ILLUSTRATION: BINAY SINHA

Inflation and agency accountability

In tune with global thinking, India created a monetary policy committee to target inflation. Six years later, it's time to strengthen its accountability

Inflation in 2022 has been generally above 6 per cent, the upper bound of the notified inflation target. The government stated in Parliament recently that the Reserve Bank of India (RBI) had furnished a report, explaining its failure. On the question of making the report public, the government said that the law does not provide for it. As this column argues, there are good reasons for making this report public, if necessary, by amending the law.

What is the wise path forward? We need to engage in first-principles thinking on structuring the principal-agent relationship between Parliament and the central bank (CB).

Inflation is bad for everyone and hurts the poor disproportionately. Low, stable and predictable inflation is the foundation of long-range plans of economic entities. How can a firm plan a long-range project? How can a person at age 20 make pension plans for age 90? Planning requires reasonable certainty about low, stable and predictable inflation deep into the future. So far, India has not achieved low, stable and predictable inflation.

AARTHIKAM CHINTANAM

K P KRISHNAN

Fiat money, which is made by CBs, was invented many centuries ago. Despite the many advantages that it has brought, fiat money and CBs have faced many problems during their existence. The intellectual breakthrough on this took place in the early 1980s with the clarity that the CB should be an independent agency that creates fiat money, with a narrow mandate of delivering low, stable and predictable inflation. With inflation targeting, for the first time after centuries of failure, fiat money found its feet. Inflation targeting coupled with central bank independence generally worked well, and rapidly spread from one country to the next. There is by now ample literature on the point that economic performance in a country improves after this reform is implemented.

With the emergence of modern open-economy macroeconomic thinking in India, views on the monetary policy arrangement also shifted. The new idea began with a few intellectuals such as the late Deena Khatkhate. As with other areas of finance, a series of expert committees translated the new idea into a new orthodoxy.

Starting with the Standing Committee on International Standards and Codes, 2002, chaired by Y V Reddy; followed by the Committee on Fuller Capital Account Convertibility, 2006, chaired by S S Tarapore and the Committee on Financial Sector Reforms, 2009, chaired by Raghuram Rajan; and finally the Financial Sector Legislative Reforms Commission, 2013, chaired by B N Srikrishna, all favoured shifting the power of rate setting from the governor to a statutory Monetary Policy Committee (MPC). Intellectual consensus on making inflation targeting the primary Dharma of the RBI took a little longer. In 2014, the Expert Committee to Revise and Strengthen the Monetary Policy Framework chaired by Urjit Patel endorsed both these ideas and emphasised that there should be clear mechanisms through which the RBI would be held accountable for delivering on the objectives that have been established for it.

The formal announcement on this was made in the first budget speech of the new government in 2014 and the Monetary Policy Framework Agreement (MPFA) was signed in February 2015. Finally, in September 2016, the RBI Act of 1934 was amended to provide for a statutory MPC for maintaining price stability, while keeping in mind the objective of growth. The statutory amendment creating an MPC and prescription of an inflation target is one of the most important achievements of the present regime, alongside the Insolvency and Bankruptcy Code and the Goods and Services Tax.

Given the limitations of the Indian financial system, giving the RBI an inflation target of 2 per cent or 4 per cent, would have worked poorly. There are important weaknesses in the Indian bond market and banking sector. The bond-currency-derivatives nexus is missing. The monetary policy transmission is therefore weak. Hence, we in India are not in a position to make demands of the RBI that are well accepted in developed economies: Of delivering on a precise inflation target. Instead, the RBI was given a wide goal post, of delivering inflation anywhere in the range from 2 to 6 per cent.

For some years, this worked well and India got a new regime of price stability. In recent years, though, there has been a pronounced concern that inflation has regularly surpassed 6 per cent. This is a troubling development that must be recognised. Course correction is required, to diagnose the sources of these failures and to address them.

Theoretically, there are exactly four possibilities through which a central bank can fail on its target:

(1) Were the statistics wrong; was the economy mismeasured?

(2) Were the forecasts, based on the observed statistics, wrong?

(3) Were the decisions of the MPC, based on the forecasts, wrong?

(4) Were the right actions taken but the MP transmission was bad?

Every time there is a failure in achieving the inflation target, we need to allocate blame across the four sources of failure. Once the blame is allocated, we must undertake remedial action. This is the task of the principal i.e., Parliament, which must review its "contract" (namely the RBI Act) with the agent i.e., the RBI and modify "contract (law)" in ways that will ensure better performance by the agent. For this process, it would be useful to have a public release of the RBI's self-assessment of its failure and its own views on the required remedial measures. While recognising that the RBI has an interest in this matter, the document deserves to be in the public domain, so that neutral parties can pick through the arguments and propose the correct solutions.

This continuous process of correcting flaws and improving the institution would be helped by greater transparency. In addition to the RBI report, on a regular basis, the models and data and slideshows that go into the MPC meeting should be released. Each MPC member should be obliged to write and sign a 1000-word rationale statement that explains how she voted. Through this, each member of the MPC would have greater individual accountability for the decisions in their votes.

The writer is an honorary professor at the Centre for Policy Research, member of a few for-profit and not-for-profit boards, and a former civil servant