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An Analysis on the Effect of Inflation on the Country's Economy and Its Aftermath

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Abstract

There is an estimation of an augmented Phillips curve to examine the effects of supply shocks on inflation in India. The results suggest that supply shocks have only a transitory effect on headline and core inflation rates. The evidence is robust to various respecifications and measures of core inflation. A possible explanation for this is that monetary policy has not provided the basis for a permanent change in the inflationary process by accommodating supply shocks, i.e. the expansion of the money supply in response to negative supply shocks. Thus, monetary authorities have implicitly targeted the core measure of inflation by discounting price movements that are expected to reverse in the short term. In short, it is not supply shocks per se that are decisive in determining inflation, but how policymakers respond to these shocks.

This paper examines the drivers of headline inflation and its component, food inflation in India, using monthly data from April 1996 to March 2017. The analysis includes measures of both WPI and CPI-IW inflation along with their food inflation component. The study uses a cointegration approach to identify the determinants of inflation in India. Empirical estimates of the study show that there is a long-run relationship between inflation and its determinants, which include expected inflation, output gap, growth rate of money supply, exchange rate, interest rate, fiscal deficit, minimum support prices, international oil discounts and food prices.

Keywords

Inflation, Growth, Aftermath, Comparison, Rate

INTRODUCTION

Normalized generalized variance decompositions suggest that the determinants of inflation in descending order of importance include expected inflation, the exchange rate, the growth rate of the money supply and the output gap, and the least variation in these is explained by interest rates. This analysis is found to be similar for both inflation rates. Thus, demand factors such as the exchange rate, the growth rate of the money supply, and the output gap explain significant differences in both indicators. On the supply side, global factors such as international oil and food prices play a key role in determining

overall and food inflation in the economy. This has important policy implications in light of the new monetary framework, where the central bank has adopted flexible inflation targeting. Managing inflation becomes a more challenging task because inflation is also significantly determined by supply-side variables. A report by the Reserve Bank of India Expert Committee to Revise and Strengthen the Monetary Policy Framework (ECRSMPF) states that monetary policy has little or no effect on food and fuel inflation, which are supply-side factors. The report also finds that high inflation in food and fuel, with strong spillover effects, generalizes in the system through inflationary expectations. Shocks to food and support inflation have a high degree of persistence to household inflation expectations, leading to longer-lasting effects on headline inflation. Thus, to better manage the dynamics of inflation, the analysis of driving factors can help predict likely changes in inflation more efficiently and accurately.

Given the growing concern, particularly in the EMU area, that too low an inflation threshold may harm economic growth, this study aims to explore whether the perspective of developing countries differs. Empirical analysis is conducted using annual data from India for the period 1971–1998. The specific question addressed in this paper is the threshold inflation rate for India. The findings clearly indicate that an increase in inflation from any level has a negative effect on economic growth, and substantial gains can be made by focusing monetary policy on maintaining price stability.

OBJECTIVES

To analyse the current state of inflation in the country.

To analyse the rates of inflation of the country in the past and in the current period.

To determine the aftermath of the current progression of inflation in the country.

REVIEW OF LITERATURE

(Jha, 2008) evaluates the case for inflation targeting (IT) in India. The author provides some evidence on the effects of IT in developed and transition economies and argues that although IT may have been responsible for maintaining a low inflation regime, it has not brought down the inflation rate itself substantially and or changed the volatility of the exchange rate.

(Pattanaik & Nadhanael, 2012) state that the inflation target for monetary policy may have to be somewhat lower than the growth maximizing threshold, since any positive inflation could be a risk to inclusive and sustainable growth objective.

(Mohanty & John, 2015) attempt to identify the determinants of inflation in India in a multivariate econometric framework using quarterly data from Q1: 1996–1997 to Q3: 2013–2014. The authors point out that the identified determinants of domestic inflation such as crude oil prices, output gap, fiscal policy and monetary policy, and their relation with inflation is studied in a structural vector auto regression (SVAR) model.

(Ball *et al.*, 2016) examine the behavior of quarterly inflation in India since 1994, both headline inflation and core inflation as measured by the weighted median of price changes across industries. The authors explain core inflation with a Phillips curve in which the inflation rate depends on a slow-moving average of past inflation and on the deviation of output from trend.

