May 2013

CRISIL MonetaryPolicyReview

RBI's balancing act only gets tougher

Overview: The Reserve Bank of India's (RBI) balancing act has only got tougher in the last few years as GDP growth has fallen below potential but inflation has remained stubbornly high. The RBI today (May 3, 2013) maintained that the room for further rate cuts is limited because headline inflation remains above its threshold. I believe that the room for aggressive rate cuts will remain limited until inflation comes down to around 5 per cent on a sustainable basis. If this is to be achieved, the RBI cannot play a lone hand and will require, among other things, the support of a restrictive *fiscal* policy and removal of supply-side bottlenecks. Extreme caution is, therefore, evident from the RBI's statement in its economy review that the room for rate cut is very limited and that policy could be calibrated in either direction depending on the behaviour of risks to inflation.

At present, the economy's growth is trailing its potential and this trend is unlikely to change (growth potential is estimated around 7 per cent) in 2013-14. But WPI inflation has surprised on the downside. And for the first time in the last three years, the RBI is projecting average inflation (5.5 per cent) below GDP growth (5.7 per cent). Against this backdrop, it makes sense to utilise whatever little room for rate cuts exists by front-loading them. Today's action of a quarter percentage point cut in the repo rate was supported by the following developments:

WPI inflation fell to a 40-month low of 5.96 per cent in March 2013.The fall in global crude and commodity prices quickened the pace of decline in inflation. Therefore, despite increases in diesel and electricity prices and high food inflation, overall inflation came down faster than expected. CPI inflation too is expected to decrease from the current level of around 10 per cent.

The fall in inflation can also be attributed to the reducing pricing power of companies. Weakening demand pressures are reflected in the sharp fall in core inflation to 3.5 per cent in March 2013. There has been significant demand destruction in 2012-13, which is bringing down core inflation with a lag. Private household consumption spending had held up quite strongly in the last few years, growing at a real average rate of around 8 per cent per year during 2004-05 and 2011-12. Even the global financial crisis did not dent it much. Real growth in private household consumption spending fell only marginally to 7.2 per cent during the peak of the crisis in 2008-09 and swiftly regained its pre-crisis trend of 8 per cent per year over the next 3 years. Only in 2012-13 did private consumption growth halve to 4.1 per cent. This sharp reduction has impaired the ability of corporates to fully pass on input costs to customers, particularly in discretionary spending areas such as consumer durables. As consumption demand is unlikely to lift significantly in 2013-14, its pressure on inflation will be muted.

Lastly, fiscal consolidation initiated by the government sends positive signals to the RBI for monetary easing. Beyond today's action, unless inflation comes down at a sharper-than-expected rate, the possibility of a further rate cut this year remains low.

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Highlights

- Repo rate cut by 25 bps to 7.25 per cent, consequently the reverse repo rate stands at 6.25 per cent while the marginal standing facility (MSF) rate is now 8.25 per cent.
- Cash reserve ratio (CRR) of scheduled banks maintained at 4.0 per cent of their net demand and time liabilities (NDTL).
- RBI projects GDP growth for 2013-14 at 5.7 per cent and average WPI inflation around 5.5 per cent. RBI aims to bring down WPI inflation to 5.0 per cent by March 2014.
- With continued high CPI Inflation and upside risks to WPI inflation remaining significant , RBI sees little space for further rate cuts in 2013-14.
- Money supply (M3) growth expected to be around 13 per cent.
- Aggregate deposits and non-food credit of scheduled commercial banks (SCBs) are projected to grow in 2013-14 by 14.0 per cent and 15.0 per cent respectively.
- FIIs allowed to hedge their currency risk by using exchange traded currency futures in the domestic exchanges, draft guidelines to be issued by end-July 2013.
- RBI to issue guidelines to NBFCs regarding gold loans by end-May 2013.
- In line with the reduction in mandated SLR holding, the RBI has proposed to cap the proportion of banks' SLR holdings under the HTM (Held-to-Maturity) category at 23 per cent of their demand and time liabilities from 25 per cent earlier. This reduction will occur in a phased manner of 50 bps every quarter, beginning with the June 2013 quarter.

