



The Inflation Targeting Regime in India: A Critical Assessment of Outcomes and Policy Trade-offs

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Introduction

India's evolution in formulation of monetary policy has been dramatic over the past few decades. The Reserve Bank of India (RBI) shifted first from fiscal dominance in 1970s, to monetary aggregates in the pre-liberalisation era, to inflation targeting (IT) since 2016, embracing best international practice in embedding inflation expectations in policy decisions in the post-GFC environment as it became evident that traditional frameworks would not succeed in maintaining macroeconomic stability. This was especially relevant in India's case—a major emerging economy that has historically grappled with inflation volatility and credibility around their commitment to price stability. The formalisation of the IT framework established in the RBI Act was likely an important institutional shift going forward.

The IT framework anchored in the RBI Act in 2016 requires the RBI to maintain Consumer Price Index (CPI) inflation at 4% with a tolerance band of $\pm 2\%$, in hindsight over the past 8 years of the regime there is empirical evidence suggesting that it has contributed to lower and more stable inflation, better transmission of monetary policy and better anchored expectations (Eichengreen & Gupta, 2024). Inflation targeting has been adopted in many countries and is globally accepted as the means of price stability over other targeting methods. Inflation targeting has been crucial in RBI's achievement of the primary goal. Considering the importance of the topic at a global scale and at a national scale we have explored the topic in depth.

Literature Review

In their paper "Inflation Targeting - The Evolution from 1990s to 2020s," Kiley and Mishkin claim that inflation targeting (IT) has established itself as the primary monetary policy framework and has been particularly successful in anchoring inflation expectations in advanced economies and some large emerging markets. The main reason for the success of IT lies in its defining characteristics: explicit numerical targets, the stated commitment to price stability, a forward-looking policy framework, transparency, and accountability. Early challenges to IT involved complications around communication (signal delays) and perceived rigidity that were resolved with the development of "inflation forecast targeting" and "flexible inflation targeting." The strategy of focusing on core inflation measures, when dealing with cost-push shocks, has been a successful way to address varying degrees of policy flexibility during times of supply shocks. This low-inflation environment has raised concerns about the effective lower bound (ELB), and central banks have successfully addressed the issue using forward guidance and quantitative easing (QE). For emerging markets, IT has been successfully applied with less developed institutions and the presence of liability dollarization. IT also shows resilience in periods of global shocks to the economy (e.g. Global Financial Crisis, COVID-19 epidemic). IT-centre banks (like India who adopted IT policy in 2016) have more aggressively responded to periods of crises as expectations were more anchored. Future challenges will include new structural changes, risks of fiscal and financial dominance, expanding areas of responsibility for central banks, and capabilities related to disentangling QE/QT and the use of forward guidance (Kiley & Mishkin, 2023).

The article "Inflation Targeting and Monetary Policy in India" challenges the conventional wisdom that India successfully brought down inflation with its 2016 inflation targeting (IT) framework. The authors argue that the moderation of inflation in India happened before the IT framework was adopted. India's own trajectory of declining inflation began well before formal adoption of IT, as part of a broader global trajectory of declining inflation, regardless of whether countries adopted

IT. As for inflation expectations, some evidence has been put forward that the expectations of households were anchored, but this was also a precondition of the IT framework and took hold well before rational expectations or the formal adoption of IT in India: long-term expectations of professional forecasters have been well anchored in India since the early 2000s, well before the formal implementation of IT. Finally, the piece recalls that high nominal interest rates and the positive real interest rate policy which followed should be viewed as negatively affecting growth process in India during the initial years of the IT framework (Patnaik, Felman, & Shah, 2017; 2018).

“Inflation Targeting in India: A Further Assessment” by Eichengreen and Gupta examines India's framework for inflation targeting and concludes that the Reserve Bank of India (RBI) has performed successfully as a forward-looking inflation target-er by managing both inflation and the output gap aggressively. As a result of its flexible framework, India has increased the accuracy of measurements and lowered sustained inflation, stabilized inflation expectations, and improved policies for monetary policy transmission across the economy (Eichengreen & Gupta, 2024). Given that history is favorable, the authors advise against significant changes like broadening the RBI's remit or shifting to multiple other targets as these choices will likely lead to disaster. The key recommendations to improve inflation management strategies were to change the weight of food prices in the Consumer Price Index (CPI) basket - the authors have stripped the current weight of food prices from 45.8% down

to roughly 40% now and possibly down to 30% in ten years so that it more accurately reflects the current state of the economy and the need to outlive concerns over food inflation's impact over the target (Eichengreen & Gupta, 2024).

