SBI RESEARCH
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EXPECT REPO HIKES IN JUNE AND AUGUST TOO: 75 BPS RATE HIKE IN FY23 LOOKS IMMINENT

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The off-cycle meet of MPC announcing hike in benchmark Repo rate by 40 bps and another 50 bps hike in CRR kept the broader markets on the tenterhooks, as the realization of siding with changing realms of inflation control gained currency, already palpable for sometime as economies from developed as well as emerging worlds have struggled to rein in the galloping price rises that hurt the masses, and probably classes alike. With today's increase, the standing deposit facility (SDF) rate now stands adjusted to 4.15% and the marginal standing facility (MSF) rate and the Bank Rate to 4.65%, maintaining the LAF corridor. The MPC also decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth, reflecting the pragmatic approach even while traversing the chequered path assiduously. That asserts the flexibility in RBI's approach to choose the most suitable tool in addressing the most persisting issue, through a combination of tools, conventional to unconventional, or both!

The sinking realization that inflationary concerns were non-transitory has made almost all the central banks to take hurried measures in chalking a different pathway, one more tilted towards pausing the accommodative stance while sucking the gushing liquidity unleashed during pandemic. US Fed has taken one of the most aggressive stance as it has taken departure from bond purchases while announcing steep hikes to rein in spiraling prices, the most seen in last four decades. EU countries are steadfastly gearing in to step up the throttle while emerging economies like Brazil and Russia (war and sanctions already blowing air out of its system) embracing key rates in double digits indicating its an all wager war for most of the nations, with elevated energy and commodity prices expected to remain in upper echelons for more time than earlier anticipated.

With the current hike of 40 bps in repo rate to 4.40% it seems the rate cycle has made a U-turn (from the steep cuts seen in early 2020) and RBI would continue to increase the rates going forward and may reach the pre-pandemic level of 5.15% by end March 2023. Further, the CRR hike by 50 bps will exert further upward pressure on interest rates while sucking system liquidity by additional Rs 87,000 crore. We believe this simultaneous policy announcement of adjusting both the rate and quantum of liquidity is a clever ploy and reinforces the credibility and reputation of central bank. The CRR hike could also open up space for OMO purchases by RBI.

The push to align retail and MSME loans with external benchmarks of late ensured a growing proportion of borrowers to side with EBLR linked loan whose share in advances have gone up to 39%. Banks, already having wafer thin margin in retail loans have little incentive in not passing, to a great extent, the present and future hikes to customers whose EMIs should undergo upward revision. With the rise in CRR and expected further hike in benchmark rates, there would be a marginal increase in MCLR due to negative carry. Further, if banks raise the deposits rates then the cost of funds (CoF) will increase and subsequently MCLR will increase too. **We believe the decision for rate hike will be ultimately good for the banking sector as the risk is getting re-priced properly. The situation is different than during the global financial crisis wherein the lending started increasing aggressively (FY05 onwards) much before the rate hike cycle began (Mar'2010 till Oct'2011). Currently, the rate hike cycle has begun and now the bank lending will increase factoring in the risk.**

System liquidity is still in surplus mode with net durable liquidity at Rs 7.2 lakh crore as on 02 May 2022. RBI is likely to absorb Rs 87,000 crore of liquidity from the market on durable basis through CRR hike announced today. **High Government borrowing has ruled out the possibility of OMO sale, thus CRR increase seemed as the possible non disruptive option of absorbing the durable liquidity. We believe this opens up space for RBI to conduct liquidity management in future through OMO purchase to address duration supply while absorbing some part of the durable liquidity.**

A historical decomposition of CPI inflation to ascertain the various macro-factors that drove inflation dynamics, indicate that the inflationary pressures can be attributed mainly to adverse cost-push factors, coming from supply-side shocks in food and fuel prices, even as weak aggregate demand conditions continued to exert downward pressure on inflation.

Measures to ameliorate supply-side cost pressures would be thus critical at this juncture, especially in terms of a calibrated reduction of taxes on petrol and diesel. This would help anchor inflation expectations, prevent build-up of a wage-price nexus and provide space for monetary policy to sustain support for the still incomplete growth recovery. On the policy side, it would mean that even after rate hikes, inflation may continue to remain high for some time.

In advanced economies such as the US, labour market continued to tighten, with wages rising 4.5% in 2021 even though the labour force participation rate remained below pre-pandemic levels. Building wage pressures mirrored in the multi-decadal high annual wage growth are fuelling broad-based price pressures across all advanced economies. In contrast, in India nominal rural wages for both agricultural and non-agricultural labourers picked up during H2 FY22, with easing of restrictions lockdowns imposed by states and restoration in economic activity. However, the wage growth remained soft. The weighted contribution of wage growth in CPI build-up remains modest. Thus even after rate hikes, inflation will take time to moderate.

