

A moderation in interest rates- Why is it necessary?

WORKING PAPER 14

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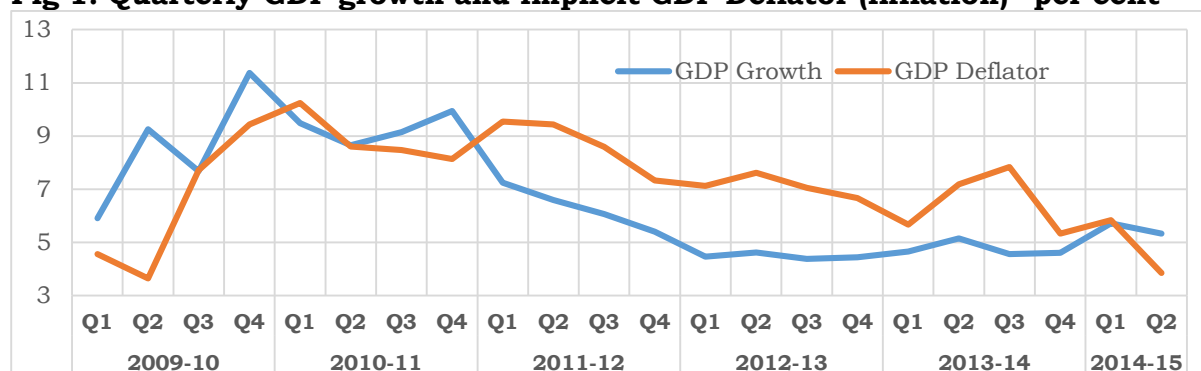
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A moderation in interest rates- Why is it necessary?

The objective of monetary policy is to meet the twin thresholds of inflation and growth. While inflation should be kept at reasonable levels, economy should experience sustained growth. There is considerable debate in India and abroad about the point of influx, the point beyond which inflation starts impinging on growth. Several studies in Indian context have estimated this point of influx at 5-7 per cent¹ of inflation measured in terms of the wholesale price index. While a low inflation could be ideal for inclusive growth, the growth sacrifice from inflation below a threshold may adversely impact the inclusion itself.

2. Data on growth of Gross Domestic Product (GDP) and implicit GDP deflator (which in effect could be taken as a true measure of underlying inflation in the economy) clearly indicate that the moderation in inflation in last 16 quarters has resulted in an equal (in fact greater) sacrifice in terms of growth (Fig 1). For over 12 quarters the observed GDP growth has also been lower than the potential growth.

Fig 1: Quarterly GDP growth and implicit GDP Deflator (inflation) –per cent



Source- Ministry of Statistics & Programme Implementation Press Notes and our calculations

Inflation is moderating

3. Implicit GDP deflators are available only on a quarterly basis and have a considerable time lag. In view this Reserve Bank of India (RBI) now looks at the Consumer Price Index (CPI- New Series) as the inflation anchor which closely reflects the cost of living and influences inflation expectations relative to other available metrics². According to the Committee, the WPI is not only an imperfect substitute for a producer price index (PPI), it does not capture price movements in non-commodity producing sectors like services. Further, the WPI is often subject to large revisions which generate large uncertainty in the assessment of inflation conditions.

4. While many consider the expectation survey on inflation by RBI as indicating disproportionately high inflation³, there has also been a lack of unanimity on using the CPI-NS (launched in January 2010) as being taken as inflation anchor. But notwithstanding these differences, inflation measured in terms of the new CPI series is also showing a moderation in inflation. Both food and non-food component of CPI shows a moderation in inflation (Fig 2). Food inflation from November 2013 to October 2014 has declined by 900 basis points, from 14.7 per cent to 5.7 per cent. Non-food inflation which has been a little more sticky hovering between 7-9 per cent during April 2012 to June 2014 has also moderated to 5.3 per cent in October 2014. Further, while there could be an upswing in food inflation (as reflected in a decline in index in December 2013 and Jan-Feb, 2014 and erosion

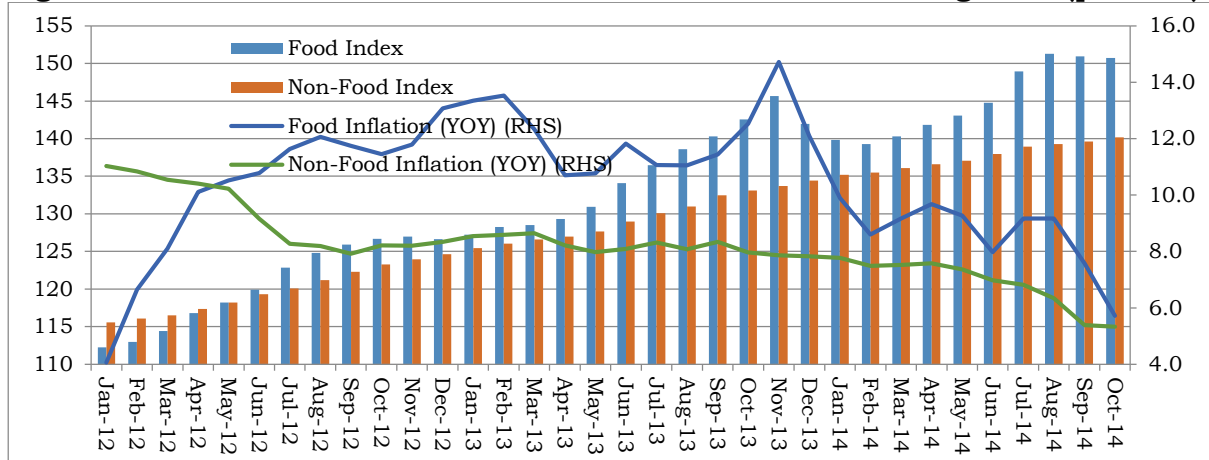
¹ RBI Working Paper Series (17/2011)- Why Persistent High Inflation Impedes Growth? An Empirical Assessment of Threshold Level of Inflation for India- Sitikantha Pattanaik and G V Nadhanael

