

Is there a case for cutting interest rates?



DESPITE THE clamour for an interest rate cut, the Reserve Bank of India (RBI) left its

benchmark repo rate (at which it lends to commercial banks) unchanged at 6.5 per cent during the earlier monetary policy review, on June 7. As Table 1 shows, RBI had previously cut the rate by 25 basis points to 6.5 per cent in April this year.

Many analysts argue with limited space for a fiscal stimulus, the burden of lifting growth lies squarely on monetary policy. Globally, too, central banks have pursued what has been perhaps the most accommodative policy stance in history, to boost growth. Benchmark rates in major developed countries such as the US, the UK, the euro zone and Japan are close to zero per cent, as shown in Table 2. In fact, some central banks have even adopted negative interest rates, hoping to boost growth.

The arguments for lowering interest rates in India centre largely around the fact that despite an increase in public sector investments, which many had hoped would store private sector investments, the latter continue to languish.

As Table 3 shows, gross fixed capital formation contracted for the first time in the fourth quarter of 2015-16. The earlier time it had contracted was in Q4 of 2013-14. Similarly, the capital goods segment in the Index of



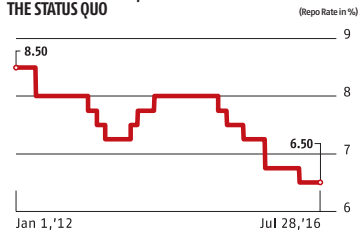
Industrial Production, a proxy for investment demand, also shows weakness. The segment has contracted for the past seven months, as shown in Table 4.

And, while companies have seen an uptick in their top line, as shown in Table 5, this should be taken with a pinch of salt, as the uptick seems linked to the recent surge in prices.

While this makes for a persuasive case for lowering interest rates, RBI's dilemma is that inflation is heading upwards. Retail inflation, measured by the Consumer Price Index, is heading upwards. It has risen to 5.77 per cent in June, from 4.83 per cent in March, largely on the back of higher food prices.

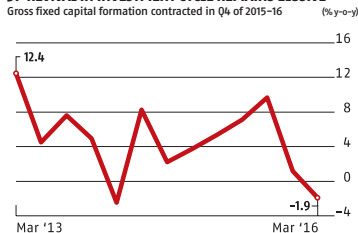
And, though a good monsoon is expected to ease pressure on supplies, inflation remains perilously close to RBI's target of six per cent, leaving little space for a rate cut. All eyes are on RBI's monetary policy review on August 9.

1: IN ALL LIKELIHOOD, RBI WILL MAINTAIN THE STATUS QUO



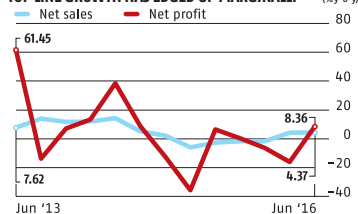
Source: Bloomberg

3: REVIVAL IN INVESTMENT CYCLE REMAINS ELUSIVE



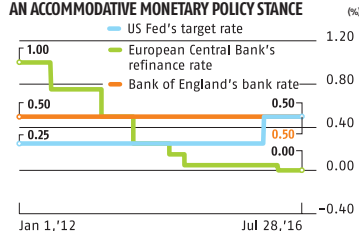
Source: MoSPI

5: WITH PRICES MOVING UPWARDS, CORPORATE TOP LINE GROWTH HAS EDGED UP MARGINALLY



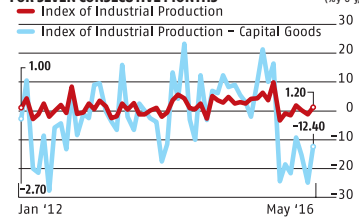
Note: Results for BSE 500 companies (for June 2016 the sample size is of 109 companies which have declared their results). Source: Capitaline

2: CENTRAL BANKS ACROSS THE WORLD HAVE ADOPTED AN ACCOMMODATIVE MONETARY POLICY STANCE



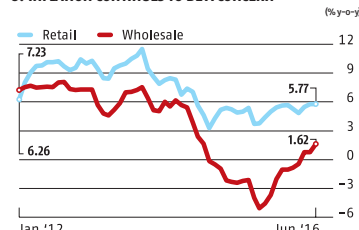
Source: Bloomberg

4: CAPITAL GOODS SEGMENT IN IIP HAS CONTRACTED FOR SEVEN CONSECUTIVE MONTHS



Source: MoSPI/Bloomberg

6: INFLATION CONTINUES TO BE A CONCERN



Source: MoSPI/Bloomberg