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RBI paper on monetary policy says raising inflation target above 4% could erode policy gains

The RBI formally adopted the flexible inflation targeting framework in late 2016 with a 4 per cent target in a band of 2-6 per cent. The target is valid for five years, after which it must be reviewed.

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Earlier this month on August 6, Governor Sanjay Malhotra had said the RBI was preparing the discussion paper, with a final view to be taken by the government. (Express File Photo by Amit Chakravarty)

The Reserve Bank of India (RBI) on Thursday released its keenly awaited discussion paper on the country's monetary policy framework, warning that raising the inflation target at the current juncture could be seen as a dilution of the framework and lead to the loss of policy gains made over the last decade or so.

In its discussion paper, the Indian central bank has sought feedback by September 18 on four key questions: if monetary policy should target headline or core inflation, if the current 4 per cent target remains optimal to balance growth and stability, whether the tolerance band of 2-6 per cent needs to be revised or even dropped, and if the target rate of 4 per cent should be removed and only a range be maintained.

"However, raising the target at this stage – when the global economy is confronted with geopolitical uncertainty and geo-economic fragmentation – can be interpreted by global investors as a dilution of the IT (inflation targeting) framework thereby undermining policy credibility. It could erode the gains in policy and institutional credibility achieved through fiscal responsibility and external stability," the discussion paper said, adding that reducing the target rate below 4 per cent "may not be appropriate in case of India".

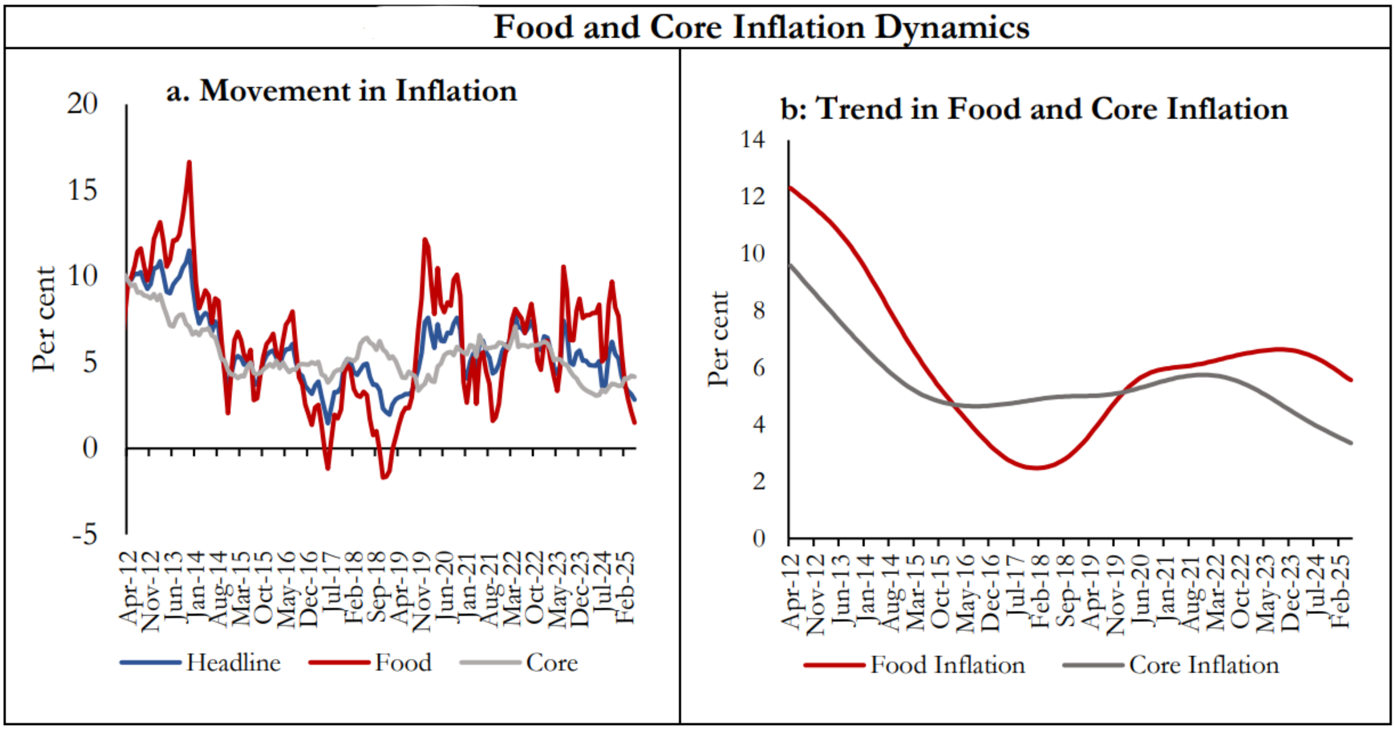
Last week, while upgrading India's rating to BBB from BBB-, S&P Global Ratings had praised the RBI, saying its record of inflation management had been burnished by headline retail inflation staying broadly within the 2-6 per cent target range. Low and stable inflation is crucial for foreign investors as sharp increases in prices can erode their investments, weaken growth and the domestic currency, and create social unrest — all factors that can lead to a rating downgrade.

