

ESSAYS ON INFLATION TARGETING IN DEVELOPING ECONOMIES



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IIM INDORE

A THESIS
SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE
FELLOW PROGRAMME IN MANAGEMENT

INDIAN INSTITUTE OF MANAGEMENT INDORE

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ABSTRACT

This dissertation studies theoretical and empirical aspects of inflation targeting regime in developing economies. The first essay focuses on the theoretical aspects of inflation targeting in a developing economy while the second and third essay focus on the empirical aspects. While commenting on the empirical aspect, I use data on the Indian economy as a benchmark for developing economies.

In the first essay, I develop a tractable growth-theoretic model of structural change for developing economies in a two-sector framework, which focuses on the role of relative prices as an intertemporal equilibrating variable to maintain balanced growth. I show that changes in the relative prices and structural change are induced by sectoral imbalances at the initial stages of development. The result also indicates that policies that attempt to rectify sectoral imbalances are as important as monetary policies that tackle inflation in the developing economies.

The second essay focuses on the measure of potential output for the Indian economy. The slope of the Phillips curve is an essential component of inflation targeting regime, and the slope of the curve is usually determined by potential output, which is an input to measuring the output gap. Hence, its accurate measurement is of utmost importance for inflation targeting regime. In this essay, I use several trend-cycle decomposition models to choose which model is the best measure of potential output for the Indian scenario. I use a model comparison exercise using Bayesian posterior odds ratio to decide which model is the best fit for potential output. I find that the correlated unobserved components model best fit the Indian data. I also find that the potential growth

rate increased after the 1991 reforms was around 8.4 percent during 1991-2007, and has significantly decelerated to 6 per cent after the global financial crisis in 2008. I also find that transitory shocks are more important in the Indian context than permanent shocks.

The last essay estimates the Phillips curve for India. I use the correlated unobserved component model, which is the best-fit model for potential output, from essay 2 as a measure of the output gap in this essay. I estimate a time-varying Phillips curve using a small model of the Indian economy. I also check for the presence of Long-run Phillips curve using a strong-form Phillips curve and a medium-form Phillips curve. An important aspect of inflation targeting regime is how the monetary policy affects the dynamics of inflation and the output gap. So, I also check for the mechanism of monetary policy transmission in the Indian context. I use a time-varying structural vector autoregression framework with stochastic volatility to estimate the parameters of the model. The main empirical conclusions are: (1) the Phillips curve trade-off is existent contrary to the findings of other papers, but the long-run Phillips curve is vertical, (2) the role played by non-systematic shocks seems more important for the post-2005 period as systematic monetary policy shocks seem to have no impact either on inflation or the output gap.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS.....	ii
ABSTRACT.....	v
TABLE OF CONTENTS.....	vii
LIST OF TABLES.....	xi
LIST OF FIGURES.....	xii
CHAPTER I.....	1
1.1 INTRODUCTION.....	2
1.1.1 What is Inflation Targeting?:.....	2
1.1.2 Evolution of Inflation Targeting:.....	3
1.1.3 The Indian Experience:.....	4
1.1.4 Motivation for this study:.....	6
1.2 LITERATURE REVIEW.....	7
1.2.1 Structural Change Models:.....	8
1.2.2 Dual Economy Models:.....	10
1.2.3 One Sector Aggregate Economy Framework & the Phillips Curve Evolution:	11
1.2.4 The Indian Scenario:.....	15
1.3 RESEARCH GAP.....	18
1.4 RESEARCH QUESTIONS.....	19

REFERENCES	20
CHAPTER II	31
2.1 INTRODUCTION	32
2.2 MOTIVATING EXAMPLE	35
2.3 THEORETICAL MODEL.....	38
2.3.1 Demand Side:.....	39
2.3.2 Production Side:.....	42
2.3.3 Market Clearing Conditions:.....	46
2.4 DYNAMICS OF THE PRICE PATH	47
2.4.1 Properties of the Price Path:.....	51
2.4.2 Discussion about Inflation Targeting:.....	54
2.5 KALDOR & KUZNETS FACT	55
2.5.1 Structural Change and Kuznets Fact:.....	55
2.5.2 Aggregate Dynamics and Kaldor Facts:	56
2.6 ELASTICITY OF SUBSTITUTION AND ITS IMPACT	59
2.6.1 Impact on Price Equation:.....	61
2.6.2 Impact on Structural Change:	61
2.7 CONCLUSION.....	62
REFERENCES	64
APPENDIX.....	67
CHAPTER III	68

3.1 INTRODUCTION	69
3.2 UNOBSERVED COMPONENT MODELS	71
3.2.1 Models:	72
3.2.2 Bayesian Estimation:	74
3.2.3 Bayesian Model Comparison:.....	75
3.3 EMPIRICAL ESTIMATION.....	75
3.3.1 Data:.....	76
3.3.2 Model Comparison Result:	76
3.3.3 Estimates and Variance Decomposition:	78
3.3.4 Break in trend growth rate:	82
3.3.5 Potential output growth:.....	84
3.4 CONCLUSION AND FUTURE RESEARCH.....	86
REFERENCES	87
CHAPTER IV	90
4.1 INTRODUCTION	91
4.2 EMPIRICAL METHODOLOGY	95
4.3 ESTIMATION STRATEGY	98
4.3.1 Transformation:.....	98
4.3.2 Priors:.....	99
4.3.3 Simulation:.....	100
4.3.4 Identification:.....	102

