

Inflation and Its Impact on Indian Economy

¹ Pradeep, ² Dr. Mukesh Kumar

¹ Lecturer in Commerce, GSSS, Kohla, Haryana, India

² Department of Economics, Maharshi Dayanand University, Haryana, India

Abstract

Inflation is in news all the time, mostly for wrong reasons with common man blaming it for all their hardships. It's perceived to negate the economic development achieved but alongside it has to be noted that Inflation if stays in prescribed limits can actually be useful for the economy driving competition and giving incentive to producers to produce. But if exceeds limits as in hyperinflation it can be deadly leading to crashing of the economy. Thus it's a double edged sword that needs to be controlled to be useful. Motivated by this controversial issue, this paper examined the relationship between inflation and growth, impact of inflation on economic growth and estimates the speed at which inflation beyond a threshold becomes harmful to growth. Another dimension that will be analyzed will be the steps that could be taken to control inflation.

Keywords: inflation, economic growth, price level, hyperinflation

Introduction

India is third largest economy in the world, but its economic growth is very slow. Many factors are responsible for this situation such as poverty, inflation, unemployment, current account deficit, fiscal deficit and depreciation of rupee. Inflation is the important factor that effects the growth of the country. However, there has been substantial debate on whether inflation promotes or harms economic growth. Inflation is an economic phenomenon which has become more important with rising global associations and trade dealings. Inflation affects every aspect of economy as well as the public specially the common man with nowadays even Governments falling due to spiraling price of onions. Also uncontrolled inflation plays havoc with the economy with crunched resources and planning failure. Inflation is a condition, when cost of services coupled with goods rise and the entire economy seems to go haywire. Inflation has never done well to the economy. However, whenever there is expected inflation, governments around the world take appropriate steps to minimize the ill effects of inflation to a certain extent. Inflation and economic growth are parallel lines and can never meet. Inflation reduces the value of money and makes it difficult for the common people. Contrary to its negative effects, a moderate level of inflation characterizes a good economy. An inflation rate of 2 or 3% is beneficial for an economy as it encourages people to buy more and borrow more, because during times of lower inflation, the level of interest rate also remains low. Hence the Government as well as the central bank always strives to achieve a limited level of inflation.

India's track record of inflation is good in the sense that it has never had to face the terror of hyper inflation. 'The highest inflation that India has ever seen in the past two centuries is 53.8%, in the famine year of 1943. Amartya Sen has often written about the havoc wreaked by that inflation in his part of the country. Satyajit Ray captured

the sufferings in Ashani Sanket, a film he made in 1973. Those were terrible times, but nothing like what Germany faced in the early 1920's or what Zimbabwe has to deal with today.

Concept of Inflation

Inflation in its simplest form can be termed as a general increase in prices and fall in the purchasing value of money observed over a period of time which may generate expectations of price rise. Unchecked price rise has its worst impact on consumers. High prices of day-to-day goods make it difficult for consumers to afford even the basic commodities in life. This leaves them with no choice but to ask for higher incomes.

Types of Inflation

Inflation can be of various types as:

1. **Galloping Inflation:** When there is a rapid increase in a very short period it is termed as Runaway Inflation and is characterized by a high rate of inflation which may be anywhere between 80-100% over a decade and even beyond it. Such inflation has an adverse effect and discourages savings.
2. **Hyper Inflation:** It is the most aggressive condition in which there is such a rapid rise in general price level and such a rapid fall in purchasing power & value of money that people lose faith in the currency of the country and government may think in terms of using an alternate hard currency or gold or even switching to barter system. This kind of inflation's best seen in post I world war Germany where in 1923, the general price level may have been nearly 30 billion times than it was 2 years ago and left the German currency in such a pitiable condition where it was more useful as fuel for gas stove than as a currency. In recent years Zimbabwe was a victim of Hyper inflation.

