RBI Cautions Against Raising India's 4% Inflation Target

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RBI Inflation Target Latest News

- The RBI, in its new discussion paper on the monetary policy framework, cautioned that raising India's 4% inflation target now would undermine the credibility of the framework and risk reversing the macroeconomic stability gains achieved over the past decade.

RBI's Discussion Paper on Monetary Policy

- The Reserve Bank of India (RBI) has released its long-awaited discussion paper on the country's monetary policy framework.
- It warns that **raising the current 4% inflation target could undermine the credibility of the framework** and undo the policy and institutional gains achieved over the last decade.

Key Questions for Feedback

- The central bank has invited public feedback on four crucial issues:
    - Whether monetary policy should target headline or core inflation.

    - If the 4% inflation target remains optimal for balancing growth and stability.
    - Whether the 2–6% tolerance band needs revision or removal.
    - Whether the explicit 4% target should be dropped in favour of only a range.

Risks of Raising or Lowering the Target

- The paper highlights that raising the target in today's environment of global geopolitical and economic uncertainty could be interpreted as a **dilution of the inflation targeting framework**, weakening investor confidence.
- Conversely, lowering the target below 4% would not suit India's current economic conditions.
- Recently, **S&P Global Ratings** upgraded India's rating to *BBB*, praising the RBI's strong record in inflation management.
- Stable inflation within the 2–6% range has been crucial for investor confidence, growth prospects, and currency stability.

Background

- India adopted the **flexible inflation targeting framework** in 2016, with a medium-term CPI target of 4% and a tolerance band of 2–6%.
- The present target is valid till **March 2026**, after which it must be reset for the next five years.

Headline vs. Core Inflation in Monetary Policy

- The **Economic Survey 2023-24** suggested that India's inflation targeting framework should consider focusing on **core inflation** (excluding food and fuel).
    - **Core inflation** – A measure of inflation that excludes highly volatile components, typically food and energy prices.
    - **Headline inflation** – The total inflation rate in an economy, encompassing the prices of all goods and services within the representative basket.
- This was due to the fact that the food prices in India often rise due to **supply shocks** rather than demand pressures—making them less responsive to monetary policy tools.
- The RBI, under former Governor Shaktikanta Das, rejected this idea, stressing that **food prices cannot be ignored**.
- In its latest discussion paper, the RBI reiterated that nearly all inflation-targeting countries, regardless of their development stage, target **headline CPI inflation**.
    - Uganda is the only exception, focusing on core inflation.

Spillover Effects of Food Prices

- The RBI highlighted that **persistent food inflation** eventually spills over into **core inflation** through higher wages, rents, and business markups.
- Empirical evidence from India shows that while core prices remain stable, non-core (food and fuel) prices tend to converge with them over the long run.

- Hence, ignoring food inflation could weaken monetary policy effectiveness.

Recent Trends

- In July 2024, **headline CPI inflation fell to 1.55%**, an eight-year low, while **core inflation** stood at 4.1%.
- Historically, headline inflation has fluctuated widely between **1.5% and 8.6%** since 2014 due to food price swings, whereas **core inflation has been more stable**.
- The RBI concluded that monetary policy must ensure both **credibility and certainty**, especially during global uncertainty.
- Therefore, it emphasised the importance of continuing with **headline CPI as the target**, since it better reflects the inflation experienced by households and investors.

Source: IE | BS