² Reserve Bank of India- Report of the Urjit Patel Committee

³ Surjit Bhalla- Indian Express, September 13, 2014

of base advantages), non-food inflation may not experience any such eventuality. Moderation in non-food inflation is likely to continue. Even on food front, with lower expenditure on NREGA and some evidence of reduction in rate of increase of rural wages, there could be somewhat less pressure of protein inflation.

Fig 2: Consumer Price Index and Inflation for Food and Non-Food segments (per cent)

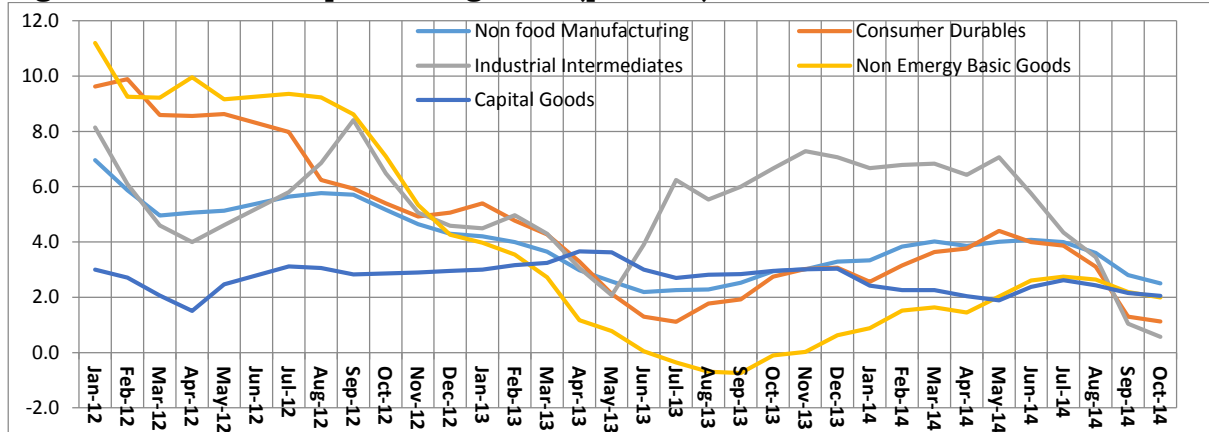


Source- Ministry of Statistics & Programme Implementation Press Notes and our calculations

Moderation in Producer’s Inflation (WPI) is even sharper

5. It may not be out of place to look at the producers’ prices. While India does not compile any Producers’ Price Index, WPI is in fact a close substitute. The wholesale prices of consumer durables, non-energy basic goods, industrial intermediates and capital goods have witnessed a sharper decline in inflation rates (Fig 3)

Fig 3: WPI for some important segments (per cent)



Source- Office of Economic Adviser Press Notes and our calculations

6. Non-food manufacturing WPI has been in the range to 2-4 per cent for nearly two years now. Inflation for consumer durables has been under 5 per cent (currently inflation for this segment of products is a little above one per cent) for 20 months. Capital goods and non-energy basic goods are also witnessing inflation well below their earlier levels and definitely below the ‘grease effect’. More important than this moderation is the fact that the corporates have little pricing power.

Corporates do not have the pricing power and profits have squeezed

7. Broad consensus on dynamics of corporate pricing power and its impact on inflation suggest that increased pricing power help pass the surge in input costs to the consumer and hence leads to higher inflation and in falling pricing power the pass-through gets restricted. Data suggests that corporate pricing power in India was gradually declining since 2009-10:Q1. Production also fell sharply since 2010-11:Q3. Empirical results indicate that a fall

in pricing power was followed by higher and faster decline in production than in inflation. Bottom-line of the corporates was affected by higher input costs and lower output realisation. As the increase in input costs arising from both internal and external shocks was not passed through by increases in selling price, the profit margin of firms declined. Also, due to subdued demand conditions, firms' response to higher input costs was reflected more in reduced production than in lower prices⁴.

8. Corporate margins, which are perhaps a better proxy for corporate pricing power, have witnessed a secular squeeze (Table 1). The decline in margins is across all sizes of the corporate sector, whether these are large, medium or small scale concerns. Only large sized companies maintained positive net profit margins in the last two years, while the small and medium sized companies incurred losses⁵.

