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ECOWRAP

OF CENTRAL BANKS AND RATE HIKES, THE PERCEPTION AND THE IMPENDING REALITY: RBI NOV 3 MEETING PURELY TO ADDRESS THE SHORTFALL IN MEETING THE INFLATION TARGET FOR 3 SUCCESSIVE QUARTERS

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The current unscheduled meeting on 3 Nov'22 under Section 45ZN of the RBI Act is only a part of the regulatory obligation and we do not foresee any other agenda to be announced at this meeting, even as it is scheduled a day after the Fed meet on 2nd Nov'22. Furthermore, looking at the past unscheduled meetings of MPC in Mar'20 and May'22, there were no press release of such meetings earlier and the announcement of rate decision was unscheduled in true sense. RBI in its Report on Currency & Finance (2020-21) has mentioned that in the case of India, failure may be redefined as inflation overshooting/ undershooting the upper or lower tolerance bands around the target **for four consecutive quarters** instead of current three quarters.

Meanwhile, global data contradictions are galore. US GDP growth came in stronger than expectations (on the back of a stronger oil exports), even as DXY has weakened against the market perception of a slower than anticipated rate hike by Fed post November. **A dovish ECB guidance, coupled with a dovish Bank of Canada rate hike confirms that such optimism of the markets may not be entirely unfounded.**

The most recent reading of the US Employment Cost Index showed a considerable slowdown in private-sector wage growth in the third quarter - it rose 1.2% compared to 1.6% in the second quarter indicating that the wage-price spiral is beginning to ease. Consumer spending, which accounts for more than two-thirds of US economic activity, showed growth slowing to a 1.4% rate from the second quarter's 2.0%. New orders for non-defence capital goods, viewed as a proxy for business spending, fell unexpectedly in September. All this conjures up **for a significantly lower probability of 75 bps hike for mid-December (65% probability), with the narrative for a 50 bps hike taking pole position now .**

Against this background, recent MPC minutes in India suggest some members looking for an early end to the rate hike cycle. The unseasonal rains in several parts of the country (in food grains producing states also) in October this year are affecting kharif crops significantly. In states like UP, the unseasonal rain was more than 400% above than the normal. In 2019, when unseasonal rains happened, average food prices more than doubled from 4.9% to 10.9% . Currently, the September food inflation is at 8.4% and a similar trend like the one seen in 2019 can put headline inflation towards 7.5% in December. **This could put a spanner to the inflation projections of RBI and market consensus. This could also mean that the terminal repo rate could still be difficult to comprehend at this time, though consensus puts it at 6.5%.**

Nevertheless, liquidity deficit in the banking system has been now consistently running at Rs 60,000 crore for the last 4 days. Banks have adjusted deposit rates significantly upwards in October**. If we look at the historical interest rate cycles, the increase in deposit rates lag the increase in lending rates. Also, given that 45% of bank deposits are CASA, it is only the 55% of term deposits that need adjustment and hence ideally, there will always be less than full adjustment of deposit rates to repo rates. In the current cycle, with a CASA ratio of 45%, a 190 basis point increase in repo rate could result in 105 basis point increase in deposit rate (190*55%). Any deposit rate increase beyond that will be an additional one. To put things in perspective, SBI has already raised its 1 year deposit rate by 100 basis points.**

The good news is that INR has continued its comparative resilience, strengthening on the back of recent fall in Dollar index. Even though the current Dollar descend could be a temporary phenomenon as markets love to side with somewhat illusory narratives before policy meets that inflation has peaked due to policy actions, the wild swings seen post select tech behemoths' results point to markets pricing in more the weaker forward guidance over the better than expected immediate results. Also, on ECB front, during the first five months in FY23, total ECB raised by corporates is a paltry $8.26 bn (against $11.23 bn in first five months during FY22 and $39.89 bn during the full year). **If better rated Corporates raise fresh ECB now, that should help the RBI in also doing Buy/Sell swaps, bringing down hedging cost while lowering the Forward Premia too! This will mean an improvement in capital flows that could have a positive bearing on exchange rate outlook.**

