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Study of the inflation propensity in India: Historical and contemporary perception

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Abstract

This study aims to investigate how inflation responds to monetary policy shocks in India, both overall and at the group level. The process of inflation is the increase of prices over a sustained period of time. Inflationary trends across different eras are examined through an examination of economic, political, and global influences beginning in the early 20th century. Economically advanced countries create policies that enhance their economic growth, while developing countries falter in preparation of sound policies due to insufficient funding, budget shortfalls, and IMF dependency. The development budget in their countries should mainly be increased, while the non-developmental budget should be tightened, as this has a significant impact on controlling inflation and unemployment and promoting economic growth. As a result of inflation, the cost of living has become more expensive, which makes life more miserable for the average person. Additionally, it may reduce the country's international competitiveness. The country's international competitiveness can be adversely affected by an increase in the cost structure and price level. An economy in development is influenced by a variety of factors that are intricately interconnected.

Keywords: Phillips curve, inflation, RBI, monetary policy

1. Introduction

In India, inflation has been a persistent challenge, reflecting the complex dynamics of a developing economy that includes global and domestic factors ^[1-2]. In emerging countries that target inflation, the objectives for inflation are approximately one percentage point higher. Almost all central banks worldwide have inflation targets that are considerably greater than zero ^[3-4]. Academics and practitioners have long been concerned about inflation as a leading financial concern, as evidenced by the high levels of American inflation in the 1970s ^[5, 6]. During the nascent Universe, inflation was a period of rapid expansion, before the conventional hot Big-Bang moment. the inflation potential needs to be adequately flat, which is not always easy to achieve in realistic scenarios and complicates the problem of constructing inflationary models ^[7].

However, The framework of India's monetary policy has been continuously developed in response to developments in the economy across various fronts. RBI, which serves as the country's central bank, together with other authorities, has consistently attempted to strike a balance between encouraging growth and controlling inflation. Since 1998, the RBI has used a multiple indicator approach rather than monetary aggregates for monetary policy. After the global financial crisis of 2008, stagflation posed a serious challenge to monetary policy, so the RBI decided in 2016 to adopt a flexible inflation targeting (FIT) framework, putting into question multiple indicator methodologies ^[8, 9].

In India, achieving this balance is especially difficult because of the economy's diverse and intricate characteristics. There are many factors that complicate the relationship between inflation and growth, including the significant impact of agriculture on GDP, variations by region, and the influence of informal sectors. Moreover, with India becoming part of the global economy, it becomes susceptible to external economic shocks. This adds to the complexity of managing inflation and sustaining growth ^[9].

1.1 Inflation at its core

Generally, inflation responds only to excess demand when the curve is relatively flat, which is the case in recessions when the gap is negative, but steep otherwise.

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According to its original definition, Core inflation is "the trend rate of increase" of either "the cost of aggregate supply" or "the cost of factors of production." Statistically, core inflation refers either to "underlying inflation" (the portion of inflation free of transitory influences) or to a measurement of all prices trending in the same direction. There are a variety of ways to measure core inflation, depending on its numerous definitions. The most common core inflation measures are "exclusion" measures that leave out specific items-like energy and food-from the overall inflation calculation. A second category of core inflation measures comprises limited-influence measures, such as medians or trimmed means [6].

2. A historical look at inflation trends on India

2.1 From 1906 to 1947

1906 to 1947 is called pre-independence era. In this period of British colonialism, India's economy was predominantly agricultural. Significant inflationary pressures were caused by the colonial government's war expenditures, particularly during World War I and World War II. The heightened need for military provisions, along with the British colonial taxation system that siphoned wealth from India, led to a resource distribution that was not uniform [1].

During this time, there were instances of high inflation caused by scarcity as well as deflation resulting from enhanced agricultural productivity. Moreover, the Indian industrial sector was not fully developed, resulting in a significant dependence on imports for both consumer products and vital industrial inputs. Due to this, domestic prices were directly affected by external price fluctuations, particularly those in global commodities markets. In the years leading up to independence, inflation was mainly a result of wartime spending, tax imposition, and inadequate domestic production capabilities [1-3].

2.2 From 1947 to 1991

From 1947 to 1991 known as Post-Independence to Liberalization era. In 1947, India gained independence, which led to considerable economic changes, including the

move toward planned economic development. Inflation was affected by both external and internal factors, including the implementation of import-substitution industrialization and state-managed pricing [1].

