Inflation Targeting and Monetary Policy in India

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Abstract

There seems to be a consensus that the inflation targeting framework adopted in India in 2016 has been successful in taming inflation. A comprehensive analysis of inflation targeting should be based on the impact on inflation dynamics, expectations and implications for growth. We illustrate the strong downward time-trend in India's inflation dynamics coinciding with the inflation targeting regime. Trend inflation levels in India and other emerging market economies also suggest a downward trajectory regardless of the adoption of inflation targeting. Thefore, it is difficult to conclusively establish that adoption of inflation targeting in India led to a moderation in inflation or anchoring of inflation expectations. On expectations, there is some evidence of anchored household expectations, however, this anchoring predates the formal adoption of inflation targeting. Long-term expectations in India have remained firmly anchored since early 2000s. In terms of growth, the high real interest rates policy followed during the initial years of inflation targeting to establish credibility of IT regime adversely affected India's growth dynamics.

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I. Introduction

Traditionally, monetary policy in India has followed a 'multiple indicator approach' under which several macroeconomic indicators are combined flexibly to meet the policy's multiple objectives: exchange rate stability, price stability, financial stability and growth (Mohan and Ray, 2019). This approach gave the Reserve Bank of India (RBI)—and its Governor—considerable flexibility in deciding which objectives were in need of critical attention at particular moments and which instruments were best suited to the task. For instance, the RBI often used the cash reserve ratio, the statutory liquidity ratio, money supply growth and other policy levers, in addition to the main policy interest rate (the repo rate), to pursue growth objectives or ensure price stability as necessary, or at times manage a flexible float during events of exchange rate volatility.

Despite the broad success of this approach, the persistently high inflation years between 2006 and 2013, followed by the 'Taper Tantrum' episode (which led to a sharply depreciating Indian rupee), led to a search for an approach that would work better. The then RBI Governor, Raghuram Rajan set up an expert committee in 2013 chaired by RBI Deputy Governor Urjit Patel to 'Review and Strengthen the Monetary Policy Framework' (RBI 2014) in a "globalized and highly inter-connected" environment.[2] In January 2014, the committee recommended the adoption of inflation targeting (IT) as *the* monetary policy framework for India, which was subsequently adopted in October 2016. Since then, a Monetary Policy Committee (MPC) has collectively determined the setting of the repo rate with the objective of keeping inflation within the target range of 2–6 percent with 4 percent as the median of the target.

The consensus view among Indian policymakers seems to be that IT has been successful in bringing inflation down. A broader assessment of the IT regime would be appropriate, and it should focus on the following four key considerations:

1) **Did IT lower inflation?** By how much, if at all, did inflation decline after the adoption of IT regime? Was any decline the result of the adoption of IT or due to exogenous factors such as a coincident decline in world inflation?

2) **Did IT anchor inflation expectations?** Was IT successful in anchoring inflation expectations, one of the explicit goals of an inflation targeting regime?

3) **Has IT come at a cost?** Has the adoption of IT helped India attain its economic goals? If in the post IT-era, India experienced lower inflation and lower real policy interest rates, then IT was successful. In contrast, if real policy rates have been higher than warranted, the growth foregone needs to be weighed against the benefits from any decline in inflation.

This paper attempts to answer some of these critical questions as it embarks on a comprehensive evaluation of the performance of inflation targeting in India. Such an evaluation is

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[2] Statement by Dr. Raghuram Rajan on taking office on September 4, 2013, available at
https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29479

critical as globally central bankers are revisiting their existing monetary policy frameworks in the aftermath of prolonged experience with persistently low inflation, followed by the COVID induced surge in inflation and now followed by a worldwide decline towards pre-COVID levels.

In the context of Indian inflation, many have conveniently attributed the moderation to the adoption of inflation targeting. Based on the trajectory of inflation in India, we find that the moderation in inflation *predates* the adoption of inflation targeting. Moreover, this moderation coincided with muted food inflation (a major component) of the Consumer Price Index.

Further, we highlight the moderation in inflation dynamics across Advanced Economies & Emerging Markets across inflation targeters & non-targeters. This poses a key challenge to establish a causality between the formal adoption of inflation targeting and moderation in inflation. Bhalla, Bhasin & Loungani (2023) explored this issue in detail across a panel of advanced and emerging markets that adopted a formal inflation targeting regime. They find significant gains for early adopters and highlight the challenges in finding casual effects of IT on improved macroeconomic performance.

On household inflation expectations, Das, Bhasin and Lahiri (2022) highlight the aggregate bias in household inflation expectations and the dynamics of disagreement among households. They find evidence of household expectations *'anchored'* at a higher level than the inflation target. We look at professional forecasts in an effort to test the impact of inflation targeting on anchoring of expectations.

The evidence linking IT to enhanced growth performance is somewhat mixed as we find *that inflation even at a near zero output gap level has moderated across countries*. This suggests the need to revisit the relationship between output and inflation. Post adoption of inflation targeting, real rates in India have averaged higher which could have had an adverse impact on growth. This is consistent with evidence from some IT adopters who followed a more hawkish policy in initial years in an effort to establish credibility of the inflation target.

