RBI’s Role - Economic Slowdown, Inflation, Growth

What is the issue?

- The RBI’s reputation as a regulator has been affected by the unusually large number of instances of fraud in the financial sector.
- Besides, the slowing of the economy suggests that the central bank’s stance on inflation may have impacted growth.
- In this backdrop, here is an analysis of the central banks’ role in terms of inflation-targeting, regulation and financial stability.

What is the role of the central banks in the West?

- Central banks command an important position in the market economies of the West today.
- Given this, it is debatable how in a democracy so much power could be ceded to an unelected body.
- In essence, it reflects two things:
    i. the political power of financial interests in the U.S. economy
    ii. the global intellectual influence of the American economic model
- The idea behind this model is the maximum creation of wealth by private individuals unimpeded by societal objectives.
- So, the goals of distribution of income and ensuring economic stability are not allowed to interrupt private individuals pursuing wealth enhancement.
- Public regulation, which sets limits to private activity, is rejected as an unnecessary interference in beneficial activity that maximises social gain.
- When applied to finance, this model requires only one action from the government, which is the control of inflation.

How does inflation work in the economy?

- It is unanticipated inflation that is the problem for producers, as it has the potential to derail their profit calculations.
- However, inflation, even when fully anticipated, can harm holders of financial assets yielding fixed incomes by eroding their wealth.
- Borrowers on the other hand are better off with inflation as the real value of their outstanding loans are now less.
- While the problem of inflation can in principle be tackled through inflation-indexation, the practice is not widespread.

- This leaves owners of financial wealth averse to inflation.

How did inflation control policy come about?

- Inflation targeting by the central bank involves use of the interest rate to keep inflation under control.
- As the volume of financial wealth in an economy increases, the power of its owners over government increases.
- With this, inflation control tends to take centre-stage in economic policy formulation.
- When inflation control is implemented via monetary policy, it results in higher interest rates.
- Managers of financial wealth lobby for such a policy on behalf of their clients.
- This lobbying is the origin of the policy of inflation targeting.

What is the effect of this?

- As the central bank targets inflation, it must let go of the employment objective.
- Inflation is retained as the target and the central bank is not accountable for unemployment.
- So, where growth, employment and inflation are jointly determined, inflation-targeting via the interest rate can lower inflation only by suppressing growth.
- As has been demonstrated for India, the other means of keeping inflation low would take the form of checking food-price inflation.

How does inflation and regulation interplay?

- If inflation-targeting is essentially a response to the financial sector's concerns, the view that the sector needs no particular regulation gets stronger.
- This view was ascendant in the U.S. and the U.K. before the 'North Atlantic Financial Crisis' of 2008.
- Following this crisis, however, there has been substantial re-thinking on inflation-targeting and the role of central banks.
- Essentially, it was recognised that satisfied by the low inflation, the U.S. central bank had ignored the possibility of financial instability.
- Consequently, instability had progressed due to complete violation of the norms of prudence by U.S. investment banks and housing societies, with lax regulation.

What is the case with India in this regard?

- **Inflation policy** - India's policymakers adopted inflation-targeting as the defining function of the RBI, even as the rest of the world was reassessing central banks' credibility.
- Though the shift was made by legislation in 2015, a hawkish inflation stance had emerged at the RBI some 2 years prior to that.
- **Interest rate** - Consequently, the real interest rate swung upward by over 5 percentage points.
- Inflation did come down, but it continued to decline even as the real interest did not do so commensurately.
- This, thus, rules out the possibility that inflation-targeting alone was responsible for the decreasing inflation.
- [Commodity prices, both of oil and domestic agricultural goods, have grown slower since.
- Oil prices have actually been declining in certain phases, and would surely have had a direct impact on inflation.]
- **Growth** - But, the slowing of the economy after 2016, which is still being experienced, suggests that inflation-targeting may have had an impact on growth.
- **Financial sector** - After the adoption of inflation-targeting in India, besides the slowing growth, there is a repetition of a pattern observed in the U.S.
- Evidently, India is witnessing stress in the financial sector.
- Following the rising non-performing assets (NPAs) of public sector banks, there is now the emergence of instability in the private segment of the financial sector.
- The most prominent case of the above was that of non-banking financial company, IL&FS.
- Some part of the burden this company faced may have been due to a slowing economy.
- However, there was evidence of financial irregularities.
- Such cases went undetected also in the cases of Punjab National Bank and the Punjab and Maharashtra Co-operative Bank (PMC Bank).

What is the way forward?

- The slowing of the economy suggests that the RBI's stance on inflation may have impacted growth.
- The emergence of financial instability following the institution of inflation-targeting is also clearly in line with happenings of the Anglo-American economic area.
- It is high time that the policy-makers in India make reflection at this front to make appropriate course corrections.

Source: The Hindu

