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   REVIEW OF LITERATURE

   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

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   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

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   ACKNOWLEDGMENTS

   REFERENCES

   APPENDIX/ANNEXURE

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INCREASING PRESSURE OF INFLATION ON INDIA'S MACROECONOMIC STABILITY: AN OVERVIEW

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KOTHRUD

ABSTRACT

In this phase of deep global recession, India is one of the economies around the world that are experiencing high pangs of inflation. Indian economy is facing the effects of severe inflation in the form of rising food and energy prices. An uncomfortably high level of inflation is one of the major pressures on India's macroeconomic climate following the global financial crisis. Between the period 2008-09 and 2011-12, inflation in India can be attributed to both microeconomic and macroeconomic factors. The microeconomic factors responsible for high inflation include adverse supply shocks coming from failure of monsoon and high volatility in global crude oil prices. The macroeconomic factors include the demand side mismanagement and failure in coordination between fiscal and monetary policies. This paper attempts to identify the factors including government's monetary and fiscal policies that are responsible for inflation in the country. This paper not only seeks to examine the relationship between inflation and output gap but also identifies possible policy challenges arising from high inflationary trends and their implication on Indian economy.

KEYWORDS
CCPI (Composite Consumer price Index), GDP (Gross Domestic Product), Inflation, supply shock, WPI (Whole Price Index)

INTRODUCTION
In India, low and stable inflation remains a key objective of monetary policy along with growth and financial stability. Inflation dynamics in emerging economies like India are, however, relatively more complex than advanced economies in view of recurrent supply shocks and large weight of volatile components such as food items in the various price indices. These supply-side factors have exhibited significant volatility in the recent years and add complexity to inflation dynamics and its forecasting. A stagflation-type environment is emerging in India. GDP growth has slowed sharply to 6.5% in the fiscal year ending March 2012, from 8.5% in the previous year. Inflationary pressures remain persistent despite the Reserve Bank of India (RBI) hiking the repo rate 13 times by a cumulative 375 basis points since March 2010. Although the latest figures show headline inflation to have eased to 6%-7% in July 2012 from the highs of 9%-10% over the last two years, the moderation was mainly on account of the cooling in food and fuel prices. Inflation is still significantly above the RBI's comfort zone of 5%-6% and underlying inflationary pressures remain strong – the RBI has recently warned that inflation risks remain high in the short term owing to suppressed administered fuel prices as well as infrastructural bottlenecks in coal, minerals and power (Reserve Bank of India 2012). Poor monsoon conditions are also likely to have an adverse impact on food prices and, as a consequence, wages. This paper focuses on India's deteriorating growth-inflation trade off and also underlines the macroeconomic imbalances and structural weaknesses of the economy.

REVIEW OF LITERATURE
The impact of inflation on growth, output and productivity has been one of the main issues examined in macroeconomics. Theoretical models in the money and growth literature analyze the impact of inflation on growth focusing on the effects of inflation on the steady state equilibrium of capital per capita and output. There are three possible results regarding the impact of inflation on output and growth: i) none; ii) positive; and iii) negative. Recent cross-country studies, found that inflation affecting economic growth negatively, includes Fischer (1993), Barro (1996) and Bruno and Easterly (1998). Fischer (1993) and Barro (1996) found a very small negative impact of inflation on growth. Yet Fischer (1993: 281) concluded —however weak the evidence, one strong conclusion can be drawn: inflation is not good for longer-term growth. Barro (1996) also preferred price stability because he believed it to be good for economic growth. In the Indian context also, there are several studies analysing the nexus between government deficits, money supply and inflation. The findings of these studies generally point to a self perpetuating process of deficit-induced inflation and inflation-induced deficit, besides the overall indication that government defi cits represent an important determinant of inflation (for example, Sarma (1982), Jhadav (1994) and Rangarajan and Mohanty (1998)). The above results have been on the expected lines given that till the complete phasing out of the ad hoc treasury bills in 1997-98, a sizable portion of the government deficit which could not be financed through market subscription was monetized. Based on cross-country and panel regression, several studies have demonstrated in recent years, that there is negative correlation between inflation and growth in the long run due to the influence of the former on reducing investment and productivity growth. There is yet another set of studies (Bruno & Easterly, 1998, Sarel, 1996) which show that harmful effects of inflation are not universal, but appear only over the —threshold level of inflation.

