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Contribution of Food Subsidy Policy to Monetary Policy

William Ginn*

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July 15, 2021

Abstract

Monetary policy is generally viewed in the literature as the only institution responsible for price stability. This approach overlooks the importance of food price stabilization policies, which are particularly important in low- and middle-income economies. We estimate a Bayesian DSGE model that incorporates monetary and fiscal policy tailored to India, where the latter includes a food demand and subsidy framework replicating the central issue price (CIP) and minimum support prices (MSP) policy framework, respectively. We find that following a world food price shock, CPI and therefore interest rate volatility would be 24% higher absent food subsidies. Putting this effect aside would lead to overestimate the effectiveness of inflation targeting in EMEs. A main finding is the subsidy policy has large heterogeneous distributional effects: welfare is increasing (decreasing) the higher intensity of food demand intervention for the non-Ricardian (Ricardian) household.

JEL Classification: E52; E60; E30; E32.

Keywords: Monetary Policy; Commodities; Food prices; Price stabilisation; DSGE Model.

Highlights :

- Monetary policy is generally viewed as the only institution responsible for price stability, which omits the influence of food price stabilization policies in low- and middle-income economies.
- We estimate a DSGE model via Bayesian methods using Indian data that incorporates a food price stabilization policies (i.e., CIP and MSP).
- The empirical evidence suggests that food subsidies create a policy-induced food price-stickiness.
- Food subsidies reduce inflation volatility and monetary policy reaction.
- We find heterogeneous distributional effects of the subsidy policy on household welfare.

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1 Introduction

Not since the 1970s has the world experienced numerous episodes of high and volatile food inflation as it has since the mid-2000s (see Figure 15 in Appendix 8.1), acknowledged as an international crisis. This creates a challenge for the conduct of monetary policy, particularly for low- and middle-income economies with a large proportion of households that are credit constrained and the share of food expenditures is large.

The literature generally assumes that the central bank is responsible for price stability (e.g., Woodford, 2003). However, Ginn and Pourroy (2019) document that food subsidies are a common fiscal policy instrument designed to stabilize food prices in low- and middle-income economies, where the share of people living under the poverty line is high; are prevalent in countries where the share of agricultural production is high; and are associated with households in countries that have a high share of food expenditures. Food price subsidies produce a gap between the actual selling price and a benchmark price (e.g., Sdralevich et al. (2014), Koplow (2009) and Clements et al. (2013)). If such a gap exists, food prices are then considered “policy-driven”.

We incorporate a food price subsidy and estimate a DSGE model using Indian data. Using India as an empirical study, our paper contributes to a small, albeit burgeoning literature on the conduct of monetary and fiscal policy in the presence of a food price shock. India provides an interesting case in point considering high food inflation has been chronic, particularly from 2006 to 2014, which was one of the highest in emerging economies (Bhattacharya and Sen Gupta, 2018), where the average food inflation during that period was 8.4% (see Figure 1).¹ India also represents the second most populous country and has the largest policy-driven distribution of subsidized food in the world. Food inflation has an important prominence in the conduct of monetary policy in India considering food represents a sizable share of household expenditures and where aggregate inflation expectations are anchored by food inflation (Anand et al. (2014) and Anand et al. (2016)).

Accordingly, our research addresses three questions: to what extent does fiscal policy via food subsidies create price stickiness? Does the Reserve Bank of India (RBI) react to food price shocks? Is the interaction between monetary and fiscal policy a strategic complement or substitute? Stripped to its core, these questions relate to price stabilization, a topic central to macroeconomic research. Food price shocks can have potential repercussions on aggregate price stability, where the latter is considered one of, if not the most important, objectives of most central banks around the world, a framework described as inflation targeting. The RBI has adopted an inflation targeting framework in May 2016 with a numerical objective for the CPI growth.²

To our knowledge, there are a couple of novelties in our paper. We develop the first empirical (as opposed to calibrated) DSGE model to estimate the mechanisms through which food price shocks affect monetary and fiscal conditions via Bayesian methods. We incorporate an incomplete pass-through of food prices and fiscal policy food designed to stabilize food prices. Second, our paper is the first research that establishes and quantifies monetary policy and fiscal policy responses as a strategic substitute. By developing an empirically-grounded framework, our research goes beyond existing papers by showing that the optimal monetary policy is dependent on the effective subsidy policy and by discussing the distributional effects of these policies. We apply an empirical approach by using the posterior values from the empirical model to conduct welfare evaluation relating to welfare gains of different fiscal policy options. This has two main advantages: this method does not suffer from an “identification problem” (Lubik and Schorfheide, 2007), as in single-equation estimation methods, and we produce counterfactual models to evaluate the interaction of monetary and fiscal policy by simulating what would be the monetary policy reaction to a world food price shock with and without food subsidies to understand the effect of that policy on the other variables.

¹The inflation rate is more than double the inflation rate relative to 2000 to 2005 (3.9%).

²The inflation target is set for a period of five years, and is currently defined as 4% CPI inflation with a band of $\pm 2\%$.

Our contribution overlaps with four strands of literature. First, the model is based on a voluminous literature on sticky price models (e.g., Woodford (2003) and Galí (2008)) which intersects with three features that are representative of low- and middle-income economies: a fraction of consumers have no access to financial instruments (Anand et al., 2015) and food prices are subsidized by a fiscal authority (Ben Aïssa and Rebei, 2012). The model incorporates a food and manufacturing sector representative of a low- and middle-income economy. We decompose the food sector into a grain and non-grain sector (Ghate et al., 2018). We develop a model that captures the main features of government intervention following a pre-announced rule to concomitantly stabilize the producer price in the grain sector while shielding households from price fluctuations. There is a narrow literature to address price subsidies using a theoretical definition of optimal monetary policy. Ben Aïssa and Rebei (2012) develop a DSGE model to estimate welfare optimizing monetary policy rules for a large set of countries. They conclude that the optimal policy is a function of markets distortions. Considering that subsidies are heterogeneous across countries, they find no single optimal monetary rule would work for all countries. Using a DSGE model for a middle-income country, Ginn and Pourroy (2019) find that coordinated fiscal and monetary reactions to food price shocks can improve aggregate welfare. They also underline that subsidies smooth consumer price index (CPI) and reduce the need for monetary policy action.³

The second strand relates to the transmission of global food price pass-through to domestic consumer prices. This area of empirical research is limited and has not necessarily achieved consensus. Ciccarelli and Mojon (2010) argue that inflation is largely a global phenomenon. Parker (2018) confirms these findings for high-income countries but only to a limited extent for middle- or low-income countries. Fernández et al. (2017) show how commodity prices, including food in an agricultural index, transmit world disturbances. Focusing on the BRIC economies, Mallick and Sousa (2012) uncover the importance of commodity price shocks which lead to a rise in inflation. Gelos and Ustyugova (2017) question why all countries do not react homogeneously when facing commodity price shocks and find that economies with a larger weight of food in the CPI experience more sustained inflationary effects. Holtemöller and Mallick (2016) and Bekkers et al. (2017) find that food price shocks are, in part, explained by the international food price. In an RBI report, Misra and Sangita (2014) find evidence for co-movement between international and domestic prices for all food groups from 2002-2008 for the case of India. We contribute to this literature in two ways. First, our empirical results confirm the presence of an incomplete pass through between the international food price and domestic consumer food price. Second, our model allows us to decompose the pass-through into several elements: exchange-rate pass-through, exchange rate change, food price subsidy and consumption substitution.

The third strand relates to the choice of policy indexation, which can pose challenges for monetary policy, particularly in recent years considering food inflation has propagating secondary effects on the aggregate price level as well as playing a pivotal role in inflation expectations (e.g., Anand et al. (2014), Anand et al. (2016)). The foregoing consensus, largely based on the novel work of Aoki (2001), is that targeting core inflation (which excludes volatile components from headline inflation, e.g. energy and food), as opposed to headline inflation, is optimal, since fully-flexible prices are posited as mean-reverting in the long-run and that targeting core inflation can achieve headline price stability (see Goodfriend (2007)). While consistent with high-income economies, the new Keynesian framework has been extended to encompass low- and middle-income economies in particular incomplete financial markets (Anand et al., 2015), a large share of domestically produced food in the consumer basket (Pourroy et al., 2016) and an exposure to global food price shocks (Catão and Chang, 2015). These authors consistently find that targeting core inflation may not necessarily be welfare maximizing. We contribute to this literature by developing an empirically-grounded framework showing that optimal monetary policy is

³Producer subsidies may operate in parallel. Chen et al. (2014) find that, while a target zone policy with agricultural product purchases may not stabilize prices, a target zone policy with price subsidy can stabilize the wholesale price level.

dependent on the effective subsidy policy and by discussing the distributional effects of these policies.

The fourth strand relates to a sparse literature on the conduct of monetary policy to control for food inflation. Yu (2014) finds that China’s monetary easing can have heterogeneous distributional effects such that five of seven food prices considered⁴ decline in response to a money expansion. This can in turn improve (harm) consumer (producer) welfare. Kara (2017) finds a significant weight for food inflation in the U.S. Federal Reserve’s Taylor Rule. Ginn and Pourroy (2020) estimate an alternative Taylor rule and similarly find that the Chilean Central Bank responds to short-term developments of food inflation. They show that a food price shock generates second-round effects despite monetary policy reaction. As opposed to Kara (2017) and Ginn and Pourroy (2020) that conclude the central bank’s ability to control prices, Bhattacharya and Jain (2020) show that at the backdrop of food inflation, a monetary tightening may in turn precipitate food inflation in a panel of emerging economies.⁵ Our results go in the opposite direction. Similarly to what Kara (2017) has shown for the US, we find evidence of a non-trivial weight for food inflation in the RBI’s Taylor Rule. Our results add to this literature by estimating the food weight using an alternative Taylor rule, while controlling for the effect of the food subsidy policy. Absent such a feature in our model, we would overestimate the effectiveness of the RBI’s ability to tame a food price shock, which in turn contributes to price stabilization.

Our main results are fourfold:

- We confirm the existence of a policy-induced price-stickiness for food goods due to a producer and consumer price subsidy, hence monopolistic competition *à la* Calvo is not the only form of nominal rigidity;
- Evaluating the fit of an alternative Taylor rule, we find that the RBI does not overlook food price inflation, the weight of food inflation in the Taylor rule being close to its weight in the CPI;
- We show that fiscal policy via food subsidy complements the RBI with regard to price stability: absent food subsidies, assuming the same monetary policy reaction function based on the posterior values, food-grain inflation volatility would be 39% higher; because of substitution effects non-grain inflation volatility would be about 10% higher; and because of second round effect non-food inflation volatility would be 9% higher following a one standard-deviation shock of the world food price. All in all, interest rate responding to headline inflation, we find the central bank would have to increase its interest rate by an additional 24% in response to world food price shock.
- Our results indicate that fiscal intervention via a food price subsidy reduces aggregate welfare, albeit we find heterogeneous distributional effects by households. The subsidy benefits credit constrained (non-Ricardian) households with no access to financial instruments to smooth consumption.

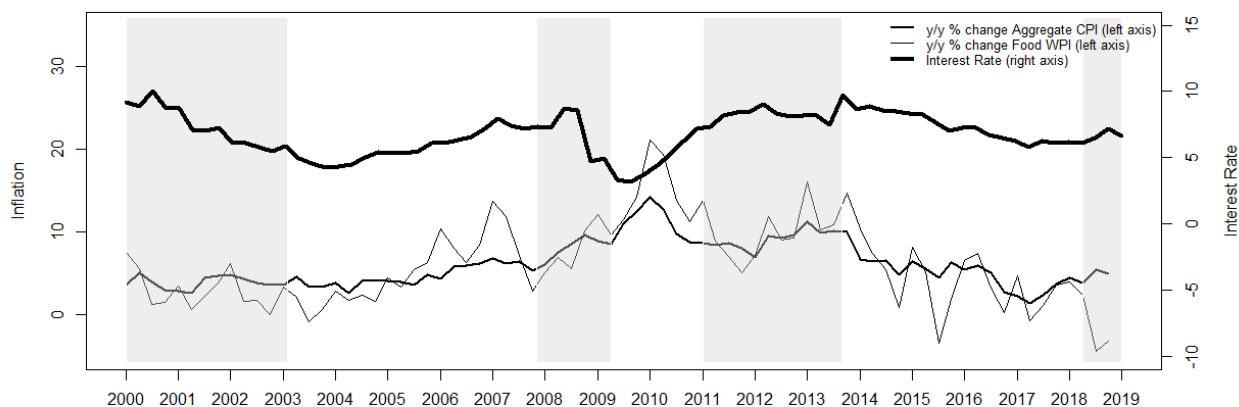
Overall, our results capture a fiscal policy-driven form of food price-stickiness that operates in parallel with, yet is different to, the classic Calvo monopolistic competition framework. This underscores the importance of a coordinated fiscal and monetary policy response considering the policy reactions are interdependent with regard to stabilizing food prices. Furthermore, our findings challenge a fiscal policy response that does not conform to a policy targeting vulnerable members of society.

The rest of the paper is organized as follows. Section 2 presents evidence on food subsidies and the conduct of monetary policy in India. Section 3 describes the model. Section 4 presents the results of the Bayesian estimation. Section 5 is dedicated to the counterfactual analyse of food subsidies. Section 6 contains the welfare results. Section 7 concludes the paper to include policy implications.

⁴These include soybean oil, poultry meat, pork, beef and mutton.

⁵Similarly Balke and Wynne (2007) find that, in the short run, nearly equal proportions of goods prices significantly increase and decrease in response to a contractionary shock.

Figure 1: Indian Inflation and Interest Rate



Sources: FRED and CEIC. Shaded areas indicate OECD recession dates.

2 Evidence of Policy Intervention

Intervention by means of a food subsidy is complex and is usually rationalized to prevent market failure in terms of food insecurity. Ginn and Pourroy (2019) find that food subsidies are a common instrument used to address food price stabilization in less advanced economies where the share of people living under the poverty line is high, are prevalent in countries where the share of agricultural production is high and are associated with households in countries having a high share of food expenditures.

Food subsidies can be viewed as a survival mechanism along two dimensions. The first relates to the government, which must be “seen to be doing something” (Poulton et al., 2006). Bellemare (2015) shows that food price spikes are correlated with civil unrest. Arezki and Bruckner (2011) find that “during times of international food price increases political institutions in Low Income Countries significantly deteriorated” (p. 11). Gouel (2014) discusses in a literature review that governmental stabilization policies may be considered as a second-best intervention in an absence of insurance and futures markets.

The second dimension involves the reduction of risk regarding food insecurity for households. According to Rocha (2007), “[t]here will be situations in which the only way of guaranteeing food security is through bypassing markets and having direct state provision of food...” Rocha (2001) argues that while food is not a public good, food security is, and that free markets may not satisfy a “socially efficient” quantity. According to Rashid (2018), “...the issue is not finding policy justifications for ensuring price stability, but rather finding appropriate policy instruments and institutions to address it...” (p. 2).

Timmer (1989) identifies three competing schools of thought concerning food price stabilization. A *free market* school, which is synonymous to a neo-classical synthesis, posits that food prices reflect market supply and demand conditions in the absence of intervention. The *structuralist* view, on the other hand, suggests domestic pricing may be misdirected; that prices may need to be set according to some income distribution mechanism. The *stabilization* school is a mix of the *free market* and *structuralist* views such that food price intervention may be warranted, yet overlooking a long-term trend may be sub-optimal which in turn could lead to a high fiscal burden.

Ginn and Pourroy (2019) provide evidence that the free market school is less in favor based on some form of food price policy intervention in lower income countries.⁶ India is no exception such that food subsidies,

⁶Ginn and Pourroy (2019) find that food subsidies are common in countries where the share of households living under the poverty line is higher; the share of food consumption is higher; and food access is lower.

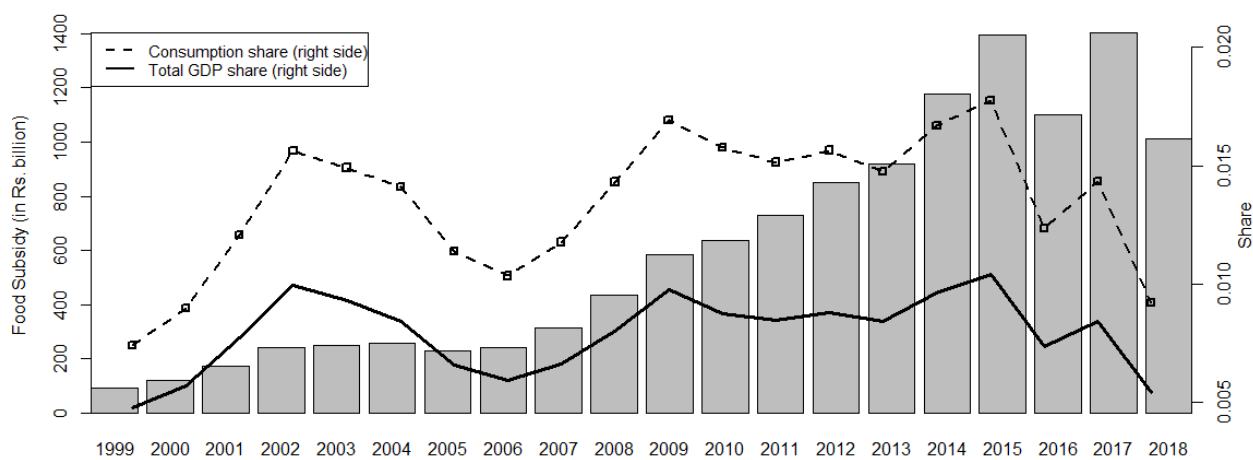
specifically for food grains, are a persistent and structural feature.

The food policy in India is based on a two tier policy, with a focus on production and consumption. In the first tier, the Government of India announces the minimum support prices (MSP) of food grains for procurement on the basis of the recommendation of the Commission of Agricultural Costs and Prices (CACP).⁷

The second tier relates to the Public Distribution System (PDS), which was introduced in the 1940s following the Bengal famine. The PDS aims to provide mainly food grains to people below the poverty line at subsidised prices from the PDS and food grains to people above the poverty line at relatively higher prices, known as the central issue price (CIP). The PDS is the largest distribution of subsidized food in the world (Balani, 2013) and is the largest safety net program in India in terms of government expenditure and beneficiary households (Bhattacharya et al., 2017). In 1992, the Revamped PDS (RPDS) replaced PDS to deliver food to mainly remote, urban areas. RPDS was replaced by the Targeted PDS in 1997, which targeted the poor in all areas (OECD, 2018). In 2013, the National Food Security Act extended access to a larger share of the population. According to Tadasse et al. (2016), "[a]lthough food grains are regarded mainly as commodities on the global market, they constitute the basic food of the poor and the “currency” of the poorest two billion people in the world.”

Food subsidies in India have significantly increased since the turn of the century, accounting for circa 1.8% (1%) of total consumption (GDP) in 2015 (see Figure 2). The subsidy has increased considerably driven by elevated and persistent food prices (see Figure 1). High food inflation has been chronic, particularly from 2006 to 2014 where the average food inflation was 8.4%.⁸

Figure 2: Food Subsidy



Sources: Ministry of Finance and FRED data. FRED data includes total GDP (mnemonic INDGDPNADSMEI) and private consumption GDP (mnemonic INDPFCEADSMEI). As the food subsidy is based on the annual budget calendar which begins in April, we take the subsidy spend from the beginning fiscal year divided by GDP of the associated annual GDP measure as a proxy for the percentage share.

