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COSTLY TO BYPASS MPC FRAMEWORK

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Inflation & Monetary Policy

Following the global financial crisis of 2007-08, India, like many other countries, embarked on a stimulus. The pump-priming did not end too well. By 2013, India crossed or approached double-digit figures in inflation and the national fiscal deficit, in addition to looming bad loans. In summer 2013, when the Federal Reserve indicated a possible reversal of its ultra-accommodative policy, macroeconomic parameters for India were so weak that it got caught up in the "taper tantrum" and experienced external sector fragility. While fiscal excesses and financial sector stress remain issues today, India has improved significantly on at least one dimension — namely, inflation — which has also stabilised the external sector.

How was this beneficial progress achieved? Starting in September 2013, the Reserve Bank of India (RBI) initiated an effort to build credibility with domestic savers and international investors on maintaining inflation at prudent levels. Three years thereafter, the RBI Act was amended to put in place a flexible inflation targeting framework. A Monetary Policy Committee (MPC), comprising of RBI representatives and external members appointed by the Government of India, was enjoined with the legal mandate of managing the policy (repo) rate — the rate at which the central bank lends money to banks, so as to keep consumer price inflation at a target level of 4 per cent, while keeping in mind economic growth.

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By objective measures, the MPC framework until recently worked rather well. It lent transparency and democratic accountability to the process of interest-rate setting; combined with efforts on managing food inflation, it has brought inflation closer to the target; it has contributed to tempering household inflation expectations; and, it has kept borrowing costs in the economy at reasonable levels in spite of the high level of government borrowing and several other distortions. Indeed, rating agencies and multilateral institutions repeatedly mention the MPC and the inflation targeting framework as a landmark structural reform towards sound macroeconomic management.

Yet, since last year, somewhat inexplicably, a series of monetary actions by the RBI have left the MPC's decision on the policy rate partly redundant, diluted the accountable process of monetary decision-making, and put at stake the sanctity of the framework.

Let me elaborate.

With a stated intention to improve the transmission of monetary policy to households and corporations, the RBI has pumped unprecedented levels of money (close to Rs 7 trillion) into the banking system. It has done so mostly by purchasing government bonds but partly also by purchasing dollars. Given impaired financial sector balance-sheets, transmission to economic growth has been at best muted; liquidity is no silver bullet to durably address financial sector stress. The primary effect of excessive liquidity has, instead, been to monetise the government's expenditures and keep its borrowing costs low. With its declared aim not being met satisfactorily, the RBI has doubled down on liquidity supply, with the same outcome.

An important casualty has been the MPC framework.

At times, even when the MPC has kept the policy rate unchanged, the RBI has injected yet more liquidity to move medium-term interest rates down; the two actions have been noted to be in direct contradiction of each other. If the objective is to move medium-term rates, why not build consensus within the MPC to cut the policy rate more aggressively and communicate the rationale?

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Further, given the enormous liquidity glut, every night banks park liquidity with the RBI at a (reverse repo) rate lower than the policy rate and which is not set by the MPC; nevertheless, this rate used to be changed only as part of the MPC Resolution. Lately, the RBI has moved this rate progressively lower than the policy rate; recently, it has done so outside of the MPC meeting cycle and not as part of the MPC Resolution. There are straightforward tools in liquidity management to ensure that in surplus conditions also, the central bank transacts with banks at the policy rate — technically, by switching from “deficit” to “floor” system of liquidity management. Such a switch is routinely adopted by central banks when they provide excess liquidity; the RBI has chosen not to do so.

The net effect is that market interest rates are being increasingly controlled by the RBI rather than the MPC. Indeed, there is a proposal that the rate at which the RBI absorbs liquidity be still lower, likely divorced from the policy rate set by the MPC. The spirit of the MPC framework enshrined in the RBI Act is being violated. It is unclear how the MPC can be expected to satisfy its legal mandate if what it seeks to achieve via setting of the policy rate is in conflict with, or compromised by, the RBI’s liquidity management.

These developments have the potential to pose risks for India’s macroeconomic stability going forward: The implicit monetisation of fiscal expenditures through government bond purchases by the RBI in the secondary market has postponed the recognition of the untenable fiscal reality. The delay has meant the government has had limited policy space since the onset of COVID.

Supply-chain disruptions due to measures taken to contain the pandemic raise the possibility of cost-push inflationary pressures, especially given the excessively easy fiscal and monetary conditions. This can abruptly raise economy-wide borrowing rates, inflict losses on banks, and imperil financial stability.

If the gains in inflation credibility built by the MPC framework are dissipated by ineffective policies and operations, both household and investor expectations for inflation in India could unhinge. It is disturbing that while referring to desirable levels of inflation, analysts appear to have already stopped referring to MPC’s mandated target inflation rate of 4 per cent and the focus has instead shifted to the upper tolerance limit of 6 per cent. Worse, it could instigate turmoil in the external sector. Excessively low bank deposit rates may induce some non-resident deposits to exit the country.

In a highly unpredictable time such as this, the RBI should preserve its inflation credibility. This requires making the institution of MPC more enduring, not bypassing it. Decision on monetary policy actions based on voting by committee members, provision of inflation and growth forecasts in the resolution statement, and coordination of rate-setting and liquidity management, need to be adhered to.

Even in desperate times, we need to follow due processes and justify with substance the extraordinary actions so that commitment is provided as to how these actions will be unwound when necessary.

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