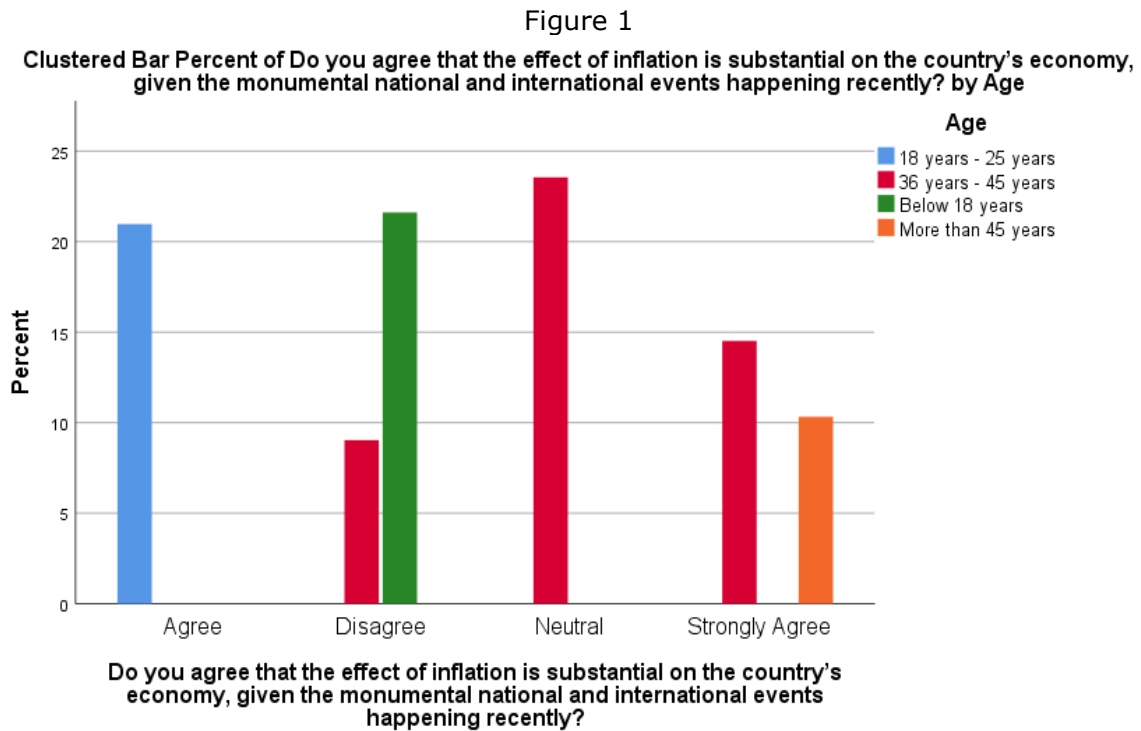
(Dua & Goel, 2021) examine the drivers of overall inflation and its component, food inflation in India using monthly data from April 1996 to March 2017. The analysis covers both WPI and CPI-IW measures of inflation along with their component food inflation.

