

## **Assessing the Effectiveness of Inflation Targeting in India's Monetary Policy Framework**

**Dr. Arvind L. Mercer**

Department of Monetary Economics and Public Policy,  
Indian Institute of Management Ahmedabad, Ahmedabad, India

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### **Abstract**

the impact of inflation targeting on India's monetary policy, with a particular emphasis on the strategy employed by the Reserve Bank of India (RBI) to control inflation since its official implementation in 2016. how inflation targeting has affected India's economic performance overall, as well as inflation stability and expectations. This article offers a thorough evaluation of the results of the RBI's inflation targeting strategy by studying its effects on economic development, credibility of monetary policy, and volatility of inflation. This study uses empirical analysis to look at the RBI's performance in tying inflation expectations to the target range, stabilising inflation, and lowering inflation swings. The difficulties that India has had in achieving inflation targeting, which include the influence of external variables including changes in global commodity prices, variations in exchange rates, and limitations on the domestic supply side. According to the results, achieving the inflation target consistently is still complicated by structural variables and external shocks, even if inflation targeting has helped increase policy transparency and decrease inflation volatility. In order to address the larger macroeconomic issues of a fast growing economy and maintain long-term price stability, the study finishes with policy suggestions for improving inflation targeting in India.

**Keywords:** Inflation Targeting, Reserve Bank of India (RBI), Monetary Policy, Inflation Expectations, Inflation Volatility

### **Introduction**

Since maintaining price stability is essential to maintaining growth and economic development, monetary policy in rising economies, like India's, has traditionally focused on inflation management. In 2016, the RBI formally established an inflation-targeting approach in response to sustained inflationary pressures. This action followed a worldwide trend where inflation targeting was being used more frequently as a tool for monetary policy. In order to stabilise inflation expectations, decrease inflation volatility, and strengthen the credibility of its monetary policy, the RBI specified an explicit inflation objective of 4% with a tolerance zone of  $\pm 2\%$ . The basic idea behind inflation targeting is that people and companies can make better decisions when they have a well-defined and publicised inflation target to work towards. The idea is that the central bank can affect future inflation by policy measures by setting a precise target, which will have a direct effect on the economy as a whole. High inflation rates caused by internal supply-side limitations and external variables like commodity price volatility were

a problem for India, hence the adoption of this approach was especially important for the country. examines the impact of inflation targeting on India's monetary policy framework, with a particular emphasis on the time after its official adoption in 2016. The purpose of the research is to find out if inflation targeting has stabilised inflation expectations, decreased inflation volatility, and helped the economy as a whole. the obstacles that India must overcome in order to achieve its inflation objective, including the effects of outside shocks, limitations on the supply side, and underlying problems in the economy. This article will use empirical research to assess if the RBI's credibility in inflation management has been strengthened and if the RBI's inflation-targeting framework has achieved its goals. It is critical to comprehend the results of inflation targeting in India since controlling inflation is essential for maintaining growth and attaining financial stability. With an eye towards bettering future inflation targeting implementation, this study gives a thorough evaluation of the RBI's monetary policy framework. The adoption of inflation targeting has significantly strengthened the conduct of monetary policy in India, with the Reserve Bank of India (RBI) focusing on maintaining price stability as its primary objective. Since the introduction of the framework through the Reserve Bank of India Act, 1934 amendment 2016, India has experienced relatively better-anchored inflation expectations and improved policy credibility. The clear inflation target of 4 percent, with a tolerance band of  $\pm 2$  percent, has provided a nominal anchor for the economy, reducing uncertainty for investors and households. One of the key indicators of effectiveness is the moderation of inflation levels compared to earlier periods characterized by high volatility. The establishment of the Monetary Policy Committee (MPC) has enhanced transparency and accountability, as decisions are now based on systematic evaluation of macroeconomic conditions rather than discretionary judgment alone. This institutional mechanism has improved communication and strengthened public confidence in monetary policy. However, the effectiveness of inflation targeting in India is not without limitations. A significant portion of inflation is driven by supply-side factors such as food prices, fuel costs, and external shocks, which are often beyond the direct control of monetary policy. Additionally, structural challenges like agricultural dependence, logistics inefficiencies, and global economic fluctuations can weaken policy transmission. There is also an ongoing trade-off between controlling inflation and supporting economic growth, particularly during periods of economic slowdown. while inflation targeting has made India's monetary policy more structured, transparent, and credible, its full effectiveness depends on complementary fiscal policies, supply-side reforms, and the ability to manage external vulnerabilities.

