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MPC's inflation data dilemma

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Wrong target Wrong result Stanth/shutterstock.com

Should it bank on forecasts that could go wrong? Or should it consider current price levels also as an input in policymaking?

Monetary authorities in India currently face a challenge on three fronts. First, they have to decide in what direction the policy rate must move and by how much. Second, they have a concern regarding the transmission mechanism. Will the changes signalled by them be picked up and transmitted by banks? Third, in deciding the rate changes, how much weight should they attach to current inflation and future forecasts?

The first two issues have been debated at length in recent weeks. Except for a small minority, almost everyone is of the view that a downward adjustment of the policy rate is needed. There is, however, some controversy over the extent of reduction. This issue is in fact closely related to the third issue.

A word on the second issue. For the banking system to pick up the signals sent out by the Reserve Bank of India, two things are needed. First, the monetary authority should take whatever action needed to make the policy change stick. They cannot simply 'order' interest rates.

Second, for the banks to act on the signal, conditions within the banks must be conducive to effect such changes. In fact the present situation is a good example. With the heavy burden of non-performing assets and shrinking profitability, banks find it difficult to effect any reduction in lending rate.

That's why the discussion on whether the reduction in policy rate should be 25 basis points or 50 basis points is purely academic. The purpose of this article is to deal with the third issue in some detail.

Policy value

It is often said that monetary policy should be forward-looking since it acts with a lag. Broadly speaking, this is true. But if the lag is long and uncertain policy loses its value. An analysis of the minutes of Monetary Policy Committee (MPC) meetings clearly indicates that the divergences among members regarding rate change can be traced to their differing perceptions over the future course of inflation.

For example, the minutes of the MPC meeting held on August 1-2, 2017, revealed that while Ravindra H Dholakia suggested 50 bps reduction in the policy rate (repo rate under LAF), Michael Debabrata Patra voted for status quo. Dholakia was perhaps guided by his perception about the trend in inflation and economic growth. He observed that "Our research now provides an empirical support from the data over the last five years to the hypothesis that the headline CPI inflation in India shows a tendency to drift towards the core inflation (excluding food and fuel) in the long run and not vice versa... Our exercise suggests that the core inflation is on a declining path with minor spikes ultimately reaching around 3.1-3.5 per cent by March-April 2018. I expect the headline inflation also to show a converging trend over long term."

On the contrary Patra observed that "Households' inflation expectations three months ahead and a year ahead have gone up! More than 70 per cent of respondents expect prices to increase,.. Professional forecasters, who are regarded as forward-looking, also see inflation rising over the rest of the year. In this context, I have also consistently held that in reading forecasts, it is the direction rather than the level that matters

There are many moving parts in inflation's near term path that need to settle... All these factors could come together in CPI readings from August. If that turns out to be the case, why not stay on hold now, watch the shape and slope of the upturn and if it is benign, deliver credible monetary policy that supports the economy?"

The views of other MPC members on inflation fell somewhere between these two ends.

Influencing perceptions

Typically, policymakers' perceptions regarding future behaviour of inflation are based on two kinds of inputs. One is the RBI's survey of households' inflation expectations; the second source of inputs is through econometric models which central banks including the RBI normally construct.

Forecasting inflation is a hazardous task. Even sophisticated econometric models cannot take into account numerous variables that have a bearing on inflation. Always, judgment is used to modify the results that flow out of the models.

The models used by the RBI have been off the mark several times. For example the fourth bi-monthly MPS of the 2016-17 forecast of inflation by March 2017 was 5 per cent. But the actual turned out to be 3.8 per cent.

Similar examples can be cited. The argument is not to find fault with the RBI. There are inherent problems in forecasting inflation. It must also be noted that inflation expectations surveys are not good guides of future behaviour of inflation.

They are useful only to the extent that they provide an indication of the perceptions of people. In fact, references to expected individual occurrences such as the impact of HRA according to the Seventh Pay Commission are not that relevant. What is crucial is the behaviour of aggregate monetary demand in relation to supply or output.

The influence of inflation

In short, policymakers deciding on changes in policy rate cannot escape making a forecast of inflation. However, can monetary authorities ignore the current behaviour of inflation?

It is true that all econometric models include past inflation as a key component for constructing future inflation expectations. Any miscalculation or error in assessing future inflation can be quite onerous. For example, even after the recent rise in CPI inflation to 3.4 per cent in August 2017, the current real interest in the economy is high and has its own effect on investment.

The monetary authorities must weigh in the loss of current output because of any miscalculation on inflation projection. If the probable loss in current output is built into their calculations, it becomes part of the policy decision. But there is always the danger of overlooking it. Frequent changes in policy rates in either direction should not be taken as a weakness. It is in the nature of things as predictions are subject to a multitude of factors. The moral of the story is that the policymakers must treat current level of inflation as an important input and assign due weightage in taking a decision on rate changes. Otherwise they may be imposing an unintended burden on the economy.

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