SBI RESEARCH

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REPO RATE IMPACT ON CORE CPI UNYIELDING BEYOND A POINT: MONETARY POLICY IS REFLECTIVE OF RATIONALE & SCIENCE AND NOT TO SATISFY MARKET EGO… RBI HAVE DECISIVELY ENTERED A PAUSE TERRITORY BARRING ANY LARGE NEGATIVE DATA SURPRISE!

CPI inflation moderated to almost 16-months low of 5.66% (**SBI estimate: 5.78%**) in Mar'23, compared to 6.44% in Feb'23 due to sharp deceleration in protein inflation. However, cereals and spices CPI is still growing in double digits. Inflation on housing, pulses, fruits and egg has inched up marginally on a sequential basis. In FY23, average CPI stands at 6.66% compared to 5.51% in FY22, mainly due to the higher food prices inflation. Core CPI also moderated to almost 2-years low to 5.74% in Mar'23 as against 6.12% in Feb'23, due to the decline in prices of miscellaneous items like household goods, transport & communication, education and personal care etc. **Against this backdrop, CPI inflation is projected at 5.2% for FY24, with Q1 at 5.1%, Q2 at 5.2%, Q3 at 5.3%, and Q4 at 5%.**

In markets parlance, no news is mostly good news!

The satire was almost lost on sections of broader markets as RBI refused to cower to those chanting monotonous rate rise mantras, not handing over predictable news, or a favoured outcome in its last policy meet, causing despair writ large in some minds it seems. The calibrated exit from the *chakravyuh* of Fed, sidestepping to create own rate pivot as we had postulated sometime back, appears to have had a meaningful breakthrough, in particular when seen through the larger prism of other Central Banks' actions **distancing themselves from the 'follow the herd' mentality** (Out of 147 countries, 90 economies held their central bank rates, only 9 countries have increased their interest rates and in 48 countries policy rate has declined) and the backdrop of inflation print released today.

RBI has made a clear distinction between policy strategy and policy stance once again and asserted that these can coexist simultaneously. While it has kept the stance same as 'withdrawal of accommodation' to calibrate liquidity and ensure that government borrowings face no disruption, its strategy has been changed by hitting the pause button on rate hike. The policy strategy may still indicate rate adjustment to quell inflationary expectations, should inflation surprise on the upside beyond tolerance. **However, we expect that RBI may have just hit the pause button as inflation trajectory looks below 6% for rest of FY24 while deftly managing liquidity in system!**

Examining the nature of relationship between Core CPI and Repo Rate, we find that Core CPI remained sticky in the period before rate hike period. **During April 2014 to February 2022, 1% increase in repo rate lowers Core CPI by 0.33%. However, it has lagged impact particularly at a lag of 2, 6, and 7 months. At the 2, 6, and 7 months lag, short run relationship coefficients are positive conveying there is significant resistance (stickiness) towards the negative equilibrium relationship between Core CPI and Repo Rate. When the same relationship has been checked for the period of rate hike i.e., March 2022 to February 2023, it has been observed that coefficient of lag 1 of significant short run relationship of Core CPI and Repo Rate is negative, conveying that increase in repo rate is trying to reduce the Core CPI with one month lag however, this impact is not able to yield any long term impact in reducing Core CPI, making the efforts unyielding.**

As per the fortnightly bank credit data, during FY23, incremental bank credit grew by Rs 17.8 lakh crore (15.0% YoY), as against Rs 10.4 lakh crore (9.6% YoY) in FY22. While, aggregate deposits of ASCB grew by Rs 15.7 lakh crore (9.6% YoY) compared to last year growth of Rs 13.5 lakh crore (8.9% YoY) showcasing resilient broad based building of the consolidation in the banking sector's balance sheet, the ongoing reduction in bad loans and the buffering of risk absorbing capacity and onward transmission in both deposit and lending rates. The decrease in CP issuances (Rs 13.74 lakh crore in FY23 as compared to Rs 20.20 lakh crore during FY22) along with significant up move in WAY hints that Corporates are returning to banks!

At 5%, the US CPI continues to be above the Fed's target of 2% and the impact of the outlook on US interest rates will have bearing on both domestic gilts and RBI posturing. IIP for Feb 23 rose by 5.6% (YoY basis) led by Electricity sector. Mining, Manufacturing and Electricity grew at 4.62%, 5.31% and 8.21% respectively.

Market watchers need to remind themselves that magic lies in the hands of the magician, not in the wand! Monetary policy formation by any Central bank can hardly be termed as ego based; it is always reflective of abundantly pitched rationale and science of the ensemble, with a twist of artistic manoeuvre thrown liberally. Monetary policy criticism sans collaborative research thus seems to be the bane of most myopic observations, reading the print while losing the plot wholly!

