Understanding Trend Inflation in India: What Do Data Speak?

***Gopinath Tulasi*[1], *Amaresh Samantaraya*[2], *Varun Tulasi*[3] and *Mausumi Mohanty*[4]**

India has formally adopted inflation targeting framework for conduct of monetary policy since 2016. Under this framework conduct of monetary policy heavily relies on inflation projection, and hence success and effectiveness of conduct of monetary policy is critically dependent on the understanding of the inflation dynamics. Drawing from the Stock and Watson (2007) atheoretical approach to understanding inflation dynamics, Gopinath et al. (2021) have found that trend inflation adequately explains the movements of inflation in India. In this paper, an attempt is made to understand what influences movements in trend inflation. The evidence presented supports a statistically and economically significant role for inflation expectations in explaining movements in trend inflation in India, be it headlines, core and food component. There is no evidence of any role for the output gap or slack (in levels) in explaining movements in trend inflation, partly reflecting data challenges associated with the estimation of slack. It is argued that there is merit in according significance to inflation expectations in monetary policy formulations by the Reserve Bank of India. It is also argued that monetary policy action has to respond suitably to the changes in inflation expectations, as the latter is found to be important to shape the inflation dynamics in India.

Introduction

A large part of the literature on inflation dynamics is predominantly in the form of New Keynesian Phillips Curve (NKPC), a detailed survey of which is undertaken by Ólafsson (2006). However, there is a branch of literature that has evolved parallelly with the pioneering work of Stock and Watson (2007), which is atheoretical, parsimonious and embodies the philosophy of 'let data speak for itself'. Stock and Watson (2007) have advocated that

[1] Director, Department of Economic and Policy Research, Reserve Bank of India, New Delhi, India. E-mail: tgopinath64@gmail.com

[2] Professor and Head, Department of Economics, Pondicherry University, Pondicherry, India; and is the corresponding author. E-mail: amaresheco@gmail.com

[3] Student of Master in Data Science, University of British Columbia, Vancouver. E-mail: varun15995@gmail.com

[4] Ph.D. Scholar, Department of Economics, Pondicherry University, Pondicherry, India. E-mail: mausumimohantybhu@gmail.com