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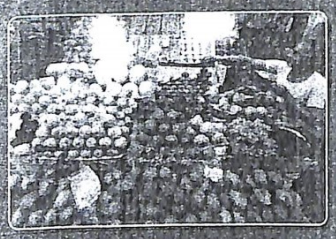
# NATIONAL LEVEL SEMINAR ON



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## PROCEEDING

## NATIONAL LEVEL SEMINAR

## ON

## INFLATIONARY PRESSURE ON INDIAN ECONOMY

29th & 30th Aug 2016

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# The Study of Inflation in Indian Economy

**Prof. Nagpure V.B**
Assistant Professor.
C.D.Jain college of Commerce
Shrirmapur.
Email – vijaynagpure.2011@rediffmail.com

- **Introduction :-**

The relationship between inflation and growth remains a controversial one in both theory and empirical findings. Originating in the Latin American context in the 1950s, the issue has generated an enduring debate between *structuralises* and *monetarists*. The structuralises believe that inflation is essential for economic growth, whereas the monetarists see inflation as detrimental to economic progress. There are two aspects to this debate: (a) the nature of the relationship if one exists and (b) the direction of causality. Friedman (1973: 41) succinctly summarized the inconclusive nature of the relationship between inflation and economic growth as follows: - historically, all possible combinations have occurred: inflation with and without development, no inflation with and without development‖.

The impact of inflation on growth, output and productivity has been one of the main issues examined in macroeconomics. Theoretical models in the money and growth literature analyze the impact of inflation on growth focusing on the effects of inflation on the steady state equilibrium of capital per capita and output (e.g., Orphan ides and Solow, 1990). There are three possible results regarding the impact of inflation on output and growth: i) none; ii) positive; and iii) negative. Sidrauski (1967) established the first result, showing that money is neutral and superneutral1 in an optimal control framework considering real money balances (M/P) in the utility function. Tobin (1965), who assumed money as substitute to capital, established the positive impact of inflation on growth, his result being known as the Tobin effect. The negative impact of inflation on growth, also known as the anti-Tobin effect, is associated mainly with cash in advance models (e.g., Stockman, 1981) which consider money as complementary to capital.

Following Friedman‘s (1977) Nobel Lecture the theoretical and empirical research on the relationship between inflation and output growth has progresses along two distinct lines. The first line of research starting with Friedman‘s hypothesis that higher nominal inflation raises inflation uncertainty, has tended to investigate the relationships among inflation, inflation uncertainty, growth and growth uncertainty. The second line of research has tended to remain within the traditional macroeconomics and investigate the relation between inflation and growth without reference to inflation uncertainty and growth uncertainty. Recently there has been an exploration into the nature of the long-term relationship between inflation and long-term growth in output. Developments in growth theory have resulted in both a theoretical and an empirical analysis of the effect of inflation on long-term growth. Theoretically the relationship has been located in the effect of inflation on investment. If investment is assumed to be the engine of growth in a model of endogenous growth, an adverse impact of inflation on investment implies an inverse relationship between inflation and growth. Empirical evidence supports the hypothesis of an

inverse relationship between inflation and long-term growth. This is in contrast to the short-term experience, where inflation and output growth occur together.

- **Growth and inflation in the Indian Economy:**

The growth rate of GDP in India increased from 3.5 % in the 1970s to 5.5 % in the 1980s. This increase in growth has been attributed to both demand and supply-side factors. But it has been suggested that _Keynesian expansion', or the increase in aggregate demand due to higher government spending and larger fiscal deficits, was primarily responsible for pushing up growth rates (Joshi and Little 1994). In the early 1980s public investment was growing rapidly, but in the second half of the decade it slowed down and government consumption expenditure grew at a much faster pace. The revenue deficit grew, indicating that government consumption was being financed by borrowing, which entailed interest and repayment commitments.

The success of expansionary fiscal policies in raising output growth, at least in the short run, can partly be attributed to the under-utilisation of productive capacity in the preceding years. By the end of the 1980s, when output was above trend levels, fiscal policy continued to be expansionary creating excess demand in the system (Joshi and Little 1994).The reform of the financial sector consists primarily of a reduction in the statutory liquidity ratio and a rationalisation of subsidised credit to priority sectors, relaxation of interest controls and restrictions on firms' access to capital markets, and more autonomy for public sector banks.