We recognize that the adoption of IT in India has been fairly recent, and inclusion of the pandemic period could contaminate our findings. Consequently, we restrict our analysis till the end of 2019. Notwithstanding the fairly recent adoption of IT, and subsequent challenges due to the pandemic, many have prematurely hailed it as a success. Overall, we conclude that IT performance in India has been mixed, and that there are some issues that will have to be addressed to ensure smooth functioning of the new monetary policy framework. Additionally, we provide evidence to demonstrate that the moderation in Indian inflation cannot be solely attributed to the India's adoption of IT.[3]

The brief outline of the paper is as follows. Section II provides an overview of inflation targeting followed by a discussion on the adoption of inflation targeting in India. The three sections that follow present our evidence on each of the three questions noted above.

To assess India's inflation and growth performance against that of other countries, our analysis uses several cross-country datasets. Data on policy interest rates is from the BIS, inflation

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[3] Also see Bhalla, Bhasin and Loungani (2025)

and GDP from the World Bank (Ha, Kose and Ohnsorge, 2019), the Parker (2018) dataset and other macroeconomic indicators are from the IMF's International Financial Statistics. For inflation forecasts, we use both the World Economic Outlook's Fall forecasts (as they are relatively better at tracking actual inflation than the Spring Forecasts) and Consensus Inflation Forecasts. For Indian data we rely on RBI's Handbook of Statistics on the Indian Economy, the MPC minutes published by the RBI, and RBI's inflation forecasts.

II. India's Adoption of Inflation Targeting

India's adoption of inflation targeting was in the aftermath of a sharp increase in inflation during the period mid-2000s and early 2010s, even as inflation moderated across the world. This divergence was followed by a sharp reduction in the value of the Indian rupee in 2013 during the Taper Tantrum episode. Figure 1 shows inflation in India and median EMEs inflation since 1995 with the upper (6%) and lower (2%) threshold for inflation targets for the MPC. Note the sharp divergence between India's inflation and the median EME inflation post the Global Financial Crisis. However, before the crisis, inflation in India post mid 1990s and till 2006/07 closely followed median EME inflation (except the onion inflation year of 1998). There was a sharp increase in inflation starting 2006, and the subsequent eight-year inflation (at a CAGR of 8.7 %) was higher than the eight-year experience between 1973 and 1980 (CAGR of 8.2 %). This acceleration in Indian inflation was contrary to the trend in global, and EM, inflation. (Median EM inflation was 5% in 2006 and 3% in 2013).

Figure 1: Inflation Trends in India and EMEs
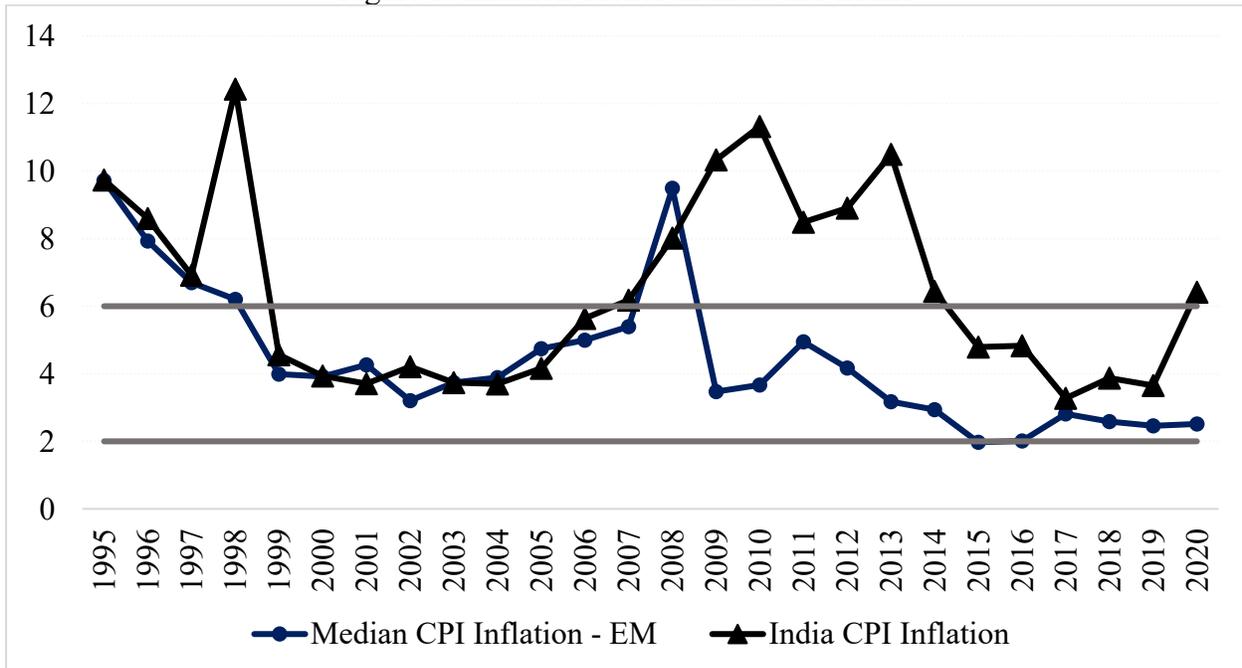
Source: Authors Computation using data from RBI and NAS, various years

The sharp increase in inflation after 2006 and growing divergence in comparison with other EMEs prompted the then RBI Governor, Raghuram Rajan to set up a committee in late 2013 to look at monetary policy frameworks (across the world) with the objective of strengthening India's framework. It was believed that this would help strengthen the credibility of RBI and enable it to expand its 'policy arsenal'. Rajan had termed monetary stability as the key function of a central bank and argued for a framework that could sustain the confidence in the value of the country's money. He then argued that this ultimately meant stable inflation and stable inflation expectations.