CPI INFLATION IS AT 16-MONTHS LOW OF 5.66%

- CPI inflation moderated to almost 16-months low to 5.66% (SBI estimate: 5.78%) in Mar'23 as compared to 6.44% in Feb'23 due to sharp deceleration in protein inflation. However, cereals and spices CPI are still growing in double digits. Inflation on housing, pulses, fruits and egg has inched up marginally on a sequential basis.
- In FY23, average CPI stands at 6.66% compared to 5.51% in FY22, mainly due to the higher food prices inflation.
- Core CPI also moderated to almost 2-years low to 5.74% in Mar'23 as against 6.12% in Feb'23, due to the decline in prices of Miscellaneous items like household goods, transport & communication, education and personal care etc.
- Against this backdrop, CPI inflation is projected at 5.2% for FY24, with Q1 at 5.1%, Q2 at 5.2%, Q3 at 5.3%, and Q4 at 5%.

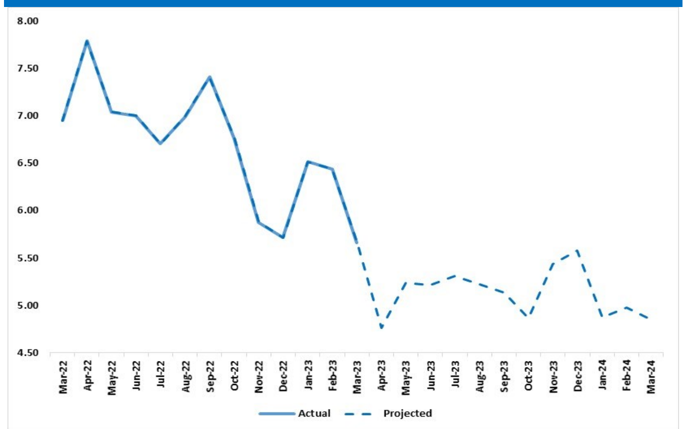
RATE CYCLE PAUSED IN OTHER ECONOMIES ALSO

- In the last Monetary policy, RBI maintained the repo rate at 6.50% and remained focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth.
- Out of 147 countries, 90 economies holds their central bank rates, only 9 countries have increased their interest rates and 48 countries policy rate has declined.
- IMF also noted in its latest WEO that disinflation is expected in all major country groups, with about 76% of economies expected to experience lower headline inflation in 2023. At the same time, core inflation is expected to decline globally much more gradually in 2023.

THE RBI'S POLICY STANCE - DISTINCTION IN STANCE AND STRATEGY

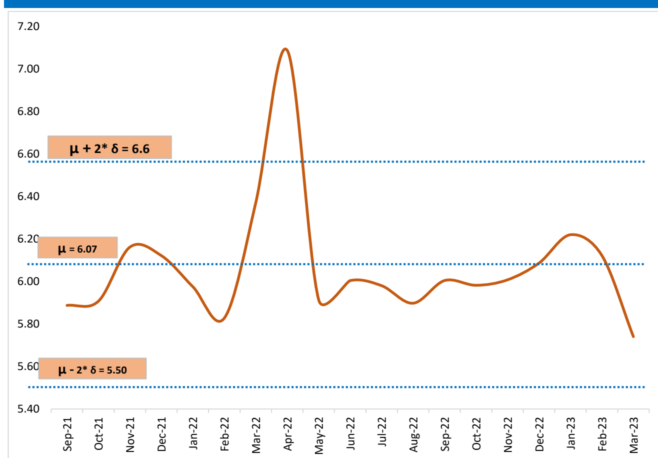
- Liquidity has turned back into moderate surplus with average net LAF at Rs 2.1 lakh crore (as on 11 Apr'23) from slight deficit at the time of the last policy. Net durable liquidity surplus is only Rs 1.0 lakh crore. RBI has been successfully managing liquidity by conducting operations at either side of the LAF. Surplus liquidity at the beginning of the FY23 has been progressively brought down by OMO sales and increase in CRR. The VRR auctions have also been used to adjust liquidity.
- RBI made a clear distinction between policy strategy and policy stance in last policy and asserted that these can coexist simultaneously. While it has kept the stance same as 'withdrawal of accommodation' to calibrate liquidity and ensure that government borrowings face no disruption, its strategy has been changed by hitting the pause button on rate hike.

