SBI RESEARCH

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RBI POLICY: DELICATE BALANCE OF REMOVING LIQUIDITY OVERHANG WITH NO UNANTICIPATED POLICY SURPRISE

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The global energy market is currently in a conundrum. Natural Gas prices, Crude oil prices have jumped manifold in recent weeks. Subdued investment in fossil fuels will only imply that the resultant volatility could be a recurring theme in future. Interestingly, the world is currently witnessing a capital expenditure boom in container ships and microchips.

Additionally, the impact of rise of prices in China will have impact on general prices of all countries dependent on material inputs. India, with over $80 billion imports from China will be impacted form rising pricing in China. Under the assumption that there will be complete pass through of rise in cost, the rise in input cost for top 20 sectors dependent on China as per our estimates could be as much 2-6 basis points. Cumulatively, the impact could be 40-120 basis points.

Against this background the RBI policy statement had to walk a very tightrope and delicate balance. In terms of liquidity management, RBI has made its intentions clear with a discontinuation of G-Sap and scaling up of VRRR. Interestingly, the liquidity management is also hamstrung by the RBI unwinding of forward premia by as much as $23 bn in the last couple of months. If the RBI wants to discourage liquidity injection in lieu of such unwinding, as the MPR notes the "*resultant rollover can trigger a vicious cycle of higher inflows and even further increase in the forward premia*". In fact, in first half of FY22, the net forex purchases by RBI were as much as Rs 3 lakh crore and the currency leakage contrary to historical trends was also minimal. Given all this, the RBI's attempt to bring down the reverse repo to Rs 3-4 lakh crore in December as the Governor has stated from the current Rs 8.8 lakh crore will be the most challenging. Capital inflows typically are autonomous and hence will pose additional challenge in liquidity management. **We thus believe that the normalization of reverse repo and repo corridor may be possibly delayed beyond December.**

On the domestic front, the level of real GDP in Q1 FY22 was 9.2% below its pre-pandemic level two years ago. Monsoon picked up in September, narrowing the deficit in the cumulative seasonal rainfall to 0.7% below the long period average and kharif sowing exceeded the previous year's level. Nevertheless, there is still some way to go before growth impulses will have attained the critical mass. Rising metals and energy prices, acute shortage of key industrial components and high logistics costs are adding to input cost pressures. Accordingly, real GDP growth is retained at 9.5% in 2021-22 consisting of 7.9% in Q2; 6.8% in Q3; and 6.1% in Q4 of 2021-22. On the inflation side, RBI expects the inflation trajectory is set to edge down during Q3 FY22, drawing comfort from the recent catch-up in kharif sowing and likely record production. CPI inflation is projected at 5.3% for 2021-22; 5.1% in Q2, 4.5% in Q3; 5.8% in Q4 of 2021-22.

Of immediate concern is the continued increase in energy prices, with fuel prices at record high, though headline CPI provides comfort. The jump in fuel prices is reflected in terms of trade moving significantly against the agri sector with the WPI data showing the jump in non-food manufacturing price index at 10.2 per cent against primary food average at 2.2 per cent. Additionally, transport spending is down as people are not travelling and hence the prices for transport services are rising less fast than for everything else. If one adjusts the weights to downgrade the lower level of spending on travel, inflation is higher.

Separately, the policy has made a number of announcements on regulatory policies. For example, carrying out retail digital payments in offline mode would be beneficial to rural / far-flung areas that battle connectivity issues. The Payments Infrastructure Development Fund (PIDF), with a corpus of Rs 345 crore that has been operationalised by RBI in Jun'20 to create 30 lakh new touch points every year– 10 lakh physical and 20 lakh digital payment acceptance devices, for deepening digital payments in Tier-3 to Tier-6 centres, in sync with ensuring last-mile Financial inclusion for merchant transactions. Deploying geo-tagging technology to target payment infrastructure avenues - PoS, QR based payment system, AePS etc, by providing location information on an ongoing basis, should go a long way in targeting areas with deficient infrastructure for undertaking focussed remedial policy action.

Consequent to earlier cohorts involving retail payment and cross border transactions / MSME lending, RBI's announcement of the Fourth Cohort as *'Prevention and Mitigation of Financial Frauds',* will strengthen the fraud governance structure.

