SBI RESEARCH

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RBI POLICY: BETWEEN SCYLLA AND CHARYBDIS

As expected, RBI decided to keep policy repo rate unchanged at 4% (7th straight time) and decided to continue with the accommodative stance as long as necessary. While the rate cut decision was always going to be universally a consensus, the voting on accommodative stance witnessed a dissent. The Governor's communication has been however very clear that RBI will do "whatever it takes" to protect growth.

While the policy strikes a delicate balance between reinvigorating growth and keeping inflation in check, it seems that RBI growth projections being retained at 9.5% is more of a statistical artefact as Q1 growth numbers have been revised upwards, while Q2-Q4 growth numbers have been significantly downgraded. Thus it is clear that the central bank currently foresees recovery as incipient which will likely lose steam as pandemic uncertainties continue to rule the roost. This provides a clear justification for central bank to continue supporting growth till it revives.

Of greater concern is the inflation projection that has been substantially revised upwards at 5.7% for FY22. Even though the RBI has clearly emphasized the inflation trajectory in upward direction to be transitory, we believe inflation management could pose a serious challenge when the elevated fuel price pass through starts to occur and thus inflation shock is unlikely to be transitory even by definition. Interestingly, the contribution of fuel, edible oil and pulses is currently more than 50% to rural headline inflation. Additionally, the second wave is having a significantly large fat tail and rural cases continue to be more than 40% in new cases, even as rural recovery continues to be patchy. This will put further upward pressure on rural inflation.

Most central banks like FED and ECB have taken recourse to the word *transitory*. The usage of the word transitory in the context of inflation in the statements is the new feature of FOMC statements since April. However, we must differentiate between transitory inflation in developed economies and in India. Developed economies had not seen inflation at more than 2% even after incessant QE. In India, inflation is now running close to 6% for the last one year and almost all inflation prints, headline, core, rural and urban are converging at 6% or upwards implying inflation numbers may not be transitory. In fact, in the US, over the next year, the transitory price increases caused by bottlenecks and supply constraints were expected to largely reverse, but with rise in COVID-19 cases in the US it needs to be seen to what extent the existing supply constraints will further push up the inflation.

Regarding liquidity management, RBI has maintained that the resumption of its Variable rate reverse repo (VRRR) auctions should not be misread as a reversal of the accommodative policy stance, as the amount absorbed under the fixed rate reverse repo is expected to remain more than ₹4.0 lakh crore at end-September 2021. This decision will push up short term rates towards repo rate. Also, the MSF relaxation has been extended by another 3 months till 31st Dec 2021. Banks are allowed under this relaxation to dip up to 3% of NDTL into SLR under MSF as against the usual 2%. This will provide increased access to funds to the extent of ₹1.62 lakh crore and qualify as HQLA for the LCR. To provide stability RBI has extended On Tap TLTRO Scheme till Dec'21. RBI is also conducting open market purchase of government securities of ₹25,000 crore on August 12, 2021 under the G-sec Acquisition Programme (G-SAP 2.0).

Here is some food for thought. If we look at the data in the post-financial crisis period, there has been a structural shift in bank credit from the industrial sector to the retail sector. The share of retail credit was 23.7% in FY08 but declined thereafter and remained in the range of 18.0-19.5% during FY09-FY15. However, it has increased again to touch 27.7% in FY20 and now is at 25.9% in June'21. The share of industrial sector in total outstanding credit has declined from 40-45% between FY10 and FY16 to nearly 27% at present.

We believe that the growth in retail credit is aided by the growth in the corporate credit. Granger Causality results between 'Corporate Credit' and 'Personal Loans Credit', over a period of 145 months (June'2009 to June'2021) indicates that there is a uni-directional causality between 'corporate credit & personal loans'. In other words, corporate credit granger cause retail credit with a lag of almost 2/3 months. It is thus imperative for corporate credit growth to revive and this could happen once the investment cycle revives in a meaningful way.

