

A 'no surprise' monetary policy

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It was a perfectly predicted policy. Given the Reserve Bank of India's (RBI) firm commitment to keep retail inflation close to 4% on a durable basis, there was absolutely no scope to lower rates or change the policy stance, amid growing risks to inflation originating from global and domestic arenas.

What surprised the markets was a policy tone, which was less hawkish than expected. This is because an uneven real sector activity in FY18 so far, and the likely adverse impact on growth of elevated commodity prices as well as shortfalls in agricultural production have made the RBI less sanguine on growth.

For the broader economy, the interest rate cycle has already turned. Irrespective of Wednesday's monetary policy signal, interest rates in credit and bond segments have been moving northwards over the past couple of months.

Liquidity surplus in the banking system has continued to decline due to a combination of several factors like the RBI's open market operations, increased non-food credit off-take, cash withdrawals from the banking system and indirect tax outflows.

Growth in bank deposits has decelerated from 11.8% as of end-March to 8.1% in November, as per the latest RBI data.

While growth rate for demand deposits has fallen to a low of 6.5%, growth in time deposits has turned negative. As a result, the incremental credit-deposit ratio of banks has gone up from 42.8% in March to almost 90% in November—a risky level from the perspective of financial stability.

This has created a strong upside bias in deposit rates, as banks need strong deposit base to sustain loan growth, going forward. Some banks have already raised bulk deposit rates by a sizeable magnitude in the past few days, and this trend is going to intensify further.

Sooner than later, this is going to translate into higher lending rates, as banks need to protect their earnings in order to take care of high credit costs and capital adequacy.

Sentiment in the bond market has been hurt due to the double whammy of surging crude prices that are raising inflation expectations and creating risks to the government's fiscal arithmetic.

Yield on the 10-year benchmark government of India paper has jumped 60 bps since the end of July, and the overall sentiment is dampened because of the government's plan to issue special debt to recapitalize public sector banks, which may crimp demand for existing debt.

Another factor weighing on

the bond sentiment is the strong possibility that the US Fed rate hikes may get implemented in line with Street expectations.

While the RBI's policy response gets influenced by the evolving dynamics of growth and inflation, the movement in market interest rates is the outcome of a confluence of market factors.

What is not very clear from today's policy statement is the monetary policy committee's (MPC) insistence on further "transmission" by banks of past monetary policy changes to reduce the cost of domestic borrowings.

Is it possible for banks to reduce lending rates, when their own cost of borrowings has developed a strong upside bias amid growing risks to inflation and steadily shrinking liquidity? In fact, banks' lending rates as well as bond yields will have to reflect a higher risk premium for inflation and fiscal slippage in the months to come.

It is interesting that the MPC has steadily increased its projection of inflation range for H2 FY18 from 3.5-4.5% in August, to 4.2-4.6% in October and to 4.3-4.7% in Wednesday's policy.

On inflation, it remains concerned not over just the shocks coming from food and fuel segments, but also about the HRA (house rent allowance) effect of Pay Commission's award.

On the other hand, it has retained its gross value added (GVA) growth projection for FY18 at 6.7%, despite the recently reported "improved" GVA and gross domestic product (GDP) numbers for Q2, FY18, factoring in the likely adverse impact on growth of elevated oil prices and the shortfalls in agricultural production.

While the recent reform measures augur well for the medium-term growth prospects for India, in the MPC's assessment they would take a minimum of four to five months to get translated into higher growth, as it has not revised upwards its growth projection for FY18.

Thus, the RBI appears to be more cautious and conservative on the growth front than the government.

Surprisingly, the RBI has not given any hints on the future course of liquidity management except its continued emphasis on "neutral" stance.

Given the prevailing liquidity conditions, this may be taken as the end of any further open market operation sales.

However, if banking system liquidity reaches the state of neutrality before the end of FY18, then the RBI may have to inject "liquidity" into the system to avoid a credit panic. This will be more like a "stabilizer" than a "stimulus" for the financial system.

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COMMENTARY