Is the Reserve Bank doing enough to rein in inflation?

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Nurturing the real economy, not just tweaking the repo rate, is the need of the hour

India's inflation, which is measured by the Consumer Price Index (CPI), has stayed above the Reserve Bank of India (RBI)'s upper tolerance limit of 6% for three months running. The central bank's monetary policy committee decided to hold benchmark interest rates earlier this month, choosing to remain accommodative "while focussing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". Western economies such as the U.S. have begun raising interest rates. Is the RBI doing enough to arrest inflation? Ananth Narayan and Lekha S. Chakraborty discuss the question in a conversation moderated by **K. Bharat Kumar**. *Excerpts:*

Lekha S. Chakraborty *is Professor at NIPFP and Member, Governing Board of Management, International Institute of Public Finance, Munich*

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Is the RBI behind the curve in reining in inflation?

Lekha Chakraborty: There needs to be a fundamental rethink on the efficacy of the inflation targeting framework itself. The crucial question is: are we able to anchor inflationary expectations properly? The sole mandate of the RBI is to look into price stability. So, now, what do we do? Do we revise the nominal anchor from the stated 4%? Or do we play around with that band plus or minus 2 percentage points? Or are we going to throw away this framework and adopt a prior inflation targeting framework?

Having said that, the context is important. Inflation is mounting. There is geopolitical uncertainty. The war in Ukraine led to supply-chain disruptions. Consignments are getting delayed. So, it's a supply-side shock. Manoeuvring with repo rate adjustments to contain inflation may not work. The reverse repo rate itself is likely getting redundant, because the RBI has introduced a new tool – the standing deposit facility rate at 3.75% – to absorb excess liquidity. That's a smart move, to work with the monetary policy corridor but leaving the rates untouched.

Ananth Narayan: I have a fundamental problem with the monetary policy framework. Monetary policy is extremely complex. All the macro variables that we care about – inflation, growth, jobs, external balance, financial stability – are interrelated; you cannot target one without touching the other. And each of these is impacted by multiple policy tools, such as interest rates (long term, short term, and everything in between), banking liquidity, fiscal balance, exchange rates, macroprudential regulations, RBI interventions and, of course, that lovely thing called sentiment. What we currently have is a simplistic monetary framework, where we pretend that CPI inflation can be controlled by the repo rate almost linearly. To just change the repo rate and expect to keep CPI inflation between 2% and 6% at all times... that is utter rubbish. We can't legislate away economic complexity.

Now, is RBI behind the curve? There are areas where it feels like the RBI was behind the curve. One, in the February policy, the RBI said it expected FY23 CPI inflation to be 4.5%. That didn't seem credible. It has revised the estimate to 5.7%.

Two, for long the RBI insisted that the 10-year government bond yield was a public good that had to be kept low. In FY21, both the central and State governments had a record borrowing programme. The FY21 weighted average government borrowing rate was a record low of just 5.8%, because the RBI effectively sat down on the curve. So, the returns for savers was brought down dramatically.

Our household inflation expectations are at 11%. Average deposit rates across all banks are at just 5%. With such hugely negative real rates, we're pushing savers to the brink, into equity markets, into Bitcoin, and into gold. The resultant asset price inflation is also increasing inequality – the top 15% are doing very well and consuming luxury products, even as the bottom 40% are struggling.

But to be fair to the RBI, it's not been an easy time. And to give credit, the RBI stopped its government bond purchases in October. It is only now that the U.S. Federal Reserve has stopped buying bonds. Likewise, our money market rates have already gone up quite a bit. One

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year ago, the one-year Treasury Bill rate was 3.7%. Today it is 4.9%. So, the RBI has allowed rates to come up. I don't think repo rate could have helped in the current context.

Would you worry about GDP growth?

LC: The inflationary expectations and the output gap are unobserved variables. How do you deal with these variables within the rules-based monetary macro framework?

The output gap variable itself is controversial, because the basic assumption here is that you are experiencing cyclicity; and that once you correct the cyclicity through monetary policy, you're going to get growth back to pre-crisis levels. This is dangerous, because if that drop in GDP is not cyclical, but a permanent scar, then monetary policy acting as a counter-cyclical policy tool will not work.

That's why fiscal dominance is very crucial. Fiscal policy has been very accommodative. We have very high fiscal deficit and high debt numbers. But from a position of strength, the Finance Minister articulated that her high fiscal deficit can be substantiated through enhancing investment – through 'crowding in' private corporate investment.

AN: The context is very tough. Let's agree for now that the RBI's basic mandate is inflation targeting. Now, inflation is a problem. Even for the current fiscal year, FY23, inflation could well cross 6% if oil prices remain where they are. It's not just oil prices, but also edible oil prices, fertilizers, chemicals, feedstock, and all-round supply chain disruptions.

