Inflation – Types, Effects and Causes of Inflation

Inflation is defined as a sustained rise in the general level of prices of goods and services over time. It is caused by disequilibrium between aggregate supply and aggregate demand. The price rise should be persistent over the period of time to be said as inflation.

Measurement of Inflation

Inflation is measured by price index. A price index is a weighted average of prices of number of goods and services; therefore it does not represent the price of single item. There are two types of price indices:

- Wholesale Price Index (WPI)

WPI is average price changes of goods that are traded in the wholesale market. It is a weekly measure of wholesale price movement of the economy. It includes only the prices of goods and does not include items pertaining to services. In India, WPI is published by the Office of Economic Adviser, Ministry of Commerce and Industry weekly. It has a time lag of two weeks.

Items Included in Wholesale Price Index

There are 697 items are included in the index. These items are further divided into three categories:

- Primary articles: The Primary articles are food items, non-food items and minerals. There are 117 items for Primary Articles.
- Fuel and Power: It includes power, light and lubricants, electricity, coal mining and mineral oil. There are 16 items for Fuel & Power.
- Manufactured Goods: It includes food products, beverages, tobacco and tobacco products, wood and wood products, textiles, paper and paper products, basic metals, alloys, rubber and rubber products etc. There are 564 items for Manufactured Products.

Weights of items in WPI

The weights of items in WPI are:

- Primary articles: 22.62%
- Fuel and Power: 13.15%
- Manufactured Goods: 64.23%

- Consumer Price Index (CPI)

Consumer Price Index (CPI) measures the changes over time in general level of prices of goods and services that households acquire for the purpose of consumption. It tracks inflation at retail level. RBI sets the target of CPI for controlling the inflation in its monetary policy. There are four CPI in India for four different set of workers:

- CPI (Industrial Workers)
- CPI (Urban Non- Manual Employees)
- CPI (Agricultural Labour)
- CPI (Rural Worker)

In India, CPI (Rural/Urban/Combined) is published by the Central Statistics Office (Ministry of Statistics and Programme Implementation) and CPI (IW/AL) is published by Labour Bureau in the Ministry of Labour and Employment. It is published on monthly basis

Items Included in Consumer Price Index

The items covered in CPI are divided into eight categories viz. Education, communication, transportation, recreation, apparel, foods and beverages, housing and medical care. The number of items in CPI basket include 448 in rural and 460 in urban

Base Year of CPI

The current base year of CPI is 2012.

Difference between WPI and CPI (WPI vs CPI)

The main difference between WPI vs CPI are:

	WPI	CPI
Meaning	It tracks price changes as wholesale level	It tracks price changes as retail level
Published by	Office of Economic Adviser, Ministry of Commerce and Industry	Central Statistics Office and Labour Bureau

Frequency	Weekly basis	Monthly basis
Base year	2011-12	2012
Items	697 items	448 items in rural and 460 items in urban
Item Groups	Three groups: Primary articles, Fuel and Power, Manufactured Goods	Eight groups: Education, communication, transportation, recreation, apparel, foods and beverages, housing and medical care

Causes of Inflation

Bases on demand side or cost side factors, generally there are two causes of inflation:

- **Demand-Pull Inflation**: There is mismatch in demand and supply. Either demand increases for the same level to supply leading increase in price of goods and service or the supply of goods and services decreases for the same level of demand leading to inflation.
- **Cost-Push Inflation**: An increase in factor cost i.e. wages, rent, raw material led to increase in cost of production causing the inflation.

Types of Inflation

Depending upon the rate of increase in price level, Inflation may be classified into three categories:

1. **Creeping Inflation**: It is a situation when price level is increasing at a mild rate. A very low inflation took place over the period of time. Some economist says creeping inflation is good for growing economy.
2. **Moderate Inflation**: When the general price level increases slowly and steadily then it is called as moderate inflation. Moderate inflation is believed to be necessary condition for economic growth.

3. **Galloping Inflation**: This is situation of very high inflation running in double or triple digit i.e 50%, 100%, 200% etc. The value of money loses very fast. In 1970s and 1980s many Latin American countries experienced such type of inflation.
4. **Hyperinflation**: Hyperinflation is a situation when a nations experiences very high and accelerating inflation where annual rate of inflation runs into millions or trillions in a very short period of time. In such a state the value of currency erodes very quickly and people lose confidence in domestic currency. Such situation happened in Zimbabwe in 2008 when local currency lost its value very quickly.

