Inflation and Economic Growth In India

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INTRODUCTION

Inflation is a persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services. A simple commonly used definition of the word inflation is simply "an increase in the price you pay for goods." According to Crowther, inflation is a state, in which the value of money is falling, i.e., prices are rising".[1] According to pigou inflation exists, "when money income is expanding relatively to the output of work done by the productive agents for which it is the payment"[2] In an article entitled "Types of war inflation" Pigou wrote that "Inflation exists when money income is expanding more than in proportion to income earning activity".[3] In other words, a decline in the purchasing power of your money". But there is more to inflation than that. There is "Price Inflation" and "Monetary Inflation". Technically, Price Inflation is when prices get higher or it takes more money to buy the same item. Monetary Inflation is an increase in the money supply which generally results in price inflation. This acts as a "hidden tax" on the consumers in that country. 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. Ackley has defined inflation as "a persistent and appreciable rise in the general level or average of prices". [4] There are three major types of inflation, as part of what Robert J. Gordon calls the "triangle model".

Demand-pull inflation is caused by increases in aggregate demand due to increased private and government spending, etc. The consensus view is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth.[5] Demand inflation is constructive to a faster rate of economic growth since the excess demand and favourable market conditions will stimulate investment and expansion. It is the condition when demand in the economy is more than the supply; naturally it will pull the prices upward. And demand can increase because of several factors, one of the more relevant ones is, increase in consumption level of income. But corresponding increase in supply does not occur that rapidly, which means that too much money is chasing too few goods, and that increases

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the price level.

Cost-push inflation, also called "supply shock inflation," is caused by a drop in aggregate supply (potential output). Supply side inflation can occur because of higher wages, cost of goods etc which pushes the prices upwards. This may be due to natural disasters, or increased prices of inputs. For example, a sudden decrease in the supply of oil, leading to increased oil prices, can cause cost-push inflation. Producers for whom oil is a part of their costs could then pass this on to consumers in the form of increased prices. Another example stems from unexpectedly high Insured Losses, either legitimate (catastrophes) or fraudulent (which might be particularly prevalent in times of recession).
Built-in inflation is induced by adaptive expectations, and is often linked to the "price/wage spiral". It involves workers trying to keep their wages up with prices (above the rate of inflation), and firms passing these higher labour costs on to their customers as higher prices, leading to a 'vicious circle'. Built-in inflation reflects events in the past, and so might be seen as hangover inflation.

In major economies, inflation is measured by CPI, which is Consumer Price Index. CPI is a measure of the average price of consumer goods and services purchased by households. The percent change in the CPI is a measure of inflation. Two basic types of data are needed to construct the CPI: price data and weighting data. The price data are collected for a sample of goods and services from a sample of sales outlets in a sample of locations for a sample of times. The weighting data are estimates of the shares of the different types of expenditure as fractions of the total expenditure covered by the index. These weights are usually based upon expenditure data obtained for sampled periods from a sample of households.

A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the consumer price index) over time.

In other words, Inflation is calculated as percentage change in CPI in two periods.

Hence,

Inflation (%) = (CPI2- CPI1)*100/CPI1

Where, CPI1 = CPI in the previous period and CPI2 = CPI in the current period

India uses a different price index called the Wholesale Price Index (WPI) to calculate the rate of inflation in our economy. It is quite similar to Consumer Price Index, but uses whole sale prices instead of retail consumer prices. WPI is the index used to measure changes in the average price levels in the wholesale market. Data on 435 commodities

is tracked through WPI, in India, which is an indicator of movement in price.

How inflation is affecting different sectors of our economy?

Inflation is welcomed by entrepreneurs and businessmen because they stand to profit by rising prices. They find that the value of their inventories and stock of goods is rising in money terms. They also find that prices are rising faster than the costs of production; so that their profit is greatly enhanced. On the contrary Inflation hits wage-earners and salaried people very hard. Although wage- earners, by the grace of trade unions, can chase galloping prices, they seldom win the race. Since wages do not rise at the same rate and at the same time as the general price level, the cost of living index rises, and the real income of the wage earner decreases. Farmers usually gain during inflation, because they can get better prices for their harvest during inflation. Investors, Those who invest in debentures and fixed-interest bearing securities, bonds, etc, lose during inflation. However, investors in equities benefit because more dividend is yielded on account of high profit made by joint-stock companies during inflation.

Inflation will lead to deterioration of gross domestic savings and less capital formation in the economy and less long term economic growth rate of the economy.

The relationship between inflation and growth remains a controversial one in both theory and empirical findings. The issue has generated an enduring debate between *structuralists* and *monetarists*. The structuralists believe that inflation is essential for economic growth, whereas the monetarists see inflation as detrimental to economic progress.

