

The Political Economy of Inflation Dynamics

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I'd like to thank Esther George for selecting such a fascinating set of papers. This is the first time that I'm seeing papers from the other side, so to speak, wearing a central banker's hat. I see a lot that I can take away from these discussions. If I put on my academic hat and ask what future work is suggested by the papers we've seen, I would argue that we have not dwelled enough on the political economy of monetary policy. This is essential for discussing monetary dynamics. It is the unspoken, perhaps even unspeakable, aspect of policymaking. Perhaps the closest that we've seen to a mention in the papers presented is in the paper by Jon Faust and Eric Leeper.

Political economy is embedded in everything we do, though much of our work is based on a technical framework, with models, forecasts and a very specific mandate. I'll argue that there is a reason for our techno-centric emphasis, but the reality of central banking is that our historical experience, as well as the current political environment, does influence the emphasis we place on various aspects of our framework.

Consider the mandate central banks have. The move toward inflation targeting probably stems from the public dissatisfaction caused by the great stagflation of the 1970s, when central bank policy discretion was found to be wanting, as also from academics such as

Kydland, Prescott and others, who argued that rules might be superior to discretion. Even within this mandate, which side of the inflation band a central bank emphasizes may stem from historical political experience. For example, one could argue, and some have, that the United States' focus on the cost of going below the lower inflation bound stems from U.S. history—the farm bankruptcies in the 19th and early 20th centuries, the “Cross of Gold” debate, the enormous cost of corporate bankruptcies and bank failures in the 1930s, and the cost of debt overhang. All of this perhaps leads today to an emphasis on avoiding breaching the lower inflation bound and thus staying away from deflation. One could argue that in Austria and Germany, the hyperinflation of the 1920s, the consequent demolition of middle class wealth and the subsequent arrival of a totalitarian regime would explain the focus on avoiding breaching the upper bound, because of the greater fear of high inflation there.

Thus a central bank's targets and frameworks are likely influenced by its people's experience. Of course, even in the ordinary course of monetary policy, there are always choices we make that are distributional, and therefore political, in nature. Through monetary policy changes, we may favor savers over borrowers, the asset rich over the asset poor, or workers over retirees and pensioners. But why is there not more debate, as suggested by Faust and Leeper, about how these distributional choices are made? Perhaps we don't spend more time debating these issues because they get evened out over the business cycle. Typically, the central bank favors one side at one point and another side at another point. Therefore, the debate calms down before it gains strength. However, when policies are prolonged in any particular direction, as we have seen post-Global Financial Crisis, then perhaps the debate gets a lot more vociferous because one side is favored more at the expense of the other side. The distributional effects become more front and center.

Perhaps because of long-term effects of demographics on participation, savings, investment and productivity, monetary policy may stay longer today in a stance, which makes it more susceptible to accusations of distributional biases. For example, was the Japanese tolerance for deflation over a long period driven by aging and the

political power of the elderly? I'll leave it to Takatoshi Ito to give the right answer, but deflation did favor fixed income pensioners at the expense perhaps of the young and indebted firms. The point I'm trying to make here is that central bankers may not be able to escape the background influence of political economy. Of course, we resort to rules and framework to broadly suggest we are apolitical but within those rules and frameworks we have the scope to be profoundly political, sometimes without recognizing it.

Now, let me talk about the disinflationary process in my own country, which is a prolonged process and, therefore, is possibly subject to distributional considerations. Unlike some of my fellow panelists, the Reserve Bank of India has the problems of a traditional central bank—a problem of high inflation and the need to bring it down. There has always been an assumed consensus in India that you want to bring inflation down because the group most hurt by the inflation tax is the poor, whose wages and investments are not protected against inflation. The poor tend to have a larger vote and, therefore, there is strong political pressure to bring inflation down. Nevertheless, despite this extremely strong consensus, for about eight to 10 years we had average inflation close to double digits. Why did we tolerate that? Why is the fight against inflation, which we are engaged in now, criticized in newspaper columns as much as it is supported?

I would argue the reason is simply because different parties are favored in the disinflationary process and different parties are hurt. To the extent that vocal parties are hurt in the disinflationary process and they make their feelings known, public criticism increases. This is particularly the case when there is limited public appreciation of what it takes to create the conditions for low and stable inflation over the medium term.

Political differences increase when disinflation takes place in a global environment of low inflation. Domestic producers of traded goods, typically manufacturers, experience low global inflation, even deflation for their outputs. The effect of decreasing per-unit revenues on profits is obviously offset, in part, by the lower cost of imported inputs, but it is exacerbated by the relatively high cost of domestic inputs (as in the disinflationary process, the exchange rate tends to

appreciate). The net effect is producers of traded goods see a much higher effective real interest rate for their borrowings because they experience lower profit inflation than perhaps do others in the economy. Such producers are very vocal about the cost of high rates.