METHODOLOGY

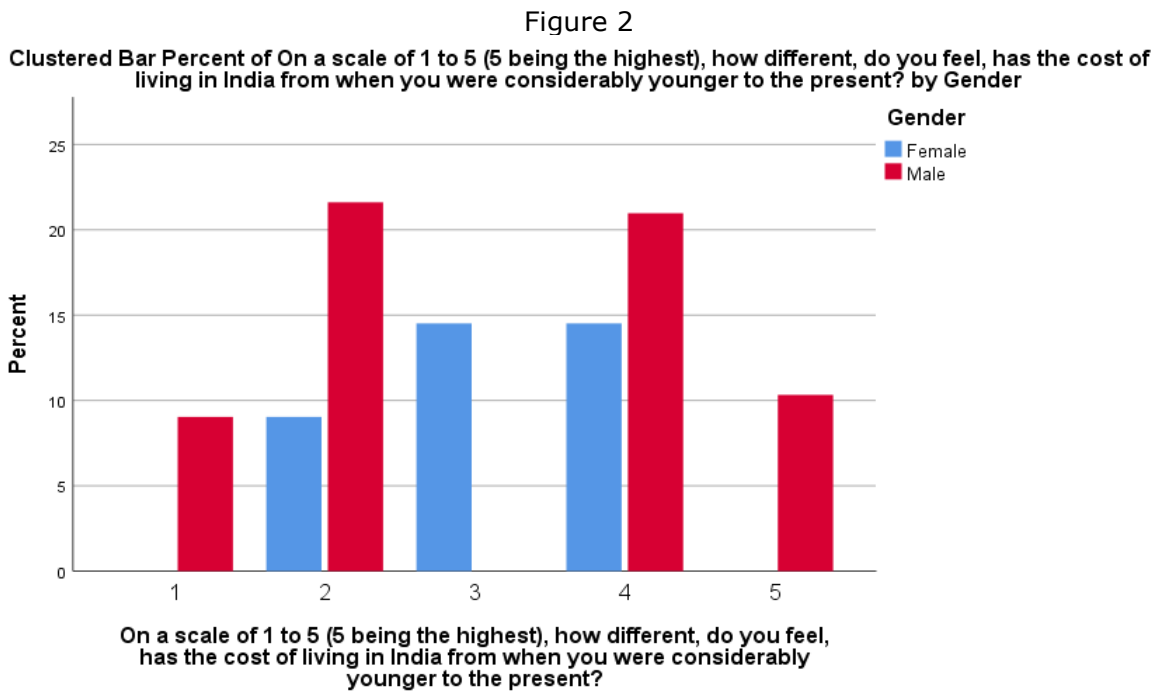
The method of research employed here is empirical research. The samples are 310 in number and were collected through a convenience sampling method. The respondents were contacted online through WhatsApp and were asked to answer an online questionnaire. Age, Gender, Marital Status and Educational Qualification are the independent variables and opinion on substantiality of effect of inflation in the country, difference in cost of living, aftermath of rate of inflation and opinion on if India's inflation

rate could be brought under control are dependent variables. The variables are statistically represented using graphs, more specifically bar graphs and pie charts.

ANALYSIS

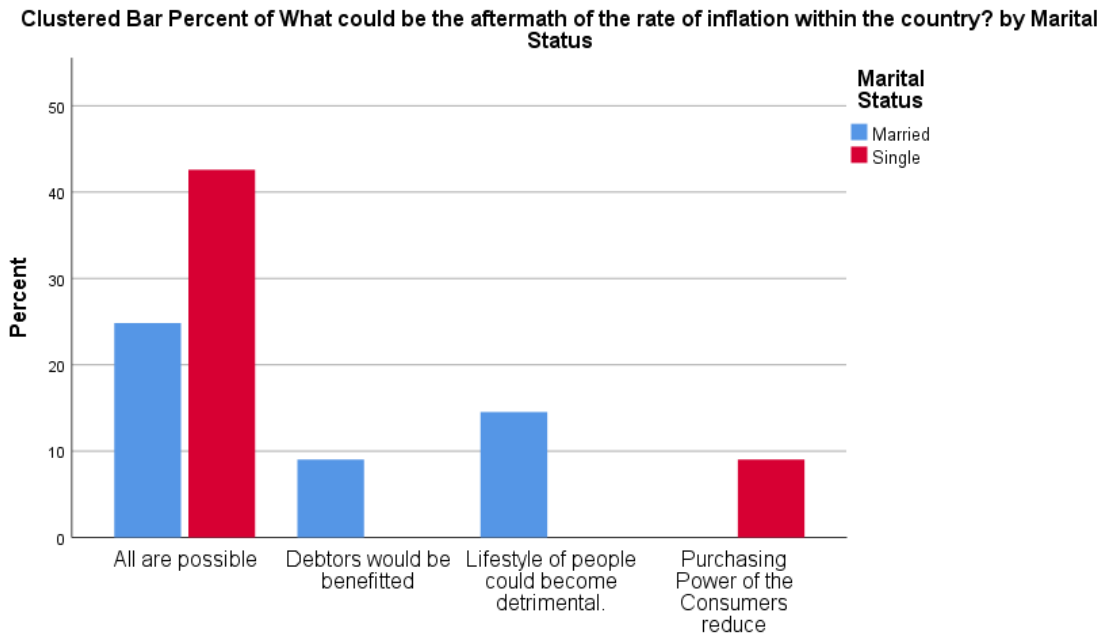


LEGEND: Figure 1 represents the age distribution of the sample population and their opinion on the substantiality of inflation with respect to the country's economy.



