

The Dynamics of Inflation in India: A Bounds Test Analysis

Mohd Fayaz and Mumtaz Ahmed

This paper investigates all the possible determinants of inflation (weighted average call money rate, food inflation, fuel and power inflation, gross fiscal deficit, trade openness, exchange rate, GDP per capita annual growth rate and world food inflation) and their impact in the long and short run in India. Using yearly data for the period from 1990 to 2016, we have employed bounds testing (ARDL) cointegration approach. Our main findings are that all the selected determinants are cointegrated with inflation in India. The error correction term with negative sign shows high speed towards equilibrium. In the long run exchange rate, world food inflation and money supply significantly contributed to increasing inflation. In the short run except for the weighted average call money rate and GDP per capita annual growth rate, all the variables play a significant role in determining inflation. The study suggests enhancement of production and productivity of agricultural commodities, especially of pulses, and management of exchange rate fluctuation that plays a multilateral role in the price management of an open economy like India.

I Introduction

Over the past few decades inflation targeting has been embraced as a dominant policy framework for the countries throughout the world. Even today elections have been won with the promises of combating inflation and failing to do that can result in losing the same. Gerald Ford (president of the US in 1974) declared inflation as the no. 1 enemy of public (Oner 2012), while Easterly and Fisher (2001) defined inflation as a tax on the poor. In the conduct of economic policy, the primary target set a low band of an acceptable inflation usually between 3-5 per cent. However, the threshold between moderate, tolerable and very high inflation has not exactly been determined. Inflation is preferred as the indicator of economic stability because high inflation erodes economic efficiency and growth. For India, the worst episode of inflation before independence was during the famine of 1943 when it reached 53.8 per cent (Rajadhyaksha 2008). From November 1973 to September 1974 inflation remained above 30 per cent (Basu 2011). After 1990s three high inflation periods, i.e., 1994-1995, 2007 and 2008,

Mohd. Fayaz, Research Scholar, Centre for Economic Studies, Central University of Punjab, Bathinda 151001, Punjab, Email: mfayaz54@gmail.com

Mumtaz Ahmed, Research Scholar, Centre for Economic Studies, Central University of Punjab, Bathinda 151001, Punjab, Email: mumtaza61@gmail.com