SBI Research

Prelude to MPC Meeting: February 6-8, 2024

Declining Core Inflation Trajectory Mirroring Behavioural Shifts across the Latitude, *NOT* a Proxy of Imaginary Demand Slowdown….

(The decline in core on a durable basis should open up more degrees of freedom for monetary policy rate cuts….)

05-February-2024

Executive Summary…..1/2

- The Federal Reserve meet last week left the key policy (FFR) rate untouched at 5.25-5.50%, dashing any hopes of an ensuing pivot by markets that were additionally jolted by a much stronger Non-Farm payroll report for December'23 at 3,53,000 (estimated 1,85,000) and hourly wage earnings indicating robust resilience continuance for average workers…however there are pain points in the US economy, that can get exacerbated with such conflicting trajectories…

- **The disruptions across key chock point in shipping lanes will continue to cloud the outlook on global trade** even as it is estimated to pick up to 2.3% in 2024. While trade in goods is still lackluster, trade in services is showing signs of recovery comparatively with global tourism slouching back to pre-pandemic levels….

- With IMF WEO projecting the mainland Chinese economy to grow by 4.6% in 2024, the **year of the Dragon** may bring some semblance of normalcy in the battered economy though the lingering impacts of the property crisis and intense collaborative blockades by Developed Economies on tech-fin front, chiefly to ringfence the ambitions of CCP, can upend and deepen uncharted risks multifold, as the stock markets' rout (both mainland as also Hang Seng) are foretelling….

- On the banking front, deposit growth has rebounded but sustained credit growth momentum has increased wedges between deposits and credit growth. As on 12 Jan, ASCBs credit grew by 20.3% (16.0% last Year) and deposits by 13.1% (10.6% last year). Latest credit growth numbers reveal a sustained pick up across Agriculture, MSME & Services….

- **On a positive note, Average Core inflation (CPI excluding food and fuel) which was extremely sticky during 2021 and 2022 (~6% average) has eased sharply to 5% in 2023….Even from the high of 7.09% in Apr'22, core CPI inflation has declined to less than 4% in Dec'23 (i.e., 3.76%)…Traditionally, the urban core CPI inflation is lesser than the rural core CPI inflation**
  - A behavioural shift looks the likely reason for the fall in core CPI (At all-India level, while CPI inflation declined by 210 bps to 5.69% in Dec'23 as compared to Apr'22 level, during the same period the weighted contribution of core CPI was declined by 159 bps)..**if this is sustained the decline in Core could become more enduring in nature opening up space for policy rate cuts…**

Executive Summary…..2/2

- **In principle, 80% of the decline in Core is driven by: transportation & communication, clothing and footwear and household goods contributed 80% of total decline in core inflation**

    - When we analyze the item-wise decline in weighted contribution of core CPI, the results are astounding…. Since the decline in core is visible in both rural and urban areas and in goods and services that are quintessential to the day-today living, thus to confer that core decline leads to a demand slowdown is might be a misnomer

    - For example, the 57-bps decline in weighted contribution in clothing and footwear/household goods & services is due to decline in multiple items like saree, shirt, trouser, clothing material, washing soap, bedsheet, etc. that are part of daily living

    - The only reason for this phenomena could be the changing behaviour of customers in buying things as we are of the considered view that people are actively using e-commerce websites to buy these essentials (preferably lured by discounted price/faster turnaround time & convenience of ‘shopping from home/office’) resulting in a shift in demand from offline to online

    - The 13-bps decline in health (non-institutional) is indicative of the fact that people are increasingly using services at Government hospitals. This is a triumph for Government that is striving to provide medical facilities to the poor strata at reasonable cost/free….

- National Agriculture Market (e-Nam) and the e-commerce network Open Network for Digital Commerce (ONDC) are successfully addressing the infrastructural bottlenecks…**Mandi price is higher than MSP for majority of the crops,** anchoring MSP as a floor for prices at Physical/digital marketplaces. We believe there is a BIG structural change in pricing behavior coming to the fore

- **Gini co-efficient for casual workers shows declining inequality for both male and female rural workers in 2023…**

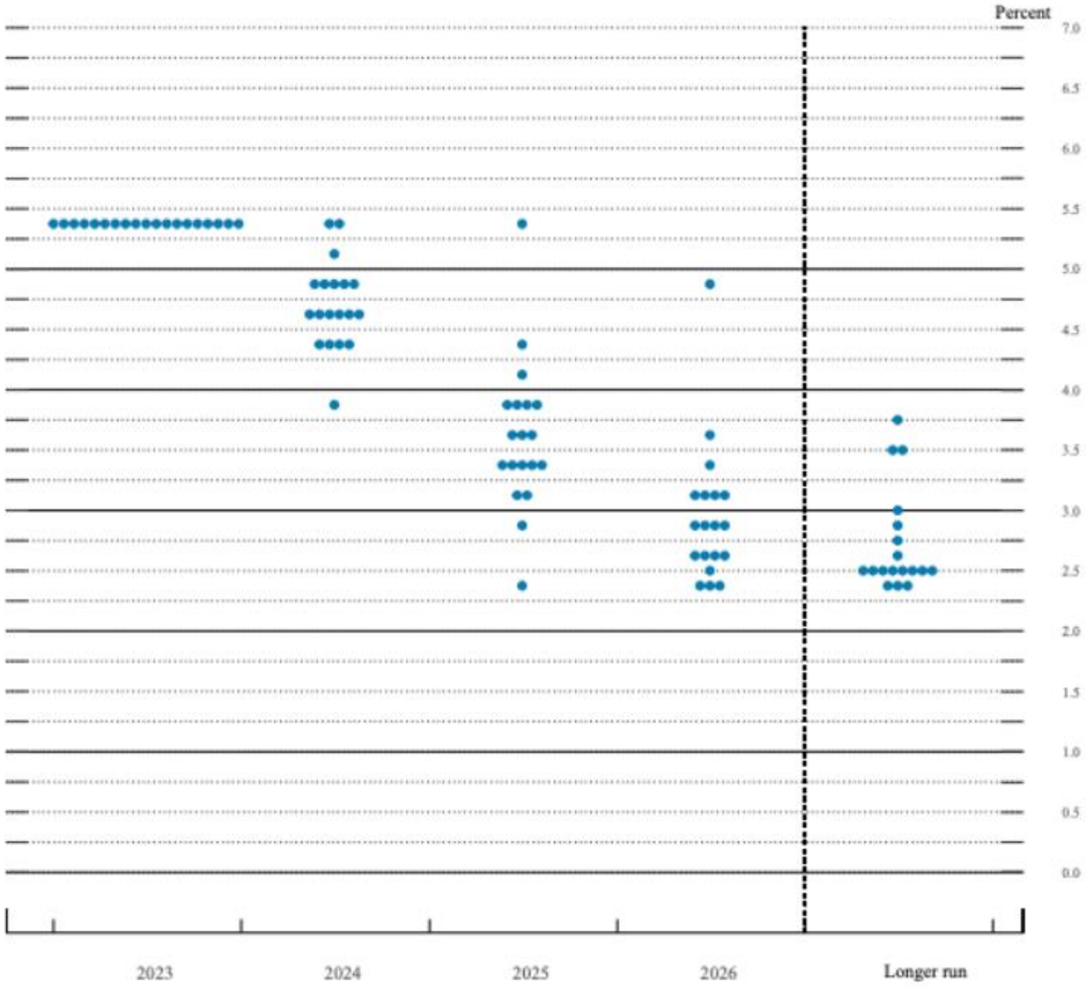
Global Backdrop

US Economy: Fed disappoints markets expectations of a Pivot anytime soon, exposes pain points