Table 1: Net Profit Margins for the Corporate Sector (per cent)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Number of Companies	3,238	2,549	2,629	2,763	2,679	2,931	2,854
All Companies	11.0	8.1	9.4	9.0	6.4	5.9	5.8
Companies with annualized sales exceeding Rs.10 billion	12.1	9.3	10.2	9.8	7.0	6.8	6.8
Companies with annualized sales between Rs.1-10 billion	8.4	4.3	6.5	5.6	3.4	1.3	0.6
Companies with annualized sales below Rs.1 billion	5.4	1.4	3.5	1.1	1.2	-4.7	-11.9

Source- Reserve Bank of India- Monthly Bulletin-October, 2014

9. Long term trends of inflation in India indicate that supply side factors like drought, inability to ramp up cost effective production of protein foods, global uncertainties, war and international commodity price have been the major reasons behind inflationary spikes in India. In the past 20 years, weighted contribution of food and fuel group of commodities to overall inflation has exceeded the combined weight in 16 years. Inflation has therefore, more of a structural nature arising largely due to supply shocks or getting transmitted through an upsurge in global commodity prices. Developing countries are more prone to supply shocks...In the presence of downward nominal rigidities, monetary policies that do not accommodate supply shocks could amplify their adverse growth effects⁶.

10. The persistence of food inflation in recent years can largely be ascribed to higher wages, particularly, in the rural sector pushed further by hikes in MSP of rice and wheat and input cost inflation. These very factors also explained the movement of food price in the short-run⁷. CPI inflation is explained by MSP inflation of the previous year. "The model simply says that the predicted inflation in any year is 5.1 per cent plus a third of the lagged MSP inflation⁸."

Economic contraction has been significant and sharper

11. The years 2010-13 witnessed a persistently high level of inflation, particularly for food products. Persistently high inflation constrained the central bank to adopt a more restrictive credit and a tighter monetary policy than what the declining growth rate warranted, as monetary policy simultaneously affects aggregate demand and the cost of capital. Further with a decline in the pricing power of the corporate sector and profitability, it also raised the

⁴ RBI Working Paper (9/2013) Corporate Pricing Power, Inflation and IIP Growth: An Empirical Investigation: Angshuman Hait; Joice John; Abhiman Das and Anujit Mitra

⁵ RBI Monthly Bulletin, October 2014

⁶ Khan, Mohsin - "Inflation and Growth in MCD Countries", Middle East and Central Asia Department, IMF, December 2005.

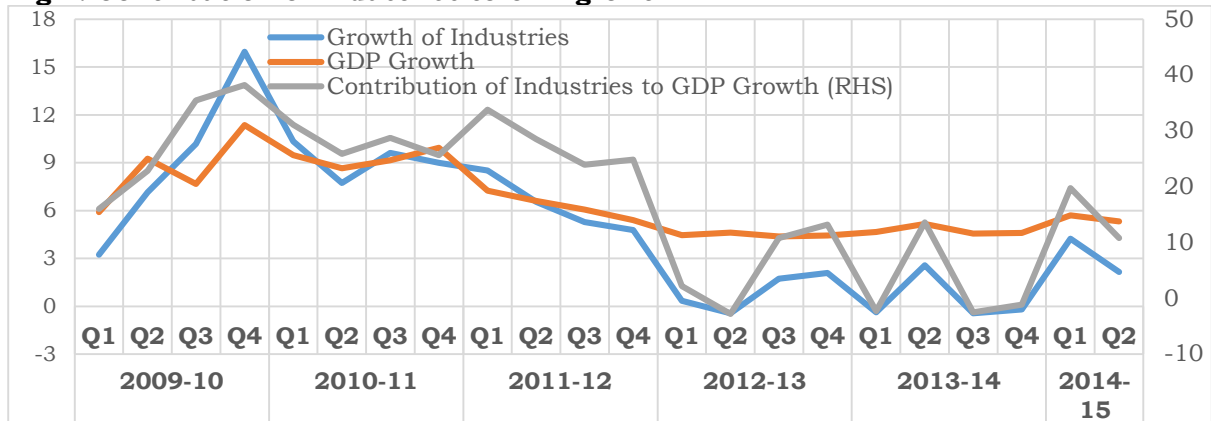
⁷ RBI Working Paper (10/2014) Analytics of Food Inflation in India: Thangzason Sonna; Dr. Himanshu Joshi; Alice Sebastian and Upasana Sharma

⁸ Surjit Bhalla- Indian Express, Sep/tember 13, 2014

demand for restructuring of loans and non-performing assets of the banks. The quality, quantity and price of credit were adversely affected.

12. Economic growth is a function of expectations, investment and efficiency. While efficiency is partly internal to economic agents, Government can improve expectations and create enabling environment for investment. One of factors which have affected addition of capacity and output from manufacturing is the cost of capital. With pricing powers of the corporate having declined considerably, high cost of capital has affected their internal accruals. Interest rates have also acted as a dampening factor for demand for consumer durables. With exchange rate largely market determined and prices of tradable being governed by the landed costs, high interest rate has acted as one of the major factors affecting competitiveness of the economy. In last 11 quarters, therefore, industrial growth has remained lower than the overall GDP growth and has turned negative on many occasions (Fig 4). Contribution of industries has also declined from 38 per cent in Q4 of 2009-10 to negative in Q4 of 2013-14. With IIP growth in Q2 of 2014-15 currently estimated at 1.1 per cent, industrial growth will remain subdued.

