Impact of Inflation and Global Economic Recession on India's Growth

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Abstract

The World Economic Recession during 2007-08 and the recent European Economic Crisis have resulted in an economic slowdown all over the world. But, the Indian economy is more self-reliant in nature and less depending on the external economy, compared to other developing countries. Hence, it is not much hit by the Global Economic Recession. But, it is the inflation which has caused great worry to our economy. This paper tries to analyse the impact of inflation and Global Economic Recession on various sectors of the Economy, which enables the Government to take corrective measures for the future development.

Keywords: *Inflation, Global Economic Recession, FDI, GDP*

Introduction

World economic recession (2007-08) and the recent European economic crisis have made economists to diagnose and find remedy for such an economic slowdown all over the world. It is realized that it was mainly due to such a situation in business cycle representing a type of economic fluctuation coupled with the inbuilt inflationary pressure. Business cycles represent a type of fluctuation in the aggregate economic activity of nations that organize their work mainly in business enterprise. A cycle consists of expansions occurring at about the same in many economic activities, followed similarly general recessions, contractions, and revivals which merge

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into the expansion phase of the next cycle. This sequence of changes is recurrent but not periodic. In duration, business cycles vary from more than one year to ten or twelve years. The adverse social, psychological and economic effects of economic meltdown or slowdown and prolonged recession will be huge for those regions that are most open to the world economy and dependent on trade. Compared to BRIC (Brazil, Russia, India, and China) nations, the Indian huge domestic economy can act as a buffer and survive economic slowdown much better than other parts of the world.

In India, coupled with the already existed inflation the impact of such recession was short run, however, needs to be analyzed from the future development perspective.

Inflation

Inflation refers to a rise in prices that causes the purchasing power of a nation to fall. When government supplies excess money to deal with crisis, prices rise at an extremely high speed to keep up with the currency surplus. This is called the demand-pull, in which prices are forced upwards because of a high demand.

Another common cause of inflation is the rise in production costs, which leads to an increase in the price of the final product. For example, when the prices of raw materials increase, it leads to an increase in the cost of production also, which in turn forces the companies to increase the prices of their products to maintain a steady profit. Rising labour costs can also lead to inflation. As workers demand wage increases, companies usually choose to pass on those costs to their customers.

Inflation can also be caused by international lending and national debts. As nations borrow money, they have to deal with interests, which at the end cause prices to rise as a way of keeping up with their debts. A deep drop of the exchange rate can also result in inflation.

Inflation can be caused by federal taxes put on consumer products such as cigarettes or fuel. As the taxes rise, suppliers often pass on the burden to the consumer; the catch, however, is that once prices have increased, they rarely go back, even if the taxes are later reduced.

Economists do not always agree on what spurs inflation at any given time. However, certain forces clearly contribute to inflation. Rising commodity prices are perhaps the most visible inflationary force because, when the prices of the commodities rise, the costs of basic goods and services generally increase. Higher oil prices, in particular, can have the most pervasive impact on an economy. This, in turn, means that the prices of all goods and services that are transported to their markets by truck, rail or ship will also rise. Exchange rate movements can presage inflation. As a country's currency depreciates, it becomes more expensive to purchase imported goods, which puts upward pressure on prices overall.

Over the long term, currencies of countries with higher inflation rates tend to depreciate relative to those with lower rates. Because, inflation erodes the value of investment returns over time, investors may shift their money to markets with lower inflation rates.

Impact of Inflation on growth

- When the balance between supply and demand goes out of control, consumers could change their buying habits, forcing manufacturers to cut down production.
- Prices increase substantially, resulting in a dramatic decrease in demand.
- Price increase can worsen the poverty affecting low income household,
- Inflation creates economic uncertainty and is a dampener to the investment climate slowing growth and finally it reduce

savings and thereby consumption.

- The producers would not be able to control the cost of raw material and labor and hence, the price of the final product. This could result in less profit or in some extreme case no profit, forcing them out of business.
- Manufacturers would not have an incentive to invest in new equipment and new technology.
- Uncertainty would force people to withdraw money from the bank and convert it into product with long lasting value like gold, artifacts.

