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THE LIMITS OF MONETARY POLICY INTERVENTION: TIME FOR FISCAL POLICY TO DECISIVELY LEAN WITH THE WIND

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As widely expected, there was no change in the key policy rate at the second MPC meeting for this fiscal, with the central bank strongly emphasizing an accommodative stance as long as required to support the economy. RBI, however, reduced its projection of real GDP growth for FY22 by 100 bps to 9.5% consisting 18.5% in Q1 (earlier: 26.2%), 7.9% in Q2 (earlier: 8.3%), 7.2% in Q3 (earlier: 5.4%) and 6.6% in Q4 (earlier: 6.2%). Interestingly, though RBI has reduced growth projections for Q1 and Q2 it has enhanced projections for Q3 & Q4, specifically Q3 by a large margin. RBI, thus, clearly expects a vaccination driven recovery post September and that should help to normalise economic activity quickly. We are, however, skeptical of a sharp pick up in growth outlook in Q3 given the devastation in rural economy and the slow vaccination. **Thus RBI forecast of 9.5% could be more of a sombre signaling of a weak growth outlook as of now.**

RBI has projected CPI inflation at 5.1% for FY22 with 5.2% in Q1; 5.4% in Q2; 4.7% in Q3; and 5.3% in Q4 FY22. The rising trajectory of international commodity prices, especially of crude, together with logistics costs, pose upside risks to the inflation outlook while a normal south-west monsoon should help to keep cereal price pressures in check. We believe inflation management could pose a serious challenge to RBI when the fuel price pass through starts to occur.

RBI has also been conscious about alleviating the stress in specific sectors through targeted liquidity measures with an effort to ensure that the distribution of liquidity is uniform. Thus to support certain contact-intensive sectors, RBI has opened a separate liquidity window of ₹15,000 crore with tenors of up to 3-years at the repo rate till March 31, 2022. RBI also provided SIDBI with special liquidity facility of Rs 16,000 crore available at repo rate for 1 year.

RBI has also increased the borrowers' exposure limit from ₹25 crore to ₹50 crore for COVID-19 under Resolution Framework 2.0. As per our estimate, almost 35-45 lakh units (with outstanding of ₹6-7 lakh crore) are already eligible for Resolution Framework 2.0 under the exposure limit of ₹25 crore. The distribution indicates that almost 80% of such units are in less than ₹10 lakh category. The increase in limit to ₹50 crore will now additionally include at most 5000 units, though their outstanding amount eligible for restructuring will be significant.

The G-SAP programme of the RBI has been largely successful in keeping the bond yields in check. However, to make the impact more meaningful, RBI may consider shifting the focus on 7-8 year papers while announcing OMO/ G-Sap etc. This will smoothen the curve and also reduce upward pressure on benchmark yield. Additionally, RBI can also come up with a prior calendar of bucket-wise maturity for GSAP-2. Furthermore, more purchases might be done in illiquid securities compared to liquid securities in each bucket. Accordingly, banks will be able to offload their HTM stocks and buy liquid ones.

We firmly believe that even as RBI has taken many measures to reinvigorate credit offtake, it continues to be low because corporates have deleveraged by repaying high-cost loans through funds raised through bond issuances. Corporate willingness for new investments remains low among all-pervasive uncertainty. **Only fiscal policy can rekindle animal spirits at this juncture – monetary policy has almost nil headroom.**

In this respect, we recommend the use of automatic stabiliser route to manage fiscal levers. This would mean that fiscal deficit can purely go up via the automatic fiscal stabilizer route whereby a reasonable cut in fuel prices or even GST tax waivers for stressed entities could work wonders. The loss in revenue for growth collapse is not in the hands of Government and hence it may be worthwhile to support fiscal policy through tax adjustments. Otherwise, economic recovery will continue to be hamstrung at fuel prices more than Rs 100 when the economy opens up after lockdown.

Finally, Reserve Bank has intervened in the forex market through operations in the onshore/offshore OTC and exchange traded currency derivatives (ETCD) segments in order to maintain orderly market conditions by containing excessive volatility in the exchange rate and accumulating sizeable reserves as ammunition. This may have nothing to with reserve transfer!