- FOMC, in its last week meet, kept the Federal Funds rate (FFR) unchanged at 5.25-5.50% (…. Time since …) as economic outlook was deemed uncertain nudging the Committee to remains highly attentive to inflation risks, carefully assessing incoming data, the evolving outlook, and the balance of risks before considering any pivot in the wake of economic activity expanding at a solid pace, job gains remaining strong despite slight moderation, and the low unemployment rate

- A surprise Non-Farm payroll data release on 01 February that showed payroll increase of 353,000 last month, much stronger than the estimated 185,000 catapulted benchmark yields, dashing broader markets hope of an imminent rate cut with average wage earnings remaining resilient

Fed Dot Plot: Target range estimate of FFR Mid-Point by FOMC participants



Source: Bankrate.com, SBI research

Global trade outlook

- Global trade growth, which had flatlined in 2023, is expected to recover in 2024, although it will likely remain below its pre-pandemic trend

- Global trade in goods and services grew at a tardy pace of 0.2 per cent in 2023 – the slowest expansion outside global recessions in the past 50 years

- The World Bank has, however, projected global trade to pick up to 2.3 per cent in 2024

- While trade in good is still lackluster, trade in services is showing signs of recovery. International tourism has been showing signs of a robust recovery, particularly in Asia, and is expected to reach pre-pandemic levels by 2024

- **The disruption across key chock point in shipping lanes will continue to cloud the outlook on global trade**

Outlook on Chinese economy

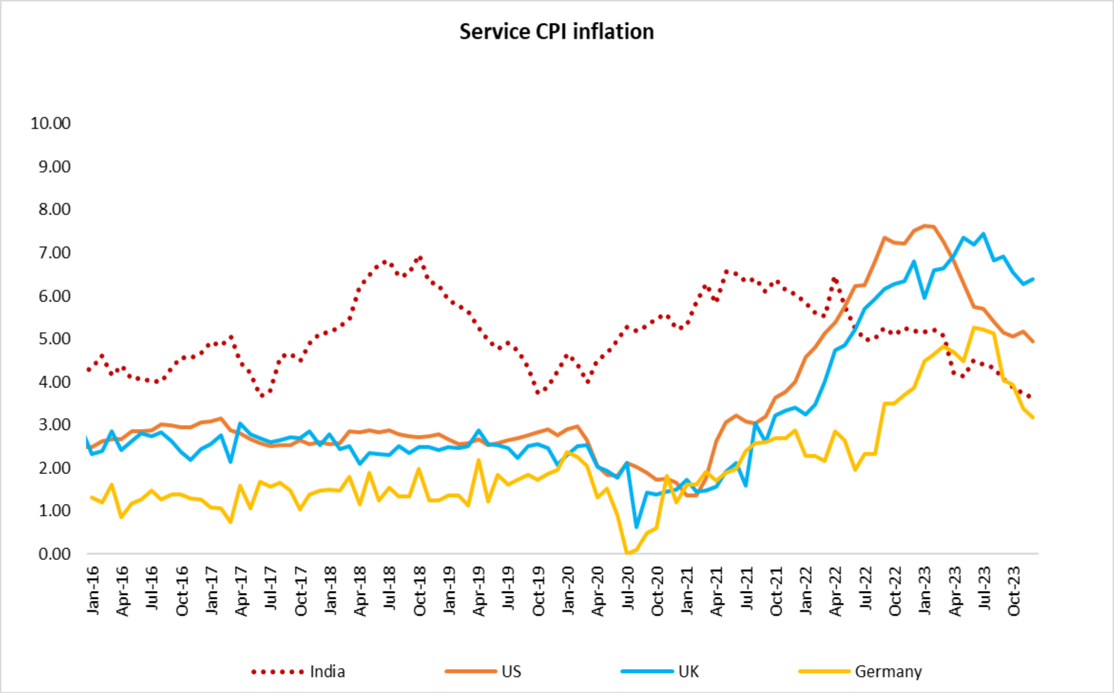
- The year 2023 was risk of high uncertainty in economic outlook of China. When all central banks were in tightening mode, PBOC was in accommodating mode

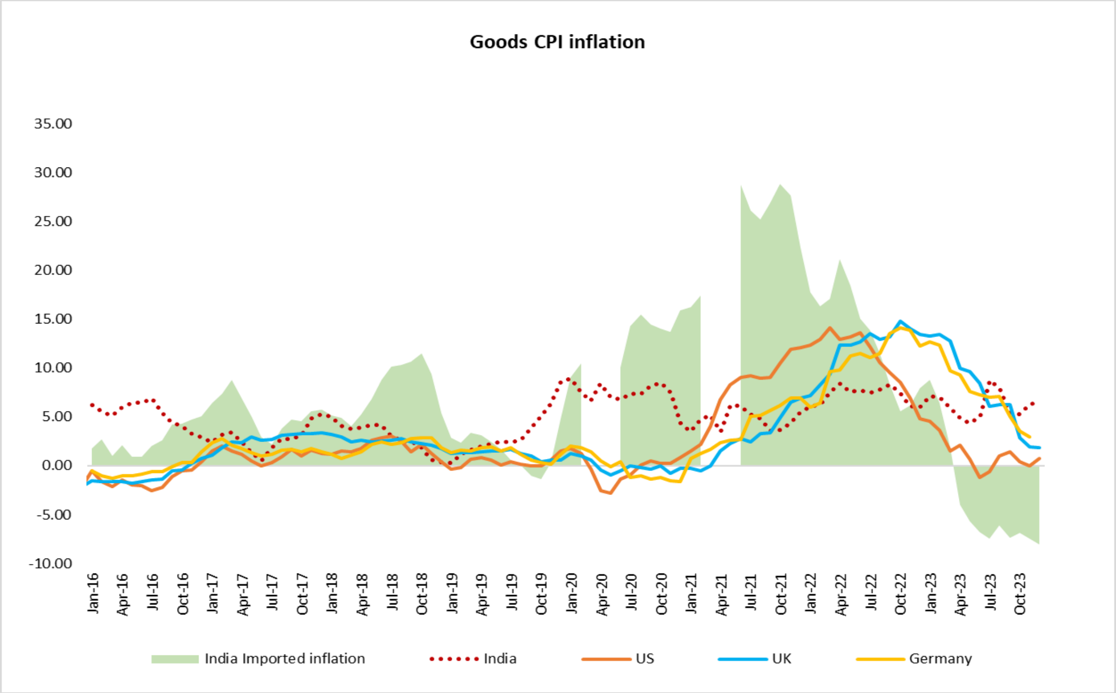
- The IMF WEO projects that China will grow by 4.6% in 2024 on the back of both fiscal and monetary policy support. But uncertainty will persist through out 2024

