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India's Finance Ministry Fails to Inspire RBI

By Kunal Kumar Kundu

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Labourers outside the Reserve Bank of India headquarters in Mumbai, April 17.

India's central bank, as widely expected, Tuesday decided to keep its policy rates unchanged while cutting banks' cash reserve ratio by 0.25 percentage point to 4.25%.

The central bank did this despite the efforts of India's Finance Minister P. Chidambaram to nudge it into action by announcing on Monday a time-bound plan to reduce the budget deficit.

In a sense the die was cast Monday, when the Reserve Bank of India also released its macroeconomic and monetary policy report, a few hours after Mr. Chidambaram's fiscal consolidation roadmap was unveiled. In its report, the central bank acknowledged economic growth was slowing but said that "inflation remains significantly above comfort levels."

"Monetary policy needs to be cautious in the interim, focusing on inflation, while using the available space to support growth to the degree it can," the bank said.

In short, the RBI was open to tolerating lower growth but wasn't ready to compromise on the inflation front. It's commendable that the RBI resisted tremendous outside pressure.

The central bank in fact hasn't been as rigid as is widely perceived. In April, it cut the policy rate by 0.5 percentage point, while the CRR has been lowered by 1.75 percentage points since January. And since August, the statutory liquidity ratio – the percentage of liquid deposits that a bank has to keep with the RBI – has been cut by 1.0 percentage point to 23%.

The reductions in the CRR and SLR requirements ensure banks have more liquidity to lend to business. But they are keeping a much higher level of SLR (close to 30%, according to RBI data), which shows that the business environment hasn't improved sufficiently enough for banks to increase lending.

Meantime, the government has failed to act in a meaningful way to either control inflation or ensure fiscal consolidation. A token five rupee per liter increase in diesel prices was a mere drop in the ocean.

Fiscal consolidation could lead to a short-term spurt in inflation, but the RBI would be comfortable if real progress was being made on the consolidation front as it would ensure a falling inflation trajectory in the longer term.

From the RBI's standpoint, the government has been making some relevant noises, but hardly any meaningful action is visible. And the fiscal consolidation plan unveiled Monday hardly inspires confidence. In that plan, the finance minister laid out a roadmap to cut the deficit to 3% by 2016-17 from 5.3% this fiscal year. But there wasn't much detail about how he plans to achieve that target.

The RBI would prefer to wait for the government to act, as in take decisive steps, rather than merely talk.

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