Monetary Policy for India

Renu Kohli

Policy Panel

4th IGC-ISI India Development Policy Conference
December 17, 2013
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

- CPI(IW) (Base shift, Jan, 2007)
- WPI (Base shift, April 2006)
- New CPI Core
- Core WPI
- Policy rate
- WPI-CPI Core inflation gap
Choice of appropriate anchor?

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


- 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