LEGEND: Figure 2 represents the gender distribution of the sample population and their rating on the differences in the cost of living.

Figure 3

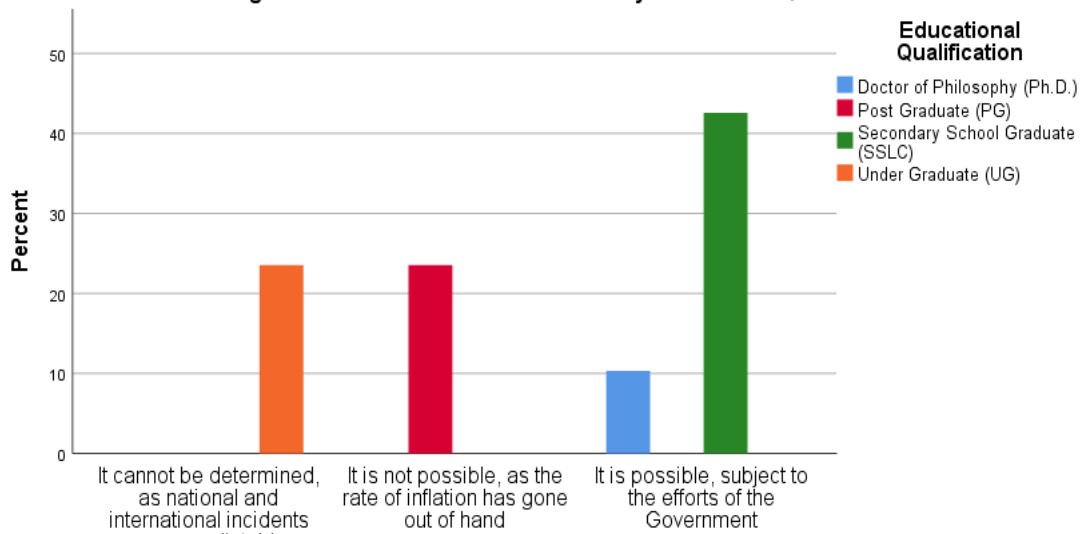


What could be the aftermath of the rate of inflation within the country?

LEGEND: Figure 3 represents the distribution of the sample population with respect to their marital status and their opinion on the aftermath of inflation.

Figure 4

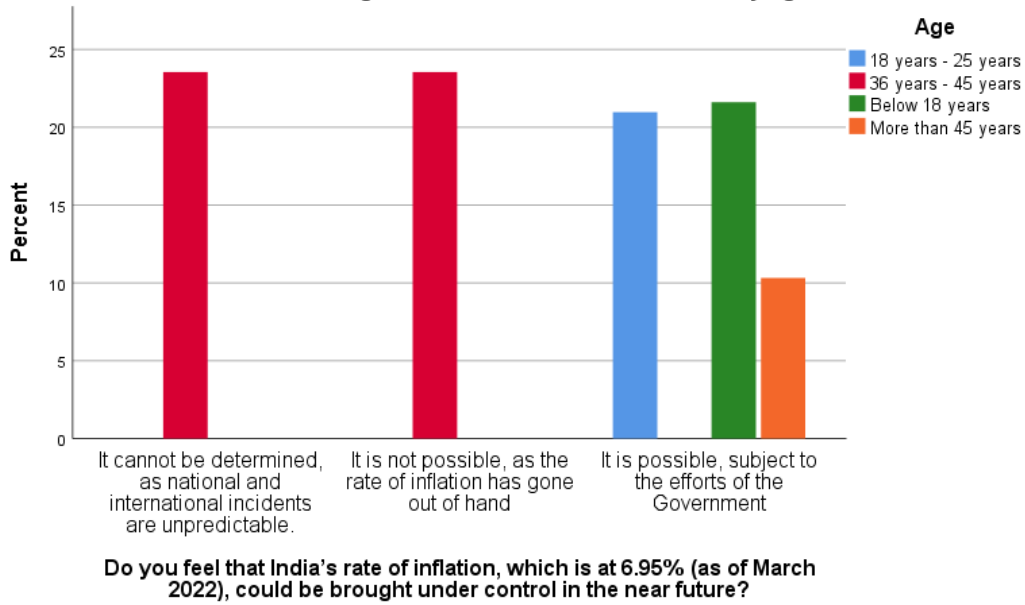
Clustered Bar Percent of Do you feel that India's rate of inflation, which is at 6.95% (as of March 2022), could be brought under control in the near future? by Educational Qualification



