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Monetary Targeting to Inflation Targeting in India

Dr. Punam Devi

Assistant Professor of Economics, Ganga Institute of Technology and Management, Jhajjar, Haryana (India)
punamhooda80@gmail.com

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Abstract

There are evidences of wide shift from monetary targeting to inflation targeting in the world history. Inflation targeting had been a big success in New Zealand and followed by more than 50 countries. But the policy has serious implications for a developing country like India. No country adopted IT after 2008 except Japan. Developing countries had been depending upon inflation to achieve the targets of growth. Due to lack of proper measurement of inflation, instable demand function for money and absence of proper transmission mechanism success of IT has been doubtful.

Keywords: *Monetary Targeting, Inflation Targeting, Developing Countries, CPI.*

Introduction to World History of Monetary Targeting

During the 1970s inflation and exchange rate was an important issue before the various countries. By the times other countries also became more conscious about the inflation. Breaking of Bretton-woods system followed by oil prices made the policy of monetary targeting a must. UK, New Zealand, Canada, Australia, France, Spain, Italy, Germany.

Monetary targeting is taking decisions about direct or indirect instrument, CPI or WPI, narrow money or broad money.US followed the internal tolerance hands for money and credit too from 1970 but announce publicly from 1975. M1 was targeted money supply in US but it showed increasing pattern and also fluctuated during 1972-82. Monetary gradualism policy started in Canada in 1975 with taking M1 as a money supply target but it was a failure only, latter during some periods it was very close to target but finally in 1982 M1 was abandoned by the governor Gerald Bouey. UK has the same experience, except some years could not achieve the targets, it started to follow M3 in 1976 but later on switched to M0. In Australia banks were given freedom to become competitive, foreign banks also permitted to open branches, NBFIs were also working there. It has to face instability in demand for money and finally in 1985 it has shifted from monetary targeting to other macro indicator.

France also started with M2 in 1977 and later on gone for dual targets including M3 in 1987 finally and soon it was exclusively targeting M3.

Germany and Switzerland too followed monetary targeting for two decades. Though policy in Germany worked wonderful, when in 1990 when pressure of high wage rate pushed the inflation up but soon it was under control.

Despite the structural changes Switzerland adopted monetary targeting. It was a small and open economy. It could not bear high level of exchange rate and finally abandoned monetary targeting temporary in 1979. Later on it could not maintain the stability of demand for money and control external shocks.

Italy too had to shift its target from M2 to amount of credit to private sector. Due to high interest rates public was subscribing government debt and instead increasing of money supply public was holding assets.

Desirability of outcome of the monetary targeting depends upon the relationship between money supply and nominal income.

In most of countries monetary targeting was adversely affected by instable demand function of demand for money. Innovations in financial assets and freedom to financial institute mad affect its stability. Sometimes “ratchet effect” also created by current and previous highest level of interest rate.

According to Deepak Mohanty and AK Mitra (1999) many countries switched from monetary targeting to inflation targeting in early 1990s and explicit inflation targets were announced publicly. He compared the number of year's monetary targeting get successful or failures.

Table 1: Outcome of Monetary Targeting

Country	Target	Period	Range or Point	Years Succeeded	Years failure
Australia	M3	1977-85	2	4	5
Canada	M1	1976-82	4	5	2
France	M2	1977-83		0	7
		1987-90	2	2	2
	M2R	1984-85	2	0	2
	M3	1986-87	2	1	1
		1991-94	2	0	4
Italy	TDC	1975-85		0	
	M2	1985-94	2-4	3	7
	CPS	1985-90	3-4	0	6
Japan	M2+CDs	1978-94	Point	6	10
Switzerland	M1	1975-78	Point	0	4
	M0	1980-94	Point	0	15
United Kindom	M3	1976-86	4	4	7
	M1	1982-83	4	1	1
	PSL2	1982-83	4	1	1
	M0	1984-94	4	8	3
	M4	1083-94	6	2	0
	M1	1975-86	2.5 – 5	3	9
	M2	1975-94	2-4	14	6
	M3	1975-94	2-4	8	12
	TDND	1083-94	3-4	9	3
Germany	CBM	1975-87	Point	0	4
			Range 2-3	5	4
	M3	1988-94	Range 3	3	4

TDC: total domestic credit, CD: Certificates of deposits, CBM: Central Bank Money, CPS: credit to private sector, M2R: M2 residents, PSL2: private sector liquidity CBM: central bank money, TDND; total domestic debt of non-financial sector.

