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STATE BANK OF INDIA

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RBI HIKES RATE BY 25 BPS UNANIMOUSLY

After a period of more than 4 years, the Monetary Policy Committee (MPC) decided to increase Repo rate by 25 bps to 6.25% unanimously and keep the stance neutral. The projection for CPI inflation for 2018-19 is revised to 4.8-4.9% in H1 and 4.7% in H2, including the HRA impact, with risks tilted to the upside.

On developmental front numerous measures have been announced. RBI has given a boost to the MSME sector. In Feb'18, RBI had permitted 180 days' time to banks/NBFCs not to downgrade the asset classification for not re-paying the dues by the GST registered MSMEs. This facility has been extended to non-GST customers also.

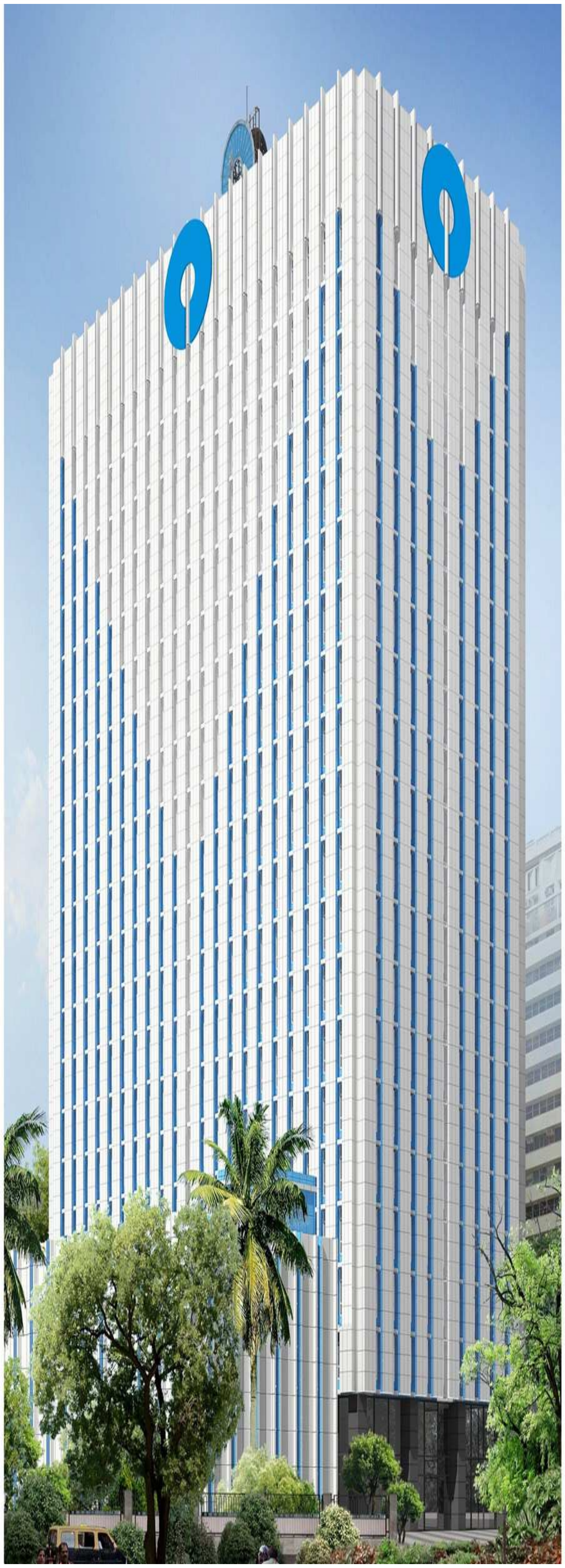
RBI had released Report of the High Powered Committee on Urban Co-operative Banks in Aug 2015 (Chairman: R. Gandhi) where it was recommended that voluntary conversion of large Multi-State UCBs into Joint Stock Companies and other UCBs which meet certain criteria into Small Finance Banks (SFBs).

