CHAPTER 7
FISCAL DEFICIT AND INFLATION

This Chapter examines the relationship between fiscal deficit and inflation in India. This chapter is divided into six sections followed by introduction. Section 2 explains the effect of fiscal deficit on inflation. Section 3 encapsulates the review of recent studies. Section 4 discusses the trends in annual percentage change in CPI and household consumption expenditure in India. Data analysis and findings are discussed in Section 5. Section 6 concludes the chapter.

7.1 INTRODUCTION

One of the highly debatable issues in India is how to control inflation. With the inelastic supply of domestic output, inflation inevitably resulted. The Indian economy had experienced an unprecedented economic crisis during the early 1990s. The balance of payments situation was precarious. There was a sharp decline in foreign exchange reserves and capital inflows through commercial borrowings and non-resident deposits. The country was experiencing large and consistent macro economic imbalances, low productivity and a low rate of return on investment. The fiscal deficit of central and state governments reached at an alarming level. There was a sharp increase in external debt. The country began to experience double digit inflation. This was the context in which the then congress government implemented the structural adjustment reforms in 1991. The thrust of the reform process was to increase the efficiency and international competitiveness of industrial production, and to utilize this, for the purpose of foreign investment and foreign technology to a greater degree. This emphasizes was also on increasing productivity, modernizing the financial sector and attaining a technological and competitive edge in the fast changing economy.

India is the 3rd largest economy in Asia but its economic growth is very slow because of various problems like increasing population, poverty, unemployment,
inflation, depreciation of rupee and fiscal deficit etc. Among the factors that have
hindered and prevented India from reaching a higher growth plane, the
growing fiscal deficit and inflation appear at the top. Theoretically, deficits are
not necessarily bad, especially for a developing economy, if its resources are
employed in a productive manner. However, if unchecked, they have the ability
to ruin a nation’s finances, thus having the ultimate impact on its citizens.

Inflation can be defined as persistent rise in the prices of commodities. There
are mainly two types of inflation

1. Demand Pull inflation
2. Cost push inflation

Demand pull inflation arises when demand is more than supply of the
product which causes upward pressure on the prices of goods. Whereas cost push
inflation means increase in the cost of production (increase in the cost of raw
material, increase in wage rate, increase in petrol prices etc) which increases the
prices of the product. With most of India’s population living close to or below the
poverty line, inflation acts as a ‘tax of poor Man’. This effect is bigger when food
prices rise, since food represents more than half of the expenditure of this group.
Food prices have increased too much and government has been unable to control the
rise. From an economic and business perspective, the inflation rate is directly
affected by gross domestic product, money supply, exports, prices of imports,
exchange rate, interest rate, fiscal deficit, government expenditure and tax revenue
etc. The most visible impact of inflation in recent times is its effect on real output,
relative prices, taxes and interest rates. The impact of these is on the manufacturing
sector which showed very slow growth rate in the year 2012-13. One of the major
reasons behind the present condition of the Indian industrial sector is the continuous
decline in the manufacturing sector’s growth.

Food inflation has increased due to supply shortage in India which has been
due to unfair climate condition and rains. Shortage of agriculture supply leads to
increase in the prices of food grains. Consequently industrial workers have to spend
more for food grains. They put pressure on employer to increase the wage rate which
increases the cost of production and industrial prices. Thus both agriculture as well
as industrial prices increased which increased the overall price level in the country. Traders and shop owners are reaping the benefit of rapid rise in price. The real people are at the short end of the stick and are suffering from consequences of rising prices.

According to Keynesian, aggregate supply (AS) curve is quite flat in short run which shows that firms can produce at existing price to meet the increased demand in the market as there is always unemployment in the economy. Keynes stated that average cost of production does not change with the change in output level. Figure 7.1 explains that aggregate supply curve (AS) is quite flat till it reached to full employment level. In such a scenario, any increase in the aggregate demand (AD₁ to AD₂) will not leads to change in the price. When output is bellow the potential output, then there is small tendency for price of goods and factors to change. On the other hand, when output is potential, then the shape of the aggregate supply curve is vertical or steep. In such case, increase in the aggregate demand will cause change in
the price level. This perspective is known as classical view. In Figure 7.2, it is pointed out that $Y_f$ is the potential output and increase in the demand ($AD_1$ to $AD_2$) will leads to increase the prices in the long run. Further, the economy is on the horizontal part of aggregate supply curve during recession and in such a scenario government can intervene in the market through expansionary fiscal policy to increase the aggregate demand without having much on the price level (inflation). Thus it can be concluded that there is little relationship between inflation and fiscal policy when economy is working below full potential. Further, fiscal policy could not affect price level in developing countries.