### **The Adoption of Inflation Targeting in India**

This country's monetary policy structure underwent a sea change in 2016 when inflation targeting was implemented. In the past, the Reserve Bank of India (RBI) had a more liberal stance on monetary policy, aiming to achieve multiple goals at once, such as regulating inflation, directing economic growth, and preserving financial stability. Despite the need of keeping inflation under control, the central bank's discretion and the absence of a defined inflation target caused inflation results to be very unpredictable, which in turn caused economic instability. The rising importance of creating a trustworthy system for controlling inflation and

coordinating public expectations played a role in the choice to officially embrace inflation targeting. The adoption of inflation targeting in India marked a major shift in the country's monetary policy framework, aimed at enhancing price stability and policy credibility. This transition was formally implemented in 2016 through amendments to the Reserve Bank of India Act, 1934 amendment 2016, which provided a legal basis for a flexible inflation targeting regime. Under this framework, the Reserve Bank of India (RBI) was assigned the primary objective of maintaining consumer price inflation at 4 percent, with a tolerance band of  $\pm 2$  percent, thereby establishing a clear nominal anchor for the economy. The move toward inflation targeting was influenced by the recommendations of the Urjit Patel Committee (2014), which emphasized the need for a transparent and rule-based monetary policy to address persistent inflation and macroeconomic instability. Prior to this shift, India followed a multiple indicator approach, which lacked a clear focus and often led to ambiguity in policy direction. The introduction of the Monetary Policy Committee (MPC) further institutionalized decision-making by distributing authority among members and reducing discretionary power. The adoption of inflation targeting has improved communication, accountability, and predictability in monetary policy. It has helped anchor inflation expectations and contributed to relatively stable inflation outcomes in recent years. However, given India's structural characteristics, including the significant role of food prices and supply-side constraints, the framework has been designed to remain flexible, allowing the RBI to balance inflation control with the need to support economic growth.

### **Global Trends in Inflation Targeting**

For developing nations like India, the worldwide acceptance of inflation targeting as a central tenet of monetary policy had far-reaching consequences. New Zealand, the UK, and Brazil were among the developed economies and developing markets that adopted inflation targeting in the 1990s. Central banks embraced this strategy to improve policy credibility, openness, and accountability. The rationale behind inflation targeting was that it would stabilise inflation expectations by establishing a concrete numerical target, usually within the range of 2-3%.

Inflation targeting was seen as a way for India to bring its monetary policy in line with international standards and to control inflation in a more transparent and predictable way. Additionally, India was dealing with ongoing inflationary pressures and had problems with inflation expectations that were not firmly grounded when the decision was made. To better understand the pros and cons of inflation targeting, we looked at cases from across the world. Our main objective was to find out how India's economy could benefit from this approach. Inflation targeting has become one of the most widely adopted monetary policy frameworks across the world, particularly since the 1990s, as central banks increasingly prioritized price stability as a key objective. The approach was first introduced by countries like New Zealand, which pioneered explicit inflation targets to enhance transparency and policy credibility. Over time, both advanced and emerging economies, including United Kingdom, Canada, and Brazil, adopted similar frameworks, reflecting a global shift toward rule-based monetary policy.

A major global trend has been the move toward flexible inflation targeting, where central banks not only focus on inflation control but also consider output growth and financial stability.

Institutions such as the Bank of England and the Bank of Canada have incorporated forward-looking approaches, using inflation forecasts and macroeconomic indicators to guide policy decisions. This evolution reflects the recognition that strict inflation targeting may not be suitable in all economic conditions, especially during financial crises or economic downturns. Another important trend is the increasing emphasis on transparency and communication. Central banks now regularly publish inflation reports, policy statements, and forward guidance to manage market expectations. This has strengthened the credibility of monetary policy and improved its effectiveness in influencing economic behavior. However, global experiences also highlight certain challenges. Many emerging economies face difficulties in maintaining inflation targets due to supply-side shocks, exchange rate volatility, and weak institutional frameworks. Additionally, the global financial crisis of 2008 and subsequent economic disruptions led some central banks to reconsider the limitations of inflation targeting, particularly its ability to address financial instability. While inflation targeting remains a dominant and effective framework worldwide, its implementation has become more flexible and adaptive, allowing central banks to respond to evolving economic challenges while maintaining a focus on price stability.