3. **Stagflation:** As name suggests it's a combination of Inflation & Stagnation as in worse possible mixture where slowdown in economy with unemployment is accompanied with Inflation. This situation may arise when inflation has gone for too long which starts affecting not only the demand for services but may also lead to rise in input prices so that not only a fall in demand ensues but also a rise in production costs.
4. **Structural Inflation:** Also termed as Bottleneck Inflation, it is typical of a developing economy like India which is characterized by scarcity of various commodities and services from time to time like scarcity of food and essential commodities due to weather and seasonal conditions, scarcity of capital and machinery, scarcity of land and infrastructural bottlenecks so that all these put together are called Structural Rigidities.
5. **Reflation:** It's a situation where the economy may start recovering from and out of a period of slowdown and recession and can be triggered by wise policy decisions of government.

Objectives of the paper

The objectives of the present study are:-

- To examine the Trend of Inflation in India.
- To identify what are the causes of Inflation and the measures taken by Government to control it.
- To study the Effect of Inflation on Economic Growth of India.
- To find out the tolerance level of Inflation.

Research Methodology

The present study is of analytical and descriptive nature. For this study data and information has been gathered through secondary data sources including Magazines, Newspapers, Economic Survey and Development Reports of various years, Govt. of Haryana document, Research Journals, and articles written by eminent authors.

1. Measurement of inflation

For measurement of inflation various indices can be used but India uses WPI (Wholesale Price Index), and CPI (Consumer Price Index) mainly to measure Inflation.

- a. **WPI (Wholesale Price Index):** This index is the most widely used inflation indicator in India. This is published by the Office of Economic Adviser, Ministry of Commerce and Industry. WPI captures price movements in a most comprehensive way. It is widely used by Government, banks, industry and business circles. Important monetary and fiscal policy changes are linked to WPI movements. It is in use since 1939 and is being published since 1947 regularly. We are well aware that with the changing times, the economies too undergo structural changes. Thus, there is a need for revisiting such indices from time to time and new set of articles / commodities are required to be included based on current economic scenarios. Thus, since 1939, the base year of WPI has been revised on number of occasions. The current series of Wholesale Price Index has 2004-05 as the base year. Latest revision of WPI has been done by shifting base year from 1993-94 to 2004-05 on the

recommendations of the Working Group set up with Prof Abhijit Sen, Member, Planning Commission as Chairman for revision of WPI series Consumer Price Index. This new series with base year 2004-05 has been launched on 14th September, 2010.

Earlier, the concept of wholesale price covered the general idea of capturing all transactions carried out in the domestic market. The weights of the WPI did not correspond to contribution of the goods concerned either to value - added or final use. In order to give this idea a more precise definition, it was decided to define the universe of the wholesale price index as comprising as far as possible all transactions at first point of bulk sale in the domestic market.

- b. **CPI (Consumer Price Index):** The CPI is a statistical estimate constructed using the prices of a sample of representative items whose prices are collected periodically. Sub-indexes are computed for different categories and sub-categories of goods and services, being combined to produce the overall index with weights reflecting their shares in the total of the consumer expenditures covered by the index. It is one of several price indices calculated by most national statistical agencies. The annual percentage change in a CPI is used as a measure of inflation. A CPI can be used to index (i.e., adjust for the effect of inflation) the real value of wages, salaries, pensions, for regulating prices and for deflating monetary magnitudes to show changes in real values

Till January 2012, in India there were only following four CPIs compiled and released on national level. But these four CPIs reflect the effect of price fluctuations of various goods and services consumed by specific segments of population in the country. These indices did not encompass all the segments of the population and thus, did not reflect the true picture of the price behavior in the country as a whole. Therefore, there was a strong need for compiling CPI for entire urban and rural population of the country to measure the inflation in Indian economy based on CPI.

Thus, now Central Statistics Office (CSO) of the Ministry of Statistics and Programmed Implementation has started compiling a new series of:-

- a. CPI for the entire urban population viz CPI (Urban);
- b. CPI for the entire rural population viz CPI (Rural)
- c. Consolidated CPI for Urban + Rural will also be compiled based on above two CPIs

These would reflect the changes in the price level of various goods and services consumed by both Urban and rural population. These new indices are now compiled at State / UT and all India levels.