India after independence has had a more stable record with respect to inflation than most other developing countries. Since 1950, the inflation in Indian economy has been in single digit for most of the years. **Between 1950-1960,** the inflation on an average was at 2.00 per cent, **between 1960-1970,** the inflation on an average was at 7.2 per cent; **between 1970-1980,** the inflation on an average was at 8.5 per cent. At p**resent, t**he inflation ended at a low of 0.61 per cent in the week ended May 9, 2009 this after reaching a 16 year high of 12.91 per cent in August 2008, bringing in a sigh of relief to policymakers. Even now the inflation and food inflation is a challenge to the policy makers.

Global Economic Recession

Since 2007-08, the global economy was found to be in deep trouble evidenced by China's flagging economy, Japan's crushing economy, Britain's sinking economy, Asia's shock …resulting in the collapse of manufacturing, financial market crisis and employment set back hitting the household sector. The Genesis of financial crisis is evidenced by

- The US sub-prime mortgage phenomenon
- The collapse of major financial institutions

- Sudden severity of liquidity (credit) crunch
- Unprecedented collapse in global stock markets
- Massive losses of market capitalization
- Rapid withdrawal (reverse flow) of capital
- Heightened sense of uncertainty and crisis of confidence
- Massive rescue and bailout measures

Global financial crisis was preceded by massive boom in crude oil and commodity prices, unleashing spectra of inflation earlier. Impact of global economic slow down has been intense. The IMF estimated World economic growth having fallen from 5.1 per cent in 2007 to 3.1 per cent in 2008, and predicts a negative growth of 1.1 per cent in 2009 and a return to positive growth of 3.1 per cent in 2010. World trade volumes (goods and services), which had declined from 9.2 per cent in 2006 to 7.2 per cent in 2007 and further decelerated to 3.3 per cent in 2008, to contract by as much as 11 per cent in 2009.

Private capital flows to emerging and developing economies to be negative $190 bn. in contrast to positive $109bn.2008 and as much as $618bn in2007.

Global policy response was prompt and coordinated, Rapid release of liquidity, Sharp reduction in interest rates, Structuring of bail-out programmes, Large acquisition of ownership in financial institutions, Raising insurance cover/guarantees to depositors, Fiscal stimulus, and IMF liquidity support to several countries. These measures stared yielding some positive results – a gradual economic recovery and restoration of confidence in the global financial market. But "the worst is not yet over…" is according to experts.

Impact on Indian Economy

The economic slow down resulted in huge loss in various sectors of Indian economy also. Direct and Indirect Impact unleashed through

- Foreign trade – falling global experts markets
- Foreign capital inflows contraction largely in non-FDI

capital inflows

- Exchange rate behavior – two-way fluctuations due to
- Uncertainties of supply-demand position of dollar
- Divergence in domestic and international interest rates
- Savings and investment
- Stress and strains of fiscal health
- Pressures on corporate performance
- Erosion in income and wealth of the households

Impact was visible – its spread and intensity became more pronounced during 2008-09 and first quarter of 2009-10. However, India has been endowed with some key beneficial factors:

- Four fifth of growth momentum is domestic demand driven and exports (goods and services) constitute only about 20.0 per cent of GDP
- Over 90.0 per cent of investments are financed from domestic savings – capital inflow account for the balance 10.0 per cent.
- Relatively moderate exposure of financial institutions to global financial risks
- IMF study broadly showed that on vulnerability score, India's rank is low (using variety of [parameters – trade, FDI, aid, remittances, imports cover, CAD, etc.

These factors have offered some basic resilience to the economy to mitigate the severity of downside risks to India. But growth drivers of the economy were impaired in the form of deceleration of household income growth, erosion in asset values, contrarians on growth of government expenditure, loss of tax buoyancy, exhaustion of the fiscal space the roll back of FRBM targets, and collapse of export markets

India's policy response

India has taken several policy measures to control the impact of

global economic recession, such as mitigating liquidity crisis, interest rate reduction and fiscal stimulus packages etc. More specific measures to mention are CRR &SLR reduction, increase in export refinance facility, special support measures, progressive reduction in repo and reverse repo rates reduction in the bank lending rates and increased planed expenditure.

