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FINANCIAL DEVELOPMENT OF INFLATION INDIAN ECONOMY

Dr.E.Thamilarasi
Assistant Professor, Department of Commerce
GSS Jain College
Vepery Chennai – 600007.

DEFINITION OF INFLATION

Inflation is the percentage change in the value of the Wholesale Price Index (WPI) on a year-on year basis. It effectively measures the change in the prices of a basket of goods and services in a year. In India, inflation is calculated by taking the WPI as base.

OBJECTIVE OF THE STUDY

The primary objective of the present study is to present an overview of inflation, its indices and measures for controlling inflation for a better development.

METHODOLOGY

This study is based on secondary data which were collected from various websites and related articles. The study also covers the information given by RBI, various inflation records of the government.

HISTORY OF INFLATION IN INDIA

India'has always suffered from the problem of inflation. There were years when the annual rate of inflation was as high as 40%, while in other years it was in the negative. During last 70 years, beginning with 1939-40, inflation rate was below 6% for 34 years and for remaining years it was above 6%. If the tolerable rate of inflation is assumed to be 6% and below, then India appears to have fared badly in terms of control over inflation, as for 36 years the rate of inflation was above 6%. For about 9 years, the rate of inflation was above 15%. Therefore, there are many who believe India to be an inflation ridden country.

CAUSES OF INFLATION

Population - The population of India has been on a continuous rise. The decadal growth rate according to the 2011 census of India has been 17.64%. The growth rate of the essential goods and commodities (like food, oil, land etc.) has not been able to match our population growth. Factors like increase in the cost of land due to population growth also lead to an increase in the cost of production.

Unbalanced economic growth - The Indian economy has been growing at a fast rate for the last few years. But this economic growth has not been balanced. The contributions towards economic growth from the primary (agriculture), secondary (industry) and tertiary (services) sectors are 17.2%, 26.4% and 56.4% respectively. So the growth in the primary or agricultural output has been way less than average. Due to this we are required to import a good quantity of basic goods and commodities for consumption. The weak INR has not helped in this regard. The prices of these imported goods and commodities have been on the rise due to a weak INR.

Increase in spending capacity – Due to economic growth people have more money to spend in general. Schemes like MGNREGS and the Sixth Pay Commission have also led to an increase in the spending power of people. People employed in the private sectors have also seen a jump in their earnings. Now this has led to an improvement in the living standards of people, but since it is not matched with a similar increase in output prices have gone up.

There has been a global increase in the price of essential commodities like food, oil, steel etc. thus further increasing the cost of imports.

Table -1

Inflation rate based on CPI index

YEAR	AVERAGE INFLATION(CPI)	ANNUAL INFLATION(CPI)
2000	4.02	3.48
2001	3.77	5.16
2002	4.31	3.20
2003	3.81	3.72
2004	3.77	3.78
2005	4.25	5.57
2006	5.79	6.53
2007	6.39	5.51
2008	8.32	9.70
2009	10.83	14.97
2010	12.11	9.47

2011	8.87	6.49
2012	9.30	11.17
2013	10.92	9.13
2014	6.42	-

The above table shows the inflation rate based on CPI which means Consumer Price Index. It also shows that the inflation is gradually increasing from 2000 and it has reached its peak at 2009, and from the above table inflation was meagre at the year of 2000.

Table -2

Inflation rate based on WPI index

Period	INFLATION RATE AS PER WPI INDEX
2000-2001	7.2
2001-2002	3.6
2002-2003	3.4
2003-2004	5.5
2004-2005	6.5
2005-2006	4.4
2006-2007	5.4
2007-2008	4.7
2008-2009	8.3

The above table shows the inflation rate based on WPI which means Wholesale Price Index. WPI index is commonly used indices for inflation calculation in India. From the above table inflation rate was highest at the period of 2008 to 2009 and reached its minimum at the period of 2002 to 2003.

FACTORS FOR CALCULATING INFLATION

There are several factors which help to determine the inflationary impact in the country and further help in making a comparative analysis of the policies for the same. The major determinant of the inflation in regard to the employment generation and growth is depicted by the Phillips curve.

DEMAND FACTORS

It basically occurs in a situation when the aggregate demand in the economy has exceeded the aggregate supply. It could further be described as a situation where too much money chases just few goods.

SUPPLY FACTORS

The supply side inflation is a key ingredient for the rising inflation in India. The agricultural scarcity or the damage in transit creates a scarcity causing high inflationary pressures. Similarly, the high cost of labour eventually increases the production cost and leads to a high price for the commodity.

DOMESTIC FACTORS

Developing economies like India have generally a lesser developed financial market which creates a weak bonding between the interest rates and the aggregate demand. This accounts for the real money gap that could be determined as the potential determinant for the price rise and inflation in India.

