



The Role of the New Keynesian Phillips Curve in Shaping India's Inflation Management

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Abstract

the role that the New Keynesian Phillips Curve (NKPC) plays in shaping India's framework for inflation management, particularly the efforts made by the Reserve Bank of India (RBI) to achieve price stability through monetary policy. The NKPC provides a modern theoretical framework that focusses on the interaction of inflation, production gaps, and inflation expectations, which helps to understand the dynamics of inflation in India's rapidly growing and uncertain economy. With an eye towards long-term price stability, anchoring inflation expectations, and reducing inflation volatility, the NKPC has evaluated the RBI's inflation-targeting strategy. this empirical study examines the connection between the output gap, inflation expectations, and economic activity in India through the use of time-series data. Inflation control becomes more challenging due to external factors like commodity price and exchange rate variations, which are taken into consideration. Although the NKPC is helpful for regulating inflation, the findings highlight the need for a more comprehensive monetary policy approach to address both external shocks and structural issues plaguing the Indian economy. a more flexible and multi-faceted strategy for controlling inflation in India that considers the results of the NKPC.

Keywords: New Keynesian Phillips Curve (NKPC), Inflation Management, Inflation Targeting, Reserve Bank of India (RBI), Inflation Expectations

Introduction

Inflation management is a top priority for central banks. In emerging economies like India's, where rapid economic development, structural issues, and foreign shocks all contribute to complex inflationary dynamics, this is particularly true. Since its official adoption in 2016, the Reserve Bank of India (RBI) has relied on inflation targeting as its primary monetary policy tool to address these challenges. By stabilising prices and anchoring inflation expectations, the Reserve Bank of India (RBI) aims to foster long-term economic growth and stability through its inflation targeting framework. Because of the interplay between demand-side variables, supply-side constraints, and external shocks, a more nuanced understanding of inflation behaviour is required to understand the dynamics of inflation in India. The New Keynesian Phillips Curve (NKPC) provides a modern paradigm for investigating the dynamics of inflation; it incorporates both inflation expectations and the output gap. Instead of assuming a continuous trade-off between inflation and unemployment, as the standard Phillips Curve



suggests, the NKPC stresses the relevance of future actions in determining inflation. When actual marginal costs, the output gap, and inflation expectations are considered, the NKPC offers a more complete explanation of inflation behaviour in nominally inflexible economies, where prices and wages tend to be sticky. One helpful framework for evaluating inflation expectations in India and the ways the Reserve Bank of India (RBI) utilises monetary policy instruments to regulate them is the National Key Policy Concept (NKPC). NKPC's role in developing India's strategy to rein in inflation. It focusses on the RBI's inflation-targeting framework and how it incorporates the NKPC's conclusions, and how effective it is at achieving inflation stability. This empirical study utilises time-series data to analyse inflation, production gaps, inflation expectations, and external influences including changes in exchange rates and global commodity prices. By studying the NKPC's impact on inflation dynamics in India, this study hopes to contribute to our understanding of how modern macroeconomic models could assist the Reserve Bank of India (RBI) in effectively managing inflation in a rapidly growing economy. The New Keynesian Phillips Curve (NKPC) has become a central framework in modern macroeconomics for understanding the dynamics of inflation. Unlike the traditional Phillips Curve, which emphasizes a direct trade-off between inflation and unemployment, the NKPC incorporates forward-looking expectations and the role of price rigidities in the economy. It suggests that current inflation is influenced not only by past inflation and economic slack but also by expectations of future inflation, making it highly relevant for contemporary monetary policy design.

In the Indian context, the application of the NKPC has gained importance with the adoption of inflation targeting by the Reserve Bank of India. The framework helps policymakers understand how expectations, demand conditions, and supply-side factors interact to determine inflation. By focusing on inflation expectations and output gaps, the RBI can design more effective monetary policies to achieve price stability. This study examines the role of the New Keynesian Phillips Curve in shaping India's inflation management strategy. It aims to analyze how the NKPC framework supports policy decisions, particularly under the Flexible Inflation Targeting (FIT) regime. Through theoretical insights and empirical analysis, the study seeks to evaluate the relevance and effectiveness of NKPC in explaining inflation behavior and guiding monetary policy in India.