RBI HOLDS RATE

- RBI's Monetary Policy Committee has unanimously decided to keep policy Repo rate unchanged at 4% (6th 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 remain at 4.25%.
- RBI reduced its projection of real GDP growth for FY22 by 100 bps to 9.5% consisting 18.5% in Q1 (earlier: 26.2%), 7.9% in Q2 (earlier: 8.3%), 7.2% in Q3 (earlier: 5.4%) and 6.6% in Q4 (earlier: 6.2%). Interestingly, though RBI has reduced growth projections for Q1 and Q2 it has enhanced projections for Q3 & Q4, specifically Q3 by a large margin. RBI thus clearly expects a vaccination driven recovery post September and that should help normalise economic activity quickly. We are ,however , skeptical of a sharp pick up in growth outlook in Q3 given the devastation in rural economy. **Thus RBI forecast of 9.5% could be more of a somber signaling of a weak growth outlook.**
- Coming to CPI projections, RBI has projected CPI inflation at 5.1% for FY22 with 5.2% in Q1; 5.4% in Q2; 4.7% in Q3; and 5.3% in Q4 FY22. The rising trajectory of international commodity prices, especially of crude, together with logistics costs, pose upside risks to the inflation outlook while a normal south-west monsoon along with comfortable buffer stocks should help to keep cereal price pressures in check. We believe inflation management could pose a serious challenge to RBI when the fuel price pass through starts to occur.

GLOBAL ECONOMY

- The RBI expects that global growth will be better going forward driven mainly by major advanced economies (AEs) and powered by massive vaccination programmes and stimulus packages.
- Activity remains uneven in major emerging market economies (EMEs), with downside risks from renewed waves of infections due to contagious mutants of the virus. World merchandise trade continues to recover as external demand resumes, though elevated freight rates and container dislocations are emerging as constraints.
- Better than expected US numbers have led to some hardening of US treasury yields. The yields have almost touched the levels just at start of the pandemic. But at the same time The Dollar Index (DXY) has lost 9 points since the onset of the pandemic in Jan 2020.

RBI Growth & Inflation Outlook for India

CPI (%)	Q1 FY22	Q2 FY22	Q3 FY22	Q4 FY22	FY22
Jun'21	**5.2**	**5.4**	**4.7**	**5.3**	**5.1**
Apr'21	5.2	5.2	4.4	5.1	5
Feb'21	5.2	5	4.3		
Dec'20	5.2	4.6	-	-	-
Real GDP Growth (%)	**Q1 FY22**	**Q2 FY22**	**Q3 FY22**	**Q4 FY22**	**FY22**
Jun'21	**18.5**	**7.9**	**7.2**	**6.6**	**9.5**
Apr'21	26.2	8.3	5.4	6.2	10.5
Feb'21	26.2	8.3	6	-	10.5
Dec'20	21.9	6.5	-	-	-

Source:RBI, SBI Research

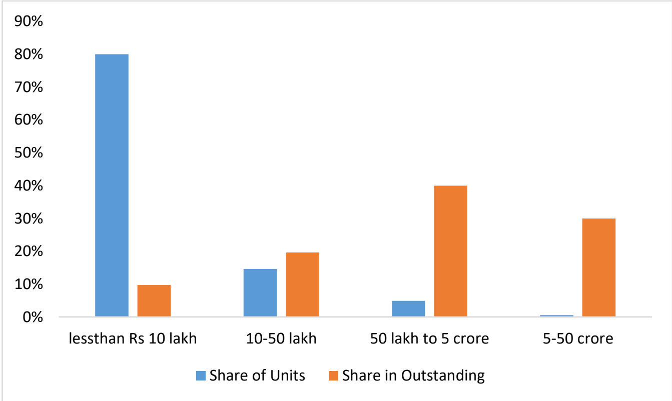
- The on-going uncertainty from the coronavirus pandemic, an increase in USD money supply due to higher proposed fiscal stimulus will keep the USD weaker than other currencies. It is expected that interest in major currencies will remain low with the exception of Canadian dollar where there is upcoming suspension of some of its major asset-purchase programs.

IMPACT OF DEVELOPMENTAL & REGULATORY MEASURES

- **On-tap Liquidity Window for Contact-intensive sectors:** During 2020-21, the global central banks and governments have taken extraordinary measures to mitigate the economic and financial spill over risks from the COVID-19 pandemic. Central banks in all geographies responded swiftly and deployed all options available in their toolkit, both conventional and unconventional, to support their economies. The universally used measures were policy rate reductions and provision of domestic and foreign exchange liquidity.
- RBI has also taken several policy measures to support the stressed sectors in terms of liquidity by special repo window, relaxation in CRR for banks on the credit offtake etc. With this the alleviating stress in specific sectors has been attended through targeted liquidity measures but there is a need for the distribution of that liquidity which is important.
- To support certain contact-intensive sectors (like hotels and restaurants; tourism; aviation ancillary services; and other services that include private bus operators, car repair services, rent-a-car service providers, event/ conference organisers, spa clinics, and beauty parlours/ saloons etc), RBI has opened a separate liquidity window of ₹15,000 crore with tenors of up to 3-years at the repo rate till March 31, 2022. This was need of the hour, as the value added by the sector 'Trade, Hotel, Transport' has hardly hit and contracted by 18.2% in FY21. The move will provide the sector much-needed liquidity support amid materially constrained cash generation ability due to several localised lockdowns.

