

ISSUES AND CHALLENGES IN MONETARY POLICY

AN ASSESSMENT OF THE URJIT PATEL COMMITTEE REPORT

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- Highlights of Urjit Patel Committee Report (Henceforth UPCR)
- In response to high inflation and high inflation expectations, in January 2014 UPCR recommended inflation target of 8% by Jan 2015, 6% by Jan 2016 and then formally adopting 4% with 2% band.
- Finance Minister Jaitley's Budget Speech, "Essential to have a modern monetary policy framework"
- Along with inflation targeting, called IT, UPCR recommended setting up of a US FOMC style Committee etc.
 - UPCR accepts that there are food supply shocks, but the recommended response to tighten policy is to prevent these shocks from spilling over into inflation expectations and overall inflation.



- CLARIFICATIONS (IF NEEDED) FOR GENERAL AUDIENCE: Why should a central bank solely target inflation and ignore growth?
- Macroeconomic Welfare = Alpha(Growth) – Beta (Inflation).
- Alpha is high, Beta is Low. So raising growth by 1 % by cutting interest rates and tolerating say 2% more inflation, Macroeconomic Welfare goes up. e.g. Swami Aiyar (9% plus 7% is better than 8% plus 6%, Eco Times, 2007).

What is wrong with such a policy?

- In long run growth cannot be bumped up by central bank above the supply determined potential growth rate, which is independent of inflation. This is called Natural Rate Hypothesis. So for maximum Long Run Welfare: pursue zero to low inflation.
- UPCR Report talks about growth maximizing rate of inflation as 6%. But if you accept NRH, ignoring temporary cost of lowering inflation, there is no basis for choosing 6% target, instead the target should be lower, say 2% to avoid risk of deflation.



- Response to UPCR : It drew huge flak from many economists and much of the media. Some of them listed alphabetically (Bhalla, Correa, Ghosh, Kohli, Singh). Various arguments against UPCR are outlined below.
- Inflation is mainly due to food supply shocks. It cannot be lowered by raising rates but by lowering say Minimum Support Price etc. (last 2-3 months inflation has fallen after MSP changes, supporting their view).
 - Raising rates will lower growth but not lower inflation, worst of both worlds.
- Also Inflation Targeting is discredited: abandoned by Bank of England etc after financial crisis. Martin Wolf, Stiglitz etc.
- Many long standing critics (BIS, Taylor, VM 2003)
- A multiple indicator approach is needed (both Wholesale Price Index or WPI and Consumer Price Index) to pursue multiple goals: inflation target, output stability, financial stability etc. It has served RBI well over the years. Committee was divided on this.



- My Evaluation of UPCR: I strongly endorse some of its courageous recommendations but quite opposed to others.

What is unequivocally good about it?

- Choice of CPI over WPI. (See VM 2001, 2007, 2008, 2009 a, b, c, 2011, 2012)
 - I have been informally calling CPI the Correct Price Index & WPI the Wrong Price Index!
- What is questionable about UPCR: pursuing the highly desirable goal of low inflation directly.
- Understanding this critique requires going into historical evolution of monetary policy.



- The term IT is a misnomer. According to me it should be called *Direct Inflation Targeting* (see VM 2003, 2009) to distinguish it from other policies.
- Many of those against DIT, to be best achieved by an intermediate target, such as a money growth rule (e.g. Milton Friedman December 1967 also called for final goal of low inflation).
- Problem with DIT that it is too reactive: if you wait until you see inflation in the whites of the eyes, its too late. Other imbalances also build up.
- Issue of Rules versus Discretion in monetary policy has got mixed up with another issue: that of preemptive versus reactive policy. Need to categorize both dimensions of specific policy.



	Rules	Discretion
Pre-emptive	Milton Friedman's money growth rule: 1950 onwards	Fed Chairman Martin (1951-69) Fed Chairman Volcker (1979-87) Bundesbank, Swiss National Bank
Reactive	Direct IT: Many central banks: NZ (1990), Canada (1991), UK (1992), Endorsed by Bernanke and Mishkin for the Fed in 1997	Greenspan (1987-2006): Discretionary pursuit of 2% (implicit) target

Source: How (Direct) Inflation Targeting Evolved, VM, mint 2009

- Volcker who killed inflation running at 10% was for a goal of stable prices but abandoned money growth and was against mechanical rules. In early 1980s he stated, "no rule can work in a complex, changing economy such as that of USA"
 - When asked whether Fed should follow IT, his reported response "what is all the fuss about?"
- Central banks with best inflation track record Bundesbank, ECB do not follow any rule, let alone DIT. They use multiple indicators and instruments to achieve final goal.
- A Nominal GNP rule and the Taylor Rule (1993) are half reactive, half preemptive: central bank should respond to both on output gap and inflation. (Note: output gap, not output)



Even before meltdown of September 2008, when Bank of England abandoned DIT, there were notable deviations from DIT.

