SBI RESEARCH

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RBI POLICY MAKES A CLEAR DISTINCTION BETWEEN STRATEGY AND STANCE: YIELDS COULD HEAD TOWARDS ~6.55%-6.6%

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The RBI surprised the market with a policy statement that has a lower GDP at 7.8% and an inflation forecast at 4.5% for FY23. This translates into a WPI projection of around 2.8% in FY23. The lower inflation forecast took the market by surprise and the 10-year yield has declined by 10 basis points and is likely to decline further.

There are 3 bets that the RBI has taken in its quest for a lower term structure of interest rates. The RBI has also clearly indicated to the market that it is comfortable with making a clear distinction between policy strategy and policy stance and these can coexist simultaneously. While a policy strategy may indicate RBI calibrating the liquidity normalization to ensure that government borrowings face no disruption, the policy stance may still indicate rate adjustment to quell inflation expectations, should inflation surprise on the upside beyond tolerance. These two mutually complement each other as RBI has several non conventional policy tools to adjust Government borrowings.

The 3 bets the RBI has taken are crude prices, US yield and the Government borrowing program that determine yield trajectory will largely be under control. While crude price increase may have bottomed out, the US yields might soften today on the back of lower than expected inflation print. The third and the largest elephant in the room is the size of Government borrowing program. We expect for FY23, the Government has budgeted net market borrowing of Rs 11.2 lakh crore, that however could be lower by at least Rs 2.5 lakh crore.

Notably, small saving rates continue to be attractive in terms of rates. In FY22, small savings collections exceeded the budgeted amount by a large Rs 2 lakh crore, and that had resulted in net borrowing falling short by Rs 1.7 lakh crore. The challenge lies in FY23 with net borrowings increasing by Rs 3.4 lakh crore but small savings lower by Rs 1.7 lakh crore than the revised FY22 amount. We expect small saving schemes in FY23 continue to surpass budgetary expectations amidst surplus savings of households and large rate differential with bank deposit rates. Notably, the Government has budgeted Rs 1.75 lakh crore surplus cash balances for FY23. But we believe that it might end up having higher surplus cash balances by at least Rs 1 lakh crore, which in turn will provide some relief to the market borrowing. Furthermore, if small savings and short term borrowings through treasury bills are higher by another Rs 1.5 lakh crore, the net market borrowing of the Government will come down from Rs 11.2 lakh crore to Rs 8.7 lakh crore.

For FY22 again if we consider there are no borrowing in the remaining part of the current fiscal, the market borrowing would get reduced by Rs 71,000 crore, thereby leading to net borrowing of Rs 7.04 lakh crore as against the RE of Rs 7.75 lakh crore. Clearly, the yields could head lower and even touch 6.55%-6.6% in FY22.

Some of the developmental and regulatory measures also deserve special mention.

First, NPCI in association with DFS, National Health Authority (NHA), Ministry of Health and Family Welfare (MoHFW), and partner banks launched an innovative digital solution – 'e-RUPI' in August 2021. The e-RUPI runs on the UPI platform and has a cap of Rs 10,000 per voucher and each voucher can be used / redeemed only once. To facilitate digital delivery of various Government schemes to the beneficiaries, RBI has increased the cap on amount for e-RUPI vouchers issued by Governments to Rs 1,00,000 per voucher and allowed use of the e-RUPI voucher multiple times.

We believe that this is an excellent step and will promote use of e-RUPI which is easy, safe and secure as it keeps the details of the beneficiaries completely confidential. In future, this could be even be used as digital rupee as the RBI onboards digital currency. Currently 16 banks and 1959 hospitals are live on e-RUPI.

Second, TReDS is an electronic platform for facilitating the financing / discounting of trade receivables of MSMEs through multiple financiers. These receivables can be due from corporates and other buyers, including Government Departments and Public Sector Undertakings. Keeping in view the growing liquidity requirements of the MSMEs RBI has increased the NACH mandate limit to Rs 3 crore (from present Rs 1 crore) for TReDS settlements.

Even as the market was surprised by the tone of the RBI policy, we believe RBI may have moved ahead of the market in terms of expectation setting. FY23 could usher in a new era of separate strategy and separate stance of the RBI, an unconventional monetary policy setting in the true sense!

