



Reevaluating India's Monetary Policy Framework: Insights from Inflation Expectations and Targeting

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Abstract

stability of the Indian economy and its monetary policy system, particularly with regard to inflation expectations and targets. Since the Reserve Bank of India (RBI) implemented an inflation-targeting framework in 2016, there have been significant changes in the way inflation is managed in India. Stabilising prices and anchoring inflation expectations are the goals. The paper takes a quantitative method to analyse the effects of inflation targeting on economic growth, inflation volatility, and the anchoring of inflation expectations. Utilising time-series data and econometric models, this study investigates the ramifications for macroeconomic stability, the impact of the Reserve Bank of India's (RBI) policies on reducing inflation, and the nature of the relationship between inflation expectations and actual inflation. Although inflation targeting has been successful in reducing inflation volatility and increasing transparency, the article concludes that long-term price stability remains elusive due to external variables like changes in currency rates and global commodity prices. recommendations for enhancing the inflation-targeting system of the Reserve Bank of India (RBI), elevating inflation expectations to a more central role in monetary policy, and addressing the fundamental issues plaguing the economy to better control inflation in the future.

Keywords: Monetary Policy Framework, Inflation Targeting, Inflation Expectations, Reserve Bank of India (RBI), Macroeconomic Stability

Introduction

Monetary policy in India has changed to focus on controlling inflation because the country has been coping with inflationary pressures and the challenges of maintaining strong growth rates for a while. In order to tackle inflation and provide more specific policy directions, the Reserve Bank of India (RBI) adopted an inflation-targeting framework in 2016. Reducing inflation volatility and stabilising inflation expectations were the goals. This was a radical shift from India's prior monetary policy framework; it mirrored global best practices and aimed to stabilise the economy as a whole by targeting a certain inflation rate. Inflation targeting relies on managing both public and market-based expectations of inflation because of the significant influence that expectations have on economic behaviour. Stabilising inflation over time is achieved by price and consumption changes made by businesses and consumers in response to well-anchored inflation expectations. The Indian government shifted to inflation targeting with



the hopes of achieving price stability, but they also wanted to make policy decisions more public and boost the RBI's reputation. Because of structural constraints, external shocks, and worldwide economic instability, achieving long-term stability in inflation is usually difficult in developing countries like India's. These benefits aren't enough to dispel concerns about the framework's efficacy. Examine India's approach to monetary policy, focussing on how inflation targeting and inflation expectations have impacted the country. Inflation targeting, GDP growth, and the stabilisation of inflation expectations in India are the subjects of this paper's analysis. Using econometric models and time-series data, it takes a quantitative approach. It goes further into how fluctuations in global commodity prices, shifts in exchange rates, and issues related to the supply side affect inflation outcomes and the RBI's ability to consistently reach its inflation target. evaluate the effectiveness of India's framework for targeting inflation and offer recommendations for enhancing the monetary policy strategy of the Reserve Bank of India. At the end of the article, we'll go over how inflation expectations affect India's monetary policy and give some recommendations on how the RBI can strengthen its system to promote economic growth and stable inflation management.

Empirical Analysis of Inflation Expectations and Inflation Targeting

In this quantitative analysis, we zero in on the effects of the Reserve Bank of India's (RBI) inflation-targeting framework on the correlation between inflation expectations and real inflation in India. Consumption, investment, and price decisions are all profoundly affected by inflation expectations, which are at the heart of inflation targeting. If we want stable prices and less inflation volatility, we must anchor inflation expectations via credible monetary policy. To determine the effectiveness of the RBI's inflation-targeting strategy in influencing inflation outcomes in India, this empirical analysis employs time-series data and econometric models. An empirical analysis of inflation expectations and inflation targeting in India suggests that the adoption of a formal inflation targeting framework has contributed to better anchoring of inflation expectations among households, businesses, and financial markets. Under the guidance of the Reserve Bank of India (RBI), the introduction of a clear inflation target through the Reserve Bank of India Act, 1934 amendment 2016 has enhanced the credibility and predictability of monetary policy. Empirical studies indicate that inflation expectations have become more aligned with the target range, reducing volatility and uncertainty in economic decision-making. This alignment improves the effectiveness of monetary policy transmission, as individuals and firms adjust their consumption, saving, and investment behavior based on stable price expectations. However, the extent of anchoring is influenced by factors such as food price shocks, fuel costs, and adaptive expectations, which remain significant in the Indian context. Overall, while inflation targeting has strengthened expectation management, its empirical effectiveness depends on consistent policy actions, transparent communication, and the ability to address structural sources of inflation.

