INFLATION – CAUSES & REMEDIES

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1. Definitions

Inflation is ‘persistent increases in the general level of prices’ measured against a standard level of purchasing power.

According to the Webster's New Universal Unabridged Dictionary,
"An increase in the amount of currency in circulation, resulting in a relatively sharp and sudden fall in its value and rise in prices, it may be caused by an increase in the volume of paper money issued or of gold mined, or a relative increase in expenditures as when the supply of goods fails to meet the demand."

The American Heritage Dictionary of the English Language,
“A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services.”

2. Measures of Inflation

There are mainly two measures of Inflation which measures nominal changes in prices

- Wholesale Price Index (WPI)
- Consumer Price Index (CPI)

Other measures are GDP deflator, Core-inflation etc.

Wholesale Price Index (WPI)

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

Computation:-

In the computation of WPI, the 3 major variables are considered.
Manufactured products have always enjoyed more weight in the calculation of WPI.

Sr. No.	Particulars	Weight
1	Primary Articles	22.03
2	Fuel, Power, Light & Lubricants	14.23
3	Manufactured Products	63.75

Wholesale price index or WPI is the measure for inflation in India. The government comes out with WPI inflation figures every Friday. The WPI presently consists of 435 items and it is dominated by manufactured goods which make up 63.75% of the index.

Consumer Price Index (CPI)

CPI is a statistical time-series measure of a weighted average of prices of a specified set of goods and services purchased by consumers. It is a price index that tracks the prices of a specified basket of consumer goods and services, providing a measure of inflation.

CPI is a fixed quantity price index and considered by some a cost of living index. Under CPI, an index is scaled so that it is equal to 100 at a chosen point in time, so that all other values of the index are a percentage relative to this one.

3. Effects of Inflation

Effects depends on speed of inflation & economy of country

- Increasing uncertainty may discourage investment and saving.
- **Redistribution**
  1. It will redistribute income from those on fixed incomes such as pensioners and shifts it those who draw a variable income (say from profits)
  2. Redistribution of wealth from lenders to borrowers-government is a net debtor and therefore inflation benefits government debts-hence inflation is considered as a ‘hidden tax’
- **International Trade:** If the rate of inflation in a country is higher than what obtains abroad, a fixed exchange rate will be undermine through a weakening of the balance of trade.
- **Shoe Lather Costs:** Because the value of cash is eroded by inflation, people will tend to hold less cash during times of inflation (reference to increase trips of customers to banks wear and tear to the shoes!)
- **Menu Costs:** Firms must change their prices more frequently which imposes costs (restaurants having to reprint menus often to reflect higher prices.)
- **Relative price distortion (between companies):** Economic discussions will be distorted as relative prices (some firms pushing up prices because of in elasticity of demand while others forced to keep prices stable because of elasticity of demand) don’t reflect relative scarcity of different goods.
- **Impact on Household Sector:** Inflation directly reduces the purchasing power of the household sector. Lower income group suffers most. Effects on businessmen are very less.
- **Impact on Business Sector:** Moderate inflation (2-3%) is good for business sector. Initially Firms are benefited from rising prices. Soon, demand falls as consumers reduce consumption. There will be different fall for different commodities depending on the price elasticity of demand. Production costs go up, especially if wages are linked to inflation index-Costs increase which will leads to squeezing up of profits.

- **Impact on Debtors and Creditors:** Redistribution of income from creditors to debtors-repaid debt in depreciated value as purchasing power has eroded to the extent of inflation.
- **Impact on Govt.:** Govt. expense goes up in tandem with increase in price level. The rate of Inflation is of great concern to the Central Bank of a country as well as to its Government.

4. Types of Inflation

In the long run, inflation is a monetary phenomenon.
In the short and medium term it is influenced by the relative elasticity of wages, prices and interest rates.

There are mainly four types of inflation but still different authors have different views. Here four types are explained.

Caused by excess demand in the economy (Demand-Pull Inflation)

Aggregate Demand > Aggregate Supply
"Too much money chasing too few goods."
Inflation caused by increases in aggregate demand due to increased private and government spending, etc. Demand inflation is constructive to a faster rate of economic growth since the excess demand and favourable market conditions will stimulate investment and expansion. The failing value of money, however, may encourage spending rather than saving and so reduce the funds available for investment.

