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Understanding inflation targeting

C. Rangarajan

Inflation targeting re-emphasises the primacy of price stability as the objective of monetary policy. Given the rigidities in the economy and lags in policy impact, it must be operated with flexibility

Inflation targeting is back in the news and this is welcome. I have always held the view that the dominant objective of monetary policy is the maintenance of price stability. Inflation targeting gives precision to the concept of price stability.

In any monetary policy framework, a key ingredient is an enunciation of its objectives. This aspect has assumed increased significance in the context of the stress being laid on the autonomy of central banks. Autonomy goes with accountability, and accountability in turn requires a clear statement of goals.

The case of price stability as the major objective of economic policy rests on the assumption that volatility in prices creates uncertainties in decision-making. Rising prices adversely affect savings while making speculative investments more attractive. These apart, there is a crucial social dimension, particularly in developing countries. Inflation adversely affects those who have no hedges against it, and this includes all poorer sections of the community. This is indeed a very strong argument in favour of the maintenance of price stability in emerging economies.

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Price stability and growth

A crucial question that arises in this context is whether the pursuit of the objective of price stability by monetary authorities undermines the ability of the economy to attain other objectives such as growth. In short, the question is whether there is a trade-off between inflation and growth. There is a general consensus that over the medium and the long term, there is no such trade-off and an environment of low inflation is most conducive to faster economic growth. However, there could be such a possibility in the short term. By injecting greater demand and thereby generating higher inflation, higher growth may be achieved. However, to sustain this growth, the authorities may have to generate higher and higher inflation. This will end up as a self-defeating exercise.

What then is the tolerable level of inflation? At very low levels of inflation, there may not be any adverse consequences on the economy. However, in every economy, given its structure, there is always a certain level of inflation beyond which costs of inflation begin to rise steeply. It is this inflation threshold which can provide guidance to policymakers. Interestingly, the Chakravarty Committee, of which I was a member, regarded the acceptable rise in prices as 4 per cent. Several studies in the Indian context have estimated that the threshold level of inflation may be around 6 per cent.

Other objectives

Questions have been raised about the robustness of such models. Even large econometric models are not in a position to capture all the costs of inflation. This order of inflation is however higher than what developed countries normally aim for. This will have some implications for the exchange rate of the currency and Current Account Deficit. In the Indian context, it is best to work towards an average of 4 per cent and take strong action if it touches 6 per cent. This will amount to inflation targeting with a band, as recommended by the Urjit Patel Committee. Such a commitment will also dampen inflation expectations.

Does the focus on inflation targeting by monetary authorities mean a neglect of other objectives such as growth and financial stability? Hardly so. What inflation targeting demands is that when inflation exceeds the threshold level, the primary focus of monetary policy must be to bring it back to the desired level. It is sometimes claimed that the financial crisis of 2008 in the United States and western Europe sounded the death knell for inflation targeting. There is continuing debate on whether the crisis was precipitated by monetary policy failure or regulatory failure. Countries like Canada and Australia, which were committed to inflation targeting, were not caught in the crisis.

Central banks have multiple functions. Apart from monetary policy, regulation of the financial system, particularly the banking system, is entrusted to central banks in most countries. There has to be close coordination between these two functions. For the crisis itself, regulatory lapses have to take major responsibility while monetary policy in these countries might at best have played a facilitating role. The low interest rate regime which prevailed because of low inflation could have created an environment favourable for high risk-taking. A rise in asset prices should have alerted the monetary authorities and they should have taken appropriate action. Inflation targeting does not preclude other objectives from the purview of monetary authorities so long as inflation remains within the comfort zone. The control of inflation becomes its exclusive concern only when inflation crosses the acceptable level.

Can it be done?

Can the Reserve Bank of India (RBI) or for that matter any central bank effectively implement an inflation mandate? Do they have enough instruments to achieve the goal? The ability of the central banks to control inflation when such inflation stems from excess demand is normally conceded. It is when inflation is triggered by supply shocks that some doubts are raised. Such supply shocks are most common in countries like India where agricultural production is subject to the vagaries of nature. Even when inflation is triggered by food inflation, monetary policy and fiscal policy have a role to play. If food inflation lasts long, it gets generalised. Wages rise leading to a general cost push inflation. If head line inflation exceeds the acceptable level, monetary policy must act at least to ensure that the return on financial assets is positive in real terms. In a situation of supply shocks, it may take longer for monetary policy to bring down inflation. The recent experience with inflation in our country is a good example of this. That is why the inflation mandate must provide for a range and a time frame for adjustment which should not be too short. Nevertheless, monetary policy must act irrespective of what triggered inflation. Obviously, supply side management is needed in situations of supply stock and that should be the responsibility of the government.

Institutional framework

The appropriate institutional framework for implementing the inflation mandate also raises certain questions. The first issue is on who should determine the acceptable level of inflation. In most countries which have adopted inflation targeting, the target is set by the government or Parliament. This appears to be appropriate in as much as the acceptable level of inflation is not purely an economic issue. However, once a mandate is prescribed by the government or Parliament, the monetary authority should be left with full autonomy to use whatever instruments that are available to it to implement the mandate.

The second issue relates to an appropriate price index which should be used to monitor inflation. In India, we have monitored inflation by mostly looking at the wholesale price index. That was because of the easy availability of this index. Until recently, we have had no composite retail price index. Since the objective of inflation targeting is to minimise the impact of price rise on people, the appropriate index will be retail inflation.

The third issue relates to institutional arrangements within the monetary authority to take policy decisions consistent with an inflation mandate. In several countries, a technical monetary policy committee is constituted with members drawn from the central bank, from the government and from outside experts. My preference would be to constitute a committee of the board of the RBI to do this. This is what was done when the Board for Financial Supervision was set up. While constituting the central board of the RBI, this aspect of the work of the bank must also be kept in view.

Inflation targeting re-emphasises the primacy of price stability as the objective of monetary policy. Given the rigidities in the economy and the lags in policy impact, it must be operated with flexibility.

(Dr. C. Rangarajan is former Governor of the Reserve Bank of India.)

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