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## LIMITS OF INFLATION TARGETING IN A SUPPLY CONSTRAINED ECONOMY IN INDIA- AN OVERVIEW

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### ABSTRACT

Inflation targeting is a monetary policy strategy used by central banks for maintaining inflation at a certain level or within a specific range. In general, central banks normally follow a policy of keeping inflation sufficiently low. However, in inflation targeting, there is a preset, publicly declared target. Using methods such as interest rate changes, the central bank and other monetary authorities are expected to guide inflation to a targeted level or range. Such a policy makes the central bank focus on a single variable and imposes a penalty if the target is not adhered to. This policy was initially adopted by New Zealand in 1990, although other countries, most notably Germany, had evolved something close to inflation targeting considerably earlier. Thereafter, many countries have adopted inflation targeting as a part of monetary policy during the 1990s.

**Keywords:** Inflation Targeting, Monetary Policy, Economic Growth, Price Stability, Fiscal Coordination.

### INTRODUCTION

The government and RBI signed an inflation-targeting agreement (IT) in February 2015 and amended the RBI Act in May 2016. The inflation target was set by the government in consultation with RBI with the possibility of revisiting it after five years. Accordingly, the government announced, via the Official Gazette, 4 percent Consumer Price Index (CPI) inflation as the target from August 5, 2016, with an upper tolerance limit of 6 percent and a lower limit of 2 percent. It announced that the government would constitute a six-member Monetary Policy Committee (MPC), including three ex officio members from the RBI -- the Governor (who would also be its Chairperson), the Deputy Governor in charge of Monetary Policy, and one officer nominated by its Central Board -- together with three external members to be appointed by the government. External members were to hold office for four years and could not be reappointed.

The RBI was required to organize at least four meetings of the MPC annually, as per a schedule published in advance. It was asked to publish a Monetary Policy Report every six months, explaining the sources of inflation. It was to provide forecasts of inflation for a period between six to eighteen months; the resolution adopted by the Committee; further details on the fourteenth day after every meeting of the MPC, including the minutes of the proceedings of the meeting; the vote and statement of each member of the MPC; and a document explaining steps to be taken to implement the decisions of the MPC. Finally, if the inflation target was not met, the RBI was required to submit a report detailing the reasons for failure to achieve it; remedial actions; and the estimated time-period within which the inflation target could be achieved. The agreement specified that the RBI would be deemed to have missed its target if inflation exceeded 6.0 percent or declined below 2.0 percent for three straight quarters.

The first MPC successfully completed its term four years ago, and in September this year a second MPC will complete its full term. There has been a smooth transition of the external members as well as the three members from the RBI, with changes in the latter coinciding with the turnover of the RBI staff. Altogether 6 external members and 10 RBI staff have been the members of the two MPCs (which includes three Governors and two Deputy Governors).

For most part, targets set under the IT have been met; and on almost all counts, the IT has performed as envisaged. It has been only once that inflation exceeded the upper tolerance band of 6 percent for three consecutive quarters (during January 2022-September 2022). The RBI, in its own review of inflation targeting in 2021, endorsed its continuation in all respects, including the targets, design, and implementation. The only revision it suggested was that failure may be deemed to have occurred when the inflation band is breached for four consecutive quarters rather than three.

## **BENEFITS**

- ✓ Inflation targeting allows monetary policy to “focus on domestic considerations and to respond to shocks to the domestic economy”, which is not possible under a fixed-exchange-rate system.
- ✓ Transparency is another key benefit of inflation targeting. Central banks in developed countries that have successfully implemented inflation targeting tend to “maintain regular channels of communication with the public”.
- ✓ An explicit numerical inflation target increases a central bank’s accountability, and thus it is less likely that the central bank falls prey to the time-inconsistency trap. This accountability is especially significant because even countries with weak institutions can build public support for an independent central bank.

## **EVOLUTION OF INFLATION TARGETING**

The key policy objective of central banking is price stability, and the concept of giving it a numerical precision was considered very modern after monetary and exchange rate targeting had failed in the 1980s. The hunt for a better target led to experimentation with a “checklist” of economic indicators by Australia in mid-1980s and explicit squeezing of inflation rate by New Zealand by late eighties. After some trials and initial success, the IT regime was formally inaugurated in March 1990 in New Zealand with the negotiation of the first Policy Targets Agreement between the Government and the central bank. Historically, some countries, of which a few at the push of the International Monetary Fund (IMF), switched to IT after the successful adoption by New Zealand (1990), Canada (1991), and UK (1992).

