

Suman Bery: On dealing with external shocks

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The right policy response to global price increases is not straightforward.

The draft report of the High-Level Committee on Financial Sector Reforms, chaired by Professor Raghuram Rajan (of the Chicago Graduate School of Business), was posted on the Planning Commission's website on yesterday (April 7).^{*} The draft report is wide-ranging in its scope, and it attempts to provide a coherent, integrated view of financial sector reforms that would equip India's financial sector to support growth, widen financial access and maintain stability over the next decades.

The report is being released for public discussion at a critical juncture in both the domestic and global economy. An important global debate is underway on how to deal with the return of inflation as a global phenomenon. Much of the global consensus on monetary matters is today being subjected to intense scrutiny.

One of the early chapters of the draft, Chapter 2, deals with the macro-economic framework and financial sector development. Given my own expertise and interest, I was most closely associated as a member of the committee with this aspect of its work. It is useful to see what guidance the committee's proposals might provide Indian policymakers in managing the current global inflationary surge.

I do so with two caveats. First, I recognise that the committee's proposals in this particular area form part of a larger whole, and that there are risks in focusing on only one part of the design. Second, there is absolutely no expectation in the report that its proposals would be used to deal with our current problems.

The chapter describes the current monetary policy regime as one where the RBI's monetary policy actions are directed at achieving multiple objectives (external competitiveness; real credit growth to support growth of output; anchored inflation expectations) whose relative priority shifts over time. Of these, the tension between managing inflation and managing the nominal exchange rate (presumed to be a powerful influence on the real effective exchange rate) has been particularly apparent in the recent period of strong inflows of external capital.

The committee's recommendation is that "monetary policy should be reoriented towards a single objective [and] this objective should be price stability (defined as low and stable inflation)". Around this core proposal, the chapter proposes a range of operational and institutional innovations to allow the economy to derive the maximum benefit from this greater clarity and accountability.

Let us assume, then, that this was indeed the agreed framework for monetary policy today. What would that imply for the monetary policy actions of the Reserve Bank (or indeed for the combination of monetary and fiscal policy) in a situation where there are large relative price changes taking place in the international economy.

There is controversy on this issue even among commentators in the industrial economies. There are two distinct but related analytic issues to be addressed. The first is what the appropriate monetary policy response should be to a domestic supply-side price shock (such as a drought). The second is what the monetary policy response should be to an external price "surprise". Negative examples at present include the recent sharp increases in international prices of cereals, minerals and petroleum; positive examples include the large increase in the supply of manufactured products over the last four or five years.

In the specific case of the UK opposing points of view on this issue have recently been expressed in the pages of the Financial Times. As is well known, the UK has for a long time has been formally committed to inflation targeting, with an official target currently of 2%. Yet its distinguished columnist Samuel Brittan has recently observed ("When inflation comes from abroad," March 27, 2008) that "it is one thing for central banks to hold price increases generated in their own countries or regions to 2%. It is quite another to compress them to offset potentially large price increases emanating outside their area". His proposal, accordingly is "that the emphasis in counter-inflationary policy should shift towards domestically generated inflation."

The opposing point of view has been advanced by George Kopits, formerly of the IMF and now a member of the Monetary Council of the National Bank of Hungary. In a letter to the same paper (April 3), he argues that externally driven inflation can only be ignored when the central bank has excellent credentials as

an inflation-fighter, and there is little risk that external price increases will not affect domestic inflation expectations. The spectre that presumably haunts Mr Kopits and many other monetary economists is that of the 1970s. The policy response to the oil shocks of that time, together with the abandonment of the dollar peg to gold, is widely credited with the decade of stagflation that followed, which had to be brutally terminated by the Volcker recession at the end of that decade.

A comparable debate is currently underway in the columns of this paper. In his column of April 5, Surjit Bhalla advances an argument very similar to that of Brittan. He argues that "imported inflation cannot be handled by domestic monetary policies", and seems to imply also that it shouldn't. This seems to me to ignore the fact that, first, imported inflation represents a loss of income to the economy, and there are more and less inflationary ways in which this terms of trade loss is distributed through the economy. Tightening monetary policy is at least one instrument available to accommodate this real income loss. By the same token, common global shocks (both now and in the past), such as oil and commodity price spikes, have had very different impacts in different economies (the case of Japan comes to mind), clearly indicating that national issues of structure, institutions and expectations also matter.

To conclude where we began, then, an inflation-focused central bank would make an assessment of the real income losses that the economy has suffered through deteriorating terms of trade. It would also make an assessment of the likely role of the fiscal authorities in accommodating this income loss through increased public savings. It would make an assessment of the direct and indirect consequences for prices of increasing interest rates, recognising that at heart what is needed is a real depreciation. Only then would it act.

**http://www.planningcommission.gov.in/reports/genrep/report_fr.htm*

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