CRISIL RESEARCH

February 2016

CRISIL Monetary Policy Review

As expected, RBI stands pat. Budget, inflation to prompt next rate cut

As expected, the Reserve Bank of India (RBI) on Tuesday (February 2) kept the repo rate unchanged at 6.75% with the Union Budget on the anvil and while awaiting more data on the inflation trajectory. Since its last policy-rate cut, some room for monetary easing has opened up as global growth weakened leading to a sharp decline in crude oil and commodity prices which supported lower inflation. But the RBI also wants to tame consumer price inflation (CPI) to 5% by March 2017 – or a clear percentage point lower than its March 2016 target. This will be a tough ask if the Seventh Pay Commission recommendations are implemented and the monsoon remains inadequate. A non-inflationary Budget will also be a factor in future rate cut decisions.

Our view:

- ***We expect the RBI to slice the repo rate by 25 basis points after the Budget***. The RBI policy stance remains accommodative, but before wielding the knife, it will wait for clarity on both fiscal policy and inflation.
- ***For fiscal 2017, we expect CPI to stay soft at 5% average -- unchanged from fiscal 2016 if India is blessed with a normal monsoon.*** While the upward push to inflation from a low-base effect has played out, food price movement will be the key monitorable in the coming months. A normal monsoon in 2016 is therefore critical for keeping a lid on food inflation. Given the excess capacity in industry, weak demand and soft commodity and oil prices, the impending Seventh Pay Commission payouts are unlikely to swing inflation away from the RBI's glide path.
- ***Policy transmission is an area of concern and lately tighter liquidity conditions have hindered further decline in market-driven interest rates.*** The 10-year benchmark government security yield remains elevated reflecting hardly any impact of monetary easing. The yield at around 7.7% average in January 2016, remains unchanged from a year ago. Downward rigidity in bank base rates is the other big worry. We believe fiscal 2017 should see faster rate cut transmission as average borrowing cost of banks comes down and they begin to fix their lending rates based on marginal cost of funds.
- ***Non-inflationary fiscal policy will be a key trigger for rate cut.*** The Budget for fiscal 2017, to be revealed on February 29, will have to continue to support fiscal consolidation by controlling spending while keeping focus on structural reforms that boost growth in the medium term. These could include, among other things, policies that push agriculture production (and therefore lower food inflation) and those that improve ease of doing businesses and help attract foreign capital, in addition to encouraging domestic businesses to invest. Policies that push supply in services sectors such as education and health, where the inflation is high and stubborn, will also create grounds for a rate cut.
- ***Divergent monetary policies across the world could trigger capital volatility.*** But a low current account deficit and improving macroeconomic conditions are likely to attract higher inflows relative to last year.

(1) Inflation to slide down the intended glide path making room for rate cuts

The RBI's target of 6% CPI inflation by March 2016 looks attainable, but meeting the next year's target of 5% inflation by March 2017 could be a tall order if monsoon plays truant. We expect CPI to stay soft at 5%, unchanged from fiscal 2016, assuming a normal monsoon, softer oil and commodity prices and only a mild pick-up in domestic demand.

Key monitorables for food inflation in 2016 are; 1) the impact of lagged sowing of Rabi output; 2) global food prices; and, 3) the monsoon. The El Niño occurrence has spawned weather changes across the world in the last few months. The Australian Bureau of Meteorology believes the event has peaked in recent weeks and ocean temperatures suggest this has been one of the three strongest El Niño events in the past 50 years. El Niño conditions are expected to ebb in the coming months and weather patterns should return to normal by the first quarter of next fiscal. In India, wheat production is expected decline for the second consecutive year in 2016 due to an unusually warm winter in central and northern India and pest infestation. In case temperatures rise further by February and March -- which is the harvest season -- production levels could fall further and below the governments' target. Rabi sowing so far has lagged considerably – it is 3% below last year's level as of January 28, 2016, with the worst-affected crops being rice (sowing down 7%), wheat (down 4.4%), and pulses and oilseeds (each down 2.7%). Next fiscal, the benefit from falling global food prices could also somewhat reduce. And for the first time in four years, global food prices are expected to rise. But the pick-up seen is a mild 1.5% as per World Bank estimates, compared with a 15% drop in 2015.

