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RBI POLICY: HIGH ON INNOVATIONS AND MINDFUL OF DISRUPTIONS WHILE SUPPORTING GROWTH QUOTIENTS UNEQUIVOCALLY

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Halfway past the year, there are no signs that Central Banks are going to be unhinged from the show-stopper position they have enjoyed through early 2022, the most keenly watched actors in the current milieu that looks high on near permanent disruptions even while on a positive side, there are multiple innovations amidst technology eating the world!

Against this backdrop, MPC of RBI decided to keep repo rate at 6.50% and decided to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth. RBI revised upward its inflation projection for FY24 by 30 bps to 5.40%. The huge upward revision in Q2 at 6.2% (earlier: 5.2%), due to spike in vegetable prices, chiefly led by tomatoes is a matter of concern, however, we believe that the impact will be transitory and likely to correct with fresh arrivals of vegetables **(which is likely to start as the first week of August data is revealing**) as also waning of demand after holy month of Shawan ends late August. RBI has retained its real GDP projection at 6.50% for FY24.

RBI has decided to impose an incremental cash reserve ratio (I-CRR) of 10% on the increase in SCBs net demand and time liabilities (NDTL) between May 19, 2023 and July 28, 2023 as a temporary measure to absorb excess liquidity. The incremental NDTL for ASCBs during the stated period stands at around Rs 10 lakh crore. Thus, Banks have to maintain additional CRR of 10% or ~Rs 1 lakh crore from the fortnight beginning 12 Aug'23. This amounts to 0.3% of the current NDTL of ASCBs. Thus, even though the RBI has kept the CRR unchanged at 4.5%, this temporary measure amounts to increasing the CRR rate by 30 bps (4.8%). The current durable liquidity (inclusive of government surplus cash balances of Rs 1.8 lakh crore) stand at Rs 3.6 lakh crore. With the current move of incremental CRR of 10%, the surplus liquidity will come down to ~Rs 2.6 lakh crore.

The move will not have any material impact on the 10-year G-sec yield as banks will not have to resort to selling of government securities to meet the additional CRR requirement. But it will have adverse impact on short-term yield of 91-D treasury bills as it is a temporary measure. RBI will continue to monitor the liquidity situation and has offered to review the decision on 8 Sep'23 or even before as liquidity squeeze is expected in coming weeks.

The CRR as an instrument of active liquidity management is expensive to administer and "using reserve requirements to fine tune the money supply is like trying to use a jackhammer to cut a diamond" [Mishkin 1997]. The RBI had earlier resorted to **incremental CRR of 100% earlier in 2016 to absorb liquidity** but that was unprecedented due to demonetization. However, the current excess liquidity is mostly due to Rs 2000 notes and is not exceptional. **Thus, today's policy statement, with incremental CRR and increase in inflation forecast has a hawkish tone.**

The development and regulatory policies include a range of announcements showing increasing alignment with innovation and continuity. Reforming the financial benchmarks with a view to enhance governance and oversight arrangements, conflict of interest, controls, and transparency was the need of the hour.

To ease customer experience in payment system, especially in UPI, RBI has announced Conversational Payments on UPI, which will enable users to engage in a conversation with an AI-powered system to do transactions and allowed offline payments in UPI through NFC and increased transactions limits to Rs 500 for small value digital payments in offline mode. Both UPI lite and NCMC card work as wallet and the pre-loaded money in App/Card can be spend near offline mode, i.e., debit (payments) can be made without an Internet connection, and credits into the account will be done online. As the NCMC card can be used at ATM, online payments etc. so the increase in transaction limit to Rs 500 will enhance use of cash-less transactions through UPI lite and NCMC card.

Relaxation of guidelines for NBFCs should be funds accretive for infra sector's huge demands while consolidation and harmonisation of the instructions for submission of applicable Supervisory Returns into a single Master Direction (which will be a single point of reference for all supervised entities) should ease the burden for compliance.

