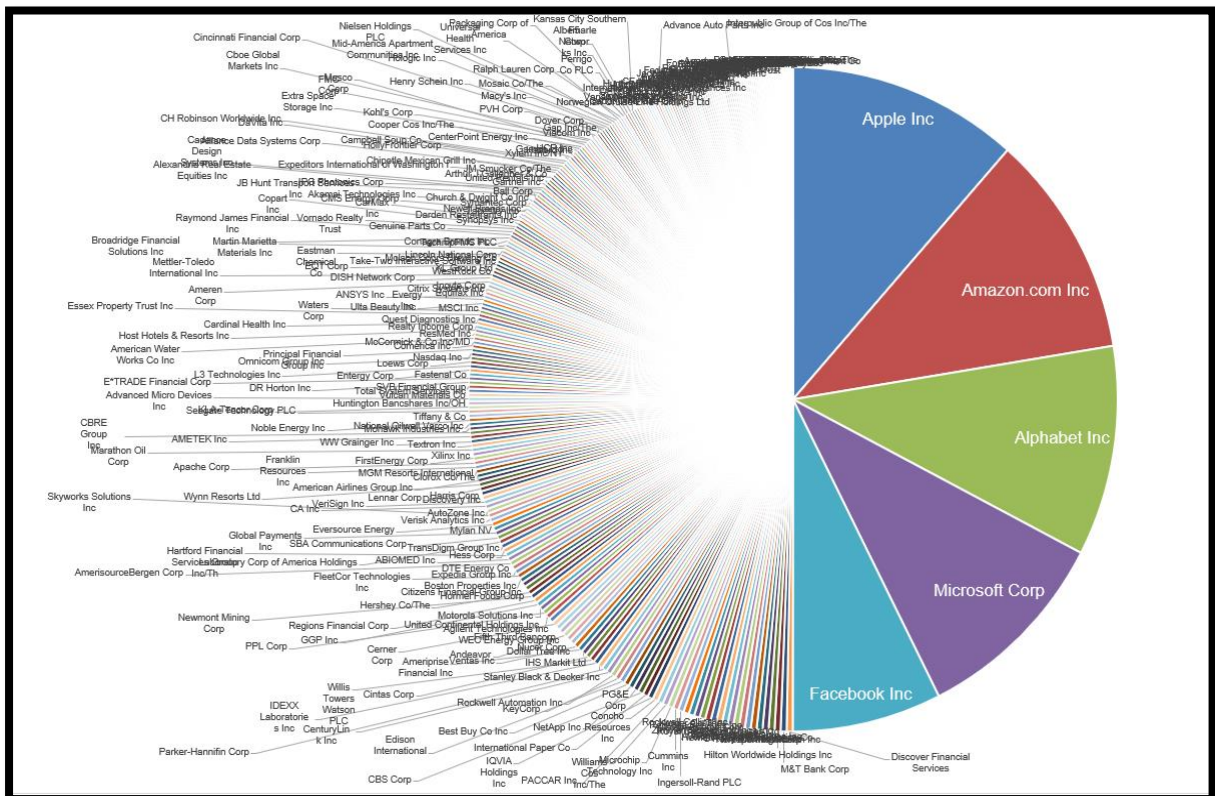
Cloud Computing Services industry  
Healthcare (along with IT)  
Ed tech  
Software Apps  
Computer/Smartphone  
Online retail  
Precious metals  
Biotech

### POST-COVID POTENTIAL LOSERS (Industries)

Air transport  
Banks  
Hotel  
Oil exploration

The tech industry has emerged as a clear winner from the Covid situation, investors sensing an opportunity are rushing in to put their money and hence acting as a blower to this bubble.

### Tech Bubble going on in NASDAQ index



\*source: market-watch.

### Market Cap milestones

	\$ 100 billion	\$ 500 billion	\$ 1 trillion	\$ 2 trillion
<b>FACEBOOK</b>	2012	2018	-	-
<b>APPLE</b>	2007	2012	2018	2020
<b>AMAZON</b>	2012	2017	2018	-
<b>MICROSFT</b>	1996	1999	2019	-
<b>GOOGLE (Alphabet)</b>	2005	2012	2020	-

- **FACEBOOK and GOOGLE** - Online ad business, focus on advertising revenues.
- **APPLE and MICROSOFT**- Old companies but regained its growth trajectory through launching iPhone and cloud services Azure respectively. These are their current cash machines.
- **AMAZON** - Company reinvented itself as a disruption platform, ready to go after any business it chose to, with the backing of amazon prime subscribers.
- **NETFLIX** - Old company, pivoted its business from video rental service, mailing DVDs to customers to a dominant player in OTT along with producing its own content. Subscription revenue is their cash machine.

## **Measures taken by the central bank – USA**

The US central bank has been proactive in taking bold steps in order to blunt the impact of Covid crisis.

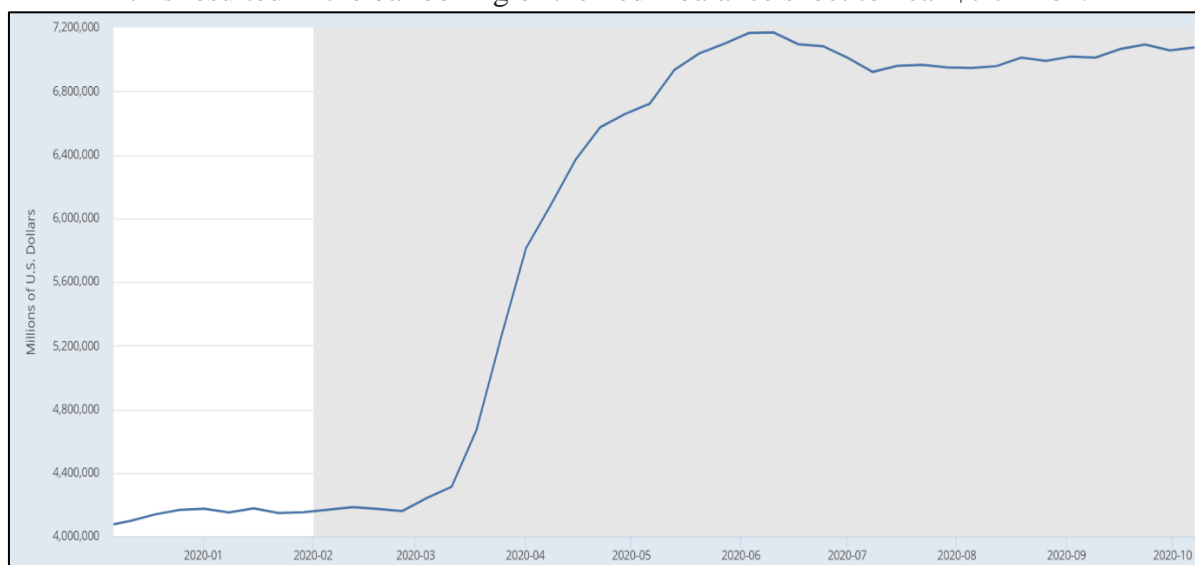
### **Measures announced by the Federal Reserve:**

- At an unscheduled meeting of the Federal Reserve Open Market Committee (FOMC) in the beginning of March, it lowered the Fed Funds Rate target by 50 bps, to 1 to 1.25%.
- After holding an unscheduled meeting again in mid-March, the FOMC announced 3 actions:
  - The federal funds target rate lowered from 100 bps to 0 to 0.25%.
  - Actions to support the flow of credit to households and businesses with a \$700 billion QE plan.
- The Federal Reserve Board approved "decreasing the discount rate (the primary credit rate) at the Banks from 1-3/4% to 1/4%, effective immediately."
- The Fed announced several new emergency programs to support the economy, businesses, and households:
  - it lifted the limit on QE plan and adds \$300 billion to make an unlimited purchase corporate bonds, treasury bonds and MBS.
- The FED announced another \$2.3 trillion of financing into businesses and revenue-pinched governments.
- The Federal reserve opened "swap lines" to the central banks of nations such as Australia, Japan, Mexico, and Norway.

### A note on swap line:

A "swap line" is like an **emergency pipeline of dollars** to countries that need them. The dollars are "swapped," i.e., traded for the other country's currency. As dollar is seen as the world's currency, there was a mad rush to get dollars around the globe as the crisis started unfolding and FED is the only institution to print them.