The expert committee was chaired by Dr Urjit Patel, and it submitted its recommendation to revise and strengthen the monetary policy framework in India on 21st January 2014. The committee advocated for adoption of a monetary policy framework with a formal inflation targeting regime. It further stressed shifting the monetary policy decision making to an MPC instead of relying on the discretion of just the RBI Governor.

The report highlights the broad understanding that inflation of 1 to 3 per cent corresponds to price stability in Advanced Economies while the same for EMEs would be in the range of 4 to 5 per cent. They then add that 6 per cent could serve as a meaningful upper bound for inflation targeting while 2 per cent could be a lower bound for the same. They further mention that under inflation targeting, expectations could be well anchored at a lower rate.

The report recommended 4 percent to be the inflation target with a range of +/- 2%. This figure was derived by using various techniques, including various filters to arrive at the potential output. They estimated the average inflation rate at near-zero level of output gap and the exercise resulted in the conclusion that inflation target in India should be at 4 per cent. Moreover, they also suggested that 'the choice of exact numerical range or target for a country is also informed by inflation in comparator EMEs and trading partners, consistent with its broader integration of the global economy'. Incidentally, *the choice of 4 per cent was not a coincidence as EMEs had an average median rate of around 4 per cent since 2000.*

There were several reports that had also argued for a monetary policy framework with a formal inflation targeting mandate. The RBI Report of the Advisory Group on Transparency in Monetary and Financial Policies (2000) was one such report which mentioned that multiple indicator approach gave great comfort to the RBI. This comfort was on account of having little accountability while trying to manage the impossible task of fulfilling contradictory objectives. Thus, the report argued that a single objective should be given to the Reserve Bank of India. The Percy Mistry Report (2007) and the Raghuram Rajan Report (2008) argued that the single objective of RBI's monetary policy must be inflation control. A New Monetary Policy Framework was subsequently adopted in 2016. A Monetary Policy Committee was set up and provided with an inflation target of 4 per cent (+/-2%) as recommended by the Urjit Patel Committee Report (2014).

III. Did Inflation Targeting Lower Indian Inflation?

Several authors have attempted to review the performance of inflation targeting in India since its introduction. Behera and Patra (2020) look at the trend inflation levels in India and find that there was a fall in the trend inflation even *before* adoption of IT in 2016. Indeed, there is moderation in inflation from 7.7 per cent in the three years preceding inflation targeting to 5 per cent in 3 years post inflation targeting. However, moderation in inflation rate started post 2013 and we find a significant downward time-trend in inflation.[4]

They state that IT *entrenched* the existing tendency. They attribute the reduction in trend inflation prior to FIT to the fact that conditions of FIT were being put in place from 2014 onwards. It is relevant to note that after averaging 3% in 2013 and 2014, EME median inflation collapsed to its lowest ever level of 1.9 % in 2015 and second lowest reading of 2% in 2016. However, there was no explicit inflation target adopted in India in 2014, nor was there a legal framework for inflation targeting which is an important part of the five key elements of inflation targeting as per Mishkin (2002).

Sophisticated econometric techniques have been adopted to suggest that the trend inflation in India has moderated, and this has been cited as evidence to suggest that inflation targeting has been successful in India.

RBI, Report on Currency and Finance, RCF (2021) mentions *"Trend inflation to which actual inflation converges after a shock provides an appropriate benchmark for the inflation target; trend inflation has fallen from above 9 per cent before FIT to a range of 3.8 – 4.3 per cent during FIT, indicating that 4 per cent is the appropriate level of the inflation target for India."*

We present a simple analysis of trend inflation in India followed by an attempt to identify a structural break in Indian inflation[5]. Creel & Hubert (2010) & Levin and Piger (2004) have used a similar technique of using structural breaks to evaluate inflation dynamics. However, we modify the use of structural breaks for analyzing the impact of inflation targeting or its contribution towards moderation in inflation.

We argue that to be able to conclude that the moderation in trend inflation could be an outcome of inflation targeting regime, one would need to find a structural break within a one-year period of introduction of inflation targeting.

Figure 2 shows the structural break in inflation for India. There is a structural break (upwards) in India's inflation series in the year 2008 post which we see a sharp increase in inflation which coincided with persistently high food prices till 2013. After that inflation started to moderate and this moderation was ***before*** the introduction of inflation targeting. Therefore, it is difficult to

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[4] This decline coincides with a drop in global oil prices, muted domestic food inflation and a shift in India's nominal anchor from Wholesale Price Index to Consumer Price Index inflation. Also see Bhalla, Choudhary and Mohan (2011).
[5] We use the Zivot Andrews test to arrive at structural breaks.

attribute the tendency of moderation in the inflation rate to inflation targeting as the decline begins well before introduction of inflation targeting (& incidentally even before 2014).

