SBI RESEARCH

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HOW MONEY IS MORE IMPORTANT THAN MONETARY POLICY:RBI FOCUSES ON LIQUIDITY MANAGEMENT

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As expected, RBI's Monetary Policy Committee unanimously decided to keep policy repo rate unchanged at 4% (9th straight time) and decided to continue with the accommodative stance (with 5-1 vote) as long as necessary. As far as projections go, RBI has retained its projection of real GDP growth for FY22 at 9.5% consisting of 6.6% in Q3 (earlier: 6.8%) and 6.0% in Q4 (earlier: 6.1%) as well as CPI inflation forecast at 5.3% for FY22 with 5.1% in Q3 (earlier: 4.5%); and 5.7% (earlier: 5.8%) in Q4 FY22. CPI inflation for Q1 & Q2 FY23 is projected at 5.0%.

RBI has been actively managing liquidity in the system through various means. However, system liquidity still remains in the surplus mode with the average daily net absorption under the liquidity adjustment facility (LAF) at Rs 8.4 lakh crore as on 7 Dec'21. RBI has now decided to increase the VRRR amount (currently Rs.6 lakh crore) to Rs 6.5 lakh crore on 17th December and Rs 7.5 lakh crore on 31st December. However, we believe that RBI might not continue getting full amount under this window. RBI has now decided to absorb liquidity mainly through auction route from January 2022. The next line of action could be in form of capping the fixed rate reverse repo and opening SDF window, otherwise it would be difficult to absorb full liquidity through VRRR. Alternatively, VRRR timing may be shifted from first half to second half to achieve this target as banks tend to keep sufficient liquidity with them for day's operations. The RBI has however also reduced the MSF limit from 3% of NDTL to 2% of NDTL from Jan'22,

We believe the decision to maintain status quo on reverse repo is a well thought out move, though MPC is not empowered to act on reverse repo as per the RBI Act. Even though short rates at VRRR auctions have moved up and there are commentaries suggesting the RBI has already acted stealthily on rates and hence an increase in reverse repo would have been a non event in MPC decision, such a perception is seriously misleading. It may be noted that overnight rates still hover around the lower end of the corridor with Treps averaging around 3.30%. Overnight rates start rising towards the upper end of corridor when total amount parked in overnight reverse repo dips below Rs 1 lakh crore, and it is likely to begin from Jan'22 onwards. This will complete the corridor normalization process. A hike in reverse repo rate beyond this could be the ideal opportunity and better timed assuming no increase in infections post omicron.

Meanwhile, the recent increase (of Rs 3.3 lakh crore during fortnight ended 05 Nov) and swift slump of deposits in the subsequent fortnight (of Rs 2.7 lakh crore) clearly points out that liquidity management cannot be divorced from market microstructure. The market microstructure affects decision-making at the micro stage and price discovery at the macro stage. This means that the recent aberration in deposits data has disrupted the liquidity management for banks and RBI. This, in turn, reinforces the need for stronger market microstructure.

Among the developmental and regulatory measures, the infusion of Capital in Overseas Branches and Subsidiaries of Banks and Retention/Repatriation/Transfer of Profits by these entities without the prior approval of RBI would ensure faster turnaround time for decision making adding to operational convenience and efficient fund management on a composite basis, while meeting regulatory requirements of foreign offices efficiently. Also, timely repatriation of additional profits can augment the domestic operations in select cases.

A UPI-based payment product for feature phone users, simplification of process flow for small value transactions over UPI, and increase in UPI transaction limit for specified categories will further enhance the popularity of UPI in the country. These steps are crucial as still India has 55 crore feature phone users who are in need for proper digital payment products.

Given the uncertainty around the Omicron, RBI policy seems to be well thought out. Policymakers must carefully calibrate their response to incoming and evolving data. Varying inflation conditions and strength of recoveries across countries show why the policy response needs to be tailored to country specific circumstances, given sharply higher uncertainty associated with Omicron.

Lastly some positive news, ASCB data shows that since October the incremental credit growth is picking up with Rs 1.18 lakh crore reported during 22nd Oct to 19th Nov'21 period. Sectors such as Power, Road, Electronics, Paper and Paper Products, Gems and Jewellery etc. reported positive numbers. Commercial Paper (CP) issuances also increased by 157% (MoM) in November'21 to Rs 2.88 lakh crore, highest in recent time, as NBFCs issued CPs worth Rs 1.90 lakh crore.