- Some of the key emerging risk to 2024 include the following:
  - The property crisis is only deepening with largest property developer undergoing liquidation
  - There is fresh wave of consolidation in rural banking of China to tide over the build-up of risk
  - Lackluster outlook on goods trade is negative for overall from China’s perspective
  - Rise in freight costs due to instability across major choke points is also risk in 2024
  - Instability in Chinese stock markets is also a cause of concern

Global Inflation trends

Good and Services inflation provides a contrasting picture in India and ROW….





- A comparative between good and services inflation in India and select advance countries show that CPI services has moderated across countries
- **However, the goods inflation is sticky in India on account of sticky food prices**
- **Service inflation in India is declining though it is rising in ROW**
- Imported component of CPI in Indian basket so has minimal impact

Red Sea disruption and inflation outlook

- Attacks launched by Houthi group on commercial ships at the southern end of the Red Sea and the subsequent fallout on shipping via the Suez Canal has emerged as important concern for India and global trade in general

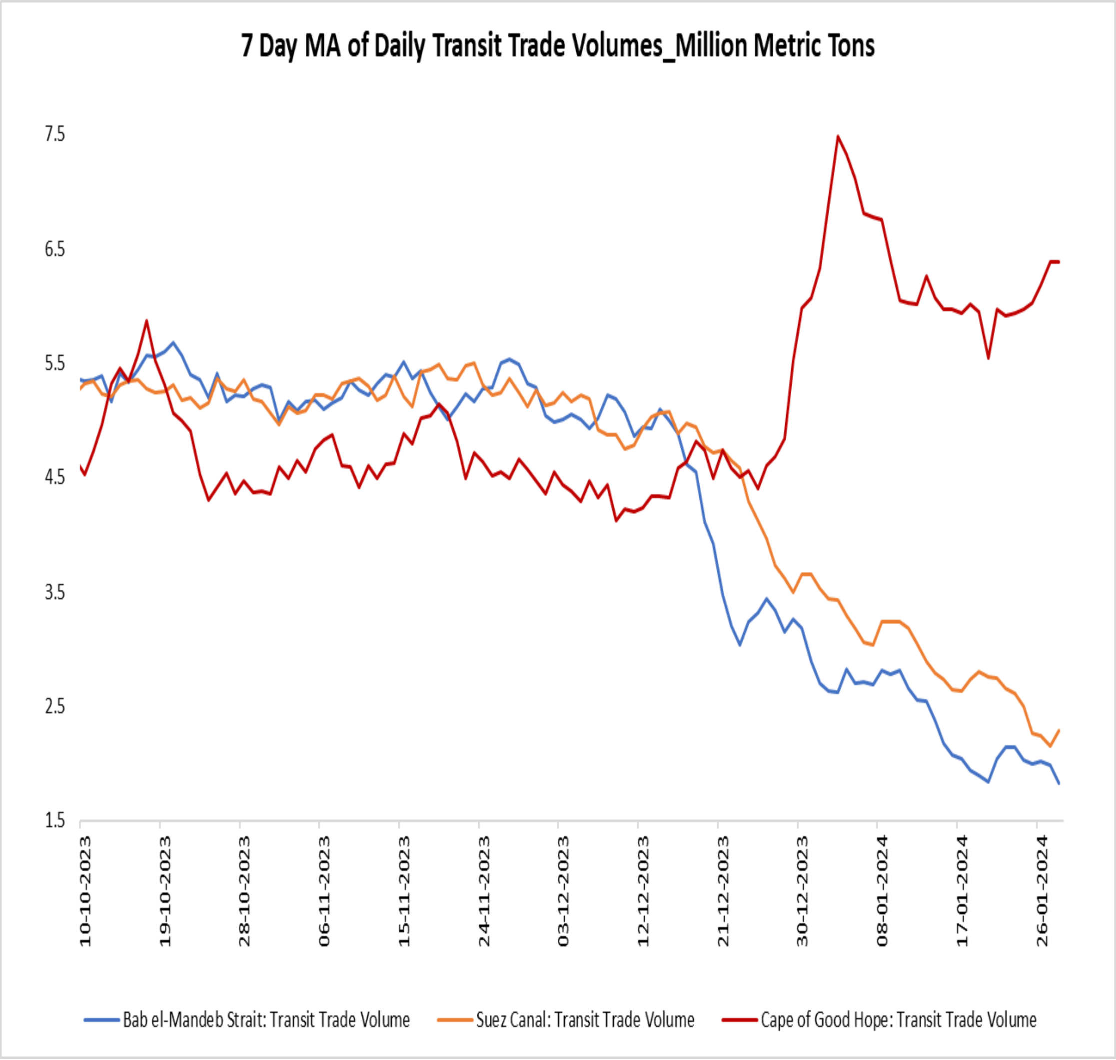
- In case of India the Suez Canal route is import from both exports and import point of view. Nearly 50% of the exports and 30% imports pass through this router

- The Suez route is used predominantly for importing Russian oil whose share has increased and so far, there have been no disruptions. But the cost of shipping has gone up for imports. Unless there is major disruption to energy supplies the pass through of the rise in logistic cost will be function of pricing power of the importer for onward selling

- Disruption in exports may create a temporary demand supply imbalance in domestic market leading fall in domestic prices

- Thus, on standalone basis, the current crisis is not appearing inflationary for Indian case. Any uptick will be conditional on will rise on cost of logistics be passed on or absorbed

