SBI RESEARCH

ECOWRAP

SLEDGEHAMMER APPROACH TO CURTAIL INFLATION LIKELY 40 BPS AND 35 BPS RATE HIKE IN JUNE & AUGUST, 100 BPS INCREASE IN CRR

Issue No. 08, FY23
Date: 12 May 2022

CPI inflation surged to 7.79% on yearly basis in Apr'22 as compared to 6.95% in Feb'22 mainly on account of food price inflation. Inflation prints are now likely to stay higher than 7% till September. Beyond September, inflation prints could hover between 6.5%-7%. Our FY23 inflation forecast is at 6.5%, taking into account the possibility of an extended food price shock.

The Russia-Ukraine conflict has significantly impacted the trajectory of inflation. The latest April 22 inflation print shows wheat, protein items (chicken in particular), milk, lemon, cooked meal, chillies refined oil, potato, chillies, kerosene, firewood, Gold and LPG are contributing to overall inflation in a substantive manner. Interestingly, inflation in protein items like chicken, mustard oil etc. softened in April. However this might be an aberration, given that April was the month of Navratri and other religious festivals. This is also reflected in increase in prices of milk and even fruits like mangoes.

Surprisingly, the contribution of petrol and diesel in overall inflation has been declining steadily since Oct'21, while there is a steady increase in weighted contribution of kerosene and firewood in headline inflation. The significant increase in weighted contribution of kerosene perhaps reflects the impact of high fuel costs in rural areas. This does not augur well for rural demand. The weighted contribution of LPG has also increased reversing a downward trend. This however, may be attributed to commercial usage of LPG.

We now expect RBI to raise rates both in June and August policy meeting by a cumulative 75 basis points. Beyond August, rate actions might be more balanced and judicious. We are expecting the terminal repo rate to be 5.15%-5.25% by FY23. The rupee has sharply depreciated against the dollar on account of galloping inflation both in the US and domestically. Aggressive rate hikes in the US have strengthened the dollar against the basket of currencies. The Dollar index gone beyond 104, its highest since December 2002.

Based on ASCB housing loan data from 2005, we have estimated that 8.75% is the threshold weighted average lending rate for housing loan beyond which housing loan disbursals might decline. This is tantamount to saying **RBI should not increase the repo rate by more than 1.25% for an incremental negative contribution to kick in. With 40bps hike already done in May, repo may not be increased more than 80 bps, i.e. upper limit should be 5.25% (5.15% Repo rate+10 bps CRR impact). This would imply a full transmission of 125 basis points over and able the current EBLR of Banks.**

Meanwhile, system liquidity is still in surplus mode with net durable liquidity at Rs 6.8 lakh crore. **RBI may increase the CRR rate by another 100 bps, after raising it by 50 bps in the last monetary policy.** This would lead to absorption of ~Rs 1.74 lakh crore from the market on durable basis (Rs 87,000 crore absorbed earlier). High Government borrowing has ruled out the possibility of OMO sale, thus CRR increase seems as the possible non disruptive option of absorbing the durable liquidity. Furthermore, this opens up space for RBI to conduct liquidity management in future through OMO purchase. **RBI can give back to the market at least 3/4th of the Rs 2.6 lakh crore absorbed through CRR hike or Rs 1.95 lakh crore in some form to address duration supply. This would lower the Market Borrowing to around Rs 12.36 lakh crore for FY23 compared to the BE of Rs 14.3 lakh crore.**

Additionally, the rupee has accordingly moved northwards breaching the 77-mark. With normalization of LAF corridor, it was expected that rupee will witness some volatility. The FII outflows in the equity may persist as normalization of interest rates in advance economies will impact the growth outlook in emerging markets. Rupee is expected to move in range ₹75-78 with swings on either side. The hardening of rate outlook in the US, leading to shunning of risks across asset classes has seen windfalls for the Dollar index whose marauding strength has taken it to 20 year highs, creating a free fall for many other currencies, the perplexing situation exacerbated by persistent FPI outflows in massive numbers.

