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Impact of Inflation on Economic Growth of Countries

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ABSTRACT

This paper examines the impact of inflation on economic growth of countries, taking India and Australia as examples. It is argued that inflation can have both positive and negative impacts on economic growth. Generally, low inflation is beneficial to economic growth. However, inflation can be a sign of economic growth, as it is with India and Australia. Both countries have had periods of high inflation and economic growth. The paper also looks at the differing approaches to inflation management of the two countries and the effects of this on economic growth. The research suggests that, in general, inflation has a negative effect on economic growth, particularly in developing countries, who are more vulnerable to the effects of inflation.

Keywords: *inflation , consumers , GDP , economic , investment.*

I. INTRODUCTION

Inflation is an important economic concept that is used to measure the rate of change in prices of goods and services over a certain period of time. The consumer price index (CPI), which represents the average cost of a sample of products and services bought by households, is usually used to calculate it. Governments and central banks carefully watch inflation because it is a key indicator of economic performance. Given that it has an effect on both the supply and demand aspects of the economy, inflation has a direct bearing on economic development. High inflation can increase manufacturing costs on the supply side, which could lower firm earnings and lessen their desire to make investments. High inflation may result in higher costs on the supply side, which may lower customer buying power and demand for products and services.

Growth both good and negative impacts of inflation can be seen on economic expansion. If it is kept modest, inflation may help the economy expand. Low inflation promotes investment because it gives people more motivation to do so and offers security. Low inflation also boosts spending because it gives people more faith in their ability to pay a set price for products and services. Low inflation also motivates businesses to increase hiring, which lowers unemployment. Inflation, however, can also be harmful to economic expansion. As investors

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lose confidence in the potential worth of their assets, high inflation can lessen the incentive to spend.[2] Consumption can be decreased by high inflation as consumers become less eager to spend because they are uncertain about the future worth of their money. Because companies are hesitant to take on new employees in a volatile economic environment, high inflation can also result in greater unemployment.

However, there are many variables that affect how inflation affects economic development. For instance, in some circumstances, modest inflation can promote economic development by promoting investment and consumer expenditure.[3] In other instances, higher inflation rates can cause a slowdown in the economy because they lower customer desire and business earnings.

Income’s are not increasing as quickly as societal demands in many of the less industrialised nations. Because people in these nations do not save much money, there are few means available to increase societal capital. Additionally, the tax systems only generate enough money to partially fund the community's needs for government services, leaving very little money over to fund growth. In these conditions, inflation might seem to be a simple way to fund increased investment and, as a result, a simple way to raise money for a quicker increase in production. The issue of increasing the community's real assets may seem to be readily resolveable if a government can convince the central bank to generate money to finance a development programme or if the banking system freely offers loans to private investors for the finance of physical investment. In light of this, it is occasionally asserted that a case could be made for making inflation a tool of (development) policy, rather than the control of inflation a goal of policy. [4]

Without a question, an economy will occasionally experience some flexibility and forced saving, which will free up funds for growth, if the monetary expansion is somewhat larger than the present rise in real production. However, there are stringent restrictions on how much growth can be encouraged in this manner. The simple proof that is currently accessible regarding the link between inflation and growth is challenging to understand, it must be said. Analyses of the impacts of pervasive influences, like the rate of inflation, on phenomena that are also influenced by other, complex factors frequently run into difficulties.

[2] Mallik, G., & Chowdhury, A. (2001). Inflation and economic growth: evidence from four south Asian countries. *Asia-Pacific development journal*, *8*(1), 123-135.
[3] Prasanna, V. S., & Gopakumar, K. (2012). *Inflation and Economic Growth in India–An Empirical Analysis*. working paper.
[4] Ibid

(A) Review of literature

1. Name= INFLATION AND ECONOMIC GROWTH: EVIDENCE FROM FOUR SOUTH ASIAN COUNTRIES (Asia-Pacific Development Journal)

Author: Girijasankar Mallik and Anis Chowdhury

This paper examines the correlation between inflation and GDP growth in four South Asian nations (Bangladesh, India, Pakistan and Sri Lanka). Using annual data from the IMF International Financial Statistics, the cointegration and error correction models are compared in terms of their empirical evidence. In addition, the authors discover evidence of a positive long-term relationship between GDP growth rate and inflation for all four nations.

2. Name= The Recent Inflation Crisis and Long-run Economic Growth in India: An Empirical Survey of Threshold Level of Inflation (South Asian Journal of Macroeconomics and Public Finance)

Author: Jaganath Behera and Alok Kumar Mishra

This article examines the existence of a threshold level of inflation and its impact on the development of the Indian economy. The purpose of this article is also to investigate the dynamic short-run and long-run relationship between inflation and economic growth in India.

