



Inflation Targeting and Growth: The Way Forward for India

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ABSTRACT: This paper looks at the genesis of inflation targeting and the impact of repo rate on Gross Domestic Product (GDP) and brings out our experience with a reconstituted Monetary Policy Committee (MPC) with its thrust to combine inflation targeting [1] with growth. It brings out how an extremely cautionary approach in fixing repo rate can have deleterious impact on growth and concomitantly on private sector investment and animal spirits. Tracing the importance of Taylor rule in taking a balanced approach towards actual and potential growth and inflation for repo rate determination, the paper brings out, how there is a broad congruence now between growth and inflation, once the MPC system fixes a reasonable repo rate. The paper also looks at macro economic variables like low PLF in power sector combined with surging thermal generation, twin balance sheet challenges that continue to confront the corporate and banking sector affecting capacity utilization and dissuading new investment. The paper makes a strong case for a much lower repo rate, in order to take the country come out of its morass of low investment trap and kindle the animal spirits of the investors.

Keywords: GDP, MPC, PLF, Taylor Rule, Repo Rate

I. INTRODUCTION

The high inflation of the 1970s in the USA, triggered largely by oil price hike in the 1970s and which became worse during Jimmy Carter's Presidency [2]. Though not his first choice, Paul Volcker was the man to rein in the runaway inflation that had been sapping the strength of the US economy. The inflation rate came down from 14% to less than 3% in just a matter of three years. Volkering led to double digit unemployment, dollar depreciation and two recessions, before the prices finally stabilized around 5%. The economic model still needed improvement. It was Bernanke who pointed out the much-needed reform: inflation targeting along with growth (Bernanke & Mishkin, 1997) [3]. A single-minded pursuit of inflation targeting and exclusion of other macroeconomic objectives would hostage the economy. Inflation targeting in India, unveiled in 2014, is counted as a key legacy of Governor Raghuram Rajan [4], who chose CPI over WPI for the policy setting and is closely linked to "Tinbergen Rule" which states that a policy instrument can only be effective if it has a single objective.

This paper tries to analyse:

- a) Impact of inflation targeting on growth in India.
- b) Role of Monetary Policy Committee on repo rate and growth.
- c) The fiscal constraints.
- d) Way forward for balancing inflation expectation with economic growth.

II. INFLATION TARGETING AND ITS IMPLICATIONS ON GROWTH

Inflation Targeting has become a significant monetary policy initiative in both advanced and developing economies. Although many countries that have customized inflation targeting, certain empirical evidences can be adduced. The most prominent one is an announcement by the government or the central bank regarding numerically specified inflation rate. Publicly committing to a target helps the central banks guide future expectations and thereby maintain stability in the economy.

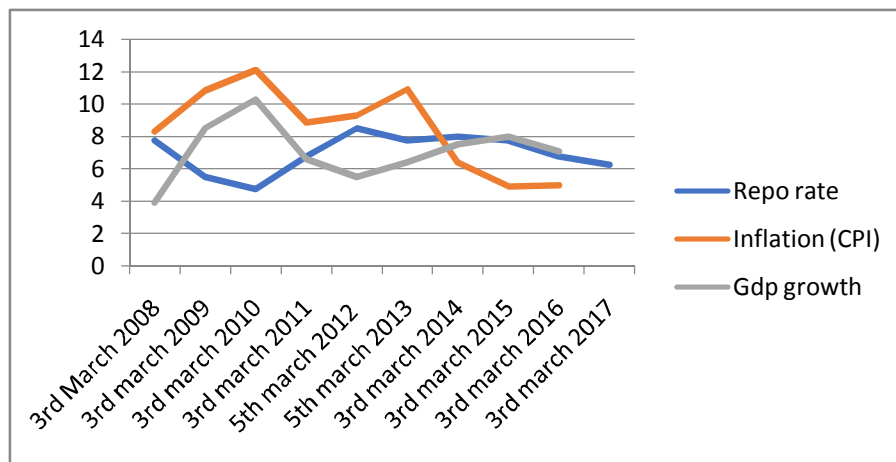
Volker adopted the "Tinbergen Rule" [5] that for each policy objective, at least one policy instrument is required and according to him "if inflation is the target, the policy instrument to be used is the short term interest rate (repo)".

