Why Raghuram Rajan won't ease rates despite US Fed gift

by Sourav Majumdar **Sep 20, 2013**

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Raghuram Rajan, perhaps India's most talked about Reserve Bank of India (RBI) governor in a long time, is surely a lucky man. Unlike his predecessor, he came in at a time when the pall of gloom and uncertainty surrounding the economy began lifting just a bit.

This patch of good luck culminated in 18 September's US Federal Reserve decision to delay the tapering of its stimulus programme and continue with the asset purchases for now, given that the data was still not comforting enough for such tapering to begin.

The breathing space by the US Fed decision will be used to resolve domestic issues: Reuters

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Rajan, who shifted his first policy review by two days to 20 September from the earlier 18 September to factor in any possible Fed decision, can now breathe just a tad easy since the global uncertainty relating to the tapering programme has receded for now.

The US Fed's status quo on stimulus led to a buying frenzy on the stockmarkets on 19 September, with the 30-share BSE Sensex soaring a hefty 684.48 points – or 3.43 percent – to close at 20,646.64, while the rupee hit its month high, ending the day at 61.77 to the dollar, a far cry from the 68 levels it touched just a few days ago as uncertainties over a possible Fed move dominated markets.

The euphoria in the equities and the currency markets is a typical short-term phenomenon, now that any immediate move to reduce asset purchases has been ruled out by the Fed.

But away from the market celebrations, analysts and policywatchers, however, are justifiably cautious about the future. And it is this caution which is also bound to reflect in RBI's mid-quarter policy review, despite the receding of the global headwinds for now. For someone who had managed to read the signs correctly and virtually predicted the financial crisis of 2008, Raghuram Rajan would, perhaps, be the last person to jump into any premature action at a time when caution is the need of the hour.

Consider the ground realities.

Inflation – both retail and wholesale – is still quite uncomfortable and food inflation continues to be a cause for concern. Moreover, the rupee, despite being much stronger now than a few weeks ago, is still not entirely out of the woods and the picture on the current account deficit (CAD) needs to be carefully monitored.

Add to that the fact that exports have increased of late but primarily owing to a weaker rupee, and that imports have been contained mainly by containing gold imports, and you have a situation where there are still no clear signs of structural issues being addressed.

On the policy side, the government has only just begun attempting to kickstart investments by clearing projects and there is no clinching evidence of green shoots on the ground. The one-off July IIP growth figure of 2.6 percent is being attributed more to aberrations in some segments rather than any real recovery.

What the US Fed's decision to postpone tapering does is merely to allow RBI some more breathing space by concentrating on the domestic problems at hand. With one less variable to worry about for now, RBI can shore up foreign exchange further and use them when the Fed actually begins tapering, which is now expected sometime around or after December. Besides, RBI will also be closely monitoring the CAD and the fiscal deficit and how the government actually goes about addressing these twin deficits.

This means it is highly unlikely that Rajan will lower the repo rate – the rate at which RBI lends short-term funds to banks – on 20 September, since that would mean sending a signal of monetary easing. Very few analysts are also willing to bet on Rajan bringing down the Marginal Standing Facility rate which it had raised to 10.25 percent in a bid to squeeze liquidity and cushion the rupee, a move which was seen as a virtual hiking of interest rates.

Mirroring this sentiment, a report by Kotak Mahindra Bank says: "The RBI will likely use the space provided to strengthen its forex position and keep the lid on the depreciation pressure by maintaining status quo on interest rates. We continue to expect no change in policy rates on September 20, including the non-removal of MSF rate of 10.25 percent. However, we do not rule out some operational easing for banks through relaxation in the daily CRR maintenance of 99 percent. This should be positive for banks."

At best, Rajan is, therefore expected to ease the daily CRR stipulation, providing banks some breathing space on liquidity.

Significantly, just a day before the policy review, State Bank of India, the country's largest lender, went ahead and hiked its base rate, the rate below which banks are not permitted to lend, by 10 basis points from 9.70 percent to 9.80 percent. Following this hike, auto and home loans will become more expensive.

Reuters

Stability, inflation first, growth later

Despite the RBI governor's inspiring first-day speech, Rajan is unlikely to get into a big-bang policy easing mode at his first review. Remember, while tapering has been delayed, it is still very much on the horizon and all steps must be taken to ensure that when it does happen, it does not rattle the rupee like it did a few weeks ago, throwing all calculations off gear. Any move now will have to factor in that eventuality on the currency side.

The second factor is anchoring inflation expectations. With WPI once again at a much higher 6.1 percent and food prices on the rise, RBI will have no room for any kind of monetary easing. As a recent report from CRISIL pointed out, despite lower core inflation, any loosening of monetary policy to support growth will run the risk of bringing about high generalized inflation since supply shocks persist. In fact, CRISIL too expects Rajan to maintain status quo on 20 September, and for the remainder of the year.

Growth, despite the general slowdown, will unfortunately need to be the third in RBI's list of priorities as monetary stability and the rupee keep the monetary authority occupied.
Rajan, who met finance minister Palaniappan Chidambaram two days ago, would surely have discussed all these concerns and imperatives at the meeting.

A former Chief Economic Advisor, Rajan knows only too well that the view from New Delhi’s North Block is quite different from that in RBI’s headquarters in Mumbai’s Mint Road. Perched from his chamber in RBI, Rajan’s priorities will have to be somewhat different from that of the finance minister of a government heading into state- and central elections a few months from now.

By delaying the taper, Fed chairman Ben Bernanke has just given Rajan some breathing space. He has not changed the dynamics for the ‘rockstar’ RBI governor.