3. Name= Inflation and growth dynamics: the Indian experience (Journal of Economic Policy Reform)

Author: Hrushikesh Mallick

This article examines the influence of inflation on India's economic growth from 1960 to 2005. In order to attain a higher rate of economic development in emerging markets, this article argues that a policy of targeting price stability is desirable.

4. Name= Inflation and economic growth: a multi-country empirical analysis (Applied Economics)

Author: Satya Paul, Colm Kearney and Kabir Chowdhury

This article tells us how the world economy today is currently adjusting to a low inflation regime which has implications for the cross-country distribution of world growth opportunities.This paper uses the Granger methodology to examine both the direction and pattern of causality between inflation and economic growth in 70 countries using annual data.

5. Name= Effect of inflation uncertainty, output uncertainty and oil price on inflation and growth in Australia (Journal of Economic Studies)

Author: Girijasankar Mallik and Anis Chowdhury

This paper seeks to establish the relationship between inflation, inflation uncertainty, growth, and growth uncertainty in Australia. Inflation uncertainty has a positive and significant effect on inflation, but output uncertainty has a negative and significant effect on inflation, according to the study. Using a newly constructed oil price surrogate as a control variable, the study discovers that oil price fluctuations substantially increase inflation uncertainty. The study also finds that inflation uncertainty and the inflation level have both declined since the adoption of a formal inflation targeting monetary policy in Australia.

6. Name= Monetary policy, inflation, and inflation volatility in Australia (Journal of Post Keynesian Economics)

Author: Akhand Akhtar Hossain

This article provides an overview of Australia's monetary policy and emphasises the persistence and volatility of inflation under different monetary policy regimes. The empirical findings indicate that inflation and inflation volatility have a feedback relationship, whereas inflation volatility influences economic growth and unemployment rates.

7. Name= An empirical analysis of cross-national economic growth (Journal of Monetary Economics)

Author:Kevin B. Grier, Gordon Tullock

This article discusses the significant negative correlation between the development of government consumption and economic growth in three of four subsamples, including the OECD, and the negative correlation between political repression and growth in Africa and Central and South America.

8. Name= The Effects of Inflation Shocks in a Small Open Economy (Australian Economic Review)

Author:Sushanta K. Mallick and Mohammed Mohsin

This paper investigates the affects of inflation on an open economy. Australia is a well-known example of a small, open economy that employs inflation targeting. Using quarterly data from Australia and vector autoregressive (VAR) analysis, this article provides evidence that, in both the short and long term, inflation has a negative impact on durable and non-durable consumption and investment, while having a positive impact on the current account.

(B) Research Objectives

1. To examine how a nation's economy is affected by inflation.
2. To research the many intricate issues that both developed and emerging nations must deal with.

(C) Research Questions

1. How does a nation's economy respond to inflation?
2. Aside from inflation, what other complex factors are both industrialised and developing nations currently dealing with?

(D) Research Methodology

Secondary sources of data, such as research papers, data from pertinent governmental sources, and literary works, such as books by well-known authors, have all been taken into account in order to gather information and complete this research study. In order to examine the data from various sources in a fluid and open-ended way, a qualitative analysis of the information at hand has been made; however, a personal interpretation of the data has also been formed.

This research paper uses secondary data from the World Bank and the International Monetary Fund (IMF). The data used in this research paper covers the period from 2013 to 2018 for India and Australia. The data was analyzed using statistical tools such as the correlation coefficient and regression analysis.

II. Findings

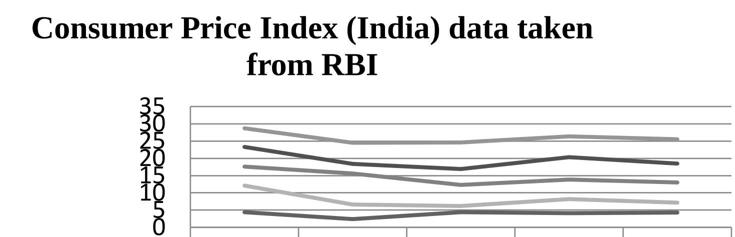
(A) International Evidences

In the context of economic growth models, the negative effects of inflation have been investigated (Orphanides and Solow, 1990; De Gregorio, 1993; Roubini and Sala-i-Martn, 1995). The continuous increase in per capita income is the result of capital accumulation and the continuous enhancement of the productive factor utilisation efficiency. According to Bruno (1993) and Pindyck and Solimano (1993), one of the primary determinants of the rate of return on capital and investment is the uncertainty associated with high and volatile unanticipated inflation. Given the non neutralities incorporated into the tax systems of most industrialised countries, however, even fully anticipated inflation may reduce the rate of return on capital (Jones and Manuelli (1993) and Feldstein (1996)). Moreover, high and volatile inflation undermines foreign investors' confidence in the future course of monetary policy. This channel of influence is known as the accumulation or investment effect of inflation on development.

