Positive & Negative aspects of inflation in India

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Abstract

Inflation remains a recurrent problem in some transition countries. How this may affect their growth prospects is of interest, given the widespread goal of achieving high economic growth. There is some robust evidence that inflation has been found to have a negative effect on growth within developed countries. Inflation can also be described as a decline in the real value of money—a loss of purchasing power in the medium of exchange which is also the monetary unit of account and the monetary store of wealth. When the general price level rises, each unit of currency buys fewer goods and services. A chief measure of price inflation is the inflation rate, which is the percentage change in a price index over time. There are various factors that contribute to this rise in prices. Some are natural factors like unfavourable weather conditions which affect the food production and lead to the shortage of commodities in the market. With more money chasing fewer goods, the prices take to the wings. This study attempts to outline the trends of inflation and effect of inflation on growth and impact of the general price level in the Indian economy. The purpose of this paper is to study the magnitude and trend of inflation in food & non food items. Further more, the paper aims to suggest policy measures towards the solution of problem of inflation in India.

Key Words: Inflation Measurement, price index, monetary policy and Inflation

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Introduction

There is hardly a thing or commodity whose price has not gone up in the recent times. Rise in prices has become a common feature in India. Inflation refers to a general rise in prices measured against a standard level of purchasing power. Previously the term was used to refer to an increase in the money supply, which is now referred to as expansionary monetary policy or monetary inflation. Inflation is measured by comparing two sets of goods at two points in time, and computing the increase in cost not reflected by an increase in quality. There are, therefore, many measures of inflation depending on the specific circumstances. The most well known are the CPI which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy. The prevailing view in mainstream economics is that inflation is caused by the interaction of the supply of money with output and interest rates. Mainstream economist views can be broadly divided into two camps: the "monetarists" who believe that monetary effects dominate all others in setting the rate of inflation, and the "Keynesians" who believe that the interaction of money, interest and output dominate over other effects. Other theories, such as those of the Austrian school of economics, believe that an inflation of overall prices is a result from an increase in the supply of money by central banking authorities. Related concepts include: deflation, a general falling level of prices; disinflation, the reduction of the rate of inflation; hyper-inflation, an out-of-control inflationary spiral; stagflation, a combination of inflation and poor economic growth; and reflation, which is an attempt to raise prices to counteract deflationary pressures. Price stability is a major objective of macroeconomic policy and improved forecasts make for better understanding and policy. A high and sustained economic growth in conjunction with low inflation is the central objective of macroeconomic policy. Low and stable inflation along with sustainable budget deficit, realistic exchange rate, and appropriate real interest rates are among the indicators of a stable macroeconomic environment. Thus, as an indicator of stable macroeconomic environment, the inflation rate assumes critical importance. The causes of inflation, and the method by which inflation is transmitted through the economic system, are two of the important recurring theoretical issues in modern economics According to the FAO, international food prices rose by 37% in March 2011, reflecting both higher demand and weather related supply disruptions. The increase in global food prices was led by the prices of cereals (60%), edible oils (49%) and sugar (41%). Large supply shocks emerge as an important source of inflation in EMEs. As pointed out by Fischer (1981), supply shocks may have major macroeconomic implications for EMEs like India. Notwithstanding the nature of the shock - i.e., temporary versus permanent - the size of the overall price impact hinges on the importance of the sector in question for overall consumer inflation. For instance, food sector has a relatively larger share in the CPI compared to advanced economies. Consequently, a marked increase in prices of agricultural commodities not only raise short-run inflation owing to their high weight in CPI, but also can engender a sustained increase in the inflation rate if it raises expectations.

Causes of Inflation

This is not the first time that the world economy has witnessed such sharp increase in the food prices and other services. Inflation can cause both short-term and long-term damages to the economy; most importantly it causes slow down in the economy. But, rather than this simplistic approach, it is likely that there are many other factors at work. So, it is important to study all these factors before to suggest policy measures.

- **Exogenous Factors:-**
  Exogenous factors such as rise in global commodity prices, drought condition in the country have been significant contributors to the inflationary trend. International Food price inflation flared to 23% in 2008 & after coming down to -17% in 2009 in 2010 was up again to 7.2%. The deficient South-West monsoon during 2009, with a short fall of 23% in precipitation, resulted in drought in several states.

- **Structural Factors:-**
  However, it is increasingly being viewed by researchers & policy makers that there are structural elements embedded in the food inflation being witnessed in India.

  - **Decelerating Production:-:**
    Annual Growth in food grain (cereals & pulses) production in the country has been decelerating from 2.8% in the 1980s to 1.6% in the 1990s and further to 1.2% 2000 onwards.