The spread of IT was contagious and according to Mahadeva and Sterne (2000), 54 countries had adopted IT by 1998. By 2004, according to Rose (2007) formal inflation targeting was in place in a number of countries making up one-quarter of world economy. The situation changed after the recent financial crisis and rethinking of the economic strategies that went wrong before 2008 compelling many economists and policy makers to conclude that the role of economic blinkers that IT imposed on the policy makers cannot be ignored. Marcus (2014)<sup>2</sup> observed that application of IT in an emerging country like South Africa faced many challenges - opposition of the trade union; disagreement on limits of transparency; arguments whether IT regime was sufficient to ensure price stability; and finally, questions of the level of targets. It probably is for similar reasons that none of the countries have adopted IT after 2008, except Japan in 2013 but with a different motivation.

## **India's Inflation Targeting Framework**

The essential position of inflation control stands in India's monetary policy framework because of previous high inflation rates and economic instability alongside external disturbances. Prior to adopting Inflation Targeting (IT), the Reserve Bank of India (RBI) employed multiple performance indicators that combined inflation objectives with forex exchange rates and money stocks as well as credit expansion and related macroeconomic conditions. The discretionary monetary framework generated unpredictable inflation control and several negative outcomes for inflation and public trust. The challenges necessitated a formal adoption of Inflation Targeting through the Monetary Policy Framework Agreement (MPFA) in 2016, establishing a new rule-based framework for monetary policy in India (RBI, 2016).

### **Before Inflation Targeting (Pre-2016)**

Before 2016, India suffered from continuous inflation instability, which resulted from food and fuel price volatility, global commodity price fluctuations, and fiscal imbalances. The RBI operated through regular repo rate modifications as its inflation management tool without establishing a specific target. The yearly inflation exceeded the target range at 11.5% during 2013 because of international oil price fluctuations and domestic raw material limitations. The nation experienced widespread growth variability because its GDP increased by 8.5% during 2010 but decreased to 5.5% during 2013 due to inflationary pressures and external challenges (IMF, 2021). Monetary policy inefficiencies, higher borrowing costs, and lower investor confidence became problems because the central bank lacked an organized inflation control mechanism.

### **After Inflation Targeting (Post-2016)**

Implementing Inflation Targeting (IT) during 2016 established a systematic method to achieve a transparent inflation control framework. The key changes included:

- **Formal Inflation Target:** India established Flexible Inflation Targeting (FIT) through the MPFA by selecting 4% as the medium-term target for CPI inflation, with an allowable band between 2% higher and lower (RBI, 2016). The inflation expectation anchor helped stabilize monetary policy success alongside its goal of establishing price expectation anchors.
- **Formation of the Monetary Policy Committee (MPC):** A six-member Monetary Policy Committee (MPC) was established to make interest rate decisions based on inflation trends. The MPC replaced the Governor-centric decision-making model, making monetary policy more transparent, data-driven, and independent.
- **Shift from a Growth-First to an Inflation-Control Approach:** While monetary policy before 2016 emphasized growth, post-IT adoption, the focus shifted toward inflation control as a precondition for sustained economic expansion. The RBI used interest rate adjustments as the primary tool to keep inflation within the target range, with less direct intervention in currency markets and credit expansion.

### **Major limits of inflation targeting in India**

The Flexible Inflation Targeting (FIT) framework in India, which mandates the Reserve Bank of India (RBI) to maintain headline CPI inflation at 4% ( $\pm 2\%$ ), faces several structural and operational limits, particularly in a supply-constrained environment.

- **Ineffectiveness against Supply Shocks:** Monetary policy tools, such as the Repo Rate, primarily influence demand. They cannot directly resolve supply-side disruptions like monsoon-induced crop failures, global oil price spikes, or geopolitical conflicts.
- **Persistent Food Inflation:** In India, food accounts for nearly 46% of the CPI basket (though a rebased series with a lower weight is expected in early 2026). High food prices are often driven by seasonal factors that interest rate hikes cannot fix.
- **Energy Prices:** Fuel prices are largely determined by international crude oil markets and domestic taxes, leaving them outside the RBI's direct control.