SIGNIFICANCE OF THE STUDY
This paper is a moderate attempt to identify that the macroeconomic stability is one of the preconditions for sustained growth and the heavy bouts of inflation not only disturbs the macroeconomic climate of the economy but also impedes its growth. The paper is also significant as it pronounces that a prolonged high inflation even if originating from supply side would give rise to increased inflation expectations and cause general prices to rise. Poorly anchored inflation expectations make long-term financial planning more complex with potential adverse effects on investment and growth. The study also highlights the policy challenges arising due to economic slowdown in India following high inflationary trends and their implications on the macroeconomic climate of the country.

STATEMENT OF THE PROBLEM
One of the major pressures on India's macroeconomic climate following the global financial crisis is an uncomfortably high level of inflation. Thus it becomes imperative not only to study all the micro and macro economic factors including supply side problems and challenging demand side management, responsible for inflation in India, but also the policy challenges faced by the Indian economy following the inflationary trends and their implications on the macroeconomic stability of the country.

OBJECTIVES
1. To identify the inflationary trends and analyze the factors responsible for impeding the macroeconomic stability of India
2. To examine the relationship between inflation and output gap in India
3. To identify possible policy challenges arising from high inflationary trends and their implication on Indian economy

HYPOTHESES
1. Inflation and long term economic growth are negatively related.
2. The sensitivity of inflation to changes in growth rates is larger than that of growth to changes in inflation rates.

RESEARCH METHODOLOGY

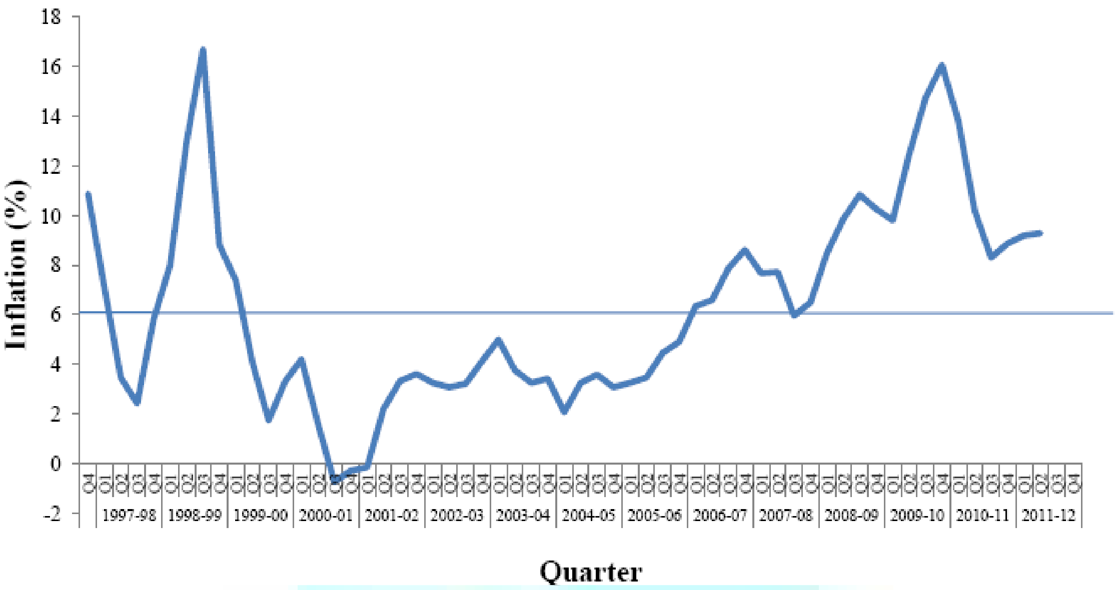
The research is descriptive and is based on secondary data collected from the bulletins of RBI. Even, data from earlier research studies have also been used. Research institutions, trade associations, universities and research scholars do collect data but they normally do not publish it. Such unpublished data have also been used wherever relevant. For an economically diverse country like India, a single measure of inflation does not suffice. Thus, the wholesale price and composite consumer price indices have been used to measure inflation. Besides, graphs have been used to indicate PLR (Prime Lending Rate), deposit rate and to depict the relationship between the output gap and inflation. Changes in Fiscal deficit as a percentage of GDP (Gross Domestic Product) have also been worked out.