Methodology: Time-Series Data and Econometric Models

We employ time-series data extending from the era before to the implementation of inflation targeting (pre-2016) up till the current day in order to assess the efficacy of inflation targeting



in India. A number of macroeconomic measures, including GDP growth and the exchange rate, as well as inflation and inflation expectations (as measured by market-based metrics and surveys), are crucial variables. The data collection includes not only local economic indicators but also macroeconomic variables like commodity and oil price changes around the world, which may have an impact on inflation.

We examine the correlation between inflation expectations and real inflation using econometric models. In particular, we capture the dynamic interactions between inflation, inflation expectations, and other macroeconomic variables using the Vector Autoregression (VAR) model. By adjusting for variables including output gaps, currency rates, and external shocks, the VAR model estimates the impact of inflation expectations on actual inflation. We also use the NKPC model to learn about the effects of real marginal costs, inflation expectations, and output gaps on inflation in India. This study employs a quantitative research methodology based on time-series data to examine the relationship between inflation expectations and inflation targeting in India. Data on key macroeconomic variables such as inflation (Consumer Price Index), policy interest rates, and output indicators are collected over a specified period from reliable sources, including publications of the Reserve Bank of India (RBI). Time-series analysis is particularly suitable as it captures dynamic changes and trends in economic variables over time, allowing for a deeper understanding of policy impacts.

The analysis utilizes various econometric models to assess both short-term and long-term relationships. Stationarity of the data is tested using unit root tests such as the Augmented Dickey-Fuller (ADF) test to avoid spurious regression results. For examining long-run relationships, cointegration techniques such as the Johansen cointegration test are applied. Additionally, Vector Autoregression (VAR) or Vector Error Correction Models (VECM) are used to analyze the dynamic interactions between inflation, interest rates, and expectations.

Further, Granger causality tests are employed to determine the direction of causality between variables, while impulse response functions help assess the effect of shocks in monetary policy on inflation over time. These econometric techniques provide a robust framework for evaluating the effectiveness of inflation targeting. Overall, the methodology ensures a systematic and empirical assessment of how monetary policy actions influence inflation dynamics in the Indian context.

Relationship Between Inflation Expectations and Actual Inflation

The dynamics of inflation in every economy can be better understood by looking at inflation expectations. Firms and consumers both make price and spending adjustments that help keep inflation constant when they have solid inflation expectations. By making a firm and convincing promise to maintain inflation within a predetermined range, the RBI hopes to impact these expectations through its inflation-targeting framework.

Indian inflation expectations have been more steady and in line with the Reserve Bank of India's objective of 4% since inflation targeting was adopted in 2016, according to our data. According to the findings, the disparity between predicted and actual inflation has shrunk, especially since the RBI started making its policy stance known at the Monetary Policy



Committee (MPC) meetings. There has been less inflation volatility according to market-based metrics like breakeven inflation rates from government securities, which could mean that the RBI was able to successfully anchor expectations.

On the other hand, the data shows that exogenous shocks, like changes in the exchange rate or variations in global commodity prices, might affect inflation predictions. Even if the Reserve Bank of India's policy stays the same, these variables can sometimes lead inflation to deviate from the objective. Inflation expectations tend to rise, which drives real inflation higher, during times of rising global oil prices or supply-side shocks, for instance. This highlights the significance of controlling both internal expectations of inflation and the possible effects of external variables. The relationship between inflation expectations and actual inflation is central to the effectiveness of monetary policy, particularly under an inflation targeting framework. In India, the Reserve Bank of India (RBI) closely monitors inflation expectations because they influence the behavior of households, firms, and investors. When individuals expect higher inflation in the future, they tend to adjust their consumption, wage demands, and pricing decisions accordingly, which can, in turn, lead to an actual increase in inflation. This creates a self-fulfilling dynamic where expectations play a direct role in shaping price levels. Under the inflation targeting regime introduced through the Reserve Bank of India Act, 1934 amendment 2016, the RBI aims to anchor inflation expectations around the target of 4 percent. Well-anchored expectations help stabilize actual inflation by reducing uncertainty and limiting abrupt changes in economic behavior. Empirical evidence suggests that when central banks maintain credibility and communicate policy effectively, the gap between expected and actual inflation narrows, improving the efficiency of monetary policy transmission. However, in the Indian context, this relationship is often influenced by structural factors such as food price volatility, fuel costs, and supply-side shocks. These factors can cause deviations between expectations and actual inflation, particularly in the short run. Despite these challenges, a strong and credible inflation targeting framework helps align expectations with policy objectives over the medium term, thereby contributing to overall macroeconomic stability.