RBI HOLDS RATE

- RBI's Monetary Policy Committee has unanimously decided to keep policy Repo rate unchanged at 4% (8th 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 has retained its projection of real GDP growth for FY22 at 9.5% consisting of 7.9% in Q2 (earlier: 7.3%), 6.8% in Q3 (earlier: 6.3%) and 6.1% in Q4 (earlier also: 6.1%). The RBI's quarterly growth projections are changing rapidly. For example, for Q2 FY22, RBI in June policy had projected 7.9% growth, reduced to 7.3% in next policy and then again in this policy increased it to 7.9% (at the Jun level). For Q1 FY23, RBI retained GDP growth at 17.2% which is possibly on the higher side.
- Coming to CPI projections, RBI has projected CPI inflation at 5.3% for FY22 (earlier: 5.7%) with 5.1% in Q2; 4.5% in Q3; and 5.8% in Q4 FY22. CPI inflation for Q1 FY23 is projected at 5.2%. We believe inflation management could pose a serious challenge to RBI as the domestic pump prices remain at very high levels and rising metals and energy prices, acute shortage of key industrial components and high logistics costs are adding to input cost pressures. **Though a calibrated reduction of the indirect tax component of pump prices by the Centre and states can help to substantially lessen cost pressures.**

EFFECTIVE LIQUIDITY MANAGEMENT

- RBI has been effectively managing liquidity in the system with various measures taken amidst the pandemic. Liquidity has remained in the surplus mode with the average liquidity as given by Net LAF operations at Rs 7.8 lakh crore in Sep'21 compared to Rs 7.4 lakh crore in Aug'21 and Rs 5.7 lakh crore in July. This surplus liquidity has increased further to Rs 8.3 lakh crore in Oct'21 (till 7th Oct'21). The RBI has injected a total of Rs 2.4 lakh crore through OMOs, including G-SAP during Apr-Sep'21. Meanwhile, the Government surplus cash balances stand at Rs 4.0 lakh crore as on 7 Oct'21.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q2 FY22	Q3 FY22	Q4 FY22	FY22	Q1 FY23
Oct'21	5.1	4.5	5.8	5.3	5.2
Aug'21	5.9	5.3	5.8	5.7	5.1
Jun'21	5.4	4.7	5.3	5.1	-
Apr'21	5.2	4.4	5.1	5.0	
Real GDP Growth (%)	**Q2 FY22**	**Q3 FY22**	**Q4 FY22**	**FY22**	**Q1 FY23**
Oct'21	7.9	6.8	6.1	9.5	17.2
Aug'21	7.3	6.3	6.1	9.5	17.2
Jun'21	7.9	7.2	6.6	9.5	-
Apr'21	8.3	5.4	6.2	10.5	

Source:RBI, SBI Research

- Thus owing to this liquidity overhang in the system together with no additional borrowing requirement by the Government for GST compensation, the RBI has decided to stop the G-SAP operations for now. But it has decided to continue its 14-day variable rate reverse repo (VRRR) auctions on fortnightly basis and has also expressed its willingness to conduct 28-day VRRR if requirement arises.

DEVELOPMENTAL AND REGULATORY MEASURES

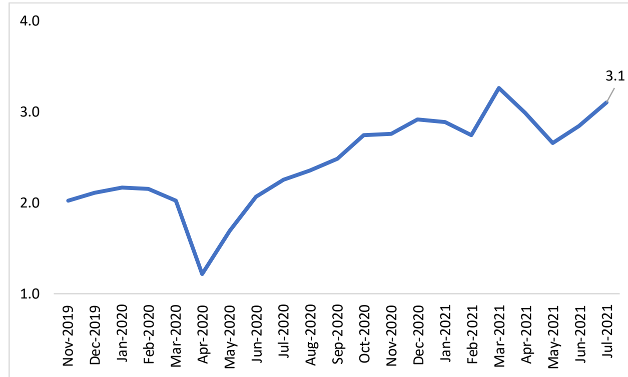
- **On Tap Special Long-Term Repo Operations (SLTRO) for SFBs:** Scheme extended till 31st Dec 2021. The scheme has also been made on-tap.
- **Introduction of Digital Payment Solutions in Offline Mode:** Carrying out retail digital payments in offline mode would be beneficial to rural / far-flung areas area that battle connectivity issues despite proliferation of internet in last few years, giving them one more simplified avenue to ensure secure shift towards digital payment.
- **Geo-tagging of Payment System Touch Points:** Payments Infrastructure Development Fund (PIDF), with a corpus of Rs 345 crore, has been operationalised by RBI in June'20 to create 30 lakh new touch points every year– 10 lakh physical and 20 lakh digital payment acceptance devices, for deepening digital payments in Tier-3 to Tier-6 centres, in sync with ensuring last-mile Financial inclusion for merchant transactions.
- Deploying geo-tagging technology to target payment infrastructure avenues - PoS, QR based payment system, AePS etc, by providing location information on an ongoing basis, should go a long way in targeting areas with deficient infrastructure for undertaking focussed remedial policy action.

