PRICE INFLATION AND GDP GROWTH-WHAT MATTERS MOST? EVIDENCE FROM EGYPT AND INDIA

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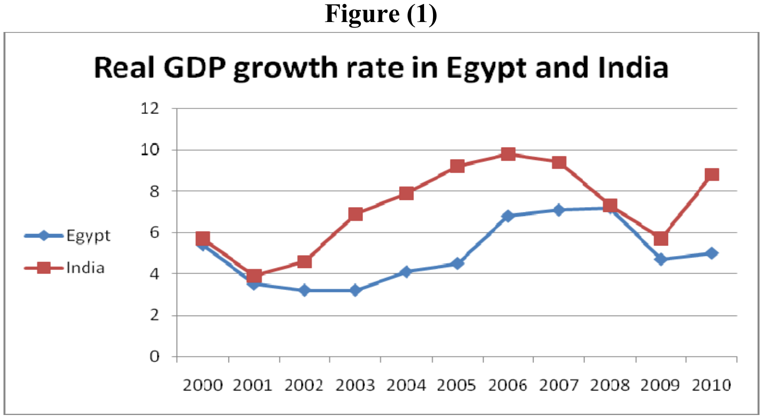
ABSTRACT

Egypt and India are both emerging developing countries which share some common economic features; their rate of economic growth has approximately the same trend while they both begin series of economic reform process in the same period of time (early 1990's) while passing through high inflation rates. This paper analyses the Indian distinguished high economic growth rates while having higher inflation rates in comparison with Egypt in the period 2000-2010. The paper concludes that India's inflation was accompanied by an increase in labor productivity, at the same time focusing on successful sectors in the economy, boosting savings and investments. The paper recommends that emerging countries while applying economic reforms process do not focus on inflation targeting, but rather let the market correct itself and focus on real production and productivity since growth in labor and capital productivity is the key engine of economic growth.

INTRODUCTION

Analyzing GDP growth rates trend between the two countries during the period; it is shown that it is higher in India though both countries almost have the same trend.

Figure (1)

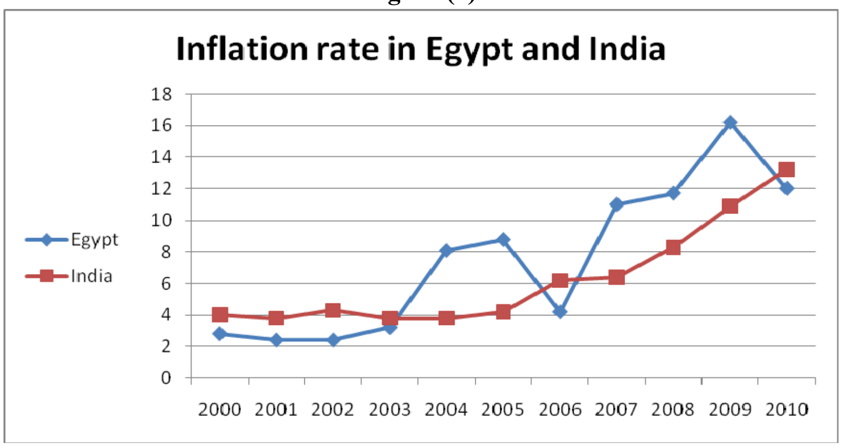


Source: international monetary fund data and statistics

The two countries started by a decline in the GDP growth rate during the period from 2000 to 2001, then showed an increase through the period 2001 to 2007, India then decreased from 9.4 to 7.3, while Egypt went up from 7.1 to 7.2 (2007 to 2008), the two countries went down following the global financial meltdown in 2008. India jumped to 8.8% in 2010 while Egypt achieved only 5%.

India' GDP growth rate recovered faster than Egypt after the 2008 financial crisis, although the two countries suffered high rates of inflation, which reflects the underlying strengths of the Indian economy.

