STUDY NOTES · BASIC CONCEPT

What Is Inflation? What Is the Repo Rate? What Is Monetary Policy Tightening?

Indian Economy

12 Oct 2026

1. What Is Inflation?

Inflation is the sustained increase in the general price level of goods and services in an economy over time.

Effects of inflation:

1. Reduces the purchasing power of money.
2. Increases the cost of living.
3. Can reduce real savings when returns fail to keep pace with prices.
4. Creates uncertainty for businesses and investors.
5. Affects different income groups unevenly.

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2. Types of Inflation

1. Demand-pull inflation: Occurs when aggregate demand grows faster than the economy's capacity to supply goods and services.
2. Cost-push inflation: Occurs when production costs rise due to factors such as higher fuel prices, wages or raw material costs.
3. Core inflation: Measures inflation after excluding selected volatile components, commonly food and fuel in Indian economic analysis.
4. Headline inflation: Reflects the overall change in prices across the relevant consumer price index basket.

3. What Is the Consumer Price Index (CPI)?

1. The Consumer Price Index measures changes in the prices of a basket of goods and services consumed by households.
2. It is an important measure of retail inflation in India.
3. CPI inflation plays a central role in the RBI's inflation-targeting framework.
4. Food, fuel, housing and other components influence the overall index.

4. What Is the Repo Rate?

The repo rate is the policy rate at which the RBI lends funds to eligible banks against eligible securities under the repo mechanism.

When the RBI increases the repo rate:

1. Banks' borrowing costs may rise.
2. Lending rates may increase.
3. EMIs on loans linked to relevant benchmark rates may rise.
4. Consumption and investment may moderate.
5. Inflationary pressure may ease over time.
6. These effects are not automatic or immediate; they depend on financial conditions and how banks transmit policy changes.

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5. What Is a Basis Point (bps)?

A basis point is one-hundredth of a percentage point.

- 1 basis point = 0.01 percentage point.
- 25 basis points = 0.25 percentage point.
- 100 basis points = 1 percentage point.
- 150 basis points = 1.50 percentage points.

Example: If the repo rate rises from 5.50% by 150 basis points, it would reach 7.00%, assuming the entire increase is implemented.

6. What Is Monetary Policy Tightening?

Monetary tightening refers to measures taken by a central bank to reduce inflationary pressure, usually by increasing policy interest rates or tightening liquidity conditions.

Its major objectives include:

1. Moderating excessive demand.
2. Anchoring inflation expectations.
3. Supporting price stability.
4. Preventing inflation from becoming persistent.
5. However, excessive tightening can weaken investment, employment and economic growth.

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7. What Is Inflation Targeting in India?

India follows a flexible inflation-targeting framework under which the RBI's Monetary Policy Committee determines the policy repo rate.

The notified CPI inflation target for the current five-year target period, April 2026 to March 2031, should be verified from the applicable government notification before using it as a current-affairs fact. Under the earlier notified framework, the target was 4%, with a tolerance band of 2% to 6%.

The framework seeks to maintain price stability while keeping growth considerations in view.

8. What Is the Monetary Policy Committee (MPC)?

The MPC is the RBI's statutory committee responsible for determining the policy repo rate under India's inflation-targeting framework.

Its decisions are intended to keep inflation within the prescribed target range over time, while considering broader macroeconomic conditions.

9. Why Can Inflation Reach 7%?

Possible causes include:

1. Higher crude oil prices: Increase transport, energy and production costs.
2. Food supply disruptions: Weak monsoons or crop damage can raise food prices.
3. Currency depreciation: Makes imported goods and inputs more expensive.
4. Rising input costs: Businesses may pass higher costs on to consumers.
5. Inflation expectations: Households and businesses may anticipate further price increases, influencing spending and pricing decisions.

The news headline reflects a reported risk scenario, not a certainty that inflation will reach 7%.

10. What Is the Difference Between Monetary and Fiscal Policy?

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Monetary policy: Conducted by the RBI; uses instruments such as policy interest rates and liquidity management to influence inflation and financial conditions.

Fiscal policy: Conducted by the government; uses taxation, public expenditure and borrowing to influence economic activity and public finances.

Both policies can affect inflation, demand and economic growth.

UPSC Syllabus Relevance

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- GS Paper III: Indian economy, inflation, monetary policy and growth.
- GS Paper II: Statutory and regulatory institutions, including the RBI.
- Essay: Price stability versus economic growth.
- Prelims: CPI, repo rate, basis points, MPC and inflation targeting.