New Vision IAS Academy
....wings to aspirations

CLASS NOTES
INFLATION

- Inflation
- Stagflation
- Deflation
- Disinflation

INFLATION

- "Increase in money supply faster than the growth in real national income".
- Inflation can be defined as a sustained upward movement in the aggregate price level that is shared by most products.
- It can also be viewed as a fall in the purchasing power of money.
- The opposite of inflation is deflation.

Fall in

- Gross domestic product(GDP)
- Employment
- Investment &spending
- Capacity utilization
- Household incomes
- Business profits

While Rise in

- Bankruptcies
- Unemployment rate

<u>Causes of inflation</u>:-

- High growth rate, per capita income has increased demand.
- Spendthrift population
- Supply capacity falls short of demand
- Post reform period, large inflow of foreign currency.
- Money through purchase of foreign exchange from the banking system.
- Suddenly increased in expenditure on social sector schemes – MGNREGA.
- Erratic agricultural growth.
- Growth of industrial & service sector. Supply side is lagging behind.
- Depreciation/Devaluation of the domestic currency.
- Monopolistic & oligopolistic tendencies.
- Increase in cost of capital.
- Headline
- Core (non-food Manufactured goods)
  Excluding Energy & food article from inflation
  Popular in western economies
- Cost push
- Demand pull

TYPES OF INFLATION

- **Low inflation(creeping)**
  Single digit rate

- Skewflation
- Reflation
- Hyper-inflation

Inflation of about 3 % annually. ,slow & predictable

- **Galloping inflation**
  Very High inflation, range of double digit or triple digit ,20%,100%,200% per year.
  1970-1980 Argentina, Chile,Brazile--50-700%
- **Hyper Inflation**
  Prices shot up more than three digit rate per annum

1989-1990

Argentina-2314%.Peru-7481%,Brazil-2737.7%
Yugoslavian inflation 1993- 20 % per day

TOOLS TO MEASURE INFLATION:-

- Wholesale Price Index (WPI)
- Consumer Price Index (CPI)
- Producer Price Index
- GDP deflator :-
  - It gives real GDP from the nominal GDP by deflating price effect.
  - It takes into account changes in govt. consumption, capital formation, international trade & household consumption
  - Nominal GDP(GDP at current price)
    Real GDP (GDP at constant price)

Measure of inflation

Wholesale Price Index (WPI) &Consumer price index (CPI)

WPI is the index that is used to measure the change in the average price level of goods traded in wholesale market

The Consumer Price Index measures prices of a selection of goods and services purchased by a "typical consumer

In India, a total of 435 commodities data on price level is tracked through WPI

Composition of WPI

Primary Articles (wt= 22.0)

Cereals, Pulses,Fruits &vegetables, egg, fish, oilseeds, spices, fibres, etc

Fuel Power, Light & Lubricants (wt.= 14.2)

Mineral Oil,Electricity,Coal Mining

Manufactured Products (wt.63.8)

Sugar,edible oils,textiles, chemicals, iron & steel machinery, transport equipment, etc

CPI

- Food & Beverages - 54 % (Seasonal)

- Fuel & Light - 8 % (International)

Rate of Inflation=

$$\frac{\text{WPI for a certain year} - \text{WPI for a base year}}{\text{W PI for a base year}} \times 100$$

Base year 1993-1994(435 commodities) issued from July 1999

CAUSES OF COST-PUSH INFLATION

- Cost-push inflation is caused by an increase in production costs.
- It is generally caused by
  - an increase in wages
  - Increase in cost of factors of production
  - an increase in the profit margins of the entrepreneurs.
- **Fluctuation in output & supply(Agri& industry)**
  a. Reduced food grain production due to Natural calamities
  b. Industrial dispute as strike, lock-outs, power breakdown
  c. Hoarding(hidden supply) by traders & black marketers & farmers
- **Taxation**
  a. Government imposed fresh commodity tax give traders to raise prices of goods
  b. VAT,excise duty
- **Administered prices**
  PSU --raise prices of their products & services ------ - raw material for other industries Ex. cement,steel,coal
- **Hike in oil prices**
  a. Due to rise in prices of crude oil in September 1973 &consequent upward revision of prices of oil & oil based products
  b. 1980---OPEC---130% rise in fuel prices
  c. Petroleum is essential fuel for transport & component of manufactured items

