

# Halting the rate-cut cycle – for now

CRISIL Monetary Policy Review

February 8, 2017

The Monetary Policy Committee (MPC) on Wednesday kept the policy repo rate unchanged at 6.25%, and moved its stance from 'accommodative' to 'neutral'. That could very well mark the end of the current rate cut cycle, which began in January 2015 – at least in the near term.

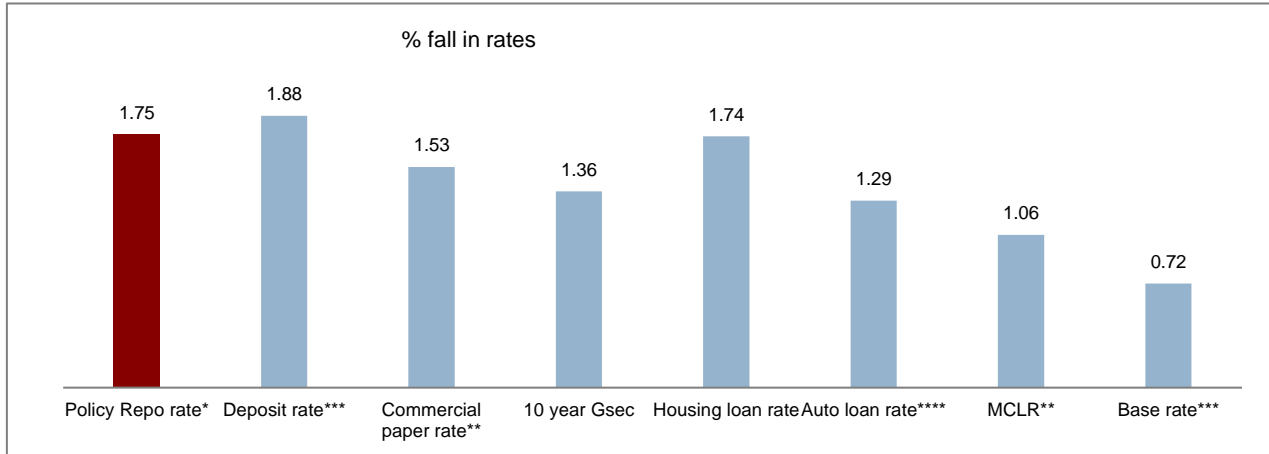
A 'neutral' stance gives the Reserve Bank of India (RBI) the flexibility to move in either direction of the interest rate cycle as macro conditions permit. The shift reflects the central bank's decision to exert caution on the inflation front in its journey towards the medium-term inflation target of 4%.

The RBI forecasts GDP growth in this and next fiscal at 6.9% and 7.4%, respectively, which is exactly CRISIL's call, too.

## Our view

- **Current macros are conducive for a neutral stance:** At 6.25%, domestic macros are much more comfortable compared with November-December 2010, when the repo last touched this level. That was when consumer price inflation (CPI) averaged ~12% and the government's fiscal deficit was nudging 5% of GDP. Today, inflation is averaging ~4.7% for the current fiscal and fiscal deficit is at 3.5% of GDP. What's more, not only has government exercised fiscal restraint in a year when the domestic demand is weak, but the quality of spending is somewhat better with a quarter of total spending going for capex, up from 20% in fiscal 2011.
- **Focus hereon will be on speeding up interest rate transmission:** The central bank's focus will now be on further pushing the transmission of rate cut to borrowers so they can benefit from the 175 bps of policy rate cuts announced since January 2015. This fiscal, transmission has improved a touch because of demonetisation-driven liquidity, the introduction of the marginal cost of lending rate (MCLR), and successive reduction in small savings interest rates by the government. To be sure, market-determined rates can come down a lot more. The RBI Governor Urijit Patel mentioned on Wednesday that weighted average lending rates in the banking system have declined just 80-85 basis points since the rate cut cycle began.
- **Caution on inflation front drives shift in stance:** The RBI reiterated its medium-term inflation target of 4%, and given the inflationary pressures in the economy, policy space is constricted. CRISIL, too, expects CPI inflation to inch up to 5% in fiscal 2018, from an estimated 4.7% in fiscal 2017. This will be driven by 1) rising global oil and commodity prices amid geopolitical tensions and a weaker rupee (that can drive up imported inflation), and, 2) core inflation (non-food, non-fuel), which, despite seeing a small demonetisation-led decline, remains firm and could rise as demand picks up mildly in fiscal 2018. However, a prudent Union Budget does cap the upside pressures that a populist one could have had on inflation. Besides these, the central bank also awaits clarity on the durable impact (if any) of demonetisation on inflation and growth.

**Scope for further transmission of policy rates**



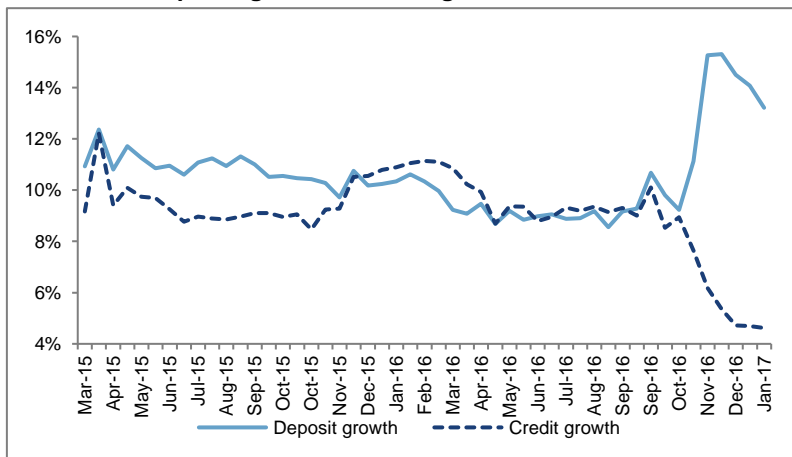
Source: RBI, CEIC, CRISIL Research. Note: \*average, \*\*6 months tenure, \*\*\*major 10 banks, month-end, \*\*\*\*top six public sector banks

## Banking sector view

### Credit and deposit growth at divergence post demonetization

After demonetisation, as of January 20, 2017, credit growth has slumped to 4.6%, while deposit growth has been strong at 13.2%. Credit growth has been impacted mainly because of deterioration in corporate credit. As of December 23, 2016, industry credit has declined by 4.3% on-year, while services credit growth has been in single digits at 8.3%. Growth has mainly been supported by retail credit, which has clocked a double-digit increase of 13.5%. Due to the huge influx of cash following demonetisation, deposit growth has surged, though it is now lower than the peak of 15.3% in December first week.

### Credit and deposit growth at divergence



Source: RBI, CRISIL Research

**Despite rate cuts, GNPA's to remain high**

Notwithstanding the reduction in lending rates by banks at the beginning of 2017, asset quality is expected to remain under pressure over the next year as well. GNPA's for the banking system are expected to increase to 9.8% as of March 2017 from 7.6% as of March 2016. We expect GNPA's to remain at elevated levels in the next fiscal as well due to business disruption on account of demonetisation, overall weakness in demand, continued slowdown in investment-linked sectors, strained corporate cash flows, slippages from restructured assets, and lower sales of bad loans to asset reconstruction companies.

**Analytical Contacts:****Dharmakirti Joshi**

Chief Economist, CRISIL Ltd.  
dharmakirti.joshi@crisil.com

**Ajay Srinivasan**

Director, CRISIL Ltd.  
ajay.srinivasan@crisil.com

**Dipti Deshpande**

Senior Economist, CRISIL Ltd.  
dipti.deshpande@crisil.com

**Media Contacts:****Saman Khan**

Media Relations  
CRISIL Limited  
D: +91 22 33423895  
M: +91 9594060612  
B: +91 22 3342 3000  
saman.khan@crisil.com

**Shamik Paul**

Media Relations  
CRISIL Limited  
D: +91 22 3342 1942  
M: +91 9920893887  
B: +91 22 3342 3000  
shamik.paul@crisil.com

**Khushboo Bhadani**

Media Relations  
CRISIL Limited  
D: +91 22 3342 1812  
M: +91 72081 85374  
B: +91 22 3342 3000  
khushboo.bhadani@crisil.com

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