

Inflation targeting and beyond

CORE ISSUE. Food prices finally determine headline inflation. It is not clear to what extent inflation targeting has worked



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In India's chequered history of inflation management, the last one year has stood out for its remarkable volatility. In December 2024, food inflation was above 7 per cent, and CPI hovered around 5 per cent. By mid-year food inflation had tumbled to less than 2 per cent, contributing to a CPI lower than 4 per cent. In both scenarios, the RBI Monetary Policy Committee (MPC) with its usual policy arsenal of repo rate, seemed to be fighting a largely indifferent opponent: it was not clear whether policy rate changes had any impact on inflation. Food inflation, as is well acknowledged, drove the inflation dynamics. As RBI goes ahead with the evaluation of the 'Inflation Targeting' regime in March 2026, the experience of the last one year should inform policy-making to a great extent. Is it time to look beyond inflation targeting to a pragmatic approach given the ground realities for India? To answer these questions, we discuss three crucial facets of the inflation targeting regime. First, how robust is the evidence on the success of inflation targeting in India? Second, what does the experience on food inflation movement teach us? Third, have we been able to anchor inflation expectations adequately?

SUCCESS OF FIT IN INDIA

Has FIT worked for India? Chart 1 shows that seemingly inflation has remained range bound, relative to the pre-FIT period. However, annual average CPI inflation has been more than 4 per cent in six out of nine years, after the adoption of FIT in 2016. Also, a causal attribution that adoption of inflation targeting resulted in

The trajectory of core inflation does not demonstrate that interest rate policies have had a strong influence on curbing it

CHART 1

Average inflation in India

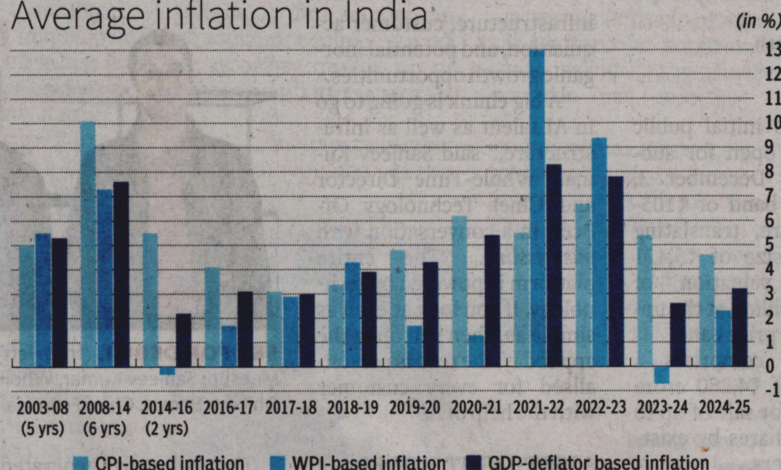
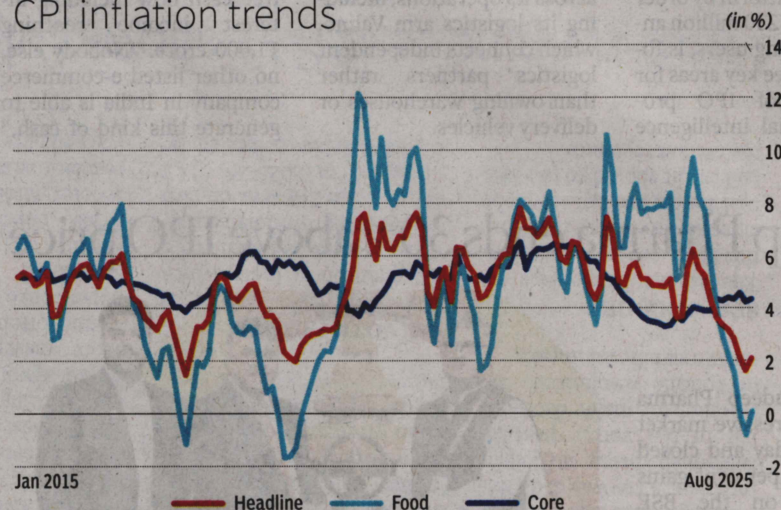


CHART 2

CPI inflation trends



Source: RBI database, Note: Inflation correlations: (headline, food) = 0.89; (headline, core) = 0.31; (core, food) = -0.10

controlling CPI inflation within 4 per cent is very hard to prove in the absence of the counterfactuals. On the contrary, there is evidence that States have a different story. The declining trend in inflation has occurred in other emerging market economies regardless of the adoption of inflation targeting (Bhalla *et al.*, 2025). In this scenario, we need to be cautious in attributing the success of inflation control to the FIT regime alone.

TARGET HEADLINE OR CORE?

The importance of food inflation in the overall inflation metrics is an important

consideration. As the RBI Governor mentioned, "Low inflation is primarily attributed to a sharp fall in food inflation, aided by improved supply prospects and measures by the government to effectively manage the supply chain" (Malhotra, RBI Governor, October 1, 2025). This clearly shows food inflation management remains central to achieve India's price stability objective. Chart 2 depicts the trends in CPI headline, food and core inflation. The core inflation is a derived measure, after excluding food, fuel, petrol and diesel from the CPI basket and has a weight of 45 per cent. In all practical

senses, the success or the failure of FIT framework critically hinges on the success or the failure of maintaining food inflation (correlation between food and headline inflation remains extraordinarily high at 0.89).

It is true that if RBI failed to achieve the inflation target in the past, it was primarily due to high and volatile food inflation. On the other hand, when inflation fell below 4 per cent, it was also due to sharp deceleration of food prices alone. So far, there is no clear evidence that RBI has achieved its target with its ability to engender a drastic decline in core inflation. Of course, it could be also true that in absence FIT framework adoption, core inflation would have been even higher. But that is just a conjecture — the trajectory of core inflation does not demonstrate that interest rate policies have had a strong influence on curbing it. Even now, the core inflation is running above 4 per cent when headline inflation is below 2 per cent.

India's food inflation mean reverts and hence it has helped RBI to achieve the inflation target in all times. In the proposed CPI with expected lower food weight, one wouldn't be surprised if RBI's task becomes much harder to achieve the inflation target. The targeting of headline inflation remains pragmatic, and the credibility and reputation of RBI is expected to improve if it continues to target headline inflation. In fact, lower the income, the more the pinch of inflation. Hence going forward, taking into account the income distribution in assessing the impact of inflation and designing policies becomes necessary.

INFLATION EXPECTATION

In India, households are greatly influenced by food inflation. If anchoring of inflation expectations becomes a pre-requisite for the success of FIT framework, there is no other way to achieve it other than by sustaining a low and less volatile food inflation. This is especially important given the adverse impact of food inflation on the lower quantile of income classes. Since this deals with supply-side measures, the accountability to achieve a 4 per cent inflation target squarely falls on the government as well.

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