MY VIEW | VOX HETERODOX

US monetary policy: Is it curbing inflation or risking a recession?

The US Fed's intended solution could turn out to be worse than the problem and that could put other economies at threat too

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AP

The Federal Reserve System, the central bank of the US, has increased its benchmark interest rate, from near zero in mid-March 2022 to 3-3.25% in late-September 2022, in five hikes over the past six months, and projections place it in the range of 4.5% by end-2022. This rate is a benchmark for every other interest rate in the US economy, from borrowing rates for mortgages to business loans. It also influences, often determines, many other interest rates across the world.

The stated objective is to control inflation in the US, which reached a peak of 9.1% per annum in June 2022, the highest in four decades, and is in the range of 8.5% since then. It might seem that real gross domestic product (GDP) growth in the US was robust at 5.7% in 2021. However, given the negative growth at -3.4% in 2020, combined with -1.6% and -0.6% respectively in the first and second quarters of 2022, US GDP in mid-2022 is roughly where it was in 2019. Employment levels have recovered better. The unemployment rate has dropped from 5% in 2019 to 2.5% in July 2022.

Such sharp increases in the benchmark Federal funds rate—the main monetary policy tool in the US—is puzzling at this juncture. It is bound to dampen growth when the economy is already in a downturn, for the post-pandemic recovery barely made up for the earlier contraction in output. The recent hikes will raise all interest rates in the economy. The actual increase in the cost of borrowing will depend on the maturity-profile and the creditworthiness of the borrower. Interest rates for business loans will rise sharply to squeeze if not stifle investment. Borrowing by individuals for consumer durables such as cars, or for houses, will become more expensive, squeezing consumption and reducing aggregate demand, which is bound to have multiplier effects. Thus, the consequences of higher interest rates, both on the supply side and the demand side, could further dampen the fragile growth in output and hurt the modest recovery in employment.

The facts about inflation are important. From 2012 to 2020, consumer price inflation in the US was in the range 1-2% per annum, with the average annual rate at 1.6%. Inflation in the US rose to 7% per annum only in 2021.

The efficacy of any policy instrument in curbing inflation depends upon an understanding of the essential underlying cause, just as a doctor's prescription will cure a patient only if the diagnosis is correct. The critical question, then, is what is driving inflation in the US? In situations where prices are being driven up by excess liquidity, tightening monetary policy using higher interest rates could—but might not always—curb inflation. If that was the diagnosis, interest rates—almost zero for two years from March 2020 to March 2022—should have been raised earlier, when inflation gathered momentum in 2021. But the monetary policy response followed with a considerable time lag. The belief that excess liquidity is driving inflation is not quite plausible, as the era of near-zero interest rates and quantitative easing ended in 2016. However, in response to the covid crisis, the benchmark rate, above 2% in late 2019, was lowered to near-zero by March 2020, and the Fed expanded its lender-of-last-resort role for a short period, increasing its balance sheet from $4.5 trillion to $7 trillion between March and May 2020; but this was done only to mitigate the devastating consequences of lockdowns on output and employment, particularly for small businesses (manufacturing and services alike) and laid-off workers who lost their livelihoods. The liquidity eased economic hardship and distress at the time. How did excess demand or excess liquidity surface in this situation?

It is more plausible to argue that inflation in the US, as elsewhere in the world, is being driven by supply-demand imbalances. There are four underlying factors. First, the covid pandemic not only led to a contraction in output because of prolonged and repeated lockdowns in economies everywhere, including the US, but also because it disrupted global supply-chains, which led to a contraction in the supply of consumer goods provided by imports in normal times, particularly in the US. Second, just as the world economy was beginning to recover, the Russia-Ukraine war, which started early 2022, disrupted global supply-chains, particularly in food and fuels. Third, consequences of climate change such as heat waves, or floods, led to a sharp drop in agricultural production, which also reinforced inflation in food and necessities. Fourth, China's continuing zero-covid policy has reduced the supply of manufactured consumer goods in the world market.

Given these underlying factors, rising interest rates are likely to dampen investment and reduce consumption, thereby leading to a contraction on aggregate demand which is bound to have multiplier effects on output, while leading to plummeting house prices and stock markets. Financial distress could also lead to bankruptcies. The US economy, already in a downturn, could well slip into a recession. Fighting inflation using higher interest rates, could belie hopes of a soft landing with moderated inflation which also revives output growth and employment expansion. This belief, embedded in the orthodoxy of central banks everywhere, represents a triumph of hope over experience. The chances of a hard landing, with the nightmare prospect of stagflation, are significant, indeed far higher. The intended solution, then, could turn out to be worse than the problem, not only for the US, but also for countries elsewhere because its unintended consequences will inevitably spread to the world economy.

