SBI Research

The success of Inflation Targeting in India is largely a byproduct of a vibrant financial ecosystem where RBI, Government and the Banks are working closely in unison in ushering in market reforms…However, it is important that we also undertake reforms in data infrastructure for a bottom-up policy making

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- India's tryst with inflation targeting has been largely successful. Although the potential benefits of IT adoption are clear from the literature, the empirical evidence on its impact on inflation performance in India supports that India had a largely successful inflation targeting regime…. Compared to advanced economies like the USA, Germany, and France, India had one of the lowest deviations from its inflation target in the triennial average inflation from 2021-2024

- The success of India's inflation targeting is also a byproduct of close co-ordination with the Government. Monetary and fiscal policy coordination in India has worked seamlessly since pandemic

- Also, effectiveness of monetary policy in India's pre–Inflation Targeting regime was constrained by several India specific factors that affected transmission of the policy impulses through the interest rate channel. Some of the major factors were: i) sustained fiscal dominance, ii) large informal sector & significant presence of informal finance, and iii) bank's behaviour in pricing loan products. All these have been addressed successfully through the assiduous efforts of the Government, RBI and the Banks in unison in the last decade

- The argument that food inflation remains sticky but core inflation has moved down and hence it is better to target headline inflation excluding food is actually counterfactual. It is precisely that successful inflation targeting by RBI has anchored inflationary expectations and thus the spillover from higher food to core. The more the RBI communicates that 4% is the inflation target, the more will be the successful anchoring of inflation targeting

Inflation Targeting in India

- ❑ Following the recommendations by an expert panel in 2014, and RBI Act amended by the Government to bring the provisions of regarding constitution of MPC into force on June 27, 2016, which formally established an inflation target of 4% (and a tolerance band of ±2%), by constituting the six member MPC in September 2016

- ❑ India became the 36th country to adopt an inflation targeting monetary policy regime
  - • Prior to that, in February 2015, a Monetary Policy Framework Agreement (MPFA) was signed between the Government of India and RBI, and it was decided that RBI will target CPI inflation in the range of 4±2% for all subsequent years

- ❑ So, India's history of inflation targeting (IT) is very short. Before this, RBI followed a multiple-indicator approach, with low and stable inflation as just one of the objectives. Under the multiple-indicator approach, policy perspectives were drawn by juxtaposing output data against interest rates or rates of return in different markets, along with movements in currency, credit, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing, and transactions in foreign exchange.

- ❑ The fortunes of IT and India's first MPC were intertwined over a tumultuous period by any reckoning. The latter held 50 meetings in total, including two off-cycle

FOR

❑ First, IT reduces the time-inconsistency problem of monetary policy, which helps to achieve lower and less variable inflation

❑ Second, IT enhances the credibility of a central bank and anchors inflation expectations, thanks to its clear target as well as transparency and accountability

❑ Third, IT offers more flexibility, inflation targets are set as a medium-term goal; consequently, short-term deviations from the target may not harm credibility. IT also allows stabilizing output without sacrificing the inflation target