Recent trends in Indian Economics

India has been one of the best performers in the world economy in recent years, but rapidly rising inflation and the complexities of running the world's biggest democracy are proving challenging**.** India's economy has been one of the stars of global economics in recent years, growing 9.2 per cent in 2007 and 9.6 per cent in 2006. Growth had been supported by market reforms, huge inflows of Foreign Direct Investment, rising foreign exchange reserves, both IT and real estate boom, and a flourishing capital market.

India's Economy has grown by more than 9.0 per cent for three years running, and has seen a decade of 7.0 per cent plus growth. This has reduced poverty by 10.0 per cent, but with 60.0 per cent of India's 1.1 billion populations living off agriculture and with droughts and floods increasing, poverty alleviation is still a major challenge.

The structural transformation that has been adopted by the national government in recent times has reduced growth constraints and contributed greatly to the overall growth and prosperity of the country. However, there are still major issues around federal and state bureaucracy, corruption and tariffs that require addressing. India's public debt is 58.0 per cent of GDP according to the CIA World Fact book, and this poses another challenge.

During the present period of stable growth, the performance of the Indian service sector has been particularly significant. The growth rate of the service sector was 11.18 per cent in 2007 and now

contributes 53.0 per cent of GDP. The industrial sector grew 10.63 per cent in the same period and is now 29.0 per cent of GDP. Agriculture is 17.0 per cent of the Indian economy.

Growth in the manufacturing sector has also complemented the country's excellent growth momentum. The growth rate of the manufacturing sector rose steadily from 8.98 per cent in 2005, to 12.0 per cent in 2006. The storage and communication sector also registered a significant growth rate of 16.64 per cent in the same year.

Additional factors that have contributed to this robust environment are sustained in investment and high savings rates. As far as the percentage of gross capital formation in GDP is concerned, there has been a significant rise from 22.8 per cent in the fiscal year 2001, to 35.9 per cent in the fiscal year 2006. Further, the gross rate of savings as a proportion to GDP registered solid growth from 23.5 per cent to 34.8 per cent for the same period.

Like most of the countries of the world, however, India had to face testing economic times in 2008. The Reserve Bank of India had set an inflation target of 4.0 per cent, but by the middle of the year it was running at 11.0 per cent, the highest level seen for a decade. As a part of the fight against inflation, a tighter monetary policy was expected, which will add to the slow growth of the Indian economy still further, as domestic demand will be dampened. External demand is also slowing, further adding to the down slide risks. The Indian stock market has fallen more than 40.0 per cent in six months from its January 2008 high. Around $6b of foreign funds flowed out of the country in that period, reacting both to slowing economic growth and perceptions that the market was over-valued.

GDP and Economic Growth Statistics

The growth rate of Gross Domestic Product (GDP) was 9.0 per cent in 2006, whereas the corresponding figure was 7.4 per cent in 2007.

The rate of GDP growth for 2008 was projected to be 8.7 per cent. The growth rate of the Indian IT and ITES sector was around 20 per cent in 2007.

The figures for foreign direct investment (FDI) have also recorded substantial growth over the last few years. In 2004, the FDI figure was US$ 4.11 billion. In the next year it stood at US $8.2 billion. The corresponding figure for 2006 was US $12.35 billion – this is an incredible 73.35 per cent compounded annual growth.

Industrial, manufacturing, and service sectors together amounted to 77.0 per cent of India's GDP in 2007.The deceleration in GDP and Indian Industry Performance (IIP), and their remarkable recover is depicted in Table-1.

Table-1: GDP and Indian Industry Performance (IIP) growth rates.

