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Inflation Targeting in India: Issues and Challenges

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Abstract

Success of Inflation Targeting in New Zealand and 54 countries had adopted IT by 1998 of which some has done it on the recommendation of International Monetary Fund. India switched from multiple indicators targeting to IT regime in 2016. But in developing country economists could not be confident enough about success of IT. Being fiscal dominant and also lacking in continuous and reliable measuring tool for inflation make it unsuitable for developing country. India had switched from WPI to CPI with announcing a new series of CPI. Supply shocks in food supply and existence of Philips curve are major problems for India.

Keywords: *Inflation, Multiple Indicator Approaches, CPI.*

Introduction

Inflation targeting is becoming a popular and dominant monetary policy for economies both developing and developed countries. IT was initially considered and later on successfully implemented by New Zealand. It was tested by some successful trials before following and announced formally in March 1990. Soon New Zealand became an example for other countries and many countries switched to the policy. IT was also successful in UK with results as reduced inflation and low output volatility, 54 countries had adopted IT by 1998. But after the starting of financial crisis the policy lost the confidence. Since 2008 onwards hardly any country adopted it.

It was a replacement for monetary targeting in various countries. Monetary targeting is all about taking some decisions about weather direct or indirect instrument, CPI or WPI, narrow money or broad money. Before IT monetary targeting was adopted by many developed and developing countries but due to one or another reason finally abandoned.

US too followed anchoring the money and credit from 1970 but yet announced publicly from 1975. Initially M1 was targeted as money supply in US but it showed increasing pattern and has also been fluctuated during 1972-82. Monetary gradualism policy was started in Canada in 1975 with M1 as a money supply target but it was a failure only, latter on during some periods it had been very close to target but finally in 1982, M1 was abandoned by the than governor Gerald Bouey. UK had also been the same experience, except some of years it could not achieve the targets, initially started to follow M3 in 1976 but later on had to switch to M0. In Australia too banks were given freedom to become competitive and foreign banks were also permitted to open branches, NBFIs were also working there simultaneously. It has to face instability in demand for money and in 1985 it has shifted attention from monetary targeting to other macro indicator. France too started with M2 since 1977 later on gone for dual targets including M3 in 1987 finally it was exclusively targeting M3.

Germany and Switzerland had been following monetary targeting for two decades. The Policy in Germany worked wonderful even when in 1990 there was pressure of high wage rate and pushed the inflation up but soon it was under control.

Despite going through the structural changes Switzerland also adopted monetary targeting. Though it was a small and open economy and could not bear high level of exchange rate still gone with this decision and as a result finally abandoned monetary targeting temporary in 1979. Later on it could not also maintain the stability of demand for money and neither could control external shocks. Italy started from M2 but shifted its target from M2 to amount of credit to private sector. Due to high interest rates public preferred government debt and instead increasing of money supply public was actually holding assets.

Desirability of outcome of the monetary targeting depends upon the relationship between money supply and nominal income. It was failure of monetary targeting which intend countries to opt for the alternative.

Monetary targeting was severely affected by instability of money demand functions during the 1980s, and some of the countries switched to direct

inflation targeting. Countries like New Zealand 1990, Canada in 1991, Australia in 1993, Finland in 1993, Spain in 1994, Sweden in 1993 and the UK in 1992 switched to inflation targeting.

IT had been an issue of debate for two decades in India; evidences could be seen in various publications of RBI. Some important lectures and speeches are worth mentioning here.

Subbarao (2013)1 opposed of IT, he was in favoured multi targeting instead of inflation targeting. He mentioned the concept of 'impossible trinity'. It means no policy can balance all these three variables 1.Independent monetary policy 2. Fixed exchange rate and 3. Free capital flows. He doubted solution of supply side shocks through as IT can control demand side shocks only. Any reduction in aggregate demand may push the growth down. But there is a view point also which protects IT. If inflation-targeting regime is effectively implemented may have the favourable effects on welfare by shading the uncertainty and as encourages investment.

Issue was also discussed in L. K. Jha Memorial lecture which was presented by the Governor of the central bank of New Zealand held on 17 June, 1999 in Mumbai about it was about New Zealand's experience with Inflation Targeting and how it can be adopted by developing country like Indian (Brash, 1999)2 . Donald T. Brash who was then Governor of the Reserve Bank of New Zealand compared the basic nature and structure of developed and developing economies for IT prospective.

