Shaktikanta Das: Balancing inflation and growth - the cardinal principle of monetary policy

Address by Mr Shaktikanta Das, Governor of the Reserve Bank of India, at the High-Level Policy Conference of Central Banks from the Global South "Building Synergies", organised by the Reserve Bank of India as a part of commemoration of its 90th year, Mumbai, 21 November 2024.

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I am delighted to welcome you all to this 'High-Level Policy Conference of Central Banks from the Global South'. This conference has been organised as part of the commemoration of the 90th year of the Reserve Bank of India since its establishment in 1935. Since then, the Reserve Bank has established itself as a credible public institution in India. This landmark event provides a unique forum to deliberate on current policy challenges from the vantage point of the Global South. This event is also a part of various conferences and seminars which we have organised this year. These include three international conferences, this being the third one. The first international conference was on 'Digital Public Infrastructure and Emerging Technologies' held in Bangaluru in August 2024. The second conference was held in New Delhi in the month of October 2024 on the theme 'Central banking at Crossroads'. The theme of today's conference is specifically dedicated to issues critical to the central banks of the global south. We are extremely happy that all of you from the global south and other parts of the world are here with us to participate in this conference. Depending on your feedback and interest, we propose to make this an annual event whereby we will assemble together central bankers from the global south with focus on sharing each other's experiences and dealing with the emerging challenges given the kind of uncertainties that we face.

Over the last few years, the world economy has gone through multiple crises: a global pandemic; supply chain disruptions and realignments; geopolitical conflicts and wars; a global surge in inflation; geoeconomic fragmentations in trade, technology and capital flows; debt sustainability challenges; and visible impacts of climate change. Together, they have posed humongous challenges for all central banks, including those of us in the Global South.

This conference gives us an opportunity to learn from each other's experience and reflect upon our respective journeys over the past few years. In my address today, I propose to focus on three challenging areas of policymaking and implementation, which, I feel, contain useful lessons for the Global South. These are (i) balancing inflation and growth; (ii) monetary policy communication; and (iii) crisis management. In each of these areas, I shall first present the Indian perspective and then highlight certain issues relevant for the Global South.

Balancing Inflation and Growth

The FIT Framework

The period since the onset of the pandemic is an example of how the Reserve Bank of India could effectively maintain balance between price stability and growth within the space provided by the flexible inflation targeting (FIT) framework. The flexibility of this framework is embedded in the law itself, which defines the objective of monetary policy, namely, to maintain price stability while keeping in mind the objective of growth. Thus, while primacy is accorded to price stability, the law enjoins upon the Reserve Bank to pay due regard to growth considerations also. There is also a tolerance band around the target to accommodate supply shocks, forecast errors and measurement issues. Further, inflation target is spelt out in terms of average rather than on month-to-month basis. Failure is defined as breaching the target for three consecutive quarters. As monetary policy is forward-looking, the aim is to keep future inflation aligned to the target.

Monetary policy involves taking considered call with a degree of judgement in the best interest of the economy. How much weight is assigned to a particular objective - inflation or growth - depends on the assessment of risk it imposes on the balanced path of the economy. When the COVID-19 hit the Indian economy, it was crucial to support the economy to avoid greater damage, not only in the short-term but also in the long-term. We, therefore, used the flexibility embedded in the framework to focus on reviving growth as we looked through inflation spikes which were assessed to be transitory and driven by supply shocks. In hindsight, we were correct in our assessment since inflation receded, as supply chains normalised and the pandemic subsided. Incidentally, to set the record straight, the Reserve Bank had started the cycle of rate cuts one year before the pandemic as economic growth was slowing down while inflation remained aligned to the target.

We had not even come out of the shadows of the pandemic when the Russia-Ukraine war started and drastically affected the policy calculus. The war-induced price pressures in key commodities, especially energy, edible oil and food, together with domestic drivers such as weather disturbances pushed inflation higher than the upper threshold of our target. This presented a situation in which inflation became a much bigger concern, even as growth impulses were getting stronger. We responded to the need of the hour by changing the stance to withdrawal of accommodation, followed by frontloaded rate hikes. Therefore, whether it was the pandemic-induced growth slowdown or the war-induced surge in inflation, monetary policy responded appropriately to address both the objectives of inflation and growth. The overarching priority was to achieve a balance between inflation and growth. The timing of each and every policy measure, especially when there was a change of course, was also equally important. While taking these measures, we were very much mindful of the issues pertaining to financial stability. What implications our policies would have on the aspect of the overall financial sector stability was also kept uppermost in our mind – i.e. the trade offs, complexity of challenges, which I think every central bank in the world and particularly, in the global south, is faced with while taking such decisions.

Role of Complementary Policies

The 2020–23 period was unique in view of the incidence of multiple and overlapping shocks to food and oil prices, which challenged the conduct of monetary policy. It was necessary to neutralise the impact of these shocks through effective coordination with fiscal policy. While monetary policy worked on anchoring inflation expectations and containing demand-pull pressures, eff ective supply management by the government alleviated supply chain pressures and moderated cost-push inflation. Thus, effective fiscal-monetary coordination was at the core of India's success in the face of a series of adverse shocks. From this perspective, macroeconomic stability becomes a shared responsibility of both monetary and fiscal authorities.

