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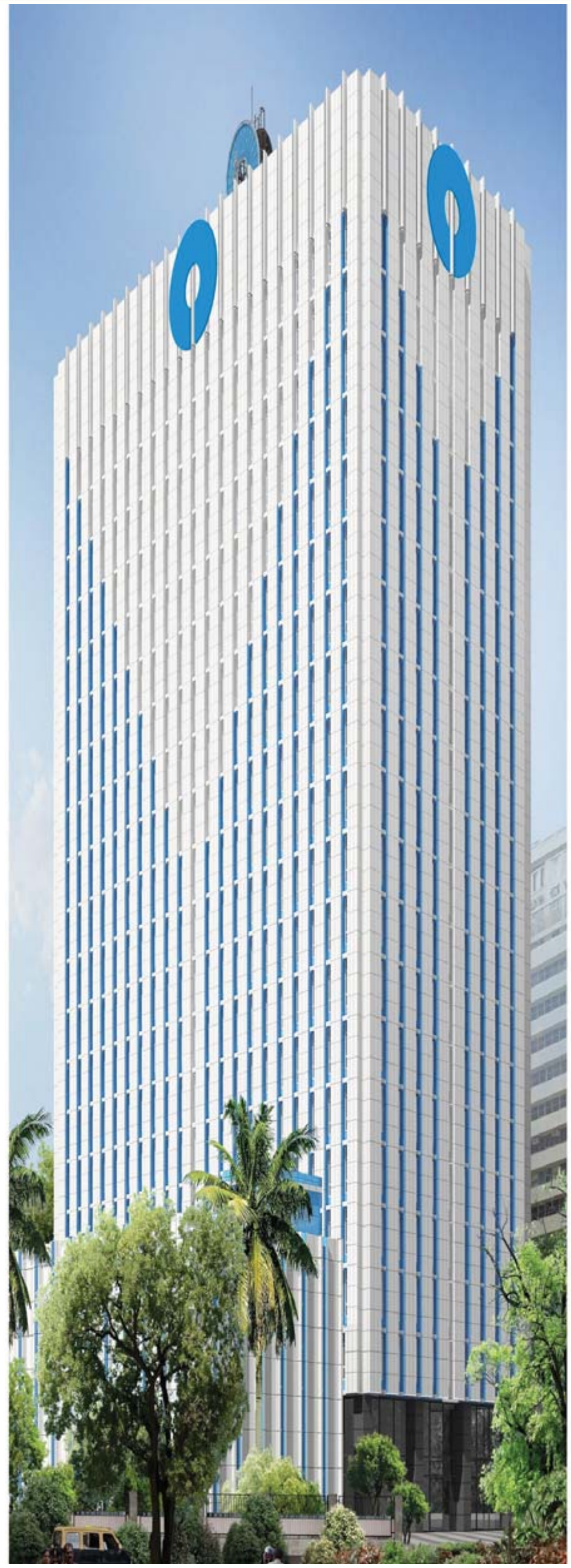

EXCISE CUT MOST WELCOME, STATES ARE ALREADY CUTTING IN TANDEM: SHORT TERM STEPS BY RBI NOW A MUST FOR CURRENCY MARKET STABILITY

The latest move by RBI on relaxing the norms on overseas borrowing for state-run Oil Marketing Companies (OMCs) is a welcome step in the medium to long term but such a step may not be able to support rupee with an immediate succour. This is because:

Firstly, the OMCs have not been raising the funds from ECB channel and have preferred replacing the ECBs by foreign currency bonds or other options. Secondly, a prudent risk management policy may call for hedging. Thirdly, if one adds the estimated hedging cost of 4.50%, the effective cost of raising ECB is likely to be 8.62%. The SBI 3 Yr MCLR currently stands at 8.70%.

