



RESEARCH ARTICLE

INFLATION TARGETING IN INDIA: CURRENT SCENARIO

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ABSTRACT

Inflation targeting (IT), since its inception, has been a topic of much debate for economists all around the world. In this paper, the suitability of inflation targeting for an emerging economy like India is explored, pitching it against the multi-variable approach currently being followed. One of the foremost challenges in the present context of global economic crisis is the debate whether priority should be accorded to IT or financial stability.

INTRODUCTION

Inflation, an increase in the general level of prices, is considered detrimental. It erodes savings, discourages investment, stimulates capital flight (as domestic investors put their funds into foreign assets, precious metals, or unproductive real estate), inhibits growth, makes economic planning a nightmare, and, in its extreme form, provokes social and political unrest. Governments consequently have tried to squelch inflation by adopting conservative and sustainable fiscal and monetary policies. In recent years, many central banks, the makers of monetary policy, have adopted a technique called *inflation targeting* to control the general rise in the price level. In this framework, a central bank estimates and makes public a projected, or "target," inflation rate and then attempts to steer actual inflation toward that target, using such tools as interest rate changes. Because interest rates and inflation rates tend to move in opposite directions, the likely actions a central bank will take to raise or lower interest rates become more transparent under an inflation targeting policy. Advocates of inflation targeting think this leads to increased economic stability.

Technically, inflation targeting is a type of monetary policy framework. A Monetary Policy Framework shows how a central bank's policy instrument (like repo) works in the economy to influence (hit) a target (like inflation). The main features of inflation targeting framework are:

- Single target: inflation
- Single instrument used by the central bank: short term interest rate (repo)
- Single objective: Price Stability.

Objectives of the Study

- To Understand the concept of Inflation Targeting
- To review the literature in the context of Inflation Targeting
- To review the Current Scenario of Inflation Targeting in India

MATERIALS AND METHODS

The present paper is a descriptive research based on secondary data.

Review of Literature

Since its inception in 1990, a considerable amount of literature on inflation targeting (IT) has evolved. While some of these provide the modeling details as to how to frame economic policies for IT, some others highlight the pros and cons of IT, while the rest debate which parameters are to be considered for IT. Major advocates of IT reason that one of the most important advantages of having IT is the accountability and transparency it brings to policy making. It helps in putting a quantitative target, and a fixed target horizon. The central banks following inflation targeting have to publish a regular monetary policy report which includes the bank's forecast of inflation and other variables. A slight variant, flexible IT also helps to monitor other economic variables.

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Target variables of central banks with flexible IT include not only inflation but other variables as well, such as the output gap. Proponents of IT demonstrate empirical studies showing IT helped reduce the level and volatility of inflation in the countries that adopted it (Hammond, 2012). There is relatively robust empirical evidence that an explicit numerical target for inflation anchors and stabilizes inflation expectations (Svensson, 2007). This, in turn, would stimulate economic activity also. According to some, IT has also proved resilient during the financial crisis in some countries. Finally, IT gives independence to the Central Banks to target inflation using any instrument they want to (Ito, 2004). One of the countries where inflation targeting has been quite successful in reducing both inflation and output volatility is the UK. Adoption of IT conferred Central Banks the liberty to differ from government numeric. The publishing of the minutes of meeting between the Governor and the Chancellor to the public, helped in enhancing the Central Bank's credibility and thereby led to formation of lower inflation expectation across consumers (Sterne, 2004). By comparing the effectiveness before and after the Bank of England gained independence, Sterne showed that inflation targeting was successful even when the bank was not independent.

However, he observed that conditions in emerging economies are 'noisier'; hence the factors which led to the success in UK should not be directly generalized to these economies. The most damaging critique is that strictly following IT may give too much weight to inflation stabilization, prove detrimental to the stability of real economy or other possible monetary-policy objectives, hence credibility of the policy is questioned (Svensson, 2007). For countries like Japan, where persistent policies to raise the inflation rate may end up achieving a very high inflation rate eventually and IT might be detrimental to the economy. Also, there is great ambiguity as to which measure of inflation to target: there are different CPI numbers to target; choice of GDP deflator may not be appropriate as it is delayed. Another side-effect might be that the long-term interest rate might go up as a result (Ito, 2004). Also, IT is costly in terms of institutional and technical requirements, making the framework unsuitable for some emerging market economies. The financial crisis in 2008 made quite a few economists skeptical about IT and its application to large-scale financial shocks. While some were of the opinion that IT was altogether dead (Frankel, 2012), some others called for fixing certain policies of IT to make it flexible enough to handle shocks (Broadbent, 2013).

