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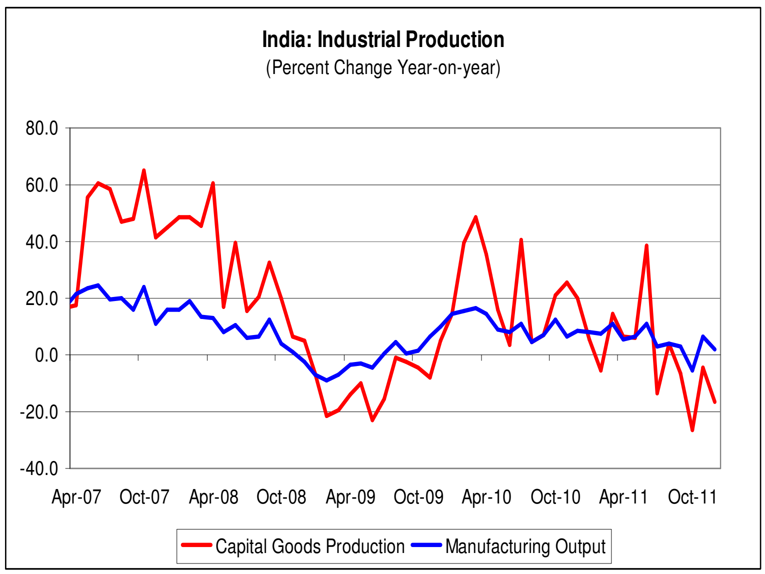
India: Is the RBI Behind the Curve?

All evidence on the economy points to the need for a significant monetary-policy easing in India. The evidence also suggests that the potential costs of such policy in terms of inflation-risk are extremely low at present. Put simply, the balance of risks has tilted quite transparently in the direction of recession-risk, and there is in fact a non-negligible chance that the central bank may be behind the curve in a manner that could be very noticeable in the coming months: given the headwinds facing the Indian economy, and a particularly restrictive monetary policy, real GDP growth in the coming quarters *might* slow close to post-2008 speed.

The RBI has begun to acknowledge the following facts as trends:

- a slowing industrial production, which expanded only 0.9% year-on-year in the last quarter of 2011, by far its worst performance since the first half of 2009. Notably, production of capital goods fell by 16.2% year-on-year in the October-to-December period, and 11.2% for the entire second half. This suggests a continued decline of gross fixed capital formation, which in the third quarter fell by 0.6% year-on-year; the (strong) hint is that investment spending would have fallen into a deeper hole in the final months of the year.

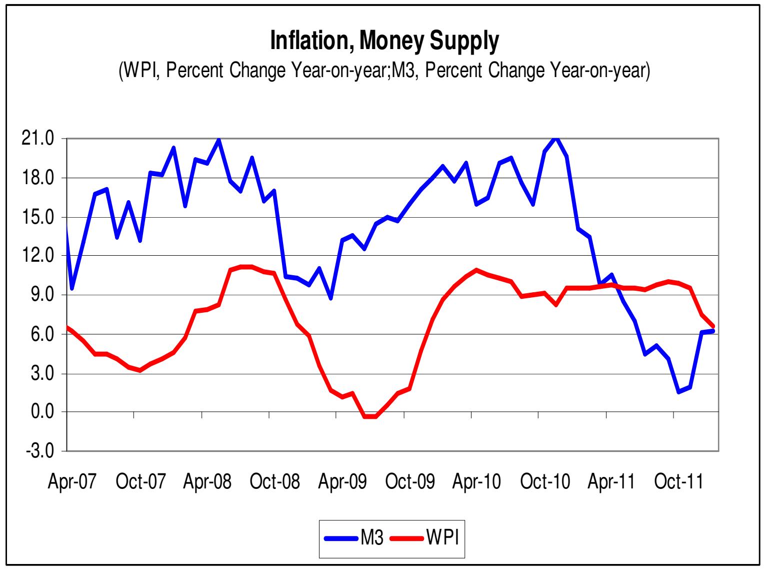


- inflation has turned around and was, as of January, 6.6% year-on-year, as measured by the officially-tracked WPI. This is down from a peak of 10% year-on-year in October of last year. It should be noted that, on a sequential basis, WPI inflation looks even weaker, running at an average of 0.2% month-on-month since the end of the third quarter.

The bank has moved, but very cautiously, in response to these developments, reducing reserve requirements--as of January 28, 2012--from 6% to 5.5%, but leaving the policy-(repo) rate unchanged at 8.5%, which means that on both a running-inflation and a year-on-year actual inflation, real interest rates have switched from deep negative to substantially positive in a matter of a few months, with a high likelihood that profile will remain in place unless an unexpected supply-side shock were to push commodities back up.

Given present and foreseeable conditions in the world economy, such a shock appears unlikely except perhaps for a *possible* geopolitically-induced oil price escalation.

The RBI, however, continued to insist in their last quarterly review (January 24, 2012) that "it is premature to begin reducing the policy rate" because policymakers believe that there is "considerable suppressed inflation" in the economy, resulting from "global crude oil prices, the lingering impact of rupee depreciation, and slippage in the fiscal deficit".



Thus, the bank will—presumably—proceed with caution as regards interest rate changes, which from a practical standpoint means that policymakers will attempt to deal with rising growth-risk, and with the mounting evidence of anemic domestic credit flows, by lowering commercial banks' cash requirements further. Also from a practical standpoint, if –as suggested above – the Indian economy is in a phase of intensifying deceleration, the central bank's resistance to reverse the sharp interest rate increases of the past couple of years (from 4.75% in early 2010 to 8.5% at present) substantially increases the likelihood of a downward growth surprise in the coming quarters.