The fall of the rupee to new lows, with spiking volatility breaching the psychological levels of 77 augurs the uneasy situation, reflective of the turbulence in broader markets globally, and the limited choices before the Central Bank in managing the exchange rate, even with seemingly comfortable levels of forex reserves close to US$600 Bn. **The strategy being adopted by RBI would increasingly align with interventions in NDF (preferably in near months where liquidity is more) and currency futures, with intervention in spot market playing the second fiddle. That also saves the reserves, with only settlement of differential amount with counterparties on maturity dates.** That should re-instil confidence in the Central Bank's role as a neutral, confidence building regulator, whose primary job would be to reduce volatility without nudging rupee to any specific levels. **We don't expect the rupee to breach the levels of 80 and instead show an appreciative bias over time.**

In our March'14 Ecowrap, we had suggested for the Central Bank to intervening in the NDF market instead of the onshore market through Banks during Indian time zone as this has the benefit of not impacting rupee liquidity, other than majority of USD trading in onshore market following the offshore markets. Thus, directly intervening in the NDF market will reverse the arbitrage too.

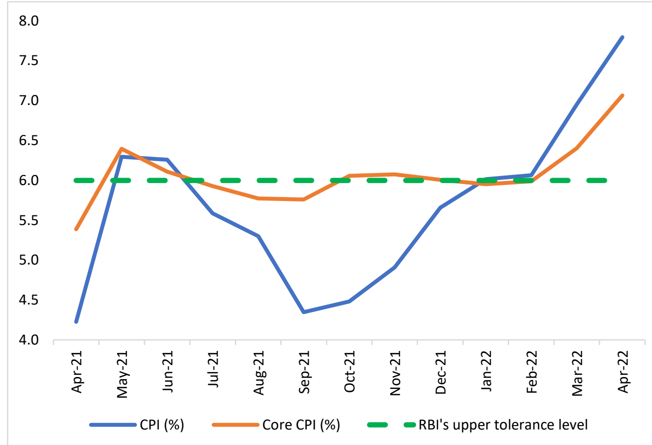
CPI RISES TO 8-YEAR HIGH OF 7.79%

- CPI inflation rose to a 95-month (almost 8 years) high to 7.79% in Apr'22 as against 6.95% in Mar'22 and 4.23% in Apr'21 due to significant increase in vegetable and fuel prices. For the four consecutive months CPI inflation is now more than 6% (RBI's upper tolerance level). Fuel and light inflation jumped from 7.5% in Mar'22 to 10.8% in Apr'22. Inflation in transport and communication also increased from 8% in Mar'22 to 10.9% in Apr'22.
- Core CPI breached the 7% mark for the first time in last 8 years and stood at 7.07% in Apr'22.
- Rural CPI increased to 8.38% from 7.66% in Mar'22, while in Urban Areas CPI increased to 7.09% from 6.12% in the previous month.
- The item-wise index indicate that inflation has crossed 20% in 18-items and 10-20% is in 63-items. Contribution of items like milk, mustard oil, refined oil, wheat and LPG has crossed 20 bps each in the overall inflation.

WHAT THE RBI ACT SAYS?

- In exercise of the powers conferred by section 45ZA of the Reserve Bank of India Act, 1934, the Central Government, in consultation with RBI, has fixed the inflation target of 4% with tolerance level at 6% and lower tolerance level at 2%.
- Further, if the average inflation is more than the upper tolerance level of 4% + 2%, that is, 6%, or less than the lower tolerance level of 4% – 2%, that is 2%, for any **three consecutive quarters**, it would mean a failure to achieve the inflation target. Where RBI fails to meet the inflation target, in terms of the provisions of RBI Act, it shall set out a report to the Central Government stating the reasons for failure to achieve the inflation target; remedial actions proposed to be taken by RBI; and an estimate of the time-period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions.
- With more than 6% average CPI inflation for Q4 FY22 and a projection of 6.30% for the Q1 FY23 (as per RBI's Apr'22 MPC report fan chart), the average CPI inflation will remain more than 6% for at least 2 consecutive quarters. For Q2 FY23, RBI projects 5.80%. **Thus with the third consecutive quarter very close to the upper limit of 6%, it seems that RBI is likely to take a sledgehammer approach and increase the repo rate aggressively and frontload it.**

