

Finding a Goldilocks policy interest rate

Too high, too low or just right? The question has been approached from two distinct perspectives in economic theory: normative economics and positive economics

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The slide in private investment and growth is not just a cyclical problem easily reversible by simply lowering the repo rate; it is a challenging structural problem. Photo: Aniruddha Chowdhury/Mint

Is the policy interest rate too high, too low or just right? The policy rate which anchors the structure of interest rates, known as the repo or repurchase rate, is only one of several monetary policy instruments used by the Reserve Bank of India (RBI). However, it is mainly the repo rate that is the subject of much debate. Recently, two of our leading economists engaged in an open debate on this issue. Economic Advisory Council member Surjit Bhalla published a pugnacious critique of senior Bhartiya Janata Party leader Yashwant Sinha's earlier broadside against the government's mismanagement of the economy (*The Indian Express*, 29 September). Subsequently, former National Statistical Commission chairman Pronab Sen published a detailed rebuttal of Bhalla's critique (*The Indian Express*, 11 October).

Their exchange covered a range of issues, but this column is limited to issues raised by them regarding interest rate policy. For purposes of transparency I should mention that as professional colleagues some of us discuss these policy issues privately. However, Sen has suggested that given the topical importance of the interest rate question, our discussion on this issue should be in the public domain. Hence this article.

The question of interest rates has been approached from two distinct perspectives in economic theory, both of which were mentioned by Sen. Grossly oversimplifying, we may describe these as the perspective of normative economics, the economics of what ought to be, and the perspective of positive economics or the economics of what is. Both approaches offer a framework of principles for determining the optimal rate of interest, but neither framework can translate those principles into an actual number. At the end of the day, judgement is required in deriving an optimal rate of interest based on either approach.

The normative approach is due to Frank Ramsey, a student of John Maynard Keynes. Ramsey was a brilliant Cambridge philosopher, mathematician and economist. He unfortunately died at the early age of 26, but by then had made several foundational contributions to economics, including his theory of optimal savings. Building on Irving Fisher's pioneering theory of interest rates, in particular the key notion of time preference that a unit of consumption today is valued more than the same unit of consumption at a future date, Ramsey developed a theory of the optimal inter-temporal path of savings and consumption that would maximize the present value of social welfare over the entire time horizon.

A central component of the theory is the rate at which the future stream of consumption should be discounted by society to derive its present value. This social rate of time preference should be determined in principle by elected governments in representative democracies. The Fisher-Ramsey tradition led to the emergence of an arcane branch of mathematical economics known as optimal growth theory. It also provided an optimization framework for economy-wide planning. In his article, Sen refers to the choice of a social time preference rate of 4% by the erstwhile Planning Commission, a choice that Sen himself may have contributed to during his earlier association with the Planning Commission.

So far as I am aware, the Fisher-Ramsey framework or a social rate of time preference has not generally been used by central banks in determining interest rate policy. However, the famous Fisher equation defining the real interest rate as the difference between the nominal interest rate and expected inflation is often used for policy purposes. The Chakravarty Committee appointed by the RBI in December 1982 to review the working

of the monetary system used this as the foundation for its recommendations on interest rate policy.

One of India's leading mathematical economists of the late 20th century, Sukhamoy Chakravarty, was an authority on Ramsey economics. However, he was not only a theorist but also an ardent practitioner who devoted several decades to development planning and other practical policy matters. Under his chairmanship, the Chakravarty Committee recognized the need for a positive real interest rate to encourage financial savings and discourage profligacy in the use of bank credit.

The committee's recommended nominal interest rate for 15-year dated securities was the expected inflation rate plus 3% real interest. For Treasury Bills, the recommended nominal rate was the expected inflation rate plus a marginally positive real return. For securities of between 1-15 years, the recommended real rate was in the range of 1% to 3%. On the deposit side, the recommended rate was 2% above the expected inflation rate for five-year term deposits. The recommended real rate for one-year term deposits was marginally positive as for Treasury Bills. For term deposits of other maturities, the recommended rate was between these two rates. The recommended lending rate was 3% above the maximum term deposit rate, amounting to expected inflation plus 5%.