Emerging market economies often find it unnecessarily costly to implement the IT framework. This is because there are a number of pre-conditions that need to be satisfied for proper implementation of IT. These include institutional independence of the central bank, a well-developed technical infrastructure in terms of forecasting, modeling and data availability and an economy with fully deregulated prices, not overly sensitive to commodity prices and exchange rates, and with minimal dollarization. It also calls for a healthy financial system with sound banks and well-developed capital markets, with price stability as the overriding monetary policy goal and absence of fiscal dominance. In other words, to implement IT in an economy, the transmission mechanism needs to be smooth for the economy to reap the benefits of IT within a short period of time.

There needs to be broad domestic consensus on the prominence of inflation target, some basic understanding of the transmission mechanism and a reasonable capacity to affect short term interest rates. But evidence suggests that some of the inflation targeting emerging economies did not fulfill the preconditions in place before adopting IT. There have been large deviations from the standard IT framework by various Latin American inflation targeting countries which helped them deal with the 2008 recession and recover rapidly (Céspedes, Roberto and Velasco, 2012). Some of their policy responses for dealing with various economic problems have been the change in the monetary policy rate, programs of international reserves accumulation, exchange rate interventions and taxes on foreign purchases of fixed income securities. They have pushed for minimum reserve requirements, widening of acceptable collateral for central bank operations and provision of international liquidity. The fact that central banks had ample space to implement these "unconventional" measures helped to reduce uncertainty and limit negative effects of the recession on these countries. These nations returned to a pre-crisis state very quickly. Some central banks were reluctant to let the exchange rate to appreciate in order to reduce inflation pressures. Most Latin policymakers used both interest rate policy and reserve requirements at the same time for curtailing credit. Increasing rates would have attracted capital and appreciated exchange rates, while raising reserve requirements achieved the same target of curtailing credit without creating unwanted interest rate differentials.

Generally, IT is set between 1-3% for industrialized countries (Khan and Senhadji, 2000). It might be difficult to set a higher target and maintain it for India, as this might affect growth and exchange rates (Svensson, 2007). IT above a rate of 3-4% might incur welfare costs for the public at large. Target horizon for IT is also a concern for India, as it is subject to short-term economic and political shocks. Various economists have given their versions of how to model inflation targeting. In 2001, the IMF developed a two-country version of the Global Economy Model (GEM), a Dynamic Stochastic General Equilibrium (DSGE) model. Developed to address issues that involve both monetary and fiscal policy, it has been extensively used in the IMF to analyze the impacts of debt, fiscal stimulus, external shocks, pension reforms on domestic policies and explain the effects of IT. These models have been useful, but they have some noteworthy limitations, including that the current version of DSGE lacks linkages between the macro-economy and the financial sector (IEO, 2011).

If policy makers do believe these models' forecasts, they will always be handling a very well behaved economy that faces little problems because whatever the size of external shocks, it is only a matter of time for the market adjustment to pull the country out of the mess (Garcia, 2011). Hence, for an emerging country like India, considering the pros and cons of inflation targeting, modeling it on the basis of DSGE may lead to economic system failure in high intensity turmoil. The models can serve as good guides but many more factors would need to be considered. Moreover, in India the arguments against inflation are constantly neglecting the demographic aspect. In this context, there has been a constant flow of good research from Japan. Shirakawa (2012) argues that the economic profession does not make a distinction between the qualities of population in their models of economic growth.

The expansion of the working age population along with free trade led to rapid growth in advanced countries but things are changing since 1990s. The behavior of the ageing population is different from the young population, as is their productivity and consumption pattern, which impacts the current account, reflecting the savings-investment gap in the economy. The "spending wave" hypothesis is associated with young population and Shirakawa (2012) refers to empirical studies correlating inflation with population growth rate in 24 advanced countries. Bullard, Garriga and Waller (2012) find that a young population generates high inflation and ageing population places downward pressure on inflation. Ikeda and Saito (2012) using a dynamic general equilibrium model report that ageing lowers real interest rates in the economy, implying lowering of inflation. Finally, Nishimura (2011), argued that in Japan, the US, and some other countries, asset markets are correlated to the working age population, and that bubbles coincide with turning points in demographic trends. Blanchard (2010) has been advising countries to raise their inflation targets, because targets that are too low impact employment and growth.

