

OPINION: MONETARY POLICY PANEL'S MANDATE NEEDS AN OVERHAUL

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Even as the finance ministry and the Reserve Bank of India (RBI) butt heads over the idea of “independence” for the latter, never mind what national goals are, this is as good a time as any to go back to the one area where the two agree: That the primary goal of monetary policy is to target retail inflation.

After the creation of the monetary policy committee (MPC), the agreement between the government and RBI shifts the inflation mandate to the MPC.

Under the pact signed on 20 February 2015, between the then RBI governor and the government, the main objective of monetary policy is ensuring price stability, with the monetary policy committee mandated to focus on a specific retail inflation rate of 4%, plus or minus 2%.

The wording, in Clause 2 of the agreement, confirms that “the objective of monetary policy is primarily to maintain price stability, while keeping in mind the objective of growth”.

This wording essentially makes RBI/MPC responsible only for inflation, which means that growth can often be given the go-by. While the inflation mandate is specific, the growth mandate is too vague to be meaningful. It cannot be interpreted in any meaningful way at all. RBI will effectively not be held accountable for damaging growth, since it will be judged and called to account only on inflation. Missing the inflation target has consequences, but not growth.

While it seems good to have clearly definable targets for monetary policy, this unitary focus on inflation is not particularly useful for a complex economy like India, where the bulk of the inflation risks emanate largely from two uncontrollable factors, food and fuel.

So, when fuel or food prices fall, as has been the case for much of the Modi era, RBI and the MPC may get credit where it is not due, but since it can slam the brakes whenever inflation seems structural, it cannot be blamed for slowing growth since its mandate is to focus on inflation. The latest retail inflation print of 3.31% for October—the lowest in 13 months—has almost nothing to do with the MPC's actions, and more to do with factors beyond its control.

Now consider how the US Federal Reserve has been given its mandate. There is no specific inflation target. Though the Fed may set itself one, the emphasis is on other objectives simultaneously. Under the mandate given by the US Congress when the Fed was created in 1913, the central bank has to conduct monetary policy “so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates”.

The US Fed has a triple objective, though vaguely defined, while the MPC has only one primary goal, which anyway it cannot directly influence since the major components relate to food and fuel, where fiscal policies and global trends have a more direct impact. Put another way, it seems as if the RBI-government pact of 2015 has focused on inflation because this is the only measurable parameter on which the central bank can be held accountable. An inability to measure other things has made other equally important objectives of monetary policy secondary.

Clearly, the US Fed mandate is more flexible, and a better model to follow than the flawed deal

signed by RBI and the finance minister. If growth, interest rate stability and inflation were to be a triple mandate, the MPC can follow a more nuanced policy. Right now, the policy is lopsided, and unduly focuses only on inflation. In India, unemployment rates are not being measured properly, and so growth and wage inflation may be better gauges than jobs growth. This can change once we have a more accurate measure of the jobs situation as in the US, and jobs can be specifically inserted into the mandate.

It does not make sense to target a specific rate of inflation regardless of what is happening to growth or long-term rates, leave alone employment. India has needlessly been seduced by monetary fundamentalists who have sold us a pup. We need to change the MPC mandate to one that is more nuanced and fluid. More so, when the world is turning topsy-turvy, where deglobalization is gathering steam, and demographic trends in the world are anyway puncturing growth both in the global economy and in India.

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