SBI Research

Prelude to MPC Meeting: June 5-7, 2024

The Rise of the 'Collateral' risks globally: Weather, Geo-Politics, AI-led Tech disruptions, Mainland's aggression and fragmented trade relations to impact the glide path of Central Banks Inflation Targeting Framework…RBI among Top 3 most efficient regulators in managing inflation….7.5% growth looks a reality for FY25 with average inflation at 4.5%....RBI needs to use more innovative tools to manage liquidity conundrum as Government cash balances likely to stay out of banking sector with JIT mechanism of fund transfer…

Issue # 6, FY25 05-June-2024

Executive Summary…..1/2

- US benchmark yields have been on a see-saw ride with rally in the bond market anchoring the 10-year treasury note testing the lower upward-sloping trendline once again, right back at the ~4.40% area…further sojourn completely data driven with a wedge-formation most likely…US Banks’ Prime Lending rates near 2008-GFC highs impacting the households, students, credit card spends and businesses the most even as probabilities of a Fed pivot move further to September meet

- Supercore Inflation in US has been an early indicator of trend. There seems a strong divergence between the CPI Supercore and the PCE Supercore. The PCE indexes peaking ahead of the CPI index and leading the CPI lower earlier, seem to have an ensuing recurrence, having a bearing on Fed action

- Despite declared guilty on 34 counts of felony by jury, broader markets euphoric for a return of Trump in ensuing elections which could boost sentiments & businesses locally though also risking more protectionism and tariff barriers for EMs

- ECB giving signals that it may pivot to an uneven rate cut trajectory, starting in its 6th June meet though sticky services inflation may play spoilsport

- **Using Banker, Chames & Cooper (BCC, 1984) Model of Data Envelopment Analysis (DEA) to find out the most efficient central bank in containing inflation (minimum increase in interest rate leading to maximum decline in inflation) post Russia-Ukraine Conflict for 12 countries, RBI comes on third place, after smaller economies of Thailand and Poland, vouching for its strategic handling of multi pronged stress**

- Indian economy grew by 8.2% in FY24 (7.0% in FY23 and 3Y-Moving Average of 8.3%). Given a historical ICOR of 4.3 and gross investment rate at 33.3%, strong growth of 7.5% for FY25 could be a reality!

- The CPI inflation is expected to approach the RBI tolerance band (mid-point) in H1 FY25 as CPI for Apr’24 stands at 4.83%, while core inflation is at 3.22%....CPI inflation is expected to remain close to 5.0% till May and declining thereafter to 3% in July. Inflation is expected to stay below 5% beginning October till the end of FY25…. For the whole FY25, CPI inflation is likely to average to 4.5% (FY24: 5.4%)

- RBI’s recent strategic move to repatriate 100 MT of gold from London to India shows the completion of cycle, from vicious (1991 pre-LPG) to virtuous one now even as the country readies for a power play during next few years with incremental multi faceted brand equity accrual

Executive Summary…..2/2

- The Net liquidity was in surplus mode from 1 Apr’24 to 19 Apr’24 with an average of Rs 1.1 lakh crore, afterwards going to deficit mode with an average of Rs 1.4 lakh crore…..**This is mainly due to surplus government cash balances which averaged to Rs 2.5 lakh crore in FY25 (till May) …**RBI has been actively managing liquidity through main and fine-tuning operations

- Average supply of liquidity by way of variable rate repo auction held in FY25 is Rs 1.70 lakh crore, and average absorption through variable rate reverse repo auction amounts to Rs 0.32 lakh crore…Durable/core liquidity surplus has come down to ~Rs 1.50 lakh crore

- Amidst the recent build-up of government surplus cash balances and the ensuing liquidity deficit, RBI announced buyback of Government securities to the tune of Rs 2.0 lakh crore in May’24 though market participants showed lower interest in the buybacks with offered amount of Rs 1.24 lakh crore and accepted bids amounting to Rs 22,960 crore (11.5% of the notified amount). RBI also lowered the auction amount of the Government’s T-bills to a total of Rs 72,000 crore on a weekly basis between May 22 and June 26, as against Rs 1.32 lakh crore announced earlier facilitating release of additional liquidity for banks

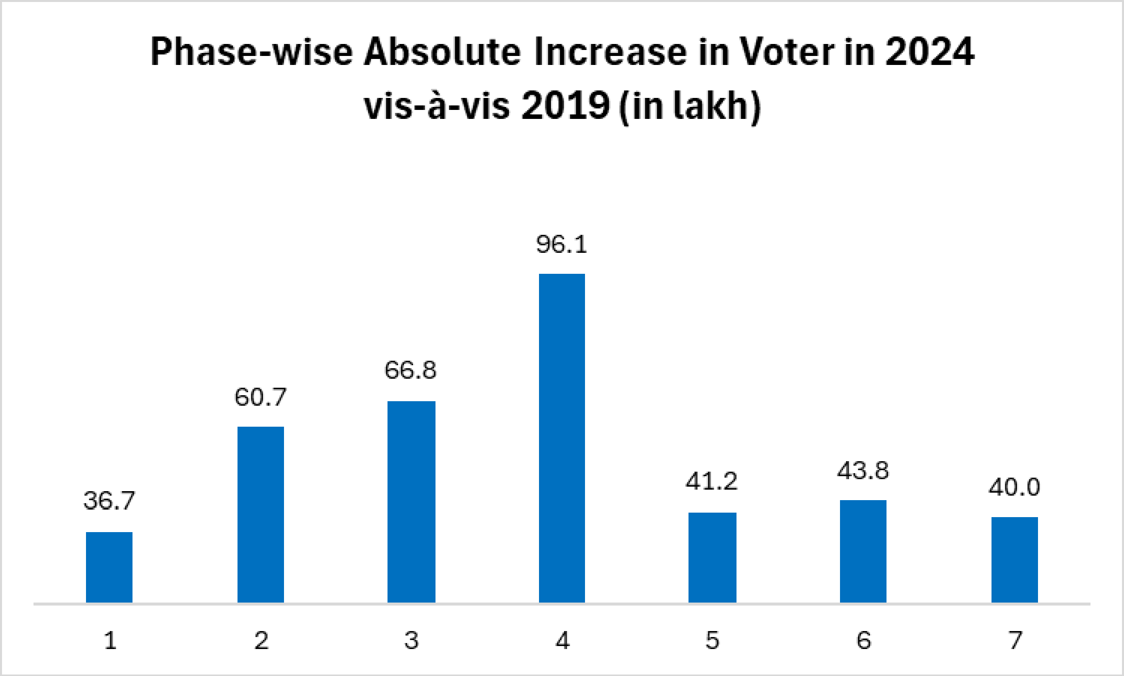
- The banking sector has performed well in FY24, credit growth continues to remain strong at 19.5% as on May 17, 2024 (last year 15.4%) PSBs, cumulative profit crossed Rs 1.4 trillion in the financial year ended March 2024, recording a growth of ~35% over the previous year

