

Inflation Dynamics and Impact of Demand and Supply Shocks: Evidence from India

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This present article tries to comprehend the dynamics of inflation with respect to both core and headline measures of inflation. To understand the dynamic movement in both the measures of inflation, first core inflation is calculated using the traditional exclusion measure (excluding food and energy), and statistical measure using the trimmed mean approach by considering monthly Combined Consumer Price Index (CPI) y-o-y cross-sectors headline distribution of data from January 2012 and December 2018. Next, a comparative study is attempted to know the reaction of both core and headline inflation measures to different demand and supply shocks by the Structural Vector Autoregressive Techniques.

Based on empirical analysis, it is proved that 20 per cent trimming of the extremely volatile components from the headline inflation can be considered as a better proxy for core inflation series. Core inflation series by trimming 20 per cent has the better predictive ability for the underlying trend in the overall inflation. In addition, empirical findings further show that core inflation is more responsive to demand shocks, suggesting that core inflation is mostly affected by real economic activity whereas the fluctuation in headline inflation, on the other hand, is more explainable by supply side factors in India. It is much more volatile. Thus, considering headline inflation in the decision making process of the monetary policy in the determination of policy rates can contribute to biasness and hence affect the long term objective of inflation targeting. Variations in core inflation are more observed due to monetary policy behaviour and hence making it an important component in the policy decision making.

I Introduction

Inflation targeting within the specific range has become a major challenge for monetary policy of a country for those who consider price stability as their main objective. In India, the monetary policy has undergone with two major macroeconomics development. (i) Announcement of a new monetary policy committee for the task of deciding the bench mark key policy rate. (ii) Formal declaration of inflation targeting framework (ITF) by considering consumer price

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