SBI Research: Investigating Regime Switch in US Labour Market & its impact on emerging economies

27-July-2022

An Uncertain Global Context

- Nearly two-third of the world is suffering from inflation above 7 per cent, though there are signs that the pace of acceleration in inflation is slowing down in select jurisdictions
    - US headline CPI inflation (y-o-y) soared to 40-year high of 9.1% in June 2022, the highest since November 1981
    - Euro area annual inflation soared to a new record of 8.6% in June, primarily driven by energy and followed by food, alcohol and tobacco
    - CPI inflation in the UK also accelerated to a fresh peak of 9.1% (y-o-y) in May 2022 (declined in June to 8.2%)
    - Inflation in Brazil at 11.9% in June remained in double digits for the tenth consecutive month
    - In China, inflation rose to a 22-month high of 2.5%
- Monetary tightening continued synchronously across the globe in June/July 2022 with many central banks increasing the pace of tightening to tackle historically high levels of inflation
- Crude oil prices exhibited heightened volatility and changing momentum owing to exceptionally stringent supply conditions
- The FAO food price index retreated for the third successive month in May from the all-time high registered in March due to moderation in prices of vegetable oil, cereal and sugar, while meat and dairy prices continued to increase
- Aggressive monetary tightening and the protracted war in Europe will continue to weigh down global growth prospects during 2022 and 2023

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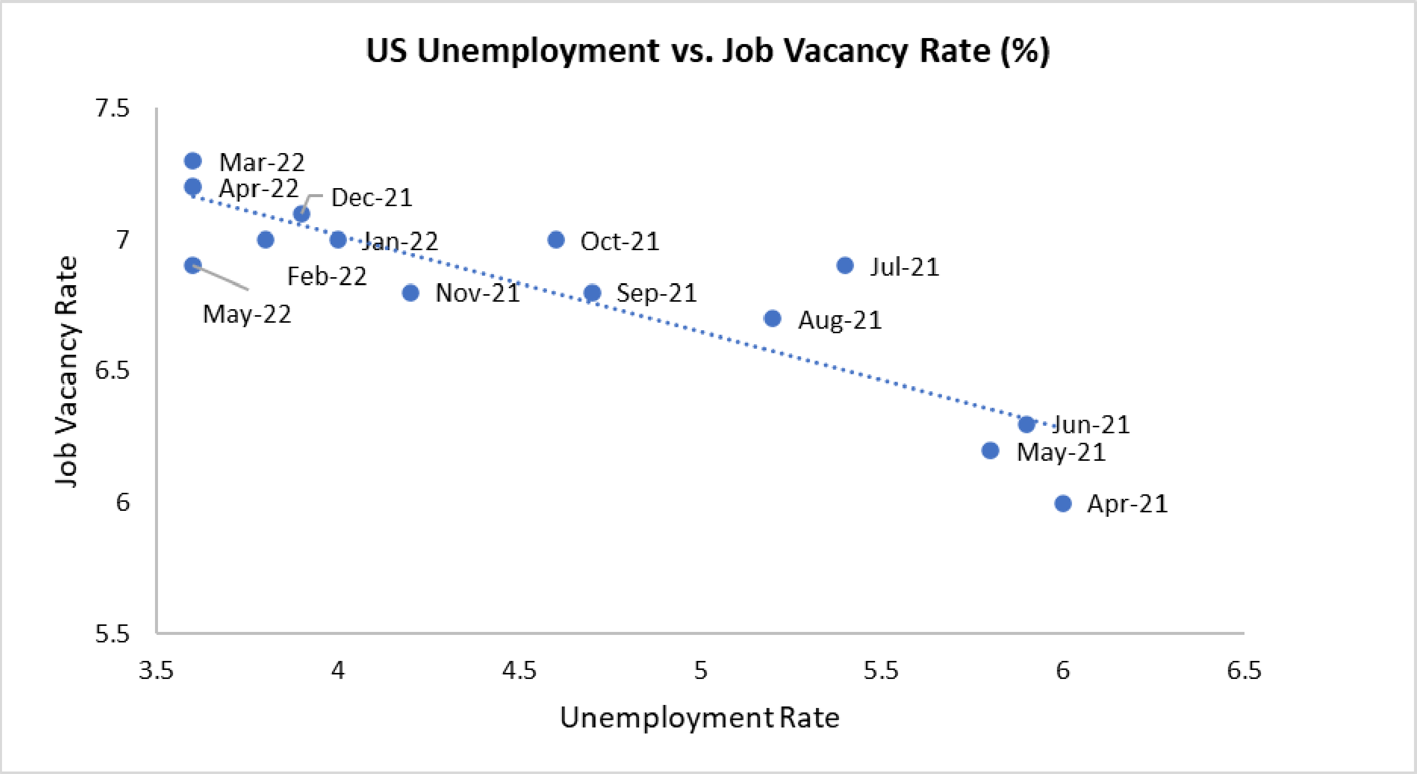
How the Fed *could not anticipate* the rampaging inflation threat

An appropriate revelation of current US Labour Market could be depicted by the Beveridge Curve

- Beveridge curve traces the relationship between the job vacancy and unemployment rates
- The historical relation between job vacancies and unemployment since the 1950s shows that vacancies decline from the peak only with a significant increase in unemployment
- Its recent shape suggests that were vacancies to return to their 2019 level, when the labour market was in balance, the unemployment rate would have to rise from 3.6% today to more than 6%: Can it happen?.....



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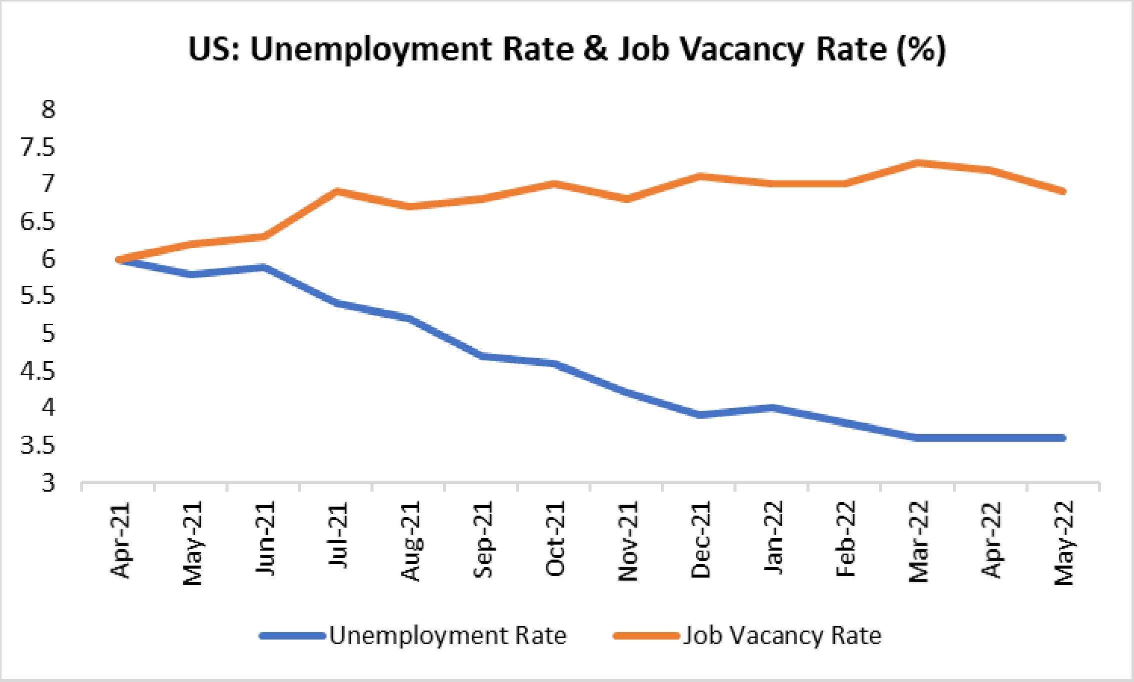
- ….The wide gap between the job vacancy rate (currently at 6.9%) and unemployment rate (currently at 3.3%) in USA currently indicates a strong labour market (also vindicated by significantly high quit rates)
- Fighting inflation will require an increase in unemployment rate and a decline in vacancies: This looks difficult as higher vacancies in US labour market are a by-product of inadequate skill matching on which Fed has little control
- *"In those circumstances historically, businesses have brought down hiring and reduced openings rather than necessarily laid off workers"* (Fed Vice-Chair: Lael Brainard)
- This is, thus, likely to translate into continued higher nominal wages. This in turn might create a **wage-price spiral**. Hence a moderation in commodity prices may not be enough to halt rising inflation and we might end up in a situation of slow growth and high inflation



