SBI ECOWRAP

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STATE BANK OF INDIA

'Be the Bank of Choice for a Transforming India'

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RBI TO HIKE RATES BY 25 BPS, MAY NOT BE LAST IN FY19: BUT MARKETS MORE CONCERNED ABOUT FINANCIAL STABILITY

We expect a 25 bps hike in repo rate in October policy. But more importantly, there is now a larger debate regarding modern monetary policy in so far as its dependence on unobservable variables such as neutral interest rate, output gap and inflation target in framing policy decisions! India is no exception to this.

Take the example of the efficacy on the existing monetary policy framework in the context of episodes of financial market instability. For example, the FOMC even 10 years after global financial crisis has reached no agreement to date to change the framework to handle financial instability or the heightened probability of effective lower bound (ELB) episodes. Thus, it is now being felt that a formal evaluation of existing framework and open consideration of alternatives, would institutionalize good policy practice.

Extending this parlance to India, markets now unambiguously expect a nuanced communication from RBI in restoring confidence in market following the recent upheavals. We welcome the LCR measure, as it will improve transient liquidity and further improve LCR, due to kick in from January, 2019 (100% requirement). However, this may also push up long end of the yield curve, as we estimate that excess holding of Government bonds (long end) by banks will go up by 2% as a consequence.

The need of the hour is thus to **(a)** Improve permanent liquidity through OMO. Since primary liquidity is currently in deficit mode, injection of liquidity through OMO would not create any negative implication for currency also unlike 2013, when the system was in liquidity surplus mode. The markets and the regulator need to clearly understand this dichotomy and thus do frequent OMOs to calm the nerves **(b)** Improve confidence in market. Interestingly, reverse repo outstanding has touched Rs 1.2 lakh crore from Rs 4600 crore in just 3 days. This clearly implies, that credit lines may have been disturbed to entities like mutual funds and the surplus money through redemptions is seeking avenues elsewhere.

Meanwhile, we believe the current uptick in core inflation is because of structural changes unleashed in lieu of changing household behaviour with more spending on health and education services. We also find that the continued increase in fuel prices is now having a larger impact on headline inflation (50 bps as per SBI estimates). With currency still under pressure, crude crossing $80, the rate hike cycle may just not be over yet. Also, the currency supportive measures though may perk up sentiments, still does not address the large scale Chinese imports (these components are only 5% of Chinese imports). We need a policy on exports quickly!

In the words of Ceaser "*the fault, dear Brutus, is not in our stars, But in ourselves, that we are underlings*".

RBI LCR MEASURES TO EASE TRANSIENT LIQUIDITY: BUT BOND RATES MAY HARDEN

- To ease the apparent liquidity pressure, RBI has now given additional relaxation of 2% under Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) (presently 13% of the bank's NDTL). The total carve-out from SLR available to banks would be 15% of their NDTL. This is expected to impact Indian banking system positively as it will additionally release funds from HQLA requirement and improve the LCR position. However, this may lead to a negative incremental demand for bonds.
- This will lead to injection of around Rs 2,00,000 crore of assured liquidity at the repo rate and this **will ensure weighted average call money rate to be around policy rate**. Though, short term rates (like in CP market) which are purely credit driven will take some more time to come down as that is more linked with financial stability issues.
- Under the new arrangement medium to long end of the curve which is more driven by demand and supply is likely to go up. Hence, supported shorter end and higher longer end yield will result in steep yield curve going forward.

