4% INFLATION TARGET RETAINED FOR 2021-26 RBI'S RATE PANEL

Context:

The Government of India has decided to retain the inflation target of 4%, with a tolerance band of +/- 2 percentage points for the Monetary Policy Committee of the Reserve Bank of India (RBI) for 2021-2026.

Relevance:

GS-III: Indian Economy (Economic Development of India, Macroeconomics, Monetary Policy, Inflation)

Dimensions of the Article:

1. India's decision regarding maintenance of Inflation rate at 4%
2. Monetary Policy Committee (MPC)
3. How does the MPC target inflation?
4. How is Inflation Controlled?
5. What is Inflation targeting?
6. How is Inflation Targeting done?
    - Advantages of Inflation Targeting
    - Disadvantages of Inflation Targeting

India's decision regarding maintenance of Inflation rate at 4%

- In 2016 itself, the central government mandated he RBI to keep the retail inflation at 4%

with a margin of 2% on either side for a five-year period (i.e., till March 2021) to control the price rise.

- The central bank and the government agreed in 2015 on a policy framework that stipulated a primary objective of ensuring price stability while keeping in mind the objective of growth.
- The Flexible Inflation Target (FIT) was adopted in 2016. The Reserve Bank of India Act, 1934 was amended to provide a statutory basis for a FTI framework.
- The amended Act provides for the inflation target to be set by the Government, in consultation with the RBI, once every five years.
- Now, the inflation target for the period 1st April, 2021 to 31st March, 2026 under the Reserve Bank of India Act 1934 has been kept at the same level as was for previous 5 years.

Monetary Policy Committee (MPC)

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- The Monetary Policy Committee of India is responsible for fixing the benchmark interest rate in India.
- The meetings of the Monetary Policy Committee are held at least 4 times a year and it publishes its decisions after each such meeting.
- The committee comprises six members – three officials of the Reserve Bank of India and three external members nominated by the Government of India.
- They need to observe a "silent period" seven days before and after the rate decision for "utmost confidentiality".
- The Governor of Reserve Bank of India is the chairperson ex officio of the committee.
- The Reserve Bank of India Act, 1934 was amended by Finance Act (India), 2016 to constitute MPC which will bring more transparency and accountability in fixing India's Monetary Policy.
- The monetary policy are published after every meeting with each member explaining his opinions.
- The committee is answerable to the Government of India if the inflation exceeds the range prescribed for three consecutive months.
- Key decisions pertaining to benchmark interest rates used to be taken by the Governor of Reserve Bank of India alone prior to the establishment of the committee.
- The Governor of RBI is appointed and can be disqualified by the Government anytime.

How does the MPC target inflation?

- Every two months, the Reserve Bank's MPC has a review meeting where they discuss the likely inflation and growth estimates over the coming months.
- Based on this review, the MPC targets inflation using the policy rate, or the repo rate.

When inflation is higher than the inflation target set by the central bank, then the MPC must increase the repo rate. On the other hand, when the actual inflation is lower than the target, the MPC could decrease the repo rate. The

- MPC looks at consumer price inflation (CPI) as the inflation target that it must keep between 2% and 6%.

How is Inflation Controlled?

There are broadly two ways of controlling inflation in an economy:

1. Monetary measures and
2. Fiscal measures

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Monetary Measures

- The most important and commonly used method to control inflation is monetary policy of the Central Bank (RBI in India).
- Most central banks use high interest rates as the traditional way to fight or prevent inflation.

Monetary measures used to control inflation include:

1. Bank Rate Policy
2. Cash Reserve Ratio and
3. Open Market Operations.

Fiscal Measures

- Fiscal measures to control inflation include taxation, government expenditure and public borrowings.

- The government can also take some protectionist measures (such as banning the export of essential items such as pulses, cereals and oils to support the domestic consumption, encourage imports by lowering duties on import items etc.).

What is Inflation targeting?

Inflation targeting is basically a monetary policy system wherein the central bank of a country (RBI in India) has a specific target inflation rate for the medium-term and publicizes this rate.

How is Inflation Targeting done?

- Inflation targeting is done by raising or lowering interest rates based on above-target or below-target inflation, respectively.
- The conventional wisdom is that raising interest rates usually cools the economy to rein in inflation; lowering interest rates usually accelerates the economy, thereby boosting inflation.

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Advantages of Inflation Targeting

- Inflation targeting allows monetary policy to "focus on domestic considerations and to respond to shocks to the domestic economy", which is not possible under a fixed-exchange-rate system.
- Transparency is another key benefit of inflation targeting. Central banks in developed countries that have successfully implemented inflation targeting tend to "maintain regular channels of communication with the public".
- An explicit numerical inflation target increases a central bank's accountability, and thus it is less likely that the central bank falls prey to the time-inconsistency trap. This accountability is especially significant because even countries with weak institutions can build public support for an independent central bank.

Disadvantages of Inflation Targeting

- There is a propensity of inflation targeting to neglect output shocks by focusing solely on the price level.
- Leading economists argue that inflation targeting would maintain or enhance the transparency associated with a system based on stated targets, while restoring the balance missing from a monetary policy based solely on the goal of price stability, thus neglecting other factors of an economy as well.

-Source: The Hindu

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