CHANGING THEORY AND PRACTICE OF MONETARY POLICY IN INDIA

Abstract:

This paper attempts to analyse the recent changes in the theory and practice of monetary policy in India vis-à-vis the international experience. Globally as well as in India the objectives, instruments and operating mechanism of monetary policy have undergone a sea change over the last few decades. Although maintenance of price stability – more so the domestic price stability if not the external price (exchange rate) stability - has long been considered as the dominant objective of central banks, the global financial crisis followed by the Euro zone debt crisis has changed the objectives spectrum of central banking in a fundamental way. The orthodoxy of central banking before the sub-prime financial crisis was: single objective - price stability; single instrument - short-term interest rate, although individual central banks deviated to different extents from this modest standpoint. The global financial meltdown came as a strong criticism against central banks for having neglected financial stability in their single-minded pursuit of price stability.

Even as central banks are struggling to balance the demands of price stability and financial stability, there is now yet another heavy assault on central bank orthodoxy arising from the euro-zone sovereign debt crisis. The European Central Bank is being called upon to bend and stretch its mandate to bail out countries whose current financial crisis is basically a result of their failure to pursue norms of financial prudence. If a central bank is committed to financial stability, it cannot ignore the feedback loop between financial stability and sovereign debt sustainability, and by extension therefore, it has to be mindful of sovereign debt sustainability concerns. The central banks of the developing countries in general and those of the emerging market economies in particular have an added responsibility to insulate their financial markets from the contagion of global financial crisis.

Thus in the fast changing global scenario, the mandate of central banks has extended from the single objective of price stability to triple objectives of price stability, financial stability and sovereign debt sustainability. Can central banks simultaneously support all these three objectives and do so efficiently? This in essence is what has come to be termed as the new trilemma. How do the three objectives underlying the trilemma reinforce each other, and in what ways do they conflict with each other? What is their impact on growth? Is the trilemma an exclusive phenomenon of crisis times, or does it manifest in normal times as well? What is the nature and extent of the responsibility of central banks for each of these objectives? Are central banks equipped to handle these additional responsibilities? What does this extended mandate mean for the autonomy of central banks and effectiveness of monetary policy? This paper attempts to analyse how the central banks in the emerging market economies general and the Reserve Bank of India in particular address these and other related issues.

JEL classification: E-5, F3, G1, G2, G3.

Key Words: Reserve Bank of India, Monetary theory and policy, Trilemma of objectives, Price stability, Financial stability, Sovereign debt management, Instruments of monetary policy, Interest rates, Global financial crisis, Euro-zone debt crisis.