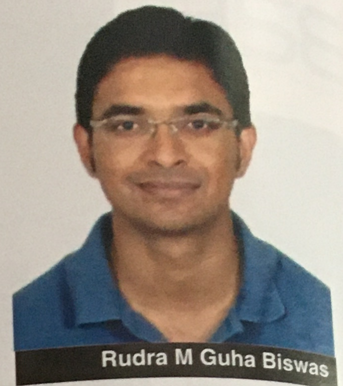
Report

Should RBI become an Inflation targeting Central Bank?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The Urjit Committee recently recommended that the RBI set an inflation target of four percent, with a price band of two percent; it further recommended that the "transition path to the target zone should be graduated to bringing down inflation from the current level of ten percent to eight percent over a period not exceeding the next twelve months and six percent over a period not exceeding the next 24 months, before formally adopting the recommended target of four percent inflation". A valid question, however, is should a central bank even embark on the path towards 'inflation targeting', a subject that has aroused a fair bit of debate amongst the international economists' community.

Inflation Objectives

'Inflation targeting' is an economic policy in which a central bank of a country estimates and makes public a projected or 'target' inflation rate; it can be conducted through an interest rate, such as a short-term cash or repo rate. A more robust definition of inflation targeting from Mishkin (2000) attributes five main elements to a successful 'inflation targeting' strategy; "a public announcement of medium-term numerical targets for inflations; an institutional commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated; an information inclusive strategy in which many variables, and not just monetary aggregate or the exchange rate, are used for deciding the setting of policy instrument; increased transparency of the monetary policy strategy through communication with the public and the markets about the plans, objectives, and decisions of the monetary authorities; and increased accountability of the central bank for attaining its inflation objectives."

Emerging Market Economies

The IMF has been actively advocating an open economy 'inflation targeting' arrangement, enthused by the success the program saw in the 1990s. Cavoli and Ramkishen Rajan cite a growing body of empirical evidence that finds 'inflation targeting' arrangements to have "improved the macroeconomic outcomes in emerging market economies, in terms of lower and more stable inflation and lower output volatility without the fragility of pegs". They, however, add the caveat that such benefits accrued during relatively benign periods and have not really been tested in the turbulent cycles that are currently transpiring.

Credit Crisis of 2008

The first instances of 'Inflation targeting' were seen around the early 1990s, in countries such as New Zealand, Canada and the United Kingdom; they chose to keep inflation around the two percent mark, with a leeway of about one percent. Several emerging market economies also chose to follow their path. However, in the aftermath of the credit crisis of 2008, the criticism of 'inflation targeting' efficacy has increased.

Gradual Reduction of Inflation

According to Mishkin (2000), one of the earliest examples of an emerging economy utilising 'inflation targeting' was Chile; the inflation rate in Chile during the 1990s was in excess of twenty percent. It announced an annual inflation objective to significantly reduce inflation. On the whole the evidence suggests that it was successful in its objective. Inflation fell from twenty percent in 1990 to three percent in 2000, while its output growth averaged at eight percent per year from 1991 through 1997, an average that was comparable to the growing economies of Asia in that period, i.e. the Asian tigers. Mishkin (2000) acknowledges that the Chilean example can indeed be hailed as a success for gradual reduction of in-

flation, even for countries with a high starting rate, however he makes the point that the reduction in inflation cannot be attributed solely to the central bank; "supportive policies such as absence of large fiscal deficits and rigorous regulation and supervision of the financial sector were crucial to its success".

'Inflation targeting' has always been the subject of heavy debate, which has just gotten more vociferous after the financial crisis. Many have come out in support of the method; most famously our current governor of the Reserve Bank of India, Mr. Raghuram Rajan along with Eswar Prasad, in an op-ed piece extorted the RBI to "move towards a single objective for monetary policy – low and stable inflation" in 2008. There is some empirical evidence across the globe that has shown the impact of supply shocks on inflation to be lower in countries whose central banks have actively pursued 'inflation targeting'. The theory goes that 'inflation targeting' regimes are expected to better control inflation expectation, through their active communication with the markets, and thus cushion the 'pass-through' effects of the shocks. The leeway or band is therefore a vital part of any 'inflation targeting' armory. According to a recent article by Gangadhar Darbha, a financial market practitioner, "anchoring generalised inflation expectations is the clearest and most important objective for any central bank", a thought that is echoed in the ideas of the late great economist Milton Friedman, "Inflation is always and everywhere a monetary phenomenon".

Raghuram Rajan, Governor, Reserve Bank of India: Achieving inflation targetting through interest rate

Domestic Considerations

Mishkin (2000) gives us some of the other advantages of the 'inflation targeting' system. He suggests that in the medium term, "in contrast to an exchange rate peg, inflation targeting enables monetary policy to focus on domestic considerations and to respond to shocks to the domestic economy". "Also in contrast to 'monetary targeting', a possible alternative monetary policy strategy, 'inflation targeting' has the advantage that a stable relationship between money and inflation is not critical to its success". The 'inflation targeting' strategy does not depend on such a relationship; it uses all available information to determine the best setting for the instruments of monetary policy. Due to a high level of interaction and communication with the market, it is also a highly transparent strategy.

Output Argument

The arguments against 'inflation targeting' focus heavily on the output argument. Economist worry that focusing on inflation in developing economies forces a central bank to raise interest rates, which raises borrowing costs and thus hurts economic growth. Baig and Das write, " The period since the 2008 global financial crisis has not been kind to the theory and practice of inflation targeting. After two decades of enthusiastic embrace by many central banks, both from advanced (e.g. Australia and UK) and emerging market (Brazil, Thailand) economies, the wisdom and efficacy of inflation targeting have come under intense scrutiny".

The critics, as well as the champions of 'inflation targeting' have, over past two decades, raised pertinent issues regarding targeting a level of inflation. It is best to use the summaries of Mishkin (2000) and Bernanke (1997), both of whom echo the sentiments of many economists who have lent their voices to this debate, to bring this discussion to a close. Bernanke and Miskin (1997) suggested in their preliminary assessment that "'inflation targeting', if used as a framework for making monetary policy, rather than as a rigid rule, has a number of advantages, including more transparent and coherent policy-making and increased accountability". Mishkin (2000) suggests that although inflation targeting is not a panacea, it can be a highly useful monetary policy tool for some emerging market economies. At a juncture where the RBI has to decide to move towards an 'inflation targeting' regime, it would be best advised to follow a middle approach. It can be confident that this tool has produced results in both developed as well as developing countries, however it should also be aware of the numerous pit falls in the path, highlighted by various luminaries of the economic landscape.

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