7 October 2022

Aditi Gupta
Economist

Will credit growth slow down due to repo rate hikes?

Rates inching up

After keeping repo rate unchanged at a record low of 4% for 2 years, RBI announced a 40 bps hike in repo rate in May'22. This was in response to rising inflation and the evolving global economic situation typified by uncertainties that go with war. Since then, RBI has raised repo rate by a cumulative 190 bps (including the 50 bps hike in the policy last week). In response, banks have also announced increases in their respective lending as well as deposit rates.

Table 1 shows that compared with a 140 bps increase in repo rate (before the last rate hike of 50 bps on September 30), deposit rates on term deposits of banks (more than 1 year maturity) has increased by only 40bps. Even in terms of weighted average domestic term deposit rate (WADTDR), the rate hikes are muted at 26bps for SCBs (as of Aug'22). However, within this group, foreign banks have been much more responsive with an 87bps increase in WADTDR.

Table 1: Both lending and deposits rate have inched up since Apr'22

	Change since Apr'22, in bps
Repo rate	190
Deposit rates	
Term deposit rate >1Y (avg.) (as of 23 Sep 2022)	40
WADTDR: SCBs (as of Aug'22)	26
WADTDR: PSBs (as of Aug'22)	22
WADTDR: PVBs (as of Aug'22)	25
WADTDR: Foreign banks (as of Aug'22)	87
Lending rates	
MCLR: Overnight (avg.) (as of 23 Sep 2022)	55
1 Year MCLR: SCBs (as of Sep'22)	50
1 Year MCLR: PSBs (as of Sep'22)	45
1 Year MCLR: PVBs (as of Sep'22)	42
1 Year MCLR: Foreign banks (as of Sep22)	105
WALR: SCBs (as of Aug'22)	41
WALR: PSBs (as of Aug'22)	36
WALR: PVBs (as of Aug'22)	46
WALR: Foreign Banks (as of Aug'22)	68

Source: RBI, Bank of Baroda Research

In terms of lending rates, the transmission is much better. Both in terms of MCLR (+50bps) and WALR (+41bps), interest rates have increased more than the increase in deposits rate (1 year average as well as WADTDR). Here again, foreign banks have been more proactive in passing on the rate hikes to the customers.

Impact on credit growth:

Despite rising rates, credit demand has grown at a robust rate in FYTD23. In fact, credit growth has risen by 4.2% since Apr'22 (since RBI hiked repo rate) compared with 1.3% in the same period last year led by an increase in non-food credit. Credit growth to all major sectors has shown a pickup. While a part of the increase in credit can be attributed to a positive base effect, a pickup in economic activity has also ensured a steady demand for credit. Table 2 shows the sector wise picture in detail in terms of incremental credit demand as well as YoY growth in credit since Apr'22 till Aug'22. April has been chosen as the base period for comparison as interest rates had remained unchanged until the beginning of May when the repo rate was increased.

Table 2: Credit growth remains robust

S.No.	Sector	Incremental credit (Apr over Aug), Rs lakh crore		% YoY	
		FYTD22	FYTD23	FYTD22	FYTD23
I.	**Total credit**	**1.41**	**5.03**	**1.3**	**4.2**
II.	**Food credit**	**0.10**	**-0.15**	**17.9**	**-34.8**
III.	**Non-food credit**	**1.31**	**5.18**	**1.2**	**4.3**
1	**Agriculture and Allied Activities**	**0.22**	**0.62**	**1.6**	**4.2**
2	**Industry**	**-0.48**	**0.46**	**-1.6**	**1.5**
2.1	Micro and Small	0.19	0.17	4.6	3.1
2.2	Medium	0.20	0.02	14.2	0.7
2.3	Large	-0.87	0.27	-3.7	1.1
3	**Services**	**-0.15**	**1.44**	**-0.6**	**4.8**
3.1	Transport Operators	-0.03	0.03	-2.1	1.8
3.2	Computer Software	0	-0.01	-2.5	-2.7
3.3	Tourism, Hotels and Restaurants	0.01	-0.01	1.3	-1.2
3.4	Shipping	0.02	-0.01	27.2	-10.3
3.5	Aviation	0.01	0	4.1	0.5
3.6	Professional Services	0.03	0.01	2.9	0.7
3.7	Trade	0.03	0.26	0.4	3.6
3.7.1	*Wholesale*	0.00	0.15	0.0	4.0
3.7.2	*Retail*	0.03	0.11	0.9	3.3
3.8	Commercial Real Estate	-0.10	0	-3.5	0.0
3.9	NBFCs	-0.34	0.59	-3.7	5.4
3.10	Others	0.23	0.58	4.6	10.7
4	**Personal Loans**	**0.42**	**2.04**	**1.4**	**5.9**
4.1	Consumer Durables	0.02	0.04	13.8	13.9
4.2	Housing: Incl. Priority Sector Housing	0.34	0.80	2.3	4.7
4.3	Advances against Fixed Deposits	-0.08	0.13	-10.8	15.7
4.4	Advances to Individuals against Share, Bonds,	0.00	0.01	3.0	8.8
4.5	Credit Card Outstanding	0.03	0.14	2.7	8.9
4.6	Education	0.01	0.05	1.3	5.9
4.7	Vehicle	0.01	0.31	0.3	7.6
4.8	Loans against Gold Jewelry	-0.04	0.04	-5.7	4.9
4.9	Others	0.12	0.52	1.6	5.8

Source: CEIC, Bank of Baroda Research

Some important observations are:

