SBI RESEARCH

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PEAK REPO RATE SEEN AT 5.5-5.75%, ABOVE PRE-PANDEMIC LEVEL BY AUGUST: MSP HIKE FOR KHARIF CROPS TO INCREASE INFLATION BY 15-20 BPS

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As widely expected, RBI's Monetary Policy Committee unanimously decided to increase policy Repo rate by 50 bps to 4.90% while also remaining focused on 'withdrawal of accommodation' to ensure that inflation remains within the target going forward, all the while supporting growth. RBI has retained its real GDP growth forecast for FY23 at 7.2% with risks broadly balanced. However, inflation projection for FY23 has been revised upwards by 100 bps to 6.7% on account of several factors including tense global geopolitical situation, elevated commodity prices, adverse global supply conditions and heightened crude oil prices. Average crude oil price (Indian basket) assumption is now taken at $105 per barrel from $100 per barrel. With recent average 6% MSP hike for the kharif crops, there will be an upside pressure of 15 to 20 bps on inflation.

In terms of liquidity, the RBI has done a smart job and currently net LAF has declined to Rs 3.2 trillion from Rs 5.54 trillion as on March end. Core liquidity has also declined to Rs 7.1 trillion from Rs 8.3 trillion, of which Government cash balances is at Rs 3.5 trillion. We believe as the Government starts to spend towards the later part of the year, this may necessitate a CRR hike more as a policy tool to support OMO operations at a later date when Government borrowing picks up pace.

The regulatory changes announced by the RBI have mainly focused on increasing credit to construction/housing sector and some announcements in payments systems and margin requirements for Non-centrally Cleared Derivative contracts. The increase in limit on individual housing loans by cooperative banks and permitting Rural Cooperative Banks to extend finance to 'commercial real estate – residential housing' within the existing aggregate housing finance limit of 5% of their total assets will provide the necessary push to credit flow to housing sector. Additionally, linking of RuPay credit cards (CC) to UPI is expected to provide more avenues and convenience to 1.50 crore customers in making payments through UPI platform.

Meanwhile, the Governor has also alluded to the proactive role that fiscal policy can also play in unison with monetary policy as a coordinated attempt to control inflation. This could be achieved with state cutting VAT on fuel as a policy option to anchor inflationary expectations. Interestingly, economic literature suggests that a monetary policy contraction accompanied with fiscal policy expansion is the ideal coordinated policy outcome with the maximum payoff.

The policy also highlighted the global uncertainty with countries grappling with multi-decadal high inflation and slowing growth, persisting geopolitical tensions and sanctions, elevated prices of crude oil and other commodities and lingering COVID-19 related supply chain bottlenecks. As per World Bank's latest assessment, global growth is expected to slump from 5.7 percent in 2021 to 2.9 percent in 2022— significantly lower than 4.1 percent that was anticipated in January. Russian invasion of Ukraine has magnified the slowdown in the global economy, which is entering what could become a protracted period of feeble growth and elevated inflation.

However, the good thing is that even as global uncertainties are in abundance, growth numbers continue to show optimism locally. Capacity utilization rates have now moved up to 74.5%, with new investment announcements at a record high of Rs 20 trillion in FY22 and manufacturing sector leading from the front. This will give more comfort to RBI in pushing through the rate hikes and controlling inflation as its primary and foremost option.

Against this background, we are now expecting that RBI could factor in a rate hike in August and even October policy also, and take it higher than pre-pandemic level by August to 5.25% and in October to 5.5%. Our peak rate at the end of the cycle now has now a lower bound of 5.5% and could go up to 5.75% depending on inflation trajectory. This is purely data dependent and subject to revisions.

However, we believe 10 year benchmark yields are likely to be capped at 7.5%, even assuming a 175 basis point spread over our peak repo rate at 5.75%. This is because, term premium is likely to be 50 basis points, factoring in a further market adjustment of 50 basis points over and above 5.75% as an insurance rate hike and an additional 75 basis points because of supply overhang. This makes the total spread of 175 basis points over 5.75%. Interestingly, the pre pandemic spread was around 135 basis points.