Figure 2: Structural Breaks in Indian Inflation
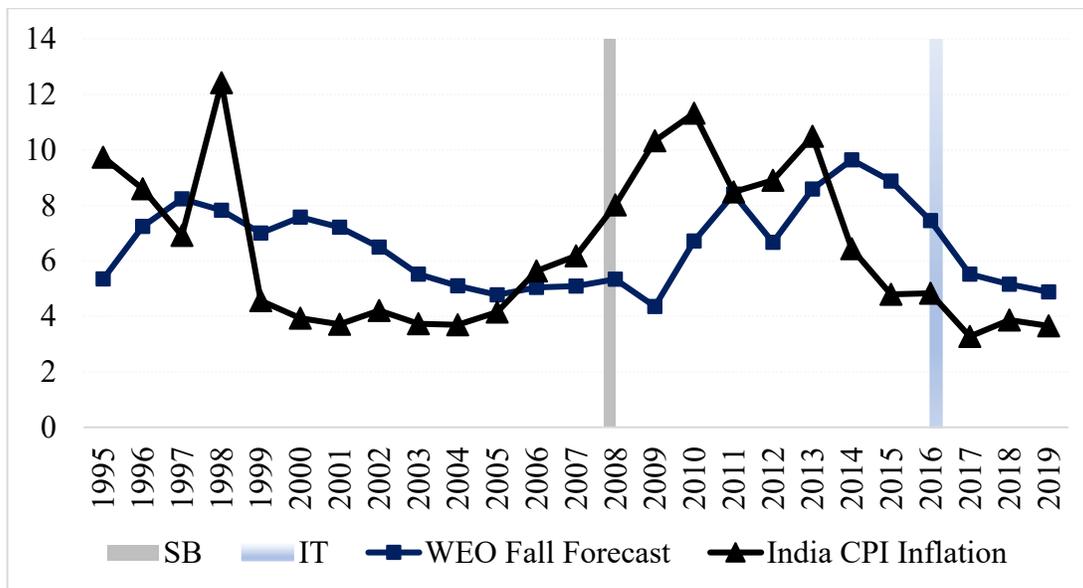
Source: Authors Computation using data from World Bank and IFS

One of the widely acknowledged evidence in support of India's Inflation Targeting regime is its success in taming inflation. It is important to evaluate whether the moderation in inflation has been a unique feature limited to India during this period – or whether other countries have experienced something similar.

RBI's RCF (2021) sheds some light on this issue as they state, *"In the international experience, inflation targeting emerging market economies (EMEs) have generally lowered their inflation targets and narrowed tolerance bands."*

Inflation has come down in inflation targeting economies, however, this is not sufficient to establish the adoption of inflation targeting led to the moderation in inflation. As shown in Bhalla, Bhasin & Loungani (2023), inflation moderation is not unique to formal inflation targeters. Furthermore, using the synthetic control method, they report positive effects of inflation targeting in about half the countries. In Table 1, we compute the mean and median inflation rate for advanced and emerging market economies over the last three decades. We find inflation has moderated for both inflation targeting and non-targeting economies. Therefore, there is a reasonable possibility of an exogenous factor that could have led to the moderation in inflation across the world.

Table 1: Average Inflation in IT and Non-IT Country Groups

	Number of Countries		Mean Inflation		Median Inflation	
	IT	Non-IT	IT	Non-IT	IT	Non-IT
Advanced Economies						
1990-99	5	22	2.0	3.1	2.3	2.7
2000-09	7	19	2.8	2.1	2.2	2.2
2010-19	9	17	1.8	1.2	1.4	1.5
Emerging Markets & LDCs						
1990-99	6	123	7.2	5.4	5.1	8.4
2000-09	19	147	4.7	5.0	5.0	4.7
2010-19	22	139	4.0	3.5	3.1	3.1

Source: Authors Computation using data from World Bank

Additionally, RBI's RCF (2021) states that inflation volatility has reduced significantly during the inflation targeting regime which suggests that FIT has been successful in achieving its primary mandate.

"During the period under review, headline CPI inflation averaged 3.9 per cent in India with a decline in inflation volatility, attesting to the success of FIT in terms of its primary mandate." (RCF, 2021)

Table 2 provides the standard deviation of inflation rates for inflation targeting and non-inflation targeting regimes. The average inflation volatility has decreased for both Advanced Economies and EMEs & LDCs. The volatility has reduced for both inflation targeters and non-inflation targeting regimes over the last 3 decades.

Table 2: Average Inflation Volatility

	IT Regime	Non-IT Regime
Advanced Economies		
1990-99	1.5	2.3
2000-09	2.2	1.4
2010-19	1.1	1.2
Emerging Markets & LDCs		
1990-99	3.2	4.4
2000-09	3.0	4.1
2010-19	2.7	3.4

Note - Inflation Volatility is measured by the standard deviation
Source: Authors Computation using data from World Bank

Inflation targeting regimes in EMEs and LDCs have an average inflation standard deviation of 3.2 in 1990s, and this has reduced to 2.7 in 2010s. For EMEs that did not introduce an inflation targeting regime, this has reduced from 4.4 to 3.4 in the same period. Curiously, for advanced economies, the average standard deviation of inflation was broadly similar in the previous decade, however, non-inflation targeters had a higher volatility in the 1990s. Thus, the reduction in inflation volatility has been sharper amongst non-inflation targeters in Emerging Markets.

IV.   Did Inflation Targeting Anchor Inflation Expectations in India?

Anchoring of inflation expectations has been cited as a major success of the inflation targeting framework as adopted by India. Blagrave and Lian (2020) evaluate India's inflation process before and after inflation targeting and they find an important role for domestic factors in driving inflation in India and claim that 'inflation expectations have become more anchored' since 2015. They attribute the anchoring of inflation expectations to either FIT adoption (in 2016) or due to the 'persistently low food prices' which coincides with the post-FIT adoption period. Thus, they point to these two as the major reasons which could be responsible independently, or collectively, in the moderation of inflation in India.