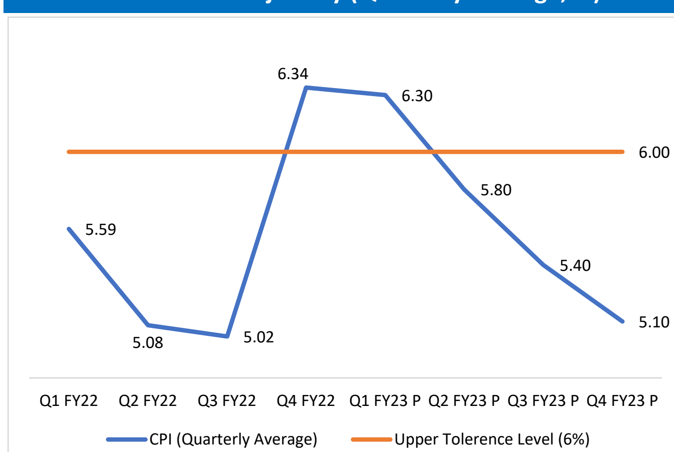
CPI & Core-CPI Inflation (%)



Source: SBI Research

Anatomy of CPI (%)			
	Mar-22	Apr-22	Change in bps
Fastest 5 increases in price			
Vegetables	11.6	15.4	377
Fuel and light	7.5	10.8	327
Transport and	8.0	10.9	291
Fruits	2.5	5.0	245
Spices	8.5	10.6	205
Fastest 5 decline in price			
Meat and fish	9.6	7.0	-266
Egg	2.4	0.0	-244
Oils and fats	18.7	17.3	-145
Pulses and prod-	2.6	1.9	-71
Sugar and confec-	5.5	5.2	-29
Memo:			
CPI All Groups	7.0	7.8	84
Source: SBI Research			

CPI Inflation Trajectory (Quarterly Average, %)



Source: SBI Research; P: RBI Projections

TRANSMISSION OF POLICY RATES TO DEPOSIT AND LENDING RATES OF BANKS

- In response to the cumulative reduction of policy repo rate by 250 bps during the easing phase (Feb'2019 to Apr'2022), the 1-year MCLR of SCBs declined by 155 bps
- Transmission to lending rates has improved considerably more so since October 2019 when there has been a complete pass-through of repo rate cuts to the weighted average lending rate (WALR) on fresh rupee loans. Further, the improvement in transmission to outstanding loans is also pronounced during the same period.
- In February 2019, more and more loans linked to MCLR, primarily in the 1-year bucket are getting reset since February 2020 contributing to the improvement in transmission to WALR on outstanding loans. In addition, the increase in the share of external benchmark linked loans in the total outstanding loans has also played an important role, which is increasing.
- The adoption of external benchmark-based pricing of loans strengthened market impulses for quicker adjustments in deposit rates. The weighted average domestic term deposit rate (WADTDR) on outstanding rupee deposits has declined by 180 bps since October 2019 as compared to the decline of mere 7 bps during February-September 2019.
- Additionally, the reduction in deposit rates was also perceptible for saving deposits, which form nearly 34% of the total deposits of SCBs. The saving deposit rates of five major banks dropped to a range of 2.70-3.00% from 3.25-3.50% that prevailed prior to the introduction of the EBR system (end September 2019).
- As retail loans are benchmarked to an external rate (mostly to RBI's repo rate) with quarterly reset clause so the loans benchmarked to repo rate may increase directly with the increase in repo rate, so there will be 100% transmission.
- As of Dec'2021, around 39.2% of the loans are benchmarked to external benchmarks, so the increase in repo rate will eventually increase interest cost on consumers and demand may crash during an increasing rate scenario.
- Further, the interest rates on the various small savings instruments, after being lowered sharply during Q1:2020-21 in alignment with the formula based rates, were left unchanged after that, as it impacted small depositors during COVID-19 period.