Do you feel that India's rate of inflation, which is at 6.95% (as of March 2022), could be brought under control in the near future?

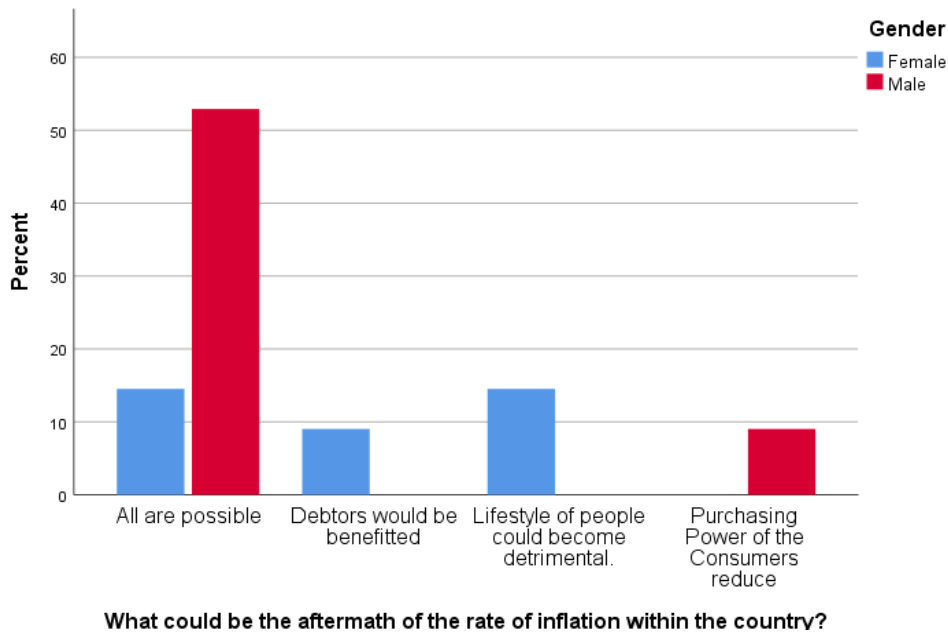
LEGEND: Figure 4 represents the distribution of the sample population with respect to their educational qualifications and their opinion on if the country's inflation can be brought under control

Figure 5
 Clustered Bar Percent of Do you feel that India's rate of inflation, which is at 6.95% (as of March 2022), could be brought under control in the near future? by Age



LEGEND: Figure 5 represents the age distribution of the sample population and their opinion on if the country's inflation can be brought under control.

