Economics

India: policy to be data dependent

DBS Group Research 7 April 2015

- **The RBI left the repo rate, the reverse-repo rate and CRR unchanged**
- **Policymakers are concerned over near-term cost-push inflation risks, as oil prices stage a modest rebound**
- **We maintain our call for another 25bp cut before a prolonged pause**
- **The benefits of a looser policy have yet to trickle to the real economy. Lending growth needs more than a liquidity boost**
- **The availability of non-bank funding also weigh on loan growth**

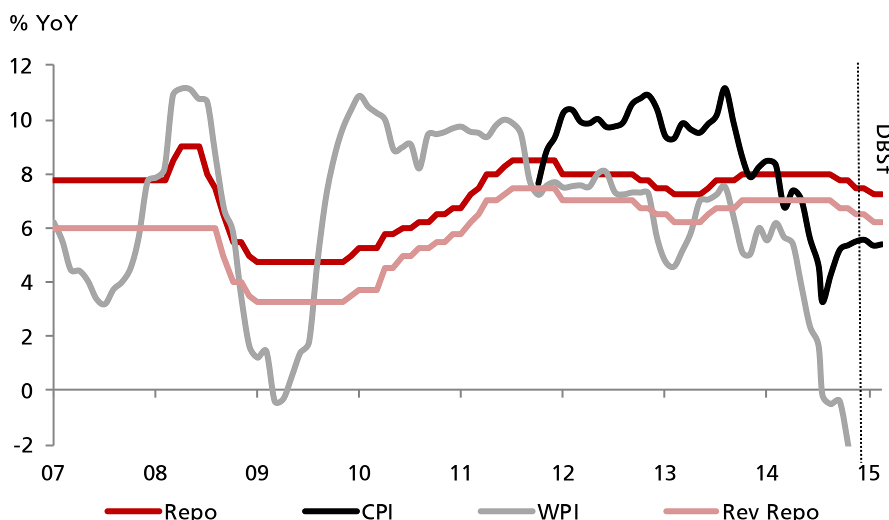
No surprises

Tuesday's policy review did not surprise. The Reserve Bank of India (RBI) held the repurchase rate steady at 7.5% after two off-cycle cuts in January and March (Chart 1). Calls to lower the cash reserve ratio (CRR) to aid lending growth were left unanswered, as expected.

The central bank acknowledged that inflation was well-behaved in early-2015 but risks a turn north owing to unfavourable weather impacting farm output. Press reports suggest a fifth of the winter crop area has been damaged by rains in the central and western belts of the country. This will likely dent supplies of wheat, oilseeds and pulses in the coming weeks, with vegetable prices already up by double-digit percentage in March.

Official projections point to headline CPI inflation at 4.0% by August and to 5.8% by end-year. Our estimate is for inflation to settle between 5%-5.5% in 1H15 and to inch up thereafter, owing to the weak winter harvest and a gradual upturn in global commodity prices (Chart 2, next page).

Chart 1: Sticky inflation stays RBI hand at April rate review



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On growth, the RBI is cautiously optimistic, believing activity is likely to firm in the March quarter. The RBI reiterated doubts about the new GDP series, adding that the "leading and coincident indicators suggest a downward revision of these estimates when fuller information on real activity for the last quarter becomes available". Based on the revised series, FY15/16 GDP growth estimate stand at 7.8%, with a "downside bias". This affirms our non-consensus view for growth this year of 7.8%, up from an estimated 7.5% in FY14/15.

Rate outlook

The RBI confirms that policy remains in easing mode subject to: a) transmission of front-loaded cuts; b) food price inflation; c) fiscal support to address supply side constraints; d) rationalisation of subsidies and clearance of stalled projects; e) US rate hike risks.

Given the modest upturn in growth and existing spare capacity, we believe the output gap has not yet been filled. We expect the RBI to deliver another 25bp cut by June and to pause thereafter, based on expectations for US rate hikes in 2H15, a narrowing in the output gap and gradual rupee depreciation. The upcoming shift to a formal inflation-targeting regime and a lower inflationary path will also oblige the RBI to assume a data-dependent stance and to proceed cautiously.

Lending growth needs more than a liquidity boost

There are many reasons why banks are reluctant to lend

Benefits of easier monetary policy have yet to reach the real economy. Banks remain hesitant to lend due to worries over asset quality, uncertain demand recovery, lack of clarity over upcoming cuts and availability of alternate funding options (discussed below).

In the run-up to Tuesday's meeting, CRR cuts were expected. The RBI did not oblige. A lower CRR would have eased liquidity conditions without straining banks' interest margins. However there is little assurity that this would have convinced banks to lift lending. To the extent lending is limited due to weak demand and concerns over asset quality, lower rates may simply not be relevant.

Some suggest aggressive cuts would lift lending. If history is a guide, this is not necessarily so. During the last easing cycle between Jan 2012 and mid-2013, the base rate fell by a modest 40bp despite more than 100bp rate and CRR cuts (Chart 3).

