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Economics

IMPACT OF INFLATION ON ACHIEVING HIGH GDP GROWTH RATES, IN EMERGING ECONOMIES LIKE INDIA.

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ABSTRACT This paper attempts to understand the impact of inflation on economies especially, emerging market economies like India. In most of these economies there is a trade-off between growth and controlling price rise. A number of times inflation comes under the category of imported inflation but even in such cases, the monetary policy has to deal with it in a manner to reduce its adverse impact. The paper concludes with an attempt to understand certain policy measures that the government might have to undertake.

KEYWORDS :

1. Basic Macroeconomic equation

In many of the less developed countries incomes, are not increasing as much as the wants and desires of the people, leading to low savings and thus less resources available for investment.

$$Y = C + I \ldots..(1)$$
$$Y = C + S \ldots..(2)$$

The above are simple macro equations, specified under certain assumptions, and are part of the explanation of consumption and investment that takes place in a closed economy. The first equation indicates that the income earned by the producer is spent on the production of consumption goods and investment goods. The second equation indicates that the income earned by the consumer is spent on consumption and saving. Thus, if we equate their savings and investment we get an identity equation which is:

$$S \equiv I$$

This means that the savings generated by the consumer are being employed by the producer for investment. It is this quantity that will indicate the extent of production that is going to take place in the economy and would then impact GDP. For the economy to grow it is extremely imperative that savings increase and they are then gainfully employed in the form of investment.

2. Effect of inflation on economic growth

Problems that are peculiar to emerging economy is that savings are low and thus there is limited amount of money which becomes available for investment. The government in its attempt to expand investment which is essential to expand output depends on the central bank to achieve its targets.The central bank could pump in money into the economy but this could lead to increased prices (inflation) rather than an increase in output.

2.1 Definition of Inflation

Inflation is the decline in purchasing power of money and/or a general increase in prices. Thus, any price increase is called inflation.

2.1.1 Advantages of Inflation:

- Moderate inflation enables economic growth.
- Moderate inflation allows adjustment of real wages.
- Moderate inflation allows adjustment of prices.
- Inflation is better than deflation — which can cause recession.

2.1.2 Disadvantages of Inflation:

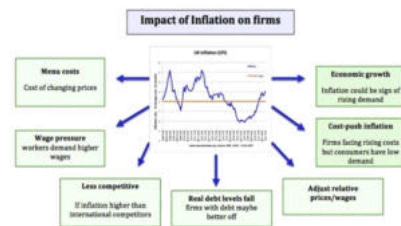
- Creates uncertainty of lower investment.
- High inflation often leads to lower growth and less stability.
- Reduces International competitiveness.
- Reduced inflation can lead to recession.
- Fall In the value of savings.
- If wages don't keep up with inflation it results in lower real wages.

3. Impact of Inflation

3.1 Different types of inflation:

Demand-pull inflation - occurs when the demand is greater than the supply and this pulls the price up leading to inflation.

Fig. 1 Impact of Inflation on firms



Source : https://www.economicshelp.org/18 November 2016

1.1 Different types of inflation:

Demand-pull inflation - occurs when the demand is greater than the supply and this pulls the price up leading to inflation.Cost pull inflation - occurs when the cost of the factors of the production increase, and it leads to overall price increase (inflation).

Stagflation- occurs when rise in prices is simultaneous with stagnant growth.

GDP (Gross Domestic Product) - Is the standard measure of the value-added created through the production of goods and services in a country during a certain period. It also measures the income earned from that production or the total amount spent on final goods and services. This amount is generated from basically three sectors of the economy namely

1. Agriculture
2. Industrial / Manufacturing
3. Services

While calculating GDP we could use the income method, expenditure method or the product/output method. The final result should be the same irrespective of the method used.

Whenever the word 'real' is used it means that price changes are being taken into account. When the price is not taken into account it is called nominal GDP. Thus, the nominal GDP is the value of all final goods and services that an economy produces during a given year. The prices that are used are the current prices of that year in which the output is produced. The value of any commodity is equal to price multiplied by quantity. If prices change from one period to another and output does not change this implies that nominal GDP has gone up but real GDP has remained constant.

The real GDP is defined as the real value of all final goods and services during a given year. This is calculated by using the prices of the selected base year. In calculating real GDP the actual increase in the economy due to a higher output production is known. As real GDP indicates that prices are constant and any increase is due to an increase in output. To counter the effect of inflation, an inflation deflator is required. This could be of the form of a GDP deflator which is calculated by dividing nominal GDP by real GDP and then multiplying it by a hundred.

The base year is taken as that year which is a normal year (a year where there are no droughts or floods). The normal year is equated to a hundred and then with respect to it, the other years are calculated.