We expect RBI now to announce short term steps to stabilize the rupee. For example, opening a swap window for the OMCs for buying $ at least for one month so as to dilute the impact of rupee decline due to hardening of crude prices in the short run. This will divert an estimated $ 400 million per day from the forex market that could bring immediate relief. Additionally, imports from Iran could be denominated in rupee terms, a hike in repo rate in forthcoming policy with a change in stance, a widening of the repo – reverse repo corridor and a preferential swap window for banks could be other steps in tandem.

We believe, the RBI is caught between a Scylla and Charybdis as of now, since selling $ from reserves may also imply in part a decline in currency in circulation that has fallen the most in Q2FY19 in the last 5 years. Meanwhile, the jump in US treasury rates might also accelerate if countries like China reduce their share of US treasury holdings (India has also reduced its holdings by $14 bn).

We heartily welcome the excise cut on petrol and diesel by Centre and some of the states. We estimate that states are getting an incremental bonanza for 6 months at Rs 13,000 crores, based on current level of crude. States can thus cut the petrol prices by Rs 4.60 /litre and diesel by Rs 3.30/ litre on an average without affecting their revenue arithmetic. We are not sure whether there could be a Government mechanism to sell diesel at subsidised rates for farmers who use it for Gen sets and Tractors.

RBI RELAXES BOWROWING NORMS FOR OIL MARKETING COMPANIES

- The latest move by RBI on relaxing the norms on overseas borrowing for state-run Oil Marketing Companies (OMCs) is a welcome step considering the pressure on rupee. While, we appreciate the move but we believe this will support rupee only in the medium or long run but may not be with immediate succour due to following reasons:
  - The OMCs have not been raising the funds from ECB channel and have preferred replacing the ECBs by foreign currency bonds or other options. In July 2017 Hindustan Petroleum Corp. Ltd (HPCL) raised $500 million through a maiden 10-year US dollar bonds issue, though the funds were raised to meet the capex requirements. Even BPCL had raised funds through the same channel in Jan 2017.
  - Secondly, the removal of mandatory hedging with the Board of Directors being asked to put in place a Prudent risk management policy needs to be redefined as a risk management policy would definitely call for hedging, especially when no natural hedge is available in the transaction.
- Additionally, as per the move, the public sector OMCs, with heavy requirement of foreign currency to import crude oil, would be able to raise ECBs for working capital purposes with a minimum average maturity of three to five years from all lenders under the automatic route. It may, however, be noted that the share of Foreign Currency Loans in Total Debt has declined from 25% in FY201703 to 21% in FY201803 and the scope of raising ECB at this juncture may not be remunerative. **Consider this, 3 Yr Libor currently is 3.12% plus spread of 120 bps makes it 4.12%. While the RBI has relaxed hedging options, the onus on currency risk needs to be pre-defined. If one adds the estimated hedging cost of 4.50% the effective cost of raising ECB is likely to be 8.62%. The SBI 3 Yr MCLR currently stands at 8.70%.**
- We expect the RBI to announce a swap window for the OMCs for buying $ at least for one month so as to dilute the impact of rupee decline due to hardening of crude prices in the short run. **This will divert an estimated $ 400 million per day from the forex market that could bring immediate relief.**

WHY THIS RBI MOVE? IS IT BECAUSE OF DECLINING CURRENCY IN CIRCULATION?

- The RBI in its 2016-17 Annual Report has quoted "currency in circulation (CIC) rose sharply in Q1 but fell back in Q2, reflecting the usual seasonality". This is getting reflected in past 10 years' data. However, the decline in CIC during Jul-Sep quarter in 2018 is the highest in 5 years. Cutback in discretionary spending by households could be happening due to rising crude, leading to further decline in CIC. And that is why the RBI is hesitant about selling dollars as it sucks out liquidity even further.
- The good thing is that in Q3 the Currency in Circulation rebounds as festive demand picks up.

