INFLATION: A SIGNIFICANT OBSTACLE TO THE GROWTH OF INDIAN ECONOMY

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Inflation is getting increasingly generalised in the Indian economy as is evident from a gradual narrowing of the gap between 'headline inflation' and 'core inflation'. Not only is the current rate of inflation substantially higher than the targets set but the continuation of severe inflationary tendencies in the economy is per se a serious area of policy concern. For, such a significant and persistent inflationary trend could quite conceivably hamper the growth momentum and endanger inclusive growth. In view of this, the present article goes deeper into various aspects of the complex problem of inflation in India and finds that a high rate of domestic inflation is likely to put a serious obstacle in the attainment of practically all the objectives of public policy in a developing economy like India. Therefore the real challenge of monetary policy and macroeconomic management in India is one of maintaining the growth momentum in the economy along with price stability in the times to come. Towards this end, the need of the hour is to employ an optimal-mix of mutually reinforcing set of policies both on the demand-side as well as supply side as the severe inflationary pressures prevalent in the Indian economy right now are the outcome of a complexity of demand-pull and cost-push factors operating both at domestic as well as international levels.

1 Introduction

In its First Quarter Review of Monetary Policy 2011-12 released in July 2011, the Reserve Bank of India (2011a) has admitted that Inflation continues to be the dominant macroeconomic concern. For, controlling inflation is imperative both for sustaining growth over the medium-term and for increasing the potential growth rate.

Prior to this, in its Financial Stability Report released in June 2011, the Reserve Bank of India (2011b) had cautioned that Inflation remains a big challenge as high oil and commodity prices pose one of the major downside risk to India's Gross Domestic Product (GDP) growth during 2011-12.

Likewise, in the Economic Survey 2010-11 released in February 2011, the Ministry of Finance, Government of India (2011) too had observed that as the world economy has begun to stabilize in the aftermath of the global crisis, inflation has re-emerged as a

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major concern particularly in the fast-growing developing economies.

In the light of this growing concern for inflation as expressed by the monetary authority in India, it becomes pertinent to go into the genesis of this problem and analyse the root cause of the inflationary tendencies prevalent in the Indian economy. Side-by-side, it is crucial to have a closer look at the problem of inflation in India in terms of its macroeconomic impact and present dimensions so as to suggest remedial measures and derive suitable insights for policy making. Against this backdrop, the present article goes deeper into the various dimensions of the complex problem of inflation in India with a view to examining the extent to which inflation is posing an obstacle to the growth of Indian economy.

The next section explores the current state of inflationary tendencies prevailing in the Indian economy and tries to identify their likely macroeconomic repercussions. This is followed by a detailed investigation of the major trends and factors responsible for inflation in India. On the basis of such a detailed analysis of the genesis and implications of the problem of inflation in the Indian economy, suitable insights and lessons for policy making are derived in the subsequent section. And finally the main conclusions following from our analysis are recorded in the concluding section.

2 Inflationary Tendencies and their Repercussions

In its report entitled "Current State of Indian Economy-June 2011", the FICCI *i.e.* Federation of Indian Chambers of Commerce and Industry (2011) has cautioned that the inflation situation in the economy continues to be a cause for concern. For, the WPI-based annual rate of headline inflation stood at 9.1 percent in May 2011.

In its Mid-Quarter Monetary Policy Review released in June 2011, the Reserve Bank of India (2011c) has also stated that the headline WPI inflation rate which was 8.7 per cent in April 2011 rose to 9.1 per cent in May 2011. Evidently, the headline inflation of this order is way above the upper bound of the comfort zone since it exceeds the trend of 5.0 to 5.5 per cent as observed during the 2000s and is significantly higher than the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

In this context, it is worth noting that the headline inflation in India is calculated on the basis of the Wholesale Price Index (WPI) and recently the Government has released a new series of the WPI changing the base year from 1993-94 to 2004-05. This new series was in fact employed for the first time in calculating the official rate of headline inflation for the month of August 2010. The new series is a better representative of overall commodity price inflation in as much as it significantly improves on the scope and coverage of commodities and is more adapted to the underlying economic structure in terms of the evolving consumption patterns and price trends at a disaggregated level.