Caused by high costs (Cost-Push Inflation)

It is presently termed "supply shock inflation," caused by drops in aggregate supply due to increased prices of inputs. For instance a sudden decrease in the supply of oil, which would lead to increase oil prices. Producers for whom oil is a part of their costs could then pass this on to consumers in the form of increased prices.

Caused by excessive increase in money supply (Monetarism).

The money supply is also thought to play a major role in determining moderate levels of inflation, although there are differences of opinion on how important it is. For example,
Monetarist economists believe that the link is very strong;
Keynesian economics, by contrast, typically emphasize the role of aggregate demand in the economy rather than the money supply in determining inflation.

They disagree with the notion that central banks control the money supply, arguing that central banks have little control because the money supply adapts to the demand for bank credit issued by commercial banks.

Built-in-inflation caused by adaptive expectations (Price/ Wage spiral)

It is induced by adaptive expectations, often linked to the "price/wage spiral" because it involves workers trying to keep their wages net ot CPI after tax with prices and then employers passing higher costs on to consumers as higher prices as part of a "vicious circle."

Built-in inflation reflects events in the past, and so might be seen as hangover inflation.

5. Causes of Inflation

Causes of Inflation

1.Demand Factors
- Growth of Population
- Rise in employment & income
- Increasing pace of urbanisation

2. Supply Factors
- Irregular agricultural supply
- Hoarding of essential goods
- Rise in administered prices
- Inadequate growth of industrial production
- Agricultural Price Policy
- Rising prices of Imports

3. Monetary & Fiscal Factors
- Rising level of Government Expenditure
- Deficit financing

4. Global Factors
- Global imbalance the cause for global liquidity
- Higher International farm prices
- The psychological dimension
- Growth & forex flows

1. Demand Factors

<u>Growth of Population</u>: Increase in population by 18 to 19 million every year means constant increase in demand for food stuff & other materials. The continuously rising population is responsible for the widening gap between demand and supply in almost all consumer goods & services. It has resulted in demand pull inflation

Rise in employment & income: There has been steady rise in employment rate. This has resulted in higher income & consequently greater demand for goods. The result has been continuous rise in demand pull inflation.

Increasing pace of Urbanisation: Rate of urbanisation has been rising. This raises the demand for superior goods by the migrant population due to demonstration effect of urban areas.

2. Supply Factors

Irregular agricultural supply: There has been irregular agricultural supply due to natural factors like drought and floods situations. When there is scarcity of agricultural supply, their prices rise which leads to cost-push inflation.

Hoarding of essential goods: It is generally observed that big farmers and trades hoard food grains. This creates scarcity and continuous increase in their prices. Likewise, even in industrial products like oil, medicines, etc. traders holds them and this results in cost-push inflation.

Rise in administered prices: There are a number of important agricultural commodities for which price level is administered by the govt. Many of these commodities are produced in public sector. The govt. keeps on raising prices from time to time in order to cover the losses in the public sector. The result is cost-push inflation.

Inadequate growth of industrial production: There has been large expansion of money supply creating big demand for industrial goods. The rise in industrial growth has been inadequate, which has pushed up the prices of industrial products and this has led to cost-push inflation.

Agricultural price policy: The government has minimum support price policy for agricultural products. Through this policy, the govt. announces the price at which it would be buying agricultural products. This ensures minimum price to framers and completely eliminates risk. This policy largely benefited big farmers who have been pressurising the govt. to raise support prices. The result is cost-push inflation.

Rising prices of imports: During the last two-three decades, India has not been freely allowing imports. Rise in import prices of raw materials, machines, etc., have risen cost of production. This has pushed up prices and resulted in cost-push inflation.

3. Monetary and Fiscal Factors

Rising levels of Government expenditure: There has been significant rise in govt. expenditure since 1950-51. Public expenditure has raised due to rise in population, national, national income and employment. It is almost 40% of our national income.

About 40% of the public expenditure is on non-developmental activities. It has led to demand-pull inflation.

Deficit Financing: The govt. has frequently resorted to deficit financing in order to tide over the gap between public revenue and public expenditure. A small amount of deficit financing makes fund available for growth of the country, but a large amount of deficit financing increase money supply with people and it will lead to demand pull inflation.