Understanding Inflation Targeting

Many central banks adopted inflation targeting as a pragmatic response to the failure of other monetary policy regimes, such as those that targeted the money supply or the value of the currency in relation to another, presumably stable, currency. In general, a monetary policy framework provides a *nominal anchor* to the economy. A nominal anchor is a variable policymakers can use to tie down the price level. One nominal anchor central banks used in the past was a currency peg—which linked the value of the domestic currency to the value of the currency of a low-inflation country. But this approach meant that the country's monetary policy was essentially that of the country to which it pegged, and it constrained the central bank's ability to respond to such shocks as changes in the terms of trade (the value of a country's exports relative to that of its imports) or changes in the real interest rate. As a result, many countries began to adopt flexible exchange rates, which forced them to find a new anchor. Many central banks then began targeting the growth of money supply to control inflation. This approach works if the central bank can control the money supply reasonably well and if money growth is stably related to inflation over time. Ultimately, monetary targeting had limited success because the demand for money became unstable—often because of innovations in the financial markets. As a result, many countries with flexible exchange rates began to target inflation more directly, based on their understanding of the links or "transmission mechanism" from the central bank's policy instruments (such as interest rates) to inflation.

How does it work?

Inflation targeting is straightforward, at least in theory. The central bank forecasts the future path of inflation and compares it with the target inflation rate (the rate the government believes is appropriate for the economy). The difference between the forecast and the target determines how much monetary policy has to be adjusted. Some countries have chosen inflation targets with symmetrical ranges around a midpoint, while others have identified only a target rate or an

upper limit to inflation. All countries have set their inflation targets in the low single digits. An inflation target of zero is not recommended because it would not allow real interest rates to fall sufficiently to stimulate overall demand when a central bank is trying to boost the economy. A major advantage of inflation targeting is that it combines elements of both "rules" and "discretion" in monetary policy. This "constrained discretion" framework combines two distinct elements: a precise numerical target for inflation in the medium term and a response to economic shocks in the short term. Rather than focusing on achieving the target at all times, the approach has emphasized achieving the target over the medium term—typically over a two- to three-year horizon. This allows policy to address other objectives—such as smoothing output—over the short term. Thus, inflation targeting provides a rule-like framework within which the central bank has the discretion to react to shocks. Because of inflation targeting's medium-term focus, policymakers need not feel compelled to do "whatever it takes" to meet targets on a period-by-period basis.

What is required?

Inflation targeting requires two things. The first is a *central bank able to conduct monetary policy with some degree of independence*. No central bank can be entirely independent of government influence, but it must be free in choosing the instruments to achieve the rate of inflation that the government deems appropriate. Fiscal policy considerations cannot dictate monetary policy. The second requirement is *the willingness and ability of the monetary authorities not to target other indicators*, such as wages, the level of employment, or the exchange rate.

Having satisfied these two basic requirements, a country can, in theory, conduct a monetary policy centered on inflation targeting. In practice, the authorities may also take certain preliminary steps:

- Establish explicit *quantitative targets* for inflation for a specific number of periods ahead.
- Indicate clearly and unambiguously to the public that hitting the inflation target takes precedence over all other objectives of monetary policy.
- Set up a model or methodology for *inflation forecasting* that uses a number of indicators containing information about future inflation.
- Devise a *forward-looking operating procedure* through which monetary policy instruments are adjusted (in line with the assessment of future inflation) to hit the chosen target.

Present Scenario of Inflation Targeting In India

Why inflation targeting is controversial?

A unique and at the same time a controversial feature in inflation targeting is that the central bank should sideline all other objectives to ensure that the single goal of price stability is realized. This strategy makes the IT framework generally unacceptable in the developing world. This is because there are two problems while a developing country central bank adopt it. First, fighting inflation or price stability is one important objective of the general macroeconomic objective in fast growing developing economies.

The equally important objective is achievement faster economic growth. Second one is that generally there is conflict or trade-off between the objective of price stability and economic growth. Another limitation of inflation targeting in countries like India, it neglects the real cause of inflation – agricultural supply shocks which can't be solved by any monetary policy action. There is intense debate about the suitability of inflation targeting in developing economies on the one hand and on the other many economists argue that after the global financial crisis, inflation targeting has lost much of its relevance. A negative side of inflation targeting as a philosophy is that it openly accepts reduction of economic growth as a way to achieve price stability. But growth is as important as price stability. In this context, inflation targeting was introduced in India several years after the suggestion of its adoption by the Urjit Patel Committee. Following are the main features of the inflation targeting regime introduced in India.

