India’s masked policy confusion

The political and the monetary authorities need to work together to ward off the emerging risks to the economy

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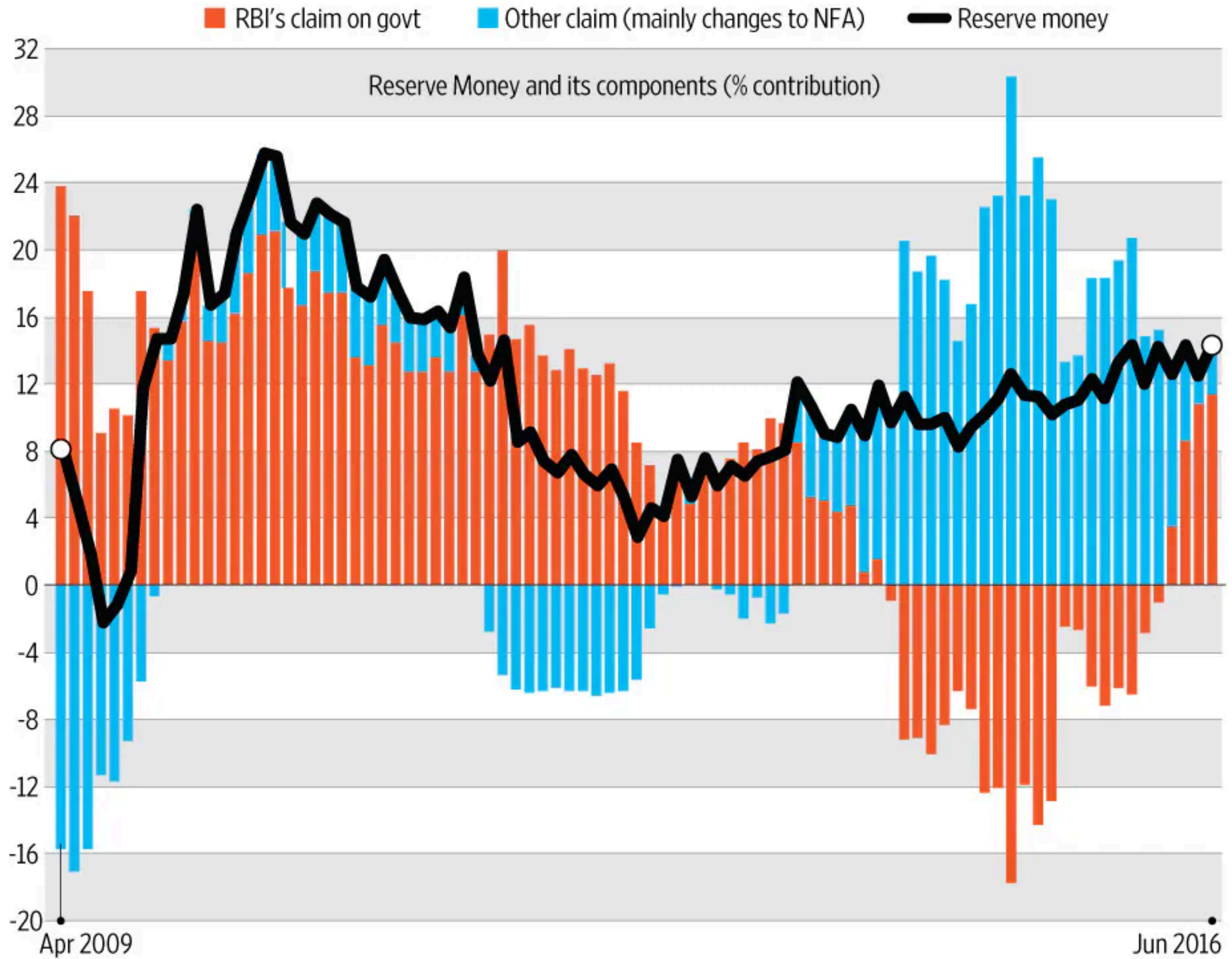
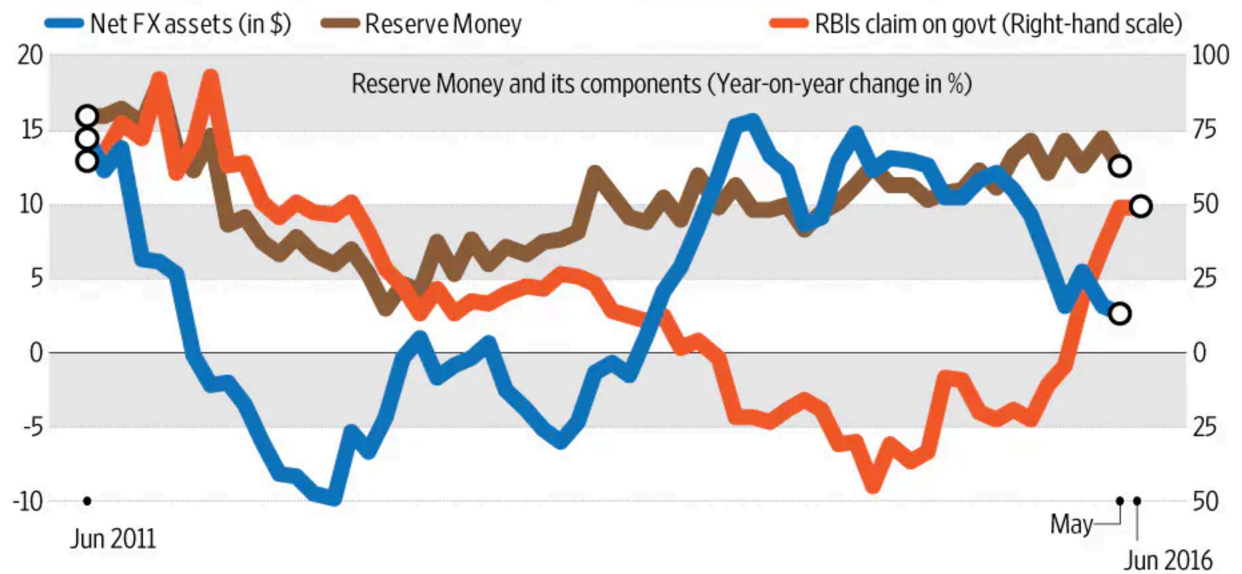
Storm clouds may be on the horizon for India’s economy while India’s policymakers continue to emphasize the relatively high real gross domestic product (GDP) growth of 7.6% in FY2016 along with macroeconomic stability. Recent monetary policy and fiscal policy announcements have not been encouraging, but in fact confusing. The Reserve Bank of India (RBI), as we shall see below, now has two monetary policy frameworks—inflation targeting and “monetary targeting”—that it wants to follow and these could be contradictory, creating confusion about monetary policy intent. RBI’s policy quandary has to an extent been driven by the poor quality of the fiscal adjustment that the government has undertaken. The Indian government’s fiscal consolidation efforts thus far have been an accounting mirage.

