ESSAYS ON INFLATION TARGETING IN DEVELOPING ECONOMIES

A THESIS
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INDIAN INSTITUTE OF MANAGEMENT INDORE

By
Sudipta Sen

Thesis Advisory Committee

Prof. Subhasankar Chattopadhyay (Chairman)

Prof. Indrajit Thakurata (Member)

Prof. K. Kiran Kumar (Member)

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.

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