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- We have used the Markov regime-switching model to understand the structural shifts in the US Labour market
- The Markov regime-switching model is a popular type of regime-switching model which assumes that unobserved regimes are determined by an underlying stochastic process known as a Markov-chain
- 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 has changed**
- We have run the Markov regime-switching model for US unemployment and Job Vacancy rate (Jan'18 to May'22). Our results indicate that:
  - In the case of unemployment rate: Regime 1 / Low Unemployment Rate is the persistent regime with a 98% probability
  - In the case of job vacancy rate: Regime 2 / High Job Vacancy Rate is the persistent regime with 97% probability
- **Low unemployment and high job vacancy rate may continue to define the US Labour market even though the Fed will continue to hike rates**

Average	Unemployment Rate	Job Vacancy Rate
Regime 1	4.4%*	4.5%
Regime 2	11.1%	6.8%*
*** Current Regime**		

US Unemployment Rate: Transition Probabilities

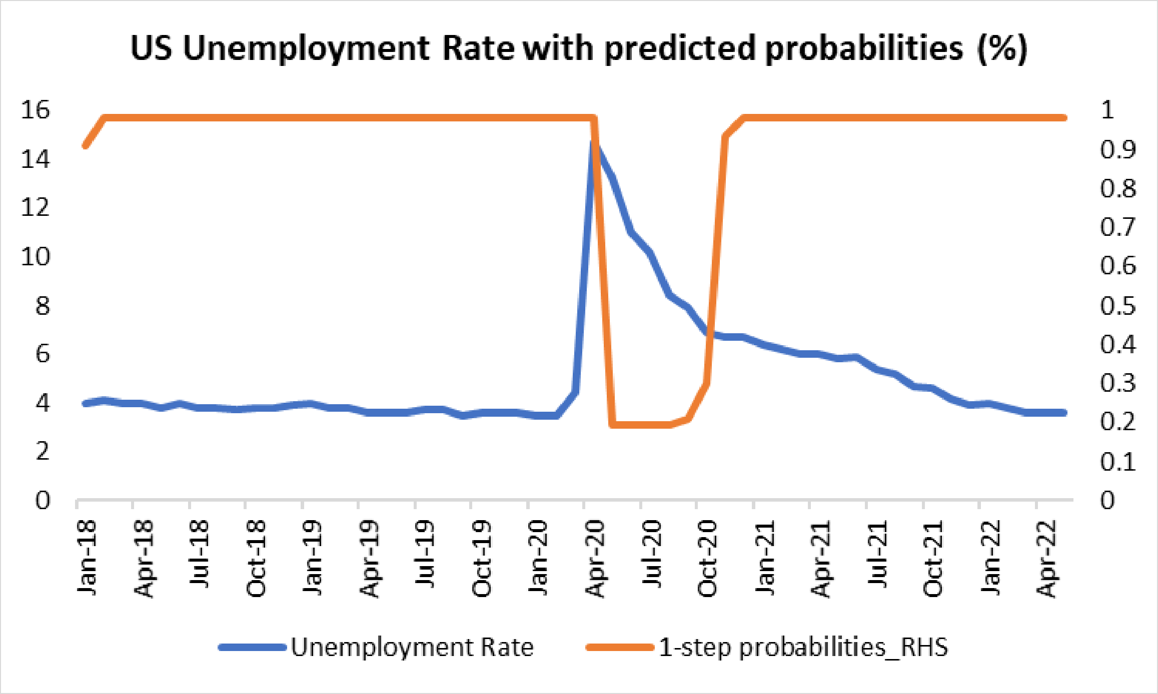
From/To	Regime 1	Regime 2
Regime 1	98%	2%
Regime 2	19%	81%

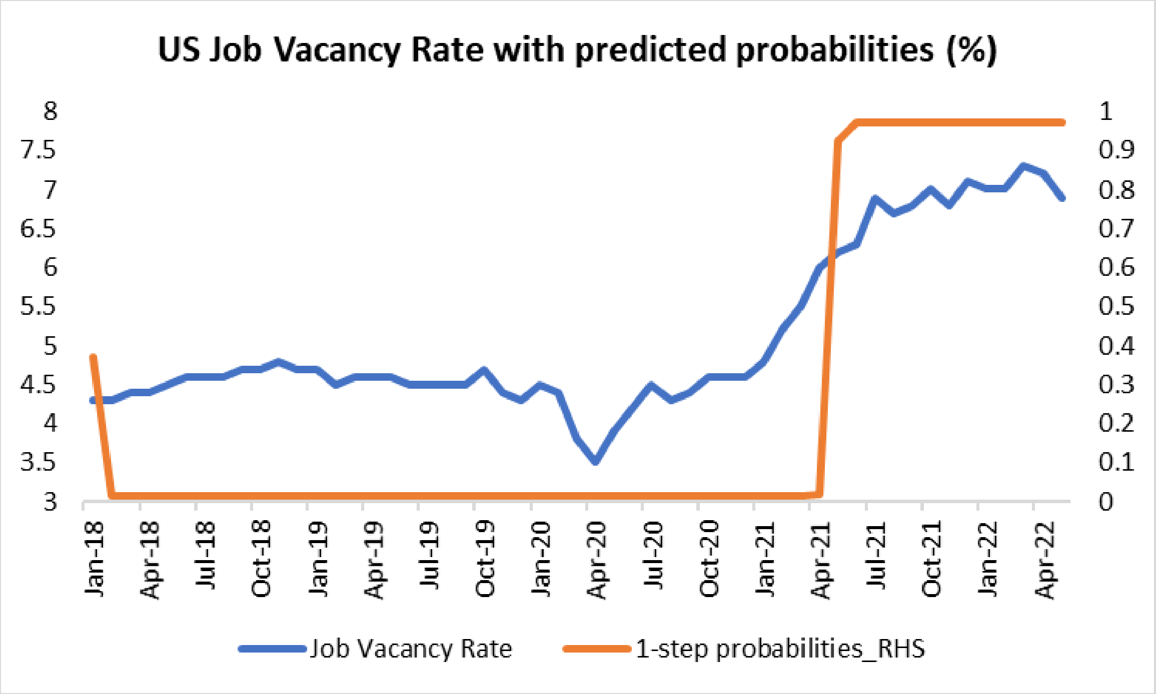
US Job Vacancy Rate: Transition Probabilities

From/To	Regime 1	Regime 2
Regime 1	98%	2%
Regime 2	3%	97%

Predicted Probabilities of Unemployment Rate remaining in regime 1 and Vacancy rate remaining in regime 2: April 2021 is the defining moment in US Labour market that the Fed failed to have noticed

- 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
- Our predicted probability juxtaposed against both actual unemployment and job vacancy rates indicate
  - In October 2020, there was a regime switch to a low unemployment rate in the US labour market in terms of jump in probability and it has continued to remain so
  - In April 2021, there was a regime switch to a high vacancy rate in the US labour market in terms of jump in probability and it has continued to remain so
- **Taking the maximum of 2 months, April 2021 & October 2020, we thus conclude that the simultaneous occurrence of high vacancy rate and low unemployment rate in the US labour market beginning April 2021 was a defining point that went unnoticed by the Fed**





The structural break in the US Labour market beginning April 2021 is also confirmed by Chow Test

- From the previous analysis it is clear that in the US low unemployment and high job vacancy rate will stay for few more months
- We also performed the Chow breakpoint test at April 2021 (the point where predicted probabilities changed their course) and found out a significant structural break at that particular point
- **This indicates that the US Fed waited too long before raising the rates. Since the US Fed started to raise rates only from March 2022, effectively, Fed could have been 11 months behind the schedule**
- The Fed may have followed the classic Brainard (1967) intuition which is that the central banker should follow a path of gradualism: what the Fed failed to anticipate was the persistence of inflation and perhaps a more aggressive response to inflation shock was warranted for. Specifically, if there is uncertainty about inflation persistence, it is always better to assume that inflation is persistent. This is because the costs of making a mistake when the inflation process is actually less persistent are not as high as making the opposite mistake