Core Inflation and Headline Inflation

Core Inflation represents price rise in all goods and services but does not include articles from food and energy sector. This is a measure of inflation strips seasonal and volatile commodities. Core Inflation is also known as underlying inflation is a measure of inflation which excludes items that face volatile price movement, notably food and energy.

Headline inflation is measured through the WPI, which is measured on year-on-year basis i.e., rate of change in price level in a given month vis a vis corresponding month of last year. This headline inflation is also known as point to point inflation

Reflation and Stagflation

Reflation is fiscal or monitory policy measure to increase money supply by increasing public expenditure, reducing tax rates, interest rate cuts etc to boost demand in economy. This measure is usually taken after a recession in business cycle to increase the level of economic activity.

Stagflation is a situation of persistent rise in inflation along with dip in growth and increase in unemployment.

Deflation

Deflation is the situation where prices fall continuously or have tendency to fall. It can rise when aggregate demand is less than aggregate supply. It is characterized by fall in output, increase in unemployment and general slowdown of economic activities. The period of great depression from 1929 to 1933 is an example of deflation. During deflation, the prices fall and the value of money rises, hence debtors are the losers and the creditors are the gainers. Wage earners and salaried persons gain during deflation because with the falling prices, the wages and salaries cannot be reduced. Also the debenture and bond holders gain because income remains constant while price falls and equity holders loose because their incomes fall with the falling prices.

Inflation is better than deflation

- Inflation does not reduce national income while deflation reduces the national income
- Inflation is a post-full employment phenomenon, while deflation is an under-employment phenomenon
- It is easy to control inflation by adopting fiscal and monetary measures while it is difficult to recover the economy from deflation
- Mild inflation is better than deflation from the point of view of economic development

Skewflation

It is a phenomenon where there is a price rise of one or a small group of commodities over a sustained period of time. Skewflation is a state in which the economy shows the characteristics of both inflation and deflation. A small Skewflation, usually of up to 2%, is natural for a rapidly growing economy.

Effects of Inflation:

<u>The retardation effects of inflation:</u>

- Stimulation of speculative activities
- Creation of balance of payment problems
- Increase in Inflation tax
- Inelastic food supply
- It discourages foreign capital.

<u>Economic effects of Inflation :</u>

1. **Effects on Production**: It hinder capital formation as inflation increases the price of capital goods. It disincentives the producer to invest more capital. It stimulates the speculative activities like hoarding and misallocation of productive resources.
2. **Effect on Debtors**: Due to inflation the debtors pay back less in real terms, thus they are gainers during the inflation.
3. **Effect on Creditors**: The creditors tend to lose as they get less as compared to what they have lent.
4. **Effect on Entrepreneurs**: The entrepreneur gain on the account of windfall profit arises because price rises at faster rate as compared to cost of production.
5. **Effect on Investors**: When the price rises, the return on equities goes up on account of rise in profits while bonds and debenture holder gains nothing as their income remains fixed.
6. **Effect on Farmers**: Farmers generally gain during the period of inflation on the account of following reasons:
    - The price of farm products goes up faster than cost
    - Farmers are generally debtors in India. They have to pay less in real terms.

7. **Effect on Wage earners/Labourers**: The unorganised workers suffer during inflation because wages do not rise as much as the rise in price of commodities which they consume.
8. **Effect on Middle class/Salaried**: The middle class which receives fixed income in the form of past savings, fixed interest or rent, pensions etc. suffers during the period of rising prices as their incomes remains fixed.
9. **Effect on Government**: The government has to spend more on goods and services for carrying out their project and schemes. This may lead to increase in deficit or taxes are raised.

<u>Non economic effects of Inflation:</u>

- It widens the gap between haves and have-nots caused due to the redistribution of income and wealth in favor of the rich
- It encourages black marketing and enables the businessmen to reap wind-fall gains by undesirable means like introduction of adulteration in the products
- Disruption of political life of a country and loss of faith in the government

Measures to control inflation

- **Monetary measures**: The central bank of a country can curb inflation by restricting the supply of money and credit.

Fiscal measures: Fiscal measures refer to taxation, government spending and public borrowings. Some of the fiscal measures to contain inflation are:

- Allowing imports of the commodities which are scarce in market
- Imposing minimum export prices

- **Direct measures**: Many countries have direct measures to control inflation. These include price control and rationing of essential commodities.