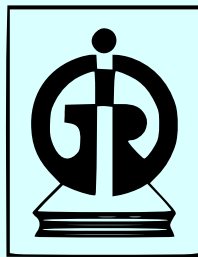


Monetary Policy in India: The Long Road to Inflation Targeting

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ABSTRACT

This paper traces the evolution of monetary policy in India and the institutional, intellectual, and macroeconomic forces that culminated in the adoption of flexible inflation targeting (FIT) in 2015. It documents the transition from a regime of fiscal dominance and quantitative controls to a market-based, interest rate-driven framework, highlighting key reforms in financial markets, liquidity management, and central bank autonomy. The paper shows how persistent inflation in the post-Global Financial Crisis period exposed the limitations of the Multiple Indicator Approach and created the conditions for a shift toward a rule-based framework with a clear nominal anchor. It also evaluates the post-FIT experience, noting improvements in inflation outcomes, expectations anchoring, and policy transparency, while emphasizing continuing constraints from fiscal dominance, and exchange rate management.

Keywords: Inflation Targeting, Monetary Policy Framework, Central Bank Credibility, Inflation Expectations, Emerging Economies

JEL Code: E52, E58, E31, E42, E61

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Introduction

India's monetary policy has undergone a profound transformation over the past several decades, shaped by domestic challenges and global developments. It has evolved from a system dominated by fiscal imperatives to a more autonomous, rules-based framework under inflation targeting (IT) that was adopted in 2015. While the final trigger for the IT adoption came from a phase of high and volatile inflation in the years immediately preceding it, the momentum had been building up for several years. The overarching, structural changes that India's monetary policy framework underwent since the mid-1980s eventually made it possible to switch to IT—a much more well-defined, systematic, transparent and comprehensive framework than its

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predecessors. IT has been a watershed reform in India's modern economic history. In this chapter we discuss the journey to IT and the experience thereafter.

In the pre-reform period, monetary policy was largely an extension of fiscal policy with the Reserve Bank of India (RBI) engaging in automatic monetisation of fiscal deficits and enforcing financial repression through the state-owned banking system. Monetary policy relied on quantitative credit controls and administered interest rates, leaving it largely ineffective in containing inflation, which averaged 8–9 percent in the 1970s and 1980s. The structural reforms of the 1990s, triggered by the 1991 balance of payments crisis, reduced fiscal dominance, phased out automatic deficit monetisation, and developed active government securities and money markets, thereby providing the infrastructure for more market-based monetary operations.

By the late 1990s and early 2000s, the RBI transitioned toward interest rate-based tools under the Multiple Indicator Approach and the Liquidity Adjustment Facility (LAF). These reforms enabled more precise liquidity management and replaced quantity-based instruments such as the Cash Reserve Ratio with interest rate corridors. The shift from quantity-based instruments toward interest rate-based monetary policy, coupled with a growing understanding of price stability as a key objective, laid the foundation for a more modern monetary policy framework and greater central bank autonomy.

While this improved operational efficiency, monetary policy continued to remain constrained by RBI's active foreign exchange interventions, and the challenges of managing an open economy, as evidenced during episodes such as the Global Financial Crisis (2008–09) and the 2013 taper tantrum.

The intellectual and institutional groundwork for formal IT emerged in the late 2000s, as persistently high and volatile inflation exposed the limitations of the erstwhile Multiple Indicator Approach. Reports by high-profile committees, including the Raghuram Rajan Committee on Financial Sector Reforms (Rajan, 2008) and the High Powered Expert Committee on Making Mumbai an International Financial Centre (Government of India, 2007), emphasised inflation targeting as the most effective means to anchor expectations, strengthen RBI's credibility, and provide a transparent rule-based framework that would insulate monetary policy from political pressures.

The Expert Committee to Revise and Strengthen the Monetary Policy Framework (Reserve Bank of India, 2014) formalised this approach, recommending flexible inflation targeting (FIT) with consumer price index (CPI) as the nominal anchor while acknowledging short-term trade-offs between inflation and growth.

The formal adoption of FIT was achieved through the Monetary Policy Framework Agreement (MPFA) in 2015 and statutory amendments to the RBI Act in 2016, establishing price stability as the primary objective, CPI inflation as the nominal anchor, and a six-member Monetary Policy Committee (MPC) with operational independence to set the policy rate. With this the

RBI, for the first time since its establishment in 1934, was given a legal mandate to achieve a CPI inflation target of 4 percent within a ± 2 percent tolerance band.

Since the adoption of FIT, inflation volatility in India has declined and long-term inflation expectations have arguably become better anchored. Monetary policy communication has also evolved, with clearer, more readable statements, forward guidance, and public accountability through regularly published minutes of the MPC meetings.

Despite these reforms, challenges remain. Fiscal dominance, residual financial repression through instruments such as the Statutory Liquidity Ratio (SLR), and active exchange rate management continue to constrain the effectiveness of FIT. Episodes like the Covid-19 pandemic and post-2022 global commodity shocks tested the flexibility and credibility of FIT.

Nevertheless, India's journey—from fiscal subservience and ad hoc monetary interventions to a transparent, rules-based inflation-targeting regime—represents a landmark evolution in monetary policy, highlighting both the successes achieved and the constraints that endure. This experience demonstrates that institutional reforms, financial sector development, well-defined monetary policy targets and instruments, and transparent communication practices must work together to ensure the credibility and effectiveness of inflation targeting in a complex, open, and emerging economy.

9.2 The journey to IT

9.2.1. Freeing monetary policy from fiscal subservience

In the pre-reform period, monetary policy in India functioned largely as an extension of fiscal policy. In the erstwhile centrally planned system, the government prioritised growth over inflation, leading to persistent fiscal deficits. Commercial banks faced a mandatory Statutory Liquidity Ratio (SLR) requirement according to which they had to hold a certain proportion of their liabilities in the form of government securities (G-Secs) at artificially low interest rates. This created a captive market for G-Secs, amounting to financial repression. The rates on G-Secs were fixed by the government and no active G-Sec market existed, as a result of which there was no market-imposed discipline on fiscal deficits.

Any excess fiscal deficit was financed by the RBI through the issuance of ad hoc treasury bills in a system of automatic monetisation of deficits. This would inevitably result in an expansion of the money supply. To counter the consequent inflationary impact, the RBI repeatedly raised the Cash Reserve Ratio (CRR) and the SLR, which became its main policy tools. The CRR—reserves that banks had to maintain with the RBI—rose to nearly 15 percent, while the SLR climbed to 38 percent of bank liabilities. Monetary policy thus lacked a coherent operating procedure.

At the time, nearly 90 percent of the banking sector was state-owned, and capital markets were underdeveloped. Credit allocation by nationalised banks was directed by the RBI in accordance with the government's Five-Year Plans, and its policy pronouncements were explicitly termed "credit policy statements." The RBI also determined the banks' lending and deposit rates. Credit controls and adjustments in the administered rates were actively used as instruments of monetary management. Pre-1980s monetary policy thus focused on regulating the quantity, cost, and direction of credit to support fiscal policy and promote growth. This tight integration with fiscal policy, however, rendered monetary policy ineffective in containing inflation, which averaged 9 percent in the 1970s and 8 percent in the 1980s (measured by the Wholesale Price Index).²

From the 1980s, steps were taken to streamline monetary policy. Following the recommendation of the Sukhomoy Chakravarty Committee in 1985, the RBI adopted a Monetary Targeting framework in the mid-1980s, which involved setting explicit money supply growth targets. The Committee also emphasised the need to develop an active G-Sec market, laying the groundwork for future financial reforms. From this period onwards, policymakers and academics gradually started recognising that high inflation was detrimental to growth (Rangarajan, 2022).

In 1991 India faced a severe balance of payments crisis which triggered wide-ranging structural reforms aimed at liberalisation, privatisation, and deregulation of the economy. These reforms also transformed the conduct of monetary policy. The RBI gradually gained greater autonomy as monetary policy was freed from fiscal dominance. By 1996–97, the SLR had been reduced to 25 percent and the CRR to 10 percent, while the administered interest rate structure of the banking system was progressively dismantled.

These reforms facilitated the development of both the government securities and money markets, with G-Sec yields becoming largely market-determined. The issuance of ad hoc treasury bills was gradually phased out, compelling the government to raise resources through bond market auctions rather than direct borrowing from the RBI. This shift enabled the RBI to operate in the secondary G-Sec market and use open market operations (OMOs) to manage system liquidity. Consequently, OMOs emerged as a key instrument of monetary policy.³

Under the Monetary Targeting framework, money supply growth (M3) served as the intermediate target of RBI's policy, based on the then-stable money demand function and the belief that monetary aggregates strongly influenced prices. However, this framework was short-lived. With economic liberalisation, financial deregulation, and rapid innovation in the financial sector, money demand became increasingly unstable, and by the late 1990s targeting money supply growth was no longer feasible.

² Back then inflation in India was measured using the Wholesale Price Index (WPI), a practice that ended with the adoption of IT.

³ Open market operations (OMOs) refer to the outright sale and purchase of G-Secs by the central bank in order to manage system liquidity.

