drishti

Flexible Inflation Target

Why in News

The **Reserve Bank of India (RBI)** in its **Currency and Finance (RCF) report** for the year 2020-21 has said that the **current inflation target band (4% +/-2%) is appropriate for next 5 years.**

Key Points

- **Inflation Targeting:**
    - **Meaning:**
        - It is **a central banking policy** that revolves around **adjusting monetary policy to achieve a specified annual rate of inflation.**
        - The principle of inflation targeting is **based on the belief that long-term economic growth is best achieved by maintaining price stability,** and price stability is achieved by controlling inflation.
    - **Strict inflation targeting** is adopted when the central bank is only concerned about keeping inflation as close to a given inflation target as possible, and nothing else.
    - **Flexible inflation targeting** is adopted when the central bank is to some extent also concerned about other things, for instance, the stability of interest rates, exchange rates, output and employment.

- **India's Flexible Inflation Target Framework:**
  - **Background:**
    - The central bank and the government **agreed in 2015 on a policy framework** that stipulated a primary objective of ensuring price stability while keeping in mind the objective of growth.
    - The **Flexible Inflation Target (FIT) was adopted in 2016.** This has **put India on par with other nations in terms of flexible inflation targeting.**
    - The **Reserve Bank of India Act, 1934 was amended to provide a statutory basis** for a FTI framework.
    - The amended Act **provides for the inflation target to be set** by the Government, in consultation with the RBI, **once every five years.**
  - **The FIT Framework:**

    India **adopted a flexible inflation targeting mandate of 4 (+/-2) percent** and headline **consumer price inflation** was chosen as a **key indicator.**
  - **Purpose:** Inflation targeting is known to bring more stability, predictability, and transparency in deciding monetary policy.

    This is because of the argument that rising prices create uncertainties and adversely affect savings and investments.
  - **Fixed Accountability:** The framework made the RBI more accountable to explain to the government if it fails to meet the inflation targets.

    The flip side of this is such targets will restrain the RBI from taking any tight or accommodating monetary policy stance.
- **RBI's Stand (Findings of the RCF Report):**
  - The **trend inflation has fallen from above 9% before FIT to a range of 3.8-4.3 % during FIT,** indicating that **4% is the appropriate level of the inflation target** for the country.
  - An **inflation rate of 6% is the appropriate upper tolerance limit** for the inflation target.
    - On the other hand, **a lower bound above 2% can lead to actual inflation frequently dipping below the tolerance band.**
    - While, **a lower bound below 2% will hamper growth,** indicating that an **inflation rate of 2% is the appropriate lower tolerance bound.**
  - During the FIT period, **monetary transmission has been full and reasonably swift** across the money market (trading in very short-term debt instruments) but less than complete in the **bond markets.**

    While there has been an improvement in transmission to lending and deposit rates of banks, **external benchmarks** across all categories of loans and deposits could improve transmission.

Monetary Policy

- It is the macroeconomic policy laid down by the central bank. It involves **management of money supply and interest rate** and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.
- In India, monetary policy of the Reserve Bank of India is **aimed at managing the quantity of money in order to meet the requirements of different sectors** of the economy and to increase the pace of economic growth.
- The RBI implements the monetary policy through **open market operations, bank rate policy, reserve system, credit control policy, moral persuasion** and through many other instruments.

Accommodative and Tight Monetary Policy

To avoid inflation, most central banks alternate between the accommodative monetary policy and the tight monetary policy in varying degrees to encourage growth while keeping inflation under control.

- **Accommodative monetary policy** is adopted when central banks expand the money supply to boost the economy.
  - These measures are meant to make money less expensive to borrow and encourage more spending.
- A **tight monetary policy** is implemented to contract economic growth.
  - Converse to accommodative monetary policy, a tight monetary policy involves increasing interest rates to constrain borrowing and to stimulate savings.

Monetary Policy Committee

- It is **a statutory and institutionalized framework under the Reserve Bank of India Act, 1934,** for maintaining price stability, while keeping in mind the objective of growth.
  - The **Governor of RBI is ex-officio Chairman** of the committee.
- The MPC **determines the policy interest rate (repo rate)** required to achieve the **inflation target (4%).**
  - An RBI-appointed committee led by the **then deputy governor Urjit Patel in 2014 recommended** the establishment of the Monetary Policy Committee.

Way Forward

- In the conduct of monetary policy in an open economy setting, **foreign exchange reserves** and associated liquidity management are key, there is a need to enhance the RBI's sterilisation capacity to deal with surges in capital flows.
- The primary focus of FIT on price stability augurs well for further liberalisation of the capital account and eventual internationalisation of the Indian rupees.

Source: TH