⁷The CACP takes into account numerous factors based on demand and supply conditions, which includes domestic and international prices. Sharma and Alagh (2013) find that the rising food subsidy is determined by high domestic and world food prices.

⁸This is more than double the inflation rate relative to 2000 to 2005 (3.9%).

3 The Model

We develop an open economy DSGE model which incorporates a manufacturing and food sector (e.g., Catão and Chang (2015) and Pourroy et al. (2016)), where the latter is decomposed by food grains and food non-grains (Ghate et al., 2018). We follow Anand et al. (2015), Portillo et al. (2016) and Pourroy et al. (2016) by incorporating food subsistence in utility.⁹

Labor is assumed to be immobile between food and non-food sectors (e.g., Anand et al. (2015) and Ginn and Pourroy (2019)). Our treatment by household and production type can be rationalized since the agricultural sector is associated with rural regions. According to OECD (2018) research on agriculture policies in India, “[l]ow farm incomes lead to high poverty rates among farmers. Rural poverty is both widespread and severe, largely reflecting very low farm labour productivity and insufficient non-farm employment opportunities” (p. 102). According to the the FAO, the majority (70%) of India’s rural household’s depend mainly on agriculture for their livelihoods.¹⁰ Furthermore, the World Bank estimates that 43.9% of India’s share of the working population work in agriculture. According to RBI (2012), around 82.7% of the poor population live in rural areas.

We develop a model where food prices are explained by two stylized facts. First, the domestic price is, in part, driven by the international food price (Catão and Chang (2015), Ginn and Pourroy (2019)), a property that is confirmed in empirical papers (e.g., Holtemöller and Mallick (2016) and Bekkers et al. (2017)). Second, we consider fiscal intervention through the effect of India’s two-tier institutional food price subsidy in the grains sector, which includes a distorted procurement (MSP) and the distorted consumer (CIP) price a household pays. Ginn and Pourroy (2019) show fiscal intervention via food price subsidy is a prevalent feature of MICs, which are a component of the pass-through from world food prices to domestic inflation, where India is no exception. Based on the empirical evidence presented in Section 2, food subsidies in India represent circa 1% of GDP in 2015. Such a policy can create a wedge between the distorted price faced by household and non-subsidized price. This allows us to capture key factors to analyze fiscal and monetary policy simultaneous responses to food price volatility. In an RBI report, Misra and Sangita (2014) find evidence for comovement between international and domestic prices for all food groups from 2002-2008. Mishra and Roy (2012) show the co-movement is stronger when prices are lower, which they conjecture may be that “the government is more unwilling to allow the pass-through when prices are higher” (p. 157). Similarly, Saini and Gulati (2016) find that while domestic and international food prices are incomplete in the short-run, they do tend to converge in the long-run. Taking this evidence into account, we assume the domestic food price and exported food price is subject to local currency pricing, which in turn allows for deviations in the law of one food price (Ginn and Pourroy, 2020).

3.1 Households

We introduce a two-agent New Keynesian model, where home is populated by a continuum of households indexed by $j \in [0, 1]$ (Galì et al., 2004). A share $1 - \lambda$ represent the neo-classical Ricardian household (r), who has access to financial assets and is able to smooth consumption. The rest λ of the households are labeled non-Ricardian (n), who does not have access to asset markets. This type of household representation is referred to as TANK (two-agent New Keynesian) model in the literature, as opposed to single-agent RANK (representative agent

⁹A large share of food subsistence in the consumption bundle is a key element of the “food problem” (Gollin et al., 2007) that justifies the food security program.

¹⁰See <http://www.fao.org/india/fao-in-india/india-at-a-glance/en/>. This phenomena is quite common relative to other non-developed countries. According to the U.N. (2003), “(t)hree quarters of the world’s poor live in rural areas of developing countries and depend mainly on agriculture and related activities for their livelihood”.

New Keynesian) model and diverse-agent HANK (Heterogeneous Agent New Keynesian) model (see e.g., Galí (2018)). Bilbiie (2017) and Kaplan et al. (2018) show that taking into account household heterogeneity allows for a better understanding of the indirect effects of monetary policy (endogenous amplification on output), as opposed to RANK models which tend to over-estimate the direct effect of monetary policy (intertemporal substitution). Kaplan et al. (2018) have developed a Heterogeneous Agent New Keynesian (HANK) model where household heterogeneity includes a portion of poor households who behave in a hand-to-mouth fashion, combined with a wealthy hand-to-mouth manner. Thus, in the HANK model the direct effects of changes in the interest rate on demand is not as important than its indirect effect (e.g., different assets with different yields, borrowing constraint not always binding). Finally, Debortoli and Galí (2017) show that TANK models can be viewed as a “tractable framework that captures well the predictions of HANK models.”

To simplify notation for the household, let $i \in (r, n)$. Household member i is assumed to have symmetric consumption preferences for food ($C_{i,t}^F$) and manufacturing ($C_{i,t}^M$) goods combined in a CES basket:

$$C_{i,t} = \left[\varphi^{\frac{1}{\theta}} (C_{i,t}^F)^{\frac{\theta-1}{\theta}} + (1-\varphi)^{\frac{1}{\theta}} (C_{i,t}^M)^{\frac{\theta-1}{\theta}} \right]^{\frac{\theta}{\theta-1}} \quad (1)$$

where φ relates to the share of food in consumption and θ is the elasticity of substitution between food and non-food goods. Following Ghate et al. (2018), we decompose food into grains and non-grains goods:

$$C_{i,t}^F = \left[\varphi_F^{\frac{1}{\theta_F}} \left(C_{i,t}^G - \overline{C}_i^G \right)^{\frac{\theta_F-1}{\theta_F}} + (1-\varphi_F)^{\frac{1}{\theta_F}} \left(C_{i,t}^N - \overline{C}_i^N \right)^{\frac{\theta_F-1}{\theta_F}} \right]^{\frac{\theta_F}{\theta_F-1}} \quad (2)$$

where θ_F represents the elasticity of substitution between food grains and non-grains sector.

In a standard real business cycle model, the typical CES basket following aggregate consumption price index (CPI) per unit of consumption would be implied as follows:

$$P_t = \left[\varphi (P_t^F)^{1-\theta} + (1-\varphi) (P_t^M)^{1-\theta} \right]^{\frac{1}{1-\theta}} \quad (3)$$

Considering the government intervenes in the food grains sector via food price subsidy, we incorporate the presence of distorted prices in equation 3 as follows:

$$\overrightarrow{P}_{i,t} = \left[\varphi \left(\overrightarrow{P}_{i,t}^F \right)^{1-\theta} + (1-\varphi) (P_t^M)^{1-\theta} \right]^{\frac{1}{1-\theta}} \quad (4)$$

where \overrightarrow{P}_t^F and P_t^M represent relative prices faced by the household,

where the former can be further defined as follows:

$$\overrightarrow{P}_{i,t}^F = \left[\varphi_F \left(\overrightarrow{P}_{i,t}^G \right)^{1-\theta_F} + (1-\varphi_F) (P_t^N)^{1-\theta_F} \right]^{\frac{1}{1-\theta_F}} \quad (5)$$

with $\overrightarrow{P}_{i,t}^G$ and P_t^N denoting subsidized consumer food grain price and non-grain price respectively.

Following Ben Aïssa and Rebei (2012) and Ginn and Pourroy (2019), we introduce the effect of fiscal intervention to smooth prices in the food grains sector as follows:

$$\overrightarrow{P}_{i,t}^G = \kappa_i \overrightarrow{P}_{i,t-1}^G + (1-\kappa_i) P_t^G \quad (6)$$

where $0 \leq \kappa_i \leq 1$ is the degree of fiscal intervention for household type i (ricardian or non-ricardian). As κ_i approaches zero (unity), household i effectively pays the market price (fully subsidized) price. This mechanism

generates a policy-induced form of price stickiness determined by the degree to which the fiscal authority subsidizes food consumption to shield consumers from changing food prices.

The optimal consumption for food and non-food consumption by household type are:

$$C_{i,t}^M = (1 - \varphi) \left(\frac{P_{i,t}^M}{\overrightarrow{P_{i,t}}} \right)^{-\theta} C_{i,t} \quad (7)$$

$$C_{i,t}^F = \varphi \left(\frac{\overrightarrow{P_{i,t}^F}}{\overrightarrow{P_{i,t}}} \right)^{-\theta} C_{i,t} \quad (8)$$

The optimal demand for grain and non-grain food is as follows:

$$C_{i,t}^G = \varphi_F \left(\frac{\overrightarrow{P_{i,t}^G}}{\overrightarrow{P_{i,t}^F}} \right)^{-\theta_F} C_{i,t}^F + \overline{C_i^G} \quad (9)$$

$$C_{i,t}^N = (1 - \varphi_F) \left(\frac{P_{i,t}^N}{\overrightarrow{P_{i,t}^F}} \right)^{-\theta_F} C_{i,t}^F + \overline{C_i^N} \quad (10)$$

We assume the household has perfect foresight on the underlying price changes they face at the time they occur, and thus chooses the consumption bundle that minimizes expenditure.

3.1.1 Ricardian Household

Ricardian households represent optimizing agents, both inter-temporally and intra-temporally. These households derive utility from consumption and labor effort in the manufacturing sector ($N_{r,t}$):

$$U_{r,t} = E_t \sum_{t=0}^{\infty} \beta^t \left(\frac{1}{1 - \rho} C_{r,t}^{1-\rho} - \frac{\psi}{1 + \chi} N_{r,t}^{1+\chi} \right) \quad (11)$$

where β^t represents the subjective discount factor ($0 < \beta^t < 1$); χ is the intra-temporal elasticity of substitution of labor supply ($\chi > 0$); and ψ denotes the disutility of labor supply ($\psi > 0$). ζ_t represents an inter-temporal preference shock (e.g., Coenen and Straub (2005), Adolfson et al. (2007)), which affects the Ricardian household's willingness to smooth consumption over time. Ricardians solely owns financial assets. Financial assets include domestic (B_t) and foreign (B_t^*) bonds, which pay a return of $(1 + i_{t+1})$ and $e_t (1 + i_{t+1}^*) \Theta(\mathcal{B}_t)$, respectively. We follow Schmitt-Grohé and Uribe (2003) by assuming that the household faces an interest rate that is increasing in the net asset position. i_{t+1}^* is the foreign interest rate at which the households may borrow. The interest rate is a function of the world interest rate with a country risk premium:

$$\Theta(\mathcal{B}_t) = \exp(-\zeta(\mathcal{B}_t - \mathcal{B})) \quad (12)$$

where $\mathcal{B}_t = \frac{e_t B_t^*}{P_t Y_t}$ and \mathcal{B} is the steady state net foreign asset position.

The representative Ricardian agent faces the following intertemporal budget constraint:

$$\begin{aligned} \frac{(1 + i_{t+1}) B_t}{\overrightarrow{P_{r,t}}} + \frac{e_t (1 + i_{t+1}^*) \Theta(\mathcal{B}_t) B_t^*}{\overrightarrow{P_{r,t}}} + (1 - \tau_t)(W_t^M N_{r,t} + \Pi_t^M) = \\ \frac{B_t}{\overrightarrow{P_{r,t}}} + \frac{e_t B_t^*}{\overrightarrow{P_{r,t}}} + (1 + \tau_t)(C_{r,t} + \overline{C_r^G} + \overline{C_r^N}) \end{aligned} \quad (13)$$

where Π_t^M and τ_t denote profit and the tax rate, respectively.

The representative Ricardian household maximizes utility as in equation (11) subject to the resource constraint in equation (13) with respect to $C_{r,t}$, B_t , B_t^* and $N_{r,t}$. The first order conditions (FOC) are provided in the Appendix.

3.1.2 Non-Ricardian Household

The non-Ricardian household is assumed to be financially constrained such that current consumption equates to wages. Their utility is based on consumption and labor in the food sector:

$$U_{n,t} = \frac{1}{1-\rho} C_{n,t}^{1-\rho} - \frac{\psi}{1+\chi} N_{n,t}^{1+\chi} \quad (14)$$

The budget constraint for the representative non-Ricardian agent evolves as follows:

$$(1 + \tau_t) \vec{P}_{n,t} C_{n,t} + \vec{P}_{n,t}^F (\overline{C}_n^G + \overline{C}_n^N) = (1 - \tau_t) (W_t^F N_{n,t} + \Pi_t^G) \quad (15)$$

where Π_t^G is the profit distributed to the household due to government intervention to incentive food grain production (defined in Section 3.2.1). The FOCs are provided in the Appendix.

3.2 Production

Production is based on the food (Y_t^F) and manufacturing (Y_t^M) sectors. Firms maximize profit subject to demand and a labor augmenting technology (e.g., Lubik and Schorfheide (2005) and Del Negro and Schorfheide (2009)).

Food grain prices are sticky due to government intervention, while food non-grain prices are flexible. Manufacturing firms are allowed to set pricing à la Calvo (1983).

There are two types of wages, W_t^F and W_t^M , for the food and manufacturing sectors, respectively. Inter-sectoral food labor (i.e., grain and non-grain) is perfectly mobile and inter-sectoral food wages are equivalent, i.e. $W_t^F = W_t^G = W_t^N$.

3.2.1 Food Sector

There is empirical evidence showing that exchange rate fluctuations are partially transmitted to the prices of internationally-indexed goods in the short-run for India. In an RBI report, Misra and Sangita (2014) find evidence for co-movement between international and domestic prices for all food groups from 2002-2008 for the case of India.¹¹ The price transmission has been somewhat muted, considering India's ban on exports of rice and wheat during 2007–11 (Ganguly and Gulati, 2013). Sahoo et al. (2014) show that the rise in world food prices was much sharper than the rise in Indian food prices, especially in 2007-08 and 2010-11. Mishra and Roy (2012) show the co-movement is stronger when prices are lower, which they conjecture may be that “the government is more unwilling to allow the pass-through when prices are higher” (p. 157). Sahoo et al. (2014) show that since 2013, global prices declined while domestic prices remained slightly elevated where the co-movement between wheat and rice are is limited due to price interventions, whereas domestic palm oil and sugar prices exhibited co-movement with international prices. Saini and Gulati (2016) find that while domestic and international food prices are incomplete in the short-run for the case of India, they do tend to converge in the long-run. Taking this evidence into account, we incorporate deviations from the law of one food price in the

¹¹The study includes the following groups: edible oil (0.87), food articles (0.80), rice (0.79), wheat (0.80) and sugar (0.79). See <https://www.rbi.org.in/scripts/PublicationsView.aspx?id=18621>.

short-run between international and domestic prices.¹² Hence, we incorporate an international linkage between the domestic ($P_t^{\mathbb{X}}$) and foreign sector price ($P_t^{\mathbb{X}^*}$) at the prevailing exchange rate, i.e. $P_t^{\mathbb{X}} = e_t P_t^{\mathbb{X}^*} / \Psi_t^{\mathbb{X}}$ indexed by sector $\mathbb{X} \in \{G, N\}$ relating to the food grains and non-grains, respectively. Variable $\Psi_t^{\mathbb{X}}$ corresponds with deviations in the law of one price (Monacelli, 2005).¹³

Food Grain Production

Food production is based on labor and aggregate productivity:

$$Y_t^G = A_t^G N_t^G \quad (16)$$

The food grains sector optimally allocates labor resources by minimizing cost subject to production technology:

$$\min_{N_t^G} \frac{W_t^G}{P_t^G} N_t^G + \varphi_t^G (Y_t^G - A_t^G N_t^G) \quad (17)$$

where φ_t^G can be interpreted as the marginal cost for the respective firm. Optimization yields the real marginal cost:

$$\varphi_t^G = \frac{W_t^G}{A_t^G P_t^G} \quad (18)$$

The government intervenes in the food grain sector by procuring these goods via the Food Corporation of India (FCI), where it provides the grains producer a markup above production cost:

$$P_t^{G,S} = \left(\frac{\epsilon_g}{\epsilon_g - 1} \right) \varphi_t^G P_t^G \quad (19)$$

The result is that the food grain procurement (MSP) price ($P_t^{G,S}$) is above the flexible producer price (P_t^G), since the government effectively allows each food grains firm to set its price equal to a markup above the nominal marginal cost. The difference between the MSP and producer price is paid as a producer subsidy by the government to ensure remunerative prices to farmers and incentive food grains production (Sharma and Alagh, 2013). Our framework is consistent with Sharma and Alagh (2013) and Acharya et al. (2012), such that the MSP can be explained, in part, by world food prices, where the MSP is subject to a markup above marginal cost (Ghate et al., 2018). $\Pi_t^G = Y_t^G (P_t^{G,S} - P_t^G)$ represents the dividends from the producer subsidy paid by the government.

Food Non-grain Production

Food production in the non-grain sector is similarly based on labor and aggregate productivity:

$$Y_t^N = A_t^N N_t^N \quad (20)$$

The non-grain food sector optimally allocates labor resources by minimizing cost subject to production technology:

$$\min_{N_t^N} \frac{W_t^N}{P_t^N} N_t^N + \varphi_t^N (Y_t^N - A_t^N N_t^N) \quad (21)$$

Optimization yields the real marginal cost:

$$\varphi_t^N = \frac{W_t^N}{A_t^N P_t^N} \quad (22)$$

¹²Our approach is similar to e.g. Medina and Soto (2005), An and Kang (2011), Poghosyan and Beidas-Strom (2011) and Ginn and Pourroy (2020) who apply a law of one price gap for commodity prices as an AR(1) process.

¹³Note that purchasing price parity holds if $\Psi_t^{\mathbb{X}}$ is equal to unity. Our approach is similar to e.g. Medina and Soto (2005), An and Kang (2011), Poghosyan and Beidas-Strom (2011) and Ginn and Pourroy (2020) who apply a law of one price gap via an AR(1) process.