RBI HOLDS RATE

- RBI's Monetary Policy Committee has unanimously decided to keep policy Repo rate unchanged at 4% (9th straight time) and decided to continue with the accommodative stance (with 5-1 vote) as long as necessary (to revive growth on a durable basis with check on inflation). Reverse repo rate remains unchanged at 3.35% and MSF and the Bank Rate remains at 4.25%.
- RBI has retained its projection of real GDP growth for FY22 at 9.5% consisting of 6.6% in Q3 (earlier: 6.8%) and 6.0% in Q4 (earlier: 6.1%). However, as per our estimates we now expect GDP growth for FY22 to top 9.5%, the RBI forecast. For Q1 FY23, RBI has retained GDP growth at 17.2% and 7.8% for Q2.
- RBI has projected CPI inflation at 5.3% for FY22 with 5.1% in Q3 (earlier: 4.5%); and 5.7% (earlier: 5.8%) in Q4 FY22. CPI inflation for Q1 & Q2 FY23 is projected at 5.0%. We believe inflation management could pose challenge to RBI as cost-push pressures from high industrial raw material prices, transportation costs, and global logistics and supply chain bottlenecks continue to impinge on core inflation.

LIQUIDITY MANAGEMENT & MARKET MICROSTRUCTURE

- RBI has been actively managing liquidity in the system through various means. However, system liquidity still remains in the surplus mode with the average daily net absorption under the liquidity adjustment facility (LAF) at Rs 8.4 lakh crore as on 7 Dec'21. The durable liquidity stands at Rs 11.2 lakh crore compared to Rs 12.0 lakh crore at the time of previous policy. Liquidity surplus has progressively narrowed since RBI stopped liquidity infusion through GSAP operations. Total absorption under VRRR has increased from Rs 5.44 lakh crore on 7 Oct'21 to Rs 7.20 lakh crore on 7 Dec'21.
- RBI has decided to increase the VRRR amount (currently Rs.6 lakh crore) to 6.5 lakh crore on 17th December and 7.5 lakh crore on 31st December. However, we believe that RBI might not continue not getting full amount under this window and the cut off will continue to remain at 3.99. Also, it has decided to absorb liquidity mainly through auction route from January 2022. The next line of action could be in form of capping the fixed rate reverse repo and opening SDF window, otherwise it would be difficult to absorb full liquidity through VRRR. Alternatively, VRRR timing may be shifted from first half to second half to achieve this target.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q3 FY22	Q4 FY22	FY22	Q1 FY23	Q2 FY23
Dec'21	5.1	5.7	5.3	5.0	5.0
Oct'21	4.5	5.8	5.3	5.2	-
Aug'21	5.3	5.8	5.7	5.1	-
Real GDP Growth (%)	**Q3 FY22**	**Q4 FY22**	**FY22**	**Q1 FY23**	**Q2 FY23**
Dec'21	6.6	6.0	9.5	17.2	7.8
Oct'21	6.8	6.1	9.5	17.2	-
Aug'21	6.3	6.1	9.5	17.2	-

