

Cut, it is

Monetary Policy Review

October 04, 2019

Back to convention

- The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in its fourth bi-monthly monetary policy review for fiscal 2020 today, cut the repo rate by 25 basis points (bps), in line with expectations. Consequently, the repo rate now stands at 5.15%, and the reverse repo and marginal standing facility rates, at 4.90% and 5.40%, respectively. The decision to cut the rate was unanimous. One of the six members, in fact, plumped for a 40 bps rate cut. The MPC also decided to continue with the accommodative stance.
- The decision to cut the policy rate was guided by the following factors:
 - Inflation based on the consumer price index (CPI) remains contained, with the latest print for August at 3.21%. The MPC retained its inflation forecast at 3.5-3.7% for the second half of fiscal 2020 and 3.6% for the first quarter of fiscal 2021. It, however, noted that three-month and one-year ahead inflation expectations of households polled by the RBI had risen in the current round, reflecting near-term price pressures. Even though the MPC suggested mild upward risk to inflation outlook on account of volatile oil prices, it was hopeful that food (especially vegetables) inflation would start moderating from winter season, and core would remain subdued. Overall, inflation is expected to remain below the target of 4.0% in the near term. CRISIL forecasts CPI inflation for fiscal 2020 at 3.6%, marginally higher than 3.4% in fiscal 2019, on account of higher food prices.
 - Gross domestic product (GDP) growth has slowed down sharply. At 5.0%, real GDP growth in Q1 fiscal 2020 was at its lowest in 25 quarters. High-frequency indicators continue to point to subdued domestic demand. The latest print of -0.5% core sector growth for August, along with weakness in most high-frequency indicators and slowing exports, suggest the economic slowdown persists. According to the MPC, “The business expectations index of the Reserve Bank’s industrial outlook survey shows muted expansion in demand conditions in Q3.” Accordingly, it revised down its real GDP growth forecast for fiscal 2020 by 80 bps to 6.1%. CRISIL, too, had recently revised down its real GDP growth forecast for fiscal 2020 to 6.3% from 6.9% earlier. Slowdown in growth has opened up the output gap and created space for further rate cuts.

Our view

A lot has happened since the MPC’s previous policy meet in August. Most importantly, the fall in Q1 GDP growth to 5.0% – down from 5.8% in the previous quarter – was a major surprise that led to an almost synchronised downward revision in India’s GDP growth outlook for fiscal 2020 by almost all stakeholders. RBI’s sharp downward revision of growth forecast to 6.1%, from 6.9%, also stands testimony to that. Taking cognisance of the *larger-than-anticipated* slowdown in the economy, the government announced a number of steps to bring back the animal spirit, chief amongst which was a reduction in the corporate tax rate to 22% from 30% for existing companies and to 15% from 25% for new manufacturing companies. Despite the fiscal hit from this move, the government has promised to keep the deficit at the budgeted level of 3.3% for the current fiscal.

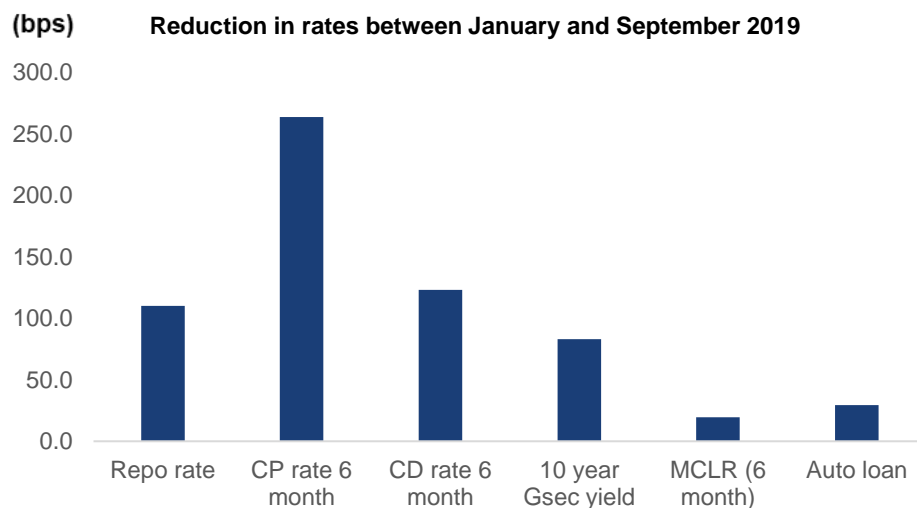
With four successive rate cuts beginning February this year and a change in the monetary policy stance to *accommodative* in June, the MPC has already adequately displayed its focus on providing the required monetary support to growth. Today’s rate cut – the fifth successive one this year – was, therefore, more or less a given, especially as headline inflation remains contained and core has softened.

Dovish stance of major advanced economies aided the rate cut decision. Global central banks were tilting lower and accelerated rate cuts. Both USA and Euro Area cut policy rates in September. Earlier, Australia, New Zealand and Thailand had gone for unexpected rate cuts.

Today’s 25 bps rate cut brings the total reduction in policy rate, since February this year, to 135 bps. The repo rate at 5.15% now is the lowest since April 2010, when it stood at 5.25%.

The focus, however, remains on monetary transmission, where, despite some pick-up, progress remains slow. To speed up transmission, the RBI issued a circular making it mandatory for banks to link their lending rates to an external benchmark specified by them. This is against the extant practice of banks basing their lending rates on conditions endogenous to the banks. Banks are gradually linking their loans to repo rate, but given the flexibility to charge a spread/mark-up, considering other costs, the final lending rates are yet to come down in a commensurate manner.

Monetary transmission in lending rates remains weak



Source: RBI, CRISIL Research

Meanwhile the RBI's internal working group (IWG) submitted its report on liquidity management framework, keeping the contours of liquidity management broadly unchanged. While the IWG proposed sticking to the current corridor system with repo as the policy rate and targeting weighted average call rate, it suggested moving from neutrality to slight deficit (0.25-0.50% of net demand and time liability). Despite this requirement, the framework left scope for the liquidity to move into surplus, should financial conditions so warrant. This implies that in the current situation, when financial conditions are tight, the RBI has flexibility to maintain surplus liquidity and might continue to do so. The RBI clarified that the IWG report is currently in public domain for inviting comments and it is yet to take a call on the recommendations in the report.

MPC decided to continue with its accommodative stance as long as it is necessary to revive growth. This, in conjunction with weak economic outlook, implies that the output gap is unlikely to close soon and another rate cut could be in the offing.

Banking sector view

Credit growth slows on economic slowdown

Credit growth of scheduled commercial banks slowed to ~10.3% on-year as of September 13, 2019 and ~9.9% YoY as of August 30, 2019 when compared with 11.0% on-year as of fiscal 2019.

Industrial credit growth (accounts for ~32% of gross bank credit) which remained at 6% plus levels for the past five months has slowed down to 3.9% in August 2019. Services sector (~27% of gross bank credit) and retail segment (~27% of gross bank credit) also registered slower growth of ~13.3% YoY and ~15.6% YoY as against 17.8% and 16.4% respectively as on fiscal 2019. The slower pace in credit growth was on account of economic slowdown, declining private consumption and more cautious lending norms adopted by banks.

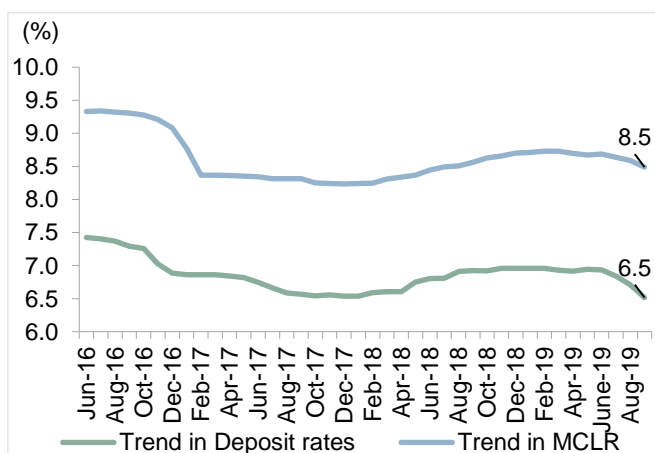
For August 2019, overall services growth was majorly driven by NBFCs (which grew at ~39% YoY) as NBFCs are increasingly shifting their borrowings from debt capital markets to banks. Excluding credit given to NBFCs, overall services credit grew only by ~5.4% as of August 2019.

Deposits grew at 10.0% YoY as of September 13, 2019 and by 9.7% YoY as of August 30, 2019 supporting incremental credit demand.

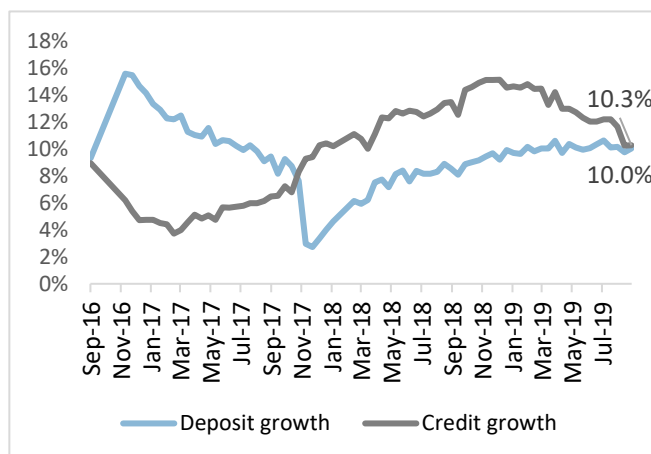
Given economy slowdown, overall bank credit growth for fiscal 2020 is expected to be in the range of ~10-11% as NBFCs are expected to grow at a slower pace and would lose some of their market share to banks. Also, in view of the ensuing festive season and a normal pickup in growth rate in the second half of the year as compared to first half, CRISIL Research expects net banking credit to grow at a higher pace in the next two quarters.

Deposit growth is expected to decline marginally to ~8.5-9.5% in fiscal 2020 on account of decreasing deposit rates and lower credit growth.

MCLR and deposit rates of banks



Credit and deposit growth of banks (YoY)



MCLR: Marginal cost of funds based lending rate

Note: Average of one-year MCLR of 10 banks. Deposit rate is average of 1-2 years of maturity of 10 banks.

Source: Reserve Bank of India, CRISIL Research

Repo rate under liquidity adjustment facility lowered by 25 bps; impact of external benchmarking of retail floating rate loans is likely to be felt gradually

In order to boost consumption growth which has slowed down in the last few quarters, the Reserve Bank of India (RBI) reduced repo rate – which is the key policy rate at which the central bank lends to commercial banks – by 25 basis points to 5.15%.

While inflation has remained within the central bank's target range, global as well as domestic economic activity has been sedate. The RBI slashed India's gross domestic product growth forecast for fiscal 2020 to 6.1% from 6.9% in its August policy, citing weak private final consumption expenditure, along with moderation in exports and sluggish investment activity.

Today's repo rate cut is the fifth in a series of consecutive cuts this calendar year - three cuts of 25 bps each over February-July 2019 and 35 bps in August 2019. Till now, repo rate has been cut in total to the tune of 135 bps since February. However, reduction in marginal cost of funds-based lending rate (MCLR) has not been uniform with majority of banks reducing rates in the range of 10-35 bps over February – September 2019 as against repo reduction of 110 bps during in this period.

In order to aid quicker transmission of reduction in repo rates, RBI has mandated linking of floating portion of retail loans such as housing, auto and MSME loans with either of the external benchmarks i.e., REPO rate, 3-month treasury bill yield, or 6-month treasury bill yield effective from October 1, 2019. These external benchmark linked products would be re-priced at a much rapid pace of 3 months.

With external benchmark coming into picture and in order to protect NIMs going forward, most banks are likely to cut deposit rates by ~10-15 bps over the next 2-3 months.

Increased limit to MFI borrowers to improve credit to bottom of the economic pyramid

The RBI also proposed an increase in microfinance institution (MFI) borrowers' household income limit - an eligibility criterion for MFI loans - to Rs.1.25 lakh from Rs.1 lakh in rural areas and to Rs.2 lakh from Rs.1.6 lakh in semi urban/urban areas. This step is expected to help MFIs widen their customer base.

While the proposed increase in per borrower loan limit gives MFIs the opportunity to lend more, they would have to continue exercising caution by factoring in the existing sanctioned loan quantum and the repayment capacity of borrower.

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