VISIONIAS
INSPIRING INNOVATION

QUICK REVISION MODULE
[UPSC PRELIMS 2021] ECONOMICS

Inflation

⇩

A sustained rise in the general price level in the economy over a period of time.

⇩

Types of Inflation (Based on causes)

Types	**Demand pull Inflation**	**Cost push Inflation**	**Structural Inflation**
Meaning	Demand > Supply ⇩ Too much money chasing too few goods.	Supply shock Inflation. ⇩ Reduction in Aggregate Supply (AS). ⇩ Because of increased prices of inputs.	Bottleneck Inflation. ⇩ Due to operation of the structural weaknesses (supply bottleneck, lack of Infrastructure etc.)

Causes	▪ Increase in Government Expenditure. ⇩ Putting large money in the hands of public. ▪ Rising population. ▪ Increase in black money. ▪ Changing consumption pattern. ⇩ Rise in Income → People eat certain food more frequently. eg. Protein rich foods. ▪ Increased wages. ▪ Decrease in direct taxes → Increase in disposable income. ▪ Increase in exports and decrease in imports. ▪ Depreciation of currency.	▪ Rise in wages. ⇩ Increase the cost of production. ▪ Increase in indirect taxes → Increase the cost of product. ▪ Increase in administered prices. e.g. MSP or reduction of subsidies. ▪ Hoarding speculation.	▪ Infrastructure bottleneck such as lack of proper roads, electricity, water etc. ▪ Fluctuation due to seasonal and cyclical reasons. e.g. Failed monsoon. ▪ High number of middle-man. ▪ Cartelisation practices adopted by some of the traders.

Types of Inflation
(Based on the rate of Inflation)

Types	Creeping Inflation	Trotting Inflation	Hyper Inflation
Inflation rate	1% to 5%	5% to 10%	Exceeds 50% for a period of month.
Impact	▪ Referred to as **manage-able** and sometimes **inevitable** in a growing economy.	▪ If not controlled then **"Galloping Inflation".** ⇩ may worsen into ⇩ "Runaway inflation".	▪ **Very high** within a **very short span** of time. ▪ It rapidly reduces the value of currency.

Impact of Inflation

1. Recession in some of the sectors

- Price of certain goods↑ → their demand↓ → Recession.

2. Adversely impacts the wage earners

- Wages remain constant → Purchasing power↓

3. Creates distortions in production pattern

- Production shifts from essential to non-essential goods.

4. Impact growth and availability of credit for industry

- To curb inflation → Interest rates↑ → Cost of Capital↑ → Credit crunch → Growth↓

5. Impacts exports

- Costlier goods → discourages foreign importers → Export↓

6. Impacts imports

- Cheaper imported goods → Import↑

7. Adverse impact on foreign exchange

- Higher imports → Higher demand of foreign currencies → Depreciation of the national currency.

8. Discourage savings

- Value of money↓ → uncertainty → Saving rate↓

9. Creates unequal distribution of Income

- Poor becomes poorer.
- Speculators and black marketer's income↑

} Imbalance in distribution of income.

10. Breeds Corruption

- Encourages black marketing, hoarding etc.

11. Increased fiscal Deficit

- Costlier borrowing for the Govt. → Fiscal Deficit↑

Measures to curb inflation

Monetary measures	Fiscal measures	Administrative measures
Taken by Central Bank of the country (RBI in case of India). **Contractionary or Dear money policy** • To reduce money supply. • Tools: CRR,↑SLR,↑ Repo↑rate etc. • Also, **qualitative control methods** - raising margin of loan. **Limitations of Monetary measures** • Not successful - If inflation caused by cost push factors. • High interest rate - reduced flow of credit to the productive sector→Growth.↓ • Large presence of unorganized banking sector.	Taken by Central Govt. It is implemented through fiscal policy i.e. **budgetary policy.** • Increase in Direct taxes. • Decrease in Indirect taxes. • Decrease in Government Expenditure. **Limitations of fiscal measures** • Increasing direct taxes discourage spending. • Decreasing Indirect taxes reduces Govt. revenue. • Government expenditure↓: ▸ Political constraints ▸ Expenditure on critical projects cannot be reduced suddenly.	Taken by administrative agencies: • Banning of export of certain items e.g.-edible oil, onions, pulses etc. • Strengthening PDS system to reduce leakages. • Restrictions on hoarding and speculation. • Import of commodities which are in short supply. • Imposing temporary ban on trading in future in some of the essential commodities.