Source: "Experience with Monetary Targeting in India", EPW, January 1999.

According to Deepak Mohanty and AK Mitra (1999)[1] Many countries switched from monetary targeting to inflation targeting in early 1990s and explicit inflation targets were announced publicly. He compared the number of year's monetary targeting get successful or failures.

IMF (1986)[2] paper examined the practice of monetary targeting in seven major industrial countries. Countries studied are 1.Canada 2. West Germany 3. France 4. Italy 5.Japan 6.UK 7. US. Findings are that experiences of central banks in these countries reveals that central banks cannot control their monetary aggregates precisely so monetary targets have been specified more in terms of ranges, rather than in terms of points. And since it is impossible in practice to anticipate all the macro-economic disruptions to which it would be socially desirable for the central bank to react and realised that adherence to any such mechanical rule would be both socially undesirable and

politically in- feasible. Another problem was financial revolution where different types of 'money' and introduced new versions, consequently, individual measures of monetary growth are a poor guide

Monetary targeting was badly affected by instability of money demand functions during the 1980s, some of the countries switched to a strategy of direct inflation targeting. Countries like Australia in 1993, Canada in 1991, Finland in 1993, New Zealand 1990, Spain in 1994, Sweden in 1993 and the UK in 1992 switched to inflation targeting during the early 1990s and explicit inflation targets are publicly announced.

Canada is targeting CPI (Consumer Price Index) for medium term, Japan CCPI (Core Consumer Price Index) for two years while New Zealand HCPI (Headline Consumer Price Index) for medium term. UK is targeting CPI for all time and Sweden if following annual CPI.[3]

Monetary targeting in India

India has taken up monetary targeting when many countries were leaving and moving away from such policies. Monetary targeting approach was pursued in India since about middle of the 1980s.In contrast to its general abandonment in a number of industrial countries India was pertaining the following features:

1. Substantial stability in the demand function for money
2. Administered interest rate structure
3. Absence of significant innovations in the financial sector
4. Lack of large cross- border capital flows

During a phase when major industrial economies attempted moving away from reliance on monetary targeting, India has begun to adopt monetary targeting. We are advantageous as improved version of 'monetary targeting with feedback' is available with the lessons learnt from experience of developed economies and, to some extent, adaptation to the specific situation of the Indian economy (Mujumdar, N. A., 1989) Chakravarty Committee did not consider it necessary to focus on the choice of an appropriate monetary aggregate for monetary policy. Although the committee has not explicitly recommended M3 as a monetary aggregate to be used for monetary targeting. RBI considered M1 as an inappropriate measure and M3 was the only option remaining for the monetary authorities. From 1985 to 1998 during the pursuing of monetary targets only 4 times out of 13 years, the actually targets could be achieved (in 1985-86, 1987-88, 1990-90 and 1995-96).

