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RBI RATE HIKE CYCLE COULD EXTEND TILL DEC: A HIGHER TERMINAL RATE COUPLED WITH A LOWER GDP GROWTH IN FY24 TO PROVIDE BUFFER FOR A RATE REVERSAL CYCLE?

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As widely expected, RBI raised the Repo rate by 50 basis points to 5.90%, as the MPC seeks to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. While, the central bank retained its CPI inflation projection at 6.7% for FY23, it downgraded the real GDP growth projections for FY23 to 7.0% from 7.2% and FY24 at 6.5%. CPI is likely to remain above the 6% for first three quarters of FY23. Elevated imported inflation pressures remain an upside risk for the future trajectory of inflation, amplified by the continuing appreciation of the US dollar. **We believe that a 35 bps rate hike in December looks imminent but beyond December it would be a touch and go. Additionally, the announcement of new projects declined to Rs 4.35 lakh crore in Q1FY23 as compared to Rs 5.75 lakh crore in Q4 FY22. It seems even though the intended capex announcements slowed down in Q1FY23, the working capital utilisation is still contributing to the double-digit credit growth. We need to look at this trend for the perceived growth inflation rate trade off.**

For most of the crops, the difference between mandi prices and MSP prices have declined in the past five months. This indicates that mandi prices are actually moderating (including paddy) which will have a favourable impact on cereals inflation (which is one of the drivers of current high CPI inflation) in coming months.

Following Aizenman (2012), we estimated the monetary policy independence /MI. Interestingly, **the current MI index is at a significant 10 quarter low / March 2020** levels implying significant loss of monetary autonomy. This has happened since US Fed has increased rates unprecedentedly and India must follow the monetary decisions of US, even though Indian economy is more resilient than US economy. **The unprecedented scenario foretelling apparent loss of monetary independence of emerging economies is the key driver behind actions of their central banks.**

On the liquidity front, if we exclude the SLF extended to primary dealers (Rs 0.21 lakh crore), then liquidity is still in moderate surplus mode (Rs 0.024 lakh crore). The net durable liquidity (or, core liquidity) is also in surplus mode outstanding of Rs 3.69 lakh crore, with Government surplus cash balances amounting to Rs 3.87 lakh crore. Looking ahead, as the Government increases spending owing to higher tax collections, pressure on liquidity will ease further. In line with the current liquidity situation, RBI will continue with 14-day variable rate reverse repo (VRRR) auctions and will stop conducting 28-day VRRR auctions. **As per the RBI data, banks have reduced excess SLR in G-secs by Rs 75,000 crores till August / 1.6% of NDTL. A further 2% reduction could free up Rs 1 lakh crore and bring SLR to ~25% of NDTL. We however believe that a further reduction below 25% can only be done by banks after carefully evaluating the liquidity situation as maintaining comfortable buffer for LCR window norms given the current uncertain scenario might be a preferred option for the banks.**

The RBI has indicated **migration towards expected credit loss (ECL) regime for provisioning**. The announcement addresses the drawback that rate of standard asset provisions has not been determined based on any scientific analysis or credit loss history of Indian banks. **This provisioning framework inherently does not have countercyclical or cycle smoothening elements.** RBI has also decided to introduce a framework for securitisation of stressed assets in addition to the ARC route. This in part has been due to the preference of banks shifting to alternative avenues, with asset sales declining as a proportion to outstanding GNPAs across bank groups. This was also due to the worsening acquisition cost of ARCs as a proportion of book value of assets, reflecting higher haircuts and lower realisable values in respect of their acquired assets.

On a separate note, the recently released US New home sales data should be seen in the context of Fixed Mortgage rates vs. ARM (Adjustable Rate Mortgages) applications as also refinancing vs. new home applications. While ARM mortgages are beneficial to borrowers in the falling interest rate scenario, the present age of spiking FFR, having a cascading effect on Fixed Mortgage Rates, is forcing the borrowers to prepone in favour of FRM from ARM to ring fence from the series of future hikes in FFR through 2023 and that might be getting reflected in stronger than expected new home sales data while existing home sales data have fallen for seven straight months now. This could reverse the gung-ho generated in markets about the resilience of home financing, as recent data could be read as the preparedness of buyers to switch over to FRM (new home applications have not shown much growth anyway). Already, **prices are softening across 98 major markets and builders/sellers are reported to be offering better prices to induce buyers before mortgage rates enter the next normal**. We believe there should be a lull in the offing as US consumer sentiments may wither going forward. **However, the funny part is that domestic bond investors have been unnecessarily spooked by this data as an interpretation of still strong US consumer sentiments despite Fed being on a rate raising spree.**

