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INFLATION – CHECK IT BEFORE IT CHECKS

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Introduction:

The RBI (Reserve Bank of India), headed by dynamic and dashing Governor Sri Raghuram Rajan, took markets by surprise when it reduced the REPO rate by a sharper-than-expected 50 basis points on September 29, 2015. With this action, the REPO rate was reduced to 6.75%, while the reverse REPO rate and the MSF (marginal standing facility) were reduced to 5.75% and 7.75%, respectively.

India's consumer price index (or CPI) had fallen to 3.3% in November 2014. According to its latest reading, India's CPI fell to 3.66% in August compared to 3.69% in July, which was revised down from an earlier reading of 3.78%. Stability in food prices was the primary driver for the decreased growth pace in India's consumer price index.

The slow pace of the consumer price index inflation in India and on the whole Inflation being much lower than compared to its January 2016 target of 6.0% are reasons that the RBI (Reserve Bank of India) cited for a reduction in the REPO rate. The Reserve Bank of India (or RBI) refers to the consumer price index (or CPI) when it talks about inflation.

The purpose of this study is to throw light on the concept of inflation, variations on inflation, causes of inflation, consequences of inflation, measuring inflation, inflation in various countries and finally to control inflation.

Meaning of inflation:

In economics, an increase in general level of prices of goods and services in an economy over a period of time is called as inflation. When the general price level rises, each unit of currency buys fewer goods and services. Thus, inflation results in loss of value of money. Another popular way of looking at inflation is "too much money chasing too few goods". That is the value of rupee will fall and purchasing power of money declines.

Several variations on inflation:

- Deflation: Deflation refers to situation, where there is decline in general price levels and opposite of inflation. Thus, deflation occurs when the inflation rate falls below 0% (or it is negative inflation rate). Deflation increases the real value of money and allows one to buy more goods with the same amount of money over time. Deflation can occur owing to reduction in the supply of money or credit. Deflation can also occur due to direct contractions in spending, either in the form of a reduction in government spending, personal spending or investment spending. Deflation has often had the side effect of increasing unemployment in an economy, since the process often leads to a lower level of demand in the economy.
- Hyperinflation: It is unusually rapid inflation. It often occurs when there is a large increase in the money supply, which is not supported by growth in Gross Domestic Product (GDP). Such a situation results in an imbalance in the supply and demand for the money. In extreme cases, this can lead to the breakdown of a nation's monetary system.
- Stagflation: Is the combination of high unemployment and economic stagnation with inflation. Stagflation occurs when the economy isn't growing but prices are going up.

Causes of Inflation

There is no one cause that's universally agreed upon, but at least two theories are generally accepted and they are as follows:

Demand - pull inflation: In this type of inflation prices increase results from an excess of demand over supply for the economy as a whole. Demand inflation occurs when supply cannot expand any more to meet demand; that is, when critical production factors are being fully utilized, also called Demand inflation.

Cost - Push Inflation: When companies' costs go up, they need to increase prices to maintain their profit margins. Increased costs can include things such as wages, taxes, or increased costs of imports. These three factors could contribute to Cost-Push inflation.

Consequences of inflation:

Many governments believe that persistently high inflation can damage economy i.e

- **Income redistribution**: One risk of higher inflation is that it has a **regressive effect** on lower-income families and older people in society. This happen when prices for food and domestic utilities such as water and heating rises at a rapid rate.
- **Falling real incomes**: With millions of people facing a cut in their wages or at best a pay freeze, rising inflation leads to a fall in real incomes.
- **Negative real interest rates**: If interest rates on savings accounts are lower than inflation, people who rely on interest from their savings will be poorer. Real interest rates for millions of savers have been negative for at least four years
- **Cost of borrowing**: High inflation may also lead to higher interest rates for businesses and people needing loans and mortgages as financial markets protect themselves against rising prices and increase the cost of borrowing on short and longer-term debt. There is also pressure on the government to increase the value of the state pension and unemployment benefits and other welfare payments as the cost of living climbs higher.

- **Risks of wage inflation**: High inflation can lead to an increase in pay claims as people look to protect their real incomes. This can lead to a rise in unit labour costs and lower profits for businesses
- **Business competitiveness**: If one country has a much higher rate of inflation than others for a considerable period of time, this will make its exports less price competitive in world markets. Eventually this may show through in reduced export orders, lower profits and fewer jobs, and also in a worsening of a country's trade balance. A fall in exports can trigger negative multiplier and accelerator effects on national income and employment.
- **Business uncertainty**: High and volatile inflation is not good for business confidence partly because they cannot be sure of what their costs and prices are likely to be. This uncertainty might lead to a lower level of capital investment spending.