FINDINGS AND RESULTS

1. STATE OF INFLATION IN INDIA

The rise in inflation expectations has been the key macro stability challenge. In the past, price levels as measured by WPI and CPI (industrial workers) usually tracked a similar trend — but over the last three years, a huge gap has opened up. The gap in price levels is not just because of higher weight of food in CPI and higher food inflation. Non-food CPI levels have also persistently been higher than WPI/non-food WPI. The following figure shows that inflation based on the Composite CPI (CCPI) is above 6 per cent since Q1 2006-07, the period after the Indian economy saw significant adverse supply shocks. The shock pertains to food and fuel.

FIGURE 1: INFLATION IN CCPI (%) FROM Q4 1996-97 TO Q2 2011-12



Source: Reserve Bank of India, WPS Jan 2012

During the post-crisis phase of 2008-12 while growth generally moderated, inflation rose complicating the task of monetary management. The Reserve Bank began exiting from the crisis-driven accommodative monetary policy stance in October 2009, first by phasing out all the unconventional measures and then raising interest rates. Overall, headline WPI inflation increased to an average of 7.6 per cent during 2008-12 largely reflecting near double digit inflation for most months during January 2010 - November 2011 period. WPI inflation has since moderated to around 7.0 per cent but remains above 5.5 per cent observed during the pre-crisis period. Growth moderation, coupled with signs of thawing of WPI inflation since December 2011, prompted the Reserve Bank to cut the repo rate by 50 basis points to 8.0 per cent in April 2012.

TABLE 1: MONETARY AND INFLATION INDICATORS (%)

	Pre-Crisis (2003-08)	Post Crisis (2008-12)	2012-13 (latest)
1	*2*	*3*	*4*
Money & Credit			
1. *Growth in Reserve Money (M_0)*	*20.4*	*11.6*	*7.1*
2. *Growth in Broad Money (M_3)*	*18.6*	*16.4*	*13.9*
3. *Growth in Non-food Bank Credit*	*26.7*	*18.3*	*16.2*
4. *Credit-GDP Ratio*	*39.3*	*50.8*	*-*
5. *Money Multiplier (M_3/M0)*	*4.6*	*4.9*	*5.3*
Inflation			
1. *Wholesale Price Index*	*5.5*	*7.6*	*6.9*
1.1 Food Articles	*5.2*	*11.8*	*10.1*
1.2 Fuel Group	*7.3*	*9.0*	*6.0*
1.3 Non-Food Mfg.	*5.0*	*4.8*	*5.4*
2. *CPI-Industrial Workers(IW)*	*5.0*	*10.1*	*10.1*
2.1 CPI-IW Food	*5.5*	*10.9*	*10.5*
GDP Deflator based Inflation	*5.3*	*7.7*	*-*