CPI Inflation (% YoY) : Actual vs Future Trajectory



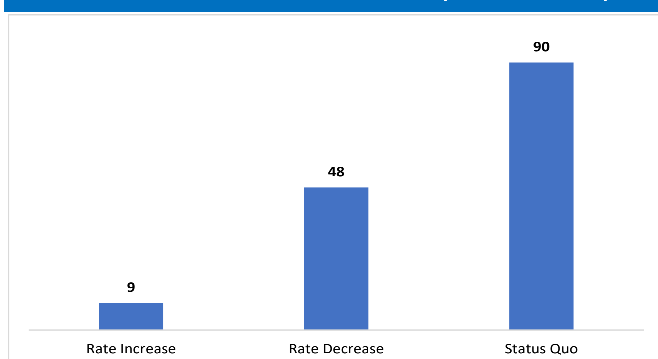
Source: SBI Research

Distribution Curve of Core CPI



Source: SBI Research

Central Banks Latest Rate Actions (# of Countries)



Source: SBI Research

- The policy strategy may still indicate rate adjustment to quell inflation expectations, should inflation surprise on the upside beyond tolerance. An interesting anecdote is the switch to unyielding core inflation from the sticky one! However, we expect that RBI may have just hit the pause button as inflation trajectory looks below 6% for rest of FY24!

STICKY CORE TURNING INTO UNYIELDING CORE

- Examining the nature of relationship between Core CPI and Repo Rate, we found that Core CPI has remained sticky in the period before rate hike period.
- **During April 2014 to February 2022, 1% increase in repo rate decreases Core CPI by 0.33%. However, it has lagged impact particularly at a lag of 2, 6, and 7 months. At the 2, 6, and 7 months lag, short run relationship coefficients are positive conveying there is significant resistance (stickiness) towards the negative equilibrium relationship between Core CPI and Repo Rate.**
- **When the same relationship has been checked for the period of rate hike i.e., March 2022 to February 2023, it has been observed that coefficient of lag 1 of significant short run relationship of Core CPI and Repo Rate is negative, conveying that increase in repo rate is trying to reduce the Core CPI with one month lag however, this impact is not able to yield any long term impact in reducing Core CPI, making the efforts unyielding.**
- We checked the impact of Core CPI and Food CPI separately into General CPI for major period (April 2014 to Feb 2023) and it's two subperiods (April 2014 to Feb 2022, and Mar 2022 to Feb 2023).
- **It has been observed that Core CPI is neither impacting General CPI in major period nor in two subperiods, instead it is the Food CPI which is impacting General CPI in aforementioned major period and sub-periods. 1% increase in Food CPI increases the General CPI by 0.6% in the period of April 2014 to Feb 2023. Even in the rate hike period of Mar 2022 to Feb 2023, 1% increase in Food CPI increases the General CPI by 0.46%.**
- **Therefore, it is the Food CPI which impacts the General CPI and not the Core CPI.**

Sticky Core CPI from April 2014 to February 2022
ARDL Model; Dependent Variable: Core CPI

Variable	Coefficient	Std Error	P value
Adjustment factor (Core CPI L1.)	-.356	0.112	0.003***
Long Run Relationship			
Repo rate	-.334	0.106	0.003***
Short run Relationship			
D1.Repo Rate	0.058	0.345	0.866
LD.Repo Rate	-.290	0.342	0.4
L2D.Repo Rate	0.622	0.354	0.085*
L3D.Repo Rate	0.236	0.318	0.46
L4D.Repo Rate	0.001	0.312	0.995
L5D.Repo Rate	0.094	0.31	0.762
L6D.Repo Rate	1.001	0.295	0.001***
L7D.Repo Rate	0.605	0.32	0.065*
Constant	2.563	0.757	0.001***

Source: SBI Research

Unyielding Core CPI from March 2022 to February 2023
ARDL Model; Dependent Variable: Core CPI

Variable	Coefficient	Std Error	P value
Adjustment factor (Core CPI L1.)	-1.138	0.272	0.006***
Long Run Relationship			
Repo rate	-.075	0.091	0.443
Short run Relationship			
D1.Repo Rate	-.776	0.388	0.093*
LD.Repo Rate	-.421	0.382	0.313
L2D.Repo Rate	-.641	0.398	0.159
Constant	7.816	1.881	0.006***

Source: SBI Research

Food CPI Impacting General CPI^ ARDL Model
Dependent Variable: General CPI

Variable	Coefficient	Std Error	P value
From April 2014 to February 2023			
Adjustment factor (General CPI L1.)	-0.115	0.046	0.015**
Food CPI	0.61	0.107	0.0001***
Constant	0.243	0.135	0.077*
From April 2014 to February 2022			
Adjustment factor (General CPI L1.)	-0.352	0.134	0.013**
Food CPI	0.509	0.042	0.0001***
Constant	0.856	0.363	0.025**
Fom March 2022 to February 2023			
Adjustment factor (General CPI L1.)	-2.02	0.809	0.088*
Food CPI	0.461	0.04	0.001***
Constant	7.167638	2.796	0.083*