It became an important issue and committees were formed by RBI in 2000 followed by Committee formed by GoI in 2007 and also by Planning Commission in 2009.

R. Rajan (2013)3, advocated the low and stable inflation and thus IT, in his first speech delivered as RBI Governor.

Narasimham committee (2000) and Rajan Committee (2007) Committees both recommended the implementation of Inflation targeting. Inflation targeting as in India not only will provide complete autonomy to the central bank but also make the central bank more accountable too. It is essential for targets achievement that no government or parliament should interfere. By maintaining a low and stable inflation by achieving target set under the IT a steady growth in GDP can be ensure. A stable economy will allow investors, firms and households to forecast better and make right decisions. As multiple targeting is not indicating any clear goal but IT can be a tangible and clear goal working as residuals of various policies adopted by government.

Multiple Indicators Approach in India

Monetary targeting approach was pursued in India since about middle of the 1980s; M3 was accepted by RBI as monetary anchor. But from 1985 to 1998 during the pursuing of monetary targets only 4 times out of total 13 years, the targets could be actually achieved (in 1985-86, 1987-88, 1990-90 and 1995-96). Monetary targets could not be achieved in majority of years but it could not be considered as failure as targets were either points or very narrow range. Moreover if we compare the time period without and with targeting GDP increased 5.8 percent during 1985-98 from 4 percent during 1970-85.

In 1998 Indian monetary policy switched from monetary targeting to multiple variable targeting. India is a developing country and it has to balance variable forces. But multiple indicator approach was criticised due to non-presence of a precise target. The previous structure of monetary targeting was became obsolesce for economy where financial markets are developing and openness of economy is getting more integrated with global economy. Monetary transmission was also improving and enabling the economy to adopt IT economy and better transmission of monetary policy.

As multiple indicators approach was criticised for the absence of the fairly specified anchor but according to Subbarao (2013) multi-indicator approach was rewarding. The approach includes and various phenomenon such as exchange rate, output, interest rate, inflation rate etc. it does a complete and comprehensive analysis. Various variables are inter-related and can be better managed in a systematic way. Reddy (2008)[4] too advocates the multi targeting approach, presence of democracy enable people to judge the policies and react accordingly. A wide range of economic issues are related to political setup in India. This factor

makes our policy to result and perform better than other developing countries. India has been facing problem if undervaluing of currency, Jha (2008)[5] presented multi targeting as a solution for increasing exports and as well as growth too. Inflation and interest rates has been maintained properly in India through the multiple targeting. He criticised IT for India, as pre condition required for that are not available in India. Well-developed financial markets, autonomy of central bank, flexible exchange rate and globally integrated capital market with high degree of confidence level, continuous availability of accurate data, are some important pre conditions. In India it is not demand side only which should be controlled for stable economy but supply side plays an important role. In India monetary policy can't be separated from the monetary policy, but both policies work in combination. Moreover transmission mechanism is also weak in India.

Rajan (2007) supported the IT policy by discarding any possibility of slowdown in economy due to low inflation. He argues that adoption of IT will not allow RBI to ignore the credibility by the mass and already inflation is not too high in India. Even in IT regime all variables will be treated with equal responsibility. In case of any slowdown central bank can cut short term rates to accelerate growth without any increase in inflation expectations. Narasimham Committee advocated the policy of IT for stability of exchange rate through the low inflation rate.

India has been facing various issues and challenges in the way to adopt inflation targeting. There are evidences of successful implementation of the policy in developed countries but developing country could not be equally confident about IT. Being fiscal dominant and too much relying on inflation taxes, results are doubtful. Undeveloped capital market is also a reason for fiscal dominance. It is also lacking in continuous and reliable measuring tool for inflation. Poverty has been a big challenge for developing country like India. Growing GDP is required to mitigate the woe where a substantial proportion of population is living under the poverty line. Inflation is a big source of optimism for investor. If a low inflation prevails, Subbarao (2013) expressed his concern about a depressed growth of GDP due to low inflation. Epstein, Gerald, and Erinc Yeldan (2008)[6] found that out of 21 countries taken for study seven countries exhibited a decline in the average annual rate of real growth. The study found out that three countries (Canada, Hungary and Thailand) have not achieved any increase in growth rates. There are some examples of lower employment level post IT too. There are some beliefs that inflation has a very high cost, on the other hand if there is low inflation, economy will work well. But this study stated that aiming at low inflation and making it a sole goal by central bank is not desirable at all. They could not found a better alternative anchor and go for 'inflation-focused' monetary policy.