Ushering in a Digital Public Tech platform for timely and paperless credit dispensation to marginalized sectors viz. KCC and MSMEs going forward can revolutionize the ecosystem and lead to better price discovery among all actors. The rising escalation in points of friction between USA and China on chips technology is promising to have deep and wide ramifications.

REPO RATE AT 6.5%: MAINTAINED STATUS QUO BUT IMPOSED I-CRR TO ABSORB EXTRA LIQUIDITY

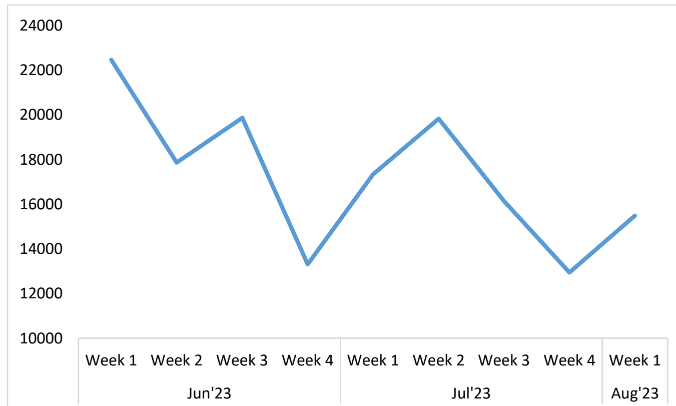
- As widely expected, MPC decided to keep repo rate at 6.50%. It also decided to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth, though not unanimously. One of the members expressed reservations on withdrawal of accommodation.
- RBI revised upward its inflation projection for FY24 by 30 bps to 5.40% with Q2 at 6.2% (earlier: 5.2%), Q3 at 5.7% (earlier: 5.4%), and Q4 at 5.2% (earlier: 5.2%). The huge upward revision in Q2 inflation projection (due to spike in vegetable prices, led by tomatoes) is a matter of concern, however, we believe that the impact will be transitory and likely to correct with fresh arrivals of vegetables (which is likely to start as the first week of August data is revealing).
- Our research of the past 10 years data shows that tomato price increase alone did not influence the overall CPI inflation much. It was only when the tomato price increase was accompanied by substantial increase in price of potato and onion. We believe if tomato price increase along with a substantial change in potato and onion then average inflation in Q2 FY24 will come around 6.3-6.4% (as against RBI projection of 6.2%).
- The inflation trajectory is also likely to be shaped by progress of the monsoon (which is quite impressive with very less uneven distribution) and kharif sowing. Crude oil prices is expected to firmed up amidst production cuts.
- RBI has retained its real GDP projection at 6.50% for FY24 with Q1 at 8.0%, Q2 at 6.5%, Q3 at 6.0% and Q4 at 5.7%. All estimates are same as provided in last policy. The recovery in kharif sowing and rural incomes, the buoyancy in services and consumer optimism, healthy balance sheets of banks and corporates, supply chain normalisation, business optimism and robust government capital expenditure will drive the growth in FY24. Weak global demand, volatility in global financial markets, geopolitical tensions and geo-economic fragmentation, however, pose risks to the outlook. It is interesting to note that list of positive factors influencing growth as stated in RBI policy statement outweigh negative factors in the same.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q1 FY24	Q2 FY24	Q3 FY24	Q4 FY24	FY24	Q1 FY25
Aug'23	4.6*	6.2	5.7	5.2	5.4	5.2
Jun'23	4.6	5.2	5.4	5.2	5.1	-
Apr'23	5.1	5.4	5.4	5.2	5.2	-
Real GDP Growth (%)	**Q1 FY24**	**Q2 FY24**	**Q3 FY24**	**Q4 FY24**	**FY24**	**Q1 FY25**
Aug'23	8.0	6.5	6.0	5.7	6.5	6.6
Jun'23	8.0	6.5	6.0	5.7	6.5	-
Apr'23	7.8	6.2	6.1	5.9	6.5	-

Source: RBI, SBI Research *actual

Weekly Vegetables Arrival: Weighted Average of City Arrival (Metric Ton)



