

“The single-minded focus on inflation targets is not necessarily desirable or even achievable in a country like India” – Jayati Ghosh

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The debate over the state and future of the Indian economy has been rife over the last couple of years but increasingly there is a sense that the time to determine the course of its future is now or never. The current government was arguably elected on the mandate of economic reforms and development but the two most decisive steps have been taken by the Reserve Bank of India, led by Governor Raghuram Rajan. Earlier this year a new monetary policy framework that for the first time sets the agenda of the central bank as inflation targeting (CPI 4% with a band of +/-2% from financial year ending in March 2017), came into place and in September this year a surprise rate cut of 50 bps was announced, that added considerably to the 75 bps cut made gradually over the course of the 2015.

*In this context, Pragya Tiwari spoke to **Jayati Ghosh** about the potential of this rate cut and about the role of monetary policy in the current state of the Indian economy. In the first part of this [two-part interview](#) they discuss inflation targeting and wage-led demand.*

Click [here](#) for part two of the interview where Jayati Ghosh discusses savings, transmission and the need for greater public spending.

Is the new monetary policy framework a step in the right direction? What is your take on the debate on inflation targeting?

I am not a fan of inflation targeting, I believe in a country like India it's much more important to have multiple targets and there have been many studies that have shown that inflation targeting is not very effective, especially in a country which has a very large informal sector; where there is a significant element of cost push inflation; where there are often very specific sectoral bottlenecks that can generate inflationary tendencies, and also where we have a real concern about employment generation. So I would say macroeconomic policy, which includes monetary policy, has to be focused on a range of targets. Yes, you want economic stability and therefore some degree of limit on inflation but you also want to generate economic activity and particularly generate employment. So, I don't believe that the single-minded focus on an inflation target is necessarily something desirable or even achievable in a country like India.



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Not even flexible inflation targeting with a band?

When you are in a slump, a band of two percent is not a big deal. You really do need to look at a range of targets – where you are in the business cycle, what kind of monsoon you have had etc.

Can the 125 bps cut this year, along with the cut in the Statutory Liquidity Ratio (SLR) and the loan-to-value ratios for housing loans, create a scope for demand led growth in the country?

Globally we have seen this tendency, especially in the period after the great recession, that all the burden has been put on monetary policy. I mean except for the fiscal expansion in the US, there's this general tendency to expect monetary policy to somehow fill the slack. I don't think it works. And I don't think it's going to work in the present case. That doesn't mean that it will have no impact. Sure, there will be some easing. Corporates have been asking for this, the finance minister has been asking for this, so presumably they feel that there will be some positive impact. However you cannot get the required expansion today without some kind of demand stimulus and without some kind of productive stimulus that will reduce the supply bottlenecks. Private Investment is not geared to reducing supply bottlenecks because most of these are infrastructural and they have long gestation periods, involve high risk etc. so they need public involvement and the demand stimulus doesn't come necessarily through credit based expansion especially when you already have a debt overhang.

I think often in India we forget the extent to which we have debt overhang not just among corporates but also among the middle classes. The boom which we had was significantly credit driven- retail credit went from 4% of total of lending to close to 28%. There is significant middle class involvement in the debt-based purchase of consumer durables, in debt-based real estate purchase etc. and now with the real estate market slumping from the last year or so, that has affected the viability of those loans. The general stagnation, or shall I say deceleration of the rate of growth and the stagnation of wage incomes has meant that all these people who took EMIs [equated monthly installments] for a range of consumer durables are also feeling the pinch. A rate cut eases the pinch but doesn't necessarily make them rush out and spend more. So I'm not overly optimistic that this rate cut and other monetary measures that are designed to increase demand are going to be enough to pull up economic growth.

Would you say rural demand is a bigger problem, given the extent to which rural wage growth has slowed down?

Yes, and it's not just rural wages. One of the really disturbing things about economic policy – especially since 2011, so it predates this government, is that the government started cutting down on the kinds of expenditure that effect

the real income of the mass of population. So, for instance, money on [MNREGA](#) came down. Now the new government has come in and has really slashed it. Social sector spending has drastically come down. The state governments are not filling the slack, so in many parts of the country, at least 8-10 states, social spending has collapsed and there's a real mess. You cannot go to the local health centre; you don't want to put your child in that public school any more, so you are forced to spend on these. This, obviously, reduces your ability to spend on other things. So there is already tremendous impact on urban, semi-urban and rural demand.

On top of that we have an aggressive attempt on the part of the government to control real wages and this has succeeded to the point where real wages are falling. This, to be quite honest, I think is obscene. An economy that is officially growing at 7% GDP should not show real wage decline. And yet we have a ministry of finance which in its own publication is celebrating what is called "wage moderation" because it supposedly makes India more competitive. I think there is a real problem in failing to see that wage income is a source of demand. The more you keep trying to suppress wage income in the hope that this will make you globally competitive, the more you reduce your domestic demand; the more, therefore, you reduce investment and more you reduce the scale of production. Which means you lose out on both static and dynamic economies of scale and eventually you become less competitive. So it's a very counterproductive strategy. They are saying we are going to spend on smart cities, which nobody has seen any sign of and they are cutting spending in all these critical areas that has knock on negative multiplier effects. We have had even the head of CII [the Confederation of Indian Industry] saying that the market is not expanding and therefore we are not interested in going out there and investing in expansion.

Corporate indebtedness and reduced demand are two reasons why investment might not pick up in a hurry despite monetary easing. What then can spur investment?

The boom after 2002, I would say, had two legs. One leg was very clearly that you are offering a kind of primitive accumulation to capital. You give resources cheaply – coal, spectrum, water, mineral resources etc., and that creates animal spirits and you have a lot of investment because of that. But the other thing was that there were strategies to raise rural income and wage income. One very important thing was the Employment Guarantee Act, but there was also public spending on agriculture in rural areas. There was a push to improve the amount of priority sector credit going to rural areas. Not all of this was implemented in an ideal fashion or to the required extent, but it was in the right direction.

Some analysts have estimated a multiplier of four or so in rural areas, which means that the economy contains people who have relatively low levels of income spending practically all the additional income they receive locally. During the boom you will find a lot of the consumer companies were producing consumer durables specifically for the rural markets. Growth doesn't have to come from the Ambanis and the Tatas and so on, it can come from small and medium enterprises but that requires a market. And for that to happen, more than lowering the interest rate policy needs to ensure access to bank credit for the small and medium companies. Right now they are going to local lenders for 30% interest a year so the rate cut means little to them. And you have to focus on raising the demand and doing it in a viable way that is not making the demand rely on indebtedness. So I go back to the point I made earlier that wage income needs to be seen as a source of demand and therefore as a source of dynamism, instead of being seen as a burden.

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