Fig 4: Contribution of Industries to GDP growth

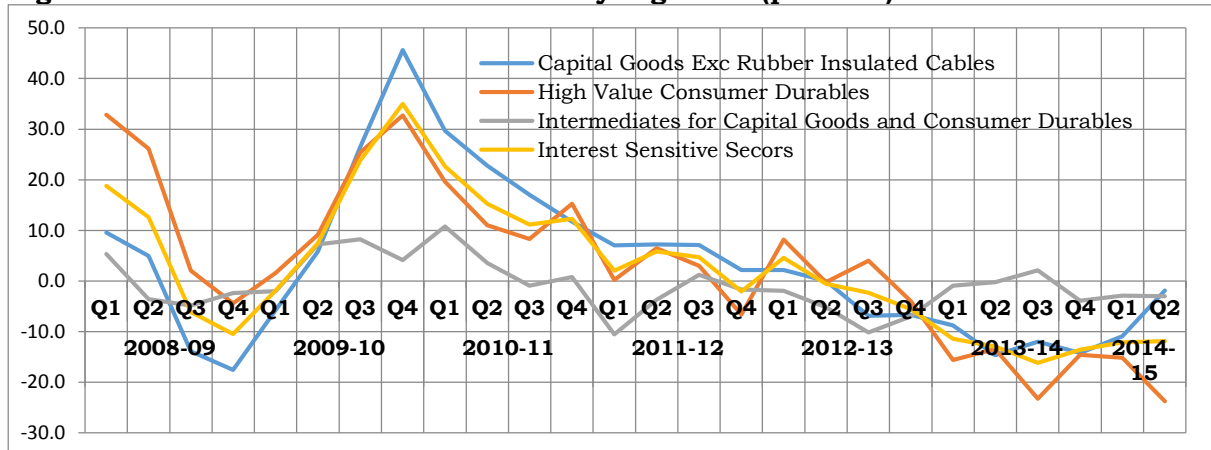


Source- Ministry of Statistics & Programme Implementation Press Notes and our calculations

Interest sensitive industrial sectors have suffered the most

13. Within industries, interest sensitive sectors have performed even poorly. A look at the performance of the sectors comprising the capital goods, high value consumer goods, industrial intermediates, particularly for capital goods and consumer durables indicate that there growth on an aggregate basis has been in negative territory for 9 quarters on a continuous basis (Fig 5). Negative growth has persisted for capital goods (excluding the volatile rubber insulated cables) and consumer durables for 7-8 quarters.

Fig 5: Growth of Interest sensitive industry segments (per cent)

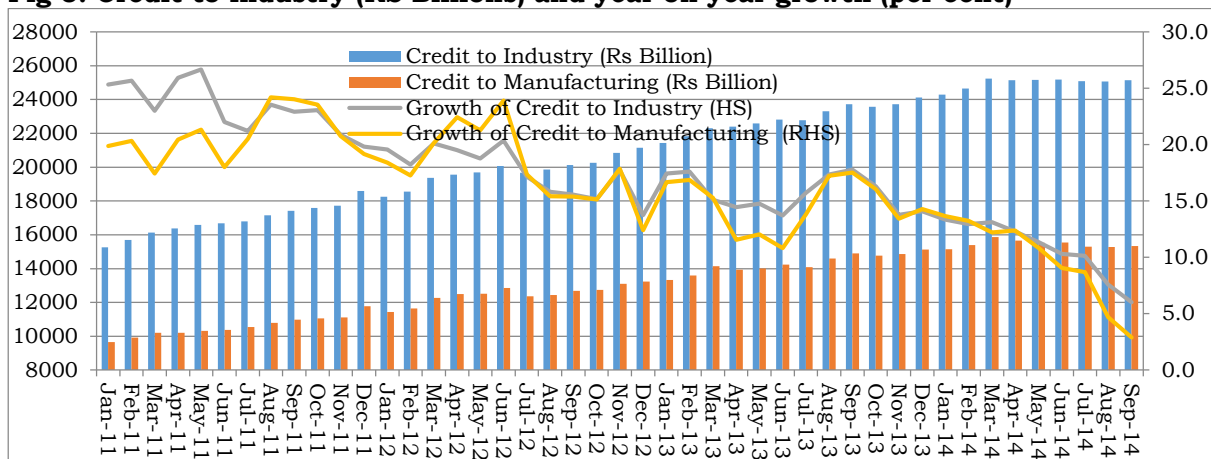


Source- Ministry of Statistics & Programme Implementation- Production of 399 selected products for the Index of Industrial Production and our calculations

Credit off take has also moderated

14. There has been a decline in the growth of credit disbursed from the banking sector to industry and the manufacturing sector. Outstanding credit to manufacturing has virtually been flat for last 10 months. Overall credit to industry has also been flat for nearly six months (Fig 6). Growth of credit disbursed to medium industries has remained negative during May-Sep, 2014 (5 months continuously). With ample liquidity this situation is clearly indicative that cost has been an important factor.