Now let's look at growth. The real GDP for FY22 is pretty much the same as it was two years ago before

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the pandemic. Effectively, two years have gone by with zero real growth. In the last two years, inflation has been 6% compounded annual; high inflation and zero growth are a disaster. The RBI's growth estimate of 7.2% for the current fiscal is also at risk. High oil and commodity prices tend to reduce our growth. Exports might be impacted because of a global slowdown.

It is also a terrible situation with jobs. CMIE data suggest that over the last five years, we've lost two crore jobs outside agriculture. Even before the pandemic, we were losing jobs. Our fiscal situation is already stretched, our external situation is going to get tricky going forward, we are looking at a current account deficit possibly of \$100 billion, it could be a record the next fiscal year because of elevated oil prices. FII flows look very iffy, given the global context. Even if FDI flows come in, we're still going to see a very large outflow from the RBI which has to be made up. Of course, robust tax collections thanks to formalisation and record currency reserves offer us some buffer for now.

It's a nightmarish situation for policymakers. Under such circumstances, what can they do to control inflation? Normally, pushing up repo rates and tightening liquidity makes sense when there's a lot of credit growth. If we have 25-30% credit growth, which is creating aggregate demand and money supply, we have to arrest that by increasing the cost of money. For the last two years, however, we have had credit growth of just 7.5% annualised, which is lower than the nominal GDP growth rate. It is difficult to argue that credit growth is causing inflation. If anything, we need more credit in investments and job creation.

Market sentiment is a key factor. Most central banks are tightening monetary policy globally. If we stand out and say we're not going to tighten, it does attract negative sentiment. We've got to give the credibility that we are focussing on inflation. Now the RBI has tried to bring back credibility, by reiterating its focus on inflation, which is great. Improving the return for long-term savers – by not repressing government bond yields – will go a long way in reducing inequality, controlling inflation, and managing financial stability.

The ultimate way to control inflation for India is for us to create jobs and output. The real economy is the only way to improve all our macro variables. Monetary policy cannot do much for either growth, jobs, or for inflation control. Eventually, it's the real economy, which is where the government comes into the picture.

Is the CPI index appropriately represented? How relevant is the composition now?

LC: The real issue here is the divergence between the WPI and CPI and of course, the energy price volatility and food inflation. So, how the RBI is able to anchor these is key. In India, inflation is not strictly a monetary phenomenon. There are many supply-side shocks. So, can inflation targeting control or manoeuvre those supply side shocks through the 'expectations channel' is an important question. Credit infusion – the predominant narrative of economic stimulus packages – is not working very well, because if there is no corresponding growth in the economy, then this credit infusion can lead to mounting NPAs.

On the fiscal policy side, the government has to act as an employer of last resort through 'participation income' (not 'basic income') in the hands of people, by providing guaranteed jobs. This can be a very strong policy to tackle inflation rather than the government providing cash transfers, a huge fiscal stimulus, into the hands of people.

But at the same time, where is the fiscal space? A crucial question is whether we can do a fiscal-monetary policy coordination through the monetisation of deficit once again, because that's exactly what Kaushik Basu and Nobel Laureate Abhijit Banerjee have highlighted; they are all arguing for the re-emergence of monetisation of deficit through better coordination of fiscal and monetary policy. So, we need to wait and see because that is again inflationary in nature. But heterodox economists always say that when you are below the full employment equilibrium, it will not lead to mounting inflation, but will lead to growth. My hunch is it's not the CPI per se (or the core inflation or the headline inflation) that we need to focus on, on the RBI side; the question is a little bigger than that, and that's about 'employment'.

AN: The way in which the CPI basket is constructed, as I understand it, is you look at the Consumer Expenditure Survey, and you look at what people are consuming, and then you try and create a rural and an urban basket, which approximates to the average consumer as to what they actually consume; you try and arrive at the median. Now, the last consumer survey was done in 2011-12. There was one done in 2017-18, the results of which remain a mystery to us. There is one report that I saw in Ideas for India. Given that there's no Consumer Expenditure Survey, they looked at the consumption pattern indicated by the Consumer Pyramids Household Survey (CPHS) of the CMIE. Their conclusion was based on the 2019 pre-pandemic consumer CPHS data; that the basket wasn't off the mark. Of course, individual items like typewriters need to be corrected in the next Consumer Expenditure Survey, which hopefully will happen in 2022-23.

But the reality also is that people's perception of inflation is far higher than what the CPI number indicates. It reflects in the household expectations survey that the RBI itself conducts. That's not a very robust survey so that has its own limitations. But when I speak to folks in the industry, when I speak to even MSMEs, their perception of inflation seems far, far higher than 6%. I think that recent hikes in petrol prices and diesel prices will also add to that expectation.