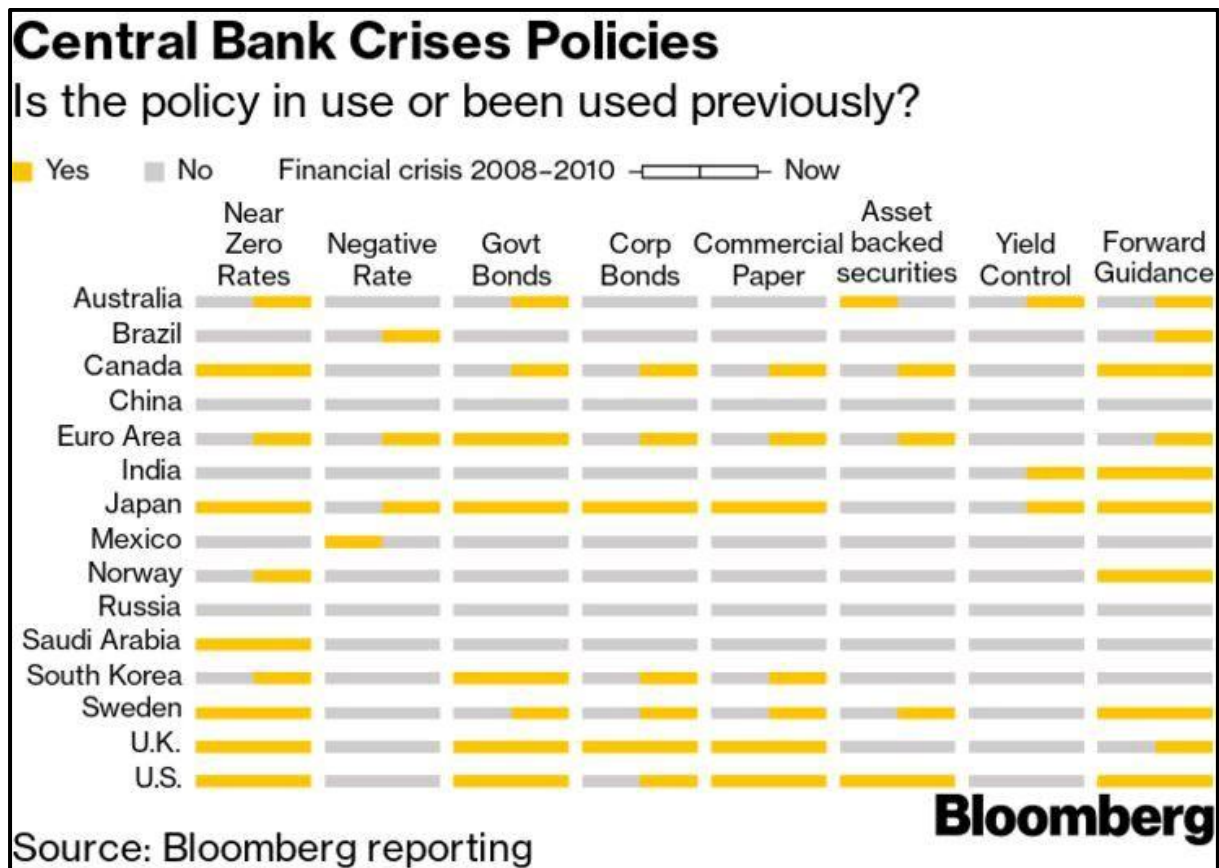
All this resulted in the ballooning of the Fed's balance sheet to near \$7 trillion:



\*source: FRED



## Snapshot of Monetary Policy Implemented during the crisis crisis by central banks all over the world.



### Unconventional monetary policy

Conventional monetary policy already tested in 2008-10 financial crisis.

Most notably, Japan and Australia have moved away from the conventional policies used during the last crisis and have tried and tested unconventional monetary policy this time.

## **Measures taken by the central bank – INDIA**

The RBI has been taking cues from the US central bank's policies and measures in dealing with the crisis.

### **Relief measures announced by Reserve Bank of India:**

- Reduction of policy repo rate by 75 basis points (from current 5.15% to 4.40%)
- RBI conducted auctions of TLTRO (Targeted Long-Term Repo Operations) for a total amount up to INR 2 lakh crore (~USD 26 billion), 50% corporates, 25% for development institutions for onward lending to agriculture, housing and medium / small enterprises and 25% for NBFCs and MFI). Another TLTRO of INR 1 lakh crore was announced later.
- CRR of all banks reduced by 100 basis points to 3% beginning March 28, for 1 year. This will release liquidity of INR 1,37,000 crore across the banking system MSF raised from 2% of SLR to 3% with immediate effect.
- Liquidity coverage ratio for banks reduced from 100% to 80% likely to release liquidity
- **These liquidity measures will inject liquidity of INR 4.74 lakh crore (~USD 63 billion) to the system.**
- **RBI revised its priority sector lending** rules to widen the spread of credit flow in the country, giving a higher weightage to districts where per capita priority sector lending is less than Rs 6,000 and a lower weightage to those districts where per capita priority sector lending is more than Rs 25,000, giving benefits to states like UP, Bihar, Jharkhand and majority of the north-east states. The urban co-operative banks have also been directed to increase their lending targets to priority sectors (75% by 2024).

- RBI sanctioned ECB (External Commercial Borrowings) worth \$ 3.5 billion or an estimated Rs 26,000 crore in April-June'2020. It favours the Indian corporates who can borrow at favourable borrowing costs supported by stable rupee outlook.
- Recently, the RBI went off-track and decided to buy bonds issued by the state governments. This measure was normally reserved only for central government bonds.

#### **Regulatory measures:**

- Allowed the lenders to grant a loan moratorium for three months of EMI (Equated Monthly Instalments), falling due between March 1 and May 31, 2020.
- Moratorium period to be excluded while computing 90 Day NPA norms for asset downgrade.

#### **Insolvency and Bankruptcy Code (IBC):**

- Threshold of default under section 4 of the IBC has been increased from Rs 1 lakh to Rs 1 crore with the intention to prevent triggering of insolvency proceedings against MSMEs.
- Loans for COVID-19 excluded from definition of default.

#### **Loan Moratorium Extension**

- Later, RBI extended it for further three months till August 31 and it did not extend it further initially.
- The central bank later permitted the lenders a one-time restructuring of loans without classifying them as non-performing assets for only those companies and individuals whose loans accounts are in default for not more than 30 days as on 1 March 2020.
- RBI Governor Shaktikanta Das said that banks can extend the loan moratorium by 3, 6 or even 12 months under the one-time restructuring.

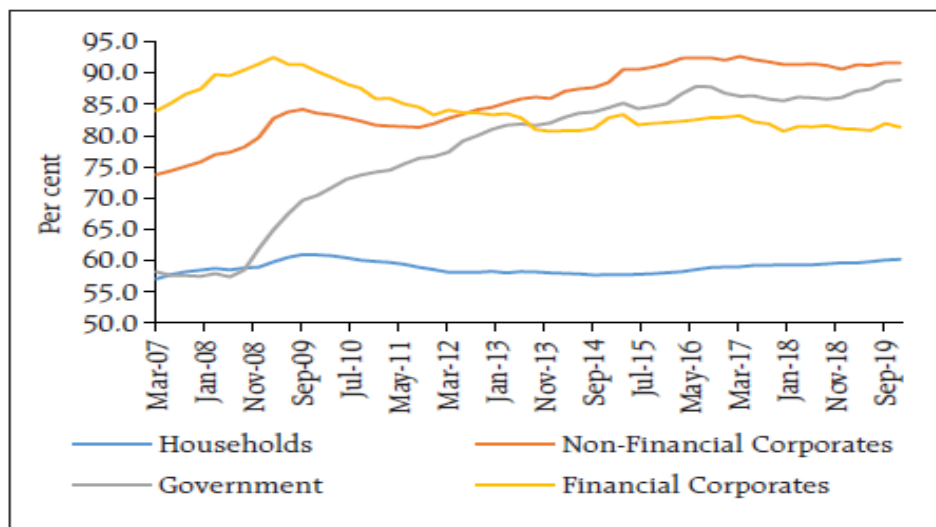
- The RBI set up a five-member committee under former ICICI Bank chief executive chairman K.V. Kamath on 7 August to recommend eligibility parameters for restructuring stressed loans. Kamath committee has identified four financial parameters including total outside liabilities to adjusted tangible net worth, total debt to EBITDA, debt service coverage ratio (DSCR), average debt service coverage ratio (ADSCR).
- In its report the five-member committee said power, construction, iron and steel, roads, real estate, wholesale trading, textiles, consumer durables, aviation, logistics, hotels, restaurants and tourism, mining are among the sectors that will need restructuring.
- The loan moratorium was again extended by the Supreme Court till September 28.