With bank privatisation and interest rate deregulation, credit controls and targets were gradually phased out. The simultaneous development of financial markets allowed interest rates to replace quantity-based tools such as the CRR and SLR as the primary instruments of monetary policy. During this transition, WPI inflation declined sharply from nearly 14 percent in 1991–92 to 4 percent in 1997–98, while real GDP growth averaged 5 percent.

The institutional reforms of the 1990s fundamentally reshaped the conduct of monetary policy, laying the groundwork for the eventual adoption of inflation targeting.

9.2.2 A new operating framework

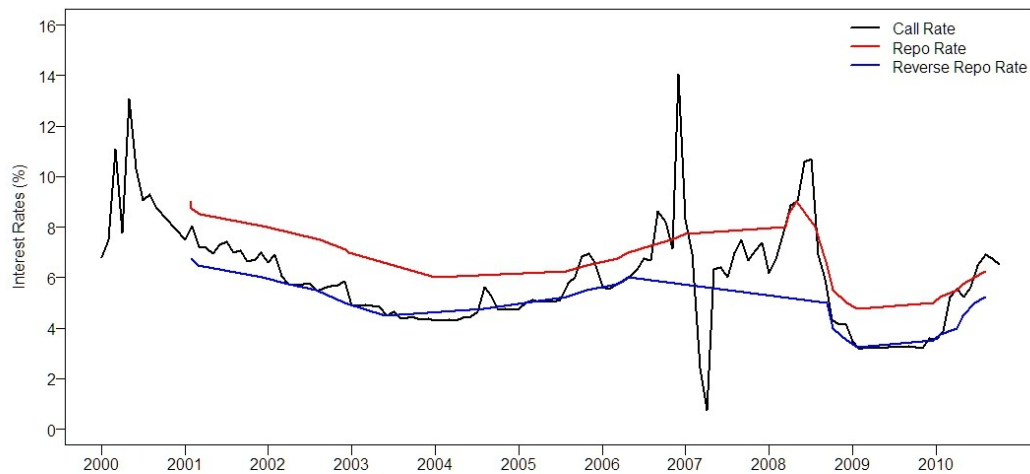
By the late 1990s, the Monetary Targeting framework had lost effectiveness as growing global integration and rapid financial sector development—including the expansion of banks, bond, equity, and money markets—rendered money demand unstable. An alternative framework was therefore needed. During this period, the RBI also began shifting toward interest rates as the primary instruments of monetary policy, with the bank rate emerging as an important tool.

While several advanced economies had adopted IT, India lacked consensus on this approach. Instead, under Governor Bimal Jalan in 1998, the RBI introduced the Multiple Indicator Approach. As noted in Samantaraya (2023), Dua (2020), and Pandey et al. (2024), under this approach the RBI monitored a broad set of economic and financial indicators—including interest rates, credit growth, fiscal deficit, industrial output, inflation, exchange rate, capital flows, trade, money supply, and equity prices—rather than focusing solely on inflation, to arrive at its monetary policy decisions. Monetary policy implicitly pursued price stability, output growth, and financial stability at the same time, but no well-defined objective was stated explicitly. The prevailing view was that this framework gave the RBI the flexibility to respond to evolving macroeconomic conditions. In other words the RBI responded to the state of the economy in a seemingly ad hoc and discretionary manner.

In 2000, the RBI introduced the Liquidity Adjustment Facility (LAF), to streamline the operating procedure of monetary policy. This established, for the first time, an interest rate corridor to guide short-term money market rates in line with monetary policy objectives. The repo rate served as the ceiling and the reverse repo rate as the floor, with the RBI actively managing the overnight call money rate within this corridor through independent adjustments of both rates (Figure 9.1).⁴ The LAF enabled more effective daily management of banking system liquidity and allowed the RBI to reduce reliance on quantitative tools such as the CRR. Consequently, monetary policy shifted further toward price-based instruments, with changes in the repo, reverse repo, and bank rates serving as key policy signals.

⁴ The repo rate is the interest rate at which the RBI lends overnight to the commercial banks against the collateral of G-Secs. The reverse repo rate is the interest rate that banks earn when they deposit excess overnight liquidity with the RBI. The call money rate is the rate at which the commercial banks lend to and borrow from each other in the overnight interbank market.

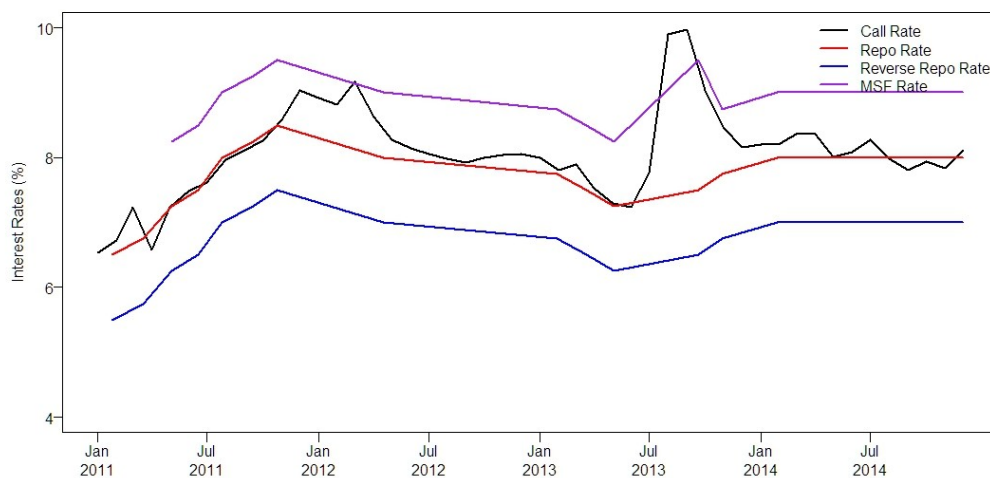
Figure 9.1: Liquidity Adjustment Facility (LAF) corridor, 2000-2011



Note: This graph shows the Liquidity Adjustment Facility or LAF corridor from inception in 2000 till 2010 before it was modified, with the repo rate as the ceiling, the reverse repo rate as the floor and the call rate in between. Source: CEIC database.

While varying both the repo and reverse repo rates gave the RBI flexibility, it also created ambiguity about the policy stance. To address this, the LAF was modified in May 2011, with the repo rate designated as the single policy rate and the reverse repo rate pegged 100 basis points below it. A Marginal Standing Facility (MSF) was also introduced, allowing banks to borrow from the RBI without G-Secs as a collateral, but at a higher interest cost; the MSF rate thus became the new ceiling of the corridor (Figure 9.2). The operating target shifted to the call money rate, which the RBI sought to keep within the 100-basis-point corridor. Movements in the call rate signalled liquidity conditions—falling when liquidity was ample and rising when tight—and transmitted to interest rates across money and bond markets.

Figure 9.2: Liquidity Adjustment Facility (LAF) corridor, 2011-2014



Note: This graph shows the Liquidity Adjustment Facility or LAF corridor from 2011 till 2014, with the Marginal Standing Facility (MSF) rate as the ceiling, the reverse repo rate as the floor and the repo rate in between. During this period the call rate moved between the repo rate and the MSF rate.

The modified LAF brought greater clarity, certainty, and transparency to the RBI's monetary policy framework, while also enabling banks to manage liquidity more effectively. This institutional foundation proved crucial for the subsequent adoption of IT. The LAF, supplemented by OMOs, became the RBI's principal operating procedure—a framework that continued even after the formal adoption of IT.

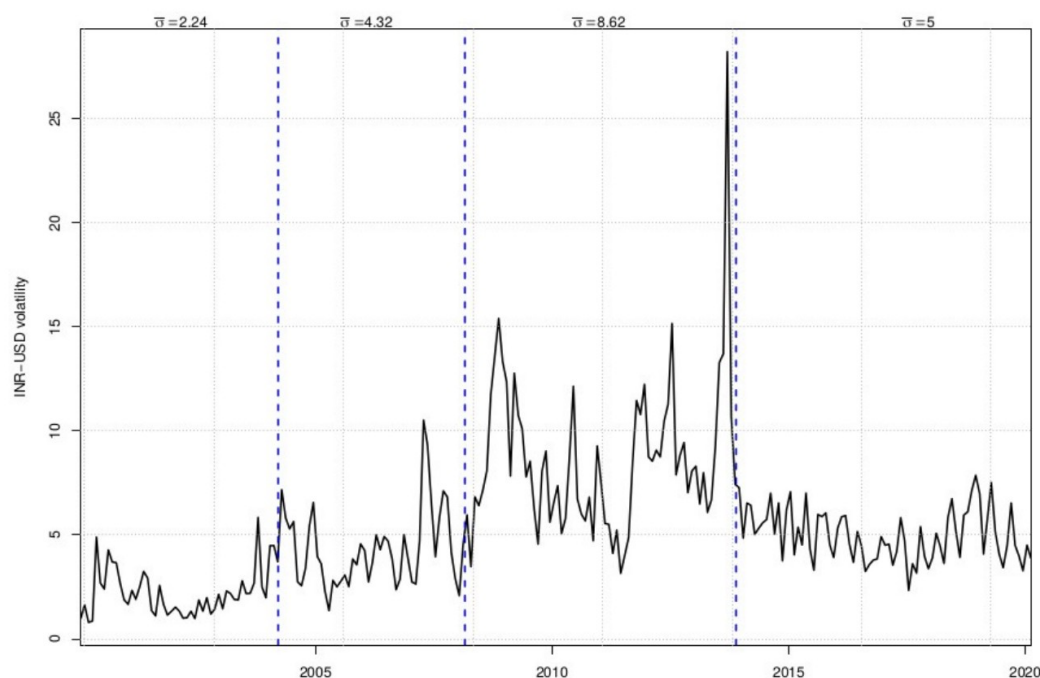
Another major development in the 2000s was the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003. As noted by Reddy (2010), despite the 1990s reforms that fostered the G-Sec market and ended automatic monetisation of deficits, monetary policy remained constrained by fiscal dominance. The RBI, through its participation in primary G-Sec auctions, was obliged to facilitate low-cost government borrowing—an obligation that became increasingly burdensome as borrowing expanded. The FRBM Act addressed this by prohibiting RBI participation in primary G-Sec auctions, thereby enhancing the autonomy and flexibility of monetary policy.

