ICRA COMMENTS ON RBI'S FIFTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2018-19

MPC pauses in December 2018 amid heightened uncertainty to inflation outlook

December 2018

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Highlights of the RBI's Fifth Bi-monthly Monetary Policy Statement for 2018-19 – December 2018

- The Monetary Policy Committee (MPC) voted unanimously to retain the Repo rate under the Liquidity Adjustment Facility (LAF) at 6.50% in the fifth review of monetary policy for FY2019. Moreover, the Committee retained the calibrated tightening stance of monetary policy, by a vote of 5:1.
- With status quo on the Repo rate, the Reverse Repo rate, Marginal standing facility (MSF) rate and bank rate were also kept unchanged 6.25%, 6.75% and 6.75%, respectively.
- However, the MPC has proposed to reduce the Statutory Liquidity Ratio (SLR) by 25 bps every quarter, starting January 2019, until the same reaches 18% of NDTL.
- The MPC revised its CPI inflation forecast for H2 FY2019 to 2.7-3.2% from 3.9-4.5% projected earlier in October 2018, while the inflation projection for H1 FY2020 was placed at 3.8-4.2%. However, it described the risks are tilted to the upside.
- The MPC maintained its GDP growth for FY2019 at 7.4% for FY2019 (7.2-7.3% in H2 FY2020), while placing its GDP growth forecast for H1 FY2020 at a higher 7.5%, with risks to the downside.
- The Cash Reserve Ratio (CRR) was kept unchanged at 4.0%. The Reserve Bank of India (RBI) maintained its stance of neutral liquidity. It had already announced open market operations (OMOs) to purchase Rs. 400 billion of Government securities for the month of December 2018, to infuse durable liquidity, and has now indicated that it may continue OMO purchases in Q4 FY2019, if required.

Outlook

While the repo rate was unanimously retained at 6.5%, there was one dissenting vote in favour of changing the stance back to neutral. The individual MPC members' views on the inflation outlook may be clarified in the upcoming minutes of the December 2018 meeting. Overall, there appears to be a substantial likelihood of a change in the monetary policy stance to neutral from calibrated tightening in Q4 FY2019. This may well be followed by a repo rate cut in Q1 FY2020, if the feared inflationary pressures do not materialise.

Following some stabilization in crude oil prices in recent sessions and the unexpected decline in the US 10-year yield below 3%, the yield for the 10-year Government of India security (G-sec) had already retreated below 7.6% prior to the policy announcement. The yield declined further to around 7.44% after the sharp reduction in the MPC's inflation forecasts and the indication that open market operations would continue to be used to inject liquidity, even though the Central Bank did not cut the CRR along expected lines. We expect the 10-year G-sec yield to trade in a band of 7.3-7.7% in the remainder of this quarter. An upward revision in the Government of India's borrowing calendar for Q4 FY2019, is the key risk that could significantly push up G-sec yields from the current levels.

Contacts:

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Aditi Nayar
+91 124 4545 385
aditin@icraindia.com

Anil Gupta
+91 124 4545314
anilg@icraindia.com

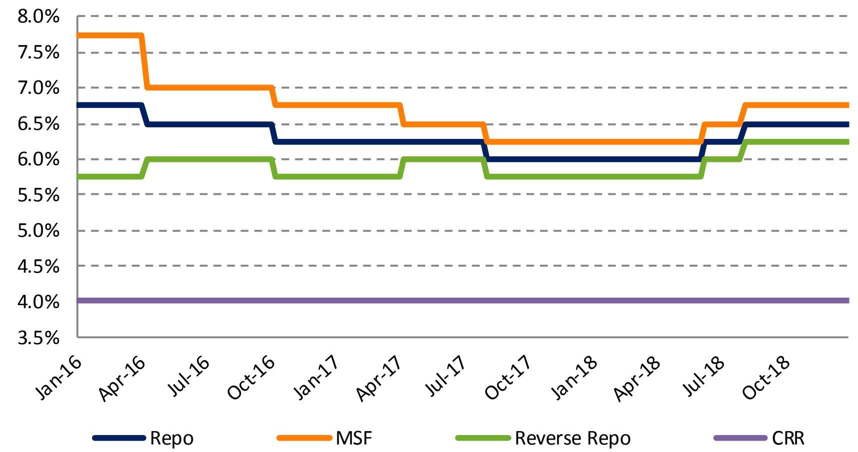
MPC votes for pause in repo rate and stance