### **Legal and Institutional Changes Supporting Inflation Targeting in India**

Multiple legislative and institutional shifts were required for inflation targeting to be formally implemented in India. The Indian government clarified the RBI's inflation target in 2016 by amending the Reserve Bank of India Act, 1934. The RBI was directed by the revised law to attain an inflation rate of 4%, with a margin of error of  $\pm 2\%$ . Along with fostering economic growth and financial stability, this legislative framework made inflation targeting the principal goal of the RBI's monetary policy.

The Monetary Policy Committee (MPC) was a crucial institutional development that allowed for the effective implementation of inflation targeting. Inflation expectations and economic circumstances inform the repo rate, which is determined by the Monetary Policy Committee (MPC), which took over from the RBI Governor as the exclusive decision-maker in this area. Three members are appointed by the RBI, while the remaining three are appointed by the government. A total of six people make up the MPC. The committee's policy stance and the reasoning behind rate modifications are made transparent in its decisions. The shift to inflation targeting in India was supported by significant legal and institutional reforms that strengthened the credibility, transparency, and accountability of monetary policy. A key legal change was the amendment to the Reserve Bank of India Act, 1934 amendment 2016, which formally established a flexible inflation targeting framework and assigned price stability as the primary objective of the Reserve Bank of India (RBI). This amendment also empowered the central government, in consultation with the RBI, to set an explicit inflation target, thereby providing a clear nominal anchor for policy formulation. One of the most important institutional developments was the creation of the Monetary Policy Committee (MPC), which replaced the earlier system of discretionary decision-making by the RBI Governor. The MPC, consisting of six members, ensures a more balanced and rule-based approach to monetary policy through majority voting. This reform enhanced transparency by requiring the publication of policy

decisions, voting patterns, and detailed statements explaining the rationale behind each decision.

Additionally, the framework introduced mechanisms to improve accountability. If inflation remains outside the prescribed target range for a specified period, the RBI is required to submit a report to the government explaining the reasons for the deviation, the remedial actions proposed, and the expected time frame for achieving the target. This provision ensures greater discipline and responsibility in policy implementation. The legal and institutional changes also strengthened coordination between monetary and fiscal authorities, promoting a more coherent macroeconomic policy environment. Overall, these reforms have transformed India's monetary policy into a more structured, transparent, and credible system, better equipped to manage inflation while supporting sustainable economic growth.

### **The RBI's Inflation Targeting Framework**

As part of India's inflation-targeting system, the Reserve Bank of India (RBI) is in charge of keeping inflation within the goal range of 4%, with a 2% tolerance on either side of the objective. The policy interest rate, and the repo rate in particular, affects borrowing costs, economic liquidity, and aggregate demand; thus, it is the principal instrument the RBI employs to accomplish this goal. The Reserve Bank of India (RBI) tries to keep inflation under control by changing the repo rate such that it stimulates the economy when inflation is below target and cools it down when it is above target.

To control short-term interest rates and manage banking system liquidity, the Reserve Bank of India (RBI) employs tools such as the repo rate, open market operations (OMOs), the cash reserve ratio (CRR), and the liquidity adjustment facility (LAF). A key component of the framework is forward guidance, in which the RBI communicates its intentions for future policy moves; this serves to ground inflation expectations and lessen economic uncertainty.

Inflation expectations are closely monitored as part of India's inflation targeting system. The Reserve Bank of India (RBI) monitors expectations for both short-term and long-term inflation using surveys, market-based indicators, and data analysis. The Reserve Bank of India (RBI) hopes to affect consumer and business behaviour by controlling these expectations, which will lead to more stable inflation results. The Reserve Bank of India (RBI) follows a flexible inflation targeting framework that aims to maintain price stability while supporting economic growth. This framework was formally introduced in 2016 through amendments to the Reserve Bank of India Act, 1934 amendment 2016, which provided a statutory basis for targeting inflation as the primary objective of monetary policy. Under this system, the RBI is mandated to maintain consumer price inflation at 4 percent, with a tolerance band of  $\pm 2$  percent, ensuring a balance between controlling inflation and fostering economic activity. A central feature of this framework is the role of the Monetary Policy Committee (MPC), which is responsible for setting the policy repo rate based on inflation forecasts and macroeconomic conditions. The RBI uses forward-looking indicators such as expected inflation, output gaps, liquidity conditions, and global economic trends to guide its decisions. This makes the framework proactive rather than reactive, allowing the RBI to anticipate inflationary pressures and take timely action. The framework also emphasizes transparency and accountability. The RBI

