EDUZONE: International Peer Reviewed/Refereed Multidisciplinary Journal (EIPRMJ), ISSN: 2319-5045
Volume 15, Issue 2, July-December, 2026, Available online at: www.eduzonejournal.com

Evaluating India's Inflation-Targeting Framework: An Analysis

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ABSTRACT

This paper explores the how India balances low inflation with high economic growth while facing fiscal challenges. Low inflation slows nominal GDP growth, reducing tax revenue and making it harder for the government to meet Budget and fiscal deficit targets. Inflation is defined as the rise in prices of commodities and services in an economy over a period of time. Inflation is the sustained rise in the general price level every rupee buys a little less than before. India's inflation control strategy is currently restricted to using the interest rate to dampen aggregate demand. Food price inflation in India has recently reached nearly 10%, significantly above historical averages. It conveniently absolves the policymaker from addressing the challenge of ensuring the production of food at affordable prices.

Keywords: inflation, balance, tax revenue, reduction, production, commodities and services

INTRODUCTION

India as one of the most inspirational economies should grow faster to achieve its developed economy status. Consensus on the prime reason for the sticky and stubbornly high Consumer Price Index, that is retail inflation of India, is due to supply side constraints; and still where interest rate remains the only tool with the Reserve Bank of India. The challenges in developing economy are many, especially when in context of the monetary policy with the Central Bank, the inflation and price stability phenomenon. There has been a universal argument these days when monetary policy is determined to be a key element in depicting and controlling inflation. Shocks are increasing inflation, widening fiscal stress, and exposing supply chain vulnerabilities. In India, inflation's impact is pronounced due to economic disparities and a population numbering in the billions.

The Central Bank works on the objective to control and have a stable price for commodities. A good environment of price stability happens to create saving mobilization and a sustained economic growth. The former Governor of RBI C. Rangarajan points out that there is a long-term trade-off between output and inflation. He adds on that short-term trade-off happens to only introduce uncertainty about the price level in future. There is an agreement that the central banks have aimed to introduce the target of price stability while an argument supports it for what that means in practice. "Changes in inflation are widely attributed to increases in the money supply, fluctuations in real demand for goods and services (also known as demand shocks, including changes in fiscal or monetary policy), changes in available supplies such as during energy crises (also known as supply shocks), significant decreases in interest rates set by the central bank, or changes in inflation expectations, which may be self-fulfilling"(Romer, David 2019).

Higher inflation rate also constraints India's manufacturing environment inflation rate in India was 5.5% as of May 2019, as per the Indian Ministry of Statistics and Programme Implementation. This represents a modest reduction from the previous annual figure of 9.6% for June 2011. Inflation rates in India are usually quoted as changes in the Wholesale Price Index (WPI), for all commodities. According to the latest official statistics, the rate of inflation ballooned to a near 39-month high at over 11 per cent in June 2008 from an average of six per cent during the year 2007 as measured from the Wholesale Price Index (W PI). It is nearly double from the previous year. "According to some experts, the policy of the RBI to absorb all dollars coming into the Indian economy contributes to the appreciation of the rupee"(Venkitaramanan S 2003:68). CPI numbers are typically measured monthly, and with a significant lag, making them unsuitable for policy use. India uses changes in the CPI to measure its rate of inflation.

The WPI measures the price of a representative basket of wholesale goods. In India, this basket is composed of three groups: Primary Articles (22.62% of total weight), Fuel and Power (13.15%) and Manufactured Products (64.23%). Food Articles from the Primary Articles Group account for 15.26% of the total weight. The most important components of the Manufactured Products Group are, Food products (19.12%); Chemicals and Chemical products (12%); Basic Metals,

Alloys and Metal Products (10.8%); Machinery and Machine Tools (8.9%); Textiles (7.3%) and Transport, Equipment and Parts (5.2%).Inflation in India generally occurs as a consequence of global traded commodities and the several efforts made by the Reserve Bank of India (RBI) to weaken rupee against the dollar. This was done after the Pokhran Blasts in 1998" (Shailaja 2008)

With the common man already hit by the runaway increase in the prices, the current spurt in inflation-mainly owing to crude oil, cereals, vegetables, and a number of manufactured goods turning dearer-is set to reduce the concept of household budgeting to a meaningless exercise. "Inflation in India generally occurs due to global traded commodities and the several efforts made by the Reserve Bank of India (RBI) to weaken the rupee against the dollar. This was done after the Pokhran Blasts in 1998" (G. Shailaja 2008:58). High and volatile international crude oil prices are inflating India's import bill and creating inflationary pressure domestically.

