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Government restraint key to RBI rethink

By Kunal Kumar Kundu

The Reserve Bank of India's Expert Committee to Revise and Strengthen the Monetary Policy Framework, chaired by Deputy Governor Urjit Patel, submitted its report last week. The report suggests rule-based conduct for monetary policy, which would have two major impacts: the entire exercise would become more transparent while becoming relatively more predictable and also likely make the central bank less amenable to government influence.

No less importantly, the committee has proposed changing the official benchmark to the Consumer Price Index (CPI) from the Wholesale Price Index (WPI). It also recommended the setting up of a Federal Reserve-style monetary policy committee in which each member would have a voting right with regard to the policy decision, a clear move away from the current policy of only the RBI governor having the final call.

The expert committee, which was set up by the RBI in September 2013, has recommended that retail inflation, measured by the CPI, replaces wholesale price inflation as the price-gauge anchor. This is a move in the right direction as CPI is a better measure of inflation; unlike WPI, it includes certain services that are an integral part of a consumer's basket. Nevertheless, while CPI is a better measure of inflation, a 50% weighting on food makes it an imperfect measure as well. High food inflation results in higher headline inflation.

While targeting CPI makes sense, it is important to work toward formulating a better measure of inflation as the RBI may end up targeting inflation that is inherently elevated and hence may end up following a tighter than appropriate policy.

According to the suggestion of the expert panel, the ultimate target of the central bank would be to bring the inflation rate to 4% in three years, with a band of plus or minus 2%. Based on the proposed timeframe, the targeted CPI inflation would be 8% over the next 12 months, 6% in the next two years and finally 4% after three years. This essentially means that the RBI will tolerate an inflation rate of around 6% going forward.

The focus would be on headline inflation instead of core inflation since this "closely reflects the cost of living and influences inflation expectations relative to other available metrics".

The committee recommends that if the monetary policy committee fails to achieve its target for three quarters in a row, it must issue a public statement signed by the five members, mentioning the reasons for the failure and the remedial measures that will be implemented.

Having said that, formal inflation targeting is very important to keep inflationary expectations in check. Lack of formal communication and ambiguity in terms of approach (including the non-existence of formal inflation targeting) has resulted in India's inflation expectations remaining stubbornly elevated.

According to the Inflation Expectations Survey of Households conducted during the third quarter of 2013 by the RBI, households expect inflation to accelerate. Based on the survey, which covered 4,765 urban households in 16 cities, households expect prices to climb from an average annual rate of 11.8% in the quarter ending September 2013 to 12.8% in the next three months. This result represents the 16th consecutive double-digit average inflation expectation since December 2009.

The biggest advantage of rule-based monetary policy action is the greater degree of autonomy that the RBI would enjoy given that it would finally be able to free itself from government intervention. With the government failing miserably to adhere to fiscal discipline and persistently delaying necessary structural reforms, there have been multiple instances of immense pressure being put on the RBI by India's finance minister to take steps (read cut interest rates) to revive the flagging economy while inflation has remained a major problem.

The critical question, however, is whether the transition will effectively solve India's current inflation problem. The noise coming out of the finance ministry is a cause for concern. The target set by the committee ideally means that India's monetary policy will remain fairly tight and any easing is ruled out in the near to medium term. Whether there may be further rate increases will depend on how inflation pans out.

The problem is, inflation in India is fairly structural, and it is equally important that the government makes an honest effort to curb fiscal profligacy. Given that national elections are fast approaching, such expectations will be belied, despite Finance Minister Chidambaram's promise of sticking to the avowed fiscal deficit target of 4.8% of GDP.

While a relevant correction in diesel prices (highly subsidized transport fuel widely used in India) is ruled out, though essential for fiscal discipline, the politically weakened UPA government (with Congress being the majority party) has now gone for the jugular by raising the limit of subsidized LPG gas (per household) from nine to 12 cylinders with an eye to the forthcoming election. This will likely increase the subsidy burden by approximately 50 billion rupees (US$800 million).

As if that was not enough, within the past few days, Congress-led governments in various states across the country have announced a spate of populist policy measures. The state of Haryana reduced the power rate for the farm sector by 60% for the current financial year. The decision, which will cost the state exchequer 6 billion rupees per year and benefit 3.8 million domestic consumers, which account for 95% of total consumers, and 0.6 million agriculture consumers.

Not to be left behind, Maharashtra state reduced power tariffs with cuts that will impose an additional 71 billion rupee burden on its coffers. While these will not show up in the fiscal deficit of the central government, the finances of the states will worsen further and will push up the combined deficit of the center and the states.

Clearly, while the government refuses to play its part, it desperately wants the RBI to cut rates with the hope of reviving growth as it struggles to regain credibility.

Not surprisingly, the expert panel's report exhorted the government to get back to a fiscal trajectory consistent with the now-lapsed Fiscal Responsibility and Budget Management Act, which calls for a zero revenue deficit and a fiscal deficit of three per cent of gross domestic product. The fact is, the effectiveness of the proposed monetary policy rule will depend on a well laid-out fiscal policy rule.

The committee also recommended that the government's current practice of postponing required adjustments in administered prices be done away with. While non-adherence to this reduces the effectiveness of the monetary policy, government actions (as discussed above) leave a lot to be desired. The proposed rule would serve no purpose if, subsequently, the RBI is forced to justify its inability to stick to the target by blaming government inaction. In the end, it takes two to tango.

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