

## **RBI's Role - Economic Slowdown, Inflation, Growth**

### **What is the issue?**

- The RBI's reputation as a regulator has been affected by the unusually large number of instances of fraud in the financial sector.
- Besides, the slowing of the economy suggests that the central bank's stance on inflation may have impacted growth.
- In this backdrop, here is an analysis of the central banks' role in terms of inflation-targeting, regulation and financial stability.

### **What is the role of the central banks in the West?**

- Central banks command an important position in the market economies of the West today.
- Given this, it is debatable how in a democracy so much power could be ceded to an unelected body.
- In essence, it reflects two things:
  - i. the political power of financial interests in the U.S. economy
  - ii. the global intellectual influence of the American economic model
- The idea behind this model is the maximum creation of wealth by private individuals unimpeded by societal objectives.
- So, the goals of distribution of income and ensuring economic stability are not allowed to interrupt private individuals pursuing wealth enhancement.
- Public regulation, which sets limits to private activity, is rejected as an unnecessary interference in beneficial activity that maximises social gain.
- When applied to finance, this model requires only one action from the government, which is the control of inflation.

### **How does inflation work in the economy?**

- It is unanticipated inflation that is the problem for producers, as it has the potential to derail their profit calculations.
- However, inflation, even when fully anticipated, can harm holders of financial assets yielding fixed incomes by eroding their wealth.
- Borrowers on the other hand are better off with inflation as the real value of their outstanding loans are now less.
- While the problem of inflation can in principle be tackled through inflation-indexation, the practice is not widespread.

- This leaves owners of financial wealth averse to inflation.

### **How did inflation control policy come about?**

- Inflation targeting by the central bank involves use of the interest rate to keep inflation under control.
- As the volume of financial wealth in an economy increases, the power of its owners over government increases.
- With this, inflation control tends to take centre-stage in economic policy formulation.
- When inflation control is implemented via monetary policy, it results in higher interest rates.
- Managers of financial wealth lobby for such a policy on behalf of their clients.
- This lobbying is the origin of the policy of inflation targeting.

### **What is the effect of this?**

- As the central bank targets inflation, it must let go of the employment objective.
- Inflation is retained as the target and the central bank is not accountable for unemployment.
- So, where growth, employment and inflation are jointly determined, inflation-targeting via the interest rate can lower inflation only by suppressing growth.
- As has been demonstrated for India, the other means of keeping inflation low would take the form of checking food-price inflation.

### **How does inflation and regulation interplay?**

- If inflation-targeting is essentially a response to the financial sector's concerns, the view that the sector needs no particular regulation gets stronger.
- This view was ascendant in the U.S. and the U.K. before the 'North Atlantic Financial Crisis' of 2008.
- Following this crisis, however, there has been substantial re-thinking on inflation-targeting and the role of central banks.
- Essentially, it was recognised that satisfied by the low inflation, the U.S. central bank had ignored the possibility of financial instability.
- Consequently, instability had progressed due to complete violation of the norms of prudence by U.S. investment banks and housing societies, with lax regulation.

### **What is the case with India in this regard?**

- **Inflation policy** - India's policymakers adopted inflation-targeting as the defining function of the RBI, even as the rest of the world was reassessing central banks' credibility.
- Though the shift was made by legislation in 2015, a hawkish inflation stance had emerged at the RBI some 2 years prior to that.
- **Interest rate** - Consequently, the real interest rate swung upward by over 5 percentage points.
- Inflation did come down, but it continued to decline even as the real interest did not do so commensurately.
- This, thus, rules out the possibility that inflation-targeting alone was responsible for the decreasing inflation.
- [Commodity prices, both of oil and domestic agricultural goods, have grown slower since.
- Oil prices have actually been declining in certain phases, and would surely have had a direct impact on inflation.]
- **Growth** - But, the slowing of the economy after 2016, which is still being experienced, suggests that inflation-targeting may have had an impact on growth.
- **Financial sector** - After the adoption of inflation-targeting in India, besides the slowing growth, there is a repetition of a pattern observed in the U.S.
- Evidently, India is witnessing stress in the financial sector.
- Following the rising non-performing assets (NPAs) of public sector banks, there is now the emergence of instability in the private segment of the financial sector.
- The most prominent case of the above was that of non-banking financial company, [IL&FS](#).
- Some part of the burden this company faced may have been due to a slowing economy.
- However, there was evidence of financial irregularities.
- Such cases went undetected also in the cases of [Punjab National Bank](#) and the [Punjab and Maharashtra Co-operative Bank](#) (PMC Bank).

### **What is the way forward?**

- The slowing of the economy suggests that the RBI's stance on inflation may have impacted growth.
- The emergence of financial instability following the institution of inflation-targeting is also clearly in line with happenings of the Anglo-American economic area.
- It is high time that the policy-makers in India make reflection at this front to make appropriate course corrections.

**Source: The Hindu**