Chow Breakpoint Test at April 2021	
F-statistic	229.2 (p-value: 0.0000)
Log-likelihood ratio	164.9 (p-value: 0.0000)
Wald statistic	229.2 (p-value: 0.0000)

Fed could have even gripped the moment through an off-cycle announcement

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- The FOMC holds eight regularly scheduled meetings during the year and other meetings as needed. It’s a tad surprising the Fed did not convene an off cycle meet to shock the markets, riding high on euphoria, with hike in policy rates once the sticky inflationary prints became evident to it
- The Federal Reserve Act of 1913 (Sec 12A FOMC) prescribed at least 4 meetings each year, subsequently raised to 6 and now the frequency of scheduled meets in a year is at least 8 (i.e. each meet after nearly 6 weeks)
- Thus, the chair of FOMC (by convention, the chair of Fed) is empowered to call an unscheduled meet. Any three members of the FOMC can also jointly ask for a non-scheduled meet. In recent years, one unscheduled meeting was held in October’2019 while two unscheduled meetings were held in March’2020.
- Job gains have been robust in recent months, and the unemployment rate has remained low; the FOMC minutes proclaimed in every other meet without recognising the imminent threat lurking around the corners as US job openings continued rising to record highs against persistent worker shortages, in turn pushing employers to raise wages, thereby keeping inflation uncomfortably high as demand remained stubbornly unflinching
- The high number of people quitting jobs (4.5 million in March22) that captures the avenues available for future employment to such persons showed the clear shift in resilience in economy that was going strong despite sprouts of pandemic and preparing a bedrock for elevated inflation levels continuing

…. Hence…. Federal Reserve & ECB rate outlook

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- The annual inflation rate in the US accelerated to 9.1% in June of 2022, the highest since November of 1981 Discussion on base effect on inflation is likely to emerge soon in developed countries

- At the same time economy is slowing with Philadelphia Fed Manufacturing Index in the US decreased for the fourth consecutive month to -12.3 in July of 2022

- Total nonfarm payroll employment rose by 372,000 in June, and the unemployment rate remained at 3.6%, the U.S. Bureau of Labor Statistics reported

- Notable job gains occurred in professional and business services, leisure and hospitality, and health care

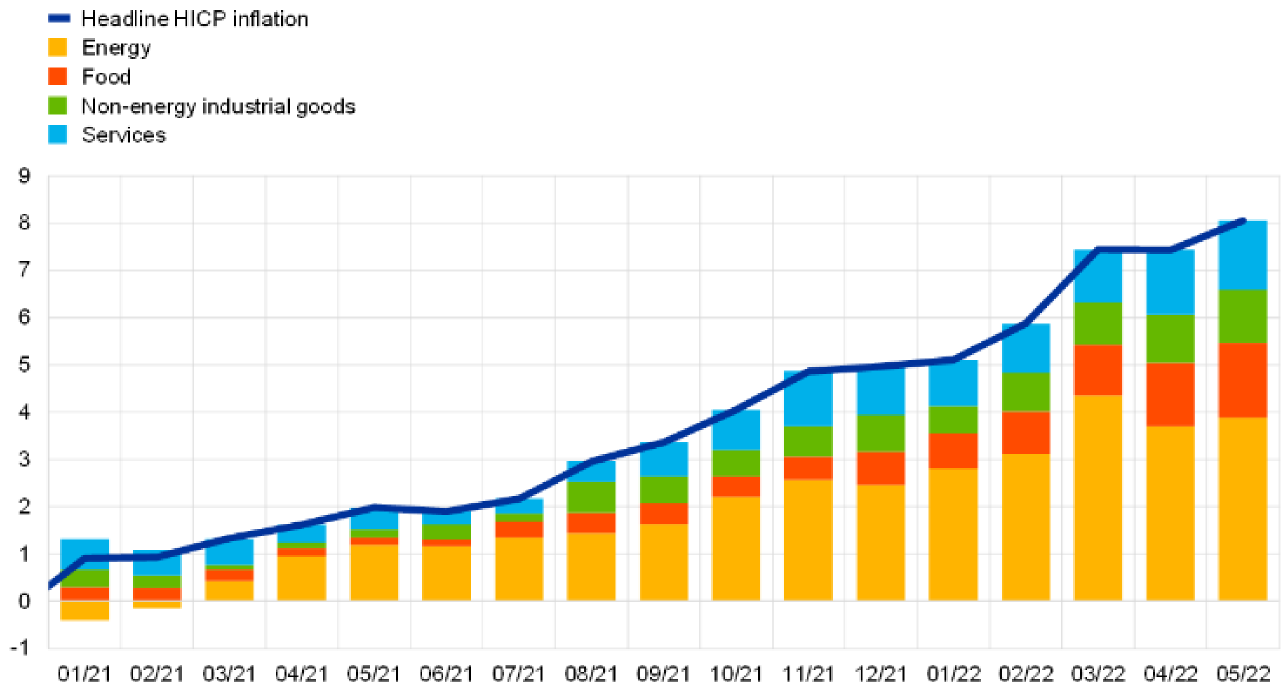
- Given the tight rope, Fed is expected to raise target funds rate by 75 bps with some expecting even higher raise at 100 bps

…….European Central Bank rate outlook

- ECB decided to raise the three key ECB interest rates by 50 basis points after 14 years
- Inflation increased further to 8.6% in June
- Surging energy prices were the most important component of overall inflation
- Higher inflationary pressures are also stemming from the depreciation of the euro exchange rate
- A prolongation of the war in Ukraine remains a source of significant downside risk to growth

Headline inflation and its main components

(annual percentage changes; percentage point contributions)



Sources: Eurostat

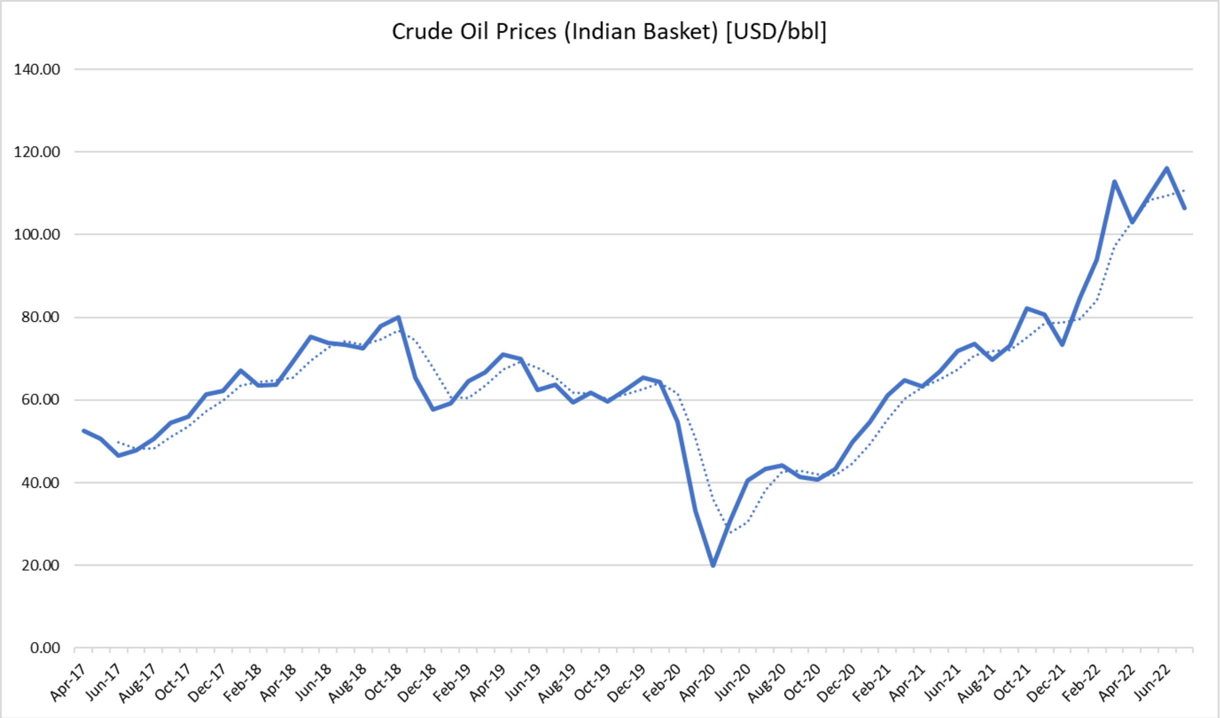
Outlook – Crude Prices

- From its low of ~$20 per bbl (supply bottlenecks ensured oversupply of oil leading to an unprecedented collapse in oil prices, forcing the contract futures price for West Texas Intermediate (WTI) to plummet in early days of Virus spread), the crude prices have risen to $120 per bbl