- **Monetary policy and growth:**

A noteworthy feature of Indian growth process over the last one and a half decades has been its stability. This is evident from the substantially lower coefficient of variation of real GDP growth during the post-reform period as compared to that during the pre-reform period, that is, before the nineties. It is also important to note that India's growth is driven by domestic consumption, contributing on an average to almost two-thirds of the overall demand, while investment and export demand are also accelerating. As consumption is less volatile component of demand, this has also contributed to reducing the volatility of GDP.

The inflation rate accelerated steadily from an annual average of 1.7% during the 1950s to 6.4 % during the 1960s and further to 9.0 % in the 1970s before easing marginally to 8.0 % in the 1980s. India had generally not experienced runaway inflation. On the other hand, the volatility in the inflation rate, as measured by the coefficient of variation, which was fairly high in the 1950s at 4.4, moved in a narrow band of 0.4–1.0 in the subsequent decades, thus reducing the inflation-risk premium. The pickup in inflation rate from 1970s onwards reflected the impact of a sharp rise in money supply growth and also partly supply shocks from crude oil prices and crop failures. Demand pressures, emanating partly from the widening fiscal imbalances, also contributed to inflationary pressures in the 1980s. The second half of the 1990s was marked by a significant turnaround in the inflation outcome reflecting the improved monetary-fiscal interface.

- **Trends in Inflation in India**

Inflation is a permanent characteristic of Indian economy. After the second world war, there has been a strong inflationary pressure on the economy which has

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remained repressed. During 1949-67 our country inherited a strong inflationary pressure because of the world wars and the devaluation of Indian rupee. The situation was stabilized in the coming years because of the bumper agriculture production in the country. Because of the various measures taken during 1991, in the initial years the inflation rate was high. However, the inflation varied through several highsand lows over these time periods. The average WPI inflation between 1952–53 and 2012–13 was 6.3 per cent. Retail inflation averaged 8.1 per cent between 1970–71 and2012–13. A number of factors have caused high inflation: food inflation and core inflation; entrenched inflation expectations; cost-push shocks; a weaker rupee; and ongoing energy price increases.

| Period | Casual factors |
|---|---|
| April 1956-Feb 1957 | Drought and decline in Agricultural output |
| Aug 1964-Feb1965 | Indo-Pak war ,Drought |
| March 1966 –Nov. 1967 | Drought , Indo-Pak War, First Oil Price Shock, Large Monetary Expan- sion |
| June 1979- Aug 1981 | Global inflation , Second oil Price shock, Drought |
| Nov. 1990 –July 1992 | Large fiscal deficit , Drought ,In- crease in the prices of administered items and excise duties |
| March 1994 – May1995 | Substantial hike in administered prices |
| June 2008 – Oct 2008 | High global commodity prices, Large credit expansion |
| March 2010-Jul 2010 | Drought ,Administered prices increased |
| Jan 2011- Jan 2015 | Rising prices of primary articles and fuel |

India had not faced double digit inflation in food during the last several years despite serious drought and decline in food outputting some years. The scene of food inflation has turned quite different after 2008. Factors driving food inflation are ; shift in dietary habits towards protein foods, pressure stemming from inclusive growth policies ,large increase in minimum support prices of food grains ,supply-side constraints ,and rising cost of production. Food inflationism spreading to other areas resulting in overall inflation. On an average, from December 2009 to August 2013, the egg, meat, and fish group has recorded the highest inflation rate of 17.16%, followed by milk (11.78%), fruits and vegetables (10.84%), food grains (9.11%), condiments and spices (7.08%), and tea and coffee (6.14%). The average inflation rate of food products (in the manufactured products group) also ruled highat7.14%. Such a trend has serious adverse welfare effects when in the same period, food inflation at global level has been low /negative. There is serious concern regarding stickiness of food prices.In the past four decades, WPI and CPI inflation have risen steadily in India. CPI inflation in 2012 was 10.9% compared to 3.2% in 1971-72. Similarly, WPI inflation rose to7.4% from 5.6% over the same period. Another change has been the divergence between WPI and CPIinflationfrom1994onwards.WPI inflation registered a sharp decline while CPI inflation rose sharply during 2009-10. Specifically, CPI increased from 10.83 in 2008 to 12.11% in 2009 and in contrast WPI fell from 8% to 3.8% during the same period. The sharp surge in consumer prices was duet adverse global and domestic factors with high