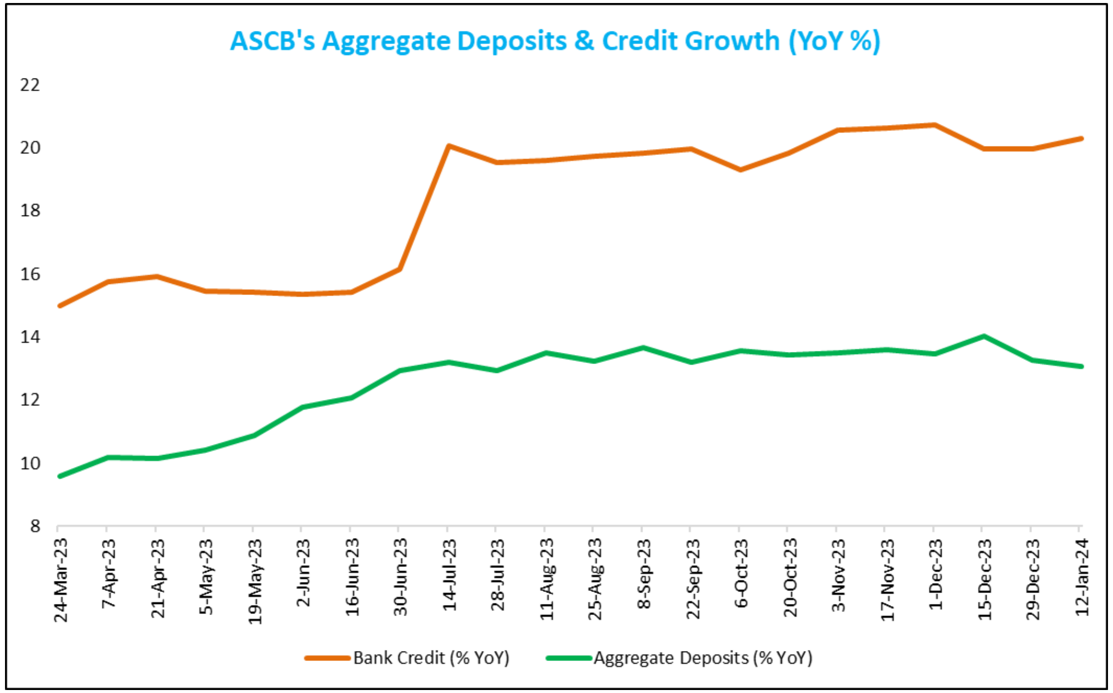
- **Such crisis if any, will be impacting global food prices. This may influence the CPI through the imported component of the basket**



Corporate India: Good Times Galore as PFCE expected pick up meaningfully post May elections

Credit continues to grow in double digits

- On the banking front, deposit growth has rebounded but sustained credit growth momentum has increased wedge between deposits and credit growth
- As on 12 Jan, ASCBs credit grew by 20.3% (16.0% last Year) and deposits by 13.1% (10.6% last year). Latest credit growth numbers reveal a sustained pick up across Agriculture, MSME & Services
- However, excluding HDFC personal loans credit grew by 17.7%, due ***to moderation in credit growth to housing, vehicle and other personal loans. This may be due to the increased risk weights by RBI***



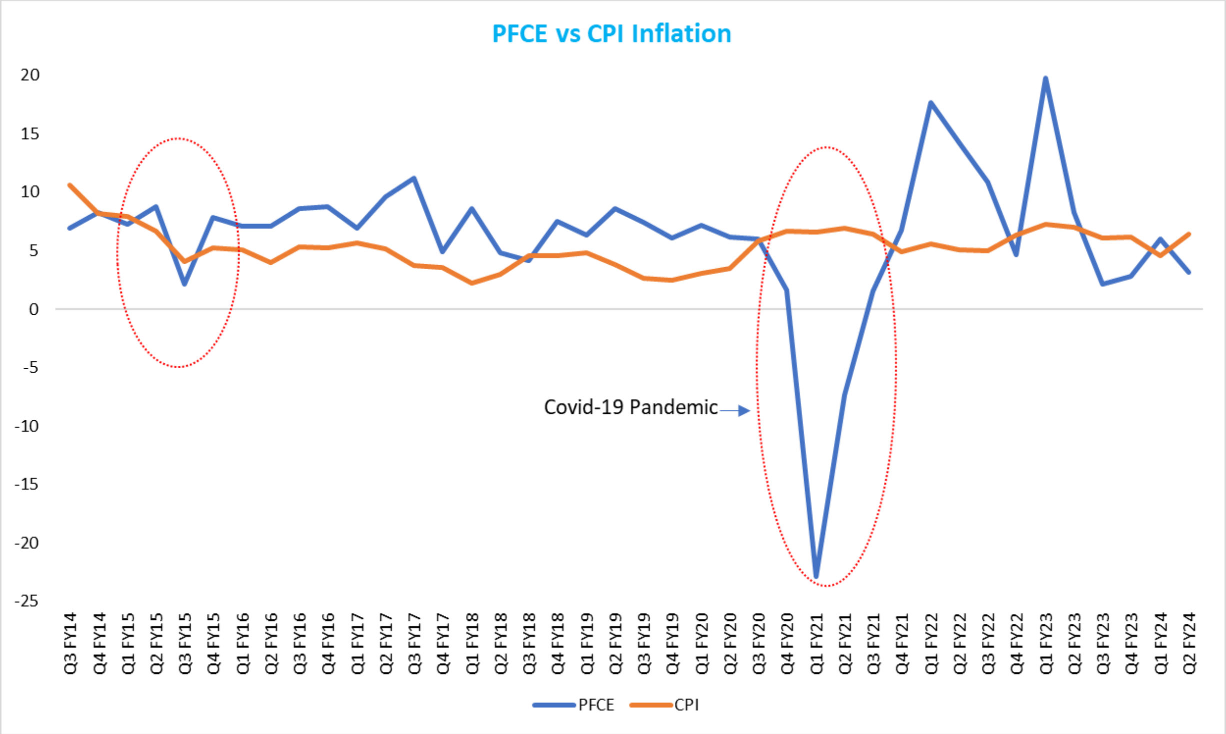
ASCBs Sector-Wise Credit Flow (Rs bn): December 2023

Sectors	Apr-Dec 2022 (FY23) YTD		Apr-Dec 2023 (FY24) YTD		YoY %		FYTD 24 as X times as FYTD 23
	Rs bn	%	Rs bn	%	FY23 (Dec)	FY24 (Dec)	No of times
Agri. & Allied	**1724**	**11.5**	**2664**	**15.4**	**11.6**	**19.5**	**1.5**
Industry	**1397**	**4.3**	**2484**	**7.3**	**8.6**	**8.6**	**1.8**
MSE (Priority)	1642	11.5	2729	16.6	11.6	20.4	**1.7**
Infrastructure	125	1.0	771	6.4	6.1	5.8	**6.2**
Services	**4958**	**16.0**	**7064**	**19.1**	**19.4**	**22.9**	**1.4**
NBFCs	2882	27.9	1787	13.3	34.0	15.1	**0.6**
Personal Loans	**5707**	**16.5**	**9946**	**23.8**	**20.4**	**28.5**	**1.7**
Housing (Including Priority)	2210	12.8	6517	32.8	16.4	35.6	**2.9**
Other Personal Loans	1791	19.8	1848	16.1	25.2	22.9	**1.0**
Gross Bank Credit	**14155**	**11.9**	**22861**	**16.7**	**14.9**	**19.9**	**1.6**

