live mint

Print Close

Fri, Jun 12 2015. 12 42 AM IST

The interest rate conundrum

The time has come to reduce RBI repo rates by percentage points rather than basis points

Deepak Nayyar

Between March 2010 and October 2011, RBI raised the repo rate 13 times, from 4.75% to 8.5% per annum. Photo: Bloomberg

Interest rates are in the news. Most stakeholders wanted a reduction larger than what was announced by the Reserve Bank of India (RBI). The finance minister sought to stimulate growth. Corporates hoped to revive investment. Households waited for smaller monthly instalments payable on their borrowing. Everyone was disappointed with the outcome. It also shaped expectations. Stock markets tumbled. This is no surprise. Interest rates are among the most important price signals in a market economy that determine investment decisions of firms and consumption decisions of households.

In its periodic monetary policy review, the RBI announces changes in the repo rate, the rate at which it lends to commercial banks, which is the basic determinant of interest rates in the economy. It is a reference rate, much like US prime (based on the federal funds rate) or Libor, so that lending or borrowing rates set by commercial banks or financial institutions use it as a benchmark for interest rates that depend, inter alia, on maturity periods and risk profiles.

Between March 2010 and October 2011, RBI raised the repo rate 13 times, from 4.75% to 8.5% per annum. It was changed seven times thereafter, up or down, until January 2014, but remained broadly in the range of 8% per annum. The downturn in the economy, from 2011-12 to 2013-14, witnessed a sharp slowdown in growth, a substantial drop in investment, persistent double-digit inflation and mounting balance of payments deficits, leading to massive erosion in confidence. Raising interest rates, time after time, was the policy response and the last resort of the government. It did almost nothing to tame inflation or resolve macroeconomic problems. And the political outcome was a drubbing for the government in the national election.

The **Narendra Modi** government that assumed office in May 2014 inherited a difficult economic legacy. Yet, its decisive mandate shored sentiment and restored confidence to unleash expectations. Alas, its first Union budget, no more than a holding operation, did little to revive growth. But the gods were kind.

The monsoon turned out to be better than expected. And there was more manna from heaven. World prices of crude oil dropped from around $110 per barrel in end-June 2014 to less than $50 per barrel in end-January 2015, to remain in the range $55-60 per barrel since then. This bonanza of $50 billion per annum created fiscal space for the government and slashed the trade deficit and current account deficit in the balance of payments. Above all, it dampened inflation. Between April 2014 and April 2105, the annual rate of inflation dropped from 6% to -2.7% in terms of the Wholesale Price Index and from 8.4% to 4.9% in terms of the Consumer Price Index.

Thus, in the first year of the Modi government, inflation dropped by 8.7 percentage points (870 basis points) to 3.5 percentage points (350 basis points) depending on the measure used, largely because of the collapse in world oil prices and decent supply management in a deficient monsoon year. This provided a fantastic window of opportunity to drop interest rates. The RBI response was feeble. It reduced the repo rate by 25 basis points each time in January, March and June 2015. It was simply too little too late. Given that inflation dropped anywhere between 3.5 and 8.7 percentage points, while the RBI rate dropped by a mere 0.75 percentage points, real interest rates, in fact, rose by 3 to 8 percentage points. In this context, we must also remember that lending rates are at least 4-5 percentage points higher than the repo rate. The time has come to reduce RBI repo rates by percentage points rather than basis points.

The slowdown in growth during 2011/12-2013/14 was, in large part, attributable to the drop in investment, as gross fixed capital formation fell from 33.6% to 29.7% of GDP (2011-12 series), by almost 4 percentage points. Things got worse in 2014-15, as this proportion was 28.7%, which was another 1 percentage point lower than in 2013-14. Obviously, high interest rates crowded out investment. It is almost impossible for manufacturing firms to use borrowed capital for financing investment, when rates of return have to be higher than nominal interest rates at 13% per annum and real interest rates much higher than in the past as inflation has come down. If investment continues to be stifled, possibilities of reviving growth and creating employment are seriously constrained.

