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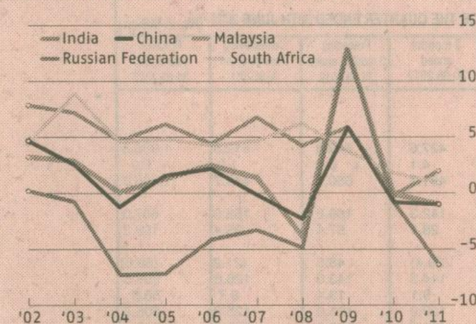
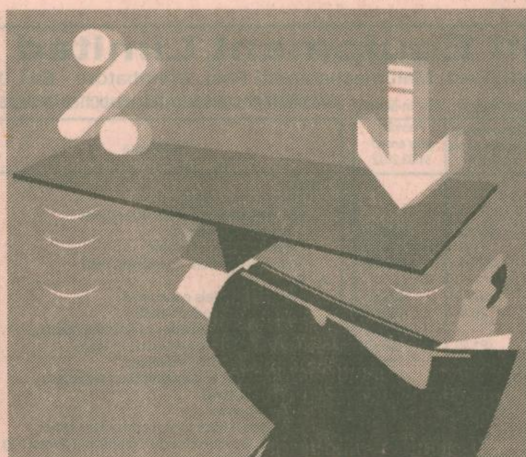
REAL INTEREST RATES: INDIA, CHINA, MALAYSIA, RUSSIA , SOUTH AFRICA – 2002-2011



Source: http://data.worldbank.org/indicator/FR.INR.RINR/countries/IN-CN-MY-RU-ZA?display=graph



Decision analysis for interest rates-II

India needs to make practical choices that prioritise growth, argues Shyam Ponappa

A UN report last June stated: "...the increasing independence of central banks, tighter monetary policy, and inflation-targeting regimes, unnecessarily high — and sometimes, pro-cyclical - -policy interest rates were probably one of the most important contributors to the worldwide slowdown in growth..."[1] The economy is slowly grinding down as high interest takes its toll. While fear of inflation is understandable, demand-side resolve will not help our supply problems.

Surely monetarists also see growth as being dangerously low for India, with its large, explosive, not-so-well-served, -educated, nor -prosperous population? Focusing on anything except growth as the highest priority is a mistake we cannot afford. Everything else depends on it, whether it is feeding people, clothing them, providing livelihood, sanitation, shelter, electricity, social stability, even law and order.

My previous column (*Business Standard*, July 5, 2012) explained how lower interest rates could improve growth by increasing net profits. The purpose was to demonstrate the application of decision analysis through simulation, using financial process-flow logic. The question addressed was: what happens if interest rates are lowered in the present circumstances? Answer: profits would rise, reviving growth through higher income, employee compensation and taxes, with more savings and investment.

Consider what might have happened. In March 2012, net profit was 8.8 per cent of total revenues for 2,840 companies.[2] This would have risen to 11 per cent by June if interest costs fell 20 per cent per the example. With some reduction in raw-material costs, net profit could have risen further.

What actually happened? The RBI held firm, and net profit stayed about the same at 9.1 per cent (+0.3) for the quarter ended June (711 companies reporting by July 30, roughly 25 per cent). This was despite revenues dropping by about 3 per cent, higher taxes (0.4 per cent), and interest costs rising from 11.1 per cent in March to 17.3 per cent, as expenses dropped by 7 per cent with big cuts in inventories.

Commentary

Some issues in responses to the earlier article are outlined below, assuming an understanding of finance and awareness of economic history.

1. Straw-man arguments: Zero rate or 100 per cent debt

Some readers asked, why not a zero rate? Answer: misallocation and lower productivity. Others asked, why not 100 per cent debt? Answer: bankruptcy risk. Still others suggested that providing support to business was not the only requirement. This is addressed above in growth being the highest priority. Reducing rates from current levels does not mean dropping to zero, nor ignoring prudential norms for debt/equity. Our goal is presumably sustained growth, not volatility with risk. Near-zero rates are known to create problems through misallocation, asset bubbles, and reduced productivity, e.g., in Japan, the USA, and the UK. However, Switzerland used low rates to tackle an overvalued currency in the late 1970s.

Low rates induce a propensity to higher debt. This is because of a tendency to misconstrue the Modigliani Miller theorem, viz., that a firm is valued by the earning power of its assets and their risk unrelated to capital structure, to mean that high leverage has no adverse consequences. The lower the rates, the more the temptation to leverage, and the greater the risks.

2. The "correct" interest rate

If rates were cut, what figure would be "correct"? Instead of a search for the perfect mathematical step, it is much more important to act in the right direction. Simulation helps to establish an appropriate range. Within that range, the rate is less important than that it's a significant cut in these circumstances (1 per cent?), while not being too drastic. This is not a theoretical search for a perfect rate, but a pragmatic step to induce growth, for India to regain its investment destination status.

The idea of a closed-form point estimate that is "correct" is misplaced, because correctness depends on circumstances, timing, and cultural/emotional/political responses, i.e., animal spirits. Simulation helps in exploring the range of probable outcomes for causal factors. Each factor has its own probability distribution, sometimes contingent on others (a Markov chain), yielding a range of probable outcomes, and not a point estimate.

3. The RBI intended to slow growth

One view is that the RBI slowed growth in the hope of containing inflation. Therefore, criticising it for achieving the intended result serves no purpose. Surely the intention was not to slow to this extent?

Other critical issues: Processes for growth

Apart from lower interest rates, certain fundamental processes also need to be addressed with undiluted focus. These are goal setting, prioritisation, and coordination.

a) Goal setting: Capital requirements

India needs capital to grow, from both domestic and foreign investors. Paradoxically, growth is a critical prerequisite. If this is seen as greed or sophistry, let's devise a better plan.

b) Prioritisation: Growth is the first requirement, as everything else depends on it.

c) Coordination: Effective coordination is the key to achieving growth. This is exemplified by the current state of electricity distribution, despite the addition of 20,000 Mw of capacity last financial year, mostly stranded, with the supply of coal supposedly being addressed, but without positive results.

Real interest rates (and growth)

In addressing these processes, one problem is conflicting information, for example on real interest rates. Does India have negative rates as some claim? The chart above shows World Bank data until 2011, with India's generally higher rates.

Food inflation (and growth)

Food inflation is constraining interest rate cuts. The RBI's statements and some commentators' remarks lamenting that food inflation prevents rate cuts epitomise a misapprehension about supply and demand that sorely needs resolution. A recent study covering four states (Bihar, Punjab, Uttar Pradesh, West Bengal) suggests that rainfall drives agricultural output in Uttar Pradesh and West Bengal.[3]

The report concludes that supply side problems primarily affect food prices, not fluctuations in demand. Add supply constraints from inadequate infrastructure and distribution processes, and it is clear that high interest rates cannot possibly solve the problem of food inflation.

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1: "The Scorecard on Development, 1960-2010: Closing the Gap?", Mark Weisbrot and Rebecca Ray, June 2011: http://www.un.org/esa/desa/papers/2011/wp106_2011.pdf
2: http://www.moneycontrol.com/earnings/
3: "The Curious Case of Indian Agriculture", Nilanjan Banik and Basudeb Biswas, April 28, 2012: http://mpra.ub.uni-muenchen.de/38634/1/MPRA_paper_38634.pdf