UNSCHEDULED RBI MEETING CALLED ON NOV 3 UNDER SECTION 45ZN OF RBI ACT AND REGULATION 7 OF MPC

- Under Section 45ZN of the RBI Act, when RBI fails to meet the inflation target for three consecutive quarters, it is required to set out in a report to the Central Government – (a) the reasons for failure to achieve the inflation target; (b) remedial actions proposed to be taken by the Bank; and (c) an estimate of the time-period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions.
- Also, in the event of failure of the RBI to meet the inflation target, in accordance with the Regulation 7 of the RBI MPC and Monetary Policy Process Regulations, 2016, a separate meeting is required to be scheduled by the Secretary to the Committee, as part of the normal policy process to discuss and draft the report to be sent to the Government. The Report is required to be sent to the Government within one month from the date on which the Bank failed to meet the inflation target. **As the Sep'22 inflation data was revealed on 12th Oct, the RBI has to submit the report to the Government before 12th Nov'22.**
- Thus, the unscheduled meeting on 3 Nov'22 recently announced is only a part of the regulatory obligation **and we do not believe any other agenda to be announced at this meeting, against the market expectation of a slim chance of rate hike as the meeting is scheduled a day after the Fed meets on 2nd Nov'22**. Furthermore, looking at the past unscheduled meetings of MPC in Mar'20 and May'22 there was no press release of such meetings earlier and the announcement of rate decision was unscheduled in true sense.
- RBI in its Report on Currency& Finance (2021) has mentioned that in the case of India, failure may be redefined as inflation overshooting/ undershooting the upper and lower tolerance bands around the target **for four consecutive quarters** instead of present three quarters.

GLOBAL ACCOUNTABILITY MECHANISMS

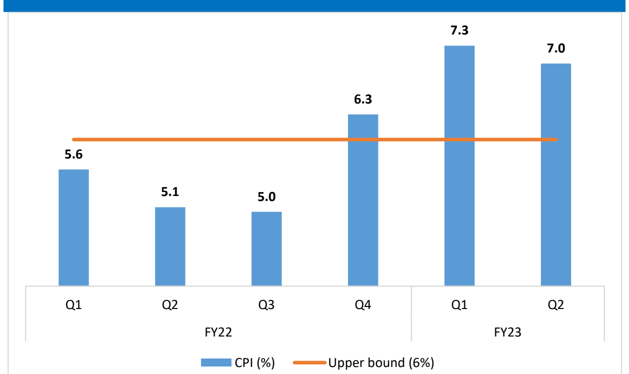
- Globally, as in the case of India, accountability mechanisms for monetary policy are usually enshrined in Central Bank Acts. They take the form of (a) 'parliamentary hearings' in a structured reporting to the Parliament on monetary policy; or (b) 'open letters' addressed by the Governor/Bank/MPC to the Government. *Open letters are more prevalent in central banks with MPC structures*. In addition to open letters, some central banks also have parliamentary hearings. In India, the RBI reports to the Central Government, therefore, the accountability for failure through a report to the Central Government is the appropriate procedure.

Definition of Failure in Central banks having Committee structure

Country	Range	Definition of Failure
Brazil	4 +/- 1.5%	Deviation of inflation from the upper and lower tolerance level
UK	2%	Deviation from inflation target by 1 percentage point in either direction
Iceland	2.5%	Deviation of 1.5% from target in either direction
Israel	1-3%	If inflation target is missed over more than six months
India	**4 +/- 2%**	**The average inflation is more (less) than the upper (lower) tolerance level for three consecutive quarters**
New Zealand	1-3%	Deviation of inflation from target range
Norway	2%	Deviation of inflation from target
South Africa	3-6%	Deviation of inflation from target rate
Thailand	1-3%	Average headline inflation in past 12 months or forecast of average inflation over the next 12 months exceeds the target range
Turkey	5 +/- 2%	Deviation of inflation from target range

Source: RBI; SBI Research

Quarterly CPI Inflation (% yoy, Average)



Source: SBI Research

Accountability Mechanism post target breach

Accountability Measures	# of Countries	Country
Parliament hearing	9	Australia, Canada, Chile, Czech, Hungary, Peru, Sweden, Israel, South Africa
Open letter and Parliament hearing	9	Indonesia, Philippines, South Korea, Brazil, UK, New Zealand, Norway, Thailand, Turkey
Report to Central Government	1	India
Open letter and Public report to the Government and Parliament hearing	1	Iceland

Source: RBI; SBI Research; Countries in red font denote central banks having Committee structure

UNSEASONAL RAINS: THREAT FOR INFLATION?