RBI RAISES RATE BY 50 BPS

- As widely expected, RBI today raised the rate by 50 basis points to 5.90%, as the MPC seeks to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. However, the decision was not unanimous. One of the members voted to increase the repo rate by 35 bps and while another member voted against the withdrawal of accommodation. The SDF now stands adjusted to 5.65%.
- RBI has retained CPI inflation projection at 6.7% for FY23 despite uncertainty surrounding the course of geopolitical conditions. There is some easing of input cost and output price pressures across manufacturing, services and infrastructure firms, however, the pass-through of input costs to prices remains incomplete. The outlook for crude oil prices is highly uncertain and tethered to geopolitical developments. Elevated imported inflation pressures remain an upside risk for the future trajectory of inflation, amplified by the continuing appreciation of the US dollar. CPI inflation projections for Q2 is 7.1%; Q3 is 6.5%; Q4 is 5.8% and Q1 FY24 is projected at 5.0%.
- RBI has downgraded the real GDP growth projections for FY23 to 7.0% from 7.2% due to geopolitical tensions, tightening global financial conditions and the slowing external demand. However, rural demand is catching up and urban demand expected to strengthen further. Consumer outlook remains stable and firms in manufacturing, services and infrastructure sectors are optimistic about demand conditions and sales prospects. RBI's GDP growth projections for Q2 is 6.3%; Q3 is 4.6%; and Q4 is 4.6%.

WHAT IS THE CURRENT STATUS OF RBI MONETARY INDEPENDENCE?

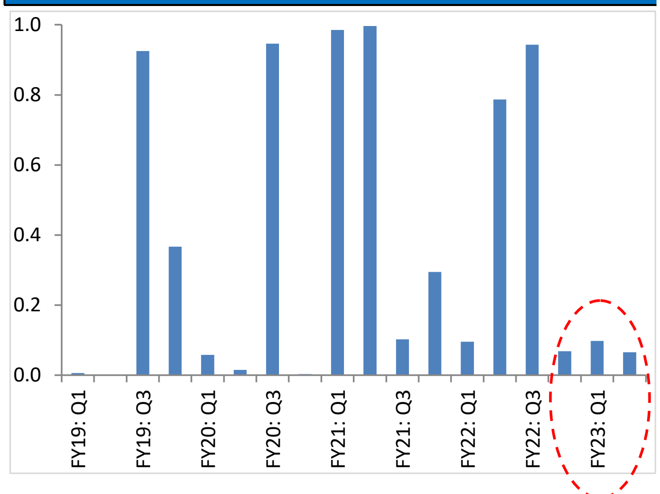
- Following Aizenman (2012) we estimated the monetary policy independence /MI as the reciprocal of the correlation of the weekly short-term interest rates (91-days treasury bills) between the home country (i.e., India) and the base country (the US).
- As expected, the MI index is at significantly 10-quarter low levels now, implying significant loss of monetary autonomy. This has happened since US Fed has increased rates unprecedentedly and India may have to recalibrate the monetary decisions of US Fed. Thus, the actions of EME's central banks going forward could largely be dictated by the unprecedented scenario prevailing on loss of MI front.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q2 FY23	Q3 FY23	Q4 FY23	FY23	Q1 FY24
Sep'22	7.1	6.5	5.8	6.7	5.0
Aug'22	7.1	6.4	5.8	6.7	5.0
Jun'22	7.4	6.2	5.8	6.7	-
Real GDP (%)	**Q2 FY23**	**Q3 FY23**	**Q4 FY23**	**FY23**	**Q1 FY24**
Sep'22	6.3	4.6	4.6	7.0	7.2
Aug'22	6.2	4.1	4.0	7.2	6.7
Jun'22	6.2	4.1	4.0	7.2	-

Source: RBI, SBI Research

Monetary Policy Independence



Source: SBI Research

$$MI = 1 - \frac{corr(i_i, i_j) + 1}{2}$$

DIFFERENCE BETWEEN MANDI PRICES AND MSP IS NARROWING

- In most of the crops the difference between mandi prices and MSP prices has declined in the past five months. This indicates that mandi prices are actually moderating (including paddy) which will have a favourable impact on cereals inflation (which is one of the drivers of current high CPI inflation) in coming months.

DEVELOPMENTAL AND REGULATORY MEASURES

Development and regulatory policies include two major announcements both in respect of management of credit risk by banks.