In the paper "Inflation Targeting and the Legacy of High Inflation" by Jácome, Magud, Pienknagura and Uribe, various forms of implementation of monetary policy among inflation-targeting countries are highlighted and linked primarily to the legacy of high inflation (Jácome, Magud, Pienknagura & Uribe, 2025). Their framework suggests that to achieve low inflation, a more aggressive monetary policy is required, and the relationship between the costs in terms of output are higher when the historical experiences of inflation have an impact on the cognitive development of expectations. Their empirical analysis indicates that central banks in countries with a history of high inflation will react to inflation expectations diverging from the target inflation to a degree greater than other central banks. These findings led them to find a "credibility puzzle" that when the central bank raises its credibility, the central banks effectiveness of policy action with respect to inflation divergences does not change materially, which indicates that the past inflation experience "casts a long, persistent shadow" on policy (Jácome, Magud, Pienknagura & Uribe, 2025). The authors conclude that to improve how a central bank manage inflation in the future, theoretical models need to consider path dependence and imperfect credibility of central banks, in order to accurately represent the empirical truths of how past inflation impacts how a central bank may act today for either the credibility or output objectives.

Contemporary Developments / Issues of Inflation Targeting in the Monetary Environment

In the face of rising inflation during the 1970s and 1980s, central banks in the developed world began to think of new monetary policy tools used to fight inflation. Inflation targeting is a monetary policy framework that emerged in the early 1990s as a means to anchor inflation expectations. New Zealand, Canada, the UK, and Sweden were the first 4 developed countries to adopt IT. The aim of this policy was to target inflation within a specific range to reflect a long-term target of about 2% inflation. This policy seeks transparency and accountability with respect to monetary policy (Mishkin & Kiley, The Evolution of Inflation Targeting from the 1990s to 2020s: Developments and New Challenges , 2025) .

Emerging markets such as India slowly adopted inflation targeting as a major policy tool to attempt to reduce high inflation levels and improve the credibility of monetary policy. Historically, India has been subjected to severe inflation shocks, especially during the 1970s and 1980s when money supply increased dramatically with inflation averaging about 8.8%. (Eichengreen, Gupta, & Choudhary, 2021) The RBI adopted a multiple indicators approach in 1998 and focused on many more macroeconomic factors, additionally more fiscal discipline was introduced with the Fiscal Responsibility and Budget Management (FRBM) Act in 2003. However, fiscal and monetary discipline returned in the early 2000s and all monetary policy was focused on interest rates (Eichengreen, Gupta, & Choudhary, 2021).

In 2009, following the Global Financial Crisis which saw a drastic reduction in economic growth, central banks reduced their interest rates close to zero and embraced non-conventional or unconventional policies (such as forward guidance and quantitative easing) that were intended to influence long-term rates and improve economic conditions (Mishkin & Kiley, The Evolution of Inflation Targeting from the 1990s to 2020s: Developments and New Challenges , 2025). Since then, RBI

embarked upon different policy strategies and then finally settling on IT starting in 2016 formalized with amendments to the Reserve Bank of India Act. The establishment of IT was expected to, improve credibility, stabilize inflation expectations, and diminish volatility in the economy. The government fixed the inflation target at 4 % inflation with a tolerance range ± 2 %. The RBI then instituted a Monetary Policy Committee (MPC) in 2016.

Following is a summary of the history of repo rates changes from 2016 to the present (2025):

