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On hold for now, but stance tilts towards tightening

Monetary Policy Review

October 5, 2018

The development

- The Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC) decided to keep policy rates on hold, contrary to the consensus view in the market. Repo rate, therefore, stays at 6.50%. Accordingly, the reverse repo and marginal standing facility (MSF) rates are 6.25% and 6.75%, respectively. The MPC also changed its policy stance from *neutral* to *calibrated tightening*. Five of the six members of the MPC supported the decision to keep rates on hold, whereas one member voted for a 25 basis points (bps) rise. Likewise, five of six members voted in favour of change in stance.
- The decision to hold the rate was based on the following factors: i) to observe the evolving situation on inflation front (the recent inflation prints were lower than the projections on account of sharp slowdown in food inflation and accordingly, there has been a downward revision to the future inflation trajectory compared with August 1 projections) and ii) to support liquidity in the system which has come under pressure recently
  - With food inflation slowing down sharply in the previous two months, CPI inflation has fallen below the RBI's medium-term target of 4.0%. In August, CPI inflation measured 3.7%. Despite patchy southwest monsoons, kharif production in most crops has been adequate and the mandi prices continue to trail MSP. The efficacy of the government's procurement, and hence the inflationary impact of higher MSPs, is yet to pan out. That said, RBI did point out to several upside risks such as high crude oil prices, depreciating rupee, Pay Commission hikes at the state level and volatility in international financial and currency markets.
  - Liquidity in the system again moved into deficit during September 11-29 on the back of an increase in government cash balances and the RBI's forex interventions. To support liquidity, RBI conducted OMOs worth Rs 200 billion and injected Rs 406 billion through the liquidity adjustment facility (LAF) in September. It also allowed banks to have a higher carve out from the statutory liquidity ratio (SLR) to support liquidity in the banking system.
  - In view of the ensuing risks to inflation in the future and in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2%, the MPC changed its monetary policy stance from *neutral* to *calibrated tightening*, which means one can't expect a rate cut in the in the ongoing rate cycle.

Our view

The decision to stand pat must have been a tough one, for going by the consensus view in the market, a rate hike was almost a given, considering the macroeconomic pressures.

That said, the growth-inflation mix has improved since the last policy decision on August 1. A status quo is in sync with the monetary policy's primary objective of "maintaining price stability while keeping in mind the objective of growth". It is important to keep in mind that the monetary policy decision was presented in the backdrop of tightening liquidity after some adverse developments in the domestic financial market.

Since market interest rates are already on the rise, the RBI decided to wait and allow for the impact of past policy rate hikes to play out. The government's commitment to maintaining the fiscal deficit at 3.3% of the gross domestic product (GDP) this year and announcement of a lowering of borrowing requirement in the second half of this fiscal also provided comfort on the fiscal control front.

Without doubt, the double whammy of rising oil prices and weak rupee have increased the upside risk to inflation since the last policy meet. At the same time, the inflationary impact of minimum support price (MSP) hikes on food inflation (which has a higher weight in consumer inflation) is difficult to assess. With normal production, and in an environment of soft global food prices, the impact of MSP hikes on food inflation could be lower than expected.

So there was scope for the MPC to wait and watch the evolving situation. It is important to note that there is an option for the RBI to hike rates outside the policy cycle, should the inflation developments warrant.

As the monetary policy stance has been changed from neutral to calibrated tightening, CRISIL believes the RBI can hike the policy rates by another 25bps this fiscal. The sharp depreciation in the rupee, the spurt in global crude oil prices, and the potential impact of MSP hike on food inflation do present upside risks to future inflation trajectory. Improving demand conditions are already reflecting in high core inflation. CRISIL has forecast CPI inflation to average 4.8% in fiscal 2019, up from 3.6% in fiscal 2018.

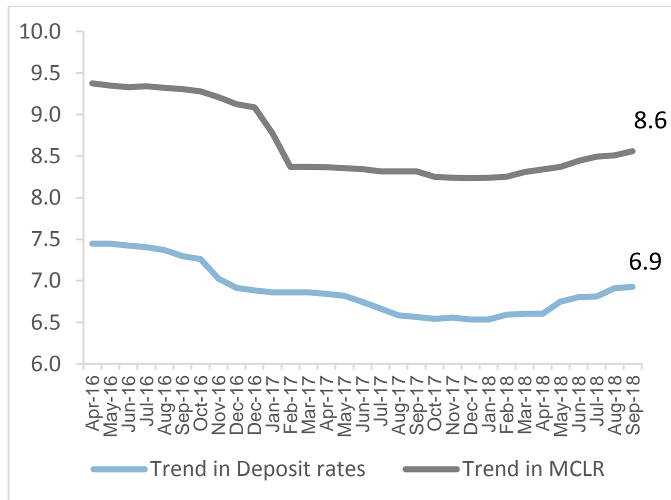
Our view on the banking sector

Credit growth continues to accelerate

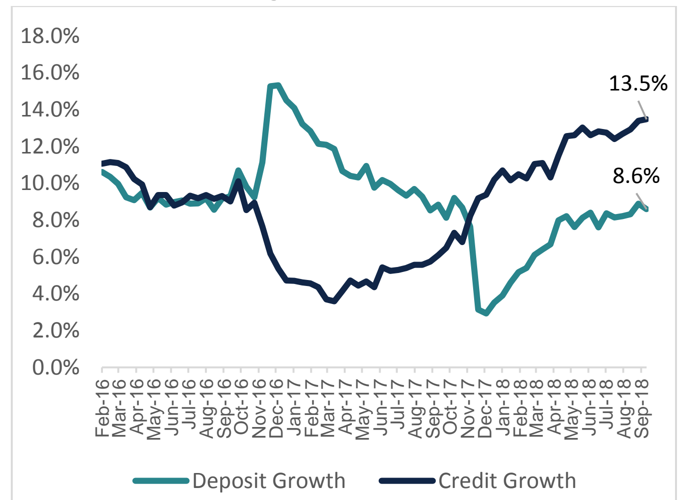
Banking credit continued posting double-digit growth, at 13.5% on-year as of September 14, 2018. However, growth was still not broad-based as industrial credit growth remained marginal. As of August 2018, industrial credit (which accounts for 34% of gross bank credit) grew ~2%, while the services sector (which accounts for 27% of gross bank credit) and retail segment (which accounts for 25% of gross credit) logged ~27% and ~18% growth on-year, respectively. However, deposit growth remained weak, as it grew 8.6% on-year as of September 14, 2018, partly due to a demonetisation-led high base.

CRISIL Research expects banking credit to grow upwards of 10% on-year in fiscal 2019, driven by strong retail credit 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 ~8.5% partly supported by higher deposit rates offered by the banking sector.

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

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