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# A Tale of Two Ineffective Monetary Policies

By Kunal Kumar Kundu

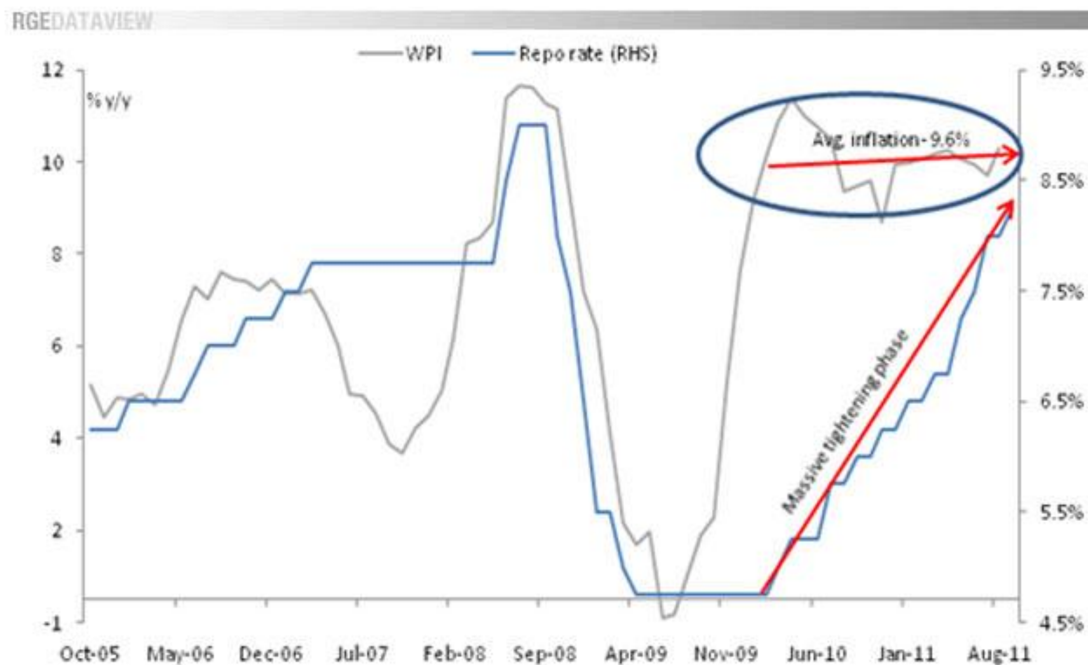
Monetary policy refers to the process by which a country's central bank controls money supply, often through manipulation of interest rates with the aim of promoting economic growth and stability while maintaining relatively stable prices and low unemployment. A monetary policy is either expansionary (mainly by lowering interest rates to combat recession or a recessionary situation) or contractionary (raising interest rates to control inflation).

Interestingly, two different economies are following divergent monetary policies trying to solve their economic riddle – one aiming to control high levels of inflation and the other trying to move out of stall speed of economic growth (nay standing on the precipice of economic recession) with unacceptably high level of unemployment. Here I am referring to the Indian and the US economies and their respective monetary policies. While India's RBI has been tightening the monetary screws (12 rate increases over the past 18 months) unlike ever before, the US Fed is following ultra expansionary monetary policy. However, success has been steadfastly eluding both. So, what gives?

Even at the cost of sounding clichéd, I am tempted to use one of the most abused phrases, 'this time it's different'. The reason I say so is because the past sins are clearly catching up now, rendering the monetary policy actions ineffective. To add to their woes, even the external factors are conspiring against their success.

First let's focus on India. India's average inflation since January 2010 is 9.6%.

**Figure 1: Inflation and Monetary Policy**




*Source: Office of Economic Advisor – GoI, RBI*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The very fact that such a long tightening phase has failed to impact inflation to the extent desired, clearly indicates that inflation in India is mostly structural in nature (and not cyclical). Years of neglect suffered by the agriculture sector are evident from the excessively low level of investment in this sector.

**Figure 2: Gross Capital Formation (GCF)**

| Period | GCF in agri. as %age of total |
|---|---|
| 2004-05 | 2.56 |
| 2005-06 | 2.66 |
| 2006-07 | 2.54 |
| 2007-08 | 2.69 |
| 2008-09P | 3.09 |
| 2009-10QE | 2.97 |

*Note: QE – Quick Estimate, GCF – Gross Capital Formation*
*Source: Economic Survey, GoI*

For a sector that supports about 65% of India's population, there is but a high price to be paid for such neglect. Not surprisingly, agriculture productivity levels in India are among the lowest in the world, as is evident from yield the comparison table below.