4. Consumer Price Index and Wholesale Price Index

Fig. 2 WPI vs CPI

Source : https://economictimes.indiatimes.com/heres-is-how-consumer-price-index-differs-from- wholesale-price-index/articleshow/March 23rd 2015

Both Consumer Price Index (CPI) and Wholesale Price Index (WPI) are often used as measures of inflation. Recent trends have indicated that India's consumer price index (CPI) has crossed the upper limit of RBI's (Reserve Bank of India) tolerance band in January 2022. This means that if bank savings earn an interest rate of less than the inflation rate it implies robbing the general public in the name of growth. In such instances, entrepreneurs increase their earnings and inequalities in the economy increase. Since 2016, the RBI has consciously decided to follow the path of inflation targeting like most other economies of the world. This means that it would like to keep the inflation in a band of 4%±2%. This essentially means that the RBI will not interfere in the market process as long as the inflation remains in this range. If it is out of this range on any side of the spectrum then the government would either move to increase the interest rate and thus decrease the supply of money or decrease the interest rate and increase the supply of money. In the last 2 years, the government has kept all rates constant despite inflation increasing to encourage growth, which has greatly suffered due to the lockdown imposed under the covid 19 pandemic situation. The inflationis hovering around the upper limit primarily due to imported inflation. India being an economy that is dependent on oil imports it has to suffer if the price of its imports increase.

Given the current deposit rates the upper limit of RBI's tolerance band is biased against depositors and is in favour of entrepreneurs. This enhances the already existing inequalities of income in the system.

In the calculation of CPI in India, food inflation is important as it has a weightage of 45%. The other important factor is edible oil. This also has an important weightage in the CPI. Till recently, edible oil inflation had touched 35% but this has come down to 18% after the reduction in import duties.

Fig 3. The 8 Major groups of CPI

Source: https://www.mediafire.com/ March 10th 2022

Moving to the definition of Consumer Price Index (CPI) and Wholesale Price Index (WPI). CPI is a Price Index that consists of a weighted average market basket of consumer goods and services purchased by households. Changes in the measured CPI track changes in prices over time.The Whole Sale Price Index (WPI) is the price of a representative basket of wholesale goods. Some countries adopt the Wholesale Price Index (WPI) as a central measure of inflation. India recently adopted the CPI as a measure of inflation. WPI measure tracks the changes in the price of goods before they reach consumers. Wholesale goods are those that are sold in bulk and/or traded.

1. Trade-off between growth and inflation

Continuous inflation is not conducive for growth in emerging market economies but some inflation is good for both developing and developed economies.

An increase in price signals that the suppliers have to increase production. This in turn means an increase in the demand for factors of production namely land, labour, capital and entrepreneurship. This results in an increase in their incomes, savings and investment leading to growth in the economy. The above is an example of the positive impact of inflation.

Excessive increases in prices can be detrimental to the economy, especially for an emerging market economy. For example, the Russia Ukraine conflict that has flared into a war has led to increasing global commodity prices especially that of crude oil and gas. India, depends upon imported crude oil, to meet its demands for petroleum and other products will feel the heat of high prices. India's monetary policy has aimed at inflation targeting of 4%±2%. India's Consumer Price Index (CPI) reached 6% in January 2022 which is the upper limit of RBI's tolerance bank. The wholesale price index (WPI) is more than double at (12.96%). In the US inflation is at 7.5% which is at a 40 year high1 . A number of economists feel that the RBI may not be in a position to tame inflation. These high rates of inflation result in what is known as an "inflation tax". If the RBI doesn't step in to control these high levels, in the hope of spear heading growth it could result in inflation getting out of control and infact adversely affecting growth. Indian depositors are losing the real value of their money because of this hidden "inflation tax" (as the return on saving deposit is 3% and inflation levels are +6%).

The Indian government as well as the RBI are extremely keen on fuelling growth, especially after the pandemic keeping the inflation rates on the back burner. This essentially means that controlling inflation is no longer the main priority, growth is. This policy measure may be the right step if the RBI is sure that it can tame inflation in the future. The breaching of the upper limit of RBI's tolerance band has an inbuilt bias against depositors and is in favour of entrepreneurs accelerating inequalities in the system. To do justice to the huge number of people on whose deposits the entirebanking system hinges, then one should ensure a positive real rate of interest. This really means that the rate of interest one earns on deposits should be higher than the inflation rate.

Low and stable inflation helps long term economic growth and this is the reason why most Central banks have made it, its primary objective of monetary policy. Inflation expectations are due to many factors some of them may be the increasing cost of Brent crude oil, the excess money supply in the economy, high fiscal deficit to name a few. Emerging market economies have in addition to deal with unexpected supply-side changes due to inadequate supply of agricultural commodities. This could be because of weather-related reasons (floods, drought, inadequate rainfall, crop diseases etc.). The dependency of the agricultural sector on weather conditions makes the economy vulnerable. To solve this issue the spread of irrigation needs to be all-encompassing. The ability of the Central Bank to control inflation whether domestic or imported will depend upon the institutional capacity to deliver on its commitment. It also depends on how deep and widen is the financial system.

