India’s Macroeconomic Policy: Locked in an Anti-Growth Trap

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Executive Summary

This report draws attention to the poor performance of Indian economy during the last few years. To study the effectiveness of India's economic policy, we sampled relevant macroeconomic variables for India over the last 30 years. Data reflected anti-growth conditions. The average bank lending rate during the period of our study has been 14.32% and inflation has been consistently around 8%. Income disparity in India increased over the studied period. According to World Bank data in 2009 India ranked 78th in the list of 134 countries.

We compared India's monetary policy with other high GDP economies such as USA, UK, Italy, Switzerland and developing economies like China and Brazil. Most of the developed countries managed to maintain low-interest–low-inflation combination for most of the years following 1990.

We suggest that high interest rate policy is incorrect for India. Low interest rates have a stimulating effect on the economy because they make it more attractive to borrow and invest. Increased investments in profitable ventures will lead to increase in output and employment. Therefore lower interest rates can help achieve faster sustainable-inclusive growth.

Introduction

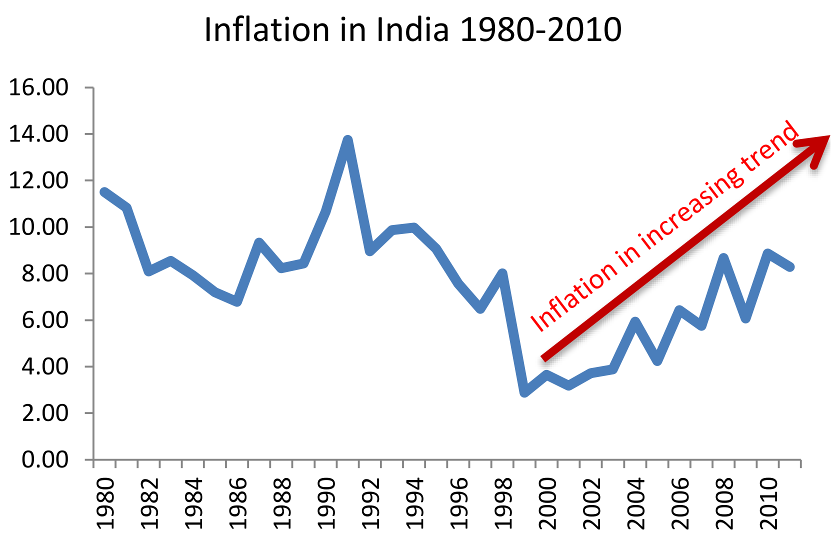
India is one of the fastest growing economies in the world. But in the last decade India's economic growth has not been satisfactory. Modern India is facing policy crisis affecting its growth and development. At present India faces a dreadful combination of high interest and high inflation.

Interest-rate targeting is a vital tool in monetary policy and is used for promoting economic growth and stability. At a personal level, high interest rates provide a safer way to earn a high return but in the long run they have a negative impact on economy. Higher interest rates have an adverse effect on economic growth and it affects the developing nations more. In the next section, we discuss why high interest rates are bad for Indian economy.

Why Higher Interest Rates are Bad for India

High Interest Rates are Ineffective in Controlling Inflation

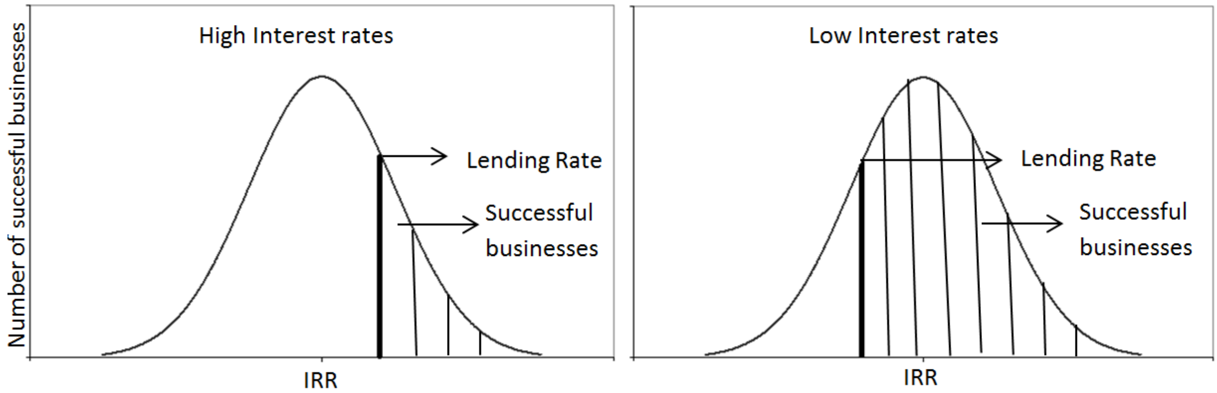
Reserve Bank of India claims that the primary goal of high interest rates is to control inflation. Graph below clearly shows that RBI failed in achieving its prime objective of maintaining a low inflation rate. Inflation in India has always been on the higher side except during the period between 1998-2001 where it was below 4%. After that, Inflation has been increasing consistently and in 2012 it was around 8%. This can be because of high interest rates in the past as they inhibit long-term supply of goods and services, affecting the long term inflation.