REPO RATE HIKED BY 40 BPS

- In an off-cycle meeting, RBI's Monetary Policy Committee (MPC) unanimously increased the Repo rate by 40 bps to 4.40% with immediate effect. The standing deposit facility (SDF) rate stands adjusted to 4.15% and the marginal standing facility (MSF) rate and the Bank Rate to 4.65%. The MPC also decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.
- Including RBI's today's decision, 21 countries have increased interest rates so far in Apr and May this year. Of these 21 countries, 14 countries hiked rates more than, or equal to 50 bps. Markets are also expecting a 50 bps rate hike by US Fed in its meet concluding today - its biggest hike since 2000. Moreover, it could also be the first time in 16 years that the US Fed will hike borrowing costs at two consecutive meetings.
- RBI has further stressed that monetary policy remains accommodative and will be focused on a careful and calibrated withdrawal of pandemic-related extraordinary accommodation, keeping in mind the inflation-growth dynamics. This indicate that by the end of Mar-23, Repo rate may reach the level of 5.15%.

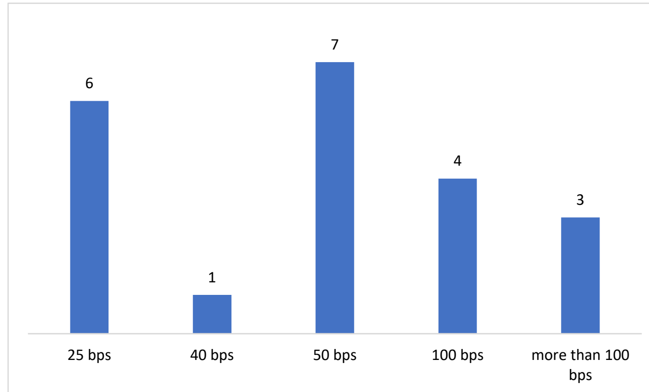
CRR HIKED BY 50 BPS

- In keeping with the stance of withdrawal of accommodation and in line with the earlier announcement of gradual withdrawal of liquidity over a multi-year time frame, RBI has also decided to increase the cash reserve ratio (CRR) by 50 basis points to 4.5% of net demand and time liabilities (NDTL), effective from the fortnight beginning May 21, 2022. The withdrawal of liquidity through this increase in the CRR would be of the order of ₹87,000 crore.

IMPACT ON INTEREST RATES

- During the pandemic, RBI had reduced the policy repo rate by 115 bps in 2-instances (first 75 bps in March 2020 and thereafter 40 bps in May 2020) and it has been kept unchanged since then. With the current hike of 40 bps in repo rate to 4.40% it seems the rate cycle has made a U-turn and RBI will continue to increase the rates and may reach the pre-pandemic level of 5.15% by end Mar'23. Further, the CRR hike will exert further upward pressure on interest rates.

Quantum of Rate hike by countries in Apr/May



Source: SBI Research

Outstanding Floating Rate Rupee Loans of SCBs across Interest Rate Benchmarks (Per cent to total)

	Mar-20	Mar-21	Jun-21	Dec-21
Base Rate Regime	10.2	6.4	6.5	5.3
MCLR Regime	77.7	62.8	60.3	53.1
External Benchmark Regime	9.3	28.6	32.2	39.2
Others	1.7	1.5	0.5	1.9

Source: RBI

- As retail loans are benchmarked to an external rate (mostly to RBI's repo rate) with quarterly reset clause so the loans benchmarked to repo rate may increase directly in the range of 30-40 bps, as banks don't keep a wider spread in retail loans to remain competitive in the market.
- As of Dec'2021, around 39.2% of the loans are benchmarked to external benchmarks, so the increase in repo rate will eventually increase interest cost on consumers and may impact from the next quarter onwards.
- Though, the share of MCLR linked loans have declined over a period but still have a major share at around 53%. With the rise in CRR and expected hike in benchmark rates, there would be a marginal increase in MCLR due to negative carry. Further, if banks raise the deposits rates then the cost of funds (COF) will increase and subsequently MCLR will increase.

