

Second, governments in many countries have issued inflation-indexed bonds. These bonds apart from providing the investors a hedge against inflation, give an estimate of inflation expectations. In 1997, India had introduced a variant of inflation-indexed bond where the capital was indexed to inflation. There was no subsequent issue of such bonds due to lack of investor response. Now that we have been through a period of above-trend inflation, the appetite for such bonds may have increased. Further, the issuance of such bonds could signal the firm commitment for containing inflation and thereby, inflation expectations as well. It is, therefore, important that such products be introduced in the Indian debt market to get a pulse of the market based inflation expectations.

Third, while there is substantial research on inflation expectations for advanced countries, there is hardly any research in the Indian context. Since the Reserve Bank puts in public domain the results of the various inflation expectations surveys, there is available data base for research in this area. This will not only help improving the quality of the surveys but also will enhance understanding of the process of expectations formulation in the Indian economy. Alongside, financial market variables such as yields and futures prices could be analysed to extract market information about inflation expectations.

## **Conclusion**

Let me conclude.

First, it is clear that peoples' belief about future inflation is an important factor in shaping inflation trends. But it is not so clear how these inflation expectations are formed: are they formed purely on the basis of past experience or in a forward-looking manner after processing all information or a combination of both? The Reserve Bank's household expectations surveys suggest that expectations are formed adaptively with learning; but here there is a dominance of food inflation in shaping overall household inflation expectations. Such behaviour of inflation expectations underscores the need for the Reserve Bank to continue to monitor in the Indian

context, an array of measures of inflation — both overall and disaggregated components, to assess the underlying inflationary pressures.

Second, even professional forecasters, who are considered more rational, have moved up their inflation expectations. This suggests that food inflation is acquiring a structural character feeding into inflation expectations: rather than treating higher food prices as a temporary shock, households are assessing this as a permanent structural factor. This has inflationary implications in terms of higher wage-price spiral. If workers' and producers' inflation expectations go up then the latter's demand for wage increases is more likely to be acceded to by the former. If such wage increases are in excess of productivity increase they will be inflationary, making the inflation process persistent and raising the costs of disinflation.

Third, in 2007-08, professional forecaster's medium- to long-term inflation expectations in the range of 4.5-5.5 per cent was well in line with the Reserve Bank's comfort level and what can be considered growth enhancing threshold level of inflation. Subsequently, as the actual inflation performance has deteriorated, medium- to long-term inflation expectations have also risen to a range of 6.0-7.3 per cent. This underscores the need that the current level of inflation ought to be brought down to better anchor inflation expectations which is vital for maintaining price stability in an enduring manner.

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