Independent decision making by central banking is pre condition for the inflation targeting along with IT as a sole target for central bank. In India where we are going through various structural changes and monetary policy is used in combination with fiscal policy taking IT as a sole motive may prove dangerous for health of economy. The relationship between monetary instruments and inflation should be stable and predictable too. But monetary transmission is found poor in developing countries as compared to developed countries.

Mazumder, S. (2011)[7]studied the existence of Philips curve in India. According to him positive and a significant relationship exists between inflation and inflation. He found existence of Okun's Law too which means that a negative relationship prevails between inflation and unemployment in India. He also found more lasting inflation in CPI than WPI. Inflation rate and unemployment rate are two of the key indicators of an economy

He found coefficients which are highly positive and significant, indicating that the Phillips curve relationship between inflation and output is important for India. And the results also imply via, that should be negatively related as expected from theory. CPI inflation in India appears to be more persistent than WPI inflation he added. Economist A. W. Phillips in 1958 demonstrated that when inflation is soaring, unemployment is depressed, and vice versa. This relationship is given the Phillips Curve, a negatively sloped curve.

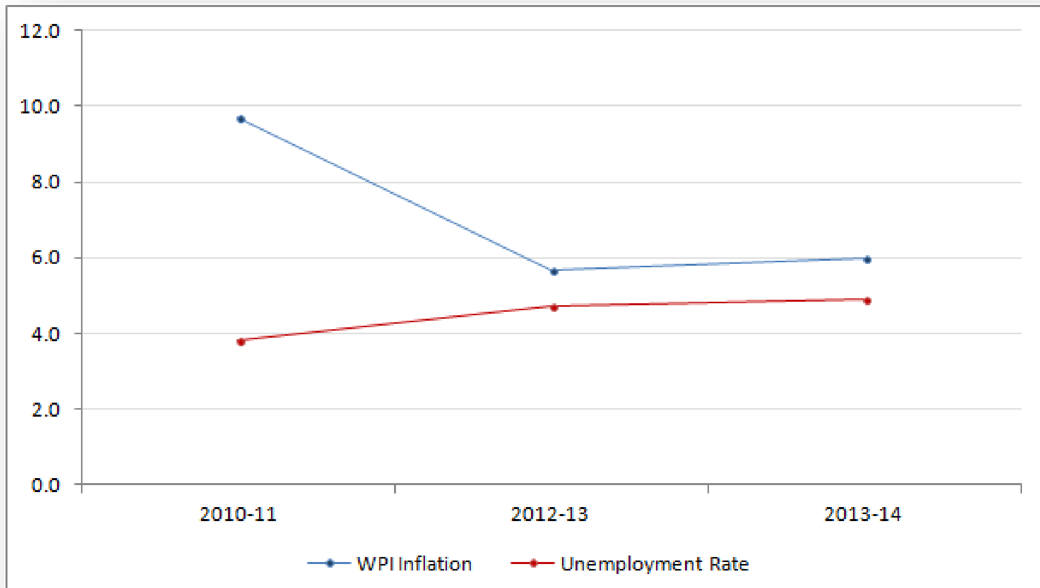

Figure 1: WPI Inflation and Unemployment Rate

Source: Open Government Data platform of India.[8]

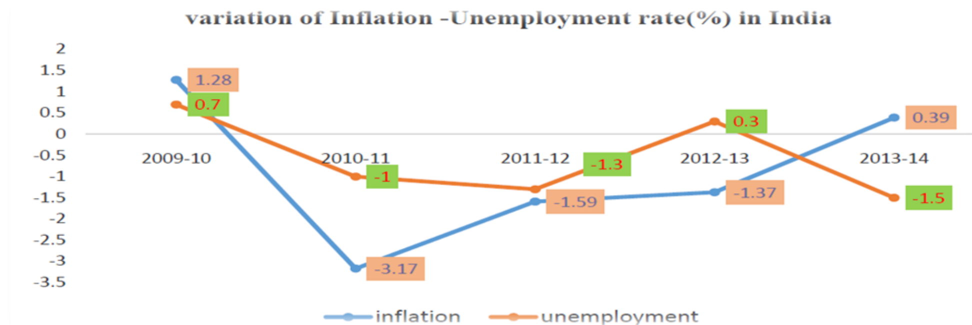

Figure 2: Variation of Inflation versus Unemployment

Singh, D., & Verma, N. (2016)[9] too have studied the correlation between unemployment rate and Inflation rate. He found a strong and negative relationship between Unemployment and inflation but he denies for any effect of unemployment on real GDP.

