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RBI POLICY AIMED AT MANAGING MARKET EXPECTATIONS: LIQUIDITY BULGE LOOKS LIKELY…FIRST RATE CUT EXPECTATIONS PUSHED TO Q4FY24 AS SEQUENTIAL Q-O-Q GROWTH SLOWDOWN OVER FY24 COULD TAKE CENTRE STAGE BY THEN….

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The monetary policy committee decided to keep the policy repo rate unchanged without committing to a pivot. Thus, the current pause still signals a tightening stance as projected inflation continues to be above the tolerance band of RBI. From this perspective current policy remains a non-event, largely on expected lines.

The outlook on global economy is clouded by sideways movements in most of the indicators even when moderating inflation, tighter financial conditions, banking sector stress, and lingering geopolitical conflicts persist. Weak external demand owing to slowdown in advanced economies, elevated debt levels and geoeconomics disintegration amidst tighter external financial conditions pose risks to growth prospects.

Domestic GDP growth is now on firm footing with urban demand showing good traction. The lagging rural demand is a cause of concern and high frequency indicators show movements both ways, preventing a concrete opinion formation. The RBI GDP forecast for FY24 has undergone some change since April policy in light of CSO estimate for FY23 GDP. Upward revisions have happened in H1 while marginal downward revisions have been made in H2. **It is interesting to note that list of positive factors influencing growth as stated in RBI policy statement outweighs negative factors in the same.**

Importantly, the series of RBI rate hikes have resulted in a combination of declining unemployment rate and stabilizing vacancy rate over the period of RBI rate hike cycle . This signifies that RBI's rate hikes have been able to successfully trim the excess labor demand in the market without contraction in employment. Additionally, the declining current inflation as well as declining inflation expectations for next fiscal gives a clear cut signal that there is no conflict in the inflation and its expectations, signifying that the lagged impact of rate hikes will be able to successfully control inflation in the target band.

Inflation has cooled substantially in May on the back of large favourable base effects and witnessed notable corrections across groups. **The inflation trajectory is now conditional on spatial variation of monsoons and possible development to ENSO. The headline inflation trajectory is likely to be shaped by food price dynamics.** Wheat prices could see some correction on robust mandi arrivals and procurement under the shadow of possible sharp drop in output in Australia. The inflation glidepath of RBI for FY24 has undergone some revision with FY24 inflation expected to peak in Q3.

Meanwhile, liquidity surplus in the system has again increased with the Net LAF absorption at Rs 2.2 lakh crore as on 07 June from an average of Rs 1.0 lakh crore in Apr-May'23. The government surplus cash balances has also started declining from the 3rd week of May. Even the deposit of Rs 2000 notes in banks has added to the liquidity. As we have earlier highlighted, around 85% of the Rs 2000 notes are deposited in the bank accounts and not exchanged for smaller denominations. Thus, bank deposits are likely to increase by atleast Rs 2 lakh crore assuming some of the notes would already be with banks in currency chests. **Overall deposit growth in FY24 should grow over 11% yoy. This will effectively imply that spate of deposit rate hikes could be a thing of the past.**

The regulatory changes announced in the policy statement are positive.

With the increased popularity and acceptance of RuPay cards outside India, RBI has now permitted banks to issue RuPay Prepaid Forex cards to the Indians travelling abroad and also allowed RuPay cards to be issued in foreign jurisdictions.

Widening the scope of prudential framework for stressed assets will also further strengthen the recovery mechanisms.

The RBI decision to put in place a regulatory framework for permitting Default Loss Guarantee arrangements in Digital Lending is a win-win situation for loan service providers as well as for regulated entities (Banks/NBFC).

Overall, the RBI policy statement is cautious and pragmatic and is clearly aimed at managing expectation build up of a rate cut not any time soon. The emphasis on 4% is to clearly anchor the market expectations for the future. While we rule out a rate cut any time soon, we might be reminded that rate cuts in the past have happened over the cycle. For example, as growth weakened from 8% in FY16 to 6.8% in FY18, RBI had cut rates by 200 basis points. With GDP growth declining from 9.1% in FY22 to 6.5% in FY24, will this be construed as a signal of growth slowdown and hence future rate actions by RBI? With GDP growth in FY24 set to decline from 8.0% in Q1 to 5.7% in Q4, we pencil in the first rate cut by RBI in Q4 FY24. The magnitude could be larger than 25 bps.

