SBI ECOWRAP

भारतीय स्टेट बैंक
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ONE TIME OMO UNLIKELY TO NUDGE YIELDS MUCH

The announcement by RBI to conduct OMO of Rs 100 bn was not entirely unexpected as core liquidity in the banking system is currently at the lowest level since Nov 2016. In fact, core liquidity is now only Rs 230 bn, a significant decline from Rs 4000 bn in June 2017.

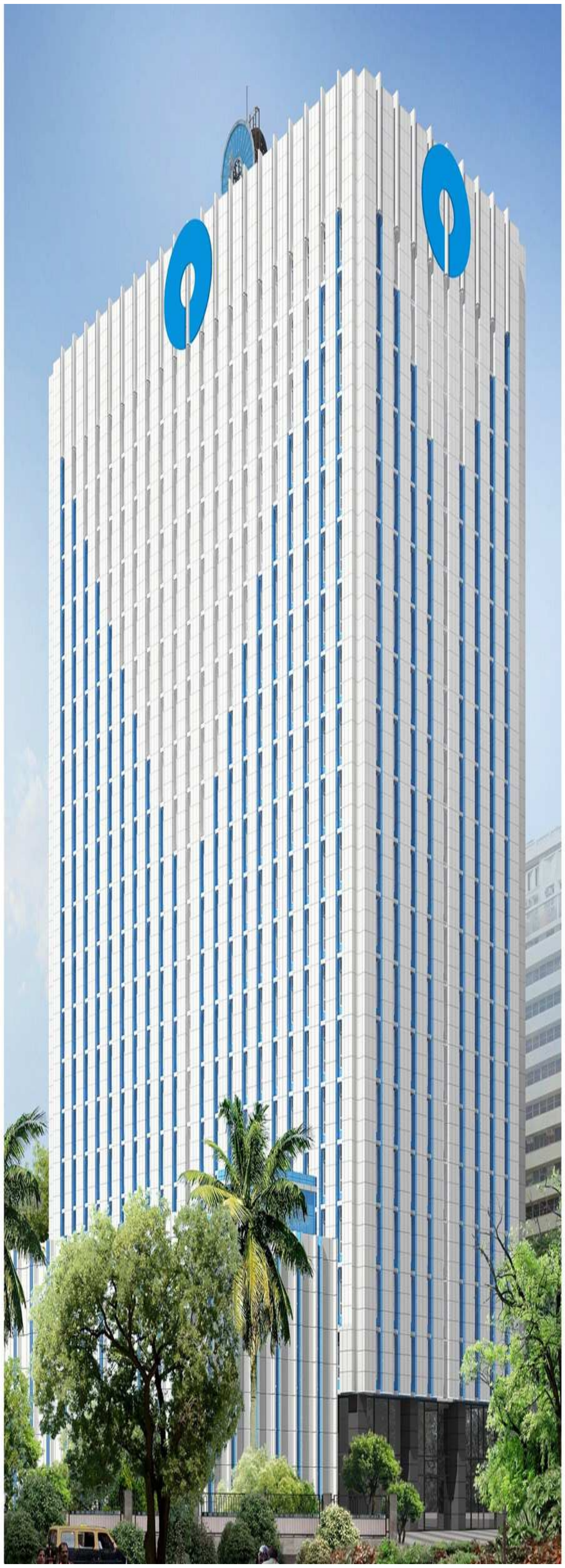
There are several reasons for such decline in liquidity. First, the RBI's OMO sales in FY18 of Rs 900 bn perhaps spooked the market as the threshold OMO which the market could have absorbed given the demand supply of Government papers was at Rs 400-Rs 500 bn at most. In fact, historical trends since FY95 suggest that the average OMO sales was Rs 200 bn, with the maximum at Rs 500 bn. It is possible that the RBI may have erred on the side of abundant caution post the huge deluge of liquidity post demonetization.

Second, deposit growth in FY18 was at 6.7% and is at 54-year low of 6.7%, due to the base effect post demonetisation and significant spurt in currency withdrawal. For example, currency withdrawal by public in April is at Rs 75,000 crore, 31% higher than the trend growth before demonetization. We expect, a currency leakage of close to Rs 3 trillion or more in FY19, with flurry of state elections around the corner, culminating with general elections.

Third, with rupee under pressure, RBI intervening in foreign exchange markets could also have an impact on liquidity, if there is a direct $ sale. Interestingly, even as foreign exchange reserves have declined by $3.2 bn in one week, corresponding rupee liquidity has actually increased indicating such $ sale may be mostly buy sell swaps, apart from valuation, if any.

The decline in liquidity is a matter of concern, as it comes despite a redemption of Government papers in April of Rs 714 bn. Meaningful redemption are now due only in February of Rs 530 bn.

The bottom-line of all these is market is expecting more aggressive OMO /liquidity support on a more sustained basis to address any meaningful recovery in yields. An elevated yield is also inimical to policy transmission on the part of the banks.



