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Inflation Threshold in India: An Empirical Investigation*Deepak Mohanty, A B Chakraborty, Abhiman Das and Joice John*

Today, the Reserve Bank has released a Working Paper Series titled "[Inflation Threshold in India: An Empirical Investigation](#)" authored by Deepak Mohanty, A B Chakraborty, Abhiman Das and Joice John. The paper attempts to find threshold level of inflation for India in view of growing importance attached to inflation management by the central bank.

High output growth and low inflation are among the important objectives of macroeconomic policy. But there are trade-offs between lowering inflation and achieving high growth. Empirical evidence emphasizes that the growth-inflation relationship depends on the level of inflation—at some low levels, inflation may be positively correlated with growth, but at higher levels inflation is likely to be harmful to growth. In other words, the relationship between inflation and output growth is non-linear. In this context, the authors examine the issue of the existence of threshold effects in the relationship between inflation rate and real GDP growth in India using 3 different approaches. In view of the structural changes of the economy, the empirical analysis uses data for the period of Q1:1996-97 to Q3:2010-11 in order to capture the more recent picture of the growth inflation nexus. Also, a specific question addressed in this paper is 'does inflation in India have to reach some minimum "threshold" before the growth effects turn adverse?'

The findings of the paper suggest that inflation threshold in the sense of structural break point exists for India and this implies a non-linear relationship between inflation and growth. There exists statistically significant structural break in the relation between output growth and inflation in between 4.0 and 5.5 per cent of inflation above which inflation retards growth rate of GDP and below the threshold level, there is a statistically significant positive relationship between inflation rate and growth. Thus substantial gains can be achieved if inflation is kept below the threshold.

The authors argue that the concepts of inflation target and inflation threshold are distinct. Inflation targeting is a construct of monetary policy making in which a central bank announces a 'target' and then steers its policy tools towards achieving that target. Inflation threshold is a point of inflexion for the growth-inflation trade-off. Therefore, authors underlined that inflation threshold need not necessarily be the 'target' of monetary policy. In their opinion, the inflation objective or the target level of inflation for monetary policy should be lower than the inflation threshold, considering

the existence of significant lags in the transmission of monetary policy measures and the costs of inflation.

The Reserve Bank of India introduced in April this year, a 'RBI Working Paper Series' (RBI - WP) to provide a platform to the Reserve Bank Staff for presenting their research studies as well as to receive feedback from informed researchers.

The views expressed in all the research publications of the Reserve Bank, including the RBI Working Papers Series, do not necessarily reflect the views of the Reserve Bank and as such should not be reported as representing the views of the Reserve Bank of India.

Feedback, if any, on the papers could be addressed to the respective authors of the research studies.

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