  - **Growing population & per capita income:-**
    India's population is rising annually by 1.5% (2004-05 to 2009-10) and per capita income is showing robust growth of 6.9%(2004-05 to 2009-10) and the fact that the present level of average nutrition and food intake levels are way below prescribed levels has led to an accelerated growth in food demand.

  - **Changing dietary patterns:-**
    With increase in income levels, the consumption basket is getting diversified from carbohydrate dominated diet to include more proteins such as pulses, milk, poultry & fish and vitamin sources such as vegetables & fruits. The decomposition of food inflation indicates that during the recent period the key drivers of food inflation are non-cereals.

- **Institutional Factors: -** Besides, there are certain features of the food sector in India that perpetuate inflation.

  - **Inadequate Storage Infrastructure:** Food storage capacity in the country is very low and the quality of storage infrastructure is not suitable for keeping food beyond a few months. This is particularly true for semi-perishable and perishable foods. Because of this, much of the growth during a year of bumper production cannot be carried over to meet a shortfall in production in the next season. (EPW, 27 Feb 2010, Understanding the Nature and Causes of Food Inflation)

- **Constraints in Importing:** In theory, in a scenario of domestic shortage, imports can be used to augment demand. In case of edible oil the theory works very well for India. India's demand for edible oil far exceeds the production. Large public & private import houses regularly import edible oil and the size of the international edible oil market is quite big. This has been in instrumental in keeping prices of edible oil under control. However, this is not true for other commodities and many constraints are encountered in importing. it is due to Lack of private import houses in case of certain commodities, **heavy government regulation & control over imports**, high import duties on grains, vegetables & fruits. The classic case here is of that of pulses. The **size of the international market** is small relative to the growing demand of pulses in India. India already imports 30% of the total pulses internationally traded

- **Hoarding & Speculation:** From time to time episodes of hoarding & speculation come to fore. The availability of opportunity to indulge in these points towards failure of regulations & trade policies in respect of the sector.

Trend of Inflation

Inflation in Food Items

Food inflation is hitting India. In the recent years, India has been struggling with high inflation in food items. Food (Primary) inflation accelerated from 5.6% in 2007-08 to 8% in 2008-09 & further to 20.6% in2009-10.In the current year these numbers had flared up to as high as 20% in the first half of the year. Although the trend of food prices is now downward, the instability still leads to much macroeconomic instability and with the ever increasing population and hence demand for agricultural products never has grown multi-fold. Nevertheless, a fall in food prices is a good sign but still strong policy measures need to be adopted to maintain the trend while
increasing agricultural productivity.

Inflation in Non-Food Items

The inflation in non-food manufactured products, which represents the core-inflation, and which has a weight of 55% in the WPI, too has inched upwards since 2009-10. It averaged 4% in the 2000s, and even moderated in the second half of the decade, only to start rising from 2009-10. Deepak Mohanty claims that "the non-food manufactured products inflation shows a major structural break towards the middle of 2009-10 around the time the global commodity prices rebounded".

ISSN 2249-5908
Issue 3, Vol. 1 (January 2013)

Inflation and Economic Growth-:

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

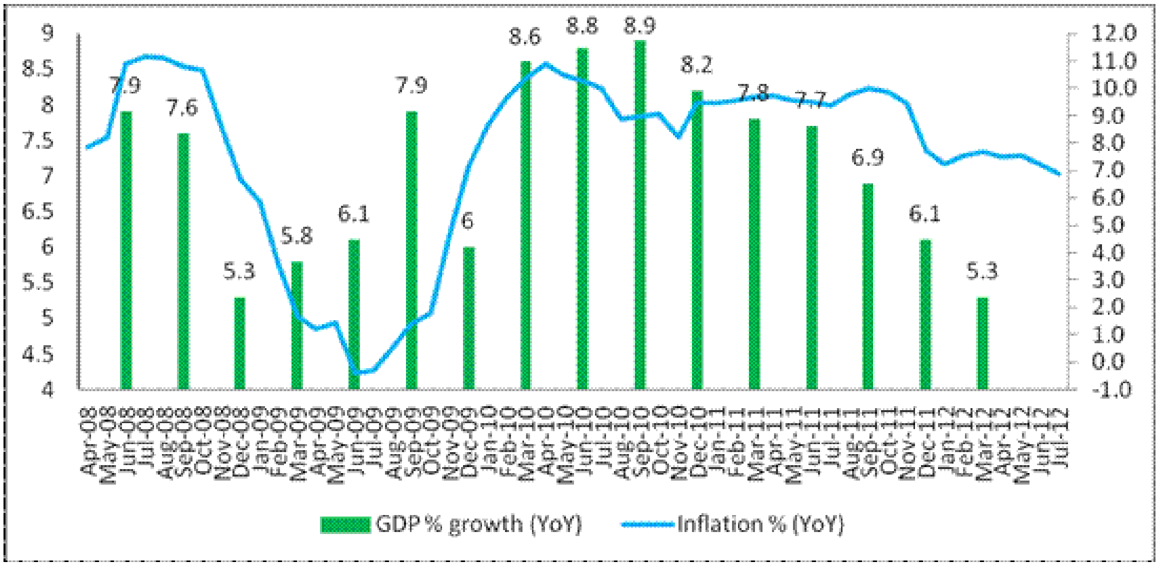

Fig: 1.1

Figure1.1 explains that percentage of increase in inflation is high in comparison to increase in GDP. In 2008 inflation was more than GDP, in the year 2009 and 2010 inflation increased with 1 or 2 percent but GDP was higher than inflation. In the year 2011 and 2012 GDP decreased and inflation was again more than GDP.

The relationship of inflation and economic growth is manifested in the following cases:

- **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.

- **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 shell out more money for the same goods.

- **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.

- **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.

- **Stocks:** The returns a company offer, on investment fully depend on the performance of the company. Past performance, current positions of the company and future trends decide 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.

Inflation isn't unique to India, it's global

Today, inflation is a problem across the world. Inflation today is caused more by global rather than by domestic factors. Indians are worried that wholesale price inflation is approaching 13%, and consumer price inflation is approaching 9%. Developed western economies, particularly the United States, are consuming on a massive scale leading to gargantuan trade deficits. In effect, developing countries are building their foreign exchange reserves while the developed countries are accumulating the corresponding debt. After all, it takes two to a tango.

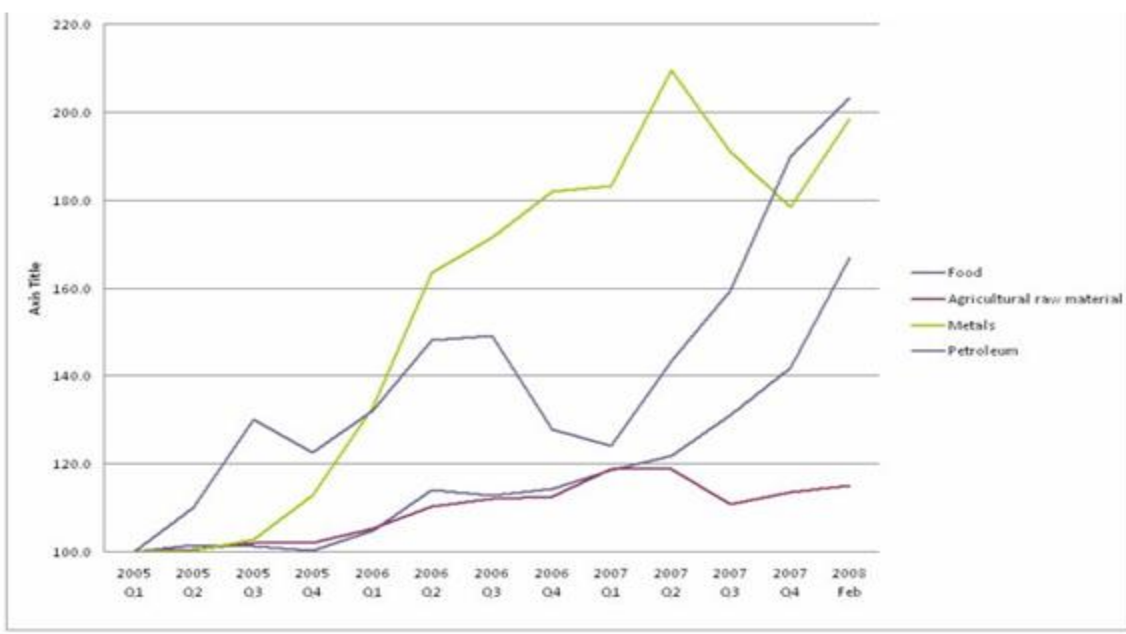

Fig: 1.2

Fig: 1.2 indicates that the US current account deficit is estimated to be 7 per cent of GDP in 2006 and stood at approximately $900 billion. Obviously, the current account deficit of the US becomes the current account surplus of other exporting countries, viz. China, Japan and other oil producing and exporting countries. The reason for this imbalance in the global economy is the fact that after the Asian currency crisis; many countries found the virtues of a weak currency and engaged in 'competitive devaluation.

