Impact of Inflation and Interest Rate on Growth of Indian Economy: A Study in Input- Output Framework

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ABSTRACT:

The year on year growth of Indian economy has been constrained by high inflationary pressures since 2006-07 when agricultural output suffered a setback due to scanty rainfall. Several steps have been taken to bring inflation under control. But money supply, including credit creation by banks, has been the major instrument for mitigating inflationary pressures in the Indian economy. RBI has increased CRR, Repo Rate and/or interest rates by 25 to 50 points basis. But these measures have not succeeded in mopping up excessive liquidity in the economy. However, credit has been made costlier than before. Besides, demand pull inflation has been supplemented by cost push, particularly interest cost push inflation. Interestingly, neither employment has increased nor growth has been accelerated despite high inflationary pressure as is stipulated in Philips' hypo- thesis. As against the policy objectives, investment has declined and growth has marginally decelerated in current price since 2007-08 under the given policy regime while the growth rate has declined from 9.7 in 2006-07 to 6.8 in 2008-09 in constant prices which is a substantial decline. This compares very poorly with 15.2% in current prices. The difference of 8.4 percentage points between these two rates displays the impact of inflation on growth.

Process of growth operates though multiplier effect of consumption and accelerator effect of investment. Inflation directly affects the disposable income of households which, in turn, adversely affects both consumption and savings/investment. Though higher interest rate is expected to stimulate savings, but increased cost of credit discourages investment. On the top of it, inflation induced reduction in disposable income does not leave households with the same surplus income to save.

This paper attempts to examine the inter-relations between interest rate hikes, inflation and growth in Indian economy in an input output framework.
Regression model shall be used to estimate impact of inflation on commodity wise consumption and investment. These two estimated sets of figures will constitute the final demand vector of I-O model.
Input-output model shall be used to determine the effect of reduced consumption and reduced investment on the growth of Indian economy. Leontief Inverse of I-O tables of 2003-04 and 2007-08 shall be used as data base.