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Inflation and its impact on Indian economy: A Review

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Abstract: Inflation has long been the common man's concern about economy. In regular social discourse and everyday conversation inflation is commonly referred as the synonymous index for the price hike of daily commodities. Though inflation is the most immediate economic parameter to be associated with the hike of price, it has its long and far reaching effects on the society and social concerns. Globally the strong currencies those control the monetary strategies in the international level are less vulnerable to the effects of global inflation than the currencies of the poorer and developing nations. So in respect of obtaining a better view of the effects and influence of inflation on the society we need to take mainly the experience of poor and developing nations which are commonly termed as Third World. This paper analyses the effects of inflation on our country's economy that emerged in the recent past.

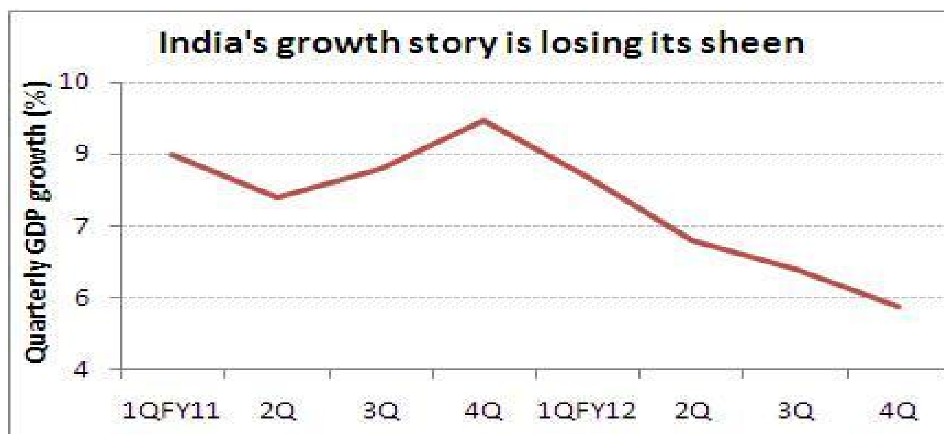
Key words: Inflation, Economy, index, price hike, monetary strategy

1. Introduction

Though inflation has always been a major public concern and always been subject to heated political debate, it is an astonishing truth that since 1950 India has experienced one of the lowest inflation rates in the world in comparison to other developing countries and most of these years it had consistently maintained a steady control over the inflation rate by limiting it to only a single digit figure. The biggest turmoil of inflation came in the year 2008 to 2009 when India experienced both the highest ever rate of inflation in the country and the lowest rate also within span of just few months. Though with proper and efficient fiscal management India has been able to mostly avoid the disastrous global effects of inflation, various sectors of Indian economy suffered from the onslaught of inflation in various periods. Presently Oil and aviation fuel, automobile, banking, steel and cement are some of the key industries that are mostly suffering from the present inflation syndromes. Among other industries IT, FMCG or consumer

durable industries are facing pressurized by the effects of inflation and either increasing the price of their deliverables or initiating severe cost cutting measures.

High inflation has an adverse impact on growth through a variety of channels. First, high inflation leads to uncertainty which impacts investment and growth. As it is, investment decisions are subject to a lot of uncertainties. High and volatile inflation adds further to these uncertainties. Second, high inflation makes banks deposits less attractive and encourages investment in physical assets and speculative activities, which leads to diversion of savings away from formal. The Indian economy finally gave a numerical evidence of the slowdown. During the January-March quarter, the gross domestic product (GDP) is estimated to have grown at a meager rate of 5.3%. This is the lowest growth rate in the last nine years. The Indian economy could grow only by 6.1% in October-December 2011. The growth rate in the previous quarter was much lower compared with the 8.3% growth achieved in the same period of the previous year and 6.9% achieved in the July-September quarter. Incidentally, this has been the slowest growth rate achieved by the Indian economy since the January-March 2009 quarter. Some of the main reasons for the slowing economic growth are high inflation, a declining rupee, messy government finances and policy paralysis among others. It is high times the government gets out of its denial-mode and stops putting the blame on the eurozone crisis and other external factors.



2.Causes of Inflation

Inflation refers to a rise in prices that causes the purchasing power of a nation to fall. Inflation is a normal economic development as long as the annual percentage remains low; once the percentage rises over a pre-determined level, it is considered an inflation crisis. There are many causes for inflation, depending on a number of factors.

Excess printing of money: Inflation can happen when governments print an excess of money to deal with a crisis. As a result, prices end up rising at an extremely high speed to keep up with the currency surplus. This is called the demand-pull, in which prices are forced upwards because of a high demand.

