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Inflation Targeting: A New Approach to Monetary Policy

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Abstract:
Inflation is a double edge sword which causes damage to an economy on either extreme. High inflation causes dissaving in the economy which hampers medium and long run growth. RBI controls money supply to manage optimum rate of inflation for the economy but often it fails to do so. Inflation targeting is the new buzz world in the money market which provides a new frame work to tame the inflationary expectations. This paper is an attempt to analyse the merits and demerits of this new approach and to suggest some important prerequisites for its successful implementation.

Keywords: *CPI index, Expectations, Inflationary band, Inflationary, Phillips curve, Unproductive assets*

1. Introduction

The Reserve Bank of India's Committee to Revise and Strengthen the Monetary Policy Framework, chaired by Urjit Patel, also known as the Urjit Patel Committee has proposed a transition to Inflation-targeting, this is in stark contrast to the current conduct by the RBI of the monetary policy which has targeted employment, output and prices.

The inflation-targeting approach moves to a focus of single policy objective- targeting inflation through the new combined Consumer Price Index (CPI), this is in tandem with the 2009 Raghuram Rajan Committee, when he was not the governor of the RBI, which recommended that "The RBI should formally have a single objective, to stay close to a low inflation number, or within a range, in the medium term, and move steadily to a single instrument, the short term interest rate (repo and reverse repo) to achieve it."

In the most recent statement by Raghuram Rajan, the governor of RBI points towards RBI adopting the Inflation Targeting approach, with a target of 4% with a deviation of 2%.

This paper deeply analyses Inflation Targeting as an approach, the implications of its implementation and the additional necessary framework that is required for a smooth transition.

2. Inflation Targeting: The concept

Inflation targeting as macroeconomic policy tool is now more than two decades old. It entails an explicit central bank mandate to pursue price stability and also calls for a high degree of operational autonomy; quantitative setting of the inflation target which is 4%, according to the latest statement by the RBI; central bank accountability for performance in achieving the inflation objective mainly through high-transparency requirements for policy strategy and implementation and a forward looking approach towards inflationary pressures, in essence it's genesis draws closely from the widely accepted "Tinbergen Rule" which states that a policy instrument can only be effective if it has a single objective.

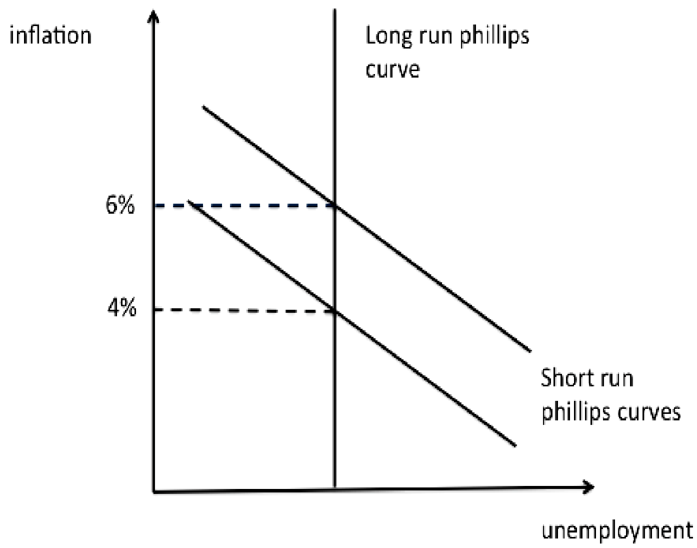
The framework works through a stable link between the inflation rate and monetary policy, with rule-based monetary action.

Practically, it works as "constrained discretion" as the precise numerical target for inflation is achieved over the medium term, allowing policy to respond to short-term economic shocks. A short run trade-off in which higher economic growth can be obtained with the cost as higher inflation, may exist, but the two are independent in the long run, because a short-term inflation-growth trade-off may tempt the RBI to occasionally favor growth, an Inflation Targeting approach seeks to commit to a low inflation target, once a belief that inflation will remain low even is strengthened, the medium-term inflation outlook will not change much even when economic shocks occur. The underlying idea that grants impetus to this policy is the recognition that there lies inconsistency and inefficiency in pursuing multiple goals.

The RBI has also made strides towards fully adopting Inflation Targeting with setting up of a glide path to 6% inflation by January 2016; correspondingly, the RBI recently cut the repo rate by 25 basis points bringing it to 7.25%, these are all signals to a shift towards Inflation Targeting as the main monetary policy objective of the RBI.

3. Inflation Targeting: Understanding through the Phillips curve and Solow Model

The Phillips curve graphs the relationship between Inflation and unemployment, in the short run we face a trade off between inflation and unemployment, however in the long run we see that lower inflation can generate a higher savings rate, when people have established belief that inflation will remain the same in the medium and long-term they increase their savings and the effect of the same on capital formation can be well deduced from the Solow Model.