Will the rate cut bring summer cheer?

The Reserve Bank of India (RBI) cut repo rate by 25 basis points to 7.25 per cent today (May 3, 2013). We believe this move was warranted, given the easing inflationary risks and weaker-than-anticipated demand pressures. The current slowdown in GDP growth - to 5.0 per cent in 2012-13 from 9.3 per cent in 2010-11 – is more pronounced and longer-lasting as compared to the deceleration during the Lehman crisis, when GDP growth had slowed to 6.7 per cent in 2008-09 from 9.3 per cent in the preceding year. In particular, private consumption growth, which had held on well during the Lehman crisis period, has now fallen to a decadal low of 4.1 per cent in 2012-13.

GDP growth in 2012-13 fell much below expectations (Figure 1), indicating weaker-than- anticipated demand momentum. For 2013-14 too, GDP growth forecasts have consistently been revised downwards. Slowing real wage growth, especially in rural India, also indicates weaker demand momentum. Further, with global prices of crude oil and other commodities expected to remain below their 2012-13 average, the chances of WPI inflation surprising on the upside are now low. In fact, even for March 2013 actual WPI inflation was lower than what was expected earlier by the RBI (Figure 2). However, despite lower WPI inflation, the space for further rate cuts is limited due to continued high consumer price inflation.

Lower repo rates would help lift consumption demand only if lending rates come down. In 2012-13 despite a 1.0 per cent cut in repo rate, lending rates came down by a much lower magnitude. Moreover, lower interest rates can revive investments only if other issues such as such as delays in land acquisition, forest & environmental clearances, and insufficient supply of raw materials, are resolved. In the absence of these supportive measures, the ability of lower interest rates to revive the economy is limited.

Figure 1: Revisions to median forecast of real GDP growth (y-o-y, %) for 2012-13 and 2013-14

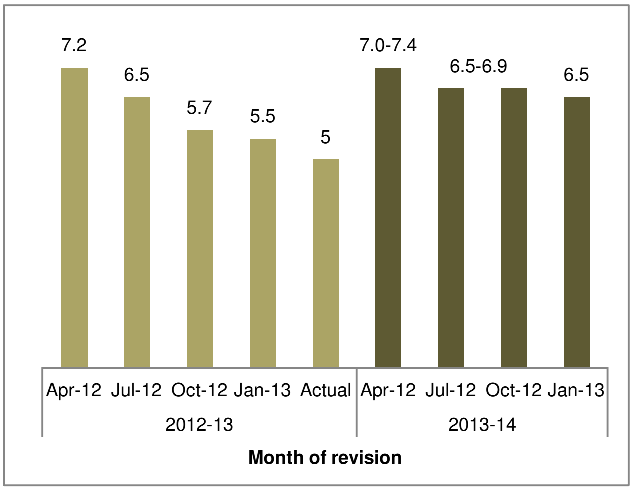
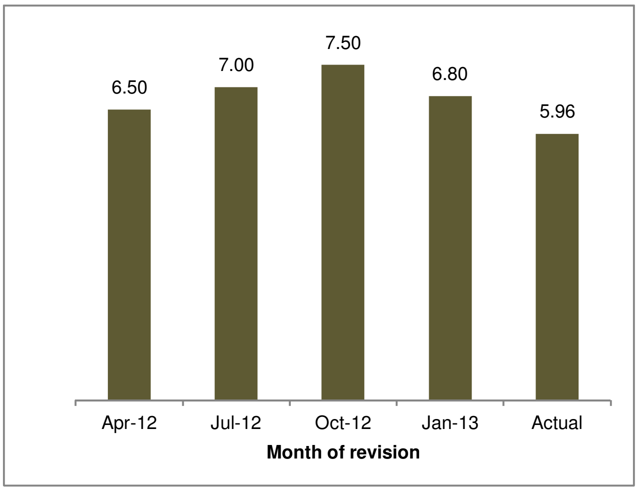