Eichengreen, Gupta, and Choudhary (2020)[6] suggest that the policy rates became lower after adjusting for inflation and output gaps in the post FIT regime as an outcome of better anchoring of inflation expectations. Further, they argue that IT central bankers were able to respond better to COVID – 19 crises as inflation expectations were better anchored in these countries which provided greater policy room to maneuver.

Goyal and Parab (2019) also explore the issue of anchoring of inflation expectations. They find that the repo rate has limited effect on inflation expectations. They acknowledge that there has been an improvement in anchoring and discuss about the greater impact of RBI's communication and short-term inflation targets become more credible while RBI's inflation forecasts now have a greater impact on inflation targets. However, they state that it is too early to conclude that inflation expectations are anchored – and to determine the contribution of the new policy regime in achieving the same.

Bhasin, Das and Lahiri (2022) looked at household inflation expectations from the Reserve Bank of India. They find a large and persistent bias in aggregate household expectations, which continues post adoption of IT. There is some moderation in inflation expectations that coincides with the drop in domestic food prices and the shift to CPI inflation as the nominal anchor. The evidence for anchoring is modest and indicative of anchoring at an inflation level higher than the official target.[7]

Prominent policymakers and commentators have also weighed in on this debate suggesting that the 'anchoring' of inflation has improved under FIT with greater convergence between headline and core inflation, the volatility of inflation has largely reduced, and that FIT was doing a reasonably successful job in its tenure thus far. This is despite acknowledging the shortcomings of the RBI in forecasting inflation during the same period.

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[6] Also see Eichengreen and Gupta (2024)

[7] We interpret these results as indicative of more work needed to establish the credibility of inflation target before households moderate their inflation expectations. In an updated version of Bhasin, Das and Lahiri (2025), they show roughly 14% of this bias is due to the continued use of 2011-12 weights for computing CPI inflation.

To evaluate the impact of adoption of inflation targeting on long-run inflation we look at the Consensus Inflation Forecasts. The data for India begins in 1995 and provides us with 1 to 10 years ahead inflation forecasts. In Table 3, we report the forecasts from the month of October, but the results are consistent for other forecasts. The average 5 & 10 year ahead inflation forecasts are broadly the same for the last two decades. The same is true for the standard deviation. However, more importantly, the average 3, 5 and 10 year ahead inflation forecasts are well within the 4 – 6 per cent range for the last two decades. This indicates professional forecasts have been anchored around the inflation target prior to the adoption of IT.

Table 3: Inflation & Consensus Forecasts for India

	Inflation	1 year Ahead Forecast	3 Year Ahead Forecast	5 year Ahead Forecast	10 year Ahead Forecast
Mean					
1990-99	9.1	8.3	7.9	7.7	7.3
2000-09	6.3	5.7	5.3	5.1	4.8
2010-19	6.8	5.4	5.7	5.3	5.0
Standard Deviation					
1990-99	3.4	1.1	1.3	1.4	1.7
2000-09	3.1	1.6	0.6	0.5	0.4
2010-19	2.6	1.1	1.0	0.5	0.3

Forecasts are from Consensus and are the October forecasts for India

Table 4 gives us the range for consensus forecasts for various years. The long-term inflation forecasts appear to have a narrower range while being contained within the 6 per cent mark from 2000 onwards. Short – to medium - run forecasts however do tend to have a wider range and they go beyond the 6 per cent level.

Table 4: Range of Consensus Forecasts

Year	Inflation	1 year Ahead Forecast	3 Year Ahead Forecast	5 year Ahead Forecast	10 year Ahead Forecast
1990-99	4.0-13.9	6.1-9.3	5.6-9.3	5.9-10.0	5.3-10.0
2000-09	3.8-12.0	4.6-9.6	4.7-6.6	4.3-6.0	4.2-5.6
2010-19	2.5-10.9	4-7.6	4.6-7.5	4.8-6.0	4.7-5.6

Forecasts are from Consensus and are the October forecasts for India

Figure 3 shows the October 10-year ahead inflation forecasts & CPI inflation for India along with the Median CPI Inflation for emerging market economies. The evidence from Consensus Data suggests that long-term inflation expectations in India were anchored well before adoption of a formal inflation targeting regime in India. One possible explanation behind

anchoring of long – term inflation expectations in India before adoption of Inflation Targeting could be the independence of the central bank and its credibility.[8]