**Figure 7.2**
Vertical Classical Supply Curve

![Vertical Classical Supply Curve](image)

### 7.2 EFFECT OF FISCAL DEFICIT ON INFLATION

Many economists and policy makers suggest that there are mainly two options to revive economy and for faster economic growth. First view is that the central bank should bring down rate of interest because at lower interest rates people will borrow and increase their consumption, businesses and investors will benefit from increased demand and consequently, the economy will grow more rapidly. The
second group of thoughts suggests that the government should increase public expenditure. As the government spends more money, that money will distributed as profits and income in the hands of people and this will increase household demand for goods and services. Consequently, through the multiplier effect economy will grow faster than before. The second view seems to be dominating the debate currently in case of India because large fiscal deficit may put inflationary pressure in the economy. High fiscal deficit creates upward pressure on interest rate and also the burden of interest payment on central government. As per the data of RBI, India's Central government spends nearly a quarter of its total expenditure for payment of the high debt burden. This is imperative for the government to bring it down so that valuable space will leave for other important expenditures.

There are many macroeconomic variables that cause fiscal deficit. Inflation is one of them. According to Keynes, inflation occurs because aggregate demand exceeds aggregate supply of output. Aggregate demand in the economy increases as a result of government expansionary policy. Keynes stated that when there is depression in the economy then there is excess productive capacity and aggregate supply curve is horizontal. In such a situation, increase in aggregate demand would not create inflation. Further, Keynes also argued that when the economy approaches to full employment level, then aggregate supply curve will be vertical straight line. In such a situation, increase in aggregate demand creates upward pressure on prices. Keynes view about relationship between money supply and inflation is only through interest rate. According to him, increase in the money supply lowers the interest rate. This increases marginal propensity to consume and create pressure on the aggregate supply. This disequilibrium leads to increase the price in the market in the short run. Keynes stressed that there is no direct relationship between money supply and inflation rather it is via interest rate or liquidity preference curve.

Inflation affects fiscal deficit indirectly. Inflation reduces the purchasing power of consumers; they have to spend more on the goods and services which previously were available at low prices. Thus it reduces aggregate saving and investment in the economy and fewer funds are available for manufacturing sector and other development activities. It results in crowding out of private investment.
This in turn reduces production and profits for the corporate and manufacturing sector which leads to decline in government’s revenue due to reduced revenue from corporate tax, service tax, excise duty, VAT etc and for the development purpose government has to borrow funds not only from domestic sources but also from external sources like from IMF, World Bank etc creating interest burden on government. Thus inflation affects fiscal deficit indirectly.

7.3 REVIEW OF LITERATURE

Barro (1979) explained the effect of public expenditure on money growth in United States by using regression analysis over the period 1954-1976. The results showed that public expenditure played important role in money growth.

Hamburger and Zwick (1981) investigated that fiscal deficit and inflation are significantly related to each other. Further, the study found that an expansionary fiscal policy causes inflationary pressure in the economy.

Levy (1981) found that monetary base, government budget deficit and inflation are positively and significantly related to each other in US economy.

Dwyer (1982) found the relationship between the federal deficit and inflation. He used Vector Auto Regression model to test the relation between government deficit and number of macroeconomic variables in the U.S. over the period of 1952 to 1978. The results showed that deficit played no role in inflationary spiral.

Ahking and Miller (1985) examined deficits, money growth, and inflation in the U.S. over the period 1950-1980 as an autoregressive process. The study treated government deficits, base money growth, and inflation as endogenous variables in the autoregressive model. Two-way causal relationship was found for the 1950s and the 1970s between government budget deficits and inflation. The study also found that government deficits appear to be inflationary in 1950s and 1970s but not in 1960s.

