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RBI's puzzle

The central bank has to perform the difficult task of keeping a balance among inflation, exchange rate and public debt

SNAKES & LADDERS

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The RBI's main objective is to deliver a consumer price index (CPI) rate of 4 per cent. It also has two other objectives: Exchange rate policy and public debt management. There are interesting tensions shaping up between these objectives. High interest rates can defend the exchange rate and ensure adequate sale of government bonds, but that will slow down the economy and give inflation of below 4 per cent. Monetary policy in the coming year will be about dealing with these contradictory impulses.

From its creation in 1934 till February 2015, the RBI had no well-specified objective. This created confusion. The RBI repeatedly switched from one objective to another, and, in the eyes of the market, had low credibility in the pursuit of any one objective. There is a well-known tension between rules and discretion in this field: When there is high discretion, there is low effectiveness. A central bank becomes effective by not having discretion in switching objectives. In the old environment, the RBI's effectiveness was hampered. These problems resulted in high and variable inflation, exchange rate crises, financial instability, etc.

Inflation hurts the vast Indian populace. Good economics and good politics are aligned in focusing the power of monetary policy on delivering one task: A CPI rate of 4 per cent. In February 2015, the "Monetary Policy Framework Agreement" was signed and it established a 4 per cent CPI rate as the RBI's objective. This was written into the RBI Act in February 2016. Now, for the first time in the RBI's history, it had a legal mandate — to deliver low and stable inflation.

Clarifying the RBI's objective improves the credibility of monetary policy. Economic actors have slowly understood that the RBI is synonymous with delivering a 4 per cent CPI rate. Ordinarily, it takes many years for the gains from a new inflation targeting regime to seep into the economy. In our case, the new system appears to have given better behaviour of inflation soon after the 2015 announcement. These are valuable gains.

The process of clarifying the RBI's purpose is not complete. Normally, the world over, the rise of an inflation target goes with freeing up the exchange rate. The central bank takes responsibility for inflation and the exchange rate becomes a market-determined price. In India's case, we had made the transition to a market-determined rate in the 2008-13 period but this was reversed thereafter.

The other problem concerns bond issuance for the government. At present, the RBI is the debt manager for the government. This gives the RBI the objective of securing low-cost financing for the government, i.e. to keep interest rates low. This may or may not be consistent with the inflation objective from time to time.

When there are conflicting objectives in a central bank, they do not result in difficulties every day. They only yield difficulties in certain episodes. For example, when the RBI sharply cut rates after the 2008 crisis, this was good for the debt management objective. In the rest of this fiscal year, these conflicts appear to be an important part of the story.

The US Fed may raise rates two to three times in the rest of this year. Global economic and geopolitical risk may result in higher global uncertainty, e.g. as measured by the VIX (volatility index). Under these conditions, there could be a reversal of capital flows to emerging markets (EMs) in general and India in particular.

This would create pressure on the rupee to depreciate. The RBI has the choice of hiking interest rates in order to attract debt capital flows. As an example, in 2013, the 91-day rate was raised by over 400 basis points in an attempt to defend the exchange rate. But in 2013, the RBI had the legal mandate to juggle multiple objectives. Today, rate choices of the monetary policy committee (MPC) are made with an eye to meeting the 4 per cent target.

The other problem is public debt management. The RBI is also the debt manager for the government. In this capacity, it has the objective of obtaining low-cost and low-risk financing for the government. Wearing this hat, the RBI would like to sell long-maturity bonds at low rates.

This problem has become harder in the last one year. Suppose global commodity prices go up, and suppose they impact upon inflation. The RBI has to keep the CPI rate at 4 per cent and will raise rates. The 10-year rate can be thought of as the average of the values forecast for the short-term rate over the coming 10 years. So some of the action on the short end will show up in the 10-year rate.

Long-dated bonds are quite sensitive to interest rates. For each 1 percentage point increase in the 10-year interest rate, the price of the bond goes down by 10 per cent. Banks are fearful of these capital losses, particularly when their equity capital has been depleted by the recognition of non-performing assets.

There is a feedback loop in operation here. Fears of the long rate going up are making investors afraid of the long bond, and this gives a decline in the price of the long bond. In normal financial markets, there is a large and diverse pool of participants, which prevents such feedback loops. In the Indian government bond market, however, we have a narrow pool of homogeneous participants. Foreign investors and mutual funds are voluntary participants, but most others are not. This creates a greater risk of a feedback loop developing.

The RBI's puzzle lies in dealing with these complexities in the coming year under the present institutional environment. These are important questions, and everyone gains when the RBI makes the right calls.

The inflation target has brought a new element of macroeconomic stability into the Indian environment. The fact that the market sees commitment around one critical pillar strengthens the RBI's hand. In the long run, we should undertake institutional reform on the remaining pieces, with a market-determined exchange rate, an independent debt management agency and a vibrant bond market that is able to consistently finance the government's deficit.

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