Impact of Change in LCR: Demand for bonds to decline

	% of NDTL	
	Existing Scenario	New Scenario
SLR requirement	19.50%	19.50%
LCR requirement in terms of NDTL equivalence	19.50%	19.50%
Total gross requirement of Government Bonds (SLR+LCR)	39%	39%
Permitted SLR and LCR overlap till today's announcement	13%	15%
Net mandated requirement of Government Bonds	(39-13)% = 26%	(39-15)% = 24%
Existing holding of Government Bonds by banking system (% of NDTL)	30%	30%
Hence excess holding of Government Bonds by banking system to go up	(30-26)% = 4%	(30-24)% = 6%

NEED OF THE HOUR TO INJECT PERMANENT LIQUIDITY THROUGH OMO

- Further, RBI will conduct OMO today to inject permanent liquidity in the system. This would restore demand supply balance in the Government bond market in the form of additional demand generation. Since primary liquidity deficit is currently in deficit mode injection of liquidity through OMO would not create any negative implications for currency also unlike 2013.

SYSTEM LIQUIDITY IS SILL IN DEFICIT MODE THOUGH HAS IMPROVED SIGNIFICANTLY

- System liquidity is in the deficit mode. However, outstanding total reverse Repo has been increasing in the past few days. It has risen from Rs 46.71 billion as on 19 Sep'18 to Rs 1205.15 billion as on 26 Sep'18. Owing to the significant increase in reverse repo, outstanding net repo has declined to Rs 715.53 billion as on 26 Sep'18 compared to Rs 1294.6 billion as on 19 Sep'18.

Outstanding Repo Operations (Rs bn)

	Total Repo	Total Reverse Repo	Net Repo (- Injection/ + absorption)
26-Sep-18	1920.68	1205.15	-715.53
25-Sep-18	1922.58	785.95	-1136.63
24-Sep-18	1734.7	297.15	-1437.55
21-Sep-18	1510.25	151.68	-1358.57
19-Sep-18	1341.31	46.71	-1294.6

Source: SBI Research, RBI

- It seems that liquidity is currently not much of a problem, however, it is the uncertainty in the market which is contributing to credit crisis. The recent increase in mutual funds redemptions is resulting in increase in bank deposits and due to uncertainty in the market banks are parking their funds with RBI.
- With the recent assurance by Government and RBI on liquidity fronts, there is some amount of reduction in anxiety in the market but people are still jittery. In July 2018, the Mutual Fund industry has seen outflow of Rs 32,628 crore (redemption of liquid funds Rs 31,141 crore and Rs 7950 crore from liquid and income funds, inflows of Rs 10,585 crore in ELSS) and the industry expects Rs 50,000 crore from the debt market in September 2018.

- In 2012-13, after frontloading a 50 bps policy rate reduction, RBI had addressed the sluggish credit growth and tight liquidity conditions with a series of calibrated measures that included cuts in the CRR and SLR and Rs 1.5 trillion in outright OMO purchases, besides large accommodation provided through LAF repos. Further, as headline inflation moderated RBI reduced the repo rate by 25 bps in May 2013, over and above the 50 bps reduction in Q4 of 2012-13. Subsequently, in order to restore stability in the forex market, the RBI has taken several measures since mid-July 2013, which include: (i) hike in Marginal Standing Facility rate/Bank Rate by 300 bps; (ii) restriction on banks' access to funds under LAF repo 1%; (iii) OMO sales; (iv) maintenance of minimum daily CRR balances by SCBs at 99% of the requirement; (v) capping of PDs' access to LAF at 100% of their individual net owned funds; and (vi) restrictions on gold import.
- Consequent to the above measures, RBI has also opened a special liquidity window of Rs 25,000 crore @ 10.25% for the banks to meet the cash requirements of mutual funds (MFs), which faced heavy redemption pressure in debt-oriented MF schemes. Further, banks availing of the additional liquidity support could seek a waiver of penal interest for any shortfall in maintenance of the SLR up to 0.5% of their deposits, in addition to the 2% waiver allowed under the MSF.
- In spite of reasonably sound macro economy, low inflation and not so worrisome CAD, India is witnessing higher volatility as well as sell off in both currency and capital market in the last one month. Since the beginning of the fiscal though Nifty moved up from 10211 to 11143 till today, in the last one month it has come down by around 600 points from its recent peak of 11760. During the same period under review, 10 year yield hardened from 7.33% to 8.07% with an high of 8.23% in between. As opposed to the US$ Indian rupee has steadily depreciated from 65.01 since fiscal beginning to 72.21 as on today. In between it has registered all-time low of 72.98 also.

