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Global food prices and monetary policy in an emerging market economy: The case of India

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Abstract

This paper investigates a perception in the political debates as to what extent poor countries are affected by price movements in the global commodity markets. To test this perception, we use the case of India to establish in a standard SVAR model that global food prices influence aggregate prices and food prices in India. To further analyze these empirical results, we specify a small open economy New-Keynesian model including oil and food prices and estimate it using observed data over the period 1996Q2 to 2013Q2 by applying Bayesian estimation techniques. The results suggest that a big part of the variation in inflation in India is due to cost-push shocks and, mainly during the years 2008 and 2010, also to global food price shocks, after having controlled for exogenous rainfall shocks. We conclude that the inflationary supply shocks (cost-push, oil price, domestic food price and global food price shocks) are important contributors to inflation in India. Since the monetary authority responds to these supply shocks with a higher interest rate which tends to slow growth, this raises concerns about how such output losses can be prevented by reducing exposure to commodity price shocks.

Keywords: Commodity prices, food prices, New-Keynesian macroeconometric model, inflation, India, structural vector autoregressive model.

JEL Classification: C32, E31, Q02.

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