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UP, UP AND AWAY

...that's the way inflation is going. So if you've been wondering why your rupee isn't stretching these days, Sunday Times gives you a crash course in the whys and hows of price rise

Shankar Raghuraman & Siddhartha | TNN

What is inflation and how is it measured?

Inflation in the everyday sense refers to an increase in prices. The problem is to arrive at a single figure for inflation when prices of different commodities are changing at varying rates. This is done by constructing a price index. The index essentially arrives at an overall rate of price increase by assigning different weights (jargon for how important or unimportant a particular commodity is) to different items. Thus wheat or rice, which everybody consumes on a daily basis, will have a relatively high weight, whereas glass would have a low weight. Prices of items with a large weight would be more crucial in determining the overall average than those that have low or negligible weights.

Why are there so many price indices?

Different groups of people are affected by price variations very differently. If, for instance, you are not building a house, the price of cement may be irrelevant to you, but for a builder or the cement manufacturer it is the most important item. In India, therefore, we have five different types of price indices. One of these is the Wholesale Price Index (WPI), which measures changes in wholesale prices. The inflation rate most often cited is the one calculated on the basis of the WPI. The annual inflation rate for a particular week tells you how much the average level of prices of the commodities tracked by the WPI has risen compared to the corresponding week a year (or 52 weeks to be precise) earlier. It is important to recognise that the inflation rate going down does not mean prices are declining. It only means the rate at which prices are going up has slowed down.

Why does the official rate seem to understate price rise?

The official rate, as we have seen is based on the WPI. What the consumer actually deals with, of

course, is not wholesale prices, but retail prices. Also, while the WPI tracks virtually all commodities, any one consumer may consume some of them only very rarely. Each of the four consumer price indices, therefore, tries to measure the overall price increase in a typical consumption basket for a particular kind of consumer. These are the CPIs for agricultural labour (AL), industrial workers (IW), urban non-manual employees (UNME)

and rural labour (RL).

What explains the current spurt in prices?

The latest surge in inflation has essentially been spurred by very high increases in some specific commodities. For instance, while the overall i n fl at i o n rate for the week ended Feb 3 was 6.73%, prices of pulses have risen almost 24% over the last year, fruits and vegetables are 19% costlier, prices of basic metals have gone up by close to 17%, cement is roughly 16% more expensive and edible oils are 16% dearer than they were on Feb 4, 2006. In general, prices of primary articles — things which are not manufactured — have risen at 12.3%, much faster than manufactured items (6.4%). The third major category in the WPI fuel, power, light & lubricants has witnessed just a 2.3% increase, thanks largely to the fact that oil prices are more subdued than the previous year. This also explains why the inflation rate measured by the CPIs is significantly higher (see graph) than that measured by the WPI. Things like wheat, pulses or fruits & vegetables understandably account for a much larger weight in the CPIs and the fact that prices

of these have risen faster than the overall average means the CPIs are also going up more sharply than the WPI.

What measures is the government taking to rein in inflation?

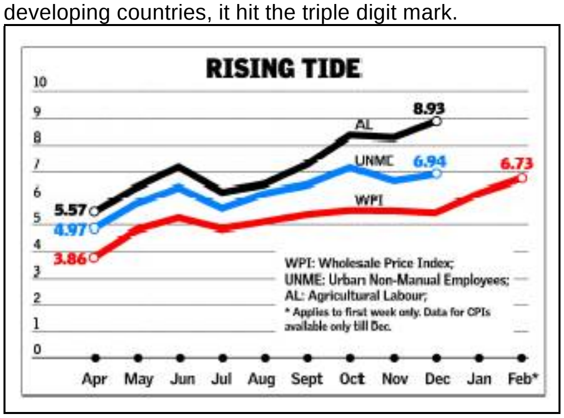
It has banned the export of some items like wheat, milk powder and pulses and could ban onion exports as well. It has also imported wheat to augment domestic supplies. Another step taken has been to reduce customs duties on metals, cement, edible oils etc. Petrol and diesel prices have been cut. Besides these, the RBI has hiked interest rates and the cash-reserve ratio. The idea behind both these measures is to reduce the supply of money, the theory being that when a larger amount of money chases the same amount of goods, prices are bound to go up and conversely they are bound to fall when less money is in circulation.

Why have these measures not worked?

Some have. For instance, the rise in the wheat index is down from about 17.4% at the beginning of the year to just over 11% in the first week of February. Similarly, the rise in cement prices has also been moderated. An earlier ban on exports of sugar has meant that it is one of the few items that is 10% cheaper than it was a year ago. The RBIs measures have been less effective for two reasons: First, trying to control inflation by squeezing money supply is at the best of times a medium term strategy rather than a quick fix. Most economists agree that it would take anything between a year and 18 months for the full impact to show. Secondly, where prices are rising mainly because of supply constraints as in pulses, where domestic and global output is inadequate squeezing money

supply by itself can do little.

COINING INFLATION And you thought inflation was a modern phenomenon. It dates back to the third century when Romans rulers produced the first recorded case of inflation by debasing their coins. **THE PRICE OF WAR** The 20th century saw the worst inflation. Countries printed excessive amounts of currency to pay for World War I. The German economy almost collapsed in 1923 after hyperinflation. A meal that cost one mark at the start of WW I cost 1 trillion marks by 1923. And Hitler rode on the support of a ruined middle class. **SAMBA RUMBLE** Living with inflation? Latin America can teach a lesson or two as they've lived with it through the 20th C because of independent monetary policies. Inflation here averaged 160% per year in 1980s and 235% in the early 1990s. Brazil's inflation exceeded 1000% per year in four of the five years between 1989-93. **COMING AT A COST** World War II gave people a tough time too. The worst inflation occurred in Hungary in 1946 when the pengo drowned in zeroes. By July 1946, it took 400 quadrillion pengoe to purchase 1 forint (the new currency). **OIL'S NOT WELL** After countries began floating their currencies in 1973, the OPEC oil crisis hit, producing an inflation-inducing supply shock that lasted for the rest of the decade. By the time the second oil shock hit in 1979, unemployment had risen, growth declined and inflation worsened. Developed countries suffered double digit inflation while in developing countries, it hit the triple digit mark.




Rome, 3rd century Rome felt the pinch a long time back


Germany, 1923 A German feeds a stove with notes made worthless by hyper-inflation. Hitler used the price rise as a political plank

Hungary, 1946 The largest denomination banknote ever officially issued for circulation was by the Hungarian National Bank