Stance stays, tone eases

Monetary Policy Review

June 7, 2017

- The Monetary Policy Committee (MPC) review meeting concluded today, announcing no policy rate change (repo rate stays at 6.25%, the reverse repo rate at 6%, and marginal standing facility rate at 6.5%). It maintained its neutral monetary policy stance, but significantly softened its tone on inflation. Five out of six members were in favour of the monetary policy decision.
- The MPC's fiscal 2018 forecasts on gross value added (GVA) growth and consumer price inflation (CPI) were both lowered. GVA growth was mildly reduced to 7.3% (down 10 basis points) but the inflation forecast was brought sharply down to ~ 3.5% (from 4.8% average). The MPC reiterated its medium-term inflation target of 4%.

Our view

Despite a sharp reduction in its inflation forecast, the MPC's policy stance has been kept neutral citing inflation risks *(see below)* on which they seek more clarity. ***Yet, we believe, given the likely undershooting of inflation, the 'neutral' stance has a de facto softening bias. Our inflation forecast is lowered to 4% (down from 5% earlier) for fiscal 2018, given the downside from food inflation. We now assume increased chances of a 25 basis points (bps) repo rate cut, most likely in the August MPC review meeting.***

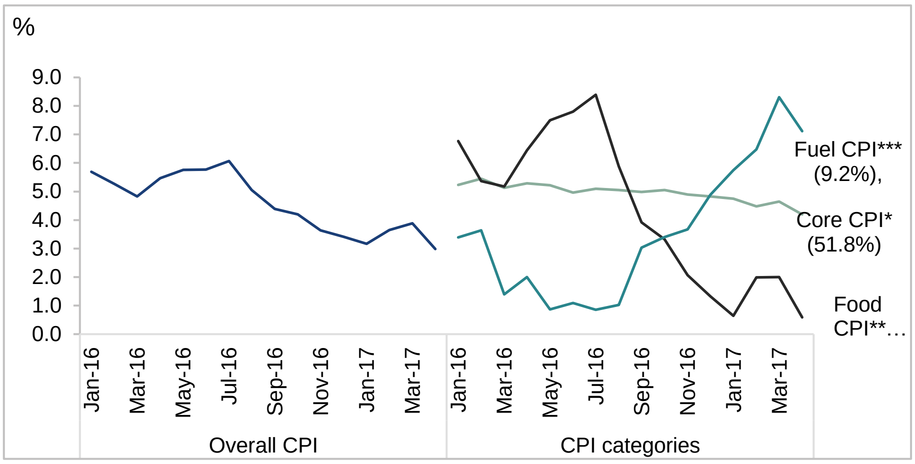
Why a lower inflation number for fiscal 2018?

Inflationary pressures have reduced dramatically in the last several months, with food inflation (especially pulses and vegetables) being the key driver. The latest inflation print (for April 2017) was 3% with food inflation at 0.6%. True that a dent to demand from demonetisation and fire sales during the period must have played a transitory role, but the continued drop in food inflation (both perishables and non-perishables) even in 2017 speaks of a longer lasting impact of robust food supplies on prices. Latest estimates by the Ministry of Agriculture suggest that growth in food grain production, at nearly 9% in fiscal 2017, was the highest in six years, with pulses production rising 37% on-year. For fiscal 2018 too, agriculture production is expected to stay healthy given the Indian Meteorological Department's (IMD) rainfall forecast of 98% of normal. Two consecutive years of normal and evenly distributed rains have in the past brought extended period of gains to food production and prices. ***We therefore expect food inflation to stay low this fiscal, which should keep a tab on overall inflation.***

What drives the MPC's yet cautious stance on policy rates?

Lack of clarity on three key factors is probably behind the MPC's decision to maintain caution. ***One*****,** the distribution of rainfall. The IMD has forecast normal rains but past instances show that evenly distributed rains are equally crucial. Clarity on that will only emerge as the monsoon season progresses. ***Second****,* the impact of revision in house rent allowance on inflation trajectory also remains unknown. With a weight of 10% in CPI, housing inflation at over 5% is already a concern. The MPC estimates that if the recommended increase in HRA is adopted, just the direct impact on CPI could be to the tune of 100-150 bps over their forecast. ***Three****,* resilience in private consumption demand even during the demonetisation phase, and uncertainty of its persistence reduces clarity on the core inflation (inflation excluding food and fuel items) trajectory. Core inflation is the stickier part of overall inflation. In fiscal 2017, while overall inflation fell to 4.5%, core inflation was almost 5%. Therefore, persistence in consumption demand can keep core inflation high and arrest the decline in overall inflation. The MPC has chosen to await developments on these factors before embarking on an accommodation cycle.