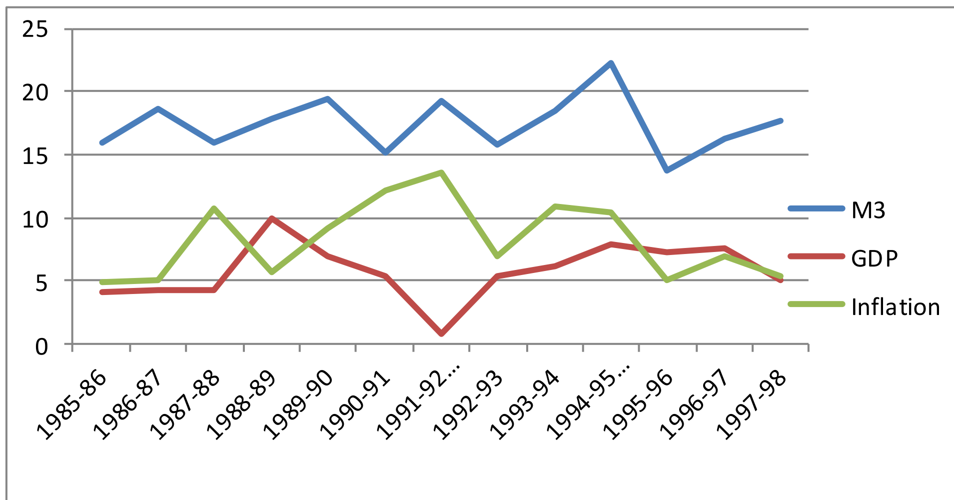

Figure 1: Magnitude of M3, GDP and Inflation

Data Source: Handbook of Statistics on Indian Economy

Monetary targets could not be achieved in majority of years but targets were either points or very narrow range. If we compare the time period without and with targeting GDP increased 5.8 percent during 1985-98 from 4 percent during 1970-85.

The monetary policy in India switched from a monetary targeting to a multiple indicators approach, as being a developing country other objectives (other than inflation) could not be sacrificed. But multiple indicators approach invites the criticism due to non-presence of a fairly defined anchor. The previous structure of monetary targeting was became obsolesce for economy having the advancements in financial markets and elevating degree of integration with the world economy.

Since mid-1990s monetary policy has to face external shocks from capital flows and fluctuating exchange rate. Control on monetary aggregate was more difficult now. Bank credit to private sector also started rising (as a per cent of GDP), but it was still lesser as compared to developed economies.

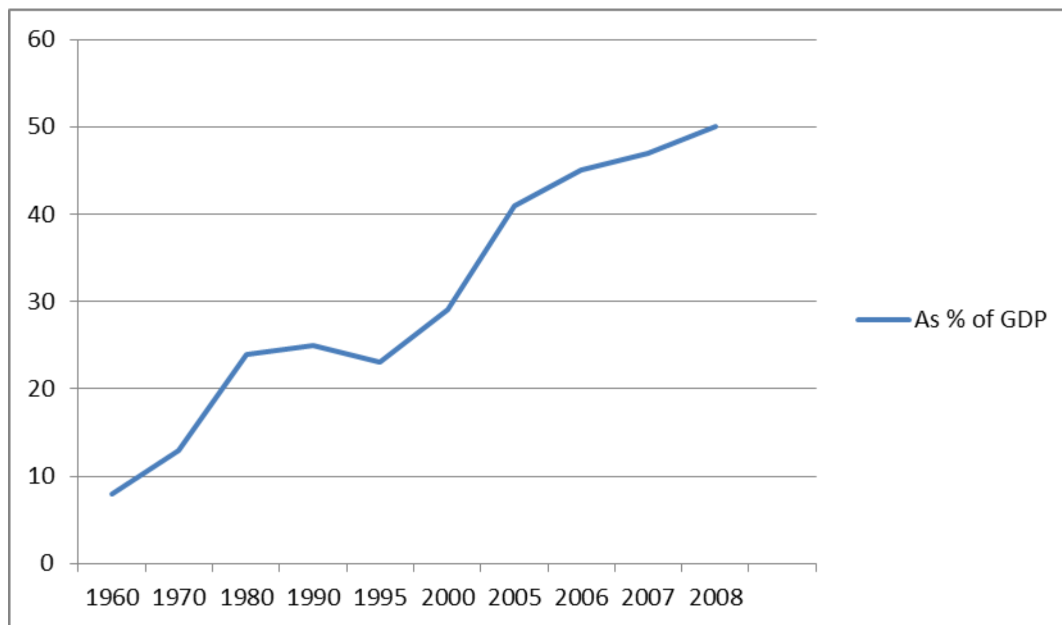

Figure 2: Domestic Credit to Private Sector

Source: World Development Indicators Online, World Bank.

