

Inflation Targeting and Its Impact on Price Stability: Insights from India

Manas Verma

(Research Scholar, CCSU, ICSSR)

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Abstract

Inflation targeting is a strategy used by central banks to promote price stability. Thus implementing the flexible inflation-targeting framework (FITF) in 2016, the Reserve Bank of India (RBI) has aimed to maintain inflation within a designated band of $\pm 2\%$, focusing on the Consumer Price Index (CPI). This paper assesses the RBI's approach to FITF, examining its effectiveness in stabilizing prices and its broader implications for the Indian economy. It explores the trade-offs between managing inflation and fostering economic growth, paying special attention to factors like food and core inflation, as well as challenges from external economic shocks.

Introduction

Inflation targeting has become a favoured policy framework for monetary authorities globally, including in India. The RBI adopted this model in 2016, aiming to balance price stability with economic growth. The framework establishes an inflation rate target, which the RBI strives to meet through various policy instruments. This study evaluates the effectiveness of India's inflation-targeting framework in promoting price stability and explores the balance between controlling inflation and supporting economic growth.

2. The Flexible Inflation Targeting Framework (FITF, 2016) In India

2.1 Adoption and Objectives

The RBI introduced FITF in 2016 with the objective of keeping inflation around a 4% target, with a tolerance range of $\pm 2\%$. This is interpreted that if the inflation goes 2% and 6% then the target of 4% set by the RBI will not be changed. This approach addressed the persistent high inflation that had troubled India's economy in the last decade. The framework primarily relies on the CPI to represent consumer living costs. By anchoring inflation expectations and stabilizing inflation rates, it seeks to create a conducive economic environment for growth. Tools like the repo rate, open market operations, and liquidity adjustments are employed to influence inflation trends within the target range.

2.2 Implementation Mechanisms

The framework functions through periodic policy reviews, where the RBI evaluates economic conditions and adjusts its policy stance by several monetary tools. The Monetary Policy Committee (MPC)—comprising RBI and external experts—determines policy rates based on a detailed analysis of inflation trends, global economics, fiscal developments, and supply constraints. The RBI communicates its decisions and inflation outlook through bi-monthly statements to influence market expectations and ensure transparency.

3. Impact on Price Stability

3.1 Achievements in Inflation Control

Since adopting FITF, the RBI has generally succeeded in maintaining inflation within its target. Between 2016 and 2019, inflation volatility decreased, with CPI rates largely staying within the 4% target and following the $\pm 2\%$ band. This price stability fostered a more predictable economic setting, supporting investment and planning. Clear communication of inflation targets and policy intentions has helped the RBI guide the expectations of consumers, businesses, and markets, curbing potential inflationary pressures.

3.2 Challenges with Food Inflation

Food inflation continues to challenge the framework due to high volatility in food prices, driven by factors like unpredictable monsoons, supply chain issues, and global price shifts. Since food makes up a significant part of the CPI basket, increases in food prices can push overall inflation beyond the target range that is 4%. The RBI has limited control over food inflation, as it is often driven by supply-side factors beyond its direct influence. For instance, poor monsoon seasons can reduce agricultural output, raising food prices and creating inflationary pressures that are challenging to address through monetary policy alone.

4. Trade-Offs Between Inflation Control And Economic Growth

4.1 Impact on Economic Growth

While the FITF has helped achieve price stability, it raises concerns about its impact on economic growth. Efforts to control inflation through tighter monetary policy can result in higher interest rates, which may reduce investment and consumption. In a developing economy like India, where growth is a key policy focus, this trade-off is particularly significant. During periods of high inflation, the RBI's focus on inflation targets may lead to a contractionary stance, potentially slowing down economic growth. For example, in the years after adopting FITF, India saw a GDP growth slowdown, partly due to restrictive monetary policy.

4.2 Core Inflation vs. Headline Inflation

Core inflation, which excludes volatile food and fuel prices, is often viewed as a more accurate measure of underlying inflationary pressures. The RBI closely monitors core inflation because it is less variable and more indicative of demand-driven pressures. However, because headline inflation (including food and fuel) also affects policy, the RBI must address both demand and supply-side shocks. This dual focus can lead to policy challenges. For example, if core inflation is stable but headline inflation rises temporarily due to spikes in food or fuel prices, the RBI may face a choice between tightening policy to curb headline inflation and maintaining accommodative measures to support growth.

5. The Role Of External Shocks

India's inflation trends are also shaped by external factors like global commodity prices, exchange rate changes, and international economic shifts either because of war or pandemic/epidemic. For instance, a rise in global oil prices can increase domestic inflation due to India's reliance on oil imports. Similarly, a depreciation of the rupee can raise import costs, leading to imported inflation. The RBI's FITF must consider these external shocks, which complicate efforts to maintain price stability. The central bank must balance inflation control with other goals, including exchange rate stability and economic growth, limiting its flexibility to respond to such shocks.

5. Conclusion

The RBI's FITF has largely succeeded in achieving its main objective of price stability, as evidenced by reduced inflation volatility and more stable inflation expectations. However, the framework also presents challenges, especially in balancing inflation control with economic growth. The volatility of food prices and the impact of external shocks make it difficult to keep inflation within the target range consistently. Moving forward, the RBI must continue refining its inflation targeting approach to address the unique features of the Indian economy, including structural challenges and external vulnerabilities. Achieving a balance between price stability and growth will require a flexible and nuanced approach to monetary policy, supported by coordinated fiscal policy and structural reforms.

6. References

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