SBI Research

Prelude to MPC Meeting: April 3-5, 2024

India a notable exception to strong evidence of Emerging Economy Central Bank rate actions being predicated by Advanced Economy Central Bank rate actions …Structural shifts underway in US markets with coexistence of low unemployment rate coupled with elevated job vacancy rate…inflation is currently being driven by food price dynamics… We expect deposits and credit may grow 14.5-15% and 16.0-16.5% respectively in FY25…. RBI might cut rates only in Q3FY25

02-April-2024

Executive Summary…..1/4

- The US monetary policy tightening seems to have achieved its objective of anchoring the short-term inflation expectations as the latest monetary policy report indicates cooling of inflation expectations; 2.1%-2.8% in 2024, 1.9%-2.6% in 2025 and 1.9%-2.4% in 2026. Thus, current short term inflation expectations are clearly anchoring to the target Fed inflation rate of 2%

- The scatter plot between US inflation and unemployment (the Phillips Curve) shows that for all sub periods, the long run Phillips curve is tracing the 100-year average range of 4.5-5.5%. The long-term expectation on unemployment in the recent monetary policy report is 3.4-4.3%. Current unemployment shows tight labor markets with reference to long term trends

- **The slope of the short Phillips curve is varying, nonetheless steepening in 2023 indicating that any unexpected deviation in inflation expectations can be controlled without much cost. Thus, it appears Fed will retain its 2% inflation rule for the time being given the steepening of Philips curve**

- Interestingly, the US labour market seems to have embraced two contrasting trends simultaneously: a low unemployment rate coupled with elevated job vacancy rate…Ideally, fighting inflation would have resulted in an unemployment rate and a decline in vacancies, but that continuously eludes the US job market…in particular, structural shifts in the US labour market through a Markov switching regime (US Unemployment and Job Vacancy rate through Jan'18 to Jan'24) reveals low unemployment rate and elevated job vacancy rate….will now last longer till the end of 2025…..

- The mercurial rise of gold has entered a new, somewhat uncharted zone in terms of price as also demand…the Central Banks seem to fan the demand, their appetite for this precious metal exceeding net demand in excess of 1000 ton for two years in a row…..World Gold Council latest data shows cumulative holding of the Central Banks in yellow metal reaching a record ~7,800 tonne as on end Dec'23 (~6,671 ton as on end'22) as they bought ~1,037 ton of gold in the year 2023, a little low from 2022 high of ~1,082 ton. Global official sector gold reserves are now estimated to total 36,700 ton…Gold clearly, appears to have more headroom

Executive Summary…..2/4

- US households appear to be in a Catch-22 situation, now paying roughly as much interest on other kinds of debt, from credit cards to student loans, as they are on their mortgages, as per recent Bureau of Economic Analysis (BEA) numbers. Non-mortgage interest payments climbed to an annual rate of $573.4 billion in January which is the highest on record even after adjusting for inflation.…Plus, the distress sale of plummeting commercial real estate at key places points to embedded pain points and recovery not being uniform!

- The pivot on rate cuts can be a long (and enduring) journey for markets…. Federal Reserve chair Powell put some ice on broader market's hopes of an early pivot by decisively speaking that the Fed would like to see more progress on price front despite a favorable PCE reading…PCE, which strips volatile food and energy prices, rose 0.3% in February, after rising 0.5% in January, marking its biggest back-to-back gain in a year time. Incidentally, the data for January was revised higher to show the PCE price index rising more than what was previously published. The CME FedWatch tool as also other market polls now indicate a maximum easing of 75 bps of rates through 2024, against 100 bps predicted earlier

- The BoJ signaled a complete departure from the unconventional monetary policy as the BoJ raised its short-term interest rates to around 0% to 0.1% from -0.1%, ending Japan's negative rates regime in place since 2016. The BoJ also announced the abolition of its radical yield curve control (YCC) policy for 10-year JGBs, which the central bank has employed to target longer-term interest rates by buying and selling bonds as necessary in a fight to boost persistently low inflation. **The holdings of BoJ in US treasury at ~$1.14 trillion may find some way back home to benefit from the expected rise in benchmark yields, though not of materially significant levels as of now, with some appreciation on course in Yen as carry trades by leveraged funds appear to have peaked**

- **The somewhat surprise visit of a 20-strong US business tycoons' ensemble in last week of March to mainland, along the sidelines of China Development Forum, what the state media described as extension of history of friendly exchanges offered a glimpse into mellowed stance by Xi even as the 5% growth projections for the nation have been dubbed as too ambitious….ring fenced by the USA on key technology procurement and other critical supply chain issues, this could alter the supply chain dynamics and renew the Sino-US relations in the last days of Biden regime though the Chinese economy has not reached the bottom of an engulfing, somewhat opaque property sector crisis**

Executive Summary…..3/4

- To test the hypothesis of future values of emerging economy rates being influenced by past values of advanced economy rates, granger causality tests, involving the data from Jan 2008 to Mar 2024 shows that all major emerging economies rates such as of Indonesia, India, Malaysia, Saudi Arabia, Thailand are either being predicted by past movements of US rates or UK rates, signifying granger causality relationship…Lag of 2 months is found to be optimal lag of operation in the interplay of these rates across countries….**RBI might cut rates only in Q3FY25**

- Back home, With moderate fuel prices, inflation is currently being driven by food price dynamics. CPI inflation is mostly driven by good inflation. Looking ahead evolving food prices will determine domestic inflation. CPI inflation is expected to remain slightly above 5.0% in the remaining month of FY24. Core CPI declined to 3.37% - a 52-months low

- Inflation is expected to decline till Jul'24 but increase thereafter to reach a peak of 5.4% in Sep'24, followed by a deceleration. **For the whole FY25, CPI inflation is likely to average to 4.5% (FY24: 5.4%)**

- Liquidity deficit has declined since the last policy in Feb'24. Net LAF has remained in the deficit mode since mid-Sep'23, with average of Rs 0.97 lakh crore post Feb'24 policy….. Government surplus cash balances have declined to an average of Rs 1.18 lakh crore post Feb'24 policy…Durable/core liquidity surplus has come down to Rs 1.87 lakh crore.. However, the impending JIT mechanism will keep the Government cash balances elevated going forward…while this could have an adverse impact on liquidity, the spectre of capital flows in FY25 could pose challenges and opportunities for RBI liquidity management…

Executive Summary…..4/4

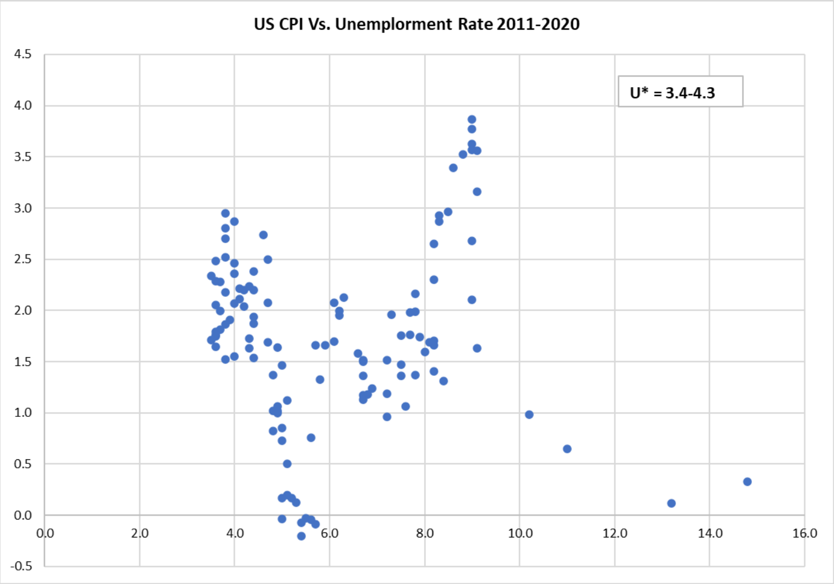
- On the banking front, deposit growth has rebounded but sustained credit growth momentum has increased wedge between deposits and credit growth…As on 08 Marc, ASCBs credit grew by 20.41% (15.7% last Year) and deposits by 13.7% (10.3% last year). **Latest credit growth numbers reveal a sustained pick up across Agriculture, MSME & Services… We expect deposits and credit may grow 14.5-15% and 16.0-16.5% respectively in FY25**

