Monetary Policy: RBI may be forced to cut rates despite inflationary pressures

Reserve Bank Governor Duvvuri Subbarao faces perhaps his biggest challenge when he sets this fiscal year's monetary policy on Tuesday. While there are enough reasons for him to keep interest rates where they are, a growing clamour for rate cuts from industry and finance ministry officials may force him to play to the gallery despite abundant evidence of inflationary pressures lurking beneath the surface.

A quick-fix approach to monetary policy setting, popular before the credit crisis, is giving way to intense analysis of more factors beyond the economic growth rate. It gets more complex especially when the data thrown by government agencies is volatile and becoming suspect.

As many as 16 of the 20 economists and fund managers polled by ET are forecasting a token 25-basis-point cut in repo rate, with the rest forecasting a pause. Seven are predicting a cut in cash reserve ratio, the portion of deposits that banks need to keep with the RBI. A basis point is 0.01 percentage point. Repo rate is at 8.5% and CRR at 4.75%.

High government borrowings, current account deficit, tight liquidity conditions, slowing deposit growth, strong sales despite high interest rates, easy international monetary conditions, high commodity prices, overseas debt repayments and foreign fund flows are among the several objects clamouring for attention in Subbarao's kaleidoscope.

Numerous forecasters and corporate lobbyists base their demand on what is believed to be capturing economic activity - the index of industrial production - and price level, which is perceived to be reflected in the Wholesale Price Index. Neither of them can be trusted anymore. The governor calls IIP data 'analytically bewildering'.

Fear of Wage-Price Inflation

Finance Minister Pranab Mukherjee says the data is 'totally baffling'. The common man finds that prices have risen faster at the marketplace while the statistical office says otherwise. For the record, both these numbers are falling, supporting the call for a cut in repo, the rate at which the RBI lends to banks. To boost industrial production, cost of funds should be lowered, and the slowing price rise shows that inflation is not a threat to the value of the currency now. IIP in February grew 4.1% from a revised 1.1% in January. Before the revision it was 6.8%. Wholesale prices in March, to be announced on Monday, may rise 6.65%.

But Subbarao, who institutionalised the so-called 'outreach' programme at the RBI, visiting villages to feel the economic pulse, will also factor in taxi drivers' demand for a fare hike and workers seeking a pay rise, factors that could lead to a wage-price inflation, the nightmare of all central bankers.

"The expected drop in March core inflation towards the RBI's comfort range of 4-4.5% and the persisting weak momentum of the economy will likely allow it to cut repo rate by 25 basis points," says Taimur Baig, economist at Deutsche Bank. "The RBI will be willing to support growth by cutting repo rate, unless the March inflation surprises sharply to the upside." The deteriorating inflation outlook has already led to economists cutting their overall rate cut target this fiscal by half to 75-100 basis points from 150-200 basis points six months ago.

The catch here is that inflation numbers suppress the actual price rise that would have happened had the government not been administering prices of petroleum products, coal and power. With crude oil, which constitutes nearly a third of total imports, at $120 a barrel, the price situation could only worsen if the government decides to pass on higher prices.

Subbarao is convinced that 'suppressed inflation' still poses a danger to the economy and the economic slowdown is not as pronounced as it appears to be when one looks at corporate sales growth. Every dollar increase in crude prices may push up trade deficit by $800 million, worsening current account deficit that is at a level last seen in 1991 when the nation pledged gold and devalued the currency by more than a fifth to balance trade.

HSBC's India Purchasing Managers Index for the services sector in March at 52.3 and manufacturing PMI at 54.7 showed growth. Order backlog soared to an all-time high of 56.4. The strength is partly derived from the skewed pricing policy of the government that is bloating fiscal deficit, which jumped to 5.9% of the gross domestic product last fiscal. This year it is forecast to fall to 5.1%, but few believe that it would not be breached like it happened last year.

"The government's record market borrowing of Rs 5.7 lakh crore will crowd out private sector credit," says Nagaraj Kulkarni, economist at Standard Chartered. "The lack of decisive government steps to improve investment sentiment and kick-start the investment cycle will also weigh on credit growth." Market interest rates are rising with banks raising deposit rates to attract funds as the near-10% inflation for two years drove investors away from bank deposits that grew the slowest in 7 years. Savings rate has declined to 30.5% of Gross domestic product in 2012, from 36.8% before the crisis.

Despite two cuts in CRR and open market purchases of bonds letting in Rs 2 lakh crore into the market, bank borrowings from the RBI are more than double of what the central bank is comfortable with. "Liquidity imbalance is partly long term, which has been created by intervention in the forex markets and a mismatch in demand and supply of money," says Abheek Barua, chief economist, HDFC Bank. "Despite temporary improvement in liquidity, it is incompatible with patterns that we have seen in the past. In its policy rhetoric, the RBI's emphasis will be to make it clear that further monetary easing will be contingent on the inflation situation and how administrative prices are passed through."

But having remained steadfast in his stance of not easing till he won over price rise and rejecting suggestions of his technical advisory committee, there is an outside chance of the governor holding on to a pause instead of cutting. With sales of BSE Sensex companies forecast to rise 29% in the March quarter and automobiles sales of Mahindra & Mahindra and Tata Motors rising at about 30%, any cut could fuel demand, leading to further price rise that may become uncontrollable.

"A misunderstanding in the markets is that lowering interest rates is the answer to boost Gross domestic product growth," says Madan Sabnavis, chief economist, Care Ratings. "Cutting key interest rates will only improve investments, but that does not take care of the slowdown in consumption and need for increased government spending."

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