## 2. The Growth-Inflation Trade-off

Aggressive tightening to curb supply-driven inflation can inadvertently stifle economic growth.

- **Output Sacrifice:** Raising rates to meet inflation targets when the economy is already facing supply constraints can lead to a significant decline in investment and consumption, resulting in a "growth sacrifice".
- **Policy Dilemma:** As of early 2025, the RBI faced a dilemma where high interest rates to control inflation (which peaked at 6.2% in October 2024) risked further slowing a decelerating GDP growth.

## 3. Imperfect Monetary Transmission

The effectiveness of inflation targeting depends on how quickly and fully RBI's rate changes reach the broader economy.

- **Banking Inefficiencies:** Transmission to lending and deposit rates remains incomplete and lagged due to structural issues in the banking sector and the presence of a large informal economy that is less sensitive to interest rates.

## 4. Conflict with Other Mandates

The RBI often has to balance its primary inflation goal with other critical responsibilities:

- **Exchange Rate Management:** Intervening to prevent sharp INR-USD depreciation (which can cause "imported inflation") often conflicts with domestic liquidity and interest rate objectives.
- **Debt Management:** As the government's debt manager, the RBI faces pressure to keep interest rates low to manage borrowing costs, which can conflict with the need for higher rates to fight inflation.

## 5. Data and Measurement Constraints

- **Outdated CPI Basket:** Until the recent 2024–25 base revision, India's CPI was based on 2012 consumption patterns, which overemphasized food and may have led to "forecast errors" that weakened policy credibility.
- **Second-Round Effects:** While initial shocks are supply-side, they can lead to "second-round effects" by raising long-term inflation expectations and wages, forcing the RBI to act even when it cannot fix the underlying supply issue.

As the framework faces its statutory renewal in March 2026, the government is likely to retain the 4% target but may focus on improving monetary-fiscal coordination to handle supply-side challenges more effectively.

### **Empirical experience since adoption**

Since adopting Flexible Inflation Targeting (FIT) in 2016, India experienced initial success in anchoring inflation between 3.8% and 4.5%, a significant drop from prior levels, improving policy credibility and anchoring long-term inflation expectations. The framework faced challenges during the COVID-19 pandemic and the Russia-Ukraine conflict, leading to the first mandate failure in 2022 when inflation exceeded the 6% upper limit for three consecutive quarters, although the FIT regime is suggested to have reduced overall inflation volatility.

### **Need for policy coordination**

In a supply-constrained economy like India, monetary policy is a "blunt instrument" that can only dampen demand; therefore, monetary-fiscal coordination is essential to address the root causes of inflation without crushing growth. While the Reserve Bank of India (RBI) manages liquidity and interest rates to anchor expectations, the government must lead on supply-side interventions, such as reducing import duties on edible oils, managing buffer stocks of pulses, and improving agricultural logistics to prevent seasonal price spikes. Without this synergy, the RBI is often forced into "over-tightening," where high interest rates penalize private investment to compensate for high food prices that the bank cannot actually control. Furthermore, as noted in the RBI's Report on Currency and Finance, effective coordination ensures that government spending (fiscal policy) does not inadvertently fuel inflationary pressures, allowing the FIT framework to function without excessive output sacrifice.

### **Alternative and complementary approaches**

Alternative and complementary approaches to Flexible Inflation Targeting (FIT) in India focus on balancing growth with price stability, especially when inflation is driven by supply-side constraints rather than excessive demand.

### **Alternative Monetary Frameworks**

- ❖ **Core Inflation Targeting:** Some analysts suggest the Reserve Bank of India (RBI) should target "core" inflation (excluding volatile food and fuel) instead of headline CPI. This would prevent unnecessary interest rate hikes in response to temporary supply shocks. However, the RBI currently resists this, arguing that food prices significantly affect the poor and often lead to "second-round" effects on general wages.
- ❖ **Inflation Zone Targeting:** This approach proposes targeting a broad "zone" rather than a specific point (like 4%). It allows the Monetary Policy Committee (MPC) to wait for beneficial supply shocks to bring inflation down naturally once it enters the tolerance band, thereby maximizing growth.
- ❖ **Nominal GDP Targeting:** An alternative where the central bank targets the total value of goods and services produced, automatically allowing higher inflation during periods of low growth to support the economy.
- ❖ **Multi-Indicator Approach:** Returning to a framework that monitors a wider range of variables—including credit growth, employment, and exchange rates—rather than a single nominal anchor.