As expected, the six-member MPC voted unanimously for a pause in the policy repo rate at 6.5% in the December 2018 policy review. In addition, it retained the stance of monetary policy at calibrated tightening, by a vote of 5:1, while emphasising the prevailing uncertainty related to various inflation risks. The CPI inflation projections were revised downwards by the MPC, with risks tilted to the upside. However, the MPC retained its GDP growth projection for FY2019 at 7.4%, while placing its GDP growth forecast for H1 FY2020 at a higher 7.5% with downside risks.

The headline CPI inflation eased to a 13-month low 3.3% in October 2018, whereas the core CPI inflation (excluding food and beverages, fuel and light, petrol and diesel for vehicles) rose to a disconcerting 6.1%. While the MPC noted that the broad-based weakening of food inflation, and the reversal in crude oil prices have imparted a downward bias to retail inflation, it nevertheless reiterated the need to closely monitor these factors. In addition, it highlighted several risks to the inflation trajectory, such as the likelihood of a sudden reversal in inflation for food items, particularly for volatile perishable items; uncertainty regarding the impact of higher minimum support prices (MSPs); lack of clarity on the medium-term outlook for crude oil prices; volatility in global financial markets; elevated and sticky one-year ahead inflation expectations of households; fiscal slippage at the centre or state level; and staggered impact of HRA revision by the state governments. On balance, the MPC placed its headline CPI inflation forecasts at 2.7-3.2% for H2 FY2019 (previously 3.9-4.5%) and 3.8-4.2% for H1 FY2020, while describing the risks as tilted to the upside.

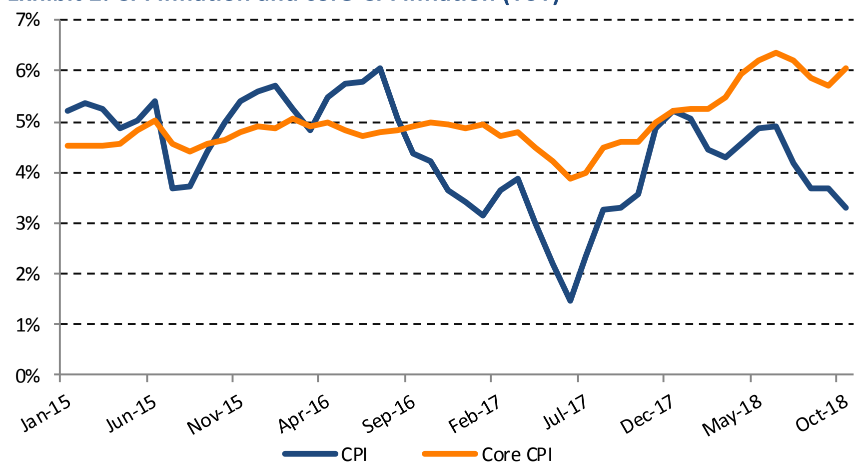
With capacity utilisation improving to a seasonally adjusted 76.4% in Q2 FY2019, the Committee highlighted that the output gap remains virtually closed. This, in conjunction with acceleration in investment activity, suggests that capacity addition may continue in the near term. Moreover, it expects the reversal in crude oil prices to boost corporate earnings as well as the purchasing power of households, which would support growth in H2 FY2019. Additionally, a pickup in credit offtake from the banking sector, as well as the improving outlook for FDI inflows, would support the growth momentum. However, the MPC also emphasized downside concerns to economic growth. For instance, the unfavourable rabi sowing trends may dampen rural demand, going forward. Moreover, persisting volatility in the financial markets, slowing global demand, as well as rising trade tensions, may drag export prospects, and consequently, the growth outlook. Overall, the MPC retained its GDP growth projection for FY2019 at 7.4%, factoring in a growth of 7.2-7.3% in H2 FY2019, while placing its forecast for H1 FY2020 to a healthy 7.5%, with risks somewhat to the downside.