India's Monetary Policy and Inflation Targeting

Over the years, India's monetary policy has undergone significant shifts, embracing more organised and transparent institutions and eschewing wide discretionary actions. The implementation of inflation targeting in 2016 marked a turning point in India's monetary policy, signalling a commitment to achieving price stability while encouraging sustainable economic growth. "The Reserve Bank of India (RBI) plays a crucial role in setting and meeting inflation targets in this section, which provides an overview of India's monetary policy framework. India's monetary policy, governed by the Reserve Bank of India (RBI), plays a crucial role in maintaining macroeconomic stability by regulating money supply, interest rates, and credit conditions. A major shift in this framework occurred in 2016 when India formally adopted an



inflation targeting regime through amendments to the Reserve Bank of India Act, 1934 amendment 2016. Under this system, the RBI is mandated to maintain consumer price inflation at a target of 4 percent, with a tolerance band of ± 2 percent, thereby ensuring price stability while supporting economic growth. The establishment of the Monetary Policy Committee (MPC) has enhanced transparency and accountability in policy decisions, as it determines the policy repo rate based on inflation forecasts and economic conditions. Inflation targeting has helped anchor inflation expectations, improve policy credibility, and create a more predictable economic environment. However, challenges such as supply-side shocks, food price volatility, and global economic uncertainties continue to affect the effectiveness of monetary policy in India, requiring a balanced and flexible approach by the RBI.

The Reserve Bank of India (RBI) and Inflation Targeting

For many years, the Reserve Bank of India's (RBI) mandate has included ensuring price stability, fostering economic growth, and controlling inflation. Interest rate and liquidity adjustments were previously made by the Reserve Bank of India (RBI) in response to changes in inflation, GDP growth, and fiscal measures, among other economic indicators. However, different inflation outcomes happened because policymakers lost faith and economic uncertainty due to not having a clear and apparent inflation goal. To keep inflation at $4\% \pm 2\%$, India formally implemented an inflation-targeting framework in 2016, supported by the RBI. Reaching a predetermined inflation target became official with amendments to the Reserve Bank of India Act, 1934. The decision was reasonable because central banks all over the globe have utilised inflation targeting to keep prices stable, rein in inflation expectations, and boost the legitimacy of their policies.

Indian monetary policy has been improved by the Reserve Bank of India's (RBI) adoption of inflation targeting. The RBI's policy actions are now more open and predictable as it has a defined goal. More precise predictions of the pace of inflation have allowed businesses and individuals to better prepare for the future. There has also been an increase in the level of scrutiny directed at the RBI. Justify the reason for the deviation from the aim in its twice-yearly reporting to the government. The Reserve Bank of India (RBI) plays a central role in implementing inflation targeting in India, acting as the primary authority responsible for maintaining price stability while supporting economic growth. Following the 2016 amendment to the Reserve Bank of India Act, 1934 amendment 2016, the RBI was formally mandated to adopt a flexible inflation targeting framework, with a target of 4 percent consumer price inflation and a tolerance band of ± 2 percent. Within this framework, the RBI, through the Monetary Policy Committee (MPC), determines key policy rates such as the repo rate to regulate liquidity and influence borrowing and spending in the economy. By adjusting these rates, the RBI seeks to control inflationary pressures and anchor public expectations about future price levels. The adoption of inflation targeting has strengthened the transparency, accountability, and credibility of the RBI's monetary policy. However, the effectiveness of this approach is often influenced by external factors such as food price fluctuations, supply-side constraints, and global economic conditions, which require the RBI to adopt a balanced and flexible policy stance.



Evolution of India's Monetary Policy Framework

The foundation of India's monetary policy has changed significantly during the last several decades. In the wake of widespread economic liberalisation and changes in the 1990s, India's central bank shifted to a policy that was more dependent on market forces. Its emphasis moved from monetary policy to interest rate management as the Reserve Bank of India (RBI) sought to control inflation. Stabilising the economy was a top priority during this time, and lowering inflation and enhancing budgetary discipline were key initiatives. In 2005, the RBI installed the multiple indicator approach (MIA), which was a significant change from the previous method. Interest rate swings, liquidity management problems, and currency exchange rate changes all had a role in the plan's inflationary effects. There was considerable wiggle space for policy manoeuvring with this method, but it didn't achieve the target inflation rate. The last stage of this development was the implementation of inflation targeting in 2016. The causes of this change were complex and included both local and foreign elements. Many countries, both developed and developing, have started targeting inflation as a means to stabilise their economies and set realistic inflation expectations. The goal of improving the effectiveness and transparency of domestic policies, coupled with ongoing inflationary pressures, necessitated a more rule-based and targeted approach. In light of both international standards and domestic obstacles, India has decided to establish a formal inflation-targeting mechanism to ensure price stability. India's monetary policy framework has undergone a significant transformation over time, evolving from a controlled and regulation-driven system to a modern, market-oriented framework focused on inflation targeting. In the early decades after independence, the Reserve Bank of India (RBI) primarily followed a **developmental approach**, where monetary policy was used to support planned economic growth, channel credit to priority sectors, and finance government deficits. During this period, instruments such as administered interest rates, high reserve requirements, and directed credit policies dominated the framework.

