April 2016

CRISIL Monetary Policy Review

Aligning rates, plugging liquidity holes

The Reserve Bank of India (RBI) on Tuesday (April 5) cut the repo rate by 25 basis points (bps) to 6.5% on the back of prudent fiscal consolidation path envisaged in the Union Budget, softer inflation and the imperative to boost growth. The RBI also narrowed the policy-rate corridor to +/-50bps to align market-driven rates closer to the repo rate. Additionally, to manage liquidity conditions, the central bank reduced the minimum daily requirement of the cash reserve ratio (CRR) from 95% to 90%. It lowered the average ex-ante liquidity deficit in the system from 1% of net demand and time liabilities (NDTL) to neutrality, implying greater injection of liquidity.

Our view:

- ***We expect another 25bps cut this fiscal.*** The RBI's policy stance remains accommodative, but before wielding the knife, it will monitor growth recovery and watch how the things unfold in the money market.
- ***For 2016-17, we expect CPI to stay soft at 5% on average -- unchanged from 2015-16 -- if India is blessed with a normal monsoon.*** While the upward push in inflation from a low-base effect has played out, food-price movement from hereon will be the key monitoriable. A normal monsoon in 2016 is, therefore, critical for keeping a lid on food inflation. Given the excess capacity in industry, fiscal restraint, weak demand and softer 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 likely to improve, although at a slow rate, as tight liquidity conditions restrict the fall in the market-driven rates.*** We believe 2016-17 should see faster rate-cut transmission as the average borrowing cost of banks comes down with a decline in small-savings deposits and they begin to fix lending rates based on the marginal cost of funds.
- ***Non-inflationary fiscal policy supports a rate cut.*** The Budget for 2016-17 continued to support fiscal consolidation by controlling spending, while keeping focus on structural reforms that boost investment and growth in the medium term. These include policies that push agricultural production (and, therefore, lower food inflation) and those that improve the ease of doing businesses and help attract foreign capital, in addition to encouraging domestic businesses to invest.
- ***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.
- ***We expect GDP growth to rise to 7.9% in 2016-17, assuming a normal monsoon.*** *In comparison, the RBI's growth forecast is at 7.6% for the current fiscal and its inflation target stands at 5% for March 2017*

Inflation to slide down the intended glide path, making roosm for another rate cut

We expect CPI to stay soft at 5%, unchanged from 2015-16, assuming a normal monsoon, softer oil and commodity prices and only a mild pick-up in domestic demand. Key variables to monitor for food inflation in 2016 are: 1) the impact of lagged sowing of rabi, or winter crop, output; 2) global food prices; and, 3) the monsoon. The El Niño occurrence has spawned weather changes across the world in the past few months. Based on 26 El Niño events since 1990, half of the incidents have been followed by a neutral year, while 40% have been followed by La Niňa. La Nina is characterised by cooling of sea-surface temperatures and higher rainfall. The Australian Metrological Bureau estimates that a neutral or La Nina condition is equally likely for the second half of calendar 2016, while a repeat occurrence of El Niňo is least likely.

On the other hand, the benefit from falling global food prices could also decline somewhat in 2016. 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.

Monetary policy effectiveness to improve gradually, while liquidity conditions remain tight

In this rate-cutting cycle that began on January 2015, the RBI has brought down the repo rate by 150 bps. But, while market-driven interest rates, such as those on commercial paper and certificates of deposits, fell sharply until November, tighter liquidity conditions have of late pushed them up again. At the same time, base lending rates of banks have come down only by about 60 basis points, limiting the boost to consumption from lower interest rates.

However, in the coming months, policy transmission is expected to improve as: 1) the government has cut the small-savings rate, effective April 1, 2016, giving more room to banks to reduce their deposit rates. This, in turn, will help reduce the cost of funds, which is a key component when pricing loans; and 2) the shift to marginal cost of funds based lending rate (MCLR) for pricing loans, from using the average cost of loans, will also reduce lending rates.

With liquidity conditions remaining tight, the policy-rate transmission is likely to be gradual for now. In March, the net liquidity injection was at Rs 1.9 billion, compared with Rs.1.3 billion in January. This is mainly a result of larger government cash balances with the RBI, faster growth in currency with public (15% on-year) and higher seasonal demand for bank credit (11% on-year). The RBI has announced steps to improve liquidity in the system by: 1) lowering the average ex-ante liquidity deficit in the system from 1% of NDTL to neutrality; 2) reducing the minimum daily maintenance of CRR from 95% of the requirement to 90%; and 3) moderating the build-up of government cash balances with the RBI.