Transmission from the Repo Rate to Banks' Deposit and Lending Rates (Variation in basis points)

Interest Cycle	Period	Change in Repo	Deposits Rate	Lending Rates		
			WADTDR (Outstanding Deposits)	1 - Year Median MCLR	WALR (Outstanding Rupee Loans)	WALR (Fresh Rupee Loans)
Decreasing	Jan-12 to Aug-13	-1.25	0.00	-	-0.36	-
Increasing	Sep-13 to Dec-14	0.75	-0.27	-	-0.33	-0.07
Decreasing	Jan-15 to May-18	-2.00	-1.90	-0.97	-1.59	-2.05
Increasing	Jun-18 to Jan-19	0.50	0.20	0.32	-0.01	0.55
Decreasing	Feb-19 to May-20	-2.50	-0.79	-0.95	-0.48	-1.45
COVID-19 Period	May-20-Mar-22	0.00	-1.09	-0.60	**-1.02**	-0.84
Increasing	Apr-22 - till Now	0.40	-	0.00	-	-
Memo:						
Current Easing Cycle	**Feb-19 to Apr-22**	**-2.50**	**-1.87**	**-1.55**	**-1.48**	**-2.14**
	Oct-19 to Mar-22*	-1.40	-1.80	-1.20	-1.50	-1.86

Source: RBI, SBI Research *External Benchmark Lending Rate Regime

Internal vs External Benchmark System for pricing of loans

External benchmark linked rate (EBLR)	Internal benchmark (Base rate or MCLR)
Direct transmission: 1-1 basis (if spread remains unchanged)	Indirect transmission to lending rates: as lending rates are determined on a cost-plus basis and is contingent upon changes in deposit interest rates
Mandated to pass to the existing borrowers within 3 months	Majority of loans are linked to 1-year MCLR and are reset annually
EBLR framework prohibits banks from adjusting their spreads for existing borrowers for 3- years in the absence of a significant credit event.	

Source: SBI Research

Outstanding Floating Rate Rupee Loans of SCBs across Interest Rate Benchmarks (Per cent to total)

	Mar-20	Mar-21	Jun-21	Dec-21
Base Rate Regime	10.2	6.4	6.5	5.3
MCLR Regime	77.7	62.8	60.3	53.1
External Benchmark Regime	9.3	28.6	32.2	39.2
Others	1.7	1.5	0.5	1.9

Source: RBI

Share of Outstanding Floating Rate Rupee Loans of SCBs (in %): Interest Rate Regimes

Segments	Base Rate	MCLR	EBR
MSMEs	5.5	35	58.5
Personal Loans	6.2	57	35.3
Housing	7.3	41.9	49.1
Vehicle	4.3	57.3	38.2
Education	32.0	40.7	23.7
Other Personal Loans	2.1	78	19.3

Source: RBI Bulletin July 2021, SBI Research

- Going forward, as lending rates will increase, bank's will also increase the deposit rates to align with the small savings rates.
- To be fair to RBI, the external benchmark is good for better transmission but may affect the borrowers during the rising interest rate cycle. EBLR is mostly popular in western countries for setting lending rates as banks there depend largely on short-term funds but Indian banks, on the other hand, have a strong sticky retail deposit base and hence do not resort to borrowings from the central bank.
- The large share of public deposits in total liabilities for countries like India has important implications for macro stability and policy transmission. Firstly, with banks funding themselves through retail deposits, the source of vulnerability to external contagion is significantly reduced. Second, only 1% of the bank borrowings is currently at the policy rate of 4.4%. Third, the share of public deposits has a preponderance of CASA (44.7% approximately) that is mostly interest rate agnostic in India with an average interest rate of around 2.7-3.5%. The rest are time deposits with a fixed interest rate for the duration of the deposit tenure. **Thus, when, say, repo rate say changes by 25 basis points, even under full transmission there could be at most a 15-basis point impact on deposit rates (25 bp*59% interest sensitive time deposits) and thereby on lending rates. In internal benchmark systems like MCLR/Base rate. While in EBR, directly 25 bps will be transmission in lending rates, which will affect customers.**

