A forward-looking move

Monetary Policy Review

August 1, 2018

The development

- The Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC), at the end of its review meeting today, raised policy rates by 25 basis points (bps). The move comes close on the heels of a 25 bps hike effected in June. With this, the repo rate stands at 6.50%, the reverse repo at 6.25%, and the marginal standing facility rate at 6.75%. Five of the six members of the MPC supported the resolution.
- The decision to hike is based on two factors: i) a sustained and broad-based rise in core inflation (headline excluding food and fuel), reflecting strong demand conditions and ii) future upside risks to overall inflation
  - Both headline and core inflation have inched up since the last policy meet. While overall CPI inflation reached 5% on-year in June, core inflation touched 6%. Along with this, inflation expectations have continued to surge. "The June round of the Reserve Bank's survey of households reported a further uptick of 20 basis points in inflation expectations for both three-month and one-year ahead horizons as compared with the last round," the RBI noted. The virtual closing of output gap, as pointed out by RBI, entails rising cost push pressures ahead.
  - Given the government's decision to fix the minimum support prices (MSPs) at a minimum 150% of the cost of production for all kharif crops for sowing season 2018-19, the MPC revised up the CPI inflation forecast for the second half of fiscal 2019 by 10 bps to 4.8%. But it also cited uncertainty on the exact impact, which would depend on the efficacy of the government's procurement operations. The GDP forecast for fiscal 2019 was left unchanged at 7.4%.
  - Despite the rate hike, the MPC maintained its neutral monetary policy stance, with a focus on keeping medium-term inflation at 4%. The neutral stance implies it has kept options open given the uncertainty on the inflation trajectory. The MPC will therefore remain vigilant on this front.

Our view

Today's rate hike was largely a pre-emptive move, in anticipation of the upside risks to inflation. Both headline and core inflation have firmed up since the last policy meet. Even though crude oil prices have stabilised in the last few weeks, future remains uncertain. Food inflation, which has remained benign so far, faces upside risk from implementation of MSP hikes. Other factors are implementation of Pay Commission hikes at the state level and increased corporate pricing power amid improving demand conditions leading to a greater pass through of the input cost. The latest corporate results do point to improvement in growth/ demand conditions.

The good part on the fuel front is that Brent crude has come off its highs and is hovering below the levels seen during the June monetary policy review. That said, oil prices are significantly elevated compared with last year. CRISIL Research expects a 22% on-year jump in crude prices this fiscal. Even though the weightage of fuel in CPI is low, the first-round impact reflects immediately given the deregulation of petrol and diesel prices. The worry is now about the second-round impact, i.e. the broad-based increase in inflation under healthy demand conditions.

The neutral stance notwithstanding, CRISIL believes the RBI will be on hold hereon unless higher-than-anticipated upside risks to inflation from crude oil, stronger demand conditions and food prices materialise. Upcoming domestic and global data holds the key to further moves.

Our view on the banking sector

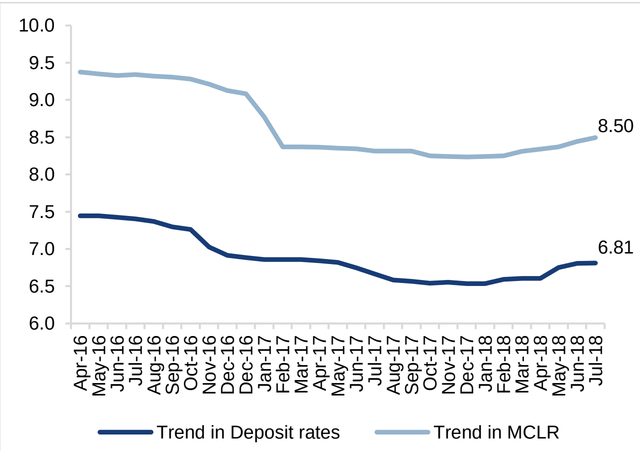
Credit growth picking up

Bank credit continues to grow in double-digits, and logged 12.4% on-year as of July 20, 2018. However, growth was still not broad-based as industrial credit growth remains anaemic. As of June, 2018, industrial credit (which accounts for 34% of gross bank credit) grew 1% on-year, while the services sector (which accounts for 26% of gross bank credit) and retail segment (which accounts for 25% of gross credit) logged double-digit growth of 23% and 18% on-year, respectively.

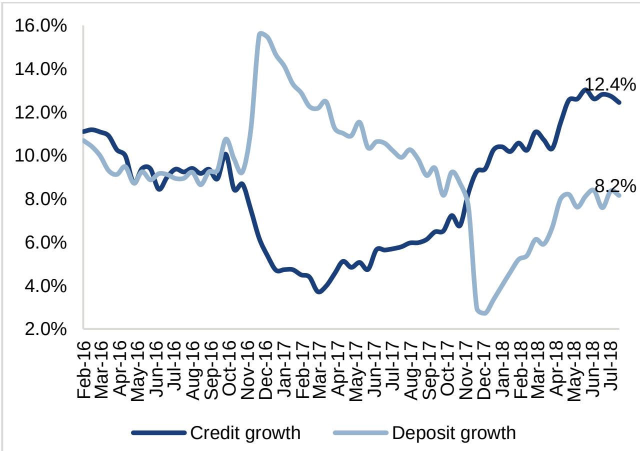
Deposit growth remains weak, at 8.2% on-year as of July 6, 2018, as the impact of demonetisation wears off.

CRISIL Research expects bank credit growth to accelerate to 11-12% on-year in fiscal 2019, supported by an improvement in economic growth, increase in working capital requirement due to rise in commodity prices and resolution of big-ticket stressed assets, while deposit growth is expected to be 7-7.5%.

MCLR and deposit rates of banks



Credit and deposit growth of banks (YoY)



Note: Average of one-year MCLRs of 10 banks Considered. Deposit rate is the average of 1 to 2 Years of maturity, considered for 10 banks.

Source : RBI, CRISIL Research

Gross NPAs to peak out in the second half of fiscal 2019; timely resolution of IBC critical

Banking industry saw slippages of Rs 5 trillion in fiscal 2018. About a fifth of the slippages were due to withdrawal of various structuring schemes by the RBI in February 2018, after the Insolvency and Bankruptcy Code (IBC) process came into force. As a result, system gross non-performing assets (NPAs) ratio increased to 11.6% of advances as on March 31, 2018, compared with 9.3% of advances as on March 31, 2017.

CRISIL Research expects moderation in slippages, better recoveries from NPAs, and improved provision coverage in fiscal 2019. Systemic gross NPA ratio are projected to peak out in the second half of fiscal 2019 at around 12% and then start reducing.

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