RBI'S INDIA'S INFLATION TARGETING - ECONOMY

RBI paper on monetary policy says raising inflation target above 4% could erode policy gains. In a recent paper, the RBI cautioned against raising the 4% inflation target, arguing it would harm policy credibility and undo past gains. It advocates continuing the current Flexible Inflation Targeting framework, focusing on headline CPI within the 2-6% band to balance price stability and growth.

RBI's Stance on India's Inflation Targeting Framework

Core Issue - RBI Cautions Against Raising Inflation Target

The Reserve Bank of India (RBI) has strongly cautioned against raising the current 4% inflation target.

Primary Concern - The RBI believes such a move could undermine the credibility of its monetary policy and reverse the hard-won gains in price stability achieved over the past decade.

Context - This stance was detailed in the RBI's discussion paper (released in August 2025), which is part of a review of the Flexible Inflation Targeting (FIT) framework.

Highlights from the RBI's Discussion Paper

Concerns over Target Adjustment - Raising the inflation target, especially amidst global uncertainty, could be interpreted as a dilution of the commitment to price stability, potentially reducing investor confidence.

Empirical Evidence - Since 2014, India's headline inflation has fluctuated between 1.5% and 8.6%, largely driven by volatile food prices. While core inflation has been more stable, the paper notes that shocks in non-core items (like food) eventually spill over into core inflation.

Global Practices - Almost all central banks that target inflation focus on headline CPI. The central bank of Uganda is the only notable exception, as it targets core inflation.

Investor Confidence - The RBI argues that maintaining inflation within the established 2% to 6% band has been crucial for strengthening investor confidence, supporting economic growth, and ensuring currency stability.

Global Recognition - The paper highlights that S&P Global Ratings recently upgraded India's sovereign rating to 'BBB', specifically citing the RBI's consistent and successful track record in inflation management.

Key Issues Debated in the Paper

1. Target Variable - Headline vs. Core Inflation

The Debate - Should monetary policy target headline inflation (which includes volatile food and fuel prices) or core inflation (which excludes them)?

Economic Survey 2023–24 View - Suggested targeting core inflation, arguing that food inflation is often caused by supply-side factors beyond the RBI's control.

RBI's Argument - The RBI maintains that headline inflation must remain the target. This is because food inflation inevitably spills over into core components through its impact on wages, rental costs, and public inflation expectations.

2. The Optimal Inflation Target

Current Target - The current midpoint target of 4% is considered optimal as it effectively balances the objectives of price stability and economic growth.

Risks of Raising the Target - A target higher than 4% could dilute policy credibility, be seen as a weakening of fiscal-monetary discipline, and alarm global investors.

Risks of Lowering the Target - A target below 4% is viewed as inappropriate for a developing economy like India, which needs some flexibility for growth.

3. The Tolerance Band (2%–6%)

The Question - The paper discusses whether the current tolerance band should be narrowed, widened, or eliminated entirely.

RBI's Stance - Emphasizes the need for policy certainty and credibility, especially in the current environment of high global uncertainty, suggesting the band remains crucial.

4. Range versus Point Target

The Debate - Should India continue with its current system of a point target (4%) with a tolerance band, or shift to a pure range target (e.g., 2%–6%) without a specific midpoint.

Understanding Headline vs. Core Inflation

Headline Inflation

Definition - Measures the total inflation within an economy, covering all items in the Consumer Price Index (CPI) basket.

Characteristics - It is more volatile due to its inclusion of fluctuating food and energy prices and is used to track the **actual cost of living** for the general population.

Core Inflation

Definition - An inflation measure that excludes volatile items, primarily food and fuel, from the CPI basket.

Characteristics - It is more stable and is believed to reflect the **underlying, long-term inflation trend**. It is often preferred by central banks for making long-term monetary policy decisions.

About the Flexible Inflation Targeting (FIT) Framework

Definition of Inflation Targeting - A monetary policy framework where the central bank uses its tools (like interest rates) to achieve a publicly announced annual inflation rate.

What is Flexible Inflation Targeting (FIT)?

A framework where the central bank sets an inflation target but also gives importance to other economic goals, such as growth and employment. It allows for temporary deviations from the inflation target to accommodate shocks and support broader economic stability, unlike a strict inflation targeting regime.

Global Context - First adopted by New Zealand in 1990 and now a mainstream approach for many central banks worldwide.

International Targets

1. **US Federal Reserve:** ~2% target.
2. **Bank of England:** 2% CPI target.
3. **Brazil:** Higher target of 3% with a ±1.5% band to balance growth needs.

India's Journey with FIT

Adoption - The framework was formally adopted in **2016** following an agreement between the RBI and the Government of India in 2015.

Legal Backing - The **RBI Act, 1934, was amended** to provide a legal mandate for the FIT framework.

Target Setting - The inflation target is set by the **Government of India in consultation with the RBI** every five years.

Current Target - The current CPI inflation target is **4% with a tolerance band of ±2%** (i.e., a range of 2% to 6%), which is valid until **March 31, 2026**.

Structure of the Monetary Policy Committee (MPC)

Purpose - The MPC was established to implement the inflation-targeting framework.

Legal Basis - It is constituted by the central government under Section 45ZB of the amended RBI Act, 1934.

Composition - The MPC has six members:

1. RBI Governor (ex-officio Chairperson).
2. RBI Deputy Governor in charge of monetary policy.
3. An officer of the RBI nominated by the Central Board.
4. Three external members appointed by the Central Government.

Function - The MPC's primary role is to set the benchmark policy rate (repo rate) to keep inflation within the target band.

Decision-Making - Decisions are made by a majority vote. The RBI Governor holds a casting vote in case of a tie.

Accountability - If inflation remains outside the 2%-6% band for three consecutive quarters, the RBI must submit a report to the government explaining the reasons and the proposed remedial actions.

Limitations and Criticisms of Inflation Targeting

Growth Trade-off - A tight focus on controlling inflation can lead to higher interest rates, which can slow down economic growth and job creation.

Ineffective for Supply-Side Shocks - In India, inflation is often driven by supply issues (e.g., poor monsoons, high global oil prices). Monetary policy is less effective in controlling this type of inflation.

Dependence on Government Action - Since food has a high weightage in India's CPI, the RBI's success depends heavily on the government's supply-side measures (e.g., cutting import duties on edible oils).

Neglects Financial Stability - The 2008 Global Financial Crisis showed that price stability alone does not guarantee financial stability. An overemphasis on inflation can lead to neglecting other crucial regulatory functions.

Sidelines Broader RBI Roles - A singular focus on inflation can sideline the RBI's other important responsibilities, such as promoting growth, employment, and financial sector stability.

The Way Forward

Policy Continuity - Continue with the current framework of targeting headline CPI at 4% with a 2%–6% band.

Strengthen Supply-Side Management - The government must take proactive measures to manage food and fuel inflation.

Enhance Communication - The RBI should improve its communication strategy to better manage public inflation expectations during volatile periods.

Refine CPI Basket - The CPI basket, due for revision in 2026, should be updated to better reflect current consumer spending patterns.

Coordinate Policies - There should be better coordination between fiscal (government) and monetary (RBI) policies to balance the growth-inflation trade-off.

Conclusion

The conduct of monetary policy today demands both certainty and credibility, given the high levels of global and domestic uncertainties. Therefore, India should continue with the proven and effective framework of flexible inflation targeting. The focus should be on preserving its core principles while making gradual refinements to ensure a balanced approach to price stability, economic growth, and overall financial resilience.

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