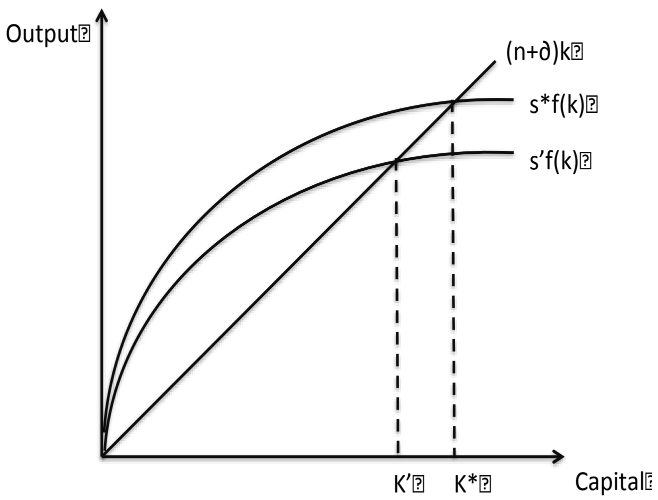


Targeting lower inflation through lower money supply shifts the Phillips curve downward in the long run.

Consequentially, higher savings rate s* pushes the savings curve upwards in the Solow Model putting the economy on a higher steady state level.

Therefore we see that targeting lower inflation has an all round positive effect on savings and thereby on capital formation and employment, in the long run.

4. Inflation and its relation with assets



Over a period of last six years we see a trend of rising inflation and correspondingly rising

Gold prices, this implies a simple conclusion that with rising inflation the demand for gold increased.

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A deeper economic intuition points to the fact that investors viewed gold as a good investment, gold is being used to hedge against inflation. A simple calculation to calculate return on Gold further strengthens these arguments; an individual purchasing 10 grams of gold in 2009-10 would have got a 102.26% return in 2013-14, as opposed to approximate 9% return on Fixed Deposits that he or she would have earned over the same five year time period.

Years	Inflation*	Gold Prices
2008-09	8.3	12500.00
2009-10	10.9	14500.00
2010-11	12.1	18500.00
2011-12	8.9	26400.00
2012-13	9.7	31799.00
2013-14	10.1	29,329.00

Average Consumer Prices
Source: RBI

Resulting lower inflation through inflation targeting will boost savings in fixed deposits with banks, thereby increasing the savings rate, this implies that savings will then be channeled to other financial assets and productive investment avenues boosting overall economic growth and granting impetus to businesses. Moreover, with inflation set and known, business houses are able to calculate project analysis costs with certainty, also with lower inflation; our exports will see a boost as export competitiveness for the country improves, further strengthening the argument for Inflation Targeting.

5. Impediments to Implementation of Inflation Targeting

5.1 Fiscal Prudence

Fiscal policy, its impact and dominance takes center stage when it comes to Emerging Market Economies (EMEs) including India, the primary and perhaps the most significant impediment is that of establishing strong institutional support, more so fiscal support as fiscal policy has a close relationship with aggregate demand and fiscal dominance is very often a key driver when it comes to inflation and has the ability to subside the effects of monetary policy.

5.2 Operational autonomy to Central Bank and development of the financial framework

Secondly, Inflation targeting as a policy option demands a very high degree of operational freedom to be given to the Central Bank of the country, in our case the RBI.

Operational autonomy to the RBI is still a barrier in our country, taking a look at the regulatory framework will give a better idea, the current financial governance institutions in our country comprise of the RBI, the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority (IRDA), the Pension Fund Regulatory and Development Authority (PFRDA) and the Forward Markets Commission (FMC). All of these regulatory institutions come under the purview of two ministries of the Government of India- Finance and Food and Consumer Affairs, two departments within the department of finance play and administrative and policy role- The Department for Financial Services for the RBI, IRDA and PFRDA while the Department of Economic Affairs performs this role for SEBI.

Since, introduction of Inflation Targeting will result in higher savings and correspondingly higher investments, the need for developing a sound and strong financial framework that functions like a well-oiled machine is the need of the hour, a synchronized construction of all the pillars of financial sector governance in a holistic and organized fashion, giving autonomy to the RBI with respect to administration and policy matters will create a conducive environment for a smooth transition to Inflation Targeting.

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In the current Indian context, financial markets and the financial economy has seen its fair bit of maturity, in recent times, there has been a surge in the number of ATMs and also the number of people using ATM Cards, though this shows financial innovation, this also increases the velocity of transactions in the economy and the ability of deposit creation by banks, this has a direct effect on prices and tends to increase fluctuation in prices.

