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Let RBI Be

India's macroeconomic stability depends on the credibility of its central bank

Strong and credible institutions aid a country's growth. In pursuit of this goal, the law governing Reserve Bank of India was amended last year to introduce a framework to squarely target inflation. The amendment set up a monetary policy committee (MPC) – with some members from outside the central bank – and gave it legislative backing to function autonomously, as that is the bedrock of a credible central bank. Unfortunately, this seems to be an idea the finance ministry is not yet comfortable with.

India's inflation targeting framework is based on the idea that it is the prerogative of an elected government to set an inflation target. Once a target is set the MPC is given the necessary autonomy to achieve this goal. In the event it fails to achieve the target, it has to provide government a formal explanation. This architecture recognises that a credible and independent central bank needs a clearly defined mandate. In other words it cannot be burdened with other objectives such as pushing up economic growth. That has to be achieved through other policy levers the government commands.

Given this context, it was singularly ill conceived for finance ministry to invite members of MPC ahead of a monetary policy meeting, presumably to tell them how to do their job. It is to the credit of MPC that they turned down the invitation as the perception of independence is critical. Unless myriad economic agents are convinced about the credibility of a central bank, monetary policy cannot be effective. The government should stop trying to micro-manage RBI, whose reputation took a beating during the demonetisation episode.

This is not to say that finance ministry should have no role to play. The legal framework does allow them to convey their views formally to MPC. But divergent views are inevitable, given that a central bank and government have different priorities. It is just bad policy to pin hopes on a rate cut by MPC to resolve deep structural problems in the economy. For that, rather than passing the buck to RBI, the government needs to push a reform agenda. The division of labour between government and an independent central bank is what investors look to when they want to assure themselves of India's overall macroeconomic stability. Finance ministry should not undermine an inflation targeting architecture which it itself helped establish.