RBI has proposed convergence of the PSL guidelines for housing loans with the Affordable Housing Scheme. Consequently, the same amount of money will be released from RIDF and bank may invest the same with a higher return.

To ease the pressure for LCR compliance, RBI has given additional relaxation of 2% under Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) (presently 9% of the bank's NDTL). The total carve-out from SLR available to banks would be 13% of their NDTL.

RBI has also decided that state development loans will be valued at the price at which they have been traded in the market and in case of non-traded securities, the valuation shall be based on the state-specific weighted average spread over the yield of the G-sec of equivalent maturity, thus abolishing the 25 bps markup rule.

However in sum and substance, the rate hike will progressively slow the PFCE (upon which the present rate hike was justified) which has benefitted from growth in personal loan segment. The current rate hike appears to be on the back of vulnerability on the external sector. At six months import cover and available data on external debt, the reserves are just sufficient to cover transactions, precautionary and speculative motives leaving little room for geopolitical and other risks.



RBI HIKE REPO RATE BY 25 BPS TO 6.25%

- After a period of more than 4 years, the Monetary Policy Committee (MPC) decided to increase Repo rate by 25 bps to 6.25% unanimously and keep the stance neutral. The last increase happened in Jan'14.
- RBI has retained the Real GDP growth projection at 7.4% in 2018-19 as growth is projected in the range of 7.5-7.6% in H1 and 7.3-7.4% in H2, with risks evenly balanced.
- Projection for CPI inflation for 2018-19 is revised to 4.8-4.9% in H1 and 4.7% in H2, including the HRA impact for central government employees, with risks tilted to the upside. Excluding the impact of HRA revisions, CPI inflation is projected at 4.6% in H1 and 4.7% in H2.

RBI Growth & Inflation Outlook for India				
CPI Inflation (%)	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19
Jun'18 (2nd Bi-monthly)*	4.8	4.7	4.7	4.7
Apr'18 (6th Bi-monthly)*	5.5	5.0	4.6	4.4
Feb'18 (6th Bi-monthly)	5.5	5.0	4.6	4.4
GVA Growth (%)	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19
Jun'18 (2nd Bi-monthly)*	7.5	7.4	7.2	7.3
Apr'18 (1st Bi-monthly)*	7.2	7.4	7.2	7.5
Feb'18 (6th Bi-monthly)	7.4	7.3	7.1	7.2

Source: RBI, SBI Research; * Projections of Real GDP

- RBI has cited various risks to the inflation like increase in crude oil prices, global financial instability, impact of HRA revisions and rise in households' inflation expectations.