Figure 2: RBI's revision to forecast of March 2013 WPI inflation (%)



Source: Professional Forecasters Survey on Macroeconomic Indicators, RBI

Five reasons why WPI inflation is likely to ease in 2013-14

- While upward revisions in prices of administered fuels (coal, electricity, diesel) could put pressure on fuel inflation, these price revisions are unlikely to have a significant second-round impact due to the reduced pricing power of corporates.
- Softening crude oil prices will keep inflation of globally linked fuels such as petrol, naptha, bitumen etc low.
- Slowing real wage growth in rural areas (figure 5) would keep demand pressures relatively weak. Even if consumption demand picks up after the monsoon, given that manufacturing growth is currently well below its potential, core inflation is unlikely to flare up in 2013-14.
- The government's ability to provide another stimulus to rural India is limited in view of its commitment to fiscal consolidation.
- Normal monsoons, as predicted by Indian Meteorological Department, could potentially rein in food inflation.

…However, close watch on inflation is still necessary

With consumption growth falling to a decadal low of 4.1 per cent in 2012-13, demand-side pressures on inflation, as measured by non-food manufacturing inflation, have eased considerably. In February 2013, non-food manufacturing inflation, also known as core inflation, dropped below the 4.0 per cent mark for the first time in almost 3 years. The decline in non-food manufacturing inflation can be attributed to two factors.

Firstly, the sharp slowdown in demand has reduced the pricing power of corporates (Figure 4). Although input prices have risen due to a weak rupee and the ongoing corrections in administered fuel prices, corporates have not been able to pass on the cost increases to consumers. Secondly, over the last 6 months, inflation in metals has fallen sharply (to 0.9 per cent in March 2013 from 7.4 per cent in September 2012) and is exaggerating the decline in demand-side pressures on inflation. As metal prices have fallen due to slowing global demand, rather than domestic demand conditions, including them in the core inflation overestimates the decline in demand-side pressures in the economy.

To correct for this, CRISIL has constructed an alternate index, CRISIL core inflation indicator (CCII) which excludes metal prices from WPI manufacturing inflation. While CCII has also fallen significantly in the second half of 2012-13, it is higher than non-food manufacturing inflation. In March 2013, CCII stood at 4.8 per cent, down from its peak of 6.5 per cent in September 2012 (Figure 3). While this confirms that demand-side pressures in the economy have fallen significantly, the sharp slide in non-food manufacturing inflation may be exaggerating the decline. Upside risk to inflation during the year could also come from any potential depreciation of rupee which will raise imported inflation.

Figure 3: Core Inflation 3MMA (y-o-y, %)

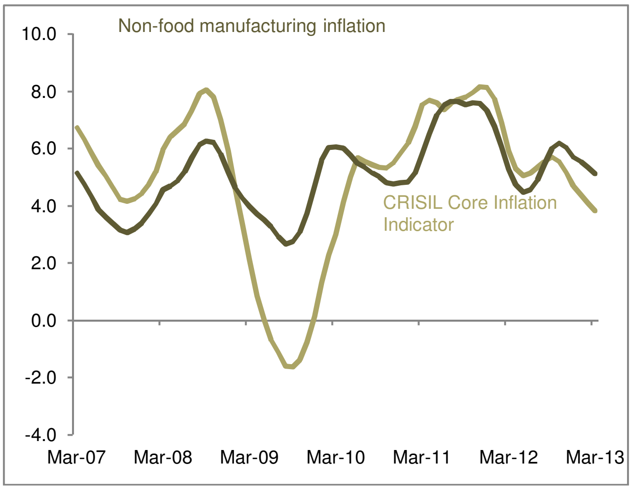
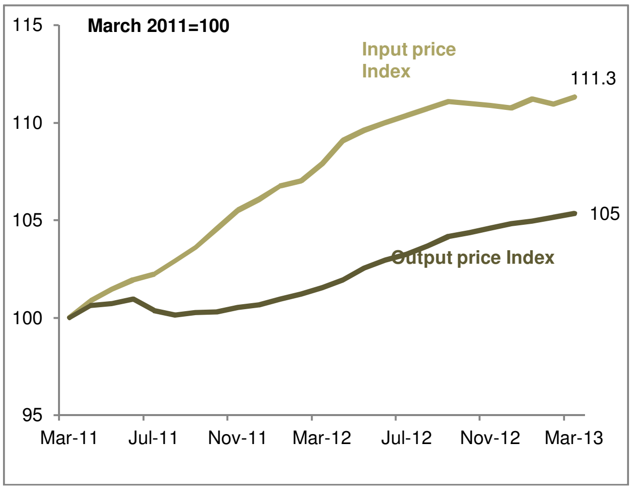