9.2.3 Monetary policy in an open economy

A central principle of international finance is the 'Impossible Trilemma', which posits that an open economy can achieve only two of three objectives: monetary policy independence, capital account openness, and exchange rate stability. Monetary independence allows a central bank to focus on domestic inflation and growth rather than external factors such as capital flows and exchange rates. Capital account openness reflects the degree of financial integration with the global economy, while exchange rate stability involves limiting volatility in the domestic currency. As India gradually liberalised its capital account in the 1990s and permitted foreign investment in equity and debt markets, the RBI frequently confronted the challenge of reconciling monetary policy independence with exchange rate stability. Two major episodes of this conflict occurred in the pre-IT period.

Although India formally adopted a 'market-determined exchange rate' as part of the 1990s liberalisation reforms, the RBI continued to intervene actively in the foreign exchange (FX) market supposedly to contain volatility but implicitly, to influence the exchange rate level. Patnaik and Sengupta (2022) examine India's post-reform exchange rate regimes and show that the rupee was tightly pegged to the US dollar during 2000–2004, with sustained RBI intervention leading to a sizeable accumulation of FX reserves. In contrast, between 2004 and 2008, the rupee exhibited greater flexibility but was effectively pegged to a basket of currencies (Figure 9.3).

Figure 9.3: Annualised volatility of the Rupee-Dollar exchange rate, 2000-2020



Note: This graph plots the annualised volatility of the INR-USD nominal exchange rate across the different exchange rate regimes highlighted by the dashed vertical lines (Patnaik and Sengupta, 2022). The mean currency volatility in each regime is given at the top of the graph. Source: BIS database and authors' calculations.

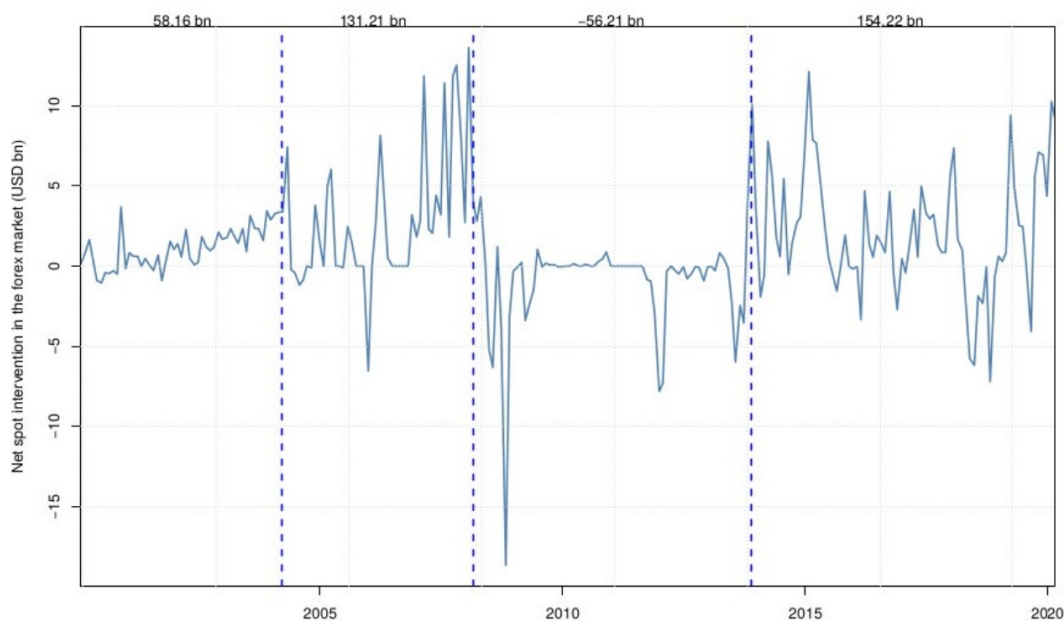
During this period, India experienced rapid economic expansion, with real GDP growth averaging 8 percent. Strong growth prospects, coupled with global macroeconomic stability—characterised by low inflation and steady growth—drew large volumes of foreign capital into emerging markets such as India in search of higher yields. As a result, India's gross capital flows (inflows plus outflows) rose from 18 percent of GDP in 1993–2000 to nearly 50 percent by 2007, underscoring the country's deepening financial integration with the global economy.

Faced with surging capital inflows, the RBI intervened heavily in the FX market to curb rupee appreciation, a move supported by the exporters (Figure 9.4). It regularly purchased large volumes of dollars in the spot market, leading to a sharp buildup of reserves—equivalent to eight to nine months of imports, well above conventional adequacy benchmarks (Patnaik and Shah, 2011). These interventions, however, expanded domestic money supply and fuelled inflationary pressures. For a time, the RBI sterilised the liquidity impact by selling G-Secs and absorbing excess liquidity from the financial system.

By 2004, the RBI had exhausted its stock of G-Secs for sterilisation. To address this, the Market Stabilisation Scheme (MSS) was introduced, allowing the RBI to issue bonds on behalf of the government solely for sterilisation purposes, with the proceeds kept outside the government's budget to avoid fiscal use. While this framework enhanced transparency, it limited the scope for sterilisation. As a result, interventions under the MSS were only partially sterilised, meaning that RBI's exchange rate policy had direct monetary consequences. The liquidity spillovers

aggravated inflationary pressures in an already overheated, rapidly growing economy (Pandey and Patnaik, 2020).

Figure 9.4: RBI's Net interventions in the currency spot market



Source: RBI database and authors' calculations. The graph shows the net FX intervention by the RBI i.e. purchase minus sales of US dollars in the spot currency market, with the totals in each regime given at the top of the graph.

By 2006, average consumer price index (CPI) inflation had risen above 6 percent and remained persistently high, climbing from 5 percent in January 2006 to 16 percent by January 2010. This episode illustrates how the RBI's pursuit of a managed exchange rate eroded monetary autonomy and contributed to sustained inflationary pressures (Sengupta and Sen Gupta, 2019).

The second major conflict between currency management and monetary policy arose during the 2013 'taper tantrum'. In May 2013, U.S. Federal Reserve Chairman Ben Bernanke signalled the possibility of tapering its quantitative easing programme, which triggered a sharp sell-off by global investors anticipating tighter U.S. liquidity conditions. Emerging economies with weaker macroeconomic fundamentals were hit hardest, and India—classified among the 'Fragile Five'—experienced large capital outflows and a rupee depreciation of about 17 percent between May and September 2013.

This period was marked by severe macroeconomic instability in the Indian economy. Real GDP growth had fallen to 4 percent, both the current account and fiscal deficits had widened sharply, creating a 'twin deficit' problem, and retail inflation was hovering near 10 percent. In response to the rupee's sharp depreciation, the RBI sold dollars from its reserves and introduced capital flow management measures, though these proved insufficient to stem the fall. In an unexpected move, it then tightened monetary policy by raising the MSF rate by 200 basis points and

restricting banks' access to the repo window, aiming to curb speculative pressures in the FX market by constraining liquidity.

The explicit use of monetary policy to defend the currency arguably compromised the RBI's policy independence during this episode. Ironically, it occurred just a year before the Urjit Patel Committee (Reserve Bank of India, 2014) strongly recommended adopting an IT framework. The tension between monetary policy objectives and exchange rate management, however, has persisted even after the adoption of IT, as discussed in Section 9.3.2.

9.2.4 The intellectual journey to IT

Until 2016, the Preamble to the RBI Act, 1934 set out the objectives of the RBI as:

“to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.”

There was no explicit mandate for price stability. From the 1980s onward, monetary policy thinking in India gradually shifted toward the recognition that low and stable inflation was a prerequisite for sustained growth, rather than being in conflict with it. In fact the Chakravarty Committee report mentioned 4 percent as the acceptable rise in prices that would reflect the changes in relative prices necessary to attract resources to growth sectors. Eventually when India did adopt an inflation target, 4 percent CPI inflation was stipulated as the medium-term target of the RBI's monetary policy.

