INFLATION AND INDIAN ECONOMY: UNDERSTANDING INFLATION AND CONTROLLING IT

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ABSTRACT

The relationship between inflation and growth remains a controversial one in both theory and empirical findings. The impact of inflation on growth, output, and productivity has one of the main issues examined in macroeconomics. Inflation can cause both short-term and long-term damages to the economy; most importantly it causes slowdown in the economy. This paper endeavors to explore the topic of Inflation and how and why it takes place and what is the effect of it on economy. Inflation is an economic indicator that assesses the fall in purchasing power of a currency. This is measured through various types of price indices including the Consumer Price Index and Producer Price Index (measuring prices set by producers for their output), using data obtained by the government. However, in the short and medium term inflation may be affected by supply and demand pressures in the economy, and influenced by the relative elasticity of wages, prices and interest rates.
The paper in the course of discussion shall explore the following questions.
Why inflation take place in economy and how it affects the economy?
What are methods used to measure inflation and types of inflation?
What are the actions taken by RBI and Ministry of Finance to control this economic problem?

Inflation

Inflation is that state in which the price of goods and services rises on the one hand and value of money falls on the other. When money circulation exceeds the production of goods and services, the state of inflation take place in the economy. Inflation is an economic indicator that assesses the fall in purchasing power of a currency. This is measured through various types of price indices including the Consumer Price Index and Producer Price Index (measuring prices set by producers for their output), using data obtained by the government. Inflation is generally the percentage increase in these numbers, although it is nearly impossible to assess exactly due to changes in consumer preferences. Usually inflation is caused by an increase in the money supply, which leads to price increases.

Measurement of Inflation

India uses the wholesale Price Index to calculate and then decide the inflation rate in the economy. Most developed countries use the Consumer Price Index to calculate inflation. In India, data on a total of 435 commodities prices is tracked through WPI, which is an indicator of movement in prices of commodities in all trade and transactions.

Many economists say that India must adopt CPI to calculate inflation as CPI measures the increase in price that a consumer will ultimately have to pay for. United States, the United Kingdom, Japan, France, Canada, Singapore and China use CPI to measure inflation.

Inflation is measure by general price index. General Price index measures the changes in average prices of goods and services. A base year is selected and its index is assume as 100 an on this basis price index for the current year is calculate. If the index of the current year is below 100, it indicates the state of deflation and, on the contrary, if index of the current year is above 100 it indicates the state of inflation. Some other price indices of importance are defined below:

Consumer Price Indices (CPIs)

Which measures the price of a selection of goods purchased by a “typical consumer?”

Cost-of-living Indices (COLI)

Are indices similar to the CPI which is often used to adjust fixed incomes and contractual incomes to maintain the real value of these incomes?

Producer Price Indices (PPIs)

Which measure the prices received by producers. T his differs from the CPI in that price subsidization, profits and taxes may cause the amount received by the producer to differ from what the consumer paid. There is also typically a delay between an increase in the PPI and any resulting increase in the CPI. Producer price inflation measures the pressure being put on producers by the costs of their raw materials. This could be "passed on" as consumer inflation, or it could be absorbed by profits, or offset by increasing productivity. An earlier version of the PPI was called the Wholesale Price Index.

Commodity Price Indices

Which measures the price of a selection of commodities. In the present commodity price indices are weighted by the relative importance of the components to the "all in" cost of an employee.

Important Banking Rates and Ratios:

Bank Rate: It is the rate at which the RBI extent credit to commercial banks.

Cash Reserve Ratio (CRR): A commercial bank is require to keep a certain percentage of its total deposits with the RBI in cash. It is called cash Reserve Ratio.

Statutory Liquidity Ratio (SLR): it is that ratio/percentage of its total deposits which a commercial bank has to maintain with itself at any given point of time in the form of liquid assets like cash in hand, etc.

Repo Rate : The rate at which the RBI borrows from banks for a short term. An increase in the repo rate may be a precursor to an increase in the bank rate.

Reverse Repo Rate : The rate at which banks deposit their surplus short-term funds with RBI. If RBI increases reverse repo rate, commercial banks, in turn, tend to pass on the impact through their short-term lend rates to their customers.