AGAINST

❑ Although the potential benefits of IT adoption are clear from the literature, the empirical evidence on its impact on inflation performance remains ambiguous….**however in India the data supports that India had a largely successful inflation targeting regime….**
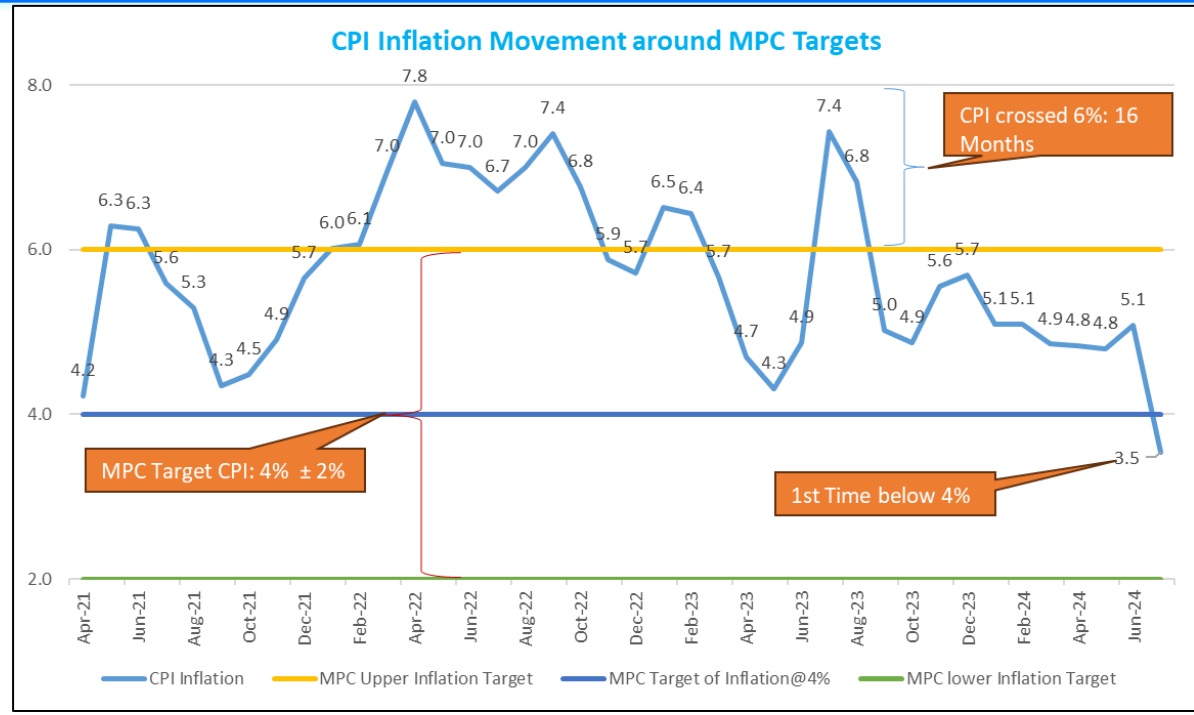
- ❑ Being a late entrant to the club of countries that have been practicing monetary policy making in an IT framework since the 1990s, India adopted the best practices and procedures for the decision-making process

- ❑ Despite the challenges posed by global demand-supply imbalances due to ongoing geopolitical tensions, India's inflation rate was within its target range of 2-6% in FY24 so far. Compared to advanced economies like the USA, Germany, and France, India had one of the lowest deviations from its inflation target in the triennial average inflation from 2021-2024

Cross Country Inflation Targeting Experiences						
Country	Inflation Target	2024 Average(Till July)	2021	2022	2023	Avg Deviations (2021-2024) from Targetted Inflation
Brazil	3.25	4.2	8.3	9.3	4.6	3.4
France	2.00	2.4	1.6	5.2	4.9	1.5
Germany	2.00	2.3	3.1	6.9	6.0	2.6
India	4.00	**4.8**	**5.1**	**6.7**	**5.7**	**1.6**
Mexico	3.00	4.8	5.7	7.9	5.6	3.0
Russia	4.00	8.1	6.7	13.8	5.9	4.6
S.Africa	4.50	5.2	4.6	6.9	5.9	1.1
UK	2.00	2.7	2.6	9.1	7.4	3.4
USA	2.00	3.2	4.7	8.0	4.1	3.0

Source: SBI Research

Inflation Targeting: Headline CPI is the best ancho, though Core CPI is nicely aligned with headline numbers

- A section of researchers debate that India should target CPI ex food instead of overall CPI
- However, a volatility analysis indicate that overall CPI has the lowest coefficient of variation among the core CPI and CPI ex food (though the average of Apr'21 to Jul'24 period is higher in the case of overall CPI)
- Core CPI has also a volatility that is nicely aligned with Headline CPI indicating that inflation targeting have resulted in breaking the nexus between Food Inflation spilling into Core Inflation
- Further, only 16 times in the last 40 months that CPI inflation exceed the upper tolerance band

CPI Inflation Movement around MPC Targets

CPI crossed 6%: 16 Months

MPC Target CPI: 4% ± 2%

1st Time below 4%

Legend: CPI Inflation — MPC Upper Inflation Target — MPC Target of Inflation@4% — MPC lower Inflation Target

Anchor (Apr'21 to Jul'24)	Max	Min	Mean	CV
CPI Overall	**7.8**	**3.5**	**5.7**	**0.13**
Core CPI	7.1	3.1	5.2	0.16
CPI ex food	7.5	2.2	5.4	0.23

CV: Coefficient of Variation

6

The monetary and fiscal policy worked in coordination in the aftermath of covid pandemic

- Soon after the lockdown was announced, the Government announced various schemes including Pradhan Mantra Garib Kalyan Yojana, emergency working capital facility for businesses and also increased demand in the economy by announcing LTC cash voucher and festival advance for the Government employees and enhanced capital expenditure