Inflationary pressures dipping



*Note: *excludes food, fuel, light, petrol, diesel, **excludes food, non-alcoholic beverages, prepared meals, ***excludes fuel, light, petrol and diesel. Figures in brackets indicate weight in the CPI basket*

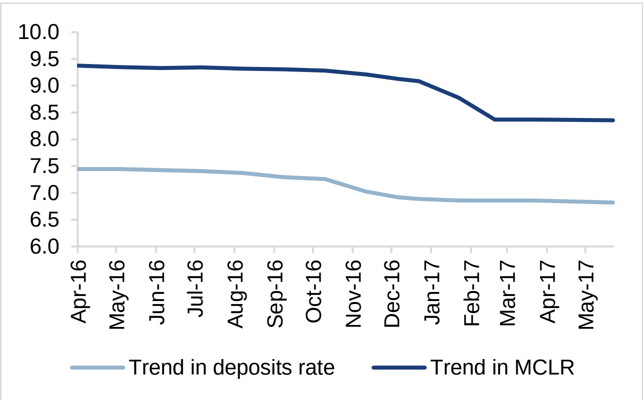
Source: RBI, CEIC, CRISIL Research

Banking sector view

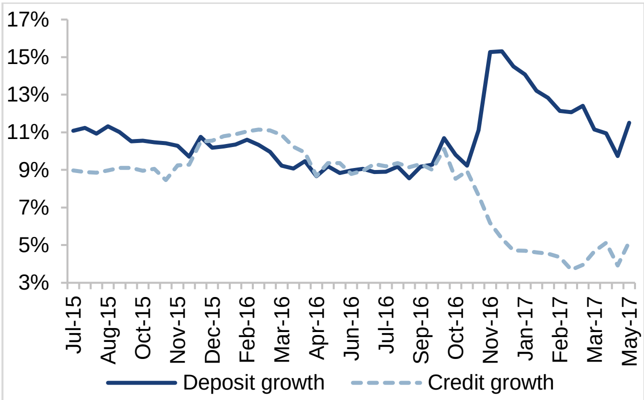
Credit growth to pick-up in FY18

As of May 12, 2017 credit growth was 5.2%, showing some sign of recovery from the after-effect of note ban. As of March, 2017 industrial credit (which accounts for ~38% of gross bank credit) de-grew by 1.9%, while growth was mainly been supported by services sector (26% of gross bank credit) which showed strong double digit growth of 19.5%. Retail credit (23% of gross bank credit) clocked a double-digit increase of 16.7%. Also, a 50 bps cut (starting June 24) in the statutory liquidity ratio (SLR), while theoretically infusing more liquidity, has little bearing because banks have preferred to maintain far higher levels of SLR for a long time now. Deposit growth continues to be strong, up 11.5% as of May 12, 2017, but is still below the peak of 15.3 seen % in December 2016 as the impact of demonetisation is tapering. This fiscal, CRISIL Research expects the banking credit to grow at 8-10% supported by an improvement in economic growth and domestic demand, while deposit growth will hover around 10-12%. Given abundant liquidity and the rather tepid credit demand, banks could reduce interest rates anew over the next few months.

Trend in MCLR and deposit rates (%) of banks



Credit and deposit growth at divergence



Note: Average of 1Yr MCLR rate of 10 banks considered. Deposits rate is average of 1 to 2 years of maturity is considered for 10 banks
Source: RBI, CRISIL Research

GNPAs to remain high going forward

Asset quality in the banking system remains under pressure. Gross non-performing assets (GNPAs) are expected to have increased to ~9.5% as on March 31, 2017, from 7.5% as on March 31, 2016. We expect slippages to be lower in fiscal 2018 compared with the previous two fiscals, but GNPAs are nevertheless expected to remain at elevated levels and touch 10.5% of advances by March 31, 2018, due to slower recoveries.

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