ILLUSTRATION: AJAY MOHANTY

Monetary policy that stabilises

When expected inflation drops, the policy rate should drop even more

The lever of monetary policy can be a force for destabilisation. When the economy faces new difficulties, the forecasted inflation rate declines. If the policy rate does not also commensurately decline, the real rate goes up. When times become hard, and monetary policy does not respond, it makes things worse by raising the real rate. For monetary policy to be a force for good, two features are required. First, the monetary policy committee (MPC) has to be able to peer into the future and forecast inflation. Second, it must respond strongly to changes in forecasted inflation, both on the way up and on the way down. This diverges from the bureaucratic instinct that prizes being non-controversial.

SNAKES & LADDERS

AJAY SHAH

The first lesson in economics is that only real rates matter. If forecasted inflation is 15% and if you are paying 15% interest, then effectively, it is a zero interest loan. When inflation is 4% and you are paying 12%, this is a very high real rate of 8%. The dynamics of the household or firm balance sheet is shaped by the real rate, and decision-makers respond to real rates.

Suppose we start at a situation where forecasted inflation is at the target, of 4%, and the policy rate is at 6%. This means that the real rate is 2%. Now suppose there are adverse economic shocks. When hard times come along, forecasted inflation goes down. Suppose the forecasted inflation goes down from 4% to 2%.

In this situation, if monetary policy does nothing, then the real rate just goes up from 2% to 4%. To do nothing, when adverse shocks arise, is tantamount to monetary policy tightening. This is destabilising: When times are tough, the inactive monetary policy makes it worse.

This same story works in reverse. Suppose there are positive shocks, and things are going to get better. Forecasted inflation goes up from 4% to 6%. Suppose monetary policy does not respond, and the policy rate stays at 6%. In this case, the real rate has declined, from 2% to 0%. This is destabilising. When a boom is starting up, the inactive monetary policy makes it bigger.

The solution lies in a monetary policy strategy that responds to changes in forecasted inflation. At the minimum, the response must be one-on-one. Let's think about the scenario with bad news. There are adverse economic shocks, forecasted inflation comes down from 4% to 2%, monetary policy responds one-on-one by cutting the policy rate from 6% to 4%, and the real rate stays at 2% all through. This is neutral, it is better than inaction, monetary policy is no longer destabilising.

But we can do better. Monetary policy can respond more strongly. As an example, suppose we plan that the response of monetary policy to changed inflation forecasts will be 1.5 times (x) larger. For a decline in forecasted inflation of 2 percentage points, we will cut the rate by 3 percentage points. How will this play out?

We start out at forecasted inflation of 4%, a policy rate of 6%, which is 2% in real terms. Now forecasted inflation drops by 2 percentage points. Using the 1.5x rule, we cut the policy rate by 3 percentage points, to 3%. It becomes 1% in real terms. Monetary policy has responded to bad times by cutting the real rate. Now, monetary policy is stabilising.

These concepts were developed by the economist John Taylor, and this requirement of a more-than-one-on-one response is called "The Taylor Principle". All the major central banks in the world have an amplification factor of between 1.5 and 2, as a consequence of this insight.

Before inflation targeting, the RBI used to look at multiple instruments and pursue multiple objectives, and more or less did what it felt like. There was a lack of response to changes in inflation, the real rate used to jump around quite dramatically. Monetary policy was a source of macroeconomic instability. The formal inflation-targeting system puts us in roughly the right place: It forces the RBI to respond to inflation to stabilise the real rate.

In the Indian policy discourse, inflation targeting was seen as an accountability mechanism for the RBI, to rule out high inflation and the immense damage that goes with it, and to increase trust in the Indian rupee on multi-decade horizons. All of these considerations are important. In addition, there is this additional powerful idea: That without inflation targeting, monetary policy is actually a source of macroeconomic volatility. With a well-implemented inflation targeting system, monetary policy is shifted from being part of the problem to being part of the solution.

While the mere enactment of the inflation-targeting law puts us in roughly the right place, the point of this article is to go closer to the fine structure. It is not enough to roughly get it right, we should think more formally about forecasted inflation, estimates of the real rate, and how the real rate is changing alongside changing conditions in the economy.

By this reasoning, cautiously making small changes in the policy rate is not sufficient. There is a conflict between the desire to stabilise the macroeconomy and the desire to avoid controversy. If inflation in India is more volatile than is the case in developed economies, the changes in the policy rate here must be larger than those seen in developed economies. The MPC must organise its thinking and communication around the impact of changing economic conditions upon forecasted inflation, articulate its inflation forecast, its estimate of the real rate, and show how its actions are stabilising.

This will require improvements in intellectual capacity on macroeconomics in India. At present, we have weaknesses in data and a limited body of knowledge. There is a very small pool of capable scholars in the country, who are able to discuss these issues and engage in policy-relevant debates. Broad capacity building is required, feeding into each member of the MPC, so as to ultimately obtain better voting and better writing by the MPC.

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