- Price is expected to be in range of $100-110 per bbl for next two months though recent softening stance of EU on Oil and food grains from Russia augurs well for price collapse

- The EU ban on Russian oil is expected to keep the prices high for some time. However, the ensuing slowdown in EU will soon set in motion the correction of high prices

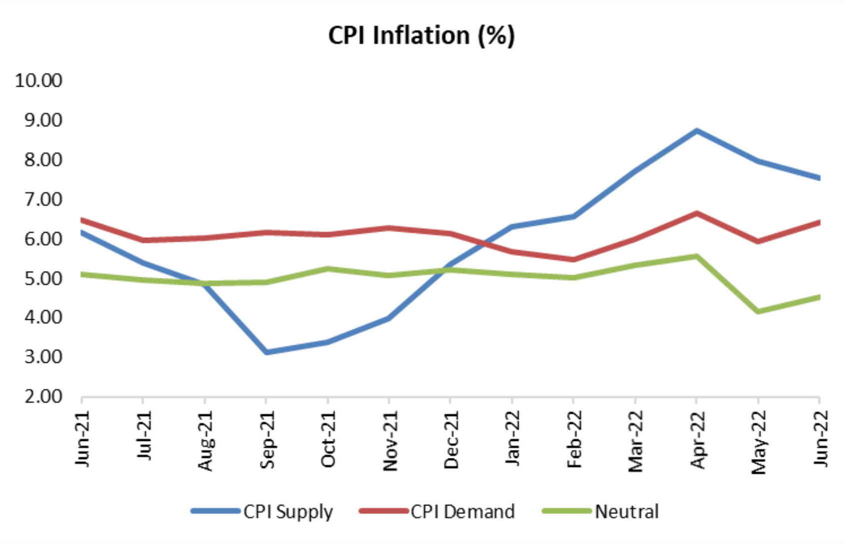
- For India it is good option to look at Iran as a source for oil as it is both cheaper logistically and well suited for domestic production technology



Domestic Conditions

Contrast to Fed, RBI has been on the crystal ball in terms of the rate raising cycle…Slicing Headline CPI into Demand Pull & Cost Push Inflation reveals jump from Feb'22 & RBI effectively raised rates in April

- Using the idea from the recent paper by Shapiro (How Much Do Supply and Demand Drive Inflation? FRBSF Economic Letter, June 21, 2022), we sliced CPI inflation into Supply/Demand CPI and Neutral. Our analysis shows that out of 299 commodities in CPI, 171 are categorised as supply driven, 99 as demand driven and 29 are neutral.
- Our results show that supply side factors are currently responsible for almost 60% of the current elevated level of CPI inflation. This in part reflects supply constraints from continued global supply disruptions related to the pandemic and the war in Ukraine. Demand factors contribute only to one-third to CPI inflation



Demand & Supply Inflation: Weighted Contribution (%)

	# of Items		Apr-22	May-22	Jun-22
Demand CPI	99	%	2.6	2.3	2.5
		Share	34%	33%	36%
Supply CPI	171	%	5.0	4.6	4.3
		Share	64%	65%	62%
Neutral	29	%	0.2	0.1	0.2
		Share	2%	2%	2%
Overall CPI	299	%	7.8	7.0	7.0

Source: SBI Research

CPI	Categories included
Demand	Fuel and light, Household goods and services, Health, Transport and communication, Recreation and amusement, Education
Supply	Food and beverages, Pan, tobacco and intoxicants, Clothing and footwear, Personal care and effects

The movement in Rupee has mostly to do with a strengthening DXY .. Rupee depreciation has been modest

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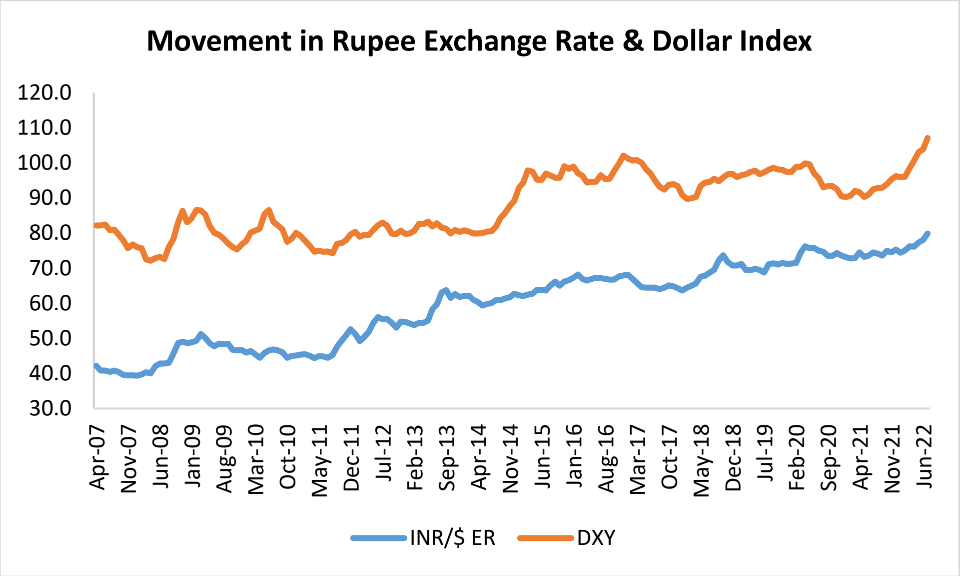
- Rupee Dollar exchange rate is closely aligned to the Dollar Index. Appreciation of the dollar leads to depreciation of the Rupee/Dollar Exchange rate. The correlation between the two is high at 0.86
- Regression of Rupee exchange rate on dollar index (DXY) from Apr-07 to Jul-22 reveals that 1% change in DXY (or appreciation of dollar) leads to 1.13% change in rupee exchange rate (depreciation of the Rupee)
- The Indian rupee (INR) depreciated by a modest 5.6% vis-à-vis the US dollar since the war broke out. The US $ Index has appreciated by 9.9% during the same period, thus indicating that much of the weakness in rupee was in lieu of a strong $. In fact, the correlation coefficient between INR/$ Exchange rate and DXY has increased to 0.96 since Mar-21 from 0.63 between Jan-08 to Feb-12
- There have been instances in the past which shows that rupee depreciation has been much more than the appreciation of the Dollar (like Jan-08 to Feb-12 and Oct-12 to May-14), which had happened because of our weak domestic macro-economic fundamentals