Source: Reserve Bank of India, WPS

2. INFLATION AND INDIA'S MACROECONOMIC CLIMATE

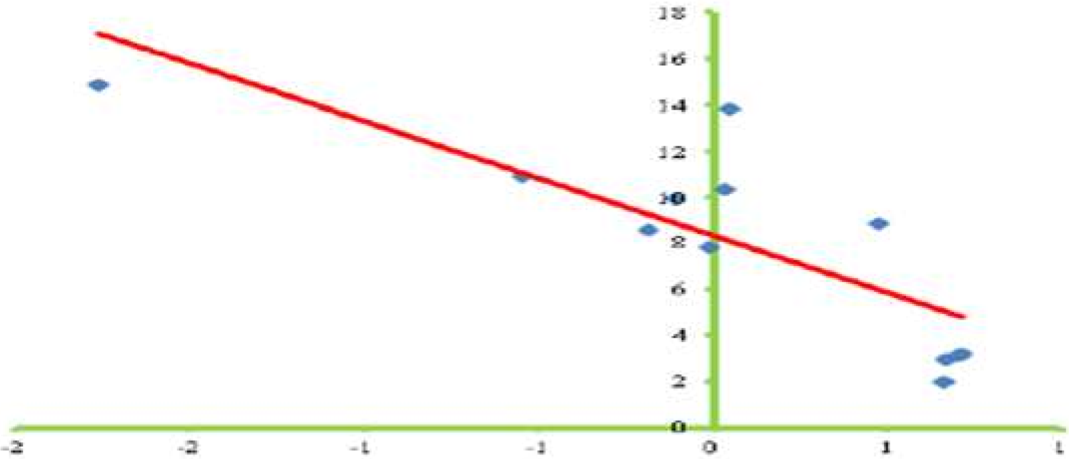
An uncomfortably high level of inflation is one of the major pressures on India's macroeconomic climate following the global financial crisis. Between the period 2008-09 and 2011-12, inflation in India can be attributed to both microeconomic and macroeconomic factors.

i. MICROECONOMIC FACTORS

The microeconomic factors are primarily supply side problems which refer to adverse supply shocks or cost-push inflation. Goyal and Pujari (2004) have found that the Indian economy is subject to large supply shocks. Inflation in India may be high due to negative supply shocks coming from two main sources- the failure of monsoon (kharif season production in 2008-09 and 2009-10) and high volatility in selected commodities in the global market, mostly fuel and basic metals or because of the residual term.

The following figure presents the linear relationship between the output gap and inflation.

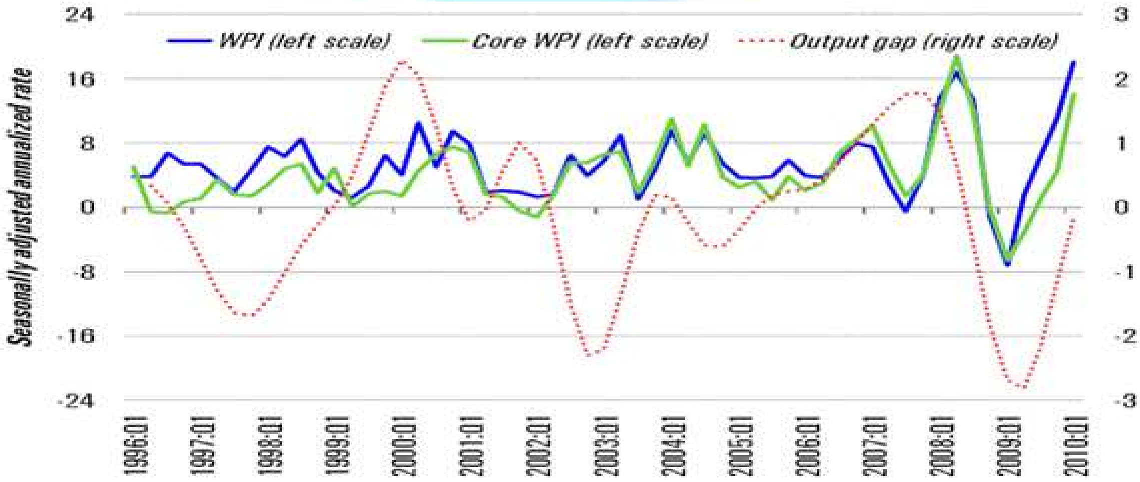
FIGURE 2: SUPPLY SHOCKS



Source: Reserve Bank of India, WPS Jan 2012

After the financial crisis, 2008-09 to 2011-12, the magnitude of the output gap in India was not at its minimum; at the same time, the inflation rate was also high. Available evidence supports that the government missed the macroeconomic objectives of output gap and inflation stabilization.