- **Enhancement of the Exposure Thresholds under Resolution Framework 2.0:** RBI has increased the exposure limit from Rs 25 crore to Rs 50 crore for COVID-19 related stressed businesses under Resolution Framework 2.0. The restructured amount will not only provide much needed breather to the units but also has multiplier effect on all the economic agents connected to the units. As per our estimate, almost 35-45 lakh units (with outstanding of ₹6-7 lakh crore) are already eligible for Resolution Framework 2.0 under the exposure limit of ₹25 crore. The distribution indicates that almost 80% of such units are in less than ₹10 lakh category. The increase in limit to ₹50 crore will now additionally include at most 5000 units, though their outstanding amount eligible for restructuring will be significant.
- **Placement of Margins for Government Securities Transactions on behalf of FPIs:** In government securities market, the low levels of limit utilisation at 38.4% by FPI entails that FPI have not taken position in government securities. With a view to easing operational constraints faced by FPIs and promoting ease of doing business, RBI has permitted Authorised Dealer banks to place margins on behalf of their FPI clients for their transactions in G-secs (including State Development Loans and Treasury Bills), within the credit risk management framework of banks. This will bring the necessary additional liquidity thus checking yields.
- **Permitted RRBs to issue Certificates of Deposit (CDs):** To facilitate small banks, especially RRBs, in their liquidity management, RBI has already allowed them to participate in the call/notice/term money market, subject to prudential limits. The RBI has further allowed RRBs to issue CDs to eligible investors, which will help them to manage their liquidity efficiently.
- With the support from RBI, the CD ratio of RRBs has been rising from 61% in June'20 to 66% in Mar'21. Among the RRBs, it has been observed some RRBs has crossed or near to 100% CD ratio, which are not allowing them to lend more.
- **Availability of National Automated Clearing House (NACH) on all days of the week:** The volumes of DBT transactions through NACH products has steadily increased over the years and in FY21 5.7 billion DBT transactions worth Rs 3466.2 billion were conducted. To further provide customer convenience, and to take advantage of the availability of RTGS on all days of the year, RBI has now proposed to make available NACH on all days of the week throughout the year, effective August 1, 2021.

Eligible MSME units under Resolution Framework 2.0 (upto Rs 25 crore)



Source: SBI Research

FPI Debt (G-Sec) Utilisation Status					
Instrument Type	Eligible Foreign Investors	Upper Limit (Rs Cr)	Total Investment (Rs Cr)	% of Limits Utilised
Central Government Securities	General	243914	93671	38.4
	Long Term	112914	19797	17.5
State Development Loans	General	76766	825	1.1
	Long Term	7100	0	0

Source: CCIL; Data as of 04 June

- **Special Liquidity Facility to SIDBI:** RBI has extended special liquidity facility of Rs 16,000 crore available at repo rate for 1 year, for on-lending / refinancing through novel models and structures including double intermediation, pooled bond / loan issuances, etc. This is in addition to Rs 15,000 crore announced in the Apr'21 policy. This is a timely measure specially in the light of the fact that SIDBI plays an important role in extending credit to MSME sector which has been hard hit by the pandemic. In FY20 also RBI extended ₹15,000 crore support to SIDBI, of which SIDBI had already sanctioned assistance to 16 Banks, 50 NBFCs and 39 MFIs, by 31 Jul'20, at Repo-linked rates to tide over the crisis.