POSITIVE IMPACT OF FPI MEASURES/OMO PURCHASE

- In the last couple of days, RBI has taken a slew of measures and has given more leeway to foreign portfolio investors (FPIs) in domestic bonds and relaxed norms for external commercial borrowings (ECBs), to arrest the northward trend of bond-yields. Some of the noticeable measures are: (i) Revision of minimum residual maturity requirement to below 1 year for G-secs, and SDLs and 1 year in corporate bonds for the FPIs; (ii) Revision of security-wise limit to 30% of the outstanding stock of that security from the existing 20%; (iii) Discontinue the auction mechanism of beyond 90% of the limit with effect from June 1, 2018 for the FPIs. Before to this, in the first week of Apr'18, RBI increased limit for FPI investment in Central Government securities (G-secs) by 0.5% each year to 5.5% of outstanding stock of securities in 2018-19 and 6% of outstanding stock of securities in 2019-20.
- Simultaneously, in a step aimed at facilitating cheaper access of overseas funds, RBI has liberalised the ECB policy by including more sectors (housing finance companies, port trusts etc) in the window. To harmonise the extant provisions of foreign currency and rupee ECBs and rupee denominated bonds, the RBI decided to stipulate a uniform all-in-cost ceiling of 450 bps over the benchmark rate.
- Further, RBI has announced Rs 100 billion to purchase of Government securities under OMOs on 17 May'18, through 5-dated securities with the maturity ranging from the year 2020 to 2033. Out of the 5 securities offered for buy-back, 3 securities are illiquid. There was also a long standing demand to correct the asymmetric liquidity management of RBI.
- However, the impact of RBI's FPI measures might still be minimal as these are not exactly liberalised measures. The residual maturity requirement was replaced by a stringent requirement that investment in securities of any category with residual maturity less than a year must be 20% or less than of the FPI's total investment in that category. In addition, the RBI introduced concentration requirements, which have put off many investors, among other things, an FPI could not buy a majority of any issue of a corporate bond.
- The impact of OMO purchase is quite visible and 10-year yield decreased by 10 bps in just 2 working days. Since Jul'17 (when RBI started OMOs sale), India's benchmark 10-yr G-sec yield increased by around 107 bps to 7.73% (5 May'18), though IT declined by 10 bps on 7 May. During the same period the bond yield has also increased in five developed/ developing countries (China, Germany, UK, US and Euro Area) and it is within the range of 7-61 bps. This indicates that the typical market idiosyncrasies has caused a significant extra bump up in bond yields in India. We believe a large part of such is mainly due to unfavourable/negative news/ communication that circulates in the market and even some of them could have been avoided.

OMO Vs Yield Movement

Month	OMO sale (+)/ Purchase (-) (Rs Bn)	Avg. 10 Yr G-sec (%)	Yield (Increase / Decrease) in bps
May-18	-100	7.71	21
Apr-18	0	7.50	-12
Mar-18	0	7.62	2
Feb-18	0	7.60	28
Jan-18	0	7.32	20
Dec-17	0	7.12	21
Nov-17	100	6.97	20
Oct-17	200	6.77	18
Sep-17	200	6.59	9
Aug-17	200	6.50	2
Jul-17	200	6.48	-4
Jun-17	0	6.52	-

Source: RBI & SBI Research

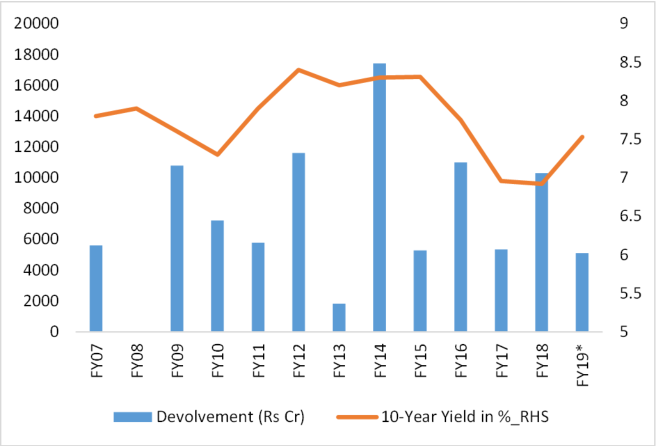
Cross Country – Yield Movement

Country/ Region	03 Jul'17	May'18 (Latest)	Change in BPS
	B	C	C-B
China	3.59	3.70	11
Germany	0.47	0.54	7
India	6.55	7.71	116
Japan	0.08	0.05	-3
Russia	7.70	7.32	-38
South Africa	8.83	8.36	-47
UK	1.26	1.40	14
US	2.34	2.95	61
Euro Area	0.47	0.56	9

Source: SBI Research

- RBI's OMO purchase was inevitable as there has been a spate of devolvement in the last few auctions. There is a positive correlation between increasing devolvement and 10-yar G-sec yield. During FY18 total devolvement on PDs was around Rs 10,000 crore which was almost double the amount of FY17 devolvement.
- In FY19 (till May), only 5 auctions had done and out of that Rs 5000 crore has already devolved on PDs. This is a disturbing sign and that need to be correct.

Graph 2: Devolvement on PDs (Rs Crore)



Source: SBI Research

WAY FORWARD

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- The decline in liquidity is a matter of concern, as it comes despite a redemption of Government papers in April of Rs 714 bn. Meaningful redemption are now due only in February of Rs 530 bn.
- The bottomline of all this is market is expecting more aggressive OMO /liquidity support on a more sustained basis to address any meaningful recovery in yields (looks likely as swap transactions may have moved forward the issue of liquidity) An elevated yield is also inimical to policy transmission on the part of the banks.

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ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management, corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

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