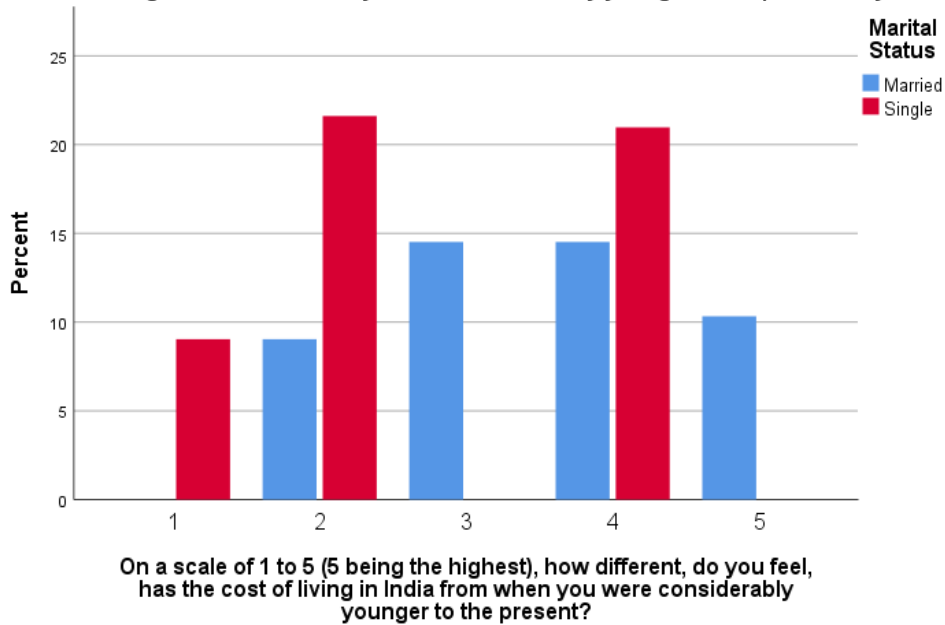
Figure 6
 Clustered Bar Percent of What could be the aftermath of the rate of inflation within the country? by Gender



LEGEND: Figure 6 represents the gender distribution of the sample population and their opinion on the aftermath of inflation.

Figure7

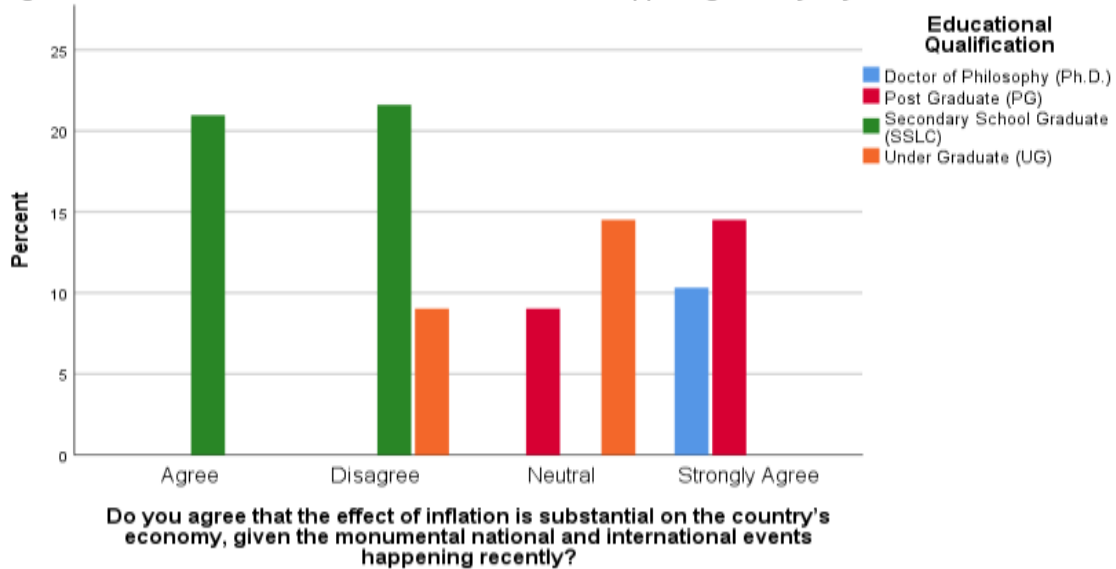
Clustered Bar Percent of On a scale of 1 to 5 (5 being the highest), how different, do you feel, has the cost of living in India from when you were considerably younger to the present? by Marital Status



LEGEND: Figure 7 represents the distribution of the sample population with respect to their marital status and their rating on the differences in the cost of living.

