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Understanding Dynamics of Inflation through P-Star Approach: A Study of Post-Independence India

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This paper tries to understand the dynamics of inflation of India through the lens of P-star approach for the period 1952-1953 to 2013-2014. The equilibrium values for the relevant variables are estimated using two versions of Hodrick-Prescott (HP) filter. Three different types of models have been tested following the P-star approach- Price Gap Model, Output Gap Model and Velocity Gap Model. The study finds satisfactory fit for all models, as all of them reveal expected signs with statistically significant coefficients for the output gap and velocity gap variables. However, forecasting performance shows Output Gap Model as the most appropriate model in understanding inflation in India.

I Introduction

Stability of an economy is often judged by analyzing the rate of inflation. To be more correct, rates of growth of GDP and inflation are used to assess the extent of instability of an economy. However, the relation between inflation and growth has been in the limelight since long. The Keynesians argue that a moderate inflation is actually growth augmenting. The Neo-classicals approve this with a rider that it should be low and should not go up or down both in reality and in expectations. Advent of the Phillips curve along with Okun's law provided great pace to different researchers across the globe to establish relation between the two by conducting empirical tests with different sets of data. The theory of adaptive expectation and the theory of rational expectation in particular, challenged the validity of Phillips curve. Recently, however, concept of optimum rate of inflation is being popularized, courtesy IMF. Economics, as a science of choice, seeks to find out trade-off between two correlated variables. But priority of one phenomenon over other one is determined by many factors. One of this is the trade-off between short term management of the economy and the long term targets. That, on the other hand, depends upon how the policy makers view the extent of

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Details of results are available with the authors and can be supplied if demanded.