This seems ironic that RBI has been given leeway to undertake and implement innovations that tend to increase fluctuation in prices but has not been given a mandate to control such fluctuation through the monetary policy. Introduction and adoption of Inflation Targeting will entail giving such autonomy to the RBI and taking India to the next level of financial maturity.

5.3 Supply Side Factors

The RBI through it's monetary policy is only able to influence demand side factors of inflation and keep them under check through the instruments of interest rate and money supply, however with the recent announcement by RBI governor Dr. Raghuram Rajan to make a transition to a combined CPI to determine inflationthe problem of supply side factor creeps in.

CPI includes food and fuel prices, for a developing economy like India these prices of these two commodities are perhaps the most detrimental for inflation and also vulnerable to supply side shocks.

India's food grain production in 2013-14 was 263.20 million tons according to the Annual report of the Ministry of Agriculture, which is an increase

of 6.07 million tons from 2012-13, this points out to the fact that India's on the path to achieving greater food self-sufficiency, this is further positively enforced with accompanying developments in access to rural credit, over the last decade following agricultural credit has more than doubled following a Government of India decision in June 2004, Kisaan Credit Card (KCC) Scheme has also seen positive developments with the State Governments being advised to launch village level campaigns to make available KCC to all eligible farmers, additionally it has been decided to convert KCCs into smart cards to allow its operation through an ATM.

With drought management in place and increased focus on warehousing and storing of produced grains, including developing state of the art warehouses, inventory management, logistics and developments aforementioned, food inflation will be in control.

India, the very first country to set up a Ministry for non-conventional energy- Ministry of New and Renewable Energy, has made great strides in alternate energy, the Jawaharlal Nehru National Solar Mission launched in 2010 seeks to establish 20,000 MW of grid connected solar power by 2022. According to a report by Ernst and Young on Renewable Energy in India in 2013, 68% of power generation from renewable sources was attributed to wind, making India the fifth largest producer of wind energy. Keeping this in mind, and the current scenario of low global oil prices, the situation looks favorable for low fuel inflation taking care of two of the most pivotal commodities most prone to supply side shocks.

5.4 Transmission of Monetary Policy

Former governor of the RBI, D. Subbarao, has articulated reasons for not adhering to Inflation Targeting, he states that "Drivers of inflation in India often emanate from the supply side which are normally beyond the pale of monetary policy, finally, a necessary condition for inflation targeting to work is efficient monetary transmission".

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In India transmission of monetary policy has been improving but is still fairly away from best practice. The existence of an asymmetric relationship between depositors and banks- banks often react asymmetrically and frame their interest rate policy in line with their own internal procedures, therefore a rate cut does not necessarily translate into lower rates on loans to borrowers. This is another impediment to the introduction of Inflation Targeting in the country. If done right it can be a powerful tool to achieve macroeconomic stability in EMEs

The policy has the unique merit of being pro-businesses and pro-poor, by putting an end to fluctuating inflationary expectations, businesses not only work in a better economic environment but higher savings are also channeled in to productive investments which can be leveraged by industry,

5.5 Financial Inclusion

Another impediment to a smooth transition to Inflation Targeting is financial inclusion of those at the grass-root level.

Micro financing, which enables extension of loans to the rural poor without the need of surrendering collateral has been successful in India, supporting the cause of financial inclusion.

A step that needs to be lauded is the introduction of Micro Units Development Refinance Agency (MUDRA) Bank Initiative in the most recent Union Budget of 2015, the Mudra Bank Initiative seeks to cater to inclusion of Scheduled Castes and Scheduled Tribes and the government has decided to pledge a corpus of INR 20,000 Crore and a credit guarantee of INR 3000 Crore for the same.

With such initiatives on the rise and deeper penetration and inclusion, the Indian Economy is all set for the next stage of central banking policy and provides the perfect stage for introduction of Inflation Targeting.

6. Conclusion

It is important to note that Inflation Targeting is not to be seen as an end in itself but a road to a much broader end, namely macroeconomic stabilization, developing strong fiscal, financial and monetary institutions is very critical to the success of Inflation Targeting as noted by Mishkin (2004), but if done right it can be a powerful tool to achieve macroeconomic stability in EMEs

The policy has the unique merit of being pro-businesses and pro-poor, by putting an end to fluctuating inflationary expectations, businesses not only work in a better economic environment but higher savings are also channeled in to productive investments which can be leveraged by industry, moreover lower inflation also instills confidence in the share market. The most direct impact of lower inflation is on the poor, inflation reduces real disposable income and if nominal wages increase less than the price of the goods consumed, then workers' real wages will decline.