- While showing an improvement, credit growth to industry remains subdued at 1.5% this year. Within this group, micro and small enterprises have seen the maximum traction. On the other hand, large scale industries have seen only a modest 1.1% growth.
- Services sector has witnessed a sharp pickup in credit demand with a growth rate of 4.8% compared with a decline of 0.6% in the same period last year.
- Within services, “other services”, NBFCs and trade has seen the most improvement.
- More importantly, the maximum improvement in credit offtake can be attributed to the personal loan segment. In fact, out of the total incremental credit of Rs 5.03 lakh crores since Apr’22, close to 40% or Rs 2.04 lakh crores has been in this segment alone.
- In terms of growth rate, the personal loan segment has recorded a growth rate of 5.9% compared with a meagre growth of 1.4% in the preceding year.
- In this group, the sectors which are showing a healthy pickup are housing and vehicle loans.

<u>What does this mean for credit demand going forward?</u>

Credit growth has remained robust in recent months. With more rate hikes expected by the RBI, concerns have emerged remain whether the growth in credit can be sustained. It is expected that the RBI is likely to hike repo rate to 6.5% by Mar’23 which will also push lending rates higher. However, our analysis shows that despite rising rates, credit growth has remained robust. This is due to a number of factors.

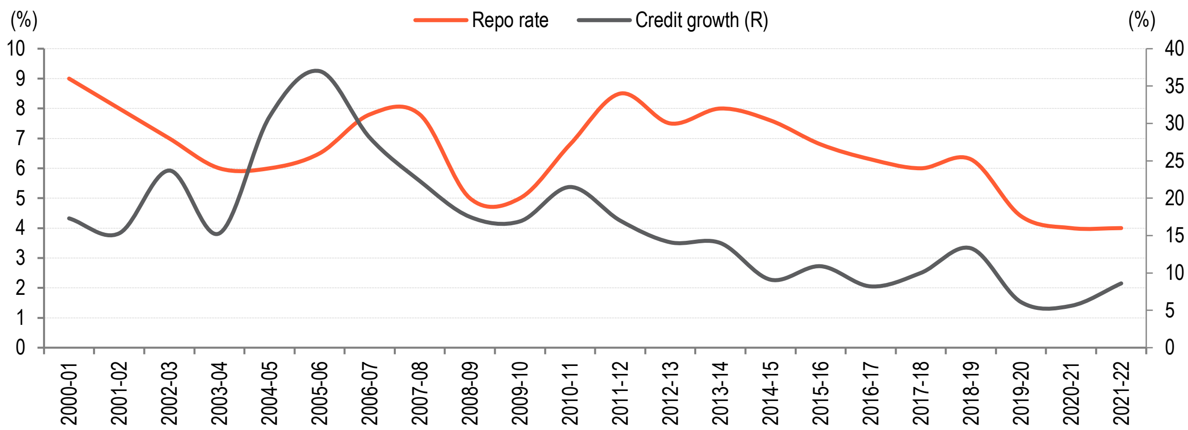
- While credit demand by industry remains muted, most of the increase in credit offtake can be attributed to increased demand from the personal loans segment. Here again, home and auto loans have seen a pickup.
- The pent up demand phenomenon for both houses and vehicles will keep demand for credit up even with cost of loans going up. Rates are likely to inch up further as RBI hikes rate further to control inflation. This is so as these are long term investments and are more dependent on the personal choice and affordability of the consumers. Further, since most of these loans are long-term, the adverse impact of rising rates now may very well be offset in case the interest rate cycle reverses. Other components of the personal loan segment are also likely to continue to growing supported by increased spending due to pent-up and festive demand.
- Even for industry, credit demand mostly relates to purchase of raw materials/capital equipment, which again may not be feasible to postpone. Furthermore, corporate profitability has also shown a positive momentum in recent months which bodes well for higher investments. For MSMEs, growth in credit has been led by government schemes to reduce stress in this sector and hence will continue to ensure that credit demand from this sector does not weaken.
- For services sector, higher demand for services after easing lockdown restrictions has supported credit demand from the sector, which is not likely to taper-off in the near-term.

Therefore given that lending rates do not increase by the same quantum as the repo rate changes, there would be a tendency for credit growth to be less affected by these repo rate hikes provided the economy continues on the current path of 7% growth. Loans linked to external benchmarks would however hurt more as the transmission would be faster both in terms of time and quantum.

A look into the past

The graph below plots growth in credit on an annual basis along with the repo rate at the end of the period. The coefficient of correlation between the two series form 2000-01 to 2021-22 is 0.30 while on an incremental basis is 0.19. Both ways the correlation coefficient is positive and not negative, which it would have been in case credit growth slows down. The clue is in the state of the economy. With the economy growing at a steady pace, higher rates were not a limitation to credit growth even when the repo rate was high or increasing. Similarly with interest rates kept low during the covid time a boost was not seen in credit.

Figure 1: Relation between repo rate and credit growth



Source: RBI, Bank of Baroda Research

Conclusion:

The above analysis shows that higher rates may not be a deterrent for credit demand as investment decisions by both individuals as well as companies is much more need based. With overall economic activity growing at a steady pace so far, demand for credit is likely to continue growing at a healthy pace, even withstanding the prospects of more rate hikes by the RBI. Hence, we do not expect a precipitous slowdown in credit demand. However, rising inflation and sluggish growth in deposits may pose challenges to sustaining this momentum.

Visit us at www.bankofbaroda.com

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
aditi.gupta3@bankofbaroda.com