RBI HOLDS RATE

- RBI's Monetary Policy Committee has unanimously decided to keep policy Repo rate unchanged at 4% (10th straight time) and decided to continue with the accommodative stance (with 5-1 vote) as long as necessary (to revive growth on a durable basis with check on inflation). Reverse repo rate remains unchanged at 3.35% and MSF and the Bank Rate remains at 4.25%.
- RBI has projected real GDP growth for FY23 at 7.8% with 17.2% in Q1, 7.0% in Q2, 4.3% in Q3 and 4.5% for Q4. Though surprising that RBI projected sub-5% growth for Q3 and Q4, if we analyse the past trends these projections look reasonable.
- RBI has retained projected CPI inflation for FY22 at 5.3% for FY22 with 5.7% in Q4 FY22. On the assumption of a normal monsoon in 2022, RBI has projected the CPI inflation for FY23 at 4.5% with 4.9% in Q1, 5.0% in Q2, 4.0% in Q3 and 4.2% in Q4 with risks broadly balanced.
- In Union Budget 2022-23, nominal GDP growth is projected at 11.1%. Given the RBI's projection of 7.8% of real GDP growth the GDP deflator comes out to be around 3.3%, that translates into a the estimated WPI inflation for FY23 at 2.8%. The average WPI for Apr-Dec'21 is 12.5% and for whole year the average WPI would be around 10-12%.
- This also indicates that RBI assume that both food and services inflation will remain under control. RBI also assumes that huge base effect will paly a positive role in keeping inflation under limits and heavily bank on it.

CURRENT LIQUIDITY SITUATION

- RBI has been actively managing liquidity in the system through various means. However, system liquidity still remains in the surplus mode with the average daily net absorption under the LAF at Rs 6.5 lakh crore as on 9 Feb'22 compared to an average of Rs 6.3 lakh crore in Jan'21 and Rs 7.4 lakh crore in Dec'21. Meanwhile, the average surplus Government cash balances are at Rs 3.5 lakh crore in Feb'22 against an average of Rs 4.0 lakh crore in Jan'22 and Rs 3.7 lakh crore in Dec'21. After taking into account the currency in circulation, Government surplus cash balances, forex intervention by RBI and OMO operations of RBI, we believe liquidity surplus will be around Rs 2 lakh crore by March 2022.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q3 FY22	Q4 FY22	FY22	Q1 FY23	Q2 FY23	Q3 FY23	Q4 FY23	FY23
Feb'22	5*	5.7	5.3	4.9	5.0	4.0	4.2	4.5
Dec'21	5.1	5.7	5.3	5.0	5.0	-	-	-
Oct'21	4.5	5.8	5.3	5.2	-	-	-	-
Real GDP Growth (%)	**Q3 FY22**	**Q4 FY22**	**FY22**	**Q1 FY23**	**Q2 FY23**	**Q3 FY23**	**Q4 FY23**	**FY23**
Feb'22	6	5.9	-	17.2	7.0	4.3	4.5	7.8
Dec'21	6.6	6.0	9.5	17.2	7.8	-	-	-
Oct'21	6.8	6.1	9.5	17.2	-	-	-	-

Source: RBI, SBI Research, *Actual

NON-CONVENTIONAL WAYS TO MANAGE GOVERNMENT BORROWINGS IN FY23

For FY23, the Government has budgeted net market borrowing programme of Rs 11.2 lakh crore, that however could be lower by at least Rs 2.5 lakh crore. The RBI can still manage this borrowing program without adversely impacting any macro parameters.

- *First*, RBI has to support the borrowing program by maintaining liquidity at reasonable levels. Liquidity is a policy strategy and rates are a policy stance and both can coexist in market and are not antithesis.
- *Second*, RBI may properly distribute securities based on their duration so that it can mapped with the redemption profile. During the FY 2021-22 (YTD), out of total G-Sec issuance of 8.27 Tn, bonds due for repayment in 0-5 and 5-10 years bucket constituted 28.4% and 24% of total value respectively, implying ~48% of amount raised were through papers having maturities in excess of 10 years, by all means not a favourable fiefdom of the otherwise bankable banks. We expect tenor with distribution as given in table.

Expected Distribution	
1-5yr	20%
5-9yr	15%
10yr	24%
11-15yr	21%
Long term	20%

Source: SBI Research

- *Third*, RBI may opt for the non-conventional support like exercising of the green shoe option.