Source: RBI, SBI Research

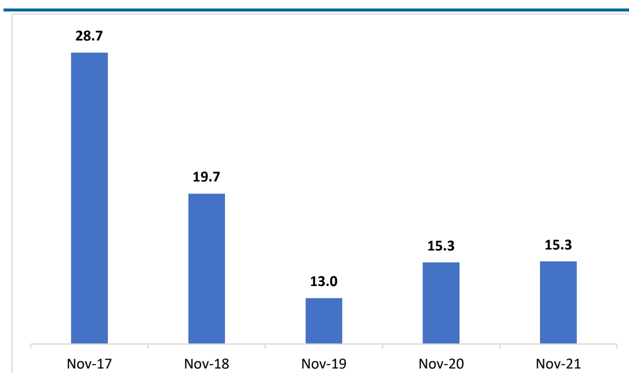
- Going forward, the main operation of 14-day VRRRs will continue to be complemented by longer term VRRRs, the size and maturities of which will be decided on the basis of continuous assessment of the evolving liquidity conditions. It is believed that the increase in amount of VRRR may reduce the placement in overnight fixed rate reverse repo window. However, it seems less likely as VRRR window is in first half and Banks tend to keep sufficient liquidity with them for day's operations. The VRRR amount may have been increased looking at the increased spending by the GOI in coming months which will reduce the GOI cash balance with the central bank and consequently increasing the liquidity in the banking system.
- Notably, in March 2020 banks were allowed to avail of funds under the marginal standing facility (MSF) by dipping into the Statutory Liquidity Ratio (SLR) by up to 3% of NDTL from 2% earlier. It provided additional liquidity of Rs 1.4 lakh crore under the LAF. But as this window is not being used much by the banks due to surplus liquidity conditions, RBI has now decided to reduce the MSF limit from 3% of NDTL to 2% of NDTL from Jan'22.
- The money market forms the first link in the transmission of monetary policy impulses to the real economy through the interaction of bank reserves and interest rates. Monetary policy's ability to impinge on aggregate spending decisions via the money market and the term structure of interest rates is essential.
- The recent increase (of Rs 3.3 lakh crore during fortnight ended 05 Nov) and slump of deposits in the subsequent fortnight (of Rs 2.7 lakh crore) poses serious threat to the liquidity management & market microstructure.

- Literature suggests that market microstructure affects market liquidity. The process by which market microstructure affects price discovery in a market and market liquidity via changes in market participants' behaviours is composed of two stages: (a) from when market participants hold potential trade needs based on their individual reasons to when they actually decide to place orders in the market (the micro stage), and (b) the stage in which such orders are accumulated in the market and trades are executed (the macro stage). The market microstructure affects decision-making at the micro stage and price discovery at the macro stage. This means that the recent aberration in deposits data has disrupted the liquidity management for banks and RBI. This in turn reinforces the need for strong market microstructure.

DEVELOPMENTAL AND REGULATORY MEASURES

- **Infusion of Capital in Overseas Branches and Subsidiaries of Banks and Retention/Repatriation/Transfer of Profits by these entities:** In a view to provide operational flexibility to banks, RBI has allowed banks meeting the regulatory capital requirements may, with the approval of their Boards, infuse capital in their overseas branches and subsidiaries; retain profits in these centres; and repatriate/transfer profits therefrom, without prior approval of RBI. This will cut down on the turn around time and not only add to operational convenience but also help in efficient fund management, which will improve speed of decision making.
- **Discussion Paper on Charges in Payment Systems:** RBI has proposed to issue a discussion paper covering all aspects related to charges involved in various channels of digital payments such as credit cards, debit cards, PPI (cards and wallets), UPI, etc. As payment infrastructure induced huge costs, card issuers have been charging the payment processing fees as MDRs. However, transaction charges should not be deterrent in growth of digital payments. As there is no charge in UPI transactions on customers/merchants, this has been gaining growth momentum and crossing milestones every month.
- Significant reduction in MDR will encourage the use of debit cards. With the reduction and capping of MDR, merchants will be encouraged to accept debit cards. So, RBI should find a way so that it should not discourage merchants to accepts digital transactions. Further, this will create a way for the introduction of Central Bank Digital Currency (CBDC) in future.
- **External Commercial Borrowing (ECB)/Trade Credit (TC) - Transition from LIBOR to Alternative Reference Rate (ARR):** RBI had already issued instructions to Banks to prepare for LIBOR cessation. However, the spread for ECB and Trade Credit was not reviewed so far. The new instruction defining all in cost ceiling for ECB and Trade Credit is going to bring clarity to the market about the probable pricing of these products when linked with ARRs. It will help in ensuring smooth transition from LIBOR to ARR by mitigating future transaction risks when new benchmark replaces Libor.
- **Discussion Paper on Review of Prudential Norms for Investment Portfolio of Banks**: RBI Prudential norms are based on a framework introduced in October 2000. RBI intends to review and update these norms. A discussion paper will be placed on RBI's website shortly for comments.
- **UPI for Feature Phone Users:** Currently, feature phone users can use NUUP (National Unified USSD Platform) as an option for availing basic payment services using the shortcode of *99#. However, the use of this feature has not picked up or even declined in the recent years (from Rs 28.7 crore transaction value in Nov'17 to Rs 15.3 crore in Nov'21). Hence, the central bank has proposed to launch a UPI-based payment product for feature phone users. This step is crucial as still India has 55 crore feature phone users who are in need for proper digital payment product.

