

Monetary Policy and Inflation in India: A Structural VAR Analysis

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This paper provides a Vector Auto-Regression (VAR) analysis of inflation and monetary policy. It identifies monetary policy shocks in a benchmark recursive structure of VARs with two alternative inflation measures, viz., headline WPI and core inflation measure. Unlike the results in case of WPI, the response of core prices declined swiftly, following a positive call money interest rate shock. Thus, the interest rate channel is stronger for core prices. It is pertinent as RBI currently operates its monetary management through interest rate channel. The study checks robustness of results of the benchmark recursive model against alternative ordering and non-recursive identification schemes. Finally, a core price targeting scenario is generated in the benchmark VAR model with non-recursive identification scheme.

I Introduction

The Reserve Bank of India (RBI) (1935) sets out the object of monetary policy as “maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy.” With progressive liberalization and increasing globalization of the economy, maintaining orderly conditions in the financial markets emerged as an additional policy objective (Mohanty 2010a). The conduct of monetary policy and its operating procedure has also transformed significantly over time in accordance with the pace and changes in financial market and underlying structure of the Indian economy.

The monetary policy framework in India between the period 1985 and 1998 is considered as “monetary targeting with feedback” policy, recommended by the Chakravarty Committee (1985). Under this approach, M3 is used as a nominal anchor, reserve money as the operating target and bank reserves as the operating instrument (Mohan 2005). The framework was, however, a flexible one allowing changes in the projected monetary growth consistent with the expected real GDP growth and a tolerable level of inflation (Mohanty 2010b). In the late 1990s

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