The BEST interest rate policy

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It is often hard to change the mindset. But progress depends crucially on flexibility in the thought process. So, it is imperative that we change our mindset as and when the need arises. Otherwise, history can repeat itself in bad ways. The issue here is the interest rate policy.

This article is based on this author's book (Singh, forthcoming). This piece will begin by explaining how the all too familiar prevailing interest rate policy intervention is blunt, not very effective, large-sized and non-transparent. The article will go on to provide an alternative interest rate policy which is innovative and BEST - Better-targeted, Effective, Small-sized and Transparent compared to the prevailing policy.[1]

The prevailing policy

The Reserve Bank of India (RBI), like any other central bank, faces a paucity of policy tools. To see this, let us consider, for simplicity, the simple macroeconomics textbook setting of a closed economy. The RBI has, let us say, two objectives - low and stable inflation, and "full employment". But it has one (main) policy tool, the interest rate. So, the prevailing interest rate policy is not very effective. Of course, it is well recognised that the transmission of the central bank's policy can be weak and that aggregate demand can be interest inelastic. But there are also other serious difficulties that need to be confronted.

Under the prevailing policy, the interest rate needs to be changed now and then by the RBI. It is interesting that much of the variation in the interest rate is not due to the market forces but is due to the central bank's policy. The variations matter because there are serious side-effects for asset price stability, and distribution.

Briefly, the interest rate risk goes up in asset markets with frequent changes in the interest rate by the RBI. When it is reduced, asset prices, ceteris paribus, rise. And, when interest rate is raised, asset prices can fall. Asset prices include not only bond prices but equity prices and real estate prices as well. The path from a low interest rate to a high rate, and vice versa can be, in practice, quite uncertain - notwithstanding the communications from the RBI. So, asset prices can fluctuate. This can, in turn, affect balance sheets of banks and other such financial institutions, given that these tend to hold a large amount of bonds. This is not all. Changes in the interest rate can affect interest incomes for the middle class (the rich do not invest very much in instruments like bank deposits). Also affected are the pensioners, widows, endowment funds of educational and research institutions, non-governmental organisations (NGOs), resident welfare associations (RWAs), etc. which hold simple debt instruments like bank deposits.

The side-effects of the prevailing policy are even more serious in the more realistic case of an open economy but these are outside the scope of this article. Is it inevitable that (a) the policy is not very effective in maintaining low and stable inflation, and "full employment", and (b) the policy has adverse side-effects for asset price stability, and distribution?

Paving the way to the proposed policy

We have observed over decades that the central bank sets the interest rate. This is what we are very used to. And, this appears to be natural, obvious, intuitive, and perhaps even axiomatic. In the light of all this, it is hard to think that we can have anything different in this context. But there is an alternative.

Before we come to the alternative policy, it can help to make three observations. First, interest rate is a price like any other price in an economy; it is, albeit, a very important price. Second, when the central bank sets this particular price which is the interest rate, it is a case of, what we otherwise know of as, an administered price. Third, the general way in which a price is changed by the public authorities includes not just the case of administered pricing but also a change in price through a tax-subsidy scheme by the Ministry of Finance (MoF). A subsidy can reduce the effective price while a tax can increase the effective price. These observations pave the way for considering a tax-subsidy scheme by the MoF not just in the context of changing the prices of goods and services but even in the context of changing a special price like the interest rate. Now this may sill seem abrupt but a little further explanation can help.

When the RBI lowers the interest rate, it reduces the interest costs for all borrowers and it reduces the interest incomes for all depositors or lenders. It is as if the RBI is giving a subsidy to all borrowers and it is imposing a tax on all depositors. So, already we have an implicit tax-subsidy scheme when the RBI lowers the interest rate. And, we have an opposite implicit tax-subsidy scheme when the RBI raises the interest rate. This brings us to the possibility of using an explicit and transparent tax-subsidy scheme by the MoF for the purpose of setting the interest rate right such that the policy is well-targeted, effective and small-sized.