FIGURE 3: INFLATION AND OUTPUT GAP



Source: IMF Staff calculations

ii. MACROECONOMIC FACTORS

The macroeconomic factors relate to the effectiveness of demand management through fiscal and monetary policies. But in Indian context, Demand-side management had been a challenge during this period, not only because of the adverse spill over effect of global economic uncertainties on the Indian economy but also because of the political cycle (the general elections were held in 2009) that led to unsustainable fiscal expansion.

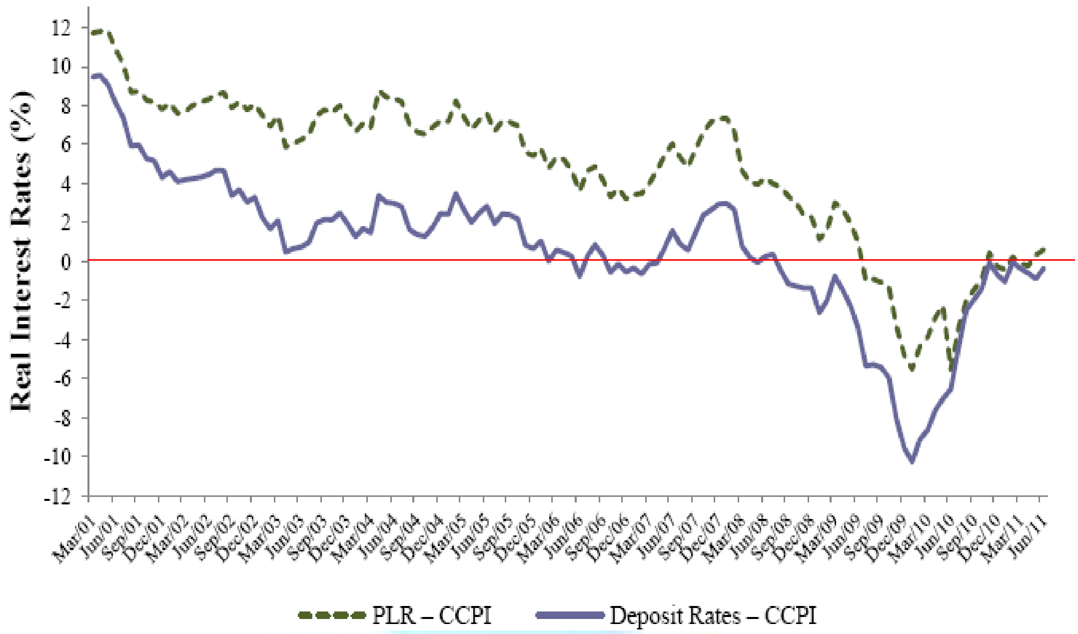
In 2008-09, the need to stimulate the economy following the global financial crisis dictated the stance on fiscal and monetary policy. Although there was coordination of monetary and fiscal policies during this phase, the co-ordination weakened when the government sought to exit the fiscal stimulus. After 2008-09, fiscal consolidation was achieved at the state and central government levels in 2010-11 but both the fiscal and monetary stances were loose during the financial years 2008-09 and 2011-12, and there was little or no indication that these would be tightened. Policy rates were raised several times in tiny doses that kept the real interest rate down; the interest rate was negative in 2010-11. In 2011-12, though the real interest rate finally reached a positive level in a few months, the slippage in fiscal consolidation proves that the fiscal-monetary policy co-ordination was a failure.

iii. FAILURE IN CO-ORDINATION BETWEEN FISCAL AND MONETARY POLICIES

2008-09

In the year 2008-09, the global financial crisis created turmoil in the Indian economy and worsened the slowdown in the domestic economy. As a result, the government introduced expansionary monetary and fiscal policies.

