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Fight over interest rate policy exposes India's economic vulnerabilities

Government pushes for monetary easing despite central bank doubts

While India swelters in record high June temperatures, senior officials in Prime Minister Narendra Modi's government are sweating for another reason. The heat is coming from a debate over whether the country is poised for a V-shaped recovery after last November's shock demonetization or if it is teetering on the edge of a broad slowdown.

Demonetization, which involved the withdrawal from circulation of large-denominated bank notes in an effort to combat the underground economy, was seen as highly disruptive. It dealt a blow to India's cash-reliant economy and caused big job losses in the informal economy, which employs more than 90% of the workforce. Government officials now say economic growth started to slow markedly in mid-2016, months before demonetization was launched on Nov. 8.

But where policymakers appear to differ is over how to re-ignite private investment, capital formation and bank lending. Modi has pledged to create a "New India" by 2022. His colleagues clearly want the Reserve Bank of India, the central bank, to use the blunt-edged instrument of lower interest rates. The RBI has dug in its heels, arguing that wider policy steps need to be taken to boost growth in gross domestic product to near the double digits required to create millions of new jobs for a young population.

Those differences burst into the open after it was announced on May 31 that GDP growth slowed to 7.1% in fiscal 2017, which ended in March, from 8% the previous year. Gross value added, which many economists believe is a better measure of economic activity than GDP, grew by only 6.6% in fiscal 2017.

On June 7, the RBI defied the government by holding interest rates steady. This was despite the GDP data, which also showed the economy grew by only 6.1% in the first three months of 2017.

The central bank maintained the benchmark repo rate, the rate at which it lends to commercial banks, at 6.25% for the fourth time since December 2016. Also, the RBI warned that an interest rate cut alone would not stop the economy from slowing, but that more government action was needed.

Remarks by the central bank governor Urjit Patel underlined the policy disagreements. Patel, who took office last September, said the Monetary Policy Committee had been summoned by the finance ministry ahead of its policy meeting. "The meeting did not take place. All the MPC members declined the request of the finance ministry for that meeting," Patel told a press conference.

Arvind Subramanian, the chief economic adviser in the finance ministry, lashed out at the RBI's obduracy in a statement issued shortly after the June 7 MPC meeting. At the end of January, Subramanian had forecast GDP would grow between 6.75% and 7.5% in fiscal 2017. The consumer price index had been running well below the RBI's target of 4%, he said, arguing that this provided room for the central bank to cut rates. "In this view, the inflation outlook has been rendered benign by an appreciating exchange rate, a good monsoon and the capping of oil prices by structural shifts."

Warning signs

Subramanian then warned that various indicators suggested that the economy had been slowing since July 2016 and was not in danger of overheating. Instead, growth could stall because of weak investments and reduced fiscal spending. Even personal loans, a proxy for private consumption, were slowing. "In recent times, seldom have economic conditions and the outlook warranted substantial monetary policy easing," he said.

But Patel, a known inflation hawk, seems determined not to be railroaded. He acknowledged that the factors that have kept inflation low could persist for the time being. The CPI fell to 2.18% in May from 5.76% a year earlier, mainly due to excess supplies of pulses, cereals and vegetables that have depressed prices. But he added that it was difficult to gauge how long these conditions would remain. "With so many moving parts, and the outlook clouded with uncertainty, the MPC decided, by a vote of 5-1, to stay on hold and wait for greater clarity to emerge with incoming data," he told the press briefing.

Patel further noted that the central bank was concerned that "several earlier enunciated risks," including rising rural wages, robust consumption demand, the imminent implementation of a big pay rise for government employees and imported global inflation, could cause a rise in the CPI in the medium term. The RBI currently estimates that the CPI will range between 2% and 3.5% in the first half of fiscal 2018 and between 3.5% and 4.5% in the second half, but the central bank is clearly worried about inflation accelerating.