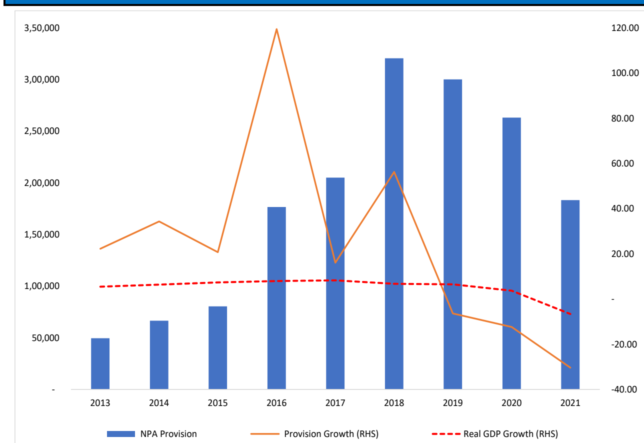
- The RBI has indicated **migration towards expected credit loss (ECL) regime for provisioning**. The announcement addresses the drawback that rate of standard asset provisions has not been determined based on any scientific analysis or credit loss history of Indian banks. This provisioning framework inherently does not have countercyclical or cycle smoothening elements. The movement in provisioning towards NPA vis-à-vis real GDP is shown in graph.
- The second major announcement is in respect of **securitisation of NPAs**. RBI has decided to introduce a framework for securitisation of stressed assets in addition to the ARC route, similar to the framework for securitisation of standard assets. This in part has been due to the preference of banks shifting to alternative avenues, with asset sales declining as a proportion to outstanding GNPAs across bank groups. This was also due to the worsening acquisition cost of ARCs as a proportion of book value of assets, reflecting higher haircuts and lower realisable values in respect of their acquired assets.
- Further, the share of security receipts (SRs) subscribed to by banks has decreased over the years, and their share hovered around 58% in 2019-20 and 2020-21. The share of ARCs in SR holdings has declined over the years, with the investor base having gradually diversified with an increasing share of foreign banks and other institutional investors.
- **Further easing of Internet banking facility to RRB customers**. This is a welcome step and **in our special report dated 01 Apr'22**, we have highlighted this point prominently. In our report we mentioned that RRBs are mandated to fulfil several conditions such as CRAR, NPA, Profitability etc. for providing transaction rights to their INB customers. We pointed out that it will be useful if outcome based regulation is separated from rule based regulation and Internet Banking Transaction Rights are purely made ex-ante and not ex-post for the RRBs.

Difference between Mandi Prices and MSP (Rs/Qtl)

Crops	Apr-22	Jun-22	Aug-22
Kharif crops			
Jowar	-646	-499	-363
Bajra	57	-186	-46
Maize	226	361	432
Ragi	-804	-882	-758
Arhar	-479	-543	139
Urad whole	494	408	1038
Soyabean	3163	2295	1793
Paddy Common	2141	2627	1831
Cotton	3996	4613	3806
Sesamum	2422	1862	3071
Niger Seed (Ramtil)	-2001	270	-280
Rabi Crops			
Wheat	258	256	463
Barley	764	843	812
Gram whole	176	-273	131
Masur/Lentil	3459	3243	2987

Source: Agrimarknet, SBI Research; Green (MSP less), Yellow (MSP more)

Movement of ASCB NPA Provision and Real GDP Growth



Source: RBI, SBI Research

WHAT US HOUSING SECTOR IS FORETELLING

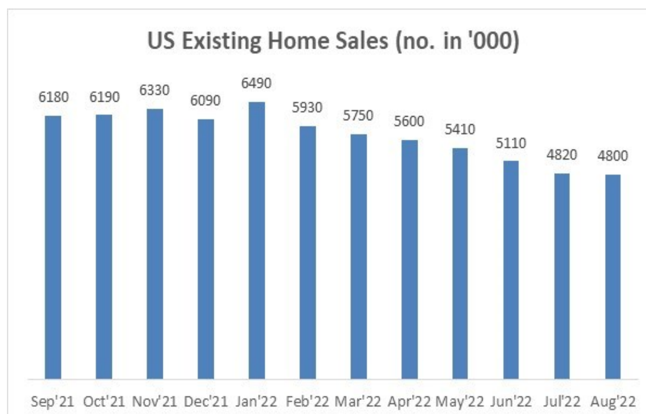
- For a sector that has hardly been able to move away fully from the scars of sub-prime days, that eventually led to GFC and its cataclysmic systemic effects through QE and sovereign bail outs in years ahead, recently published (27 Sep) US NEW residential sales statistics for August'22 cheered the markets as elevated sales, stronger than market forecasts, indicated possibility of consumer sentiment resilience acting in defiance of crumbling market minarets, with all asset classes getting hammered in the sell off against a looming recessionary scenario. The 'bounce back' exuberance, however, looks a flimsy froth.
- Analysing US housing markets sales trend since 1974, when Freddie Mac started collecting the data for 30-year Fixed Rate Mortgage (30-Y FRM), the decades later have seen wide variation in home sales as also financing new homes / refinancing existing homes rates through both Fixed rate as also Adjustable rate mortgages (ARM) of various tenor. From a high of 18.45% in 1981, 30-Y FRM were hovering sub-3% in 2020-21, prompting substantial sales of homes by byers who rushed to lock down the rates (FRM).
- The four major territories where home sales data are collated show varying trends with home sales not picking in important geographies. Existing (previously owned) home sales in the US edged 0.4% lower (seasonally adjusted) to 4.8 million in Aug'22, the lowest figure since May'20, continuing the course from a downwardly revised 5.7% fall in July.
- Hence the strong US housing data should be seen in the context of FRM vs. ARM applications as also refinancing vs. new home applications. While ARM mortgages are beneficial to borrowers in the falling interest rate scenario, the present age of spiking FFR, having a cascading effect on Fixed Mortgage Rates, is forcing the borrowers to prepone in favour of FRM from ARM to ring fence from the series of future hikes in FFR through 2023 and that might be getting reflected in stronger than expected new home sales data. This could reverse the gung-ho generated in markets about the resilience of home financing, as data could be read as the preparedness of buyers to switch over to FRM (new home applications have not shown much growth anyway). We believe there should be a lull in the offing as US consumer sentiments wither going forward. However, the funny part is that domestic bond investors have been unnecessarily spooked by this data as an interpretation of still strong US consumer sentiments even as Fed is raising rates.