Source: SBI Research

IMPACT OF INCREMENTAL CRR

- RBI has decided to impose an incremental cash reserve ratio (I-CRR) of 10% on the increase in their net demand and time liabilities (NDTL) between May 19, 2023 and July 28, 2023 as a temporary measure to absorb excess liquidity. The incremental NDTL for ASCB during the stated period stands at around Rs 10 lakh crore. Banks have to maintain additional CRR of 10%, around Rs 1 lakh crore from the fortnight beginning 12 Aug'23. This amounts to 0.3% of the current NDTL of ASCB. Thus, even though the RBI has kept the CRR unchanged at 4.5%, this temporary measure amounts to increasing the CRR rate by 30 bps (4.8%).
- The current durable liquidity (inclusive of government surplus cash balances of Rs 1.8 lakh crore) stand at Rs 3.6 lakh crore. With the current move of incremental CRR of 10%, the surplus liquidity will come down to Rs 2.6 lakh crore.

- The CRR as an instrument of active liquidity management is expensive to administer and "using reserve requirements to fine tune the money supply is like trying to use a jackhammer to cut a diamond" [Mishkin 1997]. In this context, today's policy was hawkish.
- Interestingly, as we have highlighted in our recent research before that the banks are keeping excess amount (~Rs 50,000-70,000 crore) owing to the 24*7 NEFT/RTGS settlement which gets parked as SDF, it seems that the current move is directed at impounding that excess amount.
- The RBI had earlier resorted to incremental CRR of 100% earlier in 2016 to absorb liquidity due to this the total CRR requirement of the banks increased to around Rs 8 lakh crore from Rs 4.3 lakh crore. Banks had to resort to selling of Government Securities under repo operations in order to manage their liquidity position which in turn led to rise in the yield of Government papers. However, this time is different. The move will not have any impact on the 10-year G-sec yield as banks will not have to resort to selling of government securities to meet the additional CRR requirement. But it will have adverse impact on yield of short term papers as 91-D treasury bills as it is a temporary measure. RBI will continue to monitor the liquidity situation and has said to review the decision on 8 Sep'23 or even before as liquidity squeeze is expected in coming weeks.

DEVELOPMENTAL AND REGULATORY MEASURES

- ***Regulatory framework for Financial Benchmark Administrators:*** RBI had decided to revise the extant regulations issued in June 2019 and put in place a comprehensive, risk-based framework for administration of financial benchmarks. Reforming the financial benchmarks in a bid to enhance governance and oversight arrangements, conflict of interest, controls, and transparency is a welcome move.
- ***Payment Systems:*** To ease customer experience in payment system, especially in UPI, RBI has announced slew of measures like (i) Conversational Payments on UPI, which will enable users to engage in a conversation with an AI-powered system to do transactions; (ii) Offline payments in UPI through NFC; and (iii) Enhancing transactions limits to Rs 500 for small value digital payments in offline mode including for National Common Mobility Card (NCMC) and UPI Lite.
- Both UPI lite and NCMC card work as wallet and the pre-loaded money in App/Card can be spend near offline mode, i.e., debit (payments) can be made without an Internet connection, and credits into the account will be done online. As the NCMC card can be used at ATM, online payments etc so the increase in transaction limit to Rs 500 will enhance use of cash-less transactions through UPI lite and NCMC card
- As banks in India are working closely on their technology using AI and ML tools to expand digital banking services, this will enhance customer experience and also in in decision-making and operations.
- **Regulatory framework for Financial Benchmark Administrators:** Since the LIBOR scandal, sanctity and integrity of financial benchmarks become very important. Keeping with trends to develop domestic benchmarks, RBI in this policy has expanded the list of benchmarks, covering administration of all benchmarks related to foreign exchange, interest rates, money markets and government securities such as benchmarks on certificate of deposits (CDs) rates, repo rates, and FX Options Volatility Matrix as well as other benchmarks on government securities. This move will create robust benchmarks in each category leading orderly financial market development.
- **Review of Regulatory Framework for NBFC – Infrastructure Debt Funds (IDF-NBFCs)**: With a view to channelise funds to infrastructure sector RBI has relaxed guidelines for IDF-NBFC sector. Revised framework envisages – (i) withdrawal of the requirement of a sponsor for the IDFs; (ii) permission to finance Toll Operate Transfer projects (ToT) as direct lenders, (iii) access to ECBs; and (iv) making tri-partite agreement optional for PPP projects. The move is expected to diversify the sources of financing infrastructure.
- **Greater transparency in Interest Rate Reset of Equated Monthly Instalments (EMI) based Floating Interest Loans**: As the bank product pricing haves increasingly migrated to EBLR regime, there was need to bring more rule-based practices in floating rate resets and EMI. Keeping this in mind, RBI envisages a framework envisages that lenders should clearly communicate with the borrowers for resetting the tenor and/or EMI, provide options of switching to fixed rate loans or foreclosure of loans. This brings more customer centricity in product design and informed customer decisions making.

