Need to move away from garden-variety monetary policy

It is widely accepted that India's economy is in a protracted slowdown. Interestingly, there is no more inconsistency between the trend suggested by high-frequency indicators and the quarterly GDP estimates. The Reserve Bank of India's (RBI) industrial outlook survey too reveals a waning of optimism in Q2 about demand conditions and other parameters like capacity utilization, profit margins and employment. The government's increasing reliance on counter cyclical buffers like agricultural loan waivers and rural flagship schemes and the recent move to set up an Economic Advisory Council to propel the economy, reflect its growing worries over economic outlook.

Moreover, the economic slowdown is structural rather than cyclical in nature and a broad-based economic revival is seen several months or even years away. According to Asianomics, Asia's leading independent economic research provider, "this is not a simple cyclical slowdown or a case of the economy working through one-off exogenous shocks i.e. demonetisation and the introduction of GST. There are structural hurdles to overcome – including the roll-out of GST, the resolution of bank bad loans and corporate sector debt and capacity overhangs. Overcoming these hurdles will put the next economic upcycle (and long-term growth) on a strong footing but it will take time to get there and it will be painful". Against this background, there is a need for RBI to implement its flexible inflation targeting framework in true spirit. Under flexible inflation targeting, the central bank aims at stabilizing inflation around the inflation target, and at the same time put some weight on stabilizing the real economy. Under flexible inflation targeting, the objective is not only to achieve inflation target but also to control the "output gap" (i.e., the difference between potential and actual output). Unfortunately, there is no perfect way to measure "potential output" (i.e., country's productive capacity with stable inflation), especially for a developing country like India due to serious data gaps and measurement errors.

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However, sustained weak prints for growth in industrial production, exports and bank credit, low capacity utilization rates and the slow corporate de-leveraging process since 2011 do suggest deep-rooted stresses in the broader economy and an urgent need to stabilize the real sector.

On the inflation front, the headline CPI has averaged at 2.5% during 2017 so far—way below RBI's target of 4% on the back of near collapse of food inflation and weak aggregate demand. However, CPI inflation spiked to 3.4% in August on the back of higher food inflation (mainly vegetables—due to supply distortions), higher fuel inflation (due to global factors) and higher core inflation (due to house rent allowance and GST effect). But these pressures entirely reflect cost-push rather than demand-pull elements in the inflation trajectory.

Going ahead, CPI inflation may inch up due to the unfavourable statistical base, adverse impact of floods and erratic rainfall on food price inflation, rising global crude prices and the impact of GST. These fears would certainly weigh on RBI and could induce it to tighten rather than loosen monetary policy.

Coming to the fiscal side, despite a muted growth in revenues at 2.1% during April-July 2017, total expenditure of the central government has grown at 7.5% during the same period (with maximum spending on agriculture sector followed by defence). The central government's fiscal deficit has already touched 92% of budget estimates. Even the state governments' fiscal position remains stretched primarily on account of Ujwal DISCOM Assurance Yojana (UDAY) scheme to turn around power discoms and increasing proportion of farm loan waivers.

The current combination of relatively lax fiscal policy and monetary policy fixated on a specific inflation target brings us to an important argument by Alan Blinder—the noted monetary economist who showed how the mix of expansionary fiscal policy and contractionary monetary policy pushed

aggregate demand sideways in the US in 1980s, while keeping interest rates sky high. That was the phase when President Ronald Reagan pushed spending while the Federal Reserve under Paul Volcker declared war on inflation. As a consequence, the US economy faced very high bond yields, stronger dollar and an acute economic slowdown. This compares well with Indian situation today as we too are facing very high real interest rates, overvalued currency, acute industrial slowdown, weak exports and rising current account deficit, when global growth is getting stronger and government is taking a fiscal risk to support growth through counter cyclical spending.

According to Blinder, a central bank is expected to practice garden variety monetary policy (maintaining a bright and inviolable line between fiscal and monetary policy) only under normal circumstances. However, in a phase of severe economic slowdown, a dedicated focus on inflation control may be counterproductive. Such situations warrant lower interest rates and accommodative stance by a central bank to enable sound companies to raise capital at reasonable costs from bond and primary equity markets—a necessary step to boost the languishing manufacturing sector.

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This is the first in a series of columns ahead of RBI's bi-monthly monetary policy meeting on 3 and 4 October.

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