It would seem that little has changed at RBI. The previous governor, **Duvvuri Subbarao**, was much criticized for his hawkish approach to interest rates. However, the present governor, **Raghuram Rajan**, is even more of an inflation warrior, as he has turned a deaf ear to every plea that has urged him to lower interest rates. The ostensible reason is that the war against inflation is not yet over. Clearly, even facts cannot change belief systems that are embedded in ideology. But it is important to recognize that the underlying macroeconomics is flawed.

There are debates among competing schools of thought. Yet, the two essential questions are the same: what causes inflation and what should be done about it? The basic monetarist view, born and brought up in Chicago, is that excess liquidity causes inflation so that a restrictive monetary policy is the solution. Insofar as governments are fallible, simple rules are best. In the heyday of monetarism in the 1980s, the most favoured rule prescribed expanding money supply at a constant rate. This rule was discredited when it became clear that the demand function for money was unstable and unpredictable especially in developing countries. Inflation targeting then became the preferred rule. In this, the central bank sets an inflation target for the medium term, which is made public, and interest rates are raised or lowered to stay on target. This rule also turned passé, as there were serious problems of coordination with fiscal policy in managing external balance and in coping with asset bubbles, which became clear in the global economic crisis. Strangely enough, in India, the belief survives to hold sway.

The problem lies not only in the approach but in its understanding. If inflation in India was being driven by excess liquidity, high interest rates and repeated hikes should have dampened inflation. It did not happen since inflation in India was driven by supply-demand imbalances, which were real rather than monetary factors. It was the sharp drop in oil prices, combined with better supply management, which was responsible for taming inflation. In such circumstances, restrictive monetary policy was probably counterproductive because it stifled investment, dampened growth and, if it squeezed supply more than demand, inflation persisted.

Indeed, it is plausible to argue just the opposite. Lower interest rates would stimulate investment and revive growth, while employment creation would stimulate domestic demand that would, in turn, drive growth. But that is not all. It is credit more than money supply that matters for the level of economic activity. If firms and households are credit constrained, lowering interest rates may mean that firms will have more money to invest and households will have more money for consumption. If lenders have rules limiting lending to debt servicing capacity, lower interest rates would lead to an increased willingness to lend on the part of commercial banks. This might create a virtuous circle of cumulative causation.

The alleged trade-off between inflation and growth, stressed by orthodoxy, is a false dilemma. Experience across countries provides little if any evidence in support. It is only very high inflation or hyperinflation that is associated with low growth or economic recession. In fact, evidence does not validate the orthodox view that low inflation facilitates economic growth. On the contrary, it shows that moderate rates of inflation have often been accompanied by rapid economic growth. The fight against inflation, in the orthodox mode, almost always leads to higher unemployment. It is true that the less well-off or the poor bear the costs of inflation, but it is just as important to recognize that the costs of fighting inflation in the monetarist mode are perhaps even greater for the less well-off or the poor, particularly the unskilled and the unemployed.

Economic ideas and ideologies set the agenda for action and change. But we must learn to question and get away from a blind belief in any idea, for ideologies that turn into faith are dangerous. Monetary policy might seem trivial in the wider context of economy, polity and society. But economic outcomes, which are path dependent, do have political consequences at election time and social consequences in the well-being of people. It would be both prudent and wise for the government not to put all its eggs in one basket. Instead, it should be open-minded in considering different views before making critical economic policy decisions. In such matters, there is always a need for institutional checks and balances so that neither the Reserve Bank of India nor the ministry of finance function in an unfettered unilateral manner. This is too important a matter to be left to economists alone, let alone one person in Mint Street.

Deepak Nayyar is emeritus professor of economics, Jawaharlal Nehru University, New Delhi. He served as the chief economic advisor, Government of India, from 1989 to 1991, and as vice-chancellor, University of Delhi, from 2000 to 2005.