There are various evidences of prevailing of Philips curve in India. It makes IT an important tool to enhance employment in short run. No strong relationship is found in long run. Even monetarists had doubt about the relationship between inflation and employment in long run.

It is a big challenge for developing country like India to sacrifice the growth for maintaining the less uncertain environment where growth is quite doubtful.

New CPI in India

Another challenge is to fix the suitable and reliable target variable. WPI has been used by India for a long time as measurement of inflation. We have switched to CPI now but it is different from old CPI.

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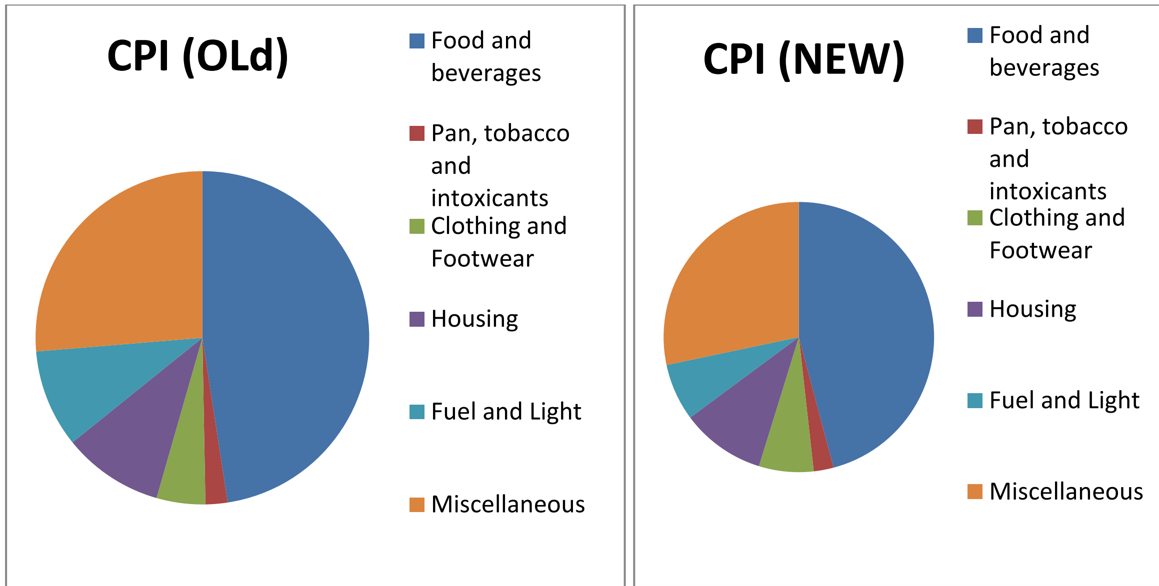

Figure 3(a): CPI Old **Figure 3(b): CPI New**

Source: MOSPI (2015)

A new series of CPI introduced with 2011-12 as base year. 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. As food prices are fluctuating in 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.

It is highly desirable to study the impact of IT on inflation rate and production. Success of IT depends upon these immediate results.