In the long run, the various PPIs, WPIs and the CPI show a similar rate of inflation. In the short run PPIs often increase before the WPI and CPI. Investors generally follow the CPI more than the PPIs. In India WPI is used instead of CPI. Since April 2014, RBI has decided to

adopt New CPI as a key inflation measure on recommendation of Urijit Patel committee where in new CPI (Combined) is taken as a key measure of inflation.

2. Trend of Inflation in India

The inflation rate in India was recorded at 5.52 percent in

October of 2014. Inflation Rate in India averaged 9.23 Percent from 2012 until 2014, reaching an all time high of 11.16 Percent in November of 2013 and a record low of 5.52 Percent in October of 2014. Inflation Rate in India is reported by the Ministry of Statistics and Programme Implementation (MOSPI), India.



Fig 1

Table 1

Actual	Previous	Highest	Lowest	Dates	Unit	Frequency
5.52	6.46	11.16	5.52	2012 - 2014	Percent	Monthly

Historically, the wholesale price index (WPI) has been the main measure of inflation in India. However, in 2013, the governor of the Reserve Bank of India Raghuram Rajan had announced that the consumer price index is a better measure of inflation.

In India, the most important category in the consumer price index is Food, beverages and tobacco (49.7 percent of total weight). Fuel and light accounts for 9.5 percent; Housing for 9.8 percent; Transport and communication for 7.6 percent; Medical care for 5.7 percent; Clothing,

bedding and footwear for 4.7 percent and education for 3.4 percent.

3. Causes of inflation

Inflation in any economy could be due to two sets of factors as in demand pull factors and cost push factors.

A. Demand Pull factors: If the economy is at or close to full employment then an increase in AD leads to an increase in the price level. As firms reach full capacity, they respond by putting up prices, leading to inflation. Also, near full employment, workers can get higher wages which increases their spending power.

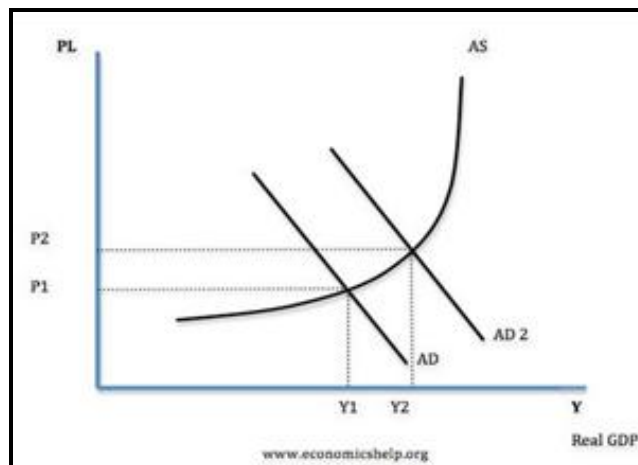


Fig 2

Demand pull factors can be caused by many factors listed below:

1. Rising population
2. Increase in government expenditure particularly non planned expenditure as this is by and large nonproductive and merely generates demand.
3. Rise in FOREX reserves leading to corresponding increase in domestic liquidity
4. Black money
5. Fiscal Deficit and deficit financing
6. Rise in income, wages and salaries
7. Changing consumption patterns by way of shift to high protein items.

B. Cost Push factors: If there is an increase in the costs of firms, then firms will pass this on to consumers. There will be a shift to the left in the AS.