- Meanwhile, RBI also took a plethora of monetary and liquidity measures to supplement the fiscal support by the Government. A number of other measures including reduction in Cash Reserve Ratio (CRR) and Marginal Standing Facility (MSF), targeted TLTROs, special refinance facilities to NABARD, SIDBI and NHB, restructuring and change in NPA norms, deferment of Interest on Working Capital Facilities, broadening the scope of priority sector lending among others were taken to ease credit conditions

- The monetary policy committee maintained the accommodative stance since June 2019

- RBI, however, also raised repo rates and changed the stance to withdrawal of accommodation since May 2022 to rein in excess liquidity

- The coordinated efforts of the authorities helped in keeping inflation under control

| Fiscal - Monetary Policy Coordination		
	Swerve	**Go Head-on**
Swerve	(0, 0)	(-1, +1)
Go Head-on	(+1, -1)	(-10, -10)

Policy coordination between the Government and the Central Bank follows a chicken game

But in times of crisis, the two are required to coordinate and drive the economy towards prosperity

Why Core CPI should not be used an anchor?

❑ One should recognize that targeting core inflation instead of overall CPI is consistent with overall structure of Indian economy as explained above and may accentuate the cross-subsidization between households and those sectors which form the part of core CPI

❑ Core CPI also may not be an appropriate nominal guidance given the complexities. For example, core CPI contains items like service sectors that face supply bottlenecks (healthcare, education etc.), as well as items like clothing & footwear which have unique characteristics / non-discretionary and non-leveraged and may not respond to monetary policy signals

❑ The argument that food inflation remains sticky but core inflation has moved down and hence it is better to target headline inflation excluding food is actually counterfactual. It is precisely that successful inflation targeting by RBI has anchored inflationary expectations and thus the spillover from higher food to core. The more the RBI communicates that 4% is the inflation target, the more will be the successful anchoring of inflation targeting

Stable HH Leverage ratio is conducive for Inflation targeting

❑ One of the factors that help in success of IT in India is the low and stable household leverage ratio.

❑ While the indebtedness of Indian households has been on an upward trajectory reflecting financial deepening, it needs to be seen in the context of an increase in their financial assets as well

❑ An analysis of Household leverage ratio (ratio of household debt to financial assets) indicate that although it has increased from 25% in Sep'21 to 28% in Mar'23, yet it has remained largely flat (between 25 and 27) in 37 out of 48 quarters


Quarterly Household Leverage (%)
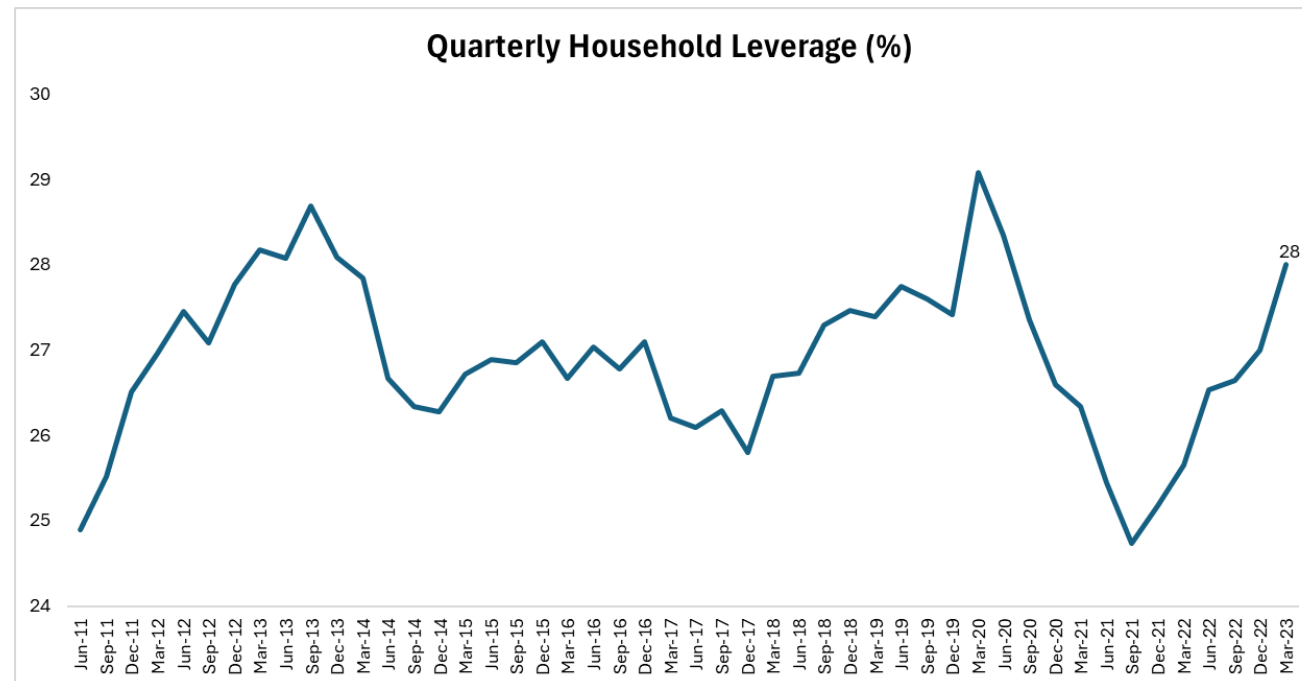
How the new CPI numbers may impact Inflation Targeting?