Exhibit 1: Movement in Key Rates



Source: RBI; ICRA Research

Exhibit 2: CPI Inflation and core-CPI inflation (YoY)



Source: CSO; ICRA Research

RBI maintains its stance of neutral liquidity, to continue OMO purchases in Q4 FY2019, if required

Since the last monetary policy review on October 5, 2018, the systemic liquidity conditions have remained largely in deficit, with surpluses witnessed only on three out of the 45 days till December 1, 2018. On a daily-average basis, the liquidity deficit widened to Rs. 802 billion during October 6, 2018 till December 1, 2018, from Rs. 212 billion during the previous policy period of August 1, 2018 till October 5, 2018.

The daily average liquidity deficit rose from Rs. 623 billion during October 2018 to Rs. 811 billion in November 2018, despite sizeable OMO purchases conducted by the RBI during October 2018 (Rs. 360 billion) and November 2018 (Rs. 500 billion), partly because of net selling by FPIs in both the equity and debt segments in October 2018. Moreover, a rise in currency with public (CWP) related to the festive season also tightened liquidity conditions. Although the FII flows were positive during November 2018, incremental bank credit outpaced deposits, contributing toward tighter systemic liquidity. The YoY growth in non-food bank credit growth stood at 15.11% as compared to 9.1% growth in deposits as on November 9, 2018.

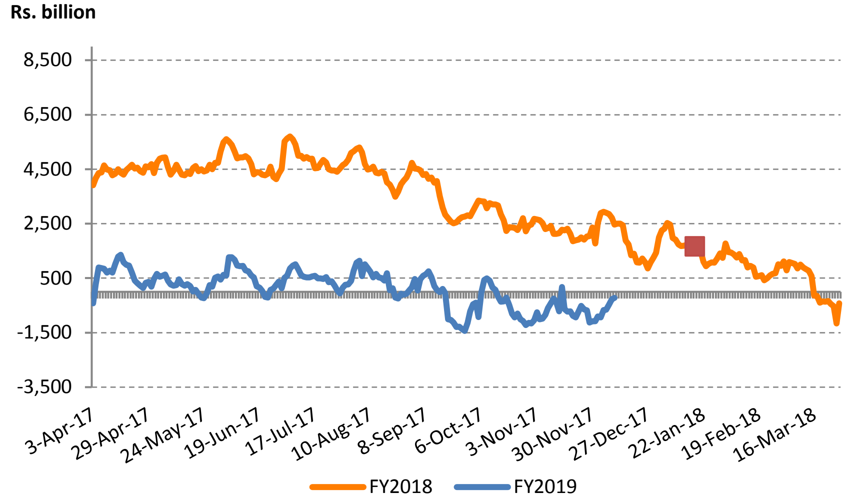
The liquidity deficit peaked at Rs. 1.37 trillion on October 22, 2018. With FII inflows in November 2018 and OMO purchases, the liquidity conditions turned into marginal surplus of Rs. 21 billion on November 7, 2018. The liquidity conditions reversed in the subsequent days and reached a deficit of Rs 1.28 trillion on November 20, 2018, because of the likely strong credit growth from the banking system. With the upcoming payment of advance tax in December 2018, which is expected to tighten the liquidity conditions, the RBI has announced further OMO purchases of Rs. 400 billion for the ongoing month, to infuse the durable liquidity and maintain neutral liquidity conditions. With this, the total OMO purchases for FY2019 will stand at Rs. 1.76 trillion (including the Rs. 400 billion announced for December 2018).