Darrat (1985)’s empirical study on the deficits and inflation in the U.S. during the post-1960 period and found a connection between the two variables. Ordinary Least-Squares (OLS) technique was applied to find the results. The study
found significant association between monetary growth, inflation and deficits. In addition, he concluded that federal deficits had a strong and reliable relationship with inflation and weak relationship with monetary growth.

Eisner and Pieper (1987) reported a positive association between budget deficits and inflation in the United States and OECD nations.

Choudhary and Parai (1991) found that budget deficits and money supply have considerable impact on inflation in case of Peru over the period of 1973 to 1988.

Eravi et al. (1992) found that deficits did not directly granger cause exchange rate changes although there was an indirect effect through the money supply and the price level.

Buffie (1994) investigated the short- and long-run effects of cutting investment in social infrastructure in a simple perfect foresight model. They found out that when the productivity of social infrastructure is comparable to or above that of private capital, inflation is likely to increase in the long run. An investment cut increases inflationary pressures in the long run by reducing tax revenues and real money demand.

Karra (1994) found that fiscal deficit is not inflationary. The study also found that fiscal deficit is negatively associated with real GDP and increased deficits delay investment generally one or two years.

Chaudhary and Ahmad (1995) examined the relationship between inflation and budget deficit and found that there is significant positive association between inflation and budget deficit. The study also found that monetary policy played an important role in controlling the inflationary pressure in the economy.

Shojai (1999) found that deficit spending lead to high inflation in the developing countries. Simultaneously, the study found that fiscal deficit distorts interest rate and real exchange rates, which consecutively weakens the global competitiveness of the economy.

Darrat (2000) investigated the association between budget deficits and inflation in Greece during the time period 1957-1993 by using Error Correction Model (ECM). The study found that deficit variable had a positive and statistically
significant impact upon inflation in Greece. It was concluded that “besides money growth, higher budget deficits have also played a significant and direct role in the Greek inflationary process”.

Cevdet et al. (2001) investigated the long-run association between budget deficit, inflation rate, and real output growth. The study found that there is no significantly association between inflation rate and budget deficit.

Piontkivsky et al. (2001) found that budget deficit and inflation are significantly correlated to each other in case of Ukraine economy.

Solomon et al. (2004) tested the effect of the budget deficit on inflation in Tanzania. The Tanzanian economy had experienced the dual problems of high deficit and high inflation simultaneously for a prolonged period despite the absence of hyperinflation. The tests involved cointegration analysis over the period 1967-2001. The study concluded that the monetization of the deficit, led to significant increases in inflationary trends in Tanzania.

Alavirad et al. (2005) investigated the impact of the budget deficit on inflation in the Islamic Republic of Iran. The study was based on an analysis of time series annual data (1963-1999). To explore the relationship of budget deficits with inflation in the long-term, they used univariate cointegration tests such as the autoregressive distributed lag models (ARDL) and Phillips-Hanse methods. The error correction model was used to study the behavior of the model in the short-term. They found that budget deficits as well as liquidity had an impact on inflation rates in the Islamic Republic of Iran.

Catao and Terrones (2005) investigated the impact of fiscal deficit on inflation using data of 107 countries over the period of 1960-2001 and found a strong positive association between fiscal deficit and inflation among high inflation and developing countries group but not among low inflation advanced countries.

Lozano (2008) found a mixed association between inflation and money growths with fiscal deficit in case of Colombian economy.

Vamvoukas et al. (2008) found that inflation rate and budget deficit is positively related to each other in case of Greek economy.
Ammama et al. (2011) analysed a strong relationship between fiscal deficit and inflation and concluded that fiscal deficit displayed a powerful effect on inflation in Pakistan and there is need for coordination between fiscal policy and monetary policy to curb the inflation.

Bashir et al. (2011) focused to examine demand side and supply side determinants of inflation in Pakistan and found that long run consumer price index was positively influenced by money supply, gross domestic product, import and government expenditure.

Tiwari et al. (2011) examined the direction of causality among the fiscal deficit, government expenditure, money supply and Inflation. Causality analysis suggested that both government expenditure and money supply granger cause fiscal deficit while standard granger-causality test indicate only government expenditure granger cause fiscal deficit.