Analyzing inflation rate trends between the two countries during the period
Figure (2)



Source: international monetary fund data and statistics

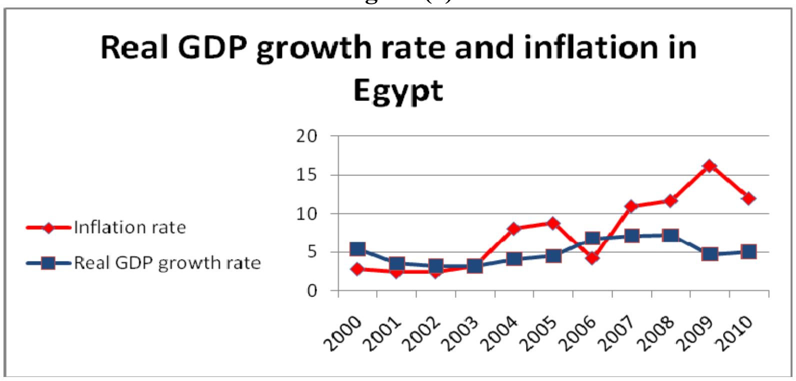
As shown in figure (2), inflation rates in Egypt in general is higher than those in India during most of the period except for the first three years, after which India witnessed a continuous increasing rate of inflation, while Egypt had sharp trends of increase in inflation rates till it reached its highest level in 2009 (16.2%).

The two countries had periods of sharp rise in inflation rates, but India passed Egypt in the GDP growth rates, in the following sections, the paper will examine the major factors that were fostering India's growth rate despite the high inflation rates.

METHODOLOGY

The paper examines data from Egypt and India through the period from 2000-2010. Since exploring the inflation dynamics following a statistical approach does not capture the behavioral structure of the economy, therefore we use the inductive methodology in tracking the position of vital macroeconomic variables of the two countries during the period of study. The data involve mainly real GDP growth rate, price inflation rates, GDP composition (demand side), taxes as a percentage of GDP, foreign domestic investments and labor productivity growth.

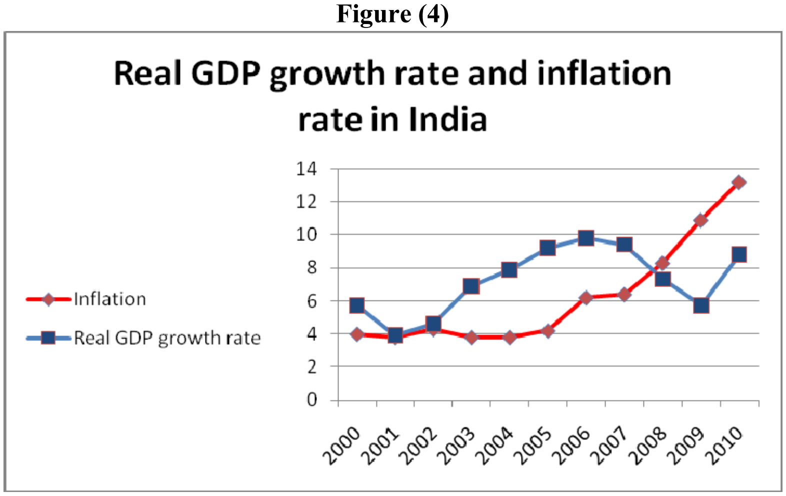
Analyzing real GDP growth rate and inflation in Egypt
Figure (3)



Source: international monetary fund data and statistics

As shown in figure (3), when inflation was at its lowest rates (2000-2003) GDP growth rates were decreasing and when inflation started to boost from 3.2% to 8.1% (2003-2004); GDP growth rate escalated until it went down to 4.7% in 2009 at the same time inflation reached its highest level in the period (16.2%).

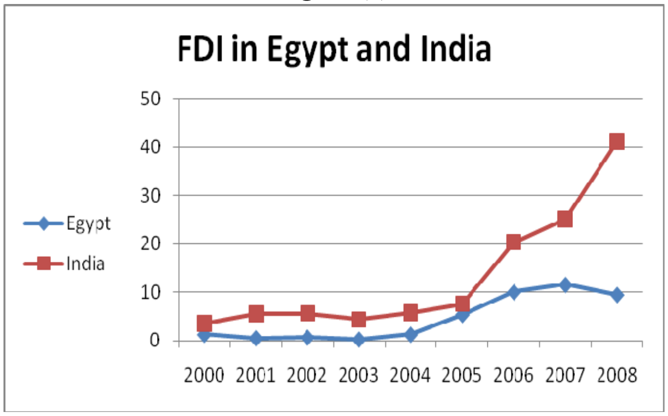
Analyzing real GDP growth rate and inflation in India
Figure (4)



Source: international monetary fund data and statistics

Figure (4) shows that GDP growth rate continued to increase at the same time the inflation rate was increasing, that was obvious in the last two years when GDP growth rate boosted from 5.5% to 8.8% at the same time inflation rate increased from 10.9% to 13.2%.

