The Other Side March 12, 2015

The Two Values of Money

The Government has recently entered into an agreement with the Reserve Bank under which the latter has been given autonomy to pursue monetary policy with the sole objective of achieving a “flexible inflation target” (FIT). The initial range is 2 to 6% in CPI terms; one loose end to be tied up is the composition of the Monetary Policy Committee, and whether the Governor can override the Committee’s recommendations.

The germ of the idea is obviously in the report of the Raghuram Rajan Committee on financial sector reform, which came out some years back (“A Hundred Small Steps”). The report argued that a single point agenda would resolve the conflict between managing the two values of money: domestic value measured by inflation, and the external value determined by the exchange rate. In fact, several of Dr. Rajan’s predecessors as Governor (except perhaps the immediate one), successfully managed both, through intervention and sterilisation measures.

Inflation targeting has had a chequered history and the record of central banks in meeting inflation targets has been poor, even in economies where the “transmission” of monetary policy actions and signals into market rates is supposed to be more efficient. The Bank of England has been missing inflation targets for five years. The European Central Bank and the Bank Japan are trying to increase inflation by following easy money and near zero interest rates for years, to no effect. And the fall in inflation in India is due more to global commodity prices and food inflation (which have 57% weight in the index) than because of monetary measures.

On the implications of FIT, it will be useful to look at some specific points in last year’s Urjit Patel Committee Report, some of which would constrain the government’s freedom:

1. Paragraph II.23, “*recognizes the existence of the growth inflation trade-off in the short run*” but emphasises *“the critical importance of price stability for sustainable growth in the medium term or over a business cycle.”* In the last three decades of

low inflation, growth in the advanced countries has fallen sharply, even as income inequality has gone up. Can we afford this with 20 mn people entering the job market each year?

2. Paragraph II.45 avers that *'inflation is clearly a monetary phenomenon in the medium run"* – 'medium term' obviously seems to be more than 5/6 years, at least in Europe and Japan. (And, as Keynes famously said, in the long run, all of us are dead anyway.)

3. Paragraph II.48 emphasises that *"Administered setting of prices, wages and interest rates are significant impediments to monetary policy transmission and achievement of the price stability objective, requiring a commitment from the government towards their elimination".* So good bye to small savings schemes, food security for the poor, priority sector lending, etc. etc.?

4. Fiscal deficit to be brought down to 3% by 2016-17. The last budget has extended the time by one year in any case.

5. One significant omission is to consider the impact of demographics on inflation.

The reality is that monetary policy has serious limitations in meeting inflation targets; that it can bring inflation down only at the cost of sky high interest rates, recessions and unemployment (US in the late 1970s, early 1980s). In one way of course comments in the UPC report are very useful: they provide enough excuses for not meeting targets!

I am tempted to quote a few comments from Prof Ha-Joon Chang's (Cambridge University) *"23 Things They Don't Tell You About Capitalism":*

1. *"An excessive focus on inflation has distracted our attention away from issues of full employment and economic growth."*

2. *"There is actually no evidence that, at low levels, inflation is bad for the economy… even studies done by some free-market economists associated with institutions such as the University of Chicago or the IMF suggest that, below 8-10*

percent, inflation has no relationship with a country's economic growth rate. Some other studies would even put the threshold higher – 20% or even 40%."

3. *"Free-market economists have deliberately taken advantage of justified fears of hyperinflation in order to push for excessive anti-inflationary policies, which do more harm than good."*

In short, the recent agreement is clearly not "a small step"!

The other price of money

As for the exchange rate, one sees a welcome change in the views of Arvind Subramaniam, the Chief Economic Adviser (CEA). In the middle of last year, well before his appointment as CEA, in an article in Business Standard co-authored by him, he had argued that the rupee was undervalued by 30%! It seems from his post-budget interviews that he now thinks differently, evidencing an open, non-ideological, non-egoistic mind. To quote from his interview in The Economic Times, March 2, *"Our exports-GDP ratios both in manufacturers and services, have been stagnant …. No country in history has grown at 8-10% for 30-35 years without roaring exports…in 2014 the rupee has become uncompetitive by about 9%...... We should be targeting $ 750 billion to $ 1 trillion of reserves ….* ***The way you accumulate reserves is by actually having a very competitive exchange rate***." And, as our Finance Minister has said, India needs sustained growth of 9/10% for *"for many, many more years than 10"* (Mint 4th March). The concern is that, with inflation targeting as its primary objective, there would be an inherent bias in the Governor's mind in favour of a "strong" rupee.

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