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RBI POLICY: WALKING THE RAZOR'S EDGE

The monetary policy announcement from RBI today, balancing the aspirations and expectations from a cross-section of market participants, and stakeholders was probably akin to fire-walking, however the regulator has chosen to walk the razor's edge with renewed elan and candor (Somerset Maugham would have lauded it for sure), setting the tone for restoration of normalcy in days to come, while vouching unwaveringly for continuance of accommodative stance on a 'need-to-sustain' basis as aggravated fault lines emanating from unprecedented geo-political tensions off late fog the chequered road ahead.

Introduction of SDF, nearly eight years after the Patel committee had propagated an independent, transparent, non-collateralised concurrent offering is a smart policy decision. As lending to central bank has no credit risk, there was no need to provide Government securities at first place as collateral when a market participant placed its funds with RBI. Interestingly, since the SDF comes with the conditionality of no collateral of G-secs to be given by RBI to banks, it will free up securities from SLR holdings of banks. This will thus result in lowering of excess SLR holdings and will lead to an increase in demand for bonds. Enhancing the HTM limit under SLR category further should give Banks enough time to manage their investment books as corporate demand was showing a revival before the war and should get a push as conditions normalise going ahead.

The SDF move will have a satiating impact on G-sec yields over the medium term. Of course, there will still be demand for Reverse repo auctions for banks that are not holding large excess SLR to meet the regulatory dispensation. Since Reverse Repo is less remunerative, it might induce such banks to now strive for investment in G-secs. Thus, in both the cases (banks holding large excess SLR and banks not so large with excess SLR) it will be a win-win for markets. Clearly, SDF will now be an added weapon of maintaining orderly financial conditions as Government borrowing programme will also now be a function of the liquidity corridor. Over time, SDF (that is currently overnight) and VRRR (that is in multiples of fortnightly durations) may have a dynamic meeting ground. It may be noted that RBI has been anchoring VRRR all through the turbulence, providing banks with better yields on floating deposits while also signalling normalisation through alignment with market determined rates.

Separately, food inflation now poses a significant upside risk to our base case. Generally the recommended MSP is calculated as 150% of the cost of production (A2+FL). MSP increase has been in the range of 3-5% in the past. In FY23, MSP might increase by around 8-10%. Our estimates show that 1% increase in MSP leads to higher CPI inflation of 3bps. **Thus overall higher MSP should lead to upside risk to CPI inflation of 24-30 bps over our earlier inflation forecast of 5.8%, pushing inflation beyond 6% in FY23. This is higher than RBI inflation at 5.7%.**

Additionally, the decision to continue with the existing dispensation of housing loans being linked to LTV has helped the banks in reducing capital requirement of around Rs 400 crore till FY22. Assuming 15% growth in housing loan portfolio in the next year, this will save capital requirement of Rs 500 crore in Mar'23. This will help banks in ensuring a rational adjustment on mortgage rates.

RBI has also proposed to allow interoperability in card-less cash withdrawal transactions at all banks and ATMs using the UPI facility. We believe this will operate as a QR code scanning at ATM through UPI to withdraw cash from any ATM. **Additionally, introducing a dual layered, SMS and password enabled withdrawal facility, on the line of SBI's YONO cash could work wonders for the diverse customers segments.**

Finally, market participants who are now factoring in large rate hikes need to understand that growth is also weak. The RBI is equally seized of giving growth a lift and hence the myriad of cacophony of such rate hikes seems to be utterly misplaced. **We believe, the RBI guidance at this time is just apt for the markets. While inflation does have the potential to surprise on the upside vis-à-vis RBI projections, growth still remains a recovery in process. From that point of view, the market cacophony of sharp rate hikes when even the FY22 growth numbers are likely to be much lower than CSO official projections at 8.9% could be misplaced at best. The good thing is though capacity utilisation (CU) in the manufacturing sector recovered to 72.4% in Q3FY22 from 68.3% in the previous quarter. It reached the pre-pandemic levels of 69.9 per cent in Q4FY20. we expect the first rate hike to happen only in H2FY23. However, deposit rates are likely to increase meaningfully over the next one-two months.**

