Economics

DBS Focus

India: Policy transmission, through banks and markets, will be key

DBS Group Research March 13, 2019

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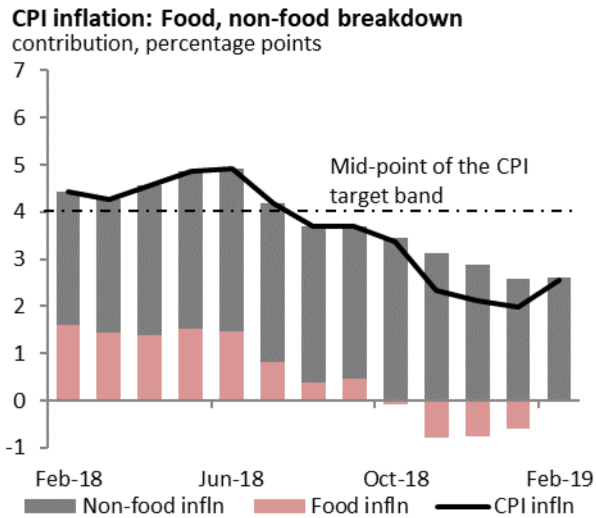
- *February inflation ticked up to 2.6% YoY vs 2% in January, on easing food disinflation*
- *Seven successive months of sub-target inflation saw India cut rates last month, first amongst its Asian peers*
- *Another 25bp reduction is likely in April*
- *We revise down our inflation forecasts for FY20*
- *Policy transmission through banks has been gradual, much to the chagrin of the central bank*
- *India's largest public sector bank set the ball rolling, but legacy issues need to be addressed for more to follow*
- *Transmission through bond markets is also important and here, liquidity matters*
- *Efficient transmission will be key for material boost to growth*
- *Regardless, the economy is headed into a soft patch in 1H19 beyond which a lift in post-election uncertainty and budgetary boost to consumption are likely to stabilise activity*

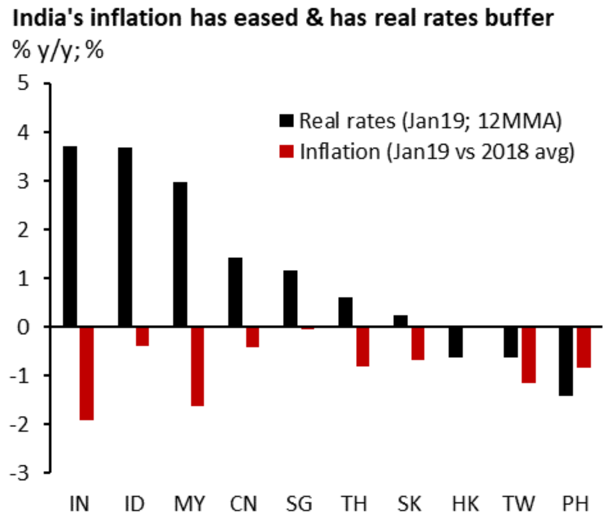
Data out late Tuesday saw February CPI inflation bottom-out, rising 2.6% YoY vs 2% in January, on easing food disinflation. High-frequency data for the food component had already pointed to a decline in vegetables, shallower fall in pulses and modest uptick in other segments. Core inflation continues to hold steady, underpinned by higher transport costs (retail fuel prices inched up on the month) and higher gold prices (personal care segment).



Source: RBI, data transformations are by DBS group Research

The next rate cut in April is a given

Amongst Asian peers, India witnessed the sharpest correction in inflation (January 2019 vs 2018 average) and has the most comfortable real rates buffer - see chart. Accordingly, the RBI-led panel was the first in the region to cut rates, on benign inflationary conditions and slowing growth.



Source: CEIC, DBS group Research

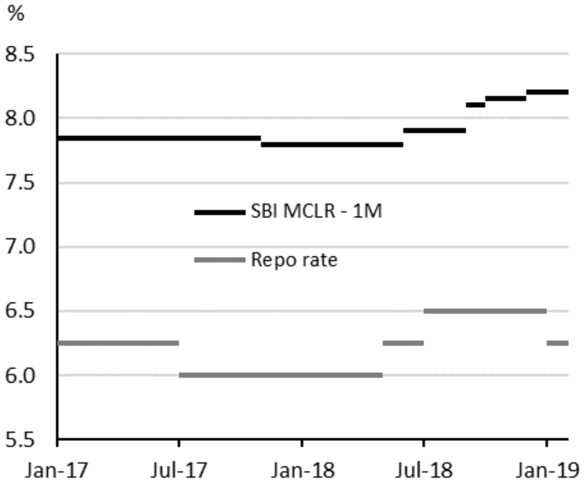
April 2018-February 2019 CPI averaged 3.5% YoY, below the mid-point of the central bank's inflation target band at +/-2% of 4%. The central bank lowered its inflation projections sharply for this year and next, at the February review. There are incipient risks to the trajectory i.e. receding base effects, which could lift inflation towards 4.0% by end-FY20, food prices could mean revert after this current phase of disinflation, with a cobweb phenomenon in the production cycle, and the expansionary budget ahead of the general elections due in April-May. However, despite these risks, evolving trends suggest FY20 will mark the third consecutive year of sub-4% inflation. **We revise our FY20 CPI inflation estimate to 3.8% YoY (vs 4.2% earlier) from a likely 3.5% in FY19.**

Notwithstanding the bounce in February inflation, a follow-up 25bp cut in April is on the cards. While we maintain our base case of a prolonged pause on rates thereafter, the probability of a last-in-the-cycle 25bp cut in Q319, is rising.