Fig 6: Credit to industry (RS Billions) and year on year growth (per cent)



Source- Reserve Bank of India- Current Statistics- Press Releases and our calculations

Interest constitute a significant component of organised manufacturing

15. Available data does not bear out that interest cost does not matter for industry. The organised factory sector data from Annual Survey of Industries reveal that manufacturing in India is still resource intensive with gross value added at less than 17 per cent of the value of output. In such a resource intensive segment, interest becomes a significant component to operating costs. Rate of interest on the borrowed funds of these units increased from 9.5 per cent in 2005-06 to 13.1 per cent in 2011-12. In last two years for which the ASI data are available, interest grew at a rate faster than gross value added (Table 2). For the non-ASI sector, interest cost may have risen faster and they may have competed out in loan disbursements as has been indicated above.

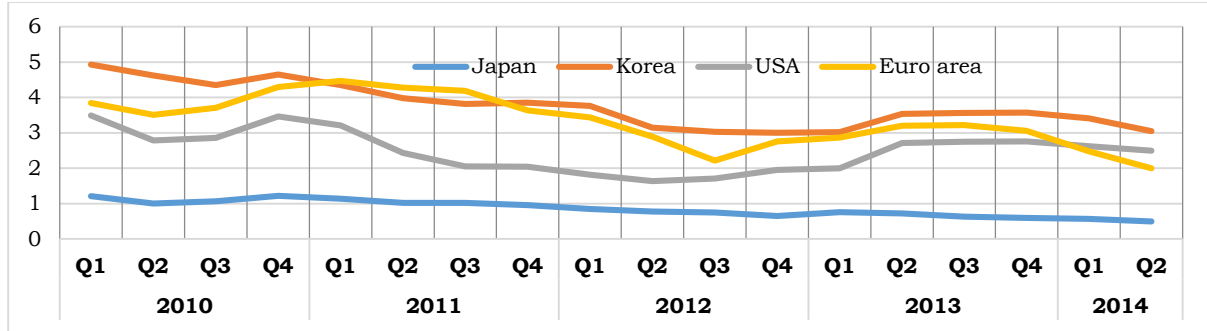
Table 2: Interest in ASI Factories

	1995-96	2005-06	2007-08	2008-09	2009-10	2010-11	2011-12
GVA as % to Output	24.3	19.1	19.9	18.7	18.7	17.6	16.9
Interest as % to GVA	22.0	9.2	9.3	11.2	10.5	10.7	12.4
Rate of Interest on borrowed funds (%)	14.5	9.5	11.3	12.8	11.1	10.7	13.1
Growth of GVA	28.2	17.8	20.1	10.6	14.0	18.4	18.4
Growth of Interest	34.0	2.9	24.6	33.4	6.8	20.1	37.1

Source- Annual Survey of Industries- Various Issues

16. There is a view that we should not indulge in competitive rate reduction, even as countries China are at it (Fig 7). Interest rates are set in each country based on its macroeconomic environment. Indonesia has raised interest rates due to reduction in oil subsidy and consequential inflation. Brazil has done the same because of high inflation and current account deficit (CAD). We need to lower interest rates taking into account various factors, particularly if that is constraining addition to productive capacities or is eroding the competitiveness of our economy. But that is what is being observed now.

Fig 7: Long term interest rates of select countries (country groups)