Increasing public expenditures by the government often had little impact on domestic production when it came to industrialization. The agricultural sector's inability to satisfy the needs of an expanding population also played a role in escalating food prices. In 1973, OPEC (Organization of the Petroleum Exporting Countries) imposed an oil embargo to increase oil prices, which resulted in a significant rise in fuel prices worldwide. For India, this posed a significant problem, as oil imports accounted for a large part of the trade deficit. During the 1970s, inflation reached double digits at times during these inflationary spirals, which adversely affected the average household [1].

2.3 From 1991 to Present

1906 to 1947 is called Post-Liberalization era. In India, the 1990s marked the beginning of a new era of economic liberalization marked by extensive market reforms that led to a significant change in inflationary trends. During India's 1991 balance of payments crisis, Manmohan Singh, who was then the Finance Minister, implemented major economic reforms under his direction. India became more exposed to the volatility of global commodity prices, resulting in periodic inflationary shocks. It can be seen in the worldwide financial crisis of 2008, when the global economy was in a serious recession that caused oil and food prices to soar, causing inflationary pressures all over the world, including India [1, 11].

In 2016, the Reserve Bank of India (RBI) adopted inflation-targeting policies, representing a determined initiative to manage and control inflation. Nonetheless, challenges persisted, such as fluctuations in agricultural prices and the worldwide escalation of oil prices (RBI, 2020). The COVID-19 pandemic intensified pre-existing inflationary trends, as disruptions in the supply chain and heightened demand for specific products caused prices to rise across multiple sectors [1].

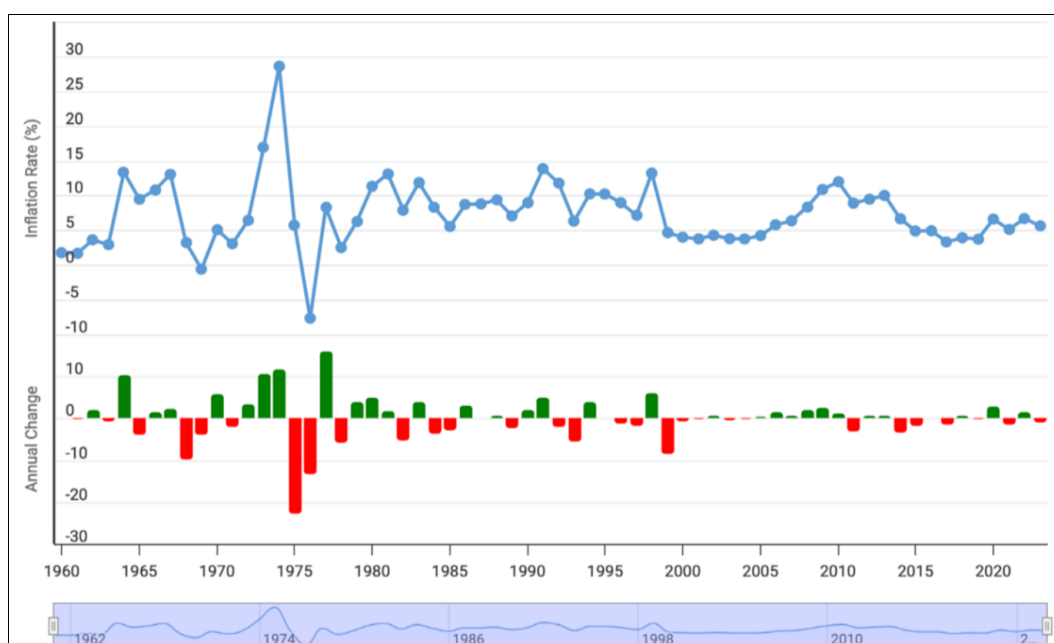


Fig 1: Inflation and Annual Charge [1]

3. Phillips Curve

A. W. Phillips popularized the inflation-employment link in 1958 with his famous paper on the Relationship between Unemployment and Money Wage Rate Changes in the United Kingdom, 1861-1957, in which he examined wage growth in response to unemployment rates ^[2].

Decision-makers have used the Phillips Curve as a tool to set monetary policy. The theory posits that central banks might influence inflation by controlling the unemployment rate. Despite this, economists have debated the relevance of the Phillips Curve to today's economy in light of instances where low unemployment did not lead to significant inflation ^[9-11].

3.1 Limitations

Several factors influence the Phillips curve relationship between inflation and unemployment, including inflation expectations among different economic agents ^[14-17].