The point of concern is that expectations of third wave building up are now firming. Kerala may have advanced into the third wave and incoming data in next few weeks will make it clear. R number is high in eight states and UTs of India. The states/UTs showing an increase in the R factor are -- Himachal Pradesh, Jammu and Kashmir, Lakshadweep, Tamil Nadu, Mizoram, Karnataka, Puducherry, and Kerala. Vaccination needs to keep up its pace so that RBI's task is eased.

RBI HOLDS RATE

- RBI's Monetary Policy Committee has unanimously decided to keep policy Repo rate unchanged at 4% (7th straight time) and decided to continue with the accommodative stance as long as necessary (to revive growth on a durable basis with check on inflation). Reverse repo rate remains unchanged at 3.35% and MSF and the Bank Rate remains at 4.25%.
- RBI retained its projection of real GDP growth for FY22 at 9.5% consisting of 21.4% in Q1 (earlier: 18.5%), 7.3% in Q2 (earlier: 7.9%), 6.3% in Q3 (earlier: 7.2%) and 6.1% in Q4 (earlier: 6.6%). Interestingly when almost all agencies have downgraded Q1 FY22 real GDP growth projection, RBI has increased it significantly. In order to maintain GDP growth for FY22 at 9.5%, RBI reduced growth projections of all subsequent quarters. For Q1 FY23, RBI projected GDP growth at 17.2% which is quite unreasonable given the huge base effect.
- Coming to CPI projections, RBI has projected CPI inflation at 5.7% for FY22 (earlier: 5.1%) with 5.9% in Q2; 5.3% in Q3; and 5.8% in Q4 FY22. RBI revised upwards inflation projections for all the quarters. CPI for Q1 FY23 is projected at 5.1%. The rising input prices across manufacturing and services sectors is expected to be offset by weak demand and efforts towards cost cutting. We believe inflation management could pose a serious challenge to RBI when the elevated fuel price pass through starts to occur. **Though a calibrated reduction of the indirect tax component of pump prices by the Centre and states can help to substantially lessen cost pressures.**

DEVELOPMENTAL AND REGULATORY MEASURES

- ***LIBOR Transition - Review of Guidelines:*** In view of impending discontinuation of LIBOR, hitherto used as a key reference rate by Banks/FIs globally for settling forex exposures, the regulator has, as a first step, permitted Banks to shift over any widely accepted Alternative Reference Rate (ARR) for extending export credit in foreign currency to exporters. While the roadmap remains challenging due to various jurisdictions involved proposing separate ARRs, switch over to SOFR (Secured Overnight Financing Rate) seems most preferred for USD denominated transactions locally.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q1 FY22	Q2 FY22	Q3 FY22	Q4 FY22	FY22	Q1 FY23
Aug'21	5.6*	5.9	5.3	5.8	**5.7**	5.1
Jun'21	5.2	5.4	4.7	5.3	**5.1**	-
Apr'21	5.2	5.2	4.4	5.1	**5.0**	
Real GDP Growth (%)	**Q1 FY22**	**Q2 FY22**	**Q3 FY22**	**Q4 FY22**	**FY22**	**Q1 FY23**
Aug'21	21.4	7.3	6.3	6.1	**9.5**	17.2
Jun'21	18.5	7.9	7.2	6.6	**9.5**	-
Apr'21	26.2	8.3	5.4	6.2	**10.5**	

Source:RBI, SBI Research; *Actual

- The clarity on Off-balance sheet items (derivatives contracts), prone to undergo change in reference rate from LIBOR / LIBOR related benchmarks to an ARR, by terming such changes as "non-restructured" in nature should give great reprieve to Banks as well as counterparties, saving huge amount of time and efforts of all concerned.
- ***Deferral of Deadline for Achievement of Financial Parameters under Resolution Framework 1.0:*** Post recommendation of Kamath Committee on norms for the resolution of COVID-19 related stressed loans, RBI issued resolution framework on 06th August 2020 and announced sector specific thresholds on 07th Sept 2020, in respect of five financial parameters, four of which are related to the operational performance of the borrowing entity, viz. Total Debt to EBIDTA ratio (Total Debt/EBIDTA), Current Ratio, Debt Service Coverage Ratio, Average Debt Service Coverage Ratio, and one related to capital structure related is Total Outside Liabilities/ Adjusted Total Net Worth (TOL/ATNW) to be achieved by March'2022.
- Further, recognising the adverse impact of second wave of COVID-19 on revival of businesses, and the difficulty in meeting the operational parameters, the RBI deferred the target date for meeting the operational threshold in respect of the above four parameters to October 1, 2022. As regards the parameter TOL/ATNW, the date for achieving the same remains unchanged, i.e. March 31, 2022.
- This is a welcome move and will give huge relief to various stressed sectors/entities in meeting the desired level of financial ratios in view of the second wave and its aftereffects.