- The credit-to-GDP gap narrowed, reflecting the improved credit demand in the economy in the face of rising capacity utilisation in the manufacturing sector. We expect the credit growth be healthy in the range of 14-15%in FY25. But some moderation is expected due to higher interest rates and regulatory action by RBI, while deposit growth will continue to lag advances by 200-400 bps

- A total of 64.2 crore voters cast their votes in 2024 as compared to 60.5 crore in 2019, **an increase of ~4 crore voters as per ECI with incumbent government continuing its third term as the most natural pathway with continuance of reforms intact**

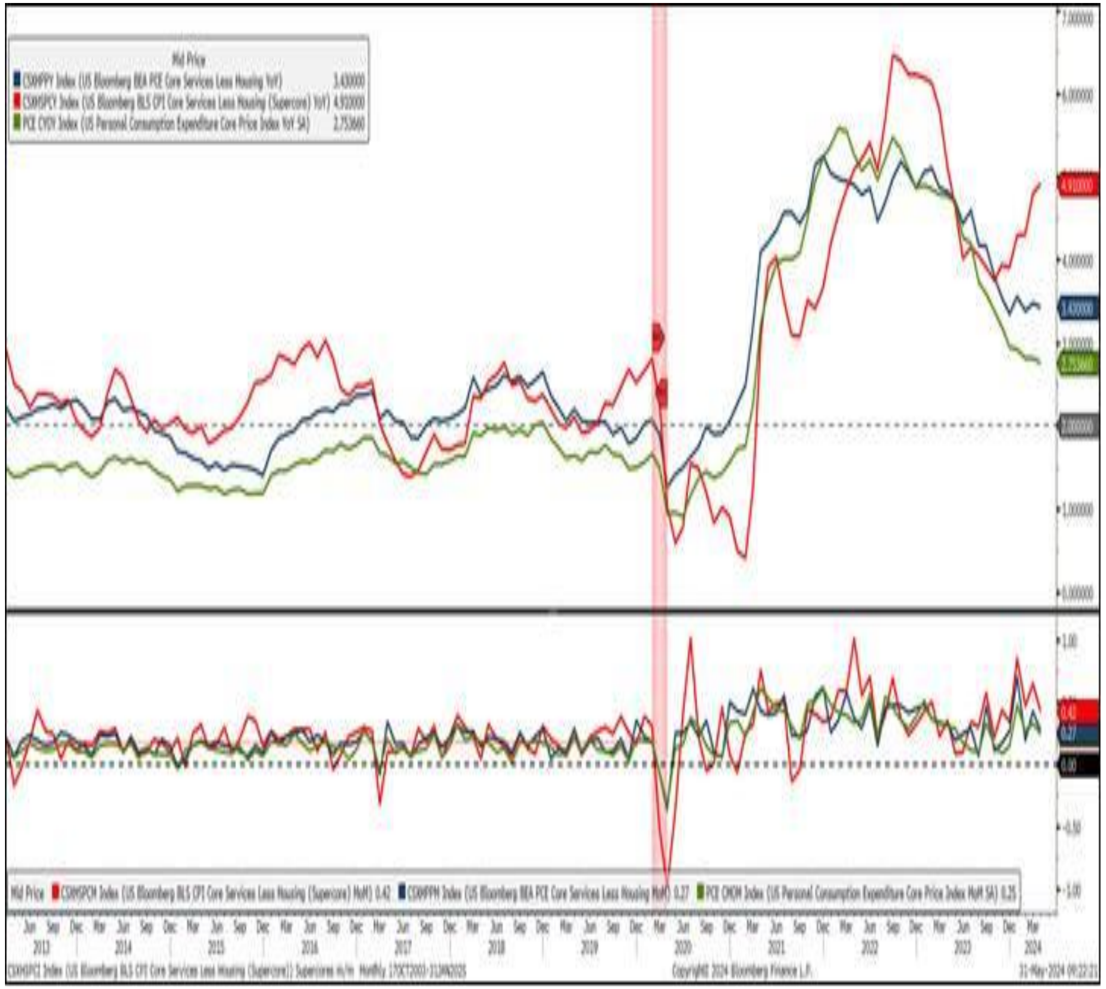
2024 Election: 4 crore Absolute Voter Turnout increased in 2024

- A total of 64.2 crore voters cast their votes in 2024 as compared to 60.5 crore casted their votes in 2019, **an increase of ~4 crore voters as per election commission**
- Election results indicate continuation of incumbent government



THE UNFOLDING US PLAYBOOK…..