In the 1990s, the RBI's Annual Reports outlined two broad objectives of monetary policy: (i) ensuring adequate credit expansion to support growth, and (ii) moderating monetary expansion to maintain a reasonable degree of price stability. Price stability was seen not as an end in itself but as a means to achieve sustainable growth, with monetary policy regarded as the most effective tool for this purpose. This evolution mirrored contemporary developments in advanced economies, many of which had by then adopted IT as the predominant medium-term objective of monetary policy.

In its 1996–97 Annual Report, the RBI noted that effective monetary policy required well-defined objectives, but a consensus had yet to form on maintaining inflation around a specific level. The report acknowledged that while monetary policy was gaining independence, greater clarity on its primary objective was still needed to enhance effectiveness. This marked the first indirect reference to IT in official documents, though the lack of a broader national consensus remained a key obstacle (Rangarajan 1998).

By the late 1990s, price stability and growth were widely recognised as the main goals of monetary policy. However, despite the failure of monetary targeting to control money supply and inflation, several factors made IT unviable. First, while it was accepted that monetary policy should have a dominant objective—best suited to ensuring price stability—the threshold level of inflation to be targeted was unclear. For example, Rangarajan (1998) suggested a 5–7

percent band, whereas Reddy (2017) argued that political pressures arose only beyond 10 percent. Second, although financial markets had become operational, interest rates were not fully integrated across different segments and market depth remained limited.

Third, critical preconditions for IT—such as effective liquidity management, reliable inflation forecasts, and data on inflation expectations—were not fully developed in India. Fourth, monetary transmission was weak due to shallow capital markets and a newly privatised banking sector. Finally, there was still debate over the extent to which monetary policy could influence inflation or growth. Since oil prices were regulated through subsidies and taxes, and food prices were heavily shaped by the government’s Minimum Support Price (MSP) programme, many argued that inflation could not be managed by the RBI alone

Between 2000 and 2013, both the feasibility and desirability of adopting IT were frequently debated. The main resistance stemmed from concerns that a formal rule would constrain the RBI. Policymakers preferred to allow the RBI discretion to balance price stability, growth, and financial stability depending on prevailing macro-financial conditions. As The Report of The Advisory Group on Transparency in Monetary and Financial Policies, 2000 observed: “*There is great comfort in a multiple objective approach in that precision is not required in defining the objectives and the RBI in turn does not have much accountability as it juggles with the almost impossible task of fulfilling contradictory objectives and as such accountability is blurred.*”⁵

At the same time, several high-profile committee reports began advocating strongly for IT. The *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre* (Government of India, 2007) argued that a formal and transparent IT framework should be the central pillar of India’s monetary policy, describing it as the ‘gold standard’ for macroeconomic stability. Drawing on the Impossible Trilemma, the report noted that as India opened its capital account, it would lose its ability to manage the exchange rate—its traditional policy anchor. IT could provide a new anchor by guiding inflation expectations and giving the RBI a clear, predictable goal. A transparent, publicly stated inflation target would also strengthen credibility with global investors and domestic businesses, helping to safeguard price stability and reduce the risk of persistent inflation that undermines growth and long-term investment.

Another key push came from the *Report of the Committee on Financial Sector Reforms* (Rajan, 2008), chaired by Raghuram Rajan—later RBI Governor and instrumental in India’s eventual adoption of IT. The report argued that inflation, as a nominal anchor, is superior to alternatives because it is simple, transparent, and widely understood. Drawing on international evidence, it showed that adopting inflation as the anchor reduces volatility and has gained broad acceptance across advanced and emerging economies. It recommended that India’s monetary policy pursue an unambiguous price stability goal, enabling the private sector to anchor expectations. The

⁵ <https://the1991project.com/public-repository/report-advisory-group-transparency-monetary-and-financial-policies-2000-chaired-m>

report further stressed that IT should be paired with fiscal discipline to limit fiscal dominance and, in line with the Impossible Trilemma, clarified that the RBI should not be held responsible for either the level or the volatility of the exchange rate.

However, the RBI leadership in the post-GFC period did not endorse these recommendations. They resisted committing to a formal inflation target, unlike many central banks worldwide, and remained hesitant to make price stability the sole objective of monetary policy. Their argument was that the GFC had exposed the limits of IT: by focusing narrowly on inflation, advanced-economy central banks had overlooked financial sector fragilities, thereby exacerbating the crisis.

In India, resistance to IT during this period stemmed largely from the view that short-term inflation was driven mainly by supply shocks—especially food and energy prices—beyond the RBI's control, limiting its ability to ensure price stability. Additional concerns included high fiscal deficits, weak monetary transmission due to shallow bond markets, and the RBI's exchange rate management. Ironically, these same factors continue to challenge the RBI nearly a decade after IT's formal adoption, as discussed below in Section 9.3.2.

By the late 2000s, it was increasingly recognised that relying on a broad set of indicators failed to provide a clear nominal anchor for monetary policy. The decisive push towards IT came from the persistently high and volatile inflation that followed the GFC, which exposed the limitations of the Multiple Indicator Approach and opened the door for a new monetary policy regime. This environment set the stage for the eventual adoption of IT as India's formal monetary policy framework in 2016.

9.2.4.1 Years of high inflation

A credible monetary policy framework requires a nominal anchor to guide its objectives. A nominal anchor is a variable that stabilises monetary policy goals and shapes their trajectory over the medium to long term. Historically, many central banks relied on a currency peg as their anchor (Pandey and Patnaik, 2020). Under this arrangement, domestic monetary policy became tied to that of the anchor country, with inflation rates converging over time. The peg effectively imposed a rule: monetary policy would be tightened to counter depreciation pressures and eased when faced with appreciation pressures.

Despite its clarity and simplicity, exchange rate targeting has major limitations, the most significant being the loss of monetary policy independence. When domestic interest rates must track exchange rate movements, the central bank's ability to respond to domestic shocks that differ from those in the anchor country is severely constrained.

As discussed earlier, until 2008 India's monetary policy relied on a de facto rupee-dollar peg maintained through RBI's active FX interventions (Pandey and Patnaik, 2020; Pandey et al., 2024). The GFC triggered large capital outflows from emerging markets like India, putting heavy depreciation pressure on the rupee. Stabilising the exchange rate required a sharp

drawdown of FX reserves, after which the RBI scaled back its interventions. Between 2008 and 2013, India came closest to a flexible exchange rate regime in the post-reform period (Patnaik and Sengupta, 2022; Sengupta and Sen Gupta, 2019), with currency volatility rising sharply from 4 percent to 8.6 percent (Figure 3). But once the exchange rate peg was abandoned, monetary policy was left without a clear nominal anchor.

Between 2008 and 2011, India faced high, persistent, and volatile inflation—the highest among G20 economies. Although debates on IT had been ongoing for years, this inflationary episode underscored the urgent need for a credible nominal anchor, strengthening the case for IT within policy circles.

The causes of this inflationary surge were multifaceted. They included the RBI's incompletely sterilised FX interventions, an overheated pre-GFC economy, poor monsoons driving up food prices, rises in global oil prices, and the expansionary fiscal and monetary policies implemented after the crisis. The government's employment guarantee programme also boosted incomes without a corresponding rise in productivity (Subbarao, 2016). Crucially, the loss of a nominal anchor further compounded inflationary pressures. As a result, average annual WPI inflation rose from 5 percent in 2005–2007 to nearly 8 percent in 2008–2011 (Figure 9.5). CPI-industrial workers (CPI-IW) inflation climbed from 6 percent in 2006–2007 to an average of 10 percent over the same period, while CPI-Combined inflation remained close to 10 percent in 2012 and 2013 (Figures 9.6 and 9.7).^{6,7} Household inflation expectations surged, and professional forecasters revised long-term expectations upward by nearly 150 basis points. This bout of macroeconomic instability severely undermined the credibility of the Multiple Indicator Approach.

During the Global Financial Crisis (2008–09), the RBI temporarily set aside its inflation-control mandate and used monetary policy primarily to support growth and financial stability, underscoring the dilemmas of operating in an open economy under global shocks. By September 2008, CPI inflation had risen to 9 percent, but the collapse of Lehman Brothers and the ensuing turmoil compelled the RBI to start easing monetary policy. From October 2008 onward, it reduced the CRR and SLR to boost credit flows and cut the policy repo rate from 7.75 percent to 5 percent by 2009, effectively adopting an expansionary monetary policy stance despite rising inflation.

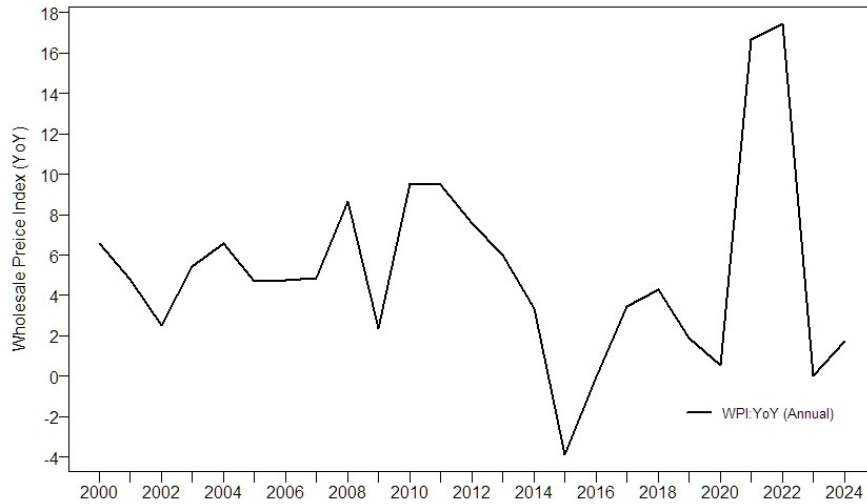
Once the impact of the crisis had weakened, the RBI began tightening monetary policy by first raising the CRR in January 2010 and then raising the policy repo rate from 4.75 percent in April 2009 to eventually reach 8.5 percent by October 2011, through as many as thirteen rate hikes (Figure 9.2). CPI inflation started coming down only from 2014 onwards. This was also

⁶ Until 2011 retail inflation was measured using the CPI-Industrial Workers index; from 2011 onwards the CPI-Combined series has been used.

