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New Keynesian Models and Their Application to Inflation Dynamics in India

Rupesh Manik
Research Scholar
Moga, Punjab.

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* Corresponding author

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Abstract
India is a fast-growing emerging economy with its own set of macroeconomic problems; using New Keynesian models can help us understand the dynamics of inflation there. A more contemporary way to look at inflation is through the New Keynesian paradigm, which places an emphasis on expectations of inflation, forward-looking behaviour, and nominal rigidities. apply the NKPC to the inflation data from India in order to study the connection between expectations, production gaps, and inflation. Using time-series econometrics, this article examines the NKPC's usefulness and applicability in understanding the dynamics of inflation in India, taking into consideration important factors including changes in output, real marginal costs, and price expectations. factors outside India's control, such as shifts in the value of the rupee, changes in the cost of raw materials, and supply-side shocks, all of which have a major impact on the country's inflation rate. While the results show that New Keynesian models do a good job of explaining inflation, the study of supply-side variables and external shocks is still essential for understanding the dynamics of inflation in India. refining New Keynesian models to address the unique difficulties of developing-world inflation modelling and bringing them up to speed with the demands of growing markets like India's.

Keywords: New Keynesian Models, Inflation Dynamics, New Keynesian Phillips Curve (NKPC), Inflation Expectations, Output Gap

Introduction
India, like many other rising economies, has struggled with inflation due to the fact that structural constraints, external shocks, and fast economic growth all contribute to high inflation. In order to make educated decisions on monetary policy, it is necessary to have a good grasp of the dynamics of inflation and a knowledge of its root causes. When it comes to macroeconomics, New Keynesian models have long been the go-to for analysing inflation dynamics, especially as they pertain to expectations, forward-looking behaviour, and nominal rigidities. When compared to more static models, these ones give a more accurate picture of inflation by taking into consideration things like price stickiness, imperfect competition, and

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the impact of expectations on future inflation. For these models, the NKPC—the New Keynesian Phillips Curve—has taken centre stage, highlighting the connection between GDP growth and inflation. In a time when central banks, like the Reserve Bank of India (RBI), actively manipulate expectations to attain price stability, the NKPC becomes even more pertinent because it includes expectations for future inflation. Understanding and managing inflation expectations is of utmost importance, especially since the Reserve Bank of India (RBI) has implemented an inflation-targeting framework in India. It is not easy to apply traditional models like the NKPC to India's inflation dynamics because of the many external factors that impact them, such as changes in global commodity prices, shifts in currency rates, and supply-side shocks. analysing the dynamics of inflation in India using New Keynesian models, particularly the NKPC. This research uses time-series econometrics to look at the connections between inflation, production gaps, real marginal costs, and inflation expectations, as well as to determine whether the NKPC is useful for understanding inflation in India. The study also considers the major external variables that impact inflation in India, including fluctuations in exchange rates, food and energy prices around the world, and the cost of living. Examining the interplay between these dynamics and the policy framework of the RBI, which includes inflation targeting, we hope to assess the New Keynesian framework's ability to depict inflation dynamics in a developing market economy. shed light on how well the NKPC models the dynamics of inflation in developing economies and help advance our knowledge of inflation in India. regions where structural rigidities and external dependencies, two distinctive problems encountered by developing markets, can be accommodated through the modification of New Keynesian models.

The New Keynesian Phillips Curve and Inflation Dynamics

A key model in modern macroeconomics for explaining the dynamics of inflation is the New Keynesian Phillips Curve (NKPC). For countries with sticky pricing and wages, for example, it lays the groundwork for understanding inflation by providing a dynamic link between expectations, economic activity, and inflation. The NKPC highlights the importance of inflation expectations, production gaps, and marginal costs in determining inflation outcomes, as opposed to conventional models that merely consider the trade-off between inflation and unemployment. Inflation dynamics in India as they pertain to the NKPC and its implementation.

Mechanisms Behind the NKPC

Inflation, according to the NKPC, is caused by both demand-side variables (such economic activity) and anticipation of future inflation. The NKPC's fundamental architecture is best described as:

Equation πt=βE[πt+1]\beta \mathbb{E}[\pi_{t+1}] = +λyt+vt\pi_t = βE[πt+1] + \lambda y_t + \nu_tπt*yt + vtIn what locations:

- At time ttt, the inflation rate is represented by πt\pi_tπt.

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- \mathbb{E}[\pi_{t+1}] = E[πt+1]The predicted future inflation is represented by E[πt+1].
- Parameters β\betaβ and λ\lambdaλ measure the responsiveness of inflation to expectations and output gaps, respectively. yty_tyt is the output gap, which captures demand-side pressures, and vt\nu_tvt is a cost-push shock, which can be changes in input costs or supply-side factors.