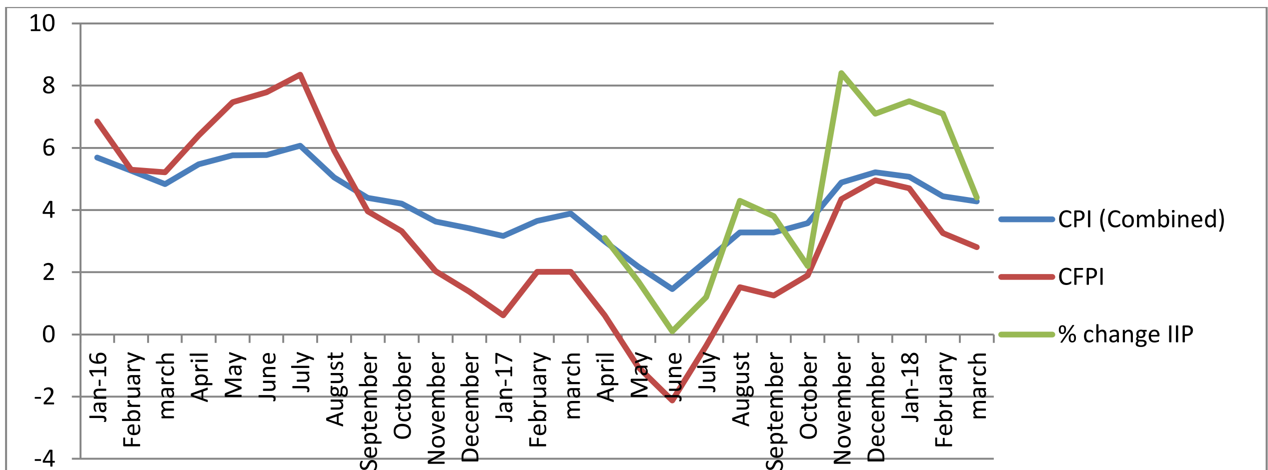

Figure 4: CPI and CFPI

Source: Data compiled from monthly reports of MOSPI

In the present diagram as we can see that CPI could not cross the limit of 6 % and remained around 4% but had been fluctuating through, this fluctuation is contributing by food prices. Supply shocks in food items and a substantial weight in CPI is responsible for such fluctuations. IIP has also been fluctuating and no signs of stability and certainty.

Demonetisation and Monetary Transmission in India

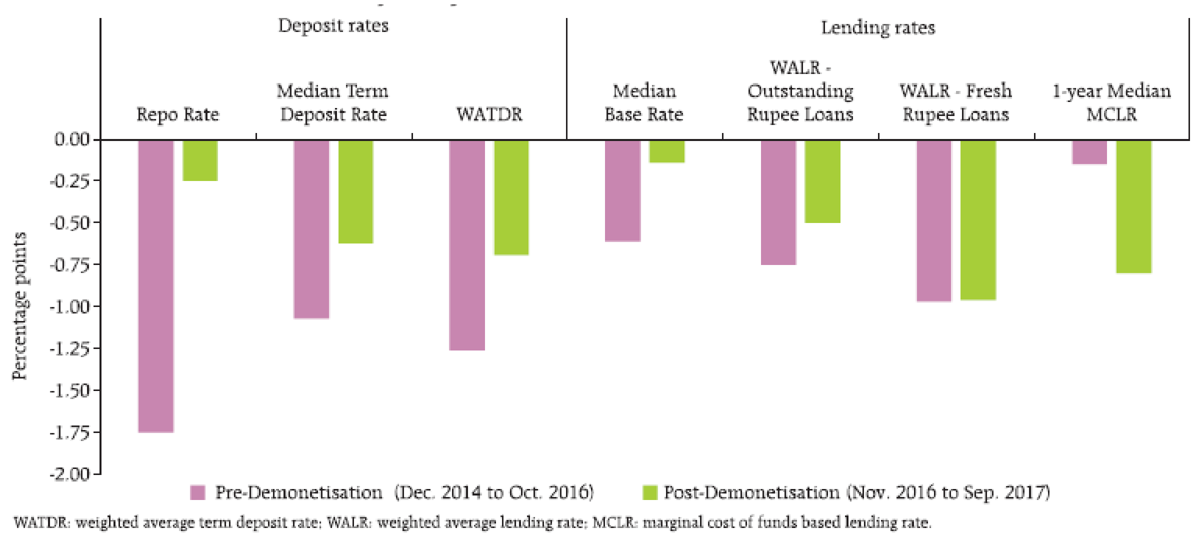

Figure 5: Monetary Policy Transmission in Post-Demonetization Period

During the demonetization people deposited currency available to them in banks. Low cost deposits increased to 40.6% in March 2017 which was 35.2 % in October 2016, but later on decreased to 38.6% in June 2017. Same time credit demand growth was low. Banks cut their lending rates. The weighted average lending rate declined substantially from November 2016 to August 2017. As we can see in above mentioned diagram increase in CASA during Demonetisation led to deposits and it resulted in to expressive elevation in transmission to bank lending rates throughout the post demonetisation period[10].

Conclusion

IT requires some pre conditions which are hardly found in developing countries. Moreover trade-off between inflation and employment create doubt on adoption of IT. A substantial portion of population is living under poverty and poverty elevation is more important than a stable CPI. Enhanced confidence of investors due to economic stability can only setback the negative effect of low inflation. In short run IT could not resulted in stability but long run targets will be suitable for developing as short run supply shocks could be ineffective. As food prices being a substantial weighted item are main reason for fluctuating CPI, underline inflation can be used for better. Reforms like demonetisation, financial inclusion and encouraging digital payment system will improve the monetary transmission in India.

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