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Thicker slice

Monetary Policy Review

August 07, 2019

Repo slashed on expected lines

- The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in its third bi-monthly monetary policy review for fiscal 2020 on Tuesday, cut the repo rate by an unconventional 35 basis points (bps). That follows three cuts of 25 bps each since February this year. Consequently, the repo rate now stands at 5.40% and the reverse repo and marginal standing facility (MSF) rates at 5.15% and 5.65%, respectively. Four MPC members voted for a 35 bps cut and two for 25.
- Today's policy decision was based on the following factors:

  i) Benign inflation scenario, especially core; ii) Sharp slowdown in domestic growth, amid global headwinds stemming from subdued global growth and escalating trade tensions

  – Inflation based on the consumer price index (CPI) remains well below the RBI's medium term target of 4%, with the latest print, for June, at 3.18%. The MPC believes headline inflation will remain under 4% in the near term and has projected CPI inflation at 3.1% in Q2:2019-20 and 3.5-3.7% in H2:2019-20, with risks evenly balanced. Not only has core inflation (taking out food and fuel) moderated sharply, but also inflation expectations of the households for one year ahead horizon moderated by 20 bps, the committee has noted. CRISIL forecasts CPI inflation for fiscal 2020 at 3.8%, up from 3.4% in fiscal 2019 as food prices are consistently moving up.

  – GDP growth for fiscal 2019 was down from 7.2% to 6.8%, with fourth quarter growth as low as 5.8%. The latest print of 0.2% for core sector growth in June along with weakness in most high frequency indicators and slowing exports may suggest further slowdown in first quarter growth. The MPC has noted that "various high-frequency indicators suggest a weakening of both domestic and external demand conditions. The Business Expectations Index of the RBI's industrial outlook survey shows muted expansion in demand conditions in Q2." Accordingly, it revised down its real GDP growth forecast for fiscal 2020 by 10 bps to 6.9%. CRISIL, too, had revised down its real GDP growth forecast for fiscal 2020 last month to 6.9% from 7.1% earlier.

Our view

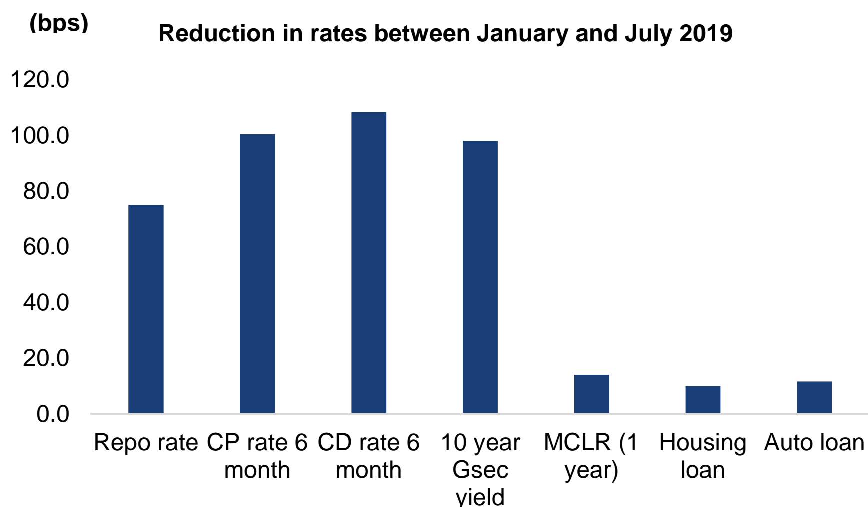
As widely expected, the RBI has sliced its policy rate. After the GDP growth hit a low of 5.8% in the last quarter of fiscal 2019, weak first quarter corporate results and dismal core sector growth suggest that the domestic slowdown may be worsening. So the MPC's decision to lower repo rate was along expected lines, although the magnitude surprised everyone. To be sure, this is the fourth rate cut in a row, bringing the total reduction in repo rate to 110 bps in 2019. The repo rate is now at its lowest level since July 2010.

After the June policy review, the uncertainty around the fiscal stance has gone with the government making clear it's staying the fiscal course. That left the monetary policy to do its bit to support growth. Also, since the June policy, international crude oil prices have remained stable, rupee has appreciated, and the US Fed has cut its policy rate. While CPI inflation has been moving up, it still remains well below the RBI's medium-term target with risks to inflation trajectory contained. All these factors persuaded the MPC to use the knife.

The problem of transmission, however, remains. With the RBI's accommodative policy stance, banking system liquidity has turned surplus in the last two months. Also, short-term rates on commercial paper and certificate of deposits, and the risk-free (10-year G-sec) rate have declined significantly. However, transmission of this to bank lending rates remains sluggish. Hopefully, today's rate cut along with surplus liquidity should speed up transmission and support the economy in the second half. Reduction in risk weights for consumer loans would also help. All that is important because non-banking finance companies (NBFC) remain under stress.