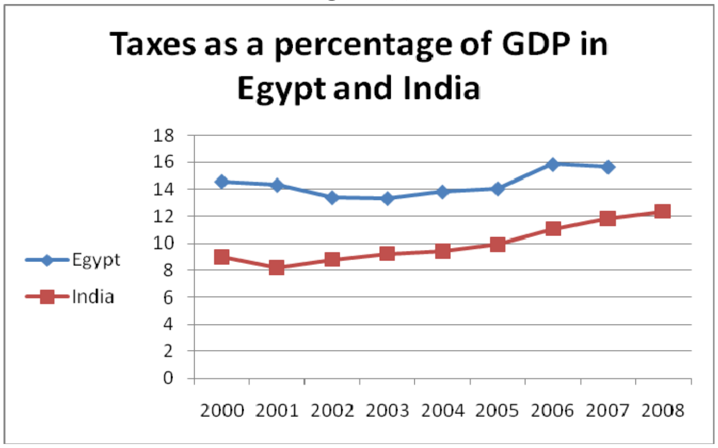
Foreign direct investment as a percentage of GDP in Egypt and India
Figure (5)



Source: international monetary fund data and statistics

Figure (5) shows that foreign direct investment as a percentage of GDP is much higher in India than Egypt with an enlarging gap. FDI's % of GDP in India reached 41.17% in 2008 versus 9.49% in Egypt.

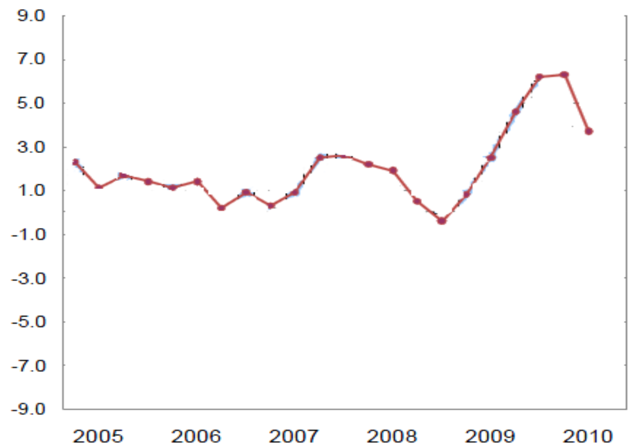
Taxes as a percentage of GDP in Egypt and India
Figure (6)



Source: international monetary fund data and statistics

Figure (6) shows that taxes as a percentage of GDP in India have lower levels than Egypt which encourages profit margins and boosts investments.

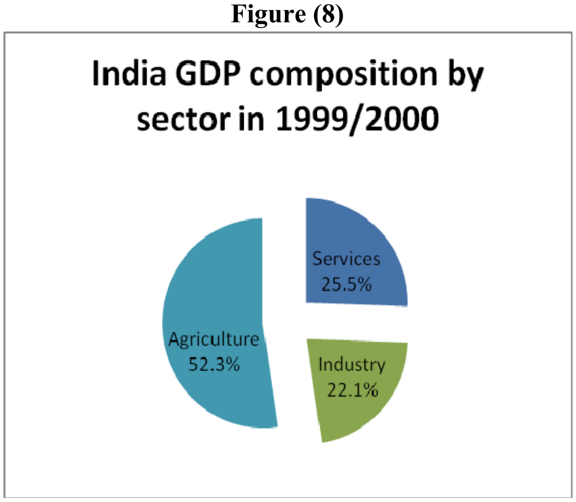
Figure (7)
Output per hour, nonfarm business, all persons, percent change



Source: productivity and costs, "US department of labor, Bureau of labor statistics, USDL-10-1211.

