Impact of Inflation on Indian Housing Finance Industry

Almas Talib
Research Scholar, Babu Banarsi Das University, Lucknow, Uttar Pradesh

ABSTRACT

Housing is one of the basic need of every individual as it provides shelter and security. As per the census 2011, 31.16 % of the total population is in the urban area. This research article describes about the inflation, various types of inflation and its impact on home loans. Recent year we have seen increasing rate of inflation having high and volatile interest rate. Although this has effected whole economy but the most drastic effect is seen on the housing finance industry. High interest rate has postpone the demand of customer for home.

Inflation

Inflation is a continuous rise in the price level in an economy. The price level refers to the average price of goods and services in the economy. This will arise when arises when the demand for goods and services in an economy exceeds the supply of same. Inflation is one of the factors in functioning of any economy.

This can also be said that the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks continuously attempt to minimize inflation, so as to keep the excessive growth of prices to a minimum level.

WPI and CPI are the two broad index that measures the increase or decrease in the price level over month or years, which correspondingly leads to increasing or decreasing in the purchasing power of a currency.

Types of inflation:

Creeping Inflation: When prices are gently rising, it is referred as Creeping Inflation. It is the mildest form of inflation and also known as a Mild Inflation or Low Inflation. According to R.P. Kent, when prices rise by not more than (up to) 3% per annum (year), it is called Creeping Inflation.

Walking Inflation: When the rate of rising prices is more than the Creeping Inflation, it is known as Walking Inflation. When prices rise by more than 3% but less than 10% per annum (i.e between 3% and 10% per annum), it is called as Walking Inflation. According to some economists, walking inflation must be taken seriously as it gives a cautionary signal for the occurrence of Running inflation. Furthermore, if walking inflation is not checked in due time it can eventually result in Galloping inflation.

Running Inflation: A rapid acceleration in the rate of rising prices is referred as Running Inflation. When prices rise by more than 10% per annum, running inflation occurs. Though economists have not suggested a fixed range for measuring running inflation, we may consider price rise between 10% to 20% per annum (double digit inflation rate) as a running inflation.

Galloping Inflation: According to Prof. Samuelson, if prices rise by double or triple digit inflation rates like 30% or 400% or 999% per annum, then the situation can be termed as Galloping Inflation. When prices rise by more than 20% but less than 1000% per annum (i.e. between 20% to 1000% per
annum), galloping inflation occurs. It is also referred as Jumping inflation. India has been witnessing galloping inflation since the second five year plan period.

**Hyperinflation** : Hyperinflation refers to a situation where the prices rise at an alarming high rate. The prices rise so fast that it becomes very difficult to measure its magnitude. However, in quantitative terms, when prices rise above 1000% per annum (quadruple or four digit inflation rate), it is termed as Hyperinflation. During a worst case scenario of hyperinflation, value of national currency (money) of an affected country reduces almost to zero. Paper money becomes worthless and people start trading either in gold and silver or sometimes even use the old barter system of commerce. Two worst examples of hyperinflation recorded in world history are of those experienced by Hungary in year 1946 and Zimbabwe during 2004-2009 under Robert Mugabe's regime.

There is no one single, universally accepted cause of inflation, and the modern economic theory describes three types of inflation

1. **Cost-push inflation** - It arises due to wage increases that cause businesses to raise prices to cover higher labor costs, which leads to demand for still higher wages (the wage-price spiral)
2. **Demand-pull inflation** - It results from increasing consumer demand financed by easier availability of credit
3. **Monetary inflation** - It is caused by the expansion in money supply

**OBJECTIVE OF THE STUDY :-**

1. To study about Inflation.
2. To study about the impact of Inflation on Home loans.
3. To evaluate the effect of Inflation on common man when he takes Home loan.

**RESEARCH METHODOLOGY :-**

The methodology of the study is both descriptive and prescriptive. The descriptive methodology is used to analyze what is inflation and what is the impact of inflation on home loans in India. The prescriptive methodology is used to define what is reason of increase in inflation and its effect on the demand of ultimate consumer for home loan and on Indian Housing Finance Industry. Thus, the methodology is contributed to the theoretical, empirical aspect of inflation on Indian housing finance Industry in India.