Figure 3: Long-Run Consensus Inflation Forecasts & Actual Inflation
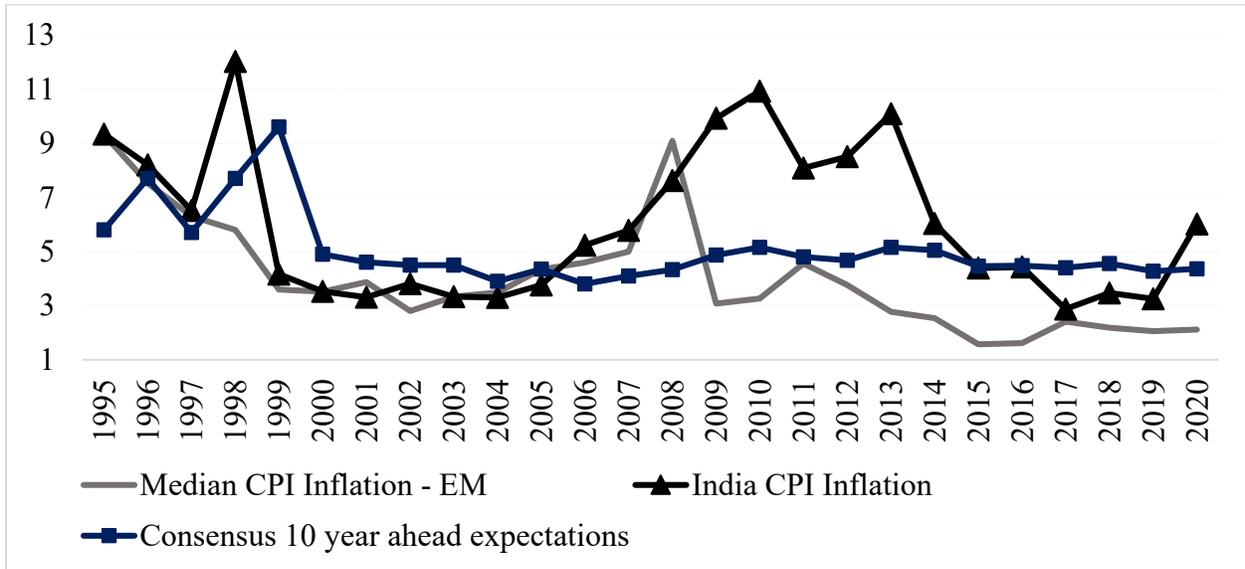
We look at the World Economic Outlook's one year ahead inflation which are made in Spring and Fall. We find that the Fall WEO forecasts are better than the Spring forecasts and thus, for our analysis we consider the Fall forecasts. In the situation of anchored forecasts, one would expect the gap between inflation and inflation forecasts as per the WEO Fall Forecast to narrow post the introduction of Inflation Targeting.

Figure 4: Inflation and Inflation Expectations Gap
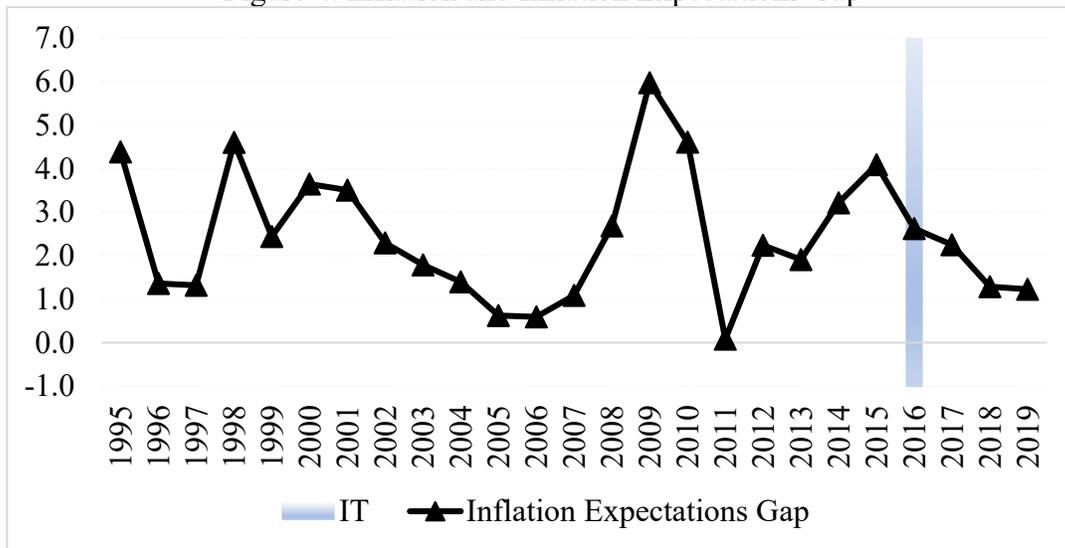
Source: Authors Computation using data from World Bank and IFS

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[8] See Gopinath (2021) for a discussion on central bank independence, credibility and anchoring of expectations.

We report the absolute value of the gap – or the WEO Fall Forecast error in Figure 4. Absolute value allows us to capture the effect of forecast undershooting or overshooting. A decline in the absolute value of the forecast error would correspond to improved forecast accuracy. In particular, we look at forecast accuracy before and after inflation targeting and find some evidence of a reduction in forecast errors from 2015 onwards.

Our interpretation of the results on expectations is mixed. For professional forecasts, there is strong evidence of anchoring of their forecasts prior to the adoption of IT – and no significant difference in long-term forecasts during the post IT period. Forecasts by multilateral institutions have improved in recent years.

V. India's Inflation Targeting Regime, Macroeconomic Stability & Growth

The purpose of the adoption of inflation targeting was to strengthen the monetary policy framework of the country which was essential to ensure long-term economic growth with macroeconomic stability. Price stability was critical towards achieving the objective and thus a formal inflation targeting regime was adopted in 2016. Several authors have recently highlighted the costs associated with inflation targeting. For instance, Nageswaran (2020) questions the ability of central banks in developing countries to tame inflation without extracting a higher price in terms of economic growth. Virmani (2020) mentions how adoption of inflation targeting had an adverse impact on India's economic growth prolonging the J-curve impact of structural reforms that were adopted before 2016.[9]

While inflation did moderate over the last decade, distilling the role played by IT is challenging. Notwithstanding these challenges, RBI's RCF (2021) makes a strong case for continuing with the current framework for the next five years.