Measurement of Inflation

(a) Wholesale price Index (WPI)

- Based on wholesale prices of selected goods **(NOT SERVICES)** from selected market.
- Constitute three Major Groups: Primary Articles (22.6%), Fuel & Power (13.1%) and Manufactured Products (64.2 %).
- Estimated by the **office of the economic advisor under Ministry of Commerce and Industry.**
- Base year: 2011-12.

Note: 1. Indirect taxes are not included while estimating the WPI.
2. Doesn't account for the products of the unorganized sector in India.

(b) Consumer Price Index (CPI)

- Inflation is calculated at the consumer level (Retail Inflation).
- As wide disparities in the consumption baskets for different segment of Consumers, **4 CPIs** adopted by India:

1. CPI (Industrial Workers)
2. CPI (Urban Non -Manual Employees)
3. CPI (Agricultural Labor)
4. CPI (Rural Workers)

1. CPI (Industrial Workers)

- Mainly used for determining Dearness Allowance (DA) paid to central/state government employees and workers in the industrial sectors.
- Compiled and maintained by the **Labour Bureau,** an attached office of the Ministry of Labour & Employment.
- Base Year: 2016.

2. CPI (Urban Non-Manual Employees)

- This index depicts the changes in the level of average retail prices of goods and services consumed by the urban segment of the population.
- It is used for determining Dearness Allowances (DAs) of employees of some foreign companies operating in India (i.e. airlines, communications, banking, insurance, embassies, and other financial services).
- Base Year: 1984-85.

Note: It is **discontinued since January 2011** because of outdated base year and also CPI (Urban) is brought out.

3. CPI (Agricultural Labor)

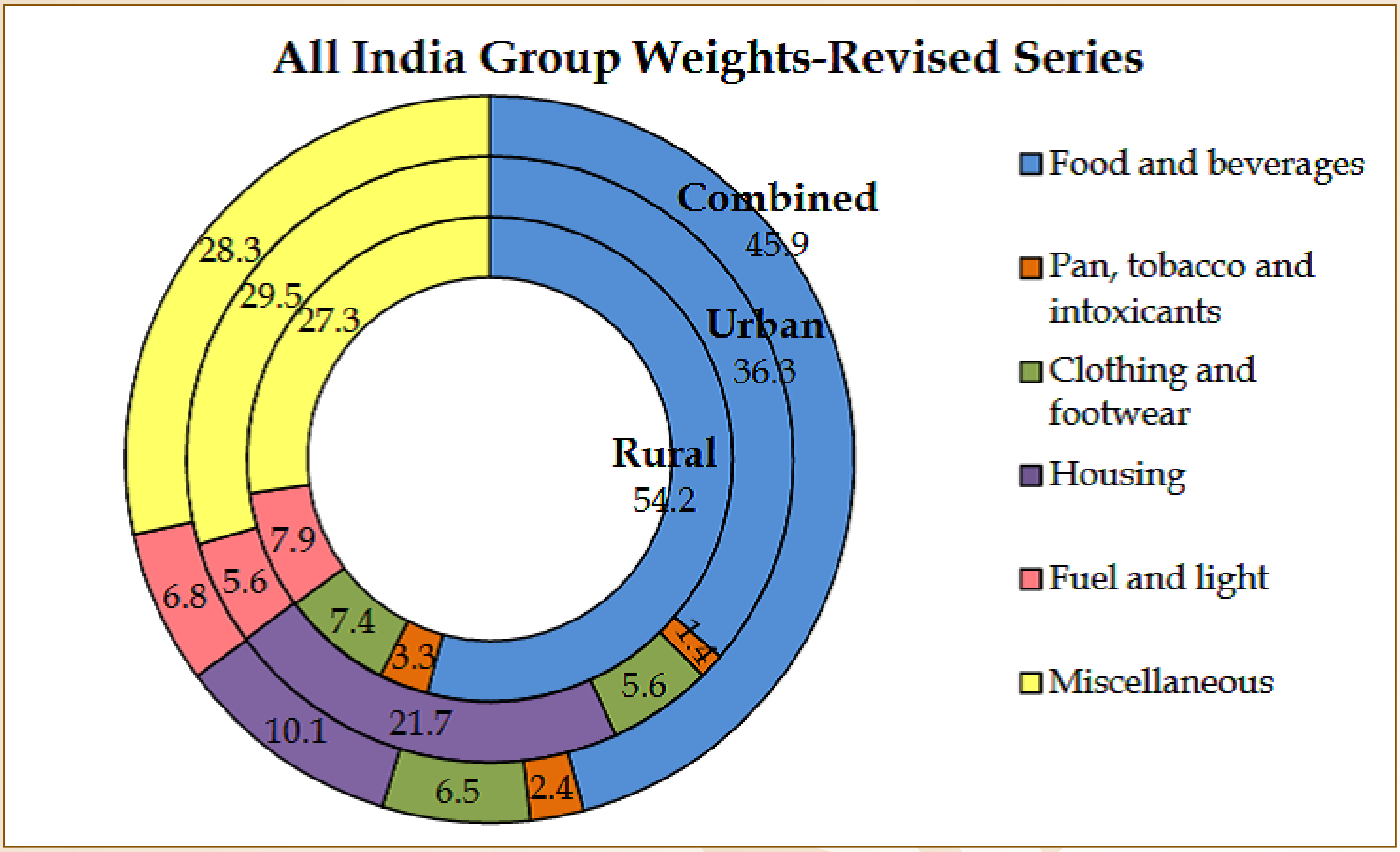
- This index is used for revising minimum wages for agricultural labourers in different states.
- **Compiled by Labour Bureau** in the Ministry of Labour and Employment.
- Base Year: 1986-87.

