

Inflationary Effect of the COVID-19 Crisis

Shubhra Suman

MA (Economics), Delhi School of Economics, Delhi University, Delhi

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ABSTRACT

The novel coronavirus caused by COVID-19 is a global pandemic that has affected the world in an unexpected way. The pandemic has impacted economic activity in the whole world through lockdowns directly and indirectly. It has effected global trade and growth. This article explores the impact of COVID-19 on the inflation and unemployment and looks at the Indian scenario amid the COVID-19 crisis. Since this is a current issue, newspapers, Government reports as well as research by leading banks are the basis for this article. The slowdown risen in the economy due to the pandemic requires efficient and extreme measures to curb the losses. Continuous Rising inflation can be said a direct cause of the pandemic. The current situation demands measures to control it.

1. Introduction

COVID-19 originated in China and has now spread to most of the world. Because of globalization, international relations and trade, the adverse situation in any one nation affects the other nations as well. The widespread impact of COVID-19 has caused serious damage to economy around the whole world and is regarded as a *black-swan event* — A random event that is completely unpredictable.

One of the concepts of economics is that in demand and supply interactions, a reduction in aggregate supply will increase prices and reduce output. The downward shift in aggregate demand will reduce prices and output. Both supply and demand shifts will thus adversely affect output and reduce the economic growth. The current global situation has resulted in compromising both demand and supply schedules. This is expected to affect prices and output which will surely impact economic growth and development.

The immediate short run measure taken by many countries including India was to put the affected areas into complete lockdown. This knee-jerk reaction is bound to have far-reaching multiple effects causing harm to industries such as airlines, travel and tourism, sports, hotels, entertainment and many more. The contribution of these industries to national income is generally very high. So, the wide-spread or contained lockdowns both would lead to layoffs and rise in unemployment rate.

The Indian Economy had been experiencing economic slowdown in the periods before the coronavirus pandemic. Business activity had been slowing while unemployment, prices and inflation had been rising slowly but steadily. The COVID-19 situation will only serve to exacerbate the ongoing slowdown of the economy. The fall in output will affect supply of goods and services. The reduced supply in the face of a huge consumer base is bound to create inflationary tendencies in the Indian economy. This article attempts to examine the effects of COVID-19 on inflation with specific focus on Indian economy.

RBI Annual Policy Report suggests that COVID-19 initially impacted economic activity in India directly due to lockdowns, followed by second round effects operating through global trade and growth (Economic Times, 2020 9 August). It however

cautioned that world over countries are preparing themselves to face the hardships caused due to the pandemic and India, too, needs to prepare itself to face the downside pressures resulting from the pandemic.

Given the low interest-rate environment after the 2008 financial crisis, firms were in tight financial position and corporate debt has piled up. The availability to cheap credit had helped many firms grow in the earlier expansion period. A "sudden stop" to the economic activity now, has cut revenue for many firms and made it difficult for them to repay the loans to their creditors. It is feared that this will lead the firms to default. And defaults of firms would hit banks and that will result into less and cautious lending by banks in the coming future. The business investments will fall bringing down expectations for future growth.

The recent fall in stock market is similar to what has been observed in past recessions and it is always the first thing that happens during recessions. The volatility in stock market has skyrocketed. Fluctuating interest rates and oil prices have further fuelled inflation expectations. All these combine to create numerous bottlenecks adversely affecting supply. If such supply shocks continue then it will create the situation of high inflation and unemployment in the Indian economy.

2. Inflationary effect of COVID-19 Crisis

The Ministry of Statistics and Programme Implementation has pointed out that the collection of data from economic entities was impacted due to nationwide lockdown imposed in March (Economic Times, 2020, May 29). So the economic analysis may suffer due to small sample size. However data published by the Ministry has shown that the Indian Economy has shown the weakest growth at only 3.1%, since the past decade when the global financial crisis impacted many countries.