⁷ WPI by construction is heavily influenced by global commodity prices whereas CPI indices capture retail inflation. Hence WPI inflation is likely to be more volatile depending on global commodity cycles compared to CPI inflation measures.

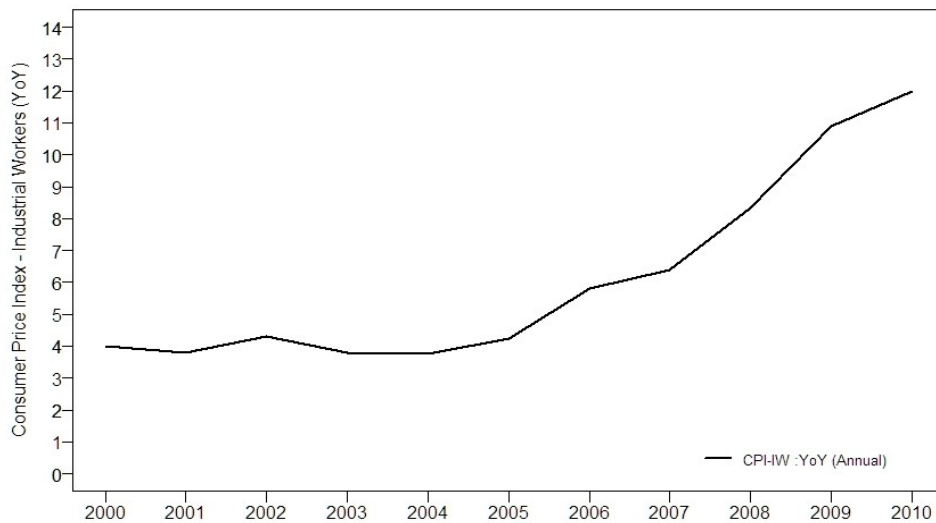
partly because from 2014 onwards food and fuel inflation became relatively benign. Given the high weight of these volatile items in the CPI basket, this pushed down overall inflation too.

Figure 9.5: Wholesale Price Index (WPI) inflation, 2000-2024



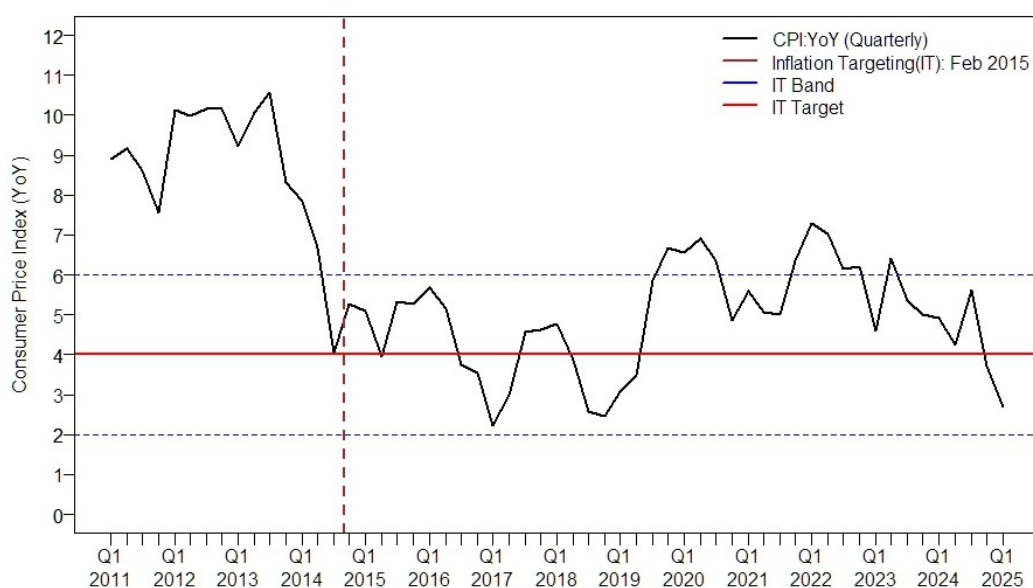
Note: This graph shows the year on year inflation calculated using the Wholesale Price index on an annual frequency. Source: CEIC database.

Figure 9. 6: Consumer Price Index-Industrial Workers (CPI-IW) inflation, 2000-2010



Note: This graph shows the year on year inflation calculated using the CPI-Industrial Workers index on an annual frequency. Source: CEIC database.

Figure 9.7: Consumer Price Index-Combined inflation, 2011-Present



Note: This graph shows the year on year inflation calculated using the CPI-Combined index on a quarterly frequency. The red line is the RBI's 4 percent inflation target. The dashed horizontal lines represent the inflation targeting band of 2 percent to 6 percent. The vertical dashed line stands for 2015 Q1 when inflation targeting was first adopted in India. Source: CEIC database.

In the post-GFC period, the RBI had internally set a goal of achieving 4-5 percent inflation (Subbarao, 2016). The debates and discussions between the RBI and the Finance Ministry during this period reflected the general mood in the intellectual and policy circles about what should be the central bank's principal mandate: output growth or price stability. This debate very much helped inform the subsequent design of the IT framework in India.

The final blueprint for adopting IT came from the *Expert Committee to Revise and Strengthen the Monetary Policy Framework* (Reserve Bank of India, 2014), appointed by Governor Raghuram Rajan and chaired by Deputy Governor Urjit Patel. Tasked with recommending a more transparent and predictable framework, the Committee strongly criticised the Multiple Indicator Approach for leaving analysts uncertain about the RBI's policy drivers, thereby weakening the anchoring of inflation expectations. It stressed the need for a rule-based framework built around a clear nominal anchor, one that would define monetary policy's medium- to long-term path and allow economic agents to align their expectations accordingly.

The *Urjit Patel Committee Report* (UPCR) highlighted the global consensus that low and stable inflation is essential for sustained growth, and argued that IT provides a transparent and predictable framework for anchoring expectations. It recommended making inflation the nominal anchor of monetary policy and adopting flexible inflation targeting, which would acknowledge short-run trade-offs between growth and inflation. Inflation, the Committee noted, is both simple and easily communicated to the public.

By 2013, consensus had firmly shifted in favour of IT. Governor Rajan emphasised that sustainable growth hinges on monetary stability, making a transition to CPI-based inflation targeting essential. This shift from WPI to CPI was a landmark reform, aligning policy with the inflation experience of consumers and providing a credible foundation for anchoring expectations.

9.2.5 Implementation of IT

The RBI accepted the Urjit Patel Committee's recommendations, culminating in signing the *Monetary Policy Framework Agreement* (MPFA) with the Government of India on February 20, 2015. This formally marked the adoption of IT, mandating the RBI to achieve a clear numerical target. The MPFA set a medium-term CPI inflation target of 4 percent, with a tolerance band of ± 2 percent, balancing sensitivity to supply shocks with the need to avoid deflation. If CPI inflation exceeds 6 percent or falls below 2 percent for three consecutive quarters, the RBI must explain the deviation to the government, outline corrective measures, and estimate the time required to return inflation within the target range.

In May 2016, the Reserve Bank of India Act, 1934 was amended to provide a statutory basis for implementing the IT framework.⁸ The amendment designated price stability as the primary objective of monetary policy, established CPI as the nominal anchor, and created a Monetary Policy Committee (MPC) to set the policy repo rate to achieve the inflation target. Prior to this change, the Preamble to the RBI Act stated⁹:

“And whereas in the present disorganization of the monetary systems of the world it is not possible to determine what will be suitable as a permanent basis for the Indian monetary system;

But whereas it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures”.

In other words, prior to 2016, the RBI lacked clearly defined objectives and accountability mechanisms. With the 2016 amendment, the Preamble was rewritten for the first time since 1934 to explicitly assign a clear objective to monetary policy:

“And whereas it is essential to have a modern monetary policy framework to meet the challenge of an increasingly complex economy; And whereas the primary objective of the monetary policy is to maintain price stability while keeping in mind the objective of growth”.

⁸ See: <https://www.indiabudget.gov.in/budget2016-2017/ub2016-17/fb/bill.pdf>.

