Rajan's rate-cut message to Modi: Now fix the budget

In cutting interest rates and giving a boost to the government's efforts to revive growth, RBI Governor Raghuram Rajan displayed the pragmatism and flexibility familiar to those who work with him.

Rajan's surprise quarter-point cut not only acknowledges that inflation is easing sharply, but also marks a concession to a government that has repeatedly, if politely, demanded monetary policy relief.

By explicitly tying future rate cuts to "high quality fiscal consolidation", the former International Monetary Fund (IMF) chief economist has put the ball back in Prime Minister Narendra Modi's court while showing enough independence to preserve his credibility with markets.

Modi's finance minister, Arun Jaitley, now needs to deliver cuts in subsidies, boost tax revenues and invest more in India's rotten infrastructure when he presents his first full-year budget to parliament next month.

"There is an assurance from the government that fiscal prudence will be followed," said one policy maker familiar with Rajan's thinking. "So what was the harm in cutting the rate before February?"

The decision, hatched between Rajan and senior policymakers over recent weeks, could ease the relationship between Jaitley and Rajan, who was hired by the last, Congress-led government.

Jaitley, clearly delighted, said the rate cut would put more money in the hands of consumers and help revive investment.

"If there is a deal between Rajan and Jaitley, that's very very positive," said said Surjit Bhalla, chairman of emerging markets advisory firm Oxus Investments and a leading commentator based in New Delhi.

"Monetary and fiscal policy should be coordinated."

The central bank is not statutorily independent from the government, but it enjoys broad autonomy in setting monetary policy.

WIGGLE ROOM

For Modi, relief for the economy cannot come soon enough, with some global CEOs venting frustration at a recent investment summit that, eight months into his rule, doing business in India is as hard as it ever was.

There is mounting evidence too that rural India is struggling as Modi curbs aid schemes championed by the last government, compounding the impact of last year's bad monsoon and a slide in prices for farm exports.

With India's $2 trillion economy yet to emerge from its longest spell of sub-par growth in a generation, sources in both Mumbai and New Delhi see room for some slippage on deficit targets as long as Jaitley puts together a credible spending plan for the fiscal year to March 2016.

"It's about the quality of spending," said one government source familiar with the budget preparations. "We need to reduce wasteful spending and spend more on building the capacity of the economy."

Jaitley, sources say, might get away with revising up next year's deficit target - to around 4 percent of gross domestic product from the 3.6 percent now envisaged - without endangering future rate cuts.

HIS OWN MAN

For now, the powerful forces braking inflation - not least a 50 percent fall in world oil prices - have handed Rajan the justification to cut rates without appearing to bow to government pressure.

"The pressure has always been there. Now we are noting a structural change in the inflation trajectory due to a 5-month decline in oil prices," said a second policy maker familiar with his thinking.

Rajan is playing a longer game to establish inflation as the central bank's main formal policy target. He appears to have buy-in from key government aides who want to avoid another boom-bust cycle like the one that followed the 2008 global crash.

"The goal is to achieve faster growth which is non-inflationary," deputy finance minister Jayant Sinha told Reuters after the rate announcement.

Inflation targeting will help make India's policy framework more predictable after Thursday's move, which was timed auspiciously to coincide with the Hindu harvest and kite-flying festival of Makar Sankranti.

While welcoming Rajan's pragmatism in ordering the rate cut between policy meetings, one investor said he would prefer not to have too many surprises.

"Care should be taken to maintain the sanctity of policy meetings," said A. Prasanna, an economist at ICICI Securities Primary Dealership, otherwise "markets could be in a perpetual state of froth".

The RBI holds policy meetings every two months, with the next one on February 3.

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