Standing pat after de facto tightening

Monetary Policy Review

April 5, 2018

- The Reserve Bank of India's (RBI), Monetary Policy Committee (MPC) kept policy rates on hold at its review meeting on Thursday. 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 decision to hold is based on uncertainty on the inflation trajectory, mainly (i) impact of minimum support price (MSP) announcement on food prices, (ii) staggered impact of house rent allowance (HRA) revisions by state governments and possible second round pressures of HRA revisions on overall inflation, (iii) impact of possible fiscal slippages, and (iv) uncertainty on the distribution of monsoon. All this will need monitoring in the coming months. Therefore, any rate action needs to be taken with due caution and after weighing the data.
- The MPC maintained its neutral monetary policy stance with a focus on maintaining medium-term inflation at 4%. For fiscal 2019, the MPC revised down its inflation outlook supported by recent sharp moderation in food prices and the statistical downside that will accrue in mid-2018 as the impact of the Seventh Pay Commission payments fades. The inflation forecast for fiscal 2019 is revised down to ~4.7% average, from ~5% estimated earlier. Yet, given upside pressures, the MPC will stay vigilant on the evolving inflation scenario. The forecast for gross domestic product (GDP) has been kept unchanged at 7.4% for fiscal 2019.

Our view

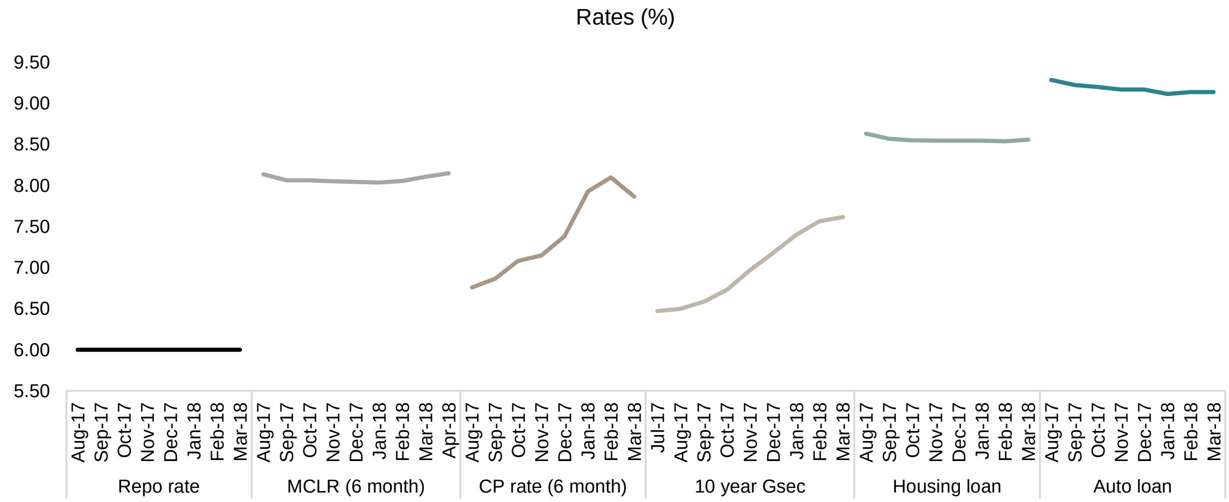
The status-quo was on expected lines. **CRISIL expects the repo rate to remain unchanged over the next six months unless upside risks to the MPC's inflation forecast materialise.**

Even with the RBI's neutral stance, there was a de facto interest rate tightening in the banking system. The risk-free rate in the economy – the 10-year government security yield – jumped 40 basis points (bps) this year so far on fears of fiscal slippage. But this has corrected now due to a trimmer borrowing program announced by the government for first half of fiscal 2019 and today's MPC decision to keep the rates on hold. Meanwhile, banks also had started raising their deposit and loan rates after a nearly four-year rate easing cycle.

Inflationary pressures need watching: Between the February MPC meet and now, some inflationary pressures have reared up. Global crude oil prices have continued to rise since then and are now nearly 27% higher on-year. In fiscal 2019, CRISIL expects prices to rise another 13%. Similarly, metal prices are also firmer. Given improving domestic demand conditions, manufacturers are likely to pass on higher input prices to consumers. Similarly, there could also be pressure on food inflation if 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 are implemented. All this will need monitoring in the coming months.

De facto tightening of interest rates: Fiscal pressures drove up the yield on the 10-year G-sec to 7.62% by March (average), from 7.18% in December. G-Sec yields have however, softened now. Similarly, banks, too, had started raising their lending rates led by two factors (i) expected drying up of surplus liquidity from the banking system as the RBI aims to go back to maintaining neutral conditions, and (ii) return of demand for bank credit from corporates as interest rates in the bond market firm up. About 7-8 banks have raised their marginal cost of lending rate (MCLR) by about 10 to 20 bps in 2018 so far, suggesting that despite the repo rate staying unchanged, banks appear to be pricing in an expectation of turn in the interest rate cycle. With today's non-move, the upside risks to lending rates has reduced.