- The latest data of CES (2022-23) has revised the weights of major food items from 47.8% in 2011-12 to 42.8% in 2022-23 at all India level. However, what is important is still the significant divergence between NAS data and CES data. The NAS data typically captures the PFCE data and this data (as released in Feb'24) shows a significant divergence of amount spent on food

- If we provisionally calculate the new CPI by looking at revised weights of CPI(IW) with 2016 as the base and logically assuming the same trend in CPI, we find that the weights of food in CPI could decline by at least as much as 6%, thus shaving of 6 basis points from current headline CPI at 4.56%. However, the postulated increase in service consumption will push up the weighted contribution of miscellaneous inflation by 23 basis points. **Thus, the overall impact will depend on the strength of food and services, though the bottomline is the revised CPI will be more representative of demand pressures as weights of services and food could be almost in equal proportion**

- We believe that the revised CPI, with low food weights will further help MPC to target inflation through policy rate

	NSO CPI (Current Wt.)	SBI CPI (Proposed Wt.)	Change	Change in Weighted Contribution (in bps) in APR-JUL 2024
Food and beverages	45.86	40.0	-5.86	-42.0
Pan, tobacco and intoxicants	2.38	2.0	-0.38	-1.3
Clothing and footwear	6.53	6.0	-0.53	-1.4
Housing	10.07	12.0	1.93	5.1
Fuel and light	6.84	5.0	-1.84	7.7
Miscellaneous	28.32	35.0	6.68	23.5
Overall	100.00	100.00		-6.5

Ultimately, thus Data Quality in Policy Making is the most important

❑ Former RBI Governor Dr. D. Subbarao in his book had mentioned that "*RBI is often wrong-footed because of the questionable quality of data*"

❑ Apart from the revision in CPI inflation data, an example of missing data is the absence of disaggregated level GDP numbers at district level in India across states. Only a handful of state governments like Telangana, Maharashtra, TN, Andra Pradesh, Bihar, etc. (with a lag) provide district level GDP data for states

❑ District level GDP could be most effective tool for better planning, potential industrialization, migration patterns and agri reforms. We found some interesting observation while analyzing district-wise per capita income (PCI):

- PCI of 76% of Telangana's districts is more than India's PCI
- Mumbai's PCI is 37% more than the Maharashtra's PCI
- In Bihar, except Patna, PCI of all districts is less than the India's PCI

Per capita GDDP (Rs)