- However, it is interesting to note that, ASCB credit outstanding in some of the stressed sectors have declined as compared to the same a year ago reflecting better financial management by some of the sectors/entities in terms of debt repayments. For example, Iron & steel and Construction sectors reported a decline in credit outstanding by Rs 601 billion and Rs 50 billion respectively as on Jun'21 as compared to a year ago.
- ***On Tap TLTRO Scheme – Extension of Deadline:*** To revive certain sectors, RBI had announced in Oct'20 to conduct Rs 1 lakh crore worth of 3-year TLTROs till Mar'21 at floating rate linked to repo rate. In Apr'21, the scheme was extended by a period of six months, i.e., till Sep'21. Given the nascent and fragile economic recovery, RBI has now decided to extend the scheme further by a period of three months, i.e., till Dec'21. As exposure under the scheme is exempt from LEF norms, this will open more investment opportunities for banks.
- ***Marginal Standing Facility (MSF) - Extension of Relaxation:*** The MSF relaxation has been extended by another 3 months till 31st Dec 2021. Banks are allowed under this relaxation to dip up to 3% of NDTL into SLR under MSF as against the usual 2%. This will provide increased access to funds to the extent of ₹1.62 lakh crore and qualify as HQLA for the LCR.

ASSET QUALITY

- The Indian banking system has performed well in Q1 FY22 with most of the banks declaring robust profits. However, a nagging concern is the deterioration in retail asset quality in Q1FY22. This is primarily attributable to the devastating second wave. Our research shows that there were deposit outflows from districts that had high deaths and, in such districts, there was also a deterioration of retail assets
- The asset quality of ASCBs improved during FY21, with the Gross NPA ratio declining to 7.5% from 8.3% in FY20, reflecting mainly the regulatory dispensations in response to the COVID-19 pandemic. The SCBs' GNPA ratios for two major sectors, viz., agriculture and industry declined during FY21, but increased for the retail/personal loans.

CORPORATE CREDIT GRANGER CAUSE RETAIL CREDIT

- The COVID-19 pandemic hit every credit segment either it is corporate/industry credit or the retail/personal loans. The latest sectoral deployment of credit indicates that credit-offtake has declined in all major sectors on YTD basis. However, some marginal revival was seen in the personal loans, especially in housing and other personal loans on YTD basis. There has been de-growth in industry credit, as it seems corporates are substituting the high cost loans with cheap credit available in the market.
- If we look the data in the post-financial crisis period, there has been a structural shift in bank credit from the industrial sector to the retail sector.

Gross NPAs of Select Banks

Bank	GNPA (%)			Retail Sector- NPA (%)		
	Q1FY22	Q4FY21	Q1FY21	Q1FY22	Q4FY21	Q1FY21
ICICI Bank	5.2	5.0	5.5	3.8	3.0	2.0
Indusind Bank	2.9	2.7	2.5	2.9	2.4	
Axis Bank	3.9	3.7	4.7	2.6	-	-
HDFC Bank	1.5	1.3	1.4	-	-	-
Kotak	3.6	3.3	2.7	-	-	-
IDBI	22.7	22.4	26.8	-	-	-
Yes Bank	15.6	15.4	17.3	3.3	2.9	1.2
Bandhan Bank	8.2	6.8	1.4	2.7	2.5	
South Indian Bank	8.0	7.0	4.9	-	-	-
Federal Bank	3.5	3.4	3.0	2.8	2.9	-
RBL Bank	5.0	4.3	3.5	3.2	2.5	0.8
CBI	15.9	16.6	18.1	5.4	5.1	4.3
Canara Bank	8.5	8.9	8.8	1.5	1.6	2.2
UCO Bank	9.4	9.6	14.4	3.5	3.0	3.5
P & S Bank	13.3	13.8	14.3	-	-	-
Indian Bank	9.7	9.9	10.9	5.0	4.1	3.6
BOM	6.4	7.2	10.9	2.3	2.4	3.1
PNB	14.3	14.1	14.1	5.9	5.3	3.4
IOB	11.5	11.7	13.9	4.5	3.9	2.6
BOI	13.5	13.8	13.9	4.7	2.9	3.0
UBI	13.6	13.7	15.0	5.0	4.5	4.5
SBI	5.3	5.0	5.4	5.1	4.5	5.3
Average	**9.2**	**9.1**	**9.7**	**3.8**	**3.3**	**3.0**

