Can a rate cut spur investment?

Banks are unlikely to transmit any cut, given structural rigidities in the sector

After a year and a quarter of the NDA rule, the spectacular hope and optimism that marked the government's coming to power has given way to disappointment and despair. In fact, the policy paralysis and dismal governance record of the previous government, on the one hand, and the election rhetoric of the promise of nirvana, on the other, led many to believe that the new government will kick-start the economy swiftly to revive the investment climate. Indeed, legacy is not easy to offload and more importantly, reforms involving legislative changes are not easy to achieve. But, it is the responsibility of the ruling party to persuade the opposition to achieve what it sets out. This has happened in the past, and it is hoped that the government will achieve this. As we see today, the tyranny of status quo in reforms continues. The much-touted *acche din* seem to be far away. With a slowing reforms scenario, an uncertain external environment and the spectre of a drought affecting many parts of the country, the revival of investment in the country seems like a mirage.

The first quarter GDP estimates, showing the deceleration in growth to 7% from 7.5% in the previous quarter does not provide much comfort, despite assertions of many in the government that the economy will record 8 per cent growth this year. For the economy to record 8% growth, it will have to record substantially higher than 8% growth in the remaining three quarters of the current fiscal year. The spectre of drought in many parts of the country and the declining reservoir levels threaten to contract the income from the farm sector for the year. As regards industrial growth, agro-based industries face an uncertain environment. The core sector continues to stagnate recording just 1% growth in July. Although the GDP growth in the industrial sector during the last quarter shows a revival to 6.5% from 5.6% in the previous quarter, there is no indication to show that it will outshine to lift the economy. The investment scenario continues to be sluggish and rather than creating the 8% hype, we should be satisfied with the economy growing at 7-7.5%. In fact, with virtually no worthwhile reforms in place, we should consider 7.5% growth, although below the potential, very respectable.

This is not to say that there have not been favourable changes in policies and their implementation. The front-loading of government's capital expenditure has helped industrial revival. There is certainly much better coordination in implementation among infrastructure sectors. Environmental clearances have been faster and have not posed constraints yet. With the Shah Commission clearing the uncertainty regarding the MAT on foreign institutional investors, confidence gets restored. Hopefully, the commission will resolve the issue of retrospective taxation to clear the cloud of uncertainty in the application of tax laws. The low commodity prices have helped to compress the subsidy bill substantially which will help the government to contain the deficit and higher buoyancy of taxes will provide additional fiscal space for it investment spending. The passage of the bankruptcy act will provide an exit route for unviable investments. Interestingly, foreign investors, particularly institutional investors too do not have many options on the table. The environment in competing countries is worse if any and they are waiting to make the investment and even the increase in the interest rate by the Fed is not likely to create a serious problem for India.

M GOVINDA RAO

In the current scenario, why would banks lower rates? After all, their performance is not judged by the risks they take for reviving the investment climate

The problem is that the government focussed too much attention on reforms based on legislative changes when it does not have the required numbers in the Rajya Sabha and without having a viable strategy. If the strategy was to force the Congress Party into subjugation, it has failed. For the sake of the people of this country, the ruling party should have worked with the opposition to ensure passage of the important bills after the election and should not have continued the acrimonious tirade. Having been reduced to an abysmal minority, this stance only provided the oxygen to the Congress party to fight for survival. It is nobody's case that wrong doing should not be punished. Ironically, the government has not been able to put anyone behind the bars or initiate action against any wrongdoing, and if there was *hawalabaazi*, those involved in should have been put in the dock. The country had the healthy tradition of getting down to business and secure bipartisan consensus after elections. Continuing acrimony has only created uncertain environment for reforms. With the GDP estimates for the first quarter out, the focus has shifted to the monetary policy stance of RBI. The slowing economy and low inflation rate has increased the clamour for cutting the interest rates and the Union finance ministry would be happy if RBI Governor Raghuram Rajan is generous enough to cut the policy rate by 50 basis points, if not more. In fact, the finance ministry has gone on to argue that there exists a deflationary environment to underscore the need for a substantial cut. The Governor has also given an indication that he has an open mind on the issue. While there is a concern about expected rate increase by the Fed, it appears that RBI has geared up to the challenge even if that happens. From all accounts, one should expect a cut in the rate though it is difficult to guess the magnitude.

Assuming that RBI will cut the rate, will it result in lower rate for the investors? The problem lies much deeper, in its transmission. There are structural rigidities in the system which Indradhanush, the bank reform programme, has failed to address. On the supply-side, the household sector's financial savings are still not very large, and it will take some time for them to move away from gold and real estate investment. Furthermore, when you have administratively-determined interest rates for small savings and provident funds, that sets a floor for determining the deposit rates. On the demand side, we have rationed the utilisation of funds through the SLR, the CRR and priority-sector lending. In this environment, how much lower rates can commercial banks give on deposits and how much lower for lending to businesses? And why should they? Their performance is not judged by the risks they take for reviving the investment climate. Separating the post of chairman from that of the managing director and getting a few competent, worthy individuals from the private sector will not solve this problem, when the structure of incentives and accountability is not in place and rigidities in the system still abound. When bad loans mount, there are taxpayers to bail them out!

The author is emeritus professor, NIPFP, non-resident senior fellow, NCAER and advisor, Takshashila Institution