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Regime change at the Reserve Bank of India

The responsibility given to the monetary policy committee is nothing short of onerous, and faces several challenges

SUDIPTO MUNDLE
is emeritus professor at the National Institute of Public Finance and Policy, and was a member of the Fourteenth Finance Commission.

SHASHANK PARADE/PTI

There have been two important changes at the Reserve Bank of India (RBI) in recently. One is the succession of Raghuram Rajan by Urjit Patel as governor of RBI. The other is the appointment of the monetary policy committee (MPC). Media attention focused mainly on the former, presumably because of Rajan's high visibility and the unfortunate controversy that was associated with his departure. But it is the other change, the appointment of the MPC, that is transformational, completely changing the monetary policy regime in India.

It is a shift from a regime in which the governor alone would decide the policy interest rate, the RBI's operating target, to one in which a committee of six experts is now mandated to collectively determine the policy rate. Three of the six members of the committee are from the RBI, including the governor and the deputy governor in charge of monetary policy. The other three members are independent experts nominated by the government. The decisions of the MPC will be based on majority vote, with a casting vote for the governor if there is a tie.

The appointment of an MPC was recommended by several committees, culminating in the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework, 2014, chaired by Urjit Patel (Patel committee). Following these recommendations, the government and RBI signed a monetary policy framework agreement on 20 February 2015, setting a flexible monetary policy goal of 4% inflation, +/- 2%, measured using the combined consumer price index (CPI). The MPC mandated to achieve this goal was established by an amendment to the RBI Act on 27 June 2016. The external (non-RBI) members of the MPC were appointed on 22 September, 2016.

To appreciate how radically the framework agreement and appointment of the MPC transform the way monetary policy is conducted in India, it is necessary to review the key underlying issues. One central issue is independence of the central bank. Independence refers to independence from political authorities. Why should central banks have such independence?

The answer is the instability that can be triggered if monetary policy become hostage to the political business cycle. In liberal democracies, ruling parties typically have short-time horizons co-terminus with their tenure. They like to see growth boosted as elections approach since high growth and the "feel good" factor helps them return to power. However, if output is already close to capacity, pump-priming unsustainable growth will mostly trigger high inflation. As widely documented, fiscal policies controlled by the political authorities are typically subject to such political business cycles. Central banks can lean against the wind and maintain macroeconomic balance only if their decision making is ring-fenced from control by the political authorities. There is compelling global evidence that economies with independent central banks enjoy greater macroeconomic stability than others.

This argument for independence has to be balanced against the need for accountability. In a democracy, the central bank cannot be an authority unto itself, setting its own policy goals. It has to be accountable to the public through their elected representatives, i.e., Parliament and the ruling party. How is this balance to be achieved? The monetary framework agreement between the government and the RBI, which the MPC is now mandated to implement, achieves this balance very effectively. Under the agreement, the government lays down the policy goal, whereas the RBI, and now the MPC, has the authority to decide on the operating target and operating procedures to achieve this goal.

A second underlying issue is about macroeconomic goals and institutions. Should central banks and governments both be responsible for managing growth as well as inflation or should they be assigned separate responsibilities? The well-known Tinbergen Rule which says that it is necessary to have as many policy instruments as policy goals does not solve the assignment problem. If the two main policy goals are growth and inflation and the two main policy instruments are government fiscal policy and central bank monetary policy, the Tinbergen Rule is satisfied. But which policy should address which goal? Or should both policies simultaneously address both goals?

Global practice on setting policy goals for central banks is varied. All countries include inflation control or price stability as a goal. However, some advanced countries such as the US include growth or employment as an equally important goal; some set it as a secondary goal. Other advanced countries and most emerging market economies make the assignment simple. Managing inflation is the sole policy goal set for the central bank. Government fiscal policy is assigned to address the growth goal.

The monetary framework agreement that the MPC is now mandated to implement follows the latter course. Its single policy goal is to meet the flexible inflation target of 4% +/-2%. The operating target, operating procedures and policy instruments are left to the RBI and MPC to determine. However, the monetary policy authority has to announce the operating target and give its inflation forecast at regular intervals. Also, it is now accountable to the government for delivering the inflation target. This is not to suggest that the MPC will ignore growth altogether. As its first decision to lower the policy rate shows, the MPC is likely to balance the requirements of growth along with inflation control, but give priority to the latter, in accordance with its mandate.

The responsibility given to the MPC is nothing short of onerous, and faces several challenges. One is the part-time appointment of external experts. The Patel committee had recommended that external experts should be appointed for non-renewable three-year terms as full-time members with full access to all the information and analysis generated within the RBI. They were not to hold any other office of profit or undertake any activity that could entail a potential conflict of interest. The government has tweaked this condition to appoint part-time members holding other jobs. The individuals appointed have excellent credentials, but that does not address the possible institutional infirmity of this modified arrangement.

Global empirical evidence indicates that anchoring inflation expectations is critical for managing current inflation

Most countries that adopt inflation targeting have MPCs in some form, and half of them don't have any external members. Some others have external members, but on a full-time basis. How effectively an MPC with part-time, non-RBI members, holding other offices of profit, can function remains to be seen. How the RBI deals with the first MPC, and how the MPC conducts itself, is of paramount importance because it will establish conventions that will be followed in the years to come.

Another challenge is setting the operating target and the inflation forecast. The MPC has to set the policy interest rate keeping in view not just the current inflation but also the inflation forecast, since this is a forward-looking exercise. Global empirical evidence indicates that anchoring inflation expectations is critical for managing current inflation.

The RBI uses a small urban sample of respondents to gauge inflation expectations. But as several commentators have pointed out, the inflation expectations generated a year ago turn out to be persistently and significantly higher than the actual inflation. If anchoring inflation expectations is so critical to setting the policy rate, then the MPC needs to fix this upward bias. But will it have the authority to do this?

The most important challenge is the transmission mechanism. There are multiple channels through which action on the policy rate has an impact on output and inflation. For limitations of space, these are listed here without discussion: interest rate, exchange rate, credit, asset prices. In India, there are many factors that impede the effectiveness of these channels. Fiscal dominance, meaning the very large share of government in the debt market, a high statutory liquidity ratio, small savings schemes with administered interest rates, priority sector lending, a large informal credit market outside the purview of the RBI and the large portfolio of banks' stressed assets. Unless these impediments are removed, transmission will remain weak. But all of them cannot be dealt with by the MPC alone. Action on many of these lies in the domain of the government, and some have to be addressed by others.

Particularly important among the latter is the double balance-sheet problem, as the last *Economic Survey* called it. Many companies are excessively leveraged and reluctant to sell their assets to make fresh investments. The Essar group's recent decision to sell virtually all its oil assets is an exception that proves the rule. Similarly, public sector banks with large portfolios of stressed assets are reluctant to take haircuts. The government too is undecided about how best to deal with the problem, which worsening by the day. This has constrained the flow of credit. The impact of this double balance-sheet problem is on growth more than on inflation. But without its resolution, we are unlikely to see a revival of the private investment cycle, notwithstanding the best intentions of the MPC.

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