Supercore points to divergence in PCE vis-à-vis CPI (ultimately softening of price print)…Bond Markets jittery

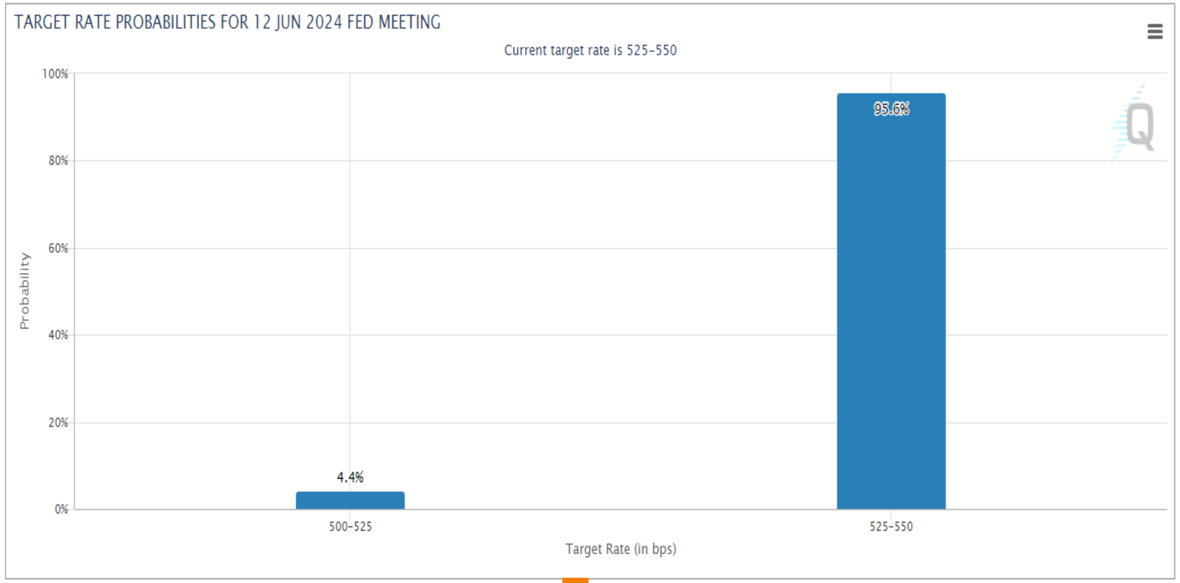


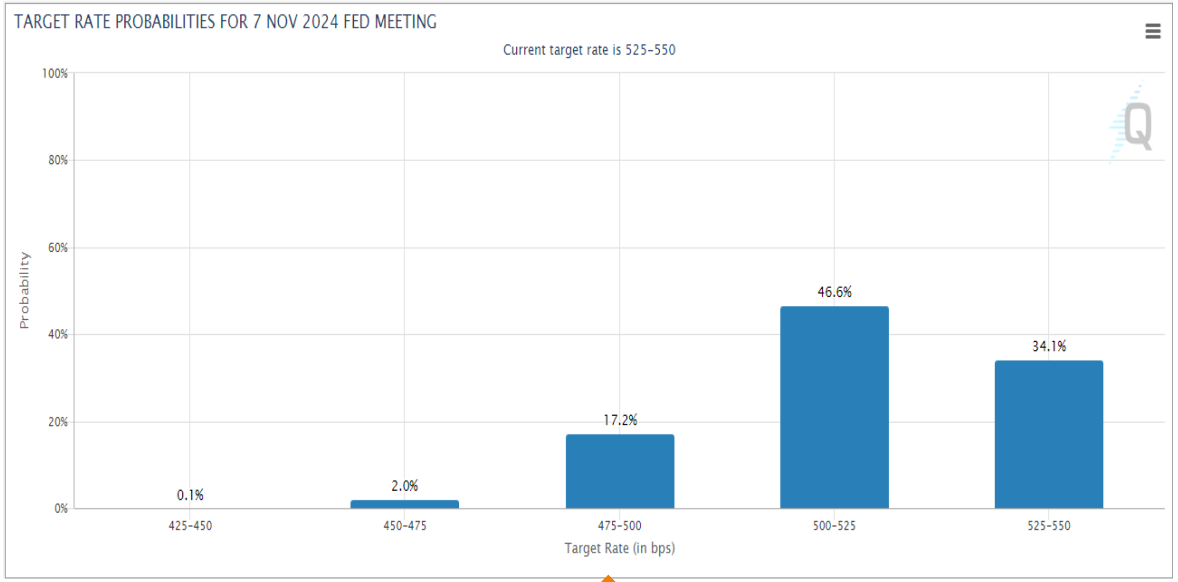
Supercore (core minus shelter & rent costs) has been an early indicator of trend. The PCE indexes peaked ahead of the CPI index and led the CPI lower. One could look forward to an ensuing recurrence having a bearing on Fed action

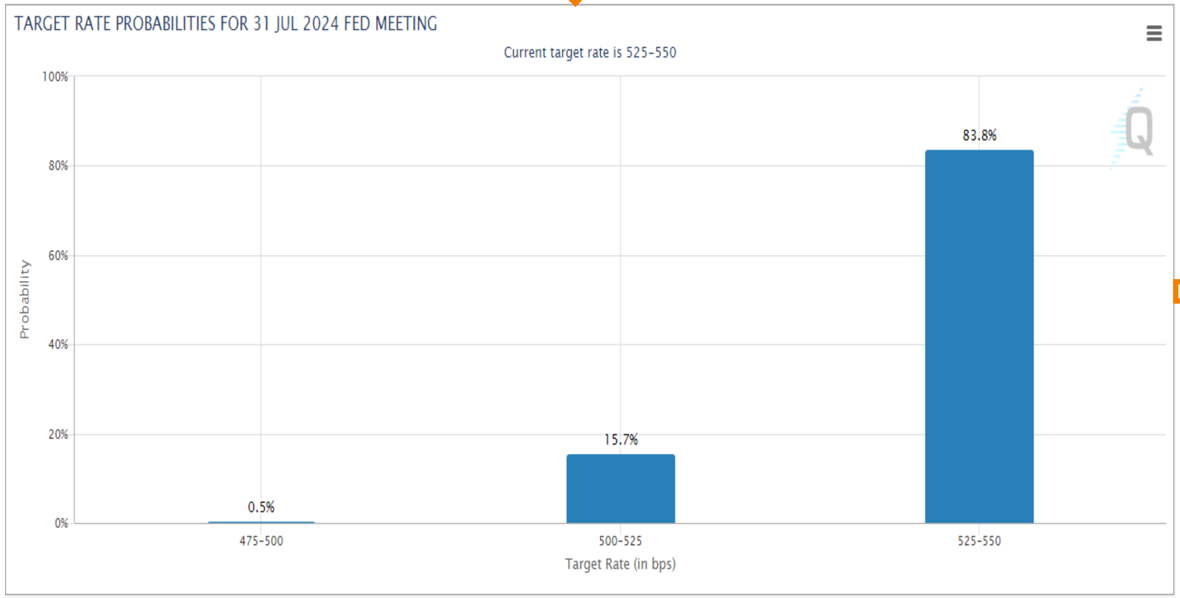
Rally in the bond market has the 10-year treasury note once again testing the lower upward-sloping trendline and is right back at the ~4.40% area…Formation of a wedge as the market gathers more data appears the **most likely future scenario**

