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# WHY RBI NEEDS TO LOOK BEYOND INFLATION

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

**MUMBAI** : Through covid-19, the Reserve Bank of India (RBI) and the Monetary Policy Committee (MPC) have had to undertake a series of extraordinary steps. These include deep policy interest rate cuts, strong banking liquidity infusion, intense bond and currency market operations, besides measures to preserve financial stability.

This journey is far from over, and 2021 could also keep the RBI and MPC very busy. This then is a good time to reflect on the inflation-targeting framework under which the RBI and MPC operate and contrast it with the actual framework on the ground during the pandemic.

Our legally-enshrined monetary policy framework requires the MPC to set the policy repo rate, so as to target CPI inflation at 4%. While it tolerates inflation between 2% and 6%, there is no mention of growth, external balance or any other secondary objective for monetary policy in the RBI Act.

This framework is questionable at several levels. First, in a country like India, the relationship between interest rates and inflation is complex. Under certain conditions, higher interest rates would indeed curb growth in money supply and inflation. However, under conditions such as those prevalent now, higher interest rates may perversely cause money supply (and the risk of monetary inflation) to actually rise.

The core premise that interest rates can control India’s inflation uniformly–even monetary inflation–is neither empirically proven, nor conceptually sound.

Second, interest rates can disproportionately influence macroeconomic variables well beyond inflation, such as foreign currency flows and the external balance, financial stability and asset prices, and arguably, investments and job creation. The framework provides no room to even acknowledge these, let alone provide any guidance around policy trade-offs.

Third, there are several interest rates in our economy, and the policy repo rate alone is insufficient to influence them all appropriately. The RBI retains other critical tools such as banking liquidity and market operations. Beyond these, government fiscal policies and external flows can also greatly impact different interest rates.

In short, outcomes such as inflation, external stability, investments and job creation etc respond in a complex intertwined manner to fiscal policies, changes in policy interest rates, banking liquidity, RBI open market operations in fixed income and currency markets and so on.

Instead, our framework is simplistic, and boils down this immense complexity to one where the policy rate lever alone is to be pulled to target retail inflation. Sadly, economics and markets follow their own laws, and are not bound by acts of Parliament.

The authors of this framework were likely well aware of all this. They still persisted with it, perhaps driven by a somewhat justifiable lack of trust in government. For, any complexity might allow the government of the day to strongly influence monetary policy in support of stimulus and fiscal spending. Second, they likely reckoned that a simple rule-bound framework with the carrot and stick of interest rates can goad the government to pursue appropriate fiscal policies.

Nevertheless, there are severe shortcomings in this MPC framework. For one, if the MPC and

RBI were to literally follow the law today, they might be busy tightening and raising policy interest rates now. After all inflation has averaged 6.75% over the last 12 months, well in excess of the upper limit of tolerance of 6%.

The MPC and RBI have instead followed a pragmatic approach, while keeping up the appearance of being true to their legal mandate. It helps that not even ardent advocates of the current framework would argue for a purist approach at this juncture.

Astute pragmatism will be needed the next year as well, under difficult conditions. Even as our weak economy is limping back to normal, India is one of the few countries in the world grappling with sticky and high inflation. In addition, our fiscal balance remains strained, even as calls on the government to invest more into productive investments persist. Through all this, given global easy money conditions, capital flows continue to pour in, increasing our currency reserves and sustaining our equity markets at their all-time highs.

While the MPC and RBI outwardly continue their inflation-targeting chants as required by law, we will finally need the right mix of policy rates, banking liquidity, RBI operations in bond and currency markets, capital flow measures, fiscal policies, and macroprudential regulations. The International Monetary Fund’s Gita Gopinath had earlier made a similar case for an integrated policy framework.

Clearly, the current context of an opaque behind-the-scenes integrated framework underneath professed inflation targeting is neither sustainable nor desirable. Eventually, we will need to debate and formally adopt a more realistic integrated policy framework.

**The big debate**

Can interest rates control even monetary inflation in India? Let us go beyond the perennial and valid argument that given food comprises 48% of the consumption basket, the ability of interest rates to control CPI inflation in India is suspect. Consider the efficacy of interest rates in controlling even pure monetary inflation, the kind caused by too much money chasing too few goods.

We define money as the sum of currency in circulation and deposits in banks, or ‘M3’ in economic parlance. M3 is created principally through three routes–when banks lend; when government deficits are financed by banks and the RBI; and with net foreign currency inflows.

If high inflation coincides with strong growth in bank credit funding consumption, then other things being equal, raising interest rates will raise the cost of money, bring down growth in credit and money supply, and hence slow down consumption and inflation. The current monetary policy framework would then indeed be useful to curb inflation.

What if the credit growth were funding productive investments, rather than consumption? Investments should eventually improve supply and ease inflation. Still, a purist might well argue that credit growth is creating fresh money at a time of high inflation, and hence interest rates would still need to be raised.