Meeting	Decision on Policy Rate	Meeting	Decision on Policy Rate
4th October, 2016	Reduced by 25 bps from 6.5% to 6.25%	7th April, 2021	4.00%
7th December, 2016	6.25%	4th June, 2021	4.00%
8th February, 2017	6.25%	6th August, 2021	4.00%
6th April, 2017	6.25%	8th October, 2021	4.00%
7th June, 2017	6.25%	8th December, 2021	4.00%
2nd August, 2017	Reduced by 25 bps from 6.25% to 6.0%	10th February, 2022	4.00%
4th October, 2017	6.00%	8th April, 2022	4.00%
6th December, 2017	6.00%	4th May, 2022	Increased by 40 bps from 4% to 4.40%
8th February, 2018	6.00%	8th June, 2022	Increased by 50 bps from 4.40% to 4.90%
5th April, 2018	6.00%	5th August, 2022	Increased by 50 bps from 4.90% to 5.40%
6th June, 2018	Increased by 25 bps from 6% to 6.25%	30th September, 2022	Increased by 50 bps from 5.40% to 5.90%
1st August, 2018	Increased by 25 bps from 6.25% to 6.5%	7th December, 2022	Increased by 35 bps from 5.90% to 6.25%
5th October, 2018	6.50%	8th February, 2023	Increased by 25 bps from 6.25% to 6.50%
5th December, 2018	6.50%	6th April, 2023	6.50%
7th February, 2019	Reduced by 25 bps from 6.5% to 6.25%	8th June, 2023	6.50%
4th April, 2019	Reduced by 25 bps from 6.25% to 6%	10th August, 2023	6.50%
6th June, 2019	Reduced by 25 bps from 6% to 5.75%	6th October, 2023	6.50%
21st August, 2019	Reduced by 35 bps from 5.75% to 5.40%	8th February, 2024	6.50%
4th October, 2019	Reduced by 25 bps from 5.40% to 5.15%	5th April, 2024	6.50%
5th December, 2019	5.15%	7th June, 2024	6.50%
6th February, 2020	5.15%	8th August, 2024	6.50%
27th March, 2020	Reduced by 75 bps from 5.15% to 4.40%	9th October 2024	6.50%

22nd May, 2020	Reduced by 40 bps from 4.40% to 4%	6th December 2024	6.50%
6th August, 2020	4.00%	7th February 2025	6.50%
9th October, 2020	4.00%	9th April 2025	Reduced by 25 bps from 6.50% to 6.00%
4th December, 2020	4.00%	6th June 2025	Reduced by 50 bps from 6.00% to 5.50%
5th February, 2021	4.00%	6th August 2025	5.50%

The COVID-19 pandemic also served as a stress test for the RBI's inflation targeting regime. With a -ve supply shock as well as a -ve demand shock, there was a lot of uncertainty. The flexible policy of inflation targeting allowed the RBI to let inflation breach the upper tolerance band in response to such exceptional circumstances (Eichengreen, Gupta, & Choudhary, 2021). The

escape clauses within its inflation targeting framework were employed by the RBI in favour of economic recovery, de-prioritising its inflation target, albeit temporarily. Since the introduction of inflation targeting, the programme has seen considerable improvements in the transmission of monetary policy in India and inflation expectations are much better anchored in the economy (proved by literatures). The RBI can better impact inflation expectations, which leads to the greater predictability and stability of the monetary policy. This, effectively, was most evident in the post-pandemic recovery, where expectations were a constant even during price hikes that were temporary (Eichengreen & Gupta, 2024).

Nevertheless, the Central Bank has many challenges to overcome when approaching IT.

High Weight of Food and Energy in the Consumption Basket

A primary obstacle to inflation targeting in India is the unrealistically high level of food and energy prices as components of the CPI. Both food and energy prices are very volatile, as may be influenced by weather patterns, supply issues, and non-monetary effects. It is impossible for the RBI to manage its target (inflation) successfully because food price uproars prevented the RBI from achieving its inflation target or even close to it.

Exchange Rate Volatility

India's dependence on imports, especially for oil and other vital commodities, renders exchange rate variations a key element in inflation trends. When the rupee falls in value, import expenses increase, potentially fueling inflation. The RBI's inflation targeting strategy needs to be adaptable enough to handle these external influences, making certain that depreciation doesn't undermine the inflation goal while also maintaining price stability. This also constitutes a component of the impossible trinity, which is discussed in the later section of the submission.

Policy Credibility

RBI has improved its communication about its policy stance. However its credibility can be tested during economic stress like supply-side inflation or external shocks. The ability of the RBI to anchor inflation expectations is important in times like these

Possible Conflict Between Monetary and Debt Management

Historically, the RBI has been tasked with managing government debt, which sometimes created a conflict of interest, especially when trying to keep monetary policy separate from fiscal needs. With the shift to inflation targeting, it's become even more important for the RBI to operate independently when setting monetary policy. The RBI's role in handling government debt, a leftover from the era of fiscal dominance, raised concerns. This shift to inflation targeting highlighted the need for a clear division between these two responsibilities.