**IMPACT OF INFLATION ON HOME LOANS**

Inflation – a word everyone is familiar with. Fuel price has risen; onions cost a small fortune as well, so definitely the effect will surely be on home loan rates as well. In fact, inflation is a major cause for the fluctuations in the interest rates. We will understand how this inflation impacts the Home Loan rates. A rising inflation rate tends to increase the rates on loans. The cost of funds for banks rises. This leads to an increase in home loan interest rates, among other loan rates, and consequently an increase in EMIs.

To control the inflation, the Reserve Bank of India (RBI) hikes the cash reserve ratio (CRR), reducing the interest rate on the CRR, and hiking the repo are reverse repo rates. These actions by the RBI are aimed at containing inflation without hurting growth. Inflation in a fast growing economy is one of the major factors in interest rate management.
What is the effect of higher CRR?

**Definition:** The CRR is the portion of deposits (net demand and time liabilities or NDTL) that is to be maintained by commercial banks with the RBI. The CRR is a tool used by the RBI to control money supply and interest rates.

A hike in the CRR draws out excess money from the banking system and check the rise in prices. This puts further upward pressures on interest rates. In addition, to further supplement the move, the RBI cuts the rate of interest payable on eligible cash balances maintained with it by banks.

Thus reducing the amount of resources available for lending with banks and lead to a rise in interest rates. Banks’ interest income will be negatively impacted by a hike in the CRR and reduction in interest rate.

The interest rates on various loans, including housing loans increase. Few years ago, gradual reduction in the CRR in successive credit policies had been one of the major contributors for the sustained reduction in interest rates on housing loans.

Simultaneously, the measures taken to control inflation also lead to increase in interest rates because of the increase in cost of funds or shortage of funds.

What aids the effect of hike in repo and reverse repo rates?

**Definition:** The repo rate is the rate at which the RBI lends to private and public sector banks. The reverse repo rate is the rate at which the RBI borrows from banks.

These rates directly impact the interest rates. Any increase in these rates leads to increase in cost of funds for banks. The banks then need to pass on the increased cost of fund to the borrowers. This leads to increase in interest rates.

Home loans become more expensive thus pushing the EMIs on home loans up. Otherwise, the EMIs may remain the same, but the loan tenure is extended

**EFFECT OF INFLATION ON INDIAN HOUSING FINANCE INDUSTRY**

Aggregate demand /Aggregate Supply diagram showing impact of Interest rates on AD. High interest rate.
1. Increases the cost of borrowing. Interest payments on credit cards and loans are more expensive. Therefore this discourages people from borrowing and saving. People who already have loans will have less disposable income because they spend more on interest payments. Therefore other areas of consumption will fall.

2. Increased incentive to save rather than spend. Higher interest rates make it more attractive to save in a deposit account because of the interest gained.

3. Rising interest rates affect both consumers and firms. Therefore the economy is likely to experience falls in consumption and investment.

4. Reduced Confidence. Interest rates have an effect on consumer and business confidence. A rise in interest rates discourages investment; it makes firms and consumers less willing to take out risky investments and purchases.

5. Time lags. The effect of rising interest rates can often take up to 18 months to have an effect. For example if you have an investment project 50% completed, you are likely to finish it off. However, the higher interest rates may discourage starting a new project in the next year.

CONCLUSION:

Lastly I would like to conclude by saying that Interest rates depend on various factors, including availability of money in the market (liquidity), inflation and monetary policies. If you opt for a floating rate loan, your home loan installments will keep changing with fluctuations in interest rates. Increase in inflation will lead to increase in Repo Rate which in turn increase the interest rate on home loan. Once done with analyzing their costs of funds and bank liquidity conditions, the banks would have no option but to increase their interest rates in the coming months. the higher interest rates would have to be passed on to the end user or the retail customer. This would effectively mean higher EMIs on home loans.

References:
4. Inflation and types of inflation.
5. Impact of inflation on home loans.