Transaction through *99# (Value in Rs crore)



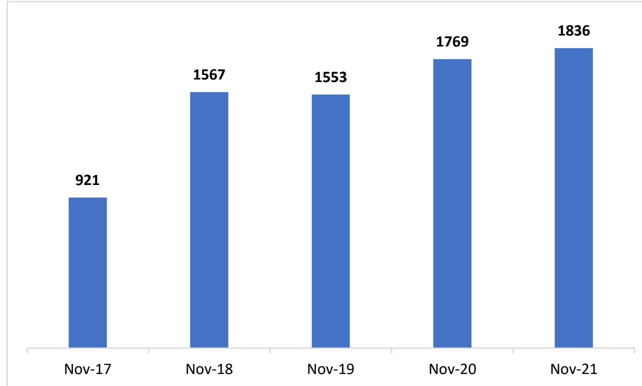
Source: SBI Research

- **Simplification of Process Flow for Small Value Transactions over UPI:** With 14 crore transactions per day in Nov-19 with average transaction size of Rs 1836 (50% transaction are below of Rs 200), UPI is going to emerge as the most-preferred mode of digital retail payment in India. RBI has thus proposed to offer a simpler process flow by enabling small value transactions through an "On-device" wallet in UPI app which will conserve banks' system resources, without any change in the transaction experience for the user. We believe that this is an excellent step towards promoting the digital payments in India with effective management and least glitches.
- **Increase in UPI Transaction Limit for Specified Categories:** Apart from retail transactions UPI has also become a popular payment option for Initial Public Offerings (IPOs) since its availability from January 01, 2019. To further encourage the use of UPI by retail investors, RBI has proposed to enhance the transaction limit for payments through UPI for Retail Direct Scheme and IPO applications from ₹2 lakh to ₹5 lakh. During Nov-21 total 12.4 lakh applications were applied for IPO through UPI and the increase in transaction limit will enhance participation in IPO through UPI.

GLOBAL ECONOMY

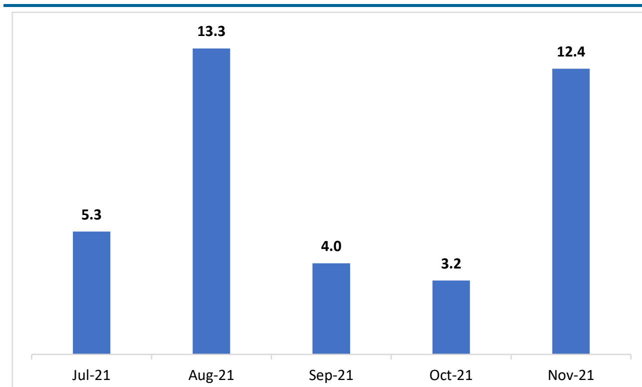
- The emergence of Omicron and renewed surges of COVID-19 infections in a number of countries has raised increased uncertainty around global economic prospects. A variant that significantly reduces vaccine efficacy could lead to further supply chain disruptions and contractions in labour supply pushing up inflationary pressures, while lower demand could have opposing effects. The sharp fall in oil prices following the discovery of Omicron and the rapid imposition of travel restrictions by countries is a sign of the volatility ahead.
- The rising energy and food prices have fuelled higher inflation in many countries. These global factors may continue to add to inflation in 2022, especially high commodity food prices.
- In sum, policymakers must carefully calibrate their response to incoming data. Varying inflation conditions and strength of recoveries across countries show why the policy response needs to be tailored to country specific circumstances, given sharply higher uncertainty associated with Omicron. Clear central bank communication, too, is key to fostering a durable global recovery.