As expected, the Central Bank did not cut the CRR to ease liquidity conditions. In our view, the RBI is likely to continue to address structural liquidity mismatches through OMOs and frictional liquidity mismatches through term repos with variable tenors in Q4 FY2019, rather than cutting the CRR in the near term. ICRA expects aggregate OMOs may exceed Rs. 2.3 trillion for FY2019.

Despite the tightening in liquidity conditions, the call money rates exceeded the repo rate of 6.50%, on only five days during October 6, 2018 and December 4, 2018, with a peak of 6.56% on October 17, 2018. On a weighted average basis, the call money rates remained below the repo rate at 6.45% during October 2018 and 6.34% during November 2018, as compared to 6.35% during August 2018 and 6.46% during September 2018.

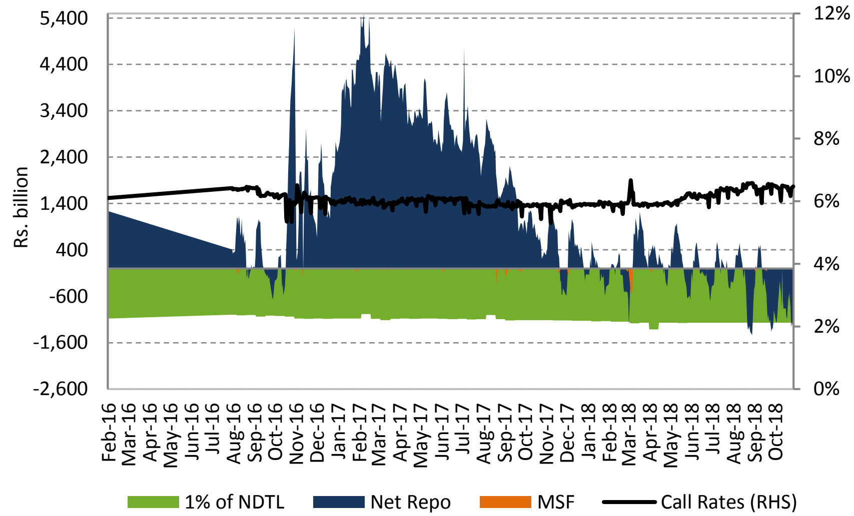
With liquidity conditions expected to remain in deficit mode, despite the RBI's stance of maintaining neutral liquidity, we expect the call money rates/short-term rates may exceed the repo rate, i.e. 6.50%.

Chart 3: Liquidity Infusion (-)/ absorption (+) (Net overnight & term repos/reverse repos; MSF; MSS)



Source: CEIC; ICRA Research

Chart 4: Call money rates



Source: RBI; ICRA Research

Other Key Developments

The RBI provided an update on the various other initiatives undertaken in the fields of banking, financial markets, payments & settlements and financial literacy as it continued to further strengthen the domestic financial system.

External benchmarking of new floating rate loans by banks

To improve the transparency in loan pricing by banks, RBI has proposed that all the new floating rate retail loans and floating rate loans to micro and small enterprises extended by banks from April 1, 2019 shall be benchmarked to one of the below mentioned external benchmarks:

- Repo rate
- 91-day Treasury bill yield
- 182-day Treasury bill yield
- Any other benchmark rate reported by Financial Benchmark India Limited (FBIL)

The spread, which is at the discretion of the bank has to remain unchanged over the tenure of the loan unless the borrower's credit profile changes, provided that the same is mentioned in loan contract. For the corporate borrowers, banks currently extend floating rate loans linked to external benchmarks are they can continue to so.

Further, within a loan product category, all the loan products in a particular category, like housing loan or car loan etc, shall be linked to a uniform benchmark for all customers of the bank.