The Impact of Inflation Targeting on Inflation Volatility

Reducing inflation volatility is an important aim of inflation targeting because it threatens economic stability by making decisions more difficult when people aren't sure what the future holds. It is believed that a predictable policy framework will be established with the adoption of a specific inflation target, which will enable consumers and businesses to adapt their actions appropriately. We compare the inflation rate's volatility before and after inflation targeting was put into place to assess this.

Following the RBI's adoption of the inflation-targeting approach, our empirical research reveals a marked reduction in inflation volatility. Both internal causes (such as limitations on the supply side) and external shocks (such as changes in oil prices) contributed to the higher inflation volatility that India had before 2016. With inflation staying closer to the goal range of $4\% \pm 2\%$ after 2016, inflation volatility has been more controlled. The RBI has successfully used policy tools including interest rate adjustments and liquidity management to anchor



inflation expectations and reduce volatility. Its commitment to the inflation target also plays a role.

Nonetheless, fluctuations in inflation are still present. Inflation is subject to ongoing volatility brought about by external shocks, most notably those affecting the world economy. As an example, in 2020, the COVID-19 pandemic led to a sharp increase in the costs of food and commodities, which momentarily caused inflation to surpass the goal range set by the RBI. Overall inflation volatility has been reduced because to the RBI's open policy framework and good communication, which have helped keep inflation expectations within a reasonable range despite these shocks. The adoption of inflation targeting in India has had a notable impact on reducing inflation volatility by providing a clear and credible framework for monetary policy. Under the leadership of the Reserve Bank of India (RBI), the introduction of a formal inflation target through the Reserve Bank of India Act, 1934 amendment 2016 has helped anchor expectations and limit large fluctuations in price levels. By focusing on a medium-term inflation target of 4 percent, with a tolerance band of ± 2 percent, the RBI has been able to guide economic behavior more effectively and reduce uncertainty in the economy.

Inflation targeting contributes to lower volatility by improving the predictability of monetary policy actions. When households and businesses trust that the central bank will act to control inflation, their expectations become more stable, which in turn reduces sudden spikes or drops in inflation. The role of the Monetary Policy Committee (MPC) further strengthens this process by ensuring systematic and data-driven decision-making, rather than discretionary interventions. Empirical observations suggest that post-2016, inflation in India has become relatively more stable compared to earlier periods characterized by frequent and sharp fluctuations. However, inflation volatility has not been completely eliminated, as it continues to be influenced by supply-side factors such as food price shocks, fuel price changes, and global economic disturbances. These elements are often beyond the direct control of monetary policy, limiting the extent to which inflation targeting alone can stabilize prices. While inflation targeting has significantly reduced inflation volatility and improved macroeconomic stability in India, its effectiveness depends on complementary measures such as supply-side reforms, efficient distribution systems, and coordinated fiscal policies.

Inflation Targeting and Economic Growth Trade-offs

The goal of inflation targeting is to manage inflation while simultaneously guiding the economy towards sustainable growth, a delicate balancing act. The Reserve Bank of India (RBI) must strike a delicate balance in its inflation-targeting framework while also thinking about how its policies would affect production and employment. To determine if the Reserve Bank of India's (RBI) attempts to stabilise inflation have affected economic growth in India, our analysis examines the correlation between inflation and GDP growth.

