Mains Practice Question

Q. RBI's monetary policy which is based on inflation targeting needs reform. Comment. (250 words)

11 Sep, 2019 GS Paper 3 Economy

Introduction

- RBI is the main decision maker for the country's financial system and is mandated with ensuring its stability. RBI currently uses inflation targeting as key to monetary policy. Monetary Policy Framework Agreement 2015 between RBI and the central government mandates RBI to contain Consumer Price Inflation (CPI) within 4% with a band of (+/-) 2%.
- However, in the era of globalization, the role of the central bank in the economy must be kept in sync with the changing domestic and global economy.

Limitations of dependence on monetary policy based on inflation targeting

- Easy money policy is needed to increase economic activity during slowdown. This is done by keeping the interest rates low. Thus, RBI needs to **balance inflation targeting and accelerated economic growth.**
    - For example, even though the current inflation rate is at around 3%, there is a slowdown in the economy and GDP growth was at 6 year low of 5% in the April-June 2019 quarter.
- Inflation targeting **cannot ensure stability** in the economy.
    - For ex: It failed to detect financial crisis situations like IL&FS default and the NPA (Non Performing Assets) crisis in the banking industry.
- **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 and thereby growth.
- Inflation targeted policy **cannot ensure enough employment creation** in the country.
    - For ex: even though current inflation rates are stable, unemployment in India has been highest in the last 45 years as per NSSO data.
- There is a **conflict of interest** in RBI **managing the monetary policy** and **selling bonds** for the government which require keeping interest rates low and thus is inflationary.
- **Inflation** in emerging markets such as India is very **sensitive to exogenous shocks** like global oil prices, a weaker rupee and a poor monsoon.
    - Global Financial crisis of 2008 showed that monetary policy defined by inflation targeting can no longer be treated as the centerpiece of macroeconomic policy.

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

Way Forward

- **Fiscal policy** should be the primary tool to stabilize the economy. Better policies targeted at

efficient taxation and government spending should be used to influence the economy in the long run.

- 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.
- Also, the **Public Debt Management Agency (PDMA),** proposed in Finance Bill, 2015 should be formed at the earliest to avoid any conflict of interest in RBI’s role in monetary policy formulation and managing government debt.