SBI RESEARCH

ECOWRAP

REVERSE REPO HIKE CAN WAIT AND COULD BE INTER POLICY TOO!

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The forthcoming monetary policy comes against the backdrop of the global scare of Omicron, that we are still trying to unravel. However, the good thing is we have now vaccinated 125 crore people and this might have given India better preparation for the future as the gap between the first and second wave was only 2 months. However, we must be conscious of vigorous contact tracing and testing as suppressing such can give us relief for a couple of months but after such the pandemic will break out with greater ferocity, as is happening in most countries. The pandemic has also worked its way through the population resulting in larger herd immunity. We thus remain hopeful from the global Omicron scare!

Meanwhile, system liquidity still remains in the surplus mode with the average daily net absorption under the liquidity adjustment facility (LAF) at Rs 7.6 lakh crore in Nov'21. However, the RBI has made a calibrated progress towards liquidity normalisation since the October policy with amount parked in overnight fixed reverse repo declining to Rs 2.6 lakh crore from Rs 3.4 lakh crore at pre-October policy. The lower increase in currency in circulation as more people are now using digital modes of payments has also contributed to the build-up of the surplus liquidity. The RBI has also largely achieved its objective of pushing up short term rates with 3M T-Bill rate which was below reverse repo for major part of August now at 3.52%, factoring in the impact of VRRR. Similarly, 6M and 1 Year T-Bill rates have shifted upwards by 20-30 bps since last MPC.

Against this background, we believe the talks of a reverse repo rate hike in the MPC meeting may be premature as RBI has been largely able to narrow the corridor without the noise of rate hikes and ensuing market cacophony. Section 45Z (3) of the amended RBI Act of 2016 clearly states that "*The Monetary Policy Committee shall determine the policy rate required to achieve the inflation target*". Nowhere in the MPC's mandate is there any reference to its role in liquidity management, which remains internal to the functioning of the Bank consistent with its policy stance. **Thus, the RBI is not obliged to act on reverse repo rate only in MPC**. **Also, change in reverse repo rate is an unconventional policy tool that the RBI has effectively deployed during crisis when it moved to a floor instead of the corridor**. As Goodhart (2010) observes, the width of the policy corridor acts as an independent instrument for the central bank in a crisis and an asymmetric corridor is a logical outcome under such. **We believe, the RBI may deflate the hype around reverse repo hike in monetary policy by explaining the virtues of using reverse repo change as a pure liquidity tool and not a rate tool!**

The main advantage of a floor system is that monetary policy, to phrase Keister et. al. (2008), can be divorced from money. The central bank can (for whatsoever reason) supply any amount of additional liquidity without pushing short-term money market rates below the key policy rate. Thus the interest rate can be set to achieve monetary goals, while the amount of liquidity in the banking system can play the role of financial market stabilization. **Since pandemic, the RBI has done exactly this balancing act, and the pandemic is not yet over!**

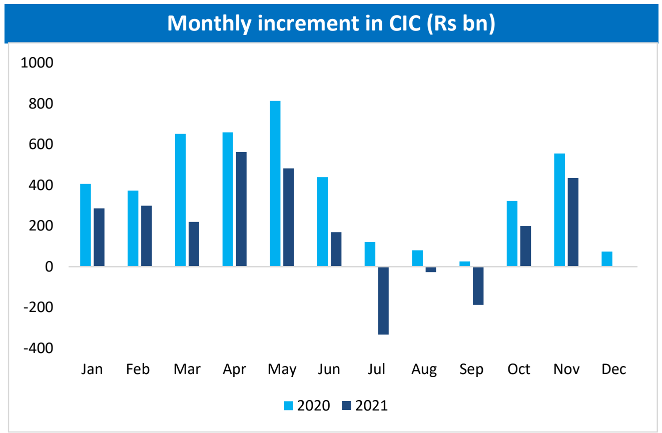
Finally, US Fed has indicated accelerating the bond tapering program, thereby ending it earlier than anticipated. The rate hikes are also in card sooner than expected as inflation is no longer chided as transitory. Unless Omicron proves more fatal than Delta variant, this in turn would imply strengthening of the dollar and depreciation pressures for the rupee. Thus RBI would have to look for multiple objectives.

Against this background, delaying normalisation measures is prudent in the current situation which would also give time for economic recovery to strengthen further. Also, rate differential needs to emerge between VRRs of different maturities so that Banks are incentivised to park funds in the longer tenor VRRRs. This can be achieved by reducing the amount available under auction in 7days and reallocating the same to 28 days.

Additionally, as per RBI notification in Feb' 21, the dispensation of enhanced HTM of 22% was extended till March 31, 2023 to include SLR securities acquired between April 1, 2021 and March 31, 2022. Further, the enhanced HTM limit has to be restored to 19.5% in a phased manner, beginning from the quarter ending June 30, 2023. However, the notification remains silent on acquisition of securities in HTM between April 2022 and June 2023. Clarification in this regard may be provided.

