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Medium-term framework: Govt may maintain inflation target band-Business Journal

By BUSINESS JOURNAL

Pertinently, a recent paper by RBI deputy governor Michael Patra and researcher Harendra Kumar Behera made a case for maintaining the 4% target, saying "if it ain't broke, don't fix it".

The government may keep the inflation target band unchanged at 4% (+/-2) once a review of the medium-term framework is over this month, as it doesn't want to trim focus on price pressure in pursuit of economic growth.

Economists had earlier cautioned against any dilution of the target – especially given the elevated fiscal deficit projections until FY26 – amid volatile food and soaring fuel prices. The inflation target typically influences rate-setting by the monetary policy committee (MPC) of the Reserve Bank of India (RBI).

"There is a good case for maintaining the target under the flexible inflation targeting frame-work," a source close to the development told FE. The extant five-year target, set in 2016, expires this month.

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The review comes at a time when retail inflation spiked to 5.03% in February, having hit a 16-month low of 4.06% in the previous month, reflecting broad-based price pressure, as both food and core inflation rose. Before January, headline retail inflation had exceeded the upper end (6%) of the RBI's tolerance level for 10 of the 12 months.

Already, oil prices remain elevated, which can potentially inflate transport costs. Even discretionary items like clothing and health-related expenses added to sequential momentum in core CPI inflation in February. Core inflation (CPI excluding food, beverages and fuel) rose to 5% in February from 4.5% in January.

The benchmark 10-year government bond yields, which had dropped below the 6% mark in early October 2020, started hardening in the past two months to breach 6% again on January 27. It opened at 6.17% on Wednesday.

Sonal Varma, chief economist for India and Asia (ex-Japan) at Nomura, recently told FE: "India certainly needs growth but at the same time it can't afford to let inflation spike. Even within the current framework, there is enough flexibility for the MPC to address growth concerns, as was witnessed last year."

"But if the target is raised in the backdrop of elevated fiscal deficit, it will signal an expansionary policy. So, from a signalling perspective, too, the target shouldn't be altered," she had added.

Similarly, according to **M Govinda Rao**, member of the 14th Finance Commission and current chief economic advisor at **Brickwork Ratings**, once the current output gap narrows, surplus liquidity conditions could pressure inflation and the RBI will have to be vigilant. "But that doesn't mean that the inflation targeting framework should be meddled with."

The paper by RBI's Patra and Behera had said: "A target set below the trend imparts a deflationary bias to monetary policy because it will go into overkill relative to what the economy can intrinsically bear in order to achieve the target."

"Analogously, a target that is fixed above trend renders monetary policy too expansionary and prone to inflationary shocks and unanchored expectations," they argued.

For its part, the MPC has retained its accommodative stance to aid growth prospects in the aftermath of the pandemic, despite high retail inflation.