To maintain the price stability the central bank uses the interest rates. Changes in interest rates are extremely important as it has direct influence on the fund demand and supply thus affecting inflation. Raghuram Rajan, former RBI Governor, also used the “Tinbergen Rule” for targeting inflation and used the repo rate as the policy instrument. The following table will bring out the details regarding repo rate, inflation (CPI) and GDP growth of India.

Table 1: Repo Rate, Inflation (CPI) & GDP growth.

Month year	Repo rate	Inflation (CPI)	GDP growth
3 rd March 2008	7.75	8.32	3.9
3 rd March 2009	5.50	10.83	8.5
3 rd March 2010	4.75	12.11	10.3
3 rd March 2011	6.75	8.87	6.6
5 th March 2012	8.50	9.30	5.5
5 th March 2013	7.75	10.92	6.4
3 rd March 2014	8.00	6.37	7.5
3 rd March 2015	7.75	4.9	8.0
3 rd March 2016	6.75	4.97	7.1
3 rd March 2017	6.25	--	--

Source: Reserve Bank of India & World Bank [6], [7]



Source: Reserve Bank of India & World Bank

Fig. 1. Repo Rate, Inflation (CPI) & GDP growth.

It would be fit to note that repo rate increase indeed anchored inflation but also affected the economic growth of the country negatively. From the line graph, we can notice that the repo rate has been on a decline from the last three years, yet the rate of inflation is also decreasing but the flip side if GDP growth has also been on a decline.

A. Taylor Rule

It is, however, important to mark that the economist widely followed while fixing the repo is Taylor. The Taylor Rule [8] provides how to devise a realistic repo rate after taking into account the difference between targeted and actual inflation and potential and actual output growth. It gives a higher prescribed rate if inflation is higher than targeted inflation and output growth is above potential output growth.

The Taylor rule is as under:

$$i = r^* + 0.5 (pi - pi^*) + 0.5 (y - y^*)$$

Where:

i = nominal repo rate

r* = real repo rate

pi = rate of inflation

p* = target inflation rate

y = logarithm of real output
y* = logarithm of potential output

III. ROLE OF MONETARY POLICY COMMITTEE ON REPO RATE AND GROWTH

As against the earlier RBI policy of credit control and keeping inflation under check the RBI Act has been amended to include inflation control while sustaining growth, this is in line with the US Federal Reserve Policy [9]. The Policy institution all over the world keeps the Taylor Rule in the backdrop while finalizing the Repo Rate. As expected, the present policy of RBI is in line with the Taylor Rule.

The fixing of repo rates has always been at the discretion of the RBI Governor. The Parliament has recently brought in legislation to have a Monetary Policy Committee [10] to determine repo rate. The panel would have three bankers: RBI Governor, Deputy Governor and a PSB representative) and three representatives to be nominated by the government (the government, economists, and financial analysts), thus providing a balanced architecture for fixing more “realistic” repo rates.

It would be useful to see how the new MPC is responding to inflationary tendencies. The following table provides the details on Repo Rate, CPI Inflation and GDP Growth since the formation of the committee [11], [12].

Table 2: Repo Rate, CPI Inflation & GDP Growth since inception of the Monetary Policy Committee.

Month Year	Repo rate	Inflation CPI (Y-o-Y)	GDP Growth rate (Y-o-Y)
3 rd Oct 2016	6.25 (from 6.75)	4.20	7.5
Dec 2016	6.25	3.41	7.3
April 2017	6.25	2.99	6.1
June 2017	6.25	1.54	5.9
August 2017	6.00	3.36	5.7

Source: RBI, World Bank & Trading Economics (MOSPI) [13]

It would be fit to mark that rate of inflation has decreased substantially but it is on reflected on the Repo rate. The MPC has not cut down the repo rate at the same level, which has resulted in extremely slow GDP growth. As repo rates continue to be high than the ideal repo rate, investments and credit have not rolled in heavily, which would obviously affect the GDP. The year on year basis CPI Inflation data is also suggestive of a feared situation where the inflation rate is going below 2%. The decision of the MPC should be combine the objective of achieving a medium term target for consumer price index (CPI) inflation while bolstering growth. From our observation of the above table, it would rather be fit to comment that growth has been partially ignored.