At the time the committee submitted its report there was no signalling rate like the repo rate. Indeed that would have been redundant since this was still the era of administered interest rates. However, since the repo rate is a floor for the structure of interest rates, the logic of the committee would call for a repo rate that is no more than its recommended rate for Treasury Bills or one-year term deposits, i.e., less than 1%. So which is the appropriate normative benchmark for the real interest rate: the erstwhile Planning Commission's 4% social rate of time preference which Sen seems to favour or below 1% as would be implied by the logic of the Chakravarty Committee? It's a judgement call since the normative approach offers no further guidance at this level of specificity.

Let me turn now to the approach of positive economics, which is the terrain in which Bhalla argues his case that the repo rate is too high. The core concept of a positive theory of interest rates is the idea of a natural or neutral rate of interest proposed by the Swedish economist Knut Wicksell way back in 1898. By the natural rate, Wicksell meant that rate of interest at which commodity markets would be in equilibrium and prices would be stable. Interest rates lower than the natural rate would lead to excess

demand and inflation while interest rates below the natural rate would lead to deflation.

A hundred years later, building on Wicksell's idea of the natural rate, Stanford economist John Taylor developed a simple interest rate policy rule which came to be known as the Taylor Rule. The rule states that the nominal policy rate should be a function of the natural rate, the inflation rate, the difference between the logarithms of the actual and trend level of output or output gap, and the difference between the actual and target inflation rate.

The rule has been widely adopted by central banks all around the world though there are some challenges in applying the rule and there has been a long debate about its efficacy. However, as Taylor pointed out in his review at the Federal Reserve Bank of Boston conference last week, the rule has in fact been quite useful in helping central banks improve the effectiveness of their monetary policies.

In the absence of an estimated Taylor Rule function, especially a neutral rate officially recognized by the RBI, it is not easy to apply the rule as a simple benchmark to assess whether the current repo rate is too high or too low. With the monetary policy committee (MPC) having recently lowered the repo rate to 6%, and an inflation rate of under 3.5%, the implied real neutral rate assessed by the MPC would appear to be around 2.5%. This is in the same ballpark as the neutral rate in advanced countries like the US. However, since the unemployment-underemployment rate in India is high relative to the advanced countries, the neutral rate should be lower in my view.

More importantly, inflation is now well within the RBI's desired target range, in fact lower than the target rate of 4%, while the quarterly GDP growth rate has fallen below the trend rate. Hence, as per the Taylor Rule, the repo rate should be lowered now even if we assume that the correct neutral rate is 2.5%.

While agreeing with Bhalla that the repo rate should be lowered, I should hasten to add that I do not share his view that the current slowdown is a "cyclical easily reversible wound" inflicted on us by the RBI's high repo rate. As I explained in my previous column (15 September), the two principal factors underlying India's sliding growth rate are the sharp increase in the trade deficit by over 295% during the past year, partly as a consequence of exchange rate appreciation, and the decline in the investment rate, especially the private investment rate, because of commercial banks' festering non-performing loans problem or "twin balance sheet" problem that has constrained the flow of credit.

In an earlier article (*The Indian Express*, 18 September) that argued along similar lines as his recent piece, Bhalla went to great lengths to show how exports have grown despite the appreciation of the exchange rate. But he was silent on the sharp increase in the trade deficit, i.e. exports net of imports, which is what counts for the leakage from aggregate demand. On the problem of non-performing loans, he remarked, “resolution of the NPA problem will significantly improve investments and growth, but the resolution will need a different instrument than lowering the interest rates”.

There you have it. The slide in private investment and growth is not just a cyclical problem easily reversible by simply lowering the repo rate. It is a much more challenging structural problem. As I had mentioned in my previous column, without coming to grips with this problem, it will be difficult to revive either private investment or long-term growth.

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