Impact of Crude oil on CPI Inflation

Weighted Contribution (%)	Jun-17	Aug-18	Change (Aug over Jun)
CPI	1.46	3.69	2.23
Total Fuel Impact	0.29	0.79	**0.50**
Fuel and light	0.29	0.56	0.26
Direct Impact	0.14	0.35	0.21
Other	0.16	0.21	0.05
Indirect Impact	0.15	0.44	0.29
Memo:			
Crude oil Prices ($/bbl.)	46.6	72.7	26.1

Source: MOSPI & SBI Research

- As the case is similar to the 2013 currency crisis, RBI should raise **the policy repo rate at least 25 bps. We rule out a hike of 50 bps, as it may spook the market. However, there is an outside probability of change in neutral stance too, as 3 successive rate hikes with a neutral stance could contradict RBI message.**

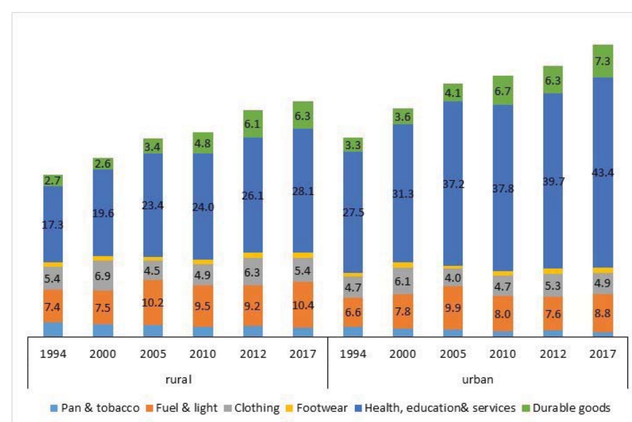
CURRENT MEASURES TO SUPPORT CAD

- As previously announced, Government has now imposed higher tariff on 19 items with immediate effect to contain the import of certain non-essential goods. The higher import duty was imposed on premium consumer durables such as air conditioners, refrigerators, washing machines as well as on radial car tyres, aviation turbine fuel, cut and polished diamonds, jewellery and footwear among others.
- The total value of imports of these items in the FY18 was about Rs 86000 Crore (3% of Merchandise Imports) and the higher tariffs could help the domestic industry. However, it depends on the price elasticity of demand and domestic capacity.
- The impact of these measures is miniscule on the imports so it will not help a lot in reducing CAD. As rupee movement is influenced by the CAD, these might not help a lot in propping up the Rupee. When we look at imports from China (16% of Total imports in FY18), the components add up to roughly around 5% from China's imports. So Chinese imports may not be impacted much directly.
- However, these measures send a signal that the Government is ready to defend its external metrics.

JUMP IN CORE INFLATION MORE STRUCTURAL IN NATURE

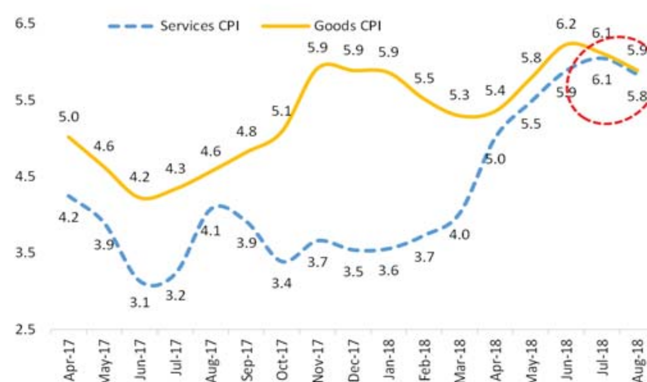
- The data on pattern of consumer expenditure provided by NSSO through its various surveys suggest that household expenditure behaviour has changed significantly
- Since 1994 the expenditure on services, particularly in health and education, is steadily increasing. This could be due to more awareness, availability, access to banking facility (like no frill/PMJDY account), and preference for a better standard of living among people. In short, the recent financial inclusion initiatives by the Government is facilitating increased spending on health and education and thus the increase in core inflation is more structural in nature.
- Subsequently, service inflation and goods inflation has now almost converged. The increase in service inflation indicates that the relation between inflation and output gap does not seem sacrosanct in Indian context and hence the RBI argument of *output gap almost closed* needs to be carefully validated.