3.2.2 Manufacturing Sector

The manufacturing sector production is derived as follows:

$$Y_t^M = A_t^M N_t^M \quad (23)$$

These firms optimally allocate labor resources by minimizing costs subject to output, with an additional step involving pricing decisions. The first stage consists in minimizing cost to maximize profit based on perfectly competitive factor markets which is generalized as follows:

$$\min_{N_t^M} \frac{W_t^M}{P_t^M} N_t^M + \varphi_t^M (Y_t^M - A_t^M N_t^M) \quad (24)$$

Optimization yields the real marginal costs:

$$\varphi_t^M = \frac{W_t^M}{A_t^M P_t^M} \quad (25)$$

As in Schmitt-Grohé and Uribe (2005), we incorporate price stickiness à la Calvo (1983) in the second stage such that each non-tradable firm faces an exogenous probability $\phi_M > 0$ of not being able to re-optimize its price charged from the previous period. This can be expressed in the following optimization process:

$$\max_{P_{j,t}^M} E_t \sum_{s=0}^{\infty} \phi_M^s \Xi_{t+s} \left\{ \left(\frac{P_{j,t}^M}{P_{t+s}^M} - mc_{t+s}^M \right) Y_{j,t+s}^M \right\} \quad (26)$$

subject to sector specific demand:

$$Y_{j,t}^M = \left(\frac{P_{j,t}^M}{P_t^M} \right)^{-\epsilon_m} Y_t^M \quad (27)$$

The pricing kernel is equivalent to the marginal utility of consumption, i.e. $\Xi_{t+s} = \Lambda_{r,t+s}/\Lambda_{r,t}$. Inserting the demand (29) into the maximization process (28) simplifies the optimization from a constrained maximization to an unconstrained one:

$$\max_{P_{j,t}^M} E_t \sum_{s=0}^{\infty} \beta^s \phi_M^s \Xi_{t+s} \left(\frac{P_{j,t}^M}{P_{t+s}^M} \left(\frac{P_{j,t}^M}{P_t^M} \right)^{-\epsilon_m} - \left(\frac{P_{j,t}^M}{P_t^M} \right)^{-\epsilon_m} mc_{t+s}^M \right) Y_t^M \quad (28)$$

Note that $P_{j,t}^M$ is decided in period t and not $t+1$ since manufacturing firms choose the optimal price in the current time which will occur in the next period. The first order conditions with respect to $P_{j,t}^M$ yields the well-known optimal price setting equation as follows:

$$\frac{\tilde{P}_t^M}{P_t^M} = \frac{\epsilon_m}{\epsilon_m - 1} \frac{E_t \sum_{s=0}^{\infty} (\beta \phi_M)^s \Xi_{t+s} Y_{t+s}^M mc_{t+s}^M \left(\frac{P_{t+s}^M}{P_t^M} \right)^{\epsilon_m}}{E_t \sum_{s=0}^{\infty} (\beta \phi_M)^s \Xi_{t+s} Y_{t+s}^M mc_{t+s}^M \left(\frac{P_{t+s}^M}{P_t^M} \right)^{\epsilon_m - 1}} \quad (29)$$

Note that if prices are completely flexible (i.e., $\phi_M = 0$), equation (29) simplifies to $\frac{\tilde{P}_t^M}{P_t^M} = \frac{\epsilon_m}{\epsilon_m - 1} mc_t^M$. We work with the condition of symmetric prices where $\tilde{P}_t^M = P_t^M$, implying marginal cost would be equivalent to the inverse mark-up, i.e. $mc_t^M = \frac{\epsilon_m - 1}{\epsilon_m}$. It is convenient to express (29) recursively, which simplifies to $\epsilon_m \times f_{1,t}^M = (\epsilon_m - 1) f_{2,t}^M$ where:

$$f_{1,t}^M = \Xi_t Y_t^M mc_t^M + (\beta \phi_M)^s E_t \left(\frac{P_{t+1}^M}{P_t^M} \right)^{\epsilon_m + 1} f_{1,t+1}^M \quad (30)$$

$$f_{2,t}^M = \Xi_t Y_t^M + (\beta \phi_M)^s E_t \left(\frac{P_{t+1}^M}{P_t^M} \right)^{\epsilon_m} f_{2,t+1}^M \quad (31)$$

Prices can be expressed as a weighted average of the fraction of manufacturing firms which optimized its price and those that did not optimize prices (which are stuck at charging prices from the previous period):

$$P_t^M = \left[(1 - \phi_M) (P_t^M)^{1-\epsilon_m} + \phi_M (P_{t-1}^M)^{1-\epsilon_m} \right]^{\frac{1}{1-\epsilon_m}} \quad (32)$$

3.3 Fiscal Policy

Fiscal intervention has two distinct objectives: on the one hand, the fiscal authority aims to smooth consumer prices, while on the other hand the fiscal authority aims to support farmers incomes. In the following we refer to the former policy as “demand subsidy” and the latter as “supply subsidy”. Based on Equation (6) we can define the spending by the fiscal authority for demand subsidy :

$$S_t^D = (C_{r,t}^G + \overline{C_r^G})(P_t^G - \overrightarrow{P_{r,t}^G}) + (C_{n,t}^G + \overline{C_n^G})(P_t^G - \overrightarrow{P_{n,t}^G})$$

Where $\overrightarrow{P_{i,t}^G}$ is synonymous with India’s CIP. Similarly, based on Equation (19) we can define the spending by the fiscal authority for supply subsidy :

$$S_t^S = Y_t^G (P_t^{G,S} - P_t^G)$$

Where $P_t^{G,S}$ is synonymous with India’s MSP.

Assuming a closed economy equilibrium (i.e. $Y_t^G = C_{r,t}^G + \overline{C_r^G} + C_{n,t}^G + \overline{C_n^G}$) we can write total subsidy spending as a function of the spread between CIP and MSP, with $S_t = S_t^D + S_t^S$,

$$S_t = Y^G (P_t^{G,S} - \overrightarrow{P_t^G})$$

or in other words, total subsidy is a function of the spread between producers’ price and consumers’ price. The food subsidy cost is the difference between cost of food grains and their sales realisation at CIP fixed for TPDS (Sharma and Alagh, 2013), where the household price is less than MSP, i.e. $P_t^{G,S} > P_t^G$.

The government’s inter-temporal budget constraint is funded via domestic (B_t^G) debt and tax (T_t) revenues to finance a stream of food price subsidies.¹⁴

$$B_t^G - (1 + i_{t-1})B_{t-1}^G = S_t^D + S_t^S - T_t \quad (33)$$

$$T_t = \tau_t (\overrightarrow{P_{n,t}^G} C_{n,t} + \overrightarrow{P_{r,t}^G} C_{r,t} + \overrightarrow{P_{n,t}^G} \overline{C_n^G} + \overrightarrow{P_{r,t}^G} \overline{C_r^G} + P_t^N \overline{C_n^N} + P_t^N \overline{C_r^N} + W_t^F N_t^F + W_t^M N_t^M + \Pi_t^G + \Pi_t^M) \quad (34)$$

For purposes of ensuring stability, a Ponzi scheme is ruled out, i.e. both the consumer budget constraint and a debt ceiling will always bind. The share of the government’s budget financed via debt: $\tau_t = \phi \frac{B_t^G}{P_t Y_t}$ which relies on the leverage parameter ϕ . As ϕ approaches zero, the fiscal response will be financed mainly by debt. However, $\phi > 0$ ensures solvency related to time-varying marginal tax rates on consumption, labor wages and profits.

3.4 Monetary Policy

The central bank conducts monetary policy by following a Taylor-like Rule (Taylor, 1993) via changing short-term interest rates in response to changes in the price level and output:¹⁵

¹⁴See e.g. Stähler and Thomas (2012) and Ginn and Pourroy (2019).

¹⁵The RBI has formally adopted an inflation targeting framework in 2016. Prior to that adoption, consumer price stability was already the main objective of monetary policy. According to Hutchison et al. (2010), the exchange rate is not an important

$$\frac{1+r_t}{1+r} = \left(\frac{1+r_{t-1}}{1+r}\right)^{\psi_r} \left[\left((\pi_t^M)^\varrho (\pi_t^F)^{1-\varrho} \right)^{\omega_\pi} (\Delta y_t)^{\omega_y} \right]^{1-\psi_r} e^{\varepsilon_t^{MP}} \quad (35)$$

The Taylor Rule incorporates interest rate smoothing depending on the degree of inertia $0 < \psi_r < 1$. The policy weights with respect to deviations from the inflation rule and output are denoted ω_π and ω_y , respectively. The inflation rule makes an assignment on non-food (π_t^M) and food sector (π_t^F) CPI which is governed by $0 \leq \varrho \leq 1$. This allows a simple framework to evaluate whether the central bank pursues core inflation ($\varrho=1$) versus a policy response that responds to food inflation ($\varrho < 1$).¹⁶ ε_t^{MP} relates to a monetary disturbance.

3.5 Foreign Economy

The balance of payment is equivalent to the trade balance (TB_t) and the foreign asset position:

$$e_t B_t^* = e_t (1 + i_{t-1}^*) \Theta(B_t) B_{t-1}^* + TB_t \quad (36)$$

$$TB_t = P_t^N Y_t^N - P_t^N C_t^N \quad (37)$$

Equation (36) represents the position on foreign bond holdings (B_t^*). Equation (37) shows that the trade balance depends on domestic absorption.¹⁷

3.6 Aggregation

Following Galí et al. (2007), aggregate consumption (C_t) and labor effort (N_t) are defined by, respectively:

$$C_t = (1 - \lambda) C_t^n + \lambda C_t^r \quad (38)$$

$$N_t = (1 - \lambda) N_{r,t}^M + \lambda N_{n,t}^F \quad (39)$$

Output is equal to consumption, food price subsidy and the trade balance:

$$\vec{P}_t Y_t = \vec{P}_t^F C_t^F + P_t^M C_t^M + \vec{S}_t + TB_t \quad (40)$$

In the absence of a food price subsidy, the price level becomes non-distorted:

$$P_t Y_t = P_t^F C_t^F + P_t^M C_t^M + TB_t \quad (41)$$

4 Estimation Method

The model is evaluated using Bayesian methods, which are commonly used in empirical macroeconomic research (e.g., Schorfheide (2000), Smets and Wouters (2007), Fernandez-Villaverde and Rubio-Ramirez (2004)). Bayesian DSGE models have also been used in business cycle research to understand commodity price shocks (e.g. Medina and Soto (2005), Bodenstein et al. (2011), An and Kang (2011), Poghosyan and Beidas-Strom (2011)).

determinant of India's monetary policy relating to the period of the period of 1999:Q1 to 2008:Q2. Consistent with recent empirical evidence, we apply a Taylor-like rule in relation to changes in prices and output (e.g., Banerjee and Basu (2015), Banerjee and Basu (2019), Anand and Khera (2016)) for the case of India. Nevertheless, we add an exchange rate to the Taylor-like rule and present the findings in Section 8.4.1.

¹⁶The assignment ϱ is motivated by Anand et al. (2015) and subsequently Ginn and Pourroy (2019) who develop a DSGE model to describe optimal inflation used in a welfare analysis.

¹⁷Grain exports were limited for a certain time due to government restrictions (Sharma, 2011), therefore only non-grain are assumed to be traded internationally.

4.1 Data

The model is based on eight observable variables (see Table 1). The variables include real GDP¹⁸; CPI inflation; WPI food inflation¹⁹; the international grain and non-grain food inflation (proxied via the FAO international food price data); real effective exchange rate (REER); the policy rate and an international interest rate.²⁰ The sample period covers 1999:Q1 to 2019:Q4. With the exception of the interest rate, all variables are seasonally adjusted and computed as a quarter-to-quarter log-difference.²¹ The policy rate and foreign interest rate are transformed from an annualized rate to a quarterly gross interest rate to conform the model with observable data: $R_t^{obs} = 1 + \frac{R_t^{data}}{100 \times 4}$. We take the three month treasury bill rate as a proxy of the nominal interest rate (e.g., Patnaik et al. (2011), Anand et al. (2014) and Gabriel et al. (2016)).

Table 1: Variable Selection

Description	Source	Mnemonic / Descriptor
Nominal GDP	FRED	INDGDPNQDSMEI
Aggregate CPI	FRED	INDCPIALLQINMEI
Food WPI	FRED	WPOTFD01INQ661N
REER	FRED	RBINBIS
International Grain Food CPI	FAO	Real Grain Food CPI
International Non-Grain Food CPI	FAO	Real Non-Grain Food CPI (see [a])
Interest Rate	CEIC	3 Month Treasury Bill Rate
International interest rate	U.S. Federal Reserve	Shadow Federal Funds Rate

[a]: The Non-Grains Food CPI is computed by excluding the grains price and reindexing the weights (provided by FAO) using the FAO price data by product group applied to the non-grains food groups.

4.2 Calibrated Parameters

The model parameters are summarized in Table 2. The discount factor (β) is set to 0.9832, which corresponds with the observed data over the sample period. The share of food in aggregate consumption (φ_F) is set to 0.4.²² The share of labor attributed to the food sector (λ^F) is set to 0.4.²³ The share of food grains is set to one-third of the share of food.²⁴

4.3 Prior Distributions:

The prior distributions of the estimated parameters are summarized in the Table 3.

The inverse of intertemporal elasticity of substitution (ρ) is set to 2 (e.g., Aguiar and Gopinath (2007)). The inverse Frisch parameter (χ) is set unity (e.g., Medina and Soto, 2005, García-Schmidt and García-Cicco,

¹⁸Real output is derived by dividing nominal GDP by the GDP price deflator of a base year. The approach is consistent with “Databasics” from the Federal Reserve. See: <https://www.dallasfed.org/research/basics/nominal.aspx>.

¹⁹We take the food WPI as a proxy for food inflation considering food CPI is not available prior to 2013. The food WPI and food CPI has a correlation of 0.98 from 2013:Q1 to 2018:Q4.

²⁰Considering the sample period overlaps with the U.S. federal funds rate was at the zero lower bound between 2008:Q4 until 2015:Q4, we use the shadow federal funds rate (Wu and Xia, 2016) to reflect the stance of U.S. monetary policy.

²¹For consistency, CPI, food CPI, food WPI and REER are seasonally adjusted using the U.S. Census Bureau’s ARIMA X12 algorithm. Hence, with the exception of the interest rate, all variables are seasonally adjusted.

²²According to the World Bank (Global Consumption database), food represents 44.63% of total household expenditures in India. According to the World Bank (ILOSTAT database), agriculture represents 43.86% of employment for 2018 in India.

²³Financial access is estimated to be 79.9%, while 42.4% have borrowed money (age 15+) based on 2018 Indian data (World Bank Global Findex database)

²⁴According to Anand et al. (2016), the grains sector represents 34.2% of total food consumption.

Table 2: Calibrated Parameters

Description	Symbol	Value
Discount factor	β	0.9832
Share of food in consumption	φ	0.4
Share of food grains in food consumption	φ_F	0.33
Share of Non-Ricardian	λ	0.4
Leverage Response (ensures stability)	ϕ	0.2

2020). We set the elasticity of food (θ) to 0.75.²⁵ The elasticity between grain and non-grain food is set to 0.85.²⁶

Following Ginn and Pourroy (2020), we assume the central bank targets aggregate headline inflation, hence ρ has a prior set to the ratio of the aggregate food expenditure (i.e., $\rho = 0.60$) consistent with the RBI mandate.²⁷ The prior for the interest rate smoothing parameter (ψ_S) and the policy weights with respect to deviations from the inflation rule (ω_π) and output (ω_Y) are set to 0.7, 1.5 and 0.5, respectively (e.g., Ginn and Pourroy (2020)).

Following Schmitt-Grohé and Uribe (2003), we incorporate a bond adjustment cost; the prior is set to $\zeta=0.02$.

The Calvo price signal (ϕ_M) in the manufacturing sector is assumed to be two-thirds (see e.g. Anand et al. (2015)). The intensity of food intervention (κ_n and κ_r) is assumed to 0.33 and 0.1, respectively, to reflect fiscal authorities' propensity to subsidize food prices by household type²⁸, which may be poorly targeted (e.g., Ramaswami and Balakrishnan (2002), Jha and Ramaswami (2010) and Sharma and Alagh (2013)).

We incorporate eight shocks in the model which obey an AR(1) process, each of them drawn from an i.i.d. normal process. These shocks include a sector-specific technology shock (e.g., (Anand et al., 2014)); global food price shock (e.g., Catão and Chang (2015), Pourroy et al. (2016), Ginn and Pourroy (2019) and Ginn and Pourroy (2020)); law of one price gap (e.g., Monacelli, 2005, Medina and Soto (2005) and Ginn and Pourroy (2020)); monetary policy shock (Smets and Wouters, 2007); foreign interest rate shock (Devereux et al., 2006); and preference shock (e.g., Coenen and Straub (2005), Adolfson et al. (2007)).

4.4 Empirical Findings

4.4.1 Posterior Distributions

The prior and posterior distributions are summarized in Table 3.

Parameter θ is estimated to be 0.73, hence food has an inelastic demand. The posterior for food grains (θ_G) is estimated to be 0.94. Considering the value of θ_G is lower than unity demonstrates that food grain and non-grain are two clearly separated goods in the consumer basket that cannot be easily substituted.

The posterior Calvo probabilities for the manufacturing sector (ϕ_M) is estimated to be 0.58, a standard value for monopolistic competition sector.

²⁵This is in line with the USDA estimate for India using 2005 data; the elasticity of food and uncompensated own-price elasticity for food is estimated to be 0.78 and 0.74, respectively.

²⁶Anand et al. (2016) find the the expenditure elasticity of grain relative to total expenditure on food is 0.848 for India.

²⁷Theoretically, the more recent research argues that targeting strictly core inflation is not necessarily optimal (Anand et al. (2015), Catão and Chang (2015), Pourroy et al. (2016) and Ginn and Pourroy (2019)) for a non-developed country. In practice, the RBI has adopted an inflation targeting framework since May 2016, where the inflation target is set by the Government of India, in consultation with the Reserve Bank, once every five years.

²⁸According to OECD (2018), those households in the lowest decile received 45% and 38% of their rice and wheat consumption from TPDS in 2011-2012 vs. 13% and 16% for the highest decile.

Table 3: Prior and Posterior Distributions

		Density	Prior		Posterior			
			Mean	StD	Mean	90% interval	StD	
$\overline{C^G}$	Food subsistence: grains	I	0.1	2.00	0.0387	0.0264	0.0518	0.0085
$\overline{C^N}$	Food subsistence: non-grains	I	0.1	2.00	0.0224	0.0184	0.0268	0.0031
ρ	Inverse of intert. elasticity of subst.	G	2	0.10	2.0748	1.8948	2.2759	0.0976
χ	Inverse Frisch	G	1	0.10	0.9508	0.8012	1.0808	0.0951
ζ	Bond adjustment costs	I	0.02	2.00	0.0211	0.0068	0.0331	0.0061
ϵ_m	Manufacturing sector market power	I	11	2.00	10.7934	7.7035	13.3985	1.5612
ϵ_g	Food grain government intervention	I	6	2.00	5.6519	3.6767	7.8027	1.1313
θ	Elasticity of substitution F and M	G	0.75	0.05	0.7253	0.6474	0.8027	0.0458
θ_G	Elasticity of substitution G and N	G	0.85	0.05	0.9399	0.8642	1.0163	0.0458
κ_r	Policy intensity: CIP	B	0.1	0.05	0.2541	0.1958	0.3249	0.0559
κ_n	Policy intensity: CIP	B	0.33	0.05	0.3514	0.2656	0.4511	0.0509
ϕ_M	Calvo signal	B	0.66	0.05	0.5823	0.5209	0.6541	0.0490
ϱ	Policy price index	B	0.6	0.05	0.5914	0.5170	0.6846	0.0502
ψ_S	Interest rate smoothing	B	0.7	0.10	0.5593	0.5013	0.6266	0.0403
ω_π	TR response: inflation	N	1.5	0.10	1.7460	1.6328	1.8686	0.0919
$\omega_{\Delta Y}$	TR response: GDP	N	0.5	0.05	0.4546	0.3770	0.5301	0.0502
ρ^{AN}	AR on food non-grain productivity	B	0.5	0.10	0.8783	0.8221	0.9421	0.0325
ρ^{AG}	AR on food grain productivity	B	0.5	0.10	0.8939	0.8619	0.9354	0.0255
ρ^{AM}	AR on manufacturing productivity	B	0.8	0.10	0.9366	0.8962	0.9734	0.0214
ρ^{F^*}	AR on food price	B	0.75	0.10	0.8955	0.8767	0.9174	0.0117
ρ^{MP}	AR monetary policy	B	0.5	0.05	0.2848	0.2324	0.3388	0.0291
ρ^{i^*}	AR foreign interest rate	B	0.46	0.05	0.5548	0.4789	0.6308	0.0470
ρ^{Ψ_G}	AR LOPG: food grains	B	0.9	0.05	0.9344	0.9208	0.9525	0.0093
ρ^{Ψ_N}	AR LOPG: food non-grains	B	0.9	0.05	0.8021	0.7533	0.8482	0.0345
σ^{AN}	StD non-grains productivity	I	0.1	2.00	0.0205	0.0171	0.0242	0.0020
σ^{AG}	StD food grains productivity	I	0.1	2.00	0.0217	0.0169	0.0260	0.0020
σ^{AM}	StD manufacturing productivity	I	0.1	2.00	0.0164	0.0141	0.0193	0.0015
$\sigma^{P^{F^*}}$	StD food price	I	0.1	2.00	0.0346	0.0307	0.0389	0.0026
σ^{MP}	StD monetary policy	I	0.1	2.00	0.0111	0.0099	0.0125	0.0010
σ^{i^*}	StD foreign interest rate	I	0.1	2.00	0.0101	0.0087	0.0114	0.0008
σ^{Ψ_G}	StD LOPG: food grains	I	0.1	2.00	0.0477	0.0422	0.0526	0.0037
σ^{Ψ_N}	StD LOPG: food non-grains	I	0.1	2.00	0.0436	0.0352	0.0511	0.0048

Note: distributions include Beta (B), Gamma (G), Inverse Gamma (I) and Normal (N). “StD” for standard deviation.

