Inflation

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

Types of Inflation (Based on causes)

<table>
<thead>
<tr>
<th>Types</th>
<th>Demand pull Inflation</th>
<th>Cost push Inflation</th>
<th>Structural Inflation</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Too much money chasing too few goods.</td>
<td>Reduction in Aggregate Supply (AS).</td>
<td>Due to operation of the structural weaknesses</td>
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<td></td>
<td></td>
<td>Because of increased prices of inputs.</td>
<td>(supply bottleneck, lack of infrastructure etc.)</td>
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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. e.g. Protein rich foods.
- Increased wages.
- Decrease in direct taxes → Increase in disposable income.
- Increase in exports and decrease in imports.
- Depreciation of currency.
- Increase 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)

<table>
<thead>
<tr>
<th>Types</th>
<th>Creeping Inflation</th>
<th>Trotting Inflation</th>
<th>Hyper Inflation</th>
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<tbody>
<tr>
<td>Inflation rate</td>
<td>1% to 5%</td>
<td>5% to 10%</td>
<td>Exceeds 50% for a period of month.</td>
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<td>Impact</td>
<td>Referred to as manageable and sometimes inevitable in a growing economy.</td>
<td>If not controlled then “Galloping Inflation”. may worsen into &quot;Runaway inflation&quot;.</td>
<td>Very high within a very short span of time.</td>
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<td>It rapidly reduces the value of currency.</td>
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Impact of Inflation

1. Recession in some of the sectors
   - Price of certain goods $\uparrow$ $\rightarrow$ their demand $\downarrow$ $\rightarrow$ Recession.

2. Adversely impacts the wage earners
   - Wages remain constant $\rightarrow$ Purchasing power $\downarrow$.

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 $\rightarrow$ Interest rates $\uparrow$ $\rightarrow$ Cost of Capital $\uparrow$ $\rightarrow$ Credit crunch $\rightarrow$ Growth $\downarrow$.

5. Impacts exports
   - Costlier goods $\rightarrow$ discourages foreign importers $\rightarrow$ Export $\downarrow$.

6. Impacts imports
   - Cheaper imported goods $\rightarrow$ Import $\uparrow$.

7. Adverse impact on foreign exchange
   - Higher imports $\rightarrow$ Higher demand of foreign currencies $\rightarrow$ Depreciation of the national currency.

8. Discourage savings
   - Value of money $\downarrow$ $\rightarrow$ uncertainty $\rightarrow$ Saving rate $\downarrow$.

9. Creates unequal distribution of Income
   - Poor becomes poorer.
   - Speculators and black marketer’s income $\uparrow$ $\rightarrow$ Imbalance in distribution of income.

10. Breeds Corruption
    - Encourages black marketing, hoarding etc.

11. Increased fiscal Deficit
    - Costlier borrowing for the Govt. $\rightarrow$ Fiscal Deficit $\uparrow$.
Measures to curb inflation

<table>
<thead>
<tr>
<th>Monetary measures</th>
<th>Fiscal measures</th>
<th>Administrative measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taken by Central Bank of the country (RBI in case of India).</td>
<td>Taken by Central Govt. It is implemented through fiscal policy i.e. <strong>budgetary policy</strong>.</td>
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<td><strong>Contractionary or Dear money policy</strong></td>
<td>- Increase in Direct taxes.</td>
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<td>- To reduce money supply.</td>
<td>- Decrease in Indirect taxes.</td>
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<td>- Tools: CRR,↑SLR,↑Repo↑rate etc.</td>
<td>- Decrease in Government Expenditure.</td>
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<td>- Also, <strong>qualitative control methods</strong> – raising margin of loan.</td>
<td><strong>Limitations of fiscal measures</strong></td>
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<td><strong>Limitations of Monetary measures</strong></td>
<td>- Increasing direct taxes discourage spending.</td>
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<td>- Not successful – If inflation caused by cost push factors.</td>
<td>- Decreasing Indirect taxes reduces Govt. revenue.</td>
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<td>- High interest rate – reduced flow of credit to the productive sector→Growth.↓</td>
<td>Government expenditure↓:</td>
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<td>- Large presence of unorganized banking sector.</td>
<td>- Political constraints</td>
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<td>- Expenditure on critical projects cannot be reduced suddenly.</td>
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**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)**
   - 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 take 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.