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Inflation Forecasting: Issues and Challenges in India : RBI Working Paper Series

The Reserve Bank of India today placed on its website a Working Paper Series for the month of January 2012 titled "[Inflation Forecasting: Issues and Challenges in India](#)" by Shri Muneesh Kapur.

In view of long and variable transmission lags, it is important for monetary policy to respond to expected inflation and output dynamics. Reliable forecasts of growth and inflation are, therefore, important for effective monetary management. The paper focuses on modelling and forecasting inflation in India using an augmented Phillips curve framework. Both demand and supply factors are seen as drivers of inflation. Demand conditions are found to have a stronger impact on non-food manufactured products inflation (NFMP) vis-a-vis headline WPI inflation; moreover, NFMP is found to be more persistent than headline inflation. Both these findings support the use of NFMP as a core measure of inflation. But, the impact of global non-fuel commodities on NFMP is found to be substantial, which tempers the case for using NFMP as a core measure. Inflation in non-fuel commodities is seen as a more important driver of domestic inflation rather than fuel inflation, although the focus more often is on fuel prices.

The exchange rate pass-through coefficient is found to be modest, but nonetheless sharp depreciation in a short period of time, as it occurred during July-September 2011, can fuel inflationary pressures. The estimated equations show a satisfactory in-sample performance based on dynamic simulations. Nonetheless, forecasting challenges emanate from volatility in international oil and other commodity prices and domestic food supply dynamics. These supply-side factors have exhibited significant volatility in the recent years and add complexity to inflation dynamics and its forecasting. Finally, structural food inflation emanating from protein-rich items and fruits and vegetables has emerged as a key driver of domestic inflation. Though this factor has not been considered in the paper it would be useful to incorporate them in the modelling framework for a better understanding of inflation dynamics.

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