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