In the last Monetary Policy Committee in the perception between RBI Officials and Professor Ravindra H. Dholakia, Director Indian Institute of Management Ahmedabad, who is a member of the MPC. Professor Dholakia had advocated a 50 basis point (one basis point is one-hundredth of a percentage point) cut in the repo rate, which would have brought it down to 5.75% since CPI had come down below the floor level inflation which is 4%. This would essentially show that the RBI is conservative in its assessment.

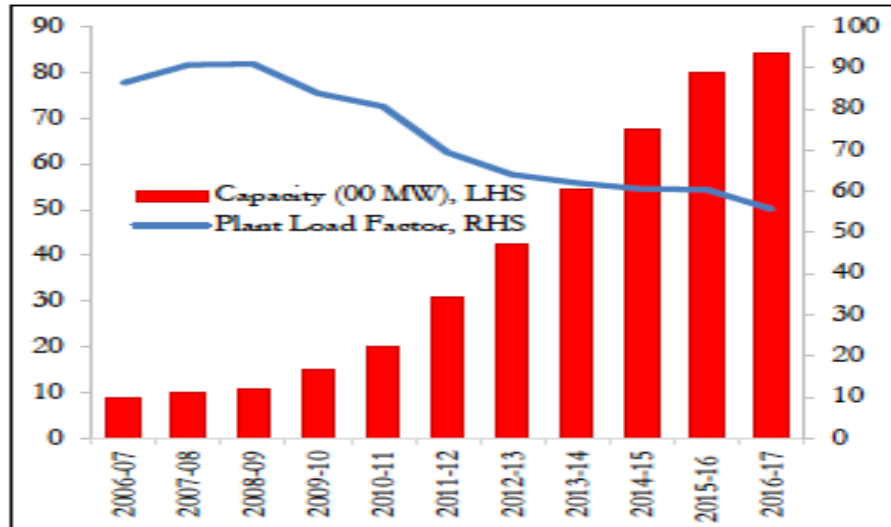
IV. THE FISCAL CONSTRAINTS

It was Keynes who had famously written that private investment is guided by “animal spirits” that is the investors are not averse to risk taking. In India, private sector investment over the last four years has been decreasing as represented by Economic Survey Volume 2 and the RBI Annual Report 2016-2017.

A. Infrastructure

The reasons are high level of indebtedness of many private sector firms, who have invested in infrastructure, low capacity utilisation in the power sector, high cost of capital, which is 12% in India compared to developed nations having it under 2%, and poor efficiency of labour and inadequate structural reform in the labour market on a cross country basis.

The following figures will explain the above in respect of private sector thermal generation, where the spurt in supply is accompanied by decreasing plant load factor.

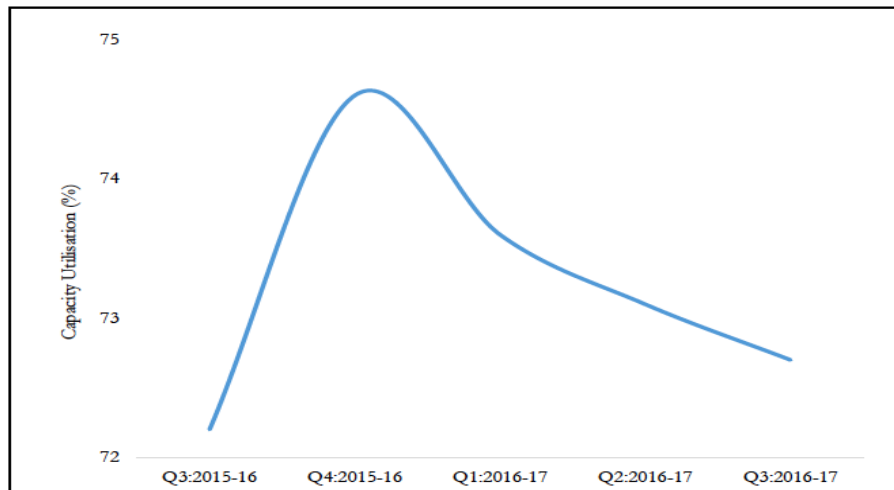


Source: Economic Survey (2016-2017 Vol-II) [14]

Fig. 2. Private Sector Thermal Generation Capacity & Plant Load Factor (RHS).

