Off-target on Monetary Policy

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Disregarding international experience of recent years, the Urjit Patel Committee recommends that the Reserve Bank of India pursue a single objective of inflation targeting. It focuses on the interest rate to control inflation (by influencing inflation expectations), though experience has shown that in India this mechanism has a weak impact on inflation and a stronger one on output. It is a disappointing report drawing on a textbook reading of the New Keynesian model.

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The events during and after the 2008 global financial crisis have undermined all certainties faced by policymakers, especially central bankers in developing countries.

To start with, the crisis questioned the belief that the United States financial system represented the best approximation of an efficient financial market with appropriate levels of competition and transparency – Glass-Steagall was no more the innovation-killing monster it had been made out to be. Second, as investors who had rushed in during the pre-crisis boom exited developing country markets to cover losses and meet commitments at home; open economic borders did not seem such a good idea. Whether located in a country that was a favourite of investors or in a market being shunned, central banks faced immense problems stabilising liberalised exchange rates (prone to excessive appreciation or depreciation) and managing their balance sheets. Working the monetary lever seemed near impossible.

Third, drawing from the Japanese experience with a long recession, and faced with the real economy fallout of the financial crisis, governments were called upon to use the fiscal lever to address the downturn, since monetary policy alone was inadequate for the task. The idea that monetary policy should be privileged and fiscal policy downgraded was brought into question. And within monetary policy, there was a far greater willingness to expand balance sheets indiscriminately as quantitative easing demonstrated. Finally, the policy measures adopted in the developed countries in the aftermath of the crisis also had an impact on the so-called "emerging market economies" (EMEs), in ways that made monetary management and the use of the monetary lever extremely difficult. Any remaining belief in the omnipotence of the "independent" central banker was undermined.

To summarise, capital inflows and outflows tied the hands of central bankers, monetary policy measures did not have their intended impact, and central bankers were called upon to address multiple objectives varying from traditional ones such as reining in inflation and stabilising exchange rates to more "innovative" ones such as injecting liquidity to spur or sustain growth.

As Borio (2011) notes:

> The crisis has shaken the foundations of the deceptively comfortable central banking world. Pre-crisis, the quintessential task of central banks was seen as quite straightforward: keep inflation within a tight range through control of a short-term interest rate, and everything else will take care of itself. Everything was simple, tidy and cosy. Post-crisis, many certainties have gone. Price stability has proven no guarantee against major financial and macroeconomic instability. Central banks have found themselves reaching well beyond interest-rate policy, aggressively deploying their balance sheet in a variety of "unconventional" monetary policies. As a result, the line between monetary and fiscal policy has become blurred precisely at a time when public sector debts are ballooning and sovereign risk is rising again. And many increasingly question the very ability of central banks to maintain inflation within acceptable ranges, notably to avoid deflation.

Given these lessons learnt in difficult times, an element of humility is to be expected of even diehard monetarists. Monetary policy could no more be "single-minded", pursuing one overarching and dominant target by adopting a strictly defined and straitjacketed set of monetary operations. Flexibility in terms of objectives, instruments and operations seemed to be not just advisable but unavoidable.

In India, the constant tussle between the finance ministry and the Reserve Bank of India (RBI), that runs parallel to a conflict between business and the financial markets (especially international finance), over how high interest rates or how tight the monetary environment should be, reflected this need for the pursuit of multiple objectives with a degree of flexibility. The strain on the central bank was obvious. On the one hand, the removal of price controls, the deregulation of administered prices (including that of oil) and the decision not to curb the activities of "market players" meant that inflation ruled high, the burden of addressing which fell on the central bank. Central banks, in turn, could only seek to manage liquidity and manoeuvre interest rates to achieve that end. On the other hand, with fiscal policy having been rendered largely ineffective by "fiscal reform", the central bank was called upon to sustain and even spur growth. That required lowering interest rates and pumping liquidity into the system. Given these conflicting pulls, central banking was a tightrope walk, with one eye focused on the exchange rate and the other on the foreign investor. It was as much an act of diplomacy as it was an exercise in economic management in a complex environment. Multiple objectives and flexibility were unavoidable.

Shocker

Read in this context the report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework chaired by RBI Deputy Governor Urjit Patel, which was submitted in late January, is a shocker. This is not because the committee's recommendations are extraordinary or wildly innovative. They are, in fact, an instance of the belated advocacy in India of a rather "strict" version of a much tried and periodically violated framework – "inflation targeting" (IT). As the report notes, a host of countries have adopted IT as a monetary policy objective since the 1980s and there is a vast literature making a case for that policy. Much of the report is, in fact, a selective and rather banal review of that literature.