4. Global Factors

Global imbalance is cause for global liquidity: This is simply because developed western economies, particularly the United States, are consuming on a massive scale leading to extremely high trade deficits. Developed countries are consuming both the production and investment originating from the developing countries.

The reason for this imbalance in the global economy is competitive devaluation after Asian currency crisis. Due to fall in value of dollar, a price of all other assets & commodities rises.

Higher international farm prices impact Indian farm prices: Global trends have put upward pressure on domestic prices of wheat and are expected to continue to do so during the course of this year.

No wonder, despite the government lowering the import tariffs on wheat to zero, there has been no significant quantity of wheat imports as the international prices of wheat are higher than the domestic prices.

The psychological dimension: There is no sign of correction in imbalance & devaluation due to this reason players started hedge of US dollar. Increased liquidity has led to the increase in commodity prices as a whole.

The twin causes -- excessive liquidity due to undervaluation of various currencies (technical) and fear of the US dollar collapse leading to increased purchase of various commodities to hedge against a fall in US dollar (psychological) -- needs to be tackled upfront if inflation has to be confronted globally.

Growth and forex flows: Another cause for the increase in the prices of these commodities has been due to the fact that both India and China have been recording excellent growth in recent years. It has to be noted that China and India have a combined population of 2.5 billion people.

Given this size of population even a modest $100 increase in the per capita income of these two countries would translate into approximately $250 billion in additional demand for commodities. This has put an extraordinary highly demand on various commodities. Surely growth will come at a cost.

This Reserve Bank of India's strategy of dealing with excessive liquidity through the Market Stabilization Scheme (MSS) has its own limitations. Similarly, the increase in repo rates and increase in CRR rates are policy interventions with serious limitations in the Indian context with such huge forex inflows.

6. History of Indian Inflationary Condition (Decade Wise)

During the 1950s, the average decadal rate of inflation was very low at 1.7%. The rate varied in range from negative value of 12.5% to a positive value of 13.8%. The minimum inflation at a negative rate prevailed in 1952-53 due to the bumper agricultural production. The maximum inflation rate prevailed in 1956-57 due to rise in investment demand.

During the 1960s, the average decadal inflation went up to 6.4%. It was due to Chinese war in 1962, Pakistan war in 1965 & Famine conditions during 1965-66.
Maximum Rate – 13.9% (1966-67)
Minimum Rate – (-)1.1% (1968-69)

During the 1970s, the average decadal inflation rate was still higher at 9%. Maximum rate – 25.2% (1974-75) due to failure of kharif crops and rise in crude oil prices.
Minimum rate – (-)1.1% (1975-76) due to anti-inflationary measures taken by the govt.

During the 1980s, the decadal average inflation was 8%.
Maximum Rate – 18.2% (1980-81)
Minimum Rate – 4.4% (1985-86)

During 1990-91 to 1997-98, the average inflation rate was 9% high. The first half of decade was characterised by double-digit inflation following the gulf crisis. From the year 1993-94 trend changes with inflation rate of 8.4%. From the year 1995-96 there was a reversal of inflationary trend; measures began to show positive impact on prices.

Following table shows past eight years inflation rate: -

Sr. No.	Year	Inflation Rate
1	1998-1999	5.3%
2	1999-2000	6.5%
3	2000-2001	5.5%
4	2001-2002	1.6%
5	2002-2003	4.4% - due to oil prices
6	2005-2006	4.7%
7	2006-2007	6.44%
8	2007-2008	7.14%

Following is weekly condition of this year for all commodities with the help of Indexation; base year is 1993-94

Date	Index
05/01/2008	217.6
12/01/2008	217.8
19/01/2008	218.2
26/01/2008	219
02/02/2008	218.8
09/02/2008	219.4
16/02/2008	220.4
23/02/2008	220.9
01/03/2008	222.3
08/03/2008	225.7
15/03/2008	226.4
22/03/2008	224.8
29/03/2008	226

Date	Index
05/04/2008	226.6
12/04/2008	226.9
19/04/2008	227.5
26/04/2008	227.7
03/05/2008	228.6
10/05/2008	229

7. **Remedies**

Reconstruction of WPI

The immediate step to take will be the reconstruction of the WPI. So, that it indicates the genuine level of inflation. Like our outdated poverty line, which tells that only about 26% of the Indian population is poor, the current WPI is also outdated.