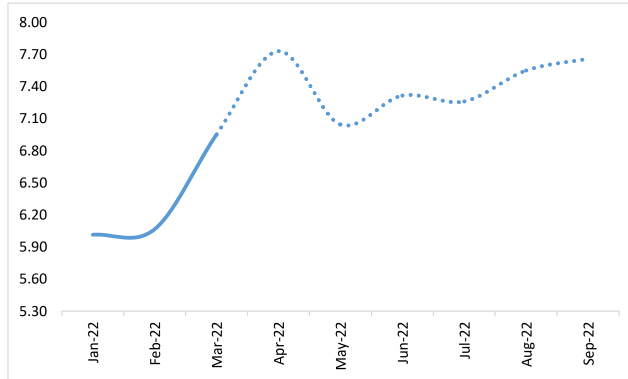
RECENT TRAJECTORY OF CPI INFLATION

- Russia-Ukraine conflict has significantly impacted the trajectory of inflation. The latest March'22 inflation print shows wheat, protein items (chicken in particular), milk, refined oil, potato, chillies, kerosene, firewood, Gold and LPG contributing to overall inflation in a substantive manner. The conflict has pushed up prices of chicken abruptly as chicken feed imports from Ukraine are getting disrupted. The pressure on sunflower oil supplies from Ukraine has led to change in export policy from Indonesia, thereby leading to lower palm oil imports. Further the war has exacerbated crop loss concerns in South America which in turn has impacted soybean oil supplies.
- A historical decomposition of CPI inflation to ascertain the various macro-factors that drove inflation dynamics, indicate that the inflationary pressures can be attributed mainly to adverse cost-push factors, coming from supply-side shocks in food and fuel prices, even as weak aggregate demand conditions continued to exert downward pressure on inflation.
- Persistence in CPI was driven by inflation in food prices. The contribution of semi-perishable goods edged up till October but declined thereafter. Durable goods inflation has transmitted heightened cost-push pressures in the manufacturing sector.

INFLATION-WAGE SPIRAL

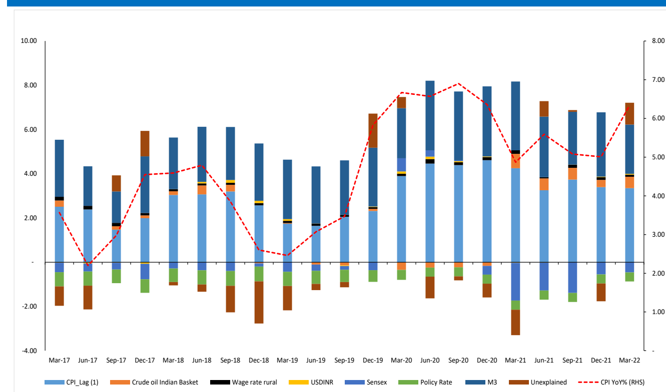
- In advance economies such as the US, labour market continued to tighten, with wages rising 4.5% in 2021 even though the labour force participation rate remained below pre-pandemic levels. Building wage pressures mirrored in the multi-decadal high annual wage growth are fuelling broad-based price pressures across all advanced economies.
- The International Monetary Fund (IMF) has revised down its forecast of global output growth for 2022 by 0.8 percentage point to 3.6 per cent, in a span of less than three months. The World Trade Organization has scaled down projection of world trade growth for 2022 by 1.7 percentage points to 3%. It is expected that Federal Reserve will embark on one of the most aggressive rate hikes to combat inflation.
- In Indian context, rural wages had increased sharply during May-June 2020 reflecting labour shortages during the nationwide lockdown period and the hike in wages by ₹20 under the MGNREGA scheme effective April 1, 2020.

CPI Inflation Trajectory



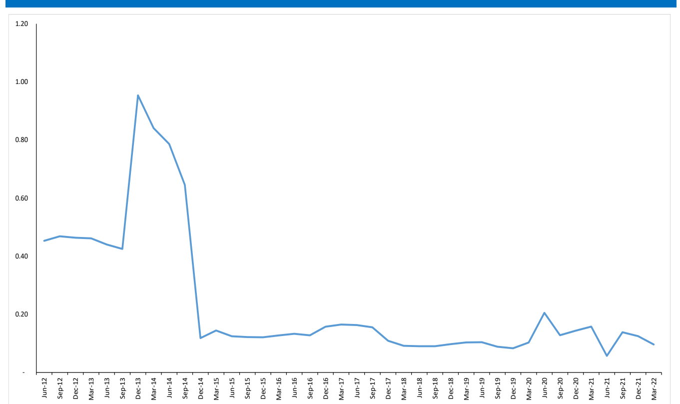
Source: SBI Research

Historical Decomposition of CPI Inflation



Source: SBI Research

Weighted Contribution of rural wage in CPI Inflation



Source: SBI Research

- Nominal rural wages for both agricultural and non-agricultural labourers picked up during H2 FY22, with easing of restrictions/lockdowns imposed by states and restoration in economic activity. However, the wage growth remained soft. The weighted contribution of wage growth in CPI build-up thus remains modest.

