ICRA COMMENTS ON RBI'S FOURTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2017-18

As expected, MPC left the repo rate unchanged at 6.0%; statutory liquidity ratio reduced by 50 bps to 19.50%

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Highlights of the RBI's Fourth Bi-monthly Monetary Policy Statement for 2017-18 – October 2017

- In line with our expectations, the Monetary Policy Committee (MPC) left the Repo rate under the Liquidity Adjustment Facility (LAF) unchanged at 6.00%, in a split decision, with one member in favour of a cut of at least 25 bps. Moreover, the Committee retained the neutral stance of monetary policy in the Fourth Policy Review for FY2018.
- With a status quo on the Repo rate, the Reverse Repo rate, Marginal standing facility (MSF) rate and bank rate were also kept unchanged at 5.75%, 6.25% and 6.25%, respectively.
- However, in view of the increasing liquidity coverage ratio (LCR) requirements of banks, the Statutory Liquidity Ratio (SLR) was cut from 20.0% to 19.5%, effective from October 14, 2017. Nevertheless, the Cash Reserve Ratio (CRR) was kept unchanged at 4.0%.
- The MPC revised its forecast for the CPI inflation including the impact of the revision in house rent allowance (HRA) by the Central Government, to 4.2-4.6% in H2 FY2018. It also revised its baseline forecast for GVA growth for FY2018 to 6.7% from 7.3%, led by the loss in economic momentum in Q1FY2018, the disappointing First Advanced Estimates of kharif production and transitional impact of the goods and services tax (GST) on production schedules.
- The RBI acknowledged the surplus liquidity conditions are persisting in the system, despite the outflows towards advance tax in September 2017, increase in currency in circulation as well as liquidity absorption through open market operations (OMOs), and short term tools such as treasury bills (T-bills) issued under the market stabilisation scheme (MSS), cash management bills (CMBs) etc. Nonetheless, these measures have contributed to a decline in the net average absorption of liquidity under the LAF to Rs. 1.6 trillion in the second half of September 2017, from Rs. 3.0 trillion in July 2017. As a result of the reduction in surplus liquidity, the short term rates also inched upwards, though they remain lower than the Repo rates.

Outlook

Receding vegetable prices and the recent cut in central excise duty on petrol and diesel by Rs. 2/litre would douse inflationary pressures, and cause the CPI inflation to plateau in September-October 2017. However, an uptrend would resume in the subsequent months, on account of the decline in output of most kharif crops forecast by the First Advance Estimates for Crop Production, the as-yet incomplete pass-through of the GST to final prices of various goods and services, the staggered impact of HRA revision on housing inflation, and an unfavourable base effect.

Benefitting from the muted inflation in H1 FY2018, the average CPI inflation for this fiscal is likely to be well-below 4%, suggesting some scope for further monetary easing. However, the expected uptrend in inflation during H2 FY2018 may remain a sticking point. On balance, the scope for rate cuts in this year would be restricted to 25 bps, which would materialize only if the inflation trajectory significantly undershoots expectations.

MPC maintains status quo to guard against looming inflation risks

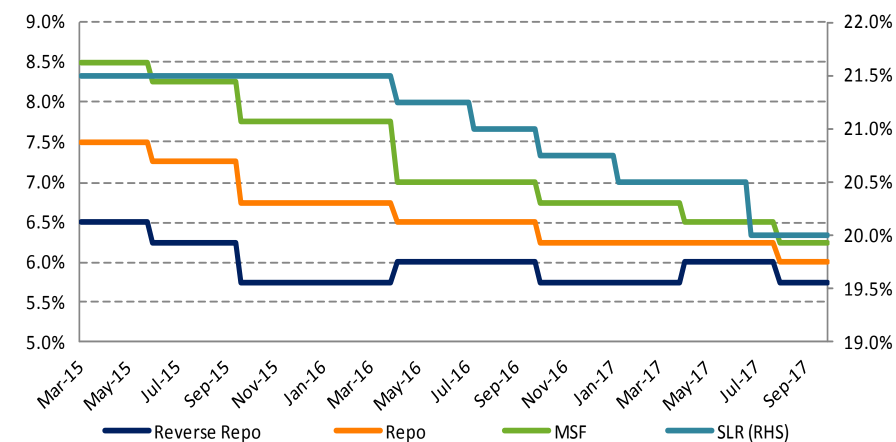
In line with our expectations, the MPC left the repo rate unchanged at 6.0% and retained the neutral stance of monetary policy in the Fourth Policy Review for FY2018, despite paring its baseline growth forecast. It reiterated its focus on achieving the medium term inflation target of 4%, thereby reinforcing its independence. As expected, the decision to keep the Repo rate unchanged was not unanimous, with one member voting for a reduction of at least 25 bps, highlighting the variation in individual members' prognosis of the inflation-growth dynamics, which may persist going forward.