No Nuance

In the event, with minimal argumentation and little concern for nuance, the report makes the following salient recommendations. To start with, a nominal inflation rate of 4% (surrounded by a 2% band) should be the "target" of monetary policy, which must subordinate all other objectives including growth to that goal. It is only, "subject to the establishment and achievement of the nominal anchor", that monetary policy "should be consistent with a sustainable growth trajectory and financial stability". The second is that the combined-consumer price index (CPI) that is being released since early 2011, as opposed to the wholesale price index (WPI), should be the basis for calculating the rate of inflation. While there is strong reason to believe that the CPI is a better indicator of inflation in the country, opting for the CPI as inflation indicator for monetary policy purposes has a larger implication. Since inflation as measured by the CPI tends to rule much higher than inflation as measured by the WPI, making the former the anchor would require a proactive and much more restrictive monetary policy. The committee in fact lays out such a proactive road map.

Third, while recognising that the food and fuel groups are overwhelmingly responsible for consumer price inflation, and that inflation in these commodity groups is driven from the cost/supply side and often imported, the committee still believes that "headline inflation" (as measured by the CPI in full) as opposed to "core inflation" (which excludes commodities like food and fuel from the calculation) should be the anchor. This according to the committee is because holding down inflation requires dampening "inflation expectations" that contribute to the inflationary trend. In its view

> high inflation in food and energy items is generally reflected in elevated inflation expectations. With a lag, this gets manifested in the inflation of other items.

Moreover

> Shocks to food inflation and fuel inflation also have a much larger and more persistent impact on inflation expectations than shocks to non-food non-fuel inflation. As such, any attempt to anchor inflation expectations cannot ignore shocks to food and fuel.

Having decided that IT should be the main concern of monetary policy the Urjit Patel Committee goes on to prescribe a simple rule of thumb: when the inflation rate is above the nominal anchor, the real policy rate, which is to be the overnight repo rate at which banks can access liquidity adjusted for inflation, should be positive, with the degree to which it is in positive territory being determined by the Monetary Policy Committee, taking account of the output gap or the level of actual output growth relative to trend or potential.

No Discretion

This emphasis on a single-policy instrument is strengthened by the requirement set by the committee that to ensure transmission of policy impulses in the form of interest rate adjustments, no discretionary measures to enhance liquidity should be adopted. Provision of liquidity by the RBI at the overnight repo rate is to be "restricted to a specified ratio of bank-wise net demand and time liabilities (NDTL), that is consistent with the objective of price stability". In addition, any measures of credit allocation to specific sectors that influence the level of liquidity in the system must be abjured. And, since the interest rate is to emerge as the crucial policy variable, sector specific interest rate subventions are to be phased out.

How is this framework expected to work? Conceptually, it is made to appear simple. "Adjustments in the policy interest rate, for instance, directly affect short-term money market rates which then transmit the policy impulse to the fuller spectrum of interest rates in the financial system, including deposit and lending rates, that in turn affect consumption, saving and investment decisions of economic agents and eventually aggregate demand, output and inflation." All that is required is an "independent" central bank, adopting the IT framework and taking the limited decisions it can, based on discussions and voting by a five-member committee consisting of the governor and two officials of the central bank and two external members nominated by the governor and deputy governor. That is presented as ensuring technocratic integrity, transparency and full "independence" in the pursuit of the best monetary policy.

However, admitting that the "effectiveness of monetary policy…remains constrained by several country-specific factors", the report makes a case for (i) reducing the persistence of "fiscal dominance" despite fiscal reform, that effects transmission and leads to "crowding out of the private sector"; (ii) reducing the statutory liquidity ratio (SLR) and trimming the captive market for government securities that suppresses the cost of borrowing for the government and dampens the transmission of interest rate changes; (iii) resetting interest rates paid on small saving at shorter intervals (half-yearly or quarterly) so that they do not have a competitive edge vis-à-vis bank deposits and erode "the effect of the monetary transmission mechanism, especially the bank lending channel"; and (iv) examining the adverse impact on transmission that interest rate and non-interest subventions (such agricultural debt waiver schemes) have. That is, IT has to be combined with a range of rather typical neo-liberal, reform measures.

New Keynesian Model

To back its case for a restrictive form of IT as the basis for monetary policy, the report approvingly refers to an almost textbook version of the New Keynesian model "based on optimising behaviour of households and firms, rational expectations, and market clearing", presenting it as gospel truth. That model, built on a framework loaded with assumptions, is even made deceptively simple for the policymaker in terms of three equations. First defines the current output gap as being positively influenced by the past and/or expected future output gap and negatively by the real rate of interest. A second makes current inflation dependent on past inflation, the output gap and the expected future inflation rate. And the third is a monetary policy rule, which requires the policy interest rate to be set taking into account the inflation rate, the deviation of output from its steady state value and possible shocks.

Besides making assumptions about firm and household behaviour that are questionable, this model rests not just on predictable expectations about inflation and output that are seen as homogeneous across decision-makers but on the assumption that those expectations determine prices and outputs today as well. This makes the task of policy one of influencing both the output gap (which through its impact on demand and supply helps bring inflation to target) as well as inflation expectations, since those expectations are seen as capable of sustaining inflation at higher than targeted levels even when the output gap does not warrant it. Above all, just one instrument, the nominal short-term rate, unhindered by counteracting factors like fiscal profligacy or subventions, is seen as capable of ensuring the required adjustment.