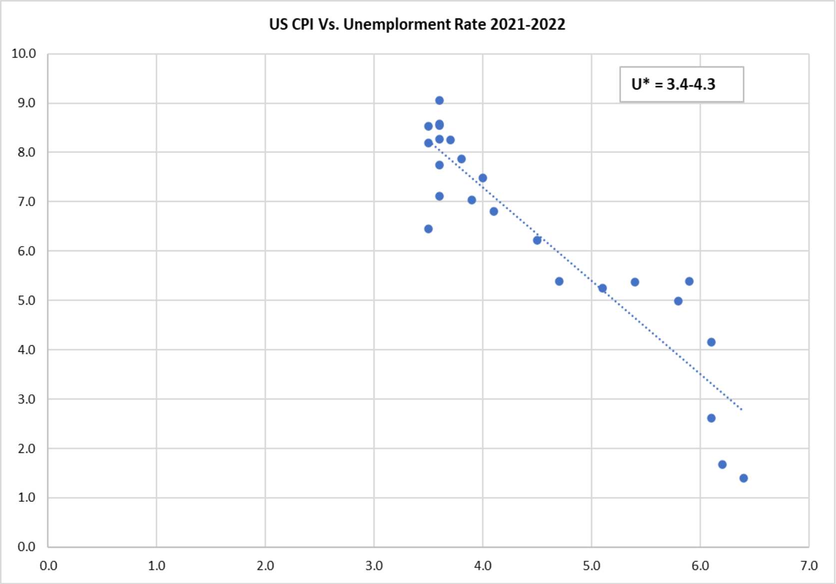
- India has beaten rest of the Asian markets by attracting the highest foreign funds flow in March, defying geopolitical crises and concerns that the higher interest rate regime will continue for some more time

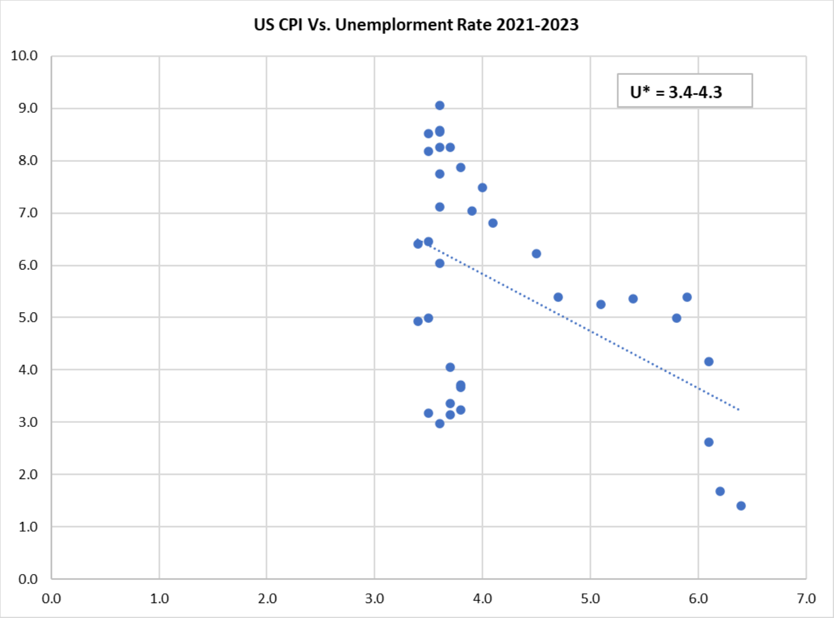
- Equity inflows comprises of ~80% of total inflows as of now but going forward we believe the debt inflows can pick up big time as passive investments in bonds under FAR route start trickling for both JP Morgan as also Bloomberg index investors…the $30-35 billion estimated investments can help in cooling the yields on benchmark securities (reducing the borrowing costs) though exchange rates can witness some volatility

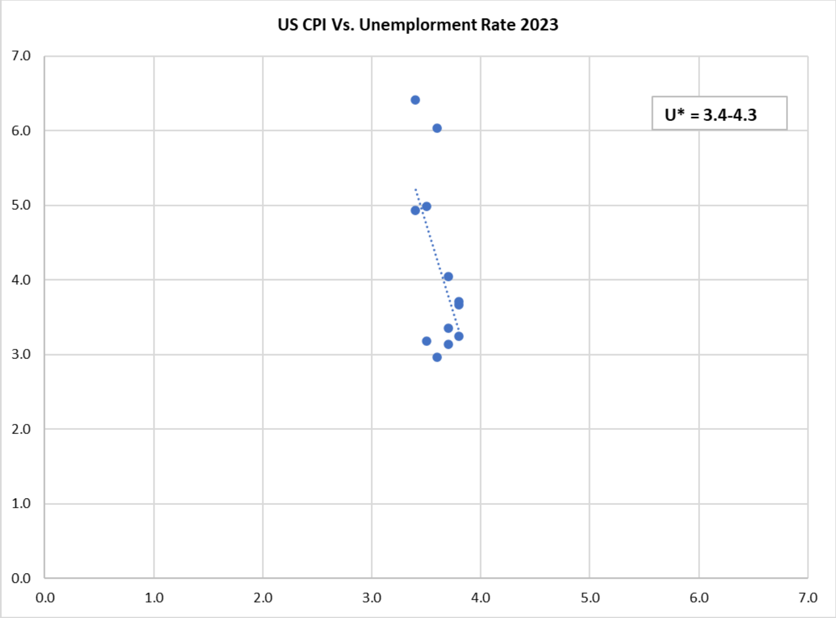
Current Regime for US Unemployment Rate/Vacancy rate will last longer

US Phillips Curve Long and Short Historical Trends







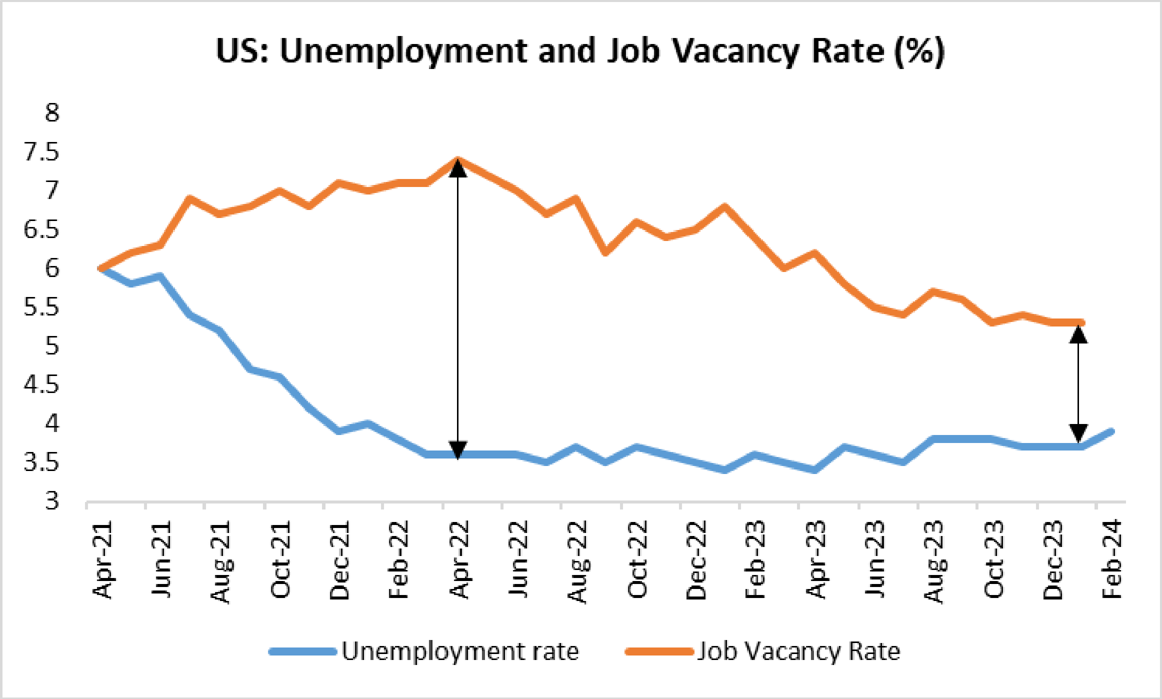


US interest rate outlook – a foreseeable pause and then a cut

- US monetary policy tightening has achieved its objective of anchoring the short-term inflation expectations
- The latest monetary policy report indicate cooling of inflation expectations 2.1-2.8 in 2024, 1.9-2.6 in 2025 and 1.9-2.4 in 2026
- Thus, current short term inflation expectations are clearly anchoring to the target Fed inflation rate of 2%. This rules out drastic action of raising rates soon
- The scatter plot between US inflation and unemployment (the Phillips Curve) shows that for all sub periods, the long run Phillips curve is tracing the 100-year average range of 4.5-5.5%
  - The long-term expectation on unemployment in the recent Monetary policy report is 3.4-4.3%
- **Current unemployment shows tight labour markets with reference to long term trends**
- The slop of the short Phillips curve is varying, nonetheless steeping in 2023 indicates that any unexpected deviation in inflation expectations can be controlled without much cost
- It appears Fed will retain its 2% inflation rule of the time being given the steeping of Philips curve

Gap between the job vacancy rate and unemployment rate is shrinking

- The wide gap of 380 bps in Apr'22 between the job vacancy rate and unemployment rate in the US has come down to merely 160 bps currently
- Fighting inflation require an increase in unemployment rate and a much faster decline in vacancies…however, this has eluded the US labour markets with a small increase in US unemployment rate and a slow transition to lower vacancies in US job markets…