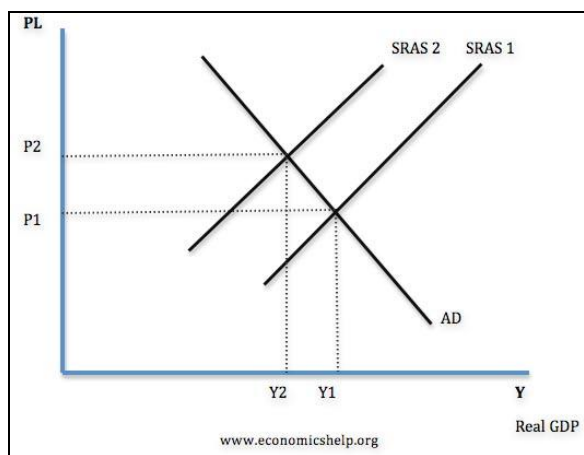


Fig 3

Cost push inflation can be caused by many factors listed below:-

1. Infrastructural bottlenecks and shortages like erratic power supply, inadequate roads and ports, inadequate transportation & warehousing all of which may raise cost of both production and distribution.
2. Rise in administered prices like MSP for major crops, railway freight and rates and other goods and services whose prices are determined arbitrarily.
3. Supply shortages of essential commodities from time to time due to weather, seasonal fluctuations and other such structural rigidities.
4. Rise in international prices of petroleum products, some critical metals and minerals all of which lead to what is called Import Cost Push Inflation as these may be used widely by Indian industry
5. Hoarding, Speculation and Black Marketing
6. Rise in income and wages
7. Fiscal deficit also resulting in high interest rates adding to overall cost burden.
8. Futures trading in some of the essential commodities may marginally add to overall inflationary pressures.

4. Measures to control inflation

Three steps of measures could be taken to control inflation.

A. Monetary Policy: A mix of quantitative and

qualitative tools by the Central Bank (RBI in case of India) could be employed which are referred to as Measures of Credit Control. RBI predominantly used Repo rate in the last 2 years as many as 13 times by raising it to tame inflation. Central banks may also adopt a set of selective measures which in case of country like India may be more effective because as inflationary pressures gather, traders indulge in hoarding and speculation so that RBI may raise margins on loans for such commodities in which traders may indulge in hoarding. However monetary policy may be more effective to curb demand and as such if inflation is more due to supply side problems, monetary policy may have little impact.

B. Fiscal Policy: In the fiscal policy regime, the only measure that may have some impact on controlling inflation has invariably been reduction of various indirect taxes like import duties, excise duties, service tax & even some state level taxes. The government has found itself helpless more often in terms of bringing about any reduction whatsoever in any expenditure particularly non planned expenditure as a large part of it is welfare and community expenditure.

C. Administrative Measures

Various set of administrative measures could be employed by the government as:-

1. Imposing a temporary ban on export of certain essential commodities whose exports may have been creating domestic shortage
2. Resorting to additional imports of essential commodities whose scarcity has been adding to inflationary pressures.
3. Imposing a temporary ban on futures trading in some essential commodities.
4. Strengthening the PDS by mobilizing cooperatives and state run agencies to engage in door to door supply of some essential commodities which can have a moderating effect on open market prices.
5. Invoking the provisions of Essential Commodities Act from time to time so as to ensure distribution of certain essential commodities from surplus to deficit states. Also govt. under this act makes it obligatory for traders to notify stock limits of essential commodities with them on a daily basis which prevents hoarding.
6. Conducting frequent raids on warehouses & godowns of essential commodities to unearth hoarded stuff.
7. Strict enforcement of law to provide severe/summary punishment (without trial) to all those engaged in hoarding & black marketing.
8. Enforcing ESMA (Essential Service Maintenance Act) so as to impose ban on strikes in case of essential services.
9. Strict enforcement of law to penalize those manufacturers of essential inputs who indulge in cartelization practices.

Both monetary & fiscal policies work with lags (time

lapse) so that there may be a wide gap between the time they adopted & time they start having their desired effect. Hence in a country like India more often the Govt. adopts a large no of administrative measures to improve distribution & available supply of essential commodities so as to moderate inflation.