Figure 8

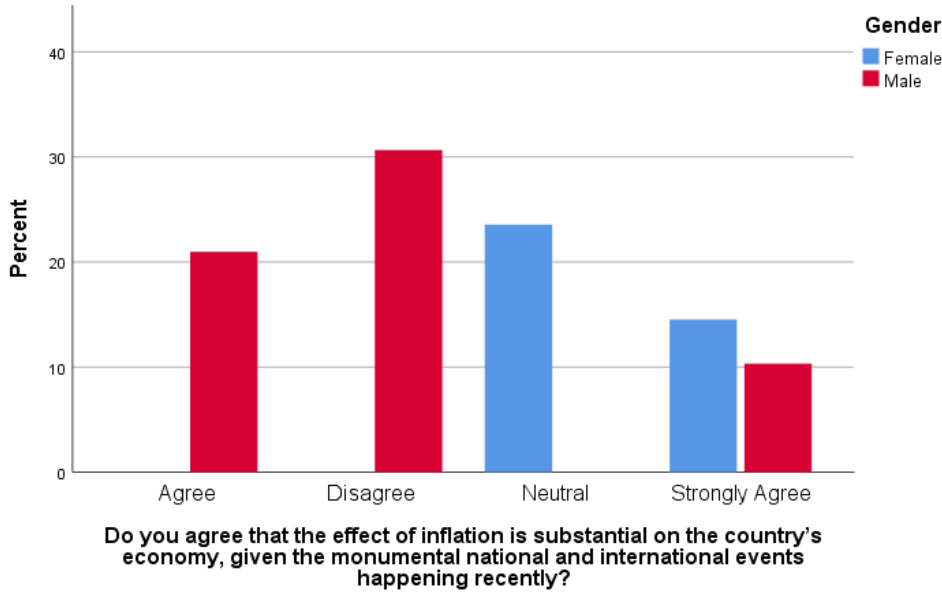
Clustered Bar Percent of Do you agree that the effect of inflation is substantial on the country's economy, given the monumental national and international events happening recently? by Educational Qualification



LEGEND: Figure 8 represents the distribution of the sample population with respect to their educational qualifications and their opinion on the substantiality of inflation with respect to the country's economy.

Figure 9

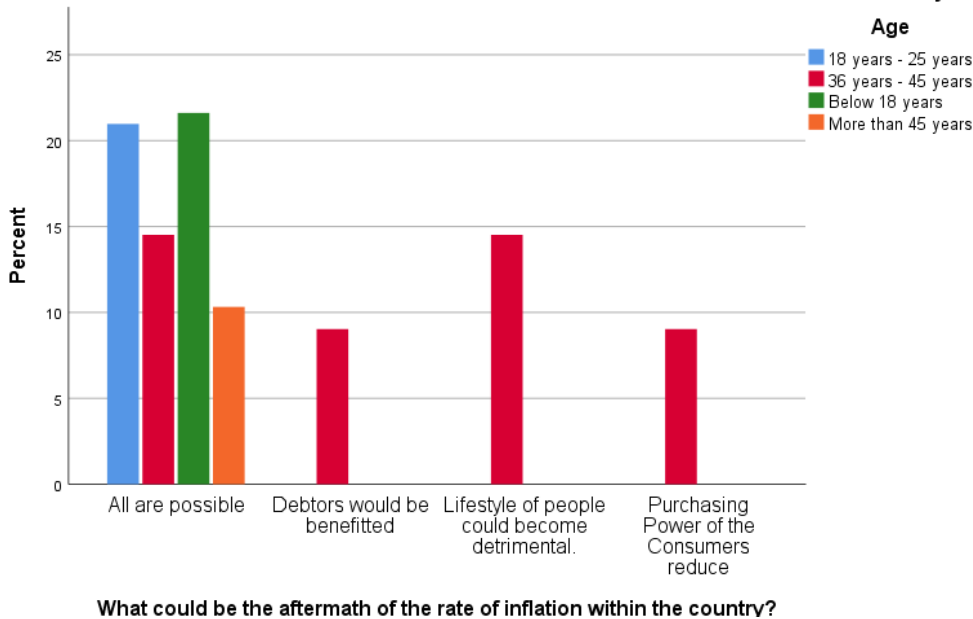
Clustered Bar Percent of Do you agree that the effect of inflation is substantial on the country's economy, given the monumental national and international events happening recently? by Gender



LEGEND: Figure 9 represents the gender distribution of the sample population and their opinion on the substantiality of inflation with respect to the country's economy.