Source: SBI Research, Bank results

Granger Causality Results

Hypothesis	F-Stat	P
H0: Personal Loans does not Granger Cause Industry credit	0.0318	0.9686
H0: Industry credit does not Granger Cause Personal Loans	10.0639	0.0000*

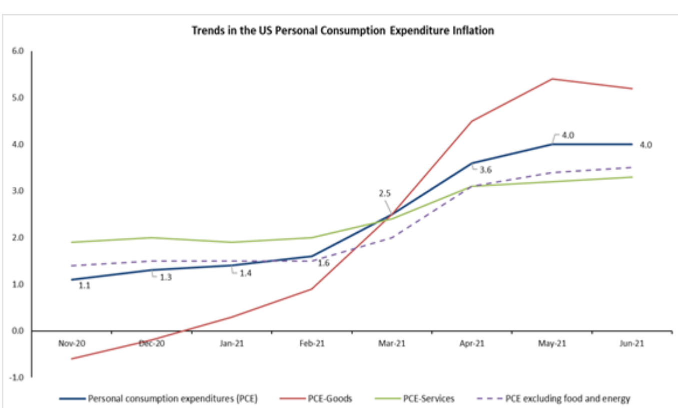
*Significant

- The share of retail credit was 23.7% in FY08 but declined there after and remained in the range of 18.0-19.5% during FY09-FY15. However, it has increased thereafter to touch 27.7% in FY20 and now is at 25.9% in June'21. The share of industrial sector in total outstanding credit has declined from 40-45% between FY10 and FY16 to nearly 27% at present.
- We believe that the growth in retail credit is aided by the growth in the corporate credit. To test the causality between 'Industry Credit' and 'Personal Loans Credit', Granger Causality test over a period of 145 months (June'2009 to June'2021) was done. The results indicate that there is a uni-directional causality between 'corporate credit & personal loans'. In other words, corporate credit granger cause retail credit with a lag of almost 2/3 months and hence a continuous decline in corporate credit will lead to decline in retail loans going forward. It is thus imperative for corporate credit growth to revive and this could happen once the investment cycle revives in a meaningful way.

US INFLATION OUTLOOK

- Recent 12-month change measures of inflation, using either Personal Consumption Expenditures (PCE) prices or the consumer price index (CPI) in the US, were boosted significantly by the base effects of the drop in prices from the spring of 2020 rolling out of the calculation. In addition, a surge in demand as the economy reopened further, combined with production bottlenecks and supply constraints, contributed to the large recent monthly price increases.
- For the PCE index, which is tracked by Federal Reserve (Fed) for policy guidance, the near-term outlook for inflation was revised up markedly, Fed continued to expect the rise in inflation this year to be transitory. The 12-month change in total and core PCE prices had moved well above 2 percent in April-June, and incoming CPI data suggested that PCE price inflation would remain high in coming months.
- The recent 12-month measures of inflation were being boosted significantly by the base effects. Fed expects the 12-month change in PCE prices to gradually move down in coming months, reflecting, importantly, the fading of base effects along with smaller expected monthly price increases, but PCE price inflation was forecast to still be well above 2 percent at the end of this year.
- Over the next year, the transitory price increases caused by bottlenecks and supply constraints were expected to largely reverse, and the growth in demand was forecast to ease.
- With rise in COVID-19 cases in the US it needs to be seen to what extent the existing supply constraints will further push the inflation up.

