

Structural Rigidities and the Feasibility of Inflation Targeting in India

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Abstract

Notwithstanding the contentious debate on the veracity of inflation targeting as monetary policy objective to achieve price stability, specifically in the context of emerging economies plagued by persistent structural inflation driven by food and energy prices, central banks across the world are moving towards this very objective. India has been no exception to double-digit consumer price inflation which continues to remain higher than the wholesale price inflation. Monetary policy has been constrained in its ability to put a lead on inflation due to higher fiscal and current account deficit; largely driven by uncertain food prices because of monsoon reliant agriculture as well as due to heavy dependence on large scale imports of commodities and oil respectively. In order to assess the nature and causes of elevated levels of prices, we do critical review of inflationary process in India. Further, we test our hypotheses of structural rigidities in India, perform a trade-off between growth and inflation targeting objective, by constructing a structural-VAR model with output gap, structural component of fiscal deficit, structural component of current account deficit and exchange rate as the pre-specified variables resulting in persistence of inflation in India. From the empirical results, we therefore, conclude that the primacy of the policy objective in India should be focused more on fiscal consolidation and lowering current account deficit by removing structural rigidities and making exports competitive.

Keywords: Monetary Policy, Inflation Targeting, Structural-VAR

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