⁹ <https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RBIA1934170510.PDF>

The amended RBI Act came into effect in June 2016. In August 2016, following the MPFA, the government set a CPI inflation target of 4 percent with a ± 2 percent tolerance band for the period August 5, 2016, to March 31, 2021. The wording of the Act reflects the flexibility of India's IT framework: it does not demand rigid price stability at all times but holds the RBI accountable for achieving the publicly announced target. Accordingly, India's framework is often called Flexible Inflation Targeting (FIT), with the wide tolerance band further underscoring this flexibility. The Act also mandates that the government, in consultation with the RBI, review and set the inflation target every five years. Following the 2020 review, the target was renewed for the next five-year period, with the third review scheduled for March 2026.

Under the Multiple Indicator Approach, the RBI often relied on the WPI rather than the CPI because WPI data were available more frequently and at a higher level of disaggregation (Pandey and Patnaik, 2020). The UPCR recommended redefining the target in terms of the year-on-year change in headline CPI—including food and fuel—which better reflects the cost of living for the average Indian household. This aligns India with international practice among IT central banks.

A key objective of adopting FIT was to make it visibly and transparently clear that persistent deviations from the inflation target would not be tolerated. This was intended to stabilise and anchor the expectations of all economic agents, thereby influencing their behaviour and aggregate demand (RBI, 2014). Accordingly, the FIT framework in the Act includes provisions to ensure accountability, transparency, and predictability in monetary policy operations (Pandey et al., 2024).

In most IT countries, monetary policy decisions are made by a committee. The amended RBI Act, 1934 established a six-member Monetary Policy Committee (MPC) tasked with setting the policy repo rate to achieve the inflation target. The MPC serves a four-year term and comprises three internal RBI members, including the Governor as chair, and three external members appointed by the government. The first MPC was formed in September 2016 and held its inaugural meeting in October 2016. The second MPC was appointed in October 2020, and the current committee assumed office in October 2025. Pandey and Patnaik (2020) provide a detailed discussion on the choice of CPI versus WPI, the debates around MPC formation, and the selection of the inflation band.

In each MPC meeting, the repo rate is determined by a majority vote of members present, with each member having one vote and the governor holding a casting vote in case of a tie. The Act mandates at least four MPC meetings annually, with the schedule published on the RBI website at least one week before the first meeting of the year. This ensures greater predictability and transparency in monetary policy decisions.

9.3 The IT experience

9.3.1 Monetary policy conduct and outcomes

There is by now a sizeable body of work evaluating India's FIT framework. Pandey et al. (2024) provide a detailed account of MPC meetings from 2016 to 2024, including policy rate decisions and members' voting patterns. The authors note a fair degree of dissent among MPC members, reflecting the Committee's purpose of incorporating diverse perspectives into monetary policy deliberations.

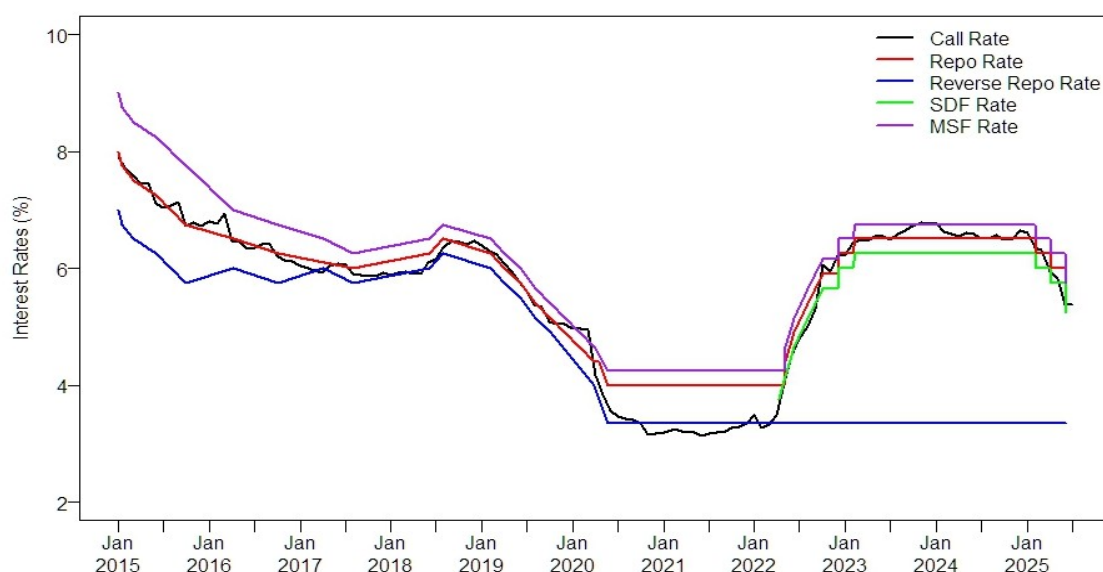
Between 2016 and 2019, CPI inflation largely remained within the target range (Figure 9.7), with volatility lower than in the preceding five years (Eichengreen and Gupta, 2024). After 2019, inflation frequently exceeded the 6 percent upper threshold, driven mainly by high food prices and elevated commodity, particularly crude oil, prices. During the Covid-19 pandemic, inflation stayed in the 6–7 percent range due to supply chain disruptions. The most severe inflation episode of the FIT period began in 2022, following Russia's invasion of Ukraine, which exacerbated pandemic-related supply constraints and pushed global commodity prices higher. As a major importer, India faced several quarters of persistently high inflation, further compounded by poor monsoons that sharply increased food prices.

Average year-on-year CPI inflation rose from 5 percent in 2021 to almost 7 percent in 2022 (Figure 9.7). During this period, the RBI failed to achieve the inflation target set under the amended RBI Act of 2016, as CPI inflation exceeded the 6 percent upper threshold for three consecutive quarters (January–September 2022). In accordance with the Act, an additional MPC meeting was held on November 3, 2022, to draft a report for the government explaining the reasons for missing the target, outlining remedial measures, and providing an estimate of when inflation would return to the target range.

However, it is worth noting that this high-inflation episode was not as severe as the post-GFC period, most likely due to the RBI's proactive monetary tightening this time around and its commitment to bringing inflation back to 4 percent in line with the legal mandate.

Figure 9.8 shows the evolution of the LAF corridor during the FIT period. When CPI inflation fell below 4 percent, the MPC implemented expansionary measures, such as in 2016–17, 2019, and again in 2025. Conversely, to curb high and rising inflation, the MPC raised the policy repo rate consecutively from May 2022 to February 2023, cumulatively by 250 bps. CPI inflation declined to 5.7 percent in 2023 and further to 3.5 percent in the first four months of 2025.

Figure 9.8: Liquidity Adjustment Facility (LAF) corridor, 2015-Present



Note: This graph shows the Liquidity Adjustment Facility or LAF corridor for the FIT period, with the Marginal Standing Facility (MSF) rate as the ceiling, the reverse repo rate as the floor till 2021 and then the Standing Deposit Facility (SDF) rate as the floor. The policy repo rate lies in the middle of the corridor and the call rate moves between the repo and the reverse repo rates, for most of the time period.

Regarding inflation expectations, Kishor and Pratap (2023) analyse professional forecaster predictions and construct a newspaper-based inflation sentiment index from 2010 to 2022. They find that long-term inflation expectations became less sensitive to inflation sentiment after 2016, suggesting that FIT helped anchor expectations. Similarly, Pattanaik, Nadhanael, and Muduli (2023) show that household inflation expectations post-FIT react less to new information and align more closely with the RBI's target.

Eichengreen and Gupta (2024) find that during the FIT period, the RBI has been considering both output and inflation when setting policy rates, with expectations better anchored. Garga et al. (2024) show that FIT enhanced the RBI's credibility, as reflected in market participants' macroeconomic forecasts. Lakdawala and Sengupta (2024) examine the impact of unexpected monetary policy actions on financial markets, finding that the magnitude of policy surprises declined under FIT, indicating that RBI policy became more predictable.

The adoption of the IT framework also transformed the RBI's monetary policy communication. Beyond policy rates, central banks use official statements, speeches, and press conferences to shape market expectations—a role that became increasingly important in the post-GFC period when policy rates in advanced economies were near zero. The RBI's communication has evolved considerably over the decades.

Mathur and Sengupta (2019) analyse RBI policy statements from 1998 to 2018 and find that pre-FIT statements were longer, more complex, and less readable. While RBI communication

remains linguistically dense compared to advanced economies, statement length has declined and readability has improved under FIT. They also note a semantic shift, with greater emphasis on terms like ‘inflation’, ‘fuel’, and ‘food’, replacing language typical of the pre-IT period.

Raghuram Rajan, RBI Governor from 2013 to 2016, oversaw the critical transition to FIT and regarded monetary communication as vital for stabilisation, reform, and public education. He used speeches to explain policy, build market confidence, and establish early credibility for reforms. As the chief technocrat managing macroeconomic risk, he viewed communication as an integral part of his role (Rajan, 2017). On taking office, he emphasised transparency and predictability, aiming to serve as a ‘beacon of stability’ and to pre-empt media narratives through timely press releases.

