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India makes cautious start on interest cuts

By Kunal Kumar Kundu

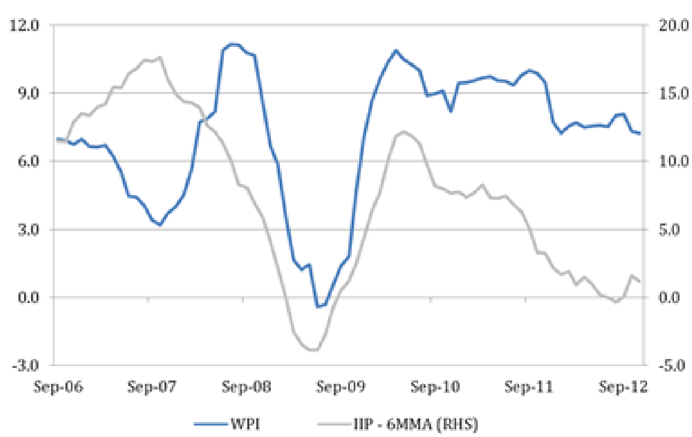
NEW DELHI - As was widely expected, the Reserve Bank of India has finally set out the path of easing monetary policy after holding back for nine long months.

The bank cut its benchmark interest rate by 25 basis points on Thursday to 7.75% from 8%, following a surprising 50 basis points cut in the repo rate in April 2012. While the cut in the policy rate was widely expected, the surprise the RBI delivered was by opting for a 25 basis point cut, to 4% from 4.25%, in the cash reserve ratio (CRR), the ratio of the demand and time deposits that the scheduled banks have to keep with the central bank. (100 basis points is equal to 1 percentage point.)

Thus far the RBI has steadfastly been refusing any suggestion of a rate cut (and rightly so) till the government walks the talk of fiscal consolidation. The debilitating effect of a high fiscal deficit (which pushes up inflation) was not lost on the RBI, and its refusal to toe the government line finally bore fruit as the government has announced a slew of measures aimed at containing the deficit.

The deficit situation cannot be turned around overnight, but intent was what the RBI was looking for and that is what it got. While that provided comfort to the central bank, vastly slowing economy and easing of inflation ensured that the RBI would act to arrest the fall as the concern shifted from inflation to growth.

The central bank was more enthused by the sharp fall in core-inflation (headline inflation stripped off the volatile components like food and energy) to a 33-month low of 4.24%.



Note: 6MMA - six-month moving average. Source: Economic Advisor, Govt. of India; MOSPI; author's calculation.

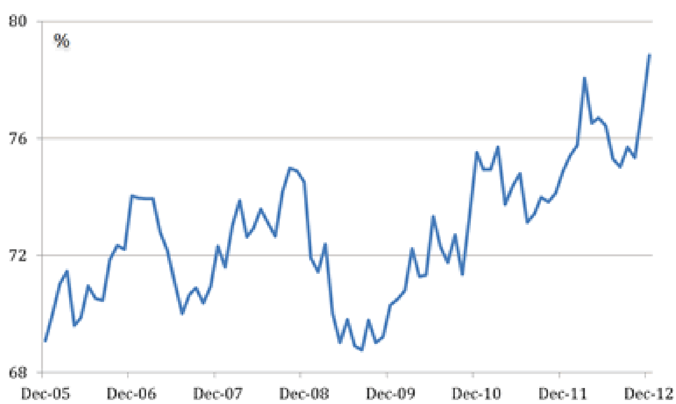
As the chart shows, while headline inflation, as given by the wholesale price index, has peaked and is showing clear signs of easing, industrial production (as depicted by the Index of Industrial Production (IIP) has plummeted. With investment slowing to a trickle, the central bank took the opportunity to cut interest rates to shore up business sentiment. This has been hit not just by high interest but also by the fairly long period of policy paralysis and political demands for imprudent policies (such as retrospective tax-avoidance rules, or GAAR, cancellation of 2G telecom licenses, delays to the adjustment of regulated prices of oil products and so forth).

The RBI remains cautious about inflation facing a potential tailwind. Despite the high base effect (inflation has remained stubbornly high for three successive years), inflation is unlikely to fall drastically as the short-term effect of fiscal consolidation through reduction of subsidies will yet be inflationary, despite what the deputy chairman of India's Planning Commission, Montek Singh Ahluwalia, would have us believe.

The likely increase in social sector spending from next financial year onward (on account of the general election due in 2014) can yet derail the fiscal consolidation process. Also, a slowing economy, high domestic inflation and falling savings are leading to a rise in the current account deficit (CAD), which, unless contained, will drag down growth.

The recent decision by the government to raise the import duty on gold (ostensibly to reduce gold imports, which apparently is impacting the CAD) has no economic justification and much more needs to be done on the policy-making front to bring down the deficit.

While the market was surprised by the CRR cut, the RBI wanted to ensure that a potential increase in liquidity demand, as interest rates fall, does not lead to a liquidity crunch. In fact, the economy has been seeing some stress on that front since November. This is evident from the sharp increase in the credit-to-deposit ratio (CDR) of the scheduled commercial banks.



Source: Reserve Bank of India; author’s calculation.

The CRR cut will release 180 billion rupees (US$3.4 billion) to the banking system. It is expected that greater availability of liquidity along with the rate cut would pressurize the banking sector to pass on the lower cost of funds to the borrowers.

Going forward, however, I believe that the RBI would prefer to err on the side of caution and be muted in its rate cut endeavors. For the remainder of this calendar year, I expect a total rate cut of another 0.75 percentage points, starting with a cut of 0.25 percentage points at the next RBI policy meeting in March.

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