MEDIUM-TERM FRAMEWORK

Don't dilute inflation target: Economists

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AS THE GOVERNMENT and the Reserve Bank of India (RBI) gear up for a review of a medium-term inflation targeting framework in March, many economists have cautioned against a dilution of the extant target, especially given the elevated fiscal deficit projections until FY26. Some even pitched for having a closer look at core inflation while continuing to target the headline retail inflation in the 4 (+/-2)% band.

The inflation target typically influences rate-setting by the monetary policy committee (MPC). Pronab Sen, former chairman of the National Statistical Commission, suggested that the target be retained, though he batted for two

Headline inflation target should be retained but within it, a lower core inflation target should be set. MPC's remit also needs to be widened

— **PRONAB SEN,** FORMER CHAIRMAN, NSC

As output gap narrows, surplus liquidity can pressure (inflation).... But that doesn't mean the targeting framework should be meddled with

— **M GOVINDA RAO,** CHIEF ECONOMIC ADVISOR, BRICKWORK RATINGS

Even in the extant framework, there is scope for MPC to address growth concerns. If the target is raised..., it will signal an expansionary policy

— **SONAL VARMA,** CHIEF ECONOMIST FOR INDIA AND ASIA (EX-JAPAN), NOMURA

changes in the overall framework. Within the broader target, a separate, lower core inflation band of 4 (+/-1)% should be set, he said. "Moreover, the remit of the MPC should be widened to cover instruments beyond just the key policy rates," Sen added.

Pertinently, a recent RBI paper made a case for maintaining the 4% target, saying "if it ain't broke, don't fix it".

Sonal Varma, chief economist for India and Asia (ex-Japan) at Nomura, 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."

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"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 added. Varma said there is some merit in looking at core inflation as well, as it's a more stable gauge of price pressure, given that the overall consumer price index is loaded with food products. However, there has to be a standardised method of calculating core inflation. The Centre intends to cut its fiscal deficit to 4.5% of nominal GDP by FY26, against the pre-Covid goal of containing it at 3.1% by FY23. Its deficit is now estimated to surge to 9.5% in FY21 and remain as high as 6.8% next fiscal. M Govinda Rao, member of the 14th Finance Commission and current chief economic advisor at Brickwork Ratings, said the framework is a medium-term one (for the next five years) and should not be tailored to suit temporary disruptions.

High fiscal deficit in FY21, he noted, was unlikely to stoke inflationary pressure due to prevailing muted demand conditions and large output gap in the economy. "However, as the output gap closes down...surplus liquidity conditions can put pressure (on inflation) and the RBI will have to be vigilant. But that doesn't mean that the inflation targeting framework should be meddled with, for inflation is a compulsory tax predominantly on the poor," Rao said. The paper by RBI deputy governor Michael Patra and researcher Harendra Kumar Behera in December 2020 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. Saugata Bhattacharya, chief economist at Axis Bank, said the 4% inflation target has succeeded in anchoring India's inflation and, more importantly, expectations. The FY22 Budget is growth-oriented, with a focus on capital spending. Despite the revised deficit glidepath and consequent high public expenditure, the embedded supply-enhancing steps, if well implemented, might mitigate some inflation risks, Bhattacharya argued.

"A key question is, will the 2% average inflation differential over developed countries targets serve to sustain or inhibit our aspirational 7-8% potential growth?" he asked. In a post-Budget interview to FE, economic affairs secretary Tarun Bajaj discounted inflation fears due to elevated deficit, saying the government would deploy much of the resources in creating productive assets. Moreover, with capacity utilisation trailing the trend level in the wake of Covid-induced disruptions, even the supply side is unlikely to react negatively to this fiscal push, he said. For its part, the MPC has retained its accommodative stance to aid growth prospects in the aftermath of the pandemic, despite high retail inflation. Importantly, the inflation gauges have given conflicting signals over the past one year or so. Retail inflation plunged to a 16-month low of 4.06% in January, on moderating food inflation and a conducive base. But prior to this, it had remained above the upper end (6%) of RBI's tolerance level for 10 of the 12 months. In contrast, wholesale price inflation remained subdued, having moved in the range of -3.4% to 3.5% during this period, complicating the job of assessing actual price pressure in the economy. Of course, the MPC targets only the retail inflation.