Figure 10

Clustered Bar Percent of What could be the aftermath of the rate of inflation within the country? by Age



LEGEND: Figure 10 represents the age distribution of the sample population and their opinion on the aftermath of inflation.

RESULTS

A significant number of respondents belonging to the age group of 18 to 25 years have equivalently stated that the effects of inflation are substantial on the country's economy (**Figure 1**). A large number of male respondents rate a 4 out of 5 that the cost of living from when they were younger is different from now (**Figure 2**). Majority of single

respondents state that all given options are possible when referring to the aftermath of inflation in India (**Figure 3**). Respondents who happened to be Secondary School Graduates, state that controlling the current inflation rate is possible, subject to the efforts of the Government (**Figure 4**). Respondents, who happen to be within the age group of 18 to 25 years, state that controlling the current inflation rate is possible, subject to the efforts of the Government (**Figure 5**). A large number of male respondents state that all given options are possible when referring to the aftermath of inflation in India (**Figure 6**). A significant number of single respondents rate a 4 out of 5 that the cost of living from when they were younger is different from now (**Figure 7**). Respondents who happened to be Secondary School Graduates, have equivalently stated that the effects of inflation are substantial on the country's economy (**Figure 8**). A large number of male respondents have equivalently stated that the effects of inflation are substantial on the country's economy (**Figure 9**). Respondents, who happen to be within the age group of 18 to 25 years, state that all given options are possible when referring to the aftermath of inflation in India (**Figure 10**).

DISCUSSION

A significant number of respondents belonging to the age group of 18 to 25 years have equivalently stated that the effects of inflation are substantial on the country's economy. This shows the awareness of the respondents on the economic situation of the country (**Figure 1**). A large number of male respondents rate a 4 out of 5 that the cost of living from when they were younger is different from now. This shows a visible difference, according to the respondents, in the cost of livelihood in different time periods. (**Figure 2**). Majority of single respondents state that all given options are possible when referring to the aftermath of inflation in India. This showcases the multiplicity of impacts that inflation has on the economy (**Figure 3**). Respondents who happened to be Secondary School Graduates, state that controlling the current inflation rate is possible, subject to the efforts of the Government. This points out the belief of the respondents within the government of India. (**Figure 4**). Respondents, who happen to be within the age group of 18 to 25 years, state that controlling the current inflation rate is possible, subject to the efforts of the Government. This points out the belief of the respondents within the government of India. (**Figure 5**). A large number of male respondents state that all given options are possible when referring to the aftermath of inflation in India. This showcases the multiplicity of impacts that inflation has on the economy (**Figure 6**). A significant number of single respondents rate a 4 out of 5 that the cost of living from when they were younger is different from now. This shows a visible difference, according to the respondents, in the cost of livelihood in different time periods (**Figure 7**). Respondents who happened to be Secondary School Graduates, have equivalently stated that the effects of inflation are substantial on the country's economy. This shows the awareness of the respondents on the economic situation of the country (**Figure 8**). A large number of male respondents have equivalently stated that the effects of inflation are substantial on the country's economy. This shows the awareness of the respondents on the economic situation of the country (**Figure 9**). Respondents, who happen to be within the age group of 18 to 25 years, state that all given options are possible when referring to the aftermath of inflation in India. This showcases the multiplicity of impacts that inflation has on the economy (**Figure 10**).

LIMITATIONS

The nationwide lockdown implemented due to the outburst of the COVID-19 pandemic happened to be a strong impediment for conducting the study as it restricted the means and ability to traverse out to gain samples and to get in direct contact with the sample population. This was replaced by the online collection of samples from the respondents.

CONCLUSION

The wheat futures market on the National Commodity & Derivatives Exchange Ltd. (NCDEX) was studied and the efficiency was estimated using the Johansen cointegration approach for different futures forecast horizons ranging from one week to three months. The commodity futures market is not efficient even in the short term. Social loss statistics also point to poor price detection. Growth in the volumes of commodity futures markets also has a significant impact on inflation in the economy.

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