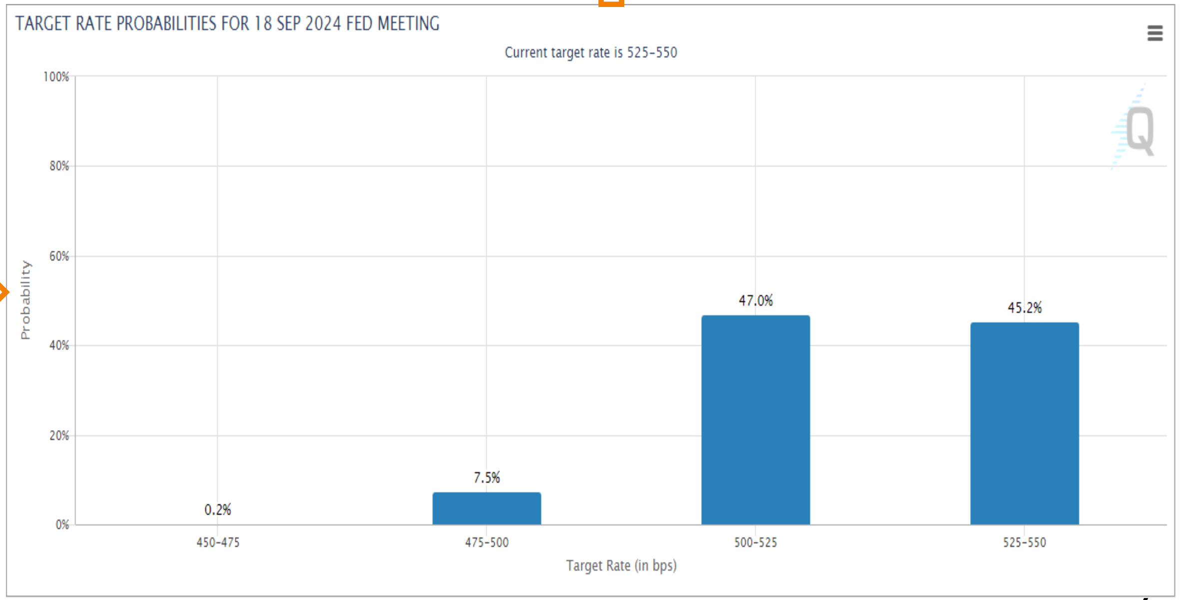
MARKETS HAVE 'MIS'PRICED FED'S MIND TOO MANY TIMES…. PIVOT KEEPS SHIFTING SOUTH

Consequently, Bank's Prime Lending Rates are fixated to toxic-GFC highs (2008) having implications for consumers/businesses the most….









Source: CME FedWatch, SBI Research

Trump found guilty- Impact on Market

- Former President Trump has been found guilty of all 34 felony charges against him by a jury in New York, and a sentencing hearing has been set for 11 July, four days before the start of the Republican National Convention
- Three other legal cases are pending against former President Trump and a looming Supreme Court decision on presidential immunity. With these other cases stalled, it appears unlikely that they will be finalized before the November election
- **Impact on Election:** Undecided voters are less likely to vote for Trump after he is being found guilty of 34 felony charges. However, Wall Street believes he still has a solid chance of winning the November election as the verdict can be considered politically motivated, thereby energizing Trump's base
- **Impact on Market:** The presidential race has been remarkably static for most of the year, and not many investors are making bets on the outcome for their portfolio. Near-term issues of the economy, geopolitical risk, inflation, monetary policy decisions have crowded out the potential post-election market impact. Memorial Day often serves as an unofficial start to the election and with this verdict and upcoming debates, we expect greater market reaction to potential 2024 election outcomes.
- Trump victory could broadly boost the stock market. A second Trump term could be supportive for equities, especially if Trump is able to avert tax hikes promised by Biden. Trump's promise to support fossil fuel production and a relatively more business-friendly approach to environmental regulation could also boost sentiment in the energy sector
- However, higher tariffs and trade protectionism could be negative leading to higher revenues but at the cost of weaker growth and higher inflation

However, ECB is expected to cut rate this week, but restricted easing going forward

- The ECB is expected to start easing the policy this week (25 bps expected), however future course is more uncertain

- The ECB has made it clear over the last few months that it would need to have clarity on the: (i) inflation outlook, (ii) the dynamics of underlying inflation and (iii) the strength of monetary policy transmission before easing policy

- Interestingly, core and domestic prices continue to show some stickiness. Sticky inflation, rapid wage growth and surprisingly robust euro-zone output will constrain monetary loosening

- ECB communication strategy indicates that this is not the beginning of a long and deep rate-cutting cycle and guiding markets towards a very gradual easing before slowly aiming for the long-term neutral rate

- The Fed has signaled that US rates may have to stay high for longer to ensure inflation returns to 2%, thereby causing the ECB to adopt less dovish stance with two cuts (at most) expected this year than 3 cuts expected earlier