Why Are the Prices Rising?

It could be the breakdown of the "Goldilocks era" for global commodities-a period stretching back more than 30 years, during which the price of basic foodstuff remained relatively constant. For most of this period, the cost of staples such as wheat, corn and Soya has actually fallen in real terms.

At present, the food buffer stocks are at-time lows as countries saw no need to accumulate them, but it seems this long period of stability is coming to an end. Experts believe we are on the cusp of a new era of volatility and rising prices, which will last for some time to come.

What is the effect?

The main losers are poor people who live in cities in developing countries, who are facing higher prices for imported food on low incomes. Food riots from Haiti to Indonesia are causing increasing political instability.

The World Bank says that the high price of food could lead to developing countries missing international poverty targets. The main gainers are farmers in rich and emerging market nations like the US, Brazil, Argentina, Canada and Australia, Who are getting record prices for their harvests.

Causes of Inflation

let's get back to our discussion on the fundamentals of inflation. Economists believe that inflation is a monetary phenomenon. However, in the short and medium term inflation may be affected by supply and demand pressures in the economy, and influenced by the relative elasticity of wages, prices and interest rates.

1. Over-expansion of money supply i.e. excess liquidity in the economy leads to inflation because "too many money would be chasing too few goods".
2. Expansion of Bank Credit Rapid expansion of bank credit is also responsible for the inflationary trend in a country.

3. Deficit Financing: The high doses of deficit financing which may cause reckless spending, may also contribute to the growth of the inflationary spiral in a country.
4. A high population growth leads to increase in demand and money income and cause a high price rise.
5. Excessive increase in the price of fuel or food products due to political, economic or natural reasons will lead to inflation for short- as well as long-term.

For example – We all remember that price of crude went up from $50 to $140 within two years. Almost every industry including agriculture, transportation and manufacturing depends on crude for its operation. Any excessive increase in the price of crude leads to increase in cost of good and services i.e. inflation.
Another example – China and India consist of almost 34% of the world's population. As the economy in these two countries are growing at a rate of over 9%, people are consuming more and more goods due to increased income and better life. Demand for those goods and services have led to a high inflationary environment in these countries.

States of Inflation

There are different states of inflation which is characterized based on its value as well as variation from the previous value.
1. **Hyperinflation** – It is a very high rate of inflation, usually a rate in excess of 50%. History has some excellent examples of hyperinflation. In Germany, inflation exceeded 1 million % in 1923. It was said that a horse cart full of money would not buy even a newspaper. Right now, Zimbabwe is having an inflation of 1 million %. They have to issue currency of $500 Million dollar (I am not kidding!!) which could only buy a lunch at McDonalds.
2. **Deflation** – It is the decrease in the general price level of goods and services only when annual inflation is below 0% resulting in the real value of money. Hence, it is sometimes called "negative inflation". Japan suffered from deflation for almost a decade in 1990s. To control recession and Central Bank of Japan was forced to have a negative interest rate on deposit for over a decade.
3. **Disinflation** – It refers to a time when the rate of change of prices is falling while the inflation rate is positive. For example – if the inflation rate comes down from 3% to 2%, we

would say it is disinflation. In India, we have a disinflation because inflation has come down from a high of 13% to 6% and it is still dropping.

4. **Stagflation** – It is an economic situation in which inflation and economic stagnation occur simultaneously and remain unchecked for a period of time. Stagflation can result when an economy is slowed by an unfavorable supply shock, such as an increase in the price of oil in an oil importing country, which tends to raise prices at the same time that it slows the economy by making production less profitable.

Effects of Inflation on economy

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 slow down in the economy.

1. 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.
2. 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.
3. 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.
4. Rising inflation can prompt trade unions to demand higher wages, to keep up with consumer prices. Rising wages in turn can help fuel inflation.
5. 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.

