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Standing pat

Monetary Policy Review

October 4, 2017

- The Monetary Policy Committee (MPC) of the Reserve Bank of India today kept its policy rates unchanged, with repo rate at 6%, the reverse repo rate at 5.75%, and marginal standing facility rate at 6.25%. Five out of six members of the committee were in favour of the decision, while one voted for a 25 basis points (bps) cut.
- The MPC maintained its neutral monetary policy stance, but remains concerned on the inflation trajectory given the recent rapid rise in inflation (excluding fuel and food). For the first five months of fiscal 2018, consumer price inflation (CPI) averaged 2.5%. The MPC expects the second half of fiscal 2018 to see CPI average 4.3-4.6% after including the impact of house rent allowance promised by the Centre. The MPC reiterated its focus to maintain medium-term inflation at 4%.
- The MPC sharply cut its gross value added (GVA) growth forecast to 6.7% from 7.3% estimated earlier taking cue from a sharper-than-expected slide in growth in the first quarter of fiscal 2018 and initial hiccups faced by the manufacturing sector due to goods and services tax (GST) implementation.

Our view

The MPC's stance is in line with our expectation. To be sure, there are concerns with GDP growth sliding down to a thirteen-quarter low of 5.7% in the first quarter of fiscal 2018. But a large part of the slowdown is expected to be transitory, led by waning impact of demonetisation and initial hiccups because of the implementation of GST. Though this does bring down our full-year GDP growth estimate to 7% (from 7.4% earlier, and also below the fiscal 2017 estimate of 7.1%), the economy will grind up over the next few quarters as the impact of demonetisation and destocking due to GST implementation wears off.

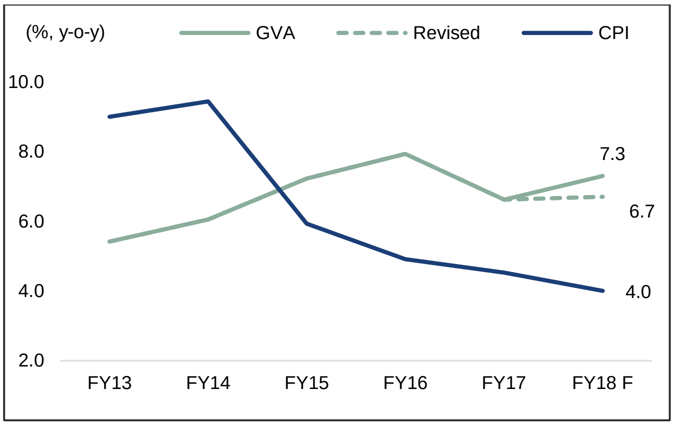
Preliminary signs of bottoming out in some sectors are visible -- auto sales have started picking up in July and August led by passenger and commercial vehicles, while core infrastructure sector data shows that on-year production growth so far in the second quarter is higher than in the previous quarter.

Meanwhile, although inflation remains within the 4% band, its steady rise has led the MPC to flag concerns. Waning of low-base effect, some bump up in oil prices, and the possible impact of GST have led to a rapid rise in the consumer price index (CPI)-based inflation. In August, CPI inflation jumped to 3.4% from 2.4% in July. More importantly, despite the dent in demand due to recent disruptions, core inflation (which excluded food, fuel, light, petrol and diesel) has stayed quite sticky. Core inflation fell just 120 bps from its peak in June 2016 to 3.9% in June 2017, whereas overall inflation fell 460 bps during that period. Core inflation has now climbed up to 4.4%.

Going ahead, if the risks to growth rise, and inflation undershoots the MPC's forecast, then there is a possibility of a rate cut. The second-quarter GDP data will be a key deciding factor. If growth sulks down further, it can potentially bring down core inflation, too. A dip in core can provide a faster downside to overall inflation. Meanwhile, reasonably healthy food production aided by good monsoon will keep food inflation low, too.

MPC's dilemma – to pick growth or inflation?

