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OF RATE HIKES, RUPEE AND INFLATION: THE DILEMMA OF RBI : TERMINAL RATE LOOKS CLOSER TO >=5.75%, WITH AN OCTOBER RATE HIKE ALSO LOOKING IMMINENT

Few periods in history could rival the present deciduous state of global economy and the baffling melodrama unfolding at heightened frequency before the regulators where, within the broader mandate(s) entrusted have to wage battles on many fronts while pitching constantly for a war fuelled centred around malignant inflationary patterns that both the erudite minds and economic models somehow missed to read in pre-war days. War, and the hardening rate cycle initiated by Fed in its scheduled mid-March meet as an aftermath of supply side shocks became evident for crucial commodities and energy security with a pass through to other essential items buried the term transitory. The Ukraine Russia conflict seems the tipping point to finally acknowledge that ultra-loose monetary policy globally were creating a doppelganger across asset classes, while fuelling unsatiable demands from job markets that seemed on a high in select countries. The dilemma before the Central Banks globally as they shift stance to rein-in masquerading prices (while keeping a squinted focus on growth and jobs stabilisation) lays bare the Gordian knot that two years of pandemic piled, impacting the rich and the underprivileged alike, albeit with varying severity.

Against this background, RBI today raised the rate by 50 basis points to take it to pre-pandemic levels at 5.40%, as the MPC seeks to bring inflation closer to the mid point of 4%. RBI retained CPI inflation projection for FY23 at 6.7%. In June policy statement, RBI Governor mentioned that inflation projection of 6.7% for FY23 does not take into account the impact of monetary policy actions taken today (i.e. 50 bps hike). Thus this rate hike indicates three possibilities: (a) The last 50 bps hike did not have any material impact on the inflation trajectory as of now and will impact inflation in the longer horizon, (b) RBI does not want to put a lower inflation forecast at this time as it wants to remain ahead of the curve in an uncertain global environment of currencies and inflation, and (c) Today's 50 bps hike is an indication that RBI is more concerned about rupee and external situation, i.e. using interest rate as an defence to protect the rupee.

Even though the RBI may have frontloaded the rate hikes, it remains to be seen how it influences the trajectory of rupee over the medium term. While the rupee did witness a smart recovery after the policy announcement, it was unable to hold onto the gains. Research suggests that countries with low prior FX reserves are more likely to choose an interest rate defence than countries with high reserves. This is probability not the case for India (FX reserves: $572 billion). Further, defending the currency through interest rates could also indicate the market participants getting into a self-fulfilling prophecy of expecting more rate hikes to automatically protect the domestic currency whenever it is under pressure. However, in a situation when current account deficit is likely to cross 3.5%, raising the rates might be the best carry trade bet to finance the large CAD.

RBI retained real GDP growth projection for FY23 at 7.2%. However, 39.2% of the loans are benchmarked to external benchmarks (EBR), so the increase in repo rate of 140 bps will eventually increase interest cost on consumers ~ Rs 42,500 crore on Retail & MSME. **This may have an impact on growth. Rural demand has also been impacted going by the results of FMCG companies.**

Meanwhile, central banks around the world are refraining from giving any forward guidance. For example, Fed Chair Powell did not provide any material forward guidance in its July meeting but signalled for a data-dependent decision going forward. Moreover, the ECB clearly stated it will operate month-by-month, meeting-by-meeting on the basis of data and adjust and calibrate accordingly. Elsewhere, policymakers from Australia to Switzerland to Sweden execute startling U-turns on policy signals they had sent only weeks earlier. In the current period of extreme market volatility central banks across the world are bidding goodbye to the forward guidance as it has become a threat to their credibility.

In India, the RBI has reiterated its commitment to bring inflation down hinting at future rate hikes without giving the exact amount of rate hikes. However, the word count analysis of Governor's Statement indicates how rupee is getting featured more often along with inflation and growth.

RBI's measures on bringing CICs under the ambit of Ombudsman scheme and Standalone Primary Dealers/BBPS should enhance the latitude as well as longitude of relevant segments.

RBI would strive to keep yield threshold at 7.5%.