Markov regime-switching dynamic regression model: US Labour Market has transitioned to an extended low unemployment and a high vacancy rate regime with a low volatility

- Markov-switching models are used for series that are believed to transition over a finite set of unobserved regimes, allowing the process to evolve differently in each regime. The transitions occur according to a Markov process. The time of transition from one regime to another and the duration between changes in regime is random
- **We used the Markov regime-switching dynamic regression model to understand the structural shifts in the US Labour market. We have run the Markov regime-switching model for US unemployment and Job Vacancy rate (Jan'18 to Jan'24)**
- As per our analysis,
  - Regime 1 (i.e., low unemployment regime) is the current regime in US unemployment rate and
  - Regime 2 (i.e., high/moderate job vacancy regime) is the current regime in US job vacancy rate
  - Since it would be unreasonable to assume same variance for both high/low volatile regimes, we have calculated the regime-wise variance also. Accordingly, the volatility of the current unemployment regime 1 is low compared to regime 2

US	Regime	Average	Variance
Unemployment Rate	1	4.1%*	0.43
	2	10.9%	2.14
Job Vacancy Rate	1	4.6%	0.25
	2	6.6%*	0.44
***Current Regime**			

US Labour Market will remain in the current regimes……

- A key characteristic of a Markov-chain is the estimation of **transition probabilities**. **The transition probabilities describe the likelihood that the current regime stays the same or changes**
- Values closer to 100% indicate a more persistent process, or in other words, that it is expected to stay in a given regime for a long time
- Our results indicate that:
  - **In the case of unemployment rate: Regime 1 / Low Unemployment Rate is the persistent regime with a 98.6% probability!!!**
  - **In the case of job vacancy rate: Regime 2 / High Job Vacancy Rate is the persistent regime with 95.3% probability!!!**

US Unemployment Rate: Transition Probabilities		
From/To	Regime 1	Regime 2
Regime 1	98.6%	1.4%
Regime 2	18.0%	82.0%

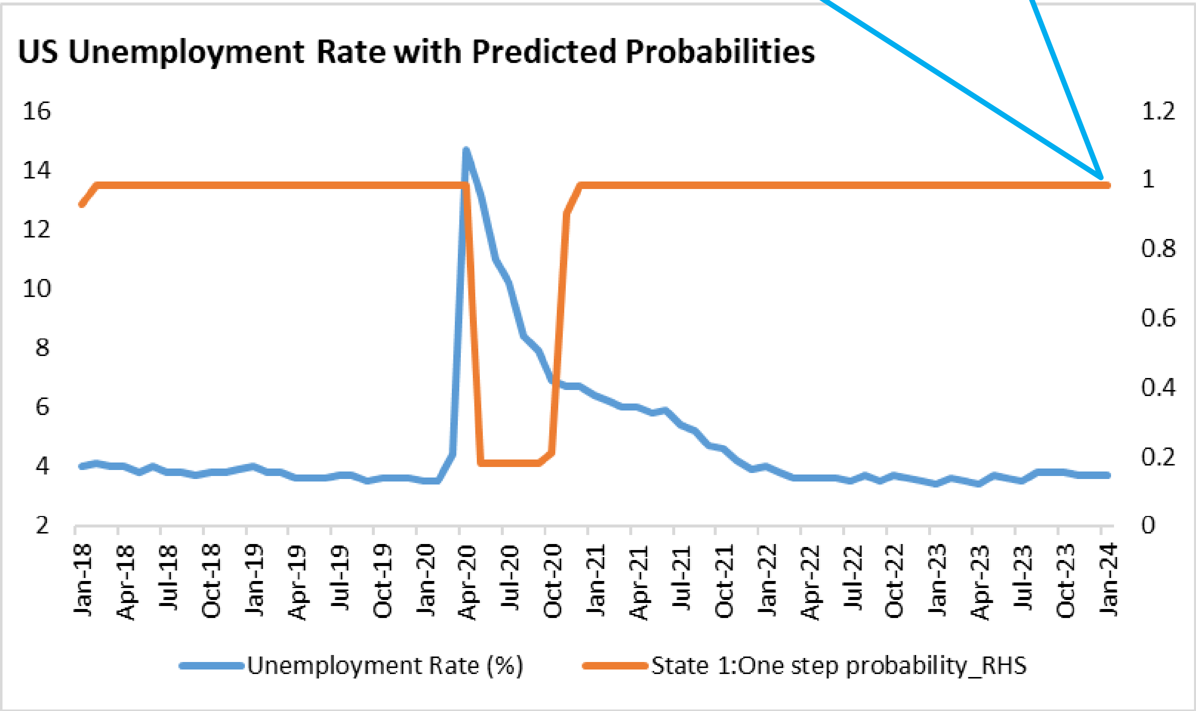
US Job Vacancy Rate: Transition Probabilities		
From/To	Regime 1	Regime 2
Regime 1	98.4%	1.6%
Regime 2	4.7%	95.3%

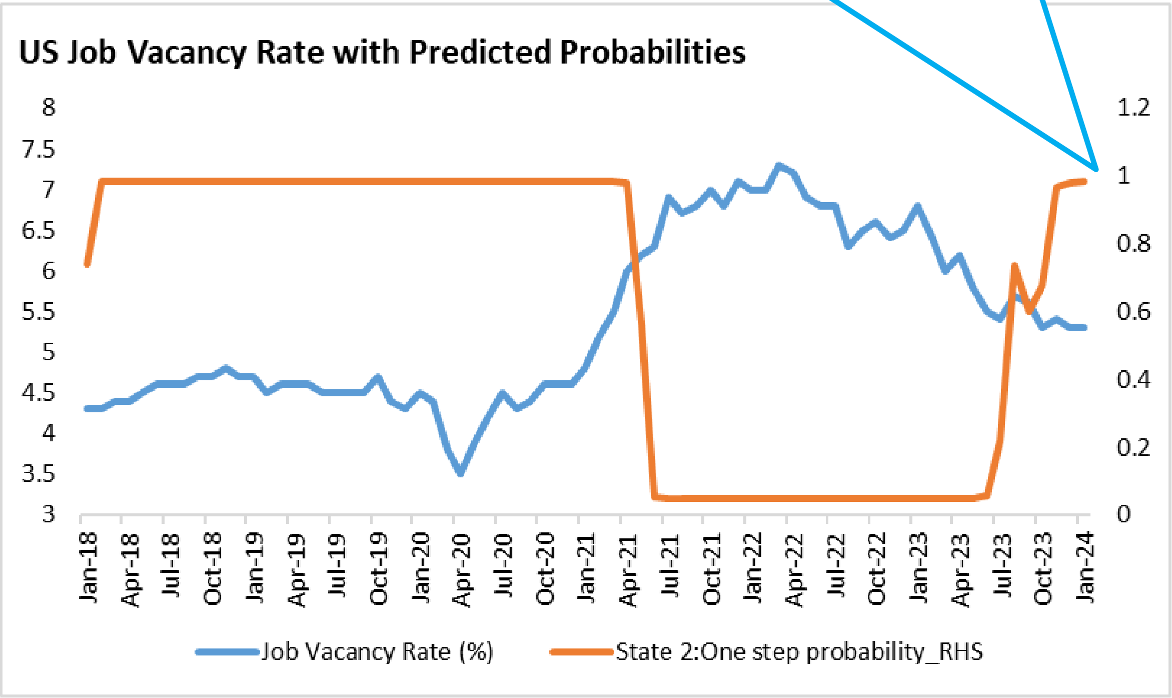
Technically, Current Regime for Unemployment Rate/Vacancy rate could last much longer

- We also predict the probability of being in the various regimes. We have only two regimes, and thus the probability of being in (say) regime 1 / regime 2 tells us the probability for both regimes
- Apart from this, we have predicted **the expected duration of the current regime (i.e., average time it spends in a given regime)** for both US unemployment rate and job vacancy

As per the estimate, the current regime of low unemployment **will last for another 3 years from Jan-24**