Firms, according to the NKPC model, factor in future costs and collective demand when determining pricing. Inflation expectations impact present inflation through a feedback loop in which firms raise prices today to prepare for rising costs if they anticipate higher inflation in the future. The conventional Phillips curve looks at the relationship between inflation and economic activity in the here and now, but the NKPC looks ahead, which is what makes it different.

Output Gaps, Marginal Costs, and Inflation Expectations

An integral part of the NKPC architecture is the output gap. When the economy is running above capacity, as seen by a positive output gap (actual output exceeds potential output), prices rise because demand exceeds supply. We anticipate a rise in inflation under these circumstances. In contrast, when economic activity falls short of potential, a negative output gap occurs and prices fall since demand doesn't match production capacity.

Another important component that affects the dynamics of inflation is real marginal costs, which are commonly represented as unit labour costs or the cost of production. Firms will most likely increase prices for consumers when they experience increases in input costs, such as those associated with wages or raw materials. For the NKPC model's inflation behaviour to make sense, one must grasp the connection between inflation and marginal costs. When enterprises anticipate that rising real marginal costs will continue into the future, inflation tends to rise along with them.

The NKPC also heavily relies on inflation expectations. Past inflation, signals from central banks, and external economic conditions are some of the variables that can influence these expectations. Anchoring inflation expectations to a specific target has been the goal of India's Reserve Bank of India's (RBI) inflation-targeting system, which aims to control inflation in a credible manner. The Reserve Bank of India (RBI) faces challenges in managing inflation due to internal shocks and global price changes (such as oil prices).

Application of the NKPC in India

Because of its fast-expanding economy, vulnerability to outside shocks, and fundamental economic difficulties, India is an exceptional example for implementing the NKPC. The demand side, including increased consumption and economic expansion, and the supply side, including volatility in global commodity prices and problems with agricultural productivity at home, have both contributed to the country's high inflation rate in recent decades. By considering the domestic production gap and the role of external shocks in generating inflation, the NKPC provides a helpful framework for analysing these dynamics of inflation.

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Factors outside of India's control, such as changes in the value of the rupee relative to other currencies, the cost of food and energy on a global scale, and other similar issues, can have a significant effect on the country's inflation rate. The NKPC becomes more complicated when these outside forces provide cost-push pressures that aren't immediately felt in the home economy. For instance, as oil prices rise around the world, businesses anticipate greater production and transportation expenses, which in turn raises inflation expectations. Consequently, this may cause domestic inflation to rise, regardless of whether the output gap is negative or stays the same.

Agricultural inefficiency, inadequate infrastructure, and logistical bottlenecks are examples of supply-side restrictions that impact India's inflation dynamics. Since the NKPC presupposes a somewhat efficient and well-run economy, these variables may produce inflationary pressures that the central bank fails to adequately account for. So, although the NKPC is helpful for understanding the demand-side factors that cause inflation, it needs to be complemented with models that take into consideration the specific supply-side issues faced by India.

Conclusion

The use of New Keynesian models, specifically the NKPC, to comprehend the dynamics of inflation in India. Inflation in nominally inflexible economies, such as India's, can be better understood using the NKPC paradigm, which places special focus on inflation expectations, production gaps, and marginal costs. Inflation, production gaps, and inflation expectations are the main demand-side factors that impact inflation in India, as shown in the study. Evidence from India's inflation dynamics suggests the NKPC can shed light on key questions, like how the output gap and inflation expectations interact to shape inflationary pressures. But when you apply this paradigm to India, you see a lot of problems. Managing inflation simply through domestic demand-side policies becomes more complicated when external shocks, like changes in exchange rates and swings in global commodity prices, become a factor. In addition, the NKPC does not completely account for the continuing inflationary pressures caused by supply-side restrictions and structural rigidities in the economy, such as agricultural inefficiencies, infrastructural bottlenecks, and regional pricing discrepancies. Regardless of these obstacles, the results highlight the significance of including both internal and external economic variables in inflation models for developing nations like India. Models that take into consideration India's specific structural and external vulnerabilities should supplement the NKPC, which is still a good foundation for understanding the demand-driven components of inflation. keeping inflation expectations under check is crucial in India, especially with the Reserve Bank of India's (RBI) inflation-targeting system in place. Stabilising prices in India will not be possible without firmly anchoring inflation expectations with credible policy actions. To keep the economy stable, the RBI must be able to react quickly to inflationary pressures both at home and abroad. Finally, the NKPC sheds light on the dynamics of inflation in India, but its implementation must be modified to accommodate the country's unique combination of supply-side limitations and external shocks. Indian policymakers should keep honing their inflation targeting technique by considering supply-side and demand-side variables. In order to better

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understand the intricacies of inflation in developing nations like India, future studies may look into hybrid models that merge the NKPC with other macroeconomic frameworks.

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