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PLANNING AN EXIT OUT OF THE EASY MONEY REGIME

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

The Reserve Bank of India (RBI) embarked on an extraordinary expansionary policy to manage the financial pressures unleashed by COVID-19. It slashed policy interest rates aggressively, flooded the market with an unprecedented amount of liquidity and instituted a slew of measures for targeted assistance to especially distressed sectors.

As we sight springshoots in the economy, the RBI must be planning for a non-disruptive exit out of the easy money regime. Crisis management is a percentage game. When the house is on fire, central banks do what they think has the best chance of dousing the flames, shedding their characteristic deliberation. In contrast, reversing a crisis-driven expansionary policy has to be a deliberative process, with the timing and sequencing carefully planned. Indeed, one of the big lessons of the global financial crisis is that any missteps on the exit path by way of commission, omission, or importantly communication, can be costly in macroeconomic terms.

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So what are the challenges that the RBI will confront on the way out?

By far the biggest challenge will be to manage the tension between restraining inflation and supporting the recovery. This is a policy dilemma even when the macroeconomic situation is benign; the pandemic, shrouded in unusual uncertainty, has made the dilemma much sharper.

Consider the most recent Monetary Policy Committee (MPC) review in early December. Inflation remained above the RBI's target band for the past several months, and according to the RBI's own estimates, is expected to remain above the band for the next several months. Yet, the MPC decided against any rate action out of concerns for growth and financial stability. The MPC expects inflation to soften on its own in the weeks ahead as supply chains, disrupted by the lockdown, normalise, and the bumper winter crop comes into the market.

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That outcome is not inevitable. Inflation could be pressured upwards by several factors even though there could be some apparent softening purely because of base effects. There is the risk that persistent high inflation expectations would result in food inflation getting more generalised. Core inflation could firm up because of rising input prices. 'Excessive margins', among the factors cited by the MPC as one of the causes of high inflation, may not disappear if firms, regaining pricing power amid demand recovery, raise prices to mend their balance sheets.

Equally, there are concerns that the recovery, for all the positive signals, is still fragile. It has also been uneven and unequal, with large industries finding their foothold while small and medium enterprises and the entire informal sector continue to be in distress. And there is heightened concern about an aggravated unemployment problem caused by big firms retrenching labour to cut costs.

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Quite apart from the upside risks to inflation and downside risks to growth, the RBI should also be concerned about the plight of savers who are being shortchanged by low interest rates at a time of high inflation. All these concerns taken together make a complex cocktail of dilemmas for the RBI as it seeks to normalise the policy rates.

A second and related challenge will be to withdraw the ‘excess’ liquidity in good time. Banks are routinely depositing trillions of rupees with the RBI every day, evidencing that all the money that the central bank unleashed into the system is not doing much good anymore. For sure, there was a clear purpose behind the RBI joining the global central bank bandwagon of ‘dash for cash’ — to inspire confidence in the economy when confidence was at very low ebb. Hopefully, we are out of that abyss now and it is time to think of an exit.

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Every financial crisis can be traced back to mispricing of risk, and mispricing of risk is what results when there is too much liquidity sloshing around the system for too long. It will drive investors into dodgy ventures and threaten financial stability.

As the RBI seeks to guard financial stability by normalising liquidity, it will have to contend with possible market tantrums. Remember the ‘taper tantrums’ that reverberated across global markets when Ben Bernanke, then chairman of the U.S. Federal Reserve, announced in a routine statement in May 2013 that they were considering gradually tapering ‘quantitative easing’. Any news like that, implying that the American economy, the epicentre of the global financial crisis, was showing signs of a robust recovery, should have been cheered by the financial markets; instead, the panic sell-off showed that investors, used to the ease of abundant liquidity, were unprepared for the ‘punchbowl’ being snatched away. The lesson from the taper tantrums clearly is that the RBI will have to manage its communication as carefully as it does the liquidity withdrawal.

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That allows me a segue into the third big challenge for the RBI going forward which will be to restrain the rupee from appreciating out of line with fundamentals. Here, the RBI is confronted with a classic case of ‘the impossible trinity’ — of keeping doors open for capital flows while simultaneously maintaining a stable exchange rate and restraining inflation. Maintaining a policy balance across all three conflicting objectives can be tricky. As a former Governor, I can vouch for it.

The current account surplus this year together with massive capital flows has meant a surfeit of dollars in the system putting upward pressure on the rupee which is already overvalued in real terms. The RBI has absorbed nearly $90 billion this fiscal year to prevent exchange rate appreciation and to maintain the competitiveness of the rupee. The RBI’s ability to continue to intervene in the forex market will be constrained by its anxiety about how the resultant liquidity might aggravate inflation and the risk to financial stability. Managing the impossible trinity will be a tricky challenge for RBI going forward.

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It is better to be rough right, as Keynes said, than be precisely wrong. That should be the guiding principle for RBI as it navigates its way out of the crisis driven easy money policy.

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