

## South Asia

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### RBI shows its wisdom

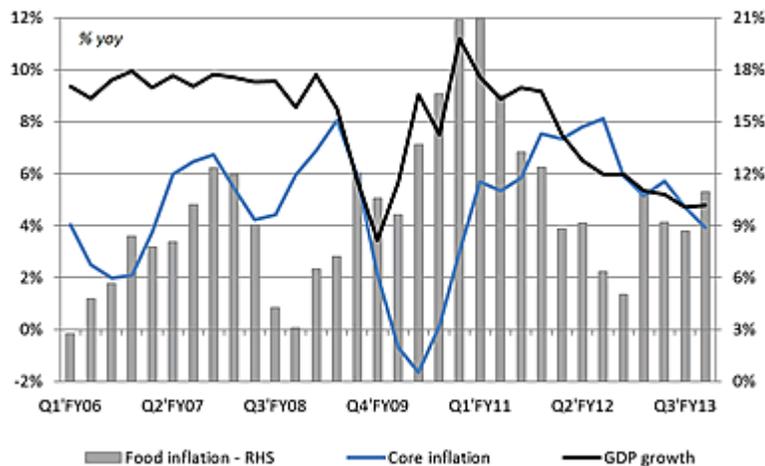
By Kunal Kumar Kundu

NEW DELHI - The Indian government's inability to improve business sentiment and hence investment, coupled with external concerns, forced the hand of the Reserve Bank of India (RBI) as it rightly decided not to cut its key interest rate while also keeping unchanged the amounts of cash banks have to hold in reserve.

The RBI, at its June 17 meeting, left its repo rate at 7.25% while keeping the cash reserve ratio for banks at 4%. On the face of weak economic condition and easing inflation, the policy stance may seem to be counter intuitive and it is not a surprise that RBI drew a lot of flak from industry while government mandarins shook their heads in disbelief.

However, the central bank deserves all credit for being level-headed and not getting swayed by superficial short-term concerns, as longer-term problems can be more vicious. In fact, the Indian corporate houses, rather than chiding the RBI should actually be after the government and force them to do what they should have done. Unfortunately, quite often we hear them singing paeans in public, even if they tear their heads in frustration in private.

For starters, core inflation has been falling simply because domestic demand has been falling, leading to a weak growth environment. However, food inflation continues to maintain a high trajectory as the dollops of social-sector spending lead to rising rural income without any increase in productivity or improvement in rural infrastructure.



Source: CEIC, author's calculation.

Any sustained pick-up (if there is any at all) in demand from here on will surely perk up the economy but inflation would also rise, until investment starts picking up. This requires the government to act. The fact is that the governance deficit has reached such an extent that everybody is hoping that a good monsoon will be able to douse the flame of inflation rather than expecting the government to act. Even the government is resorting to semantics as it dubs even small administrative measures as reforms, while real reforms continue to elude it.

The inflation optimist, should, however, be wary of the infinite ability of the government even to overturn the effect of a good monsoon. Here I am talking about the impending food security bill. In fact, the entire charade about the food security bill that was played out recently clearly shows that the government is not in control - which in itself is a dangerous signal for any potential investor.

For some time, the government has been roaring about going the ordinance route to roll in the food security bill, only to start purring at the end as the opposition threatened the government with instability if it followed through. Eventually, however, this bill will become a reality, the government will become an even larger hoarder of food grains, and inflation will rise. More so because this will only mean an increased Minimum Support Price (MSP) to be provided to the farmers which, while making for a great political statement before the elections, will only lead to increased prices.

To top this, external factors have played a role in the RBI taking the decision to pause in cutting interest rates. Inadequate reforms and political instability meant that while relatively stable foreign direct investment (FDI) flows have declined to a trickle, the unstable foreign portfolio investment flows have remained strong on the expectation of the economy bottoming out after certain policy decisions taken way back in September 2012.

However, with the economy continuing to weaken further while none of those decisions manifesting in real action on the ground, hot money returned home at the slightest hint of the Fed likely to close its quantitative easing tap.

The problem for India is that the country became so used to financing its bulging current account deficit with hot-money flows that the sudden withdrawal has led to a dramatic fall in the value of the rupee. For a country that is hugely dependent on oil imports, that is an inflation genie waiting to come out again.

Already, the domestic price of petrol has been increased by 2 rupees (US\$0.34) a liter on account of the depreciating rupee. With diesel and kerosene prices to be increased only in a graded manner, this will only lead to an increase in the oil subsidy burden and additional pressure on the fiscal deficit.

Also, what is important for the loose monetary brigade to realize is that the transmission mechanism of a monetary policy decision on rate action by the banks has been broken. Non-performing assets react to a slowing economy with a lag, and the banking system has now got to deal with an increased level of provisioning, which reduces banks' ability to pass lower costs to customers.

More importantly for the banks, deposit growth has been anemic. This is not a surprise as there is increased household preference for physical, compared with financial, assets, given the debasement in the currency due to the sustained level of inflation, which has resulted in very low real interest rates.

Falling deposits do not allow the banks to reduce deposit rates and make it that much more difficult for them to reduce the lending rate. Moreover, a falling savings rate manifests itself in the form of rising current account deficit, leading to a vicious circle of a depreciating rupee and increasing inflation.

While the decision by rating agency Fitch last week to upgrade India's credit rating from negative to stable (though at the lowest investment grade) did help to arrest the fall, all eyes were on helicopter Ben Bernanke at the Federal Reserve and his forthcoming statement about a timeline for possible tapering of QE. Now that tapering has been formally announced, the rupee has plunged once more.

Make no mistake, however. India's problem is internal. Unless the quality of governance improves, the economy will continue to stay weak. Given the current environment, I still believe that total rate cut to be effected by RBI during 2013 would be 100 basis points (or one percentage point). Thus far we have seen a cut of 75 basis points in policy rate and I expect another 25 basis points cut towards the third quarter of 2013.

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