- **Enhancing Transaction Limit in IMPS to ₹5 lakh:** Enhancement in IMPS limits to Rs 5 lakh per transaction from Rs 2 lakh will be catalysing the domestic payment settlements due to real-time, round the clock, multiple model accessibility features. Though IMPS transactions have crossed NEFT in terms of volume but in value it is much lower. So, the increase in limit in IMPS will help retail customers for instant transfer.
- **Regulatory Sandbox – Announcement of the Theme for a New Cohort:** Consequent to earlier cohorts, RBI today announced the Fourth Cohort as *'Prevention and Mitigation of Financial Frauds', thereby bringing to the* fore need to using technology for reducing the lag between the occurrence and detection of frauds, strengthening the fraud governance structure and minimising response time to frauds by Financial institutions, battling the menace (Indian banks and other financial institutions reported frauds worth Rs 1.38 trillion in 2020-21, down 25% compared to the previous year, when the amount involved was Rs 1.85 trillion (for fraud cases above 1 lakh).
- **Internal Ombudsman for NBFCs:** In line with Internal Ombudsman Scheme formulated for Banks and non-Bank payment system participants, RBI has extended this to select NBFCs too . The measure should mitigate the hardships of customers of these institutes to a great extent.
- **PSL- Permitting Banks to On-lend through NBFCs:** Bank lending to registered NBFCs (other than MFIs) for on lending to Agriculture (investment credit), MSE and housing (with an increased limit) was permitted to be classified as priority sector lending up to certain limits, has been extended till 31 March 2022. This will help the cash starved NBFCs for lending and banks for meeting the PSL targets.

FINANCIAL STABILITY INDEX

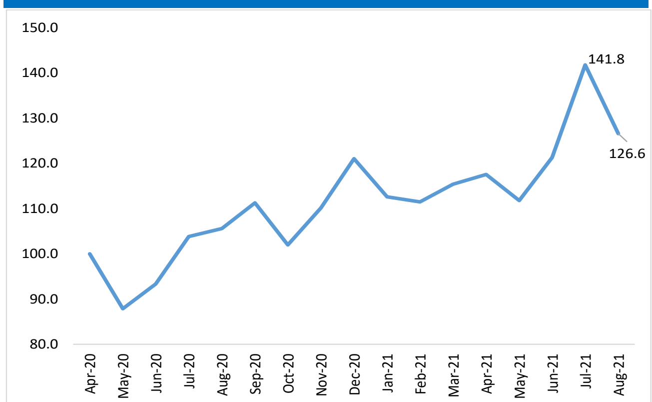
- Our Financial Stability Index which is based on 10 indicators covering banking, CP market, mutual fund market, has declined during the month of August after reaching a peak in Jul'21.
- The recent months witnessed higher mutual fund redemption, greater MF investment in Sovereign and increase in AAA corporate bond spread. Meanwhile, amount issued above the average CP rate increased along with decline in total amount issued by the corporates through the CP. All this indicates higher instability in the financial market during August.

IMPS Volume (Rs lakh crore)