High Interest Rates Discourage Entrepreneurs

Interest rates influence the cost of availability of money and credit within an economy. For an investment to be worthwhile, expected return on capital must be greater than the cost of capital. Businesses are induced to invest by the expected rate of return on new investments and the rate of interest paid. Higher interest rates discourage investment to businesses and make it harder for a business to succeed while low interest rates promote entrepreneurship. The businesses that have Internal Rate of Return (IRR) higher than the interest are successful. In the figure below, shaded region shows projects where IRR is more than the interest rates. In India most of the population have little or no resources and they largely depend on banks to fulfil their entrepreneurial dreams. Low interest rates will allow more businesses to succeed which will help Indian economy in long-run.

Low-Interest rates promotes entrepreneurship



To show entrepreneurial hardships in India, we compared net margin of Fortune 500 group and prime lending rates in India. We assumed net margin to be identical to free cash flow with each of the Fortune 500 companies. In such case net margin becomes nearly equal to IRR. India's prime lending rates are much higher than the net margin of these companies for all these years. Even these businesses would not have succeeded if they were set out in India.

India's Prime Lending rate and Net margin of Fortune 500 Companies

Year	India's Prime Lending Rate (%)	Net margin (%)
2000	12.3	4.9
2001	12.1	4.5
2002	11.9	3.2
2003	11.5	3.1
2004	10.9	4.6
2005	10.8	5.2
2006	11.2	5.9
2007	13.0	6.3
2008	13.3	5.7
2009	12.2	3.7
2010	8.3	3.8
2011	10.2	5.5

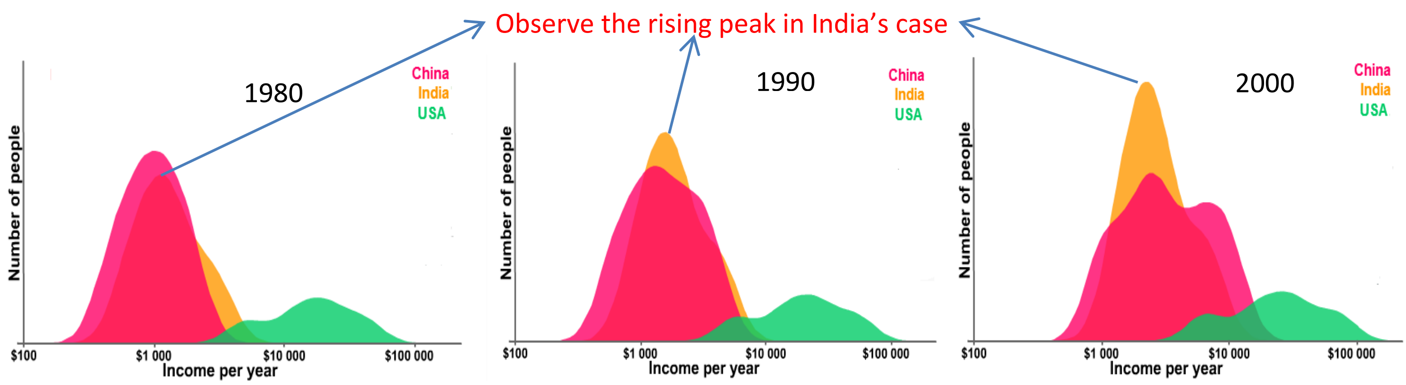
Source: CNN Money

Entrepreneurial activities lead to economic growth. They have been found to create a broad array of economic benefits. Entrepreneurship promotes capital formation through effective utilization of resources, creates large scale economic opportunities, promotes balanced development, reduces concentration of power, leads to wealth distribution, increases Gross Domestic Product (GDP), improves standard of living. In short, it facilitates faster inclusive growth and increased assets for investment in future.