REPO RATE: STATUS QUO

- As widely expected, MPC decided to keep repo rate at 6.50%. It also decided to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth, though not unanimously.
- RBI revised downward its inflation projection for FY24 by 10 bps to 5.10%. The inflation trajectory is likely to be shaped by food price dynamics. Milk prices may pose threat also due to supply shortfalls. Crude prices, on the other hand, have eased. The quarterly projections are as follow: Q1 at 4.6% (earlier: 5.1%), Q2 at 5.2% (earlier: 5.4%), Q3 at 5.4%, and Q4 at 5.2%.
- RBI has retained its real GDP projection at 6.50% for FY24 with Q1 at 8.0% (earlier: 7.8%), Q2 at 6.5% (earlier: 6.2%), Q3 at 6.0% (earlier: 6.1%) and Q4 at 5.7% (earlier: 5.9%). Higher rabi crop production, expected normal monsoon, and the sustained buoyancy in services will drive the growth in FY24. Weak external demand, geo-economic fragmentation, and protracted geopolitical tensions, however, pose risks to the growth outlook. It is interesting to note that list of positive factors influencing growth as stated in RBI policy statement outweigh negative factors in the same.
- On various occasions we have noticed that though RBI retained its annual growth forecast number but has adjusted quarterly numbers. This time while retaining the 6.5% real GDP growth forecast for FY24, RBI has revised upwards the Q1/Q2 numbers and revised downwards the Q3/Q4 numbers.

WHAT IS DRIVING INFLATION?

- CPI inflation moderated to almost 18-months low to 4.70% in Apr'23. In order to appreciate the drivers of inflation we have divided 299 commodities of CPI into supply driven (171) demand driven (99) and neutral (29).
- Our results show that, supply side factors which contributed more than 50% of inflation in Jan'23 plunged to 46% in the latest print due to ease in supply side disruptions. On the other hand share of demand-driven inflation has increased from 45% to 50%.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q1 FY24	Q2 FY24	Q3 FY24	Q4 FY24	FY24
Jun'23	4.6	5.2	5.4	5.2	5.1
Apr'23	5.1	5.4	5.4	5.2	5.2
Feb'23	5.0	5.4	5.4	5.6	5.3
Real GDP Growth (%)	**Q1 FY24**	**Q2 FY24**	**Q3 FY24**	**Q4 FY24**	**FY24**
Jun'23	8.0	6.5	6.0	5.7	6.5
Apr'23	7.8	6.2	6.1	5.9	6.5
Feb'23	7.8	6.2	6	5.8	6.4

Source: RBI, SBI Research

RBI GDP Forecast vis-à-vis NSO Final (%)

		Apr Policy	Jun Policy	NSO Final
FY22	Q1	26.2	18.5	21.6
	Q2	8.3	7.9	9.1
	Q3	5.4	7.2	5.2
	Q4	6.2	6.6	4.0
	Annual	10.5	9.5	9.1
FY23	Q1	16.2	16.2	13.1
	Q2	6.2	6.2	6.2
	Q3	4.1	4.1	4.5
	Q4	4.0	4.0	6.1
	Annual	7.2	7.2	7.2
FY24	Q1	7.8	8.0	-
	Q2	6.2	6.5	
	Q3	6.1	6.0	
	Q4	5.9	5.7	
	Annual	6.5	6.5	

