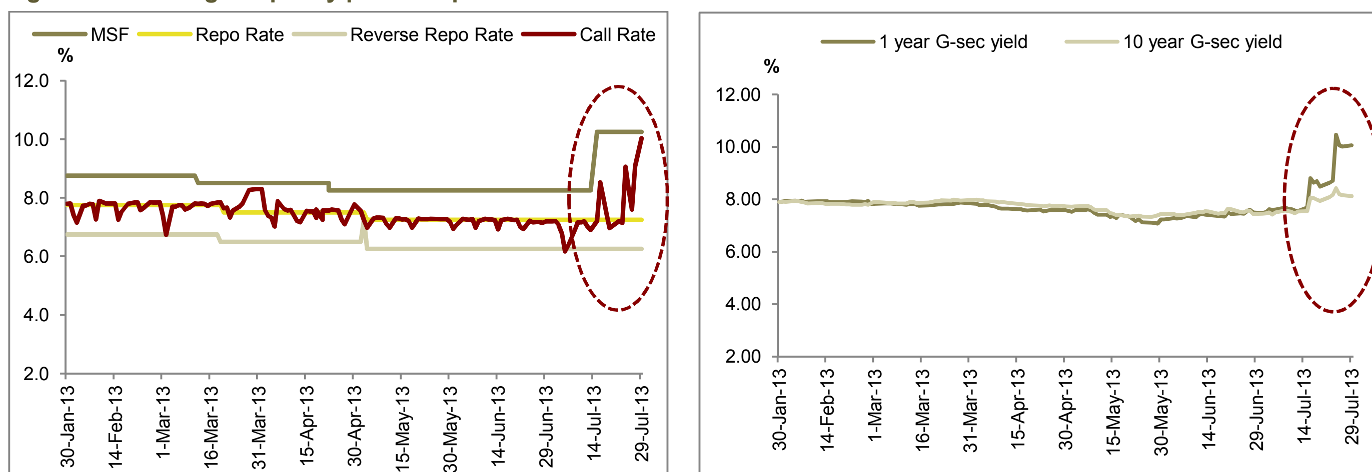
July 2013

CRISIL MonetaryPolicyReview

RBI holds guard against inflation and rupee volatility

Figure 1 and 2: Tight liquidity pushes up market interest rates



Source: RBI, CRISIL Research

The Reserve Bank of India (RBI) today (30th July), kept the repo rate unchanged at 7.25 per cent citing inflation and exchange rate concerns. Despite scaling down their growth forecast to 5.5 per cent from 5.7 per cent for 2013-14, the status-quo on policy rates was guided by upward risks to inflation and high volatility of rupee. CRISIL Research believes that there is now significantly diminished probability of a repo rate cut during the rest of 2013-14. As a result, there is less likelihood of a decline in lending rates during the year. This will be true even if the monetary tightening measures undertaken recently are reversed. Monetary policy is hence unlikely to bolster growth this year. CRISIL Research has therefore revised its GDP growth forecast for 2013-14 down to 5.5 per cent from 6 per cent earlier. Our average WPI inflation forecast for 2013-14 however, remains unchanged at 5.3 per cent. A depreciated rupee will offset the gains arising from weak demand pressures.

The RBI's current stance reflects its intention to maintain tight liquidity in the system to restrain exchange rate volatility. Recently, the RBI announced a host of measures to tighten liquidity. These included (i) restriction on banks' and primary dealers' access to funds under the liquidity adjustment facility window, (ii) hike in Marginal Standing Facility rate by 200 bps to 10.25 per cent, (iii) maintenance of higher daily balance on cash reserve ratio by banks, and (iv) open market sale of government securities.

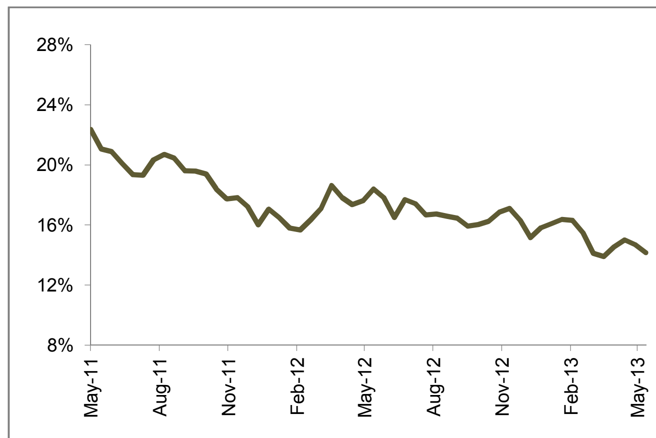
The flipside of tighter liquidity is higher interest rates. Since the RBI first started reducing liquidity (July 15), bond market yields as well as money market interest rates have moved up steeply (Figure 1 and 2). Yield on the 1 year G-sec bond has risen nearly 150 bps and on the 10 year G-sec bond by 60 bps. Higher yields would entail higher cost of borrowing – a drag on the government's debt burden. The hike in MSF rate has had two implications; (i) it has pushed up interest rates across money market instruments - rates on commercial paper and certificate of deposit have risen 120 to 140 bps, and (ii) it has increased volatility in these rates by widening the corridor within which the money market rates move (distance between reverse repo and MSF rate) - the interbank call rate traded in a broader range of 7-10 per cent in the second half of July as against to 6.2-7.2 per cent in the first half.