4. CPI (Rural Worker)

- It is used for determining minimum wages and those for the government's rural jobs programme under the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA).
- **Compiled by Labour Bureau** in the Ministry of Labour and Employment.
- Base Year: 1983.

Recent changes in CPI

- In 2011, **CSO (Now NSO)** brought out revised CPI - **CPI (Urban) - CPI (Rural) - CPI (Combined).**
- Base year : 2012
- The weight of different groups in revised CPI-rural, CPI-urban, and CPI-combined is depicted below:



Note: 1. CPI (Combined) is used as the sole inflation measure for the purpose of monetary policy.

2. CPI basket is broader than WPI basket.

(c) Inflation measurement based on period

Annual Average Inflation rate

- Average of inflation rate in the last 52 weeks.

Point to point inflation rate

- It reflects the change in the inflation rate between a particular week of the last year and the same week of the current year.

(d) GDP deflator

- The ratio between GDP at current prices and GDP at constant prices.
- A better measure of price behavior as it covers all goods and services produced in the country.

(e) Producer Price index (Proposed Index)

- It measures the increase in prices/cost till the last stage of production i.e. it does not include the cost incurred in distribution stage. Example- transportation cost, profit margins etc.

Important Associated terms

Disinflation

- It refers to a reduction in the rate of Inflation.
- Price level decreases without a decrease in National Income, Output, employment.
- It is generally desirable.

Deflation

- It refers to a persistent fall in the price level.
- It is a situation in which price level reduces along with fall in output, employment etc.
- It leads to a recession.

Reflation

- When the economy overcome recession/depression.
- It is a situation in which price level increases along with an increase in output, employment etc during the phase of economic recovery.

Inflationary Gap

- It refers to a situation in which Aggregate Demand (AD) is more than the productive capacity of an economy i.e(Aggregate supply at full employment level).
- It leads to inflation.

Deflationary Gap

- It leads to deflation and recession.

Recession

- It is a situation which is characterized by negative growth rate of GDP in two successive quarters.

Depression

- It is an extreme form of recession and characterizes a situation in which the recession may have gone on for too long resulting in depression in the economy. A common rule of thumb for recession is two quarters of negative GDP growth. The corresponding rule of thumb for a depression is a 10 percent decline in gross domestic product (GDP).

Inflation Spiral

- An inflationary situation in an economy, which results out of a process of wage and price interaction 'when wages press prices up and prices pull wages up', is known as the inflationary spiral. It is also known as the wage-price spiral.

Overheating of economy

- It is a situation during the boom in which further increase in Aggregate Demand (AD) fails to increase real output/employment etc, resulting in inflation.

Suppressed/repressed inflation

- It refers to a situation to which AD>AS but Government prevents price level from rising through direct price control measure like price regulation, ceiling prices etc.

Open Inflation

- It is a situation in which price level increases without any price suppressive measure by the Government.
- It refers to a persistent increase in the price level.

Misery Index

- It is the summation of the inflation rate and the unemployment rate.

Stagflation
- It is a situation in which high inflation is accompanied by recession or unemployment.
- It is also called inflation with recession and unemployment.
- It is caused due to cost- push inflation.

Core Inflation
- It is based on prices of only those commodities whose prices are non-volatile it does not takes into account prices of food and fuel times.
- It is used to show the trend of Inflation.

Headline inflation
- It is based on prices of all groups/types of commodities.

Agriflation
- It refers to food inflation.

Skewflation
- It is caused due to an uneven increase in the price level of a few items.

Angles law
- The percentage of income allocated for food purchases decreases as income rises.

Base effect
- It refers to distortion in the growth rate of a variable due to its extreme value during the corresponding period of the previous year.