Efficiency of Central Banks in Containing Inflation post Russia-Ukraine Conflict

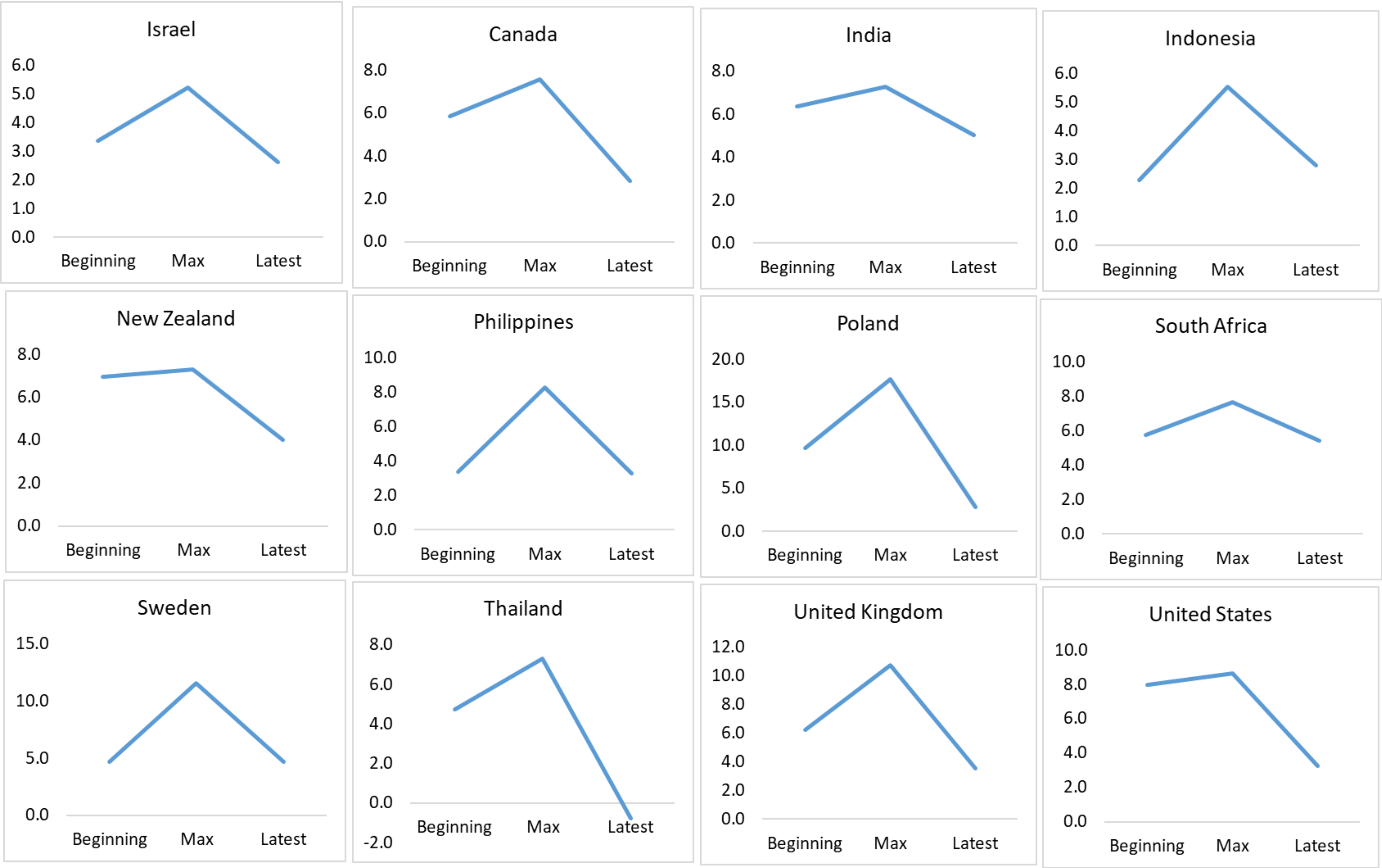
Using DEA Approach

Backdrop

- The Russian invasion of Ukraine that started on 24 February 2022 and the related energy crisis have had a substantial effect on the economy and inflation of almost all major economies
- The sheer expectation of future shortages (especially in natural gas) has contributed to a significant increase in energy prices. The price of food has also gone up: directly, because Russia and Ukraine are major producers of agricultural products as well as indirectly because energy is an important input for the production and transportation of food. Energy and food inflation has further led to an increase in other prices, at least through the input-output structures, automatic indexations of many goods and services, and automatic indexations of wages
- For the global economy, fuel and food shortages caused by the war are exacerbating post-pandemic inflation that had already reached multi-decade highs in most of the world
- Accordingly, almost all central banks responded to this situation of high inflation by tightening monetary policy (i.e. increase in interest rates) with a vigilant eye on growth
- However, not all the countries are equally successful in containing inflation along-with protecting growth by using higher interest rates

Inflation Movement in Major Inflation Targeting Economies

- After the beginning of Russia-Ukraine conflict inflation reached its peak but due to tight monetary policy it has declined thereafter



Efficiency of Central Banks in Containing Inflation

Objective

- Our Objective is to find out the most efficient central banks which with the minimum increase in interest rate led to maximum decline in inflation. So, we maximized decline in inflation subject to minimum increase in interest rate

Data & Methodology

- Data set include 12 major inflation targeting countries, for the time period: Q1 2022 to Q1 20224 (9 quarters)
- **Input variable: Change in Interest rate**
- **Output variable: Change in Inflation rate**
- We have used BCC Model of Data envelopment analysis (DEA) to find out the most efficient Central Bank in containing inflation post Russia-Ukraine Conflict
- Proposed model of BCC Output Oriented model

Min M

s.t M- dj ≥ 0   j = 1…n

$$\sum_{i=1}^{m} WiXij \leq 1 \ \ j = 1 \ldots . n$$

Where M: Change in Inflation; dj as a binary variable represents the deviation variable of Country / DMUj and Wi are weights and X is Change in interest rate

Result: India among the TOP 3 countries in being the most efficient in managing the crisis

