No proof required: Making RBI accountable

A year has passed since the first meeting of the Monetary Policy Committee in October 2016. An in-house observation (by MPC member Michael Patra in a speech on October 27) is, not surprisingly, self-laudatory. The facts speak differently. While the CPI inflation this fiscal year, at 2.7 per cent, is the lowest in the last 40 years, real policy rates are the highest in the last 14 years and industrial production, the fifth lowest in 21 years. GDP growth is at sub-6 per cent levels, from an 8.5 per cent level just two years ago.

Amidst much fanfare and support, the MPC made its first decision in October 2016. The MPC mandate was to bring the CPI inflation rate to below 4 per cent by March 2018, some five months from now. But what appears forcefully from the table (pre-MPC, the eight months of 2016 prior to the arrival of the MPC; post-MPC, the 14 months since) is that headline inflation has consecutively registered an inflation level well below 4 per cent for the last 12 months.

We need to explore the reasons for the controversial decision of the MPC to stubbornly raise the real repo rate. We are in an age where central banks are ever eager to communicate their thoughts, their policies, and do so well in advance. Unfortunately, the MPC members display a grandiose failure to communicate.

One of the most cited reasons for the RBI being so obstinate in not lowering real repo rates is that the MPC, being a new institution, had to show its independence from the Centre. Then why, just one month into the job, did the MPC cut rates in October 2016? The last eight months' inflation data was registering an average of 5.5 per cent, the real repo rate (nominal repo rate minus y-o-y CPI inflation) had averaged 1.1 per cent, and was well below the assumed RBI repo target rate of 1.75 per cent. The GDP growth for the first two quarters was averaging 8.5 per cent. So why the unseemly hurry to cut the repo rate to 6.25 per cent ?

Patra defended the October MPC action as follows: Last month (August 2016) inflation data came in at 5 per cent, the repo rate is at 6.5 per cent, and unlike Raghuram Rajan, the MPC believes that the appropriate real repo rate for the Indian economy, in a world of declining and low inflation, is 1.25 per cent, some 50 basis points lower than the Rajan rate.

It all sounded so sensible. Then all hell broke loose — from the RBI/MPC side. Over the last 14 months, inflation has averaged 3.3 per cent, and the real repo rate has tripled to 3 per cent. In other words, the MPC has been way behind its own curve, its own stated goals. What explains this backward-bending RBI?

One popular explanation for the MPC acting in this high-handed manner is that it was "forced" into the decision of demonetisation, much against its wishes. However, it is very unlikely that RBI Governor Urjit Patel was not told about the impending demonetisation — we know that Rajan knew, and opposed, it. We can easily infer that if Patel had opposed demonetisation, he would not have accepted the job.

Some more facts. The 4 per cent goal was originally set by Rajan-Patel (and the ministry of finance) for March 2018. Second, the 4 per cent goal has now been met for the last 12 months, with an average deficiency of 100 bp. Third, even an outside rating agency (Moody's) has approved of both demonetisation and declining inflation. It has remarked that inflation "has declined markedly and foreign exchange reserves have increased to all time highs, creating significant policy buffers to absorb potential shocks," while the MPC expected demonetisation to raise inflation.

One final point about the strange goings on in Mumbai. The second lesson in economics, (after identification of winners and losers — see below) is that when uncertainty goes up markedly, the central bank is supposed to accommodate the uncertainty by lowering real rates. And what has Lord MPC done — the opposite, and raised such rates by 190 basis points (see table).

Does the RBI/MPC have an explanation for their policy actions? They have shifted the goalpost many times, and unfailingly, without reason. Core inflation, service inflation, HRA inflation, oil inflation, vegetable inflation, and unforeseen inflation. Not only have they not offered any explanation, they have manufactured reasons to hike rates.

I am not using the term “manufactured” lightly; readers of this column know that I have diligently reported that I cannot reproduce the RBI results on fiscal deficits causing inflation; worse, the RBI, in this open age, flaunts all norms of research by selectively picking data to suit its ideological biases (for those interested, the entire “accusation”, and the data, are posted in a short paper, ‘Attempting to Reproduce RBI Results on Fiscal Deficits Causing Inflation,’ at <http://goo.gl/cMpjdu>\). I would encourage readers to run their own models to see who is wrong— me or the RBI. There is no in-between here.

Gainers — behind the MPC scene: It is easy to identify the winners with real rates being the third highest in the world (behind Brazil and Russia). Rakesh Mohan, former RBI deputy governor, had identified “lazy banking” as being a major outcome of the Indian financial system. The regulator (RBI) sets real interest rates so high that bankers find it worthwhile to safely loan to the government by buying more government securities than mandated by the SLR. Presently, the banks’ share of government securities is about 10 percentage points higher than mandated.

The second group that benefits are foreign investors. They borrow at less than 2 per cent in their home countries, buy Indian government bonds (thanks to the MPC) yielding an exorbitant 7 per cent, do not hedge exposures, and laugh their way to the bank.

The third group that benefits from high real interest rates is the political Opposition. You have to be living in a cave not to have noticed the spring in the step of every Opposition politician since the announcement, end of August, of 5.7 per cent GDP growth. This ammunition is just in time for state elections. It is universally-acknowledged that PM Narendra Modi’s popularity remains very high; also universally accepted is the fact that the only way for the Opposition to dent this popularity is if India has slow GDP growth, and low employment growth. And it is also universally acknowledged that employment and GDP growth are correlated — that is high real interest rates are an important cause of low GDP growth.

Not so curiously, the political opposition failed to mention RBI policy in their critical comments about the effect of demonetisation on GDP growth. The opposition chose to mention the tail (demonetisation) affecting growth, and not the biggest elephant (high interest rates) obstructing GDP growth. In my comments on the anniversary of demonetisation, I emphasised the important causative role of the MPC in causing growth to slow, and others agreed with me behind the scenes, but admitted that they could not object on TV!

Losers from MPC actions: Losers from MPC policy are the Indian economy, the Indian government, and the politicians in charge of the economy. In addition, interest payments are affected by RBI policy, and such payments account for over 96 per cent of the budgeted fiscal deficit for 2017-18; in 2015/16, they accounted for “only” 83 per cent.

The independence of the RBI, and MPC, is sacrosanct. But other countries have also encountered the problem of an institution not adhering to its mandate, going astray as it were. The most prominent example of an independent institution being made answerable to the people is the US

FED. That is the subject of my next article.

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