PGDM(RM), 2018-20
Macroeconomics for Retailers
RM-303
Trimester – III, End-Term Examination: March 2019

Time allowed: 2 Hrs 30 Min
Max Marks: 50

Roll No: ____________

Instruction: Students are required to write Roll No on every page of the question paper, writing anything except the Roll No will be treated as **Unfair Means.** All other instructions on the reverse of Admit Card should be followed meticulously.

Sections	No. of Questions to attempt	Marks	Marks
A	3 out of 5 (Short Questions)	5 Marks each	3*5 = 15
B	2 out of 3 (Long Questions)	10 Marks each	2*10 = 20
C	Compulsory Case Study	15 Marks	15
		Total Marks	**50**

Section A

(Attempt any 3 out of 5 questions given below. Limit your answers to 100 words)

A1. Why is it important to know how much output has been produced in a country? Who uses such information?

A2. Is it possible for unemployment rates to increase at the same time that the number of employed persons is increasing? How?

A3. Would it be advantageous to borrow money if you expected prices to rise? Would you want a fixed rate loan or one with an adjustable interest rate?

A4. What events might prompt consumers to demand fewer goods at current prices?

A5. Why might the Reserve Bank of India want to decrease the money supply?

Section B

(Attempt any 2 out of 3 questions given below. Limit your answers to 200 words)

B1. Does the fact that your bank keeps only a fraction of your account balance in reserve make you uncomfortable? Why don't people rush to the bank and retrieve their money? What would happen if they did?

B2. Suppose you have $500 in savings when the price level index is at 100.

- B2a- if inflation pushes the price level up by 20 percent, what will be the real value of your savings?

- B2b- What is the real value of your savings if the price level declines by 10 percent?

B3. Why do high interest rates so adversely affect the demand for housing and yet have so little influence on the demand for pizzas?

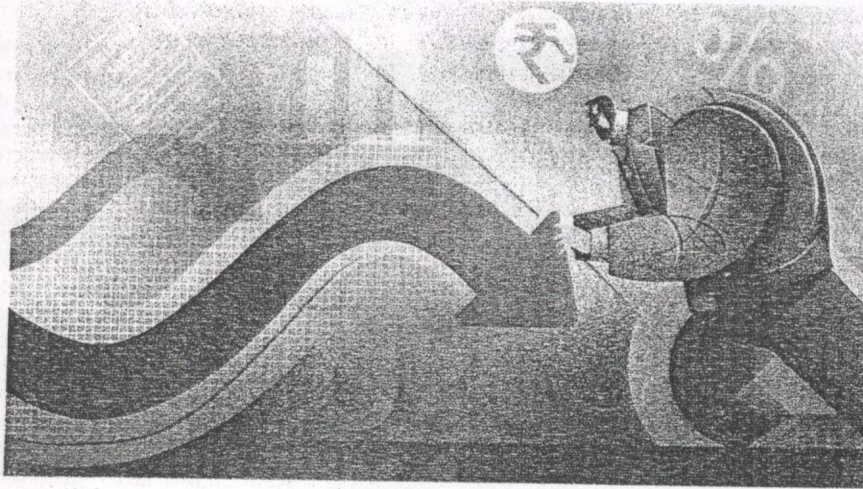
Section C

(Attempt both the case studies. Each case carries 7.5 marks each)

C1. Accompanying article by Ajay Shah (the new world of 4% inflation) which was published in the Business Standard (March 11, 2019) talks about the new paradigm of 4% inflation in India. Please go through the article and illustrate how if 4% inflation will impact your company's sales target in future?

C2. Below is an article published in the Economist (Modifications on March 2nd 2019). In the article the present NDA government's macroeconomic performance is evaluated. Please write critical review of the article from macroeconomics knowledge you have gained in the class.

ILLUSTRATION BY AJAY MOHANTY



The new world of 4% inflation

Business building will be put on better foundations when we fully adapt the assumptions underlying financial analysis to the new low-inflation environment

From 2015 onwards, the RBI has committed to delivering year-on-year CPI inflation of 4 per cent. Most of the discussion on inflation targeting has emphasised how low and predictable inflation stabilises the macroeconomy. Expectations of stable 4 per cent inflation change many things about how we plan for the future. In this article, we show implications for wage hikes, borrowing, public finance, rupee depreciation, corporate investment and fund management.

The new world of low inflation: A long inflation crisis began in February 2006. The policy community was persuaded that institutional reform of monetary policy was required, which led up to the Monetary Policy Framework Agreement (MPFA), signed on February 20, 2015. The RBI has been transforming itself to deliver on the transparent single-objective of 4 per cent inflation. So far, the points of pain have been inflation that is too low, not too high.

It now looks likely that the RBI will succeed in delivering inflation in the region of 4 per cent all the way to February 20, 2020, thus giving a full five years' performance in macroeconomic stability. Before the MPFA, the thumb rule for inflation in the future was 8 per cent, and now we have increasing confidence in stable 4 per cent inflation. This has important consequences for numerous areas of decision making in the private sector and in public policy.

