Research

CRISIL
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Pause for now

Monetary Policy Review

February 06, 2020

Exercising restraint

- Status quo for now, but room for further policy easing indicated
- Concrete steps such as long-term repo operation for improving monetary transmission, complemented by encouraging flow of bank credit to key productive sectors, especially micro, small and medium enterprises (MSMEs)
- CRISIL expects 6% growth and 4% inflation in fiscal 2021

- The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in its sixth bi-monthly monetary policy review for fiscal 2020 today, opted to keep policy rates on hold. This is the second consecutive meeting the MPC has opted for a status quo, after five consecutive cuts last calendar. Hence, the repo rate remains unchanged 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.
- The decision not to cut the policy rate was guided by the current high inflationary environment, some nascent signs of mild growth recovery, and continued focus on improving monetary transmission.

  Inflation remains near-term worry: Inflation based on the consumer price index (CPI) has trended up and reached 7.4% in December 2019 – the highest since July 2014 – largely due to double-digit food inflation. At the same time, fuel inflation has moved out of deflation. While prices of onions, the key contributor to high food inflation, have seen some easing, prices of some other food categories such as milk and pulses have been firming up. According to the MPC, "the recent pick-up in prices of non-vegetable food items, specifically in milk due to a rise in input costs, and in pulses due to a shortfall in kharif production, are all likely to sustain." It accordingly expects inflation to come down only gradually. With the assumption of a normal monsoon, the MPC projects inflation at 6.5% for Q4, fiscal 2020, 5-5.4% for H1 fiscal 2021, and 3.2% for Q3 fiscal 2021.

  Mild recovery in growth: The MPC acknowledged the mild positive drift in some high-frequency indicators. Citing mixed signals, the MPC noted that while sales growth of tractors turned positive in December, those of motorcycles and passenger vehicles continued to contract. On the other hand, domestic air passenger traffic grew at a healthy pace in the last two months. The MPC projects GDP to grow 6% in fiscal 2021, in the range of 5.5-6% in H1, and at 6.2% in Q3. CRISIL's forecast of real GDP growth in fiscal 2021 is also at 6%.

  Transmission to lending rates and encouraging banks to dispense credit: The RBI adopted a new liquidity framework that promises better liquidity management. The new framework is doing away with targeted provisions linked to net demand and time liabilities (NDTL), which means "the Reserve Bank will ensure adequate provision/absorption of liquidity as warranted by underlying and evolving market conditions – unrestricted by quantitative ceilings – at or around the policy rate". It also announced term repos of one-year and three-year tenures worth up to Rs 1 lakh crore, aimed at providing durable liquidity at a reasonable cost to banks. It provided provision for banks to reduce their cash reserve ratio (CRR) requirement in lieu of the retail credit extended for automobiles, residential housing and MSMEs till the fortnight ending July 31, 2020. Loans to micro and small enterprises were already linked to external benchmarking, and this has now been extended to medium enterprises as well.

Our view

In its monetary policy review in December, the MPC had halted the rate cutting cycle and sought more clarity from incoming macro data – especially the fiscal stance of the government – for future monetary policy decisions.

Three important developments since then:

1) CPI inflation – managing which has been the overarching objective of our inflation-targeting central bank – reached a 65-month high of 7.4% in December. While this was largely on account of food inflation – a transitory factor – it crossed the upper mark of RBI's 2-6% inflation target for the first time, giving reason to worry.

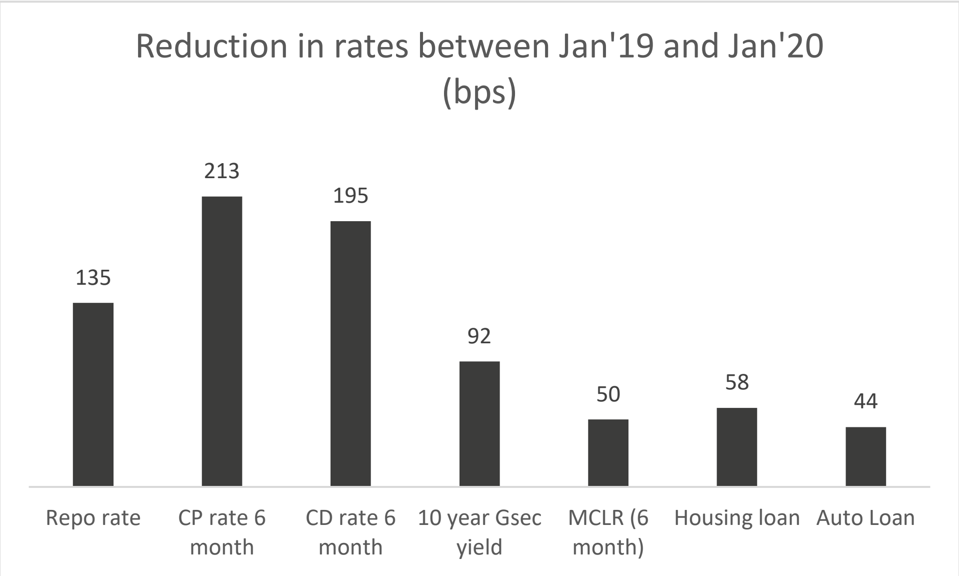
2) The Union Budget veered off its fiscal consolidation path by 50 bps, both for this fiscal and the next, printing at 3.8% and 3.5%, respectively. This, we believe, will not be inflationary.