The RBI formally adopted the flexible inflation targeting framework in late 2016. As per the framework agreed with the central government, the target is valid for a period of five years, after which it must be reviewed. Since the framework's inception, the medium-term target for the RBI has been 4 per cent in terms of the Consumer Price Index (CPI)-based inflation, within a band of 2-6 per cent.

The target, which is valid until March 2026, must be notified again for a five-year period starting April 2026. Earlier this month on August 6, Governor Sanjay Malhotra had said the RBI was preparing the discussion paper, with a final view to be taken by the government. "We will give our views to the government as to how we should move ahead in this regard," Malhotra had said in the post-policy press conference.

Headline versus core inflation

The debate on whether monetary policy should target headline or core inflation – which is inflation without taking into account food and fuel items, whose prices can be rather volatile – came to the fore over the last year after the Economic Survey for 2023-24, tabled in Parliament in July 2024, said "it is worth exploring whether India's inflation targeting framework should target the inflation rate excluding food" on account of the high weight of food in the CPI.



In its discussion paper released Thursday, the RBI pointed out that almost all inflation targeting countries have chosen headline CPI inflation as the target, irrespective of their inflation target level and stage of development, with only Uganda targeting core inflation.

"India's inflation targeting framework should consider targeting inflation, excluding food. Higher food prices are, more often, not demand-induced but supply-induced. Short-run monetary policy tools are meant to counteract price pressures arising out of excess aggregate demand growth," the Survey had argued.

However, the RBI under the then governor, Shaktikanta Das, had fought back, saying that food prices could not be ignored by the monetary authority.

In its discussion paper released Thursday, the RBI pointed out that almost all inflation targeting countries have chosen headline CPI inflation as the target, irrespective of their inflation target level and stage of development, with only Uganda targeting core inflation.

"Food inflation, if persistent, can spill over to core inflation through higher wage costs, higher rents and higher mark ups. Empirical exercise in the Indian context suggests that non-core prices converge to core prices in the long run. There are also spillovers from non-core inflation to core inflation, possibly through the cost-push and expectation channels, implying that monetary policy cannot ignore second-round effects emanating from persistent supply-side shocks," the discussion paper said.

Headline retail inflation as measured by the CPI slumped to an eight-year low of 1.55 per cent in July – its second-lowest print ever under the current inflation series, which is set to be updated in early 2026. Meanwhile, CPI inflation excluding food and fuel edged down to 4.1 per cent.

Headline inflation has moved in a broad range of 1.5-8.6 per cent since January 2014, driven by CPI food inflation, which has ranged from -2.7 per cent to 14.2 per cent. Meanwhile, core inflation has been far more stable.

"The conduct of monetary policy frameworks needs both policy certainty and credibility. This has become particularly important during the current environment of heightened uncertainty. It is, therefore, important that the basic tenets of the framework that have been tested and judged to be favourable are continued," the discussion paper said.

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