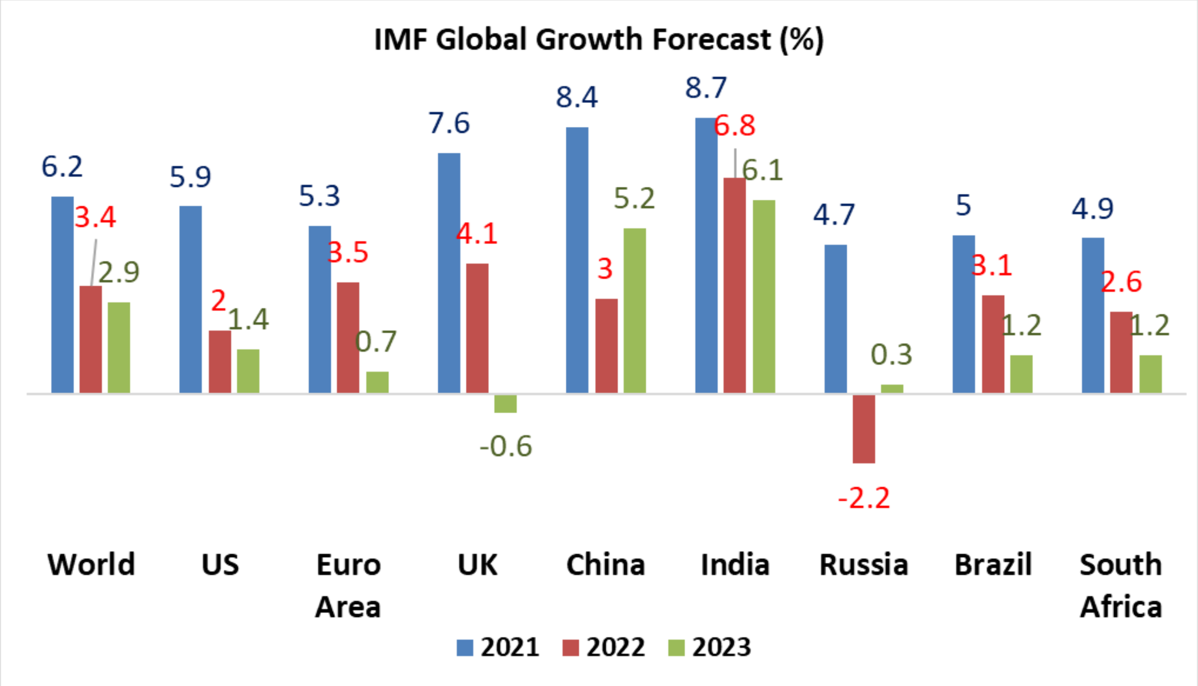
SBI Research

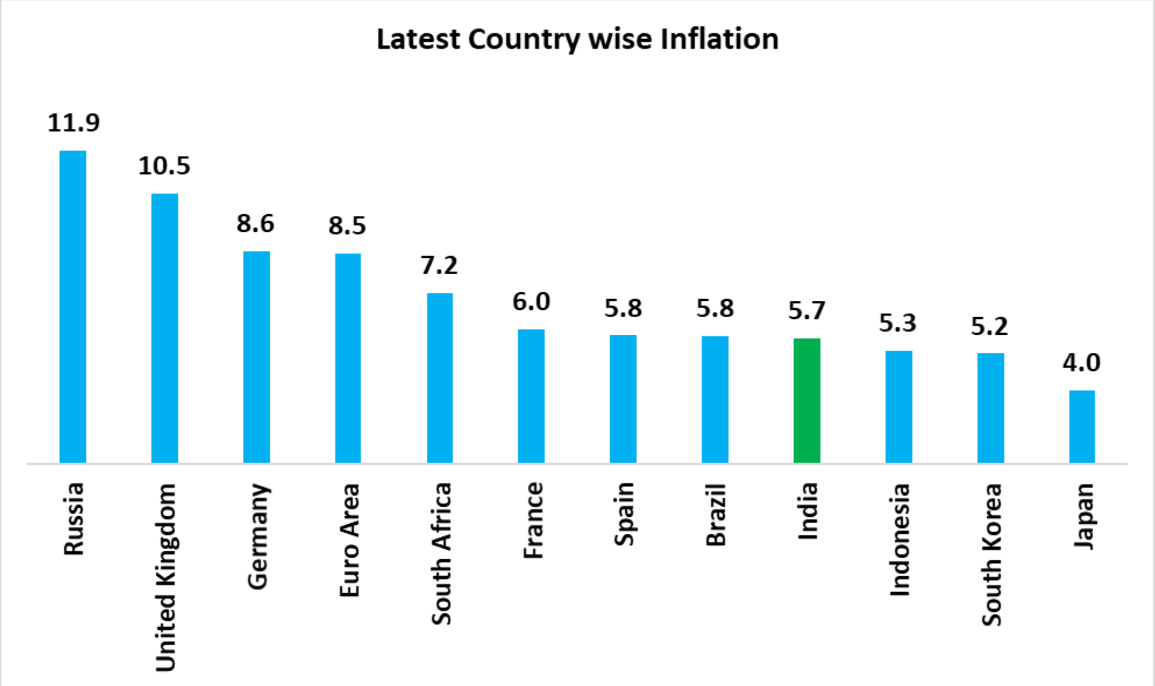
Prelude to MPC Meeting on Feb 6-8, 2023

06-February-2023

Global Economic Situation

Economy Status: Growth is slowing down, and inflation is trending much higher…



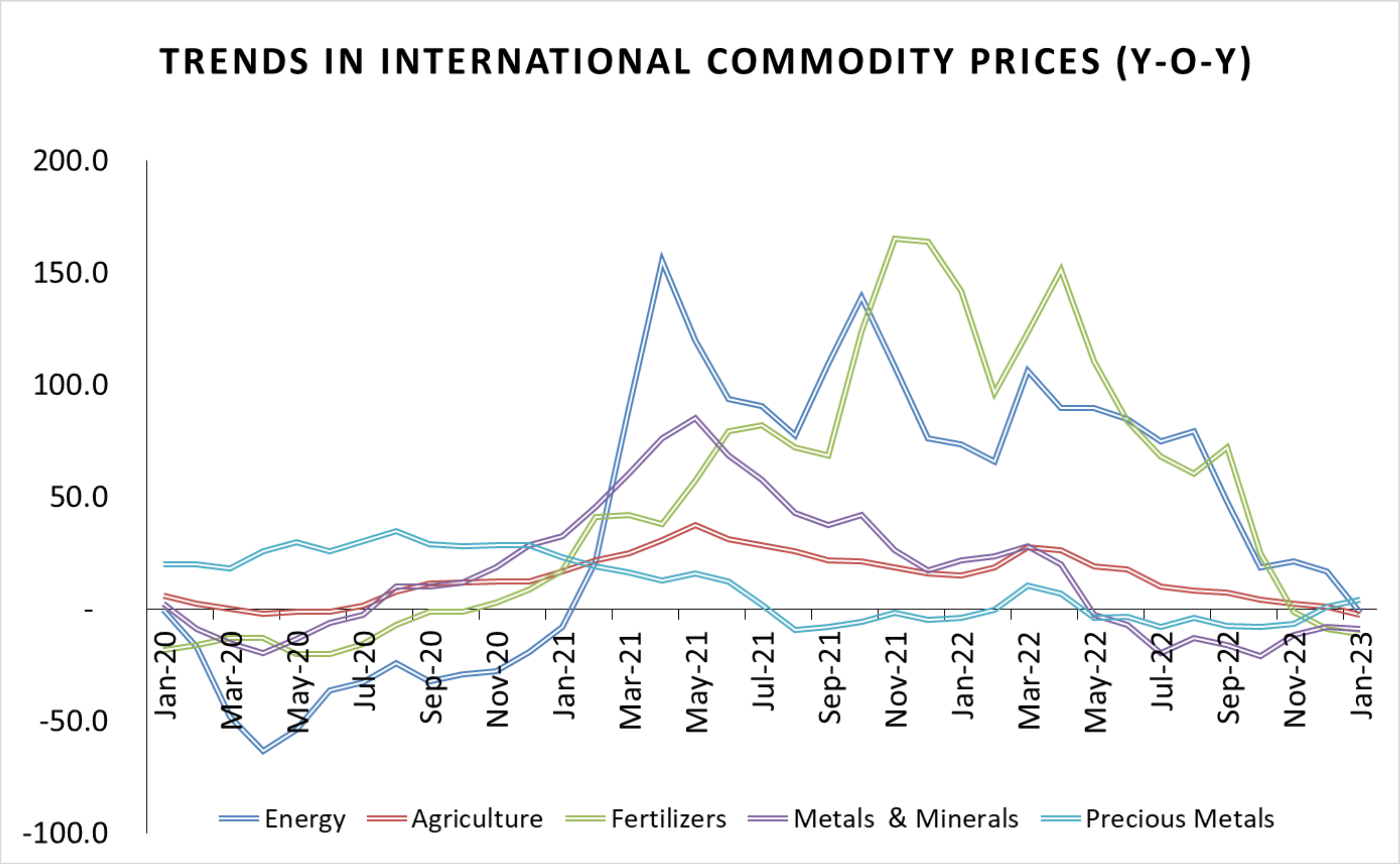


- World output growth is projected to decelerate to only 1.9% in 2023, marking one of the lowest growth rates in recent decades
- The near-term economic outlook remains highly uncertain, however, as myriad economic, financial, geopolitical and environmental risks persist
- Rapidly tightening global financial conditions have exacerbated balance of payment and debt vulnerabilities in many developing countries

China entering new normal with declining population and high-end value addition

- Growth in China is projected to moderately improve in 2023 after weaker-than-expected performance in 2022
- Growth is projected to pick up in 2023 due to the easing of COVID-19-related restrictions but will likely remain below the pre-crisis trend

Commodity prices receding from their recent peaks



Global investment outlook turning negative, even as India has clearly bucked the trend

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- New investment project numbers, including greenfield announcements, international project finance (IPF) deals, and cross-border mergers and acquisitions (M&As), all shifted in reverse after Q1 2022

- IPF and M&As were especially affected by deteriorating financing conditions, rising interest rates and growing uncertainty in financial markets. Cross-border M&A sales were 6% lower and IPF values more than 30% lower in 2022

- Greenfield project announcements for 2022 as a whole still showed growth (+6%) due to the momentum in the first part of the year. Values increased more because of several megaprojects and an increase in average project size in the renewables sector

- Three of the 10 largest announcements concerned chip making factories, in response to global shortages and supply chain restructuring trends. Six of the top 10 project announcements were in renewables

- The outlook for global FDI in 2023 appears weak. Negative or slow growth in many economies, further deteriorating financing conditions, investor uncertainty in the face of multiple crises and, especially in developing countries, increasing debt-related risks will put downward pressure on FDI. India though bucks the trend

Global monetary tightening synchronization impacts volatility and financial stability….1

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- In the aftermath of global financial crisis, global central banks first resorted to a series of synchronized rate hikes since November 2008, then synchronized rate cuts till Feb 2010, followed by synchronized rate hikes till November 2011..Most of such decisions were synchronized…

- Post 2011, central bank rate actions were mostly nonsynchronous as they made an exit from such coordinated monetary policy actions