3) Outbreak of coronavirus, which can impact tourist arrivals and global trade, and therefore has adverse implications for growth.

We believe, given the current inflationary pressures, the RBI's cautious stance was prudent and on expected lines. While an unusual surge in some vegetable categories seems to be correcting, prices in some other food categories seem to be firming up. At the same time, increased telecom prices and current hike in import duties in some consumer goods would mean some upward pressure on core inflation.

Moreover, there is still ample scope of the monetary transmission of the previous rate cuts (that credit growth remains low despite banks being flush with funds indicates inadequate transmission). In the context, today's monetary policy scores by introducing a number of innovative steps – adoption of new liquidity framework, introducing LTRO, incentivising banks to lend more to productive sectors of the economy, and extension of One-time Restructuring Scheme for MSME advances, etc. – which will help speed up monetary transmission, improve credit flow and help address the NPA problem to an extent.

Monetary transmission is gradually improving



Source: RBI, CRISIL Research

But what about future monetary policy action?

To be sure, even though the government has decided to breach the fiscal deficit target, it is not too growth supportive (please refer to our budget analysis for more on this). At 6% GDP growth, the economy is expected to remain below potential in the coming fiscal. This implies that once the inflationary pressures show clear signs of easing[1], the MPC will resume the rate cutting cycle, especially as it continued to retain its accommodative monetary policy stance in

[1] It is important to note that household inflation expectations which had shown a sharp pick up in the previous round have once again eased as per the latest January 2020 round: three month and one year ahead household inflation have fallen by 60 and 70 bps respectively.

today's meeting. In fact, the MPC statement categorically mentioned "there is policy space available for future action". This, along with regulatory changes announced today with respect to providing adequate durable liquidity, will also help assuage bond yields.

Banking sector view

Credit growth slumps on weak macros

Prolonged slowdown in the economy, low private consumption, cautious lending by banks, poor capital expenditure (capex) and declining commodity prices led to weak credit growth. As on December 20, 2019, scheduled commercial banks registered credit growth of 7.0% on-year as against 11% growth in fiscal 2019. As on January 3, 2020, banking credit crossed a milestone of Rs.100 lakh crore (grew by 7.6% on-year) whereas incremental credit for the year grew by only 2.8% as against ~7.9% in the same period last year.

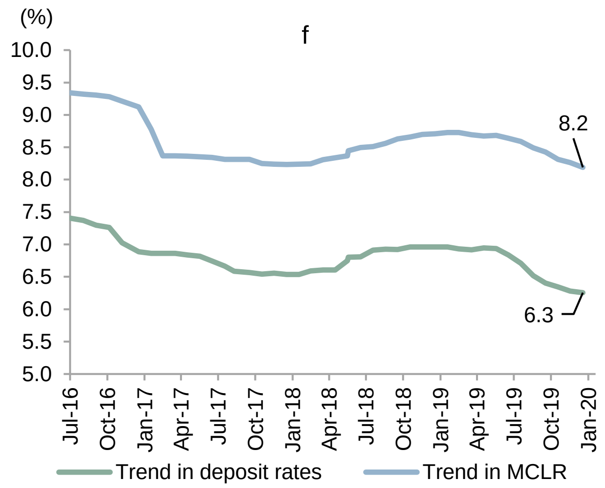
As of December 20, 2019, industrial credit (constituting ~32% of gross bank credit) and services credit (~27% of gross bank credit) both posted a subdued growth rate of 1.6% and 6.2% respectively whereas retail credit (~28% of gross bank credit) grew at 15.9% on-year driving the entire banking credit growth. Retail credit was driven by the housing sector (~18% on-year growth) and other personal loans (~19% on-year). On an incremental basis till December 20, 2019, industry de-grew by ~3% and services by 2% on a non-annualised basis as against growth of ~2% and ~9% respectively for the same period last year.

Growth in services was entirely driven by non-banking finance companies (NBFCs) – up 28% on-year as of December 20, 2019. Excluding credit given to NBFCs, overall services credit de-grew ~1% and overall bank credit growth was significantly lower at 5.5%.