4.4 EMPIRICAL RESULTS.....	103
4.4.1 Evidence on Phillips Curve Trade-off:	105
4.4.2 Impact of exogenous monetary policy:	108
4.4.3 Impact of Taylor-type interest rate rules:.....	112
4.5 CONCLUSION.....	118
REFERENCES	119
APPENDIX.....	124

LIST OF TABLES

Table III-1: Log marginal likelihoods of competing models.....	77
Table III-2: Estimated posterior means of competing models. Numerical standard errors are in parentheses.....	80
Table III-3: Estimated trend growth rates of competing models. Numerical standard errors are in parentheses.....	82
Table III-4: Potential growth rates of competing models.....	85
Table IV-1: Unit Root Tests.....	124
Table IV-2: Log marginal likelihoods of competing models.....	124
Table IV-3: Posterior means of VAR coefficients with 10th and 90th percentile in parentheses.....	125

LIST OF FIGURES

Figure II-1: Expenditure Share: US	36
Figure II-2: Movement of Relative Price of Agriculture: US.....	37
Figure II-3: Expenditure Share: India	37
Figure II-4: Movement of Relative Price of Agriculture: India.....	38
Figure II 5: Expenditure Shares	41
Figure II 6: Engel Curves.....	41
Figure II-7: Convergent price path	49
Figure II-8: Divergent price path	50
Figure II-9: Structural change.....	56
Figure II-10: Elasticity of substitution and its impact	61
Figure III-1: Trend-cycle estimates of DT- (91) model. The left panel shows the trend; the right panel shows the cycle estimates	78
Figure III-2: Trend-cycle estimates of UCCR model. The left panel shows the trend; the right panel shows the cycle estimates	79
Figure III-3: Trend-cycle estimates of UCCR- (91) model. The left panel shows the trend; the right panel shows the cycle estimates	80
Figure III-4: Posterior densities of under UCCR (left panel), UCCR-(91) (middle panel) and UCCR-(91,08) (right panel).....	81
Figure III-5: Posterior densities of under UCCR (left panel), UCCR-(91) (middle panel) and UCCR-(91,08) (bottom panel)	82

Figure III-6: Posterior densities of difference in trend growth rate between 1982-1990 and 1991-2015 under UCCR-(91) model (right panel) and the difference in trend growth rate between 1991-2007 and 2008-2015 under UCCR-(91,08) model (left panel).....	83
Figure III-7: Annualized trend output growth under HP model. The left panel shows the annualized trend growth; the right panel shows the cycle estimate.....	84
Figure III-8: Annualized trend output growth under UCCR-tv model. The left panel shows the annualized trend growth; the right panel shows the cycle estimate.....	85
Figure IV-1: Phillips curve time varying trade-off coefficient with the 16 th and 84 th percentiles	105
Figure IV-2: Output Gap response to a 1% permanent increase in inflation with 16 th and 84 th percentiles. (a) Simultaneous response, (b) response after 10 quarters, (c) response after 20 quarters, (d) response after 60 quarters	106
Figure IV-3: Output Gap response to a 1% permanent increase in inflation.....	107
Figure IV-4: Posterior mean, 16 th and 84 th percentiles of the standard deviation of (a) residuals of the inflation equation, (b) residuals of the output gap equation and (c) residuals of the interest rate equation or monetary policy shocks	110
Figure IV-5: (a) Impulse responses of inflation to monetary policy shocks in 2003, 2008:IV and 2013:IV, (b) difference between the responses in 2003, 2008:IV with 16 th and 84 th percentiles, (c) difference between the responses in 2003, 2013:IV with 16 th and 84 th percentiles, (d) difference between the responses in 2008:IV, 2013:IV with 16 th and 84 th percentiles	111
Figure IV-6: (a) Impulse responses of output gap to monetary policy shocks in 2003, 2008:IV and 2013:IV, (b) difference between the responses in 2003, 2008:IV with 16 th and	

84 th percentiles, (c) difference between the responses in 2003, 2013:IV with 16 th and 84 th percentiles, (d) difference between the responses in 2008IV, 2013:IV with 16 th and 84 th percentiles	112
Figure IV-7: Interest rate response to a 1% permanent increase of inflation with 16 th and 84 th percentiles. (a) Simultaneous response, (b) response after 10 quarters, (c) response after 20 quarters, (d) response after 60 quarters.	113
Figure IV-8: Interest rate response to a 1% permanent increase in inflation.....	114
Figure IV-9: Interest rate response to a 1% permanent increase of output gap with 16 th and 84 th percentiles. (a) Simultaneous response, (b) response after 10 quarters, (c) response after 20 quarters, (d) response after 60 quarters	115
Figure IV-10: Interest rate response to a 1% permanent increase in output gap	116