(2) Tighter liquidity, slow rate cut transmission hampering monetary policy effectiveness

In this rate-cutting cycle that began on January 2015, the RBI has brought down the repo rate by 125 bps. But while market-driven interest rates such as those on commercial papers and certificates of deposits had been falling sharply until November, tighter liquidity conditions have lately pushed them up. At the same time, the base lending rates of banks have come down only by about 60 basis points, limiting the boost to consumption from lower interest rates. Also, tighter liquidity – the average daily net injection in January was Rs 190 billion – and prospects of increase in issuance of state debt (as per the UDAY program for discoms) has kept the 10-year benchmark yield at elevated levels of around 7.7% average in January 2016 – or unchanged from a year ago. This is mainly a result of increased supply of government bonds (this year states will be issuing bonds as discom losses are transferred to the states), larger government cash balances with the RBI, faster growth in currency with public (12% on-year) and higher seasonal demand for bank credit (10.8% on-year). Daily data compiled by the RBI shows that government's daily average cash balances during January rose to Rs 977 billion from Rs 761 billion in December. By the month-end, the cash balance with the RBI was higher at Rs 1.4 trillion.

Figure 1: 10-year G-Sec yields firm despite monetary policy easing

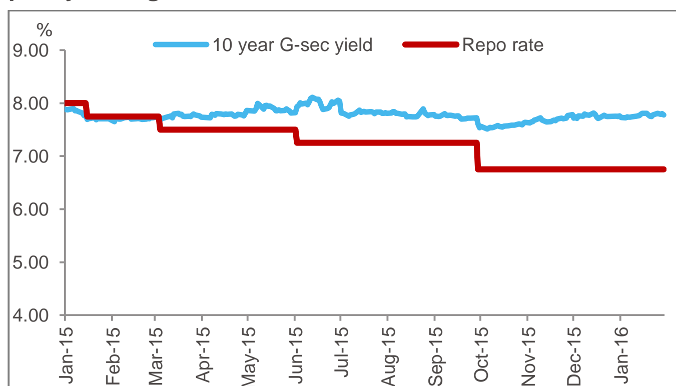
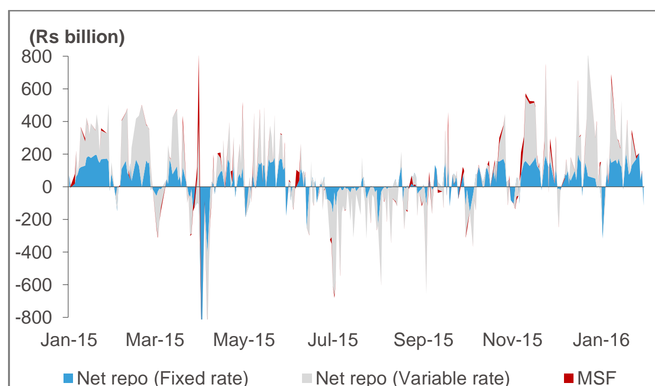


Figure 2: Tighter liquidity restricting further plunge in borrowing costs



Source: RBI, CEIC, CRISIL Research

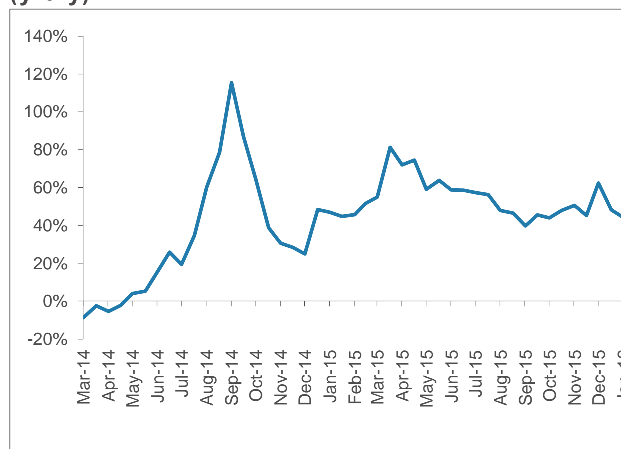
Bank credit growth to improve in 2016-17