Successful transactions in NACH Products- Direct Benfit Transfer

	Volume(billion)	Value(Rs billion)
2016-17	1.5	1305.7
2017-18	1.8	2663.9
2018-19	2.1	4530.9
2019-20	2.5	5122.3
2020-21	5.7	3466.2

Source: SBI Research

TWEAKING THE G-SAP COULD BRING MORE BENEFITS

- Under the G-SAP 1.0 programme two auctions have been conducted so far (₹ 25,000 crore in April and ₹35,000 crore in May). This had an impact on reducing the yields and borrowing costs. The 10-year G-sec yield declined to an average of 6.07% in April from 6.19% in Mar'21. It further dipped to an average of 5.99% in May'21. Likewise, the AAA corporate bond yields have reduced, leading to lower spread to 70 bps in Apr'21 from 100 bps in Mar'21. However, the spread increased to 82 bps in May'21. Also, the weighted average yield of CP has reduced in the last two months.
- The RBI has further announced further purchase of ₹40,000 crore under G-SAP 1.0 on 17 June. However, of this ₹10,000 crore would be in SDLs (State Development Loans). This in turn will have negative impact on the G-Sec as earlier the whole amount was in Central government papers. Furthermore, G-SAP 2.0 has been announced for Q2 FY22 for ₹ 1.2 lakh crore. Though the G-SAP 1.0 program helped in stabilising market expectations, possibly a lower than expected amount of purchase in G-SAP 2.0 has led to increase in G-Sec yield to 6.01%.
- **However, some tweak is required in the G-SAP program to make the impact more profound on the markets**. For example, looking at the yields, RBI efforts are clearly seen on 10 year benchmark, this is also resulting in stress in G Sec yield curve. At this time the while the 10 year benchmark is at 6.01%, Jan 2028 paper is traded at 6.18% and July 2029 paper is traded at 6.28%. The high yields in shorter terms paper is actually pulling 10 year yield up.
- RBI may consider to shift the focus on 7-8 year papers and papers of these tenor can be preferred while announcing OMO/ G-Sap etc. This will smoothen the curve and also reduce upward pressure on benchmark yield.
- Additionally, RBI can also come up with a prior calendar of bucket-wise maturity for GSAP-2. This way without even deciding on security, RBI can push yields down in required maturities. Furthermore, more purchases should be done in illiquid securities compared to liquid securities in each bucket. Accordingly, banks will be able to offload their HTM stocks and buy liquid ones.

EXCHANGE RATE AND FOREX MARKET INTERVENTION BY RBI

- India witnessed a record amount of foreign investment inflows into equity markets which supported the rupee. Due to the volatile nature of inflows, they increase the possibility of a currency getting hammered once sentiments start turning sour.

Average yield data (%)

	Mar'21	Apr'21	May'21	Jun'21
91 Day T bill Yield	3.26	3.34	3.37	3.41
10 Year Gsec Yield	6.19	6.07	5.99	6.01
AAA Corporate Bond Yield	7.20	6.77	6.81	6.73
G-Sec& AAA Corp Bond Spread	1.00	0.70	0.82	0.72
CP WAY	4.35	3.73	3.75	3.76

Source: SBI Research

- This is especially true for developing market currencies. Sell-off pressures are only warded off when there are ample foreign reserves with the central bank of the said economy.
- Thus, the Reserve Bank intervened in the forex market through operations in the onshore/offshore OTC and exchange traded currency derivatives (ETCD) segments in order to maintain orderly market conditions by containing excessive volatility in the exchange rate and accumulating sizeable reserves as ammunition.
- There has been some speculation in the market that RBI intervened in the forex market heavily which facilitated the large surplus transfer to the government.
- This is misleading as RBI's two-way intervention in the forex market (currently buy-sell, earlier sell-buy) was due to a constellation of global and domestic factors, which resulted in episodic bouts of outflows/inflows. It is not as if the RBI intervened heavily to generate more profits which was transferred to the government.
- The valuation of Currency and Gold , Investment in Foreign Securities and Rupee Securities and Forward Exchange Contracts does not occur at the end of the financial year in RBI's annual accounts. They are done at different intervals throughout the year and Rupee has shown movement in both the directions during the year.

RBI Intervention, exchnage rate and capital flow($ million)

	Net Foreign Direct Investment	Net Portfolio Investment	Net Purchase(+)/ Sale (-)of Foreign Currency	Average Spot exchange rate (USD/INR)	Outstanding Net Forward Sales (-) /Purchase (+)
Jan-20	5,252	2,039	10,266	71.29	-1,215
Feb-20	2,737	-1,148	9,144	71.49	-2,295
Mar-20	3,974	-14,635	-4,054	74.43	-4,939
Apr-20	171	-1,972	-1,142	76.24	-1,739
May-20	-183	-561	4,363	75.68	-1,958
Jun-20	-788	3,174	9,814	75.75	2,459
Jul-20	3,513	472	15,973	74.97	-379
Aug-20	18,163	5,347	5,307	74.63	10,351
Sep-20	2,907	1,178	8,172	73.51	13,881
Oct-20	4,563	2,943	15,640	73.47	13,556
Nov-20	5,636	9,427	10,261	74.27	28,344
Dec-20	6,509	8,403	3,991	73.62	39,792
Jan-21	3,520	1,508	2,854	73.11	47,383
Feb-21	-2891	2845	-1219	72.80	74,014
Mar-21	1971	3634	-5699	72.81	68,315

