

Lack of transmission isn't a reason not to cut repo

Deciphering the central bank's moves are never easy, but RBI's latest policy moves are more perplexing than in the past since one of the reasons given for not cutting repo rates is that there has been no transmission of the last few rate cuts by 50 bps—by this logic, when banks don't raise their base rates by the same amount as the central bank raises the repo, RBI should stop hiking repo rates. When Raghuram Rajan became RBI Governor, he raised the repo 75 bps between September 2013 and January 2014 while SBI raised its base rate by just 20 bps. In any case, it is true that banks always take longer to pass on rate cuts since doing so hurts their net interest margins—cutting base rates cannot take place till the average costs of deposits fall. In such a situation, if RBI is looking for more transmission—in response to the earlier repo cuts of 50 bps, ICICI Bank cut its base rate 25 bps, while SBI and HDFC Bank cut their respective base rates by 15 bps each after RBI announced its policy on Tuesday—its best bet would have been to cut rates further, to send a clearer signal to the markets on the future of inflation. What is even odder is that this is probably the best time for RBI to cut rates since, once the US starts raising rates, it will become that much more difficult to cut the repo—if RBI cuts rates when the US is raising them a few months from now, it will be argued this will reduce FII inflows significantly.

While it is curious RBI should say it will keep an eye on food prices since policy rates are typically set based on core inflation, a lot depends on what the final inflation levels are. Though the 1.5-2% real interest rate target is high given what is happening in other parts of the world, RBI's latest forecast is a 5.8% CPI by March 2016 as compared with 5% by Citibank—the central bank's forecast, of course, leaves very little room for further cuts in the repo. The forecast needs to be examined carefully since the central bank got its inflation forecast wrong quite hugely in the past. In August 2014, for instance, RBI was projecting a January 2015 CPI of 8% as compared to the actual of 5.1%. Which is why, for instance, it is not clear why RBI expects inflation to rise to 5.8% by March 2016 after falling to 4% by August 2015—presumably, this is due to the fact that CPI collapsed after August 2014, but the 'base effect' story is one RBI has got wrong just recently.

RBI is, of course, right in pointing out that the government needs to continue to do its bit in terms of easing supply-side constraints. The recent coal auctions, for instance, will do a lot to ease power supply constraints though it is an open question as to what this will achieve unless electricity tariffs are also raised. The government backtracking on the land Bill, of course, will be a big negative for new projects, and RBI has done well to reiterate the need to see the government moving towards proper targeting of subsidies. Apart from the high fiscal costs, not moving away from the current MSP-based policy on agriculture will prevent growth from picking

up in fruits and vegetables. In which case, the 4% CPI target for FY18 will be impossible to meet.