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Down comes the repo

Monetary Policy Review

August 2, 2017

- The Monetary Policy Committee (MPC) today announced a 25 basis points (bps) reduction in the policy rates (repo rate is down to 6%, the reverse repo rate to 5.75%, and marginal standing facility rate to 6.25%). Four out of six members were in favour of the decision, while one voted for a 50 bps cut and another for status quo.
- The MPC maintained its neutral monetary policy stance, but is now more comfortable with the inflation trajectory since several upside risks have reduced or not materialised.
- The MPC's fiscal 2018 forecasts on gross value added (GVA) growth and consumer price inflation (CPI) are retained at 7.3% and ~3.5% average, respectively. The MPC reiterated its focus to maintain medium-term inflation at 4%.

Our view

The policy rate cut was in line with our expectation. In our view, the timing was opportune since inflation has dipped to record lows and is only likely to rise gradually hereon. For the first quarter of fiscal 2018, CPI averaged 2.2%, which is closer to the lower bound of the MPC's forecast (2-3.5%) for the first half of the year. For the second half, the MPC forecasts inflation around 3.5-4.5%. Despite a rate cut, the MPC's policy stance has been kept neutral given the expected uptick in inflation.

We do not expect any further reduction in the repo rate this fiscal.

The MPC maintained its neutral monetary policy stance, but is now more comfortable with the inflation trajectory since several upside risks have reduced or not materialised. The recent dip in inflation was accentuated by demonetisation-led crimp in demand and seasonal downside pressures on food, most of which are temporary and will soon fade. What is comforting is that beyond this noise, there are other factors that will act as bigger curbs. These are; (i) normal monsoon, which will keep food inflation in control; (ii) benign global oil and commodity prices, which along with a strong rupee, will keep imported inflation in check; and, (iii) only a moderate pick-up in domestic demand, which will keep the pressure on core inflation muted.

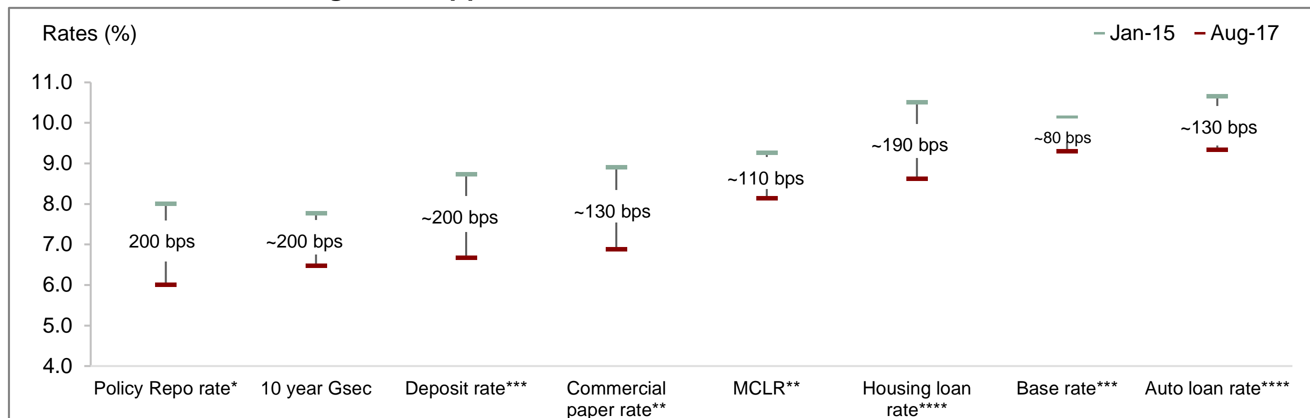
Why did MPC choose to cut now?

Inflation has dipped to record low levels (1.5% in June 2017 and 2.2% average in first quarter of fiscal 2018). The MPC derived considerable comfort from the sharper-than-expected downward trajectory in inflation so far, especially core inflation (inflation excluding food and fuel) and, smoother-than-expected GST implementation. Moreover, it estimates the impact of revision in housing rent allowance (HRA) on inflation to be much lower than previously anticipated. These factors opened the door for today's cut. The timing feels right because with base effect (especially in vegetables) waning out from August and some impact of GST-led price revisions, inflation could edge up from here. There is also uncertainty on the possible inflation upside due to 7th Pay Commission revisions by state governments.