The status quo followed from the rapid uptick in the CPI inflation to 3.4% in August 2017 from the series-low 1.5% in June 2017, which coincided with mounting global geopolitical uncertainty and financial market volatility. The MPC expects the CPI inflation, including the impact of the revision in HRA by the Central Government, to range between 4.2-4.6% in H2 FY2018**.** In addition, it warned that farm loan waivers and pay revision at the state level could impart upside risks to the inflation trajectory. Similar to the last policy resolution, the MPC highlighted that state-level pay revision has not been factored into its baseline inflation projections. It indicated that a magnitude of increase equivalent to the revision undertaken by the Central Government, could push inflation above the baseline estimate by 100 bps over 18-24 months.

The MPC reduced its baseline forecast for GVA growth for FY2018 to 6.7% from 7.3%, prompted by the subdued print for Q1 FY2018, the estimated kharif output, and the adverse impact of the transition to the GST on production schedules, cautioning further that the latter may delay a revival in investment activity. Moreover, rising input costs and weak pricing power may erode corporate margins, which would dampen the GVA growth for the industrial sector. The MPC also highlighted the need to adequately recapitalise public sector banks to ensure ample flow of credit to the productive sectors. However, it emphasized that recently introduced structural reforms are likely to boost growth over the medium term, by improving the business environment, augmenting transparency and prompting a formalisation of the economy. Furthermore, it suggested higher infrastructure spending, restarting stalled projects, improvements in the ease of doing business including simplification of the GST, and swifter implementation of affordable housing, as possible remedies to the prevailing growth slowdown.

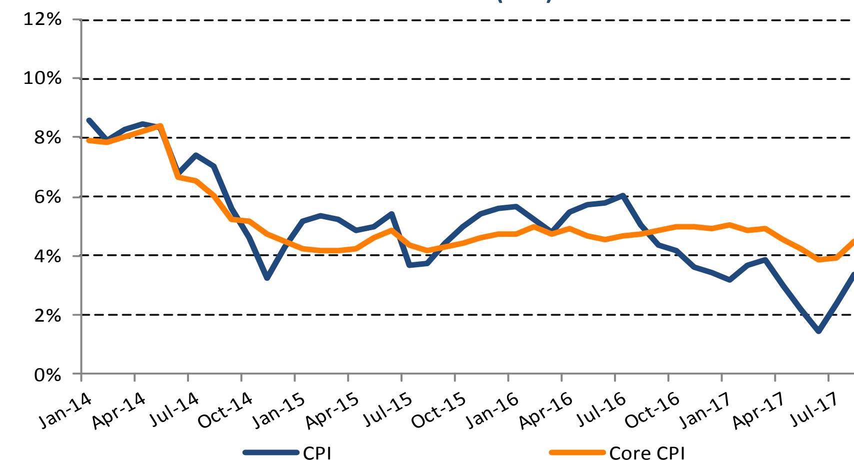
In our view, data for various formal sectors for August 2017 provides some evidence of a reversal of the transitory slowdown in volume growth observed during the transition to the GST. Moreover, a back-ended pickup in spending by the state governments and a favourable base effect are likely to contribute to

Chart 1: Movement in Key Rates



Source: RBI; ICRA Research

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



Source: CSO; ICRA Research

higher GVA growth in the remaining quarters of FY2018, from the muted 5.6% in Q1 FY2018.

The RBI maintained its neutral stance on liquidity, even as the inter-bank surplus persists. However, the size of the same has moderated during Q2 FY2018 relative to Q1 FY2018, benefitting from the increase in currency circulation to almost 88% of pre-demonetisation levels, and OMOs undertaken by the RBI during Q2FY2018 amounting to Rs 600.0 billion. In contrast, certain factors have caused the surplus liquidity conditions to persist, including a) the front loading of expenditure by the Government of India, b) strong foreign capital inflows c) large redemption of Government securities (G-sec; Rs 1.4 trillion during H1FY2018 as against total redemption of Rs 1.7 trillion for FY2018) and d) weak credit demand from banking system.