Fiscal Dominance and change in global trade

India's monetary policy has long been shaped by fiscal dominance, where the central bank was expected to finance

government deficits, sometimes at the cost of inflation control. External shocks, geopolitical tensions, increased trade restrictions and supply chain disruptions often compel the RBI to change its policy stance. These changes may drive up costs in some sectors but they do not necessarily weaken the effectiveness of an inflation-targeting regime. RBI can manage changes by adapting flexibly to both temporary and enduring shocks, making certain that inflation goals stay attainable. (Goyal, 2018)

Technological Changes

Traditionally, the RBI was bound up with the management of public debt and conflicts of interest between monetary policy and the government's fiscal requirements. It is now quite clear that a form of independence when issuing monetary policy will be required under an inflation targeting regime. The historical obligation of the RBI to manage public debt, generated by explicit and implicit expectations under the period of fiscal dominance, raised a few eyebrows. The implementation of inflation targeting will require some prophylactic measures that explicitly delineate monetary and fiscal responsibilities. (Mishkin & Kiley, The Evolution of Inflation Targeting from the 1990s to 2020s: Developments and New Challenges, 2025)

Risk to Financial Stability and Central Bank Intervention

Events such as the pension fund crisis in UK (2022) and the US 2023 banking turmoil, along with the Credit Suisse scandal have shown the tension between achieving inflation control and financial stability. Central banks now feel to prioritize other objectives such as financial instability, climate change, and income inequality along with their core inflation control mandate, may create tensions even further. The possibility of a tension between those objectives may, in turn, undermine support for central bank independence and complicate policy decisions (Heenan, Roger, & Peter, 2006)

Analysis of Inflation Targeting in India

The basic reason for adopting price stability as the primary objects of monetary policy is to create a stable and non-inflationary environment for resource allocation and to stabilize price expectations which is an essential requirement for long-term contracts (Kannan, 1999). Price stability refers to a situation where money maintains its purchasing power.

Monetary policy framework provides a nominal anchor to the economy. A nominal anchor is a variable policy-makers can use to tie down the price level. Currency Peg was used by central banks earlier as a nominal anchor. Central banks would tie their country's currency to the currency of country with low inflation (Jahan & IMF). Such approach leads to effectively importing the monetary policy of the country to which the currency was pegged (Jahan & IMF). Such policy constrained the central bank's ability to respond to shocks or changes in the real interest rate (Jahan & IMF). As a result, many countries began to adopt flexible exchange rates, which forced them to find a new anchor. We use the impossible trinity dilemma to understand the earlier statements.

The Mundell-Fleming Trilemma or the impossible trinity refers to the impossibility of a nation attaining all three objectives at the same time, namely free capital mobility, independence of monetary policy, and fixed exchange rate (Bain, n.d.). A nation can have only two out of the three.

For instance, if a nation imposes a fixed exchange rate and lets capital flow freely, it cannot control its interest rates and its monetary policy. To keep the peg, it has to tighten or loosen rates in tandem with international forces - limiting its response to local economic cycles such as recessions. Alternatively, if a nation chooses monetary independence and free capital flows, it has to let the exchange rate float, embracing currency uncertainty in reaction to interest rate changes. If it desires a fixed exchange rate and management of monetary policy, it has to implement capital controls to forestall market forces' destabilization of the peg.

Many central banks then began targeting the growth of money supply to control inflation. This type of regime is commonly referred to as monetary targeting. Under this system, the central bank moves its instruments (for instance, interest rates) to control monetary aggregates, which are considered the main determinants of inflation in the long run (IMF, Croce, & Khan, 2000). Thus, controlling monetary aggregates would amount to indirectly controlling the inflation rate. This approach works if the central bank can control the money supply reasonably well and if money growth is stably related to inflation over time (Jahan & IMF). Ultimately, monetary targeting had limited success because the demand for money became unstable (Jahan & IMF). As a result, many countries with flexible exchange rates began to target inflation more directly, based on their

understanding of the links or “transmission mechanism” from the central bank’s policy instruments (such as interest rates) to inflation (Jahan & IMF).

Inflation targeting has its origin from two important issues. **The first is the problem of credibility** as explicit commitments have been made to build private sector confidence in the authorities’ credibility to make a low inflation equilibrium sustainable and attainable at minimum cost. The **second problem** is known as ‘**policy engineering**’ which refers to the **task of bringing about price stability** (Kannan, 1999).