Positive side of Inflation:

Not always inflation is evil as everyone thinks. Inflation affects different people in different ways. It also depends on whether inflation is anticipated or unanticipated. If the inflation rate corresponds to what the majority of people are expecting (anticipated inflation), then we can compensate and the cost isn't high. For example, banks can vary their interest rates and workers can negotiate contracts that include automatic wage hikes as the price level goes up. Problems arise when there is unanticipated inflation:

- Creditors lose and debtors gain if the lender does not anticipate inflation correctly. For those who borrow, this is similar to getting an interest-free loan.
- Uncertainty about what will happen next makes corporations and consumers less likely to spend. This hurts economic output in the long run.
- People living off a fixed-income, such as retirees, see a decline in their purchasing power and, consequently, their standard of living.
- The entire economy must absorb reprising costs ("menu costs") as price lists, labels, menus and more have to be updated.
- If the inflation rate is greater than that of other countries, domestic products become less competitive.

Measuring Inflation:

A number of goods that are representative of the economy are put together into a basket referred to as a "market basket." The cost of this basket is then compared over time. This results in a price index, which is the cost of the market basket today as a percentage of the cost of that identical basket in the starting year.

Inflation is usually measured based on certain indices. In India, broadly, there are two categories of indices for measuring inflation i.e. Wholesale Prices and Consumer Prices. There are certain sub-categories for these indices. Whereas in North America, there are two main price indices that measure inflation. They are consumer price index (CPI) and Producer price index (PPI).

An Index number is a single figure that shows how the whole set of related variables has changed over time or from one place to another.

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Price Indexes / Indices used in India :

In India we use five major national indices for measuring inflation or price levels.
The Wholesale Price Index (base 1993-94) is usually considered as the headline inflation indicator in India. In addition to Whole Price Index (WPI), there are four different consumer price indices which are used to assess the inflation for different sections of the labour force. In addition to above five indices, the GDP deflator as an indicator of inflation is available for the economy as a whole and its different sectors, on a quarterly basis

1. Wholesale Price Index (WPI) :

This index is the most widely used inflation indicator in India. This is published by the Office of Economic Adviser, Ministry of Commerce and Industry. WPI captures price movements in a most comprehensive way. It is widely used by Government, banks, industry and business circles. Important monetary and fiscal policy changes are linked to WPI movements. It is in use since 1939 and is being published since 1947 regularly. Since 1939, the base year of WPI has been revised on number of occasions. The current series of Wholesale Price Index has 2004-05 as the base year. This new series has been launched on 14th September, 2010. A brief on the historical development of this WPI is given below: -

Base Year	Year of Introduction	No of Items in Index	No of Price Quotations
Week ended 19th August 1939	1942	23	23
End August 1939	1947	78	215
1952-53 (1948-49 as weight base)	1952	112	555
1961-62	July 1969	139	774
1970-71	January 1977	350	1295
1981-82	July 1989	447	2371
1993-94	April 2000	435	1918
2004-05	September 2010	676	5482

Earlier, the concept of wholesale price covered the general idea of capturing all transactions carried out in the domestic market. The weights of the WPI did not correspond to contribution of the goods concerned either to value - added or final use. In order to give this idea a more precise definition, it was decided to define the universe of the wholesale price index as comprising as far as possible all transactions at first point of bulk sale in the domestic market.

Thus the latest WPI has a basket of 676 items with 5482 quotations. The major criticism for this index is that 'the general public does not buy at the wholesale level', thus WPI does not give the actual feeling of the amount of pressure borne by the general public. However, the increase in wholesale prices does affect the retail prices and as such give some feel of the consumer prices.

1. **Consumer Price Index (CPI)**

The CPI measures price change from the perspective of the retail buyer. It is the real index for the common people. It reflects the actual inflation that is borne by the individual. CPI is designed to measure changes over time in the level of retail prices of selected goods and services on which consumers of a defined group spend their incomes. Till January 2012, in India there were only following four CPIs compiled and released on national level.

- Industrial Workers (IW) (base 2001),
- Agricultural Labourer (AL) (base 1986-87) and
- Rural Labourer (RL) (base 1986-87)
- Urban Non-Manual Employees (UNME) (base 1984-85),