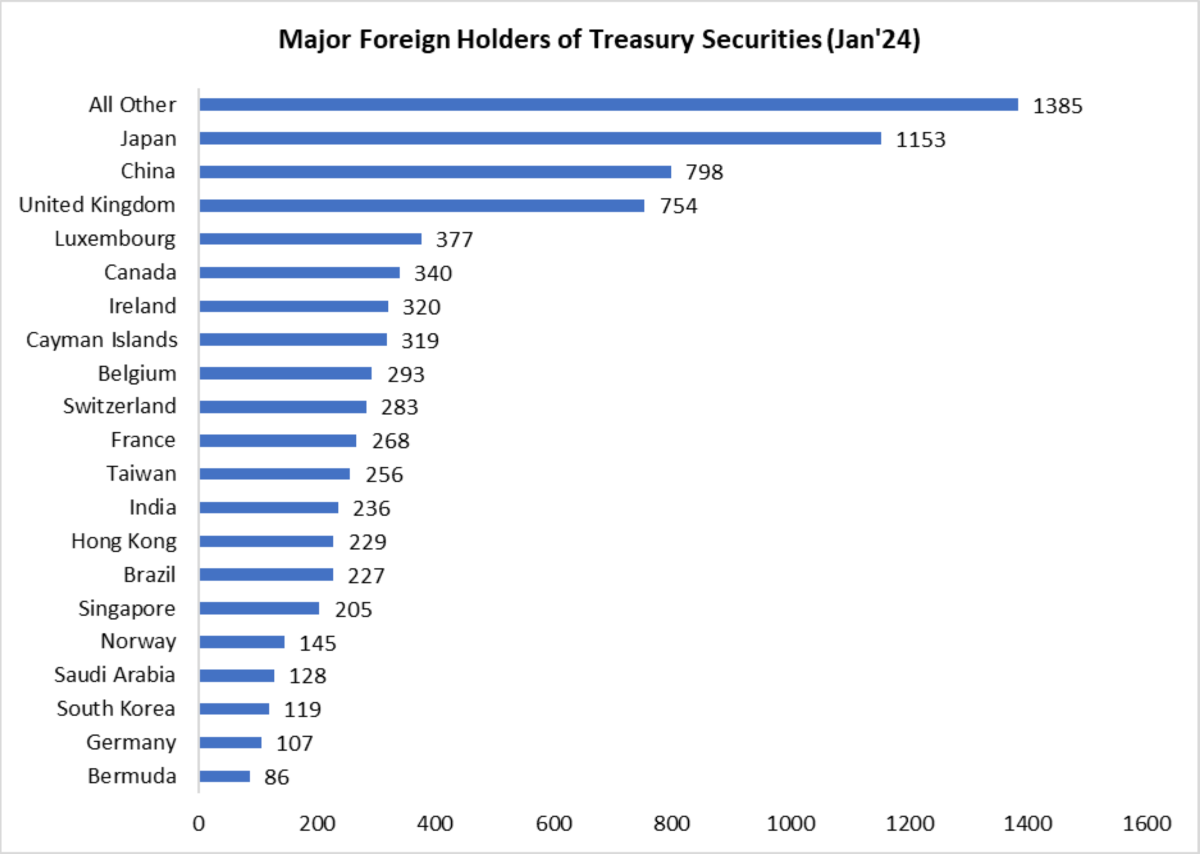
In case of job vacancy rate, the current regime of somewhat higher vacancy rate **will last for another one & half year from Jan-24**

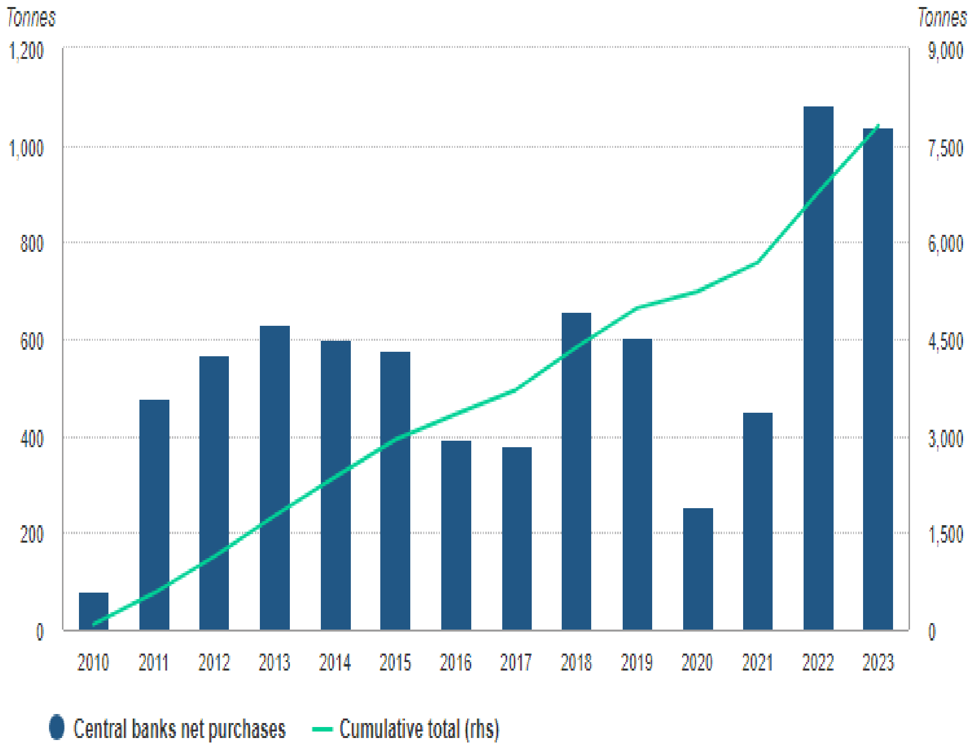




Gold enters uncharted territories…crystal gazing the global upheavals in place for 2024!

- World Gold Council latest data shows cumulative holding of the Central Banks in yellow metal reaching a record ~7,800 tonne as on end Dec'23 (~6,671 ton as on end'22) as they bought ~1,037 ton of gold in the year 2023, a little low from 2022 high of ~1,082 ton. Global official sector gold reserves are now estimated to total 36,700 ton

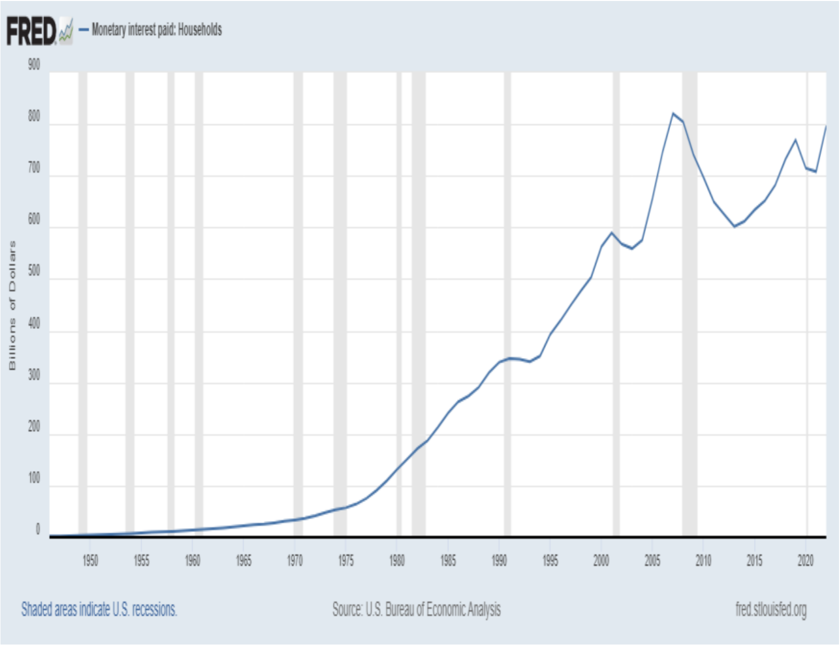




Graph: WGC, SBI Research

Households' pangs to reverberate through economic corridors…..not a smooth landing at all

