Business Standard

A Panglossian countenance on inflation

Central bank communication had moved decisively from "secrecy" to "transparency and accountability" over the decades.

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In the third week of August 2019, Reserve Bank of India (RBI) watchers were in for some real “literary” treat. RBI Governor Shaktikanta Das, in a confident speech on the Indian economy, said: “I am not saying we maintain a Panglossian countenance and smile away every difficulty.” Many readers had to find out through a Google search that “Panglossian”, derived from a character in a Voltaire novel, is an attitude characterised by extreme optimism.

The minutes of the August 5-7, 2019, meeting of the Monetary Policy Committee (MPC), published on August 21, inter alia, contained a statement from Chetan Ghate, then member of the MPC: “Estimates of economic growth in India have unfortunately been subject to a fair degree of floccinaucinihilipilification.” This linguistic beauty is “a rare word originated in the mid-18th century to describe the action of estimating something as worthless”.

Such remarks, though interesting adjectives or anecdotes in jest, open up usual concerns on the reliability of growth and inflation data. Such puzzles get greater focus during times of economic stress. How reliable are our estimates? What about projections? Without any worthwhile estimate on economic growth, how is it possible to have meaningful assessments of inflation, particularly expected inflation?

It goes to the credit of Mr Das that he has never dropped that balanced optimistic demeanour. Moreover, the media discovered the RBI-finance ministry “rift”, which at times used to overshadow even major policy announcements and has been completely banished into thin air, enabling the stakeholders to focus fully on policies.

How does a central bank maintain such a high level of confidence and consistently at that — particularly when the events and numbers indicate a perfect storm ahead? Part of the answer lies in central bank communication. The other part lies in seeing a silver lining amidst the clouds better than others. Or perhaps a genuine confidence in the power of the policy kit available and the skills to use them appropriately as events unfold.

Communication by central banks has always been an art. Those artistic skills need to be elevated during crises to smoothen the shocks and sustain confidence in the monetary and credit system. Central bank communication had moved decisively from “secrecy” to “transparency and accountability” over the decades. With the introduction of “forward guidance” as part of policy communication at times, it even punctured future surprises. However, increasing use of unconventional monetary tools, post-Lehman global financial crisis, and the “whatever it takes” — like stand of some central banks have blunted that hard-earned transparency, reverting communications to delicate and complex artistic exercises.

In the 2022 February policy, the RBI surprised the pundits by keeping the status quo on the policy rate and the inflation forecast of 4.5 per cent for FY2022-23. The RBI views inflation marginally above 6 per cent, the upper band of the target rate, during January and February 2022 as a temporary aberration.

We do not disbelieve the inflation projections of the RBI. However, like many analysts, we believe that the ongoing politico-economic developments shake us from that comfort zone. Surging inflation everywhere, the energy and other commodity price spiral, Ukraine war-induced spikes and uncertainties, sanctions induced supply-demand imbalances, imported inflation in many countries potentially leading to stagflation — all these coming in addition to the crippling disruptions of the pandemic are harsh realities. Inflationary expectations are propelled by these factors, with many of them outside the control of central banks.

India has adopted a flexible inflation-targeting framework with a Monetary Policy Framework Agreement (MPFA) signed between the Central government and the RBI on February 20, 2015. Later, this was hard-coded in law by amendments to the Reserve Bank of India Act, 1934 (with effect from June 27, 2016). Importantly, this amendment also removed the "temporary" status of the RBI Act, 1934, by altering its Preamble, after 82 years! (Disclosure: One of us, Nair, was associated with these exercises.)

The Preamble to the amendment Act, inter alia, reads: "AND WHEREAS the primary objective of the monetary policy is to maintain price stability (emphasis added) while keeping in mind the objective of growth …"

The MPFA stipulated bringing down the inflation rates below 6 per cent by January 2016 and subsequently to maintain the "target" within a band 4 per cent ± 2 per cent. If actual inflation falls outside the target rate for three consecutive quarters, it is considered "failure".

With the introduction of the flexible inflation-targeting framework, India has been saved from the uncertain and often double-digit inflation plaguing her for several decades. For six years, inflation has been well within the target rate — both a measure of success and satisfaction for the RBI and the nation.

Can we take that hard-won credibility for granted in the changed output-price calculus? Should the RBI give primacy to maintaining price stability, particularly when the primary objective of monetary policy is that, and also keeping in mind growth? After all, inflation hurts real economic growth and real returns on savings and investments, and affects the poor disproportionately. While the posture and communication of the central bank have to be sanguine in "signalling-over-sound", it should factor in changing ground realities. Untamed inflation, even transitory, and inflationary expectations self-feed and produce inflation tornadoes, dimming the credibility of the central bank — a harsh reality being faced even by the powerful US Fed, with some experts calling it consistently behind the curve.

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First Published: Mar 29 2022 | 10:45 PM IST

Page URL :https://www.business-standard.com/article/opinion/a-panglossian-countenance-on-inflation-122032901578_1.html