Course and Year: BA H Semester II

Instructor: Gaurav Bhattacharya

Paper: GE Introductory Macroeconomics

Note: Money, Prices and Inflation

Flawed premise, misplaced prescription

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JULY 26, 2016

The policy framework of inflation targeting suggested by the Urjit Patel panel is drawn from a foreign context. The RBI must weave in trade and capital flows into the proposed policy fabric

Indians have been described as argumentative. In everyday usage, it means they argue for the sake of arguing. And there is more than just a grain of truth in it. Look at the criticism of the current dispensation at the Reserve Bank of India (RBI). There was a lot of debate about the membership of the Monetary Policy Committee to be set up. Who will appoint the members? Will the RBI Governor have the final say, etc…? Then there was the red herring about the green card (pun intended). These issues could be potentially important. But nothing could be as important as the present regime at the RBI foisting an inflation-targeting framework for the conduct of monetary policy without much debate (though some academics had written on it when it was first submitted). In my opinion, the Urjit Patel Committee Report (referred to as the report below) that suggested this framework is an example of copy-and-paste from foreign policy sources. Even this is done inconsistently. I focus attention on the report, as the new regime in the RBI readies to implement it.

Goals of monetary policy

Let us start at the beginning. What should the goals of the monetary authorities be? Some obvious desirable candidates are full employment (or a high growth path), low inflation, financial stability, budget balance and external balance (what used to be called equilibrium in the balance of payments). And inevitably there are serious trade-offs between these objectives. High growth can come accompanied by stress in the banking system (as happened in the U.S. in the run-up to the financial crisis), or with a huge current account (of the balance of payments) deficit (this implies growth is funded by international borrowing).

In the advanced capitalist countries, the professional consensus has moved towards inflation targeting as the objective of monetary policy (after the Lehman Brothers crisis of 2008, the importance of financial stability is not debated). The broad argument in favour of inflation targeting runs as follows (also repeated in the report): monetary policy cannot significantly alter the level of employment (or not for any length of time) — this is determined by “real factors” such as productivity, labour market rigidities, and possibly the fiscal stance of the government. Monetary policy should target nominal variables, such as rate of inflation.

Targeting inflation comes from a belief that policy should be simple and transparent, so that the private sector can factor this into their decision-making. The question that this poses is: are there more "complicated" policies which are better? I just note that one such policy is called "nominal income targeting". But it is more complicated and the private sector is deemed to be intellectually challenged. An engineer building a bridge picks the best plan and not the one that motorists find easy to comprehend. But let that be.

Inflation targeting and India

In these countries, inflation targeting could be the desirable policy because there is no restriction on the movement of (financial) capital; the issue of balance of payments needing policy intervention is not even on the menu. Their interest rates equal the interest rate in the rest of the world (interest parity holds) and the country concerned can borrow abroad to finance the deficit — for example, the U.K. has been running a current account deficit close to 8 per cent of GDP that no developing country could get away with.

But more relevant here is that there is no pressure on the Bank of England to intervene to correct this. As a matter of fact, the macroeconomic distinction between a developed and a developing economy is that the latter needs to settle its debt in an internationally accepted currency. Being in possession of real estate or natural resources is not enough, since foreign lenders will not accept rupees. Thus, at the very least, a developing economy also needs to have some notion of external balance.

On the external front, the report says the RBI should intervene to smooth exchange rate volatility. It also discusses what the RBI should do in the face of large foreign capital inflows and outflows. To insure against outflows, it says, India needs a war chest of foreign exchange reserves. And this is generated by intervening in foreign exchange markets during periods of foreign inflows, via something called "sterilised intervention". But the takeaway from the report is that the external sector needs attention in emergencies, not on an ongoing basis.

So is India like a developed country that can disregard the external constraint? India is a fairly open economy, reliant on foreign capital flows. Gone are the days when we could think of ourselves as a closed economy not really worried about foreign trade and payments. I note, en passant, that even when this was true (before liberalisation), we had two major balance of payments crises that altered the subsequent trajectory of the economy — the first one contributing to the "socialism" of Indira Gandhi, and the second one leading to liberalisation. Thus, trade and capital flows have to be woven into the proposed policy fabric.