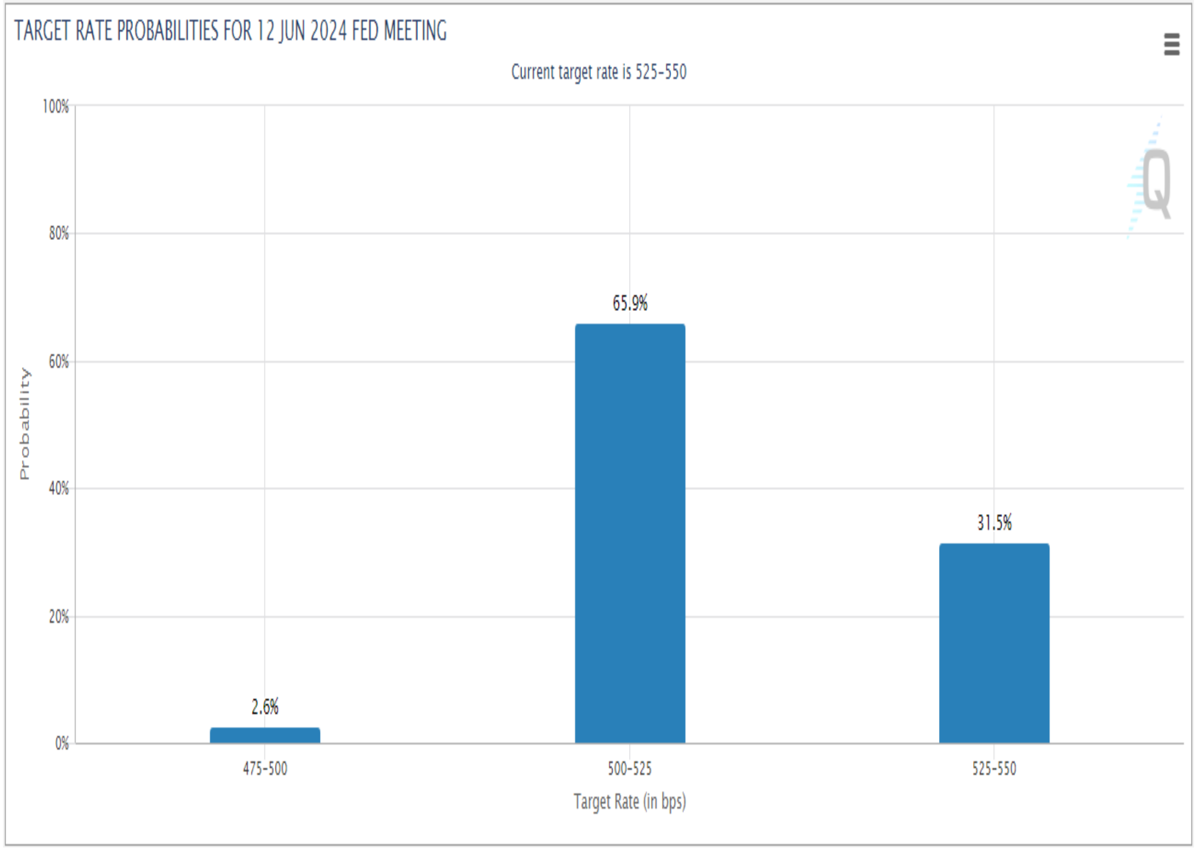
- US households are now paying roughly as much interest on other kinds of debt, from credit cards to student loans, as they are on their mortgages, as per recent Bureau of Economic Analysis (BEA) numbers. Non-mortgage interest payments climbed to an annual rate of $573.4 billion in January which is the highest on record even after adjusting for inflation — and within a hair's breadth of the $578.3 billion in annual mortgage interest that households were shelling out as of the last quarter of 2023. Even with a palpable decrease in PCE, Fed's preferred gauge of prices, this could bite the average men & women on street going ahead, already battling dwindling savings and higher cost of living…Plus, the distress sale of plummeting commercial real estate at key places points to embedded pain points and recovery not being uniform!



Fed chair to markets: in no hurry as the path to a stable 2% is sometimes bumpy

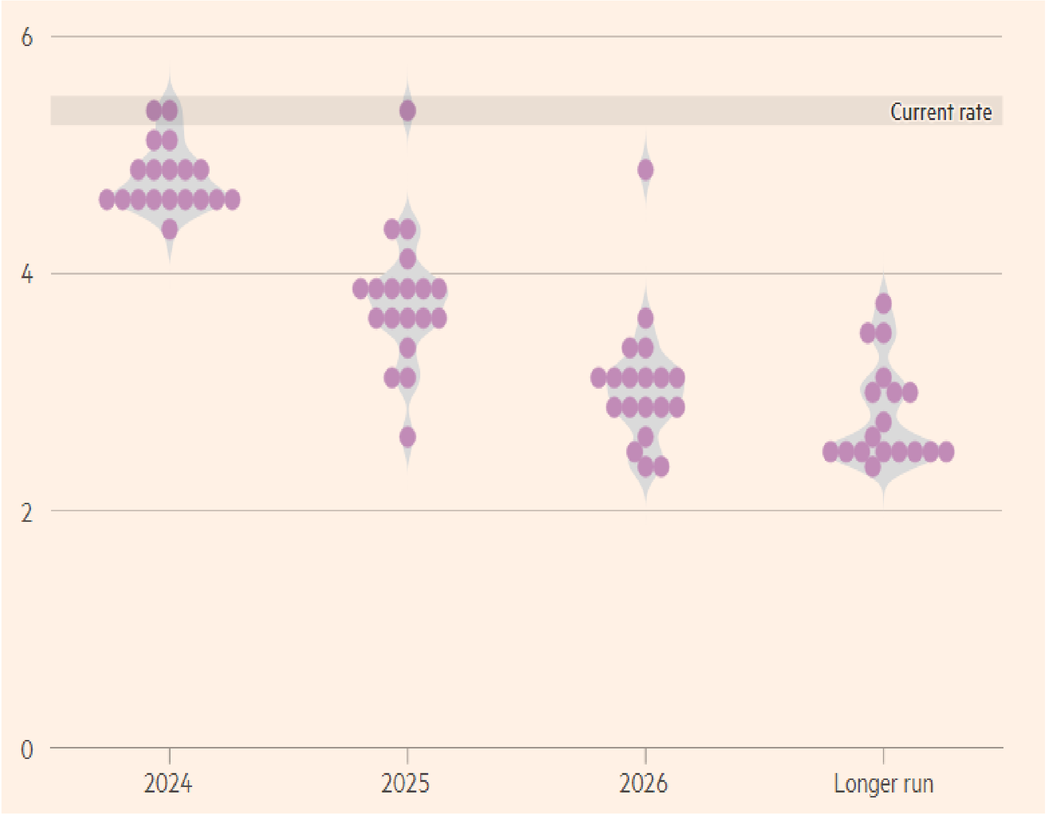
- Federal Reserve chair Powell put some ice on broader market's hopes of an early pivot by decisively speaking that the Fed would like to see more progress on price front despite a favorable PCE reading…PCE, which strips volatile food and energy prices, rose 0.3% in February, after rising 0.5% in January, marking its biggest back-to-back gain in a year ….the CME FedWatch tool as also other market polls now indicate a maximum easing of 75 bps of rates through 2024, against 100 bps predicted earlier

Nearly a third of CME FedWatch participants see a status quo even through June meet….



Graph: CME, SBI Research

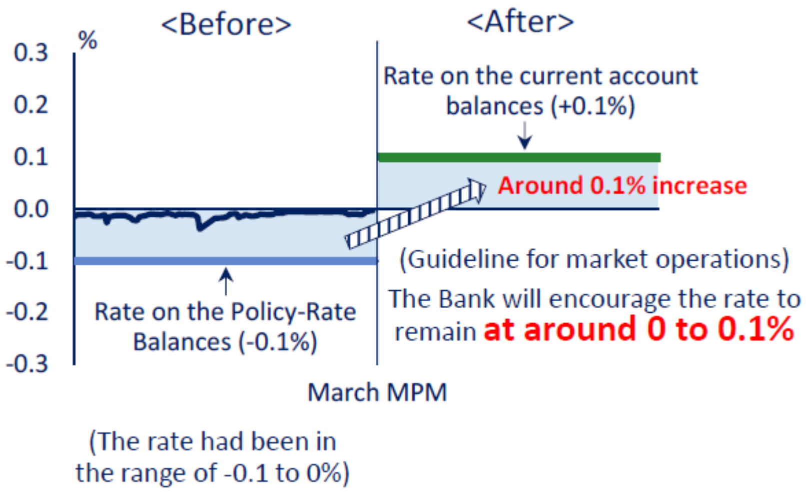
Each dot represents one FOMC participant's projection for the midpoint of US interest rates (%) from every meeting since March'2024