Major structural reforms undertaken in India in recent years, in particular the introduction of the FIT framework, implementation of the nation wide goods and services tax (GST) and enactment of the Insolvency and Bankruptcy Code (IBC) brought about a paradigm shift in the Indian economy and helped in raising the medium and long-term growth potential of India. Resilient growth has given us the space to focus on inflation to ensure its durable descent to the 4 per cent target. A stable inflation or price stability is in the best interest of the people and the economy. It acts as a bedrock for sustained growth, enhances the purchasing power of the people and provides stable environment for investment.

Relevant Issues for the Global South

(i) Importance of Growth and Price Stability

The Global South faces more difficult growth-inflation trade-offs. First, unlike advanced economies, these countries have a lot of catching up to do to increase their per capita income and productivity. Therefore, growth is a fundamental necessity for these countries, but it cannot be and should not be at the cost of price stability. To achieve higher growth, countries in the Global South need to step up investment in physical and social infrastructure, leverage technology and innovations, and carry out institutional reforms. All these require congenial public policies, including monetary policy, to be growth supportive, while maintaining balance with inflation.

In fact, price stability is just as crucial as growth to enable economic agents to plan ahead, reduce uncertainty and inflation risk premium, encourage savings and investment, all of which provide a boost to the potential growth rate of the economy. Thus, in the long-run, price stability supports sustained high growth. Price stability is also important because high inflation is disproportionately burdensome on the poor.

(ii) Fiscal-Monetary Coordination in balancing Inflation and Growth – Why is it important for the Global South?

Another aspect of managing the balance between growth and supply driven inflation relates to the role of fiscal-monetary coordination. This is very important for countries of the Global South, which have a significant share of low-income population with large developmental needs. They are most vulnerable to supply shocks, needing fiscal support which puts further burden on the limited budgetary resources of these countries. In this context, the Indian experience in managing supply side inflation through effective fiscal monetary coordination could be a learning template for all of my fellow central bankers from the Global South.

Central Bank Communication

Over the last few decades, central bank communication has undergone a transformation – from being cryptic and obfuscating prior to the 1990s to being eloquent and prescient in recent times. There has been greater realisation that monetary policy, in essence, is the art of managing expectations and its effectiveness is enhanced through active and more lucid communication.

At the Reserve Bank of India, we have actively used communication to anchor expectations. When conditions warranted, we combined rate and liquidity operations with appropriate forward guidance for greater effectiveness of our policies. For instance, we provided both state- and time-based forward guidance of continuing with the accommodative stance of monetary policy during the pandemic to support growth. In the tightening phase, which commenced in April-May 2022, the nature of communication was appropriately finetuned to ensure successful transmission of policy rate hikes. When we took a pause on the policy rate in April 2023 after having raised it by 250 basis points, it was important to anchor market expectations from running ahead or front running the central bank. It was, therefore, emphasised that it was a pause and not a pivot. This was to ensure that past rate actions were transmitted fully to the broader economy. The focus was on anchoring inflation expectations by emphasising our firm commitment to re-align inflation with the target. We also categorically said that it is not enough to be within the tolerance band and that our job is not finished until we reach the target of 4 per cent on a durable basis.

Communication – Why it is Important for the Global South?

In countries of the Global South, communication assumes greater significance and new dimensions. For the countries of the Global North, it was linked more to the exhaustion of conventional policy space once they reached the policy lower bound in the aftermath of the Global Financial Crisis (GFC). This led to the adoption of forward guidance as a powerful tool to guide the expectations of the public. For countries of the Global South, the focus on central bank communication is a more recent phenomenon and has been associated with a variety of factors in line with their macroeconomic, socio-economic, institutional and developmental stages. Let me elaborate.

First, the role of communication has increased with the transition of the economies of the Global South towards establishing more independent central banks and the associated need for transparency in the interest of democratic accountability to the public. The adoption of inflation targeting by some of us since the turn of the century further necessitated effective and transparent communication to explain policy regime changes, institutional environment challenges and also to guide expectations.

Second, as central banks in these emerging market and developing economies gained greater independence in their sphere of operations, they realised the need for communication to adequately explain policy decisions, especially in the context of multiple objectives of growth and stability. Further, in periods after the GFC and the pandemic, monetary policy easing in advanced economies increased the exposure of the Global South to large swings in capital flows, exchange rates and commodity prices. This has further complicated the tasks of central banks to explain policy trade-offs amidst continuing volatility.

Third, there is growing recognition that effective communication obviates the need for large or frequent policy changes, or even any changes at all, if the inflation expectations are well anchored through appropriate communication. Of course, communication has to be backed by actual action as may be required from time to time.

Overall, effective communication in sync with the conduct, stance and goals of policy would contribute to fostering macro economic stability. Learning from each other's experience and building synergies in this important aspect of monetary policy can go a long way in laying out the blueprint for 'Best Practices in Communication for the Global South'.