In its 5 April monetary policy statement, RBI introduced a monetary targeting framework in the guise of liquidity management—“(RBI will be) modulating net foreign assets (NFA) and net domestic assets (NDA) growth over the course of the year, broadly consistent with the demand for liquid assets to meet transaction needs of the economy” (to facilitate growth). NFA and NDA together are reserve money, a monetary aggregate—essentially RBI’s analytical balance sheet that it intends to manage at an unknown growth rate—indicating substantial non-transparency in monetary policy. Using this approach of reserve money targeting to achieve a certain GDP growth would imply knowledge of future GDP growth, the precise demand for money, the velocity of money and the money multiplier, each of which can be very difficult to forecast, creating significant uncertainty about monetary policy intent.

An inflation-targeting regime on the other hand, such as the one adopted in 2015 by RBI and implicitly followed by it since February 2014, explicitly targets an inflation rate (4%, +/- 2%). The policy instrument is the repo rate that RBI calibrates to ensure that inflation remains within its target zone over the short to medium term. Fixing the repo rate (price of money) and the supply of money (through reserve money targeting) together is possible only if the demand for money is known and stable. And as noted earlier, demand for money can be quite unstable and therefore it is almost impossible to determine both money supply and interest rate simultaneously as RBI is trying to now do.





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So why has RBI adopted reserve money targeting? The monetary transmission mechanism under the inflation-targeting regime has been unsuccessful as repo rate cuts have not translated into lower lending rates.

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Secondary market yields have largely been driven by domestic liquidity that has been determined mainly by foreign capital flows. At the same time, median household inflation expectations three months ahead have come down from 12.9% in March 2014 to 8.1% in June 2016 and one-year ahead inflation expectations remain higher at close to 10% in June 2016. This is not particularly impressive given the steep decline in commodity prices during this period. At 5.8% y-o-y in June 2016—a 21-month high—India's inflation rate remains the highest among all Asian countries that comprise the MSCI emerging markets index.

The ability of RBI to lower rates more than the 150 bps cuts it has undertaken since late 2014 has also been hampered by the persistence of fiscal dominance and a plethora of administered prices that do not allow an independent monetary policy to be followed in India. For example, after international oil prices declined in 2014, the consequent decline in domestic oil prices would have been greater than what was allowed since the federal government raised excise duties on diesel and petrol to cover its fiscal deficit. Consequently, the decline in consumer price index (CPI) inflation was less than what would have happened had additional taxes not been levied, and RBI could not therefore cut policy interest rates as much as it could have. Likewise, the increase in service tax in 2015-16 led to an increase in inflation, reducing RBI's ability to cut interest rates.

Furthermore, fiscal consolidation would imply corrective actions to ensure fiscal sustainability as the economy grows, not one-time efforts such as divestment and sale of spectrum licences. The Union Budget for FY2017 estimates the fiscal deficit to be lower at 3.5% of GDP compared with 3.9% of GDP in 2015-16. An incremental 0.4% of GDP in revenues in FY2017 is because of increased divestment proceeds and sale of spectrum for a total of 1% of GDP that are one-time measures, and should be considered more as financing items rather than revenue items. Excluding this incremental 'revenue' of 0.4% of GDP the fiscal deficit would be 3.9% of GDP in 2016-17—the same as in 2015-16. A likely overshoot in expenditures and shortfall in revenue would exacerbate the situation. This would imply the very opposite of fiscal consolidation, further constraining RBI from lowering rates in the future.

But here is the major crunch in monetary policy currently. In order for credit growth to happen, money supply needs to grow. The growth in money supply needs an increase in reserve money—an increase in NFA (or foreign exchange reserves) and/or an increase in NDA (lending to the government or commercial banks). When there was a pullout of portfolio funds in January/February 2016, the NFAs declined and without an adequate compensating increase in RBI's credit to the government (monetization or printing of money to fund the government) to increase NDA, the domestic liquidity situation became very tight with a slowdown in reserve money growth.

Relying only on repo rates for monetary transmission does not work in this situation; monetary targeting becomes important and RBI eventually increased its net credit to the government substantially in February/March 2016 after a slight dip in reserve money in January 2016 due to capital outflows. And with uncertainty on foreign flows, in the Indian context, monetary targeting becomes more critical.

Since April 2016, because RBI's foreign exchange reserves were not growing, and in order to not let reserve money fall, RBI printed money to give it to the government. Figure 1 shows that RBI credit to government contributed to a substantial chunk of reserve money creation in April and May 2016 when RBI's foreign exchange reserves remained static. As an example, if the authorities want credit growth to be in the region of 10%, then RBI would need broad money to grow around 10% as also reserve money (assuming a constant money multiplier).

