SOUTH INDIAN Bank
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STUDENTS' ECONOMIC FORUM

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To kindle interest in economic affairs...
To empower the student community...

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Theme 320

AN INSIGHT INTO INFLATION

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Theme No: 320: "An Insight into Inflation"

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products.

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". This month the topic for discussion is "An Insight into Inflation".

Inflation is one of the most familiar words in economics. Inflation has plunged countries into long periods of instability. For Example - Venezuela with the highest inflation rate in world is starving even though the country has the world's largest oil reserves. Inflation wipes out the savings quickly, deters people from investing which will cause recession and lead to capital flight. Inflation distorts the purchasing power of the people. There are some who gain and some who lose for example – a pensioner who receives a fixed 5 percent yearly increase in pension when the prevailing inflation is higher than 5 percent is a loser with reduced purchasing power. On the other hand a borrower who pays a fixed interest rate of 5 percent on the borrowing would benefit from 5 percent inflation because the real interest rate i.e., the nominal rate minus the inflation rate is zero. Servicing this debt would be easier if the borrower's income keeps up with inflation. Let us discuss about what is inflation, how to measure it and the different types and procedures to control Inflation.

1. What is Inflation?

Inflation is the rate of increase in prices over a given period of time. Inflation is typically a broad measure, such as the overall increase in prices or the increase in the cost of living in a country. But it can also be more narrowly calculated for certain goods, such as food or for services. Whatever the context, inflation represents how much more expensive the relevant set of goods or services has become over a certain period. Inflation normally results in reduced purchasing power.

The opposite of inflation is deflation. Deflation refers to situation where there is a decline in general price levels. When prices are falling, consumers tend to delay their purchases anticipating lower prices in future. This means less economic activity, less income generated by producers and lower economic growth. Japan is a country which faces deflation for a longtime.

Apart from Inflation and Deflation there is a situation where economic growth is very slow or stagnant and prices are rising, which is known as Stagflation.

2. How is Inflation measured?

There are two main set of inflation indices for measuring price level changes – the Wholesale Price Index (WPI) and the Consumer Price Index (CPI). The WPI quotes the prices of wholesalers, compiled by Office of Economic Affairs, Ministry of Commerce and Industries. Ministry of Statistics and Programme Implementation (MOSPI) and Ministry of Labour and Employment (MOLE) are calculating different CPIs for various sectors. CPI inflation is also called as retail inflation as the prices are quoted from retailers.

The inflation rate is calculated based on base year. For example – If the base year CPI is 100 and the current CPI is 110 then inflation is 10 percent over the period.

The monetary policy framework of RBI uses inflation based on the all India Consumer Price index.

Different price indices in India

Index	Office in charge for Compiling the various Index
WPI	Office of Economic Affairs, Ministry of Commerce and Industries (MOCI)
CPI All India, CPI -Urban and Rural	CSO, Ministry of Statistics and Programme Implementation (MOSPI)
CPI-AL (CPI for Agricultural Labourers)	Labour Bureau, Ministry of Labour and Employment (MOLE)
CPI-RL (CPI for Rural Labourers)	
CPI-IW (CPI for industrial workers)	

3. What are the different types of Inflation?

Types of Inflation: On the Basis of Cause

i. Demand-pull Inflation: The demand-pull inflation exists when the aggregate demand increases rapidly than the aggregate supply. In other words, for a level of aggregate supply the aggregate demand increases manifold, then the demand-pull inflation occurs. This increase in the demand can be due to the monetary factors i.e., increase in money supply and real factors, Viz. Cut in tax rates, increase in government expenditure etc.

ii. Cost-Push Inflation: The Cost-Push inflation occurs when the cost of raw material, labour, and inputs necessary for the production of final goods increases. Firms who have monopoly in a particular industry raise the price level to enjoy higher profit margins due to which the general price level increases. This is called as profit-push inflation. Another kind of cost-push inflation is the supply-shock inflation when the firms restrict the aggregate supply of goods and services. The third type of cost push Inflation is known as wage-push inflation which occurs due to the increase in wage that in turn leads to an increase in the price of goods and services.

Inflation: On the Basis of Rate

i. **Moderate Inflation:** The moderate inflation is also known as Creeping Inflation. During the period of moderate inflation the price increases persistently but at a mild or moderate rate, i.e. less than 10% or at a single digit inflation rate.

ii. **Galloping Inflation:** The galloping inflation refers to the exceptionally high inflation rate that leads to an increase in the general price level. Generally, the inflation is in double or triple digit and is reflected in the high price of goods and services, i.e. prices increase manifold.

iii. **Hyper Inflation:** The hyper inflation is the situation when the prices rise at an alarmingly high rate, i.e. more than a three-digit rate per annum. The prices rising above 1000% per annum marks the beginning of hyper inflation.

4. What are the measures taken to control the inflation in an economy?

There are broadly two ways of controlling inflation in an economy:

i. Monetary measures

ii. Fiscal measures

i. **Monetary Measures**

Central Bank uses high interest rates as the traditional way to fight or prevent inflation. The Monetary measures used to control inflation include:

a) **Bank rate policy:** It is used as the main instrument of monetary control during the period of inflation. When the Central Bank raises the Bank Rate, it is said to have adopted a dear money policy. The increase in bank rate increases the cost of borrowing which reduces commercial banks' borrowing from the central bank. Consequently the flow of money from the commercial banks to the public gets reduced. Therefore, inflation is controlled to the extent it is caused by the bank credit.

b) **Cash Reserve Ratio (CRR):** To control inflation the Central Bank raises the CRR which reduces the lending capacity of the Commercial Banks. Consequently, flow of money from commercial banks to public decreases. In the process, it halts the rise in prices to the extent it is caused by bank credit to the public.

c) **Open Market Operations:** Open market operations refer to sale and purchase of government securities and bonds by the Central Bank. To control inflation Central Bank sells the government securities to the public through the banks. This result in transfer of a part of bank deposits to Central Bank account and reduces credit creation capacity of the Commercial Banks.

ii. **Fiscal Measures**

Fiscal measures to control inflation include taxation, government expenditure and public borrowings. The Government can also take some protectionist measures (such as banning the export of essential items such as pulses, cereals and oils to support the domestic consumption, encourage imports by lowering duties on import items etc).

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