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Inflation Targeting in India: Issues and Challenges

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Abstract

Inflation may have shown some very inspiring downward trends but for an emerging market economy like India that is in state of transition, inflation targeting as a policy poses certain risks in realization in its true sense. Although there is no long run trade off, experience shows that non-inflation targeting countries have grown at a faster than those who have adopted inflation targeting in some form.

Introduction

The statistics regarding inflation in India is made available by the Ministry of Statistics and Programme Implementation (MOSPI), India and the rate of inflation brought cheers when they showed a downward trend after reaching the all time high of 11.16 percent in November 2013. The rate of inflation was recorded to be as low as 4.38 percent in November 2014 and is presently about 5 percent. These figures are of Consumer Price Index (CPI) that has come under scanner after RBI made a policy shift of making this as a policy anchor on the basis of Urjit Patel committee recommendations coining a new term "flexible inflation targeting". Historically, the wholesale price index (WPI) has been the key measure of inflation in India. However, in 2013, the Governor of the Reserve Bank of India Mr. Raghuram Rajan announced a shift in policy anchor considering flexible inflation targeting. This presents the policy makers' stance of not tolerating inflation as a deterring factor in the economy any more. This has brought about two most important structural changes in the economy, one, Price stability is now primary policy objective and two, The nominal policy anchor is CPI.

CPI reflects the demand side pressures more closely as the service sector carries a weight of about 26% and includes the basic services like health care, entertainment and education etc. Also a higher weightage is given to food and fuel components that shape the consumption basket of a consumer in general. To be more precise, in India, consumer price index gives highest importance to Food, beverages and tobacco contributing about 49.7 percent of total weight. Similarly, light and fuel accounts for 9.5 percent; housing 9.8 percent; communication and transportation 7.6 percent; medical care 5.7 percent; clothing, bedding and footwear for 4.7 percent and education for 3.4 percent. This is as against the Wholesale Price Index (WPI) that furnishes higher weightage to manufacturing sector contributes about 65% in overall inflation index.

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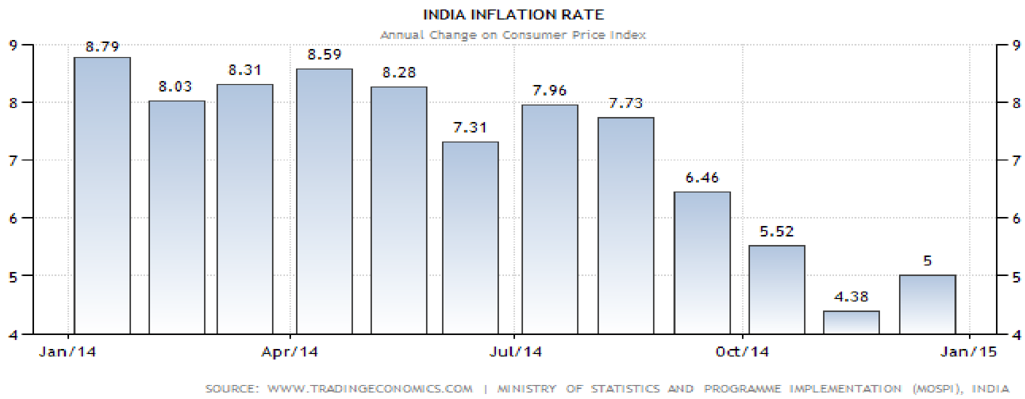
Although there has been a lot of buzz over an increasing inflation to be associated with growth and there may be short run trade-off definitely, but there is no long run trade-off between the two.



With a broad based inflation plummeting, along with commodity tailwinds there is an increased scope for the monetary policy to support growth and RBI can expect the process of easing cycle gradually. However, RBI has yet again kept the policy rates unchanged despite pressure from the Government and Industry lobbies while boosting banks' liquidity by cutting the statutory liquidity ratio (SLR- the minimum portion of net deposits that banks must hold in government bonds, cash or gold) by 50 basis points to 21.5 percent in a bid to persuade them to lower lending rates after they failed to pass on the benefits of the last official rate cut three weeks ago. However, only three of India's 45 commercial banks cut base lending rates in the wake of the RBI's reduction in the repo rate by 25 basis points on January’15, hurting the government's drive to lift business investment. Supporting this RBI spokesperson stated "Given that there have been no substantial new developments on the disinflationary process or on the fiscal outlook since January 15, it is appropriate for the Reserve Bank to await them and maintain the current interest stance".