Rising risks to growth, under-shooting inflation and dovish stance of major central banks opens up possibility of more rate cuts this year.

Monetary transmission in lending rates remains weak



Source: RBI, CRISIL Research

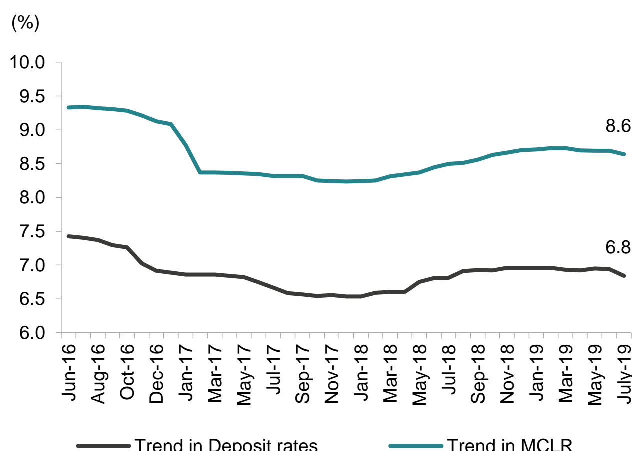
Banking sector view

Credit growth picks up pace

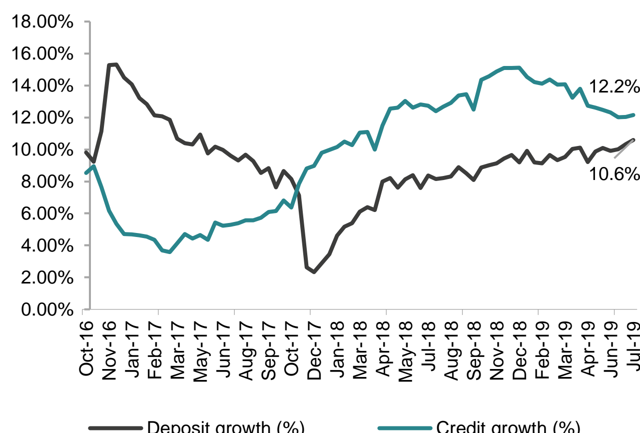
Scheduled commercial banks continued to post double-digit growth (excluding credit extended to NBFCs), registering credit growth of ~11.3% YoY as of May 24, 2019. Industrial credit growth extended its recovery since the past fourth months, after almost two years of subdued growth. As of April 2019, industrial credit (which accounts for ~33% of gross bank credit) grew ~6.9% YoY, while the services sector (~27% of gross bank credit) and retail segment (~26% of gross bank credit) registered healthy growth of ~10% YoY and ~16% YoY, respectively, driven by strong consumption demand and higher credit requirement by NBFCs. Excluding credit given out to NBFCs, overall services credit growth was ~11% as of April 2019. Deposit growth too improved, growing ~10.1% YoY as of May 24, 2019, supporting incremental credit demand.

CRISIL Research expects net banking credit to grow ~13-14% in fiscal 2020, compared with ~12.2% in fiscal 2019 and ~7.4% in fiscal 2018, driven by strong retail credit growth, higher disbursements to NBFCs and resolution of big-ticket stressed assets. Deposit growth is expected to be ~11-12% in fiscal 2020, partly due to higher share in subscriptions to debt issuances versus mutual funds.

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 35 bps; to aid quicker transmission of rates

In order to boost consumption growth which has slowed down in the last 1-2 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 35 basis points to 5.40%.

While inflation has remained within the central bank's target range, global as well as domestic economic activity has been slowing down. India's gross domestic product growth for fiscal 2020 has been revised downwards to 6.9% from 7.0% in the June policy, primarily because of a downward revision in private final consumption expenditure along with moderation in exports and sluggish investment activity.

Today's repo rate cut is on the back of already three cuts of 25 bps each over February-June 2019. However, reduction in MCLR has not been uniform with majority of banks reducing rates in the range of 5-20 bps.

With relatively higher liquidity in the banking system, most banks are likely to cut deposit rates over the next 1-2 months, enabling them to reduce lending rates by ~20 bps over the next 2-3 months.

RBI continues to take steps to enhance credit flow to NBFCs; counterparty norms and PSL limits relaxed

By relaxing limits on single counterparty exposure to 20% of tier-I capital of the banks, from 15%, and by classifying NBFCs which are lending to the agriculture sector (up to Rs 10 lakh per borrower), micro, small and medium enterprises (up to Rs 20 lakh per borrower - constitutes ~15% of NBFCs outstanding), and the housing sector (up to Rs 20 lakh per borrower - constitutes 20-25% of NBFCs outstanding) under the Priority Sector Lending framework will improve the liquidity situation among NBFCs, and will also increase banking credit flow to the sector.

About 15% of NBFCs MSME outstanding and additional 20-25% of HFCs/NBFCs Housing outstanding (since loans upto Rs.10 lakh per borrower were already covered earlier) can get classified under Priority Sector Lending framework for banks with this announcement.

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