Source: SBI Research *** Significant at 1%, ** Significant at 5%, * Significant at 10%,^ Long Run Relationships

Core CPI not Impacting General CPI^
ARDL Model; Dependent Variable: General CPI

Variable	Coefficient	Std Error	P value
From April 2014 to February 2023			
Adjustment factor (General CPI L1.)	-.149	0.054	0.008***
Core CPI	0.93	0.611	0.132
Constant	0.014	0.473	0.975
From April 2014 to February 2022			
Adjustment factor (General CPI L1.)	-.108	0.053	0.047**
Core CPI	1.023	1.103	0.357
Constant	-0.025	0.591	0.965
Fom March 2022 to February 2023			
Adjustment factor (General CPI L1.)	-0.159	0.407	0.733
Core CPI	6.711	18.114	0.747
Constant	-5.57	7.402	0.53

Source: SBI Research
*** Significant at 1%, ** Significant at 5%, * Significant at 10%,^ Long Run Relationships

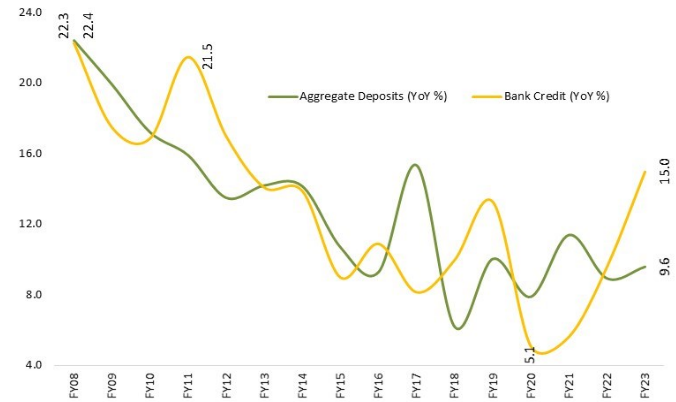
ASCB'S CREDIT GROWTH (YOY) AT 9-YEAR HIGH OF 15.0% IN FY24

- The Indian financial sector has remained resilient building on the consolidation of the banking sector's balance sheet, the ongoing reduction in bad loans and the buffering of risk absorbing capacity. Credit growth continued to grow in double digits and became broad based across sectors.
- As per the fortnightly bank credit data, during FY23 incremental bank credit grew by Rs 17.8 lakh crore (15.0% YoY), as against Rs 10.4 lakh crore (9.6% YoY) in FY22. While, aggregate deposits of ASCB grew by Rs 15.7 lakh crore (9.6% YoY) compared to last year growth of Rs 13.5 lakh crore (8.9% YoY).
- With credit growth outpacing growth in aggregate deposits, the incremental CD ratio is at 113%, raising concerns about the long-term sustainability of double digit credit growth.
- **Though, Pvt banks (18.4%) credit grew at a higher rate compared to PSBs (13.7%) in 2022-23 but PSBs were the major driver of the incremental credit extended by ASCBs (PSBs: 52.7% and Pvt Banks:46.7% in incremental credit).**
- As demand for credit continues, we expect credit may grow up by 13-14% and deposits by 10-11% in FY24.
- With the rise in repo rate, banks have transmitted it to both deposit and credit rates. In the present rate rising regime, lending rates transmitted in the range o 130-250 bps (250 bps in EBLR, 95 bps in WALR Outstanding loans and 173 bps in fresh loans), while 130-170 bps transmitted to deposit rates.

RATE HIKE CYCLE WEIGH ON SHORT TERM PAPER, CORPORATES RETURN TO BANK COUNTER

- Commercial Paper (CP) issuances in FY23 declined by around 32% to Rs 13.74 lakh crore as compared to Rs 20.20 lakh crore during FY22, while Bank credit grew by more than 15% during the same period.
- CP Weighted Average Yield (WAY), primary issuances, increased by 353 bps to 7.90% in Mar'2023 as compared to 4.37% in April'2022.
- In FY23, CP issuances by NBFC sector too declined by around 44% to Rs 5.27 lakh crore as compared to Rs 9.32 lakh crore in FY22. In NBFC space also, WAY increased by 353 bps i.e. from 4.43% in April'2022 to 7.96% in Mar'2023.