The interest rate smoothing parameter (ψ_S) has a posterior mean of 0.56, suggesting presence of policy inertia. The policy coefficients on the inflation (ω_π) and output deviations (ω_Y) are estimated to be 1.75 and 0.46, respectively. The posterior for the policy price index reaction ($\varrho = 0.59$) is marginally lower than the share of food in aggregate consumption price index ($\varphi = 0.60$). This indicates that the RBI has a clear headline inflation targeting framework, as opposed to a core inflation targeting strategy (see Anand et al., 2015), thereby indicating that food price stability is considered as a RBI policy objective.

The posterior policy intervention κ_n and κ_r is estimated to be 0.35 and 0.25, respectively. The estimated

values of κ_n and κ_r , confirm three findings: (1) food subsidies are an important component of India's economy; (2) food prices are sticky due to fiscal policy; and (3) food subsidies are targeted toward by households type.

We compare the fit of three models where monetary policy targets core inflation; empirical-based inflation target; and an inflation response with a strong inflation response to food prices. Based on the Bayes factor derived from the empirical estimation suggests the empirical-based inflation target rule is more strongly favored by the data (summarized in Table 7 in the Appendix, Section 8.3).

4.4.2 Model Fit

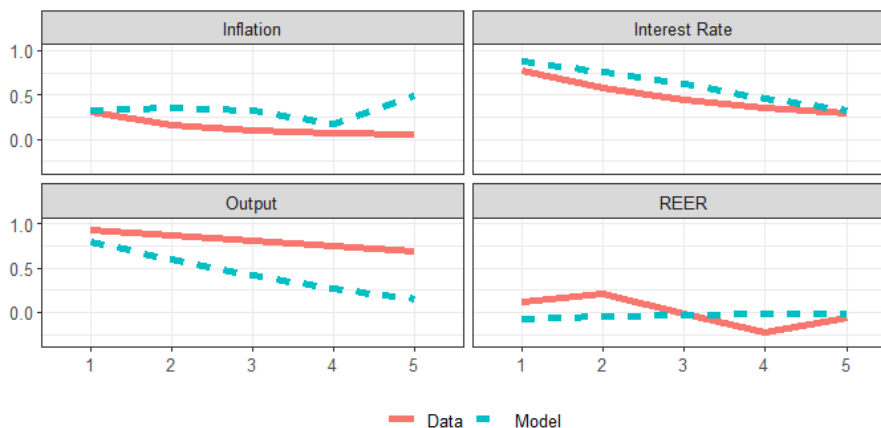
To evaluate model performance, we provide the actual moments (standard deviation) and first-order autocorrelation values compared with the model derived values (see Table 4). The model tends to overpredict the volatility of output growth, inflation, the policy rate and the exchange rate (Table 4). The persistence between the data and estimated model for output, inflation and interest rate are similar at order 1. Figure 3 plots the autocorrelation (up to lag 5). Overall, the model is able to replicate the key features in the data reasonably well.

Table 4: Business Cycle Statistics

	Growth ($\Delta \ln Y_t$)	Inflation (π_t)	Interest rate (R_t)	Exchange rate ($\Delta \ln e_t$)
Standard Deviation				
Data	0.0140	0.0096	0.0041	0.0254
Empirical Model	0.0225	0.0170	0.0128	0.0425
Autocorrelation (order=1)				
Data	0.7930	0.3640	0.8743	0.0180
Empirical Model	0.9178	0.3025	0.7670	-0.0274

Note: "Data" refers to data-based standard deviation values; "Empirical Model" refers to the estimated model standard deviation values. The sample includes 1999:Q1 to 2019:Q4.

Figure 3: Autocorrelation



We report the conditional variance decomposition (Table 5) at different time horizons (quarters 1, 4 and 8). The manufacturing, food grains and food non-grains technology shocks account for the majority of output fluctuations, particularly relating to the former. A shock to the policy rate has a significant effect on inflation, interest rate and the exchange rate. The exchange rate is mainly affected by external factors. The international food price and the deviations from the law of one price jointly exhibit large contributions in explaining variability

in inflation, the exchange rate and the policy rate. In the short-term (quarter 1), the international food price accounts for around 4%, 12% and 15% of domestic inflation, the policy rate and the exchange rate.

Table 5: Conditional Variance Decomposition (in %)

	Prod			World	World	Monet.	G	N
	M	G	N	P^{F*}	i^*	Policy	LOP	LOP
Quarter 1								
Growth ($\Delta \ln Y_t$)	45	42	6	1	2	5	0	0
Inflation (π_t)	1	0	2	4	25	66	1	2
Interest rate (R_t)	1	1	3	12	71	1	5	5
Exchange rate (Δe_t)	8	3	1	15	26	26	20	1
Quarter 4								
Growth ($\Delta \ln Y_t$)	56	31	4	3	1	2	2	0
Inflation (π_t)	1	0	2	5	24	65	2	2
Interest rate (R_t)	1	1	2	19	60	1	8	8
Exchange rate (Δe_t)	7	3	1	15	27	25	20	1
Quarter 8								
Growth ($\Delta \ln Y_t$)	63	25	4	3	1	1	3	0
Inflation (π_t)	1	0	2	5	23	64	2	2
Interest rate (R_t)	2	1	1	23	53	1	11	8
Exchange rate (Δe_t)	7	3	1	16	27	25	20	1

Note: The columns indicate the respective shock. Each shock is treated as an AR(1) process. "M" refers to manufacturing, "G" food grains, "N" food non-grains, " P^{F*} " the world food price, " i^* " the world interest rate, and law of one price (LOP) gap.

5 Model Experiments

We conduct two types of model experiments based on a disturbance of the food price level. The first relates to analyzing the effect of different fiscal intervention models (κ_i) that may be used to circumvent a food price shock. The second analyzes the effect of the monetary policy response type (ρ).

5.1 International Food Price Shock and Fiscal Policy

We conduct four experiments to better understand how fiscal intervention affects the model. The first experiment (Model I.a) relates the estimated model ($\kappa_n = .35$; $\kappa_r = .25$; $\epsilon_g = 5.6$). The second experiment (Model II.a) relates to no subsidy ($\kappa_n = \kappa_r = 0$; $\epsilon_g = 10e5$). The third experiment (Model III.a) is a "strong" demand subsidy response for both household types ($\kappa_n = \kappa_r = 0.5$) and no supply subsidy ($\epsilon_g = 10e5$). The fourth experiment (Model IV.a) is a "strong" supply subsidy ($\epsilon_g = 2.2$) and no demand subsidy ($\kappa_n = \kappa_r = 0$).

The IRFs are provided in Figure 5. All other parameters remain unchanged for both model experiment types, i.e. are based on the posterior mean (see Table 3).

We find that food subsidies modify the propagation of the world food price in terms of duration and size. First, subsidies create a lag between the time of the shock ($t=0$) and the peak food price the household faces. In

the presence of no fiscal intervention (strong demand intervention) as in Model II.a (Model III.a), the peak food price occurs at $t=0$ ($t+4$). Second, subsidies reduce the magnitude of the food price shock; the “strong demand subsidy” (Model III.a) policy implies that the maximum price is circa half of the price without subsidies at the onset of the shock. A “strong supply subsidy” (Model IV.a) is a polar case, which tends to strongly increase food grain price perceived by producers.

The effect of the food price shock on consumption differ by household type. Ricardian total consumption decreases in response to an increase in the interest rate response. Ricardians substitute food for non-food goods. The effect on non-Ricardian income is quite different as their consumption increases. Due to the relative increase in the food price, non-food consumption increases to a larger extent than food consumption. While food labor supply falls, it does not compensate for the food wage increase.²⁹

As non-Ricardians are treated “hand-to-mouth”, this household is unable to smooth consumption, yet the government may intervene and do so for them. In the absence of fiscal intervention, non-Ricardian food consumption drops. However, in the case of fiscal intervention (Models I.a and III.a), a food demand subsidy allows food consumption smoothing.

Despite the low elasticity of substitution between food grain and food non-grain goods, both households substitute food non-grain for food grain.³⁰ Consequently, food non-grain price increases. A strong demand subsidy decreases the need to substitute food-grain and non food grain thus stabilizing not only food grain price, but also food non-grain price. A strong supply policy provides an additional income to farmers and therefore has two effects. First, it smooths food grain consumption by rural households (albeit less than the demand subsidy). Second, the farmer labor supply falls. The latter contributes to increase non-grain price, with negative impact on non-grain consumption by urban households. To put it simply: the supply subsidy does not change the main characteristic of the shock, but the supply subsidy complicates the transmission channels through which the shock spreads throughout the economy.

Absent subsidy policy, food exports increase at the time of the shock, reflecting a relative productivity gain. However, food subsidies reduce labor supply in the food sector: non-Ricardian households can consume a similar amount by spending less. Hence, since they are hand-to-mouth by nature, spending less means working less.

The last graph in Figure 6 shows the effect on public debt associated with fiscal intervention, depending on the degree of food price smoothing (κ_i) and producer support (ϵ_g).

5.2 International Food Price Shock and Monetary Policy

We conduct three additional experiments to illustrate how the choice of monetary policy price indexation (ϱ) influences the model. We consider $\varrho=0$ (Model I.b) relating to core inflation; the empirical model (Model II.b); and “strong” policy reaction scenario (Model III.b).³¹ The corresponding IRFs are shown in Figure 8. All other parameters remain unchanged for both model experiment types, i.e. are based on the posterior mean (see Table 3).

As expected, as ϱ increases, the interest rate response also increases at the time of the shock. Interestingly, even when $\varrho = 0$ there is still a positive increase in the policy rate. This is partly explained by monetary policy reaction to the output gap (which is positive due to an increase in non-food production).

The central bank reaction consists of raising the policy rate, which has a stronger impact on Ricardian consumers than on non-Ricardians. When the policy rate increases in response to an increase in the food price,

²⁹ Assuming productivity remains constant, an international food price shock can put upward pressure on non-Ricardian wages.

³⁰ While Non-Ricardian food non-grain consumption increases, Ricardian food-grain consumption decreases, but by a lower scale than food grain consumption.

³¹ By “strong” reaction, we assume $\varrho=0.8$, which is higher than the value based on the posterior estimate (0.59).

Ricardian consumption falls.

Figure 8 shows that food prices are slightly lower the stronger the monetary policy reaction. The food price faced by non-Ricardian household is lower than the food price faced by Ricardian household due to the subsidy policy, creating a policy-induced price distortion. Two important findings can be drawn from Figure 8. First, in case of a food price shock, monetary policy is relatively inefficient considering food and non-food prices evolve in the same direction. Second, in the case of a strong monetary policy reaction, the increase in food inflation is lessened which also implies a lower fiscal policy reaction. Considering this inter-dependency into account underscores the importance of monetary and fiscal policy coordination.

When monetary policy reacts to core inflation, non-food inflation is the central bank target, and therefore core inflation remains almost flat. When monetary policy incorporates a strong reaction, overall consumer inflation is the central bank target.

5.3 Contribution of Food Subsidies to Price Stability

Monetary policy and food subsidies share a common goal of price stability, *inter alia*. To quantify the contribution that food subsidies has on price stability, we conduct a counterfactual experiment by assigning different fiscal policy values and observe how price volatility changes.³² The results are presented in Figure 10. The x-axis represents the coefficient applied to the food subsidy parameters. The empirical model ($\kappa_n = 0.3078$, $\kappa_r = 0.2256$) corresponds to $x = 1$.³³ The y-axis represents the inflation standard deviation, expressed relative to the empirical model standard deviation. Therefore, any value higher (lower) than 1 corresponds with higher (lower) inflation volatility relative to the empirical model.

We highlight four findings. First, food demand subsidies can reduce inflation volatility, particularly food grain inflation, whereas the effect on food non-grain and non-food prices is limited. The limitation is due to the low elasticity between the two goods. Figures 10 and 11 demonstrate the effect of the food price subsidy in relation to the inflation standard deviation relative the empirical model (shown with a 90% confidence interval corresponding to the Bayesian posterior uncertainty). While a food demand subsidy stabilizes food grain inflation, this effect disappears for food non-grain prices when food subsidies for $x > 1.5$ to the extent that more subsidies maintain non-grain price volatility unchanged.

Second, while price stability is generally considered an objective of monetary policy, we show that food demand subsidies also contribute to price stability. The empirical model (point[1, 1]) compared with the non-food subsidy (point[0, 0]) underscores the stabilizing effect of food subsidies. Hence food-grain (non-grain) inflation volatility would be 39% (10%) higher in the absence of food subsidies, a non-trivial effect on the observed inflation rate. Thus, the interaction of the two policies can be viewed as a shared burden in India and a strategic substitute.

Third, food demand subsidies in our model can stabilize aggregate inflation because of the sizable share of household food expenditures ($\phi = 0.4$). Our results would be valid for a low and middle-income country with presence of a fiscal food price stabilization policy depending on the intensity of the policy.³⁴ Figure 12 demonstrates how the subsidy stabilizes aggregate and food CPI. Consistent with Figure 11, the larger the food subsidy, the lower inflation.³⁵ We estimate that absent food subsidies and assuming Taylor rule parameters

³²All other parameters remain unchanged for model experiment types, i.e. are based on the posterior mean. We simulate a one standard deviation shock on the world food price.

³³Similarly, if for example $x = 2$, then $\kappa_n = 2 \times 0.3078$ and $\kappa_r = 2 \times 0.2256$. In the case of no subsidy, $x = 0$.

³⁴The effect of the subsidy would be less pronounced (if any) for a high-income country, considering food expenditures are lower (see Pourroy et al. (2016).)

³⁵For sake of simplicity, the x-axis in Figure 12 is based on a universal subsidy (i.e., $\kappa_n = \kappa_r$). Assuming a universal subsidy

remain unchanged, following a food price shock, CPI volatility would be 24% higher.

Lastly, we compute the contribution of food subsidy to the interest rate response to a food price shock. Assuming the estimated Taylor rule parameters remain unchanged, according to Figure 13 the interest rate volatility following a world food price shock would be 24% higher in the absence of a food subsidy, a non-negligible amount. Similarly, as shown on Figure 5 (second line, left graph, grey and red lines), the central bank would increase the interest rate twice more 6 basis points) at the time onset of the shock ($t=0$) in the absence of a food demand subsidy. Therefore our results show that absent food demand subsidies, the policy rate would have to react stronger to external shocks in order to achieve the inflation target. Furthermore, our findings run counter to the voluminous literature which tends to side with inflation targeting as the only policy framework to achieve price stability, and that the central bank's role to achieve price stability may be overestimated if subsidies are not considered.

makes the computation of the CPI simpler because the two households face the same prices. Considering subsidies are not universal in the empirical model, we can only express the results in absolute terms.