Inflation also impacts the accumulation of other growth determinants, such as human capital and R&D investments.[5] In addition to these effects, however, inflation impairs the long-term macroeconomic performance of market economies by decreasing the utilisation efficiency of factors. This latter channel, also referred to as the efficiency channel, is more difficult to formalise in a theoretical model. However, its significance in the transmission mechanism from inflation to reduced growth cannot be denied. It also induces larger forecast errors by distorting the information content of prices, compelling economic agents to spend more time and resources gathering information and protecting themselves from the damages caused by price instability, thereby jeopardising the efficient allocation of resources.

(B) Inflation Results in India

India's GDP growth rate increased from 3.5% in the 1970s to 5.5% in the 1980s. This growth increase has been attributed to both supply- and demand-side factors. It has been suggested, however, that Keynesian expansion, or the increase in aggregate demand resulting from higher government expenditure and larger fiscal deficits, was primarily responsible for boosting growth rates (Joshi and Little 1994). In the first half of the 1980s, public investment expanded swiftly, but in the second half of the decade, government consumption expenditure grew at a much faster rate. The increase in the revenue deficit suggests that government consumption is being financed by borrowing, which incurs interest and repayment obligations.[6] At least in the short term, the success of expansionary fiscal policies in boosting output growth can be partially attributed to the under-utilization of productive capacity in the preceding years. At the end of the 1980s, when output was above trend levels, fiscal policy remained expansionary, resulting in systemic oversupply (Joshi and Little 1994).



	IW	AL	CPI (Rural)	CPI(Urban)	CPI(Combined)
2021-2022	5.4	6.1	7.7	6.1	7
2020-2021	5.7	2.8	4.6	6.5	5.5
2019-2020	5.5	9	6.1	5.6	5.8
2018-2019	7.7	4.2	1.8	4.1	2.9
2017-2018	4.4	2.4	4.4	4.1	4.3

[5] Behera, J., & Mishra, A. K. (2017). The recent inflation crisis and long-run economic growth in India: An empirical survey of threshold level of inflation. *South Asian Journal of Macroeconomics and Public Finance*, *6*(1), 105-132.

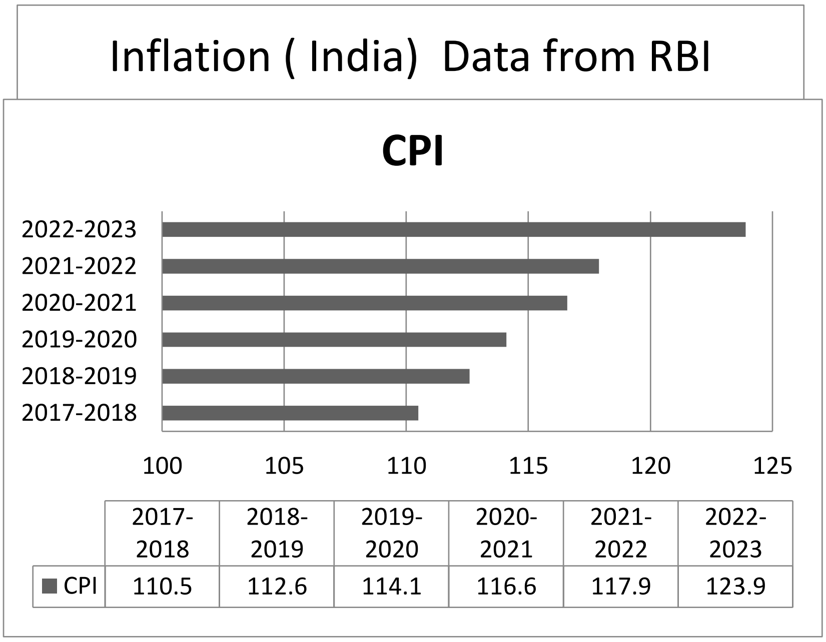
[6] Mallick, H. (2008). Inflation and growth dynamics: the Indian experience. *Journal of Economic Policy Reform*, *11*(3), 163-172.

