Status Quo or Change?

Retail or Core Inflation as the Target for RBI in the Next Five Years

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The Reserve Bank of India (RBI) has announced a review of the current framework for setting its policy interest rate—the REPO rate (repurchase rate for authorized securities from commercial banks and other financial institutions). The REPO serves as the central policy tool for regulating money supply, making borrowing either costlier or cheaper across the economy. It acts as a guiding signal for consumption, savings, and investment decisions in the short, medium, and long term.

The adoption of a credible monetary policy requires a clear inflation target to anchor expectations. This was recognized in 2014 by a committee chaired by then Deputy Governor Dr. Urjit Patel, which recommended adopting a flexible inflation targeting (FIT) framework. At the time, India faced the dual challenge of persistently high inflation and sluggish growth in the aftermath of financial crises dating back to the late 1990s.

The FIT framework—globally acknowledged as a tool for macroeconomic stability and growth—was formally adopted in 2016 through amendments to the RBI Act, 1934. The agreement between the Government of India and the RBI set an inflation target of 4% (year-on-year, measured monthly), with a tolerance band of ±2%.

This framework allows short-term deviations to absorb supply shocks such as food and fuel price spikes or crises like the pandemic and geopolitical conflicts. By accommodating these shocks, the framework enables growth during downturns while ensuring a return to the target over the medium term.

RBI and Government: Shared Responsibility

While the RBI has full authority under the RBI Act to design and implement monetary policy, the central government is empowered under the Constitution to raise revenue, frame budgets, and finance deficits through borrowing. Both share equal responsibility for maintaining steady growth with price stability. Experience—both global and domestic—demonstrates that growth with stability is only possible through close coordination between fiscal and monetary authorities.

The First Five Years of FIT

The first five years of the FIT regime coincided with extraordinary global developments.

The COVID-19 pandemic devastated economies worldwide, causing massive loss of lives and livelihoods. Production, consumption, and investment collapsed, dragging down growth. Recovery from late 2020 to 2021 was strong, supported by fiscal expansion, easy monetary policy, and pent-up demand.

However, in 2022 the Russia–Ukraine war disrupted global supply chains, particularly in food and energy, fueling inflation worldwide.

The US Federal Reserve, which initially dismissed inflation signs in 2021 as "transitory," kept rates near zero until April 2022. By contrast, the RBI acted earlier and more cautiously, raising the REPO rate from 4% in December 2021 to 6.5% by April 2022. The rate was held until February 2025, before being gradually reduced to 5.5% in June 2025 as inflation showed a sustained decline.

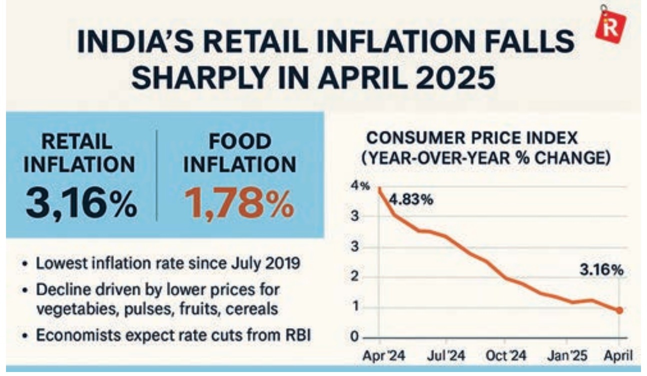
The Food Inflation Debate

By mid-2024, India's inflation appeared to be moderating. Headline inflation fell from 5.1% in January 2024 to 3.6% in July—below the 4% target. Yet, RBI was cautious, holding the REPO at 6.5% until a firmer downward trend was visible. Food inflation, however, remained stubborn.

In October 2024, retail inflation spiked to 6.21% due to food price volatility. This prompted Union Commerce Minister Piyush Goyal to publicly criticize the RBI, arguing that including food prices in the inflation measure was flawed and that high interest rates were slowing economic growth. Union Finance Minister Nirmala Sitharaman also voiced concern, warning that high lending rates were stressing borrowers.

RBI Governor Shaktikanta Das defended the framework, asserting:

"Food inflation cannot be ignored. Since India has a large low-income population, food inflation is very sensitive to changes in the prices of essential commodities."



Where We Stand Now

By mid-2025, with headline inflation easing to 1.61% in July (from 4.26% in January), the REPO was cut in phases to 5.5%. The debate now is whether the RBI should continue targeting headline retail inflation (CPI) or shift its focus to core inflation, which excludes volatile food and fuel prices.

Some key research findings a 2024 study by Professor Barry Eichengreen (University of California, Berkeley) and Dr. Poonam Gupta (then at NCAER, now Deputy Governor, RBI) reached the following conclusions

- The RBI's inflation targeting regime has performed well.
- Radical changes, such as broadening its mandate or shifting to a discretionary regime, would be risky .
- The 4% target, with a ±2% tolerance band, and focus on headline inflation remain broadly appropriate
- The weight of food inflation in the CPI basket should be reconsidered to better reflect household consumption patterns.

Conclusion

The RBI's review comes at a critical juncture. While there are calls to exclude food inflation from the target, the larger concern remains India's socio-economic reality—where food prices significantly impact household budgets. The prudent path may therefore be retaining the current framework, with refinements to the CPI basket, rather than adopting radical changes that could undermine hard-won monetary credibility. ■

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