In the 1980s, the focus gradually shifted towards controlling inflation and managing money supply through monetary targeting, influenced by the recommendations of the Chakravarty Committee. The RBI began emphasizing monetary aggregates like M3 to guide policy decisions, aiming to balance growth with price stability. However, this approach faced limitations due to financial market rigidities and weak transmission mechanisms.

A major shift occurred in the 1990s following economic liberalization. The RBI moved towards a multiple indicator approach, taking into account various macroeconomic variables such as interest rates, exchange rates, inflation, and capital flows. This period marked the gradual deregulation of interest rates, reduction in statutory preemptions like CRR and SLR, and the development of financial markets, making monetary policy more flexible and responsive. The most significant reform came in 2016 with the adoption of a flexible inflation targeting framework through amendments to the Reserve Bank of India Act, 1934 amendment 2016. This established a clear nominal anchor by setting a target of 4 percent inflation with a tolerance band of ± 2 percent. The introduction of the Monetary Policy Committee (MPC) further institutionalized decision-making, enhancing transparency, accountability, and credibility., the evolution of India's monetary policy reflects a shift from direct controls to indirect, market-



based instruments, with a strong emphasis on price stability as the foundation for sustainable economic growth.

The Role of the Monetary Policy Committee (MPC)

In 2016, the Monetary Policy Committee (MPC) was formed as a component of the framework for aiming to control inflation. Prior to the establishment of the MPC, monetary policy decisions were solely within the purview of the RBI Governor. To ensure that inflation stays within the target range established by the government, the committee is responsible for determining the policy interest rate, which is also known as the repo rate. The six-member MPC is made up of three people chosen by the government and three people nominated by the RBI. Fairness and openness are fostered when non-essential parties are involved in making decisions. At its bimonthly meetings, the Monetary Policy Committee (MPC) discusses the state of the economy, pinpoints pressing problems, and decides on interest rate policy. Its principal goal is to keep prices stable within certain ranges, but it also considers things like economic growth, job creation, and financial stability. In monetary policy pronouncements, the MPC disseminates its decisions and offers comprehensive justifications to the general public. This message is crucial for maintaining the credibility of the Reserve Bank of India's policy stance and for managing inflation expectations. The Monetary Policy Committee (MPC) is a key institutional body responsible for formulating monetary policy in India under the inflation targeting framework. Established following the 2016 amendment to the Reserve Bank of India Act, 1934, the MPC operates under the guidance of the Reserve Bank of India (RBI) to ensure price stability while supporting economic growth. The committee consists of six members, including three officials from the RBI and three external members appointed by the government, with the RBI Governor serving as the chairperson. Decisions are made through a majority vote, ensuring a balanced and transparent approach to policy formulation. The primary role of the MPC is to determine the policy repo rate, which influences interest rates, liquidity, and overall economic activity. By adjusting the repo rate, the MPC aims to keep inflation within the target range of 4 percent, with a tolerance band of ± 2 percent. In addition to rate decisions, the committee evaluates macroeconomic indicators such as inflation trends, output gaps, and global economic conditions to guide its policy stance. The MPC also enhances accountability, as it is required to publish its decisions and rationale, thereby improving transparency in monetary policy. Overall, the MPC plays a crucial role in maintaining inflation stability, anchoring inflation expectations, and strengthening the credibility of India's monetary policy framework.