More specifically, according to the 'Economic Survey 2010-11' released by the Ministry of Finance, Government of India (2011), a representative commodity basket comprising 676 items has been selected in the new WPI series with 2004-05 base. Some of the prominent items included in the commodity basket for the new series are flowers, lemons, and crude petroleum in primary articles and ice-cream, canned meat, palm oil, readymade/instant food powder, mineral water, computer stationery, leather products, scooter / motorcycle tyres, polymers, petrochemical intermediates, granite, marble, gold and silver, construction machinery, refrigerators, computers, dish antenna, transformers, microwave ovens, communication equipment (telephone instruments), TV sets, VCDs *i.e.* Video Compact Disks, washing machines, and auto parts in manufactured products. Further, the total number of price quotations has also been increased from 1918 in the old series to 5482 in the new series thereby signifying a better representation of the prices in the wholesale markets.

Of late, the RBI *i.e.* the Reserve Bank of India (2011a) has found the headline WPI inflation rate to have remained stubbornly close to double digits for the first quarter of the fiscal year 2011-12 thereby indicating that inflationary pressures continue to be broad-based in the Indian economy. As per the RBI, both the level and the persistence of WPI inflation are a cause for concern.

From the perspective of framing long-term policy, however, a preferred measure of inflation is 'Core inflation' which by definition excludes items like food and energy that face volatile price movements. According to FICCI (2011), Core inflation too has moved up from 8 percent in April 2011 to 8.6 percent in May 2011.

It must be realised that the main items of concern in non-food inflation in India are raw cotton, raw jute, raw silk, copra, castor seed, sunflower, raw rubber, copper ore, zinc, iron ore, cotton textiles, petrochemical intermediate, and industrial machinery and machine tools. In this context, even the RBI has observed that the non-food manufactured product inflation ruled above 7 per cent in the first quarter of 2011-12 thereby suggesting that producers are able to pass on the rising wage costs and other input prices to the consumers in the form of higher prices of products manufactured by them. It is against this backdrop that the RBI is of the firm view that inflation continues to be the dominant macroeconomic concern.

Further, in its publication entitled "Macroeconomic and Monetary Developments in 2010-11" issued with the Monetary Policy Statement 2011-12, the Reserve Bank of India (2011d) has expressed the apprehension that risks to inflation in 2011-12 have amplified from an uncertain outlook on international commodity prices, incomplete pass-through to domestic prices and possibility of prices of food, fuel, minerals and metals staying firm.

It is widely acknowledged that when the inflation rate crosses all permissible limits, the real rates of interest in the economy tend to be negative which in turn has a dampening effect on the growth of bank deposits as savers looking for higher returns divert their surplus funds towards unorganised credit markets. Once this happens, *financial repression* is likely to set in as genuinely productive investment activities typically experience a severe credit constraint while socially unproductive activities get easy access to funds thereby hampering the growth process of the economy. As banks in India, of late, have already begun to experience such a deceleration in their deposit growth, it is high time to put a check on the rising price level before it assumes catastrophic dimensions and eventually leads to financial repression and poses a major obstacle to economic growth.

In addition, rising prices are also unwelcome from the perspective of economic and social welfare in view of the highly iniquitous nature of inflation in the sense that it adversely affects the fixed-income groups of the society while enabling some variable-income groups, profiteers and speculators to enjoy *windfall gains*. By making the cost of borrowing capital artificially low in real terms, severe inflationary tendencies also tend to encourage the use of capital-intensive technologies in production which in turn is obviously undesirable in a labour-abundant economy characterised by large-scale unemployment like India. Furthermore, when the domestic rate of inflation is far in excess of that abroad, it tends to have a dampening effect on the Balance of Payments in as much as it makes imports relatively cheaper and exports from the economy *ceteris paribus* less competitive at the international level. It is thus clear that a high rate of domestic inflation is likely to put a serious hindrance in the attainment of practically all the objectives of public policy in a developing economy like India.

3 Current Trends of Inflation in the Indian Economy

According to Reserve Bank of India (2011e) in its 'Handbook of Statistics on Indian Economy 2010-11' released in September 2011, the trends in Wholesale Price Index as also its prominent components in India with 2004-05 as the base year can be summarised as shown in Table.

