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Does monetary policy really work?

By targeting aggregate demand across the whole economy, monetary policy may be too blunt an instrument to tackle the ongoing inflationary pressures in the economy, instead adding to the already chronic high unemployment rates in the country

SASHI SIVRAMKRISHNA

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The Reserve Bank of India has just announced a 50 bps or 0.5% hike in repo rates to 5.4% as a measure to control inflation, which is presently above its target level. The transmission mechanism of monetary policy is simple: increased repo rates would mean that commercial banks can access reserve money from the Reserve Bank of India for interbank settlements at higher rates and would therefore charge the final borrowers including households and businesses higher rates of interest on loans. With increased costs of borrowing, the non-banking private sector will defer spending thereby contracting aggregate demand and consequently, inflation.

However, there are many slips between the cup and the lip. While most of these pertain to the responsiveness of the banking sector to pass on the costs or benefits to their borrowers in the same measure hoped by the central bank, there are others that remain unaddressed and unanswered both theoretically and empirically.

Higher interest rates would mean higher interest pay-outs not only on government debt but on all debt. While the latter would mean a mere change of hands of money from borrowers to lenders, higher interest payments on government debt in effect boils down to higher government spending, which, all else constant, would mean net additions to aggregate demand and inflationary pressure. Interestingly, if we look at the first few months of the Volcker experiment in the US, we find that while the interest rates were increased from 11% in September 1979 to 18% in April 1980, the inflation rates soared from 9% to more than 14% in the same period. From then on, interest rate cuts from their peak to 9% in July 1980 coincided with a falling inflation rate over the next quarter. Although this does not establish cause and effect, the facts are too stark to be ignored.

A paper by Kang-Soek Lee and Richard Werner empirically tested data on nominal growth, 3-month interest rates and 10-year bond yields for the US, UK and Japan over 52 years only to find that higher growth led to higher rates and vice-versa. Importantly, the causation happens from growth to interest rates and not the other way around. Even for India, even a cursory look at gross fixed capital formation or investment shows a secular decline between 2012 and 2019 even as interest rates were consistently lowered during that period.

If we were to go with conventional wisdom that higher rates would increase the costs of borrowing and contract investment demand of businesses, the long-term implications of this are disconcerting. If physical capacity-building for the future is being constrained by the present hikes in interest rates then this may mean greater and more chronic supply-side bottlenecks in future, ultimately contributing to inflation when demand revives. In a study of three sectors of the US economy, namely the semiconductor industry, housing and oil, **Alex Williams** found that 'reflexive turn to monetary policy as an inflation control measure may risk worsening this [physical] capacity shortage.'

The close relationship between fiscal and monetary policy also remains tentative. If monetary policy effectively slows down economic growth and reduces the rate of inflation, there is a possibility that the former will mean a larger fiscal deficit, which is after all an automatic stabilizer. This larger deficit could then, according to conventional wisdom, induce inflationary pressures in the economy, drawing the economy into a vicious loop of austerity, falling investment, capacity shortages and inflation.

Returning to the Volcker years, a **study** argues that it was fiscal policy that actually induced a recession and brought down inflation in 1980. This is because high inflation rates reduced the *real* fiscal deficit. Adjusting for inflation, the fiscal deficit in 1980 was just about 44% of the deficit in 1976. Fiscal deficits are usually discussed in nominal terms and real spending is not considered. During periods of high inflation, lower real fiscal deficits, unadjusted for inflation, may induce a slowdown, while making it seem that monetary policy is effectively countering the boom.

All these conflicting views only add to the many existing doubts over monetary policy actually addressing the true causes of the current bout of high rates of inflation across the world: higher profits by oligopolistic businesses, the supply-chain disruptions post-Covid and the ensuing Ukraine-Russia war. By targeting aggregate demand across the whole economy, monetary policy may be too blunt an instrument to tackle the ongoing inflationary pressures in the economy, instead adding to the already chronic high unemployment rates in the country.

As suggested by Modern Money Theory economist, **Stephanie Kelton**, it is necessary to consider some of the thoughts expressed by US Senator Ayana Pressley: 'There's an old adage that if all you have is a hammer, everything looks like a nail… The Fed knows that raising interest rates will not address the root causes of rising prices…we need a more sophisticated toolkit … to tailor a more precise response to inflation … Regulating the availability of credit in the specific sectors of the economy experiencing high inflation without impacting other sectors.'

In the Indian context, while the RBI has to deal with other issues in addition to inflation, including exchange rate movements on account of the recent hikes in interest rates by the US Federal Reserve, monetary policy as a tool for inflation control needs rethinking.

Sashi Sivramkrishna studies macroeconomics from a Modern Money Theory (MMT) perspective.

Views are personal and do not represent the stand of this publication.

SASHI SIVRAMKRISHNA *is an economist, economic and environmental historian, and documentary filmmaker. Twitter: @Sashi31363.*