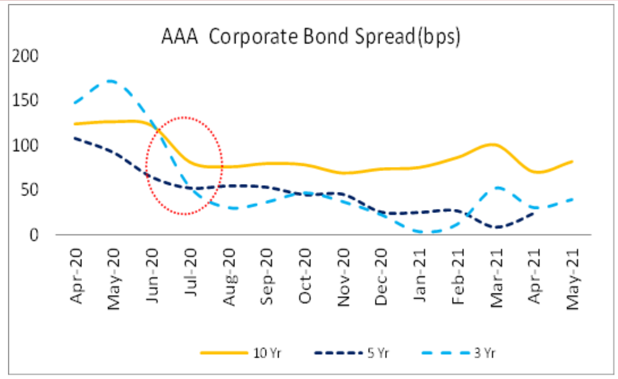
Source: SBI Reseach

- The data till March shows that Rupee has been allowed to appreciate and in fact RBI went turned net seller in the last two months of this fiscal. The objective of the central bank is to keep the financial markets stable as is clear through its two sided interventions in spot, forward and futures markets.

TEPID DEMAND FOR CREDIT BY CORPORATES

- Credit offtake continues to be low because corporates have deleveraged by repaying high-cost loans through funds raised through bond issuances. Corporate willingness for new investments remains low among all-pervasive uncertainty. **Only fiscal policy can rekindle animal spirits at this juncture – monetary policy has almost nil headroom.**
- In our analysis of more than 1000 listed entities, it is observed that across sectors corporates deleveraged to cut finance cost and also used the bond market route to substitute high cost debt through bond issuances. Some of the sectors where higher reduction of loan funds were witnessed during FY21, include Refineries, Steel, Fertilisers, Mining and Mineral Products, Textiles etc.
- Primary issuances of bond, as per CCIL, by Manufacturing sector increased to ₹34764 crore in FY21 from ₹5585 crore in FY20. Further, it is interesting to note in the year of pandemic i.e. FY21, corporate issuance of bond was to the tune of ₹7.52 Lakh crore, a growth of 9% over FY20, against bank credit growth of 6%, taking benefit of the declining spread. Resource raised through equity instruments also increased by 105% during FY21.
- Spread of AAA bond for a 10-year tenor declined from 124 bps in April 2020 to 70 bps in April 2021. Similarly spread for 5 year and 3-year bond declined from 89 bps and 147 bps in April 2020 to 9 bps and 30 bps in April 2021 respectively.
- Investment announcements seem to be bleak in private sector, where new investment announcement, has declined by 56% to ₹3.6 lakh crore in FY21 from ₹8.28 lakh crore in FY20.

Credit Consumption from different sources (Rs lakh crore)			
Descriptions	FY20	FY21	Growth
Bond Primary Issuances	6.90	7.52	9%
Equity (IPO/ FPO/ OFS/ QIP/ InVits etc.)	0.92	1.89	105%
Bank Credit O/s	103.72	109.51	6%
Source: SBI Research; Prime database; CCIL			



SOME FOOD FOR THOUGHT: NEED TO VACCINATE TEACHERS ON URGENT BASIS

- Education system is badly hit by the Covid-19 pandemic. As a precautionary measure all schools/ colleges/universities has remained closed in both first and second wave. As the fear of third wave is still looming, it is pertinent to vaccinate all teaching and non-teaching staff at an urgent basis so that when the new session will begin all the staff members will be duly vaccinated at least with one dose. In India, as per the latest available data there are around 87 lakh school teachers and 14.2 lakh college and university teachers. Colleges and universities have 12.1 lakh non-teaching staff also. **In total, Government needs to vaccinate these 1.13 crore teaching plus non-teaching staff as early as possible so that we don't need to cancel the board examinations once more!**

Total teaching + Non-teaching staff (in lakh) in India		
School Teachers (2015-16)	Primary Only	26.1
	Upper Primary only	26.1
	Secodary only	14.3
	Higher Secondary Only	20.4
	Total Teachers	86.9
University & College Teachers (2018-19)	Teaching Staff	14.2
	Non-teaching staff	12.1
	Total	26.3
Total teaching + Non-teaching staff		113.2
Source: SBI Research		

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