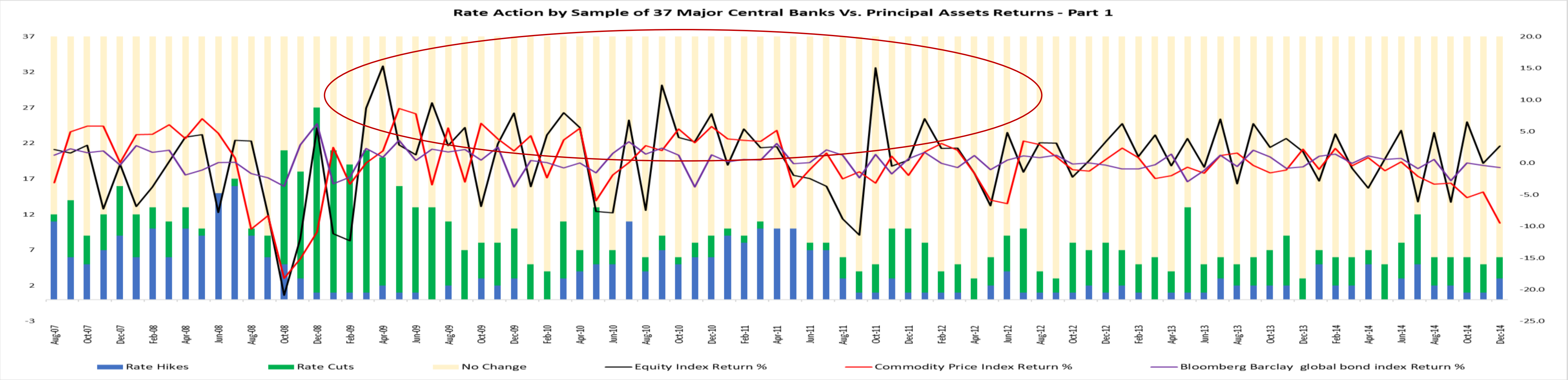
- In the current rate cycle, however rate actions; both hikes and cuts, have again been largely synchronized

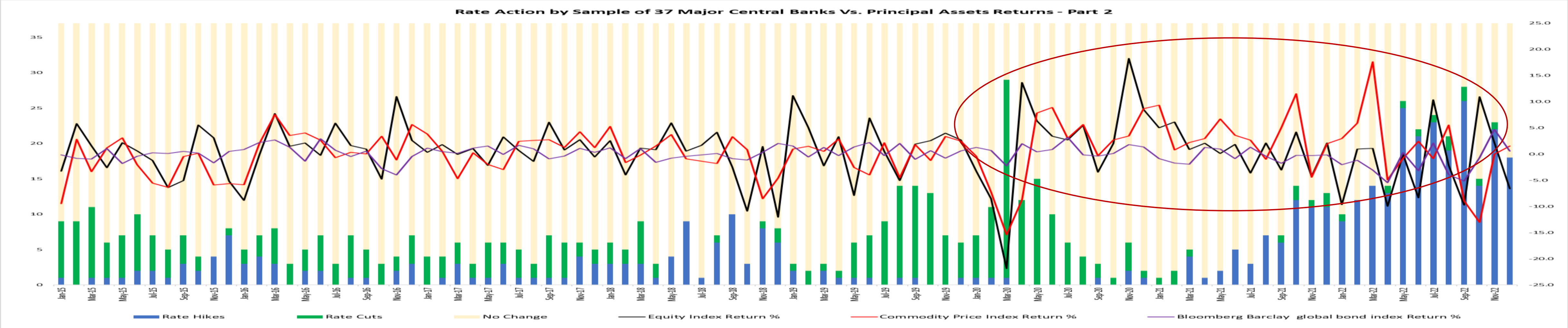
- We find evidence that synchronized rate actions have resulted in increased market volatility and financial stability in both the periods; post global financial crisis and the current regime

- A nonsynchronous monetary policy action in 2023 by central banks across the world could thus materially result in lower volatility and financial stability…

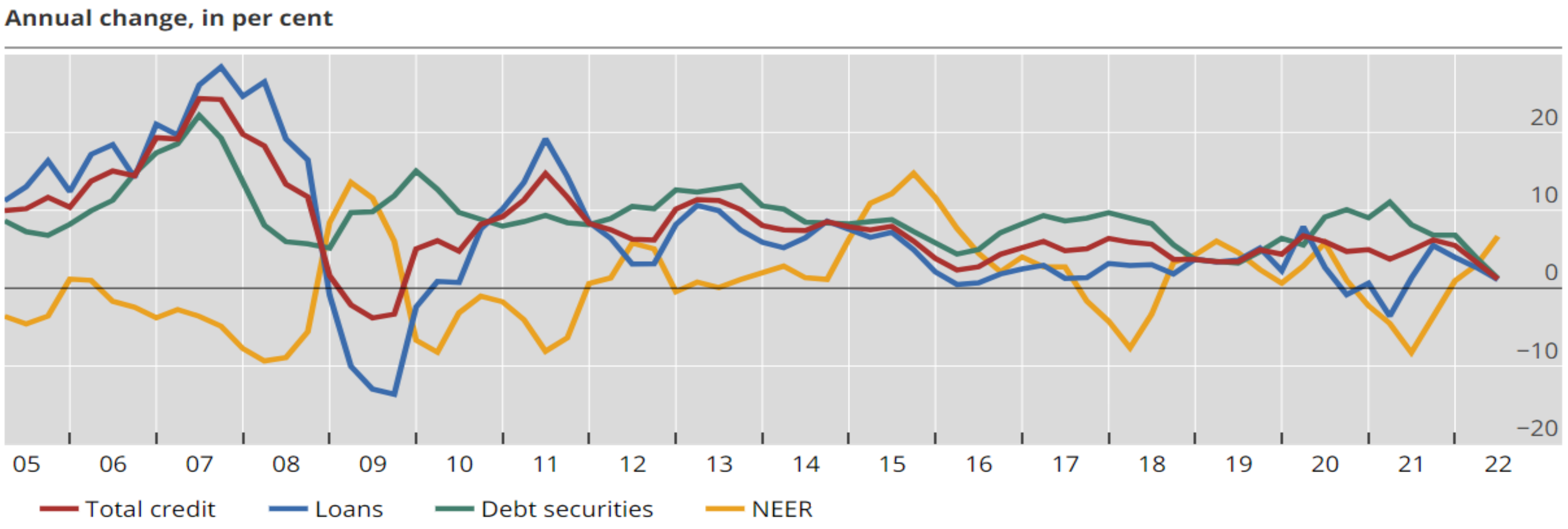
    - As the RBI mulls any further rate action on February 8, this could be set as a boundary condition of such a move….