OUR RECOMMENDATIONS

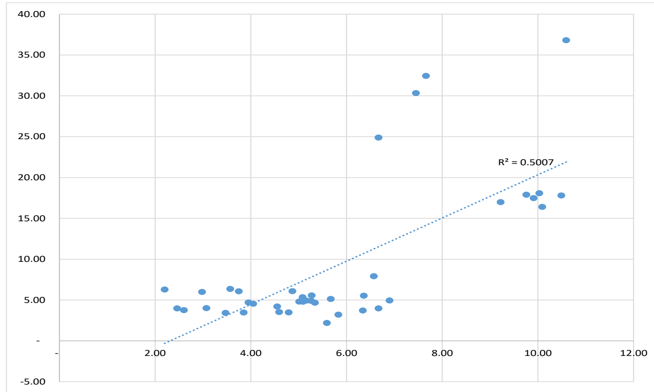
- Measures to ameliorate supply-side cost pressures would be critical at this juncture, especially in terms of a calibrated reduction of taxes on petrol and diesel. This would help anchor inflation expectations, prevent build-up of a wage-price nexus and provide space for monetary policy to sustain support for the still incomplete growth recovery. On the policy side, it would mean that even after rate hikes, inflation may continue to remain high for some time.

LIQUIDITY MANAGEMENT BY RBI

Through CRR hike RBI explored the advantages of liquidity management through both quantum & rate channels.

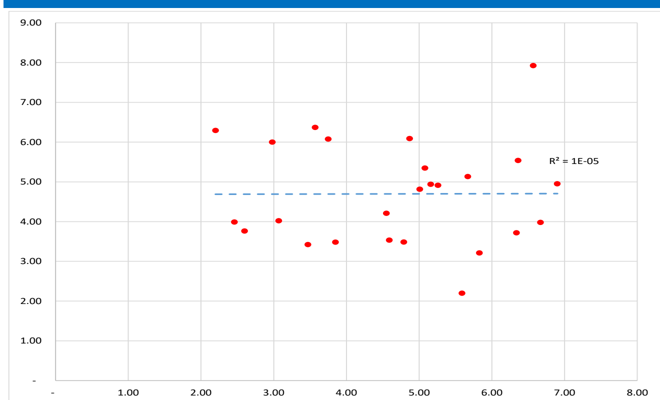
- **Quantum Channel:** Liquidity conditions of central banks have been assessed by partitioning bank balances with the central bank in terms of their balance sheet flows emanating from "discretionary" policy operations and other "autonomous" factors. Autonomous liquidity (AL) is the sum of primary liquidity available to banks stemming from regular central banking functions as the currency authority and banker to banks and the government. In a stylized central bank balance sheet, AL could comprise the claims on the government (A1) and the rest of the world (A3) netted for leakages from the banking system, such as currency (L1) and net other liabilities (L3), that is: AL = A1 + A3 − L1 − L3
- AL is the summary measure of the primary liquidity that flows to the banking system. On the other hand, discretionary liquidity (DL), the balance primary money flows to the banking system, arising out of the central bank's money market operations.
- If the central bank decides to maintain the existing liquidity conditions (interest rates), it could offset net liquidity (NL) with DL. Intuitively, if DL does not fully offset NL, then ceteris paribus, interest rates change to clear the market for bank reserves. The realised liquidity in the market for bank reserves is, ex post, simply the balances banks maintain with the central bank.
- **Rate Channel:** In addition to the quantum of liquidity, short-term interest rates also react speedily to changes in the price of DL— the price at which liquidity is made available from the central bank to the market—such as changes in the central bank policy rate. Thus, while changes in the policy rate have an instantaneous (direct) "announcement effect" on the market interest rate, they also have an indirect effect on the cost of liquidity within the banking system.

CPI Inflation- Rural Wage Correlation (2012-2022)



Source: SBI Research

CPI Inflation- Rural Wage Correlation (2016-2022)



Source: SBI Research

- As such, the "announcement effect" gets reinforced by the "liquidity effect" of policy changes

(Source: Comparative Statics of Central Bank Liquidity Management: Some Insights, Indranil Bhattacharyya and Satyananda Sahoo, May 2011)

CRR HIKE OPENS UP SPACE FOR OMO PURCHASE BY RBI

- System liquidity is still in surplus mode with net durable liquidity at Rs 7.2 lakh crore as on 2 May 2022. RBI is likely to absorb Rs 87,000 crore of liquidity from the market on durable basis through CRR hike announced today. High Government borrowing ruled out the possibility of OMO sale, thus CRR increase seemed as the possible non disruptive option of absorbing the durable liquidity.
- We believe this opens up space for RBI to conduct liquidity management in future through OMO purchase to address duration supply while absorbing some part of the durable liquidity.

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