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March 30, 2017

DRG Study: Shocks and Inflation

The Reserve Bank of India today released on its website the DRG study* titled, "[Shocks and Inflation](#)". The study is authored by Prof. M. Ramachandran, Pondicherry University and Shri Rakesh Kumar, Assistant Adviser, Reserve Bank of India.

In general, shocks induced by supply side factors are believed to have no long-lasting impact on inflation. Therefore, inflation driven by supply shocks does not warrant any policy intervention. This DRG study documents empirical evidences to understand the dynamic response of inflation to such shocks. The conventional measures of supply shocks suffer from significant measurement errors. Hence, the present study uses a new methodology to construct a measure of supply shocks. The study finds that inference drawn based on the new measure seems to be contradicting to the conventional belief. The econometric evidences obtained from a dynamic vector autoregression model indicate that supply shocks have enduring impact on inflation. The inflation dynamics are better explained by unanticipated component of real money stock as compared to that of real output. Further, the evidence from time varying vector autoregression models confirms that the manner in which demand and supply shocks influence inflation has undergone significant change over time. Overall, the evidence supports the conviction that shocks to real money stocks are important factors in tracking inflation in India.

**: Development Research Group (DRG) has been constituted in Reserve Bank of India in its Department of Economic and Policy Research to undertake quick and effective policy-oriented research backed by strong analytical and empirical basis, on subjects of current interest. The DRG studies are the outcome of collaborative efforts between experts from outside Reserve Bank of India and the pool of research talent within the Bank. These studies are released for wider circulation with a view to generating constructive discussion among the professional economists and policy makers. DRG Studies are published in RBI web site only and no printed copies will be made available.*

Press Release: 2016-17/2619

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