Source: RBI, SBI Research

PFCE vs Headline Inflation

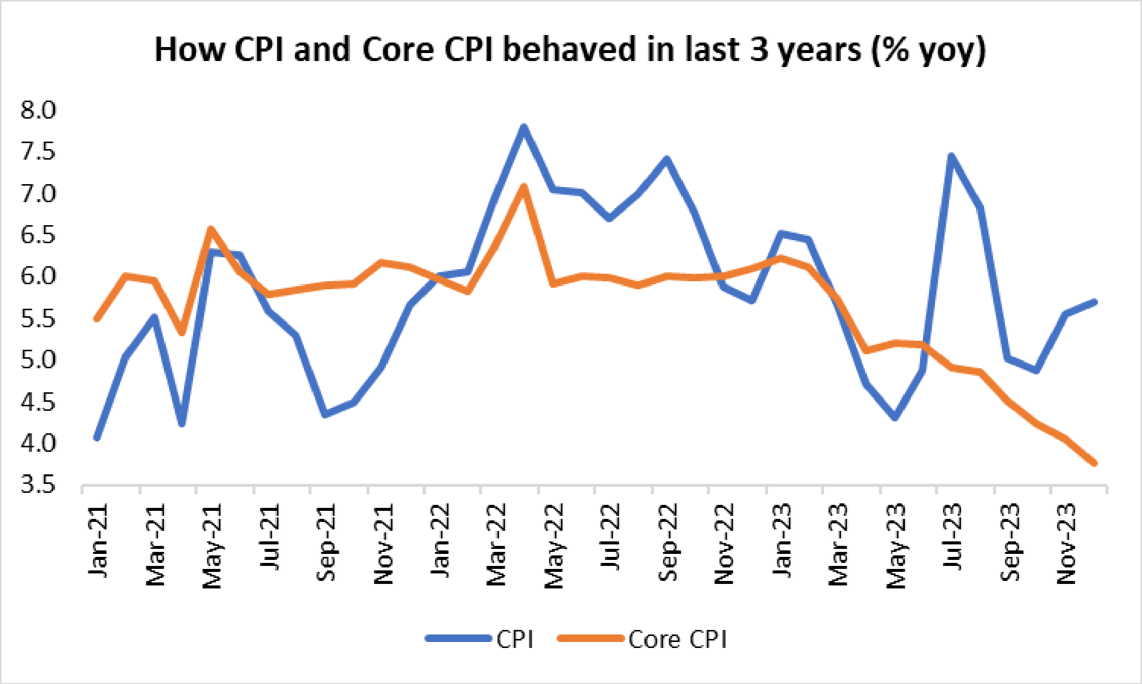
- PFCE has emerged as the strongest driver of India's growth in the post-pandemic period. Though, various concurrent factors have played a key role but the most important was the unfolding latent demand that could not find an outlet during the pandemic-driven lockdown
- PFCE has been declining from Q3FY23 and slowed to 3.1% YoY during Q2FY24 from 5.9% in Q1FY24 and averaged at 3.5% over the past 4 quarters (compared to 10.9% average in previous 4-quarters: Q3FY22 to Q2FY23)
- To test the sensitivity of PFCE towards headline CPI inflation, we have modelled inflation on PFCE and found that a negative relation of 25%. As inflation is going to decline materially in coming months, it is expected that PFCE will expand commensurately post elections in Apr-May 2024

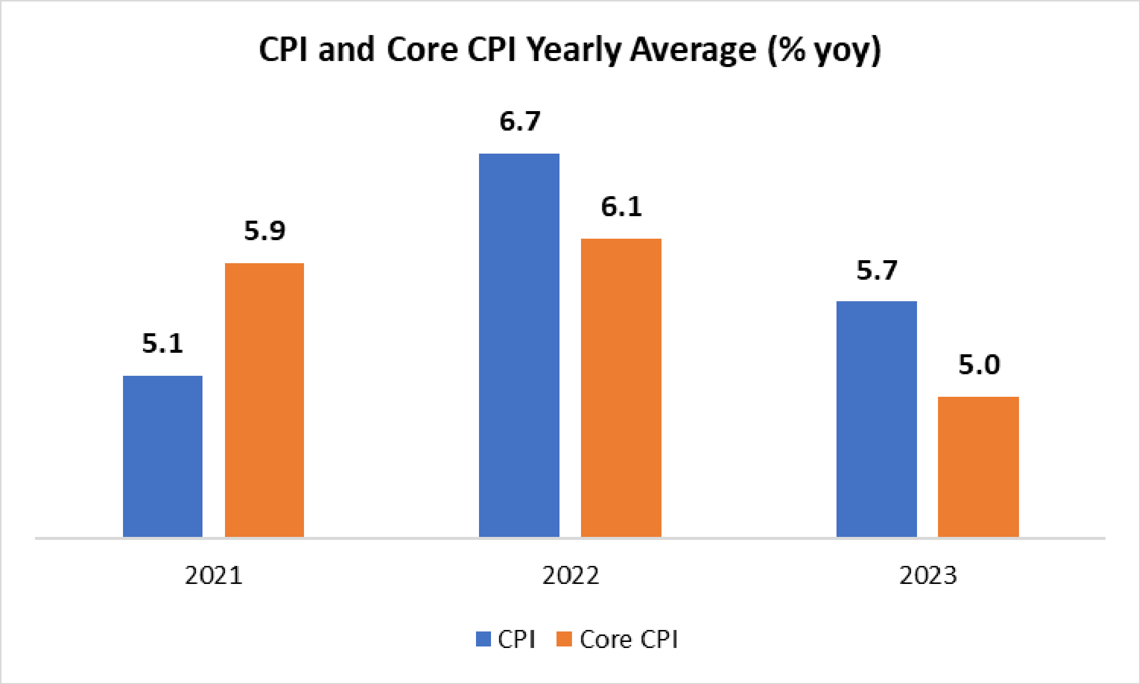


How Changing Spending Behavior Impacts Core CPI Inflation

Core CPI: Loosing Strength permanently?........