Sterilised intervention

To go back to the report, I note here that the very discussion of sterilised intervention implies that India's financial markets are not integrated with world markets (for that I say, "thank god"!). So what is sterilised intervention? When capital inflows occur, the RBI could do nothing and let the rupee appreciate. If it chooses to intervene, it could buy foreign exchange. This would increase the supply of money, and possibly cause inflation. So it may buy back the rupees by offering government bonds. This is "sterilised intervention" — sterilised because the policy leaves money supply unchanged. But since this policy increases the supply of government bonds, the yield on them must rise in order to make the public hold them. And this is possible only if the domestic interest rate can differ from the international one. The whole notion of having adequate foreign exchange reserves, and acquiring them via sterilised intervention, means that we must pay attention to the details of the external sector. How much foreign exchange to buy? How much sterilisation? Similarly for an outflow, the choice involves a depreciation of the currency versus loss of reserves.

But the nature of the external constraint is not just what I mentioned. You may get the details of the intervention right, you may be a good boy with inflation and budget deficits under control, and yet face chaos. This is what happened to Latin America after Russia defaulted in 1998. There was a reversal of capital flows that left the more open economies stranded. To not even consider such an eventuality in the design of the architecture of monetary policy is surely being foolhardy. Other developing economies that have adopted inflation targeting often say "inflation-targeting plus" — the "plus" suggesting that there are possible complications.

Finally, I note that East Asia has grown out of poverty by using the exchange rate as a tool to generate demand for domestic goods. The RBI Governor has said that today there is no space for such a strategy. But India's trade balance has been in deficit (around 8 per cent of GDP till recently); a depreciated exchange rate could surely claw back some of this demand by making Indian products slightly more competitive in world markets.

Not factoring in supply shocks

Not addressing the external constraint is the biggest shortcoming of the report. There are also other examples of cut-and-paste. In an economy like India's, why does monetary policy have nothing to say directly on supply shocks, for example, a failure of the monsoon or a rise in oil prices? A narrow focus on consumer price index targeting means that adverse output shock like El Nino is relevant only if and when it feeds into inflationary expectations. And what will inflation targeting do? After a failed monsoon, and high food prices that have led people to expect high prices, policy would increase interest rates and have a prolonged period of demand compression from a one-off monsoon failure. I note, though without further discussion, that nominal income targeting has been shown to be vastly superior in dealing with this kind of a shock.

Similarly, if oil prices were to rise, one way of minimising the inflationary impact of that is to let the exchange rate appreciate. If you were half-conscious of the external balance, it is obvious you do so at your peril (because then the pressure on the current account is being compounded).

Another example of cut-and-paste is the box item on the so-called New Keynesian Phillips Curve. Whatever its usefulness in industrialised countries, to lift this and use it to illustrate one's preferred policy set-up in India is a bit rich. The example in the report assumes no supply shocks. Also, is the price stickiness assumed there at all a decent representation of how goods prices are determined in the Indian economy?

The RBI is about to embark on a new policy framework based on poor economics. It reminds me of an episode of The Two Ronnies programme, where little Ronnie (Corbett) is doing a crossword. The clue was: “What is red and picked in a garden? It is a four-letter word ending with SE?” Big Ronnie (Barker) says, “It is obvious — Rose.” Little Ronnie suggests the appropriate answer is “Nose”. Now the latter answer is not incorrect but possibly a little off!

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The perils of RBI’s fixation on inflation

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JANUARY 17, 2020

The central bank’s shift of focus from financial stability to inflation targeting could have led to regulatory infirmity.

Inflation is back in the news and attention has willy-nilly turned on the Reserve Bank of India (RBI). This would lead us to recognise what the central bank is mandated to do and assess how much of its objective it actually achieves.

The establishment of some of the world’s oldest central banks was inspired by the goal of maintaining financial stability. It was recognised that when private commercial banks fail, whether due to malfeasance or misjudgment, they not only harm their trusting depositors, they can also take down with them the rest of the financial system. The latter can take place when banks have lent to one another, which is not uncommon. In the crisis that ensues, there is a collapse of credit which, in turn, leads to a downturn in economic activity. To avoid this, the central bank was conceived of as the lender of last resort, one that could pre-empt a run on banks and give them time to put their books back in order. However, this was to be accompanied by the adoption of a tough regulatory stance, whereby the central bank would stay hawk-eyed towards the activities of banks, particularly risky lending. This was necessary as the knowledge that they could always rely on the lender-of-last-resort facility may leave banks less than diligent or even make them indulge in plain dishonesty. However, with the rise of neoliberalism, the central tenet of which is that markets should be given free play, the regulatory role of central banks took a back seat. They came to be primarily mandated with inflation control. It is hardly the case that central banks were unconcerned with inflation earlier, but they were at the same time concerned with financial stability and the level of economic activity.

