SBI ECOWRAP

भारतीय स्टेट बैंक
STATE BANK OF INDIA

MARCH 09, 2018
ISSUE NO: 74, FY18

ARE YIELD INCREASES TURNING INTO A SERIOUS BUGBEAR FOR THE BANKS?

In recent months, there has been a rapid increase in currency in circulation. On a monthly basis, such incremental growth has been 0.45 lakh crore and 0.51 lakh crore in Jan'18 and Feb'18 respectively, compared to an average of 0.1 lakh crore and 0.2 lakh crore respectively in these two months in previous years (except 2017).

Given that many state elections are scheduled for 2018, growth in currency in circulation will be robust. This in turn would put pressure on bank deposits to expand. Furthermore, the bank recapitalization plan through recap bonds will also lead to leakage of deposits from banks. In order to plug this leakage banks may have no other option but to increase the deposit rates, that in turn may put pressure on MCLR.

The situation of rising yield has also been aggravated with the bond yields going through the roof. One factor for such increase could be the asymmetric liquidity management by RBI. Alternatively, it is withdrawal of permanent liquidity through OMO but injection of temporary liquidity through repo. Interestingly, in the last three months the excess SLR holdings of banks have been reduced by only Rs 21,389 crore. Thus offloading of Government securities by banks is not the primary reason for bond yields rising as this number has not been significant.

In the wake of the recent financial market developments, the onus will also now lie on RBI to balance financial stability with inflation targeting. "*One shortcoming of Inflation Targeting (whether strict or flexible) is that it neglects important information about the build-up of financial imbalances and thus Inflation Targeting poses serious risks to financial stability*." Interestingly, with inflation likely to decline significantly in February and slip below 5%, it remains to be seen how the RBI perceives such build up of financial imbalances. Huge treasury losses by banks also posit a threat to financial stability.

DEPOSITS LEAKAGE

- After the initial spike in deposits due to demonetization, deposits growth has started moderating from Apr'17. From a peak of 15.6% y-o-y growth in fortnight ending 25 Nov'17, the growth came down to 10.9% in Apr'17. This has further reduced to 5.9% for fortnight ended 16 Feb'18.

M-o-M Incremental Currency in Circulation (Rs lakh crore)						
	2012	2013	2014	2015	2016	2018
Jan	0.18	0.17	0.03	0.15	0.14	0.45
Feb	0.19	0.20	0.17	0.20	0.37	0.51*
Mar	0.13	0.12	0.13	0.23	0.42	
Apr	0.37	0.35	0.41	0.44	0.57	
May	0.16	0.02	0.24	0.19	0.13	
Jun	-0.05	-0.11	-0.06	-0.14	0.00	
Jul	-0.15	-0.11	-0.10	-0.22	-0.09	
Aug	0.01	-0.03	-0.10	0.03	0.09	
Sep	-0.08	-0.01	-0.04	0.14	-0.05	
Oct	0.21	0.31	0.33	0.24	0.50	
Nov	0.23	0.28	0.02	0.39	-5.89	
Dec	0.02	0.07	0.20	0.15	-2.50	

Source: RBI, SBI Research, *data for 2 Mar 2018 used to calculate this

- Meanwhile, the currency in circulation has increased rapidly in the past two months. On a monthly basis, growth has been 0.45 lakh crore and 0.51 lakh crore in Jan'18 and Feb'18 respectively, compared to an average of 0.1 lakh crore and 0.2 lakh crore respectively in these two months in previous years (except 2017). Incidentally, income velocity (based on GDP estimates for H2 FY18) for Jan'18 and Feb'18 is also showing an uptick, despite the increase in currency with public. This indicates better growth prospects for the economy.
- Given that many state elections are scheduled for 2018, growth in currency in circulation is likely to remain robust. This in turn would put pressure on bank deposits to expand as it represents a leakage from the banking system. Furthermore, the bank recapitalization plan through recap bonds will also lead to leakage of deposits from banks. In order to plug this leakage banks may have no other option but to increase the deposit rates, that in turn may put pressure on MCLR. This trend may pick up pace with more banks joining the bandwagon.
- The situation of rising yield has also been aggravated with the bond yields going through the roof. Bond yield in India have jumped by close to 3 times than what it rose in USA (for the 8 month period ended March) implying that the increase in bond yields in India is also because of other factors apart from tightening of global yields. One such factor could be the asymmetric liquidity management by RBI. Alternatively, it is withdrawal of permanent liquidity through OMO but injection of temporary liquidity through repo.
- Interestingly, excess SLR of ASCB which increased to double digits for a few months after demonetization has declined steadily and has reached around 9% in the recent month. From a high of excess SLR worth Rs12.73 lakh crore for the fortnight ended 6 Jan'17 the excess SLR has now been reduced by Rs1.84 lakh crore to Rs10.89 lakh crore for the fortnight ended 16 Feb'18. In the last three months the excess SLR holdings of banks have been reduced by only Rs 21,389 crore. Thus offloading of Government securities by banks is not the primary reason for bond yields rising as this number has not been significant.

FINANCIAL STABILITY

- Additionally, an important development which has happened in the financial arena is the expedition of NPA resolution process. This will put pressure on bank margins and also lessening of disposable funds for lending as banks will apportion a bigger chunk to provisioning.
- In the wake of the recent financial market developments, the onus will also now lie on RBI to balance financial stability with inflation targeting. According to a working paper of Central Bank of Brazil "*One shortcoming of Inflation Targeting (whether strict or flexible) is that it may neglect important information about the build-up of financial imbalances given that these developments do not materialize rapidly into consumer price pressures. By ignoring asset bubbles and other financial developments, Inflation Targeting could pose serious risks to financial stability*." Interestingly, with inflation likely to decline significantly in February and slip below 5%, it remains to be seen how the RBI perceives such build up of financial imbalances. Such build-up of financial imbalances has also been exacerbated by huge treasury losses of banks, posing further risks to financial stability.
- We also believe if the banks' hands are completely tied due to the caveats imposed on them imminently rather than sequentially, it might be difficult for them to maintain the current momentum of lending.

ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

The *Ecowrap* is not a priced publication of the Bank. The opinion expressed is of Research Team and not necessarily reflect those of the Bank or its subsidiaries. The contents can be reproduced with proper acknowledgement. The write-up on Economic & Financial Developments is based on information & data procured from various sources and no responsibility is accepted for the accuracy of facts and figures. The Bank or the Research Team assumes no liability if any person or entity relies on views, opinion or facts & figures finding in Ecowrap.

CONTACT DETAILS

Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India
Corporate Centre
Madam Cama Road
Nariman Point

Email: soumya.ghosh@sbi.co.in
gcea.erd@sbi.co.in
Phone: 022-22742440

: @kantisoumya