In theory, Inflation targeting is straightforward. The central bank forecasts the future path of inflation and compares it with the target inflation rate. A major advantage of inflation targeting is that it combines elements of both “rules” and “discretion” in monetary policy (Jahan & IMF). This “constrained discretion” framework combines two distinct elements: a precise numerical target for inflation in the medium term and a response to economic shocks in the short term. The approach has emphasized achieving the target over the medium term - typically over a 2 - 3 years horizon.

According to (Jahan & IMF) inflation targeting requires two things:

1. Independent Central Bank. Therefore, Fiscal policy considerations cannot dictate monetary policy.
2. Willingness and ability of the monetary authorities not to target other indicators, such as wages, the level of employment, or the exchange rate.

According to (Mishkin & Kiley, 2025) inflation targeting is a monetary policy strategy that has five key elements:

1. The public announcement by a central bank of medium-term numerical targets for inflation in order to tie down inflation expectations (Mishkin & Kiley, Nber.org, 2025);
2. An institutional commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated (Mishkin & Kiley, Nber.org, 2025);
3. A forward-looking, information inclusive strategy in which many variables, and not just monetary aggregates or the exchange rate, are used for deciding the setting of policy instruments (Mishkin & Kiley, Nber.org, 2025);
4. Increased transparency of the monetary policy strategy through communication with the public and the markets about the plans, objectives and decisions of the monetary authorities (Mishkin & Kiley, Nber.org, 2025);
5. Increased accountability of the Central Bank for attaining its inflation objectives (Mishkin & Kiley, Nber.org, 2025).

A central bank does not perfectly control the short-run behavior of inflation, but it does control inflation in the long run, or steady state (Ball, 2014). Policymakers can choose a target for the inflation rate and keep inflation close to this level on average (Ball, 2014).

Central banks can also pursue flexible inflation targeting. The Central Banks have pursued this type of strategy by focusing on stabilizing “core” measures of inflation, which take out items from the price index that are subject to supply shocks, such as food and energy, rather than focus on stabilizing headline inflation (Mishkin, 2007). Research has shown how such a focus on core inflation can help a central bank balance stabilization of prices and activity in response to supply shocks that have temporary effects on inflation (Bodenstein, Erceg, and Guerrieri, 2008). In essence, a central bank allows temporary rises in headline inflation above the long-run target when a negative supply shock occurs.

What should be the optimal inflation target rate and why an inflation target rate of 0% is not advised? Higher inflation target raises the long-run levels of nominal rates, allowing larger decreases in rates before the zero bound becomes binding (Ball, 2014). This stems from the equation of $r^* = \text{Nominal Interest rates} - \text{Inflation}$. To provide stimulus to the economy in case of supply shocks a reduction in “real interest rates (r)” would be required. Since, Nominal Interest rates are lower bound by 0 having lower inflation target would reduce the flexibility in reducing the nominal interest rate. A slightly higher inflation rate target allows the Central bank to have more flexibility. This flexibility makes it easier for a central bank to restore full employment when an economic slump occurs. The danger of hitting the zero interest-rate bound depends on the central bank’s choice of an inflation target. A low inflation rate target such as 2% would have a higher chance of hitting zero interest rate lower bound than a 4% inflation rate target. A higher inflation target implies that rates can fall by more, making it more likely that policymakers can restore full employment (Ball, 2014).

Economists have pointed out many adverse effects of inflation. (Mishkin ,2011) gives a typical list: distortions in cash holdings; overinvestment in the financial sector; greater uncertainty about relative prices and the aggregate price level; distortions of the tax system; redistributions of wealth; and difficulties in financial planning. Empirical studies conducted to examine inefficiencies arising from relative-price variability have not produced a compelling case that inflation is harmful (Ball, 2014). As (Krugman ,1997) remarks, “one of the dirty little secrets of economic analysis is that even though inflation is universally regarded as a terrible scourge, efforts to measure its costs come up with embarrassingly small numbers.” A Number of cross-sectional studies conducted resulted in a common finding that inflation rates above some threshold reduce growth, but lower levels of inflation are neutral (Ball, 2014). Estimates of the threshold vary considerably from 8% to 40% (Ball, 2014). Considering the above factors a slightly higher inflation target rate than the 2% rate in the developed world is advised by (Ball, 2014). The same study also points out why the developed economies will not increase their inflation target rate.