Bakare et al. (2014) investigated the long run association between money supply, budget deficit, and inflation in Nigeria over the period 1975-2012. The study found strong causal association between inflation and budget deficit.

7.4 ANNUAL PERCENTAGE CHANGE IN CPI AND HOUSEHOLD CONSUMPTION EXPENDITURE: INDIAN SCENARIO

Figure 7.3 explains that annual percentage change in the consumer prices was 11.36 percent in 1980 increased to 13.11 percent in 1982 came down to 3 percent in 1989.in 1991, the consumer price index in India increased to 13.87 percent due to devaluation and balance of payment crises.
Continuing the increasing phase it reached at 13.23 percent in 1998. The average inflation during 1990-98 was 10.08 percent. However, the average inflation during 1999-2007 came down to only 4.94 percent. The improved supply response, improved financial and real economy, better monetary policy and emphasis on fiscal consolidation all helped bring down inflation during this period. But it increased to 10.87 percent in 2008 and 12 percent in 2009. Rise in real per capita income and increase in growth rate above nine percent from 2005 to 2008, raised the aggregate demand in the economy. Thus disequilibrium in demand and supply created the problem of high inflation especially after economic crises. The average inflation during the period of 2009-2016 was 10.34 percent. The drought of 2009 followed by the uneven rainfall in 2010 and increase in aggregate demand have kept food prices inflation in double digits during this period. However, this high inflation came down to 4.94 percent in 2016.
It is reflected in Figure 7.4 that household consumption expenditure (annual percentage growth) was 10.54 percent in 1980 which increased to 12.39 percent in 1983. In 1984 it showed a negative growth rate (-0.59) percent. It increased to 9.31 percent in 1988 but came down to 2.68 percent in 1990. It increased to 9.62 percent in 1993. Further, it increased to 12.48 percent in 1996. However, the growth in annual household consumption expenditure was only 1 percent in 1997. In 2004, it showed a negative growth of 2.15 percent. However, in 2008 after economic crisis, annual growth rate of household consumption expenditure increased to 13.86 percent. This is the result of government expansionary policy during recession. It came down in 2009 but increased in 2011. However, the average annual growth rate during 2012 to 2016 was 7.14 percent.

7.5 DATA ANALYSIS AND DISCUSSION

The Central Statistics Office (CSO), Ministry of Statistics and Programme Implementation has revised the base year of the Consumer Price Index (CPI) from 2010=100 to 2012=100. In this revised series, many methodological changes have been incorporated, in order to make the indices more robust.
As food production index plays key role in calculating CPI in India, so food production index is taken to investigate its impact on inflation. Food production index covers food crops that are considered edible and that contain nutrients. Coffee and tea are excluded because, although edible, they have no nutritive value.

In order to capture the impact of aggregate demand, household final consumption expenditure is taken. Household final consumption expenditure is the market value of all goods and services purchased by households and data are in current local currency.

Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as yearly.

Fiscal deficit as percentage of GDP has been taken to analyze its impact on inflation. The data is taken from World Bank Indicators and Reserve Bank of India for the period of 1981-2015. All the data are converted into natural logarithm form. Inflation (Inflation) is taken as dependent variables and Food production index (Food), Household final consumption expenditure (Hexp), fiscal deficit (FD) are taken as independent variables.

**The ARDL Equation**

\[
\Delta \log(\text{Inflation}) = \mu_0 + \sum_{i=1}^{4} \mu_i \Delta \log(\text{Inflation})_{t-i} + \sum_{i=0}^{k} \mu_i \Delta \log(\text{Food})_{t-i} + \sum_{i=0}^{k} \mu_i \Delta \log(\text{Hexp})_{t-i} + \sum_{i=0}^{k} \mu_i \Delta \log(\text{FD})_{t-i} + \phi_1 \log(\text{Inflation})_{t-1} + \phi_1 \log(\text{Food})_{t-1} + \phi_1 \log(\text{Hexp})_{t-1} + \phi_1 \log(\text{FD})_{t-1} + \epsilon_t
\]