QUICK READ

The Fed's monetary tightening is aimed at taming US inflation but may end up hurting growth more, given that price pressures appear traceable to supply shortages more than excessive liquidity.

Since effects of the pandemic, the war in Europe, drops in farm output due to climate change and China's zero-covid policy are largely to blame for those gaps, rate hikes may not achieve much.

MINT CURATOR

The UK's laissez faire approach to energy needs a good rethink

Truss rails against the 'nanny state' but public advisories are useful

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British PM Liz Truss's crisis response departs sharply from the EU's

AFP

When covid spread, Britons got used to government messaging such as "hands, face, space." But as the pandemic wore on (and on), a backlash against advice and ever-evolving rules took hold. Britain has long responded to public information campaigns, but people wanted more freedom to decide which risks to take. UK Prime Minister Liz Truss rode that wave to power this summer. She railed against hand-outs and the "nanny state." Take back control, that Brexit message, became something more like "give back control." Her point was helped by advice like "stay out of the heat" (cue eye-rolls).

Problem is, Truss has leaned so far into her ideological aversion to interventionism that the UK government risks failing households as a winter energy crisis hits. It reportedly scrapped a £15 million plan to provide energy-saving advice to consumers. "We're not a nanny-state government," said climate minister Graham Stuart. The UK's latest approach seems to be to beef up a "help for households" website.

Contrast it with the European approach. Like the UK, EU countries offer substantial support for consumers and businesses to cushion the blow of rising energy costs. But unlike the UK, Europe is going for demand management. The EU's target is to cut gas consumption by 15% and electricity use by 10% by end-March 2023. Many countries have public campaigns to contain demand, an approach that fits with the literature on how to achieve energy savings in a hurry, says Yael Parag, vice-dean of the School of Sustainability at Reichman University in Israel. "To be honest, I don't understand the rationale behind not giving advice to people." It can help ensure that vulnerable folks like the elderly don't take unnecessary risks.

Chile did just that when it experienced an electricity shortfall brought on by a drought in 2007-2008. The government offered financial support for the most vulnerable along with a host of measures to reduce demand. Parag recalls that when sabotage took out a natural gas pipeline from Egypt in 2012, Israeli radio carried broadcasts urging people to turn off unnecessary appliances during peak hours. "You don't need everyone to respond; it's enough that some do," she says. A sweeping 2011 International Energy Agency study examined the impact of demand-reduction strategies in New Zealand, Chile, Ontario, Japan and elsewhere. It found that government-led efforts to reduce demand helped effect large-scale behavioural change in a hurry.

Truss figures Brits don't need to be told to turn down the thermometer and buy blankets. This laissez-faire approach is partly based on the assumption that Britain won't face an energy shortage as it doesn't have Europe's dependency on Russian gas. Truss went so far as to rule out black-outs this winter during her leadership campaign. And yet, Britain's National Grid operator has admitted that scenario is possible.

But even without a shortage situation, there is an economic case for encouraging demand reduction, as the UK government—that is, the taxpayer—has promised some £60 billion in energy support.

It's true that nanny states deny people autonomy and encourage an over-reliance on handouts, which can destroy innovation and growth. But given the enormous need to save on energy costs and risk of supply problems, such objections feel absurd in this case. One in five UK households with dependent children experienced fuel poverty in 2020, and the outlook for this winter, given surging prices, is grim. Many families will struggle to pay their bills even with the government's support package.

While many websites have information on energy reduction, the internet can be a confusing place. What measures provide the most impact at the lowest cost for certain properties or households? A clear, targeted public information campaign can reduce some of the noise and focus on options that will be most effective. Adding insulation is probably the most important step many UK homes can take, but smaller things like not running a washing machine or dishwasher until full, or changing to energy-saving light bulbs, are also useful. Some councils are offering local "warm spaces" so residents can come in from the cold.

Of course, a public information campaign should only be part of a demand-reduction strategy. Whether aimed at achieving mandatory net-zero targets or getting through the winters ahead, a comprehensive approach would focus on food and agriculture, transport, residential buildings, non-domestic buildings and industry, and involve a range of tools from price-signalling to potentially rationing. By comparison, the UK's is too haphazard and passive.

Truss's dogmatism has already landed the government in a heap of trouble with markets and her own party. It's one thing to hope for the best, quite another to fail to prepare for the worst.

