INFLATION TARGETING

Policy Put the Kettle On

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A new monetary policy framework has come into operation, which may be described as one of flexible inflation targeting. It has a legal sanction and requires the RBI to maintain consumer price index (CPI) inflation at 4% with a margin of +/–2%. So how should this mandate be interpreted?

To do so, we should also allay some of the misgivings entertained by opponents of inflation targeting. The amended preamble to the RBI Act mentions that "the primary objective of monetary policy is to maintain price stability, while keeping in mind the objective of growth". But should the focus on price stability exclude consideration of other objectives such as growth and financial stability? The answer depends on how the mandate is interpreted.

Inflation targeting as a scheme demands that when inflation goes beyond the 'comfort zone', the exclusive concern of monetary authorities must be to bring it back to the mandated level. The policy instrument, the repo rate, must be effectively used for this purpose. So long as inflation remains within the comfort zone, the RBI must take care of other objectives.

The rules relating to the operation of the scheme of inflation targeting are not as simple and rigid as the rules of the gold standard. Under inflation targeting, when inflation remains within the permitted range, there is considerable discretion, and the monetary authority, which now includes the Monetary Policy Committee (MPC), must weigh in several considerations.

The authorities may raise or lower or keep unchanged the policy rate depending on their assessment of the prospects of real growth, inflationary trends and sometimes even considerations of financial stability. Some critics point out that inflation targeting did not prevent the 2008 financial crisis.

There is a continuing debate whether the crisis was precipitated by monetary policy failure or regulatory failure. Countries like Canada and Australia that were committed to inflation targeting were not caught in the crisis.

The low-interest regime that prevailed because of low inflation may have created an environment favourable for high risk-taking. Rise in asset prices should have alerted the monetary authorities and it was here that they failed to act. Inflation targeting as a policy framework does not prevent raising the policy rate even when inflation is low, if other considerations demand it.

To repeat, what it only demands is that if inflation is outside the permitted range and if it is expected to persist, the monetary authority should act decisively to control it.

The MPC has an important role in the new scheme. It must look upon its mandate as going beyond setting the policy rate. It must be concerned with all the dimensions of monetary policy consistent with its name. It is not enough to decide on the policy rate.

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See that inflation over there?

It is equally important to see how the decision will get transmitted. The RBI must take necessary actions to make the decision stick by expanding or contracting liquidity. In recent reviews, the RBI has been conspicuously silent on money supply. There is no mention even on the extent of rise in reserve money. General statements on being 'accommodative' are not sufficient.

Quite clearly, had the decisions to lower the policy rate in the past been accompanied by reductions in cash reserve ratio (CRR), there would have been an immediate effect. The RBI itself, in one of its recent statements, made a distinction between 'temporary' and 'permanent' liquidity.

Operations at the discount window have largely an effect on 'temporary' liquidity. If 'permanent' liquidity is to be altered, this can be done only by a change in CRR or through open-market operations. In short, what is being emphasised is that the 'signal' of a change in policy rate must be combined with actions that are necessary to influence liquidity. The RBI cannot simply order interest rates.

Inflation targeting has many dimensions. But let's focus on one aspect: to position inflation targeting in the context of monetary policy objectives. The existence of multiple objectives before monetary policy has always been recognised. When there are multiple objectives, it is necessary to rank and create a hierarchy. Only then can an institution be held responsible and accountable.

The new monetary policy framework makes price stability as the dominant objective of monetary policy. This is a welcome elaboration. However, the inflation targeting mechanism does not necessarily preclude considerations of other objectives.

The mechanism is flexible enough to take care of them. It is only when inflation crosses the permissible limit, exclusive concern with inflation control emerges.

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