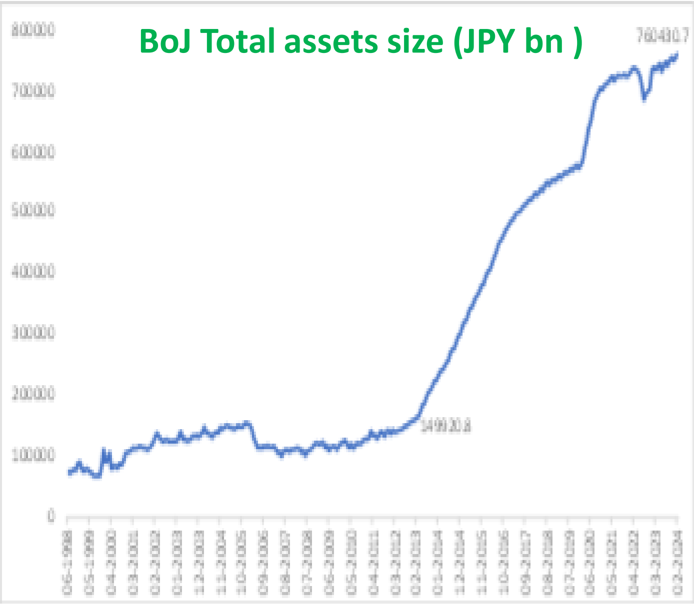


Graph: FT, SBI Research

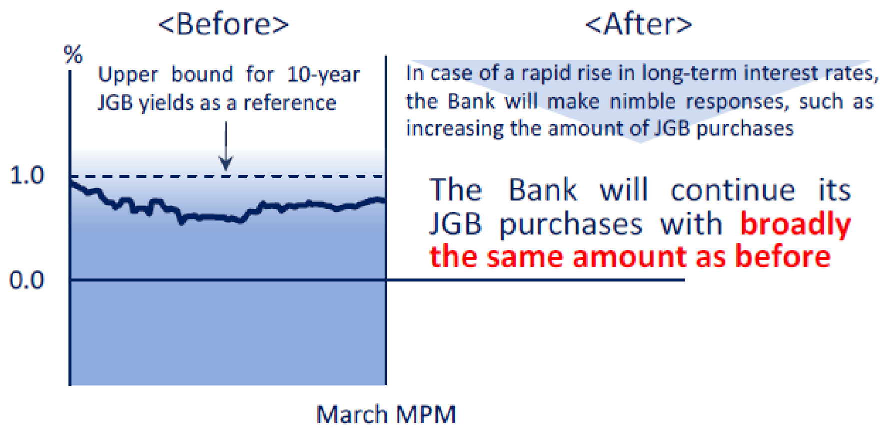
- The BoJ signaled a complete departure from the unconventional monetary policy pursued for long often dubbed as Kurodanomics/Abenomics that, of late, appeared little in sync with changing realms of the deglobalizing world post pandemic, with economic and technological might of Japan waning and the currency undergoing a tailspin with leveraged bets rising against the yen to big time highs
- The BoJ raised its short-term interest rates to around 0% to 0.1% from -0.1%, ending Japan's negative rates regime in place since 2016. The BoJ also announced the abolition of its radical yield curve control (YCC) policy for 10-year Japanese government bonds, which the central bank has employed to target longer-term interest rates by buying and selling bonds as necessary in a fight to boost persistently low inflation. In the roughly 8 trillion dollar JGB market, BoJ has had an overwhelming share (47.1% as on June’2023 against 43.7% pre-pandemic in Dec’19)
- The holdings of BoJ in US treasury at ~$1.14 trillion may find some way back home to benefit from the expected rise in benchmark yields, though not of materially significant levels as of now, with some appreciation on course in Yen as carry trades by leveraged funds appear to have peaked

Japan Short-term interest rate





Japan Long-term interest rates



Mainland China attempts a déjà vu of early 2000s…. Invoking history of friendly exchanges, forced by constraints

- Last week of March saw an ensemble of 20-odd business tycoons descending on Beijing, along the sidelines of China Development Forum, what the state media described as history of friendly exchanges….

- Comprising Blackstone Group chief Stephen Schwarzman, Chipmaker Qualcomm's head Cristiano Amon, insurer Chubb's Evan Greenberg and FedEx's Raj Subramaniam among others, the group had a 90-minutes meet with premier Xi Jinping who appeared keen on exploring more common ground and consensus among the two nations, on logger heads in recent years as the mainland has set an annual growth target of 5% for the ongoing fiscal year, a goal which analysts, as also economists brand as very ambitious

- The meet was dubbed as a natural corollary to Xi's visit to the US last year to attend the APEC summit in San Francisco where he had a meeting with the US president Joe Biden, apart from meeting top corporate honchos including Tesla's Elon Musk and Apple's Tim Cook. During the meet, Xi had said that China is ready to be a partner and friend of the US, indicating a softened stand mellowed by the USA ringfencing it on key technology procurement and other critical supply chain issues. In fact, Tim Cook attended the China Development Forum meet this year, pledging fresh investment into the country and hailing its "vibrant" and "dynamic" economy, though the markets saw it a desperate attempt by the tech behemoth to uplift the plummeting iPhone sales in a bewildered economy marred by a property crisis whose ripples are now reaching far and wide.

- With embattled Chinese developer Evergrande ordered to undergo forced sale/liquidation by the Hong Kong's High Court amidst $333 billion of debt, China's biggest private property developer Country Garden facing a winding-up petition and Chinese developer Radiance Holdings Group defaulting on a $300 million bond in late March this year after it missed a due payment, the crisis seems yet to bottom out in the embattled Chinese property market

Major Emerging Economies rates are influenced by Advanced Economies

- To test the hypothesis of future values of emerging economy rates being influenced by past values of advanced economy rates, we have done the granger causality tests, involving the data from Jan 2008 to Mar 2024
- It has been observed that all major emerging economies rates such as of Indonesia, India, Malaysia, Saudi Arabia, Thailand are either being predicted by past movements of US rates or UK rates, signifying granger causality relationship
- Rates of Philippines and South Africa are not being predicted conclusively from the past values of either US rates or UK rates
- **Lag of 2 months is found to be Optimal lag of operation in the interplay of these rates across countries**

Granger Causality of Advanced Economy Rates on Emerging Economies Rates (2008 onwards)

Country	US Rate			UK Rate		
	Chi-square	P Value	Granger Causality	Chi-square	P Value	Granger Causality
Indonesia	9.982	0.007	Yes	2.117	0.347	No
India	2.495	0.287	No	7.590	0.022	Yes
Malaysia	1.990	0.370	No	25.983	0.000	Yes
Phillipines	0.717	0.699	No	3.240	0.198	No
Saudi Arabia	8.179	0.017	Yes	4.576	0.101	No
Thailand	57.752	0.000	Yes	10.339	0.006	Yes
South Africa	1.573	0.455	No	0.258	0.879	No

Source: SBI Research

Granger Causality of USA and UK rate

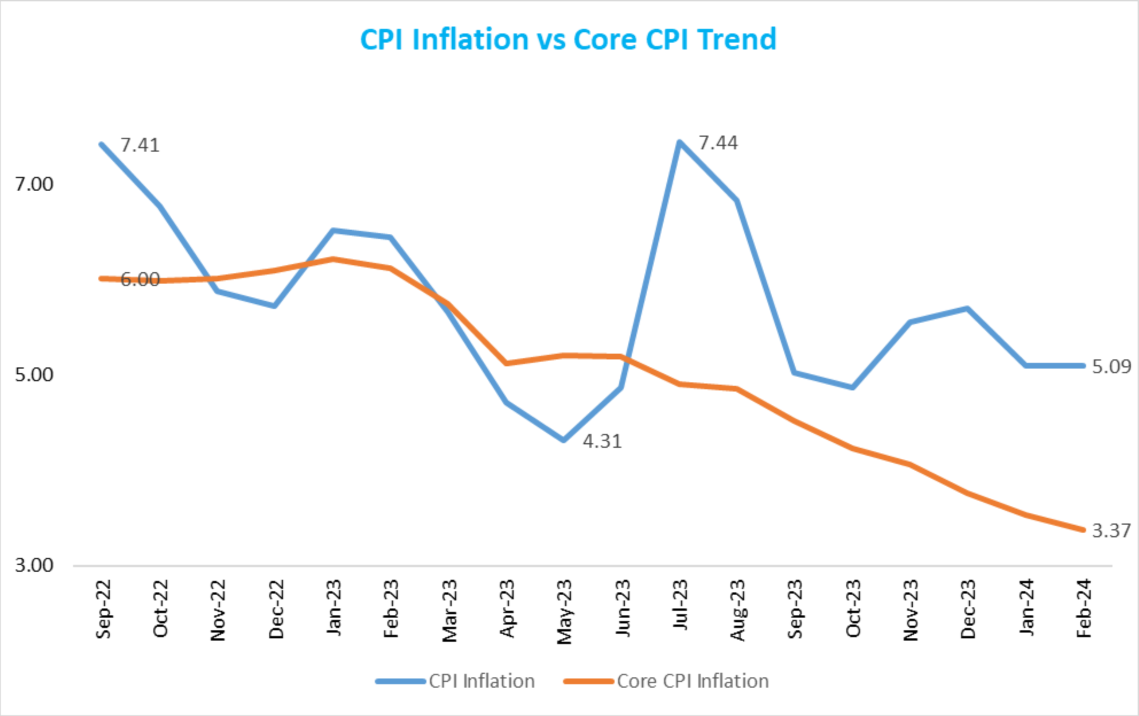
Rate	Chi-square	P Value	Granger Causality
USA rate over UK rate	23.990	0.000	Yes
UK rate over USA rate	15.253	0.000	Yes