INCREMENTAL HOME LOAN GROWTH MIGHT TURN NEGATIVE IF TERMINAL REPO RATE INCREASES BEYOND 5.25%

- Weighted average lending rate for Housing loans stood at 7.48% in FY22. Based on ASCB housing loan data from 2005, we have estimated that 8.75% is the threshold weighted average lending rate for housing loan beyond which incremental housing loan would turn negative.
- Thus with most of the loans now linked to the repo rate, transmission will happen automatically. **This in turn implies that RBI should not increase the repo rate by more than 1.25%. With 40bps hike already done in May, repo may not be increased more than 80 bps, i.e. upper limit should be 5.25%.**

RBI MAY GO FOR ADDITIONAL 100 BPS CRR HIKE

- System liquidity is still in surplus mode with net durable liquidity at Rs 6.8 lakh crore. RBI should increase the CRR rate by another 100 bps, after raising it by 50 bps in the last monetary policy. This would lead to absorption of Rs 1.74 lakh crore from the market on durable basis (Rs 87,000 crore absorbed earlier).
- High Government borrowing has ruled out the possibility of OMO sale, thus CRR increase seems as the possible non disruptive option of absorbing the durable liquidity. Furthermore, this opens up space for RBI to conduct liquidity management in future through OMO purchase. RBI can give back to the market at least 3/4th of the Rs 2.6 lakh crore absorbed through CRR hike or Rs 1.95 lakh crore in some form to address duration supply.
- This would lower the Market Borrowing to around Rs 12.36 lakh crore for FY23 compared to the BE of Rs 14.3 lakh crore.
- Yields are a function of real economic activity. 10 year domestic yield rise could be capped as real economic activity slows down following the prolonged geo-political conflict. US 10 year yields have already softened sharply, perhaps indicating what the future holds in store!

WAY FORWARD

- Russia-Ukraine conflict has significantly impacted the trajectory of inflation. The conflict has pushed up prices of chicken abruptly as chicken feed imports from Ukraine are getting disrupted. The pressure on sunflower oil supplies from Ukraine has led to change in export policy from Indonesia, hereby leading to lower palm oil imports. Further the war has exacerbated crop loss concerns in South America which in turn has impacted soybean oil supplies.
- A historical decomposition of CPI inflation to ascertain the various macro-factors that drove inflation dynamics, indicate that the inflationary pressures can be attributed mainly to adverse cost-push factors, coming from supply-side shocks in food and fuel prices, even as weak aggregate demand conditions continued to exert downward pressure on inflation.

- Persistence in CPI was driven by inflation in food prices. The contribution of semi-perishable goods edged up till October but declined thereafter. Durable goods inflation has transmitted heightened cost-push pressures in the manufacturing sector.
- Measures to ameliorate supply-side cost pressures would be critical at this juncture, especially in terms of a calibrated reduction of taxes on petrol and diesel. This would help anchor inflation expectations, prevent build-up of a wage-price nexus and provide space for monetary policy to sustain support for the still incomplete growth recovery. On the policy side, it would mean that even after rate hikes, inflation may continue to remain high for some time.

- The rupee has sharply depreciated against the dollar on account of galloping inflation both in the US and domestically. Aggressive rate hike in in the US have strengthened the dollar against the basket of currencies. The dollar to 104.44, its highest since December 2002.
- The rupee has accordingly moved northwards breaching the 77-mark. With normalization of LAF corridor, it expected that rupee will some volatility. The FII outflows in the equity may persist as normalization of interest rates in advance economies will impact the growth outlook in emerging markets. Rupee is expected to move in range ₹75-78 with swings on either side.

*****

Contact Details:

Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in,
gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya