Monetary Policy for India

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Policy Panel

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The Context

- Common perception amongst some segments the existing framework (multiple indicator) lacks transparency (discretionary, balancing twin objectives), credibility (high inflation)

- Prime Minister's call to evolve fresh thinking on monetary policy *in a globalised economy and dealing with the constraints of its macro economic policies.*
    1. High inflation in past few years, possibly owing to loose monetary-fiscal policies → Insulate central bank and its monetary policy setting from political/fiscal policy constraints → Inflation targeting or some variant

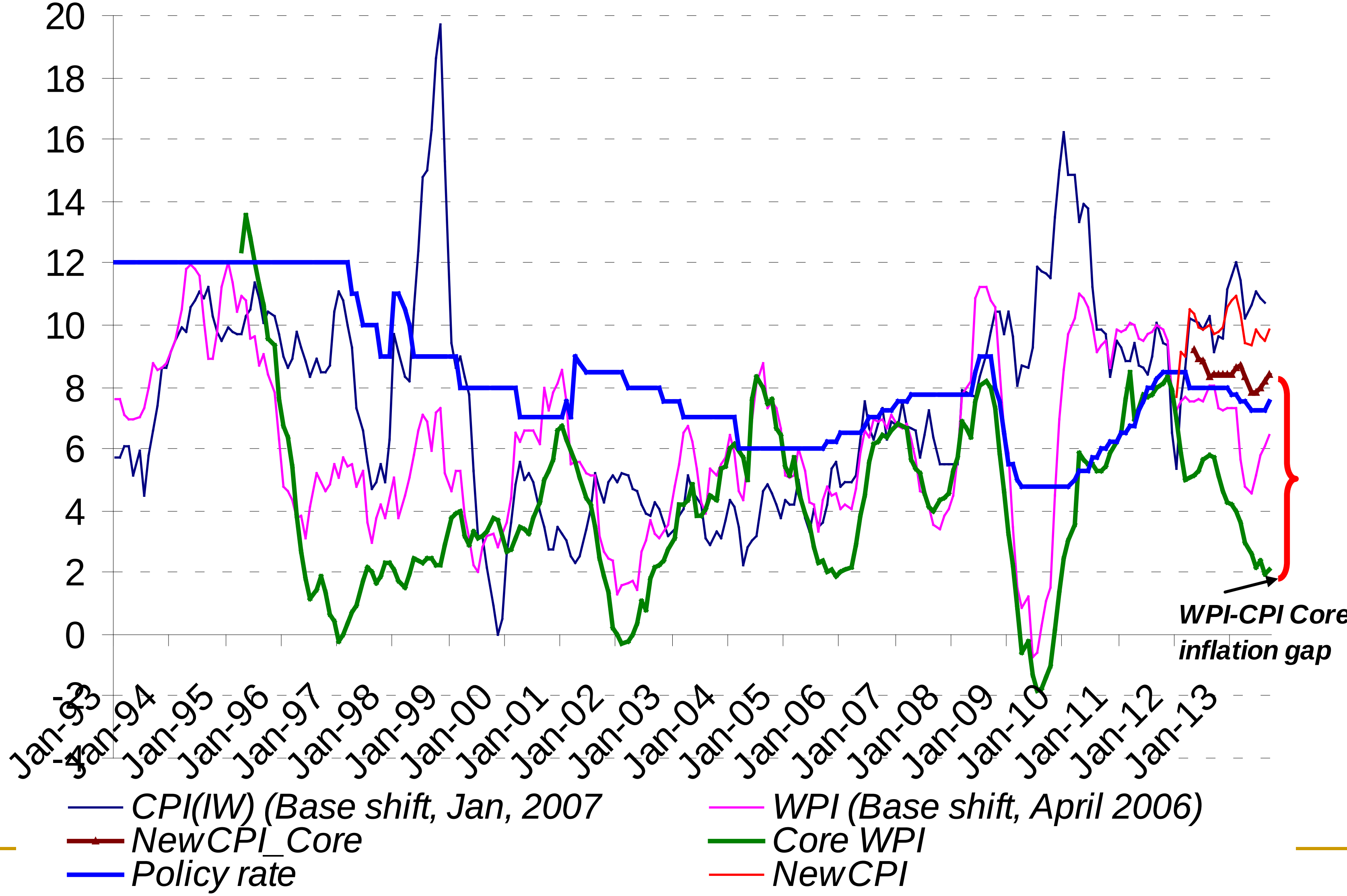
- RBI's Expert Committee examining current monetary policy framework to consider *what needs to be done to revise and strengthen it with a view to, inter alia, making it transparent and predictable.*

- Committee's ToRs include: objectives & conduct of monetary policy; choice of appropriate nominal anchor; review of existing framework; current impediments in transmission

What was wrong so far?

- Starting point of any reform
- How has the existing framework failed, not delivered? What are the problems and how do they affect financial versus real segments?
- Transparency, predictability (Is the evidence convincing; financial vs real sector tradeoffs) - Confusion → higher inflation → higher interest rate premium → pushing up long-term interest rates. Uncertainty → Higher volatility
- Is high inflation in recent past due to wrong framework or monetary policy errors?

Inflation and Monetary policy in historical perspective



Choice of appropriate anchor?

- One or two objectives? Price stability, exchange rate, or both? What's wrong with two objectives?

- Benefit of contrasting experiences: Balancing twin objectives – monetary and exchange rate – until 2009. Essential part of strategy to manage capital flows through intervention-cum-reserves' accumulation. Exchange rate policy shift in 2009; no formal announcement though. Stoppage of to reserves' accumulation.

- Subsequent events, viz. flood & drought in capital flows, higher financial and real volatility, increased macro stability risks, draw attention to self-insure against external liquidity-driven, financial shocks; tradeoffs in uncertainty for financial-real segments.

- What exchange rate policy to be followed in future? Real Exchange rate appreciation – drivers of REER (productivity, government spending, capital flows, etc.); export-import elasticities insufficiently researched; argument that real appreciation matters little for competitiveness more assertion than empirical (Important for framing policy responses). Whether necessary to counter or not?

- What tools to be retained to manage volatility in capital flows, financial shocks from abroad? *There isn't a 'trilemma' but 'dilemma' (Rey) as risk-on/risk-off key determinant of capital mobility, not UIP of Mundell-Fleming model.*

- Need to compare and contrast different macro-management strategies followed pre- and post-crisis. Scale of financial globalization, role of global banks, CAD & its dynamics crisis call for caution in shifting to single objective

Single anchor - Which inflation indicator?

- Multiple indicator framework - *WPI, CPI*, inflation expectations, plus monetary aggregates, output indicators inputs into monetary policy decisions
- Inflation indicator – *WPI* or *CPI*?
- *CPI* - New index; comprehensiveness & robustness issues (three-fifths weight for food, fuel prices that tend to be very volatile and whose role in conduct of monetary policy is debatable; 9.77% weight for house rents - largely imputed, measurement concerns). Eliminating these, along with food and fuel prices where supply shocks dominate significantly reduces informational content of core-CPI inflation. Also geographically sensitive; linkages with other macro variables unknown; precludes analytical insights; still evolving;
- Macroeconomic risks associated with moving solely to CPI – households' inflation expectations→ food inflation enters reaction function →transmission/spillovers into generalized inflation doesn't correspond to observed demand indications so far; danger of locking economy into very high interest rate regime; unpredictability of CPI forecasts; possible loss of credibility from policy errors or if inflation target too ambitious
- What if there was no *WPI*? Should existing information be ignored, discarded?

Thank You