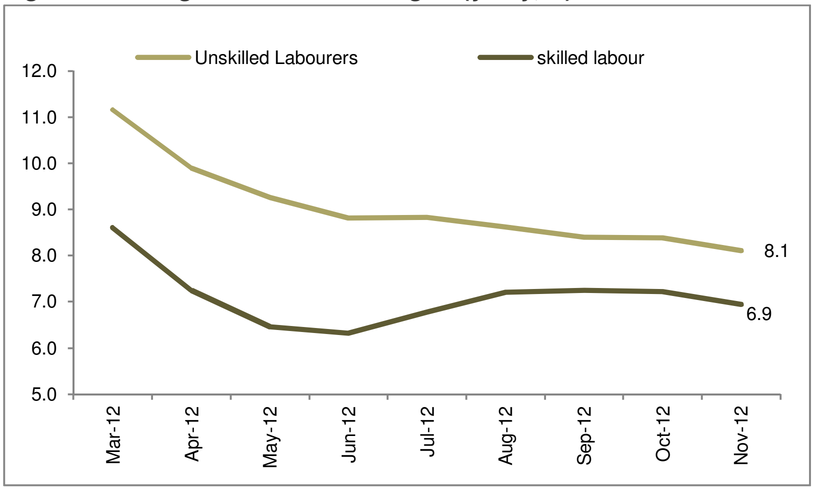
Figure 4: Limited pass-through of rising input costs



Note: Input Index is a weighted average of the WPI index for basic metals, non-metallic mineral products, wood and wood products, chemicals, rubber and plastic. Output index is WPI manufactured products less WPI manufactured food and input products.

Source: Ministry of Commerce and Industry, CRISIL Research

Figure 5:Real growth in rural wages (y-o-y,%)



Source: RBI, Ministry of Commerce and Industry, CRISIL Research

Managing rising risks in the external sector

Current account deficit (CAD) is expected to have risen to around 5 cent of GDP in 2012-13. At such high levels, the CAD is much above the sustainable threshold. Bringing down the deficit would require raising export competiveness, while at the same time reducing import demand. However, these adjustments will take time to materialise. In the meantime, the high CAD would have to be financed through higher capital inflows.

In 2013-14, financing CAD (4.5 per cent of GDP) would require capital inflows to the extent of US$90-95 billion. Today's rate cut would reduce the interest rate differential between India and other countries. However, capital inflows are not solely driven by interest rates. Improving business climate is critical for India to attract more durable investments like FDI, and reduce its reliance on volatile FII inflows (Figure 6 and Figure 7) for financing the CAD. As noted in the RBI's working paper (Sensitivity of Capital Flows to Interest Rate Differentials: An Empirical

Assessment for India, May 2011), other determinants of capital inflows overshadow the impact of interest rate differential most of the times. Hence, interest rate decisions should not be constrained by its impact on capital inflows, but rather on growth and inflation.