Rise in production costs: Another common cause of inflation is a rise in production costs, which leads to an increase in the price of the final product. For example, if raw materials increase in price, this leads to the cost of production increasing, this in turn leads to the company increasing prices to maintain steady profits. Rising labor costs can also lead to inflation. As workers demand wage increases, companies usually chose to pass on those costs to their customers.

International lending and national debts

Inflation can also be caused by international lending and national debts. As nations borrow money, they have to deal with interests, which in the end cause prices to rise as a way of keeping up with their debts. A deep drop of the exchange rate can also result in inflation, as governments will have to deal with differences in import/export level.

Rise in tax and duties:

Finally, inflation can be caused by federal taxes put on consumer products such as cigarettes or fuel. As the taxes rise, suppliers often pass on the burden to the consumer; the catch, however, is that once prices have increased, they rarely go back, even if the taxes are later reduced. Wars are often cause for inflation, as governments must both recoup the money spent and repay the funds borrowed from the central bank. War often affects everything from international trading to labor costs to product demand, so in the end it always produces a rise in prices.

3. Effects of inflation

As we know Inflation is the increase in the price of general goods and service. Thus, food, commodities and other services become expensive for consumption. Inflation can cause both short-term and long-term damages to the economy; most importantly it causes slowdown in the economy.

 People start consuming or buying less of these goods and services as their income is limited. This leads to slowdown not only in consumption but also production. This is because manufactures will produce fewer goods due to high costs and anticipated lower demand.

 Banks will increase interest rates as inflation increases otherwise real interest rate will be negative. (Real interest = Nominal interest rate – inflation). This makes borrowing costly for both consumers and corporate. Thus people will buy fewer automobiles, houses and other goods. Industries will not borrow money from banks to invest in capacity expansion because borrowing rates are high.

 Higher interest rates lead to slowdown in the economy. This leads to increase in unemployment because companies start focusing on cost cutting and reduces hiring. Remember Jet Airways lay off over 1000 employees to save cost.

 Rising inflation can prompt trade unions to demand higher wages, to keep up with consumer prices. Rising wages in turn can help fuel inflation.

 Inflation affects the productivity of companies. They add inefficiencies in the market, and make it difficult for companies to budget or plan long-term. Inflation can act as a drag on productivity as companies are forced to shift resources away from products and services in order to focus on profit and losses from currency inflation.

4. Objective of the study: The main objective of the study is to analyse the impact of inflation in Indian economy with respect to growth rate from the year 1999 to 2011.

5.Methodology: The study is based on secondary data. Inflation and growth rate is collected from World Economic Outlook for the period of thirteen years from 1999 to 2011.

Tools Used: Karl Pearson's Correlation Coefficient is used to study the relationship between inflation and growth. Trend Analysis is used to predict the trend for 4 years from 2012 to 2015.

Table 1: Karl Pearson's Correlation

Year	Inflation	Growth	x^2	y^2	XY
1999	6.7	7.24	44.89	52.42	48.51
2000	5.4	5.83	29.16	33.99	31.48
2001	3.77	3.89	14.21	15.13	14.67
2002	5.4	4.56	29.16	20.79	24.62
2003	3.8	6.85	14.44	46.92	26.03
2004	4.2	7.59	17.64	57.61	31.88
2005	4.2	9.03	17.64	81.54	37.93
2006	5.3	9.53	28.09	90.82	50.51
2007	6.4	9.99	40.96	99.80	63.94
2008	8.3	6.19	68.89	38.32	51.38
2009	10.9	6.77	118.81	45.83	73.79
2010	11.7	10.09	136.89	101.81	118.05
2011	8.9	7.8	79.21	60.84	69.42

Correlation Coefficient (r) = $\frac{N\sum xy-\sum x\sum y}{\sqrt{N\sum x^2-(\sum x)^2}\,[N\sum y^2-(\sum y)^2]}$

$$\frac{13 \times 642.20 - 84.97 \times 95.36}{\sqrt{13 \times (639.99) - (84.97)^2}\,(13 \times 745.82-(95.36)^2)}$$