Market interest rates rising despite status quo on policy rates



*Note: *period-end, **6 month tenure, ***major 10 banks, average, ****top 7 public sector banks, average.*

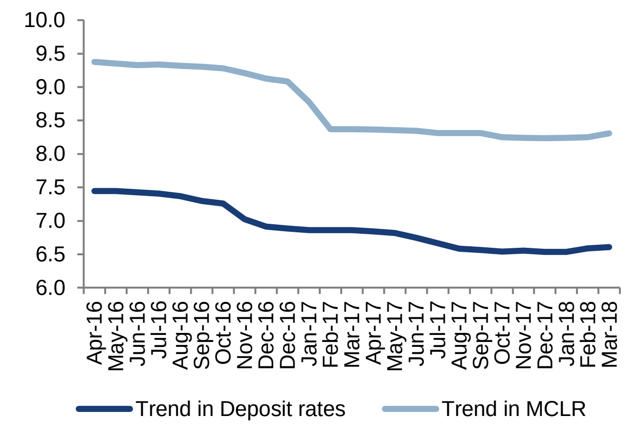
Source: RBI, CEIC, CRISIL Research

Banking sector view

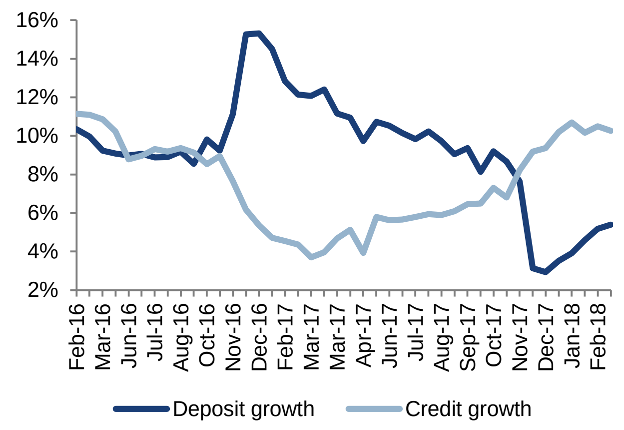
Credit growth ticking up

Credit growth grew in double digits at 10.3% as of February 16, 2018. Industrial credit (which accounts for 36% of gross bank credit) expanded 1%, while the services sector (25% of gross bank credit) and the retail segment (25% of gross credit) increased by 14% and 20%, respectively. Deposits growth has clawed up post November to scale 5.4% as of February 16, 2018. CRISIL Research expects banking credit to grow 8-9% and 10-12% in fiscals 2018 and 2019, respectively, supported by improved economic growth and domestic demand. While deposit growth will likely reach 6.5-7% and 7-7.5%, respectively, credit growth will be marginally higher, leading to a higher credit-deposit (CD) ratio. We expect the CD ratio to improve to 77-80% in fiscals 2018 and 2019.

MCLR and deposit rates of banks



Credit and deposit growth of banks



Note: Average of one-year marginal cost of funds-based lending rates (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 lower lending rates of banks at the beginning of calendar 2017, asset quality has remained under pressure. Gross non-performing assets (GNPAs) have increased to ~10.3% as of December 2017 from ~9.3% as on March 31, 2017.

While we expect lower slippages this fiscal compared with the previous two ones, the GNPAs will still remain elevated, touching 10.5% of advances by March 31, 2018 owing to slower recoveries. However, the pace of fresh additions to NPAs has declined in fiscal 2018 and is expected to break stride further in fiscal 2019. This would be supported by continued improvement in credit outlook of corporate sector, driven by rising commodity prices, stabilization in operating cycles and improved debt protection metrics. Thus, CRISIL Research expects the GNPA as a proportion of total advances to come down to ~10.3% in fiscal 2019 after touching ~11%.

Developmental and Regulatory policies announced

- With the view to promoting greater credit discipline among working capital borrowers, RBI proposed to stipulate a minimum level of loan component in fund based working capital finance for large borrowers. Draft guidelines are being issued for feedback in this regard.
- RBI has decided not to activate Countercyclical Capital Buffer (CCCB) at this point of time.
- RBI decided to defer implementation of Indian Accounting Standards (Ind AS) by SCBs (excluding RRBs) by one year (April 1, 2019).
- In order to have unfettered access to all payment data for supervisory purposes, RBI decided that all payment system data will be stored only in India, companies required to ensure the compliance within 6 months.

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