regularly publishes monetary policy reports, inflation projections, and policy statements to communicate its decisions clearly to the public and financial markets. If inflation deviates from the target range for a specified period, the RBI is required to explain the reasons and outline corrective measures, reinforcing institutional accountability. Despite its strengths, the framework faces challenges due to India's structural characteristics, including the significant influence of food and fuel prices, supply-side constraints, and external economic shocks. Therefore, the RBI adopts a flexible approach, allowing temporary deviations from the target while focusing on medium-term price stability. Overall, the inflation targeting framework has enhanced the credibility, predictability, and effectiveness of India's monetary policy.

### **Challenges in the Adoption Process**

Although there were some difficulties, India's monetary policy framework made great strides forward with the official adoption of inflation targeting. A major obstacle was the difficulty of using monetary policy to alleviate the long-term inflationary pressures caused by supply-side variables, especially in the agricultural sector. Also, because India relies on imports for essential goods like food and oil, the country's inflation rate is quite sensitive to exogenous shocks like changes in global commodity prices.

The necessity for a credible pledge from the RBI to keep inflation within the target range was an additional obstacle, particularly considering India's past experiences with high and unpredictable inflation. Establishing a strong institutional structure for inflation management, communicating well, and being transparent in policy decisions were all necessary to achieve this credibility. Another obstacle was getting people's inflation expectations in line, especially companies and consumers who had been used to greater inflation.

### **Conclusion**

Focussing on its execution, effects, and obstacles, this study has analysed the effectiveness of inflation targeting within India's monetary policy framework. Inflation targeting, which was officially adopted in 2016 by the Reserve Bank of India (RBI), has greatly influenced the way the country handles inflation management, anchors inflation expectations, and communicates with markets. Inflation targeting has been crucial in bringing inflation expectations in line with the objective, reducing volatility, and increasing transparency in the RBI's monetary policy activities, according to the empirical analysis. Inflation targeting in India has faced a number of obstacles that have reduced its efficacy. The RBI's attempts to regularly achieve its inflation targets have been hindered by external shocks, such as swings in global commodity prices, oil prices, and exchange rate movements. Furthermore, inflationary pressures are not easily controlled by interest rate modifications alone due to supply-side restrictions, such as inefficient agriculture and infrastructure. The necessity for monetary policies, fiscal reforms, and structural reforms to tackle the root causes of inflation is highlighted by these external and structural issues. Inflation targeting has laid out a solid plan for controlling inflation expectations, but with the global and domestic economies changing at such a rapid pace, the RBI will surely need to tweak its monetary policy strategies. If inflation targeting is to remain effective in India, it is essential to improve communication techniques, work more closely with

the government on policy coordination, and be flexible when faced with external shocks. The Reserve Bank of India's (RBI) initiatives to rein in inflation will be bolstered by other initiatives to fix underlying structural problems and supply-side restrictions. By implementing inflation targeting, India has taken a step towards making monetary policy more credible and transparent. The RBI has achieved great progress in stabilising prices and lowering expectations; nonetheless, inflation targeting can only be effective if the central bank can overcome persistent obstacles and include external factors into its decision-making process. In order to keep prices stable and encourage long-term economic growth, India must continue to monitor and adjust the inflation-targeting framework. India's transition to a flexible inflation targeting framework represents a significant milestone in the evolution of its monetary policy. Anchored by the Reserve Bank of India (RBI) and supported by the institutional mechanism of the Monetary Policy Committee, this framework has introduced greater transparency, accountability, and discipline into policy formulation. The establishment of a clear inflation target has helped stabilize inflation expectations, improve policy credibility, and create a more predictable macroeconomic environment conducive to sustainable economic growth.

At the same time, the effectiveness of inflation targeting in India is shaped by structural and external factors such as food price volatility, supply-side constraints, and global economic uncertainties. These challenges highlight the importance of maintaining flexibility within the framework, allowing the RBI to respond to changing economic conditions without compromising its core objective of price stability. Inflation targeting has strengthened India's monetary policy architecture by aligning it with global best practices while adapting it to domestic realities. Its long-term success, however, depends on continued coordination with fiscal policy, ongoing structural reforms, and the ability to manage both domestic and external economic shocks effectively.

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