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Need to Reform Financial Policy

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This article is based on the editorial ***"Even central banks need 'capital' infusion"*** *that appeared in The Hindu on 29th June 2019. This article critically analyses the Reserve Bank of India's monetary policy that focuses on Inflation targeting.*

The central bank of India- **Reserve Bank of India** (RBI) is the main decision maker for the country's financial system and is mandated with ensuring its stability. However, in the era of globalisation, the role of the central bank in the economy must be kept in sync with the changing domestic and global economy. So the economic arrangement should include the dynamism of the current times.

Thus, RBI needs to follow a pragmatic monetary policy and its current policy that largely focuses on **inflation targeting** must be reviewed.

What is Inflation targeting?

- Inflation targeting involves using monetary policy to keep inflation close to the agreed target.
- RBI and Government of India signed a Monetary Policy Framework Agreement in February 2015.
  - As per terms of the agreement, the objective of monetary policy framework would be primarily to maintain price stability (inflation targeting), while keeping in mind the objective of growth.
  - According to the agreement, RBI would aim to contain consumer price inflation within 4% with a band of (+/-) 2% for all subsequent years.

Why monetary policy based on Inflation targeting must be reviewed now?

The government and the RBI, by acting in synergy implemented a deflationary macroeconomic policy via fiscal contraction and monetary tightening respectively.

Deflationary macroeconomic policy: It is a set of macroeconomic policies that are designed to combat rising inflation. It can be done by:
  - **Fiscal contraction:** It is a monetary measure referring to a reduction in government spending.
  - **Monetary tightening:** It means Central Bank's policy to constrict spending in an economy by reducing the money supply, that is seen to be accelerating too quickly or to curb inflation when it is rising too fast.

- The global financial crisis has led to a substantial re-thinking of macroeconomics. The main revisions are that monetary policy defined by inflation targeting can no longer be treated as the centrepiece of macroeconomic policy,
  - **Fiscal policy should be used to stabilise the economy when needed and that financial regulation is a must.**
  - The limitation of inflation targeting was understood when the great moderation (an extended period of low inflation in western countries like the US and EU) ended in the financial crisis.
  - Central Bank's focus on inflation targeting lost sight of the emerging financial instability.
- This has recently been experienced in India in:
  - **The IL&FS crisis:** A major NBFC in India defaulted on its payment obligations jeopardising the interests of hundreds of investors, banks and mutual funds. The IL&FS crisis was touted in intelligentia as India's Lehman brother default.
  - Also, the Indian banking sector is under crisis due to rising non-performing assets **(NPAs)** of banks even as RBI ensured inflation was abating.

Lehman brother default the largest bankruptcy filing in U.S. history started a domino effect that resulted into Global Financial meltdown in 2008-09

- Inflation targeting in India has coincided with a substantial rise in the real policy rate. This has been accompanied by declining borrowing in the formal sector likely affecting investment.
- Though many in government appreciate their attainment of macroeconomic stability defined by low inflation, unemployment has been rising in the country (according to NSSO, unemployment in India has been highest in the last 45 years).
- Inflation has come down after MOU signed between RBI and Government regarding inflation targeting. However, it is to be considered that-
  - Inflation in emerging markets such as India is very sensitive to exogenous shocks like as global oil prices, a weaker rupee and a poor monsoon.
  - The inflation in most emerging markets came down in recent years because of global factors such as muted oil prices and the deflationary impact of the Chinese export boom.
  - Food inflation, which impacts the common people the most, is prone to supply-

side bottlenecks, which are out of the scope of any remedy under the aegis of monetary policy of RBI.

So RBI not only needs functional independence, but it needs to follow a more pragmatic financial policy. In this scenario, RBI's role must now be redefined through a recalibrated monetary policy, which is in sync with changing economic conditions.

Drishti input

RBI's monetary policy which is based on inflation targeting needs reform. Comment