RBI's inconsistent view

The decision by the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) to keep the policy rate unchanged was not a surprise. However, the interpretation of the grounds underlying the decision has led to disagreement, even controversy. There are two issues here. The first is the analytical credibility of the MPC's approach. The second is public dissonance in the views of the finance ministry and the RBI.

PUBLIC INTEREST

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The policy rate is on hold since December 2016. In December, the MPC cited volatility in crude oil prices, financial market turbulence, rising food prices, and uncertainties about the impact of demonetisation to hold rates arguing "...it is prudent to wait and watch how these factors play out and impinge upon the outlook...". In February, the MPC changed its policy stance from "accommodative" to "neutral". It did not specify what the change in adjective meant but justified holding the policy rate"...to assess how the transitory effects of demonetisation on inflation and the output gap play out...". In April, the MPC asserted that "underlying inflation pressures persist...", and foresaw an increase in aggregate demand pressures, while the effects of demonetisation are "distinctly on the wane, and should fade away by the Q4 of 2016-17". There was now an explicit judgement that inflation was expected to rise. In the latest, June 7 statement, the MPC noted that "the transitory effects of demonetisation have lingered on in price formations...entangled with excess supply conditions with respect to fruits and vegetables..." It went further: "...the current state of the economy underscores the need to revive private investment, restore banking sector health and remove infrastructural bottlenecks. Monetary policy can play a more effective role *only* when these factors are in place" (my italics).

I cannot see a consistent strategic view of the Indian macro economy in this journey. The MPC appears to have reversed its stance on inflationary expectations and reversed its call on the transitory effects of demonetisation. It seems to have taken a new normative call on the effectiveness of monetary policy in the presence of structural constraints that have been present for some time now. I can interpret this in two ways. First, that the MPC is averse to doing anything about cutting interest rates except *post facto*, when the consequences of poor real economy performance are so negative that rate cuts become inevitable. This is unacceptably risk averse; the MPC is expected to be proactive in taking account of growth considerations while fulfilling its inflation mandate. Second, that the MPC understands that the real problem with stagnant growth and investment is structural weakness in the Indian economy which implies weak monetary transmission effects and, therefore, yields little payback to reductions in the policy rate. If so, the MPC should say this explicitly and argue that holding rates, while reducing the Statutory Liquidity Ratio (SLR) and the risk weight on home loans, makes sense.

The Chief Economic Advisor (CEA) has seen fit to issue a public statement on the MPC decision and has provided an alternative macroeconomic assessment, citing large inflation forecast errors that systematically overstate inflation, a benign inflation outlook due to exogenous circumstances, and arguing that the weak outlook for growth and the twin balance sheet problem negate inflation concerns.

I share his view that, in the circumstances, there are low risks to monetary easing. However, if the MPC and the CEA are both right then the repo rate is policy impotent at this time. If the constraints to growth are structural, then transmission will be ineffective. Cuts in the SLR are irrelevant given that the banks are already holding more government debt than the current SLR requires, and easier home loans can help people buy homes but do nothing for builders with stressed balance sheets.

Does this mean that monetary policy is of no consequence? I don't think so. The problem here lies in the confusion between target and instrument. The inflation target is not decided on the basis of a technical or econometric assessment of the relationship between some inflation index and the policy rate. It should be a decision taken by the government bearing in mind the overall macroeconomic context.The MPC's job is to use interest rates as an instrument to secure the target set by government. Hence, if government wished the RBI to reduce rates for structural reasons, then the logical thing to do would be to mandate it to target inflation at a higher rate than at present, in a narrower band, say, 5-7 per cent. Instead, the government has chosen to plead for lower interest rates, while seeking to maintain the current target, which leads to the present publicly expressed dissonance between the two institutions. This damages institutional credibility far more than biting the bullet and fixing a higher inflation target.

The inflation target is decided by the government.The logic for the target and the approach to securing it through coordinated macro-policy action is, and should be, discussed by the RBI governor and the finance minister, as is presently the case. A *formal* meeting between the MPC and finance ministry mandarins is not in order as the MPC is required to exercise independent judgement based on their expertise in assessing information and taking account of the views of all stakeholders,including those provided to them in writing by the government. They were, therefore, quite correct in declining such a meeting, in my view.

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