DEVELOPMENTAL AND REGULATORY MEASURES

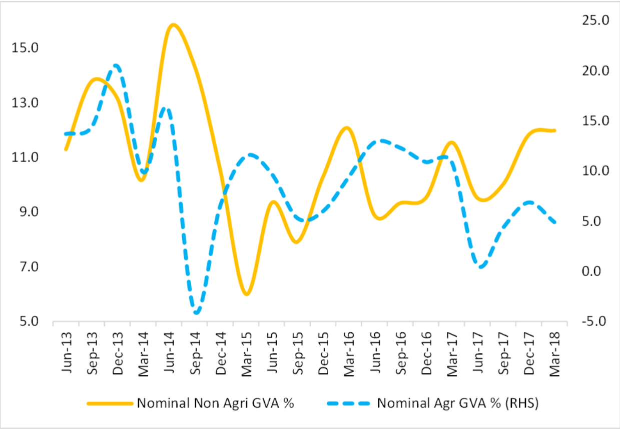
- Banks in India on an average have invested in G-secs and other approved securities which are around 30% of the total NDTL. Further, investment of ASCBs in G-Secs as a % of their total investment has noticeably increased since 2014 but the continuous increase in G-sec yield affects the banks severely in the MTM losses. Previously, RBI has given time to adjust the MTM losses in Q4FY18 to adjust in the next 4-quarters. This has been extended for Q1FY19 to adjust the losses in another 4-quarters. So, this move will help the banks positively and will not affect banks` profitability.
- In line with Government's focus, RBI has also given a boost to the MSME sector. In Feb'18, RBI had permitted 180 days' time to banks/NBFCs not to downgrade the asset classification for not re-paying the dues by the GST registered MSMEs. Further, to increase the formalization of the economy, it has been extended to non-GST customers also. This will definitely help the cash trapped MSMEs and the banks.
- RBI had released Report of the High Powered Committee on Urban Co-operative Banks in Aug 2015 (Chairman: R. Gandhi) where it was recommended that voluntary conversion of large Multi-State UCBs into Joint Stock Companies and other UCBs which meet certain criteria into Small Finance Banks (SFBs). Now RBI has accepted the recommendation. We believe that it is a good step in transforming the banking landscape of India, as this will increase the operation areas of the UCBs who are aspiring to be SFBs. As, the regulatory and supervisory frameworks of UCBs and SFBs are different, we believe there may or may not be any voluntary conversion happening in the sector.
- Convergence of the PSL guidelines for Housing loans with the Affordable Housing Scheme is a welcome step and may help banks to meet the PSL targets. Consequently, the same amount of money will be released from RIDF and bank may invest the same with a higher return. However, we still believe that the increase in limit should have been more due to sharp rise in the construction cost. Further, RBI has raised concern about the rising NPAs in the housing loans segment up to Rs 2 lakh (10-11% as on FY17) and indicated to raise the LTV ratio and/or increase the risk weights.
- In line with the international practices, RBI also decided to implement the margin on collateral in LAF operations on the basis of residual maturity in five buckets in the range of 0.5% to 4.0%, rather than the present 4% and 6% in central G-secs and SDLs respectively. So, this will increase the collateral loan amount in short-term securities.
- Presently many banks find it difficult to achieve their LCR target of 100% by January 1, 2019. So to ease the pressure, RBI gave additional relaxation of 2% under Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) (presently 9% of the bank's NDTL). The total carve-out from SLR available to banks would be 13% of their NDTL. This is expected to impact Indian banking system positively as it will additionally release funds from HQLA requirement and improve the LCR position. However, this may lead to a negative incremental demand for bonds.

- RBI decided that the securities issued by each state government should be valued at the price at which they have been traded in the market and in case of non-traded securities, the valuation shall be based on the state-specific weighted average spread over the yield of the G-sec of equivalent maturity. This may impact the banks in negative way as earlier these were valued applying the Yield to Maturity (YTM) method with a uniform mark-up of 25 basis points above the yield of the Central Government securities (G-Secs). The proposed change in valuation methodology may negatively impact banks profitability.

INDIA IS GROWING, BUT NOT BHARAT

- RBI said in the policy that, "*increase in growth has been underpinned by a significant upward revision in private final consumption expenditure (PFCE) due especially to improved rural demand on the back of a bumper harvest and the government's thrust on rural housing and infrastructure*". Compared to second advanced estimates, GVA grew by 10 bps more to 6.7% in FY18 and PFCE grew by 50 bps more to 6.6%.
- Interestingly, the RBI's explanation of improved rural demand is thus purely a statistical artefact as PFCE growth has infact still decelerated on a y-o-y basis fro 7.3% to 6.6%. On a quarterly basis, PFCE has expanded by 6.7% over a weak base. In fact, on an unchanged base, PFCE has decelerated to 4.5% in Q4FY18, the lowest since Q4FY17. Clearly, the narrative on PFCE may be euphoric and too early to celebrate.

Nominal Non-Agri & Agri GVA (% yoy)



Source: SBI Research

- The nominal non-agri GVA has expanded from 11.5% in Q4 FY17 to 12.0% in Q4 FY18. During the same period, nominal Agri GVA however declined from 10.9% to 4.9%. CLEARLY, India is growing, and not Bharat.
- This indicate that the growth in overall GVA is primarily due to growth in industry and services segment not the agriculture segment.