Michael Patra who was a member of the first MPC had stated that India's neutral real rates were 1.25[10] per cent thereby indicating that MPC would have a lower rate in the event of inflation being below the target (and growth below the potential) and vice versa.

Despite inflation consistently below the target, RBI had a higher real repo rate till the second quarter of 2019. High real rates had an adverse impact on India's growth process and thus is a cost associated with the adoption of inflation targeting. Figure 5 provides us with the evidence on monetary policy based on high real rates which was followed post adoption of FIT.

Several central banks have followed a hawkish monetary policy during the early years in an effort to anchor inflation expectations. The objective is to firmly establish the credibility of the central bank and its commitment to the inflation targeting regime. However, doing so comes at the expense of growth. Figure 5 provides some evidence of a similar approach adopted by the Monetary Policy Committee in the initial years after the adoption of IT.

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[9] Also see Bhalla (2017)
[10] Edited Transcript of Reserve Bank of India's Fourth Bi-Monthly Post Policy Conference Call with Media

Figure 5: Real Rates and Inconsistent Monetary Policy
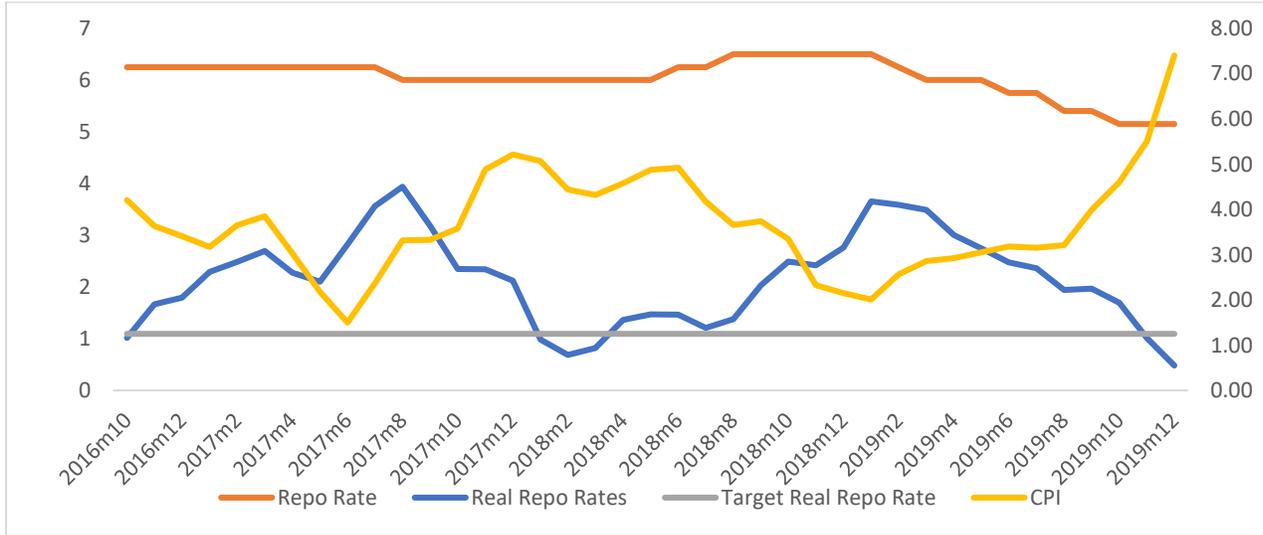
Source: Authors Computation using data from Reserve Bank of India

As illustrated above, the MPC did not consider the Neutral Real Rate that it proposed and allowed for real rates to be higher even though inflation was below the target. This indicates that the new policy framework coincided with excessively tight monetary policy even when inflation was well under control. The real repo rates in India were lower than the neutral rate for 5 months out of a total of 39 months even though inflation remained well within the tolerance band or lower for 38 months during the period.[11] Incidentally, India's growth started to decelerate during this period when monetary policy was excessively tight.