### Keeping up with RBI

#### **Fiscal Stability Report**

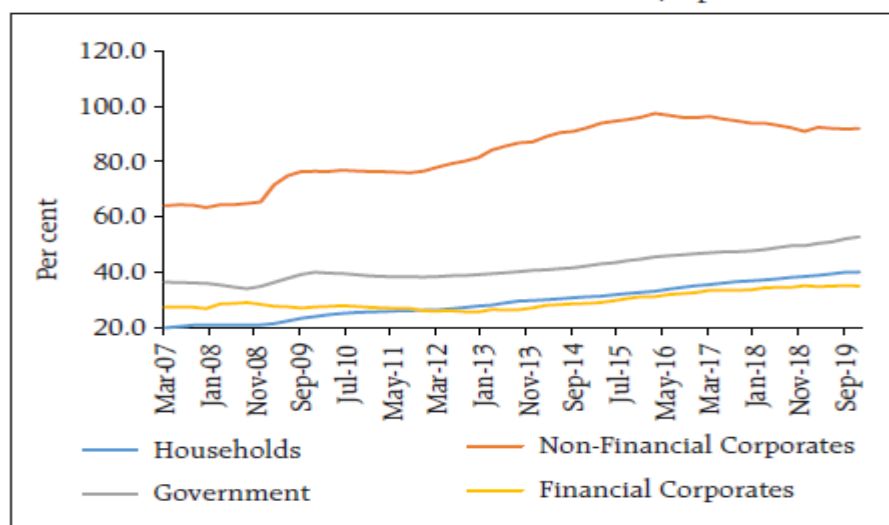
- The Reserve Bank of India releases the **Financial Stability Report (FSR)** every **six months**. In it, the RBI elaborates on the trends & progress in the banking system of India.
- The current Covid situation made this document even more relevant to get a grasp of the banking and macro environment.

**Globally, government debt as a % GDP has reached an unprecedented level.**  
(as per cent of GDP)



Source: International Institute of Finance (IIF).

**For emerging markets, most notably, household's debt has seen an uptick since the financial crisis coupled with low savings rate.**  
(as per cent of GDP)



Source: IIF.

### Loan moratorium (% of loans outstanding)

#### Loans Under Moratorium In Round-1

As On April 30, 2020

Sector	Corporate	MSME	Individual	Others	Total
Public banks	58.0	81.5	80.0	63.7	67.9
Private banks	19.6	42.5	33.6	40.9	31.1
Foreign banks	7.7	50.4	21.1	4.8	11.5
Small finance banks	43.7	52.3	73.2	12.3	62.6
Urban co-operative banks	69.3	65.5	45.9	59.2	64.5
NBFCs	56.2	61.1	37.3	41.4	49.0
<b>Scheduled commercial banks</b>	<b>39.1</b>	<b>65.3</b>	<b>56.2</b>	<b>55.7</b>	<b>50.0</b>
<b>System</b>	<b>41.9</b>	<b>65.0</b>	<b>55.3</b>	<b>54.6</b>	<b>50.1</b>

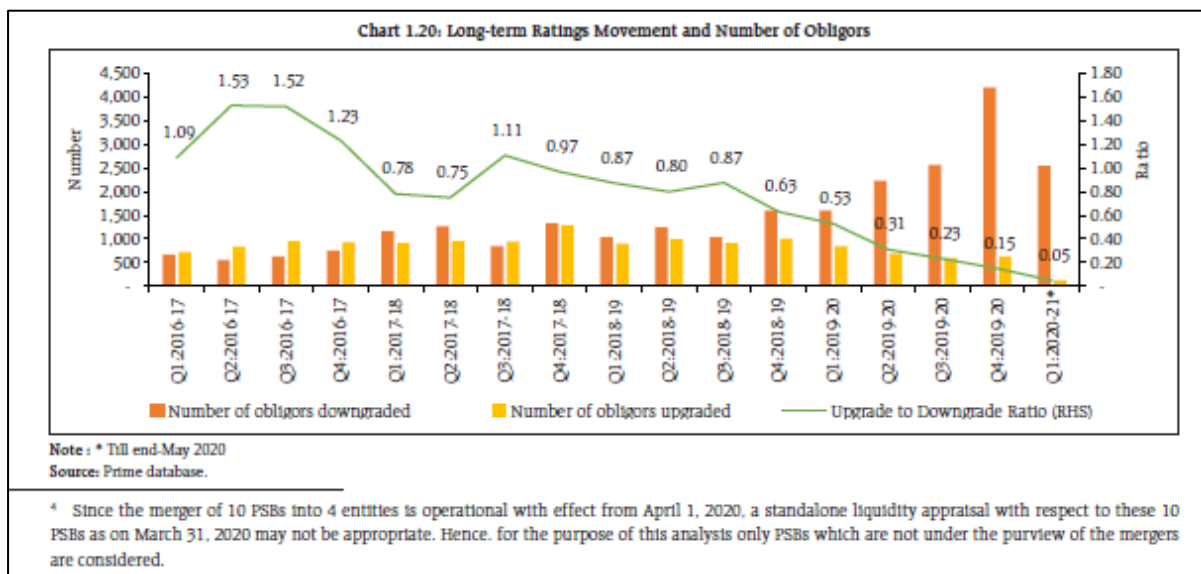
Source: FSR

Bloomberg | Quint

- Most banks have let customers avail the moratorium. The report states 52% of all customers from scheduled commercial banks (like HDFC and SBI) opted to defer their loan repayments—about 56% of all outstanding loans.
- 80% of MSMEs have opted for the moratorium through Public banks while for private banks it is half of it.
- From the corporate perspective, 39% of all corporates took the moratorium option from SCBs.
- There has been an uptick in downgrading by CRAs, especially for MSMEs, signaling the operational and financial distress facing them.
- However, the catch is most of them are sub-investment grade cos., grappling with leveraged balance sheets and stretched liquidity. Already struggling due to muted economic conditions, these were the worst impacted by the pandemic-led lockdowns and accentuated demand pressures. With business operations curtailed severely due to

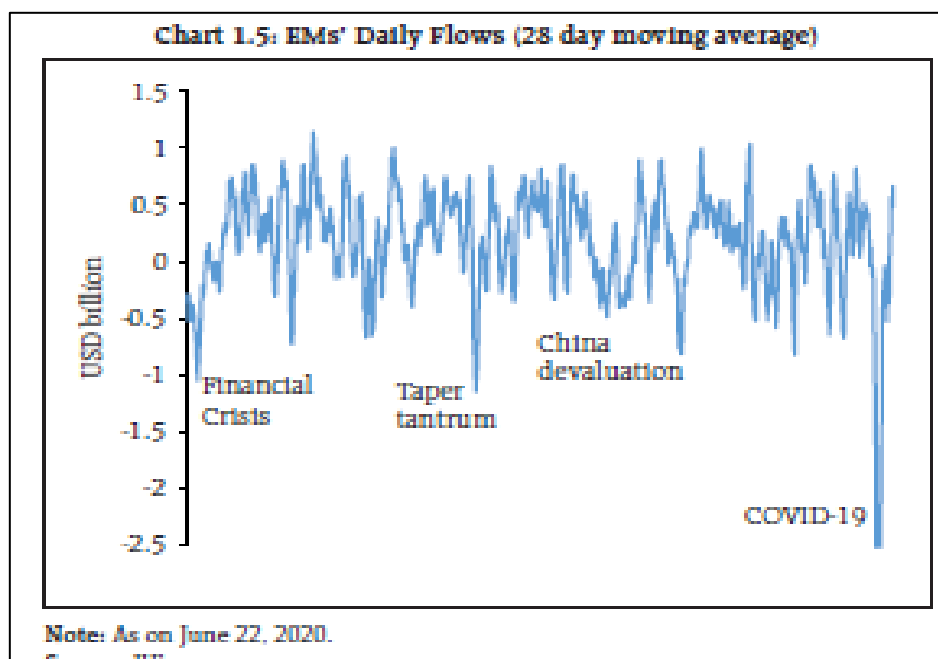
stressed demand pressures, the cash flows almost dried up for most of these entities, which typically have few funding avenues beyond bank lines. The moratorium has given them breathing space, but they have very little cushion margin.

**There has been an uptick in downgrading by CRAs, especially for MSMEs, signaling the operational and financial distress facing them.**



- MSME's account for 29% of the country's GDP, and account for half of India's exports. All told, they employ nearly 110 million people—40% of India's workforce.
- The Securities and Exchange Board of India (SEBI), which regulates CRAs, had asked agencies to not downgrade companies during the moratorium so they wouldn't end up with a default rating.
- The government on their part has unveiled a slew of measures to prop the MSME sector up during the pandemic. Among these was the provision for Rs 3,00,000 crore (\$40.5 billion) in collateral-free loans, which was announced in May as a part of the 20 trillion rupees Covid relief package.

