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The case for a rate cut

If the RBI wishes to do its bit to boost growth, it must keep its inflation target flexible

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Did demonetisation impact the economy badly? Observers have been awaiting the growth figures for the full year, 2016-17, for a clear answer to the question. Well, the figures are out now. But the answer is not as clear as some would like to believe.

Demonetisation happened on November 8, 2016. Observers had said its effects would be reflected in the figures for growth in the third quarter of the year (October-December). They were proved wrong. Growth held up quite well in Q3 compared to that in the previous quarter.

Hold on, critics of demonetisation said, you will see the effect with a lag in the fourth quarter. It would appear they have been proved right. Growth, measured by Gross Value Added (GVA), did slow down – from 6.7% in Q3 to 5.6% in Q4. But if demonetisation did impact the economy, growth for the year as a whole should have been lower than forecast before demonetisation.

Check the timeline

This has not happened. Growth in GVA for the year as a whole, at 6.6%, is in line with estimates prior to demonetisation. Growth in GDP, which is GVA plus net taxes, came in at 7.1% for 2016-17. This is what the Central Statistics Office (CSO) had forecast even before the impact of demonetisation became known.

Some argue that the impact of demonetisation may not be reflected in aggregate growth but it is reflected in particular sectors that bore the brunt of demonetisation. Manufacturing slowed down from 8.2% in Q3 to 5.3% in Q4. The growth rate in construction over the two quarters changed from 3.4% to minus 3.7%. Segments of the services sector also slowed down sharply in Q4. The services sector as a whole was rescued by an acceleration in public administration, defence and other services.

The difficulty is in disentangling the effect of demonetisation from that of other factors. Merely because growth in FY 2016-17 is lower than in 2015-16 or because there was a deceleration in Q4 of 2016-17 relative to Q3, we cannot conclude that demonetisation is primarily responsible.

In 2015-16, the Indian economy reaped the benefits of a sharp drop in oil prices and the boost to consumption it gave. The *Economic Survey* of 2014-15 had estimated the potential gain for the next year at 2 percentage points of GDP. This gain was absent in 2016-17 when oil prices stabilised or even rose slightly. Private investment has continued to decelerate.

The fall in GDP growth from 8% in 2015-16 to 7.1% in 2016-17 reflects these larger factors.

Reserve Bank vs CEA

So much for the impact of demonetisation. The fact remains that growth has decelerated over the past year. The policy question is: how should the Reserve Bank of India (RBI) respond? Chief Economic Adviser (CEA) Arvind Subramanian and the RBI differ on this all-important question.

Mr. Subramanian noted in an article last month that "since the middle of last year (2016) there has been a noticeable deceleration in manufacturing activity". He went on to argue that "there is a strong case for broad macro policy support, including monetary policy support, to reinvigorate the economy."(*Mint*, May 25, 2017.)

That is not the line that the RBI has been taking. The minutes of the Monetary Policy Committee (MPC) meeting of April 20 noted that growth in GVA was poised to rise to 7.4% in 2017-18 from the then estimated level of 6.7% in 2016-17. Further, in its monetary policy report, the RBI noted that manufacturing activity had gained momentum in the second half of 2016-17. The RBI seemed to be saying: growth is recovering of its own accord, there isn't much that we need to do.

This is not quite true. Even if growth were recovering, it would be below the output potential of the economy. We need to aim for higher growth. The case for the RBI to cut interest rates in order to support growth does not go away.

But growth is not the primary mandate of the RBI today. The primary mandate is keeping inflation within a targeted band of 4% plus or minus 2%. The MPC's interpretation of this mandate has evolved. To start with, the MPC suggested that it only needed to ensure that inflation stayed with the overall band. In February 2017, the MPC made a significant shift: it signalled that its inflation target was 4%. Where do we stand in relation to this target?

In his VKRV Rao memorial lecture last month, Mr. Subramanian argued that the economy has "over-achieved" on inflation. Consumer Price Index (CPI) inflation is well below the RBI's medium target. "True core" inflation, that is, inflation minus food, fuel and transport services, has been falling for the past several months.

The central bank, however, is guided, not by past inflation, but by inflation expected in the future. In its monetary policy report of April 2017, the RBI noted that "core" inflation (CPI inflation minus food and fuel) was sticky. The RBI said it expected inflation to average 4.5% in the first half and 5% in the second half of 2017-18.

There is every prospect that inflation in 2017-18 will be within the RBI's 4% target. However, if the RBI does not want to take chances, it can cite several factors that could cause the 4% inflation target to be breached. GST might impact the price level adversely. The climatic factor known as El Niño could disrupt food output. Commodity prices may harden. Allowances prescribed by the last Pay Commission could cause the inflation rate to edge up. And so on.

For a government that is keen to push growth, the RBI's position does present a problem. A cut in the policy rate would help repair the balance sheets of banks and corporates and reverse the fall in the investment rate. It would further boost consumption. By checking the appreciation of the rupee we have seen over the past year, it would give a fillip to exports.

Rupee not a worry

Until December 2016, when the U.S. Federal Reserve announced the first of many interest rate increases expected in a tightening cycle, the concern was that any rate cut by RBI would lower the difference in yields on the rupee and the dollar, cause an exodus of funds from the Indian markets, and lead to a destabilising fall in the rupee exchange rate. This is not such a concern today when foreign inflows remain strong and the problem we have is of rupee appreciation.

Whichever way you look at it, the Indian economy could use a rate cut today. However, the RBI's commitment to an inflation target of 4% renders a rate cut difficult. If the RBI wishes to do its bit to boost growth, there is only one way out. It must avail of the flexibility it has been provided under the inflation mandate. It must return to its initial commitment to the inflation band of 4% plus or minus 2% instead of being fixated on a 4% target. The alternative would be to squander a great opportunity for stepping up growth.

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