Interest rates likely to stay high in foreseeable future

The Reserve Bank of India (RBI)'s latest policy review is clear in intent. It adopts a policy of targeting retail inflation and it sets long-term inflation targets based on the Urjit Patel panel recommendation. The central bank wants to pull retail inflation (as indicated by the Consumer Price Index) down to eight per cent by January 2015 and to six per cent by January 2016.

The CPI was rising at 9.87 per cent, year-on-year in December 2013, and the y-o-y rate of change has not been below eight per cent since a three-month period ending February 2012. The CPI rate of change has not been below six per cent since October 2007-February 2008.

Reining inflation back to those levels is not merely a matter of tight monetary policy. A tight money policy works when there's too much money chasing too few goods. This is not the case with the most persistent area of retail inflation - food, which has almost 50 per cent weight in the CPI.

There is enough food and there isn't too much cash chasing it. The price rise in food items is more due to distortions in the supply chain, which will require legislative reforms to break the trader -cartels that control food markets. It will also require the development of better infrastructure in the form of good roads, cold chains, etc.

By setting clear targets, RBI implies some things and it sets a challenge for the government. One big implication is that it will not drop interest rates to enable growth. High interest rates means the government's cost of borrowing to fund the fiscal deficit will remain high. If the government wants interest rates to come down, it will have to find ways to reduce food inflation. This is extremely unlikely to happen in the short run, at least. So, RBI could miss its inflation targets. That in turn, means interest rates are likely to stay high for the foreseeable future.

One can also ignore the encouraging remarks about RBI not raising rates unless retail inflation rises. It's odds-on that CPI will climb in spring and summer, inducing RBI to hike rates again. Food inflation usually spikes in summer and to add to inflationary pressures, the economy will be flooded this summer with easy money due to the general elections. That, in turn, makes it likely RBI will raise interest rates again, soon enough.

This makes life difficult for banks, non-banking financial companies and other rate-sensitive sectors. When rates go up, banks start losing business volumes. They also get hit in terms of net interest margins, since it's difficult for them to entirely pass on the rising cost of capital.

Similar considerations affect other lenders in housing finance, vehicle finance and infrastructure lenders to sectors such as power. At the same time, rate-sensitive businesses such as real estate, automobiles, heavy manufacturing, cement, steel, etc, get hit by higher interest costs.

The change in policy should mean a long-term downtrend for financial stocks and a certain amount of pressure on the share prices of other rate-sensitive sectors. The Bank Nifty has already responded to the RBI Policy by dropping close to 10 per cent. It could end up moving much further down over the next several months.

There might be countervailing factors. If the economy starts to rebound, and inflation does slow down, bank stocks will bounce as loan recovery improves and so does credit offtake. If the political situation changes, there could be a flood of liquidity and that, too, would push bank stocks up. The political situation will not be clear until April-May. The inflation situation will also depend on the change of season given the high weight of agricultural components. So, March-April will provide the first signs of which direction inflation patterns are likely to break.

In the short-intermediate terms, the Bank Nifty should travel down. The US Federal Reserve's decision to increase the pace of tapering will add to the short-term pressure. There will be bounces, of course, but those will only create more opportunities for bear-hammering.

(Business standard)