### Emerging markets' daily flows.



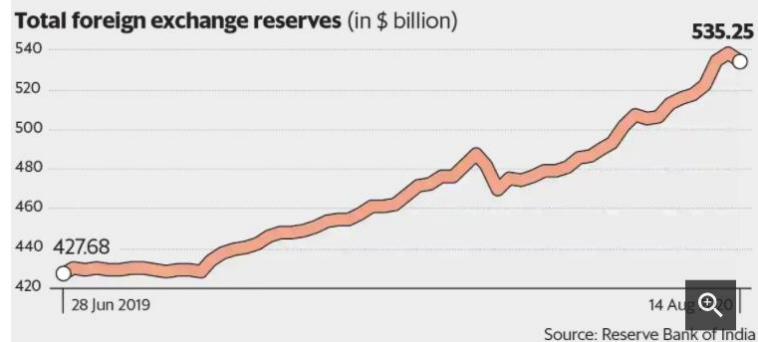
- Covid panic led to high outflow of capital from India depicting risk averse nature of FII for emerging markets, as evident from financial crisis (2008) and taper tantrum.
- Taper tantrum – winding up of quantitative easing rolled out from 2009 to tackle GFC – led to high outflow of capital from emerging markets.
- Foreign investors started exchanging rupee for dollar. The rupee took a hit. The value of our currency eroded (60 -68).
- Sensing a similar situation in near future, the RBI already started bulking up forex reserves as seen in the graph below:

Item	As on September 25, 2020	
	₹Cr.	US\$ Mn.
	1	2
<b>1 Total Reserves</b>	<b>3989568</b>	<b>542021</b>
1.1 Foreign Currency Assets	3679789	499941
1.2 Gold	264971	35999
1.3 SDRs	10836	1472
1.4 Reserve Position in the IMF	33972	4608



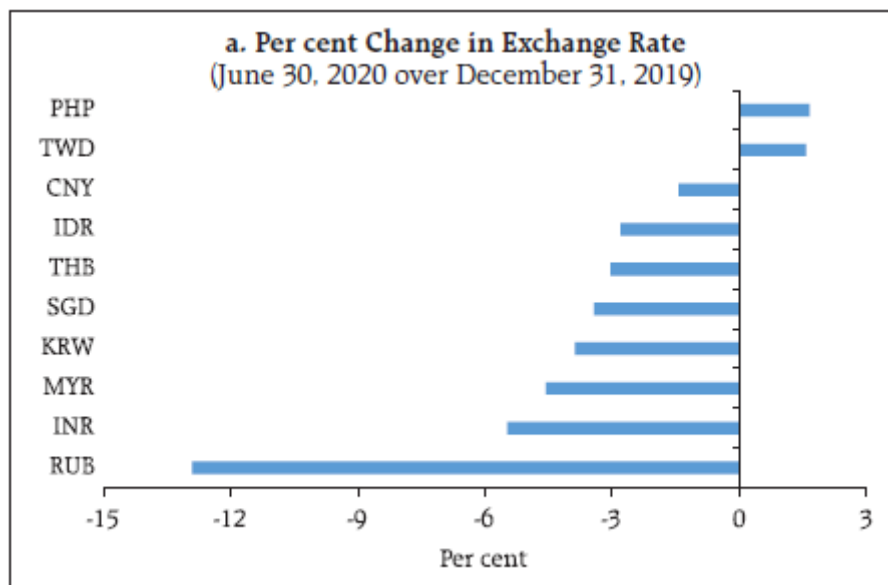
## Sudden surge

In the period between 27 March and 14 August this year, foreign exchange reserves rose 12.6% to \$535.25 billion. In comparison to a similar period in 2019, the reserves had climbed by just 4.5% to \$430.5 billion.



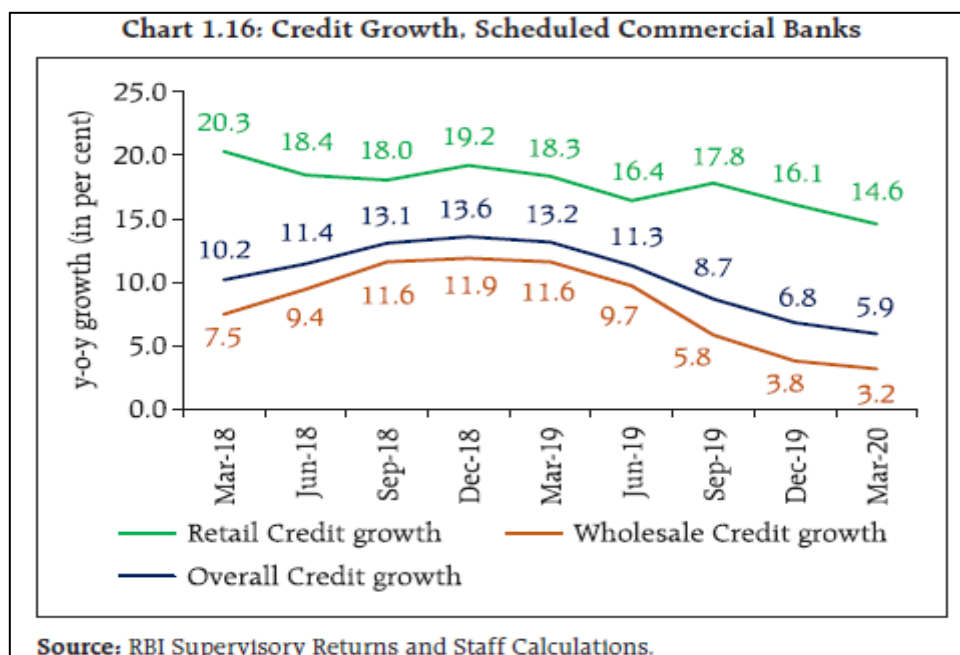
\*source: The mint, RBI.

## Performance of EM currencies



- Rupee was the worst performing “Asian currency”.
- After that, it went on to appreciate by as much 5% mainly due to:
- Foreign capital inflows from deals related to Jio platform and Schneider electric, combining a total of approx. \$ 17 billion (Rs.1.20 lakh crore) coupled with lack of intervention by RBI, which allowed the rupee to appreciate.
- Surplus in current account balance to the tune of \$19.8 billion due to a sharp decline in merchandise imports relative to exports.

### Credit growth of Scheduled commercial banks



- The corporate sector's credit demand has been modest. Even after lowering rates, their demand for credit hasn't picked up because just lowering interest rate would not induce them to make more investment rather, they rely on what's called the "hurdle rate" ( $WACC + \text{some premium}$ ) which drives their investment decision. Hence, it could be inferred that there is a lack of profitable investment which could cross this hurdle rate which may lead to credit growth.
- SCBs' credit growth is mainly characterized by a robust but slowing retail credit growth across bank groups, coupled with decelerating wholesale credit growth.
- On the other hand, SBCs have been reluctant to lend despite sharp rate cuts from the RBI.
- It can be attributed to the Reversal Interest Rate theory as coined by Markus.K. Brunnermeier and Yann Koby in 2018 NBER paper.

They empirically establish that if the central bank reduces policy rate below such reversal interest rate, the monetary policy to stimulate the economy could backfire.

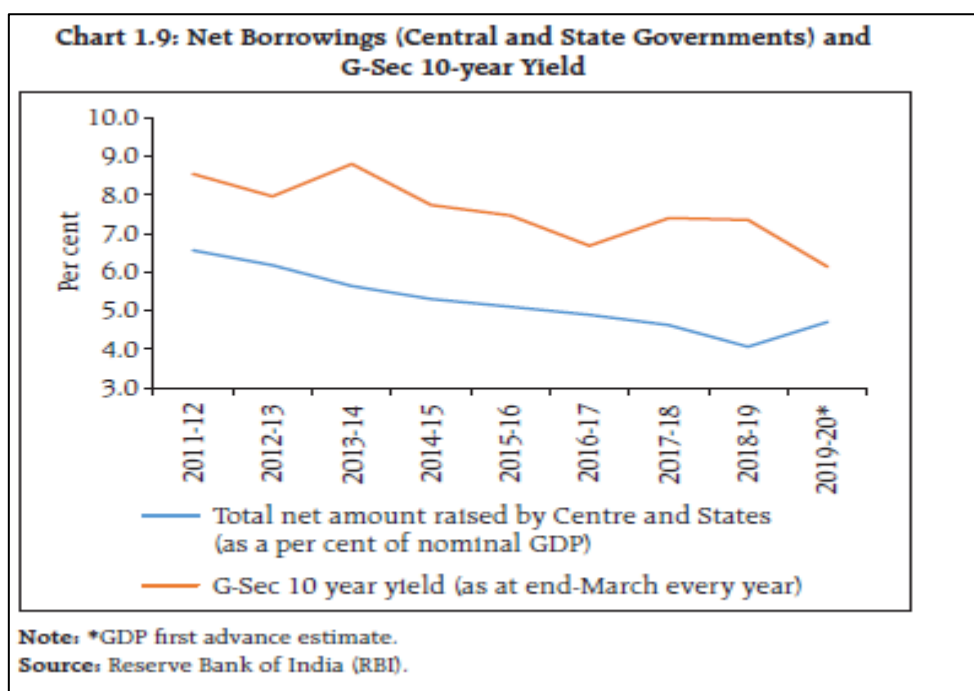
### How it works:

A cut in the policy rate increases the value of the bank's long term (perpetual) assets making up the bank's core capital (Tier 1 / Tier 2 bonds), this increases the value of their equity, makes them better capitalized along with resulting in higher profitability. On the other hand, a lower policy rate also lowered its net interest margins assuming lower policy rate is being passed onto lenders and depositors. Hence it becomes a balancing act between Capital gain and Net interest margin.