EXTERNAL FACTORS

The exchange rate determination is an important component for the inflationary pressures that arises in the India. The liberal economic perspective in India affects the domestic markets. As the prices in United States of America rises it impacts India where the commodities are now imported at a higher price impacting the price rise. Hence, the nominal exchange rate and the import inflation are measures that depict the competitiveness and challenges for the economy.

MEASURES FOR CALCULATING INFLATION

INDEX NUMBER:

An Index number is a single figure that shows how the whole set of related variables has changed over time or from one place to another. In particular, a price index reflects the overall change in a set of prices paid by a consumer or a producer, and is conventionally known as a Cost-of-Living index or Producer's Price Index .

PRICE INDEXES / INDICES USED IN INDIA :

In India there are five major national indices for measuring inflation or price levels.

(a) The Wholesale Price Index (base 1993-94) is usually considered as the headline inflation indicator in India.

(b) In addition to Whole Price Index (WPI), there are four different consumer price indices which are used to assess the inflation for different sections of the labour force.

(c) In addition to above five indices, the GDP deflator as an indicator of inflation is available for the economy as a whole and its different sectors, on a quarterly basis

WHOLESALE PRICE INDEX (WPI) :

This index is the most widely used inflation indicator in India. This is published by the Office of Economic Adviser, Ministry of Commerce and Industry. WPI captures price movements in a most comprehensive way. It is widely used by Government, banks, industry and business circles. Important monetary and fiscal policy changes are linked to WPI movements. It is in use since 1939 and is being published since 1947 regularly. With the changing times, the economies too undergo structural changes. Thus, there is a need for revisiting such indices from time to time and new set of articles / commodities are required to be included based on current economic scenarios. Thus, since 1939, the base year of WPI has been revised on number of occasions. The current series of Wholesale Price Index has 2004-05 as the base year. Latest revision of WPI has been done by shifting base year from 1993-94 to 2004-05 on the recommendations of the Working Group set upwith Prof Abhijit Sen,, Member, Planning Commission as Chairman for revision of WPI series.

CONSUMER PRICE INDEX (CPI)

The CPI measures price change from the perspective of the retail buyer. It is the real index for the common people. It reflects the actual inflation that is borne by the individual. CPI is designed to measure changes over time in the level of retail prices of selected goods and services on which consumers of a defined group spend their incomes.

PROBLEMS OF INFLATION

There are potential problems with an inflation target in an emerging economy such as India. More than in advanced economies, the consumer price index (which the RBI wants to target) is dominated by subsistence goods, such as energy or food. These items are subject to external shocks, which may force the central bank to react even when interest rates can do little to solve the underlying causes of inflation. This is why the RBI is right to be thinking about targeting a band, rather than a single-digit benchmark. This flexibility would be handy even in the event of temporary currency shocks.

Changing the monetary framework will not, on its own, solve India’s inflation problem. This requires building better infrastructure so that food and other goods are transported more easily, limiting the risk of price spikes. It is also necessary that the government narrows its large budget deficit, for example cutting rural employment programmes that help to push up wages artificially in the countryside.

METHODS TO CONTROL INFLATION

One popular method of controlling inflation is through contractionary monetary policy. The goal of a contractionary policy is to reduce the money supply within an economy by decreasing bond prices and increasing interest rates. This helps reduce spending because when there is less money to go around, those who have money want to keep it and save it, instead of spending it. It also means less available

credit, which also reduces spending. Reducing spending is important during inflation because it helps halt economic growth and, in turn, the rate of inflation.

There are three main ways to carry out a contractionary policy. The first is to increase interest rates through the Federal Reserve. The Federal Reserve rate is the rate at which banks borrow money from the government, but, in order to make money, they must lend it at higher rates. So, when the Federal Reserve increases its interest rate, banks have no choice but to increase their rates as well. When banks increase their rates, less people want to borrow money because it costs more to do so if that money accrues interest. So, spending drops, prices drop and inflation slows.

The second method is to increase reserve requirements on the amount of money banks are legally required to keep on hand to cover withdraws. The more money banks are required to hold back, the less they have to lend to consumers. If they have less to lend, consumers will borrow less, which will decrease spending.

The third method is to directly or indirectly reduce the money supply by enacting policies that encourage reduction of the money supply. Two examples of this include calling in debts that are owed to the government and increasing the interest paid on bonds so that more investors will buy them. The latter policy raises the exchange rate of the currency due to higher demand and, in turn, increases imports and decreases exports. Both of these policies will reduce the amount of money in circulation because the money will be going from banks, companies and investors pockets and into the government’s pocket where they can control what happens to it.

CONCLUSION

While inflation is expected to slow down reflecting monetary tightening and likely softening of global commodity prices, fiscal policy needs to be supportive in containing aggregate demand. In addition, there is an urgent need to address the issue of structural supply constraints, particularly in agriculture, so that these do not become binding constraints in the long-run task of inflation management.

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