CRISIL
An S&P Global Company

Pulling the trigger

Monetary Policy Review

June 6, 2018

- 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). Rates had been kept on hold since the last rate cut in August 2017. With this, the repo rate stands at 6.25%, the reverse repo at 6%, and the marginal standing facility rate at 6.5%. All six members of the MPC unanimously supported the resolution.
- The decision to hike is based on two factors: i) a sharper-than-anticipated pick-up in not just headline inflation, but also core inflation (headline excluding food and fuel), and ii) evidence on soundness of domestic growth revival.
  - The main worry is that core inflation (even after excluding the impact of house rent allowance revision) jumped 80 bps to 5.3% in April. This not only reflects the sharp increase in oil prices over that period, but also other input cost pressures faced by manufacturers due to firmer metal prices and a weaker rupee – which they have possibly begun to pass on to consumers as domestic demand conditions improve.
  - A note of caution was sounded on persistence and pass-through of input price shocks into generalised inflation given that headline inflation has been higher than MPC's medium-term target of 4% for six successive months. This is also reflected in the latest survey of households' inflation expectations, which saw a significant rise. Rising household inflation expectations pose a threat as these can potentially enter wage negotiations and become generalised.
- The MPC accordingly raised its average inflation forecast up mildly, by 10 bps, to ~4.8% for fiscal 2019. The GDP forecast was left unchanged at 7.4%.
- Despite the rate hike, the MPC maintained its neutral monetary policy stance with a focus on maintaining medium-term inflation at 4%. The neutral stance mainly implies that options are left open as uncertainty remains on the inflation trajectory. The MPC will therefore remain vigilant on this front.

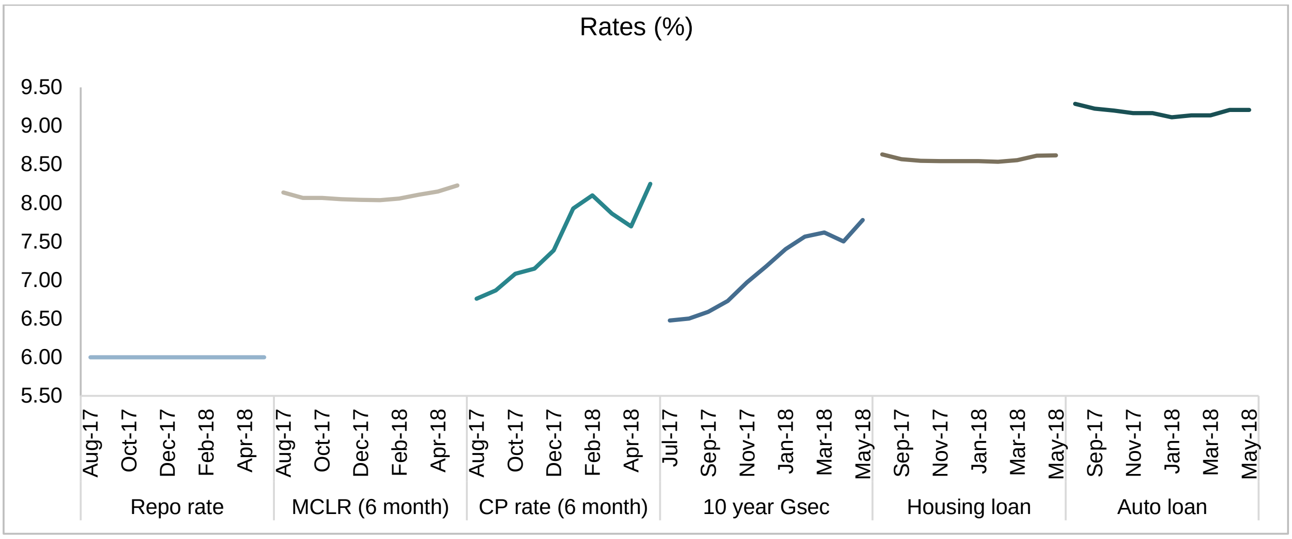
Our view

CRISIL believes there is a possibility of another rate hike if crude oil prices stay at current levels. While monetary policy will stay vigilant, further policy rate action will most likely only be effected if the rise is perceived as being sustainable, with pressures suggesting seepage into generalised inflation through stronger domestic demand.