Table : Wholesale Price Index in India- Annual Average (Base: 2004-05 = 100)

Year	All Commodities	Primary Articles	Fuel and Power	Manufactured Products
2004-05	100.0	100.0	100.0	100.0
2005-06	104.5	104.3	113.6	102.4
2006-07	111.4	114.3	120.9	108.2
2007-08	116.6	123.9	121.0	113.4
2008-09	126.0	137.5	135	120.4
2009-10	130.8	154.9	132.1	130.1
2010-11	143.3	182.4	148.3	130.1

Source: Reserve Bank of India (2011), *"Handbook of Statistics on Indian Economy 2010-11."*

As is evident from Table, the Primary Articles have remained a significant contributor to inflationary rise in the Wholesale Price Index in India over the period under review *viz.*, 2004-05 through 2010-11. For, the Price Index of Primary Articles rose at the fastest pace over the concerned period so much so that it increased by around 82 percent in a matter of just six years. As is also clear from Table, the inflation in price of Primary Articles tended to gather momentum particularly since 2007-08. Consequently, the rate of growth of the Wholesale Price Index of Primary Articles substantially surpassed that of the Wholesale Price Index for All Commodities.

Another major contributor to 'headline inflation' in India based on the Wholesale Price Index for all commodities as per the data given in Table has been 'Fuel and Power' whose Wholesale Price Index has exhibited an erratic and volatile trend over the period under consideration. More specifically, the price index for Fuel and Power rose sharply by 13.6 percent from 2004-05 to 2005-06 but the pace of its growth declined by next year *i.e.*, 2006-07 when it merely rose from 113.6 to 120.9. Notably, over the next year it rose only marginally to 121 in 2007-08 thereby signifying stagnancy. But this trend turned out to be short-lived in as much as over the next year *viz.*, 2008-09, the Wholesale Price Index for Fuel and Power rose rather sharply to reach the level of 135 reflecting a growth as high as 11.6 % per annum. Quite surprisingly, however, it registered deceleration *i.e.*, negative growth or *deflation* when it fell down to 132.1 by 2009-10. But over the next year the fuel and power prices picked up their inflationary tendency when the relevant wholesale price index for them again rose sharply to 148.3 during 2010-11 indicating an annual growth of around 12.3 percent as is obvious from Table-I.

As is also clear from Table, it was only in the case of manufactured products that the inflation in the relevant wholesale price index was least which in a way contributed in somewhat containing the inflationary rise in overall price level resulting from other components namely 'primary articles' as well as 'fuel and power.' To be specific, over the entire sample period except for 2007-08, the Wholesale Price Index for Manufactured Products has been characterised by a lower rate of growth in comparison to the rate of inflation in the Wholesale Price Index for All Commodities. It must, however, be realised that in recent years especially since 2009-10 even manufactured products have started showing a tendency towards high inflation in the sense that between 2009-10 and 2010-11, the price index for manufactured products rose by approximately 5.7% from 123.1 to 130.1. This is in sharp contrast to its corresponding growth of just 2.2% over the previous year when it had increased from 120.4 in 2008-09 to 123.1 in 2009-10. That a component of the overall price index which has moderated its growth in the past is itself acquiring an inflationary tendency of growing at a faster pace in recent years is no doubt a grave area of policy concern for the Indian economy.

In the contemporary context, the price situation in India is particularly worrisome in the light of the fact that inflationary tendencies have started gathering momentum when the Indian economy has still not fully recovered from the impact of the global economic slowdown arising out of the financial crisis in the advanced economies popularly known as the U.S. sub-prime lending crisis. Evidently, it is imperative to ensure that any attempt at containing inflationary pressures in India should not jeopardise or endanger the growth recovery of the economy. This is all the more crucial in the face of an uncertain global environment that prevails in the current scenario. In the current circumstances, the Reserve Bank of India (2011c) has conceded that some short-run deceleration in growth may be unavoidable in bringing inflation under control.

Nevertheless, the monetary policy stance remains firmly anti-inflationary as acknowledging the significance of inflation control, the Reserve Bank of India (2011d) has expressed the strong opinion that policy interventions are necessary to address near-term and structural imbalances to bring down inflation on an enduring basis in India.