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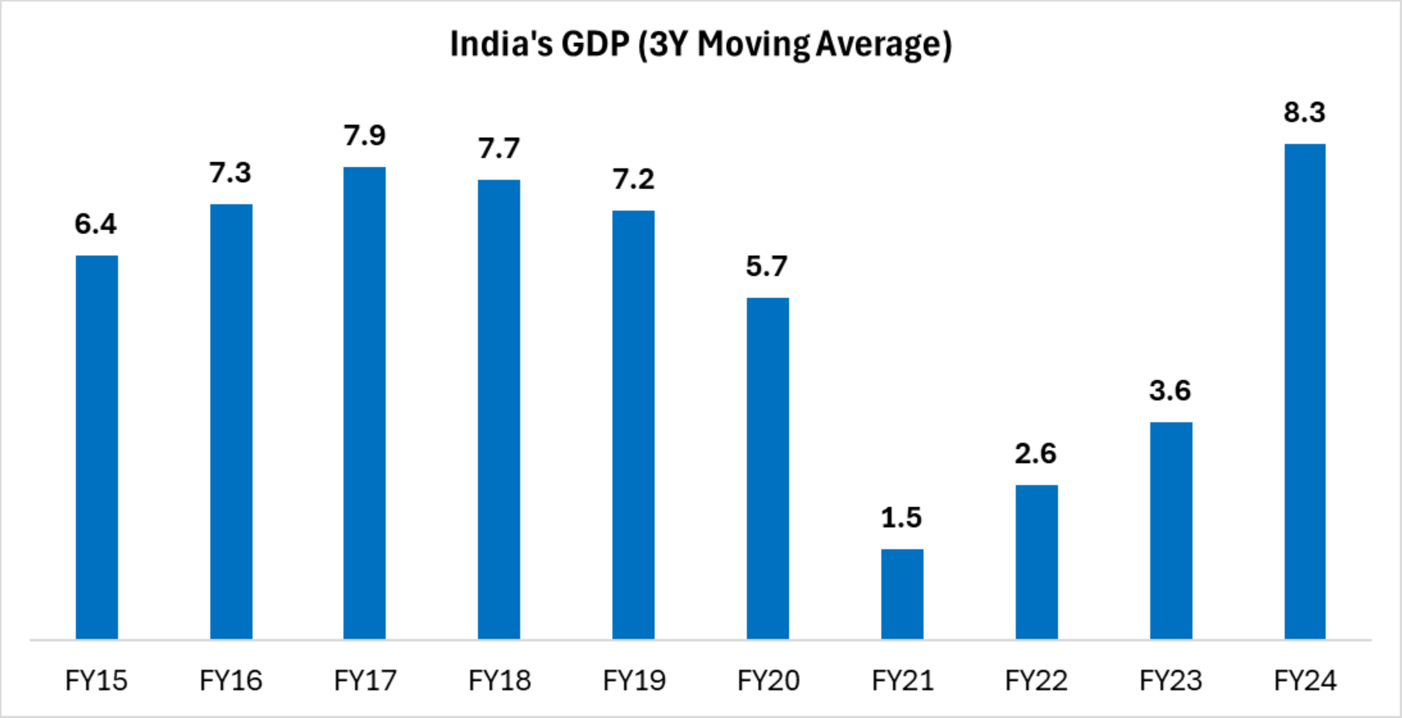
RANK	
1	Thailand
2	Poland
3	India
4	Indonesia
5	Sweden
6	South Africa
7	Israel
8	United Kingdom
9	Philippines
10	New Zealand
11	Canada
12	United States

Domestic Economy

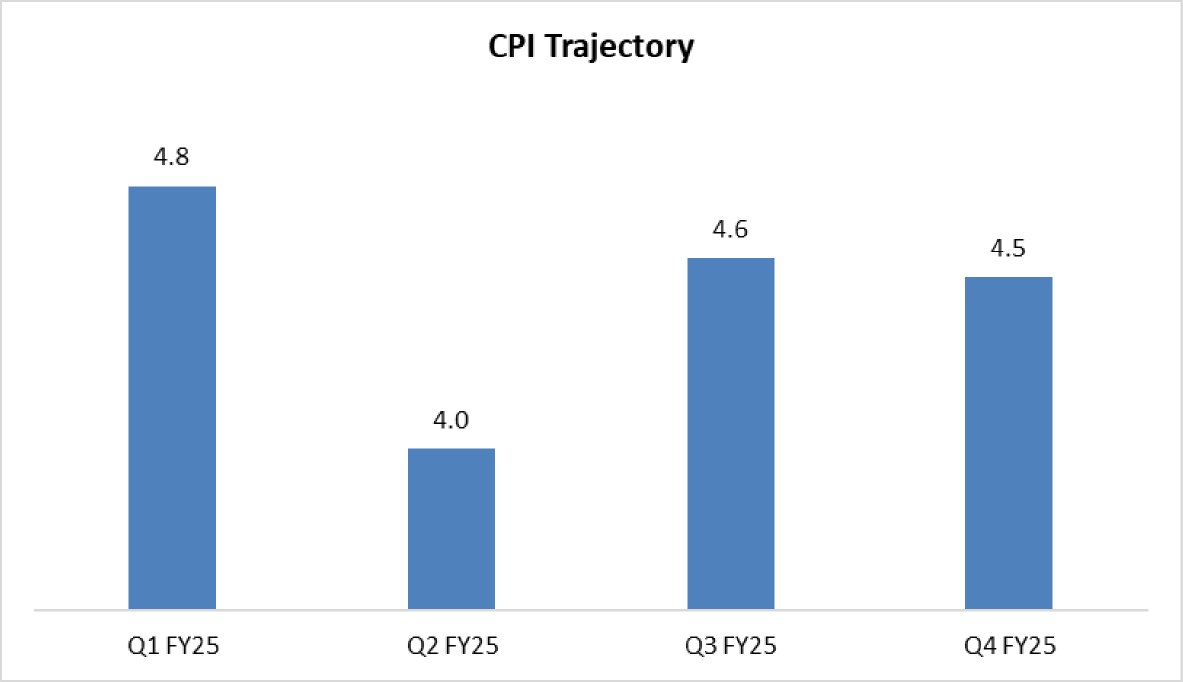
FY24 Growth at 8.2%....FY25 likely to clock strong momentum at 7.5%

- India’s economy grew by 8.2% in FY24 as compared to 7.0% in FY23. The 3-year moving average is highest at 8.3% since FY15
- Given a historical ICOR of 4.3 and gross investment rate at 33.3% as per professional forecasters, 7.5% growth for FY25 could be a reality!