Year (Quarterly)	GDP Growth rate	Year (month)	Growth rate	
2007-08 Q1	9.2		IIP (General)	Manufacturing
2007-08 Q2	9.0	July-08	6.4	6.9
2007-08 Q3	9.3	Aug-08	1.7	1.7
2007-08 Q4	8.6	Sept-08	6.0	6.2
2008-09 Q1	7.8	Oct-08	0.1	-0.6
2008-09 Q2	7.7	Nov-08	2.5	2.7
2008-09 Q3	5.8	Dec-08	-0.2	-0.6
2008-09 Q4	5.8	Jan-09	1.0	1.0
2009-10 Q1	6.33	Feb-09	2.2	0.2
2009-10Q2	8.68	Mar-09	3.3	-0.4
2009-10Q3	6.00	Apr-09	1.1	0.4
2009-10Q4	8.60	May-09	2.2	1.8
2010-11Q1	8.88	Jun-09	8.2	7.8
2010-11Q2	8.90	Jul-09	7.2	7.4
		Aug-09	10.4	10.2

Source : *Compiled from different sources*

India's GDP was US $911 billion in 2007. Exports contributed US $127 billion to the Indian GDP in the 2007 with a growth rate of 20.9 per cent. Import figures stood at US $192 billion during 2007, with a growth rate of 21.59 per cent. Portfolio investment amounted to US $7.1 billion in 2007. The 2007-2008 Indian Economic Survey has projected inflation to be just above 4 per cent for 2008. However, the rapid rise in food, oil and other commodities prices pushed inflation above 11.0 per cent by July 2008. A target has also been set to lower the fiscal deficit below 3 per cent per annum. Sectoral trends are as follows;

1. Industrial Growth

The recent data released on the Industrial growth continues to show weakness. The industry grew by 2.7 per cent in May 2009 as compared to the growth of 4.4 per cent posted in the corresponding month of the previous year. Mining and manufacturing sector related activities too were seen to slow down, as these posted growth of 3.7 per cent and 2.5 per cent in May 2009 as against the growth of 5.5 per cent and 4.5 per cent recorded in the corresponding month of the previous year. Production of electricity rose by 3.3 per cent in May this year compared to the growth of 2.0 per cent in same month of previous year.

2. Core infrastructure industries

The data during the first two months of 2009-10 on six core infrastructure industries indicated improvement in output. The main drivers of growth seen in the six core infrastructure industry during the period were cement, power and coal posting growth of 11.7 per cent , 5.1 per cent and 11.8 respectively in April-May 2009-10 compared to the growth of 5.4 per cent , 1.7 per cent and 9.5 per cent respectively during the same period of previous fiscal. However, production of crude petroleum and petroleum refinery were badly hit

3. Inflation Trends

Slowdown in the economy and rapid decline in global commodity prices toned down the overall inflation to below 0 levels for the first time in 35 years. However, it was found that prices of some of the items of mass consumption were still rising. While, the average overall inflation numbers for the month of June 2009 turned negative. However, the food articles falling within the category of primary commodities continue to rise by 8.6 per cent in June 2009 compared to 6 per cent in the previous year. In June 2009 prices of non-food articles, fuel, leather and basic metals dropped by 2.0 per cent, 12.6 per cent, 1.0 per cent and 14.0 per cent respectively from positive growth of 17.0 per cent, 16.0 per cent, 1.6 per cent and 21 per cent seen in the previous year

4. Monetary Indicators

Money supply in April 2009 calculated over March 2009 shows, M3 swelled by 2.6 per cent in April 2009 compared to 0.6 per cent growth recorded in the corresponding period of previous year. Further, in March 2010 it increased by 16.9 per cent. The net bank credit to the government sector swelled by 4.1 per cent from 0.1 per cent growth posted in the previous year. Growth in the bank credit to the commercial sector remained negative. The net foreign exchange of banks continued to slide by 1.4 per cent compared to an increase of 1.4 per cent recorded in the previous year. Aggregate deposits expanded by 2.4 per cent in April 2009 as against the Y-o-Y variation of 0.1 per cent in the same month of the previous year. Investment stepped up by 6 per cent as compared to 4 per cent in the previous year.