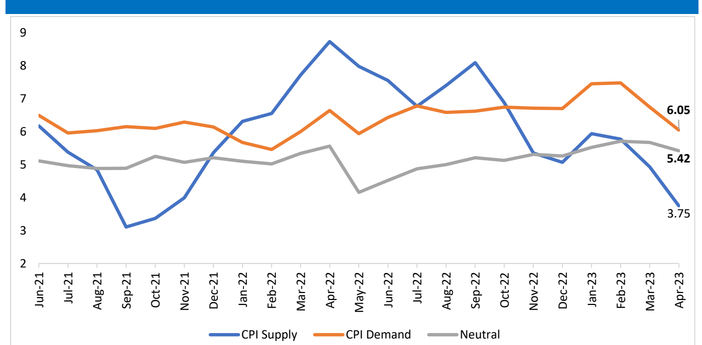
Source: RBI; SBI Research

Bifurcation of CPI headline inflation into Demand led and Supply led Inflation

	# of Items		Jan-23	Feb-23	Mar-23	Apr-23
Demand CPI	99	%	2.93	2.94	2.65	2.35
		Share	45%	46%	47%	50%
Supply CPI	171	%	3.40	3.30	2.82	2.16
		Share	52%	51%	50%	46%
Neutral	29	%	0.19	0.20	0.20	0.19
		Share	3%	3%	3%	4%
Overall CPI	299	%	6.52	6.44	5.66	4.70

Source: SBI Research

CPI Inflation: Demand and Supply



Source: SBI Research

DEVELOPMENTAL AND REGULATORY MEASURES

- **Borrowing in Call and Notice Money Markets by Scheduled Commercial Banks:** RBI has permitted the scheduled commercial banks to set their own limits for borrowing in Call and Notice Money Markets in order to provide them greater flexibility for managing the money market borrowings. However, this is not going to have significant impact as the banks usually resort to repo for meeting their requirements and the volumes in call money and notice money are low. Smaller banks might borrow more via this window, but the lenders should have the interbank limits to provide more funds.
- **Widening of the Scope of Prudential Framework for Stressed Assets:** RBI issued Prudential Framework for Resolution of Stressed Assets on June 7, 2019 to provides a broad principle-based framework or early recognition, reporting and time bound resolution of stressed assets.
- Indian Banks had written off more than Rs 10 lakh crores in last five years. Banks continue to pursue recovery actions initiated in written-off accounts through various recovery mechanisms available, such as filing of a suit in civil courts or in Debts Recovery Tribunals, action under the SARFAESI Act, 2002, filing of cases in the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016, through negotiated settlement/compromise, and through sale of NPAs etc.
- With a view to provide further impetus to the same as well as to harmonise the instructions across all regulated entities and incorporating lessons from Covid-19 in asset resolution, RBI has issued a proposal to (i) issue a comprehensive regulatory framework governing compromise settlements and technical write-offs covering all regulated entities; and (ii) rationalise the extant prudential norms for implementation of resolution plans in respect of exposures affected by natural calamities. Thus is a welcome step and will be an enabler for effective resolution of stressed assets. RBI has proposed to issue detailed guidelines on the above separately.
- **Default Loss Guarantee Arrangement in Digital Lending:** First Loss Default Guarantee (FLDG) is an arrangement whereby a third party compensates lenders if the borrower defaults. While issuing the Press Release dated August 10, 2022 on Implementation of the Recommendations of the Working group on Digital Lending, RBI stated that the recommendation pertaining to FLDG is under examination with RBI.
- **Rent-an-NBFC model by digital lenders**: Under this model that specifies FLDG / a synthetic structure enabling unregulated entities to lend without complying with prudential norms is through credit risk sharing arrangements by way of a "First Loss Default Guarantee (FLDG)" extended by the Lending Service Provider (LSP). Under this, the LSP provides certain credit enhancement features such as first loss guarantee up to a pre-decided percentage of loans generated by it. Practically, credit risk is borne by the LSP without having to maintain any regulatory capital. The loan portfolio backed by FLDG is akin to off-balance sheet portfolio of the LSP wherein the nominal loans sit in the books of the lender without having to partake in any lending process. In some cases, the LSP as a non-banking non-financial company (NBNC) may be undertaking balance sheet lending in partnership with a bank/ NBFC or on stand-alone basis, while not satisfying the principal business criteria to remain outside regulation. Besides, there are higher operational risks which arise due to increasing reliance of lenders on third-party service providers. With increasing share of digital lending in retail/ personal space, there is a potential for risk build-up because of these platforms. This may also be adding to counterparty risks posed by the platform to its lending partners.
- In view of the above, and in tune with RBI objective of maintaining a balance between innovation and prudent risk management, RBI's decision to put in place a regulatory framework for permitting Default Loss Guarantee arrangements in Digital Lending is an win-win situation for LSP as well as for regulated entities (Banks/NBFC).