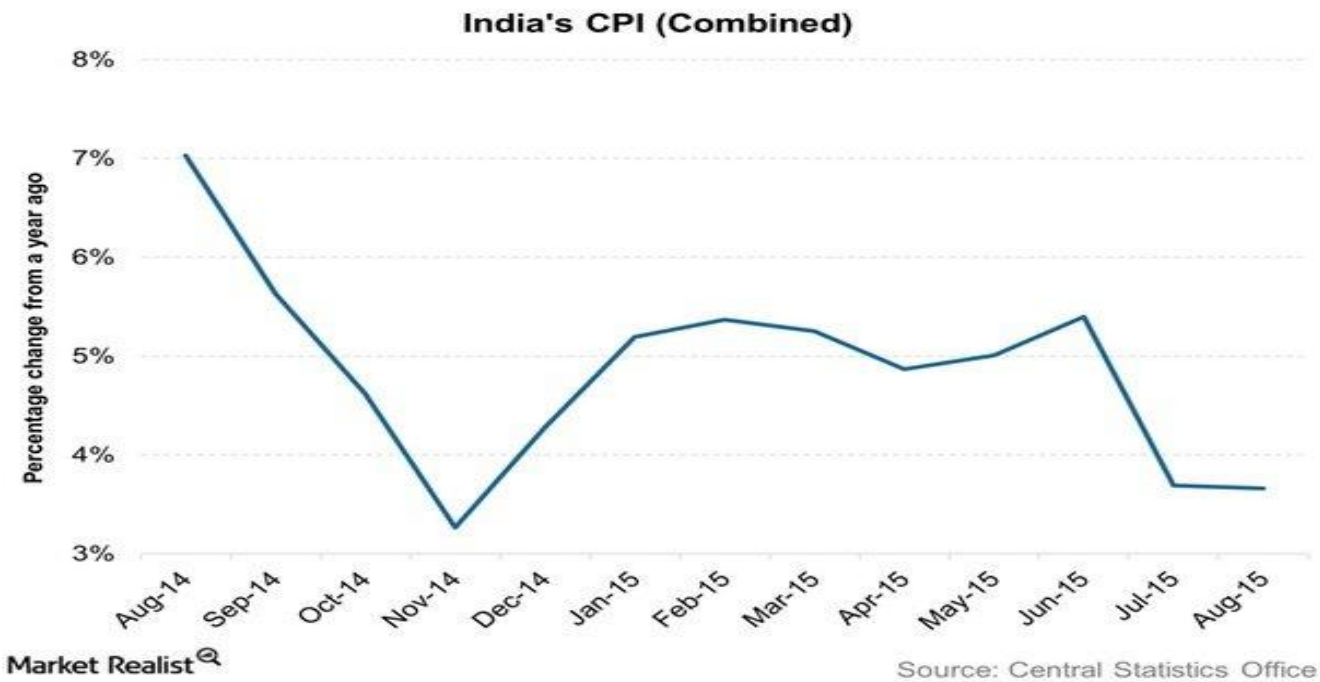
The first three are compiled by the Labour Bureau in the Ministry of Labour and Employment, and the fourth is compiled by Central Statistical Organisation (CSO) in the Ministry of Statistics and Programme Implementation.
These four CPIs reflect the effect of price fluctuations of various goods and services consumed by specific segments of population in the country. These indices did not encompass all the segments of the population and thus, did not reflect the true picture of the price behaviour in the country as a whole.New Series of CPI Started in 2012. Therefore, there was a strong feeling that there is a need for compiling CPI for entire urban and rural population of the country to measure the inflation in Indian economy based on CPI. Thus, now Central Statistics Office (CSO) of the Ministry of Statistics and Programme Implementation has started compiling a new series of CPI for

- CPI for the entire urban population viz CPI (Urban);
- CPI for the entire rural population viz CPI (Rural)
- Consolidated CPI for Urban + Rural will also be compiled based on above two CPIs

These would reflect the changes in the price level of various goods and services consumed by the Urban and rural population. These new indices are now compiled at State / UT and all India levels.

The CPI inflation series is wider in scope than the one based on the wholesale price index (WPI), as it has both rural and urban figures, besides state-wise data. The new series, with 2010 as the base year, also includes services, which is not the case with the WPI series.

Indian inflation rate in past twelve months:



Consumer prices in India increased 3.66 percent year-on-year in August of 2015, slowing slightly from a revised 3.69 percent rise in July and in line with market expectations. The inflation rate fell to a fresh record low in August, staying below the central bank's target of 6 percent by January 2016..

Figures for July were revised downwards to show the inflation rate at 3.69 percent from an initial estimate of 3.78 percent.

India Prices	Last	Previous	Highest	Lowest	Unit
Inflation Rate	3.66	3.78	11.16	3.66	Percent
Consumer Price Index CPI	124.70	123.70	124.70	86.81	Index Points
GDP Deflator	117.80	114.40	171.30	100.00	Index Points
Producer Prices	176.70	177.50	185.90	97.50	Index Points
Producer Prices Change	-1.13	-4.05	34.68	-11.31	Percent
Export Prices	312.00	284.00	312.00	100.00	Index Points
Import Prices	518.00	459.00	518.00	100.00	Index Points
Food Inflation	2.20	2.15	14.72	2.15	Percent
Inflation Rate Mom	0.40	0.60	1.77	-1.00	Percent

Ways to Control inflation:

Some of the most important measures that must be followed to control inflation are through

1. Fiscal Policy: Fiscal measures are highly effective for controlling government expenditure (reduction in unnecessary expenditure, surplus budgets, postponing the redemption of public funds), personal consumption expenditure (increase in taxes, increase in savings) and private and public investment.
2. 2. Monetary Policy: Monetary measures aim at reducing money incomes such as credit control policy by central bank, demonetization of currency.
3. Other Measures: The other types of measures are those which aim at increasing aggregate supply and reducing aggregate demand directly by increasing production, freezing wages, controlling prices, proper rationing of scarce goods

Ways to control deflation:

Deflation can be controlled by adopting monetary and fiscal measures in just the opposite manner to control inflation.

Conclusion:

From the various monetary, fiscal and other measures discussed above, it becomes clear that to control inflation, the government should adopt all measures simultaneously. The recent decision of reducing the REPO rate by RBI is one of those controlling measures to put inflation rate on the right track and inflation is a serious business for the Governments to handle and control, otherwise it will start controlling Governments.

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