Figure 4: Food Price Shock and Food Subsidies

- Model I.a - Empirical Model ($\kappa_n = .33; \kappa_r = .25; \epsilon_g = 5.89$)
- - - Model II.a - No Subsidy ($\kappa_n = \kappa_r = 0; \epsilon_g = 100000$)
- · - · Model III.a - Strong Demand Subsidy ($\kappa_n = \kappa_r = 0.5; \epsilon_g = 100000$)
- · - · Model IV.a - Strong Supply Subsidy ($\kappa_n = \kappa_r = 0; \epsilon_g = 2.2$)

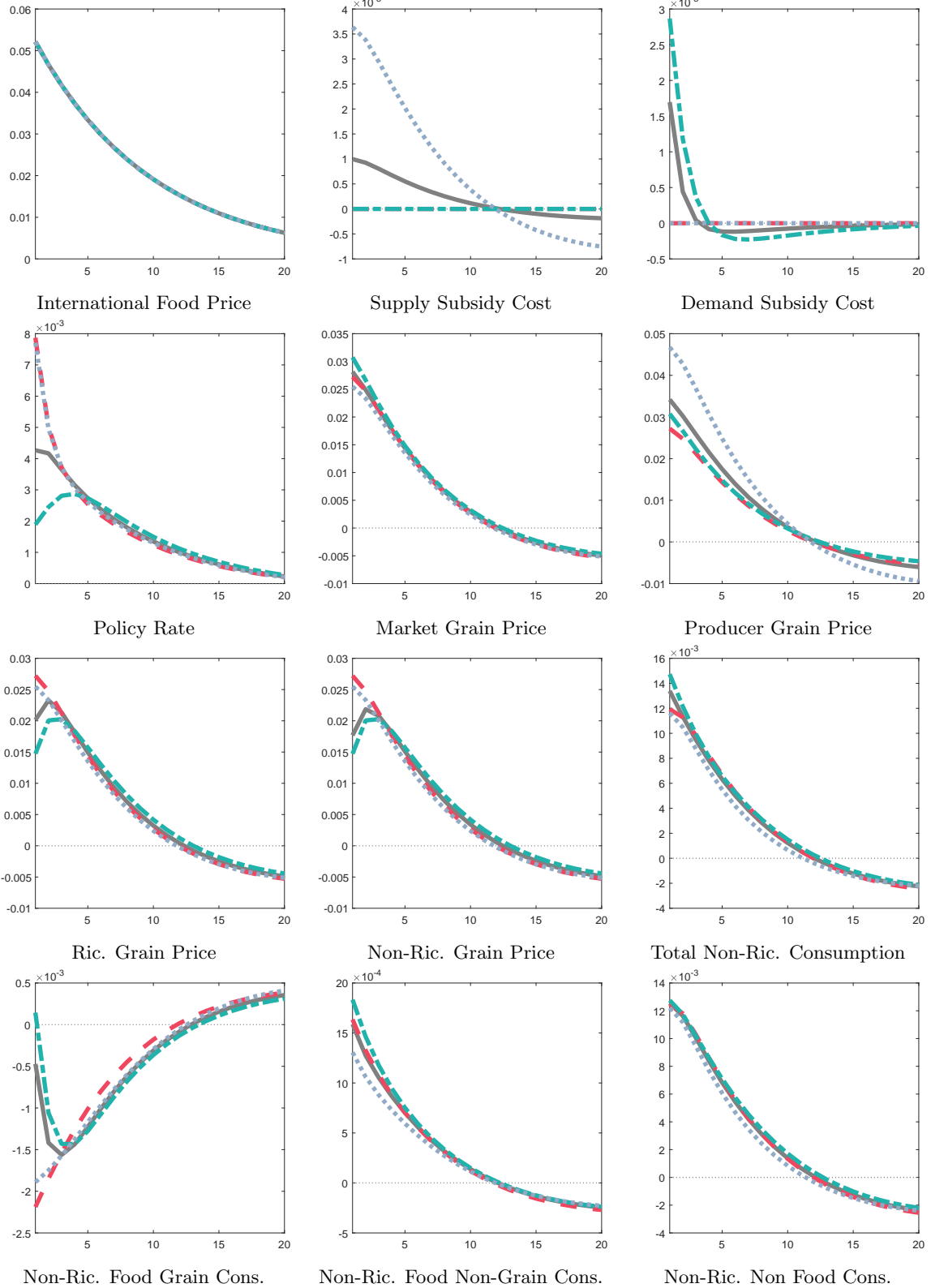


Figure 5: Food Price Shock and Food Subsidies

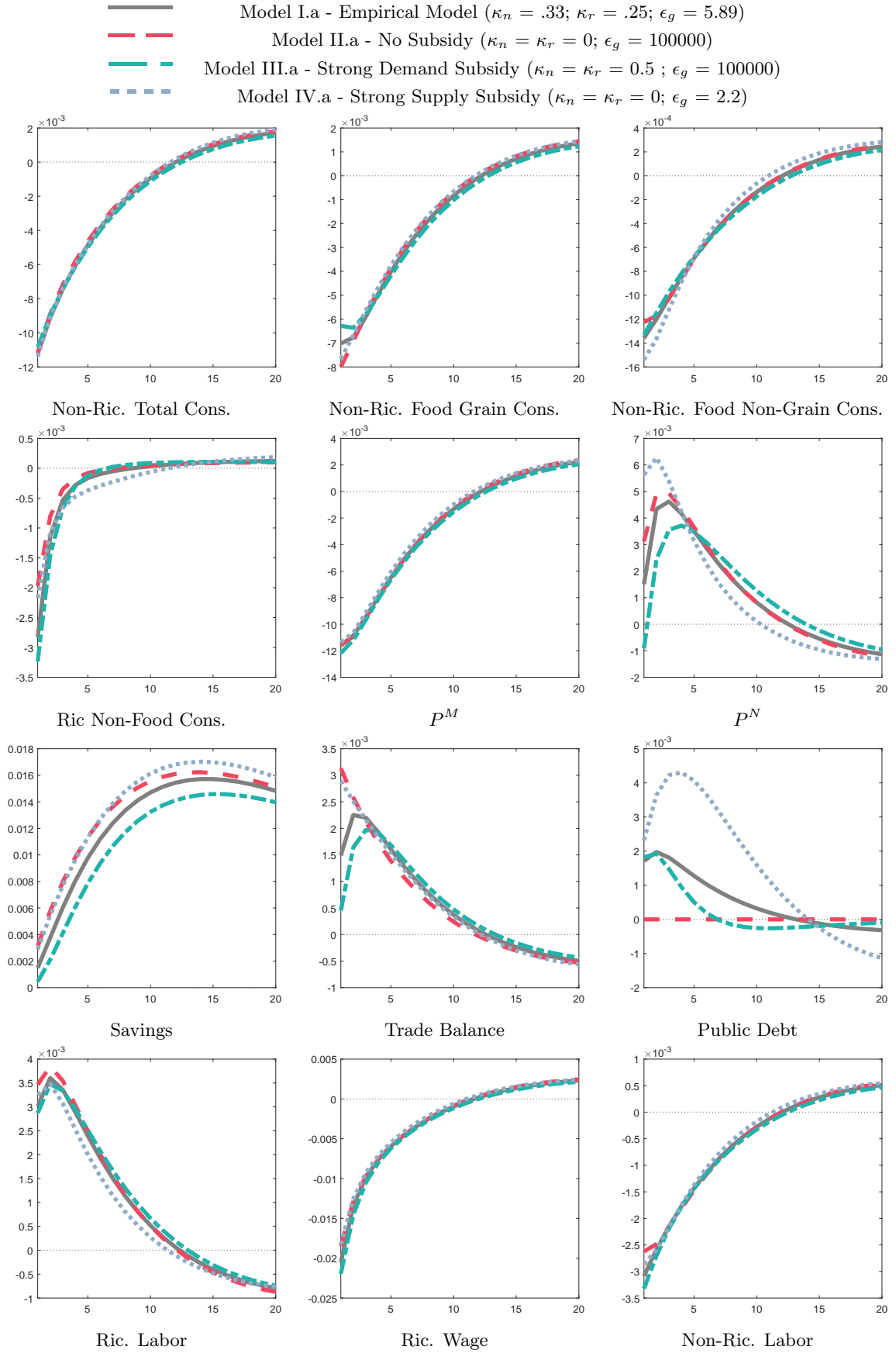


Figure 6: Food Price Shock and Food Subsidies, cont.

- Model I.a - Empirical Model ($\kappa_n = .33; \kappa_r = .25; \epsilon_g = 5.89$)
- - Model II.a - No Subsidy ($\kappa_n = \kappa_r = 0; \epsilon_g = 100000$)
- - Model III.a - Strong Demand Subsidy ($\kappa_n = \kappa_r = 0.5; \epsilon_g = 100000$)
- - Model IV.a - Strong Supply Subsidy ($\kappa_n = \kappa_r = 0; \epsilon_g = 2.2$)

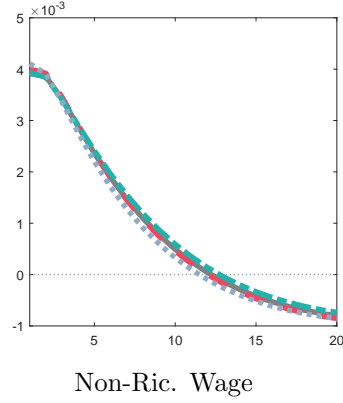


Figure 7: Food Price Shock and Monetary Policy

- Model I.b (Core Inflation) $\rho = 0$
- - Model II.b (Empirical Model) $\rho = 0.58$
- - Model III.b (Strong reaction) $\rho = 0.8$

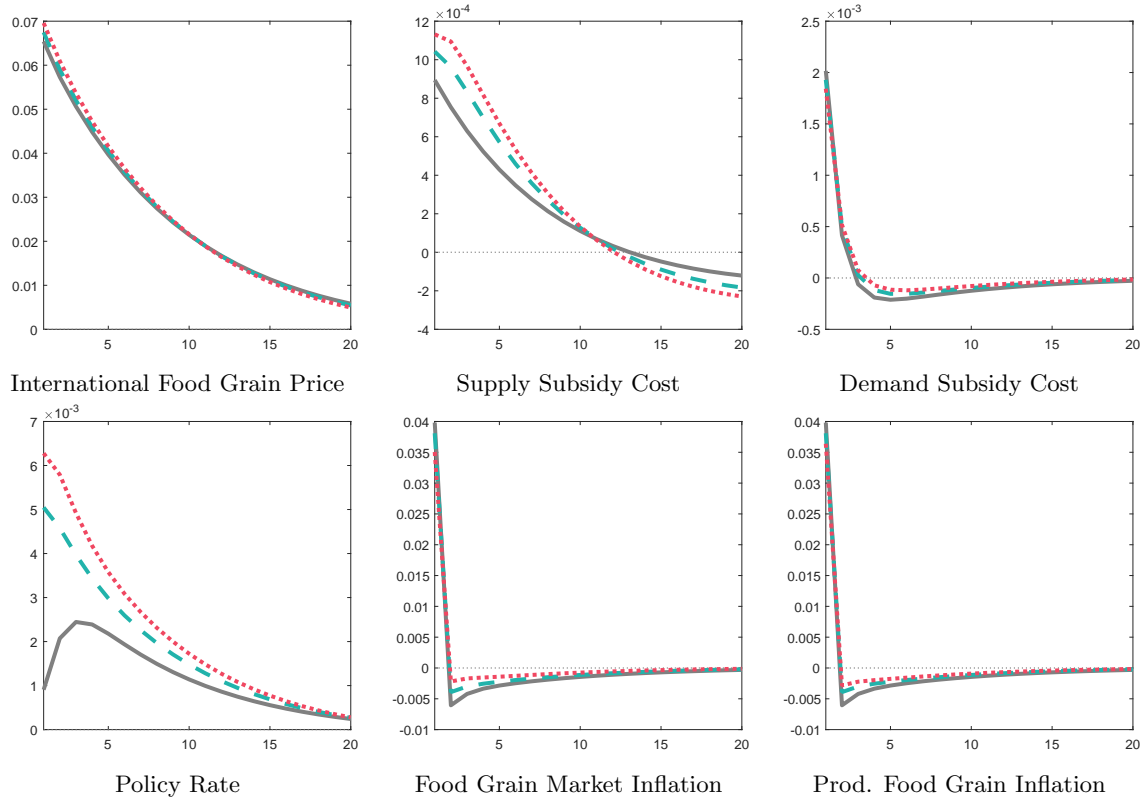


Figure 8: Food Price Shock and Monetary Policy

— Model I.b (Core Inflation) $\varrho = 0$
 - - - Model II.b (Empirical Model) $\varrho = 0.58$
 ···· Model III.b (Strong reaction) $\varrho = 0.8$

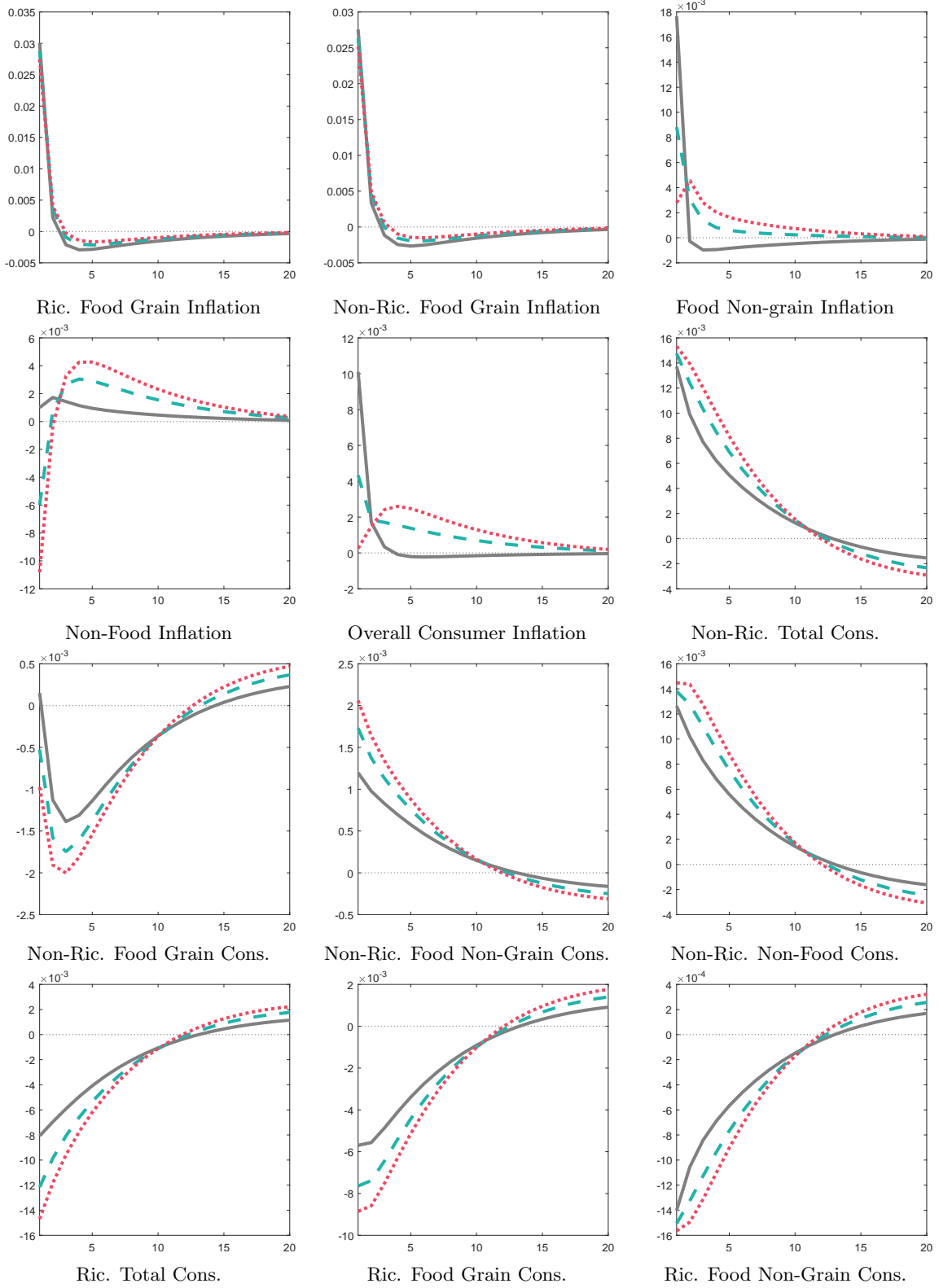


Figure 9: Food Price Shock and Monetary Policy

— Model I.b (Core Inflation) $\varrho = 0$
- - - Model II.b (Empirical Model) $\varrho = 0.58$
- - - Model III.b (Strong reaction) $\varrho = 0.8$