Figure 6: Cumulative net FII inflow

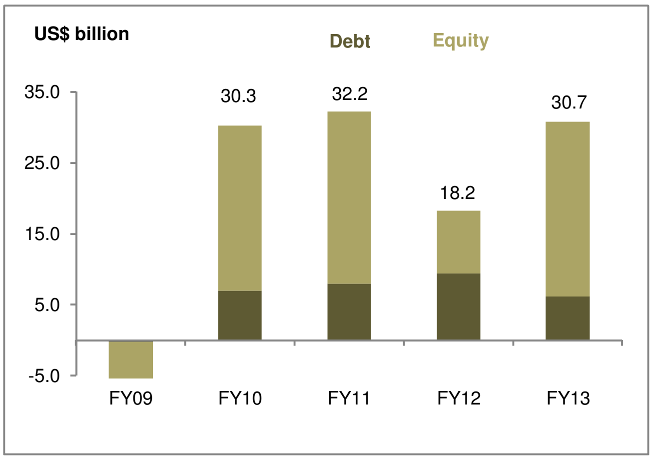
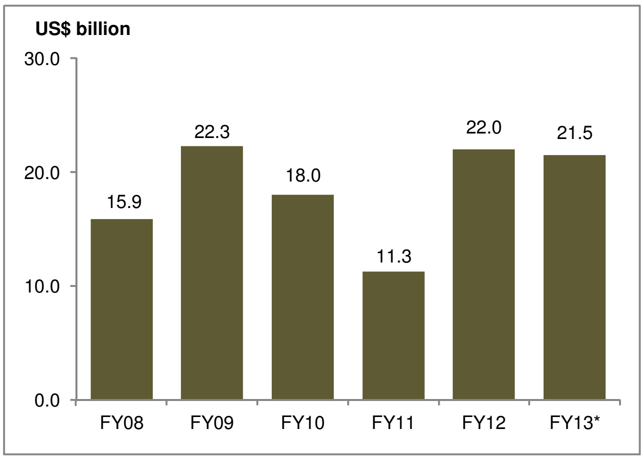


Figure 7: Cumulative net FDI inflow



Note: FY13* till February 2013

Source: RBI, CRISIL Research

Macroeconomic outlook 2013—14

GDP: CRISIL Research expects the Indian economy to grow by 6.0 per cent during 2013-14, if monsoons are timely and normal. Normal rainfall will enhance farm incomes and revive consumption demand. In addition, at least partial resolution of the mining issue, and consequent improvement in fuel supply to power plants, would provide some support to industrial growth, Lower repo rate, if translated into lower retail lending rates, would also support demand growth in interest-sensitive sectors. With the global economic scenario expected to improve, exports growth is likely to pick up. The upturn in growth, however, cannot be sustained next year unless the investment pipeline begins to replenish, supported by necessary policy action. Even in 2013-14, a monsoon failure can drag down GDP growth to last year's levels of 5 per cent.

Inflation: We expect WPI inflation to soften to around 6.3 per cent during 2013-14 from 7.3 per cent during 2012-13. Further, a correction in global commodity prices, slower GDP growth and normal monsoon (as predicted by IMD) are expected to ease pressure on fuel, core and food inflation, respectively. While CPI inflation also is slowing down, it continues to hover at high levels.

Interest rate: Moderating inflation as well as a lower repo rate (the floor for the G-sec yield) would help alleviate pressure on the G-sec yields. However, high fiscal deficit to the tune of 5.1 per cent of GDP would keep government borrowings high, and thereby exert upward pressure on the yield. These opposing forces are expected to keep the 10-year G-sec yield at the current levels of 7.7-7.8 per cent by March-end 2014.

Exchange rate: The Indian rupee is expected to settle at current levels of 54 against the US dollar by March-end 2014. We believe policy measures, such as an increase in investment limits for foreign institutional investors and permitting FDI in different sectors, will attract the necessary foreign inflows and compensate for the current account deficit of around US$90-100 billion. However, given the heavy reliance on volatile FII inflows, the vulnerability of the rupee to an external shock, like an adverse event in the Euro zone, remains high.