Trends of consumption expenditure in India



Source: SBI Research

Goods CPI vs Service CPI (YoY %)



Source: SBI Research

Trends in percentage composition of consumer expenditure since 1993-94												
	rural						urban					
	1994	2000	2005	2010	2012	2017	1994	2000	2005	2010	2012	2017
cereals	24.2	22.2	18.0	15.6	12.0	10.0	14.0	12.4	10.1	9.1	7.3	6.0
gram	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
cereal substitutes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.0
pulses & products	3.8	3.8	3.1	3.7	3.1	3.1	3.0	2.8	2.1	2.7	2.1	2.0
milk & products	9.5	8.8	8.5	8.6	9.1	8.5	9.8	8.7	7.9	7.8	7.8	7.0
edible oil	4.4	3.7	4.6	3.7	3.8	3.7	4.4	3.1	3.5	2.6	2.7	2.1
egg, fish & meat	3.3	3.3	3.3	3.5	3.6	3.6	3.4	3.1	2.7	2.7	2.8	2.5
vegetables	6.0	6.2	6.1	6.2	4.8	5.3	5.5	5.1	4.5	4.3	3.4	3.2
fruits & nuts	1.7	1.7	1.9	1.6	1.9	1.8	2.7	2.4	2.2	2.1	2.3	2.0
sugar	3.1	2.4	2.4	2.4	1.8	1.7	2.4	1.6	1.5	1.5	1.2	0.9
salt & spices	2.7	3.0	2.5	2.4	2.4	2.3	2.0	2.2	1.7	1.5	1.7	1.4
beverages, etc.	4.2	4.2	4.5	5.6	5.8	6.1	7.2	6.4	6.2	6.3	7.1	6.4
food total	**63.2**	**59.4**	**55.0**	**53.6**	**48.6**	46.5	**54.7**	**48.1**	**42.5**	**40.7**	**38.5**	**33.7**
pan & tobacco	3.2	2.9	2.7	2.2	2.4	2.0	2.3	1.9	1.6	1.2	1.4	1.0
fuel & light	7.4	7.5	10.2	9.5	9.2	10.4	6.6	7.8	9.9	8.0	7.6	8.8
clothing	5.4	6.9	4.5	4.9	6.3	5.4	4.7	6.1	4.0	4.7	5.3	4.9
footwear	0.9	1.1	0.8	1.0	1.3	1.2	0.9	1.2	0.7	0.9	1.2	1.0
health, education& s	17.3	19.6	23.4	24.0	26.1	28.1	27.5	31.3	37.2	37.8	39.7	43.4
durable goods	2.7	2.6	3.4	4.8	6.1	6.3	3.3	3.6	4.1	6.7	6.3	7.3
non-food total	**36.8**	**40.6**	**45.0**	**46.4**	**51.4**	**53.5**	**45.3**	**51.9**	**57.5**	**59.3**	**61.5**	**66.3**
Total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

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!

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CONTACT DETAILS

Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India
Corporate Centre
Madam Cama Road
Nariman Point
Mumbai - 400021

Email: soumya.ghosh@sbi.co.in
gcea.erd@sbi.co.in
Phone: 022-22742440

: @kantisoumya