However, the shift in the policy poses certain risks. There are likely to be short run output sacrifices associated with disinflation during the transition to medium term inflation target of 4% (+/-2% band). The output loss arises due to shift to significantly higher consumer price inflation as nominal anchor from much lower producer price inflation. This constitutes a permanent loss of output as it has occurred as a result of structural changes causing a lasting increase in the real cost of capital to which the producer firms need to adjust over longer time period.

- With larger significance of cost of capital for manufacturing and tradable sector, the risk is of a resource shift towards non-tradable, which would destabilize the intended

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direction of structural adjustments to bring about lasting corrections in current economic imbalances.

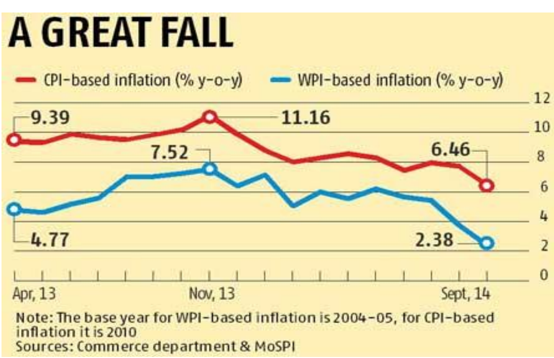
- With CPI as nominal anchor, food inflation would be included under this and as food inflation openly spills over into generalized price increase or core inflation, aggregate demand will have to be kept sufficiently compressed until rapid supply side responses set in the economy.

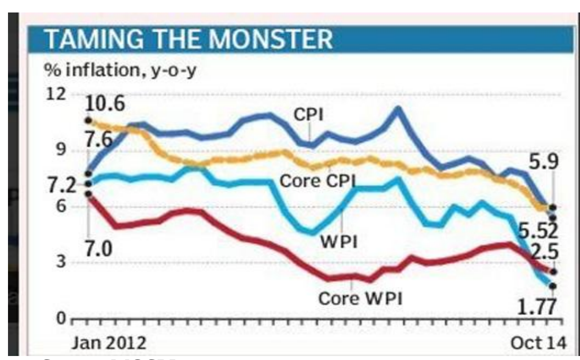
- At the time of transition, economy may be gripped under the vicious circle if the supply side responses are unforthcoming along with low growth conditions.

- In emerging market economies, where fiscal dominance is often a key inflation driver, due to its close and direct relationship with aggregate demand, it can cancel out the monetary policy efforts of the RBI.

- Further, in emerging market economies, exchange rate stability is a key element in stabilizing CPI inflation. “Exchange rate fluctuations cannot be altogether ignored especially depreciations that lead to a rise in inflation from pass-through of higher import prices and greater export demand, besides detrimental effects of dollarized liabilities and vulnerability of access to international markets which endangers financial stability” (Mishkin 2004)

- Strong institutional support is an essential element in inflation targeting to be successful.





Source: MOSPI

The Present Scenario

Price of food & beverages rose to 5 percent, accelerating from a 3.5 percent increase in November, as shown by provisional estimates. The food index alone rose to 4.78 percent (3.14 percent in November). Similarly the prices of vegetables went up by 0.58 percent while prices of fruits increased by 14.84 percent (13.74 percent in November). In contrast, price of oil and fats were reported to have decreased (-1.24 percent) along with the prices of sugar (-0.84 percent).

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Cost of fuel and light rose 3.41 percent in December, slightly up from 3.27 percent in November whereas cost of clothing and footwear slowed to 6.51 percent from 6.97 percent in the previous month.

Conclusion

As underlined by Mishkin (2004) developing strong fiscal, financial and monetary institutions is very critical to the success of inflation targeting in emerging markets and India is no exception to this. On the basis of his examining the Brazilian and Chilean economies, he concluded that inflation targeting is more complex in EMEs but if done correctly, it can become a powerful tool to bring in macroeconomic stability in a country. As far as India is concerned, economists are suspicious about using CPI as a policy anchor. It is seriously felt that that the new CPI is fairly a new series available only since 2011 and hence does not adequately portray the underlying trends. It was also mentioned that a multiple indicator approach should be used to guide monetary policy as recent experience suggests that focusing narrowly on a single variable is not justified. We could be ignoring warning signs from other variables like GDP growth, asset prices, exchange rates and term structure of interest rates, which are as important indicators to maintain economic and financial stability.

In addition, it was also pointed out that India is country in need of capital but has a high interest rate structure. Therefore investment tends to follow demand with a lag thereby leading prices to edge up. Though this adds to inflationary pressures but paves way for lower prices in the long run as new capacities come on board. Thus while keeping a tab on inflation is important but the overarching objective should be promoting growth.

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