Last fiscal, global crude oil prices rose 18% on average. CRISIL Research expects another 22% increase this fiscal, taking the average price of the Indian basket to $70-72 per barrel. The first two months of this fiscal have seen prices average $74 per barrel – even hitting $80, the highest since November 2014 – fuelled by geopolitics. While this raises concerns, the shock to CPI inflation could be less severe than it has been in the past. Higher market linkages of retail fuel prices bring about larger first-round impact of rising prices on inflation. And that is clearly visible for now. But persistent transmission of these into generalised inflation will depend on how robust the domestic demand revival is. With improvement in capacity utilisation, the output gap is narrowing, RBI noted.

Moreover, despite keeping policy rates on hold for the last 10 months, market interest rates had already begun to witness de facto tightening. The risk-free rate in the economy – the 10-year government security yield – has jumped 60 bps on average so far in 2018 (and about 15 bps since the last policy meet) on fears of fiscal slippage. Meanwhile, with somewhat tighter liquidity conditions in the banking system, rates on commercial paper borrowings have hardened nearly 90 bps so far in 2018, and 40 bps since the last policy. Meanwhile, banks also have started raising their deposit and loan rates after a nearly four-year rate easing cycle. Hardening of market interest rates in India mirrors a similar trend in Asia where some central banks (South Korea, Malaysia and Indonesia) have begun raising their policy rates in response to weaker currencies and/or tighter global capital flows.

Market interest rates rising despite status quo on policy rates



*Note: *period-end, **6 month tenure, ***major 10 banks, average, ****top 7 public sector banks, average.*

Source: RBI, CEIC, CRISIL Research

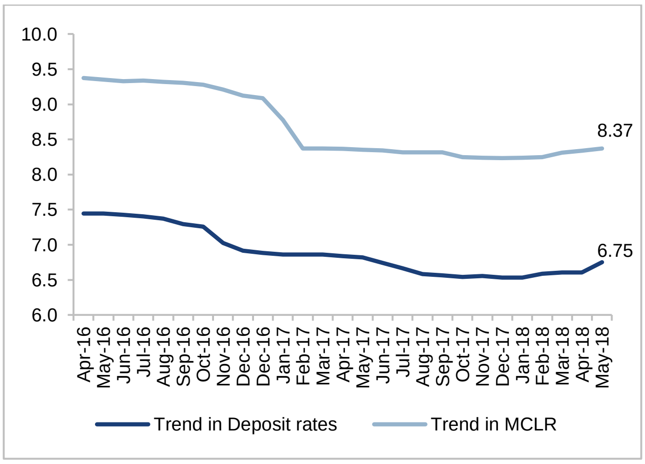
Banking sector view

Credit growth picking up

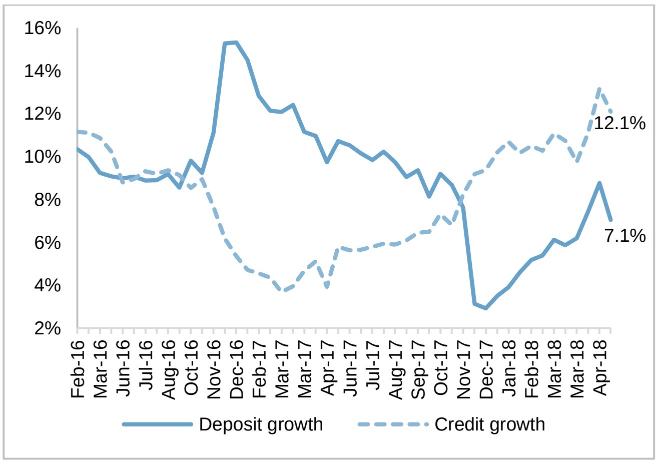
The double-digit run-up in banking credit continues, with growth printing at 12.1% on-year as of May 11, 2018. However, it is still not broad-based and industrial credit growth remains anaemic. As of April 2018, industrial credit (which accounts for 35% of gross bank credit) grew 1% on-year, while the services sector (which accounts for 26% of gross bank credit) and retail segment (which accounts for 25% of gross credit) logged a double-digit growth of 21% and 19%, respectively.