In the above equation, \( \Delta \) is the first difference operator, \( \mu_0 \) is the intercept, \( \mu_1, \mu_2, \mu_3, \mu_4 \) are short run coefficients, \( \phi_1, \phi_2, \phi_3, \phi_4 \) are long run coefficients and \( \epsilon_t \) is the error term. \( k \) is the lag operator, \( t \) is the time.
**ECM equation**

\[
\Delta \log(\text{Inflation})_t = \beta_0 + \sum_{i=1}^{4} \beta_i \Delta \log(\text{Inflation})_{t-i} + \sum_{i=0}^{4} \beta_i \Delta \log(\text{Food})_{t-i} + \sum_{i=0}^{4} \beta_i \Delta \log(H\ exp)_{t-i} + \sum_{i=0}^{4} \beta_i \Delta \log(\text{FD})_{t-i} + \lambda ECM_{t-1} + \mu
\]

In the ECM equation $\lambda$ is the coefficient of error correction term, $ECM$ is the error correction term.

**Table 7.1**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log(Inflation)</td>
<td>-0.31928</td>
<td>0.14505</td>
<td>-2.20117</td>
<td>0.03800</td>
</tr>
<tr>
<td>Log(Food)</td>
<td>-6.97346</td>
<td>2.01892</td>
<td>-3.45406</td>
<td>0.00220</td>
</tr>
<tr>
<td>Log(Hexp)</td>
<td>12.41273</td>
<td>2.42037</td>
<td>5.12845</td>
<td>0.00020</td>
</tr>
<tr>
<td>Log(FD)</td>
<td>-0.65770</td>
<td>0.76866</td>
<td>-0.85564</td>
<td>0.40110</td>
</tr>
<tr>
<td>C</td>
<td>-20.50132</td>
<td>7.32010</td>
<td>-2.80069</td>
<td>0.01020</td>
</tr>
</tbody>
</table>

The results of the ARDL model to find long run relationship are presented in Table 7.1. The negative value of Food(-6.97) indicate that there is negative relationship between inflation and food production which means that increase in the food production will reduce inflation in long run. Further, positive coefficient of household consumption expenditure indicates that increase in household consumption expenditure will also increase the inflation in long run. The coefficient of fiscal deficit is insignificant. This means that fiscal deficit is not the reason for inflation in India rather there are two main causes for inflation in the country (Food Production and household consumption expenditure) that affects inflation in the country. In addition, increase in household expenditure (as a result of expansionary fiscal policy or increase in the money supply) stimulate aggregate demand in the market and creates disequilibrium in goods market. Thus increase inflation in the country.
Table 7.2
Diagnostic Statistics

<table>
<thead>
<tr>
<th>R-squared</th>
<th>Adjusted R-squared</th>
<th>Sum squared residuals</th>
<th>Prob (F-statistic)</th>
<th>Akaike info criterion</th>
<th>Durbin-Watson statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.801595</td>
<td>0.723958</td>
<td>1.120559</td>
<td>0.000003</td>
<td>0.061258</td>
<td>2.378399</td>
</tr>
</tbody>
</table>

The ARDL model passed the entire diagnostic test (Table 7.2). The value of $R^2$ is 0.80. This indicates that 80 percent variation in inflation is explained by the explanatory variables. The value of Durbin Watson also indicates no autocorrelation in the model. F-statistics indicate the fitness of the model. Further, Table 7.4 consists of Breusch-Godfrey (BG) Serial Correlation LM Test shows no serial correlation. Table 7.4 also indicates no hetroskedasticity.

Table 7.3
Results of Bound Test

<table>
<thead>
<tr>
<th>Test Statistic</th>
<th>Value</th>
<th>k</th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>4.603154</td>
<td>3</td>
</tr>
</tbody>
</table>

Critical Value Bounds

<table>
<thead>
<tr>
<th>Significance</th>
<th>I0 Bound</th>
<th>I1 Bound</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>2.37</td>
<td>3.2</td>
</tr>
<tr>
<td>5%</td>
<td>2.79</td>
<td>3.67</td>
</tr>
<tr>
<td>2.50%</td>
<td>3.15</td>
<td>4.08</td>
</tr>
<tr>
<td>1%</td>
<td>3.65</td>
<td>4.66</td>
</tr>
</tbody>
</table>

The value of F statistics (4.60) is greater than the upper bound limit at 5 percent level of significance confirms that the variables are co integrated in the long run.
Table 7.4
Breusch-Godfrey Serial Correlation LM Test and Heteroskedasticity Breusch-Pagan-Godfrey Test