But what if credit growth is tepid, while inflation is high? Consider the current context. Despite the contraction in the economy, M3 is growing at 12.5% per annum. At just 5.8% per annum, credit growth is clearly not the principal cause of this M3 growth. Instead, government fiscal deficits and net foreign currency inflows are.

At a time when tax revenues have contracted sharply, banks and the RBI have lent our governments over 9 trillion this fiscal year, leading to M3 growth. Likewise, over 6.5 trillion of money has accrued from foreign currency inflows.

If ‘too much money’ was behind the current high inflation, would raising short-term interest rates help?

Credit growth is already subdued, and would not be impacted by higher rates. The government is unlikely to curb its fiscal deficit in response to higher interest rates. Instead, given global interest rates are at historic lows, raising our interest rates would bring in more ‘carry trades’ of foreign currency inflows chasing higher yields. This would further increase money supply, and, hence, perversely raise the risk of monetary inflation. This underlines a big lacuna in our current monetary policy framework. It ignores the impact of interest rates on our foreign currency flows and external balance. Nor is the current situation an aberration.

For instance, during 2017-18, we saw $60 billion of ‘carry-seeking’ opportunistic foreign currency flows, attracted by the relatively high interest rates under our inflation-targeting mandate. Paradoxically, these fickle inflows added to our deposits and money supply, and hence added to the risk of monetary inflation.

In fact, then as now, domestic credit growth was already muted, and not really adding to money creation. In addition, these reversible flows kept the rupee relatively strong at a time when our current account deficit was a high $49 billion. Besides disadvantaging domestic industry, this also built up our external vulnerability. True enough, the next fiscal year saw much of these fickle flows reverse out, causing intense volatility in our currency markets.

A blinkered adherence to our inflation-targeting mandate can be far more dangerous than we realize.

**An integrated framework**

Unlike much of the world, India is grappling with high headline and core inflation, despite a contraction in our income. Lower food prices and higher output should hopefully bring down headline inflation, even as rising money supply and a resilient rural sector hopefully revive economic activity.

But there are risks. During 2010-13, the rise in money supply and consumption was not matched by increased domestic output. Inflation, higher imports and external imbalance then followed. Our trends in domestic output and the success of Atmanirbhar Bharat will therefore be critical, even as non-oil imports recover to pre-covid-19 levels.

While recent recovery is gratifying, our economy is battle scarred, weak, and needs delicate handling. Our central and state governments will have little choice but to continue with large fiscal deficits. Including off-balance sheet expenditures and delayed payments, the combined fiscal deficit this year could well exceed 14% of GDP. Yet, our governments may need to spend even more, and channel funds into productive investments into infrastructure, healthcare, education and nutrition. In the midst of all this, we have seen strong foreign currency inflows, particularly into our equity markets.

Here’s an integrated policy mix that might help navigate these trying circumstances.

First, notwithstanding inflation, short-term rates should continue to stay low, as long as net foreign currency flows continue to pour in, and our credit offtake remains subdued. Withdrawing banking liquidity and raising short-term rates would not impact our depressed credit growth.

Instead, it could risk attracting fickle carry-seeking currency inflows, and push up money supply even further.

However, whenever credit growth recovers, if inflation still persists, the RBI will have to withdraw the punch bowl of banking liquidity rapidly, using the ample tools in its arsenal.

Second, longer-end interest rates have been repressed by RBI's interventions in government bond markets. In addition, banks have been encouraged to buy government bonds with surplus banking liquidity and favourable macroprudential rules. Besides increasing money supply, all this has short-changed our savers with interest income well below inflation.

One way around this would be for the government to directly borrow from savers through a special Corona Bond, rather than from banks and the RBI. This would recycle existing money supply rather than adding to it, provide adequate return for long-term savers, reduce the risk of asset bubbles, and allow the government to channel funds into productive investments. Such Corona bonds can be repaid via eventual disinvestments.

Finally, RBI's strategy of accumulating foreign currency reserves and preventing excessive rupee appreciation is sensible. This year's current account surplus is temporary, and there is little evidence yet of carry-seeking flows chasing our interest rates. Inflation suggests that domestic production could still be a challenge. If so, excessive rupee appreciation could hurt domestic industry. The 36-country trade weighted real effective exchange rate (REER) shows that the rupee still remains overvalued by over 16%.

Given the uneven recovery, inflation, and stresses in the economy, strong currency reserves serve as an insurance buffer. In the single year FY08 alone, RBI had purchased $93 billion. Over the next six years to FY14, RBI had to sell it all back and more. High currency gives us space and time to repair our economy and bring back jobs and productivity.

**In conclusion**

Financial economics is complicated. Our current flexible inflation targeting framework attempts to keep it simple, and ends up being acutely simplistic.

At best, it might have served as a rule-based carrot and stick that would goad the government to pursue prudent policies. Through the pandemic, however, as the inadequacies became obvious, we have moved to paying lip-service to inflation targeting, while pursuing a de facto and fairly opaque integrated policy framework.

Over time, the current status quo is neither sustainable nor desirable.We may eventually have to debate and formalize a new realistic integrated policy framework to replace inflation targeting.

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