Change in Currency in Circulation during Q2 and Q3 (Rs Bn)

Year	During Q2	During Q3	Net Increase (Q2 + Q3)
2018	-359	-	-
2017	599	1045	-
2016	-173	-7895	-
2015	-341	767	426
2014	-489	502	12
2013	-392	613	220
2012	-395	463	68
2011	-254	443	189
2010	-36	537	501
2009	-34	394	360
Average (2009-2018)	**-188**	**-348**	-
Average (2009-2018) ex 2017	**-275**	**531**	-

Source: RBI; SBI Research

PETROL AND DIESEL PRICES SLASHED BY RS 2.50 BY CENTRE: STATES TOLD TO DO AN EQUIVALENT AMOUNT. MAHARASHTRA AND GUJARAT OBLIGE

- Today, Central Government has decided to cut excised duty by Rs 1.5 and directed the OMCs to cut Re 1 per litre from their profit margin. Apart from this States are also asked to cut by the same amount.
- In the last 6 months (since Mar'18) Petrol and Diesel prices have increased continuously and have even crossed the psychological figure of Rs 90 in some States. This increase in petrol and diesel prices gives States a windfall gain because of tax on tax approach followed across States.

- In continuation of our earlier estimates we now estimate that states are getting annualized additional revenue of Rs 25,000 crore in FY19 over and above the budget estimates of states revenue. For 6 months, this figure should thus come to around Rs 13,000 crores. We estimate that as the states are getting surplus revenue, they can cut the petrol prices by Rs 4.6 /litre and diesel by Rs 3.30/ litre, without affecting their revenue arithmetic. Hence if the states cut by Rs 2.50, it should be mostly revenue neutral.
- Responding to the Central Government initiative, some states have already started giving rate cuts, beginning Gujarat and Maharashtra.

States can Cut Petrol/Diesel Prices (Per Litre) From the Present Price		
States	Diesel	Petrol
Maharashtra	4.0	6.2
Madhya Pradesh	3.8	5.7
Punjab	2.7	5.7
Andhra Pradesh	4.0	5.3
Tamil Nadu	3.9	5.2
Kerala	3.9	4.9
Karnataka	2.8	4.4
Jammu & Kashmir	2.8	4.4
Rajasthan	3.3	4.4
Chattisgarh	4.2	4.3
Haryana	2.8	4.3
Uttarakhand	2.7	4.1
Gujarat	4.1	4.1
Uttar Pradesh	2.7	4.1
Bihar	3.0	4.0
Odisha	4.1	4.0
Himachal Pradesh	2.3	4.0
Jharkhand	3.8	3.9
West Bengal	2.6	3.9
Average	**3.3**	**4.6**
Source: SBI Research		

US TREASURY SECURITIES JUMP

- US bond yields has soared to multiyear highs after data showed that the economy remained robust in September, triggering the latest retreat from safe debt.
- China has accumulated over $1 trillion in US government securities, almost a fifth of all such issues. Despite the recent trade war between US and China, China has not offloaded any US securities yet. However, if this continues, China could exercise this option to take the sting out of a resilient US economy and consequently cause a rethink of US' trade policy.
- A few countries like Japan, Cayman Islands have reduced their holdings by 1% in a year. There are some countries say Brazil, Luxembourg, Saudi Arabia, France and Canada has increased their holding of US securities.
- From Mar-July 2018, India has also cut it's US securities holding by $14 billion, but the share remains at 2%.
- All these measures are going to put pressure on US yields even further.

Countries holding US Treasury Securities			
	Jul'18	Jan'18	Jul'17
China	19%	19%	19%
Japan	17%	17%	18%
Ireland	5%	5%	5%
Brazil	5%	4%	4%
UK	4%	4%	4%
Switzerland	4%	4%	4%
Luxembourg	4%	4%	3%
Cayman Islands	3%	3%	4%
Hong Kong	3%	3%	3%
Saudi Arabia	3%	2%	2%
Belgium	2%	2%	2%
India	2%	2%	2%
Singapore	2%	2%	2%
France	2%	1%	1%
Korea	2%	2%	2%
Canada	2%	1%	1%
Source: SBI Research			

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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