5. Stock Market Trends

The Indian stock market plunged below (BSE – Sensex) 10 K points in December 2008 from a high 20K in January 2008 and it took more than a quarter to get the index back to above 10K level .

6. Fiscal Management

Total tax collections were severely hit during the recent period. Tax collections shrunk by 12 per cent in May 2009 as against an expansion of more than 36 per cent in the same period of previous year. Thinner corporate earnings and greater tax relief seized the growth in tax collections. Tax collected from the corporate sources was observed to increase by 10 per cent in May 2009 compared to a growth of 60 per cent in the previous year. Contribution from income tax during the month rose by 11.7 per cent only compared to the increase of 76.0 per cent recorded in the previous year. Increase in the taxes received from the indirect sources however plunged to negative on account of tax relief given by the government. The tax collection got thinner on account of steps taken by the government to aid the industry. Budgeted outlay for 2009-10 shows an increase of 36 per cent over the budget estimates of last year. With 36.0 per cent budgeted increase the government has planned a gross market borrowing programme of Rs 4,51,093 crore, however the actual market borrowings targeted would be 3,97,957 crore after the net scheduled repayments of Rs 53,135 crore. This market borrowing may go up if the government is again forced to announce stimulus measures.

7. Foreign Trades

Decline in total merchandise trade continues. Performance of merchandise exports remains bad as it posted negative growth for straight eighth months. Exports registered a negative growth of 30 per cent in May 2009 compared to an increase of 12 per cent in the same month of previous year. Imports too were seen to weaken, slipping by 60 per cent in May 2009

8. Capital Inflows

Foreign investment received in 2008-09 was USD 35.1 billion, slightly higher than the FDI received in 2007-08 (USD 34.3 billion). A significant difference in the total investments of 2008-09 and

2007-08 has been on due to the inflow and outflow of foreign investment observed in 2007-08 and 2008-09 respectively. In the first month of the fiscal 2009-10 the country attracted investment of USD 2.3 billion with USD 2.2 billion of portfolio investments

9. Foreign Exchange Reserves

An expansion was seen in the country's FOREX reserves as it crossed USD 260 billion from USD 250 billion about a month back. This was on the back of foreign currency assets which is expressed in US dollar terms and includes appreciation or depreciation of non-US currencies and increase in the inflows of foreign institutional investments in the country.

10. Trends in the Exchange Rates

The rapid fluctuations in the exchange rate between the USD and Indian Rupee lowered the margins of trading community. We have seen the Indian Rupees against the USD shuttling between 47- 50. This kind of movement can be covered partly only, through forward contracts.

Conclusion

Global economic recession had short run impact to slow down some sectors of the Indian economy. Global economic recession had major hit on high caliber employment. Our young energetic, potential engineers; managers/executives had a great disappointment almost for a year. However, since Indian economy is more self-reliant in nature or less depending on the external economy, it is not much hit by the global economic recession. But, what is more worried in Indian economic context is inflation. Inflationary pressure (extreme low to high) would effect more, the growth of Indian economy. Therefore, managing balanced markets with no much price fluctuation is more important.

Poverty in India is reducing but it is still a major issue. Rural Indians depend on unpredictable agriculture incomes, while urban Indians

rely on jobs that are, at best, scarce. This is really what happened to Indian economy in the recent years due global economic recession and inflation.

Since its independence, within India the issue of poverty has remained a prevalent concern. According to the common definition of poverty, when a person finds it difficult to meet the minimum requirement of acceptable living standards, he/she is considered poor. Millions of people in India are unable to meet these basic standards, and according to government estimates, in 2007 there were nearly 220.1 million people living below the poverty line. Nearly 21.1 per cent of the entire rural population and 15.0 per cent of the urban population of India exists in this difficult physical and financial predicament. Therefore, poverty, unemployment and agricultural development are still the priority of Indian economic development and suggest that macroeconomic indicators are still depending on them and they have powerful impact on those sectors.

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