In our view, the above proposal is expected to improve the transparency in loan pricing by banks as the existing benchmarks, especially the base rate, have not led to a full transmission of the benefits of decline in cost of funds for banks to borrowers. Furthermore, the profitability of banks may see a higher volatility, unless they are able to raise floating rate deposits linked to external benchmarks. On the other hand, for the borrowers, it may lead to a more frequent reset on their EMIs.

Mandatory loan component in working capital finance

In its statement of April 2018, RBI had proposed to stipulate a minimum level of 'loan component' in fund based working capital finance for large borrowers, the draft guidelines for which were issued in June 2018. As per the proposal, the cash credit limits, which are unconditionally cancellable facilities and don't attract any capital charge on undrawn portion of facility but can be suddenly utilised by borrower may result in liquidity and capital management for banks. Accordingly, RBI had proposed that, a certain portion of cash credit limits to be sanctioned as working capital demand loan (WCDL) facilities with defined repayment schedule, which can enable bank to have a better liquidity as well as capital management. As per the draft guidelines, the above proposal was scheduled to be implemented from October 1, 2018, however it has now been deferred to April 1, 2019.

Aligning Statutory liquidity ratio (SLR) with liquidity coverage ratio (LCR)[1]

RBI has proposed to reduce the minimum SLR holding requirements for the banks by 25 bps (of net demand and time liabilities - NDTL) every quarter from January 2019 for next six quarters. As a result, the minimum SLR holding requirements of the banks will reduce to 18% by April 2020 from the existing level of 19.5%.

The proposal has been to align the SLR and LCR requirements of the banks as currently, 13.0% out of 19.5% SLR holdings of the bank can be included in the LCR requirements of a bank apart from 2% (of NDTL) marginal standing facility (MSF). So overall 15% out of 19.5% of the overall SLR can be included for calculation of LCR ratio, which currently stands at 90% and is scheduled to increase to 100% from January 1, 2019.

In our view, the proposed cut is expected to be relatively more positive for private sector banks (PVBs) as their SLR holdings are closer to regulatory requirements; as against public sector banks (PSBs). Notwithstanding the already high credit - deposit ratio, the proposed cut raises the ability of PVBs to deploy their deposits in higher yielding loan assets. PSBs on the other hand will need to shore up their capital position to pursue credit growth and benefit from the lower SLR requirements.

Expert committee on MSME

The stress in asset quality of the banks from the MSME sector has prevailed despite various regulatory forbearances given by RBI for the sector.

In order to understand the economic forces and transactions costs affecting the performance of the MSMEs, RBI has proposed to constitute an expert committee to identify causes and propose long-term solutions for the economic and financial sustainability of the MSME sector. The composition of the committee and its terms of reference will be finalised by the end of December 2018 and the report will be submitted by the end of June 2019.

[1] LCR for a bank is defined as ratio of high quality liquid assets / total net cash outflow over next 30 days.

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: communications@icraindia.com
Tel: +91 124 4545 860

Branches

Registered Office:

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi - 110 001
Tel: + 91 11 2335 7940-45

Corporate Office:

Building No.8, 2nd Floor,
Tower A, DLF Cyber City Phase II,
Gurgaon- 122 002
Tel: +91 124 4545300

Ahmedabad

907 & 908, Sakar – II,
Ellisbridge, Opp. Town Hall,
Ahmedabad - 380 006
Tel: +91 79 4027 1500/01

Bengaluru 1

'The Millenia', Tower- B,
Unit No. 1004, 10th Floor,1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber,
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre,
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',
Above SBI-HPS Branch,
Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Hyderabad 2

4A, 4th Floor, SHOBHAN,
6-3-927, A&B Somajiguda,
Raj Bhavan Road,
Hyderabad – 500082
Tel: +91 40 40676500

Kolkata

A-10 & 11, 3rd Floor, FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 0202
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg, Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road, Shivajinagar,
Pune - 411 020
Tel: +91 20 2556 1194

Email: info@icraindia.com
Helpdesk: 124 3341580
Website: www.icra.in/ www.icraresearch.in

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