- Aggregate bank credit growth increased marginally to 10.8 % y-o-y as on January 8, 2016, from 10.4% in the last fiscal. Growth has been on an uptrend from November 2015 onwards. The growth in bank credit was mainly because of lower interest rates and higher credit growth to services sectors. Funds raised through commercial paper though registered 44% growth in January 2016 only marginally lower as compared to last fiscal's 47%.
- Corporate loan off-take was at 6.7% in December 2015 similar to that in the same period last fiscal. However, growth has shown improvement compared to September 2015.
- We expect a gradual pick-up towards the end of 2015-16, driven by a rise in retail loan (automobile and home loans), public-sector investments (which will in turn drive-up working capital demand across allied sectors) and small-scale enterprises. Overall, bank credit growth is projected to increase to 11-12% by March 2016 vis-à-vis ~10% in 2014-15.
- CRISIL Research expects credit growth to be in the range of 12%-14% in 2016-17, supported by pick-up in economic growth, declining difference in bank base rate and capital market rates, and healthy retail credit growth.

Figure 3: Credit growth (y-o-y)

Source: RBI, CRISIL Research

Figure 4: Commercial paper issuances rise (y-o-y)



Source: RBI, CRISIL Research

Deposits growth also to pick up slightly in 2016-17

- Bank deposit growth slowed to 10.2% y-o-y as on January 8, 2016, compared with 11.5% in last fiscal, because of lower need for funds by banks.
- Deposits are forecast to increase 11 percent by March 2016, similar to that achieved in 2014-15, backed by higher disposable income on account of low inflation and higher volatility across other investment avenues. In 2016-17, deposits growth will be range bound to 11%-13%.

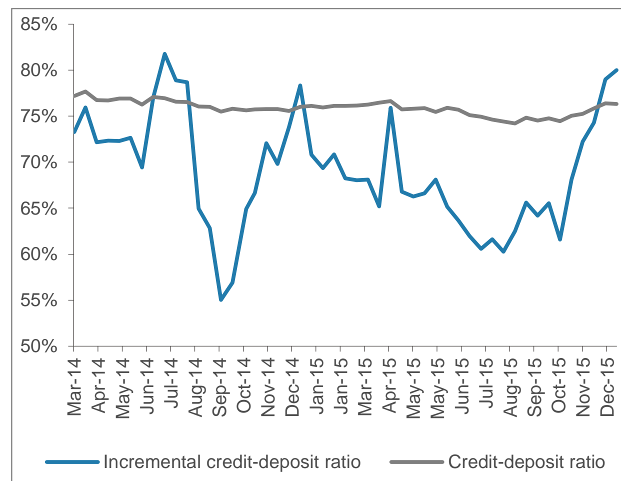
Figure 5: Deposit growth, y-o-y

Source: RBI, CRISIL Research

CD ratio to increase further in 2016-17 as credit growth improves

- Credit-deposit (CD) ratio stood at 76.3% as on January 8, 2016, up by 40 bps compared with January 9, 2015, led by higher credit growth. However, incremental CD ratio has improved to 80% as on January 8, 2016 vis-à-vis 62% as on October 30, 2015 on account of higher credit growth.
- While credit demand will pick up slightly in the Q4 of 2015-16, deposits will grow moderately. We, therefore, expect the CD ratio to remain stable at 75-77% in 2015-16.
- In 2016-17, as the credit is expected to pick up reasonably faster, the CD ratio is expected to be in the range of 77-79%.

