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Tone balanced, path cautious

Monetary Policy Review

February 7, 2018

- The Reserve Bank of India's (RBI), Monetary Policy Committee (MPC) left the policy rates unchanged at its review meeting on Wednesday. It maintained the repo rate at 6%, the reverse repo at 5.75%, and the marginal standing facility rate at 6.25%. Five of the six committee members supported the decision, with one voting for a 25 basis points (bps) hike.
- The MPC believes the Indian economy's recovery is still nascent, and requires nurturing. Therefore, any rate action needs to be taken with due caution and after weighing the data. The MPC flagged a slew of inflationary pressures in the shape of crude oil prices, fiscal slippage, and any pass-through of higher minimum support prices (MSPs) on crops to food inflation, which will need monitoring in the coming months.
- The MPC maintained its neutral monetary policy stance with a focus on maintaining medium-term inflation at 4%, while supporting growth. However, it will stay vigilant on the evolving inflation scenario. The inflation forecast for fiscal 2018 was upped ~20 bps, to 3.8% average after including the impact of house rent allowance. Inflation for fiscal 2019 is forecast at ~5% average, with upside risks. This fiscal's forecast for gross value added (GVA) growth was lowered 10 bps to 6.6% and set at 7.2% for fiscal 2019.
- The RBI has allowed a 180-day dispensation for classifying non-performing Goods and Services Tax-registered (GST-registered) small and medium enterprise accounts as non-performing assets (NPAs), as against 90 days currently. This would lower asset quality pressure for banks and ensure continued flow of credit to SMEs. The harmonisation of benchmark rates may not help borrowers whose loans are still linked to the base rate, given the upward bias in interest rates.

Our view

CRISIL Research believes the MPC's stance is along expected lines. So far, inflation has stayed within the projected trajectory despite an upside from the prices of oil, fruits and vegetables, and higher housing inflation. In fiscal 2019 too, the MPC expects inflation to be higher on an annual average basis, but sees significant moderation in the second half. In light of this, **CRISIL expects the repo rate to remain unchanged over the next six months unless significant upside risks to the MPC's inflation forecast materialise.**

Rate hike pressures could mount in case of the following risks:

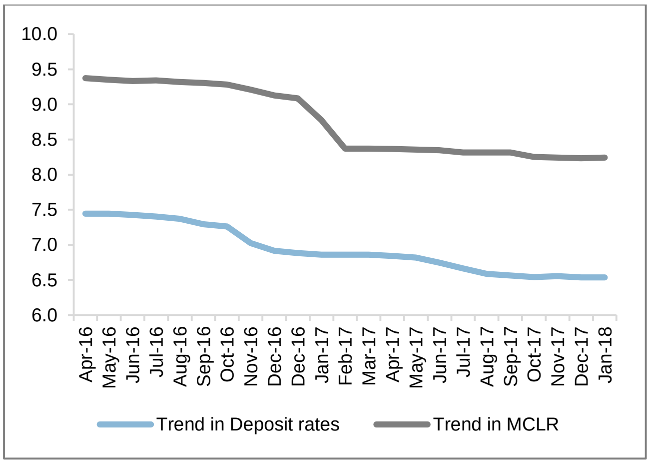
1. **Fiscal actions exert higher influence on inflation:** A fiscal deficit slippage of 0.3% of GDP each in fiscals 2018 and 2019 implies extra spending of Rs 1.2 trillion over what was targeted. Since most of this is revenue, an inflationary impact cannot be discounted. Similarly, elements of the MSP announcement, such as setting it at 1.5 times the cost of production, extension of MSP to all kharif crops, and assuring at least MSP is paid to all farmers, together with rise in import duties, can feed inflation. The MPC awaits clarity on the quantum of MSP increases and their likely rollout to assess the impact on inflation.
2. **Firmer input prices translating into higher core inflation:** Input prices are expected to see an uptick in 2018 -- CRISIL Research forecasts global crude oil prices to rise to $63-68/barrel from $54.1/barrel in 2017, while the World Bank forecasts a near 2% increase in metal prices. Given improving domestic demand conditions, manufacturers are likely to pass on higher input prices to consumers, which will show up in core inflation. Already, core inflation has stayed elevated and, even after excluding the category of housing inflation, core inflation has been edging up since November 2017.
3. **Rising interest rate differential:** Stronger recovery in the United States and expectation of three more Fed rate hikes in 2018 have led US benchmark yields to steadily firm up, making them attractive. Particularly in India, foreign capital inflows to the debt markets have slowed post October 2017. Though external factors do not play an important role in the policy rate decisions of the MPC, such developments are not easy to ignore in the present interconnected world.

Banking sector view

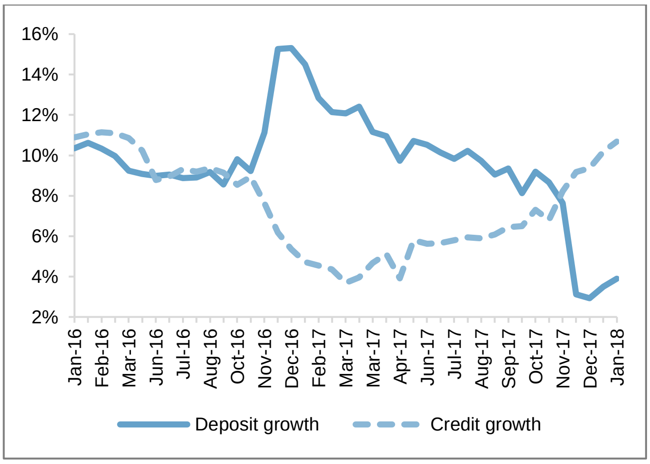
Credit growth ticking up

Credit growth touched double digits for the first time since September, 2016, growing by 10.7% as of January 5, 2018. As of December 2017, industrial credit (which accounts for 36% of gross bank credit) grew 2%, while the services sector (25% of gross bank credit) and the retail segment (25% of gross credit) expanded by double digits, at 15% and 19%, respectively. Deposits growth has slowed to 3.9% as of January 5, 2018, taken against the high base of the post-demonetisation surge in deposit growth. CRISIL Research expects banking credit to grow 9-10%, supported by improved economic growth, domestic demand, and capital inflow for public sector banks, while deposit growth will grow at 6-7% in fiscal 2018 as the impact of demonetisation subsides.

MCLR and deposit rates of banks



Credit and deposit growth of banks



Note: Average of one-year MCLRs (marginal cost of funds-based lending rate) of 10 banks considered. Deposit rate is the average of 1 to 2 years of maturity, considered for 10 banks.

Source : RBI, CRISIL Research

GNPAs to remain high

Gross non-performing assets (GNPAs) of the banking system have increased to ~9.6% as on March 31, 2017, from 7.5% as on March 31, 2016. The asset quality of banks further deteriorated in the second quarter of fiscal 2018, as a result of which the GNPA increased to ~10.2% as of September 2017. We expect slippages to be lower in fiscal 2018, compared with the previous two fiscals. However, the GNPA is nevertheless expected to remain elevated and touch 10.5% of advances by March 31, 2018, due to slower recoveries.

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