In country like India monetary policy in isolation with fiscal policy can't work but as a complimentary to the fiscal policy. Net reserve bank credit to central government (1985 - 92) which was 96 percent of monetary base decreased to 65 percent (1993 - 98).

With the instability of demand function for money monetary targeting was a doubtful policy. It was already abandoned widely by industrial economies but could work in country with stable demand function for money only.

Inflation Targeting in India Success of Inflation Targeting in New Zealand many countries adopted it. IT was adopted by New Zealand in 1990 after some trial and successes. 54 countries had adopted IT by 1998 of which a few due to recommendations of the International Monetary Fund.

But developing country could not be confident enough about IT. Being fiscal dominant and relying on inflation taxes and also lacking in continuous and reliable measuring tool for inflation make it unsuitable IT.

Rajan (2013)5 favours and advocates the concern of low and stable inflation for Indian monetary policy. He mentioned it in his speech delivered by him as RBI Governor. Important event was revision of and strengthened the

Monetary Policy Framework (RSMPF) in January 2014 and submission of its report the by January on IT.

Issue was already discussed in L. K. Jha Memorial lecture by the Governor of the Reserve Bank of New Zealand on 17 June, 1999 in Mumbai about New Zealand's experience with Inflation Targeting and how it can be adopted by developing country like Indian (Brash, 1999)6 . Donald T. Brash, Governor of the Reserve Bank of New Zealand compared the basic nature and structure of developed and developing economies for IT prospective.

Poverty is a big challenge in front of developing counties like India and growth of economy is the way to mitigate the woes. But there is always tradeoff between inflation and growth. Though monetary expansion and growth is doubtful in long run but could be a remedy for short run. Subbarao (2011, 13)7 criticise the policy for India; he was more in favour of multi targeting and stated its success in context of India. He doubted about supply side shocks as IT can control demand side shocks only. If IT affects demand side and there is reduction in demand may affect the growth. But there was another view point which favours IT as remarkable inflation-targeting regime will have the positive effects on wellbeing by reducing uncertainty. Investment will be encouraged by certainty.

It was recommended by panel of Reserve Bank of India that monetary policy will be fixed by a committee. New Consumer price index (CPI) inflation will be used to set an inflation target. It was set as 4% with wide tolerance band of ±2 per cent around the inflation. Headed by Dr Urjit Patel, the Committee comprised of Dr PJ Nayak, Deepak Mohaty, Dr Sajjid Chinoy and Dr Gangadhar Darbha.

India chose to use the WPI due to its national coverage and timely release but in April, 2014, government made decision to move to the CPI to measure the inflation rate in the Indian economy however CPI does have certain limitations as a measure of inflation, such as the unequal weight age to food which is 48 percent in the CPI but two percent in the WPI and lack of representation of services. Though GDP deflator is the broadest measure of inflation in India but rejected by RBI due to its use of proxy indicators of quantity and time lag in publication of this number.

In India food prices are a major contributor to high CPI inflation and also not under the control of the RBI's monetary policy. New series of CPI introduced with lesser weight of food and various other variations.

Table 2: Consumer Price Index

Group Description	Old Series of CPI (Weights computed on the basis CES 2004-05)			Revised Series of CPI (Weights computed on the basis CES 2011-12)		
	Rural	Urban	Combd.	Rural	Urban	Combd.
Food and beverages	56.59	35.81	47.58	54.18	36.29	45.86
Pan, tobacco and intoxicants	2.72	1.34	2.13	3.26	1.36	2.38
Clothing and Footwear	5.36	3.91	4.73	7.36	5.57	6.53
Housing	-	22.54	9.77	-	21.67	10.07
Fuel and Light	10.42	8.40	9.49	7.94	5.58	6.84
Miscellaneous	24.91	28.00	26.31	27.26	29.53	28.32
Total	100.00	100.00	100.00	100.00	100.00	100.00

Source: MOSPI (2015)

As food prices are fluctuating in developing countries like India lesser weight is given to food items in new series. Except fuel and light weights of all items are increased. Methods and coverage also improved. The commodities included in rural India increased from 437 to 448 and for urban India from 450 to 460.