The Monetary Policy Committee: The MPC would be entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level. Under the RBI Act, the Central Government, in consultation with the RBI, determines the inflation target in terms of the Consumer Price Index (CPI), once in every five years. This target would be notified in the Official Gazette.

Determination and notification of Inflation Target: In exercise of the powers conferred under the Reserve Bank of India Act, 1934, the Central Government, in consultation with RBI, has fixed the inflation target for the period beginning from August 5, 2016 and ending on the March 31, 2021, as under:

- Inflation Target: Four per cent.
- Upper tolerance level: Six per cent.
- Lower tolerance level: Two per cent.

While setting the above target, the government elaborated that inflation targeting in India will consider the growth dimensions also.

What is the condition for a failed monetary policy with respect to the set target?

The fresh element in the government notification is the interpretation of monetary policy failure and the launch time for correction measures. As per the policy, if inflation goes above 6% or goes below 2% for three consecutive quarters, then it will be treated as the failure of the RBI's monetary policy. Counteractive measures should be initiated in such a scenario.

What the RBI to do if the inflation target is not met?

The new notification also prescribes the procedure to be followed by the RBI if the target is missed. "Where RBI fails to meet the inflation target, it shall set out a report to the Central Government stating the reasons for failure to achieve the inflation target; remedial actions proposed to be taken by RBI; and an estimate of the time-period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions."

What is the time period for a set target?

The Central Government, in consultation with the RBI, determines the inflation target in terms of the Consumer Price Index (CPI), once in every five years. This target would be notified in the Official Gazette. The current target will end on March 31, 2021. - See more at: <http://www.indianeconomy.net/splclassroom/251/inflation-targeting-in-india-what-are-the-features-and-why-it-is-controversial/#sthash.ILa11I2I.dpuf>

Advantages Expected

- The decision to retain the inflation target would impart continuity to policy setting amidst the impending shift towards a MPC-determined policy rate. It allows the MPC to recognise the short-run tradeoffs between inflation and growth but enables it to rein in prices in the long run and over the course of business cycles.
- This target also allows (it) to accommodate unanticipated short-term shocks even while nudging public inflation expectations on the centre of the range, to which the monetary policy will return the economy over the medium term, leading to transparency and predictability.
- The range also accommodates data limitations, projection errors, shortrun supply gaps and instability in agriculture production, an important factor for CPI inflation. Food articles account for a major weight in the indices.

Statutory Backing

The earlier agreement, in the form of a memorandum of understanding, has now been given statutory backing with the latest notification by an amendment to the RBI Act. The amendment lays down that the central government will, in consultation with RBI, determine the inflation target once every five years. The preamble in the RBI Act, as amended by the Finance Act, 2016, now provides that the primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of growth, and to meet the challenge of an increasingly complex economy. RBI would, accordingly, operate a monetary policy framework. Thus, now there is a statutory basis for a monetary policy framework and the Monetary Policy Committee.

Monetary Policy Committee

The amendment to the RBI Act provides for the creation of a six-member MPC chaired by the RBI governor, who will have a casting vote in the event of a tie. Of the six, three will be from RBI — the governor, a deputy governor and another officer. The other three members will be appointed by the central government on the recommendations of a search-cum-selection committee. They will be chosen from experts in economics, banking, finance and monetary policy.

Target practitioners?

Central banks from advanced, emerging, and developing economies and from every continent have adopted inflation targeting (see table). Full-fledged inflation targeters are countries that make an explicit commitment to meet a specified inflation rate or range within a specified time frame, regularly announce their targets to the public, and have institutional arrangements to ensure that the central bank is accountable for meeting the target.