A reserve money growth rate of 10% would imply foreign exchange reserves and NDA growing by 10% each or a combination to ensure a 10% growth in reserve money. With foreign exchange reserves at $350 billion, this would imply an accretion of $35 billion, or a 10% growth, else NDA (mainly lending to government) would rise by a greater proportion which is what has happened in recent months. But a higher money supply backed by monetization of government debt will be inflationary and undermine the external value of the rupee as well leading to a depreciation of the currency. The alternative is to have a lower reserve money growth in the light of foreign exchange reserves not continuing to rise, leading to lower credit and economic growth. This situation will only get aggravated as a major chunk of FCNR (B) deposits of non-resident Indians get redeemed beginning in the fourth quarter of 2016.

Clearly, with structural reforms remaining elusive and the economy facing uncertainty over capital inflows (given global financial fragility), the ability of RBI to lower rates significantly under the inflation targeting framework coupled with monetary targeting will likely be constrained in either case of higher or lower reserve money growth. While the former scenario would lead to inflationary pressures, the latter scenario of lower reserve money growth together with lower rates could lead to an outflow of foreign portfolio in debt markets impacting the value of the rupee and leading to inflationary pressures.

In case lower reserve money growth comes with higher interest rates, it would come with its own set of problems of impacting debt sustainability and exacerbating non-performing loans—at government, firm and household levels. As long as nominal GDP growth is higher than interest rates, public debt is sustainable.

Likewise for firms and households, as long as revenue (excluding cost of goods) growth is higher than their cost of borrowing—else their loans become non-performing. With nominal growth in India being close to 15% on average in FY2010-15 and cost of borrowing averaging around 8%, the 7% differential worked in favour of reducing government (federal and state) debt from 65% of GDP to 55% of GDP during the same period—essentially inflating away the debt as most GDP growth was driven by inflation. With nominal GDP growth at 8.6% in FY2016, and the cost of borrowing close to 8% the government debt is likely to increase, especially as the government recapitalizes public sector banks and pays for the UDAY (Ujwal Discom Assurance Yojana) power sector scheme.

The political and the monetary authorities need to work together to ward off the emerging risks to the economy. There needs to be a concerted effort to undertake structural reforms to make prices more market orientated and reduce administrative price controls and fixings, which includes foreign exchange rates. Serious attention needs to be paid to fiscal consolidation for sustainability rather than accounting jugglery to show lower deficits.

Finally, RBI will need to be transparent about the adoption of an eclectic monetary policy embracing both interest rate and monetary targeting for monetary transmission, rather than indulge in jawboning about the adoption of inflation targeting that will not work in the Indian economic institutional set-up, especially with fiscal dominance. Else the risk of inflation, low growth, unsustainable debt (government, corporate and banking) and a sharp decline in the rupee will become more real.

Rajan Govil and Janak Nabar are, respectively, co-founder and managing director at Marketnomix and a former IMF economist, and co-founder and director of research at Marketnomix and head of Centre for Technology, Innovation and Economic Research (CTIER).

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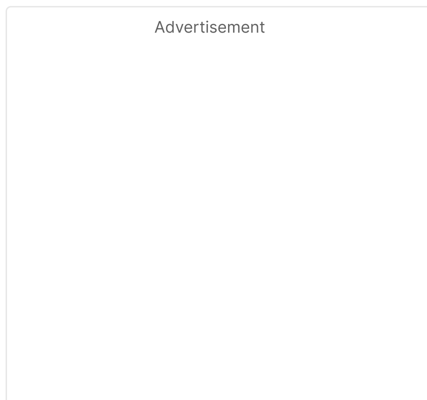

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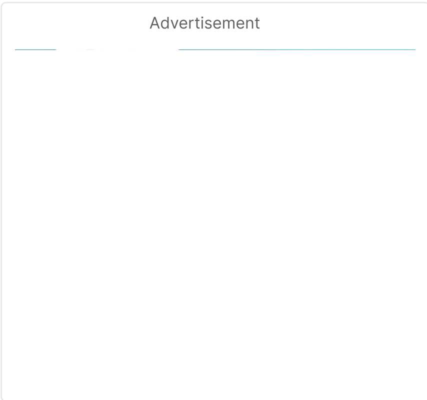