- The Phillips Curve does not take into consideration supply-side shocks, like variations in the price of oil or other essential commodities, which can greatly affect inflation and unemployment rates ^[12, 13].
- In view of the fact that Phillips Curve relies on 1950s and 1960s UK data, it cannot be applied to other countries or historical periods. This is not for Universal ^[14].
- Phillips Curves can be useful for managing inflation and unemployment in the short term. However, it has its limitations and cannot be relied upon for long-term use ^[15].
- The Phillips curve's structural interpretation was no longer accepted after the high inflation of the 1970's ^[15-17].

3.2 Phillips curve vs NAIRU curve

The presence of nonlinearities in the Phillips curve can result in varying consequences for how monetary policy is implemented ^[18]. NAIRU, or Non-Accelerating Inflation

Rate of Unemployment, is a measure of unemployment where inflation remains stable. An increase in inflationary pressures occurs when unemployment falls below a certain level, and a decrease when unemployment rises above that level. Unemployment benefits will also be permanently increased along with the NAIRU increase. In industrialized economies, there is a negative correlation between inflation and unemployment based upon the Phillips Curve concept ^[19, 20]. A NAIRU is a modern inflation theory that predicts low unemployment rates do not lead to high inflation. The NAIRU and Phillips curve both need to factor in the effects of hysteresis. During times of increased unemployment, structural unemployment as well as frictional unemployment may increase. According to NAIRU, if unemployment rates are below NAIRU, inflation is likely to increase, if unemployment rates are above NAIRU, inflation may be stable or balanced. According to Helali (2018), the NAIRU model is a standard inflation model based on the expectation of an augmented Phillips curve ^[21, 22].

3.3 Phillips curve on India

Within the Indian context, several studies have validated the Phillips curve framework at the national level, indicating that inflation (as measured by changes in WPI) reacts to both demand and supply shocks. On the contrary, Srinivasan *et al.* (2006) were unable to find evidence supporting the Phillips curve. India cannot be excluded from the Phillips curve, even if supply shocks are explicitly considered ^[24, 25].

4. Relationship between unemployment and employment

A.W. Phillips, an economist, presented findings in a 1958 article that would later be widely referenced in economic literature, demonstrating an inverse correlation between wage growth rates and unemployment rates. The potential connection between fluctuations in the price level and variations in employment volume, a topic of considerable contemporary economic discussion, has previously been addressed in the Review ^[27, 28].

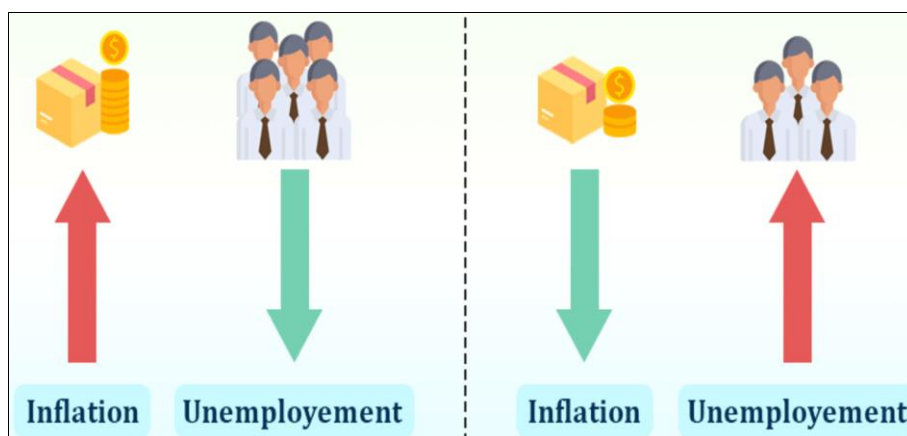


Fig 2: Relation between Inflation and Unemployment

i) High Inflation vs Low Unemployment

Due to the scarcity of jobless individuals, employers might find it difficult to fill roles when unemployment is low. As a result, they provide greater remuneration to entice and keep staff members ^[28, 29].

ii) Low Inflation vs High Unemployment

During periods of elevated unemployment, companies can

minimize recruitment expenditures because of the abundance of available labor (Fields, 2012; Pappas, 1989; Bodnar, 1982). Increase customer acquisition, businesses may reduce the prices of their products, a strategy that could potentially result in low inflation, or even deflation ^[28, 29].