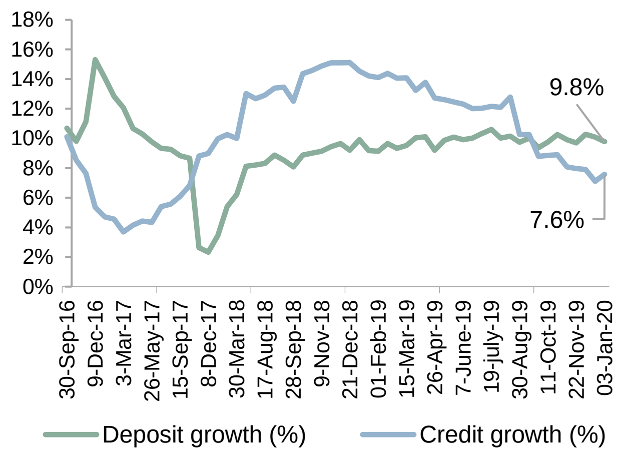
Deposits, which grew 10.1% on-year as on December 20, 2019, and 9.8% on-year as on January 3, 2020 exceeded the credit growth rate for the respective periods.

Given the sluggish economy, CRISIL Research expects net banking credit to moderate to ~5% in fiscal 2020 and is expected to marginally increase to ~7-8% in fiscal 2021. This is compared with ~11% in fiscal 2019 and 7.4% in fiscal 2018. Deposit growth is pegged to be ~9% till fiscal 2021, 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; measures announced to improve credit demand

Recognising there is policy space available for future action and considering elevated levels of inflation along with rising inflation trajectory in the fourth quarter of fiscal 2020, 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 December 2019 policy, India's gross domestic product (GDP) growth for fiscal 2020 was projected at 5%. Considering factors such as recovery of private consumption in rural areas, rise in food prices supporting rural income, ease of global trade uncertainties encouraging exports and investment activity, pickup in transmission of rates along with budgetary measures to boost rural and infrastructure spending, GDP growth is projected at 6.0% for fiscal 2021. GDP is forecast to be in the range of 5.5-6.0% in the first half and 6.2% in the third quarter of fiscal 2021 in RBI's monetary policy dated February 6, 2020.

Against ~110 bps cut in the repo rate since April 2019, average deposit rate for the top 10 banks (which constitutes 65-70% of the market share as on fiscal 2019) has come down by ~67 bps while the average MCLR for the same set of banks has come down by ~54 bps. Out of the 54 bps reduction in MCLR, 14 bps were cut till August; whereas remaining 40 bps have been reduced since September, indicating that rate transmission is picking up.

Incentivising Bank credit to specific sectors

The RBI has permitted incremental lending to certain retail segments like automobiles, residential housing and MSME without the requirement of cash reserve ratio (CRR) until July 31, 2020. The idea is to revitalize flow of credit to sectors that have multiplier effect and support growth. The CRR is 4% and the funds kept for maintaining CRR does not earn any return, thus having a negative carry on overall borrowings. The Reserve Bank's move would reduce the negative carry and incentivise banks to increase flow of credit to these sectors. CRISIL Research estimates the saving for banks on this score to be in the range of 8 – 10 bps. If this is passed on to customers by way of lower interest rate, it could help spur the demand to some extent.

External benchmarked loans to MSMEs

In order to aid quicker transmission of reduction in repo rates, the RBI had, with effect from October 1, 2019, mandated linking of the new floating rate personal or retail loans, such as housing, auto and loans to micro and small enterprises with external benchmarks. Now, to strengthen monetary transmission further, loans to medium enterprises will also be linked to an external benchmark effective April 1, 2020. 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.

Extension of One-time Restructuring Scheme for MSME advances

Considering importance of MSMEs in the economy and to maintain credit flow to the sector, one-time restructuring of loans to MSMEs that were in default but classified as 'standard' on January 1, 2019 was permitted without an asset classification downgrade. Given that the process of financial stability is still underway, one-time restructuring is extended to standard MSME accounts that were in default as on January 1, 2020. The restructuring under the scheme has to be implemented by December 31, 2020 and the same will benefit the MSME entities which could not be restructured under the provisions of the circular dated January 1, 2019. While the move would mask actual delinquencies in the sector temporarily, proactive steps by banks in terms of monitoring of restructured loans and constant engagement with borrowers would help minimize credit cost on this score.

Debt restructuring allowed for stalled projects in Commercial Real Estate

RBI has extended permission to not downgrade project loans under commercial real estate sector (developer loans for commercial and residential projects) for another one year where commencement of commercial operations is delayed due to reasons beyond the control of promoters. This provision is in addition to government's initiative of alternative investment fund (AIF) of Rs.25,000 crore to provide funding to stalled real estate projects. The provision is essential to ensure continued flow of credit to viable projects but affected by weak environment. However, the onus rests on lenders to ensure only the deserving projects derive this benefit.

Long term repo operations (LTRO) for improving monetary transmission

The RBI has announced conducting term repos of one and three years, of appropriate sizes upto Rs.1 lakh crore at fixed rate repo. The utilization of this facility by banks would depend on individual bank's cost of borrowing. Most of the banks' borrowing cost is below the fixed rate repo at present. Secondly, expectation on interest rate movement would have a direct bearing on utilization of this facility as it is relatively a long term commitment.

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