Global monetary tightening synchronization impacts volatility and financial stability……2





Dollar liquidity outside the US is getting tighter, including the GBP and Euro



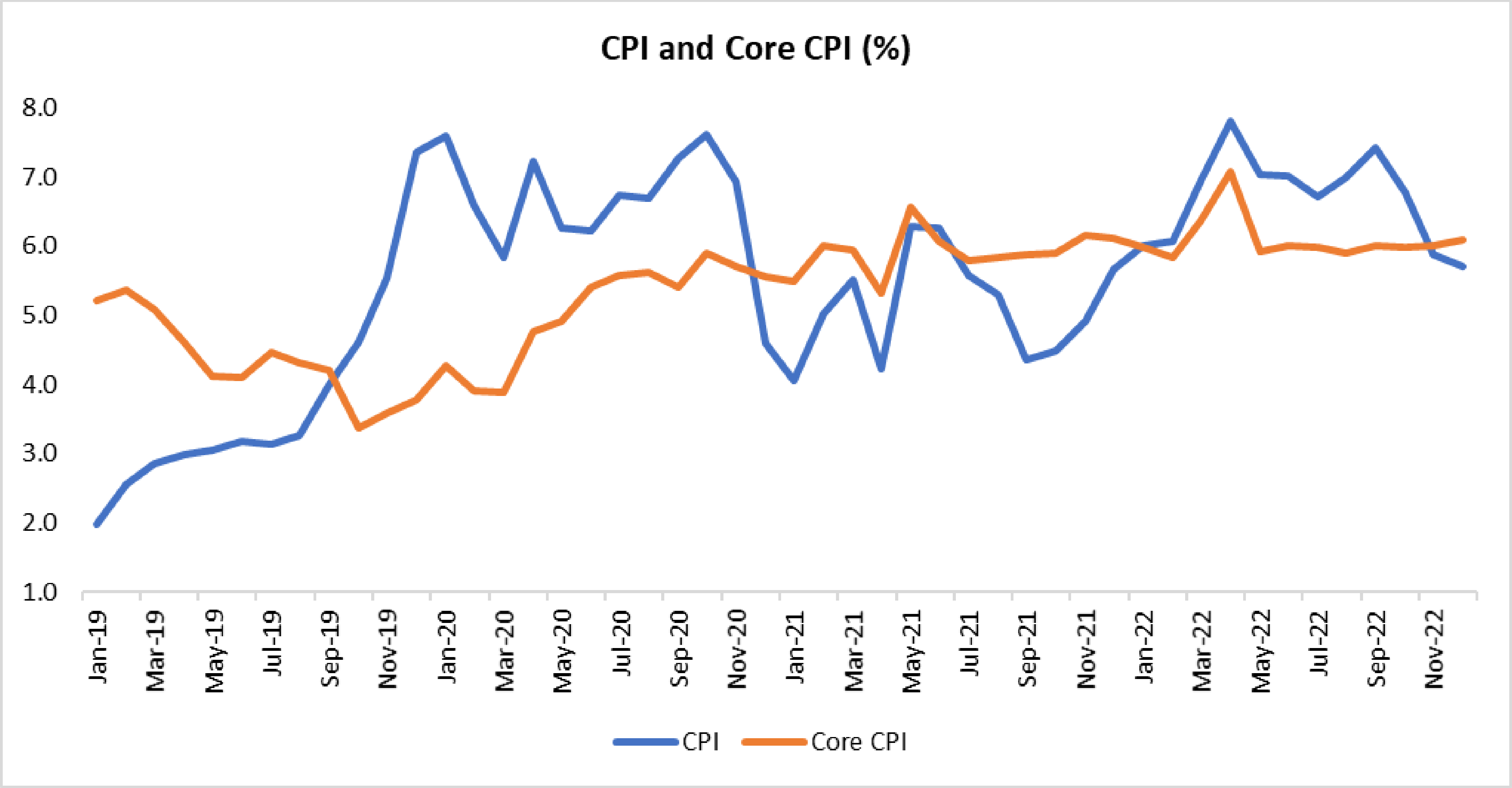
Source: BIS

- In Q2 2022, foreign currency credit denominated in US dollars contracted while that in euros expanded
- Foreign currency credit to non-banks in emerging market and developing economies (EMDEs) also weakened in dollars but accelerated in euros
- Monetary tightening to continue in 2023 with Fed, ECB and BOE expected to hike rates at moderate pace