RBI HOLDS RATE

- RBI's Monetary Policy Committee has unanimously decided to keep policy Repo rate unchanged at 4% (11th straight time) and decided to continue with the accommodative stance (unanimously) while clearly communicating their focus on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. MSF and the Bank Rate remains at 4.25% while the standing deposit facility (SDF) rate, which will now be the floor of the LAF corridor, will be at 3.75%
- RBI has revised downward its FY23 projection from 7.8% to 7.2% with Q1 at 16.2%; Q2 at 6.2%; Q3 at 4.1%; and Q4 at 4.0%. We believe that this is a reasonable estimate given the current situation.
- Taking into account of several factors (like volatile and elevated crude oil price, broad-based surge in prices of key industrial inputs, global supply chain disruptions, input cost push pressures) RBI has revised upwards its CPI inflation projection to 7.5% from 5.3%. Assuming average crude oil price (Indian basket) at $100 per barrel RBI projected CPI inflation for Q1 at 6.3%; Q2 at 5.8%; Q3 at 5.4%; and Q4 at 5.1%.

INTRODUCTION OF SDF

- To absorb additional liquidity (currently at Rs 7.5 lakh crore) without any collateral, RBI decided to institute the SDF with an interest rate of 3.75% with immediate effect. The SDF will replace the fixed rate reverse repo (FRRR) as the floor of the LAF corridor. By removing the binding collateral constraint on the RBI, the SDF strengthens the operating framework of monetary policy. We believe that this is an excellent step and will have multiple positive impacts.
- As the percentage of excess SLR holding for both PSBs as well as their private sector counterparts has gone up considerably in recent times (~9% above 18%) banks are expected not to park their excess funds at fixed rate reverse repo and hence it should remain side lined in the dynamic management of liquidity over a period. Banks with large excess SLR portfolio may earn 40 bps more by parking their excess fund with SDF instead of reverse repo. The Patel committee in its report had mentioned that the introduction of the SDF may replace reverse repo in the long-run as Reverse repo will no longer be the tool for liquidity management.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q4 FY22	Q1 FY23	Q2 FY23	Q3 FY23	Q4 FY23	FY23
Apr'22	6.1	6.3	5.8	5.4	5.1	5.7
Feb'22	5.7	4.9	5.0	4.0	4.2	4.5
Dec'21	5.7	5.0	5.0	-	-	-
Real GDP Growth (%)	**Q4 FY22**	**Q1 FY23**	**Q2 FY23**	**Q3 FY23**	**Q4 FY23**	**FY23**
Apr'22	4.8	16.2	6.2	4.1	4.0	7.2
Feb'22	5.9	17.2	7.0	4.3	4.5	7.8
Dec'21	6.0	17.2	7.8	-	-	-

Source: RBI, SBI Research

Introduction of SDF is expected to have multiple other benefits:

- First, non receipt of Government securities in reverse repo and term reverse repo will boost the overall demand for Government securities for maintenance of requisite Statutory Liquidity Ratio (SLR), since securities obtained under reverse repo are eligible for SLR;
- Second, absorption of additional surplus liquidity at a lower rate through SDF (vis-à-vis VRRR which has been clamouring around the policy repo rate off late and has seen spike in volumes) will positively impact the entire interest rate structure. Additionally, the side lining of fixed rate reverse repo, while anchoring better priced liquidity absorption products should also anchor Banks' quest to offer better rates on select deposits.
- Fourth, with the introduction of the SDF at 3.75%, the policy repo rate being at 4.00% and the MSF rate at 4.25%, the width of the LAF corridor is restored to its pre-pandemic configuration of 50 bps.

GLOBAL ECONOMY

- It does not require much elaboration to state that global situation has worsened since the outbreak of the Ukraine conflict. Commodity prices have shot up substantially across the board amidst heightened volatility, with adverse fallouts on net commodity importers such as India.
- Crude oil prices jumped to 14-year high in early March and continue to remain elevated.

