The Other Side October 23, 2014

Monetary policy and inflation

With few charismatic political leaders in any major economy (with the exception of Mr. Modi), central bank governors have become the ruling icons for much of business media. Close attention is focused on their actions and statements. Our central bank is also talking to the government about giving it an inflation target, as recommended by the Urjit Patel Committee. Central bank governors in the major advanced industrial economies continue to be occupied with their own inflation targeting: to bring the rate up to 2%, the worry being a deflationary spiral.

The US, UK, euro zone and Japan have been following easy money and low interest policies at least since the financial crisis of 2008. Contrary to monetary theory, inflation remains low. While there is some improvement in growth and employment in the two Anglo Saxon economies, the numbers in the euro zone and Japan remain disappointing. At one time, our policy makers were worried about the effect on portfolio capital flows when quantitative easing (QE) in the US stops: this may lead to an increase in USD interest rates, and capital outflows from emerging economies. In the event, despite the imminent end to QE, the 10-year bond yield in the US has actually fallen (1.85%)! Nor are low interest rates resulting into any increase in corporate investment in the real economy: companies are buying back their own shares with the cheap money rather than creating assets and output/employment.

Stock markets in New York and London were volatile last week, but ended on a high on some comments suggesting that QE may continue. The put option on asset prices written by Alan Greenspan, has obviously not expired, though by any traditional measure, stocks seem to be overvalued. The cyclically adjusted price earnings (CAPE) model developed by Nobel Laureate Robert Schiller, also evidences this. For half a century before 2008, government bonds yielded less than earning yields on equities. The reverse has been the case since 2008.

It seems that the age-old belief in monetary policy influencing inflation does not seem to be valid any longer. To be sure, this has been true for quite some time now and monetary policy fashions have changed dramatically over the last few decades: from money supply, to short term interest rates, to “influencing inflation expectations” of economic agents. But, inflation expectations, as evidenced by the prices of inflation indexed bonds in the US, and the 5-year * 5-year inflation swap (market expectation of the average 5-year inflation starting 5 years from now), remain low. I admire the bravery of those who can predict, and put their money on, the average 5-year inflation starting 5 years from now!

As one more measure of monetary stimulus (and to the horror of the conservative Germans), the European Central Bank CB is likely to start buying asset-backed securities from the market – and has appointed a hedge fund to pick and choose the ABS to be bought. Like financial markets, the memories of central banks also seem to be short: the principal cause for the financial crisis of 2008 was very low interest rates, and complex asset-backed securities.

Instead of confessing their inability to meet inflation targets, the policy pronouncements are hedged with qualifications and jargon. To quote a few standard expressions, consider “pent-up wage deflation”; “forward guidance”; “second round effects”; “structural unemployment”; “secular stagnation”; replacing “inflation target” by “price target”; etc. etc. (How one longs for the innocent boy who shouted “But the emperor is naked” in the old fable!) One has also serious doubts whether the standard macroeconomic models are at all workable in the real world, given the unrealistic assumptions. Barry Eichengreen recently criticized “*the spurious precision of these techniques and the false scientism to which they give rise*” (Financial Times, August 23, 2014). The more I think about it, the more I believe that perhaps two major influences on inflation are the demographics of a country, and the “animal spirits” of economic agents. The first is not factored in the models, and the second is not susceptible to mathematical formulation. It is perhaps time for policy-makers to go back to Keynes, the “savior” after the 2008 crisis: if monetary stimulus does not work, the only remedy left to avoid a deflationary spiral is fiscal stimulus. But the quasi-religious faith in the virtue of balanced budgets precludes this. Meantime, the real economy pays the price in terms of unemployment and increasing inequality.

Inflation targeting in India

In this background, it is difficult to support parliament mandating an inflation target to the central bank. For one thing, even if this includes a commitment to employment numbers, our published data on this issue is very suspect. The number of unemployed seems too low: perhaps even the rag pickers on Mumbai's streets are considered self-employed. Secondly, while inflation in India has come down in terms of both the wholesale and retail price indeces, this seems to be more the result of a .sharp fall in global commodity prices, particularly oil, and food. Surely monetary policy has little to do with either: meantime, growth in IIP remains disappointingly low.

Industry continues to lobby for lower interest rates. I do not know what direct impact this will have on investment: after all, interest cost as a percentage of the topline is barely 2 to 3% for the corporate sector as a whole. But it may well help raise their animal spirits!

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