

Why an inflation objective?

Raghuram Rajan and Eswar Prasad

There has been a spate of commentary on the draft CFSR report, much of it on this page. We are encouraged that some commentators have engaged in a serious debate of the issues. Others, however, seem to have little acquaintance with the details and logic of the report, instead setting up straw men that they demolish with great gusto. We would urge readers to actually read the report and judge the breadth and merits of the proposals for themselves. Echoing R. Ravimohan, a committee member, it presents “real solutions for real problems”.

That said, the report is long since it covers a vast terrain. We will summarize our main monetary policy recommendation and the rationale today, and follow up with a discussion of exchange rate policy in our next column. In the future, we hope to continue the debate with substantive discussions on the rich recommendations elsewhere in the report.

Before we reprise the committee’s proposal on monetary policy, let us review the context. The RBI already has a medium-term inflation objective of 5 percent that is regularly cited in speeches by its leading officials. But the central bank is also held responsible, in political and public circles, for a stable exchange rate. The RBI has gamely taken on this additional objective but with essentially one instrument, the interest rate, at its disposal, it performs a high-wire balancing act, with the objective of monetary policy depending on the particular economic circumstances.

What is wrong with this? Simple that by trying to do too many things at once, the RBI risks doing none of them well. For instance, it is now widely recognized that a central bank needs to control the public’s expectations of inflation in order to manage actual inflation. If workers think prices are not going to increase rapidly, they are less likely to demand a compensating increase in their wages, thus preventing an inflationary spiral from taking off. But if the public never knows whether the central bank is going to focus on the nominal exchange rate or the inflation rate, it is confused. It is likely to have higher inflationary expectations, and be more sensitive to any local price jump, which even if from imported goods like oil, could initiate an inflationary spiral.

This confusion is compounded when foreign capital flows into the country in copious amounts, as is now the case, since this pushes the exchange rate to appreciate. While the central bank can intervene in currency markets, buy the inflows of foreign currency by exchanging it for domestic currency, and re-export the foreign currency (meanwhile withdrawing the domestic currency it has printed by issuing “market stabilization” bonds), there are limits to this process. Eventually, the central bank has to decide whether to allow the nominal exchange rate to appreciate or allow higher inflation. A central bank with multiple objectives will flit between the two, implying further confusion and possibly adding to inflationary expectations.

The RBI has managed the balancing act as best as it possibly can so far. But the rope is fraying under its feet. Could we make its job easier?

Our suggestion is to move towards a single objective for monetary policy—low and stable inflation. But this is not about sacrificing growth or other important objectives at the altar of low inflation. There is no long-run tradeoff between growth and inflation, and for monetary policy to try and engineer a short-run tradeoff can be dangerous. Well-anchored inflation expectations constitute the best tonic that monetary policy can provide for growth. The evidence also shows that low and stable inflation reduces macroeconomic volatility and is good for financial stability. Even exchange rate volatility is lower in inflation targeting economies. While there are shocks that will buffet the exchange rate, stable macroeconomic policies at least prevent those policies from themselves becoming a source of uncertainty. If we intervene haphazardly, the exchange rate will move in bigger jumps, and we will also create bigger one-way bets.

Moreover, focusing on an inflation objective can be useful in communicating that monetary policy has its limits. It can be a recipe for disaster if the public believes that monetary policy is a panacea for all the ills that an economy faces, and expects the RBI to produce magic somehow.

Would a central bank with an inflation objective simply continue pushing inflation down even when the economy is self-destructing on high interest rates? Of course not! If inflation is expected to be below the objective, as would be true if the economy slows, the RBI would cut rates, just as it would raise rates if inflation was expected to be above objective. The U.S. Federal Reserve is cutting interest rates because it believes the current recession will bring inflation down significantly below its target.

Indeed, the RBI's objective could be restated as low inflation, and growth consistent with the economy's potential. They amount to essentially the same thing! But it would let the RBI off the hook for targeting the exchange rate. And that is the key point.

Shouldn't monetary policy have some more freedom to compensate for other huge problems in the economy—an inflexible labor market, inadequate infrastructure and, most important, fiscal policy whose discipline is open to question. The report highlights the need for fiscal policy that results in a reduction of the government budget deficit and the level of public debt. And the other problems could constrain the effectiveness of monetary policy and, more directly, India's long-term growth. But all of this only puts even greater demands on monetary policy. Adding another constraint—in the form of an exchange rate target—is hardly the right solution.

Finally, what about the argument that a focus on inflation is a rich country luxury? Time and again, our politicians refute this—and rightly so--by emphasizing the control of inflation as being essential for the poor. Indeed, we are at a better starting place than most countries in that we have a consensus that low inflation is necessary. And if emerging markets around the world can develop the tools to measure inflation and inflationary expectations, as well as models to track them, why can't we?

What about the exchange rate? Doesn't neglect of the exchange rate constitute hara-kiri for a developing economy like India that is trying to build up its manufacturing base? This is a legitimate and important question—we turn to it in our next column.

Raghuram Rajan (professor, GSB Chicago) and Eswar Prasad (professor, Cornell University) were part of the team that helped produce the report of the Committee on Financial Sector Reforms.