Flexible Inflation Targeting Framework

For Prelims: **Reserve Bank of India**, **Flexible inflation targeting**, **Monetary Policy Committee**, **Food inflation**

For Mains: Significance of India’s Flexible Inflation Targeting framework, Monetary–fiscal coordination in managing supply shocks

Source:DD

Why in News?

The **Reserve Bank of India (RBI)** has affirmed the successful performance of the **Flexible Inflation Targeting (FIT) framework** in maintaining price stability. A recent discussion paper from RBI indicated that, since its introduction, inflation remained low and stable, averaging around 4% until the end of 2019.

What is the RBI’s Flexible Inflation Targeting (FIT) Framework?

- **Context: Post the Global Financial Crisis, India experienced a mix of persistently high inflation and sluggish growth, prompting debate on improving monetary policy credibility.**
  - Urjit Patel Committee Report (2014) recommended adopting Inflation Targeting with inflation as the nominal anchor for monetary policy.
- **Adoption of FIT:** India formally adopted FIT in 2016 through amendments to the RBI Act, 1934.
  - The adoption followed a Monetary Policy Framework Agreement signed between the Government of India and the RBI in 2015.
- **Need for Flexibility:** Unlike strict inflation targeting, FIT allows short-term deviations from the target to accommodate supply-side shocks (e.g., food price spikes, fuel volatility), and economic crises (e.g., pandemic, war).
  - It provides room to prioritize growth during downturns while returning to the inflation target path over the medium term.
- **Target & Tolerance Band:** The **4% inflation target with a tolerance band of ±2% balances price stability and growth,** aligning with global norms for emerging economies. Since adopting FIT in 2016, inflation volatility has decreased.
  - **The current band** provides flexibility to absorb shocks from food, fuel, and global volatility, with 94% of inflation staying within this range.
    - Given India's high food share and potential future volatility, a wider band remains essential for stability.

Key Features of FIT Framework:

Component	**Details**
Target Metric	Consumer Price Index (CPI) (headline inflation)

	based inflation.
Mandate	Maintain CPI-based inflation target at 4% with a tolerance band of ±2% (i.e., 2%–6%).
Review Period	Every five years
Accountability Mechanism	Breach of the target band for 3 consecutive quarters triggers a formal report to the government.
Decision-Making Body	[Monetary Policy Committee (MPC)]
First Review Outcome (2021)	Target of 4%, with tolerance band of ±2% retained for 2021–2026.

How has the FIT Framework Performed in India?

Successes

- **Disinflation Achieved**: Average inflation under FIT (2016–2025) was **4.9%**, down from **6.8%** in the pre-FIT period.
- **Anchoring Expectations**: FIT helped stabilize **long-term inflation expectations** among consumers and investors, reducing uncertainty.
- **Institutional Transparency**: MPC voting, and communication improved RBI's policy credibility.
- **Policy Flexibility**: During Covid-19 and the **Russia-Ukraine war,** RBI shifted focus between inflation and growth based on macroeconomic needs.
- **Public Accountability**: In 2022, RBI formally reported to the Government after breaching the upper band for 5 consecutive quarters.

Challenges

- **Exogenous Shocks**: Pandemic and global conflicts led to breaches of the upper threshold despite domestic policy prudence.
- **CPI Base Outdated**: **Current base year (2012)** does not reflect recent consumption patterns; food weight may be overestimated.
- **Periodic Dissent in MPC**: Within MPC members, significant voting differences and occasional government interference highlight challenges in reaching a consensus, which impacts the effectiveness of the FIT framework.

What are the Key Debates Regarding RBI's FIT Framework?

Headline Inflation vs Core Inflation as Target

- **Debate**: Should the RBI continue to target **headline inflation** **(including food & fuel)** or switch to **core inflation** **(excluding food & fuel)**.
- **Arguments for Headline Inflation: Food and fuel account for over 50% of CPI; excluding them would make the target unrepresentative.**
    - Persistent food inflation can spill into core prices through wages and markups. It aligns with global practice, converges with core inflation over time, and provides clear communication for households and businesses, making it a more representative and effective guide for monetary policy.
- **Arguments for Core Inflation:** It is more stable and less volatile as it reflects demand-side pressures. Food and energy prices are largely driven by supply shocks and don't respond well to interest rate changes.
    - Targeting core inflation helps avoid overreaction to temporary spikes and ensures better resource allocation by reducing policy distortions.

Point Target vs Range-Only System

- **Debate**: Should RBI continue with a **point target (4%) within a band**, or adopt a **range-only target** (e.g., 3%–6%)?
- **Arguments for Point Target**: Acts as a **clear anchor** for inflation expectations. Promotes **policy clarity** and accountability. Global trend supports **point target with tolerance band**.
    - Switching to a range could be interpreted as a weakening of commitment to price stability. Global investors and markets may view it as signaling RBI's loss of control or political interference.
- **Arguments for Range-Only**: Provides **greater flexibility** in uncertain conditions. Explicit ranges acknowledge forecasting limitations and high global economic volatility.
    - It avoids unnecessary **policy tightening** in short-term overshoots. Can better integrate goals like employment or output growth in times of economic stress.

What Should be the Way Forward for Better FIT Framework?

- **Revise CPI Base Year:** Update CPI Base Year to reflect structural changes in consumption and improve measurement accuracy.
- **Retain Core Tenets:** Using the inbuilt adaptability of FIT to respond to shocks without diluting the anchor.

- **Strengthen Policy Credibility:** Ensuring consistency and avoiding frequent changes to maintain public and market trust.
- **Address Food-Energy Shocks:** Focusing on better supply-side management since food and fuel dominate India's CPI basket.
    - Government supply-side actions should complement RBI's tightening to control spillover effects.

Drishti Mains Question:

Q. India's flexible inflation targeting framework has improved monetary policy credibility, yet faces emerging challenges amid a volatile global economy. Discuss

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q 1. The lowering of Bank Rate by the Reserve Bank of India leads to (2011)

(A) More liquidity in the market
(B) Less liquidity in the market
(C) No change in the liquidity in the market
(D) Mobilization of more deposits by commercial banks

Ans: A

Q.2 Consider the following statements: (2020)

1. The weightage of food in Consumer Price Index (CPI) is higher than that in Wholesale Price Index (WPI).
2. The WPI does not capture changes in the prices of services, which CPI does.
3. Reserve Bank of India has now adopted WPI as its key measure of inflation and to decide on changing the key policy rates.

Which of the statements given above is/are correct?

(a) 1 and 2 only
(b) 2 only
(c) 3 only
(d) 1, 2 and 3

Ans: (a)

Q 3. If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do? (2020)

1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate

Select the correct answer using the code given below:

(A) 1 and 2 only
(B) 2 only
(C) 1 and 3 only
(D) 1, 2 and 3

Ans: B

Q. In India, which one of the following is responsible for maintaining price stability by controlling inflation? (2022)

(a) Department of Consumer Affairs
(b) Expenditure Management Commission
(c) Financial Stability and Development Council
(d) Reserve Bank of India

Ans: (d)

Q. Which of the following statements is/are correct regarding the Monetary Policy Committee (MPC)? (2017)

1. It decides the RBI’s benchmark interest rates.
2. It is a 12-member body including the Governor of RBI and is reconstituted every year.
3. It functions under the chairmanship of the Union Finance Minister.

Select the correct answer using the code given below:

(a) 1 only
(b) 1 and 2 only
(c) 3 only
(d) 2 and 3 only

Ans: (a)

Mains

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. **(2019)**