Country	Inflation targeting adoption date	Inflation rate at adoption date (percent)	2010 end-of-year inflation (percent)	Target inflation rate (percent)
New Zealand	1990	3.30	4.03	1 - 3
Canada	1991	6.90	2.23	2 +/- 1
United Kingdom	1992	4.00	3.39	2
Australia	1993	2.00	2.65	2 - 3
Sweden	1993	1.80	2.10	2
Czech Republic	1997	6.80	2.00	3 +/- 1
Israel	1997	8.10	2.62	2 +/- 1
Poland	1998	10.60	3.10	2.5 +/- 1
Brazil	1999	3.30	5.91	4.5 +/- 1
Chile	1999	3.20	2.97	3 +/- 1
Colombia	1999	9.30	3.17	2 - 4
South Africa	2000	2.60	3.50	3 - 6
Thailand	2000	0.80	3.05	0.5 - 3
Hungary	2001	10.80	4.20	3 +/- 1
Mexico	2001	9.00	4.40	3 +/- 1
Iceland	2001	4.10	2.37	2.5 +/- 1.5
Korea, Republic of	2001	2.90	3.51	3 +/- 1
Norway	2001	3.60	2.76	2.5 +/- 1
Peru	2002	-0.10	2.08	2 +/- 1
Philippines	2002	4.50	3.00	4 +/- 1
Guatemala	2005	9.20	5.39	5 +/- 1
Indonesia	2005	7.40	6.96	5 +/- 1
Romania	2005	9.30	8.00	3 +/- 1
Serbia	2006	10.80	10.29	4 - 8
Turkey	2006	7.70	6.40	5.5 +/- 2
Armenia	2006	5.20	9.35	4.5 +/- 1.5
Ghana	2007	10.50	8.58	8.5 +/- 2
Albania	2009	3.70	3.40	3 +/- 1

Sources: Hammond, 2011; Roger, 2010; and IMF staff calculations.

Targeting inflation

There are 28 countries that use inflation targeting, fixing the consumer price index as their monetary policy goal. Three other countries—Finland, the Slovak Republic, and Spain—adopted inflation targeting but abandoned it when they began to use the euro as their currency. The first country to adopt inflation targeting was New Zealand, in December 1989. The only central banks to have stopped inflation targeting once they started it are Finland, Spain, and the Slovak Republic in each case after they adopted the euro as their domestic currency. Armenia, the Czech Republic, Hungary, and Poland adopted inflation targeting while they were making the transition from centrally planned to market economies. Several emerging market economies adopted inflation targeting after the 1997 crisis, which forced a number of countries to abandon fixed exchange rate pegs.

Many economies use an inflation target to define their monetary policy framework but are unable to maintain the inflation target as the foremost policy objective. This monetary policy regime is often referred to as “inflation targeting light” (ITL). The ITL countries choose not to adopt a fixed exchange rate because it would leave them vulnerable to a speculative attack, but a monetary target is not practical due to the instability in money demand. Yet they do not become full-fledged inflation targeters because of constraints, such as the absence of a sufficiently strong fiscal position. Often, ITL is used as a transitional approach—aiming at maintaining monetary stability until the implementation of structural reforms in support of a single nominal anchor. Poland, for example, switched from monetary targeting to ITL before making the full transition to inflation targeting. There are also a number of central banks in more advanced economies—including the European Central Bank, the U.S. Federal

Reserve, the Bank of Japan, and the Swiss National Bank—that have adopted many of the main elements of inflation targeting, and several others are moving toward it. Although these central banks are committed to achieving low inflation, they do not announce explicit numerical targets or have other objectives, such as promoting maximum employment and moderate long-term interest rates, in addition to stable prices.

Conclusion

It is difficult to distinguish between the specific impact of inflation targeting and the general impact of more far-reaching concurrent economic reforms. Nonetheless empirical evidence on the performance of inflation targeting is broadly, though not totally, supportive of the effectiveness of the framework in delivering low inflation, anchoring inflation expectations, and lowering inflation volatility. Moreover, these gains in inflation performance were achieved with no adverse effects on output and interest volatility. Inflation targeters also seem to have been more resilient in turbulent environments. Recent studies have found that in emerging economies, inflation targeting seems to have been more effective than alternative monetary policy frameworks in anchoring public inflation expectations. Furthermore, the monetary policy of inflation targeters appeared to be more suited to dealing with the recent financial crisis. In some countries, notably in Latin America, the adoption of inflation targeting was accompanied by better fiscal policies. Often, it has also been accompanied by the enhancement of technical capacity in the central bank and improvement of macroeconomic data. Because inflation targeting also depends to a large extent on the interest rate channel to transmit monetary policy, some emerging economies also took steps to strengthen and develop the financial sector.

Thus, the monetary policy outcomes after the adoption of inflation targeting may reflect improved broader economic, not just monetary, policymaking. Inflation targeting has been successfully practiced in a growing number of countries over the past 20 years, and many more countries are moving toward this framework. Over time, inflation targeting has proven to be a flexible framework that has been resilient in changing circumstances, including during the recent global financial crisis. Individual countries, however, must assess their economies to determine whether inflation targeting is appropriate for them or if it can be tailored to suit their needs. For example, in many open economies, the exchange rate plays a pivotal role in stabilizing output and inflation. In such countries, policymakers must debate the appropriate role of the exchange rate and whether it should be subordinated to the inflation objective.

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