Post-GFC, the RBI introduced forward guidance to signal how it would respond to evolving macroeconomic conditions, helping shape market expectations in line with practices adopted by advanced economy central banks from 2009 onwards. This tool gained particular prominence during Rajan’s tenure. Lakdawala and Sengupta (2024) find that the impact of RBI’s monetary policy forward guidance on financial markets was strongest during this period. A key objective of the FIT framework is to enhance the predictability and clarity of monetary policy, especially regarding the nominal anchor, which the RBI must communicate unambiguously in order to signal a clear regime shift (RBI, 2014). Accordingly, the amended RBI Act requires that resolutions adopted by the MPC must be published on the RBI website after each monetary policy meeting. The RBI must also publish the minutes of the MPC meetings two weeks after every meeting, as well as a detailed monetary report twice a year, outlining the sources of inflation and the forecasts for inflation.

The implementation of these provisions reflects a marked change in the de jure conduct of monetary policy under FIT compared to earlier frameworks. In the pre-FIT period, although monetary policy statements were published on the RBI’s website as Governor’s Statements, their frequency and timing were irregular and varied across regimes. Moreover, multiple types of publications—such as policy statements, quarterly reviews, and monetary reports—coexisted, unlike the more streamlined and uniform communication observed under FIT.

9.3.1.1. The Covid-19 period

One of the biggest challenges during the FIT period was the Covid-19 pandemic. Following the nationwide lockdown announced on March 24, 2020, India faced two pandemic waves over the next eighteen months, alongside persistent domestic and global supply chain disruptions. Consequently, while economic growth plummeted due to a severe demand shock, CPI inflation rose due to supply constraints. Between March and November 2020, average CPI inflation was 6.8 percent, well above the RBI’s 4 percent target.

During this period, the RBI adopted expansionary monetary policy to support economic recovery even though inflation was relatively high. It is also worth noting that according to the FIT mandate, the monetary policy rate to be decided by the MPC is the repo rate. During Covid,

the RBI lowered the repo rate by 1.15 percent from 5.15 to 4 percent between March and May 2020. During the same period, the RBI lowered the reverse repo rate by 1.55 percent to 3.35 percent. The larger cut in the reverse repo rate was done to inject substantial liquidity into the banking sector by reducing banks' incentives to park excess funds with the RBI, and to push the call money rate to the bottom of the LAF corridor. However, this also created an asymmetric LAF corridor for the first time since FIT was adopted wherein the repo rate was closer to the ceiling than to the floor of the corridor (Figure 9.8).

Some external MPC members expressed concern over the RBI Governor's unilateral adjustment of the reverse repo rate. In the minutes of the 22 May 2020 meeting, one external member noted that this action effectively made the reverse repo rate the policy rate (Reserve Bank of India, 2020). This concern was valid, as under the amended RBI Act, the MPC is empowered only to set the repo rate, with the reverse repo previously linked automatically to it. The monetary easing stance was eventually reversed in April 2022, once inflation became persistently high and growth began to recover.

During the Covid period, the RBI also implemented a series of unconventional monetary policy (UMP) measures to boost system liquidity. These included Targeted Long-term Repo Operations (TLTRO) wherein the RBI provided long-term money (up to three years) at the policy repo rate to the commercial banks, with the idea that the banks would in turn lend this money to certain targeted sectors of the economy; Operation Twist wherein the RBI would simultaneously sell short-term G-Secs and buy long-term G-Secs to twist the yield curve and lower long-term interest rates; and the Government Securities Acquisition Programme (GSAP) wherein the RBI committed to buying G-Secs in advance to provide liquidity to the bond market. As these measures fell outside the MPC's remit, they were announced separately by the Governor and not included in MPC statements. . Lakdawala et al. (2023) find that the RBI's early UMP actions provided an expansionary impulse to the government bond market, lowering bond yields and the overall cost of borrowing. However, UMP measures introduced later in the pandemic were comparatively less effective.

9.3.2 Conflicts and Challenges

A key challenge for effective FIT in India is fiscal dominance. Although automatic monetisation of fiscal deficit and direct RBI participation in primary G-Sec auctions have long ended, fiscal considerations continue to influence monetary policy. RBI's OMOs in the secondary market, while intended for liquidity management, are sometimes used to manage government borrowing costs, creating a 'backdoor' deficit monetisation that can compromise the credibility of liquidity operations. The SLR, which mandates banks to hold a portion of liabilities in G-Secs, remains around 18 percent implying continued financial repression and a captive market for G-Secs. Moreover, expansionary fiscal policy can fuel inflation, forcing the RBI to tighten policy and undermining its monetary autonomy.

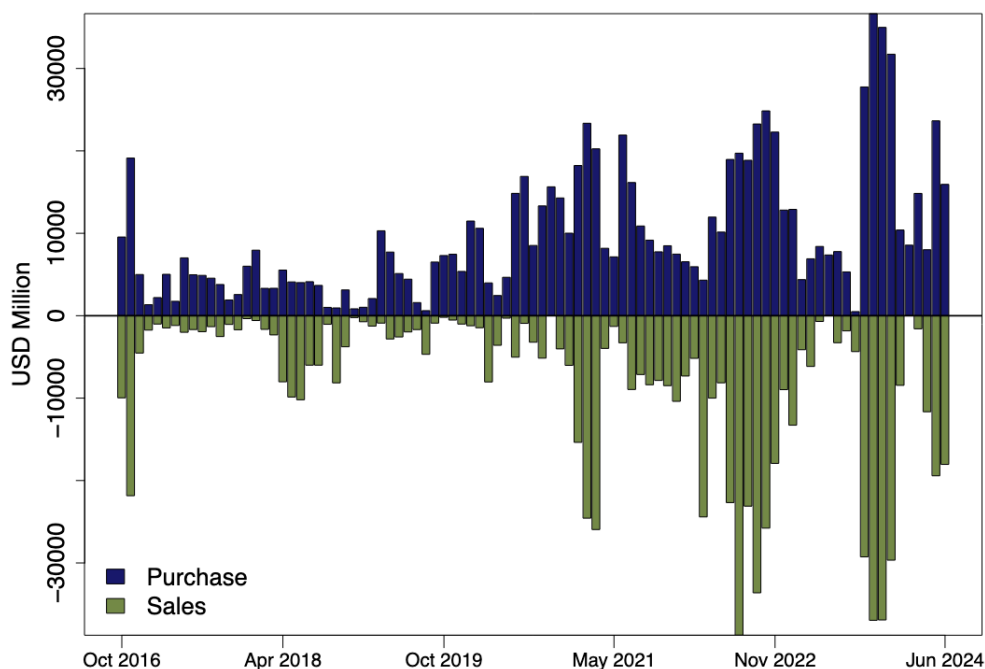
Relatedly, the role of the RBI in government debt management has been debated for years. In India the RBI has always been the public debt manager for the government. It owns and

controls the G-Sec market infrastructure and also regulates the market. However, now that RBI has been given the legal mandate of achieving an inflation target, there is a direct conflict of interest between the RBI's objective as a central bank (to deliver a target rate of inflation) and the RBI's objective as a debt manager (to deliver a low cost of borrowing for the government). Any action taken by the central bank to lower the government's borrowing costs through interventions such as the open market purchase of G-Secs may run counter to a tight monetary policy stance and confuse the market participants. In other words, as long as the RBI remains in charge of public debt management, the efficacy of FIT in India will remain questionable.

The second major constraint on FIT in India is the RBI's active and frequent FX market interventions aimed at stabilising currency fluctuations. While the RBI asserts that it does not target a specific exchange rate but smooths volatility to support macroeconomic stability, the Impossible Trilemma shows that in an open capital account economy, monetary policy independence and exchange rate management cannot coexist. As noted in Section 2.3, this tension emerged in the mid-2000s and remains a challenge nearly a decade after the adoption of FIT.

From late 2022 onwards, the RBI actively managed the exchange rate (Figure 9.9). Despite volatile capital flows, the INR-USD rate showed much lower volatility, with average annualised volatility of just 1.9 percent between April 2023 and July 2024—well below the long-term average of 5 percent from 2000 to 2020 (Figure 9.10). This marked the lowest exchange rate volatility in three decades, even compared to the late 1990s and early 2000s when the rupee was closely pegged to the dollar (Figure 9.3).

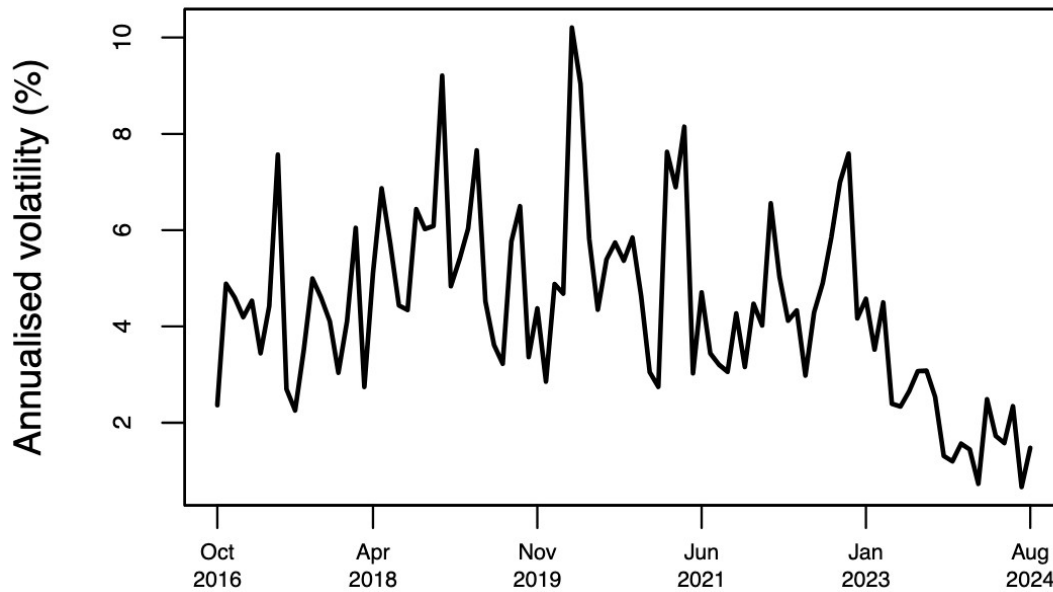
Figure 9.9: RBI's interventions in the currency spot market, 2016-2024



Note: This graph shows the purchase and sale of dollars by the RBI in the currency spot market. Since late 2022, the scale of intervention increased significantly. Source: RBI and authors' calculations.

