Inflation Targeting and Emerging Economies with Special Reference to India

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Abstract

Inflation has been a cause of concern for almost all the countries in recent times. To tackle the problem of inflation the strategy of inflation targeting has been devised. Inflation targeting has been a topic of debate since its starting. In this paper the advantages and disadvantages of this strategy have been explained with an attempt to explore its relevance for an emerging country with special reference to India where inflation is more of a supply side phenomenon rather than a demand pulled one.

Keywords — *Inflation targeting, monetary policy, central bank, economic growth, developing countries, MPC.*

Materials and Methods— *The study is based on secondary sources of data/information. Different books, journals, related research materials, websites and newspapers have been consulted in order to make the study an effective one.*

I. INTRODUCTION

Inflation means a persistent rise in general price level. Most countries try to maintain a low level of inflation in order to stimulate the growth in the economy. However, unanticipated and speedier rise in price level leads to low rate of sustained economic growth as it entails substantial costs in terms of redistribution of income in favour of wealthy. One of the goals of modern Governments is to control inflation and ensure price stability in the economy. To accomplish this job, a policy strategy of inflation targeting has been devised where the monetary policy concentrates on the primary aim of controlling inflation. This policy was initially adopted by New Zealand in 1989, followed by many countries. This strategy of inflation targeting has some advantages as well as disadvantages. This paper attempts to describe benefits as well as shortcomings of the strategy of inflation targeting and its relevance in developing countries with special reference to India.

II. WHAT IS INFLATION TARGETING

Monetary policy consists of the actions of a central bank, currency board or other regulatory committee that determines the size and rate of growth of the money supply in order to ensure price stability and general trust in the currency. Authorities often focus on a single variable as a nominal anchor during framing the monetary policy. Inflation targeting is a monetary policy strategy used for maintaining inflation at a specific point or within a specified range. Such a policy makes the central bank focus on a single variable, inflation as its nominal anchor around which all the policy decisions should be centered. In recent years, there is a growing consensus that the central bank should have instrumental independence and concentrate on a single target of inflation control. Many central banks adopted inflation targeting as a pragmatic response to the failure of other monetary policy regimes, such as those that targeted the money supply or the value of the currency in relation to another, presumably stable, currency.

Inflation targeting encompasses public announcement of medium term numerical targets for inflation and subordination of all other targets to this one. These targets are well communicated to the public so this strategy ensures transparency in monetary policy and increased accountability of central bank for attaining its inflation objectives.Along with well defined and communicated targets, there is a predefined rule regarding when to consider monetary policy a failure and the procedure to be followed by the central bank in case of a monetary policy failure.

III. EMPIRICAL EXPERIENCES IN FAVOUROF INFLATION TARGETING

Inflation targeting has been successfully practiced in a growing number of countries over past 20 years and many more countries are moving towards this framework. Over time, inflation targeting has proven to be a flexible framework that has been resilient in changing circumstances, including during the recent global financial crisis. The most important advantage of having this strategy is the accountability and transparency it brings to policy making. It helps in putting a quantitative target and a fixed target horizon which helps to monitor other economic variables. Empirical studies, like that of Hammond(2012) shows that it helped reduce the level and volatility of inflation in countries that adopted it.[1] It has been successful in reducing both inflation and output volatility in the UK.

Unlike an exchange rate peg, where policy decisions depends mainly on external changes and shocks, in inflation targeting monetary policy is determined by domestic considerations, the state and changes in the state of domestic economy. Together with that, inflation targeting has the advantage of focusing the political debate on what a central bank can do in the long run, which is controlling inflation, rather than focusing on the areas where fiscal policy would be a better alternative, i.e., raise output growth, lower unemployment and increase external competitiveness. This is particularly helpful for developing countries which have often had a history of monetary mismanagement. This ensures independence of central bank as monetary policy is separated from fiscal policy which rules out conflict of interest between the price stability function of central bank and financer of government.

As illustrated by Frederic Mishkin and Adam Posen(1997),[2] Ben Bernanke, Thomas Laubach, Frederic Mishkin and Adam Posen(1999), inflation targeting central banks have frequent communications with the government and public at large, which keep them accountable.[3]

IV. DIFFICULTIES OF INFLATION TARGETING STRATEGY

However, inflation targeting has been subject to skepticism, mainly with respect of emerging economies. Some superfluous objections which have been raised against the strategy of inflation targeting, like this is too rigid, it allows too much discretion, has the potential to increase output instability and will lower economic growth, can be answered by designing a proper constrained discretion system of inflation targeting. Still, some serious disadvantages are there with this strategy. In contrast to exchange rates and monetary aggregates, inflation rates cannot easily be monitored by the central banks. There are a number of indexes, like Wholesale Price Index(WPI), Consumer Price Index(CPI), and Producer Price Index(PPI), from amongst which the right index has to be chosen to center the policy on it. Wrong choice of index might end up in faulty decisions.If the chosen index contains goods whose prices are controlled by the government, it affects the forecasting of headline inflation as government controlled prices are difficult to predict based on market tendencies.

