Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: about the inflation targeting framework, repo rate; CPI; MPC

News: Last year, there were calls to review RBI’s inflation targeting framework. With the term of the current monetary policy committee ending in September, it’s time to review the performance of the rate-setting framework.

What are the terms of the policy framework?

In 2016, the government amended the Reserve Bank of India Act (1934) and institutionalized a framework for a monetary policy committee (MPC), which was mandated to maintain price stability while keeping the objective of growth. MPC was given a policy tool of the repo rate in order to ensure inflation was within a target level. The inflation target given to MPC was 4%, with 6% as the upper tolerance level and 2% as the lower tolerance level. That is, MPC was supposed to adjust the repo rate in order to ensure that inflation stayed within two percentage points of the target of 4%.

How does the current framework function?

MPC meets every two months and decides the policy rate based on the available data. MPC’s primary mandate is to curb inflation and it looks at consumer price index (CPI) figures as the preferred indicator of inflation. There is a neutral real repo rate, which is the policy rate at which monetary policy is neither accommodative nor contractionary. Therefore, in the event of higher inflation (or higher than potential growth), MPC would have a real policy rate higher than the neutral real rate. That is, it will increase the interest rates. Conversely, in the event of lower-than-target inflation, MPC would cut the repo rate.

Okay, so what is India’s neutral real repo rate?
There is no official paper on India’s neutral real rate. When Raghuram Rajan was RBI governor, it was believed to be 1.5-2%. Since the adoption of the monetary policy framework, in response to a question during the first MPC press briefing, one of the members indicated that the rate could be 1.25%. The neutral real rate is not a constant and changes from time to time.

Why are our real rates higher than the target?

Focusing solely on retail inflation targeting would be problematic at a time when the food inflations is high and actual GDP growth is lower than the potential GDP growth. This could very well be the case in January and next month. Figures released on Monday showed December retail inflation at 7.35%, driven primarily by onions and vegetables. There’s evidence to suggest that monetary policy has little or no impact on food inflation. The framework thus needs to be revised to look at our real policy rates.

What are the changes being argued for?

The current inflation target given for five years expires in 2021. With MPC’s term ending in September, it is time to objectively look at the performance of the framework. Many believe we have sacrificed growth due to an overtly hawkish stance and that a target for growth rate should be included, besides a mandate for financial stability. Else, revisit the 4% inflation target and mandate that MPC considers wholesale price inflation with CPI while framing monetary policy.