

INFLATION

Consumer Price Index for the month of June-2010 has been announced recently and we are all busy in estimating the dearness allowance. We all know when index is more than the previous months it's inflation and we get more DA. But do we know what is inflation is all about? Let's brush up the basics now.

Barter System:

Before the advent of money, there was barter system. Unlike money economy, the barter system had many difficulties and disadvantages. Take an example, imagine that you have a pen and you need a pencil and your friend has a pencil and he needs a paper. Even though your friend has pencil which you need, you cannot get it from him because the paper he needs is not with you. This is one of such difficulties of the barter system and it is known as 'double coincidence of wants'.

The pen you have could not be exchanged for the pencil you need. So, pen is not a 'medium of exchange'. Medium of exchange i.e., 'money' is something which could be exchanged for anything else. So many things (that are thought to have value) served as 'mediums of exchange' during different times and different parts of world. Gold, silver, copper, salt, peppercorns, large stones, shells, alcohol, cigarettes are but few examples of 'mediums of exchange'.

Precious Metals as Medium of Exchange:

Over a period of time, coins of precious metals became standard 'medium of exchange'. As there was the problem of wear and tear during the course of handling of these coins which reduced the value of these coins, a method was devised. The government would get the coins of precious metals and issue paper money of equivalent value. The paper money issued by the government could be given back to it anytime and the precious metals of equivalent value would be returned. The power of government to issue paper money was limited only to the amount of precious metals it has. This was followed by most of the modern governments till the middle of this century and it was called 'gold standard'.

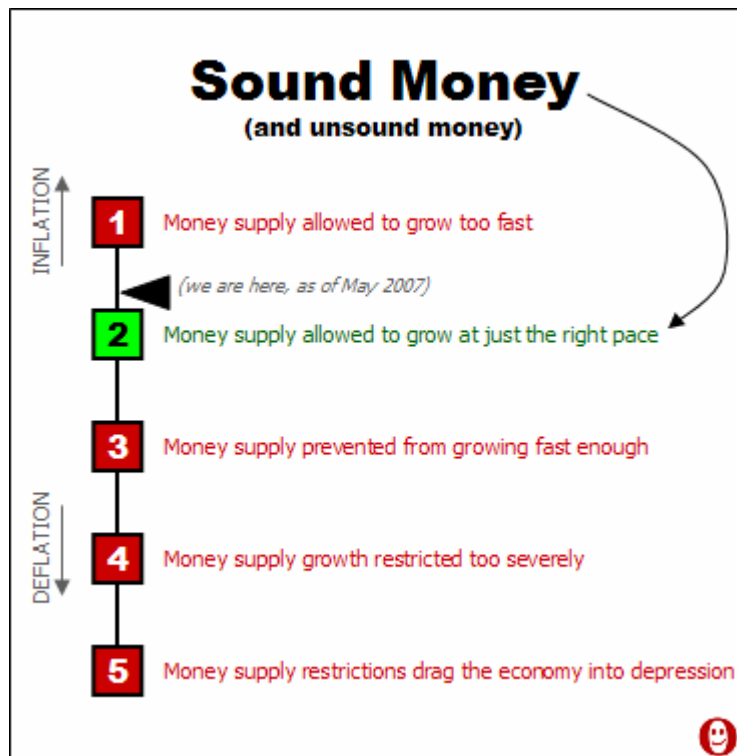
Paper Money:

The population is always growing but not the supply of precious metals. To meet the needs of growing population, governments need more paper money. So, how can a government tackle the problem? It can issue paper money in excess of the precious metals it has. Are any of the governments doing this now? Yes. Invariably all the governments do this. And it is called 'minimal reserve system' which means any government must have precious metals of certain minimum value and can issue paper money to any extent.

What is the problem with this arrangement? Suppose that the government issued paper money in excess of the precious metals in its possession. What happens if all the people who had paper money want to get the equivalent precious metals back from the government (this is not possible now)? The Government could not give all the people their precious metals. The direct consequence of this that people lose faith in the paper money issued by the government and the value of it gets reduced. This is 'inflation'.

