Source : www.livemint.com Date : 2018-10-22

OPINION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Inflation & Monetary Policy

In the last instalment of this column, I warned that recent appointments by the Narendra Modi-led government to the board of the Reserve Bank of India (RBI) might ultimately be aimed at watering down, or ditching altogether, the monetary policy framework agreement between the RBI and the Union ministry of finance. The agreement enshrines, for the present, an inflation targeting policy mandate for the central bank, to be determined by an independent monetary policy committee, and free from government interference.

Those who do not like inflation targeting may well say good riddance if that were to happen. But that would be a short-sighted reaction indeed. As I have noted on numerous occasions in this space, critics of conventional monetary policy frameworks, such as monetary targeting or inflation targeting (which includes me on occasion), have the daunting challenge of coming up with an alternative framework that would be demonstrably superior.

Unless one is proposing a return to a gold or some other commodity standard, or to a revamped version of a Bretton Woods-style hybrid system for the global economy (which seems far-fetched), it is hard to find viable alternatives to inflation targeting for India or other emerging economies. The only option is classical exchange rate targeting—in other words, fixing the exchange rate to a major currency, such as the US dollar.

Now, for those complaining about a weakening rupee, how would things have operated for India with an exchange rate pegged to the dollar at (say) 60 or 65 rupees? According to the celebrated “impossible trinity” or “trilemma” of Nobel economist Robert Mundell, an economy cannot simultaneously fix the exchange rate and control its domestic monetary policy (read: policy interest rate as instrument, or price level as target) in the presence of an open capital market.

Well, in the presence of incipient rupee depreciation, the result would have involved the central bank purchasing rupees and selling dollars to maintain its announced parity, according to received textbook theory. The impact on the domestic Indian economy would have been disinflation, or, more likely, economic contraction.

Or, to put it another way, in the absence of rupee depreciation to absorb the impact of external shocks, something else would have to give in a world of sticky prices, which would have been domestic aggregate demand. Would all of those decrying a falling rupee and the RBI’s legally mandated fixation on inflation be so happy if the price of a stable rupee were a recession? I suspect not.

The truth is, that in the absence of a new global monetary compact to replace the long-defunct Bretton Woods system, it makes little sense for a large emerging economy such as India to adopt a fixed exchange rate against the US dollar and thereby sacrifice the insulation properties of a flexible monetary policy regime—in particular, inflation targeting.

To use an analogy, in the absence of a world government, the best that each country can do is to have its own national government. Holding out for a world government and living with anarchy at home in the meanwhile is not a sensible alternative. Thus, in the absence of a rules-based global monetary system (call it Bretton Woods 2), the best that any large economy such as India can do is to stabilize its own domestic inflation rate via inflation targeting, and allow the exchange rate to follow its own market-determined path.

Orthodox macroeconomic theory tells us that such a policy stance is best to minimize deviations of output from its long-run or “natural” rate as well as minimize deviations of the inflation rate from its (policy-determined) target.

Interested readers may wish to consult Richard Clarida, “Monetary Policy in Open Economies: Practical Perspectives for Pragmatic Central Bankers”, *Journal of Economic Dynamics & Control*, 2014. As an aside: Clarida, who is one of the originators of the academic consensus on inflation targeting, is now a central banker himself (presumably a pragmatic one). He was nominated by US President Donald Trump and recently confirmed by the US Senate as vice-chairman of the US Federal Reserve System.

For what it is worth: my own view is that early evidence suggests that inflation targeting has been working in India in the few years since the inception of the new policy framework. (See Niranjan Rajadhyaksha, “The great Indian inflation puzzle”, *Mint*, 17 October, for a nuanced and erudite take on this debate.) There is good reason to believe, in my judgement, that the RBI’s inflation target has managed to anchor the public’s inflation expectations around the target, so that the public is able to look beyond transitory shocks that have an impact on inflation in the short run, as they believe in the credibility of the RBI’s inflation target.

If that is the case, as I hope it to be, we should be sanguine about the future prospects for inflation in India in the near to medium term, and there is every reason to credit the inflation targeting regime for this success.

Despite all the hoopla by the Modi government and all the gripes by the critics, the monetary policy framework agreement is one of the Modi government’s signal accomplishments and a genuinely important, major reform. It would be a tragedy if short-run political calculations were to put this at risk.

Vivek Dehejia is resident senior fellow at the IDFC Institute, Mumbai. Read Vivek’s Mint *columns at livemint.com/vivekdehejia.*

END