Another area of concern is that several states look set to announce write-offs of huge swathes of agricultural loans after Uttar Pradesh, the most populous state, announced a 360 billion rupee (\$5.5 billion) debt "waiver" two months ago. Violent protests over loan repayments have left several farmers dead in Madhya Pradesh, which is also ruled by Modi's Bharatiya Janata Party. A third state, Maharashtra, bought peace with angry farmers this past Sunday with a 300 billion rupee loan write-off.

Such largesse could result in inflationary pressure, Patel warned. "There is a risk that unless there is space in existing state government budgets...the likelihood of going down the slippery path and dissipating the important gains we have made in fiscal rectitude over the past two or three years can come about," he said. Past experience, he noted, has shown that significant fiscal slippages result in increased inflation.

Arun Jaitley, the finance minister, managed to limit the central government's fiscal deficit to 3.5% of GDP in fiscal 2017, while state government deficits totaled 2.7% of GDP. For fiscal 2018, Jaitley has pledged a deficit of 3.2% of GDP, while state deficits would amount to a combined 2.5% of GDP. The central government and state deficits, when added together, total 5.7%, which is high by global standards. But it is still better than the combined deficit of 10.8% in



An Indian trader counts rupees at a wholesale vegetables market on the outskirts of Jammu, India on March 6. © AP

fiscal 2009 when the previous Congress government, eager to win a second term, announced 600 billion rupees in farm loan write-offs and gave state employees a huge pay rise on top of profligate social sector spending.

Looking at the Indian economy overall, the biggest headaches for Modi are the sluggish rates of investment and job growth, and the failure to come to grips with the bad loan problem affecting banks and overleveraged companies. Compounding the problem, troubled banks did not pass on a series of interest rate cuts to borrowers.

This is blunting the effect of interest rate cuts, said RBI Deputy Gov. Viral Acharya, explaining that the RBI's monetary easing in 2015 and 2016 failed to revive investment as it did not get transmitted by the stressed banks to indebted sectors.

"Interest rate policy works well when it is transmitted seamlessly by financial institutions and markets to the real economy. Absent efficient transmission, changes in interest-rate policy go to waste, and potentially have unintended consequences," he told the same press briefing.

He added that the investment slowdown since last year is "deeply rooted in the structural debt overhang problem of a number of our industrial sectors. Their excessive debt is saddled on our bank balance sheets."

Highlighting the issue, Credit Suisse, an investment bank, recently issued a grim corporate health report. It estimated that as of the end of March, stressed loans at both India's state-owned and private banks amounted up to 13.6 trillion rupees, or 17% of total loans outstanding. This was equivalent to 160% of bank capital or 241.6% in the case of state-owned banks. Of this, the total of recognized impaired loans stood at 11.34 trillion rupees and gross non-performing assets at 7.7 trillion rupees.

Instead of relying on interest rate cuts, the RBI now believes it should concentrate on "targeted intervention" to boost lending to healthier sectors of the economy that have recently slowed down. Delinquency is lowest in the home loan segment, for example, so the RBI will relax its risk weightings to encourage property purchases.

There are other danger signals for Modi to consider. Gross fixed capital formation, an indicator of investment, grew by a paltry 2.4% in fiscal 2017. The Nikkei India Manufacturing Purchasing Managers' Index dropped to a three-month low of 51.6 in May from 52.5 in April. A reading above 50 indicates economic expansion, while one below 50 points to contraction.

"This suggests that there are more fundamental factors at work that public policy should address urgently to rekindle the animal spirits and reinvigorate entrepreneurship and business optimism," Patel said.

Modi faces a string of important state elections ahead of national elections in 2019 when he will be seeking a second term. Most analysts expect him to fall back on populist spending programs. If the imminent rollout of a national goods and services tax with its multiple rates is not conducted smoothly, it could hinder rather than help economic growth. The question is whether Modi will heed Patel's warnings and revive investment and job creation, or keep caged what some analysts see as India's animal spirits of growth.

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