According to (Kannan, 1999) following issues with the implementation of inflation target regime can be observed:

1. **Index selection:** Selecting which index to track becomes is an issue as different indices meant to track inflations are proxies using different measuring metrics. The characteristics of the index composition needs a thorough consideration. CPI, Headline inflation, core inflation all differ in characteristics.
2. **Speed of approach:** It is important to distinguish the achievement of inflation target in the medium term and in the short term. Usually, these targets vary depending upon the period we consider. Adopting a multi-duration approach allows flexibility about how rapidly the target should be approached. The risk in such approach is that if the present rate of inflation is very close to medium term objective, then, the inflation target would create some confusion in the minds of the public (Kannan, 1999).
3. **Band width:** The band's width must be sufficient to encompass the impact of shocks to the price level which occur in the interval between setting of policy and its impact on inflation. Volatility of inflation is an important factor in determining the band width of inflation target range.
4. **Time Dependent Targets:** If the authorities know that monetary policy affects inflation with a lag, it makes sense to set different targets for the initial period from those for the period after the policy change has impacted the economy. Otherwise, the authorities risk losing face when they miss the target in the initial period

The Reserve Bank of India operates under a flexible inflation target regime as described earlier (Eichengreen & gupta, Inflation targeting in India: A Further Assessment, 2024). This means it responds to both the output gap and inflation when setting policy rates. The RBI has become neither more hawkish nor more reactive with the transition to inflation targeting. Analysis of reaction functions shows that the output gap has a positive and significant coefficient, and inflation also has a positive coefficient, meaning policy rates respond to both. The study found no evidence of threshold effects, suggesting the weights on the output gap and inflation are not different when these variables are unusually high or low (Eichengreen & gupta, Inflation targeting in India: A Further Assessment, 2024).

Furthermore, the IT regime has not made the RBI overly reactive to every small deviation or food inflation spike. The RBI changed its key policy rate 17 times during the IT period (September 2016 - June 2024), compared to 24 times in the 8 years prior to IT (Eichengreen & Gupta, Inflation Targeting in India: A Further Assessment, 2024). This indicates a more measured approach to policy adjustments.

Analysis of whether requirement of Inflation rate target regime is met in India yields the following results. Since the Monetary Policy Framework Agreement between RBI and the Government in 2015 the government set a CPI-based inflation target of $4\% \pm 2\%$, and the RBI was formally granted independence in pursuing it through its Monetary Policy Committee (Eichengreen & Gupta, Inflation Targeting in India: A Further Assessment, 2024). The six-member MPC makes policy decisions by majority voting, with the RBI Governor holding the casting vote in ties and ensures a balance between independence and accountability. In addition to the above the mandate allows only inflation targeting along with multiple reiterations from RBI Governor that RBI is not targeting anything other than inflation.

Contrary to popular presumption, food price inflation has not been higher than core and headline inflation and neither is it more persistent (Eichengreen, Gupta, & Choudhary, Inflation Targeting in India-An Interim Assessment, 2021). Based on the analysis performed by the World Bank it was confirmed that the core inflation and headline inflation are both persistent. The impulse half-life measure analysis also confirms the higher persistence of core inflation (Eichengreen, Gupta, & Choudhary, Inflation Targeting in India-An Interim Assessment, 2021). Their analysis further suggests that past values of

food inflation help predict core inflation, but past values of core inflation do not help predict food inflation. But it does suggest that neglecting food price inflation that diverges from target for an extended period of time can have negative consequences. Thus, India should track the core inflation measure while not ignoring the food & Fuel inflation for long periods of time.

A number of earlier papers have estimated reaction functions for the RBI. These studies find that the output gap is important (Hutchison et al 2013, Mohanty and Klau 2005) but that the exchange rate also matters, especially from the late 1990s when it became more flexible. Inflation in general has a much smaller coefficient, both absolutely and relative to the Taylor rule benchmark of 1.5. Empirical studies show that the RBI's policy rate responds to the output gap and exchange rate, with inflation playing a lesser role than in conventional Taylor rules.