CPI Inflation

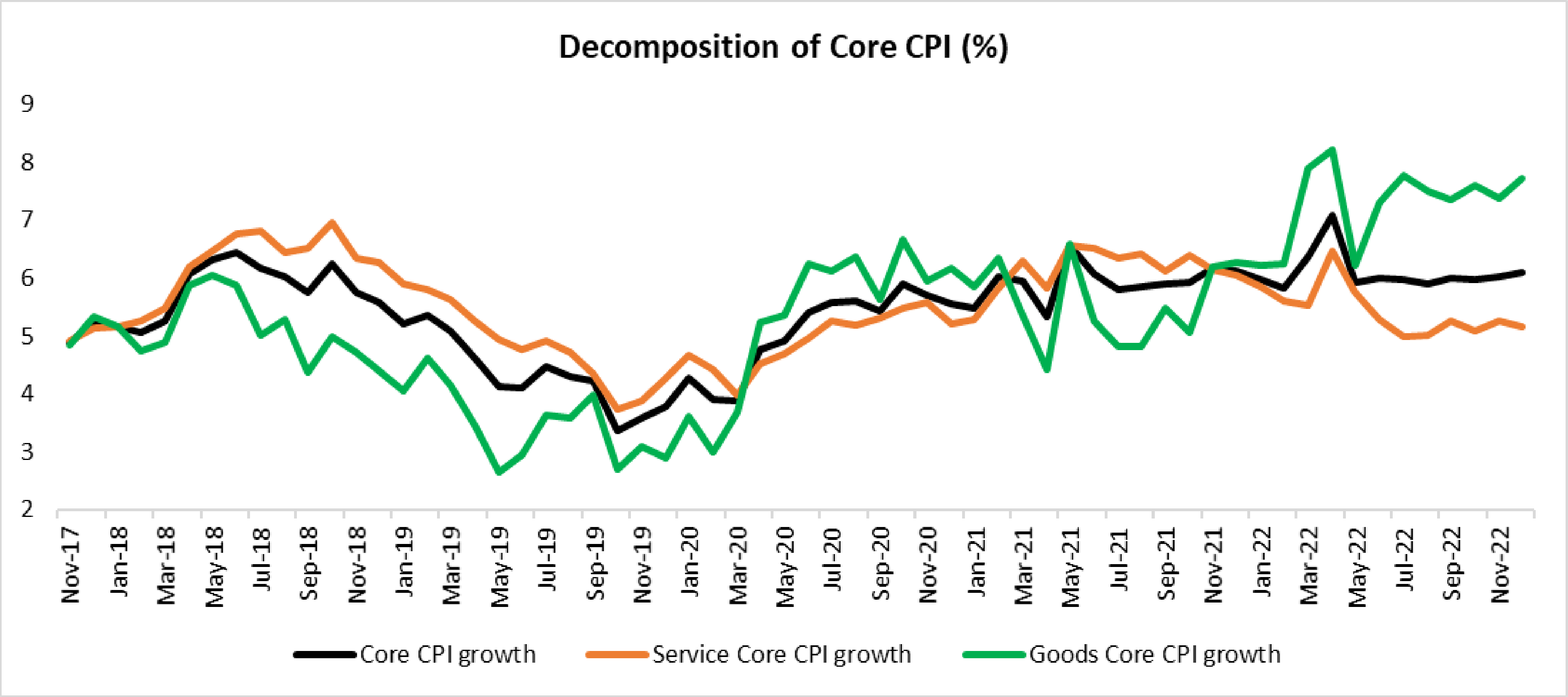
Is core inflation sticky?

- While CPI inflation has fluctuated in the range of 4-8% (since Jan-21), core CPI is sticky around 6% during the same period



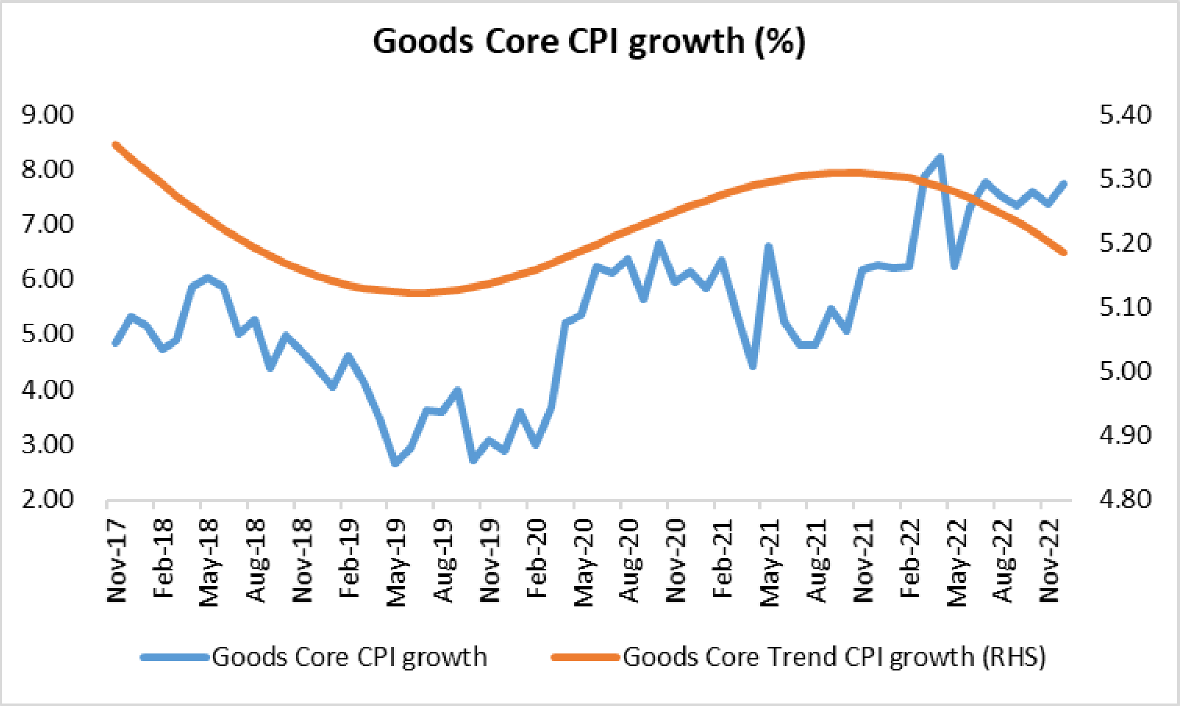
Core CPI is declining…..

