Flexible Inflation Targeting

What is the issue?

- The 4% and +/- 2% target cycle for inflation under the Flexible Inflation Targeting (FIT) approach comes to an end this fiscal (March 31, 2021).
- With the government tasked to notify the revised numbers, here is a look at how the target so far has worked.

What is FIT?

- The Flexible Inflation Targeting (FIT) approach has served the RBI's monetary policy for the last four years.
- Inflation was the primary, clear target of this approach.
- The FIT worked with a band that specified a target for inflation at an average of 4%.
- It was however open to swinging up or down by two percentage points.

How does it work?

- The adoption of FIT through a legislative mandate on September 29, 2016 was a landmark decision.
- It worked as a milestone in the monetary and fiscal interface.
- India since then followed a contractual approach of inflation targeting.
- Under this, the government decides and notifies the target.
- It gives the RBI the operational independence to operate its policy instruments to deliver on the agreed target.

How has FIT performed?

- Since the inception of FIT in 2016, GDP growth starting 2016-17 and ending 2019-20 stood at 8.26, 7.04, 6.12 and 4.18 (all in Y-o-Y and in percentage terms).
- In the same period, the average inflation rate was at 4.5, 3.6, 3.4 and 4.8 (in percentage terms).
- So in the first four years, the mandate has been met.
- To that extent, it can be said that the monetary policy has been effective.

What is the recent inflation scenario?

- The COVID-19 pandemic has put severe pressure on the monetary policy objective.
- There was an unprecedented contraction in the growth rate of 23.9% in Q1 and 7.5% in Q2 of 2020-21, and an estimated contraction of 7.7% for fiscal 2020-21.
- Worryingly, the headline inflation rate remained above the upper band of 6% for eight consecutive months during the period April–Nov 2020.
- However, the December 2020 CPI inflation is at 4.59% on Y-o-Y basis.
- This was mainly on account of deceleration in food inflation by 3.87%.
- The Monetary Policy Committee (MPC) in its December 2020 resolution had stated that the inflation rate will come down to 5.8% in Q4 of 2020-21, with risks broadly balanced.
- Thus, the RBI is hopeful of returning to the target as soon as the supply side bottlenecks ease.

Why should FIT continue?

- FIT has worked reasonably well with the average of 4% and a band of +/- 2%.
- A reasonable band of 2% on the lower side and 6% on the upper side gives the RBI manoeuvrability for inflation management.
    - This is especially given the fact that India has many uncontrollable variables, most notably monsoons.
    - Besides food inflation, fuel inflation is also dependent upon the volatility of crude oil prices.
- Also, 4% headline inflation with an upper ceiling of 6% keeps the core inflation (headline inflation minus food and fuel inflation) at an appropriate level.
    - This is because there is a co-movement of core inflation with the headline inflation and vice versa.
- Any increase in the band above 6% will put pressure on the RBI in anchoring inflation expectations.
- On the lower side of the band, any inflation rate lower than 2% has the potential risk of the economy entering in a deflationary situation.
- Prior to the adoption of FIT, the RBI did not have the exposure in terms of responding to the CPI inflation.
- Earlier, WPI was taken as inflation measurement. However, CPI gives a weightage of around 46% to food inflation on which the RBI has no control.
- Over the four-year period since FIT adoption, the RBI's CPI inflation forecasting has been reasonably successful.
- RBI has also been effective in anchoring inflation expectation in a three-month and one-year ahead time frame.

What lies ahead?

- FIT should not be considered as a statistical measure to balance the risk of inflation alone.
- In many ways, it is a barometer of measuring the quality of macroeconomic management particularly in a country where poverty predominates.
- What is required is not the change in FIT but an effective fiscal and monetary interface with responsible and functional autonomy to the RBI.

Source: BusinessLine