The RBI has clearly stated that its liquidity tightening measures are temporary, and will be rolled back as stability is restored in the foreign exchange market. It will however, be difficult to decide the timing of this reversal. If the rupee has become more stable in recent days because of the RBI measures, the currency could see higher volatility when these measures are reversed. This will be especially true as and when US Federal Reserve starts winding down QE3 towards the end of this calendar year.

Loan offtake to remain sluggish in 2013-14

- The deceleration in domestic growth has impacted banking credit demand. Aggregate bank credit growth slowed to 14.3 per cent y-o-y as on July 12, 2013 from 17.7 per cent as on July 13, 2012. Sluggish investment demand and increased risk aversion, given the deterioration in asset quality of public sector banks (PSBs) over the past few quarters, affected growth.
- We project a 15-16 per cent y-o-y growth in bank credit in 2013-14, along the lines of the growth witnessed in the previous fiscal. While investment demand would remain slack, demand for loans for meeting working capital requirements, growth in agricultural loans and certain segments of retail loans such as home loans would drive credit growth.

Figure 3: Credit growth, y-o-y

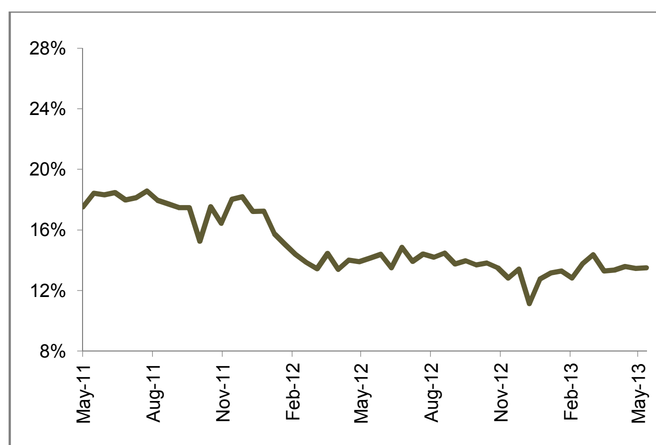


Source: RBI, CRISIL Research

Growth of 14-15 per cent likely in 2013-14

- Growth in bank deposits slowed to 13.8 per cent y-o-y as on July 12, 2013, from 14.9 per cent as of July 13, 2012, primarily because of a reduction in the household savings rate, especially financial savings, and repayment of bulk deposits by PSBs.
- Bank deposits are forecast to grow at 14-15 per cent in 2013-14, a tad higher than in 2012-13. Tightening liquidity and increase in short-term rates leave little scope for banks to cut deposit rates. Firm deposit rates, and volatility in returns from other asset classes, are therefore expected to help sustain investor interest in bank deposits.

Figure 4: Deposit growth, y-o-y

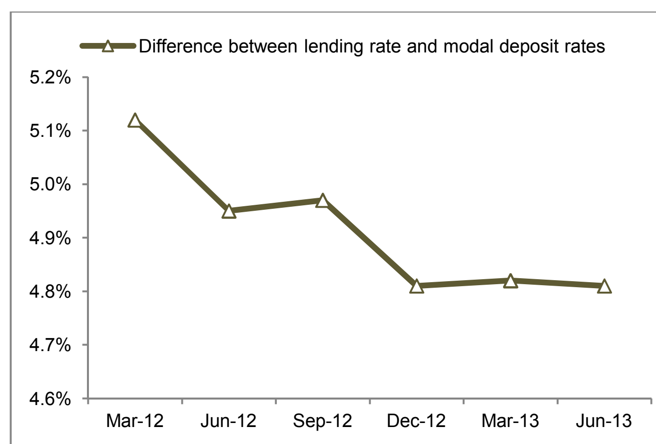


Source: RBI, CRISIL Research

Lending rates to stay elevated; NIMs under pressure

- With no rate cut likely this fiscal, we do not expect any major cut in the base rate of banks in the medium term.
- With a rise in the cost of short-term funds and rising delinquencies, Net Interest Margins (NIMs) will remain under pressure, especially for public sector banks. Average NIMs are thus expected to decline by 15-20 bps during 2013-14.

Figure 5: Pressure on banks' spreads



Source: RBI, CRISIL Research

Gross NPA to reach 4.0 per cent by March 2014

- Credit quality of corporates is likely to be weakened by the slow growth in GDP, heightened currency volatility, and higher-than-expected interest rates. Specifically, stress will increase in sectors such as power, construction, engineering, and steel, and lead to higher non-performing assets (NPAs) in the banking system. We expect GNPA to reach 4.0 per cent by March 2014, from 3.3 per cent as of March 2013.

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