CAUSES OF DEMAND PULL INFLATION

- **Increase in money supply & Deficit financing**
  - GOI uses DF as a method for financing development.
  - Under this government borrows money from RBI.
  - This increases money supply in country
- **Black money**
  - Unaccounted black money in the hands of tax evaders& black marketers
  - Which is used in buying & selling of essential goods & influencing pushing up prices
- **Growth in population**
- **Reduction in direct or indirect taxation.**
  a. If direct taxes are reduced consumers have more real disposable income causing demand to rise
  b. Reduction in indirect taxes will mean that a given amount of income will now buy a greater real volume of goods and services
  c. Both factors can increase aggregate demand

CONSEQUENCES OF INFLATION

- Tax Distortions:
  - Personal income tax increases with the consumer price index.
  - When inflation increases, the actual value of the tax deductions is much less than it should be due to the declining purchase power.
- Unfair gains & loses:
  - Effects on production, that is, changes in the tempo of economic activity.
  - Effects on income distribution, that is, re-distribution of income and wealth.
  - Effects on consumption and welfare.
- Multi dimensional effects on economy at micro & macro level
- Redistribute income, distort relative prices, destabilizes employment, tax, saving& investment policies & finally bring recession
- **On creditors & debtors**
  Inflation changes the allocation of income.
  lenders suffers than the borrowers
  because the loans sanctioned previously are paid back later in the form of inflated currency
- **On lending**
  Inflation effect --- Time Value Money(TVM). This acts as a principal component of the rates of interest
  Change rates of inflation --- changes in the rates of interest
  Banks and other lenders adjust for this inflation risk by creating a higher initial stated interest rate
- **On exchange rate**
  The currency of economy depreciates and losses its exchange value. Inflation influences the investments of a country
- **Market:** They add inefficiencies in the market, and make it difficult for companies to budget or plan long-term.
- **Investment and saving :** Uncertainty about the future purchasing power of money discourages investment and saving
- **Tax**
  Indirect taxes are imposed on value, increased prices of goods make tax payers to pay increased indirect tax
  Direct tax payers burden also increases as tax are paid but real value of money does not increase due to inflation
- **It redistributes income**

from people on fixed incomes (that do not rise with inflation) to people on variable incomes (that do rise with inflation).

- **Trade**
  Inflation rate in the economy is higher than rates in other countries; this will increase imports and reduce exports, leading to a deficit in the balance of trade.

CONTROL OF INFLATION

1. **Monetary Measures**
2. **Fiscal Measures**
3. **Other Measures**

1. **Monetary Measures**

Credit Control

- Reduction of amount of credit allowed i.e. bank lending
  Reduction in money supply in economy through
- In case of inflation, the bank rate is increased; the supply of money is controlled.
- Use of cash reserve ratio(CRR) & statutory liquidity ratio(SLR)
- Demonetization of currency
  - process of ceasing to produce and circulate currency, when inflation is uncontrollable

2. Fiscal Measures

- **Reduction in government Expenditure**

A cut in government expenditure reduces government demand for goods & services

- **Increase in Taxes**

Increased taxes reduces disposable income of people & thereby consumer demand

- **Policy of surplus budgeting** (both measure at a time) spend less than tax revenue
- **Public Debt**

During inflation, government increase the public borrowing

3. Other Measures

- **To Increase Production & supply**

Improvement in PDS

Providing tax incentives for producers in private sector to improve supply position

Increase in import of edible oil, sugar,pulses

Initiatives by FCI

- **Rational Wage Policy**

Wage control is used where inflation is cost-push

Rise in wage rate is prevented directly by imposing a sealing on wage incomes in both private & public sectors

- **Price Control:** A maximum retail price of goods &services is fixed, scarce goods

STAGFLATION

- Low GDP
- High inflation
- High unemployment

DEFLATION

- Reduce business profit
- Raises real debt
- Discourages household consumption and investment

CAUSES OF DEFLATION

- Decreasing Money Supply.
- Increasing Supply of Goods.
- Decreasing Demand of Goods.
- Increasing Demand for Money.