Action Taken by RBI and Ministry of Finance to control economic problem

As most of economists feel that the most horrible economic problem which India is facing currently is inflation. To come out of these problems RBI and ministry of finance and other relevant government and regulatory entities are taking various initiatives which are as follows;

RBI MONITORY POLICY

With the introduction of the Five year plans, the need for appropriate adjustment in monetary and fiscal policies to suit the pace and pattern of planned development became imperative. The **monitory policy** since 1952 emphasized the twin aims of the economic policy of the government:

- Spread up economic development in the country to raise national income and standard of living, and
- To control and reduce inflationary pressure in the economy.

This policy of RBI since the First plan period was termed broadly as one of controlled expansion, i.e.; a policy of "adequate financing of economic growth and at the same time the time ensuring reasonable price stability". Expansion of currency and credit was essential to meet the increased demand for investment funds in an economy like India which had embarked on rapid economic development. Accordingly, RBI helped the economy to expand via expansion of money and credit and attempted to check in rise in prices by the use of selective controls.

OBJECTIVES OF MONITORY POLICY

- PRICE STABILITY
- MONITORY TARGETTING
- INTEREST RATE POLICY
- RESTRUCTURING OF MONEY MARKET
- REGULATION OF FOREIGN EXCHANGE MARKET

WEAPONS OF MONITORY POLICY

Central banks generally use the three quantitative measures to control the volume of credit in an economy, namely:

- Raising bank rates
- Open market operations and
- Variable reserve ratio

However, there are various limitations on the effective working of the quantitative measures of credit control adapted by the central banks and, to that extent, monetary measures to control inflation are weakened. In fact, in controlling inflation moderate monetary measures, by themselves, are relatively ineffective. On the other hand, drastic monetary measures are not good for the economic system because they may easily send the economy into a decline.

In a developing economy there is always an increasing need for credit. Growth requires credit expansion but to check inflation, there is need to contract credit. In such a encounter, the best course is to resort to credit control, restricting the flow of credit into the unproductive, inflation-infected sectors and speculative activities, and diversifying the flow of credit towards the most desirable needs of productive and growth-inducing sector. It should be noted that the impression that the rate of spending can be controlled rigorously by the contraction of credit or money supply is wrong in the context of modern economic societies. In modern community, tangible, wealth is typically represented by claims in the form of securities, bonds, etc., or near moneys, as they are called. Such near moneys are highly liquid assets, and they are very close to being money. They increase the general liquidity of the economy. In these circumstances, it is not so simple to control the rate of spending or total outlays merely by controlling the quantity of money. Thus, there is no immediate and direct relationship between money supply and the price level, as is normally conceived by the traditional quantity theories. When there is inflation in an economy, monetary restraints can, in conjunction with other measures, play a useful role in controlling inflation.

FISCAL POLICY

Fiscal policy is another type of budgetary policy in relation to taxation, public borrowing, and public expenditure. To curve the effects of inflation and changes in the total expenditure, fiscal measures would have to be implemented which involves an increase in taxation and decrease in government spending. During inflationary periods the government is supposed to counteract an increase in private spending. It can be cleared noted that during a period of full employment inflation, the aggregate demand in relation to the limited supply of goods and services is reduced to the extent that government expenditures are shortened.

Along with public expenditure, governments must simultaneously increase taxes that would effectively reduce private expenditure, in an effect to minimise inflationary pressures. It is known that when more taxes are imposed, the size of the disposable income diminishes, also the magnitude of the inflationary gap in regards to the availability of the supply of goods and services. In some instances, tax policy has been directed towards restricting demand without restricting level of production. For example, excise duties or sales tax on various commodities may take away the buying power from the consumer goods market without discouraging the level of production. However, some economists point out that this is not a correct way of combating inflation because it may lead to a regressive status within the economy.