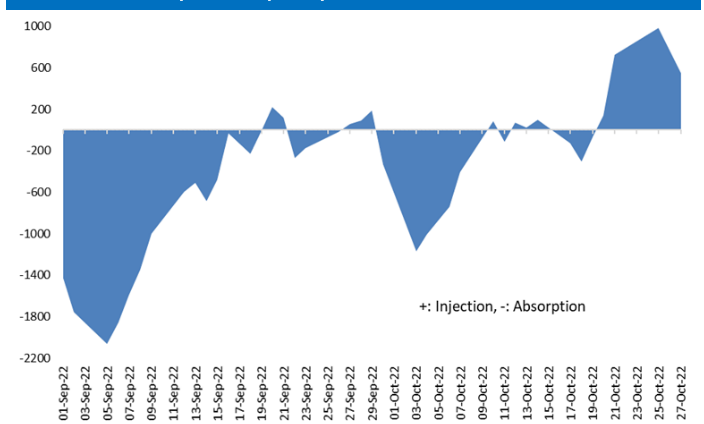
- The unseasonal rains in several parts of the country (in foodgrain producing states also) in October this year are affecting kharif crops significantly. In states like UP, the unseasonal rain was more than 400% above than the normal. Overall, India has received a staggering 54% above normal rains in Oct so far.
- We believe that along with grains, the prices of vegetables, milk, pulses and edible oils, which account for over a quarter of the overall CPI, are rising and likely to remain high in coming months. During 2019, when India's October rainfall was 44% above normal, the 3 months average food CPI was whopping 10.9% as against 4.9% in the preceding 3 months. This indicates that unseasonal rains may have a large negative impact on food inflation in coming months.

SYSTEM LIQUIDITY & INTEREST RATE SITUATION

- The system surplus liquidity has moderated in September, coupled with advance tax outflows, and continued increase in credit off-take. However, with the increase in government spending in beginning of October, the situation has improved for few days but again turned into deficit mode. If we look at the daily liquidity operations in October 2022, on all but 8 days there is a liquidity injection of Rs 335 billion (avg) by RBI into the system. One interesting trend observed is that around Rs 1295 billion (avg) money is parked as Reverse Repo/SDF window under LAF.
- As per the latest fortnightly available data for ASCBs credit continues to grow in double digit by 17.9% YoY as on October 07, 2022 compared to last year growth of 6.5%. On incremental basis (YTD), in the current year so far (Apr-07 Oct'2022) ASCB's credit has increased by Rs 9.65 lakh crore (8.1%), compared to last year incremental growth of only Rs 65,458 crore during the corresponding period. The pick-up in bank credit growth was led by the term loans category. With economic activity gaining momentum, growth in bank credit for working capital has also caught up in recent months reflecting an optimistic outlook for demand conditions. On the other hand, ASCBs deposits grew by 9.6% on YoY basis (Rs 8.0 lakh crore on incremental basis), compared to last year growth 10.2% (Rs 6.4 lakh crore on YTD).

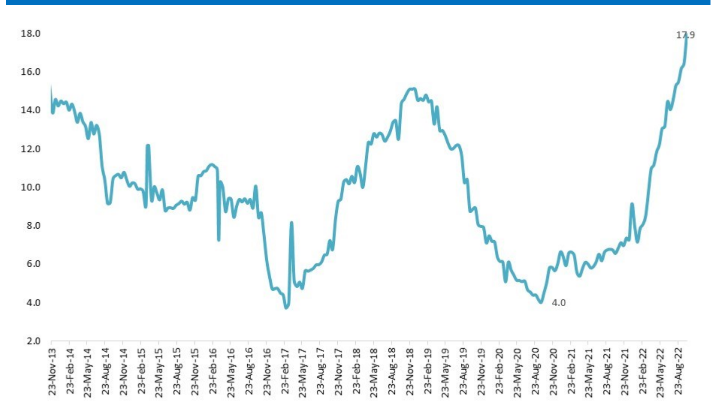
Unseasonal Rainfall: % Deviation from Normal				
	Oct-19	Oct-20	Oct-21	Oct-22
Andhra Pradesh	31	10	-28	20
Bihar	-59	-53	208	43
Gujarat	213	44	45	6
Haryana	-49	-100	154	299
Jharkhand	78	-20	50	29
Karnataka	105	34	48	54
Kerala	55	-27	94	-27
Madhya Pradesh	51	-47	76	199
Maharashtra	127	68	16	84
Odisha	76	62	-20	16
Punjab	2	-100	294	14
Rajasthan	121	-64	109	193
Tamil Nadu	27	-43	29	4
Telangana	73	82	-36	23
Uttar Pradesh	-40	-98	188	421
West Bengal	24	-39	58	1
India	**44**	**3**	**33**	**54**
Memo: Food inflation during Nov-Jan (%)				
Average Food Inflation	10.9^	5.1	4.2	8.4*
Source: CEIC; SBI Research; *Sep22; ^ increased from 4.9% in preceding three months				