Policy transmission under watch

Just as the rate-cut cycle gets underway, attention turns to the efficacy of policy transmission. An inefficient transmission mechanism limits the scope of spurring credit growth, which then fails to boost growth/spending. The RBI's Report on the Monetary policy framework in 2014 outlined that the impact on lending rates typically shows with a lag of 2-4 quarters, hinging on the prevailing business cycle, domestic liquidity and (we add) certainty over the quantum of rate easing in the pipeline.

RBI policy rate vs banks' MCLR (SBI 1M as proxy)



Source: RBI, CEIC, DBS group Research

In December 2018 (and after an initial study), the RBI proposed banks to link their floating rate loans to external benchmarks, such as the repo rate, 91-day T-bill rate and 182-day T-bill, amongst others. Spreads were to be left to the commercial judgement of banks, with regular assessment and resetting of rates. This would have marked a departure from the current system of pegging loans to Marginal Cost of Funds-based Lending Rate (MCLRs). **In February this year, the RBI clarified that this proposal was under review.** Such a shift will make lending rates more attuned to changes in the broader rate direction but is not without pitfalls, particularly in instances when the rate direction reverses.

Changes in the policy rate impacts the economy primarily through; i) interest rate channel, (ii) credit channel, (iii) exchange rate channel, and (iv) asset price channel [1]. Impact of the money market rates is usually immediate i.e. into commercial papers, treasury bills; in some instances, by equal magnitude e.g. call money rates. The boost to domestic exchange rates also follows, with the scale and persistence hinging on broader risk sentiments.

Ball set rolling, but banks face challenges

Of all these channels, transmission through the domestic banking system is crucial. February's rate cut was followed by small reduction in sectoral rates by a couple of banks, but benchmark base lending rates were little changed. RBI Governor Shaktikanta Das met officials of state-run and private lenders last month to jumpstart policy transmission.

Showing a conciliatory hand, the largest public sector bank in India, set the (transmission) ball rolling. Effective May 2019, saving deposits (over INR100k) – 32% of total deposits, according to the press – will be pegged at 275bps below the prevailing repo rate; for now, this works out to be at 3.5%, that is status quo. On the other hand, certain cash credit accounts and working capital loans (above INR100k) – makes up 25% of the loan book – will be priced at 225bps above the repo rate. Proportionately, cuts in the policy rate will lower returns on more deposits than the extent of loans that will yield low interest. Nonetheless, this levels the impact on the bank's assets and liabilities to the external benchmark, (repo rate in this instance).

More banks are expected to follow suit, but the scale of adherence will be guided by their respective balance sheet strength, deposits size, and anticipated duration of the rate-cutting cycle.

In this regard, there are few legacy issues that institutions are dealing with:

Firstly, the state of the banks' balance sheets dictates the extent to which they can eat into interest margins. An RBI paper [2] established that banks' gross NPA and stressed assets ratios impact banks' net interest margins (NIMs), prodding them to build in a margin over their lending rates. The additional premia are tapped either to buffer bad debt provisions or to maintain their return on assets at the targeted level. The central bank's baseline scenario suggests that the peak in gross NPA levels is behind us, with the ratio expected to fall from 11.5% in March 2018 to 10.2% in 3Q19. Intuitively then, weak banks would prefer to keep NIMs unchanged to retain short-term profitability. Banks are still looking to resolve and recover from their distressed accounts, which are at different phases of the resolution framework. This will impair the banks' willingness and ability to lower their lending rates in a hurry.

Secondly, any downward adjustment in rates kicks off by lowering deposit rates first, followed by lending rates. In this cycle, however, the former has been rigid as deposit growth lags a rebound in loans, keeping the LDR (Loan to Deposit ratio) sticky at 76-77% in recent months. Household saving rates have also been on the decline, pulling overall savings lower. This stickiness on the liability side of the banks' balance sheet lowers the impetus for banks to pass benefits on to assets (i.e. loans), making base rates sticky.