India Per capita GDP for FY23: 194879
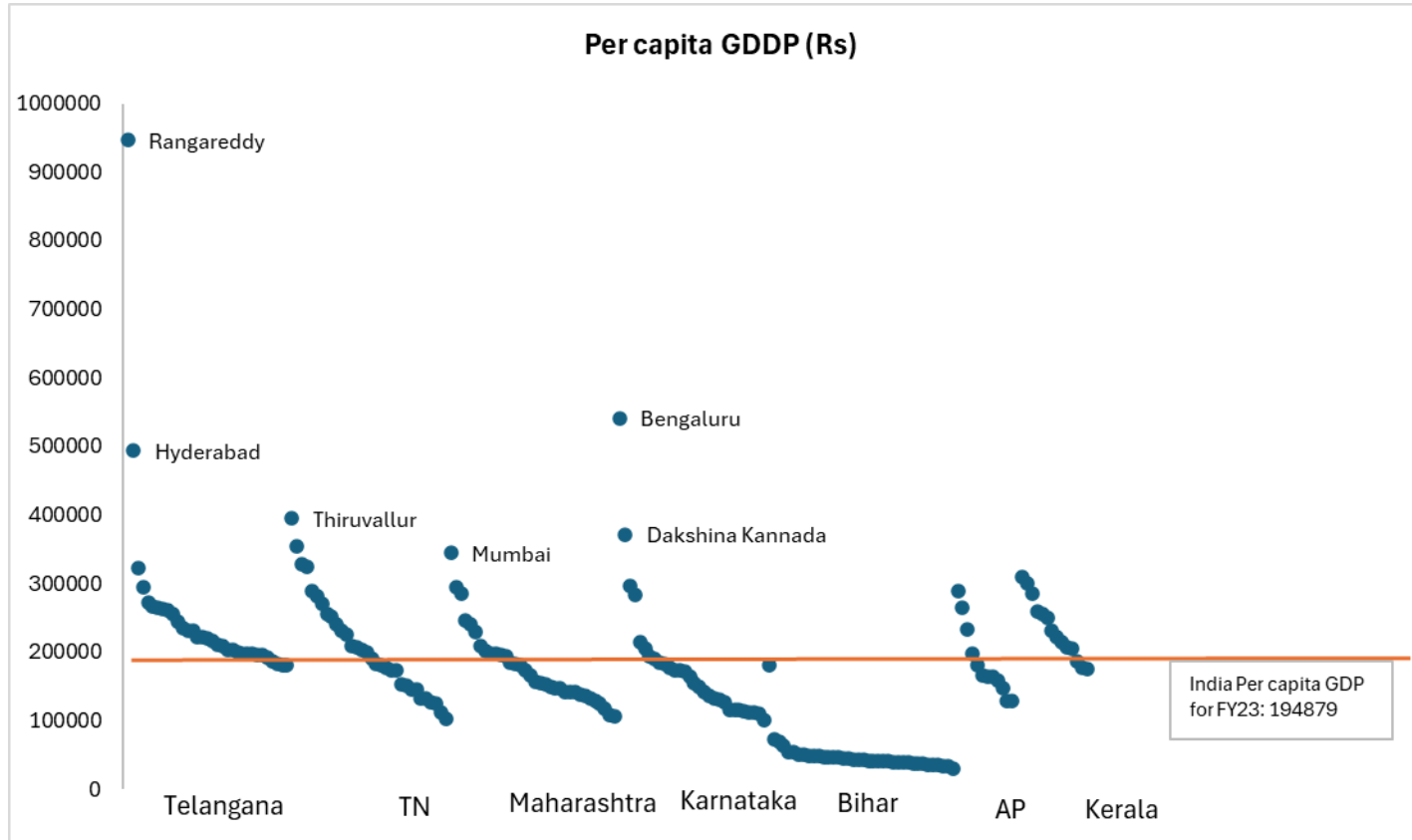
INDIA: Unity in Diversity
(Per capita GDDP in Lakh:FY22/23)

Rangareddy	**9.50**
Vikarabad	**1.80**
Mumbai	**3.40**
Nashik	**1.97**
Bengaluru	**5.40**
Mysuru	**1.54**
Krishna Dist.	**2.90**
Srikakulam	**1.30**

Source: State wise DES, MOSPI;
Telangana per capita GDDP is for FY23, all other states for FY22

- The review of the inflation target in March 2025 in India will coincide with many expected other changes – CPI base change; household consumer expenditure survey; and census

- We believe that composition of CPI is a major factor that do affect the India's IT framework. Apart from an imminent revision that has eluded the CPI basket since 2012, the CPI basket in India may be also relooked into to include mortgage interest payments

- In countries like UK, mortgage interest payments is included as an item in CPI, to make the transmission more effective (absent in India). For example, in UK, the weight for mortgage interest payments is based on a modeled mortgage incorporating both repayment and endowment components over a long period. Each of these is updated annually and expressed in terms of average weekly expenditure

- Such mortgage interest payments are included in CPI basket in countries like UK, to make the transmission impact more effective

- The inclusion of interest-sensitive items in CPI basket will make it more appropriate for policy formulation

- India's IT framework, with a tolerance band of ±2 per cent, already has in-built characteristics of a "make up" strategy. Structural changes – globalisation; e-commerce; climate change – may test this embedded flexibility

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