

AT LEAST 59% OF THE INCREASE IN INFLATION IS BECAUSE OF GEO POLITICAL CONFLICT: FUTILE TO BLAME CENTRAL BANKS

Inflation continues to be a bugbear and it looks unlikely that it will correct anytime soon. **The latest inflation numbers however reveal that while in the rural areas, the impact has been disproportionately higher for food prices, in urban areas it is disproportionately higher as far as fuel price impact and pass through is concerned since the war began.**

We did a dipstick study to understand the exclusive impact of war on inflation trajectory in both the rural and urban areas. Using February as the base case (the beginning of the Ukraine and Russia conflict), our study reveals that because of war alone, Food and Beverages (assuming that vegetable price increase was mostly because of seasonal factors, that are largely domestic) and Fuel and Light & Transport contributed 52% of the increase in overall inflation since February. If we also add the impact of input costs particularly on the FMCG sector, thus adding the contribution of personal care and effects, **the total impact at all India level comes to 59%, purely because of war.**

Against the continued increase in inflation, it is now almost certain that RBI will raise rates in forthcoming June and August policy and will take it to pre-pandemic level of 5.15% by August. However, the important challenge facing the central bank remains whether inflation will tread down meaningfully because of such rate hikes if war related disruptions do not subside quickly.

In particular, as retail loans are benchmarked to an external rate (mostly to RBI's repo rate) with quarterly reset clause, so the interest rate on loans benchmarked to repo rate will increase directly with the increase in repo rate. 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. In a situation of incipient demand recovery post Covid, the question will be whether growth could be a large casualty in case of large and persistent rate increases, even as inflation prints will continue to be of serious concern.

It is noteworthy that transmission to lending rates since October 2019 reveals that even as repo rate was cut by 140 basis points, the weighted average lending rate (WALR) on fresh rupee loans declined by more than 186 basis points. This was one of the primary reasons for significant jump in credit impulses during pandemic, apart from financial stability concerns being addressed eloquently by RBI through using yield curve as a public good. The current turbulence in a way mirrors such conundrum the RBI faced while navigating through the pandemic as larger rate hikes to quell inflation might have an impact on nascent growth impulses. Also, the RBI may have to use a shorter window to address inflationary concerns given the realpolitik challenges in the not so distant horizon.

We thus must support RBI in its endeavour to quell inflation through hikes in interest rates. A higher interest rate will be also positive for the financial system as risks will get repriced. The situation is different than during the global financial crisis wherein the lending started increasing aggressively from March 2009 onwards much before the rate hike cycle began (Mar'2010 till March'2012). Currently, the rate hike cycle has begun and now the bank lending will increase according to the adequate risk pricing and demand. Interestingly, retail personal loans have grown at a scorching pace of 23.1% in FY22 with an interest rate that is much higher than home loan rates which are EBLR linked rates. **Additionally, Household Leverage as a % of GDP has now declined to 31.8% of GDP in March 2022 from a high of 37.2% in March 2021.**

There is one point of caution though. Indian inflation internals are much different than those of advanced economies such as the US. Building wage pressures mirrored in the multi-decadal high annual wage growth are fuelling broad-based price pressures across all advanced economies. In contrast, in India nominal rural wages for both agricultural and non-agricultural labourers picked up during H2 FY22, with easing of restrictions/lockdowns imposed by states and restoration in economic activity. **However, the wage growth has remained soft. The weighted contribution of wage growth in CPI build-up remains modest. Thus, even after rate hikes, inflation will take time to moderate in India.**

We also strongly recommend that the RBI may intervene 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. This will also save the foreign exchange reserves, with only settlement of differential amount with counterparties on maturity dates.

IMPACT OF WAR ON CPI INFLATION

- ◆ 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 pass through in fuel prices.
- ◆ The latest inflation numbers however reveal that in while in the rural areas , the impact has been disproportionately higher for food prices, in urban areas it is disproportionately higher as far as fuel price impact and pass through is concerned since the war began.
- ◆ Using February as the base case (the beginning of the Ukraine and Russia conflict) reveal that only because of war, Food and Beverages (assuming that vegetable price increase was mostly because of seasonal factors, that are largely domestic) and Fuel and Light & Transport contributed 52% of the increase in overall inflation since February. If we also add the impact of input costs particularly on the FMCG sector, thus adding the contribution of personal care and effects, **the total impact at all India level comes to 59%, purely because of war.**

THE INFLATION AND GROWTH CONUNDRUM

- ◆ 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 for consumers and this may directly impact demand.
- ◆ To be fair to RBI, the external benchmark is good for better transmission for borrowers. It is noteworthy that transmission to lending rates since October 2019 reveal that even as repo rate was cut by 140 basis points, the weighted average lending rate (WALR) on fresh rupee loans declined by more than 186 basis points. This was one of the primary reasons for significant jump in credit impulses during pandemic. Envisaging a similar scenario now, there could be faster rate transmission for borrowers but in the reverse direction.
- ◆ The depositors however will stand to gain as there could be an equally faster transmission in an increasing interest rate scenario.

Impact of Russia-Ukraine Conflict on CPI inflation			
Change in CPI Inflation (Apr over Feb), in %	CPI Rural	CPI Urban	CPI All India
		2.0	1.3
Share of Various items in CPI Increase			
Food and beverages, of which	65%	52%	58%
Cereals and products	12%	9%	10%
Milk and products	6%	7%	6%
Oils and fats	3%	6%	4%
Fruits	4%	6%	5%
Vegetables	31%	23%	28%
Spices	8%	5%	7%
Prepared meals, snacks, sweets etc.	3%	3%	3%
Pan, tobacco and intoxicants	1%	0%	0%
Clothing and Footwear	5%	8%	6%
Housing	0%	-2%	-1%
Fuel and light	10%	6%	9%
Miscellaneous, of which	18%	34%	23%
Transport and communication	8%	21%	13%
Personal care and effects	7%	7%	7%

Source: SBI Research

- ◆ The large share of public deposits in total liabilities for countries like India has had 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, in the earlier regime of pre EBLR, when, repo rate say changed by 25 basis points, even under full transmission there could have been be at most a 15-basis point impact on deposit rates (25 bp*59% interest sensitive time deposits) and thereby on lending rates. While in EBR, directly 25 bps will be transmission in lending rates, which might impact borrowers.**
- ◆ We expect CRR will be hiked, but mostly as a pre-emption tool to manage larger Government borrowing by In this context, we may consider communication from RBI like equal burden sharing between Govt (higher interest payment for increase in borrowing), RBI (higher interest payment for Variable Rate Reverse Repo) and Market Participant (interest forgone for higher CRR amount by banks) as a basis for 150 bps CRR hike to ward of the current challenges.

Disclaimer: The Ecowrap is not a priced publication of the Bank. The opinion expressed is of Research Team and not necessarily reflect those of the Bank or its subsidiaries. The contents can be reproduced with proper acknowledgement. The write-up on Economic & Financial Developments is based on information & data procured from various sources and no responsibility is accepted for the accuracy of facts and figures. The Bank or the Research Team assumes no liability if any person or entity relies on views, opinion or facts & figures finding in Ecowrap.

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