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RBI Inches Closer to a Cut

By Kunal Kumar Kundu

Dhiraj Singh/Bloomberg News

Although the Reserve Bank of India left its key interest rates unchanged, there is evidence the central bank is paving way for a rate cut in early 2013, says Kunal Kumar Kundu.

The Reserve Bank of India unveiled its mid-quarter monetary policy review Tuesday and, as expected, it maintained its benchmark interest rates at the same levels.

After the policy review, the central bank governor said that, "in view of inflation pressures ebbing, monetary policy has to increasingly shift focus and respond to the threats to growth from this point onwards."

With the RBI shifting focus toward growth while veering toward accepting a higher inflation threshold, the central bank is paving way for an interest rate cut during the first quarter of 2013.

It seems that the introduction of greater foreign investment in retail, a flurry of other reform measures (including the much-awaited land acquisition bill) and a clear commitment toward keeping the fiscal deficit in check (even if the revised fiscal deficit target of 5.3% of gross domestic product is likely to be breached) may have helped the RBI change its focus from inflation to growth.

Make no mistake, inflation may not have eased to the extent the latest data suggests, especially given the likelihood of an upward revision to the most recent numbers.

However, the RBI seems to banking on improved sowings of winter crops which may help in easing of food inflation, the primary driver of higher prices. On the other hand, what has been hailed as better October industrial production data is more noise than fact and clearly reflects the drop in demand that has happened recently.

I believe the RBI's first move will be an easing of 0.50 percentage point to show that, after months of standing pat, the central bank is serious about stimulating growth.

Still, we should not expect the RBI to be go on an easing spree thereafter. Rather, it may pause for the rate cut to have an impact on the economy, especially given inflation's continued high level.

Retail inflation (as measured by the Consumer Price Index) stood at 9.9% in November and will likely feed into a wage-price spiral that pushes core inflation even higher.

Inflation also will likely be stoked by spending in the upcoming election season, especially in advance of the 2014 general election. Competitive populism will gnaw deep into the heart of India's financial position, thereby weakening it further. There is, therefore, every possibility that India will experience slippage next year in its efforts to rein in the deficit. Hence the RBI will remain cautious.

Too aggressive a rate cut would likely lead to demand moving faster than investment, thereby reigniting inflation.

Last few years, declining investment has proved to be India's bane as it fuelled inflation. While some factors such as falling external demand are uncontrollable, many others are controllable. They include rising government borrowing that crowds out private investment and the government's policy missteps that have made investors sceptical.

So, even if the RBI cuts rates by 0.25 or 0.50 percentage point early next year, I don't believe India will experience a flood of investment. The government has to act and reenergise the investment cycle by taking appropriate policy decisions while keeping a tab on wasteful expenditure so that it can free up funds for capital expenditure.

RBI Governor D. Subbarao has frequently said that he wants to see meaningful government action on reining in public finances before the RBI can be confident in easing; there's no reason to think he is willing to abandon that stance altogether if the government gives in to populism and allows the economy to deteriorate.

Only if the government keeps its commitment will the RBI do the same, and India will experience a virtuous cycle of higher economic growth and relatively lower inflation. In the end, after all, it takes two to tango.

Kunal Kumar Kundu is senior economist at RGE India, based in New Delhi. The views expressed are his own.