An Overburdened Instrument*

C.P. Chandrasekhar

On August 9, RBI Governor Raghuram Rajan released the last bi-monthly monetary policy statement that would be drafted under his leadership. No changes were made: the benchmark 'repo' rate was kept at 6.5 per cent, the cash reserve ratio at 4 per cent and the Statutory Liquidity Ratio at 21.5 per cent. According to the RBI, growth in this fiscal is projected at 7.6 per cent because of the beneficial effects of the good monsoon and the expansionary effects of the implementation of the [7th Pay Commissions recommendations](). So growth is not an immediate problem. But, in the view of the RBI, this growth brings with it the risk of inflation. Hence, any further reduction in interest rates was not warranted, at least for now.

Rajan has the image of a policy maker with a penchant for a high interest rate regime. When he took over as Governor in the first week of September 2013, the repo rate stood at 7.25 per cent. It was raised to 7.5 per cent soon thereafter, and then climbed to 7.75 per cent on 29 October 2013 and 8 per cent on 28 January 2014, where it stayed till 15 January 2015. As of that date it has been reduced thrice by 25 basis points (a quarter of a percentage point)and once by 50 basis points to bring it to its current level. In sum, he may have been determined, but not incalcitrant.

The defence Rajan had for his adherence to a high interest rate policy was that it was needed to combat actual, or preempt potential, inflation. In fact, inflation targeting moved to the centre-stage of monetary policy making under Rajan. He set up an Expert Committee to Revise and Strengthen the Monetary Policy Framework (chaired by Deputy Governor Urijit Patel), which submitted its report in January 2014 and recommended a strict version of the "inflation targeting" framework. Inflation was to be the focus of monetary policy, and had to be kept within a two-percent band around an annual 4 per cent rate. Among the measures that had to be adopted to realise this objective was a manipulation of interest rates and adjustments of the level of liquidity in the economy.

Many of the recommendations of the committee have been explicitly adopted or implicitly adhered to. But the emphasis has been more on keeping interest rates high rather than limiting liquidity. Overall, the numbers do seem to suggest that inflation was reined in during Rajan's tenure. But not everybody is convinced that it was because of his interest rate policy. Oil prices collapsed during those years and the commodity price boom ended early into his tenure, both of which contributed in no small measure to the moderation of inflation. Further, the persistence of the crisis in Europe and spread of the global recession to emerging markets dampened world demand, with similar effects on prices. Separating out the contribution of factors such as these from the effect of the interest policy is not easy, but there is reason to believe that the former may have had a more important role in taming inflation.

But this was not the main point of contention between Rajan and his critiques in the establishment. Even those who disagreed with him were not in favour of disbanding the inflation-targeting approach. Their view, it appears, was that there was a trade-off between inflation and growth, so monetary policy had to be more accommodating. Even if credit was available for financing investment and consumption, a high interest rate would discourage debt-financed spending and curtail demand, keeping growth below its feasible potential. So, with the economy having lost some of its growth momentum after 2012, industry complaining of slack demand and inflation well below its previous peak, they expected that the Reserve Bank of India would soften interest rates even more to stimulate consumption and investment demand. The resulting growth would not be accompanied by unacceptable rates of inflation. In fact, a year back, the Chief Economic Advisor in the Finance Ministry, referring to the fact that the rate of inflation based on the Wholesale Price Index (as opposed to the Consumer Price Index) was negative, went on to say that the danger India faces is deflation and not inflation. This according to him called for an interest rate cut.

As the figures show, Governor Rajan did go part of the way in accommodating this view. Yet inflation as of now is within the prescribed limits. And, if the GDP figures are right, growth too is reasonable. This could be seen as sending out a message that a compromise between contending positions on where the interest rate should stand has resulted in an optimal compromise that delivers reasonable growth with moderate inflation.

The argument leading to that conclusion is questionable on many counts. The first and most obvious is the effectiveness of the RBI's benchmark rate as an instrument to adjust the interest rates banks charge their clients. If the "transmission" of benchmark rate adjustments to actual interest rates paid by the clients of financial institutions is weak or non-existent, any effects that a change in the interest rates would have on either inflation or growth would remain unrealised. In fact, in his April briefing on monetary policy Raghuram Rajan alluded to the evidence that though the RBI had cut interest rates by 125 basis points the rates at which banks lend to firms and individuals had come down by a much smaller amount.

The second problem is that interest rate changes may not be the most effective means to influence movements in the target variables, be they prices or incomes. If, for example, inflation is largely of the "cost-push" kind, where increases in costs are driving up prices, raising interest rates may not help. The principal route through which the interest rate impacts on prices is by restricting demand, by reining in bank lending or raising interest rates and increasing the costs of debt-financed spending. That helps curtail demand, not hold back cost increases, which may even be driven by changes in global prices. On the other hand, if the objective is one of influencing growth, the effect of relatively small interest rate changes on investment and demand may not be strong enough to counter any stagnation or recessionary trends. In fact, in Europe, Japan and elsewhere the effort at reducing interest rates to counter the recession has taken rate into negative territory. Banks have to pay the central banks to maintain cash deposits with it, with the hope that this would force them to lend even if at low interest rates. But the evidence is overwhelming that, the state of confidence and expectations of the future are such that even this does not stimulate lending and debt-financed spending.

It is for this reason that many have for long held that fiscal policy is a far more effective instrument than monetary policy in addressing the problem of growth. But the ideology that has accompanied the rise to dominance of private finance globally, looks down on fiscal policy because, dependence on it would inevitably lead to increased taxation of the well to do and/or increased government deficits and public debt. In a world where the private sector is supposed to lead the growth process, increased taxation is seen as disincentivising savings and investment. And, on the presumption that debt financed public spending would inevitably lead to inflation, which would erode the real value of financial assets, deficit spending is seen as a practice that needs to be reined in. The result has been that the Indian government, like many other governments across the globe, set itself stringent targets of the size of the fiscal deficit. With increased direct taxation frowned upon and debt-finance government spending on hold, fiscal policy has been rendered ineffective.

This forces dependence on monetary policy, with the interest rate seen as being the principal instrument for macroeconomic management. Unfortunately, that is proving to be a blunt tool when combatting inflation or promoting growth.

* **This article was originally published in the Frontline, Print edition: September 16, 2016.**