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RESERVE BANK OF INDIA

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RBI Bulletin - November 2020

The Reserve Bank of India today released the November 2020 issue of its monthly Bulletin. The Bulletin includes one Speech, seven Articles and Current Statistics.

The seven articles are: I. State of the Economy; II. An Economic Activity Index for India; III. Preliminary Estimates of Household Financial Savings - Q1:2020-21; IV. Revisiting the Determinants of the Term Premium in India; V. India's Gilt Market; VI. LIBOR: The Rise and the Fall; and VII. Fintech: The Force of Creative Disruption.

I. State of the Economy

At a time when global economic activity is besieged by the outbreak of the second wave of COVID-19, incoming data for the month of October 2020 have brightened the near-term outlook for the Indian economy and stirred up consumer and business confidence. There are, however, formidable downside risks that confront the path of recovery.

II. An Economic Activity Index for India

Real-time tracking of high-frequency activity indicators provides timely information on the state of the economy and directional movements in GDP growth ahead of official releases. Accordingly, this article constructs an Economic Activity Index for India from twenty-seven monthly indicators using a dynamic factor model.

Highlights:

- The index suggests that the economy rebounded sharply from May/June 2020 with the reopening of the economy, with industry normalising faster than contact-intensive service sectors, pointing to a short-lived contraction.
- The index nowcasts GDP growth at (-) 8.6 per cent in Q2:2020-21, implying that India is likely to have entered a technical recession in the first half of 2020-21 for the first time in its history with two successive quarters of GDP contraction.

III. Preliminary Estimates of Household Financial Savings - Q1:2020-21

Considering the large impact of COVID-19 on the key macroeconomic aggregates and indicators for Q1:2020-21, which is already evident from the early official estimates of GDP and its key components, this article aims to provide preliminary estimates of household financial savings for Q1:2020-21.

Highlights:

- Preliminary estimates show a jump in household financial savings to 21.4 per cent of GDP in Q1: 2020-21, up from 7.9 per cent in Q1 and 10.0 per cent in Q4: 2019-20.
- The sharp increase is counter-seasonal and may be attributed to the COVID 19-led reduction in discretionary expenditure or the associated forced saving and the surge in precautionary saving despite stagnant/reduced income.
- The yawning gap between credit extended and deposits mobilised during the Q1: 2020-21 contributed to the spike in household financial savings as the financial instruments relating to banks continue to dominate the household financial assets and liabilities.
- The increased flows to mutual funds seems to have been driven by the relative returns on bank deposits, particularly when the stock markets rebounded after an initial volatility in the wake of COVID-19.
- The rise in subscription to insurance products reflects the pandemic-led increased awareness of life insurance amongst the households faced with a health crisis.
- The estimated increase in financial savings looks consistent with other macroeconomic statistics, in particular, the decline in private final consumption expenditure and the surplus position in the external current account.

IV. Revisiting the Determinants of the Term Premium in India

The underlying relationships that drive term premia are complex and constantly shifting. Empirical analysis over the period from January 2006 through September 2020 suggests that global uncertainty and liquidity are the main drivers of the term premium in India.

V. India's Gilt Market

A country's financial development hinges around the existence of deep and liquid government securities market. Spurred by reforms undertaken over the years, the gilt market in India has gained depth, liquidity and vibrancy while exhibiting resilience through periods of instability and crises, including the recent pandemic. This article examines the development and microstructure of government securities market in India, especially in the context of the policy initiatives underpinning its evolution.

Highlights:

- The legal and regulatory framework for the government securities markets has evolved over the years to facilitate efficient management of public debt and foster the development of secondary markets.
- Measures on the supply side have facilitated availability of securities across tenors, elongation of the yield curve, transparency in auction process and development of Primary Dealers' system. Robust and well-integrated market infrastructures developed over the years have contributed to efficiency, better price discovery and market liquidity.
- On a comparative perspective, the Indian government securities market fares well *vis-à-vis* other emerging market economies on various parameters. The

Indian government securities market also exhibits certain idiosyncratic features such as concentration of secondary market liquidity in few securities and limited participation in interest rate derivatives market.
- Increasing liquidity across tenors in the sovereign yield curve, widening the investor base and developing the derivatives market can be the focus areas for further development of the market.

VI. LIBOR: The Rise and the Fall

The year 2021 is an important year for the global financial markets. The regulatory mandate for the publication of the financial benchmark, London Interbank Offered Rate (LIBOR) is expected to cease after end-2021. In this backdrop, this article traces the journey of LIBOR and the efforts being undertaken for transition from LIBOR to alternate benchmarks. The Article also covers the progress on LIBOR transition in India and the measures taken by the Reserve Bank. There is a need for coordinated approach across all stakeholders to deal with the issues around LIBOR transition.

Highlights:

- The financial benchmark LIBOR became increasingly unverifiable as a result of the decline in volumes of the unsecured interbank transactions. The findings on issues related to the polling process of LIBOR acted as a catalyst for the global reform of financial benchmarks.
- Globally, the transition from LIBOR to Alternative Reference Rates (ARRs) based on shorter-tenor contracts is underway. The market for financial contracts referencing ARR is gradually developing. The development of term ARRs is one of the challenges involved in the LIBOR transition process.
- The measures taken by the Reserve Bank are aiding the progress of smooth LIBOR transition in India. In India, the Mumbai Interbank Forward Outright Rate (MIFOR) – which has LIBOR as one of its components – is a key benchmark used in the interest rate swap markets. An alternate benchmark will need to be developed in place of the MIFOR.
- The transition away from LIBOR to a new benchmark will be full of challenges. Every stakeholder – the financial sector; regulators; tax, legal and accounting systems; and real sector participants – needs to play a role in ensuring smooth transition.

VII. Fintech: The Force of Creative Disruption

This article provides a succinct review of the FinTech sector, encompassing its evolution, characteristics and driving factors, both for the world and India.

Highlights:

- FinTech has the potential to fundamentally transform the financial landscape, provide consumers with a greater variety of financial products at competitive prices, help financial institutions become more efficient, and bolster financial inclusion.
- The rapid and transformational changes brought on by FinTech need to be monitored and evaluated so that regulators and society can keep up with the underlying technological and entrepreneurial flux.

- The industry, as it stands today, is the result of a unique concoction of technological enablers, regulatory interventions and business opportunities as well as certain other characteristics unique to India.
- For a healthy and sustainable business ecosystem, FinTechs need to bridge the digital divide and promote equitable, broad-based customer participation. Cross-border payments, privacy concerns, potentially deleterious impact on financial stability, inequality of access, digital literacy and maintaining regulatory neutrality are identified as key future challenges in the sector.

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