GUEST VIEW

Overtaxing online gaming will favour grey operators

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Five years ago, not even the staunchest believers of India's online gaming success story could have predicted that by 2022, this industry would be entertaining over 200 million people, generating over $2 billion in revenues and be worth over $20 billion. Similarly, it is hard to foresee today that by 2030, Indian online gaming companies could be generating over $25 billion in revenues and offering India's most dominant form of entertainment after cricket. Achieving this dream, however, would require more than just entrepreneurial spirit, of which there is no dearth in the country. It would require the right policy framework that gives operators an opportunity to innovate, protects users from operator and self-abuse, and maximizes tax revenues without hurting the industry's growth and innovation.

The online gaming industry currently pays 18% GST on its revenues or platform fee intake (known as 'gross gaming revenue' or GGR) for providing users a platform to play. This fee happens to be roughly 15% of the overall prize pool in any contest. This means that GST today is about 2.7% of the overall prize pool. Certain sections of policymakers expect to levy 28% GST on the overall prize pool, which would result in a 1,000% increase in the effective tax burden, and make the tax almost twice of operator revenues.

Such a tax policy would make it impossible for this sunrise sector to achieve Prime Minister Narendra Modi's vision of India becoming a gaming superpower and the industry being a meaningful contributor to a trillion-dollar digital economy. It would also open the floodgates for (offshore) grey market operators that will be able to offer much bigger prize pools than tax-compliant domestic operators that will be forced to pass on higher taxes to users. This story has already played out in the case of horse racing, where the imposition of 28% GST on prize pools reduced industry revenues by over 60% and tax collections by over a third.

In the online world, where there are no domestic boundaries and anything is only a click away, the outcome could be the polar opposite of a $25 billion industry by 2030. As Tamil Nadu's finance minister Palanivel Thiagarajan explained, "Servers could be anywhere, access could be anywhere, it could be through VPNs that mask your identity, it could be through payment of bitcoin or other cryptocurrency that is not registered anywhere in the system." This could potentially wipe out our industry overnight, leaving tens of thousands of jobless, thousands of crore in tax revenue lost, and millions of gullible users falling prey to grey-market operators.

How did we get here? A large part of it has to do with confusion around the current tax law. Some in the government argue that under current law, games of skill are required to pay GST on the entire entry-fee pool instead of just their commission or GGR. This is a gross misreading of the law, which states that the total pool is taxable only if the underlying activity is deemed to be "betting and gambling". Supreme Court and high court judgements have time and again established that games of skill do not constitute gambling. Recent high court judgements from Tamil Nadu and Karnataka have gone further and ruled that online games of skill are no different from games of skill played offline. They have further ruled that states do not have the right to regulate online games of skill under their powers to regulate "betting and gambling" under entry 34 of the Constitution, because such games enjoy constitutional protection.

The Union government has taken a very constructive approach to regulating games of skill by creating an inter-ministerial task force and holding exhaustive consultations with the industry. Recent advisories from the ministry of information and broadcasting on refraining betting and gambling sites from advertising on digital and broadcast mediums is a positive step towards distinguishing games of skill and chance. But somehow, this approach seems inconsistent with another arm of the government pushing for taxes that would crush the industry. One reason for this could be that some stakeholders in the government see real money gaming as a vice and want to shut it down. While consumer protection in real-money gaming is a must, there is enough evidence to prove that most stories around social ills related to online gaming are overblown or downright false. Independent entities like the Rotary Club and several prominent psychologists have questioned the premise that growth in online gaming is correlated with an increase in social problems.

In any case, shutting down the local industry is not going to protect consumers. It has been proven time and again in several other industries that penalizing taxes only end up shifting consumption in favour of non-compliant illicit operators instead of disincentivizing users, and therefore becomes a self-defeating exercise.

The challenges that concern online gaming might be new to India, but countries like the UK have been working on them for almost two decades now. India can skip all the pain that Western countries have faced on their path to regulating real-money games and leapfrog to the world's best-in-class standards to protect consumers.

An industry-friendly, progressive policy with consumer protection at the forefront will accelerate healthy growth for the online gaming sector and bring in incremental tax revenues, which could make India a global online gaming powerhouse in return.

QUICK READ

Some policymakers reportedly plan to levy 28% GST on the overall prize pool, which would raise the organized industry's effective tax burden hugely and push traffic to shady game sites.

A taxation muddle arises from a legal dichotomy in India under which would-be tax imposers seek to classify online gaming as a form of gambling instead of regular games of skill.