- Jump in global commodity prices has exacerbated inflationary pressures across advanced economies and emerging market economies alike causing a sharp revision in their inflation projections. Federal Reserve "generally agreed" to cut up to $95 billion a month from the central bank's asset holdings as another tool in the fight against surging inflation, even as the war in Ukraine tempered the first U.S. interest rate increase.
- Thus, from the global side - geopolitics, inflation and global interest rates are bound to influence the RBI action to manage the domestic condition. This indeed reflects in the decision to institute the SDF at this juncture. The narrowing of the corridor is indicating that RBI will trade off higher rupee volatility for much stable domestic interest rate.

DEVELOPMENTAL AND REGULATORY MEASURES

- **SLR Holdings in HTM category:** With a view to enable banks to better manage their investment portfolio in FY23, RBI decided to enhance the limit for inclusion of SLR eligible securities in the HTM category to 23% of NDTL from the current limit of 22% till March'23 to enable banks manage their investment book better as growth should reinvigorate demand from corporates.
- **Individual Housing Loans – Rationalisation of Risk Weights:** In Oct'20, RBI had rationalised the risk weights for individual housing loans based on the loan to value ratio (LTV).
- As per the decision, a risk weight of 35% was applicable where LTV is less than or equal to 80%, and a risk weight of 50% where LTV is more than 80% but less than or equal to 90%. This decision benefitted banks particularly giving relief in case of big ticket loans, above Rs 75 lakhs where risk weight was higher. Such loans have a share of 12-15% in total housing portfolio. This helped the banks in reducing capital requirement of around Rs 400 crore till FY22. Assuming 15% growth in housing loan portfolio in the next year, this will save capital requirement of Rs 500 crore in Mar'23. This could enable banks to ease rates to boost demand.
- **Card-less cash withdrawals across all banks and ATM networks using UPI:** RBI has proposed to allow interoperability in card-less cash withdrawal transactions at all banks and ATMs using the UPI facility.
- The card-less cash withdrawal transactions would help in containing frauds like skimming, card cloning, device tampering, etc. We believe this will be operate as QR code scanning at ATM through UPI to withdraw cash from any ATM. As this facility is already available in ATMs for on-us customers, so RBI can implement it easily with the help of NPCI without changing any technological upgradations.
- **Cyber Resilience and Payment Security Controls of Payment System Operators (PSOs):** A payment system operator means a legal entity responsible for operating a payment system. The PSO provides services by operating on certain models. They largely outsource their payment and settlement-related activities to various other entities. Examples of PSOs include Google Pay, Amazon Pay, NPCI, Paytm etc. RBI has aimed to set up a robust governance structure and implement common minimum standards of security controls for digital payment products and services. The guidelines are technology and platform agnostic and shall create an enhanced and enabling environment for customers to use digital payment products in a more safe and secure manner.
- **Bharat Bill Payment System – Rationalisation of Net-worth Requirement for Operating Units:** RBI has proposed to align the net worth requirement of non-bank BBPOUs with that of other non–bank participants who handle customer funds (like Payment Aggregators) and have a similar risk profile. Accordingly, the net worth requirement for non-bank BBPOUs is being reduced to ₹25 crore from the present Rs 100 crore.

UPSIDE RISK TO FOOD PRICE INFLATION

- There was huge gap between WPI and CPI food inflation with WPI food prices being higher than CPI food prices, which indicates incomplete pass-through of prices. The gap was 4.7% in Jan'22 and it has now reduced to 2.3%. **There could be 30 bps upside risk to CPI inflation owing to food CPI increase**.
- We have already taken the impact of this pass through of WPI food inflation to CPI food inflation while estimating our average CPI of 5.5%-6% (oil price of $95-$100 per bbl).