Figure 1: 10-year G-Sec yields respond to fiscal deficit cut

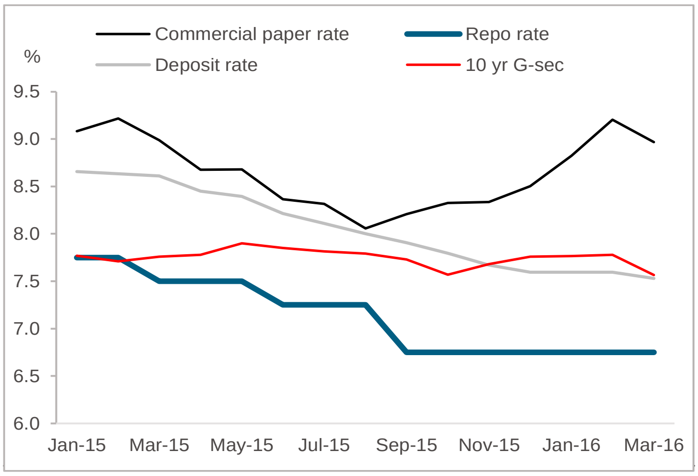
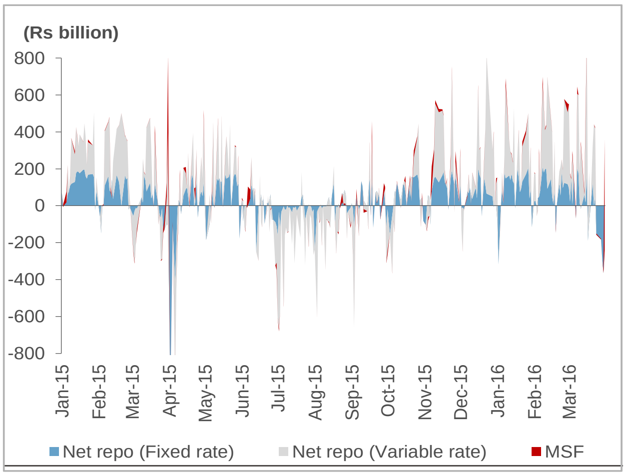


