Slash the Policy Rates

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Inflation targeting is working, RBI must promote growth and jobs now

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Let us give credit where it's due. Over the last couple of years RBI has re-established its credentials as an inflation fighter. Its initiatives both in terms of changing the very paradigm of monetary policy – by explicitly targeting consumer inflation and setting transparent targets for its level – as well as judicious use of the policy interest rate have brought consumer price inflation below the target of 6% set for January 2016.

However, it's time for the central bank to consider a further reduction in policy rates. To start with the global macroeconomic situation, we are in a deflationary syndrome. Large pockets of the global economy are experiencing sluggish growth and a turnaround in the near future seems unlikely. Slow global growth has pushed commodity prices on a downward path. The CRB index, a widely used measure of commodity price levels, is down by 15% year on year. For the Indian economy, imported inflation has ceased to be a threat.

On the domestic front, the government has adopted a rational approach to minimum support prices (MSP) that according to many analysts were a significant contributor to food inflation. For two years now, the increase in MSP in paddy and wheat has been moderate and just in line with cost increases for cultivators. Besides, the rural wage spiral that was feeding a more broad-based wage spiral a couple of years back seems to have died down. Rural wages increased by only 5% in April 2015 as compared to a 16% increase in October 2013.

RBI had expressed legitimate concern that policy or repo rate cuts are not being transmitted to borrowers. Banks have taken a cue and reduced base rates. However, the state of industry is such that sales growth remains in the doldrums. The problem is twofold. Lack of demand is manifested in both weak volumes and a decimation of pricing power.

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The wholesale price index might not be the correct gauge for measuring the cost of living for households but the nine-month long deflation in the WPI index cannot entirely be ignored when capturing price movements faced by business. In fact it is a strong signal that for industry, it is low rather than high inflation that is the key problem. The moral of the story: unless demand is revived through a cut in interest rates and pricing power returns to the system, the hope of an investment revival is likely to remain unfulfilled.

The final question is: can banks reduce lending rates further to give a helping hand to the economy?

It is important to recognise here that lending rates can go down further only if the cost of deposits declines. What stands in the way of lower deposit rates? First, small savings rates that compete directly with deposits are sticky and remain high with major schemes like PPF offering an 8.7% return. The benchmark risk-free or government bond rate of a 10 year tenor is close to 8%, entailing a real rate of return of over 2.5%. Its level ultimately determines the deposit and lending rates that banks set for themselves.

Finally, let us not forget banks also have statutory preemptions like CRR and SLR along with the capital that they need to hold to maintain their mandated capital adequacy ratio. Risk weights that determine this ratio also need to be factored in to arrive at the cost of funds. In short, the cost structure of the banking system does not easily allow for a reduction in the interest rate.

What can break this gridlock is further reduction in the policy rate along with some rationalisation in rates offered on competing instruments like small savings, reduction of risk weights on assets to international levels. A drop in policy rates / liquidity cost reduces the cost of short term funds and also pulls down benchmark rates like the 10-year bond and a drop in risk weights reduces capital requirements. These measures will create an environment that is conducive to a reduction in both deposit and lending rates.

This should lead to a revival in investments, growth and job creation and a break in the vicious cycle of high interest rates, sluggish investments and low growth.

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