RBI RAISES RATE BY 50 BPS

- RBI today raised the rate by 50 basis points to take it to pre-pandemic levels at 5.40%, as the MPC seeks to bring down inflation to its comfort band and in line with policy tightening by key central banks. The SDF now stands adjusted to 5.15%.
- RBI retained CPI inflation projection for FY23 at 6.7%. In June policy RBI Governor mentioned that inflation projection of 6.7% for FY23 does not take into account the impact of monetary policy actions taken today (i.e. 50 bps hike). Now this indicates three possibilities: (a) The last 50 bps hike doesn't have any material impact on the inflation trajectory as of now and will impact inflation in the longer horizon, (b) RBI does not want to put a lower inflation forecast at this time as it wants to remain ahead of the curve in an uncertain global environment of currencies and inflation, and (c) Today's 50 bps hike is an indication that RBI is more concerned about rupee and external situation, i.e. interest rate defence.
- RBI retained real GDP growth projection for FY23 at 7.2% owing to increasing demand for contact-intensive services, improvement in business and consumer sentiment, government's capex push, improving bank credit and rising capacity utilisation. However, there are some risks to the growth also, viz., protracted geopolitical tensions, the upsurge in global financial market volatility and tightening in global financial conditions.

INTEREST RATE DEFENSE

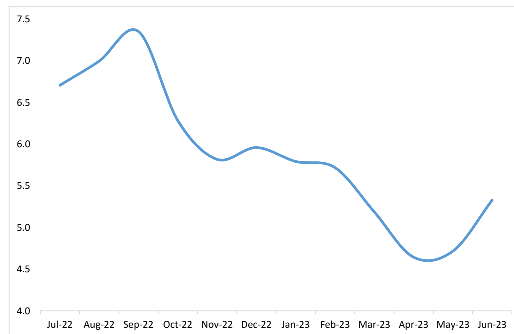
- In the light of recent currency depreciation, two key policy questions are how to defend a currency and what are the effects of different avenues of defense. A commonly used defense is to raise short-term interest rates sharply to deter speculation. Interest rate defense has had both successes and failures.
- Textbook models indicate that with imperfect capital mobility high domestic currency interest rates are a tool to attract foreign capital and strengthen the domestic currency. From a more micro perspective, high interest rates deter speculation by increasing the cost of speculation. Today's rate hike indicates that RBI's raised rates in order to protect the rupee. But how effective this hike will be is a matter of time. Research suggests that countries with low prior FX reserves are more likely to choose an interest rate defense than countries with high reserves. This is probability not the case for India (FX reserves: $572 billion).

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q1 FY23	Q2 FY23	Q3 FY23	Q4 FY23	FY23	Q1 FY24
Aug'22	7.3*	7.1	6.4	5.8	6.7	5.0
Jun'22	7.5	7.4	6.2	5.8	6.7	
Apr'22	6.3	5.8	5.4	5.1	5.7	
Real GDP Growth (%)	**Q1 FY23**	**Q2 FY23**	**Q3 FY23**	**Q4 FY23**	**FY23**	**Q1 FY24**
Aug'22	16.2	6.2	4.1	4.0	7.2	6.7
Jun'22	16.2	6.2	4.1	4.0	7.2	
Apr'22	16.2	6.2	4.1	4.0	7.2	

Source: RBI, SBI Research; *actual

Inflation trajectory (%) - SBI Projections



Source: SBI Research

- Further, RBI need not defend the currency through interest rates as market is getting into a self-fulfilling prophecy of expecting more rate hikes to automatically protect the rupee if the need arises.

FORWARD GUIDANCE

- The US Fed and the ECB rate hike decision are based entirely on inflationary trajectory. Neither says anything about the currency/or exchange rate movements guiding their behaviour. In fact, the recent policy decisions of the two show that they have moved away from forward guidance completely in these volatile times.
- Fed Chair Powell did not provide any material forward guidance in its July meeting but signalled for a data-dependent decision going forward .
- Even the ECB raised the rate by 50 bps (more than what it had flagged in June when setting out its policy-tightening plans). Moreover, the ECB clearly stated it will operate month-by-month, meeting-by-meeting on the basis of data and adjust and calibrate accordingly. Elsewhere, policymakers from Australia to Switzerland to Sweden execute startling U-turns on policy signals they had sent only weeks earlier.

- The theory behind forward guidance is that by signalling the central bank's intentions, and explaining their view of the economy, central bankers can guide long-term interest rates and other market decisions. Clear statements about the future path of short-term rates and policies such as bond purchases can direct longer-term rates, the argument goes. Giving notice of future policy is also supposed to reduce market turbulence. However, in the current period of extreme market volatility central banks across the world are bidding goodbye to the forward guidance as it has become a threat to their credibility.
- In India the RBI has reiterated its commitment to bring inflation down hinting at future rate hikes without giving the exact amount of rate hikes. However, the word count analysis of Governor's Statement indicates how rupee is getting featured more often along with inflation and growth.