NPAs of SCBs Recovered through Various Channels (Rs Crore)

Recovery Channel	2019-20				2020-21				2021-22 (P)			
	No of cases referred	Amount Involved	Amount recovered	Recovery Rate %	No of cases referred	Amount Involved	Amount recovered	Recovery Rate %	No of cases referred	Amount Involved	Amount recovered	Recovery Rate %
Lok Adalats	5986790	67801	4211	6.2	1949249	28084	1119	4.0	8506648	119005	2777	2.3
DRTs	33139	205032	9986	4.9	28182	225361	8113	3.6	29487	47165	12114	25.7
SARFAESI Act	105523	196582	34283	17.4	57331	67510	27686	41.0	249475	121642	27349	22.5
IBC	1986	224935	104117	46.3	536	135319	27311	20.2	885	199250	47421	23.8
Total	6127438	694350	152597	22.0	2035298	456274	64229	14.1	8786495	487062	89661	18.4

Source: RBI; SBI Research

- **Priority Sector Lending (PSL) Targets for Primary (Urban) Cooperative Banks (UCBs):** The strong grass-root level presence of co-operative banks facilitates their pivotal role in furthering financial inclusion. The priority sector lending norms for UCBs were revised on March 13, 2020 — requiring them to meet the target of 45%, 50%, 60% and 75% of adjusted net bank credit by end-March 2021, 2022, 2023 and 2024, respectively. Now with a view to ease the implementation challenges faced by the UCBs, RBI has decided to extend the phase-in time for achievement of the said targets by two years, i.e. upto March 2026. Though PSL of UCBs has always exceeded the stipulated target over the last decade, we still believe that this extension of target will help them to glide over the target with more ease.
- **Rationalisation of Licensing framework for Authorised Persons (Aps) under FEMA, 1999:** The licensing of Aps in FEMA has been done to ensure orderly exchange of foreign exchange. Further with new players entering foreign exchange business, the licensing framework needs revision to accommodate new market players and reduce the cost of retail customers dealing in foreign exchange markets.
- **Expanding the Scope and Reach of e-RUPI vouchers:** The e-Rupi which was launched in Aug'2021 is currently used for disbursal of Government benefits and issued by banks only. The RBI has now proposed to expand the scope and reach of e-RUPI vouchers by (a) permitting non-bank PPI issuers to issue e-RUPI vouchers and (b) enabling issuance of e-RUPI vouchers on behalf of individuals. One should not confuse with e-RUPI & CBDC, as e-RUPI is a person and purpose specific, while CBDC is digital currency of RBI. During Sep'2022 to Apr'2023, 2.02 lakh e-Rupi has been issued by different Government agencies specifically in health sector. The expansion of e-RUPI will definitely be a game changer and may substitute the paper-based/digital PPI vouchers and can be used in basic feature mobile.
- **Streamlining Bharat Bill Payment System (BBPS) processes and membership criteria:** BBPS provides an interoperable and easily assessable bill payment service to consumer via multiple channels like internet banking, mobile banking, mobile apps etc. Currently, BBPS has onboarded over 20,500 billers and processes 1097 mn transactions with RS 1906 bn in FY23. The revised guidelines is expected to further enhance the efficiency of the BBPS system and to encourage greater participation of billers and customers.

Primary UCBs: Current Target Path (% of ANBC)

Total PSL	FY	Mar-21	Mar-22	Mar-23	Mar-24
	Target	45%	50%	60%	75%
	Actual	51.5%	55.1%	-	-
Micro Enterprises	7.50%				
Weaker Sections	12.0%				

Source: RBI; SBI Research

e-RUPI Vouchers Issued (in Volume)

Month	Voucher Created	Voucher Redeemed
Sep-22	6650	2533
Oct-22	8268	660
Nov-22	28262	3315
Dec-22	30665	3020
Jan-23	28767	3007
Feb-23	33967	7020
Mar-23	26178	5839
Apr-23	39363	7199
Total	**202120**	**32593**

Source: NPCI, SBI Research

- **Internationalising Issuance and Acceptance of RuPay Cards:** With the increased popularity and aceeptance of RuPay cards outside India, RBI has now permitted banks to issue RuPay Prepaid Forex cards to the Indians travelling abroad. Further, RBI has also allowed RuPay cards to be issued in foreign jurisdictions. These measures will expand the reach and acceptance of RuPay cards globally and helps customers.