Breusch-Godfrey Serial Correlation LM Test:

<table>
<thead>
<tr>
<th></th>
<th>F-statistic</th>
<th>Prob. F(2,21)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>1.492922</td>
<td>0.2476</td>
<td></td>
</tr>
<tr>
<td>Obs*R-squared</td>
<td>4.10796</td>
<td>0.1282</td>
<td></td>
</tr>
</tbody>
</table>

Heteroskedasticity Test: Breusch-Pagan-Godfrey

<table>
<thead>
<tr>
<th></th>
<th>F-statistic</th>
<th>Prob. F(9,23)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>0.862807</td>
<td>0.5699</td>
<td></td>
</tr>
<tr>
<td>Obs*R-squared</td>
<td>8.329316</td>
<td>0.5013</td>
<td></td>
</tr>
<tr>
<td>Scaled explained SS</td>
<td>5.467324</td>
<td>0.7918</td>
<td></td>
</tr>
</tbody>
</table>

Figure 7.5: Cusum

Figure 7.6: Cusum Square

Table 7.5
Error Correction Model

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>DLog(Food)</td>
<td>-2.97305</td>
<td>2.21864</td>
<td>-1.34003</td>
<td>0.19100</td>
</tr>
<tr>
<td>DLog(Hexp)</td>
<td>1.70711</td>
<td>2.05907</td>
<td>0.82907</td>
<td>0.41410</td>
</tr>
<tr>
<td>DLog(FD)</td>
<td>-0.74442</td>
<td>1.64804</td>
<td>-0.45170</td>
<td>0.65500</td>
</tr>
<tr>
<td>ECT(-1)</td>
<td>-0.98726</td>
<td>0.37087</td>
<td>-2.66198</td>
<td>0.01270</td>
</tr>
</tbody>
</table>

After examining the long run relationship, the next step is to analyze short run relationship among the competing variables. The results of error correction...
model are presented in Table 7.5. The results show that all the coefficients are insignificant in the short run at 5 percent level of significance. However, the value of error correction term is significant at five percent level. The negative coefficient of error correction term (-0.98) indicate that any disequilibrium in the long run will be corrected with the speed of 98 percent per year.

7.6 CONCLUSION

The results of ARDL model indicate that there is negative relationship between inflation and food production which means that increase in the food production will reduce inflation in long run. Further, positive coefficient of household consumption expenditure indicates that increase in household consumption expenditure will also increase the inflation in long run. However, fiscal deficit is found insignificant at five percent level. In addition, the negative coefficient of error correction term (-0.98) indicate that any disequilibrium in the long run will be corrected with the speed of 98 percent per year. India is a developing country, so fiscal policy does not affect price level directly. Increase in the household consumption expenditure as a result of government expansionary fiscal and monetary policy, raised inflation in India. It is recommended that government should increase the supply of food grains and manufacturing items to meet the demand of rapidly growing population. This will correct the disequilibrium in the demand and supply of goods and control over the prices. New research and techniques should be induced for increasing food production in India.

The above study shows that fiscal deficit does not directly affect inflation. Consumers have to spend a large portion of their income on consumption due to inflation. This reduces the saving and investment pattern. Few funds are available for government investment. Government has to borrow from external sources which creates interest burden on government. Most of the part of national income comes in the hands of a few industrialists and common person suffers from consequences of this hike leads to creating income inequality in country as the national income increase only in monetary terms not in physical output.
Fiscal policy plays an important role for reducing price fluctuation by contractionary and expansionary fiscal policy. India is facing recession now a days due to depreciation of rupee, high interest payment on borrowings, increase in oil and petrol prices in the international market. Because of these problems industrial production came down which create unemployment, inflation and further reduce demand. So this is the time to apply expansionary fiscal policy by reduction of taxes for manufacturing sector and making investment in infrastructure, electricity, education, health etc to boost the demand which will induce private player to produce more and more. This action will have long term stabilization affect on the economy. It will increase production results in increasing purchasing power by providing them employment, reduce inflationary pressure by reducing demand and supply mismatch, thus helpful in curbing inflation.