**Figure 3: Comparison of Yields (hectogram per hectare)**

*Yield (Hg/ha)*

| Country | Maize | Millet | Onions, dry | Potatoes | Pulses, nes | Rice, paddy | Tomatoes | Wheat |
|---|---|---|---|---|---|---|---|---|
| **China** | 53,518 | 17,443 | 210,426 | 145,308 | 20,000 | 65,901 | 226,740 | 47,480 |
| **France** | 91,081 | 57,142 | 222,222 | 437,909 | 45,454 | 57,066 | 1,611,111 | 74,466 |
| **Germany** | 97,499 | n/a | 482,093 | 440,557 | 24,000 | n/a | 2,233,333 | 78,084 |
| **India** | **20,595** | **8,180** | **162,649** | **188,134** | **5,333** | **29,767** | **186,126** | **28,408** |
| **Indonesia** | 42,372 | n/a | 102,434 | 164,745 | 5,000 | 49,985 | 165,985 | n/a |
| **Japan** | 25,384 | 10,234 | 480,833 | 327,647 | n/a | 65,224 | 578,145 | 32,366 |
| **Pakistan** | 36,705 | 6,155 | 131,626 | 202,848 | 7,423 | 35,811 | 100,887 | 26,567 |
| **Philippines** | 26,208 | n/a | 87,624 | 148,948 | 8,648 | 35,889 | 112,400 | n/a |
| **Sri Lanka** | 25,515 | 10,876 | 133,549 | 149,033 | n/a | 38,002 | 103,529 | n/a |
| **Thailand** | 41,779 | n/a | 147,368 | 165,948 | 10,126 | 28,698 | 187,967 | 10,000 |
| **UK** | n/a | n/a | 407,230 | 414,387 | 29,333 | n/a | 4,106,018 | 79,266 |
| **USA** | 103,389 | 18,868 | 565,628 | 462,734 | n/a | 79,412 | 806,079 | 29,886 |

*Note: HG/HA – Hectogram per Hectare*
*Source: FAO*

Hugely inadequate physical infrastructure in agriculture (be it irrigation, cold storage facility, transportation etc) not only leads to low levels of productivity but also huge loss of foodgrain due to improper storage. In India, more than 10% of foodgrain production gets wasted every year. As per the report of the 11th Planning Commission, preventable post-harvest losses of foodgrains are estimated at about 20 million tonnes a year, which is nearly 10.5 percent of the total production. To put things in perspective, India wastes close to 50% of Australia's annual foodgrain production. Even a bumper crop is a problem for India and the country had to resort to exporting foodgrains this year to tide over the storage problem, while every day millions of Indians go to bed hungry.


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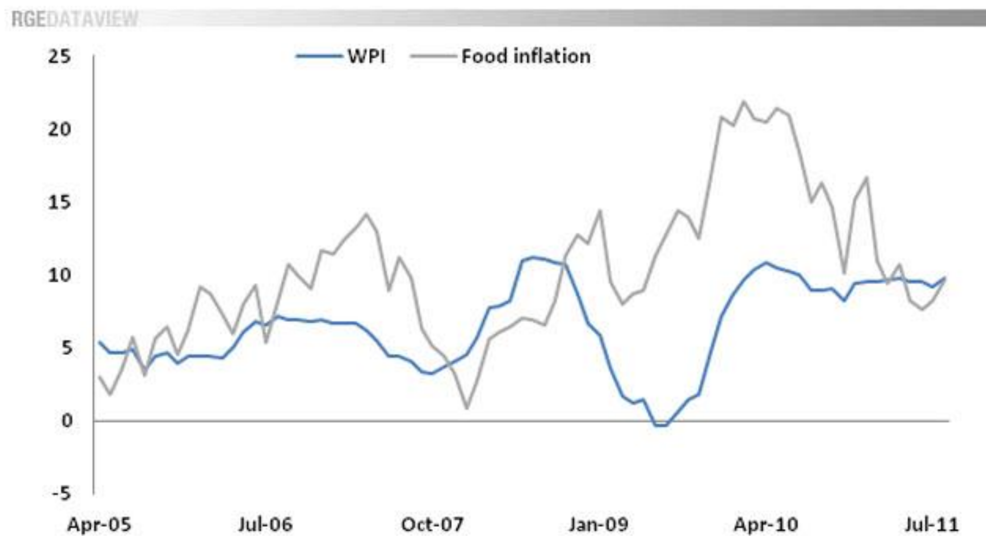
Not surprisingly, food inflation remained persistently high in India, which has started feeding into overall inflation.