Together with this, inflation targeting requires forecasting of inflation for medium term, which emerging economies are unable to forecast mainly on account of the lack of skills to do so which is further challenged by fast changing macroeconomic variables. Many a factors affect the forecast of inflation, for which sufficient data may not be available and are revealed only after a substantial lag. In these circumstances, where inflation forecasting is erroneous, inflation targets will tend to be missed and credibility of central bank will be difficult to be maintained.

Another problem is that inflation targeting demands fiscal independence which may be difficult to maintain in these countries because of the socio-economic conditions prevalent in these countries where large fiscal deficits are commonplace. Here, government is responsible for availability of many services. In the long run these large fiscal deficits will cause an inflation targeting regime to break down. Besides, inflation targeting requires flexibility in nominal exchange rates which may cause balance of payments problems in developing countries. Developing countries cannot afford to ignore the exchange rate stability in their pursuit to control inflation.

Thus, although inflation targeting has been quite successful in developed countries, individual countries must assess their economies to determine whether this strategy would be appropriate for them or fit could be tailored to suit their needs.

V. INFLATION TARGETING AND INDIA

The finance bill, 2016 made inflation targeting the sole objective of monetary policy. To target inflation, a setup is needed to forecast inflation over a range of 8 to 12 quarters at least but India lacks this skill to forecast inflation over a longer horizon of time. Another question arising in the process of inflation targeting is the choice of index to be used for targeting inflation. There exists a number of indexes namely Wholesale Price Index(WPI), variants of Consumer Price Index and Producer Price Index to name a few. Economists are of different opinion regarding which index to choose for the inflation targeting purpose.

Earlier, RBI had given more weightage to Wholesale Price Index (WPI) than CPI as the key measure of inflation for all policy purposes. Recently, it has adopted new CPI (combined) as the key measure as per the recommendations of Urjit R. Patel committee.[4] It was the Urjit Patel committee which recommended adopting inflation targeting as the sole aim of Monetary Policy, following which Bi-monthly policy review system was started and Monetary Policy committee(MPC) was set up consisting of 6 members, 3 from the government and 3 from the RBI including the governor.[5]

The MPC is entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level. Under the RBI Act, 1934, the central government, in consultation with the Reserve Bank of India, determines the inflation target in terms of the Consumer Price Index(CPI), once in every five years. This target would be revised every five years and would be notified in the Official Gazette. In exercise of the powers conferred under the Reserve Bank of India Act, 1934, the Central Government, in consultation with the RBI, has fixed the inflation target for the period beginning from August 5, 2016 and ending on the March 31, 2021 as 4% with an upper tolerance level of 6% and lower tolerance level of 2%, keeping in mind the growth dimension of the country as well. As per the policy, if inflation goes above 6% or below 2% for three consecutive quarters, it will be treated as the failure of the RBI's monetary policy failure. When the RBI fails to meet the inflation target, remedial actions proposed to be taken by the bank and an estimate of the time period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions shall be notified by the RBI.[6]

But in an economy like India, which has unemployed resources, an increase in demand may be expected to lead to a rise in output and a rise in price if there is a shortage of some inputs into production. However, the increase in output may be expected to lead to an increase in employment as goods require labour for their production. Thus there is concurrent increase in output, employment and prices.

Under the strategy of inflation targeting, the central bank raises the rate of interest which, when passed on by commercial banks, reduces the demand of credit, lowers investment and output growth. There is concomitant reduction in the demand for the labour and material inputs whose price rise constituted the inflation. This procedure reduces the inflation. Thus inflation targeting approaches the problem of inflation from demand side. It checks the inflation by restricting demand. This entails welfare loss as employment is thereby reduced.

The problem of inflation in India is mainly on account of supply side bottlenecks. Stemming the problem of inflation which originated due to supply shortages by reducing demands is not the correct course of action. It can only be tackled via an expansion of the supply shortfall through either imports or increased production.

VI. CONCLUSION

It is widely accepted that inflation targeting has helped most countries reduce their inflation rates successfully. It helped increase the transparency and credibility of the central bank, thus allowing it to carry out its monetary policy with greater effectiveness.

But on the other hand, it demands a number of pre-conditions for its successful implementation such as independence of central bank, flexible exchange rate etc, which most emerging countries, including India, lacks. India was able to remain insulated from the financial crisis of 2008 to an extent owing to its multi indicator approach and focus on financial stability, and not just price stability.Inflation targeting strategy is mainly designed for countries where inflation is demand driven, where in emerging countries, like India, it is the supply side factors, such as agricultural vagaries due to irregular monsoons and huge import bills, which are causing inflation.

Multi-indicator approach that India followed till now yielded good results for the economy. If the inflation targeting strategy now resorted to would be able to keep the economy stable without sacrificing the growth dimension would be known in future only but inflation targeting should be accepted as a strategy with a pinch of salt. Inflation control cannot be a sole aim for an economy which is rich in young population and about to peak the demographic dividend. Growth and employment concerns cannot be sidelined for the sake of inflation control.

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