

IFC – Is It a Good Framework for Monetary Policy

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POLICY BRIEF

Introduction

The Centre for Policy Research (CPR), Delhi in collaboration with the BSE Ltd., Mumbai have started a monthly Macro Economic Seminar Series. The objective of these Seminars is to generate fresh analytical insights into the Indian macroeconomic issues for potential use by policy makers. The unique format of these seminars is to bring together macroeconomists who have different perspectives on the state of the macro economy, depending upon their location in think tanks, financial institutions and corporate organisations.

The first seminar of the series was held in BSE corporate office, Mumbai on 26th October. The topic of the seminar was 'IFC – Is It a Good Framework for Monetary Policy'. A panel discussion between Sajjid Chinoy, Surjit S bhalla and Ramgopal Agarwala was moderated by Rajiv Kumar.

The government released a revised draft of the Indian Financial Code (IFC) in July 2015 that formally mandated the RBI to move towards Flexible Inflation Targeting (FIT). Under this agreement, the objective of monetary policy is "primarily to maintain price stability, while keeping in mind the objective of growth." This has opened up a debate on the appropriateness of the FIT for India and of the composition of the monetary policy committee (MPC) as that might affect RBI's autonomy and dilute its principal responsibility for controlling inflation. Literature review does not give clear picture whether Inflation targeting is beneficial for developing countries or not.

Summary of The Panel Discussion

The panel agreed that in the long run, there is no trade-off between growth and inflation. India had experienced sustained elevated inflation during the period 2006-2013. This high and volatile inflation raised macro uncertainties as real interest rate turned negative for 5 consecutive years which led to the collapse of household financial savings, depressed consumption, deteriorated current account deficit and choked off investments.

Inflation in India is an extremely complicated process to model as it depends on many factors like rural wage, MSP (Minimum support price), output gap, global food prices, oil prices, inflation expectations etc. Degree of simultaneity and endogeneity between MSP, rural wages and inflation is such that it is difficult to discern the primary driver. The persistence in inflation arises from institutional mechanisms. For example, MSPs are based on 5 different variables, many of which are backward looking. Rural wages are indexed to backward looking data. Inflation expectation is also very adaptive. All these lead to significant persistence in inflation data making it difficult to separate out cause and effect.

One view was that the monetary policy matters in India as output gaps had played an important role for last 50 years in driving inflation. The Phillips curve fits in Indian economy model. Thus, Inflation targeting (IT) becomes appropriate.

Globally and particularly in emerging markets, a nominal anchor has been a necessary pre-requisite to rein in inflation and inflation expectations. Scott Thomas (2010) has shown that countries adopting Flexible IT experienced lower inflation rates on average along with higher growth for two decades from 1999 to 2000 and 2001 to 2010. Amongst the different nominal anchors available, flexible inflation targeting has been the most successful.

It was discussed in detail whether RBI should focus only on core and not on headline inflation as drivers of food inflation are outside the control of monetary policy. However, it is already established that permanent shocks like sustained food inflation quickly translates to core inflation, so debate between headlines vs. core becomes somewhat irrelevant. Turning a blind eye to food inflation and focusing solely on core is equivalent to giving a blank cheque to policy makers for setting administrative prices. Incentive compatibility of headline Inflation targeting has feedback impact on disciplining fiscal policy. For instance if MSP rises then interest rate would have to rise to offset the inflation.

The other view was that India should not blindly follow the western doctrine of inflation targeting. Monetary authorities of East Asian countries like China, Korea and Japan have done well on balancing growth and price stability. East Asian case studies show that financial stability is possible without an independent central bank. Price stability alone is too limited an objective of monetary policy. External value of rupee, financial stability should also concern RBI.

Monetary policy can have significant consequences not only on inflation but also on growth and employment for which the elected representatives of the people will be held responsible. Issues of inflation, growth and employment have to be determined simultaneously and not in silos. Moreover, half of the determinants of inflation are beyond the control of policy rate and thus monetary authorities on their own cannot be expected to devise an action program to ensure price stability. It should be done in consultation with elected representatives.

The panel also argued that there should be a distinction between goal independence and instrument independence. Best practices around the world suggest that while the sovereign should set the goal (inflation target), the central bank must have instrument independence to rein in inflation. Panel suggested that Monetary Policy Committee (MPC) of technocrats should be set up as outcome of a committee is always better than that of an individual. Majority of members of MPC should be appointed by RBI so as to have a semblance of control over the process with a casting vote for Governor in case of a tie.

There should be a measure of accountability of the MPC so as to increase the credibility of RBI policy actions. The governor has to report to the cabinet committee to inform about 'hits and misses'. In case inflation target is missed for two successive quarters, specific corrective measures will have to be announced. The issue of whether a more stringent incentive structure would be needed to raise the level of accountability, as for example in the case of New Zealand, the governor of the central bank is required to demit office in case the inflation target, is not achieved.

Conclusion

- The IFC, while representing a strong start in the right direction, could be an over-determined regulation with too many fine prints. There should be more institutional flexibility to deal with dynamic and evolving situations. It should be reviewed carefully to build-in sufficient flexibility in the law, delegate for the legislature and clearly define the responsibility of the government and central bank.
- It will be difficult to get the complex IFC document passed at one go. So, it may be more practical to go piece meal.
- It is seen that amongst the various nominal anchors available, flexible inflation targeting has been the most successful. It has the added beneficial impact of disciplining the fiscal policy. So, India should opt for flexible inflation targeting but with sufficient flexibility to adapt it to the Indian ground realities. Once flexible inflation targeting is in place, other institutional pre-requisite will fall into place.
- However, price stability alone is too narrow an objective of monetary policy. Growth, exchange rate and financial stability should also be included in the objective function of the RBI.
- The CPI target should not be hard-wired into law. Inflation must be defined in much broader sense as this might lead to problems subsequently, requiring amendments to the law, which is a complex and uncertain process. Instead of annual target, medium term inflation targets should be agreed upon and announced.
- The central bank should not have goal autonomy but have instrument autonomy. The targets should be decided by the government in consultation with RBI. The RBI should be asked to be accountable to the Parliament, which represents the people's expectations and aspirations.
- The panel suggested a MPC of technocrats with the majority appointed by RBI and a casting vote (not a veto) for the Governor. The MPC will be also accountable for meeting the inflation target.