Inflation

[UPSC Notes]

Inflation Meaning

In simple words, Inflation is the rise in the price of goods and services within an economy over a period of time due to which each unit of currency has less purchasing power.

- Inflation can have positive as well as negative consequences like inflation is good for tangible assets but has a negative effect on cash holdings.
- It is estimated as the percentage rate of change in price index over the reference time period.
- Currently in India inflation rate is measured with the help of the Consumer Price Index- combined (Base year- 2012).
- Till April 2014, the Inflation rate was measured with the help of WPI (Wholesale Price Index).
- Rate of Inflation= (Current period price index-Reference period price index)/(Reference Period Price Index)×100

Types of Inflation

We have segmented the types of inflation on the basis of causes and speed or intensity.

Based on causes inflation is divided into the following types

1. Currency inflation: The printing of currency notes causes this type of inflation.
2. Credit inflation: Credit expansion leads to a rise in price level causing inflation.
3. Deficit-induced inflation: When expenditure exceeds revenue, the government can ask RBI to print money to meet the budget deficit causing deficit-induced inflation.
4. Demand-Pull inflation: An increase in aggregate demand over the available output leads to a rise in the price level and is called demand-pull inflation.
5. Cost-push inflation: Inflation in an economy may arise from the overall increase in the cost of production and is known as cost-push inflation.

Based on Speed or Intensity, Inflation is divided into as follows:

1. Creeping or Mild Inflation
    - When the speed of upward thrust in prices is slow but small, it is known as creeping inflation.
    - It is helpful for economic development.
    - Price rise at a very small rate (<3%).
2. Walking or Trotting Inflation
    - When prices rise moderately and the annual inflation rate rises by a single digit, walking inflation occurs.
    - It is the time when government should focus on the issue.
    - Price rise at moderate rate (3% <Inflation< 10%)
3. Galloping and Hyperinflation:
    - When creeping and walking inflation are left unchecked, the rate of inflation will rise above 10% and is termed galloping inflation.
    - This leads to instability of the economy.
    - Hyperinflation is when the prices of goods and services rise more than 50% per month.
    - It is the last stage of inflation.
    - Examples: Germany in the 1920s, Zimbabwe in the 2000s, American Civil War, and Venezuela in 2018.
    - Price rise at very high rate (20% < Inflation < 100%)
4. Stagflation:
    - It is a situation in which the inflation rate is high, the economic growth rate slows, and unemployment remains steadily high.
    - It is also known as recession inflation.
    - It is a dilemma for economic policy, since actions intended to lower inflation may worsen the unemployment situation.
5. Core Inflation
    - Price rise in all goods and services except food and energy due to high price fluctuations is core inflation.
    - It is calculated as government needs a stable and true picture of inflation.
6. Headline Inflation
    - This measure considers total inflation in an economy, including food and energy prices, which are more volatile.

Causes of Inflation

Some major causes of inflation include demand-pull factors, cost-push factors, built-in inflation, and monetary inflation. We have covered all these causes in brief below.

Demand-Pull Factors

These are the set of factors due to which there may be an increase in the demand for goods and services in an economy. Its example includes

- Increase in government expenditure putting more money in the hands of the public which in turn increases demand and prices automatically increase.
- Population increase
- Money hoarding
- Fluctuated consumption pattern.

Cost-Push Factors

This factor is a result of the increase in the prices of production process inputs. For example: If wages increase then productivity, and an increase in the price of a product can be seen.

- Increase in indirect taxes like custom and excise duty raise the cost of production and increases the price.
- MSP (Minimum Support Price) increase
- Infrastructural issues
- Failed monsoon and disaster.

Built-in inflation

As the price of goods and services increases, labor expects and demands more wages to maintain their cost of living that increasing prices and the wage-price spiral continues

Monetary Inflation

Reserve Bank of India printing more money (deficit financing) can trigger inflation. It is a sustained increase in the money supply of a country or currency area.

Remedies to Control Inflation

The remedies to solve the problems related to inflation are

Monetary Policy

The monetary policy of RBI aims to manage the quantity of money to meet the requirements of different sectors of the economy and drive economic growth.

This policy is applicable by increasing interest rates and decreasing bond prices. This helps to reduce the expenses during inflation that pause the economic growth and the inflation rate.

Fiscal Policy

Fiscal policy can be taken by the government in two ways

- Cutting expenditure on schemes, projects, spending, etc.
- Increasing direct or indirect tax.

Supply Managemnt Measures

- Import commodities that have less supply and Decrease exports
- Distribution through Public Distribution System
- Government may check on hoarding

Measurement of Inflation

Wholesale Price Index (WPI): Wholesale Price Index or WPI measures the changes in the prices of goods sold and traded in bulk by wholesale businesses to other businesses. It is released by the Economic Advisor in the Ministry of Commerce and Industry.

- An upward surge in WPI indicates inflationary pressure in the economy.
- The base year is taken 2011-12 in India.
- Major components of WPI are primary articles subdivided into Food Articles and Non-Food Articles.
- another component: Fuel & Power, Manufactured Goods like Textiles, apparel, Metals, Sugar, Oils, and more.
- The monthly WPI shows average price changes of goods usually expressed in ratios or percentages.
- However, it does not include services such as the health, IT, Education, transport and unorganized sector, etc.

Consumer Price Index: It measures retail inflation in the economy by collecting the change in prices of common goods and services like food, housing, apparel, transportation, electronics, medical care, education, etc. This provides insights as to how much a consumer can spend to be on par with the price change.

Producer Price Index: it measures the average price changes in the selling prices over time received y the domestic producer.

Effects of Inflation on the Economy

Following are the effects of Inflation on the economy

- Due to inflation, some group faces losses while other group faces gains
- Due to inflation the demand decreases, which hamper production
- Imports increase and export decrease for other countries that have a direct impact on the forex service

- Sudden inflation rates are harmful to the overall economy. It causes instability in the market that makes it difficult for the companies to plan their long-term budget.

Effects of Increasing Inflation

Increasing Inflation has both positive and negative impacts. Below we have jotted down both benefits and disadvantages of increasing inflation.

Benefits	Disadvantages
-Lower interest rate -Currency depreciation -Profits of business people -Export benefits due to currency depreciation -Increasing nominal wage -Investment, savings, and rise in employment in short term.	-Lower purchasing power -Salaried and pensioners suffer -Imports suffer due to depreciation of currency -Decrease in the real wages -Decline in competitiveness -Rupee purchasing power declines

Terms Related to Inflation

- Disinflation: Decrease in the rate of inflation
- Deflation: Negative inflation or persistent price level decrease.
- Reflation: This happens when the Price level increases because the economy recovers from recession.
- Stagflation: When stagnation and inflation coexist in the economy. Stagnation- low national income growth and high unemployment. Inflation + Recession (Unemployment)
- Misery index: Rate of inflation + Rate of unemployment
- Inflationary gap: Aggregate demand > Aggregate supply
- Deflationary gap: Aggregate supply > Aggregate demand
- Suppressed / Repressed inflation: Aggregate demand > Aggregate supply. The government will not allow the rising of prices in this.
- Open inflation: Situation where price level rises without any price control measures by the government.