Word Count Analysis: Governor's Statement			
	Rupee	Inflation	Growth
Aug'22	5	23	14
Jun'22	1	37	12
May'22	0	32	20
Source: SBI Research			

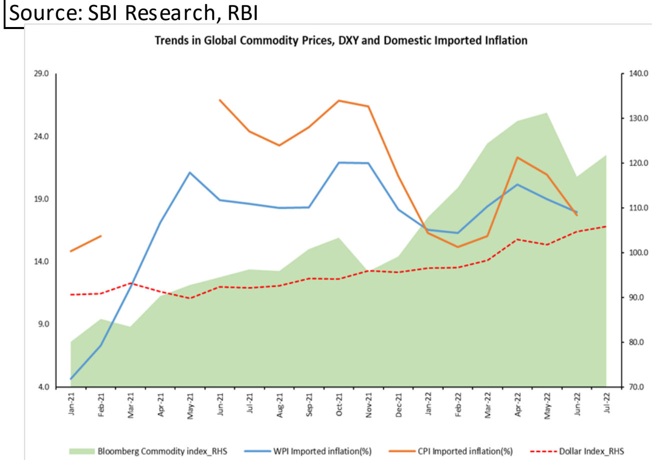
LIQUIDITY SITUATION

- System liquidity has been in the surplus mode this fiscal. However, RBI has been actively managing the same. Liquidity as indicated by Net LAF operations was an average of Rs 6.4 lakh crore during 1 Apr'22 till 4th May'22 when the RBI started raising the rates. Liquidity kept on declining since then reaching an average of Rs 4.0 lakh crore till the next MPC meeting on 8th Jun'22.
- Interestingly, banks had to increasingly resort to MSF borrowing during 22-28 Jul'22 because of liquidity squeeze. However, after moving down to Rs 492 billion as on 27th Jul'22, net LAF absorption has again started increasing since then with the average now at Rs 1.5 lakh crore till 4 Jul'22, indicating that the liquidity situation has normalised.
- Government surplus cash balances which increased to Rs 4.7 lakh crore as on 27th Jul'22 have also moved down to Rs 3.3 lakh crore as on 4th Aug'22.

GLOBAL ECONOMY

- The prospects of global growth have moved south as mounting cost of supply side disruption, lagged impact of COVID-19 pandemic, continue to prevent full recovery.
- The outlook by IMF has been sharply scaled down and disinflationary monetary policy is expected to slow global growth rate further, with global output growing by just 2.9 percent.
- Global inflation has been revised up due to food and energy prices as well as lingering supply-demand imbalances and is anticipated to reach 6.6 percent in advanced economies and 9.5 percent in emerging market and developing economies this year—upward revisions of 0.9 and 0.8 percentage point, respectively accordingly to IMF.
- Going by the past precedence Fed will aggressively rise rates. The technical recession which triggered the recent bond rally will not sustain. Another rate hike in the range 50-75 bps is likely. In the short run the dollar will appreciate, and Federal Reserve will remain hawkish. There will be flight to safety and the FII flows will be driven by sentiments. The appreciation of the US dollar can feed into imported inflation pressures in India.
- Under the current situation interest rates will rise including in India. If the rate hike is aggressive in America and EU in subsequent cycles, then rate hike will reflect in India. Today's hike is already more than market expectation of some moderation. Under the evolving situation the repo rate will tend to be at 6% +/- 25 bps by end of FY23.

Average Liqiudity Trends in FY23 (Rs lakh crore)			
Date	Net LAF	Net Durable Liquidity	Outstanding Government Surplus Cash Balances (as on end date)
1 Apr'22-4 May'22	6.4	7.3	1.4
5 May'22-8 Jun'22	4.0	6.8	3.0
9 Jun'22-27 Jul'22	2.3	5.9	4.7
28 Jul'22-4 Aug'22	1.5	5.4	3.3
Source: SBI Research, RBI			



