



India Completes a Decade of Inflation Targeting as Supply Shocks and a Flat Phillips Curve Test Monetary Policy Effectiveness

Published On: 09-09-2026

Recent Developments:

- **India's Flexible Inflation Targeting (FIT) framework has completed a decade of operation in 2026**, marking ten years since the statutory framework was institutionalised and the first Monetary Policy Committee (MPC) was constituted in 2016. The framework gave **price stability** a formal primacy while requiring monetary policy to remain mindful of economic growth.
- The framework was introduced through amendments to the **Reserve Bank of India Act, 1934**, following the recommendations of the **Urjit Patel Committee**, and shifted monetary policy from a largely discretionary approach towards a transparent, committee-based and rule-oriented framework.
- The Government initially notified a **4% CPI inflation target**, with a **2% lower tolerance limit and 6% upper tolerance limit**, for August 2016–March 2021 and subsequently retained the same framework for April 2021–March 2026.
- RBI's assessment of the initial FIT period found that headline inflation averaged around **3.9%**, while inflation volatility declined substantially, indicating improved price stability and greater monetary-policy credibility.
- However, the decade has also highlighted structural limitations because **food-price shocks, crude-oil movements, climate events, supply-chain disruptions and imported inflation** can raise consumer prices even when domestic demand remains weak.

India's Inflation Targeting Framework:

Evolution and Legal Basis:

- India moved towards formal **Flexible Inflation Targeting** after the **2015 Monetary Policy Framework Agreement** between the Government and the RBI, followed by amendments to the RBI Act in 2016 that provided the framework with a statutory basis.
- The framework was based substantially on the recommendations of the **Expert Committee to Revise and Strengthen the Monetary Policy Framework**, chaired by **Dr. Urjit Patel**, which favoured an explicit inflation target and greater institutional accountability.
- **Section 45ZA of the RBI Act, 1934** empowers the Central Government, in consultation with the RBI, to determine the inflation target once every five years in terms of the **Consumer Price Index (CPI)**.
- The choice of **CPI** is significant because it reflects changes in the prices paid by consumers and therefore provides a direct measure of retail inflation.

Inflation Target and Tolerance Band:

- The framework established **4% CPI inflation as the central target**, with a **2–6% tolerance band**, thereby combining a numerical nominal anchor with flexibility to accommodate temporary economic shocks.

- The framework is termed **flexible** because the RBI is not expected to mechanically eliminate every temporary deviation from 4%; instead, it seeks to bring inflation back towards the target over the medium term while considering growth conditions.
- A formal **failure to maintain the inflation target** occurs when average inflation remains above the upper tolerance level or below the lower tolerance level for **three consecutive quarters**. In such a situation, the RBI must explain the reasons for the deviation, specify remedial measures and indicate the expected period for returning inflation to the target.

Monetary Policy Committee and Institutional Architecture:

Role and Composition of MPC:

- The **Monetary Policy Committee** determines the policy rate required to achieve the inflation target and replaced the earlier system in which monetary policy decisions were primarily associated with the RBI Governor.
- The MPC consists of **six members**, with three members from the RBI and three external members appointed by the Central Government.
- The committee-based mechanism improves **transparency, accountability and collective decision-making**, because individual members record their votes and statements after every meeting.
- The MPC is required to meet at least **four times a year**, while its decisions and voting records are publicly disclosed.

Primary Objective:

- The statutory framework establishes **price stability as the primary objective of monetary policy while keeping the objective of growth in mind**.
- This creates a **flexible hierarchy rather than a rigid trade-off**, because the RBI can give greater attention to growth when inflation is under control but must prioritise disinflation when persistent inflation threatens macroeconomic stability.

How Inflation Targeting Works:

Demand Channel:

- When inflation is driven by excessive aggregate demand, the RBI can **raise the repo rate**, increasing borrowing costs for banks, households and firms.
- Higher interest rates can reduce **consumption, housing demand and private investment**, thereby moderating aggregate demand and easing demand-driven inflation.
- Conversely, lower policy rates can stimulate borrowing, investment and consumption when weak demand and low inflation threaten economic activity.

Expectations Channel:

- Inflation targeting attempts to **anchor inflation expectations** around the official target so that households and firms do not permanently anticipate high inflation.
- Well-anchored expectations can reduce the possibility of a **wage-price spiral**, because workers and firms are less likely to incorporate persistently high expected inflation into wage and price decisions.
- RBI research indicates that the FIT framework improved the anchoring of inflation expectations, although repeated supply shocks after the pandemic created renewed risks of de-anchoring.

Monetary Transmission Channel:

- Changes in the **repo rate** influence money-market rates, bank lending rates and financial conditions, which eventually affect aggregate demand and inflation.