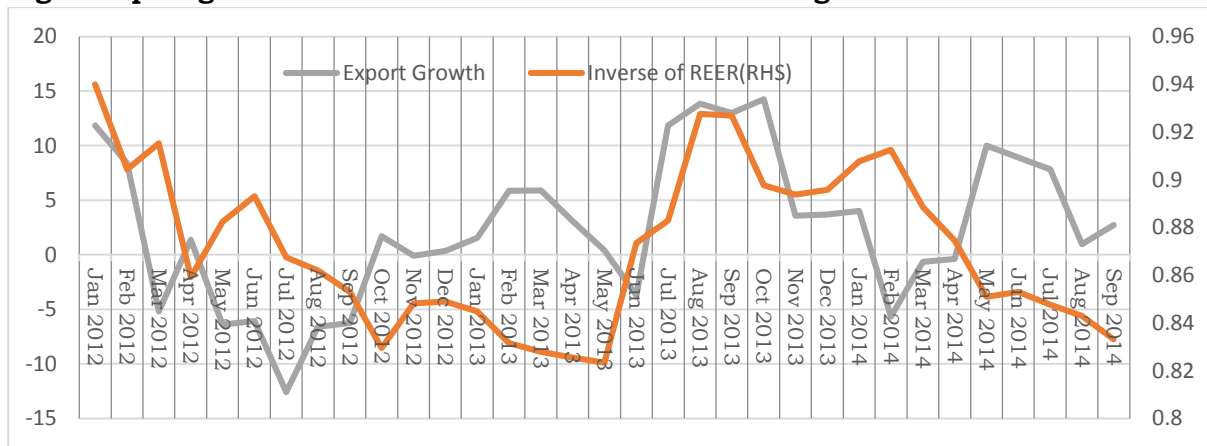


Source- OECD Statistics accessed through their Website

High interest rates and higher REER has eroded competitiveness of economy

17. Indian rupee, after being range-bound around 46 per USD in the post Lehman crisis period, started depreciating from 2011 and reached to a record low of 68 per USD by end August 2013 becoming the most vulnerable of the five emerging economies. The measures to support currency by RBI during this period were successful and rupee reverted to an exchange rate considered aligned to macro fundamentals and has been hovering around 60-62 level for some time now. But this apparent stability of nominal exchange has concealed the appreciation in terms of real effective exchange rate (REER). Though global economic growth has been an important factor, the export growth of merchandise goods in recent months also appear correlated (Fig 8) with inverse of real effective exchange rate (6 Currencies trade based weights with 2004-05 as base) suggesting that a stable and depreciated REER may be desirable for both merchandise and service exports.

Fig 8: Export growth and inverse of Real Effective Exchange Rate



Source- Reserve Bank of India- Data base on Indian economy- accessed through their website

18. There has also been a view that lowering interest rates may create some problems for financing our current account deficit. CAD is expected to be less than 2 per cent of GDP for this fiscal, despite some increase in gold imports in October 2014. Though exports to Europe are not expected to grow, at least exports to US, UAE and ASEAN may show increase provided there is no erosion in our competitiveness relative to their other competing trade partners. PMI index on export orders point to a secular increase in the index in the past few months. Further, our total debt and equity flows this year is a record at US \$ 39 billion, which is higher than full year inflows of US \$ 31 billion in calendar year 2012. This has certainly driven up asset prices. With an improving US economy attracting investment and possible interest rate increase next year by the Fed, problems of outflow could be an issue with RBI, but with reserves built up already and QEs by European Central Bank and Bank of Japan, we may not face a problem as we faced in 2013.

19. We are of the view that geopolitical issues may not be allowed to get out of hand, as has been evidenced in Iranian nuclear issue this week. There are economic costs to adventurism and at the rate of growth in the world being what it is; there is less appetite for other misadventures.

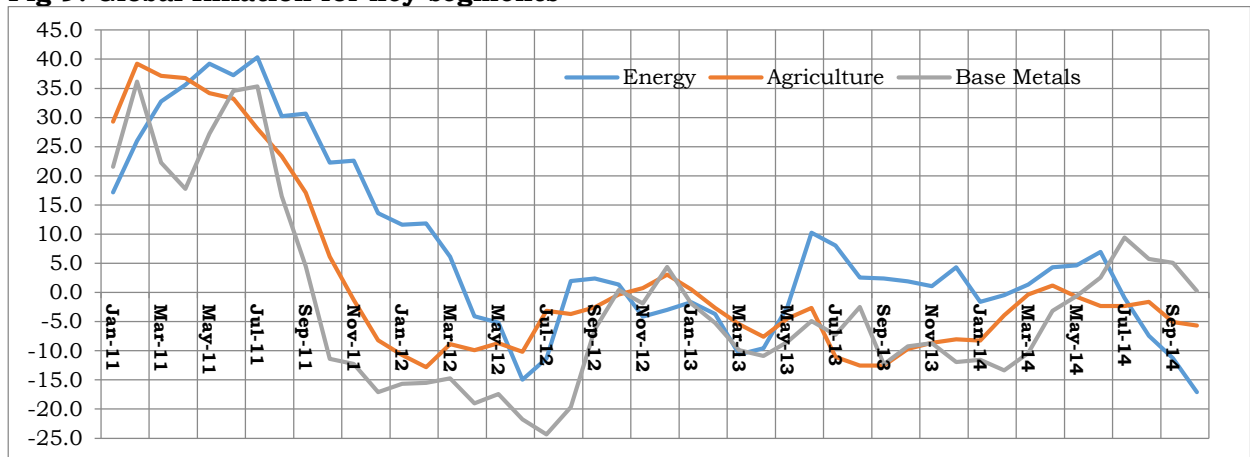
20. One view is that lowering rates now will increase asset prices especially as it would come on top of copious inflows; such increase in asset prices is not warranted by fundamentals. The inflows are in any case neutralised to a large extent by open market operations (OMO) in forward dollar market by RBI. There will be competing demand for resources for investment with Government exhibiting its intent and committing through action to enable manufacturing to take off in a big way. Already total credit in the private non-financial sector has dropped down to 50 per cent of GDP and there will be a demand for investment when realisation dawns that rates will go southward with inflation coming down.

Global Inflation remains benign

21. In contrast to the domestic inflation, the global economy is currently characterized by benign price regime. In open economies, with no trade restrictions, domestic prices of tradable products usually converge to their export or import parity prices. Since Indian food prices are lower than international prices, there is no similar moderating influence on food inflation. The close association of domestic and global prices is therefore reflected in a moderate non-food manufacturing inflation, defined as core inflation.