Borrowing Pattern: FY22

Rs Lakh Crore	Gsec Auction Amount	Short Term Borrowing accepted amount	Green Shoe
Q1 FY22	3.52	5.3	0.29
Q2 FY22	3.73	3.21	0.22
Q3 FY22	2.71	4.57	
Q4 Till 4 Feb	1.07	1.47	0.02
Total	**11.03**	**14.55**	**0.53**

Source: SBI Research

- *Fourth*, RBI can consider higher borrowing through T-bill (higher amount in each weekly 91 Day, 182 Day and 364 day T-bill auction) amid comfortable liquidity.
- *Fifth*, the RBI can use the surplus cash balances to mitigate the size of the Government borrowing program.
- Also, small saving rates continue to be attractive in terms of rates. In FY22, small savings collections exceeded the budgeted amount by a large Rs 2 lakh crore, and that had resulted in net borrowing falling short by Rs 1.7 lakh crore. The challenge lies in FY23 with net borrowings increasing by Rs 3.4 lakh crore but small savings lower by Rs 1.7 lakh crore than the revised FY22 amount. We expect small saving schemes in FY23 continue to surpass budgetary expectations amidst surplus savings of households and large rate differential with bank deposit rates.
- We believe that Government surplus cash balances might end up higher than the budgeted by at least Rs 1 lakh crore, which in turn will provide some relief to the market borrowing. Furthermore, if small savings and short term borrowings are higher by another Rs 1.5 lakh crore, the net market borrowing of the Government will come down from Rs 11.2 lakh crore to Rs 8.7 lakh crore.
- For FY22 again if we consider there are no borrowing in the remaining part of the current fiscal, the market borrowing would get reduced by Rs 71,000 crore, thereby leading to net borrowing of Rs 7.04 lakh crore as against the RE of Rs 7.75 lakh crore.

DEVELOPMENTAL AND REGULATORY MEASURES

- **Extension of Term Liquidity Facility of ₹50,000 crore to Emergency Health Services:** Looking at the positive response of on tap liquidity window for Covid related emergency Health Services, which qualified as priority sector lending and further incentive was given to banks to park their surplus liquidity up to the size of the COVID-19 loan book with the RBI, has been extended for another 3 months till June 2022.
- **Extension of On-tap Liquidity Window of ₹15,000 for Contact-intensive Sectors:** On similar lines, as the contact intensive sector continues to suffer owing to the Omicron wave, the impact of which though is less compared to the previous two waves, the on-tap liquidity window for contact-intensive sectors has also been extended further till June 2022.
- **Voluntary Retention Route (VRR) – Enhancement of Limits:** RBI's announcement today to enhance the available limit under Debt-VRR route should be seen as a natural corollary towards our preparations before onboarding major bond indexes going forward, more of a stop-gap arrangement till the crucial issues and corresponding impacts woven around likely avalanche of funds through index inclusion (US$ 15-20 billion annually on the lower frequency side) are analysed and forward linkage with effects on liquidity, yields, repatriation/stability of such funds and most critical perhaps, counter-currents underpinning rupee's behaviour (with exchange rate management given the least priority amidst growth and inflation conundrum off-late) is established, with necessary fortifications wherever warranted.
- In the last three years since its launch by RBI in March'19 with an initial limit of Rs 75,000 crore, Debt-VRR has been quite successful, and trend agnostic in attracting and retaining the stable inflows of around Rs 1,50,000 crore now. The move is expected to provide some respite to certain categories of FPIs, with their exposure in applicable papers nearing saturation (though, interestingly overall investment limits have largely remained underutilized in non-VRR general debt as well as corporate papers dismally (@6% of available stock) and heightened levels of ownership in other Emerging Economies like Brazil, Mexico, South Africa, Indonesia etc. even as US Fed and other central banks walk a tight rope, unwinding the knot in their swollen balance sheets.

FII Flows ($ Million)

CY	2019	2020	2021	2022#
EQUITY	14368	23012	3760	-5494
DEBT	3748	-14060	-1398	449
DEBT-VRR	--	3392	4463	-501
HYBRID	1292	1693	246	225
CY TOTAL	19408	14037	7070	-5321