Deposits growth has, however, slowed down to 7.1% as of May 11 as the impact of demonetisation wears off. CRISIL Research expects banking credit to accelerate to 10-12%, supported by an improvement in economic growth and resolution of big-ticket stressed assets, while deposit growth is expected to be 7-7.5% in fiscal 2019.

MCLR and deposit rates of banks



Credit and deposit growth of banks



Note: Average of one-year MCLRs of 10 banks considered. Deposit rate is the average of 1-2 year maturity, considered for 10 banks.
Source : RBI, CRISIL Research

Enhancing PSL limit for housing loans positive for banks

The proposed move to revise the upper limit for housing loans to qualify as priority sector loans (PSL) loans to ₹35 lakh from ₹28 lakh in metropolitan centres (with population of 10 lakh and above), and to ₹25 lakh from ₹20 lakh in other centres, provided the overall cost of the dwelling unit is within the specified limits, would enable a greater proportion of housing loans given out by banks to qualify for PSL. As of April 2018, 37% of housing loans given out by banks qualified for PSL.

Gross NPAs to reduce by this fiscal-end

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, after the Insolvency and Bankruptcy Code (IBC) process came into force. As a result, gross non-performing assets (NPAs) increased to ~11.2% of advances as on March 31, 2018, compared with ~9.5% as on March 31, 2017.

CRISIL expects the asset-quality picture to gradually improve in fiscal 2019 owing to moderation in slippages, better recoveries from NPAs, and improved provision coverage. Systemic gross NPAs are projected to peak at around 11.5% this fiscal and then start reducing.

Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Ltd.
dharmakirti.joshi@crisil.com

Ajay Srinivasan
Director, CRISIL Ltd.
ajay.srinivasan@crisil.com

Dipti Deshpande
Senior Economist, CRISIL Ltd.
dipti.deshpande@crisil.com

Media Contacts

Saman Khan
Media Relations
CRISIL Limited
D: +91 22 3342 3895
M: +91 95940 60612
B: +91 22 3342 3000
saman.khan@crisil.com

Hiral Jani Vasani
Media Relations
CRISIL Limited
D: +91 22 3342 5916
M: +91 982003 9681
B: +91 22 3342 3000
hiral.vasani@crisil.com

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Research

CRISIL Research is India's largest independent integrated research house. We provide insights, opinion and analysis on the Indian economy, industry, capital markets and companies. We also conduct training programs to financial sector professionals on a wide array of technical issues. We are India's most credible provider of economy and industry research. Our industry research covers 86 sectors and is known for its rich insights and perspectives. Our analysis is supported by inputs from our large network sources, including industry experts, industry associations and trade channels. We play a key role in India's fixed income markets. We are the largest provider of valuation of fixed income securities to the mutual fund, insurance and banking industries in the country. We are also the sole provider of debt and hybrid indices to India's mutual fund and life insurance industries. We pioneered independent equity research in India, and are today the country's largest independent equity research house. Our defining trait is the ability to convert information and data into expert judgments and forecasts with complete objectivity. We leverage our deep understanding of the macro-economy and our extensive sector coverage to provide unique insights on micro-macro and cross-sectoral linkages. Our talent pool comprises economists, sector experts, company analysts and information management specialists.

CRISIL Privacy Notice

Last updated: April 2016

Disclaimer

Argentina | China | Hong Kong | **India** | Poland | Singapore | UK | USA
CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited

CRISIL
An S&P Global Company