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Boosting Manufacturing - Interest Rates and Inflation

What is the issue?

- The RBI has cut the benchmark interest rate in the recent period with the aim of boosting investments and manufacturing in India.
- But the moves have not brought the intended results and here is a look at the reasons.

What are the recent measures?

- To boost manufacturing, the government sharply cut the corporate tax rate in 2019.
- At the same time, RBI, under the governorship of Shaktikanta Das, has cut the benchmark interest rate (repo rate) in the economy.
- It is down by as much as 250 basis points (bps) between February 2019 and May 2020.
- Over this period, the RBI has also worked with the banks to improve the transmission of these cuts to the banking system.
- Over the last 12 months, for instance, RBI has cut 150 bps and the MCLR (marginal cost lending rate) has come down by 104 bps.

What is the inflation-interest rate link?

- It is not just the nominal interest rates that have come down; even the real interest rates have come down.
- Real interest rate is essentially derived after subtracting the inflation rate from the nominal interest rate.
- [Real Interest (R) = Nominal Interest Rate (N) — Inflation Rate (I)]
- So if the nominal interest rate is 10% and inflation is 8% then the real interest will be 2%.

What was the plan?

- RBI targets retail inflation, which is calculated by the Consumer Price Index (CPI).
- So, it is easy to believe that the real interest rates are coming down.

- If N (Nominal Interest Rate) is falling sharply and I (Inflation Rate) is increasing then, R (Real Interest rate) must be falling.
- In that case, a low real interest rate should encourage businesses to borrow more and make new investments in the economy.
- But this is not happening.

Why is interest rate cut not boosting manufacturing?

- In common perception, "inflation rate" refers to the "retail" (CPI) inflation in the economy.
- This is the inflation that common consumers face.
- But businesses are not exactly like consumers.
- For instance, a steel-producing firm cares little what the inflation in fruits and vegetables is.
- It is more the wholesale inflation that affects the businesses.
- In effect, inflation is something like a proxy of the "pricing power" that a firm or industry enjoys.
- In any economy, this pricing power varies between businesses, say a steel producer, a sanitizer maker, a vegetable grower and a travel agency.
- This variation depends on the market conditions such as the demand for their product, ability to store inventories etc.
- So, while calculating the "R" for a firm in the manufacturing sector, it would be odd to use "retail" inflation.
- Since these products are sold wholesale, the Wholesale Price Index-based inflation is more appropriate.
- Even within the wholesale inflation, it is apt to look at the non-food manufacturing inflation, otherwise called the "core-WPI".

What is the real scenario then?

- So, contrary to common perception, real interest rates have actually gone up in the recent years.
- In effect, the core-WPI has decelerated even faster than the rate at which nominal interest rates have come down.
- This odd situation has arisen because retail and wholesale inflation rates are diverging.
- The RBI targets the retail inflation but the relevant inflation rate to monitor for boosting investments right now could be the core-WPI.

Source: The Indian Express