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Limits to efficacy of monetary policy

PREMIUM

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The current decision by Reserve Bank of India (RBI) to lower the repo rate by 50 basis points is seen by many a welcome move, especially, at a time when our growth rate has slowed down to 6.1 per cent.

A slowdown takes place when there is a mismatch between demand and supply of output. From a layman's perspective, managing a slowdown, therefore, is to manage the demand-side factors, the supply-side factors, or a combination of both, affecting availability of output (gross domestic product, or GDP). Demand-side factors are consumption expenditures, investment expenditures, government expenditures, and demand for exports and imports. Supply-side factors, on the other hand, take into account availability of foodgrains and manufactured items, besides looking at the availability of fuel items such as oil.

Given this information, when the RBI reduces interest rates (repo and reverse repo rates), it is seen as an attempt to increase demand by trying to stimulate demand-side factors.

A lower interest rate most often translates into lower loan rates. It can prop-up consumption expenditures (contributing close to around 65 per cent of economy-wide demand) and, by reducing the cost of capital, also spur investment expenditures.

The economic expansion of 2005 that lasted until the early part of 2007 was mainly because of increase in consumption expenditures. At that period of time, the RBI followed a tighter credit policy to rein in inflation. In fact, the tighter credit policy of April 2007 was influential in reducing inflation rates from around 6.7 per cent to around 3.5 per cent within a quarter. What RBI is now trying to do is just the opposite.

With the economy slowing down, a lower interest rate is expected to prop-up the growth factors. There are studies indicating a link between broad money supply (M3), and the Wholesale Price Index (WPI).

CURRENT SCENARIO

But what happens if the cause of slowdown (or, for that matter inflation) is related to supply-side factors, speculation, or lack of coordination between the government and the RBI?

For instance, this time, Mr D. Subbarao was cautious in his approach, stating that any further rates cut might not be forthcoming. His area of concern was high food inflation in March — rising sharply to 9.94 per cent, from 6.07 per cent in February.

This rise in price may have been on account of lower supply of agricultural output, which has grown at a slower pace, at 6.5 per cent during 2011-12 as opposed to 7 per cent during 2010-11. In fact, this might even lead to higher food inflation over next few months and has nothing to do with increase in demand; it is because of lack of supply.

In India, supply of agricultural output is affected by drought (especially when around 55 per cent of our agricultural produce depends on rainfall), capacity constraint (lack of availability of physical infrastructure) and even speculation.

Studies have spoken about association between spot and future prices (in terms of their movements) in the agricultural commodities market (that is, spot and futures prices react similarly in the event of any new information).

There is evidence about speculation leading to high futures prices. The high oil price inflation is a testimony to that. Since futures prices for agricultural and commodity items in India are integrated with global futures prices, and there is a convergence between spot and futures prices, one can very well argue that speculation in the agriculture and commodities market is also contributing to inflation. Monetary policy cannot control these factors.

INVESTMENT TRIGGER

Even the present idea of propping up investment demand by lowering interest rates may not work. Though investment expenditure in India contributes around 33 per cent of GDP, more than half of this investment comes from the household sector.

That is, a relatively small portion of our investment is actually used for building new factories, adding to existing capacity for factories and to build physical infrastructure— something that can ease capacity constraint.

Although cost of capital is an important component in terms of doing business, to a business leader, other important factors are cost of doing business, and a clear policy direction from the government. Both these are fiscal components.

At present, the government is sending a wrong signal on undertaking reforms. A higher fiscal deficit may crowd out efficient private sector investment and contribute to inflation.

From the policy perspective, if the root cause of inflation is supply-side factors, and because of fiscal imprudence there is a necessity for the government to address these issues to allow monetary policy work.

What is required is the use of supply management policies such as investments in building suitable infrastructure, focusing on new technology to improve agricultural productivity, better water management to reduce volatility of agricultural output, and, more importantly, policy coordination between the Ministry of Finance and the RBI.

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