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India's interest rate cut passes growth woes to government

By Kunal Kumar Kundu

NEW DELHI - The Reserve Bank of India (RBI) on Tuesday made its second successive rate cut, repeating its 0.25% reduction of January to bring the policy repo rate to 7.5%

The move is in line with the market and this author's expectations, since India is now clearly facing a threat of stagflation, with growth slowing to a 15-quarter low of 4.5% while headline inflation remaining above the RBI's comfort level.

Despite an uptick in industrial production in January (after two consecutive months of contraction), weakness in manufacturing persists, especially if one looks at the capital goods segment and continued weakness in mining activity. More worrying, India's growth engine, the service sector, is also showing signs of a slowdown and may now be growing at its slowest pace in a decade.

However, while growth weakness is a serious concern, stubbornness in inflation is unlikely to influence monetary policy action since it is but a consequence of the government's determined effort to bring about fiscal consolidation, which requires raising administered prices of certain products, most notable of which are oil and oil products like diesel, kerosene and cooking gas.

Not surprisingly, the RBI looked beyond the headline inflation rate and focused on core inflation (headline inflation stripped of more volatile food and energy prices), which has been falling continuously since August last year and has now reached a 35-month low of 3.79%. This clearly indicates lack of companies' pricing power, an indication of falling demand - which underscores a slowing economy.

Unfortunately, the cuts in the policy rate are yet to percolate down to a reduction in the commercial banks' lending rate. From April 2012 to March 2013, the repo rate has been reduced by 1% and the cash reserve ratio (CRR), or the percentage of deposits that the banks have to keep with the RBI, by 1.5%. Yet, the cut in lending rates so far has been quite miniscule.

As per CEIC data, the benchmark lending rate of State Bank of India during this period went down by 0.30%, of ICICI Bank by 0.25%, of HDFC Bank by 0.20% - while that of Axis Bank has seen no change.

What can possibly explain this phenomenon is that despite the reduction in repo rate and in the CRR, the cost of funds may not have reduced sufficiently due to a rise in non-performing assets (NPAs) and of restructured loans. Also, in October last year, the RBI imposed an additional provisioning requirement of 0.75% on standard restructured assets.

The problem has been exacerbated by continued delays in implementation of several projects (something the government has failed to address, although it has been promising for some time to reverse this trend), which leads to increasing recognition of such assets as NPAs or get restructured in certain cases, thereby raising provisioning requirements.

Going forward, I believe RBI will pause during its next meeting in April and will take a call for further easing only during its following meeting, in June. This will give it some time to see how the cut in repo rates thus far translate into lower borrowing costs for the economy and how the inflationary situation pans out.

While RBI was clearly enthusiastic about by the government's budgetary promise of sticking to the path of fiscal consolidation, there is no guarantee that it will be followed.

The proposed fiscal consolidation path appears more as an accounting effort rather than any real intent behind it. Also, now that the government has been further hamstrung as one of its key allies, the DMK from Tamil Nadu, deciding to pull out the ruling coalition yesterday, it might not be in a position to carry out some important reform measures and might even decide to abandon the fiscal consolidation path mid-way.

Rather, we might see the government resorting to populist measures (which will jeopardize the country's finance) as it bids to win the next general election, scheduled for 2014.

As the RBI stated in its press release following the announcement, "the foremost challenge for returning the economy to a high growth trajectory is to revive investment. A competitive interest rate is necessary for this, but not sufficient. Sufficiency conditions include bridging the supply constraints, staying the course on fiscal consolidation, both in terms of quantity and quality, and improving governance."

All of these look iffy at this point and hence the RBI might not be left with much headroom for easing going forward. For the remainder of this year, there is unlikely to be more than a 0.50% cut in the policy rate.

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