In the face of economic uncertainty, the GDP growth figures were revised down the in Q1, Q2, and Q3 of 2019 and stood at 5.2 per cent, 4.4 per cent, and 4.1 per cent respectively (Financial Express, 2020 May 29) portraying a scary future. The impact of the expected inflation resulting from the coronavirus induced pandemic is expected to occur on

various sections of the economy like firms and consumers in terms of investment, consumer price index, demand and supply.

3. Impact of COVID-19 on businesses and investment

Some experts suggest that instead of inflation the Indian economy may actually experience deflation due to low aggregate demand. But inflationary pressures are more likely to emerge after the global economy begins to recover. (Business Standard, 2020 April 9).

The new social norms and requirements of social distancing are bound to increase operational costs for businesses. The associated costs of social distancing and redesigning sale end-points will be passed on to consumers who will have to pay more for lesser services. Additionally, during the crisis a number of firms have been forced to close down. This has reduced competition in the marketplace, leaving more pricing power in the hands of the surviving firms, a classic case of imperfect markets. The remaining firms will now be price-makers instead of price-takers and can easily charge higher prices.

For Indian market, since movement of goods trains had been generally excluded from the lockdown, domestic supply has not been very adversely affected. This has also ensured that the general price level has remained manageable and prices of essential commodities have not sky-rocketed.

A consideration of bank credit provides a similar dismal picture. The lockdown has led to stoppage of earnings for most business establishments. Many of which had borrowed from banks. Now they are in no position to repay their loans. This has put pressure on the banks. When inflation picks up, the banking sector led by the Reserve bank of India will have to decide how much of inflation to tolerate. The banks may have to take tough decisions focusing on whether to promote easy credit or control inflationary trends.

Data from the lockdown period throws up significant scares. Unemployment rose from 6.7% on 15 March to 26% on 19 April 2020. During the lockdown, an estimated 14 crore (140 million) people lost employment while salaries were cut for many others. More than 45% of households across the nation reported an income drop as compared to the previous year. The Indian economy was expected to lose over ₹32,000 crore (US\$4.5 billion) every day during the first 21-days of complete lockdown which was declared following the coronavirus outbreak. Under complete lockdown, less than a quarter of India's \$2.8 trillion economic movement was functional. Up to 53% of businesses in the country were projected to be significantly affected. State Bank of India research estimates a contraction of over 40% in the GDP in Q1 FY21 (Economic Times, 2020 May 27). The contraction of economic activity will not be uniform across sectors, rather it will differ according to the degree of human inter-personal interactions involved in any exchange. Thus hospitality, retail sales, construction etc. are bound to suffer. This will then lead to adverse impact on related industry like tours-travels, event management, real estate etc. to name just a few sectors.

4. Consumer Price Index (CPI) and Inflation

When considering the inflationary impact on the economy, the Reserve Bank of India uses the Consumer Price Index

(CPI) to examine inflation. Headline consumer price index (CPI) inflation breached the upper tolerance band of the target in December 2019 and peaked in January 2020, before ebbing prices of vegetables, fruits and petroleum products produced a downward shift of 100 bps in February (Business Standard, 2020 April 9). Currently the relative easy supply of vegetables and fruits along with cereals has tended to keep prices in check. supply disruptions were for very short periods during the lockdown, but easing of restrictions will bring its own set of challenges. In such a situation a strain on food supply cannot be ruled out. If prices of food items rise, the inflationary tendency in the economy will be difficult to control.

The outlook in March suggests that people did not expect inflation to rise much in the early stages of the pandemic. But as the pandemic stretches on and economic recovery gets delayed, fears of rising inflation cannot be ignored.

Production side of the economy is suffering due to unavailability of easy finance and credit, coupled with low expectations of profits. This will then lead to reduced supply. Further the COVID-19 has been affecting various regions of the country in varying degrees. While some areas are facing a second wave of infections others are still in the first wave. This is bound to create distortions due to staggered regional lockdowns. Government policy like taxes on petrol and diesel to augment the exchequer will also increase the inflationary tendencies. While the food basket has been heavily influencing the CPI, further increases in commodity prices as well as services becoming expensive with time (Dhasmana, 8 August, 2020) will also have an increasing effect on the rate of inflation. This expectation of rise in prices of consumer goods and services is not misplaced as they providers will try to make up for their lost earnings. The increased prices will have to be borne by the consumers who are already suffering from lower incomes.