22. Commodity prices are expected to be lower thanks to faltering growth in china and Europe, over production due to new areas getting opened and insistence on maintaining production levels not to lose market share. Crude oil is not expected to reach levels beyond US \$85 in the foreseeable future. Corn prices have declined by more than 15 per cent this year, iron ore by 40 per cent, cotton by more than 25 per cent, copper by more than 9 per cent and thermal coal by more than 20 per cent with less probability of going up in the near future. Global inflation for three key commodity segments shows a continuous moderation (Fig 9).

Fig 9: Global Inflation for key segments



Source- World Bank Pink Sheet- data accessed through their website

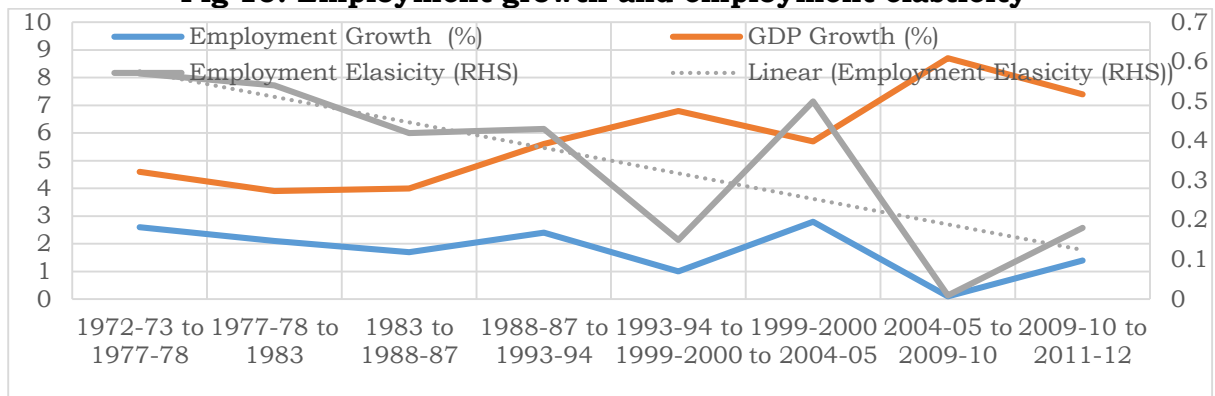
Both domestic and global slacks are currently available

23. Though the RBI’s monetary policy stance has remained focused on the twin objectives of containing inflation and facilitating growth, inflation management has had an overriding objective. This has led to a sharper slowdown of economy than anticipated. Further, with a significant part of inflation getting generated because of poor supply responses, a shift in policy stance of RBI coupled with improving access of credit with moderation in its cost would be desirable. This is all the more important in view of the slacks seen both at domestic and global levels.

Large unemployment unutilised potential

24. Using compound average annual rate of growth approach, Reserve Bank has calculated employment elasticity of Indian economy for the NSSO survey periods from 1977-78 (Fig 10)⁹. Employment elasticity declined to 0.01 during 2004-05 to 2009-10 period before improving marginally in next two years. The high growth during this period was in fact a job less growth. There has been a need to shift labour from agriculture to manufacturing, particularly the organised manufacturing. Data from ASI clearly shows that even during last seven years, characterised as job-less growth, the ASI factories recorded an employment growth of 6.9 per cent¹⁰ reinforcing the possibility of employment growth with appropriate skill setting and other supportive policies. The decline in employment or its near stagnation was more apparent in agriculture and unorganised sector.

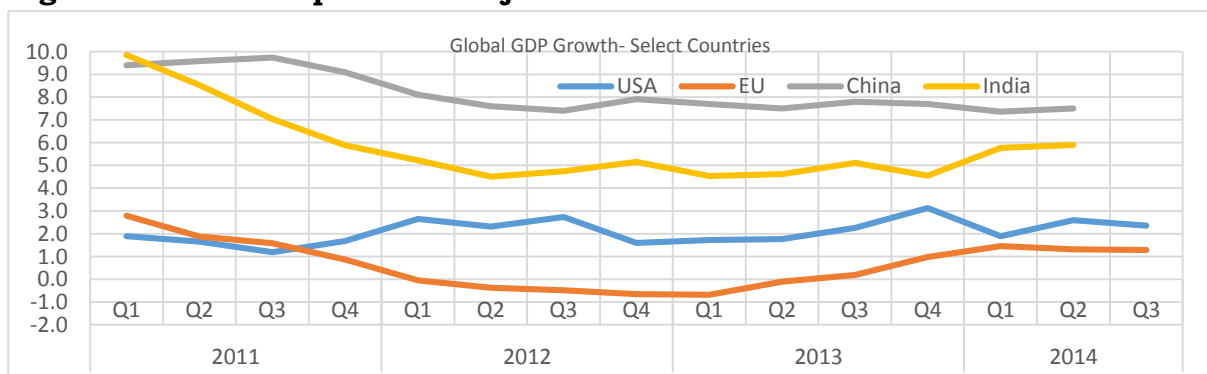
Fig 10: Employment growth and employment elasticity



Source- Reserve Bank of India and NSSO Reports

25. There is global excess capacity with relatively less buoyant growth expectations (Fig 11). Except for US other economies are likely record lower growth. Largely due to weaker-than-expected global activity in the first half of 2014, the growth forecast for the world economy were revised downward to 3.3 percent for 2014, 0.4 percentage point lower than in the April 2014. The global growth projection for 2015 was lowered to 3.8 percent¹¹. Lower growth projections not only reduces to that extent the potential output growth through exports, it also raises the issue of excess capacity globally and possible dumping affecting domestic output.

