

# Reflections on Analytical Issues in Monetary policy

India's central bank is essentially "a full service central bank," unlike central banks in advanced economies (AEs), RBI plays many roles: as the monetary authority, as a regulator of the banking and non-banking systems as also of many other segments of the financial markets, including the payment and settlement systems. The RBI also acts as the debt manager for the central and state governments. The RBI, thus, has enormous presence in the public policy space and is, therefore, required to not only be transparent of its actions, but also communicate the rationale of its policy measures in a credible manner. The RBI has formally and legally adopted flexible inflation targeting (FIT) as its policy framework since early 2016, almost a year after an overall agreement on the need to have FIT between the central government and the RBI. Inflation targeting is adopted as the monetary policy framework in a number of countries since 1989. In India, inflation targeting as a monetary policy framework was not discussed in official reports and peer reviewed journals till almost 2013. That there was no serious shortcoming with its predecessor, an eclectic framework famously known as "multiple indicator approach" (MIA).

Prior to the MIA, India had "monetary targeting" (MT) with "feedback" loop, targeting money supply growth was given up in favour of a discretionary MIA. The RBI began to announce, under both the MIA and FIT regimes, the short-term rate of interest as a possible way of ensuring that output growth goes along with price stability. The replacement of the MIA with inflation targeting was conceived from within the RBI from around the beginning of September 2013 under the leadership of former Governor Raghuram Rajan. Rajan strongly supported and justified it on the grounds that the target of inflation should correspond with the threshold rate of inflation needed to optimise growth.

In the Indian case, financial stability is sought to be secured by a number of institutions belonging to a number of segments of the overall financial system. It is the RBI that brings out financial stability reports and helps evolve macro and micro prudential policies with regard to the banking sector.

Central banks, thus, have to act to stem any financial crisis. Financial stability has to be the main reason why central banks are created. This point was not fully appreciated once the Advanced Economies began to experience stable economic conditions along with growth. It was taken for granted that stable economic conditions would be largely secured if central banks undertake policies to control inflation. Low or stable inflation was understood to promote growth. The global financial crisis (2007-2008) has thrown up an important clue, that central banks would have to reorient their thinking about monetary policy and allied operations in a manner that takes care of concerns that go beyond issues of currency and inflation

This is necessary essentially to ensure that people's confidence in banks is not eroded. Erosion of confidence in the banking system cannot be easily erased even if managements say that the bank suspected to be under financial stress is "too big to fail. Commercial banks' own communications, however sophisticated and reasonable they may appear, would not assure the people of the safety of deposits.

### **Tinbergen rule**

The FIT, it is said, could have two objectives, but with a specified or assumedly specified hierarchy between the objectives. The two objectives in question relate to inflation control and stability, and output stability or employment stability. Central banks seem to believe, in line with the Tinbergen rule, that if there are  $n$  number of objectives, they should have  $n$  instruments of policy so that there would be appropriate identification of the system.

No economic policy planner in India, however, swore by the applicability of the Tinbergen rule to Indian economic realities. Almost all policy planners and central bankers of India till recently felt that while inflation should be under control, output growth as well as financial development and stability should also be regarded as equally important.

In reality, however, policy goals, policy designs, and policy tools or instruments cannot be viewed as distinct. They are often in the form of mixed compounds. Jan Tinbergen pointed out that policy mixes in terms of targets, designs, and instruments often exist and interact with one another. He stated that there cannot, a priori, be an  $n \times n$  objectives-instruments compatibility always. He, in fact, went to the extent of saying that "complicated systems of economic policy will almost invariably be a mixture of instruments

### **Rationale for FIT (flexible inflation targeting)**

Advocates of FIT place a number of arguments, implicitly or explicitly, against discretion in policy on the grounds that it is inefficient and would lead to dynamic inconsistency problems. FIT will work well if central banks forecast for both inflation and real activity, thus making it "forecast targeting". yet more powerful argument in favour of inflation targeting is that central banks as well as governments can decipher and aim at the threshold rate of inflation where growth can be optimised. In the case of India, the threshold rate of inflation, was placed at about 6%–7%, The Indian FIT felt that the inflation target could oscillate between 2% and 6% during a medium-term period of three years, and should be at the mid-point of 4% at the end of the medium-term period.

### **Taylor Rule**

Most central banks consider the short-term interest rate as a best operational target of monetary policy. The framework of policy should permit the central bank to control the operational target. Inflation targeting is one such framework. Instruments of

policy are used to achieve the operational target. In modern days, the tools that most central banks use are a variety of instruments—standing facilities, open market operations (OMO), cash reserve ratio (CRR), and quantitative easing (QE). The MPC decides upon the official rate and thereby gives the stance of policy to the wider public. The level of the short-term interest rate as the operational target is set is provided by the Taylor rule, which was first formulated in 1993 (Taylor 1993). The rule in its original form was stated thus:  $R = r^* + p + a(y - y^*) - 1 + b(p - p^*)$ , where  $R$  is the target nominal interest rate that is policy-centric,  $r^*$  is the equilibrium real level of the policy interest rate,  $y$  is output,  $y^*$  is the potential output level,  $p$  is inflation and  $p^*$  is the target for inflation, and  $a$  and  $b$  are parameters that describe the response of the policy rate to deviations of output and inflation, respectively, from their potential level and target rate. The Taylor rule has not been officially proclaimed as necessary for arriving at the official nominal interest rate by any central bank.

### **Real interest rate**

that real interest rate is equal to actual or expected nominal interest rate minus expected inflation, is hardly helpful in understanding the impact that the real rate of interest is supposed to have on investment and on income. The real interest rate, mysterious as it is, does not have a real life counterpart, posing a problem for economic theory. As he reasoned, changing the real interest rate through central bank operations would not change the real return on capital and stimulate investment through that channel because the price of capital is determined by the money interest rate. This is very different from the concept of the real rate of interest that was propounded by Irving Fisher in 1930. The current notion that the real interest rate is essential for the inflation targeting framework has given rise to the idea that monetary policy should be concerned with managing inflation expectations in order to keep the real interest rate at a stable level, consistent with the point of equilibrium that helps equate saving and investment.

### **Inflation expectations**

Most surveys in India of expectations of inflation provide respondents' responses based on past experience and on some information on the current indications about the direction of movements in major macro indicators as reported for a quarter ahead. Much of the current information, it must be recognised, is not based on a firm information base and could well have some speculative guesses, information frictions, noise arising from failure of proper signal extraction, etc. A number of efforts were made under a class that is broadly known as rational expectations models. It is largely agreed that short-term interest rates help influence money market rates and the structure of interest rates, also known as the yield curve. There is also general agreement that long-term interest rates should generally be such that investors would be enthused to undertake new projects or for expansion of existing projects. Some of

the EDEs that have not even attained the medium-income levels have taken to inflation targeting as the framework of their monetary policy. Aggravation of inequalities in the emerging and developing economies would lead to politico social Conflicts and throw up uncertainties in macroeconomic policymaking and implementation of the frameworks in existence.