RE-EVALUATING INFLATION TARGETING

(PRELIMS: Economic & Social Development – Sustainable Development, Poverty, Inclusion, Demographics, Social Sector Initiatives, etc.)

Context:

- Term of the original agreement between the Centre and the Reserve Bank of India (RBI) on inflation targeting ends on March 31, 2021.
- The inflation rate has remained within the prescribed band of 2% to 6% since 2016, when inflation targeting was introduced
- RBI has succeeded in anchoring inflationary expectations. In fact, the lower inflation rate has been seen as the outcome of the latter.

Inflation TARGETING:

- Inflation-targeting agreement was taken place in February 2015 between government and RBI and consequently an amendment in RBI Act in May 2016, gave the central bank a statutory inflation target.
- India formally adopted flexible inflation targeting (FIT) in June 2016 to place price stability, defined in terms of target CPI (consumer price index) inflation, as the primary objective of the monetary policy.
- As per the current mandate, the RBI has to maintain headline inflation at 4 per cent by March 31, 2021, with an upper tolerance of 6 per cent and a lower tolerance of 2 per cent.

India and the inflation target:

- Inflation targeting is only one of a set of imagined inflation control policies.
- Globally, inflation control became *de rigueur* after the high inflation that followed the oil shock in the early 1970s.
- In fact, well before inflation targeting was advanced, Milton Friedman had brought inflation control to the centre stage through his relentless highlighting of the ever-lurking threat of inflation.

- On the other hand, in India, policymakers had engaged with inflation since the 1950s, when plans to industrialise met the challenge of inflation.
- Thus, scepticism about inflation targeting as a strategy of inflation control does not imply that inflation control is not a legitimate objective of economic policy.
- While the monetarist Friedman had prescribed money-supply targeting as the means to control inflation, inflation targeting prescribes the use of the interest rate to target inflation.
- There is, however, the vague suggestion that it is likely to be more effective than the monetarist approach, as the instrument, the policy interest rate, is under the direct control of the central bank.

Logical vulnerabilities:

- However, what has remained hidden in public discourse is the economic model that underlies inflation targeting.
- This model revolves around the proposition that inflation reflects “overheating”, or economic activity at a level greater than the “natural” level of output, having been taken there by central banks that have kept interest rates too low, at a level lower than the “natural” rate of interest.
- From this follows the recommendation that the cure to inflation is to raise the rate of interest set by the central bank, the so-called policy rate, which in India is termed ‘repo’ rate.
- A feature of this theory of inflation is that its central construct, the natural level of output, is unobservable.
- This makes it next to impossible to verify the explanation, which is also self-referential.
- Despite this logical vulnerability, inflation targeting is a reality in that it is the Centre’s stated policy of inflation control.

A mirage success:

- Inflation targeting has been successful on the grounds that the inflation rate has remained within the band agreed to between the government and the RBI, and whether it has been achieved by “anchoring inflation expectations”.
- However, Inflation in India entered the prescribed band of 2% to 6% two years before inflation targeting was adopted in 2016-17.
- In fact, inflation had fallen steadily since 2011-12, halving by 2015-16.
- This by itself suggests that there is a mechanism driving inflation other than what is imagined in inflation targeting.
- The view is further strengthened by the finding that the decline in inflation over the five years concerned was led by the relative price of food.
- While falling food-price inflation per se does not rule out the possibility that expectations of inflation may have fallen in this period.

- But it would be difficult to explain why expectations would have fallen so sharply even in the absence of inflation targeting, considered essential for anchoring expectations.
- Finally, it is the flaring up of both inflation and inflation expectations after March 2020, when the COVID-19 lockdown was announced, that makes it difficult to believe the thesis of an "overheating" economy.
- On the other hand, we can explain the flaring up of inflation in terms of food prices, as supply chains were disrupted due to the lockdown.

Conflicting patterns shown:

> Over the past five years, inflation in India has been controlled via inflation targeting and its benefits will be analyzed through five variables, namely growth, private investment, exports, non-performing assets (NPAs) of commercial banks, and employment.

Growth:

- The economy's trend rate of growth actually began to decline after 2010-11.
- So, inflation targeting could not have caused it, but it is of interest that sharply falling inflation could do nothing to revive growth, belying the proposition that low inflation is conducive to growth.

Investment:

- For investment, there is reason to believe that higher interest rates, the toolkit for inflation targeting, may have been harmful.
- The swing in the real interest rate of over 5 percentage points in 2013-14 was powered further in 2016, when inflation targeting was adopted, and could have contributed to a declining private investment rate.
- It is interesting that policy entrepreneurs assert that the benefits of low inflation may be considerable for private investment.

Export and employment:

Exports and employment performed fairly poor since inflation targeting became official.

NPA's (non performing assets):

- It has long been recognized that a central bank focusing on inflation may lose control of financial stability.

- NPAs have grown since 2016, and the cases of IL&FS, PMC Bank, PNB and YES Bank suggest that poor management and malfeasance in the financial sector could escape scrutiny when the central bank hunkers down to inflation targeting.

Conclusion:

- Thus, Inflation control will always be relevant but there is no conclusive evidence that the policy has worked in India. The presumed benefits of low inflation are yet to surface.
- So, we should guard against the possibility that inflation targeting may deliver the worst of all worlds, i.e., raising interest rates, with all negative consequences, without lowering inflation.
- Lastly, assuming that the decline in inflation in India is due to inflation targeting would stand in the way of acknowledging the source, the vagaries of the price of food.


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