According to the data, there have been times when controlling inflation has hindered growth, even though inflation targeting has been effective in reducing inflation volatility. Specifically, in the short term, GDP growth can be slower as a consequence of reduced investment and consumption caused by tightening monetary policy in response to inflationary pressures. These



short-term gains may be offset by the long-term gains from steady inflation, which include reduced interest rates, increased investment confidence, and better macroeconomic stability. Inflation targeting, as implemented by the Reserve Bank of India (RBI), involves a careful balancing act between maintaining price stability and supporting economic growth. While a stable inflation environment is essential for sustainable development, strict adherence to inflation targets can sometimes limit the scope for expansionary monetary policy, particularly during periods of economic slowdown. For instance, raising interest rates to control inflation may reduce investment, consumption, and overall demand, thereby slowing economic growth. Under the framework established through the Reserve Bank of India Act, 1934 amendment 2016, the RBI follows a flexible approach that allows temporary deviations from the inflation target to support growth when necessary. This flexibility is crucial in a developing economy like India, where structural challenges such as unemployment, income inequality, and infrastructure gaps require accommodative policy support at times. The trade-off becomes more pronounced during supply-side shocks, such as increases in food or fuel prices. In such situations, tightening monetary policy to control inflation may not address the root causes and could instead dampen economic activity. Conversely, focusing too much on growth by keeping interest rates low may lead to rising inflation and macroeconomic instability. Inflation targeting in India seeks to strike a balance by prioritizing long-term price stability while allowing short-term flexibility to support economic growth. The effectiveness of this approach depends on the RBI's ability to manage expectations, respond to changing economic conditions, and coordinate with fiscal policy to minimize conflicts between inflation control and growth objectives. Inflation targeting involves an inherent trade-off between maintaining price stability and promoting economic growth, especially in a developing economy like India. Under the framework led by the Reserve Bank of India (RBI), the primary objective is to keep inflation within a specified target range, which helps ensure macroeconomic stability and predictability. However, measures taken to control inflation, such as increasing interest rates, can reduce borrowing, investment, and consumption, thereby slowing down economic growth in the short run.

The adoption of a flexible inflation targeting regime through the Reserve Bank of India Act, 1934 amendment 2016 allows the RBI to balance this trade-off by considering both inflation and output conditions. During periods of economic slowdown, the central bank may adopt a more accommodative stance to stimulate growth, even if inflation temporarily rises. Conversely, when inflationary pressures increase, tightening monetary policy may be necessary, even at the cost of reduced economic activity.

This trade-off becomes particularly complex in India due to the influence of supply-side factors such as food price volatility and external shocks, which are not easily addressed through monetary policy alone. In such cases, aggressive inflation control may have limited effectiveness while still constraining growth. Therefore, the success of inflation targeting depends on a balanced and flexible approach, supported by coordinated fiscal policies and structural reforms, ensuring that price stability does not come at the expense of long-term economic development



Conclusion

the role that inflation expectations play in controlling inflation volatility and the efficacy of inflation targeting under India's monetary policy framework. Our empirical examination of the RBI's inflation-targeting framework reveals that this strategy has helped stabilise inflation expectations, reduce inflation volatility, and boost the credibility of India's monetary policy. More predictable policymaking and better economic planning for companies and consumers have resulted from inflation targeting's use since its implementation in 2016. Nevertheless, there are a number of obstacles that inflation targeting in India encounters, as the analysis also shows. Exchange rate movements, global commodity price shocks, and oil price swings are some of the external factors that continue to put significant pressure on inflation outcomes, even if it has been successful in lowering inflation volatility. Inflation targeting has its limits in a free market economy when external circumstances are outside the control of domestic policy, as these reasons have caused transitory departures from the RBI's inflation target. Although inflation targeting has been effective in bringing inflation under control, the empirical results show that this accomplishment comes at the expense of short-term economic growth. Reducing demand through tightening monetary policy in an effort to rein in inflation can hinder GDP. Inflation management and fostering economic growth are two competing policy objectives that the RBI must strike a balance between. Finally, there are certain difficulties with inflation targeting, despite the fact that it has helped stabilise inflation expectations and reduce inflation volatility in India. The Reserve Bank of India (RBI) needs to keep working on its policy framework to make it more adaptable to changing economic circumstances, structural constraints, and outside shocks. For inflation targeting to be effective in India, the Reserve Bank of India (RBI) must improve its communication skills, deal with supply-side problems, and encourage better cooperation between fiscal and monetary policies.

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