Finally, with EBLR linked loans gaining traction, repo rate increase will curtail inflation through the credit channel as well. As every 1 bps increase in repo has combined impact of ~ Rs 305 crore on demand from Retail & MSME Consumers, with terminal repo rate at 5.75% there will be reduction in demand from consumers to the tune of Rs 45,000 crore.

RBI HIKES REPO RATE BY 50 BPS

- As widely expected, RBI's Monetary Policy Committee has unanimously decided to increase policy Repo rate by 50 bps to 4.90% and decided to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. In May'22 in an off-cycle meeting RBI increased Repo rate by 40 bps. India is now in the club of countries which hiked interest rates in two consecutive meetings.
- SDF rate stands adjusted to 4.65% and the MSF rate and the Bank Rate to 5.15%.
- RBI has retained its real GDP growth forecast for FY23 at 7.2% with Q1 at 16.2%; Q2 at 6.2%; Q3 at 4.1%; and Q4 at 4.0%, with risks broadly balanced.
- Taking into account several factors (like tense global geopolitical situation, elevated commodity prices, adverse global supply conditions and crude oil prices) RBI has revised upwards its CPI inflation projection by 100 bps to 6.7% from 5.7% for FY23. Assuming average crude oil price (Indian basket) at $105 per barrel (from $100 per barrel) RBI projected CPI inflation for Q1 FY23 at 7.5% (earlier: 6.3%); Q2 at 7.4% (5.8%); Q3 at 6.2% (5.4%); and Q4 at 5.8% (5.1%).

DEVELOPMENTAL AND REGULATORY MEASURES

- **Individual Housing Loans by Cooperative Banks – Enhancement in Limits:** The housing loan portfolio is almost stagnant for UCBs in the last five years (hovering around Rs 25,000 crore) and its share in total advances is also declining (from 9.7% in FY17 to 8.1% in FY21). In order to give necessary fillip to this segment, RBI has enhanced the housing loan limits for UCBs and RCBs. The limits for Tier I /Tier II UCBs shall stand revised from ₹30 lakh/ ₹70 lakh to ₹60 lakh/ ₹140 lakh, respectively. As regards RCBs, the limits shall increase from ₹20 lakh to ₹50 lakh for RCBs with assessed net worth less than ₹100 crore; and from ₹30 lakh to ₹75 lakh for other RCBs.
- **Permitting Rural Co-operative Banks (RCBs) to lend to Commercial Real Estate - Residential Housing (CRE-RH) Sector:** In line with the dispensation available to scheduled commercial banks (SCBs) and UCBs, the RBI has also proposed to permit rural cooperative banks to extend finance to 'commercial real estate – residential housing' (i.e. loans for residential housing projects), within the existing aggregate housing finance limit of 5% of their total assets. This will bring level playing field in the co-operative banking universe.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q1 FY23	Q2 FY23	Q3 FY23	Q4 FY23	FY23
Jun'22	7.5	7.4	6.2	5.8	6.7
Apr'22	6.3	5.8	5.4	5.1	5.7
Feb'22	4.9	5.0	4.0	4.2	4.5
Real GDP Growth (%)	**Q1 FY23**	**Q2 FY23**	**Q3 FY23**	**Q4 FY23**	**FY23**
Jun'22	16.2	6.2	4.1	4	7.2
Apr'22	16.2	6.2	4.1	4	7.2
Feb'22	17.2	7.0	4.3	4.5	7.8

Source: RBI, SBI Research

Individual Housing Loans by Cooperative Banks – Enhancement in Limits

in Rs lakh		From	To
UCB	Tier I	30	60
	Tier II	70	140
RCB	Net worth < 100 crore	20	50
	All other	30	75

Source: RBI

Housing Loans by UCBs (Rs crore)

FY	Amount O/S	% YoY growth	Share in total advances
FY17	25,300	-	9.7
FY18	26,500	4.7	9.4
FY19	22,721	-14.3	7.5
FY20	25,359	11.6	8.3
FY21	25,211	-0.6	8.1

Source: RBI; SBI Research

- **Permitting Urban Cooperative Banks (UCBs) to Offer Doorstep banking:** Doorstep Banking Services in India was formally launched in Sep'20. At present, around 10 basic banking services are being offered by 12 PSBs under doorstep banking services with the assistance of two service providers in the selected 100 centres. Currently ~19 crore customers are availing doorstep banking services by PSBs in India. Now in order to attain harmonization of regulatory framework across all banks and to provide convenience of banking services to the customers at their doorstep, RBI allowed UCBs to extend doorstep banking services to their customers on par with scheduled commercial banks. There are 1534 UCBs in India and this step will provide benefit to millions of UCBs' customers.