Figure 2: Tighter liquidity restricting further plunge in borrowing costs

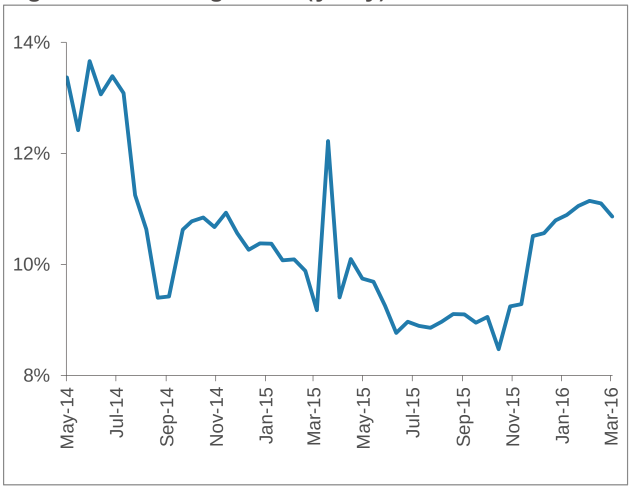


Source: RBI, CEIC, CRISIL Research

Bank credit growth to improve in 2016-17

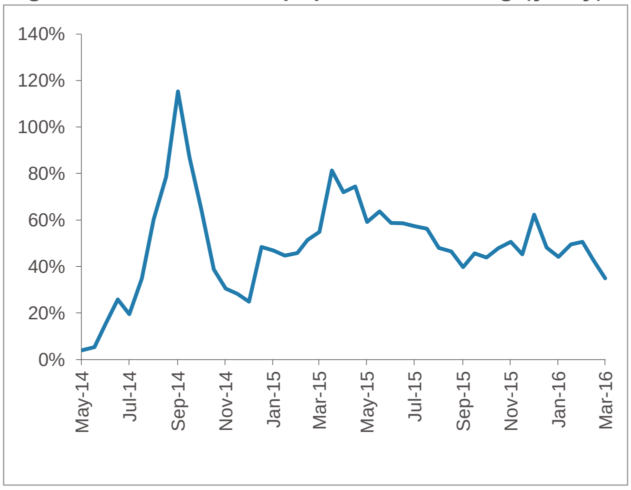
- Aggregate bank credit growth increased marginally to 10.9% y-o-y as on March 18, 2016, from 9.2% in the last fiscal. Growth has been on an uptrend since November 2015, mainly because of pick-up in retail segment, which accounts for 21% of gross bank credit now, compared to 19% a year ago. Funds raised through commercial papers though registered 35% growth as of March 2016, lower than last fiscal's 55%.
- Corporate loan off-take stood at 6.6% in January 2016 similar to that in the same period last fiscal. However, credit has gone up since November 2015.
- Overall, bank credit growth is projected to increase to 11-12% by end of March 2016 vis-à-vis ~10% in 2014-15.
- CRISIL Research expects credit growth to range between 12%-13%% in 2016-17, supported by spurt in economic growth, declining difference between bank lending and capital market rates, and healthy retail credit growth.

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



Source: RBI, CRISIL Research

Figure 4: Commercial paper outstanding (y-o-y)

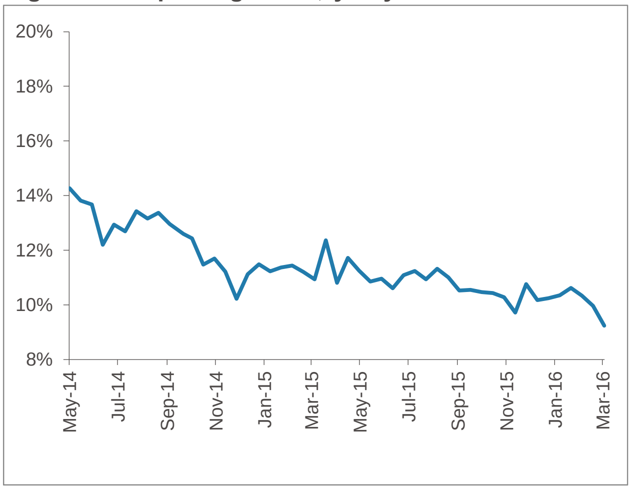


Source: RBI, CRISIL Research

Deposits growth also to improve slightly in 2016-17

- Bank deposit growth slowed to a decadal low of 9.2% y-o-y, as on March 18, 2016, compared with 10.9% in last fiscal.
- Deposits are forecast to increase by about 10% by March 2016, slightly lower than that achieved in 2014-15. In 2016-17, deposits growth will be range-bound between 11% and 12%. However, repayment of foreign currency non-residential (FCNR-B) deposits raised by banks towards the end of calendar year 2013 will remain a monitorable.

Figure 5: Deposit growth, y-o-y

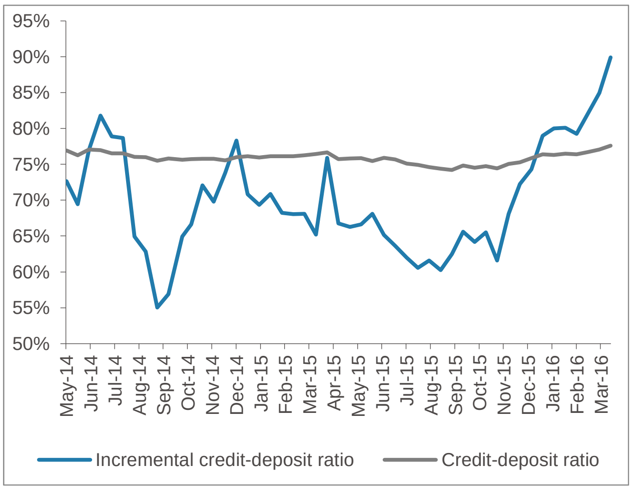


Source: RBI, CRISIL Research

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

- Credit-deposit (CD) ratio stood at 77.6% as on March 18, 2016, up by 110 bps compared with March 20, 2015, led by higher credit growth. However, incremental CD ratio has improved to 90% as on March 18, 2016 vis-à-vis 65% as on March 20, 2015 on account of higher credit growth as well as decadal low deposit growth. We expect the CD ratio to remain stable at 77-79% in 2015-16.
- In 2016-17, as credit is expected to pick up reasonably faster, the CD ratio is expected to be in the range of 78-80%.