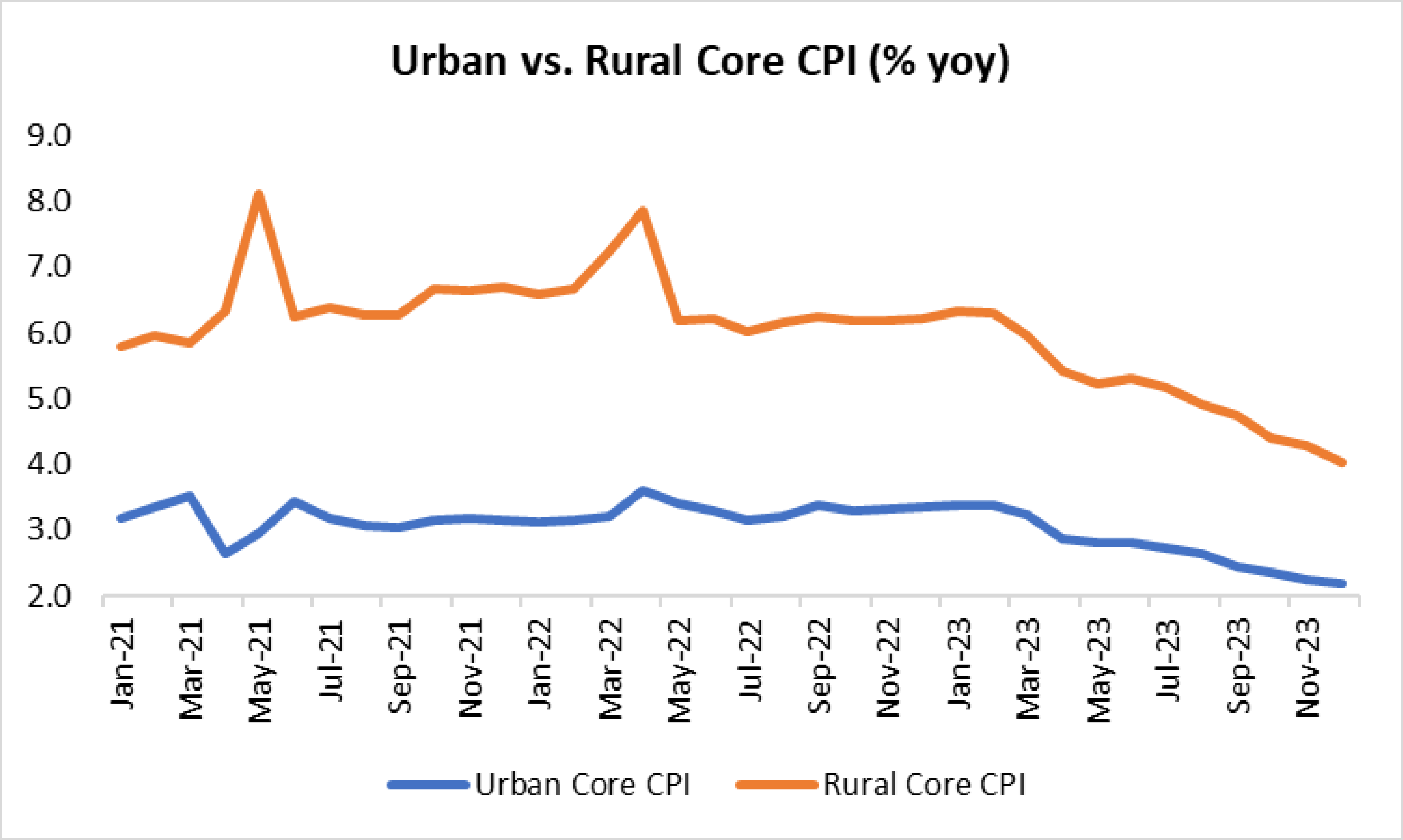
- **Average core inflation (CPI excluding food and fuel) which was extremely sticky during 2021 and 2022 (~6% average) has eased sharply to 5% in 2023**
- Even from the high of 7.09% in Apr'22, core CPI inflation has declined to less than 4% in Dec'23 (i.e., 3.76%)
- From that point of time, the weighted contribution of core inflation has also moderated from 3.36% to 1.77%





Core CPI: Urban vs. Rural

- Traditionally, the urban core CPI inflation is lesser than the rural core CPI inflation



Why is Core CPI declining?.....

- At all-India level, while CPI inflation declined by 210 bps to 5.69% in Dec’23 as compared to Apr’22 level, during the same period the weighted contribution of core CPI declined by 159 bps
- Of this decline, the three segments (transportation & communication, clothing and footwear and household goods) contributed 80% of total decline in core inflation
  - **In Rural these segments contribute 83% decline in core CPI**
  - **In Urban these segments contribute 93% decline in core CPI**

All-India, Rural and Urban core Inflation (%)												
Item	Combined				Rural				Urban			
	Weight(%)	Apr-22	Dec-23	Change in bps	Weight(%)	Apr-22	Dec-23	Change in bps	Weight(%)	Apr-22	Dec-23	Change in bps
Overall CPI	100	7.79	5.69	**-210**	100	8.38	5.93	**-245**	100	7.09	5.46	**-163**
Weighted Contribution												
Core CPI	47.3	3.36	1.77	**-159**	37.9	3.04	1.55	**-148**	58.1	3.60	2.17	**-143**
of which,												
Clothing and footwear	6.5	0.64	0.25	**-40**	7.4	0.80	0.27	**-54**	5.6	0.45	0.22	**-23**
Household goods and services	3.8	0.29	0.13	**-17**	3.8	0.29	0.13	**-16**	3.9	0.30	0.12	**-18**
Health	5.9	0.44	0.31	**-13**	6.8	0.51	0.35	**-16**	4.8	0.35	0.27	-8
Transport and communication	8.6	0.87	0.16	**-71**	7.6	0.70	0.17	**-53**	9.7	1.06	0.14	**-92**
Recreation and amusement	1.7	0.12	0.05	-7	1.4	0.07	0.04	-3	2.0	0.17	0.06	-11
Personal care and effects	3.9	0.33	0.28	-5	4.3	0.39	0.30	-9	3.5	0.26	0.27	1
Core of Core CPI	36.4	2.48	1.61	**-88**	-							
Source: MOSPI, SBI Research, Core of Core CPI excludes transport and communication												

Item-wise Decomposition of Weighted Average of Major Core Item reveal that talks of a demand slowdown in rural areas is misleading…….