Trends in US Inflation (%)



Source: SBI Research

EUROPEAN UNION INFLATION OUTLOOK

- Annual HICP inflation declined slightly in June, after successive increases since the start of the year. This measure eased from 2.0% in May to 1.9% in June.
- The current increase is largely being driven by higher energy prices and by base effects from the sharp fall in oil prices at the start of the pandemic and the impact of the temporary VAT reduction in Germany last year.
- HICP inflation excluding energy and food (HICPX) decreased slightly, from 1.0% in May to 0.9% in June. Non-energy industrial goods (NEIG) inflation rose further in May and June, while services inflation declined in June.
- HICPXX inflation, which also excludes clothing, footwear and travel-related services, continued its upward trend observed since February to stand at 1.4% in June. Looking at other measures of underlying inflation, the Supercore measure increased from 0.8% in May to 1.0% in June, while the Persistent and Common Component of Inflation (PCCI) remained roughly stable at 1.4%.
- Inflation is expected to increase further over the coming months and to decline again next year.

CENTRAL BANK COMMUNICATION POLICY: PLAYING WITH THE WORD TRANSITORY

- Over the last two decades, central banks have moved towards clearer communication and greater transparency. Central banks have realised that open and transparent communication enhances policy effectiveness. This shift reflects a shift in the theory of monetary policy.
- Until the early 1990s, monetary policy was strongly influenced by Robert Lucas' argument that monetary policy affected real variables only if the policy changes were unanticipated. This encouraged obscurity over openness and clarity. Lost in the message was the fact that monetary policy always affected nominal variables like inflation even if fully anticipated.
- In the 1980s, Finn Kydland and Ed Prescott argued that fully transparent rules rather than discretionary policy changes were more efficient and credible. This was the beginning of the push towards rules over discretion and greater central bank transparency. In uncertain times like the pandemic clear communication is the key.

- Internationally the Fed communication has improved and has become increasingly transparent over the years. However, in the recent meeting the Fed did not give a timeline for QE tapering even though the chair Powell has assured to provide advance notice before making any changes to their purchases. He even mentioned that despite improvement in employment, the labor market has a ways to go. He also said that inflation will likely remain above their target in coming months, however, it is mainly due to transitory factors. The usage of the word *transitory* in the context of inflation in the statements is the new feature of FOMC statements since April.
- It seems that fresh concerns about global economic growth and the spread of the delta variant of the coronavirus have eased inflation concerns somewhat and taken some pressure off the Fed to be more forthcoming about its tapering plans. Now everyone is eyeing for the annual Jackson Hole conference of central bankers in August.
- When we look at ECB latest statement, it said it would keep buying bonds and maintain its deeply negative interest rates in an attempt to shift the eurozone economy out of its persistent pattern of sluggish inflation. The bank added that it was prepared to tolerate a moderate and transitory overshoot of its price growth target of 2%. The ECB slightly changed its forward guidance as a result of the new strategy, becoming even more dovish.
- As a result, any tapering announcement in September looks highly unlikely. However, this decision of the ECB to become more tolerant of inflation before raising interest rates has been criticised by some of its more hawkish policymakers, an early indication of the divisions in its debate over when to scale back bond-buying. But the central bank left its guidance on asset purchases unchanged and Governor Lagarde said it was "totally premature" to discuss tapering them. However, she denied the new wording implied low rates for longer, saying it would help the Eurozone economy hit its target.
- In India, the communication has been very clear from the start that growth gets priority and RBI has reiterated that it will do "whatever it takes" to support the nascent recovery. The inflation concerns have been mentioned but the current assessment is that these pressures are transitory and largely driven by adverse supply side factors.
- There was only one dissenting member, Prof. Jayanth R Verma who had reservations about continuing with the accommodative stance. Prof. Verma in the Oct'20 policy had disagreed with the choice of the word "decided" when it comes to the date based forward guidance in the MPC resolution and was more in favour of the word "expected".
- The minutes can shed more light as to what reservations Prof. Verma has. But overall, the communication is clear that the accommodative stance will continue.

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