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Govts must protect central banks' independence, says Rajan

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Raghuram Rajan

Reserve Bank of India (RBI) Governor Raghuram Rajan on Tuesday said governments must protect the independence of central banks to act as they think fit and should look beyond uninformed criticism. He argued that India's real interest rate was actually in the middle-of-rates prevailing in the world, and lower than China's.

The outgoing governor has in the recent period sharpened his attack on his critics who repeatedly pinned the central bank for not slashing rates, which the critics argue would spur rapid growth. Rajan's address at the 10th Statistics Day Conference held at the RBI headquarters is an extension to that.

An exhibit presented by Rajan showed that India's real interest rate (interest rate minus inflation) is lower than one per cent, whereas in China, one of the fastest growing major economies, the rate of interest is close to 2.5 per cent.

“Why is the debate uninfluenced by the data? Why is it that as we seem to be bringing inflation under control, public voices to abandon the fight are loud? I don’t know for sure but let me hazard a guess: Is it possible the political economy of inflation is different from the received wisdom we were taught in class as students? And are there parallels to the political economy of bank clean-up?” Rajan said at his address to a gathering of statisticians and economists from across the world.

“Specifically, despite all the public commentary against inflation and its pernicious effect on the weaker sections of society, there seems to be surprisingly little anxiety in public commentary about inflation so long as it stays in the high single digits.”

Industrialists enjoy negative interest rates and the critics usually portray examples of companies that pay high interest rates because of their bad credit profile.

“With no powerful and vocal political constituency getting agitated about generalised inflation so long as it is only moderately high, opponents of disinflationary policies are free to frame the debate as they wish. The persuasive way is to claim that interest rates are hurting growth.”

The best way central banks can support growth over the medium term is by keeping inflation low and stable, he said, adding “Without any political push back as inflation rises, it is necessary to build institutions to ensure macroeconomic stability.... Perhaps this is why successive governments, in their wisdom, have given the RBI a measure of independence.”

To refute the argument of his critics, Rajan reiterated the differences between the high credit growth of the private banks and tepid growth rate at the public banks, arguing the problem is with the public sector banks that are now saddled with bad debt and are therefore risk averse.

“In sum, the Indian evidence, supported by the narrative of experiences from other parts of the world such as Europe and Japan, suggests that what we are seeing is classic behaviour by a banking system with balance sheet problems,” Rajan said in his address. “It is important that governments around the world look beyond sometimes uninformed and motivated public criticism and protect the independence of their central bank to act. That is essential for stable sustainable growth.”

“The obvious remedy to anyone with an open mind would be to tackle the source of the problem — to clean the balance sheets of public sector banks, a remedy that has worked well in other countries where it has been implemented,” he said, adding, “Clean-up is part of the solution, not the problem, and that is what we are doing.”

Rajan also defended the stance of the central bank’s inflation targeting framework that critics argue do not take into consideration volatile components like vegetables and other food. The monetary policy committee will have to explain its failure only in case the inflation target is missed for three quarters in a row, and here “volatile components like vegetables tend to be smoothed over three quarters,” the governor said.

However, it was not reasonable to drop food entirely from the target index, given that “it is the single most important consumption category for most Indians still,” and would exert further pressure in favour of prices for certain favoured items as Indians get richer.

Rajan also lauded the government effort in increasing production of pulses after years of high pulses price-led inflation.

Under Rajan, the central bank has cut policy rates by 150 basis points and managed to rein in inflation below six per cent even as prices have started inching up slowly again because of persistently high food and rising commodity prices.