RBI policy review: High retail prices may deter softening of interest rates

Releasing the Reserve Bank of India's (RBI) monetary policy review in October 2012, RBI Governor Duvvuri Subbarao had said there could be a softening of interest rates in the last quarter (January-March) of 2012/13. In December, he reiterated that guidance and also talked about responding to the threats to growth.

Today, growth continues to remain a challenge. The RBI has lowered its gross domestic product (GDP) forecast for 2012/13 to 5.7 per cent from the earlier projection of 6.5 per cent. Global bank HSBC has lowered its GDP growth estimate to 5.2 per cent from 5.7 per cent. Clearly, there is room for the RBI to reduce the repo rate by 25 to 50 basis points from eight per cent to support growth at this juncture.

However, there is a new variable that could hinder a softening of interest rates in 2013. And that variable is the Consumer Price Index (CPI), which is an indicator of retail inflation.

The Wholesale Price Index (WPI) is usually the main indicator for the Reserve Bank of India (RBI) for while taking a decision on interest rates. The WPI had softened to 7.18 per cent by December 2012.

However, the CPI was still in double digits in December, at 10.56 per cent.

While the WPI is computed on an all-India basis, the CPI is constructed for specific segments. Today, there are actually three different CPIs covering different segments of the population: urban, rural, and a combination of both.

The WPI is no longer sticky and actually fell to 7.18 per cent from 7.50 per cent in October last year. But the WPI has a broader coverage than the CPI in terms of the number of commodities, quotations, non-agricultural products and tradable items.

In the past, the RBI has often been criticised for using the WPI as the headline inflation index. Many economists and experts believe that it fails to capture the real prices of goods in the neighbourhood market, such as, say, of onions or potatoes. They suggest that the CPI is the correct indicator, as it reflects ground realities.

Going by that argument, there is hardly any scope for a rate cut in the January 29 review by the apex Bank.

Subbarao has conceded in the past that conceptually, the CPI is a better indicator of demand-side pressures than the WPI. Last year, the RBI Governor also explained in a seminar that an increase in wholesale prices eventually leads to a hike in prices by retailers. "We do not have a single CPI that is representative of the whole country," said Subbarao.

The policy rate, which is the repo rate or the rate at which the RBI lends funds to banks, was last tinkered with in April last year - a 50-basis-point reduction to eight per cent. Thereafter, the RBI consistently addressed liquidity issues by lowering the cash reserve ratio - the level of cash banks have to maintain with the RBI - and also through open market operations, by buying bonds from banks. But that hasn't resulted in any dramatic decline in rates, as borrowers still end up paying high interest rates on home or car loans. The same is true for the corporate sector.

If the RBI does institute another cut on Tuesday, it could well mark the beginning of an easing of interest rates in the economy.

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