

Cutting policy rate, CRR: How much impact do they have?

POLICY EFFECT. Impact of long term or short term interest rates on various segments of investment is not fully understood



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The monetary policy decision announced by RBI on December 6, 2024 raises number of issues relating to the content of monetary policy and also the division of labour between RBI and Monetary Policy Committee.

POLICY RATE AND LIQUIDITY

Two major announcements were made — one was to keep the policy rate unchanged. The second was to reduce the cash reserve ratio by 50 basis points in two instalments which will release liquidity equivalent to ₹1.16 lakh crore.

Two out of the three external members of MPC voted against keeping the policy rate unchanged. One interesting question to ask is whether the final two-fold decision announced by RBI will have an effect different from a reduction in policy rate.

There is some misunderstanding in the way a rise or fall in policy rate works. It is expected that when the policy rate changes, all the other rates in the market also change. Central banks cannot order interest rates. They cannot act like King Canute. Central banks must take such actions as are necessary to raise or lower the rate. If the policy rate is to go up, they must contract liquidity. If they want it to fall, they must expand liquidity. Quite clearly, they must act on liquidity which they normally do through 'open market operations'.

For example, in the US, the Federal open market committee's instructions to the Market Desk on December 18, 2024 began by saying "Undertake open market operations as necessary to maintain the federal funds rate in a target range of 4 ff to 4 fi per cent."

In fact, had RBI lowered the policy rate, it must have acted to expand liquidity. Essentially this is what they have done by reducing the CRR. The reasons given for lowering CRR in the Governor's statement are somewhat unclear. But the release of primary liquidity of the order of ₹1.16 lakh crore cannot but bring down market interest rate. This is the same situation that would have prevailed, had the policy rate been brought down and the necessary follow up actions were taken. Perhaps the signalling effect is different, as people are now accustomed to looking at policy rate for the signal.

CONTROL OF INFLATION

I share the concern of RBI with respect to inflation. My interpretation of inflation targeting framework is when inflation stays persistently above the target and particularly above the upper limit, the central bank must definitely act. The central bank should not be shy of saying that it is acting to control inflation.

Growth considerations are relevant. But the central bank has a special responsibility with respect to inflation. The inflation targeting framework that we have has enough flexibility. It takes into account the compulsions of growth and the need to control inflation.

It is not clear whether the Monetary Policy Committee members had knowledge of the decision to cut CRR or whether they were consulted. If they had no role to play on the decision to cut CRR it is somewhat odd to call the committee Monetary Policy Committee. It is just a Policy Rate Fixation Committee. We should call it so. But

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then it is prevented from taking a holistic view.

The main point I wish to make is decisions to raise or lower policy rates involve concomitant decisions to lower or raise liquidity. In substance, they are not independent decisions. The terms 'Quantitative easing' and 'quantitative contraction' have come into use because of this. In equilibrium, both price and quantity are determined.

IMPACT OF INTEREST RATE

In taking a decision to raise or lower policy rate RBI, for that matter any central bank, must have a clear understanding of the quantum of the impact that a change in interest rate will have. Keynes always thought that the relevant interest rate in this context rate was long term interest rate which affected investment and through the operation of the multiplier affected income or output.

What evidences do we have on the impact of interest rate changes on investment in India? While there are econometric equations dealing with private investment as a whole, there are not enough studies on various segments or sectors of investment. In the US there are many such studies. The broad conclusion from these studies is that only investments of long term nature such as housing are affected by interest rate.

While Keynes talked of long term interest rates, Hawtrey argued it was the impact of short term interest rate on inventory holding that was important. Because of a rise in short term interest rate, inventory holding comes down and the availability of goods increases. This reduces inflation.

The Radcliffe Committee in UK propounded the 'three gears view' on interest rate impact. According to it, small changes in interest rate do not have any effect. Only substantial changes from one gear to another will have an impact.

Some analysts look at interest rate as an element in cost. If interest payments constitute only a small part of the total cost, firms may ignore changes in interest rate. Thus there are a host of issues regarding the link between interest rate and output. Monetary policy relies on interest rate (price) and liquidity (quantity) to bring about changes in the economy. We need lot more studies linking these variables to growth and inflation. We should not ignore the liquidity impact.

FOOD INFLATION

While talking of control of inflation, there is some controversy over whether we should look at headline inflation or some subset. Some argue for 'core inflation' that excludes food inflation. This implies that monetary policy measures do not have any effect on food prices. This is incorrect. Food inflation will be different when money supply or liquidity is at different levels. When food inflation is high, if liquidity is injected for other reasons, food inflation will go up. Given a budget constraint, sharp increases in individual prices will only result in an adjustment of relative prices.

Seven decades ago, strangely while addressing an Indian audience Milton Friedman said, "It is true that the upward push in wages produced inflation, not because it was necessarily inflationary but because it happened to be the mechanism which forced an increase in the stock of money".

It is the policy response to increasing individual prices at the macro level in terms of expanding or contracting liquidity that impacts the general prices level or inflation.

The current inflation targeting mechanism takes due care of concerns relating to growth and inflation. The flexibility allowed should be wisely used.

The writer is former Chairman, Prime Minister's Economic Advisory Council and former RBI Governor