CPI expected to remain within RBI target in FY25

- CPI for Apr’24 stands at 4.83%, while core inflation was at 3.22%
- The CPI inflation is expected to approach the RBI tolerance band in H1 FY25
- CPI inflation is expected to remain close to 5.0% till May and declining thereafter to 3% in July. Inflation is expected to stay below 5% beginning October till the end of FY25
- For the whole FY25, CPI inflation is likely to average to 4.5% (FY24: 5.4%)



Current Liquidity trend shows ~Rs 0.6 lakh crore average deficit in FY25

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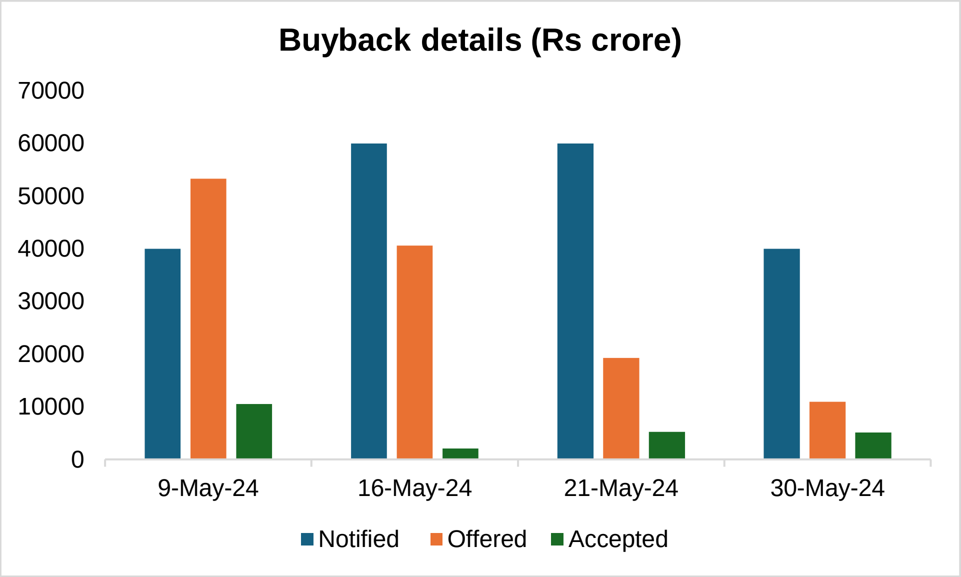
- The Net liquidity was in surplus mode from 1 Apr'24 to 19 Apr'24 with an average of Rs 1.1 lakh crore, then it went to deficit mode with an average of Rs 1.4 lakh crore
- **This is mainly due to surplus government cash balances which averaged to Rs 2.5 lakh crore in FY25 (till May)**
- RBI has been actively managing liquidity through main and fine tuning operations
- Average supply of liquidity by way of variable rate repo auction held in FY25 is Rs 1.70 lakh crore, and average absorption through variable rate reverse repo auction amounts to Rs 0.32 lakh crore
- Durable/core liquidity surplus has come down to Rs 1.50 lakh crore as on 31 May

Average Liquidity Position (Rs lakh crore)			
	5-Apr-24	**Post policy average**	**31-May-24**
Repo Outstanding	0.04	1.55	2.04
Reverse Repo Total	0.06	0.06	0.00
SDF	1.62	0.82	1.17
MSF	0.03	0.06	0.03
Net LAF (-absorption)	-1.48	0.85	1.01
Government Cash Balance (net LAF-core liquidity)	1.06	2.67	2.76
Core Liquidity (-Surplus) system liquidity adjusted with GOI Balances	-2.36	-1.75	-1.50
Ratios	**29-Mar-24**	**31-May-24**	**change in bps**
30 Year Gsec	7.13	7.14	1.1
20 Year Gsec	7.11	7.11	-0.2
15 Year Gsec	7.10	7.03	-6.8
10 Year Gsec	7.06	6.98	-7.5
5 Year Gse	7.06	7.05	-0.3
2 Yers Gsec	7.03	7.00	-3.2
364 days Tbill	7.08	7.04	-4.2
182days Tbill	7.14	7.01	-13.7
91days Tbill	7.01	6.85	-16.2
AAA Corp Spread(bps)	46.40	58.79	12.4

Source: RBI, SBI Research

Buyback auction by RBI showed lackluster response

- Amidst the recent build-up of government surplus cash balances and the ensuing liquidity deficit, RBI announced buyback of Government securities to the tune of Rs 2.0 lakh crore in May'24
- However, market participants have shown lower interest in the buybacks with offered amount of Rs 1.24 lakh crore and accepted bids amounting to Rs 22,960 crore (11.5% of the notified amount)
- RBI also lowered the auction amount of the Government's T-bills to a total of Rs 72,000 crore on a weekly basis between May 22 and June 26, as against Rs 1.32 lakh crore announced earlier. This released additional liquidity for banks
- Liquidity however still remains in the deficit mode and Government surplus cash balances will continue to remain elephant in the room RBI should adopt more innovative mechanisms to manage system liquidity