## Complementary Supply-Side Policies

Since monetary policy is a "demand-side" tool, it must be complemented by government-led "supply-side" actions to be effective in India:

- **Strategic Buffer Stock Management:** Augmenting and selling buffer stocks of essential items like grains and pulses to cool retail prices.
- **Trade Policy Interventions:** Reducing import duties on edible oils or imposing export curbs on commodities in short supply.
- **Infrastructure & Logistics:** Long-term investments in cold storage and supply chain infrastructure to reduce seasonal wastage and price volatility.

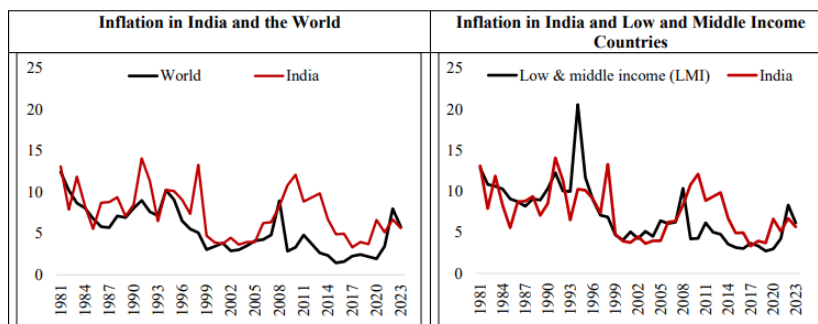
## Institutional Refinements for 2026

As the FIT framework faces statutory renewal in March 2026, proposed refinements include:

- **Rebased CPI Weights:** Updating the CPI basket to reflect current consumption patterns, likely reducing the weight of food from ~46% to closer to 40%.
- **Extended "Failure" Window:** Redefining a mandate failure as breaching the tolerance band for four consecutive quarters instead of three, providing more time for supply shocks to self-correct.

## Successes of Inflation Targeting in India

- **Lower inflation volatility:** Inflation in India has averaged 7.5% since the 1980s, except in the early 2000s when it averaged 4%. Inflation has declined since the adoption of IT, compared to the preceding years and relative to the average inflation of the world and low- and middle-income countries.



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- **Less volatility:** Following the adoption of IT, the exchange rate, the stock market, and the call money rate, Yields on government debt have become less volatile. In contrast, the volatility of portfolio capital flows has not changed.
- **Increased investment:** Price stability has helped fuel growth, allowing businesses to plan without worrying too much that surging their projections will be upset by surging costs. It has also reduced interest rates because it has improved central bank credibility.

## Challenges associated

- a) **Use of headline inflation** as the nominal anchor causing "second-round effects" such as spillover of food inflation to non-food inflation through a wage-price spiral.

- b) The current CPI series is based on the 2011-12 consumption survey. Though updated in 2015, it still contains obsolete items like DVDs and audio cassettes.
- c) **Policy transmission lag:** Transmission to bank lending rates and bond yields of longer-tenure securities is weaker and has not improved with the adoption of IT.
- d) **Growth vs Inflation Dilemma:** Tight monetary policy to control inflation can stifle growth, especially during economic downturns, making it hard for the RBI to balance these competing objectives.

## CONCLUSION

Inflation targeting has improved transparency and credibility of monetary policy in India. However, in a supply-constrained economy, it is necessary but not sufficient. Sustainable price stability requires structural reforms, supply-side intervention and policy coordination, beyond interest rate adjustment. While Flexible Inflation Targeting (FIT) has provided a framework for the RBI, structural issues limit its effectiveness in a supply-constrained economy like India. The significant weighting of food and fuel in the CPI basket means interest rate changes may not address the underlying causes of inflation. The sustainability of the framework depends on monetary-fiscal coordination and supply-side reforms.

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