r = 0.302

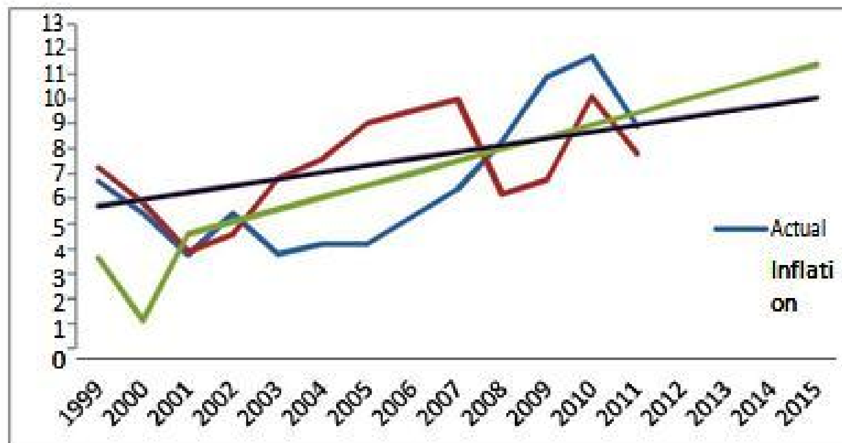
According to the table Correlation between Inflation and growth is 0.302. There are number of factors that affect the economic growth, inflation is one among them. A single factor affects the growth upto 0.3 shows a strong impact of inflation on economy.

Table 2: Inflation and growth in India from the year 1999 to 2011 and

Trend value for Inflation and Growth from 1999 to 2015

Year	Inflation	Inflation Trend	Growth	Growth Trend
1999	6.7	3.63	7.24	5.71
2000	5.4	1.11	5.83	5.98
2001	3.77	4.60	3.89	6.25
2002	5.4	5.08	4.56	6.52
2003	3.8	5.57	6.85	6.79
2004	4.2	6.05	7.59	7.06
2005	4.2	6.54	9.03	7.34
2006	5.3	7.02	9.53	7.61
2007	6.4	7.51	9.99	7.88
2008	8.3	7.99	6.19	8.15
2009	10.9	8.48	6.77	8.42
2010	11.7	8.96	10.09	8.69
2011	8.9	9.44	7.8	8.96
2012		9.93		9.23
2013		10.41		9.50
2014		10.90		9.77
2015		11.38		10.04

From the above table growth is always lesser than the level of inflation in India. Though the trend value for growth is predicted at a growing rate for the years 2012, 2013, 2014 and 2015, trend value for inflation is also predicted to be higher than that of trend value for growth which can be depicted as below by a chart



The chart shows that the inflation and growth is always fluctuating in India. There is no steady growth in Indian economy whereas trend value predicted for both inflation and growth is in straight lines showing a steady growth which could be accepted for growth but has to be curbed for inflation.

6.CONTROLING MEASURES

There are broadly two ways of controlling inflation in an economy:

- Monetary measures and
- Fiscal measures

Monetary Measures

The most important and commonly used method to control inflation is monetary policy of the Central Bank. Most central banks use high interest rates as the traditional way to fight or prevent inflation.

Monetary measures used to control inflation include:

i. Bank rate policy
ii. Cash reserve ratio and
iii. Open market operations.

Bank Rate Policy: This policy is used as the main instrument of monetary control during the period of inflation. When the central bank raises the bank rate, it is said to have adopted a dear money policy. The increase in bank rate increases the cost of borrowing which reduces commercial banks borrowing from the central bank. Consequently, the flow of money from the commercial banks to the public gets reduced. Therefore, inflation is controlled to the extent it is caused by the bank credit.

Cash Reserve Ratio (CRR): To control inflation, the central bank raises the CRR which reduces the

lending capacity of the commercial banks. Consequently, flow of money from commercial banks to public decreases. In the process, it halts the rise in prices to the extent it is caused by banks credits to the public.

Open Market Operations: Open market operations refer to sale and purchase of government securities and bonds by the central bank. To control inflation, central bank sells the government securities to the public through the banks. This result in transfer of a part of bank deposits to central bank account and reduces credit creation capacity of the commercial banks.

Fiscal Measures: Fiscal measures to control inflation include taxation, government expenditure and public borrowings. The government can also take some protectionist measures such as banning the export of essential items like pulses, cereals and oils to support the domestic consumption encourage imports by lowering duties on import items etc.

7.Conclusion

Indeed, compared with a fragile world economy, India on autopilot could chug along quite happily, growing faster than most other countries. The government would carry on acting like a tinkering housekeeper with a habit of pinching loose change. Plenty of new firms would still triumph despite the red tape and most people would be better off. There would be fewer roads and more poor people than there might otherwise be, but the opportunity cost of the forfeited reforms would be a subject confined to scholarly debate. All that would still be a vast improvement on how things once were. Yet it would be a curious finale for the politicians and officials now in power who pushed through the reforms of 1991. Twenty years ago they said the yardstick against which India should be measured was its potential. On that measure, there is much to do.

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