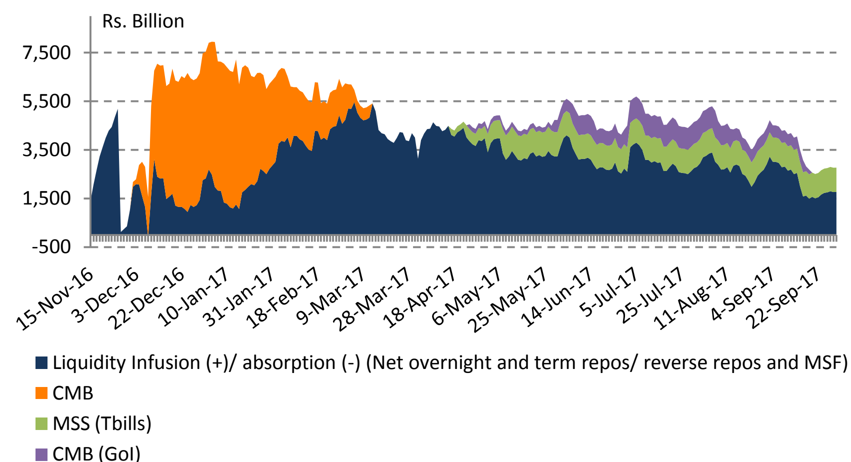
As a result, while the daily average liquidity absorption during Q2FY2018 under the LAF, CMBs (GoI) and MSS T-bills reduced to Rs. 4.28 trillion from Rs. 4.58 trillion during Q1FY2018, it remained high. However, the liquidity surplus eased to Rs. 2.7 trillion during the last fortnight of September 2017, with the outflows towards the payment of advance tax. Excluding the CMBs (GoI) and MSS T-bills, the daily average liquidity absorption under the LAF reduced from Rs. 3.5 trillion during Q1FY2018 to Rs. 2.6 trillion during Q2FY2018, and further to Rs. 1.65 trillion during the last fortnight of September 2017.

As on September 15, 2017, the year-on-year (YoY) growth in bank credit (7.5%) continued to lag the deposit growth (10.0%). Bank credit growth has been muted because of demand side pressures, such as the sluggish investment cycle of corporates; a surge in finer priced domestic debt market issuance; and weak capitalisation of the public sector banks, which account for a major share of advances. In absence of credit demand, the transmission in banks' lending rates continues to lag the cut in policy rates, banks deposit rates as well as the yields offered in the debt market.

ICRA expects bank credit offtake to grow by 7.5% in FY2018, which would entail a sharp rise in the incremental credit offtake in the remainder of this fiscal, in line with seasonal trends. Moreover, we expect bank deposits to rise by 6.0% in FY2018. After netting off the CRR as well as the SLR requirements, we estimate that additional credit offtake would exceed deposits by a sharp margin, resulting in a moderation in the liquidity surplus.

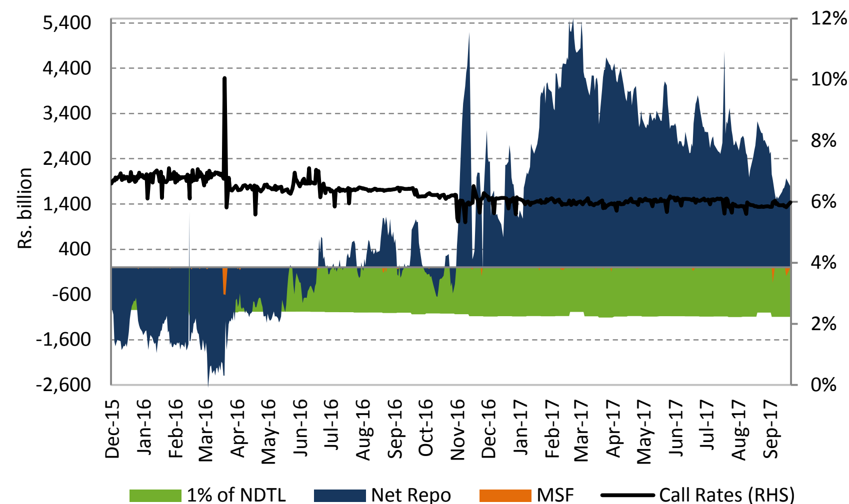
Based on an expected rise in currency in circulation, seasonal rise in credit demand and some moderation in FII inflows, we anticipate the size of the liquidity surplus to decline in H2 FY2018. Accordingly, ICRA expects the RBI to use LAF operations as the primary tool to manage surplus liquidity in H2 FY2018, with other tools unlikely to be required during this period.