DEVELOPMENTAL AND REGULATORY MEASURES

- **Inclusion of Credit Information Companies (CICs) under the RBI - Integrated Ombudsman Scheme (RB-IOS) & Internal Ombudsman (IO) Mechanism:** In order to strengthen the internal grievance redress, RBI has decided to bring CICs under the ambit of RB-IOS 2021 and the Internal Ombudsman (IO) framework. This will provide a cost free alternate redress mechanism to customers of Regulated Entities (REs) such as banks & FIs, for grievances against CICs.
- Recently, RBI has modified the CICs guidelines with an objective to more entities can tap into info with CICs. This comes at a time when digital lending, including lending through online platforms and mobile apps, and neo-banks are gaining ground.
- Currently, there are four CICs, namely (CIBIL), Equifax Credit Information Services Pvt Ltd, Experian Credit Information Company of India Pvt Ltd and CRIF High Mark Credit Information Services Pvt Ltd. These companies are governed by the Credit Information Companies (Regulation) Act (CICRA) in 2005.
- **Enabling Bharat Bill Payment System (BBPS) to Process Cross-Border Inbound Bill Payments:** To facilitate NRIs undertake utility, education and other bill payments on behalf of their families in India, it is proposed to enable BBPS to accept cross-border inward payments. This will also benefit payment of bills of any biller onboarded on the BBPS platform in an interoperable manner.
- **Standalone Primary Dealers (SPDs):** SPDs are now permitted to offer all foreign exchange market-making facilities as currently permitted to Category-I Authorised Dealers, subject to prudential guidelines. This measure will provide customers with a wider set of market makers to manage their foreign currency risk. This will also increase the breadth of the forex market in India.
- Furthermore, SPDs can now undertake transactions in the offshore Rupee Overnight Indexed Swap (OIS) market with non-residents and other market makers. This along with similar measure taken for banks in Feb'22 will strengthen the objective of removing the segmentation between onshore and offshore OIS markets and improving price discovery.
- **Committee on MIBOR Benchmark:** Along the lines of moving to alternate benchmarking rates globally, RBI has proposed a committee to examine the need for transitioning to an alternate to MIBOR.
- Lastly, RBI has also proposed to issue master direction on managing risks and code of conduct in outsourcing of Financial Services in order to facilitate the updation of current guidelines, adoption and incorporation of global practices and enabling all instructions at one place for Regulatory Entities (REs).

FRONTLOADING TRANSMISSION

- 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. However, with the rise in inflation and other factors, RBI has reversed the interest rate cycle and raised 140 bps in repo rate to 5.40% (40+50+50 bps) and crossed the pre-pandemic level of 5.15%.
- 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 will directly increase the retail loans rate and impact consumers.
- As of Dec'2021, around 39.2% of the loans are benchmarked to external benchmarks (EBR), so the increase in repo rate of 140 bps will eventually increase interest cost on consumers ~ Rs 42,500 crore on Retail & MSME consumers (1 bps increase in repo will have combined impact of ~ Rs 305 crore on Consumers – MCLR Loans: Rs 65 crore and MCLR: Rs 240 crore) and demand is likely to be impacted.

Transmission of Policy Rate

	Mar-22	Latest	Change (in bps)
Repo Rate	4.00	5.40*	140
Wt Avg. Lending Rate (WALR) on O/S Rupee Loans	8.74	8.93	19
WALR on Fresh Rupee Loans	7.63	7.94	31
Wt Avg. Domestic Term Deposits (WADTDR) on O/S Deposits	5.03	5.13	10
ASCB-MCLR (1 Year)	7.25	7.55	30

Source: RBI, SBI Research *increased 50 bps today

Q3 EARLY TREND—VALUE DRIVEN DEMAND IN FMCG, VOLUME CONTINUE TO DECLINE MORE IN RURAL

- In Q3FY23, early results from around 1000 listed entities reported 6% growth in top line while EBIDTA declined by 2% on sequential basis. However, on YoY top line grew by 43% while PAT grew by 29% led by Bank, Auto, Fertilizers, Chemicals, FMCG etc.
- FMCG sector, as reported by 25 listed entities, reported 14% growth in net sales and 8% in EBIDTA on a sequential basis. Further, on a YoY basis FMCG sector reported top line growth of 25% mainly on account of value and not in volume term.
- FMCG Sector continued to witness tepid demand as rising retail inflation exerted pressure on share of wallet for FMCG. It is natural for consumers, in such inflationary scenarios, to feel the pinch of increased pressure on their wallets and they adjust volumes and prioritize essentials over discretionary to manage the household finance.
- HUL also reported YoY growth in domestic revenue of 19% led by price while volumes continue to decline, more in rural areas. In last three months, HUL has reported volume degrowth of 3% in urban and 7% in rural. However, Dabur reported that both rural and urban demand growth have been at par and reported 5% growth in volume.

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Contact Details:
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in,
gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya