

# Mint Road surprises

Monetary Policy Review

December 05, 2019

## Eyes back on prices

- The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in its fifth bi-monthly monetary policy review for fiscal 2020 today, gave pause to cutting repo rate. The unexpected break came after five consecutive cuts this calendar year and as opposed to the wider expectation of a 25 basis points (bps) cut this time around, too. Hence, the repo rate continues to stand at 5.15%, and the reverse repo and marginal standing facility rates, at 4.90% and 5.40%, respectively. The decision to hold the policy rate was unanimous. The MPC also decided to continue with the accommodative stance, as long as it felt it necessary to revive growth.
- The decision not to cut the policy rate was guided by the current rise in inflationary pressures and gradual improvement in monetary transmission. Importantly, the RBI is looking for more clarity on data, particularly the fiscal stance in upcoming Union Budget, before taking further action.

**Focus reverts to inflation:** Sharp rise in the consumer price index (CPI) based headline inflation in the past two months has led the MPC to hold further rate cut at this juncture. Surge in vegetable inflation led headline inflation to rise to 4.6% on-year in October. The RBI expects food inflation, particularly vegetables, to remain elevated in the immediate months. It also sees pressure from other food items such as pulses, milk, etc. A likely rise in telecom prices could also push up core inflation. The MPC, accordingly, revised upward its inflation projection to 5.1-4.7% second half of current fiscal from 3.7-3.5% projected earlier. Another worry is that, given the adaptive nature of households, the current spike in food inflation has led their inflation expectations to go up. As per the MPC resolution, "Households' inflation expectations, measured by the Reserve Bank's November 2019 round of the survey, increased by 120 basis points over the 3-month ahead horizon and 180 basis points over the 1-year ahead horizon".

**Ample scope for monetary transmission:** The MPC acknowledged that monetary transmission, which has been swift across money market instruments, is now also improving for credit markets. According to the MPC, the 1-year median marginal cost of funds-based lending rate (MCLR) has declined 49 bps in response to the 135 bps cut in policy rates so far. "After the introduction of the external benchmark system, most banks have linked their lending rates to the policy repo rate of the Reserve Bank. The median term deposit rate has declined by 47 bps during February-November 2019. The weighted average term deposit rate declined by 9 bps in October as against a decline of just 7 bps in eight months during February-September. This augurs well for transmission to lending rates, going forward", it noted. Despite improving transmission, the slowing credit growth is worrisome. If a slowing economy has reduced credit appetite, risk aversion and weak sentiment has diminished the willingness to supply credit, too.

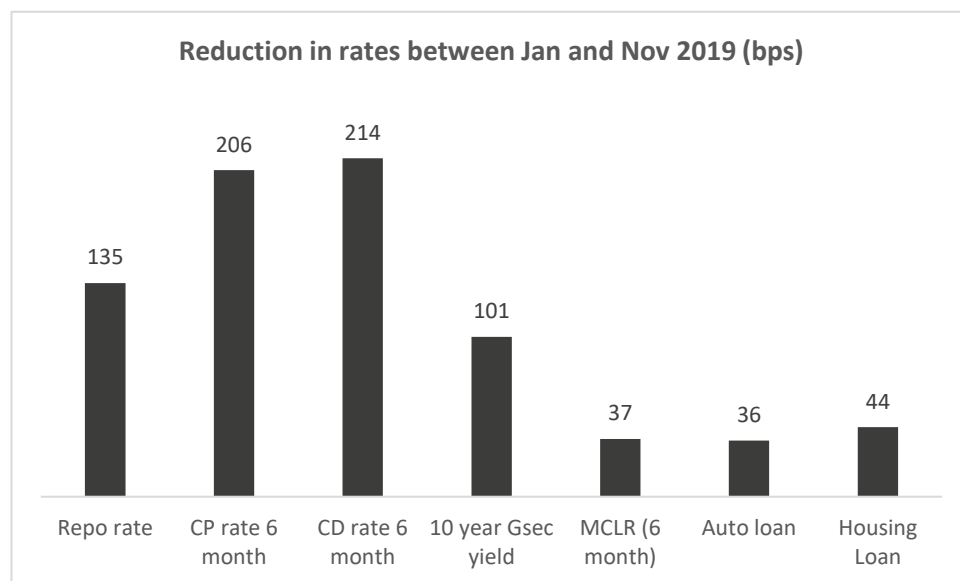
## Our view

Given that the economy is well below its potential with a negative output gap, demand side pressures on inflation are likely to remain dormant. Food inflation could surprise on the upside as it normalises from a very low base of last fiscal. The base case projections from RBI show inflation coming down in first half of fiscal 2021 after firming in the second half of this fiscal. As recovery will be very gradual and the economy is likely to remain below potential in the next few quarters, we expect policy to continue tilting towards a rate cut.

Data surprises, of course, will hold sway. Three developments to watch out for before the next monetary policy are:

1. Fiscal policy stance in the upcoming Budget
2. Developments on food inflation front and anticipated telecom price increases
3. Monetary transmission and credit growth

### Monetary transmission improving only gradually



Source: RBI, CRISIL Research

## Banking sector view

### Prolonged slowdown in the economy pulls down credit growth

Slowdown in the domestic economy, cautious lending by banks, low private consumption, and poor capital expenditure (capex) resulted in weak credit growth.

Scheduled commercial banks registered credit growth of 8.4% on-year as on October 25 and slipped to 8.1% on-year growth on November 8, as against 11% growth in fiscal 2019.

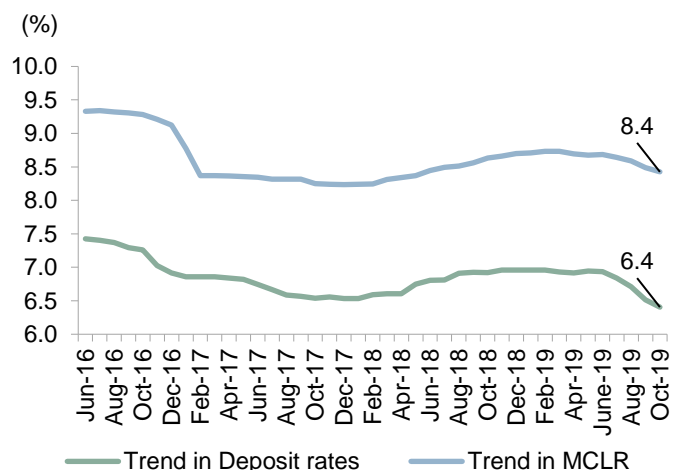
The services segment (~27% of gross bank credit) posted 25-months-low growth of 6.5% on-year in October 2019. While industrial credit (~32% of gross bank credit) grew at a subdued rate of 3.4% in the month, on account of poor capex, the retail segment (~27% of gross bank credit) grew 17.2% on the back of the housing sector (19.4% on-year growth). The auto sector, which forms a major chunk in retail segment continued to contract except the sub segment of passenger vehicle that showed a slender positive growth due to festival demand and in response to promotional measures of auto companies.

For October 2019, services growth was driven entirely by non-banking finance companies (NBFCs) – up 27% on-year. Excluding credit given to NBFCs, overall services credit de-grew 0.4% and overall bank credit growth was significantly lower at 7%.

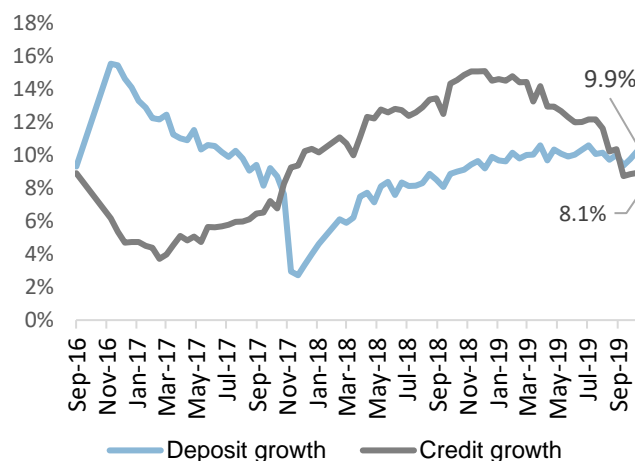
Deposits, which grew 10.3% on-year as on October 25 and 9.9% on-year as on November 8, exceeded the credit growth rate for the respective periods.

CRISIL Research expects net banking credit to moderate to ~10% in fiscal 2020, compared with ~11% in fiscal 2019 and 7.4% in fiscal 2018. Deposit growth is expected to be in the range of 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 (on-year)**



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 unchanged; room left for transmission of rates**

Recognising there is room for future monetary policy action and considering the growth-inflation dynamics, the Reserve Bank of India (RBI) kept the repo rate – which is the key policy rate at which the central bank lends to commercial banks – unchanged at 5.15%.

In the second quarter of fiscal 2020, inflation was within the central bank’s target range. However, since it was much higher than expected in October, Consumer Price Index-based, or retail, inflation projection for the second half of fiscal 2020 has been raised to 5.1-4.7%. India’s gross domestic product growth projection for fiscal 2020 has been lowered from 6.1% in October monetary policy review to 5.0% primarily because of weak domestic and external demand conditions, moderation in exports, sluggish investment activity, declining capacity utilisation levels, and lower manufacturing activity.

Against a repo rate reduction of 135 basis points (bps) over February-October 2019, banks, on average^, have reduced their deposit rates by 62 bps and one-year MCLR by only 41 bps since February. Out of 41 bps reduction in MCLR, 14 bps was reduced till August; remaining 27 bps have been reduced in the past four months, indicating that delayed rate transmission is picking up and there is enough room for further transmission.

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

Rate transmission is expected to improve going forward, as (i) the share of base rate loans, interest rates on which remain sticky, declines; (ii) MCLR-based floating rate loans, which typically have annual resets, become due for renewal; and (iii) the share of external benchmark-linked loans increases.

^Average of 10 banks, which command 65-70% of the total market share

## **Urban Cooperative Bank Regulations are strategy positive**

The Reserve Bank's proposal to amend urban cooperative bank (UCB) regulations relating to single party and group exposure norms will strengthen credit discipline among UCBs. Further, the proposal to bring UCBs with assets of above Rs.500 under the CRILC (Central Repository of Information on Large Credits) would reduce information asymmetry with respect to borrowing from cooperative banks.

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