Prior to analysing the policy stance of the monetary authority in India as regards *containing inflation* and *anchoring inflationary expectations*, it is imperative to go into the root cause and genesis of the problem of Inflation in the Indian economy. For, the policy approach and its efficacy is essentially conditioned as also constrained by the major factors responsible for the emergence and continued persistence of the problem of Inflation in the economy.

4 Genesis of the Problem: The Main Factors Leading to Inflation in India

The monetary authority has time and again conceded in its various policy documents that the rate of inflation in India continues to remain at unacceptably high levels so much so that in recent years, many a times, the Indian economy witnessed double-digit inflation rates. Such alarming rates of inflation are way above the 5 percent mark considered as the 'growth promoting inflation level' or the 'normal inflation level' by the Reserve Bank of India.

According to FICCI (2011), for most part of the year 2010, it was the 'Primary Articles' segment which contributed substantially to overall inflation. Further, within the 'Primary Articles' segment, it was 'Food Articles' where inflation was at an uncomfortably high level throughout 2010. The problem is further compounded by the recently observed change in the consumption basket in favour of protein-rich items such as egg, meat and fish where price rise has been high just like milk and pulses.

The high level of food prices is indeed a matter of serious concern as the Indian economy is experiencing a continuing shortage of food items such as pulses and edible oils. Though owing to a good monsoon in recent months, the growth prospects of Indian agriculture especially the *rabi* crops appear to be quite bright, yet there is always a risk of the food price inflation acquiring a *structural character* in India in case the supply response does not improve sufficiently.

Apart from food, the Indian economy is particularly vulnerable to these supply shocks even on the front of energy as reflected by the sharp and persistent increases in fuel prices. In fact, beginning 2011, the contribution of 'Primary Articles' including 'Food Articles' to overall inflation has gone down whereas that of the other two broad segments *viz.* 'Fuel & Power' and 'Manufactured Goods' has gone up swiftly. According to FICCI (2011), while inflationary pressures seen in the case of 'Fuel and Power' can be attributed to the increase in prices of items like petrol and coal, the build-up of inflationary pressure in manufactured goods is largely the result of rising prices of raw materials and industrial inputs which are being passed on by manufacturers in the final prices of their products.

Owing to inflation getting increasingly generalised over time and inflationary pressures gradually spreading to all the three broad segments of the WPI, the gap between WPI-based 'headline inflation' on the one hand and 'core inflation' capturing the non-volatile components of WPI on the other has been narrowing down. It is worth noticing that while the supply shocks on the front of food primarily emanate at the domestic level say on account of a *drought* or *poor monsoon*, the supply shocks pertaining to petroleum, oil and lubricants essentially emerge at the international level.

Further, such supply shocks have typically been observed to be reinforced by demand-side pressures in worsening the inflationary scenario in the Indian economy. For instance, an increase in money supply unaccompanied by a commensurate increase in the productive capacity of the economy is potentially inflationary as it is likely to enhance the purchasing power and thereby *effective demand* in the economy without there being corresponding increases in supply. Such episodes of *demand-pull inflation* were more common during the pre-reform era prior to 1990s wherein there was frequent monetisation of public debt.

In recent years, however, due to the Government's commitment to fiscal discipline and effective curbing of fiscal deficits under a regime of *fiscal prudence* and fiscal responsibility legislations, the potential significance of this factor in contributing towards inflationary price rise in the economy has gone down. The fact of the matter is that in the contemporary context, even the Government of India has to carry out realistic cost-benefit calculations in case it wishes to increase its spending as it has no option but to raise resources from the market.

This should not, however, be taken to imply that demand-side factors have not contributed towards the recently observed high inflation rates in India. For, demand-side forces could operate in various forms at various levels. One such instance is visible in the case of recent food inflation in India which is essentially propelled by an enormous increase in the demand for various food items beyond cereals such as protein-rich sources like pulses, milk, meat, fish and eggs that are relatively deficient in supply. As the demand for sugar, fruits and vegetables in the economy is surging and as increasingly affluent consumers in India are gradually diversifying their dietary patterns away from cereals and towards protein sources whose supply is unable to effectively cope up with the expansions in demand, the inevitable outcome is an increase in prices.

