Limits of a High Interest Rate Policy as Initiated in India

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The announcement, on May 4, for a 40 bp raise in the policy Repo rate along with a 50 basis point rise in the cash-reserve ratio by the Reserve Bank of India is claimed officially as a measure to put a rein to current inflation, currently fuelled by the rising food prices rising at 7.68%, oil and fats at 18.79% and vegetables at 11.64% over the same month. The announcement has come with the deliberations on part of the MPC projecting further increases in the Repo rate which will be well above the pre-Covid accommodative rates.

Policies as above, identified as "inflation- targeting", has not been new in India. Examples include the continuous tightening of the fiscal deficit, targeted to 3% of the GDP in terms of the Fiscal Responsibility and Budget Management Act (FRBMA) which India enacted in 2003 Since the fiscal deficit, cut to size, was to be financed by market borrowings in terms of the new norms, the rising interest bill arrogated as much as 25% of public expenditure in 2018-19 and later years. As a result less was available of public expenditure to meet expenses on social sector or capital investments by the government – a fact well-observed in successive budgets reflecting their steady declines as shares to aggregate public expenditures.

Responsibilities of the official bodies on "inflation- targeting", however, does not end with fiscal cuts via the budget. One witnesses, in India and in many other countries, the use of interest rates as a tool to control aggregate spending. Both practices relate to the much criticised Thatcher-Regan variety of monetarist policies introduced in early 1980s. The theoretical content of those were backed by the Chicago school brand of monetary theory as formulated by Milton Freiedman.

RBI's current announcement of the hike in repo rates to 4.40% is based on the claim of monetarism that prices can be controlled by cutting down the supply of money, which is a straight-forward application of the age-old Quantity theory! A rise in interest rate here targets achieving a decline in credit from banks - by making loans more costly as a result of the rise in bank rates.

Cycles of tight money in India date back to the previous decade or earlier, having bank rates at 8.75% and 10.25% respectively on 19th March and 15th July of 2013. With the Covid related distress, softening of the rate, already started by mid-2019, was followed by rate cuts in 2020 and bank rate was down to 4.25% by 25th May 2021. Above phase of relatively soft lending to redress covid issues has obviously given way to the new phase of tightened credit as at present, to control inflation.

To understand the principles (or theory) behind monetarist policies of inflation-targeting which relies on fiscal-monetary squeeze, we recall the three basic assumptions in the Friedmanite formulation. Those include first, flexible prices and clearance of markets under perfect competition, second, money, like any other commodity, considered to be under full control by authorities, and third, that the supply of money can be controlled exogenously, say by central bank. Relying on the assumptions as above the monetarist policies claim to control inflation with cuts in the so-called supply of money from banks by raising interest rates as well with increased cash-reserve ratios.

Theoretical framework, as above has been open to criticisms, both on grounds of the unreality of the underlying assumptions and the limited validity of the framework in empirical tests.

Since the success of any policy when applied, relies on the initial conditions laid down in the assumptions it starts with, we point at the related problems as are encountered in a strategy of reducing inflation with cuts on money supply. Starting with the last two assumptions which rely on the notion of money as any other commodity, or as 'commodity-money' which can be controlled by external bodies, the implication is one of a total neglect of what constitutes money in the economy. Money as viewed since the early beginning of banking industry in any economy, has been more than the number of coins and printed paper currency notes. Money also comprises of 'credit-money', which include bank cheques (promises to pay by banks) which can be converted to paper currency notes. Money in today's financial circles can originate with asset-based securitization by converting assets held by an individual to securities, providing potential sources of liquidity (money supply), Use of various instruments like options and futures in the stock market open further sources of liquidity generation.

On the whole it is a misnomer that the Central Bank in any country today can be in control of money supply in their economy. Money supply, as held in alternative formulations, is determined endogenously within the system, typically with demand for credit and the generation of liquidity to meet various activities in both the real and the financial sectors.

What then, are the possible effects of the RBI-led raise in the interest rate on the economy? Will the cut in public expenditure via the fiscal route and of private expenditure via the raise in interest rate succeed in controlling the on-going inflation?

Markets, unlike what is assumed in the "inflation-targeting "strategy, do not provide a quick and flexible adjustment to prices in response to a drop in aggregate expenditure (or demand) in the economy. Rather the rise in interest rate can lead to cost-push inflation, especially with oligopolistic pricing of manufactures as well as services. Also, the higher rates will also add to the interest bill in the budget on market borrowings by the government causing further rise in the share of interest payments in public expenditure. Currently it has already been above 25%.

Inclinations on part of policy-makers to adjust the interest rate upwards can, in addition to inflation targeting, be motivated to encourage further flows of foreign capital which are likely stall due to inflation and possible depreciation of domestic currency. In other words, RBI's move to pitch domestic repo rates higher can also be seen as a bid to provide incentives for foreign rtfolio finance abd FDIs. This has been more so with the Fed designs of a rise in US interest rates in near future. In such situations the autonomy of domestic policy makers is surrendered completely to overseas agents, in this case the US government - a case of subordinated financialisation!

Monetarism and the policies of austerity it designs to control inflation have been generally counter-productive in developing countries – with perceptible losses of output and employment. India has been no exception, as can be observed from on-going stagflations in recent times

We cite here Nicolas Kaldor who was invited by the RBI to deliver the Deshmukh Memorial lecture in 1984. The lecture on The Failure of Monetarism reads as:

"In my view the proper test of competence of a Central Bank is how far it succeeds in ensuring that the banking system grants sufficient credit at the disposal of industry and commerce so that the true economic potential of the economy can be reasonably fully exploited without being over-exploited. In other words, bank credit should expand at the right rate, neither more nor less. This is neither ensured nor prevented by attempts to control the vagaries of the money supply"

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