The Other Side February 4, 2016

Some thoughts on inflation targeting

It is likely that the Indian Financial Code (IFC) may get enacted in the forthcoming budget session of Parliament. One major issue policymakers in Delhi may need to be cautious about is the inflation target based on the consumer price index: once a quantitative target is enacted, it will be politically impossible to increase it, should this become necessary, given the political sensitiveness of the inflation issue. (Instead of a specific numerical target, will it be better to use an expression like “stable prices”?).

This apart, many economists have questioned the concept of inflation targeting. For example, in a recent article, Stephen Roach of Yale University argued that, “*inflation targeting was once essential to limit runaway price growth. In today’s inflationless world, however, it is counterproductive.”* Do we really apprehend a Zimbabwe-type hyper-inflation in India?

Helene Rey, Professor of Economics at the London Business School, and a specialist in international finance, adds another dimension to the issue of independent monetary policy. She has challenged the notion of the “impossible trinity”, namely that a fixed/managed exchange rate, a liberal capital account, and an independent monetary policy cannot co-exist. This thesis was propounded by Nobel Laureate Robert Mundell back in the 1960s. Ms. Rey has argued that given the scale of financial globalisation, this theory is no longer valid. “*The belief largely is that if you have a flexible exchange rate, then the exchange rate can insulate you from financial shocks and so you can pursue your independent monetary policy. In fact,* ***that’s what inflation targeters have been arguing***” (Finance and Development, June 2015). Her 2013 research paper *“The Global Financial Cycle and Monetary Policy Independence”*, invalidates the *“trilemma”* and points to a *“dilemma”, an “irreconcilable duo”: “independent monetary policies are possible if and only if the capital account is managed, directly or indirectly via macro prudential policies.*”

The Reserve Bank’s own Financial Stability Report, December 2015, indirectly acknowledges the *“dilemma”*, and also seems to suggest higher public investment. To quote, “*Despite improved macro-economic fundamentals and resilience compared to its peers – given the challenges for the rupee to maintain external competitiveness on the one hand and manage inflationary pressures and requisite capital flows on the other –*

sluggishness in domestic demand and private investment call for higher public investment." Interestingly, in his C.D. Deshmukh Memorial Lecture in New Delhi last week, the Governor made the opposite argument: "*Ordinarily one would think that a government should borrow less, that is, run lower fiscal deficits, in order to reduce its debt. But there is indeed a theoretical possibility that the growth generated by the fiscal expansion is so great as to outweigh the additional debt that is taken on. Unfortunately, the growth multipliers on government spending at this juncture are likely to be much smaller, so more spending will probably hurt debt dynamics." Incidentally,* the IMF had initially estimated the ratio of fiscal compression to GDP contraction at 0.5, supporting Dr Rajan's scepticism. On the other hand, in the crisis in the euro zone, the actual number turned out to be much higher, nearer 2. On reviewing its regression analysis in 2011, the IMF discovered that the actual multiplier was far larger, and can even exceed 3! In other words, fiscal compression can lead to a much larger drop in the nominal GDP, thus increasing the debt to GDP ratio, contrary to Dr Rajan's views.

Would this be all the more so given CPI as the inflation target? As I have argued, given that CPI is hugely influenced by supply side factors, the burden of monetary policy falls primarily on the manufacturing sector. Even today we have a situation where the CPI is significantly positive but WPI, and GDP deflator, point in a different direction.

In the same speech, Governor Rajan cautioned the government against "over ambitious" growth targets. But employment creation on the needed scale, given our demographics, needs higher growth: countries like China have achieved 10% growth on a sustained basis for decades. This kind of growth can only come from a rapid expansion of the industrial output -- but our current monetary, exchange rate and fiscal policies may hinder this.

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Banks often charge penal interest to clients in breach of covenants. In saying in Tuesday's policy statement that *"controlling spending will create more space for monetary policy"* was the central bank telling its biggest borrower, the government, that it would be penalised with higher interest rates unless it sticks to the *Laxman Rekha* of fiscal deficit?

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