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Central bank independence

In his recently released book, *‘Who moved my interest rate*’, Dr. D.Subbarao, the former Governor, is critical of the then Finance Minister, Shri P. Chidambaram, for his private and public criticism of the interest rate policy adopted by the Reserve Bank, which, the Finance Minister felt, was not very helpful to economic growth. (Subbarao’s successor also seems to have had policy differences on interest rates with Delhi.) The Governor’s belief was that ‘*The Reserve Bank was targeting price stability precisely because it is a necessary condition for sustained growth*.’ The arguments that, in the long run, there is no conflict between price stability and growth; that inflation hurts the poor most; etc. have become standard clichés. I myself had an occasion to comment on the issue in a meeting of financial journalists which Dr. Subbarao had called ahead of a monetary policy review. The point I made was that while inflation hurts the poor most, the lack of a regular job affects the poor even more. The question is that, given our demographic profile, what do we need more: growth and jobs, or low inflation? Interestingly, Nobel Laureate Joseph Stiglitz, who was in India early this month, in a lecture in Bengaluru advised Indian policymakers to pay greater attention to growing India’s economy than ‘*getting overly obsessed about inflation*’.

The virtues of low fiscal deficits, irrespective of the source (expenditure or investment), low inflation and deregulated finance have become a standard Anglo Saxon prescription since the 1980s. By now there is enough empirical evidence of the weaknesses of this framework. For one thing, the 2008 financial crisis which triggered the largest global output loss since the 1930s depression, was the direct outcome of financial deregulation, so fervently pursued by Alan Greenspan. Second, years of low interest rates and a huge increase in money supply in advanced industrial economies (and in Japan’s case, decades also of fiscal deficits) has not led to inflation as theorised by Milton Friedman. Are demographics a larger influence on inflation than liquidity and interest rates? Third, central banks, including the US Federal Reserve, look very closely at the employment numbers while reviewing monetary policy. Earlier this month, a Fed governor averred that low rates are important for growth: clearly, there is a connection between the two. Fourth, as for fiscal austerity, recently the European Central Bank President Mario Draghi urged governments of the euro zone member countries to spend more in order to speed up growth.

Turning to the issue of exchange rates, Dr. Subbarao has argued in his book that the RBI needs a transparent forex policy, and should admit that, '*building of reserves is the objective of forex management'.* He also seems to believe that, '*RBI should shift more of the adjustment burden on exchange rate movement to market participants.'* (Business Standard, July 16, 2016) In effect, this means that it is the foreign portfolio investors who will determine the rupee's exchange rate: Dr. Subbarao experienced the risk inherent in this at first hand in the last week of his Governorship, thanks to the 'taper tantrum'. Should we give up control over a very important macroeconomic variable to a score or so foreign fund managers? To my mind, the objective of the exchange rate policy should be to have a reasonable balance between exports and imports; an external balance sheet strong enough to sustain capital flight; and helping growth and employment creation. The result of Subbarao' incumbency was that India's net external liabilities (i.e. negative international investment position) jumped from $ 54.3 bn to $ 296.2 bn, or an increase of more than 5 times in 5 years! Do we need to learn from the experiences of all the 'miracle' economies in Asia, particularly China, than accept Anglo-Saxon philosophy?

As it happens, I am currently reading Stiglitz' *Freefall*, a book on the financial crisis of 2008. At one place he asks a rhetorical question: *'can we have confidence in a system that can depend so precariously on the economic philosophy or understanding of one person?'* (The reference is obviously to Greenspan). After all democracy is a system of checks and balances – and hence the good old aphorism: 'war is too important a matter to be left to the generals'. Is macroeconomic policy any less important in a developing/emerging economy? Surely it should be a consensus between Delhi and Mumbai, given the priorities of the economy? Has Dr. Subbarao's book politicised the central bank and its policies even more?

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