Success of Inflation Targeting

Why in news?

The government can continue with the current Monetary Policy regime after it successfully completed its five year term.

What is the history behind the Inflation targeting?

- In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a Constitutional basis for the implementation of the flexible inflation targeting (FIT) framework.
- The act allows the Centre to set the inflation target in consultation with the RBI once every five years.
- On that basis, India's inflation target was set at 4 % with a 2 % extension in the upper bound and 2 % in the lower bound.

Was this policy implementation successful?

- The average inflation rate measured through the GDP deflator which was 5.69 % five years in the pre-inflation targeting period has declined to 3.47 % in the last five years.
- India is one of the highest achievers of reducing inflation when compared to other Asian Nations..
- Consumer Price Index (CPI) inflation declined from 8.26 % during the 2011-2015 to 4.99 % in 2016-2019, a 3.27 % point fall.
- This is highest among both inflation-targeting countries as well as those that did not adopt it.
- India has also achieved a substantial fall in average inflation volatility during the said period.
- It was 7.93 % for five years before inflation targeting now declined to 0.89 % during the inflation targeting regime.
- This fall is highest compared to Indonesia, Thailand, Philippines and Korea.

How is this possible?

- This is possible because of the Central government's strong coordination with monetary policy committee despite fiscal dominance in developing countries like India.

- This maintenance of a stable inflation rate provides certainty to inflation and investment decisions for sustainable growth.
- However, some critics of inflation targeting feel that its sole focus on price stability ignores growth imperatives.
- But the RBI Act rightly opted for maintaining price stability as its prime objective while giving due importance to economic growth.
- The real GDP growth did not decline during this period which was 6.50 % during 2011-2015 increased marginally to 6.63 % during 2016-2019.

How has transparency got improved?

- The Inflation Expectations Survey of Households (IESH) shows that the inflation expectation has been forward-looking in the post inflation targeting period in India.
- The lagged impact of past inflation expectations on current inflation expectations was significantly higher before the adoption of inflation targeting.
- This lagged dependency has fallen in the FIT framework regime which suggests that households are increasingly using the current and future information to form inflation expectations.
- This implies that transparency in monetary policy is helping to reduce inflation expectations.

How is this transparency is possible?

- RBI is following the international practices to increase communication with financial markets and the citizens.

- The frequency of the Monetary Policy Committee meeting is set at 6 times per year which is in line with most of the developed countries.
- RBI takes two weeks to release minutes of the proceedings of MPC, which provides a forecast of CPI inflation and GDP growth.
- Further, every 6 months, the RBI publishes a Monetary Policy Report where it explains the sources of inflation and provides an inflation forecast for 6-18 months ahead.

What can we infer from this?

- The inflation targeting in India has been a success story and India must continue with the FIT regime.
- The RBI has toiled to achieve its credibility and has rightly earned the goodwill and confidence of the financial markets around the world.
- The review committee should try to find out areas of further improvement in the monetary policy framework which will strengthen the MPC to achieve the

inflation target.

- It should also disclose the models used in inflation and GDP forecasting as other inflation-targeting countries do.
- Further, the RBI may include a forecast of core inflation in the minutes.

Source: Business Line

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