The reversal interest rate becomes the rate at which capital gains are too low to compensate the loss in net interest income thereby limiting the bank's ability to take on risk.

This along with saddling NPAs coupled with potential default in coming days is forcing the banks to lower their risk exposure.

### Net borrowings (Central + State) and G-Sec 10-year yield

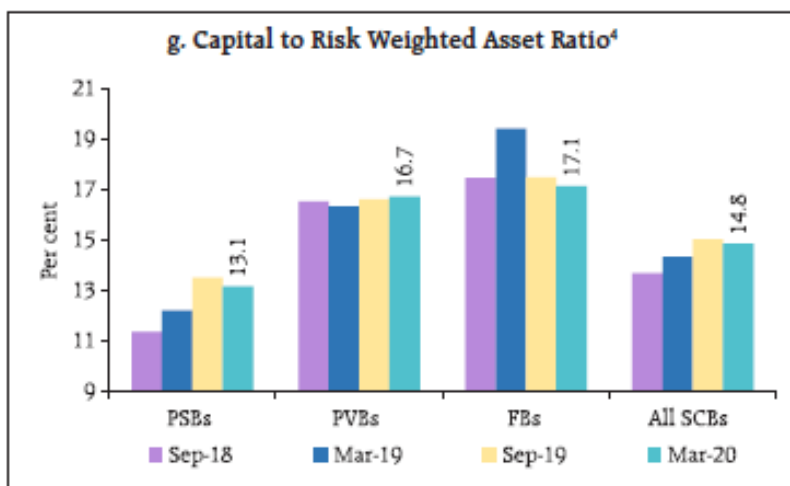


- 10-year yield has been on a downward trajectory.
- However, decreasing yields have led to increase in bond prices as they both are inversely related resulting in superior performance of gilt funds over other debt funds.

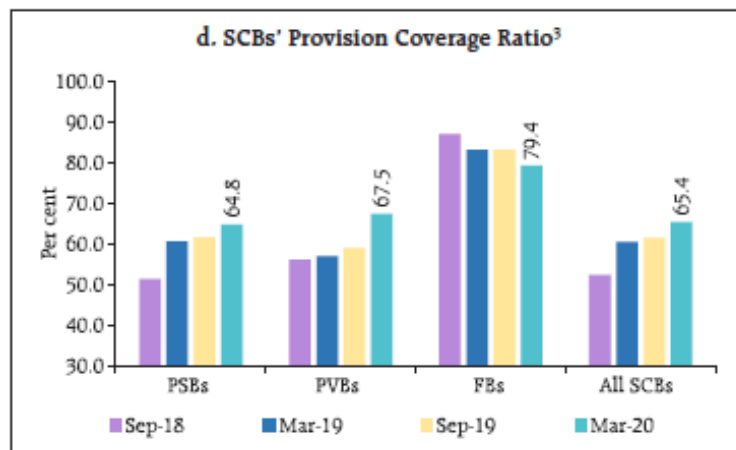
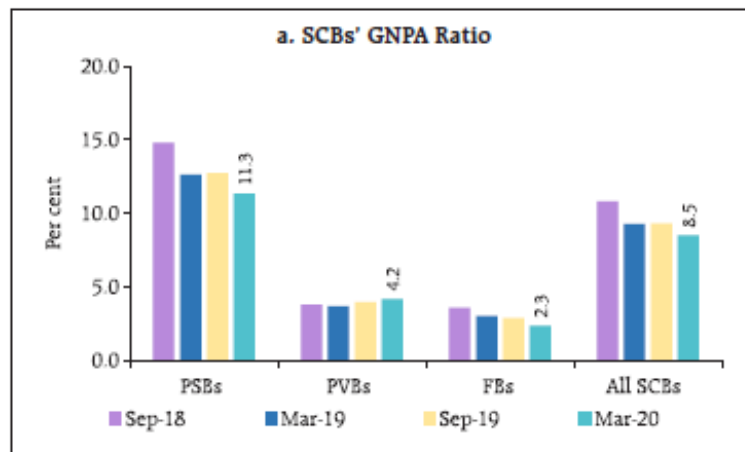
Scheme Name	Return 1 Year (%) Direct	Return 3 Year (%) Direct	Daily AUM (Cr.)
SBI Magnum Gilt Fund	11.75	8.97	3,691.22
HDFC Gilt Fund	10.01	7.08	2,129.61
IDFC GSF Investment	13.77	10.20	1,597.06
Nippon India Gilt Securities Inst.	12.02	10.06	1,503.85

### Provisions and coverage from SCB's

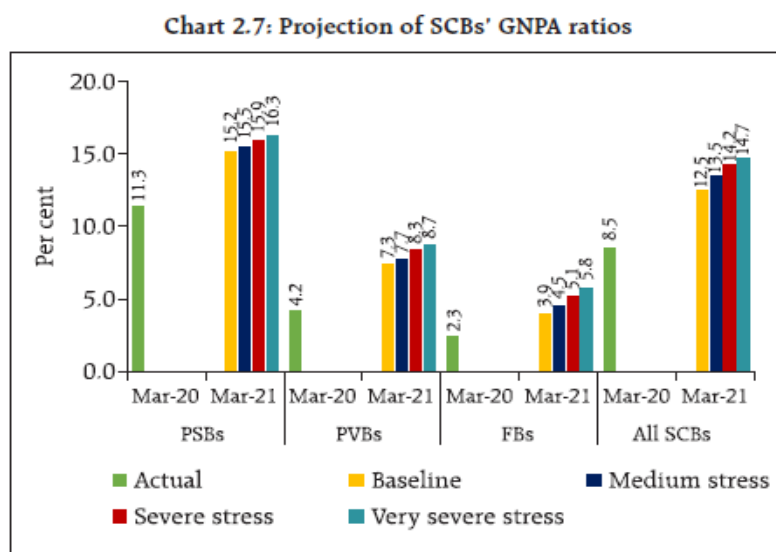
Capital Adequacy ratio for PSBs has been on the lower side



PSBs has the highest GNPA and lowest provision coverage ratios.



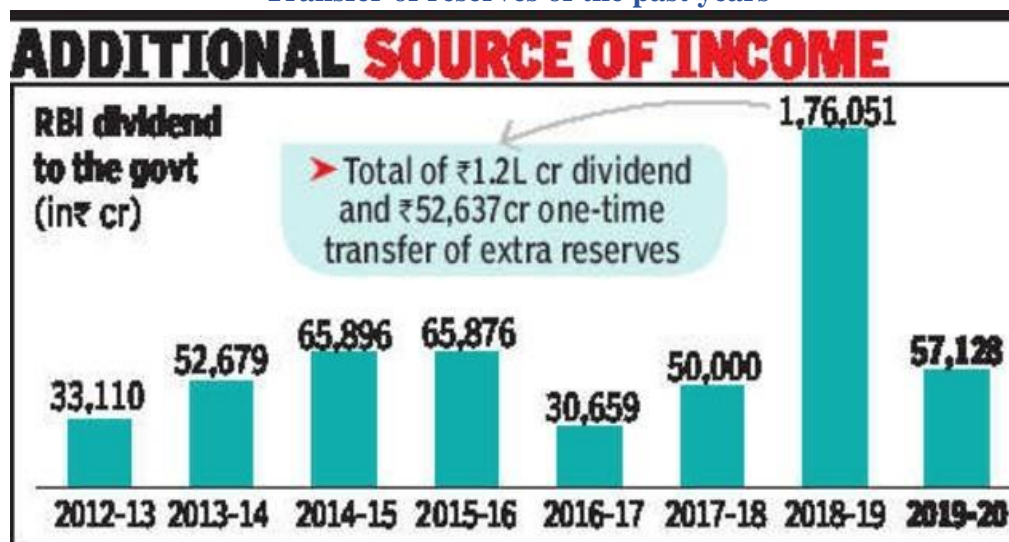
Loan moratorium may bring even greater stress as depicted in the graph below.



### A key point from RBI's annual report through cause and effect.

- **The effect:** -The RBI's balance sheet increased by 30%, or Rs 12,31,888 crore, from Rs 41,02,905 crore to Rs 53,34,793 crore.
- **The cause:** The RBI has been pro-active in trying to reduce the devastating impact of COVID-19 by way of creating new money. Creating new money means an expansion of both RBI's balance sheet and reserves. The RBI prints new money to buy government bonds from the open market.
- **The effect:** The year ended with an overall surplus of Rs 57,128 billion which was transferred to the government.
- **The cause:** The government is liable to pay interest on these bonds purchased by the RBI. Hence, the Reserve Bank can make more money from the little money it created earlier. This counts as income and when the RBI sets aside some of this money for future use, their reserves build up. Out of these reserves created the RBI transfer a portion of the reserves based on what it deems fit.