- **Margin Requirements for Non-Centrally Cleared Derivatives (NCCDs):** One of the significant recommendations from G-20, post Financial crisis of 2008, stipulated that NCCDs should be subjected to higher capital requirements and also attract margin requirements since Counterparty credit risk remains a major source of systemic risk in the OTC (Over the Counter) derivative market. The practice of bilateral margining reduces contagion and spill over risks. Margin requirements on NCCDs should also help in the gradual promotion of Central Clearing since centrally cleared derivatives attract significantly lower capital charge. RBI's efforts to align with global practices in promulgating margin for Non Centrally Cleared foreign exchange / interest rate / credit derivative contracts should promote twin objectives of reduction of systemic risk / enhance central clearing.
- **Review of Payments Infrastructure Development Fund Scheme:** The Scheme had targeted 90 lakh PoS terminals and QR codes to be deployed over three years till end-2023. Beneficiaries of PM SVANidhi Scheme in Tier-1 and 2 centres were included in August 2021. As at end-April 2022, over 1.18 crore new touch points have been deployed under the Scheme. It is now proposed to make modifications to the PIDF Scheme by, inter-alia, enhancing the subsidy amount, simplifying the subsidy claim process, etc. This is expected to further accelerate and augment the deployment of payment acceptance infrastructure in the targeted geographies.
- **Enhancements to UPI – Linking of RuPay Credit Cards:** RBI has proposed to allow linking RuPay credit cards (CC) to UPI, which was a long demand from the banking industry. This move is expected to provide more avenues and convenience to the customers in making payments through UPI platform.
- Though, RuPay has a large share in the debit cards market, it lags in the credit card space. As per estimates, RuPay has only 20% share of India's CC market which is led by Visa, followed by MasterCard.
- If we look at the latest available data, India's PoS infrastructure is only 61 lakhs, while UPI QR code are 18.07 crore and 7.5 crore credit cards. If we assume 20% of CC are in RuPay, then around 1.5 crore credit card holders will benefit and able to use at 18 crore UPI QR code platforms. This will give further push to the digital banking and a less cash economy.
- As India's credit market is highly underpenetrated and expected to grow by 3x in the next few years and that means all players can get a fair share of the market based on their offerings. It is an open and competitive market and we have a view that with the CC linkage to UPI platform a push will be given to the credit card transactions market.
- **e-Mandates on Cards for Recurring Payments – Enhancement of Limit:** RBI has proposed to enhance the limit from ₹5,000 to ₹15,000 per recurring payments, this will increase customer convenience with added security.

Card Acceptance Infrastructure & Card Statistics: April 2022 (in lakh)	
PoS	61
Bharat QR Codes	41
UPI QR Codes	1807
Credit Cards	752
Source: SBI Research, RBI	

Credit Card (CC) Transactions (Volume in crore & Value in Rs lakh crore)						
Year	Credit Cards		PoS		e-comm & Others	
	Volume	Value	Volume	Value	Volume	Value
2020-21	176	6.30	87	2.81	90	3.50
2021-22	224	9.72	111	3.81	113	5.91
2022-23 (April)	22	1.05	12	0.40	11	0.66
Memo: Share of CC Transactions at PoS & e-com						
2020-21	100%	100%	49%	45%	51%	55%
2021-22	100%	100%	50%	39%	50%	61%
2022-23 (April)	100%	100%	52%	38%	48%	62%
Source: SBI Research, RBI						

GLOBAL ECONOMY

- Global economy continues to grapple with multi-decadal high inflation and slowing growth, persisting geopolitical tensions and sanctions, elevated prices of crude oil and other commodities and lingering COVID-19 related supply chain bottlenecks. As per World Bank's latest assessment, global growth is expected to slump from 5.7% in 2021 to 2.9% in 2022. Russian invasion of Ukraine has magnified the slowdown in the global economy, which is entering what could become a protracted period of feeble growth and elevated inflation.

