



The RBI may carry out a small rate cut, but is it advisable?

By [T.K. Jayaraman](#) on [06/02/2017](#)

If the monetary policy committee waits until April, it will have a better idea of demonetisation's negative impact and a firmer grasp of global commodity price trends.



Credit: Reuters/Danish Siddiqui/Files

There are expectations all around that Reserve Bank of India [will lower](#) its policy interest rate when its monetary policy committee meets on February 7-8 for considering its bi-monthly credit policy. The markets speculate the cut will be by 25 basis points (bps) from the current level of 6.25 to 6% so that bank credit to investors becomes cheaper and investment can be boosted.

The reasons behind the expectations are as follows: First, demonetisation has hurt the already falling rate of investment (the rise in investment by 4.9% in 2014-15 was followed by only 3.9% increase in 2015-16) while there was actual decline by a negative 0.2% in 2016-17.

Second, inflation has been benign as reflected in changes in consumer price index (CPI); it has been below RBI's target of 5% and retail inflation was at 3.41% in December thanks to plentiful supply of vegetables and due to weak demand post-demonetisation.

Third, the estimated fiscal deficit in the 2017 Budget, announced on February 1, would only be 3.2% of GDP as against 3.5% in 2016-17 Budget and 3.9% in 2015-16, indicating a greater role for monetary policy.

Last, the growth in bank deposits has been much higher than the growth in bank credit. In late March 2016, bank deposits were Rs 94 lakh crore, which rose to Rs 105 lakh crore in January 2017, a rise by 11.5%; on the other hand, during the corresponding period, bank credit registered a small increase, by 1.4%. Bank credit increased from Rs 73 lakh crore in March 2016 to Rs 74 lakh crore in Jan 2017. The market expects this gap between deposits and credit can be bridged only if the cost of borrowing is lowered further.

Weak transmission mechanism

These arguments, however, are neither new nor compelling.

It is not clear whether there is any link between interest rate change and change in investment. The transmission mechanism from interest rate to investment has been weak. The Economic Survey presented on January 31 prior to Budget on February 1 observes: "The transmission of the rate cuts remain far from perfect."

The liquidity was high due to rise in deposits following demonetisation. Looking to the rise in liquidity some banks cut their interest rates in the last few weeks. They reduced their marginal cost-based lending rates by up to 90 bps, ushering in a low interest rate regime for new borrowers across the board. This was due to the low-cost deposits coming in after demonetisation.

Bank woes

Further, RBI cannot afford to allow the banking woes to rise any more. The non-performing loans or assets (NPA) of banks are now 12% of gross advances. The Economic Survey has targeted these NPAs as being responsible for the negative trend in investment growth, as the increasing ratio of NPA to total assets has resulted in "the consequent squeeze of banks", which

in turn “has led them to slow credit growth to crucial sectors-especially to industry and medium and small scale enterprises”.

Any cut in interest rate would only aggravate the situation until the banks put their house in order.

Low rate of investment is more due to falling external demand and the prevailing environment, which has been compounded by demonetisation, the full effects of which and the required line of action will be clear only when more data are available.

Rising oil prices

Although one would take comfort from the inflationary trend, the Economic Survey notes the low oil price environment of last few years will not be repeated in 2017. On the wholesale-price front, a reversal trend was observed from a trough of negative 5.1% in August 2015 to 3.4% at the end of December 2016 due to rising crude prices. The Economic Survey says there is a possibility of “sharp rise in prices in 2017/18 may narrow the scope for monetary easing, if higher oil prices stoked inflationary pressure”.

The Table below presents the data series on monthly Consumer Price Index (CPI) and Wholesale Price Index (WPI) and crude price in US\$ per barrel. The correlation coefficients between WPI and crude price, and CPI and crude price are high, at 0.8445 and 0.8271 respectively.

2016: Oil price, WPI and CPI

	Oil	WPI	CPI
2016	US\$/barrel	Index	index
Jan	29.0	175.7	126.3
Feb	31.1	174.0	126.0
Mar	37.3	174.6	126.0
Apr	40.8	177.0	127.3
May	46.0	179.4	128.6
June	47.7	182.0	130.1
July	44.2	183.9	131.1
Aug	44.8	183.1	131.1
Sep	45.1	182.8	130.9
Oct	49.3	182.9	131.4
Nov	45.3	183.0	131.2
Dec	52.6	183.1	130.4

Source: RBI Monthly Bulletin for WPI and CPI; and Index Mundi for monthly crude price

In the prevailing uncertain conditions, inflation would stem from rising oil prices. The RBI Governor, in his address at Vibrant Gujarat Summit, has already notified the markets of inflation dangers lurking around the corner.

It is not the right time to expect a rate cut. Maybe by April, when RBI's Monetary Policy Committee meets, we will have a better quantitative assessment of the demonetisation impact and clearer picture of trend in global commodity prices, which would determine the future directions of monetary policy.

Professor T.K. Jayaraman teaches at Fiji National University