Chart 2: Inflation off trough

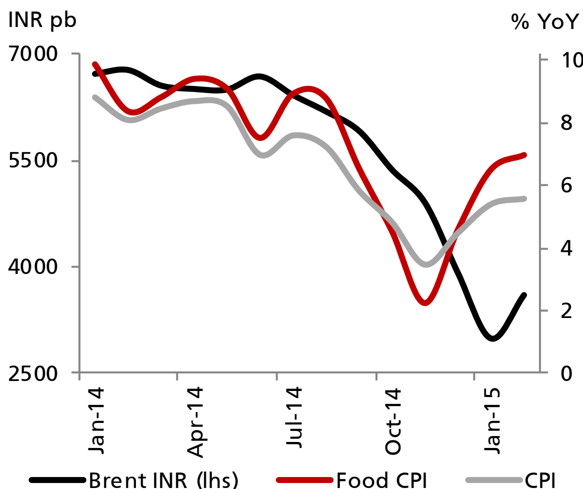


Chart 3: Base rate moves vs Repo and CRR

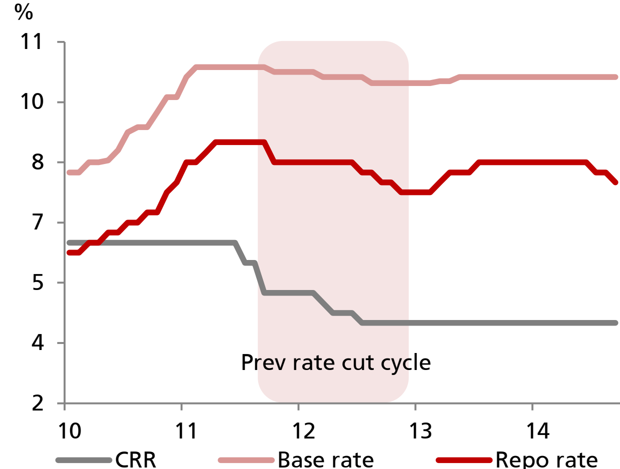


Chart 4: Loan growth continues to lose steam

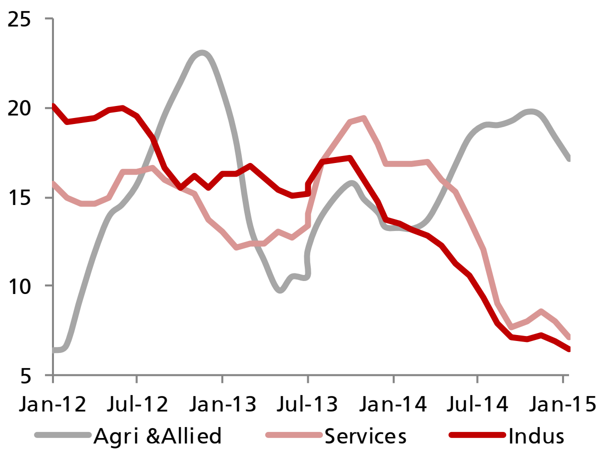
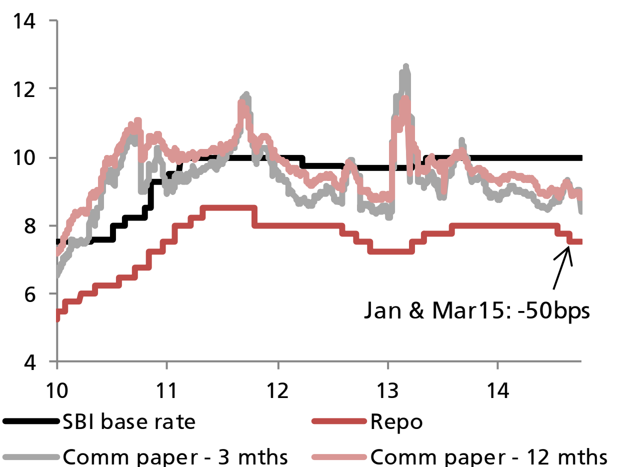


Chart 5: Money market borrowing rates ease



Looking ahead, directed measures to lift lending may prove ineffective. Moral suasion notwithstanding, stronger demand, supportive fiscal policy and redressal of the banks' stressed assets are probably required to left lending. Structural changes (discussed below) may prevent obstacles as well.

Shift from bank-based funding adds to slow credit growth

Credit growth slowed to 11% YoY in FY14/15 from 15% the year before (Chart 4). Apart from tepid demand and stress on banks' balance sheets, availability of non-bank (and cheaper) funding options have also weighed on lending activity.

Corporates have increasingly resorted to bond issuances / commercial papers to meet funding needs. Money market borrowing costs are 100-150bps lower than banks' base rates (Chart 5). Varied tenor needs are being fulfilled by the central bank's push for longer-term papers.

The push to non-bank lending has advantages

The shift is likely permanent. The RBI itself has proposed that part of the corporates' capital needs be raised from bond and commercial paper markets to lower dependence on banks. This is already in motion as banks' share in corporate borrowings has eased from about 100% in 2004-05 to 60% in 2011-12, while non-bank sources inched-up to about a third.

Such a push has advantages. First, less reliance on banks would ease stress on balance sheets and address concentration risks. As of September 2014, banking sector non-performing loans (NPLs) stood at 4.5% of total advances, up from 4.1% in Mar 2014. Including restructured loans, stressed advances are high at 10.7%. The need to raise capital ahead of Basel III changes and limited budgetary support from the government are also drags.

Second, developing / deepening corporate debt markets has been one of the pillars of the central bank's financial sector reforms. Diverting fund-raising to non-bank sources would boost the number of issuers and its overall scale. Low global bond yields, which have spilled over to the corporate space, will also help India's case.

Notably, this shift will introduce volatility in borrowing costs and will require corporates to be prudent in their business operations as decisions will be scrutinized by bond markets.

In sum, the RBI seeks to anchor inflation expectations and coordinate with fiscal consolidation, while pushing for rate cuts to be passed to the real economy. Trickle down is likely to be a gradual process.

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