CURRENT LIQUIDITY SITUATION

- RBI has been actively managing liquidity in the system through various means. However, system liquidity still remains in the surplus mode with the average daily net absorption under the liquidity adjustment facility (LAF) at Rs 7.6 lakh crore in Nov'21. The durable liquidity stands at Rs 11.2 lakh crore compared to Rs 12.0 lakh crore at the time of previous policy. Liquidity surplus has progressively narrowed since RBI stopped liquidity infusion through GSAP operations. Total absorption under VRRR has increased from Rs 5.44 lakh crore on 7 Oct'21 to Rs 6.95 lakh crore on 30 Nov'21.
- The amount parked in overnight reverse repo has seen reduction with major portion of banking liquidity being parked in longer tenor VRRRs offering higher rates. Total amount parked in overnight fixed reverse repo is around Rs 2.6 lakh crore compared to Rs 3.40 lakh crore before October MPC. Overnight rates still hover around the lower end of the corridor with Treps averaging around 3.30%. It is observed that overnight rates start rising towards the upper end of corridor as total amount parked in Overnight Reverse Repo dips below Rs 1 lakh crore.
- Asymmetric distribution of liquidity and avenues to deploy between Banks and other participants led to arbitrage opportunities for Banks between VRRR and Treps/ Croms. As VRRR absorption increases, competition for borrowed funds in Treps/ Croms increases, leading to spike in rates in that segment. Despite higher available VRRR auction size, participation is limited by Banking system's ability to borrow and place funds.
- RBI operates VRRR under its main operation (14 Day) and fine-tuning operation (7D/ 28D). The cut-offs in all VRRRs have been converging towards the upper end of the corridor (3.98%). Rate differential needs to emerge between VRRs of different maturities so that Banks are incentivised to park funds in the longer tenor VRRRs. This can be achieved by reducing the amount available under auction in 7D and reallocating the same to 28D. Further increase in total amount available under VRRR shall have marginally less utility as Banks are constrained by their ability to borrow and place funds profitably.



Source: RBI; SBI Research

Monthly Change in digital payments (Rs billion)

	Credit Card		Debit Card		UPI	
	2020	2021	2020	2021	2020	2021
Jan	8	13	1	-20	137	150
Feb	-44	-46	-43	-39	63	-61
Mar	-116	122	-104	82	-161	798
Apr	-298	-133	-250	-112	-553	-112
May	115	-43	147	-130	673	-30
Jun	105	80	97	78	434	567
Jul	28	121	26	100	287	589
Aug	48	28	44	38	78	328
Sep	8	25	6	-23	307	152
Oct	135	133	138	97	571	1171
Nov	-23	-37	-13	-42	49	-30

Source: RBI, NPCI, * October and November 2021 change is from Daily Payment and Settlement Systems data from RBI

LOWER RATE OF CURRENCY INCREASE AND HIGHER GROWTH IN DIGITAL PAYMENTS

- The lower increase in currency in circulation (CIC) as more people are now using digital modes of payments has also contributed to build up of the surplus liquidity. During Apr'21-Nov'21 so far, incremental CIC stands at Rs 1.3 lakh crore compared to Rs 3.2 lakh crore during the same period last year.
- The digital payments data shows increasing use of UPI compared to debit and credit cards. As many as 3.5 billion transactions worth Rs 6.3 trillion were recorded through UPI in the month of October 2021 signalling a jump of 100% while transaction value jumped by nearly 103% compared to October 2020. However, the latest daily data from RBI shows modest decline in November compared to October.

POLICY CORRIDOR

- Across the world, the most common liquidity operational framework is a so-called corridor system, which India also currently practices. Developments during the financial crisis of 2008 and 2009 have, at least temporarily, changed the way monetary policy is implemented in many countries.

- Before the crisis, most countries implemented policy through some form of a corridor system. During the crisis, the need to supply more reserve balances meant that many central banks found it necessary to move towards a floor system, in order to break the link between reserves and the overnight interest rate. In a floor system, there are limited incentives for interbank trading, but the central bank can control the overnight rate and the level of excess reserve balances independently.
- India currently follows the corridor system, however, in the current situation of excess liquidity reverse repo becomes the effective policy rate.

INFLATION SCENARIO

- Increase in tariffs by telecom companies is likely to have some impact on inflation going ahead. Also, GST has been hiked on apparel and footwear to 12% from 5%, effective Jan'22. This too will have some impact on inflation. Our estimates show that increase in telecom tariffs will increase CPI inflation by around 25 to 30 bps while GST hike on apparel and footwear might have a positive impact of around 15 bps on CPI inflation. We believe CPI inflation for Q4 FY22 would come around 6.3%.

