RBI gives a boost to economy, over to banks/govt now

With the government committing to review the framework for setting rates for small savings schemes, chances of a fuller transmission of RBI 's 50 bps rate cut look a lot brighter—high small savings rates have been something banks have frequently pointed to as a big obstacle to cutting deposit, and hence lending rates; which is why RBI's policy statement on Tuesday spoke of 'working with the Government to ensure that impediments to banks passing on the bulk of the cumulative 125 basis points cut in the policy rate are removed'. Of the 125 bps rate cuts made by RBI since April 2014, banks had passed on just 32 bps till before the policy announcement—deposit rates have, though, been cut 100 bps. After the announcement, SBI, however, has cut base rates by 40 bps and more banks are likely to follow. What will also help transmission, apart from the lower rates that banks will be able to access deposits at—their ALCOs will need to look at the exact costs of deposits—is the sharp increase in FPI limits which will keep bond yields down. Foreign ownership of government bonds is expected to go up from around 3.6% of outstanding stock right now to around 5% by March 2018—that is an increase of R120,000 crore for central government bonds by March 2018 and another R50,000 crore for state government paper. RBI has also lowered risk weights for low-cost housing, so interest rates on those are likely to come down over and above the rate cuts that banks pass on.

If stock markets were somewhat subdued in the immediate aftermath of the policy—they picked up later and the Sensex closed 162 points up —it was because RBI was somewhat downbeat on growth prospects. And not surprisingly, since while July IIP grew 4.2%, core sector had all but collapsed to 1.1% and while consumer durables rose 11.4%, this was on the back of a minus 20.4% performance in July last year; FMCG actually contracted 4.6% in July. Which is why, as RBI pointed out, non-oil, non-gold imports went back into contraction mode in Q2. It is this lack of demand, other than global deflationary pressures, that caused August CPI to come in at 3.7%—the same as in July, after a sharp fall from 5.4% in June. As Governor Rajan said, these inflation levels were despite a bad monsoon.This, of course, is why RBI has now lowered its January 2016 inflation target to 5.8%—chances are it will be more in the range of 5.4-5.5%—and is looking at a 5% inflation by March 2017.

Whether spending will pick up significantly after Tuesday's sharp repo cut depends not just on how much the banks pass on, but also on how the economic growth situation pans out. A benign inflation outlook means more real savings for households and increased consumption; but it is the growth/ jobs outlook that matters more. RBI has cut its growth projection for FY16 to 7.4% from 7.6% earlier. Certainly, investing will look more attractive than it did when real rates—based on WPI—were in the 11-12% range, but the fact that there is so much surplus capacity means the investment response will be slow. Which is why, while talking of front-loading the rate cuts, RBI also talks of monetary policy needing to remain accommodative—“investment is likely to respond strongly if there is greater certainty about the extent of monetary stimulus in the pipeline, even if transmission is slow”. It is over to the banks and the government now—the former for transmission and the latter for easing the obvious constraints to doing business.