5. Global comparison of india's inflation

The inflation trends in India need to be viewed in the

context of global trends. The inflation rate in India has remained relatively stable compared with that in Lebanon, which experienced hyperinflationary spikes in the late 1980s and another sharp rise following 2020. Due to greater economic stability, India has maintained inflation within a manageable range, mostly under 10%. Compared with Canada, India, Egypt, UK and UAE has experienced dramatic inflationary surges, notably reaching nearly 500% in the 1980s due to economic instability, followed by another steep increase post-2020 due to financial crises and currency devaluation [1].

The inflation outlook for India may, however, be affected by future risks such as global oil price fluctuations, geopolitical tensions, and disruptions in supply chains [1]. A combination of effective monetary policy measures, liquidity control measures, and fiscal strategies helped the RBI maintain stability. In India, A key role played by the Reserve Bank of India (RBI) in managing inflation is its monetary policy [1]. Inflation has been a major concern for the Reserve Bank of India's monetary policy committee. Inflation is expected to be 5.2% in 2023-24, but the Reserve Bank hopes inflation will ease in this year's CPI inflation [30, 31].

5.1 In India Inflation rate from 2010 to 2025

In India, additional studies could investigate the relationship

among the inflation rate and development of the economy. The primary objective would be to examine the effects of varying inflation figures for key macroeconomic indicators like GDP development, investment, work opportunities, and income allocation [30, 32].

India had an inflation rate of 12.0% in 2010 and 8.90% in 2011. In 2013, India's inflation rate was approximately 10.01% higher than that of 2012. However, after that, there was a period of relatively stable prices, and in November 2014, inflation even fell below 3.31%. In 2017, the inflation rate in India was 3.30% and in 2016, it was 5.00%. There was a decrease of 1.7% in inflation from 1.7% in of 2017 to 3.30% in 2018 [33].

The mean inflation rate in Asia's developing economies would be approximately 2.9 percent, significantly lower than the range of India's inflation during 2020. The inflation rate in India in 2021 was 8 5.99% to 10.80%; in 2022, it was 6.71%. An inflation rate of 5.59 percent was recorded in the Financial Year 2022-23. During May 2025, India's annual inflation rate was 2.10% [26, 33]. According to the Indian Institute of Statistics, retail inflation for the year 2021 was 5.13% [34]. The average annual inflation rate, as indicated by the headline Wholesale Price Index (WPI), over the 62-year period from 1950–1951 to 2012–2013 was approximately 6.70% [35].

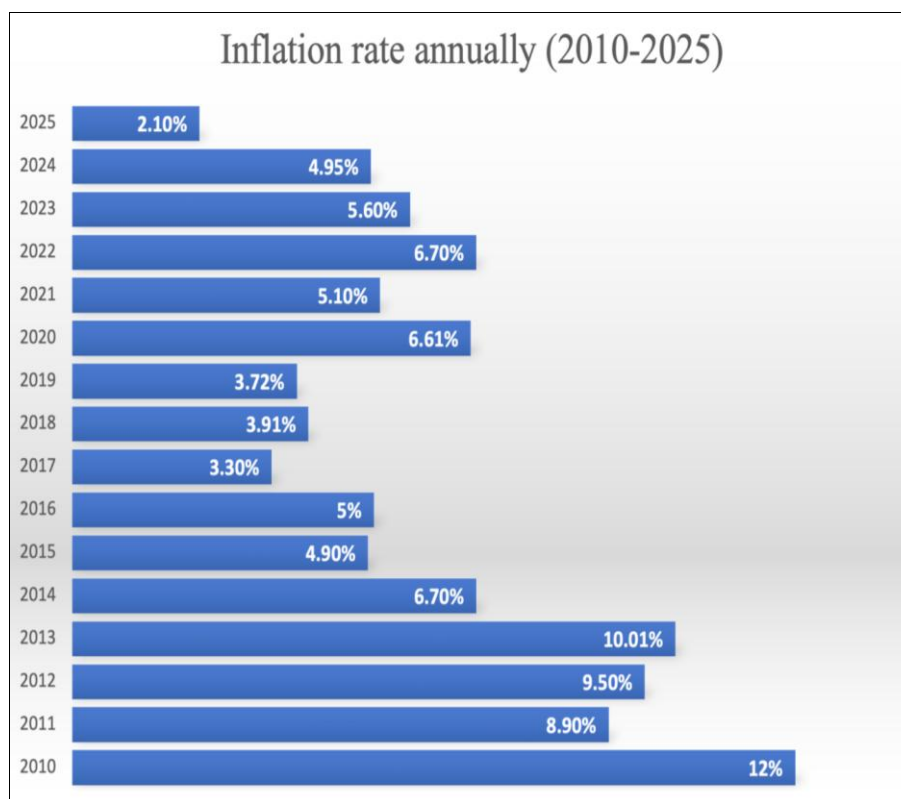


Fig 3: Inflation Rate in India From 2010 to 2025 [33]