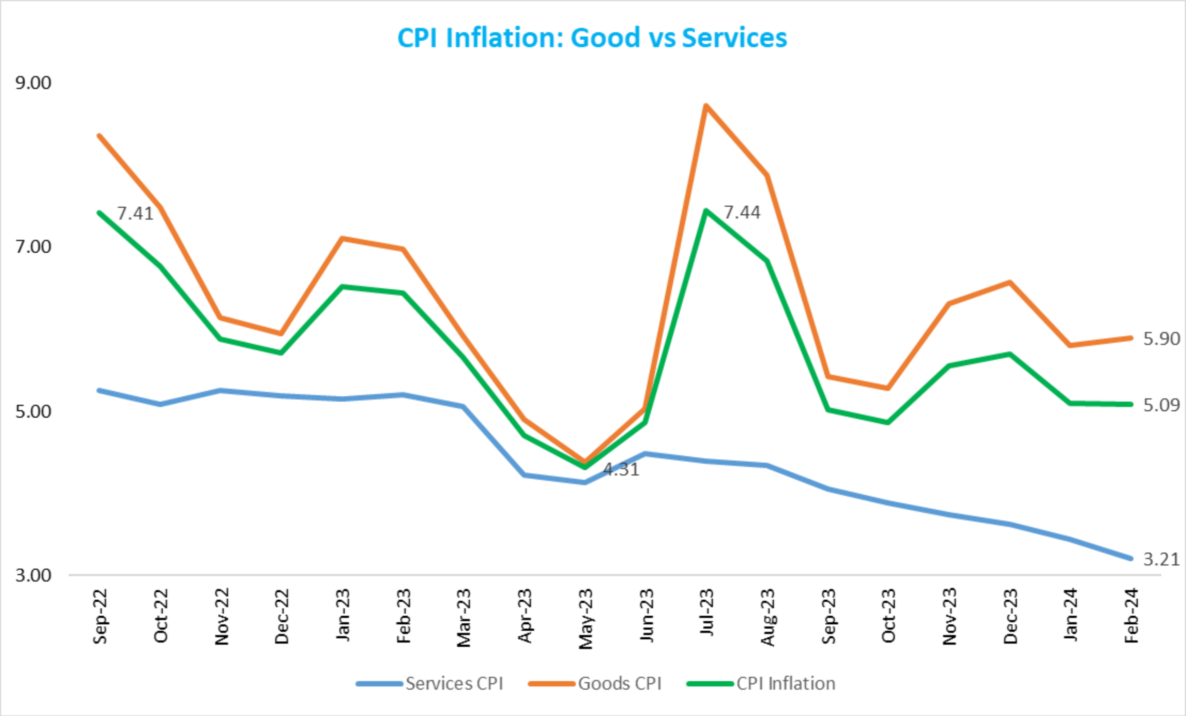
Source: SBI Research

Domestic Economy

CPI Inflation: Good vs Services

- With moderate fuel prices, inflation is currently being driven by food price dynamics. CPI inflation is mostly driven by good inflation. Looking ahead evolving food prices will determine domestic inflation. CPI inflation is expected to remain slightly above 5.0% in the remaining one month of FY24
- Core CPI declined to 3.37% - a 52-months low and reached the level of Oct-19

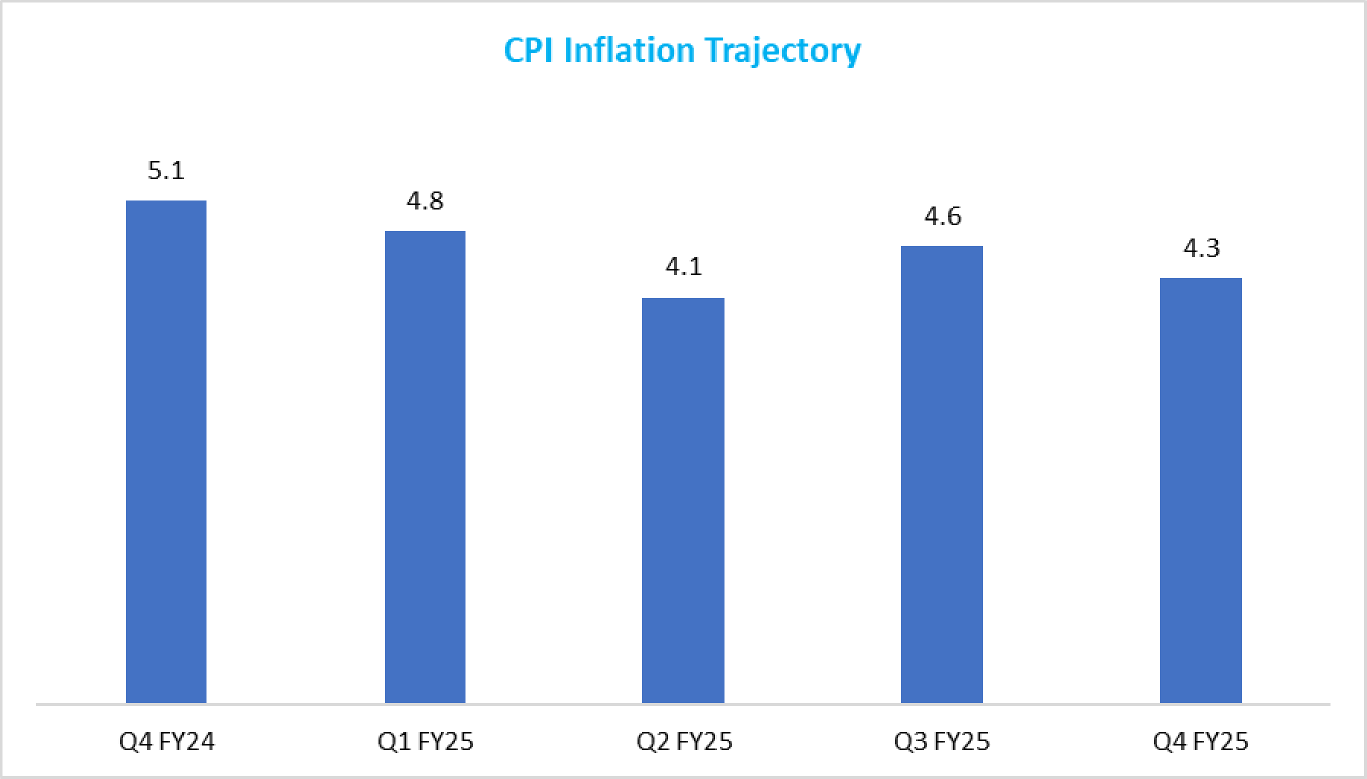




CPI expected to remain within RBI target in FY25

- Inflation is then expected to decline till Jul'24 but increase thereafter to reach a peak of 5.4% in Sep'24, followed by a deceleration

- For the whole FY25, CPI inflation is likely to average to 4.5% (FY24: 5.4%)



Current Liquidity Update shows ~Rs 0.7 trillion surplus….

- Liquidity deficit has declined since the last policy in Feb’24. Net LAF has remained in the deficit mode since mid-Sep’23, with average of Rs 0.97 lakh crore post Feb’24 policy

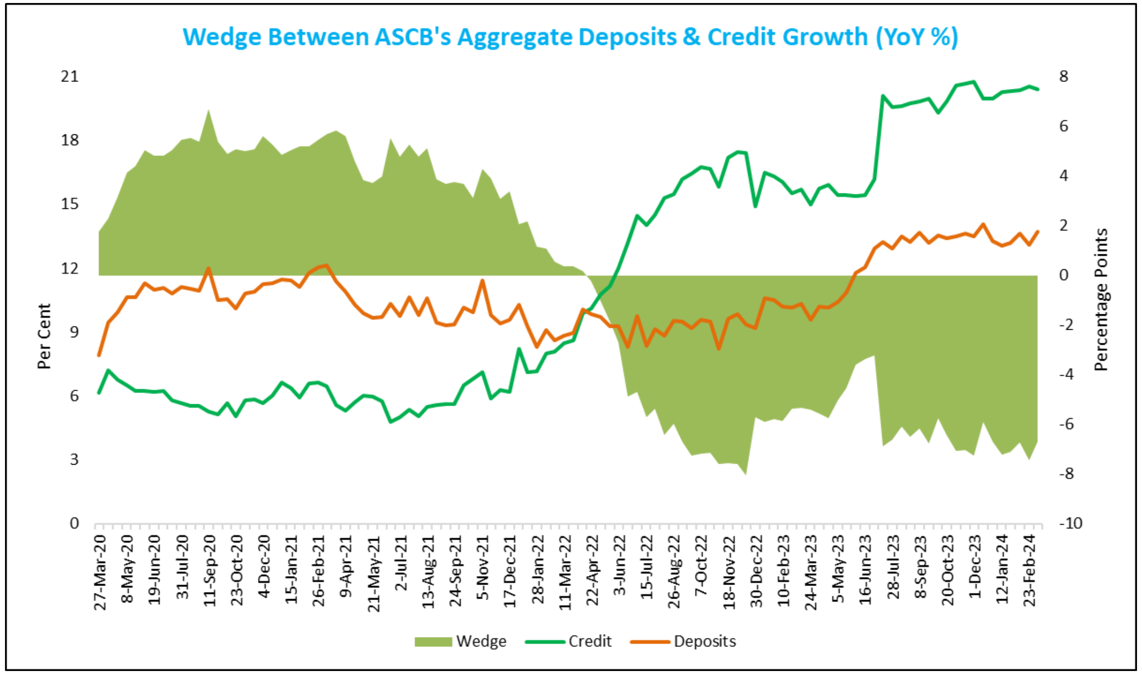
- **Government surplus cash balances have decreased to an average of Rs 1.18 lakh crore post Feb’24 policy**

