Inflation

Introduction

- Inflation can be defined as a calculated surge in the average prices of goods and services for a longer duration in the economy.
- It is a macro concept, wherein the effect of inflation is seen over a large basket of goods.
- The ultimate effect of inflation is that the value of money is reduced that mean the purchasing power of money is reduced.
- As per RBI, an inflation target of 4 % with a +/-2 % tolerance band.

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Measurement of inflation

Indices which measure inflation in an economy

- Wholesale Price Index (WPI)
- Consumer Price Index (CPI)
- Producer Price Index (PPI)
- Commodity Price Indices
- Core price Index
- GDP deflator

Wholesale Price Index (WPI)

- WPI measures the changes in the prices of goods sold and traded in bulk by wholesale businesses to other businesses.
- In other words, WPI tracks prices at the factory gate before the retail level.
- The numbers are released by the Ministry of Commerce and Industry
- Even as the WPI is used as a key measure of inflation in some economies, the RBI no longer uses it for policy purposes, including setting repo rates.

Consumer Price Index (CPI)

- It is an index measuring retail inflation in the economy by collecting the change in prices of most common goods and services used by consumers.
- It is released by Central Statistics Office (CSO) under Ministry of Statistics and Programme implementation.
- In April 2014, the RBI had adopted the CPI as its key measure of inflation

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Producer Price Index (PPI)

- The Producer Price Index or PPI is an index that measures the average price change of goods and services.
- It can be calculated either when the goods leave the place of production or as they enter the production process.
- The PPI measures price movements from the seller's point of view.
- It tracks price change in both the goods and the services sector, giving a clear picture of the inflation in the country.

Commodity Price Indices

- A commodity price index is a fixed-weight index or (weighted) average of selected commodity prices, which may be based on spot or futures prices.
- It is designed to be representative of the broad commodity asset class or a specific subset of commodities, such as energy or metals.
- It is an index that tracks a basket of commodities to measure their performance.

Core price Index

- It measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices.
- It is a way to measure the underlying inflation trends.

GDP deflator

- The GDP deflator is a measure of inflation and is also called implicit price deflator.
- It helps to record and measure all the price level changes of an economy in the output of goods and services of one year.
- Gross domestic product deflator shows the amount of change in GDP due to inflation and not increase in output.

Types of Inflation

- There are various types of Inflation-
  - Demand Push Inflation
  - Cost Push Inflation

Inflation

Demand Push Inflation

When price rise because aggregate demand in an economy is greater than the aggregate supply of goods and services.

This rise in demand is such that it cannot be met by currently available supply of output. Demand for goods and services exceeds available supply, thus there is is a situation where too much money chasing few goods and services.

Increase in aggregate demand can be due to various factors -

Increase in aggregate demand can be due to various factors, Rise in Government expenditure, Steep rise in net exports, Rise in house hold consumption, RBI adopts cheap money policy, cheaper credits are available, Rise in Private Investments.

Cost Push Inflation

When price rise because aggregate supply in an economy declines or is lower than the aggregate demand (at full employment level) of goods and services.

This decline in aggregate supply is majorly due to rise in production cost.

The production cost can increase mainly due to following factors -

Increase in wages of the employees, Increase in prices of raw materials, Increase in Profit margin by firms, Increase in prices of imports

Effect of Inflation

Inflation decreases the value of money over time. Money loses value when its purchasing power falls.

They lead to market instability and thereby make it difficult for companies to plan a budget for the long-term.

Inflation is bad for lender and good for borrower. Inflation re-distribute wealth from creditors to lenders.

Inflation can act as a drag on productivity as companies are forced to mobilize resources away from products and services to handle the situations of profit and losses from inflation.