Economic Shocks and Relationship between Relative Price Variability and Inflation

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Abstract

We investigate the relationship between inflation rate and relative price variability in India in the era of economic reforms and structural adjustment initiated since July 1991. The causality test in bivariate as well as multivariate frameworks support in favour of strong positive association between these two variables. Moreover, strong causal impact of inflation rate on relative price variability is also detected. These results are robust with respect to various level of dis-aggregation of price data. The evidence of lagged impact in reverse direction, however, is not very conclusive. A five variable Near-VAR model, including price, output, money, exchange rate and relative price variability also provides similar evidence. Empirical results show that mis-perceived component of money growth plays very important role in explaining variations in both inflation rate and relative price variability. In addition, significance of shocks in output and exchange rate are also detected in explaining future path of these two variables. Thus it appears that though money is very important in explaining price behaviour, it alone is not sufficient. Impacts of relative price adjustments (through instantaneous impact) and shocks in output and exchange rate are also significant. However, as unanticipated component of money growth has significant contribution on relative price variability, it appears that the monetary policy has rooms to reduce the extent of relative price adjustment and thereby to reduce its inflationary impact.