

**An exchange rate modified inflation target is called for
by Vivek Moorthy**

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The steep fall in the rupee has attracted much attention

The Reserve Bank of India and other central banks that formally target inflation, but invariably respond to the exchange rate as well, should consider changing to an exchange rate modified inflation targeting regime. Such a policy can be operationalized by adding a quantitative clause to whatever inflation target measure or formula is currently mandated.

The steep fall in the rupee past the threshold value of Rs. 90 per US dollar has attracted much attention, with even a big story in a leading newspaper on the history of the rupee exchange rate going back to pre-Independence days! This fall will be scrutinized, analyzed and criticized by various analysts to a much greater extent than normal, because of the ongoing Monetary Policy Committee meeting of the RBI, the outcome of which will be announced tomorrow, 5th December. Whether the RBI was right or wrong in deciding to stop defending the Laxman Rekha of Rs. 90, which it was obviously doing for some time and could have continued to do so, will be debated by forex analysts and market participants.

Prior to the sharp drop in the rupee, it would be fair to say that dominant opinion was that RBI will not cut the rate at this meeting. The reasons for expecting no rate cut, even prior to the rupee's recent drop are straightforward. To begin with, there has been enough easing in the pipeline (with the repo rate cut from 6.25% to 6.0% in April and then to 5.50% in June, which is the current rate). Further the latest GDP growth of 8.2% reported early this week has been both strong, and stronger than expected, thereby raising the risks that the economy may be prone to overheating. A leading commercial bank has been emphatic in a recent report that the repo rate will not be cut, and that the stance of policy will remain neutral.

With the rupee at about 90.40 per USD as of this morning, a 70 paise drop over a week, the chances of a rate cut are increasingly remote. Globally the rupee has been one of the worst performers over the last month and year, not just the last one week. However, if one goes by recent and the latest inflation data, a rate cut is called for. For October 2025, inflation fell to an unbelievably low of 0.25% over a year ago. Although this largely reflects about 5% deflation in food items, that does not by itself imply that it should be treated as a transitory shock to be ignored. Since June 2025, food prices have been falling i.e. food inflation has been negative, except for August when it rose by a meagre 0.8%.

More important, headline inflation has been below the mandated inflation target since February this year. While the GST rate cut in September would have contributed to October's very low value of 0.25%, for the preceding three months of July, August and September, headline inflation has been 1.6%, 2.0% and 1.4% respectively, mostly below the bottom of the target range of 2% to 6%. Thus, going strictly by the Parliamentary mandate, RBI should certainly cut the repo rate.

However, the rupee's weakness and steep drop of over 1.5% over a month, warrants keeping the repo rate at its current level of 5.5%, while perhaps even changing the stance of policy to tightening from the current neutral. Although one can never tell for sure, but it is a foregone conclusion that the RBI will not cut the repo rate, which runs the risk of aggravating the recent rupee drop. This would be a sound decision, in my opinion.

Stepping back from the nitty gritty of this meeting, and taking a broader perspective, there are grounds for suggesting that the RBI modify its inflation target to take account of the exchange rate. Indeed, when the Urjit Patel Committee was undergoing its deliberations, and even after it submitted its report, one valid criticism that cropped up was that in an economy in which the exchange rate and the external sector play a large role, it is impossibly hard to pursue an inflation target. This matter is independent of whether or not the central bank looks past oil and food supply shocks or strictly follows the headline target.

A central bank can certainly respond to exchange rate changes in a discretionary way, as Germany's mighty Bundesbank, effectively merged into the European Central Bank, which never had a formal inflation target, would do. Indeed, despite not having an inflation target, its track record in inflation was better than that of the Federal Reserve. Quite often, even when money growth and inflation were at what it considered acceptable levels, if the deutsche mark had fallen sharply since the last meeting, the Bundesbank would raise the repo rate.

The RBI, and other central banks that formally target inflation, but invariably respond to the exchange rate as well, should seriously consider changing to an exchange rate modified inflation targeting regime. Such a policy can be operationalized by adding a quantitative clause to whatever inflation target measure and/or formula mandated.

Specifically, whatever repo rate is mandated by the inflation target, if say the currency has depreciated by say 5% or more since the last meeting, other things equal, the repo rate should be raised by 25 basis points, or 50 basis points for a 10% or more depreciation etc. Vice versa for an appreciation of the currency. Such a clause has been suggested for big enough swings in food inflation by this author (Modifying the Inflation Target when Food Remains Too Expensive, Business Review, St. Joseph's Institute of Management, Vol. 18, No. 1, pg. 1-29). Independent of food prices, a similar clause can be added for the exchange rate.

Such an exchange rate clause will reduce the suspense and excitement preceding the MPC meeting, but it will also reduce speculative trading of currency and bonds related to the meeting. The ensuing reduction of volatility in the financial markets will contribute to better outcomes in foreign trade as exporters and importers can focus more on their own products.

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