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food and fuel prices dominating overall CPI . This rise in wholesale food prices was not captured by WPI as the weight age for food articles was just 14.3% in this index . On the other hand, the weight age for food was 57% in CPI items which captured the impact of food prices better. Crude oil prices certainly helped inflation move down in 2014 .Central Bank had adopted the new CPI as the key measure of inflation as it reflects cost of living on the recommendations of Urjit Patel panel. The CSO has revised the base year from 2010 to 2012 .CPI inflation in terms of the revised series stood at 5.1 percent in January, 2015. Table 1shows the annual and average inflation rate on CPI bases. The consumer inflation rose to 5.32 % in urban areasand4.71percent in rural areas during Dec 2014. While growth continues to weaken, WPI and CPI inflation persists at significantly higher level. Stagflation-type environment is emerging.

| Year | Annual(CPI) | Average Rate | Year | Annual | Average Rate |
|---|---|---|---|---|---|
| 2015 | - | 6.276 | 2005 | 5.57 | 5.79 |
| 2014 | 5.86 | 6.58 | 2004 | 3.78 | 4.25 |
| 2013 | 9.13 | 6.37 | 2003 | 3.72 | 3.77 |
| 2012 | 11.17 | 10.92 | 2002 | 3.20 | 3.81 |
| 2011 | 6.49 | 9.30 | 2001 | 5.16 | 4.31 |
| 2010 | 9.47 | 8.87 | 1999 | 0.47 | 3.77 |
| 2009 | 14.97 | 12.11 | 1998 | 15.32 | 4.02 |
| 2008 | 9.70 | 10.83 | 1997 | 6.29 | 4.84 |
| 2007 | 5.51 | 8.32 | 1996 | 10.41 | 13.17 |
| 2006 | 6.53 | 6.39 | 1995 | 9.69 | 7.25 |

*Table 1 Source: www.rbi.org.in/scripts/publicationsview.aspx?id=13840*

- **Control of Inflation in India**

The handling of India's inflation challenge consisted of careful combination of effort on the part of the RBI and government, including the Ministry of Finance and several other ministries. There was action on several fronts— monetary, fiscal, and supply chain management. The Bank Rate stands at 6.50 per cent. The cash reserve ratio (CRR) of scheduled banks has been retained at 4.00per cent of their net demand and time liabilities (NDTL).It has been decided to reduce the statutory liquidity ratio(SLR) of scheduled commercial banks to 21.50 per cent .Government continued to curb fiscal and revenue deficits. Govt has imposed export restrictions on certain farm commodities. However monetary policy has very limited role to counter inflation in food commodities which is essentially caused by supply side constraints and the underlying deficiencies. fuel prices dominating overall CPI. This rise in wholesale food prices was not captured by WPI as the weight age for food articles was just 14.3% in this index. On the other hand, the weight age for food was 57% in CPI items which captured the impact of food prices better. Crude oil prices certainly helped inflation move down in 2014. Central Bank had adopted the new CPI as the key measure of inflation as it reflects cost of living on the recommendations of Urjit Patel panel. The CSO has revised the base year from 2010 to 2012. CPI inflation in terms of the re- vied series

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- **Conclusion : -**

This study has been motivated by the recent developments in the literature on the relationship between inflation and growth and the apparent contradictory evidence provided for the developed and developing economies. In this paper, the co integration and error correction models have used to empirically examine long-run and short-run dynamics of the inflation-economic growth relationship in India using annual data. The main objective was to examine whether a relationship exists between economic growth and inflation and, if so, its nature. The interesting results found in this exercise is that the, inflation and economic growth are negatively related. Second, the sensitivity of inflation to changes in growth rates is larger than that of growth to changes in inflation rates. These findings have important policy implications.

In this study, the inflation-growth nexus in India has been systematically analyzed. The important conclusion is that any increase in inflation from the previous period negatively affects growth. Therefore, unlike in the case of the EMU area, the most desired policy for India is the one in which there is always a downward pressure on inflation, without having to worry about what is the threshold level. Further, the policymakers should note that any increase in inflation from the previous period at any level has negative effect on economic growth. However, the fact that the common people and the decision makers do not like inflation has enormous effects on the consumption pattern, which in turn affects the output demanded.

Macroeconomic stability and the necessary infrastructure are among the preconditions for sustained growth. Among the ways inflation can affect growth, an important avenue is the effect of inflation on investment. Low or moderate inflation is an indicator of macroeconomic stability and creates an environment conducive for investment. A review of the existing cross-country international evidence, as well as evidence from Asia, indicates a negative relationship between inflation and long-term growth. Countries with low or moderate rates of inflation have higher growth rates over the long-term compared with countries with high inflation rates. However, low inflation does not constitute a sufficient condition for growth.

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