Moving the goal post

In India, the RBI had earlier pursued a ‘multiple indicators approach’, implying concern for outcomes other than inflation, including even the balance of payments. But, developments in economic theory discouraged such catholicity by arguing that having economic activity as an objective of monetary policy leads to higher inflation. It should be noted that this argument privileged low inflation over low unemployment, favouring owners of financial wealth over workers. But, not to be left behind in the race to adopt the architecture of the West, the Indian government also instituted inflation targeting as the sole objective of monetary policy. The RBI was permitted to exceed or fall short of a targeted inflation rate of 4% by a margin of 2 percentage points. This was hailed by the government as the adoption of the ‘modern monetary policy framework’ by India, and came into effect from the year 2016-17.

The late Arun Jaitley as Finance Minister projected the attainment of macroeconomic stability, represented by slow inflation, as a major achievement of his tenure. Adherence to fiscal discipline and inflation targeting were taken to be the instruments. Throughout Mr. Jaitley’s tenure, inflation remained within the range envisaged under the inflation targeting regime agreed to between the government and the RBI. But have all the objectives of the RBI’s original mandate as a central bank been met as a result? I believe not.

In 2018, within three years of the adoption of inflation targeting goal, a crisis engulfed IL&FS, a non-banking financial company in the infrastructure space. It defaulted on several of its obligations, including repayment of bank loans and the redemption of commercial paper. The IL&FS was not just another ‘shadow bank’; it operated over 100 subsidiaries and was sitting on debt of ₹94,000 crore. Given this, its default had a chilling effect on the investors, banks and mutual funds associated with it both directly or indirectly. Since then, in 2019, a run on the Punjab and Maharashtra Co-operative Bank had to be averted by imposing withdrawal limits. It was discovered that fictitious accounts, reportedly over 21,000 of them, had been created so that the books would tally, even as deposits were siphoned off as loans to the promoters. While in the case of IL&FS, some part of the problem may have been caused by a slowing economy, outright fraud underlay the crisis at PMC Bank. And now, in early 2020, curbs have had to be placed on withdrawals from the Bengaluru-based Sri Guru Raghavendra Sahakara Bank. Even if it is too early to declare that financial instability prevails in India, it is not too early to ask if the RBI’s responsibility to regulate the financial sector may have taken a back seat after adoption of inflation targeting as the main objective. Has a fixation with inflation rate made the RBI take its eyes off the loan books of the banks?

Rise in inflation

Further, even apart from regulatory infirmity, it is not as if the RBI is doing spectacularly on the inflation targeting front either. At over 7%, the inflation rate in December is the highest in five years. This may not be reason to panic, for the price rise could be seasonal and may well abate, but it does raise a question on the efficacy of inflation targeting as a means of inflation control. Inflation led by rising prices of food stuff cannot quickly or easily be contained by the mode of control underlying inflation targeting. It requires enhancing supplies which, in turn, would mean raising imports in the short run. Be that as it may, the extent of failure of inflation targeting right now is substantial indeed; the inflation rate has exceeded the permissible range of error by 65%. This must give pause as to how much the shift to the ‘modern monetary policy framework’ has delivered. If the inflation rate was within the intended range so far, that may have been due to both declining food prices and, for a phase, oil prices.

Finally, we come to what the ordinary Indian considers the RBI’s principal mandate, the management of the currency so that trade is facilitated. The central bank has the monopoly on the issue of notes. Why then is there is an absolute shortage of small denomination notes in the bazaars of India? ‘Bazaar’ is here only a word for a site of commerce; from the north to the south of the country, from airports to village stores, trade and production is held up due to the absence of notes and coins of the denomination appropriate to the transaction.

The RBI and the government showed themselves to be entirely out of touch with reality when, in 2016, the 1,000-rupee note was replaced with a 2,000-rupee note. It is anybody’s guess whether the daily wage for a labourer is more than ₹500 in much of India. Small denomination notes are mostly unavailable, or, if available at all, are of so shabby an appearance that it makes you wonder whether those responsible for the management of our economy take any pride in discharging their tasks. In this department, India’s central bank has failed substantially.

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