Percentage of months with inflation more than 1% above the target		
	2001-06	2007-08
Canada	14	19
Iceland	64	95
Norway	11	24
United Kingdom	0	29
Switzerland	0	5
Sweden	3	52
Euro area	1	52
Australia	17	43
NZ	29	57

Source: Lavinge R. "Inflation targeting: The Recent International Experience, Bank of Canada Review, 16-28 (2012)



- Practical difficulties in responding to Inflation

WPI (YoY in %)	High	Low	Range	Mean
2003-04	6.7	3.9	2.6	5.4
2004-05	8.7	4.3	4.4	6.5
2005-06	6.0	3.3	2.7	4.5
2006-07	6.7	3.9	2.8	5.5
2007-08	7.8	3.1	4.7	4.7

Source: Dissecting our Inflation target (VM, Mint, 29 July 2008)

If RBI took 5 - 5.5% target seriously, it should have been moving interest rates up and down every year by 300-400 bps for the last five years... As policy goes this would have been a disaster.....Those explicitly for an inflation rule (Raghuram Rajan and others) must concretely specify at what frequency this should be done and accept the interest rate swings that would result. The devil is in the detail; very much so" (VM, above article)



- Specific Critique of UPCR: Does not distinguish between metric versus measure of inflation. UPCR calls CPI and WPI metric of inflation. I call them measures, metric is specifics of measurement.
- Using different metrics for a given month, inflation varies enormously.
 - For the following metrics [MoM(sa) 3MA (SA)MoM Quarterly yoy, QOQ (Sa) QOQ (SA) Avg basis, yoy 12MA yoy, 3Year MA YOY] the range of inflation rates for USA varies from 0.1% to 3.0%. For India range is from 0% to 10.5%. (From Chapter 2 of Shrikant Kolhar, IIMB doctoral thesis 2013)
- Bottom line: even annual inflation is too volatile, 3 year moving average is a good metric for policy. This correlates well with inflation expectations.



- My conclusions and specific recommendation: RBI should be far more hawkish and less owlsh on inflation goal (2% is best)
 - The econometric studies claiming that a choice of 6% threshold inflation to maximize growth are questionable (Citations in UPCR, report Annex 3) This conclusion violates the Natural Rate Hypothesis
- A 25 bps rate hike would signal commitment to reduce inflation.
- However, RBI should be far more flexible on how to achieve 2%.
 - RBI may need to ease if repo window goes into huge surplus mode and the money market rates fall below policy rate.
- Longer-term: A Taylor strategy (not a precise rule) coupled with macro prudential measures, and inflow restrictions. CPI Inflation metric should be based on three year moving average and also inflation expectations.
- A prediction: RBI may have to go beyond DIT and may have to respond to capital flows, ignoring its inflation target. (as for Swiss National Bank and Czech National Bank).



My Critique of the Food Supply Shock View of Inflation

- SUPPLY SHOCKS: Oil, Food prices, Rupee depreciation
- India's structural inflation cannot be controlled by policy.
- Food price hikes attributed to Minimum Support Price (**MSP**) for major food items and also to supply bottlenecks due to lack of FDI in retail.
- There have been hikes in Minimum Support Price of wheat, rice, etc.
- Overall both WPI and MSP increase were low during 2003-07. During 2007-10, both % increases were high overall. Thus, the exogenous variable MSP seems to drive food prices. Eg. Procuring Inflation Fin. Express 5th Nov, 2012
- However, should MSP be treated as Exogenous? According to me, NO.
- Granted, exogenous/ political aspect in setting of MSP (UP had highest rise under Km. Mayawati). Still, my answer is no!
- MSP can be explained as part of IAPC process. As inflation increases, agricultural wages also increase. Then, to cover rising costs, farmers demand higher MSP. (Dr. Ashok Gulati chairman CACP has justified high MSP due to rising input costs and wage costs).



Has Minimum Support Price Affected Food Price Hikes?

- Note that prices for most commodities without MSP have risen faster.

Grain Price Rise 2008-2012

Commodities with MSP	% Rise	Commodities without MSP (chosen randomly from agmark)	% Rise
Jowar	49	Bengal Gram Dal	65
Maize ರಾಗಿ ಮುದ್ದೆ!!	43	Cumin Seeds	34
Ragi	88	Egg	111
Bajra	13	Gur	58
Rice	29	Kabuli Channa	101
Wheat	32	Other Pulses	50
Average	42	Average	70

- Source: Procurement Price Inflation Bogey, Anupam Manur, Fin. Express, Mar 2013



- Own Articles related to talk. Listed with some links on economicsperiscope.com:
- "Targeting Nominal GNP" with Spence R. Hilton, in Intermediate Targets and Indicators for Monetary Policy, Federal Reserve Bank of New York Staff Studies, 1990
- "Setting Small Saving and Provident Fund Rates" Econ & Pol Weekly, Oct 2001
- "Overheating and Under-eating" with Srikanth Kolhar, 12th August, 2007, Business Standard
- "Dissecting our Inflation targets" 29 July 2008, mint
- "Will CPI stand up Please?" 1st April 2009, mint
- "How Inflation Targeting Evolved" 27 Oct 2009, mint
- "Time to Downgrade WPI" Nov 2009, with Sunil Shankar, mint
- "Rising Food Prices and India's Monetary Policy" with Shrikant Kolhar (Jan, 2011) IIMB Working Paper #325, published in Indian Growth and Development Review.
- "Reorienting India's Financial System: In Conversation with RBI Governor, (June 2012) IIMB Management Review.
- "Its High Inflation: Not Just Food, with Anupam Manur, Financial Express, 2013
- "In Support Of Monetary Stability:" Financial Express, June 2012
- "Inflation Measurement for Policy: Analytical Issues and Application to India",
 - IIMB FPM doctoral thesis by Shrikant Kolhar" March 2103

