BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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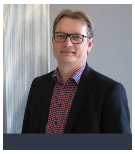
BLOG

The pandemic hits monetary policy in India

Today – Blog



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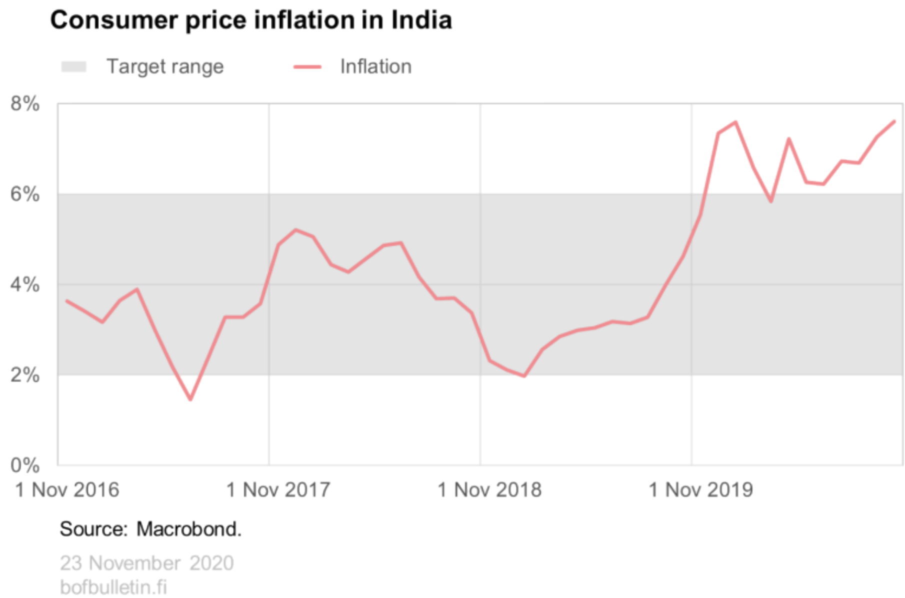
It has been a year since the inflation rate in India exceeded the target range of 2–6 percent and started to hover between 6–8 percent (Chart 1). The survey evidence signals that households expect inflation to continue well above the target. Concerning? Perhaps. But we should be mindful that a pandemic creates a truly exceptional set of circumstances for monetary policy authorities in every country.

Chart 1.

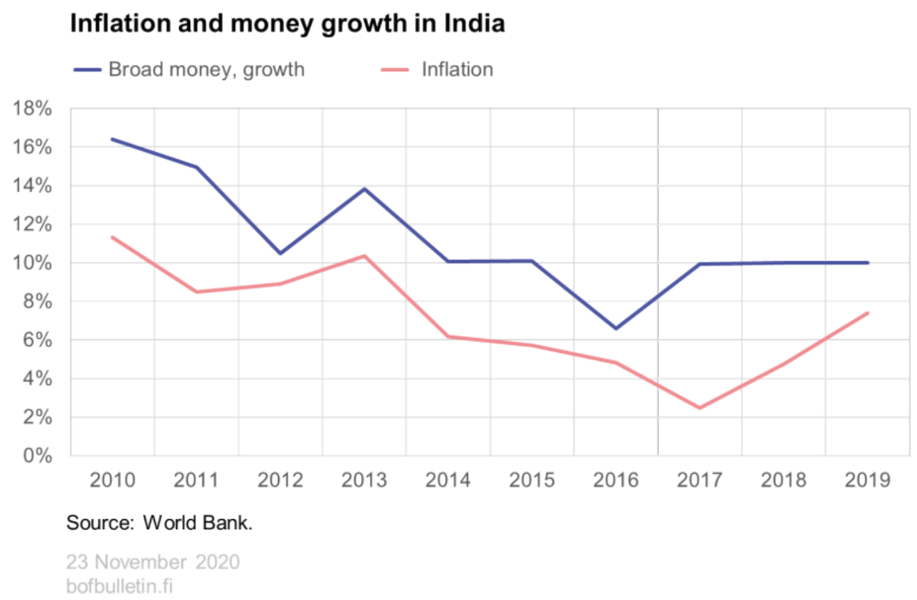


Various indicators signal a relatively successful transition to inflation targeting in 2016 from the prior idiosyncratic "multiple indicators" approach. Just a year ago, inflation rates were still inside the target range. The volatility of inflation, inflation expectations, and the exchange rate had diminished relative to pre-inflation targeting levels (Eichengreen et al., 2020), thereby making the economic environment easier to navigate for firms and households.

Monetary data also give positive signals about the health of India's relatively new inflation-targeting regime. We could shrug off money growth data as irrelevant and even misleading because money is – according to the best models – merely a noisy indicator of more meaningful intermediate targets for monetary policy such as inflation expectations. Indeed, at the Reserve Bank of India (RBI), as well as the Federal Reserve and the European Central Bank, monetary analysis has taken a back seat (RBI, 2020).

To overlook *money*, however, risks confusing the map with the terrain. A key issue, especially in an emerging market context, is whether the central bank can really commit to its mandate. It is not unusual that governments in "inflation targeting" countries de facto mobilize central bank facilities to other ends. The fact that Indian money growth slowed markedly in 2016–2019 as the economy decelerated is therefore a sign of central bank independence in India (Chart 2). An aggressive campaign to boost growth by expansionary monetary policy would likely have resulted in a markedly different monetary path.

Chart 2.



The flexibility afforded to monetary and fiscal policy by an inflation targeting regime is a key strength for India as it navigates through the pandemic and beyond. It has allowed the RBI to loosen monetary policy to support economic recovery. The downside from policy easing thus far has been relatively benign in terms of inflation and exchange rate developments. However, the continued success of India's monetary policy rests on a credible path to monetary policy normalization after the crisis subsides.

In the short term, the main uncertainty is how fast India recovers from the pandemic. The sooner this happens and the sooner the monetary policy accommodation, including the extraordinary measures such as the targeted long-term repos, can be lifted and inflation rates brought back to target, the less the risk that inflation expectations de-anchor further. Over the long term, key uncertainties include the prospects for the fiscal economy and the financial system, both of which have been hampered by the pandemic.

Tags

BOFIT, corona, corona pandemic, India, inflation targeting, monetary policy