On the other hand, savers have endured very high inflation for a long time. Domestic Consumer Price Index (CPI) inflation is much higher than global inflation, and thus much higher than wholesale price inflation (which is what the producers see). Because the central bank has focused in the past on curbing wholesale price inflation, which is determined globally to a large extent, and has allowed high levels of CPI inflation, savers have been facing negative real rates for a long time and they have reacted, in part, by moving away from financial assets to other real assets such as housing and gold. As a result, household financial savings have been coming down, and our current account deficit has also expanded during the period that we had negative interest rates. So it would make sense to bring CPI inflation down steadily and surely, and this is something the central bank has been indicating clearly. The problem, of course, is that in bringing it down through higher rates, we affect the traded goods producers and they complain about the high cost of the inflation fight.

If it was a short-duration fight it would not pose a problem; soon, you would be able to cut interest rates and defuse the opposition. But because disinflation is a long-run process, and over time the complaints about “deindustrialization” increase, pressure from the traded goods sector does build.

All this is complicated by global capital flows, because as we disinflate, fixed-income assets become much more attractive in India. Foreign investors want to come in and buy fixed income assets, the exchange rate appreciates and that adds once again to the problem of the tradeable goods producers.

So, what can be done? How do you deal with these problems quickly in a way that you avoid the political economy? One answer would be to disinflate fast, before opposition builds, but then you need a Volcker-style disinflation with extremely high interest rates, at which point the economy could slow considerably. The associated public

pain from layoffs and corporate closures is unlikely to be acceptable in a country with very limited safety nets. Therefore, there is a certain politically tolerable pace of disinflation that that central bank has to stay within, and indeed the measured disinflationary path we have laid out incorporates these considerations.

Once such a path is laid out, and is supported by the government through an explicit inflation agreement, we can then turn to frameworks, technical models, projections, etc. The political economy is incorporated into the broad mandate, and the central bank can focus on “technological” action to achieve the mandate.

Of course, we have to pay attention to the distributional consequences of our actions, keeping in mind that we have limited instruments. Under the circumstances we face, we have tried to make life easier for the traded goods producers by resisting the appreciation pressure that comes from capital inflows. Despite some intervention in exchange markets to build foreign exchange reserves, we have experienced some appreciation; we are still one of the stronger emerging market currencies, having moved up with the dollar quite a bit. Nevertheless, public opposition to our monetary policy has been far more muted than it might have been if we had not intervened.

Furthermore, the capital that is seeking to benefit from this disinflationary process is short-term capital—capital is attracted today by high interest rates but if there is a perception that at the end of the disinflationary process the exchange rate may be overvalued, foreign capital will want to exit. One of the ways we tried to keep from getting too much of such inflow is to prohibit short-term debt inflows and require a minimum maturity for debt investments. While this does not prevent investors in long-term assets from selling out when they want to exit, at least they have not perfectly matched the maturity of their investment to their horizon, which forces them to think a little before investing.

The broader point I wanted to make is that the job of a central banker cannot be immune from considerations of political economy, especially if policy is in a particular direction for a long time, and we ought to take this into account in our discussion of monetary

dynamics. That we don't talk about the political economy very publicly does not mean that these concerns do not exist, mostly in the background, but sometimes in the foreground. Given recent congressional discussions of a monetary rule to impose on the Fed, and debates on the appropriate role of the European Central Bank in purchasing sovereign debt, I presume such concerns are widespread.

Governor (Marek) Belka asked how we communicate about it. Maybe the answer is that there is no real way to communicate, except in sessions like the current one. Once you communicate, you introduce yourself into the political dialogue, which you are in no position to actually participate in because you're a technocrat whose supposed view is apolitical. So demystifying the role of the central bank may actually politicize it because we insert ourselves in dialogues where we really don't have strong legitimacy, especially in areas where policy requires the use of discretion.

Is the alternative to turn to strict policy rules as Athanasios Orphanides suggested? Perhaps not, because that would force us not just to ignore information that might be policy relevant and was not anticipated by the rule, it might also cause us to ignore political forces that we really have to pay attention to, especially in prolonged episodes like the current one. An overly strict policy rule may destroy political support for the central bank, even if the intent is to make policy decisions less discretionary or political.

Perhaps there is no alternative to muddling through; use frameworks and explicit mandates as a broad guide but within that, use discretion to maximize some sort of social welfare function that the central bank believes society has tasked it with. Yes, there is scope for an unelected technocrat making decisions that infringe on the prerogative of elected officials, and yes, these decisions may mean political tradeoffs, but in policy, unlike in academic models, nothing can really be clean. These are just thoughts of somebody who is traversing both academia and central banking.