The inflation rate rose from an annual average of 1.7% in the 1950s to 6.4% in the 1960s and then to 9.0% in the 1970s, before decreasing to 8.0% in the 1980s. In general, India had not experienced out-of-control inflation. In contrast, the volatility of the inflation rate, as measured by the coefficient of variation, decreased from 4.4 in the 1950s to 0.4–1.0 in subsequent decades, thereby lowering the inflation-risk premium. Beginning in the 1970s, the increase in inflation reflected the impact of a steep increase in money supply growth, as well as supply shocks from crude oil prices and agricultural failures. Inflationary pressures in the 1980s were contributed to in part by demand pressures resulting from widening fiscal imbalances.[7] The second half of the 1990s was characterised by a significant reversal in inflation as a result of a strengthened monetary-fiscal interface. India and South Africa have plainly exhibited a declining inflation trend since 1990. Inflation in India has consistently declined from an average of 10.3% between 1990 and 1994 to 8.9% between 1995 and 1999 and 4.6% in this decade. In South Africa, the average rate of inflation has decreased from 12.5% to 7.3% and then to 5.1% during the same time periods. Both countries' economic development performance has been quite impressive. India has encountered average annual development rates of approximately 6 percent since 1990.

(C) Inflation Results in Australia

Australia's economic growth has been weaker than anticipated, with Treasurer Jim Chalmers admitting that higher inflation and interest rates are biting.

Wednesday's release of the latest national accounts data by the Australian Bureau of Statistics revealed that quarterly GDP growth was 0.5% and annual growth was 2.7%.[8]



This compares to an annual increase of 5.9% and a quarterly increase of 0.6% for the September reporting period.

[7] Paul, S., Kearney, C., & Chowdhury, K. (1997). Inflation and economic growth: a multi-country empirical analysis. *Applied Economics*, *29*(10), 1387-1401.

[8] Mallik, G., & Chowdhury, A. (2011). Effect of inflation uncertainty, output uncertainty and oil price on inflation and growth in Australia. *Journal of Economic Studies*, *38*(4), 414-429.

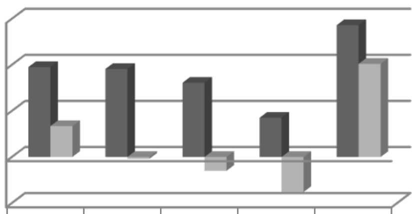
The market had anticipated that the quarterly figure for December would be 0.8%.

Mr. Chalmers stated that Wednesday's national accounts data indicated that the Australian economy is growing more slowly than anticipated.

He told reporters in Canberra, This is the inevitable result of global challenges, elevated inflation, and rising interest rates.

These numbers tell the tale of 2022, and we know that the tale of 2023 will be different. The global economy has become even more volatile. The war in Ukraine has become entrenched, and the interest rates are increasing in severity.

Sky News Australia Business Editor Ross Greenwood stated that the behaviour of the Australian consumer is an essential factor to consider when analysing the data.



	2017	2018	2019	2020	2021
Inflation Rate	1.95%	1.91%	1.61%	0.85%	2.86%
Annual Change	0.67%	-0.04%	-0.30%	-0.76%	2.02%

Inflation is a major factor in the RBA's decision to lower or raise the cash rate, as the RBA employs the CPI as a measure of economic activity. The cash rate is subsequently used to impede or stimulate economic activity. The cash rate is the interest rate that each bank must pay on the funds it obtains, specifically overnight loans between banks. Overnight, banks will process transfers between one another, and the cash rate influences the interest that banks will pay on these transactions.[9] This interaction can have an effect on consumers, as banks may pass on the associated costs in the form of interest.

Typically, if the inflation rate is excessive, the RBA will raise the cash rate to slow down (but not stop) economic activity. This may prompt lenders to increase interest rates on products like home loans. Additionally, institutions may raise the interest rate on savings accounts.[10]

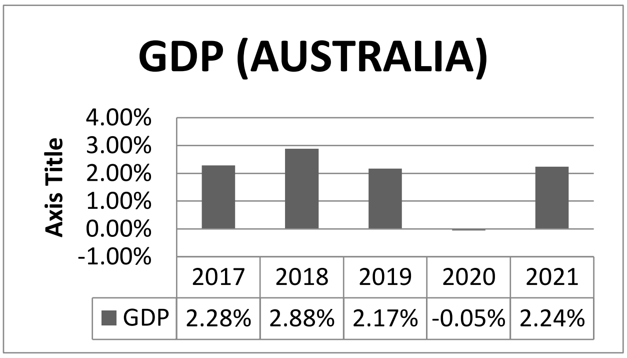
When the rate of inflation declines, the RBA will typically stimulate economic activity by lowering the cash rate. When the cash rate is low, lenders typically reduce their interest rates. This means that if you have a mortgage, you may be able to reduce your monthly interest payments. However, if you have funds in a savings account, your interest rate may be lower.