Table 1: India Outlook 2013-14

	2012-13	2013-14F
Real GDP factor cost (y-o-y% growth)	5.0*	6.0
Agriculture	1.8*	3.5
Industry	3.1*	4.4
Services	6.6*	7.3
Other macroeconomic variables		
WPI Inflation (average)	7.3	6.3
10 year G-sec yield (March-end)	8.0	7.7 – 7.8
Exchange rate INR/US$ (March-end)	54.4	54
Fiscal Deficit (% of GDP)	5.2#	5.1

Note: * Advance estimate by the Central Statistical organization (CSO), # Revised Estimate

Source: CSO, Ministry of Commerce and Industry, Budget documents, CRISIL Research

Impact analysis on banking sector

Bank deposits to grow by 14-15 per cent in 2013-14

Growth in bank deposits slowed to 13.5 per cent y-o-y as on March 31, 2013, because of a reduction in the household savings rate, repayment of bulk deposits by public-sector banks (PSBs) and near-zero real interest rate on term deposits due to high inflation. The fall in financial savings and investors' preference for asset classes such as gold and real estate also impacted demand for time deposits during 2012-13.

In 2013-14 as well, mobilising deposits will remain a challenge for banks. While inflation is expected to moderate, term deposit rates are also likely to decline as policy rates are cut further. Consequently, we expect bank deposits to grow by about 14-15 per cent during the year.

Loan offtake to revive slightly in 2013-14

The slowdown in domestic growth was reflected in demand for credit in 2012-13. The outstanding credit of scheduled commercial banks is estimated to have grown by ~16 per cent (y-o-y) as on March 31, 2013. Sluggish investment demand and increased risk aversion, due to the deterioration in the asset quality of PSBs over the past few quarters, led to deceleration in credit growth.

Growth in bank credit to industry moderated considerably to 15.7 per cent in March 2013 from 20.3 per cent in March 2012. Growth in credit to industry slowed across major sub-segments, especially infrastructure, metals and mining and quarrying. While growth in credit to retail was stable, credit growth to services sector accelerated on a y-o-y basis.

In 2013-14, aggregate bank credit is expected to grow by 16-17 per cent y-o-y, driven by an improvement in agriculture growth, consumption-led recovery in the economy and pre-election welfare spending by the government.

Lending rates to come down gradually and selectively

We believe that the 25 bps cut in the repo rate will not immediately translate into a proportionate reduction in lending rates. Subdued deposit mobilisation and high credit-deposit ratio (77.4 per cent as on April 05, 2013) will constrain the ability of banks to cut deposit and lending rates across the board. Banks are likely to cut lending rates gradually, and selectively, for some portfolios. The median base rate of 10 banks reduced by only 20 bps in 2012-13 even though the RBI had reduced the repo rate and the CRR by 100 bps and 75 bps, respectively, during this period.

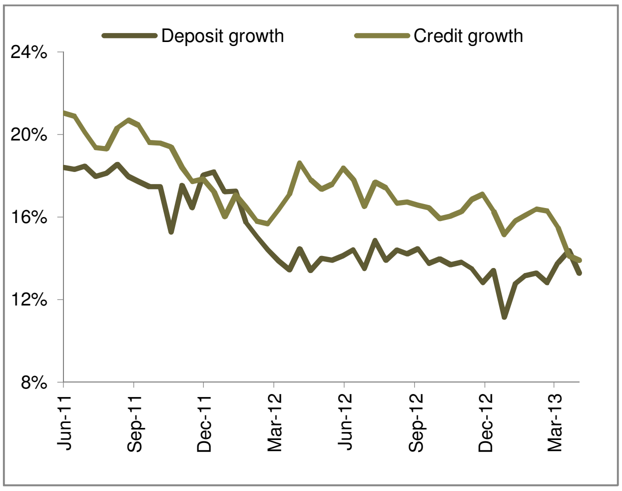
Net interest margins (NIMs) are forecast to decline by 10-15 bps in 2013-14 owing to lower lending rates, rising competition and stickiness in deposit rates (deposit re-pricing takes place with a lag). In fact, some banks had raised deposit rates from mid-December 2012 in certain maturity buckets in view of tight liquidity conditions; the impact of this increase will be visible during 2013-14.

