Interesting Turn Around*

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Reserve Bank of India (RBI) Governor Raghuram Rajan has surprised many by opting for a "bold", 50 basis points (or half a percentage point, with one basis point equal to 0.1 per cent) reduction in policy (interest) rates. The interest rate payable on borrowing by banks from the RBI (or the repo rate) has been brought down to 6.75 per cent and the interest rate banks get when they hold deposits with the RBI (or the reverse repo rate) has been reduced to 5.75 per cent. The significance of this move comes through from the historical record. First, for almost a year starting late January 2014, the repo rate was kept at 8 per cent. Subsequently a process of gradual easing involving reductions of 25 basis points each in January, March and June 2015 had brought the repo rate down to 7.25 per cent. The September reduction of 50 basis points is an effort at accelerating the pace of interest rate easing. Second, the last time the repo rate was set at 6.75 per cent was in March 2011, implying that in a period of eight and a half months, the repo rate has been brought down to a four and a half year low.

The recent announcement of a rate cut, therefore, signals that the RBI and its governor have bought into the argument that high interest rates are hurting growth, and that the decline in the rate of inflation warrants a rate cut to stimulate growth. Finance Ministry mandarins have been demanding such a steep rate reduction, on the grounds that the danger in India now is not inflation but deflation, driven by a combination of domestic and international factors.

The rate cut announcement is surprising, not merely because of its magnitude, but also because the governor had in the recent past held out against pressure to reduce policy interest rates, on the grounds that cheaper credit could spur inflation. Though the rate of consumer price inflation has come down, he argued, that decline was because of special factors (such as movements in the international price of oil and the collapse of commodity prices). Once those benefits are no longer relevant, prices are likely to rise again as a result of domestic drivers. Moreover, with the monsoon this year declared deficient, the potential for further inflation remained high. So erring in the direction of preventing inflation rather than spurring demand and growth was the appropriate policy in his view.

Given that stance, the 50 basis points reduction in September, which was justified as an attempt to "front-load" the process of monetary easing in the face of a global downturn, reflected the admission that the pace of rate reduction thus far has been too slow. It is indeed true that the annual rate of CPI-based inflation in August (relative to August of the previous year) was, at 3.66 per cent, low. And the inflation rate expected for the full financial year is well within the RBI's "target" range. But the decline in the rate of inflation has been with us for sometime now and, as mentioned earlier, this year's poor monsoon threatens to trigger food price inflation. If despite this the RBI governor has opted for a steep cut in rates, it suggests that he wants to send out a signal that he is doing his bit for growth. The objective of the recent rate cut, whether realised in practice or not, is clear. It is to increase access to cheaper liquidity so that debt-financed investment, housing purchases and consumption would revive and growth would accelerate. So clearly the governor has either changed his view and now considers growth, rather than inflation, the bigger problem to address, or does not want to be held responsible in case India experiences a slowdown.

The rate cut reflects a shift in stance for one other reason. Rajan had strong views on the relative roles of the central bank and the government. The RBI he seemed to believe should focus on targeting inflation, while the government by resorting to deregulation that removes "impediments" to investment and ensuring a stable macroeconomic environment that builds business confidence (by realising its fiscal deficit reduction targets, for example) should be responsible for growth. That too has changed now. In a clear turnaround the governor in his monetary policy statement has not only admitted that it is time now to revive demand, but that the central bank has a role to play in the process. He has bluntly stated that a signal that the RBI is committed to providing a monetary stimulus would revive investment and growth. It is for that reason, he indicated, "the Reserve Bank has front-loaded policy action by a reduction in the policy rate by 50 basis points".

This dramatic shift in perspective and change in policy stance is bound to be seen as a sign of the RBI accommodating or submitting to the government view, expressed by Finance Minister Arun Jaitely and his team, that stimulating growth requires a monetary stimulus. The stimulus here is not just the direct effect that the reduced cost of capital is expected to have on investment. Investment can be quite unresponsive to interest rates, if demand is slack. So the real intention is to spur demand by making it cheaper for households, corporates and other economic agents to borrow and spend. The idea is to put India back on to a strategy where debt-financed demand stimulates a revival.

Implicit in this stance is the admission that the GDP growth rates, which are still high (though lower than earlier), do not reflect the true state of the Indian economy. Hence the reference to "still-low industrial capacity utilisation" and the need for more domestic demand "to substitute for weakening global demand". The RBI governor went even further, and made a weak case for a fiscal stimulus when he said that "public expenditure on roads, ports and eventually railways could … provide some boost to construction" and that the implementation of the Pay Commission's recommendations (which would stimulate demand) is not likely to be inflationary, so long as fiscal deficit targets are met.

However, this obsession with fiscal deficit targets may be the government's undoing. With the government unlikely to raise direct taxes to mobilise revenues to finance its expenditures, any increased spending on infrastructure, for example, when deficit targets are met, would amount only to a change in the composition of government-induced demand growth, not its volume. It is the latter that is important in the current circumstance. With demand slackening, fiscal rather than monetary stimuli are needed for growth.

Moreover, even if the rate cut is an adequate weapon, its effectiveness would depend on banks passing on that benefit to potential borrowers. A problem in recent times has been that India's banks, seeking to deal with their large non-performing assets and improve their balance sheets, were not just unwilling to lend as before but were also unwilling to pass on a significant share of the benefits of any reduction in interest rates (or the cost of their capital) to their customers. The large repo rate reduction and the reduction in the reverse repo rate (or the interest earned by banks on deposits with the central bank) seem to be geared to addressing this problem. But the fact that this time around banks have responded quickly to bring down their lending rates by twenty five to thirty five basis points suggests that the government and the central bank are pressurising them to do so, so as to transmit the effects of the rate cut to potential borrowers. But this in itself may not be enough. A banking system straining under the burden of stressed assets has turned cautious about lending more. Further, following the borrowing spree of the 2000s, corporates and, to some extent, households are also overburdened with debt. So the universe of creditworthy borrowers is also likely to have shrunk. Expecting the economy to revive only because the RBI has cut interest rates may be wishful thinking.

In sum, the “surprising” move by Rajan is unlikely to serve its intended purpose—that of reviving growth, so long as government spending is curtailed in the name of “fiscal consolidation”. All it does is signal that the RBI has accepted that the principal threat in India today is not inflation, but deflation, where a combination of falling inflation and falling demand could precipitate bankruptcies, which would depress demand further and set off a vicious cycle.

Not wanting to be held responsible for any such outcome, Rajan has decided to drop his ideological inclinations and reverse his policy stance. This, however, is not surprising. In the past too Rajan has displayed an ability to signal that he is on both sides of a debate, holding positions that are in conflict. Because of a Jackson Hole address delivered by him, he is seen by some as one who is cautious about financial development spurred by deregulation and, more importantly, one who “predicted” that the consequences of deregulation would precipitate a 2008-type financial crisis in the US. But, in India, the report of the Committee on Financial Sector reforms that he headed, which was submitted when the global crisis was unfolding, had recommended deep and wide-ranging deregulation and expansion of the financial sector in India. That was not a surprise, coming from a committee headed by a former Director of Research of the IMF. But, Rajan has managed to ensure that the reputation he carries is still heavily influenced by his Jackson Hole address.

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