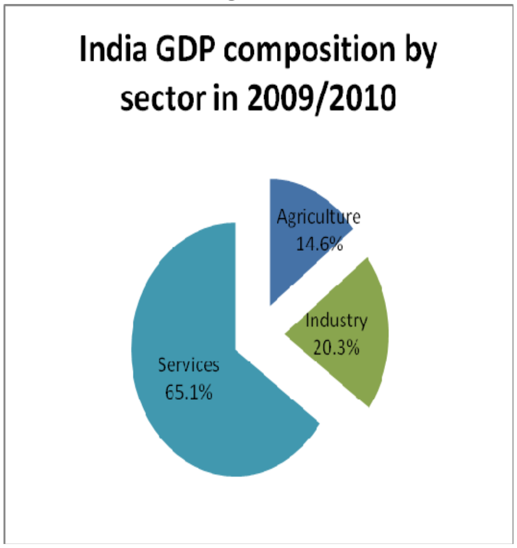
Figure (7) shows the progress of growth in India's nonfarm business productivity which increased at an average annual rate of 2.5% in the period (2000- 2009).
In 2009, Egypt grew in its industrial production by 6.4% from previous year (2008) while India grew by 10.3% in the same period, despite the financial crisis of 2008.

India GDP composition by sector in 1999/2000
Figure (8)



Source: Reserve bank of India, monetary policy statements

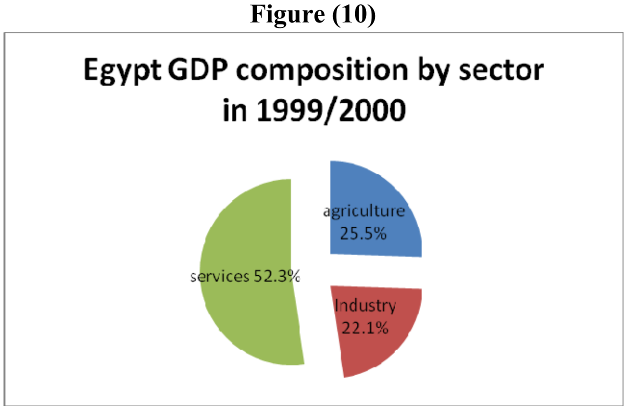
Figure (9)



Source: Reserve bank of India, monetary policy statements

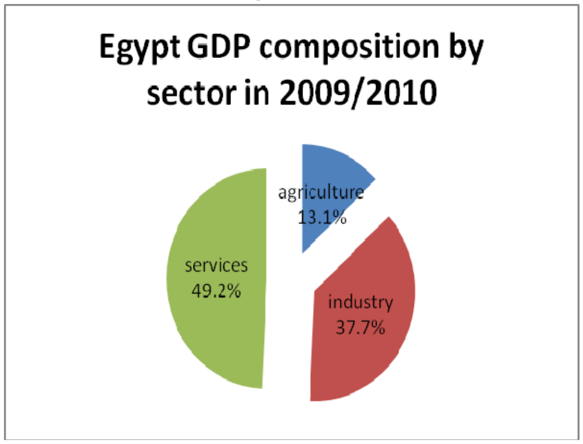
As shown in the above figures, India's economic reforms that began in 1991 helped transforming its economy from one depending on agriculture to an open and progressive one that depends on services.

Egypt GDP composition by sector in 1999/2000
Figure (10)



Source: Reserve bank of India, monetary policy statements

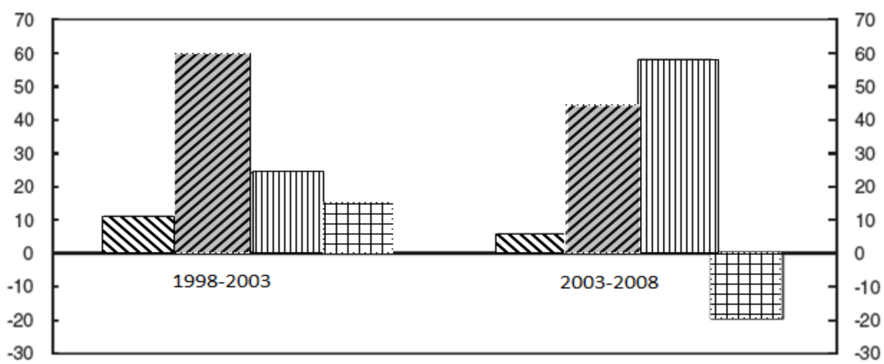
Figure (11)