Transfer of reserves of the past years



\*source: TOI

### What the RBI is trying to do?

- **Focus on high frequency Indicators:**

Recent data showing sharp recovery:

- PMI at 56.8 (8 year high)
- GST collections at pre-lockdown levels.
- E-way bills at highest level since March.
- Railway freight loading and Power demand at much improved levels.

- **Inflation check:**

- Price stability is the core agenda. It fears sustained rise in prices may be attributable to cost-push inflation due to shortage of labors.

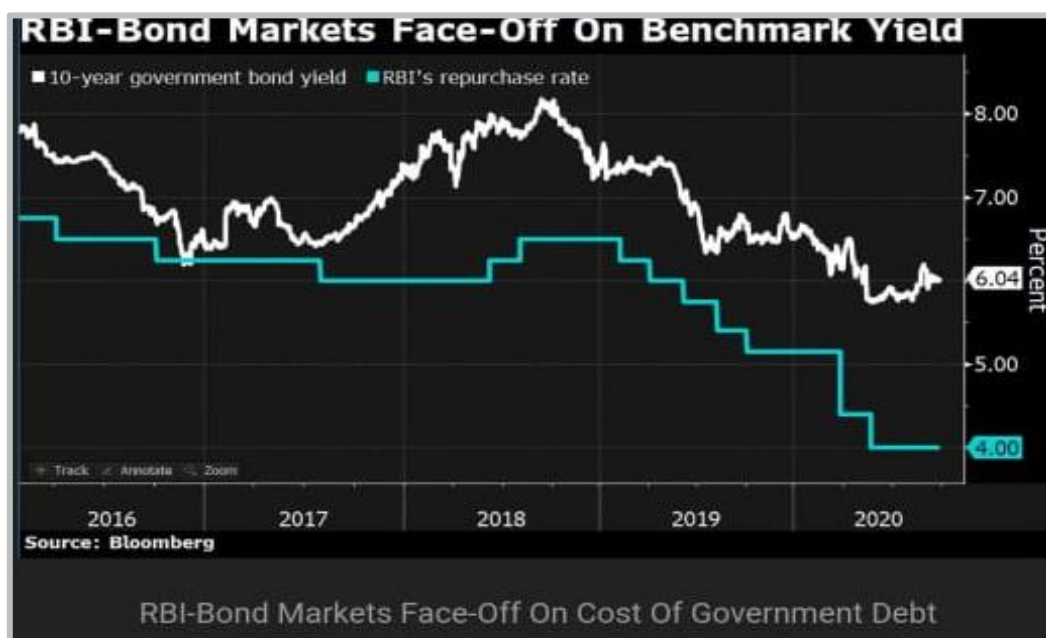
Inflation targeting may be difficult, the reason being the index chosen to target inflation – CPI. It is heavily weighted towards food and fuel prices and small changes here can have a drastic impact on the final inflation figure. So, to presume that RBI can somehow balance these wild movements is a bit overstated.

The central bank, contrastingly, is reducing its intervention in the currency markets in order to allow the rupee to appreciate as a result capital flows into the country. The recent appreciation of rupee will work towards containing the imported inflationary pressures.

- **Bond yields:**

- Fighting a tug-of-war with the bond market investors to keep bond yields in check. While policy rate cuts and abundant liquidity helped bring down yields sharply, yields have been surging lately amid rising worries about the government overshooting its fiscal deficit target set at this year's budget due to excess borrowing for providing Covid related relief measures and the trajectory of inflation, which has breached the upper end (6%) of RBI's mandate.

- The central bank's record devolvement of the auction of 10-year benchmark government securities, rejecting yield demand of 6.18-6.21 per cent, is sending a clear signal that it wants yields to soften to 6% or below which becomes unacceptable to the market as they would have to forego any chance of getting both real return and term premium.
- The RBI is using measures such as Open Market Operations (OMOs) and Operation twist (sell shorter and simultaneously buy longer duration bonds) to keep yields in check.



▪ **Loan restructuring policy:**

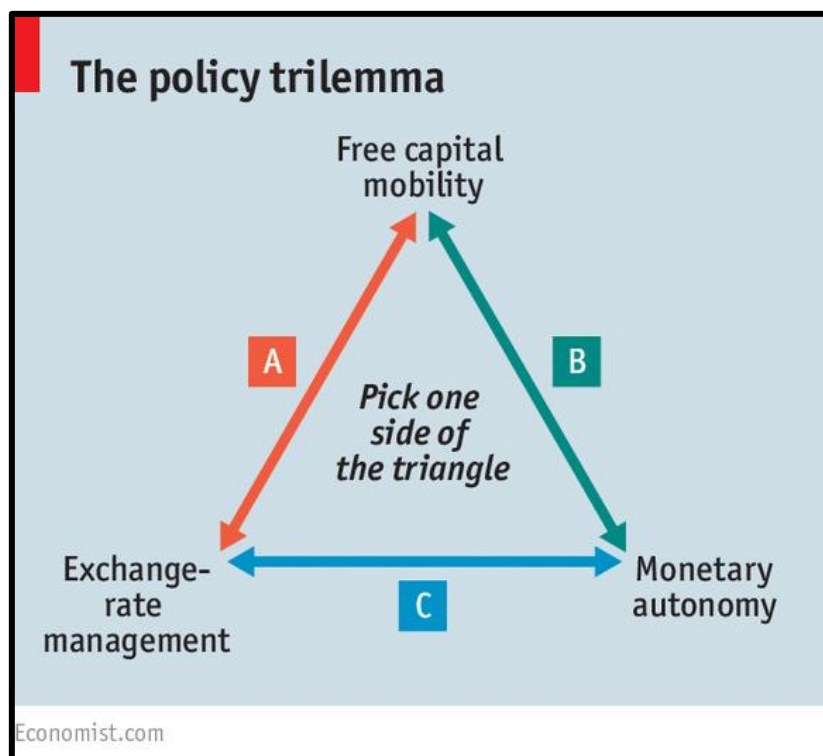
- If the borrower defaults, instead of classifying them as NPAs, the banks can offer a moratorium period of two years to retail investors after the deadline of 28th September and offer them some extra headroom without downgrading the loan, subject to certain conditions.



- On the other hand, restructuring has restricted access. The lenders will have to follow key indicators and guidelines laid down by the KV Kamath Committee while restructuring the loan.

### “Impossible trinity” trilemma.

It's a concept that says that a country must choose between allowing free flow of capital or investment for business, managing its exchange rate monetary autonomy for inflation management. Out of these 3, only 2 are possible to be controlled at a time.



India too faces this trilemma which are mentioned in a decreasing order of control as follows:

- Monetary autonomy: RBI follows an independent monetary policy and keeps a constant control over the interest rate.
- Free capital mobility: Occasionally, it controls capital flows.
- Exchange rate management: Usually, it allows a free-floating exchange rate.

During this challenging time, the central bank will need to strike a fine balance between managing the rupee through exchange-rate management, inflation through monetary policies and bond yields through free capital mobility in the bond market.

### **The RBI is doing all it can, now the focus shifts to the government.**

#### **Rs 20 lakh crore (\$265 billion, 10% of India's GDP) Covid-19 economic package announced by Finance Minister Nirmala Sitharaman.**

The focus of this package was mainly on MSMEs in order to provide them an incentive structure to steer them towards a new era of growth.

- Collateral-free loans, backed by the central government, of up to Rs 3 lakh crore have been introduced for MSMEs\*.

*\*Only half of the targeted micro, small and medium enterprises have benefited from the government's Emergency Credit Line Guarantee Scheme. The approved loan stood at Rs 1.61 lakh crore, or 54 per cent of the targeted amount of Rs 3 lakh crore, as of September first week. The amount disbursed was Rs 1.13 lakh crore.*

- Up to Rs 20,000 crore liquidity support through subordinate debt for stressed MSMEs. It involves providing support to credit guarantee fund trust for micro and small enterprises (CGTMSE) who in turn will provide partial credit guarantee support to banks, promoters of MSMEs will be given debt by banks, which will then be infused by promoter as equity in the unit.
- A fund of funds of up to Rs 50,000 crore for equity support to MSMEs with growth potential. A mother fund with an initial corpus Rs. 10,000 crores will be set up by the government, the funds will then move to few small daughter funds in a piecemeal

fashion and **try** and get other outside investors on-board these smaller funds to fill up the remaining Rs. 40,000 crores which will help leverage the Rs 50,000 cr. of funds announced.

