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Guest Column

Balancing Act Getting Tougher for Central Bank

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In an economy, there is always a tussle between interest rates, inflation and growth. As economic output starts to move beyond the potential rate of growth, inflation starts surfacing prompting the central bank to increase rates to pull back economic growth momentum. Conversely, when growth starts to slow down materially, a central bank reduces interest rates in order to make consumption cheaper and investments in businesses more profitable.

It is a matter of great importance for an economy that inflation and inflationary expectations are kept under control. Else, the economy risks getting into a situation where any sign of even moderately strong economic growth leads to the onset of high inflation, thus, structurally reducing the potential rate of growth of the economy. However, the timing of the increase and decrease in rates is always a very difficult decision as it has to ensure a delicate balance between both inflation and growth. India is now at that crucial stage where inflation is falling, growth has slowed down significantly and more interest rate cuts are expected. However, the timing of these rate cuts is a bit uncertain as the inflation trajectory is still not very clear. One has to remember that India has witnessed continuously high inflation over the last 7 years and, therefore, the central bank would likely to wait for concrete proof that inflationary expectations have been broken before cutting rates further.

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Meanwhile, growth is elusive and this is putting enormous stress on Corporate India and the financial sector. There is a great deal of pain in investment sectors of the economy such as construction, infrastructure, commodities and power sectors. There is consequent pain in the banking sector due to high levels of NPAs. Some of these heavily leveraged sectors are in great need of equity by way of capital infusions or asset sales. Neither can come about unless the economy starts to show some meaningful signs of buoyancy.

Exports continue to be under pressure due to weak global demand and a relatively strong rupee. While, consumer sentiment is strong, actual consumption demand is nothing to write home about as consumers wait for money to come into their pockets. That leaves only the government expenditure to support growth. So, while the central government does have some newly created fiscal space to spur investments, courtesy crude oil prices, the impact of government spend is likely to be limited due to its absolutely low size. Public sector units, which use to be a great tool for spurring investments in the economy, do not seem to be carrying their usual cash arsenal, having paid generous dividends during the last five years. So, where will the growth come from?

Growth thus has to come from the private sector and the private sector shall wait for rates to come down, demand to show signs of revival and deleveraging of balance sheets before it starts to invest again.

This means that the pain of slower economic growth will have to be lived with for some more time as any unwarranted dovish stance by the central bank can lead to a rise in inflationary expectations in the economy. In such a scenario investors should continue to invest in their high conviction calls with patience and wait for the 'around the corner' turn in the economic cycle. Remember, where there is no pain, there is no gain.

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