Source: Reserve bank of India, monetary policy statements

The above figures show that Egypt's progress in expanding its industrial sector share in GDP was limited (from 22.1% to 37.7%) in 10 years. The service sector's share in GDP decreased from 52.3% to 49.2%). The share of agriculture decreased to 13.1% from 25.5%.

Figure (12)
Contributions to GDP growth 1998-2003and 2003-2008 in India



Source: L. de Mello, "Growth and sustainability in Brazil, China, India, Indonesia, and south Africa", OECD, 2010

Government consumption

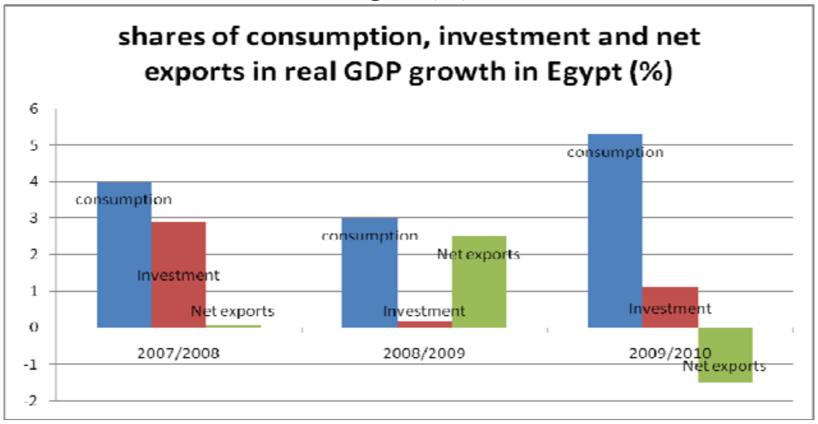
Private consumption

Investment

Net exports

Figure (12) represents the contribution to GDP growth in India, which shows that investment is the biggest contributor to GDP growth. India succeeded to boost its investment at the expense of consumption.

Shares of consumption, investment and net exports in real GDP in Egypt (%)
Figure (13)



Source: central bank of Egypt annual economic review, different issues

Figure (13) shows that Egypt in the last 3 years (2007-2010) had increased its consumption's share in GDP growth (from 4% to 5.3%), decreased its investment's share in GDP growth (2.9% to 1.1%) and shifted its net exports share to GDP growth to negative (-1.5). This will not help Egypt to rely on real savings and domestic sources resulting from investment in its economic progress, which will have its effect on the strength of the economy.

CONCLUSION

Tracking Egypt and India's price inflation trends, Egypt has experienced short bursts of high inflation, but India had acceptable rates during the first 5 years (ranged from 3.8% to 4.2%). A low or moderate inflation for long periods provides a favorable environment for growth. The duration of keeping lower rates of inflation for a long time helps driving trust in the government's commitment of lower inflation thus fostering investments and high expectations. The long run solution to the real inflation problem depends on the ability of the government to provide adequate supply and stabilize domestic demand. Therefore, a government that is producing high inflation is a government that has lost control of macroeconomic management. Macroeconomic stability exists in a country if it manages to resolve the macroeconomic crisis that emerged within a year or two, which was the case of India.

Some studies argue that it is not clear whether applying inflation targeting leads to better performance of the economy, the performance of these countries after applying the inflation target policies are different than before applying them in containing inflation for only short terms. Therefore targeting policies might have lower short run effects in countries fighting inflation, if they do not have negative recessionary impact on the economy. India fostered its real GDP growth rates while having high inflation rates by applying policies that focused on real production and productivity, shifting its economy towards successful sectors that generates income in the short run (industry and services), at the same time having acceptable tax rates, hence boosting investment and generating more income. Then; what matters most is GDP growth rate, emerging countries should focus on productivity and investment rather than inflation targeting and let the market correct itself.

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