System Liquidity Turned Deficit Mode



Source: SBI Research

ASCB's Credit Growth at 9-Year High



Source: SBI Research

- To ease the liquidity strain RBI has been conducting variable repo actions. In September on an average of ₹106 bn was injected through MSF window, and it has increased to ₹138 bn during October. The weighted average call rate (WACR) is traded in the range of 10-15 bps above the policy repo rate (on average) during October, indicating somewhat tightened liquidity conditions.
- In view of the moderation in surplus liquidity in the monetary policy statement on September 30, RBI has taken a slew of measures and reiterated that fine-tuning operations of various maturities for absorption as well as injection of liquidity will continue as may be necessary from time to time. Furthermore, drawdown of excess CRR and excess SLR holdings of banks are also helping banks tide over fund flow mismatches.
- With the rise in policy repo rates, almost all banks have raised their EBLRs by 190 bps but MCLR and base rates has increased in the range of 50-70 bps only. The median term deposit rate of SCBs, which reflects the prevailing card rates on fresh deposits, increased by 26 bps during May-September 2022. **The extent of pass-through to term retail deposit rates, however, has been higher for longer tenor maturities. Beyond September, there has been a large increase in deposit rates. For example, SBI has increased its 1 year deposit rates now by 100 basis points.**
- If we look at the historical interest rate cycles, the increase in deposit rates lag the increase in lending rates. Also, given that 45% of bank deposits are CASA it is only the 55% of term deposits that need adjustment and hence ideally, there will always be less than full adjustment of deposit rates to repo rates. In the current cycle, with a CASA ratio of 45%, a 190 basis point increase in repo rate could result in 105 basis point increase in deposit rate. Any deposit rate increase beyond that will be additional one.
- We believe RBI is pushing banks to increase their deposits rates to garner more deposits or secured funds to finance the credit growth and this could be one of the reasons to keep the liquidity in deficit mode for an extended period.

Transmission of Policy Rate

	Mar-22	Latest	Change (in bps)
Repo Rate	4.00	5.90	190
Wt Avg. Lending Rate (WALR) on O/S Rupee Loans	8.74	9.13	39
WALR on Fresh Rupee Loans	7.63	8.33	70
Wt Avg. Domestic Term Deposits (WADTDR) on O/S Deposits	5.03	5.29	26
ASCB-MCLR (1 Year)	7.25	7.75	50
SBI Term Deposits 1-Yr	5.10	6.10	100
SBI EBLR	6.65	8.55	190
SBI MCLR –6 Months	6.95	7.90	95
SBI MCLR –1 Year	7.00	7.95	95

Source: RBI, SBI Research

Historical Change in Interest Rates

Scenario	Period	Change (in bps)		
		Repo Rate	Lending Rate (WALR on Fresh Loans)	Deposits Rate (WADTDR)
Decreasing	04.03.2015 to 05.06.2018	-175	-167	-188
Increasing	06.06.2018 to 06.02.2019	50	50	20
Decreasing	07.02.2019 to 03.05.2022	-250	-244	-187
Increasing	04.05.2022 to 30.09.2022	190	82	26* (till August) SBI has raised 1 year by 100 bps

Source: RBI, SBI Research

CHINA'S GROWTH OUTLOOK

- The recently concluded 20th National Congress of China has some important hints at the outlook of China's economy. The emphasis on zero-COVID policy and no clear path towards resolution of debt problems in the construction sector entails that China's growth will either stagnate or will fall. The mention of high unemployment indicates that rebalancing towards consumption will be difficult. The pressure on Yuan, high inflation, technology sanctions and looming recession in the US will further compound the problems.