Fig 11: Growth Prospects for major economies



Source- OECD Statistics accessed through their Website

⁹ Reserve Bank of India, Working Paper, 6/2014

¹⁰ Total number of persons engaged in ASI factories increased from 8.45 million persons in 2004-05 to 13.4 million persons in 2011-12.

¹¹ IMF- World Economic Outlook- October 2014

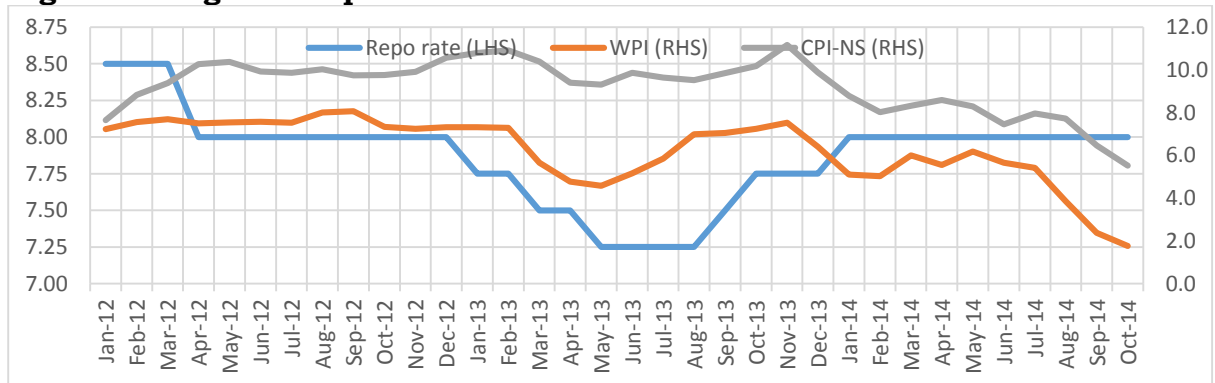
Is lowering of interest rate so urgent

26. There has been a view that with ample liquidity in the system, banks are reducing both deposit and lending rates, why should then one bother about repo rates. There are undoubtedly transmission lags in monetary policy and these tend to differ from one country to another owing to differences in economic and market structures. For instance, these lags are found to vary from 1-14 quarters for transmission of policy rates to output across a gamut of advanced and emerging economies with varied monetary arrangements¹². The broad consensus emerging from various studies indicate that monetary policy in India impacts output with a lag of about 2-3 quarters and WPI headline inflation with a lag of about 3-4 quarters and the impact persists for 8-12 quarters. There are also recognized leakages such as, sustained fiscal dominance reflected in large borrowing programs of the State with intermittent use of open market operations to manage yields, pre-emption of banking resources through statutory liquidity ratio, large informal sector and money and credit market frictions constrain the transmission of monetary policy instances to output and prices. But, yet normal monetary policy operates on the principle that there is a "market clearing" interest rate (or set of market rates), that balances desired saving and desired borrowing and prevents resources from remaining unutilized. The central bank's normal goal, then, is to adjust its policy rate to nudge market rates toward that market-clearing level. Further, if rates are also moderating is it not proper to recognise it upfront?

Repo rates are now well above the inflation threshold

27. The repo rates after remaining below the headline inflation for a considerable period is currently ruling above these rates (Fig 12). Yes, it is possible to take a view that this is only a recent occurrence and one should wait for it to get stabilised. But both the global and domestic factors indicate that price pressures are not significant any more. Further, it is always important for monetary policy to remain ahead of the curve, becoming a little accommodative when inflation is below threshold and output gap is positive.

Fig 12: Changes in Repo Rates and Headline WPI and CPI-NS inflation



Focus should now shift to growth enhancing measures

28. GDP and its growth has long been one of the indicators and by anchoring market expectation around that makes for better management of supply shocks. It implies a more accommodative policy, when the economy is already being hit by a negative supply and inflation near or even below its threshold level or the point of influx. While first half of 2014-15 gave a better than expected growth (partly on account of the base effect), and partly because of a better than expected agricultural growth despite weak monsoon. With infrastructure index still performing poorly and Q3 nearing completion, the expectations for Q3 growth are generally subdued, which may give a growth of a little over 5 per cent for 2014-15. While government is making efforts in creating expectations, fast tracking implementation of projects, reducing regulatory hurdles and above all fiscal consolidation, monetary policy stance need to change to signal growth back on its radar. Synchronisation

of fiscal policy particularly with regard to the quality of fiscal consolidation (achieved through a reduction or relatively slower growth of non-plan expenditure), keeping the increase in the minimum support prices to reasonable level warranted by cost increases only and an increased investment activity through its parastatals should bring back the growth momentum.

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