- Definition of MSMEs have been changed:

Existing MSME Classification			
Criteria : Investment in Plant & Machinery or Equipment			
Classification	Micro	Small	Medium
Mfg. Enterprises	Investment<Rs. 25 lac	Investment<Rs. 5 cr.	Investment <Rs. 10 cr.
Services Enterprise	Investment<Rs. 10 lac	Investment< Rs. 2 cr.	Investment<Rs. 5 cr.

Revised MSME Classification			
Composite Criteria : Investment And Annual Turnover			
Classification	Micro	Small	Medium
Manufacturing & Services	Investment< Rs. 1 cr. and Turnover < Rs.5 cr.	Investment< Rs. 10 cr. and Turnover < Rs.50 cr.	Investment< Rs. 20 cr. and Turnover < Rs.100 cr.

Now, manufacturing and service has come under same purview. Turnover criteria have been introduced to facilitate making clear distinction between Micro Small and Medium using GST fillings as previous investment only criteria were unclear.

- EPF contribution reduced from 12% to 10% for business and workers for 3 months till August.
- Special liquidity scheme of up to Rs 30,000 crore announced for NBFCs, housing financiers and microfinanciers. Under this scheme investment will be made in both primary and secondary market transactions in investment grade debt paper of NBFCs/HFCs/MFIs, with a view to supplement liquidity.

- DISOCMS will be given a liquidity injection of Rs 90,000 crore to pay off their dues to GENCO's. The primary reason for this measure is the poor financial condition and revenue collection abilities of most state DISCOMS. There is a “payment of dues” tussle going on between GENCOs and DISCOMs.
- Rs 50,000 crores liquidity through TDS/TCS rate reduction. The payment of contract, professional fees, interest, rent, dividend, commission and brokerage shall all be eligible for the reduced rate.
- Last but not the least: Micro-credit scheme for street vendors, a working capital loan of up to rs10,000 for 50 lakh vendors resulting in a total package of rs50,000 crores.

The government later introduced more measures targeting central government employees, such as LTC Cash Voucher Scheme costing around Rs 7500 crore, in order to boost consumer spending as consumers are becoming more spend thrift and preserving cash as indicated by the country's Cash-to-GDP ratio as it is approaching a high of 14-15%.

**10 or 01?**

**There was a debate going on about the actual fiscal support provided by the government:**

Although the headline stimulus package showed a staggering package of 20 trillion (\$267 billion), corresponding to roughly 10% of India's FY21 GDP (estm.), finance Minister said the Rs 20 lakh crore economic stimulus package included Rs 8.01 lakh crore of liquidity measures announced by the Reserve Bank since March onwards, combine it with credit guarantee and liquidity support measure, it will take it to 90% of the total package announced thereby leaving actual fiscal support of only 10% or 1% of the estm. FY.21 GDP.

**Fiscal deficit + Moody's rating.**

**Fiscal deficit:**

	Budget estimates 2020-2021	Actuals up to august 2020	% of actual to budget estimates
	Rs.	Rs.	Current
<b>Total receipts</b>	<b>2245893</b>	<b>377306</b>	<b>16.80%</b>
<b>Total Expenditure</b>	<b>3042230</b>	<b>1247653</b>	<b>41.00%</b>
<b>Fiscal Deficit</b>	<b>796337</b>	<b>870347</b>	<b>109.30%</b>

**Fiscal deficit breakup (M-o-M and YTD):**

Months	2020-21	
	Monthly	Year to date
April	279512	279512
May	186831	466343
June	196020	662363
July	158986	821349
August	48998	870347

\*figures from controller general of accounts, MoF.

- India's fiscal deficit reached **109% of the full-year target** in the first five months of the ongoing financial year as the government's finances were stretched by the ongoing coronavirus pandemic situation. The gap between revenue and expenditure reached Rs 8.70 lakh crore during this period. The reason for this huge gap can be attributable to lower tax collection and significant spending behind various covid-19 relief packages and programs - namely Pradhan Mantri Garib Kalyan Yojana, Atmanirbhar Bharat package, free rations, grants to states - announced by the government.
- It is important to note that, **according to CAG, the actual fiscal deficit may be much higher** than the reported fiscal deficit, owing to **off-budget borrowings** to fund capital expenditure and even revenue expenditure through Food Corporation of India (food subsidy) and NHAI (spending on road infra.)
- The government has also raised its budgeted market borrowings for the fiscal ending March 2021 to Rs 12 lakh crore from Rs 7.8 lakh crore.
- The **combined fiscal deficit of the Centre and states may reach up to 12 per cent** of the GDP.
- These announcements are sending a negative signal to the bond market resulting in yields surging on government bonds. The burden would now fall on the RBI to keep the yield in check.

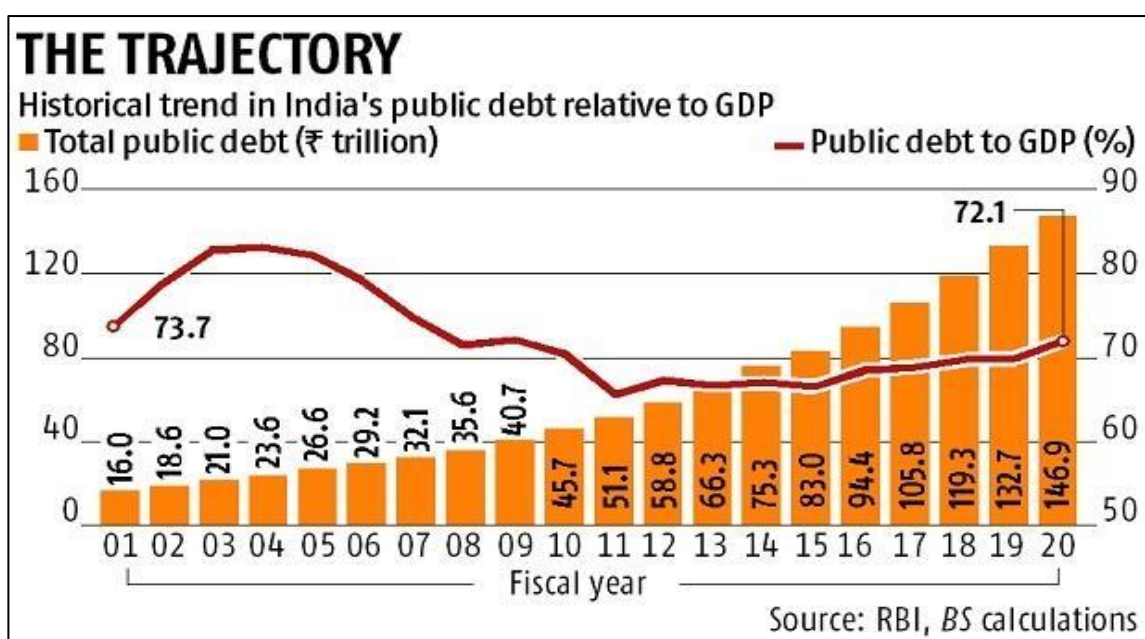
### **MOODY'S RATING – On the edge!**

- Nov 07, 2019: **Baa2** with a negative outlook.
- June 01, 2020: **Baa3** with a negative outlook.

**It is to be noted that according to Moody's that the downgrade was not because of the impact of the pandemic rather due to the following reasons:**

- Hopes of effective implementation of key reforms to strengthen the credit profile were belied since 2017.
- The low impact of policies implemented decelerated India's GDP growth.
- The government failing to meet its fiscal deficit target each year coupled with a steady accumulation of government debt from an already high Debt/GDP\* ratio as seen from the category of credit rating under which it sits

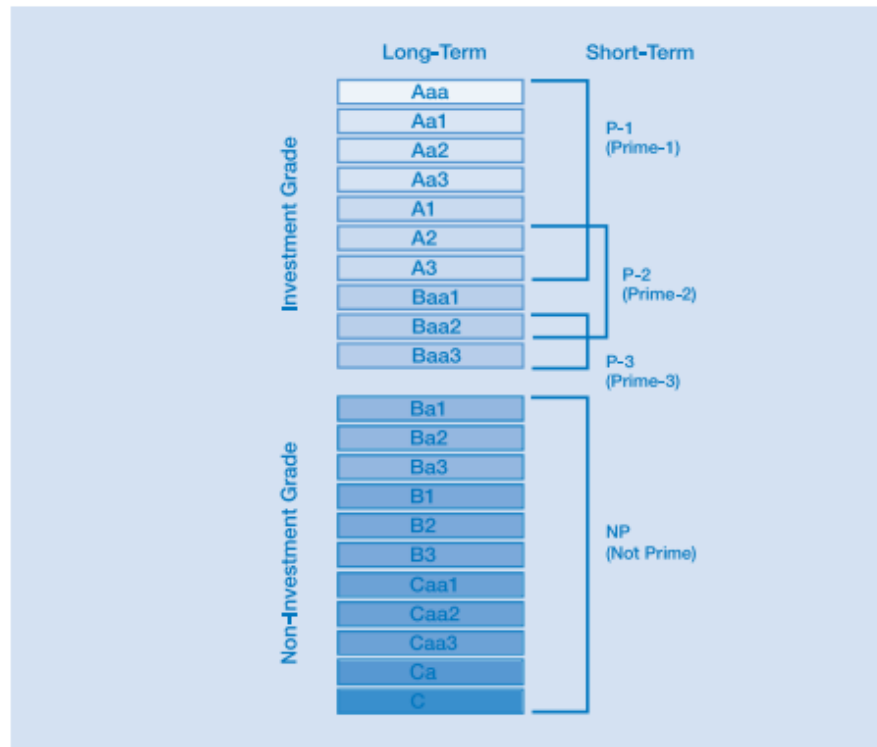
\*It is expected to go up to 84% for FY 21.