Inflation is low, but so is growth



Note: GVA forecasts are by the MPC, inflation forecast is by CRISIL
Source: CSO, CRISIL Research

A rate cut at this juncture will only mildly support private consumption in our view. Private investment revival hinges on many other factors which are yet not favourable. Capacity overhang and high leverage that persist in many sectors will hold back any meaningful revival of private investment this fiscal. And with government's ability to spend constrained by the fiscal math, overall investments will remain subdued this year as well.

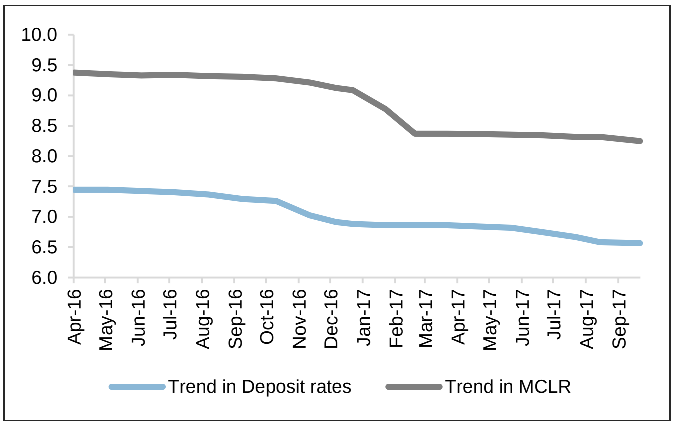
Private consumption will, therefore, be the key driver of growth. The role of private consumption is important because unless huge capacities with manufacturing firms are utilised, appetite to invest will not come by. Currently, some levers to push up consumption growth in the economy are active. These include a near-normal monsoon, benign inflation, lower interest rates facilitated by improved transmission post demonetisation, the Seventh Pay Commission revision-led increases in salaries and pensions, and the retail focus of banks and non-banks. However, the dent to demand due to demonetisation has prolonged because of the uncertainty following the implementation of GST.

Banking sector view

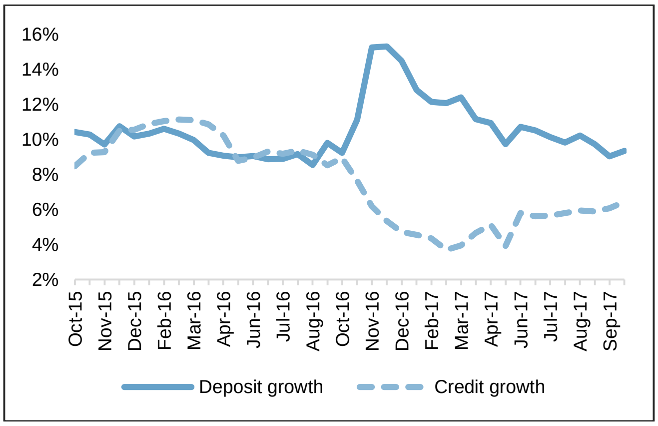
Credit growth to pick- up in fiscal 2018

As of September 15, 2017, credit growth was 6.5%, showing some signs of a recovery from the after-effects of demonetisation. As of August 2017, industrial credit (which accounts for 38% of gross bank credit), declined 0.3%, while the services sector (which accounts for 24% of gross bank credit) registered moderate growth of 5%. Thus, credit growth was mainly supported by the retail segment (which accounts for 24 % of gross bank credit), clocking a double-digit increase of 15.7%. Deposit growth continues to be strong at 9.4% as of September 15, 2017, though it is now lower than the peak of 15.3% in December 2016, as the impact of demonetisation is tapering off. In 2017-18, CRISIL Research expects banking credit to grow 8-10%, supported by an improvement in economic growth and domestic demand, while deposit growth will remain strong at 9-11%.

MCLR and deposit rates of banks



Credit and deposit growth converging



Note: Average of one-year MCLRs 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

Notwithstanding the reduction in bank lending rates at the beginning of calendar 2017, asset quality has remained under pressure. Gross non-performing assets (GNPAs) in 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 first quarter of 2017-18, as a result of which GNPA increased to ~10.2% as of June 2017. We expect slippages to be lower this fiscal, compared with the previous two, but overall GNPAs are expected to remain elevated and touch 10.5% of advances by March 31, 2018, because of slower recoveries.

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