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India gives ground on inflation targeting

By Kunal Kumar Kundu

BANGALORE - Reserve Bank of India governor Duvvuri Subbarao, having let go of the bank's inexplicable fetish for limiting interest rate increases to 25 basis points, now claims that inflation targeting is neither feasible nor advisable in India.

The bank last week increased its benchmark interest rates by 50 basis points. It increased the repo rate, the rate at which the RBI provides credit to banks, to 7.25% (up from 6.75%) and the reverse repo rate, the rate at which banks park funds with the RBI, to 6.25%. The cash reserve ratio for banks was unchanged and the savings banks deposit rate increased to 4% from 3.5%.

Subbarao, in a speech posted on the RBI's website, said "... In an emerging economy like ours, it is not practical for the central bank to focus exclusively on inflation oblivious of the larger development context ... The Reserve Bank cannot escape from the difficult challenge of weighing the growth-inflation trade off in determining its monetary policy stance."

Is this a subtle hint at a shift in policy focus from a stated primary objective of combating inflation? Or a way to deflect blame for the bank's inability to read the economic conditions correctly and hence to gauge inflation?

The RBI (let alone government officials) has not covered itself with glory in its estimation as to where inflation is headed. Since the middle of the fiscal year that ended in March 2010, the stated official line was that the year would end with 5% inflation. It ended with a rate at more than double that figure.

The predictive failure of the collective wisdom, rather than leading to a change in forecast, led to an even more determined emphasis on year-end inflation (this time for the year to March 2011) of 5.5%. Confidence in the forecast stemmed from two factors - one statistical (a high base effect) and the other fortuitous (a better monsoon and hence a good harvest).

Yet fiscal 2011 ended with inflation at a little less than 9%. This can actually be revised upwards, given that the January inflation number has been revised upwards from 8.2% to 9.4% (an increase of a considerable 120 basis points). Some improvement!

Inflation is not always a monetary phenomenon. Monetary policy can hardly (if at all) play an important role in stemming food inflation. Also, given its inherent structural deficits, the Indian economy is prone to bouts of high inflation whenever there are a few consecutive years of high and solid growth. Clearly these are governance failures, and there is not much a central bank can do in such circumstances.

The RBI, however, can gain solace from the fact that central banks the world over have not been notably successful in taming the inflationary demon. Additionally, the RBI lacks formal independence and this makes its task difficult as politics quite often end up playing an important role.

This does not absolve the RBI for its failure. Expectations play an equally important role on determining direction. Even with a current repo rate at 7.25%, the real interest rate in India continues to be negative and it has been persistently so for a fairly long period. This is a bad policy response, and India cannot but face the consequences of such folly.

In a high-inflation scenario, the baby steps in the rate hike cycle lead to front loading of demand (especially leveraged demand) to beat the rising future rates, thereby fueling inflationary pressure. With the external environment turning adverse, the inflation genie is well and truly out of the bag. Persistently high food and other commodity prices have resulted in high headline inflation percolating to core inflation through a wage price spiral.

One is not surprised, therefore, to see that the RBI has suddenly started to believe that there is a growth-inflation trade-off while earlier they were not so convinced.

The highly accommodative (read persistently negative real rate) monetary policy has failed to push gross domestic product (GDP) growth to a higher orbit. Indeed, the Indian economy is showing signs of slowdown, with a clear slowdown in the index of industrial production. Demand for capital goods has been falling. Growth in real imports, discounting for higher commodity prices, remains low, indicating weakening demand. The trade-off is very clear.

While this way the RBI can feel that it is morally correct, ask Indian consumers how they feel. According to a recent survey (titled "If middle class people are suffering so much due to inflation, what about poor and below poverty line citizens?") by The Associated Chambers of Commerce and Industry of India, household savings of an average employee in the metropolitan areas have come down by 45% in the past six years due to exorbitant increases in the prices of essential commodities, fuel, education, housing loan payments and increases in health insurance premiums. The standard of living is now a quarter less than what it was in 2006.

Releasing the findings of the survey, secretary general D S Rawat said, "In an average salary structure of Rs 40,000 [US$894) per month, the amount available for discretionary spending is not more than Rs 17,000 as [the] average employee shells out over Rs 6,000-8,000 on housing loan or rent, 5,000 loan on cars, two-wheelers, 7,000-10,000 on education cost and FMCG [fast-moving consumer goods]. The share of insurance premia, including health insurance is over Rs 3,000-5,000 each month as employees need to ensure [sic] themselves including their families as there is no social security net in it."

In such a situation, what indeed is the plight of the poor? I have always been a votary of consistent (even if a relatively low) level of growth with low inflation rather than spurts of high growth with high inflation that squeezes out the poor.

India's inexplicable policy has resulted in GDP growth showing signs of a slowdown, but inflation is not slowing down as desired - unless the global environment suddenly changes. Policymaking in India, it seems, factors in a large dose of luck when it seeks to achieve a stated objective.

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