5. Effect of inflation on economic growth

Economic development is the sustained, concerted actions of policy makers and communities that promote the standard of living and economic health of a specific area. Economic development can also be referred to as the quantitative and qualitative changes in the economy. Philips curve is one of the indicators used to study relationship of inflation which general economic society by measuring the correlation between changing rate of unemployment with change in rate of inflation. In economics, the Phillips curve is a historical inverse relationship between rates of unemployment and corresponding rates of inflation that result in an economy. Stated simply, decreased unemployment, (i.e., increased levels of employment) in an economy will correlate with higher rates of inflation.

The effect of Inflation on Economic Growth is manifested in the following cases:

1. **Investment:** If the prices of goods increases and people have to compensate for the increase in price, they usually make use of their savings. In the event when savings are depleted, fund for investment is no longer available. An individual tends to invest, only if savings of an individual is strong and has sufficient money to meet his daily needs.
2. **Interest rates:** Whenever inflation reigns supreme, it is a well known fact that the value of money goes down. This leads to decline in the purchasing power. In the event, when the rate of inflation is high, the interest rates also rise. With increase in both parameters, cost of goods will not remain the same and consequently people will have to sell out more money for the same goods.
3. **Exchange rates:** Inflation and economic growth are affected by exchange rates as well. Exchange rates denote the value of money prevailing in different countries. High rate of inflation causes severe fluctuations in exchange rates. This adversely affects trade (export and import), important business transaction across borders and value of money also changes.
4. **Unemployment:** Growth of a nation depends to a large extent on employment. If rate of inflation is high, unemployment rate is low and vice versa. This theory is propounded by economist William Philips and this gave rise to the Philips Curve.
5. **Stocks:** The returns a company offer, on investment fully depend on the performance of the company. Past performance, current position of the company and future trends decides how much (money, in form of bonus or dividend) is to be returned to the investors. Owing to inflation, several monetary as well as fiscal policies are impacted.

6. Tolerance level of inflation

By tolerance level we mean the comfort level of inflation. In India its about 3-5%. A mild rate of inflation provides necessary incentive for producer to grow and consumer can also absorb it. Beyond it, it starts causing harm to the economy and starts affecting adversely investment and production. In western countries, a policy of Inflation Targeting is adopted. Central banks in each of the developed nations target a rate/ range of inflation [New Zealand was the first country to start this]. They start using all policy tools to ensure inflation doesn't go beyond the Inflation Target as only a mild rate of inflation is sine que non for growth.

In India RBI has adopted a Nominal Anchor CPI method on the recommendation of Urjit Patel committee. By adopting this RBI has shown an interest in keeping inflation in check for attaining maximum growth and prosperity for the country. By this a target of 2-6% inflation is kept. With the minimum level of inflation being at 2% and maximum at 6%. Ideal inflation target is 4% but a band of 2%-6% is kept because in real life, it is not possible to get inflation controlled at exactly 4% level as There might be unanticipated price shocks in food and fuel items, wars, famines and natural disasters. Hence as a room to accommodate such shocks, the target of 2-6% is kept.

7. Conclusion

Government takes different approaches to controlling inflation, depending on what they believe is causing it. In the case of a demand-pull or cost-push situation, a government taking a classical economics approach would do nothing, since this approach is based on the idea that the market will naturally work itself out and get back to normal without government influence. A government taking a Keynesian approach would become involved in the economy by breaking up monopolies, regulating commodity prices, or controlling wage levels. A monetarist government, or one that believes in the quantity theory, would make changes in policy to control the amount of money in an economy.

8. References

1. Government of India, Planning Commission, Twelfth Five Year Plan 2012-17
2. Misra S.K. & Puri V.K. (2013). Indian Economy (31st Revised Edition), Himalaya Publishing
3. House, Mumbai.
4. <http://planningcommission.gov.in>, May 3,2013
5. Economic Suvery
6. The Hindu Survey of Indsutries
7. www.tradingeconomics.com
8. Indian Economy by Sanjeev Verma
9. Indian Economy by Ramesh Singh
10. Indian Economy by Dutt & Sundaram
11. National Sample Survey Organisation
12. Index of Industrial Production