First, there is the impact of **high oil prices,** which affect agricultural costs directly because of the significance of energy as an input in the cultivation process itself (through fertilizer and irrigation costs) as well as in transporting food.

Second, there is the impact of both oil prices and **government policies in the US**, Europe, Brazil and elsewhere that have promoted bio-fuels as an alternative to petroleum. This has led to significant shifts in acreage as well as use of certain grains..

Third, the impact of policy **neglect of agriculture** over the past two decades is finally being felt. The prolonged agrarian crisis in many parts of the developing world; the shifts in acreage from food crops to cash crops relying on purchased inputs; the excessive use of ground water and inadequate attention to preserving or regenerating land and soil quality; the lack of attention to relevant agricultural research and extension; the over-use of chemical inputs that have long run implications for both safety and productivity; the ecological implications of both pollution and climate change, including desertification and loss of cultivable land: all these are issues that have been highlighted by analysts but largely ignored by policy makers in most countries. Reversing these processes is possible but will take time and substantial public investment, so until then global supply condition will remain problematic.

Fourth, there is the impact of **changes in market structure**, which allow for greater international speculation in commodities. It is often assumed that rising food prices automatically benefit farmers, but this is far from the case, especially as the global food trade has become more concentrated and vertically integrated. A small number of agribusiness companies worldwide increasingly control all aspects of cultivation and distribution, from supplying inputs to farmers to buying crops and even in some cases to retail food distribution. This means that marketing margins are large and increasing, so that direct producers do not get the benefits of increases expect with a time lag and even then not to the full extent. This concentration also enables greater speculation in food, with more centralized storage.

Impacts of Inflation

Inflation generally increases the price level gradually over time. When price starts increasing, the consumers may opt for making purchases at present time, out of the fear of further increase in price level in future. If the imbalance between demand and supply and the resulting inflation go beyond the control of the government, both the producers and buyers get adversely affected. The buyers cut down their day-to-day expenditures to cope with the increasing price level. The producers on the other hand, reduce their output levels to retain the minimum profit margin. We have so many impacts of inflation on various aspects

Impact on the treasury of a nation

Inflation exerts impact on the treasury of a nation as well. In United States of America, Treasury Inflation-protected Securities (TIPS) ensures safety to the American government, assuring the public that they will get back their money. However, the rates of interest charged by TIPS are less compared to the standard Treasury notes.

- **Impact on purchasing power of money**

  The most immediate effect of inflation is the decrease in the purchasing power of dollar and its depreciation. Inflation influences the investments of a country. The Inflation-protected Securities (IPSs) may act as a guard against the loss in the purchasing power of the fixed-income investments (like fixed allowances and bonds), which may occur during inflation.

- **Impact on allocation of income**

  Inflation changes the allocation of income. This exerts maximum effect on the lenders than the borrowers at the time of persisting inflation, because the loans sanctioned previously are paid back later in the form of inflated dollars.

- **Encouragement to speculation**

  Inflation leads to a handful of the consumers in making extensive speculation, to derive advantage of the high price levels. Since some of the purchases are high-risk investments, they result in diversion of the expenditures from regular channels, giving birth to a few structural unemployment.

- **Impact of Inflation on Savers**

  Inflation leads to a rise in the general price level so that money loses its value. When inflation is high, people may lose confidence in money as the real value of savings is severely reduced. Savers will lose out if nominal interest rates are lower than inflation – leading to negative real interest rates. For example a saver might receive a 3% nominal rate of interest on his/her deposit account, but if the annual rate of inflation is 5%, then the real rate of interest on savings is -2%.

- **Inflation Expectations and Wage Demands**

Inflation can get out of control because price increases lead to higher wage demands as people try to maintain their real living standards. Businesses then increase prices to maintain profits and higher prices then put further pressure on wages. This process is known as a ‘wage-price spiral’. Rising inflation leads to a build-up of inflation expectations that can worsen the trade-off between unemployment and inflation.

- **Arbitrary Re-Distributions of Income**

  Inflation tends to hurt those employees in jobs with poor bargaining positions in the labour market - for example people in low paid jobs with little or no trade union protection may see the real value of their pay fall. Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts. And, the rate of interest on loans may not cover the rate of inflation. When the real rate of interest is negative, savers lose out at the expense of borrowers.