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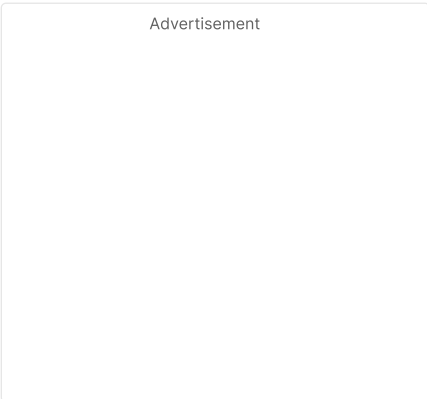

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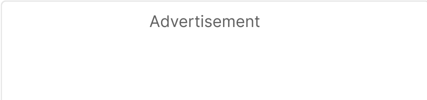

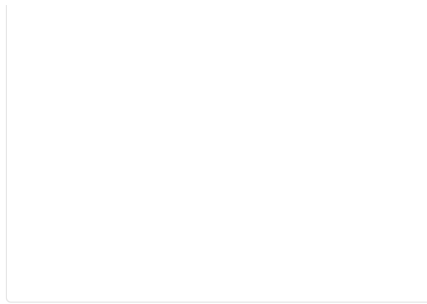

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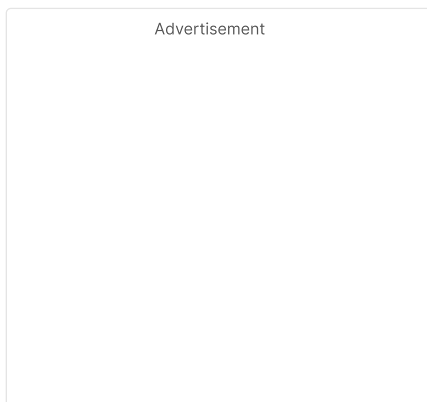

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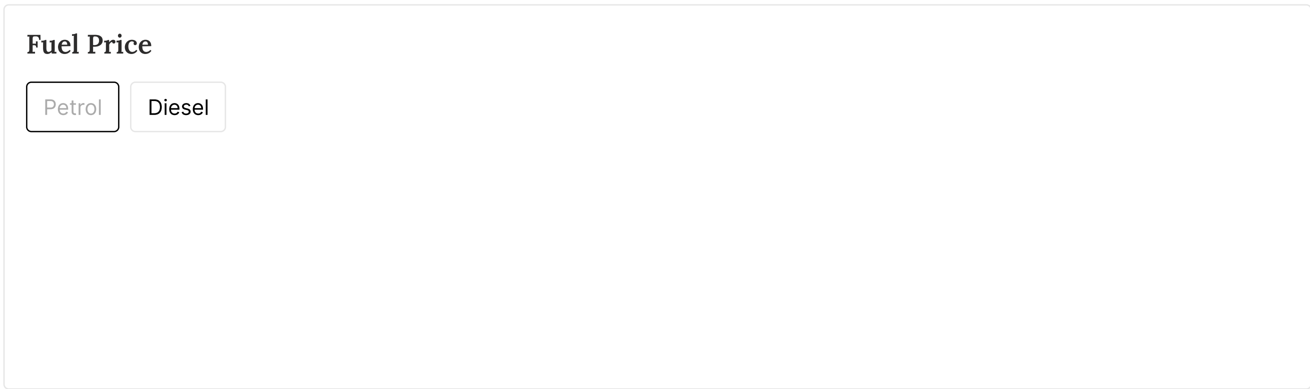

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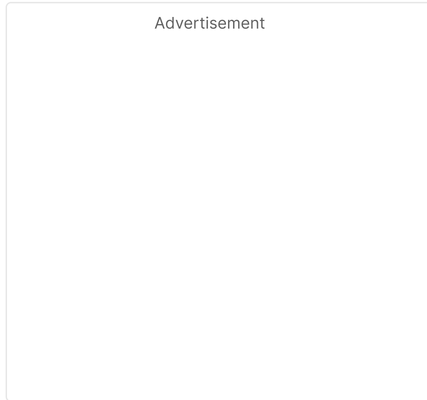

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