B. Capacity Utilisation in Industries

The position on capacity utilisation in industry is brought out in the figure below.



Source: Economic Survey (2016-2017 Vol. II)

Fig. 3. Capacity Utilisation in Industry.

C. Non Performing Assets in Banks

Stressed assets of the public sector banks is a major concern in the Indian economy, affecting further private sector investment. The trends of nonperforming assets during the last three years are under:

Table: Trend of Non Performing Assets in Banks

Year	Gross Advances (rupees in lakh crore)	NPA %
2014	6.61	4.4
2015	7.27	6
2016	7.49	9.3

Source: Economic Survey (2016-2017, Vol. II)

The major reasons are attributable to lack of due diligence while giving loan, change in business environment, delay in land acquisition in the infrastructure sector, where many corporate have borrowed heavily from the public sector banks. The Bankruptcy Code 2016 has been introduced to ensure that finalisation process is completed in 180 days and the deliberations are conducted by an insolvency professionals.

Further, the government has identified 12 banks with heavy indebtedness where a decision can be taken by the RBI whether to go for a haircut, recapitalize the banks or privatise. The long term solution would be to infuse private sector discipline in the PSBs, strengthen the lending procedure, risk management framework and privatize those PSBs which have become unviable.

D. Towards a Reasonable Repo Rate

Interestingly a careful reading of the RBI Annual Report (2016-2017) and Ministry of Finance Survey [15] there is a congruence that inflation during 2017-2018 would be 3.5%-4.5%(RBI) and less than 4% by the Economic Survey. According to the Economic Survey report (2016-2017) India is less susceptible to the vicissitudes of geo-economies (OPEC) and the production of cereals-major item of consumption in India- has become more resilient to poor monsoons. As these two factors have become less volatile, the inflationary process can be taken into account. Therefore there is a strong case for bringing down repo rate significantly less than the present level. An attempt has been made to work out a possible repo rate for India based on the Taylor Rule viz. $i = 4 + 0.5(\pi - p^*) + 0.5(y^* - y)$. Based on the assessment of potential output and real repo rate of 3% inflation target of 4% a realistic nominal repo rate for India would be:

$$\begin{aligned} i &= 3 + 0.5(5-4) + 0.5(8-6.5) \\ &= 3 + 0.5 + 0.5(1.5) \\ &= 5.25\% \end{aligned}$$

This would be substantially lower than the present repo rate of 6%.

V. CONCLUDING THOUGHTS

The Monetary Policy Committee (MPC), by amending the Reserve Bank of India Act, 1934, has been formed with the objective of ensuring steady consumer price index (CPI) inflation of 4 per cent, while supporting growth. But it has been largely conservative with its decisions. By using the Taylor Rule, the possible repo rate for India could be as less as 5.25%, which is 0.75% less than the current repo rate of 6%. The great disparity between the rates suggests that the MPC, especially the RBI officials, are still overly concerned about inflation without looking at the persistent declining trends in CPT. Due to the various reasons discussed above, the private sector investment over the last four years have stagnated, due to low capacity utilisation, high cost of credit, low ROI and stressed assets. Mrs. Chanda Kochhar, Chairman, ICICI Bank had rightly said, "Investment in infrastructure is a long term requirement for growth and a long term factor that will make growth sustainable". The fact that investment is on a declining trend and so is infrastructural development, sustaining growth is affected seriously due to the high repo rates. While it must be admitted that the inflation targeting has anchored in the rate of inflation, it has not been able to "sustain growth". The dissonance between the RBI and the price trends regarding low level of food prices and a normal monsoon needs to be done away with. It was John Maynard Keynes [16] who had written "The difficulty lies not in introducing new ideas but in replacing old ones". The time has come in India to abdicate our obsession with inflation targeting and establish a synergy between steady low inflation with fiscal and monetary initiatives for investments as the private sector and generate significant employment opportunity in the country. It is only with an adroit mix of stable inflation by using repo rate mechanism pragmatically and fiscal initiatives that promote high tax collection and public invest, India will achieve high growth with price stability in the long term.

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