Economists V Shunmugam and D G Prasad working with India's largest commodity bourse (The Multi Commodity Exchange) have come out with a research paper arguing that the government urgently needs to shift the method of calculating inflation.

Currently, in India, we go through boom-and-bust cycles, sometimes GDP growth rates are very high and sometimes GDP growth rates drop sharply. This boom-and-bust cycle is unpleasant for every household. There is a powerful international consensus that stabilising inflation reduces this boom-and-bust cycle of GDP growth.

Following are the main remedies against the particular situation of inflation

A. Reduce Demand Pressures

If inflation is caused by high demand then

- Raise interest rates to reduce consumer’s disposable income.
- Raise interest rates to discourage borrowing and demand
- Raise taxes to reduce disposable income and spending.

These policies should all reduce people’s ability to spend too much money

B. Reduce Cost Push Pressures

If inflation is caused by high costs

- Limit wage increases if possible e.g. public sector workers
- Force electricity and gas companies to hold their prices.
- Increase the value of foreign currency in order to reduce the cost of importing.

C. Reduce Money Supply Pressures

If inflation is caused by too much money in the economy

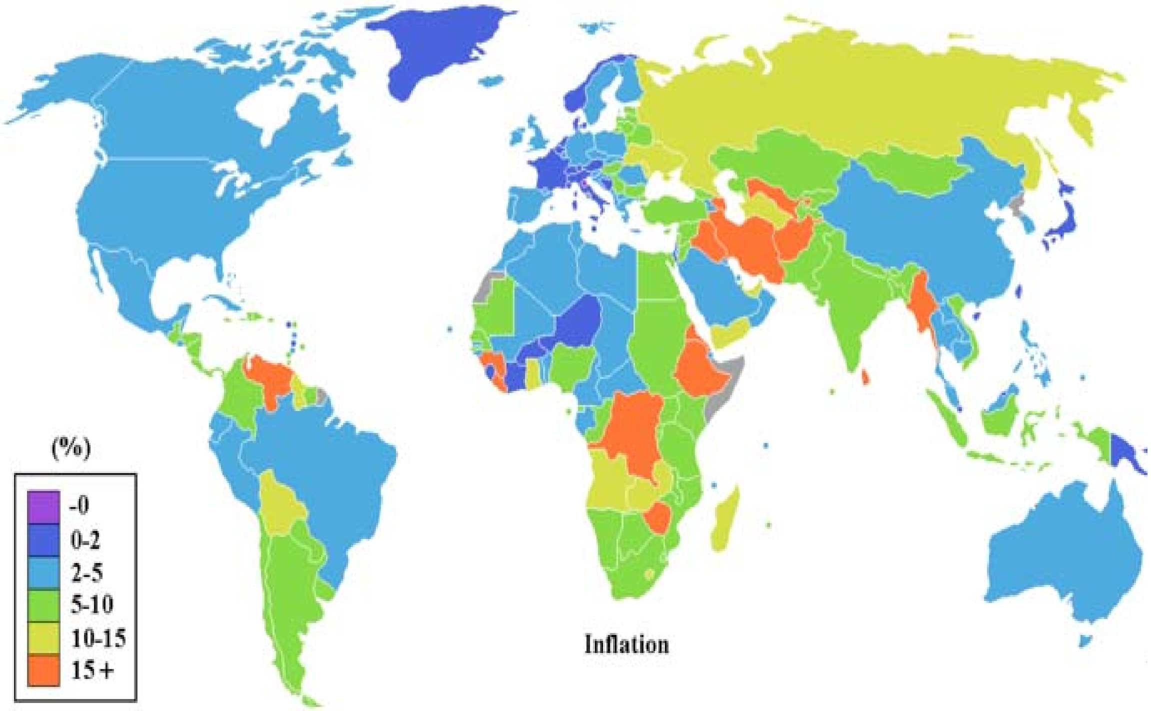
- Print less money
- Withdraw some money from circulation.

Each of the above approaches has its advantages and disadvantages.

POLICY 1 is effective but will be unpopular with consumers and may cause a minor recession

POLICY 2 could be effective but it is very difficult for the government to tell private firms how much to charge for inputs and also how much to pay their workers.

Following map shows condition of Inflation during the year 2007 in the world



Funny picture showing current situation