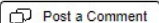


View: Hello RBI, your inflation fight may be missing forest for the trees

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By Pankaj Murarka

By now it is more than apparent that the MPC (the [Monetary Policy Committee](#) of the RBI) has been behind the curve in cutting interest rates. The prominent concerns expressed by the MPC members for not cutting rates are rising pressure on food prices, inflationary effects of farm loan waivers, HRA under the 7th Central [Pay Commission](#), implementation of [GST](#) and unfavourable base effect.

A perusal of these concerns reveals that MPC is focused on short-term cyclical factors and its impact on near-term [inflation](#) and has missed the sight of the significantly larger trends driving the underlying transformation of the Indian economy and the disinflationary process.

India's industrial credit growth has been slowing for the last 7 years and witnessed contraction (-1.9%) for the first time in FY17. For any increase in inflation, there has to be significant growth in industrial credit which seems unlikely given the fact that state-owned banks which have over 70% [market](#) share do not have the capacity to lend, are besieged with asset quality issues and are shrinking their balance sheets due to paucity of capital.

India's Investment rate has fallen from 34.3% to 27.1% over the last 5 years. There has not been any meaningful job creation in the economy due to lack of investments. The only sector that was creating new [jobs](#) was [technology](#) driven start-ups. Even that froth has dissipated and they have been gone for huge layoffs as their funding has dried up. Corporate salaries have been growing at low to mid-single digits for the last few years. Thus, there cannot be a meaningful increase in aggregate demand until the economy creates new jobs.

The capacity utilisation in industrial sectors is in low 70's and would need sustained increase in demand for few years before manufactures can exercise pricing power. Food prices are driven by vagaries of [monsoon](#) and need proactive policy response from the government in case of crop failures. But for seasonal impacts, the global agricultural commodity prices are at multi-year low and India's food production is at record high. Loan waivers are a reflection of farm level distress in India due to surplus output or bad weather and are unlikely to lead to increase in aggregate demand.

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Over and above this, the Indian government has had the largest fiscal consolidation in history by reducing [fiscal deficit](#) by 2.3% from 5.8% to 3.5% over the last 4 years.

It's an axiom that corruption breeds inflation. Emerging economies generally tend to experience high inflation due to persistence of corruption. Reducing corruption has been the pivot of all the policy initiatives of this government. In fact, it has become the core narrative of the government as they keep their eye focused on getting re-elected in 2019.

The DBT scheme launched by the government for distribution of subsidies and grants ensures that the funds are transferred to the account of the beneficiaries and there is no leakage by middlemen. This is hugely disinflationary as the beneficiaries spend the money on staples adversely impacting the discretionary demand generated by the middlemen.

There has not been any significant corruption case relating to the government in the last three years. This is a big surprise to Indians who have been used to crony capitalism. The [real estate](#) prices in NCR region have collapsed 30-40% and yet there is lack of demand because the slush money which easily found its conduit into real estate has been missing. Thus, the real estate bubble to the extent it was fuelled by slush money has been pricked and it has significant implications on demand given that real estate accounts for 56% of household savings in India.

For the lack of corruption Index, MPC members would find it very difficult to measure the impact of these initiatives on the economy.

The squeeze in supply chain due to GST and the implementation of RERA has further adversely impacted demand aiding the disinflationary impetus. Finally, it's an accepted principle of money supply that [demonetisation](#) by its very nature is disinflationary.

Thus, there can be some spike in inflation due to short-term cyclical factors. But until, the aggregate demand in the economy rises in a meaningful and sustainable manner and the negative output gap is closed, inflation cannot increase meaningfully and will undershoot.

Inflation targeting requires central banks to look through the short-term cyclical factors and focus on medium-term inflation targets. It seems the MPC members have missed the forest for the trees.

(The author is founder of Renaissance Investment Managers. Views are personal.)