As a result, this may lead to a further rise in prices of goods and services, and inflation can spread from one sector of the economy to another and from one type of goods and services to another. Therefore, a reduction in public expenditure, and an increase in taxes produces a cash surplus in the budget. Keynes, however, suggested a programme of compulsory savings, such as deferred pay as an anti-inflationary measure. Deferred pay indicates that the consumer defers a part of his or her wages by buying savings bonds (which, of course, is a sort of public borrowing), which are redeemable after a particular period of time, this is sometimes called forced savings. Additionally, private savings have a strong disinflationary effect on the economy and an increase in these is an important measure for controlling inflation. Government policy should therefore, include devices for increasing savings. A strong savings drive reduces the spendable income of the consumers, without any harmful effects of any kind that are associated with higher taxation. Furthermore, the effects of a large deficit budget, which is mainly responsible for inflation, can be partially offset by covering the deficit through public borrowings. It should be noted that it is only government borrowing from non-bank lenders that has a disinflationary effect. In addition, public debt may be managed in such a way that the supply of money in the country may be controlled. The government should avoid paying back any of its past loans during inflationary periods, in order to prevent an increase in the circulation of money. Anti-inflationary debt management also includes cancellation of public debt held by the central bank out of a budgetary surplus.

Fiscal policy by itself may not be very effective in combating inflation; therefore a combination of fiscal and monetary tools can work together in achieving the desired outcome.

DIRECT MEASURES

Direct controls refer to the regulatory measures undertaken to convert an open inflation into a repressed one. Such regulatory measures involve the use of direct control on prices and rationing of scarce goods. The function of price control is a fix a legal ceiling, beyond which prices of particular goods may not increase. When ceiling prices are fixed and enforced, it means prices are not allowed to rise further and so, inflation is suppressed. Under price control, producers cannot raise the price beyond a specified level, even though there may be a pressure of excessive demand forcing it up.

In times of the severe scarcity of certain goods, particularly, food grains, government may have to enforce rationing, along with price control. The main function of rationing is to divert consumption from those commodities whose supply needs to be restricted for some special reasons; such as, to make the commodity more available to a larger number of households. Therefore, rationing becomes essential when necessities, such as food grains, are relatively scarce. Rationing has the effect of limiting the variety of quantity of goods available for the good cause of price stability and distributive impartiality.

Another control measure that was suggested is the control of wages as it often becomes necessary in order to stop a wage-price spiral. During galloping inflation, it may be necessary to apply a wage-profit freeze. Ceilings on wages and profits keep down disposable income and, therefore the total effective demand for goods and services. On the other hand, restrictions on imports may also help to increase supplies of essential commodities and ease the inflationary pressure. However, this is possible only to a limited extent, depending upon the balance of payments situation. Similarly, exports may also be reduced in an effort to increase the availability of the domestic supply of essential commodities so that inflation is eased.

In general, monetary and fiscal controls may be used to repress excess demand but direct controls can be more useful when they are applied to specific scarcity areas. As a result, anti-inflationary policies should involve varied programmes and cannot exclusively depend on a particular type of measure only.

Fixed Interest Rate

As we know high inflation reduced the value of money. A number of smaller countries who do not have sophisticated banking system rely on tying their currency with that of a developed country. Under a fixed exchange rate currency regime, a countrysinglequotes currency is tied in value to another single currency or to a basket of other currencies (or sometimes to another measure of value, such as gold). A fixed exchange rate is usually used to stabilize the value of a currency, vis-à-vis the currency it is pegged to.

Government Measures

Apart from these two broad methods, government takes some protectionist measures as well to fight inflation. Government may ban export of essential items such as pulses, cereals and oils to support the domestic consumption and hence reduced their prices. Also, government may lower duties on the import of similar items which are having less supply in the economy.

Positive side of inflation

You may be wondering how come inflation is good for economy. A little bit of inflation is not a bad thing. It implies the possibility of higher prices and profits in the future. To the worker, a little bit of inflation may imply rising wages in the future. What I am trying to say is that they are based more on "psychology" than "economics".

Conclusion

The inflation rate has been rising continuously. It has a major impact on investments. A rising inflation rate erodes the value of investments. Inflation is a rise in prices of goods and services over time. It is calculated by taking into consideration a set of goods and services. The prices of the items in that set are compared to prices one year ago. Here, inflation is measured based on the Wholesale Price Index (WPI) which measures the change in prices of a selection...

Inflation was the buzzword last week. Whether it was the IMF, ADB or government, they are of the opinion that if anything that can put a spanner in the growth path it is inflation. Inflation in food in the past year has been in double digits though the recent two readings have shown a marginal decline. Non-food price inflation is also now on the rise.

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