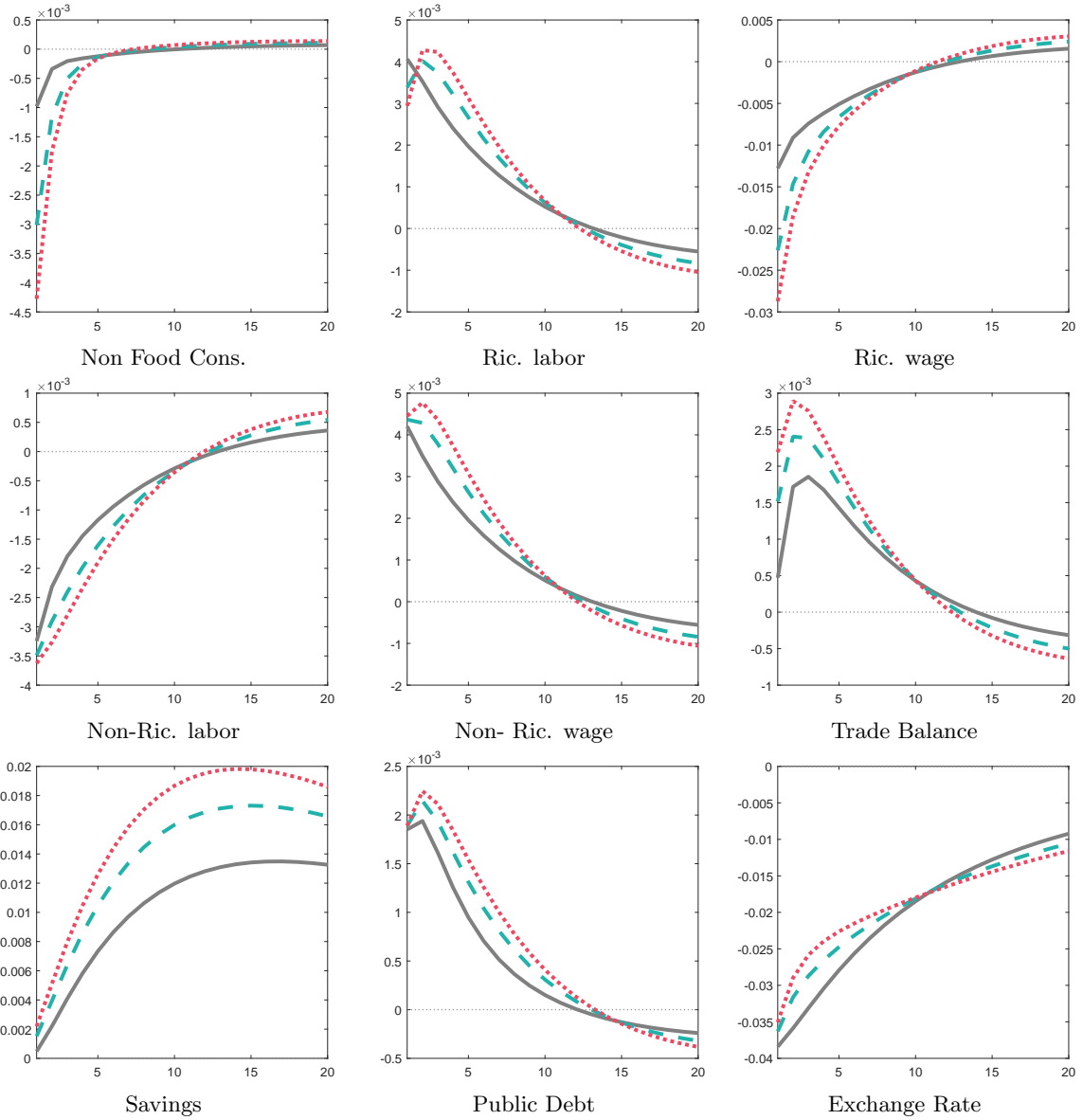


Figure 10: Food Subsidies Impact on Relative Price Volatility

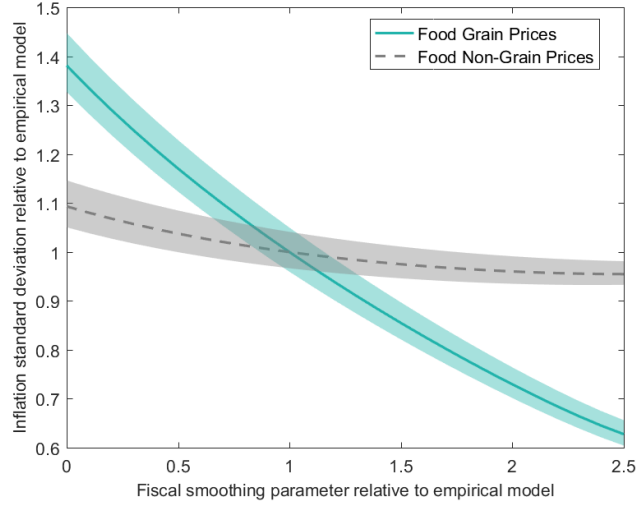


Figure 11: Food Subsidies Impact on Relative Price Volatility

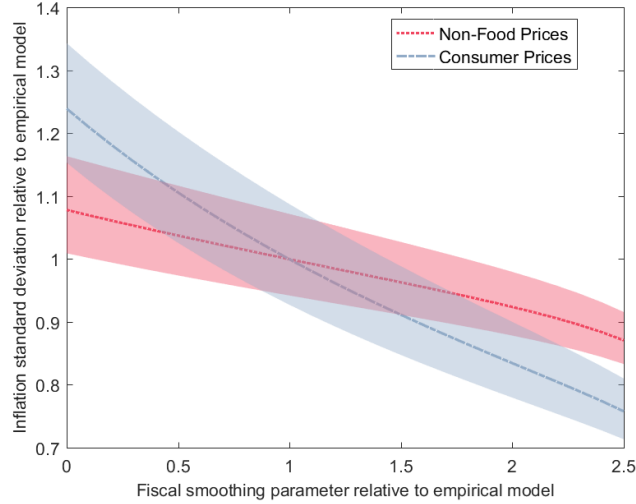


Figure 12: Food Subsidies Impact on Absolute Price Volatility

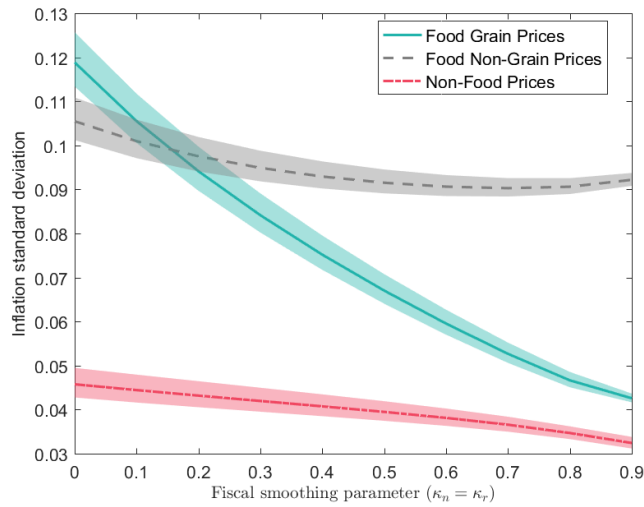


Figure 13: Food Subsidies Impact on Interest Rate Volatility

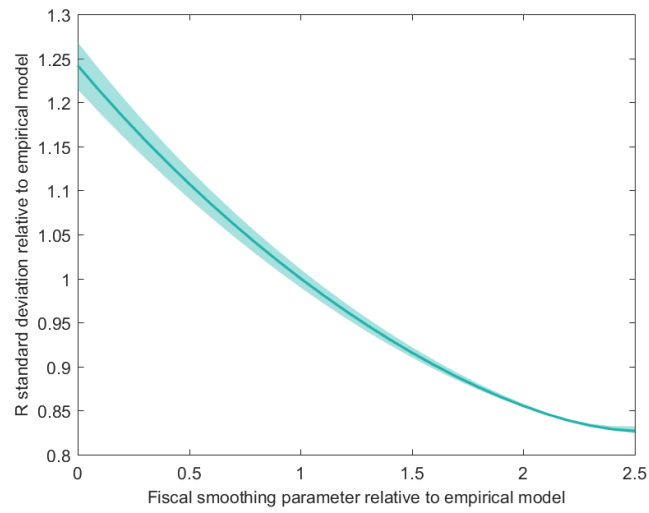
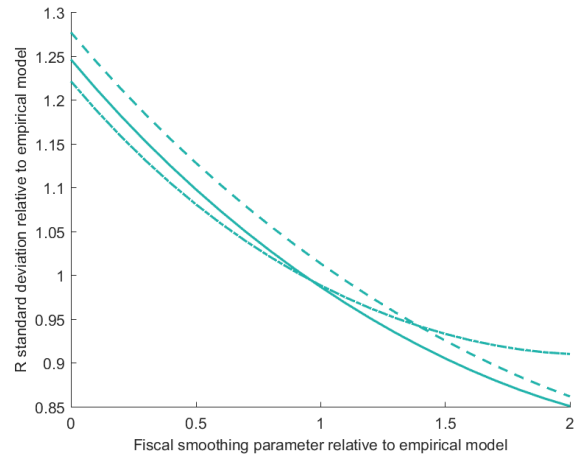
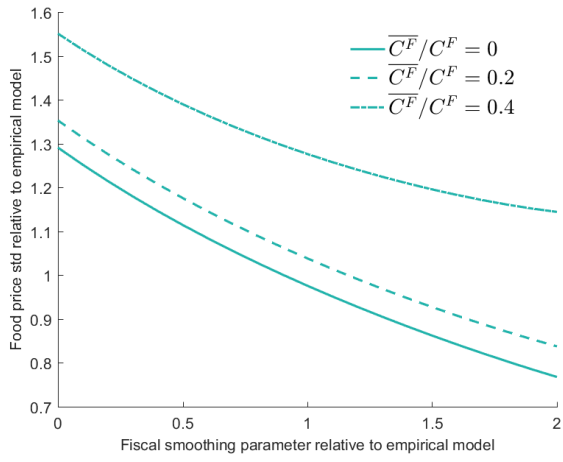
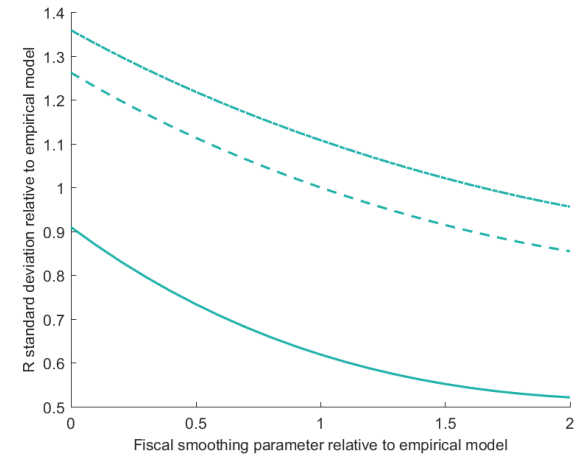
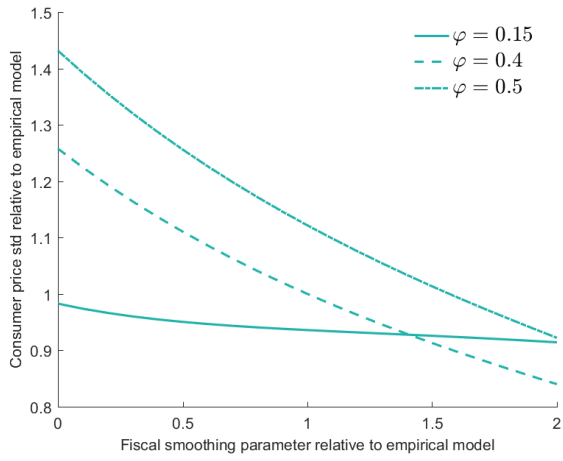


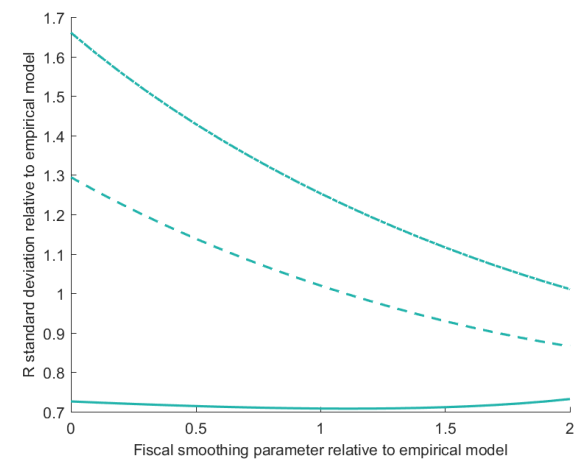
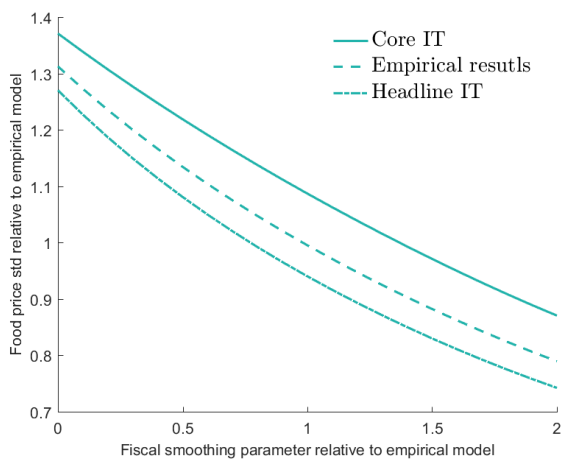
Figure 14: Food Price Intervention and Monetary Policy Interaction



Subsistence Share in Food Consumption



Food in Consumption



Monetary Policy

5.4 Sensitivity analysis

To further explore the conditions where food subsidies and monetary policy are complementary, we analyze the effect of a change in the share of food in consumption and the monetary policy target has on food inflation stabilization and the policy rate in standard deviation units (see Figure 14).

It follows that the higher (lower) the share of food subsistence, the greater (lower) food demand subsidies can contribute to stabilizing inflation. This is due to the fact that subsistence reduces the elasticity of substitution between food and non-food goods, which subsequently results in an increase of food price volatility. Consequently, we find an increase in the policy rate the higher the degree of food subsistence (see the top right graph in Figure 14).

As expected, the higher the share of food expenditures corresponds with a higher standard deviation of the inflation rate and policy rate (see middle-left and middle-right graph in Figure 14).

We find that the standard deviation on food inflation is lower if the RBI targets Headline Inflation, marginally followed by the Empirical Model. Under a Core IT framework, the RBI would not respond to food inflation, which would result in higher food inflation volatility which in turn yields a lower standard deviation of the policy rate.³⁶ A Core IT framework would then result in an absence of complimentary interaction between food price intervention and monetary policy (see the bottom right graph in Figure 14).

Overall, our results show that the interaction between food price intervention and monetary policy are complementary insofar that monetary policy reacts to food inflation for all three of the conditions analyzed.

6 Welfare

We consider the welfare gains (in consumption units) of fiscal policy to smooth food prices by household type. We find it natural to consider the stabilization properties of five policy rules based on a second-order approximation of household welfare. The first rule corresponds with no price subsidy (i.e., $\kappa_i = 0$ and $\eta_G = 10e4$). The second rule relates to supply subsidy only (i.e $\eta_G = 5.6$, the posterior value) and no demand subsidy ($\kappa_i > 0$). The third and fourth rules relate to targeted ($\kappa_n > 0$, $\kappa_r = 0$) and universal intervention ($\kappa_n = \kappa_r > 0$), respectively. All models have the same steady state. The last rule is based on the empirical model (i.e. η_G, κ_n and κ_r at posterior values). Following Faia and Monacelli (2007), we define welfare for household type as follows:

$$\mathcal{W}_{i,t} = E_t \left\{ \sum_{n=0}^{\infty} \beta^n U_i(C_{i,t+n}, N_{i,t+n}) \right\} \Big|_{x_0=x} \quad (42)$$

Following Schmitt-Grohé and Uribe (2004), Adjemian et al. (2011) and Pourroy et al. (2016) the second-order welfare approximation takes the following form :

$$\mathcal{W} = \{E_{-1} \{\mathcal{W}_0\}\}_{y_{-1}=\bar{y}} = \bar{\mathcal{W}} + \frac{1}{2}[g_{\sigma\sigma}] + \frac{1}{2}\mathbb{E}_0 \{[g_{uu}(u_1 \otimes u_1)]\},$$

where $\bar{\mathcal{W}}$ denotes the welfare value at the steady-state, $g_{\sigma\sigma}$ the second derivative of the policy function (g) with respect to the variance in the shocks, and g_{uu} the Hessian of g with respect to shock vector u . We can express welfare in equation 42 recursively:

$$\mathcal{W}_{i,t} = U_i(C_{i,t}, N_{i,t}) + \beta \mathcal{W}_{i,t+1} \quad (43)$$

Aggregate welfare is defined as the weighted sum of household welfare:

$$\mathcal{W}_t = (1 - \lambda)\mathcal{W}_{r,t} + \lambda\mathcal{W}_{n,t} \quad (44)$$

³⁶Headline IT is represented by a Taylor rule where food inflation has the same weight as food goods in the consumption basket. Core IT is represented by a Taylor rule that reacts to non-food goods only.

The results of the welfare evaluation, presented in Table 6, suggest that observed fiscal intervention (Empirical model) does not improve aggregate welfare, albeit we find heterogeneous distributional effects by household type.

We find that food demand subsidies are welfare improving only for credit-constrained households conditional that the subsidies are not universal. The non-Ricardian household type is sensitive to changes in food prices considering food represents a sizeable share of expenditures and their limited financial access to smooth consumption (Ginn and Pourroy, 2019). The government can thus borrow for non-Ricardians, thereby decreasing non-Ricardians' vulnerability to food price shocks. Food supply subsidies increase welfare for non-Ricardian households types (i.e., farmers receive a higher income), but reduces the welfare of the Ricardian household (reflecting higher consumer price).

Consistent with Ginn and Pourroy (2019), we find a polar case for the Ricardian household; any fiscal intervention toward demand reduces welfare for this household.³⁷ Any price intervention results in an increase level of debt and future stream of tax liabilities. The results from Table 6 indicate that the higher the intensity of food demand subsidies corresponds with lower welfare for the Ricardian household.

In our setup, aggregate welfare is negative, which reflects the larger share of Ricardian households in the population. It is worth noting that a policy recommendation is not straight forward. An analysis that gives the same weight to each household would reject a subsidy policy. However, in a Rawlsian perspective, it may be argued that the social planner should give more weight to the constrained household.³⁸ Finally, these results could also be seen in a political economy perspective as reflecting different households ability to control policy makers.

Table 6: Welfare Results

Scenario	Calibration			Relative Welfare		
	κ_n	κ_r	ϵ_g	\mathcal{W}	\mathcal{W}_n	\mathcal{W}_r
No subsidy	0.000	0.000	10e4	0.000	0.000	0.000
Supply Only	0.000	0.000	5.655	0.018	0.114	-0.101
Demand Targeted	0.325	0.000	10e4	-0.003	0.012	-0.017
Demand Universal	0.325	0.325	10e4	-0.072	-0.064	-0.073
Empirical Model	0.325	0.241	5.655	-0.035	0.072	-0.159

Note: all models are based on the posterior mean. Welfare results are presented in percentage changes relative to "No Subsidy".

7 Conclusion

This research offers a novel approach to understand the interaction between fiscal and monetary authorities. To our knowledge, our paper is the first study to estimate the contribution of fiscal subsidies to price stability. Accordingly, we have studied the implications of how fiscal intervention to shield households from food price volatility affects inflation and monetary policy. We estimate a Bayesian DSGE model that incorporates key features of low- and middle-income economies including a food demand price smoothing subsidy, a food

³⁷Note Ben Aïssa and Rebei (2012) and Anand et al. (2015) analyze welfare with respect to an alternative Taylor rule while the novelty of this paper is to focus on the fiscal rule.

³⁸As explained by Fontan et al. (2016): "Rawls's difference principle, which, as standardly understood, requires that institutions ensure inequalities in income and wealth maximize the expectations of the least advantaged." See Rawls (1999).

producer subsidy, incomplete markets with credit-constrained consumers and a high share of households food expenditures. The model is applied using Indian data, considering only food grain received subsidies.

Four key findings emerge from our analysis. First, the empirical evidence suggests that food demand subsidies creates a policy-induced form of price stickiness that is different to, yet operates in parallel with, the classic Calvo price stickiness. This underscores the importance of a coordinated fiscal and monetary policy response considering the joint policy reactions are interdependent with regard to stabilizing food prices.

Second, by evaluating the fit of an alternative Taylor rule, we find the RBI does not overlook food price inflation. This empirical link implies a revealed preference of the actions of RBI in response to developments in both core and headline price indices, consistent with the RBI's mandate to stabilize the CPI.

Third, we find that food demand subsidies contribute to stabilizing inflation, which in turn reduces the monetary reaction to food inflation volatility. We compare the contribution that the food subsidy policy has on the monetary policy objective of price stability, *inter alia*. Following a world food price shock, we find that absent food subsidies, RBI's interest rate increase to a typical food price shock would be 24% larger absent food subsidies. Thus, while monetary and fiscal policy may be viewed as achieving a shared policy goal of price stabilization, hence the interaction of the two policies can be considered a strategic substitute.

Fourth, aggregate welfare diminishes the higher the degree of food demand intervention, albeit there are heterogeneous distributional effects. Welfare is increasing (decreasing) the higher intensity of food demand intervention for the non-Ricardian (Ricardian) household. Non-Ricardians are unable to smooth consumption, unlike the Ricardian household, however the government can do so for them by borrowing vis-à-vis a food price subsidy. This, in addition to the policy influence for food goods (due to survival consumption which does not exist for other goods), makes monetary and fiscal policy complementary in India. While food supply subsidies are not found to contribute to price stability, it appears to be welfare improving for farmers only. With largely heterogeneous distributional welfare effects, the precise setting of food subsidies may better be seen as a political economics object.

The existing literature generally relies on the assumption that monetary policy is solely charged with stabilizing inflation by setting the interest rate (Galì, 2008). In low- and middle-income countries, the transmission channel of monetary policy is weakened by the presence of non-Ricardian households who are unable to smooth consumption (Galì et al., 2004). We contribute to the literature by highlighting that fiscal intervention via food price subsidies can complement monetary policy such that the former creates a policy-induced form of price stabilization to reduce the pass-through of global shocks to domestic prices. Our results therefore show that the standard NK model in which a primary goal of monetary policy is price stability, is not necessarily suitable to an emerging economy such as India. Not only would a standard NK model tend to overestimate the influence of monetary policy, it would also omit the interrelated influence of fiscal policy. The academic literature tends to view inflation targeting as the sole policy framework that is responsible for stabilizing prices. Our results show that fiscal policy based on a food subsidy, a feature that is common in many low- and middle-income countries, contributes to the overall price stability.

Additionally, the results have two policy implications. First, the welfare results challenge a fiscal policy response that does not conform to a policy targeting vulnerable (non-Ricardian) members of society considering a scarcity of fiscal resources, particularly in low- and middle-income economies. Second, a coordinated fiscal and monetary policy response may be optimal, considering the policy reactions are interdependent, under the condition that food price subsidies are properly targeted to households that are unable to smooth consumption.