Transmission remains on course

Liquidity in the banking system has stayed in the surplus zone, facilitating swifter transmission of interest rate cuts across instruments. So far in the current easing cycle starting January 2015, the repo rate has been reduced by 200 bps, while rates on commercial paper (CP) and certificates of deposit (CD) have also fallen by the same extent. In level terms, too, rates offered on these papers are closer to the repo rate. That suggests monetary transmission is happening. However, there continues to be some rigidity in bank lending rates. The MPC has proposed a review of the current marginal cost of lending rate (MCLR) mechanism to introduce a more dynamic bank lending rate that is directly benchmarked to market rates.

Transmission in lending rates appears on track for most instruments



*Note: *period-end, **6 month tenure and as of July 2017, ***major 10 banks, average, ****top 7 public sector banks, average. For MCLR, rate change is with respect to April 2016*

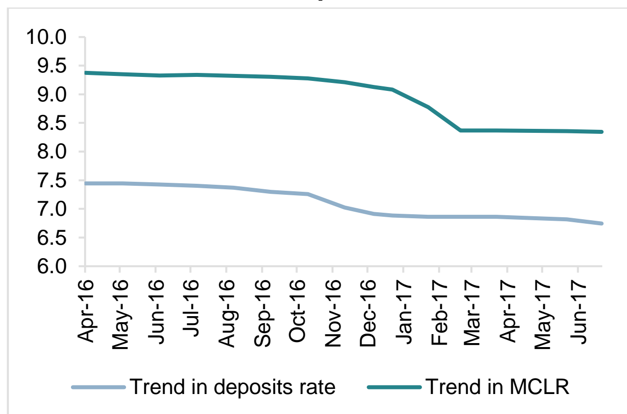
Source: RBI, CEIC, CRISIL Research

Banking sector view

Credit growth to pick-up in H2 FY18

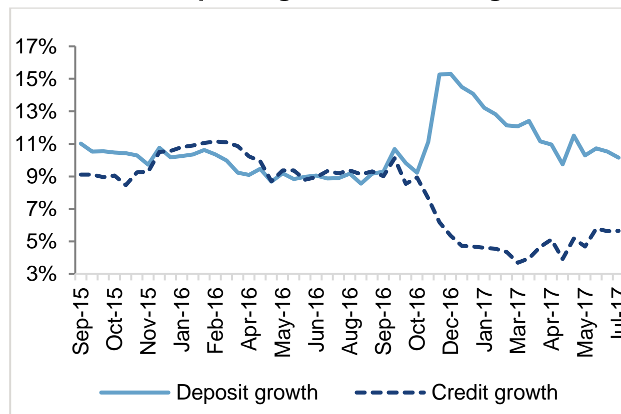
As of July 7, 2017 credit growth was 5.7% on-year, showing some sign of recovery from the after-effects of demonetisation. As of May, 2017 manufacturing sector credit (which accounts for ~38% of gross bank credit) declined by 2.1%, while services sector (24% of gross bank credit) registered moderate growth of 4%. The growth in credit was thus mainly supported by Retail credit (23.5% of gross bank credit), which clocked a double-digit increase of 13.7%. The deposits growth continues to be strong and grew by 10.1% as of July 7, 2017, though it is now lower than the peak of 15.3% in December 2016 as the impact of demonetisation is tapering off. In 2017-18, CRISIL Research expects banking credit to grow at 8-10% supported by an improvement in economic growth and domestic demand, while the deposits growth will remain strong at 9-11%. Given the abundant liquidity and rather tepid credit demand, banks are likely to further bring down interest rates over the next few months.

Trend in MCLR and deposit rates of banks



Note: Average of 1Yr MCLR rate of 10 banks considered. Deposits rate is average of 1 to 2 years of maturity is considered for 10 banks

Credit and deposit growth at divergence



Source: RBI, CRISIL Research

GNPAs to remain high going forward

Notwithstanding the reduction in lending rates by banks at the beginning of calendar 2017, asset quality has remained under pressure. Gross non-performing assets (GNPAs) for the banking system have increased to ~9.6% as on March 31, 2017, from 7.5% as on March 31, 2016. We expect slippages to be lower in fiscal 2018 compared with the previous two fiscals, but GNPAs are nevertheless expected to remain at elevated levels and touch 10.5% of advances by March 31, 2018, due to slower recoveries.

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