MANAGING THE INDIAN MONEY MARKET

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The Reserve Bank of India has repeatedly raised the bank rate in the last one year on the grounds that it is necessary to curb inflation and for this purpose make credit more expensive. This follows the classic western model of using a higher credit rate to ease inflationary pressures and to reduce the rate when the economy appears to be heading towards stagnation. In India our recent experience is that with increase in the bank rate and a very substantial increase in the cost of fuel there is a rise in prices and a higher rate of inflation instead of a cooling down of prices. This is largely because our retail purchases are still mainly in cash rather than by credit cards. This has forced me to write on the subject, despite the fact that I have no pretensions to being an economist. Let me confess that this is being written on the basis of instinct rather than knowledge. Sometimes, however, even that which is intuitive merits serious consideration because that which is based on knowledge has failed.

In a well-developed economy the system is entirely monitised. All transactions are based on money availability through earning or through credit. So long as the credit, produce and repayment are balanced the economy remains in equilibrium. When, however, credit exceeds repayment capability and does not result in increase in production, when credit is given against an overvalued asset which cannot subsequently be converted into money terms and thereby the credit cannot be repaid, the system goes into disequilibrium. If there is very easy credit and this results in a change in the consumption pattern it may lead to more money flowing into production, or it may result in too much money chasing too few goods, resulting in inflation. It is here that the central banking system applies brakes through making credit a little more expensive, thus cutting down on consumption and, therefore, having a strong disinflationary effect. A stage may be reached that leads to unemployment, when credit may again be eased through a miner manipulation of the interest rate and the economy may be kick-started by easier availability of money.

In the United States of America and large parts of the western world the system not only went into disequilibrium but into a free fall when there was unprecedented expansion of credit against nonexistent or highly overvalued assets, so that when loans were recalled there was nothing with which to make repayment. One lesson that India should have learnt from that period is that because our economy is by no means as monitised as that of the western world, what happened to the western banking system largely bypassed the Indian banking system. Of course a great deal of credit goes to Y.V. Reddy for holding the Reserve Bank of India steadfastly on a conservative course and refusing to succumb to pressure of the then Finance Minister, P. Chidambaram, to open up the banking sector to private, foreign and Indian investors.

The Indian economy being only partially monitised is only partially affected by banks and the prescribed bank rate. A great deal of trade uses sources of money outside the banking system. Under British rule and shortly thereafter this was known as the informal banking sector, though now it is covered by the generic term ‘black money’. The legitimacy of the hundi and the informal banking sector has been questioned and virtually demolished, as if all financial transactions in India are done through the banks. This despite the universal knowledge that, for example, almost all property transactions have between forty and sixty percent component of cash sourced from outside the banking system. If trade, property transactions, even at least a part of investment in industry comes from outside the banking system, how can manipulation of the bank rate have any major effect on the economy? One area where the bank rate can have an adverse effect is agriculture. To the extent that this affects agricultural credit, which becomes more expensive, the cost of investment in agriculture goes up and pushes up the price of

the agriculture produce. If this is combined with increase in electricity tariff and the cost of fuel, raising the bank rate has a definite inflationary effect rather than a disinflationary one. In other words, whereas manipulating the bank rate may not have a major effect on our economy, except in the organised sector, certainly in agriculture the adverse effect of raising the bank rate would be felt immediately.

Raising the bank rate in an inflationary situation is done on the grounds that if money supply is reduced the consumption market will shrink and if demand shrinks commodity prices will stabilise or will show a downward trend. However, if we see the price index we would find that maximum increase in prices has been in those commodities such as foodstuffs, whose consumption cannot be reduced substantially because a large proportion of the population is already at subsistence level. Therefore, reduction in the money supply through raising the bank rate does not control inflation—it reduces the credit available for production, affecting productivity and because demand is already at the margin and cannot be reduced, it pushes up commodity prices. Simultaneously by making money more expensive for business and industry, it makes Indian business less competitive in the world market and this further affects industrial viability. The interest rate, therefore, as a weapon for ensuring that inflation remains under control, is far less effective than is estimated by our Planning Commission and the Reserve Bank of India.

Does India need old style economists only? Do we not have any economists who think beyond orthodoxy and try to understand India from the point of view of India and not Cambridge University or Harvard University? We need a completely new paradigm for managing our economy because the western model is not really applicable to this country. Anna Hazare and Baba Ramdev want the parallel economy to disappear by forcing people to disclose their wealth and repatriate money into the legitimate system. That will not happen, which means that we must recognise that there is a parallel economy and make a realistic estimate of what it contributes to business, industry, individual incomes, real estate and all the other components of the economy. The new model would then aim at harnessing the parallel economy, not by legitimising black money but by evolving a formula to bring the indigenous banking system and money flows out in the open. Our present approach to the economy just does not work

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