During the period 2010-2013, there were high inflation rates, exceeding 7%. During the period 2020-2024, inflation rates have fluctuated between 6-4%, but there has been a general slowdown. COVID-19 caused economic disruption in India and increased inflation in 2020, due to COVID-19. In 2024, India saw a decrease in retail inflation, with rates reaching a six-year low. From January 2010 to December 2011, high inflation persisted for two years, with an average WPI inflation rate of 9.5% per year. In 2020, consumer price inflation reached 6.6%, in contrast to the previous

year's figure of 3.7%. In 2017 to 2018, India experienced an average inflation rate of 3.3%. At that time, this represented the lowest figure in the preceding six financial years [30-34].

6. Inflation measurement

Also, monetary policymakers must measure inflation, as it has an impact on economic welfare and serves as a policy objective of its own. For example, one of their main objectives is to keep inflation low and stable. There is actually a strong argument that the Federal Reserve should

aim at stabilizing inflation measures above zero, partly due to the tendency of the U.S. CPI to overstate changes in living costs [36, 37].

Consumer price indices (CPIs) are a logical way to measure inflation since inflation is defined as "a process of continuously rising prices, or equivalently, of continuously falling dollar values". This approach has considerable conceptual weaknesses (e.g., lagged announcements, international variations in measurement, and the improbability that CPI estimates provide a suitable representation. The process of inflation measurement involves aggregating the fluctuations in prices of specific items and services to produce an estimate of overall price change [36, 37].

7. Relationship between inflation and budget line

Each economy experiences inflation as it heats up or cools down. It is a well-established fact that economic measurements are frequently impacted by the budget deficit. For example, one of the many effects of a budget imbalance is inflation. According to macroeconomic theory, there is a known correlation between inflation and budget deficits. On the one hand, in contrast to what the Ricardian equivalency theory implies, a budget deficit resulting from a tax cut initially makes people feel wealthier and improves aggregate demand and the price level. On the other hand, raising taxes to cover the budget deficit raises manufacturing costs and product prices [38, 39].

Additionally, Budget deficits and inflation are examined, including direct effects, regulating effects, as well as indirect effects via money supply and exchange rate as mediating variables [39-41]. Bleaney *et al.* (2016), Catao and Terrones (2005), specifically examined the direct relationship between the budget deficit and inflation, and their findings are supported by the fact that the budget deficit has a substantial impact on inflation [39, 41-43].

However, the impact of the budget deficit occurs with lags and is statistically significant. A budget deficit will also increase inflation by causing additional aggregate demand. It is important to note that inflation and budget deficit are two of several aspects and main economic indicators in a country, regardless of its level of development or transition [44, 45].

8. Conclusion

India's monetary policy aims at maintaining a reasonable degree of price stability as a key component of economic policy. In India, inflation is a complicated and multifaceted economic phenomenon that mirrors the interaction of historical legacies, structural challenges, and evolving global dynamics. Nonetheless, external elements like fluctuations in global oil prices, disruptions in supply chains, and the effects of the COVID-19 pandemic persist in posing challenges for policymakers. The Indian government's handling of inflation is commendable, especially compared to advanced economies that are still wrestling with inflationary pressures. Majority of their countries increase their development budgets and reduce their non-developmental budgets in order to control inflation and unemployment and boost economic growth. Watch closely the inflation flow in the country and keep an eye on factors that affect inflation both long term and short term. It is important to keep the budget *always* balanced and not to rely on any other country's fund, because it will make the

country slave and they themselves will make this country for their own benefit and interfere with their own business.

Monetary policy plays a much larger role in influencing prices of domestic non-tradeables.

Consequently, the focus of macroeconomic analysis and policy thinking in India should shift from the WPI to the CPI. The inflation figures from the recently published all-India CPI will be accessible next year. In India, 2010 and 2011, During the first half of the decade, India faced considerable inflation. Due to the pandemic, the inflation rate grow in 2020. The new index should assist in boosting confidence regarding the use of consumer prices in policymaking.

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