Inflation α 1/Economic growth

Which means inflation is inversely related to the economic growth. This is also shown in the given diagrams.

This implies that **Inflation α 1/Economic growth**, i.e. inflation in inversely related to the economic growth. Inflation's effects on an economy are various and can be simultaneously positive and negative. Negative effects of inflation include a decrease in the real value of money and other monetary items over time, uncertainty over future inflation which may discourage investment and savings, and if inflation is rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Positive effects include ensuring central banks can adjust nominal interest rates (intended to mitigate recessions), and encouraging investment in non-monetary capital projects.

Causes of Inflation during the process of Economic growth

- **Over- Expansion of Money Supply:** Many a times a remarkable degree of correlation between the increase in money and rise in the price level may be observed. The Central Bank (India's RBI) should maintain a balance between money supply and production and supply of goods and services in the economy. Money supply exceeds the availability of goods and services in the economy, it would lead to inflation.

- **Increase in Population**: Increase in population leads to increased demand for goods and services. If supply of commodities is short, increased demand will lead to increase in price and inflation.

- **Expansion of Bank Credit:** Rapid expansion of bank credit is also responsible for the inflationary trend in a country.

- **Deficit Financing:** Deficit financing means spending more than revenue. In this case government of India accepts more

amount of money from the Reserve Bank India (RBI) to spend for undertaking public projects and only the government of India can practice deficit financing in India. The high doses of deficit financing which may cause reckless spending, may also contribute to the growth of the inflationary spiral in a country.

- **High Indirect Taxes:** Incidence of high commodity taxation. Prices tend to rise on account of high excise duties imposed by the Government on raw materials and essentials.

- **Black Money:** It is widely condemned that black money in the hands of tax evaders and black marketers as an important source of inflation in a country. Black money encourages lavish spending, which causes excess demand and a rise in prices.

- **Poor Performance of Farm Sector:** If agricultural production especially foodgrains production is very low, it would lead to shortage of foodgrains, will lead to inflation.

- High Administrative Pricing. Other reasons are capital bottleneck, entrepreneurial bottlenecks, infrastructural bottlenecks and foreign exchange bottlenecks.

Monetary measures

Credit control is one of the significant monetary measures strategies. The central bank of the nation follows a number of ways to control the quantity and quality of credit. For this cause, it raises the bank rates sells securities in the open market, raises the reserve ratio and follows a number selective credit control measures such as raising margin requirements and regulating consumer credit. Monetary measures used to control inflation include:

- Bank rate policy
- Cash reserve ratio and
- Open market operations.

Bank rate 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.

The most tremendous monetary measure is the issue of new currency in place of the old ones. Under this operation, one new currency note is negotiated for a number of currency notes of the old ones. The value of bank deposits is also set respectively.

Fiscal Measures

Fiscal measures such as slashing down unwanted expenditure, rise in taxes, rise in savings, surplus budgeting and public debt are the fiscal tools to control inflation. Government reduces its expenditure and thereby freeing up resources for the private sector. This would enable private sector to borrow from banks to invest more in their future projects. It can also resort to increasing taxes so that people have less disposable income at their disposal thereby reducing the pressure on prices. Though generally fiscal measure are ineffective in controlling inflation because it generally works only against demand pull inflation, while in the current scenario, which is basically a cost push inflation, it resort to monetary measures, which are decided by the RBI.

Similar to monetary measures fiscal measures alone cannot help in controlling inflation and they should be surrogated by monetary, non-monetary and non-fiscal measures.

CONCLUSION

There is a great controversy among economist as to whether inflation promotes economic development. There is no doubt that there will be some inflationary rise in prices at least in the initial stages consequent upon deficit financing in a developing economy like India. The reason being that the supply of consumer goods in such an economy does not increase as rapidly as the supply of money in the initial stages of deficit financing. Thus, inflation becomes somewhat inevitable in the process of economic growth. In fact, economic growth and inflation go together. Inflation leads to economic growth, and economic growth, in its turn results in inflation. Inflation, it is pointed out, distorts the saving habits of the people and slows down the rate of capital accumulation in the economy. Inglation may even drive out the foreign capital already

invested in the economy.
From above analysis we can say that process of inflation is causing adverse effects upon developing India. The business community is getting more and more inclined towards speculative financial investment. The supply of resources are diverted from essential to non essential and from productive to unproductive method both for the mobilisation of resources and for restraining inflationary pressures. Capacity to export is reduced. Inflation causes a major upset in the structure of economic planning of the country.

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