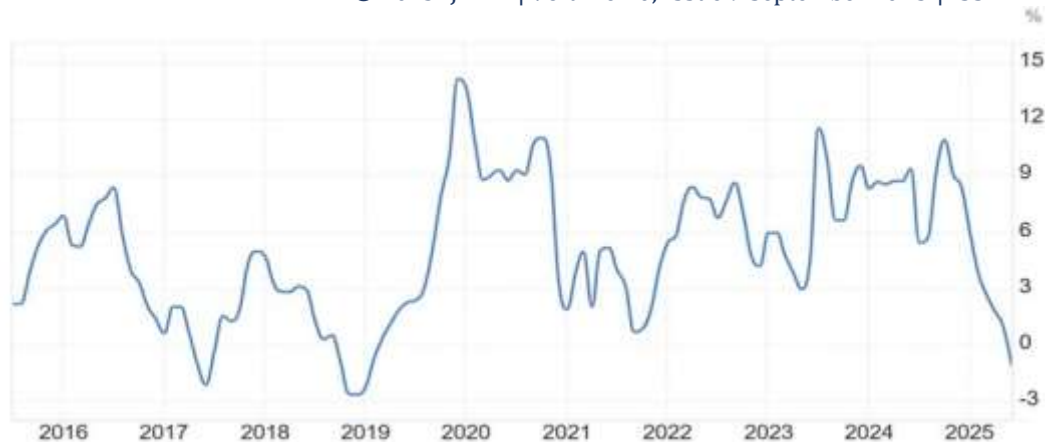
The outcome of the analysis by World Bank suggests that the policy rate is positively and significantly correlated with the output gap and exchange rate depreciation. It is also positively correlated with inflation, although the correlation is weaker and significant only at 10 percent level (Eichengreen, Gupta, & Choudhary, Inflation Targeting in India-An Interim Assessment, 2021).

The evidence presented in (Eichengreen & Gupta, Inflation Targeting in India: A Further Assessment, 2024) points to several improved outcomes during the IT period:

- **Lower and Less Volatile Inflation:** Inflation has been lower and less volatile compared to previous periods. CPI headline, core, and food inflation were all lower in the IT period compared to pre-IT. For example, CPI inflation decreased from 8.0% in 2011-2015 to 4.0% in 2016-2019 and 6.0% in 2020-2023. The volatility of CPI headline and core inflation also significantly declined after IT adoption.
- **Better Anchored Inflation Expectations:** Inflation expectations have become better anchored. Both professional forecasts and household expectations of inflation have declined in line with actual inflation since the shift to IT. Studies indicate that long-term inflation expectations became less sensitive to short-term sentiment post-2016.
- **More Effective Monetary Policy Transmission:** The transmission of monetary policy has improved. Transmission is found to be greater for treasury bill and short-tenure government bonds, and this improved after IT adoption. However, transmission to bank lending rates remains relatively weak and has not improved with IT adoption.
- **Reduced Volatility in Financial Markets:** Exchange rate and equity market volatility have decreased under the IT regime. Yields on government debt have also been lower.

Appropriateness of 4 Percent Midpoint: While some other emerging markets have reduced their inflation targets, India's 4 percent target is considered appropriate. This is justified by India being a lower-income, faster-growing "catch-up economy," which implies relatively high service-sector inflation due to the Balassa-Samuelson effect. India is one of the fastest growing economies in the world. With high growth the economy would experience higher upward pressure on the prices on account of stronger demand. A slightly higher inflation target gives policy flexibility to accommodate this demand without triggering premature tightening of monetary policy. In the paper by (Ball, 2014) he makes a case for higher inflation target (at around 4%) for developed economies. Considering the points covered earlier from the same case we can agree that the inflation target of 4% with a 2% band width is appropriate for India. Raising the inflation target could have negative impacts on future inflation expectation.

