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Spend Prudently, Build Infrastructure

The government must spearhead the war on inflation through fiscal consolidation and capacity creation

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The market and bankers were expecting a hike of 25 basis points (bps) in the central bank's policy repo rate. This was based on the assumption that previous rate hikes were starting to take effect, leading to a slowdown in the rate of GDP growth: credit growth was moderating, global growth was expected to slow down with a consequent moderation in commodity prices, inflation was a demand-and-supply-side phenomenon that an interest hike alone would not solve. So, we could choose to risk a 25-bps rise and not chance a big slowdown in growth. The yield curve in the markets reflected the above. The government yield curve was extremely flat. The 364-day T-bill yield was 8.15-8.20%, while the benchmark 10-year bond was trading at 8.30% levels, reflecting expectations of a slowdown. The absolute rates on T-bills of all maturities had come off 10-15 bps from their highs, reflecting expectations of the end of the hiking cycle.

The RBI decision to hike policy rate by 50 bps surprised the market and industry. However, it must be recognised that the RBI has done its best to manage the growth and inflation dynamic in the face of global uncertainty and less-than-optimum support from fiscal policy.

The ground reality is that inflation has moved to 9.4% in June and is likely to be revised upwards by a fair bit to reach double digits. The figures for July and the subsequent months will be worse as the impact of the fuel price hikes announced in the last week of June kicks in. In fact, the signs of moderation in demand are, at best, patchy. Some sectors such as automobiles have slowed down, while others such as white goods continue to boom. Besides, wages are rising both in the organised and unorganised sectors and job creation has picked up this year. Advance tax collections have been strong and corporate profit margins have shrunk a little in the last quarter but remain healthy. So, the ingredients of classical demand-pull inflation seem to be still in place. It is clear that monetary tightening in advanced economies will not happen and we are unlikely to see a softening of commodity prices as the impact of weakening demand will be offset by excess liquidity — giving no respite on the supply side.

The market thoughts today can be summarised as: (a) the RBI action would impact growth, and (b) there are more hikes in the offing and the liquidity will remain in deficit for the next three months. Other factors remaining stable, the base effect will bring down inflation to 7.4% by June. Managing the growth and inflation dynamic is tough, and it is only with 20/20 hindsight can you determine what should have been the correct action. In the meantime, you take action based on best judgement of available information and future trends.

Will this aggressive action pay off? And is the RBI compensating for fiscal policy?

The RBI role is not confined to a conventional demand manager. The domestic monetary policy traditionally has to endeavour to offset the impact of fiscal policy (deficit), an inflationary agricultural price policy and inadequate investments in infrastructure and agricultural supply chain. The fiscal deficit that was budgeted at 4.6% of GDP for 2011-12 is likely to slip. Expecting monetary policy to be the mainstay of inflation control will unbalance the growth inflation dynamic — specifically in an economy with structural imbalances and a liberal fiscal policy. Relentless interest tightening may temporarily bring down prices but, in the absence of supply-side improvement, it will result in lowering growth and return of inflationary pressures. Clearly, we need fiscal and monetary policy to be on the same page to tackle inflation effectively. Fiscal consolidation is an imperative but has to be done carefully. We cannot compromise on capital expenditure while we persist with revenue spending such as subsidies — which do not reach intended beneficiaries. We must also recognise that interest rate is a blunt tool that cannot at the same time curb consumption and increase capacity creation through investment. Therefore, if we do not want GDP growth to slow down, reduction in demand should be matched by increase in investment (GDP = C + I + G).

The combination of an uncertain domestic and international environment and high interest rates means that private investments are likely to be relatively thin. Thus, the burden of capacity creation will have to be borne by an entity that is not as sensitive to interest rates: the government. Thus, fiscal consolidation will have to involve a sharp compression of revenue spending and income transfers with a firm focus on infrastructure and supply-chain building. Only then can we hope to get a permanent reduction in inflation levels.

(The author is managing director of HDFC Bank)

Sharper Rate Hikes Hurt More

	PRE-HIKE (%)	POST-HIKE (%)	CHANGE (BPS)	REMARKS
91-day T-bills	8.10	8.40	30	
364 day T-bills	8.30	8.50	20	Reflects rising interest expectation and tight liquidity lasting six months
10-year G-secs	8.30	8.45	15	Reflects unanticipated increase and liquidation of a heavily-long market, but also pricing a slowdown
1-year OIS	7.95	8.35	40	Reflects unanticipated rise and liquidation of a received market, and expectations of tight liquidity for another six months
5-year OIS	7.55	7.65	10	Reflects all-round expectations of a slowdown