2. CONCLUSION

The current Russia-Ukraine conflict has made it imperative to control inflation in all sectors of the economy. With respect to agriculture, it is important to reform the grain management cum food subsidy system so that scarce precious resources could be released for other important growth aspects. India's inflation is already at 6% as of January 2022 which is the upper limit of the tolerance bank of the RBI. The reason that RBI has not actively controlled this aspect is that it wants to revive growth (GDP) and it feels that controlling inflation would not be a major issue once growth is in place. But given the Ukraine crisis, there is an additional impact on inflation with the anticipated high growth being not so easily achievable. The war has led to an unprecedented increase in oil prices resulting in risks of higher inflation, lower growth and larger debts. Larger debts of the government mean that their expenditure is far greater than their revenue. This has been under great strain when most economies of the world have been spending excessively to give that push to growth. The worst impact of the war could be a situation of "stagflation", which means a combination of

high inflation and low economic growth. Stagflation can alternatively be defined as a period of high inflation combined with GDP decline. Which could result in increasing the cost of living of consumers in the economy and it may result in the central banks gradually raising interest rates to curb inflation. This means that the banks may have to forgo the emphasis on growth as inflation levels are rising rapidly. Russia and Ukraine are the biggest exporters of wheat and oil.Countries of the world dependent on them could face higher imported inflation. As inflation increases it could spark a "wage-price spiral" where people start demanding higher wages to compensate for the higher cost of living resulting in increasing prices of the products they produce which may further fuel inflation. They could on the other hand not raise the prices of the final product but cut down on their workforce leading to yet another disastrous situation for the country in the form of higher unemployment.

If stagflation becomes a real phenomenon then central banks would have to withdraw their support which is important for increasing investment and eventual growth of the economy resulting in low business confidence, lower investment and thus fewer jobs.

The immediate impact of the conflict is going to be felt in
1. Inflation
2. Increase in the current account deficit (a $5 per barrel increase in crude oil will translate into a $6.6 billion increase in the trade or current account deficit (Sunil Kumar Sinha, principal economist at India Ratings and research))
3. Rupee depreciation.

With respect to the price of Brent crude oil, it had gone up to $130 a barrel from approximately $90 a barrel before the war broke out, but fluctuates around $110 a barrel. As regards the rupee depreciation the rupee on the 7th-8th March, 2022 was at its new low of 76, which has raised concerns about the RBI interfering in the foreign exchange market to stem the decline. Rising oil prices will push Indian inflation as the country imports 80% of its energy needs resulting in a relatively subdued GDP growth in 2022.

Ukraine is also the world's third-largest export of corn and maize. Ukraine and Russia are the two top exporters of sunflower oil. Russia and Belarus are important producers of potash which is an important element in the manufacture of fertilisers. Skyrocketing global prices have made Indian wheat exports very competitive. Huge amounts are being exported at rates well above the minimum support price. It is likely that the procurement of wheat would be less than in previous years. This requires the government to carefully manage its own stock, with respect to overall domestic availability of wheat as well as enough supplies to meet the demand required by the publicdistribution system. The positive of this could be that it will lead to a bonus for the farmers. High prices (above MSP) and a good monsoon could act as inducements for farmers to increase the acreage under cotton, soya bean, groundnut and sunflower resulting in weaning the farmers away from sugarcane. This might be a positive takeaway from the war but the downside is the increase in fertiliser prices leading to a higher input cost.

For the Indian economy in particular the threat of the war is a disruption in trade and rising oil prices. It is only recently that restrictions from the coronavirus wave have started to ease in the whole country. The war would push the import bill for mineral fuels and oil, gems and jewellery, edible oils and fertiliser. India has a high import dependence on these items. As the price of crude oil is going up it is going to lead to inflation in the Indian economy. The only way to reduce its impact is to pass on the price increase to the consumers (this has already been done by the Indian government) and secondly greater emphasis on alternative sources of energy. The government should try and keep its fiscal deficit under control which will in turn reduce the inflationary effect.

The war is expected to widen the current account deficit to 3% of GDP in FY 23 (financial year). The reason is exogenous cost-push inflation. This will have an impact on all stakeholders, households, businesses and the government. The high prices will result in deterioration of macro stability and currency volatility. Studies have indicated that a 10% rise in oil prices would widen India's current account deficit by 30-35 bps of GDP. The balance of payment deficit is likely to be 0.5-1% as capital flows are likely to be lower than the current account deficit. This may be partially cushioned due to the large foreign exchange reserves which are available with India. This is a development that the RBI will have to take cognisance of in its MPC (Monetary Policy Committee) which is to be held in April 2022.

The final impact would have to be measured in its correct perspective to be in a position to judge the total impact of the war. All said and done the current situation is not something that one would like to continue, as, besides the impact on inflation and growth, nothing can take away the misery, the loss of lives and livelihood that the war entails.

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