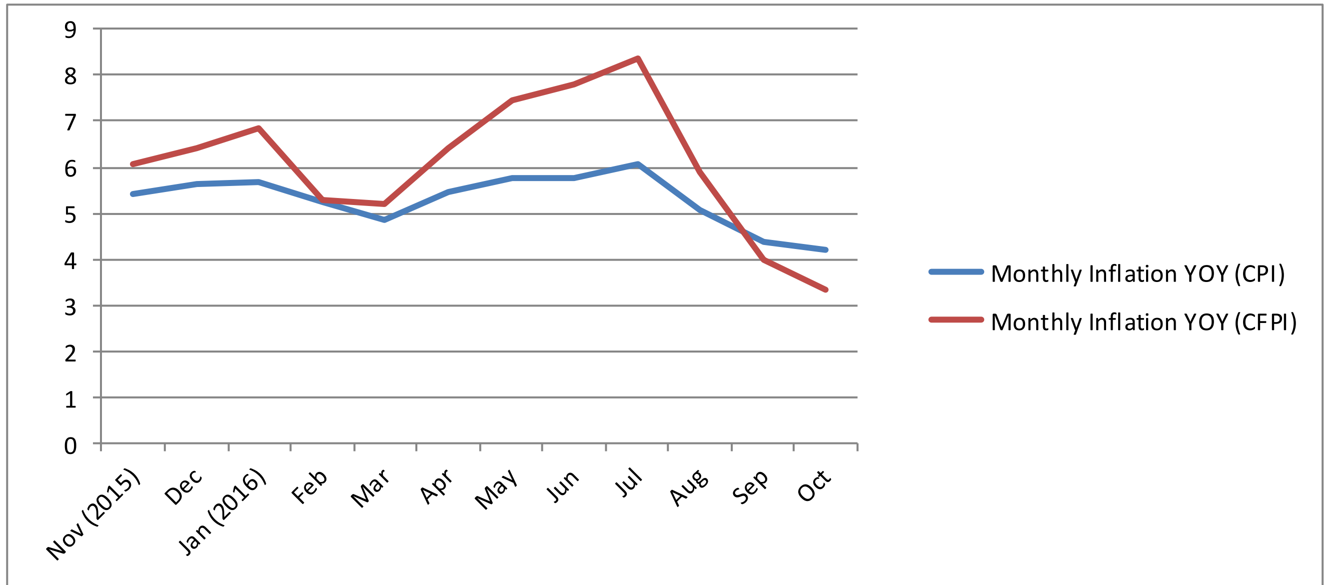

Figure 3: Monthly Inflation YOY

Source: MOSPI (Annual Report 2016-17)

CPI was highest in July 2016 and main contributor remained food prices. Food price having substantial weight in CPI remain volatile in developing countries and is the biggest challenge.

Table 3: Monthly inflation (CPI)

Months	New CPI - Combined	CPI - Industrial Workers : Food Group
Oct (2016)	131.4	310
Nov	131.2	307
Dec	130.4	301
Jan (2017)	130.3	298
Feb	130.6	297
March	130.9	298
Apr	131.1	301
May	131.4	302
June	132.1	308
July	134.2	315

Data Source: Handbook of Statistics on Indian Economy

CPI during 2017 remained under control. CPI yet not crosses even the limit of 5 percent and fluctuating around the target of 4%. It was three months highest at 4.58 in April 2018 and CFPI remained only 2.80 percent.

Conclusion

It is extensively admitted that carrying of Inflation Targeting has helped most of the countries curtailing their inflation rates victoriously. But there are a number of pre-conditions that need to be satisfied for proper implementation of IT. Continuous and accurate measure of inflation, proper transmission system, independence of the central bank. Emerging market economies usually believe it as unnecessarily costly to take up the IT framework. But other options are also not easy and less costly. Results of IT in India proved that even developing country can implement it with caution. The present paper calls for further study how a controlled inflation affects investors, aggregate demand and output in a developing country like India.

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