UPI: Per Transaction Value (Rs)



Source: SBI Research

UPI IPO Remitter (Volume in lakh)



Source: SBI Research

Top 10 Major Countries with more than 20% weekly growth in Covid-19 cases

Country	Cases in the last 7 days	Cases in the preceding 7 days	Weekly % Change	Fully vaccinated population (%)
South Africa	83,170	19,292	331%	25.2%
China	586	187	213%	74.1%
Israel	3,814	2,355	62%	66.4%
USA	8,18,697	5,83,030	40%	58.5%
France	3,12,087	2,24,813	39%	69.8%
Spain	82,582	60,869	36%	73.2%
S. Korea	35,080	26,280	33%	80.7%
Norway	26,911	21,021	28%	70.5%
Italy	1,05,783	86,398	22%	73.2%
Denmark	35,180	29,400	20%	74.3%
Total 10	**15,03,890**	**10,53,645**	**43%**	**-**

Source: SBI Research

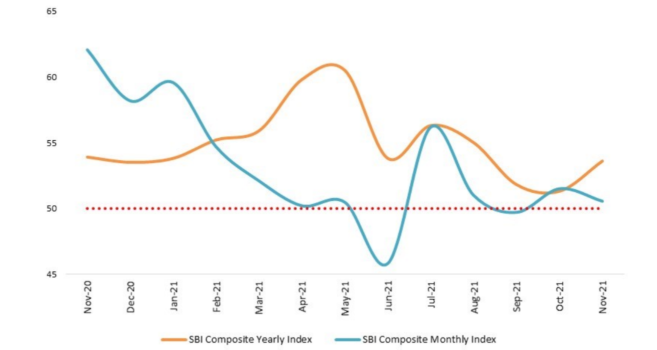
SBI MONTHLY INDEX DECLINES

- The yearly SBI Composite Index improved to 53.6 (Moderate Growth) in November 2021, from 51.3 (Low Growth) in October 2021, but the monthly index declined to 50.55 (Low Growth) in November 2021, compared to 51.5 (Low Growth) in October 2021. However, it is better to concentrate on Monthly Index because of a distorted base in the same period last year. The decline in Monthly index indicate normalisation after the festive jumps.
- Based on the SBI index, we believe IIP may grow 4.0-4.2% & IIP manufacturing by 3.5-3.8% in October, but may decline in November 2021.

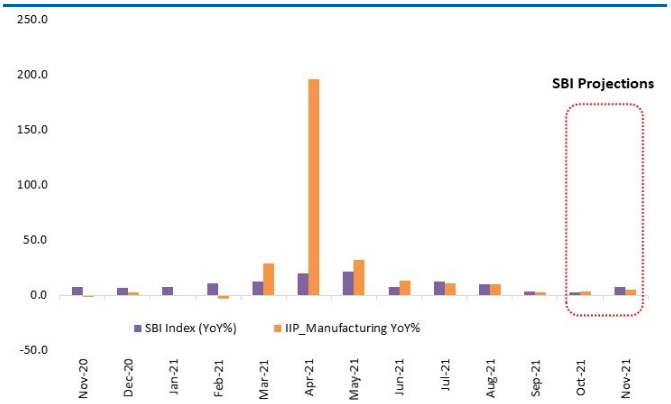
INFRA COULD DRIVE THE FUTURE CREDIT DEMAND

- ASCB reported a credit growth of around 7% (YoY) in the current year, as per the latest number published by Reserve Bank of India. Moreover, on YTD basis i.e. from March'21 level the same is below 2%, mainly driven by retail personal loan and Industry credit growth, as per the sectoral credit deployment data, is still in negative zone.
- However, what is encouraging to see that, since October the incremental growth is picking up and ASCB reported an incremental credit growth of Rs 1.18 lakh crore during 22nd Oct to 19th Nov'21 period. Sectors such as Power, Road, Electronics, Paper and Paper Products, Gems and Jewellery etc. reported recovering growth numbers.
- Commercial Paper (CP) issuances also increased by 157% (MoM) in November'2021 to Rs 2.88 lakh crore, highest in recent time, as NBFC issued whopping CP worth Rs 1.90 lakh crore.
- Further, we can see Infrastructure sector including Power, Airport, Road etc. along with others such as Electronics, NBFC, Chemicals including fertiliser might drive the credit demand in coming quarters.

SBI Yearly and Monthly Composite Index Trend



SBI Index (YoY) vs IIP Manufacturing (YoY%)



Source: SBI Research

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