Inflation is almost universally regarded as a bad thing. However, very few people really understand the mechanics of inflation. They even do not understand why it is bad and why it rises. They simply understand that the prices of day-to-day commodities shoot up. Inflation is, in fact, increase in the general price level. However, there is no unique measure of the general price level. Conceptually, it is the weighted average of the prices of all goods and services in the economy, where weights are the relative shares of different goods and services in the aggregate expenditure. These weights may change over time because of a shift in consumer behaviour. if the weight structure changes, the general price index may change even if there is no change in prices. To overcome this problem, the general price index is constructed with fixed weights. All published price statistics-Wholesale Price Index. Industrial Workers Cost of Living Index. ' etc.--are fixed weight indices. It means that they do not incorporate shift in consumer behavior.

However, there is still bigger problem with respect to weights. It is well known that the pattern of consumer behaviour differs widely among different rosin-economic groups. A poor in India has to spend as much as 90 per cent of his income on food while a rich may spend even less than 10 per cent of income on food. Therefore, for a poor man the weight of food price should be 0.8 and for the rich only 0.1. The average weight in this case (30 per cent or 0.3 in the Wholesale Price Index) therefore grossly underestimates the impact of food price rise on the welfare of the poor people. On the other hands poor man will be less sensitive to rise in petroleum price than a rich. If food prices rise and prices of luxury commodities the entire general index may not rise appreciably. The resultant drop in the inflation rate may conceal the true cost of inflation for the poor.

The rise and fall in the prices is s natural phenomenon being witnessed all across the economies and countries-developing and developed. But if the rise in prices is not proportionate to die rise in per capita income inflationary tendency sets in. In India, the significant increase in prices was experienced for the first time during the Second World War. However the rise in prices was not too high to affect the economy of the country. During recent years the rise has been abnormally high and has become a cause of concern for the government. Inflation is a vicious circle; a nation once caught in its trap finds it difficult to come out of it. In India inflation has become a chronic disease.

This is confirmed by the latest statistics released in terms of inflation. The rate of inflation could not be contained despite a number of steps initiated. During the week that ended on March 15. The Wholesale Price index (WPI) inflation surged to 6.56 per cent on a point-to-point basis the highest in 13 months. Compared to the previous week the increase was as high as 0.76 percentage points, one of the highest spikes ever recorded over such a short period and far above market expectations. The latest spurt is attributed to an all around increase in prices, especially iron and steel and food articles. What is particularly worrying is that global pressures on the domestic price situation, notably through oil and food prices show no signs of abating. The government has taken a number of fiscal and other measures to make exports of certain items including steel and non basmati rice, mineral ores and cement less attractive by modifying the incentives available to them. Furthermore, the government slashed the import duty on edible oil and banned its export.

Expressing concern over the ballooning inflation in India the RBI said. "Inflation is unacceptably high. We are in full readiness to take appropriate action to contain inflation." It further added, "Inflation has (now) turned but to well more than anticipated. The RBI Governor Y.V. Reddy said that the government was already taking some measures on the supply side. "This would help to contain inflation." (Reddy 1999) The problem of the increasing number of educated-unemployed has added to the woes of the country too. Slow improvement in Rate of Capital Formation. He further hinted tight monetary measures to be taken in the next credit policy to contain inflation. India's GDP growth has averaged around 6-7% over the past years, while inflation (rate of increase in prices) has typically hovered around 4-5%

The cause of inflation is one of the most controversial subjects in economics. One school of thought attributes inflation solely to excess money supply. While the other school argues that inflation is not a pure monetary phenomenon. Some even

argue that inflation has nothing to do with money supply; it is in fact the result of an increase in cost of production and or sectorial imbalance in demand and supply. The cost of production can rise in various ways, an increase in wage cost, increase in raw materials and inputs cost, a rise in petroleum prices, etc. In addition, profit-maximizing firms would increase prices, causing high inflation. Sectoral imbalances can also result in inflation for instance the food demand increases faster than food supply, which may be caused by flood, drought, etc. then food price would rise irrespective of whether money supply has increased or not. Hence, inflation can be contained if its causes are properly identified and accordingly suitable measures are taken.