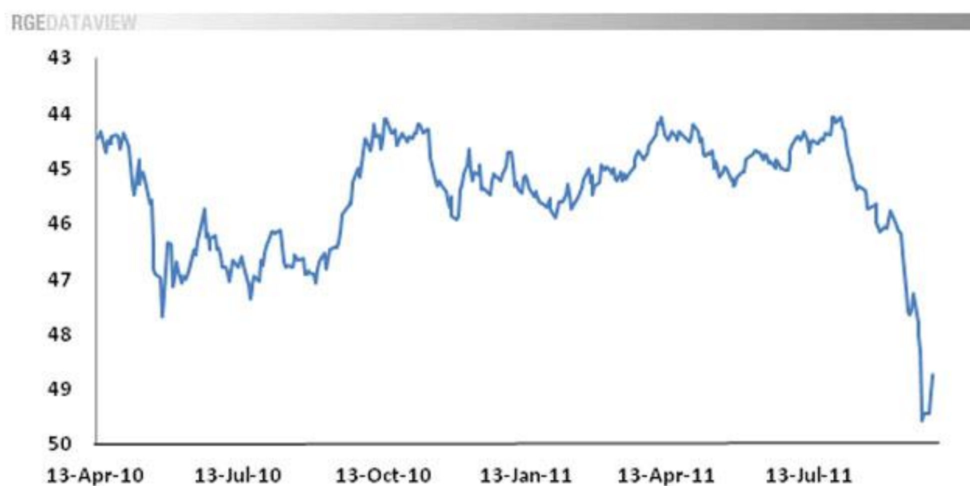
**Figure 4: WPI/Food Inflation (%, y/y)**




*Source: Office of Economic Advisor – GoI*

Also, as has been enumerated in my previous posts, inflationary pressures are also coming from the trade channel through persistently high prices of oil and other commodities. The problem has been further compounded by the recent depreciation of the INR, mainly on account of perceptible retreat of forex flows due to dimming appetite for EM risk assets, as European sovereign debt crisis continues to boil.

**Figure 5: USD/INR**




*Source: Bloomberg*

This is leading to imports becoming even costlier (negating the effect of some recent softening of commodity prices), further adding to inflationary pressures and thereby rendering the central bank's monetary policy efforts futile. All these, despite clear evidence of demand destruction in India.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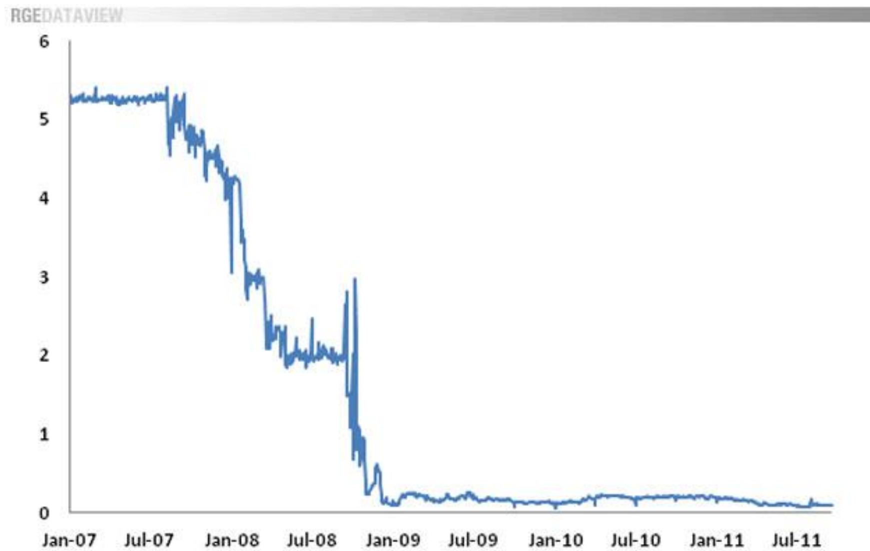
At the other end of the Monetary policy spectrum lies the US Fed.

