Why gentlemen still prefer bonds

Refusing to monetise the deficit is the best possible way to keep government spending in check, says **Vivek Moorthy**

An easy money policy that lowers interest rates does not help in the long run. It merely leads to inflation and high (money) interest rates without any increase in real growth. There is no long run trade off between growth and inflation. Countries such as Germany, whose central banks are frequently criticised for unduly raising interest rates, tend to have the lowest inflation and interest rates in the world. These tenets, principles and facts are perhaps too obvious to be belaboured.

Nevertheless, Mr Venkitaramanan seems to deny these basic tenets, suggesting that we should tolerate more inflation now to promote growth. ("...the goals of growth should dictate a larger recourse to money financing now... As the Chinese leadership has decided recently, it is far better to risk a bit of inflation now through 'money financing' now than to lower the targets of growth", *ET*, June 29).

The context of the above discussion has been the RBI's current policy of trying to curb inflation by compelling the government to borrow from the market (to finance its huge deficits). The success of the liberalisation programme may depend in part upon whether the lapses that have already occurred in implementing this policy can be rectified, or at least prevented from recurring. Commenting on this policy, I drew on the US experience of the early 1980s to argue that such a policy worked: inflation was brought down without a long run decline in growth while the "exploding"" debt burden has been fairly well contained, despite widespread predictions to the contrary ("Print bonds, no money", *ET*, July 24).

In an urbane rejoinder (Should we prefer money or Bonds? *ET*, August 9), Mr Venkitaramanan emphasises that (1) it is wrong to generalise from the experience of the US which had special "escape valves"; (2) the costs of the disinflation — the worst postwar recession in the US in 1882, the international debt crisis and the "lost decade" for Mexico and Latin America — were too high; (3) his earlier piece only sought to point out that since the deficit was going to be monetised anyway, it is better to do it sooner. I shall deal with these themes sequentially. Throughout this discussion it should be kept in mind that the (money) interest rate equals the real interest rate plus inflation.

Mr Venkitaramanan had first cited an academic paper by Sargent and Wallace (1981), written when the US budget deficit was soaring, to justify monetary laxity now in India. To evaluate the merits of the case, it was therefore necessary for me to look at the US evidence in depth during that decade. There were certainly special factors that facilitated the US disinflation of the early 1980s. But almost all the major OECD countries also reduced inflation over the last ten years, and have managed to keep it low, despite large budget deficits and rising debt to GDP ratios. The problem of the real rate of interest being much higher than the real growth rate, thus causing the debt to explode rapidly, has been a transitory one during disinflation, not only in the US but elsewhere.

Easy money leads to high inflation and raises interest rates but not growth

	INFLATION	INTEREST RATE	GDP GROWTH RATE
Malaysia	3.90	5.90	9.90
South Korea	4.30	13.90	9.90
Thailand	5.40	10.75	8.40
Singapore	1.70	3.44	7.20
Taiwan	4.70	5.75	7.00
Indonesia	10.00	16.00	6.80
India	10.30	12.97	5.30
Hong Kong	8.90	5.77	5.10
Phillipines	6.80	9.69	4.70

Source: The Economist, August Issues; IFS

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The accompanying chart outlines relevant data, for emerging and some recently emerged Asian economies, to illustrate the tenets emphasised at the start of this article. (China's growth rate is currently about 9 per cent and inflation is about 20 per cent. Due to the unavailability of interest rate data, China has been omitted from the chart). Most of these countries have had, until recently, administered interest rate structures and varying degrees of restrictions on inflows and outflows of foreign capital; many of them still do. Hence their situation is more closely comparable to India than that of the Western countries. What is clear is that real growth across these countries has not been enhanced by monetary stimulus and inflation. To characterise conclusions which are based on this extremely robust fact as "today's *mantra*" and "textbook faith" does not facilitate fruitful discussion.

Turning to the second theme, most discussion of the costs of reducing inflation fails to explicitly distinguish between a steady inflation rate versus a rising, unsustainable one. If inflation were of the former variety, its permanent nuisance value, although large, might be worth living with, in order to avoid the larger transitional cost of disinflation. Yet, it is only in response to unsustainable pressures that inflation reducing programmes are enacted, which then may appear to cause a permanent loss of output.

The US disinflation of 1980-83, which led to the international debt crisis and the lost decade for Mexico and Latin America, is a case in point. The roots of the debt crisis were formed during the borrowing binge of the 1970s, when US monetary policy was too expansive. This borrowing was fuelled by interest rates that were relatively low compared to projections of inflation and earnings growth. The lost decade was preceded by a 'too fast' decade.

The collapse of the Mexican peso in December 1994 also stemmed partly from monetary laxity. From September 1992 to February 1994, the US federal funds rate was kept at 3 per cent, a level that barely kept pace with inflation, and well below market determined long term bond yields. The flow of capital overseas, partly induced by this low level of the funds rate, was a major factor underlying the emerging markets equity boom.

An overheated economy has to be followed, sooner or later, by an over-cooled one. Delay in applying the brakes only means having to slam on them much harder later on, and causing more dislocation in the process. The aftermath of an inflation reducing programme is painful, like a hangover after one is forced to stop drinking. But this does not imply that the 'patient' would have been better off by continuing to do so, although the euphoria could have lasted a bit longer.

With regard to the Indian financial sector reforms in 1991, it is true that the share of interest payments in the revenue deficit and in GDP risen sharply after 1991. This is bound to happen during the transition to market-based government borrowing. Mr Venkitaramanan states that the administered interest rate structure of the 1980s "did not translate itself into high inflation" (*ET* August 9). But during the 1980s inflation averaged a little under 10 per cent. Although this inflation was suppressed in loans made to the government, it showed up in high scheduled commercial bank lending rates. The call money rate averaged almost 15 per cent during 1990, before the financial sector reforms were started.

Last but not least, the monetisation of the deficit needs to be discussed. While eventual monetisation may be highly probable, unlike death and taxes, it is far from inevitable. Refusing to monetise the deficit is the best possible way to keep government spending in check, short of a constitutional cap on such spending. To say that large deficits lead to inflation is to put the cart before the horse. With an independent central bank, the deficit can never get too large; so explosively rising interest payments on the debt need not occur. After all, if the government is denied access to the printing press, like any private entity, it will be compelled to balance its books. Postponing monetisation provides the government the necessary time to cut primary (i.e. non-interest) spending and raise taxes. Thus mere postponement can reduce both the deficit's size and the probability that it will finally get monetised.

The welfare implications of currently choosing to monetise a deficit that seems unlikely to be reduced still depends on a specific prediction as to how interest rates will respond, under tight money, to two opposing forces or effects: declining actual inflation, which would tend to lower interest rates, and the fear of future inflation due to potential monetisation, which would tend to raise them. The conclusion that printing money now is preferable is based on the (Sargent-Wallace) assumption that the latter effect dominates. Empirical evidence indicates that the former effect, declining past inflation, is stronger. Under these circumstances bond issue issue may be preferable, even if future deficit reduction seems unlikely.

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