- Growth in advanced economies is projected to sharply decelerate from 5.1 percent in 2021 to 2.6 percent in 2022 - 1.2 percentage point below projections in January. Among emerging market and developing economies, growth is also projected to fall from 6.6 percent in 2021 to 3.4 percent in 2022.
- Our in-house composite Global Uncertainty Index, from LME Metal Index, Baltic Dry Index, Semiconductor index, Fertilizer Price index, World container Index and Food Price Index, with base (100) as 24 Feb-2022) indicates a declining trend and stood at 91 in June 2022.

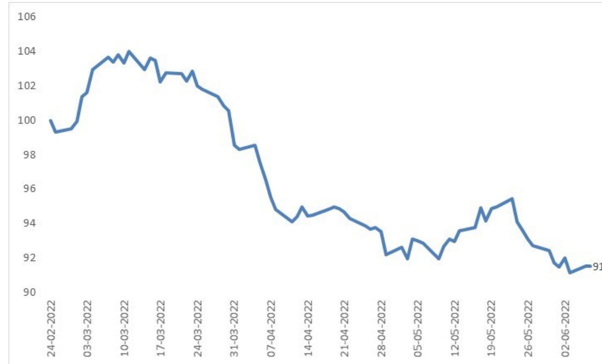
WAY FORWARD

- In the current scenario where the RBI is adopting the contractionary monetary policy to fight the sticky inflation, fiscal authorities must adopt expansionary policy. After the Centre has cut oil excise duty, the onus is on states to cut their VAT rates on oil which will help in easing inflation expectations.
- With the dropping of 'accommodative stance' and stress on 'withdrawal of accommodation' RBI has given clear forward guidance that withdrawal of liquidity will be the preferred option in combating inflation. With inflation now projected at 6.7% and crude oil prices average increased to $105/bbl from $100/bbl and existing further risks to inflation trajectory, we believe that RBI is likely to hike rate both in August and October policy taking the repo rate to 5.25% in August and 5.5% in October. Our peak rate at the end of the cycle now has a lower bound of 5.5% and could go up to 5.75% depending on inflation trajectory. This is purely data dependent and subject to revisions.
- However, we believe 10 year yields are likely to be capped at 7.5%, even assuming a 175 basis point spread over our peak repo rate at 5.75%. This is because, term premium is likely to be 50 basis points, factoring in a further market adjustment of 50 basis points over and above 5.75% as an insurance rate hike and an additional 75 basis points because of supply overhang. This makes the total spread of 175 basis points over 5.75%. Interestingly, the pre pandemic spread was around 135 basis points.

CAPACITY UTILIZATION (CU) NEARING 75%, INVESTMENT ACTIVITY EXPECTED TO STRENGTHEN FURTHER

- Capacity Utilization in the manufacturing sector further improved to 74.5% in Q4FY22 from 72.4% in Q3. Last quarter CU crossed the pre-pandemic levels of 69.9% in Q4FY20.

SBI's Global Uncertainty Index Declined



Source: RBI; SBI Research

- Investment activity is thus expected to strengthen, driven by rising capacity utilisation, government's capex push and deleveraged corporate balance sheets.
- Further, as suggested by new investment announcements in FY22, as per projects today, is all time high of around Rs 20 trillion. Private sector also announced, record investments of Rs 13.6 trillion in FY22, which is 2.5x the previous year.
- Major manufacturing sectors where new investment is seen includes Iron & Steel, Basic Chemicals, Electronics, Automobiles, Cement etc.

Capacity utilisation in Manufacturing sector

Source: RBI; SBI Research

New Investment Announcements in FY22 (major manufacturing sector)		
Sectors	Number of Projects	Amount Rs Crore
Iron & Steel	281	2,65,495
Basic Chemicals	1,336	2,11,533
Electronics	75	73,124
Mining	135	68,093
Automobiles & Auto Ancillaries	103	53,619
Plastic & Plastic Products	151	41,551
Cement & Asbestos	83	39,478
Non Ferrous Metals	23	23,019
Food Products	296	20,066
Textiles	115	14,486

Source: Projects Today; SBI Research

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