The value of money is persistently getting decreased even though government makes effort to control it. How do you know that the value of money is decreasing? Simply, the money could not purchase the same amount of goods or services as it did earlier. Suppose that your monthly budget for the last year is Rs.5,000/- and now the same has risen to Rs.7,500/- without any major or significant change in the goods or services you bought last year, it is evident that the value of money has depreciated. The 'purchasing power' of money has become less which signifies 'inflation'.

What is inflation?



The word 'inflation' itself shows that the money is circulating more than a country needs it. Simply, there is excess money in the country. What are the causes? There are 2 major causes for inflation. 1) Demand-pull inflation 2) Cost-push Inflation. Demand-pull inflation is a situation where more money is chasing few goods / services. Obviously, when demand increases the price increases. The second type of inflation 'Cost-push inflation' is caused by the increase in the cost of production of goods / services which may be due to rise in the wages of employees or the rise in the cost of raw materials.

What does government do to control inflation?

It can either reduce the supply of money or decrease the demand for money. How can it achieve this? A government can ask banks to lend less which reduces the supply of money or it can just increase the interest rates which obviously will decrease the demand for money. In most of the countries this management of money is not directly done by the governments but by the central banks ('Reserve Bank of India' in our country) and the policy that these central banks make regarding this is known as 'monetary policy'.

To quote one interesting method central banks follow to reduce supply of money is manipulating the 'cash reserve ratio'. Suppose that our country has only one bank and it has got only Rs.100/-

as its deposit. How much can it lend? Rs. 25/-? Rs.50/-? Or Rs.99/-? It may be surprising to know that with Rs.100/-, a bank could lend up-to Rs.10,000/- with a 'cash reserve ratio' of 10%. How is it possible? It is theoretically possible. Consider the 'cash reserve ratio' is 10% which means the bank should keep 10% of its deposits as reserve. So, with Rs.100/- it can lend Rs.90/-. Theoretically, this Rs.90/- is going to come into the banking system again as a deposit. So, now the bank gets Rs.90/- as a fresh deposit from which it could lend Rs.81/- (i.e., Rs.90 – 10% of Rs.90/- (which is 'cash reserve ratio')). It already lent Rs.90/- and now it has lent Rs.81/- and the total is Rs.171/-. If you continue this calculation, with a 'cash reserve ratio' of 10% a bank could lend up to 10 times of its deposit.

The formula is simple:

**Number of times a bank
could lend its deposits } = 100 / Cash Reserve Ratio**

In our example we have taken 'cash reserve ratio' as 10%, so 100/10 which equals 10 is the amount of times bank could lend which is Rs.10,000/-. Just increase the 'cash reserve ratio' to 20% and the amount of money the bank could lend is dropped to Rs.5,000/- But, it is not sure that every bank of an economy would exactly lend proportionate the 'cash reserve ratio'. It is but one technique handled by the central banks to decrease the money supply.

There are many other confusing rates and ratios such 'Prime Lending Rate', 'Statutory Liquidity Ratio', 'Repo Rate' Reverse Repo Rate' etc., which central banks use to contain inflation. All the methods central banks use to control are not complex. They may also be so simple such as releasing a long term government bond (for example 'Indra Vikas Patra') to suck out the excess money or reducing the number of transactions that could be done in a savings bank account.

Measures of Inflation:

How is inflation measured? There are again two types of measuring it 1) Whole Sale Price Index 2) Consumer Price Index. Whole sale price index, as the name indicates, measures the increase the cost of production. And the Consumer price index measures the cost of living. Both of these indices have separate basket of goods / services whose rise in price is measured and are compared with those of the previous week, month or years indices and the percentage with which it differ with those indices are announced as 'inflation rate'.

Necessary Evil:

Can an economy be without inflation? It is impossible. Because as the population grows the government must ensure that everyone is getting enough money for their living which will obviously increase the amount of money being circulated in an economy which ultimately causes inflation. Hence, inflation is unavoidable but it must be kept in control. George Bernard Shaw said "Marriage is a necessary evil", so is the inflation.