Three Striking Features

There are three striking features of this framework. First, policy is completely endogenous, since how the policy rate is to be moved to achieve the goal of bringing inflation down is defined from within, once the inflation rate and output gap are known. In the event, IT by an ostensibly independent central bank does the same – circumscribes and limits monetary policy. Second, inflation expectations that play a crucial role are implicitly being seen as determined by the commitment of the central bank to IT. If the central bank's commitment to controlling inflation is credible, inflation expectations are low. And low inflation expectations help keep current inflation down. Third, once inflation is controlled everything else takes care of itself. This, according to the report, is because high inflation (a) depresses saving by rendering real interest rates negative; (b) undermines competitiveness, weakens the currency, intensifies inflation and worsens the balance sheets of firms that have borrowed in foreign currency; (c) adversely affects investment allocation and growth; and (d) worsens income distribution. So using just one instrument, the interest rate, to control inflation, helps realise multiple objectives.

These features do not make the reasoning particularly convincing. Conceptually, the call to subordinate all else to IT does require a leap of faith. So, in the final analysis the appeal must be to reality. Does the evidence show that IT works? As a first step, do interest rate adjustments help rein in inflation? Not surprisingly, while the committee recognises that in many contexts the interest rate channel for transmission of monetary policy impulses is weak, it selectively refers to a set of empirical studies that seem geared to establishing that in India, "among the channels of transmission, the interest rate has been found to be the strongest".

Weak Impact on Inflation

The fact of the matter is, there is much evidence internationally that the impact of interest rate changes on inflation is weak, and that the impact on investment is stronger. So relying on IT delivers less in terms of reducing inflation while hurting growth significantly. In India too, though interest rates have been raised significantly over the last three to four years, inflation has continued to rule at relatively high levels.

Two trends have been especially responsible for this outcome. First is the rise in the international prices of oil and the decision of the government to link domestic to international oil prices, resulting in a rise in the prices of this universal intermediate with attendant cascading effects on costs and prices. Second, this has been a period when the government has been seeking to reduce subsidies and decontrol prices in a range of areas that have an impact on costs and prices. To expect interest rates to neutralise these cost-push influences is without basis.

The IT framework does this by attributing much of inflation to what goes on in the minds of individuals. If expectations can be reined in so can inflation. So the framework makes the assumption that a declared policy of targeting inflation can make a difference to how expectations respond to food and fuel shocks, ensuring that inflationary expectations do not heighten when cost-push inflation occurs. And since those expectations are so weighty in influencing the rate of inflation, the result is a significant reduction in the latter. That amounts to little more than an assertion, with no real empirical grounds.

Moreover, cost-push inflation is likely to intensify given the committee's recommendation that all price controls should be withdrawn since they are seen as contributing to, rather than helping to dampen, inflation or as reducing the efficacy of monetary policy in curbing inflation. This despite the fact that higher prices for commodities like fertiliser, power or fuel, resulting from decontrol have been known to and are bound to aggravate inflationary trends as has happened in the recent past.

Waking Up to Reality

Finally, the validity, if any, of all of this depends on the assumption that in today's world central banks can enjoy the luxury of the independence required to pursue IT confident that the necessary transmission would occur. The fact of the matter is that in a world of large and volatile cross-border capital flows and relatively open financial borders, central banks are tied down to addressing the exchange rate and liquidity effects of such flows. That requires them to focus on a lot more that just inflation, necessitating policy flexibility of the kind addressed at the beginning of this essay. The Urjit Patel Committee suddenly wakes up to this reality in Chapter V titled "Conduct of Monetary Policy in a Globalised Environment", in which the consequences for developing country monetary policy of capital inflow surges and developed country policies such as quantitative easing and the taper are discussed.

This chapter, that reads like a standalone essay unrelated to the thrust of the rest of the report, seems to question even the possibility of pure IT, let alone its efficacy. It is as if would-be believers are taken through a long course in IT catechism, only to be suddenly revealed the truth that those principles cannot hold. The treatise on IT seems irrelevant at best, or bad economics at worst.

Purpose of Exercise?

As a result, the serious reader is left asking what the intent of this whole exercise was. One interpretation could be that, committed to financial liberalisation but fearing capital flight, RBI mandarins want to keep interest rates high in order to stall the exit of foreign financial investors. IT is just being used a weak defence of that strategy, whether right or wrong. The second, and the more favourable interpretation is that the RBI wants to place on the table an extreme defence of its policy of keeping interest rates high so long as inflation is high, so that even minor concessions it makes in term of either not raising rates or enhancing liquidity would be received with much applause. The third, which may not be fair, is that the committee was just not up to the task set by its title and the accompanying terms of reference.

REFERENCE

Borio, Claudio (2011): "Central Banking Post-Crisis: What Compass for Uncharted Waters?", BIS Working Paper No 353, Monetary and Economic Department, Bank for International Settlements, Basel.