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Subir Gokarn: The interest rate pendulum

Fiscal, rather than monetary, forces will determine interest rates in the coming months

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Fiscal, rather than monetary, forces will determine interest rates in the coming months, says *Subir Gokarn*

When oil prices turned down sharply in July 2008, the global inflation surge that had been in force since early in the year virtually came to an end. This allowed central banks around the world to reverse their anti-inflationary positions and begin to focus on dealing with the recession which was, by then, gaining in severity.

From about August 2008 right through the first half of this year, central banks typically brought down their policy rates at regular, even frequent, intervals. Many went further by infusing additional liquidity as well, a process that culminated in the "quantitative easing" measures that the US and Japan initiated when their policy rates had effectively reached zero.

With all of this monetary action, one would logically have expected that market interest rates would also decline considerably, a development that would in turn have stimulated borrowing and demand for goods and services. This is how expansionary monetary policy works in the textbook. But events proved otherwise. In many countries, market interest rates began rising in early 2009 and have continued to harden ever since.

In India, the yield on 10-year government securities, which is widely viewed as a market benchmark, reached its lowest monthly average of 5.2 per cent in December 2008. It has since risen consistently. The average level in June 2009 was 7 per cent and it has not changed very much during July.

The same pattern is visible in virtually all the major economies in Asia. During the period April-June 2009, the yields on 10-year government securities in India rose by 70 basis points (bps). Those in Australia rose by 90 bps, while the increases in New Zealand matched India's. Rates in Singapore and Hong Kong rose by 60 and 50 bps respectively, while Korea, Thailand and Malaysia experienced increases of 40 bps. The only notable exception was Indonesia, which saw its yields drop by 110 bps, although this was smaller than the 220 bps drop in the preceding six months.

It is quite clear why rates have been behaving differently from textbook predictions. When fear about the depth of the recession peaked in the aftermath of the Lehman Brothers bankruptcy, fiscal stimulus packages became the order of the day. China announced its mammoth $589 billion package in November and many countries initiated their own measures over the next few months.

India's supplementary budget amounting to Rs 237,000 crore was passed in October, effectively being one of the first fiscal packages in the world, even though it was hardly recognised as such. The Interim Budget pegged the fiscal deficit for 2008-09 at 6 per cent of GDP, with another approximately 1.5 per cent accounted for by off-budget subsidies. With the number for 2009-10 now in at 6.5 per cent (though the subsidy burden will be significantly lower than last year because of lower oil prices), the fiscal stimulus effectively works out to 3.5 per cent of GDP, if one accepts the FRBM ceiling of 3 per cent as a 'normal' situation.

In India as elsewhere, these large increases in government borrowing requirements cannot but push interest rates higher. In effect, even as the economy gradually moves into the upward phase of the business cycle, interest rates have already moved to levels that would be consistent with it being at the trend rate of growth or even, perhaps, in a boom phase.

As the proposed government spending materialises, the pace of recovery will unquestionably pick up. At this point in the cycle, it is quite reasonable to argue that private spending — consumption and investment — is unlikely to spur growth so the government has no choice but to step in, regardless of what impact it might have on interest rates. But, looking ahead a few months, inordinately high interest rates will almost certainly impact on the pace (possibly) and the composition (certainly) of the recovery.

The robustness of the recovery is significantly dependent on its ability to spread as widely as possible across sectors. The prospects for many sectors will, in turn, depend on the availability and cost of finance. Both retail and wholesale borrowers have to compete with the government, an unequal battle as far as most lenders are concerned. Why take chances with consumers and corporates in an environment in which uncertainty still prevails and default risk remains high? High-yielding government securities are an attractive proposition in these circumstances.

If this is the case, there is a risk of the recovery momentum being confined to sectors directly linked to government spending patterns. This may provide a reasonable spread but it obviously cannot make up for persistently sluggish private spending in the face of elevated interest rates. In turn, if private spending is slow to return to its trend rate of growth, government spending will become more and more critical in sustaining the recovery, which could set a vicious circle in motion.

Of course, in the current benign inflationary scenario, central banks with a fair amount of headroom on their policy rates, including the Reserve Bank of India, can consider further easing. But, there are significant arguments in favour of maintaining the status quo in the current situation. For one, the inflation numbers will turn positive in the next few months as the base effect wears off. In fact, oil and commodity prices, not to mention food prices in the Indian case, are already indicating the return of a supply shock, even if it is a relatively moderate one. This could be aggravated by demand pressures resulting from further policy easing. Looking ahead six months or a year, the inflation scenario simply does not look as benign as it does now.

The bottom line is that the key determinants of interest rates over the next few months in India as well as in other countries will be fiscal rather than monetary forces. In countries that manage to balance their budgets during normal times, the process of rolling back deficits should not prove to be too difficult. Relatively high revenue buoyancy should help to roll back the deficit quickly enough to open up the space for private spending.

However, in a situation like India’s in which the deficit is too large to be amenable to business-as-usual solutions, significant new initiatives will be required. News that the disinvestment target will be far more ambitious than the Budget provided for is a positive indication, but much more will need to be done if we are to revert to the textbook.

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