Reviewing the Inflation Targeting

Why in news?

Recently various studies are evaluating the efficacy of Monetary Policy as the Inflation Target agreement ends on March 31, 2020.

What is Inflation Targeting?

- It is the process of adjusting monetary policy for achieving long-term economic growth by maintaining price stability.
- In 2016, the Centre and RBI concluded a four year agreement to maintain the inflation in the range of 2% to 6%.
- India engaged with inflation since 1950s, when it planned to industrialise the economy to meet the challenge of inflation.

What is the issue with Inflation Targeting?

- The economic model that underlies inflation targeting is that inflation occurs when the economic activity takes place at a greater level than the natural level of output.
- But the feature of this theory of inflation is that the natural level of output cannot be observed.
- When asked how output is actually higher, the response is inflation is rising which reflects that the phenomena is based on faith not on scientific evidence.
- Despite this logical vulnerability, inflation targeting is a reality in the policy of inflation control.

Whether India has achieved its inflation targets?

- Inflation in India entered the prescribed band of 2% to 6% two years before inflation targeting was adopted in 2016-17.

- But inflation had fallen steadily since 2011-12, halving by 2015-16.
- This suggests that there is a mechanism which drives the inflation other than inflation targeting.
- The view is further strengthened by the fact that the decline in inflation over the five years was due to the relative price of food even in the absence of inflation targeting.

- RBI data on household expectations expects that the price will be well above 6% for twelve years up to 2020.
- But the prices soared up only after March 2020, when the COVID-19 lockdown was announced.
- This was because the supply chains were disrupted due to the lockdown.
- Therefore inflation targeting is a not reality in that it is the Centre's stated policy of inflation control.

What are the other arguments which support this?

- The economy's trend rate of growth actually began to decline after 2010-11 and sharply falling interest could do nothing to revive growth.
- The swing in the real interest rate of over 5 percentage points in 2013-14 was powered further in 2016.
- This could have contributed to a declining private investment rate.
- The exports and employment fared poorly since inflation targeting became official.
- Finally, NPAs were rising since 2016 when central bank focussed on inflation.

- It began to lose control over the financial stability and the crises faced by o IL&FS, PMC Bank, PNB and YES Bank reflects this.

What are the takeaways from this?

- Inflation control will always be relevant but there is no conclusive evidence that the policy has worked in India.
- Secondly, the presumed benefits of low inflation are yet to surface.
- Hence the strategy must be to raise the interest rates, with all negative consequences.

Source: The Hindu