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RBI Is Likely to Cut Policy Rate

By Kunal Kumar Kundu

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RBI might take the much desired monetary policy action of an interest rate cut, says Kunal Kumar Kundu.

In the run-up to the Jan. 29 monetary policy meeting, data and policy announcements both seem to be converging on a much-desired monetary policy action: an interest rate cut.

India's headline inflation is still above the Reserve Bank of India's comfort zone but it's showing some encouraging signs of easing. More importantly, core inflation — headline inflation stripped of volatile components like food and energy and on which monetary policy action has a more direct effect — has been falling. In December, it reached a 33-month low of 4.24%.

The demand destruction that has happened following years of persistently high inflation and tight monetary policy is evident in anemic industrial production numbers. The six-month moving average of the industrial production data has consistently been below the 2% annual growth rate since last January. In November, it was just 1.17%. This, combined with the fact that global commodity prices have been easing, suggests core inflation won't pose a challenge any time soon.

The biggest threat to inflation has been the runaway fiscal deficit. In the financial year 2011-12, the fiscal deficit remained below 6% of GDP because the government didn't pay its share of the oil subsidy bill in the last quarter. It only paid out during the first quarter of this financial year.

Policy moves in recent months indicate that the government is finally acknowledging the gravity of the situation. Decisions to slowly move away from the administered price regime for oil products like diesel, kerosene and cooking gas, increasing railway passenger fares and focusing on cash transfer of subsidies all point in that direction.

Even though overall inflation remains above the RBI's comfort zone, this is the right time for the central bank to act and cut the rate. That would signal it is willing to play the ball now that the government is finally acting. So far, the RBI has stuck to its guns and has rightly refused to cut the policy rate (at present at 8%) until the government addresses the alarming fiscal deficit levels.

The only way to get back to a high and sustainable economic growth path is to revive the investment cycle. Years of falling investment have resulted in a slowdown in the country's potential growth rate. It is not just the high interest rate that is holding back investments – many big-ticket projects are stuck because of policy hurdles, not least relating to land and the environment.

But several new and brownfield projects by small and medium industries are stuck because of excessively high interest costs. Many of these companies are under threat as their margins have shrunk drastically. The RBI's mid-year review shows that interest cost as a percentage of operating profits of non-government, non-financial companies jumped from 15.2% in the fourth quarter of 2009-10 to 30.3% in the first quarter of 2012-13. Also, investment as measured by new projects shows a decline from 28.5% of GDP to 9.7% of GDP over the same period, according to the Centre for Monitoring Indian Economy. Even for the government, interest expense accounts for nearly 36% of its revenue receipt.

Lowering the interest rate — in conjunction with the positive policy developments – would likely improve the business environment. The potential short to medium term inflationary impact of policies to reduce the fiscal deficit shouldn't influence monetary policy action as the long-term effect will be positive for the economy.

Ideally the RBI should cut the policy rate by 0.5 percentage point, as it did in April, to have a fast impact on lending rates.

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