In India the inflation rate generally exceeds 10 per cent which is identified as hyper inflation in the Indian standard, though not necessarily in the international standard, especially in the developing countries of Latin America where annual inflation rate often exceeds 100 per cent, particularly at a time when there is drought. In the last sixty years, double-digit inflation has occurred many times, practically all of them in a severe drought years. Another major cause of hyper inflation in India is the sudden acceleration in oil prices-1973-74, 1979-80, 1990-91, and the present time when the oil prices have gone over $140 a barrel, the highest price ever. Money supply in these years increased to accommodate higher government expenditure on account of rising costs. Money supply was therefore a symptom rather than a cause of hyper-inflation in India. Excess money supply has, however, contributed to some extent to inflation. Developing economies like India have generally a lesser developed financial market which creates a weak bonding between the interest rates and the aggregate demand. This accounts for the real money gap that could be determined as the potential determinant for the price rise and inflation in India.

There is a gap in India for both the output and the real money gap. The supply of money grows rapidly while the supply of goods takes due time which causes increased inflation. Similarly, hoarding has been a problem of major concern in India where onion prices have shot high. There are several other stances for the gold and silver commodities and their price hike This has been regarded as the root cause of inflation crisis rather than the domestic inflation. “According to some experts the policy of RBI to absorb all dollars coming into the Indian economy contributes to the appreciation of the rupee. When the U.S. dollar has shrieked by a margin of 30%, the RBI had made a massive injection of dollar in the economy make it highly liquid and this further triggered off inflation in non-traded goods. The RBI picture clearly portrays for subsidizing exports with a weak dollar-exchange rate. All these account for a dangerous inflationary policies being followed by the central bank of the country” (Venkitaramanan S, 168) Inflation is the sustained rise in the general price level of goods and services in an economy over time. The RBI has consistently missed its targeted inflation rate of 4% over the past five years.

One of the principal causes of inflation is the deficit financing. In order to make up for the gap India has been resorting to the printing of more paper currency as the losses could not be maintained by foreign aid and taxes levied. This results in greater circulation of money. Moreover, the purchasing power of the people increases leading to the prices of various commodities goes high. “Inflation numbers are often seasonally adjusted to differentiate expected cyclical cost shifts. For example, home heating costs are expected to rise in colder months, and seasonal adjustments are often used when measuring inflation to compensate for cyclical energy or fuel demand spikes. Inflation numbers may be averaged or otherwise subjected to statistical techniques to remove statistical noise and volatility of individual prices” (Vavra, Joseph 2014:215). The rise in inflation is also attributed to the unethical attitude of the traders. They are solely concerned about their own benefits and try to fleece the customers as much as possible. Besides black money also gives wings to speculation which always contributes to inflationary rise of prices.

Recent spurt in prices of food has not been rising due to drought or production short falls. Indeed the harvest this year may be among the highest ever. The problem is that world prices have skyrocketed. In an era of globalization, liberalization and information technology, the adverse impact of any development cannot be continued to that region only. Its likely imports span all across the globe. “Rapid increases in the overall money supply have occurred in many different societies throughout history, changing with different forms of money used” (Dobson, Roger 2002). This is time with the current situation. In fact, the trend in food price rice is a global phenomenon. It is due to two successive droughts in Australia and diversion of one-third of the US maize to ethanol have led to short falls in world production and food stocks.

Many food-deficit countries have sought to import more. As a consequence the world price of rice in the last six months has shot up 60 per cent and wheat by 40 per cent and soyabean oil by 40 per cent. Initially it was favourable for the exporting countries, but as world demand pushed their domestic prices to alarming levels it led government to impose curbs on exports to tame local prices. However, this reduced supplies to world market and sent world prices spiraling even higher. Such steps have contributed to inflation.

CONCLUSION

Though the government has recently taken some corrective measures to contain inflation, it is very unlikely to have positive result in recent times as the problems of inflation have global aspect, Indian government in isolation cannot do much to improve the situation. Inflation will come down only when world food production rises and world oil prices fall. This is not going to happen soon. Inflation is called a necessary evil no one likes it but it is needed for economic growth. Too much inflation can create major problems for policy makers. Both wholesale and retail inflation continued to increase month-on-month in April 2021, though the rise in the former has been much sharper. Common causes of inflation in India include rising minimum support prices for crops, higher fuel costs internationally, and more money chasing fewer goods.

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