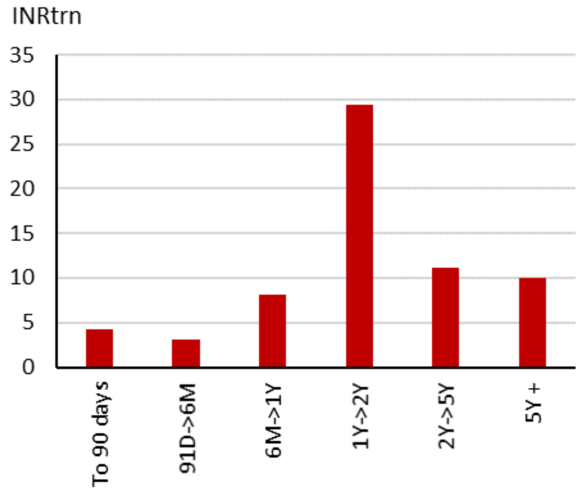
Add to this, the maturity profile of deposits is skewed towards medium to long-term deposits. As of March 2018, over a third of banks' deposits are above the 2Y maturity, hence making it a challenge to revise down deposit rates swiftly (see chart).

Finally, competition from alternative deposit instruments, including small saving schemes, post office savings, mutual funds (financial investments) etc. has risen, with few accompanied tax benefits. Given the disadvantageous position on adjusted basis, banks prefer to keep deposit returns unchanged.

Credit deposit ratio stays high around 77-78%

Source: CEIC, DBS group Research

Maturity pattern of bank deposits (as of Mar18)



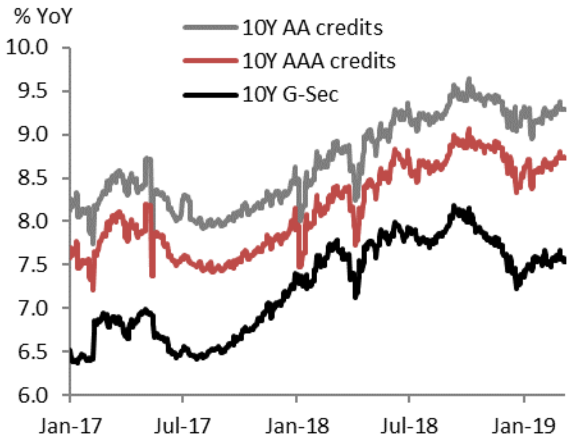
Source: RBI, DBS group Research

Bond market transmission is also crucial

Besides banks, policy transmission through bond markets also matter. Short-tenor bonds have gained from the RBI's accommodative bias, but the belly-longer tenor papers have underperformed. Pass-through to the latter has been overridden by other concerns; lacklustre demand from banks to buy bonds, subdued foreign portfolio interests, domestic liquidity drain, and a sizeable government borrowing program for FY20. Offsetting part of these risks, the central bank was a notable participant in the bond markets this year, with buybacks amounting to INR2.9trn by mid-March, making up 55% of the FY19 gross borrowings. This prevented a sharper sell-off in the long-end of the INR bond curve.

Shallower pass-through through the bond markets limit the extent to which corporate borrowing costs can fall – see chart. **As witnessed during the post-demonetisation period, liquidity conditions are an important ingredient in determining the extent of transmission.** Banking system liquidity has been near neutral-to-deficit since 4Q18, despite the central bank's support. We expect sustained efforts by the central bank, through more term and variable repos, open market operations and, if required, durable liquidity infusion through reserve ratio cuts, heading into FY20 to support the transmission process.

Borrowing costs are off highs but unable to retain gains



Source: Bloomberg, DBS group Research

Slowing growth underpins calls for policy support

Much has been made about the pick-up in credit growth in the past year. The sectoral breakdown, however, reveals that the boost to lending activity is more concentrated in the personal loans and non-banks space, rather than to the industrial sector, particularly MSMEs. Farm loan waivers in selected states are also likely to deter banks from aggressively pursuing agri-related loans.

Overall, growth is likely to be in a rough patch at least for March and June quarters, as investment and consumption cycle ease, ahead of elections. January data signals that the slowdown has spilled over into 2019. Sectors that continue to reflect weakness include, auto sales likely on the back of tighter financing conditions (particularly non-banks), slower real estate activity, lower core imports and softer IIP numbers even as PMI numbers hold above the 50-neutral mark. The budgetary room for fiscal support has increased due to higher deficit targets, but only a part of the pro-consumption push will be implemented ahead of the polls, along with which the government is likely to consolidate capex spending, thus limiting material boost to growth prospects.

For March and June 2019 quarters, we expect growth to soften to 6.0-6.5%. In 2HFY20, growth is expected to stabilise (pre-election trends also concur - see here) as uncertainty is lifted and public/ private spending resume and policy transmission spurs lending growth (assuming the above mentioned issues are ironed out). **Our real GDP growth forecasts at 7.1% for FY19 and 7.4% for FY20 face modest downside risks.**

The confluence of low inflation-soft growth is likely to keep the central bank on the easing bias in April, with rising odds of one more cut in 3Q19.

Notes:

[1] RBI Deputy Governor, Viral V Acharya, speech; Inaugural Aveek Guha Memorial Lecture; November 2017

[2] RBI Occasional paper; Asset Quality and Monetary Transmission in India; May 2018

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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