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Analysing India's Credit Policy: Keeping An Eye on Inflation and the Elections

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The Reserve Bank of India (RBI) last week announced that it would keep interest rates unchanged, and chose to adopt a wait and watch policy. Markets and commentators in India had expected a reduction in interest rates, following the United States Federal Bank's decision to reduce rates in two tranches by 1.25 percent.

There were two reasons that prompted the market watchers to expect a softening of interest rates in India. First, there have been significant inflows of capital into the financial markets since October last year, forcing the RBI to buy up the excess dollars in the market, and to sterilise the consequent liquidity through the issue of market stabilisation bonds. This approach keeps the strengthening of the rupee against the dollar within limits that can be managed by the RBI. The costs of this operation, in the nature of the interest burden of these bonds, is met by the Indian government from its budget and, therefore, the cost of keeping the rupee-dollar rate from appreciating is a actually a burden on the government fisc. In the face of reduction of United States interest rates, it was expected that the differences in interest rates between India and the United States would lead to accelerated flows into Indian markets that would strengthen the rupee even further and affect exports even more.

It was also the expectation of the corporate sector that interest rates needed to soften, given the apparent slowdown in the off-take of credit and the slowdown in consumption expenditure as well as in the stock markets.

The RBI chose to look the other way on these two, and two comments made by the RBI were interesting. The first was that inflationary pressures were lurking in the economy and that this was a matter for concern. The second was that banks had enough leeway to reduce borrowing and lending rates, and that money supply was already ahead of expectations and there was, therefore, sufficient liquidity in the economy.

Only a few weeks back, the RBI and the government had congratulated themselves on keeping a lid on inflation, having brought it down to less than five percent. Further, the expected increases in petrol and diesel prices did not materialise and the consumer was cushioned from the burden of increased energy prices. On the agriculture front, there have

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been reports that winter wheat sowing has been above expectations and the recent steps taken by the government to stockpile wheat have yielded satisfactory results. The sudden concern over inflation, therefore, appears to be a little intriguing. The RBI's answer is that it is looking at a three to four percent rate by next year and the Finance Minister, Mr P. Chidambaram, has said that, between a high growth high inflation scenario and a somewhat moderate economic growth and low inflation alternative, choosing the former would be 'disastrous.' In fact, in Davos, he said that half a percent lower growth would still leave the country with a healthy eight percent rate of growth. A possible explanation is that there is a need to be extra careful in an election year and that while growth may not win votes, inflation will surely lose them. The future of oil and food prices beyond the middle of the year is still unclear and it may, therefore, be better to wait than to do something. Further, there is little evidence yet that credit deflation is happening and, hence, it is better to guard against inflationary pressures.

The RBI and the government have also been urging the banks to look at their borrowing and lending rates. The RBI, in particular, feels that the margins that the banks are making are quite a lot and can be reduced. There was, thus, need to put pressure on the banks to look at borrowing and lending rates – the Foreign Minister had already said as much at a recent meeting with the bankers. It has been clear for some time that credit supply has been quite skewed. Corporate India has had access to all the credit that it needs and there are several cash surplus companies that have had access to credit limits that they have used for arbitraging the market. At the same time, interests on housing loans have been up and retail loans as well as small-medium enterprises have had to bear the brunt of high charges. The argument of the RBI on interest rates apparently was that there was enough scope for the banks to reduce rates by themselves. Coupled with the information that investment expenditure in projects and infrastructure continues to be robust, there was merit in the RBI taking the 'do nothing' stand.

The corporate and the media have been critical for the same reason. The third quarter results of many of the firms have been published in the last week and clearly show pressures on margins. It is interesting that several companies have reported considerable increases in 'other incomes' – possibly a euphemism of the incomes earned in the financial markets. These entrepreneurs would, therefore, have benefited most from an interest rate cut and, hence, have felt let down.

That the RBI and government have moved in the right direction is clear from the fact that the HDFC bank cut interest rates for home loans soon thereafter and the market is now expecting other banks to follow. If the effect of the RBI stance improves credit flows at lower rates for home loans and consumption, it would have achieved its purpose.

Finally, there was the need for the RBI to be cautious. The effects of the interest rate cuts in the United States and the efforts to revitalise that economy are not yet clear. If the interest rate arbitrage does indeed bring in greater flows to the Indian capital markets, then the costs of sterilisation by the RBI will go up. The Indian Foreign Minister has already talked about the impact of the market stabilisation scheme (MSS) on the budget. The higher interest burden and the costs of MSS are likely to squeeze out all the benefits of buoyancy in tax revenues, leaving the government little room for populist schemes, without hurting the fiscal deficit. This being the last full budget before elections, there is likely to be great pressure on give-aways as well as pressure on subsidies for food, fertilizer and oil. If there is dampening

of growth as well, then sops for exports and tax concessions will be pressed for by interested groups. The government and the RBI need room for maneuvering in the next few months.

At the same time, if the effects of the decline in the United States economy do not translate into greater interest in the Indian financial markets, then there would continue to be a fall in equity values and, after a lag, in real estate prices. As it is, market analysts are predicting a fall of at least another 12 to 15 percent in the stock markets over the next few weeks.

No wonder that the RBI did not do anything, and indeed, it was the best thing that they could have done.

The silver lining that everyone is looking for is a domestic upturn later in the year. The argument is that investment is robust, particularly in construction and infrastructure and, therefore, demand would be robust. Equity offerings and new mutual fund offerings in infrastructure have garnered huge investible resources, that are waiting to be deployed in the financial markets, and soon. A good wheat crop would stabilise rural incomes and energise rural demand. Foreign investors, waiting in the wings, would also be ready to come in with their investments. If the opportunities arise, it would then be the right time for the RBI to pump prime the economy through a rate cut later in the year. And then one would have a very smooth sailing into election mode. There are several elections to state assemblies, including Rajasthan and Madhya Pradesh, that are very important for the Congress this year, and it is important that everything runs smooth in the economy.

The only risks in this scenario would be that of inflationary pressures caused by increases in energy and commodity prices. Even here, it is likely that these may not be passed on to the consumers in an election year. They would be absorbed as subsidies adding to fiscal strains and they could be tackled later.

It is obvious that investors, funds and the Indian government would be waiting expectantly for things to right themselves out and until then, markets may continue to be soft.

These are interesting times to live in.

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