- Durable/core liquidity surplus has come down to Rs 1.87 lakh crore

Average Liquidity Position (Rs lakh crore)			
	Average in FY24	Average post policy 8th Feb	30-Mar-24
Repo Outstanding	0.63	1.60	1.04
Reverse Repo Total	0.29	0.13	0.00
SDF	0.82	0.85	2.60
MSF	0.46	0.20	0.83
Net LAF (-absorption)	0.06	0.97	-0.61
Government Cash Balance (net LAF-core liquidity)	2.37	2.70	1.18
Core Liquidity (-Surplus) system liquidity adjusted with GOI Balances	-2.33	-1.74	-1.87
Ratios	31-Mar-23	30-Mar-24	change in bps
30 Year Gsec	7.41	7.13	-28.3
20 Year Gsec	7.40	7.11	-29.0
15 Year Gsec	7.34	7.10	-23.9
10 Year Gsec	7.31	7.06	-25.0
5 Year Gse	7.17	7.06	-11.6
2 Yers Gsec	7.06	7.03	-2.9
364 days Tbill	7.31	6.99	-32.0
182days Tbill	7.28	7.04	-24.0
91days Tbill	6.73	6.90	17.0
AAA Corp Spread(bps)	49.70	46.40	-3.3
Source: RBI, SBI Research			

Growth in Banking Business: Actual vs Estimated

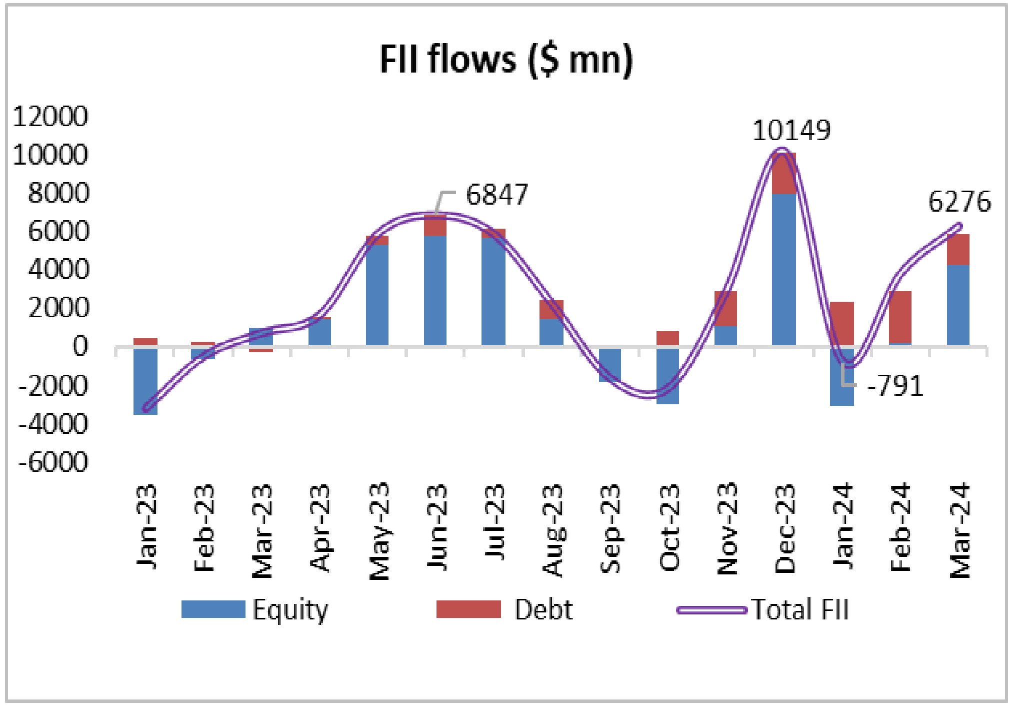
- On the banking front, deposit growth has rebounded but sustained credit growth momentum has increased wedge between deposits and credit growth
- As on 08 March, ASCBs credit grew by 20.41% (15.7% last Year) and deposits by 13.7% (10.3% last year). Latest credit growth numbers reveal a sustained pick up across Agriculture, MSME & Services
- We expect deposits and credit may grow 14.5-15% and 16.0-16.5% respectively in FY25

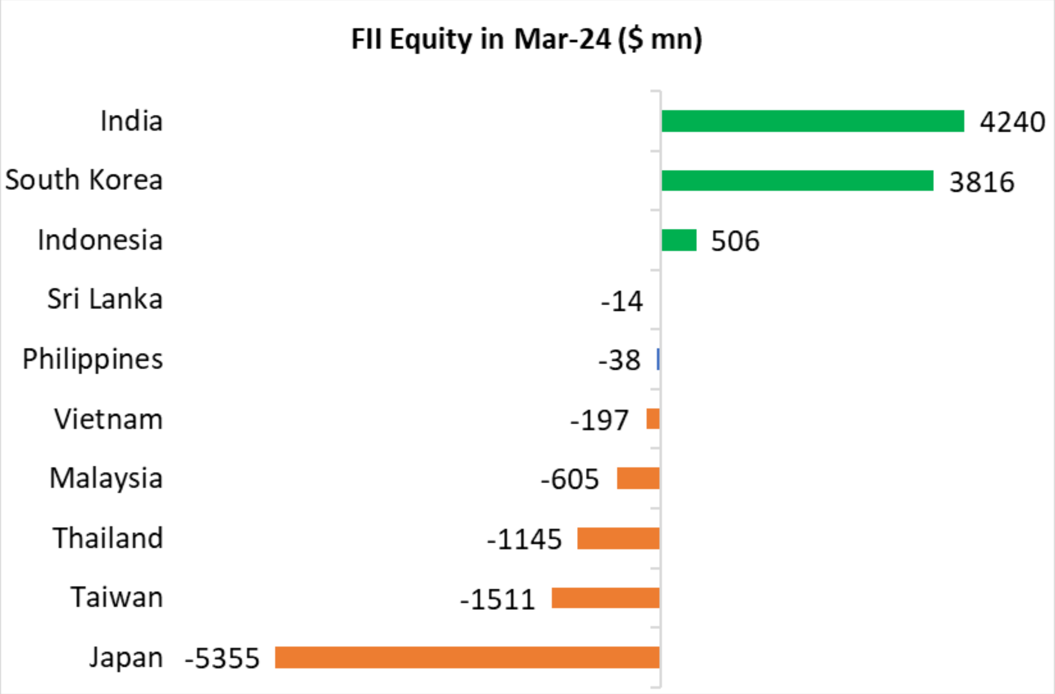


ASCBs Sector-Wise Credit Flow (Rs bn): February 2024							
Sectors	Apr'22 to Feb'23 (FY23)		Apr'23 to Feb'24 (FY24)		YoY %		FYTD 24 as X times as FYTD 23
	Rs bn	%	Rs bn	%	FY23 (Feb)	FY24 (Feb)	No of times
Agri. & Allied	1981	13.2	3075	17.8	15.0	20.1	1.6
Industry	1365	4.2	2605	7.6	6.8	9.1	1.9
MSE (Priority)	2023	14.1	3172	19.3	13.4	20.3	1.6
Infrastructure	-64	-0.5	681	5.6	1.3	6.8	10.6
Services	5244	16.9	7852	21.2	20.5	24.0	1.5
NBFCs	2870	27.8	1729	12.9	31.9	14.7	0.6
Personal Loans	6514	18.9	10869	26.0	20.6	28.3	1.7
Housing (Including Priority)	2357	13.6	6943	34.9	15.2	36.7	2.9
Other Personal Loans	2189	24.2	2229	19.4	26.7	21.9	1.0

Capital flows to remain robust through FY25…

- India has beaten rest of the Asian markets by attracting the highest foreign funds flow in March, defying geopolitical crises and concerns that the higher interest rate regime will continue for some more time
- Equity inflows comprises of ~70% of total inflows as of now but going forward we believe the debt inflows can pick up big time as passive investments in bonds under FAR route start trickling for both JP Morgan as also Bloomberg index investors…the $30-35 billion estimated investments can help in cooling the yields on benchmark securities (reducing the borrowing costs) though exchange rates can witness some volatility





Final Thought

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

Indicator	Our View
Global Economy	❑ The scatter plot between US inflation and unemployment (the Phillips Curve) shows that for all sub periods, the long run Phillips curve is tracing the 100-year average range of 4.5-5.5%. The long-term expectation on unemployment in the recent monetary policy report is 3.4-4.3%. Current unemployment shows tight labor markets with reference to long term trends ❑ The US labour market seems to have embraced two contrasting trends simultaneously: a low unemployment rate coupled with elevated job vacancy rate… this trend could continue through 2025 ❑ US China relations taking new realms in the current dispensation of Biden….
Stance & Repo Rate	❑ We believe the stance should continue to be withdrawal of accommodation ❑ **Strong evidence of Emerging Economy Central Bank rate actions are predicated by Advanced Economy Central Bank rate actions…India is an exception…first RBI cut in Q3FY25…such rate cut cycle likely to be shallow**
Measures to augment liquidity	❑ The impending JIT mechanism will keep the Government cash balances elevated going forward…while this could have an impact on liquidity, the spectre of capital flows in FY25 could pose challenges and opportunities for RBI liquidity management…temporary liquidity injections should replace temporary liquidity withdrawals…thus OMO cannot be a tool to counterbalance idiosyncrasies in Government cash balances…only VRRR can replace such..

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