Impact on wage hikes: Our thumb rules about wage hikes change. Earlier, wage hikes were anchored around the number of 10 per cent. The floor for wage hikes was 10 per cent, which was 2 per cent real, and some employees got more than 10 per cent. Now we need to anchor ourselves around 5 per cent wage hikes. Keeping up with inflation is a 5 per cent wage hike, and some employees will go above 5 per cent.

SNAKES & LADDERS

AJAY SHAH

When inflation rates come down, for some time, the economy keeps going with old assumptions about inflation. Perhaps hiring by firms has been slower than usual in recent years because wages have been too high compared with the growth of the top line (that has declined because of lower inflation). Perhaps we will get back to a more normal environment on the labour market once firms recalibrate down to lower wage hikes.

Impact on borrowing: Lower inflation changes how we think about debt. High nominal growth has a way of making old loans subside. In India, we had got used to the assumption of 15 per cent growth in the balance sheet every year. This gave a doubling every 4.6 years. So a loan which feels like a stretch today is half as worrisome within 4.6 years; both sides have to only fight it out for the first 4.6 years.

This was particularly important for banks and banking regulation. Banks were used to racking up bad debt and then growing out of it. Banks would lend 100, of which 20 went bad. Accounting and regulatory tools were used to postpone the bad news, so the bad debt was only confronted after 4.6 years. At this point there was a recovery of five and a loss of 15, but the loss of 15 was expressed on total assets of 200, and that was survivable.

The old environment of sharp growth of the balance sheet has changed. When balance sheet growth drops to 11 per cent a year, in the low-inflation environment, this is a doubling every 6.3 years. Alongside this, the willingness to play the old game of hiding bad news has reduced at all levels: The Department of Financial Services, RBI, bond markets and corporate boards. These two factors have induced a valuable sea change in the behaviour of the debt market. The lending process needs to become much more analytical, away from the old ways of doling out debt without studying the borrower.

Impact on public finance: The key number that drives the budget process is the assumption about future nominal GDP growth. Traditionally, big numbers went in — 6 per cent growth and 8 per cent inflation was 14 per cent nominal GDP growth. But now we should be more cautious: 6 per cent growth and 4 per cent inflation give 10 per cent nominal GDP growth.

Impact on INR depreciation: When Indian inflation was at 8 per cent and the world was at 2 per cent, this created a systematic pressure of about 4 per cent rupee depreciation every year. With an inflation target of 4 per cent, that systematic pressure is largely out of the way.

There will, of course, be substantial exchange rate volatility. When emerging markets float the exchange rate, they get to about 12 per cent volatility. When India fully graduates to a modern monetary policy capability, we will get much higher INR volatility. But there will be no systematic pattern of INR depreciation.

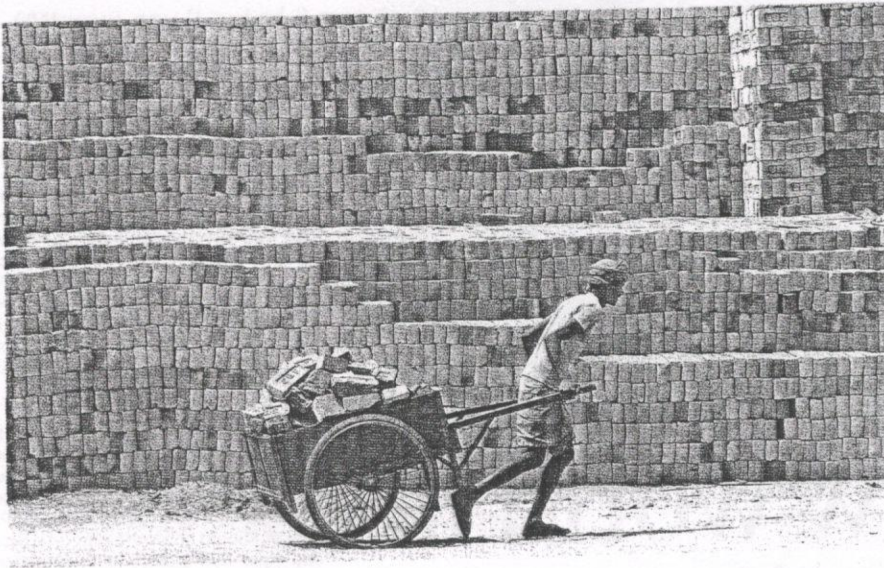
Impact on rates of return: Assumptions about rates of return in India tend to be very high. We tend to look back at the BSE Sensex performance from 1979 to 1990, and the Nifty returns from 1990 onwards, and form a very optimistic sense of the rates of return on public equity. These assumptions need to change because inflation has come down by 4 percentage points, and because the equity index got a one-time surge when India opened up.

If you used to believe that the long-run average Nifty returns will be 16 per cent, you need to rescale this downwards to 12 per cent owing to lower inflation. The rough numbers may be as follows (https://bit.ly/2HmSCvX). With an inflation target of 4 per cent, the short-term riskless rate may be 6 per cent, on average. The equity premium may be 5-6 percentage points, giving equity index returns of 11-12 per cent.