LIQUIDITY SURPLUS

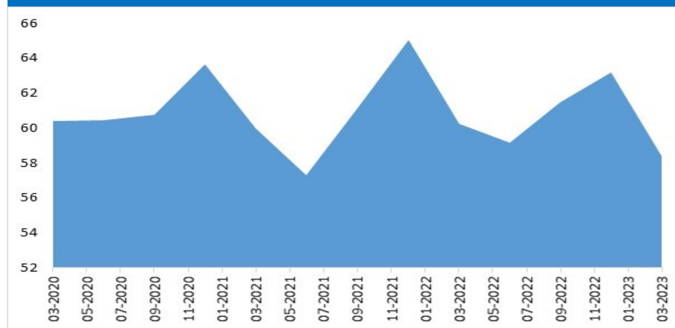
- Liquidity surplus in the system has again increased with the Net LAF absorption at Rs 2.2 lakh crore as on 07 June from an average of Rs 1.0 lakh crore in Apr-May'23. The government surplus cash balances has also started declining from the 3rd week of May, thereby increasing the surplus. Even the deposit of Rs 2000 notes in banks has also added to the liquidity. As we have earlier highlighted, around 85% of the Rs 2000 notes are deposited in the bank accounts and not exchanged for smaller denominations. Thus, bank deposits are likely to increase by atleast Rs 2.0 lakh crore assuming some of the notes would already be with banks in currency chests. Overall deposit growth in FY24 should grow over 11% yoy.
- Meanwhile, there has been decline in in the currency in circulation since the 3rd week of May. The latest data for the week ended 2 Jun'23 shows currency in circulation at Rs 34.14 lakh crore, down by Rs 63,492 crore from 19 May'23.

- The consequent increase in banking liquidity will ensure that there is no immediate need for CRR cut. Even the need for OMO is reduced, now that RBI has provided greater than expected dividend of Rs 874 billion which will boost durable liquidity as and when the Government spends it. Moreover, balance of payment surplus in FY24 is expected to the tune of $15-20 billion thus providing further liquidity support.

HARD LANDING VS SOFT LANDING

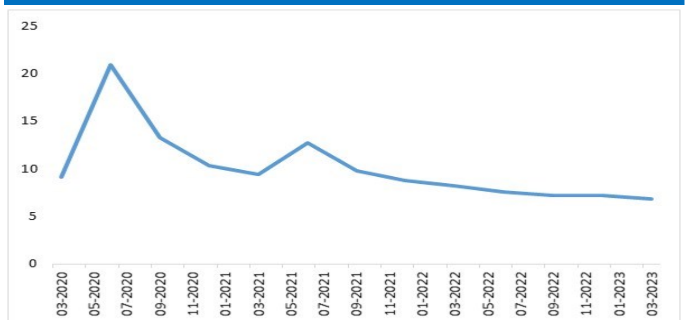
- In USA, there is a lot of debate going on whether the US Fed current rate hike cycle to control inflation will lead to 'Hard Landing' or 'Soft Landing'.
- If Central Bank increases the interest rate too quickly or by too much, there is a risk of hard landing. Differencing factor between the hard landing and slow landing is recession. If the Central Bank is able to successfully steer the economy through the contractionary cycle without the recession or direct cost on economic activity, it is known as Soft Landing.
- While RBI has increased the rate too quickly from last year, it's impact on slowdown (if any) on economic activity may be evaluated as follows:
- There is not much impact of RBI's rate hike cycle on Aggregate Demand as Private Consumption (as % of Nominal GDP), remains hovering around pre-pandemic level with cyclical ups and downs.
- Urban Unemployment rate which saw all time high around Covid-19 peaks is continuously declining since then.
- For vacancy rate, We considered the Naukri Job Speak Index data . The Index has improved considerably from the pandemic lows with upward trend. However, since onset of RBI's rate hike cycle, it has lost increasing trend but has stabilized at the same level.
- **Combination of declining unemployment rate and stabilizing vacancy rate over the period of RBI rate hike cycle signifies that RBI's rate hikes have been able to successfully trim the excess labor demand in the market without contraction in employment.**
- The declining current inflation as well as inflation expectation for next fiscal gives a clear cut signal that there is no conflict in the inflation and its expectations, signifying that the lagged impact of rate hikes will be able to successfully control inflation in the target band.