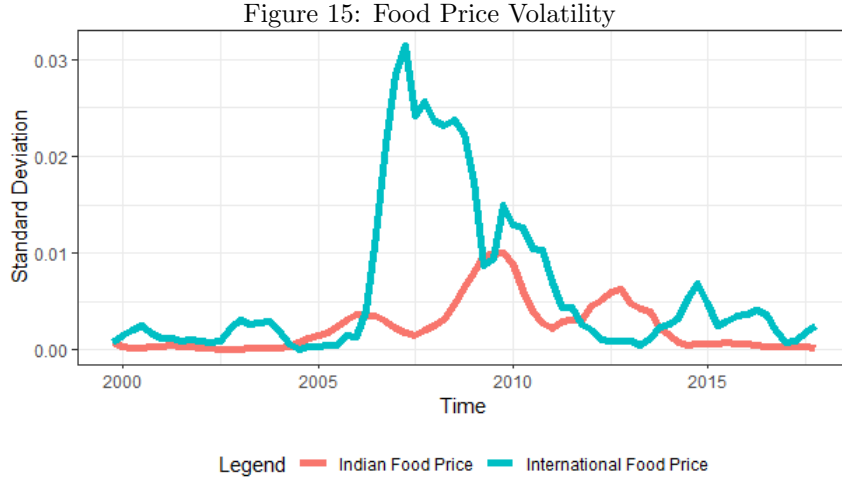
This paper opens perspectives for future research. A range of tools for managing food prices in a country may be considered beyond the scope of this paper. These may include storage design for price stabilization

and counter-cyclical tariffs (pro-cyclical tariffs) when the world price is high (low) for an importer (exporter) (Gouel et al., 2016). Additionally, while we have modelled India, a net-food exporter, the model could also be developed for a net-food importing economy. These questions are left for future research.

8 Appendix

8.1 Food price volatility

Figure 15 demonstrates that since approximately 2007, the international food price (based on FAO data) and domestic food price in India have been relatively more volatile and persistent. Furthermore, while the two prices share a dynamic relationship, the international food price volatility is leading where food price volatility appears to be less severe in India. We observe three main hikes in the international food price volatility occurring in 2007, 2010 and 2013.



Note: volatility is measured as a moving average of the log food price standard deviation. Sources: FAO food price and FRED for the Indian food price (Mnemonic WPOTFD01INQ661N).

8.2 Household Optimization

8.2.1 Ricardian Household Optimization

The Ricardian agent's optimization can be formalized as follows:

$$L_{r,t} = \sum_{t=0}^{\infty} \beta^t \left(\frac{1}{1-\rho} C_{r,t}^{1-\rho} - \frac{\psi}{1+\chi} N_{r,t}^{1+\chi} \right) + \Lambda_{r,t} \left(\frac{(1+i_{t+1})B_t}{\overrightarrow{P_{r,t}}} + \frac{e_t(1+i_{t+1}^*)\Theta(\mathcal{B})B_{t+1}^*}{\overrightarrow{P_{r,t}}} + (1-\tau_t)W_t^M N_{r,t} + (1-\tau_t)\Pi_{r,t}^M + (1+\tau_t)(C_{r,t} + \overline{C_r^G} + \overline{C_r^N}) - \frac{B_t}{\overrightarrow{P_{r,t}}} - \frac{e_t B_t^*}{\overrightarrow{P_{r,t}}} \right) \quad (45)$$

where $\Lambda_{r,t}$ represents the shadow value on the budget constraint. Optimization yields the following first-order conditions:

$$\frac{\partial L_{r,t}}{\partial C_{r,t}} : \Lambda_{r,t} = \frac{C_{r,t}^{-\rho}}{(1+\tau_t)} \quad (46)$$

$$\frac{\partial L_{r,t}}{\partial B_t} : \Lambda_{r,t} = \beta^t E_t \left[\Lambda_{r,t+1} \frac{(1 + i_{t+1})}{\pi_{r,t+1}} \right] \quad (47)$$

$$\frac{\partial L_{r,t}}{\partial B_t^*} : \Lambda_{r,t} = \beta E_t \left[\Lambda_{r,t+1} \frac{(1 + i_{t+1}^*)}{\pi_{r,t+1}} \frac{\Theta(\mathcal{B}) e_{t+1}}{e_t} \right] \quad (48)$$

$$\frac{L_{r,t}}{\partial N_{r,t}} : \psi N_{r,t}^\chi = \Lambda_{r,t} (1 - \tau_t) W_t^M \quad (49)$$

Equations (46) and (49) represent the inter-temporal optimization relating labor supply decisions with the marginal rate of consumption and real wage. The Euler equation is represented by equations (47) and (49) for domestic and foreign bonds.

8.2.2 Non-Ricardian Household Optimization

The non-Ricardian utility maximization yields the normal intra-temporal labor supply optimality condition:

$$\frac{\partial L_{n,t}}{\partial C_{n,t}} : \Lambda_{n,t} = \frac{C_{n,t}^{-\rho}}{(1 + \tau_t)} \quad (50)$$

$$\frac{\partial L_{n,t}}{\partial N_{n,t}} : \psi N_{n,t}^\chi = \frac{(1 - \tau_t) \Lambda_{n,t} W_t}{P_{n,t}} \quad (51)$$

8.3 Posterior Comparison of DSGE Models

We compare the fit of three models where monetary policy targets core inflation (\mathcal{M}_1) as a baseline model; empirical-based (\mathcal{M}_2) inflation target; and an inflation response with a strong inflation response to food prices (\mathcal{M}_3). The criteria is based on the log marginal data density and the corresponding Bayes factor summarized in Table 7. Based on the Bayes factor derived from the empirical estimation suggests the empirical-based inflation target rule (\mathcal{M}_2) is more strongly favored by the data.³⁹ Overall, the empirical evidence suggests that the RBI pursues inflation targeting that responds to both food and non-food price deviations in the short run, consistent with RBI's CPI objective.

Table 7: Model Comparison

Model	Inflation Target Model	$\ln p(Y \mathcal{M}_i)$	Bayes Factor vs. \mathcal{M}_1
\mathcal{M}_1	Core ($\rho = 1$)	1739.78	1
\mathcal{M}_2	Empirical Model ($\rho = 0.59$)	1761.04	$\exp(21.26)$
\mathcal{M}_3	Strong Reaction ($\rho = 0.8$)	1743.62	$\exp(3.84)$

Note: \mathcal{M}_3 is the empirical model used in this paper. The log data density for the three models is computed using the modified harmonic mean (Geweke, 1999).

8.4 Robustness tests

We consider two alternative models. The first includes an alternative Taylor rule where it may be argued that the stability of the exchange rate was also given some weight in the central bank objective function. The second alternative model is based on a fiscal policy that smooths the food grains price, where the food grain price is based on a steady state value. Each model is discussed in turn.

³⁹The Bayes factor is an empirical test to quantify the support of one model relative to an alternative model. According to Kass and Raftery (1995), values between 1-3 implies "not worth more than a bare mention", between 3-20 "positive" evidence, between 20-150 "strong" evidence and greater than 150 "very strong" evidence.

8.4.1 Alternative Taylor rule

The RBI has adopted an inflation targeting framework in 2016. Prior to this period, price stability was already a main objective of monetary policy. However, it may be argued that the stability of the exchange rate was also given some weight in the central bank objective function. See Garcia et al. (2011) among other, on this topic. Consequently, as a robustness test, we consider the following Taylor Rule:

$$\frac{1+r_t}{1+r} = \left(\frac{1+r_{t-1}}{1+r} \right)^{\psi_r} \left[\left((\pi_t^M)^\varrho (\pi_t^F)^{1-\varrho} \right)^{\omega_\pi} (\Delta y_t)^{\omega_y} (\Delta e_t)^{\omega_e} \right]^{1-\psi_r} e^{\varepsilon_t^{MP}} \quad (52)$$

where ψ_r is the degree of interest rate smoothing and ω_π , ω_y and ω_e are the weights given to inflation, the output-gap and exchange rate, respectively.

Consistent with Adolfson et al. (2007), we allow for an interest rate response to a change in the exchange rate (ω_e), with a prior mean of zero set for this parameter (we keep all other priors the same). The estimates of this alternative model are presented in Table 8. We obtain a low posterior mean ($\omega_e = 0.04$), where most of the posteriors are similar to the baseline model (see Table 3).

We provide the welfare results for the alternative Taylor-like rule (see Table 9), which is similar to the baseline model (Table 6).

Lastly, we demonstrate the effect that fiscal price intervention has on the volatility of the interest rate based on the alternative Taylor-like rule (see Figure 16) is similar to the baseline model (Figure 13).

Figure 16: Robustness: Alternative Taylor Rule

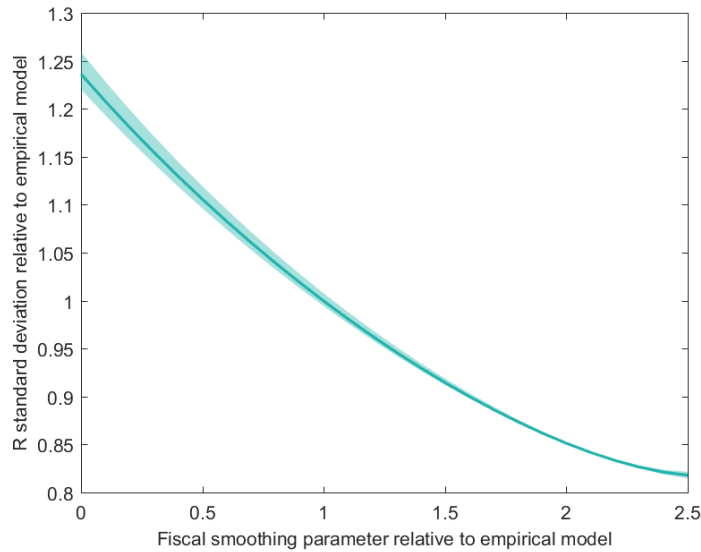


Table 8: Prior and Posterior Distributions via Alternative Taylor Rule

		Density	Prior		Posterior			
			Mean	StD	Mean	90% interval	StD	
$\overline{C^G}$	Food subsistence: grains	I	0.1	2.00	0.0379	0.0231	0.0542	0.0084
$\overline{C^N}$	Food subsistence: non-grains	I	0.1	2.00	0.0217	0.0166	0.0272	0.0032
ρ	Inverse of intert. elasticity of subst.	G	2	0.10	2.0460	1.9029	2.1881	0.0976
χ	Inverse Frisch	G	1	0.10	0.9500	0.7846	1.1019	0.0951
ζ	Bond adjustment costs	I	0.02	2.00	0.0184	0.0085	0.0279	0.0061
ϵ_m	Manufacturing sector market power	I	11	2.00	10.4009	7.5217	12.8153	1.5654
ϵ_g	Food grain government intervention	I	6	2.00	5.5053	3.0522	7.8111	1.1409
θ	Elasticity of substitution F and M	G	0.75	0.05	0.7418	0.6659	0.8125	0.0457
θ_G	Elasticity of substitution G and N	G	0.85	0.05	0.9409	0.8588	1.0053	0.0457
κ_r	Policy intensity: CIP	B	0.1	0.05	0.2586	0.2054	0.3206	0.0573
κ_n	Policy intensity: CIP	B	0.33	0.05	0.3580	0.2905	0.4478	0.0510
ϕ_M	Calvo signal	B	0.66	0.05	0.5834	0.5096	0.6491	0.0496
ϱ	Policy price index	B	0.6	0.05	0.5679	0.4818	0.6676	0.0504
ψ_S	Interest rate smoothing	B	0.7	0.10	0.5523	0.4852	0.6168	0.0403
ω_π	TR response: inflation	N	1.5	0.10	1.7438	1.6181	1.8756	0.0923
$\omega_{\Delta Y}$	TR response: GDP	N	0.5	0.05	0.4444	0.3572	0.5196	0.0502
ω_e	TR response: exchange rate	N	0	0.05	0.0396	- 0.0309	0.1046	0.0471
ρ^{AN}	AR on food non-grain productivity	N	0.5	0.10	0.8751	0.7467	0.9664	0.0326
ρ^{AG}	AR on food grain productivity	B	0.5	0.10	0.8896	0.8424	0.9280	0.0256
ρ^{AM}	AR on manufacturing productivity	B	0.8	0.10	0.9379	0.8983	0.9745	0.0228
ρ^{F^*}	AR on food price	B	0.75	0.10	0.8926	0.8674	0.9144	0.0123
ρ^{MP}	AR monetary policy	B	0.5	0.05	0.2821	0.2392	0.3234	0.0293
ρ^{i^*}	AR foreign interest rate	B	0.46	0.05	0.5277	0.4552	0.6014	0.0465
ρ^{Ψ_G}	AR LOPG: food grains	B	0.9	0.05	0.9291	0.9147	0.9449	0.0096
ρ^{Ψ_N}	AR LOPG: food non-grains	B	0.9	0.05	0.8162	0.7670	0.8722	0.0358
σ^{AN}	StD non-grains productivity	I	0.1	2.00	0.0212	0.0172	0.0254	0.0020
σ^{AG}	StD food grains productivity	I	0.1	2.00	0.0216	0.0188	0.0258	0.0020
σ^{AM}	StD manufacturing productivity	I	0.1	2.00	0.0154	0.0134	0.0174	0.0015
$\sigma^{P^{F^*}}$	StD food price	I	0.1	2.00	0.0343	0.0292	0.0385	0.0026
σ^{MP}	StD monetary policy	I	0.1	2.00	0.0115	0.0098	0.0129	0.0009
σ^{i^*}	StD foreign interest rate	I	0.1	2.00	0.0102	0.0085	0.0118	0.0009
σ^{Ψ_G}	StD LOPG: food grains	I	0.1	2.00	0.0483	0.0419	0.0543	0.0037
σ^{Ψ_N}	StD LOPG: food non-grains	I	0.1	2.00	0.0445	0.0363	0.0529	0.0048

Note: distributions include Beta (B), Gamma (G), Inverse Gamma (I) and Normal (N). “StD” for standard deviation.

8.4.2 Lump Sum Tax Model

In our model, the government budget is funded via combination of debt and tax revenues. Tax revenues are compulsory to rule out a Ponzi scheme. However, taxes may create a distortion in favor of one sector relative to others sectors. There are two solutions to avoid such a distortion: either to tax all flows identically (as in the baseline model) or to incorporate a lump sum tax.

Table 9: Welfare Results for Alternative Taylor Rule

Scenario	Calibration			Relative Welfare		
	κ_n	κ_r	ϵ_g	\mathcal{W}	\mathcal{W}_n	\mathcal{W}_r
No subsidy	0.000	0.000	10e4	0.000	0.000	0.000
Supply Only	0.000	0.000	6.037	0.016	0.109	-0.094
Demand Universal	0.325	0.325	10e4	-0.063	-0.055	-0.066
Demand Targeted	0.325	0.000	10e4	-0.002	0.012	-0.016
Empirical Model	0.325	0.228	6.037	-0.028	0.077	-0.144

Note: all models are based on the posterior mean. Welfare results are presented in percentage changes relative to “No Subsidy”.

In our baseline framework, we present a number of tax instruments based on a single tax rate.⁴⁰ To check the robustness of our model, we compare the baseline results with the alternative model based on a lump-sum tax. The household program takes the following form:

$$L_{r,t} = \sum_{t=0}^{\infty} \beta^t \left(\frac{1}{1-\rho} C_{r,t}^{1-\rho} - \frac{\psi}{1+\chi} N_{r,t}^{1+\chi} \right) + \Lambda_{r,t} \left(\frac{(1+i_{t+1})B_t}{\overrightarrow{P}_{r,t}} + \frac{e_t(1+i_{t+1}^*)\Theta(B)B_{t+1}^*}{\overrightarrow{P}_{r,t}} + W_t^M N_{r,t} + \Pi_{r,t}^M + C_{r,t} + \overrightarrow{C}_r^G + \overrightarrow{C}_r^N + \frac{B_t}{\overrightarrow{P}_{r,t}} - \frac{e_t B_t^*}{\overrightarrow{P}_{r,t}} - tax_t \right) \quad (53)$$

where $\Lambda_{r,t}$ represents the shadow value on the budget constraint.

The government’s inter-temporal budget constraint is funded via domestic (B_t^G) debt and lump-sum taxes (tax_t):

$$B_t^G - (1+i_{t-1})B_{t-1}^G = \overrightarrow{S}_t - tax_t \quad (54)$$

Stability is ensured by defining a relation between tax and debt. With ρ^τ the lump-sum tax elasticity to the government budget, we have: $tax_t = \rho^\tau \frac{B_{t-1}^G}{\overrightarrow{P}_t \overrightarrow{Y}_t}$.

We provide the results corresponding with the Bayesian estimation in Table 10. The results are closely aligned with the baseline model (see Table 4). Consistent with the baseline model, we highlight that the estimated posteriors for the food price intensity for the non-Ricardian (κ_n) is higher than the one for the Ricardian (κ_r), which suggests there is higher food price smoothing for the non-Ricardian household. Furthermore, the estimated posterior for the share of food that enters the Taylor-like rule is estimated to be 0.59 and 0.61 for the baseline and lump-sum model, respectively, which underscores the actions taken by the RBI in response to developments based on food and non-food inflation.

We provide the welfare results for the alternative Tax rule (see Table 11), which is consistent with the baseline model (Table 6) at the exception of supply subsidy.

Lastly, we demonstrate the effect that subsidies have on the volatility of the interest rate based on the alternative Taylor-like rule (see Figure 17) is similar to the baseline model (Figure 13).

⁴⁰The baseline model contains six instruments on taxes on consumption and income (see equation 33).

Table 10: Prior and Posterior Distributions via Lump Sum Tax Model

		Density	Prior		Posterior			
			Mean	StD	Mean	90% interval	StD	
$\overline{C^G}$	Food subsistence: grains	I	0.100	1.0000	0.0339	0.0243	0.0451	0.0063
$\overline{C^N}$	Food subsistence: non-grains	I	0.100	1.0000	0.0232	0.0180	0.0295	0.0035
ρ	Inverse of intert. elasticity of subst.	G	2.000	0.1000	2.0904	1.9564	2.2330	0.0979
χ	Inverse Frisch	G	1.000	0.1000	0.9314	0.7728	1.0667	0.0925
ζ	Bond adjustment costs	I	0.020	1.0000	0.0142	0.0079	0.0210	0.0043
η_M	Manufacturing sector market power	I	11.000	1.0000	11.0558	9.5216	12.4095	0.9429
η_G	Food grain government intervention	I	6.000	1.0000	5.9638	4.6275	7.2946	0.8931
θ	Elasticity of substitution F and M	G	0.750	0.0500	0.6971	0.6460	0.7494	0.0419
θ_G	Elasticity of substitution G and N	G	0.850	0.0500	0.9601	0.8976	1.0349	0.0450
κ_r	Policy intensity: CIP	B	0.150	0.0500	0.2363	0.1866	0.2996	0.0479
κ_n	Policy intensity: CIP	B	0.300	0.0500	0.3177	0.2553	0.3898	0.0513
ϕ_M	Calvo signal	B	0.660	0.0500	0.6129	0.5483	0.6833	0.0444
ϱ	Policy price index	B	0.600	0.0500	0.6147	0.5465	0.6925	0.0430
ψ_S	Interest rate smoothing	B	0.700	0.1000	0.5418	0.4844	0.6005	0.0404
ω_π	TR response: inflation	N	1.500	0.1000	1.7291	1.5716	1.8888	0.0921
$\omega_{\Delta Y}$	TR response: GDP	N	0.500	0.0500	0.4573	0.3707	0.5483	0.0499
ρ^{A^N}	AR on food non-grain productivity	B	0.500	0.1000	0.9131	0.8785	0.9553	0.0252
ρ^{A^G}	AR on food grain productivity	B	0.500	0.1000	0.8838	0.8353	0.9249	0.0263
ρ^{AM}	AR on manufacturing productivity	B	0.800	0.1000	0.9457	0.9187	0.9732	0.0187
ρ^{F^*}	AR on food price	B	0.750	0.1000	0.8892	0.8712	0.9080	0.0118
ρ^{MP}	AR monetary policy	B	0.500	0.0500	0.2689	0.2275	0.3051	0.0271
ρ^{i^*}	AR foreign interest rate	B	0.460	0.0500	0.5808	0.5186	0.6474	0.0449
ρ^{Ψ_G}	AR LOPG food grains	B	0.900	0.0500	0.9239	0.9085	0.9397	0.0101
ρ^{Ψ_N}	AR LOPG: food non-grains	B	0.900	0.0500	0.7820	0.7158	0.8323	0.0352
σ^{AN}	StD non-grains productivity	I	0.100	2.0000	0.0215	0.0179	0.0254	0.0021
σ^{AG}	StD food grains productivity	I	0.100	2.0000	0.0204	0.0174	0.0231	0.0019
σ^{AM}	StD manufacturing productivity	I	0.100	2.0000	0.0144	0.0126	0.0164	0.0013
σ^{F^*}	StD food price	I	0.100	2.0000	0.0337	0.0295	0.0374	0.0026
σ^{MP}	StD monetary policy	I	0.100	2.0000	0.0115	0.0101	0.0130	0.0010
σ^{i^*}	StD foreign interest rate	I	0.100	2.0000	0.0101	0.0089	0.0114	0.0008
σ^{Ψ_G}	StD LPOG: food grains	I	0.100	2.0000	0.0502	0.0427	0.0570	0.0037
σ^{Ψ_N}	StD LPOG: food non-grains	I	0.100	2.0000	0.0385	0.0310	0.0451	0.0048

Note: distributions include Beta (B), Gamma (G), Inverse Gamma (I) and Normal (N). "StD" for standard deviation.