5 Implications and Lessons for Policy-Making

It is clear from the foregoing analysis of the genesis, present dimensions and macro-impact of inflation in India that the severe inflationary tendencies prevalent in the Indian economy are the outcome of a complexity of demand-pull and cost-push factors operating both at domestic as well as international levels. To put it simply, the serious macro-problem of inflation in India is attributable to demand-side factors as also supply-side shocks observed not only at domestic but even global level.

Though a tighter monetary policy regime can be reasonably expected to go a long way in demand management with a view to dampening inflationary pressures, yet the problem of supply shocks calls for immediate efforts to quickly increase the availability of concerned items, as the long-term outlook of inflation in the economy is contingent on them. It must be realised that apart from enhancing domestic capacity, supply in the economy can also be expanded by effectively tapping global sources as has actually been done in the case of *white goods* in India under an era of globalisation and trade liberalisation ever since the early 1990s.

Side-by-side, the Government shall continue with and preferably intensify its other efforts to contain inflationary rise in the prices of essential commodities such as prevention of speculative hoarding of essential items, selective ban on exports and futures trading in food-grains, zero import duty on select food items, permitting import of pulses and sugar by public-sector undertakings, distribution of imported pulses and edible oils through the Public Distribution System (PDS), and release of higher quota of non-levy sugar.

This evidently suggests that no single type of economic policy in isolation can be relied upon to tackle the complex problem of inflation in the Indian economy. The need of the hour is to employ an optimal-mix of mutually reinforcing set of policies both on the demand-side as well as supply side so as to effectively rein in inflation and anchor inflationary expectations in India.

In this connection, FICCI (2011) is of the view that concerns on inflation are likely to remain on the policy agenda throughout the year 2011. Further, with restrictive monetary measures such as policy rate hikes by the Reserve Bank of India having failed to deliver on the stated objective of reining in inflationary pressures and bringing down inflationary expectations, it is high time that the government actively pursues supply side measures to curtail inflation in the Indian economy.

Likewise, in the context of inflation control, the Economic Survey 2010-11 of the Government of India (2011) observes that in addition to fuel, metal and mineral prices are also putting pressure on the domestic economy. Food inflation in particular has remained stubbornly in double digits for over a year now, which has welfare costs. There is need to remain cautious and be prepared to take proactive steps as the emerging scenario warrants, with the objective of bringing down inflation. Nevertheless, the Economic Survey 2010-11 is optimistic that going forward, inflation is likely to moderate in line with the monetary tightening measures taken by the Reserve Bank of India and other steps taken by the Government to address the supply-side bottlenecks.

There is, however, no ground for complacence on the front of inflation but rather a pressing need for continued vigilance against the build-up of demand-side pressures as risks to inflation remain on the upside in the near future, both from domestic demand and higher global commodity prices.

6 Conclusion

A high rate of domestic inflation is likely to put a serious hindrance in the attainment of practically all the objectives of public policy in a developing economy like India. For, severe inflationary tendencies pose a major obstacle to economic growth by leading to *financial repression*. In addition, inflationary pressures compound on the *unemployment problem* by encouraging capital-intensive technology in production, widen *inequalities* by affecting fixed and variable income-groups differently and *adversely affect the Balance of Payments* by inducing imports and making exports relatively costlier and hence less competitive at the international level.

This implies that high and persistent inflation could *per se* jeopardize the growth momentum and inclusive growth. Given that as per the relevant data, the Indian economy has witnessed more than expected inflation in the recent past and risks to inflation in 2011-12 have amplified from an uncertain outlook on international commodity prices, incomplete pass-through to domestic prices and possibility of prices of food, fuel, minerals and metals staying firm, sustaining the growth recovery while reining in inflation has become the top-priority area of macroeconomic management by planners and policy makers in India.

As the severe inflationary tendencies prevalent in the Indian economy right now are the outcome of a complexity of demand-pull and cost-push factors operating both at domestic as well as international levels, the need of the hour is to employ an optimal-mix of mutually reinforcing set of policies both on the demand-side as well as supply side so as to effectively rein in inflation and anchor inflationary expectations in India.

Thus it can be reasonably concluded that the current growth and inflation trends in India warrant that economic and public policy should be so designed as to effectively tackle both the demand as well as supply driven inflation shocks that are frequently experienced by the Indian economy.

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