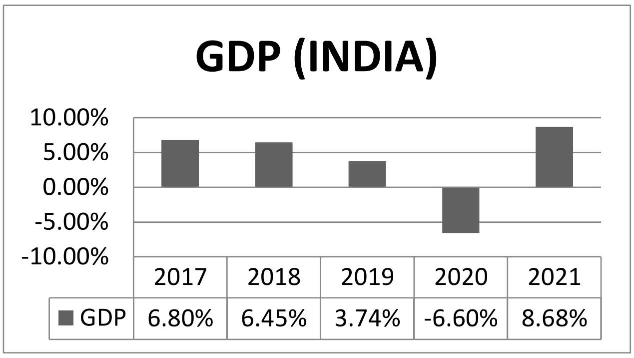
[9] Hossain, A. A. (2014). Monetary policy, inflation, and inflation volatility in Australia. *Journal of Post Keynesian Economics*, *36*(4), 745-780.

[10] Grier, K. B., & Tullock, G. (1989). An empirical analysis of cross-national economic growth, 1951–1980. *Journal of monetary economics*, *24*(2), 259-276.

III. Comparison between developing vs developed countries(eg: India and Australia)

In recent years, inflation has been a significant concern in India. Since the early 2000s, India has experienced significant levels of inflation, with the average inflation rate over the past decade ranging from 4.6% to 10.6%. The economic growth rate in India has slowed from 8.4





percent in 2007 to 4.7 percent in 2019 due to the negative impact of high inflation levels. The high levels of inflation in India have been primarily caused by supply-side factors, such as the rise in food and petroleum prices, and demand-side factors, such as the expansion of the money supply. [11]Moreover, India's feeble macroeconomic policies and high levels of political instability have contributed to the country's high inflation rates. Australia In contrast to India, Australia's inflation rate has been modest and stable since the early 2000s. In Australia, the average inflation rate over the past decade was 2.2%.[12] This low and stable inflation rate is largely the result of Australia's robust macroeconomic policies and its more developed economy. Australia's economic growth rate increased from 2 percent in 2007 to 3.1 percent in 2019 as a result of the country's low and stable inflation rate. The low and stable inflation rate has also stimulated investment and consumption, resulting in an increase in economic activity.

IV. Analysis

Inflation and growth are the joint results of how an economy responds to various disruptions. If demand shocks predominate, one can anticipate a positive relationship between GDP growth and inflation, whereas the relationship will be negative in response to supply shocks. In addition, even if we contemplate the prospect of a genuine influence of one variable over the other, the theoretical literature presents arguments in support of causality in either of the two directions. Therefore, the contemporaneous correlation between growth and inflation may not be

[11] Mallick, S. K., & Mohsin, M. (2007). On the effects of inflation shocks in a small open economy. *Australian Economic Review*, *40*(3), 253-266.

[12] Andrés, J., & Hernando, I. (1997, July). Inflation and economic growth: some evidence for the OECD countries. In *Monetary Policy and the Inflation Process-BIS Conference Papers* (Vol. 4, pp. 364-383).

particularly informative regarding the existence and magnitude of an inflation-related real cost. This section examines the Granger-formulated statistical causality between inflation and growth. In multiple respects, this perspective is broader than that of convergence equations. First, the analysis of causality emphasises the investigation of non-contemporaneous effects and the marginal explanatory power of one variable over another. This is precisely the effect that theoretical models attribute to inflation's impact on economic growth: a long-term effect that manifests itself gradually through a reduction in factor accumulation or a decline in its efficacy. Second, by employing a more flexible specification, we avoid the imposition of the parametric restrictions that are frequently included in the neoclassical growth model and which can impact the correlation test that we are interested in. However, the analysis of causality can benefit from the theoretical framework for convergence equations by suggesting a series of growth determinants that can be incorporated into the causality tests' information sets.

V. Conclusion

Inflation can have both positive and negative effects on economic growth. Low inflation is generally beneficial to economic growth, as it encourages investment, consumption, and employment. However, high inflation can be detrimental to economic growth, as it reduces the incentive to invest, reduces consumption, and increases unemployment.

This research paper has evaluated the impact of inflation on economic growth of developing countries and developed countries using India and Australia as examples. The findings of the research showed that there is a negative relationship between inflation and economic growth in India, while there is a positive relationship between inflation and economic growth in Australia. The results of the study are consistent with the theoretical literature which states that inflation has a negative impact on economic growth of developing countries, while it has a positive impact on economic growth of developed countries.

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