LIQUIDITY, GOVERNMENT SURPLUS CASH BALANCES AND OMO

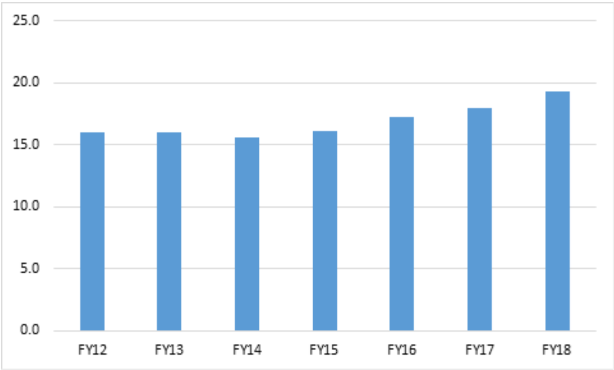
- RBI has raised the interest rate but has kept the policy stance neutral. RBI should atleast make its policy in cognizance with the liquidity situation in the economy. For a neutral stance, system liquidity should be more or less equal to the Government surplus cash balances. The current fiscal has so far liquidity surplus of Rs 352 bn while the Government surplus cash balances have averaged to Rs 249bn. Thus the two are not very much different currently.
- However, forward purchase and sale of foreign currency data by RBI shows that of the total Rs 20.8 bn outstanding forward purchase, around $20.6 bn (Rs 1318 bn) will be done in less than a year period. This in turn implies that Government will inject liquidity to the tune of Rs 1.3 tn this year. Also, currency with public has increased by Rs 985bn in FY19 so far and is expected to increase by Rs 2.5 tn.
- This means that the system is expected to have a net deficit of Rs 1.1 tn in FY19. Hence, RBI should do the OMO purchase of at least Rs 1 tn this fiscal.

SUM AND SUBSTANCE

- The RBI`s policy decision is counter intuitive and is based mostly on one observation that Private Consumption has been revised in latest May GDP figures. This supports revival in demand and when compared with RBI Quarterly survey's support for a rate hike.
- However, there are many unexplained factors. How is a rate hike justified when for the year as a whole the GDP growth is slowing? The private consumption growth is itself at odds with RBI Consumer Confidence Survey. Current situation index slid down by one point into the pessimistic zone, the future expectations index (FEI) showed a marginal uptick. The PFCE is driven on the back of credit, a rate hike, will moderate the PFCE growth going forward. However this in no way to insulates the economy from cost push pressures due to high crude oil prices.

- What is even more striking that external sector has received very little attention in the policy. This despite the fact that current account will come under pressure as commodity cycle reverses. The Survey of Professional Forecasters on Macroeconomic Indicators indicates a CAD projection of 2.4%.
- The RBI itself admits that: "*Financial markets have been driven mainly by monetary policy expectations and geopolitical developments.*" If this being the case, the cause of rate hike is definitely external and not internal.
- This brings the need to assess the external situation more closely. Based on the Keynesian motives, the reserves adequacy can be assessed. This analysis being static, ignores the dynamic reserve management but does establish that economy is vulnerable to geopolitical risk that may have bearing on the current account. At 6 months import cover and available data on external debt, the reserves are just sufficient to cover transactions, precautionary and speculative motives.

Personal Loans as Percentage of PFCE



Source: SBI Research

Reserve Adequacy Based on Keynesian Motives	
Transaction's Motive (@ 6 Months imports)	229.83
Precautionary motive (Estimated debt servicing FY19)	29.30
Speculative motive (Short term debt and FII)	164.93
Required reserves	**424.06**
Actual Reserves	**424.00**

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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!

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CONTACT DETAILS

Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India
Corporate Centre
Madam Cama Road
Nariman Point
Mumbai - 400021

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

: @kantisoumya