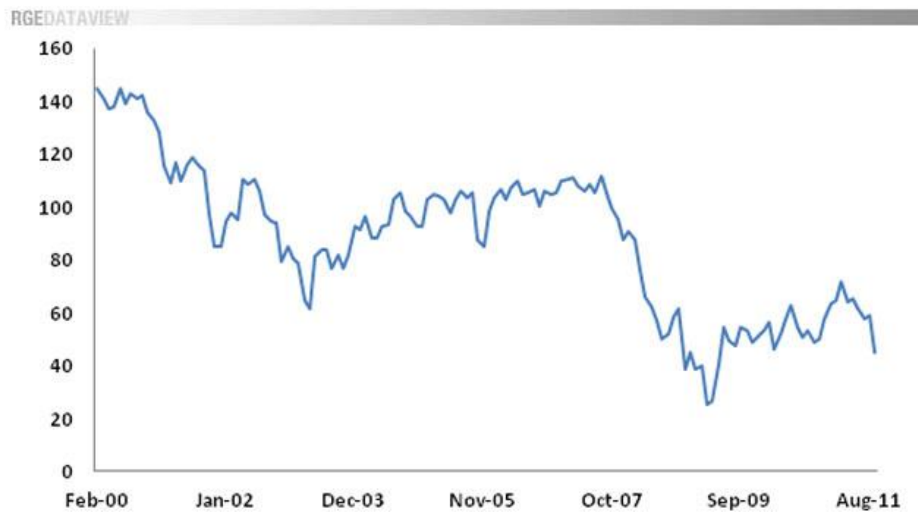
**Figure 6: Fed Funds Rate**




*Source: Fed*

As the global crisis erupted, the Fed acted quickly and embarked on an easy money policy as fast as it could. However, with the Fed Fund rates being close to zero as possible and for a fairly longish period of time, the Fed is no longer left with any further policy bullets except for keeping the rates low for an extended period of time, which is what it is doing. Here again, such an extended period of ultra low interest rate has not been able to ratchet up the economy. With house prices yet to bottom out and unemployment levels remaining stubbornly high, the excessively leveraged US consumers seem to be thoroughly down and out. The Conference Board Consumer Confidence Index stagnated at its two year low in September, indicating that the consumers are deeply worried about the state of the economy and hence about their income and employment situation.

**Figure 7: Conference Board Consumer Confidence Index**




*Source: Bloomberg*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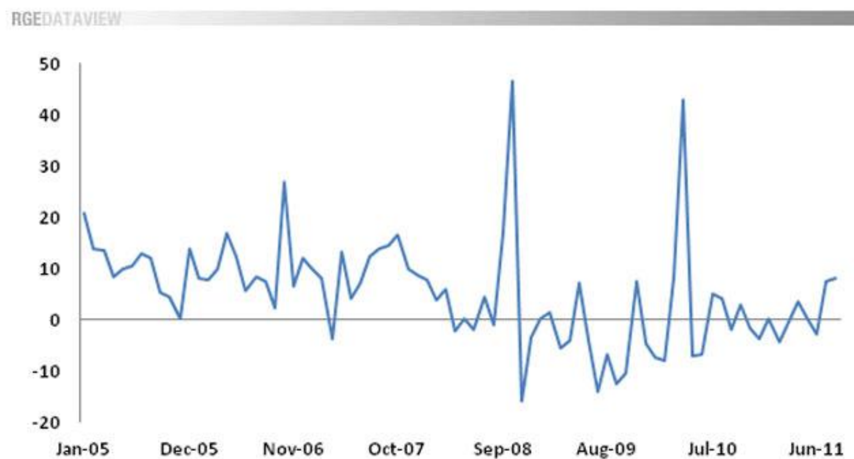
With the consumers retreating and the crisis of confidence becoming all pervasive, the low interest rate regime simply failed to spur the economy. The limitation that 'close to zero' interest rates entailed forced the Fed to go for QE. Unfortunately, even this did not help much. Credit growth did not perk up as much and all that the QE resulted was in rising excess reserves (rather than further lending), as the credit worthy borrowers refrained from borrowing and the lending institutions also preferred to hold tight, given the crisis of confidence and for fear of tighter regulations.

**Figure 8: Bank Credit (%, SAAR)**




*Source: St. Louis Fed*

With corporate profits moving to record high levels, most of the companies, especially, the non financial ones, preferred to use up their cash to deleverage. Same goes for the credit worthy consumers. Even the tax breaks that were afforded and the transfers that were made were, to a great extent, used to reduce debt. Although it did help to arrest the slide of consumer spending, there was no major increase in the same. Even the vast sum of money that was utilised for 'cash for clunker' scheme or the 'second home buying scheme' helped the economy to perk up only in the short term and the positive multiplier effect faded away soon. Of course it did not help that Europe was hurtling deeper and faster into trouble.

Fact also remains that, both the central banks did not necessarily take the right decisions always. However, these been debated enough in the public domain and hence beyond the scope of this article. Even the politicians of both the countries played significantly important role in spoiling the party – in the US through one-upmanship and in India through sheer inertia (policy paralysis for some). Reminds me of what Charles Dickens wrote in his 'A Tale of Two Cities' (it was the age of wisdom, it was the age of foolishness .....), in a slightly altered form though – when the world needed wisdom, foolishness was more on display.

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