- **Consolidation and harmonisation of instructions for Supervisory data submission**: With a view to make compliance and regulatory reporting easy, reduce compliance burden, RBI will consolidate and harmonise the instructions for submission of applicable Supervisory Returns into a single Master Direction which will be a single point of reference for all supervised entities.
- **Public Tech Platform for Frictionless Credit With rapid progress in digitalization:** RBI Innovation hub has been spear heading the end-to-end digitalization of KCC loans upto 1.60 lakh (sans collateral) in sync with select banks in certain districts of five states on pilot basis, using eKYC and eSign to ensure doorstep delivery of instant credit to small and marginal farmers for both agri and allied (dairy at present) purposes, eliminating frictions in onboarding, assessment, underwriting that cause significant delay in time bound disbursal viz. doing away with obtention of land holding records or visiting bank branches in person. The initial success of the project has made it ready for a Pan-India launch while laying ground for employing the lessons learned in credit dispensation to other groups chiefly MSMEs, Startup entrepreneurs and SHGs/FPOs, leveraging data available with various state/market agencies on a non-siloed approach through a digital Public tech platform.
- The move assumes great ramifications as need based and time bound credit dispensation to vast swathe of customer groups can upend our quest to seize a vast stake in fragmented yet upwardly oriented-global growth while enhancing domestic consumer demand manyfold. As the platform can host and connect multiple financial sector entities, it should usher in better price/rate discovery eventually while ensuring stricter adherence to rules by all stake holders.

GLOBAL DEVELOPMENTS

- The roller-coaster ride for the select large economies of the world continues unabated, with tiffs and tussles adding much fire to the fuel. The rating downgrade of US from 'AAA' to 'AA' by Fitch reflected the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and importantly, the erosion of governance, somewhat reminiscent of a similar 2012 downgrade and was soon followed by Moody's downgrading 10 select banks for rising deposit costs and increased use of wholesale funding while recessionary clouds loom large. While markets did not double down completely, these are more of a leading indicator for the troubled times ahead as benchmark yields hardened, moving in tandem with announcements regarding enhanced borrowing plans in coming months.
- Also, the latest announcement of sanctions from Biden administration screening future projects (not ongoing projects as of now) towards blocking American capital in the months ahead from being invested in certain semiconductor, quantum computing, and artificial intelligence companies operating in China or under the control of the Chinese government assumes significance as Japan and Netherlands, the most crucial components of the zig-saw puzzle in the chips industry seem to have joined hands to thwart Chinese military threats through use of these chips. Among them, Dutch ASML, makers of immersion deep ultraviolet (DUV) lithography machine, which is used to manufacture memory chips and extreme ultraviolet (EUV) lithography machine which is used to make more advanced chips is most critical as ASML is the biggest supplier to Taiwan based TSMC, the king of advanced chip making globally. Amidst faltering export/imports and big real estate developer Country Garden missing coupon payments on dollar bonds, this could push China to the walls going forward.

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