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Report on Currency and Finance (RCF) for the year 2020-21

Today, the Report on Currency and Finance (RCF) for the year 2020-21 was released by the RBI. First published in 1937, the RCF adopted a theme-based approach from 1998-99. After a hiatus between 2014 and 2019, the Report has been revived with this release. The theme of the Report is “Reviewing the Monetary Policy Framework” which assumes topical relevance in the context of the review of the inflation target by March 2021 against the backdrop of structural changes in the macroeconomic and financial landscape that have prompted several central banks to undertake policy framework reviews. The period of study in this report is from October 2016 to March 2020 commencing with the formal operationalisation of the flexible inflation targeting (FIT) framework in India but excluding the period of the COVID-19 pandemic in view of data distortions.

The Report carries a Foreword from the Governor, Reserve Bank of India. The contents of the Report, its findings, views and conclusions are entirely those of the contributors and do not represent the views of the Reserve Bank.

Highlights

- In the international experience, inflation targeting emerging market economies (EMEs) have generally lowered their inflation targets and narrowed tolerance bands.

- During the period under review, headline CPI inflation averaged 3.9 per cent in India with a decline in inflation volatility, attesting to the success of FIT in terms of its primary mandate.

- Trend inflation to which actual inflation converges after a shock provides an appropriate benchmark for the inflation target; trend inflation has fallen from above 9 per cent before FIT to a range of 3.8 – 4.3 per cent during FIT, indicating that 4 per cent is the appropriate level of the inflation target for India.

- Threshold inflation above which growth is unambiguously impaired ranges between 5 and 6 per cent in India, indicating that an inflation rate of 6 per cent is the appropriate upper tolerance limit for the inflation target. On the other hand, a lower bound above 2 per cent can lead to actual inflation frequently dipping below the tolerance band while a lower bound below 2 per cent will hamper growth, indicating that an inflation rate of 2 per cent is the appropriate lower tolerance bound.

- The current numerical framework for defining price stability, *i.e.*, an inflation target of 4 per cent with a +/-2 per cent tolerance band, is appropriate for the next five years.

- The institutional architecture of FIT in India, including the size of the monetary policy committee (MPC) and its composition, the decision making process, communication practices and accountability mechanisms is in line with international best practices, while the definition of the time horizon of failure, processes of onboarding of MPC members, some aspects of forward guidance and timings relating to release of minutes, shut periods and release of transcripts warrant a review.

- During the FIT period, monetary transmission has been full and reasonably swift across the money market but less than complete in the bond markets; while there has been an improvement in transmission to lending and deposit rates of banks, external benchmarks across all categories of loans and deposits could improve transmission further.

- In the conduct of monetary policy in an open economy setting, foreign exchange reserves and associated liquidity management are key; hence, there is a need to enhance the RBI's sterilisation capacity to deal with surges in capital flows.

- The primary focus of FIT on price stability augurs well for further liberalisation of the capital account and eventual internationalisation of the Indian rupee.

(Yogesh Dayal)
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