Monetary Policy, Interest Rates and Inflation

Last week's election results strongly suggest that the voters prefer power, water, roads, the politics of growth and employment; to promises of *roti, kapda, makan,* the politics of distribution and subsidies delivered with ever greater inefficiency, to "povertarianism"; the political economy of Jagdish Bhagwati to that to that of Amartya Sen. World Bank research also suggests that the best way to reduce poverty is economic growth, not "entitlements" and subsidies.

Both prices of money – external and domestic, the latter generally measured as inflation – are very important to growth and employment creation. In this column, I have often argued about the exchange rate policy, most recently on 8th May. As for the domestic value (i.e. inflation), the Urjit Patel Committee (PRC) recommended earlier this year the adoption of inflation targeting based on the Consumer Price Index (CPI), also claiming that *"in the long run, there is no trade-off between inflation and employment",* without quantifying "the long run". (As Keynes said a century back, the only reality is that in the long run all of us are dead anyway). The UPC has also used the non-inflationary rate of unemployment (NIRU) to determine the upper band of inflation at 6%, without quantifying the former, let alone specifying an employment creation target. (In contrast, the current easy monetary policy of the US Federal Reserve is aimed at bringing unemployment down to a preannounced number.) And, the concept of NIRU/NAIRU has proved an empirical bust, where tried.

There is enough other evidence about the unreliability of macro-economic models. One example: the IMF, using the standard Dynamic Stochastic General Equilibrium (DSGE) model of the macro economy, had concluded that the ratio of fiscal compression to GDP contraction is 0.5. In the crisis in the euro zone the actual number turned out to be much higher, nearer 2, at huge cost to the poor in Greece. On reviewing its regression analysis in 2011, the IMF discovered that the actual multiplier was far larger, and can exceed 3!

The reason, to my mind, is the unrealistic assumptions underlying the DSGE model used by most central banks. As John Kay wrote in an essay (September 26, 2011) for *The Institute for New Economic Thinking*, the assumptions include:

⇒   *"everyone lives for two periods, of equal length, and works for one and spends in another;*

⇒   *there is only one good, and no possibility of storage of that good, or of investment;*

⇒   *there is only one homogenous kind of labour;*

⇒   *there is no mechanism of family support between older and younger generations."*

Any comment is superfluous!

The inflation target approach to monetary policy-making requires a model to quantify the inflation "threshold" which leads to a growth slowdown, and hence the paramount need to control, to bring down, inflation. But the number crunching seems to suffer from too many missing variables: the real exchange rate; the regulatory environment; the ease of doing business; the enforcement of contracts; the "animal spirits" of investors/entrepreneurs. To quote Keynes again, *"too large a proportion of recent 'mathematical' economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world."*

Empirical evidence suggests that demographics is a crucial factor which influences inflation. As the proportion of retirees grows, inflation falls, even to negative levels (Japan). To quote from a St. Louise Federal Reserve research paper (2012), *"economies with a higher share of younger population are associated with higher inflation."* IMF economists (Finance and Development, March 2014) find *"that monetary policy has had a diminished and diminishing impact on variables such as unemployment and inflation since the mid-1980s".* To be sure, both the studies are based on developed economies: one would have liked the Urjit Patel Committee (UPC) to have studied this issue given that India has the youngest population amongst the major economies.

The statement that inflation hurts the poor most is accepted without question; arguably, lack of employment hurts the poor even more. And behavioural economics tells us that the answers to questions often depend on the wording of the latter: asked to choose between 10% and 4% inflation, most would opt for the latter; phrased differently (10% inflation and a job, 4% inflation without a job) the poor would surely prefer the former, more so when there is no unemployment insurance in India. And, India needs to create 20 mn jobs each year. (To be sure, the better off would always prefer low inflation rates to protect/increase the value of their savings.)

Again, an effective solution to food inflation, a significant part of CPI, may only come from the supply side of the equation: a sharp increase in organised retailing, scrapping the agricultural produce marketing acts, etc. Suppressing demand in the other sectors through monetary policy may only reduce growth and unemployment.

Overall, one is inclined to agree with Kaushik Basu who, in an interview in Hindustan Times (July 21, 2012) said *"We should go for 10% inflation and 11% GDP growth. After all, 11% GDP growth is real growth; so people are every year better off by 11%"*. This apart, it may be useful for the new finance minister to learn from our public sector bank Chairmen: clean up the balance sheet (fiscal numbers, including the carried forward payments) in the first profit and loss account/budget presented after you take over!

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