- **Business Planning and Investment**

  More generally, inflation can disrupt business planning. Budgeting becomes difficult because of the uncertainty created by rising inflation of both prices and costs - and this may reduce planned capital investment spending. Lower investment then has a detrimental effect on the economy’s long run growth potential

- **Competitiveness and Unemployment**

  Inflation is a possible cause of higher unemployment in the medium term if one country experiences a much higher rate of inflation than another, leading to a loss of international competitiveness and a subsequent worsening of their trade performance. If inflation in the UK is persistently above our major trading partners, British exporters may struggle to maintain their share in overseas markets and import penetration into the UK domestic market will grow. Both trends could lead to a worsening balance of payments. The UK government believes that monetary stability (i.e. low inflation) is a precondition for sustained economic expansion. As the chart below demonstrates, the UK has made progress in reducing the volatility of its inflation rate in the last decade. The era of high and volatile inflation may have come to an end.

- **Impact on retired people**- Inflation can have severe impact on the retired people who live on a fixed source of income. As price level keeps on increasing, the worth of their savings decreases and they find it really difficult to maintain their livelihood.

Measures to control inflation

The government monitors the price situation regularly as price stability remains high on its agenda. Measures taken to contain prices of essential commodities include selective ban on exports and futures trading in food grains, zero import duty on select food items, permitting import of pulses and sugar by PSUs, distribution of imported pulses and edible oils through the PDS, and release of higher quota of non-levy sugar. In addition, state governments are empowered to act against hoarders of food items by holding in abeyance the removal of restrictions on licensing, stock limits, and movement of food articles under the Essential Commodities Act 1955. Some of the important anti-inflationary measures taken:

Fiscal Measures

- Reduced import duties to zero for rice, wheat, onion, pulses, edible oils (crude) and to 7.5 per cent for refined and hydrogenated oils and vegetable oils.

- Permitted National Dairy Development Board (NDDB) to import 50,000 tonnes of skimmed milk powder and whole milk powder and 15,000 MT of butter, butter oil, and anhydrous milk fat at zero duty under tariff rate quota.

- Permitted the State Trading Corporation of India (STC)/Minerals and Metals Trading Corporation (MMTC)/Project Equipment Corporation (PEC) and National Agricultural Cooperative Marketing Federation of India (NAFED) to import duty-free white/refined sugar initially with a cap of 1 million tonnes. Later duty-free import was also allowed by other central / state government agencies and private trade without any cap on quantity.

Administrative Measures

- Removed levy obligation in respect of all imported raw sugar and white/refined sugar.

- Banned export of edible oils (except coconut oil and forest-based oil) and pulses (except Kabuli chana and organic pulses up to a maximum of 10,000 tonnes per annum).

- Imposed ban on export of non-basmati rice and wheat for short period of time.

- Permitted export of edible oils in branded consumer packs of up to 5 kg subject to a limit of 10,000 tonnes.

- Prohibited export of milk powders (including skimmed milk powder, whole milk powder, dairy whitener, and infant milk food), casein and casein products.

- Ban on export of onion was imposed for short period of time whenever required. Exports of onion were calibrated through the mechanism of minimum export prices (MEP) of onion.

- Maintained the central issue price (CIP) for rice (at ` 5.65 per kg for below poverty line [BPL] and ` 3 per kg for Antyodaya Anna Yojana [AAY]) and wheat (at ` 4.15 per kg for BPL and ` 2 per kg for AAY) since 2002.

- Ten lakh tonnes of wheat and 10 lakh tonnes of rice allotted under the Open Market Sale Scheme (OMSS) and 15 lakh tonnes of wheat for bulk sale, including sale to small traders for the period October 2011to September 2012.

Monetary Measures

As part of the monetary policy review stance, the RBI has taken suitable steps with 13 consecutive increases in policy rates and related measures to moderate demand to levels consistent with the capacity of the economy to maintain its growth without provoking price rise. As per the most recent announcement of the RBI on 24 January 2011, the cash reserve ratio (CRR) has been cut by 50 basis points (bps) from 6 per cent to 5.50 per cent and repo rate and reverse repo rate have remained unchanged at 8.5 per cent and 7.5 per cent respectively.

Conclusion

Inflation is, at the same time, one of the most dreaded and one of the most misunderstood of economic phenomena. Inflation has been with humankind ever since we moved away from barter to the use of mediums of exchange, like paper money, precious metals or even cigarettes, as happened in a prisoners of war camp during the Second World War (Radford, 1945).Inflation can cause both short-term and long-term damages to the economy; most importantly it causes slow down in the economy. There is a negative relationship between inflation and growth, which is firmly established when looking at the temporal association of growth with discrete high inflation crises. The government monitors the price situation regularly as price stability remains high on its agenda. It is a big danger in front of economy and measures should be taken to control inflation.

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