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THE PERILS OF RBI’S FIXATION ON INFLATION

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A Reserve Bank of India (RBI) logo in its headquarters in Mumbai. | Photo Credit: Reuters

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.

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?

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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