FIGURE 4: REAL INTEREST RATES – CCPI



Note: *1. PLR – Prime Lending Rates for five major banks.*
2. Deposit Rates – Rates on deposits of more than one year maturity

Source: Reserve Bank of India, WPS Jan 2012

On the monetary side, the real prime lending rate was brought down by 300 basis points (see figure 4), while on the fiscal side, the fiscal deficit of the central government and state governments was raised by 3.5 per cent and 1.1 per cent of the GDP respectively (see Figure 5). The central government's fiscal stimulus was stronger partly because the slowdown occurred just before general elections to Parliament. Since a monetary policy makes its effects felt with a lag, the monetary policy of 2008-09 would have had an impact on the growth of the following year. As a result, 2008-09 did not witness a problem of overheating. However, in Q3 2008-09, there was an adverse supply shock because of the failure of food grains production in the kharif season, which caused inflationary pressure.

FIGURE 5: CHANGE IN FISCAL DEFICITS AS A PERCENTAGE OF GDP

Source: Macroeconomic and Monetary Developments (July 2011, RBI)

2009-10

Inflationary pressures were much more visible in 2009-10 when the economy began to overheat because of the impact of monetary policies and the extended second round of fiscal stimulus. The output gaps for Q2 and Q4 2009-10 touched 1.7 per cent and 1.2 per cent respectively. This was worsened by an adverse supply shock arising from a second successive year of kharif crop failure in the third quarter of the year. The crop failure was more severe than that of 2008-09.

2010-11

In 2010-11, fiscal tightening happened at both the central and the state level, but overheating continued because of the impact of monetary policy – real prime lending rates had been negative from June 2009 to September 2010 after which they began moving closer to zero.

2011-12

In the first half of the 2011-12, real prime lending rates reached a positive level, but the central government's failed attempt at fiscal consolidation for a second year has caused overheating of the economy.

POLICY CHALLENGES AND RECOMMENDATIONS

Following are the policy challenges for the Indian economy to regain the growth momentum.

- Though supply shocks are temporary in nature, monetary tightening is required.

- The major challenge is to dampen inflation and focus on removing supply side bottlenecks and adopting policies that would improve productivity.
- Indian economy that is not fully adjusted to a given rate of inflation may suffer from relative price distortions caused by inflation. Policy makers need to make a provision for this as well.
- Though the output gap is an unknown variable, stabilisation of the output gap may help lower inflation and hence, should be the major macroeconomic policy objective.
- There is an urgent need to coordinate the fiscal and monetary policies. Rule-based fiscal policy becomes absolutely important to afford the space for monetary policy to contribute to the improved macroeconomic performance. Fiscal prudence is also required to alleviate the resource constraints by boosting domestic saving crucial for raising domestic investment rate.
- Monetary policy needs to focus on containing inflation and anchoring inflation expectations. This is essential to usher in a low interest rate environment which is crucial for raising the overall investment.
- The major policy challenges arise from higher money growth on account of persistent fiscal constraint, revival in private credit demand and surges in capital flows, on the one hand, and higher policy interest rate chasing higher inflation on the other.
- Nominal interest rates are often controlled, and hence real interest rates may become negative and volatile, discouraging savings. This may pose a great challenge for the policy makers.
- Depreciation of exchange rates may lag behind inflation, resulting in variability in real appreciations and exchange rates.
- Real tax collections do not keep up with inflation, because collections are based on nominal incomes of an earlier year (the Tanzi effect) and public utility prices are not raised in line with inflation. For both reasons, the fiscal problem is intensified by inflation, and public savings may be reduced. This may adversely affect public investment and thus a provision is required to be made for it.
- Policy makers also need to see that the high inflation is unstable. There is uncertainty about future rates of inflation, which reduces the efficiency of investment and discourages potential investors.

CONCLUSION

India's current economic slowdown reflects both cyclical and structural factors. A slowdown in the investment cycle, combined with supply constraints and a subdued external environment has caused growth to slow to below trend. The post-crisis policy environment suggests that the supply shock was handled inappropriately. Fiscal and monetary stimuli were not designed to achieve macroeconomic stability. While fiscal tightening was hindered by the impending elections, there was also a delay in tightening the monetary policy. In view of long and variable transmission lags, it is important for monetary policy to respond to expected inflation and output dynamics. Reliable forecasts of growth and inflation are, therefore, important for effective monetary management.

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