Figure 17: Robustness: Lump Sum Tax Model

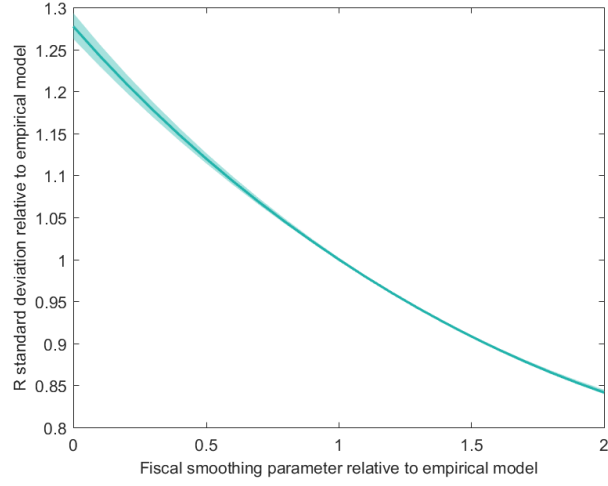


Table 11: Welfare Results for Alternative Tax Model

Scenario	Calibration			Relative Welfare		
	κ_n	κ_r	ϵ_g	\mathcal{W}	\mathcal{W}_n	\mathcal{W}_r
No subsidy	0.000	0.000	10e4	0.000	0.000	0.000
Supply Only	0.000	0.000	6.379	-0.007	-0.217	0.082
Demand Universal	0.332	0.332	10e4	-0.079	-0.073	-0.081
Demand Targeted	0.332	0.000	10e4	-0.006	0.011	-0.023
Empirical Model	0.332	0.23	6.379	-0.064	-0.267	0.019

Note: all models are based on the posterior mean. Welfare results are presented in percentage changes relative to “No Subsidy”.

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Authors' note to the Editor

We thank the Editor and two anonymous referees for the detailed feedback. Building on the useful comments and suggestions, we have made improvements to the paper, including major structural changes and have clarified assumptions and novelties. We also provide detailed answers addressing all questions raised by the Reviewers, which has helped us overall improve the exposition of the paper.

Referee One has encouraged us to better structure the paper, focusing on the main motivations and to clarify assumptions and novelties. This has led to major improvements.

Referee Two has encouraged us to model the food price stabilization policies in India in a more realistic way. We did so by incorporating in this updated framework making a distinction between food demand subsidy (CIP) and food supply subsidy (MSP) and by distinguishing food grain (subsidized) and food non-grain (no subsidy). We worked extensively to add these additional features and believe these features have led to clear improvements of the paper, which is now more realistic and policy oriented. Considering that we have tailored the food subsidy policies (i.e., CIP, MSP) to India, we suggest to slightly modify the title to now include "in India".

Authors' note to Referee 1

We thank the anonymous referee for her/his very detailed report and useful comments and suggestions. We have taken them all into consideration in this revised version of the paper. The subsequent modifications encouraged us to rewrite some sections. We mention the modifications and refer to specific page numbers in this summary. The main comments made by the Referee are listed below (in the ordering of the Referee's report), followed by detailed responses. For convenience, our feedback is highlighted in blue.

This is an interesting paper that fits very well a relatively new strand of literature regarding incorporating food prices into DSGE models. The model is based on the latest state-of-art contributions on this topic. I found the paper well written and with a good potential.

I have a few recommendations for improving it:

1) The authors should better motivate their approach: what is exactly new in their paper relatively to the DSGE models in India and/or to the literature on food prices and DSGE models. **Answer:** we adjusted the introduction which includes further clarification on the scope of the research and a summary to describe novelties in the paper.

In the introduction, we first clarify the scope of the research:

"Accordingly, our research addresses three questions: to what extent does fiscal policy via food subsidies create price stickiness? Does the Reserve Bank of India (RBI) react to food price shocks? Is the interaction between monetary and fiscal policy a strategic complement or substitute? Stripped to its core, these questions relate to price stabilization, a topic central to macroeconomic research. Food price shocks can have potential repercussions on aggregate price stability, where the latter is considered one of, if not the most important, objectives of most central banks around the world, a framework described as inflation targeting. The RBI has adopted an inflation targeting framework in May 2016 with a numerical objective for the CPI growth.⁴¹"

We then clarified the contributions to the literature:

"To our knowledge, there are a couple of novelties in our paper. We develop the first empirical (as opposed to calibrated) DSGE model to estimate the mechanisms through which food price shocks affect monetary and fiscal conditions via Bayesian methods. We incorporate an incomplete pass-through of food prices and fiscal policy food designed to stabilize food prices. Second, our paper is the first research that establishes and quantifies monetary policy and the fiscal food price stabilization responses as a strategic substitute. By developing an empirically-grounded framework, our research goes beyond existing papers by showing that the optimal monetary policy is dependent on the effective subsidy policy and by discussing the distributional effects of these policies. We apply an empirical approach by using the posterior values from the empirical model to conduct welfare evaluation relating to welfare gains of different fiscal policy options. This has two main advantages: this method does not suffer from an "identification problem" (Lubik and Schorfheide, 2007), as in single-equation estimation methods, and we produce counterfactual models to evaluate the interaction of monetary and fiscal policy by simulating what would be the monetary policy reaction to a world food price shock with and without food subsidies to understand the effect of that policy on the other variables."

⁴¹The inflation target is set for a period of five years, and is currently defined as 4% CPI inflation with a band of $\pm 2\%$.

2) The authors should also discuss at length their main assumptions regarding the incorporation of food prices. What we have now is some footnotes. This is a key part of the paper since otherwise the model is rather conventional. **Answer:** we have shifted much of the information from footnotes to the main text. Additionally, we have made major structural changes by decomposing the food sector in food grains and food non-grains (Ghate et al., 2018), where food grains prices are subject to government intervention. We improved the justifications of our assumptions, and introduce a producer subsidy (which we refer to as MSP in the text) which was absent in the previous submission. This has overall improved the readability of the text.

3) Related to 2: the authors might consider alternative assumptions and present the key results. **Answer:** we have decomposed the food sector by grain and non-grain production, where the government intervenes in the grain sector regarding central issue prices (CIP) and minimum issue prices (MSP). Based on this structural improvement, we clarify some important assumptions, which include a producer and consumer subsidy, which we refer to in the text as MSP and CIP, respectively. Also, note that we present a detailed sensitivity analysis in Section 5.4 on parameters related to subsistence share in food consumption; to the share of the agricultural sector in the economy; and to the weight on food in the monetary policy rule. Finally, we present in Appendix 8.4.1 alternative assumptions with respect to the Taylor Rule and Appendix 8.4.2 alternative assumption with respect to the fiscal rule.

4) Related to 2 3: a discussion of theoretical mechanism behind the result would be more than welcome. **Answer:** we greatly improved the mechanisms and the way that they are presented. In Section 2, page 5, we clarify the producer (i.e., MSP) and consumer subsidy (i.e., CIP). We then incorporate these two subsidies into equations (6) and (21). We also add references to our assumptions.

5) The paper should also discuss comparatively the results with those in the literature. **Answer:** we have further consulted the literature and add commentary on numerous areas of the paper, mainly focusing on a proper literature review including a better grounding of the *de facto* supply and demand food subsidy framework; referencing all priors used in the existing literature; and a more focused discussion on the welfare results, not only for demand subsidies which are consistent with Ginn and Pourroy (2019), but also for supply subsidies.

6) How relevant is the food commodity shock for India? Maybe some specific food products are more sensitive to world prices. This should be discussed. **Answer:** In the introduction, we now highlight the importance of a food price shock in India by adding the following text:

”Using India as an empirical study, our paper contributes to a small, albeit burgeoning literature on the conduct of monetary and fiscal policy in the presence of a food price shock. India provides an interesting case in point considering high food inflation has been chronic, particularly from 2006 to 2014, which was one of the highest in emerging economies (Bhattacharya and Sen Gupta, 2018), where the average food inflation during that period was 8.4% (see Figure 1).⁴²”

We include additional references on the food price transmission:

”There is empirical evidence showing that exchange rate fluctuations are partially transmitted to the prices of internationally-indexed goods in the short-run for India. In an RBI report, Misra and Sangita (2014) find evidence for co-movement between international and domestic prices for all food groups from 2002-2008 for the case of India.⁴³ The price transmission has been somewhat muted, considering India’s ban on exports of rice and wheat during 2007–11 (Ganguly and Gulati, 2013). Sahoo et al. (2014) show that the rise in world food prices was much sharper than the rise in Indian

⁴²which is more than double the inflation rate relative to 2000 to 2005 (3.9%).

⁴³The study includes the following groups: edible oil (0.87), food articles (0.80), rice (0.79), wheat (0.80) and sugar (0.79).

food prices, especially in 2007-08 and 2010-11. Mishra and Roy (2012) show the co-movement is stronger when prices are lower, which they conjecture may be that “the government is more unwilling to allow the pass-through when prices are higher” (p. 157). Sahoo et al. (2014) show that since 2013, global prices declined while domestic prices remained slightly elevated where the co-movement between wheat and rice are is limited due to price interventions, whereas domestic palm oil and sugar prices exhibited co-movement with international prices. Saini and Gulati (2016) find that while domestic and international food prices are incomplete in the short-run for the case of India, they do tend to converge in the long-run. Taking this evidence into account, we incorporate deviations from the law of one food price in the short-run between international and domestic prices.⁴⁴ Hence, we incorporate an international linkage between the domestic ($P_t^{\mathbb{X}}$) and foreign sector price ($P_t^{\mathbb{X}^*}$) at the prevailing exchange rate, i.e. $P_t^{\mathbb{X}} = e_t P_t^{\mathbb{X}^*} / \Psi_t^{\mathbb{X}}$ indexed by sector $\mathbb{X} \in \{G, N\}$ relating to the food grains and non-grains, respectively. Variable $\Psi_t^{\mathbb{X}}$ corresponds with deviations in the law of one price (Monacelli, 2005).⁴⁵

⁴⁴Our approach is similar to e.g. Medina and Soto (2005), An and Kang (2011), Poghosyan and Beidas-Strom (2011) and Ginn and Pourroy (2020) who apply a law of one price gap for commodity prices as an AR(1) process.

⁴⁵Note that purchasing price parity holds if $\Psi_t^{\mathbb{X}}$ is equal to unity. Our approach is similar to e.g. Medina and Soto (2005), An and Kang (2011), Poghosyan and Beidas-Strom (2011) and Ginn and Pourroy (2020) who apply a law of one price gap via an AR(1) process.

Authors' note to Referee 2

We thank the anonymous referee for her/his very detailed report and useful comments and suggestions. We have taken them all into consideration in this revised version of the paper. In particular, we have major structural changes to our model that allows us to distinguish between food grain and food non-grain goods, and to better capture the two tier subsidy policy that we now decomposed into a food demand subsidy in the one hand, and a food supply subsidy in the other hand. While really challenging to be implemented, we believe these new features contribute to make the model more realistic. The subsequent modifications encouraged us to rewrite some sections. We mention the modifications and refer to specific page numbers in this summary. The main comments made by the Referee are listed in bold below (in the ordering of the Referee's report), followed by our responses. For convenience, our feedback is highlighted in blue.

Summary:

This paper explores the role of food price subsidy for the macrodynamics and welfare of a low-middle income economy in a Dynamic Stochastic General Equilibrium (DSGE) framework estimated with Indian data using Bayesian method. This study develops a model economy with two types of households, namely, the Ricardian household and the liquidity constraint household who cannot save and borrow. There is a minimum consumption level for food. The government provides subsidies on food prices, such that the liquidity constraint households face a lower level of food prices compared to the Ricardian households. The rest of the model consists of the standard DSGE structure such as non-food sector having Calvo-type sticky price setting mechanism and the central bank aiming at stabilizing aggregate prices and output gap.

Estimating the model using Bayesian technique using Indian data, the authors arrive at the major findings that food subsidy reduces aggregate price volatility and reaction of monetary policy responses. It increases welfare of liquidity constrained household, while reduces that of the Ricardian households leading to a reduction in the aggregate welfare.

Critique:

In order to capture the food subsidy policy of India, the authors of the present study assumes the fiscal authority of the country subsidies consumer food prices to stabilize them. There are a few caveats to this.

First, the food subsidy policy in India is a two tier policy. In the first tier, before the harvest seasons, the Government of India announces the minimum support prices (MSP) of foodgrains for procurement on the basis of the recommendation of the Commission of Agricultural Costs and Prices (CACP) which along with other factors, takes into consideration the cost of various agricultural inputs and the reasonable margin for the farmers for their produce. The government procures those commodities at MSP via the Food Corporation of India (FCI). The difference between the procurement price or Minimum Support Price (MSP) and the producer price is paid as subsidy by the government to FCI. This way, the government stabilises wholesale prices by setting a floor to it. The empirical evidence suggests that continuous rise in MSPs have become the source of high and persistent (sticky) food inflation in India.

In the second tier, the Targeted Public Distribution System (PDS) of India aims at providing food grains to people below the poverty line at highly subsidised prices from the PDS and food grains to people above the poverty line at higher prices. Apart from the food grains, no subsidy is given on the rest of food commodities such as fruits, vegetables, meat, fish and egg and milk. While food constitutes 40% of the share in total Consumer Price Index (CPI) basket, the items subject to subsidies consumer price, i.e., food grains constitute only 12% of the CPI basket. Hence, in order to correctly capture the food subsidy policy in India the authors should do the following modifications of the model:

- They should decompose the food sector into food grains and non-food grains sectors. **Answer:** the food sector is now decomposed into grain and non-grain food goods. According to Anand et al. (2016), the grains sector represents 34.2% of total food consumption. We therefore set the grains sector share of total food consumption to 0.33, which implies $40\% \times 33\% = 13.2\%$ of the total CPI basket, which is consistent with the 12% mentioned above.
- They should introduce Minimum Support Price for foodgrain sector which is always higher than the cost of production providing a positive margin to farmers. The difference between MSP and producer price of foodgrains constitutes a part of the food subsidy given by the government. **Answer:** We now incorporate a MSP, which is represented via Equation 19. The introduction of the MSP provides a positive margin to farmers, which was absent in the previous submission. As opposed to the demand subsidy, MSP does not contribute to price stability. However, we find it to be welfare improving for the farmers households (and only them).

The food subsidy in the present study is modelled following Ginn and Pourroy (2019). They found that food subsidy stabilises food prices, hence food consumption which is welfare enhancing. However the authors of the present study derives a contradictory conclusion that food subsidy is not welfare enhancing. It is not clear what drives these different views on welfare effect of food subsidy, when food subsidy is modelled in the same way in both studies. The authors of the present study needs to clarify this. The utility function is assumed to be uniform across the liquidity constrained households and the Ricardian households. But food subsidy is mainly targeted to the population below the poverty line (BPL). This fraction of the population barely consumes the minimum level of food consumption required for sustainability. Food price subsidy helps them to increase their food consumption above the minimum level. When they are only able to consume minimum level of food, non-food items will not even appear in their utility function. **Answer:** Our welfare analysis concludes that the subsidies are welfare improving for the credit constrained (i.e., non-Ricardian) households, in line with your comments. The previous version of the paper was admittedly confusing because we commented aggregated welfare, which is not improving with the subsidies, due to the share of Ricardian households. In the current version, we also investigate the heterogeneous distributional of the food price subsidy. In the updated version (i.e., including the structural changes making a distinction between food grains and non-grains and adding a CIP and MSP), we achieve results more in line with Ginn and Pourroy (2019) with regard to a demand subsidy (the supply subsidy was absent in Ginn and Pourroy (2019) and the previous version of this paper).

- **Aggregate Welfare:** is negative, which reflects the larger share of Ricardian households in the population. It is worth noting that a policy recommendation is not straight forward. An analysis that gives the same weight to each household would reject a subsidy policy. However, in a Rawlsian perspective, it may be argued that the social planner should give more weight to the constrained household.⁴⁶ Finally, these results could also be seen in a political economy perspective as reflecting different households ability to control policy makers. We also decompose welfare by household type:

Non-Ricardian Welfare: We find that food demand subsidies are welfare improving only for credit-constrained households conditional that the subsidies are not universal. The non-Ricardian household type is sensitive to changes in food prices considering food represents a sizeable share of expenditures and their limited financial access to smooth consumption (Ginn and Pourroy, 2019). The government can thus borrow for non-Ricardians, thereby decreasing non-Ricardians' vulnerability to food price shocks.

⁴⁶As explained by Fontan et al. (2016): "Rawls's difference principle, which, as standardly understood, requires that institutions ensure inequalities in income and wealth maximize the expectations of the least advantaged." See Rawls (1999).

Ricardian Welfare: Consistent with Ginn and Pourroy (2019), we find a polar case for the Ricardian household; any fiscal intervention toward demand reduces welfare for this household. Any price intervention results in an increase level of debt and future stream of tax liabilities. The results from Table 6 indicate that the higher the intensity of food demand subsidies corresponds with lower welfare for the Ricardian household.

- **Welfare impact of Supply Subsidy (MSP):** a new finding from this research is the welfare evaluation in the presence of food supply subsidies (see Table 6). A food supply subsidy (MSP) increases welfare for non-Ricardian households types (i.e., farmers receive a higher income), but reduces the welfare of the Ricardian household (reflecting higher consumer price).

In the light of the above comments, I recommend for major revision of the paper.