DAY-4

INFLATION & INFLATION INDEX

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Disclaimer

The course contains material for a total of 6 days. The materials are designed in such a way that it will give an overview to Macroeconomics. The materials designed as a part of bootcamp are self-explanatory. Video linkshave been added wherever needed. Team FEBS wishes you a happy learning!

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ALL The Best!

Team FEBS

Society of Finance, Economics and

Business

IIT Bhubaneswar.

Inflation and Inflation Index

Overview - What is Inflation?

In economics, inflation is a general increase in the prices of goods and services in an economy.
When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation corresponds to a reduction in the purchasing power of money.
The opposite of inflation is deflation, a sustained decrease in the general price level of goods and services.

Inflation is taxation without legislation

- Milton Friedman

Inflation explained: https://youtu.be/UMAELCrJxt0

Causes of Inflation

An increase in the supply of money is the root of inflation, though this can play out through different mechanisms in the economy. A country's money supply can be increased by the monetary authorities by:

1. Printing and giving away more money to citizens
2. Legally devaluing (reducing the value of) the legal tender currency
3. Loaning new money into existence as reserve account credits through the banking system by purchasing government bonds from banks on the secondary market (the most common method)
   These can be categorised into mainly two causes
      - Demand pull cause
      - Cost push cause

Demand Pull Causes:

Demand-pull conditions occur when demand from consumers pulls prices up.

It occurs when consumer demand for goods and services increases so much that it outstrips supply.

Factors resulting in Demand Pull

- Marketing and New Technology
- Expansionary Fiscal Policy
- Expansionary Monetary Policy

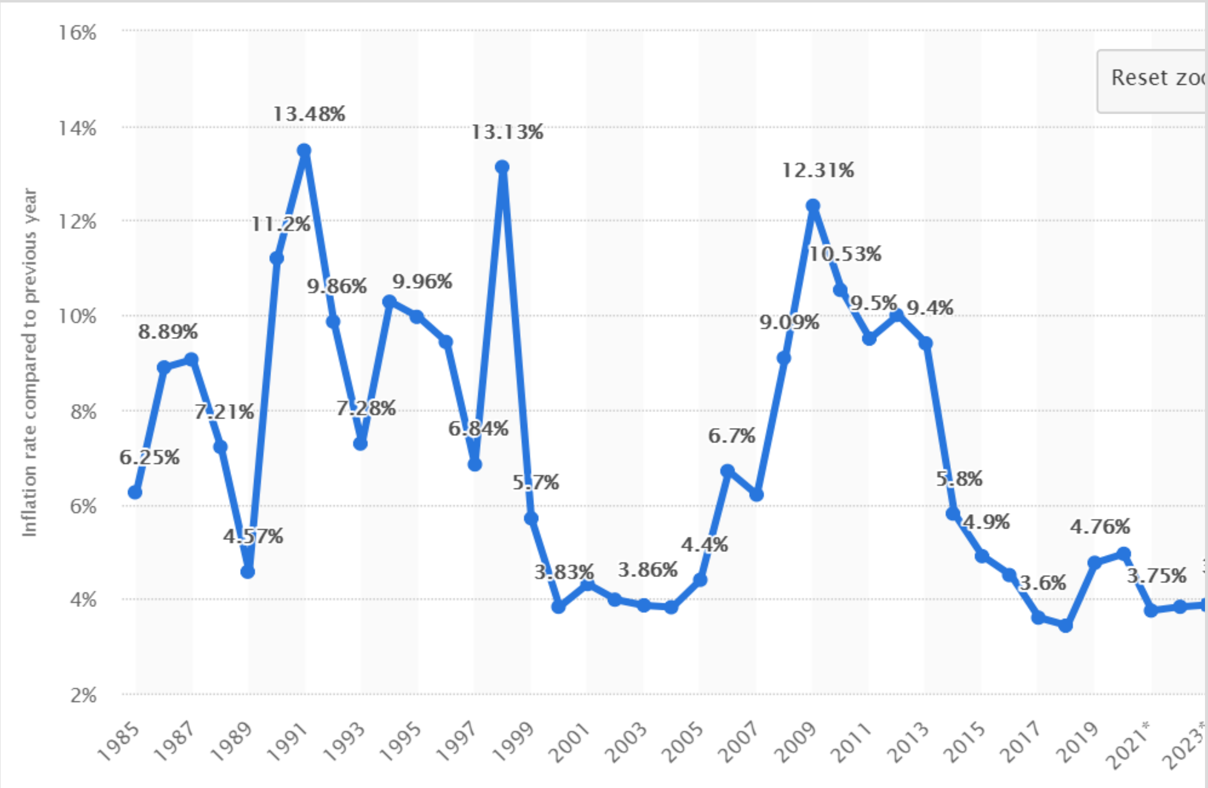
Cost Push Causes:

Cost-push occurs when supply costs force prices higher.

It only occurs when there is a supply shortage combined with enough demand to allow the producer to raise prices

Factors resulting in Cost Push

- Global supply chain disruptions example during Covid - 19 we saw supply chain disruption
- Monopolies example: De Beers Group (---- Find out about it----)
- Government regulation and taxation



Inflation Data of India

CASE STUDY: ZIMBABWE

In 2008, Zimbabwe had the second highest incidence of hyperinflation on record. The estimated inflation rate for Nov 2008 was 79,600,000,000%. That is effectively a daily inflation rate of 98.0. Roughly every day, prices would double.

What led to this Crisis?

- In the late 1990s, the Zimbabwe government introduced a series of land reforms. This involved redistributing land from the existing white farmers to black farmers. But, with little experience, the new farmers struggled to produce food, and there was a large fall in food production.
- The economy experienced a sharp fall in output (both agricultural and manufacturing), and this caused a collapse in bank lending.
- The government began increasing the rate at which they were printing money and increasing the money supply. This started with printing money to finance a war in the Congo and also to increase the salaries of officials and soldiers. But, as the economic crises worsened, printing money became a very short-term solution to try and placate people relying on government pay.
- With the economy in decline, government debt increased. To finance the higher debt, the government responded by printing more money, which caused more inflation.
- Inflation meant bondholders saw a fall in the value of their bonds and so it was hard to sell future debt.

The economy also experienced many shortages of goods

Inflation Index

An index is a ratio that compares the value of one thing to another thing. It allows you to view the first thing in terms of its relative value when compared to that of the other thing.

Inflation Index represents a ratio of the price of an item or a group of many items at one time to the price of that same item or items at another time. But it's commonly shown as a whole number such as 100.

An inflation index is used to look at the rate of inflation and thereby gauge changes in the general price level over time. Knowing the rate of inflation is crucial, because it allows central banks to enact fiscal policies that keep inflation at a rate that keeps jobs and prices stable. The rate of inflation is used for governments to create budgets.

The ways to measure inflation differ. That is why there is more than one index to look at it.

- Consumer Price Index (CPI)
- Wholesale Price Index (WPI)
- GDP deflator (ECI)

Consumer Price Index (CPI):

A consumer price index is a retail inflation index. It is calculated as weighted average prices of goods and services purchased by household sector. It is basically the inflation index at a consumer's level.

There are several types of CPI based on which commodities you are taking, Like if you are targeting rural economy, you will take commodities used by rural people. This is known as CPI Rural. Similarly, there are many types of CPI.
Simplified :- Suppose you bought a basket of commodity from a shop in 2021 and it costed you Rs. 6000 and when you bought the same basket of commodity in 2022, it costed you Rs. 6,500. Notice that the cost increased by Rs. 500. This inflation is captured in CPI

https://youtu.be/oRdLvp6H3CU

Wholesale Price Index (WPI):

A wholesale price index (WPI) is an index that measures and tracks the changes in the price of goods in the stages before the retail level. Simply put, it is inflation in the wholesale level.

Simplified :- Go to wholesale market and note the price of certain commodity in Mar 2022 , now go to same market in April 2022. Notice the change in prices. This amounts to wholesale price index (WPI).

The default index of inflation is CPI Combined (Rural and urban India). So, if nothing is mentioned, assume that the inflation is CPI Combined.

GDP DEFLATOR :

GDP Deflator is the ratio of nominal GDP and real GDP.

-------------------- The End ----------------------