- When we analyze the item-wise decline in weighted contribution of core CPI, the results are astounding
  - Since the decline in core is visible in both rural and urban areas and in goods and services that are quintessential to the day-to-day living, to confer that core decline is a proxy for decline in demand or rural slowdown is misleading
  - For example, the 57-bps decline in weighted contribution in clothing and footwear/household goods & services is due to decline in items like saree, shirt, trouser, clothing material, washing soap, bedsheet, etc. that are part of daily living and hence don't indicate that demand is not happening
  - **The only reason for this phenomena is the changing behaviour of customers in buying things. We believe that peoples are actively using e-commerce websites to buy these essentials (preferably at discounted price) and hence demand is migrating from offline to online mode….if this is durable, then core inflation decline could be enduring…**
  - **Interestingly, change in behavioural habit post pandemic has also resulted in people heading back to hometowns from urban areas…. might be resulting in lower demand for domestic helps….misleading to treat it as a pain point…**
  - The 13-bps decline in health (non-institutional) is indicative of the fact that peoples are using services at Government hospitals. **This is a triumph for Government that trying hard to provide medical facilities to poor at reasonable cost/free**

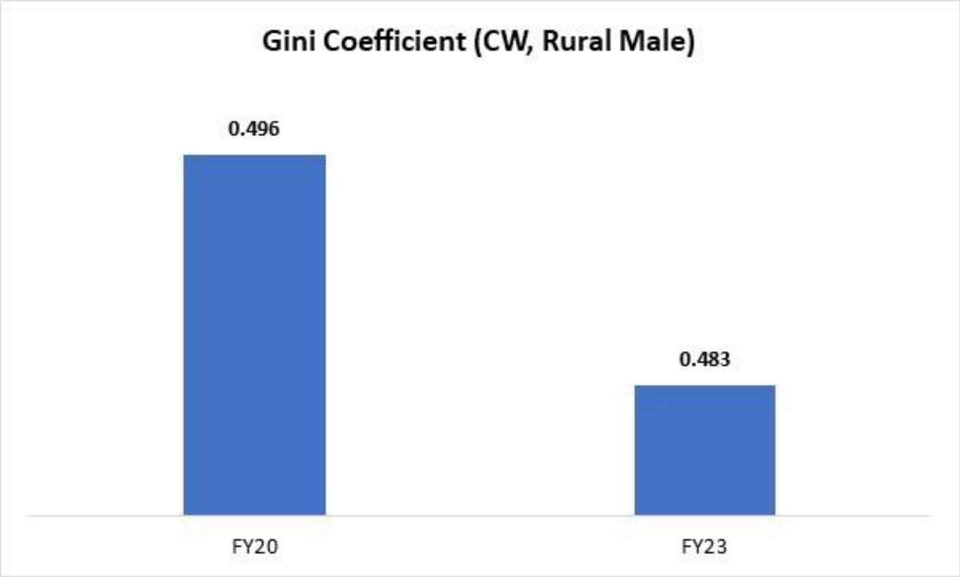
Item-wise Decomposition of Weighted Average of Major Core Items

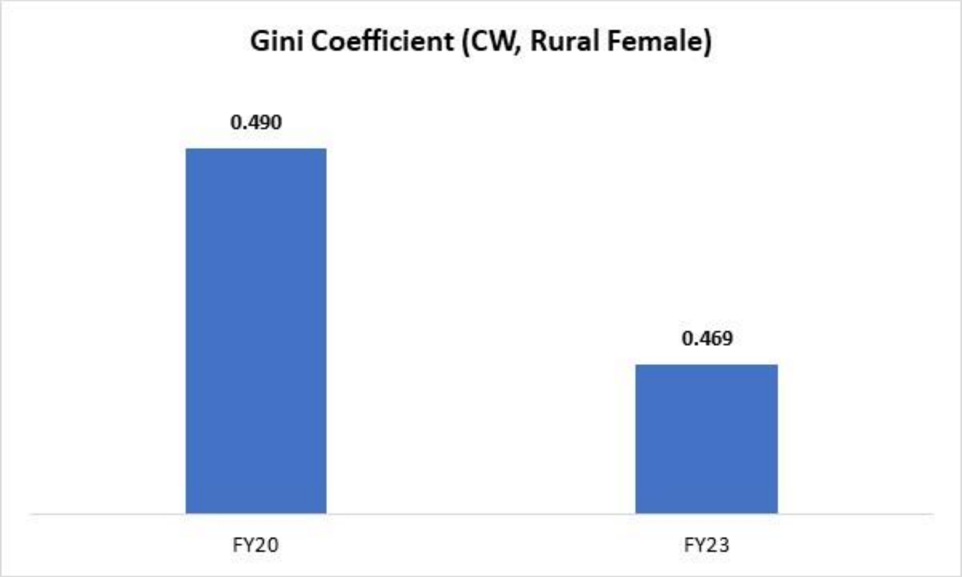
Item	Combined			
	Weight(%)	Apr-22	Dec-23	Change in bps
Clothing and footwear	**6.5**	**0.64**	**0.25**	**-40**
of which,				
saree	0.9	0.09	0.03	-6
shirts, T-shirts	0.6	0.06	0.02	-4
baniyan, socks, other hosiery and undergarments, etc	0.5	0.05	0.01	-4
cloth for shirt, pyjama, kurta, salwar, etc	0.7	0.08	0.03	-4
shorts, trousers, bermudas	0.6	0.05	0.02	-3
cloth for coat, trousers, suit, etc.	0.4	0.04	0.02	-2
rubber / PVC footwear	0.3	0.04	0.01	-3
Transport and communication	**8.6**	**0.87**	**0.16**	**-71**
of which,				
petrol for vehicle	2.2	0.37	0.00	-37
telephone charges: mobile	1.8	0.16	0.03	-13
bus/tram fare	1.4	0.08	0.03	-6
taxi, auto-rickshaw fare	0.6	0.05	0.02	-3
motor cycle, scooter	0.8	0.06	0.05	-2
Household goods and services	**3.8**	**0.29**	**0.13**	**-17**
of which,				
washing soap/soda/powder	0.9	0.07	0.02	-5
domestic servant/cook	0.6	0.06	0.02	-4
bed sheet, bed cover	0.2	0.02	0.01	-1
Health	**5.9**	**0.44**	**0.31**	**-13**
of which (non-institutional),				
medicine	4.0	0.31	0.23	-8
doctor's/ surgeon's fee-first consultation	0.8	0.06	0.04	-2

Source: MOSPI, SBI Research

…….Even Income Inequality is on a decline in rural India

- Using the PLFS data, Gini coefficient was estimated for casual workers
- Gini coefficient declined from 0.496 in FY20 to 0.483 in FY23 for rural males
- For rural females, it declined from 0.490 in FY20 to 0.469 in FY23





ONDC & e-NAM game changing for agriculture…..