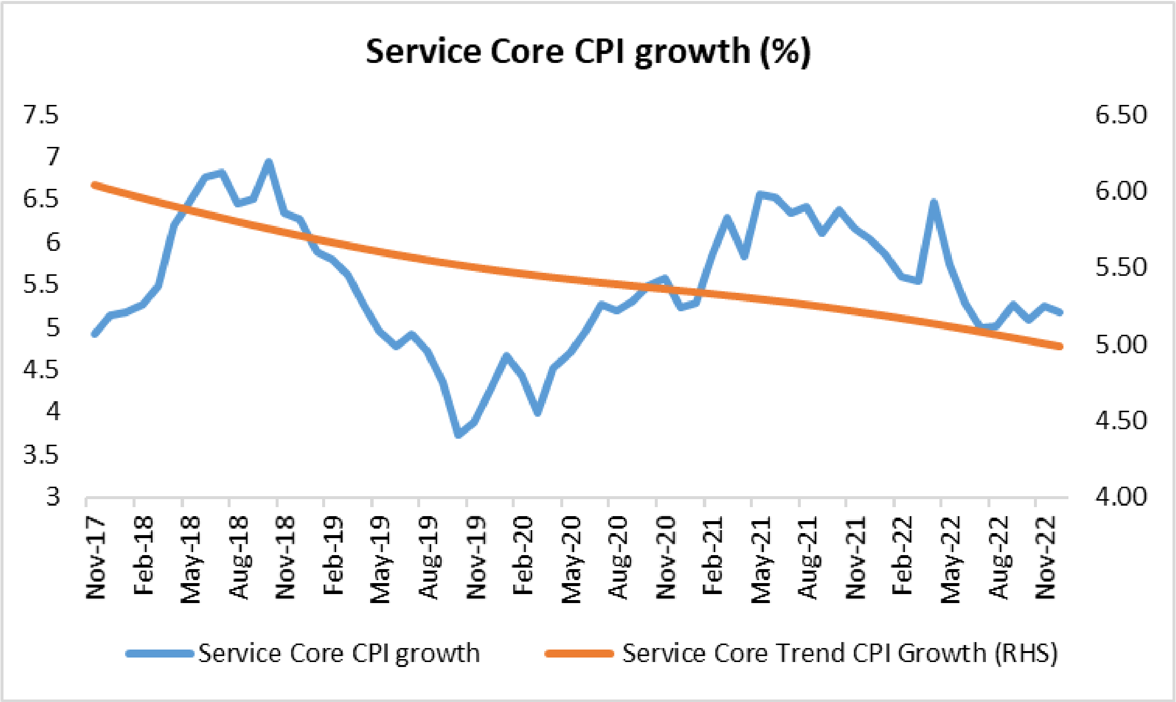
- The anatomy of core CPI inflation, bifurcating it into core goods and core services CPI reveals that Goods Core CPI is more volatile compared to Services Core CPI
- Service Core CPI has driven movements of Core CPI in pre-pandemic period but thereafter, Goods Core CPI is providing increasing momentum to core CPI possibly due to supply chain issues



Core CPI to gravitate towards Headline CPI in FY24….could head towards 5.5% or lower

- Goods Core CPI growth when compared with growth in its trend, it has been observed that Goods Core trend CPI is decreasing since March 22
- Service Core trend CPI is also on a declining path
- Trends of both Goods and Service Core CPI are on a declining path. It can be concluded that Core CPI is losing its momentum
- We believe Core CPI could gravitate towards 5.5% or lower in the interregnum, as headline CPI move towards 5% in FY24