Figure 6: Trend in CD ratio

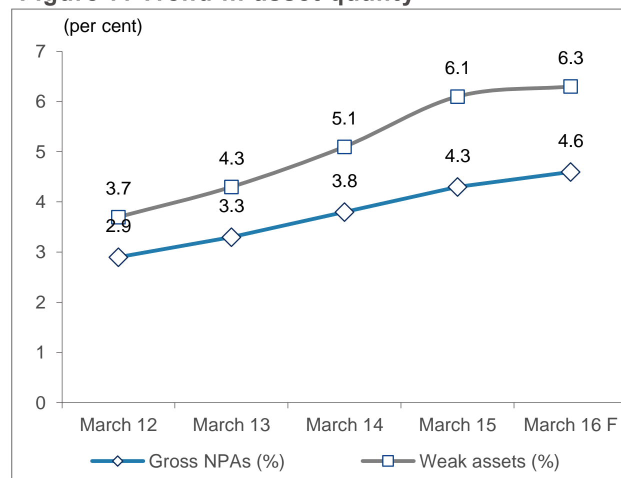


Source: RBI, CRISIL Research

Asset quality to remain weak

- Gross non-performing assets (GNPAs), at 4.3% of advances as of March 2015 have increased significantly from 3.8% in March 2014. As of September 2015, public sector banks (PSBs) reported GNPAs of 5.7% (95 bps higher y-o-y). The asset quality of private sector banks, was relatively robust, with GNPAs of 2.1%, however, there are signs of high slippages even in portfolio of private banks.
- In 2015-16, GNPAs is estimated to inch up to 4.6% on account of lower sales to asset reconstruction companies (ARCs) and high slippages mainly from restructured standard accounts. Conversion of debt to equity by banks through the strategic debt restructuring route and restructuring under the 5/25 scheme is expected to limit GNPA increase.
- In 2015-16, CRISIL expects sales to ARCs to be Rs 60 billion compared with an estimated sale of Rs 160-170 billion in 2014-15 due to regulatory policy changes requiring ARC's to put in more capital

Figure 7: Trend in asset quality



E: Estimated; F: Forecast

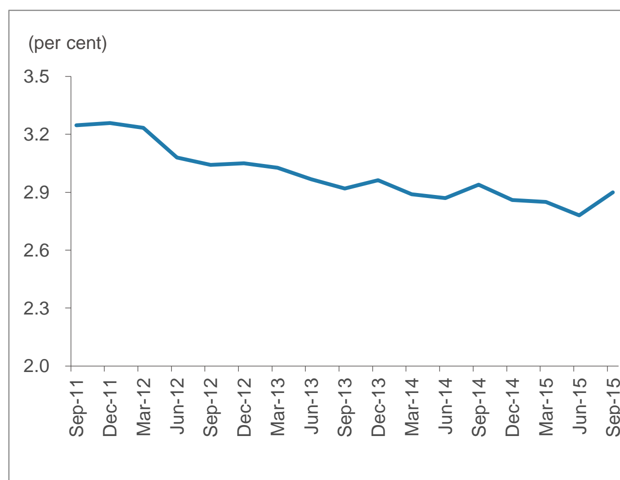
Weak assets = reported GNPA + 35% of outstanding restructured advances (excluding state power utilities) + 75% of investments in security receipts + 15% of loans structured under the 5/25 scheme

Source: RBI, CRISIL Research

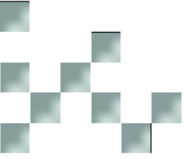
NIMs to decline marginally in 2015-16

- Despite the 125 bps cut in the repo rate since January 2015, we have seen lending rates decline only by median 60 bps, given higher risk aversion and pressure on banks' interest income growth.
- While net interest margins (NIMs) of PSBs fell by 12 bps y-o-y in September 2015 quarter, those of private sector banks contracted by 4 bps, led by lower interest expenses arising from a favourable liability mix and higher CD ratio.
- NIMs are expected to be marginally lower in 2015-16, on account of lower yields and higher GNPAs (especially of PSBs).

Figure 8: Net interest margins



Source: Company reports, CRISIL Research



Analytical Contacts:

Dharmakirti Joshi
Chief Economist, CRISIL Research
Email: dharmakirti.joshi@crisil.com

Ajay Srinivasan
Director, CRISIL Research
Email: ajay.srinivasan@crisil.com

Dipti Deshpande
Senior Economist, CRISIL Research
Email: dipti.deshpande@crisil.com

Media Contacts

Tanuja Abhinandan
Media Relations
Email: tanuja.abhinandan@crisil.com
Phone: +91 22 3342 1818

Jyoti Parmar
Media Relations
Email: jyoti.parmar@crisil.com
Phone: +91 22 3342 1835

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CRISIL Limited
CRISIL House, Central Avenue,
Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: +91 22 3342 3000 | Fax: +91 22 3342 8088
www.crisil.com

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