- Recognizing the need to enhance and stabilize farmer's income, over the years, several initiatives have been undertaken by the government to expand marketing opportunities for farmers and to create an efficient and competitive marketing system. National Agriculture Market (e-Nam) and the e-commerce network Open Network for Digital Commerce (ONDC) have addressed the infrastructural bottlenecks

- So far, 1389 markets in 23 States and 4 Union Territories have been linked to e-NAM. This has clearly benefitted the farmers as the latest average modal prices in e-NAM mandis are higher than the MSP for FY24 for many crops. Even mandi price is higher than MSP for majority of the crops. Thus, it seems that the Government's efforts to increase MSP is now making a clear impact as MSP is now becoming a floor for prices at Physical/digital marketplace. We believe there is a structural change in pricing behavior

- In ONDC, so far 4000 farmers producer organisation (FPOs) have joined the ONDC network through various Seller Network Participants with as many as 3,100 varieties of value-added agricultural products sold using the facility. The government wants to bring 6000 FPOs into pan-India digital market-place by the end of FY24. Also, 400+ Self-Help Groups (SHGs), micro-entrepreneurs and social sector enterprises have onboarded the network

- The infrastructure development in terms of better roads, market density, tele-density, irrigation facilities by the government leading to better connectivity between the rural and urban areas has reduced the gap between the hinterland and the cities. All these efforts have helped in improving the agri-supply chain and farmers' price realization

Contours of Liquidity

Durable Liquidity surplus ~Rs 1.8 trillion because of surplus government cash balances

- Liquidity deficit has increased since the last policy in Dec’23. Net LAF has remained in the deficit mode since mid-Sep’23, with the current system liquidity deficit at Rs 2.3 lakh crore and average of Rs 1.8 lakh crore post Dec’23 policy

- **However, Government surplus cash balances have increased to an average of Rs 3.97 lakh crore post Dec’23 policy**

- With higher Government surplus cash balances and reduced system liquidity, durable/core liquidity surplus has come down to Rs 1.8 lakh crore

Average Liquidity Position (Rs lakh crore)				
	Average in FYTD24	8-Dec-23	Average post policy	31-Jan-24
Repo Outstanding	0.40	0.09	1.54	2.59
Reverse Repo Total	0.32	0.22	0.03	0.00
SDF	0.82	0.43	0.46	0.44
MSF	0.52	0.63	0.72	0.08
Net LAF (-absorption)	-0.14	0.13	1.83	2.29
Government Cash Balance (net LAF-core liquidity)	2.28	2.77	3.97	3.80
Core Liquidity (-Surplus)	-2.47	-2.45	-2.11	-1.77
Source: RBI, SBI Research				

Structural change in Liquidity

- We have earlier highlighted the issue that owing to the 24*7 payment systems, banks were keeping more than sufficient funds as cushion to enable probable large outflows post business hours/on Saturdays in particular or on the eve of scheduled holidays as RTGS/NEFT funds movement in large value affects their funds management capability. One set of banks resorting to parking funds in SDF and another borrowing from MSF. The amount parked by banks in SDF during the liquidity deficit days is termed as unusable liquidity/precautionary motive

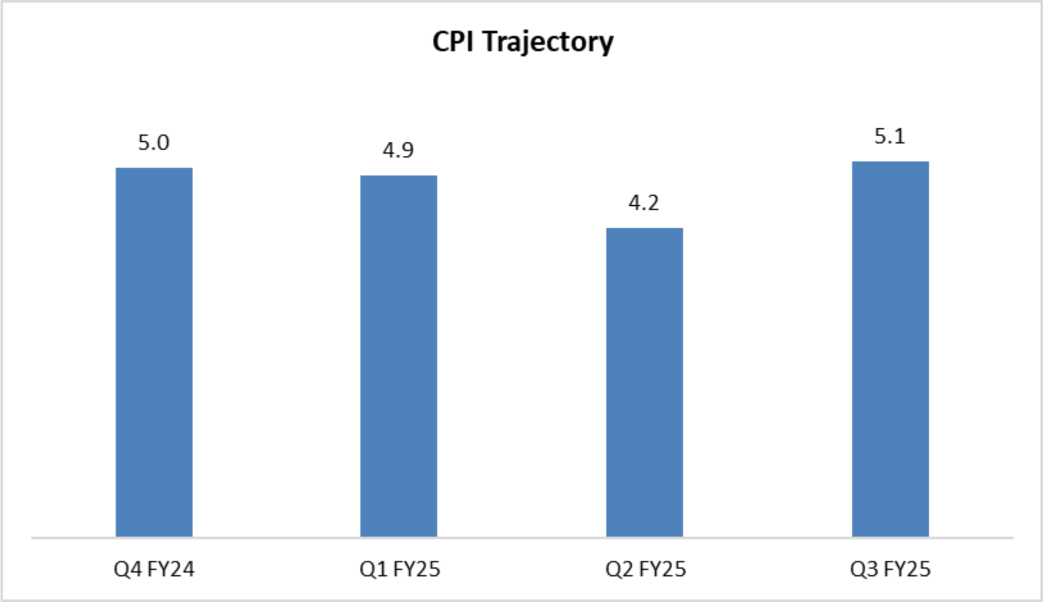
- To address this asymmetry, RBI in its Dec'23 policy decided to allow reversal of liquidity facilities under both SDF and MSF even during weekends and holidays

- The data shows that the situation has moderated since then. The average amount parked in SDF post the last policy comes at Rs 0.46 lakh crore (Rs 0.41 lakh crore in Jan'24). Meanwhile, amount borrowed by banks through MSF has eased to an average of Rs 0.70 lakh crore since then (Rs 0.46 lakh crore in Jan'24)

- Some measures to address the issues…make CRR & LCR norms attuned to liquidity mismatches……
  - **Clear articulation that CRR and LCR can fall below mandated levels in case of emergency and that should be automated…..**
  - **Published set of rules/guidelines that define emergency and facilitate auto-implementation without any prior approval**

CPI expected to remain within RBI target

- India's annual retail inflation increased to 5.69% in December from 5.55% in November
- While the inflation decelerated significantly in 2024 as compared to 2014, the inherent composition remains the same. Food contribution, then and now, remains the same
- CPI is expected to come around 5.4% in FY24 and 4.6% to 4.8% in FY25



Final Thought

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

Indicator	Our View
Repo rate	❑ We expect the RBI to continue pause stance in upcoming policy ❑ Strong US non-farm payroll data and wages seem to have pushed back on market expectations for a quick pivot to rate cuts ❑ First rate cut on table from Jun'24….Aug'24 looks the best bet now…
Stance	❑ We believe the stance should continue to be withdrawal of accommodation
Measures to augment liquidity	❑ Clear articulation that CRR and LCR can fall below mandated levels in case of emergency and that should be automated….. ❑ Published set of rules/guidelines that define emergency and facilitate auto-implementation of such facility without any prior approval
Forward Guidance	❑ It is not advisable to give a forward guidance yet…..
Any Other	❑ A behavioural shift looks the likely reason for the fall in core CPI (At all-India level, while CPI inflation declined by 210 bps to 5.69% in Dec'23 as compared to Apr'22 level, during the same period the weighted contribution of core CPI was declined by 159 bps)..if this is sustained the decline in core could become more enduring in nature

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