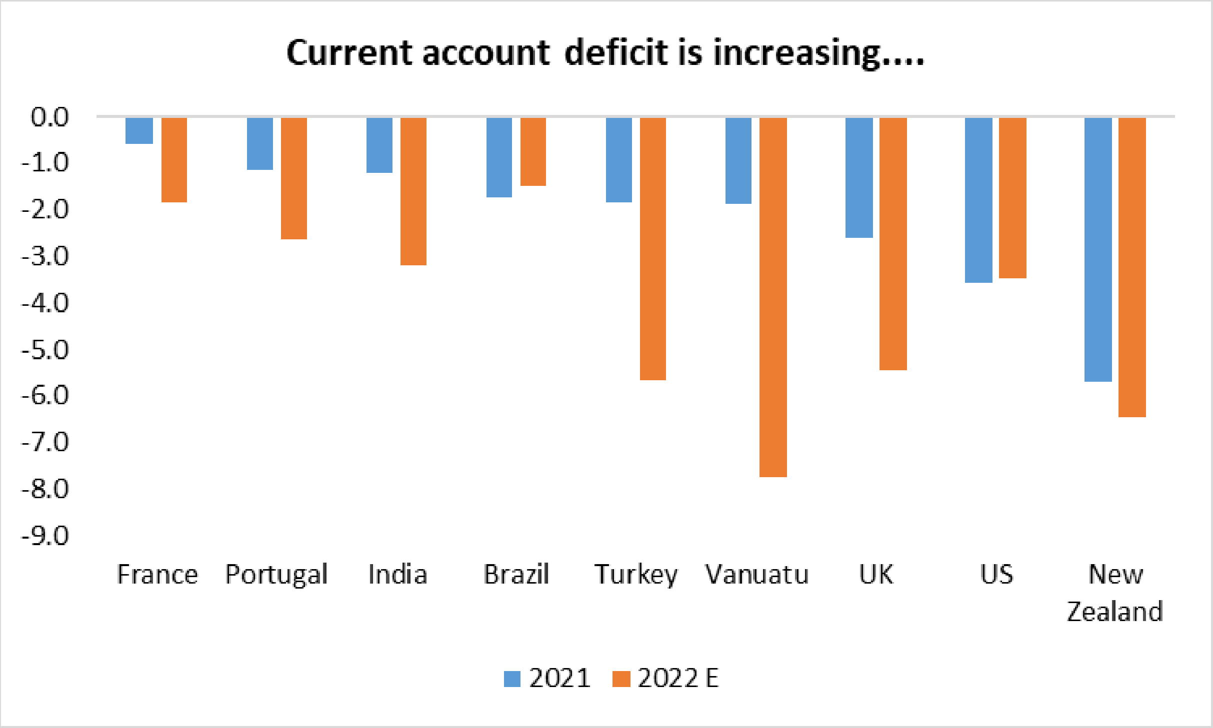


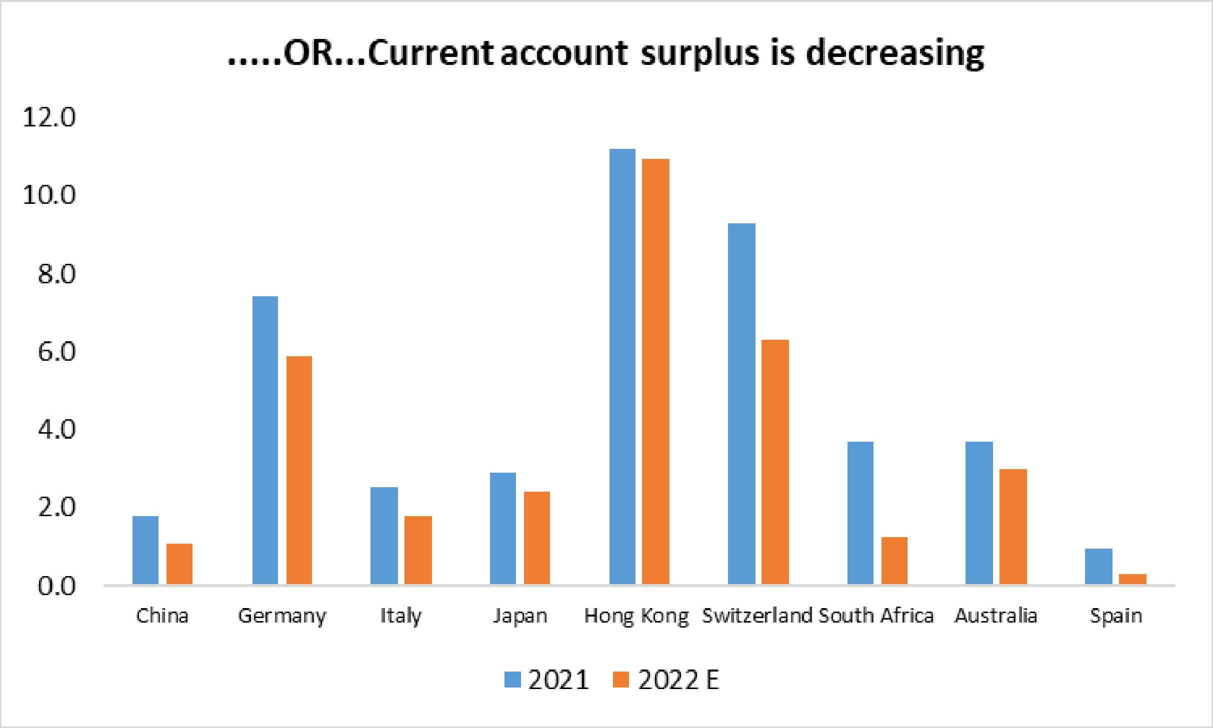
USD INR Rates & Dollar Index (2008 till current)				
Period	Depreciation of Rupee	Appreciation of Rupee	Net movement of Rupee	Movement of Dollar index during the period
Jan-08 to Feb-12	-33.5	6.4	-27.1	3.9
Feb-12 to Oct-12	-12.7	4.3	-8.4	1.0
Oct-12 to May-14	-20.2	7.0	-13.2	0.3
May-14 to Jan-18	-15.0	6.7	-8.3	13.6
Jan-18 to Jul-19	-15.7	6.6	-9.1	7.2
Jul-19 to Mar-21	-10.9	4.5	-6.4	-5.5
Mar-21 to Jul-22	-9.7	-	-9.7	16.4

Source: SBI Research, Bloomberg

Current account deterioration is expected across the World & India cannot be an exception….

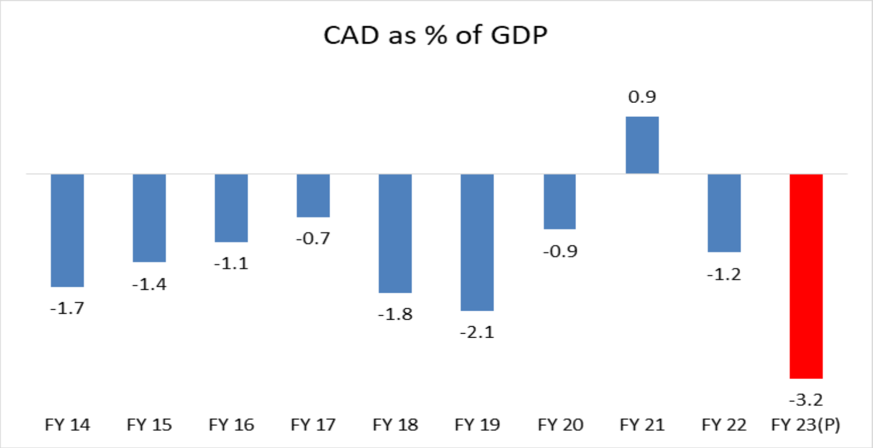
- All the major economies are expected (according to IMF WEO database) to have a deteriorating current account balance (either they are in deficit or surplus mode) in 2022 as compared to 2021

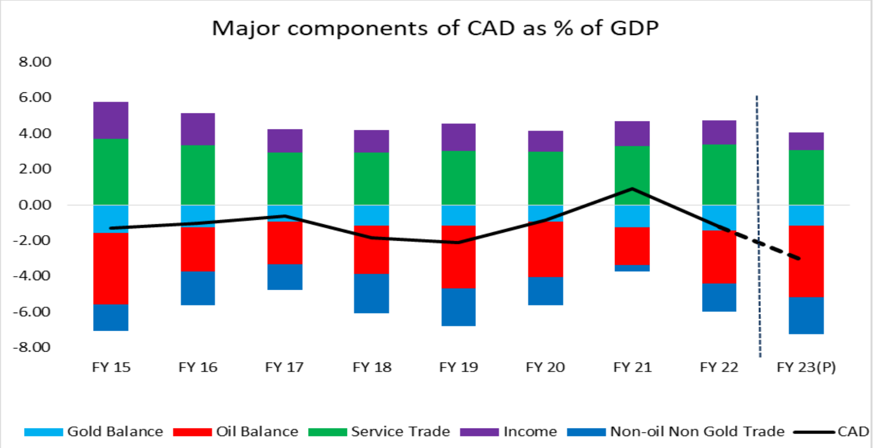


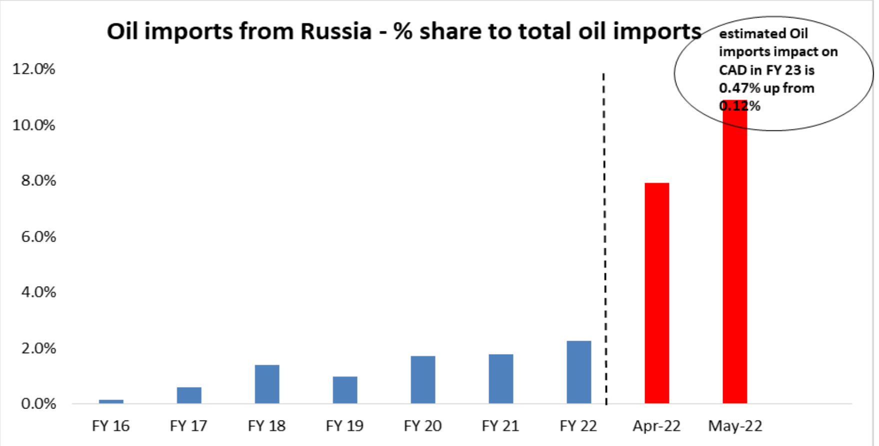


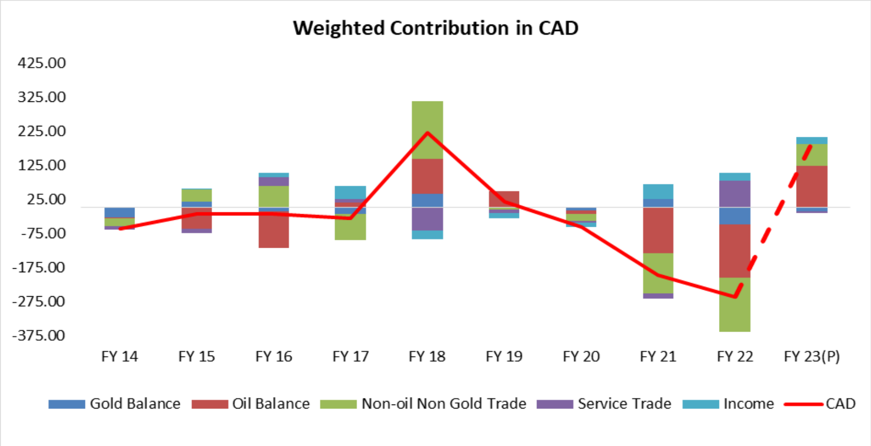
CAD may rise to a decade high in FY23

- India recorded a current account deficit of 1.2% of GDP in FY22 as against a surplus of 0.9% in FY21 as the trade deficit widened to $189.5 billion from $102.2 billion a year ago
- FY23 will be a challenging year since as per our estimates CAD will breach the 3.0% mark and may reach 3.2% of GDP









The worst of the Rupee fall may be close to being over……….

- Analysing the movement of rupee against dollar since global financial crisis period reveals that there were only three instances where the pace of currency depreciation lengthened more than 4 quarters
- Though this is also true that once the currency settled at a lower level, appreciation of currency picked up dramatic pace

Duration of Rupee Depreciation	
Time Period	Months Taken
Jan-08 to Mar-09	14
Apr-10 to Dec-11	20
Feb-12 to Jul-12	5
Oct-12 to Sep-13	11
May-14 to Feb-16	21
Jan-18 to Oct-18	9
Jul-19 to Apr-20	9
Mar-21 to Jul-22	16
Average	**13**
Source: SBI Research	

The $59 bn decline in FCA since beginning of Ukraine war does not imply RBI used the entire amount in defending rupee…. valuation impact was large enough as $ gained strength against all currencies

- Since Russia-Ukraine war broke out RBI's forex currency assets or FCA (forex reserves excluding gold, SDR) have declined by $59 bn
- However, FII outflows during the same period amounts to $23 bn only, thus part of remaining $36 bn (62% of the total decrease in FCA) decline can be attributed to fall in value of non-dollar reserves amidst steep and secular dollar appreciation
- We tried to estimate the amount of decline in FCA held in currency other than dollar by assuming (EUR + Yen + Renminbi) depreciation approximates the non-USD reserves basket: As per our estimate, non-USD currency might comprise 45% of the total foreign currency assets of RBI
- **RBI might not have used more than $25-30 bn in defending rupee, given the increasing penchant of the regulator to intervene in NDF/Future markets….Rest of the decline might be purely because of valuation…Enough support for rupee is thus still available**

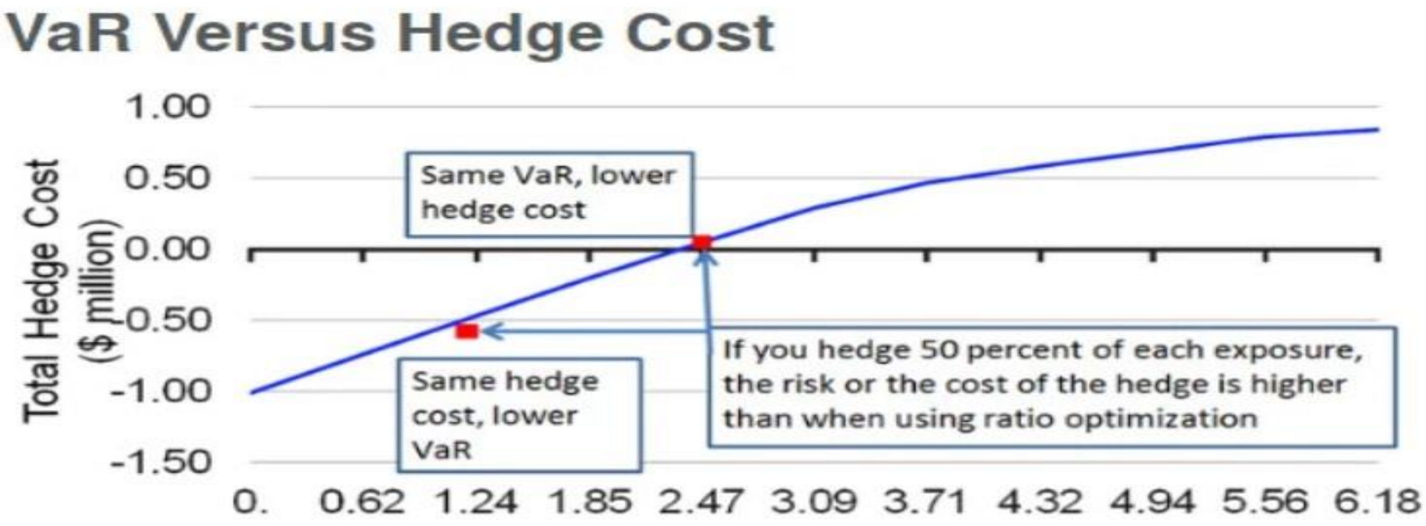
Estimation of non-dollar reserves with RBI (bn)	
Current FCA	572
FCA decline since War broke out in Feb	58.8
FII outflows since war	22.6
Decline in FCA due to dollar appreciation	36.2
Average depreciation in Pound, Yen and EUR	14%
Estimation of non-dollar reserves	259
Non dollar reserves (as % of total FCA)	45%

Hedging the Unhedged: Fears of unhedged rupee are misplaced……

- RBI's extant instructions on hedging of FC exposure through ECBs raised by corporates prescribes mandatory 70% hedge in case of Infrastructure space companies for ECBs of tenor less than 5 years while rest have to follow concerned sectoral or prudential regulations
- Research shows the cost of fully hedging an ECB dramatically jacking up the overall cost vis-à-vis domestic financing options available, obliviating the very reason behind raising ECB (cost-efficiency). As per research studies, optimal hedging for corporates in India hovers in the range of 63-66% (based on prevailing benchmark reference rates)
- UFCE (Unhedged Foreign Currency Exposure) format by RBI provides the granular details for hedged (financial/natural hedging) as well as unhedged exposure of all corporates through MLIs
- Most of the companies raising ECB have either sovereign windows (OMCs), pass through to parents (government backed developmental financing companies in power/railways etc.) or PSUs giving them a natural hedge character. Additionally, natural hedge in terms of export receivables / other payments during the loan tenor offers cushion from the currency market volatility. RBI has amply demonstrated its ability to reduce the bouts and spikes of volatility while judiciously utilizing the large reserves coffers to meet the necessary obligations
- **Corporates, in alignment with board approved Risk Management Policies, would have hedged a significant portion (even if not optimal) during the recent upheaval when rupee was facing volatility against a galloping USD primarily on Euro and JPY depreciation turf. With the current action of ECB raising the benchmark deposit rates by 50 bps, we believe this should be accretive for INR through bringing parity in major Central Banks action**
- Major and better rated Corporates also have the time tasted option of ***refinancing*** the existing ECB obligations thereby remaining unfazed by the much-touted exchange rate risk
- Not all the payments shown due and Unhedged (USD 79 bio as per March FSR) are in the immediate vicinity (lumpy payments) and should be well distributed along at least a 5-year curve giving the corporate entities much respite to repay out of future accruals along scheduled timelines. In the recent past, corporate profits have shown robust growth and the trend should continue well, fortifying repayment obligations sans hiccups.
- **The regulator can look at providing granular data along sector, tenor, financial/natural hedge availability in future to quell the miscommunication from select quarters without much understanding of the modus operandi of the ECB mechanism**

Hedging the Unhedged

- The efficient frontier curve (EFC, in blue curved line) capturing the diminishing marginal return to risk below (since every increase in risk would result in a relatively smaller amount of return for the hedging entity) plots the relationship between Fx VaR (Value at Risk) and lowest hedge cost necessary to achieve it. If corporates choose a random ratio- say 50% of each currency obligation, the cost of hedging would be far higher than achieved through optimization, increasing the debt servicing cost significantly
- Corporate treasuries with risk oriented outlook and board approved policy utilize a slew of sophisticated derivative products available in currency markets to protect the imminent exposure which may be in the form of position taken in divergent Currency Futures (functional currencies vis-à-vis exposure currencies) / Forwards or even NDF markets as also Exit/Put Option, Prepayment/Call Option for forex loans outstanding



Using exchange rate as a shock absorber in the current scenario may not be the ideal option when trade deficits are purely a reflection of price effect

- Trade deficit has reached record high of $26 billion in June with significant jump in our import bill and moderate export growth
- Cumulative exports for Jan-June 2022 was $230 billion and imports $359 billion, thereby clocking trade deficit of $128 billion compared to mere $73 billion during the same time in 2021
- **However, decomposition of the data reveals that there is significant price effect that is leading to higher import bill. It is only in case of certain items, including gems and jewellery, marine products, plantation and textile imports, our quantity effect is higher than the price effect**

Imports: Quantity & Price Effect (Jan-May' 2022 over Jan-May' 2021)			
Commodity group	**Share in Total Imports**	**Quantity effect**	**Price effect**
Petroleum Crude and Products	30.1%	17%	83%
Chemicals and Related Products	8.6%	7%	93%
Gems and Jewellery	6.0%	112%	-12%
Ores and Minerals	7.1%	-8%	108%
Agri and Allied Products	4.1%	21%	79%
Base Metals	3.5%	-19%	119%
Plastic and Rubber Articles	2.4%	-42%	142%
Plantation	0.2%	51%	49%
Textiles and Allied Products	0.1%	52%	48%
Leather and Leather Manufactures	0.1%	36%	64%
Others	0.1%	4%	96%
Paper and Related Products	0.0%	-7%	107%
Marine Products	0.0%	411%	-311%
Total (for 70 commodities)	62.3%	**-3%**	**103%**
Source: SBI Research, CEIC			

Surplus Liquidity has significantly declined… MSF is also now being resorted to….

- RBI has been actively managing system liquidity. It is also using spot intervention in the forex market as a policy tool to surprise the market
- Net absorption through LAF has now come down to Rs 0.74 lakh crore from Rs 6.35 lakh crore at the beginning of the financial year. Core liquidity has also reduced to Rs 6.05 lakh crore from Rs 8.32 lakh crore as on 1 Apr’22
- However, this excessive liquidity absorption might become self defeating as banks have now started relying on MSF to borrow funds
- Government surplus cash balances has increased to Rs 5.5 lakh crore. They are expected to increase further since ITR filing deadline date has not been extended. However, we are hopeful that such surplus cash balances may decline towards the end of the month with the increase in redemption of G-sec and payment of salary to Government employees
- Meanwhile, all short term rates have also increased significantly

RBI Liquidity Position

Rs Lakh Crore	**01-Apr-22**	**Latest**
A. Repo Outstanding	0.84	0.84
B.Reverse Repo Total	6.78	2.14
C.SDF statrted on 08.04.2022	2.35	0.52
D. MSF	0.01	0.59
E. Net LAF (-ve absorption)(A+D+SLF-B-C)	-6.35	-0.74
F. Government Cash Balance	1.08	5.45
G. System Liquidity(-ve absorption)	-7.24	-0.59
H. Core Liquidity Deficit (-ve Surplus)(G-F)	-8.32	-6.05
Rates		
Call Rate	3.30	5.09
Treps	3.10	5.15
91-T bills Yield	3.80	5.20
182- T Bills Yield	4.30	5.90
364- T bills Yield	4.60	6.20
1 Yr Gsec	4.70	6.20
5 Yrs Gsec	6.30	7.10
10 Yrs Gsce	6.80	7.37
Source: SBI Research, CCIL,RBI,Bloomberg		

The changing landscape of Non Resident Deposits…déjà vu of 2013 not imminent currently!

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- RBI directives on temporarily removing the interest rate cap offered on fresh retail / bulk overseas deposits to boost foreign exchange inflows, diversify and broaden the sources of foreign exchange funding, and reduce global impacts in order to lessen volatility should augur well for fortifying forex reserves through mobilising such deposits (fresh/rollover of deposits placed across maturities in Banks) though a return to 2013 looks highly improbable at this juncture (when the FCNR(B) kitty attracted US$33 bio in a short span of 7 months with FCNR(B) deposits alone swelling by ~US$27 bio).
- Aggravated outflows by FPIs and moderation being witnessed in longer tenor debt financing (ECB mode) of late have cast some spell on BoP and CAD levels though the adverse situation seems more like plateauing now as markets price in the future policy actions from a set of Central Banks with enhanced clarity going forward
- Since March'20, the net outflows from FCNR(B) deposits has been to the tune of US$8.3 bio, while NRE deposits witnessed growth in 2021 only (over 2020) offsetting the overall impact on total kitty though growth in NRO deposits could be witnessed till very recently. *Inter alia*, the FCNR(B) deposits are back to **pre Taper Tantrum days** while the total system deposits have nearly doubled since then!

Facility (US$ mio)	FCNR(B)	NRE	NRO	TOTAL	DIFF (+/-)
May 22	15,910	99,928	21,250	1,37,089	**-2,113**
Apr 22	16,135	1,01,559	21,508	1,39,202	180
Mar 22	**16,918**	1,00,801	21,303	1,39,022	**-2,873**
Mar 21	**20,473**	1,02,579	18,842	1,41,895	11,314
Mar 20	**24,244**	90,367	15,969	1,30,581	158
Mar 19	23,170	92,017	15,236	1,30,423	4,241
Mar 18	22,026	90,035	14,121	1,26,182	9,314
Mar 17	**21,002**	83,213	12,652	1,16,867	**-10,061**
Mar 16	**45,316**	71,468	10,145	1,26,929	11,766
Mar 15	42,824	62,746	9,593	1,15,163	11,318
Mar 14	**41,823**	52,908	9,114	1,03,844	**33,022**
Mar 13	**15,188**	45,924	9,710	70,822	12,214
Mar 12	14,968	31,408	12,232	58,608	6,926
(Diff. represents the net positive/negative accretion from preceding period)					

Cost of hedging of FCNR(B) deposits keeps a lid on the ceiling of interest rates offered by banks to prospective depositors. Banks deploy these funds through PCFC (pre shipment credit) or FCNR(B) loans, whose effective cost is neutralised by the cost of hedging over the interest rate offered plus spread. Better rated Corporates have no incentive in opting for these loans that currently inches upwards of 7% as they can get them at low rates from market. However, these loans can be marketed to mid-rated corporates or EOUs (to save on fx payments without conversion loss). The regulator can devise ways to meet the Fx demand at maturity, at least partially, to make the products competitively and attractively priced for deserving eligible borrowing entities

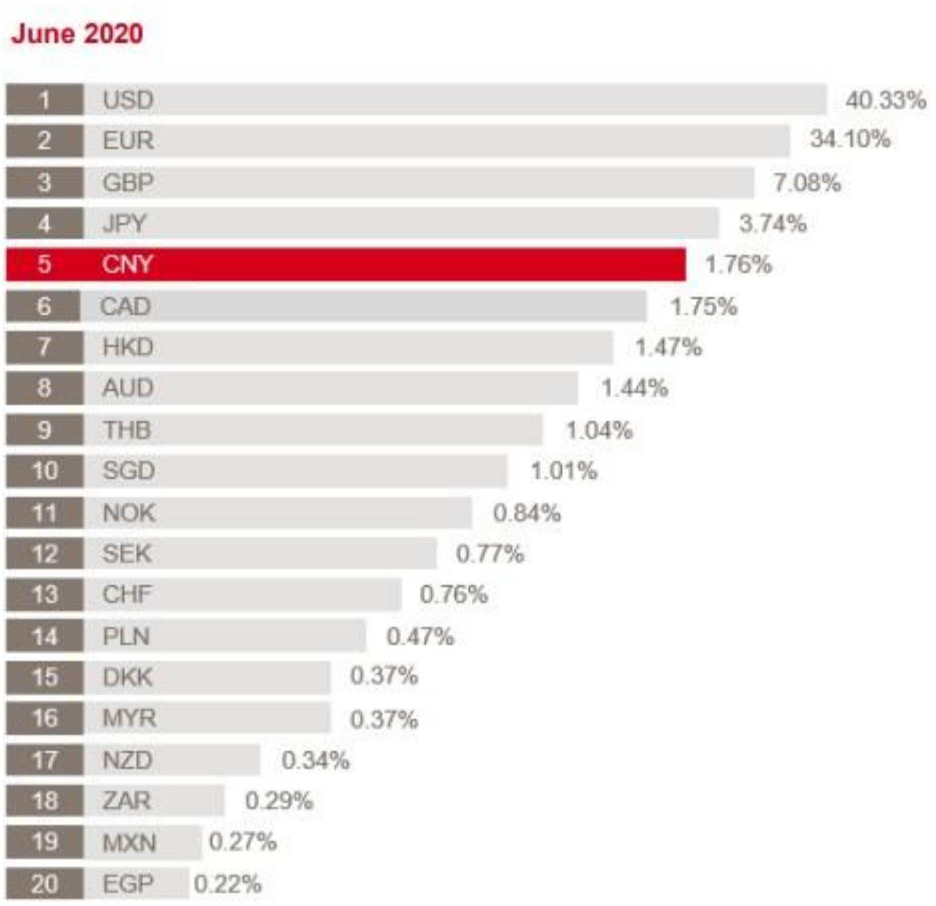
- RBI's move to allow trade invoicing, payment and settlement in rupee with willing 'partner nations' should open up new vistas of opportunities for the Indian Currency in a changing world order as trade dynamics between countries are going off the pattern at a fast pace. In terms of Total Trade (Exports plus Imports) for USA, both Canada and Mexico have gained traction, elbowing China to third slot (though, in terms of imports alone, China still has some legroom over the two neighbouring nations of USA). At home, we have seen emergence of Russia as the second most important crude exporter (after Iraq) to us, pushing the once significant partner Saudi Arabia to third position. Value wise, Russian imports amounted to ~13% of India's crude imports in May22 from just a tad over 2% in March'22 (and that too at a discounted pre-war pricing). Both Russia and Iraq could be significant 'partner nations' accepting the rupee denominated payment mechanism proposed, thus easing the forex outgo on this count to a great extent. To begin with, at least part of imports must be invoiced and paid in INR with these friendly countries to stabilise the system in a gradual manner

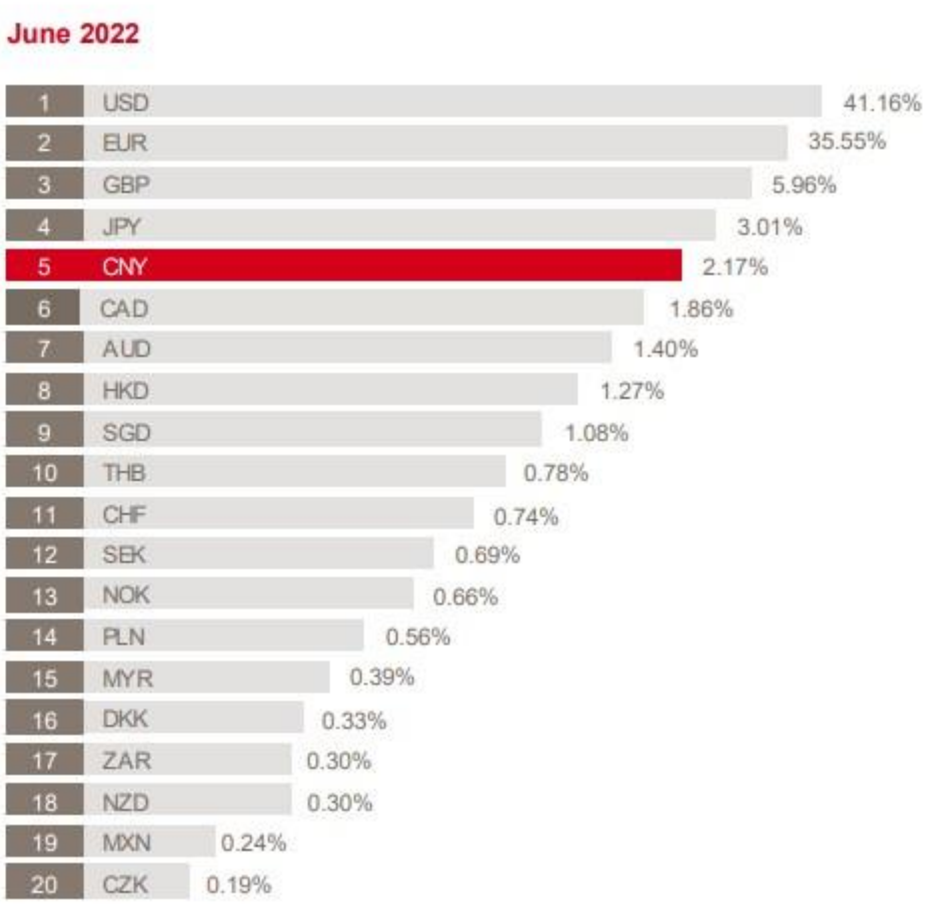
- The EU has announced to ease sanctions on Russia under recent '**Maintenance and Alignment**' package to avoid any potential negative consequences for food and energy security around the world. However, such relaxations could also have a collateral effect on nascent payment/settlements initiatives in INR as most trading concerns may be inclined to resort to prevailing settlement mechanism in vogue, thwarting the well intended attempts to internationalize the Rupee. It would be foolhardy to taper the efforts at this juncture in view of proposed CBDC initiatives (Wholesale payment) that could simplify the trade payment dramatically going forward. We can take a cue from the Chinese efforts to **'position' the renminbi as a global currency**, now the fifth most active currency by value (2.17%) for global payments. Since the Rupee surplus balance can be used for permissible Capital and Current account transactions, including G-Sec/T-Bills, this should channelise the surplus reserves to debt markets (The rupee vostro account with Moscow should be in surplus mostly)

- Trade settlement with countries member of ACU (Asian Clearing Union) in currency outside the ACU mechanism (as specified for Sri Lanka recently) may be looked at to promote INR denominated settlement further and embed payment architecture in place for future usage as also promoting usage of indigenous messaging platforms

RMB's share as a global payments currency: Will CBDC-in-making provide a major fillip?

- PBOC has, over the years, made constant efforts to enhance the acceptability of Yuan as a global payment currency. The infrastructure and limited acceptability of present days could see major traction as China lures willing partners with efficient CBDC mechanism that promises to cut transaction cost and time greatly





Source: SWIFT RMB Tracker including payments with Eurozone

Final Thought: Clearing the Air

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

Indicator	Our View
Repo rate	• **35 bps hike** as inflation in India possibly might have peaked: aggressive response to shocks by RBI has been just appropriate to tackle the uncertainness regarding inflation persistence • Also, with 1 year inflation forecast at less than 5%, possibly 2 more rate hikes could take us to 5.5%, rendering a positive real rate >50 bps one year ahead
Stance	• Continue to focus on withdrawal of accommodation: *However, it should now be carefully calibrated such that it is not self defeating given that Government cash balances has jumped to record highs and continued RBI intervention in spot market has resulted in banks resorting to MSF in recent times with significant drawdown of non policy induced liquidity*
Risks for growth/inflation	• Protracted war in Europe • Monetary tightening and Rupee depreciation • Crude prices remaining uncertain/volatile
Forward Guidance	• The RBI could clear some market confusions regarding the exact nature of intervention: a good part of the decline in RBI reserves is clearly attributable to revaluation of foreign exchange reserves and hence RBI has enough ammunition to guard the rupee if the need so arises • Even though RBI has cleared the air on hedging, RBI can also look at providing some data along sector, tenor, financial/natural hedge availability in future to quell the miscommunication from select quarters without much understanding of the modus operandi of the ECB mechanism

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