ASCBs Credit Growth at 9-Year High



Source: SBI Research

GLOBAL AND DOMESTIC INTEREST RATES

- The US inflation has moderated in the latest reading. At 5% the US CPI continues to be above the Federal Reserves target of 2%. Thus, despite the moderation, interest rates in the US will continue to have upward bias but the pace of hike will be moderating to balance both economic considerations and inflation.
- The impact of the outlook on US interest rates will have bearing on both domestic gilts and RBI posturing. For the foreseeable future the rate of market rates will moderate tracing the US yields but will not be sufficient to compel RBI to translate pause into a pivot.

TREND OF CPI, CORE CPI AND REPO RATE

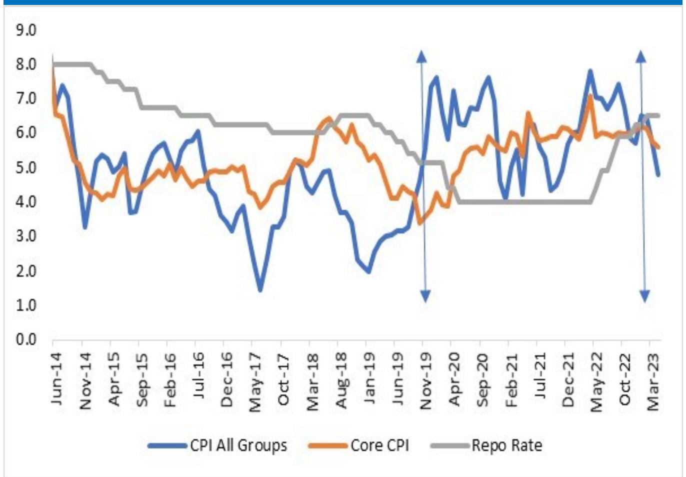
- It has been observed that upto Nov 19, CPI and Core CPI inflation rate has been lower than Repo Rate.
- Trajectory of CPI and Core CPI inflation Rate are above repo rate from Nov 19, and April 20 onwards respectively. When the same happened, RBI can not act instantly due to the onset of the pandemic which may have culminated into continuing and non transitory inflation, making it difficult to deal with it.
- However, with the continued efforts of RBI in controlling inflation, it is observed that both CPI and Core CPI inflation are going below repo rate from Feb 23 onwards. With the Mar 23 CPI and Core CPI inflation coming at 5.66% and 5.74% respectively, the same has been affirmed in Mar 23 as well.
- **We also expect April 23 CPI and Core CPI inflation to be at 4.8% and 5.6% respectively, which is again lower than the current Repo Rate.**

- **With three period CPI and Core CPI inflation lower than the Repo rate, and USA inflation also cooling down to some extent, it is expected that 6.5% Repo rate could be a terminal repo rate and no further rate hikes would be needed to tame inflation.**
- Picture would be more clear with three months CPI and Core CPI Inflation trajectory by June 23 but our estimation suggests 6.5% could be a terminal repo rate in the rate hike period.

INDEX OF INDUSTRIAL PRODUCTION

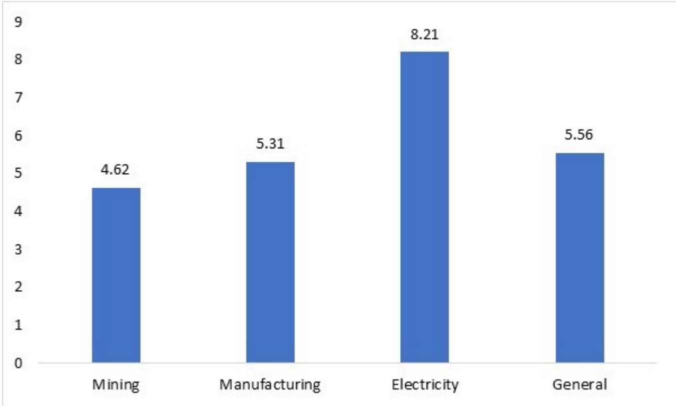
- IIP for Feb 23 rises by 5.6% (YoY basis) led by Electricity sector. Mining, Manufacturing and Electricity grew at 4.62%, 5.31% and 8.21% respectively.
- With respect to Use based classification of IIP, Primary goods, capital Goods, Infrastructure/Construction Goods, and Consumer Non-durables grew at 6.8%, 10.48%, 7.89%, and 12.14% respectively. Intermediate Goods and Consumer durables contracted at 0.35% and 3.99%b respectively.

TREND OF CPI, CORE CPI AND REPO RATE



Source: SBI Research

Index of Industrial Production



Source: SBI Research

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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