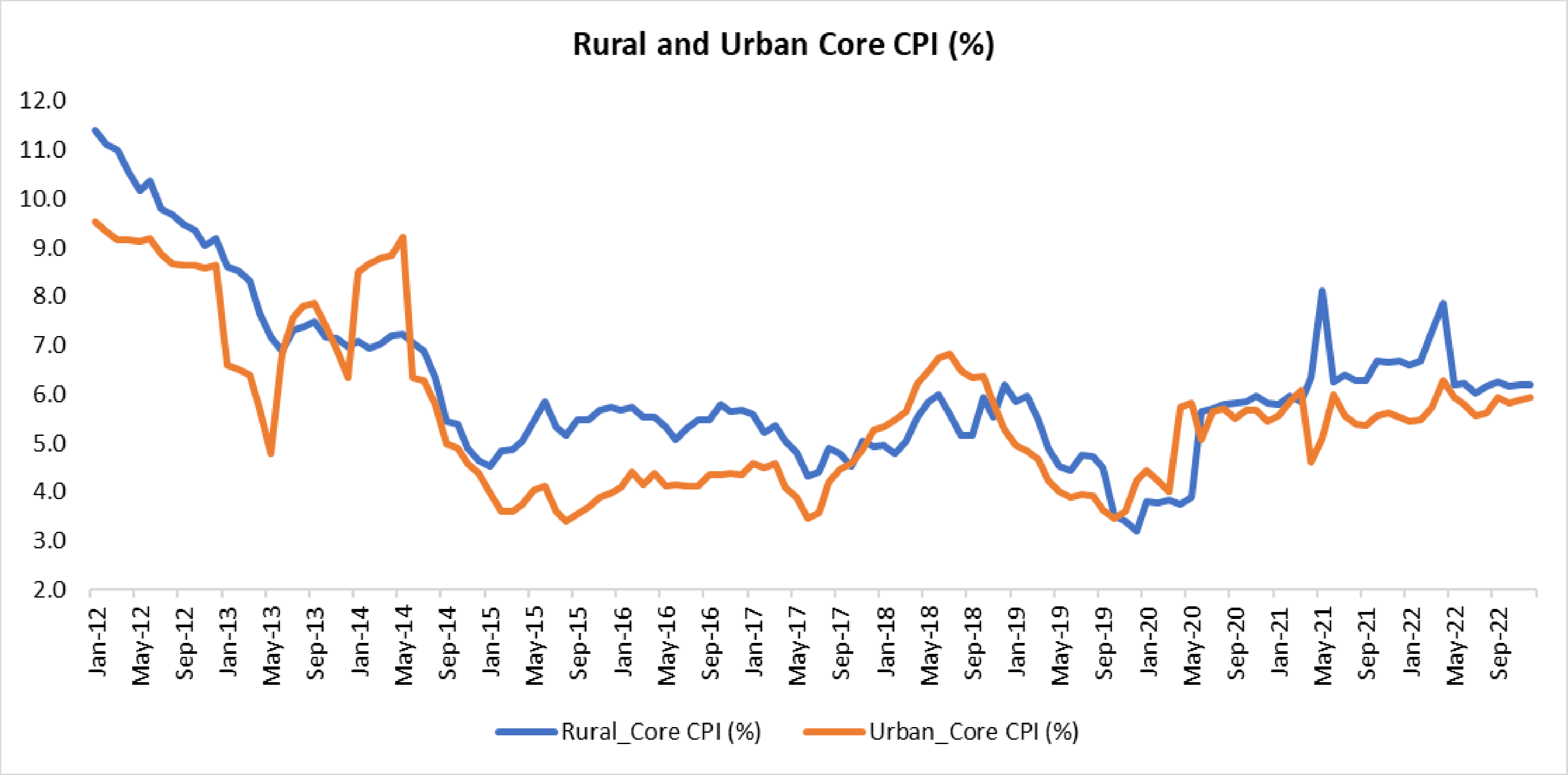
Rural & Urban Inflation: Summary Statistics

- An analysis of key summary statistics reveals that while rural inflation behaved similar to overall CPI inflation for a period of Jan-12 to Dec-22, particularly in terms of mean and volatility (as measured by the standard deviation of monthly y-o-y inflation), the urban inflation is quite different from the overall CPI
- Urban CPI has low mean and it is less volatile also

All-India, Rural and Urban Inflation - Summary Statistics			
	Overall CPI	**Rural CPI**	**Urban CPI**
Mean	5.93	6.05	5.80
Median	5.56	6.00	5.31
Minimum	1.46	1.22	1.41
Maximum	11.51	12.34	10.58
Standard Deviation	2.32	2.60	2.10
Variance	5.37	6.75	4.40
Kurtosis	-0.60	-0.55	-0.54
Skewness	0.44	0.31	0.48
Source: SBI Research			

What Rural and Urban Core CPI Indicates?

- Since Jan-12, for most of the period Rural Core CPI is more than the Urban Core CPI
- Only in the increasing inflation scenario, Urban Core is more than the Rural Core CPI. This indicate that urban core is the primary driving factor in the times when overall Core CPI increases



Domestic Conditions

RBI Liquidity Management in FY24 to be crucial to maintain orderly conditions in bond market

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- For FY24, gross market borrowing through dated securities budgeted at Rs 15.43 lakh crore and taking repayments of Rs 3.62 lakh crore (adjusted for recovery of Rs 78,104 crore from GST compensation fund), net market borrowing stands at Rs 11.8 lakh crore (66% of fiscal deficit)
- The Government has also announced switch of Rs 1.0 lakh crore in FY24
- The demand of securities from banks to be in line with the incremental supply (around Rs 5.9 lakh crore) to ensure LCR compliance
- Insurance sector could subscribe to Rs 3.9 lakh crore. Good demand is also expected from other participants given expected growth in AUM
- However, lower system liquidity, lack of additional HTM space, lower demand from insurance sector could pose challenges to smooth conduct of borrowing program
- **Taking the demand from different participants into consideration, there could still be a gap of Rs 2 lakh crore between the demand and supply of securities**
- **This could be filled by RBI through OMOs or switches in the 2nd half to balance supply demand dynamics especially if small savings collection does not pick up pace**

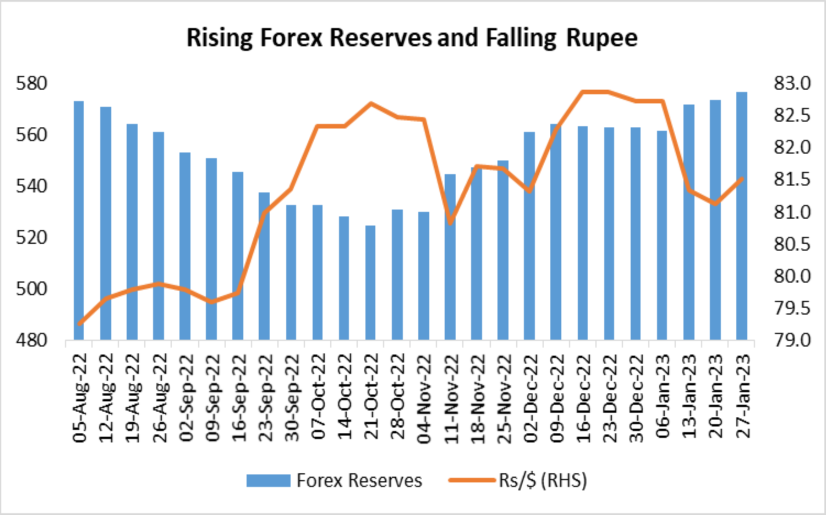
Borrowing Arithmetic	
Demand from Banks/FIs	
in Crore	**FY24**
Demand from Banks	5,90,000
Demand from non-Bank PDs	7,040
Demand from PFs	1,32,847
Demand from Insurance cos	3,87,200
Demand from MFs	11,387
FPI Demand	31,680
Demand from Co-op banks	18,941
Demand from others	2,64,000
Financial institutions	44,899
Corporates	62,284
Government Buyback	-
RBI OMO Purchases	
Total Demand	**15,50,277**
Net G-Sec issuance	11,80,000
Net SLD Issuance	5,30,000
Net T-Bill issuance	50,000
RBI OMO Sale	0
Total Supply	**17,60,000**
Supply-Demand	**2,09,723**

