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RBI falling behind the inflation curve

By Kunal Kumar Kundu

After a lull of about three months, the credit policy unveiled by the Reserve Bank of India (RBI) on Wednesday was a bit disappointing. While I was expecting a 50 basis points (bps) interest rate increase (if the real intent is to fight inflation), the RBI adopted a more gradual stance in its tightening intent.

The repo and the reverse repo rates have been increased by 25 bps to 6.5% and 5.5%, respectively. On a less surprising note, the RBI substantially increased its end-March 2011 inflation forecast, from 5.5% to 7%.

I see a clear dichotomy in the stance of India's central bank. While it seems to be vocally concerned about inflation, in reality it is more concerned about growth.

It seems that food inflation running at double digits is looked at as an aberration and may moderate over the next few months. While this is partially true, it seems that the central bank is either yet to gauge the full extent of inflationary pressure likely to hit India in 2011 (see Indian inflation waiting to strike, Asia Times Online, December 23, 2010) or it believes that since inflation is likely to be a global phenomenon this year, it had better take a sector-specific stance rather than depending on conventional monetary policy measures.

On the other hand, this week's policy measures betray the RBI's over-riding fears regarding growth. In a few of my previous articles, I have articulated that growth is expected to slow down and that there is already clear evidence of a slowdown in industrial production. Additionally, the widening current account deficit (CAD), loose fiscal policy and high inflation can derail growth prospects.

However, despite knowing that high inflation can impede growth prospects, the RBI seems to be more concerned about a likely slowdown in growth due to high interest rates rather than a slowdown in growth due to inflation. This is a surprise. Or maybe not.

Looking at the RBI's past actions and statements, the bank has clearly underestimated the inflationary scenario for a long time. The very fact that it has upped the inflation expectation by 150 bps at the tail end of the financial year clearly exhibits that the bank has been in denial mode all this time while sticking to its 5% inflation target to be achieved by the financial year end in March.

That the RBI is yet unable to read the real signals properly is also clear from its expectation of India's current account deficit. During April/June 2010, the deficit was at 3.7% of gross domestic product and the RBI hopes that India will end the financial year with a deficit of 3.5%. Even assuming that its expectation of slight moderation is correct, such levels of deficit will be debilitating for the economy.

Yet, while the RBI highlights that as a substantial threat, it does not seem to be doing much about it. The fact remains that a high current account deficit implies that India is consuming more, much more, than the country should, given its level of exports and foreign exchange reserves. Yet the RBI is failing to take the bull by the horns.

Another point of concern is that the external situation is also deteriorating. As of the end of September 2010, India's total external debt was not much different from its total forex reserves. More importantly, the ratio of short-term debt to total debt (based on residual maturity) rose by about 5 percentage points to 43% as compared to 38% a year ago.

Agreed, a good part of CAD is accounted for by oil imports which get skewed even more due to rising oil prices. But it is equally important to ensure that oil demand does not grow by leaps and bounds. With domestic car demand flying through the roof, the RBI has failed to put in an adequate deterrent to this surge in car ownership.

The overall fiscal situation will worsen even more since the government decided to continue with a heavy subsidy of diesel (given its inflationary concern, since India's commercial transportation sector runs on diesel and a likely hike in the diesel price through a reduced subsidy will further raise inflation). So, we have a situation where the demand for cars will not fall away much, while there will be a clear shift in preference for diesel cars over petrol cars, thereby queering the fiscal pitch even further.

It is quite well understood that appropriate conduct of monetary policy requires tempering of inflationary expectations. The RBI governor had the chance to make a bold statement, but let it slip and thereby India's central bank continues to be behind the curve.

Going forward, I expect a relatively regular increase in interest rates as reality continues to dawn on the RBI with every passing phase. The minimum expectation is another 75 bps hike in interest rates over the remainder of the year.

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