Prudent Policy

When Finance Minister Arun Jaitley proclaimed in Parliament, whilst presenting the Budget for 2017, that he intended to stick to fiscal targets the markets were overjoyed and harboured expectations of a cut in interest rates by the Reserve Bank. What may have added to their jubilation was the belief that since banks were flushed with funds post-demonetisation, a reduction in pricing should logically follow. Regrettably, that did not turn out to be the case. In its bi-monthly policy review a few days later, the Reserve Bank not only held rates constant but in fact altered its stance from "accommodative" to "neutral" which in economists' jargon basically implies that interest rates won't fall in a hurry. On the contrary, the Monetary Policy Committee (MPC) effectively signalled that rates could just as easily harden. This should come as no surprise. Domestic interest rates are governed by a series of considerations, which include fiscal imbalances, inflation expectations, bank lending and growth. It is true that headline inflation has been dropping and stood at 3.4 per cent in December, but closer examination would suggest that core inflation, which excludes food and fuel, has remained sticky at 4.9 per cent. This is near the higher end of the RBI's own target band for the short term.

Growth is weak and so is credit offtake and hence a temptation to believe that a drop in interest rates would spur both. But here again the facts are not straightforward. The capacity utilisation rate within industry (based on the RBI's own surveys) has been persistently low since 2013 and currently stands at 72.4 per cent. New investment involving the creation of fresh capacities usually kicks off when the utilisation rate exceeds 80%. Understandably, industry and investors are jittery that enlarging capacities during a period of anaemic demand will leave them stranded with dud assets. It is therefore logical to conclude that credit offtake and growth are weak because underlying demand is subdued and industry is uncomfortable about the longer term outlook. Reducing interest rates will hardly fix these.

• Adding to the RBI's basket of woes are global developments specifically those in America. For many years, the world's important central banks such as the United States' Federal Reserve, the ECB and the Bank of Japan fought hard through unusual policies to perk up demand and fight deflation. Some estimates suggest that they have issued bonds to the tune of USD 7 trillion carrying negative returns, effectively turning the banking system upon its head. However, things changed rather abruptly following the US Presidential elections. When Donald Trump assumed office, US bond yields unexpectedly spiked from 1.7 per cent to 2.5 per cent. Over the last few months, the Federal Reserve has hiked interest rates twice and markets expect another three hikes during this year. What has also stirred things is the fact that the inflation neutral rate has edged up giving rise to the speculation that the interest rate cycle, at least in America, is northward bound. Understandably, therefore, the dollar has strengthened against all global currencies. The uncertainty extends beyond monetary policy to include the fiscal tack likely to be adopted by the Trump administration. Mr Trump wants tax rates to fall to 20 per cent and this, coupled with a massive investment in infrastructure and the 'America First' programme, may attract capital in droves back to the United States. As a result [of the Trump administration's

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fiscal policies], emerging market currencies will decline and inflation will mount. Across the world therefore, interest rates are expected to rise and it would audacious for the Reserve Bank to head in a blatantly opposite direction.

Whilst this may be construed as bad news by industry the fact is, the central bank has little latitude in the short term. However, if circumstances were to improve in the coming months, for instance by way of reduced inflation or less volatility in global currency markets, the picture may change for the better. Domestically, if a more aggressive bank recapitalisation programme or steps to revive business sentiment were to be undertaken, a recovery in the investment cycle can be hastened. Reforms in tax administration should perhaps be counted as amongst the first to be pursued and the attention, for now, should shift from the Reserve Bank to the treasury. ■

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