Figure 6: Trend in CD ratio

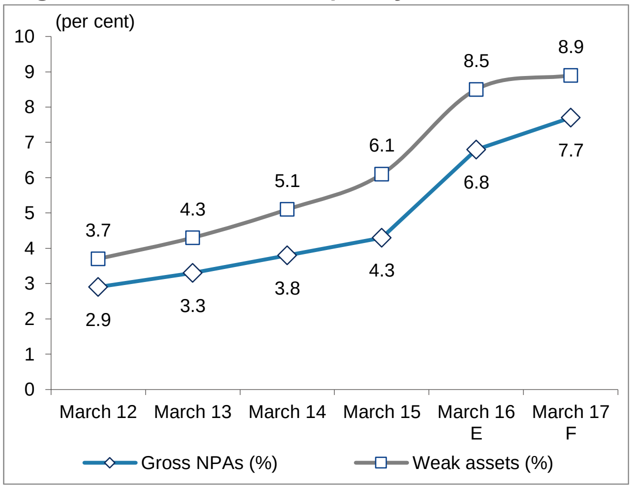


Source: RBI, CRISIL Research

Asset quality to remain weak

- As of December 2015, public sector banks reported gross non-performing assets (GNPA) of 7.1%. The asset quality of private sector banks has also felt the heat but remained healthy with 2.5% GNPAs; however, there are signs of significant slippages even in portfolios of private banks.
- In 2015-16, GNPAs are estimated to inch up to 6.8% on account of RBI's diktat to recognise stress accounts as NPAs under its asset quality review initiative, and high slippages, mainly from restructured standard accounts. In 2016-17 also, GNPAs are expected to be high at 7.7% due to increased slippages from large accounts.

Figure 7: Trend in asset quality



E: Estimated;

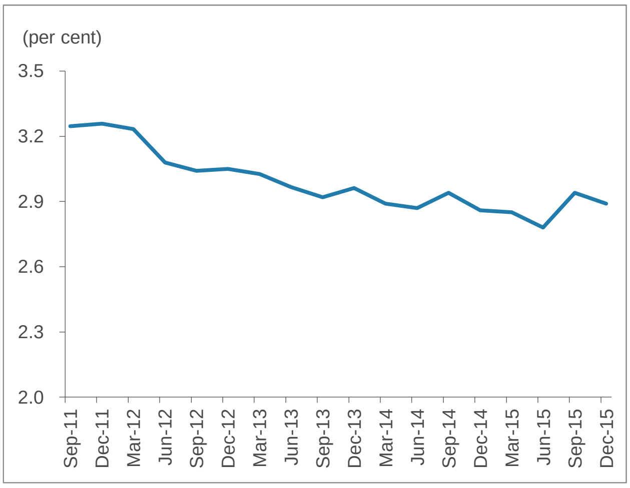
Weak assets = reported GNPA + 35% of outstanding restructured advances (excluding state power utilities) + 75% of investments in security receipts + 15% of loans structured under the 5/25 scheme

Source: RBI, CRISIL Research

Net interest margins to decline further in 2016-17

- The introduction of marginal cost of lending rate (MCLR) mechanism, reduction in small savings rate, and refinement in liquidity management framework by RBI is expected to improve the transmission of policy rate cuts by RBI.
- NNIMs of PSBs contracted by only 4 bps y-o-y in December 2015 quarter; margins of private sector banks were stable because of lower interest expenses arising from a favourable liability mix and higher incremental CD ratio.
- NIMs are expected to be marginally lower in 2015-16, on account of lower yields and higher GNPAs (especially of PSBs), and forecasted to decline further by 10 bps in 2016-17 due to the impact of slippages, the new MCLR regime and the Ujwal DISCOM Assurance Yojana to revive discoms.
- Depsite only a marginal contraction in NIMs, profitabililty (return on assets) of PSBs is expected to be significant pressured in 2015-16 as well as 2016-17 due to higher provisioning requirements following increase in GNPAs.

Figure 8: Net interest margins



Source: Company reports, CRISIL Research

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