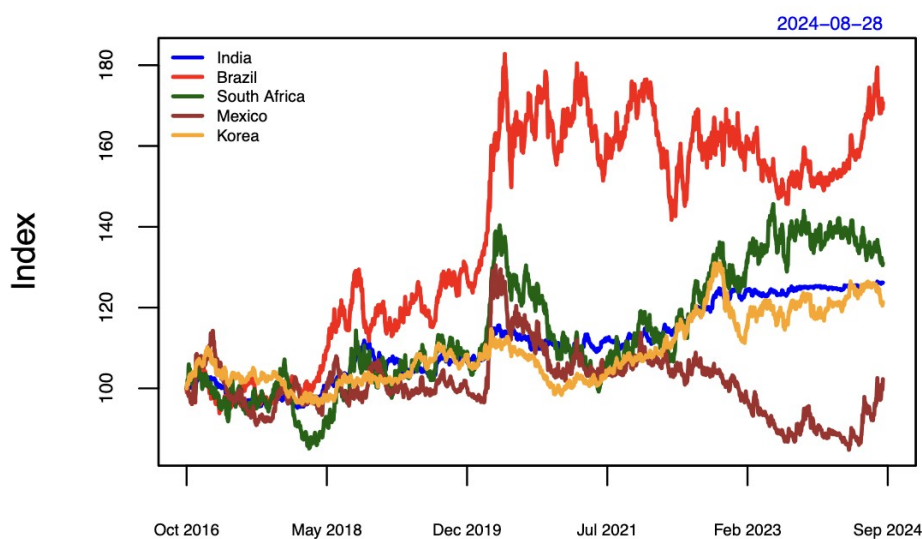
Even relative to its emerging market peers, the rupee showed the lowest volatility during this period. Figure 9.11 indexes EM currencies to 100 in October 2016, marking the start of the FIT framework. While most EM currencies depreciated against a stronger dollar in 2022, the rupee remained stable (Pandey et al., 2024).

Figure 9.10: Annualised volatility of the Rupee-Dollar exchange rate, 2016-2024



Note: This graph shows the annualised volatility of the INR-USD nominal exchange rate. The figure shows that the volatility reduced considerably since late 2022, indicating greater control over the rupee. Source: BIS database and authors' calculations.

Figure 9.11: Emerging market currencies: Indexed to 100 as on October 2016



Note: This figure shows the nominal exchange rate of EM currencies, indexed to 100 as on October 2016. The rupee was the most stable currency, suggesting active exchange rate intervention by the RBI.

9.4 The RBI's monetary policy autonomy

The autonomy of the RBI has been a contentious issue for several decades. In the pre-reform period, the central bank had little independence, as monetary policy was largely subordinated to fiscal dominance. During Governor Rangarajan's tenure at the RBI (1992-1997), several key reforms were introduced—phasing out ad hoc treasury bills, ending the automatic monetisation of the deficit, and reducing the CRR and SLR, thereby freeing up banking resources for lending. These measures provided the RBI with much-needed autonomy and limited the government's ability to finance its deficit through the central bank.

During Governor Subbarao's tenure (2008–2013), just prior to the implementation of IT, the relationship between the RBI and the government was often strained. In the immediate aftermath of the GFC, tensions arose as the Finance Minister sought more aggressive interest rate cuts and liquidity injections than the RBI deemed appropriate. Later, when the RBI tightened monetary policy to combat high inflation, the Finance Ministry viewed these actions as overly hawkish and potentially harmful to growth, arguing that the RBI's price stability objective should be interpreted within the broader mandate of promoting economic growth.

For IT to be successful, central bank autonomy, accountability, and credibility are crucial. Under the RBI Act, the Central Government has the authority to appoint and remove the Governor and may issue directions to the RBI in the public interest. The Governor is institutionally accountable to the government and regularly interacts with Parliament through the Standing Committee on Finance, while also assisting the Finance Minister in responding to parliamentary queries.

During the initial years of FIT in India, Governor Rajan (2013-2016) consistently emphasised the importance of the RBI's independent technocratic role, particularly in managing macroeconomic risks. Rajan noted that every government tests the autonomy of the RBI Governor but maintained that the central bank should always have operational freedom. Citing former Governor Subbarao, he highlighted the value of independence and the Governor's capacity to say No. He supported the creation of an independent MPC to insulate monetary policy from political pressures and underscored the public's right to hold the RBI accountable under the FIT framework. Additionally, he cautioned against any dilution of RBI powers without a sound rationale.

The MPFA, which laid the groundwork for India's formal adoption of FIT, was finalised during Governor Rajan's tenure in coordination with the government. The subsequent establishment of the MPC in 2016 was also a joint achievement: while the RBI, through the Urjit Patel Committee, proposed its structure, the government legislated it into law. This institutionalised the RBI-government relationship by clearly delineating roles—the government sets the ultimate inflation target, while the RBI is granted operational independence to employ appropriate tools to achieve it.

The MPC structure established from 2016 onwards, under Governor Urjit Patel, provided a key safeguard against political pressure for premature interest rate cuts.¹⁰ At the same time, however, the persistence of fiscal dominance and financial repression as mentioned in Section 3.2 above continues to hamper the RBI's autonomy to a very large extent.

9.5 Conclusion

India's adoption of flexible inflation targeting (FIT) in 2015 marked a watershed in the evolution of its monetary policy. The journey from fiscal dominance and multiple objectives toward a rule-based framework was neither linear nor inevitable. It was shaped by successive reforms—ranging from the phasing out of automatic deficit monetisation and the introduction of the Liquidity Adjustment Facility, to the gradual recognition that low and stable inflation is a prerequisite for sustainable growth. The experience of persistent high inflation in the post-Global Financial Crisis period was pivotal in forging consensus among policymakers that a credible nominal anchor was essential.

The statutory amendment of the RBI Act in 2016 enshrined price stability as the primary objective of monetary policy, institutionalised the Monetary Policy Committee (MPC), and aligned India's framework with global best practices. Since then, inflation outcomes, inflation volatility, and the behaviour of expectations have shown signs of improvement, particularly till the Covid-19 pandemic. Empirical studies suggest that professional forecasts, household expectations, and financial markets increasingly treat the inflation target as a credible anchor. Moreover, monetary policy conduct has become more transparent and predictable, aided by regular MPC meetings, published minutes, and improved communication strategies.

At the same time, India's experience demonstrates the constraints of inflation targeting in an emerging economy setting. Episodes such as the Covid-19 pandemic and the Russia–Ukraine war, which led to severe supply chain bottlenecks, and general vulnerability to supply-side shocks from food and fuel highlight the limitations of monetary policy in addressing structural and external drivers of inflation. Moreover, fiscal dominance, high levels of public debt, the RBI's continued reliance on foreign exchange intervention as well as the RBI's role as the government debt manager remain persistent challenges. These factors potentially dilute the monetary policy autonomy of the central bank. The debates around the use of the reverse repo rate as the de facto policy rate during the pandemic and the persistent use of unconventional monetary policy even in the face of rising inflation underscore the tensions between short-term exigencies and the discipline of the IT framework.

¹⁰ As Rajan (2017) noted, when industrialists or politicians demanded lower rates despite high inflation, the RBI could point to the government-mandated inflation target as its primary duty—an important safeguard for central bank independence. Soon after the MPC's first meeting in October 2016, the government's demonetisation exercise withdrew over 85 percent of currency in circulation. This was essentially a government decision rather than a central bank monetary policy issue. Despite this massive monetary shock and the market expectations of a rate cut to help provide some relief to the economy, the MPC chose to hold the policy rate steady in its meeting in December 2016, citing persistent inflationary pressures. This is yet another example of central bank independence exerted right after the formation of the MPC.

Overall, nearly a decade into its adoption, FIT has strengthened India's monetary policy credibility and contributed to a more stable macroeconomic environment. However, going forward, its effectiveness will depend on complementary reforms: fiscal consolidation, subjecting government borrowing to greater discipline of the bond market, setting up of an independent public debt management agency, development of deeper financial markets, and greater tolerance for exchange rate flexibility. Inflation targeting in India remains a work in progress—neither a panacea nor a straitjacket—but a significant institutional advance that reflects the broader trajectory of India's economic reforms.

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