POLICY EXPECTATIONS: STATUS QUO

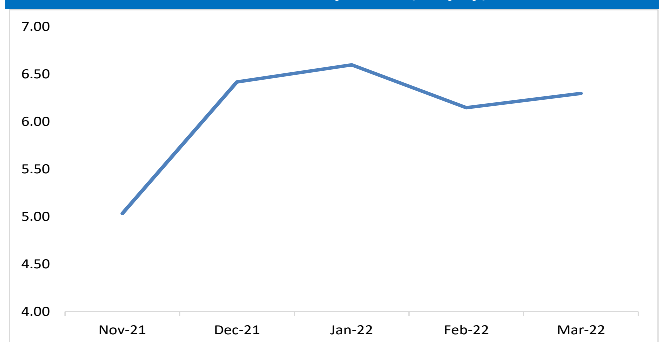
- 3M T-Bill rate which was below reverse repo for major parts of August and September has moved up with VRRR increases announced by RBI. Currently 3M T-Bill is at 3.52%, factoring in the impact of VRRR and expected normalisation measures of RBI. Similarly, 6M and 1 Year T-Bill rates have shifted upwards by 20-30 bps since last MPC. VRRR and expected corridor normalisation had a flattening effect on the G-Sec curve with yields in shorter dated securities moving up while longer dated securities traded range bond. Similarly, spreads between shorter and longer tenor OIS has seen compression. Pre policy spread of 93 bps between 2Y OIS and 5Y OIS has compressed sharply to 63 bps signifying the effect of normalization measures.
- Markets expect RBI to narrow the rate corridor to 25 bps in two steps by Feb 2022 MPC. Debt market is already pricing-in this normalisation. OIS markets have run ahead of RBI and currently pricing in corridor normalisation and 50 bps of cumulative Repo rate hike in the next 12 months. Higher than expected tax revenues, anticipated announcements related to Bonds Index inclusion and degree of steepness in yield curve is expected to cap rise in 10-year yield despite RBI normalisation measures.

Inflationary impact of rise in telecom tariffs and GST

Items	Effective Weight	Current Weighted contribution in CPI	Impact on CPI
Clothing and footwear	5.4	0.39	15 bps
Transport and communication	1.8	0.83	25 to 30 bps

Source: SBI Research

CPI Inflation Projection (%, yoy)



Source: SBI Research

- However, corridor normalisation has to be communicated without raising rate hike bets. The stance needs to continue to be accommodative to support growth while the recovery remains uneven. Any change in stance at this point may disrupt the markets affecting the nascent recovery.
- G-sec rates, although on a rising trajectory, have taken comfort in the supply-demand balance. Rate cues from RBI, not in line with the market expectations may disrupt this balance. Liquidity neutral Operation Twists can be announced as per requirement to tame longer tenor rates.
- The latest CPI inflation also indicates that weighted contribution of domestic inflation has been falling since July while that of imported inflation is rising gradually. Thus, inflation dynamics too don't warrant a change in the policy currently.
- Globally, there have been renewed concerns about a new coronavirus variant, Omicron. When the second wave hit India, our genomic sequencing capacity was not adequate as INSACOG was created right around March. Further, vaccination remained confined to frontline personnel.

- However, in the current situation, with average number of new cases remaining below 10K and the capacity to sequence 1,000 genomes per day, our ability to detect new variants seems at a far better pedestal than during earlier phases.
- Analysis of historical data across geographies does prove that suppressing contact by imposing phased lockdowns can keep a lid on rising cases only for a limited period, with the pandemic intensity seeing higher resurgence once restrictions are lifted.
- Waning immunity levels, manifesting requirements of additional booster doses to already vaccinated lot as also less than desired numbers on administering double dose to all eligible at present should be the new frontiers of concern for us even as we brace for the Omicron, while drawing solace from the fact that we have at least partly vaccinated a large percentage of country.
- With proven models to predict the likely caseloads and corresponding resources needed in specific states or at national level, along with benefits of a shorter prediction lead time now (should a new variant do a sweeping act replacing the Delta/Plus variants) and availability of ICMR's sero-survey data of June-July, policy makers have better prospects of neutralizing the perils of pandemic if the Omicron variant proliferate rapidly, as being feared.
- The travel restrictions imposed by many countries on the source of the new strain seems to ratify the quick transmissibility of Omicron, though the low vaccination numbers in the sub-African region could well be an exceptional enabler towards the unfolding scenario.
- The US Fed has also indicated accelerating the bond tapering program, thereby ending it earlier than anticipated. The rate hikes are also in card sooner than expected as inflation is no longer considered transitory with realization dawning on most Developed Markets that inflation could be persisting in sync with Government spending and rising levels of wealth. Unless Omicron proves more fatal than Delta variant, this in turn would imply strengthening of the dollar and depreciation pressures for the rupee.
- Thus RBI would also have to take into account the rising depreciation pressures on the Rupee along with managing liquidity.
- The evolving situation needs to be carefully watched. Delaying normalisation measures is prudent in the current situation which would also give time for economic recovery to strengthen further. As the situation is still evolving, a status quo may be maintained in the next policy, keeping in mind the effective rate has already been pushed up with VRRRs and the amount and tenor of the same can be fine tuned for desired outcome.

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