This impacts upon corporate finance, structuring of private equity funds, etc. The process of business building will be put on better foundations when we fully adapt the assumptions underlying financial analysis to the new low-inflation environment.

When inflation rates come down, for some time, the economy keeps going with old assumptions about inflation. Perhaps investment by firms has been slower than usual in recent years because it has been hard to find projects that are viable at excessively high hurdle rates. Perhaps we will get back to a more normal environment in investment when we recalibrate to lower required rates of return.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi



India's economy

Modifications

Despite high expectations, Narendra Modi's economic policies have not made a decisive break with the past

NARENDRA MODI, India's prime minister, stormed to power so decisively in 2014 that it is difficult now to imagine any other outcome. But try. Imagine that the United Progressive Alliance (UPA), a tired coalition led (if that is the word) by the Congress party, had limped to victory instead. What economic policies might it have pursued in a third term? This is not an entirely idle question. Any assessment of Mr Modi's economic record in his first stint as prime minister requires a counterfactual scenario against which to measure it. A third UPA government is one such baseline.

A Congress-led government would no doubt have built on some of its existing pet initiatives, such as a job guarantee, providing employment on public works to rural households, and an identification scheme, giving every Indian a unique identity number based on a fingerprint or an iris scan. It presumably would have allowed the central bank to continue to fight against inflation, aided by a drop in oil prices.

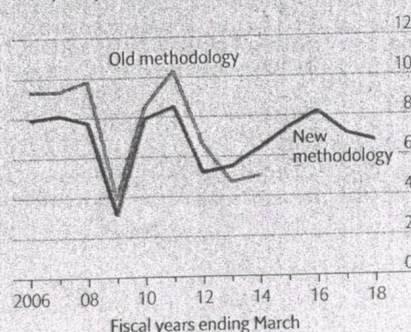
A third UPA government would surely have shied away from reforming India's onerous labour laws or privatising poorly run public enterprises, like Air India. It probably would also have dallied with resolving the banking system's bad loans, fearing it might otherwise be condemned for bailing out crony companies.

As the next election approached, the UPA government would no doubt have indulged in giveaways to farmers (as in previous political cycles) and disguised its failure to hit fiscal targets through budgetary tricks. GDP growth and job creation would probably have improved little.

The UPA never, of course, got this third bite of the cherry. It lost instead to Mr Modi, who promised a radical alternative to this steady-as-she-goes approach. But despite these bold pledges, Mr Modi's first term in charge of the economy has proved to be rather similar to the hypothetical third UPA term described above. Much of what probably would have happened if Mr Modi had somehow lost also happened after he won.

The parallels loom large. GDP growth has averaged about 7%, quicker than any other big economy but little different from the average for the five years before Mr Modi entered office. There have been no big reforms of land or labour markets; no junking of the employment guarantee or the identity scheme; and a costly delay in tackling banks' bad loans. The government's proudest economic feat was to implement a nationwide value-added tax that Congress had previously proposed.

Revising history
India, GDP, % increase on a year earlier



Sources: Morgan Stanley Research; Central Statistics Office

This continuity should not be a surprise. Although Mr Modi's party won a rare majority in parliament, India's political system still imposes checks on his power through the upper house, the courts, public auditors and the states, which have sole or joint responsibility for many of the reforms India needs. And although the Modi vote was a plea for more jobs and fewer scams, it was not a vote for liberal economics per se. Capitalism in India remains "stigmatised", notes Arvind Subramanian, a former economic adviser to the government, in his new book, "Of Counsel".

Mr Modi did manage some departures from the baseline. It is hard to imagine the UPA cutting red tape as zealously (India has risen 65 places in the World Bank's rankings of the ease of doing business since 2014) or courting foreign-direct investment (FDI) as assiduously. He contributed to the conquest of inflation by removing some fuel subsidies and limiting increases in the minimum prices for crops. His government helped open bank accounts for the poor and passed a welcome new bankruptcy law for firms. Corruption has been reduced.

Sadly, fertiliser subsidies persist, minimum crop prices have jumped again, and the new bankruptcy system will take about six years to clear the backlog of cases at its present pace, reckons Mr Subramanian. Planned changes to e-commerce rules could hobble foreign firms operating in the country, such as Amazon and Walmart.

Mr Modi's most innovative decision was also his worst: the abrupt cancellation of high-denomination banknotes. The aim was to wipe out "black money", piles of ill-gotten cash stashed outside the banking system. The government was therefore surprised when most of the notes were returned to the banks, before they expired, by long queues of depositors. It is a miracle the stunt did little lasting harm to the economy, if official data are to be believed.

And that, sadly, is a real question. The government's other alarming innovation has been to discontinue, revise or delay some official data that do not flatter it. It tried to prevent publication of a new report on employment, prompting two members of the country's statistical-oversight body to resign. They also objected to the manner in which revised GDP data were released (see chart). The world will never know what would have happened under a third UPA government. And with less reliable official statistics, it will be harder to know what has happened under Mr Modi, too. ■