Perspectives in Crisis Management

I have briefly touched upon our tempestuous journey while navigating the crisis-ridden years. Let me now briefly summarise how the Reserve Bank's experience has been unique among central banks. When the COVID 19 pandemic struck, we reduced the policy repo rate, but not below our inflation target of 4 per cent which would have made real policy rates negative; thus, we were not ultra-accommodative. We took conventional and unconventional measures to address liquidity constraints created by COVID-19 related dislocations and lockdowns. These measures were not just aimed at enhancing the overall liquidity in the system, but ensuring its distribution across the needy sectors. These measures were not open-ended. In fact, most of them were time bound and announced with pre-set terminal dates. As a result, their unwinding did not cause market disruption. Further, the counterparties involved in our liquidity operations were only banks and All India Financial Institutions (AIFIs) regulated by the Reserve Bank with no dilution of collateral standards. The Reserve Bank of India's balance sheet was not diluted and I am happy to share that within three years or so of the commencement of the pandemic, the size of the Reserve Bank's balance sheet had again come back to where it was at the beginning of the pandemic. In other words, the liquidity infusion during the pandemic had been pulled back due to the fact that the liquidity measures were not open ended. They had terminal dates announced at the time of their announcement. In fact, if you recall, the COVID-19 pandemic hit most parts of the world in March 2020. We had actually started the process of infusing a bit of liquidity even before the pandemic in the month of February 2020. In January 2021, we slowly started unwinding various measures to drain out the excess liquidity in the system in terms of the revised liquidity management framework of February 2020.

If you recall, earlier in my address today, I had mentioned about the importance of timing of decisions. I would like to emphasise that not only the decisions have to be right but the decisions have to be timed well because, as I have pointed out elsewhere very recently, often central banks are accused of doing too little too late or too much too early. Therefore, timing is a crucial aspect of every decision making and a well-timed decision enhances its effectiveness. That is something which, as central bankers, is our responsibility. We should have a correct assessment or at least endeavour to have a correct assessment of the current situation and the expected situation or the outlook and suitably time our decisions.

We confined our asset purchase programme to government securities and solely through the secondary market, unlike some inflation targeting EME central banks that made emergency provisions to operate in the primary market to finance the government directly. It was a considered and prudent decision by the Reserve Bank and the Government of India to avoid monetisation of fiscal deficit, a practice which was discontinued by the Reserve Bank in the late 1990s. Also, the resolution frameworks for COVID-19 related stressed assets of banks and non-bank lenders were not open ended, but were subject to certain financial and operational parameters to be achieved as part of the loan restructuring process.

It may be observed that most of our pandemic time measures were nuanced, keeping in mind the price and financial stability challenges that may arise in future. Just as the liquidity measures we announced were not opened ended, similarly, for the resolution frameworks for stressed loans, we had set certain operational and financial parameters to ensure that the resolutions were prudent and specific to the requirements of the borrowers.

During the tightening cycle in the aftermath of the war in Ukraine, our actions also stood out in contrast to many other central banks. First, the quantum of our rate hikes was not as high as those of several advanced economies (AEs) where 75 bps became the new normal, as they had negative or near negative interest rates for quite sometime. Second, while changing the stance of monetary policy, our pitch was not as shrill as that of AEs. Our communication was nuanced and focused on building market confidence on the central banks' unambiguous commitment to align inflation with the 4 per cent target. Third, we refrained from giving any forward guidance on the terminal rate in the prevailing cycle, given that such guidance was inherently risky in an uncertain environment. Fourth, even while pausing on the policy rate, we continued with the restrictive stance till we achieved a balance between inflation and growth.

Summing up, in designing our response to both the pandemic and the inflation upsurge, we have not been tied down by conventional theory or any kind of dogma. We were nimble and flexible in our actions and policies. To quote an eminent economist "Good policy ----. requires combining the science of the economist with the art of the practitioner".[1] In that sense, through our actions we have perhaps lived up to the maxim that says "monetary policy is science but monetary policy making is an art." It is, however, for others to judge.

Conclusion

Let me now conclude. While the global economy has managed to hold its ground in the highly stormy weather of the last few years, clouds of uncertainties still loom on the horizon. Policymaking in this environment of heightened uncertainty is akin to driving a car through a foggy path ridden with speedbumps. These are conditions which will test the driver's patience and skill. Historical regularities are looking improbable, and policymakers are being put to test. When the history of our times is written, the experiences and learnings of the last few years will, in all probability, be a turning point in the evolution of central banking.

For the countries of the Global South, maintaining overall stability which includes sustained growth, price stability and financial stability continues to be a daunting challenge. Central banks need to work towards more robust, realistic and nimble policy frameworks that use monetary, prudential, fiscal and structural policies synergistically to achieve the desired outcomes. I am confident this conference today and tomorrow will throw up important ideas and takeaways for charting out a future course for the Global South. I wish the conference all success.

Thank You. Namaskar!

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[1] C. E. Walsh (2001): The Science (and Art) of Monetary Policy, Federal Reserve Bank of San Francisco (FRBSF) Economic Letter, May 4, 2001.