Income Distribution Went from Bad to Worse

High interest rates also hamper the goal of income distribution. Poor people are unable to raise money because of high cost of borrowing. It further leads to the problem of unorganised borrowing. Poor suffer the most as they do not get the opportunity to participate in the economy. Figure below shows the income distribution for China, India and USA over the last 3 decades. In India incomes are not smoothly spread out evenly through the middle of the distribution. The top 10% of earners make almost five times more than the median 10%, but this median 10% makes just 0.4 times more than the bottom 10%. This shows that most of the resources are in hands of few people.

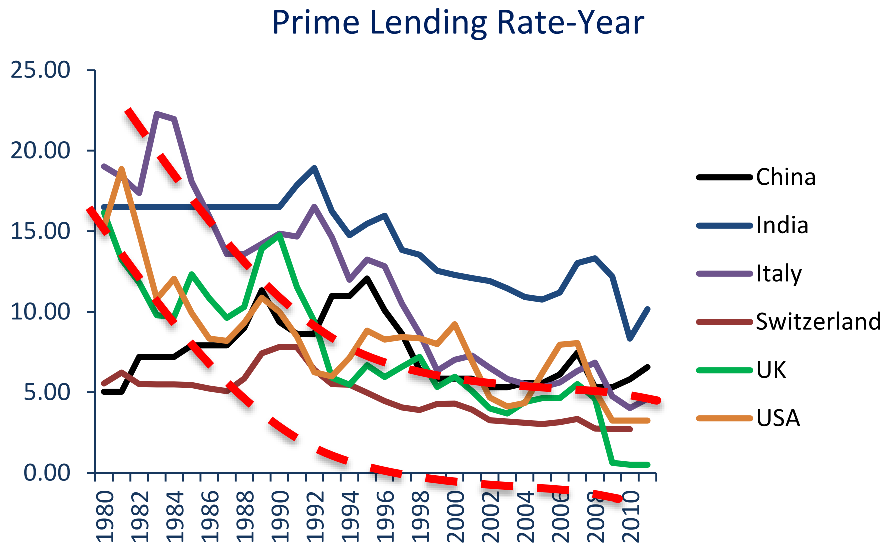
Income Distribution in India, China and USA during 1980, 1990 and 2000



Source: Gapminder

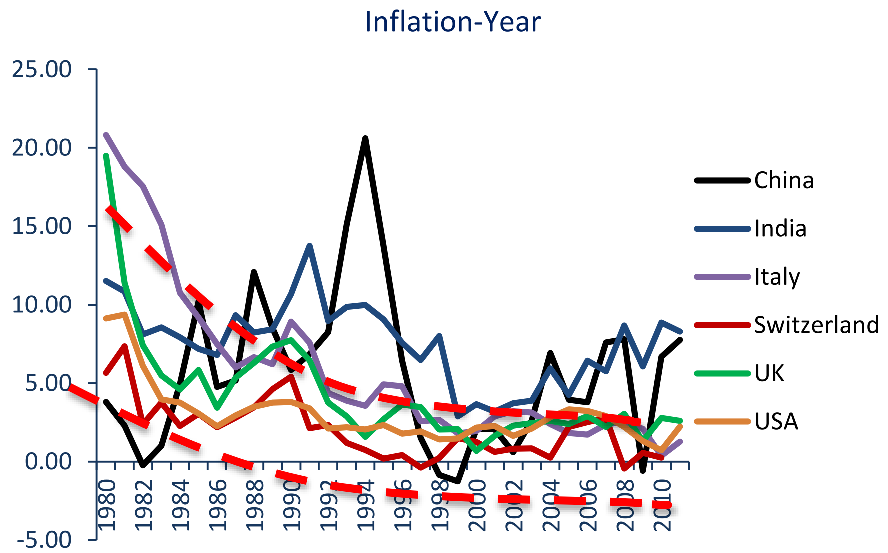
Economic Policy in the Developed World

During the period of study, developed economies have favoured low interest rates. Graph below shows the downward trend in lending rates. India has much higher rates than the advanced economies while China's interest rates are nearer to that of developed nations.