Private Consumption (% of Nominal GDP)



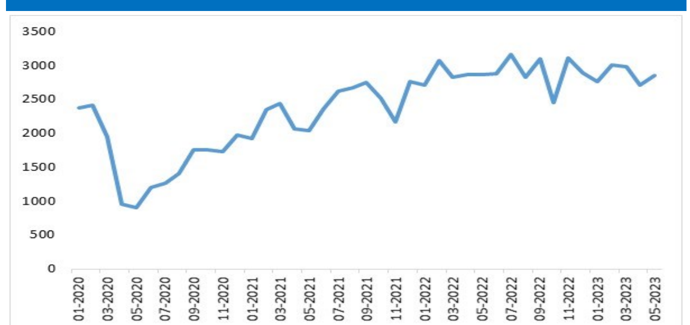
Source: SBI Research, CEIC

Urban Unemployment Rate



Source: SBI Research, MOSPI, CEIC

Vacancy (Naukri Jobspeak Index)



Source: SBI Research, CEIC

Inflation

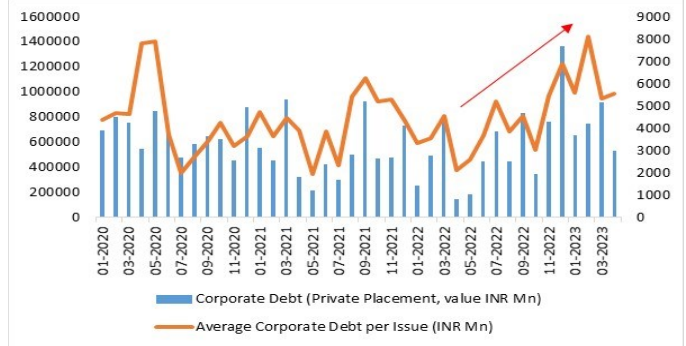
Source: SBI Research, CEIC

- **Thus as far as labor market and inflation is concerned, RBI has been able to successfully steer the economy from hard landing with effective monetary policy.**
- However, on the macro-prudential side, some effective steps need to be taken to gauge the impact of too quick rate hikes.
- Average amount of Corporate Debt raised through private placement has been increasing continuously since the onset of RBI's rate hike cycle signifying that corporate debt requirements have increased along with high debt servicing cost.
- RBI's Housing Price Index has been increasing continuously with an uptrend, particularly without any course correction, since the RBI's rate hike cycle, signifying that there may be untended consequences of rate hikes in the form of increased asset prices.

GLOBAL ECONOMY

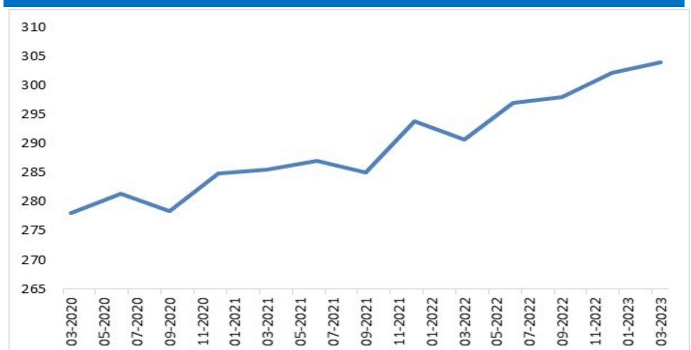
- The outlook on global economy is clouded by sideways movements in most of the indicators even when moderating inflation, tighter financial conditions, banking sector stress, and lingering geopolitical conflicts persist. Weak external demand owing to slowdown in advanced economies, elevated debt levels and geoeconomics disintegration amidst tighter external financial conditions pose risks to growth prospects which may impact domestic conditions as well in limited ways.

Corporate Debt Stress



Source: SBI Research, CEIC

Housing Price Index



Source: RBI, CEIC

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