Asset quality to deteriorate further in 2013-14

Besides sluggish demand, the deceleration in credit growth of the banking sector can also be attributed to the sharp deterioration in asset quality and rising cases of restructuring, especially by public sector banks (PSBs). Gross NPAs (GNPAs) of scheduled commercial banks are estimated to be around 3.5 per cent as of March 2013 (up from 2.9 per cent as of March 2012).

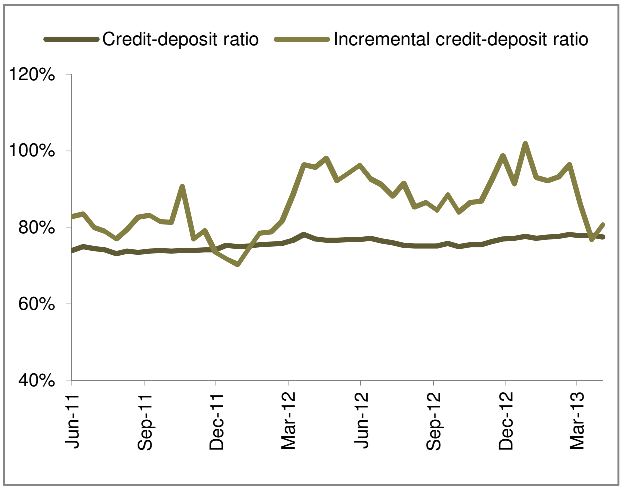
CRISIL Research expects GNPAs to increase further to 3.8-4.0 per cent by March 2014, due to slippages from loans restructured in 2011-12, continued loan repayment pressures in sectors such as power and construction, and higher NPAs in segments such as commercial vehicles financing.

Figure 8: Growth in credit and deposits



Source: RBI, CRISIL Research

Figure 9: CD and Incremental CD ratios



Source: RBI, CRISIL Research

Other key developments

- To attract more capital inflows into the equity and debt markets and to enable investors to hedge currency risks, the RBI has proposed to allow Foreign Institutional Investors (FIIs) to participate in the currency derivatives market.
- In line with the reduction in mandated SLR holding, the RBI has proposed to cap the proportion of banks' SLR holdings under the HTM (Held-to-Maturity) category at 23 per cent of their demand and time liabilities as compared to 25 per cent earlier. This reduction will occur in a phased manner of 50 bps every quarter, beginning with the June 2013 quarter.
- The RBI has proposed to enhance loan limits eligibility for classification under priority sector advances for certain segments:
  - Micro and Small Enterprises (MSEs) in the services sector – Rs 20 million to Rs 50 million per borrower
  - Loans to dealers/sellers of products classified as indirect finance to agriculture – Rs 10 million to Rs 50 million per borrower.
  - Pledge loans given to either individual farmers or firms engaged in agriculture and allied activities – Rs 2.5 million to Rs 5.0 million

- Citing the relatively lower risk in the residential real estate segment, the RBI proposes to carve out a separate sub-sector, Commercial Real Estate (CRE) - Residential housing, within the CRE sector, with relatively less stringent regulations on risk-weights and provisioning. Detailed guidelines on the same will be issued by June 2013. This would be a positive measure for developers engaged in residential real estate projects.
- To address the risks arising from unhedged forex exposure of corporates, the central bank has proposed to increase the risk weight and provisioning requirement on banks' exposure to such corporates. Guidelines regarding the same will be issued by end-June 2013.
- In addition, the RBI has proposed to restrict the facility of advances against the security of gold coins per customer to gold coins weighing up to 50 gm. Detailed guidelines will be issued by end-May 2013.

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