Source: SBI Research; # YTD till 09 Feb'22

- **Review of Credit Default Swaps (CDS) Guidelines:** RBI's continued efforts to deepen the credit markets, making it competitive, multi-sourced and efficient with optimal price discovery in a self-fulfilling ecosystem, while building adequate safeguards against fragilities should get a fillip with the revised guidelines on CDS (being announced later), broad basing the protection sellers and providing the much needed hedge against risks in corporate debt issuance in a resurgent CDS market, third biggest OTC derivatives market globally, with a notional market size of ~USD 9 trillion globally.
- The reforms in corporate bonds markets over the years have seen a tectonic shift in credit offtake, with formal bank credit increasingly cannibalised by bonds/CP market which offered better alignment with benchmark interest rates. The proposed guidelines, aimed at better acceptance of papers, in particular from lower rated corporates, should go a long way in bolstering the market depth and reducing transaction costs by mitigating acceptance barriers as risk gets redistributed, shifting from protection buyer to seller. However, it would be prudent on part of RBI to constantly check/monitor the ecosystem and ensure that lessons learnt are revisited and enforced lest select market players rig the system. The RBI has done well on these scores by limiting the FPI CDS protection selling to 5% of the outstanding stock of corporate bonds as a first measure.
- **Permitting Banks to Deal in offshore Foreign Currency Settled Rupee Derivatives Market:** RBI's decision to allow banks in India to undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) market with non-residents and other market makers through their branches in India, their foreign branches or through their IFSC Banking Units should go a long way in deepening the OIS market, while reducing barriers between Onshore/ Offshore (as RBI has been working towards an 'Onshoring the Offshore ecosystem' with GIFT city at IFSC being primed to challenge the hegemony of global high streets like London, NY and Singapore/ HK, promising global significant stakeholders a credible alternate deep, liquid and mature market in post LIBOR days.
- **Enhancement of the Cap under e-RUPI by 10x:** NPCI in association with DFS, National Health Authority (NHA), Ministry of Health and Family Welfare (MoHFW), and partner banks, launched an innovative digital solution – 'e-RUPI' in August 2021. This is a person-specific and purpose-specific cashless voucher and can be used by individuals, corporates or governments. e-RUPI runs on the UPI platform and has a cap of Rs 10,000 per voucher and each voucher can be used / redeemed only once.
- To facilitate digital delivery of various government schemes to the beneficiaries, RBI has increased the cap on amount for e-RUPI vouchers issued by Governments to Rs 1,00,000 per voucher and allow use of the e-RUPI voucher multiple times.
- We believe that this is an excellent step and will promote use of e-RUPI which is easy, safe and secure as it keeps the details of the beneficiaries completely confidential. The entire transaction process through this voucher is relatively faster and at the same time reliable, as the required amount is already stored in the voucher.
- Currently 16 banks and 1959 hospitals are live on e-RUPI.
- **Increasing NACH Mandate Limit for TReDS Settlements:** TReDS is an electronic platform for facilitating the financing / discounting of trade receivables of MSMEs through multiple financiers. These receivables can be due from corporates and other buyers, including Government Departments and Public Sector Undertakings. TReDS settlements are carried out through mandates in the National Automated Clearing House (NACH) system. Keeping in view the growing liquidity requirements of the MSMEs RBI has increased the NACH mandate limit to Rs 3 crore (from present Rs 1 crore) for TReDS settlements.
- The age of digital finance offers fresh hopes and promise to bridge the unmet credit needs of MSMEs, who contribute 30% to India's GDP, 45% to manufacturing and 48% to merchandise exports of India. As Government of India aims to enhance the share of MSMEs to GDP to 50% in the coming years, these type of measures will provide necessary thrust to address the problems of MSMEs.

GLOBAL ECONOMY

- Rapid spread of Omicron variant and the associated restrictions have dampened global economic activity. In its January 2022 update of the World Economic Outlook, the International Monetary Fund (IMF) revised global output and trade growth projections for 2022 downward to 4.4% and 6.0% from its earlier forecasts of 4.9% and 6.7%, respectively.
- The global composite PMI slipped to an 18-month low of 51.4 in January 2022, with weakness in both services and manufacturing. World merchandise trade continues to grow, however, headwinds emanating from persistent container and labour shortages, and elevated freight rates.
- The annual inflation rate in the US accelerated to 7% in the last month of 2021, a fresh high since June of 1982, in line with market expectations and compared to 6.8% in November. Energy was the biggest contributor to the gain, but the rise was smaller than in November (29.3% vs 33.3%). In the next release too the expectation is further climb from the previous levels of 7%. Inflation Rate in the United States is expected to be 6.2% by the end of this quarter.
- With three rate hikes and no clarity on quantum of rate hike, 2023 will be a volatile year on account of mood swings in respect of both dollar and US treasuries.

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