Source: World Bank

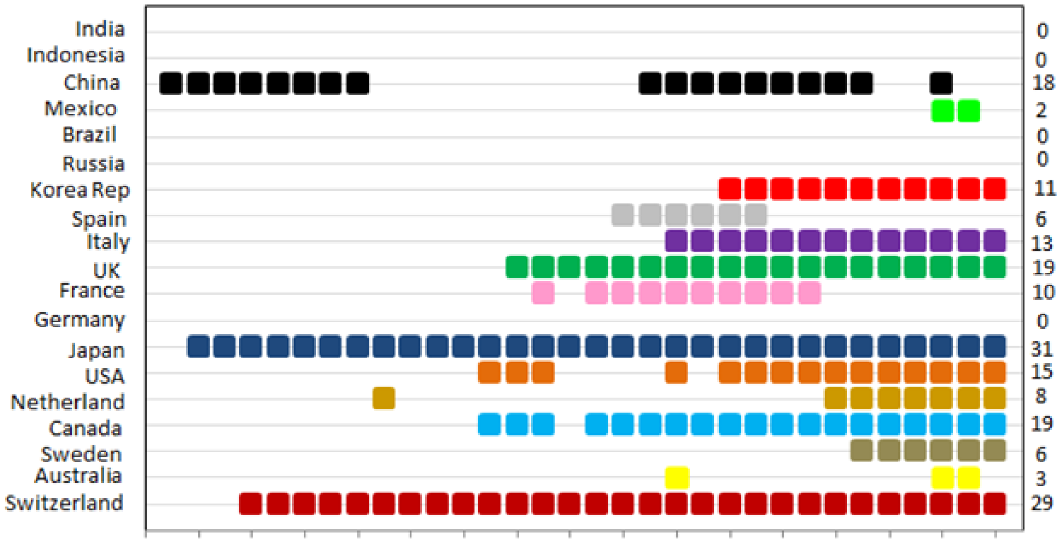
These developed nations were able to control inflation. We attribute this to the low interest rates maintained just after globalisation in 1990's which proved to be beneficial in the long-run. Graph below shows falling inflation for the developed nations. India and China have relatively high inflation rates.



Source: World Bank

Developed Countries are able to maintain low interest-low inflation combination. Figure below shows the period of low interest-low inflation for the entire sample. India has no year where inflation was lower than 5% and interest lower than 8%. China has 18 years when both the parameters were low. This may be the reason why China is developing at a faster rate. It might be possible that in India's case high interest rates are contributing to high inflation.

Years with low interest-low inflation combination



Source: World Bank

Money Growth Does Not Always Cause Inflation

According to quantity theory of money: MV=PY

Where, M = money supply, V = velocity of money, P = price level, Y = real GDP

It is conventional wisdom that higher money supply causes inflation. This false alarm prevents us from doing what we need to do during a slowdown. An increased money supply (due to lower interest rates) will lead to inflation is based on the assumption that V is constant and Y is at its maximum, which implies that there is 100% employment. In such a case, price has to rise to maintain the equality.

Now considering India, where there is large unemployment (9.4%, 2012) and considering its present economic slowdown increase in money supply would not contribute much to the price rise as our GDP is not at the maximum possible level and during a slowdown people tend to decrease their expenditure, decreasing V. Thus low interest rates will lead to increase in productivity and more employment in the nation.

Conclusion

We find that low interest rate is one of the hygiene factors for achieving long term growth. It is not the only factor affecting growth but falling interest rate have a stimulating effect on the economy and it leads to increased investment, output and employment. Small increase in credit growth leads to much larger growth in productivity because of the multiplier effect. Considering the present slowdown in India, increase in money supply may not lead to inflation because of possible growth in GDP. Also lower interest rates will help to achieve faster sustainable-inclusive growth. India needs to learn from developed nations who are following low interest rate regime since last 20 years.

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