

Flexible Inflation Targeting

December 29, 2020

In news

Recently, RBI's working paper on inflation has found a steady decline in trend inflation to 4.1-4.3 per cent since 2014.

Key highlights of the report/paper

- The report says that Maintaining the inflation target at 4 per cent is appropriate for India in the backdrop of the steady decline in trend inflation to 4.1- 4.3 per cent since 2014
- The observation by the report assumes significance given that the flexible inflation targeting/ FIT (formally instituted in June 2016), which commits the RBI to a consumer price inflation (CPI) target of 4 per cent with an upper and lower tolerance band of +/- 2 per cent, has to be reviewed by end-March 2021.
- The authors report Harendra Kumar Behera, Director, and Michael Debabrata Patra, Deputy Governor, RBI underscored that: "The credibility bonus accruing to monetary policy warrants smaller policy actions to achieve the target (FIT). This points to maintaining the inflation target at 4 per cent into the medium-term. If it ain't broke, don't fix it."
- As per the paper, central to the design and conduct of monetary policy is the concept of trend or steady state inflation. It is the level to which actual inflation outcomes are expected to converge after short run fluctuations from a variety of sources, including shocks, die out.
- The paper points out that the real time estimate of trend inflation was around 5 per cent until the end of 2013, but it declined steadily thereafter to 4.1 per cent in Q1 of 2019, before inching up thereafter during

the COVID-19 pandemic.

- The authors said it is worthwhile to note that trend inflation still remains above the target under FIT, although it is on a declining trajectory.
- As per the authors, this indicates that inflation expectations are not yet fully anchored to the target but convergence is under way

What is Flexible Inflation Targeting(FIT)?

FIT is a monetary policy strategy used by the Central Bank to maintain the price level within a certain range. This strategy indicates the importance of price stability as the prime factor of monetary policy. Inflation targeting is known to bring more stability, predictability, and transparency in deciding monetary policy.

Monetary policy refers to the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the Act. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934.

Flexible Inflation Targeting Framework

- **In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the flexible inflation targeting framework.**
- The amended RBI Act also provides for the inflation target to be set by the Government of India, in consultation with the Reserve Bank, once in every five years.
- Accordingly, the Central Government has notified in the Official Gazette 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.

- The Central Government notified the following as factors that constitute failure to achieve the inflation target:
 - the average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or
 - the average inflation is less than the lower tolerance level for any three consecutive quarters.
- **Prior to the amendment in the RBI Act in May 2016, the flexible inflation targeting framework was governed by an Agreement on Monetary Policy Framework** between the Government and the Reserve Bank of India of February 20, 2015.