Figure 6: Real GDP Growth for India, EMEs and AEs
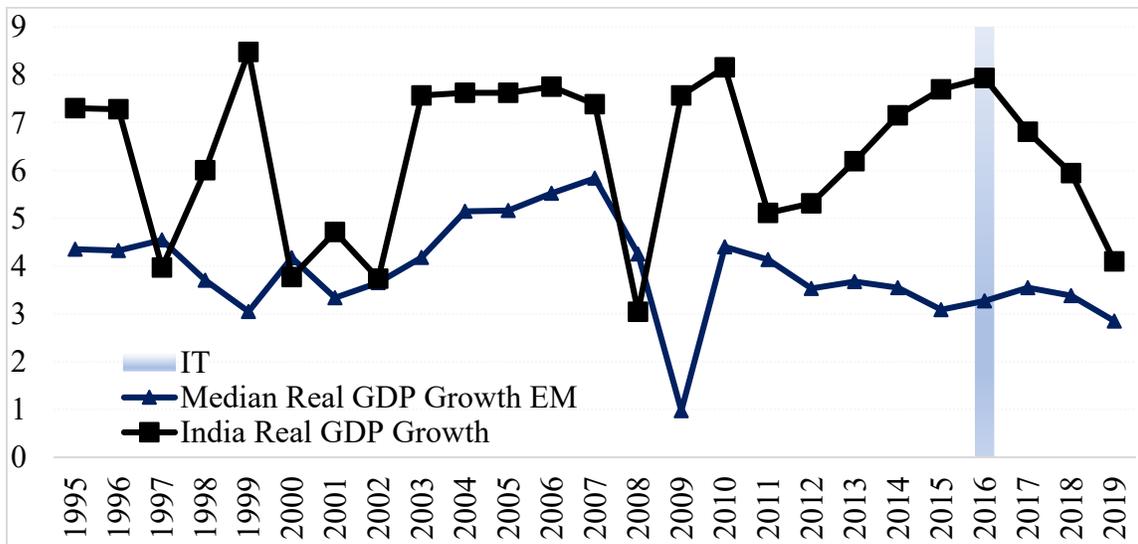
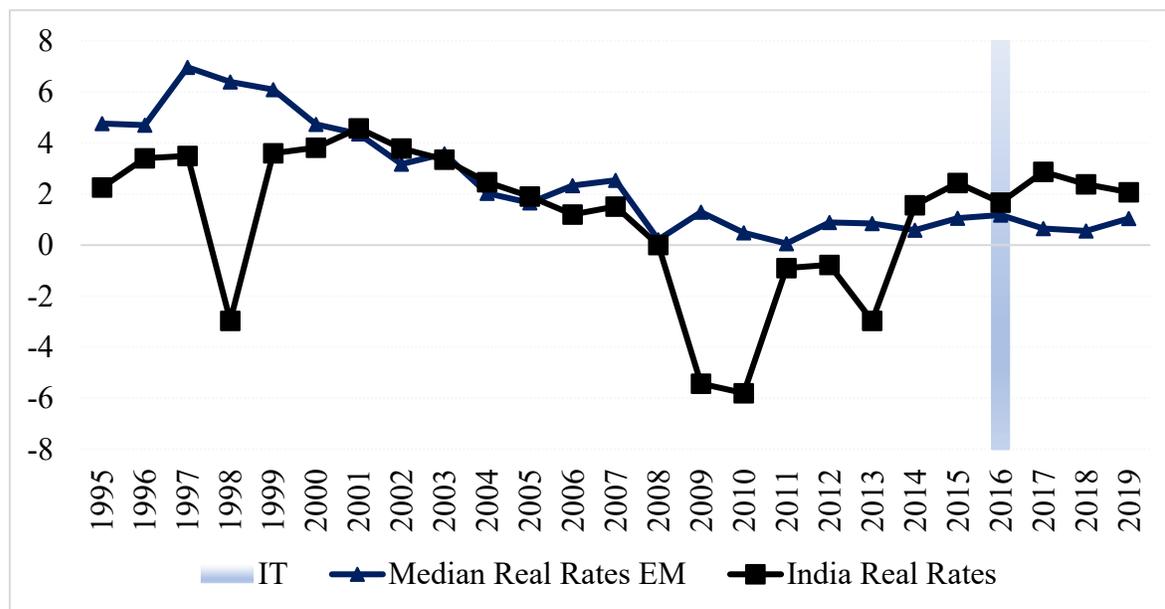Source: Authors Computation using data from World Bank

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[11] We consider inflation under the upper threshold of 6 per cent here.

Figure 6 illustrates how post introduction of inflation targeting the gap between India's real growth and median real growth has narrowed. This reduction in growth post introduction could be an outcome of various factors – however, high real interest rates contributed to this slowdown as one of the key factors.

Figure 7 shows India and EM real rates and it illustrates how India's real rates were increasing even as real rates across the world were decreasing. The reason for the increase in India's real rates was not an increase in repo rates but instead a sharp decrease in inflation. Thus, by maintaining or being too slow while cutting rates, the monetary policy was tight even as inflation remained within the inflation targeting range.

A hawkish policy followed in initial years after adoption of IT is not unusual as central banks sacrifice growth in order to credibly establish the inflation target. The long-term benefit of such a policy is that once expectations are anchored and credibility of the target is established, it allows for lower real rates on average thereby having lower sacrifice ratios. A further assessment of the cost and benefits of India's adoption of IT and hawkish policy during initial years would be warranted in subsequent years.

Figure 7: India and EM's Real Rates

Source: Authors Computation using data from World Bank

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VII.   Conclusions

The moderation in India's Inflation has been attributed to the adoption of Flexible Inflation Targeting regime in 2016. It has been argued by several authors that the adoption of FIT reduced the trend inflation, resulted in better anchoring of inflation expectations and thus has been a success in India. This paper reviews the evidence on each of the following. We find that India's inflation has moderated over the last several years, but this trend in moderation *predates* the adoption of inflation targeting. Moreover, inflation has *moderated* across the world *irrespective of whether a country has an inflation targeting regime or not*. The evidence on anchoring of inflation expectations is mixed. The pursuit of a hawkish monetary policy could partly be explained by a policy preference to establish credibility of inflation targeting regime. However, *long-run expectations have largely remained anchored since the early 2000s*. The pursuit of hawkish policies in initial years led to significant slowdown in economic growth, particularly in 2018 and 2019. A further assessment is warranted in subsequent years to evaluate whether the pursuit of hawkish policies in initial years succeeded in establishing credibility of the inflation target and have contributed to lower long-run real rates and sacrifice ratios.

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