THE US RATE OUTLOOK

- The most recent reading of the US Employment Cost Index showed a considerable slowdown in private-sector wage growth in the third quarter - it rose 1.2% compared to 1.6% in the second quarter indicating that the wage-price spiral is beginning to ease.
- However, with US labour markets continuing to remain tight, the possibility of aggressive 75 bps rate hike is still not ruled out in December. The outlook is also consistent with the dot-plots released in the last policy meet. The US rates will continue to rise in 2023, albite at slower pace if the inflation corrects.
- The rates hike in the US are having have a negative impact on housing and auto sales. The higher cost of living has already muted the US auto sector outlook. The outlook for the auto sector has become more uncertain with economic slowdown and inflation weighing on consumers. The auto manufacturers continue to grapple with supply constraints even when there is some easing of pressures.
- The US housing market is all set for correction as the US mortgage rates have touched 7% following the rate hike.

GLOBAL CONTRADICTIONS OUTWEIGH

- US GDP coming back in the black, clocking 2.6% growth after two consecutive quarters of negative growth seems to have put some mojo back in an otherwise moribund market. However, the outlook remains susceptible to mounting uncertain outlook as the cumulative effect of a 300bps (and, counting) rate hike cycle weigh on activities, ranging from business to borrowing to consumer spending against a resilient Fed signalling it would rather tolerate a sustained period of sub-trend growth to ensure inflationary mandate is met comfortably.
- Benchmark US yields sobered following Commerce Department data showing consumer and business spending slowed in the third quarter, raising hopes to a possible peak out of inflation that should allow the Fed to ease its aggressive tightening spree. Consumer spending, which accounts for more than two-thirds of US economic activity, showed growth slowing to a 1.4% rate from the second quarter's 2.0%. New orders for non-defence capital goods, viewed as a proxy for business spending, fell unexpectedly in September.
- Battered street is loading up on a relief rally, built on the optimism that FOMC may taper its tightening speed in Mid-December meet, post the near unanimous 75 bps increase early next week. Slowdown in consumer and business spending is taken as a cue that Fed efforts to cool the runaway price rise has started bearing fruits.
- With the US economy embracing growth in the third quarter, the Dollar Index has taken a partial retreat, giving some breathing space to currencies globally while the rout in tech stocks seems to have given investors a reason to load on hitherto expensively looking yet growth-oriented stocks at better valuations, explaining the handsome gains in equities this week. All looks good though the elephant in the room remains the geopolitical tensions flaring up as Russia would like to advance and neutralise large parts of Ukraine in the ensuing winter.
- Fed funds futures, as per CME's FedWatch, are pricing in an 87% probability of a 75-bps hike by FOMC in its Nov 2 meet, and a 38% chance of a similar increase in mid-December. The probability of 75 bps hike is significantly lower, in particular for mid-December, which last week was hovering near 65% as the narrative for a 50 bps hike is taking pole position now.
- Back home, yields have moved almost in tandem with benchmark US yields and should see some correction post Nov 3 announcement from the RBI as recent auctions have seen an orderly behaviour from market participants. At higher end of the yield curve, market witnessed increased activity from Insurance companies and Mutual Funds who locked in funds. Durable liquidity, despite occasional bouts of squeeze, has largely remained in surplus mode. While talks of India's inclusion in global bond indexes have dried up, we believe, now is the right time to walk the tightrope to announce the arrival of the country in high streets of finance and hog the limelight.
- INR has continued its comparative resilience, strengthening on the back of recent fall in Dollar index. Even though the current Dollar descend could be a temporary phenomenon as markets love to side with somewhat illusory narrative before policy meets that inflation has peaked due to policy actions, the wild swings seen post select tech behemoths' results point to markets pricing in more the weaker forward guidance over the better than expected immediate results.
- Also, on ECB front, during the first five months in FY23, total ECB raised by corporates is a paltry $8.26 bn (against $11.23 bn in first five months during FY22 and $39.89 bn in full year). If corporates raise fresh ECB now, that should help the RBI in doing Buy/Sell swaps, bringing down hedging cost while lowering the Forward Premia too!

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