## Moody's rating scale

### Moody's Rating Scale

The following is a ranking (from highest to lowest) of Moody's long-term and short-term categories. The indicated relationship between long-term and short-term ratings is approximate and may not necessarily apply in all situations.



- We have slipped to the lowest level of rating under the investment grade category.
- One slip from here, will take us to the highest level of rating BUT under the NON-INVESTMENT grade category.
- Our sovereign bond's rating will move from Baa category to Ba category.
- Bonds issued by the Indian governments will be more "riskier".
- Governments and companies will have to raise debts at a much higher rate of interest.



### GST shortfall.

- The centre failed to keep its promise of compensating the shortfall in state's tax revenue due to implementation of GST through the GST compensation fund due to lack of funds.
- The COVID-19 pandemic and the consequent lockdown have amplified the issue even more, leading to both the centre and states facing a revenue shortfall hence, limiting the ability of the Centre to meet states' compensation needs.
- States were presented two options to resolve the issue of compensation shortfall:
  - Option 1\*: Rs. 97,000 crores representing the shortfall only due to GST rollout via a special window granted by the RBI meaning the interest cost on these borrowings will be “at or close to” the yield on G-Sec and in the event of the cost being higher, the centre will bear a part of the difference through a subsidy to the tune of 50bps (.50%).
  - Option 2\*: Rs. 2.35 Lakh crore representing the total shortfall due to GST rollout + Covid 19 via open market borrowing meaning relatively higher interest burden along with no interest subsidy from the centre.

*\*The two options were subsequently revised to Rs 1.1 and Rs 1.8 lakh crore respectively.*
- States had initially marked both the options as “untenable” as their borrowings has been 50% higher relatively to the corresponding period 2019-20 resulting in the yield on the 10-year state development loans (SDLs) rising to a range of 6.60-6.70 per cent. But recently majority of the states have decided to go with **Option 1**.

## Fiscal responsibility

Dr. Raghuram Rajan, former governor of RBI, on being asked in an interview on India's current fiscal deficit situation, this is what he had to say:

*“In India, what we can do is strengthen the **commitment to a new fiscal responsibility bill**, but also put in place targets **for how much we will bring down debt** over the medium term, become much more transparent about our budget. If instead, we try and **contain the spending now**, even though our deficits are big, we may impair longer term growth. And if we're doing this in order to maintain credit ratings, **we may end up neither with credit ratings nor with growth**”.*

Some more suggestions:

**BUSINESS INSIDER INDIA**

# GDP Dip

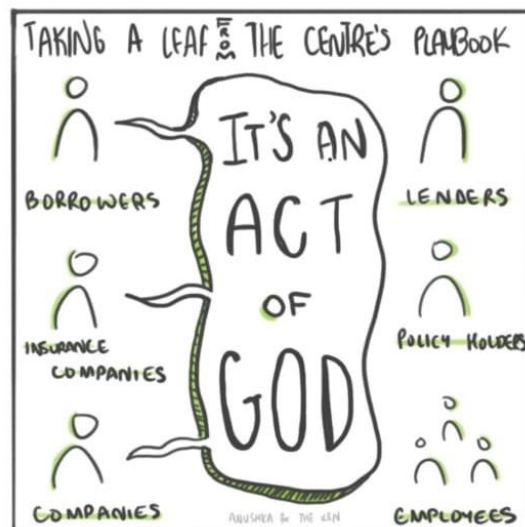
**5** things Raghuram Rajan believes can help

- Borrow more without scaring the bond market
- Government should sell, sell, sell
- Prioritise govt spending
- Reign in the private sector for help
- Either stimulus or reforms

The infographic features a portrait of Dr. Raghuram Rajan at the bottom right, set against a blue background with a subtle pattern of Indian Rupee symbols (₹).

## When nothing seems to work, there is always GOD

Finance Minister Nirmala Sitharaman said the economy is facing an Act-of-God-like situation, attributing the shortfall in GST collections to disruptions caused by Covid-19.



\*source: The Ken

## **Conclusion**

### **Outlook for asset classes:**

**Equity:** The Covid-19 meltdown did bring down equity prices, but it was short-lived as it later rebounded and made a sharp rally. Indices across major economies are trading at an extremely high valuation such as NASDAQ, Sensex as investors have started looking beyond this crisis while making their expected earnings forecasts. Equity investors should remain caution before raising their exposure although they can make allocation in certain select companies that have remained buoyant and emerged strongly, in fact gained, out of this crisis.

**Debt:** Rate cuts by central banks have resulted in sharp yield drop. This has led to an increase in the bond prices as they are inversely related, resulting in superior performance of gilt funds over other debt funds. Given the stance taken by Fed Reserve chairman, Jerome Powell to maintain current policy rates of “0 %” till 2023. It seems that any further rally in bond prices and outperformance of gilt funds remains unlikely.

**Gold:** Given the recent rally in gold, retail investors especially can look at Gold ETFs to get some exposure in gold as an asset class.

**Crude oil:** Prices unlikely to reach pre-Covid levels in medium term amid falling demand and shadow inventory. On the positive side it will help ease the pressure on India’s already deteriorating fiscal numbers.

### **Outlook for the Indian economy:**

The central bank of India has taken measures to stimulate the economy out of the crisis. But it faces certain limitations such as not being slash policy rates any further as inflation during this period has spiked and is currently at the upper spectrum of the its inflation band.

Given India’s current fiscal condition coupled with rising Debt/GDP ratio, investors have been demanding higher yields on government bonds to the dismay of RBI. This has led to muted response from the bond market at the government bond auctions, the RBI had to devolve multiple auctions or resort to monetizing the government’s debt. Going forward the central bank is expected to bring out a resolution in order to effectively maintain the liquidity flow in the economy.

The Indian government along with its states are facing the brunt of this crisis as their fiscal condition is going from bad to worse and on top of that they are having to borrow more at marginally higher rates. Debt/GDP ratio (Debt/GSDP for states) have reached to an unsustainably high level. If this condition does not improve then it won’t take much longer before CRA’s shift India’s government securities under non-investment grade category which will increase the “country risk premium” even further thereby leading to capital outflows from India’s financial markets by global investors.

However, on the brighter side if India does commit to it’s FRBM stance and take measures to boost its economic growth through either stimulus or reforms and provide global investors the confidence of investing here then it should see significant capital inflow which will help boost the development of its financial markets.

## **Appendices**

### **Overview of financial markets.**

- <https://in.investing.com>
- <https://www.rbi.org.in>
- <https://www.federalreserve.gov/>
- <https://www.bankrate.com/rates/interest-rates/federal-funds-rate.aspx>
- <https://fred.stlouisfed.org/>
- <https://www.mcxindia.com/products/bullion/gold>
- <https://www.marketwatch.com/story/this-1-chart-puts-mega-techs-trillions-of-market-value-into-eye-popping-perspective-2018-07-18>
- <https://en.wikipedia.org>

### **The role played by central bank.**

- <https://www.americanactionforum.org/insight/timeline-the-federal-reserve-responds-to-the-threat-of-coronavirus/>
- <https://www.federalreserve.gov/monetarypolicy/2020-06-mpr-part1.htm>
- [https://www.rbi.org.in/scripts/bs\\_viewcontent.aspx?Id=3894](https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=3894)
- <https://www.financialexpress.com/economy/rbi-measures-to-deal-with-covid-19-fallout-here-is-the-chronology/1967624/>
- <https://bfsi.economictimes.indiatimes.com/news/policy/10-decisions-taken-by-rbi-to-counter-coronavirus-impact-on-economy/74844644>
- <https://www.npr.org/sections/money/2020/04/21/839374663/why-is-the-fed-sending-billions-of-dollars-all-over-the-world>

## Keeping up with the RBI

- <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/OFSRJULY2020C084CED43CD1447D80B4789F7E49E499.PDF>
- <https://sbi.co.in/web/about-us/research-desk>
- <https://www.rbi.org.in/Scripts/AnnualReportMainDisplay.aspx>
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