NEW RESIDENTIAL SALES AUGUST 2022

New Houses Sold[1]:	685,000
New Houses For Sale[2]:	461,000
Median Sales Price:	$436,800

Next Release: October 26, 2022

[1]Seasonally Adjusted Annual Rate (SAAR)
[2]Seasonally Adjusted
Source: U.S. Census Bureau, HUD, September 27, 2022



US MORTGAGE RATES MOVEMENT 1974 –2022 (FRM 30/15Y) & ARM (5/1Y)

Source: US Census Bureau/US DOHUD, SBI Research

MODERATION IN SURPLUS LIQUIDITY

- Liquidity has been in deficit mode of late, with the net LAF injection of Rs 0.19 lakh crore as on 29 Sep'22. However, if we exclude the SLF extended to primary dealers (Rs 0.21 lakh crore), then liquidity is in moderate surplus mode (Rs 0.024 lakh crore).
- Even the average net LAF absorption since Aug'22 stands at Rs 0.87 lakh crore, indicating moderate surplus. Further, if we exclude the SLF extended to primary dealers (average of Rs 0.35 lakh crore), then average liquidity surplus increases (Rs 1.2 lakh crore). The net durable liquidity (or core liquidity) is also in surplus mode outstanding of Rs 3.69 lakh crore with Government surplus cash balances amounting to Rs 3.87 lakh crore. Advance tax outflows and GST payments temporarily moderated surplus liquidity in the third week of September.
- RBI has been managing liquidity actively. The surplus liquidity moderated in H1 FY23, driven by the CIC demand, net forex outflows and the build-up in government's cash balances. The drawdown by banks of their excess reserves partially ameliorated liquidity pressures.
- RBI used OMO sales and increase in CRR by 50 bps to suck out liquidity from the banking system in H1 FY23. The consequent moderation in surplus liquidity was reflected in lower absorptions under the LAF – the average daily liquidity absorption under the LAF fell from Rs 7.7 lakh crore in April to Rs 1.9 lakh crore in September (till 29 Sep'22). Looking ahead, as the Government increases spending owing to higher tax collections, pressure on liquidity will ease further. In line with the current liquidity situation, RBI will continue with 14-day variable rate reverse repo (VRRR) auctions and will stop conducting 28-day VRRR auctions.

RBI Liquidity Position (Rs lakh crore)

	01-Apr-22	Latest
Repo Outstanding	0.84	0.84
Reverse Repo Total	6.78	0.48
SDF statrted on 08.04.2022	2.35	0.75
MSF	0.01	0.34
Net LAF (+absorption)	6.35	-0.19
Government Cash Balance	1.08	3.60
Core Liquidity (+Surplus)	8.32	3.69
System was in deficit mode for 20,21, 27, 28 and 29 Sep'22		

SIGNIFICANT IMPROVEMENT IN RESOURCE FLOW

- Total flow of financial resources from banks and non-banks to the commercial sector has improved significantly to Rs 9.3 lakh crore in this financial year so far (up to September 9) from Rs 1.7 lakh crore in the corresponding period of last year mainly contributed by Bank credit with incremental credit of Rs 6.6 lakh crore as compared to a decline of Rs 0.37 lakh crore last year.
- However, mobilisation of resources through the issuances of CPs fell to Rs 7.20 lakh crore during H1FY23 (up to September 26) from Rs 10.09 lakh crore in H1FY22 and bond primary issuances also, as per the provisional numbers, declined by around 10% to Rs 2.9 lakh crore in FY23 so far.
- Further, public equity fundraising, in first half of FY23 also dropped by 55 per cent, due to uncertain market condition, to Rs 41919 crore from Rs 92191 crore in the corresponding period of the previous year.

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