- However, there is an additional factor that could lead to upside risk to inflation in the next fiscal year. There has been an increase in prices of various inputs used in agriculture. Diesel prices have increased by Rs 10 in the last 2 weeks. Meanwhile, FMB fertiliser prices have surged in the range of 70%-240% between Feb'22 and Feb'21. Notably, labour charges have increased on an average by 4% compared to 6% in the previous fiscal. Nonetheless, there is likely to be an overall net increase in the cost of production of around 5-7%. Thus, CACP will take this higher cost of production into account while estimating MSP for FY23.
- Generally the recommended MSP is calculated as 150% of the cost of production (A2+FL). MSP increase has been in the range of 3-5% in the past. In FY23, MSP might increase by around 8-10%. Our estimates show that 1% increase in MSP leads to higher CPI inflation of 3bps. **Thus overall higher MSP should lead to upside risk to CPI inflation of 24-30 bps over our earlier inflation forecast of 5.8%. This is higher than RBI inflation at 5.7%.**

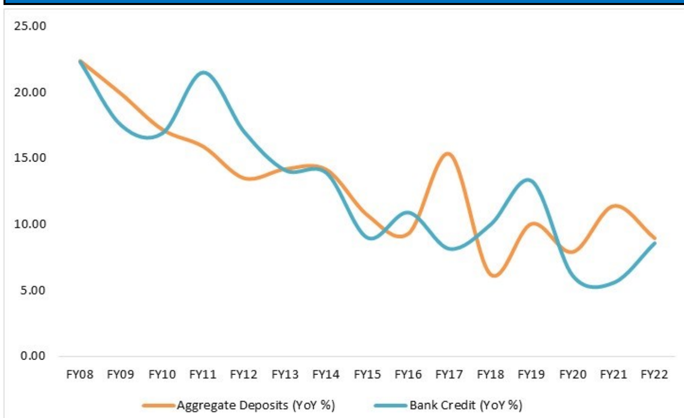
CAPACITY UTILISATION REACHED PRE PANDEMIC LEVEL

- Capacity utilisation (CU) in the manufacturing sector recovered to 72.4 per cent in Q3FY22 from 68.3 per cent in the previous quarter. It reached the pre-pandemic levels of 69.9 per cent in Q4FY20.
- Above 70 per cent CU was last reported in Q1FY20 i.e. 73.6 per cent which was reduced to 47.3 per cent in Q1FY21 (see graph).

CREDIT GROWTH IMPROVED IN FY22

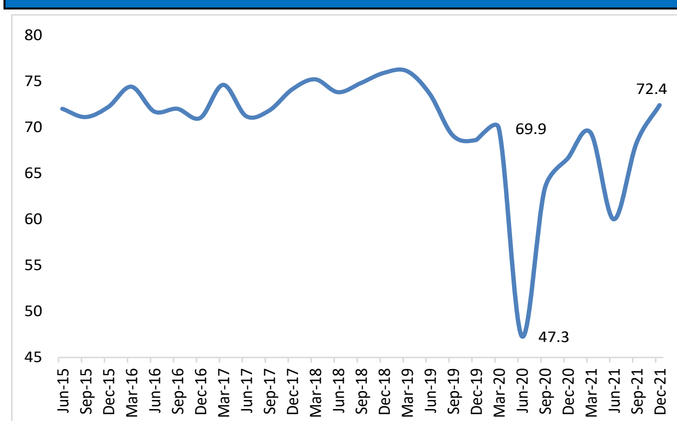
- Credit offtake picked up during 2021-22, with the gradual return of normalcy after the pandemic. ASCB's credit grew by 9.6% as on March 25, 2022 (5.6% a year ago). The recovery in bank credit was led by private sector banks that provided the bulk (50.4%) of the incremental y-o-y credit (up to March 25, 2022), followed by PSBs (44.7%). Credit growth was driven by all the major economic sectors.
- Interestingly Retail loans have emerged as the main driver of bank credit in recent years and now have the largest share (30.5%) in the outstanding credit of ASCBs, displacing industrial loans (28.9%). Within retail, housing loans have the largest share (47.7%). The importance of retail loans has increased for both PVBs and PSBs. In view of subdued profitability and deleveraging by corporates, banks shifted their focus away from large infrastructure and industrial loans towards retail loans.
- **ASCBs deposits growth slowed to 8.9% in FY22, compared to 11.40% in FY21.**

ASCB's Deposits & Credit Growth



Source: RBI; SBI Research

Capacity Utilisation in Manufacturing



Source: RBI; SBI Research

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