

Wait and watch

Monetary Policy Review

December 5, 2018

The development

- As widely expected, the Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC) decided to keep policy rates on hold. Repo rate, therefore, stays at 6.50%, and the reverse repo and marginal standing facility (MSF) rates at 6.25% and 6.75%, respectively. The MPC also continued with its policy stance of *calibrated tightening*. All the six members of the MPC supported the decision to keep rates on hold. However, one of six members voted in favour of change in the stance back to neutral in view of inflation undershooting.
- The decision to hold the rate was based on the following factors: i) A slower-than-expected inflation print in the last few months and abatement in some of the upside risks to the future inflation path, and ii) to support liquidity in the system, which has come under pressure recently, and to address downside risks to growth
 - Inflation based on the consumer price index (CPI) has remained below the RBI's medium-term target of 4% in the last three months, reaching a 13-month low of 3.31% in October 2018. This is largely attributed to food inflation, which has been unusually subdued in the past few months, with a negative print (-0.8%) in October. Mandi prices of many commodities languishing below their minimum support prices (MSPs) and a healthy food output have pushed food inflation lower. On its part, fuel inflation is expected to be assuaged by a reduction in global crude oil prices and excise cut on petrol and diesel. Taking cognizance of these developments, RBI had reduced its inflation forecast for H2 2018-19 to 2.7-3.2%, from 3.9-4.5% earlier. It, however, continued to cite several upside risks to inflation such as impact of MSPs going ahead, uncertainty on crude oil prices basis geo-political tensions, any fiscal slippage at centre/state level, staggered impact of state level HRA revision etc.
 - Liquidity in the NBFC space and systemic liquidity in the banking system have come under deficit in the past few months. The RBI has been trying to address both. The central bank has reduced the minimum holding period requirement for NBFCs raising funds via securitisation of loans of original maturity above 5 years. To support liquidity in the banking system, the RBI has jacked up open market operations (OMO). It conducted OMOs worth Rs.360 billion in October and Rs.500 billion in November. And injected Rs 560 billion and Rs.806 billion of liquidity under LAF in October and November respectively. To improve the assessment of liquidity requirements by banks, RBI will provide information on daily CRR balance of the banking system to market participants on the very next day as opposed to a lag of 2-3 days so far.
 - Despite undershooting of inflation, RBI cited upside risks to inflation and continued with its monetary policy stance of *calibrated tightening*, which, in the current context, should be interpreted as a pause. The MPC wants to monitor the evolving situation before deciding to revisit its current stance.

Our view

The macroeconomic backdrop – both global and domestic - against which today's policy was announced has more downside risks to growth vis-à-vis the October policy. Even in the *calibrated tightening* mode, the bias in the near term is clearly towards holding rate steady.

So, the decision to hold policy rates was mostly on the expected lines and without much ambiguity. Worries on the inflation front have reduced and a number of upside risks to the inflation path seem to be off the radar for now. Domestically, food inflation continues to surprise on the downside and with lackluster food procurement by the government, the upside risk to food inflation from higher MSPs appear contained for now. Globally, crude oil prices have shown significant downward movement and subdued global growth prospects may keep oil prices in check, though the risk from geopolitical risks has not abated. A strengthening of the rupee against the greenback has reduced imported inflation pressures. Also, a slowdown in domestic growth could keep core inflation contained.

The RBI is also expected to continue to support systemic liquidity, which has seen some stress in the last two months.

Even as the MPC has stuck to its calibrated tightening stance, the possibility of another rate hike this fiscal appears to be low. The sharp drop in oil prices, subdued food inflation and strengthening of rupee mean

lesser risk to inflation trajectory. Given the downtrend in domestic GDP growth, a policy rate hike may just have to wait. CRIISL recently cut its inflation forecast for fiscal 2019 to 4.6% (with a downward bias), from 4.8% earlier, and also reduced its growth forecast by 10 bps to 7.4%.

Banking sector view

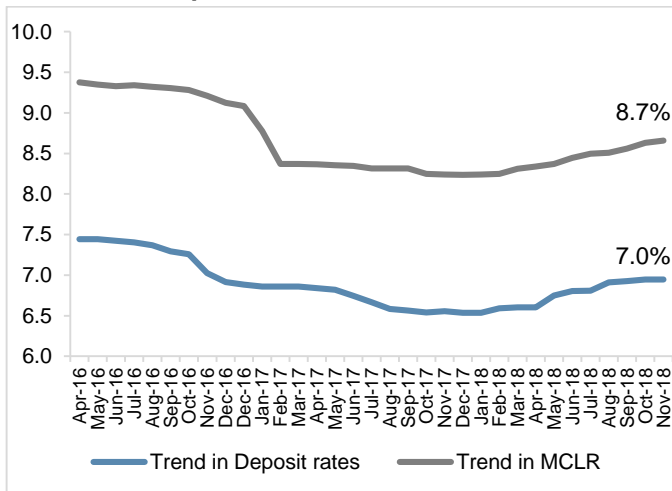
Credit growth continues to accelerate

Banking credit continued to post double-digit growth, growing 14.9% on-year, as on November 9, 2018. However, growth was still not broad-based, hampered by anaemic industrial credit growth.

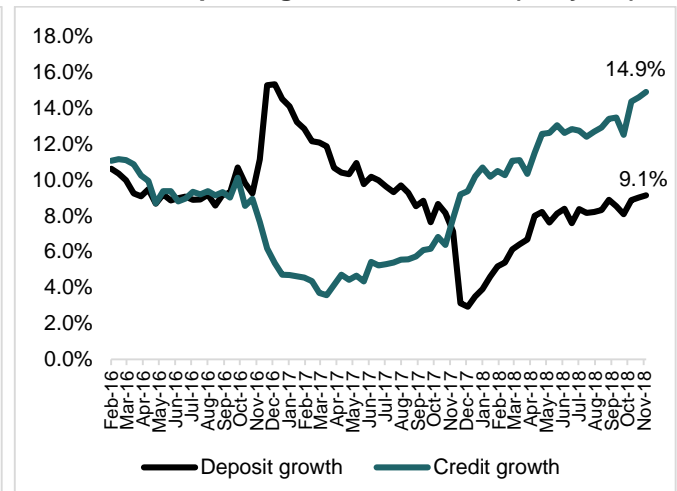
As of October 2018, industrial credit (accounting for ~33% of gross bank credit) grew only ~3.7% on-year, while the services sector (~27% of gross credit) and retail segment (~25% of gross credit) clocked strong ~27% and ~17% on-year growth, respectively, driven by strong consumption demand and higher non-bank credit requirements. Deposit growth also improved, growing ~9.2% on-year, as on November 9, 2018.

CRISIL Research expects banking credit to clock upwards of 11% on-year growth in fiscal 2019, compared with 7.4% growth in fiscal 2018, driven by strong retail credit growth, higher disbursement to non-banks and resolution of big-ticket stressed assets. Deposit growth is estimated at ~9% on-year in fiscal 2019, partly supported by the higher deposit rates offered by the banking sector.

MCLR and deposit rates of banks



Credit and deposit growth of banks (on-year)



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

Source: RBI, CRISIL Research

RBI cuts SLR by 0.25%; to bring it down to 18% over the next 18 months

The Reserve Bank of India (RBI) has mandated a cut in the statutory liquidity requirement (SLR) ratio by 0.25% for the next 6 consecutive quarters starting from January 2019, when it reaches 18%. CRISIL Research doesn't expect the reduced SLR requirements to significantly impact overall systemic liquidity as all banks already carry surplus SLR over the required 19.5% on their books.

Retail and MSME loans to be linked to new external benchmark

As per a RBI mandate, effective April 1, 2019, banks must issue incremental retail and micro, small and medium enterprises (MSME) loans based on a new methodology that links floating interest rates with either the REPO rate, the Government of India's 91-day treasury bill yield, the Government of India's 182-day bill yield or any benchmark interest rate produced by the Financial Benchmarks of India Pvt Ltd (FBIL), compared with earlier MCLR or base rate benchmarking. Over and above the external benchmark, banks are allowed to charge spreads at their own discretion which must remain constant over the term of the loan.

The final impact of the changed methodology would only be determined after the issuance of full guidelines by the RBI by the end of December.

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