Inflation targeting
14th April, 2018

Making a case for doing away with inflation targeting by the RBI, Economic Advisory Council to the Prime Minister (EAC-PM) member Surjit Bhalla recently said it has made zero impact on prices. Under the new policy framework, the RBI aims to contain inflation at 4% with a band of (+/-) 2%.

Concerns:

Average inflation in 2017-18 was 3.5%. India's real interest rate is higher by 2.5%, which is 3rd highest in the world.

What is inflation targeting?

- Inflation targeting is a monetary policy in which a central bank has an explicit target inflation rate for the medium term and announces this inflation target to the public. It will have price stability as the main goal of monetary policy.
- Many central banks adopted inflation targeting as a pragmatic response to the failure of other monetary policy regimes, such as those that targeted the money supply or the value of the currency in relation to another, presumably stable, currency.

Why it is good?

- It will lead to increased transparency and accountability.
- Policy will be linked to medium/long term goals, but with some short term flexibility.
- With inflation targeting in place, people will tend to have low inflation expectations. If there was no inflation target, people could have higher inflation expectations, encouraging workers to demand higher wages and firms to put up prices.
- It also helps in avoiding boom and bust cycles.
- If inflation creeps up, then it can cause various economic costs such as uncertainty leading to lower investment, loss of international competitiveness and reduced value of savings. This can also be avoided with targeting.

Associated concerns:

Inflation targeting puts too much weight on inflation relative to other goals. Central Banks Start to Ignore More Pressing Problems. Inflation target reduces "flexibility". It has the potential to constrain policy in some circumstances in which it would not be desirable to do so.

Not a panacea:

Inflation targeting has been successfully practiced in a growing number of countries over the past 20 years, and many more countries are moving toward this framework. Over time, inflation targeting has proven to be a flexible framework that has been resilient in changing circumstances, including during the recent global financial crisis. Individual countries, however, must assess their economies to determine whether inflation targeting is appropriate for them or if it can be tailored to suit their needs. For example, in many open economies, the exchange rate plays a pivotal role in stabilizing output and inflation. In such countries, policymakers must debate the appropriate role of the exchange rate and whether it should be subordinated to the inflation objective.

What's important?

- For Prelims: MPC and inflation targeting.
- For Mains: Inflation targeting- need, significance and challenges.

To be looked in UPSC Paper 3 Topic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.