- Effective transmission is therefore essential because a change in the policy rate does not immediately translate into equivalent changes in borrowing costs throughout the economy.

New Keynesian Phillips Curve and Inflation Dynamics:

Concept of NKPC:

- The **New Keynesian Phillips Curve (NKPC)** explains inflation through the interaction of **expected future inflation, economic activity and supply-side costs**.
- A simplified relationship suggests that current inflation rises when expected inflation increases or when economic activity exceeds productive capacity.
- Stronger demand can increase employment, wages and production costs, which may subsequently translate into higher prices.

Relevance to India:

- RBI monetary-policy models incorporate the **output gap, inflation expectations, exchange-rate movements and supply-side factors** to understand inflation dynamics.
- However, the Phillips Curve relationship may not be stable or equally strong across all economic conditions because India experiences substantial **food, fuel, weather and external commodity shocks**.

Concerns Regarding the Effectiveness of Inflation Targeting:

Flat Phillips Curve:

- Evidence from recent analysis of Indian industrial output and CPI inflation suggests that the **Phillips Curve has become relatively flat**, implying a weaker relationship between changes in economic activity and inflation.
- A flatter curve means that changes in output or employment may generate only a limited inflation response, reducing the effectiveness of demand compression as a tool against certain forms of inflation.
- RBI research also recognises that the Phillips Curve can be **non-linear**, remaining relatively flat at negative output gaps but becoming steeper when economic activity generates significant excess demand.

Weak Wage-Output-Inflation Link:

- A large informal workforce and relatively weak **collective wage-bargaining power** can weaken the conventional transmission from higher employment to higher wages and subsequently to consumer prices.
- Consequently, stronger output does not always produce the wage pressures predicted by a conventional Phillips Curve.

Supply-Side Nature of Inflation:

- Indian inflation frequently originates from **food-price shocks, adverse weather, climatic events, supply-chain disruptions, crude-oil prices and imported commodity costs**.
- Monetary tightening cannot directly increase agricultural production, repair disrupted supply chains or reduce international crude-oil prices.
- Excessive reliance on interest-rate increases against supply-driven inflation can therefore impose **output and employment costs without adequately addressing the original source of inflation**.
- RBI research similarly highlights the importance of supply-side shocks, particularly food and energy shocks, in shaping India's inflation trajectory.

Inflation Expectations and Measurement Challenges:

- Household inflation expectations can differ considerably from official CPI inflation because households give greater weight to **frequently purchased items**, particularly food and fuel.
- RBI research finds that household expectations contain significant biases but can still provide useful information for forecasting inflation after appropriate adjustments.
- Persistent supply shocks can nevertheless cause temporary inflation to become embedded in expectations, creating **second-round effects** that monetary policy must address.

Risk to Economic Growth:

- Persistent monetary tightening raises borrowing costs and can discourage **private investment, housing demand and household credit**, thereby slowing economic activity.
- If inflation remains high because of supply constraints rather than excess demand, the economy may face a difficult combination of **high inflation and lower growth**, often described as a stagflationary risk.
- Therefore, monetary tightening must be calibrated according to the **source, persistence and second-round effects of inflation**, rather than relying solely on headline inflation.

Way Forward:

Strengthening the Inflation Targeting Regime:

- Monetary policy should distinguish between **temporary first-round supply shocks** and persistent inflation generated through expectations, wages and broader demand pressures.
- The RBI should continue strengthening **forward guidance, communication and expectation management** because credibility is central to the success of inflation targeting.
- Government policy should complement monetary policy through **food-stock management, supply-chain improvements, climate-resilient agriculture, energy diversification and targeted fiscal measures**.
- Better coordination between monetary and supply-side policies can reduce the burden placed on interest rates while preserving the RBI's operational independence.
- Improving the quality and timeliness of **price, employment, wage and output data** can help policymakers identify whether inflation originates from demand, supply or expectations.

Value Addition for UPSC:

Key Conceptual Takeaway:

- **Inflation targeting is not merely an interest-rate mechanism; it is a framework for establishing a credible nominal anchor for the economy.**
- The Indian experience demonstrates that **monetary credibility can reduce inflation volatility and improve expectations**, but monetary policy alone cannot permanently resolve structurally supply-driven inflation.
- A balanced UPSC assessment should therefore recognise the **success of FIT in improving price stability and institutional transparency** while highlighting the constraints created by **food inflation, climate shocks, imported inflation, weak wage transmission and a potentially flat Phillips Curve**.
- The ideal policy approach is “**credible monetary policy + resilient supply chains + prudent fiscal policy + anchored expectations**”, rather than excessive dependence on any single instrument.