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Chaitanya Kalbag -- Has Urjit Patel moved India's inflation goalposts?

In its Oct. 4 report, the RBI appeared to highlight the upside risk of inflation. It said that its September survey of household expectations saw inflation at 9.5% three months ahead and 11.4% a year ahead, driven mainly by higher food and healthcare costs. RBI staff forecast CPI averaging 5.3% in the fourth (Jan-March) quarter of this fiscal year. Big pay rises for government employees coupled with festival-season spending are also seen spurring price rises.

"Expectations have to be brought down," Varma said. "Probably in Japan people haven't seen nominal salary increases in 20 years, but in India people expect nothing less than 5%. India is still a supply-constrained economy. Most of the rest of the world is demand-constrained." Even at zero or negative interest rates in advanced economies, investment is not picking up.

BANKS AT FAULT?

Economists believe the real problem lies with Indian banks which are not transmitting lower interest rates to borrowers. Industry is not borrowing, so banks are concentrating on retail lending.

Patel said the RBI would deal with the growing mountain of non-performing assets at Indian banks with firmness but also and with pragmatism. "Just five sectors contribute 61% of the stressed assets of the banking sector -- infrastructure, steel, textiles, power and telecoms. These sectors are each individually important and dealing with stressed assets will require skill and creativity. There are many reasons that led to this situation, but now helping banks to deal with this situation is of utmost importance for the country," the governor noted.

The other goalpost Patel has moved relates to the real neutral interest rate, or the difference between the benchmark interest rate and inflation. It is an

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policy. If you keep the real neutral rate too high you deter investors, if it is too low, you deter depositors.

RBI executive director Michael Patra explained that the central bank had adopted a lower real neutral rate of 1.25%, because it "does not stay still at a point in time, and changes with things like demographics or the potential output itself. And the world over, the sense is that the neutral rate is going down and that is why you see many countries actually putting in place negative interest rates." But the senior economist said this effectively gives the central bank a lot of leeway to trim rates even further. Rajan had adhered to a neutral rate range of 1.5% to 2.0%.

To take India's example, the RBI could justify further cuts by arguing that if the inflation target is 4% and the real neutral rate is 1.25%, then the nominal interest rate could go as low as 5.25% -- which could mean more swingeing cuts are in store. "You've thrown away the lynchpin of your interest-rate regime," the economist said.

The central bank governor, however, was sanguine about the immediate future. "If I look at over the next seven, eight quarters, the government has introduced structural policies, reform policies which is of course done to address supply constraints. There is larger investment in railways and roads which will improve infrastructure, the ease of doing business, [and] proactive food management have played a crucial role in the past two years and will continue to play a crucial role in times to come. There is an improvement in pulses supply which has been the main contributor [to inflation] and there has been a sharp improvement in [India's] competitiveness ranking," he said.

Is Patel's confidence justified? India has jumped 16 places to 39 among 138 countries in the World Economic Forum's Global Competitiveness Index. But the International Monetary Fund was glum in its World Economic Outlook issued in early October, ahead of its annual meetings in Washington D.C. The Fund underlined the precarious nature of recovery eight years after the global financial crisis. It saw global growth at 3.1% this year and 3.4% in 2017. While emerging markets are forecast to speed up incrementally, to 4.2% this year and 4.6% the next, the IMF did see India as a bright outlier, averaging 7.6% both this fiscal year and next. But, it cautioned, India must keep up investment-friendly reforms.

That means India's gross domestic product growth is seen as flat after rising 7.6% in 2015/16. Most economists say India needs to grow by between 8% and 10% annually over a sustained period if it wants to lift about 370 million people from dire poverty.

This is not going to be easy. The pace of GDP growth slowed to an annual 7.1% in the first (April-June) quarter. Commerce and Industry Minister Nirmala Sitharaman said at the WEF's India summit on Oct. 6 that the country still needs to remove regulatory hurdles and improve

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Aside from inflation and bank balance sheets, the other challenge for Patel is the redemption of \$26 billion in foreign currency non-resident (FCNR) deposits, which are maturing between September and November. Rajan approved the scheme on the day he took over in September 2013, faced with a weakening rupee and a possible balance of payments crisis.

As Rajan noted in his Sept. 3 speech, the rupee has been one of the most stable emerging-market currencies over the past three years; it currently trades at about 66.74 to the dollar. India's foreign exchange reserves stood at \$370 billion on Sept. 23. Although the RBI expects a temporary hiccup in liquidity and a likely blip in the exchange rate, the central bank has said it has prepared adequately for the FCNR redemptions.

Rajan's final speech as governor was extraordinarily candid. Talking about the RBI's independence, he said: "The Reserve Bank cannot just exist, its ability to say 'No' has to be protected." He explained why the RBI governor needed to be ring-fenced: "There is a reason why central bank governors sit at the table along with the finance ministers in G20 meetings. It is that the central bank governor, unlike other regulators or government secretaries, has command over significant policy levers and has to occasionally disagree with the most powerful people in the country...It is dangerous to have a de facto powerful position with low de jure status." Has that begun to happen to Urjit Patel?

Chaitanya Kalbag is a former Asia editor at Reuters and former editor-in-chief of the Hindustan Times and Business Today

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