Patel Defies Calls for Lower Rates Amid India's Cash Chaos

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Spare a thought for Governor Urjit Patel.

Handpicked by Prime Minister Narendra Modi to lead India's central bank after relations soured with his outspoken predecessor, Raghuram Rajan, Patel's monetary panel on Wednesday shrugged off his boss by keeping interest rates unchanged. The bold call came amid the nation's biggest currency overhaul that’s expected to dent demand in the world’s fastest growing major economy.

While several government officials have made no secret of their desire for lower borrowing costs, this time it was Modi himself who openly called for cheaper loans. So Patel’s decision is being read by economists as an unexpected but wise move before the U.S. reviews policy next week.

"The decision by the Reserve Bank of India was a surprising one, but a prudent one," said Sonal Varma, chief India economist at Nomura Holdings Inc. "The focus needs to be more on the transmission of the rate cuts already delivered, rather than lowering the signaling rates much further."

Uncharted Territory

Yet, the pressure to ease isn’t likely to go away any time soon. Lobby group Federation of Indian Chambers of Commerce and Industry called for a slashing of the key policy rate to 5.75 percent from 6.25 percent after the central bank lowered its growth forecasts for the year through March. The RBI kept rates unchanged at a six-year-low, a move predicted by just eight of 44 economists in a Bloomberg survey, while the rest saw a cut.

The truth is, no one can be absolutely certain about India’s outlook. While the nation’s markets are indeed oiled by cash, the unprecedented scale of Modi’s move and the opaque nature of the vast shadow economy make it hard to have accurate forecasts.

"The demonetization move puts India’s economy in entirely uncharted territory," said Gareth Price, a senior research fellow at The Royal Institute of International Affairs, also known as Chatham House, in London. "If it is a once-in-a-lifetime event that shakes a substantial amount of black money out of the system, and if it is followed up with some form of transaction tax, and if this works, then potentially India's economy is transformed. But there are a lot of ifs in that sentence."

'Sad Day For Transparency'

Patel defended the policy to scrap old high-denomination banknotes in a feisty 30-minute press conference following the decision; the briefing was 10 minutes longer than announced and twice as long as October's abrupt interaction. He sought to assure Indians that there's plenty of cash in the system and urged individuals not to hoard the bills.

"The problems of the common person in this context were on the top of our radar," Patel told reporters.

However, several media organizations weren't allowed access to the briefing, which was held in a room much smaller than previous events.

"The Economist no longer invited to RBI policy meeting press conference," Stanley Pignal, the newspaper's reporter in Mumbai, tweeted. "Won't let me in. Sad day for transparency."

The RBI spokeswoman was unavailable for comment.

Structural Changes

Patel has also been under fire from a powerful bank union, which called for his resignation citing poor execution of the currency clampdown. Cash shortages have prompted global investment banks including Goldman Sachs Group Inc. and Credit Suisse Group SA to slash their growth estimates for India, complicating the policy mix for Patel.

"The RBI's job is very difficult, they now have to assess the state of an economy that has structurally changed," said Alex Wolf, an economist for emerging markets at Standard Life Investments Ltd. in Edinburgh. "The terms of inflation, sharper downward decline, fiscal impacts, and outlook for fiscal reform are now materially different."

For instance, too steep a rate cut to cushion expansion would lower returns for foreign investors, who would then pull money from India especially if the Federal Reserve increases rates next week. Capital outflows will further weaken the rupee -- which sank to a record low last month -- boosting India's import bill, stoking consumer price gains and imperiling the RBI's inflation target. The central bank itself slashed a key measure of economic growth.

Glimmer of Hope

A glimmer of hope comes from the RBI's decision Wednesday to do away with some extraordinary measures imposed to counter a surge in banking liquidity, as Indians rush to deposit their defunct banknotes. Banks no longer need to sequester these deposits, and the increase in liquidity may force them to lower lending rates for customers, Kuntal Sur, partner and leader for risk and regulatory at PwC India, said in a statement.

The move will probably allow banks to reduce their deposit and lending rates, Chanda Kochhar, chief executive officer of ICICI Bank Ltd., India's secondlargest private lender, said in a statement. Arundhati Bhattacharya, chairman of the largest lender State Bank of India, said in a separate statement that banks will be better able to manage their liquidity conditions. She didn't mention specific rates.

For now, Modi's administration is supporting Patel's decision. Chief Economic Adviser Arvind Subramanian said the move is "bold and brilliant," and will buy Patel time to better assess incoming data.

Not all agree.

"Demonetization and the ensuing economic uncertainty have clouded the normal channels of monetary policy transmission," said Eswar Prasad, a professor at Cornell University in Ithaca, New York. "This balancing act could become more complicated if a rate hike by the Federal Reserve, and a consequent portfolio rebalancing by international investors, were to result in a further pullback of capital inflows."