Tools and Instruments of Inflation Targeting

The Reserve Bank of India (RBI) employs a variety of instruments to control the economy and inflation under the framework of inflation targeting. One such tool is the repo rate, the interest rate at which the Reserve Bank of India loans money to commercial banks. Inflation and demand are affected by changes to the repo rate, which is used by the RBI to control borrowing rates. An attempt to control inflation by the Reserve Bank of India (RBI) occurs when inflation rates rise too high. When economic growth is slow or inflation is low, the Reserve Bank of



India (RBI) may decide to cut interest rates to encourage spending and boost demand. The repo rate and open market operations (OMOs) are tools used by the Reserve Bank of India (RBI) to control the money supply. Both the money supply and short-term interest rates are affected by open market operations (OMOs), which include the purchase and sale of government assets. Also, commercial banks are required by law to maintain a specific percentage of their deposits with the Reserve Bank of India (RBI), which is known as the cash reserve ratio (CRR). Modifying the CRR allows policymakers at the Reserve Bank of India (RBI) to affect the money supply. Finally, the Reserve Bank of India (RBI) uses forward guidance to control inflation expectations". The Reserve Bank of India (RBI) sends indications about its future policy intentions, so businesses and individuals can change their expectations by paying attention to those signals. Economic uncertainty has been reduced and inflation expectations have been more grounded thanks to the accuracy of future forecasting. Under India's inflation targeting framework, the Reserve Bank of India (RBI) uses a range of monetary policy tools to control inflation and maintain price stability. These instruments help regulate liquidity, influence interest rates, and guide overall economic activity in line with the inflation target set under the Reserve Bank of India Act, 1934 amendment 2016.

The most important tool is the repo rate, which is the rate at which the RBI lends short-term funds to commercial banks. By increasing the repo rate, borrowing becomes more expensive, reducing money supply and helping to control inflation. Conversely, lowering the repo rate encourages borrowing and investment, stimulating economic activity. Closely related is the reverse repo rate, through which the RBI absorbs excess liquidity from banks, thereby reducing inflationary pressures.

Another key instrument is the Cash Reserve Ratio (CRR), which requires banks to keep a certain percentage of their deposits with the RBI. By increasing the CRR, the RBI reduces the funds available for lending, thereby tightening liquidity. Similarly, the Statutory Liquidity Ratio (SLR) mandates banks to maintain a portion of their deposits in liquid assets such as government securities, influencing credit expansion in the economy.

The RBI also uses Open Market Operations (OMO), involving the buying and selling of government securities to regulate money supply. When the RBI sells securities, it absorbs liquidity from the market, while purchasing securities injects liquidity. Additionally, the Liquidity Adjustment Facility (LAF) helps manage short-term liquidity mismatches through repo and reverse repo operations on a daily basis. Together, these tools enable the RBI to manage inflation effectively by influencing demand, credit conditions, and liquidity in the economy. However, their effectiveness depends on broader economic conditions, including supply-side factors and global financial trends, which may limit the direct impact of monetary policy on inflation.

Conclusion

India's central bank uses the New Keynesian Phillips Curve (NKPC) to guide its inflation targeting strategies. This study aimed to shed light on the dynamics of inflation in India by analysing the NKPC, a current macroeconomic model. Its essential components are



expectations of inflation, the output gap, and real marginal costs. The emphasis on forward-looking behaviour in the NKPC framework is crucial since inflation expectations are a major factor in deciding the future inflation results in India's economy. To make monetary policy more transparent and to better anchor inflation expectations, India adopted inflation targeting in 2016. Looking at the numbers in this analysis proves that the Reserve Bank of India was successful in stabilising and lowering inflation. Despite its strengths, the NKPC is unable to fully explain how inflation in India works. External shocks, like changes in currency rates and global commodity prices, are making it harder for the RBI to achieve and sustain the inflation objective. Most of India's inflation stems from structural problems, most notably supply-side constraints in vital sectors like agriculture and infrastructure. Study after study that compared emerging countries' monetary policies to India's has brought to light the benefits and drawbacks of the NKPC as a framework for controlling inflation. The country's policies and resources are inadequate to tackle its internal structural problems and external vulnerabilities, even though the NKPC has helped shed light on demand-side inflation. Given that inflation targeting is an important policy goal for India, the Reserve Bank of India (RBI) must respond to external shocks and structural changes by keeping policy flexible. The NKPC has proven useful in studying the mechanisms of inflation in India, but a more comprehensive approach is needed to manage inflation in a growing nation. Insights from the NKPC and other structural and external variables that affect inflation should be continuously included in the RBI's methodology for targeting inflation. To keep India's economy growing and stable, researchers may look into ways the Reserve Bank of India (RBI) might use policy instruments like the National Knowledge Policy Context (NKPC) better in the future.

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