

Inflation targeting is not a good idea

Kanhaiya Singh



Hits and misses The target is the problem Mutlu/shutterstock.com

It has not worked elsewhere. And it could lead to instability in exchange rates, interest rates and GDP growth

May 7, 2015:

The Centre and the Reserve Bank of India signed an agreement on February 20, 2015, which intends to put in place the inflation targeting framework (ITF) as the preferred monetary policy approach to be operated by the RBI. The objective for monetary policy that it has set is “to maintain price stability, while keeping in mind the objective of growth”.

The target lies in a flexible band of 2 per cent to 6 per cent of CPI-based inflation. Deviation in inflation from this band in either direction for a consecutive period of three quarters (nine months’ average) would mean a failure to meet the target. The RBI governor would have to offer explanations for the deviation and the timeline to bring the inflation within the desired band. This effectively means that the RBI has to follow the ITF, overriding other objectives of monetary policy. Moreover, the agreement does not include any commitment on the part of the government to maintain fiscal prudence.

Clarifying the position

Essentially, the ITF approach consists of setting an inflation target, aligning monetary policy to ensure its attainment, and doing so in a manner that is both transparent and accountable. It requires a robust and predictable relationship between output gap, inflation and policy rate in the economy to exploit a trade-off. It also requires the ability to forecast potential output and demand which together determine output gap, the expected inflation and the corresponding time path for policy rate that would keep inflation within the stipulated limit.

However, the monetary policy statements do not go beyond fan charts for inflation and growth in gross value added. Specifically, there is no answer to several pertinent questions, for example the contribution of policy rates in bringing down recent WPI inflation or the effect of prolonged high interest rate on potential output. In the absence of such transparency, the decisions on policy rates seem to remain as ad hoc as before.

Therefore, the RBI has the responsibility to make public the source of its confidence in shifting to ITF despite the uncertainties regarding supply shocks and productivity growth across sectors. The 2014 report of the expert committee to revise and strengthen the monetary policy framework also did not show any such preparedness.

Moreover, the Reserve Bank of India Act 1939 (amended up to February 2013) has no provision to allow the RBI and the Union government to enter into such an agreement. In such a situation the legal status of the agreement is not clear.

Coping with instability

At the same time, the pure inflation targeting regime is already under strain as it has not been able to cope with financial instability and supply side shocks. Since the 2008 crisis, central banks have found themselves faced with new challenges which have raised questions about the future of inflation targeting as a framework for the conduct of monetary policy; modifications are being suggested to incorporate additional goals. In fact, for the past five years, several inflation targeting countries have missed their target bands and suffered from excessive instability in interest rate, exchange rates and GDP growth.

In contrast, China and the US, which together produce more than one-third of the global income, do not have an explicit inflation target. Yet both these countries have consistently maintained a low inflation, low interest rate regime for almost two decades. During the last five years, from 2008 to 2013, these two countries have not only posted a better

inflation and growth record but also outperformed several inflation targeting countries in terms of level of achievement and variations. The variations in exchange rates, GDP growth and interest rates are remarkably high in prominent inflation targeting countries.

Stabilisation of inflation is always an implicit target of any central bank, but along with that, managing financial stability and exchange variations is equally important. After the 2008-09 financial crisis, these aspects of central banking have taken centre-stage.

Structural issues

The monetary framework for India needs to factor in its structural problems. The frictional cost between point of production and consumption, which is generally reflected in wide gaps between WPI (proxy of producer price) and CPI, is aggravated by increasing interest rates. A high interest rate inhibits growth in potential output by constraining investments in infrastructure, storage and modernisation.

Poor and inadequate infrastructure creates supply-side constraints, limits growth in productivity and potential output, and raises the prices of goods and services. This is likely to be mistaken as the result of excess demand prompting central banks to adopt monetary tightening. For example, take the case of construction of roads, railways, ports and other infrastructure, including digital cables, electrification, hospitals and schools. During the construction phase, such investment tends to increase output gap for the current year, and may be mistaken as a source of overheating.

Thus, in a growing economy which is trying to make up for the infrastructure deficit, an inflation targeting central bank will put all the breaks on money supply, leading to high costs and deceleration. Such deceleration will create a vicious cycle of supply constraints, raising prices further. This may be how India got itself into a high inflation, high interest rate regime for some time now.

In fact, countries such as China followed policies that motivated huge investment in futuristic infrastructure. They brought down the cost of inputs, including the cost of energy, and stabilised the economy at low inflation and low interest rate. This has paid huge dividends in terms of sustained growth without overheating. India needs to come out of the inflation targeting syndrome, reduce interest rates and take measures to fix supply-side issues.

The writer is a senior fellow at NCAER. The views are personal

(This article was published on May 7, 2015)

Printable version | May 8, 2015 10:56:33 AM | <http://www.thehindubusinessline.com/opinion/columns/inflation-targeting-is-not-a-good-idea/article7181343.ece> © The Hindu Business Line