Domestic Liquidity: Liquidity has become almost neutral

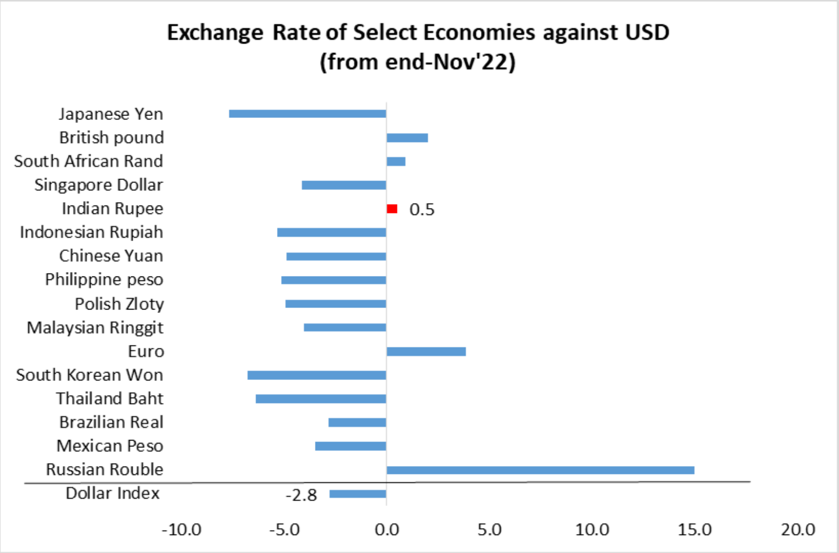
- Liquidity inflows to the financial system could be either policy induced by the central bank (for example changes in reserves, open market operations etc) or non-policy induced (foreign exchange reserves, government cash balances, and currency in circulation)
- Liquidity in the system has become almost neutral with the Net LAF at Rs 0.54 lakh crore as on 2 Feb’22 compared to surplus of Rs 6.35 lakh crore at the beginning of the fiscal year. Average core liquidity stands at Rs 2.51 lakh crore, which is almost neutral given that RBI considers liquidity amounting to 1.5% of NDTL (currently at Rs 2.8 lakh crore) as non-inflationary
- By March-end, we expect that the system might be in liquidity deficit within tolerable limits if there are no liquidity injection / withdrawals

Liquidity (Rs lakh crore)		
	01-Apr-22	**02-Feb-23**
Repo Outstanding	0.84	0.84
Reverse Repo Total	6.78	0.35
SDF statrted on 08.04.2022	2.35	1.17
MSF	0.01	0.02
Net LAF (+absorption)	6.35	0.54
Government Cash Balance	1.08	1.96
Core Liquidity (+Surplus)	8.32	2.51

Rupee has been depreciating against US dollar as RBI is consciously building up reserves… not to be construed as a justification of a rate hike to prop up the rupee



Reserves Recouping by RBI		
	Forex Reserves in $ Bn	Rs/$
Beginning of 2008 Crisis	312	40.0
Lowest point	246	49.6
Reserves back at same level after 27 months	303	44.6
Reserves recouped	58	
Beginning of Ukrain Crisis	606	76
Lowest pont	525	83
Current level	577	82
Reserves recouped	52	



- Indian rupee has shown a negative bias against the dollar for the past two months even though many other currencies have in general appreciated against the dollar. Indian rupee has depreciated 0.5% since end- Nov’22 though the dollar index itself has weakened ~2.8% in the intermittent period

- RBI has been building back up foreign exchange reserves since Nov’22. Total reserves have increased at a significantly faster rate by $52 billion between 4 Nov’22 and 20 Jan’23. This is in contrast to post 2008 crisis when reserve build up was gradual and the exchange rate was allowed to appreciate by 10% against a 24% fall…currently, exchange rate depreciation has been only 9% allowing RBI the operational flexibility to build up reserves as a primary option

Final Thought: A Pause

- So, what will be the RBI's policy look like:

Indicator	Our View
Repo rate	• We expect the RBI to pause in February policy • In the current rate cycle, rate actions, both hikes and cuts, have been largely synchronized. We find evidence that synchronized rate actions have resulted in increased market volatility and financial stability in both the period post global financial crisis and the current regime. A nonsynchronous monetary policy action in 2023 by central banks across the world could thus materially result in lower volatility and financial stability…RBI might take cues…as financial stability takes precedence… • We believe at 6.25%, it could be the terminal rate for now…
Stance	• The stance could continue to be withdrawal of accommodation, even as liquidity is close to neutral • Even though RBI could pause as it allows past rate actions to work with long and variable lags, the RBI could still guide the markets with a rate action in future that will be purely data dependent • CPI headline inflation could decline closer to 5% by March 2023 and 4.2% in April…
Risks for growth/inflation	• Fed rate hikes could be smaller in magnitude • This will keep the boil on emerging market central banks to follow Fed though markets seems to have largely become agnostic to macros globally….pause may be the new normal and markets will be happy to accept that….this will keep capital flowing into emerging markets…
Forward Guidance	• In an environment of rising rates, it is clearly not advisable to give a forward guidance

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