The proposed policy

Suppose that aggregate demand is low and we have (growth) recession. As we know, the market interest rate tends to be low in such times due to low investment (savings are less adversely affected, if at all). But the borrowers will not invest beyond a point unless the interest rate is lowered further, given the recession. Suppose that the MoF, and not the central bank, intervenes to affect the interest rate. Further, suppose that the MoF gives a clear subsidy on funds that are borrowed for the purpose of real investment and housing, and not for financial investment. So somebody like Warren Buffet cannot borrow at the low

subsidised rate to invest in, say, the stock market! This is not to single out a person but just to give an example.

With any clear subsidy, there are two prices. Here, we have two interest rates. One is the interest rate observed in the market. The other is the effective (post-subsidy) interest rate. The latter is for borrowing for for real investment or housing. The former is for all other purposes. The subsidy can, as expected, shift the demand for funds upwards and so the interest rate observed in the market rises towards the normal level. At the same time, the effective (post subsidy) interest rate is reduced towards, what is known in macroeconomics as, the (low) neutral rate.

As the effective (post subsidy) interest rate is reduced for borrowers for real investment and housing, the aggregate demand in the real economy is increased from the low level in the recession. We have here macroeconomic stabilisation, which is the objective. And, as the interest rate observed in the market rises towards the normal level, it follows that the interest incomes, the asset prices, and the banks' balance sheets are all stabilised, and not destabilised, over an economic cycle under the proposed policy. So, the proposed policy is not blunt. And, given that the proposed policy is better-targeted, it is small sized; the amount of explicit subsidy or tax is smaller than the corresponding implicit subsidy or tax under the prevailing policy.

All this is the story of a recession. An opposite scheme can be used in (unhealthy) boom, which is to say that the MoF can impose a tax on borrowing for the purpose of real investment and housing. It is true that the proposed policy will lead to a higher fiscal deficit in recession and a lower fiscal deficit in boom but this is, as John Maynard Keynes taught us, desirable.

Whether it is recession or boom, the proposed policy applies to borrowers only. It does not apply - at least not directly - to the depositors and lenders. To the extent that it does apply indirectly, which is called tax incidence in economics, it is stabilising, as seen already.

It may be argued that the proposed subsidy in a recession may not be entirely used for real investment; some may be misused for financial investment. However, this argument is missing the large picture. In any case, what is being termed misuse under the proposed policy is allowed by law under the prevailing policy. So, even if there is some "misuse", the proposed policy is better-targeted compared to the prevailing policy.

We can now come to an important aspect. Since the change in interest rate is, under the proposed policy, handled by the MoF, the RBI can no longer use interest rate as its policy tool. But it can use the money that it issues as a policy tool. We have here an interdependence in the use of the policy tools by the RBI and the MoF. This is because central bank money can affect interest rates in the market, which has implications for the quantum of clear subsidy or tax that the MoF needs to use to affect the interest rate. However, interdependence in policy does not imply trade-off in policy.

We have now two *distinctive policy* tools - one with the MoF (which is the explicit tax-subsidy scheme to affect the interest rate) and the other is with the RBI (which is the central bank money). Since there are two policy tools and two macroeconomic objectives of low and stable inflation, and "full employment", there is, in principle, no trade-off in policy. It is true that money is often not a very useful policy tool in the short run but it is an additional policy tool now. So, the proposed policy is more effective than the prevailing policy.

The proposed policy is new but it is consistent with Pigou (1920), Keynes (1936), Tinbergen (1952), Friedman (1959), McCallum (1999), Jorda, et al (2013), Jeanne and Korinek (2019), and Kashyap and Stein (2023), though for a different reason in each case.

Conclusion

The prevailing interest rate policy has serious difficulties. A new interest rate policy has been proposed here. It is BEST - Better targeted, Effective, Small-sized and Transparent as compared to the prevailing interest rate policy. It needs to be seriously debated, if not accepted. The innovation here can have far reaching implications in theoretical economics and in practice in India and in the world economy at large.

[1]This article considers, for simplicity, a closed economy and abstracts from issues like the zero lower bound on the interest rate, different kinds of interest rates, cost-push inflation, possible implementation issues, asymmetric use of policy over an economic cycle, and Keynesian fiscal policy, which is not to say that fiscal policy is more generally absent here. But the assumptions can be relaxed, which is the case in this author's book (Singh, forthcoming).

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