Chart 3: Daily LAF and MSS outstanding



Source: RBI; ICRA Research

Chart 4: Call money rates



Source: Bloomberg; 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.

Measures to improve monetary policy transmission

1. During the last monetary policy, RBI highlighted the non-satisfactory pace of monetary policy transmission even under MCLR regime. Towards this an internal study group was constituted, which in its report observed that the internal benchmark rates of banks (base rates/ MCLR) have not delivered effective transmission of monetary policy.
2. The study group has recommended a switchover to an external benchmark for pricing of bank loans in a time-bound manner.
3. RBI will take a final view on the recommendation of the study group after taking the public feedback on the outcome of the recommendations.

Reduction in SLR (statutory liquidity ratio)

1. The excess SLR securities held by bank above the regulatory requirements are counted towards high quality liquid assets (HQLA) under liquidity coverage ratio (LCR) framework. With LCR scheduled to increase 100% by January 1, 2019 (80% as of now), RBI has reduced the SLR ratio by 50 bps to 19.50% of net demand and time liabilities (NDTL) from the fortnight of October 14, 2017.

2. The SLR securities under held to maturity (HTM) will also reduce in phased manner to 20.0% of NDTL by December 31, 2017 and 19.5% of NDTL by March 31 2018 (20.25% at present). As a result, the SLR requirements and HTM will be aligned at 19.50% of NDTL and the Available for Sale (AFS) portfolio of the banks will increase. This will add to volatility in their earnings as the AFS portfolio is required to be marked to market.

Review of foreign portfolio investments (FPI) Limits:

With surge in FPI inflows in debt investments during 2017 and consequently almost full utilisation of allowable FPI investment limits in corporate bonds and G-sec, RBI has proposed to take a detailed review of current regulations for FPI's debt investments. Regulatory changes, upon finalisation, will be made effective from April 2018.

Constitution of high-level task force on public credit registry (PCR):

1. To reduce the information asymmetry between lenders, in its monetary policy of August 2017, RBI has announced to constitute a task force to develop a public credit registry (PCR), which will provide information on the borrowings and stressed bank credits on real time basis.
2. As a step towards this, RBI has constituted a task force on PCR with representatives from RBI, NBFCs, industry, banks among others, which will submit the report by April 2018.

Legal Entity Identifier to aggregate the borrowing by corporate groups:

RBI has proposed to make it mandatory for banks to obtain the legal entity identifier for all the exposures of the banks aggregating more than Rs 5 crore. This will facilitate the consolidation of the borrowings of single corporate group from the entire banking system. The guidelines for this will be notified by end of October 2017.

Current account by non-scheduled cooperative banks (NSCBs) with RBI:

NSCBs can now directly open current account with RBI to meet their CRR requirements as against maintaining the same as deposit with other scheduled commercial banks (SCBs). This will have a negative impact on the current account deposits of the SCBs, though the impact will not be material given the quantum of the CRR requirements of NSCBs.

Regulation on peer to peer (P2P) lending:

RBI will issue the regulations for non-banking financial companies (NBFCs) engaged in P2P lending. While the regulations are yet to be released, however as per the statement by deputy governor, the entities engaged in P2P lending will not be allowed to take the credit risks.

Framework for Electronic Trading Platforms (ETPs)

RBI will announce a framework for authorising ETPs for financial instruments regulated by it (G-sec, SDL and money market instruments). The new and existing ETPs will require authorisation under this framework. A draft framework will be released by October 2017.

Revisions in short-selling in G-sec

To improve the settlement of short-sale transactions, a short-seller need not borrow securities for entire "notional short sales". To meet the requirement, the institution can borrow only for the net position, after netting off the securities held under AFS/HTM of HFT portfolio. This shall reduce the overall borrowing

and lending requirement of a particular security and hence bring more active G-sec market with greater participation from short-sellers.

State development loans (SDLs):

To improve the liquidity in SDLs, RBI has proposed to consolidate the SDLs through re-issuances and buybacks, as is done in G-sec. Also to determine risk based pricing of SDLs, the high-frequency data relating to state government finances, which is available with RBI will be disclosed on its website. RBI will issue final guidelines for this by October 2017.

Increasing retail participation in G-sec:

Among various measures earlier taken by RBI to improve the retail participation in G-sec, RBI has proposed to facilitate the retail participation, the stock exchanges will be permitted to act as aggregators for retail investors bids in the auction of G-sec and T-bills of GoI.

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