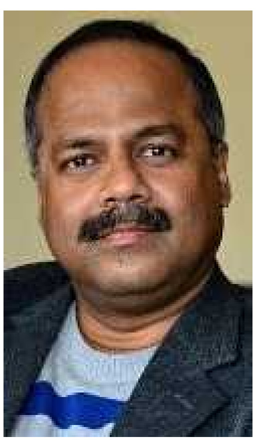
BARRON'S ASIA
ASIA'S BEST MINDS

India's Surprise Rate Cut Puts Ball in Modi's Court

Societe Generale's Kunal Kumar Kundu says investment remains weak as reforms are at a standstill.

By
KUNAL KUMAR KUNDU
October 1, 2015

India's RBI has announced its fourth rate cut in 2015. The central bank surprised the market with a 50 basis point cut, as against our and the market expectation of a 25 basis point cut in the repo rate. The subsequent statement was decidedly dovish as the RBI believes that the inflationary trajectory, despite a likely spike in the short term, will remain well within its immediate target (by January 2016) of 6%. Although the statement talks about monetary policy remaining accommodative going forward, we believe that this is the final cut before a fairly long pause by the RBI.



Surprise necessitated by weak underlying growth momentum

The window of opportunity provided by the Fed as it postponed its move towards rate normalization from September allowed the RBI to opt for a fourth rate cut in 2015. However, unlike the widely anticipated 25 basis point cut, the RBI decided to surprise the market by opting for a 50 basis point cut in the policy rate. With domestic demand remaining weak and the external macro environment uncertain, the RBI was genuinely concerned about the underlying weakness in economic growth momentum. This is best exemplified by weak investment activity prompting persistent weakness in industrial production. The second successive year of monsoon failure also resulted in increased rural stress, further exacerbating the problem.

As the release states, "with global growth and trade slower than initial expectations, a continuing lack of appetite for new investment in the private sector, the constraint imposed by stressed assets on bank lending and waning business confidence, output growth projected for 2015-16 is marked down slightly to 7.4% from 7.6% earlier." In fact, the RBI's downward revised FY16 growth expectation of 7.4% is close to our growth expectation of 7.3%.

Disinflationary trend well entrenched

As we previously mentioned, the two latest headline CPI data points, which indicate an extremely benign rate, are more an indication of a base effect than the actual inflationary trend. In fact, the post monetary policy release confirms our expectation of a pick-up in inflation from September onward as the base effect wanes. Having said that, we believe the general disinflationary trend is deeply entrenched. Despite the expected pick-up in inflation, the RBI's immediate target of 6% headline inflation by January 2016 is unlikely to be breached. The RBI has now revised down its January 2016 CPI expectation of 5.8% year-on-year and January 2017 CPI inflation of 4.8% year-on-year which is in line with our expectation of 5.8% year-on-year headline inflation in Q1 2016 and 4.9% headline inflation in Q1 2017.

Lack of transmission of monetary policy action to lending rate – the key challenge

As we have mentioned in earlier reports, the transmission of monetary policy action remains fairly weak. Prior to this rate cut, banks had generally brought down their lending rate by a mere 30 basis points on average in response to the total 75 basis point cut in the repo rate by the RBI. With incremental rate cuts of 25 basis points proving to be ineffective in prodding the banks to act, the RBI now hopes that an additional cut of 50 basis points will spur the banks into action and encourage them to cut lending rates further. Unless the transmission occurs faster, the effectiveness of the easing monetary policy stance likely will remain quite muted, making the monetary policy stance relatively ineffective.

Strong statement

We believe that the RBI's decision to surprise the market was not only aimed at ensuring faster transmission of the policy rate cut to the lending rate but also to silence the critics (both in the government and corporate world) who have time and again put all the blame for economic weakness on Governor Rajan. Some industrialists have even gone so far as to say that it is Governor Rajan who is standing between them and the recovery in investment.

While lower borrowing cost (assuming the banks do indeed pass on the benefit to the borrowers) would be of help to many excessively leveraged borrowers, fact remains that investment activity in India remains weak not because of borrowing cost being potentially higher by 50 to 75 basis points but because the overall operating environment remains weak and legislative reforms have virtually come to a standstill. Banks have been reluctant to cut rates because of the threat of high NPA (Non Performing Assets), and NPA's are high mainly because of policy inadequacies. We believe that Rajan has done whatever he could do and would opt for a pause for a fairly long period of time. He has now deftly put the ball in the government's court and it is now for the government to walk the talk.

Kunal Kumar Kundu is India economist at Societe Generale based in Bangalore.