Impact of Just in Time – impact on banks through Government cash balances

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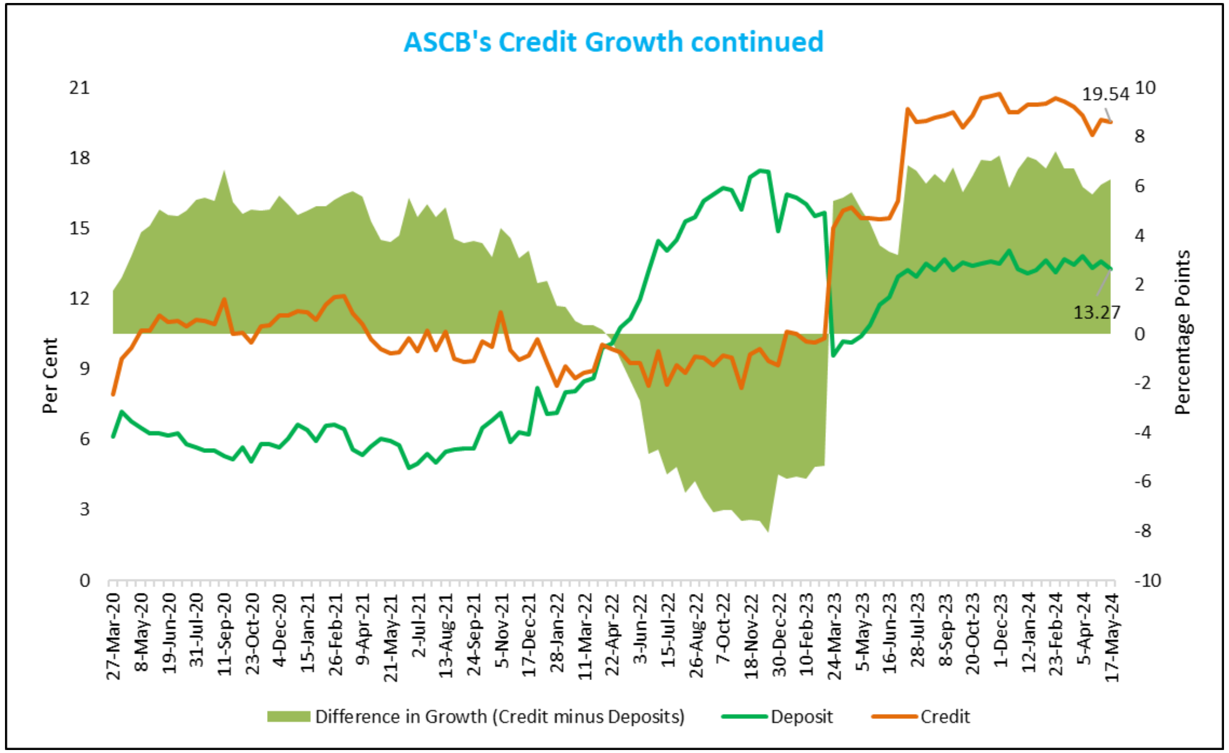
- Revised procedure (SNA) for flow of funds under CSS (Centrally Sponsored Schemes), aiming for better monitoring the availability and utilization of funds released to the States under the schemes AND to reduce float, came into effect from 1st July 2021. The principles of 'Just In Time (JIT)' is applied for releases in respect of all payments to the extent possible" and to bring about more efficiency in cash management at both Centre and States level
- The designated banks have been keeping the float funds in interest bearing Savings Bank accounts (paying differential rate of SB interest to GoI on average of such funds kept with them) and the complete exodus of these funds from the banking system is likely to impact operational efficiency of the bank(s), **viz. (a) increase in cost of deposits (b) increase in cost of lending (c) compressed Net Interest Income (NII) (d) loss to GoI through dividend income (PSBs) (e) loss of SB interest being paid on SNA-CSS (Single Nodal Agency-CSS) and (f) liquidity management of RBI by impacting systemic liquidity**

- Banking system will be impacted through the JIT mechanism as it impact government cash balances
- System liquidity slips into deficit when government is not spending whereas it improves to surplus mode when government spending resumes
- Government cash balances do not earn any interest when placed with RBI and it only earns interest when routed through banks….actually Government cash balances are auctioned by RBI…thus the JIT move though laudable could hurt
    - (a) Government in terms of foregone income as outlined above
    - RBI in terms of conduct of monetary policy

Growth in Banking Business continued

- The banking sector has performed well in FY24, credit growth continued to remain strong at 19.5% as on May 17, 2024, compared to last year growth of 15.4%.
- PSBs, cumulative profit crossed Rs 1.4 trillion in the financial year ended March 2024, recording a growth of 35 per cent over the previous year
- The credit-to-GDP gap narrowed, reflecting the improved credit demand in the economy in the face of rising capacity utilisation in the manufacturing sector. We expect the credit growth be healthy in the range 14-15%. But some moderation is expected due to higher interest rates and regulatory action by RBI, while deposit growth will continue to lag advances by 200-400 bps



ASCBs Sector-Wise Credit Flow (Rs bn): April 2024						
Sectors	(Apr-23)FY24 YTD		(Apr-24) FY25 YTD		YoY %	
	Rs bn	%	Rs bn	%	FY24 (Apr)	FY25 (Apr)
Agri. & Allied	392	16.8	427	2.1	16.8	19.7
Industry	375	7.2	35	0.1	7.2	7.4
MSE (Priority)	131	12.8	-102	-0.5	12.8	18.6
Infrastructure	361	3.4	182	1.4	3.4	4.9
Services	565	21.3	51	0.1	21.3	21.7
NBFCs	141	29.2	67	0.4	29.2	14.6
Personal Loans	370	19.4	286	0.5	19.4	27.1
Housing (Including Priority)	138	13.9	225	0.8	13.9	36.9
Other Personal Loans	183	25.7	35	0.3	25.7	19.2
Gross Bank Credit	1842	15.9	596	0.4	15.9	19.0
Source: RBI, SBI Research						

Final Thought

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

Indicator	Our View
Global Economy	❑ Political risk to dominate course of US in H2 2024 as the nation would highly polarize on key issues having a bearing on future prospects for EMs along trade / protectionism measures ❑ Chinese economy showing a resurgence with growth likely to pick up in both 2024, as also 2025 ❑ US benchmark (10Y) yields likely to move in a range, forming a wedge, data driven as Fed pivot moves ❑ Uneven balancing of growth forecasts & tech leadership between US and EU likely to prompt ECB to embrace a rate cut of 25 bps in its June 6th meet (first since 2019) as inflation nears its target
Stance & Repo Rate	❑ We believe the stance should continue to be withdrawal of accommodation ❑ Strong evidence of Emerging Economy Central Bank rate actions are predicated by Advanced Economy Central Bank rate actions…India is an exception…first RBI cut in Q3FY25…such rate cut cycle likely to be shallow
Measures to augment liquidity	❑ The impending JIT mechanism that keeps Government cash balances out of Banking system…could have an impact on liquidity… the spectre of capital flows in FY25 could pose challenges and opportunities for RBI liquidity management…temporary liquidity injections should replace temporary liquidity withdrawals…thus OMO cannot be a tool to counterbalance idiosyncrasies in Government cash balances…only VRRR can replace such.. RBI needs to innovate on liquidity management…

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