Source : www.indianexpress.com Date : 2020-08-21

# CURRENT CRISIS HAS EXPOSED LIMITATIONS OF CENTRAL BANKING FRAMEWORK

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Over the past few months, the Reserve Bank of India, along with the monetary policy committee, has undertaken a slew of measures to arrest the economic slowdown, and address the fallout of the COVID-19 pandemic. Yet, their actions, guided by multiple considerations — inflation and growth management, debt management and currency management — have inadvertently exposed the limitations of and the inherent contradictions in the central banking framework in India.

Take the monetary policy function. The MPC is guided by the goal of maintaining inflation at 4 plus/minus 2 per cent. Since February 2019, the MPC has, and rightly so, attached primacy to reviving growth, lowering the benchmark repo rate by 250 basis points. However, in its August policy, despite dire growth prospects, it chose to maintain the status quo. This decision was driven, in part, by elevated inflation which continues to average above the upper threshold of the inflation targeting framework. This raises the question: At the current juncture, should the MPC be driven by growth considerations or should short-term inflation concerns dominate?

That there is considerable uncertainty over the trajectory of inflation is beyond debate. But at its core is a question: Is COVID inflationary or disinflationary? Will it be inflationary in the short run (retail inflation is elevated largely due to supply dislocations) but disinflationary over the medium term (with demand falling)? Or does the MPC believe that it will remain inflationary over the medium term with supply-side disruptions outweighing the effects of a fall in demand?

**Opinion | Bank and the Covid pain: We must persist with a multi-year five-pillar strategy to raise credit to GDP ratio to 100%**

In large part, the current rise in inflation (CPI had fallen from January to March) is driven by supply-chain dislocations owing to the lockdowns. This is evident from the growing disconnect between the wholesale and consumer price index. Since April, while WPI has been in negative territory, CPI has been elevated, indicating, excess supply/low demand at the producer/wholesale level but excess demand/low supply at the retail/consumer level, suggestive of dislocations in the intermediate supply chain. Accepting this implies that the spurt in retail inflation will be temporary, and it will begin to trend lower as these disruptions ebb.

Monetary policy is supposed to be forward looking. So, if on balance, COVID is likely to be disinflationary over the medium term, although this will show up with a lag, then there is a case for looking beyond the current spike in retail inflation. And given the collapse in the economy and that the transmission of rate cuts takes time, it tilts the balance in favour of further easing. Worries of lower rates translating to higher future inflation may prove to be misplaced considering the extent of the fall in demand, the idle capacity in the system, and the little pricing power of producers.

Considering that the MPC expects inflation to trend lower in the second half of the year (presumably due to easing of supply side disruptions), its stance in the August meeting was puzzling. The MPC's mandate is to deliver stable inflation over long periods of time, not just a few months. Yet, it would appear as if it is more concerned about elevated inflation in the short run. Will a few more months of data end its uncertainty that this is not a cyclical deviation but a structural downshift? Perhaps. Unless the current MPC believes that it has approached the limits of conventional easing.

**Editorial | [RBI leaves rates unchanged, signals room for further easing in times of continuing uncertainty]**

One could also argue about the inefficacy of monetary policy at the current juncture, and thus the limited options before the committee other than to hold, and keep the power dry. But this argument is driven more so by the absence of policy levers available to the committee other than the repo rate. Expanding the range of policy levers available to it may well render this argument void.

Equally puzzling is the refusal to provide any firm projection of future inflation. While there is considerable uncertainty over economic conditions, surely, the committee members are basing their decisions on some expectation of future inflation and growth. These should have been publicly disclosed. While it is possible that the minutes of the MPC meeting shed light on their expectations, ideally, all MPC members should provide their individual estimates of inflation and growth.

This growth-inflation conundrum is just one part of the story. The current crisis has also brought to the fore the inherent contradictions between the MPC's operations, and the RBI's debt and currency management functions, pointing towards a larger structural challenge.

As manager of the government debt, the RBI is tasked with ensuring that the government's borrowing programme sails through smoothly. To this end, it has carried out several rounds of interventions popularly known as operation twist. These interventions involve the RBI buying longer-dated government bonds, while simultaneously selling an equivalent amount of shorter-dated securities — pushing down long-term Gsec yields, and exerting upward pressure on short-term yields as a consequence. In doing so, the RBI ended up doing exactly the opposite of what the MPC was trying to achieve by cutting short term rates, well before it reached the lower limit of its conventional policy response.

**Opinion: [Banks need to set aside credit for new firms, raise disbursements]**

Further, the RBI's interventions in the currency market — intervening in order to prevent the rupee from appreciating — have constrained its ability to carry out open market operations as these would have led to further liquidity injections into the system. Put differently, its debt management functions have run up against its currency management functions. Underlining the complexity of all this is the talk of sterilisation — the opposite of injecting liquidity in the system.

The central bank must develop a clear strategy on what to do. At the one end, it is legally bound to an inflation target. Yet, at this juncture, there is a strong argument to look past the current spurt in inflation, and test the limits of both conventional and unconventional monetary policy. At the other end, while it may want to intervene to prevent the rupee's appreciation, in doing so, it is constricting its debt management functions which will have its own set of consequences. There are no easy answers.

***This article first appeared in the print edition on August 19, 2020 under the title 'RBI's dilemma'. ishan.bakshi@expressindia.com***

**Opinion | [The marginalised have to establish their own thinktanks that equip their representatives with hard data and analysis]**

***and stay updated with the latest headlines***

**END**