
Monetary Policy Myths

Raghuram Rajan & Eswar Prasad / New Delhi May 21, 2008, 4:47 IST
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Central banks across the world can now fight spillover effects of inflation.

The draft report of the Committee on Financial Sector Reforms recommended that the RBI should focus on a medium-term objective of low inflation. While this is just one of the recommendations, it feeds into an ongoing debate, and hence has attracted more attention. In two prior articles, we addressed some concerns that had been raised.

There continues to be a misunderstanding about how an inflation objective works in practice — some, including Joseph Stiglitz, who should know better, argue that the objective would force a central bank to ignore growth and mindlessly raise interest rates whenever inflation starts to rise. This view is totally divorced from practical monetary policy making. Central bankers cannot control inflation today, it is already "in the bag" so to speak. What they can control is future inflation — hence the objective is medium-term inflation. Current inflation matters only because it conveys information about what might happen over the medium term. But a good central banker will pay attention to why inflation is high today, and to the likely future pattern of growth, in deciding about interest rates. For instance, the US Federal Reserve, despite being governed by an implicit inflation objective, is not raising rates in the face of higher current inflation because it believes slower future growth will quell inflation over the medium term.

To reiterate, the logic behind an inflation objective is that the best the central bank can do is keep growth at a level consistent with the supply constraints in the economy ("potential" growth in the jargon). Attempts to push growth beyond this through lower interest rates will simply result in more, and accelerating, inflation, while high rates that keep growth below potential will reduce inflation below the objective, and waste the economy's potential.

A number of new concerns have been raised, which can broadly be grouped into the following categories. First, India has tremendous aversion to inflation, so it is as if the RBI already has an inflation objective. Second, the RBI cannot influence inflation because much of the inflation India faces is through supply shocks — for example, a rise in the world price of commodities. Besides, the RBI doesn't have good instruments to control such inflation. Third, politicians will get into the act anyway, so the RBI should not be made responsible.

These concerns are not necessarily consistent because they come from different commentators, but they deserve answers. The first is the weakest. If India already has an implicit and overriding inflation objective, why not formally make it the RBI's focus? Ah, commentators argue, that would prevent it from intervening in the exchange rate when the inflation objective is being met. Precisely! Not only would the single objective allow the RBI to guide expectations better, we have also argued at length why exchange rate intervention is not effective in the medium term. Our critics think it is. Thus the bone of contention here is not the inflation objective, but the efficacy of exchange rate intervention, an issue we have addressed in an earlier column.

Turn to the second argument, that the RBI cannot influence inflation through monetary policy, so inflation should not be its responsibility. It is true prices can rise because of supply shocks, such as an externally induced rise in oil or grain prices. But that is already in current inflation, and indeed the RBI can do nothing about it. The key is what this will do to inflation over the medium term. By influencing liquidity and credit, the RBI can control demand

(especially from interest-sensitive sectors), and can prevent the "second round" effects of the inflationary burst from spiralling out of control. Wages are just one example of the costs that can react to a rise in the price of inputs. The local panwalla or halwai can also react to a rise in costs by increasing their prices more than proportionately. The RBI's job is to ensure that they don't see the spurt in inflation caused by an increase in input costs as a generalised increase in the inflation rate. As we argued in an earlier article, fixing inflationary expectations is key, and the RBI can best do this if it has a clearly-defined objective of maintaining low inflation over the medium term (i.e. over the next 2 to 3 years).

Put differently, India is not unique in facing supply shocks. Indeed, the recent rise in commodities prices, especially oil, has been unprecedented. Despite this, inflation across the world is still averaging in the single digits, unlike in the 1970s. The reason is that central banks across the world have acquired credibility that they will fight spillover effects, and prevent generalised inflation. Maybe our politicians have kept India's inflation low through extremely short-term and distortionary policies, but it is not that we are unique in the world. Many others have done so with far fewer distortions. Perhaps there is something to be learnt?

A related concern of some commentators is that the RBI should not be given the onerous responsibility of consistently delivering low and stable inflation because it simply doesn't have effective instruments to do so and the channels of monetary policy transmission are decrepit. This reasoning has it precisely backward. Of course, weaknesses in institutions and the financial system increase the burden on monetary policy and make it harder to get things right. But this is why a more focused and disciplined monetary policy without multiple objectives is so much more important — to promote financial stability and create fertile ground for financial reforms, and to compensate for some of the other weak links in the economy.

What about the argument that India is unique in that our politicians will always intervene? The "India is unique" argument is intellectually bankrupt. It is the natural response whenever anything is proposed that goes against the status quo. We have to offer better arguments than that, documenting precise reasons why India is different and why it matters. The truth is other countries also have politicians who worry about getting re-elected. And other countries also have poor people who are hurt by inflation. The move to make central banks responsible for inflation management was also an attempt to get the politicians out of the price setting and inflation process. If Brazil, with historically dysfunctional politics and hyperinflation not so long ago, has lower inflation than India today, we may want to ask whether its central bank's mandate of price stability is precisely what has enabled it to withstand political pressures and achieve the goal.

The consensus that maintaining low inflation is the central bank's job, and its only job, did not develop overnight in those countries, it took time. It is our hope that this consensus will develop in India also. The alternative — the bans on commodity markets, the bans on exports, the threat to impose price controls — as all sensible economists including those in the government understand, are effective if at all only in the short term, and extremely detrimental in the long term. Would it not be better if we had the confidence that the RBI was doing all that was necessary and possible to control inflation?

Indeed, there is a very real danger we have to guard against. We are slowly slipping back into the command and control economy of the past, with all the associated distortions and rents. Our proposal to strengthen the focus of the RBI is not motivated by political naivete, but by a very real concern about the political and economic consequences of accepting the status quo.

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