Source: SBI Research

Financial Stability Index



Source: SBI Research

FUEL PRICE INFLATION

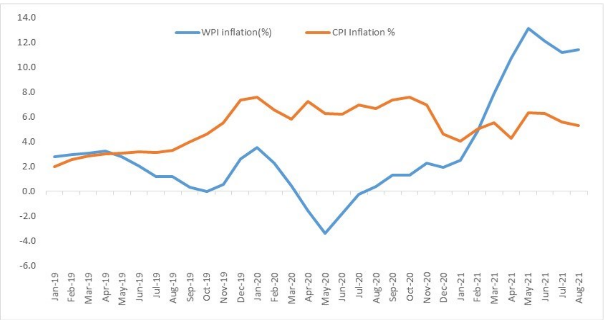
- Natural gas price has increased to \$3.62 per mmBtu for Apr'21-Sep'21 from \$1.79 per mmBtu for Oct'20-Mar'21. As there is no weight of natural gas in CPI, there is no direct impact of this on CPI inflation. But it can impact indirectly by affecting fertiliser prices since fertiliser accounts for 29% of the total natural gas consumption. However, the impact on CPI is likely to be minimal through this channel since increase in fertiliser subsidy by the Government will likely absorb the price increase.
- This is a matter of research as to what is prompting inflation in firewood and chips to increase at such a rapid pace. Firewood and chips is mainly used in rural areas for cooking purposes and increase in prices of this indicates that demand for it is more than the supply. Given the fact that almost 96.9% (Jan'20) of households in India today have an LPG connection due to Pradhan Mantri Ujjwala Yojana (PMUY), an increase in LPG prices might be the reason.

- The price of non-subsidised LPG cylinder (in Delhi) has increased from Rs 594 in Sep'20 to Rs 884.5 in Sep'21, an increase of Rs 290.5 in just one year. Interestingly the inflation in firewood and chips is also showing increasing signs post the increase in gas cylinder prices. During the same period the weighted contribution of firewood and chips has increased by almost 10 bps in CPI inflation.
- The increase in LPG prices will have a direct impact on CPI inflation, given LPG has 1.29% weight in CPI. In H1 impact of LPG price increase in CPI was 7 bps, it is expected to be 15 bps in FY22.
- Overall, there will be an impact of 25 bps in H2 FY22 through these sources.

TRADEOFF BETWEEN CPI & WPI

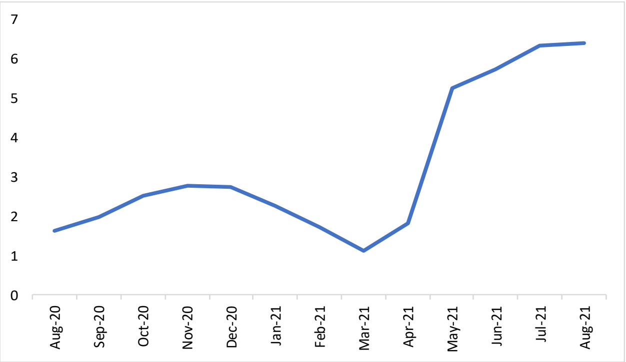
- In recent months, CPI inflation has remained below the WPI inflation, which is mainly due to the decline in food prices as food articles have higher weight (45.8%) in CPI than in WPI (15.3%). This factor plays an important role, whenever the primary trigger of inflation is food inflation.
- Policy makers cannot however afford to ignore the behaviour of WPI. WPI is not simply a reflection of international commodity prices. It also reflects domestic conditions.

WPI-CPI Divergence



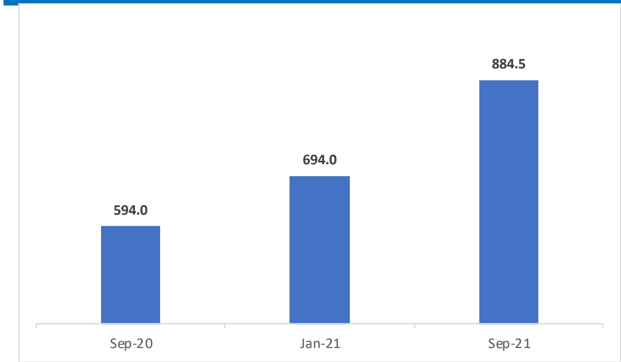
Source: SBI Research

CPI Inflation In Firewood & Chips (% YoY)



Source: SBI Research

Price of non-subsidised LPG cylinder (in Delhi) in Rs



Source: SBI Research

Impact on CPI (bps)			
	Weight (%)	H1FY22	FY22 P
Electricity	2.3	6	10
LPG	1.3	7	15
Petrol & Diesel	2.3	15	28
Total	**5.9**	**28**	**53**

Source: SBI Research; P: SBI Projections

Rise in Fuel Price Indicates in WPI-Non-food Items		
	FY21	Avg in FY22 till Aug
WPI-All Commodities	1.3	11.7
Primary Articles	1.7	8.0
Food Articles	3.2	2.2
Manufactured Non-food products	2.2	10.3

Source: SBI Research

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