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FINANCIAL STABILITY AND THE RBI

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

The Reserve Bank of India (RBI) recently carried out its mandatory bi-monthly announcement on the future course of monetary policy. These announcements ostensibly offer 'forward guidance' to economic participants, so that they may plan their future. Arguably, though, the public would have perhaps been more interested in knowing how the RBI intends to respond to the unusually large number of instances of fraud that have surfaced in the financial sector of late. The RBI's reputation as a regulator has been affected by these. What led the bank to this place needs understanding.

Central banks command an important position in the market economies of the West today. How in a democracy so much power could be ceded to an unelected body must itself come as a surprise. It reflects two things: the political power of financial interests in the U.S. economy and the global intellectual influence of the American economic model. This model revolves around the goal of maximum creation of wealth by private individuals unimpeded by societal objectives. Leave alone the distribution of income, not even the objective of ensuring stability of the economy is allowed to come in the way of private individuals pursuing wealth enhancement.

Public regulation, which sets limits to private activity, is rejected as an unnecessary interference in beneficial activity that maximises social gain, and is therefore to be avoided. When applied to finance, this model requires of the government only one action, namely, the control of inflation. Now, it is difficult to see why anticipated inflation, being an increase in all prices at the same rate, is harmful to production, the basis of an increase in wealth. After all, when prices rise together, no one individual is worse off if the inflation has been perfectly anticipated. It is unanticipated inflation that is the problem for producers, as it has the potential to derail their profit calculations. However, inflation, even when fully anticipated, can harm holders of financial assets yielding fixed incomes by eroding their wealth.

Borrowers on the other hand are better off with inflation as the real value of their outstanding loans are now less. While the problem of inflation can in principle be tackled through inflation-indexation, the practice is not widespread. This leaves owners of financial wealth averse to inflation.

As the volume of financial wealth in an economy increases so does the power of its owners over government. Now inflation control tends to take centrestage in economic policy formulation. When inflation control is implemented via monetary policy it results in higher interest rates. Managers of financial wealth lobby for such a policy on behalf of their clients. This lobbying is the origin of the policy of inflation targeting. Inflation targeting by the central bank involves use of the interest rate to keep inflation under control. As it targets inflation it must let go of the employment objective. Though 'flexible inflation-targeting' is meant to take care of this objection, inflation is retained as the target and the central bank is not accountable for unemployment. In fact, in situations where growth, employment and inflation are jointly determined, and mostly they are, inflation-targeting via the interest rate can lower inflation only by suppressing growth. This is the mechanism by which inflation-targeting inevitably lowers growth. Is this an argument for leaving inflation unchecked? No, it isn't. On the other hand it points to other means of keeping inflation low, which, as has been demonstrated for India, would take the form of checking food-price inflation.

If inflation-targeting is essentially a response to the concerns of the financial sector, it tends to go with the view that the sector needs no particular regulation. This view was ascendant in the

United States and the United Kingdom before the 'North Atlantic Financial Crisis' of 2008, so dubbed by Rakesh Mohan and Partha Ray to convey that its provenance is related to the policies pursued in that geography. Following this crisis, however, there has been substantial re-thinking on inflation-targeting and the role of central banks. Essentially it was recognised that lulled into complacence by low inflation, the U.S. central bank had ignored the possibility of financial instability. Instability had progressed due to the complete violation of the norms of prudence by U.S. investment banks and housing societies in a climate of relatively lax regulation. Alan Greenspan, the chairman of the U.S. Federal Reserve for 19 years, an arrangement seriously questionable in a democracy, was to acknowledge to a congressional committee that everything he had believed in regarding the functioning of the economy turned out to be false.

In a monumental failure of the imagination, India's policymakers adopted inflation-targeting as the defining function of its central bank, even as the rest of the world was reassessing its credibility. Though the switch was effected by legislation only in 2015, a hawkish inflation stance had emerged at the RBI some two years prior to that. The real interest rate swung upward by over 5 percentage points. Inflation did come down, but that it continued to decline even as the real interest did not do so commensurately belies the possibility that inflation-targeting alone is responsible for it. Commodity prices, both of oil and domestic agricultural goods, have grown slower since. Oil prices have actually been declining in certain phases, and would surely have had a direct impact on inflation. But the slowing of the economy after 2016, which we are still experiencing, suggests that inflation-targeting may have had an impact on growth. This would not be surprising at all.

After the adoption of inflation-targeting in India, besides the slowing growth, we see the repetition of a pattern observed in the U.S. We have seen the appearance of stress in the financial sector. Following the rising non-performing assets, or NPAs, of public sector banks, we now see the emergence of instability in the private segment of the financial sector. The most prominent case is that of non-banking financial company, ILFS. While some part of the burden this company faced before it was rescued by the government of India may have been due to a slowing economy, there was evidence of malfeasance, which went undetected also in the cases of Punjab National Bank and the Punjab and Maharashtra Co-operative Bank (PMC Bank). Improper conduct was also evident in the cases of Yes Bank and ICICI Bank. Scenes of agitated depositors outside the PMC Bank's office in Mumbai must have sent shivers down the backs of millions of Indians who have trustingly entrusted their hard-earned money to India's banks, only to find their trust violated with impunity in pursuit of private gain. The latter would be unacceptable even if the act is not risky, which in the case of PMC Bank was extraordinarily so.

The emergence of financial instability in India following the institution of inflation-targeting is in line with what we have seen in the Anglo-American economic area. In India, the virtual redefinition of the central bank's functions appears to have encouraged the RBI to consider its work done once inflation is within target. Televised monetary policy statements every two months would be no more than a charade, if inflation slows for extraneous reasons, and a smokescreen, if financial stability has been compromised due to lax regulation of the financial sector.

Even as the TV screens gurgle with news of some microscopic cut in the repo rate I see hapless vendors at Delhi's swanky new airport scrambling for change. In the new India, the buck, it seems, stops nowhere.

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