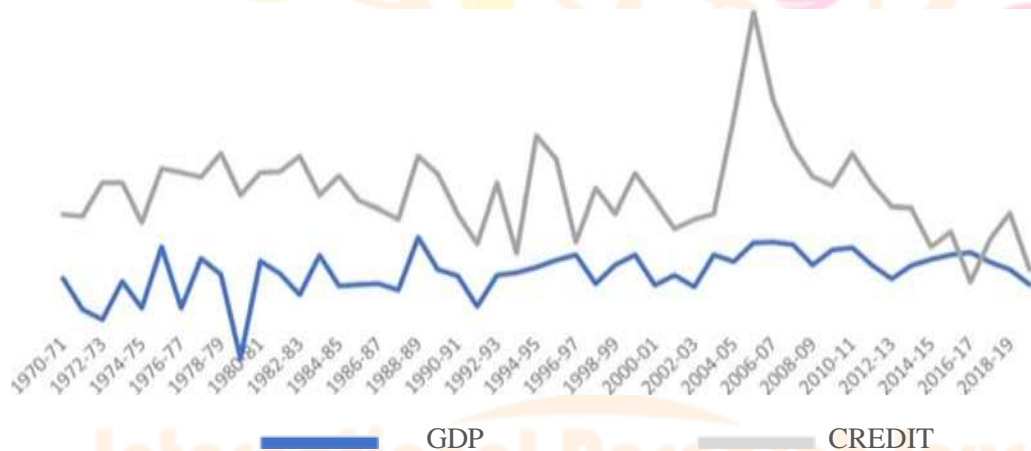
Narrowing the Tolerance Band: The RBI's +/-2 percent tolerance band is wider than some other emerging markets. However, given the heavy weighting of volatile food and energy prices in India's inflation, adopting a narrower band would likely require larger, more frequent interest rate variations. Refer graph below indicating the high fluctuations in the food inflation. Such variations could create an unpredictable investment climate, challenge financial stability, and become even more challenging in a period of heightened global economic and financial volatility. Therefore, narrowing the band is not recommended.



Source: Trading view

Consideration of Credit Growth Targeting: Credit Targeting means taking a fixed credit growth rate as a point of consideration in the flexible inflation targeting process. This metric would cater to the demand of retail and corporates. Banks are the primary credit lenders in the country and credit lending depends on the needs of the economy. Credit growth and GDP growth have historically shown a positive correlation.

Time series data of Credit growth and GDP growth in India (1970-2020)



Source: Database on Indian Economy, RBI Annual reports (Various years).

Along with the flexible inflation targeting, RBI should target a minimum **15% credit growth**. The credit growth in India declined to 6.1% in 2019-20 from 20.8% in 2010-11. The credit to GDP ratio was recently at 56% which is below average as compared to the developed economies which usually have this ratio between 150-200%. RBI Board itself suggested the credit to GDP ratio of the country should at least be 100%. To hit this mandate, we need to more than double the credit growth rate and for that the credit to GDP ratio also has to more than double, therefore 15% credit growth is a good number to begin with. We believe that RBI should also consider the credit growth in addition to the price stability mandate when considering controlling inflation.

Based on our literature review we also believe that a multi duration inflation target strategy could be made and announced to the public to increase credibility and instill the inflation expectations. We acknowledge that such multi duration time dependent inflation target announcements could be a double-edged sword and hence we also recommend a very detailed deliberation before such announcements.

Conclusion

India's adoption of inflation targeting in 2016 was a critical moment of its monetary policy approach; it opened India up to international prescribed norms while contextualized to domestic realities. The transition away from residual fiscal dominance, and monetary targeting, to flexible inflation targeting has produced real benefits - a lower and stable rate of inflation, better transmission of policy, and anchored expectations. The empirical evidence supports the assertion that the current inflation target ($4\% \pm 2\%$) is appropriate for a fast-liberalizing and fast-growing emerging economy, where food and energy comprise substantial shares of the consumption basket, especially when the context of India's structural reality is

considered.

However, challenges continue to persist. The episodes of high inflation put policy credibility into question, while continued global supply chain shocks and shifts, monetary policy external shocks to foreign exchange rates, and demands to ensure financial stability at the same time to the already high bar of monetary management. There is no shortage of proposals to refine the framework for inflation targeting practice, most notably re-evaluating the CPI weights on structure, the more gradual approach to implementing credit growth targets, and allowing for pilot testing of multi-duration inflation targeting which frankly would compliment and add value to the existing framework not compromise it.

Ultimately, inflation targeting remains a pragmatic, practical, and well-considered policy approach for India - but it requires flexibility. Given the increasing complexity of economic conditions in the domestic and global economic environment, the RBI's ability to successfully manage it all will ultimately depend on the transparency of the central bank, and continued institutional independence, data-dependent decision-making, and flexibility, all against the backdrop of wider concerns about inflation and growth, and building expectations. As the monetary policy framework evolves into its next era, the RBI engages an important issue in balancing distinguishing itself against the value of continuity, while also considering the monetary policy framework as an area for innovation to secure long-term macroeconomic stability and credibility.

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