5. Impact of COVID-19 on general masses

The COVID-19 pandemic and related lockdown measures have produced significant interruptions in young people's lives. It has interfered with their learning and earning capacities. New entrants to the work-force are finding it difficult to get jobs. At the same time many existing workers have been removed from their positions. This has led to increasing stress on the productive portion of the population by increasing the burden of non-productive consumers (dependants).

The coronavirus induced lockdown has had mixed effects on the elderly population. This age-group is in particular danger as the mortality rates from COVID-19 are much larger for them than those of the young. While retirees cannot lose their jobs, the fact remains that they are generally dependent on returns from savings or their daily expenses. Fall in interest rates are going to affect them much more harshly given that economic recovery is expected to be very slow.

Inflation has a larger detrimental impact on the asset-holders because it reduces the real value of the assets. The section of the economy that depends on rent or interest from financial assets for its living is also in a difficult position. Currently the rates of bonds and stocks are on a downswing reducing returns on investments. Similarly returns from land and housing have reduced with many tenants showing helplessness in paying their rent. This has adversely affected the income of this class of people dependant on rent incomes.

6. Effects on Demand and Supply due to COVID-19

The interaction of supply and demand will partly determine the impact of COVID-19 on inflation. The impact is very uncertain, given the sharp changes in demand, the partial closure of some industries and significant differences in experiences across sectors. The impact of spare capacity in controlling prices may be less than usual. Firms may not be able to induce increase in demand through price cuts as consumers are less able and willing to spend. So the incentive to lower prices through Sale announcements may not entice customers, leaving overall prices high. External cost pressures, such as movements in the exchange rate and commodity prices, will also influence inflation.

7. Role of Government in tackling COVID-19 crisis

Governments around the world have been spending heavily to deal with the fallout of the COVID-19 crisis. This means that the burden of public debt will have increased for most of them. It remains to be seen how Governments cope with these debts. Following inflationary policies may seem a preferable line of action but will have serious fall-backs for the economy. The Indian government has also undertaken many steps to provide relief to the people in these trying times. While many expenses have been met through the government fund for contingencies, long-term impact of these measures are yet to be known.

The government has announced a Rs 20 lakh crore revival package for the economy but some experts have said the fiscal stimulus is only about Rs 2 lakh crore, or 1% of GDP. State Bank of India Research wing expects the Government to come up with another relief package later in the year to help the economy (Economic Times, 2020 May 27)

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Raising taxes would impede the post-COVID-19 recovery. Cutting public spending would also be hard, especially after a crisis that has uncovered inadequacies in our health care systems. Of all the available options government may favour slight inflation over the others. Hence people need to prepare themselves for this eventuality as the economy limps back to normalcy.

8. Conclusion

The monetary and fiscal policy alone cannot solve the pandemic problem but it can somewhat prevent the spread of these problems to the economy in the long-run. The cuts in interest rates will provide only short run relief. In the long run the investment will fall even the interest rate reduce further because of low confidence in the market. Similarly the ease in monetary policy will have little impact on aggregate demand in this situation. However an easy fiscal policy in terms of tax-relief to hard-hit businesses, health spending, capacity building through investment in social and physical infrastructure etc. are crucial for Indian economy to sustain itself .

COVID-19 has impacted countries all over the world. Mankind has been brought to its knees by a mere virus and the long-term effects of this pandemic will change the world in the coming days. While countries including India continue the quest for vaccines and cures, the masses will have to undergo a long spell of suffering in the meantime. Rising inflation is a direct reflection of the pandemic that needs to be countered effectively. Resorting to fiscal measures in order to help the economic recovery may well be the only response in spite of its inflationary effects.